FROM THE CAPITAL

Nowhere to run from risk

The gulf between traditional safe-havens and basket cases is narrower than you think

John Robertson*

Eritrea: a great place to do business, apparently

Where would you be most willing to invest in a mining project: a country with the worst ranking of any in the world for regulatory quality, one with a ranking in the top quartile, or another within the very best 2%?

With scarcely a dissent, investors associate investment attractiveness with regulatory quality. Despite the almost universal acceptance of a positive correlation, recent investment losses by Highfield Resources prompt a second thought about the connection.

Highfield Resources has raised doubts about the development timing of its Muga potash project in northern Spain. It has publicly questioned whether the relevant government agency can provide a development go-ahead after an inconclusive general election in December.

The March 24 statement by the company came barely a fortnight after it had foreshadowed a construction start at Muga in the first half of 2016, with first production to follow in late 2017. At the time, the market value of the company was hovering around A$500 million (US$377 million).

Highfield's unusually strong investor support did not stop it complaining about the hefty discount equity investors had applied to its US$1.5 billion valuation of the Muga project and the company's longer term development potential. And yet, even this supposedly depressed market value proved too optimistic. The share price of the company declined by one third after the doubts about development timing surfaced.

Meanwhile, within the same commodity space, ASX-listed Danakali has submitted a definitive feasibility study to the Eritrean government, its joint-venture partner, for its Colluli potash mine.

Colluli has a potential 40-year mine life. It trails Highfield in its position along the development path, but is on a par with Highfield in terms of project quality and expects a production start only 12 months later.

Danakali directors also feel their project is hugely undervalued. Its US$439 million assessed first stage project value is well over 10 times higher than the sub-A$50 million company market price.

For most investors, the relatively poor treatment of Danakali would have been simple enough to explain. Spain would have been considered an overwhelmingly superior place in which to do business.

The Worldwide Governance Indicators project, sponsored by the World Bank, has ranked Eritrea at the very bottom of its regulatory quality rankings of 215 countries. Spain sits within the top quartile.

Spain is a liberal democracy. Eritrea is a one-party state without elections since a UN-led independence referendum in 1993 when the current president took control and abandoned the constitution to consolidate his power.

Australia sits at the polar opposite on the regulatory quality spectrum to Eritrea. Despite its prestigious positioning in the minds of investors and business executives, on April 1, *The Australian* newspaper reported a possible legal challenge against the Australian government by angry US fund managers.

The US managers are upset at an uncompensated confiscation of the coal exploration assets of Nucoal Resources by the current New South Wales state government. The government's unprecedented actions in 2014 have rendered an investment in Nucoal near worthless.

The move to confiscate Nucoal's exploration assets came after an independent anti-corruption authority found against a mines minister in a previous administration. The former minister responsible for granting mining licences had acted corruptly, according to the authority, in granting a coal exploration licence in 2008. Allegedly, in favouring one party, he had failed to extract the best terms for the state.

The licence in question was subsequently acquired by Nucoal, which raised funds from institutional and private investors after standard due diligence on the ownership of the assets by reputable independent parties.

There was no adverse finding against Nucoal itself by the anti-corruption commission. The presiding commissioner recommended the government consider compensating the company for the value it had contributed to the mineral resource in the event it decided to strip it of the licence. Inexplicably, the government rejected the commissioner's recognition that compensation was fitting.

In an unexpected twist, the anti-corruption authority itself was recently found by Australia's highest court to have been acting beyond its authority. In response, the New South Wales government legislated to ensure actions the High Court had found legal would be made illegal retrospectively.

By these standards, a mining company in New South Wales can never be certain about its asset ownership. Ownership retention will depend on being able to demonstrate the provenance of an asset to the satisfaction of a current government. Assets could be lost if, with the benefit of hindsight, ministers have failed to extract the best deal for the state.

Such a high benchmark is unreachable. Any investor would simply have to act on the belief that the same set of circumstances will not arise in the future. The balance of risks has been irreparably tilted.

Nucoal is urging the US fund managers to act against the Australian government under the terms of the two countries' free-trade agreement, but there is little solace for everyday Nucoal investors. Nucoal would probably prefer an investment in Eritrea over its presence in New South Wales.

The potential for inconclusive elections appears to be rising across all liberal democracies. Only extremists would seriously urge Spain to eschew elections. Highfield will be hopeful that political uncertainty currently holding it back will be quickly resolved. Whether investors recoup their losses is another matter.

Contrary to most preconceptions, Eritrea comes out ahead as the most investment friendly destination of these three, at least in the near term. Further ahead, caution is warranted.

Eritrea shares an uncomfortable political predicament with places like China, Saudi Arabia and Cuba. Their deeply flawed governance systems cannot survive indefinitely no matter how compelling the argument for doing business with them now.

Dramatic change is not necessarily imminent. Nonetheless, decisions to invest in assets located in these countries contain an implicit judgement about how well they eventually make the transition toward liberal governance standards, which have been supplanting their more autocratic models. ■

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