

Precious Metal Financing

Paul M. Angland, V.P.

HSBC Bank USA, National Association
464 Winthrop Street
Rehoboth, MA 02769
Ph: (508) 252-5410
Email: paul.m.angland@us.hsbc.com

Abstract

An overview of precious metal leasing and the role a lease plays in hedging and/or financing precious metal containing assets or inventories. Also discussed are the advantages/disadvantages of using "traditional" financing to support precious metal requirements, the challenges involved in financing "commodities" and an overview of how improper hedging of precious metal can impact the financial well-being of a company.

Key words: Precious Metal, Gold, Silver, Platinum, Palladium, Leasing, Financing, Hedging

Financing Precious Metal with Traditional Sources of Capital

In general, most companies are not sufficiently capitalized to self-finance their entire operation. As such, a company must seek out third party financing to support some portion of their assets.

There are various methods that a company can choose from to finance its assets. As an example:

- a company can request extended terms of repayment from its precious metal suppliers.
- a company may require its customers to deliver precious metal in advance (toll-in) before any manufacturing or fabrication will be started.
- a company can seek financing (term loan, line of credit or revolver) from a commercial bank.

In each of these cases, the company has sought out and used third party financing (precious metal) to help support its precious metal requirements.

The commercial lender's willingness to provide financing to any company is contingent upon the credit profile of the company. The quality of the company's credit profile is determined after

careful analysis of various factors. The following is a list of some of the factors that a lender will analyze in its credit decision process:

- purpose of the request
- collateral coverage
- historical and projected profitability
- net worth/equity investment
- cash flow generation
- credit history
- management team
- industry trends

Once a commercial lender has determined that a company is credit worthy, it will attempt to provide financing sufficient to meet the needs of the company, while minimizing the risk of loss for the lending institution.

The Challenge of Financing Precious Metals

Unlike other types of materials, precious metals are commodities which can be subject to extreme market volatility. The price of gold, silver, platinum and palladium change by the minute. One dollar of borrowed money may buy \$1 of gold today, but this same gold may be worth just \$0.90 tomorrow. A company must be aware of these changes and the impact market prices of metal have on a company's profit margin. A keen knowledge of these impacts will allow management the ability to more effectively budget purchasing requirements and set sales prices.

A Working Example

In the manufacture of precious metal containing widgets, the Purchasing Manager plans an annual need of 10,000 fto (fine troy ounce) gold to be bought in 2,500 fto increments over a 4-quarter period. During the planning phase, gold trades for \$900/fto and this amount is used as the basis in determining the sales price of the widget. At the start of the purchasing cycle, gold trades for \$950/fto and 2,500/fto are purchased at this price. In fiscal quarters 2 and 3, 5,000/fto are purchased at a price of \$975/fto and in the final fiscal quarter the remaining 2,500/fto are purchased at a price of \$875/fto.

Over the course of the year the average cost per fto works out to be \$943.75/fto. If 10,000 widgets (each containing 1 fto gold) were sold over this period at the initial planned price of \$900/fto, this company would suffer a loss of (\$437,500) due to fluctuations in precious metal prices.

Strategies for Managing Exposure to Metals

Many factors can impact the formulation of a strategy to manage exposure to metal prices. A few considerations may include total dollar amount of precious metal inventories exposed to the market, the competitive landscape, and the manner in which product is priced. Outlined below are several alternatives for managing exposure.

1. A company may do nothing (ie., be unhedged). This strategy may yield big gains, but large losses are just as possible.
2. A company may seek to build in "cushion" to allow for metal price fluctuation. Using the earlier example, although gold traded for \$900/fto on day one, the Purchasing Manager may have assumed a purchase price of \$1,000/fto for budgeting purposes. So long as metal prices remain below "assumed" purchase prices no loss on metal incurred. This method is problematic for two reasons: 1) precious metal prices could surpass the "cushion" and 2) if competitors producing similar type products are effectively hedging, they will be able to offer product at a lower price.
3. A company may seek to utilize a number of different financial products to hedge exposure to metal price volatility. Certain products are delivered through banks (may

require an approved credit line), while others can be obtained through trading houses or brokerage services.

Financing/Hedging with a Precious Metals Lease

To finance its precious metals requirements and to hedge against market exposure, a company may enter into a precious metal lease with a commercial bank. A precious metals lease is a loan denominated in "ounces" not dollars.

Suppose a company requires 10,000/fto gold for production purposes. If gold is trading for \$900/fto on the day the purchase is required, the company could borrow \$9 million from a bank for the purchase of the ounces. Alternatively, if the company is working with a Metals Bank, the firm could instruct the lender to provide it with 10,000/fto of gold.

As the leased metal is owned by the precious metal lender, the company (the borrower) is protected against fluctuations in precious metal prices. When metal is delivered to the borrower, the obligation to the lender is expressed in "ounces". As the obligation is not monetized (converted into dollars), the borrower is not impacted by metal price fluctuations. Ounces are owed to the bank, regardless of what the dollar value of the ounces happen to be. The borrower pays to the bank a fee (also called consignment fees) for the use of the precious metal ounces. When "leased" precious metal is sold, the metal is in turn bought back from the precious metals lender.

This product is most effective when a company has the ability to match the "purchase price of metal" with the "sale price of metal". Generally, the closer the hedge is to perfect, the less impact to a company from metal price volatility.

A lease may not be beneficial for small users of precious metals. There may also be tax consequences associated with the use of a lease for companies that value their inventories on a "LIFO" basis.

A Company may also seek to enter into "forward contracts" to hedge exposure. A "forward contract" is a cash market transaction in which a seller agrees to deliver a specific cash commodity to a buyer at some point in the future. Unlike futures contracts (which occur

through a clearing firm), cash forward contracts are privately negotiated and are not standardized. Further, the two parties must bear each other's credit risk, which is not the case with a futures contract. Also, since the contracts are not exchange traded, there is no variation margin requirement, which allows a buyer to avoid almost all capital outflow initially (though some counterparties might set collateral requirements). Given the lack of standardization in these contracts, there is very little scope for a secondary market in forwards. The price specified in a cash forward contract is for a specific commodity. The forward price makes the forward contract have no value when the contract is written. However, if the value of the underlying commodity changes, the value of the forward contract becomes positive or negative, depending on the position held. Forwards are priced in a manner similar to futures. Like in the case of a futures contract, the first step in pricing a forward is to add the spot price to the cost of carry (interest forgone, convenience yield, storage costs and interest/dividend received on the underlying). Unlike a futures contract though, the price may also include a premium for counterparty credit risk, and the fact that there is not daily marking to market process to minimize default risk. If there is no allowance for these credit risks, then the forward price will equal the futures price. [2]

A non-credit form of hedging is the use of an "option contract". An "option contract" is the right, but not the obligation, to buy (for a call option) or sell (for a put option) a specific amount of precious metal at a specified price (the strike price) during a specified period of time. Each option has a buyer, called the holder, and a seller, known as the writer. If the option contract is exercised, the writer is responsible for fulfilling the terms of the contract by delivering the agreed upon commodity and/or money to the appropriate party. When an option is not exercised, it expires. Options are most frequently used as either leverage or protection. As protection, options can guard against price fluctuations in the near term because they provide the buyer the right to acquire the underlying commodity at a fixed price for a limited time. [1]

Conclusion

Unlike other types of materials, precious metals are commodities which can be subject to extreme market volatility. In most cases a company must be aware of this volatility and take steps to manage it. If the volatility is not managed the operations of a company could be adversely impacted. There are various tools available to help manage volatility. Management should select financing/hedging vehicles after careful consideration of the Company's risk profile, daily operational trends and competitive environment.

References

- [1] Definition of "Option Contract" found on Investorwords.com
- [2] Definition of "Forward Contract" found on Investorwords.com