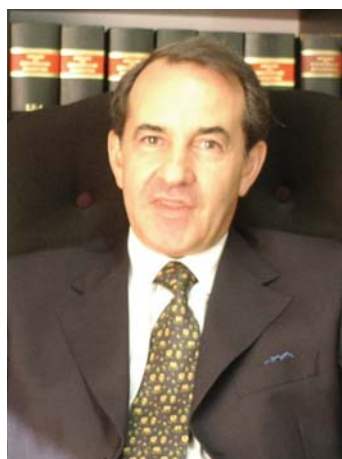


# Locking into commodities

**Collateral managers are easing commodities risks in Latin America, writes Luis Waldmann. He looks at the structures being used and players involved.**

As competition encourages banks to finance riskier farmers they had never lent to before in Latin America, trade-inspecting companies are cashing in on a booming niche. Cotecna,



**Alfaro at Alfaro Abogados Insurance is important**

Control Union and other collateral managers ensure that commodities given as guarantee are planted, harvested, stored and shipped according to the contracts. Swiss surveillance company SGS, for example, monitors tobacco, ethanol and hot-rolled coils, among other products, in Latin America. Standard Bank, WestLB and other lenders are relying heavily on collateral managers when targeting agricultural customers with little liquidity and much debt. Meanwhile, the best names

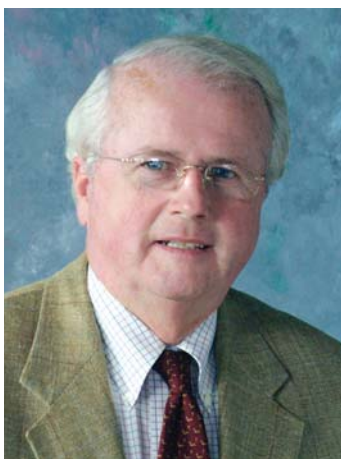


**FCStone's Goulding Ethanol boost for corn**

are favouring different types of borrowing such as initial share sales and bond issuances instead of structured commodities finance.

## Lower tier

Lending to top-tier clients is currently not too rewarding due to the high liquidity in the Latin American market and the ongoing boom in commodities financing, says Regis Carvalho, vice-president, Latin America structured finance at Standard Bank in New York. As a result, international banks are employing more



**Maloney of Maloney Commodity Services Make sure you cover risks**

sophisticated structures to delve deeper into lower-tier companies, hitherto financed mostly by trading houses, retail banks and hedge funds seeking higher yields, he comments. "Today, not only banks that specialise in commodities but also traditional ones are financing companies and sectors that until some time ago had difficulties raising money," Carvalho says. "This situation has allowed smaller clients and clients with weaker balance sheets to obtain financing." Low interest rates in the US, EU and other developed regions are luring banks and investors to emerging markets like Brazil and Argentina.

Standard Bank finances coffee, cotton, ethanol, meat, sugar, soy, and tobacco, as well as hard commodities in Latin America.

SGS has seen its business in the region expand by more than 50% in the last 12 months, says Alejandro Gomez de la Torre, managing director of SGS del Perú and chief operating officer South America.

In Brazil, SGS verifies tobacco, soybeans and its by-products, wheat, corn, sugar, cane ethanol, rice, cotton, coffee, concentrate frozen orange juice and iron silica.

As for Argentina, the firm monitors soybeans, corn, wheat and hot-rolled coils.

Moreover, SGS inspects corn, rice and soybeans in Uruguay, frozen fish, seafood, and crude and refined palm oil in Ecuador, and gasoil in Guatemala.

Robert Maloney, president of collateral management company Maloney Commodity Services, agrees that the top-tier agricultural borrowers in the region are over financed.

"We're not dealing with primary borrowers anymore. Risks are

going north and the spreads are getting tighter," says Maloney in Stamford, Connecticut. He warns that players could run into trouble for not adequately covering risks pertaining to second and third-tier credits. Carvalho has approached Maloney Commodity Services to audit the services of other surveillance companies in very specific transactions across Latin America.

He adds that the backing of surveillance companies pays off because "it's still cheaper for a producer to borrow from a bank coupled with a collateral manager than to borrow working capital from a retail bank".

Matthieu Delorme, who is vice-president, commodities and trade finance services at Cotecna, says pricing depends on the degree of responsibility that his company is required to take, and also whether Cotecna's input is resource and expertise-intensive, how much information the lenders require, how often he has to visit an area and how big it is.

"It's more issues of responsibilities and resources than the quality of the risk," says Delorme. He has not detected strong downward pressure on inspection margins.

## Best mitigants

Risks in Latin America can first be mitigated by thorough credit analysis, including country, sector of activity and borrower, says de la Torre at SGS. Second, by being aware of legal aspects, especially jurisprudence, which may impact the constitution of guarantees and their legitimacy. Last, risk is eased by transferring collateral, guarantee or pledge to a third party like SGS, he adds. Eric Bonnin, director, soft

structured commodity finance at Société Générale Corporate and Investment Banking (SG CIB), comments that commodity managers are especially effective for inventory financing, and adds that true warrants are seldom found in Brazil.

"The presence of a collateral management firm is a strong mitigant," says Bonnin. Moreover, Bonnin remarks collaterals are usually kept on the mills' own premises, leading to the usual intrinsic risks, as it's expensive for customers to have recourse to third party warehousing companies.

Maloney warns warehouse receipts pledged in Brazil can end up as part of the bankruptcy pool of assets, but "with *alienação fiduciária* the lender can avoid that". *Alienação fiduciária* applies to non-fungible goods such as receivables, whose title is pledged to lenders and not those bearing physical custody, he explains.

Maloney complains that many lenders don't bring in a collateral manager until 'quite' late in the transaction evolution. "So you're brought in the end of the day and you're asked to deal with making sure all risk mitigants are covered," Maloney says.

He adds Maloney Commodity Services is chosen for unique transactions, when there is interest in confidentiality and structures are 'a little' different, calling for a tailor-made approach.

Sadia Ricke, deputy head of mining and structured commodity finance SG CIB in Paris, says Brazil's legal framework offers strong instruments such as the assignment of contracts, promissory notes, personal guarantees from the main shareholders and agricultural and mercantile pledges. In structured commodity finance, the best means to

recover credit is usually to restructure the loan, facing only the risk of immobilisation. Meanwhile judicial recovery is not the best way based on SG CIB's track record in cases of default, Ricke says.

In the case of ill-willed borrowers, it's difficult to be fully protected from fraud, Ricke says. To counter this, SG CIB conducts careful due diligences with traders, the central banks, global databases and international surveillance companies before entering into a relationship with a new customer.

### Rural certificates

Brazil's *cédulas de produto rural* (CPRs) are certificates farmers sell to raise resources for planting. The certificates can be backed by a mortgage on property, *alienação fiduciária* of any goods and rural pledge, says Claudio Fonseca, president of Brazilian inspection firm Schutter.

Schutter monitors especially with soybeans, including oil and meal, corn, sugar, alcohol, frozen meat and wheat. CPRs exist since 1994, but only started to pick up around 1999, says Domicio dos Santos Neto, a partner at law firm Santos Neto Advogados in São Paulo. The certificate is a negotiable instrument, with a promise to deliver goods or to pay in cash, he explains.

Santos Neto says demand for collateral managers has soared since 2002 and that Cotecna, SGS, Control Union and the other companies very often take over the debtors' warehouses, leading to greater control over the stock.

Bonnin confirms farmer risk in Brazil is typically mitigated by CPR arrangements backed by mortgages and personal guarantees from farmers. Regarding performance risk, SG CIB looks at the producer's track record and its motivation

to perform with a strategic and long-standing buyer. For price risk, the bank regularly uses haircuts and hedges as



**Bonnin at SG** | **Collateral managers help in Brazil**

mitigants, Bonnin comments. Most SG CIB transactions are pre-export finance for mills or crushers and directly on small producers with very limited risks, he says, with the main risks linked to performance and price.

Risks related to farmers are different from one sector to another given some mills own their lands and crops and are not exposed to farmer delivery risks, says Bonnin. In other sectors, typically soybeans, farmer delivery risks are the main issue to be mitigated. An exit strategy for the CPRs involve knowing what law firm



**Schmitz at WestLB** | **All in the structuring**

will execute the guarantees, how fast the execution is, how experienced the law firm is and how much will it cost, comments Carvalho.

"It is a combination of legal execution and close work with the surveillance companies. The lender needs a good lawyer but also needs the surveillance company to make sure the goods are where they are suppose to be," Carvalho at Standard Bank complements. Düsseldorf-headquartered WestLB usually starts a relationship with a trading company by helping it buy harvested soy from farmers, says Martin Schmitz, executive vice-president in the agribusiness sector in Brazil.



**Mansur at Mattos Filho** | **Beware reselling**

The second step can be the pre-financing of a crop, where the risk is mitigated through CPRs sold by acceptable producers, adds Schmitz. WestLB only finances up to 80% of the collateral.

"On one hand we want the producers by financing the CPRs, on the other we want export contracts before disbursing. With this structure one can satisfactorily mitigate performance and credit risks," comments Schmitz.

WestLB further eases payment risk by demanding that all importers be based in OECD

countries, or by having the merchandise delivered only upon payment.

Pre-financing-related risks amount to the performance risk of the exporter, payment risk of the buyer, political risk and foreign exchange risk,



Cotecna's  
Delorme

Respon-  
sibilites and  
resources

explains Peter Sargent, global head, international trade finance director at Lloyds TSB in London.

Sargent says basic rules are: "If the underlying contract is



Standard  
Bank's  
Carvalho

Looking to  
lower tiers

for a 12-month period, Lloyds TSB will always look for a repayment schedule of less than 12 months, allowing a little tail in the event of a delivery delay, for example."

Neither does Lloyds TSB finance

100% of the contract value, but "only probably two thirds to three quarters of it", he comments. Lloyds TSB prefers to finance commodities traded at the London Metals Exchange, Chicago Board of Trade and other exchanges so a hedge can be in place.

Marcelo Mansur at the São Paulo-based Mattos Filho law firm warns that financiers must be watchful of customers reselling crops already committed to one lender.

Mansur adds all his clients avoid foreclosing on debtors because Brazil's judicial system is too slow.

### Argentine risks

In Argentina, the best structure when backing commodities exports is to have a warrant, says Carlos Enrique Alfaro, partner at law firm Alfaro Abogados in Buenos Aires.

Moreover, one must make sure to have the debtor's power of attorney to ward off the risk of someone else issuing an attachment to the merchandise after it leaves the deposit, or to prevent the owner himself from transporting the merchandise to a different port, Alfaro adds. He says insurance is important, too.

Third, the assignment of the payment documentation from the buyer to the seller gives a privilege in the collection of payment and stops the debtor from granting it to another bank or company, he says.

"If you have priority, if you control the delivery of the merchandise, if you have the warrant and insurance in your name, I will say that you are pretty much covered," Alfaro remarks.

He says there are three risks when financing commodities in Argentina: political, financial and legal.

Political risks such as government interventionism will last until the next presidential

elections in Argentina, which will take place in October 2007, Alfaro forecasts.

In 2006, the Argentine government limited exports of meat and wheat in a bid to keep inflation in check, and announced ceilings on corn for 2007.

"When export prices are good, producers tend to export all their output and the little that is left for the internal market is sold at a much higher price," Alfaro explains.

The economic risk amounts to a system imposed by the central bank of Argentina obliging a percentage of exports-originated dollars to be used to finance exports at very low rates and with few guarantees, he says.

Alfaro says suing the government is costly, lengthy and the results are uncertain as these extraordinary measures are justified by the eventual harm they prevent.

### Asset trends

The trend for commodities finance, surveillance companies and the market in general is the 'monetisation' of the supply chain and the rise of so-called pure asset-based and asset-backed finance, says Carvalho. This will demand ever-more sophisticated structures including receivables and stock securitisation within the supply chain going beyond second, third and fourth-tier companies, says Carvalho.

Curt Goulding, president and CEO of FCStone for Brazil, says corn has huge potential for growth as the US is utilising more of its crop to produce ethanol. Corn prices hit a 10-year high last November at the CBOT. FCStone is a commodity risk management company headquartered in Kansas City. Goulding provides information services, training, strategic planning and execution. The main commodities handled by

FCStone in Brazil, Argentina and Paraguay are soybeans, sugar and alcohol, cotton and coffee and customers include cooperatives, sugar mills, private grain companies and farmers.

SG CIB's Bonnin considers Brazil in particular the highest growth area worldwide for soft commodities production, especially pulp and paper, ethanol and biofuels.

Moreover, there is an increasing trend to assess soft commodities producers on a corporate basis, therefore extending longer facilities and looser structures, he adds. Bonnin comments: "Typical structured commodities financing has been reduced in favour of expansion finance or acquisition finance. Soft commodities producers are starting to find interest in alternative solutions such as IPOs – public or private placement with strategic foreign investors or partners, local and international bonds, and securitisation.

Maloney sees progressive use of collateral management in the coming years. He anticipates the utilisation of progressive concepts backed by integrated electronics platforms for issuing global commodity depository receipts, which would facilitate the management of physical commodities in Brazil from Europe or Africa, for example. Ignacio Greco, commercial inspection manager at Cotecna notes that the trend for typical commodities is energy, including biodiesel made from sunflower, soybean, corn or sugarcane. In all, the high liquidity dogging financial markets has been nothing short of a tonic for collateral managers. However, will commodities finance woo back top-tier players when the next crisis hits emerging markets? If so, inspection companies must brace for a harder market ahead.