

# Leading commodity traders: Filling the funding void and maxing the margins

TXF PREMIUM

*A downturn in global commodity markets and a rise in regulatory pressure has led to greater de-risking by structured trade finance banks. This funding gap is being increasingly filled by large commodity traders, giving them even greater market clout and a lending margin to add to trading profits.*



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Pre-payment finance structures have always been essential to traders, enabling access to commodities from frontier markets and enabling producers to raise debt at realistic rates. But the role of traders as on-lenders has taken on even greater significance since banks began to de-risk their balance sheets to meet the more and more stringent demands of new regulation.

But rather than be overly concerned about the prevalence of traders in the structured finance space, Stephan Jansma, head of structured and trade finance at Trafigura, believes banks are more willing to take on emerging market risk when a commodity trader leads the deal.

He tells *TXF*: "A lot of these structured deals are now trader led whereas in the past a bank would lead the financing. The difference in recent years is that it's not only the medium and smaller sized producers who are interested in these deals, larger corporates are also adding prepayments to their range of funding options."

The increase in financing options from traders has helped to bolster an already lucrative market for commodity houses – in effect a bonus on trading activity via a margin on each transaction after their own refinancing costs.

One financier tells *TXF*: "Traders often have better relationships with producers than bankers do. They do make a nice return on their on-lending to producers but their real intention is getting a big discount on buying the available commodities."

Notable deals in the oil sector have included Trafigura, Vitol, and Glencore pre-paying for crude oil from the Kurdistan Regional Government in Iraq. Vitol also used a similar structure when pre-paying for oil out of sanction-laden Iran last year.

As Alexander Peters, CFO at State Oil Group, says: "In PXF and pre-payment structures producers become an integral part of the market share of major commodity houses as they rely on them for financing."

Traders have identical Anti-Money Laundering (AML) and Know Your Customer (KYC) regulatory procedures to banks. But while some commodity banks have been burnt in risky markets in the past, larger traders have rarely been hit by such difficulties. And even if they were, only 10-20% of the risk is likely to be on their balance sheet.

## Funding flexibility

Larger traders' business models rely on price volatility and trading activity for profits, which is made significantly easier through gaining discounts on bulk bought commodities. Consequently, a key driver of commodity trading is access to cheap, annual debt on a revolving basis. Major traders such as Vitol, Glencore, and Mercuria have all secured revolving credit facility (RCF) financing at under 100bp in the past few years, which has allowed them to manage their everyday trading and working capital costs. However, this funding can occasionally be used to on-lend to producers – in effect a bonus margin for the trader which ultimately cuts its own cost of borrowing.

As Peters adds: "No trader wants to admit that they use their RCF or working capital financing for on-lending following the problems with Stemcor - but in essence they do and it allows them greater flexibility and better margins."

Banks have been more demanding on the use of trader's RCFs since Stemcor missed repayments on a syndicated loan after buying an Indian iron ore mine during the financial crisis. One European commodity financier tells *TXF*: "Banks can never truly know exactly what traders are using their RCFs for, but we have a good idea. And it does allow us to indirectly finance producers who would otherwise be too risky."

While most traders raise cash from the banks for on-lending, some have started specific trade-finance funds. For example, Galena Asset Management operates as an indirect subsidiary of Trafigura. In February, the company provided €250 million (\$266 million) to Finnish metals company Terrafame with a five-year tenor. As part of the deal Trafigura will buy 100% of the nickel-cobalt sulphide precipitates and 80% of the zinc sulphide precipitates produced by Terrafame during the next seven years.

Jansma points out that as more producers tap trader financing, the traders have begun to provide different solutions to producer's myriad needs, be it longer grace or availability periods or increased tenors.

These different solutions comprise numerous varieties of pre-payment facility, but also more unique structures. Jansma tells *TXF*: "We've seen a small rise in the use of tolling transactions whereby Trafigura supplies the raw material to a producer and offtakes the finished product. Similarly, in Asia-Pacific we've seen more hybrid RBL facilities which combine parts of RBL, pre-payment and equity financing structures."

### Controlling commodities?

While all this is a general positive for the international commodities supply chain – there are potential downsides. A key concern is the impact on the market share of smaller traders – those without the ability to act as lenders. Coextensively, Jansma suggests that banks may well be less willing to lend to smaller traders - further inhibiting their ability to compete - as there is no guarantee they will still exist in five years' time. Peters concurs stating that SMEs in the commodity trading space will likely come under increased pressure going forward.

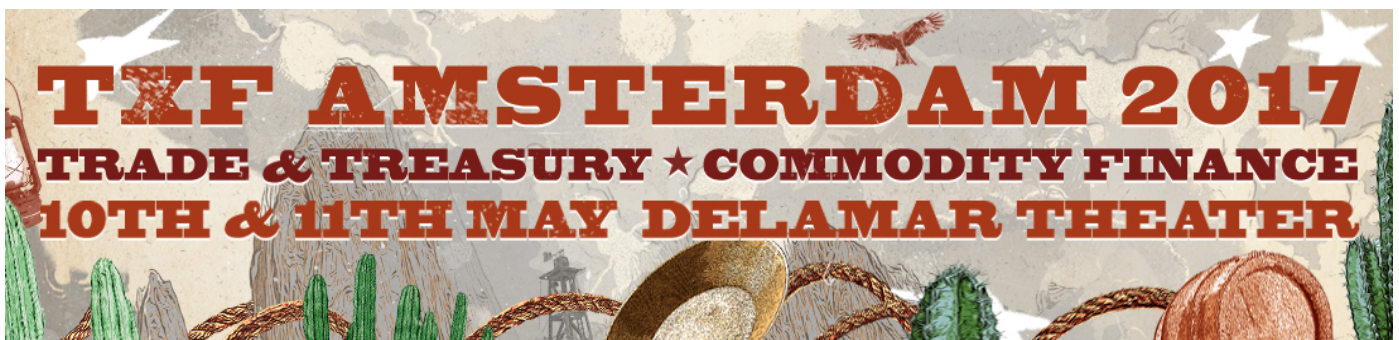
The major "traders have an edge in the financing market now given their access to producers who are too small or expensive for banks to service. Given the cheap debt they have access to, they can make a good margin on their interest spread between facilities," says a European financier.

The market domination of a small number of predominantly privately-owned Europe-based traders controlling vast swathes of commodities globally through structured financing agreements seems set to remain the status quo for now.

Interest rate changes and commodity price volatility could shift this balance in the future. And on the bank side there is a sense that the current environment of low interest rates and decreasing margins on traders' RCFs cannot continue. But as one financier notes: "Some traders are well diversified in terms of funding, with various debt tenors and the ability to fix mid-term borrowings should they need to."

*Alexander Peters and Stephan Jansma will both be speaking about their financing experiences and the current landscape at [TXF Amsterdam](#) on 10-11th May.*

*For more information, including the latest confirmed speakers and how to book, see the [event page](#). A limited number of complimentary passes are available for commodity traders, producers and processors. To enquire, please email [judith.fagelson@txfmedia.com](mailto:judith.fagelson@txfmedia.com).*



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