THE ENDGAME FOR COMMODITY TRADERS

WHY ONLY THE BIGGEST AND DIGITALLY ADVANCED TRADERS WILL THRIVE

Alexander Franke • Roland Rechtsteiner • Graham Sharp

The commodity trading industry is confronting a new, less profitable reality. After flatlining for several years, the industry's gross margins in 2016 dipped 4.5 percent to $42 billion, our research shows. (See Exhibit 1.) This decline is setting off a torrent of deal-making and speculation that is transforming the face of commodity trading – with examples like Hong Kong-based Noble Group selling part of its business to the global energy trader, Vitol; oil trader Gunvor in talks with potential acquirers; and Swiss trading giant Glencore circling US grain trader Bunge.

The industry's endgame has started. From oil to agriculture, building scale is proving to be the key competitive advantage for the future. The largest trading companies – both diversified firms and those concentrating on a single commodity – use their financial strength to dominate the industry's largest, most profitable trades and invest in cutting-edge technology.As these traders solidify their lead, the gap between those players with a critical mass in one or more commodities and the rest of the pack is widening. Within a few years, the industry will have a different profile – one that is even more dominated by the biggest players.

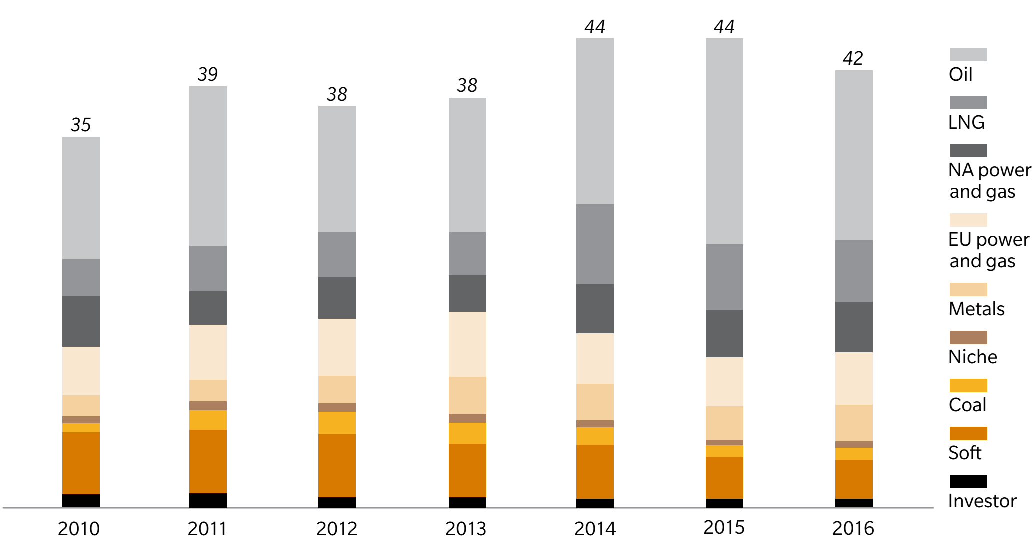
WHY BIG MATTERS

The beginning of the endgame started last year with the decline in margins and took off in earnest in 2017, as we predicted in our 2016 report, "Reimagining Commodity Trading." As companies tried to adjust to the industry's new economics, the clear edge for larger operations started to become evident. It didn't matter if commodity traders had sprawling global businesses diversified across various commodities or if they specialized in one or two. Either way, the larger traders with more than $500 million in gross margins per commodity class experienced 30 percent less gross-margin volatility on average than smaller traders, our research shows. (See Exhibit 2.)

EXHIBIT 1: COMMODITY TRADING'S NEW REALITY

After stabilizing the past several years, gross margins are sagging

US$ BILLIONS, 2010–2016, MARKET SHARES IN PERCENT

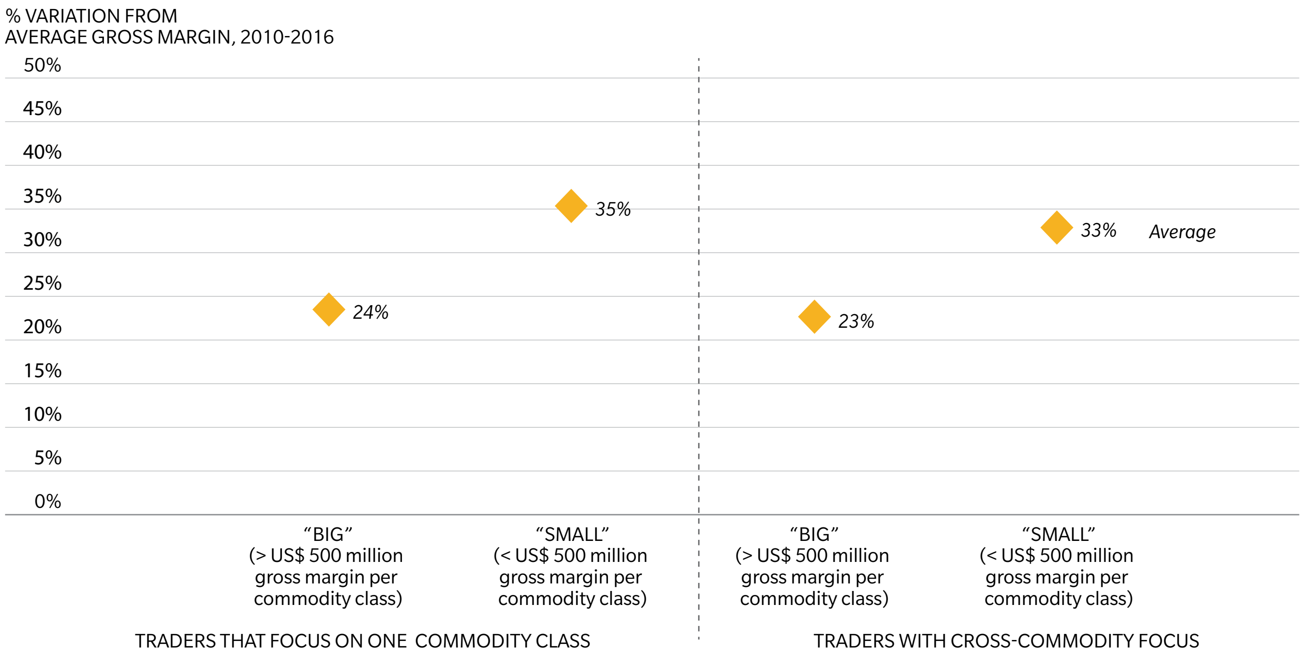


Notes: Sum of products may not equal to total due to rounding; significance of shift overstated in graphic due to rounding; niche consists of emissions, Asia power and gas and exotics (weather).
Source: Oliver Wyman proprietary data and analysis

EXHIBIT 2: COMMODITY TRADING GROSS MARGIN VOLATILITY

Larger commodity traders have less gross margin volatility

GROSS MARGIN VOLATILITY DEPENDING ON SIZE AND FOOTPRINT



Source: Publicly available data, Oliver Wyman analysis

This greater resilience permitted the industry's largest players to take greater risks, and in turn, that meant they could strike the bigger, more profitable, multi-year deals. The same few names – Glencore, Trafigura, Vitol, BP, and Shell – repeatedly were the ones carrying out the industry's largest transactions. (See Exhibit 3.) As they did, their market share grew. In LNG and oil, for instance, traders with at least $500 million in gross margins per commodity class today capture two-thirds of the gross margins in each commodity – more than double what it had been six years before in some categories.

Given these advantages, even the biggest players are working to get even bigger. With increased scale and scope, they keep raising the bar for the industry on what it takes to compete. Today, leveraging proprietary information on commodity flows across commodities and geographies to capture more value is becoming a prerequisite for staying in the game. So is accessing attractive financing for large deals, superior shipping and logistics capabilities, and the ability to source and substitute commodities globally and accommodate fragmented wholesale customers.

On almost every front, global commodity trading giants are coping more easily with thinner trading margins in increasingly mature and less volatile commodity markets, stretching from the developed countries of Europe and North America to emerging economies in Asia. But to achieve these standards, it takes investment that some players can't afford.

A RETURN ON INVESTMENT

One reason for the better economics: The largest trading operations are reaping the rewards of years of investing in building out their global reach and capabilities while

EXHIBIT 3: COMMODITY TRADING'S BIG DEALS

The industry's biggest traders repeatedly secure the industry's largest deals

10 OF THE LARGEST DEALS IN 2015, 2016 AND 2017			
COMPANY	DATE	DEAL	SIZE / VALUE
Vitol	Sep 2017	Vitol provides oil-backed loans to state-controlled companies in Kazakhstan	$5 billion
Vitol	Apr 2017	Vitol makes advance payments for crude to state-owned oil company in Kazakhstan	$3 billion
Vitol	Jan 2017	Vitol funds refined products-backed loan to National Iranian Oil Co.	$1 billion
Glencore	Nov 2017	Glencore completes silver streaming deal (sale of future output) sale of future silver output to Silver Wheaton Corp	$900 million
Glencore	Mar 2017	Glencore sells two mines to zinc company in return for larger stake in the company and exclusive marketing rights for all of its mines	$400 million
Glencore	Mar 2017	Glencore pre-pays Iraqi Kurdistan for oil	$300 million
BP/Shell	Oct 2017	BP and Shell sign 15-year contract for LNG with PTT of Thailand	Undisclosed
Gunvor/Eni	Jan 2017	Supply of LNG secured by Pakistan from Gunvor and Eni over a five-year (Gunvor) and 15-year (Eni) period	Undisclosed
Glencore	Feb 2017	Glencore is selected as sole marketer of one-third of Libya's current crude oil production	Undisclosed
BP/Eni	Oct 2016	BP and Eni sign 20-year deal to buy LNG off the coast of Mozambique	Undisclosed

Source: Publicly available data, Oliver Wyman analysis

simultaneously streamlining processes and cutting costs. Today, in spite of their sprawling size, global titans can nimbly manage deals across the globe from the point of sourcing to account settlement for a transaction. At the same time, they have managed to cut their operational costs by as much as one-third without affecting their commercial or operational performance.

More cost-savings and speed lie ahead as the larger companies continue to invest in digitizing their middle and back offices. In power and gas, for example, at least half of today's trades in commodity classes such as North American and European power and gas are carried out by automated trading systems with no human interaction.

The portion of robot-to-robot commodity trades is rapidly growing across other categories as well. Between 2012 and 2016, futures transactions using automated trading systems on both sides grew by 50 percent in energy, as much as 100 percent in precious metals, and up to 200 percent in some agricultural products, according to a white paper written by two economists from the US Commodity Futures Trading Commission (CFTC). Some players are even bringing in tools as sophisticated as blockchain technology. For instance, a cross-industry consortium – including many of the largest oil companies and independent trading firms – has started to explore ways to standardize data exchanges using blockchain technology in an effort to reduce both cost and risk.

NEW DIGITAL COMPETITION AND MARKET INTELLIGENCE

Given the industry's upheaval, it's not surprising that digital e-commerce giants like Alibaba and Amazon are attempting to encroach on existing pockets of value. For instance, wholesale platform providers like Alibaba and IndiaMart.com are rolling out small to medium-sized enterprise trading platforms in key emerging markets that challenge the first and last-mile of a trader's business – often the critical margin component – by providing cheap and easily accessible cross-border finance and credit-risk reporting capabilities.

These new industry faces can threaten smaller players or may represent a potential strategic partnership for them. For those not in the top tier, the challenge will be to build up enough scale and embrace as much advanced technology as they can afford. Digital players like Amazon and Alibaba could represent a more affordable avenue to achieving that goal.

Meanwhile, top commodity traders are also using digitization to expand their competitive advantage. Drawing on new types of data, they are offering new, customized services to a wider and more fragmented array of counterparties and clients at a much lower cost. For example, a few agricultural-commodities traders now provide farmers with portals – business-to-business-to-consumer platforms – that allow the farmer to obtain attractive financing packages with their commodity hedges at a fraction of their total present cost.

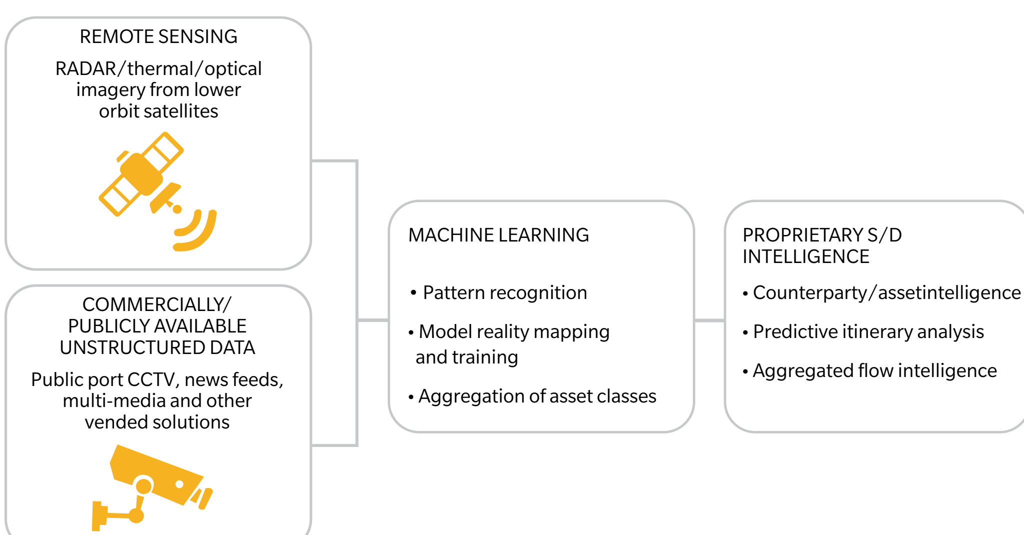
More important, the bigger commodity traders become, the more capital they have to invest in the latest analytics and artificial intelligence that let them capitalize on the vast proprietary data in their portfolios and supply chains. Increasing their ability to transform data into meaningful market intelligence only enhances their competitive advantage and permits them to mitigate risks much more effectively than in the past.

Indeed, some leaders are pioneering business practices and setting new trading standards that were practically nonexistent as recently as even a year ago. For example, top players are now building proprietary intelligence platforms that deploy machine-learning algorithms to analyze data from radar, thermal, and optical scientific imagery supplied by lower orbit

EXHIBIT 4: COMMODITY TRADING DIGITAL MARKET INTELLIGENCE PLATFORMS

New sources of data and advances in data analytics create new possibility for proprietary market intelligence

PROPRIETARY INTELLIGENCE PLATFORM



Source: Oliver Wyman analysis

satellites. By taking advantage of machine learning techniques that recognize patterns and model scenarios across commodities, these traders can form better informed, proprietary market perspectives on where commodity shortages or gluts may occur. They can anticipate demand and supply – and their impact on pricing – more precisely and fulfill trades more efficiently in real time with less risk. (See Exhibit 4.)

CONCLUSION

In the end, the advantage of scale and digitization will go hand in hand. Each feeds the other. Traders with larger financial reserves are more able to invest in the most advanced technologies. Those tools, in turn, help the company grow even larger and take even more market share. As they do, the industry's leaders will continue to set new standards and cut costs across a broad swath of services.

Those traders not in the top tier will have to figure out how to compete. Midsize firms will need to build up scale in the areas where they have an advantage, perhaps through partnerships, while simultaneously reducing their costs and process complexity. One thing is clear: The circle of players able to keep up is shrinking rapidly, and the challenge for traders today is facing the hard, cold reality of what it will take for them to survive the endgame.

Alexander Franke and **Roland Rechtsteiner** are Zurich-based partners in Oliver Wyman's Energy practice. **Graham Sharp** is a co-founder of Trafigura and a senior advisor to Oliver Wyman. Ernst Frankl, a Frankfurt-based partner, Christian Lins, a Zurich-based principal, and Adam Perkins, a London-based engagement manager in Oliver Wyman's Energy practice, contributed to this report.