PART TWO: RISKS AND REWARDS FOR BUSINESSES AND INVESTORS

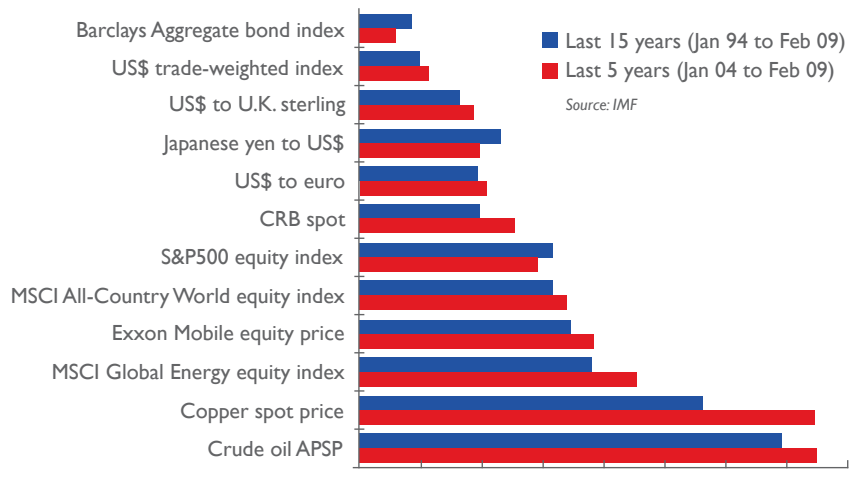
Risk exposure and challenges facing commodity producers

COMMODITY PRODUCERS MUST GRAPPLE WITH CONSIDERABLE RISK FACTORS, AS OTHMAN COLE, ASSISTANT PROFESSOR OF FINANCE AT ESCP EUROPE BUSINESS SCHOOL EXPLAINS, CITING RECENT EVENTS AT SOUTH AFRICAN MINES

In the current global epoch of complexities and uncertainties, commodity producers are increasingly faced with a myriad of risk factors. These include major fluctuations in market prices, movements in exchange rates, changes in interest rates, as well as operational risks and environmental hazards. They are also exposed to security of demand risk, quantity risk, inflationary cost risk for their key inputs, and also very importantly political risk.

While each of these risk factors deserve adequate assessment, this article focuses primarily on price risk and, related to that, highlights the recent operational and political risk events experienced by mining companies in South Africa. It can be argued that commodity prices are inherently volatile due to the cyclical nature of investments: oversupply, followed by price collapse, underinvestment, lack of adequate supply, and then price rises. According to the IMF, crude oil and copper are the most volatile across asset classes (see Figure 1 below).

Figure 1: Price volatility across asset classes



A major development that is expected to have a significant impact on crude oil prices in the medium-to-long term is the increase in production in Iraq. It is expected that Iraq's output will more than double by the end of the decade, and it will become the world's second largest oil exporter after Saudi Arabia by the 2030s. According to the International Energy Agency (IEA), Iraq would account for 45% of the anticipated growth in global oil supply in the current decade.

At present, Iraq oil exports have risen to 2.6m barrels per day, the highest in more than three decades. The IEA's central scenario predicts Iraq would more than double its exports to 6.1m barrels per day by 2020. It is expected that 80% of these exports will go to Asia, primarily China. Another factor expected to impact on crude oil prices is shale oil. According to the US Department of Energy, weekly crude oil production in the US is at the highest level since 1996, primarily due to shale oil.[1]

Volatility in metals is currently evident in iron ore prices, which collapsed by 36% to less than $90 a tonne in just two months as Chinese traders and steelmakers decided to step away from the market and run down their existing stocks. Prices have since recovered rapidly, reflecting the major fluctuations inherent in most commodity prices. For example, prices for benchmark Australian iron ore jumped 12.4% in just two days to the highest level in three months at $120.25 a tonne.

Iron ore prices are expected to rise even further in the next six months, as the Chinese government has recently approved in September plans for

Commodity producers are also faced with significant operational and political risks

Rmb1 trillion ($158 billion) in infrastructure spending, which analysts believe will have a significant impact on the short-term demand for iron ore. It is argued, however, that such an increase in demand from China and elsewhere will not be sufficient to support prices in the medium term, and it is unlikely prices will reach their previous highs of almost $200 a tonne.

Aluminium, the world's most widely used metal after steel, is facing paradoxical supply and demand dynamics. Demand is growing faster than for almost any other commodity and customers are paying record premiums to secure supplies in the physical market. However, analysts argue that there is still a vast overhang of stocks that were built up during the financial crisis (see Figures 2 and 3 below). It is believed that total global stocks stand at 10m-12m tonnes, enough to build more than 150,000 Airbus 340s.

Analysts argue that these large inventories have not triggered a price collapse because the banks and trading houses that largely own them are using them to finance long-term deals, and in effect remove them from the market. But since this will not go on forever, the question remains of what will happen when these financing deals come to an end, and what the impact will be on aluminium prices.

Commodity producers are also faced with significant operational and political risks, which is currently evident with escalating industrial unrest in South Africa. In August, Aquarius Platinum, the world's fourth-largest platinum producer by volume, experienced serious clashes at its Kroondal mine between security staff and former employees, in which three people died and at least 20 others were injured. This followed significant strike action at another mine owned by Lonmin, another major platinum producer.

In early October, Amplats, the world's biggest producer of platinum, formally dismissed about 12,000 illegally striking workers, about a fifth of its workforce. The ongoing strikes and clashes by the unions had already cost the company about Rand 700 million ($80 million) in lost revenue. The strike action has also spread to Xstrata with 400 of its 886 employees at its Eland platinum mine going on strike. It is estimated that more than 100,000 workers throughout the industry are involved in the industrial action.

Commodity producers therefore have to grapple with various risk factors to a greater or lesser extent, in which operational and political risks generally translate to revenue risk. For commodity consumers on the other hand, fundamental supply and demand dynamics as well as speculation and hedging contribute significantly to fluctuations in market prices. This has been evident across a number of commodities, as price changes since January 2007 show copper increased by 32.4%, Brent crude increased by 98.2%, and iron ore increased by 185%. ■

1 'Brent spread over WTI widens to year-high', *Financial Times*, 8 October, 2012.

Figure 2: LME aluminium stocks jump to record levels...

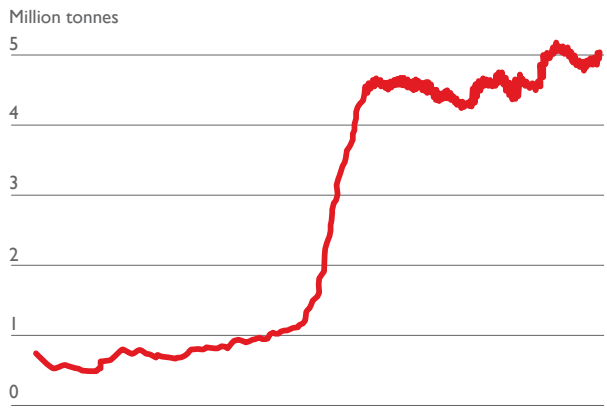


Figure 3:...while global aluminium production rises