SMARTER COMMODITY HEDGING

A GRANULAR APPROACH TO COMMODITY HEDGING PROVIDES INCREASING POSSIBILITIES FOR TREASURERS. OPENLINK'S TREASURY TEAM EXPLAINS

As their role becomes increasingly strategic, treasurers are grappling with a wider range of challenges than ever before, from regulatory change to the evolution of digital payments. At the same time, a growing focus on risk management and liquidity optimisation is prompting many treasurers to review their commodity risk management – and explore how smarter practices and technology can support a more targeted approach to hedging.

Volatility impacts

For manufacturers across different industries, thin margins mean that the issue of commodity price risk has the potential to cause substantial profit and loss volatility. Within our client base, we have seen turbulent milk prices in the US adversely impact a chocolate manufacturer's balance sheet, for example, while airlines came under immense pressure with the volatility of the price of oil.

At the same time, the way in which corporates hedge their commodity exposures is undergoing something of a shift. In recent years, a more stable commodities market has prompted corporates that rely heavily on them to reduce their hedging activities, choosing to control their balance-sheet fluctuations by using fixed-price contracts instead.

However, this approach is associated with a number of shortcomings. All too often, companies using fixed-price contracts are unable to take advantage of possible cost savings. Meanwhile, the spreadsheets and legacy technology still used by many companies tend to be both inefficient and vulnerable to fraud.

Active approach

More recently, rising commodity prices have prompted corporates to explore the possibility of adopting a more integrated, agile and targeted hedging strategy with commodity-intensive corporates looking for a strategy that enables them to be more specific in their reactions to underlying material movements.

What does this mean in practice? For one thing, while treasury and procurement functions have typically been highly segregated in the past, now, treasurers are increasingly looking to gain a better understanding of commodity risk because of the impact on their balance sheets. There is also greater pressure from shareholders to gain control over this area. We have seen clients hire specific commodity hedging/risk specialists to sit within the treasury function and work alongside procurement – not to replace procurement, but to understand their needs and be able to articulate them within the treasury function.

Mashal Jaffery, a senior manager within the energy and commodities unit at Baringa, for instance, says that treasury is increasingly managing risk on a more active basis – almost in line with the approach some banks take. She notes there is a rising convergence between treasury management and risk management, with treasury being seen more often as a centre that can enable cost savings across many different areas of the business. "Cash is no longer seen as a by-product for corporates – it's an actively managed area," she says.

Breaking it down

As companies revisit this topic, one area of focus is the possibility of hedging at the ingredient level instead of the end product level in order to achieve a more agile approach – and, indeed, greater control over the entire supply chain. If a product is made of several different ingredients, the prices of those ingredients may behave differently. For example, a corporate that sells bread might see the price of wheat go up, while the price of sugar remains stable. If the company hedges individual ingredients, it may be possible to adjust the hedging strategy based specifically on wheat movements, rather than needing to adopt a more generic position across a range of commodities. This approach may be particularly beneficial for corporates with very low margins, as these tend to have the greatest exposure to commodity price movements.

In other cases, companies may need to overcome certain challenges if derivatives for the products they use cannot be found on the normal market. For example, corporates in the dairy industry may use milk to make numerous other products. What they'll do is break it down and get milk on the normal market. From there they can make the refined product that is needed to manage their particular business.

Another consideration is that there is more to products than the ingredients themselves: the creation of products may also involve a variety of other components, such as packaging, transport, logistics and marketing. As part of a smarter approach, companies may benefit from taking a closer

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look at some of these elements. We see corporates saying, "Let's break this down and look at the components where we can take a view and tie that to something – such as a shipping index."

Pinning down the risks

Key to adopting a smarter commodities hedging strategy is making sure that the risk policy is in line with the company's goals. In many cases, revisiting the risk policy to redefine the exposures they are targeting may enable companies to find exposures they weren't previously aware of.

Once the risks have been identified, companies are in a position to apply a more targeted hedging strategy. Jaffery cites the example of a FTSE 100 company, which had a clear definition of where the business wanted to go and where synergies existed between procurement, risk management and treasury. That company naturally had the understanding and skill needed to manage currency exposures or liquidity, and wanted to extend that capability to commodity exposures, building on and adapting skills already in the business.

Not all commodity exposures can be hedged using a liquid platform. Nevertheless, identifying the risks can still enable companies to manage those risks more effectively – not least because companies that are better informed about market conditions tend to be in a better position when it comes to negotiating with suppliers.

In other cases, there may not be an easily accessible way to manage a particular exposure. At this point, it becomes a question of considering how much risk tolerance is stipulated by the company's risk management policy, and whether a particular risk should be accepted – or whether it is prudent to move out of a particular line of business.

Technology support

Finally, a smarter commodity hedging approach needs to be supported by the right technology. Many commodity-intensive corporates use tools such as spreadsheets that may reflect the financial aspects of a transaction without being attuned to the underlying physical components, and the fact that different commodities have different nuances.

In order to be effective, tools should reflect both the movements in the market and the different elements that control a particular commodity. Without a real-time view, corporates can only react on a T+1 basis, meaning they may miss the opportunity either to get out, or potentially to buy more.

Likewise, companies hedging at the ingredient level will need to use technology able to support this approach. The technology used by such companies should take into account not only cash movements and financial hedge movements, but also commodity hedging on an ingredient level across both financial and physical products.

It is important to look at tools that support typical treasury activities, such as liquidity and cash management, as well as integrating seamlessly with commodities risk management – tools that can see the cash flow on the commodity side and translate how that affects liquidity, cash management and FX exposure management.

Conclusion

In conclusion, there is much that companies reliant on commodities can do to adopt a smarter approach to commodity hedging. From redefining the exposures they face to hedging at the ingredient level, there are many opportunities for companies to adopt a more agile approach – thereby positioning themselves to protect margins more effectively in a more volatile market.

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