Are Commodity Trading Firms Worth the Lending and Investment Risk?

Rocked with increased scrutiny, escalating regulation and a barrage of fines and penalties, the commodity trading industry has seen a huge transition from its heyday in early-2007 when it was raking in trillions of dollars to present day, in which firms face devalued commodity values coupled with penalty pay outs worth billions of dollars.

The trend has been widespread, from America to Asia, there's no lack of companies that have been under the limelight for scandals in the commodities sector, be it the Enron collapse, the investigation into Qingdao Ports and most recently, accounting manipulation allegations against Noble Group.

As investors and/or lenders, this is the critical time to assess the credit quality of commodity trading firms, to find out what to buy and when to exit.

From price fixing, accounting irregularities and sometimes outright fraud, commodities traders have drawn a great deal of attention, and not only from local financial regulators, but from global organisations as well. Last year, Mukhisa Kituyi, secretary-general of the United Nations Conference on Trade and Development, accused the industry of "corruption and illicit financial flows" and "large-scale trade mispricing" in developing countries.[1]

As well as levying large fines, these stringent regulations and increasing efforts in enforcement have no doubt imposed large reputational risk to commodity traders. All in all, recent events in the market have caused banks and firms to reassess how they continue with their commodity trading and commodity financing businesses. With pressures coming in from all directions, many of the world's largest banks have scaled down their commodity trading business recently, whilst some have exited the business altogether (e.g. Deutsche Bank, Barclays).

Moreover, with commodity traders facing diminished margins as a result of fierce competition and depressed commodity values

[1] http://www.economist.com/news/finance-and-economics/21615620-commodity-trading-houses-are-growingand-running-more-risks-end-end-game

— collectively commodities fell by 32% in 2015[2] and are currently at their lowest point since March 2009[3] — stakeholders have been left questioning whether the lending or investment proposition in the market is worth all the risk.

The Economics of Commodity Trading Companies

Commodity trading is of one of the world's oldest businesses. The model is simple: seeking arbitrage opportunities between a location with ample demand and another with abundance of supply. However, in recent decades the industry has grown substantially in scope and scale.

Commodity trading firms have expanded their services, starting as simple middlemen responsible for furnishing trades, to taking on the extraction, processing, shipping and refining of commodities. As articulated by Professor Craig Pirrong, "Commodity trading firms are all essentially in the business of transforming commodities in space (logistics), in time (storage), and in form (processing). Their basic function is to perform physical "arbitrages" which enhance value through these various transformations."[4]

With differing scopes and services and varying product portfolios, the risk profile of each commodity trading firm varies significantly from one another. Furthermore, with large capital requirements in place, the difference in capital structure adopted by each company makes the nature of each investment even more unique. At the outset, it is therefore advisable to invest extra time to conduct in-depth analysis at company level prior to making an investment or lending decision. And continual credit monitoring will enable an investor or lender to understand changes in risk and allow them to safeguard their exposure.

Understanding a Company's Unique Risk Exposure Before Investment/Divestment

Since 2011, the prices of all key commodities have continued to plummet. The price index of precious materials, energy, metal and minerals and agricultural goods have depreciated by as much as 30% from its peak in 2010. Commodity trading companies have had to come to terms with vanishing margins.

The difficulties are compounded for publicly-listed companies as their operating results are scrutinised by creditors, investors and activist shareholders on a quarterly basis. Just ask Noble Group. Material movements in market capitalisation can trigger a reduction of credit facilities. During this critical time, liquidity is the most precious commodity to hold on to. As a result, it is a juggling act for commodity firms to manage their operations through a pricing crisis whilst also managing the expectations of their lenders and investors.

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Understand the Company's Business Model

First and foremost, understand the company's business model. It is crucial not only to understand how profit and cash are generated to help assess business risk, but also to pay close attention to how returns will be received (whether via repayment of debt or through dividends).

Let Past Scandals Guide You to a Successful Investment

It is interesting to see that history — and in particular disastrous events — have a way of repeating itself, even if the reasons for the past failures were well-publicised. We have included in this article two (very different) case studies that exhibit the risk of investing in and lending to commodity trading businesses — Qingdao Ports and Noble Group Limited.

The Qingdao Ports Probe

What actually happened?

Singaporean national, Chen Ji Hong, was the Chairman of Decheng Mining Limited, a Qingdao-based metals trading company with subsidiaries in Singapore and the People's Republic of China ("PRC"). Its wholly-owned subsidiary, Dezheng Resources Holdings allegedly produced multiple warehouse receipts for its cargo of commodities, and on-sold such cargo on a landed basis to other commodity traders/banks or used them as collateral in trade finance facilities drawn by fellow subsidiaries.

The subject commodities were stored in various bonded warehouses in Qingdao Port, PRC. After the discovery of fake warehouse receipts in June 2014, the Chinese authorities ordered a complete shutdown of relevant warehouses at the Qingdao Port.

Several banks and traders filed lawsuits against trading firms under the Decheng Group.

What were the consequences?

The *Wall Street Journal* reported that foreign banks and commodities firms might face potential losses of close to US$1 billion, while the estimated exposure for Chinese banks stretches into the billions of dollars citing relevant court filings, public statements by the banks and estimates from analysts.

The incident in Qingdao has brought up complex legal issues surrounding criminal charges against the warehouse operators and officials of the Port, who may be found guilty of issuing fake documents.

[2] http://www.forbes.com/sites/peterpham/2016/01/18/is-2016-the-year-for-sweet-commodities/#14c54ba5537f
[3] http://www.forbes.com/sites/greatspeculations/2015/11/02/why-the-bear-market-in-commodities-may-be-ending/#358525065aa5
[4] *The Economics of Commodity Trading Firms* by Craig Pirrong, Professor of Finance from the University of Houston

Shareholder Activism Sparks Controversy for a Singapore Commodities Trading House

Noble Group (listed on Singapore Stock Exchange)

What actually happened?

In early 2015, Iceberg Research and GMT Research published equity analyst reports raising concerns about the veracity of the audited accounts of Noble Group for the year ended 31 December 2014.

The two reports cited the divergence of Noble's accounting profits and operating cash flow generation over the past five years. Analysts from both houses raised concerns about various accounting policies adopted by the company that may have inflated the true value of its equity.

The share price of Noble Group fell by 70% in three months, from SGD$1.46 per share in June 2015 to SGD$0.41 in August 2015, despite considerable efforts by the company to defend themselves (including engagement of a Big Four accounting firm to review the accounts which were audited by another Big Four accounting firm).

What were the issues raised by the analysts?

The two analyst reports shared the common concerns, which were the divergence of operating cash flow from accounting profits and capitalising of unrealised profits reported as net fair value gains.

As of 31 December 2014, Noble Group reported the total value of net fair value gains on commodity contracts at US$7,380 million, which accounted for 37.3% of its total assets. The net fair value gain was 1.45 times the value of its equity, of US$5,063 million. Without this re-valuation, the equity of Noble would have become negative.

The other critical issue raised by the analysts was Noble Group's valuation of its investment in Yancoal, an unprofitable mining company listed on the Australian Securities Exchange. Noble Group based its valuation on a discounted cash flow model rather than the net asset value or market capitalisation of Yancoal.

In the audited accounts as of 31 December 2014, the book value of Noble Group's investment in 13.17% of Yancoal's share capital was US$322 million; compared to a value of US$25 million based on the net asset value of Yancoal and US$16.6 million in market capitalisation calculated from the closing share price as of 31 December 2014. The impairment charge of US$200 million recognised in 2014 was certainly not sufficient for the value lost in the Yancoal investment.

Glencore and Archer Midland Daniels invest heavily in their asset base, whereas Trafigura, Bunge and Noble Group accelerate returns through leverage. A few leading commodity trading firms earn exceptional returns from trading in war zone countries (e.g. Iraq), exploiting or taking control of supply sources in certain emerging markets where regulations have not been fully developed or enforcement efforts are not effective. Under these circumstances, the lenders/investors have to take into account the political and compliance risks, among other risks, of the subject firm (particularly in relation to regulations imposed by the UK Bribery Act and the Foreign Corrupt Practice Act).

Assess the Market Value of Key Assets

The key asset of commodity trading companies is obviously the relevant underlying commodity. However, the value of the same commodity can vary significantly depending on the accounting policies adopted by the company. The accounting value of inventory or fixed assets as reported on a balance sheet is a result of various factors, both from objective (buying/selling, marked to market) and subjective sources (impairment assessment, valuation model). As such, it is important for an investor to review the accounting policies of a company and validate the reported value of a commodity with the value of similar assets.

When a company states it adopted a fair value method, it is better to check whose fair value it uses.

Assess the Value of Total and Possible Liabilities

Several commodity trading companies own and operate tangible assets such as coal mines, oil and gas refinery facilities. These companies are exposed to product/disaster liabilities in the same way as companies operating in the mining and petroleum sectors. Reviews of insurance coverage, provisional policies as well as investigations into ongoing legal proceedings are a good place to start for any investor. Such action could have prevented investors from proceeding with transactions with - leading independent commodity trading and logistics house - Trafigura (or could now stall and prevent future transactions). The firm paid US$198 million to the Ivorian Government in 2007 as settlement for the allegation that a vessel chartered by Trafigura released toxic waste at the Port of Abidjan in the Côte d'Ivoire.

Gauge the Sustainability of Revenue, Profit and Cash Flow

A review of the composition of revenue can give a good sense for vulnerability as well as sustainability. In the past, the focus of a review was only on timing of recognition and concentration risk of certain products, customers or segments. In recent years, the scope has expanded to include origin and recognition philosophy. Multiple accounting schemes have been created (not only within the commodity trading sector), which enables the manager to include items not previously classified as revenue.

One easy manipulation is how a company classifies their financial investment. The generally accepted accounting policies allow companies to choose from three different standards to record their investment in financial securities, be it for trading purposes, available for sale or held to maturity. Each group is subject to different accounting standards for value recognition and adjustment as market prices move. Gains and losses of trading securities hit the income statement straight away, while those commodity assets available for sale bypass the income statement and show up as a special adjustment of equity value, and then there is nothing to report for assets held as a maturity investment. It's all decided by management.

At the end of the day, accounting and profit are merely a medium to report a company's journey; it is cash flow that indicates where a company is in terms of destination. If cash flow and profit do not align, it's likely that part of the story has been hidden or not revealed. It is important to identify if the discrepancy has been caused by temporary factors or permanent ones.

Assess the Level of Corporate Governance, Internal Controls and Compliance

As an investor in a publicly-listed company, it is not easy to fully assess the quality of a company's corporate governance and internal controls. However if you read between the lines, a company leaves a trace almost everywhere. A few places to look include the composition of their board of directors, the level of information provided in the annual report and circulars, the company's interaction with security analysts and stakeholders, and its interaction with regulators.

Reports by auditors or credit ratings agencies are all well and good, but they are not produced specifically for the investment you have made or are about to make. These reports do not take into account jurisdiction, the difficulty of asset realisation, priority of claims or tax implications. As such, audited reports and rating agency updates should not be used to replace due diligence and credit monitoring.

Do Not Overlook the Importance of Credit Review and Due Diligence

For an investor with larger exposure, it is advisable to invest time and resources for due diligence and credit review/monitoring. Make time to visit the site, see certain original documents, talk to key suppliers or customers, meet with management and understand their internal control procedures. There are numerous independent providers that offer these services along with comprehensive investigative due diligence. Time invested in these preventive measures goes a long way.

Most importantly, stay close to the investment. Information from newspaper headlines and public disclosures only tell a part of the story. It is best to maintain a dialogue with the portfolio company. If you do not communicate during the good times, what are the chances to open a dialogue when a company is in crisis? The sooner you find out about the challenges, the easier it is to resolve them. It is vital to have direct access to the right people with up-to-date financial information. So once the investment is made, stay close and you will stay relevant.

How Can We Help?

FTI Consulting has acted as a trusted advisor to companies and investors for more than 30 years. Our experts assist clients in all phases of an investment lifecycle, from pre-transaction due diligence and investor relations, to portfolio performance management and value creation.

Our team members have extensive experience in financial and operational due diligence, restructuring and turnaround, corporate recovery and forensic and litigation consulting. We recognise that the needs of stakeholders are paramount when dealing with critical decisions, and aim to utilise our experience, skills and contacts to achieve the best outcomes.

We are accustomed to helping our clients make critical decisions in challenging situations so that they can maximise the value of their investment. For more information, please contact *Chariya Poopisit*.

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