Considerations in Financing

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Thank you, Mikhail Ivanovich, and thank you to the organisers for inviting me to make this presentation at this prestigious Forum. Personally, I have already started calling this the “Second Forum of Optimists”. If we think back to the last Conference in Lisbon and of today’s generally positive tone, then we get an idea of the mindset of the market players – we are all happy when the price of gold is increasing. I think this is true both for producers and investors. We’re all in the same boat.

However, since one of the objectives of our Forum is to evaluate the attractiveness of the Russian precious metals market to investors, someone has to bring the positive and upbeat tone down a little and say that not all is as good as it seems. It is important for Russian participants to understand who we are, where we are headed and who our partners are. It is even more important for foreign investors to evaluate their risks, understand Russia’s competitive advantages and disadvantages, and, whenever possible, to get an answer to the question; ‘How can we do business in Russia and not lose anything?’

Since I have decades of practical experience working in the Russian precious metals market, playing a part in its liberalisation and the creation of the market we have today, I am able to make some general observations and try to identify some of the problems more commonly encountered in practice by investors.

First and foremost, both Russian and foreign investors must make an unprejudiced evaluation of the potential of the Russian gold market and shake off some of the more widespread myths, and it is on the basis of these that I will try to make my presentation.

We have already heard that thought here today, and more often, when we talk about Russia. For that matter, when I first spoke at the Gold Fields seminar (that was eight years ago), I shared a belief in many of these myths myself, so it is a little easier for me to speak now from a somewhat critical perspective.

Let’s take the first myth: Russia possesses a first-class mineral resource base.

That really is the case, and, without a doubt, there are some positive things here.

Firstly, there is the compatibility of Russian standards with international ones. When assessing reserves and resources, the categories applied are very similar in their interpretation, so any investor in the ore-mining sector entering Russia will be able to understand quickly the few insignificant differences, which, of course, are present. And, although there is the problem of economical evaluation of deposits and reappraisal of reserves, this isn’t so dramatic, so, on the whole, it doesn’t present any complications.

In addition to this, Russian geological study has some well qualified people, therefore, when a new company or new investor enters the Russian market, it is quite easy to find qualified specialists who can undertake technical work in the roles of experts, analysts and consultants.

Also, according to reserves put on balance back in Soviet times, when the standards of the geological division of the Soviet Union were still being followed, we can say with a good deal of certainty that the exploration carried out was of a very high standard, which has given Russia the position we have already discussed – third place according to reserves, and one of the leaders according to resources, which is probably a reflection of the true picture.
But let us not forget that the system laid down in the Soviet Union – State control of the subsoil, licensing and geological exploration – has today ceased to exist in the same form as is had during the last 10-15 years at least. There has been ever decreasing government spending on geological exploration and ever more investment on the part of private companies. On the whole, government spending today on funding geological exploration in various industry sectors probably doesn’t exceed 15% of total spending on subsoil exploration.

Consequently, this was bound to have an effect on the standard of work carried out over the last few years, since often exploration was undertaken by one set of companies, but other businesses became the final subsoil users of these sites. As a result of this, any investor entering a site explored during this period faces the problem of assessing the quality of reserves. Considerable costs must be incurred to confirm that such reserves really should be on balance. Confidence has already been damaged in this area in recent years.

Also, the State geological divisions existing in each region and the geological exploration enterprises have quite professional staff, but over this period the technical equipment and infrastructure needed to conduct explorations across entire areas, to discover new ore manifestations, and then to prepare the deposit for exploitation has broken down. In the regions at least, the mining company subsoil users have set about saving these enterprises.

In addition, geological exploration enterprises obtained mining licences, but on the whole they did not make good extractors. Today they are often either eking out a pathetic existence or have ceased operating. It would be difficult to restore them to their former status and there is no need to do this. It would increase the burden for any private investor or company wanting to develop a deposit.

Another very important factor should not be forgotten when discussing the subsoil. We must still take into consideration a certain degree of inconsistency in the actions of the government and Federal executive agencies, as Yevgeny Ivanovich Ivanov has already discussed. This of course has a negative impact on the operation of companies. For Russian parties, in particular, this is obvious, but it would seem that last year’s confrontations in the Khabarovsk region caught Russian observers unawares, when one of the biggest gold and platinum mining companies was almost fighting a Federal ministry. We could not say that all of the points of contention have been overcome. It was obvious that the regional authorities were at odds with the federal powers – seemingly over private issues.

Unfortunately, when we speak of the richness of the Russian subsoil, these are the sorts of things that have not yet been overcome, and we mustn’t underestimate the possible risks that could be encountered if we rely on some individual minister appointed to a specific post. This, without doubt, is a risk the private investor must keep in mind.

The structure of reserves across the regions – the placer and hard rock reserves – is represented here using information kindly provided by NBL Gold. I would like to discuss hard rock reserves in a little more detail.

Generally, I would say that the overall trend is quite obvious, that in relation to placer reserves Russia has reserves for the next decade, and in relation to hard rock reserves Russia has reserves right to the end of the century at the current rate of development. But nevertheless, if we take the regional structure, then not everything is so clear, since across the regions of Russia each region manages its resources and reserves very differently.
What I mean is that the regions of Magadan, Irkutsk, Republic of Sakha, Krasnoyarsk and Chukotka have traditionally been considered the gold producing regions, along with, perhaps, Khabarovsk and others – I wouldn’t like to upset anyone! They are all substantial enough, but if we consider their potential and the realisation of this potential, then we see that we have a very inconsistent picture.

Let’s take the Krasnoyarsk region. If we exclude the Polyus company, then it is significantly underachieving its potential. We can but hope that Polyus and Norilsk Nickel will take some real steps here and, in their own region at least, they have every chance of growing both reserves and current production.

The Irkutsk region depends very heavily on development of Sukhoi Log, because, in the great scheme of things, it is the biggest deposit there and all others are simply satellites of Sukhoi Log.

As things stand today, the Magadan region is making full use of its ore potential, and in this sense even prospective reserves already have companies looking at them so here we have a critical situation in that it will be very difficult to forecast any development.

With reference to the Republic of Sakha, in my opinion, this remains an unpredictable region today just as in recent years. It makes very inefficient use of the large reserves it holds, as things stand currently. It is very difficult to say how the situation here will develop because, as we can see from the outside, a concentration of assets has been planned, but how soon we will see any result from this is difficult to say, because a sort of centralisation and concentration process is underway there. But currently, of the mining assets there, only Oldanzoloto is undergoing restructuring, and we cannot yet expect any significant growth of production at Olan.

Nevertheless, summing up the current level of production, the rate of growth is high enough, but, unfortunately, recently the arrow for the pace of reserve growth could be drawn in the other direction. Yet if we are to believe the Ministry of Natural Resources since last year, for gold at least, the situation has turned around and for the first time some growth in reserves has been recorded.

But again, we can only speak in approximate terms. Unfortunately, along with information on reserves we have a whole series of legislative restrictions on their publication. However, we can estimate that gold reserves in Russia are from 10 to 15 thousand tonnes, and resources are from 26 to 40 thousand tonnes. If we take into account what Yevgeny Ivanovich has said and other prospective projects and sites, then this is about the level we arrive at.

The next myth is that Russia now has a fully prepared legislative basis and infrastructure framework. We have put a lot of effort into this, and even from the level of today’s discussions at the Forum and the standard of presentations being made by our Russian representatives, we can see that we have come a long way over the last decade. We have made big changes and, of course, the market foundation and its infrastructure are now formed.

At the very least, there are such important factors as free price formation, clear mechanisms for export and self-administration in exporting, and the possibility both on the part of enterprises and banks to buy and sell gold to practically all types of investors, be they institutional or private. After all, we have very active operators.

Let us not forget just what country we are living in and where we are. Unfortunately, a consistent line in the legislation governing the country is not followed here, and we all very much rely on the authority of individual people at any specific time. There are many examples of this, and even today at this Forum we heard in the presentation made by the respected tax service that changes to the principles of taxation of the mining industry are already under consideration today.

We mustn’t forget that a new Subsoil Code is being drawn up, which could also fundamentally change the legislative base. We all remember a few years ago the repeal, or rather the adoption and subsequent repeal of export duty on gold, and so on. Therefore, unfortunately, we are not protected from – how should we put it – some unpredictable actions on the part of the government agencies.

Moreover, the fundamental principals of the market institutions have not yet been fully
formed, if we consider the banks, exchanges and funds. In relation to the banks, quite frankly, the abundant commercial banks undoubtedly played an important role in the organisation of the market, and legislative rules for regulation of the market were created which are still in force today. But we must also be careful not to overestimate the importance of the banks in developing the infrastructure and gold trading system.

The thing is that the current trend is linked to the enlargement and strengthening of large gold mining companies. Some of the things outlined in one of Yevgeny Ivanovich Ivanov’s examples are being mirrored in other gold mining companies, and it would appear that this trend will become stronger.

In regard to the banks, if initially 130 commercial banks held licences, the actual number of real operators was always considerably fewer than the number of institutions holding a licence. Once again, this tendency began in 2000/1 and continues to this day. A whole array of banks, in particular shareholders, which don’t have any link with the gold mining industry, are now reviewing their attitude to the gold business.

There are many examples. When a management team, which developed the gold business for a bank, financed gold mining enterprises and traded on the international market and was then forced to change banks, more often this was not because the bank ran into difficulties, but rather because it changed its priorities and evaluated this business as being low income, or relatively low income. But should this really surprise us, after the oldest fixing player sold its position to another participant? It’s probably not worth being surprised, and it would appear that we could expect further changes in the banking sector.

It is very nice of course that once again the subject of an exchange has been brought up, but I cannot understand why an appeal is made to the Central Bank every time. Undoubtedly, the Central Bank can play a part in this, and it will probably do so in all its power, but it should receive from the banks – and other large market players – a clearly formulated request detailing what is needed. Current practice in trading bullion allows large operators to manage perfectly well without an exchange.

Another matter is the problem of risk hedging. Today this is being determined by every operator on the international market. Quite frankly, a large producer has the right to obtain an export licence, make independent sales, and accordingly, to put the matter of financing limits to foreign banks, or it can make use of the services of a Russian bank as an operator.

This means that the problem of rouble price hedging does exist, but I am not prepared to predict just how it will be resolved. The idea of an exchange simply hasn’t gathered enough support and perhaps isn’t even needed here in Russia. And I refuse absolutely to support isolationism, which I have already experienced in the past, whereby Moscow would become one of the indispensable centres of international trade and act as a bridge between London and Sydney, for example.

And perhaps the most important issue from the perspective of market infrastructure and its comprehensibility to investors is that Russian companies themselves are not transparent to investors. It has not yet been necessary for the large majority of Russian gold mining companies to structure their businesses so that each and every investor can clearly see what they are doing. Quite truthfully, in such a situation it is very difficult to discuss the use of some sort of resource potential.

The next quite widespread myth had to be fought for some time when we were creating the gold market and trying to prove that gold export was essential. This is the conviction held at one time by some officials that Russia possesses all she needs – the technology, the specialists, and the investment potential – to manage completely without any assistance from Western companies or investors.

Once again, there is a whole number of reasons for this, and it is perfectly true that this is not Tanzania, or Mali, or even Peru. We have a 250-year history of gold mining in Russia and a high standard of specialist training in intermediate and higher schools. Truly, the investment potential of the population is very large; I have in mind savings held in the banks and other places. We have an adequate banking sector infrastructure, and, generally speaking, sufficient factories capable of production, and the greater part of the equipment needed for gold production. In addition to this, we have approximately five refineries that have been awarded London Good Delivery status, as has already been mentioned today.

These are all very valuable prerequisites for Russia to be able to resolve many things by employing its own resources, and, pursuing the logic of the Iron Curtain, it is quite true that we would be able to get by without the assistance of Western investments. But, let's not forget that we are now living in a different era and,
although it is possible to ‘get by’, why should we, if, in many instances it is simply more advantageous to work with additional resources?

We can apply the recent illustration of the level of gold mining, which illustrates our large territory and, obviously, that to mobilise our internal resource potential is not always appropriate, even on the strength of these factors – the territory is so dispersed.

In regard to the advantages already discussed that Russia really does have, if it concerns the production of essential equipment, today the gold miner himself makes the choice. We have the factories to produce the equipment, but it is not always advantageous to place orders with them – it is not always cheaper than, say, ordering from China or purchasing higher performance equipment in Canada or America.

Also, in terms of equipment production time, it is often difficult to place orders in Russia because the equipment manufacturers have not had the best of times. Many things have gone missing. In addition, continuity has often been lost in engineering skills, given that if you spend time at Russian ore and placer mines you will meet plenty of specialists and managerial staff, but these people are over fifty years old. It is far more difficult to find specialists who are 25, 30, 40 years of age and who have already gained some sort of professional qualification.

With reference to private investors, today there simply isn’t enough trust in investing in assets and an insufficient number of instruments for long-term investments. Apart from this, there is some difference in the way business is conducted, say, by the engineering staff or manufacturers working at the plant and the financial management team there. It must be admitted that industrial managers often outclass financial managers in relation to their qualification in their relative fields. However, when a good engineer tries to resolve matters of finance, often mistakes are not avoided and a whole number of projects fail because of such an approach.

When we talk about promising sites on Russian territory, at the very least we can already identify a range of sites that are being developed with the participation of foreign companies. The number of such ventures will most likely continue to grow.

Of these, the first site to be developed on a large scale was Kubaka, also called Zunkholva. The beresite deposit is being developed by the Buryatzoloto Company, which has foreign capital invested in it, and in all likelihood, the Mayskoe deposit will also be developed using foreign capital.

As things stand today, in the order of 15% of gold mined is already being produced by joint ventures and, even if new structures or new companies incorporating Western capital fail to enter the market, this figure will most likely continue to grow.

In addition to this, we should bear in mind that there is a tendency to concentrate assets, in which others will also actively participate, including foreign producers.

The last myth, which perhaps has enjoyed widest circulation, is that foreigners do not understand Russia and are incapable of working by Russian business standards.

At this juncture, I cannot help but recall one of our colleagues who, unfortunately, is no longer with us – Chris Frith, who many of you knew. It is probably very appropriate to remember him at a location like this. He started working in Russia during the most difficult period and at a time when it was not very easy to see Russia’s potential from London and how to make money here. He was one of the first to show his colleagues and Standard Bank that it is not only possible, but it is crucial to make money here.
Even so, that myth had such wide circulation because in the early years of Russia's development there were, of course, many unlucky ventures on the part of pilot companies – junior companies – and this, not surprisingly, was reflected in Russia's reputation. However, there are many cases here where the companies themselves were not big enough or didn’t have good enough management to cope with the sites for which they had obtained licences. There were few foreign or joint ventures and a quickly changing environment. Seven years ago we could only talk about Kubaka, Buryatzoloto and the Amalynsk Company, but today this number has increased greatly. Bema Gold and Rosdragmet, the operator for Highland Gold and Peter Hambro Mining, are already operating successfully in Russia, and in all likelihood, the number will continue to increase.

The most important problem in this area, of course, is the protection and insufficiency of information available to western companies. You cannot disagree with this fact, and it would seem that a lot of time is needed before any investor will really be able to look at Russia and not see her as an area of higher risk.

As I have already mentioned, there are a number of sites being developed with the participation of foreign companies. It is interesting to note that capitalisation in western public companies operating in Russia is growing several times quicker than the capitalisation of traditional gold mining companies. This is an important phenomenon from the perspective of future western investments in Russia, and that the European Bank for Reconstruction and Development has taken on risk in the financing of placer deposits. Although the programme being conducted by the EBRD has not been completed, the fact that enterprises mining placer gold can be reliable and stable partners is nevertheless very important.

Likewise, there is the recent trend that large gold mining companies have returned to Russia. They entered during the initial phase, but the majority didn’t want to accept Russian risks. There are already many examples today, such as Barrick considering investment in the Mayskoye deposit and Rio Tinto creating a joint venture with Peter Hambro for exploration of the Amursk region.

The most important question that everybody is interested in is; where is it difficult to make money and where can money be made in Russia?

I believe that the time for short-term speculative operations, where it is possible to buy gold at a discount relative to world prices, is passing.

Without doubt, arbitrage operations will remain in place for banks and players in the gold market working with Russian banks, but it is not worth waiting for some big windfall, since sale conditions are absolutely standard and the qualification of Russian banks selling gold today is developing quickly.

In relation to the purchase of licences with the aim of their subsequent sale, Russian legislation does not really accommodate this. Even current subsoil legislation isn’t structured as in Mongolia or Peru, and we can say that the legal mechanism operating here is quite complex. It cannot be excluded completely, but to buy a licence for a deposit with the intention of selling it is a very labour intensive process and not really justifiable.

It is another matter to buy an operating enterprise in order to sell it on. This business will most likely continue to develop, and such an investor will probably act as a buffer between today’s gold mining companies and, let’s say, small private companies or those not having their own investment resources that are prepared and able to be sold, but not directly to big operators, large companies. This niche is somewhat risky, but it might be possible to make money there.

Financing of the gold mining industry for construction or development, undoubtedly, is an existing credible business, though it is not as profitable as it was not so long ago. Russian risks have lessened in this regard, in particular for the banks. It is a perfectly acceptable niche, however, its profitability is not as immediately obvious as it would be in other markets or other countries. I have already discussed increased capitalisation of gold mining companies. There are a number of foreign investors, in particular, Highland Gold and Peter Hambro Mining, which are working very well in generally buoying the stock market.

The most interesting and effective investment is the purchase of licences for exploration and construction of an operating enterprise with its subsequent capitalisation. There is an obvious trend that mergers and acquisitions will continue and in all likelihood the time is not far off when some sort of internal instruments will appear that investors will be able to use to make money – which is, the trading of shares in Russian gold mining companies. Thank you.