Base Metal Derivatives @ MCX – Risk 'Management In India'

Base metals complex consisting of metals such as Copper, Aluminium, Zinc, Nickel, etc., represent the actual inputs used in manufacturing, construction and production which is supposed to support Government's recent initiative of 'Make in India'. Companies cannot build their products or expand their facilities without using these resources. Base metals are common metals that can typically be found in plentiful supplies. Base metals have a variety of applications in almost every industry. To connect a few of their uses, Aluminium is used in automobiles, plants, planes, cans, factories and equipment. Copper is used for just about anything including wires, pipes, construction projects, heating and cooling systems. Zinc is used to produce batteries, fuel cells, die castings and making brass. Lead is used in construction projects and in the manufacturing of batteries used as static electricity devices in most products from automobile to mobile of common use. These are just a few of the uses for these well-known base metals - there are thousands more.

INTRODUCING THE RISK IN BASE METALS MARKETS

MCXMETAL Index (Fig. 1) consisting of process of all base metal derivatives traded on the MCX platform reveals a high degree of volatility in base metal prices during the year 2015-16. Base metal price volatility and hence the risk is the outcome of many economic and political factors, such as changes in demand and supply fundamentals, changing global trade patterns, geopolitical risks, environmental events/issues/regulations, labor movements, changes in government regulations, etc. Metal prices are largely controlled by consumer demand for the products that they are inputs for. Base metal prices can also rise and fall on perceived supply and demand scenario as expressed by investors and traders in the derivative markets. Moreover, reports about the Federal Reserve of U.S.A. easing monetary policy also makes the metal prices volatile, as the issuance of more governmental debt strengthens the demand for base metals because of their perceived hedge against inflation. Currency moves also affect the metals market as a lot of these metals are often globally traded and end products are consumed in various nations. This risk affects both the economies and individual stakeholders. Moreover uncertainty and volatility in base metal prices is a

Fig 1: MCXMETAL (2015-16)



Box 1: Base Metal Hedging Examples

An aluminium utensil manufacturer with an export commitment can hedge the risk of aluminium price rise (in the period between the time of export order commitment and time of procurement of aluminium for manufacturing) by buying aluminium futures contract at the time of export order commitment and then squaring-off at the time of aluminium purchase. It ensures that the additional input cost due to the anticipated price rise in the spot markets is appropriately compensated by the derivative market financial benefits. Similarly, a battery manufacturer who uses lead for manufacturing batteries can hedge the risk of lead price rise by buying lead futures contract at the time of lead procurement and then squaring-off at the time of sale of batteries. Alternatively, a seller who plans to sell a base metal at a future date but fears a potential price fall can agree to sell the same metal on the exchange platform at a pre-determined price.

Thus, both buyer and seller can avail of the hedging mechanism through the exchange platform to protect themselves from adverse price movements.



Aluminium



Nickel



Zinc

source of risk inherent in most manufacturing activities which use these in their products and hence, base metal price risk management assumes great importance to provide stability to their balance sheet and hence in their business valuation.

Price risk management

Volatility in commodity prices have always been an issue in India given that inflation has been high for the past few years now. While demand-supply mismatches have led to considerable volatility in prices, conditions have been exacerbated when there are global links in market fundamentals where price discovery takes place in geographies that are outside the reach of domestic policy measures. In such cases, Indian players become 'price takers' with exchange rate volatility adding to the existing movement in the commodity prices.

In such a situation how does one manage risk of any future price movement while their product prices are committed fairly long time in the future? In many corporates raw materials constitute about 40 - 70% of the total cost for companies depending on the industry. Given high competition, the possibility of continuously scaling up selling prices to compensate for price risks in the spot markets may not be easy. Therefore, price risk management is probably a compulsion for business houses both as buyers of raw materials and sellers of the final good.

Traditionally, price risk management through hedging had been through entering into forward contracts with suppliers, which though a solution, neither had been an optimal one nor was accessible as an option for all big or small. Futures contracts on these base metals traded on commodity exchanges have provided a useful price hedging tool for all players who deal in the respective underlying. The simple idea behind hedging is to offset the loss in one market with profit in other market. A metal processor, who requires a commodity at a future date, can protect herself from the risk of a possible price rise by buying a commodity futures contract on the commodity exchange platform at a pre-determined price. A producer who plans to sell a commodity at a future date, but fears a potential price fall, can sell a commodity futures contract on the exchange platform at a pre-determined price. Thus all categories of participants: consumers, producers and processors can avail of the hedging mechanism through commodity exchange platform to protect themselves from adverse price movements **(see Box 1)**. This platform of the exchange is electronic, regulated, and transparent.

Hedging is critical for stabilizing margins of corporates, organizations and individuals and a stable margin would enable advanced planning of their capacity enhancement and investment decisions. Hence, in an increasingly globalised and competitive market, amid persistent high volatility in base metal prices, it becomes imperative for all stakeholders to hedge their price risks through commodity derivatives. A commodity risk hedged manufacturer using base metals as raw materials would not only provide value to their investors through stable margins but would also provide for better valuation of the firm due to their ability to plan in advance for business expansion, capacity enhancement and investment.

Box 2: Perils of Not Hedging

Sierra Metals Inc. (TSWX: SMT) reports a loss in the first quarter as revenue fell due to less output and lower prices. The net loss was $5.1 million, or 3 cents per share, compared to a net loss $0.7 million, or basically zero per share, in the year-ago period. .... Revenue of $23.7 million decreased from $34.7 million in the year-ago period in part due to **decreases in the prices of silver (9%), copper (19%) and zinc (19%).**

Source: www.kitco.com ("Sierra Metals Records 1Q Loss as Metals Prices, Production Decline")

url: http://www.kitco.com/news/2016-05-13/Gran-Colombia-Posts-1Q-Adjusted-Profit-As-Gold-Production-Rises.html