

THE INDUSTRIALIZATION OF COMMODITY TRADING

WHAT ASSET-BACKED TRADERS' STRONG RESULTS
MEAN FOR THE FUTURE OF INDEPENDENT TRADERS

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One after another, the commodity trading industry's traditionally leading independent traders have been increasingly stagnating as the prices of everything from copper to crude oil, remain stuck at rock-bottom levels. By contrast, the world's slow-moving top asset-backed trading giants are announcing rock-solid results.

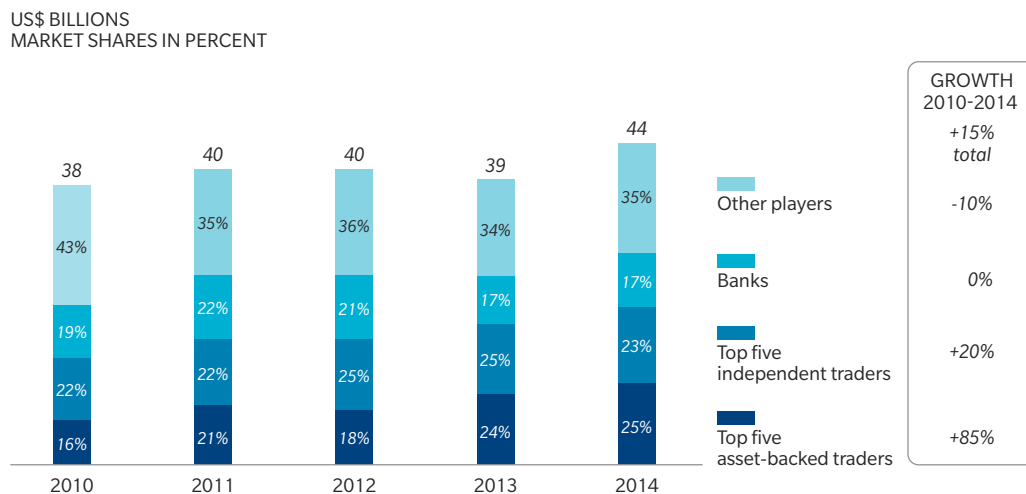
Has the commodity trading industry been turned on its head? No, but the turnabout shows that it's obeying a new set of rules – a seeming contradiction that only makes sense in light of an ongoing transformation of nonconformist commodity trading into a mature industry. The strong trading results of longstanding oil majors and other asset-backed traders provide a glimpse into the potential of strategies that will work in the future. The commodity traders that have come closest to achieving established, institutionalized global machines designed to generate earnings reliably in spite of market conditions are now at the head of the pack.

The trailblazers in the commodity world, in short, are industrializing. Oversupplied markets, rising customer expectations, and higher costs resulting from tighter governance, reporting, and asset management requirements are fracturing the principles of commodity trading that once ruled the industry. Among the casualties: Superstar commodity-trading individuals accustomed to operating solo. The new rules require more than ingenuity, agility, and speed. They call for systematically achieving superstar results by transforming market and competitor intelligence gathered from personal networks into tradable institutional knowledge, offering structured customer solutions, and monetizing "optionality" – defined as the options available to run, manage, and extract the most value from their portfolios globally. Leading players are metamorphosing into light-footed, one-stop shops able to finance, store, transport, refine, and distribute commodities globally with machine-like efficiency, avoiding operational or financial strain.

EXHIBIT 1: THE COMMODITY TRADING GAP

TOP ASSET-BACKED TRADERS WITH MORE INSTITUTIONALIZED OPERATIONS HAVE GAINED SIGNIFICANT MARKET SHARE AFTER THE FINANCIAL CRISIS COMPARED TO THEIR INDEPENDENT TRADING PEERS

COMMODITY TRADING POST FINANCIAL CRISIS GROSS MARGINS OVERALL AND BY PLAYER



Note: Top five = five largest players in 2014
Source: Oliver Wyman analysis

INSTITUTIONALIZING OPERATIONS

For now, major energy companies and other asset-backed traders are the furthest along this path. For example, in the first three months of 2015, BP's profit fell only 20 percent compared to the same period in the previous year, even though crude oil prices were cut in half. Similarly, the trading arms of Total and Shell helped to support their overall group results by taking advantage of favorable forward market conditions and storage capacity along their logistics chains. As a group, top-tier asset-backed traders have been growing their gross margins more than three times as fast as independent traders since the financial crisis. The top five asset-backed trading giants have bounced back strongly from the crisis, growing their gross margins as a group by more than 15 percent every year ever since 2010. By contrast, the gross margins of the top five independent traders have expanded annually by only 5 percent.

As a result, tightly run, maverick independent traders are, in a rare shift of industry dynamics, following the example of asset-backed traders, rather than the other way around. Independent traders are striving to institutionalize their operations without sacrificing their nimbleness and entrepreneurial drive. To that end, they are introducing middle-management positions to break down the organization's dependence on a handful of key individuals in order to gather and act quickly on market intelligence from anywhere in the world.

At the same time, they are shifting towards a more rules-based, management-run model, with explicitly defined delegations of authority and institutionalized processes around investment decision making and capital allocation. Many are also building out their corporate functions, such as corporate finance, strategy, and external communications. They are even involving their compliance and legal

departments more in complex issues such as customer relationships. Some independent commodity traders are also going so far as to outsource and offshore routine administrative work and publishing comprehensive annual reports.

Of course, no single playbook works for every player. Established commodity producers and other asset-backed traders are presently demonstrating greater resilience to difficult market conditions by centralizing supply and trading operations to optimize the returns from their massive global portfolios of production, processing, logistics, and retail assets, as we predicted in "The Dawn of a New Order in Commodity Trading" Acts II and III, which appeared in the *Oliver Wyman Risk Journal* in 2013 and 2014.

At the other end of the spectrum, many top independent traders are developing standardized tool kits to invest along their logistics chains in storage terminals, transportation, domestic distribution, and retail chains with a broad network of customers and partners. In recent months, Castleton Commodities International, backed by private

3x

The number of times faster that top-tier asset-backed traders have been growing their gross margins compared with independent traders over the past five years

investment vehicles and family trusts, bought Morgan Stanley's oil business for an estimated \$1 billion. Through subsidiaries, Vitol and Trafigura partnered with private equity and sovereign funds to expand into retail fuel distribution networks and gain control over transportation and storage assets. A Japanese trading firm joined with three Japanese oil-refining companies to form a new liquefied petroleum gas trader called Gyxis.

For most companies, the commodity-trading makeover underway requires attaining significant scale and sophistication, while not jeopardizing flexibility. Traders scramble to develop scope through capital-efficient partnerships and contracts and then seek to differentiate their services to avoid becoming commoditized themselves.

That's why commodity traders with a narrow commodity or regional footprint are rapidly expanding and forging closer relationships with customers. For instance, more midsize players active in trading only a few commodities are developing comprehensive, global cross-commodity portfolios and are broadening their offerings to counterparties in order to form longer-term relationships. A new wave of petrochemical companies is also building out trading capabilities in related commodities or service offerings.

RAISING THE BAR

For companies struggling to adapt, the industry's coming of age is problematic. Consider: The revenues from investment banks' commodity trading operations, many of which were forced to sell their physical assets and were ultimately sold off, have stagnated over the past five years. Most niche players lacking scale and sophistication have shrunk. For example, commodity hedge funds primarily betting on price directions without assets suffered massive capital outflows over the period.

In general, the industry's greater scale and sophistication raises the bar, both for those existing traders seeking to grow and for those companies considering entering commodity trading. New entrants' resolve is being tested as never before, especially as commodity prices remain flat in the near term.

Successful strategists are designing large systems and industrialized platforms that can maintain the high degree of entrepreneurship and individual talent required for them to act swiftly on monetizing opportunities. Hence the question becomes: Will independent traders

Maverick independent traders are suddenly imitating asset-backed traders, rather than the other way around

industrialize to the degree required to continue to take on established top-tier asset-backed traders as they have done in the past? And if independent commodity traders improve their resilience, will asset-backed traders be able to go on building out their capabilities and gaining market share at the same pace?

To be sure, while the current industry shift underway is significant, independent commodity traders have a solid track record of being able to not just meet, but also to exceed the industry's challenges. Still, the answer depends on whether players can recognize – and pull – the three key levers that have led to the exceptional growth and profitability of top-tier asset-backed traders in recent years. Those organizations approaching



the large-scale change underway as three simultaneous and parallel challenges – the industrialization of processes, the monetization of interconnected analytics, and the mass-customization of customer solutions through partnerships – have a greater chance of succeeding in this undertaking.

1. INDUSTRIALIZING PROCESSES

One of the biggest challenges for commodity traders is that the pace at which they have amassed massive global portfolios of commodities and logistics and retail operations in recent years has outpaced the investment in processes that are needed to monetize their potential effectively. This is especially true for independent traders that have historically had an appetite for more complex deals, which require extensive oversight by their own staff and as a result cannot be easily integrated into a standardized trading workflow.

Consequently, the more commodity traders attempt to be all things to all clients, the more their costs rise – often faster than their revenues. Commodity traders are trading a much broader range of commodities with more numerous counterparties, handling more complex logistics chains, managing more multifaceted financial and operational risks, and delivering commodities to wholesale and retail customers in smaller lot sizes around the world.

To avoid this outcome, major energy companies have been refining their ability to incorporate their longstanding operational expertise into their trading divisions' cultures. They are standardizing, automating, and outsourcing processes. They are breaking down barriers between logistics operations and their supply and trading divisions in order to improve operational stability and efficiency. At the same time, they are standardizing and outsourcing finance, risk reporting, and post-trade handling matters.

Taken together as a whole, these efforts are having a significant impact. One leading asset-backed player, for example, was able to reduce the ratio of costs to trading income by more than 10 percentage points simply by standardizing and outsourcing more work.

2. MONETIZING INTERCONNECTED ANALYTICS

Leading asset-backed traders are also developing a competitive edge in terms of automating the collection and analysis of their market intelligence in order to optimize the value captured from existing strategies and to develop entirely new opportunities. Traditionally, commodity traders have gathered market intelligence from personal networks of buyers, sellers, shippers, and agents with little formalized assessment and tracking. Centrally controlled fundamental market analytics have been critical, but these have often struggled to support fast-paced day-to-day front-office decisions.

But that's beginning to change. Leading traders are breaking down their organization's heavy dependence on a handful of key individuals for critical decision making across global systems based on market intelligence.

They are strengthening their market, weather, and competitive intelligence-gathering capabilities by upgrading the systems they are using to process the Big Data that exists across their massive operations. They are adopting remote-sensing technologies such as satellites and ground-based sensors to gather quasi-real-time market intelligence on waterborne vessels and pipeline flows, as well as the state of refineries, stockpiles, and tank farms worldwide.

By connecting their proprietary intelligence on flows, the condition of their assets, and competitor behavior with new technology-backed market and competitor

intelligence, leading traders are able to improve the precision of their trading strategies, as well as identify new opportunities. To be sure, intelligence gathered by individuals will always be hugely important to the commodity trading industry. But the new front line for competition between commodity traders is shifting toward inferring meaningful intelligence in a timely manner from a combination of proprietary intelligence and ground or remote sensing data from other sources. This can be achieved with so-called "smart machine" algorithms that learn to derive signals to trade by identifying patterns and anomalies.

3. DEVELOPING EQUITY-BASED OPPORTUNITIES

Top asset-backed traders are also beginning to play catch-up with leading independent commodity traders by successfully building out their business development and origination capabilities. In the past, top asset-backed traders have been slower than independent traders such as Vitol and Trafigura to strike capital-efficient partnerships in order to expand their capabilities and market access. That's in large part because they didn't have to. Most oil majors and other large commodity producers were already operating in most of the key markets and were able to mobilize resources globally more easily because of their already existent vast global production and processing networks.

But recently, asset-backed players have been entering partnerships in new markets to exploit profitable niches and emerging markets, especially in the Eastern Hemisphere. For example, Shell has been involved in a number of successful collaborations with logistics-services provider Royal Vopak N.V. related to infrastructure investments. BP is joining forces with Sinopec to gain access to the Chinese bunker fuel market. European utility traders are also considering Asian partnerships in order to expand and better optimize their global fuel and freight books.

Other traders are also entering deals backed by third-party master agreements with banking, logistics, project development, and engineering partners. They have discovered that these partnerships serve a dual purpose. They help their companies to avoid becoming slow and rigid in their quest for stability. At the same time, traders pick up clear guidance on complementary commodity classes, potential acquisition targets, and preferable deal structures.

BREAKING FROM THE PACK

The commodity-trading industry began as a fragmented band of individuals stepping in to smooth out global supply and demand imbalances and information asymmetries. But that's not where it will end. To remain front-runners, commodity traders must industrialize in order to become nimble, global one-stop-shops for multiple commodities, in addition to providing for their financing, risk management, and logistics.

To do so, in the next five years, commodity traders will morph into organizations with all of the benefits and challenges of other mature industries. Like automakers, manufacturers, and financial-services firms before them, as commodity traders' business models become increasingly homogeneous, they will be under even more intense pressure to distinguish themselves from the pack.

This is a tall order for an industry made up of creative and nimble customers and key trading talent unaccustomed to more institutionalized cultures. Sluggish commodity markets and slipping trading margins could threaten traditional compensation structures and levels.

Nevertheless, leading independent traders must learn from asset-backed traders in order to grow and become more resilient. If the past is an indicator for the future, independent players will find nimble and swift ways to adapt and lead again. Conversely, asset-backed traders will need to continue to push the envelope in professionalizing the industry and strive to be more agile by exploring new, innovative ways to inexpensively optimize all of the options available in their massive global operations. No one can afford to sit still.

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