Session 2: Issues Facing Refiners and Fabricators

Mehdi Barkhordar

Managing Director, PAMP

Good morning, ladies and gentlemen. Following the very informative presentations by Mark and Aram, I will attempt to provide you with some insight as to the issues that the refiners and fabricators faced during the recent financial crisis.

To start with, I think it would be useful if I remind you about some of the developments we witnessed in the market during the crisis

There was an unprecedented crisis of credibility for governments and financial systems. Many people no longer trusted anything and turned to gold as the only secure asset. Even ETFs were not considered as safe as physical gold.

You cannot walk around with 400-ounce bars to pay for something, but one-ounce coins or bars can easily be used for this purpose. Therefore, this resulted in a huge demand for physical gold in all denominations. Gold became 'mainstream', with every one interested in it.

Even Harrods approached us and we jointly launched its bullion business a couple of weeks ago.

Lack of trust in governments; lack of trust in the local currency; lack of trust in the financial system; fear of inflation; only trust physical gold.

These were attributes normally associated with an Eastern mindset. But then, more and more people in the West were demonstrating the same behaviour and turning to physical gold. This translated into new a market dynamic where the West bought gold while the East sold.

Please note that all the annual figures that I am going to show you throughout this presentation cover our financial year, which runs from 1st July to 30th June of each year. This graph represents PAMP gold bar sales by region.

As you can see, here the gold bar demand from Europe in 2009 was substantially higher than previous years, both in absolute terms and as a percentage of our total sales, while that of the Far East and India was substantially lower.

This next graph shows PAMP refining volume by region. It clearly demonstrates the fact that the East was selling gold in unusually high volumes.

As you can see, the share of Far East as a source of feed for refining in 2009 was substantially higher than in the previous years. The important point to note is that nearly all refining material from this region is in the form of scrap. I will show you another slide in a moment that will further highlight this fact.

Therefore, as you can see, while the Western markets had a new fondness for gold, it was business as usual in the East, and the traditional markets behaved in a typical manner. As a result, physical demand dried up and scrap came out in torrents, as the strong dollar meant even higher local currency prices for gold.

Both jewellery manufacturing and trade were severely hurt, with many exiting the business altogether. However, demand for retail investment bars remained fairly stable.

This graph illustrates PAMP refining by type where, for the sake of illustration, we are comparing scrap feed against other refining feed. All figures are indexed using 2006 as a base.

As you can see, this shows the huge influx of scrap that came in. The scrap represented a higher absolute amount of our feedstock in 2009 as compared to the previous years.

This graph shows PAMP gold retail investment bar sales. As mentioned earlier, the demand for investment bars remained fairly stable in traditional markets.

You can see here that the demand in the Middle East and India was fairly steady, with a slight positive bias. However, what is very interesting is the exponential increase in demand in Europe and North America. In particular, it is amazing that, at times, the North American demand was equivalent to that from India!

Having given you an overview of the overall situation, I would now like to go over some specific challenges that impacted the industry and were a direct result of the situation.

Insurance:
The insurance market was, at times, at near full capacity for single locations. Furthermore, additional capacity came at a steep premium.

Storage:
Storage space in both UK and Switzerland became scarce and, where available, storage space commanded a premium.

Shipping and logistics:
These were generally more costly. At times, due to a backlog in the clearing system, there was a premium even for immediate availability of Good Delivery large bars. There were wide swings between loco London and loco Zurich.

Substantial physical movements in both directions took place, but mainly from Zurich to London. In a nutshell, this was a boon for the insurers and transport companies, but a major cost impediment for the industry at large.

Simultaneous peak demand for both refining services and bar production meant that all staff were working at full speed and with maximum capacity utilisation. Normally, we could move people from one department to temporarily help with a surge in demand in another department, but with peak demand on all fronts, there was no slack left.

Again, the simultaneous peak demand in all departments required higher than usual amounts of working capital. As a result of this and the following points, financing became an issue for some.

Some people saw their credit lines cut altogether. This was not even due to any fault of the borrower, but because the lender had either altogether gone out of business or, due to its own liquidity constraints, needed to reduce its lending. The price rises resulted in less metal availability where lines were denominated in currency as opposed to metal. For example, a $10 million line with gold at $500 represented 20,000 ounces of metal, while at $1,000 gold, it only represented 10,000 ounces.

To make matters worse, counterparty risk took on a new meaning.

Even if you did not use credit lines and used your own resources, nothing could be taken for granted and even prime banks could not be considered as risk-free any more. We had to split large shipments to reduce the risk of potential default even with prime banks.

As an additional precaution, we actually repatriated all our excess liquidity in the form of gold bars into our own vaults.

This graph juxtaposes PAMP refining volume against the kilo bar production volume to demonstrate the point that I made earlier regarding the fact that we were working at full speed with no slack.

As mentioned, normally when there is demand for kilo bar production, the scrap supply is somewhat restrained. However, you can see here that, in 2009, this was not the case as both kilo bars production and refining were simultaneously at peak levels. The contrast is quite clear when you compare 2009 to the previous years.

So far, I have covered only the new challenges that we faced, but fortunately, with every challenge comes an opportunity, and I think on balance the new opportunities were well worth the extra efforts required.

New markets opened up:
Entirely new consumer segments emerged as many people, especially in the West, suddenly bought gold as an insurance – hence, the great demand for physical gold in all denominations. While some were totally new to the market, others bought more products, but the net result was that the size of the market in general grew substantially, which was good news for our industry. Also, further downstream, opportunities sprang up. As businesses saw market demand for products, many tried to get involved and, therefore, a whole host of companies – whether retailers, brokerage companies or jewelers – were now interested to be active in the gold market, as they wanted to satisfy their customers' needs or get into an exciting new segment either to sell products or buy back scrap. As a result, one could leverage many new distribution models. For example, we could now distribute products by providing a streamlined bullion backbone to all kinds of businesses with retail and/or wholesale customers.

There were also some new potentials in traditional markets:
Many banks in Europe, particularly in Switzerland and Germany, became quite active. This was primarily in reaction to strong demand from their customers.

There was a need for a comprehensive range of products and services, with many banks stocking up their vaults with a variety of physical products to satisfy any customer requirements.

There was a new emphasis on working with strategic partners with 360° market coverage.

Product availability and steady supply became the primary consideration rather than price. In other words, immediate product availability became critical. This is where long-term relationships showed their value, as established partners were given priority over newcomers, which was very valuable for them.

This gave many newcomers an incentive to develop long-term relationships, which can be of lasting benefit to the market.

There were enhanced revenue opportunities due to the scarcity of capacity because of the exceptional demand for refining at the same time as huge demand for physical gold products.

Furthermore, the large variety of products required, from kilo bars to small bars to legal tender bullion coins provided additional revenue opportunities

There were also some new distribution opportunities that came about:
By leveraging the global distribution network of offices around the world, we

could allow for cross-selling of products to maximise revenues.

At the same time, there was the opportunity to leverage product synergies from various producers. For example, the fact that we are primary dealers for all the major legal tender bullion coins was a win-win for us and the mints, as we could offer a unique product range and the mints could benefit from our full infrastructure.

Also, there was an opportunity to reap mutual benefits from multifaceted relationships. Again, continuing from the previous example, in some instances, we supplied the blanks to the mints for which we are the distributors; therefore, it was in our mutual interest to supply them with blanks as a matter of priority so that they could produce more coins for us to sell.

One of the more exciting opportunities was on the new product development front. While we have offered all the various components of the bullion business to our partners for many years, combining them all into a fully integrated bullion module allowed us to expand the frontiers of bullion retailing. For example, when Harrods approached us to source its bullion requirements, what it needed was a professional turnkey solution, including all the IT, product supply, hedging, etc. aspects of the business. In other words, using an analogy, it needed to have a ready-made car and not to have to assemble the various components. This allowed Harrods overnight to offer a first-class bullion service without the need to reinvent the wheel.

There was also renewed interest in allocated storage facilities:
While such facilities are not new, the level of interest in this service continues to grow in earnest as many people who buy gold want the comfort of keeping maximum control over their metal.

In conclusion, I think that there is a fundamental shift in the dynamics of the gold market. Gold in general, and physical gold in particular, have become 'mainstream'. Synergies between global markets offer new opportunities to committed participants.

Long-term strategic partners that can combine financial strength, production capacity, innovation and flexibility will have a definite edge, while less committed or innovative players will struggle.

Thank you.