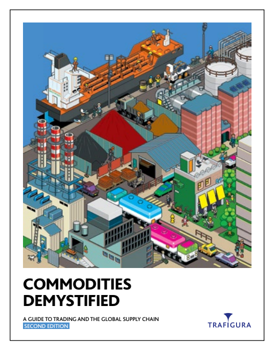
PREPAYMENTS DEMYSTIFIED

AN ADDENDUM TO THE COMMODITIES DEMYSTIFIED GUIDE

TRAFIGURA

PREPAYMENTS DEMYSTIFIED



This document is an addendum to the Trafigura-commissioned "*Commodities Demystified*" guide which explains the functions and modus operandi of commodity trading firms and the global supply chain.
www.commoditiesdemystified.info

Through this document – 'Prepayments Demystified' – we shine a light on a specific area of commodities financing: prepayment transactions. Our aim has been to describe how such agreements come about and for what purposes.

Prepayments have been around for centuries. In the past, traders entered into such agreements in order to buy ships, prior to embarking on their commercial ventures. Similarly, farmers sold their produce ahead of the harvest in order to invest in equipment. Prepayments remain, to this day, a vital component of global trade. Their complexity however has grown, as have their centrality to the economies of many commodity producing countries. By publishing this paper, it is our intention to enhance understanding and invite stakeholders to engage on how transparency in this area can develop in the future. We start that conversation with a central principle: that natural resources such as oil are public goods that should indeed deliver public good.

Trafigura is one of the world's largest traders of oil and petroleum products as well as metals and minerals. We transport commodities from where they are plentiful to where they are most in demand, safely and responsibly.

In recent years, we have become one of the leading companies engaged in Structured Trade Finance or 'STF', with total prepayments for commodities rising from USD700 million in 2013 to more than USD5 billion in 2019. We originate, structure, arrange and fund loans that are then syndicated to banks. To facilitate this activity, we utilise an extensive network of over 130 financial institutions from across the globe.

In 2014, Trafigura became the first independent commodities trading company to have declared its support for the Extractive Industries Transparency Initiative (EITI). The EITI, whose standard is implemented in 52 countries worldwide, supports the open and accountable management of natural resources. By publishing our payments to state-owned enterprises (SOEs) in EITI countries, we seek to provide useful information on a matter of global public interest.

While much remains to be done in enhancing levels of transparency within and around the commodities trading industry, public interest is forever evolving. One such area in which that evolution has been pronounced has been in commodity trade finance. Over recent years we have responded to this trend in several ways. In 2013 we published our first publicly available Annual Report containing our audited financial accounts. In 2015 we published our Environmental, Social and Governance (ESG) performance in our first Responsibility Report and in 2016 we published our 'Commodities Demystified' guide, to explain commodity trading and the role of trading firms in organising the global flows of vital materials that underpin economic growth. By publishing this 'Prepayments Demystified' document, we take a step further and hope that we contribute to evolving practices related to prepayment agreements.

Christophe Salmon,
Trafigura Group Chief Financial Officer

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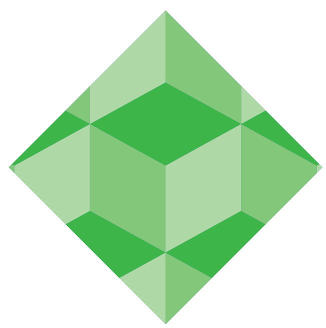

Prepayments Demystified

Feedback on the contents of this publication would be welcome to CorporateAffairs@trafigura.com

Credits. *Prepayments Demystified* was written by Trafigura Group and designed by **eBoy** (cover illustration) and **Group Charlescannon Sarl** (design and production).

INTRODUCTION

Extraction and the trading of natural resources is a vital component of the global economy, and it depends crucially on finance to succeed. Just as commodities trading is one of the oldest activities of human society, commodities trade finance is one of the oldest jobs in banking.

As the modern commodities trading industry has grown in size and sophistication, new forms of trade finance have developed that serve the needs of producers for capital and of consumers for reliable supplies.

This paper aims to explain the business of prepayments, which is part of Structured Trade Finance (STF). The STF business, in which traders organise up-front prepayments for producing counterparties and are repaid over time in commodity shipments, is one of the fastest growing parts of the resources industry, and also one of the least well-understood.

Commentary on STF often focuses on purported undisclosed financial risks or on implications for sovereign debt management. Yet at a time when the global banking industry has been reshaped and commodities producers in emerging economies are finding it harder to finance their operations directly through the banking system or through public markets, STF is more essential than ever. It has become an indispensable tool for ensuring that commodities can be efficiently produced even in the most unpromising (or challenging) and remote jurisdictions, and reliably brought where they are needed. There is thus a public interest in ensuring that its workings and any associated risks are properly appreciated by the business and financial communities, regulators and society at large.

At a time when the global banking industry has been reshaped and commodities producers in emerging economies are finding it harder to finance their operations directly through the banking system or through public markets, STF is more essential than ever

As old as commerce

It is a truism that without finance, international trade cannot take place. Millennia ago, merchants in what is now the Middle East exchanged cloth or copper for engraved tablets promising later payment in, say, silver.

When global trade started to take off from Europe in the 17th century, a new form of financial entity was required to manage the massive costs and risks involved in transporting spices and other expensive goods in large, heavily armed ships from the production centres of the Orient to European consumers. Britain's East India Company (EIC) was the world's first joint stock company with pooled resources including those of passive equity investors – in the words of the historian William Dalrymple, "one of Tudor England's most brilliant and revolutionary inventions". The EIC and its precursor in the Netherlands, the Dutch East India Company, used some of their capital to make prepayments for purchases.

These disparate examples came into being for a similar economic reason: the imperfect match between the financial needs of producers and exporters on the one hand, and buyers and importers on the other. Producers prefer being paid at the time of sale, so they can finance more production. Buyers would rather settle after receiving the goods, so they can quickly raise cash by reselling them. To bridge that gap, intermediation is needed in the form of trade finance. It is estimated that four fifths of global trade transactions rely on specialised loans or guarantees which make up the global trade finance pool.

STF is a more recent phenomenon, but it addresses the same combination of financial needs – producers' requirement for working capital to enable them to sustain production, and buyers' need for a reliable and readily-financed pipeline of product.

As production and consumption of commodities surged in the decades after World War II, the global banking system played the central pre-financing role for an increasingly diverse group of independent producing countries. When producers needed capital upfront to finance their operations, they turned to banks. In turn, the banks developed financing structures, known as pre-export financing facilities, in which producers could receive short- or medium-term credit and repay them with goods over time. Commodity trading firms, a relatively new phenomenon in their current form of large-scale logistics and risk management providers, typically became involved in such transactions as off-takers of the commodities used to repay the loans.

Pre-export financing by banks remains an important source of credit for producers. But in the last ten years, pre-export financing has increasingly been supplemented by prepayments facilities arranged and structured by the commodity trading firms themselves. Especially in emerging market countries where access to bank finance and to public capital markets has become more difficult, a wide range of clients from National Oil Companies and refining giants to small and medium-sized mining companies have turned to traders for help in raising capital. The result has been a sharp rise in prepayments by commodities traders. In providing finance in this way, trading firms are enabling production that would otherwise not be possible – thus underpinning economic growth, job creation and the generation of fiscal revenues in the countries concerned.

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It is important to recognise why STF activity by trading firms has become so important. The trend reflects significant changes that have taken place in banking and capital markets since the global financial crisis of 2008-09. Partly as a result of subsequent regulatory changes, international banks have substantially reduced their exposure to emerging market lending credit in order to focus on their domestic markets and on cross-selling to big corporate clients. With public equity and debt markets often also inaccessible to emerging market resource producers, commodities buyers – the big trading firms – have been left as one of the few sources of credit and working capital for this type of operation.

PREPAYMENTS

How prepayments work

In a prepayments transaction, arranged by a trading firm, the roles of the trader and the banks are reversed from those seen in traditional pre-export financing transactions. In the latter, banks are responsible for originating the loans and bring traders in to deal with the commodities procured in exchange. In a trader-originated prepayments deal, the trading firm acts both as buyer of a volume of commodities and as financial intermediary between the seller of the commodities and the wider banking community, as illustrated in the diagram on the next page.

First the buyer arranges to make an advance payment to the producer for future goods deliveries, with repayments backed by commercial contracts between the two parties. The trading firm originates and structures the financing, and then typically opens the facility to participation by third-party banks. Importantly, the buyer – the trading firm itself – is the borrower. The trader syndicates the credit to a consortium of banks, but typically retains a small portion of the risk. This provides banks with the comfort that the trading firm has "skin in the game", and will help to defend lenders' interests by using its influence to ensure that the borrower keeps up with the shipments required for repayment. These transactions are called "limited recourse" prepayments because, although the bank is lending funds to the trader, it mainly has recourse to the commodity producer that needs to deliver the commodity flow to the trading company.

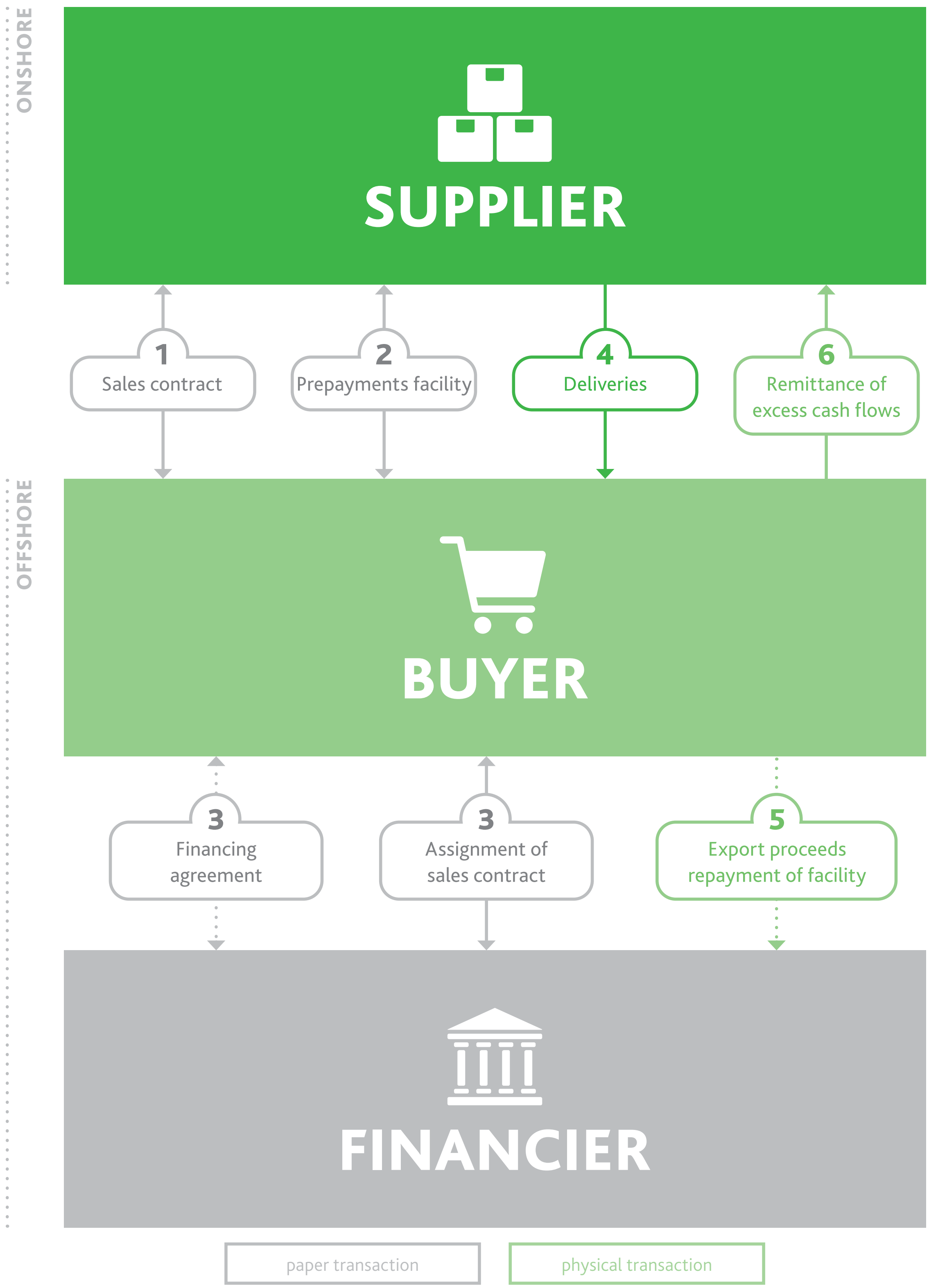
A prepayment transaction is a uniquely attractive channel to raise liquidity for many producers

A prepayment transaction is a uniquely attractive channel to raise liquidity for many producers. In some cases, as mentioned, a prepayment may be the only channel, but in many others, it will often be significantly cheaper in terms of cost of funds than an equivalent bank loan or a bond issue. The rationale for this is that the banks only assume performance risk on the producer i.e. the producer just needs to perform, and the trader ensures the conversion of the commodity into hard currency USD.

Prepayments provide producers with unique access to the trading firms' own banking partners on far keener terms than they could command on their own

In fact, prepayments provide producers with unique access to the trading firms' own banking partners on far keener terms than they could command on their own. It is inherently more attractive than corporate funding such as equity capital, which raises tricky issues of control.

HOW PREPAYMENTS WORK



TYPES OF PREPAYMENTS

Prepayments come in many different shapes and sizes, and are always established on a bespoke basis for individual clients. Some are on a fixed price basis, limiting producers' exposure to falling prices. Others are conceived as a way of addressing cash-flow issues arising from lower commodity prices. But prepays generally fall into one of two broad categories, as follows:

1. Short-term revolving working capital facility

Volume: USD5 million to 50 million

Tenor: 30-90 days, rolled over on a regular basis

Example: You are an oil producing company with inland assets in a Latin American country. Once your oil is produced it goes into storage tanks at your facility before being fed into a pipeline to the most convenient port. Between production and realisation of the proceeds through a sale "free-on-board" on to a vessel, there is a gap of 30 days. This delay ties up a lot of working capital. A prepayment gives the producer access to the cash up-front and frees its producer's capital for other uses.

2. Longer-term prepayments loan

Volume: USD50 million to 5 billion

Tenor: Three to five years

Example: You are a mining company with production from an existing mine but you are struggling to raise the capital needed to develop a second mine on the same concession. You use your existing production to arrange a prepayments loan for USD100 million which can be invested straight away to develop the new mine and grow the company further.

Advantages of prepayments

Prepayments are a lot simpler than raising credit from a syndicate of banks. The producer deals with just one counterparty on all aspects of the transaction, from product sale to finance. It also removes the headache of managing currency risk: the producer can focus on its core business of producing; the buyer takes the product and converts it into US dollars that are then used to make loan repayments. Access to foreign exchange can be a crucial consideration for a producer in a country without a convertible currency or under financial constraints. A prepayments agreement offers a surefire way of securing dollars, rather than local currency, in exchange for commodities produced.

Prepayments can even help producers cope with the notorious volatility of commodity market prices. Prepayments arrangements can be set up for periods as short as a few months or as long as five years. They specify a product delivery schedule, with prices calculated on a monthly basis in relation to a recognised international index; for oil, Brent crude oil or West Texas Intermediate crude oil; for copper, aluminium and other metals, prices are set on the London Metal Exchange. This means that producers receive the same economic value for their commodities as if they were selling them directly to the market, but without the hassle involved in doing so. Contracts specify various mechanisms to adjust the volume of commodities supplied in order to compensate for sustained price movements. They are structured conservatively with a built-in reserve to provide for the impact of more dramatic changes in prices on debt service coverage.

Prepayments can help producers cope with the notorious volatility of commodity market prices

Take for example a one-year prepayment for crude oil to a value at the moment of signing of USD120 million. In this case the value of the underlying commercial contract, calculated as the number of barrels to be delivered multiplied by the spot price, would need to be considerably higher – say, USD180 million. This means that the producer can still fulfil its obligations and continues to receive cashflow from its production even if the price of oil falls by 20 percent.

Prepayments provide reliability and certainty for producers. They draw on and channel a deep pool of global banking liquidity handled by institutions with long-standing expertise in pricing and risk management. Unlike the public capital markets, which can close to borrowers suddenly and unpredictably, prepayments are constantly available and loan pricing is not very volatile.

BENEFITS FOR PRODUCERS, TRADERS AND BANKS

Producers	Traders	Banks
• Access to funding that may not otherwise be available, to finance working capital or project development; • Diversification of funding sources; • Reliable funding on competitive terms compared to borrowing directly from banks or publicmarkets; • Opportunity to leverage the extensive banking relationships of the off-taker – i.e. the trading firm; • Secures a committed term buyer for its cargo at a known price formula; • Flexible in terms of use of funds; • Removes currency convertibility risk; • Avoids equity dilution; • Rapid execution, leaner documentation and lower legal costs.	• Guaranteed access to a long-term, steady flow of commodities on established commercial terms; • Opportunity to develop deeper supplier and onward purchaser relationships; • The ability to leverage banking relationships.	• Prepayments are a tool for banks in originating deals using the deeper relationships traders have with producers and refiners; • Lending to a trader as opposed to providing credit directly to a producer is seen as a way of reducing risk, since the buyer has underwritten the transaction and is responsible for the repayments; • Banks generally believe traders stand a better chance than they do of persuading suppliers to perform, since the supplier depends on traders for continuing market access and revenue; • Prepayments loans are easier to monitor in terms of performance than conventional credits. They enable banks to understand their exposure simply by keeping track of monthly commodity delivery volumes.

Another advantage of prepayments is their flexibility. Transactions can be structured to fit the needs of all manner of entities from giant state-owned oil companies to relatively small mining firms. Funds raised can be used to finance a company's working capital on a monthly basis, or to finance a multi-year programme of capital expenditure. For some mining projects, short-term prepayments can be the crucial element that enables the mine to start production, since other forms of finance are extremely hard to raise while a site is still being developed.

Putting a prepayments agreement together

When a trading firm embarks on a discussion of new business with a commodity producer or refiner, there will be a number of topics to be addressed beyond the basics of volume and price of the commodities to be supplied: notably the services that the trading firm can provide to add value for the producer within the transaction. These include logistical solutions such as shipping and finance.

The trader will be incentivised to find the most commercially and financially efficient way to bring the producer's commodities to end-users. The trader can bring the specific requirements of the customer into a bankable structure that meets those needs.

A producer may simply need a limited amount of working capital to bridge the gap in time between production of a volume of commodity and realisation of proceeds from its sale, or a larger sum to finance a capital expenditure programme (see examples on the previous page). Considerations for the trader in working out potential terms for a prepayments facility will include the credit-worthiness of the producer or refiner; the volume of unencumbered production available – meaning production that is not already pledged to other lenders or counterparties; and the prospects for reliable production in light of performance of the producing assets, political risk or other factors. ■

QUESTIONS AND ANSWERS

Q. Are prepayments a form of unregulated "shadow banking"?
A. No. The funds involved in prepayment transactions are bank credit. The trading firm originating the facility is merely an intermediary between the producer or refiner receiving the credit and the wider banking community.

Q. But doesn't it involve non-banking companies taking financial risks like banks – risks they may not be well equipped to handle?
A. No. Detailed knowledge of producing countries and close relationships with producers and refiners are core capabilities of trading companies. They are thus well equipped to assess credit and other risks in relation to their trading counterparties, while passing on the bulk of the financial risks to the banks to which the prepayments loans are syndicated. The main difference from traditional forms of commodities pre-financing is that trading firms take the lead in originating and structuring a prepayments transaction and then syndicate the risk to a consortium of banks.

Q. On whose balance sheet is the exposure in a prepayment held?
A. Principally on those of the producer who receives the funds, the lending banks and potentially the trader. Traders typically aim to syndicate the vast majority of the credit risk to banks, keeping a residual portion of up to 10 percent of the risk. In cases where a trader has sold on all the risk and rewards materially in a prepayment transaction, it can deconsolidate the financial risk from its own balance sheet.

Q. Who underwrites a prepayment?
A. In smaller prepayments, the trader will underwrite the transaction initially, then seek to reduce its exposure by bringing in banks. In the larger examples, underwriting is undertaken jointly and simultaneously with a syndicate of banks. For some of the very largest deals, bespoke special purpose vehicles (SPVs) are set up to house the loans on behalf of the trader and the banks. In this type of arrangement, the supply contract is between the producer and the SPV. The trader will typically lend money to the SPV alongside the banks to ensure their interests are all aligned.

Q. Are prepayments agreements a way for trading firms to make profit at the expense of producers?

A. While it is important for a trading firm that the economics of a prepayments transaction make sense, the primary motivation is not profit, but access to a reliable long-term supply of commodities, which enables a trader to generate efficiencies and economies of scale. The margin from lending under prepayments agreements goes to the banks.

Q. How are commodity prices determined in prepayments agreements?

A. The underlying commercial contract to any prepayments agreement stipulates the formula on which prices are to be calculated: usually on a monthly basis in relation to an internationally recognised market index such as Brent crude oil or the London Metal Exchange, with an appropriate quality differential.

Q. How are interest rates determined?

A. Interest rates are set based on the credit risk of the producer or refiner and of the country in which it is established, as determined by the financing banks. In cases where a trading firm initially underwrites a prepayments transaction, it will consult closely with potential lending banks on the interest rate to be proposed.

Q. How do traders manage their own risk exposure resulting from prepayments?

A. By sharing these risks with the banks, the insurance market and potentially other non-banking financial institutions.

Q. What happens if a producer or refiner falls into arrears with a prepayments, either because of a deep and prolonged slump in commodity prices or because of production problems?

A. A number of potential risk mitigants are written into and agreed as part of the contract in a prepayments transaction. As mentioned above, the contract in any case takes a conservative approach to debt service coverage, by building in a significantly higher volume to the commercial agreement than required to service the loan. In the event that prices fall further or for longer than provided for in this way, various options can be activated, including an extension in duration of the commercial contract; a top-up in volume under the existing contract; or early repayment in cash.

Q. Who has first call on the commodities flow if a producer or refiner defaults?

A. It is a basic requirement of any prepayments transaction that the trader assigns the commercial contract to the lending banks as security. This means that the banks have recourse to the commodities being procured as part of the contract. In reality, however, they will usually rely on the trader to monetise the relevant commodity volumes and repay them.

Q. How do prepayments facilities involving state-owned entities such as National Oil Companies (NOCS) relate to the relevant countries' sovereign debt?

A. NOCs may be state-owned, but they operate as commercial entities and treat prepayments just like private companies.

Q. What happens when a country with significant commitments under prepayments agreements faces a financial crisis and needs to reschedule its debts?

A. A prepayment is agreed between a trading firm and a company, not with the government of the country concerned. If the contracting company is unable to meet its commitments under a prepayments agreement, negotiations are held with the trading firm and the banks to restructure the agreement. On occasion such negotiations form part of a wider debt restructuring by the country concerned, including the wider creditor community and international financial institutions.

Q. What disclosure requirements are there for prepayments agreements?

A. A trading firm will disclose the prepayment transactions in its annual financial statement. Trafigura supports the Extractive Industries Transparency Initiative (EITI) and discloses payments to state-owned entities in EITI member countries. Discussions are underway concerning how the EITI disclosure regime may be extended to prepayments agreements.

GLOSSARY

B

Brent crude oil The most important type of crude oil used in Europe, named after the North Sea oilfield where it is extracted. It is one of many types of crude oil worldwide.

C

Counterparty The opposite party in a contract or financial transaction.

E

Extractive Industries Transparency Initiative (EITI) A global standard for the good governance of oil, gas and mineral resources. It seeks to address the key governance issues in the extractive sectors.

F

Futures Contracts for commodities to be delivered in the future. The product, quality, delivery and quantity is specified. These are traded on exchanges and there is no counterparty-based credit risk. The only variable is price. Contracts are marked to market daily.

L

Limited recourse prepayments
These prepayments occur when a bank is lending funds to the trader. It mainly has recourse to the commodity producer that needs to deliver the commodity flow to the trading company.

London Metals Exchange (LME)
A commodities exchange in London, England, that deals in metal futures. Contracts on the exchange include aluminium, copper, and zinc.
The LME is a non-ferrous exchange, which means that iron and steel are not traded on the exchange.

N

National oil company (NOC) An oil company fully or in the majority owned by a national government.

S

Special purpose vehicles (SPV)
A subsidiary created by a parent company to isolate financial risk. It is a legal entity created for a limited business acquisition or transaction, or it can be used as a funding structure. An SPV is set up to house the loans on behalf of the trader and the banks.

Structured Trade Finance (STF)
The business in which traders organise up-front prepayments for producing counterparties and are repaid over time in commodity shipments. It is one of the fastest growing parts of the resources industry and also one of the least well-understood.

W

West Texas Intermediate crude oil
A grade of crude oil used as a benchmark in oil pricing.

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