Commodity-intensive industries

New financing solutions, ongoing changes and challenges

Written by:
Could it be that commodity trading companies’ single greatest exposure is the banks that finance them?

Liquidity is the lifeblood of a commodity trading company, and the size and scope of its availability determines that trader’s ability to pursue profit. Ever more the case, the fate of that trader’s suppliers and customers depends upon its ability to access ample credit and—in turn—offer structured solutions to its commercial counterparts. Wittingly or not, traders are playing increasingly larger roles as sources of financing along the entire commodity value chain. The commercial strategy for doing so is sound, but is it a choice or is it by necessity?

By nature, commodity trading companies are nimble. Many have proven themselves wise by diversifying their sources of capital beyond revolving lines of credit, including private placements, inventory repos/intermediations, liquidity swaps, receivables discounting and for a select group, the capital markets. However, many of these alternative sources of liquidity tie back to the banks themselves, as do the aforementioned structured financings for their counterparties.

The commodity finance market remains concentrated. History shows a pattern of bold entries and meek departures by non-core banks and alternative financiers correlated with market price peaks and troughs. It is not an easy business to finance and if not embedded deep within an institution’s DNA, turbulent times often prove too much to bear. Regulatory uncertainty, fines, increased capital weightings, troubled credits and a recent bankruptcy in the commodity finance space have prompted commodity trading companies to re-evaluate their financing arrangements and re-invest in the maintenance of their banking relationships.

ING commissioned The Economist Intelligence Unit to deeper explore these issues faced by our valued commodity finance clients, their peers and their counterparts.
Global oil majors with billions in assets typically have no trouble persuading banks to provide them with credit. For a small trader, refinery or an energy producer with three wells, the situation can be far different.

Although the contributions of small companies are important to the overall energy commodities value chain, credit-conscious banks do not typically take such financial risks. Indeed, Andrew Good, current CFO at Kindle Energy and former chief financial officer, North America, at Mercuria, a large energy trader, says, “Financing arrangements are becoming much more critical to the smaller producers.”

When bank credit dries up for all but large, credit-secure traders, it creates an opportunity, or more accurately, an incentive (if they want to preserve a well-populated market) for those credit-secure traders to provide the companies they depend on with much-needed liquidity. A trading middleman can leverage existing liquidity from banks or investors to take on a financing role, such as extending collateralised loans and letters of credit to support both upstream suppliers (e.g. exploration and producers) and downstream customers (e.g. refiners). This financing opportunity also appeals to the proliferating number of private equity firms, led by former commodity bankers that profit from trading on commodity positions and for whom a healthy volume of players and traded product is essential.

“We’re able to create smart, structured solutions for these smaller players,” says Mr Good, which acts as a trader for many producers and end users in the energy market. “As the banks get more and more out of the physical commodities business, I think you’ll see more of this. But we don’t do it just to be a lender.” Indeed, Mercuria will take on more credit risk. In exchange for extending financing solutions to its partners, Mercuria benefits from more secure access to gas or crude, which in turn, benefits its own traditional customers, the energy users.

Such financing can thus carry a whole industry. But this new structure for financing, which is also appearing in commodity markets beyond energy, including metals and livestock, is just one example of how many recent economic and regulatory changes are affecting—or may effect—commodities value chains. Producers, traders and end users must all address such changes alongside normal market volatility if they’re to operate successfully in today’s markets.
The financing revolution

The shift from traditional bank financing towards commodity traders and a variety of non-bank financial firms has many facets. Following the 2008 recession, market conditions forced banks to reduce their risk exposure. Some began to retreat from volatile physical commodity markets like oil and steel, while others scaled back financial support to commodity trading firms. Later, more banks retreated in the face of new and then-pending regulatory requirements like Basel III, which set capital requirements obliging them to lower trade finance exposures. Similarly, the Volcker Rule in the US set restrictions on banks’ proprietary trading and ownership of trading assets.

The exodus carries on. Regulators express growing fears that ownership of physical assets could increase risk related to catastrophic events like oil spills and the resulting clean-up fines. To protect against such fines, reporting obligations and reputational risk, a recent proposal from the US Federal Reserve would require banks to hold higher levels of capital to support investments in physical commodity businesses, thus making commodities’ lending more costly.

Although new regulations are a key reason why banks are pulling back from financing commodities markets, cyclical factors play a role as well. Recent years have been marked by volatile price swings and a downturn for commodities as a whole. This is in large part because investment and industrial growth are slowing in China, the world’s biggest consumer of commodities. The cycle is unlikely to turn up soon. The EIU forecasts that prices of most raw materials will remain subdued over the next five years as the stock overhang is only gradually absorbed. Some commodity prices, however, have been moving upwards on expectations of greater demand generated by President Trump’s proposed infrastructure programme.

All in all, “it’s a retreat,” says Mr Good. But financing as a whole is far from screeching to a halt. These dampers aside, there is still money to be made in commodity financing. Exiting banks create a void in the market that signals opportunity to hedge funds and large commodity traders.

Adapting to change

Flavia Landsberg, until recently the global CFO, food and ingredients, at Bunge, a large global agribusiness and food company with customers and suppliers worldwide, highlights these trends in the food industry. “I think the banks are willing to finance the biggest and best,” she says, “but when you talk about some of the producers, the farmers, especially in South America, the little ones are financed by the government but the middle markets are untapped, so the trading companies are filling a gap.”

“The minute you transform finance into commercial finance, you are effectively securing the market share.”

Companies like Bunge make profits from being in the middle of suppliers and producers. But in the context of future increases in interest rates, securing market share is just as important as margins. “The minute you transform finance into commercial finance, you are effectively securing the market share,”
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explains Ms Landsberg. “I’m talking about purchasing soybeans or corn directly from the farmer; it is part of the margin and allows large and vertically integrated trading companies to charge less at the end of the chain.”

The new business of commodity traders isn’t without risk, however, especially as firms’ counterparties—which include producers—come under pressure from depressed prices. But traders also have a new edge in the reordered commodities market. Huge turnover in senior staff at banks is sending experienced people to trade houses, sovereign wealth funds, private equity firms and large traders. The talent shift has boosted the risk management and market savvy of the new players.

“Financial firms may want to get into this space because it’s a profitable business,” explains Sebastien Marlier, former senior commodities editor at the Economist Intelligence Unit. “But commodities are very volatile and, in the last couple years, have been more to the downside than upside, so whoever steps in for departing investment banks needs to tolerate a certain level of risk.” Asset managers, particularly big ones, are certainly prepared—they have taken in talent in ways that “speak volumes about banks getting out of commodities business,” according to Mr Marlier. These people likely have more intimate knowledge of the commodity market and its risks than do investment banks. “If they buy a shipment of oil from the Middle East and it takes a month to transport to the US, they need a good idea of how prices will change, including sophisticated hedging.”

Traders’ roles in structured commodities financing are actually providing a conduit for banks’ money to continue entering the commodities markets, Ms Landsberg says, adding that growing hedge fund activity has increased market liquidity and is helping to keep commodities’ prices down. “At the end it’s more money than we think it is,” she says. “It’s maintaining lower prices, mainly because it guarantees that planting is going to happen for the next season, so it influences the possible supply.”
As risk shifts across commodities markets, the largest producers are demanding excellent credit contracts from their traders. Companies such as Mondelez or InBev are requiring access to large and extremely favourable credit terms, e.g. without collateral from traders and at almost no cost.

Favourable 90-day or 120-day terms are common in this realm and can create easy parity between large buyers and large producers, since once the producers are on the front end of such trades, they can easily demonstrate to investors that they are financially stable.

Jorge Ayala, CFO at AAK USA, a subsidiary of the Sweden-based producer and refiner of vegetable oils, adds that producers of commodities such as energy or food often have immediate consumption needs. Like most global traders and suppliers of goods, AAK operates across geographies as well as time, strategizing to have inventory processed in its factories as close as possible to their buyers. “Suppliers produce the goods and sell the goods, the consumers buy it, consume it, and then the buyer says you have to make the second order—and then the third order, and they haven’t even paid the first invoice to the supplier yet. So, it’s not following a realistic model. And now it’s doable because the cost of money is nothing.” Once interest rates change, the system will have to adjust.

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As a midsize producer and trader, Mr Ayala is a financier to many small oil suppliers around the world—including communities of women manually harvesting wild-growing shea nuts in Africa for their oil and butter. Building relationships with these players, while beneficial to securing the supply, can also be a distraction to the core of the business. “We don’t feel comfortable playing the part of the financing arm to our customers and to our vendors,” he says. “We don’t want to play the bank role at all. We see risk on the number of banks we have engaged, risk of not having available all the necessary tools to immediately accommodate requests from customers or finance the crops or hedge the crops. We want to focus on our commodity business. So, I think partnerships between the banks and these commodities companies will allow us to continue focusing on what we do best. As banks exit, it’s going to be a trade-off of who’s going to be keeping those margins.”

“Usualy the credit is given to whom you sell to,” adds Ms Landsberg. “In this case you’re doubling the risk, because you also have a buying risk. And that counterparty risk could be major. You could make a lot of money, but you’ve basically doubled the exposure. The question is: If there is a problem or a systemic default, who will be hurt the most?” In the current commodities financing environment, banks have transferred much of that risk to the trading companies.
While it lasts: The interest rate shake-up

Since 2009, the market has been characterised by low commodity prices and high volatility—and by low interest rates. Rates are rising again, perhaps faster than expected in the wake of the US presidential election. How prepared is the value chain, which developed in a time of low rates, for a shake-up?

Consider the dynamic between traders and large purchasers with superior credit ratings. When those big purchasers squeeze their suppliers for ultra-favourable credit terms, suppliers survive it because they can get their own financing from banks at a lower rate. When rates go up, pushback will be higher.

Traders that extend financing to smaller firms do so at relatively modest cost to themselves. Higher rates will again squeeze financing for these firms. Mr Marlier adds that if rates rise quickly, it will become more and more difficult and expensive for smaller and midsize companies to refinance themselves, which could have an impact on the supply side.

“You’re just going to have to reallocate that financing between the different players in the supply chain,” says Judith Gorog, CFO at Skyline Steel, a steel supplier that extends low-cost financing to many players in big-contract construction projects. “The big picture is always going to be the same: When the interest rates go up, we’re going to pay more.”

“We might get a real financing change,” adds Mr Good. “We’re in this very odd period right now when not that much is going on. It’s fundamentally different than the period we’re going to be in if rates go up a bit, and then there will have to be all sorts of amendments.”

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The road ahead

The risk remains that the relatively few banks still involved in providing capital to the commodities market might yet leave, financing neither large commodity users nor the traders that are now financing smaller firms. Less-regulated traders have greater power than they’ve ever had, and merger and acquisitions are on the rise to expand their market share and vertical integration in the market. The overall effects of such changes are unknown.

Traders in the commodity space are net borrowers; their business model lives and dies by their ability to both access financing and to provide it. From that perspective, the uncertainty about the sources of capital in the midterm has a potentially complicated impact.

Most large traders have a collection of banks outside of the US providing them with financing, but even they have learned to be selective about where they set up borrowing facilities. In Europe, for example, there’s various country risk due to changing regulations and shifting political winds. Large traders are very careful not to have too many French banks or Dutch banks, for example, because if any one country adopts a regulation, or imposes a sanction on trade with partner countries, governments will go after their banks, which will then be quick to leave the commodity space. This leaves borrowers scrambling to replace liquidity lost for reasons that had nothing to do with commodity markets or even interest rates.

However, a geographic shift eastward might ease some strains. “One of the things we’re seeing—and I had a banker mention this to me—is that in the commodity space, the US big banks aren’t big players,” says Mr Good. “The Asian big banks and the European big banks tend to play much more broadly in this space.” Although the banks involved are subject to multiple sources of potential regulatory change, they also have multiple markets in which to arbitrage financial change.

The future balance of power

Traders across the globe appear ready, and in some cases eager, to fill the space left by banks. But by taking a greater role in the markets, all players are also subject to new risks concentrated in new places.

The rising power of hedge funds, for example, in the commodity space is particularly notable as they are a traditionally capricious group of liquidity providers. “If some of these hedge funds suddenly decide commodities are not the place to put their money—because they’re very short-term thinkers—that could influence the liquidity of the commodity market,” Ms Landsberg says. “The major risk here is that these trading companies may have tremendous losses that industries or Wall Street have not seen yet. It can happen if the harvest fails, if there is no commodity to sell.”

For example, in 2012, Carlyle bought a majority stake in commodities-trading hedge fund manager Vermillion. Carlyle thus became the only major alternative asset manager to have commodities as an investment offering and provide repo-type financing to commodity traders. Ultimate, it sustained heavy losses from low commodity prices and low demand for raw materials. Carlyle has since wound down Vermillion, which left many commodity players without financing options.

As the centre of financing shifts geographically eastward, so, too, does the balance of power. Ms Landsberg says Chinese trading houses like Wilmar International and COFCO (China’s two major players) are becoming more important and have the advantage of the demand. “They play big. Between the Chinese trading companies, there’s a lot more money than we think. There’s a lot more risk, too.”

The idea that traders would have such an influence on supply as a consequence of funding the producers can present additional issues. Traders’ interests may not be aligned with producers. Producers aim to avoid volatility, but trading firms typically do well in times of volatility. Without volatility, you start to see trading shops pulling away.

The knowledge trading firms have about their markets and the creditworthiness of their partners is vast. It can often enable traders to make decisions more quickly than banks. However, sudden movements by traders can shift markets dramatically—a possibility that must be on the radar of investors, market players and, increasingly, the regulators taking renewed interest in these markets.
Premium on information

For commodities-intensive businesses, there’s always been a clear premium on information and expertise for managing the markets’ inherent volatility. The new constraints, and the financing options created to overcome them, only increase that premium. “The commodity space as a whole has never been for the faint-hearted,” says Mr Good.

“What we try to do is to be as informed as we can.”

Indeed, “one of the things that’s changed over time when it comes to commodity markets is that – especially in the areas in which we compete – is that these markets have become much more global,” says Mark Garth, SVP, CFP and treasurer at Perdue Farms, an agricultural producer specialising in poultry and grain. “The things that are happening around the world can also have a big impact on what we’re deciding to do today. So, what we try to do is to be as informed as we can.”

“We talk constantly about what’s happening in South America. We’re always six months apart; we’re getting into harvest and they’re starting to plant and vice versa,” Mr Garth says. “It’s become such a global marketplace. In recent years, we’ve started importing corn into the United States and that’s never happened before. There were times when it was cheaper to import corn to the East Coast than it was to bring that corn from the Midwest.”

The purchasers of commodities, such as airlines that buy jet fuel or crushers that buy oilseeds, typically have firm contracts with trading houses to provide raw commodities, so they know how to price their goods to consumers.

“If your relationship with customers is such that you can change prices on commodity-based products as input prices change, you might not need to hedge volatility as aggressively,” says Mr Garth. But for some companies, it’s impossible to pass on price increases to consumers. Southwest Airlines, for example, is critically dependent on jet fuel but can’t adjust prices on tickets sold in advance to account for price increases. Increasing future ticket prices to offset increased fuel costs might not provide an answer either, since that might hurt the number of individuals choosing the airline for travel.

“For hundreds of years, farmers around the world have hedged their exposure to market prices by selling forward - selling a futures contract on - their crops or livestock,” says Chris Monroe, Southwest’s treasurer. “As producers, farmers want to protect their investment in crops or livestock by locking in an acceptable price in the future. As consumers, airlines have a similar problem as farmers but are exposed to increases in oil prices.” Southwest thus hedges its fuel costs using financial instruments similar to those of commodity producers.

Producers’ hedging strategies have worked for a long time, but end users must face the questions raised above about how they, with varied market power, will respond as the financing environment continues to shift.
Conclusion

In a market that has changed rapidly in the wake of the financial crisis and is now facing additional regulatory, economic and political pressures, players across the commodities value chain need to think carefully about their needs, their counterparties and the right partners to help them succeed.

Today's US banks, with few exceptions, do not lend to or within the commodity space. The remaining European banks that do so have indicated that they are committed to the commodity space. But, on the whole, large firms are likely to shift their financing eastward. These geographic shifts, coupled with rising interest rates, suggest that traders will want to structure new credit terms that squeeze their counterparties, both upstream and downstream, even more. Counterparties may be unable to oblige, and the resulting pushback will affect margins along the value chain.

What seems likely is that the role of alternative financing, through traders, private equity firms and other types of financiers interested in investing in physical commodities, will continue to increase. The role of these players is subtly but continuously shifting the markets for everything from jet fuel to wheat bread. Participants in the commodities chain will do well to look ahead at the risks inherent in these changes.