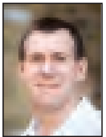
Tempered in the furnace



LAST MONTH, WE LOOKED AT HOW ARCELORMITTAL PULLED OFF A THOROUGHGOING FINANCIAL MAKEOVER. THIS MONTH, **GRAHAM BUCK** EXAMINES HOW THE STEEL GIANT'S ATTITUDE TO RISK HAS DEVELOPED SINCE ITS FORMATION.

ArcelorMittal's attitude to risk has been formed to a large extent by the different corporate cultures that have come together to form the world's largest steel producer. Mittal Steel was created by the union of two sister companies owned by Indian businessman Lakshmi Mittal in 2004 after a string of previous acquisitions. Less than two years later the group announced a $23.3bn bid for its main rival, European group Arcelor, itself the product of a three-way merger between a French, Spanish and Luxembourg steelmaker in 2002.

Mittal's initial €18.6bn offer for Arcelor in January 2006 set off a hugely controversial and protracted takeover bid. The merger process was further complicated by Arcelor itself being in the middle of acquiring a major steelmaker, Canadian group Dofasco, when it became Mittal's bid target. Despite a sometimes acrimonious battle, a deal was finally agreed by June that year.

ArcelorMittal's general manager and head of the dealing room Philippe Noury and its group treasurer Thierry Royer say bringing a variety of risk cultures together under the same corporate umbrella was not an easy task. Both companies had different risk exposures. Arcelor was based in Europe but had a significant exposure in emerging markets such as Brazil. Mittal was based in emerging markets such as Ukraine, but also had a US presence. Arcelor's completion of its Dofasco purchase just added to the challenge.

"The group was also exposed to a wide range of underlying risks such as varying interest rates, foreign exchange and fluctuating commodity prices for both the base metals essential for the group's manufacturing activities, and oil and gas," says Noury.

Royer adds that initial post-merger work focused on centralising as many activities as possible within the group's main offices, as in an organisation of ArcelorMittal's immense size, centralisation is essential for addressing risk effectively.

"Arcelor was already strongly centralised at the time of the merger, but Mittal was not," Royer says. "It initially set up a small treasury centre in Rotterdam, but decided to adopt the centralised structure that Arcelor already had in place and to base it in Paris."

RISK COMMITTEE. The risk management philosophy to which the group now adheres dates from last June, when a risk committee was set up to advise board members on effective risk management in the light of the global economic downturn. The group said the move reflected "recent developments in best practice corporate governance", and would ensure an effective risk management process was maintained to support daily management and decision-making. This board-level committee sits alongside group committees led by a member of the management team to oversee the risk management of specific financial and industrial issues.

The risk management framework is set out in a pared-down, clear and concise statement. However, for a number of the group's

exposures the range of alternative approaches was limited and logical thinking decided the risk management policy to adopt.

The written policy mentions the guidelines issued by national risk management organisations; such as the Association of Insurance and Risk Managers (AIRMIC) in the UK, and its peers in France (AMRAE) and the US (RIMS). So are the best elements of each country's code embedded in the risk framework?

"Yes," says Noury. "We don't have a country view but rather a risk matrix, and the main challenge is assessing our exposure, particularly when hedging. One may hedge a $20bn exposure, which may then be significantly reduced in the event of an economic downturn."

Deciding the group's risk appetite is the key first step in risk management, he adds. "We organise a small working taskforce to review that, which includes the global risk manager and our internal economist, and we work to find the indicators and agree a risk matrix that we can then take to management.

"But assessing risk appetite – and also how much stock we need to carry – is a lengthy process as management may be thinking one thing while various sections within the group are thinking very differently."

The downturn has inevitably had an impact, with the group's current risk appetite very different from four years ago.

Noury says: "Take 2008 when, say, your group has an EBITDA above $20bn; you're much more inclined to take risk than when it's only $5bn. You don't need a matrix for that; you already know you'll definitely take less risk than when everything is sunshine."

INDIVIDUAL SCOPE. The risk policy statement suggests that the underlying guidelines still give individual managers scope to devise specific risk management approaches for their particular unit within the organisation. But in each case the approach is based on risk identification, assessment and response, says Noury. "For financial risk, once we have agreed on the group's risk appetite we then determine whether it is transactional risk or translational for the balance sheet, and whether the main objective is to protect our margin or to smooth earnings volatility."

He says the team is very focused on the markets and will adapt the length of its hedging programme accordingly, depending on the level of risk.

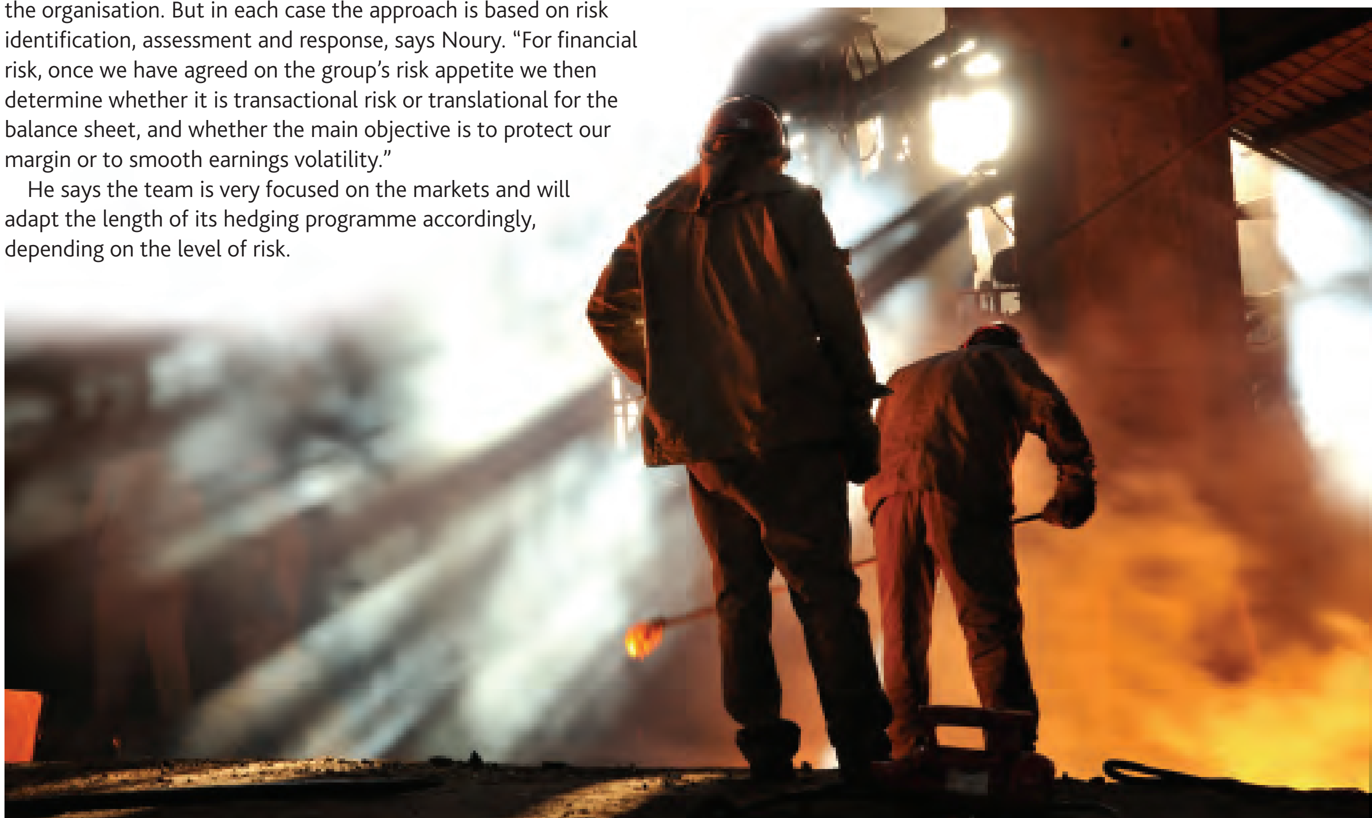
"Let's say we are at an extreme level," Noury explains. "Based on both statistical analysis and technical analysis we develop a risk matrix. When these signals tell us that our risk has reached an extreme level, we can then propose to management that they extend the hedging programme, perhaps for up to four or five years. But if the market is quiet, we will concentrate on transactional risk and hedge the firm's commitment on a more regular basis."

Back in 2008, the group entered into a four-year hedging deal denominated in Eurodollars for the raw materials required by its European businesses, at a time when commodity prices were escalating sharply.

"We had a fixed risk at that time, because one of our biggest exposures is related to the US dollar – we are short on the dollar relative to the purchase of raw materials," adds Noury. "So we can have a huge exposure in terms of Eurodollars, either on the business side or in terms of balance sheet, because at least 25% of the group is euro-denominated and our reporting is done in US dollars. That explains why we're so market-oriented. When the Eurodollar is up, we have to hedge our purchase of US dollars; when it's down we have to hedge our balance sheet."

Royer adds that when hedging, the group can choose to focus actively on the euro or the dollar part of its debt or a mix of the two. This has proved useful in the past couple of years when the dollar's value relative to the euro has fluctuated between $1.25 and $1.60. As ArcelorMittal's exposure is so great, so is its sensitivity to even small movements.

Noury offers a few examples: the group's demand for nickel represents nearly 10% of the total market for that commodity; for



zinc, the figure is 6%. Overall, ArcelorMittal accounts for a hefty 6-7% of total world freight in bulk raw materials, while in countries such as Kazakhstan its share of the total foreign exchange market is as much as 25%.

THE GROUP'S RISK POLICY. Hedging strategies are largely implemented by a group of around 28 to 30 banks. Not all of them are active in the financial markets, though, and the group contains a smaller number of active co-parties.

Mergers and acquisitions in the banking sector and the resulting reduction in available limits mean that this number is needed. "We might have a lot of banks, but because of our size we are sometimes struggling to increase the lines we have with them," explains Noury. "We're thinking in terms of billions, so if at some stage we decided to hedge all of our risks we couldn't manage it. We simply don't have enough lines, although we are fortunate in having a number of core banks which are very supportive."

In 2009, the group successfully tapped the capital market but so far has not actively explored alternative sources of funding to the banks.

Its size makes Arcelor Mittal potentially a market mover, but Noury adds that the group uses its power sparingly and with discretion; its massive hedging deal in 2008 was only revealed to the market three months after the event.

The group's risk outlook assumes continuing commodity price volatility as the market is increasingly driven by demand from China and by hedge funds. Noury says that moves by the Chinese government last year to dampen the rate of economic growth had an clear impact on the market, with general assumptions that raw material prices would fall by 25% to 30%. "But when the rate picks up again, prices are likely to rebound by 50% or 60%," he suggests.

Fast moving up the agenda since the onset of the credit crunch is what Noury describes as "the wish of regulators to drive the market and integrated financial and risk architectures", with higher collateral requirements and other restrictions. "Our main concern, as with a lot of other corporates, in terms of financial risk and impact on our daily liquidity, is that the market will no longer be OTC [over the counter] but controlled, with margin call and so on," he explains. "If this becomes the case, we will definitely have to review the ways in which we hedge. For me, that's the most important risk right now."

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