Role of MCX in Base Metals Trading





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The importance of commodity derivatives markets is increasing every day, especially for a developing nation like India, as the economy becomes more aligned with the global economy. Various sectors of the economy that are stakeholders in base metals, energy, and agri-commodities, are exposed to the price risks of international trade. To combat this threat, the Indian commodity exchanges have played an important role. Their contribution in modernising the nation's commodity sector, by bringing in more efficiency in the marketing value-chain has been paramount.

This has resulted in many beneficiaries. Apart from the large and medium stakeholders, various small players— small and medium enterprises, small traders, importers, exporters, farm community (including small and marginal farmers), manufacturers, and various other stakeholders—have been major beneficiaries of the important functions performed by these exchanges. With the advent of commodities futures trading, a critical "unmet demand" of the SME sector for risk management has been met.

Presently, in India, there are 5 (operational) national-level multi-commodity exchanges and 16 regional commodity exchanges. Of these, MCX is the largest with a market share of over 87 per cent. MCX's metal and energy contracts provide access to risk management tools to the many corporates that are unable to trade on international exchanges. The Exchange has developed contracts with different lot sizes to accommodate the needs of varied market participants to hedge their risks.

The MCX Advantage

In today's world, industrial and technological advances have increased the requirement to improve physical infrastructure in developing economies, thereby increasing the demand for base metals that have a variety of applications in almost every industry ranging from construction, manufacturing and production. Factors such as currency movement, rising inflation and interest rates in major developed countries affect the base metal demand and consequently its price. Since India is among the fastest growing nations it is evident that the domestic demand for base metals will continue to remain strong. MCX provides an exchange platform to the participants of the base metal value chain for mitigating price risks, which they could be exposed to.

MCX gives the base metal consumers an idea of the price at which the commodity would be available at a future point in time. With proper costing/financial planning they can cover their purchases. Exporters, too, can benefit with an advance indication of the price likely to prevail, which can be used to quote a realistic price to secure export contracts in a competitive market. Corporate entities, using base metals as inputs, can benefit by hedging their risks on MCX, irrespective of whether the commodity traded meets their requirements of exact quality / technical specifications.

Many of the commodities consumed in India are imported, so not surprisingly their prices follow common global price trends and global price volatility is reflected in the local price volatility. In addition, the markets for many commodities that are produced in the country are effectively integrated with global markets and their prices reflect global supply/demand conditions. In the past, it was very difficult for Indian corporates to protect themselves against global price fluctuations. Since 2003, however, Indian corporates have been able to protect themselves against volatility of globally referenced commodities by hedging on MCX, with the added convenience of having accounts in Indian Rupees and dealing with a broker in the same time zone.

With commodity futures, a hedger locks in a price and therefore the profit margin. Commodity futures exchanges like MCX provide an almost costless mechanism for risk transfer. With insurance, those who want to lay off their risks have to pay a premium to those assuming these risks. But commodity futures exchanges bring

BENEFITS OF COMMODITY FUTURES CONTRACT

- Avoid the effects of fluctuations in prices for producers who, because of their limited production volume or seasonal factors, are not able to spread out their sales over the year, or for consumers who, because of their limited size, cannot spread out their purchases;
- Protect the value of inventories, or partly finance the cost of storage;
- Secure a processing margin ;
- Lock-in future prices at an attractive level;
- Improve marketing policies and financial planning and forecasting.

together various segments of the market place with differing objectives in price outlook. No premium is required to lay off risks: a futures market allows producers and consumers to meet their objective of securing their margins, the first by selling futures contract and the latter by buying. In a typical 'producer hedging' scenario, producers 'sell futures contracts' and lock in their price realisation. On the contrary, users from infrastructure industries cover their forward purchases by 'going long' on futures contracts.

Contracts Offered

MCX offers more than 40 commodities across various segments such as bullion, ferrous and non-ferrous metals, energy, and a number of agri-commodities on its platform. The base metals spectrum comprises of over 12 commodities such as Copper, Copper Mini, Aluminium, Mild Steel Ingots, Nickel, Nickel Mini, Zinc, amongst others. The Exchange offers standardised commodity futures contracts on its platform, which provide an anonymous trading environment for ideal price discovery. Moreover, for globally-traded commodities, MCX's platform enables domestic participants to trade in Indian currency. The Exchange is the world's largest exchange in Silver and Gold, second largest in Natural Gas and the third largest in Crude Oil with respect to the number of futures contracts traded based on data published for CY 2011 on the websites of exchanges and FIA.Base metal contracts at MCX are right sized to meet the requirements of the Indian corporates especially bulk users in the SME sector. Besides, these contracts are priced in Indian Rupees and therefore obviate the need of dealing with currency related issues that one has to deal with when hedging using an international platform. Lastly, there is a high degree of co-relation in the prices of base metals traded on MCX and those traded on international exchanges. This means, for a corporate to hedge using the Exchange platform is as effective as using international exchange platforms. Considering the aforesaid, MCX is the ideal choice for hedgers.

"MCX offers an excellent platform to a variety of participants, ranging from producers, exporters, marketers, SMEs amongst others. Futures contracts provide an exceptional tool for hedging price risk exposures in today's market, allowing participants to mitigate their risks when the market moves in either direction. MCX contracts in base metals address both commodity risks as well as currency risks. Besides, the contracts are well suited for a varied set of users, thus enabling them to accumulate and/or scale down hedge positions gradually," says Mr. Shreekant Javalgekar, MD & CEO of MCX.

MCX regularly engages with commodity market participants to understand their needs. Based on the inputs received through the interactions with commodity market participants, MCX designs innovative products to suit the needs to varied participants. Recently, MCX has launched some new contracts, one of which is Mild Steel, Ingots & Billets contract. These contracts conform to the quality of the Bureau of Indian Standards (BIS) 2830:2012 specification for carbon steel Grade 'A' (with designations of C15 or C18 or C20) and have received an overwhelming response from market participants.

Mcx Mini Contracts Value Propositions to The Market Participants

MCX's contracts with smaller lot sizes are another such product innovation. It is the first commodity exchange in India to launch mini futures contracts in various commodities such as precious metals (gold and silver) and base metals (Aluminium, Copper, Nickel, Lead and Zinc), which are very popular with the hedgers, especially the SMEs. By design, these contracts are similar to the standard contracts in all parameters except the contract size.

Mini contracts facilitate gradual build-up and/or scaling down of hedge positions, better cash flow management and better risk sizing. It is therefore a very important tool for the SMEs in base metals industry.

The table below outlines the difference between the standard and mini futures of MCX. Difference between standard and mini futures contracts

Contract Size (in kg)		
Commodity	Standard Contract	Mini contract
Aluminium	5000	1000
Copper	1000	250
Nickel	250	100
Lead	5000	1000
Zinc	5000	1000

In India, the bulk of base metal users are small and medium enterprises. Price risk management tools are most important for these players. MCX's standard contracts though have a high degree of co-relation with the international markets, they offer less flexibility to many small players, especially in building and sustaining hedge positions over a period of time. By right sizing the contracts in line with the business requirements of the Indian SMEs through the launch of Mini contracts, MCX has enabled hedgers to adopt

these contracts for price risk management. Clearly, mini contracts offer at least three benefits.

• Mini futures contract facilitates gradual build-up or scaling down of hedge positions. For instance, a buyer with a monthly requirement of 25 tonnes of aluminium can purchase one mini aluminium futures lot (one tonne each) per day all through the month (assuming 25 working days). Later, at the time of actual purchase of metal from the cash market, the buyer can square -off his positions in the mini contracts. Thus, using mini futures contracts, the buyer evens out market fluctuations and gets an average price. Can the buyer not achieve the objective by simply buying one tonne a day from the spot market? Yes, it is possible. However, this method is costly as it entails 100% capital upfront and is bound to increase transportation costs and associated monitoring hassles. However, by combining cash purchases with position building in mini futures contracts, the buyer can achieve the objective of obtaining an average price for his purchase easily.

• Gradual build-up or scaling down of hedge positions results in better cash flow management. As the positions are staggered, cash requirement for margins is also staggered. This helps achieve a better control over the cash flows.

• Lastly, smaller sized mini futures contract enables better risk sizing. In extra-ordinary times of high volatility, mini contracts offer flexibility for either paring exposures or increasing exposures in small quantities. This flexibility enables SMEs to stay on even during volatile market conditions.

MCX - hedgers' Perspective

Here below we present excerpts of interviews with heads of companies that use the MCX platform to hedge base metal exposures.

Interview with Mr. Devendra Surana, MD, Bhagyanagar India Ltd.

Can you briefly explain your business operations?

- Bhagyanagar India Limited (BIL) is primarily an auto component manufacturer that also caters to the electrical industry. Our principal raw material, copper, accounts for about 70-75 per cent of the costs. Hence, it is strategic for us to keep an eye on the copper price. We import copper on LME price basis.

Do you use MCX? If so, kindly explain.

- Since we are a listed company we need to report quarterly results. High price fluctuations in copper in the past used to result in high variations in the inventory valuation, thereby affecting quarter-on-quarter profitability. As a business requirement, we hold large quantities of copper to be used in various stages of manufacturing, which is usually around 400MT. Therefore, it is imperative that we hedge price exposures in our inventory holding and desensitise our P&L to the fluctuations in copper price. This has been the primary reason behind our decision to use the MCX platform. We use MCX copper futures contract to hedge (by selling futures contract) 60 -70 per cent of our inventory exposures at all time.

In your experience, how closely does MCX track LME?

- I believe there is a high degree of correlation between these two markets. I am also very happy to see the liquidity and depth of MCX copper contracts increasing day-by-day. Earlier, we used to see a divergence between MCX and LME prices around the settlement time (around 5:00pm-5:30 pm) every day. Of late, these divergences in prices have disappeared. Lastly, for us, MCX futures contracts priced in Indian Rupee is not only able to address the price fluctuation risk in copper but also the risk associated with fluctuations in currency.

Interview with Mr. Dilip Morzaria, Director, Kamman Group

Sir, kindly elaborate upon your nature of business.

- Kamman Group is a producer, marketer and exporter of quality ferro alloys, metal powders and wires (nickel-based alloy wires, stainless steel wires, etc.) with operations based in India.

What are your main raw materials?

- As we manufacture nickel-based alloy (nickel-copper, nickel-chromium, and so on) wires. Nickel is our main raw material forming about 70 per cent of the raw material costs. The company requires about 300 MT of nickel annually.

Nickel prices are highly volatile. How do you manage these price variations?

- The price volatility in nickel is very high. In our business, we sell 50 per cent of our products based on day-to-day price prevailing in the market. About 50 per cent of our sales happen against fixed price contracts, which are to be delivered in three to six months period. As a strategy, we only hedge price exposures in fixed price contracts to protect our margins.

Can you take us through the hedging process?

MCX's Leading Size & Scale

- India's 1st listed exchange
- India's no.1 ^ commodity exchange
- World's no. 3# commodity futures exchange
- World's no. 1* exchange in silver and gold
- World's no. 2* exchange in natural gas
- World's no. 3* exchange in crude oil
- 340000+ trading terminals
- 2000+ members
- 1770+ towns and cities



*Source : * Data published for CY 2011 on the websites of exchanges and FIA data , # Data published for CY 2011 on the websites of exchanges and FIA Annual Volume Survey released in March 2012, ^Devised based on data maintained by FMC*

- As mentioned earlier, we only hedge price exposures in nickel arising out of fixed-price commitment. For hedging we use the MCX platform through an authorised member. We initiate the hedge on the day of finalising a fixed-price contract with our customer, by buying MCX nickel futures contracts equivalent to the quantity of nickel required to fulfill the contractual obligation.

For example, if an order involves 6 MT of nickel, then we would buy 24 nickel contracts, as each nickel contract represents 250 kg of nickel (24 contracts x 250 kg nickel equals to 6 MT of nickel). As and when we buy nickel from the spot market, we square-off equivalent positions taken at MCX. Thus, if we buy 2 MT from the spot market, then we would sell 8 MCX nickel futures contract (250 kg per contract * 8 contracts equals to 2000 kg or 2 MT). So, it is a simple and classic hedging operation. Sometimes, we gain in futures markets and lose in spot market and sometimes it is the other way around. Setting off gains and losses in both spot and futures markets, we achieve a purchase price close to the one on which our quotation was based.

Have you measured the effectiveness of nickel futures contract on the MCX platform?

- We are a manufacturer of nickel-based value-added products out of nickel. Our margins vary from 12-18 per cent. What we have seen post-hedging price exposures that we are able to maintain this margin, within + 2 or -2 per cent range and we are fine with this.

Do you use any other exchange markets?

- Earlier, we used to use LME. However, like everyone else, we faced challenges such as size of contracts at LME and size of our operation, dealing with currency risks independently, and so on. While LME is the global benchmark, it did not exactly meet our hedging requirements.

Don't you miss long-dated contracts of LME?

- Actually, our customers are comfortable placing orders for delivery in the next three to six months. So, currently, we do not find long-dated contracts useful.

Interview with the past-President of Bombay Metal Exchange Limited and a veteran in semi-fabricated product industry, Mr. Surendra Mardia

Tell us briefly about your business?

- We are manufacturers of 'semi-fabricated' products such as tubes, rods, sections and profiles using copper and brass – an alloy of copper (60 per cent) and zinc (40 per cent). We supply to private and public sector enterprises as well as government enterprises.

Do you hedge price exposures in your raw materials?

- We follow a 'selective hedging' policy. Accordingly, we hedge exposures arising out of long-term fixed price delivery commitments. For example, some Government tenders require us to quote a fixed price for orders that have to be executed over three to six months period.

In such cases, it becomes mandatory that we cover our exposures in the raw materials that go into the production of these goods. Else, we cannot achieve the margins as targeted at the beginning of the project due to volatility in prices of raw materials that are going to be used. So, we hedge price exposures in these cases.

Operationally, as soon as we get a tender in our favour, we hedge the entire raw material purchases required for fulfilling the tender requirement at MCX by taking 'long positions' in futures contract. We hold these long hedge positions, till we make the physical purchases from the market. Once the cash price is fixed, we lift the hedge positions by 'selling' equivalent quantities in the futures market. As a policy, we do not take more exposures in futures market than the physical purchase requirements. That is, we do not speculate.

Typically, our physical exposure size per tender is of the order of 100-150 MT over a three to six month period. Spot purchases are made based on the price quoted at the Bombay Metal Exchange. We have observed that there is a high correlation between these spot prices and the MCX futures prices, as both are derived from a common source the London Metal Exchange (LME).

Growing the Commodity Market through Innovations and Creating Awareness

MCX is focused on growing India's commodity futures market through dissemination of knowledge by conducting awareness programmes, releasing articles and books on various relevant topics, engaging with physical market participants and using the media to reach out to myriad stakeholders.

MCX has been proactively trying to increase participation on India's commodity futures market. Besides having organised awareness programmes all over india in collaboration with Forwards Market Commission (FMC) and other trade associations, the exchange has also taken lead in organising members' meet and stakeholders' meets for basemetal & bullion market participants.

The company's initiative to launch newer products such as the mini contracts in the last couple of years has been able to attract small and medium enterprises to trade on the exchange platform to hedge price fluctuations and risk diversification needs.

MCX offers a transparent platform, besides bringing about economic and financial efficiencies by de-risking production, processing and trade. The Exchange's engagement has led to large efficient gains in supply chains, with exporters gaining a larger share of global prices and producers not only getting better prices but also much better access to markets.

"MCX is one of the first commodity futures exchange in India to have implemented global best practices in terms of its technology, risk management systems and self regulatory mechanisms. Base Metal participants including other industry users can trade on MCX with trust," says Mr. Shreekant Javalgekar, MD & CEO of MCX.

By creating value for hedgers, MCX has helped catalyze India's economic growth. Its futures contracts have demonstrably brought significant benefits to not just the base metal sector but also others.

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