Commodity Finance Market Report

2017

In association with

ALLEN & OVERY

Foreword

For many years now, the commodity finance market has been in a state of flux.

We have seen players retreat and others redouble; certain geographies grow and others flatter to deceive; trading houses become leaner and meaner, with more sophisticated structuring capabilities; technologies emerge with the potential to transform certain aspects of the commodity supply chain; regulatory constraints shape a new normal; the commodity super-cycle reach its bear stage; international trade encounter new risks and adopt new risk mitigation strategies; and so much more.

Amidst this flurry of constant change, a new commodities model has begun to emerge. While market practitioners almost invariably have their ear to the ground with a number of market intelligence sources, there has remained a need for an independent, authoritative report on the condition of the commodity finance market.

This was the driving force behind TXF and Allen & Overy's launch of a survey that would reach out to market practitioners in a bid to accurately capture the pulse of the industry and provide useful data to its participants. We see this as the first step in a collaborative exercise that will eventually lead to the publication of a more comprehensive, annual report that will be of service to the industry.

We hope you find the information contained herein to be valuable and we look forward to working with you to improve its breadth and quality so that it can serve as an integral part of your annual planning in future years.

Hesham Zakai, Associate Director, TXF
Niels de Ru, Partner, Allen & Overy

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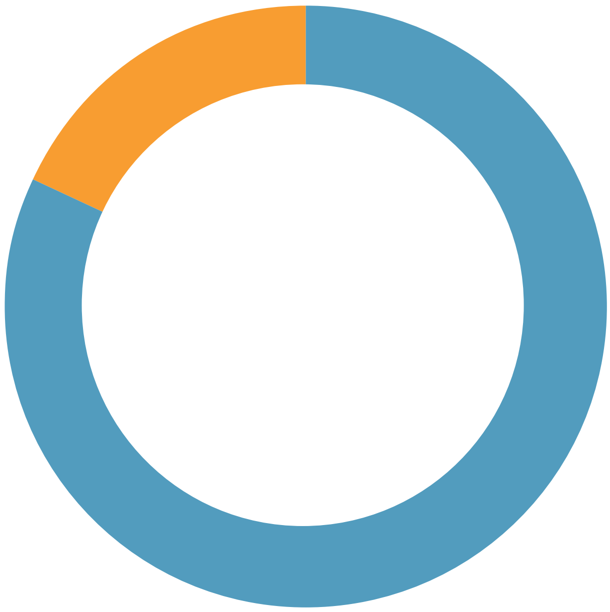
Access to finance

Market participants see a two-tier system in commodity finance for large and small traders.

On whether there is a two-tier financing system for large and small traders

- **82%** observe a two-tier system for large and small traders
- **18%** do not observe a two-tier system for large and small traders



There is a strong consensus that the market is operating a two-tier system which is seeing smaller traders feel the pinch.

This polarisation has not been helped by the low commodity price environment of the past few years, which some of the larger players have been in a position to more skilfully navigate and thrive under.

Indeed, the downturn in global commodity markets seen in 2016 and the rise in regulatory pressure has inevitably 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. It is also worth stressing that challenges in facilitating finance for SMEs are not exclusive to the commodity finance space.

Indeed, a study by the Asian Development Bank (ADB), which quantified the global trade finance gap at USD1.6 trillion, found that SMEs were disproportionately affected across the trade board – with 56% of their trade finance proposals being rejected.

This two-tier system will likely remain in place unless financial institutions find more efficient ways of meeting the rising cost and complexity of serving this market segment.

Further findings

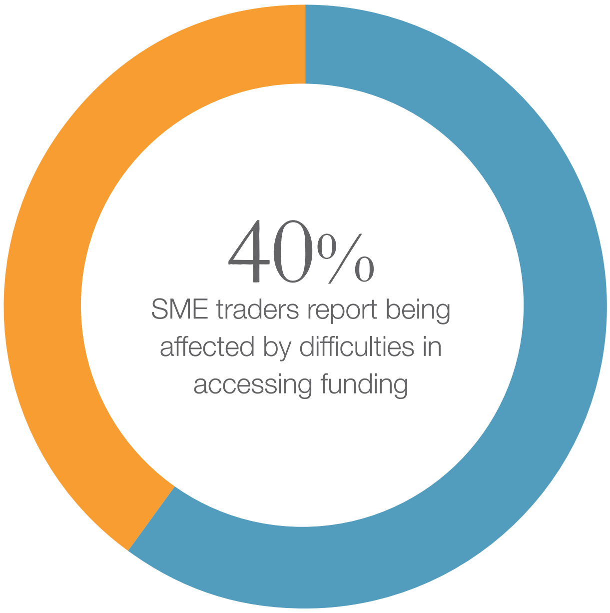
– Only 25% of large traders consider access to financial services to be a major issue in the commodity finance industry.

– By contrast, of small and medium traders, 50% consider this to be a major factor in the industry.

– When asked specifically whether difficulties in funding have affected the market position of the traders, only 14% of large traders report that this is the case.

– For SME traders, 40% report that accessibility to funding has affected their market position.

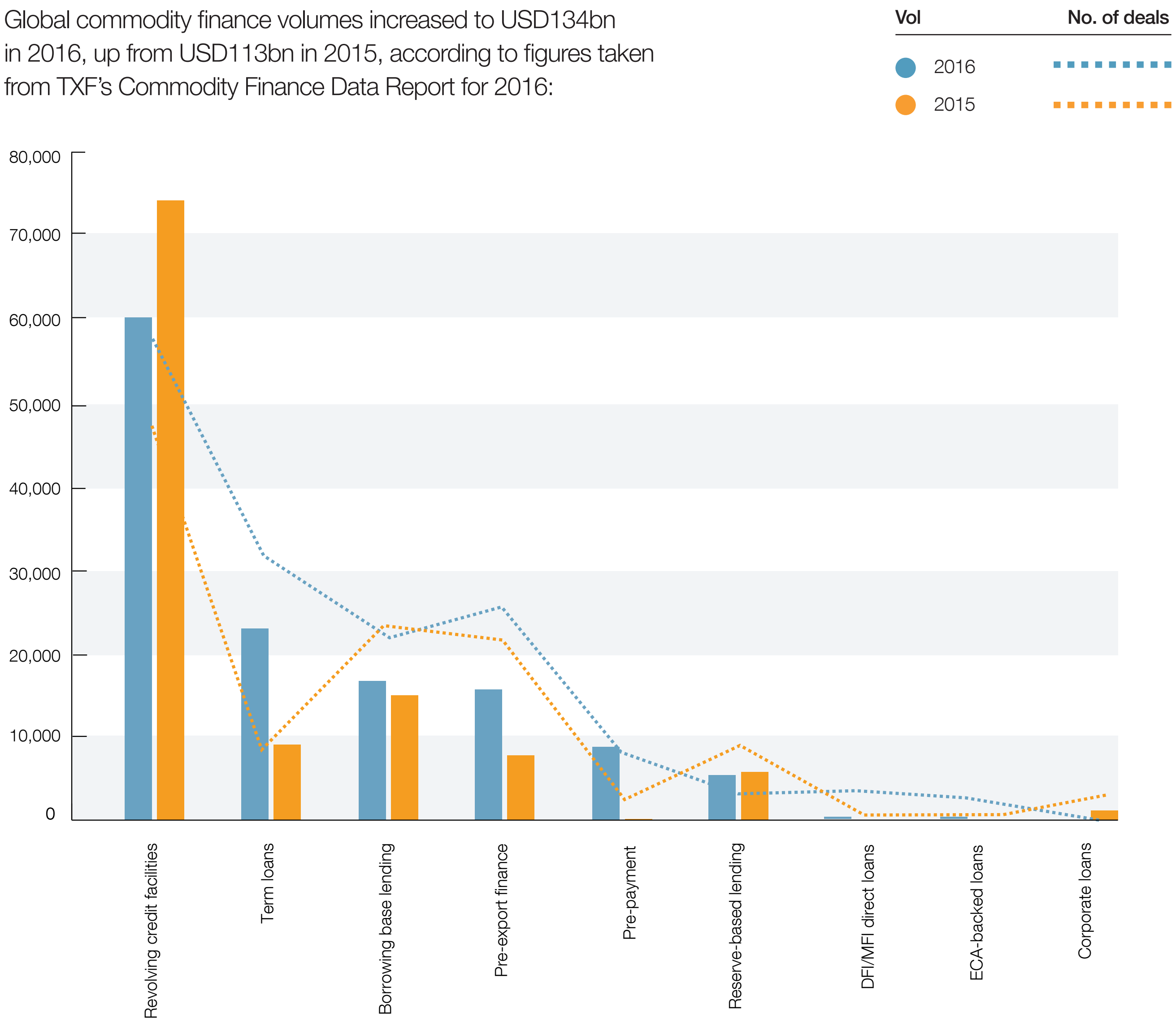
– This represents the double-pronged way in which the two-tier system works: not only are SMEs more likely to face difficulties accessing finance, but they are also disproportionately much more likely to have their market position affected by their struggle to access finance.



Deal structures

Secured products have made a comeback, combined with growing signs of product diversification strategies among corporates.

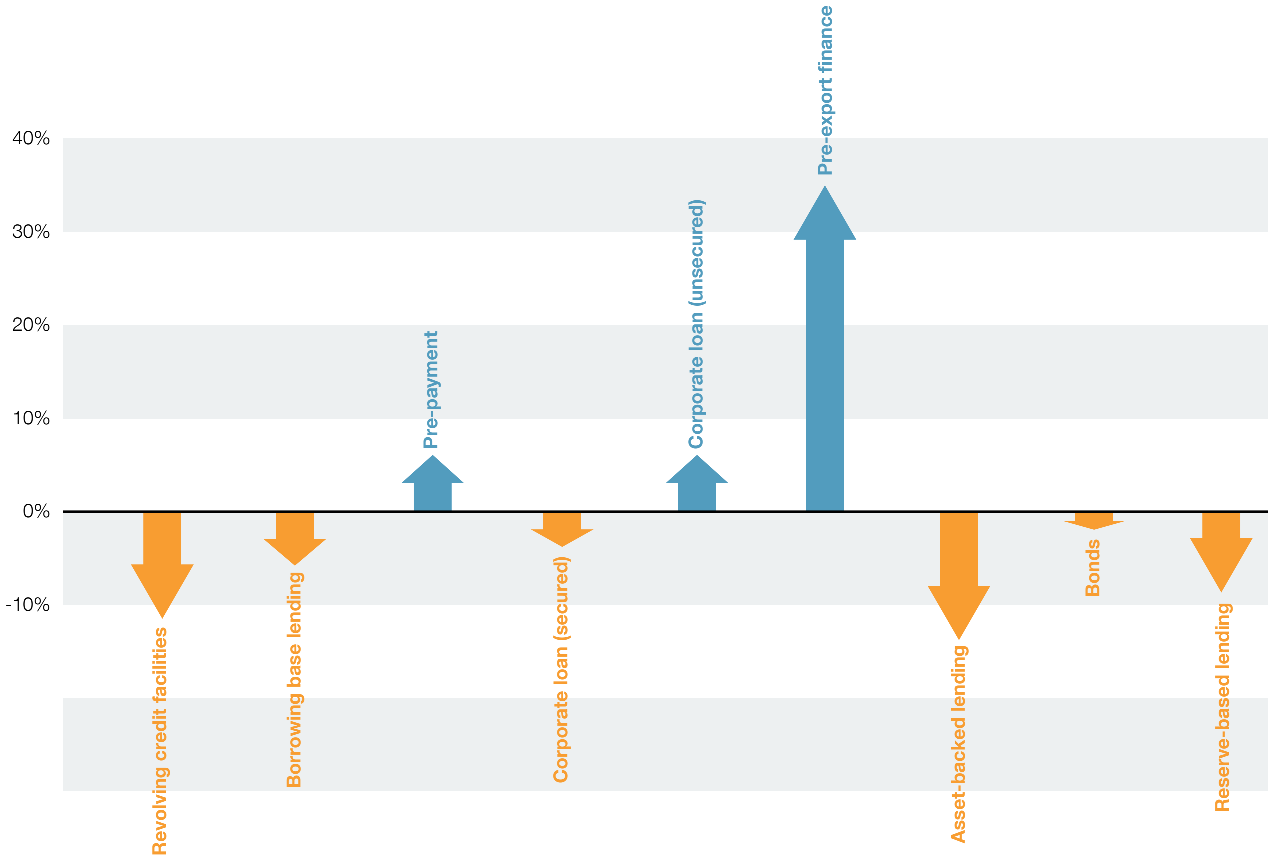
Global commodity finance volumes increased to USD134bn in 2016, up from USD113bn in 2015, according to figures taken from TXF's Commodity Finance Data Report for 2016:



"These results confirm what we have been seeing over the past 12-18 months, namely an increase in structured commodity finance transactions, particularly BBFs, prepayments and PXFs."

Niels de Ru, TCF partner at Allen & Overy

This trend tallies with the market survey's findings, in which respondents identified pre-export financing (PXFs) as the structure they are more significantly engaged in today as compared with two years ago:



This can partly be attributed to the relatively recent revival of key producing regions such as Russia and the Commonwealth of Independent States (CIS), as well as slightly lower loan pricing, giving producers greater incentive to utilise structures such as PXFs.

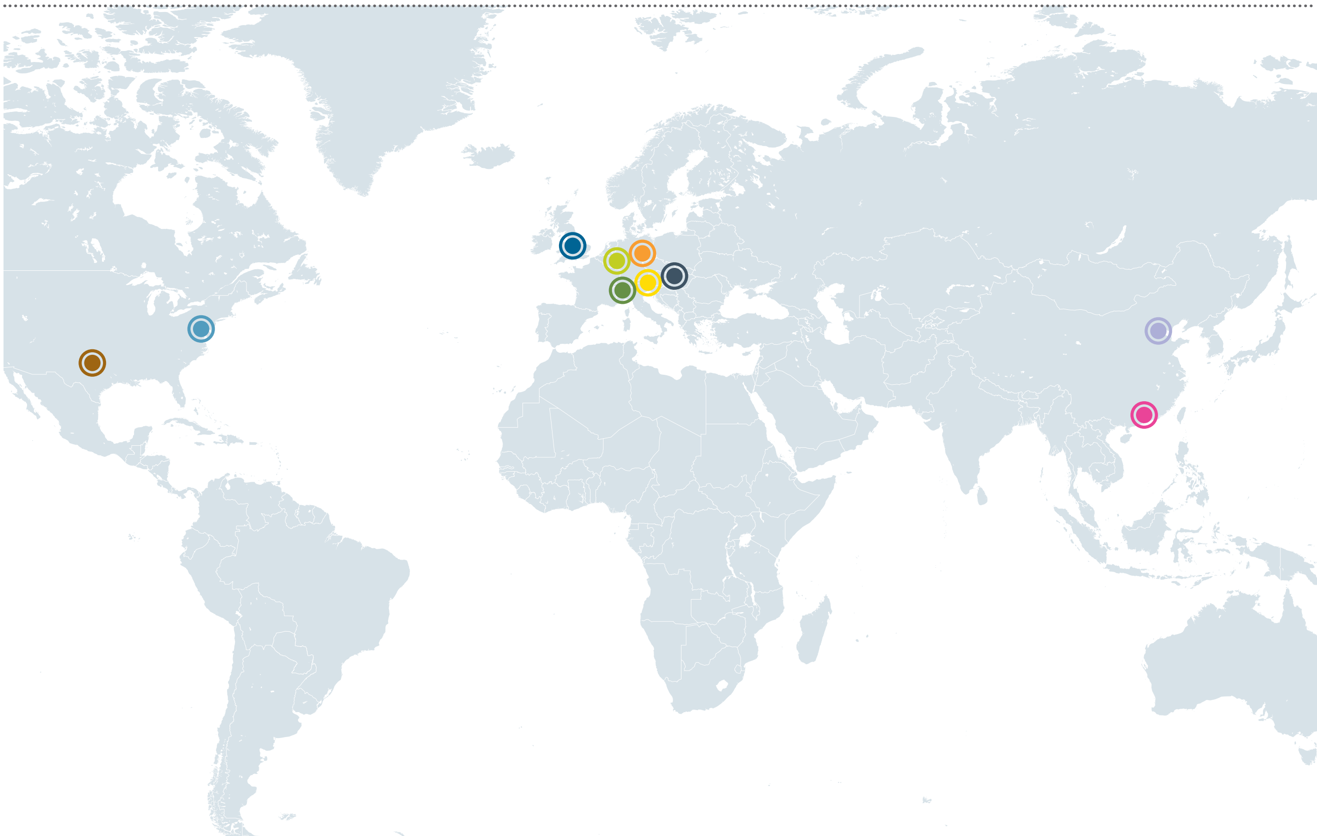
More broadly, the survey also found that commodity finance players were significantly engaged in more deal structures than they were two years ago.

This diversification of their financing toolkit helps to act as a buffer against the movement in the market of banks. It gives them the flexibility to adapt when necessary as a result of banks retrenching, for example.

Trading house activity

At a glance

TXF Data figures for 2016 show who the most active traders were and where they are headquartered.



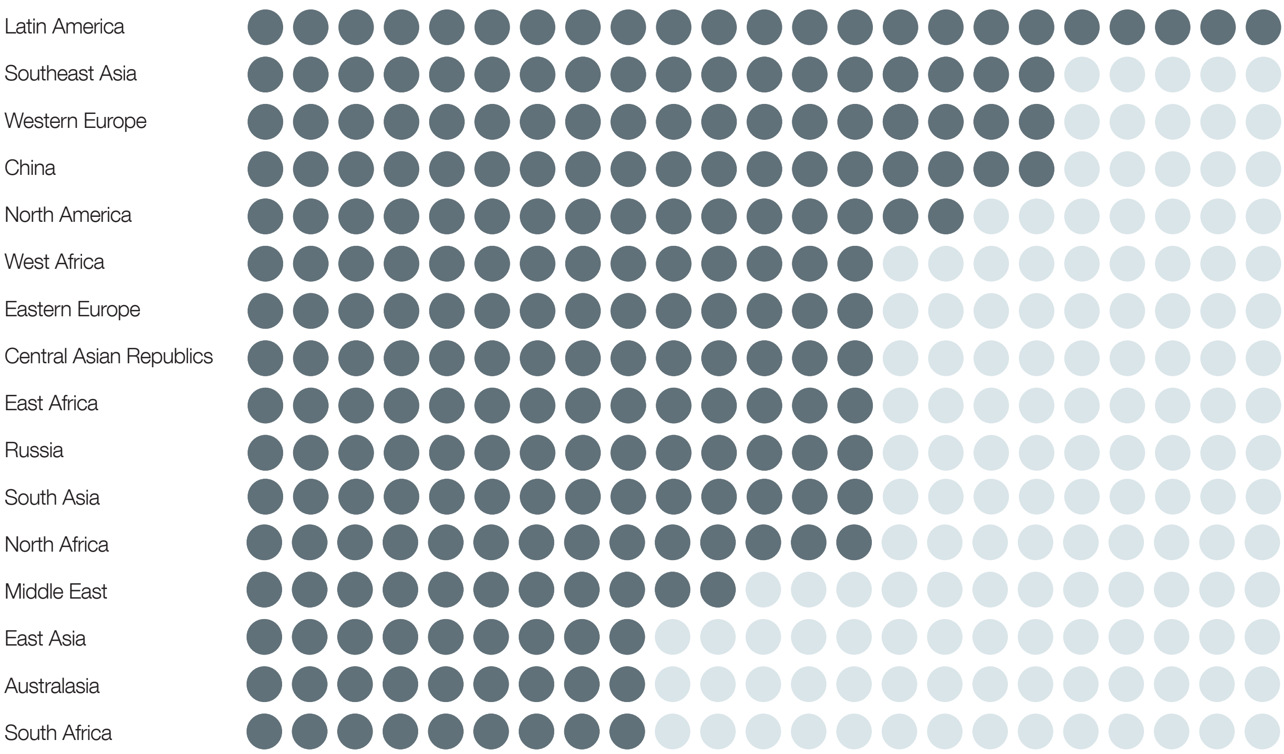
Sunoco 3.6%	USD2bn
ED&F Man 3.4%	USD1.9bn
Vitol 14.4%	USD8bn
Gunvor 5.4%	USD4.1bn
COFCO 4.7%	USD3.5bn
(CCI) Castleton Commodities Int. 5.9%	USD3.3bn
Trafigura 22.8%	USD12.7bn
Glencore 22.6%	USD12.6bn
Mercuria Energy Trading 6.1%	USD4.5bn
Noble Group 5.4%	USD3bn

New markets

27% of traders see legal and regulatory issues as the main challenge to entering new markets, followed by a lack of understanding of markets, at 20.8%.

Issue	Traders	Overall
Legal and regulatory landscape	27.1%	**34.5%**
Lack of understanding of markets	20.8%	**15.5%**
Too much competition	14.6%	**8.6%**
Concentration on currently engaged markets	10.4%	**5.2%**
Inability to access financing to do so	12.5%	**3.5%**
Risk appetite (including as a result of de-risking)	14.6%	**32.7%**

Markets showing the most promise in the next two-three years



Legal landscape

There is significant polarisation between banks and corporates in the usage of non-traditional legal services, but where they are used this is primarily driven by a need for some form of specialist expertise.

There is a contrasting approach when it comes to demand for alternative legal services: while only 8% of banks have used alternative legal services, the figure for corporates is 41%.

This trend is driven particularly by large traders, of whom 55% report that they have used alternative legal services. It also reflects the difference between banks' and corporates' in-house legal expertise. In spite of this, banks' documentation skills have come under scrutiny, with a quarter of respondents feeling that their 'drafting documentation skills are not what they used to be'.

For both bankers and corporates, the main reason why external legal partners are appointed is their specialism and expertise: mainly in specific markets, but also in specific commodities. Accordingly – for both bankers and traders – external legal partners are appointed according to their specific expertise in one region/commodity.

Elsewhere, 65% of banks have used the services of contract lawyers, while 12% have used legal services centres.

8% of banks have used alternative legal services

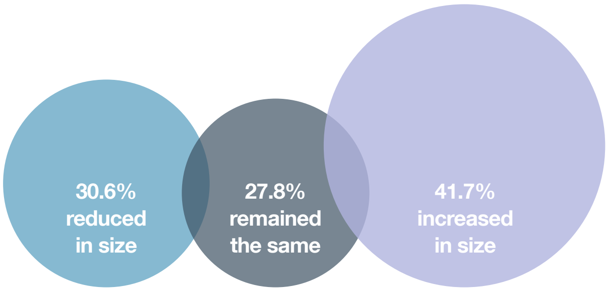
41% of corporates have used alternative legal services

55% of large traders have used alternative legal services

Future outlook

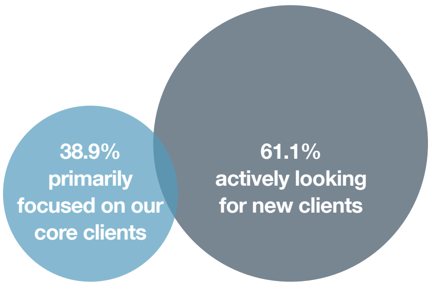
The market is mixed when it comes to strategies on internal and external growth – but both of these factors are impacted by deal approval procedures.

In the last two years, has your commodity finance team…?



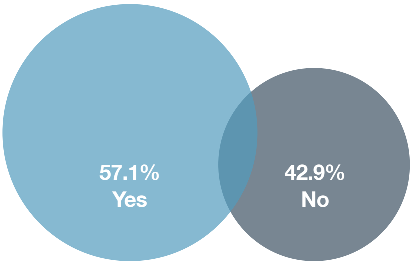
While most respondents reported an increase in the size of their commodity finance team, there was a significant amount of responses reporting a reduction in size and stagnation too. It adds weight to the picture of an industry in flux, where players are either deciding to invest in their teams and bolster their presence; or, conversely, adopting a leaner outfit and angling for a more distinctive market niche.

How active is your organisation in attracting and servicing new clients?



Similarly, the market is fairly split when it comes to either prioritising an existing client base or adding to it. To a certain extent, commodity players must continually renew their base in order to remain competitive. However, this trend has been tempered due to increased cost and complexity of onboarding new clients.

Do you think your organisation has achieved the right balance when it comes to deal/transaction approval procedures?

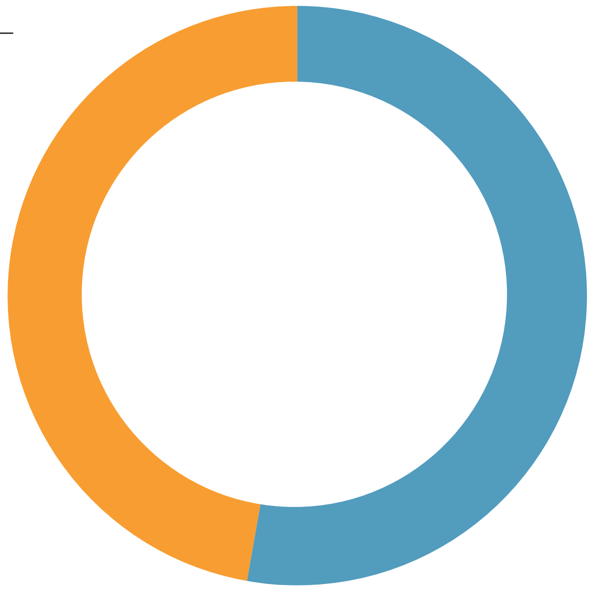


A key factor impacting responses to the first two charts on this page – and indeed to much of the sentiment in the market – is the progress being made internally to implement well-balanced deal approval procedures. While the majority (57%) do feel this has been achieved, there is a significant number who do not and this inevitably stifles deal flow.

Alternative lenders are on the rise – now and in the future.

Alternative lenders 2016

- **53%** traders that have recently used alternative lenders
- **47%** traders that have not recently used alternative lenders



Of the 47% of respondents that have not previously used alternative lenders, 23% are considering this in the near future. This trend is part of a new paradigm emerging in the commodity finance space, which has seen the entrance of new players for several years now.

Moreover, the 'alternative' space is far from a homogenous block: instead, it counts a diverse number of interested parties – from insurance funds to private equity firms – with varying levels of ambition and engagement. 64% of the traders that did not use alternative lenders were large traders, underscoring the survey's earlier findings about the greater difficulties that small and medium corporates have in accessing traditional bank financing.

One of the key reasons for turning to alternative lenders has been the higher risk appetite offered by alternative lenders, demonstrating that corporates remain ambitious in the market and keen to seek out opportunities to do business in riskier geographies and sectors.

To access non-traditional funding, corporates have agreed to pay higher prices, as liquidity providers look for higher returns – and indeed the survey found that this was the main disadvantage associated with alternative lenders.

On the other hand, respondents have remarked that the fact that boutique lenders are often flexible and have specialist knowledge in niche markets makes them a more attractive proposition.

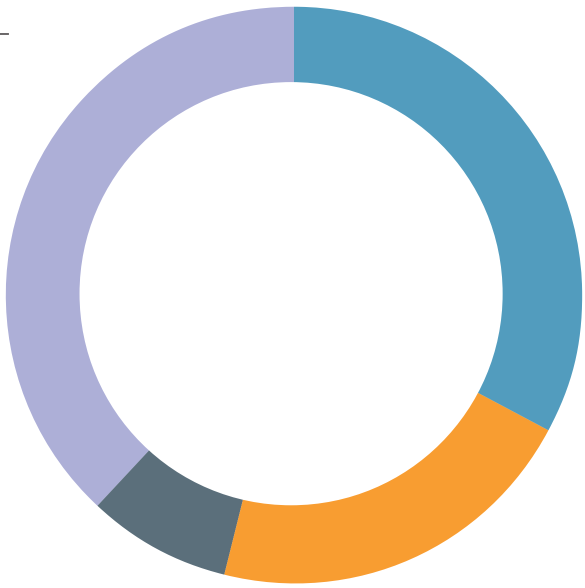
Technology

While commodity finance is not seeing a rush to digitisation at the same speed as in other finance areas – for example, cash management or retail banking – there is nonetheless a growing interest in the way in which technology can make processes quicker, cheaper and safer.

Blockchain is the technology most respondents envisage being used over the next 12 months (38%). This trend is already visible through a number of real or test cases involving distributed ledger technology in the commodities industry, from Trafigura trialling it as a way of settling deals in the oil market in the U.S., to Mercuria's attempts to use blockchain to create a simpler, permanent and public 'ledger' of transactions in a chain.

Projected use over the next 12 months

- **33%** Electronic bills of lading (eBL)
- **21%** Electronic tracking
- **8%** Bank payment obligations
- **38%** Distributed ledger technology/Blockchain



About TXF and Allen & Overy

TXF

TXF is a leading media and events company in the trade, supply chain and commodity, export and project finance spaces. Since its inception in 2013, it has developed its reputation for accurate, insightful and incisive news coverage in its core markets, as well as for the provision of data to the industry not available elsewhere.

Its global events portfolio offers a series of corporate-led, innovative opportunities ranging from small, intimate workshops and roundtables to marquee conferences welcoming several hundred guests.

For more information about TXF, please visit txfnews.com or email hesham.zakai@txfmedia.com

Allen & Overy

Allen & Overy is an international law firm providing legal services to global businesses and industry. At a time of significant change in the legal industry, it is determined to bring new and original ways of thinking to complex legal challenges.

Allen & Overy's trade and commodities finance team can translate increasingly complex finance documentation and security structures into practical and efficient solutions. An in-depth knowledge of the sector and a track record in documenting trade and commodities financings and litigators' experience of advising on a large number of disputes in the trade, commodities and export sector allow Allen & Overy to identify and solve issues upfront, providing clients with both practical and commercial advice.

For more information about A&O, please visit allenovery.com or email niels.deru@allenovery.com

Methodology

This research has been conducted by TXF Media in association with Allen & Overy LLP using telephone interviews (35%) with, or online surveys (65%) from 153 respondents, split 50/50 between traders and other industry participants (including mostly banks but also industry practitioners from insurers, professional service firms, brokers or collateral managers and other trade & commodity sector advisors), in major regional markets but primarily respondents came from Europe followed by Asia.

Trader respondents all have substantial decision-making input over their company's funding programmes and the split between SME and large traders was 50/50.

TXF Media makes every effort to provide representative information. All results are based on a sample and are therefore subject to statistical errors normally associated with sample-based information. Fieldwork was undertaken between 15 March 2017 and 3 May 2017. Percentages may not always add up to 100% due to roundings.