



USING COMMODITY STOCKS TO RAISE FUNDS DIRECTLY ON THE CAPITAL MARKET

In 2008, the international financial system entered into a terrible crisis. While trade finance has traditionally been relatively isolated from broader banking problems (after all, trade must go on), this time round the contagion effects are strong. Intra-bank lending has suddenly become expensive even for the best banks, and commodity traders have become seriously constrained by tightened credit availability. Problems have been compounded by historically still high and very volatile commodity prices. It now often is a challenge to syndicate a loan or even, find a bank which has room in its country credit ceilings. It is to be seen how long it will take before confidence returns.

Meanwhile, cash has become king. Sovereign wealth funds, private wealth funds, institutional investors and so on keep hundreds of billions of dollars/euros in short-term, liquid assets, waiting for either opportunities that are too good to let pass, or for the return of safer times. It is, of course, very difficult to reach high earnings objectives with short-term liquid assets, so it is a fair assumption that these investors remain interested in deals with low risk and good returns. Financings based on commodity stocks, if backed by a good credit support company, may well fit these criteria.

Investors can directly fund trade finance deals which are secured through collateral management arrangements, simply replacing the banks that would normally have funded such deals. But it is also possible to structure large-scale financings through the securitization of inventories: the inventories are placed into a Special Purpose Vehicle (SPV – which could take the form of a Trust), and the SPV then issues securities.

However, in practice it is not that easy. Firstly, it can be difficult to find a warehouse operator who is both reliable and affordable – there is a considerable risk of theft and "unexplained disappearances", and banks know that warehouse receipts issued do not necessarily stand for actually present commodities. Secondly, legal issues may complicate the structuring of a "true sale" for commodities. Inventory is not a self-liquidating asset: a company must perform certain operations to generate a receivable. And to perform such operations, it must maintain a certain measure of control. A bankruptcy court may decide that this implies that there was no "true sale". Third, securitizations have high set-up costs. Fourth, there are readily available alternative funding mechanism, namely warehouse receipt finance and repo-finance provided by banks, which can be more attractive in many circumstances.

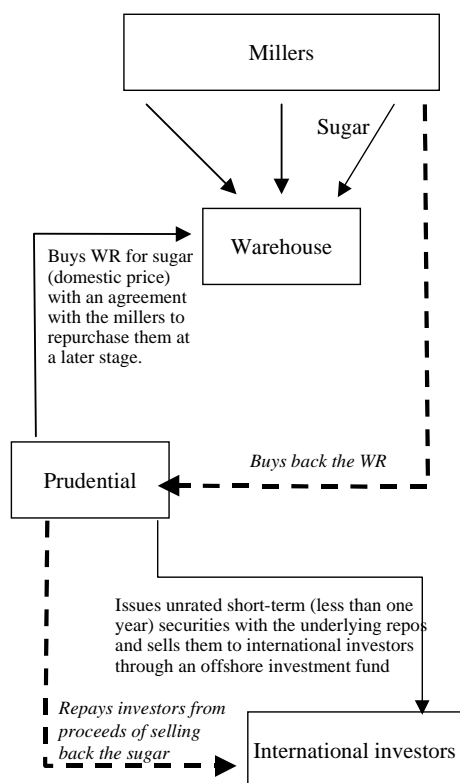
Nevertheless, securities have been issued on the basis of goods in inventory. Commodity exchanges in Colombia and Venezuela have started structuring repurchase orders (repos) for grains, with institutional investors buying and trading the paper on the exchanges. In the US, a grain cooperative securitized its inventory in a US\$ 200 million deal, and smaller issues along similar lines were later done in South Africa and in Mexico. Prudential Securities structured issues backed by sugar inventories in Mexico. Nomura, in 2000, did the first of a series of inventory-based securitizations for champagne. The year 2001 saw the first issue using diamond inventories, followed by one for metals. Deals have also been reported for wool, tobacco, wood chips and steel.



A few examples – 1. Mexico’s sugar-backed bonds

Credit was scarce in Mexico after the 1994-1995 peso crisis. Access to international bank loans and capital markets had become reserved almost exclusively to blue chip companies and large exporters. This posed serious problems for the sugar sector, as sugar companies need much finance: sugar production is seasonal while consumption is spread over the year, so sugar mills, which convert raw cane into refined sugar, have to carry large inventories.

Figure 1
Sugar bonds in Mexico



A few sugar companies with good financial standing already had access to straightforward warehouse receipt financing in dollars, but conditions were onerous. Interest rates were Libor plus 300-400 basis points, and warehousing, surveillance and other transaction costs had to be added. The banks also demanded guarantees such as mills' fixed assets, a 33% over-collateralization, a price hedge, and sometimes, a partial guarantee from a local bank and/or the foreign offtaker on performance risk (the risk that the sugar company would not be able to process and sell the sugar).

In 1996, Prudential Securities, a US bank, developed a financing alternative for Mexican sugar mills: they could finance production by selling their finished product after harvest time to Prudential, agreeing to buy it back later (this was called a repo-reverse repo scheme). So the burden of inventory finance was taken off their hands. Prudential issued securitized bonds worth some 400 million US\$, in the US capital market backed by the income stream generated by mill repurchases in the off-season. Figure 1 gives an overview of the structure.

Risk were mitigated in a number of ways. Exchange rate risk was managed by a daily marked-to-market margin call based on the domestic price versus the dollar price of the sugar. As to price risk, at issuance the securities were supported by 125% over-collateralization, and the millers had to put up additional tonnage if the price of sugar fell during the funding period. Performance risk was managed by the fact that the focal element to the structure was the sugar itself. Ownership actually passed to Prudential - unlike in standard warehouse financing - so if a mill were to go bankrupt, negotiations and legal battles for assets would be avoided. Prudential certified participating warehouses itself, but contracted out extensive inspections of the sugar to an independent collateral manager.

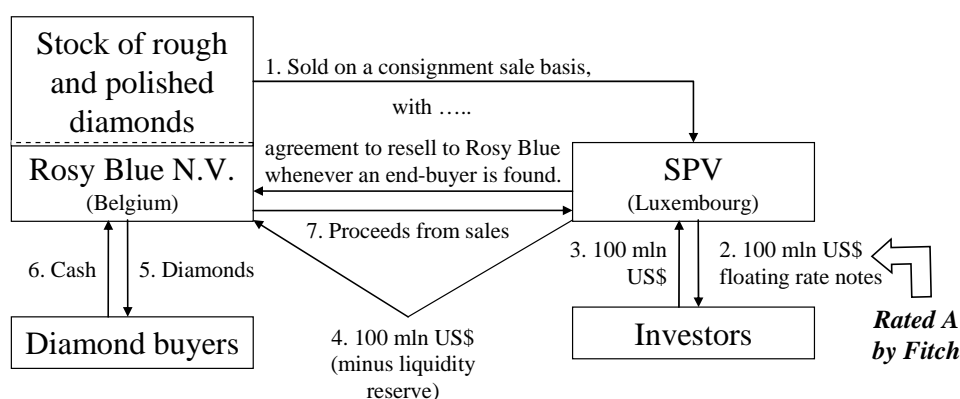
The overall cost of the product was about 11%, including Prudential's fees and commissions and the fees to warehouse inspectors. Companies reported that their all-in cost of funding, including related transaction expenses and the warehousing costs, brought the cost to 13-14%, considerably less than the 20%+ rates they would have had to pay for traditional bank loans.



2. Rosy Blue: diamonds

In 2001, an Indian company, Rosy Blue, arranged a securitization through its Belgian wholesale arm, Rosy Blue N.V. (a company with an annual turnover of, at that time, well over 1 billion US\$). Figure 2 gives an overview. A SPV called Rosy Blue Carat S.A. was incorporated in Luxembourg with, as its business, the purchase of diamonds for refinancing the stock thereof. Rosy Blue sold its stock of rough and polished diamonds worth approximately US\$ 182 million to the SPV, with the agreement that it can buy diamonds back whenever a real end-buyer is found. Payments of interest and principal to noteholders are backed by the cash flows from the ongoing sale to final buyers. The transaction is based on a revolving pool of diamonds.

Figure 2
Rosy Blue's diamond securitization



Rating agency Fitch was able to give the notes an "A" rating, because the physical stock of diamonds with the SPV will always be more than the accrued interest plus principal of the noteholders. If the stocks fall below certain levels, or the credit quality of Rosy Blue deteriorates beyond certain limits, then the transaction will be unwound, with a Belgian bank selling the stock of diamonds on behalf of the SPV. This was a very successful issue, and it was later raised to US\$ 150 million, with the notes having a final maturity in October 2009.

3. Glencore: base metals

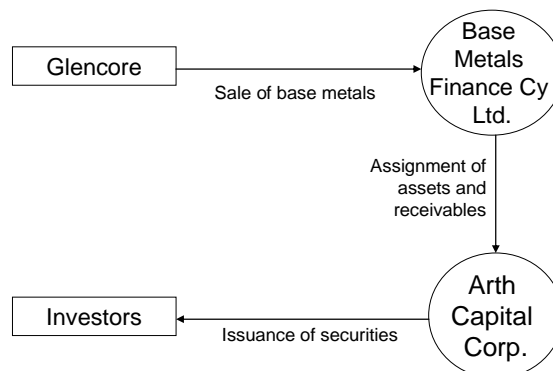
In April 2003, Glencore, one of the world's largest commodity trading firms, raised US\$ 750 million through the issuance of commodity inventory-backed securities. The basic structure of the securitization is shown in figure 3.

Arth, a Special Purpose Vehicle registered in Delaware (USA) issues commercial paper, which was rated A-, to finance the purchase and holding by Base Metals Finance Company Limited (BMFC, a Jersey-based SPV) of inventories of aluminium, copper, nickel, zinc and lead, to be held in independent Western European and Singaporean warehouses. Part is held under London Metal Exchange (LME) warrants, which implies that they can be converted into cash very easily at any time.



BMFC's metal purchases are funded through Arth as long as they stay within pre-defined limits; beyond, Glencore funds the purchases. The value of the inventories was protected through a hedging programme, which ensured that the value of the inventory would not fall below certain levels during prescribed periods - periods that were determined in such a way that, in the case of a default, BMFC would have sufficient time to dispose of its inventories without being exposed to the risk of price falls. Liquidity support was provided through a syndicate of banks for an amount that covered the volume of commercial paper due to expire over the next 16 days - this was deemed enough to manage the risk of delays in rolling over commercial paper.

Figure 3
Glencore's inventory-based securitization



Conclusion

Most securities backed by commodity stocks have fairly simple structures, and they tend to work well. It should inspire developing country entities that hold large values of inventories, including large food sector companies, fertilizer firms and government entities holding strategic stocks of foods, fuels or metals to search for ways to use their inventories to improve their financing conditions.

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This is possible through the core asset of the group, which is an extensive network of 1,200 highly skilled professional coming from a diversity of backgrounds – and operating in 30 offices throughout 24 countries.

Through its world-class systems and staff, ACE is able to secure commodities as well as a range of consumer goods (pharmaceuticals, vehicles etc.) in any location, providing comfort to industrial and commercial companies and the financial community alike. Since its inception in 1996, ACE has provided credit support services for commodity values in excess of US\$30 billion for more than 150 financial institutions and trading companies in more than 75 countries.

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