Policy Brief

January 2015
PB-15/05

Changes in the Commodities Market*

Part 2: What is the role for international trading companies?

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Summary

The gradual withdrawal of western banks from the commodity sector is a significant opportunity for the historically large traders, whose economic role should be strengthened. These traders however are facing new constraints: reduced margins, competition from other industry players operating in vertical integration strategies and the rise of Asian traders. International trade is now at a historic turning point.

The trend is almost universal in the West: most finance and investment banks are leaving the commodities sector, which is considered less profitable, a high consumer of equity under the new Basel III prudential regulations framework, and certainly more politically sensitive since the authorities have sought to mitigate speculation.[1] This withdrawal is seen in both physical trading and in the provision of risk management solutions to companies that produce commodities, end users, traders or processors. Furthermore, the activity of commodity trade finance, which aims to provide international financing and payment guarantee instruments, is suffering from a banking withdrawal and from being impacted by the need for these credit institutions to now rethink their risk exposure, including credit. Thus, according to the 2014 study by the International Chamber of Commerce (ICC),[2] almost 80% of professionals surveyed consider that Basel III will not only increase bank selectivity with regard to their customers, but also the cost of financing international trade transactions. However, everything is not negative: 72% of them believe, indeed, that such legislation is likely to strengthen the bank's innovation capacity. This combination of a stronger constraint on trade finance activities and the withdrawal of many western banks from commodity risk management is one of the major changes made recently to the commodities market and will most likely influence its physiognomy for many years. It is perceived as a short-term constraint for international traders and also as the source of many opportunities for groups whose management of uncertainty is ultimately their core business.

Perceived as a constraint, changing regulatory requirements of Basel first requires the international trading players to confront the growing demands of the banks.

Here one cannot think globally since physical trading operators and the markets in which they deal are different. Clearly, the capital structure of these companies has a significant impact on the dependency ratio to external

* This publication is the second in a series of three Policy Briefs that address the changes in the commodities market, which will be expanded upon in a Part III on the producers and end users.

[1] On this subject, see Jégourel Y. (2015), "Changes in the commodities market Part 1: prudential regulation and disengagement of the banking sector," OCP Policy Center, Rabat, PB-15/02.

[2] See the study "ICC Global survey on Trade: rethinking trade and finance, «available on the International Chamber of Commerce website.

Financial resources, and it seems that the diversity of funding options for traders echo the diversity of their business models. In particular, it is important to distinguish between pure trading companies, which often have a high debt leverage, from those with significant assets because of their material processing, or, more generally, because of their high degree of integration. In 2013, the assets to equity ratio was 2.16 for Archer Daniels Midland, specializing in trading of grain, protein and oleaginous products; agricultural services; biofuel production; and supply of food items, compared to a ratio of 3.97 for Louis Dreyfus Commodities for the same year. However, it is not in the long term the question arises more acutely since 'pure' traders' debt is in large part short-term debt, where bank loans are essential. The execution of international trade transactions is in fact based either on letters of credit and stand-by3 letters of credit, or on the principle of open account, tools for which banks are essential. What is true for international operations is particularly true for trading activities that require, by nature, a double operation of buying and selling. Even under the assumption of a small time lag, the large volumes may impose considerable financing needs on the physical trader. Bank disengagement may therefore impact the transactional financing of international traders and constrain their activity. Again, here it is important to distinguish modest sized traders from industry giants that finance the operating cycle with comfortable credit lines, and that have the opportunity to turn to Asian banks that are particularly eager for trade finance or, more generally, to those in emerging countries, which have the technical ability to find funds on the financial markets, the only alternative to bank loans. The Trafigura Group, particularly active and innovative in this area, at the end of October 2014, obtained a revolving credit of US $ 1.73 billion in Asia and one month later issued US $ 300 million in asset backed securities (ABS). Financial reasoning advocates in favor of such a securitization process, due to a particularly low default rates and, in turn, current interest in the process by some institutional investors.[4]

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Secondly, prudential regulation places strong constraints on risk management activity based on instruments traded on an OTC basis (including swaps) or organized markets. From a somewhat schematic perspective, the activity of traders/processors should reconcile the previously incompatible needs of producers and end users of raw materials, in time, space and form. In other words, the economic role of a trader is to buy a commodity at a given price, location and time, then transport/store/process it and then resell it to meet demand by end users. The trader/processor thus assumes a number of risks (commercial, performance, and financial), the first of which is a price risk on the traded product. They must therefore implement offset hedging strategies to protect their margins. These are mostly based on a double operation of purchase/sale of futures contracts, which provides protection even if the price declines and keeps its economic role within the sector. The use of such tools requires traders to be members of the exchange or to go through a member of the exchange, who then acts as a broker. Explained by the dollar funding costs (since most of these markets use the US dollar), the European Bank disengagement naturally constrains access to these markets for many traders or processors who are not members and strengthens the market power of banks still present. Furthermore, any position on futures contracts is subject to a mark-to-market process, aimed at a continuous valuation based on its market price, and when losing beyond a certain threshold, imposes that a margin call be made. Because of the cost associated with the permanent mobilization of cash, a bank acting as broker may nevertheless, for commercial reasons, open credit lines to its customers and carry the balance of margin calls to the end of term. The constraints placed by Basel III now limit the use of this practice and also lead banks to increase the extent of collateral requested. Furthermore, Conditional Value at Risk (CVaR) procedures are systematically implemented in order to test if the client's financial capability enables it to withstand market risk associated with its operations on futures contracts.

"The disengagement of Western banks opens up markets and large traders play on their comparative advantages, including physical trading, in order to take control."

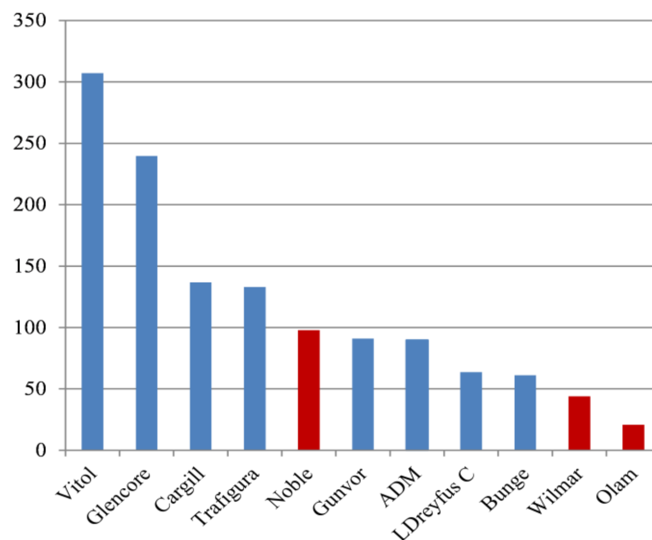
[3]For which the importer's bank agrees on behalf of his client to pay the exporter's bank for the goods purchased, on the basis of documents attesting to the successful completion of the commercial transaction.

[4]This theme will be the subject of a forthcoming policy brief.

It is clear that in accessing risk management solutions, the size factor again plays a significant role –if not a deciding role– and that the phenomenon underway in the consolidation of the international trading industry is expected to strengthen. The disengagement of Western banks opens up markets and large traders play on their comparative advantages, including physical trading, in order to take control. An example of this is the extraordinary trajectory of Mercuria Energy. Created about ten years ago, they recently acquired JPMorgan Chase bank's trading activity. More generally, traders seek trading strategies for long-term delivery contracts, vertical integration and optimal size in a highly competitive context. Downstream in the sector, in early 2014 Vitol, the top trader of petroleum products in the world, spent nearly 1.9 billion euros to acquire Shell oil group's distribution network and a refinery in Australia, after buying the fuel distribution business of the same group in 19 African countries three years earlier in partnership with an investment fund.

This profound change in the trading world can be understood as a mere strategy, a promise of a brilliant success story for historical actors whose positioning within the commodities market grows relentlessly. First, it is part of a global context of now depressed markets and, consecutively, a reduction in traders' margins. This is especially true when observing a consolidation phenomenon downstream of certain sectors that gives buyers considerable bargaining power, in the image of the future -probable- coffee giant resulting from the merger of Demb (Douwe Egberts Master Blenders) and Mondelez coffee branch.[5] Moreover, it echoes the ambitions of the major commodities producers, particularly energy and metals, which also see trading sector integration as a way to make better use of their productive activities. Lastly, it answers to competition from traders and banks in emerging countries, especially China, which has emerged in recent years. If the weight of Western groups remains substantial (Chart 1), the trajectory of firms such as Noble, Olam and Wilmar now attests to the power acquired by Asian traders (Chart 2). The Chinese group Noble's turnover rose by over 170% between 2008 and 2013, to now reach USD 97.8 billion, while the Singaporean Olam was USD 19.42 billion in 2014, compared to 8.1 billion in 2008.

Chart 1: Turnover by international traders (2013, in billions of USD)



Source : Rapports annuels

This is an overall trend. In August 2013, a subsidiary of GF Securities, one of China's largest brokers in financial products, took over base metal trading activities from the corporate and investment bank Natixis, while in 2012 the Bank of China became, through its subsidiary BOCI Global Commodities, the largest bank in the country to be the second largest member of the London Metal Exchange. While China's position continues to strengthen, the arrival in 2013 to the Geneva marketplace of a subsidiary of the Brazilian bank BTG Pactual dedicated to commodity trading, confirms that this dynamic is not just Asian.

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This statement calls for three remarks. First, the turnover does not fully reflect the market power of a group, especially when it operates in the field of international trade. If we take for example Noble, the investments partly explain the strong sales growth, but at the same time weigh on profitability. The Group's net income before tax was

[5] Since December 16, 2014, this project is the subject of a thorough investigation by the European Commission, which must ensure that the merger complies with European Union regulations on concentrations between undertakings and does not hinder competition in the European coffee market.

USD 246 million in 2013, while that of Louis Dreyfus Commodities was 761 million with a much lower annual turnover (USD 63.6 billion).[6] Second, the rise of emerging market traders should not take place without regulatory efforts by their supervisory authorities, due to the excesses that this sector can experience. In June 2014, fraud suspicions emerged about Decheng trading company operating in China, which allegedly used the same stock of copper and alumina based at the Port of Qingdao as collateral for more bank lending. Although investigations are still ongoing, this highlights the potential dangers posed by an uncontrolled development of commodity traders and threatens the sustainability of a strategic economic area. In this context and due to the credit squeeze that China is currently experiencing, it seems logical that the authorities would now keep a close eye on the expansion of trade and competition granted by the banking sector. This competition among traditional international trading operators and newcomers from emerging countries is ultimately not systemic and seeking synergies is often a strategic axis. Impala, a logistics service provider and subsidiary of Trafigura, recently reached an agreement with Citic Global Trade (CGT), a subsidiary of Citic Securities, one of the largest Chinese investment banks, to create a joint venture in storage, logistics, freight and terminal management.

Even today it is certainly premature to depict trading in the future because the strategic games that are forming appear complex. Two features nevertheless emerge: the gradual disappearance of independent traders who do not provide real added value in the sector, whether they relate to material sourcing or logistics, and a displacement of the center of gravity for financial and physical trading towards the Asian countries. While there is a change in the dynamics over the past several years in African mining policy, which promotes downstream integration strategies, few thoughts now seem to be emerging in the marketplace that the African continent could access this sector, leaving the field open to Western and Asian traders. It seems necessary to change this situation: the stakes here are enormous.

[6] This does not apply to all Asian groups: Wilmar'spre tax profit was USD 1.775 billion, for a turnover of USD 44 billion.

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