

Strike force

Chris Thorpe argues that knowing when to strike is a key factor for success when playing the markets or organising public offerings

Markets don't act predictably and often people in those markets do not act rationally. There are too many biases and inefficiencies that exist throughout the economy. The good news is that opportunities are borne from inefficiencies in the markets, no matter if you are financing a new project, taking your company public or hedging your next fuel delivery. The bad news is that identifying when the market is good for you is not easy and is often influenced by bias and 'group think' or inconsistent framing of the issue. As a result, luck plays a large part of whether business decisions look good or bad in hindsight. Can senior business managers reduce the importance of luck by identifying market opportunities and acting on them at the right time? For those exposed to financial markets and commodity risk, the best managers know when to identify opportunities and when to consistently strike the best deal.

Natural resource industries such as oil, gas and mining have a very long investment cycle, often requiring several years to return a profit. Through forecasting, investors take capital risk with some expected return. These forecasts are highly dependent on price expectations of inputs and sales projections for finished goods. Despite this dependency, costs are not usually fixed, or hedged, because revenue is not yet known. So luck becomes the greatest factor whether a business is profitable or not. And of course entrepreneurs appear luckier when they use the best analysis, technology and practices. One common utterance from successful entrepreneurs is: 'The harder I work, the luckier I am.' Though this seems true, the real skill is to reduce the luck factor by spotting an opportunity to secure profits and maintain them for long periods of time.

Financial markets pose an interesting example of timing and luck. For years, financial managers have diversified foreign exchange and interest rate risk, effectively reducing the market risk of global and local economic cycles. For example, a Japanese company selling cars in the United States would typically hedge its dollar-yen risk for a period of time to cover the cash flow back to Japan from sales expected in the US. Similarly, Canadian corporations have typically issued debt in US dollars to US investors to access deeper pockets of capital when Canadian markets did not provide necessary depth or liquidity. In tandem with the offering, US dollar liability would be hedged forward to ensure the costs of foreign debt did not

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increase in Canadian dollar terms over time. Though often foreign exchange and interest rate risk is systematically hedged for cash flow risk management, these hedges are not always executed without bias, speculation or respect for an extreme change in the market.

Take the case of **Aracruz Cellulose**, a Brazilian company that regularly hedged its dollar exposure, which is common for any Brazilian business dependent on exports. Aracruz had grown to become one of the largest global producers of commodity pulp used for paper products based on its low cost of production in Brazil. In Aracruz's case, hedging had been consistently successful for years following the election of President Lula da Silva in 2002 as the Brazilian real trended higher. As it continued to play the trend of the currency, it hedged beyond the value of its actual export sales revenue, thereby creating a speculative position. Then luck ran out. When the financial market collapsed in 2008 and the dollar spiked, Aracruz suffered losses of \$2.13 billion due to its currency hedges. The mistake contributed to the eventual sale of the company at a steep discount to its value prior to the hedging loss. In this case, management had correctly identified the opportunity to hedge, but eventually fell into the trap of overestimating its skill based on its previous luck. Time eventually exposed the error.

On the opposite side of this foreign exchange example is **Nestlé**, which recently reported a decrease of 10% in sales for the first quarter of 2011 primarily due to the stronger Swiss franc. Nestlé does not actively manage its currency exposure, arguing its business is globally diversified. Despite this, sharp swings in the Swiss franc have had a dramatic impact on financial results. Ironically, Nestlé and its global peers all actively hedge commodity exposure in areas such as sugar, cocoa, coffee and even fuel. And the strategies used to hedge commodities are actually very similar to those used to hedge currency save for the effects of interest. Often the divergence in hedging philosophy is overlooked.

In public capital markets, investment commitments tend to be long-term. Equity



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investors have no certain payback period while bond investors have defined redemption periods or maturities of their investments. When issuing new equity or debt, financial managers need to think about the current market conditions, implied costs of capital and terms that investors demand. When a company has a strong business outlook and strong financial position, it may achieve better terms when borrowing or issuing new equity. Furthermore, demand for investment products can influence the kind of terms available for borrowers. For example, when demand for debt paper is high, borrowers can negotiate callable bond features, which allow them to refinance on their own terms at a favourable rate. It can be argued that now is a terrific time to issue new debt in public capital markets, since interest rates are low and spreads – the difference between corporate rates and government rates – are narrow. On the other hand, companies with a less than optimal capital structure may be choosing to issue new equity as global markets continue to support new public offerings. Following the dramatic impact of the financial crisis in 2008 on equity and bond issuance, 2011 has proven to be a banner year for initial public offerings (IPO) and debt issuance. It is not surprising that large private commodity focused players such as **Glencore** have elected to tap the equity markets while investors remain hungry for new opportunities in the commodity space.

The market timing argument can easily be made in commodities as well. Since tools exist that allow financial and commercial managers to lock in prices for months to several years, they can be compared to the bond markets which lock in the price of borrowing for a fixed period. In fact, locking in commodity prices as a fuel consumer could hedge against inflation similar to locking in the interest rate of a bond.

Commodity markets that have higher prices in the future are considered 'normal' because they include the cost of purchasing the product financially, storing it and insuring it. Yet markets are not always normal, and can actually be priced lower in the future.

Looking at the broad oil markets currently, it could be argued that price range in the future could be very wide. With Brent crude oil well over \$120 a barrel, a \$10 move in one week wouldn't be extraordinary. In fact, the market is currently pricing options as if crude oil will trade in a band of \$30 higher or lower over the next year.

This pricing is known as 'implied volatility', where buyers and sellers agree to trade options based on expected moves in the

commodity price. When the implied volatility is low, options buyers can take advantage of the market conditions the same way a financial manager would issue debt when interest rates are low and credit spreads are narrow. What is interesting about commodity markets, and especially those based in US dollars, is they in themselves are a hedge against a depreciating greenback.

Hedging in fuel commodities tends to be more sporadic and atypical within and between industries.

In the shipping industry, fixed rate charters are more typically hedged than spot market vessels. At first glance, this approach appears sound, but upon more detailed analysis it does not make sense to remain completely unhedged since the spot vessel market pricing can be weak despite the costs to ship owners.

In the cruise line industry, there seems to be no typical fuel hedging within the sector. While **Royal Caribbean Cruises** hedges consistently, its rival **Carnival** does not. Despite the possibility of passing through all costs to the customers, it is often not commercially competitive for Carnival to do so. Other transportation companies in the marine and road industries face a similar quandary. The difference in philosophy may or may not be significant in terms of which will be successful. Strategic analysis of industry competitiveness by Harvard Professor Michael Porter suggests that luck has as much as 40% impact on explaining profitability, with industry and business unit effect each under 20% respectively. Knowing luck has so much impact on business, isn't reducing the luck factor even more important?

Natural gamblers

While there is no shortage of currency or commodity expert forecasts, business managers shouldn't take strong views when it comes to hedging. They ought to leave the directional guessing to natural gamblers like hedge funds and trading houses. For commercial business, luck has far too much impact on business profitability. If nothing else, being able to have some planning certainty is worth the trouble when it comes to hedging especially when an opportunity can be secured with known input costs or revenues. When the market creates unexpected opportunities, being prepared to act on disparities in price can be the key to longer lasting profits. A hedging strategy that is part of reducing uncertainty to achieve a set of goals is easier to understand and more effective. With some luck, a well hedged business plan will be more profitable.