COMMERCIAL BANKING

MANAGING FINANCIAL RISKS ACROSS YOUR SUPPLY CHAIN

ACT Conference 2018

LLOYDS BANK

The Group has established detailed plans to actively manage its cost base and supply chain to mitigate risks as far as possible

Uncertainty is putting even greater pressures on global supply chains. To remain successful we need to adapt and respond to these trends

We work closely with our suppliers to build strong, mutually beneficial relationships and to ensure the best results for our customers

An effective sourcing strategy creates sustainable value by driving efficiencies and margin improvement, while using our scale to deliver great quality at every price point

LET'S WARM UP WITH A QUESTION

What is the most important driver of the price of chicken?

1. Energy prices
2. US dollar
3. Feed prices
4. Price of pork and beef

LET'S TAKE A SAMPLE INVOICE

- Currency of underlying goods
- Currency of importer
- Underlying raw material price

- Cost of shipping
- Cost of logistics
- Cost of electricity

Supplier ABC
Europe or south east Asia

Description	Quantity	Unit Price	Price
Order #237461			
Goods			
Delivery / Storage			
		TOTAL in GBP	

AUDIENCE PARTICIPATION

How would you define your relationship with Procurement?

1. Strong, we work very closely together and I am aware of all financial risks embedded in the negotiations of Procurement
2. Good, we send them market updates and budget rates and they ask us for guidance
3. Limited, we just provide them with budget rates
4. I don’t know anyone in my Procurement team

SOURCING vs RISK MANAGEMENT

Sourcing

- Control the sourcing of raw materials / commodities
- Decisions made around flexibility of supply and level of customer service
- Negotiate fixed and floating elements of contracts and invoicing currency

Risk Management

- Financial risk management strategy set independently of sourcing strategy
- Hedges can be executed without the need for a physical supply contract
- Hedging strategy brought in line with wider treasury risk management policy for other financial risks e.g. FX

Procurement and Treasury can work closely together to:

- Understand the inherent risks within sourcing
- Agree floating components in the contracts so that their fluctuations can be managed
- Set and execute the corporate's risk management strategy

This leads to sourcing and risk management activities being optimised

COMMODITY RISK IN YOUR SUPPLY CHAIN

Run own fleet

Owned

- Direct fuel cost
- Alignment with wider risk management strategy

'Outsourced' Logistics Contract

3rd Party Logistics Co.

Contracts → Fuel escalator → Explicit fuel cost

Ad hoc deliveries → Embedded spot price → Implicit fuel cost

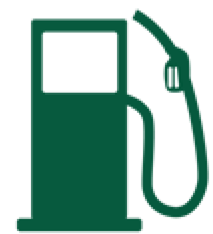
Explicit fuel cost → Easier to manage

Explicit fuel cost + Implicit fuel cost → Amount to c.30% - 40% of total invoice

‘OUTSOURCED’ LOGISTICS CONTRACT - EXAMPLE

Fuel Price Escalator	Terms
Base pallet price	£20 per Pallet
Fuel cost (40%)	£8 per Pallet
Initial fuel price	£1.00 per litre
Per pallet fuel exposure	8 litres
Number of pallets	1,000,000 Pallets

Diesel Exposure



8,000,000 litres

This risk can be managed with a diesel swap

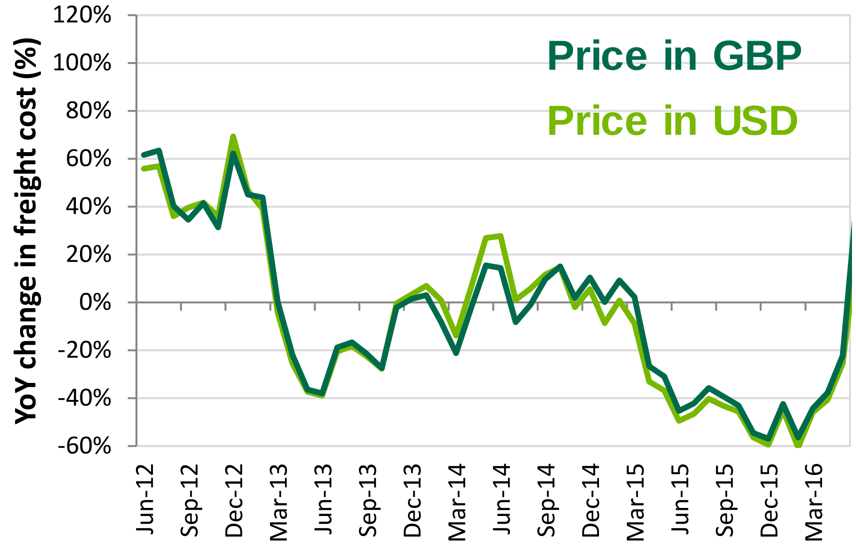
10ppl change in fuel prices → £800,000 change in fuel surcharge

CASE STUDY 1: UK RETAILER

Scenario: Retailer imports goods from South-East Asia

- Negotiates cost of freight once a year with shipping company in GBP
- Company was aware that the price for shipping goods could go up if freight markets tighten
- Company felt it was adopting a prudent risk management strategy

Composite Container Freight Rate YoY change
June 2012 – June 2016

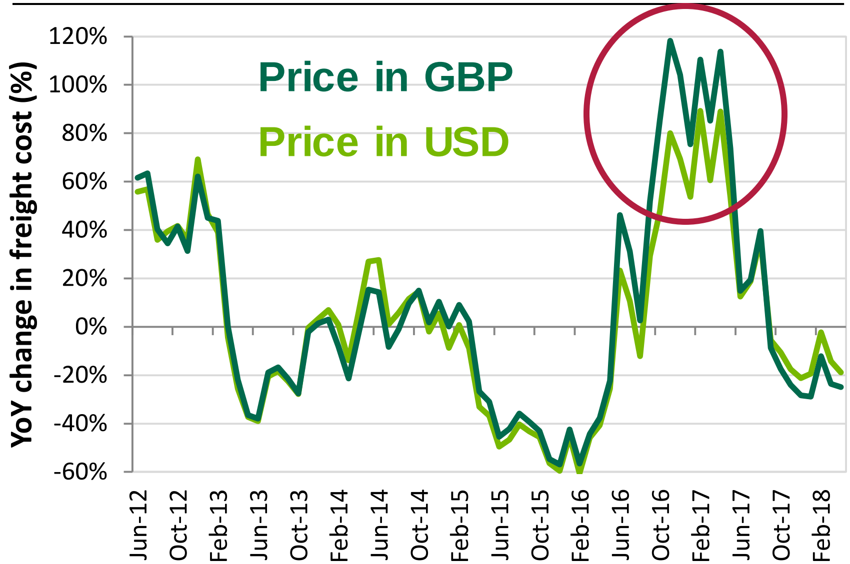


CASE STUDY 1 (CONT'D)

UK's EU Referendum had an unexpected impact on their cost of freight

- Cost of freight spiked in the second half of 2016 (in USD terms)
- The company was exposed to a double whammy with GBP depreciation
- The company now
  - Receives freight invoices denominated in USD
  - Incorporates this USD exposure into their FX hedging policy

Composite Container Freight Rate YoY change
June 2012 – April 2018



AUDIENCE PARTICIPATION

Which of the below represent a majority amongst your suppliers' contracts?

1. Dual currency invoicing - invoices in suppliers' currency or in USD so that I can manage the underlying exposure
2. Contracts in my local currency with FX clauses to allow for renegotiation
3. Contracts in my local currency and have limited visibility on the underlying exposure
4. Contracts in my local currency but supplier is hedging and passing me a hedged rate

MANAGING FX RISKS IN YOUR SUPPLY CHAIN

On what basis are FX rates set?

Does the supplier hedge?

- YES: Is the supplier's strategy aligned?
  - YES: CONSISTENCY / ADDITIONAL SAVINGS?
  - NO: WORK WITH THE SUPPLIER / CHANGE CURRENCY
- NO: Are FX clauses in the contract?
  - YES: REVIEW T&C's / STRESS TEST
  - NO: MARGIN vs. VOLATILITY / DIVERSIFY SUPPLIER BASE

CASE STUDY 2: UK FOOD MANUFACTURER

Scenario: Company imports food from Europe

- Variety of invoices from European suppliers: EUR and GBP
- Used to hedge EUR invoices out to 12 months in a layered profile
- Aware of hidden risks, but saw currency fluctuations as “some days you win, some days you lose”
- Early 2017, they undertook a thorough review of their Treasury Policy
  - Extended hedging tenor – out to 18 months
  - Increased hedging ratio – 100% for the first 12 months

TAKE AWAYS

Support from senior management on aligning Procurement and Treasury

Get closer to suppliers

Explore methods to convert indirect risks to direct exposures

Understand the impact – stress test

Consider other risk management alternatives

Thank you

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