Stocks & Shares

Moneybags

Under provisioning catches up with BoI

THE CHAIRS and ceos of all the Irish banks with the sole exception of Gillian Bowler have all stepped down. In the case of the Bank of Ireland, the retiring Governor (chairman) Richard Burrows went one step further and advised that "on my own behalf, and on behalf of my fellow directors, I apologise to our stockholders for the loss in value of their stock and for the cancellation of dividends". However, there was no apology for the recklessness in borrowing hugely on foreign wholesale money markets to enable the bank lend close on twice its own deposit base.

In fairness to BoI, it was far from the worst offender, with Bowler's Irish Life & Permanent lending three times its deposit book, while AIB for example has much greater exposure. But, examining BoI's latest figures turns out to be a sobering experience and the nationalisation of the bank is now looking more likely.

The problem with Burrows' apology was that it did not recognise that the biggest difficulty is an internal one, stemming from engaging in excessive lending to the highly cyclical property sector, overseen by a board of directors who failed to restrain an executive which abandoned traditional BoI caution. The world economy hit a serious inflection point in March 2000 when the hi-tech euphoria imploded, causing a short-lived 'mini-crash'. Subsequently the world economy was then driven up progressively by a lending frenzy, peaking out in June 2006. The March 2000 mini-crash was a warning of events to come and bankers should, even then, have started applying the breaks, only lending lower risk money and avoiding speculative property lending, just as the Canadian banks did.

Richard Burrows

LENDING GROWTH

While BoI was not the worst offender, its rate of lending growth coming out at the top of the boom verged on the reckless. In the year to March 2006 this grew a whopping 27% to €101bn. What happened after that peak boomtime lending was more irresponsible, with BoI lending growing no less than 44% in the period after the boom had peaked, increasing from €101bn in March 2006 to an absolute peak of €145bn as late as September 2008. Whatever about the excessive rate of lending pre-peak, continuing to grow lending massively thereafter is impossible to defend. The only explanation for this unchecked behaviour is that the BoI board failed in its primary responsibility.

Moreover, while BoI was accelerating lending up to and well beyond the peak of a boom, the board should have escalated its loan loss provisions so that when the party ended, the bank would have already made serious provisions to deal with the scenario in advance. This would have been a matter of basic prudence and should have been done irrespective of the general guidance to the contrary of the international accounting standards committees.

Even after the peak of the boom, in the year to March 2007, then chief executive Brian Goggin set aside only €103m in loan loss provisions to bring its total provisions at the time up to €428m. But the bank admitted to impaired loans at the same time of €679m, and thus was only making provisions to cover 63% of these. Back in the depressed 1990s, BoI had provided for 150% of impaired loans. However, what is more serious is that the figure attributed to impaired loans is not the same as its level of non-performing loans which, as of March 2007, actually came to over €3.7bn. In other words the built-up provision of €428m accounted not for 100% of these, as a very prudent bank might provide, but rather 11% – a level of imprudent provisioning that is shocking.

As the recession became apparent, BoI admitted to a 56% increase in its impaired loans to just on €1.1bn in the year to March 2008, an increase of just on €400m. Rather than provide for this increase, Goggin only set aside €232m to cover this deterioration and so, while its total impairment provisions rose to €596m, these only covered 56% of its own admitted level of impaired loans. BoI's non-performing loans, however, had by that time grown to €4.1bn. Without a squeak from the Burrows-led board, the directors were clearly becoming even more imprudent as the economy deteriorated, not less.

In its last full year to March 2009, BoI admitted to a 400% explosion in the level of impaired loans to a massive €5.3bn, a jump of €4.2bn. Instead, however, of setting aside additional provisions to cover this deterioration, the bank only set aside €1.4bn, to bring its total accumulated loan loss provisions up to €1.8bn. This level was only sufficient to cover an even lower 33% of its own admitted impaired level of loans, a significant deterioration on the preceding year's already inadequate 56% coverage.

REGIME CHANGE

What is far more dangerous about this is that BoI's total non-performing loans grew last year by 250% from €4.1bn to over €11bn, and it has only set aside accumulated provisions of €1.8bn to cover this massive deterioration in the banks loan book. Worrying too is that in the notes to BoI's accounts, management indicated that the situation is even worse than this, advising that "the group's challenged risk loans were €15.7bn as of March 2009 compared to €4.1bn at March 2008". A provision of only €1.8bn against this huge sum goes well beyond the term "imprudent".

Following the regime change in BoI, the new ceo, Richie Boucher, candidly admits that "we believe the more likely outcome of loan impairment for the overall group is now *circa* €6bn in the three year period to March 2011". Given this belief, Boucher should have insisted

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Stocks & Shares

Connemara Mining hoping for a take-out

THE IRISH mining industry is in the doldrums with some of the biggest zinc mines in the world – Tara Mines operated by Boliden, Lisheen operated by Anglo American, and Galmoy operated by Lundin Mining – all in trouble because of the dramatic drop in the zinc price. Over the last three years this has fallen from over $4,000 a tonne to just on $1,000 a tonne at the beginning of this year, resulting in mothballing of numerous projects.

John Teeling

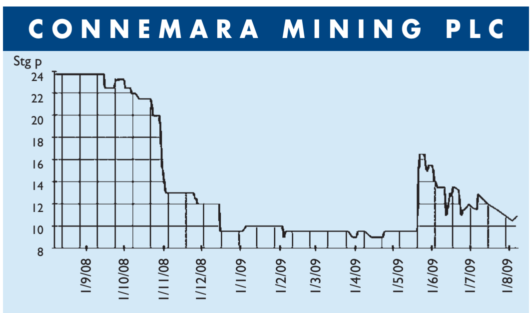
The de-stocking cycle has, however, now ended and the metal exchanges are looking a bit healthier, with zinc prices now trading up around $1,500 a tonne. A small budding Irish zinc operation, Connemara Mining, is now one of the largest mineral exploration licence holders in the country, with a total of 38 licences under its belt and a range of interesting prospects. Fans of John Teeling will be keeping their fingers crossed for some good news out of upcoming test drills.

The single most interesting contiguous block of licences held by Connemara Mining – where Teeling is joined on the board by finance director James Finn – is the Monaster Block consisting of six licences, including the Stone Park discovery licence. These are located ten miles south of Limerick City and adjoining the now very significant looking Minco zinc discovery at Pallas Green just to the north east of Stone Park. The Pallas Green licence is operated by the giant Xstrata mining group, which has spent big bucks proving up this deposit, drilling 100 holes last year, running to 42,000 metres of drilling. This is getting to a stage where this discovery, which contains zinc grades up to 30% and with a strike length of over 1,000 metres, is beginning to look like it could be really significant. Xstrata is currently operating three drills on this discovery block and, if it is declared commercial this year, will seriously upgrade the whole area.

SERIOUS PROSPECT

Connemara's adjoining Monaster Block is itself beginning to look like a serious prospect and was sufficiently interesting to attract in the Canadian Teck Cominco mining group, which farmed into the Monaster Block three years ago and committed to spending $3m to earn a 75% stake in this prospect. It completed a five-well drilling programme in 2007 which had some interesting intersections, with one of these hitting a four-metre vein, grading an average 12% zinc and 3% lead and containing within this a one-metre zone grading a very significant 28% zinc.

Last year Teck Cominco stepped up its work programme on the Stone Park licence and drilled a total of 19 holes running to just on 9,000 metres. These show that the Stone Park discovery has a strike length of over 300 metres with five of the 19 holes drilled last year containing commercial grades of zinc.



Three of these holes contained combined zinc/lead grades of over 20% in intervals of over a metre but one of these showed a combined grade of 40%, and another a significant 14 metre inter section. Cominco has just resumed drilling on this Stone Park discovery licence and is clearly encouraged by the results to date. Even if Stone Park does not prove to be big enough to be turned into a zinc mine in its own right when zinc prices recover in a few years time, it has a chance of being an ancillary resource to Xstrata's significant adjoining Pallas Green discovery.

In last year's drilling programme, Cominco did one distance step-out well one mile to the north of the main Stone Park zone, which intersected a one-metre vein, containing a combined lead and zinc grade of over 7%. This could mean that there is continuous zinc running between these two drill points and, if this is the case, would make this block very significant, with some of this year's drilling designed to look for evidence of this connection.

Connemara Mining also has a further ten contiguous prospecting licence running to over 375 sq km in the Newcastle West Block, 15 miles south east of the Stone Park/Monaster block. This too is also covered by the farm-out agreement with Teck Cominco. The block adjoins the Killmallock prospect currently being explored by Boliden (operator of Tara Mines) and this latter block already has some interesting drilling results, with one of these intersecting a vein of over five metres grading 10% zinc and 2% lead. Connemara did some geological mapping and soil sampling on its block and Cominco had a follow-up programme last year, including extensive geophysical and geological surveys, involving 850 gravity measurements, and this will form the basis on which to develop a drilling programme.

While all of this work has been paid for under the Teck Cominco $3m farm-in deal, Connemara Mining is separately carrying out a programme on its other licence areas in Ireland. One of these is the five-licence Lough Sheelin Block, which is located 15 miles west of the Tara Mine in Navan and covers an area of 170 sq km. In 1982 on the Drumlerry part of this block an earlier operator, Prospex, did sufficient work to be able to estimate from the area drilled a 1.4 million tonne ore body, grading 4.5% zinc and 0.7% lead. Last year Connemara drilled 11 widely-spaced drill holes 650 metres apart. Three of these proved quite interesting with one intersecting a five-metre vein grading a combined 4% lead and zinc, with these three drill holes confirming that the Drumlerry deposit could be larger than originally estimated.

CASTLEMAINE

One of Connemara's other licence areas is Castlemaine down in Kerry, five miles south of Tralee. This contains the ancient Annagh silver and lead mine just one mile north of Castlemaine village. Last year Connemara carried out a programme of geological mapping and prospecting followed up by a geophysical survey and some soil sampling. One boulder 400m to the west of the old mine was assessed as containing a very significant 50% zinc content, encouraging Connemara sufficiently to bring forward a drilling programme to be started later this year.

One of the more interesting blocks in the company are the three contiguous prospecting licences running to 100 sq km in County Tipperary, just four miles south of the 23 million tonne Lisheen ore body (grading 12% zinc and 2% lead) and ten miles south west of the Galmoy ten million tonne ore body (grading 13% zinc and 1% lead). This Connemara Mining block adjoining Thurles town was previously drilled and showed up some interesting results which John Teeling *et al* now intend to follow up. Another block Connemara has is the Nenagh block containing four contiguous licences covering 138 sq km in County Tipperary

James Finn

located one mile north of the old Silver Mines lead and zinc mine, which contained an 18 million tonne ore body, grading 6% zinc and 3% lead, as well as a five million tonne Barites ore body. When building the Nenagh by-pass, cut-throughs showed up general mineralisation and in particular pyritic veining, which could indicate further barites ore body.

The strategy that Teeling is clearly following in Connemara Mining is to get licences where there is already clear evidence of mineralisation or near or existing worked out mines. This explains the four contiguous licences of the Moate block running to 138 sq km in Westmeath just outside Athlone. This block is 25 miles north east of the old Tynagh Mine which contained a nine million tonne ore body grading 5% zinc and 6% lead. There is already evidence that the old mine ore body ran into this area.

Although the more serious drilling work being carried out in Connemara is being fully paid for by Teck Cominco, Connemara's own extensive programme has proved quite costly. Together with overheads the company has spent well over €1m over the last two years and has used up most of the €1.4m Connemara raised when floating in 2007. As of December last the company still had a cash reserve of €500,000 but all of this will be used up this year and Connemara will have to go fund-raising once again, but possibly on the back of some interesting drilling results from the work currently being carried out.

At the current share price on the London AIM market of 12.5p, Connemara is capitalised at just over €2m which is not a high valuation and reflects that the company will have to raise funds very shortly. However, if Cominco got particularly excited about its current drilling at Stone Park outside Limerick it could move to take the company out. On the other hand, if the results of this year's drilling programme do not add significantly to last year's outturn, then Cominco could walk and this would be a very negative signal.

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on the bank fully providing for this estimated level of loan losses. This would, of course, have pushed last year's loan loss provision up to €5.6bn and, instead of the group showing profits deteriorating from €1.9bn in the year to March 2008 to a loss of €7m last year, the latter loss would have come to €4.2bn.

Even with the Government's €3.5bn capital injection BoI had belatedly begun to rapidly reduce its loan book, cutting this back from the peak of €145bn as of September 2008 to €135bn as of March 2009 – a huge reduction in six months of €10bn. This, of course, is the very thing that the government believed its capital injection would prevent.

€12bn of BoI's loan book is lent out to the highest risk category, namely lending for land bank acquisition and property development. So far BoI does not admit to anything other than a fraction of 1% impairment on its €59bn of residential loans but does admit to a 3% impairment on its non-property commercial loans of €37bn (a worrying statistic) and a high 6% impairment on its €6bn of consumer loans. Clearly it is not just BoI's land bank and property development loan book that is in trouble but it is spread across all categories.

On top of all this, Bank of Ireland has taken a rather cavalier attitude towards properly providing for its own staff pensions. Even in the boom years the bank did not set aside sufficient funds to cover its own staff's pension obligations. For example, at the peak of the boom in March 2006, the bank under-provided as much as €800m in its pension fund. As of March 2009 this deficit had almost doubled to just on €1.5bn – representing a level of imprudence that is seriously worrying.

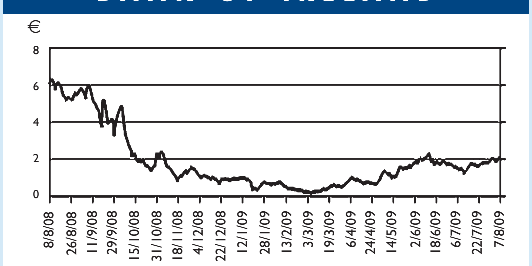
If the rate of bad debt under-funding of €4.2bn admitted to by Richie Boucher is added to the pension under-funding of €1.5bn, then deducting this from the €10bn core tier one capital (as boosted by the Government's €3.5bn injection) leaves BoI with a core tier one capital of only €4.3bn – or just over 3%. This is well below even the old Basle Accord minimum criteria of 4% that the bank is allowed to trade off.

If Richie Boucher is wrong and his estimate of €6bn of bad debts currently carried on the BoI's books turns out to be on the optimistic side – which is very likely given that the bank itself estimates that it carries challenged risk loans of €15.7bn – then BoI is in real trouble.

The final solution therefore may be to nationalise the bank. Using NAMA to grossly over-pay for assets, on the principle that NAMA will base its acquisitions on the "long term economic value", would not only impose an artificial sticking plaster to the problem but impose a huge financial penalty on the Irish taxpayer.

Richie Boucher

BANK OF IRELAND



Digging a deep hole at Kenmare Resources

KENMARE Resources has been through its ups and downs but it looks as if Mick and Charlie Carvill, two Belfast property developers who were originally involved in Pat Hughes's Tara Mines development, are on the verge of delivering what is now a massive $550m heavy sands mining project in Mozambique, albeit $200m over budget and three years late reaching full production.

To keep the show on the road, the two boys carried out a $17m funding programme last month, placing 54 million new shares at 22 cent each and are now going back to the market once again. The question is who would back them in the current climate.

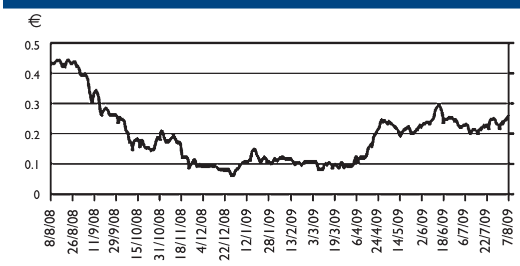
The background to this huge mining project was less than auspicious, with the giant Australian BHP Mining Group pulling out of a joint venture to develop the Moma heavy sands project in Mozambique in 2001. Kenmare itself had a troubled history in developing in the adjoining Ancuabe graphite mine in Mozambique in 1993, only to mothball it in 1999 after years of producing loss-making graphite flakes. This generated considerable internal pressures on the board of directors, with John Teeling resigning and David Horgan dismissed back in 1999, followed by the more controversial dismissal of Donal Kinsella two years ago.

Mick and Charlie Carvill have had to plug the financial hole time and time again, with last month's share placing proceeded by one 12 months ago which raised $30m. Next up is a fundraiser at what looks like an unbelievable 45 cent a share – double last month's share placing price.

The core building contract of the mine was contracted out on a fixed price $240m turn-key basis to the South African Batman engineering group and the Australian Multiplex contractor, with the project supposed to be delivered for a total price of $350m. This is now up to $550m and rising, but even by last November the plant was working at less than 30% capacity.

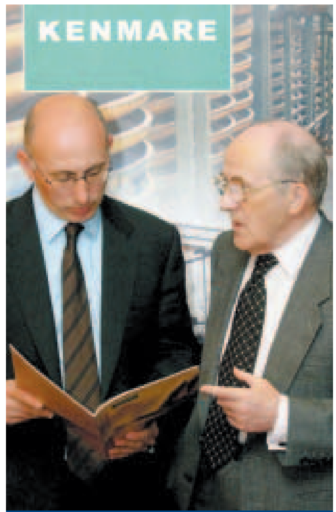
This huge project is based on two billion tonnes of heavy sands reserves and a production programme to produce 800,000 tonnes of ilmenite pa – the key material for titanium dioxide, the pigmentation source in white paint. Last year Kenmare produced and shipped 17 boatloads representing a total of 268,000 tonnes of ilmenite and 5,000 tonnes of zircon. Despite this production, Kenmare's trading accounts shows a nil revenue, which is odd given that the company got $25m for this production. What the Carvills did was net this revenue off against $58m of expenses and $28m of bank interest charges, to produce an effective loss for the year of $60m. This, however, does not appear on the trading account for the Carvills maintain that, given that the mine was not in full production, the whole of this figure should be capitalised. This partly explains why the mine now stands at a total cost to the company of $550m and why last September Charlie Carvill had to re-negotiate a new repayment schedule with his bankers, who must be concerned that the $335m they have out to Kenmare may be at serious risk.

KENMARE RESOURCES PLC



Given that Kenmare earned $25m from shipping out 268,000 tonnes of ilmenite last year, this means that even if it starts producing its full annual quota of 800,000 tonnes later this year as is now promised, this should only produce revenue of $75m. This will leave very little after paying for production costs and $28m pa interest charges.

There have been a number of recent executive changes, with Alistair Brown standing down in April this year. More significantly, the original chief operations director, Chris Gilchrist, who was brought in back in November 2004 because of his experience, was replaced in September 2008 by Terry Fitzpatrick. Fitzpatrick has far less experience, with his main achievement being the development of the failed Ancuabe graphite mine in Mozambique. It is difficult to know what particular skill set he brings to this more complex debt-ridden heavy sands project. The appointment of Jacob Deysel in Feb 2009 as chief operations officer may well help, given that he joined from Richards Day Minerals, the world's largest producer of titanium minerals.



Michael and Charlie Carvill

In May this year the company had got production up to 40,000 tonnes of ilmenite and 2,300 tonnes of Zircon. Charlie Carvill confirmed that at this rate of production the company breaks even on a cash operating basis, which is somewhat better than last year's performance. Even if full production is reached, however, at this rate Kenmare will find it hard to meet its interest bill, never mind meet its huge capital repayment programme. What could this leave over for shareholders?

Despite all this, at the current share price of 23 cent, Kenmare is now capitalised at just on €200m. Together with its $335m borrowing mountain, this means that the market is valuing Kenmare's total enterprise value at a very significant €450m. Mick and Charlie Carvill must have some fans out there.