FGM Op/Ed: Future's in the Forward Curve

October 26 2021 by Tim Triplett www.steelmarketupdate.com

(Editor's note: The following commentary was submitted by Flack Global Metals Founder and CEO Jeremy Flack.)

Looking to improve vendor relations during contract negotiations? Look no further than the forward curve.

Contract season is underway, and we hear things are choppy out there. The mills are serving up a mixture of higher extras and lower discounts - in some cases offering fixed prices rather than floating and limiting their product offerings as they want to produce what runs best on their equipment. For many buyers, this is causing significant consternation - dare we say grumpiness? - and an unwillingness to commit "too early." As Steel Market Update has reported, we are also hearing that many buyers are moving to import buys for the first half of 2022, which is understandable with $700-per-ton discounts to spot able to be found. All of this is happening as the spot price is wavering and confidence in this market is declining.

Against such a volatile background, we at Flack Global Metals (FGM) continue to believe that contract negotiations are about the wrong things. Issues of price and supply have been conflated, when in reality there is a vast opportunity to benefit by separating the two. Unfortunately, most buyers have not been motivated or incentivized to negotiate supply and price independently. But that is changing.

We at FGM believe the steel industry has become characterized by buying behaviors that do not fit today's marketplace. With steel supply available ubiquitously and globally throughout our modern history, OEM management teams have encouraged their metals buyers to follow an aggressive playbook. During contract negotiations, push for maximum discounts to the benchmark pricing index. Every business opportunity warrants an aggressive pursuit for a lower price, regardless of legions of service centers lining up to quote the same jobs. The result? Buyers are incentivized to focus almost exclusively on price per ton. They predictably get stuck arguing over the small stuff and have become accustomed to negotiating from a place of power. But I don't have to tell you - those power dynamics have now shifted to the mills for next year. How are we recommending our steel buyers react for 2022?

Steel buyers should make their supply deals with the mills and/or service centers that best fit their supply and material needs, *absent from the price discussion.* This ability to separate negotiations of supply and price lies in utilizing the forward curve.

Start by choosing the parties you want to work with in terms of service, quality, consistency, geography - whatever your buying criteria includes outside of price. Look to find counterparties that, in return, genuinely want to work with your company based on those criteria - again, not on how much money they will make on your buys. Then, structure your supply chains for the long term, much like the Japanese car companies do by crafting agreements for multiple years. Once durable supply chains are chosen, and details around supply are confirmed for both parties, close those negotiations. Now you can move your attention to garnering all of your pricing via hedging on the forward curve.

For our customers in this position, there are good deals and pricing certainty to be had. There is currently between $800 and $900 of backwardation (lower prices) out on the forward curve – pricing equivalent to imports arriving in Q1 2022. The forward curve is offering even lower pricing for the balance of 2022. So, while many buyers are quick to chase a $700 discount via import offers, they shrug their shoulders at the same discount available in the forward markets because they believe it is too "risky." But significant risk is inherent in an import supply subject to delays, government interventions, and now, dual disruptions due to a worldwide energy crisis and freight displacements. In contrast, the domestic mills are, excluding extraordinary events like a pandemic, quite reliable.

The approach we are advocating is nothing new. It is how base metals, agriculture and energy industries deal with pricing outside of supply agreements. Agriculture has been actively hedging its market for 170 years. Historically, the painful annual negotiations our industry mires itself in every fall directly result from an absence of pricing models. It is due to the steel industry's prior inability to fix prices in the forward markets that we have our annual contract season. But those days are long gone. Now, it is simply an outdated view of hedging as a valuable pricing mechanism that keeps many from exiting this annual power struggle once and for all.

Our data proves if you are not buying on the curve, you are embedding a loss of $93 per ton into your business. On top of that, you are enduring 70% more volatility than you should. What if, instead, buyers were incentivized to provide management with a cost forecast for the following 18 months they could reliably achieve, regardless of what happens on the index? Stop letting misconceptions of what hedging actually is prevent you from creating certainty in your business.

Many hear hedging and immediately think of gambling or betting. But the reality is precisely the opposite. The conservative approach is, without a doubt, to fix most of your pricing on the forward curve. Relying on an index is gambling. If you weren't convinced before, certainly the last 18 months have persuaded you there must be a better way to buy steel. We happen to believe salvation lies in the Chicago Mercantile Exchange (CME) forward curve for hot rolled coil – so much so that we purpose-built FGM with the forward curve as our foundation.

Our research indicates a 95% probability that when the dust settles on this market, another disruption will occur to drive prices wild sometime within the next three years. Not that this market is done with us yet! So always be hedging, and please, do something certain for your business.