

American barrick resources corporation

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The gold market is risky as it is impossible to predict the direction of price fluctuations. The greater the range or dispersion of the price changes, the greater the risk involved (market or price risk). When building a risk-management strategy, the firm will start by looking at its operational management to see if it can find ways of reducing the risks it is taking. It will try to ensure that the inflows and outflows are balanced in nature, by currency, and interest-rate sensitivity and so forth, thus creating internal hedges matching by costs and revenues.

Operational hedging involves the firm changing sources of supply, the location of manufacturing, adjustment of production etc. in order to reduce the impact of economic factors. Unfortunately, there are many problems associated with operational hedging. Changing suppliers disturbs existing business relationships, may lead to production and/or quality control problems and is slow to implement.

ABX might consider operational business decisions which involve considerable long-term investment which, probably have significant `exit cost elements. ABX could face considerable costs in altering operational procedures as a risk management tool and would hence not use strategic risk management as their primary means of controlling their macroeconomic exposures. arrick-Cullaton Gold Trust, marketed in Canada and Europe.

Figure 1 shows the payout diagram for the investor (right hand scale) and the costs to ABX (left hand scale). The gold trust paid investors 3% of the mine's output when the price of gold was at or below \$399 per ounce, rising to 10% of production when gold was at \$1'000 per ounce. ABX totally raised \$17 million trough this trust.

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The trust represents indirect equity comparable to preferred stock. Trust holder have a right on interest payments (can be seen as dividends) but no voting rights. The payoff for ABX was that it limited the cost of this equity to 3% (of the firms output) when the gold price was at or below \$399 and at the same time offering its investors a substantial upside potential of 10% of the mines output when the gold price would reach \$1, 000 per ounce. This limited potential cost of debts to 10% for ABX.

In addition, ABX had the possibility to buy the trust back if gold prices and production rose significantly in their favour. By doing so, they could protect themselves from paying large amounts of interests. The characteristic that the payout was tied to the mines output helped further to reduce cost of debt when the gold price was at an unfavourable level and thus stabilized the net income. This instrument does not hedge ABX gold price risk on the sales side but on the cost side.

Bullion Loans

ABX entered a bullion loan contract with Toronto Dominion Bank in which it received 77, 000 ounces of gold that ABX sold immediately on the sport market for \$25 million (\$324. 68/ounce). Over the next 4 years ABX had to repay in monthly gold ounce instalments incl. 2% annual interest. The assets of the mine (value \$54. 2 million) and a guarantee issued by ABX collateralized the loan. Additionally, ABX was required to make accelerated deliveries equal to 50% of the cash flow from the mine after deducting capital expenditures and mandatory deliveries.

Figure 2 shows the ABX firm value diagram for the bullion loans. ABX locked the price when it sold the gold on the spot market for \$325 over the next 4 1/2 years. ABX would suffer from forgone profits if the gold price rose above \$325 because they could sell it on the spot market for a higher price. On the other hand, if the price would fall, ABX is better off at a price of \$325.

Additionally, ABX was contractually committed to make accelerated deliveries equal to 50% of the mines cash flow. That means, with high cash flows ABX was in a position to quicker pay back its debt in ounces of gold. This resulted in lower forgone profits (slope decreased as depicted).

The characteristic of the repayment and especially accelerated repayment is shown in figure 3. The dotted lines indicate accelerated repayment of gold that can vary depending on the level of cash flows that the mine produced. Characteristics of the repayment of gold with possible scenarios of accelerated repayments (dotted line) ABX raised \$ 50 million in 2% gold-indexed notes. Investor paid \$1'308 per note and received \$26. 16 annual interest payments (2%) and the right to redeem the note between February 88 and February 92 with an linearly increasing amount of gold as depicted in figure 5. At expiration the note had to be redeemed. At a prior redemption date, earliest February 88, the investor could chose whether to receive cash or gold bullion whose value equalled 3. 2150 ounces at the first redemption date and 3. 3804 ounces of gold at expiry. There was no collateration.

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Figure 4 shows the payoff for ABX for the first redemption date. The payoff for ABX was limited at the cost of the index-note of 2% plus the premium of

the call option at the redemption date. The major payoff for ABX was the low debt financing costs of only 2%. On the other hand, the note holder was attracted by the fact they could participate in the raising gold price. ABX had to deliver a specified quantity of gold at specific date for a price fixed at the beginning of the contract. The parties were free to close out their positions through a negotiated settlement. Forward sellers receive a premium above the current gold price called contango. The contango rate was set according to the difference between the interest rate of \$ (7%) and the lease rate of gold (2%). This resulted in a contango premium of $7\% - 2\% = 5\%$.

ABX logged the gold prices for the future production and therefore insured the risk of price fluctuation between now and the specified delivery date of the contract. This allowed ABX to exactly predict their revenues, and with its stable production costs, its cash flows. Options and Warrants (collar strategy) ABX sells and buys simultaneously a call (sell) and a put (buy) option on gold. The exercise price of the put is below that of the call. No cash outflow occurs as the premium received from the sale of the call is used to purchase the put.

The collar with a put and a call option with different exercise prices x_1 and x_2 . By setting the exercise price of put and call ABX can determine the degree of gold price risk they want to take. ABX can adjust the exercise of new puts / calls according to new market prices. By following this strategy ABX is able to stabilize its revenues without the cost for financial instruments.