KPMG

Clarity on Commodities Trading

An industry under the spotlight

Results of KPMG's 2016 global survey

April 2016

Interview

Professor Craig Pirrong of the University of Houston shares his insights into the future of trading.

Forces of change

How are regulation, sustainability and macroeconomic events reshaping the trading industry?

Implications for traders

What is next?

Clarity on Commodities Trading

Glossary

- BEPS — Base Erosion and Profit Shifting
- COP 21 — United Nations Conference on Climate Change
- CRD — Capital Requirements Directives
- CTR — Corporate Tax Reform
- EMIR — European Market Infrastructure Regulation
- FinfraG/FMIA — Financial Market Infrastructure Act
- KPI — Key performance indicator
- LNG — Liquefied natural gas
- MiFID II — Markets in Financial Instruments Directive II
- OECD — Organisation for Economic Co-operation and Development
- ROI — Return on investment

The terms "commodities traders" and "traders" are used interchangeably for the purpose of this publication. All refer to commodities trading houses or to commodities trading operations of broader organizations.

Making the world go round

Richard Sharman
Global Head of Commodities Trading

Commodities make the world go round. While consensus suggests the low-price environment is here to stay, it looks like medium-term structural fundamentals will ease the worries about maintaining volumes. The shadow of China and the spotlight of regulation, however, are beginning to reduce the perception of opacity regarding this industry.

The critical nature of this industry is prompting calls for banking-style regulation. To us, this misses the mark. The industry acknowledges the need for greater transparency but requires a relevant, coordinated and less expensive approach to regulation.

In light of the importance of this sector to the global economy and its complexity we have launched the first global survey of commodities trading. In what will be an annual series, our survey seeks to give a voice to industry participants as well as improve awareness among observers. We look at key external drivers such as regulatory and macroeconomic trends and how traders and their business strategies are responding to the range of opportunities and threats.

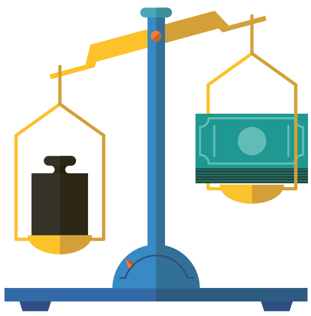
We hope you find the publication insightful, and we would be happy to discuss with you the implications of the issues raised for your own organization.

Richard J. Sharman

Richard Sharman

Global survey key findings

The trading environment

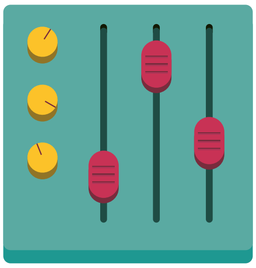


- 70 percent of respondents found low commodity prices to have a negative impact on their businesses.
- 51 percent of respondents expect commodity prices to stay at current low levels for a further one to two years with energy prices expected to increase first.
- Both low commodity prices (21 percent of responses) and the slowdown of economic growth globally (18 percent) are expected to be the biggest challenges to trading businesses over the next one to two years.
- 88 percent are experiencing "some" or "strong" pressure on trading margins. Almost one-quarter is revising their strategies as a result, and 22 percent are discontinuing certain business activities.

Financing and investments

- Restricted access to funding is affecting one-third of respondents through increased financing costs.
- 30 percent have diversified sources of financing in order to maintain sufficient access to capital.
- 25 percent see most potential to invest in upstream assets, 30 percent in midstream assets and 39 percent in downstream assets.
- North America is the region with the greatest growth potential, at one-fifth of responses.
- Most respondents said ROI on investments in the past one to two years had met or exceeded expectations. This was led by energy (72 percent) and metals (73 percent) traders. By contrast, agricultural traders generally experienced returns over the same period that were either negative or did not meet expectations.

Regulation



- 27 percent see greater regulation as the most disruptive factor in commodities trading in the longer term. This compares to 16 percent citing government interference in the free market and 15 percent saying it is the impact of policy changes on demand.
- One-third of respondents expect regulation to have a "medium" impact on existing operations. One-third meanwhile thought the impact is not yet clear.
- One in five state that complexity of regulations is the main challenge in compliance. This is followed by the increased costs of compliance.
- Expectations of what will drive the higher cost of compliance were evenly split between further use of external advisors, hiring legal and/or compliance personnel, allocating existing staff to compliance topics and additional investments in information systems.
- MiFID II leads the perceived compliance burden.

Sustainability

- More than one-quarter of respondents expect carbon emissions to impact their business most over the next one to two years; 24 percent meanwhile expect energy consumption to have the biggest effect.
- 43 percent anticipate global warming to negatively or strongly negatively affect commodities trading in the long term. 39 percent expect barely any impact.
- Global warming's impact is most felt through severe weather (38 percent), stranded assets (27 percent) and resources not being available (20 percent).
- 17 percent of respondents said their organization has a board commitment to sustainability and 12 percent stating that their firm includes sustainability in its KPIs.

Creative flexibility

Commodities traders have historically proven flexible in adapting strategies to their evolving environment. This will remain the case, with agile business models and financing being required. Financing deals will become more creative as traders use financial partners to drive maximum leverage and reduce risk while focusing on opportunities to maximize profits in operations and enter into offtake agreements.

Stability amid volatility

Despite a volatile environment driven chiefly by China's transition to a consumer-led economy, the trading industry is not expected to see any major structural change. Traders will continue to be wary about spending on any significant transformational capital investments. It is in the area of financing structures where some change will be seen, as models continue to evolve in the search for new sources of long-term capital.

Regulated disruption

Seen as the biggest long-term disruptor of the trading industry, regulation is perceived by the industry as complex, piecemeal and expensive. There is a fear that it will contribute to smaller traders being driven out of the market while large traders become even larger – creating a less competitive market. The trading industry must continue to engage with regulators to achieve more practical and globally aligned regulations.

Survival of the financially fittest

While asset-heavy traders are cutting back or postponing planned investments, firms with sufficient access to financing will naturally be better positioned to benefit from the current environment. Opportunities will present themselves for strong price negotiation and prepayment structures, although counterparty risks must be kept in mind. In this price environment, size matters.

Climate of change

Severe weather impacts, stranded assets and the unavailability of some resources are expected to be global warming's biggest impacts on the industry. Climate change regulations and laws will most likely affect commodity flows by encouraging a move towards renewable energy sources and cleaner fossil fuels such as LNG. Climate change policy amendments, while expected to have greater impact on the most vertically integrated businesses, will undoubtedly impact the whole industry.

Strategically private

Rather than going public, equity will be raised through increased use of strategic partnerships. The industry has become attractive to new sources of funds that are well suited to the entrepreneurial nature of commodities traders. Traders may find it necessary to enhance the capabilities of their treasury functions, however, to deal with more complex financial arrangements.

Dr. Craig Pirrong
Professor of Finance
University of Houston
and guest Professor
at University of Geneva

Professor Craig Pirrong, Professor of Finance at the Bauer College of Business, University of Houston, and guest Professor at the University of Geneva, shares with us his insights into current trends in the commodities trading business and where he sees the industry heading over the coming years.

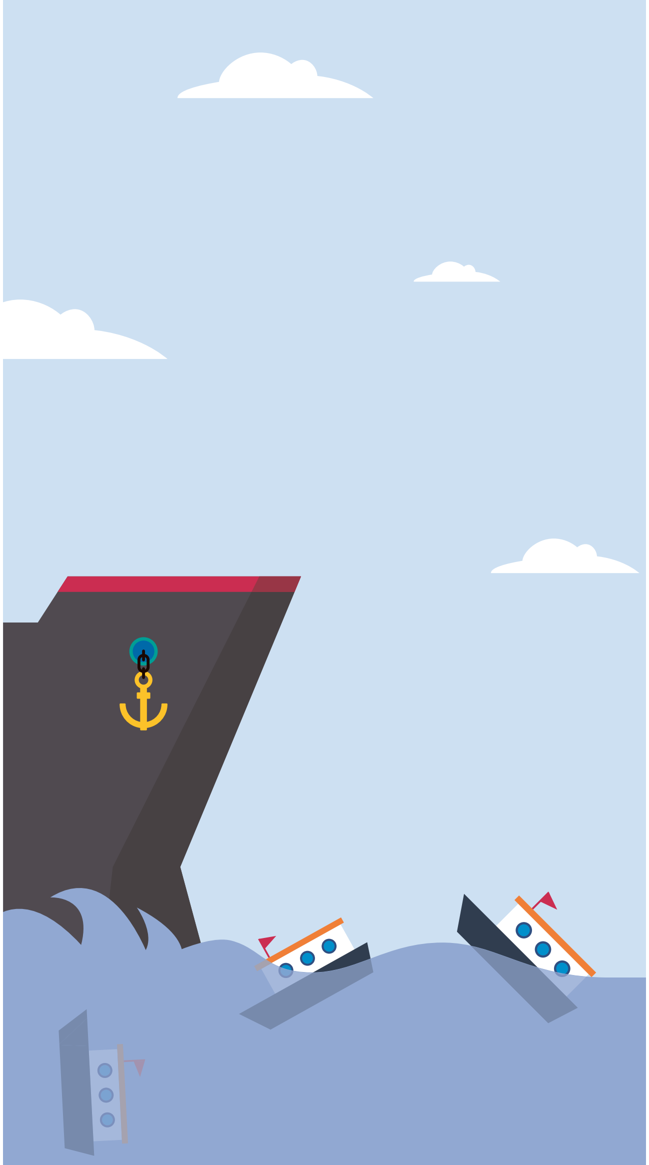
The future of commodities trading: Impacts and drivers

KPMG: Collapsing commodity prices have dominated the sector's news over the past year. Do you see the price trend as a negative or a positive?

Professor Pirrong: For businesses and end users, low prices are of course a good thing in this era of cost control – but not necessarily for commodities traders. You have to distinguish between the causes of low flat prices. Low flat prices due to high supplies are good for traders, because high supplies translate into high volumes and high margins. Low prices due to low demand, on the other hand, are not good at all for traders, as they result in lower volumes and therefore lower margins. It does mean traders have less room for error before margin erosion starts to hurt them, but I don't see business models really changing as a result. Traders that are struggling may become smaller and be forced to focus more narrowly. This gives rise to opportunities for the larger players, however, to move into the market segments the smaller players are exiting, or even to acquire the smaller players through M&A.

KPMG: Against this backdrop, how do you see regulation impacting the sector?

Professor Pirrong: The real wildcard is the impact on capital requirements. Depending on exactly which, and how regulations are implemented, capital requirements could prove to be a massive burden. Also the costs of compliance will add up and will increase the cost of doing business. It will make trading less profitable. Again, the biggest impact will be seen on smaller traders, some of whom may even be driven out of the market.



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Ironically, a policy that is supposedly intended to address "too big to fail" problems may favor the bigger firms at the expense of smaller ones.

KPMG: Where do you anticipate investments taking place in this environment?

Professor Pirrong:
If demand for commodities remains low, I think we will see less investment in midstream assets over the longer term. Even though they are generally less risky than upstream assets, midstream assets make traders more vulnerable to slowdowns in volumes and flows. You can already see some companies in the USA, for instance, suffering significantly as a result of a heavy midstream asset footprint. There's also a serious risk that current conditions could lead to stranded assets.

KPMG: And in terms of financing, what trends do you anticipate?

Professor Pirrong:
The first thing I would say is that there will be no move towards public equity, as this just doesn't make sense at the moment. I expect financing structure models to remain stable – as they have been for some time – in the absence of anything happening in the regulatory field to really change this. For commodities traders, it's their business strategy that drives the financing approach rather than the other way round. Some traders have become pretty clever in putting in place long-term funding strategies without sacrificing the core part of their business. These strategies most notably include spin-offs, minority shareholdings and very long-term debt. One change I see as possible over the coming years is private equity's entry into the market. Private equity is a very good complement to the private nature of trading.

How attractive the commodities trading sector appears to private equity houses, of course, depends on whether the trading industry contracts. I can see private equity being a useful source of fresh growth.

oversupply leading to a shift in LNG such that it becomes traded more like oil. LNG will also be boosted by negative developments in coal, which is vulnerable due to threats from renewable energy sources as well as growing environmental concern. In the metals segment, capacity really needs to be withdrawn from the market. That, like most of the trends we've discussed, will play out over the long term.

KPMG: Speaking of future trends, can you give us your prediction in a nutshell?

Professor Pirrong: It goes without saying that the scale of the trading industry will be very much determined by macroeconomic developments in emerging markets, especially in China. These have the capacity to impact greatly commodity demand, specifically for the metals segment, with reduced demand and lower infrastructure investments. On the other hand, I see a bright future for LNG as a traded commodity. In my view, an oversupply in LNG might be a very good thing for traders, as it will undermine the traditional model of LNG being contracted under long-term contracts with little spot trade. In other words, I can really see

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Synopsis and hypotheses

Recent years have seen the rise of commodities trading giants, whose activities represent a significant percentage of the global volume of trade in specific commodities. These companies have assumed positions over trading flows and, increasingly, assets in oil, metal ores and agricultural goods that were once controlled by integrated multinational corporates.

This has given rise to an extremely interesting and complex industry that justifies greater analysis. As the sector emerges into the light from relative opacity, trading activities are becoming more visible and more intelligible to persons outside the sector, whether to clients, suppliers, bankers, regulators or lay investors.

Traders were impacted by 2015's collapse of commodity prices in almost every sector, in part due to macroeconomic changes such as a slowdown in China's growth, recession in Brazil and Russia, hesitant economic recovery in Europe and the growing strength of the US dollar. Combined, these factors produced a set of circumstances that have put enormous pressure on parts of the commodities production and trading industry.

Against this backdrop, we felt it was time to take the industry's pulse. Who is feeling the pressure and why? Who is changing strategy and how? What are the new markets? Will traders continue to invest in assets? How much pressure exists on margins? How are traders adapting to the new environment? And how are they dealing with regulation? Is sustainability a topic for traders?

In this context, we set out to test the following three hypotheses.

Our hypotheses

Our conclusion

Traders need to…

…rethink how, where and in which sectors they **deploy capital** in light of the slowdown of growth in China and the continued slow rebound in other regions that is impacting commodities pricing, capital allocation/infrastructure investment and trading strategies.

- Caution will reign over the purchase of production assets due to their relative lack of flexibility and price dependency.
- The focus on logistics assets will meanwhile grow for those assets that can enhance supply chain efficiency and trading margins.
- Agriculture will see relatively restrained investment activity. Those investments that do take place will be mostly in midstream assets.
- Interest is growing in upstream metals mining assets, particularly as the current price environment allows for bargain purchases. Energy investments will focus on midstream (storage) and downstream (distribution) assets.

…structure, operate and portray themselves in a more enterprise-driven, stakeholder-friendly and possibly less entrepreneurial manner due to **regulatory and compliance** pressures.

- The changing environment presents an impetus for traders to engage more with stakeholders on particular topics such as sustainability.
- The industry is set to become more transparent through enhanced reporting obligations and greater stakeholder scrutiny.
- While these changes will impact all industry participants, they are likely to weigh heaviest on smaller traders due to the resources required to comply with stakeholder and regulatory requirements.
- It is critical that traders proactively engage and collectively interact with regulators and stakeholders to provide greater clarity for what has historically been an opaque industry.

…look for **alternative sources of finance** due to changes in volumes, costs, risk profile and availability.

- There is an increase in long-term funding strategies that avoid the need to sacrifice control of the core business. Structured financing is on the rise.
- Raising equity through strategic partnerships is hugely preferable to more traditional routes such as a public listing, which may be the preserve of traders investing heavily in fixed assets.
- Funding through private equity looks set to play an increasingly active role.

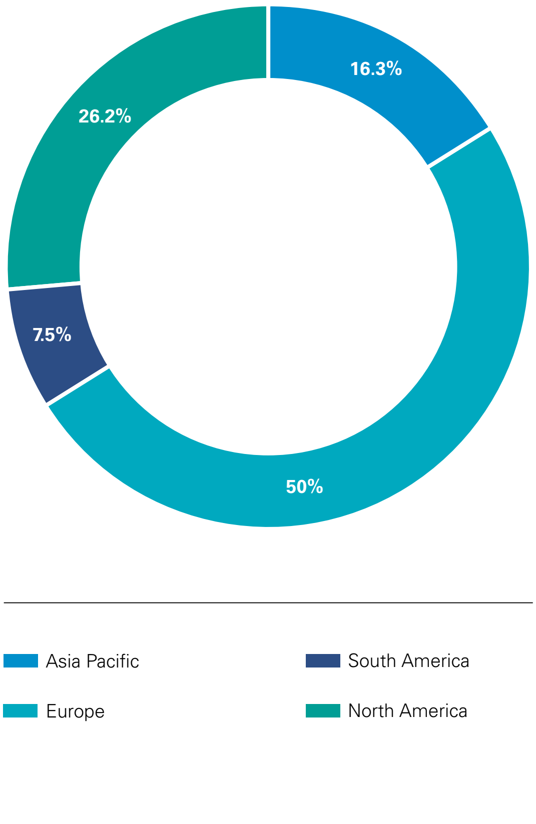
Basis and methodology

THIS GLOBAL STUDY IS BASED ON A COMBINATION OF 7 PERSONAL INTERVIEWS AND AN ONLINE SURVEY OF 80 RESPONDENTS.

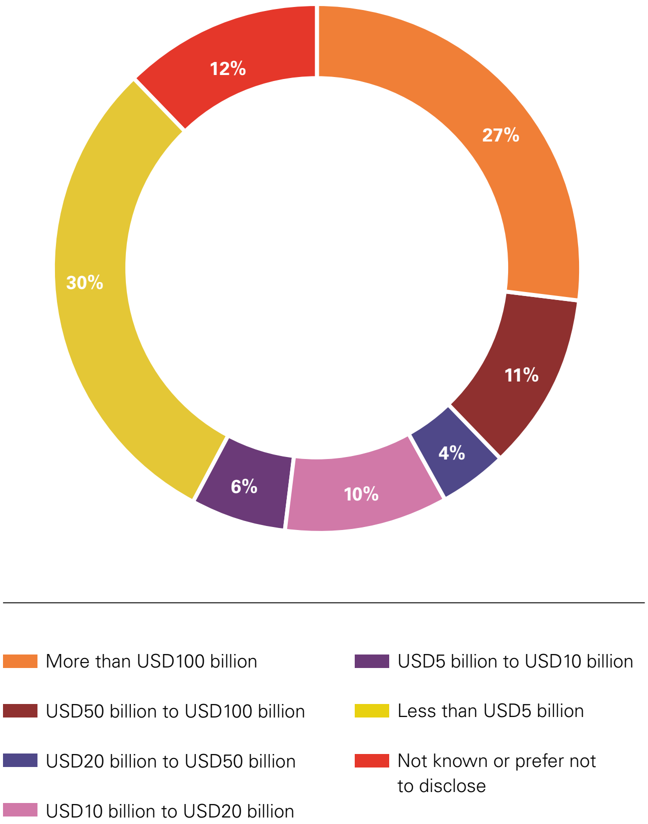
Online survey

80 individuals responded to an online survey that we circulated to our broad commodities trading network.

Location of respondents' global HQs

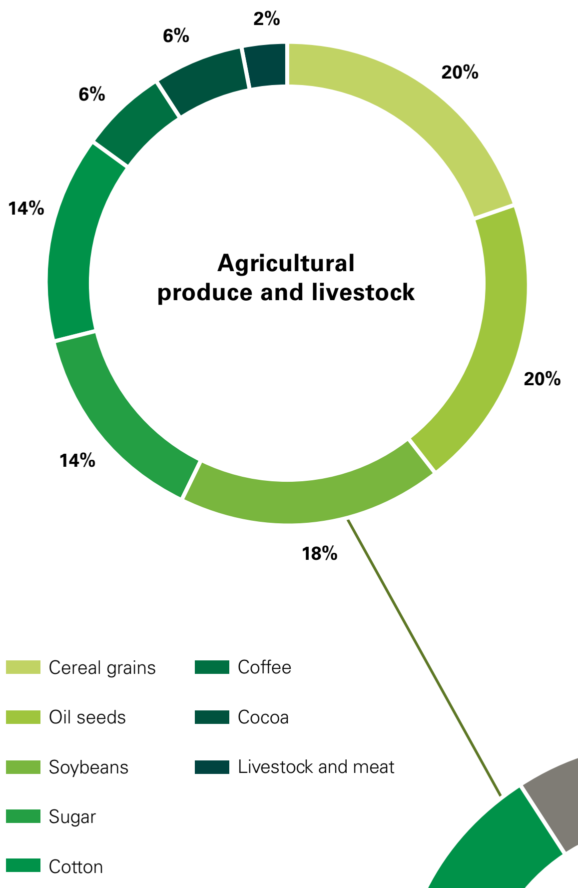


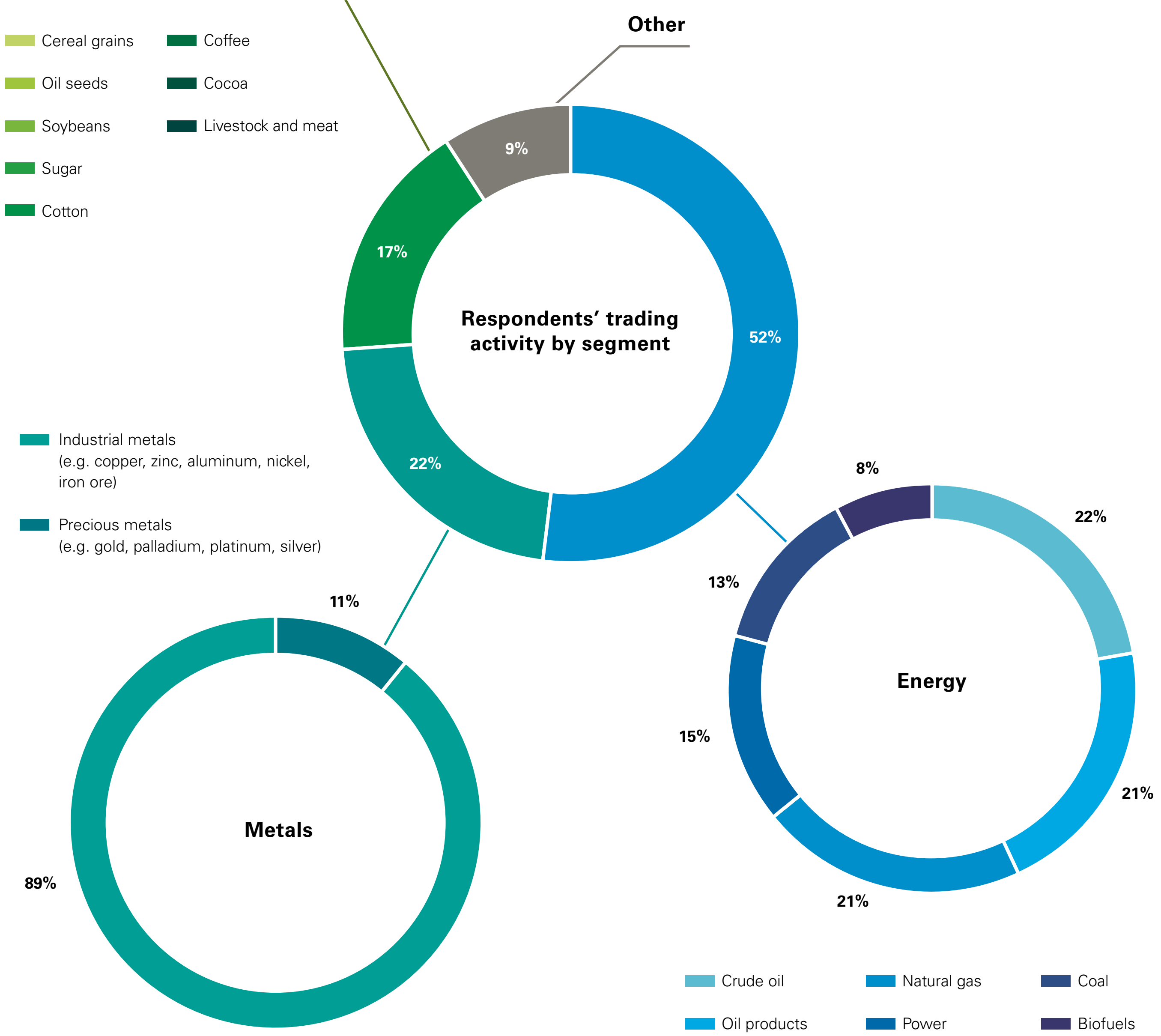
Respondents' companies' global revenue



Respondents’ trading activity by segment
(select all that apply)

Respondents represented traders from a range of commodities, notably energy (52 percent), metals (22 percent) and agricultural produce and livestock (17 percent).

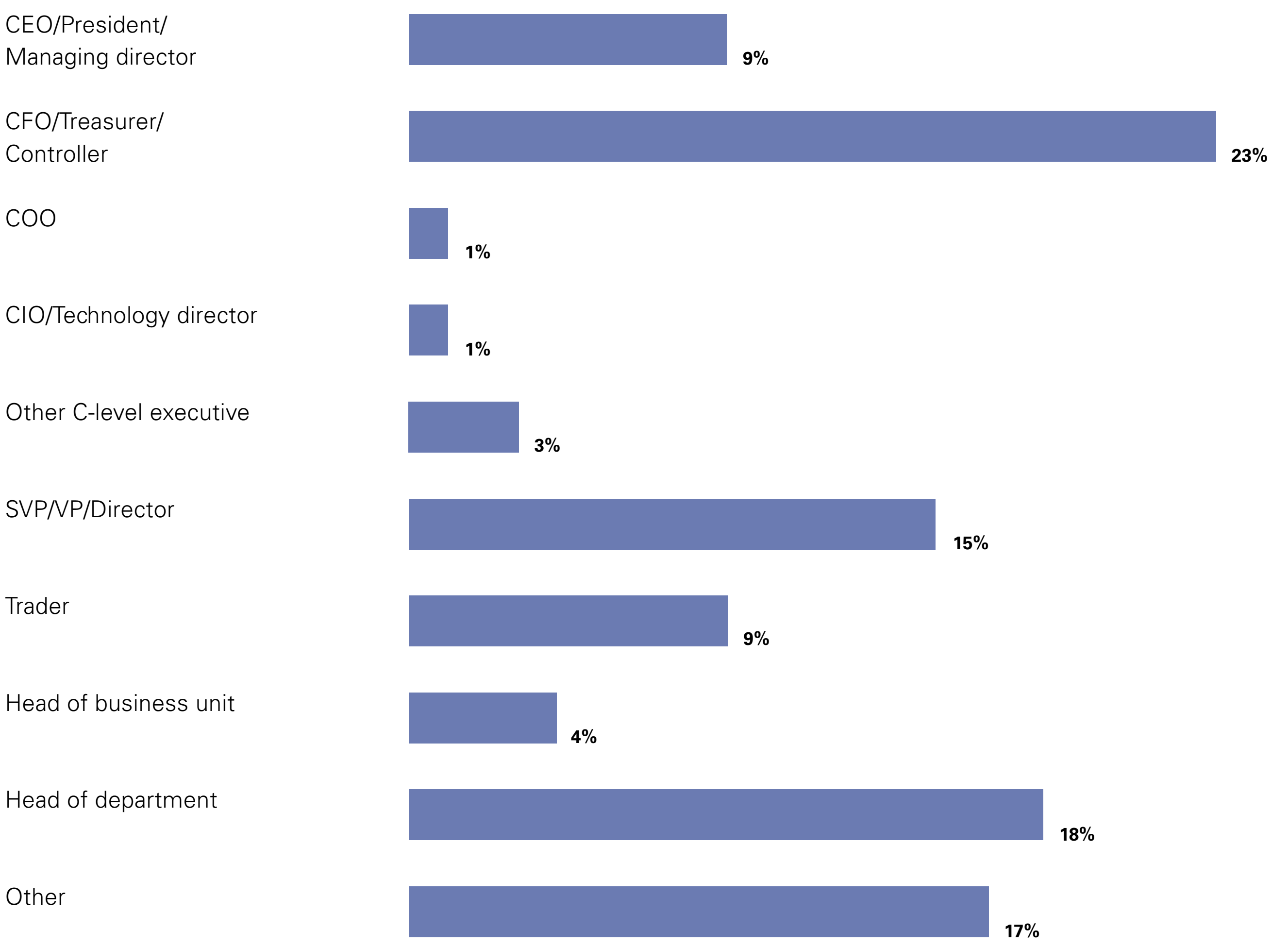




Face-to-face interviews

We conducted seven face-to-face interviews with C-level executives of major trading houses (those with revenues in excess of USD50 billion). The outcomes of these interviews have been incorporated into our analysis, giving a better grasp of the changes the industry is undergoing.

Respondents' roles



The trading environment: An overview

Regulation and sustainability are climbing quickly up boardroom agendas. Traders need to continue engaging with the wide range of stakeholders on these issues. Together with the general price environment, the challenges facing traders over the coming years remain substantial.

ALMOST EVERY SECTOR SAW COMMODITY PRICES COLLAPSE OVER THE COURSE OF 2015. TRADING COMPANIES THAT HAD LIMITED EXPOSURE TO PRICE RISK BY MINIMAL INVESTMENTS IN INFRASTRUCTURE ASSETS EXPERIENCED SOLID TRADING CONDITIONS. ENERGY TRADING COMPANIES PERFORMED PARTICULARLY WELL DUE TO HIGHLY VOLATILE ENERGY PRICES. AGRICULTURAL AND METAL COMMODITIES TRADERS, BY CONTRAST, ARE SEEING FLAT PRICES DUE TO ONGOING EXCESS SUPPLY. IN THIS PRICE ENVIRONMENT SIZE MATTERS, AND THE ABILITY TO RIDE OUT THE CYCLE WILL BE KEY.

The impact of collapsing commodity prices

Seventy percent of respondents were concerned about current low commodity prices, especially where they are the result of low demand (i.e. lower volumes) due to a slowdown in economic growth. There is less concern over low prices that result from oversupply as long as trading volumes are maintained. Unsurprisingly, respondents with larger asset bases were much more negatively exposed to lower commodity prices than their asset-lighter peers.

In the outlook for the next one to two years, the biggest challenges continue to be low commodities prices, a slowdown of economic growth globally and pressure on trading margins (see graph on opposite page).

Size matters in the current environment
Low commodity prices also raise concerns over counterparty risks (most notably where sanctions are involved), although distressed upstream producers and national oil companies in desperate need of revenue are providing opportunities for prepayment structures and strong price negotiation.

As one respondent put it:

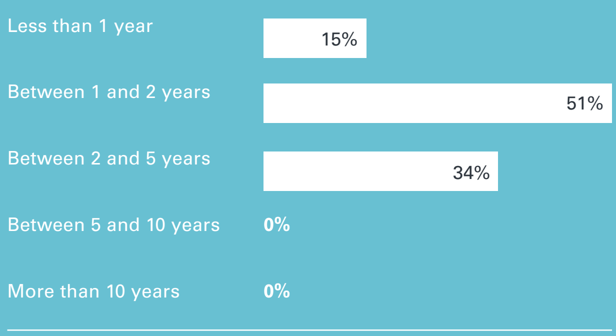
"Strategy in the sector is now shifting to a reverse beauty contest. It's the producers who now badly need marketing."

Ultimately, this means size matters. Trading companies with sufficient access to financing, as well as the degree of sophistication required by the new structures, are better positioned to benefit in the current environment.

"People with access to USD100 million facilities can leverage that very powerfully in today's market."

Low prices are expected to persist
A slight majority of respondents expect commodity prices generally to stay at the current low levels for a further one to two years.

How long do you expect commodity prices *(in general)* to stay at the current low level?



Metals: Excess capacity prevails

Respondents are most positive about a recovery of prices for energy and agricultural products. Few expect metals prices to rebound as they are linked to construction and infrastructure.

> "Aluminum, copper and iron ore are vulnerable as linked to China".

As China moves from an investment-led to a consumption-led model, demand for metals may slow further. In addition, many new mines began operating as companies sought to benefit from the China boom, therefore increasing supply. A rise in metals prices may therefore depend on a withdrawal of capacity from the market. This is a long-term process. Mine closures can be unattractive due to political reasons (e.g. job losses) and substantially lower costs.

Oil: Two to three years for the market to rebalance

All oil producers are looking to reduce costs. The short term, therefore, will see no significant reduction in oil supply. If oil prices rise, supply will increase accordingly and cap the price. Current abundant supply might be similar to the situation at the beginning of the most recent 20-year period of flat, low prices that started in the mid-1980s. Furthermore, the geopolitical environment suggests no basis for market coordination. It may take two to three years to rebalance the oil market. One interviewee noted: "There are many variables, for example how demand will evolve in China". A successful transformation of the Chinese economy is key to a fresh balance in the market.

As one interviewee optimistically stated:

> "Consumption is rising in China, so that should be good for oil volumes."

LNG: Is oversupply a positive?

Oversupply in the LNG market may be a good thing for traders, as it undermines the traditional model of LNG being contracted under long-term contracts with little spot trade. LNG trading may consequently move towards the oil model. New trade flows will be created as the abundance and arguably lower negative environmental impact of LNG has strong potential to displace coal.

What do you see as the biggest challenges for your business in the next 12 to 24 months?
Select up to three

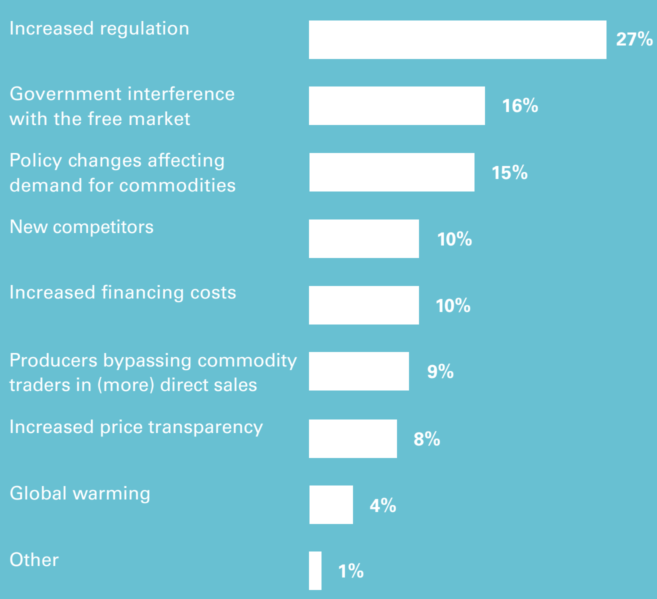
North America has the greatest growth potential
Respondents believe the following regions possess the greatest opportunities for business growth over the next one to two years, in order of highest potential first:

- North America
- China
- Asia (excluding China and India)
- Africa

Interestingly, given the current commodity price environment, these areas align exactly with where most respondents' business growth has taken place in the past 12 to 24 months. Most respondents believe the majority of new business growth in energy-related commodities will come from North America. They are also positive in their business growth expectations for India but less optimistic about Russia and Brazil. Some feel, however, that India's business environment may inhibit economic growth, particularly when compared with China. Overall, respondents cited the slowdown in emerging markets' economic growth as negatively affecting their businesses.

Potential disruptors: Regulation leads the pack
The biggest long-term disruptors for commodities trading are seen to be increased regulation, government interference in the free market and policy changes affecting demand for energy sources. It is becoming increasingly clear that traders must consider these non-market forces in their future strategies.

Which developments do you see as most disruptive for commodities trading in the longer term?
Select all that apply



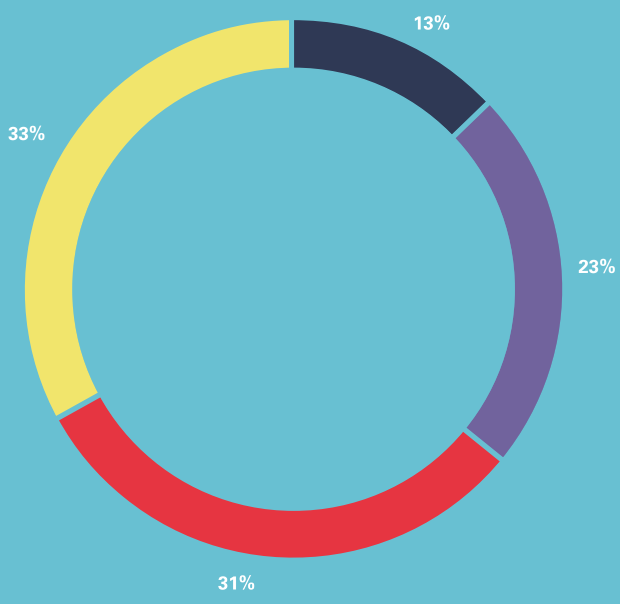
The growing regulatory burden

ALONG WITH CHINA, REGULATION IS THE BIGGEST DISRUPTOR TO THE WAY THE INDUSTRY OPERATES. IT HAS ARRIVED PIECEMEAL, COMPLICATED AND EXPENSIVE. HOWEVER, TRADERS WILL NEED TO ENGAGE IN FINDING MORE GLOBALLY COORDINATED SOLUTIONS THAT ARE RELEVANT AND MORE COST EFFECTIVE TO ALL INDUSTRY PARTICIPANTS. CONCERN (AND SOME FRUSTRATION) IS DRIVEN BY WHAT TRADERS PERCEIVE AS REGULATORS NOT FULLY UNDERSTANDING THE TRADING BUSINESS AND THEREFORE NOT KNOWING WHAT OR HOW TO REGULATE THE COMMODITIES MARKETS.

Respondents feel that, despite an international regulatory push, the lack of an aligned global regulatory agenda is leading to a misalignment in terms of objectives, rules and definitions. Multinational commodities traders must deal with separate and differing regulatory regimes and agendas.

While traders wait to see what the ultimate effect of upcoming regulatory change on their operations will be, the majority of respondents expect the following:

How great an impact do you expect regulation to have on existing operations?



Significant (e.g. consideration of change in business structure/ location, significant system changes, change in business model)

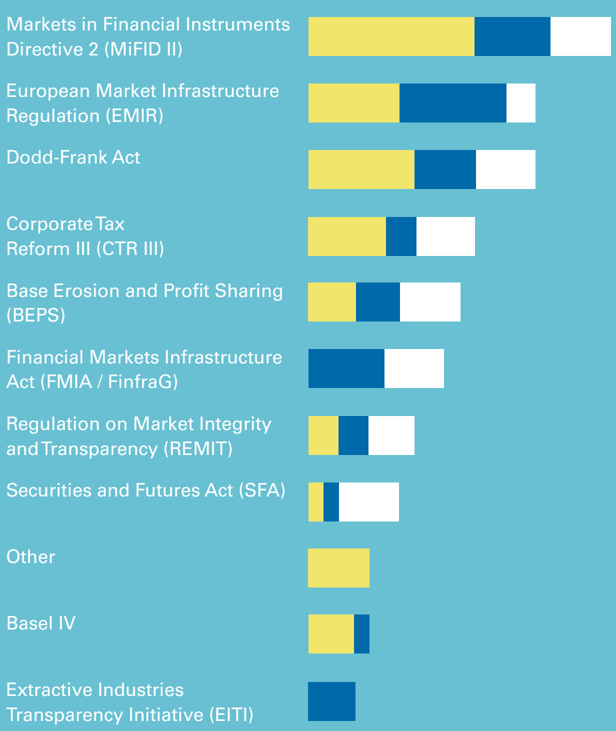
Limited (e.g. under discussion)

Not yet clear

Medium (e.g. reconfiguration of systems/reporting, employee training, hiring etc.)

These impacts are expected to be driven primarily by the following regulations:

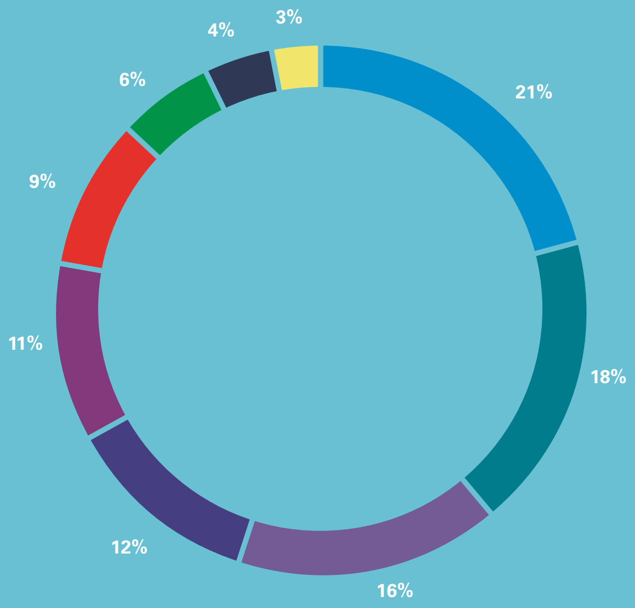
Which regulations do you expect to have (or are already having) an impact on your business? *Select top three*



1st choice
2nd choice
3rd choice

Respondents see the key challenges for traders as being the complexity of regulations, increased costs of compliance and monitoring compliance.

What are your main challenges in complying with laws and regulations?
Select all that apply



- Complexity of regulations
- Increased costs of compliance
- Monitoring compliance
- Impact of regulation on business model
- Managing reporting obligations
- Limitations of existing information systems
- Employing resources with appropriate skills
- Impact on location of operations
- Transparency on derivative proprietary trading activities

MiFID II: Increasing the burden

It is not surprising that the complexity of regulation is seen as the primary challenge; MiFID II's terms are still to be defined in detail. In February 2016, the European Commission published a proposal to postpone MiFID II's application date by one year to 3 January 2018 to allow for the complex technical infrastructure necessary for its implementation. While this anticipated delay gives companies a brief respite to set up and/or adjust internal systems and processes accordingly, compliance will be costly and time-consuming.

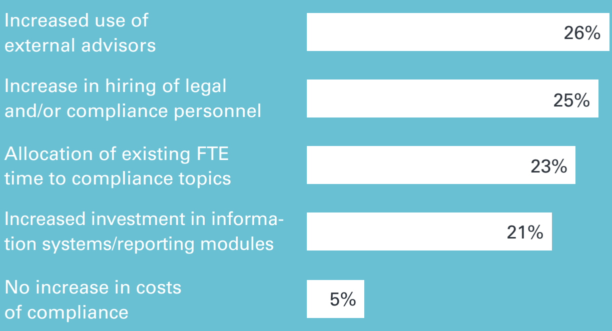
BEPS and CTR III: Changes, documentation and uncertain incentivization

The OECD's BEPS project (international tax reform targeting Base Erosion and Profit Shifting by multinationals) covers multiple areas, of which transfer pricing is a key focus. BEPS will impact commodities traders and could mean changes in how taxes are paid across a group.

In order to understand the full impact of the initiative and assess the extent to which existing transfer pricing policies can remain in place, commodities traders face an unprecedented level of complexity and costs even before BEPS goes live. Any necessary changes will have to be addressed quickly, keeping in mind the extensive documentation requirements enacted or to be enacted which represent an administrative and costly burden.

The introduction of Switzerland's CTR III responds to the abolition in 2019 of the auxiliary tax regime whereby companies in Switzerland with mainly non-domestic operations are able to benefit from privileged income taxation status and, ultimately, a reduced tax burden. CTR III seeks to offer tax incentives in order for Switzerland to remain an attractive business location. Incentives include a reduction in the ordinary rate of income tax and the option to be taxed at a reduced rate for certain assets (i.e. hidden reserves). While appearing attractive, these incentives yield uncertainty – not least because CTR III may be subject to a referendum in Switzerland. The measure would also involve complex valuation methods that would, along with the underlying asset bases, be subject to interpretation and challenge by the Swiss tax authorities.

In which of the following areas are you experiencing increased costs of compliance?
Select all that apply



The ongoing legacy of EMIR and Dodd-Frank

EMIR and its US comparator, the Dodd-Frank Act – both of which are already in force – involve ongoing monitoring and related costs (including mandatory EMIR audit requirements in certain jurisdictions). They also include reporting obligations and other obligations in relation to clearing, exchange of collateral and other risk management techniques, depending on how a company is classified under MiFID II and the level of its group over-the-counter (OTC) speculative trading.

Financial Market Infrastructure Act

Following the international movement towards a stricter regulation of the financial markets, Switzerland decided to implement FMIA. Similar to EMIR and MiFID II, it aims to ensure the proper functioning and transparency of securities and derivatives markets, the stability of the financial system, the protection of financial market participants and equal treatment of investors. It is meant to be a law that will measure up to the equivalency test abroad, thus funding the basis for companies' access to markets abroad while adequately taking into account Swiss particularities. The FMIA intends to align the regulation concerning the financial markets infrastructure as well as derivatives trading so they meet the latest international standards.

The fundamental issue

While compliance-related costs have grown, the fundamental issue for traders is that regulation is changing the focus from business to compliance. It must be recognized that capital requirements (under CRD IV), where firms become subject to the rules, might hamper a trader's access to necessary capital, potentially limiting operations or forcing the sale of assets.

Smaller traders most affected by increased costs

Respondents note that the costs of compliance have grown. With compliance becoming essentially a license to operate, there is concern that smaller traders will be driven out of the market while large traders will become even larger. The result may be a less competitive market. Our survey highlighted a significant concern among smaller companies (revenue of less than USD5 billion) regarding their ability to comply with regulation compared to their larger counterparts.

In particular, concern surrounds the cost and human resources required for compliance monitoring, managing reporting obligations and the increased overall costs of compliance. Even prominent banks such as J.P. Morgan, Morgan Stanley and Barclays have exited the physical commodities trading sector partially given heightened capital and liquidity constraints.

IT capabilities are key to compliance
The question facing traders of all sizes is how to utilize existing IT systems to extract and produce reliable data to comply with increasing reporting obligations. Companies required to comply with EMIR have, for example, put in place or leveraged systems that extract data for provision to the chosen interface provider for trade repository submission.

It is likely that companies will leverage existing systems for the additional reporting burden generated by the regulation (MiFID II, BEPS, FinfraG, etc). What is key, however, is that risk management techniques and controls are built into the relevant processes and policies; these are what will safeguard the reliable, accurate and complete data capture and reporting that the regulators require. By seeking to reduce their front-/middle-office deal administrative burden, companies might invest in supporting IT solutions such as automating the deal confirmation process or systems that reconcile data.

Key take away

The voice of commodities trading companies is not one of resistance; rather a desire that regulators should understand the business and seek a practical application of regulatory goals. In other words, address real financial market risks instead of perceived risks. Getting this view across can be aided greatly by traders continuing to interact with and disclose to regulatory bodies. This will facilitate a better understanding of the industry overall.

KEY REGULATIONS – IN A NUTSHELL

- BEPS: An interdisciplinary project of the OECD and the G20 group of nations. It tackles the problem of existing regulations that allow companies to shift their taxable profits from the place of actual business activity to other locations in order to minimize the tax burden or avoid tax altogether. The aim is to prevent such practices by drawing up shared, balanced and efficient rules at multilateral level.

- CRD IV: Introduces prudential requirements for credit institutions and investment firms and comprises the Capital Requirements Regulation (Regulation 575/2013) and the Capital Requirements Directive (2013/36/EU).

- CTR III: The third corporate tax reform, which is designed to strengthen Switzerland's appeal as a tax location, replaces a number of existing regulations in order to bring Switzerland's corporate taxation in line with international standards.

- Dodd-Frank: The Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 reforms the US financial regulatory system, primarily affecting financial institutions and their customers in order to prevent similar events such as those that led to the 2008 financial crisis.

- EMIR: EU regulation on over-the-counter (OTC) derivative transactions, central counterparties and trade repositories (Regulation 648/2012). EMIR is designed to improve transparency and reduce the risks associated with the OTC derivatives market throughout the EU.

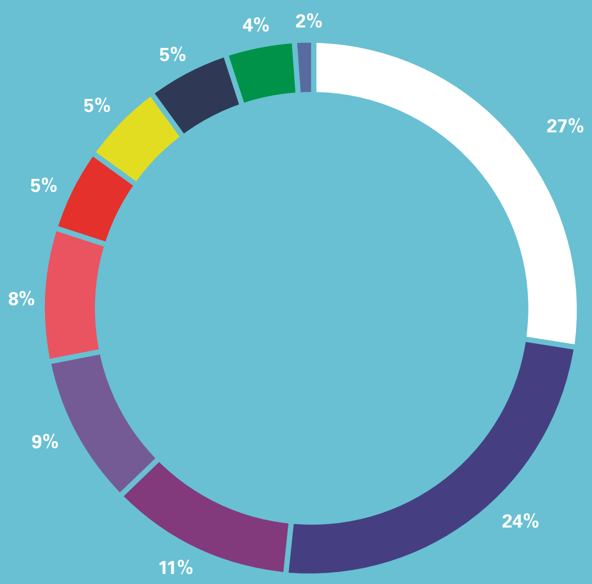
- FMIA/FinfraG: Governs the organization and operation of financial market infrastructures, and the conduct of financial market participants in securities and derivatives trading.

- MiFID II: Repeals the original Markets in Financial Instruments directive (MiFID) and comprises a Directive (2014/65/EU) and a regulation (Regulation 600/2014). Among other things, MiFID II expands the scope of the definition of financial instruments, narrows the exemptions on which commodities firms can rely and introduces a position limit regime for commodities firms.

Sustainability climbs up the agenda

INCREASING STAKEHOLDER PRESSURE AND REGULATIONS HAVE MOVED SUSTAINABILITY TO GREATER PROMINENCE FOR COMMODITIES TRADERS IN GENERAL, ALTHOUGH IT HAS BEEN IN SHARP FOCUS FOR THE MINING INDUSTRY AND, AS SUCH, THE MORE VERTICALLY INTEGRATED TRADING COMPANIES FOR SOME TIME. SUSTAINABILITY WILL BE THE SINGLE MOST IMPORTANT ISSUE ON WHICH THE INDUSTRY CAN ENHANCE ITS IMAGE WITH ITS STAKEHOLDERS.

Which, if any, of these sustainability topics do you expect will impact your business in the next one to two years?
Select all that apply

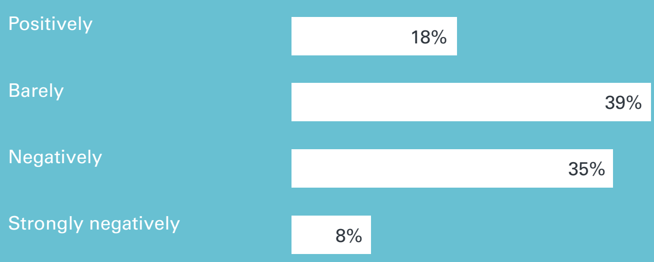


- Carbon emissions
- Energy consumption
- Health and safety
- Community involvement
- Human/labor rights
- Water scarcity
- Working conditions
- Fair trade
- None
- Other
- (Conflict minerals 0%)

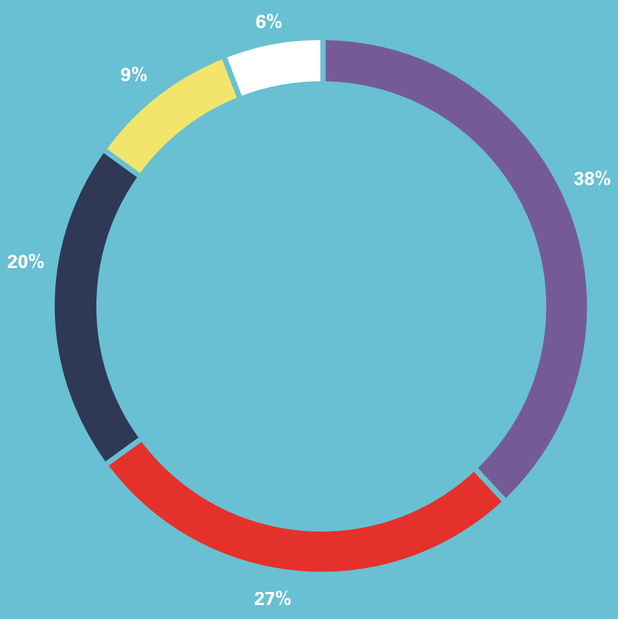
Carbon emissions, energy consumption and health and safety are high on the sustainability agenda. Interestingly, health and safety is not only a growing topic for traders with a larger fixed asset base (e.g. mining operations), but also for pure traders. In relation to carbon emissions and energy consumption, opinion among respondents is split regarding how global warming will affect commodities trading.

Results were evenly spread across traders irrespective of fixed asset bases. The exception is that a greater proportion of traders with larger fixed asset bases (more than 40 percent of total assets) responded "negatively" to the issue of global warming. This might be expected given emerging limitations on carbon emissions.

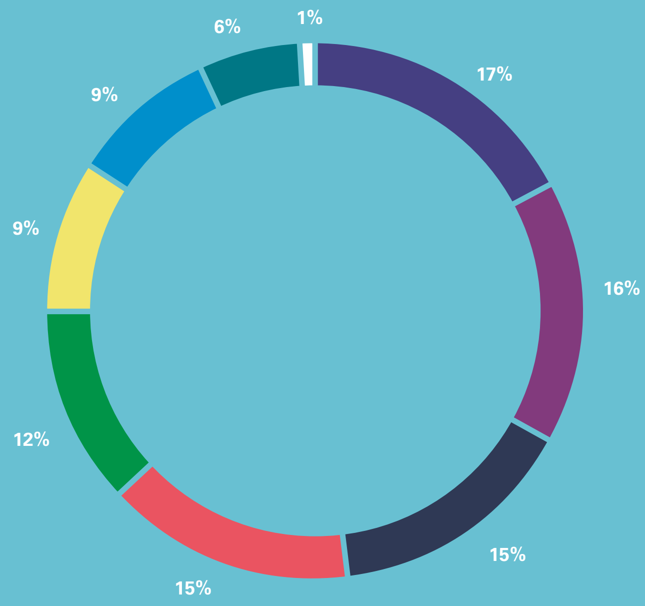
How does global warming affect commodities trading in the long term?



If affected by global warming, how are you affected?
Select all that apply



If sustainability is a focus for your company, to what extent is it integrated into the core business?
Select all that apply



For those affected by global warming, the largest impact was seen to be severe weather, followed by stranded assets and resources not being available. Severe weather and resources not being available were larger issues for pure traders (with fixed assets of 0 percent to 20 percent). Those with a heavier asset base (more than 20 percent) were more concerned about stranded assets.

Climate change and related regulations around the world (initiated and reinforced by COP 21, the 2015 UN Climate Change conference) are expected to affect future commodities flows by encouraging a shift towards the use of renewables and cleaner fossil fuels. As noted earlier, this may help feed LNG's strong potential to displace coal.

Key take away

The overall results show that commodities traders of all sizes are incorporating sustainability into their core businesses, though this might be done in various ways.

As governments commit to creating a carbon-neutral world, investors will be increasingly interested in the impact of global climate change policy on how companies plan to build shareholder value. The expectation will be for companies to become more transparent about financial, environmental and social risks and opportunities that arise from the physical impacts of climate change such as extreme weather, as well as from climate-related regulation, market dynamics and stakeholder pressure.

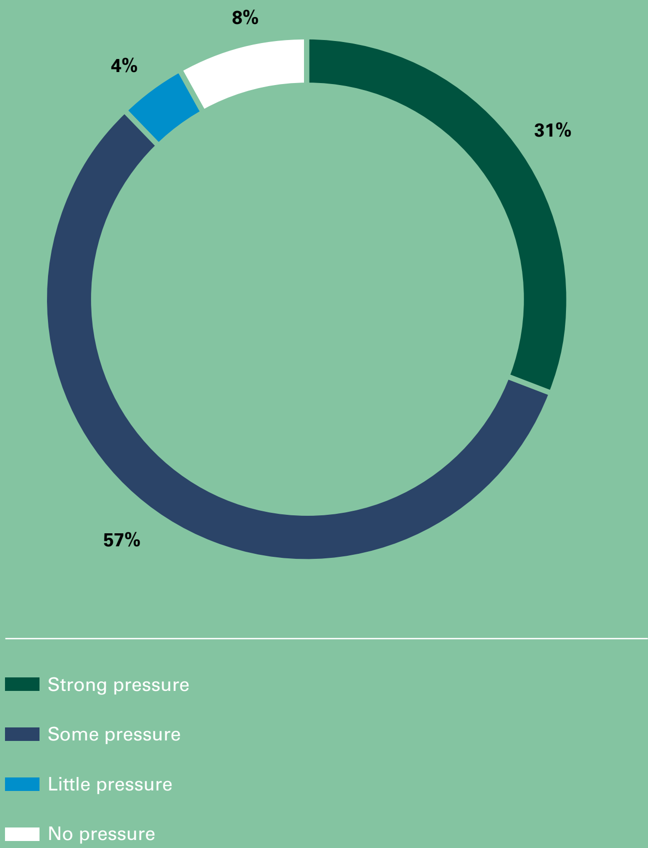
Demand from investors for transparency will reinforce the practice of sustainability reporting and the trend of integrating sustainability information into annual reports. For commodities traders, reporting on their climate change impact and other sustainability topics such as health and safety, human rights, working conditions and ethical business conduct, will be a way to further engage with stakeholders and build trust around the sustainability aspects of trading strategies and practices.

The trading environment: Impacts on commodities traders

Reduced demand and excess supply combine to intensify the pressure on margins. A significant number of respondents expect to make changes to their business strategy as a result. As financing models take greater prominence, traders may find they need to invest in more robust treasury functions.

A significant majority of respondents is experiencing pressure on trading margins, with nearly one-third saying it was "strong pressure."

How much pressure are you experiencing on trading margins?

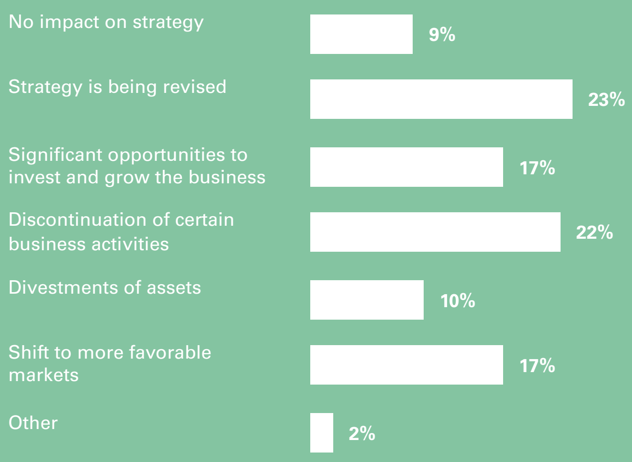


Changes expected to strategies and operating models

LOW PRICES ARE DRIVEN MAINLY BY REDUCED DEMAND AND EXCESS SUPPLY. TRADERS ARE RESPONDING BY TAKING SPECIFIC ACTIONS INCLUDING COST CONTROL MEASURES AND CUTTING BACK OR POSTPONING PLANNED INVESTMENTS. THOSE WITH HEAVIER ASSET BASES ARE REVIEWING THEIR MINE ASSET PLAN TO IDENTIFY OPPORTUNITIES TO EXTRACT AT LOWER RELATIVE COST TO CONTENT; TRADERS MEANWHILE, ARE CONSPICUOUSLY AVOIDING GREENFIELD PROJECTS.

OUR RESPONDENTS ENVISAGE THE MOST POPULAR COST CONTROL MEASURES TO BE EFFICIENCY IMPROVEMENTS, AUTOMATION OF PROCESSES, EXITING OF UNPROFITABLE MARKETS/DESKS AND REDUCTION IN EMPLOYEE HEADCOUNT.

What does pressure on trading margins mean for your strategy?
Select all that apply



As noted in the graph, the approach by traders is – and has always been – to continually revise strategies and operating models to suit their environments. Their strategy is dependent on their capability to carry out arbitrage in all situations. According to one respondent:

> "We continually diversify across our trading business to try to minimize margin pressure. We don't like to lock into specific market approaches."

From an operating model perspective, respondents noted intents to:

- improve operations, including investing in IT to better support operations and quality of information;
- develop partnerships to expand capabilities and market access;
- discontinue loss-making activities;
- diversify by geography, customer and/or product;
- allocate capital more efficiently.

There was no strong desire evident to relocate HQs, though this can always be an option if another environment proves more conducive.

We observed particular concern regarding IT costs, given how challenging they can be to manage, as well as the inherent risks and costs relating to excessively complex systems.

As effective cost management becomes even more pertinent with a need to keep overheads low, traders that already operate with low margins might find themselves under particular pressure over the coming years.

THE USE OF ASSET INVESTMENTS TO STRUCTURALLY SUPPORT TRADING STRATEGIES LOOKS AS THOUGH IT IS HERE TO STAY. STRUCTURED FINANCE IS ALSO GROWING IN POPULARITY AS TRADERS SEEK TO ACHIEVE EQUITY-LIKE CONTROL OF PRODUCTION FLOWS.

Investment trends in the current environment

Our survey set out to focus particularly on these premises regarding future investment in assets:

- Commodities traders have continued to maintain selective and opportunistic fixed asset investment strategies, predominantly in activities that enhance their supply chain efficiency (via logistics). This is because passing large or proprietary volumes through logistics assets has a significant positive impact on trading margins.

- Commodities traders avoid directional bets via fixed asset investments, as they prefer not to take structural positions. Few traders wish to expose themselves to direct upstream risk by becoming significant shareholders in commodity production assets. Where equity is deployed, it is usually as a minority shareholder with an accompanying offtake or marketing agreement. The desire for exploratory assets is even lower.

- There are clear geographic investment preferences, given the impact of falling asset prices across markets and regions.

Responses indicate that these assumptions hold true, albeit with some variations. Certainly, the use of asset investments as a structural support to trading strategy is here to stay. However, as evidenced in the funding section of this report, there is a growing use of structured finance to achieve equity-like control of production flows.

Where do you see potential to invest in assets to complement your trading activities?
Select all that apply

Energy: Midstream and downstream investments to dominate

More than 70 percent of respondents indicated that future investments would be concentrated in midstream and downstream areas. For midstream investment, storage (39 percent) and port facilities (26 percent) investments will dominate, while there is a clear preference in downstream towards distribution assets (45 percent).

Surprisingly, 23 percent of the responses identified upstream activities as a target for investment, led by natural gas. This represents a slight increase over the current level of investment in the sector (20 percent of respondents indicated investment in upstream assets in the past five years).

During our C-level interviews, traders highlighted opportunistic plays emerging in the upstream oil sector due to depressed prices. Rather than approach these on an equity-only basis, however, those with the requisite financing capability indicated they are looking to deploy structured finance solutions such as acquiring the debt on upstream balance sheets in exchange for a favorable offtake agreement. Traders thereby avoid the equity exposure while benefiting from proprietary and secured access to supply.

Only 27 percent of respondents said they had made no or minimal fixed asset investments. Thirty-five percent said they had invested significantly in midstream assets, confirming the recent trend to increase operating leverage in the supply chain.

While 16 percent of energy traders indicated having made significant investments in downstream assets, 37 percent identified that sector as a target for future investment. The current refining boom may be tempting traders to revisit that part of the value chain, though most favor distribution such as retail service station networks.

When reviewing past investments, 72 percent of energy trader respondents said that ROI had met or exceeded expectations. This is in line with the ROI for metals respondents (as follows) but is higher than that for agriculture traders.

We note that, since trading arms of oil majors also participated in the survey, the balance sheet ratio of fixed assets of all respondents was higher than for pure trading companies, with 58 percent of respondents having fixed assets representing more than 20 percent of their balance sheet value, where we would expect to see a lower figure for pure traders.

"At USD20 a barrel, upstream assets that are already producing are beginning to get interesting."

Metals: Growing interest in upstream mining

Due to the current play on distressed upstream mining assets, 27 percent of metals trading respondents indicated this is an area of interest going forward. This is up from 14 percent of respondents saying it is an area of current investment.

Sixty-three percent of respondents from the metals sector had less than 20 percent of fixed assets on the balance sheet. This is in line with the agriculture sector but is more asset-light than energy respondents.

Despite the current collapse of metals prices, 73 percent of respondents noted that ROI on past investments had met or exceeded expectations. None said ROI had been negative – this compared with negative ROI of 6 percent and 15 percent for energy and agriculture respondents, respectively.

Future investments are expected to target producing assets, storage and a blend of processing/refining assets.

Agriculture: More bearish attitudes impact investment attitudes

While agriculture traders mirror the energy and metals model by investing mostly in midstream assets, 30 percent indicated minimal or limited fixed asset investments, which is higher than for energy and metals.

Only 14 percent owned upstream assets, which correlates to the fact that few traders own the supplying farms. The exceptions tend to be in Asian markets (e.g. palm oil plantations).

Sixty-four percent of agriculture traders have less than 20 percent of fixed assets, in line with the ratios published in traders' annual reports.

The agricultural sector was the most bearish with regard to historical ROI performance. Forty-one percent indicated that ROI had not met expectations or had been negative. Indeed, a low percentage in this sector indicated that they would invest in the future.

Future investments will target processing, storage and distribution assets.

Key take away

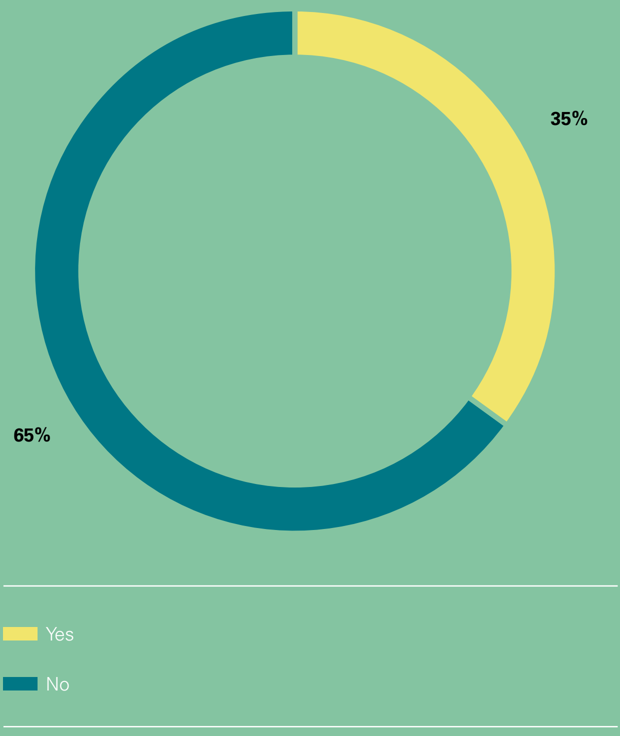
We expect selective asset investments by commodities traders to remain the preferred approach to gaining control of supply chains. With regard to accessing proprietary product flow, a growing number of traders (those with sufficiently strong balance sheets) are turning to structured finance strategies to achieve similar results to equity investments. We expect traders to make more use of novel solutions, including hybrid financing structures, increased presence of private equity and other long-term capital providers, as well as distressed asset strategies, as they seek ways to increase their leverage from production through to distribution.

The current low commodity prices will improve the flow of opportunities across all asset classes, especially in upstream where traders will ensure that they are not bound to structurally long positions. We also expect the low commodity price environment to begin contaminating midstream assets. In the North American oil sector, for example, we expect to see some distressed asset portfolios come up for sale or for debt restructuring (with either approach being viewed with interest by major commodity traders).

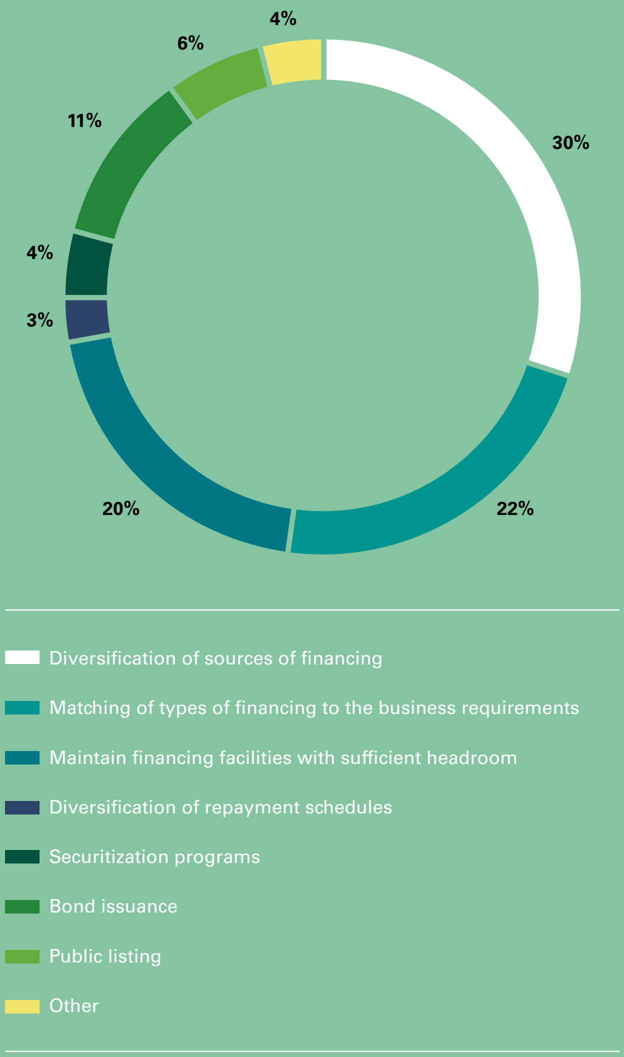
Adopting savvier long-term financing strategies

MOST RESPONDENTS REFERRED TO BEING UNAFFECTED BY RESTRICTED ACCESS TO FUNDING. THEY ARE, HOWEVER, UNDERGOING GREATER SCRUTINY AS BANKS HAVE ENHANCED THEIR COMPLIANCE MEASURES FOLLOWING THE FINANCIAL CRISIS. AFFECTED COMPANIES ARE IMPACTED MAINLY THROUGH HIGHER FINANCING COSTS.

Are you affected by restricted access to funding?



How do you manage to have sufficient access to capital? *Select up to three*



Sufficient access to capital is managed primarily by diversifying sources of finance and matching various financing options to the business's requirements. Trading companies have become more adept at creating long-term funding strategies (e.g. spin-offs, minority shareholdings, very long-term debt) without giving up the core part of their business. Examples include China National Chemical Corporation's 12 percent strategic investment in Mercuria Energy Trading and Vitol's joint ventures with Carlyle and Helios.

Such strategies not only provide a source of funding but also deliver synergies through strategic partnerships. These partnerships combine trading expertise with access to and understanding of local markets.

The general sentiment is that companies that desire to focus on pure trading will remain private. Public listings and bond issues are options mainly for companies that are heavily investing or planning to heavily invest in fixed assets.

Non-traditional participants may play a crucial role. As Professor Pirrong noted: "Private equity is a very good complement to the private nature of trading. How attractive the commodities trading sector appears to private equity houses of course depends on whether the trading industry contracts. I can see private equity being a useful source of fresh growth."

The fundamental financing structure model has been relatively stable over time and is expected to stay, in the absence of any new, relevant regulatory requirements.

Larger trading companies appear to have a competitive advantage over their smaller counterparts through greater access to and more diversified sources of funding. These companies are better positioned to benefit from the current environment, such as through the ability to provide prepayment agreements to commodity producers.

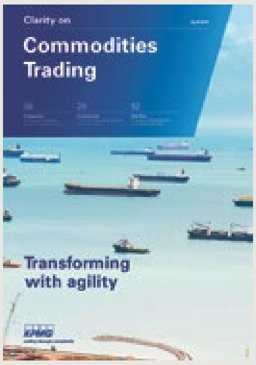
Key take away

The treasury function's strategic role is becoming increasingly important due to its capacity to develop new sources of funding and manage more complex funding arrangements. It is fundamental to enabling access to proprietary sourcing and marketing opportunities, as well as facilitating business development.

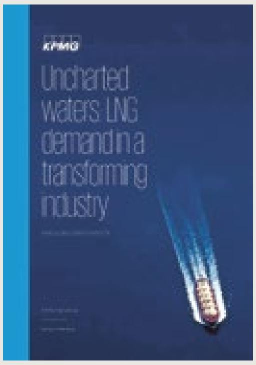
Raising equity through strategic partnerships appears more preferable than going public. These partnerships not only fit well with the private nature of trading, they are also enablers for developing new markets.

Global publications and industry insights

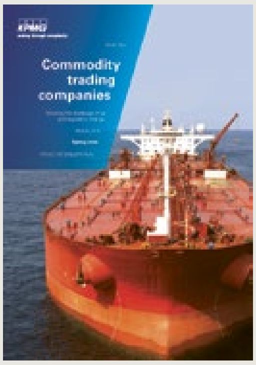
Relevant for you



Clarity on Commodities Trading 2015:
Transforming with agility



Uncharted waters:
LNG demand in a transforming industry



Commodity trading companies:
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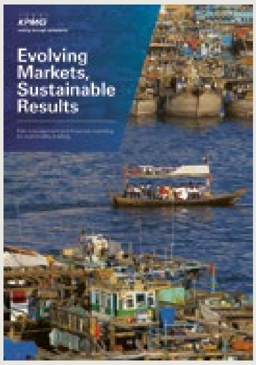
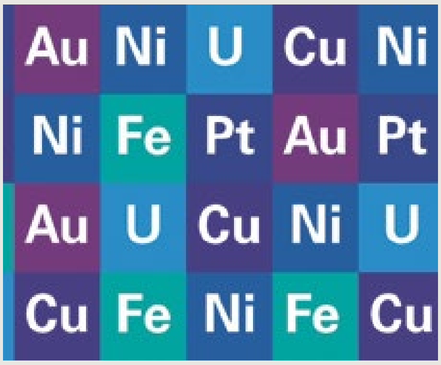


Evolving Markets, Sustainable Results

Global CEO Outlook:
Energy perspective



COMMODITY Insights Bulletin series

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