A major trend in Australian goldmining is investment in promising projects in emerging markets. The risks in these markets are significant but, writes RICHARD LEE, financing for most strong projects in emerging markets is potentially available from a wide range of sources on both the equity and debt side.

There is a clear trend towards internationalisation of the Australian goldmining sector. Moreover, what was previously almost exclusively the domain of the major international mining houses is now an accepted and realistic strategy for companies of all sizes in Australia.

One simple way to look at this phenomenon of international growth is through an estimate of gold production, not just in Australia but by Australian companies worldwide. Figure 1 shows the tremendous growth in Australian gold production between 1983 and 1990 - 30 per cent average compound growth over the period. Production appears to have levelled out at 240 to 250 tonnes a year between 1990 and 1994.

However, this understates the continuing energy and vitality of Australian goldmining. Not only have the older mines, established around the haloes of known ore bodies, shown remarkable resilience; they also responded to sound management and new exploration, mining and processing technologies. Such new discoveries in Australia as Kanowna Belle, Plutonic, Bronzewing, Chalice and Mt Todd have demonstrated how exciting the potential remains.

Moreover, Australian companies operating further afield have brought such projects as Porgera, Kelian and Mt Muro successfully into production in environments significantly more challenging than here.

Figure 2 is perhaps more pertinent to the topic. Starting in 1991, this graph adds overseas gold production by Australian companies to the domestic volume.

By 1992 overseas gold production by Australian companies reached an estimated 71 tonnes, adding almost 30 per cent to Australia's estimated production of 250 tonnes in 1994. Overseas gold production

Richard Lee is managing director of Rothschild Australia. This is an edited version of a paper he presented at the Australian Gold Conference, Kalgoorlie, 14-16 March 1995.
by Australian companies appears to have more than doubled between 1991 and 1994. The number of international projects currently under evaluation suggests that this type of growth will continue.

FINANCE
How have financial institutions met the challenge of providing financial support for this rapid growth of production in Australia and overseas? First, some details of what has been provided to the very dynamic goldmining industry in Australia.

On the equities side, over the past 10 years the Australian capital markets have been highly, if irregularly, supportive in providing risk capital to small, medium and large goldmining companies with a variety of projects throughout Australia.

As to debt finance, in 1984 Rothschild Australia was among the first two or three institutions in the world to provide gold loans for gold project development. What was a decade ago regarded as a highly innovative financing technique is now part of a standard array of financial instruments that banks offer to gold producers around the world.

On the hedging side, Australian financial institutions were among the first to develop and offer gold producers forward and spot-deferred contracts in currencies other than $US, allowing flexibility and effective management of foreign-exchange and price risk.

Options strategies, conveniently packaged, and other structured hedging instruments have also grown to meet the particular objectives of producers. All of these hedging techniques enable producers and financiers to identify and manage gold-price risk. For the producer, greater certainty can be attached to cashflows.

As a result, over the past 10 years Australian gold producers have generally hedged a higher proportion of their gold production than producers in other parts of the world. This can be attributed, at least in part, to the greater availability of credit lines to a broader spectrum of gold producers in Australia than in the case elsewhere in the world.

One very important area in which Australian financiers lead the world is in the provision of debt finance to start-up, and emerging, gold producers. This type of project finance to start-up producers is not available to the same extent outside Australia. The availability of this type of finance, together with the "can-do" spirit of the gold industry, complemented by technical and management strength, has contributed to the current structure and vitality of the Australian goldmining industry.

Australia has a much higher proportion of relatively small gold producers (less than, say, 100,000 ounces a year) than Canada, the US and certainly South Africa.

In these three important areas - debt instruments, hedging instruments and the availability of equity finance - Australian purveyors of mining finance have met the challenge of supporting the exciting development opportunities available to Australian goldmining companies.

RISKS
Banks deal in the identification and quantification of risk when they lend money. That is, a banker will assess the risk attached to a balance sheet and income statement of a corporate borrower or the risk attached to the construction, operating, marketing or price fluctuation associated with a project where project financing is involved.

After an assessment of the risks, a banker will determine the threshold question of whether the risk is acceptable and, if so, what is an adequate reward in margin and fees for taking this risk. If agreement can be reached with the borrower then a deal is done.

In the gold industry, the area of greatest progress in Australian mining finance
over the past decade has been the identi-
ification and quantification of a mining
project’s risks, especially technical risks.
When a gold project experiences difficul-
ties, as inevitably occurs from time to
time, it is vital that the lender under-
stands what is occurring so that it can
take a flexible and supportive approach
rather than cutting credit lines and
pulling out. For this reason, bankers
require technical staff who have a good
deal of industry experience in the geolo-
gy, mining engineering and process engi-
neering. Bankers also use the services of a
range of specialist consultants.

Along with other banks, Rothschild has
developed what amounts to a standard-
is
dized “bankable feasibility study” which
establishes minimum technical and other
criteria, relying on established standards
such as the AusIMM “proved and proba-
ble reserves” definition to provide rea-
sonable comfort that the gold is in the
ground, sophisticated pit optimisation
techniques to determine how best to mine
the ore economically, and reliable plant
design and construction by established
engineering firms to ensure extraction.
These all contribute to confidence, in bor-
rower and lender alike, that at the end of
the day the gold will be produced.

Banks’ improved technical knowledge
in these critical areas of risk assessment
has facilitated the financing of much
smaller companies and more difficult
projects in Australia than anywhere else
in the world.

OTHER FINANCING DEVELOPMENTS
As investors and lenders improve their
appreciation of the risks attached to gold
mining, the ability to be more flexible in
providing different types of financing
also improves. This is reflected in some of
the more recent trends in the provision of
finance to companies of different sizes in
the gold market in Australia.

Among larger companies, Poseidon
Gold last year arranged for a rating by
Standard & Poor’s which it then used to
make a 400,000-ounce gold note issue
directly to investors and pay out its
more expensive bank debt. In 1993,
Macraes Mining issued a highly success-
ful capital convertible note to the equity
markets to provide working capital
finance and to finance the development
of new projects.

For start-up gold producers, early-
stage financing has been viewed as too
risky for debt finance in the past.
However, lenders are now considering
various forms of mezzanine financing,
including convertible notes and royalties,
which permit a limited amount of financ-
ing for pre-development of promising
gold properties.

The direction of Australian goldmining
companies is increasingly towards mar-
ket overseas. Most of this investment is
directed to what are now called the
“emerging markets” (previously catego-
rised as developing countries) which
are both more geologically prospective
and more welcoming to mining invest-
ments than many OECD countries.

As a consequence, financing for
Australian gold companies will increas-
ingly have to be provided for projects in
these emerging markets. Predictably, the
major question from the banks is: What
are the risks?

The technical risks are much the same
as those encountered in Australia,
although sometimes complicated by such
issues as poor accessibility and illegal
mining. The second major issue is the
general uncertainty involved in dealing
in a less familiar market. However, these
risks seem surmountable with sufficient
time and effort. The risk of greater impor-
tance is the so-called “political” or “coun-
try” risk involved in lending to projects
in the emerging markets.

COUNTRY RISK
In the mid-to-late 1980s international
banks lost very large sums on write-
downs and rescheduling of loans to
defaulting countries. Country risk is still
there but has changed.

CRA’s experience in Bougainville and
the recent rebel attack on the
Consolidated Rutile operations in Sierra
Leone are reminders that Australian min-
ing operations overseas can be affected by
the most extreme political circumstances.

In identifying the risks, it may be useful
to revert to the standard insurer’s cate-
gories of political risk. The first category
for political risk insurance is the so-called
“CEN” cover, meaning confiscation,
expropriation and nationalisation of investment. This type of risk is in decline, with the recognition throughout the world that private-sector investment, rather than public-sector direction, is the path to successful economic development.

The second category is currency transfer risk, or the risk of foreign exchange availability. This is the risk that a country will have insufficient foreign-exchange reserves to reimburse foreign investors or lenders to successful projects. For gold producers, however, this is not a major risk as long as gold production can be sold offshore to generate foreign exchange to provide investors' returns.

The third area would be breach of contract risk, where a government might, for example, unilaterally decide not to honour a contract related to foreign investment in a gold project. This type of risk has also been in decline because of the recognition by most governments of the importance of foreign investment to their countries' development.

The fourth type of risk, and the most important, is war and civil disturbance. This type of risk is certainly on the rise in the emerging markets. Financiers currently regard this, in some countries, as the highest risk component of the four identified areas of political risk.

FINANCING OPTIONS IN EMERGING MARKETS
How do financiers handle these risks when considering loans and investments in gold projects in these countries?

Certainly, the equity markets have not been very propitious over the past several months in financing gold projects in either Australia or other developed countries, much less the emerging markets. However, it is worth pointing out that over the previous year the equity markets in general around the world were very receptive indeed to gold-mining projects in emerging markets.

This is part of a general trend in stock-markets worldwide to recognise and capture some of the extraordinary growth and profitability that can be achieved by companies operating successfully in the high-risk/high-reward emerging markets.

Certainly at the top of everyone's list would be the Ashanti flotation of last year. Another interesting float was the Bakyrchik Gold flotation which took place on the London Stock Exchange in late 1993. In Australia, Ashton Mining spun off Aurora Gold and its primarily Indonesian assets for approximately $A112 million in mid-1993.

Smaller companies have also been able to raise money on the stockmarket for exploration and project development. These would include Takoradi Gold for its properties in Ghana, Carrie Pacific for its properties in Indonesia and Dome Resources for its project development in Papua New Guinea. These examples reflect a keen appetite on the part of investors to invest in companies with exciting prospects in emerging markets.

In addition to stockmarket listings, there are a number of equity funds which specialise in investing in projects or companies in the emerging markets. An example is the Emerging Markets Gold Fund, a $US75 million ($A100 million) investment fund sponsored by the International Finance Corporation (part of the World Bank), the Rothschild Group and Pegasus Gold of North America, which specialises in investing in early-stage gold projects in emerging markets around the world.

This fund has already invested in six projects in West Africa, Asia, Latin America and the former Soviet Union and has more than 150 projects on its review list.

As for debt financing of projects in emerging markets, the export credit agencies are still in business. The Eximbanks, the European Credit Agencies and EFIC here in Australia are still capable of providing long-term debt financing. Access to this type of financing is useful and sometimes necessary for projects in countries where no other financing is available.

In addition to the individual country's export credit agencies, multilateral lending institutions such as the International Finance Corporation, the European Bank for Reconstruction and Development (EBRD) and individual country-based institutions such as DEG in Germany or CDC in the UK will also lend to commercially viable private-sector projects in developing countries. However, the resources of these institutions are quite limited and the requirements for financing are quite stringent.

That leaves private-sector financial institutions. After the huge cross-border loan losses of the 1980s, many of the traditional international lending banks from the US, Japan and Europe withdrew from lending to companies or projects in the emerging markets. During the past three years, however, the appetite for this business has slowly returned and we find that today banks are willing to lend for attractive projects in the emerging markets of Asia, to a lesser extent Latin America, and infrequently in countries in Africa and the CIS.

One way that banks and project sponsors minimise country risk is by taking out insurance on both equity investments and loans. This type of insurance is available from EFIC and other export-credit agencies, MIGA (the country risk insurance arm of the World Bank) or the private sector. One major advance in this area is the availability of political-risk insurance from the private sector, which can be tailored to almost any type of project or risk in almost any country in the world.

Given all of these potential sources of financing from export agencies, multilateral development banks, private-sector lenders, political-risk insurers and gold investment funds, what is the trend? Even for smaller projects, it is likely to be some sort of "cocktail" of finance from these different sources.