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The Next Normal: Financing Trade and Commodities

Debt & Capital Advisory

pwc

A paradigm shift

Asia Pacific during an accelerated transition to an energy generation less reliant on carbon, currently leans heavily on coal and oil to generate power needed by societies.

US Dollar strength, high interest rates and volatile prices have made it significantly more expensive to finance commodity trading. On top of this, the Ukraine-Russia conflict has triggered a profound shift in global trade flows – resulting in longer, less efficient shipping routes.

As commodity flows and the macro backdrop evolve at a quickening pace, commodity trade finance has become increasingly sophisticated. Along with the accelerating evolution, we see a few broad themes playing out across different types of commodities – whether or not the commodity is energy, metals & minerals, soft or agricultural.

These themes are driving a paradigm shift in commodity trade finance.

1. **Increased price volatility**: The volatility of spiking commodity price levels has significantly tightened collateral requirements and increased the size and frequency of margin calls. These eye-watering levels of volatility are hitting traders' liquidity.

2. **Higher cost of financing**: The stand of central banks has resulted in a rapid increase in the cost of trade financing and created an enduring challenge for industry players. Banks still compete to lend to large traders, preventing a large rise in their borrowing costs. However, smaller traders are more exposed.

3. **Banks are pulling out**: Banks are responding to risk limits, regulations, a spate of alleged frauds and investor pressures over ESG. Their response is likely to concentrate access to funding in the hands of larger traders.

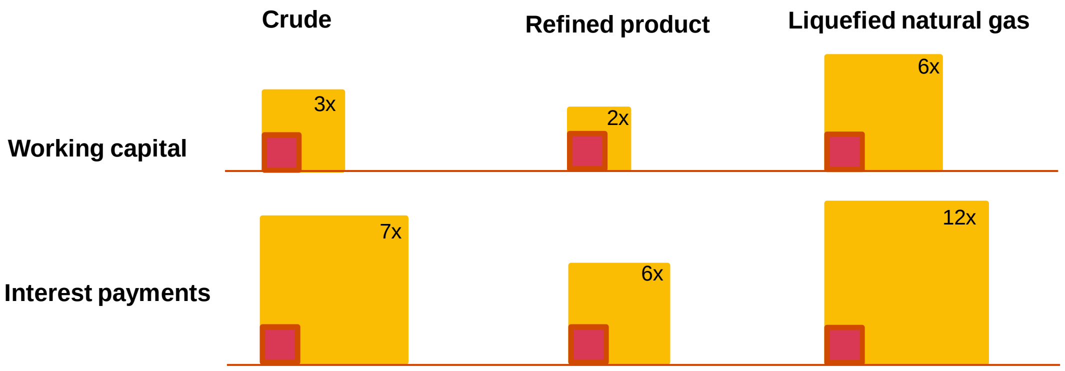
4. **NBFIs are stepping in**: The retreat of banks is prompting some traders to seek out new sources of financing. Non-bank financial institutions (NBFIs), such as credit funds, have stepped up financing of trade in commodities as banks hit their limit. This is driving increases in the cost of capital for the sector.

5. **The next normal**: We see a lending landscape made up of traditional banks, credit funds, and capital arms of major industrials to be the new providers of capital in the years to come. Traditional forms of trade finance such as letters of credit and revolving credit facilities will likely to be supplemented by hybrid structures which can cater to NBFI investors' appetites for drawn credit exposures in more nuanced ways.

How we see the market

Chart 1: An additional US$300bn to US$500bn could be required to finance global commodity trading

8%	3x	7x	2.5x
Increase in shipping time	Increase in price of energy	Interest rate payments	Increase in volatility



Source: Financial Times & McKinsey

Traders' credit lines became strained last year when global commodity prices sky-rocketed. The increase in shipping times resulting from changes in traditional trade flows only amplified the unfavorable situation. These inefficiencies will likely drive an additional funding gap of US$300b – US$500b globally by 2024.

- **The implication on credit lines is substantial.** One prime example of this phenomenon is coal, where prices nearly tripled in 2022. If a coal trader uses letters of credit to support their import letters of credits, they require a 2-3x increase in facility size to move same volume of coal.

- **Big traders are not immune** – Trafigura increased its credit lines by US$7bn to around US$73bn by the end of 2022; Glencore had to post an additional US$2bn to meet margin requirements on commodity exchanges during the first half of 2022.

- **Small and mid-sized companies are left scrambling for financing** – Lenders are more cautious about lending to small to mid-sized companies in the volatility and transition. We see this trend continuing.

A recent case study

PwC was mandated as the sole debt and capital advisor to a large commodity business in Asia to advise on a debt raise of up to approximately **US$700m**. The new funding package includes letter of credits, receivables financing and working capital loans.

The debt raise marks a big step in the commodity trader's financing and enables the business to continue its growth trajectory during a period of volatility.

PwC:

Completed:	**Is simultaneously working on:**	
up to US$450m	c. US$200m	c. US$200m
Trade Finance Facility	Ongoing Receivables Financing	Raising a Term Loan

1 **Newly carved-out business challenges**

- Our client has emerged as a standalone business and the client's business model is changing.
- Banks require 3-year historical financial statements onboard new clients.

2 **Exposures to thermal coal**

- Whilst the business doesn't invest / produce thermal coal directly and is fully committed to supporting Asia's transition to a clean energy future, it does move coal.
- Investors usually set very restrictive ESG guidelines – we needed to help our client message that carefully and in a holistic manner so the ESG issues were balanced.

3 **Capital structure efficiency**

- We faced a movement by banks away from commodities themselves and a requirement among NBFIs to deploy drawn capital.
- The innovative structure delivered savings and flexibility to our client.

4 **Creditors & shareholders dynamics**

- We effectively faced moving dynamics at both a capital structure level and a stakeholder level.

How we created value

Flexibility & innovation

- **Capital raising is highly technical and almost always situational -** we built credit stories and debt structures as the situation evolved and helped management to navigate a changing lending landscape.
- **Financing options will need to be tailored based on business need and investor appetite** - we engaged various investors and put together an innovative structure which segregated the letter of credit issuance, credit exposures and security packages.
- **Some investors prefer to have rating agencies' views on debt instruments** – we worked with agencies to come up with an appropriate rating methodology, as business risks were ring-fenced by our LC issuance structure.

Unique access to liquidity

- **It's challenging for a business to build investor relationships following a corporate restructuring** – we leveraged our networks and created opportunities for management to discuss with investors at senior and board levels.
- **Management was focused on traditional banking relationships** – we spoke with regional banks, international trade finance banks, credit funds and capital arms of industrials to ensure the business had access to an appropriate lending market.

Senior banking experience

- **It's not always easy predicting lenders' expectation and mange the delivery risk** – we understand investors' appetite and know how they think given our vast experience on underwriting and investment committees.
- **Communications between lenders and the business isn't always effective** – we share a vocabulary and outlook with lenders, enabling a large degree of trust in our judgement.

Well-resourced deal team

- **Deadline of the debt raise was fluid and management was under time pressure** - we assembled a well-resourced and international team to drive the financing process and work on different workstreams at the same time.

Debt & Capital Advisory Asia Pacific

Nick Atkinson
nick.atkinson@hk.pwc.com
+852 2289 1834
Asia Pacific

Eunice Tang
eunice.tang@hk.pwc.com
+852 2289 2064
Asia Pacific

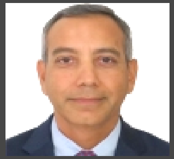
Lalit Mohan
lalit.mohan@pwc.com
+91 7738357171
India

Steven Jeong
steven.jeong@pwc.com
+82 237812551
Korea

Nelly Roquefort
nelly.n.roquefort@hk.pwc.com
+852 2289 3490
Asia Pacific

Andy Tang
andy.yt.tang@hk.pwc.com
+852 2289 1601
Asia Pacific

Alex Wondergem
alex.j.wondergem@pwc.com
+64 210412127
New Zealand



Amit Gulati
amit.gulati@pwc.com
+65 91169908
Singapore

Pamela Tse
pamela.yw.tse@hk.pwc.com
+852 2289 8277
Asia Pacific

Russell Sinclair
russell.sinclair@pwc.com
+ 61 447415984
Australia