ADAPTING TO CHANGE

The continued evolution of commodity markets has necessitated the development of new risk management strategies and created demand for a more diverse pool of trading partners, says Mike LeSage, president of Cargill Risk Management

The commodities market is in the midst of the longest price slump in 25 years. In 2014 alone, commodity prices declined by about 10%. Lower grain prices are coinciding with significant weakness in energy and petroleum markets. In this type of environment, businesses seek optionality to protect margins and control costs.

Uncertainty about future commodity market developments also creates volatility. Geopolitical and macroeconomic conditions are a major influence. With 2014's slowdown in emerging markets, we have seen dramatic price fluctuations due to concerns about burdensome surpluses. In this kind of environment, agricultural organisations around the globe typically look to risk management strategies, such as hedging, to protect their businesses by managing commodity price fluctuations.

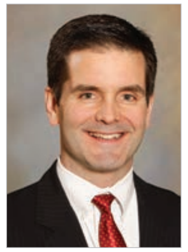
Cargill founded its risk management business unit in 1994. As a provider of customised commodity price risk solutions for customers around the world, Cargill Risk Management's customers include producers and consumers of agricultural, energy and base metal commodities, as well as institutional investors seeking exposure to these markets. In recent years, the general approach to risk management has changed among our customers due to external market developments such as financial regulation, as well as a number of events that continue to affect the demand and supply of commodities around the world. As such, many of these organisations have started to rethink their approach to risk management. They are now generally looking for more dynamic strategies that are flexible enough to meet their needs in an ever-changing commodity market environment.

Cargill believes the long-term outlook for commodities is positive, as changing demographics, income growth and the expansion of the middle class continue to create greater demand. However, risk management tools and expertise will remain in demand as businesses look to protect profits and prevent losses. There is a range of strategies available to agricultural organisations interested in hedging against price fluctuations. Cargill Risk Management works with customers to manage and hedge commodity price risk using customised solutions – these can span vanilla options, to over-the-counter (OTC) swaps, to structured products. Cargill's price risk management solutions are typically implemented through a direct financial relationship with a customer or within the supply chain to price – or re-price – the commodity as part of the physical contract.

Working together, our trading and risk management teams can gain in-depth insight into the risks that agricultural businesses face. Through Cargill's global footprint and its physical trading operations in the major agricultural markets – we trade in 15 currencies and more than 55 commodities, including grains, meat, dairy, softs, edible oils and animal feed proteins – we are able to gain a unique perspective that becomes a part of the risk management process.

Customised solutions

Cargill Risk Management has built up a solid customer base that includes corporate and industrial clients in more than 60 countries – the producers and consumers of more than 55 commodities and consumers of 15 currencies. Cargill Risk Management's customers are looking to navigate the commodity markets with varying objectives and priorities, but we can work with all of them to provide customised solutions. Farmers and ranchers, for instance, are a key market segment for Cargill Risk Management. We have seen significant growth in the use of risk management solutions among these groups to complement the physical delivery of crops to other parts of the supply chain.


Mike LeSage

Cargill Risk Management also works closely with some of the world's largest and most respected pension plans, endowments, foundations and mutual funds. Institutional investors generally allocate 3%–5% of their portfolios to commodities, for inflation protection and portfolio diversification. These groups look to diversify their portfolios and gain beta and alpha exposure to commodities. We offer such organisations access to our global footprint and fundamental trading insights, as well as expertise in OTC structuring and hedging. For example, we can create customised indexes based on fundamental analysis of micro, regional and global supply and demand, leveraging Cargill's physical insights.

New players

In the aftermath of the 2008 financial crisis, many agricultural companies started transacting with a wider range of risk management providers as some participants pulled back from certain markets, including commodities. While, in the past, many organisations typically sought risk management solutions exclusively from large banks, the market has started to open up. Cargill Risk Management, for example, can offer customers a strong alternative based on 150 years of commodity markets experience, a stable balance sheet and a reputation as one of the world's largest, privately held companies.

As a result of the post-financial crisis regulations introduced under the US Dodd-Frank Act, Cargill registered as provisional swap dealer with the US Commodity Futures Trading Commission in February 2013. Cargill Risk Management is the only authorized business unit within Cargill underwriting commodity swaps.

Although there have been additional costs to ensure compliance with these new regulations, we are committed to providing competitive products to our customers. When it comes to how we interact with customers, little has changed. Our discussions with customers and the solutions we provide continue to follow the same guiding principles that have led Cargill's business for 150 years. Our strict adherence to integrity and transparency assures our customers that we have their best interests in mind.

A holistic approach

Tighter regulation of the financial markets has contributed to the continued evolution of the structure of the agricultural trading markets in recent years. However, we have also seen substantial changes in terms of how end-user organisations approach risk management internally. Many agribusiness players are now seeking to develop a more dynamic and comprehensive approach to risk management. Our customers have become more proactive and strategic in managing their portfolio of commodity exposures versus a single commodity or currency.

Price points are impacted by a variety of factors, so simply hedging risk through futures trading or a fixed instrument will not meet all of the needs of our customers. Instead, they typically seek customised solutions that can provide greater effectiveness and efficiency. Customers are also looking to work with trusted partners to develop their risk management capabilities. In line with this attitude, Cargill Risk Management encourages a holistic approach to risk management. We take into account the value of the underlying product, energy inputs and currency exposure, because each of these factors impacts the bottom line and should be addressed when mitigating risk.

A holistic approach should begin with an assessment of the customers' needs to gain an understanding of their general level of risk and to assist in the process of creating customised solutions. We work with customers to build a hedging strategy based on the pricing period, time of shipment, exact volume, expiration and other factors that affect pricing. We then modify a structure that aligns with their risk profile.

Once a customised strategy has been established, it is vital to remain vigilant about updating it as and when market changes occur. In our view, an active hedging strategy should include diversification, discipline and control. As such, it is important to create a structure that will help customers achieve their budgetary goals. We work with our customers to achieve discipline in setting targets to defend or strengthen margins.

Cargill Risk Management can also provide tailored solutions utilising our proprietary technology platforms. Several members of Cargill Risk Management's trading technology team sit on the trading floor to better understand the needs of our trading and risk management divisions. As a result, the IT team gains insight into the technology requirements and has developed strong expertise in this area of the business.

A swap dealer's products and services should offer the necessary flexibility and control to respond in real time to market volatility and changing business dynamics. Such attributes are crucial in constantly changing commodity markets. As agricultural businesses continue to take a more proactive approach to managing commodity price risk, demand for more dynamic strategies will only continue to increase, as will the demand to work with experienced partners.