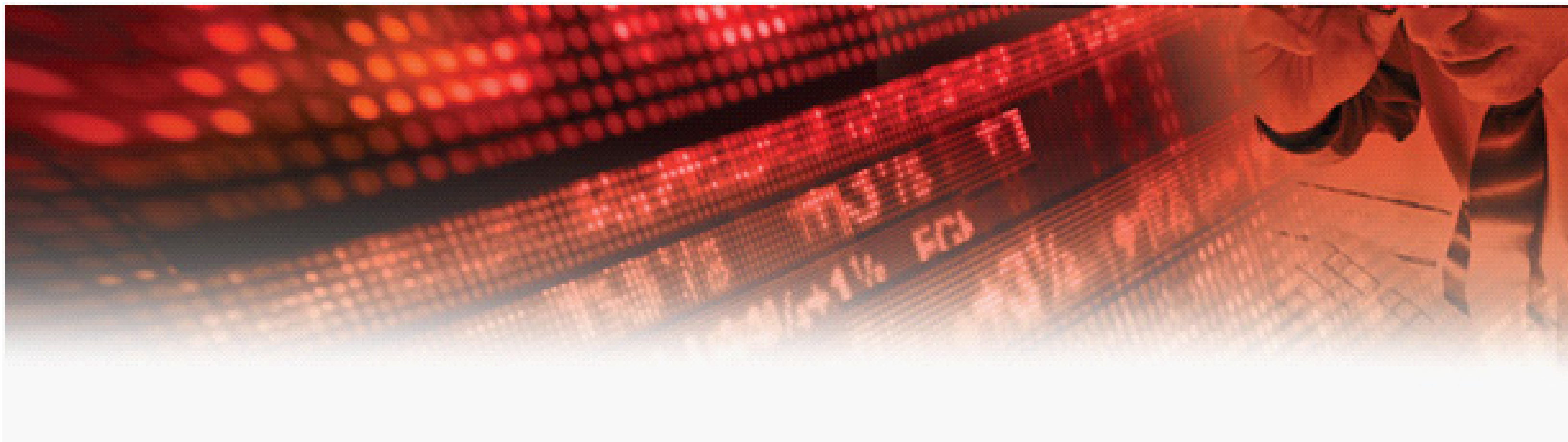

Optimize Your Buy Side

Stabilizing Margins with Better Procurement Practices

By Dennis Collins, Director, Trilateral, Inc.

Ingredient and commodity prices are at all-time highs! That was the news just a couple of years ago, along with unprecedented price volatility. Could we experience the magnitude of the 2007-2008 markets again? There are few who would say "never." Short of the 2007-2008 extremes, commodity and ingredient buyers—food manufacturers, food services, feed compounders, importers and processors—continue to experience fluctuating margins and higher average ingredient costs due to the significant swings in commodity prices.

Your suppliers' prices for energy and major ingredients—flour, vegetable oils, cheese, sugar, soybean meal, corn, cocoa, butter, sweeteners, natural gas, diesel—represent a combined contribution of several components: futures, basis, transportation, processing and local supply and demand dynamics. Of these, futures represent most of the price volatility.

People often wish to "ignore" futures because the markets seem too complex and volatile. But the reality is you can't hide from futures. Whether you choose to ignore or use futures as a pricing tool, they still impact your costs. Ignoring futures—the most volatile component of your price—will expose you to unnecessary price volatility and margin variability.

Properly implemented and managed, an investment in resources to keep you on the right side of the market will produce these returns:

- *Stabilize and improve your margins;*
- *Lower your average purchasing costs;*
- *Increase the accuracy of budget and cash flow planning;*
- *Enable more competitive pricing to your customers.*

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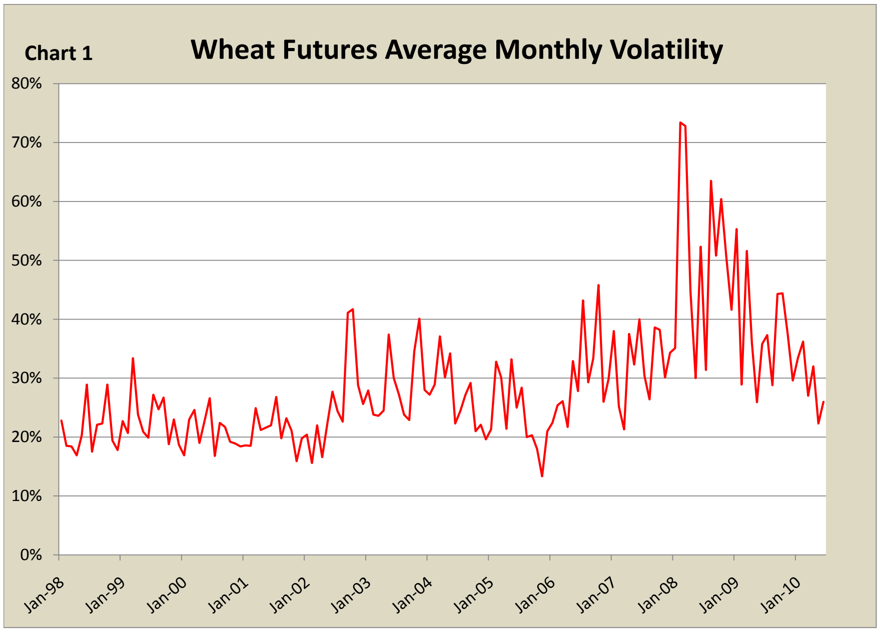
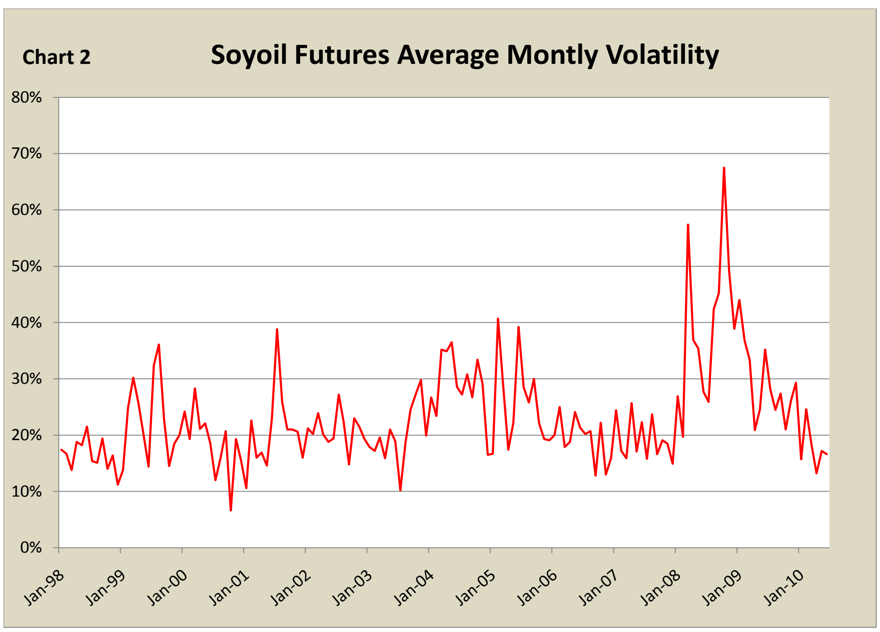
TRILATERAL
Perspectives You Can Price On

To illustrate price volatility, Charts 1 and 2 show average monthly volatility for wheat and soybean oil futures. Excluding the extremes of 2008, the average volatility for the past ten years was 29 percent for wheat, 22 percent for soybeans, 24 percent for soybean oil, and 20 percent for corn. Highs and lows among those commodities during the same time period ranged from 17 to 41 percent.





In other words, even “sideways” markets exhibit levels of volatility that can determine whether or not you make budget, or achieve margin goals.

As many buyers have discovered, however, you can mitigate your exposure to the uncertainty of this volatility and its impact on your prices and margins. These buyers use the many available risk management tools—including supplier pricing contracts that do not require maintaining futures positions.

No matter which tool or strategy you ultimately use, developing a logic-based market perspective must be the first step. Emotion must be eliminated from the decision process. When a buyer “hopes” for a specific market outcome, that buyer is already lost.

Buyers who do not develop objective market perspectives to drive their procurement and risk-management strategies subject themselves to erratic margins, pay higher average commodity and ingredient prices, diminish their pricing competitiveness and face greater uncertainty in financial planning.

Recent changes in commodity markets make buyers’ jobs increasingly difficult. The next section describes these changes and how they affect you.

Markets Have Changed

Supply and demand fundamentals still drive major trends. But the evolution of two significant changes in commodity market dynamics in recent years influence how value is determined. These factors can, and do, push fundamental trends to greater extremes and exacerbate shorter-term volatility in the process—making your job more challenging.

Internationalization of Commodity Markets

Commodity market dynamics have undergone two significant changes in recent years that . . . push fundamental trends to greater extremes and exacerbate shorter-term volatility in the process—making your job more challenging.

The first significant change has been the rapidly expanding internationalization of commodity markets and the influence of emerging economies—on the supply and demand sides alike. Wheat and soybeans provide good examples of how these international dynamics affect the ingredient costs of many of your products.

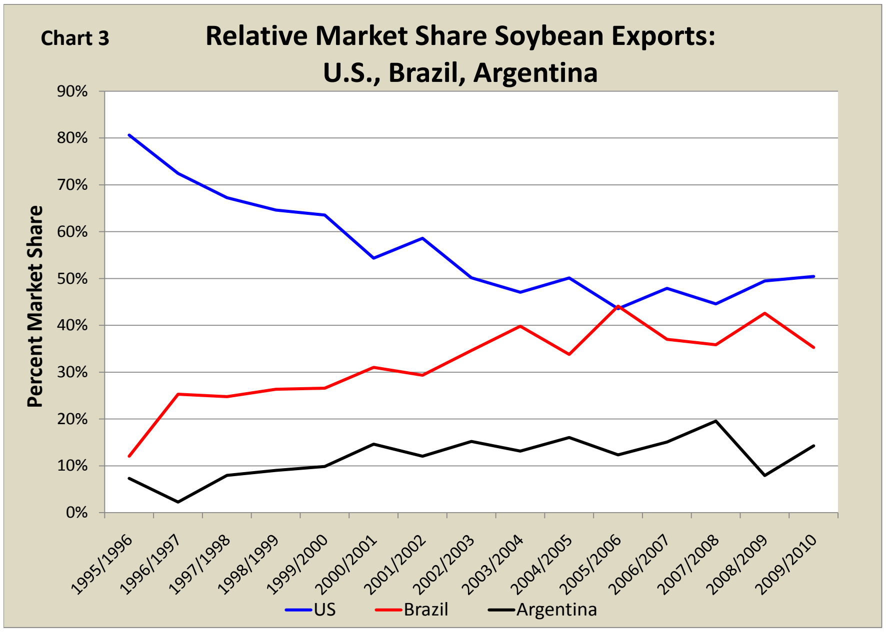
The five largest exporting countries traditionally are the U.S., Australia, the EU, Argentina and Canada. Their export market share, however, has been declining as the Black Sea area increases its exports. The global market share of U.S. exports has declined from about 25 to 17 percent over the past five years. How does this affect global prices?

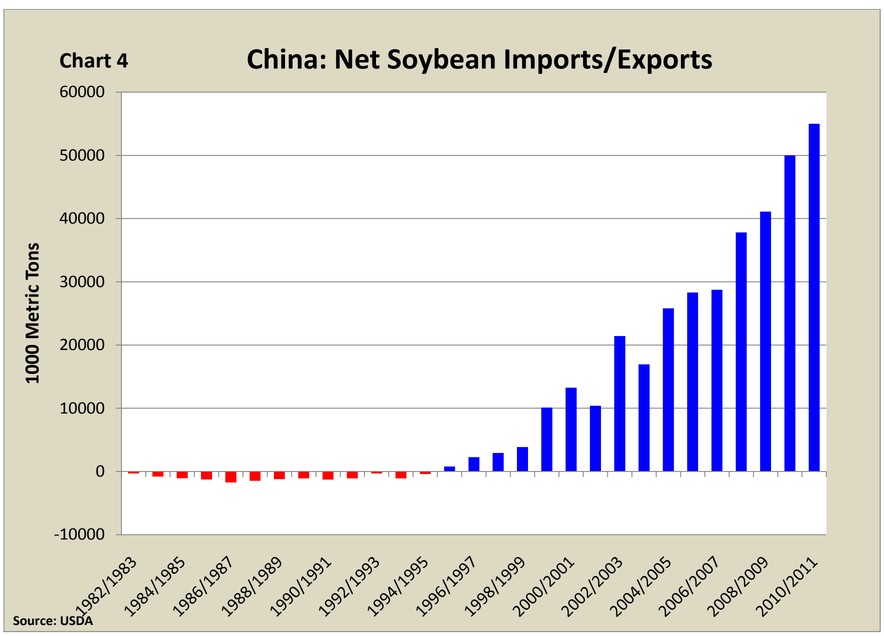
As we witnessed during the summer of 2010, production disruptions in any one or more of these areas results in significant price disruptions. This happened to a greater extent from 2006 through 2008, when adverse global weather reduced global wheat reserves to a 30-year low and prices jumped to record-high levels. However, explaining high prices and volatility is not as simple as invoking bad weather.

The global soybean market reveals similar developments. The U.S. remains the world's leading soybean producer and exporter. However, according to the USDA, the U.S. has seen its export market share decline amidst growth in its oilseed and oilseed product exports. The USDA suggests U.S. soybean production could decrease over the next ten years in the face of stronger foreign competition. Primary competition comes from Brazil and Argentina, which have achieved new record production and export levels nearly every year over the past decade. Chart 3 on the following page illustrates the relative export market share of these three countries (although Argentina tends to export soy products rather than beans).

Substantial increases in global production have been met with comparable, and sometimes greater, growth in global demand. In three of the last four years, world soybean consumption has outpaced supply; due in part to demand growth by emerging economies. Growing approximately 7 percent per year for the past decade, the trend is expected to continue with at least 3 percent annual growth over the next ten years.

China's demand growth, illustrated in Chart 4, is at center stage. The Brookings Institute estimates that "by 2021, on present trends, there could be more than 2 billion Asians in middle class households. In China alone, there could be over 670 million middle class consumers, compared with only perhaps 150 million today." The sharp increase in China's demand for soybeans should continue unabated to meet the increasing consumption of this growing middle class.





Today, while China is the world's fourth-largest soybean producer, it also commands approximately 60 percent of the world's soybean exports. Projections are for China to account for 78 percent of the growth in world trade over the coming decade. Other regions factoring into demand growth are Latin America, North Africa and the Middle East.

The evolving globalization of commodity markets has increased the number and complexity of many fundamental factors that affect your ingredients and energy costs. Events that alter market expectations and create uncertainty in even relatively "minor" segments of the market can have large repercussions in prices. Moreover, the intensity of market responses can be amplified by a relatively new category of traders.

Fund Trading

Initially, the impact of fund trading in commodity futures markets was rather inconsequential. That changed over the past decade as institutional investors and large speculative traders began placing increasing amounts of dollars in commodities as an alternative asset.

What began as a “small percentage” of investment dollars, from the perspective of the funds, has proven to be quite significant relative to the size of commodity markets. According to Barclay Hedge, as of the second quarter 2010, total assets under management for managed futures funds was $223.4 billion.

From a percent-of-market-position perspective, the CFTC reported in *This Month In Futures Markets August 2010* that non-commercials held 35.5 percent of corn positions; 57.2 percent of natural gas; 32.6 percent of wheat; 32.9 percent of soybean oil; 37.8 percent of cocoa; 44.3 percent of NYMEX crude oil; 41.6 percent of lean hogs; and 41.8 percent of live cattle.

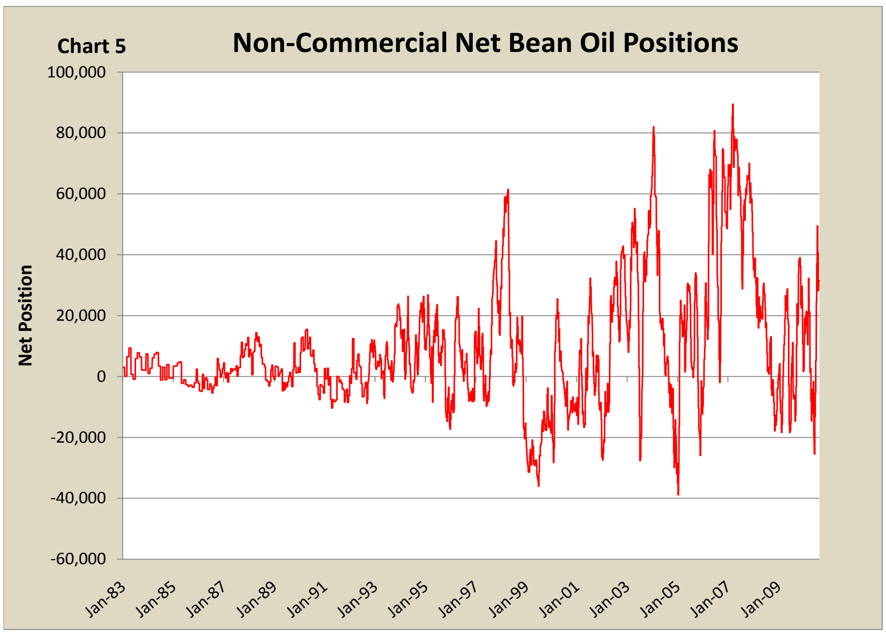


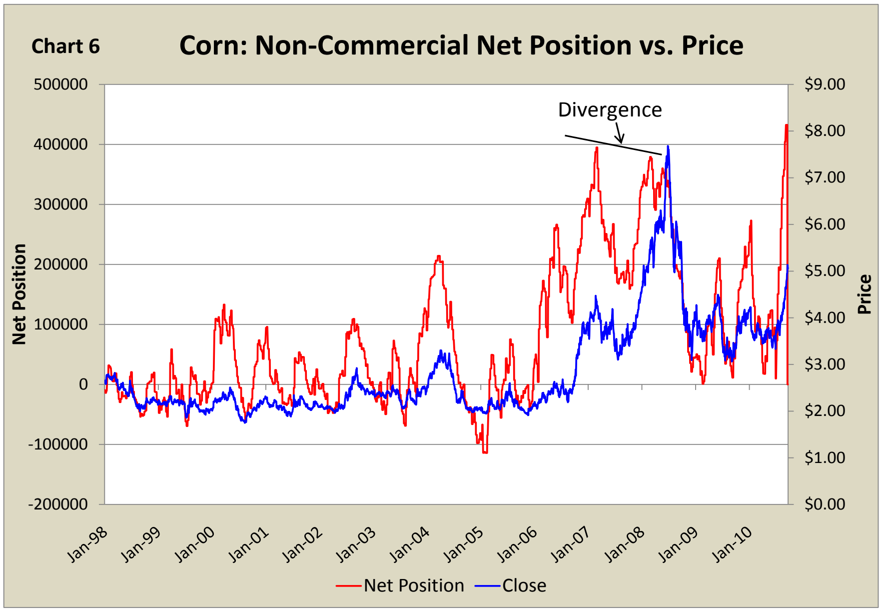
Chart 5 illustrates the growth of non-commercial participation in the bean oil market. It’s important to note both the increase in size of net positions as well as the sharp swings from one extreme net position to another—the volatility of non-commercial net positions.

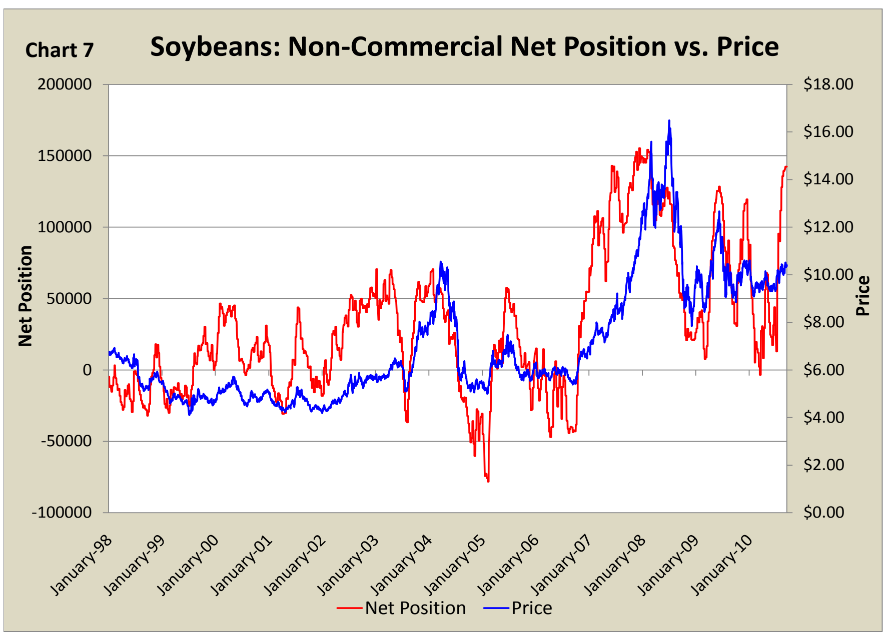
When making investment choices, funds consider the investment potential of commodities relative to other investment alternatives—i.e., as an asset class. “Outside” market factors, therefore, must now be considered as part of a comprehensive market perspective. You are familiar with them: consumer sentiment; equity indices; currency fluctuations; interest rates; energy markets; unemployment rates; inflation expectations; etc.

The following anecdotal observation from *Milling and Baking News* reflects the increasing complexity that funds have added to today’s commodity markets:

> *“On any given day [traders] weigh wheat supply and demand factors against myriad other influences often demanding equal or even greater attention, including the value of the U.S. dollar, the price of crude oil, the direction of equity markets, the status of the U.S. and world economies and the attitudes and strategies of new categories of market speculators.”* (Milling and Baking News, November 17, 2009)

Monitoring non-commercial trading patterns can provide perspective to the potential impact of fund trading activity—valuable insight for your purchasing strategies. Charts 6 and 7 show the correlation and general price-leading nature of non-commercial trading.





For example, the line marking "divergence" in the corn chart shows the initial 2007 net-position peak followed by a lower subsequent peak in a sharply rising market. This divergence suggested traders were becoming less confident in, and less supportive of, the price trend.

Combined with other factors, this was an indication that a transition was likely imminent. Shortly after there was a sharp sell-off, with prices falling over $4.50 as non-commercials reduced their net-long position by approximately 350,000 contracts. The lesson learned? Fund trading activity should be factored into your market perspective.

As the role of non-commercials in commodity markets has increased, so has the influence of technical trading. Less interested in supply and demand fundamentals than their traditional commercial counterparts, non-commercial traders are more focused on evaluating market trends and making trading decisions using technical analysis. Given the potential impact of funds trading in response to technical factors, it is crucial that buyers incorporate technicals into their analysis.

In our experience, while supply and demand fundamentals still drive general market trends, large spec non-commercial trading can, and does, drive trends to greater extremes, exacerbating price volatility. Some in the academic community acknowledge that the growth of funds has coincided with historically high price levels and increased price volatility, but hold that "further research is required to establish causal relationships."

Staying on the Right Side of the Market

Astute buyers realize that it does not matter what they or anyone else thinks about the market—it's what the market tells them that is important.

Purchasing decisions made on the wrong side of volatile price swings diminish your operating margins. That's why adept buyers and risk managers employ a variety of tools and methods—a hybrid approach—to monitor the diverse and dynamic price drivers influencing the cost of the products they buy and manage.

Remove emotion from decisions

Decisions shouldn't feel like rolling dice.

Companies that stay on the right side of the market share these qualities:

- They draw upon reliable information and analysis resources—either in-house or out-of-house—to stay abreast of price drivers for their ingredients and commodities.
- They do not feel like they're rolling the dice when making purchasing or risk management decisions because their decisions are based on logic-based analysis and decision models.
- Their confidence in making "objective" decisions is dependent upon removing subjectivity and emotion from buying decisions.
- They are always prepared to execute their strategy when the market "tells" them. Volatile markets do not allow time to ponder what to do.

Astute buyers realize that it does not matter what they or anyone else thinks about the market—it's what the market tells them that is important. A multidimensional and objective approach enables buyers to identify and seize market opportunities.

Always be ready to seize opportunity

Market voltility does not allow time to ponder decisions.

Unraveling market complexity and making optimal purchase decisions involves a comprehensive analysis of:

- Fundamental supply and demand scenarios, which dictate broad trends;
- Technical modeling to determine the maturity of trends and mathematically project where the market is headed, as well as anticipating how funds may be viewing the market;
- Macroeconomic indicators, which provide insight into evolving global economic conditions that influence commodity markets;
- The net positions and trends of fund trading activity.

Tracking these factors requires an investment in resources. Properly implemented and managed, these resources keep you on the right side of the market and will:

- Stabilize and improve your margins;
- Lower your average purchasing costs;
- Increase the accuracy of budget and cash flow planning;
- Enable more competitive pricing to your customers.

Component Pricing in Volatile Markets

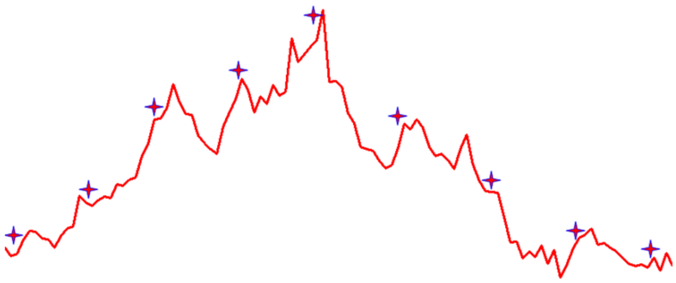
A common misconception among buyers is that the best prices can be obtained by comparing prices among various suppliers. That is true if you are comparing flat prices in the spot market. Suppliers offer the most competitive prices they can afford. But if you limit yourself to flat pricing, you preclude your ability to achieve even lower prices.

Suppliers' flat "all-in" price is an aggregate of the individual price components. Component pricing allows you to manage and price these individual segments independently and seize advantageous market opportunities. Flat pricing does not.

Buyers who employ component pricing can routinely reduce costs 10 to 20 percent.

Component pricing relies on pricing the individual price components separately—futures, basis, millfeed credits, protein premiums, etc. The most important components are futures and basis—which tend to experience an inverse relationship. The inverse nature of futures and basis means that if you flat price when futures are low, you may be locking in a higher basis; conversely, if you flat price when basis is low, you may be locking in higher futures prices. When you consider that it is not uncommon for futures prices to represent 60 to 70 percent of market risk and basis 30 to 40 percent, the contribution of these two components to your price can be significant.

Cost of Flat Pricing in the Spot Market



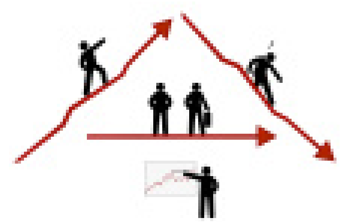
Flat price buyers typically buy in the spot market out of necessity—when they need product. Doing so, they forsake the opportunity to lock in more favorable pricing opportunities when the market presents them. Instead, as the stars show in the wheat price chart on the left—spaced at ninety-day buying intervals that many buyers follow—the cost of flat pricing is being forced to take what the market gives them, often accepting much higher prices than necessary. Moreover, the ninety-day window is the most volatile pricing period.

Component pricing, on the other hand, allows you to lock in more optimal price and basis levels. Moreover, you can extend lower-cost coverage and avoid purchasing during the higher-volatility 90-day delivery period. Buyers who employ component pricing can routinely reduce costs 10 to 20 percent.

Developing A Market Perspective

There is one key prerequisite for component pricing to keep buyers on "the right side of the market:" developing an objective perspective using logic-based analysis. This takes emotion out of the decision process. Moreover, your market intelligence and perspective must stay current. Today's volatile market environment does not give you time to ponder decisions. You must be aware of and prepared to seize opportunities when the market offers them.

Develop a market perspective



If you don't know where you're going…you'll end up on the wrong side of the market.

Suppliers offer the most competitive prices they can afford. But if you limit yourself to flat pricing, you preclude your ability to achieve even lower prices.

It is imperative that you maintain your own independent market perspective. Do not depend on suppliers to provide advice. They are not in the advisory business and cannot afford the inherent risks of recommending decisions regarding price levels, market timing or extended coverage. A mark of a good supplier is they are willing to lock in futures, basis, millfeed credits, etc., separately at your discretion. So while you may buy products from the same suppliers, you will initiate and control your own component pricing. Remember the inherent conflict of interests between you and supplies: suppliers are in the business to sell as high as they can; you need to buy as low as you can. Achieving lower prices stems from pricing individual components.

Your ability to leverage market opportunities is also contingent upon having an overall strategy. The combination of a clear strategy and objective market perspective enables you to respond swiftly to opportunities that will satisfy your specific needs.

Summary

You will achieve significantly better results with your ingredient and commodity procurement program when you:

- **Develop an objective market perspective and strategy**. If you don't know where you're going, you'll end up on the wrong side of the market.
- **Remove emotion for your purchasing decisions.** It shouldn't feel like you're rolling the dice.
- **Always be ready to seize opportunity.** Market volatility does not allow time to ponder decisions.

Some companies successfully implement component pricing using in-house resources. Many depend on the help of outside services that provide market analysis, guide the development of strategies, and provide pricing recommendations. Still others use a complementary combination of in-house and outside resources.

The benefits of component pricing can be significant:

- Improved margins;
- Lower average ingredient and commodity prices;
- More competitive pricing to customers;
- Greater stability of cash flows;
- Improved accuracy of budgeting and cash flow projections.

The value of outside services is greatly enhanced if you understand the process and tools being used. Good training improves the value of brokerage, procurement and risk management consulting services. Training programs can also improve the ability to articulate risk management recommendations to senior management and subsequently present results. Finding qualified training services, therefore, may well be your best first step to reduce ingredient costs and mitigate the volatility of your margins.

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