"Hedging strategies for recycled steel" workshop

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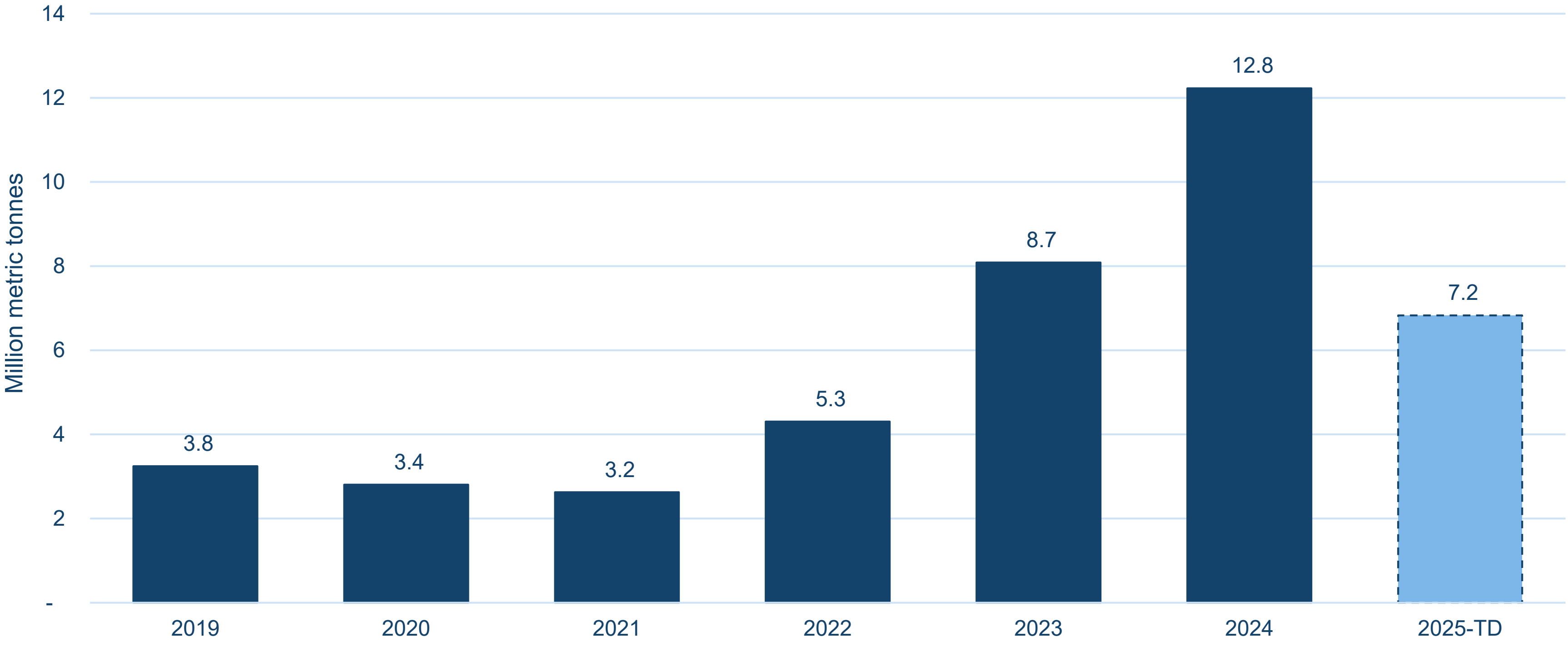
LME
An HKEX Company

SETTING THE GLOBAL STANDARD

Steel scrap futures – annual traded volumes



Source: LME

Case study 1: cargo accumulation

- Short physical position

- Buy forward on the exchange to hedge the risk of prices going up during the accumulation phase

LONG

SHORT

- Gradually sell back on the exchange as steel scrap is accumulated dockside

Notes: picture courtesy of Ward Recycling

Case study 2: demolition project / shipbreaking

- Long physical position
- Sell forward on the exchange to hedge the risk of a price decline
- Gradually buy back on the exchange as the project starts generating steel scrap

Notes: picture courtesy of Ward Recycling

Case study 3: fixed price sales (a value-add service)

- Short physical position
- Buy forward on the exchange to hedge the risk of a price increase
- Close positions on the exchange as the material for the contract is collected

Notes: picture courtesy of Ward Recycling

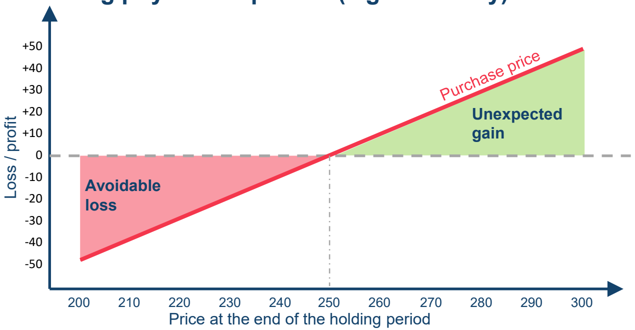
Working capital and trade finance solutions

- Advance rates and haircuts
- Unsold inventory
- Tripartite financing

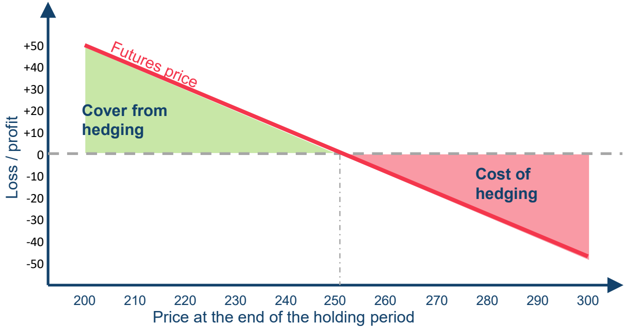
Appendix: hedging examples

Hedging a **long** physical position (1/2)

- **Long physical exposure (e.g. inventory)**



- **Hedging a long exposure with a short position**



		Market price decrease	Market price increase
Physical position	**Long physical exposure**		
	Value today	250	250
	Price in 3 months	200	300
	Profit / loss	-50	+50
Financial position	**Hedging a long exposure with a short position**		
	Price locked-in today	250	250
	Price in 3 months	200	300
	Profit / loss	+50	-50
	Actual value at the end of the period	**250**	**250**
	Actual profit / loss	**0**	**0**

- The objective of hedging is to lock-in a future prices, thus reducing exposure to price volatility risk
- Speculators do not hedge, but rather take a view on future price movements by gaining exposure with either a physical or a financial position

Hedging a **long** physical position (2/2)

Fixed price purchases / inventory

Buying at a fixed price generates a **long physical position**, as it is an obligation to **receive** material at a previously agreed price

The financial transaction needed to hedge the price risk is **forward selling** an equivalent quantity (or a fraction of it) to create a **short financial position**

Example

Steel mill ABC agrees to buy 5,000mt of scrap per month for 6 months at the price of $250 per tonne to ensure production continuity

To hedge this position, steel mill ABC decides to forward sell 5,000mt of scrap per month for 6 months at the price of $250 per tonne

After 6 months, the price of scrap…

…drops to $200

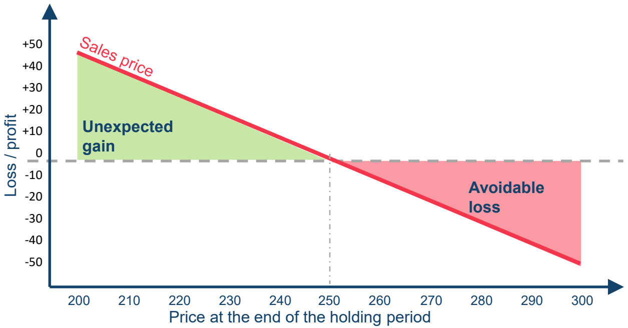
- Loss on the physical position -$50/mt
- Gain on financial hedge is +$50/mt
- **Final cost of the raw material $250/mt**

…rises to $300

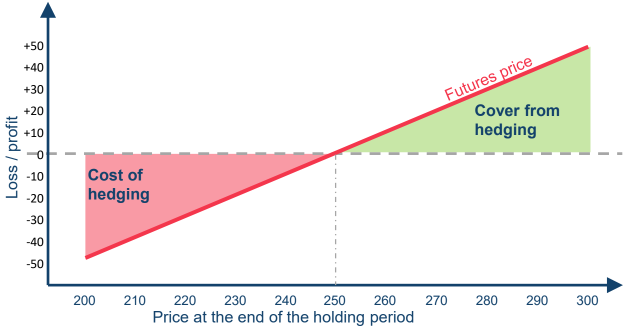
- Gain on the physical position +$50/mt
- Loss on financial hedge is -$50/mt
- **Final cost of the raw material $250/mt**

Hedging a **short** physical position (1/2)

- **Short physical exposure (e.g. sale at fixed price)**



- **Hedging a short exposure with a long position**



		Market price decrease	**Market price increase**
	Short physical exposure		
Physical position	Value today	250	250
	Price in 3 months	200	300
	Profit / loss	+50	-50
	Hedging a short exposure with a long position		
Financial position	Price locked-in today	250	250
	Price in 3 months	200	300
	Profit / loss	-50	+50
	Actual value at the end of the period	**250**	**250**
	Actual profit / loss	**0**	**0**

- The objective of hedging is to lock-in a future prices, thus reducing exposure to price volatility risk
- Speculators do not hedge, but rather take a view on future price movements by gaining exposure with either a physical or a financial position

Hedging a **short** physical position (2/2)

Fixed price sales

Selling at a fixed price generates a **short physical position**, as it is an obligation to **deliver** material at a previously agreed price

The financial transaction needed to hedge the price risk is **forward buying** an equivalent quantity (or a fraction of it) to create a **long financial position**

Example

Recycler XYZ agrees to sell 5,000mt of scrap per month for 6 months at the price of $250 per tonne to a steel mill

To hedge this position, Recycler XYZ decides to forward buy 5,000mt of scrap per month for 6 months at the price of $250 per tonne

In the delivery months, the price of scrap…

…drops to $200

- Gain on the physical position +$50/mt
- Loss on financial hedge -$50/mt
- **Final value of the material $250/mt**

…rises to $300

- Loss on the physical position -$50/mt
- Gain on financial hedge +$50/mt
- **Final value of the material $250/mt**

Please note that if Recycler XYZ decides to bear the price risk of the physical contract, may it be able to negotiate a favourable price, or a premium (maybe $5-$10?), with its customer?

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