FEATURE STORY

Dealing with the Volatility of Commodities

BY MYRA THOMAS

Commodity producers face volatile market swings due to factors such as macroeconomics and supply chain stability, creating risks for secured lenders. Understanding each commodity's nuances, risk-management strategies, and regulatory considerations is crucial. To navigate these challenges, secured lenders must maintain strong industry knowledge, adapt lending structures, collaborate with third parties, and balance risk and return for their clients.

Steel, copper, aluminum, gold, and silver producers are subject to wide swings in value. Oil, lumber, paper pulp, or even fertilizer face the same sort of pricing pressures. There are implications not only for the producer of the commodity, but also the businesses servicing them, as well as the processors and the related traders. But secured lenders handling commodities are keenly aware of the volatility in this sector, creating bespoke structures and pricing to deal with the associated risks. And those risks can be many and sometimes out of the control of the client.

Macroeconomic forces and supply and demand can have an outsized impact on commodities. The stability of the supply chain and how the product is secured are major considerations for lenders too, notes Andrew Pappas, managing director, head of ABL Special Industries Group at BMO Commercial Bank. That's why it's essential for secured lenders to keep a watchful eye on the market and why many have former traders and other commodities experts on staff to help understand the risk. Pappas notes that underwriting commodities requires a more controlled approach, since the market can easily and quickly shift. "You always manage the risk by making sure you're lending to the point where you're comfortable," he says. The right appraisers, appropriate counsel, and even trusted advisors and partners abroad can help prevent and mitigate the risks inherent in commodities.

Plus, it's a constant process to learn and evolve to handle an assortment of commodities clients, including everything from metals to frozen orange juice concentrate, says Pappas. Protein commodities, such as meat and dairy, may be subject to spoilage and the related costs. "We continually educate our team, letting them know what the trends are so we can manage our risk and add value to our customers," he notes. But no matter the commodity, the volatility is something that the ABL structure has to take into account.

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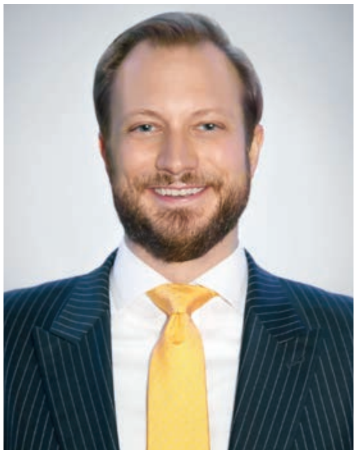

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Understanding the Nuances

Of course, the ABL structure is designed around predictability, so that there's a predictable recovery on the value of the collateral. "With commodities, it becomes more difficult to create an ABL structure that will work when there's market volatility," says Alex Sutton, managing director, head of research for Gordon Brothers' valuation practice. The volatility of commodities' pricing is something that the ABL structure has to take into account. "That's where there is a challenge," he adds. For commodities, the ABL structure also needs to be adjusted to be a percentage of market value for the commodity as opposed to the cost of the inventory.

It's also essential to understand the strategies that commodities clients employ to reduce the pricing risk of their business. Sutton notes, "It could be something as simple as locking in a price for the product that they sell to that order, so no matter what happens with the market price of the commodity, from that day forward, they lock in their margin." Others will hedge that risk, and secured lenders need to be aware of the client's own risk-management strategies.

Each commodity has different underwriting standards too. That's why it's essential to take a deep dive into how invoicing works for clients, says Douglas J. Meyer, first senior vice president, national head of specialty finance, and head of NYC Corporate Banking at Valley National Bank. "For instance, with a commodity like coffee, where there is an exchange price, there are still differentials because the quality can actually be a little bit better on a particular type of coffee bean than what the market trading it typically says," he notes. That's when field examiners and the internal underwriting team need to understand those nuances.

Even within the metals space, there are exchange-traded metals, non-exchange traded metals, and even scrap metal, and the need to create different lending structures for each, notes Meyer. It's essential to understand the flow of the commodity, and that flow will be different depending on the type of commodity, he adds. Some commodities are federally regulated in some way, which can impact the secured lender and should be accounted for in the lending structure. For example, the Perishable Agricultural Commodities Act (PACA) dictates that suppliers and sellers of agricultural products are first in line in a bankruptcy. The Packers and Stockyard Act (P&S Act) serves the same purpose, but applies to ranchers and their livestock, as well as meat and poultry products. Food safety laws and environmental concerns can also impact some commodities clients. National security and foreign policy might come into play. Plus, commodities trading is heavily regulated and can have an impact on the industry.

Preparing for the Unexpected

Often, the risks are unknown, and secured lenders must be ready to respond. The recent COVID-19 pandemic and related shutdown created havoc for many sectors, including commodities. With manufacturers and factories shut, the impact on the commodities sector was immediate. Supply chain issues added to swings in pricing. Sutton notes that secured lenders were patient with their clients. The shutdown meant on-site appraisals needed to be postponed. "There was a feeling that it was temporary and there was going to be government support," he adds.

The federal government's Paycheck Protection Program (PPP) loans saved many middle-market companies, including the weaker commodities firms. "But many of the companies were generally good performers, and they were likely going to come out of it fine," he adds. "There really weren't a lot of liquidations, even with the challenges in the economy." By and large, commodities clients weathered the proverbial storm. Given their need, demand for commodities quickly returned and prices rebounded.

Much like COVID-19, secured lenders are now responding to another unexpected risk—the war in Ukraine. According to Meredith Carter, president and CEO of Edge Capital Lending, secured lenders must be ready to respond to global conflict and other geopolitical forces at a moment's notice. Trade routes might be impacted, thus the availability and access to commodities can impact manufacturing. There are trickle-down risks that can reverberate throughout a lender's portfolio. And, Carter notes, "With the war in Ukraine, having a strong risk-analytics team can help to foresee and mitigate any problems that might arise." But she adds that "with commodities, the impact of war is not always what one might expect. There are often unintended consequences, such as the increased demand and pricing for metals as countries ramp up military production."

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Finding the Right Partners

A "one-size-fits-all approach" simply isn't on the table when it comes to commodities. Carter notes, "Lenders must also tie credit availability to the spot price and availability of the commodity." She adds that it also depends on the ubiquitousness or esoteric nature of the commodity. If secured lenders need to liquidate the collateral, they need to understand what the market would look like. That's where outside resources are essential. "We'll try to figure out the resources needed, whether it be an appraisal firm or talking to liquidators even during the diligence phase," says Carter. It's also useful for the secured lender to have boots on the ground, so to speak, especially when it comes to a volatile commodity that sits outside of a processor's jurisdiction. Well-vetted outside counsel and accounting firms are always a part of the mix when it comes to commodities, she says. That's how secured lenders can set themselves apart, as well as provide the borrower with crucial information on their own business and sector.

Meyer agrees that finding the right third parties to do some of the diligence, test third-party reports, and deal with the customs houses are essential in the process. “When it comes to commodities, you trust, but you verify,” he adds. International relationships, particularly a good corresponding banking network, are a necessity for secured lenders handling commodities clients. When it comes to due diligence, Meyer admits it’s an arduous process for commodities clients. Lenders need to understand the flows, deal with spot pricing, dissect trade routes, and so much more. Original bills of lading are key. It’s painstaking and highly manual work, he says. And, every commodity is unique.

Getting Back to Basics

The wide array of commodities and the varying risks for each does remain a challenge for asset-based lenders. Pappas notes, “We make sure our team has access to critical industry resources to make sure they better understand commodity trends and underlying market conditions impacting liquidity, which in turn allows us to serve in an advisory capacity to many of our customers.” And while commodities are, by their very nature, fungible and can be sold readily, a volatile asset does bring increased risk. Collateral underpins the financing exposure, and with commodities, the collateral is always going to be a moving target. Pappas notes that secured lenders can tweak advance rates, apply different flex covenants, and figure out how much debt to allow for one company or for one industry versus another.

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But there are some things that are universal, no matter the sector, whether it be retail or metals. As with any client, secured lenders must balance the risk with the return they are seeking to generate. Lenders need to know how quickly the inventory turns. A strong management team is critical for any client, as well as appraisals and a financing structure that makes sense. The challenge for secured lenders, as always, is continually balancing their credit risk with the needs of the borrower.

Myra Thomas is an award-winning editor and journalist with 20 years’ experience covering the banking and finance sector.