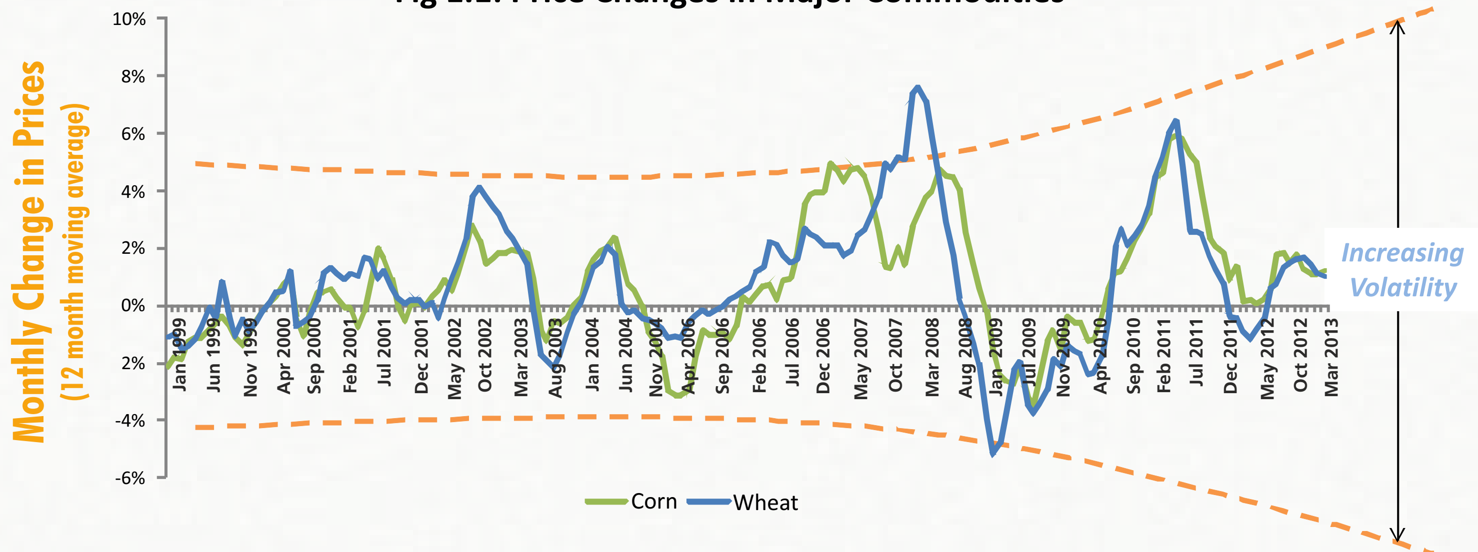
White Paper

# COMMODITY RISK MANAGEMENT

# Methods in the Madness




Some companies tend to view risk management as a budget compliance tool, whereas others view it as a means to generate savings. Regardless of the school of thought, risk management should be a key capability in an enterprise's procurement function — whether it's protecting the P&L from large unexpected cost increases or supply chain disruptions, or keeping costs in sync with budget forecasts through incremental measures.

However, effective risk management comes at a cost – building and managing a risk management team, ascertaining the level of exposures in the market, and paying a premium for the hedging products. Companies that have a sizeable spend in commodities can quantify risk management costs and justify the expense. Some of them are market movers and can partly control the prices; some companies can enter into long-term partnerships with suppliers as they are able to command a sizeable portion of the supplier's business. A few companies vertically integrate and, at times, even go to the extent of acquiring a critical supplier in a completely different industry (a case in point being Delta's acquisition of an oil supplier). Such strategies have executive backing and the raw materials are typically managed by a large commodity sourcing team, either in-house or outsourced.

Setting up a large in-house team can be a tricky situation – a dedicated risk management team may eat into margins, but its absence might expose the company to huge, potentially life-threatening losses.

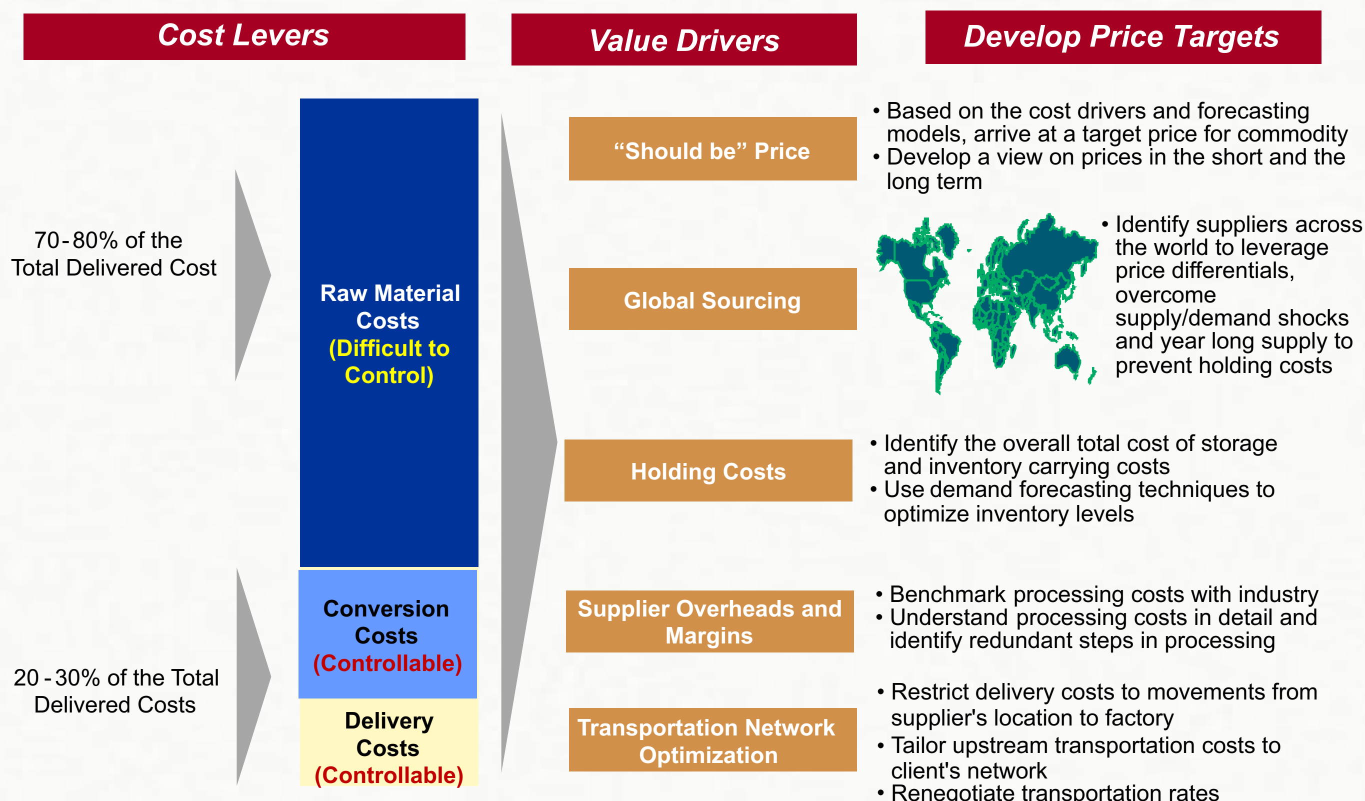
Nevertheless, there are risk levers available for procurement professionals to tide over commodity price fluctuations. The following example illustrates how GEP helped one of its clients improve margins through an effective hedging approach.

GEP was working with a food processing company that had a global presence. Canola and Palm Oil (in some regions) were used as non-core direct ingredients in the production; procurement strategies were largely localized due to the nature of requirements. Given the size of operations

# Conclusion

The nature of commodities, internal purchasing requirements and risk appetite, together dictate the nature of sourcing management. Commodity buyers should perform thorough due diligence to understand the external market dynamics and internal requirements to determine the appropriate risk management approach.

An effective commodity risk management program will prove to be a key competitive advantage for firms involved in this space. The following figure is a summary of the various sourcing value drivers available to purchasing commodity managers.




It may appear to be an unconquerable beast at the outset; however, controlling the controllable is the key to success. Since all the competitors are also subject to similar market conditions, risk management is the only way of ensuring "competitive prices".

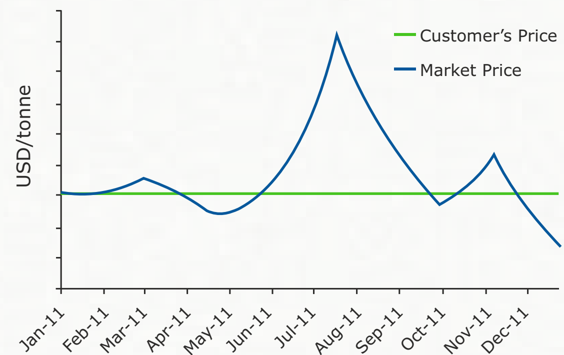
To quote Buffett again,

**"Only when the tide goes out do you discover who's been swimming naked."**

# Appendix

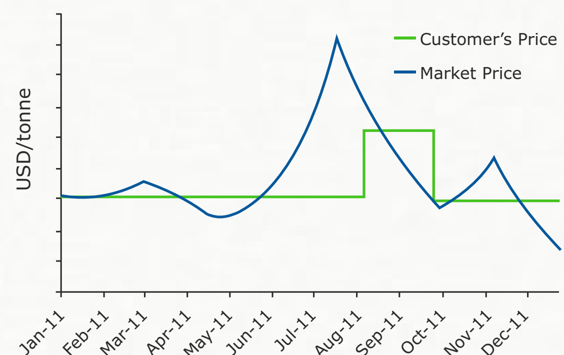
## Fixed-price hedges

| Benefits | Shortcomings |
|---|---|
| • Prices to be revisited only a few times every year<br>• Improves budgeting | • Prices at the time of purchase set prices for the year<br>• Limited opportunity to leverage volatility |



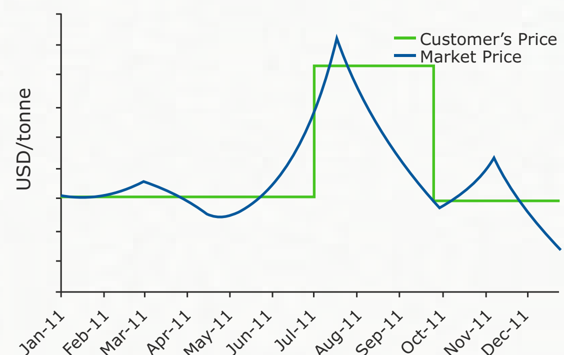

## Back-to-back purchasing

| Benefits | Shortcomings |
|---|---|
| • Leverage volatility, if markets are monitored closely | • Taking a position on the cover raises the inventory holding costs |



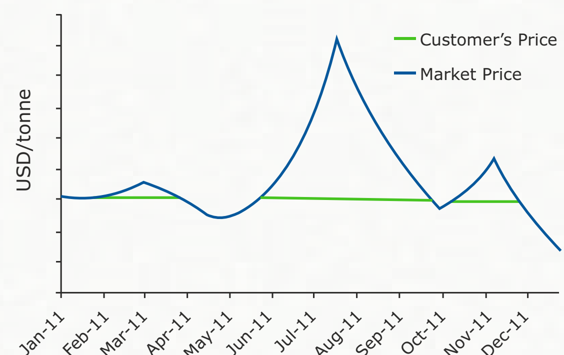

## Formula-based pricing

| Benefits | Shortcomings |
|---|---|
| • Client's prices are always in line with the market once the commodity portion is delinked | • Opportunity to "beat" the market consistently is minimal<br>• High exposure to market volatility |




## Price ceiling with an option to share gains

| Benefits | Shortcomings |
|---|---|
| • No negative market exposure once a position is taken<br>• Leverage price reductions in market | • Supplier will charge a premium for cost of the hedge instrument |



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