Commodity trade finance/ La vie en rose? Not quite

by Jean Francois Lambert
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Commodities are attractive again to investors. But the effects of depressed prices in 2015 are lingering.

Commodity prices and risk perception underpin commodity trade finance. Prices affect financing requirements. Risk perception is more subjective but also helps gauge the appetite for credit.

On the bright side, commodity financing was sustained in 2017, thanks to robust commodity prices, notably in the energy and metals sectors. This consolidated a trend which kicked off in 2016. Agriculture commodities prices, in contrast, continued to be depressed, due to record crops and despite pressures from an ever more challenging climate.

Overall, the Bloomberg Commodity spot index rose a mere 8% in 2017, after a sharp rise of 31% in 2016. But this trend hides some big ups and downs. To illustrate this, a cargo of 250,000 metric tons of Brent crude oil was worth slightly over US$100 million in early 2017 compared with US$55.0 million in January 2016. At the end of 2017, the cargo's value reached US$123million. Financing requirements per cargo followed the same pattern. In the metals and mining sectors, utilisations were also sustained by stronger prices: for instance, the price of cocking coal jumped 8% in 2017, while iron ore and copper rose 26%. The agriculture sector was much less conducive to financing, as soybean prices fell 2%, sugar dropped by 11% and cocoa prices were down by 30%.[1]

Agriculture commodity prices are still depressed

Risks rack up

If the utilisation level gave banks and investors some comfort, risks have had the opposite effect. A major fraud exposed banks to a potential US$400 million loss from US cocoa trader Transmar at the end of 2016, triggering a shock wave and shaking the belief that borrowing base facilities was bullet-proof, especially in North America. Many commodity bankers around the world had to revisit and revalidate their guidelines.[2]

In Asia, the troubled Noble Group, a Singapore-listed trader once seen as an emerging global trading house just a few years ago, also sent worrying signals all year. As a result, some commodity bankers[3] were kept busy restructuring and selling down their working capital and trade finance facilities.[4]

Another blow was dealt when Chad tried to challenge the validity of a US$1.0 billion prepayment, granted by global trader Glencore with several commodity banks on the country's future crude oil production, in an attempt to renegotiate the terms amid low crude oil prices.[5]

The challenging market on 2015 has weakened some players

These are isolated cases, and lenders can swiftly say they are by no means representative of overall commodity finance activities. But they highlight that if the challenging market in 2015 did not immediately harm corporate actors in the commodities sector, probably made more resilient after years of a supercycle, they have weakened some players.

This was bound to eventually translate into credit risk events. The insurance industry was hit as soon as 2015 and again in 2016. Banks were luckier, but 2017 did not end without several casualties.[6]

Commodity finance is looking robust in 2018

Burning bright

Most of the forecasts made earlier this year have been more favourable. Barring major geopolitical events, the commodity finance market will be healthy and buoyant in 2018 for these reasons:

A rosy macroeconomic outlook. The OECD estimated all 45 countries that make up 80% of world GDP were in growth mode this year, an exceptional situation. What is more, most economists are confident 2018 will be the first of the goldilocks years, meaning the world economic growth engine, sputtering since the end of the great financial crisis, is roaring again. The growth momentum is evident in China, India and in the developed economies. If global growth proves as resilient as experts suggest, many developing countries should pull ahead.

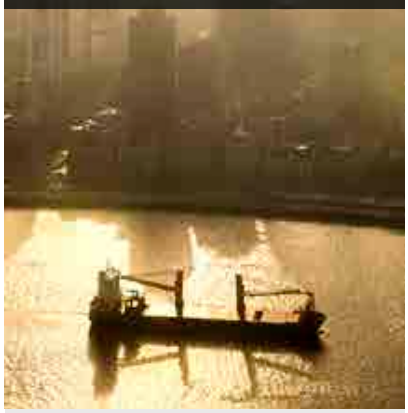
Commodities are back in fashion

In an environment of low interest rates, with inflation low and the US dollar weak, commodity demand will rise, pushing up prices. Investors are already taking a more positive view of the commodity sector and rediscovering it as an attractive asset class: investors, for instance, have made a billion-barrel bet on higher oil price as of March 2018 compared with slightly more than 300 million barrels in July 2017).[7]

But major challenges loom on the geopolitical front that could jeopardise this bullish scenario. A trade war is brewing, triggered by President Trump's decision to raise tariffs 25% on US$60 billion of Chinese exports.[8] There is still a heavy atmospheric pressure in the geopolitical landscape due to difficult talks planned between the US and China with North Korea. What is more, the US administration's cancellation of the nuclear deal with Iran could trigger more tensions in the Middle East, and provoke oil price volatility.

If the worst is avoided, a sustained strong economy would boost demand, prop up commodity prices, and increase the use of commodity trade finance facilities. Overall supply chain risks would be reduced, especially if the US dollar stays low and inflation subdued. For commodity bankers, a good scenario all around.

The most objective measure: commodity prices



Two factors underpin an activity such as Commodity Trade Finance: The absolute level of commodity prices and the perception of risk. The former provides a very practical clue of what will translate into financing requirements. The latter, more subjective but equally important dictates the overall credit appetite of lenders.

References and notes

1. Metal and agri trends calculated on average 2017 prices vs. average 2016 - source Cercle Cyclope
2. See "Impact of Transmar bankruptcy goes beyond soft commodities", Emiko Terazono, FT,Mar 2017
3. See "Decline and fall: How trading giant Noble Group came unstuck", Jon Yeomans, Telegraph Business, Feb 2018
4. See "Banks reduce loan exposure to Noble Group", Tessa Walsh and Claire Ruckin, Reuters, Jun 2017
5. See "Chad, Glencore talks to renegotiate $1 billion loan fail again", Julia Payne, Reuters, Dec 2017. Agreement was subsequently reached in Feb 2018 (See "Glencore and Chad agree to restructure terms of 'cash-for-crude' loan, David Sheppard, FT, 21 Feb 2018),
6. Noble, Transmar as discussed but also Universal Energy in Singapore, Ruchi in India to name but a few.
7. Source FT, 27 February 2018.
8. Unspecified as of 27th Mar 2018.