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## Impact of Commodity Volatility on Insolvency Work

### Contributing Editor:

Daniel F. Dooley

MorrisAnderson; Chicago

ddooley@morrisanderson.com

Much has been written over the last few years about rising commodity costs such as oil, steel, corn and many others. However, the commodity issue is much more an issue of volatility. Volatility is a much more complex business issue than one of simply increasing commodity costs because it is much more difficult to plan for volatility than it is to plan for steadily increasing, or steadily decreasing, commodity costs.

### Review of Commodity Cost Index Examples



Daniel F. Dooley

Chart 1 shows a simple statistical analysis using International Monetary Fund Commodity Index data with 2005 as the base year. Commodity volatility is defined as one standard deviation from the mean by comparing the 10 years of 1996-2005 to the almost six years of 2006 thru August 2011. Note that the volatility of most commodities is at least two times greater today than just a decade ago.

### About the Author

Daniel Dooley is CEO and principal of MorrisAnderson & Associates Ltd. in Chicago.

### Commodity Volatility Causes

Volatility of commodity costs is not simply a matter of local market supply and demand. First and foremost, many commodities have moved from national or regional markets to a truly global marketplace in the past decade. Commodity cost globalization has been driven by the Internet, which has equalized access to comparable supplier cost information by buyers. The increased impact of China as

Besides the globalization of commodity markets, two other major related factors affecting volatility are exchange rates and world events. Current exchange rates are not solely driven by supply and demand. National governments often attempt to influence exchange rates with national monetary policy or by directly controlling exchange rates with a policy of fixed exchange rates (e.g., China). Additionally, world events such as wars and major weather events (e.g., the Japanese earthquake in March 2011) impact commodity costs as well. Today, the news of these events travels worldwide in minutes, and the impact on commodity costs in global markets is felt just as quickly.

## Turnaround Topics II

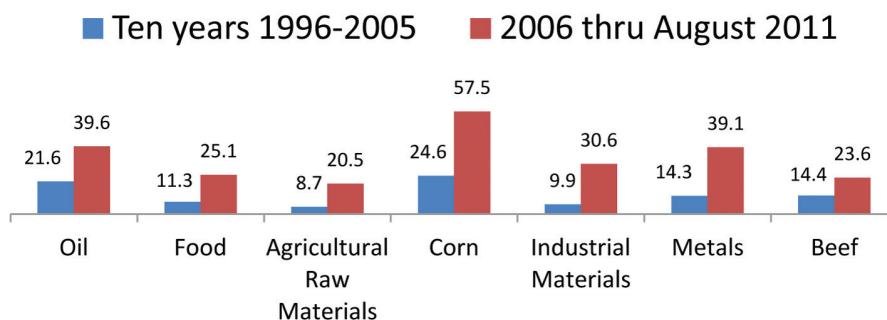
a manufacturing powerhouse is also driving costs down. In a historical sense, the global-commodity marketplace is very new. When a market has a fundamental structural change, such as the creation of a global marketplace, that market goes through a period of re-establishment of an equilibrium cost. Thus, a significant portion of the current volatility in commodity costs is simply the normal economic process of re-establishment of an equilibrium cost.

The interdependency of these events across a global marketplace means that what happens within a major economic power on an economic, exchange-rate or a world-event basis usually impacts other parts of the world and global commodity costs very quickly today. Commodity traders with near-instant market information use financially leveraged options to overamplify market movements, for the goal of commodity trading profits.

### LTAs Are Very Different Today

Suppliers have historically worked hard to get long-term agreements (LTAs) from major original equipment manufacturers (OEMs) on the theory that long-term OEM commitments were a stabilizing factor for their businesses and provided financial comfort for capital spending, employee hiring and permanent financing. However, as commodity cost volatility has increased over the last seven years, many suppliers discovered how important it is to obtain timely commodity pricing relief when costs

Chart 1: International Monetary Fund Commodity Index



increase. The lack of effective commodity cost increase pricing relief in LTAs caused many suppliers to fail in 2004-05 when both steel and oil commodity costs went up very quickly.

Today, surviving suppliers generally have effective price-relief language in their LTAs should commodity costs rise above a specific level and, of course, price give-backs if commodity costs decrease. However, the price-relief protection rarely covers any gross-margin protection or working-capital investment protection. Typically, suppliers only get commodity cost-increase relief without mark-up and must sacrifice gross-margin percent and self-fund at least some working-capital expansion if the suppliers have either asset-based loans or inadequate head room on cash-flow revolving loans.

## **Issues Affecting Business Insolvency**

The doubling of volatility of basic commodity costs has had a dramatic impact on business insolvency and the potential for businesses to work their way out of financial distress. Specific issues include the following:

### **Ability to Escalate Prices Timely**

In the industrial-products world, the ability to escalate prices is often driven by LTAs or at least annual purchasing agreements. Most agreements now allow for recovery of commodity cost changes over some agreed-upon base index. However, the ability to escalate prices is usually restricted to a quarterly or annual basis. It becomes important to lock in commodity purchase commitments and pricing on the same timeframe. If commodity costs change quickly, and ability to receive pricing lags by a quarter or two, companies can lose millions on the time lag. Trucking company Jevic Transportation lost \$3 million in one month due to rising diesel costs.

Note that in the consumer-products world, you have virtually no ability to increase prices to cover cost increases unless most suppliers act to increase overall market prices. Unless capacity is tight in an industry, rarely do most suppliers act together except in cases where they are a small number of lead suppliers.

### **Management of Liquidity Issues**

This issue manifests itself in loan commitment caps and rapid changes in borrowing bases for asset-based borrowers. Loan commitment caps come into

play when inventory commodity costs escalate quickly, dollars must be quickly invested in inventory and credit lines are increasingly consumed to fund increased inventory value.

On the borrowing base, increases in inventory cost may create short-term borrowing availability if existing inventory is revalued up, or may consume short-term availability if inventory costs quickly fall if existing inventory is revalued down. This is an area where management can often mislead itself as to collateral values in relation to outstanding loans or worse, mislead its lenders.

### **Earnings or Losses May Be Heavily Driven by Inventory Value**

The hazy world of cost accounting can come into play where inventory values are not periodically adjusted for changes in commodity costs or inventory values are changed all too frequently if costs increase to record valuation earnings. For example, if \$30 million of inventory at cost is now worth \$40 million at current market cost, the company has a \$10 million earnings pickup that can distort current run-rate or static earnings. Such inventory revaluation issues can also go in the opposite direction if costs fall. Management and lenders need to dissect cost of sales and the accounting assumptions behind the numbers to understand what is really happening.

### **Middle-Market Managers Must Actively Manage Commodity Risk**

Commodity hedging is essentially buying insurance against future cost changes, usually potential cost increases. Today's middle-market manager needs to proactively manage commodity risks much like family farmers have done for decades. This is a skill-set that very few middle-market managers have, yet now it is a survival skill. The cost of commodity hedging for any commodity-sensitive business must be considered a fixed-cost item.

## **Conclusion**

The volatility of commodity costs has doubled in the last decade. Perhaps we are just re-establishing a global market cost equilibrium, but for the near-term, those in the insolvency world will get clients because of increased commodity volatility. LTAs are not quite as attractive today as they were a few years ago, but commodity-price escalation clauses are mission-critical terms today. Business managers and insolvency consultants alike must be prepared to deal with the

impact of commodity cost volatility on pricing, liquidity, earnings and commodity hedging. ■

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