

Closing information and perception gaps

Times have not been so easy in the past few years for trade financiers. Mark Hodgson, general manager of Solens Consultants Ltd (SCL), believes that new business development in emerging markets can be enhanced through performance risk analysis (PRA). SCL specialises in the analysis of performance risk for the minerals and petroleum sectors as part of the development of structured trade and project financings.



The effects of September 11 continue to linger. The repercussions of that tragic day not only resulted in an increased level of risk awareness by the banking sector, but also in adversely affecting many other institutions and companies raising funds from credit facilities.

Speaking as one whose particular area of interest is the structured trade and project finance areas, it has become increasingly apparent that there are two classes of company who can obtain finance based on their ability to export commodities: those that are known creditworthy entities and subsequently well banked, and those who are relative unknowns and whose ability to raise finance is considerably constrained.

Structured trade finance (STF) facilities that are based on the export of commodities usually focus on those goods for which the market fundamentals are well understood and are readily fungible. Experience would indicate that such 'major' commodities are aluminium, copper, nickel, gold, steel, crude oil, selected refined oil products and in the case of so-called soft commodities,

cotton, sugar, cocoa and possibly coffee. This list is not likely to be complete but it would appear that most facilities ranging from one to five years would be based on such products. Major producers of these goods are well known and in many cases benefit from the support of the banking sector.

Don't forget the minors

Reviewing the diversity of trade that can exist, it becomes apparent that whereas the aforesaid products account for a majority of the business that constitutes the STF sector, there remains a significant contribution from what might be termed the less well-known or 'minor' commodities. Examples include titanium, manganese, chromium and palladium to name a few. Taking the US market alone as an indicator of the relative size of the market, and using US government data to provide estimates of the potential level of trade volumes which could attract STF approaches, the overall metals and minerals trade value involved would amount to some US\$7.7 billion, of which US\$1.6 billion would fall under the category of such minor commodities. This figure could well be quadrupled if an estimate for the equivalent world trade volume for STF as a whole was considered.

Why is the figure important?

Furthermore, why the significance of STF? Many economies are, and continue to be, dependent on the export of commodities. STF potentially offers such producers their first (and possibly only) route of

accessing significant working capital not only to promote these sectors but also to assist their associated regional economies. STF products often provide the vital first step in the establishment of the creditworthiness of those companies which can be identified as such outside their borders. Using the figures above, this would imply that there is a huge client base that remains to benefit from STF and its related products.

However, what is the scope for such companies in obtaining the credit facilities that would seem vital for their continued operations as well as the social infrastructures that they support?

As noted above, September 11 appeared to cause many institutions to adopt a risk averse strategy. The lead up to Gulf War II resulted in an extended state of torpor to permeate through the capital markets. The press has many stories of financial woe resulting from bad debts. Recent reports have highlighted the difficulties experienced by highly respected names in the corporate banking world. The chances of a relatively unknown commodity producer raising urgently needed capital in a country rated less than investment grade would therefore appear to be somewhat slim.

Yet the pressure on banks to meet budget targets remains. In the absence of the positive marketing by production companies formed within producing countries, whether privatised or not, who (even now) are not fully familiar with western banking marketing practice, it would appear that a better approach could be to

New business development

Performance Risk Analysis

apply a risk assessment process in which the capability of the proposed producer borrower to meet debt service obligations in hard currency under STF facilities could be quantified. Recent developments in the assessment of risk as evidenced by the launch of such products as RiskCalc, CreditRisk and PFM have been major advances in the management of portfolios for which financial data are readily available for a specified series of obligors involved.

The quandary for the STF marketer is that they will be dealing with a single client whose published financial data could range from being based on outdated practices to being highly skewed due to the effects of third parties who are wholly reliant on them for cash support. The challenge therefore is to focus on those risk issues which are relevant to the capability of the client meeting its debt service obligations.

The work that needs to be done is essentially one of bridging the gap between the operational ability of the plant and its workforce to produce saleable goods (engineering and management issues) and that of the financial or political capacity to stay in existence. Default risk for an STF transaction, is essentially the probability of there being a shortfall between the plant effectiveness and the financial target amounts to the default risk. Such is the scope of so-called performance risk analysis (PRA) as developed by ourselves.

Technology stretch affects competitiveness

In a typical PRA analysis it is possible to review the variables that constitute the cashflow which, ultimately, is the basis

of debt service and apply Monte Carlo simulation techniques to determine the incidence of a potential default situation. Understanding the underpinning engineering procedures serves to set limits on the levels of variability selected as well as to produce pragmatic views on the likely probability distributions entailed. In many cases this represents the effect of so-called

'technology-stretch' which can have a fundamental impact of the competitiveness of any mineral production operation in world terms.

Just as relevant engineering variables can be selected into the risk equations, the same can be applied to country risk components as well. Risk elements can be grouped under those political, economic and financial aspects which have a relevant bearing on the transaction under consideration. Again, the key issue is identifying the categories of risk that are relevant; blanket application of overall country risk factors is neither helpful nor appropriate for assessing a true STF transaction.

Indeed, it could be argued that if a transaction is properly subject to a full country risk weighting then the deal is not an STF one at all. For example, a major component of country risk weighting is the country's foreign exchange position which for STF transactions is either eliminated or mitigated

and logically reduced weightings must be considered for this situation alongside other relevant risk mitigants. The consequences of applying engineering and country risk factors via Monte Carlo simulation approaches under the PRA approach is to define a relationship between the risk adjusted return on capital and the likely default risk. It has been found that the risk-reward

line can be readily adjusted upwards or downwards depending on the pricing selected for the transaction. Based on the algorithms used, the point at which the risk-reward line becomes positive sets the minimum pricing for that specific deal which in turn bears some reflection of the pricing for

the country generally quoted by traditional trade and syndication departments or forfeiting houses.

To summarise, the PRA approach as briefly outlined can produce probabilities for likely cashflows being attained that are sufficient to meet debt service requirements of a specific facility under a range of conditions selected. Risk-reward profiles can be produced whereby the effects of structure can be used to quantifiably mitigate the level of uncertainty and therefore the default risk. Since the preparedness of lenders to undertake transactions appears to be inversely proportional to the level of uncertainty relating

to the risks associated with the transaction, such a model can have direct application to the introduction of new borrowers to the STF market.

PRA model not the full answer

The development of structures to assist a wide range of commodity producers is a practical possibility while accommodating the necessary safeguards a pragmatic credit policy requires. The perception of high risk is commonly and understandably associated with the difficulties in obtaining the relevant information to manage such credits. It is not my claim that the PRA model provides a fully comprehensive answer to meeting all risk issues that are likely to have impact on the setting up and execution of STF deals.

However, it provides a basis for modelling the contribution of engineering expertise, market variability as well as fundamental financial elements with a view to providing a measure of the probability of the proposed transaction being successful.

The PRA model is therefore aimed at being a contribution to closing the information and perception gaps relating to the analysis of new commodity-based lines of business. It has been designed with the view to stimulate interest in those commodity producers who not only seldom receive the attention of the STF market but also are the most likely to be in need of such support. As a consequence, the PRA approach is intended to serve as a means of realising new business opportunities through proactively quantifying the underlying capabilities and the probability of such producers to meet their obligations under the terms of the financial transactions put forward.

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