GTR Global Trade Review

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Demand for commodity finance set to skyrocl with large traders to reap rewards

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Commodity traders' demand for working capital could be set to treble, with margin calls rising to US$1.5tn in the energy sector alone, fresh research has found. But for larger traders already profiting from a volatile market, good news likely lies ahead.

A report on the future of commodity trading published this week by McKinsey says fluctuations in raw commodity prices – as well as shipping delays, rising interest rates and underlying inflationary pressures – are causing demand for trade finance to soar.

Between US$300bn and US$500bn of additional financing could be required to facilitate commodity flows, the report says – equivalent to around 10% of the GDP of Germany. These dynamics could mean traders' working capital requirements increase threefold for crude oil, and to six times current levels for liquified natural gas.

"The volatility of spiking commodity price levels has significantly tightened collateral requirements and increased the size and frequency of margin calls," the report adds.

"In power and gas, for example, price volatility has limited the scope of positions for market participants. According to estimates, energy margin calls could total $1.5tn."

Whether banks will be in a position to meet that demand largely depends on the profile of the commodity trader, industry insiders suggest.

The largest traders – those with significant portfolios and strong balance sheets – have already taken advantage of **constrained lending** (https://www.gtreview.com/news/global/inside-the-commodity-finance-flight-to-quality/) to smaller players "to increase their margins considerably", McKinsey says.

Jean-François Lambert, founder and managing partner of Lambert Commodities, says that in Europe, that trend is likely to accelerate.

Growing support from governments – not least in Germany, whose export credit agency backed a **US$3bn loan to Trafigura** (https://www.gtreview.com/news/europe/trafigura-lands-us3bn-eca-backed-financing-to-supply-us-lng-to-germany/) in December aimed at bolstering Europe's gas grid – will prompt banks that have been cautious in recent years to **eye a return to the market** (https://www.gtreview.com/magazine/the-commodities-issue-2023/five-trends-shaping-the-commodities-market-in-2023/), he says.

"This won't deter banks from lending to commodity players," Lambert tells **GTR**. "I expect banks will take a renewed interest in commodities, because they are becoming so strategically important in Europe. What we saw with Trafigura and the German government is a very clear sign of that."

At the smaller end of the market, however, the outlook is more challenging. Increases in the cost of trade finance create "a massive challenge" for small and medium-sized traders, McKinsey notes.

"When it comes to smaller players, it is the same game as usual," Lambert says. "Large trading houses will have no problem finding whatever liquidity they require, but if you are a small commodity player there is generally very little interest in financing that."

The same phenomenon is occurring in Asia's commodity trading hubs, says Eric Chen, director of business development at trade finance platform provider GUUD Finance.

"There continues to be a lack of availability of relatively affordable or economically feasible working capital funding from banks, specifically to smaller, niche or independent commodity traders," he tells **GTR**.

"This is mainly due to the exit of specialist commodity trade finance banks from the market, which were then not replaced by new entrants into this space – either from within the Asian region or banks situated elsewhere."

Certain options remain available to smaller traders, such as trade finance arrangements secured by collateral, Chen notes. However, costs arising from managing collateral mean this option can prove prohibitively expensive.

"That results in high fixed costs and creates barriers to entry, whereas the larger traders have that bigger balance sheet so do not need to rely so much on transactionally secured financing," he says.

For some non-bank lenders, this financing gap presents an opportunity, says Peter Ryan, managing director, business development at US-based private credit provider Goba Capital.

"The boom continues for us alternative lenders," he tells **GTR**. "This is partly because when you have niche players, they might be thinly capitalised and operating in challenging markets, so everything is stacked up against them. They have knocked on all the doors but they cannot obtain financing; there is nowhere else to go."

Financing from non-bank lenders or funds typically comes at a high cost relative to the margins earned from the underlying trades. But for Ryan, price volatility means quick and reliable access to liquidity is vital.

"It is volatility that leads to those spikes in margin calls," he says. "If you're a smaller or medium-sized trader, you might wake up tomorrow morning, natural gas has moved 8% and you have a US$25mn margin call.

"You need to be able to have cash on your balance sheet urgently, and funders like us can have that money there ready to use."

This scenario presents another potential opportunity for larger traders to emerge as "financiers of last resort", McKinsey notes.

Ryan says such on-lending is also "filling the gap". "A very large trader with a multi-billion-dollar top line might have a US$2bn or US$3bn revolving credit facility for its working capital needs, with 10 or 15 banks involved," he says.

"That trader may have liquidity in excess of its immediate needs, so will on-lend that to those SMEs and secure favourable contract terms."

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