Riding the Commodity Roller Coaster

Volatility Is the New Normal

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As crude oil prices reached $122 per barrel in May 2008, nearly doubling those of a year earlier, Goldman Sachs predicted further escalation: "The possibility of $150-$200 per barrel seems increasingly likely over the next six-24 months." Most professionals in the turnaround industry can recount the historic events that followed: by December, crude oil bottomed out near $30 a barrel, mirroring results for most commodity raw materials in the aftermath of the financial crisis.

After decades of relative stability, the commodity price boom of the mid-2000s and subsequent 2008 crash ushered in a new era of volatile commodity markets that persists today. The game has forever changed, and managing raw material costs in an unstable commodity environment has become a critical success factor for most domestic manufacturers and distributors.

Some companies have adjusted and even capitalized on market opportunities, while others did not survive the challenging conditions. For many manufacturers, however, adapting their businesses to new market realities is an ongoing struggle.

For lenders, investors, and advisors to companies exposed to unprecedented raw material price volatility, here are five key questions to ask when assessing a company's ability to react, adjust its business model, and successfully manage or ride out the gross margin roller coaster.

1 Are commodity price fluctuations diverting attention from more fundamental underlying business weaknesses?

While raw material cost increases may have driven recent underperformance or even caused a near-term liquidity crisis, short-term volatility should be kept in perspective relative to the longer-term financial performance and prospects of a company. It is all too easy and all too common to attribute current negative earnings before interest, taxes, depreciation, and amortization (EBITDA) trends to rising material costs, forgetting that rock bottom commodity prices in prior periods may have masked underlying business weakness. Rather, a critical assessment of true business performance, over time and on a normalized basis, should be developed before concluding that the problem at hand is short-term volatility, rather than long-term decline.

In a recent engagement to assess the short-term liquidity of a plastics manufacturer faced with significant volatility in resin prices, management had advised stakeholders that declining financial performance was largely due to a contractual lag in passing through cost increases to customers. A more detailed business assessment, however, revealed a lack of controls over product costing and margins (failed IT system conversion), inefficient manufacturing operations due to lack of reinvestment in aging equipment, and increasing price and margin pressures from both domestic and foreign competitors. Notwithstanding that significant volatility in recent monthly results were indeed driven by fluctuating raw material prices, overall profitability on a normalized basis was in steady decline.

2 Does the company's capital structure allow it to weather significant margin volatility?

The need to manage commodity exposure aggressively may largely depend on a company's capital and organizational structure. Undercapitalized companies generally need to adapt more quickly or risk insolvency. Even in cases in which liquidity is not an immediate concern, stakeholders will collectively determine the tolerance level for short-term margin volatility. This may be dictated by corporate culture (short-term focus vs. long-term view), investment outlook and timeframe, leverage structure, and management incentives, among other factors.

For example, diversified companies with commodity exposure to a single product/division, or privately held entities with limited debt, may be less concerned with short-term income variances. In such cases, management and stakeholders may be comfortable with a strategy of absorbing short-term cost variances with limited effort to normalize monthly earnings, focusing instead on longer-term profitability and business outlook.

In many instances, however, particularly with highly leveraged middle market companies, the absorption strategy is not an option and a more proactive approach to commodity risk management is required. Substantial quarter-to-quarter variances not contemplated at the time of acquisition or financing may result in peak liquidity needs above existing credit limits and/or short-term financial covenant defaults. Moreover, the presence of multiple stakeholders with different tolerance levels for EBITDA volatility can create internal friction and distract management from adapting its business model to achieve greater earnings and cash-flow stability.

Finally, an attempt should be made to determine to what extent direct competitors are able to weather short-term financial performance variances. Do other industry players have more flexibility in dealing with suppliers and customers? Situations in which competitors have a varying capacity to absorb short-term cost variances can create market opportunities for some while alternatively leaving less-flexible companies vulnerable to competitive pressures.

3 Does the company's business model hold up in a volatile commodity environment?

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A business model that was perfectly sound in a stable raw material environment can suddenly be turned on its ear when costs start to fluctuate unpredictably outside a given bandwidth. The key to mitigating raw material volatility is achieving symmetry between input/production costs and product pricing.

Therefore, identifying the company's inherent barriers to reaching this equilibrium is an important first step. A thorough assessment of the company's supply chain, customer dynamics, and market position relative to its competitors is in order. An analysis of the supply chain includes not only macroeconomic, market, and demand/supply conditions, but also company-specific factors, such as:

- **The nature of supply contracts.** A comprehensive strategy to stabilize earnings may involve greater cost certainty (locked-in prices) or, alternatively, more flexibility to react to market and competitive conditions. The first step in developing the appropriate approach is analyzing the current vendor base, supply terms, contractual pricing arrangements, order lead times, and delivery requirements.
- **A company's leverage with its suppliers.** Is the company overreliant on a few large-scale suppliers? Does it have multiple sources of supply? Does the company represent an important customer (in terms of sales volume) to its critical raw material vendors? Does it have stable, long-term supplier relationships? All of these factors impact the ability to negotiate favorable terms or modify established business arrangements. Suppliers' flexibility is also influenced by standard industry practices and the extent to which competitors are seeking similar concessions.
- **A company's ability to hedge raw material purchases.** Whether through locked-in supply agreements, access to an open futures market, or financial instruments, does the company have the ability to secure stable and predictable input prices? External options, such as commodity derivative contracts, are often restricted by provisions of a credit agreement or by virtue of existing financial defaults or distress.

Although much energy and focus is often directed toward managing the supply chain, a company's relationship and business terms with its customers are equally important in establishing symmetry between material costs and product prices. To what extent does the company have the ability to pass through cost variances to its customers in a timely manner?

The frequency and quantum of customer price adjustments needed to keep up with raw material fluctuations is likely well beyond historical business practices. Similarly to the supply chain analysis, terms of sale, contractual obligations, price adjustment mechanisms, customer relationships, industry norms, and the overall competitive environment are key elements of the business model to assess.

4 Is the organizational structure aligned to address challenging market realities?

Addressing raw material price volatility on an ad hoc basis is one thing; implementing a comprehensive strategy to actively manage commodity risk is quite another. The latter requires coordination among all functional areas of the business, many of which may have historically operated independently: product development and R&D determined material specifications, purchasing was responsible for sourcing materials and negotiating terms with suppliers, manufacturing determined production processes and MRP requirements, finance handled hedging strategies, and sales and marketing, which is most in tune with market demands and competitive pressures, set finished goods pricing.

Breaking down organizational silos and integrating all functions within a global strategy is often management's most difficult challenge. Misaligned efforts due to incomplete or inaccurate information across departments, differing market views, or old-fashioned corporate politics can become very costly.

A single senior management member should be assigned to coordinate the commodity risk management strategy, ensuring that all functional areas work cohesively. While some larger corporations with significant commodity exposure have designated an independent chief risk officer, this function is typically assumed by the CFO.

5 Should a company hedge its raw material requirements?

The first question typically associated with commodity exposure is: Does the company hedge its position? This likely stems from the fact that hedging is the primary way many organizations manage raw material price volatility. However, overreliance on hedging is not without its pitfalls, particularly as it is often carried out by the finance department with limited consideration of negotiated sales contracts. Companies that get caught on the wrong side of a forward contract can pay a heavy price.

The more appropriate questions relative to hedging should therefore be: Should a company hedge its position? Does the organization have the ability to lock in future prices? What type of hedge is most appropriate (locked-in supplier agreements, derivative contracts, inventory stockpiling, etc.)? And most important, how does the proposed hedge fit in with the overall commodity risk management strategy?

Without answering these basic questions, locking in future supply prices can be ineffectual at best and counterproductive at worst. While there are countless commodity risk management strategies that organizations can adopt, they can generally be grouped into four main categories:

a Risk transfer to suppliers, which involves exercising leverage to limit suppliers' ability to pass on price increases. This can include entering into longer-term contracts or setting "collars" on the frequency and timing of price adjustments. As previously discussed, companies can often increase leverage with vendors by diversifying their supplier base for key materials.

b Risk transfer to customers, which essentially mirrors strategies intended to transfer risk to suppliers, but applies them to the customer side of the business. They involve negotiating the terms of sales contracts (length, pricing, adjustment provisions) to support a global risk management approach. Over the past few years, several examples of successful commodity risk mitigation through customer contract negotiations or strategic partnerships included:

- A food products processor purchasing forward contracts *on behalf of* key customers and setting the contractual volume

and pricing for the upcoming quarter accordingly.
- A plastic consumer goods manufacturer implementing selling price adjustment formulas based on the public commodity index for resin.
- A company negotiating a tolling agreement with its largest customer. The tolling model is based on a direct pass-through of the commodity raw material cost in accordance with a specified formula. This business arrangement often requires strong customer relationships and transparency of conversion costs and gross margin.

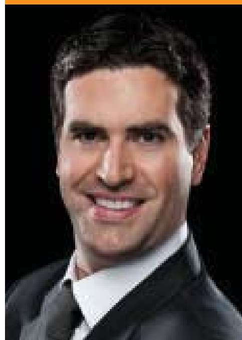
c Risk transfer to an outside party. Aligning purchasing and sales terms can be challenging when dealing with multiple vendors and customers. Although companies should not rely on them exclusively, traditional third-party hedging strategies can be an important tool in cases when transferring commodity risk to direct business partners is not feasible. It is important to note that there are no (or limited) open hedging markets for many raw material inputs and that a company's financial situation or debt structure may preclude the use of financial derivatives.

d Internal risk mitigation, which requires that a company look internally for strategies to mitigate commodity price risk. Options include:

- Developing flexibility in product development and manufacturing processes. This may enable the use of lower-cost substitute materials or shifting to foreign sourcing from areas benefiting from cost advantages.
- Stockpiling inventory. Companies may revert to building inventory reserves when third-party hedging is not available. It should be noted that stockpiling presents the same inherent limitations as a financial hedge, with a significant downside risk if stable customer pricing is not secured as part of an overall strategy.

While maintaining high inventory levels, substituting raw materials, or moving to foreign supply sources represent significant operational risk and incremental costs, these approaches may become justified if price volatility and overall cost of critical raw materials increases dramatically or certainty of supply from current sources is in doubt.

Analysts and experts have widely debated the causes of global commodity volatility, but they seem to agree that unstable market conditions are here to stay. While most domestic manufacturers may be pining for the good old days, only those that adapt will survive.



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