GLENCORE: AN EXISTENTIAL CRISIS

After its IPO in 2011, commodities behemoth Glencore appeared a few years shy of gaining special-observer status at the UN. Today, its stock sits at around a sixth of the price and financial analysts are queuing round the corner to put the boot in. Ollie Gordon assesses whether Glencore's fall from grace is all it seems, and what lessons commodity trading houses can learn from the company's experiences.

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On 19 May 2011, Glencore International became one of the world's largest commodity trading houses after it listed on the London Stock Exchange with a market capitalisation of $59 billion. Almost two years to the day later, the company merged with mining titan Xstrata to create a natural resources monolith of truly meteoric proportions. Its mission statement?: "To capture value at every stage of the supply chain from sourcing raw materials deep underground to delivering products to an international customer base." The takeover was the fifth-largest in the history of the natural resources sector and, with a market cap of $65 billion, the newly-hatched Glencore Plc became one of the 10 largest constituents of the blue-chip FTSE 100 stock index. As of 2015, the company ranks 10th in the Fortune Global 500 list of the world's largest companies, with revenues of $221 billion, and is the world's third-largest family business.

However, Glencore's post-IPO/merge honeymoon came to an abrupt halt earlier this year, when its share price began a precipitous and unyielding slide that, as of yet, has shown no sign of abating. A downturn in the commodities cycle, primarily driven by a drop off in demand from China, has diminished the prices of Glencore's upstream assets, particularly coal and copper producers, along with the commodities it trades in – the company showed a net loss of $676 million for its operations during the first half of the year.

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Along with the weak global commodities market, the company's $30 billion debt burden has proven another cause for concern for financial analysts – so much so, the company announced in September it would be selling stock and assets with the aim of reducing its leverage by a third. Post-IPO in 2011, Glencore's stock valued 529 pence a share. Today (17 December 2015), it stands at just 84p (see Graph 1). So where did it all go wrong for Glencore? And why hasn't its fate been shared by rival traders Vitol, Mercuria and Trafigura?

One senior commodities banker pointed TXF to two key factors: "Glencore has suffered from being exposed to the worst areas of the commodity price decline: energy and mining. I also think

GRAPH 1: GLENCORE'S 2015 PLUNGE

(Source: Reuters)

it proves the company should never have gone public; I think they were persuaded into it by a group of investments bankers wanting to make a killing on the float. Investors don't understand Glencore business model; but that doesn't mean that business model is failing. In fact, it's still performing as well as it always was."

Ivan Glasenberg became CEO of Glencore International in 2002 (picture credit: Dianna Bonner)

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UPSTREAM-ASSET HEAVY

Although its traditional identity is as a commodity trader, since the Xstrata merger the company has become heavily involved in commodity extraction – particularly in the metals and minerals segments. In the last few years, most commodity traders have been busy selling off their fixed assets to refocus on the standard trader model of buying commodities from a producer and reselling them to the ultimate consumer. Glencore has done the opposite: it has spent its post-float existence eagerly snapping upstream assets across the globe, particularly in South America and Africa.

Dr Rouben Indjikian, professor and lecturer in commodities and trade finance at Webster University in Geneva, and former head of the UNCTAD commodities programme, tells TXF: "I think Vitol, Mercuria and Trafigura are more traders, while Glencore is becoming closer to the big mining companies like Anglo American, BHP Billiton and Vale because it has become so heavily involved in the mining sector."

Commodity prices fell rapidly in 2014/15, and unsurprisingly, commodity producing companies were particularly vulnerable to the downward price trend. "When prices began to drop, companies involved in the supply chain, especially those with upstream assets, saw their profitability shrink rapidly," says Indjikian.

Producers focused on the oil and mining markets were hardest hit. Firms that owned producing assets in other sectors, such as the agricultural market, were generally considerably less affected. A pure agri trader, with its own production and a blend of supply, will experience ups and downs depending on price movements and on which commodity it is focused. The agri market is seasonal and a trader can monitor yields and climates, and dive in and out of different markets. When it comes to mining and oil production, it becomes a very different prospect. A senior executive at a Swiss-based commodity trader tells TXF: "For mining and oil, the up-front capex that you have is vast, and you've got to work that back over a number of years. And then you've got your running costs and ongoing exploration etc. So there's a number of those costs you're going incur regardless of the market price. It comes down to a basic question: if you have those assets, where are they on the cost curve?"

Unfortunately for Glencore, of the 125 upstream assets it now owns across the globe, 101 are in mining and oil. Since the IPO and Xstrata merger, Glencore has developed and brought onstream a considerable number of new mining assets. It was a time in which the commodities cycle was on an upturn, interest rates were low, and funding was cheap and readily available; so it was easy to boost values and

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look at different multiples.

"So when Glencore looked at its balance sheet at IPO time, a number of its asset values were probably over-inflated," says the trader. "And the correction in the asset values as well as the commodity price is where there's been a little bit of a knee jerk reaction. In the short term you've got to fix and re-balance your portfolio and work out what are your core markets, core assets, etc; which ones are marginal and which ones you can fix. And that's what we've seen Glencore doing, certainly in Zambia, the Democratic Republic of Congo and South Africa; looking at their portfolio and trying to streamline those costs. And in some cases where they couldn't cut costs or get rid of people, they've had to go care-and-maintenance or just get rid of the asset."

A difficult reality? Yes. But Glencore-centric? Most certainly not. Mining mammoths Anglo-American and BHP Billiton are currently experiencing exactly the same problems as they also look to work out their portfolios and clean up some of their overvalued assets. And, unsurprisingly, their stock has followed a very familiar trajectory (See Graph 2).

That is where Glencore's evolution has diverged from those of the other traders. While Mercuria, Trafigura, Vitol, Gunvor have all been selling off their assets, Glencore in essence has developed into a mining company with a little side salad of oil and agri. "The other traders had some mid-streams asset, but were sparse on the primary producing ones," says the trader. "Trafigura had some upstream mining assets, but they disposed of them two or three years ago. So perhaps the writing is on the wall. I think Glencore will try to migrate back to a more trading orientated model."

FLOAT OR FLOP?

Commodity traders are secretive entities by their very nature and usually prefer to stay out of sight by remaining privately-held companies – a general strategy Indjikian believes best suited to financing their business models. "I think the well-known traders should be private companies, because they can raise capital through the public issuance of corporates bonds and bank credits, rather than publicly filling their shares through IPOs. They're rated as good risks by the banks. They're trading commodities that are excellent collateral; as opposed to manufactured goods, which aren't. So having these bank credit lines and capital markets participations, the traders can resolve their problem of access to capital at competitive rates, and therefore the case of

GRAPH 2: THE MINERS' SECOND-HALF COLLAPSE (GLENCORE, BHP BILLITON AND ANGLO AMERICAN)

(Source: Reuters)

having access to share-related capital is far less compelling."

That is why it raised a few eyebrows when Glencore first announced its intention to float in 2011. Some prescribe the move down to more questionable motives than simple, unfettered commercial growth strategy. Says the trader: "I think Glencore's listing was driven by many reasons, not least because they had senior partners in there that wanted their payday and the only way to generate that kind of value was to IPO. The reason for listing wasn't solely for creating a large listed mining company, I think that became what they were being driven to. And I suppose that model will be re-looked at."

Whether there is any veracity in the accusation is impossible for TXF to say. What is true is that each of our interviewees subscribe to the view that Glencore would have been better off not listing, citing lack of understanding of the company's business model by stock-market investors.

For the trader, that lack of investor comprehension derives from Glencore's producer, rather than trader, alter-ego: mining companies require a special type of long-term commitment from investors, one which Glencore has yet to acquire. A typical trading company balance sheet, while highly-leveraged, generally matches assets and liabilities; it funds a purchase against a sale, or is financed on a back-to-back basis. But for mining companies, the asset-conversion cycle is much longer and the company is focused more on capital markets debt than trade finance or short-term matched funding. So the problem arises when commodity prices plunge and the company's asset values change; its debt burden suddenly outstrips either market value or its ability to repay it short term because it's in a much longer-term debt cycle. "Companies like Glencore are coming to terms with the fact that the model does require a lot more 'patient' capital, for want of a better term", says the trader. "So it's very important what percentage of your company is properly publicly-listed and how much is held by strategic investors who maybe have a bit more patience and will ride the curb a bit longer. Just look at your BHP Billiton: people know that's a long-term share, and you'll buy it and hold onto it. For other companies that isn't the case."

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Why Glencore is yet to attain that trust as a long-term share is a subject for debate: maybe investors are scared off by Glencore's 1.12x debt-to-equity ratio (BHP's stands at 0.48x); maybe they are yet to fully get to grips with Glencore's split-personality as a trader-cum-producer; but, then again, perhaps one does not come without the other.

Nonetheless, each of our interviewees were quite insistent that Glencore is still functioning as well as it ever was, and that its floundering share price is solely a reflection of dire market conditions that will eventually turn. And certainly Glencore's relationship banks have yet to start panicking. A total of 60 international banks participated in the company's $15.25 billion revolving credit facility in May. In recent years, Glencore has been able to dictate pricing down to such a low level – thought to be around 40 basis point over Libor on the latest RCF – that the banks are making almost no margin on the facility. Instead they fund it to put themselves in line to win other, more profitable Glencore business in the remainder of the year. And even after the firm's stock decline since May, there has been little to no murmurs of discontent within the lending ranks. One of those relationship bankers, the head of commodity finance at an Asian-based bank, tells TXF that he expects the next Glencore facility to see minimal changes in both pricing and bank commitment. The banks have no doubts over Glencore's ability to weather the current storm, he insists.

Glencore is not blameless for its current predicament: it over exposed itself to the mining sector, and its decision to list, in hindsight, looks ill advised. And many of its commodity trader rivals will be thanking their lucky stars for not following its lead and monopolising their supply chains. But peering into Glencore's crystal ball, we are in need of a sage. Perhaps one need look no further than the grizzled trade finance bankers that have worked with Glencore year in, year out since its dawn in 1974. They know the company inside out, and they have many billions of dollars skin in the game. So if they are not all that fussed… Well, at 84p a share, maybe it's time for a flutter. ■