Steel Hedging: Mitigate volatility, sustain margins

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www.cargillriskmanagement.com
Cargill: A company you can rely on

- We serve customers globally across agriculture, food, industrial and financial industries
- Cargill is the largest U.S. private company, headquartered in Minneapolis, Minnesota, USA
- Active in 70 countries
- 150,000 employees worldwide

Cargill’s Credit Rating
- S&P: Rated A
- Moody’s: Rated A2

Fortune Ranking
- #31 Global
- #11 USA

Fiscal Year 2015
- Revenues: $107.2 billion
- Earnings: $1.6 billion
- Total Assets: $57.5 billion
- Net Worth: $28.4 billion

150 years
70 countries
A credit rating
Metals Risk Management

Global trading and hedging solutions
- London Metal Exchange (LME) Category 2 member
- Commodity Exchange (COMEX)
- Member in other global exchanges

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Tailored metals and FX risk management
- Comprehensive price risk management solutions for global trading of swaps and OTC structures, futures and options*
- Continuous analysis of market conditions and volatility

OTC Swaps
- Experience implementing customized risk management practices best suited across large organizations
- Extensive market experience and access to provide price-efficient liquidity

*Futures and options are solicited and executed by Associated Persons registered with Cargill IB LLC, a registered Introducing Broker and wholly-owned subsidiary of Cargill, Incorporated.
Metal Edge Partners

Steel Market Analysis, Risk Management, Corporate Strategy

- 20+ years trading experience across commodities and equities
- Proven track record across multiple asset classes
- Risk management expertise
- Trading relationships with numerous banks/brokers/OTC counterparties
- Extensive knowledge across the steel chain, from raw material producers to mills to service centers and end users

Value Creation

Earnings Volatility

Metal Edge Partners
Tim Stevenson, Founding Partner
1107 Hazeltine Blvd, Suite 493
Chaska, MN 55318
612-310-7164
Metal Edge Partners and Cargill

- How do we work together?
  - Cargill can provide liquidity and market access
    - Strong balance sheet, registered swap dealer
    - Capabilities beyond ferrous (base and precious)
    - Credit access for margining
    - No initial margin requirements
    - Tailored sizes and tenors

- Metal Edge Partners
  - Can assist in setting up a hedging program
  - Developing market access
  - Corporate strategy
  - Market insights
  - Benchmarking best hedging practices
Steel Industry: The “way it has been done”

- Giving away free options
- Trading Mentality
- Lack of tools

Volatility in earnings and low valuations
What drives value creation?

- Level of earnings
- Growth rate
- Volatility
Volatility

Value

VOLATILITY IN EARNINGS DESTROYS VALUE!
How are companies affected by volatility?

Budgeting Issues

Experiencing Gain and Pain

Explaining Performance variation to Stockholders

Product Pricing Concerns

Removes focus
What is the solution?

The steel industry’s “disruptive technology” are the risk management tools!

- Recognize that inaction is a decision and action
- Increase your knowledge of risk management tools
- Use these financial tools to lower margin risk and give customers fixed price
- Focus on growing your business and stabilizing margins
Steel, iron ore, and scrap are becoming liquid markets

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Who are the players in the market?

**Seller**

- Producers - Steel Mill
- Steel Service Centers
- Anyone holding steel assets
- Investors

**Buyer**

- Large OEM
- Steel Service Centers
- Construction Jobs
- Pipeline Projects
- Anyone wanting a fixed price
- Investors

**Swap Contract**

**Market Price**

**Underlying Asset Price**
Turkish scrap, Busheling, Rebar, or HRC
Decrease earnings volatility

Steel Mills
- Selling the HRC contract can hedge their revenue line
- Buying scrap contact hedges a large portion of costs

Steel processors/distributors
- Buying the HRC contract fixes the cost of steel
- This enables them to deliver fixed prices to customers

Both companies can decrease earnings volatility by using these tools and all else equal should increase the value of their enterprises.
Risk Management Implementation

• **Passive:** No risk policy; spot purchases

• **Ratable:** Ratable implementation regardless of market environment

• **Tactical:** Trading the markets; using market timing to optimize price entry

• **Dynamic:** Hybrid of ratable & tactical programs
Assessing Risk in a Dynamic Environment

Systematically identify and **assess** commodity risk across the organization.

- **Assess risk tolerance**: Setting levels of acceptable risk
- **Understand exposure**: Basis, correlation
- **Understand commodity price drivers**: Fundamental, technical analysis
- **Scenario Analysis / Stress Test**
The 8-Step Checklist

1. **Design a hedging policy.** Establish boundaries, rules and limits to guide work objectives.

2. **Establish a Risk Committee.** Representatives from commercial, trading, credit, control and treasury should meet regularly and deliberate about positions, results, stress testing, portfolio concentration, sudden changes in market conditions and limits.

3. **Identify and hire the right talent.** A combination of experienced talent from within the organization and individuals from outside the confines of the company can create a complementary and fresh approach.

4. **Set up a recurring review schedule.** Establish weekly meetings to review exposures, trends, market data, policy, proposals and exceptions.
5. **Define the max concentration of each tool within your hedging portfolio.** Every tool within your portfolio needs to have a defined goal of why it is used and how it helps achieve specific objectives—as well as its downsides. Define a max concentration limit for each tool to avoid excesses.

6. **Practice recurring stress testing.** Put the team and company through the paces of different financial scenarios (i.e., “stress testing”) and share the results at the weekly committee meetings.

7. **Set up schedules for annual external reviews and benchmarks.** Bring in an independent financial consultant/firm to review results from the prior year, assess risks, and help create benchmarks to measure against in the year ahead.

8. **Set strict limits for exception approvals.** Create a short list of executives within the organization who can approve exceptions.
Maintaining the balance

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<td>Annual Performance Review</td>
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<td>Trading Authority Delineation</td>
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<td>Risk Management Policy</td>
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<td>Establish Daily Position Limits</td>
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<td>Establish Max Tenor/Time Limits</td>
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<td>Stress Testing</td>
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<td>Weekly Risk Management Meetings</td>
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<td>Daily Position Size and Tenor Reports</td>
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How to build a diversified hedging portfolio using a Delta 1 or < 1 approach

By Federico Stiegwardt

When I talk about building a diversified hedging portfolio as a business, I often use the analogy of building an investment portfolio as an individual.

With an individual investment portfolio, a mix of different, non-correlated asset classes (i.e., stocks, bonds, etc.) is used by wealth management advisers to minimize risk and maximize long-term results—no matter if it’s a bull or bear market.
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