FROM THE CAPITAL

Private equity must pay its way

PE must come to terms with the reality of resource investment

John Robertson*

Private equity investors are greedily looking for a free ride from the mining industry while cheekily complaining about potential investments not being up to scratch.

Private equity has been the long-promised saviour for a mining industry searching desperately for new finance sources in an unfriendly funding market.

The impending volume of funds sounds impressive. Ten or twelve billion dollars are often said to be earmarked specifically for the mining industry. Several tens of billions of dollars are thought to be on offer from more general investors with the discretion to buy natural resources assets if sufficiently attractive projects are found.

Miners in the Kalgoorlie region of Western Australia tell stories of an influx of private equity investors all boasting bulging wallets and attracted to the cash flows coming from a newly resurgent gold industry backed by a weaker Australian dollar.

Few, if any, deals appear to have been done on the back of this tyre kicking. Private equity investors appear to have had an unrealistic view of what the mining industry generally offers.

Private equity fund managers are pretty clear in their own minds about what would trigger a positive investment decision. They want projects near production with potentially strong cash flows based on low-cost structures and proven management. The term 'tier-one asset' is bandied around as a generalised description of what would attract their funding.

Tier-one assets, widely and correctly thought of as company making mines, remain only marginally more common than hens' teeth.

In recent times, Oyu Tolgoi in Mongolia probably qualifies. Olympic Dam makes the grade with room to spare. Chile's Escondida is there. Red Dog in Alaska is tier one, also. But they are the exceptions to a far more mundane flow of discoveries.

Tier-one assets such as Olympic Dam don't have trouble finding finance

Oyu Tolgoi, now described by Rio Tinto as "one of the most exciting developments in copper and gold mining for several decades", was discovered 15 years ago. BHP Billiton had given up looking after several years of concerted exploration following earlier investigations going back to the 1980s.

Escondida was found over 35 years ago by a subsidiary of General Electric and Getty Oil in an earlier cycle of exploration and industry enthusiasm. South Australia's polymetallic Olympic Dam mine was opened in 1988, but well after Western Mining teamed up with BP in 1979 to get the mine going.

Red Dog dates from 1968 when the first mineralisation was reported. In 1980, Cominco's exploration commitment underwrote the search. Then a subsidiary of conglomerate Canadian Pacific, Cominco was following the path of a dozen other large north American mining houses recognising what had to be done to sustain their business models even in the depth of an industry recession.

The history of tier-one mines shows two things: their infrequency and the important roles of large corporate balance sheets in the discovery and development process. Without the likes of General Electric, BP, Canadian Pacific and large mining houses, mostly no longer present, many of the world's most productive mines will have struggled to see the light of day.

As exploration spending falls and large balance sheets disappear from the industry, the company-making discovery is increasingly elusive. Smaller companies may seek to fill the discovery gap, but their stretched financial capacity prolongs discovery times even for the most successful.

Ironically, for those with private equity funds to invest, tier-one mines have also been among the most easily financed properties in the industry, with banks and institutional equity investors usually ready to participate.

Capital from these traditional funders of large mining developments is likely to also remain cheaper for a range of second-tier assets than capital from any other source. In reality, private equity may have little role to play in bringing the highest quality properties to life. Their potential lies further down the quality pecking order.

Private equity money may, under some circumstances, substitute for the catalysing role of corporates through the provision of finance but the gatekeepers for these funds appear unwilling to fund the critical discovery process. Nor, a few exceptions aside, are they able to contribute much in the way of technical expertise to drive the often complex, time consuming and costly work between discovery and a development commitment.

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Today's private equity investors are seeking to ride on the backs of the exploration and analytical efforts of others.

The private equity approach to the mining industry is an understandable neophyte tactic, but one doomed to eventual failure. Exploration is becoming tougher. Most likely, deeper and more expensive exploration programmes will be needed to pursue the next generation of meaningful mineral discoveries.

Unfortunately, an increasing reliance on individual investors to shore up exploration efforts leaves a dark cloud over exploration funding. Without the private investors who have been the backbone of the most recent global exploration efforts, the long-term outlook for private equity as a meaningful contributor to industry growth can also be dismissed.

Unwillingness to fund exploration reduces the chance of ever finding projects with the investment characteristics private equity typically seeks. The increasing lead time between initiating exploration and having a producing mine will also limit involvement of private equity funds.

Against this background, private equity funds will be at risk of their investors withdrawing capital. To avert that possibility, funds will have to modify their shopping lists. An acceptance of higher risk will be necessary.

Without such an adjustment in approach, private equity investors can be treated by the mining industry as mostly talk unmatched with action.

So, the question to be addressed to private equity fund managers by the mining industry is not how much they have to invest, but whether they have come to terms with reality. In short, if they want to participate, are they prepared to pay their way? ■

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