

# Increased grain trade risks inspire capital markets

*The changing markets of the world grains industry have not made this trade less risky. Quite the opposite, since risks have actually increased overall. As a reaction, capital markets have acquired a more influential role thanks to new participants who are looking to extend their traditional business to risk financing. Marc Timmermans identifies the main trends and risks involved in the grain and oilseed trade and provides tools to manage these.*

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The animal feed industry is an important user of grains and oilseed products. In its procurement activities, this industry must deal with developments in the international grain and oilseed markets, and is therefore also exposed to risks in these markets.

Risks within an industry are affected by changes in the hosting environment, including fluctuations in supply, demand and price; changes in the industry structure and developments in the agricultural and trade policies effective around the world. The numerous risks involved in trade can be divided into four key areas, which in one way or another, are also inter-related:

- **Crop risks:** the balance between supply and demand both in terms of quantity and quality can vary considerably in subsequent years. This balance in turn influences the price and vice versa. Quantity is always related to planted area and weather conditions, the latter of which also has influence on quality. Also aspects like contamination, food safety, tracking and tracing and biotechnology play an important role in this aspect. Demand, on the other hand, is generally more stable, but affected by the level and growth of income as well as

the population in different regions of the world.

- **Country risks:** the country risks refer mainly to the *political and transfer risk* (e.g. a ban on transferring foreign currency outside the country), which mainly exist in less developed or transitioning economies. The economic and political stability of those countries is clearly an element to be considered when dealing with foreign trade partners.
- **Counter party risks:** at company level one active in trade has to deal with the counter party risk. This includes all risks related to dependence on other companies or trade partners for the success of a particular business and encompasses *performance* and *payment risk* involved in contractual *defaults*, *credit* and *exposure risk*.
- **Market risks:** this includes *price*, *currency*, and *interest rate risk*, which relate to the volatility in the market and economic situation in various countries.

## Industry trends and risk profile

A number of developments in the grain and oilseeds industry over the past ten years have had an enormous impact on the risk profile of the industry. This can also be seen from the increased volatile price developments of grain and oilseeds, including their derived products.

There are a larger number of smaller and less experienced buyers and sellers of grain, a result largely of the drive to privatisation in developing countries and the subsequent change of ownership and structure of many of the former State Trading Enterprises (STE). Governments often guarantee payment and foreign currency risk to STE's, thereby reducing the risk of counterparts to government risk. After privatisation however there are an increased number of smaller and less experienced traders to deal with, which due to their exposure to forces in the global market place are less protected than government bodies. This increases the credit and counter party risk when trading

with them. Although Euroland is a fact at this time, on a global scale currently more countries and currencies are actively involved in grain trade because of increased international trade. While the international grain trade is basically a US dollar denominated business, some countries lack foreign currency, while opportunities to trade forward exchange contracts to manage price and currency risks are limited. Therefore the sourcing of raw material from foreign countries impose more price and currency risk.

### Larger range, smaller volumes

Another reason for the increase in risk is that a finer range of product qualities is traded in smaller volumes. Demand is shifting from bulk to higher value food products. As a consequence, the demand for grain products downstream in the chain is becoming more sophisticated. A second de-commoditisation driver is the expansion in the variety of products being made available by both traditional crop breeding and biotechnology. Reason enough to expect an even wider range of specific product qualities and applications.

De-commoditisation means that transactions between buyers and sellers are becoming more complex because quality specifications are more critical. This imposes higher quality and transport costs and risks. Price risk is also affected because premiums paid relative to the reference commodity fluctuate with changes in availability and demand. Buyers and sellers also depend more on each other's prompt delivery and payment and this increases the counter party, default and payment risks.

### Identity preservation

The de-commoditisation trend has stimulated a trading system based on identity preservation, or IP. In IP systems a crop is handled and stored separately from other commodities throughout the value chain. The origin, the production process and properties of the product should be clearly specified and traceable through labelling to assure quality, food safety and consumer acceptance.

While logistics have mainly focused on bulk commodities until now, identity preserved systems will provide a competitive edge in mitigating quality and transport risks.

The emergence of e-business is introducing a new trading format, making trading activities more global, instant, and for the time being relatively unregulated. When considering e-commerce strategies, one must not forget that despite improved transparency and ease of transactions, the grain still has to be delivered with the right quality, in the right volumes and at the right time and place.

E-business though, introduces new risks that have to be managed one way or another, including the risks related to:

- 1) Identification: counter parties are often not known;
- 2) Authorisation: it is not clear if the bidder has legal authority to bid or pay;
- 3) Performance: it is uncertain whether the seller will perform;
- 4) Payment: how will payments be settled?

Therefore an e-commerce strategy must be set-up carefully and provide synergies with existing business.

### Concentration of trade

Particularly in the developed regions traders are becoming larger, more diversified and multi-national, rather than smaller and less experienced. This concentration is often accompanied by horizontal and vertical integration and globalisation. Although only 12% of the world's grain is traded internationally, less than ten players trade more than 80% of this grain, each of which is also involved in domestic trade.

Knowing the company and judging the company's performance in each of the activities is therefore crucial to reducing trading risks. In this respect it is quite relevant for the feed industry to realise that pure traders often take greater risks than vertically integrated players and processors, simply because they are fully reliant on trading income. This imposes higher risks to buyers who's initial objective is just to secure origination of raw materials at the best prices possible.

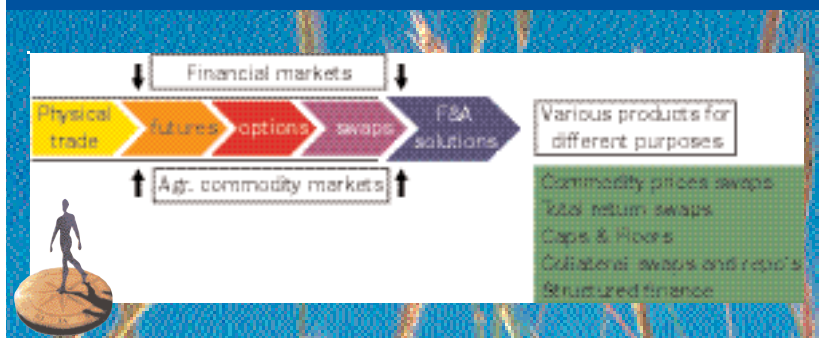
### Financing counter parties

Large traders are becoming more and more involved in financing their counter parties because of the fierce competition between these few large players. Particularly on the sourcing side, indirect financing of growers through corporates is increasing. There is a lack of direct financ-

**Figure 1 - Changing trade environment requires more sophisticated risk management**



**Figure 2 - Innovative instruments provide opportunities for more sophisticated risk management**



ing for producers. Still traders have to compete for the crop for later processing or trading. Therefore, large traders set up a commercial strategy by building closer ties with the growers in providing finance and/or inputs. This expands their risk into the area of crop risks.

### Reducing crop related risks

Crops risks are either directly or indirectly relevant to the animal feed industry, depending whether they source raw material from the world market or not. Companies that source from the world market are affected to limited extent by fluctuations in domestic or regional crop production. For companies that are involved in direct sourcing from farmers, reducing the risks on the supply side starts with setting up a good distribution network, appropriate land management practices, supported by extension services, access to suitable inputs (seeds, varieties, fertilisers) and in relevant cases with a matching financing system.

Another instrument worth mentioning to mitigate crops risks is a crop insurance system, particularly in regions where even good agricultural practices and efficient allocation of appropriate crops are not enough to mitigate the risks of drought and flooding.

### Managing counter party risks

A strong relationship with players and true understanding of the market is crucial to selecting the most reliable suppliers and reducing the counter party risk. If that is not enough, various traditional banking products, including letters of credit, are used. This is closely related to the legal issues involving the title of goods at different stages of the import/export process. Also credit insurance companies provide additional opportunities for risk alleviation.

Finally, depending on the importance of a particular origin and the need for circumventing unreliable trade partners, counter party risk can be reduced by setting up own sourcing organisations in producing countries.

### Risk financing

The main drivers in the industry mentioned above have not made this world any less risky. Quite the opposite, risks have actually increased overall. But also capital markets have acquired a more influential role thanks to new participants who are looking to extend their traditional business to risk financing. Financial institutions like re-insurance companies, pension funds, hedge funds and private investors have turned to the capital markets in search of new and more rewarding investment products.

At the same time, they are using the capital markets as a means to finance their own risk positions. Instead of investing in bonds, stocks, financial options and futures they nowadays invest in commodity markets and risk instruments. Now that risks can be separated and quantified much better than in the past, these investments generate attractive yields. The entrance of new participants has increased the liquidity of the financial markets, and this in itself is stimulating the use of the market for risk financing.

This new risk management approach and the new instruments can also be applied to food and agribusiness, particularly in the area of commodity price risks. With regard to the risks in the grains and oilseeds industry and other agricultural sectors, this has led to the integration of the instruments available on the agricultural commodity markets with those of the financial markets. Rabobank International is active in the development of tailor made hedging solutions and over-the-counter (OTC) products serving specific purposes. Various instruments, including swaps and options, are used to assist clients in managing their risks and balance sheet positions beyond the scope of what commodity exchanges can offer.

### Conclusion

Risk management in the grain industry is not a static issue; the risks of the industry are changing along with developments in the global market place. To manage the risks in the grain industry it is essential to acknowledge their existence and be aware of changes in the market and industry structure. For risks that cannot be mitigated by the industry itself, outsourcing of some of the risk-taking through insurance or teaming up with banks can lead to tailor-made transaction structures that clients feel comfortable with. ●

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