Financial Risk Management: Is It Worthwhile?

*S G Dean**

The title of this address is taken from one of David Brown's questions. A short answer might be, to use Evelyn Waugh's euphemism, "up to a point".

In turn, I am going to examine three questions which have relevance to the use of hedging techniques by commodity producers:

- Does operational efficiency ensure survival?
- How seriously should we take investment portfolio theory?
- Can hedging make sense for resource producers?

The first question is "Does operational efficiency ensure survival?" There is an argument that the best way of ensuring the economic survival of a resource company, through the ups and downs of commodity price cycles, is to ensure that its production costs are in the lowest segment of producers. This argument only holds if the following do *not* occur:

- State-owned or State-subsidised mines remain in operation despite being uneconomic. This can be achieved in a number of ways. For example, in South Africa, the exchange rate of the rand is depreciated to maintain the cost competitiveness of the mining industry.
- Low-cost producers with significant financial resources subsidise uneconomic production to protect markets.
- There is no dumping of stockpiles (for example, central bank holdings of gold) onto the market.
- Substitution of the product by other commodities.

In the 1990s markets are still far from perfect, with tariff-protected and government-subsidised mines still producing many commodities despite being uneconomic. Such distortions in commodity markets have, in some cases, forced prices down to the point where even the most cost-effective operations are loss-making. Fortunately for Normandy Poseidon, our gold operations are at the lower end of the cost curve. Nevertheless, complacency can be the forerunner of disaster.

On the other hand, Normandy Poseidon is 45% owner and manager of the Golden Grove joint venture in which the Scuddles mine produces zinc and copper. At this stage the mine produces mainly zinc. The zinc price has suffered badly in recent years and is currently at a level where

* B Com (WA), Normandy Poseidon Ltd, Adelaide.

hedging is pointless. In terms of costs, this mine is also in the lower quartile of costs per tonne. However, in this case, the only realistic strategy is to wait until zinc prices improve. That could well take some time to occur. In the meantime, we continue to look for operating efficiencies and cost reductions so that production may continue—but that process can only go so far. The timing of our entry into this commodity has not been based on opportunities in hedging markets but a desire to widen the Group's exposure to base metals. We will have to live with the zinc price for the time being.

The answer to the first question is, therefore, that cost competitiveness does not necessarily ensure survival—but neither does the existence of hedging products.

The second question is "How seriously should we take portfolio investment theory?" The application of this theory in the allocation of investment funds would suggest that an optimally diversified investor would not want a commodity producer to hedge because the investor would wish to participate fully in the risks associated with that commodity. We need to remember that this is only a theory. It has a number of practical difficulties:

1. A well implemented hedging policy could ensure that there is a stable cash flow and ongoing profitability, creating a foundation for rational decision making and ensuring the longer-term survival of the company.

   An illustration of this is the closing of a mining operation, and placing it on "care and maintenance" due to a relatively short-term drop in the price of a commodity. This is a very costly exercise and one which would be avoided unless it was absolutely necessary. Clearly, investors and managers want their assets operating as much and as long as possible.

2. Many investors are at least as interested in receiving long-term dividends and capital growth as taking exposure to commodity price movements. It seems reasonable to suppose that investors would prefer steady (albeit modest) returns, plus some commodity price risk, rather than invest in companies which present the extreme profile of either bankruptcy or bonanza.

It seems to me that the answer to the second question is that portfolio investment theory is just that: a theory. Rational investors are looking for surviving companies and will prefer those that can.

The third question is "Can hedging make sense for resource producers?" It needs to be asked in the context of the first two answers. My answer to the third question is "Undoubtedly, yes" and I will elaborate on it.

At Normandy Poseidon we undertake hedging in the gold and foreign exchange markets. So I was pleased that, at the beginning of his discussion on the demystification of financial products, David Brown emphasised that "it is essential to understand what makes them work".

Now, I am not altogether stupid about foreign exchange and my visits to Europe on business have provided some useful lessons. I generally think in terms of pounds sterling in Europe. The currencies of Northern European countries are fairly sensible. If you allow for a tip to the waiter, deutschmarks are about two and a half to the pound with Dutch guilders about two and three quarters and Swiss francs two and a quarter. French francs are about eight to the pound. My mind can cope with two and a halfish or eightish.

Scandanavia starts to get difficult but the further south you go, the harder it becomes. Southern European currencies become increasingly meaningless. In Spain you are dealing with 200 pesetas to the pound. Portugal and Greece are similarly difficult. Turkey, where we are about to commission our newest gold mining operation, is undoubtedly the worst because you are dealing with thousands of lire to the pound. You could make just as serious a mistake ordering a bottle of wine in escudos or pesetas as you could in drachma. But in Turkey you could be excused if you suffered from the numerical equivalent of dyslexia. How do you know whether the tip should be 200 lire, 2,000, 20,000? I am surprised that no-one has written a PhD thesis on "The Effect of Warm Climates on Currency Values". But I digress. The point is that financial markets are complex!

I now turn to a set of criteria which justifies the use of hedging techniques by commodity producers.

1. **Corporate survival:** As stated in its annual report, the objective of the Normandy Poseidon Group's hedging policy is "to protect the viability of its mining operations from short- to medium-term downward trends in exchange rates and commodity prices . . . The current policy is to hedge the sale price of future production so that a revenue stream sufficient to meet projected commitments for the lesser of five years or 70% of the remaining estimated life of each operation, is ensured."

   Since sufficient revenue to meet the cash operating costs and capital commitments of each mine is assured for some years to come, the ongoing operations of the Group are free from short-term fluctuations in commodity prices and exchange rates. This policy is objective and subject to regular review. It ensures that the Group's assets can be managed effectively according to a long-term plan.

2. **Meeting shareholders' needs:** This hedging policy also allows shareholders to benefit from future improvements in commodity prices and exchange rates. The Group understands that investors are looking for reasonable yields *and* exposure to commodity prices. Minimalist hedging policies, which conservatively focus on operational risk (as opposed to price risk) can achieve these twin objectives.

3. **Meeting banks' expectations:** Banks providing debt facilities prefer the existence of hedging because it provides them with some certainty over future cash flows, thus limiting their risk. Hardly surprisingly, banks also like producers to hedge because it gives them more treasury business!

   Although commodity producers have good reasons to hedge, I am not sure whether bankers' attitudes on these matters (particularly those people in banks' treasuries) exactly parallel the attitudes of their customers. In this respect, I suggest that David Brown's paper provides a clue to what I am saying.

In examining his discussion of whether hedging is worthwhile, I have taken the liberty of presuming that the order of his points indicates their importance in his argument. These points are:

- managing volatility;
- reducing transaction costs;
- reducing the risk of financial distress;
- investment optimisation; and
- customer service.

Financiers tend to focus on issues like price volatility and its impact on the bottom line. They see their products as the answer to revenue and profit stability and are anxious that corporates take full advantage of the product range available. On the other hand, commodity producers like Normandy Poseidon accept that price volatility is part of its business and inherently difficult to predict and manage.

The producer's focus is on managing assets effectively, reducing costs and using financial products in a minimalist way. By this, I mean that we undertake as much hedging as we think necessary to protect the business; rather than hedging to specifically manage price volatility. It may be argued by some that this is a relatively fine distinction but I would contend that the *reason* for hedging is just as critical in understanding a company's business as the *decision* to hedge.

I now return to the title of this address: "Financial Risk Management: Is It Worthwhile?" Initially, my response was "up to a point". What "point" is that? Financial risk management is worthwhile provided that it:

- assists in securing the underlying economic viability of the business;
- permits shareholders to receive reasonable dividend yields *and* enjoy exposure to commodity prices; and
- enhances the creditworthiness of the company in the eyes of lenders.

The willingness of banks to understand these priorities and focus financial products to meet them will determine the corporate treasurer's interest in learning about them and applying them in risk management.