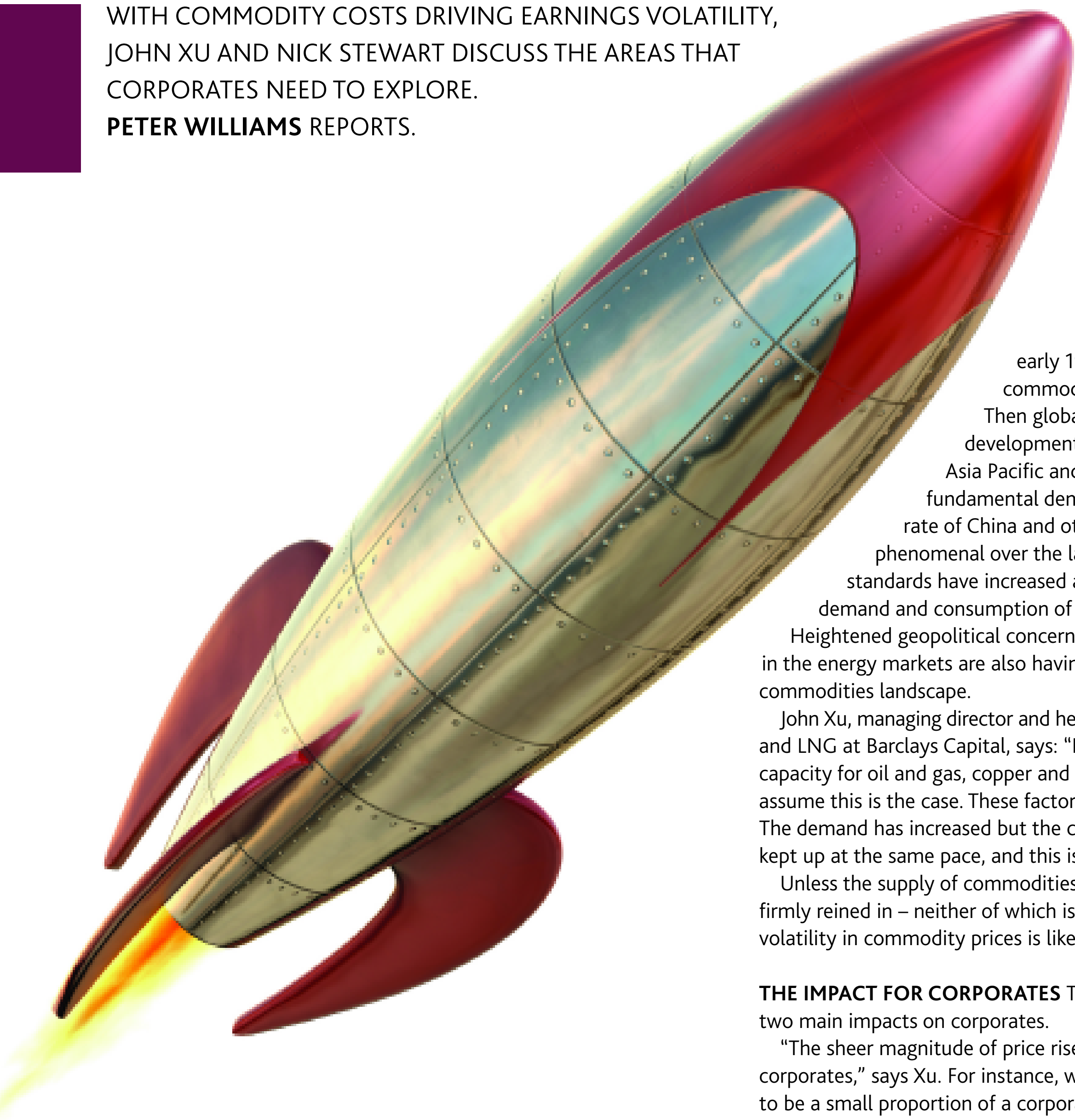
Living with the speed of change

WITH COMMODITY COSTS DRIVING EARNINGS VOLATILITY, JOHN XU AND NICK STEWART DISCUSS THE AREAS THAT CORPORATES NEED TO EXPLORE.
PETER WILLIAMS REPORTS.



Commodities have been one of the most volatile asset classes of the last few years. Back in the early 1990s there was a period when commodity prices such as oil were stable. Then globalisation and economic development, particularly in regions such as Asia Pacific and the Middle East, forced a fundamental demand/supply shift. The growth rate of China and other regional economies has been phenomenal over the last two decades, and living standards have increased as a consequence, as has the demand and consumption of a whole range of commodities.

Heightened geopolitical concerns in the Middle East and turmoil in the energy markets are also having a significant impact on the commodities landscape.

John Xu, managing director and head of European utilities, industrials and LNG at Barclays Capital, says: "In the past there was spare capacity for oil and gas, copper and other minerals. We can no longer assume this is the case. These factors are affecting earnings volatility. The demand has increased but the capacity to increase supply hasn't kept up at the same pace, and this is the fundamental challenge."

Unless the supply of commodities can be expanded or demand firmly reined in – neither of which is easy to achieve – then increased volatility in commodity prices is likely to continue.

THE IMPACT FOR CORPORATES The financial consequences have two main impacts on corporates.

"The sheer magnitude of price rises increases the costs for corporates," says Xu. For instance, whereas energy consumption used to be a small proportion of a corporate's cost base, today that cost has become significant, with the threat of spikes at any time to disrupt earnings forecasts. This long-term business and financial risk is now coming to the front of mind for chief financial officers (CFOs) and treasurers.

Second, the world has changed dramatically over the last decade from an accounting and a financial reporting perspective. Nick Stewart, risk solutions group director at Barclays Capital, says: "CFOs and treasurers need to be extremely focused on understanding and managing the risks that arise from their business, including commodities."

CHANGE IN FOCUS FOR TREASURERS Since International Financial Reporting Standards (IFRS) were first introduced for listed companies in 2005, the volatility has been more clearly reported in company results. This is set to become an issue for companies of all sizes across the globe as the International Accounting Standards Board (IASB), which defines IFRS, becomes the accepted global accounting standard setter.

This fundamental change needs to be recognised by CFOs and treasurers. They need to ensure that systems and processes are in place to manage the increased risk their companies face and to attempt to reduce costs. While this is undoubtedly a difficult and fast-moving issue, it is also clear that treasurers and CFOs could significantly improve the way they are managing these issues.

Xu says: "If you wind the clock back a few years ago, we found that our main point of contact with our clients was with procurement or purchasing, whose main focus wasn't necessarily risk management. As such, less consideration was given to commodity risk management compared to interest rates or foreign exchange."

That, however, is changing. Financial risk management is moving towards the remit of treasury and that includes the management of commodity risk. As volatility has increased, so boards have started to take an interest in this type of business and financial risk, just as they became aware of liquidity management in the credit crisis.

Xu says: "Directors are reading what is going on with commodity prices, and as they start to impact earnings, they are spending more time looking at the issue. Increasingly we see the importance of supporting clients with the benefits of a risk strategy."

However, while Xu and Stewart have seen movement in that direction, it is not yet universal among companies. "We encourage treasury to take on the management of the commodity risk systematically as another key business risk," says Xu.

Corporates need to take a holistic view across the organisation to see if overall risks are increasing or reducing. This is particularly true of commodity costs, where netting off the risks across the group should have a beneficial impact.

ACROSS THE GLOBE Barclays Capital aims to provide commodity services that match the needs of corporate clients, providing liquidity and risk management solutions in a wide range of markets from oil, gas and power, to emissions, metals, cereals and many more.

The last few years have seen the development of a power and gas market in many European countries as well as North America where the bank is keen to support clients by providing liquidity and risk management solutions.

Key sectors for commodities are oil and gas, mining, metals, utilities, transport and diversified large industrials. There is increasing interest in petrochemical and agricultural products, the latter receiving much attention over the last two years. These markets have also started to attract the attention of investors looking for exposure and investment management opportunities in these commodities.

Commodity markets remain less liquid than FX and one of the key messages from the bank is that the strategies for corporates should be as simple as possible. Xu says: "Clients respond well to that message. We see clients wanting to manage their exposure effectively but avoid any element of speculation or gearing. We work with clients to enable them to make the right choice in terms of risk management options."

The bank often finds clients are looking for detailed information and market background so that the company can be confident it is making the best decision given the circumstances. Xu, Stewart and their colleagues can provide ideas on what would be efficient in terms of cost or liquidity for a company and what is possible in terms of execution.

Commodity markets are still small and relatively illiquid. Xu says: "If a company goes into a market to trade a large volume of a particular commodity, it could dry up the market. If a client that supplies machinery tools wants to fix the price of metal for the longer term, we can work with it to find hedging opportunities that provides the risk management structure it requires."

ACTIVELY MANAGING RISK The first step in dealing with the commodity costs is to take the conscious decision to manage the risk actively. Against a backdrop of an era of greater resource constraint and increasing price volatility for commodities, taking that first step is increasingly important for more corporates. But managing this risk is challenging. To manage it effectively, CFOs and treasurers need to build a relationship that can provide analysis on activity and trends in global commodity markets and what is likely to drive the market. This information assists treasurers and CFOs in making clear the choices and the options. Once the treasury has decided its strategy, it needs a partner that can provide it with an effective route to market so it can execute deals in the size and time required.

The bank looks to its client and sector expertise and understanding of the commodity markets to share its knowledge with treasurers and CFOs. Xu says: "Once the company has decided it needs to manage its risk and has taken the necessary steps, it could see greater stability of its earnings and its earnings forecast. While this decision is highly valued by treasurers and CFOs, they need to appreciate that this is the start of a long journey.

"Many corporates have never hedged commodities because they were a small and stable part of the cost base. But that just isn't the case any more

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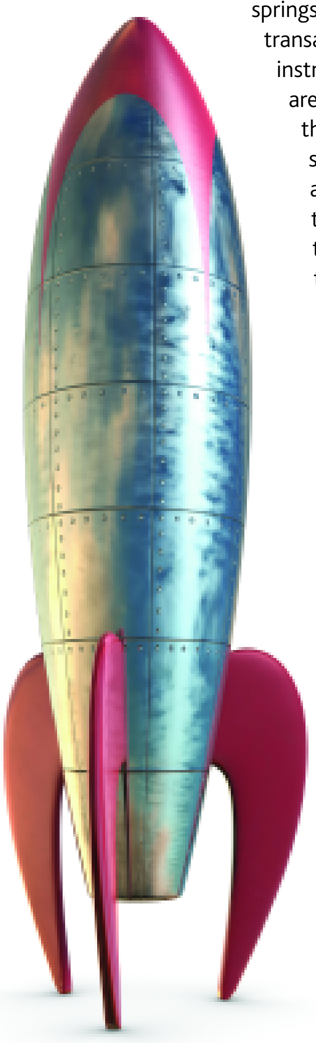
and we look to work with our clients to help them choose the right risk management option, depending on their needs." Xu regularly talks with corporates of different sizes and in different markets as they seek to progress their thinking in this area.

> "THE ACCOUNTING TAIL WILL NO LONGER WAG THE RISK MANAGEMENT DOG. SO CORPORATES WILL BE ABLE TO MAKE THE RISK MANAGEMENT DECISION AND THE ACCOUNTING SHOULD BE A SECONDARY CONSIDERATION."

REPORTING COMMODITY HEDGING In the increasingly volatile environment, accounting is an important aspect of a corporate's overall risk management practice. Before executing commodity hedging transactions, CFOs and treasurers need to understand the possible accounting and reporting implications of their actions before the issue is discussed with auditors. Hedge accounting in a risk management context is a key and often complex issue for treasurers.

IFRS standards produce volatility in the income statements of companies that prepare their reports and accounts under IFRS rules. The volatility springs from the fact that the underlying transactions and the hedging instruments such as swaps or options are accounted for differently. Prior to the introduction of IFRS in 2005, standards were less sophisticated and companies had only to show the cost of buying a commodity at the price determined or hedged by the financial instrument.



Since 2005 the derivative has to be shown separately in the accounts on a mark-to-market basis and that creates income statement volatility, impacting corporate earnings. Hedge accounting is used to mitigate that volatility by showing the effect of the hedge over the life of the transaction, rather than showing it on a mark-to-market basis in each set of accounts. The use of hedge accounting helps companies explain to investors the risk management techniques they are using.

Stewart says: "The current strict rules on hedge accounting in IAS 39 mean that many transactions that may be good risk management actions do not qualify for hedge accounting. There is currently a discrepancy between the accounting rules and risk management best practices. For instance, companies may seek to hedge particular risks in a contract but the accounting rules state that if hedge accounting is to be applied, then all risks in a particular contract must be hedged."

Stewart approves of the proposals to be introduced in IFRS 9: "The accounting tail will no longer wag the risk management dog. So corporates will be able to make the risk management decision and the accounting should be a secondary consideration. At the moment companies have to look for the product which mitigates income statement volatility rather than find the product which works best for risk management purposes."

Given the sensitivity surrounding reported results and the pressure placed on boards, CFOs and treasurers to meet market expectations, corporates look to use financial instruments and hedge accounting. IFRS 9 should help them achieve that aim. The IASB acknowledges that accounting for commodities should be improved. With complexity reduced, companies will find it easier to use hedge accounting, and improved disclosure will help readers of reports and accounts to understand how corporates are managing their risks.

THE WAY AHEAD Stewart says: "As risk management activity levels increase and IFRS practice develops, it looks certain that the treasurer's responsibility in this area is set to grow."

The current environment can, at times, be challenging to secure and source commodities at reasonable cost. Investors expect to hear from corporates through their financial reporting and treasurers have a vital role to play in examining and shaping companies' risk management policies to ensure long-term success.

Peter Williams is editor of The Treasurer.
editor@treasurers.org