

# TRADE SCHOOL

Aidan Applegarth, managing director of NoesisRede, continues his analysis of the structured trade and commodity-finance market with an in-depth look at best practices.

It's official. Trade's cool. On the back of rising oil prices and apparent global demand for commodities, banks are building up for a renewed push into structured trade and commodity finance (STCF). There's hardly a player out there that isn't recruiting. Established names are reinforcing. Newcomers are gathering their resources. Others are replacing those who have moved on. Good news for the market? That depends.

There's an acknowledged shortage of seasoned professionals, which means that many newcomers will emerge from the corporate banking, structured finance or trade finance pool to fill the available gaps. A fortunate few will be trained by experienced hands but in other instances there's a real risk of the blind leading the blind. Structured trade and commodity finance is a specialist business and there are certain pre-requisites if one is to undertake it effectively and professionally. Those who accept the need to understand before being understood will at least have a head start.

I recall last year as I was about to leave ABN Amro, one of its newcomers in Latin America asked me where he could learn about commodity finance. "On the job" was the only answer I could give him. "There is no manual, training module, or seminar that adequately covers the requirements." But even on-the-job learning needs to be in the company of experienced and supportive colleagues.

#### That was then

Now there is a dedicated 'Structured Trade and Commodity Finance Practitioner's Guide'. It has been written with newcomers in mind. Drawing on market, personal and third-party experiences, it offers a rationale for the very existence of STCF, explores various solutions in terms of their appropriateness and risk, encourages inquisitive thought processes and provides practical tips across a range of relevant topics. To be practical the manual has been prepared in modular form for ring-bind folders, so that it can be updated as needs dictate.

#### Synopsis

STCF has its roots in the combination of traditional trade finance and commodity finance. Initially it was the commodity banker who became the structured trade transactor, but structured trade gradually shifted away from commodity finance altogether, often to be housed in a separate division. Managers then assumed that structured trade had more in common with project finance, and began to hire people with no underlying commodity finance or even trade finance experience. Trade financiers and corporate bankers meanwhile continue to be thrust unprepared into a commodity finance role. The consequence of this evolution is a core of players who have little or no grounding in the basics of their discipline and who therefore can only continue to do what they know. They may then be doing things right, but are not necessarily doing the right things.

The guide therefore seeks to bridge the gap for those practitioners that have not had the benefit of a commodities or trade background, and to serve as a refresher for those that have. It goes back to the roots of the business, provides a checklist for assessing transactions, reviews legal aspects of collateral and insurance, offers practical case-studies and suggests some proven structures to be applied.

#### Part 1 – The Basics

- Commodities, a brief definition
- Regulation of markets
- The transaction chain
- The role for banks
- Bank products
- Collateral guide
- Legal aspects of collateral

- ❑ Commodity client analysis
- ❑ The futures market

#### Part 2 – The Application

- ❑ Transactional analysis
- ❑ Risk management
- ❑ Sample deal structures

To conclude, a guide to selling STCF internally is offered. When competing for capital resources or simply for survival, conveying the true impact of a properly managed STCF portfolio is imperative.

#### Food for thought

One of the toughest hurdles any STCF practitioner faces is to get credit approval. In the article 'Risky Business', which appeared in *TFR's* July/August 2005 issue, page 55, we learnt that a frequent complaint by credit managers is that the proposers of requests rarely address 'the good, the bad and the ugly' in their analysis. On the other hand, we learnt that proposers are frequently frustrated by credit's focus on historic balance sheets and P&Ls when the risk is in current and future performance. Conflict abounds.

This needs to change. Proposers must add specialist value to the financial and operational risk in their analysis while credit managers should focus on the financial aspects which really matter. Both sides need educating.

To provide food for thought, let me share with you an extract from an unattributed article which dates from around

1990 entitled, 'Lending in International Commercial Banking – Specialised Forms of Lending – Commodity Finance'. The author appears to come from a credit background, which makes his comments all the more poignant. The article states: "Many specialist commodity bankers believe that financial analysis is a waste of time, and that what matters is their knowledge of the workings

fiscally unsound betrays an unsound management. It should certainly ring a few alarm bells...and taking security isn't the answer. Never lend secured to anyone you wouldn't wish to lend to unsecured. Why not? Because a good security won't make a bad borrower any better...but that's another issue. The point is there is merit in the notion. However, by extension the

**"Never lend secured to anyone you wouldn't wish to lend to unsecured."**

of the commodity market and the techniques of financing and security. While not wholly accepting this viewpoint, credit men can agree that the emphasis of the analysis has to be rather different. It remains true, however, that if a company is sound, it will pay its debts whether they are secured or unsecured. Factors making it unsound may well also undermine the value of the security and could, in at least some cases, be pinpointed by analysis."

The same article goes on to add: "...as with other specialised types of finance, lending to commodity companies undoubtedly requires knowledge of the way the industry works and of the lending techniques. A banker skilled in lending to manufacturing industry cannot pick up that knowledge and technique in a few weeks. But here, too, the danger exists that skilled commodity lenders will think that the industry is so special that general principles of lending do not apply to them, and that controls and information requirements applied to the rest of the bank's business are irrelevant".

Certainly there was a time when the gap between the commodity banker's viewpoint and the credit manager's was wider than it is today. Experience has narrowed it down, but – according to market feedback – there is still apparently some way to go before both sides see eye to eye. For commodity bankers, let's start with the premise that balance sheets do have value.

The notion expressed by the first extract is that a company which appears to be

suggestion that a fiscally sound company underlines a sound management has already been rebutted over the years by several notable failures, each of which provided satisfactory audited financials but resorted to fraud or deception when the going got tough. What can we learn from this? That financial analysis is only a part of the overall risk assessment and unless it's put in context, it's of limited value.

Not so long ago, I faced a situation where a key client was put on watch-list because its latest results were down on the previous year, which alarmed some parties. On digging deeper, I was able to relate the financials to the previous eight consecutive years and to demonstrate that the prior year had been exceptional for a number of the client's commodities. The decline was relative to that exceptional year but was otherwise a healthy growth on the year before that, which in turn was a healthy growth on its preceding year, and so on. In the event, we ended up committing to a larger exposure based upon the company's proven expertise and consistently sound fiscal management.

#### Financial analysis for commodity companies

The module on commodity client analysis in the practitioner's guide ensures that the proposer need never be lost for something of value to comment upon, and addressing a checklist means that the essentials will be covered. It's a win:win – commodity finance's professionalism adds value to

**Banks are building up for a renewed push into STCF, says Applegarth**



credit, while credit's better appreciation of what's behind the numbers reduces the likelihood of bounce-back and makes for a more reasoned decision.

So where do we begin? Firstly, it's worth reminding ourselves why traditional financial analysis is inappropriate. The unattributed article puts it well: "Commodity trading and dealing companies are highly specialised, with balance sheet and earnings profiles very different to manufacturing, retailing or service companies... Both debtors and stocks normally turn over very quickly; this and the self-liquidating nature of their transactions enables them to borrow up to five or six times their capital... the profit margin on each transaction is small. To earn a sound return on capital thus requires a high volume of transactions, which, in turn, requires borrowing.

"The result is a company with very liquid assets but a very low current ratio and a tiny cash flow in relation to debt. This is one case where liquidation of assets in the normal course of business, not cash flow, is the expected source of debt service... new assets are constantly purchased with new debt, so that total assets and liabilities may be substantially unchanged – when business is slack, both sides of the balance sheet contract sharply, and later expand just as quickly. The balance sheets of many commodity companies gyrate in a way which would be most alarming in a manufacturing company."

Okay, so times have changed a bit, and our trader/dealer is more likely to be adding value along the chain, but relative to a core manufacturing/processing or retailing business, the comparative principle expressed is still relevant.

Of particular importance is an understanding of the trader/dealer differentiation. A trader buys commodities against firm orders, thereby avoiding price risk (provided neither his buyer nor seller defaults). A dealer buys and sells usually for his own account both physical commodities and forward contracts, frequently taking long or short positions in anticipation of price movements. Sometimes the client may be both trader and dealer.

This differentiation has a bearing on risk but cannot be easily assessed by balance-

sheet analysis alone. Further insight is therefore required of the aims of the company, the quality and competence of its management, and the tools at their disposal to monitor and control price, market and counterparty risk. The balance sheet and P&L should however provide clues: large stocks for a company which claims not to take positions need explaining, as does a marked increase in either stocks or debtors combined with an apparent slowdown in turnover – which may indicate unsuccessful positions or potential bad debts. The crux is not to provide an 'elevator analysis' of the numbers ("this went up, that went down") but to apply knowledge of the market and competitive environment to put the numbers in their appropriate context.

Below then are a few pointers to consider when looking at commodity-client financials.

#### The balance sheet

Commodity companies are able to manipulate their balance sheets in such a way as to distort the true picture: at reporting date, some may sell stock only to buy it back a few days later, thereby reducing what may otherwise be seen as an over-trading stock position; others may undertake transactions which disguise borrowings as trade items, thereby distorting the actual debt position.

The timing of the company's reporting date in relation to its main commodity cycle is also important, since a different picture will be seen in the middle of the cycle than at the end (eg, if a cocoa trader takes 31

December as his reporting date, he may then show high stocks, low trade debtors and high borrowings. By the end of June, however, the stocks will have become reduced, trade debtors will be higher, borrowings should be getting repaid and there may even be some cash available).

Balance-sheet analysis cannot therefore be done properly without making enquiry about the business. It's pivotal to understand what's behind the numbers (pre-sold versus hedged stocks, quality of receivables, cyclicity of markets, level and nature of financings, risk exposure relative to capital, etc). With commodity companies the financial analysis is not so much to show creditworthiness as to expose vulnerability.

#### Income statement (profit & loss account)

Commodity companies invariably show volatile earnings. The actual result for a particular year is therefore not so important as seeing a trend. What is reported matters less than how it was achieved.

Turnover needs to be defined. It can be overstated or misleading where a company sells a commodity, buys it back, then sells it again, or where a commodity has moved around within a group. For this reason, many companies do not report a turnover figure, but start at gross trading profit/(loss).

Where possible, the banker should find out if any losses could have been avoided (was it bad debt, poor trading, speculation or just bad luck?). Any abnormal profits should also be explained: they might have arisen through speculation (backing a hunch rather than a calculated trading position) and therefore would be cause for concern.

When coming to the bottom line, the nature of the company should be taken into consideration. A public company having a duty to outside shareholders would normally look to produce steadily

**“Not so long ago, I faced a situation where a key client was put on watch-list because its latest results were down on the previous year, which alarmed some parties.”**

increasing profits over the years. The size of the profits would be just enough to encourage investment and to retain bank support. A private company, however, is usually owned by its management and senior traders, and their interest is to reduce the amount of tax payable: accordingly,

profits tend to be small, and sometimes losses are carried to obtain tax relief. What you won't see though is any hidden reserve (a profit in the forward book between the current physical price of a commodity and the price at which the company has entered into futures transactions which are not yet due). Under prudent accounting, losses tend to be provided for upfront but profits are only accounted for when realised. Though voluntary disclosure has improved, this profit is often hidden since it does not appear in the balance sheet or income statement and any notes may be sketchy at best.

### Ratios

A ratio in itself is meaningless. Understanding what lies behind it is important as is seeing a trend.

The ratios considered relevant to analysis of a commodity company are as follows:

Liquidity (Current ratio)  $\frac{\text{Current assets}}{\text{Current liabilities}}$

This is important in indicating the ability of the company to meet debt service, absorb losses and provide for unexpected expenditure in the normal course of business (eg, variation margin calls). A ratio less than one requires close inspection.

The ratio's shortcomings are the absence of a market benchmark and the fact that the nature of stock and receivables will have a material bearing upon effective liquidity. A high liquidity ratio may also be indicative of inefficient management, which is not making the best use of the company's assets.

Quick (Acid test)  $\frac{\text{Current assets} - \text{Stock}}{\text{Current liabilities}}$

This ratio recognises the weakness of stock as a current asset – in a forced sale it is difficult to determine its true valuation.

Again there is no standard against which to benchmark and the ratio does little more than highlight the reliance a company places on stock to meet current liabilities. An assessment of the quality of stock (saleability, deliverability, market price) is needed to justify its inclusion as a reliable liquidity item. If reliance falls instead on trade debtors, their quality and credit terms need investigation.

Working Capital  $\text{Current assets} - \text{Current liabilities}$

Commodity company activities are usually self-liquidating, generating cash (via profit), which is recycled within the business as a means towards further purchases or as a source of debt repayment. This is working capital. As long as business continues normally, working capital is generated. However, in difficult trading conditions a company may show no working capital or even a negative outflow. Such instances require enquiry.

Leverage  $\frac{\text{Total liabilities} - \text{Net worth}}{\text{Net worth}}$

Leverage is an indication of capital sufficiency or the extent to which a company relies on borrowed funds together with other forms of credit – including trade credit – and the scope it has for raising further funds. Leverage is more relevant than 'gearing', which ignores trade creditors.

There is no rule as to how much leverage is good or bad. It may be argued that the higher the leverage, the better the use of available resources. On the other hand, leverage indicates borrowings, and borrowings have to be repaid, so a high leverage presents a company with a high repayment bill – can it be met (is there adequate current liquidity, are there consistent profits)?

Commodity companies are renowned for their high leverage but the figure itself is not as important as the nature of the liabilities: an apparent high leverage may be caused by heavy trade creditors, but if these are matched on the assets side by quality trade debtors, the cause for concern is reduced. If the trend for an individual company shows increasing leverage over a number of years, an explanation should be required.

The STCF market has become visibly fragmented. Even practitioners have a diverse understanding and approach to it, as new institutions and new people have brought their practices to mix with the established view. Nothing wrong with that. New ideas are welcome and to be encouraged. However, when so-called innovation is merely repackaging an old offering – though doubtless new to those promoting it – the market begins to get trapped in its own 'Groundhog Day'.

I therefore hope that by making the guide available, we will move towards a more uniform understanding; that it will both educate and stimulate the user to be better equipped for constructive challenge and to set a standard for genuine innovation in the future. Anyone interested in obtaining a copy should please e-mail [aidan@noesisrede.com](mailto:aidan@noesisrede.com) □

Please send all news releases to the TFR editor on:  
[mmartensen@ark-group.com](mailto:mmartensen@ark-group.com)