Charting a profitable course in a world of fluctuating metal prices

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As promised in the previous issue, we will explain the mechanism under which ElvalHalcor, and similar metals fabricators, report fluctuations in their profitability (EBITDA and further down into EBIT and EBT), fluctuations that do not affect their recurring profitability, which is better portrayed by adjusted figures, i.e. a-EBITDA and a-EBIT.

To understand the mechanism, one must primarily understand a basic principle under which most fabricators operate: they will not speculate on the metal prices. Therefore, they will try to match all their sales and purchases during one period, and price them at the exact same LME prices. An example would be, if Company A, producing aluminium sheets, buys all its incoming materials (e.g. aluminium ingots) at the average LME price of the month and sells all its aluminium sheets again at the average LME price of the month. If they buy the same amount as they are selling, they would be indifferent to the monthly LME price. Reality is never that simple of course, and not all purchases and sales will coincide on pricing. This is where the hedging mechanism, through the use of LME brokers or OTC contracts plays in and ensures that, eventually, all metal purchased will be sold without profit or loss (on the LME price) regardless of daily or periodical fluctuations of purchases and sales (thus inventory).

So, if Company A sells on average 10,000tn of metal each month, i.e. 120,000tn of aluminium during the year, this means that it should also buy the exact same amount of metal i.e. 120,000tn. On top of the metal price, the company will add its conversion price, to cover production costs and make a profit.

Now imagine that the aluminium price was stable for a few years, at EUR 2,000/tn, but this year, it jumps to EUR 3,000/tn. What are the immediate effects on the profitability of this company? None, if the previous apply. The cost of goods sold will go up, but also will sales. For the exact same amount, since quantities are equal, and prices equal through the hedging mechanism. The bottom line should be unaffected.

But here is where the method of valuation kicks in and complicates things. Traditionally, metals fabricators preferred methods like LIFO (last-in-first-out) which is more conservative and works fully well with the above principle and example. They preferred it not only for tax reasons but also because it simulates the business model much better. However, IFRS has forced everyone who works under it to use FIFO (first-in first-out) or weighted average methods.

Under these methods, the starting inventory and its value play a large role in the calculation. If Company A stocks three months of inventory at all stages of production (raw materials, semi-finished goods, finished goods), that stock would be in our example (with 10,000tn of monthly sales) 30,000tn. This quantity, if valued at €2,000/tn at the start of the year, would affect the cost of goods sold. With the FIFO method, COGS would be at EUR 2,750/tn while sales at EUR 3,000/tn. Ending inventory would be valued at EUR 3,000/tn, comprising of the last months' purchases. With the weighted average method, COGS would be at EUR 2,800/tn and the same price would be used for the ending inventory.

So, both methods would report profits on the sales of metal, and thus increase the value of the remaining inventory to, or near to, the current price. But is this profit, real? We argue that it is not, especially as metal prices do not always go up and fluctuate widely over the course of several years.

To return to our previous example, if next year the prices retreated to €2,000/tn again, losses would be recorded with both FIFO and the weighted average method. These fluctuations create a yo-yo effect on profitability in the short term, which does not reflect the actual business model and performance.

What is even more important, these profits or losses do not correspond to cash flows. There is no valuation method invented yet, that can change your bank balance.

One might argue that both these methods reflect better the current value of the company, by marking up the end-period inventory to (or closer to) its current value – when higher than the historical cost, as when under, it will be marked down under any method. We argue that the value of understanding the operational and repeatable profitability of the company outstrips any benefits that this may have. ElvalHalcor is here to stay for a long time. Metals will wildly fluctuate, and so will the reported results.

Now, this would leave two open questions on the table. Are you really that indifferent to metal prices? Are the bottom line and the cash flows really not affected at all by price fluctuations?

The quick answer is ‘’no’’. They do affect, to some extent, and in plenty of ways; we will cover that in another article. And finally: since you do use hedging, and LME brokers, why don’t you also hedge all the inventory (i.e., these 30,000tn for Company A). Why only use hedging to make your sales and purchases match fully? That is another important topic that we will cover in the future.

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