**American Barrick Case Questions**

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1. **You are manager of the internal Corporate Analysis Group at American Barrick. Senior Management has asked you for an initial meeting to discuss how to hedge gold price fluctuations for the next 10 – 15 years in its projected annual production of 1.2 million oz. Develop three most important questions should you have for management as you enter the meeting? Your questions should demonstrate to management that you understand the firm’s business and can speak to its key strategic objectives. This is your opportunity to demonstrate that you are a capable and valuable business colleague capable of more than just a technical knowledge of hedging design and practice.** 
   * **Three questions for management:**
     1. What is the company’s view on gold in the future? Will it continue to rise?
     2. What risk tolerance level are our shareholders at? Do they balk at the idea of hedging?
     3. How much capital is the firm willing to commit to hedging?
   * **Summarize Barrick’s business model, its view of itself and the industry in which it lives. Would a hedging program fit the firm’s view and its strategic objectives?**

Barrick is a gold mining corporation that engages in the business of gold exploration and mining. It started out as a petroleum and oil company but later transformed into a gold miner and grew aggressively through a tactic of acquiring established mines and bringing them to new levels of productivity and profit.

Barrick is seen as an industry leader with exceptional profit margin and access to financing capital. Prior to 2009, it propelled itself to the second largest gold producer by size and scaled alongside with its profits through its hedge program even when gold prices took a dive. However, with the rising trend of gold prices in the early 2000, Barrick eliminated its hedge program when it filed its IPO in 2009 citing adverse impact on its bottom line as a result of hedging. It has been maintaining an unhedged exposure to gold prices ever since.

* + **How easy is it for Barrick to pass along any increases in gold production costs to the buyers it serves? Is hedging a way that Barrick can profitably differentiate itself from competitors? Be specific.**

Given its leading position in the industry and ability to drive down production cost through economies of scale, Barrick has a considerable influence on the gold market and can easily pass along its production costs onto its buyers. To appeal to the broader investor base, hedging might not be in their best interest to differentiate from competitors, at least, not after 2009. Hedging best serves risk adverse investors / shareholders at the cost of limited upside on earnings. If the goal is to achieve stable cash flows (reduced upside and downside volatility), hedging will be the perfect solution.

1. **What are the advantages and disadvantages of each type of derivative that can be used to hedge gold price? Consider at least the following: futures, forwards, swaps, options, structured notes. Are symmetric hedges (futures, forwards and swaps) preferable to asymmetric hedges?** 
   * **Futures:**
     1. Advantages: high liquidity, low trading cost, limited downside risk
     2. Disadvantages: marked-to-market, potential margin call, limited upside profit, delivery obligation, and downward pressure on gold price through increased future supply
   * **Forwards:**
     1. Advantages: not marked-to-market, no margin requirement, stable P/L
     2. Disadvantages: not as liquid as futures, obligated to deliver gold at expiration, downward pressure on gold price
   * **Swaps:**
     1. Advantages: Exchange gold for money market currency with the agreement to repurchase in the future
     2. Disadvantages: Exposure to currency risk
   * **Options:**
     1. Advantages: no opportunity cost, inexpensive to implement due to reduced premium
     2. Disadvantages: Buyers might not want to trade with you because there is no delivery obligation.
   * **Structured notes:**
     1. Advantages: Principal protection with upside participation in gold price increase
     2. Disadvantages: Might not serve the goal of hedging and it introduces upside exposure rather than downside

While symmetric hedges limit the downside movement in gold prices, they inevitably incur opportunity cost and hamstring the firm’s ability to capture aggressive return, should gold price rise. In this case, asymmetric hedge serves shareholders interests the best.

1. **What are the primary costs and risks in the type of hedging pursued by American Barrick? Be specific. Enumerate the liquidity, funding, basis, rollover, credit and legal risks?** 
   * **Spot-deferred contract:**
     1. **Costs**: If spot market price rises above the agreed-upon strike price, Barrick will bring in less revenue than otherwise. To mitigate this opportunity cost, spot-deferred contract allows the company to roll over the contracts to next period and can continue to do so until the termination date.
     2. Risks:
        1. **Delivery risk:** Though might not be a concern for Barrick, overselling gold forwards could result in an inability to deliver, in which case, they will have to purchase from the spot market and deliver to the Bullion Bank.
        2. **Basis risk**: Backwardation, another unlikely event but can still happen. If the gold market goes into a backwardation, rolling over their futures contracts on each re-pricing date would mean lower strike prices and higher opportunity costs.
        3. **Counterparty risk**:If the Bullion Bank defaults on contract when gold price sinks to levels below strike, Barrick will have to sell their productions at spot.