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Managing uncertainty

A perspective to help commodities' buyers dealing with market volatility

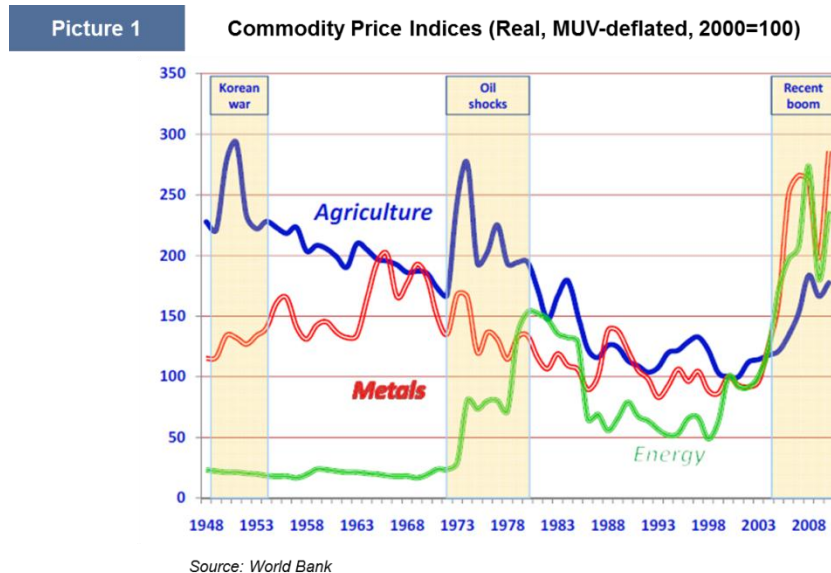
By Fabrice Saporito, CEO, Sievo



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With the financial crisis came record volatility for commodities that have ridden one of the most extraordinary rollercoasters ever recorded. Commodity prices have been swinging by a factor of up to 2.2x if you consider pre-crisis levels as baseline. Those price swings should be put in contrast with nearly three decades of low and declining commodity prices all the way to the mid-2000s.



Armed with crystal balls, economists are developing complex models to establish their own positions around the phenomena and often time with the objective to answer to the Euro 1 Bn question: “where do you think oil is going?”. Many have attempted to answer the question and often than not have failed to provide the answer. According to recent literature only Mr. Murti with Goldman Sachs was able to predict the oil spurge over USD 100 / barrel a few years ago.

The reality is that even macro-economic indicators that used to be the reliable yardstick for predicting trends fail to provide a guide for establishing positions on the commodities markets. And unless one possesses the skills of financial guru and the gift of the magician, predicting the commodities markets as a day to day buyer of chemicals, steel or other commodities is close to mission impossible.

And whilst predicting the answer is a big gamble that might cost a buyer’s shirts, the question will remain and will come again and again to haunt commodities buyers until management finds a satisfactory response to the dilemma. So is there an answer? I don’t know quite frankly. What I do know is that the question is wrong.

The alternative question

In my view the question is not so much “where do you think the price of the commodity is going?” but rather “how can we better manage volatility in the market?”. It is indeed about dealing with uncertainty rather than attempting to predict what will happen in the future. And if one agrees with the basic principle of inability to antic-

ipate the future when so many unpredictable forces are at play, I would highly encourage purchasing organizations to gear their capabilities to manage such uncertainty.

So in the end, you may not need the most talented commodity analysts, but rather a number of smart people, a mix of finance, engineering and commercially literate set of individuals to help you dealing with the issue. And I would like to offer you a starter kit in the form of three basic strategies that you should feel at ease using and that you may wish to evolve as you gain confidence and experience.

The first strategy is the “Financial Hedge” which aims at using a number of financial instruments to deal with uncertainty. The second strategy is called “Structured Pricing” and it looks at unconventional pricing related approaches to limit overall volatility. The third and final strategy I offer is the “Time Lag” that essentially buys time and aims at limiting the surprise effect inherent to commodities markets.

These strategies have been implemented by many large and mid-size corporations. They are not exhaustive nor mutually exclusive and should be complemented by a number of tactics and operational considerations to optimize your company’s exposure.

Financial Hedge

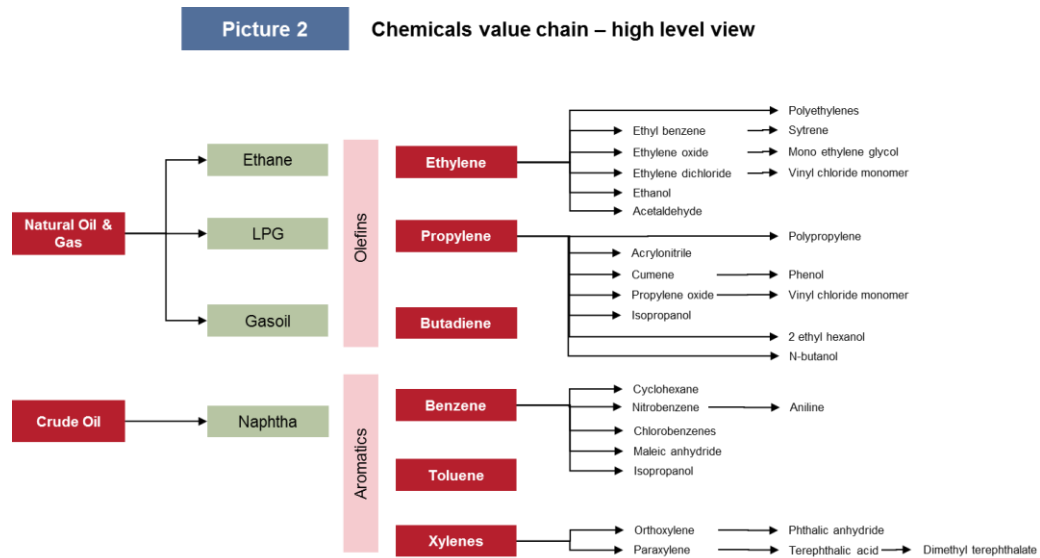
Financial hedging is one of the most technically advanced approaches to manage risks. In our case the Financial Hedge strategy refers to managing risks related to prices of commodities to be purchased that might move against you.

Like in any other financial risk management strategies, financial hedge involves the buying and selling of futures contracts that represent an agreement to buy or sell a quantity of a specific commodity for delivery on a fixed future date at a price agreed today. The idea behind the futures contract is to lock-in a price for a specific purchase quantity because the prices on this forward market appear to be attractive compared to the belief the buyer may have on the price development of that very specific commodity.

In practice what the purchasing organization buys is an option at a certain premium that he can exercise at a point of time assuming that the delta between market price (or the price the buying organization would have negotiated otherwise), and the price in the futures contract plus premium (i.e. the cost of the future) is to his advantage. If yes, the purchasing organization will benefit from such a transaction in exercising the future and will then take delivery of the goods. If not, the purchasing organization will likely not exercise the futures contract and will have to address its physical needs in an alternative fashion. In that case it would have lost the premium.

Structured Pricing

Many commodities purchased are in essence derivatives of main raw materials. From oil and gas one can count a multitude of different products that can be bought on the spot or contract markets (see picture below)



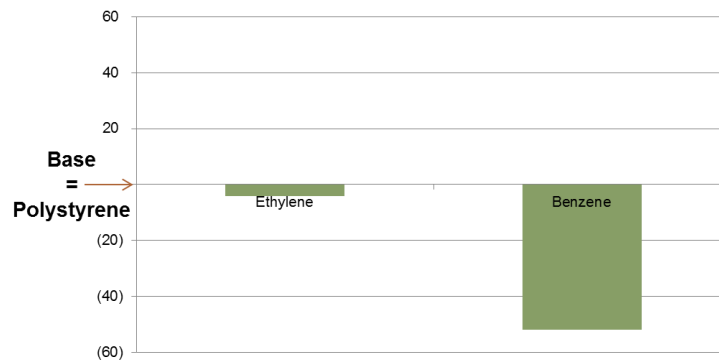
Source: Literature search , Sievo analysis

Many of these products have their own markets and can be traced on ICIS, Platts and other marketplaces that offer a mechanism to price them, but technically they are all converted from oil through specific processes. This would suggest that these products should follow the same market dynamics and have similar volatilities at the difference of their processing costs. However taking a closer look at them offers a fundamentally different picture.

Polystyrene is for instance a very interesting commodity to observe. It is produced out of Ethylene (30%), Benzene (80%) (note that some does not equal to zero due to yield loss) and some add-ons that are processed together to produce Polystyrene. But if you look at the volatility of Polystyrene itself and its raw materials you will observe significant differences and that the standard deviations surprisingly do not add up (see picture below) making Polystyrene a much more volatile chemical than its materials.

Picture 3

5 years normalized standard deviation of Polystyrene market price vs. underlying chemicals components



Source: Literature search , Sievo analysis

Such an observation has led to major changes in the way some of these commodities are being purchased. Leading buying organizations have become increasingly reluctant to pricing directly linked to the commodity market in question and have instead introduced structured pricing linked to the underlying raw materials of the commodity being purchased. By developing pricing formulas that are more closely related to the process itself as opposed to more superficial market mechanisms they have helped their companies to benefit from reduced volatility.

Implementing such strategy is not without challenges. One will have to deal with vertically integrated giants or simply powerful suppliers that are very reluctant to change their current pricing with more complex structures where the fear of losing is much greater than the actual benefits both will get. Indeed buyers need often be ready to pay a slight premium for pricing stability and reduced anxiety within their organization.

Time Lag

I started this Thought by stating that predicting market prices has more to do with the divine than with sciences and therefore managing uncertainty is more advisable than hiring a bunch of mathematicians that would spend their time trying to predict the unknown. With this third strategy I would like to propose a practice that requires little to make a real difference.

The Time Lag strategy is in fact nothing more than postponing the application of a price that is determined by the market. In plain and simple term if I buy a product priced within a particular index I will agree with the supplier to postpone the application of this price sufficiently far out in the future.

In doing so I suddenly possess the ability to “predict the future”, model the impact of market fluctuation into my EBIT margin and therefore take appropriate actions throughout the organization and communicate with confidence towards the investors’ community.

Such strategy is fairly simple to put in place and buyers generally face little resistance from suppliers. It often reinforces supplier relationships and provides benefits to the suppliers driven by the irrational buyer's fear of having to "settle the account" which in the end prolongs the duration of such deals.

Implementing the Time Lag strategy should not be viewed as an end in itself as it does not fully address the issue of procurement performance against market fluctuations but rather pushes the issue away from purchasing (e.g. now that we know in advance the possible impact we will have the sales people need to do their job to increase prices to protect overall margins). We would therefore advocate complementing this strategy with the others to have comprehensive strategy towards market fluctuations.

Are you beating the market?

Strategies are built around facts and gaining insights on your actual exposure to commodities markets is an essential step in the process. Understanding the degree of exposure each category may have to your business EBIT margins and whether they somehow naturally hedge one another are key analysis needed to manage risks on a frequent basis. And whilst such analysis will help you to react faster to adverse situations, the value of your strategies will be about your evolving position versus markets. Do your strategies beat the market or are you barely trailing along?



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About the author

Fabrice Saporito is the Chief Executive Officer of Sievo, a leading Procurement Performance Management software firm. Prior joining Sievo, Fabrice was advising clients in Europe, Middle East and the United States of America on strategy and operational issues with The Boston Consulting Group and Booz & Company. Fabrice holds a Graduate from the French Grandes Ecoles and Harvard Business School. Besides "Thoughts", his writing has been published in multiple media including CPO Agenda, Strategy + Business, Executive Magazine and CEO Middle East. He can be reached at fabrice.saporito@sievo.com

About Sievo

Sievo is a leading Procurement Performance Management software firm. Established late 2003 in Helsinki, Sievo serves clients around the world and offers integrated spend analysis, planning and controlling solutions to advance procurement performance.

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