EU-EAC MARKET ACCESS UPGRADE PROGRAMME

PRESENTATION

COFFEE PRICE RISK MANAGEMENT

TRAINING MATERIAL

Co-funded by the European Union

East African Community

JUMUIYA YA AFRIKA MASHARIKI

International Trade Centre

Coffee Price Risk Management Training Course

Moshi, Tanzania October 2021

Background

The European Union – East African Community Market Access Upgrade Programme (MARKUP) is a regional development initiative conceived by the East African Community (EAC) Secretariat in partnership with the European Union (EU) and implemented by various agencies, including the International Trade Centre (ITC) and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ). The programme is EU-funded from the Regional Indicative Programme for EAC under the 11th European Development Fund with co-funding from the German Federal Ministry for Economic Cooperation and Development.

MARKUP aims to increase exports of agribusiness and horticultural products from Burundi, Kenya, Rwanda, Tanzania and Uganda and promote regional integration and access to the European market by addressing specific challenges that Small and Medium Enterprises (SMEs), Trade and Investment Support Institutions (TISIs) and policy-makers face in accessing regional and EU export markets.

Tentative Agenda

Day One: Tuesday 5th October, 2021

0830 Welcome and Registration

0900 Welcome Address by ITC

0915 Course Introduction

- **Introduction to Participants**
- **Introduction to Trainers**
- **Overview of the Course Agenda and Schedule**

0945 Session one – Understanding Coffee Trade and Its Dynamics

- **Structure of the Tanzania Value Chain**

- SWOT Analysis of the Tanzania Coffee Industry (Group work)

1030 Appreciation of the Coffee Quality Factors

- Coffee Quality Processing Methods (Primary and Secondary Processing)
- Basic Quality Analysis Tools
- Comprehension of the Conversions and Outturns at different stages of the Value Chain
- Green Coffee Grading (Coffee Adulteration, Moisture Content, and Outturn

1035 Appreciating the Declining Coffee Production (Brainstorming)

1100 COFFEE BREAK

1130 Appreciation of the Local and Regional Market Dynamics especially in the increasing Cross-border Coffee Trade
[Brainstorming Session]

1230 International Context

- Benefits and Challenges of Engaging in International Coffee Trading
- Types of Markets & their Characteristics: Niche/Specialty/Certified Markets, Conventional Markets

1330 LUNCH

1430 Session 2- International Coffee Price Discovery

- International Price Scenes
- Physical Coffee Market
- Coffee Futures Market
- The link between Physical (cash) Coffee Market and the Futures Market
- Differential

- Online Access to Futures Prices
- [Practical Session will need Laptop and Internet]

1530 COFFEE BREAK

1600 Appreciating Coffee Price Discovery in Tanzania Coffee Export Market

1. Price Discovery for Direct Coffee Export
2. Price Discovery at Moshi Coffee Auction

[Group Discussion on Pros and Cons of each System]

1645 End of Day One Conclusions

Day Two: Wednesday 6th October, 2021

0830 Recap of Day One

0900 Session Three – Key Elements of Coffee Business and Trading Management

- What does a Coffee Trading Business look like in terms of Staffing Structure, Business Functions and Process Flow
- Tools for Coffee Trading

How to use the Tools for Coffee Trading (Practical two-Laptop)

- Traders' Tools
- Processing Tools
- Inventory Control Tools

1100 COFFEE BREAK

1130 How to use Tools for Coffee Trading Continued (Practical one-Laptop)

- Production Manager
- Finance/Accounting Manager
- Logistics Manager

1300 LUNCH

1400 Developing a Business Strategy for the Coffee Company

1500 COFFEE BREAK

1530 Overlooked Costs in the Coffee Trade

1545 Benefits of Participating in Downstream Coffee Trade

1600 Biological Break

1615 Session Four – Understanding and Appreciation of Coffee Price Risk Management

- Definition of Key Terminologies in Coffee Risk Management
- The different Risks in Coffee Trading
- Defining Price Risk and how it is created in Coffee Trading

1655 End of Day Conclusion

Day Three: Thursday 7th October, 2012

0830 Recap of day two

0845 Session Four – Understanding and Appreciation of Coffee Price Risk Management Continued

Coffee Price Risk Assessment

- Inventory/Stock Analysis (Long/Short Position)
- Purchase Pricing Calculation / Breakeven Analysis (Laptop)
- Sales Contract Profitability Analysis

1100 COFFEE BREAK

1130 Risk Management using Physical Coffee Trading

- Determining Price to Fix for buying and selling Coffee
- Back to back Operations for Fixed-price Forward Contracts
- Back to back Operations for other Structured Forward Contracts
- Benefits and Risks of each type of Contract
- How and when to use the different Contracts to manage Price Risk

1300 LUNCH

1400 Business Profitability Position and Risk Analysis

- Business Position Analysis
- Business Position Analysis Uses

1530 COFFEE BREAK

1600 Limitations of Physical Coffee Trading Strategy for Price Risk Management in Moshi Coffee Auction (Group Discussion)

1645 Income Risk Management through Portfolio Diversification

1700 End of Day Three Conclusion

Day Four: Friday 8th October, 2021

830 Exercise Review

0900 Session Five – Coffee Trade Finance

- **Appreciation of Trade Finance**
- **Sources of Trade Finance**
- **Types of Financing**

1100 COFFEE BREAK

1130 Session Five – Coffee Trade Finance Continued

- **Trade Finance Payment Methods**
- **The specific need for Trade Finance**
- **Benefits and Risks of each type of Trade Finance**
- **What to do when a Coffee Trader is unable to pay back a Loan?**

1300 LUNCH

1400 Revision and Rap up of the Training

1500 COFFEE BREAK

1530 Training Evaluation

1700 Closure

Note: Times for each module are indicative times only. The course tutors may vary periods depending upon the needs and requirements of the attendees

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Understanding and Appreciating Coffee Trade and Its Dynamics

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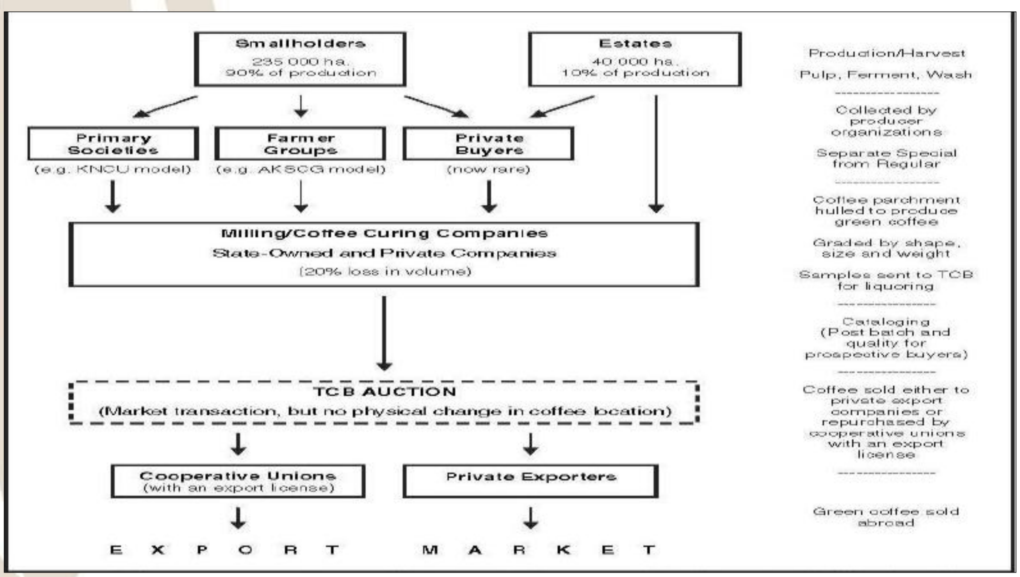
The Tanzania Coffee Value Chain



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Group Work

Identification and Analysis of Opportunities and Obstacles:

Undertake a SWOT analysis of the coffee industry in Tanzania

3

Appreciation of Quality Factors

A. Coffee Quality Processing Methods

B. Basic Quality Analysis Tools

C. Comprehension of Conversions and Out-turns

D. Green Coffee Grading

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A. Coffee Quality Processing Methods

- **Primary processing**
  - Dry – Maganda
  - Wet - Parchment
- **Secondary Processing**
  - Hulling
  - Cleaning
  - Grading

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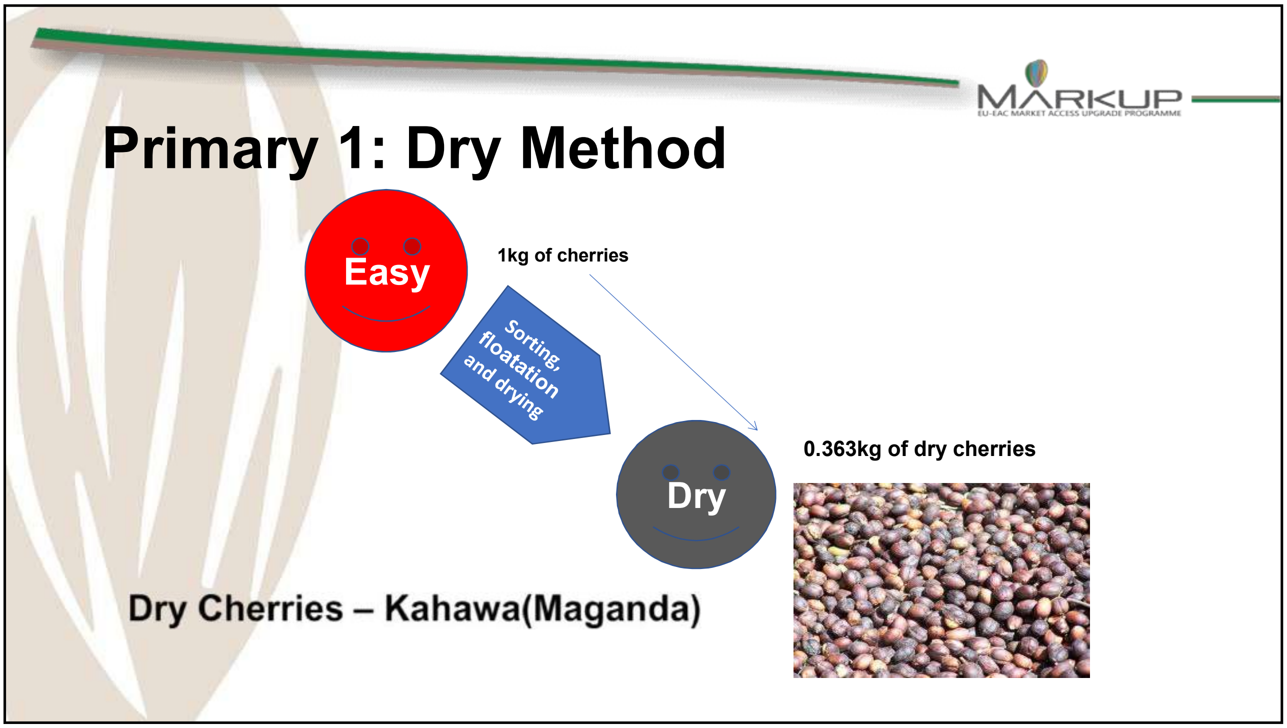
Choosing Primary Processing Method

- Depends on:
- Availability of water
- Sun shine
- Labour

Both if correctly done give unique qualities


MARKUP
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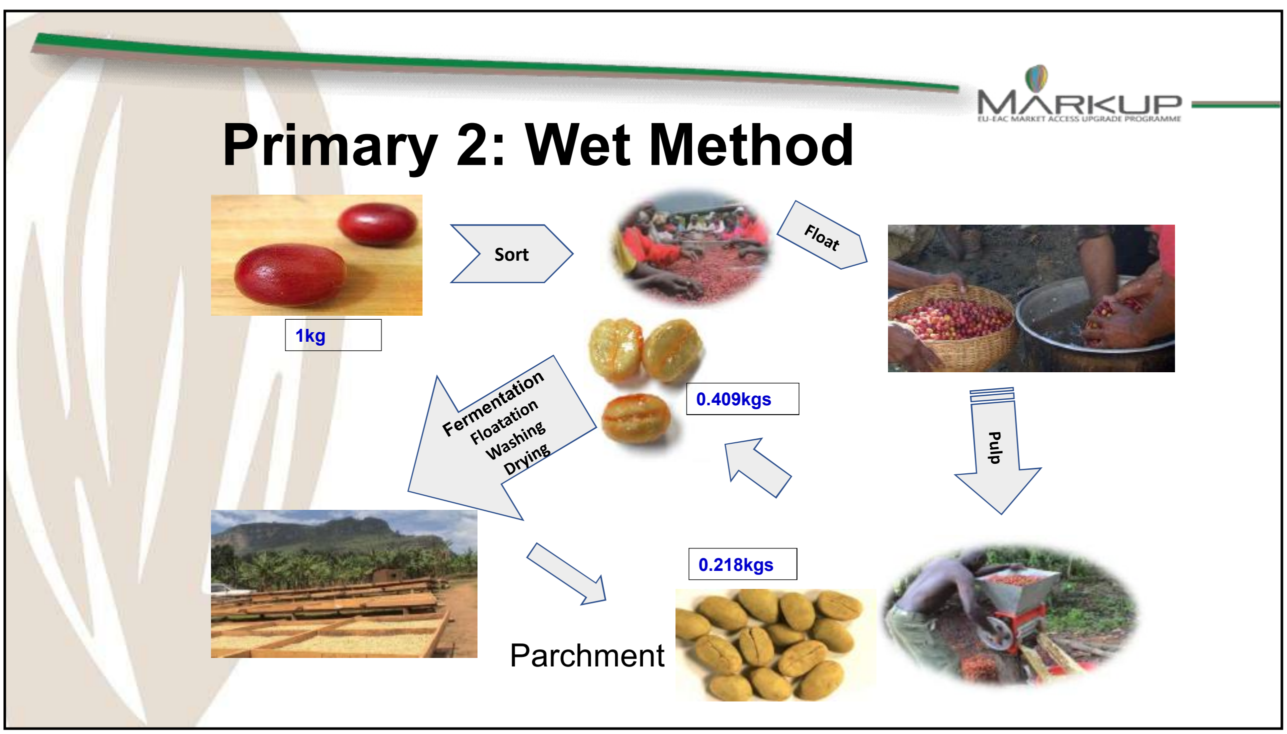
Primary 1: Dry Method
Easy
1kg of cherries
Sorting, floatation and drying
Dry
0.363kg of dry cherries
Dry Cherries – Kahawa(Maganda)


MARKUP
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Primary 2: Wet Method
1kg
Sort
Float
Pulp
0.409kgs
Fermentation
Floatation
Washing
Drying
0.218kgs
Parchment

Primary Processing Products

Dry Method	**•Natural**
Wet Method	**•Washed**

Secondary Processing

- The Dry Cherries or Parchment are:
- **Hulled**
- **Graded**
  - Density
  - Size
  - Shape
- **Cleaned**
  - Removal of Imperfections

Hulling

- Pre-cleaning
- Grading
- Hulling
- Catadoring
- FAQ

Grading

- Pre-cleaning
- Classification
- Catadoring
- Grades

Cleaning

- Gravity Table
- Color Sorting
- Hand picking

B. Basic Quality Analysis Tools

- Sampling pipe
- Weighing Scale
- Moisture Meter
- Sample huller
- Grading Screens

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C. Conversion and Out turns

1kg

0.50kg

1kg

0.80kg

C. Conversion and Out Turns

F.A.Q

X 0.8

Parchment

X 0.222

Red coffee cherries

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Conversion factors in Red Cherries

- **Weight of red cherries times 0.222 to get the weight of Dry parchment**
- **Example**
- A farmer having 10,000kgs of red cherries will end up with 10,000 X 0.222kg s of dry parchment = 2,220kg
- **Weight of red cherries times 1.18 to get the weight of green (hulled) coffee**
- **Example**
- A farmer having 10,000kgs of red cherries will end up with 10,000 X 0.18kg s of green coffee = 1,800kg

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Conversion factors Green

- **Weight of green times 5.56 to get the weight red cherries needed**
- **Example**
- For a farmer to get 10,000kgs of green it will need 10,000 X 5.56kg s of red cherries = 55,600kg
- **Weight of green times 1.25 to get the weight Dry parchment needed**
- **Example**
- For a farmer to get 10,000kgs of green it will need 10,000 X 1.25kg s of parchment = 12,500kg

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INVISIBLE LOSSES

- **Pre-Harvest Loss**
  - Drop offs before harvest, caused by delays in harvesting the red cherries.
- **Harvest Loss**
  - Picking unripe cherries/Green cherries which generates big amounts of floats
- **Post Harvest Handling (PHH) Loss**
  - Poor storage facilities and poor drying method

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Tanzanian Coffee Bean Grades

- AA -Screens: 17 and 18 = 7.2 mm
- AB-Screens: 15 and 16 = 6.6 mm
- C - Screens: 14 and 15
- PB - Pea berries
- Rob-extra: Screen 18-7.1mm
- Rob-superior(Screen 16)-6.35mm
- Rob- FAQ(Screen 14)-5.5mm
- Rob-ug(under grade)-screen12)-4.75mm

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Green Coffee Adulteration: -Foreign Matter

Characteristics

- None coffee material

Origin

- Improper selection during picking and adulteration

Effect on cup

- Various off-flavours

Appreciation of the Declining Coffee Production

- Environmental factors
- Storage life
- Regulations and rule
- Economic factors

[Brainstorming Session]

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Local and Regional Market Dynamics

Appreciation of the local and regional market dynamics especially in the increasing cross-border coffee trade

[Brainstorming Session]

- Is there any coffee trade across the boarder(Kenya, Uganda, Burundi,Rwanda)?
- If yes, why that direction?
- Why Tanzania and other countries and not the other way?

Factors for cross border Trade

- Price
- Payment lag
- Value addition(blend)
- Quality issues- Bulking
- Perception of origin- Premium

Types of markets & their characteristics: Niche/Specialty/ certified markets, conventional markets

- Well handled in the Online Videos
- Revision

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Questions - Compliments

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Coffee Break

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Thank you!

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International Pricing Scene

There is no single price for ‘coffee’ because coffee is not a homogeneous product.

The international coffee-pricing scene can be divided up as follows:

Physicals - prices for green or physical coffee.

Futures - that project prices forward for standard qualities.

Differentials – a system linking physical prices to futures prices.

Physical Coffee Market

Pricing in the Physical Coffee Market

- Day-to-day **physical [cash] coffee market** prices are determined by supply and demand.
- Participants buy and sell physical, green coffee of different qualities that will be delivered either immediately or promptly.
- **Price** setting criteria are mostly **quality**, and **availability**
- The cash price for the physical coffee is the the current local price for the **quality** in question

Participants in the Physical Market

- **Cash price** = price now for coffee (by trading the physical product for immediate or prompt delivery)
- In physical contracts, the principal market agents are exporters (sellers) and importers (buyers).
- Others are auxiliary agents such as brokers, trading houses, agents, shipping companies, among others.

Coffee Futures Market

Price Discovery in the Coffee Futures Market

- In the **coffee futures market,** participants buy and sell *a price* for a standard quality of coffee.
  - The futures transaction centres around anticipating the price of coffee at a certain point in the future and bidding on it in an open auction.
  - The futures price is the **price** one expects to pay, or receive, for coffee at a specific future **date**.
  - Its standardization allows market participants to focus on the price and the choice of contract month
- **Futures price** = expected price for coffee (by trading the different positions of the futures contract)

Forward Physical Coffee Contracts are NOT Coffee Futures Contract

- Buying green coffee now for later delivery is known as forward contract

ITS NOT THE SAME AS

- …. A Coffee futures Contract

- Forward Contracts cover physical trade of green coffee

Futures Market / Commodity Exchange / Terminal Market

All these terms mean the same thing;…

…. a market where futures contracts are traded.

Role of Commodity Coffee Exchanges in International Coffee Price Discovery

- The exchange is an organised market place that provides and operates the facilities for coffee trading; establishes, monitors and enforces trading rules and stores and disseminates trading data
- The exchange doesn't set prices or participates in coffee price determination but it ….
- Supports **PRICE DISCOVERY**, price dissemination and price quality

The Coffee Futures Exchanges and Price Discovery Transparency – HOW? 1

- There are 2 main coffee futures markets; Intercontinental Exchange in New York for Arabica and another in London for Robusta
- The futures prices that serve as benchmarks for the global coffee industry are openly derived at the coffee exchanges
- The exchanges establish a visible, free-market setting for trading future coffee contracts which supports the coffee industry to find a market price for the coffee and disseminate it worldwide

The Coffee Futures Exchanges and Price Discovery Transparency – HOW? 2

- The futures price are driven by the state of supply and demand for an average grade of widely available deliverable coffee (that is, of all the tenderable origins)
- Continuous availability of pricing information allows bigger market participation & optimal pricing quality
- More buyers and sellers in place mean better liquidity and therefore better pricing opportunities
- Futures markets have many buyers & sellers with competing price goals

The Coffee Futures Exchanges and Price Discovery Transparency – HOW? 3

- The high participation ensures a high turnover enough to permit the buying and selling of contracts at a moments notice without DIRECT price distortion
- Large transaction volume provide liquidity to the market and enables traders to pick the most appropriate contract month corresponding to the physical delivery commitments
- More bids to buy and offers to sell in the market at any given time create greater pricing efficiency for the participants

Activities of Speculators at the Commodity Exchange

- Some participants on the exchange buy or sell futures contracts with an expectation of making a profit on its future market value
- The speculators are necessary to provide liquidity at the futures market to mitigate undue price distortions
- Speculators business is usually between 10-20% though can reach 30% in a few times
- Typical speculators are commodity funds, hedge funds, fund managers, index funds, high velocity traders and non professional speculators

Link Between Physical [Cash] Coffee Market & the Coffee Futures Market Prices

- The prices from the two markets are complimentary
- Price is discovered first in the futures market and transferred to the cash market.
- Physical [cash] coffee markets use the futures prices as reference point /basis for price determination and negotiation
- The large volumes on the futures market not only affect futures prices, but inevitably have an influence on the physical coffee prices as well
- Very few futures contracts actually lead to physical coffee exchange
- Most futures contract purchases are matched by offsetting sales and vice versa and no physical delivery takes place

Group Discussion

Appreciating coffee price discovery in Tanzania coffee export market

- Pros and Cons

1. Direct Export (Group 1)
2. Moshi Coffee Auction (Group 2)

Differentials

Futures Coffee Price and the Differentials

- The futures price represents an average range of qualities and is, therefore, an average price
- Coffee is not a homogeneous product and producers receive different prices
- Each parcel of coffee is unique with regard to its characteristics, flavour and quality and hence attracts a different price.
- The physical premium or discount, the **differential**, represents the value (plus or minus) the market attaches to such a coffee compared to the futures market.
- **This price differential can reflect local physical market conditions, as well as coffee quality and grade.**
- **The differential is therefore the more accurate determinant of price for a particular coffee (Quality and Grade) because the underlying futures price is an average**
- Consequently the bulk of the coffee trade is conducted on what is known as a ‘price differential’ or ‘price to be fixed’ basis.
- This involves the buying and selling of coffee with the price expressed as a differential to the futures market,

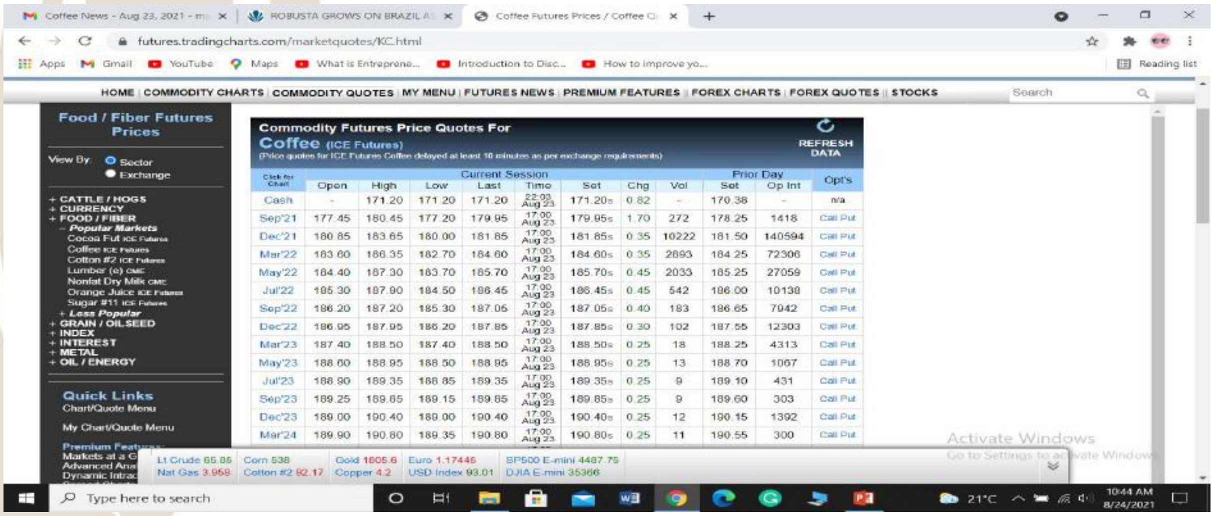
Access to Futures Market

The Two Main Futures Exchanges for Coffee at a Glance

	ICE 'C' CONTRACT	LIFFE ROBUSTA CONTRACT
Where	New York	London
Trading Hours [GMT]	08.30 – 19.00	09.30 – 17.30
Size of one lot	37,500lbs / 17 tonnes	10 tonnes
Price Quotation/Unit	US cts/lb	USD/tonnes
Delivery Months	Mar, May, July, Sep, Dec	Jan, Mar, May, July, Sep, Nov
Physical Settlement	Certain quality of washed Arabica coffee from 19 specified countries, Brazil was added in 2013	Certain quality of Robusta coffee from any country

Coffee ICE Futures Price Quotes

http://futures.tradingcharts.com/marketquotes/KC.html



Commodity Futures Price Quotes For
Coffee (ICE Futures)
(Price quotes for ICE Futures Coffee delayed at least 10 minutes as per exchange requirements)

Click for Chart	Current Session								Prior Day		Opt's
	Open	High	Low	Last	Time	Set	Chg	Vol	Set	Op Int	
Cash	-	171.20	171.20	171.20	22:03 Aug 23	171.20s	0.82	-	170.38	-	n/a
Sep'21	177.45	180.45	177.20	179.95	17:00 Aug 23	179.95s	1.70	272	178.25	1418	Call Put
Dec'21	180.85	183.65	180.00	181.85	17:00 Aug 23	181.85s	0.35	10222	181.50	140594	Call Put
Mar'22	183.60	186.35	182.70	184.60	17:00 Aug 23	184.60s	0.35	2893	184.25	72306	Call Put
May'22	184.40	187.30	183.70	185.70	17:00 Aug 23	185.70s	0.45	2033	185.25	27059	Call Put
Jul'22	185.30	187.90	184.50	186.45	17:00 Aug 23	186.45s	0.45	542	186.00	10138	Call Put
Sep'22	186.20	187.20	185.30	187.05	17:00 Aug 23	187.05s	0.40	183	186.65	7942	Call Put
Dec'22	186.95	187.95	186.20	187.85	17:00 Aug 23	187.85s	0.30	102	187.55	12303	Call Put
Mar'23	187.40	188.50	187.40	188.50	17:00 Aug 23	188.50s	0.25	18	188.25	4313	Call Put
May'23	188.60	188.95	188.50	188.95	17:00 Aug 23	188.95s	0.25	13	188.70	1067	Call Put
Jul'23	188.90	189.35	188.85	189.35	17:00 Aug 23	189.35s	0.25	9	189.10	431	Call Put
Sep'23	189.25	189.85	189.15	189.85	17:00 Aug 23	189.85s	0.25	9	189.60	303	Call Put
Dec'23	189.00	190.40	189.00	190.40	17:00 Aug 23	190.40s	0.25	12	190.15	1392	Call Put
Mar'24	189.90	190.80	189.35	190.80	17:00 Aug 23	190.80s	0.25	11	190.55	300	Call Put

Thank you!

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General Key elements of Coffee Business and Trading Management

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What does a coffee trading business look like?

We consider:

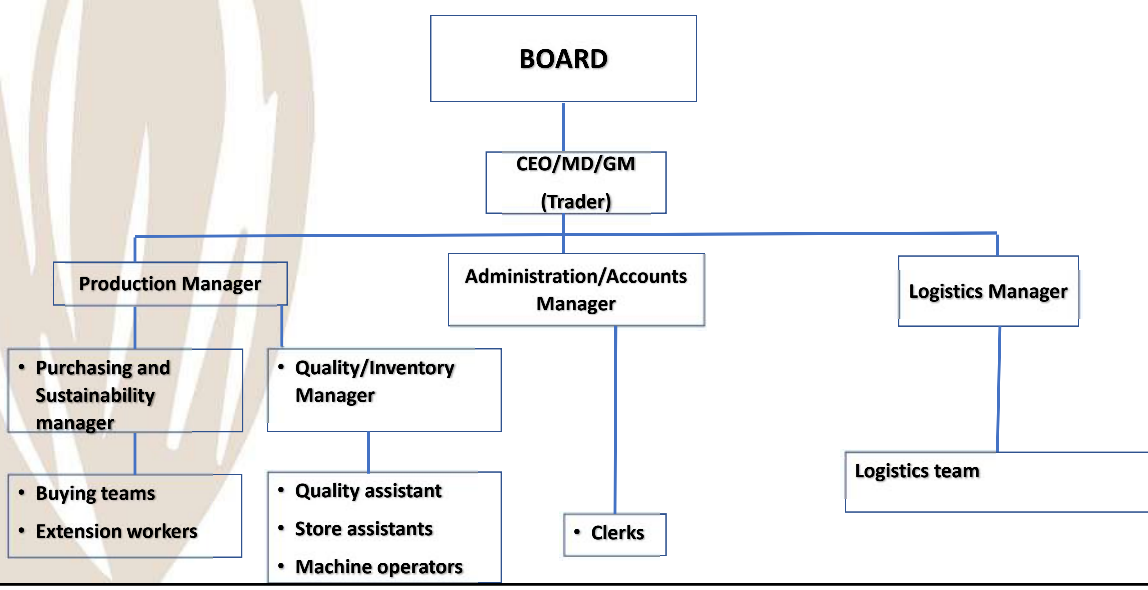
- Staffing Structure,

- Business Organogram

Staffing Structure

- Trader (CEO/ MD/GM)
- Production Manager
  - Purchasing and Sustainability Manager
  - The Quality/Inventory Controller
- Administration/ Accounts Manager
- Marketing/Logistics Manager
- Support staff

Business Organogram



Board

Responsible for:

- Policy making
- Overseeing performance
- Approving the budget, cash flow and profitability target submitted by management

CEO/MD/GM (TRADER)

- Overall management of the company
- Profit & Loss management,
- Pricing calculation,
- Contract negotiation and management of market information,
- Central to managing relationships with buyers and suppliers (with purchasing manager)
- Manages a risk managing system
- Determines the purchasing and sales strategy based on market knowledge, supply and demand
- Signs off on all payments (Accounting officer)

Trader's Tools

- Seasonal financial and volume targets,
- Profit and Loss (P&L) analysis;
- Trading position
  - "basis" position
  - open purchase contracts
  - Stock
  - open sales
- Financial position

Production Manager

- Managing coffee production (staff and machinery)
- Liaises with Purchasing/Sustainability Manager and Quality/Inventory controller in receiving coffee for processing
- Dry/wet processing; out-turns

Processing Tool

Job cards showing:

- Input
- Output
- Grades
- Losses

The Quality/Inventory Controller

- Analysing and evaluating incoming coffees
- Monitors processing to conform to client's specifications
- Records stock movements, locations, age, and loss
- Responsible for traceability in liaison with Purchasing/Sustainability Manager

Quality Control Tools

- Protocols on discounting/premium against quality analysis for purchased coffee
- Quality control cards
- Instructions for processing
- Quality control
- Instructions for shipment

Purchasing and Sustainability Manager

- Managing farmers (organizing, training, Pre-finance, certification)
- Deliveries from farmers (timely)
- Maintains a purchasing position (Production projections)

Purchasing Tool

A contract management tool for:

- Open contracts
- Valuation
- Quality.

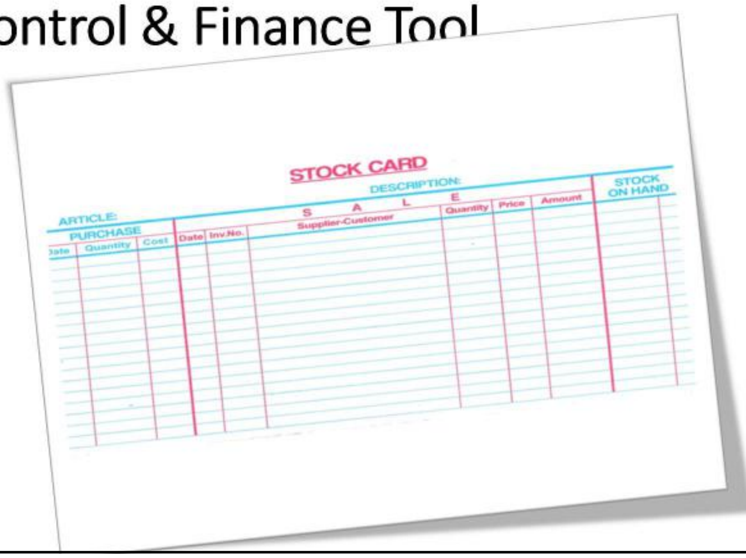
Administration/ Accounts Manager

- Valuation of stock
- Provides information to the trader for a risk management position.
- Maintains financial control over
    - cash outflows for purchasing
    - incoming finance from banks and sales.
- Human resource management

Inventory control & Finance Tool

Stock cards

- Stock movement
- Stock amount
- Valuation
- Change



STOCK CARD
ARTICLE:
DESCRIPTION:
STOCK ON HAND
PURCHASE
Date Quantity Cost
Date Inv.No.
S A L E
Supplier-Customer
Quantity Price Amount

Logistics Manager

- Monitoring specifications
- Delivery times against contract
- Transferring information to processing
- Receives the bill of lading.
- Manages documentation

Logistics

Contract management tool for:

- Open contracts,
- Specifications,
- Shipping period
- Documentation tracking

Business Strategy for a Coffee Company

Can only manage what you can measure

How do you plan to play when its comes to Volume to be Traded?

- **Big volumes come with big financing costs, risk of quality, theft**
- **Small volumes come with small profits that may not cover your costs**

Where is Your Strength Given the Experience & Resources

What Coffee are you going to Deal in?

- **Generic coffees needs big volumes/turnover to make money**
- **Specialty coffee offers high profit per transaction but not overall big profitability**

Which Will be Your Niche in the Trade?

What Services Will you Hire and Which will you Own?

- You need to know your core business and avoid getting distracted with activities you need not run like owning a gas station, fleet of vehicles, etc.
- Out Source services that you do not need all the time or whose expertise you don't have

Work Smart to Minimize Unnecessary Overhead Costs

How are you Going to Deal with the Currency Fluctuations

- You buy in Tanzania Shillings but Sell in US Dollars, exchange rates can move against you!
- Bank now fix exchange rates at a small fee for even up to 12 months

Your in Coffee Business not Speculation Fix your rates at a Profitable Rate

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Have Thought About How Your Business will be Financed?

- **Do you have equity? Or are you going to borrow?**
- **If borrowing, have you explored the least costly options**
- **Seek for innovative options like pre-financing, warehouse receipt system and the like.**

Coffee Trade Requires Big Cashflow and can be Costly, Plan?

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How do You Plan to manage the Coffee Price Fluctuations?

- **Coffee has the highest Co-efficient of variation of any Commodity in World Trading**
- **Buying coffee before knowing the selling price or selling coffee before knowing the buying price exposes you to potential loss if the price moves against you**

Where is Your Strength Given the Experience & Resources

What Coffee are you going to Deal in?

- **Generic coffees needs big volumes/turnover to make money**
- **Specialty coffee offers high profit per transaction but not overall big profitability**

Which Will be Your Niche in the Trade?

Are You Export Ready?

Domestic Success?

Production Capacity?

Financial Resources?

Management Commitment?

nternational Plan with Goals?

Know-how? (shipping & methods of payment)

Common Export Mistakes

- Lack of Export Business Plan
- Reliance on inadequate partnerships
- Failure to modify products & methods to accommodate foreign regulations and preferences

Determine Product Potential

- Examine Domestic Market Success
- Assess Unique or Important Features
- International Market Research
- Where are International Hits from on your Website? Target markets?
- Where are Your Competitors Selling?

Develop An Export Strategy

Focus Your Efforts!

- Be PRO-ACTIVE & REALISTIC about your ability to expand
- Define your resource limitations (money, personnel, and time)
- Identify a few target markets
- Evaluate target markets, customers, distribution channels
- Evaluate future profits & opportunities to expand business
- Develop an entry strategy for each market

Overlooked costs in the coffee trade

- Taxes (CESS)
- Claims from buyers
- Security
- Insurance
- Human Resources
- Cost of Money
- Delayed Sales/ Speculation
- Cost of inputs
- Sales
- Marketing
- Obstacles to Coffee Trade

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Benefits of Downstream

- **Pros**
  - Extract more value and therefore more earnings
  - Not held hostage to local conditions and buyers
  - Generate resources that can allow business growth
  - Exposure internationally with partners and buyers
  - Long term relationships locally and internationally

- **Cons**
  - Price volatility can bring big losses
  - Trading finance, access and cost is high
  - HR Management is high because of multiple variable
  - Changing trends and reformation of international trade
  - TBTs and NTBs to international trade

Thank you!

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Understanding and Appreciation of Coffee Price Risk Management

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- ✓We muddle through life making choices
- ✓Our choices are based on information
- ✓Most of us live with uncertainty in decision making
- ✓But what **is UNCERTAINTY** and how is it quantified?

UNCERTAINTY CREATES RISK

WHAT IS RISK

2

RISK
Exposure to potential damage that can arise because of a present process or a future event

- Statistics quantify risk through probabilities
- Risk combines the probability that a negative event will happen with an estimation of the damage that the risk will cause

RISK MANAGEMENT
Being prepared and protected against negative event in order to minimize the damage

3

Identifying Risks in Coffee

Risk is widespread in coffee trading and can include

1. **Counterparty** – default on contract
2. **Climate** - coffee production
3. **Quality/ Yield** – Coffee quality / volume
4. **Foreign Exchange Rates** – local/ US$ rates
5. **Physical** – damage or loss of coffee
6. **Regulatory Framework** – changes to the coffee sector
7. **Political** – Riots/ wars

Operating profitably depend on solid understanding, constant review and quick management of all these risks

4

Defining Price Risk

- **Price risk is the risk that earnings decline as a result a change in the level or volatility in commodity Prices**
- Coffee traders have exposure to price risk when they:-
- Fix a purchase price for coffee without having a sale price – coffee trader faces the risk of price declines
- Fix a selling price to buyers without having agreed a purchase price for the coffee – coffee trader faces the risk of price increases

5

Creating Price Risk

- Price risk for coffee trading business is influenced by:
- **Traders fixing the sales or purchase prices**
- **Time**
  - Buying or fixing a price before selling
  - Selling or fixing a sales price before buying
- **Volume**
  - Does not cause price risk but impacts on the magnitude of financial exposure

6

The Significance of Price Risk for Coffee

•Most domestic coffee markets are highly correlated to the international markets' quotations
•Changes to the international coffee prices will result in changes to the domestic coffee prices

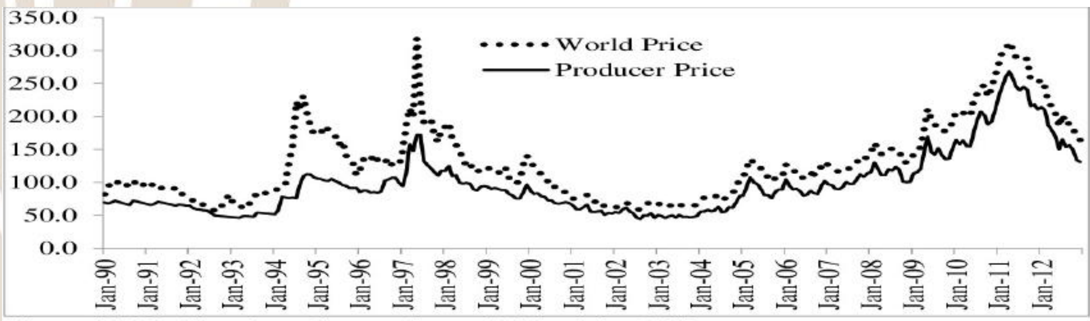


Figure 11 World and producer prices of Colombian Milds
Source: International Coffee Organization

7

World Coffee Prices - Volatility

World coffee prices are not stable but fluctuate significantly over time (sometimes sharply over a short period of time)

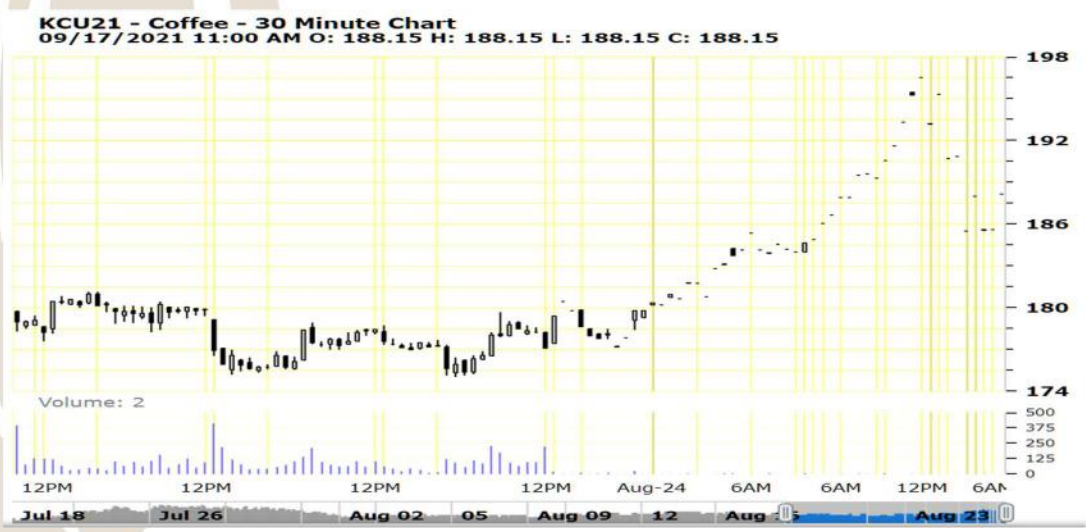
Changes in the ICO Daily Composite Indicator Price

8

Impact of Price Volatility

- World coffee prices are not stable but fluctuate significantly over time
- Most domestic coffee markets are highly correlated to the international markets' quotations
  - Any significant movement on the international coffee prices will affect the price that farmers sell for and buyers pay for
- Coffee traders who are not effectively managing their risks during the period of significant price movements generate financial losses
- As a result financial sector ends up with losses on their lending to the coffee sectors

Recent Price Volatility



Recent Price Volatility

- Recent, higher coffee prices required traders to access larger amounts of trade financing and work capital
- Intraday price vitality has increase – increasing the risk impact of adverse price movements
  a. Supply concerns-Frost in Brazil
- Recently prices have been climbing up
- The increased levels of price volatility pose significant risks to coffee traders and to the banks providing finance to them

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Has Globalisation Increased

- In the last 2 decades, many changes have taken place in the world:
- Increased competition
- Trading takes place 24 hours a day
- Markets are more volatile
- RISK is evident in every action

Do we have a risk management system that is adequate to coping with the new environment?

12

Risk Management Requires a Change in Thinking

- **Risks can be managed with foresight.**
- **Damage can be controlled with hindsight.**
- **Your choice**

Coopers and Lybrand, L.P
Advertisement in *The Wall Street Journal*
December 7, 1995

13

Transfering Risk

- Is there any way to transfer risk, such that impact and incidence of risk event are on different people?
- This is called risk transfer
  a. From person who is affected by the risk, but cannot bear its effect
  b. To person who may not be affected directly by the risk, but is willing and able to bear its effect
  c. Person taking the risk will want return, in exchange for taking over the risk
  d. Higher the risk, higher the expected return
- This is the basis of risk management

Summary of Section

1. Price risk is just one of many risks facing a coffee trading business
2. Price risk is created when a trader either buys coffee before selling or sells coffee before buying it
3. Price is driven by movement in the international price of coffee – driven by global coffee supply and demand
4. During periods of price volatility coffee traders with exposure may be impacted – and face significant financial losses

Coffee Price Risk Assessment

- **Section 2**

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Price Risk Assessment

- Risk assessment is the process of identifying risk and quantifying the financial exposure

1. **Inventory/Stock Analysis (Long/Short Position)**
2. **Purchase Pricing Calculation / Break-even Analysis**
3. **Sales Contract Profitability Analysis**
4. **Business Profitability Position and Risk Analysis**

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Inventory/Stock Analysis (Long/Short Position)

Identifying the Exposure LONG/ SHORT

NET POSITION

LONG POSITION +	SHORT POSITION -
• Purchase price is known You either own (or have an obligation to buy) the physical product at a fixed price • Sales price is unknown • **Risk is that market will move down**	• Sales price is known You either have sold or have an obligation to sell the physical product at a fixed price • Purchase price is unknown • **Risk is that market will move up**

Long and short positions can exist for an individual transaction and as the sum of the entire physical trading position.

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Short Inventory Position

Day	Inventory	Purchases	Sales	Net Physical Position (cumulative)
Monday	0	-	(5,000)	(5,000)
Tuesday	-5,000	-	(20,000)	(25,000)
Wednesday	-25,000	5,000	(20,000)	(40,000)
Thursday	-40,000	5,000		(35,000)
Friday	-35,000	10,000		(25,000)
Saturday	-25,000	15,000		(10,000)

- Short position at the end of everyday.
- The RISK is that market price of coffee will move up

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Pricing Calculation / Break-even Analysis

Pricing Calculation / Break-even Analysis

- Breakeven = covering costs
  - Fixed costs – office costs, full time staff costs
  - Variable cost – Purchase price, transport, milling
- Breakeven in terms of unit costs i.e. per Ib or ton of coffee.

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Pricing Calculations Aiming for Break-even

	Costs	Amount	Formula
a	Price to buy 1 kg of Parchment in Local Currency	2,500.00	
b	Variable Costs in Local currency	900.00	
c	Total Variable Costs in local currency	3,400.00	(a + b) = c
d	Transaction Volume in kilograms	30,000.00	
e	Total variable costs in local currency	102,000,000.00	(c × d) = e
f	Total fixed costs in local currency	5,000,000.00	
g	Total costs in local currency	107,000,000.00	(e + f) = g
h	BREAKEVEN PRICE in local currency per kilogram	3,566.67	g ÷ d = h
i	Exchange rate [1 US$ = to 2000 local currency units]	2,000.00	
j	Conversion to cts/ lb	**79.39**	(h ÷ 2.20462 ÷ i × 100) = j

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Price calculations aiming for break-even with changes in cost and in volume

	Costs	Amount	Cost change	Volume change
a	Price to buy 1 kg of Parchment in Local Currency	2,500.00	3,000.00	2,500.00
b	Variable Costs in Local currency	900.00	900.00	900.00
c	Total Variable Costs in local currency	3,400.00	3,900.00	3,400.00
d	Transaction Volume in kilograms	30,000.00	30,000.00	15,000.00
e	Total variable costs in local currency	102,000,000.00	117,000,000.00	51,000,000.00
f	Total fixed costs in local currency	5,000,000.00	5,000,000.00	5,000,000.00
g	Total costs in local currency	107,000,000.00	122,000,000.00	56,000,000.00
h	BREAK EVEN PRICE in local currency per kilogram	3,566.67	4,066.67	3,733.33
i	Exchange rate [1 US$ = to 2000 local currency units]	2,000.00	2,000.00	2,000.00
j	Conversion to cts/ lb	**79.30**	**90.52**	**83.10**

Break even Analysis and Differentials

Breakeven Costs	Cents/lb
+/- Differential	Cents/lb
Breakeven Price on the International Market (CIF/FOB/FOT/FOR/Ex-Warehouse)	X$/lb

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Sales Contract Profitability Analysis

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Sales contract value against market prices

Analyzing profit and loss against current market prices

- Market prices change everyday
- Changes in market prices affect profit and loss
- Estimate profit and loss TODAY

Sales Contract Profitability Calculation

	Costs	Amount	Formula
a	Price to Buy 1 Kilo of Parchment in Local currency	2,500.00	
b	Variable Costs in Local currency	900.00	
c	Total Variable Costs in local currency	3,400.00	(a + b) = c
d	Transaction Volume in kilograms	30,000.00	
e	Total variable costs in local currency	102,000,000.00	c × d = e
f	Total fixed costs in local currency	5,000,000.00	
g	Total costs in local currency	107,000,000.00	(e + f) = g
h	BREAK EVEN PRICE in local currency	3,566.67	g ÷ d = h
i	Exchange rate [1 US$ = to 2000 local currency units]	2,000.00	
j	Conversion to cts/ lb	80.89	(h ÷ 2.20462 ÷ i × 100) = j
k	Current Market Price	80.21	
l	Difference	(0.68)	(k - j) = l
m	**SALES CONTRACT PROFIT & LOSS**	**(9,263.30)**	**(l × d) / 2.20462**

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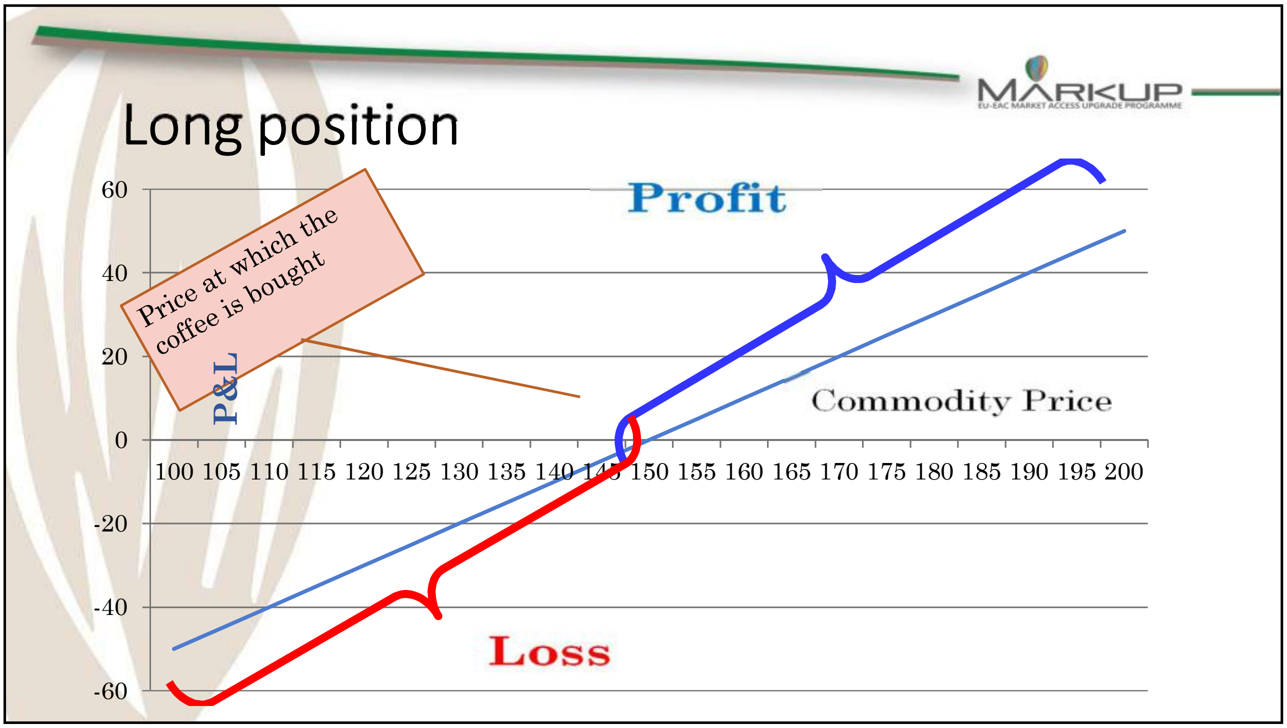
Sales Contract with International Prices Lower than Break even Costs

Breakeven Price on International Market	1.65/Ib
Current Market Price	1.55/Ib
Difference	(0.10)/Ib
Volume	30,000Ibs
Sales Contract Profit/Loss	($3,000)

Sales Contract with International Prices higher than Break even Costs

Breakeven Price on International Market	1.65/Ib
Current Market Price	1.85/Ib
Difference	0.20/Ib
Volume	30,000Ibs
Sales contract Profit/Loss	$6,000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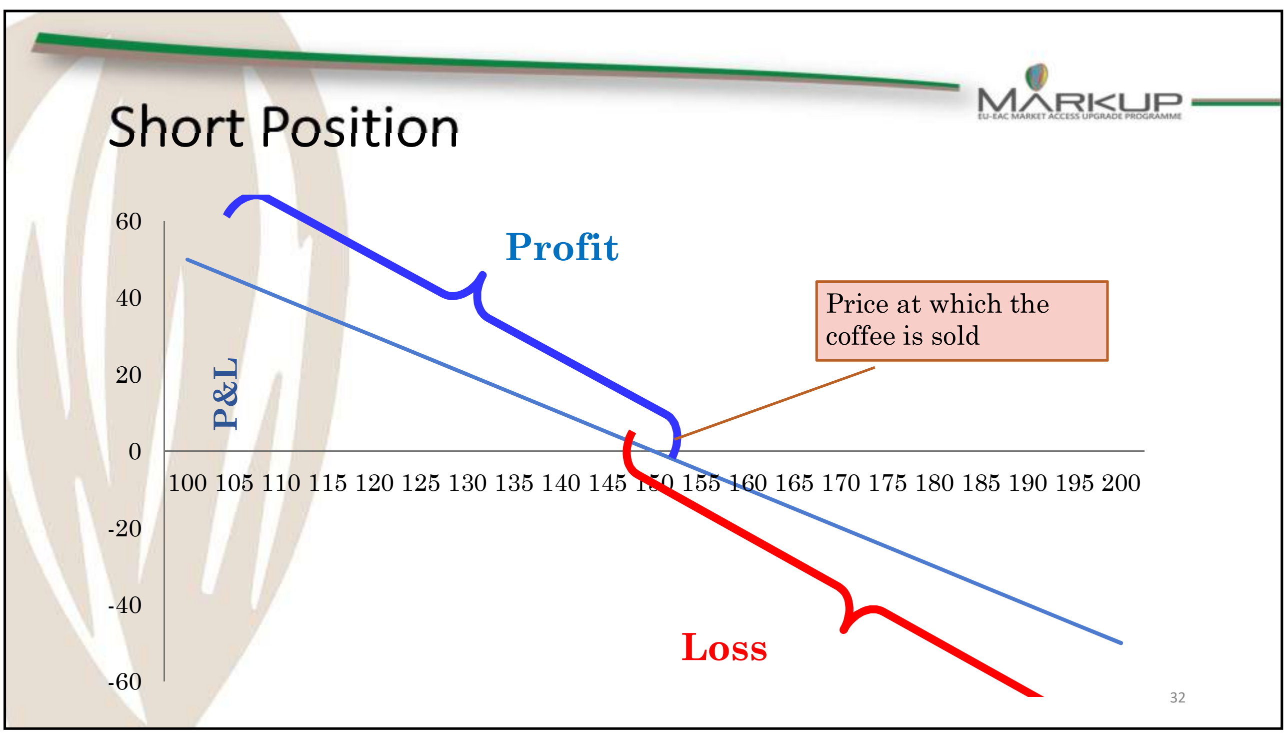
Long position
Profit
Price at which the coffee is bought
P&L
Commodity Price
Loss
60
40
20
0
-20
-40
-60
100 105 110 115 120 125 130 135 140 145 150 155 160 165 170 175 180 185 190 195 200


MARKUP
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Short Position
Profit
Price at which the coffee is sold
P&L
Loss
60
40
20
0
-20
-40
-60
100 105 110 115 120 125 130 135 140 145 150 155 160 165 170 175 180 185 190 195 200
32

Business Profitability Position and Risk Analysis

Business Position Analysis

1. It is a regular (daily or weekly) evaluation of the business profitability and risk level
2. Helps to guide decisions on trading
3. Based on the concept of "if I were to sell the business today, what would it be worth".
4. Takes into account all physical positions and values against the futures prices adjusted for specific values (ie, for different grades)
5. It is a theoretical "dashboard" and not actual. Actual positions are realized through monthly accounting/P&L reports

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Business Position Analysis Uses

1. Profitability tracking
   - It provides a a dynamic and ongoing basis upon which purchasing and sales decision can be made. This is important for volatile daily market changes both local and international
   - For example,
     - if one has many open purchases (commitments to buy), good level of stock and few open sales – in a declining market price to maintain expected profitability, one might decide to stop buying or to lock in sales contracts asap to lock in prices and profitabiltiy .
     - Or in the same position but in a strengthening market price, one might decide to hold off committing to new contracts or at least be firm in contract price negotiations, in the expectation of improving opportunities in contract prices.

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Business Position Analysis Uses

2. Risk level tracking
   - A the market prices vary with volatility, one can track how comfortable they are in risk exposure.
   - For example
     - again with many open purchases and good stock level but few open sales in a declining market – one might decide not to enter too quickly into new sales despite the entry into a "loss" position as you might expect prices to soon rebound. One may also negotiate to liqudate open purchase commitments. It depend on ones tolerance of exposure to risk of loss.

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Business Position Analysis Uses

2. Risk level tracking
   - Using the same position (many open purchases, good stock, few sales) and in an increasing market, one might see the profitability rising and instead of locking in a good level of profit by securing new sales at new, higher prices, decide to wait for ever more increasing market – the risk being that the market suddenly reverses and the chance is missed. It depends on the risk appetite.

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Exercise and Case Study

KCU and KNCU

Physical Strategy for Coffee Price Risk Management

- **Section 3**

Risk Management Strategies for Coffee Farmers…

Ordinary Farmer (No Strategy)

Season State	No. Hectares	Production cost	Productivity per hectare	Unit cost of production per kg	Price	Total income
Good price	5	1,460,250	550kg	531	2,000	5,500,000
Very low price	5	1,460,250	550kg	531	500	1,375,000
KEY	**A**	**B**	**C**	**D = B/(A x C)**	**E**	**F**

Risk Management Strategies for Coffee Farmers…

Progressive Farmer (Mitigating with Productivity)

Season State	No. Hectares	Production cost	Productivity per hectare	Unit cost of production per kg	Price	Total income
Good price	5	3,652,000	2,200kg	332	2,000	22,000,000
Very low price	5	3,652,000	2,200kg	332	2,000	5,500,000
KEY	**A**	**B**	**C**	**D = B/(A x C)**	**E**	**F**

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Buy and Hold Strategy

If coffee prices rise

	lbs	Period	Price cts/lb
BUY	25,000	JULY	140.00
SELL	25,000	OCTOBER	180.00
PROFIT or LOSS			40.00
END Result		**Profit**	**$10,000**

If coffee prices fall

	lbs	Period	Price cts/lb
BUY	25,000	JULY	140.00
SELL	25,000	OCTOBER	125.00
PROFIT or LOSS			15.00
END Result		**Loss**	**($3,750)**

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Trading with Forward Contracts

- **Back to Back strategy**
- Back to Back contracts are based on the purchase and sales agreements for physical coffee.
- A trader simultaneously agrees on the price and volume for the purchase and sale of the coffee

Benefits of Back to Back

- Lock in already quantified and known profit/loss
- Both purchase and sales prices are known
- Price risk minimized
- No up front costs

Constraints of Back to Back Strategy

- Impacts ability to take advantage of future and eventual positive price movements
- Reduces ability to hold and sell at different point in the season

Fixed Price Forward Physical Contracts

- Purchase or sell a specified product
- For a specific forward delivery
- At a specified and predetermined price
- Payment is expected at the delivery date

Example

	lbs	Delivery Period	Price (USD cts/lb)
BUY	25,000	JULY	140.00
SELL	(25,000)	OCTOBER	160.00
PROFIT & LOSS / lb			20 cents
Total lbs of coffee			25,000 lbs
END Result		Profit:	$5000

❑**Are NOT about "future price discovering/ guessing"**
❑**Commit today for future delivery**

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Benefits of Fixed Price Forward Physical Contract

- No up-front cost
- Strengthens trade relationships
- Provides assured "HOME" for product
- Can be used as a pre-harvest financing guarantee for the banks

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Challenges of Fixed Price Forward Physical Contract

- Impacts the traders' ability to take advantage of future and eventual positive price movements
- Counterparty/Default Risk
- DIFFERENTIAL Risk is not covered

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Minimum Price Sales Contracts

- Give a minimum price guarantee commonly known as FLOOR price
- Agreed for delivery at a future date.

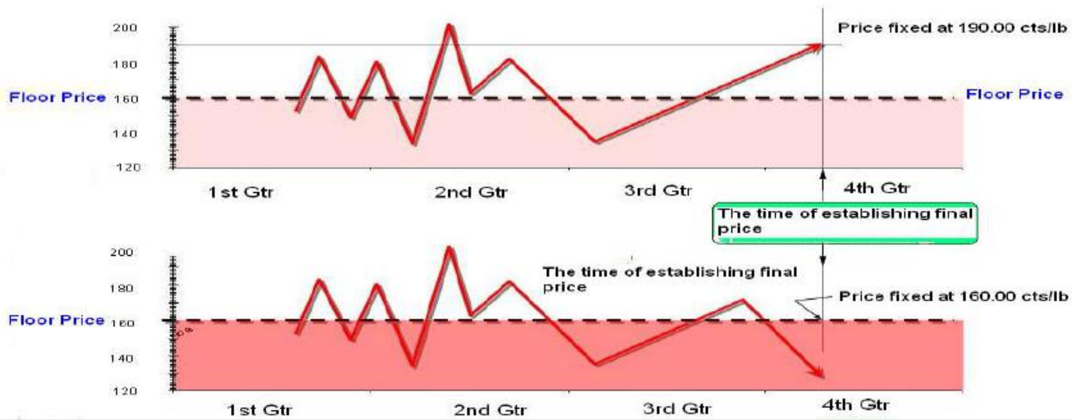

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Illustration of Minimum Price Sales Contracts

If coffee prices rise | **If coffee prices fall**

APRIL:

Trader purchases coffee at 150 cents / lb
Trader signs minimum price sales contract with buyer for 10,000 lbs coffee to be delivered in September, with a minimum price ("floor") of 160 cents / lb

If coffee prices rise:

September: Coffee at 190 cents/lb

September:
Trader delivers 10,000 lbs of coffee and receives 190 cents/lb

Equal to a profit of 40 cents/lb

Total profit of: $4,000

If coffee prices fall:

September: Coffee at 140 cents / lb

September:
Trader delivers 10,000 lbs of coffee and receives 160 cents/lb
(the price floor)

Total profit of: $1,000

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MINIMUM PRICE SALES CONTRACTS

- **Benefits**
- Locks in forward sales at minimum price and takes advantage of favourable price movements
- Potentially no-cost if part of a certification program i.e. FAIRTRADE

- **Constraints**
- DIFFERENTIAL Risk is not covered
- If not provided as part of a certification program there might be a cost to the trader for such a contract

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Price to Be Fixed Contracts

- The seller or buyer, negotiates flexibility into the contract which will allow them to fix the contract price at a time of his choosing
- Also referred to as “executable orders” or “on call contracts”

- **There is a risk of a trader speculating on such a contract**

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LONG TERM CONTRACTS – FIXED OR FLOATING

- Are long term – often linking the trader and buyer together for a much longer period
- May expose a trader to significant price risk exposure
- Can provide a guaranteed buyer of the coffee
- Build strong business relationship with a key buyer

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Income Risk Management Through

Portfolio Diversification

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Appreciating Complementary Commodities

- What to consider in complementary Commodities

1. Level of Demand
2. Price of Trade
3. Seasonality
4. Foreign Trade
5. Rate of return on investment

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Complementary Commodities to Coffee

- Maize
- Rice
- Wheat
- Beans
- Soya Beans
- Tea

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Thank you!

International
Trade
Centre

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Coffee Trade Finance

Co-funded by the European Union

East African Community

#EACMARKUP

This programme is co-funded by the European Union

german cooperation

giz

International Trade Centre

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Appreciation of Trade Finance

What is trade finance?

The Process by which companies raise capital, especial to fund growth, acquisitions, trade etc.

- Trade finance concerns international and national trade transactions
- when a buyer purchases goods or services from a seller, the financial activities involved come under the umbrella term 'trade finance'.
- The primary goal of corporate finance is to **enhance corporate value while reducing the firm's financial risks**.
- Crucial for every kind of business from start-ups to large publicly listed companies

Terms Used in Trade Finance

1. Letters of Credit (LCs)
2. Export factoring (banks secure finance based on invoices or accounts receivable)
3. Export insurance (during delivery and shipping, also covers currency risk and exposure)
4. Export credits (to reduce risks to funders when providing export or trade finance)
5. Forfaiting (purchasing the receivables or traded goods from an exporter)

4

Key Questions for SMEs Seeking Trade Finance

- Amount of money you need to raise
- Number and type of investors necessary to raise that amount of money needed
- Costs for professional services of lawyers and accountants
- The affinity group(s) that would be interested in investing in your business
- The liability and management responsibilities to investors

Benefits of Trade Finance to SMEs

Benefit	Reason
Allows growth of an SME	More working capital and better cash flow management allows business owners to keep in control of the day-to-day running costs of the business whilst growing and fulfilling larger orders that ordinarily wouldn't be possible.
Higher profit margins	A finance facility can allow an SME to buy in bulk or volume, up front (at reduced costs) and strengthens the relationship between buyers and sellers.
Greater efficiency and productivity	Working with other international players allows business owners to diversify their supplier network which increases competition and drives efficiency in markets and supply chains.
Reduces bankruptcy risks	Late payments from debtors, bad debts, excess stock and demanding creditors can quickly cause the crippling of an SME which is reliant on effective cash management in order to stay alive.

Challenges for SMEs in Accessing Trade Finance

- **From Bankers perspective**

1. Banks are using more technology and are efficiency driven, SMEs do not fulfil criteria for banks to justify lending to
2. it is more costly to assess and monitor loans to a smaller companies
3. Stability with SMEs is less certain, relative to a larger, more stable business
4. It is riskier lending to SMEs where profit is less certain, relative to a larger, more profitable business
5. Lack of security and collateral that an SME can provide.

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Challenges for SMES in Accessing Trade Finance Cont'd…

- **From the SMEs Perspective**

1. Lack awareness of types of finance available and finding sources of finance
2. High cost of borrowing, lengthy procedures for securing a loan and also the amount of paperwork and documentation required is often off-putting and cumbersome

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Sources of Trade Finance

Trade Finance Providers

- There are many service providers of trade finance; it is crucial that business owners choose the correct lending institution to access credit.

- Providers can generally be:
    a. Commercial banks,
    b. Development Finance Institutions, and
    c. Alternative finance institutions.
    d. Large Exporters

Commercial Banks

- Some commercial banks have specialized trade finance divisions, which offer facilities to businesses.
- Commercial banks represent the majority share of financial institutions globally, although they range in size from small and niche banks to large multinational banks.
- The banking services offered by trade finance commercial banks include: **issuing letters of credit, accepting drafts and negotiating notes, bills of exchange and documentary collections.**
- **Smaller domestic banks can however be advantageous to SMEs too – being niche, it can be easier to accommodate the specific (albeit riskier) needs of SMEs.**

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Development Finance Institutions

- Development finance institutions (DFIs), also known as development banks, help provide trade finance to promote economic development.
- They are often country specific, and target specific types of mid- to long-term trade finance in the agricultural, mining and projects sector.
- Development finance institutions can provide standby letters of credit, discounting facilities, project financing and are often directly or indirectly funded by governments.
- DFIs often operate as joint ventures in emerging markets which means that they can provide insurance and guarantees given that the countries may face political and socioeconomic risks.

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Alternative Finance and Non-Bank Funders

- There are many types of financial institutions that do not use public deposits as a funding resource.
- Funding sources include crowd-funded (pooled) investment, private investment and market brokering.
- Crowd-lending (peer to peer) finance have also entered the trade finance sector
- Supply credit and documentation to importers and exporters have crept onto the scene

Sources of Trade Finance in Tanzania

- **Brainstorming and Discussion Session**
  - **Name the sources you know or you have used**
  - **Indicate Benefits and Limitations of the source**

Types of Financing

Types of Financing

- **There Two general types of Financing**

- **Debt Financing:**
  Loans from private, commercial or institutional lenders; corporate bonds

- **Equity Financing**:
  Money that is received in exchange for a share of ownership in the business which typically amounts to additional shareholders in your company

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What Types of Debt Finance Exist?

- At Trade Finance Global, 'trade finance' is **a catch-all term** for the financing of international trade. Below are some types of debt finance.
  i. Trade Credit
  ii. Cash Advances
  iii. Receivables Discounting
  iv. Term Loans
  v. Leasing and Asset Backed Finance

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Obligations in Debt Financing

1. Your company has to pay interest as well as the amount borrowed.

2. Lenders do have certain rights to financial or other information from your company

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Trade Credit

- Normally the seller requires payment of goods 30 or 90 days post shipment.
- Trade credit, which is probably the easiest and cheapest arrangement is based mainly on trust directly between the buyer and the seller.
- When the two parties are less well known to each other, or if the creditworthiness of the buyer is not known, a bank backed bill of exchange can be issued and guaranteed by the buyer's bank.

Cash Advances

- **A cash advance is an injection of capital (unsecured) into the business.**
- It's often based on trust, and a cash advance can even be favorable and sought from the exporters themselves, given that timely delivery will help your business deliver and ensure their repayment.

Receivables Discounting

- Invoices, post-dated checks or bills of exchange can be immediately sold on the market at a reduced rate, less 10-30% of the invoice value.
- Receivables are mainly commercial and financial documents, and new finance houses and marketplaces allow such documents to be sold at discounted prices in return for immediate payment.
- The discount rate, which is relatively high and can be costly for SMEs is calculated based on the risk of default, creditworthiness of the seller and whether the transaction is international or domestic.

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Term Loans

- Longer term debt (including loans, commercial mortgages and overdraft facilities) can be more sustainable sources of funding.
- They are often security or guarantee backed (your business would need to own assets up to the value of the loan being sought).
- Often in the world of international trade and finance, securing against assets owned by business owners in other countries is more tricky, especially due to different ownership regulations in other jurisdictions.

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Leasing and Asset Backed Finance

- Leasing involves the borrowing of expensive fixed assets such as machinery, vehicles and equipment.
- There are several finance mechanisms which allow SMEs to have access to assets which are repaid in smaller contractual, tax deductible repayments.
- Asset finance allows SMEs to purchase equipment or assets over a period of time, worry less about the maintenance of it, and it is favorable for tax treatment in many markets.
- There are different types of leasing / asset finance, including finance lease, hire purchase and operating leases.

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Debt Advantages

- You remain full managerial control of your company.
- You do not have to give up any ownership or future profits of your business. All that a lender can require is for you to pay back your loan.
- Using borrowed money to obtain business assets will allow you to keep your business profits in the company or use those profits to pay a return to the owners of the company.
- Interest paid on the loan is generally tax deductible.

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Debt Advantages cont'd…

- Loans usually require collateral to secure the loan. If you cannot repay your loan, the lender has a right to seize your collateral.
- In case of bankruptcy, bondholders and secured lenders have preference over shareholders when the assets of the company are liquidated.

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Debt Disadvantages

- Your company must have sufficient cash flow to repay its loans.
- In most cases you will be using your cash profits to pay back the loans.
- The riskier the loan is, the higher the interest rate will be (problem for many startups)
- Most lenders will require small business loans to be cosigned or guaranteed by the owner(s) of the business.
- Too much debt may impair your credit rating and your ability to raise money in the future.

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Other types of Trade Finance

- Other types of trade finance which we think would be useful for SMEs, these aren't strictly 'trade finance' as we define, but it's worth considering.

  a. **Equity finance** includes seed funding, Angel investment, Crowdfunding, Venture capital (VC) funding, and Floatation.

- The principles is that a business owner will give a proportion of his or her shares to an investor (so that they own a share of the business) and if the company grows and shares become more valuable, they will sell their shares in the business (exit) and make a return on their initial investment.

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Equity Financing

- Issuing of equity securities to investors
- Possible investors are friends, angel investors, VC funds, corporate investors (strategic investors), buyout and turnaround funds
- This means that investors obtain some form of ownership in your company (equity)

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Equity - Benefits

- Access to capital will increase, since you can contact more potential investors.
- Your company may become more widely known.
- You may obtain financing more easily in the future if investor interest in your company grows.
- Business investors can offer their business advice, professional experience and business network
- Your company may be able to attract and retain more highly qualified personnel if it can offer stock options and other equity incentives.

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Equity - Disadvantages

- You'll likely be giving up some amount of managerial control (depends on investor)
- Obligation to keep shareholders informed about the company's business operations, financial condition and management, incurring additional cost and new legal obligations.
- Potential liability because of new legal obligations.
- You may lose some flexibility and privacy in managing your company's affairs.
- Your private or public offering will take time and money to accomplish (consultant & legal fees)

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Questions / Experience Sharing

Trade Finance Payment Methods

Methods of Payment in Trade Finance

- Importers and exporters normally require intermediaries such as banks or alternative financiers to guarantee payment and also the delivery of goods.
- Cash advances or trade credits on open accounts usually develop after the buyer and seller develop a trusted relationship
- Support for trade finance includes facilitating payment in a secure and timely manner (e.g. SWIFT), mitigating possible risks through credit insurance, and tracking the shipment of goods when they are in transit.
- Payments have varying types of risk: for the importer and the exporter.

Types of Payment Methods

i. Cash advances,
ii. Letters of credit,
iii. Documentary collections, and
iv. Open accounts

Cash Advance

- All the risk lies with the importer; a cash advance requires full payment before the goods have been shipped.
- **As an Exporter,**
  1. A cash advance is by far the least risky payment method
  2. It provides you with up front working capital to produce and/ or ship the goods,
  3. Security (no risk of no or late payments)
- **As an Importer,**
  1. A cash advance can cause cash flow problems for the business,
  2. Can be problematic if the goods aren't up to standard, faulty, or not delivered on time

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Letters of Credit (LCs)

- Letters of credit (LCs), also known as documentary credits are financial legally bound instruments, issued by banks or specialist trade finance institutions, which pay the exporter on behalf of the buyer, if the terms specified in the LC are fulfilled.
- A LC requires an importer and an exporter, with an issuing bank and a confirming (or advising) bank respectively.
- The financiers and their creditworthiness are crucial for this type of trade finance: it is called credit enhancement – the issuing and confirming bank replace the guarantee of payment from the importer and exporter.

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MARKUP
EU-EAC MARKET ACCESS UPGRADE PROGRAMME

A LC Transaction flow

1. An importer agrees to buy goods off an exporter – a purchase order (PO) is issued
2. The importer will approach an issuing bank (trade financier) who will issue an LC if it fulfils their criteria (e.g. they are creditworthy)
3. The exporter will work with a confirming bank who will request the LC documents to be shipped from the issuing bank of the importer
4. The confirming bank will then check the LC and if the terms are correct, the exporter can then ship the goods
5. The exporter then sends the relevant shipping documents to the confirming bank, who will then process the payment

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MARKUP
EU-EAC MARKET ACCESS UPGRADE PROGRAMME

A LC Transaction flow Cont'd

6. Once the confirming bank has examined the shipping documents in strict compliance against the LC terms from the issuing bank, they will forward these documents on to the issuing bank
7. The importer pays the issuing bank
8. The issuing bank then releases the shipping documents so that the importer can claim the goods that were shipped
9. The issuing bank then transfers money to the confirming bank who will then transfer this money to the exporter

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Documentary collection

- Documentary collections differ from a Letter of Credit.

1. The exporter will request payment by presenting its shipping and collection documents to their remitting bank.
2. The remitting bank then forwards these documents on to the bank of the importer. The importers bank will then pay the exporters bank, which will credit those funds to the exporter.
3. The role of banks in a documentary collection is limited, they do not verify the
4. documents, take risks, nor do they guarantee payment; banks just control the
5. flow of the documents.

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Documentary collection Cont'd

1. With documentary collections, the bank does not cover credit and country risk.
2. They are more convenient and more cost-effective than Letters of Credit.
3. Useful if the exporter and importer have a good relationship.
4. The importer is situated in a politically and economically stable market.

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Open Accounts

- An open account is a transaction whereby the importer pays the exporter 30 – 90 days after the goods have arrived from the exporter.

1. This is obviously advantageous to the importer and carries substantial risk for the exporter
2. It often occurs if the relationship and trust between the two parties is strong.
3. Open accounts help increase competitiveness in export markets, and buyers often push for exporters and sellers to trade on open account terms.
4. Exporters may seek export finance to fund working capital whilst waiting for the payment.
5. Often export credit insurance is taken out to reduce the risk of commercial losses such as bankruptcies, defaulting and insolvencies from the buyer.

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The Specific Need for Trade Finance

What does a small business use trade finance for?

Categories of trade-financing options:

i. Pre-shipment finance,
ii. Post-shipment finance, and
iii. Supply Chain finance (SCF)

Pre-shipment Finance

- Pre-shipment finance includes any finance that an exporter needs before they send goods to a buyer.
- Once the business has a confirmed order from a buyer, which is sometimes backed by a Letter of Credit, working capital finance is often required to fund wages, production costs and buying raw materials.
- Exporters can access:
  - Receivables backed financing,
  - Inventory/warehouse financing, and
    Pre-payment financing.

Pre-shipment finance Cont'd…

- **Receivables-backed financing** is essentially a loan where the goods exported are the security, so in the case of defaulting, the lender can seize the goods.
- Lenders will often fund up to 80% of the total value of the goods, but this can vary depending on the risk of exporting the goods and the lender.
- The goods being exported are also an important consideration for receivables backed export lenders
- However, if there is little demand for the goods a lender may not be able to resell in the case of commercial losses, therefore the risk is higher and they may be unwilling to finance the transaction.

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Pre-shipment finance Cont'd…

- Often lenders wish for goods to be kept in a trusted location or public warehouse (or in the borrower's premise but controlled by a third party).
- **Warehouse or inventory financing** is often favorable to borrowers for **short term working capital or loans** (especially if they have used up existing credit lines or bank overdraft facilities), and the inventory can be used as collateral or more flexible terms.

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Pre-shipment finance Cont'd…

- **Pre-payment financing** is subtly different to receivables-backed financing
- The buyer will take out a loan specifically for the purpose of paying the seller in advance of shipping the goods, and the export contract states that the buyer pays the loan back to the bank once the seller fulfils the terms agreed.
- This process ensures speedy payment and the risks are shared with the buyer and the bank.

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Post-shipment finance

- Once an exporter has shipped goods, a financier can advance the payment so they have sufficient liquidity between shipping the goods and receiving the payment.
- Post-shipment finance can operate in a number of ways:
  - Through a Letter of Credit,
  - A loan via an accounts receivables document, or
  - Via invoice factoring or Receivables Discounting (selling the invoice or receivables document)

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Supply Chain Finance (SCF)

- **What is Supply Chain Finance?**
- Global supply chain finance, (also known as GSCF or supplier finance,) is a cashflow solution which helps businesses free up working capital which is trapped in global supply chains.
- It is a solution designed to benefit both suppliers and buyers; suppliers get paid early and buyers can extend their payment terms.
- This solution allows businesses which import goods to unlock working capital as well as reduce the risk associated with buying goods in bulk and/or transporting them globally

How does supply chain finance work?

1. Normally a buyer will want to purchase goods from a supplier, who will invoice the buyer on standard credit terms (normally 1 month).
2. A supply chain finance institution acting on behalf of the buyer will remit the invoiced amount to the supplier, often paying early so that a discounted price (or early payment discount) can be applied
3. The supply chain financier will then extend the payment from the buyer to a further 30-90 days, meaning the buyer has ultimately extended the payment period
4. The financing rates are based on the buyer's risk, the supplier will normally get paid instantly, and the rates are typically 10 times lower than using a traditional factoring agency

What are the benefits of supply chain finance?

Benefits to suppliers/ exporters	Benefits to buyers/ importers
Suppliers can get paid earlier than their usual 30-day credit terms	Buyers can maintain a healthy balance sheet
Little financial risk – insurance is sorted through a supply chain financier	Buyers maintain a good relationship with suppliers
Doesn't cost the supplier any extra	Promotes competition/ diversity in suppliers
Allows supplier to have the cashflow to work on numerous deals simultaneously	Allows buyers to make purchases in bulk to save costs
Helps with the provision of liquidity and reduces financing costs	Buyers can work with complex end-to end supply chains

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Questions / Experience Sharing

Benefits and Risks of Each Type of Trade Financing

Benefits and Risks of International Buyers Pre-Export Financing

• Benefits	• Risks
• **Flexibility**:100% advance against existing contract • **Convenience**: Drawdown at the discretion of the exporter • **Transaction Flow:** Easy cash- flow management	• **Product Risk:** Quality due to climatic changes • **Manufacturing Risk**: Break down of the processing *machine* • **Transport Risk**: Poor infrastructure, fuel price increase, • **Currency Risks**: Exchange Rate

Benefits and Risks of Letters of Credit

- Benefits
  - Buyers obligation to pay
  - Early payment before good are received
  - The seller is able to tell the payment date
  - Easy sourcing of funds
  - No monthly bank interest rate

- Risks
  - Discrepant Document Risks
  - Fraud Risk: Forged documents
  - Non-payment Risk(Due to sanctions, political Risks)

Benefits and Risks of Export Credit Insurance

- Benefits
  - Improved Sales
  - Access to new market
  - Insolvency protection
  - Cash flow relief
  - Accounts receivable support
  - Facilitate bank financing

- Risks
  - It's not available for some high-risk accounts
  - Doesn't cover every non-payment situation
  - Exclusions and limitations vary- Understanding this can be quite difficult, in some cases.

Benefits and Risks of Warehouse Receipts

- Benefits
  - Reduced post-harvest losses
  - Increased profit due to extended sales period.
  - Reduction in seasonal price variation due to a consistent supply of commodity in the market.
  - Transparency in market prices due to "price discovery processes"

- Risks
  - Fraud
  - Collusion
  - Storage risk
  - Credit risk
  - Price Volatility
  - Buyer risk

Benefits and Risks of Overdrafts

- Benefits
  - An overdraft is flexible - you only borrow what you need at the time which may make it cheaper than a loan.
  - It's quick to arrange.
  - There is not normally a charge for paying off the overdraft earlier than expected

- Risks
  - The bank has the right to ask for repayment of your overdraft amount at any time
  - Overdrafts may be secured against business assets.
  - Unlike loans you can only get an overdraft from the bank where you maintain your current account.
  - The interest rate applied is nearly always variable, making it difficult to accurately calculate your borrowing costs.

Benefits and Risks of P2P

- Benefits
  - Financial transactions are concluded directly between individuals and a company without the intermediation of a Traditional financial institution
  - Offer lower borrowing rates than banks usually offer
  - They are more flexible, quicker and more Transparent
  - The borrower can get a loan at a lower rate without collateral,
  - The lender can get higher return on investments

- Risks
  - The traditional role of credit risk assessment is left to individual lenders rather than financial institutions
  - Higher chances of misrepresentation for borrowers in terms of creditworthiness
  - Most of the requested loans are from borrowers who cannot get bank loans
  - If a borrower is does not pay the requested loan, then it is necessary to prosecute a claim with risk that the full amount of the loan will not be recovered.

Questions / Experience Sharing

What to do when a coffee trader is unable to pay back a loan

What to do when a coffee trader is unable to pay back a loan?

- Investigate the cause of the loss
  i. Quality(outturn)
  ii. Drought
  iii. Competition
- Meet and Negotiate with loan provider extension of Loan repayment and mode
- Takeover management and stock until the loan is covered
- Source out equity financing options
- Use collateral security to recover the loan

Questions / Experience Sharing

Thank you