



INDUSTRY INSIGHTS

THE EDUCATIONAL SERIES

BY HALCOR

EN



WRITTEN BY:

SPYROS KOKKOLISDeputy CFO & Strategic Procurement
of Non-Ferrous Metals and Energy at
VIOHALCO

→ Unravelling the Effects of Metal Price Swings

In the first two parts, we have covered the actual effects of metal price fluctuations on the profitability of metal fabricators (like ElvalHalcor) and the impact of the valuation method on reported profitability from metal price fluctuations. We have explained in detail that real profitability is not affected, but accounting results may vary significantly. Cash flows are largely unaffected, as any variations between buying and selling prices are managed through hedging.

However, things are much more complex than that, and there are several direct or indirect effects on the profit and loss account (P&L) and the balance sheet (B/S) of any metal fabricator when metals prices veer in a direction, either short-term or long-term. This time, we will cover all these effects.

The first thing that metal price jolts may affect is demand itself. Demand may be adversely affected in the long term when prices go up. This depends on the product and various substitutes that it may have. Historically, copper has suffered various waves of substitution in product categories where alternatives are plentiful, and the advantages of using copper are not so substantial as to justify the price difference. Examples include copper roofing and sanitary (plumbing) tubes. Aluminium, on the other hand, is less susceptible to substitution. One good reason for that is that its price volatility is not so high as to create a significant disadvantage vs. substitute products. Aluminium has generally benefited from substituting copper in various uses. A notable case is that of overhead land cables, where it has almost entirely substituted copper over time.



INDUSTRY INSIGHTS

THE EDUCATIONAL SERIES

BY HALCOR

FOLLOW HALCOR
ON LINKEDIN



Substitution is a long-term effect, as product design takes time, and only long-term changes in metal prices trigger it. And in the short term —however—abrupt changes in metal prices can also affect demand. A jump in the price of aluminium might cause customers to reduce their inventory levels, especially if they hope prices will reverse soon. A drop in the copper price may momentarily block orders as customers become jittery and fear a further decline. High volatility affects buyers' short-term decisions and inventory holders' risk appetite.

Working capital is affected. As payment terms from suppliers are usually shorter than payment terms to customers, this may stress the balance sheet and debt. This will be accentuated when inventory increases. Any excess inventory must be financed at higher prices. The company must be very careful about stock levels, as short-term demand might affect stock adversely. Some might argue that the value of the existing inventory will increase. If it's not hedged, any increase in the value of the inventory is an accounting figure – we covered that in the previous article. We will discuss what happens if it is hedged (and why it should not be) in the next one!

As working capital increases, so will the cost of financing it. Insuring customers will also be more costly due to the higher turnover and balances. It will also become more difficult: limits will have to be adjusted, and not all customers will have the financial capacity to allow insurance companies to adjust their limits as needed. Some sales will have to be curtailed if the company is risk-averse. Otherwise, some risk must be taken. The same is true for supplier credit: more will be needed, and suppliers may have difficulty either financing it or obtaining the necessary insurance limits. This may further affect the balance between payables and receivables.

The supply chain is also affected. Lower metal prices will discourage scrap collection and distribution. Fewer people will bother to collect used aluminium cans if their value is low. Scrap dealers will hoard material when they believe prices are low. The opposite will happen when prices are high. Scrap collection becomes more attractive, and hoarding ties up large sums that they prefer to cash in.



INDUSTRY INSIGHTS

THE EDUCATIONAL SERIES

BY HALCOR

FOLLOW HALCOR
ON LINKEDIN



So, high prices indirectly affect scrap supply and availability for the fabricator. However, high prices also benefit the fabricator directly. A contract for scrap at a 10% discount to the LME means a discount of €200/tonne when aluminium is at €2,000/tonne but €320/tonne when aluminium is at €3,200/tonne. Discounts may adjust in the long run, but higher prices will mean more supply and demand as recycling becomes more profitable for everyone. In any case, a new balance will be achieved at some point.

Now, changes in metal prices are definitely a function of supply and demand, at least in the long term, as exchange-traded commodities are also a field of investor speculation. Looking at the demand side of the equation, high demand for aluminium products will push prices up. Low demand for copper will drag prices down. However, no direct conclusions may be drawn from that until someone drills down into the demand data and localises it by product category and region.

So, demand for aluminium products in China may be deficient – as construction activity drops there, a lot of extruded products will not be needed. How does this affect demand for rolled products in Europe? And what happens if the demand for copper wire rods for cables surges while the demand for copper alloy tubes falls? Maybe they are not affected at all...

But, if the area and product of the demand hike or drop coincide with the activity of the fabricator, conversion prices will also be affected. Positively or negatively. So, the trend of metal prices may hint at future profitability, but only if one has the full details of the cause. If it is demand-driven, is it relevant to the company?



INDUSTRY INSIGHTS

THE EDUCATIONAL SERIES

BY HALCOR

FOLLOW HALCOR
ON LINKEDIN



Last but not least: Reported profits will increase or decrease depending on metal prices, among other factors, and so will taxable profits and taxes. Unless taxable profits can be based on another valuation method, like LIFO, companies will tend to pay more taxes when metal prices rise, and their cash flows are already under some pressure, from all the above factors, to adjust.

After all that, one might wonder, what benefits fabricators more? Higher prices or lower prices of metals? I was asked this question in an executive meeting by an engineer from a plant during times of very high copper volatility: “What would be better for us — for prices to go up or to go down, as they are now?” — “None of them,” I replied. The best for us would be for prices to stabilise and never move again.

But this is in the realm of fiction; here, we only cover facts.