



# EXPOSING THE MYTH OF THE INDEX

For steel buyers, risk mitigation eliminates the disruption caused by cyclical upheavals.

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Feel like you're trapped in a maze as you navigate the ups and downs of the steel market? That's by design, and *it's the result of naked indexing.*

In a nutshell, the index model transfers price risk from the steel mill to the customer. The index is biased to higher prices through mill-controlled transaction prices and it lags spot pricing during price declines. Because prices move up much faster than they go down, OEMs using naked indexing are often forced to buy tons in the spot market as lead times stretch out, and they must take contract tons at high prices.

Many OEMs believe they have hedged price risk by attaching themselves to the index. In fact, the reverse is true: *They actually increase their risk.* Quite simply, buyers who make index deals fall into an inventory price trap.

At Flack Global Metals, we firmly believe that the naked index is good only for the mills, **and we have the data to prove it.** The index is harmful for consumers, who are forced to pay too much and who are compelled to take material they don't want.

Companies use the naked index because they think their discount to the index is the only thing they can control. When they're buying below the index price, they think they've gotten a deal. Sure, but that's the same deal everybody gets! Your mom may have told you that you're special, but you're not!

## Index model costs cut into the bottom line

Do you have \$3.4 million to throw away?

### How can risk mitigation help your organization?

- Decreased price volatility
- Stabilized cash flow
- Increased enterprise values

According to our five-year market back study, a buyer using naked indexing to purchase 20,000 tons of steel in 2018 sacrificed \$2.8 million of profit (and \$22.4 million in enterprise value) over a 12-month period.

Then there's the cost of excess inventory, as not every ton purchased is consumed at the same time. For purposes of this discussion, we assume 30 percent of the 20,000 tons – 6,000 tons – incurs interest expense and carry cost. Finance 6,000 tons at 5 percent interest, and you've lost another \$195,000 of profit.

And you can't overlook the cost differential of the tons locked in at higher prices compared to the new tons coming in (in 2018, \$24.60). The inventory overhang from the higher-price material lasts about three months, which adds up to a loss of \$442,800.

Add it all up: The costs of a naked index buy of 20,000 tons totals \$3,437,800 in lost profit.

### **Index model does not support buyers**

Naked index buyers believe they're taking a conservative approach to their steel buys by linking their purchases to an industry index.

What many steel buyers don't understand is that the index model is inherently flawed. It transfers the price risk from the mill to the buyer, and allows marginal buyers to set the price for the contract community. The naked indexing model ensures mill order books are full in down markets, while simultaneously offloading price risk onto the buyer.

Making matters worse, OEMs are still obligated to buy their required contract tons, inflating their inventory values. The price of the additional inventory buyers are forced to absorb often exceeds the current market price. In the process, OEMs become proxies for steel mills – and their own enterprise values are lowered accordingly to that of the steel mills.

Many buyers also disregard the total cost of steel ownership. At Flack Global Metals, we calculate that the total cost of ownership includes 80 percent for the physical steel cost, and 20 percent for vendor costs (including processing, freight, vendor profit and scrap). Buyers fight for discounts to the index and push for discounts on vendor costs – but completely ignore the 80 percent they think they have no control over.

### **Focus on the absolute transaction price pays off**

Price cycles in the steel industry are a given. There have been seven significant cycles in the last 16 years. Flack Global Metal's proprietary studies show that when hot-rolled coil (HRC) prices begin to rise in any significantly volatile market, the price moves up very quickly. After stabilizing, however, the price moves down slowly. In fact, **prices increase 63 percent faster than they decrease.**

And that is precisely what causes havoc for OEMs. These price increases drive OEMs to the spot market to procure material, ensuring the consistent supply they depend on when mill lead times stretch.

Attempts to “time the market” can be catastrophic if OEMs respond to increasing prices by maximizing contract tonnage requests in an attempt to protect themselves from spot buys. Eventually, mill production catches up, lead times are eased and deliveries resume – and spot pricing goes south. The OEM is now saddled with high-price, unwanted inventory.

There is a better way. The most effective OEMs pivot their focus to the absolute transaction price of the metal, which represents 80 percent of the total cost of ownership. When companies implement risk mitigation strategies – solutions used in other financial markets for more than 30 years – OEMs decrease price volatility, stabilize cash flows, improve accuracy in earnings forecasts, stop acting as proxies for steel mills, and ultimately increase enterprise values.

### **Specialists in ferrous risk mitigation**

At Flack Global Metals, we believe that no one can accurately predict the steel market. **When you make the choice to lay off price risk into the marketplace, you put your organization on the path to growth and prosperity.**

The industry leader in ferrous risk mitigation, Flack Global Metals is active in the ferrous derivatives market, using futures and options to manage risk in our own business. Flack was party to the first options trade on the CME in 2012. We practice what we preach.

Since the inception of the HRC index in 2012, Flack has made significant investments in its risk management infrastructure, employing industry-leading risk management experts to generate real-time market analysis of the steel industry through our WoW report and Steel Market Dashboard.

The FGM risk mitigation team collaborates with OEMs to determine business goals and risk appetite. Our team creates proprietary, customized risk mitigation solutions for OEMs. Flack is the only service center in the steel industry to offer its customers uniquely tailored supply chains combined with innovative risk mitigation solutions.



#### **About the author:**

Jeremy Flack

The founder and CEO of Flack Global Metals, Jeremy is a cum laude graduate of Miami University with a bachelor's degree in finance, and holds an MBA from Cleveland State University. He served as co-owner, president, and treasurer of Lawson Steel, where he managed sales, purchasing and operations, before divesting his interests and establishing FGM.

#### **About Flack Global Metals:**

Headquartered in Scottsdale, Arizona, FGM designs and fulfills supply chains for OEMs using flat rolled steel, aluminum and stainless. FGM was established to fill a void in the steel industry.

It provides customers with a geographically agnostic steel distribution process and offers industry-leading risk management services to OEMs.

FGM maintains offices in Cleveland, Chicago, and Atlanta.

**For more information, visit [www.flackglobalmetals.com](http://www.flackglobalmetals.com).**