Flack: Changing Minds in Flat Roll—Always Be Hedging

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One of the famous quotes from the 1992 movie "Glengarry Glen Ross" is, "Always be closing." Since we started Flack Global Metals (FGM) in 2010, the quote you may have heard us say more than any other is, "Always be hedging." But in an industry devoted to buying based on an index, changing minds has been hard to do. That is until the current post-COVID market.

Pre-COVID, we made steady progress over our decade in business by guiding the early-adopters in our customer base to convert from the index-based arrangements that have become the industry norm to fixed pricing options based on hot rolled coil futures. In fact, our fixed price contract book is up 1,300% in terms of volume from 2017. And while this year we have been able to save our customers the extremes of this never-before-seen market, it is unfortunate that all too often we observe customers and prospects ignoring the real risks and defaulting to indexing as the preferred method of sourcing – most often to the detriment of their businesses.

But the post-COVID steel market is changing minds – rapidly. We are seeing more interest in long-term commitments to us for tons at a fixed price in the last year than we had seen in total since the CME HRC future was developed in 2008. As the first and only flat roll distributor in North America to have built the CME HRC forward contract into every aspect of its business, we use the hedge to protect our customers and our own inventory and capital, as an opportunity to trade for our own account, and as one of the largest market makers on the CME. More importantly, our reliance on hedging means we never ask a customer to take a position we haven't taken ourselves. My team doesn't just encourage others to hedge, we ourselves are "Always hedging."

How would you have fared had you been one of those early adopters on our client roster? If you had *passively* hedged your steel buys from 2013-2020, you would have saved an average of $110 per ton off the spot price for every ton of steel you bought. Those savings are in addition to any negotiated discounts to the index which are granted by the producers and in spite of two large downdrafts in prices during 2015 and 2019. Even more telling is that, on average, our customers have saved in excess of $550 per ton by utilizing FGM's ability to hedge during the current rally.

Why then is our industry so attached to floating rate contracts? All too often, we see our customers and prospects employ buying strategies based on a stable marketplace with ample supply, loose credit and little government intervention. In our experience, the reliance on index-based pricing is because emphasis is placed on discounts to the spot market and are predicated upon market stability.

Most buyers are incented to negotiate what they believe they can, typically a discount to the spot market and the fees associated with logistics and processing of the material. But these negotiations ignore the eighty-odd percent of the total cost of procurement. By not focusing on the spot price, but instead focusing on the multitude of pricing mechanisms available via the forward curve, any company can be a good candidate for hedging no matter how they go to market.

As for market stability, the United States is the most volatile steel market in the world, and it is becoming even more so. The probability that there will be another significant market dislocation after the dust settles on the current market is nearly 100% in the 36 months following this rally based on our analysis These events are not the black swans that many believe them to be. They are simply the market as it is now, prone to price runs for new and varying reasons that *no one* can predict, ourselves included. We simply use data to predict that there will be another one – but not when or by how much.

All that being said, we continue to hear a number of rationales for maintaining index buys instead of hedging that we debunk regularly, including:

The CME HRC Contract is Illiquid

This may have been true at one point but is no longer the case. We ourselves traded over 550,000 tons last year. Yes, some instances required some patience, which is why we manage all aspects of hedging for our customers. But it is extremely rare that we couldn't get a trade placed.

The Talking Heads Say the Market is Going to Decline – That the Rally Will Not Last

No one, and we mean no one, can predict steel prices, including our team at FGM. Betting your business operations on forecasters with no skin in the game is gambling.

I Can Raise the Price to My Customer, Therefore I am Protected

At best, this is only partially true. We see our customers and prospects get caught in traps when their customers retard the price growth and postpone it as long as possible, only to expect lower prices when the market declines. The higher the volatility in pricing the more difficult it is to get the timing right, and there has never been a market as volatile as the one we are in right now.

I Don't Know How Much Business I Will Have Next Year

We never encourage our customers to hedge 100% of their volume. So, unless you plan to go out of business, you will be buying *some steel* next year. Buy the volume you know you can safely predict and use traditional buying methods for the rest.

Our industry focus when it comes to pricing needs to turn the curve, literally. We buy and sell one of the most volatile commodities in the world in one of the most, if not *the* most, volatile markets in the world. We are past the early adopter phase in the development of the forward markets for flat rolled steel and the results in measurable cost savings have been established. The forward curve presents opportunities to de-risk our businesses, decrease our volatility and add certainty to our operations. In a market like we are currently experiencing, it is hard to ask for more than that.