Commodity trading at a strategic crossroad

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Introduction and executive summary

The global commodity-trading business is a central component of our modern ability to lay off or take on risk. Against a background of rising and uncertain prices for many core commodities in food and industrial materials, the industry is on the verge of substantial change over the next two or three years. It is experiencing eroding margins as competitive intensity, price transparency, and the capital requirements of the business all increase, while access to inexpensive financing and market volatility decrease. Imminent regulatory changes will lead to rising complexity costs and a further toughening of the financing environment, which look set to accelerate the industry’s transformation. The traditional composition of the landscape, featuring a small number of “professionals” and a large number of “customers,” is also about to change, with an increasing number of players acquiring trading skills. This will enhance liquidity but will also reduce arbitrage opportunities.

Commodity traders should act swiftly now, addressing four imperatives: First, traders need to prepare rigorously for the impact of regulatory changes on the global commodity-trading system. Leaders will have to develop proprietary strategic insights through systematic, analytical business-impact assessments, stand ready to adapt operating models quickly, and seize any opportunities that arise in the transition phase. Second, contrary to the traditional culture of the sector, traders should put cost control on the agenda of top management. Third, traders should restructure their balance sheets and explore alternative and innovative sources of capital. This will likely include more radical measures, such as large-scale asset sales, M&A among complementary houses, large private-equity placements and, potentially, IPOs. It will also require a thorough assessment of realistic working-capital costing for transaction evaluation, in those cases where it is not already happening. Fourth, traders should develop mid- to longer-term company strategies that include substantial investments in differentiating downstream and upstream assets in core and new geographies.

The trading units of large commodity producers/consumers will likely find it challenging to attract sufficient support and capital from their parent companies. Smaller independent trading houses are equally likely to struggle to adapt their business models fast enough and continue raising financing at competitively low costs. The challenge for the largest independent trading houses is likely to lie in seizing the most attractive opportunities in physical and paper markets while embedding these in a consistent and differentiating strategy.

Who will be the winners? Those players that have retooled for the new high-cost environment, increased discipline in capital deployment, created strategic clarity, and strengthened their balance sheet accordingly. Winners will have moved quickly to capture M&A or market opportunities. Success in the future will be at the intersection of much more disciplined capital consumption and careful balance-sheet expansion around physical assets, as well as stronger positions in financial trading.

Changes in global commodity trading

We can identify three trends that will reshape global commodity trading over the next two to three years.

Trend 1: Increasing competitive pressure and customer sophistication is likely to lead to further erosion of the profitability of core trading operations. This is exacerbated by an environment of low volatility across commodity markets.

- Growing global profit pools, rising profiles of industry leaders, and generally decreasing barriers to entry have attracted a large number of new models into commodity trading. In Geneva alone, the number of commodity-trading companies increased from 200 in 2006 to 400 in 2011, with many players new to the industry. This has resulted in higher liquidity but also stronger competition and an erosion of trading margins.
Commodity producers become increasingly assertive in the price-discovery process and in the commercialization of their production. Rather than handing this business to trading houses, they are now setting up their own trading units. For the production they do not actively place, they also increasingly resort to cost, insurance, and freight pricing and self-manage shipping or price risk management.

Beyond their initial paper focus, many financial institutions have expanded into physical commodity trading in the past five to ten years. The largest institutions own and operate storage facilities and can enter into long-term off-take agreements with producers.

As a result of higher competitive pressure, traders must take on more risk. Locking in trading margins in well-hedged positions becomes more difficult.

Trend 2: Given high commodity prices and an increasing need to invest in physical assets, capital needs are set to increase substantially.

High commodity prices mean high working-capital needs for commodity traders. Over the last two years the price of Brent crude oil has increased by approximately $40 per barrel. For example, the financing requirement for a very large crude carrier (with carrying capacity of two million barrels or more) has risen by $80 million.

Across the commodity-trading market, the competitive advantage from superior price information has largely disappeared. For instance, the number of active price quotes on the Platts and Argus platforms has increased exponentially over the past two decades and now stands at almost 12,000 quotes. To protect their margins traders increasingly seek to own and operate physical assets that they arrange into complex end-to-end supply chains. Such supply chains provide access to unique profit pools, for example, sourcing and blending streams to meet local requirements across the Atlantic basin or to provide turnkey services such as fuel supply and conversion into power for smaller nations. Some traders are venturing into new territories, such as distribution-system supply and operatorship (for example, Vitol in Africa). Physical assets and end-to-end supply chains also open opportunities to gain access to exclusive and unpublished market information. Hence, while price-reporting agencies are relentlessly increasing price transparency, the informational value of physical-asset ownership is increasing.

Traders are also increasingly considering the ownership of physical upstream assets. Such assets are highly capital intensive and illiquid in the short term.

As a consequence, the balance sheets of traders are growing substantially—often much faster than income levels. The sustainability of commodity-trading profits now relies more than ever on balance-sheet optimization and continued access to capital (Exhibit 1). This will force trading houses to seek new sources of capital and financing.

Trend 3: Three large waves of regulatory change in the banking and derivatives-trading environments will further drive up financing and transaction costs while also creating new business opportunities for physical players as banks scale down their own commodity-trading activities (Exhibit 2). Regulatory arbitrage opportunities are unlikely across the large trading hubs.
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Exhibit 1  Commodity-trading economies are under pressure.

![Graph showing increased competition and more price transparency](source)

- **Increased competition**: Number of trading companies in Geneva
  - 200 (2006), 400 (2011)
  - Source: Geneva Trading and Shipping Association

- **More price transparency**: Number of active oil/products price quotes
  - Source: Platts; Argus

- **Low volatility, high prices**: Volatility: CBOE OVX index 
  - Indexed (Sep 12, 2008 = 100)
  - Source: CBOE; BP

- **Assets outgrowing profits**: Noble Energy example
  - 6.3x (Assets), 3.4x (Net income)
  - Source: Noble Energy

1 Chicago Board Options Exchange’s Crude Oil Exchange-Traded-Funds Volatility Index.

Exhibit 2  Key regulations are affecting commodity-trading companies.

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1 Implementation from: Q4/2012 (further clarifications to rule likely after 2012 presidential election).
2 European Market Infrastructure Regulation.
3 Exemption: central clearing not required for trading by “nonfinancial” firms for hedging purposes or other trades below a certain clearing threshold.
4 The Markets in Financial Instruments Directive.
5 Exemptions: commodity traders if trading is an “ancillary” business and dealing on own account and not a subsidiary of a financial group.
Basel III: Global regulatory standard on bank capital adequacy
In September 2010, the G20 approved Basel III, which will result in substantially increased capital requirements for banks starting in 2013–17 (transition phase) and with full effect from 2018. In particular, Basel III will increase capital requirements for trade-finance activities.

- Under the new leverage-ratio rules, banks will need to fully back trade-finance assets with capital—despite the very low default risk of, for example, letters of credit compared with other bank assets.

- Established trade-finance banks are already in the process of decreasing the level of their trade-finance activities and increasing the price of their trade-finance products. To some extent this is due to the short-term nature of trade-finance assets and the relatively low importance of trading houses as bank clients (compared with large industrial corporations, for instance).

- New trade-finance players, notably banks in emerging markets, will partly fill this void. However, the net effect will still be less access to inexpensive trade finance. This is especially true for syndicated loans.

As a consequence, Basel III is expected to lead to higher trade-financing costs at a time of rising working-capital financing requirements driven by high commodity prices.

Beyond Basel III, G20 leaders made a commitment in September 2009 that “all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, and cleared through central counterparties by end 2012 at latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.” US regulators reacted with the Dodd-Frank Act and European regulators with the European Market Infrastructure Regulation (EMIR) and the Markets in Financial Instruments Directive II (MiFID II). These new regulations will also affect the commodity-trading sector.

Dodd-Frank (US), EMIR (EU), MiFID II (EU): Regulation affecting over-the-counter derivatives trading
The Dodd-Frank Act brings profound regulatory changes to the US financial market. It has important implications for commodity traders.

- It will require central clearing of OTC derivatives and therefore more stringent capital requirements (except physically settled forwards, including book-out deals).

- It will introduce limitations on leverage and stricter requirements on transparency, risk management, and governance.

The Dodd-Frank Act was signed into law in July 2010 and was originally supposed to go into effect on July 21, 2012. However, full implementation has not yet taken place and the act’s future will not be clear until later in 2012 or beyond.

In Europe, EMIR brings similar regulatory changes. It will come into effect in January 2013, as no national transpositions are required. It stipulates the need for central clearance of “eligible” derivatives contracts, stringent trade-reporting requirements, and, importantly, tightened risk-mitigation rules. These rules will lead to increased margin and collateral requirements.

- EMIR will have the most negative impact on those traders that are not forced by their counterparties to post collateral.

- All traders will have to invest quickly in additional mid- and back-office infrastructure to comply with the new rules by January 2013.
Europe also has MiFID II, which foresees changes similar to those set out in EMIR—in fact, the regulations overlap in requiring centralized derivative-trading venues and more stringent disclosure rules. MiFID II expands on MiFID I through more expansive regulatory oversight of trading positions, stricter position limits, and compliance rules to handle conflicts of interest.

- While most trading houses are exempt from MiFID I, they are expected to be subjected to MiFID II.¹
- Furthermore, the exemption of commodity traders from Capital Requirements Directive IV will be reviewed by December 2014. Should this exemption be removed, the economics of commodity trading will further deteriorate.

Dodd-Frank, EMIR, and MiFID II are relevant across country borders. The Volcker Rule applies where any party to a trade is a resident of the United States (for example, foreign subsidiaries of US companies; US subsidiaries of non-US banks). EMIR and MiFID II will apply not only to transactions among EU counterparties but also to transactions between two entities established in one or more third-country locations that would be subject to the obligations if they were established in the EU (the so-called third-country rule).

**Volcker Rule: US regulation limiting proprietary trading of banks**

The Volcker Rule is a specific section of the Dodd-Frank Act. It restricts US banks from making certain kinds of speculative investments. This includes commodities-linked activities.

- The Volcker Rule stipulates that investment banks (given their conversion into bank holding companies) must dispose of proprietary trading activities, including in commodities.
- The Volcker Rule also potentially puts pressure on banks to sell their physical commodity assets and storage facilities.

Some estimates predict that banks will earn less than half of their current return on equity in commodity trading going forward. As a consequence, the Volcker Rule looks set to substantially reduce the participation of banks in the commodity-trading business.

**Other geographies**

Other major trading hubs outside the G20 are also likely to adopt the requirements of Dodd-Frank, EMIR, and MiFID II. For example, the Monetary Authority of Singapore released a consultation paper in February 2012 clearly stating that its regulations will be brought in line with global rules. As a consequence, there will most likely be limited latitude for regulatory arbitrage—at least in today’s main trading hubs.

The combination of these new regulations will affect the shape of the global commodity-trading market:

- Financial institutions will find it much less attractive to engage in physical commodity trading.
- The most tenacious (and probably the most successful in the past) will likely try to “save” their business through ring fencing and recapitalizing their activities.

¹ On December 8, 2010, the European Commission stated that “recent experience with various commodity firms setting up MiFID-licensed subsidiaries and the political consensus to limit exemptions from financial regulation only to necessary cases clearly underlines [that] the former justification for a specific exemption from MiFID for commodity derivative trading houses is no longer valid.” According to the draft of MiFID II, exemptions will in the future only be provided to players that trade for hedging purposes as an “ancillary activity” to their main business and qualify for one of three primary business categories: dealing on own account, providing investment services to other group companies, or providing investment services to clients of the main business. A prerequisite for qualifying as an ancillary activity is that the company owns significant physical commodity-trading assets relative to the volume of derivative trading.
Physical players will need to shore up their balance sheets. At the same time, the retreat of banks will create opportunities for them to step into the financial-services arena more broadly.

Finally, new regulations will result in lower liquidity and fewer counterparties in select derivatives markets.

Market observers state that the response from the commodity-trading community has been disparate and fragmented, reflecting a lack of collective representation, and also probably for cultural reasons. In the absence of an established representative body, the leaders in the industry have not created a unified response to regulators. Commodity trading is still shrouded in a culture of secrecy; it is anathema for many traders to divulge their economics, hence a wider reluctance to discuss the cost impact of regulations.

**Imperatives for commodity traders**

We believe commodity traders should take four immediate steps:

**Imperative 1: Rigorously prepare for the impact of regulatory changes on the global commodity-trading system.**

- **Develop proprietary strategic insights through systematic, analytical business-impact assessments.** Traders must anticipate changes in global market structures based on a solid understanding of how banks and smaller traders will be affected. Leaders will act decisively on new business opportunities, especially in paper trading and physical-asset acquisitions.

- **Stand ready to adapt their own operating models.** As capital becomes scarcer and more expensive, leaders will continue to pay particular attention to optimal capital allocation. At a minimum, traders will take a book-by-book lens and optimize capital consumption across books (for example, North Sea crudes versus Med distillates versus structured origination). The most sophisticated players will go one step further and decompose individual books into trading strategies to increase returns and free up capital wherever possible.

- **Raise their level of preparedness.** Banks have been leading in these terms, having run multiple scenarios and having come to an intimate understanding of the financial implications of the proposed regulations. This response is certainly rooted in a long history of banking regulation. The responses of physical traders have been uneven so far. While the leaders have embraced approaches similar to their competitors in the banking sector, others have adopted a wait-and-see posture. Their preparedness is unlikely to match the severity of the threat.

**Imperative 2: Put cost management on the agenda of top management.**

- **Decreasing profitability levels and increasing capital intensities make rigorous cost management a strategic priority for trading houses, from the back office to client-facing and core trading roles.** Banks have been at the forefront of unit transaction cost control given the higher-velocity/lower-margin segments they have tended to operate in (Exhibit 3). Physical traders have historically responded to margin erosion by developing new opportunities. This time it is different: regulations will raise transaction costs across the board. Continued presence in many physical segments will require much lower cost structures.

- **Tightened reporting and disclosure requirements will demand an upgrade of mid- and back-office operations.** This needs to be managed carefully to avoid substantial increases in overall costs per trade. Global leaders will optimize geographical footprints in order to minimize cost structures, especially with regard to support functions and tax arbitrage. Changes to geographical footprints will likely be aligned with the rising importance of the United States (unconventional) and Asia (consumption growth) in global energy markets.
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Imperative 3: Restructure the balance sheet and explore alternative and innovative sources of capital.

- Continued access to competitively priced and flexible capital will become a major differentiator. Trading groups backed by large integrated groups will probably find it less difficult to expand their balance sheets. Independent traders will find it harder.

- In the past, many independent traders have been creative in raising capital while keeping control of their activities. For example, many players tapped into new trade-financing sources in Asia (for example, banks in China or Australia); some traders privately placed minority equity shares with sovereign-wealth funds (for example, China Investment Corporation investing in Noble Group, the Government of Singapore Investment Corporation investing in Bunge, or Temasek holding shares in Olam); Trafigura securitized some of its trade receivables; and Vitol sold a 50 percent stake in its petroleum terminals and storage business to Petronas, a subsidiary of Malaysia’s national oil company.

- In the future, we expect more radical moves, such as large-scale asset sales and activity restructuring, M&A between complementary houses, and much larger private placements than have been seen in the past—all the way to IPOs of trading houses.2

Imperative 4: Develop mid- to longer-term company strategies that include potentially substantial investments in differentiating downstream and upstream assets in core and new geographies.

- Trading houses are now reevaluating their overall company strategies. Given the extent of change and the magnitude of capital needs, they will have to adapt their longer-term perspectives. It is not usually

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2 Even if many commodity houses find it unattractive to go public given the high value they attach to the privacy of their operations, market forces may well force them to rethink their founding paradigms.
natural for commodity traders to think and strategize in horizons longer than ten years—often the typical lifetime of a successful trading strategy is not much more than 18 months. A clear strategic road map and a robust balance sheet will go a long way to secure physical assets or to build significant positions in the financial area as banks retreat or recapitalize.

- In the physical arena, traders might acquire assets in the United States (investment banks’ midstream assets) and in Europe (distressed downstream assets at attractive prices). In emerging markets, some traders might address governments’ needs for comprehensive national energy solutions (rather than simple supply contracts). Traders will also consider organizational changes to optimally integrate assets into trading operations.

- Embracing new activities in the financial arena will mean a radical change of business model for many physical players. Scale will constitute an important entry barrier. Trading houses may find highly profitable market-making opportunities in select areas as banks step down their activities.

Different institutions will react differently to these challenges. The trading units of large commodity producers/consumers will probably find it challenging to attract sufficient support and capital from their parent companies. Smaller independent trading houses will likely struggle to adapt their business models fast enough and continue raising financing at competitively low costs. The challenge for the largest independent trading houses will most likely lie in seizing the most attractive opportunities in physical and paper markets while embedding them in a consistent and differentiating strategy.

**Conclusion**

The global commodity-trading industry is on the brink of fundamental change. Regulation will be the trigger that reshapes the balance of power among banks, large-scale trading houses backed by large balance sheets, and small to midsize trading houses with more fragile positions. Market forces will trigger substantial growth in traders’ balance sheets, and as capital becomes an increasingly expensive and scarce commodity, trading houses will need to arbitrage between opportunities much more than in the past. This will require organizational and cultural changes.

The winners will be those players that have:

- built strong asset footprints supportive of their trading activities
- retooled for the new high-cost environment
- increased discipline in capital deployment
- created strategic clarity and strengthened their balance sheet accordingly

Winners will have moved quickly to capture M&A or market opportunities. Success in the future will be at the intersection of much more disciplined capital consumption and careful balance-sheet expansion around physical assets, as well as stronger positions in financial trading. To paraphrase a famous investor, as the commodity tide recedes, the market will inevitably find out who was swimming lightly covered.
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