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Hot Commodities

Turnaround & Restructuring Insights

Southeast Asia | Q3-2022

MAKING AN IMPACT THAT MATTERS since 1845

Hot Commodities

The commodities "super-cycle" took flight in mid-2020 at time when supply was disrupted by the pandemic but when demand was accelerating driven in part by free flowing liquidity from defensive pandemic linked stimulus programs.

The major agri, energy and metal indices turned in mid-2022. Lead indicators for recession are emerging and governments are tightening monetary policy.

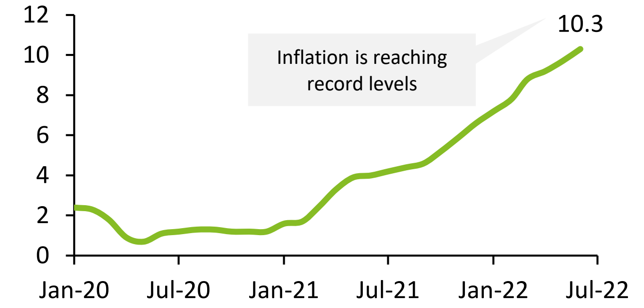
In this edition of Deloitte Turnaround & Restructuring Insights, we explore the economic trends, recent market disruptions and war stories, risk mitigation for financiers as well as strategic and tactical moves for producers and traders.

Report Contents

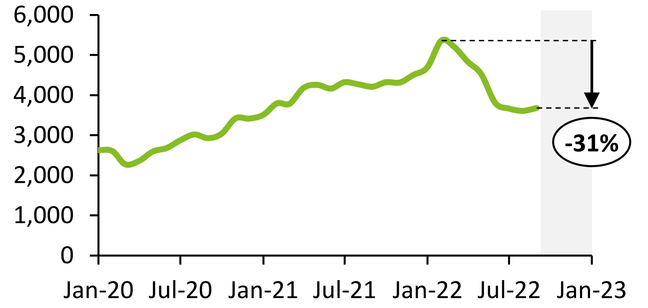
The End of the Super-Cycle?

Commodity prices serve as a barometer of expected consumer demand and global economic health. As economies emerged from the pandemic, the major indexes trended upwards …and fast. However, in mid-2022 commodity prices turned in the context of an inflationary squeeze, governments moving to tighten monetary policy and predictions of a recession. The question is whether this is a short-term correction or the end of the "super-cycle"?

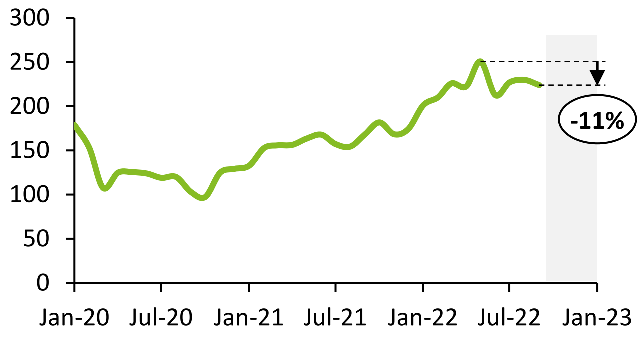
OECD Consumer Price Index (% change YoY)



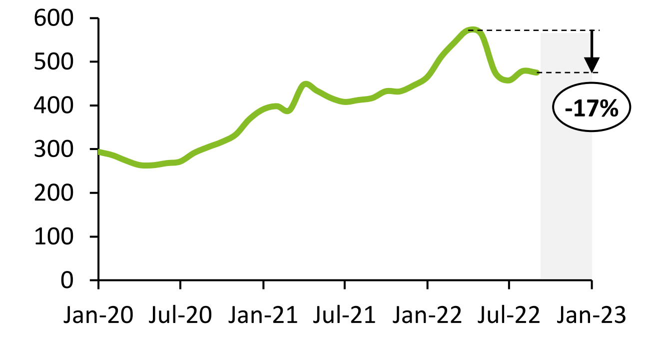
London Metal Exchange Index (USD)



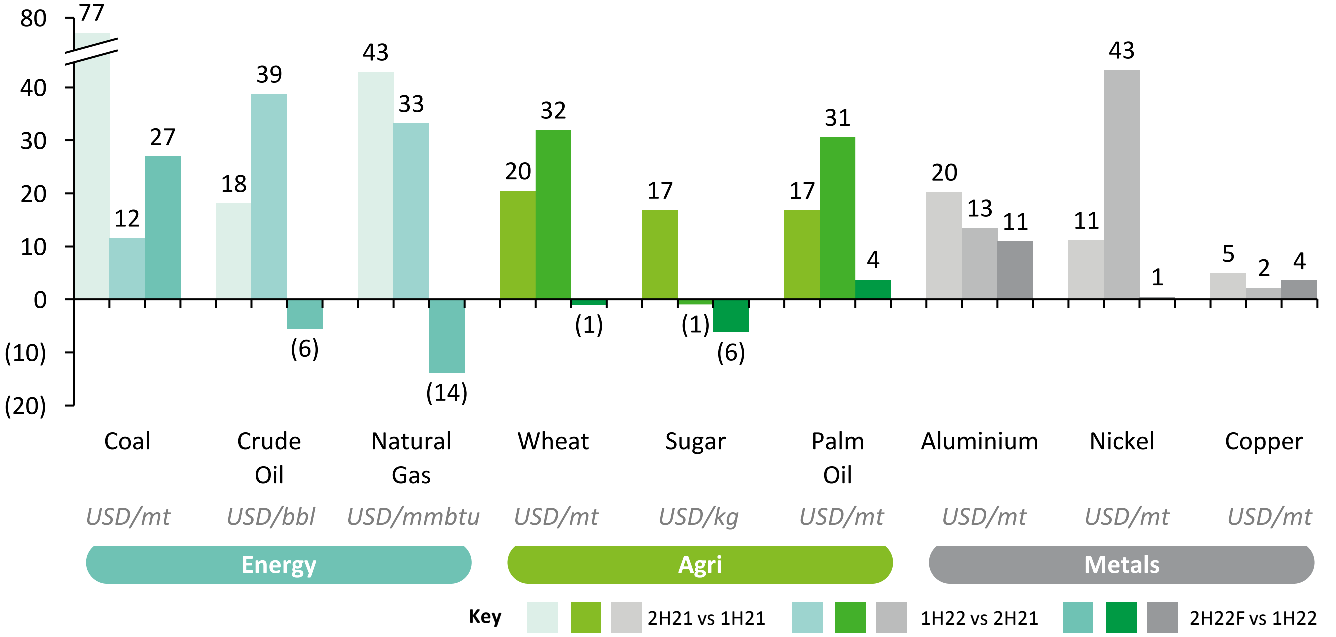
MSCI World Energy Index (USD)



S&P GSCI Agriculture Index (USD)



Select Commodity Prices (% change on a half yearly basis)



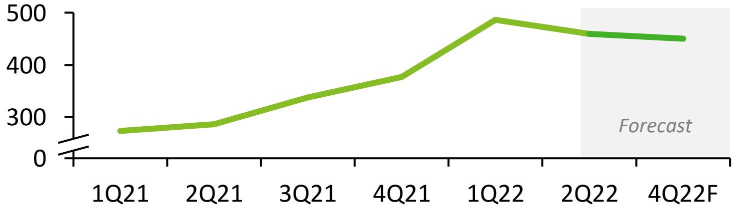
Sources: Bloomberg, Refinitiv, EIU, World Bank, MSCI, Investing, S&P

Macro-Economic Themes

1 Russia / Ukraine Conflict

Ukraine was the 6th largest wheat exporter globally in 2021 (10% of global supply). The Russia / Ukraine conflict has impacted exports putting material upward pressure on prices.

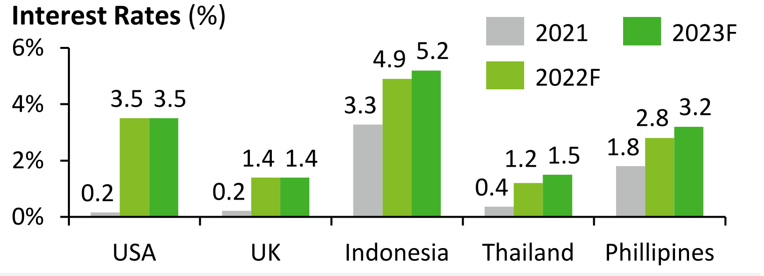
Wheat Prices (USD/tonne)



2 Monetary Policy

Central banks are signaling further interest rate rises to counter growing inflationary pressures. The resulting increase in debt servicing costs will cause a decrease in spending and capital expansion.

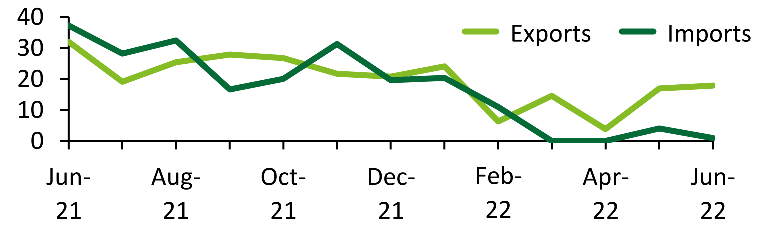
Interest Rates (%)



3 China Trade Policy

Chinese exports have surged 18% since the lockdown of Shanghai was lifted in June 2022 (with rare earth exports up 84.5% since 2021). However Chinese imports (i.e. demand) slowed in H1-2022.

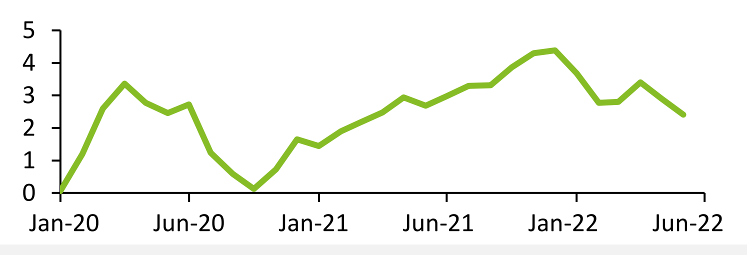
YoY Change in China's Exports and Imports (YoY %)



4 Supply Chain Pressure

Global supply chain pressures have contributed to inflation but are easing in 2022 as port and logistics operators increase resourcing to reduce congestion and suppliers re-align with evolving demand.

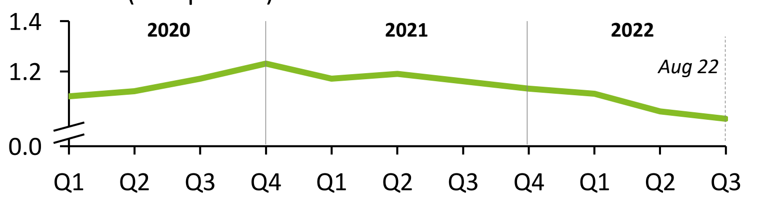
Global Supply Chain Pressure Index (GSCPI)



5 Weakening Euro

The Euro hit parity with the USD in mid 2022 for the first time in ~20 years. As Eurozone imports of USD denominated commodities (like oil) become more expensive this adds to inflationary pressures.

EUR:USD (end period)



Sources: EIU, Reuters, CNBC, Statista, World Bank, Bloomberg

Illustrative Recent Commodities Market Disruptions

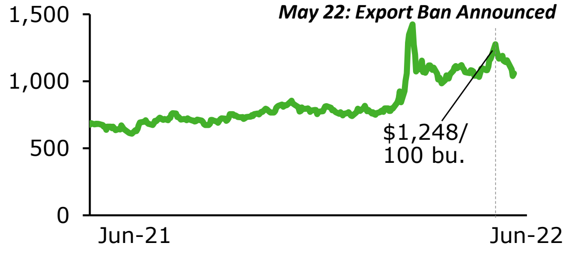
Commodity price volatility is nothing new and is a normal feature of the economic cycle. However we have observed an increasing frequency of significant market disruption in recent years. The drivers of these events range from pandemic induced dis-equilibrium, to geo-political shockwaves and even domestic concerns driving protectionist intervention. One thing is certain: uncertainty is here to stay.

Wheat (May 2022)
Indian export ban reducing global supply

The Indian government prohibited wheat exports to reign in local prices amidst weather impacted harvests.

Result: Prices jumped 6.9% over the weekend of the announcement, aggravating inflationary pressures arising from the Russia / Ukraine conflict.

Wheat Historical Price (USD/100 bushels)

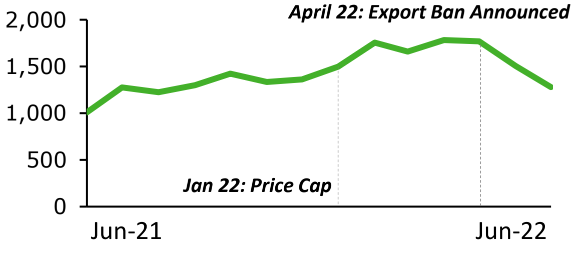


Palm Oil (April 2022)
Indonesian export ban amidst local shortage

Indonesia imposed a series of restrictions such as export bans and price caps, to mitigate against rising prices and local shortages.

Result: Prices decreased from USD1,785/tonne in April 2022 to USD1,280/tonne in July 2022 after the measures were implemented.

Palm Oil Historical Price (USD/tonne)

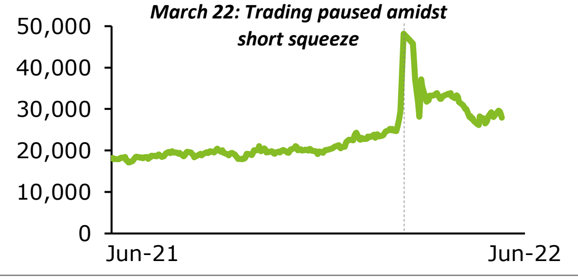


Nickel (March 2022)
Investor panic due to supply concerns

Prices doubled to over USD100k per tonne in a surge blamed on short covering by a top Chinese producer.

Result: The London Metal Exchange (LME) halted nickel trading to avoid market seizure as multiple market participants struggled and / or failed to pay margin calls.

LME Nickel Historical Price (USD/tonne)

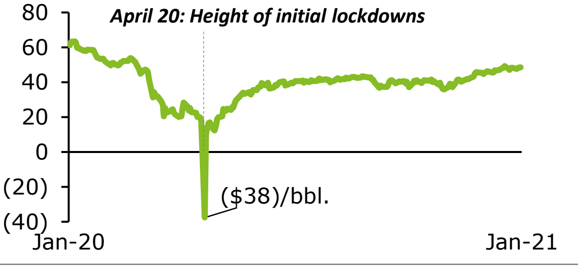


Crude Oil (April 2020)
Demand drop amidst a global standstill

Pandemic induced lock downs resulted in an economic standstill causing an oversupply of oil. The risk of overloading storage spaces resulted in a series of short-term dumping of inventory.

Result: A sharp crash in oil markets, with prices falling below zero (i.e. pay to sell) resulted from these unusual demand and supply dynamics.

WTI Crude Oil Historical Price (USD/barrel)



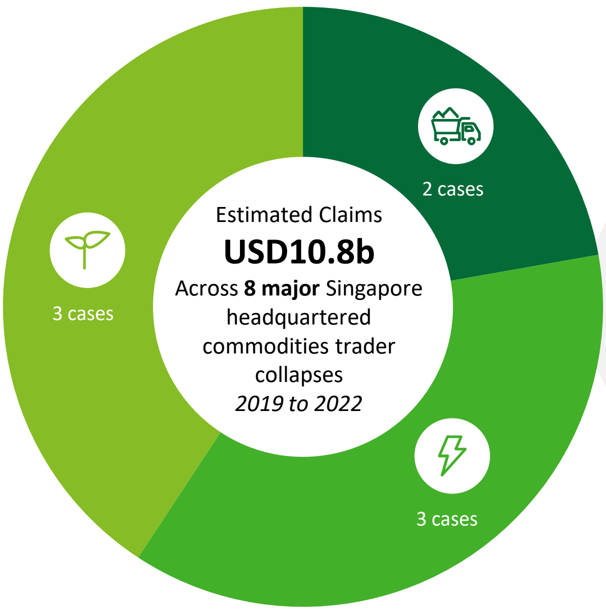
Sources: Bloomberg, Indonesia Palm Oil Association

‘Trading’ War Stories

Pandemic linked disruptions precipitated a recent wave of major corporate failures in the commodities trading space in Southeast Asia, many of which involve alleged fraud, which have shocked the industry and led major financiers to re-think their strategy. Several European banks have exited their commodities financing businesses in Asia and most (if not all) financiers have revisited their portfolio mix and risk tolerances. According to ADB, the global trade finance gap was USD1.7 trillion in 2020 and this is expected to grow. Unsurprisingly, alternative lenders are entering the space and are demanding higher returns.

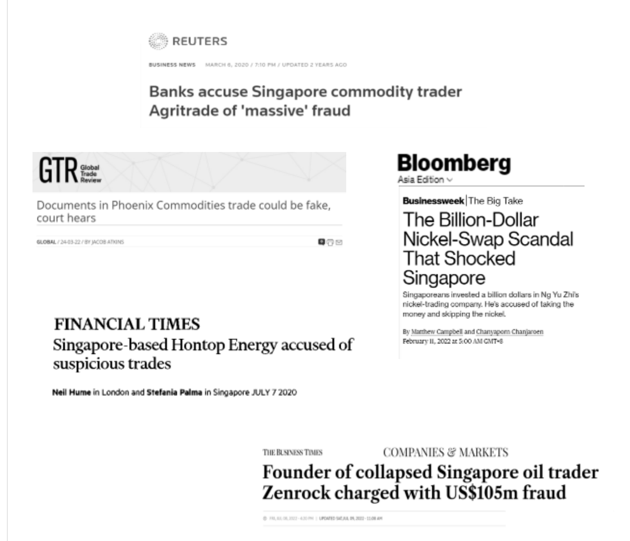
Major Commodities Trader Collapses

(% of Claims)



Primary Focus Agri Energy Metals

Illustrative Media Coverage



An Illustrative Journey | Common Themes

#	Common Themes	Commentary
1	**Market shock**	A market shock, for example the oil price crash of 2020, foreshadowed a crisis
2	**Counterparty defaults**	Debtors stretched beyond normal terms before becoming clearly impaired
3	**Liquidity crisis**	Failure to collect receivables locked up the working capital and financing cycles
4	**Debt default**	Past due positions on trade finance facilities led to loan acceleration and cross-defaults
5	**Creditor action**	Defaults (/concerns about suspicious transactions) led financiers to withdraw limits and commence enforcement
6	**Insolvency filing**	Traders sought moratorium protections through a Scheme of Arrangement or Judicial Management
7	**Fraud allegations**	In many cases, investigations uncovered evidence of raising finance from fraudulent contracts
8	**Security challenges**	Globally dispersed inventories and defunct debtors often proved incapable of providing a ‘plan b’ exit for financiers
9	**Director prosecution**	In several cases, criminal complaints and civil actions have been commenced against directors and officers

Sources: Deloitte Research and Analysis, S&P Global, Reuters, Bloomberg, Business Times, Debtwire, REDD Intelligence

Managing Risk in Commodities Financing

Financiers can mitigate the risks involved in commodities financing by implementing enhanced credit and monitoring standards, practices and controls, Upgrading to best practice can improve credit quality and secondary exit outcomes. Additionally, in response to the recent wave of defaults, several banks and regulatory groups have launched digital trade finance platforms to enhance lending practices, and to improve transparency and data security. Inevitably, paper based trading will become digitised and technology has a clear role to play in raising industry standards.

Illustrative Learnings | What Financiers Did Well

Our recent experience working to assist stakeholders through commodity trader collapses has highlighted certain **Best Practices for Financiers** which can improve recovery prospects in a contingency event

(list not exhaustive)

- Implementing enhanced counterparty **diligence,** ongoing monitoring and credit insurance
- Effective on the ground **collateral management** arrangements controlling physical goods
- **Syndicating and ring-fencing** facilities and collateral
- Control of **original documentation** (title + shipping) through the financing / delivery chain
- Systematic approaches to **market intelligence gathering** with review triggers
- Using **Trade Finance Platforms** to mitigate against double financing and other fraud risks

Illustrative Trade Finance Platforms

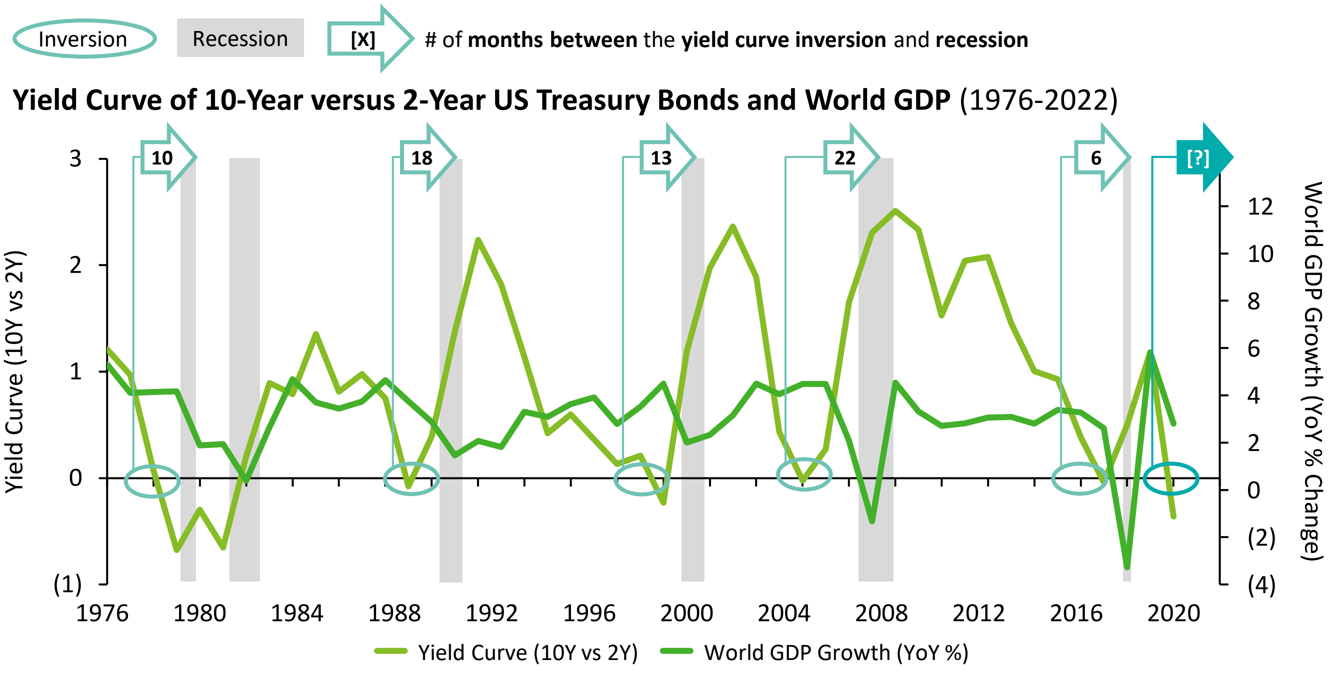
SGTraDex	Trade Finance Registry	IMDA-MAS TradeTrust
Access to real-time physical information and financial flows across supply chains, allowing participants to reconcile the authenticity of trades to actual physical flows, giving financiers confidence to fund the trade	*Allows banks to validate whether another financial institution has submitted a particular title instrument for financing purposes, alerting relevant parties when a duplicate is found. This mitigates the risk of duplicate financing among participating banks*	*Allows transfer of records and documentations, while reducing risks of forged documents, as all sources are immutably recorded. Further bolstered by the 2021 Electronic Transactions Act, which enables the creation and use of electronic BoLs that are legally equivalent to paper-based documents*
Regulator: IMDA, Future Economy Council (FEC) under Ministry of Trade & Industry (MTI) **Founding Banks:** DBS, OCBC, Standard Chartered, UOB **Others:** PSA, Trafigura, Jurong Port, PIL	**Founding Banks:** DBS, Standard Chartered **Participating banks:** ABN Amro, Lloyds, ANZ, ICICI, OCBC, Natixis, UOB, Deutsche, CIMB, Rabobank	**Regulatory Founding Groups:** MAS, IMDA, Financial Services Regulatory Authority (FRSA) of Abu Dhabi Global Market (ADGM) **Participating Banks:** DBS, Emirates NBD, Standard Chartered

Sources: Deloitte research and analysis, The Association of Banks in Singapore, SGTraDex, Trade Finance Global, Monetary Authority of Singapore

What Happens Next?

There is no perfect predictor of economic performance. However 50 years of data indicates an inversion of the 2/10 yield curve signals that a recession may follow within 6 and 22 months. The 2/10 yield curve was inverted twice in 2022 (in both April and July). Smart businesses, financiers and governments are making preparations to mitigate against a potential downside scenario now.

Yield Curve of 10-Year versus 2-Year US Treasury Bonds and World GDP (1976-2022)



Yield Curve Inversion Explained

10-year bonds usually generate higher yields than 2-year bonds because longer tenors increase risk. An inversion the 2/10 bond yields has preceded every U.S. recession since 1978 and is considered an excellent lead indicator for recession. These developments are creating unease as investors look to exercise caution that can be seen in the S&P contraction in 2022. These risks are potentially contagious to Asia.

Counter-Indicators to Recession

1. Unemployment remains at record lows globally and this an indicator of strong economic prospects
2. The pandemic "revenge spending" spree continues, and consumer demand has remained buoyant
3. Central banks are confident enough to raise interest rates to temper the demand of 2021

The Downside Case | Stagflation

"Stagflation" denotes simultaneous "stagnation" (i.e. slowing or declining economic growth) and "inflation" (i.e. increasing prices). Economic policymakers find stagflation particularly challenging to manage as attempting to cool inflation by tightening monetary policy exacerbates the other problem of slowing growth and vice versa. Stagflation is rare and the most notable historical example referenced is in the US in the 1970s when unnaturally low unemployment (driven by government policies) led to a wage-price spiral. The situation was made worse by the 1973 OPEC oil embargo (with parallels able to be drawn to other geo-political commodity supply impacts in the present day i.e. Ukrainian wheat).

Sources: Deloitte Research and Analysis, EIU, World Bank, The Wall Street Journal

Tactical and Strategic Responses for Businesses

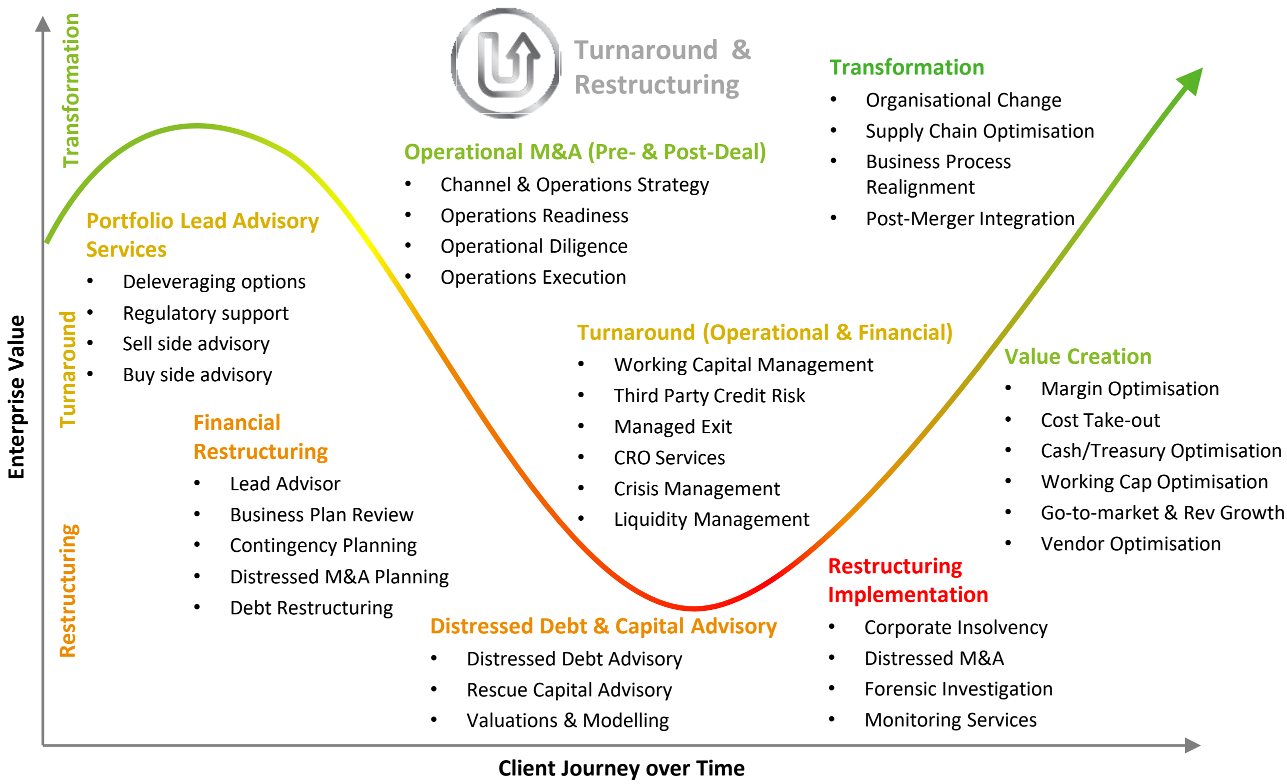
Illustrative (non-exhaustive) levers for commodity producers and commodity traders

Value Chain	Challenges	Short-Term, **Quick-Wins**	Medium to Long-Term, **Durable Change**
Commodity **Producers**	**Profitability** › Inflationary pressures › Wage pressures › Elevated logistics costs	• Price optimising pivot between **domestic and global** markets • Execute **cost and FTE** optimisation measures • Implement **logistics bidding**	• Adjust pricing mechanisms in **offtake agreements** • Consolidate / **renegotiate supply** • Strategic vertical **integration** to capture margin
Commodity **Producers**	**Liquidity + Capital** › Increasing receivables, inventory lock-up › Higher interest rates / cost of capital	• Monitor **short-term cash flow forecasts** to manage costs • Offer early payment discounts and consider **debtor financing** • Implement **just in time** strategy	• Evaluate **refinancing options** and re-align servicing to cash flows • Re-evaluate / defer **capital expenditure** plans • Adjust portfolio and **divest non-core** assets
Commodity **Producers**	**Operational Risk** › Increasing volatility › Supply chain disruptions › Adopting ESG reforms	• Adjust **hedging strategy** • Map out, monitor and adjust for **supply chain weaknesses** • Maximise use of **government incentives** for ESG	• Commodities **futures tracking** to drive sourcing, planning, and pricing decisions • Eliminate **single supplier dependencies** (including logistics)
Commodity **Traders**	**Profitability** › Intense competition › Logistics bottlenecks consuming capital and incurring demurrage	• Exit loss making **portfolios** • Re-allocate capital resources to **high margin segments** • Benchmark logistics providers and **shift risk** to sellers / buyers	• Identify and focus on areas with clear **competitive advantage** • Optimise **tax planning** to support trading evolution
Commodity **Traders**	**Liquidity + Capital** › Mismatch of commodity prices and financing limits › Higher financing costs eroding margins › Heavy reliance on credit lines	• Re-evaluate limits and consolidate **trade financing lines** at competitive rates • Review and renegotiate supplier and customer **payment terms** • Review **liquidity management** approach and cash cushions	• Maintain disciplined approach to **balance sheet** management • Re-evaluate **capital structure** and funding mix • Simplify **corporate structures** where there is no clear financial or risk management justification
Commodity **Traders**	**Operational Risk** › Elevated counterparty default risk › Rogue trading	• Adjust **risk policy** tolerances • Lock out **past due buyers** until accounts corrected • Implement daily **trading reconciliations** with clear segregation of duties	• Enhance **counterparty due diligence** and monitoring • Continuous enhancement of **internal controls** with regular auditing • Develop **data analytics** capability and uses

About Deloitte Turnaround & Restructuring

We work with clients to improve outcomes across the stress spectrum ranging from companies seeking to turnaround short term underperformance to those in deep financial distress requiring crisis management. We are actively businesses in the commodity sector across Southeast Asia and globally to turnaround, restructure and grow.

Deloitte Turnaround & Restructuring



Turnaround & Restructuring Insights

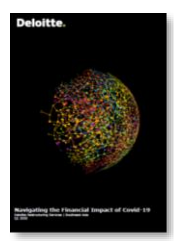
Click on the Report to learn more

"Checking Out" Retail (2022)

SEA Retail sector outlook

Electrifying Singapore (2021)

Singapore Electricity Generation



Critical Moves (2020)

Navigating the Financial Impact of Covid-19

The Liquidity Runway (2021)

A review of the SEA Airline sector

Preparing for the End of Stimulus (2020)

What it means for business

Southeast Asia Working Capital Report (2019)

Benchmarking the opportunity

Turnaround & Restructuring Contacts

Deloitte has 9 dedicated Turnaround & Restructuring Partners and over 50 dedicated Turnaround & Restructuring professionals across Southeast Asia

Andrew Grimmett
Partner
SEA Turnaround & Restructuring Leader
T: +65 6530 5555
E: agrimmett@deloitte.com

Matt Becker (Author)
Partner
SEA Turnaround Leader
T: +65 8332 1977
E: mbecker@deloitte.com

Richmond Ang
Partner
SEA Debt Advisory & Restructuring Leader
T: +65 6216 3303
E: rang@deloitte.com

CY Chew
Managing Director
AP Head of Special Situations Origination
T: +65 6530 8026
E: cychew@deloitte.com

Wei Cheong Tan
Partner
Singapore Turnaround & Restructuring
T: +65 6531 5046
E: wtan@deloitte.com

Justin Lim
Partner
Singapore Turnaround & Restructuring
T: +65 6216 3269
E: juslim@deloitte.com

Siew Kiat Khoo
Partner
Malaysia Turnaround & Restructuring
T: +60 3 7610 8861
E: skkhoo@deloitte.com

Kamolwan Chunhagsikarn (Minnie)
Partner
Thailand Turnaround & Restructuring
T: +66 2034 0162
E: kchunhagsikarn@deloitte.com

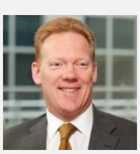
Jit Cheng Lim
Partner
Malaysia Turnaround & Restructuring
T: +60 3 7610 7626
E: jclim@deloitte.com

Edy Wirawan
Partner
Indonesia Financial Advisory Leader
T: +62 21 5081 9200
E: ewirawan@deloitte.com

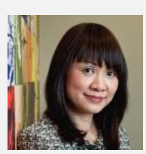
Phong Le
Partner
Vietnam Financial Advisory Leader
T: +84 28 3521 4080
E: phongle@deloitte.com

Aye Cho
Partner
Myanmar Financial Advisory Leader
T: +951 2307366
E: aycho@deloitte.com

Global and Regional Contacts



Andrew Grimstone
Partner
Global Turnaround & Restructuring Leader
T: +44 20 7007 2998
E: agrimstone@deloitte.co.uk



Jiak See Ng
Partner
Asia Pacific Financial Advisory Leader
T: +65 6531 5088
E: jsng@deloitte.com

Soo Earn Keoy
Partner
SEA Financial Advisory Leader
T: +65 6216 3238
E: skeoy@deloitte.com

Deloitte.