

A PRACTICAL GUIDE TO MANAGING FINANCIAL MARKET RISK ACROSS THE RED MEAT SUPPLY CHAIN

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Project Description

Financial markets are volatile, and this volatility impacts the profitability, sustainability and competitive standing of all companies and industries.

The red meat sector is exposed to significant financial market risks across the supply chain:

- **Foreign exchange** - direct and indirect sales of processed red meat and co-products as well as imports of capital goods;
- **Funding and Interest Rate** - from traditional funding sources and new alternate, less regulated sources of capital;
- **Commodity Price Risk** - live cattle, processed meat, as well as costs of production such as transportation, power, packaging and grain.

Managing these risks is critical to protect the profitability and sustainability of participants across the supply chain, allowing it to grow by attracting multiple sources of capital.

This Project provides a practical guide to the key financial market risks impacting the Red Meat Supply Chain giving insights into how the sector can identify, measure and manage these risks more effectively.

The Project provides an overview of commonly used risk management techniques and highlights best practices in risk management from other industry peers and industry groups.

The Project makes recommendations on how the sector can become more efficient in managing risk, including improving transparency of prices at pivotal points in the supply chain. This is critical if the sector is to be efficient, globally competitive, sustainable, and attracting domestic and international investment.

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Project Content

The Project identifies and analyses the key financial market risks and outlines the importance of risk management.

It provides an overview of each major financial market impacting the sector highlighting the depth, liquidity of existing benchmarks and a range of typical risk management alternatives.

It describes various techniques to mitigate market risk such as bi-lateral physical contracts, exchange traded futures and Over the Counter (OTC) derivatives.

It provides detailed explanation, using specific real-life examples, on how companies can hedge risks using a variety of risk management tools such as swaps and options, comparing and contrasting the benefits and shortcomings of each.

To illustrate the impact of market volatility on a processor's profit margin, a hypothetical "synthetic" beef processor was created. This "synthetic" processor assumed various types of cattle inputs that are representative of the industry, processed beef outputs and typical costs of production. Twenty years of historical data was analysed to illustrate the interrelationships between price and supply, economics of processing and sensitivity of prices and throughput to processing margins. The model is extremely flexible and can, subject to the availability of data, be utilized by industry participants for specific tailored analysis in the future.

The Project also provides insights into best practices in risk management from industry peers including various international industries, such as the New Zealand Dairy sector, other Australian agricultural sectors and the energy sector, such that the sector can learn from others facing similar risks.

While sheep sale yard activity and associated benchmarks are reported as satisfactory, the Project highlights some of the challenges facing the sector, such as the lack of transparent industry benchmarks for latter stage live cattle and processed beef and the lack of any effective, liquid market to mitigate this risk and recommends a course of action to address this.

Project Outcomes

The outcomes of this Project will be to:

- Create an industry focused reference on financial risk management that can be used as a reference point for current and future risk management activities;
- Improve the level understanding of domestic and global financial markets and the impact of volatility on profit margins;
- Understand the impact of market volatility and throughput on profit margins and how to mitigate;
- Enhance the knowledge of basic risk management techniques such as bi-lateral physical contracts, exchange traded futures, and Over the Counter (OTC) derivatives;
- Develop an understanding of commonly used risk management tool such as swaps and options;
- Explore the development of alternative sources of capital and their use in supporting the sector;
- Acknowledge the current challenges and short comings with the sector with a roadmap to improve price transparency leading to a more competitive, efficient and sustainable industry.

Benefit for Industry

This Project provides a valuable reference for the sector to identify, quantify, and understand the impact of market volatility on profit margins.

It will increase the level of knowledge and understanding of financial markets and basic risk management techniques allowing participants to learn best practices from industry peers and other industries.

It will outline a roadmap for the creation of industry accepted benchmarks providing better price transparency and a platform for participants to mitigate risk more effectively, arrange cattle supply chains more efficiently, enhancing the efficiency and sustainability of the processing industry and improving Australia's international competitive standing in the sector.

USEFUL RESOURCES

More detailed information can be found in the full Report which includes links to relevant online material.

