CSR AND PROJECT FINANCE

by

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The following article includes extracts from addresses by Mr. Kelman to the Victorian and New South Wales Divisions of The Securities Institute of Australia.

(Before Mr. Kelman’s address to the Victorian Division, June 28, 1983, an audio visual was shown which summarised CSR’s results for the year to March 31, 1983. Briefly, net profit fell 9.4 per cent from $82.4 million to $74.7 million after a sales drop of 6.5 per cent from $2679 million to $2506 million. Annual dividend was steady at 18¢ a share. Some of the presentations in the audio visual accompany this speech.)

All things considered I believe containing our profit fall to 10 per cent rather better than might have been expected.

In the same year Australia’s GDP actually fell by 0.8 per cent. The Sydney Morning Herald reported in April that a study of 252 large Australian companies revealed an overall fall in business profit of almost 20 percent in 1982.

If you take earnings before interest and tax, CSR’s profit actually increased by about 19 per cent. Or if you take the more meaningful ratio of EBIT to total assets (what we call profitability), CSR’s figure increased by 17 per cent over the previous year.

It was the net interest expense of $66.9M which really prevented us from increasing net profits. The interest cost was $43 million higher than the previous year because of increased borrowings, higher interest rates and reduced interest income.

Having said all that, I do not want to give the impression that we are at all happy with CSR’s low return on shareholders funds. We are certainly not sitting back waiting for economic recovery to put us on the road to high profitability. We have short term goals as well as long term goals. Our number one short term goal is to increase our earnings per share over the next two years.
The audio visual covered the long standing strategies which are enabling CSR to continue making profits in the current depressed climate. It also referred to the short term strategies we are adopting to improve profitability. To stress the importance we attach to those 5 short term strategies, I will now expand on them a little. You will remember the strategies are to improve marketing, reduce costs, minimise capital expenditure, continue divestments and lower interest charges.

In the marketing area, we have tightened up the marketing group in coal division to provide a more centralised, planned marketing thrust. A resident marketing representative has been appointed to Europe to further our plans to expand European coal sales. Of course some of our marketing people are already resident in Japan. All in all, this year we expect to increase coal sales from the mines we manage by about 1 million tonnes.

Marketing efforts in sugar division are being directed to achieving a satisfactory new International Sugar Agreement as well as expanding markets for raw sugar.

In oil and gas our marketing people, in association with Santos, have been strenuously arguing before an arbitrator for an increase in the price of gas to NSW to a more acceptable level. The current price of 69c/GJ is 37 per cent below the price to South Australia, and that South Australian price is low by world standards. The South Australian price will increase by a further 20 per cent next January.

That our cost control strategies are working is demonstrated by the substantial increase in EBIT to which I have already referred.

Last year we reduced employee numbers by just over 1300 which unfortunately included nearly 500 retrenchments. There will be some further reductions in employee numbers this year, though not as many. In looking to further reduce operating and overhead costs, we are streamlining our management information systems and organisation structures. We are pressing on with computerisation of operations as well as accounting and cost information. We are currently spending $18 million a year on these efforts and are starting to reap the benefits.

We have heavily reduced expenditure on exploration, evaluation and pre-development for long lead projects. This expenditure has been cut back from $41 million to $31 million over the last 2 years, and will be down to about $21 million in the current year. (These figures of course exclude expenditure by Delhi Petroleum.)

We are concentrating capital expenditure on essential ongoing business items such as plant replacements, on profitable expansion of existing activities, and on new projects already committed. New investments will only be made in activities which offer a high return and early payback. We are aiming for about $300 million capital expenditure this year, some $62 million less than last year. Next year we are planning to reduce capital expenditure further to about $200 million.

We are aiming for about $150 million of divestments this year. We have of course already sold our head office complex, with a buy-back option, for $66 million. We will continue to divest assets which are underutilised, which are not making a satisfactory contribution to profits or which do not fit our lines of business.

By rearranging debt we expect to reduce interest costs. We also expect to significantly reduce net borrowings.

These are essentially the strategies we are now pursuing. No doubt you are also interested in how we see the prospects for the year ahead.

There now appears to be general agreement that economic recovery in the United states is underway. If the recovery persists other countries will soon follow, although I do not believe we will return to boom times. Many commodity prices are rising and the recent increases in sugar and aluminium prices are particularly good news for CSR.

Last year the London Daily Price of raw sugar hovered between Stg. 100 and 110 per tonne. In May it shot up to Stg 189 and now appears to be fluctuating at a level above Stg 160. Who knows what it will do next but the prospect is for significantly reduced world production in 1983/84 because of heavy rains in Europe and drought in Southern Hemisphere countries. Unfortunately, higher prices will be offset to some extent by an expected fall of about 15 per cent in the sugar output from our mills because of the drought.

With the Tomago Smelter coming on line, on schedule, later this year, the improvement in aluminium prices by almost double last year's low is encouraging and timely. Further price rises are still needed for the aluminium industry to return to profitability.

As you will all be aware, the export prices in US dollar terms for coking coal, steaming coal and iron ore have fallen, although the actual price is influenced by the Australian Dollar Exchange Rate. Most of our non coking coal is for domestic use and we expect domestic revenues to benefit from increases in both volume and price. In spite of the reduction in iron ore price, we still expect reasonable profits from Mount Newman.
The Federal Government’s proposed stimulus to the building industry will benefit our building materials division. There are signs of improvement in the building and construction industry now, particularly in Victoria and South Australia.

The first gold was produced from the Paringa Lease on the Kalgoorlie Field in March 1983. This venture is already earning worthwhile profits.

In all, the current year will again be difficult but I am confident our strategies will continue to see us fare better than most, and we are certainly in a strong position to take advantage of the upturn in economic activity when it occurs.

In the longer term, our extensive resource base will enable us to act quickly as new opportunities open up. And then, of course, there are the exciting prospects offered by our investment in Delhi.

We bought Delhi because it was seen to be a profitable investment and would help reduce our dependence on exports, particularly those to Japan. It is living up to our expectations. The liquids project is on schedule and exploration has been more successful than we anticipated.

Although the investment is a long term one, we are obtaining some benefits now. The gas operation contributed $15.2 million to CSR’s profits last year. The contribution consists of dividends on the redeemable preference shares held by CSR in the operating company, Delhi Petroleum. Dividends on these shares can come from the ongoing gas operations only.

Dividends from the liquids project will flow to CSR via DAF, The Delhi Australia Fund. We expect net cash flow contributions from the liquids operations to start next year but it will be some time before net trading flows exceed the writing off of depreciation and capitalised expense provisions. The exact timing of dividends to CSR will of course depend on the rate of new discoveries and future oil prices.

Our aim in CSR is to give our shareholders and professionals like yourselves the relevant background and facts so that you can make informed judgements about our performance, and about our prospects for the future. We generally do not disclose our own forecasts — we’d rather leave public forecasting to you.

I would think project financing has been around in various forms since the dawn of commerce, but it is still evolving. It is not well understood, and many people have misconceptions about it. I am sure by now most of you know what project financing is but nevertheless I think we should define it.

It is:

“A method of financing for a specific project or economic unit in which a lender looks initially to the cash flows of the project as the source of funds from which the loan will be repaid and to the assets of the project as security for the loan.”

Project financing can be on or off balance sheet and it can have varying degrees of recourse to the parent company.

The best way to clarify the concepts of project financing, and to show how successful it has been, is to go into a little more detail about each of the five major project financings in which CSR has been involved.

MT. NEWMAN AND GOVE

Let me talk first about the Mt. Newman and Gove Projects because they were among the first project financings in Australia. CSR became involved in Mt. Newman when approached by American Metals Climax, or AMAX, back in 1964. A year later, in a quite separate development, we joined with Alusuisse in bidding for bauxite deposits at Gove in the north east tip of Arnhem Land.

In each case we started by forming a company with our partner but soon realised our interests would be better served through a joint venture. Amongst other benefits, a joint venture enabled us to arrange our own tax affairs and to have direct cash flow rather than a share in the dividends. We also wanted to arrange our own finance to our own best advantage.

We set up the company Pilbara Iron Limited and took in some equity partners to help with the financing of our 30 per cent share of the project. For a number of reasons we chose project financing, rather than the more conventional alternative of a corporate raising. First, the

PROJECT FINANCE AND CORPORATE REPORTING

Within this address to the New South Wales Division, September 5, 1983, Mr. Kelman made the following remarks:

Corporate reporting should always be of a high standard, but if a company is going to become involved in off balance sheet projects financing, then complete and high corporate reporting is of critical importance.
The Mr. Newman mine has become a much bigger project than first planned. Its capacity has been expanded from 8 million tonnes to 40 million tonnes and so it has consumed quite a bit more capital, Pilbara’s share being financed from additional equity, retained earnings and additional project finance.

Gove Aluminium’s cash flows, on the other hand have almost exactly followed the cash flows forecast at the time of the original investment.

Pilbara has no long term debt left, Gove will have paid off its original long term debt by 1986. The return on shareholders funds for both projects is substantial.

It was quite a period before the next suitable opportunity for project financing arose in CSR. In the meantime we learnt a fundamental lesson from the rating agencies in the US: that to obtain an unbiased credit rating, non-recourse debt is best left off the balance sheet.

**THE SECOND NEWCASTLE LOADER**

Our third major project financing, the Port Waratah Coal Services ship loader at Newcastle, was automatically kept off balance sheet because our ownership is only 33 per cent.

The Japanese supplied all of the debt and some of the equity and so you could say the risk was fairly shared between the producers and the consumers. The completed project cost was $88 million though it has since had a major expansion. We believe the project has matured sufficiently to be pronounced successful and financially sound.

**THE TOMAGO SMELTER**

In the late 70’s we were keen to become involved in aluminium smelting. When Pechiney Ugine Kuhlmann of France won the all important electric power block in NSW, Gove Aluminium was invited to join the joint venture.

A great deal of discussion took place concerning the structuring and financing of Gove Aluminium’s 35 per cent share of the $650m smelter.
In some ways it was logical to use Gove Aluminium Limited, which is the owner of the alumina to be processed. However, Gove Aluminium is a CSR subsidiary and we were seeking a relatively high gearing for our share of the project to ensure a satisfactory return on shareholders' funds. In addition, a number of banks were willing to lend to the project with limited recourse to CSR and so we decided to keep the financing off balance sheet to prevent distortion of our financial ratios.

To do this we created a new company, Gove Aluminium Finance Limited, or GAF, which is 50 per cent owned by CSR rather than the 59 per cent ownership of Gove Aluminium. GAF is essentially a tolling company for Gove Aluminium. Its other shareholders are the same as in Gove Aluminium. CSR took up some convertible notes to give it the flexibility to bring at some later date its ownership of GAF to the same level as its ownership of Gove Aluminium.

Naturally, it is too early to say whether the project will be as successful as the other cases I've mentioned. However, construction is close to time and budget. The first pot line is being commissioned now and should be at full production by mid January next year. The second pot line will come on stream in the second half of next year.

75 per cent of Gove Aluminium's share of production is committed by long term contracts, and the aluminium price has improved significantly this year. Our timing could prove to be just right.

THE DELHI FINANCING
CSR had been interested in Delhi Petroleum Pty. Ltd. for some time. Through our subsidiary AAR we had come to know quite a lot about the oil industry and the potential of the Coope Basin. We also wanted to reduce our dependence on exports because of our exposure to exchange rate fluctuations, to the steel industry, and to Japan.

You may remember there was a tender for Delhi for which no bids were received. After that we were able, in September 1981, to negotiate what we still think was a pretty reasonable price for Delhi. We negotiated a bridging finance deal in which six banks each committed $US100 million in a matter of days to enable the purchase to be carried out. We are of course very grateful to those six banks for their extremely rapid response to our needs. We then looked at many different long term financing structures.

We decided a financing trust would be more appropriate than a company. To some, a trust may seem a bit dodgy, but in fact a trust is well grounded in law and it provides certain commercial and administrative advantages. Importantly, it makes it easier and cheaper to wind up the financing entity when the debt is eventually paid off and we wish to put the project back onto our balance sheet.

The structure reflects in part the fact that in buying Delhi, CSR was buying two quite distinct businesses; an established gas producer, and a yet to be developed liquids project.

The gas business has been going now for about 14 years and supplies all the natural gas to NSW and South Australia under long term contracts. The redeemable preference shares represents CSR's investment in the gas business and Delhi Petroleum's articles of association limit the preference share dividends to profits made from the gas business only. The $15.2 million profit CSR made from Delhi last year is from these preference shares.

DAF, then, is really the vehicle to finance the Cooper Basin liquids project and the purchase of the highly prospective exploration rights.

DAF is owned 50/50 by CSR and a nominee company associated with one of the lenders, and so its debt would not be consolidated onto the CSR balance sheet even if it was a company. I will say more about that in a moment. The loans to DAF have come from CSR and a syndicate of 18 international banks.
CSR COMMITMENT TO DELHI

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LENDERS COMMITMENT TO DELHI

Loans to DAF UP TO $US 950 M
(initially $US 400 M without recourse to CSR)

The banks have agreed to lend up to $US950 million. The loan facility is to assist in funding the acquisition, the interest payable in the initial years, future oil and gas developments, and Delhi Petroleum's share of the capital costs of the $1.4 billion liquids projects. This share is expected to be about $245 million.

So far, DAF has drawn $US760 million of this facility and of this $US400 million is currently without recourse to CSR.

The recourse component may vary due to factors such as new discoveries, oil and gas price changes, and a reassessment of existing fields. We expect the recourse segment to reduce over time.

CSR will have committed $249 million by the end of March next year. We do not expect to have to contribute any more funds.

Some writers have expressed concern at the size of the exchange losses shown on the DAF balance sheet. Some of these losses are a result of repayment of the bridging finance. However, most of these losses are unrealised and the actual losses will of course depend on the exchange rate at the time of repayment. Debt repayments are not due to begin until September 1986 and will continue for 8 years thereafter. But the key point is that because of import parity pricing, DAF's revenues are effectively priced in US dollars. The gain in Australian dollar revenue should thus more than offset any exchange losses on the debt.

It is much too early to say that Delhi is an unqualified success. However, it is meeting our expectations. The first shipments of oil and condensate have already been made. Exploration is continuing at a steady rate and we are more than pleased with the results. The investment is a long term one and of course the exact timing of distributions to CSR from liquids earnings is uncertain. It will depend on future oil prices and exploration success.

Some of you may be a little concerned at the innovative structuring which keeps our Delhi investment off the CSR balance sheet. I believe the justification for this is almost entirely one of communication with our shareholders and investors. To include such an investment on the balance sheet would give a totally misleading picture of the liabilities of the CSR group. We would much prefer to give separate full disclosure of our off balance sheet financing and that is why we include financial statements for both DAF and Delhi Petroleum in our annual report.

Aha, you might say, equity accounting will bring an end to off balance sheet financing. That may be so. We do not yet know. But perhaps by then someone will also have worked out how to show limited or non-recourse debt on a balance sheet without unfairly distorting the financial ratios.

In conclusion, I hope I have shown that the best thing about project financing is that it works. It really is simple in concept: it allows higher initial gearing and hence more efficient use of equity; it spreads the risk; and it allows more flexible financing. And by doing all those things it has allowed the development of Australia's resources while retaining significant Australian ownership. To me that is very worthwhile. Project financing will certainly continue to play a major part in the growth of CSR.