



# Commodity Risk Management



Dairy Risk Management Overview  
CIT September, 2012

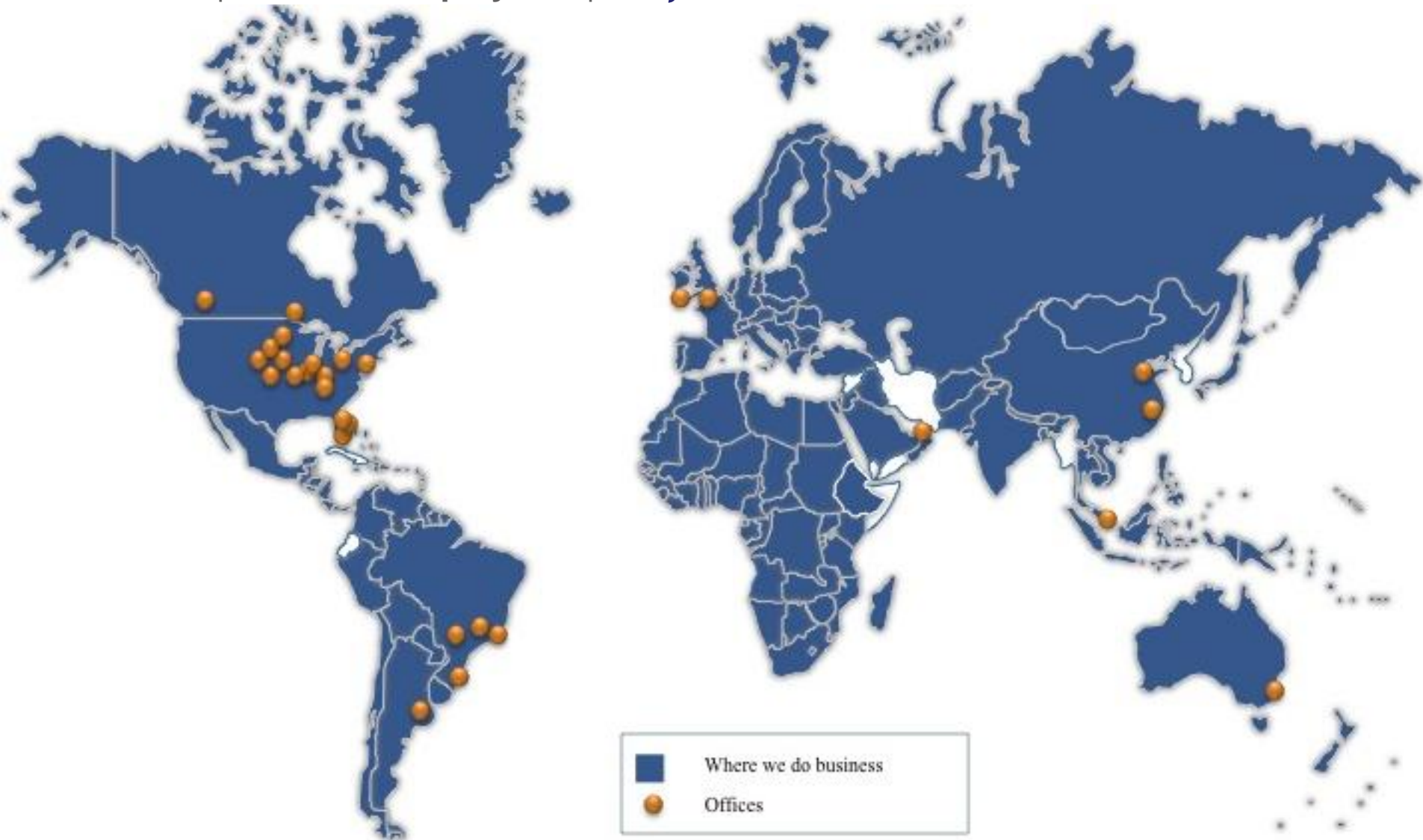
## Agenda

- **Introduction Liam Fenton**
- **Brief overview of INTL FCStone**
- **How the market has developed in the US**
- **How it is developing in Europe**
- **Issue's with Development in Europe**
- **Basic Theory of hedging**
- **How companies are utilising it today**
- **How Farmers can benefit from this market's development**
- **Does the Dairy Industry need hedging**
- **Approximate Cost's**
- **Next Steps**

## **Liam Fenton**

- **Born and raised on a dairy Farm in Co Limerick**
- **Bank of Ireland**
- **Set up my own company**
- **Traded on futures markets in NY/ Chicago/London/Dublin**
- **Established FCStone Europe office in 2008**
- **Charlie Hyland**
- **John Lancaster**
- **Still milk Cows on Family Farm!**

**30** offices | **1000+** employees | **20,000** customers in more than **100** countries



# INTL FCStone Dairy

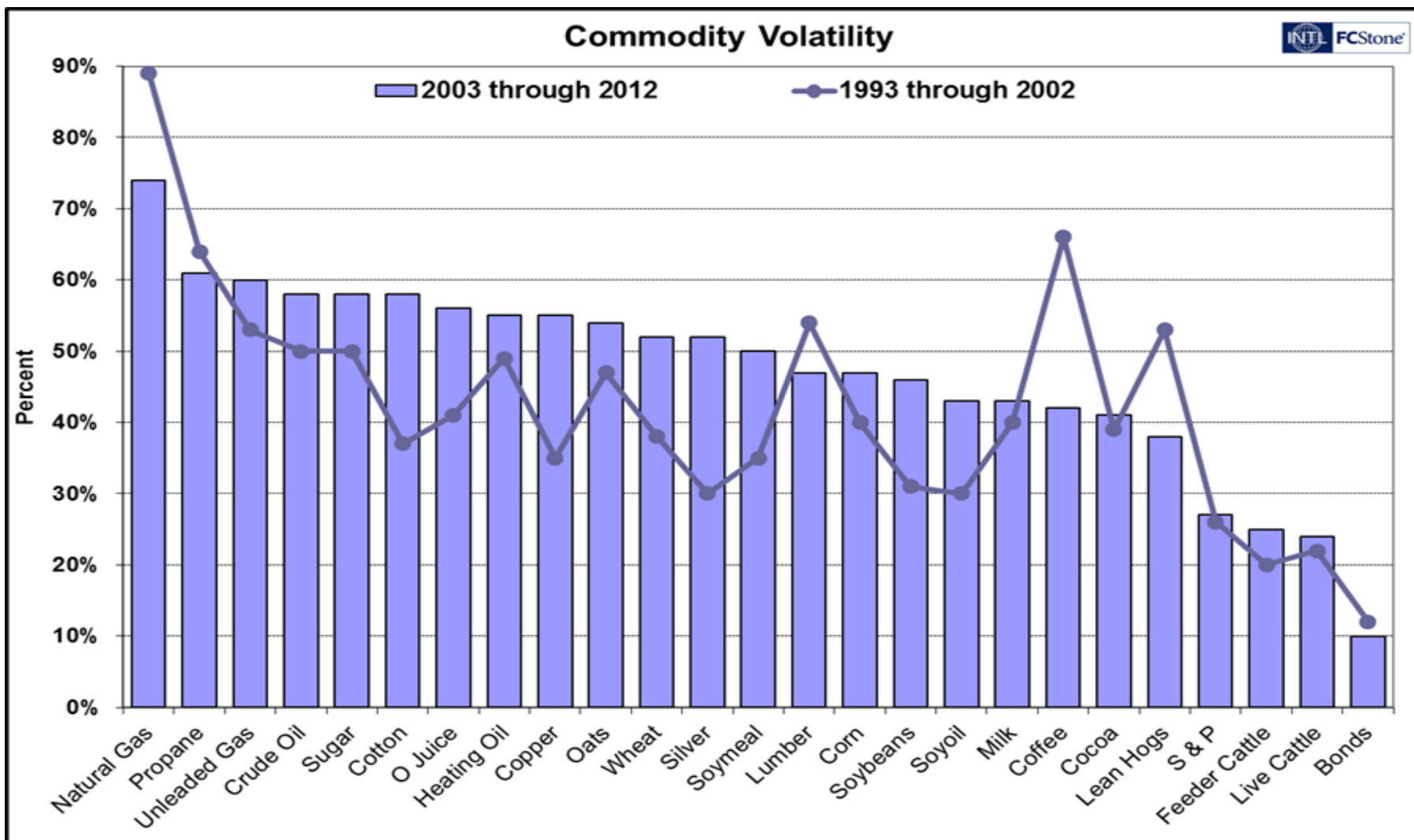
- NASDAQ Listed/Fortune 500 Company
- Began as Co-op in Risk Management
- Purchased the No1 Dairy Risk manager in US – in 2007
- Involved in US Dairy markets since their inception 20 years ago
- Leading International Dairy Economists on staff
  - Bill Brooks
- Participant in much of the CME product development
- First clearing member of the NZX
- Leading futures/option brokerage firm in Milk/Butter/Powders/Whey Product
- Establishment of the Cash Settled butter market
- Research and Development of European Dairy risk management tools part financed by the IDA

# Volatility

Causes

Solution





# **Volatility-What causes it at the moment?**

- Not Speculators – Too small

## **Cause**

- Decreasing Intervention levels and Quota changes



## Speculators in the US Market

Disaggregated Commitments of Traders- Options and Futures Combined Positions as of January 24, 2012

Reportable Positions											
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Producer/Merchant	:	:	:	:	:	:	:	:	:	:	:
Processor/User	:	Swap Dealers	:	Managed Money	:	Other Reportables	:	:	:	:	:
Long	: Short	: Long	: Short	: Spreading	: Long	: Short	: Spreading	: Long	: Short	: Spreading	:
-----											

MILK, Class III - CHICAGO MERCANTILE EXCHANGE (CONTRACTS OF 200,000 POUNDS)

CFTC Code #052641

Open Interest is 51,939

: Positions

: 27,965	23,648	0	1,797	41	1,497	41	31	5,232	3,323	11,349	:
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: Changes from: January 17, 2012

: 1,396	405	0	78	-3	-968	-136	-6	167	-250	311	:
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: Percent of Open Interest Represented by Each Category of Trader

: 53.8	45.5	0.0	3.5	0.1	2.9	0.1	0.1	10.1	6.4	21.9	:
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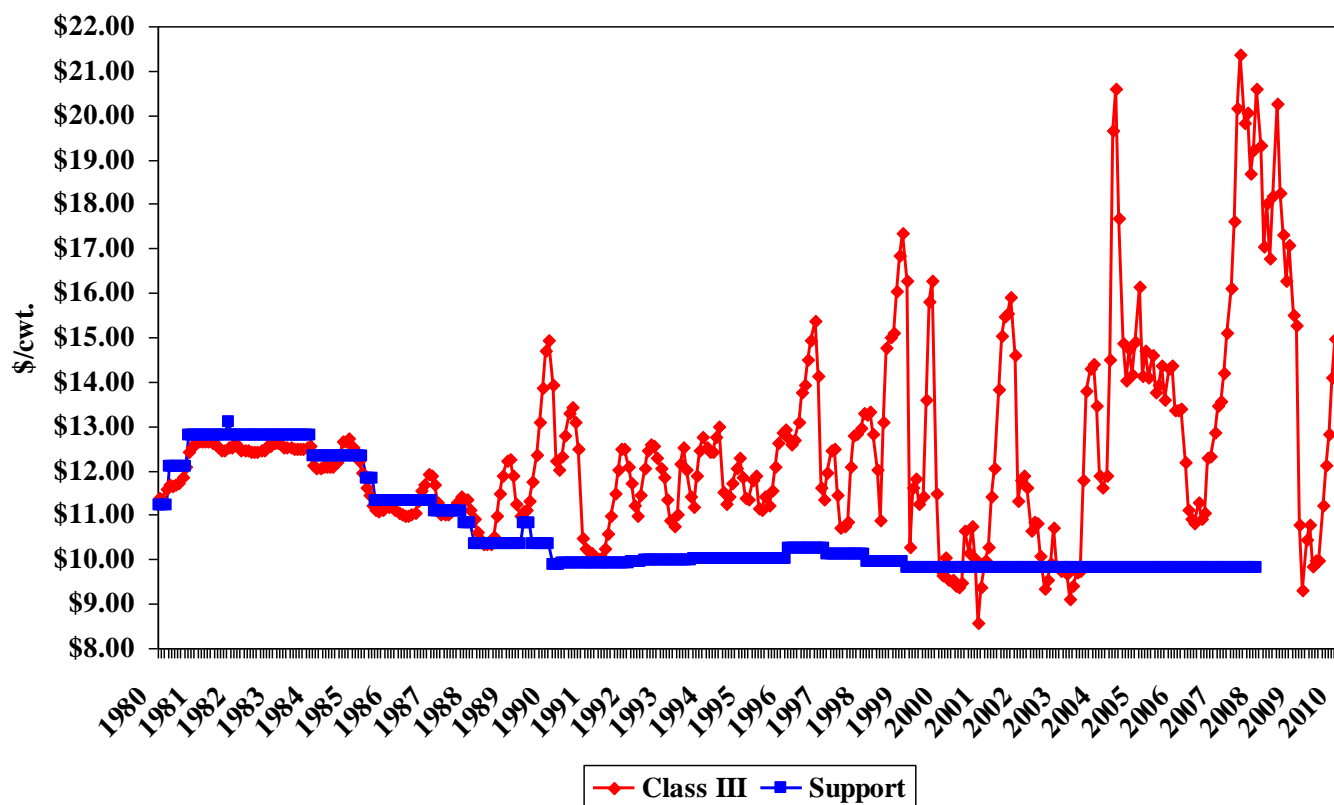
: Number of Traders in Each Category

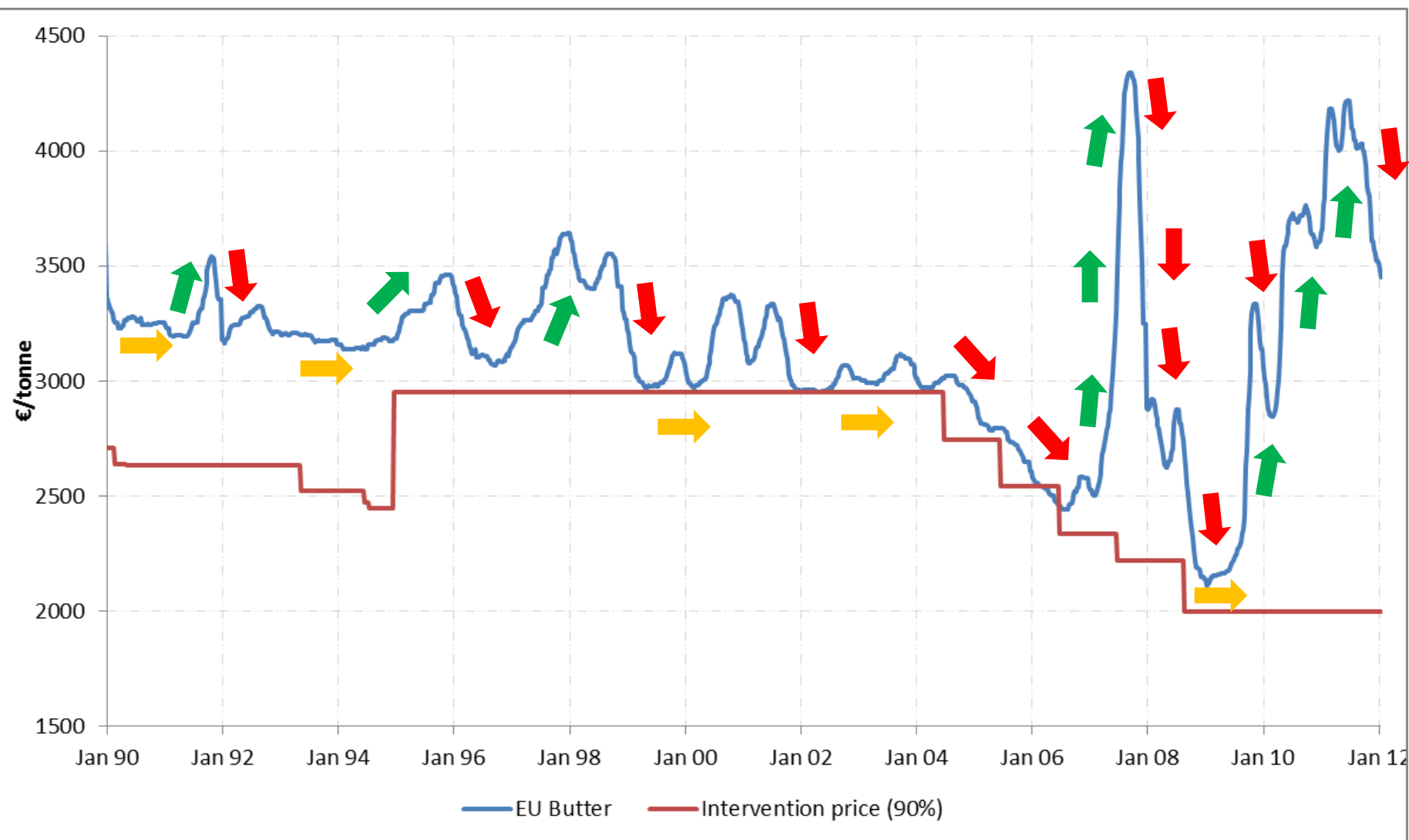
: 35	32	0	.	.	.	.	.	10	17	18	:
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Total Traders: 77

**Reduction of price supports in the US market resulted in increased volatility**

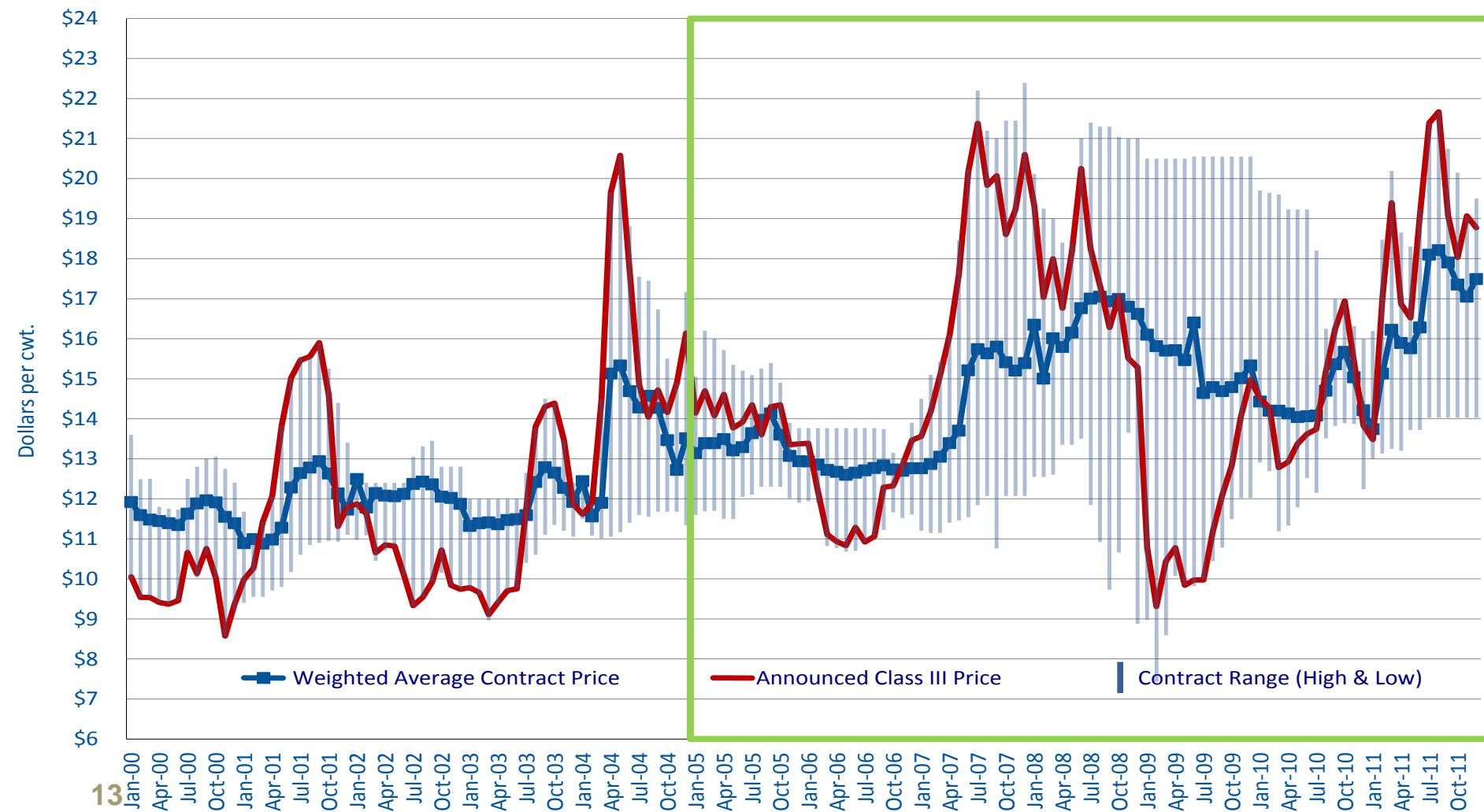
**Class III Milk Price**





# **Example of one Companies solution we have in the US**

**Weighted Average Contract Prices vs. Announced Class III Prices**  
**January 2000 through December 2011 - Contract Ranges Reflected**  
**Weighted Average Value - \$13.73 vs. Class III Average - \$13.80**



## **How Does this program work?**

Farmer phones Co-op

Asks for a price on future production

Co-op contacts FCStone (FCS)

FCS refer to market & return price to Co-op

Farmer then decides if he wishes to sell forward

Co-op relays order or otherwise to FCS



# Advantages

- Farmer has certainty as to price of future production or percentage of production
- Farmers Bank is happier/Easier to raise finance
- Co-Op secures future supply of milk
- Co-Op does not have risk of fixing its price
- Co-Op can then offer fixed pricing to Customers and ensure margin

# But its not about best Price its MARGIN!!!



**How is it developing in Europe?**

## Markets and Contracts

### Futures Markets (In alphabetical order)

- **Eurex**
  - EU Butter (Financially Settled)
  - EU SMP (Financially Settled)
- **NYSE Liffe**
  - EU SMP (Physically Settled)
  - Butter and Whey to Follow
- **NZX (New Zealand)**
  - WMP
  - AMF
  - SMP
- **CME (US Market)**
  - Non-Fat Dry Contract
  - Class III / Butter / Cheese etc.

### OTC Markets

- Flexible Contracts

# What's been hedged last year?

- 20,000 Tonnes of Product  
Butter/SMP/Cheese

# Main Participants

- Consumers
- Traders

## Less Involved

- Producers



# Issues with Development in Europe?

- Education
- Education
- Education
- Independent/Reliable Data
- Still industry dependency mentality on European Intervention
- Farmer Access/Natural sell side

# Basic Theory of hedging

# Hedging Theory

- Hedging is used to manage the effects of price volatility on businesses
- Hedging typically utilises financial markets to offset risks faced in your physical purchases and/or sales

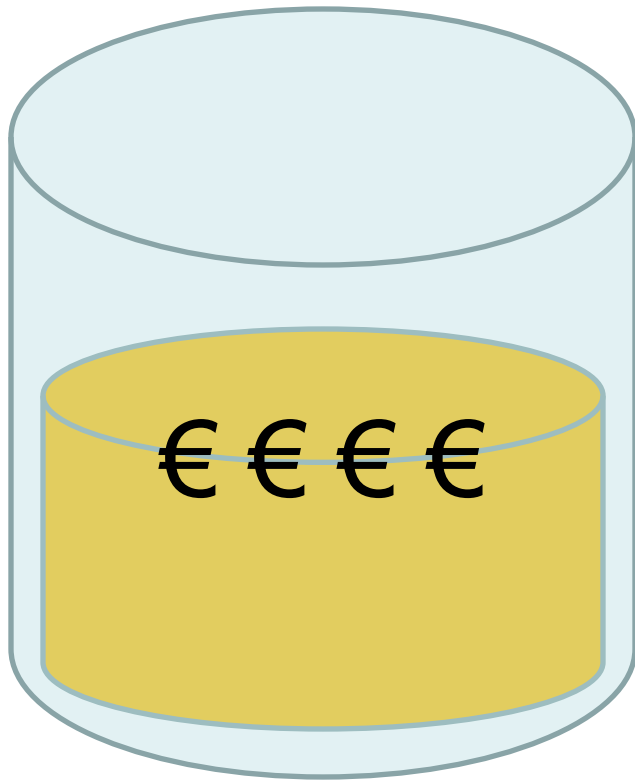
**Cash Market Losses (Gains)**

**=**

**Futures Contract Gains (Losses)**

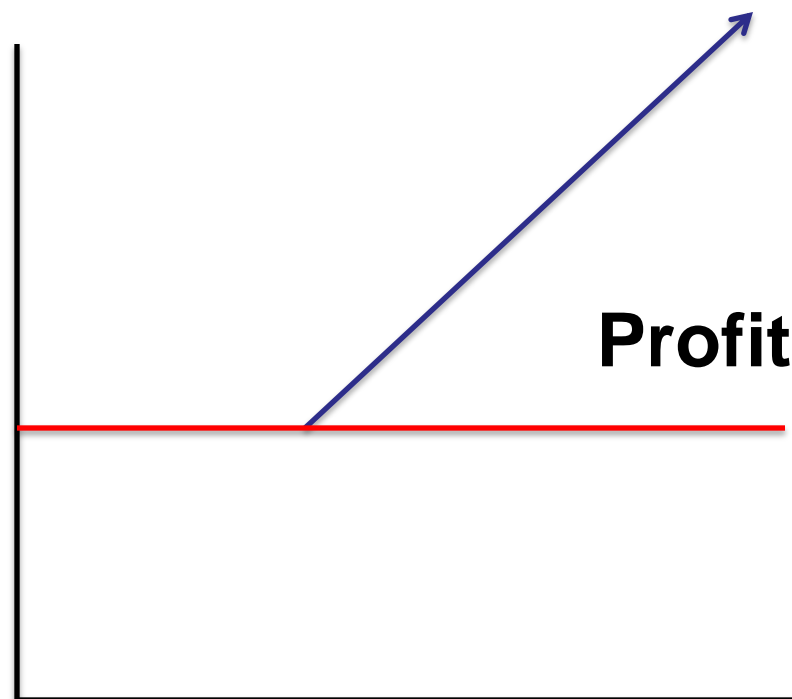
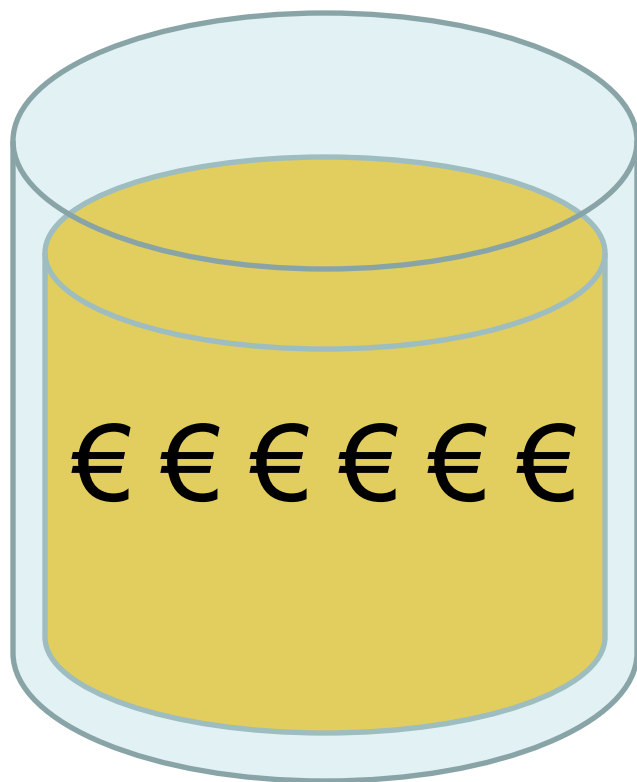
**Very basic theory – simple scenario**

**You buy inventory....at a cost**



Very basic theory – industry business model

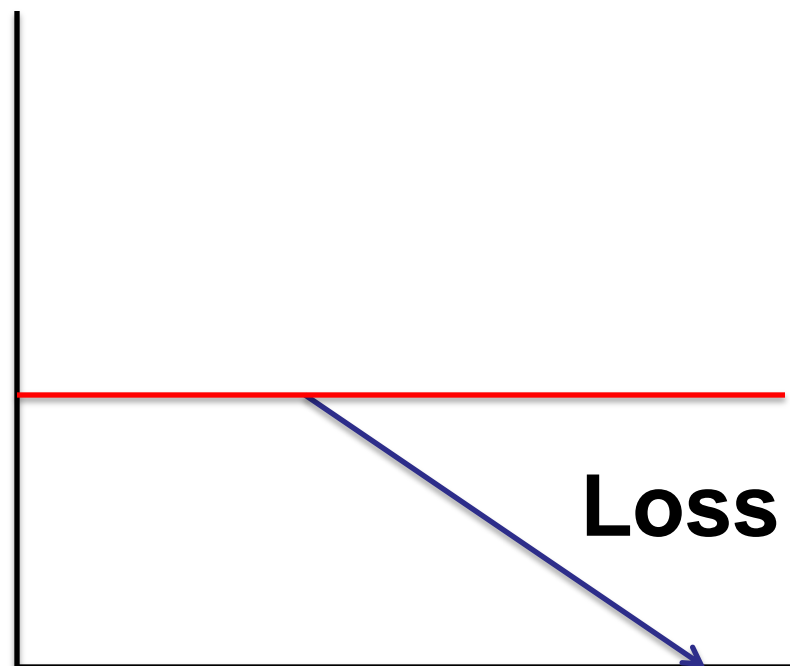
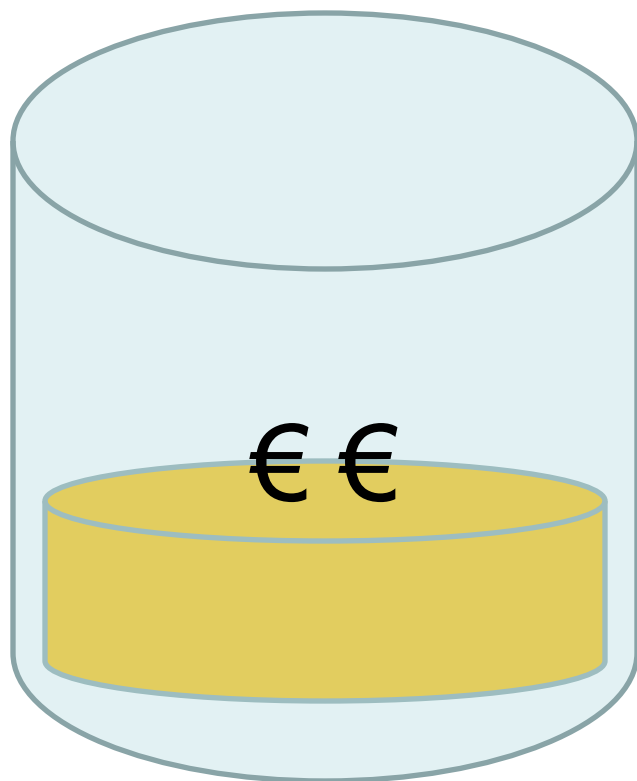
**The market rises – you gain**





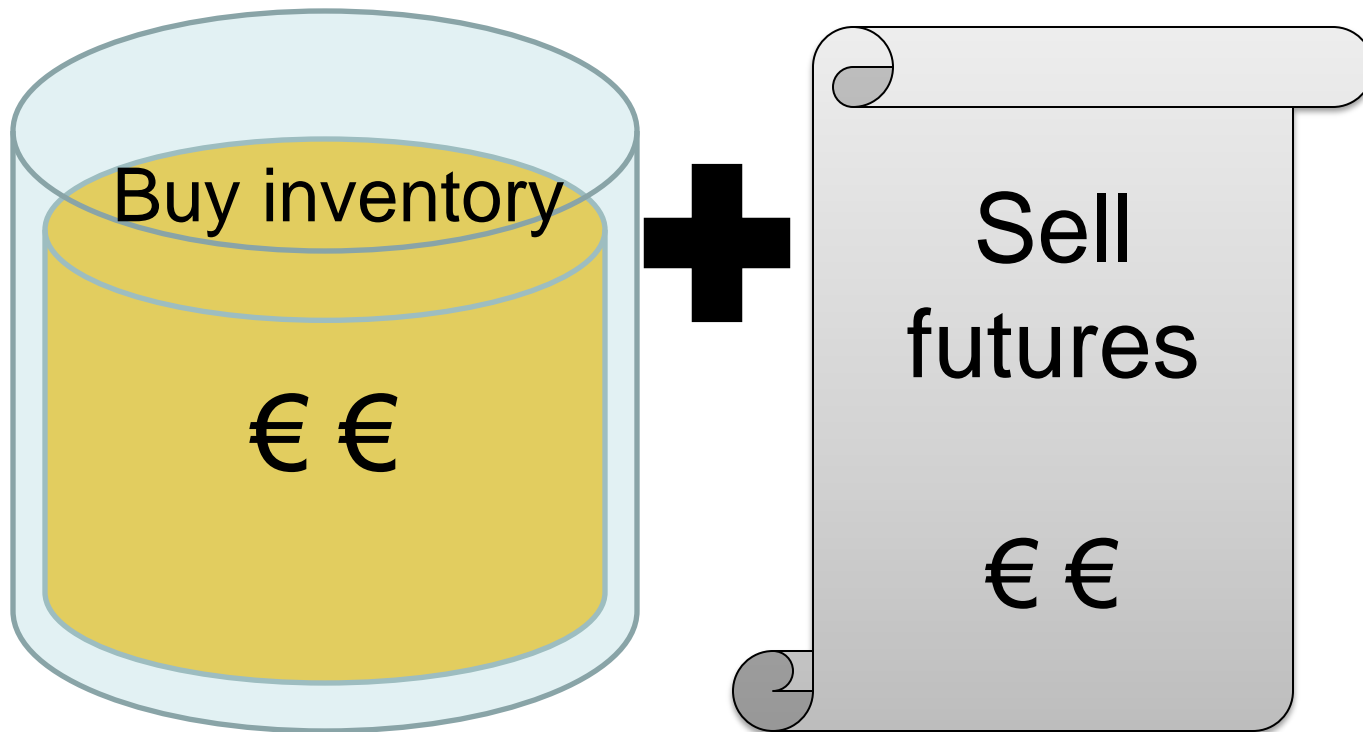
Very basic theory – industry business model

**The market falls– you loose**



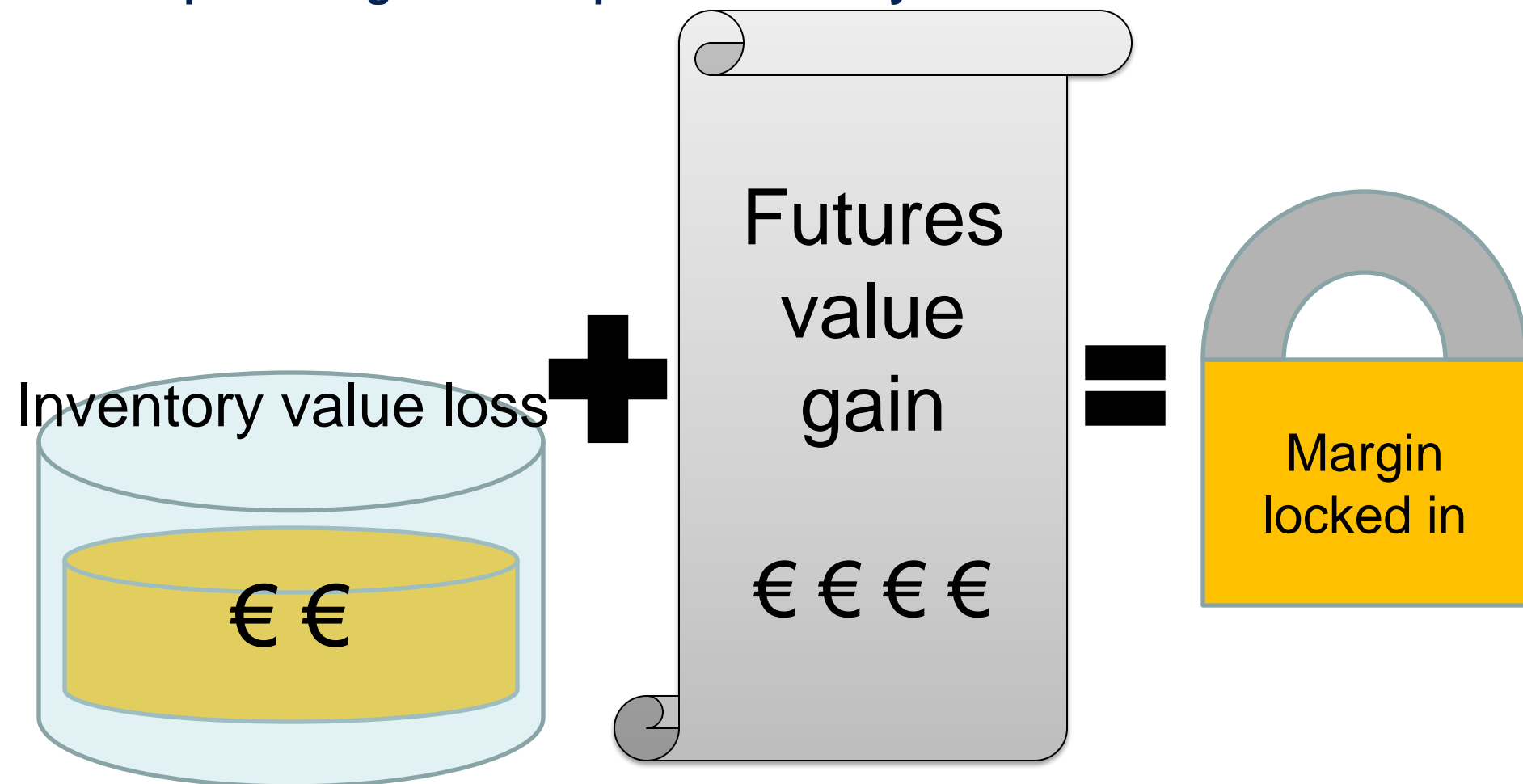
## Using futures - its an offset

To protect against this particular risk you would sell a futures



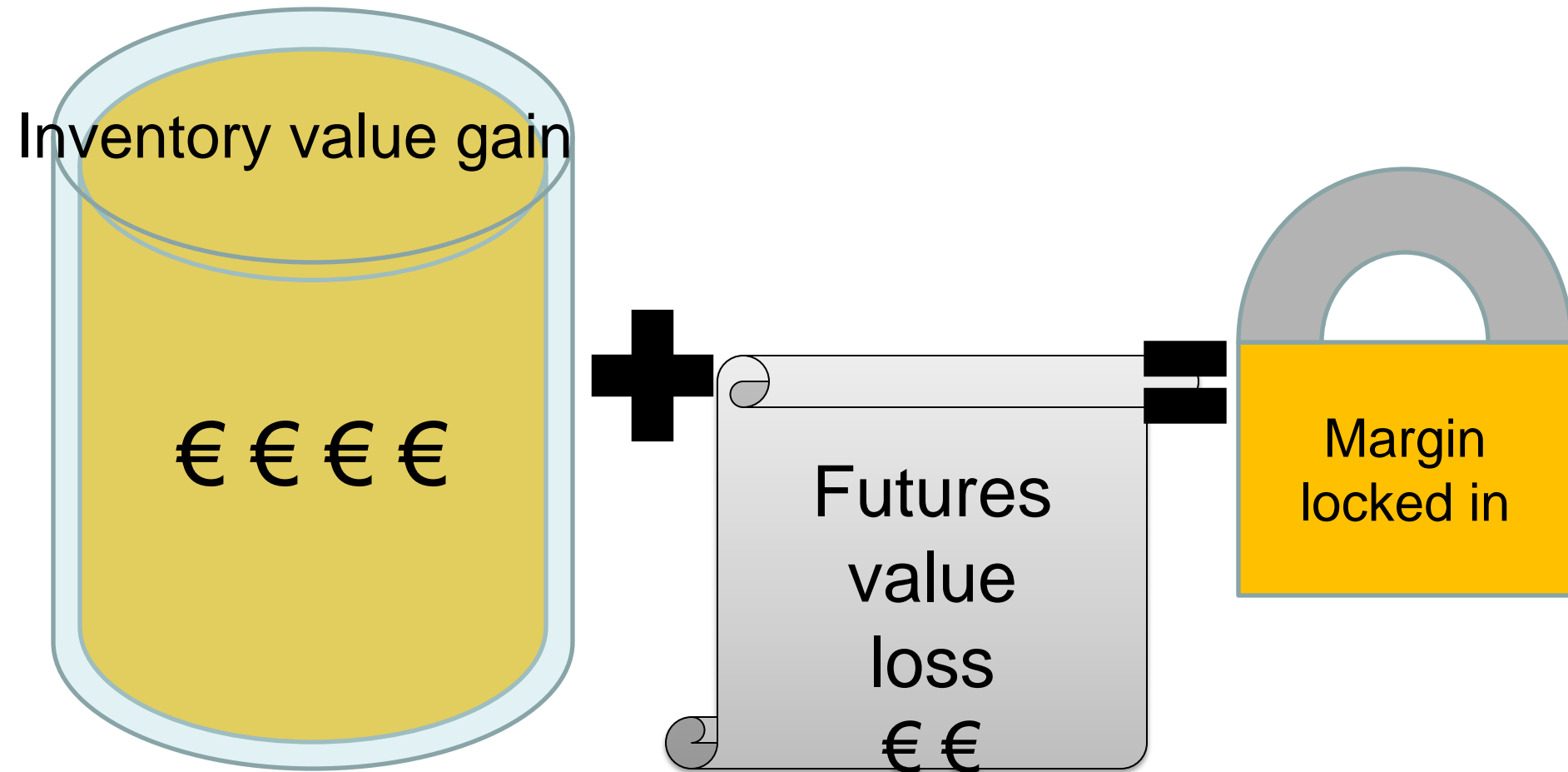
# Very basic theory – its an offset

To protect against this particular risk you would sell a futures



## Very basic theory – its an offset





To protect against this particular risk you would sell a futures



Manufacturer Fixing price of Raw Materials when making sales contracts





	Cash/Physical	Futures
SELL	1	2
BUY	2	1
Gain/Loss	Net Gain / Loss	

## Hedge Example - Increasing Markets

	Cash/Physical	Futures
SELL	 <b>3200 Eur</b>	<b>3500 Eur</b> 
BUY	 <b>3500 Eur</b>	<b>3200 Eur</b> 
Gain/Loss	<b>- 300 Eur</b>	<b>+ 300 Eur</b>



## Hedge Example - Decreasing Markets

	Cash/Physical	Futures
<b>SELL</b>	 <b>3200 Eur</b>	<b>2900 Eur</b> 
<b>BUY</b>	 <b>2900 Eur</b>	<b>3200 Eur</b> 
<b>Gain/Loss</b>	<b>+ 300 Eur</b>	<b>- 300 Eur</b>

## How are companies utilising it today?

- Do new/trades for longer period of time and improving margin
- Protect Co-op producers from time lag risk
- Protection of Inventory
- Stability of pricing
- Gain new Customers

## How Farmers can benefit from these market developments?

# Benefits for Farmers

- Allows Certainty
- Allows financial planning
- Allows him to sleep at night!

# Does Dairy Industry Need it?

- Intervention & Quotas return **NO**
- Intervention Goes **YES**

# Does Dairy Industry Need it?

Growth of demand for product

- Dairy is in competition with other products who have these tools
- One Commodity by 2050 that supply is an issue
- Industry to make most of Capital Investment

# Approximate Cost

## **Commission**

.1% (1/10 of a Percentage) of the value of milk at current prices

## **Cost of Capital**

2%-5% of the Nominal value of product



# **Common Dairy Risk Management Criticisms**

- **Not Enough Liquidity**
  - Liquidity is improving and will likely continue to do so as market volatility increases
- **Quotations not a Good Reflection of Physical Market**
  - Basis does have to be actively managed
  - Correlations are strong with most physical markets
- **Futures Will Attract Speculators to the Dairy Market**
  - Unlikely in the medium term – not big influence in the US
  - Speculators would bring liquidity

## Idea on an Action Plan

- Dairy Industry take charge of its self again
- Move away from Brussels
- No more stagnant industry of 80's and 90's
- Take advantage of our natural resource
- Work together

## What Europe/Government can provide

- **Education**
  - Co-op producers ICOS/Third Level Colleges
  - Farmers TEAGASC
- **Risk Management Costs**
  - Leverage European money for margin ICOS/IFA Lobby
  - Subsidise/Support margin hedges Mexican Govt program-AIB/BOI/Rabobank
- **Marketing**
  - Irish product as price manageable Bord Bia
  - Ireland as a location for Consumers Enterprise Ireland
- **Data** Provide Industry Data/Indices Department of Agriculture
- Form working group today and meet next week!

# What INTLFC Stone Can Provide

## Monthly FORWARD CONTRACTING PROGRAM for Co-Op

- Educate Cooperatives/Producers
  - Risk Management
  - Establish Forward Contracting Program
- Provide Software for recording forward contracting
- Provide daily real time reporting of net position
- Legal and regulated access to exchange traded products and OTCs
- Design of Indices and market pricing
- Provide Industry market forecasts and analysis ie Econometric models etc

## What INTLFC Stone Can Provide

### Monthly FORWARD CONTRACTING PROGRAM for Co-Op

- We can work with Individual companies/Group of companies or the Industry
- Paid

**Thank You!**

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