Institute of Supply Management

Managing Your Commodity Input Costs

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Moving Parts L.L.C.

Commodity

(Merriam-Webster online)

Main Entry: **com·mod·i·ty**

Pronunciation: k&-'mä-d&-tE
Function: *noun*
Etymology: Middle English *commoditee,* from Middle French *commodité,* from Latin *commoditat-, commoditas,* from *commodus*

an economic good: as

a : a product of agriculture or mining

b : an article of commerce especially when delivered for shipment <*commodities* futures>

c : a mass-produced unspecialized product

Commodity

(My definition!)

Are you in the "Commodity" business?

- Meat
  - Chicken, pork, beef
- Salad Dressings, Sauces & Shortening
- Bread Products, Wraps & Buns
- Packaging
- Manufacturing Facilities
- Transportation

Are you in the "Commodity" business?

- Meat
  - Chicken, po… b…
- Salad Dre… …ning
- Bread Products, W…
- Packaging
- Manufacturin…
- Transpo…

Grains & soybean meal

Vegetable Oil

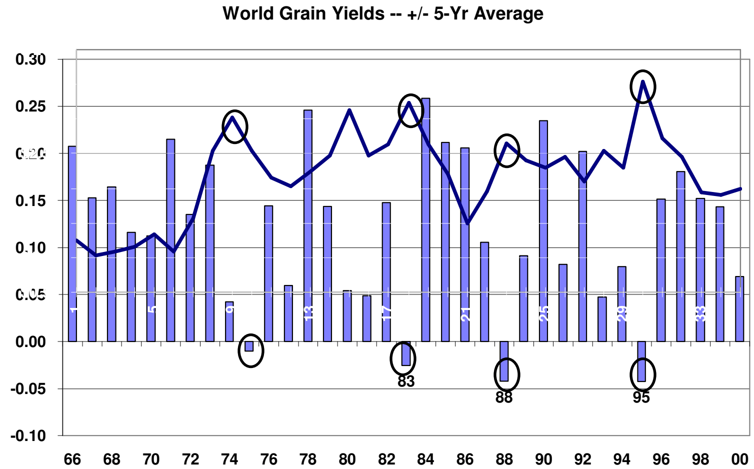
Wheat Flour

Energy

What is "Commodity Risk Management"?

- A disciplined approach to preserving our business/product margins by:
  - *Understanding our product risk profile.*
  - *Determining what we can't afford to have happen!*
  - *Determining our risk tolerance.*
  - *Utilizing available "tools" to place unwanted risk.*
  - *Measuring our results.*

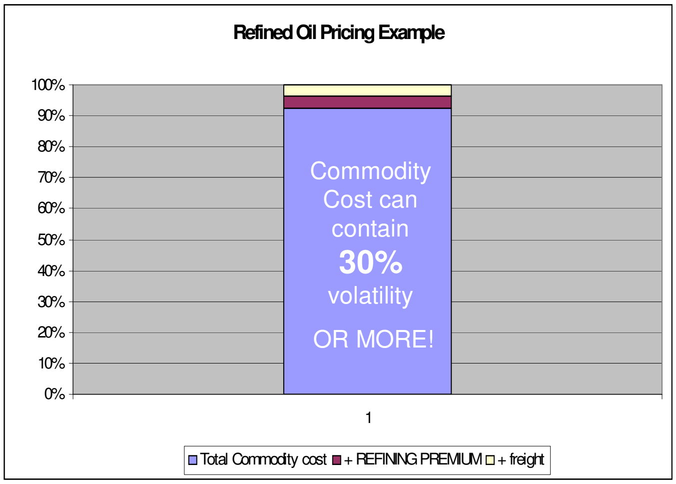
"Commodity Risk Management" is ***NOT*** out-guessing the market!



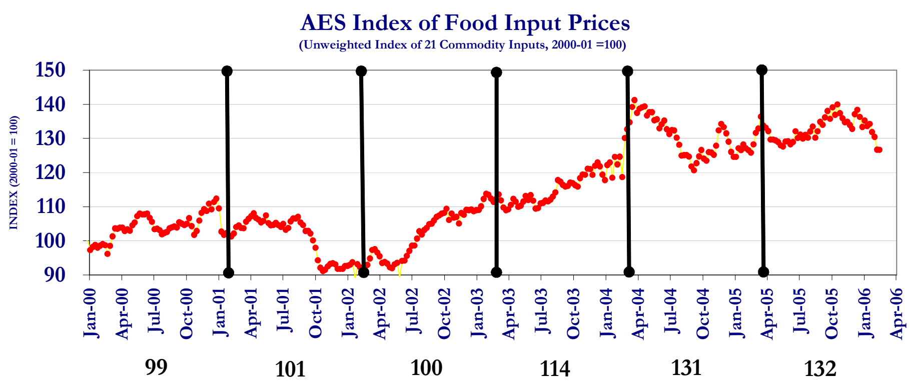
Why is Commodity Risk Management Important?

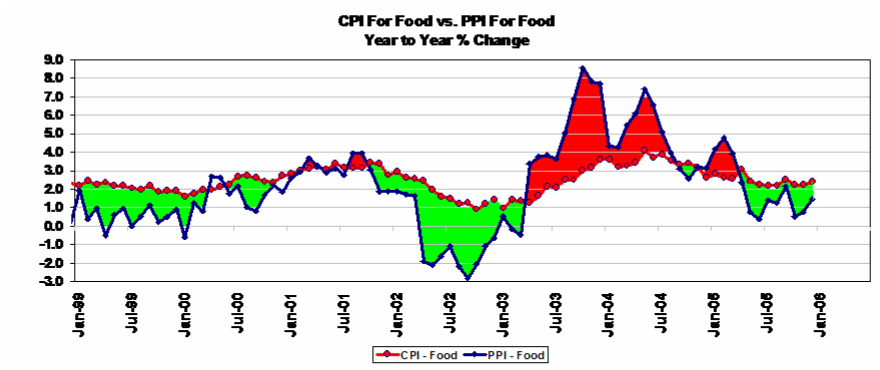
- **Margin & Profit**
  - *"Commodity's Wallop Kraft"*
    - Motley Fool July 19,2004
  - *"Food Maker Lowers Full Year Outlook"*
    - WSJ, July 19,2004
  - *"P&G, Unilever Facing Rising Prices"*
    - AP, Oct 27,2004

…………..and it is the largest and most volatile price component in many of the items you buy!



Cost Increases: ***Very Painful***





Impact of Higher Costs On A Restaurant

- Gross Margins of Typical Restaurant 5-10%
- Inputs Equal 25-30% of Revenue
- 28% Rise In Input Costs = 7-8% of Revenue
- ***Higher costs in 2003-04 Equal to More than Annual Gross Margin***

Developing and Deploying Risk Management Strategies

CORPORATE PHILOSOPHY ABOUT MARKET RISK

- **Identify Risk**
- **Risk Tolerance**
- **What can we NOT afford to have happen?**

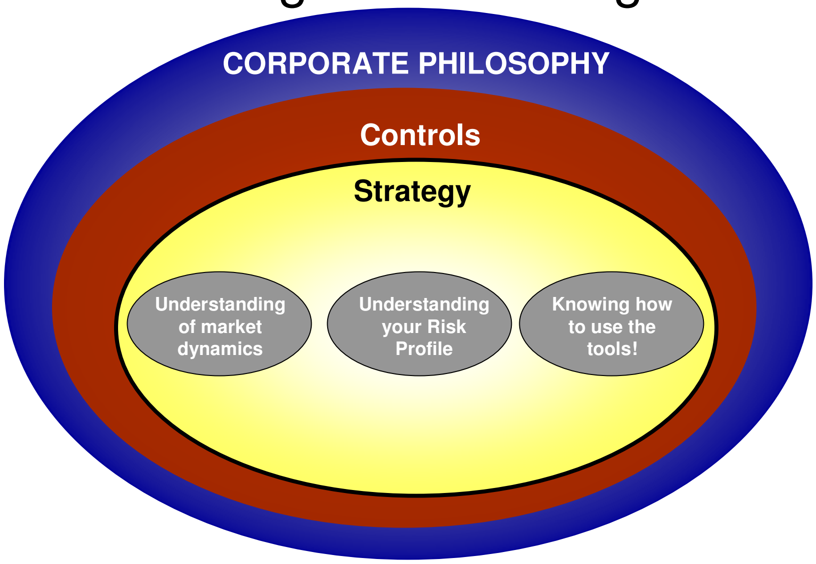
Developing and Deploying Risk Management Strategies

CORPORATE PHILOSOPHY

Controls

- **Risk Reporting**
- **Benchmarking results**
- **Systems**
- **PPV**
- **FASB-133**

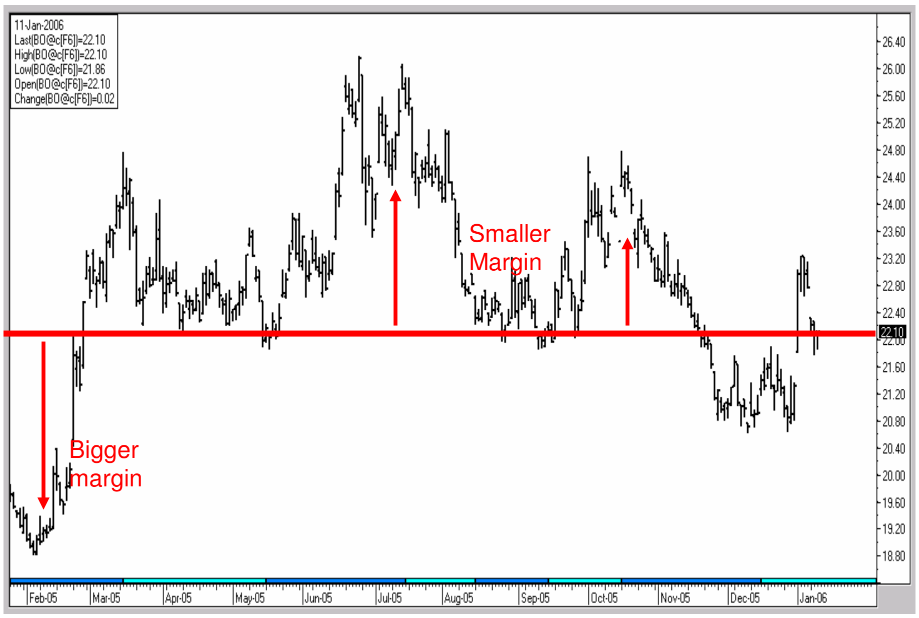
Developing and Deploying Risk Management Strategies

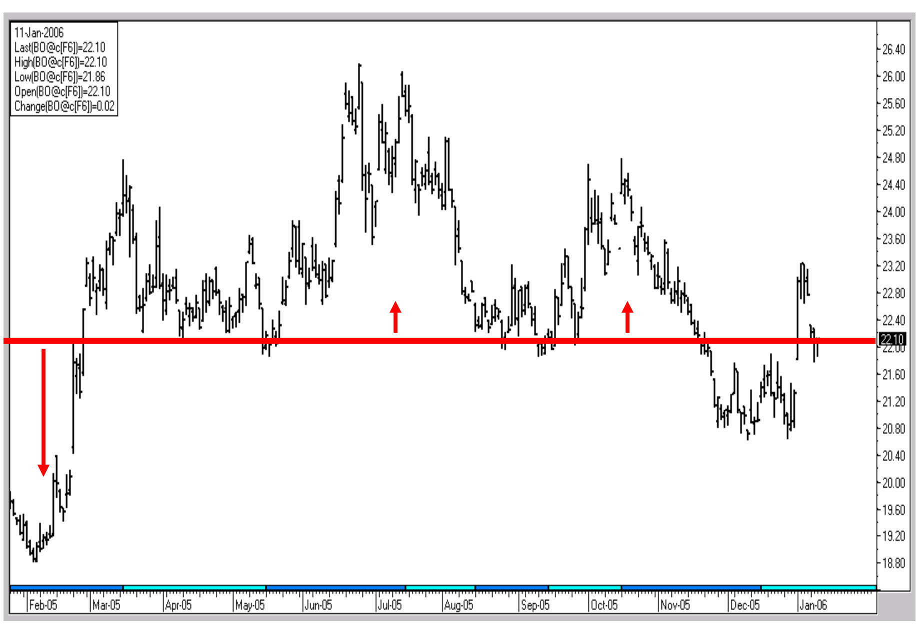


How do I manage these commodity costs?

<u>Risk Management Toolbox</u>

- Physical Purchase contract
- Inventory
- Exchange traded “Futures” contracts
- Exchange traded “Options” contracts
- “Over-the-counter” instruments


11-Jan-2006
Last(BO@c[F6])=22.10
High(BO@c[F6])=22.10
Low(BO@c[F6])=21.86
Open(BO@c[F6])=22.10
Change(BO@c[F6])=0.02
Smaller
Margin
Bigger
margin
22.10
Feb-05
Mar-05
Apr-05
May-05
Jun-05
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06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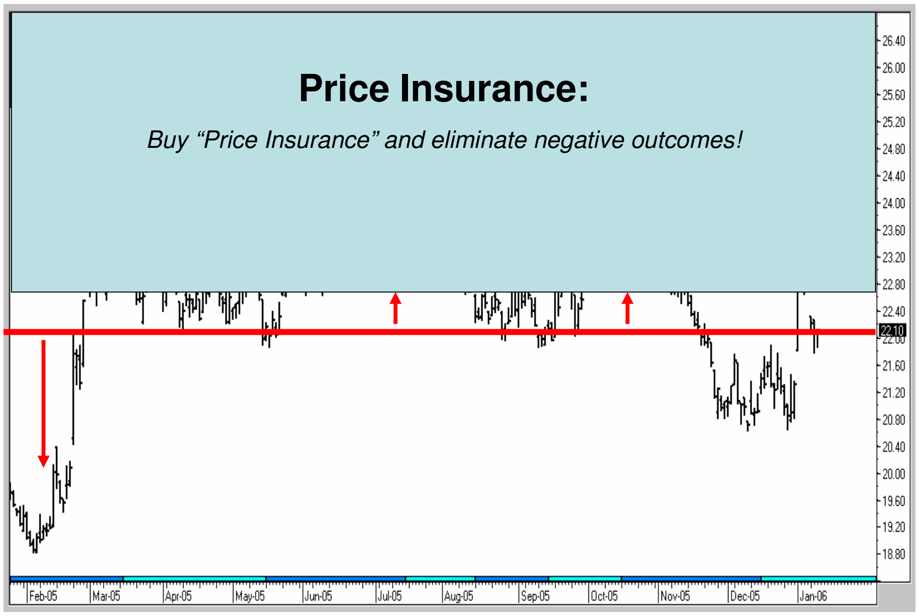

Commodity Price Risk

Different Sizes, Shapes & Flavors

Different Types of Risk & Different Market Conditions Require Different Strategies!

“How do commodity price moves affect your profitability?”

“Do you have a strategy in place to protect yourself?”

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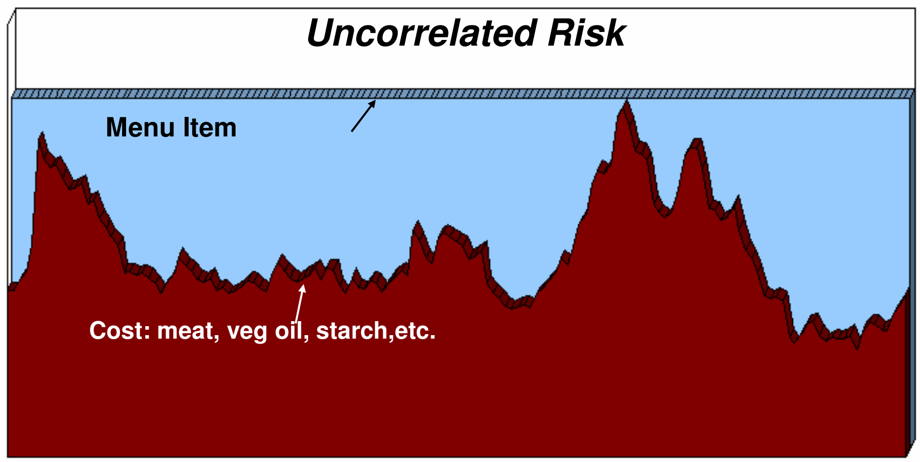
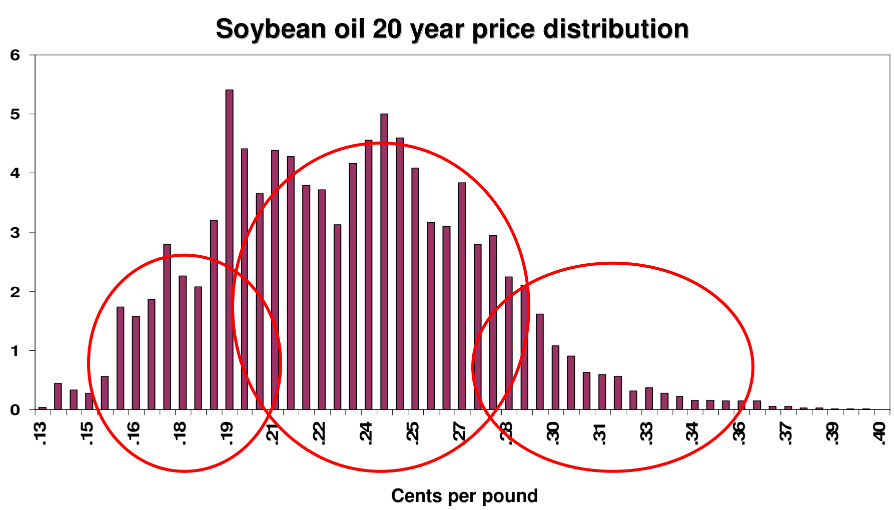


Strategy to Manage Uncorrelated Risk



Strategy Considerations for *Uncorrelated Risk*
The "First Circle": Capture Your Margin!

- Lower end of the historical price range.
  - Aggressively protect your margin.
  - Extend coverage
  - If prices continue to decline – BUY MORE!
  - Limit/eliminate price "insurance" spend.

Strategy Considerations for *Uncorrelated Risk*
The "Second Circle": Protect Your Earnings!

- Middle of the historical price range.
  - "Hold back the wave", but allow for prices to decline.
  - Use contacts containing price "insurance".
    - MAX Price
    - Boundary
    - Convertible
  - Limit actual coverage.

Strategy Considerations for *Uncorrelated Risk*
The "Third Circle": Don't make a bad situation worse!

- Upper end of the historical price range.
  - "Houston we have a problem!"
  - If we have to make a move – STAY SPOT!

- **Primary Objective:** *Not have to make a decision in this circle!*

Margin Management

vs

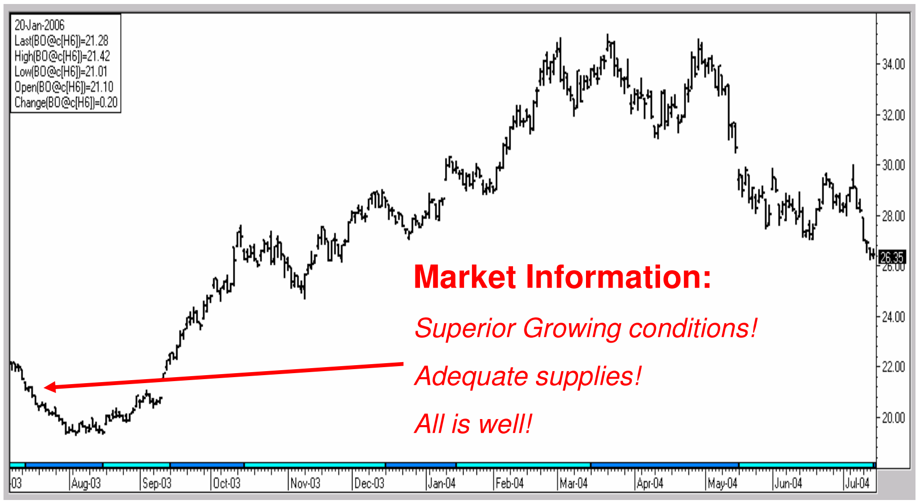
Market Based Strategy

- Market based buyers:
  - Wait on lower markets
  - "Bet" their product/business margins on an unpredictable event (in this case weather).
  - Routinely accepts "open-ended" market risk.
- Risk Managers:
  - Protects business/product margin FIRST!
  - Relies on market intell for timing and strategy development; NOT market entry!
  - Accepts ONLY quantifiable risk.

Margin Management

vs

Market Based Strategy



Risk Management

vs

Market Based Strategy

In summary…………..

- You probably ARE in the commodity biz!
  – Like it or NOT!
- Components of an effective RM Strategy!
  – Identify & quantify risk
  – Implement systems to monitor risk
  – Use your toolbox wisely!
  – Measure your results - Benchmarks
- Be a manager NOT a commodity trader!