Commodity Risks and Corporates– Perspectives and Way Forward

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According to a March 2017 report of Wood Mackenzie, an international research and consultancy firm, U.S. shale companies hedged about 27 percent of their energy production this year, compared to only 17 percent at the same point in 2016. This is hardly surprising, considering the heightened volatility in the prices of crude oil that wreak havoc on the bottom-lines of these companies, as also the downstream user industries in 2016 and 2017. Annualised volatility in global crude oil prices was 44 percent in 2016 and upwards of 25 percent in 2017 (January – June 2017). Some American companies, such as Pioneer Natural Resources, a Texas shale driller, have decided to undertake large hedging programs so as to devote their strategic resources entirely on their core business, which is oil exploration and drilling. According to Bloomberg, Pioneer has about 85 percent of its 2017 production hedged, which is enabling the company to move forward with drilling regardless of price movements.

A part of the reason companies in U.S. and other developed nations resort to hedging their risks at a level and with regularity not seen in Indian companies, surely has to do with the levels of awareness regarding risk and risk management. Another plausible reason is the lack of shareholder activism in India compared to many developed nations. Independent studies have found a direct and positive link between shareholder value and firms' hedging practices. Without an active shareholder class in India, therefore, the pressure to create value by creating a risk management function in the company and undertaking hedging activities, is low.

Risk Disclosures – Key to pricing equities

A significant step in incentivising (and possibly, pressurising) companies to take cognizance of the risks in their businesses was made by the Securities and Exchange Board of India's (SEBI) directive to all listed entities to strengthen their corporate governance by way of adequate disclosure of their risks. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, or LODR, provide the stipulations about the inclusions in the companies' Annual Reports, which include, among others, the mandate that every listed company has to disclose its commodity price risk and hedging activities under the Corporate Governance section of their Annual Reports. This landmark regulatory policy is expected to not only lead listed companies to disclose their risk and risk mitigation measures adopted by them, but also help investors and other stakeholders to effectively analyze a company's risk exposure. By evaluating and comparing the risk exposure and risk management efforts of a company with its peers, shareholders will be able to appropriately evaluate the company and price its securities, which may include bonds as well as equities.

How do Indian companies fare in terms of disclosing their commodity price risks? To answer this question, the Institute of Company Secretaries of India (ICSI) conducted a study, which involved an examination of the Annual Reports of India's 525 listed companies for the year 2015-16, covering 62 different sectors. The study found less than 45 percent of India's top listed companies to be not disclosing commodity price risks in their Annual Reports, while only 12 percent of them provided detailed disclosures (Details in Box 1).

A Study on the Level of Compliance to Commodity Risk Disclosure Regulations in India & Abroad

- Study conducted by *Institute of Company Secretaries of India - Centre for Corporate Governance, Research & Training (ICSI – CCGRT)*

Major Observations

- **Commodity Risk Disclosure**: Nearly half (44.38%) of the companies whose annual reports were analysed did not disclose commodity price risk, while a quarter of them (26.86%) just gave passing remarks about them. Only 12% of the companies provided detailed disclosures of commodity price risk in their Annual Reports.
- **Foreign Exchange Risk Disclosure**: 41.33% did not disclose Foreign Exchange risk, while 17.72% provided passing remarks about this risk in their Annual Reports. Nearly 30% of the companies provided detailed disclosures of forex risks.
- **Companies listed across the global exchanges**: Companies listed in global exchanges have provided more detailed disclosures of Market Risk, which were further bifurcated into Qualitative and Quantitative disclosures.
- **Indian companies listed abroad vide ADR/ GDR**: Indian companies listed abroad have provided detailed risk disclosures, including commodity price risk disclosure, in their annual filings with the SEC in USA, while such details have not been provided in their Indian Annual Reports.

Recommendations

- SEBI may require the companies to give separate disclosures for each type of market risk exposure in their annual reports. i.e. commodity price risk, foreign exchange risk, interest rate risk and their respective hedging activities separately.
- In line with international practices, SEBI may advise companies on the methods that can be adopted for disclosing commodity risk and commodity risk management in Annual Reports.
- There is a need for creating awareness among listed companies and their officials regarding the provisions of SEBI (LODR) Regulations, 2015 in respect of detailed disclosures of Commodity risk and Commodity Hedging in their Annual Reports.

Why hedge?

Indian companies, like their counterparts elsewhere, have to face the challenge of dealing with volatile commodity prices as critical inputs while operating in an increasingly competitive environment. While changes in input costs generally cannot be transferred quickly and efficiently down the value chain, volatility leads to weaker and more unpredictable earnings. A case in point is the meltdown in commodity prices since the period of severe financial crisis of 2008-2009. During these two years, there remained a long list of commodity related industries that missed their earnings targets being unable to effectively cope up with commodity price risks. Hence, unsurprisingly, according to a Washington based Corporate Executive Board's January 2010 survey, of top 10 risks faced by corporate participants, commodity prices risk was chosen as the number one risk faced by them.

In absence of any risk (arising from volatility) mitigating mechanisms adopted by companies, high fluctuations in commodity prices can significantly disrupt their planning and fund flow besides potentially threatening the economic viability of their business. The degree to which companies depend on any particular metal varies across industries, and among individual companies and products and so does the impact of price volatility on corporates bottom-lines. Yet input price volatility uniformly tests their ability to really respond to the stress emanating from such volatility and maintain their operational margins.

For instance during the bull run in metal prices in early 2000s (till global financial crisis of 2008-2009), in one of the cases, an aluminium products manufacturer set price ceilings for customers without capping supplier contracts, and as a result, was unable to pass on the raw material price increase over to their customers. When their raw material prices rose to unprecedented levels, the company's financials collapsed, market capitalization dropped by approximately 35 percent, and the company lost $1.1 billion over four years.

Had the company hedged, it would have been able to lock in its prices at a pre-determined level. Locking in prices not only ensures steady revenues, but also provides certainty, allowing companies to move ahead without having to worry about daily fluctuations in prices.

Strategic advantages of hedging

Evidence and research have brought out a number of strategic reasons for hedging, apart from those mentioned above, highlighting its diverse beneficial functions. Some of these benefits are:

a. Locking in costs

This is the most traditional theory justifying the merit of hedging. Basically, hedging provides insurance against risks arising out of price fluctuations. The price risk mitigation argument remains central to the need for hedging.

b. Improving firm's value

Market imperfections, such as price volatility that a firm encounters, contribute to reducing the value of the firm and thereby makes price volatility an expensive proposition for the firm. The imperfections, in turn, contribute to other deficiencies, such as expensive external financing, enhanced financial distress costs, agency costs, and costs of managerial risk aversion. These imperfections adversely affect a firm's value. By helping to reduce costs stemming from such imperfections, hedging enables in enhancing the firm's value.

c. Ensuring continuity of cash flows

Price volatility has an adverse effect on the revenue stream and can disrupt cash flows. Effective hedging insulates firms from such volatile price movements and ensures uninterrupted and stable revenue streams.

d. Decreasing distress costs

The ability to raise capital becomes critical in a firm's real or perceived distress. Every business faces the possibility of a 'distress' under adverse circumstances, said a 2008 study. Another study pointed out that even perceived circumstances of distress could be costly for firms—often in the range of 20% to 40% of the firm's value. In the extreme event, distress could lead to bankruptcy. Hence, it would be prudent for firms to hedge.

e. Enabling better inventory management

As increasing price volatility affects inventory management, firms often seek recourse to inventory/ procurement managers and logistics companies who have better knowledge of hedging. Researchers in their investigation on inventory risk caused by fluctuating procurement prices, suggest that it is possible to reduce inventory-related costs by trading appropriate amounts of derivatives of the commodity.

f. Decreasing tax liabilities

A more strategic reason for hedging is the immediate effect it can have on the tax liabilities of firms. Under a progressive taxation regime, losses of firms can be carried over for a finite number of years only. Over the medium to long run, therefore, volatile earnings induce higher taxation than stable earnings. A 1996 study proved this argument to hold good in any regime marked by increasing marginal tax rates, limits on the use of tax-loss carry forward, and minimum tax rates.

A second tax saving from hedging arises from the increasing debt capacity of companies, which in turn increases interest tax deductions. In a study of 442 firms researchers found that the benefit from increased debt capacity was 1.1% of the firm value of these firms. They also found that firms did hedge to reduce the expected cost of financial distress.

g. Empowering small firms

In a market structure characterized by small firms with low market power, it becomes essential for these firms to hedge as they have little control over input prices and are simply price-takers. In a study in 2010, researchers found that in 'output' industries, 64 per cent of the firms with low market power did hedge their commodity risks as against 18 per cent with high market power. The figures reinforce the need for players and lower market power to hedge their risks.

Creating an enabling environment

The need and benefits for risk management among the corporates is well appreciated at the policy level. However, there are still areas where policy enablements can encourage Indian firms to manage their commodity price risk risks using exchange-traded derivatives. For instance, currently, many companies seek the RBI's permission to hedge their commodity price risks in overseas OTC markets or exchanges. However, this is a capital-intensive activity as firms have to provide high margins and bear other costs. In addition, firms hedging abroad have to hedge for currency fluctuations. Therefore, given the problems and costs of hedging in overseas market, RBI may advise companies to hedge at least a part of their requirements on domestic hedging platforms. This could start with liquid segments and contracts on the Indian exchanges where their requirements can be met. Similarly, banks may be encouraged to advise their corporate clients in both agricultural and non-agricultural commodities to hedge their risk on the exchanges.

On a different note, the central bank may ask banks to follow a policy of differentiated lending for those customers who are hedged, vis-à-vis those who are not. A clear policy of differentiation in lending rates, haircut margins etc. among banks' borrowers can promote commodity hedging activities by Indian businesses, encourage their participation on commodity exchanges and thus deepen the commodity derivatives market.

Secondly, ensuring that credit rating agencies give due consideration to companies disclosing commodity price risks and undertaking price risk management activities can sensitize firms about the importance of commodity risk hedging and its effect on their valuation. It will also help measure the efficiency of different processes of risk management and help them to arrive at an optimal mode of risk management. Besides, such a policy will sensitize lenders about their exposure to commodity price risks and hence help avoid building up of NPAs through prudent lending. Overall, it will incentivize firms to use the commodity derivatives market to hedge and thus encourage corporate hedging.

Finally, creation of liquidity in the market by way of encouraging institutional participation can entice corporates to hedge in the Indian commodity derivatives market rather than overseas. Presently, the Indian commodity derivatives market is largely confined to retail participants and a limited number of commercial entities, mainly domestic firms and individuals, who use commodity futures to hedge, or insure their production, consumption, or working inventories against the effect of fluctuating prices. Participation by institutional investors such as Banks, Mutual Funds (MFs), Foreign Portfolio Investors (FPIs), Alternate Investment Funds (AIFs) etc. in commodity derivatives market would be conducive for the overall development of the commodity derivatives market, by broad-basing participation, enhancing liquidity, facilitating hedging and bringing in more depth to the market. Only recently have AIF Category III participants been allowed to enter the market, the first financial institutional category to be granted permission to trade in commodity derivative markets.

A significant category of excluded participant includes the Indian banks. Their near-universal presence across the country places them in a unique position to enable millions of stakeholders of the commodity ecosystem use the commodity derivatives market for their risk management needs. Many of these stakeholders are either unable or unaware about the modalities of trading in commodity derivatives or do not have the wherewithal or knowledge to trade. As the experience of several developing countries shows, banks can handhold their customers by creating special products for them, besides financing their margins, aggregating several small borrowers or providing innovative solutions to manage price risks arising out of commodity price volatility on commodity derivative exchanges. Banks are well suited to benefit the farmers' community by acting as aggregators by offering farmers tailor-made OTC products on the basis of their position on exchanges.

The current regulations do not permit even the bank-owned broking firms from providing distribution services in commodity derivatives, or bank subsidiaries from providing clearing services. As these institutions often have advanced skills and expertise compared to other broking firms or clearing members, this class of intermediaries can increase participation and effectiveness of the commodity derivatives market by virtue of their superior risk management system, and technological capabilities.

Commodity price risk management: A need than a choice

In September 2005, in the U.S., Delta Airlines and Northwest Airlines declared bankruptcy on the same day. By middle of the same year, United and US Airways were already in Chapter 11, as were the smaller companies Aloha and ATA. A common reason for the financial ill-health of these companies of diverse sizes and scales of operation was the sudden and high volatility of the prices of the commodity they were all heavily dependent on: Aviation Turbine Fuel (ATF), which was in turn a function of international crude oil prices, whose annualized volatility topped 32 percent for almost the entire period of 2005. Clearly, there was a need for hedging which these companies overlooked.

Be so as it may, many companies in India still do not have a coherent risk management policy in place, although they are well aware of the risks they encounter. Learning from the myriad experiences noted above, it is certain that they can ill-afford to ignore this risk. Hence, every company needs to chart out a risk management policy, the cornerstone of which should be an effective hedging strategy. The sooner they appreciate this fact, the better it is for their own growth, competitiveness and sustenance.