CENTRALISING FORCE

As more agricultural organisations explore ways to develop and enhance their trading and risk management activities, a flexible, robust, centralised technology platform should be a top priority, says Amine Chbani, head of commodities business development at Murex

Managing fluctuations in commodity prices has become central to many agricultural organisations' business activities in recent years. Volatility can affect a company's bottom line, creating uncertainty that can impact funding, investment programmes and shareholder income. As a result, agribusiness organisations have increasingly seen the need to adopt a more active approach to managing commodity price risk in recent years. But what strategies are common to this part of the market? How has the financial crisis and subsequent regulatory squeeze affected the market? And what internal changes have – and should – agribusiness companies put in place to enhance exposure visibility and build a robust price risk management programme?

Changing markets

Agribusiness price risk management programmes can include a range of strategies. Vertical integration, for instance, allows an agricultural company to expand further up or down the production chain and diversify the markets and regions in which it operates. Singapore-based commodity house Olam International, for example, purchased Archer Daniels Midland's cocoa processing business for $1.3 billion in December 2014. Olam will now operate throughout the entire cocoa value chain – from production, to processing, to marketing, allowing for more effective total margin management.

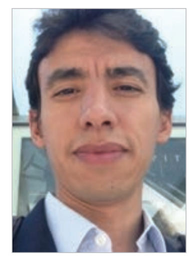
Other options available to a processor may be to substitute more expensive commodities for cheaper alternatives, enter into long-term fixed-price contracts or develop exclusive long-term partnerships with producers. Kraft Foods, for instance, signed a long-term supplier agreement with cocoa and chocolate manufacturer Barry Callebaut in 2010, making the Swiss firm a major global cocoa and industrial chocolate supplier for Kraft.

Although one of the most common strategies for managing fluctuations in the price of commodities is the use of financial hedging tools, this method of price risk management is not without its challenges. Most recently, post-financial crisis regulations have impacted supply and demand for these products. On the supply side, several major banks, including Deutsche Bank, Barclays and JP Morgan, have scaled back their commodity market activities, reducing liquidity in some segments of the market. The banks that remain as dealers have seen increased competition from hedge funds and commodity houses, which have expanded their commodity trading teams to fill this vacuum.

On the demand side, many corporates and agribusiness companies are subject to more regulation related to trade reporting, counterparty risk and changing accounting standards, which has increased hedging costs. In addition to the new rules, agribusiness companies currently face several other challenges when using financial tools to hedge against today's volatile commodity prices.

Lack of visibility

The agricultural commodities business is a diverse and complex ecosystem that requires major expertise to create meaningful financial positions to hedge. And it is not always easy for organisations to gain the necessary visibility when it comes to their



Amine Chbani

exposure to various types of risk within the commodity markets.

A starch producer, for example, might sell to diverse industries such as human and animal nutrition, pharmacy/cosmetology and biochemistry. Each open-sell contract creates a potential exposure to corn, power, sugar and freight prices, as well as to different currencies and even interest rates, if financing is involved. The same producer has also typically purchased raw materials on the market or through long-term supply contracts that might vary in terms of volume/quality delivered and type of price paid.

As such, the producer needs to be able to map the demand forecast and actuals on the supply side and determine the net volume exposure to price risk for each risk factor and contract time period. The complexity of this challenge only increases when taking into account the fact starch can be produced using a variety of inputs including corn, wheat, potatoes, rice and tapioca. Additionally, some of those commodities may not even trade in a liquid market and so risk managers must use proxies, creating additional basis risk.

Legacy IT complexities

As a result, there is a very pressing need to extract, transform and aggregate a lot of data to properly monitor an organisation's real commodities exposure. This is further complicated by the fact that, after years of mergers and acquisitions activity, some agribusiness companies have layered many legacy IT platforms on top of one another. Many organisations still operate in silos, allowing business units to develop their own solutions, rather than forming a central technology hub.

These layers can affect visibility when trying to manage exposure to key commodity markets. In an attempt to address this problem, some organisations have invested in a reporting layer connected to a risk warehouse to achieve better company-wide technological integration. The integration layer gathers data from myriad internal systems, stores it in a massive risk warehouse and then uses built-in business intelligence tools to make sense of the information. However, such a strategy can be a productivity trap. It often involves a lot of manual effort and hidden costs, and it may not even provide the necessary reporting frequency to guarantee optimal reactivity to market events.

Creating a central hub

An additional complicating factor for many agribusiness organisations trying to manage commodity price risk is the fact they often have business units all over the world, all of which create exposure to commodities. An international chocolate maker, for example, might have several production units in different regions, each forecasting a certain level of demand for cocoa, dairy products, sugar and energy. As such, establishing a central trading desk that serves different business units across an organisation can be a useful strategy when hedging against commodity price fluctuations.

These desks can be stand-alone profit-and-loss centres reporting to procurement or treasury and servicing local operating centres through transparent price transfer policies. A centralised trading desk receives input from each location into a master trading and risk management system that provides a global view of the organisation's overall commodities exposure. This allows risk managers to work out a cost-effective company-wide hedging strategy.

The benefit of having this global view is that the organisation's entire position can be taken by a central desk that interacts with the market and executes the transaction. This should save time, money and resources. In certain situations, it also allows the organisation to profit from natural hedges when netting different positions in terms of currencies or in certain commodity markets.

Robust technology platform

Organisations implementing this type of centralised trading strategy typically look for technology platforms with a range of tools including multi-entity access, multi-currency functionality and multi-Gaap software solutions. Today's trading and risk management platforms provide a variety of tools to easily build, manage and mitigate enterprise-wide commodity positions. This can include: native unit conversions, with formulas linking end-products to raw commodities; family curves projecting illiquid products to liquid market equivalents; spread correlation management; real-time prices; valuations against curves differentiated by physical and logistics characteristics, such as quality, location and international commercial terms; and the ability to manage several commodities and other asset classes, including foreign exchange and interest rates, on the same platform.

But organisations should only invest in a new platform if it is part of a real transformation programme. While some organisations have the necessary in-house expertise to build their own systems, or to extend their enterprise resource planning or treasury systems, many turn to off-the-shelf trading and risk management solutions. Hedging strategies typically involve the use of standard products and, as standard technology solutions exist to support these activities, why reinvent the wheel and develop something that already exists in the market?

Although linear derivatives and vanilla options are typically the most popular products in this sector, agribusiness players are also increasingly making use of more complex products such as accumulators. These more tailored products provide a way to build a position over time at enhanced price levels – sometimes at zero initial cost but with more risk. Over a period of six or nine months, for example, the product accumulates cash or positions in futures, depending on changing market prices. This type of product provides a lot of flexibility in terms of building a position and creating a cost-effective hedge, but it should be carefully monitored using a robust trading and risk management platform.

Making price risk management a more integral business activity is crucial for those companies facing changing markets and a more volatile price environment. When establishing a strong strategy for monitoring and managing commodity price fluctuations, agribusiness organisations must have access to the necessary tools and be able to implement robust systems and processes to support risk management activities. With the support of a centralised trading technology solution, enterprise-wide risk management can become more efficient, effective and successful.