Commodity prices: High-flying oil kings

By Tony Levene

Raw material price volatility and inflation is now a fact of corporate life. And while the "do we blame supply and demand or speculative hedge fund activity?" argument may be fascinating for academics, it is immaterial for companies faced with cost risks in commodities ranging from oil to wheat, from copper to coffee.

Yann Umbricht, a PwC partner in charge of the PwC Treasury Group, believes raw material prices will be a big long-term risk factor. "Around 30 per cent of listed company profit warnings – many in the under £500m turnover bracket – arise due to commodity concerns. But companies are not well equipped to deal with this risk," he says. "This has a material effect on cash and working capital, directly or indirectly, of most businesses. It's arguably a risk to nearly all businesses, and a surprise that it is not given more obvious priority by treasurers."

The new commodity volatility – and its effect on pricing – ensured that the Isle of Man-based Strix, which manufactures kettle controls, thermostats and water boiling elements for domestic appliances, came up with a new strategy for raw material price risk management.

Group finance director Gerry Gray says: "Copper and silver are a huge part of our costs. We were founded before the second world war and until recently, traditional hedging was a reasonable proposition. We can cope with price rises – re-engineering products is always a possibility - but the volatility of the past few years is in a different league. We now have the complication of copper driven by industrial demand and silver partly by investment as it can be a proxy for gold."

Strix had become unhappy with banks and their products. It decided to look for independent facts, data and advice. Two years ago, it teamed up with Validus, an FSA-regulated specialist commodity consultant.

Validus director Kevin Lester believes many companies are unclear about which department "owns" raw material risks.

He says: "Finance directors and treasury departments are good at managing interest rate and currency risks where there are plenty of products and counterparties. However, materials are the province of procurement whose natural interests may be different. One side needs to understand the production process better, the other the financial process but it can get lost between the two." Validus works on a consultancy fee basis to "map" commodity exposure risk.

"Companies have to understand production processes, cost bases and suppliers. Until recently, suppliers may have quoted prices which are good for a year. But Chinese demand has made commodities such as iron ore and rubber more volatile. The annual contract may have changed to quarterly or even monthly prices. We look at both the financial and production sides, trying to bridge the gap," says Mr Lester.

He adds: "The easy answer from banks, the first port of call for many companies, is to hedge prices. This is often expensive, and is only a short-term solution that buys time for change. Because most raw materials are priced in US dollars, there is obviously an interface between currency and commodity but many firms end up hedging both – sometimes effectively hedging against themselves."

Mr Umbricht at PwC also believes at looking at risks in a wide perspective. "We advise breaking down risks into the most basic components, looking at the chain from raw material to ultimate customer so a biscuit manufacturer has to consider wheat prices but also diesel with its impact on transport costs. Judging consumer appetite is also key – there's more commodity price input in a bag of flour at Tesco than a box of biscuits at Fortnum & Mason. You have to look at your competition and, often overlooked – wrongly, given the potential for profit warnings – the risk appetite of directors and major shareholders."

Mr Gray at Strix adds: "The Validus approach has helped us to mitigate our risks so we all sleep easier"