

Structured commodity finance

A proven tool with a pragmatic take on risk

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What is structured commodity finance?

Structured commodity finance (SCF) is a sophisticated commodity-based financing technique, specifically designed for commodity producers and trading companies doing business in the developing markets. Introduced in the early 1990s, SCF continues to play an important role, providing liquidity management and risk mitigation for the production, purchase and sale of raw, semi-refined or semi-processed materials.

SCF funding solutions include a variety of pre-export finance, toll finance, countertrade finance, and others. SCF can be applied across part or all of the commodity trade value chain: from producer to distributor to processor, and of course, the physical traders who buy and deliver commodities in the international and domestic markets. SCF financing is primarily based on performance risk and as such is particularly well suited for companies doing business in what are considered higher risk markets and industries.

Understanding performance risk

Unlike traditional financing which looks to the flow of funds and the sources of the money, SCF looks to the flow of the goods and their origins – with repayment realized from the export and sale of commodities in hard currency countries. In other words, the lender's risk assessment is primarily related to the company's ability to perform – to produce and deliver commodities, even under unstable or uncertain political and financial circumstances. Hence the term 'performance risk'.

By focusing on the individual transaction structure and the company's performance capability, as opposed to their balance sheet, SCF provides an alternative and cost-

effective financing tool to companies in the commodity arena, and to commodity producers and trading companies doing business in the developing markets.

The value-added of SCF solutions is their built-in ability to provide maximum security to all the parties to a transaction – producer, trader and lender – essentially by converting payment and sovereign risk into performance risk.

Evaluating performance risk

By combining a pragmatic approach to performance risk with extensive country and industry knowledge, a good commodity finance bank should be able to design individual structures for each commodity financing opportunity. Due diligence should entail a series of on-site visits to the producer, often involving third party experts such as engineers and industry specialists in order to accurately assess the company's ability in three critical areas:

- Technical ability to produce or distribute the commodity, in terms of physical conditions, capacity and management
- Financial ability, in terms of generating current assets in order to meet payroll, acquire necessary supplies and maintain plant and equipment
- Legal ability to enforce the contract, regarding the right of the lender to realize repayment in a hard currency country at the time of delivery

Who are the players?

A wide range of companies stands to benefit from SCF programs, including local producers, international and regional trading companies and financial institutions.

Local producers: The primary beneficiaries of SCF

The lender's risk is related to the company's ability to perform

liquidity management are local producers of commodities in the developing markets, who are provided working capital for purchase of raw materials, specialized or additional equipment, or other essentials for producing and delivering on a given contract.

International and regional trading companies: There is a vast group of these companies doing business in the developing markets that would benefit from pre-export financing. With SCF risk mitigation, companies that source all their raw materials in a single country, for example, or from a single provider are able to lay off some of their risk on the lender. Here a trading company may want to accommodate a commodity producer with an advance payment in order to ensure a steady flow, but fears exposure to a certain company, industry or country. When mitigated with SCF, advance payment financing enhances the ability for the trading company to do business – without an unnecessary increase in market, commodity and political risk.

Financial institutions: For the lenders, SCF presents an opportunity to add desirable new customers and expand into markets that are simply not accessible through traditional channels. Furthermore, a comparison of SCF financing in developing markets, versus traditional methods, quickly reveals that repayment by an offshore off-taker, rather than by the borrower, has historically proven to be a more effective tool against payment risk. In fact, SCF stipulations for physical evidence of the ability to perform, confirmed by special expertise as well as country and commodity knowledge and full legal documentation, often add up to transaction credit ratings that are actually higher than individual corporate and country ratings.

Why SCF is important in Asia

Today in Asia, the need for financing is more critical than ever before. Although trade flows and commodity prices continue to increase, local financial institutions often are unable to take on the additional credit risks. As result, local commodity producers and even multinationals who are active in this region often find themselves unable to obtain financing.

In China alone, there are many companies in the commodity producing business who do not have access to the capital markets. With structured commodity finance gaining in popularity, companies and traders in the commodity producing industry can have access to a whole range of alternative financing solutions, with a single,

overriding goal – to provide assistance in markets where conventional methods fail.

What Citigroup brings to the table

Citigroup's structured commodity finance group is part of Citigroup Global Transaction Services. With the largest proprietary network in the world and a correspondent bank network of over 3,000, Citigroup has the global reach and local expertise to help customers in trade and expand to new markets. We provide a full suite of trade solutions, combining end-to-end risk mitigation and funding solutions across the entire trade value chain.

Whether you are a producer seeking pre-export finance, a trading company in need of a borrowing base facility, a major oil company looking to unload your buyer's risk, or you are seeking any other type of commodity trade finance product, the Citigroup team has the extensive commodity expertise and knowledge to provide you with customized solutions to your business problems.

In a constantly shifting global marketplace, our approach to trade finance is based on helping our clients manage their working capital with a focus on facilitating trade and mitigating risk. The evolution of structured

commodity finance is consistent with our philosophy of pushing the frontiers of global banking as well as with our tradition of innovation – from improvements on letters of credit, to open account programs, to sophisticated electronic delivery of services and reporting.

More than a century of experience in Asia enables us to identify the needs of our clients, and deliver effective solutions. By combining our knowledge of local markets with the largest network and a superior global platform, we are able to deliver these solutions wherever in the world our clients do business.

Willem Klaassens is head of commodity trade finance for Asia Pacific at Citigroup Global Transaction Services, based in Hong Kong. Willem is responsible for both the bank's structured commodity finance activities as well as the classic commodity trade finance business.

A native of The Netherlands, Willem trained as a lawyer and started his career as an in-house legal counsel for Albert de Bary & Co. N.V., the Amsterdam based commodity bank and full subsidiary of Deutsche Bank. Willem has over 15 years of experience in the commodity finance business, having worked with Deutsche Bank in Amsterdam, West LB in Germany and Singapore, and Fortis Bank in London.

