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To Hedge Or Not To Hedge?

Whilst in the process of short listing gold mining companies to recommend to my newsletter readers, I recently pondered on that ugly word which makes many gold company investors sick to their stomachs, hedging. Using a forecast gold price, we have run countless companies through a financial model to see what the upside potential for each of them is going forward. When you do this exercise it really starts to dawn on you just how detrimental forward sales of gold can be to a mining company (Especially in the current environment of rising prices). I don't just mean from a bottom line perspective either. Just recently in Australia we had yet another leading gold mining company called Croesus Mining that has got itself into trouble with its inability to deliver into forward sales contracts. The share has been suspended from trading and the outlook appears bleak. Despite the inherent risks and present gold price environment, many companies are still insistent on hedging a portion of their reserves and see this as prudent risk management. Here's the interesting part. Many of these companies which are hedging are presently struggling to make a profit, which begs the following two questions:

1. **What is the logic behind locking in a sales price when you are barely making a profit?**

2. **Given the vast number of gold mining companies that remain unprofitable, are these companies operating inefficiently or has the price of gold simply failed to keep up with inflation?**

Companies that are voluntarily hedging gold at the present time are sending a very clear message to their shareholders. One they are concerned about the high costs of their mines and two they are not fully confident of higher gold prices to come. You can be virtually assured that if these companies are hedging now they are going to be even more aggressive with their hedging policies at a gold price of $100- $200 higher.

In this price environment many people are surprised how many gold mining companies are still unprofitable. The reality is the cost of production for most of these companies has risen dramatically over the past three to five years. In my opinion the price of gold has simply failed to keep up with inflation. This isn't all that surprising when you consider most of the government agencies around the world have been hell bent on having us believe inflation remains benign. This scenario is quickly changing and inflation is getting to the point where it is getting difficult to hide and the gold price is consequently responding.

Not many marginal gold mining companies are recognizing this and seem to be out of touch with the market they participate in. They are using the present strength in the gold price to add to hedge positions at a time that I believe they should be sitting tight. Significant increases in profits are just around the corner for many of these companies as they are in prime position to leverage off further gold price increases in the future. Many of these marginal companies have not experienced the same share price appreciation the lower cost producers have enjoyed but the outlook is starting to swing in their favor. Let me demonstrate what I mean:

SCENARIO (TODAY)

	Company A	Company B	Company C
Gold Production (In ounces P/A)	200,000	200,000	200,000
Average Cash Cost of Production (US per ounce)	$200	$400	$400
Hedged Ounces			
Hedging Price (US per ounce)			
Average Gold Price (For the year)	$550	$550	$550
Cost of Production	$40,000,000	$80,000,000	$80,000,000
Revenue from Gold Sales	$110,000,000	$110,000,000	$110,000,000
Net operating profit (Before Tax)	**$70,000,000**	**$30,000,000**	**$30,000,000**

In the above example we have three gold mining companies that each produce 200,000 ounces of gold a year. **Company A** is a low cost producer and has production costs of just US$200 an ounce. **Company B** and **Company C** are both marginal high cost producers and have production costs of US$400 an ounce. The difference between B and C is management's perception of the gold market and where it is heading. **Company C** has decided to take advantage of the current Gold price environment and lock in future profits by selling 2 years worth of production (400,000 ounces) forward at US$550 an ounce. **Company B** whilst also excited by the recent price increases understands how undervalued gold is and has spent the last three years reducing their hedging to nil. They will continue to employ this zero hedging policy as long as the gold price remains undervalued.

SCENARIO (1 YEAR FROM NOW)

	Company A	Company B	Company C
Gold Production (In ounces P/A)	200,000	200,000	200,000
Average Cash Cost of Production (US per ounce)	$200	$400	$400
Hedged Ounces			200,000
Hedging Price (US per ounce)			$550
Average Gold Price (for the year)	$650	$650	$650
Cost of Production	$40,000,000	$80,000,000	$80,000,000
Revenue from Gold Sales	$130,000,000	$130,000,000	$110,000,000
Net operating profit (Before Tax)	**$90,000,000**	**$50,000,000**	**$30,000,000**
Profit Increase in $ terms	**$20,000,000**	**$20,000,000**	**$0**
Profit Increase in % terms	**29.00%**	**66.00%**	**0.00%**

1 year passes and the gold price continues to catch up to its inflation adjusted value and has averaged US$650 an ounce for the year. Looking at the performances of the respective companies we can see in % terms **Company B's** profit has increased the most whilst **Company C** has failed to benefit at all. This would more than likely also be reflected in the companies share price performances. The management team of **Company C** can not quite believe the price of gold has risen as much as it has and now decide to hedge another three years worth of production at US$650 an ounce. **Company B** on the other hand is seeing their strategy start to come into fruition and decide to maintain their present path of zero hedging.

SCENARIO (2 YEARS FROM NOW)

	Company A	Company B	Company C
Gold Production (In ounces P/A)	200,000	200,000	200,000
Average Cash Cost of Production (US per ounce)	$200	$400	$400
Hedged Ounces			200,000
Hedging Price (US per ounce)			$550
Average Gold Price (for the year)	$800	$800	$800
Cost of Production	$40,000,000	$80,000,000	$80,000,000
Revenue from Gold Sales	$160,000,000	$160,000,000	$110,000,000
Net operating profit (Before Tax)	**$120,000,000**	**$80,000,000**	**$30,000,000**
Profit Increase in $ terms	**$50,000,000**	**$30,000,000**	**$0**
Profit Increase in % terms	**56.00%**	**60.00%**	**0.00%**

In the following year we can see the Gold price has continued to enjoy very healthy increases with the average price rising to US$800 an ounce. **Company B** has again enjoyed a larger increase in its profits in % terms. It has also decided to reward shareholders by paying a dividend which has been well received by the market. Its share price has also outperformed over the past two years as its profits have grown. **Company C** on the other hand has seen another disappointing year and its share price is now starting to suffer as shareholders have become disgruntled with its hedging policy. There is still three years worth of production hedged at US$650 an ounce and with market expectations of higher gold prices to come it is not a favorite in the market place. I think you can see where this is going.

There is another risk for **Company C** that I am sure many of you are not aware of. Many forward sales agreements have margin call clauses. These clauses effectively oblige the company to immediately supply the buyer with gold in the event that the gold price rises to a certain point. For example **Company C** sold 600,000 ounces forward at US$650 an ounce covering the production from years 3 through to 6. Let's say there is a margin call on that agreement which is triggered at a gold price of US$750 an ounce. Given management's poor handle on the gold market and their belief that the gold price had little upside, it is probably not surprising that such a clause did not worry them. In year two the average sale price of gold hit US$800 an ounce. The buyer now would be in their right to demand immediate delivery of their gold at US$650 per ounce, but **Company C** has not mined this gold yet and the gold is subsequently still in the ground. **Company C** must buy the gold on the market at US$800 per ounce to sell to the buyer at US$650 per ounce, which will cost them US$90 million dollars. If they don't have the cash on hand they are effectively bankrupt and a bank or the buyer will probably end up owning the company's assets. Their ability to raise the money in the market is going to be negatively impacted by the company being unpopular due to their recent history of hedging in a rising gold price environment. You can start to see the dangers that might face some of these gold companies as the price of gold becomes more volatile and surprises a few unsuspecting people in the process.

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ENSURE MANAGEMENT SHARE A SIMILAR OUTLOOK TO YOUR OWN

Before investing in a producing gold mining company I feel it is imperative that you find out from management what their hedging policy is likely to be going forward. I used to think this was something you could do by simply looking at a company's present hedge position but I have since found that this is a dangerous assumption to make. I have recently been emailing companies I have been interested in and asking them what their outlook on gold is and consequently what their future policy on hedging is likely to be. The response to these questions has been quite interesting. Most companies will tell you that they do not give an opinion on the gold price or don't even attempt to forecast where the price of gold is going. On the other hand they are more than happy to tell you about their hedging policy going forward. I think the aggressiveness of a hedging policy more or less tells an investor where the company believes the price of gold is heading. It is important to ensure the management of a company has a similar outlook to your own and that the actions they take complement your own strategy. If you are bullish on the gold price you want to invest in companies whose management teams are also bullish and consequently have very little hedging or none at all. Alternatively you may be of the opinion that the gold price might be going higher but you are also concerned about the downside risk. I can tell you there are plenty of gold mining companies out there that share this view and voluntarily hedge 25-30% of their reserves on an ongoing basis.

In conclusion I have found that it is these marginal gold mining companies that seem intent on selling gold forward. The low cost producers do not feel compelled to do so as they are generally profitable regardless of what the price of gold does. This is however reflected in their share prices already and you generally pay a premium for these types of companies. It is the marginal producers I have started to pay more attention to in my research. Finding companies with next to no hedging and a management team that shares my bullish sentiment has become increasingly difficult. The question of whether to hedge or not to is obviously a personal choice and comes down to what the company's outlook on the gold price is and their respective levels of risk aversion. Personally I am bullish on gold and feel the gold price has a long way to go to catch up with its inflation adjusted value. This will in turn see **"most"** gold mining companies become highly profitable. Therefore I prefer companies whose profitability is marginal at the present stage with a policy of little to zero hedging to maximize on the leverage of the higher gold prices to come.

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