







Commodity Finance Market Report

2018

In association with

ALLEN & OVERY

Foreword

As commodity prices begin to stabilise and the industry dusts itself off after the starkest regulatory recalibration and pricing downturn in many years, we find ourselves at a key inflection point in the timeline of the commodity finance industry.

On the one hand, we have a growing global economy, new markets and renewed commodities emerging, partly enabled by revolutionary technologies and innovations being developed in boardrooms and lab rooms alike. On the other, growing political instability, still-stringent regulatory policy, and shifting consumer demands necessitate strict scrutiny in deal and decision-making.

This landscape has fostered the move towards new models for commodity traders with the larger ones concentrating on scale and consolidation strategies, whereas the small players are striving to eke out niches and digital developments to provide a nimbler offering.

The financing spectrum is more diverse with an increasing role for alternative lenders and innovative financing techniques, while a dexterous navigation of the legal and regulatory landscape remains a cornerstone of safe and successful deal-making.

How traders view these shifts and challenges is key to determining the direction in which the industry travels. While market practitioners continue to have their ear to the ground with a number of market intelligence sources, the response to the inaugural TXF-Allen & Overy Market Report, last year, demonstrated the desire for an independent, authoritative report on the condition of the commodity finance market as detailed by commodity traders.

For this reason, we have focused this year's survey solely on traders, carrying out 60 in-depth interviews with senior professionals at commodity trading houses. We hope you find the information in here valuable and that it can form a complementary part of your strategy planning in the years to come.

Hesham Zakai, Director, **TXF**
Niels de Ru, Partner, **Allen & Overy**

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Market landscape: Today's themes

Consolidation among trading houses and consistency among banks

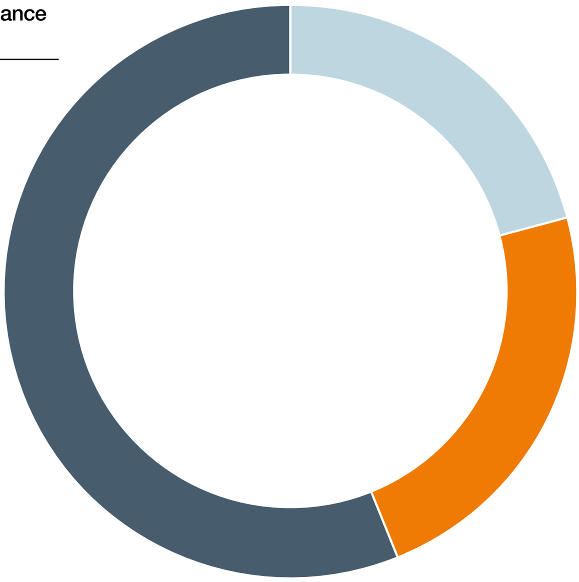
After a few years in which concerns about whether banks would pull out of commodity finance altogether have dominated, the background now appears to have stabilised. This stability finds form in a renewed optimism that banks will remain in the market for the foreseeable future, with only 21% of respondents expecting banks to withdraw from the space.

A greater number (23%) expect that banks will increase their presence in the industry, while the majority (56%) expect bank activity to remain the same.

This suggests acclimatisation, on the part of banks, to the 'new normal'. It also points to growing confidence in the market on the back of an upsurge in the global economy and commodity prices. The latter translates into higher financing volumes for banks, which ultimately benefits their revenues and their ability to stay in the business.

What do you think will happen to the banking market in commodity finance over the next 12 months?

- **21%** Banks will withdraw from the commodity finance space
- **23%** Banks will increase their activity in the commodity finance space
- **56%** It will stay the same



'Banks of smaller economic scale will have to curve their business to smaller, more knowledgeable and specialised fields.'

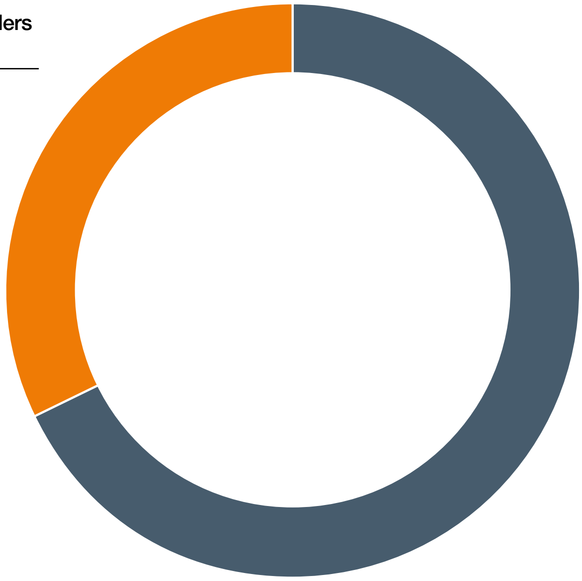
Head of Structured Trade Finance, Switzerland

If the number of active banks remains stable, then the question will become whether these banks are able to absorb the additional financing requirements of traders that are likely to arise as a result of the growth of the market and rise in prices. That the discourse is moving on from banks' retrenchment to their ambition and ability to enlarge their financing is reflective of a more positive mood emerging in the industry.

For traders themselves, the strong expectation is that the market will witness more consolidation, according to 68% of respondents. This would accelerate a trend that in recent years has its roots in the COFCO acquisition of Dutch grain trader Nidera and Noble's agribusiness.

If 2018 is to see an increase in consolidation, the current activity indicates the bulk of it will be in the agricultural sector. Reports suggest the market has seen overtures on the part of both ADM and Glencore for American agribusiness merchant Bunge, for example.

Do you expect to see consolidation among traders in commodity finance?



"The theme of consolidation continues to dominate. This trend will enable companies to be more effective in the market and they will continue to look forward to joining hands."

Group Treasurer, Singapore

The rationale behind consolidation has several elements but one strong driver is the enhanced ability to achieve economies of scale. This is particularly important in light of the contraction of margins that commodities have undergone in recent years; meaning larger volumes are needed to generate sufficient returns.

Moreover, this continues the evolution of commodity trade practices and the striving by traders to add value into supply chains in order to remain relevant. Adding value across the chain requires financial firepower – and in some cases a substantial amount. Taking the energy sector, as an example, the asset-light model has come under a lot of pressure – but both upstream and downstream assets are costly to acquire. One way to achieve access to this financial firepower is to increase in size, including through consolidation.

If this happens, then a key question will be whether traders run the risk of further regulation if authorities deem there to be too much debt concentrated in too few hands.

In last year's survey, the differing experiences of large and small traders when it came to access to finance was clear: 82% of respondents said they observed a two-tier system for large and small traders when it came to their respective ability to access financing.

In this year's follow up, it is clear that those on the smaller end face significant challenges to stay alive in the industry in their current form. While some can adapt strategically and survive, as detailed later in the survey, others are susceptible to consolidation or disappearing altogether. As the 'pure trade' approach comes under greater scrutiny, the smaller players face the task of convincing their banking group of the merits of their model; otherwise the possibility of banks retracting from them grows significantly.

Market landscape: Tomorrow's opportunities

The qualitative part of the survey's questions sought to uncover the underlying reasons behind both the optimism and the caution in traders' outlooks. From a macro perspective, the comments brought to the fore the fact that there is no single successful trading model: several of the issues cited as core challenges by some were identified as growth opportunities by others, reflecting the heterogeneous nature of traders in the market and their current standing within the marketplace.

Four exciting features

An analysis of traders' responses found the factors that most excited them could be broken down into four key categories:

1. Diversification into new geographic and sectoral markets

"There is a shift in the dynamics from conventional to renewable energy. For this reason, we are trying to diversify into new markets – such as solar and rain energy."

Finance Manager, Singapore

"The opportunity to open up to the emergence of new markets, for example Brazil. You can bring your expertise into these new markets."

Head of Finance, United Kingdom

2. Diversification of credit

"You will see a lot of non-bank financing after 2020. There is a general, newfound allure about this industry, which creates more return than expected."

Head of Structured Trade Finance, Switzerland

"The world always needs commodities. If the banks don't want to finance anymore, then we are seeing that somebody else will do it."

Treasurer, Europe & Middle East

3. The road to recovery

"We are in recovery – a bounce-back period"

Regional Head of Structured Trade Finance, Singapore

"We have a more positive outlook, more business and more opportunities."

Manager, Structured Commodity Trade, Switzerland

4. Contribution to the real economy

"In our case, we are in the value chain, contributing in the food business and to security of food supply."

CFO, Switzerland

"The most exciting aspect of the industry for us is delivering value to that end-consumer."

Finance Director, Switzerland

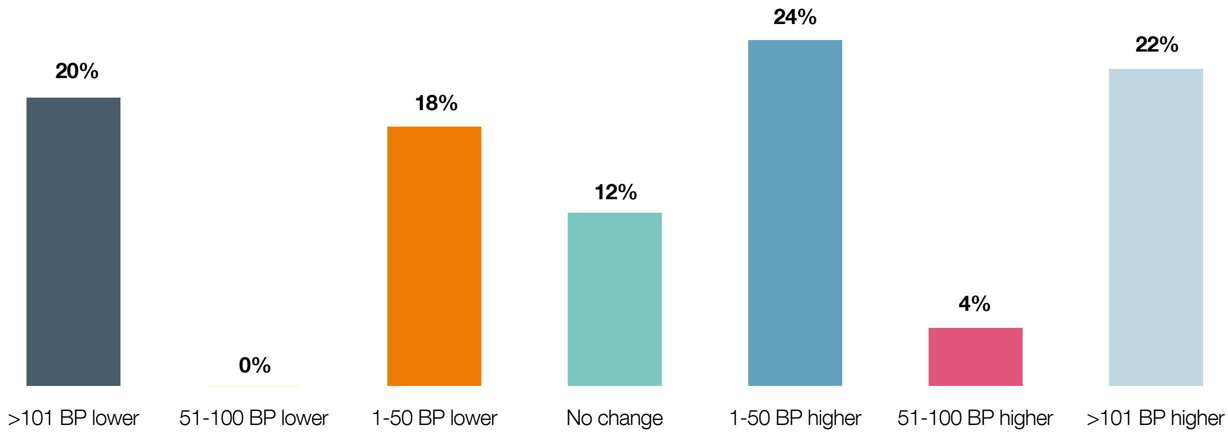
Deal-making: Pricing, cost and structures

Energy prices and cost of debt both expected to rise

The energy sector is the one most heavily backed for a price rise in 2018, with 46% of respondents envisaging this development. This complements the views of many analysts, including those at the World Bank, whose recent report forecasts price hikes for energy commodities, especially oil. Natural gas is anticipated to follow the oil trend eventually, whilst coal will continue to decline.

In terms of the cost of borrowing, respondents underwent mixed experiences in the last year. Most notably, respondents' experiences were broadly symmetrical: each respondent reporting a decrease of a particular size in their cost of borrowing was largely matched by a respondent reporting an increase of the same size. This bifurcation reinforces the aforementioned two-tier system and is reflective of the flight to quality by many financial institutions, as well as the awakening of USD interest rates.

What was the change in your cost of borrowing in 2017?



Looking ahead to next year, the predominant view (79% of respondents) is that traders' cost of borrowing will increase. This can be attributed not only to internal market issues – such as banks' risk perception – but also to external factors such as more widespread interest rate rises.

Last year's report established the comeback that secured products had made in the market, particularly as compared with the couple of years prior. This was particularly true of borrowing base lending (BBL), pre-export financings (PXFs) and prepayments.

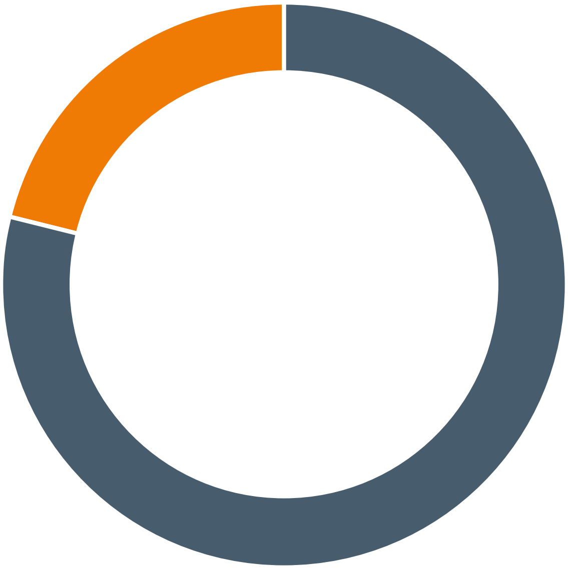
"The banks are not interested in coal anymore. They would rather finance softs and agri products."

Finance Manager, Singapore

This is consolidated once more with this year's deal information from TXF Data (see table below), which saw that structured commodity financing accounted for a total volume of USD47.4 billion in 2017, a 2% increase (USD851 million) from 2016. BBL loans led the charge, totalling USD18bn in 2017 and remaining the largest form of structured lending in volume terms in the commodity sector. Most other financing products remained steady, with the average tenor increasing modestly to 3.35 years.

Do you expect an increase in your cost of borrowing in the next 12 months?

- **79%** Yes
- **21%** No



> *"Last year it was difficult to get financing from the main actors. They will certainly increase their cost."*
>
> Trade Finance Director, Switzerland

TXF Data: Structured Commodity Finance Volumes 2017

TENOR			
	2017	2016	Difference
	Years	Years	%
Max	10.00	10.00	+0.0%
Avg	3.35	3.13	+6.6%

STRUCTURES		
	2017	2016
	USDm	USDm
Borrowing base lending	18,034	19,020
Pre-export finance	12,931	14,048
Reserve-based lending	8,670	5,266
Pre-payment	7,161	8,211

Borrowing base lending

Pre-export finance

Geographic markets

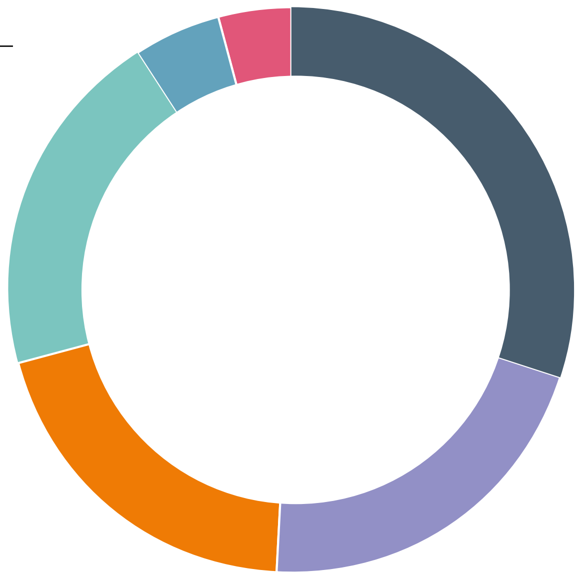
Respondents see the most potential in APAC and Europe going forward

When asked to look forward to where the best prospects for growth might be found regionally, respondents were particularly bullish on the Asia Pacific region. This is being driven by a number of factors: the growing influence of the region as a commodity trading hub (particularly Singapore and Hong Kong); the continued growth of the Chinese domestic market; and a growing private insurance market in Asia Pacific that is helping to unlock deals.

In second place, Europe was marginally ahead of the Americas and Africa for growth prospects. In Russia, although appetite for the country has remained limited due to sanctions, the market actually grew by virtue of a higher oil price. Moreover, alongside the more established opportunities, the wider CEE region appears to be benefitting from a pickup in interest. The last couple of years have seen, for example, the development of structured financing solutions in less mature markets (for example Romania and Bulgaria), evolving structures for commodity-based debt in many countries, as well as more foreign (and particularly Chinese) bank interest in the region.

Which regions do you expect to grow in terms of your business activity in 2018?

- **30%** APAC
- **21%** Europe
- **20%** Sub-Saharan Africa
- **20%** Americas
- **5%** MENA
- **4%** Russia/CIS



"The South American market will grow for us, but not North America, because there is an increase of local small producers there."

Director, Trade Finance, UK

There is also anticipation in the Americas, which will undoubtedly be driven by some of the positive developments in the trading market there over the last couple of years. The appetite of traders to grow their U.S. business has accompanied the development of the shale oil scene and thus they are raising new funding there. The market has seen successes for some of the world's biggest traders, from Gunvor securing their first U.S. borrowing base facility to Trafigura and Glencore successfully closing borrowing base facilities in the region. Moreover, U.S. players such as Castleton Commodities International have strengthened their global reach and are forging alliances with international players, for example in Japan, to support their business.

This positive regional picture could be significantly shifted by the outbreak of trade wars and more stringent protectionist measures.

New sources of liquidity

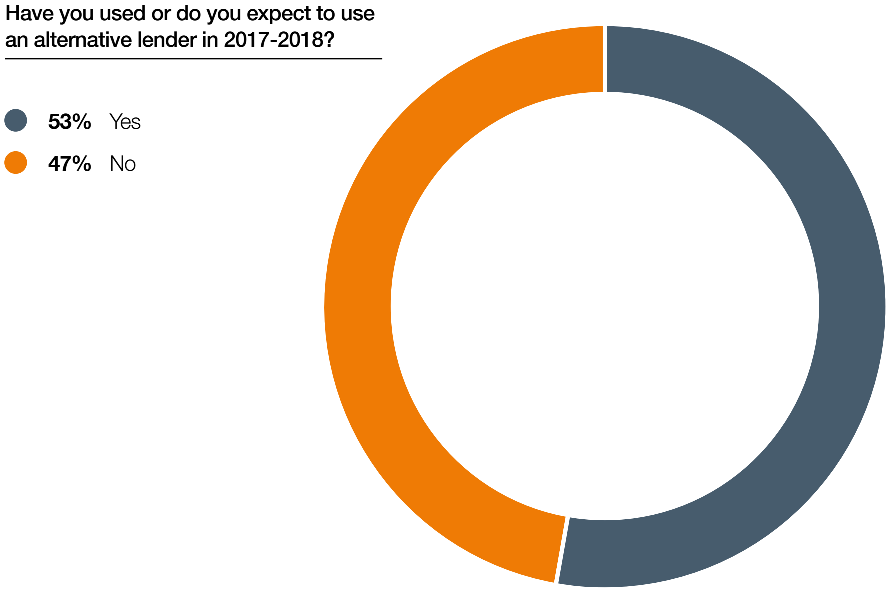
The rise and rise of alternative lenders

One of the most important developments across the trade finance spectrum has been the rise of alternative lenders, such as insurance and pension funds, often facilitated through a specialised asset manager. This was underscored by this survey, in which 53% of respondents reported that they had either used or expected to use non-traditional sources of financing in 2017-2018.

Within commodity finance, this non-conventional liquidity is being used in a number of ways, from securitisations to bilateral loans.

It is to be noted, however, that banks remain by far the chief financiers of commodity trade today in terms of volume, and that they often play a complementary, rather than competing, role with newer players. Where funds *are* competing with banks, then it is usually on the basis of appetite rather than price.

Have you used or do you expect to use an alternative lender in 2017-2018?



"We worked with an asset manager – they offer flexibility and are ready to support when traditional transaction banks won't help."

Head of Trade Finance Group, Switzerland

The rising presence of newer players is driven by the convergence of two independent developments: firstly, the compliance and regulatory requirements imposed on banks – and cited elsewhere in this report – have hamstrung banks' ability to fully finance the trade finance market, keeping the global trade finance gap at around USD1.5 trillion according to estimates by the Asian Development Bank (ADB).

At the same time, a tightening of spreads in traditional loan markets coalesced with the near decade-long pattern of low interest rates has led to a general compression of yields. This has steered investors to seek out alternative asset classes to put their liquidity into – including trade finance.

Yet while 53% of respondents cited using alternative investors, this figure has remained exactly the same as in last year's survey. A growth in alternative liquidity is not yet inevitable and there remain a number of areas of concern for traders including pricing and the knowledge of trade finance as a specialised product among investors.

Across the trade finance space, work is well underway to meet some of these challenges. This includes working towards greater harmonisation, standardisation, data and transparency, all of which would contribute to the growth of trade finance as an asset class.

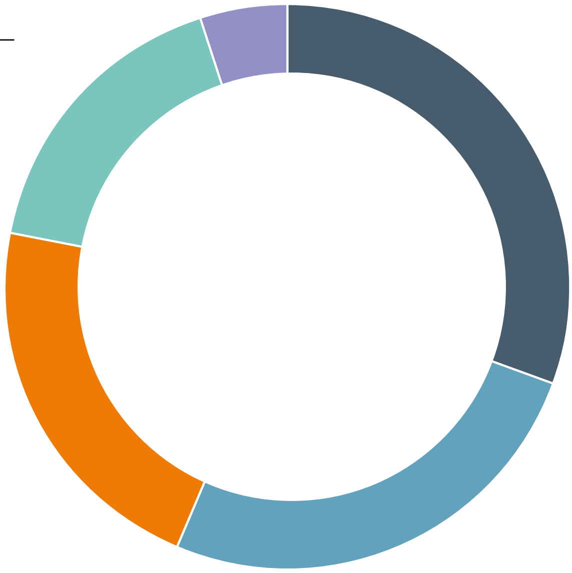
Technology

Technology and digitisation have taken root in the commodity sector, with electronic tracking of goods most widely adopted at present

From accelerating payments and tracking cargo to engendering efficiencies and mitigating risks, technology has the potential to transform the commodity supply chain. Trading houses, much like their counterparts across the chain, have been taking stock of the latest fintech and digitisation developments in order to maintain a competitive edge.

The study found that 58% of traders were currently using at least one of the technology and digitisation tools identified by the survey. Of these, it was the electronic tracking of goods that was most widely adopted which also dovetails well with interest in electronic Bills of Lading (eBL):

Which of these tech/digitisation tools are you currently using?



> *'We wait for these technologies to mature and then we will choose some in specific areas.'*
>
> Global Head of Structured Trade Finance, Switzerland

Among the many appeals of electronic tracking of goods is the vital link it can provide between physical and financial supply chains. For example, as cargo is shipped around the world, a red flag can be raised in the event the cargo's location is traced in or near a sanctioned territory or port, automatically placing a bar on payments linked to the vessel.

Innovations in this space are being ushered in not only by commodity finance stalwarts, but also by the involvement of some of the world's leading technology companies. Indeed earlier this year, shipping company Maersk announced a joint venture with one of the world's leading technology companies, IBM, to utilise a blockchain-based digital shipping system that can track cargo in real time.

This is just one of many uses for blockchain, or the underlying distributed ledger technology behind it, being used or trialled today.

Elsewhere, Louis Dreyfus successfully completed the first agricultural deal using blockchain earlier this year. That transaction saw the documents' processing time reduced to a fifth of what it would have been with the comparable paper process, underlining why the industry is gradually shifting its model.

For smaller players, new technology is seen as a great enabler that has the potential to keep them in the game at a time when banks are much more selective with their financing. If they can optimise their trading model around highly efficient, nimble and digitised supply chains, their chances of not only surviving, but also thriving, increase exponentially.

On the whole, it is clear that across company sizes and commodity sectors the use of technology is on the march. Nevertheless, respondents to the survey also highlighted the challenges in adoption of such technology that the industry must counteract. These include interoperability across different technology providers and a clear path towards scalability once a Proof of Concept has been established.

A collaborative effort that meets these needs, as well as creates a clear and well-understood legal architecture for use of such innovations, will go a long way to cementing the role of new technology in commodity trading in the future.

"Over the last year the market has seen major banks and traders start to experiment with blockchain and distributed ledger-based technology. Whether these technologies are able to move the commodity business forward from paper-based physical trades will depend on a number of factors, but one key determiner will be the level of support from legislators and regulators, which can vary significantly from jurisdiction to jurisdiction. Success means critical mass and will require wholesale adoption by the range of industry players."

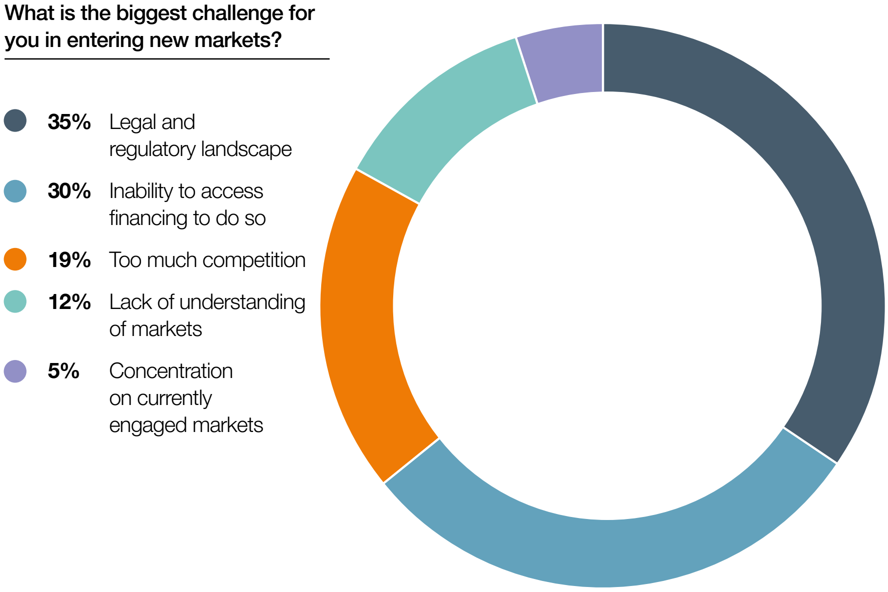
Niels de Ru, Head of Trade & Commodity Finance, Allen & Overy

Legal landscape

The legal and regulatory landscape is once again cited as the biggest barrier to entering new markets for traders

As with last year's survey, legal and regulatory issues were identified as being the greatest hurdle for traders in entering new markets (35%). By contrast, only 5% of respondents pointed to a focus on the markets they are currently engaged in – suggesting the appetite to enter new markets is there but more needs to be done to create a framework in which traders can grow their portfolio in a sufficiently risk-managed manner.

What is the biggest challenge for you in entering new markets?



"The MIFID II regulation is difficult to apply."

Managing Director, UK

Part of the issue owes itself to geopolitics, with the standoff between Russia and the West heightening in light of allegations of election interference, as well as the Trump administration's new scrutiny of the Iranian nuclear deal. Sanctions, the fear of sanctions, and an escalation of geopolitical disputes all have a deterrent effect on deal-making and a company's ability to confidently appraise counterparties' country and jurisdictional risks.

Yet this is only a part of the issue, with another being the stricter compliance procedures financiers must adhere to. Indeed, as one trader put it, "the practical risk itself has not changed, but the evaluation of the risk has changed in the banks".

While this has led in some instances to a flight to quality and caused bigger financing issues for the smaller players, the big commodity traders are also enduring the consequences, for example when trying to integrate new banks with differing compliance procedures into their existing pool.

About TXF and Allen & Overy

TXF

TXF is a leading media and events company in the trade, supply chain and commodity, export and project finance spaces. Since its inception in 2013, it has developed a reputation for accurate, insightful and incisive news coverage in its core markets, as well as for the provision of data to the industry not available elsewhere.

Its global events portfolio offers a series of corporate-led, innovative opportunities ranging from small, intimate workshops and roundtables to marquee conferences welcoming several hundred guests.

For more information about TXF, please visit txfnews.com or email hesham.zakai@txfmedia.com

Allen & Overy

Allen & Overy is an international law firm providing legal services to global businesses and industry. At a time of significant change in the legal industry, it is determined to bring new and original ways of thinking to complex legal challenges.

A&O's trade and commodities finance team can translate increasingly complex finance documentation and security structures into practical and efficient solutions. An in-depth knowledge of the sector and a track record in documenting trade and commodities financings and litigators' experience of advising on a large number of disputes in the trade, commodities and export sector allow the firm to identify and solve issues upfront, providing clients with both practical and commercial advice.

For more information about A&O, please visit allenovery.com or email niels.deru@allenovery.com

Methodology

This research has been conducted by TXF in association with Allen & Overy LLP using telephone interviews with 60 senior professionals at commodity trading houses. All have substantial decision-making input into their company's deal-making and funding programmes.

They included a mix of smaller (18%), mid-sized (53%) and larger (29%) traders, whose primary sector of engagement was broadly balanced between Energy (31%), Metals & Mining (29%) and Agri (40%).

The respondents are based primarily in key trading hubs, including Switzerland, Singapore, London and New York, but some were also based further afield.

TXF makes every effort to provide representative information. All results are based on a sample and are therefore subject to statistical errors normally associated with sample-based information. Fieldwork was undertaken in Q1 2018. Percentages may not always add up to 100% due to rounding up or down.