COMMODITY PRICE RISK MANAGEMENT

THE NEW FRONT LINE FOR MARGIN MANAGEMENT

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If asked to identify the main driver of their company’s profitability, most executives would probably point to the competitiveness of their products, the strength of their strategy, or their ability to cut fixed costs. But they would be overlooking an important inflection point.

With recent price shifts in commodities ranging from corn to copper and their ongoing volatility, the front line for companies to improve their earnings is radically changing, making it impossible for companies to stick to their old playbook and remain competitive. Managing the impact of raw material costs across a company’s value chain has become a key driver of financial performance. To successfully manage the rising impact of raw material costs on margins, procurement teams must play a bigger role in managing companies’ margins, with involvement across the broader organization as a whole.

The fundamental reason for this change is that raw material costs have climbed to become many packaged consumer goods companies’ biggest expense, accounting for about half of their costs. Yet their ability to pass through price increases in a timely manner to customers is low, particularly in highly competitive mature Western markets. As a result, packaged consumer goods companies, airlines, packaging companies, construction companies, auto makers, and utilities have all become more vulnerable to rising material costs in the past few years. (See Exhibits 1 and 2.)

Indeed, commodity price swings are now considered the second-largest driver of earnings uncertainty at publicly traded companies, following macroeconomic factors, according to a survey of nearly 500 senior financial professionals conducted recently by the Association for Financial Professionals (AFP) with Oliver Wyman’s Global Risk Center.

EXHIBIT 1: COMMODITY SPEND AS A PERCENTAGE OF REVENUES FOR MAJOR INDUSTRIES

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<tr>
<th>Industry</th>
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<tbody>
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In a world where a 10 percent jump in raw material prices can double a company’s earnings or wipe them out, senior executives can no longer afford to continue to treat procurement as simply a division that secures supplies. To stay ahead, they need to shift their procurement mind-set toward commodity price risk management. By doing so, companies have achieved a 10 percent reduction in the earnings volatility caused by commodities.

MAKING RISK MANAGEMENT A PRIORITY

Some companies have figured this out and adapted their business models to this new reality. Companies like Tyson Foods and utilities like E.ON and RWE have long considered risk management to be at the core of their activities. In the past decade, many major energy companies have also made commodity exposure a priority by founding and expanding trading business units which are now at the commercial heart of their business models. More recently, packaged consumer-goods companies have started to shift their stance toward commodity procurement. Indeed, some have founded trading businesses that cross all of their divisions. As a result, these companies can actively manage margins by managing their overall commodity position and risk management activities.

Across a wide variety of industries, a handful of players are gaining an edge over their competitors by adapting to a new environment in which procurement teams must be expert commodity price risk managers. That’s because these companies have gained a much deeper understanding of their commodity procurement risk exposure.
and its impact on their margins. They have also developed the market intelligence to improve their management of this exposure.

As a result, these companies have more control over the impact of commodity price swings on their financial results and can even turn them into a positive. Beyond improving their margins on an absolute basis, they are able to improve the predictability of their financial results along with their perception by financial analysts.

Other companies are now following suit and building up capabilities in their procurement organizations. Meantime, leading players are preparing to broaden the scope of procurement even further. They are shifting their procurement function away from purely managing costs to a commercial function that works with sales teams to manage profitability.

A new competitive playing field is developing as all of these companies attempt to manage the impact of volatile raw material costs on their products. In response, they are providing more accurate and timely volume information across their entire organization – from treasury to manufacturing to sales. Companies are aware that in order to attain full margin control they need to go as far as training their sales force on how to cope with material-induced price changes so that they can discuss alternative contracts.

So how, in this new world, can companies turn volatile commodity prices to their advantage?

**THINK ABOUT COMMODITY PRICE RISK MANAGEMENT, NOT PROCUREMENT**

A shift to a focus on commodity price risk management means that you can’t treat procurement as a division that simply secures supplies. Top-notch procurement

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**EXHIBIT 3: LEVELS OF COMMODITY PRICE RISK MANAGEMENT SOPHISTICATION**

- **Transformation Wave 1**: Create transparency on risk exposure, portfolio, and hedging options
- **Transformation Wave 2**: Change procurement philosophy and implement approach to reflect MRM principles
- **Transformation Wave 3**: Establish separate market-focused risk management activities and execution to also advise procurement and sales teams
- Coordination of hedging activities and selective leverage of proprietary market views

Source: Oliver Wyman analysis
teams still source raw materials globally at the lowest cost possible, certainly. But they also use advanced risk management techniques to enable companies’ contract strategies to optimize the trade-off between obtaining the lowest cost and mitigating the risk of a position. This might lead to a change in their value chain as some positions are more or less exposed to price movements. In some cases, for example, they may decide that companies should buy from their suppliers’ suppliers to gain greater price certainty, even should it require an effort on their part to build relationships with new suppliers and deviate from traditional supply contracts.

To achieve this, procurement teams need to recognize that their role has evolved. Accomplishing this requires a real transformation and a risk-based culture that starts with top management setting a clear vision for how an organization will profit from volatile commodity prices. (See Exhibit 3.)

Leading companies that understand the potential of commodity price risk management set goals that require different levels of capabilities. Some set a target of creating full transparency across all of the company’s commodity exposures and aligning procurement and hedging practices to match their risk appetite. More ambitious companies create a central specialized commodity risk management unit, which actively monitors commodity markets, restructures contracts, and hedges widely traded commodities. (This can sometimes entail economic or proxy hedging.) At the most sophisticated level, companies link procurement-controlled margin impact to sales activities. They may also take calculated bets to exploit potential market price movements on selected items in a controlled environment.

FOCUS ON HOW VOLATILE COMMODITY PRICES IMPACT YOUR PROCUREMENT PORTFOLIO, NOT JUST ONE REGION OR COMMODITY

As barriers to markets have tumbled, it has become much easier for companies to source raw materials across dozens of significant commodities in multiple geographies. But at the same time, it’s much more difficult to evaluate the financial impact resulting from market uncertainties. What management teams crave – and few procurement teams can provide – is the sum of the company’s exposure to commodity risks across its entire portfolio. (See Exhibit 4.)
Unfortunately, many organizations have “grown” procurement organizations which rely mainly on local buyers to fulfill key roles in procurement – negotiating contracts, keeping an eye on local markets and relationships with suppliers, and managing the supply logistics. While these physical activities are important, the organizations often lack the oversight and the holistic financial picture necessary for a company in today’s environment of volatile commodity prices to manage the complete portfolio. As a result, they miss out on multiple opportunities to improve their margins by taking a more coordinated approach.

Companies skilled at identifying opportunities presented by volatile commodities tend to have centralized commodity procurement divisions with lead buyers who can develop contracting models, financial hedging, and sourcing strategies that take into account the potential impact of a company’s entire procurement portfolio across commodities and geographies. They can nimbly take advantage of the fact that emerging markets may be able to cope with more volatile commodity prices since their sales prices can be more frequently adapted, for example.

By doing this, companies can reduce their exposure to commodity price swings by more than 60 percent, simply because they have a very different, and accurate, picture. As a result, they can avoid expensive mistakes such as overhedging without truly understanding their exposure and market dynamics.

### DIRECT EFFORTS TOWARD ILLIQUID COMMODITIES, NOT JUST THOSE WIDELY TRADED

In working with companies to manage the impact of volatile commodity prices on their margins effectively, we have been struck by how often widely-traded commodities make up less than 5 to 10 percent of overall exposure.

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**EXHIBIT 5: TYPICAL SPLIT OF RAW MATERIAL SPEND FOR PACKAGED CONSUMER GOODS COMPANY**

<table>
<thead>
<tr>
<th>Exposure Share of Total</th>
<th>Description</th>
<th>Applicable Commodities for Packaged Consumer Goods</th>
</tr>
</thead>
</table>
| 50%                     | Illiquid markets  
  - Mainly bilateral contracts without standard specifications  
  - Liquidity is very low especially for longer maturities  
  - Infrequently priced contracts  
| Fruit and vegetables  
  - Specialty ingredients  
  - Grain  
  - Sugar (some markets) |
| 35%                     | Proxy/indexed markets  
  - Dominated by local markets with significant differences in contract specifications  
  - Considerably less liquidity  
  - Weekly price index available  
| Milk powder  
  - Plastics (resins)  
  - Paper and cardboard |
| 15%                     | Liquid financial markets  
  - Global market with variety of standard financial instruments, contract maturities, different delivery points  
  - Futures available, daily pricing  
| Oil and oil products (ICE)  
  - Power and gas (EEX, TTF)  
  - Wheat (CME)  
  - Soybeans (TCM) |

Source: Oliver Wyman analysis, split varies depending on production portfolio
Yet one of the most cherished ideas in traditional procurement is that financial hedging using derivatives should be a company’s first step to managing risks introduced by volatile commodity prices. This can be a mistake. Instead, it might make more sense for financial hedging to be the last step – implemented only after contracts have been restructured and changes have been made to the sourcing strategy that makes these instruments possible by linking their exposure to traded commodities.

One food company, for example, spent only 10 percent of its direct procurement budget on commodities that were traded on liquid financial markets. Forty percent of its budget was spent on commodities that were only available on semiliquid markets. There were no liquid markets for the remaining half of its commodity spend. (See Exhibit 5.)

For this company, and many others, the biggest levers to managing margins do not lie in financial hedging. Instead, they exist in effectively adapting contracts. For example, if a transparent market for a plastic does not exist, a company might price a plastics contract based on indices of widely traded raw materials used to produce the plastic. The pricing logic can also alleviate buyer’s regret by introducing time lags, averaging prices across the month of purchase, or across cost-based formulas.

Adapting a company’s sourcing strategy so that a company can reformulate a product and obtain raw materials from players further up the value chain can also have a huge impact. For example, one consumer goods company was able to increase its margins significantly by buying resins for plastics packaging directly from petrochemical companies rather than sourcing them through the packaging supplier. This way, they were able to contract different pricing formulas based on crude oil that could be hedged in the financial market.

INVOLVE SALES, TREASURY, AND FINANCE, NOT JUST THE PROCUREMENT DIVISION

To reach the ultimate goal of stabilizing and improving a company’s margins, procurement teams need to work closely with the sales, treasury, and finance divisions.

While a procurement team will likely be the biggest driver for change, they will need input from sales and marketing to develop a perspective on how to improve a company’s margins, given the company’s flexibility and constraints on the customer side. Treasury needs to be involved, as they are often responsible for financial hedging. Finance is part of the process as they are responsible for midterm planning and therefore have the most natural interest in the development of the cost and margin structure and potential opportunity and threat scenarios.

To stay ahead, companies need to shift their procurement mind-set toward commodity price risk management

MASTER SOPHISTICATED RISK MANAGEMENT CONCEPTS, TOOLS, AND MARKET INTELLIGENCE

Companies that are capable of boosting their margins by conducting commodity risk management have models and tools that create transparency so that risk managers can nimbly evaluate options. Many also use dedicated market intelligence teams to monitor the market and collect information to stay ahead of sudden changes.
EXHIBIT 6: TRANSFORMATION PATHS
HOW TO START

Most companies operating in an environment of highly volatile commodity prices know perfectly well that they need to change their mode of operation. The problem is that the concrete actions necessary to develop the required organization, capabilities, and mind-set are less clear.

In our experience, companies that achieve some success early on in their transformation are more likely to reach their ultimate goal. They typically achieve this by taking one of two approaches. Some start with the most widely traded commodities and build a risk management function which acts similar to a trading organization within the scope of these raw materials. Others first address their biggest spend items to be sure that they have the biggest impact on the financial bottom line from the very first phase of their transformation.

A deep understanding also exists across the organization concerning the impact of commodities’ different contract structures, pricing formulas and indices, portfolio effects and correlations, risk-return terminology, and how they fit with the company’s overall risk appetite.

Ready or not, volatile commodity prices are rapidly reshaping industries. If companies fail to adapt their mode of procurement operations to engage in broader margin management, they risk experiencing rude surprises such as quarterly losses due to price spikes in the raw materials used in their products. In fact, this is already happening.

By contrast, companies that seize the opportunity created by the current upheaval to develop more sophisticated commodity price risk management capabilities are not just stabilizing their profits – they are improving them. That’s why commodity price risk management is no longer just a good idea. It’s a must.

WHAT TO CONSIDER TO CHOOSE THE RIGHT PATH

- Ambition level of the organization
- Level of internal alignment on target model and future approach to risk strategy
- Resource availability
  - For the implementation project
  - For the target market risk management organization
- Internal capabilities
- Mind-set and risk-return culture in the procurement organization

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