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COMMODITY TRADING'S COMING-OF-AGE STORY

From market brokers to industry shapers

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For the commodity trading industry, 2023 marked a year of rebalancing. Supply chains, commodity prices, market volatility, and economic growth across regions and sectors began to normalize after the disruptions in 2022. As a result, Oliver Wyman analysis shows trading gross margin declined from the 2022 record high of $150 billion to around $100 billion in 2023. Although margin declined, 2023 still ranks as the second highest level of industry profits, after sustained growth since 2018.

By providing stability to existing supply chains and support for emerging supply chains, traders gained influence in the reconfigured landscape. This position enabled traders to accumulate about $70 billion to $120 billion in cash over successive years of strong performance. With a changing of the guard at the C-suite level across commodity trading firms, those cash reserves provide the opportunity for new management teams to become more impactful long-term investors in the energy ecosystem.

The impactful role is also a high-profile role, and last year traders became more public facing than ever before, operating as trusted counterparties to a wider range of stakeholders than in the past. Traders will need to adapt their culture to accommodate their new role and the expectations it brings. This includes becoming more comfortable with additional scrutiny of their governance and sustainability practices, investing in portfolio-level risk management and steering, changing operating models, and hiring the right talent to fill critical capability gaps.

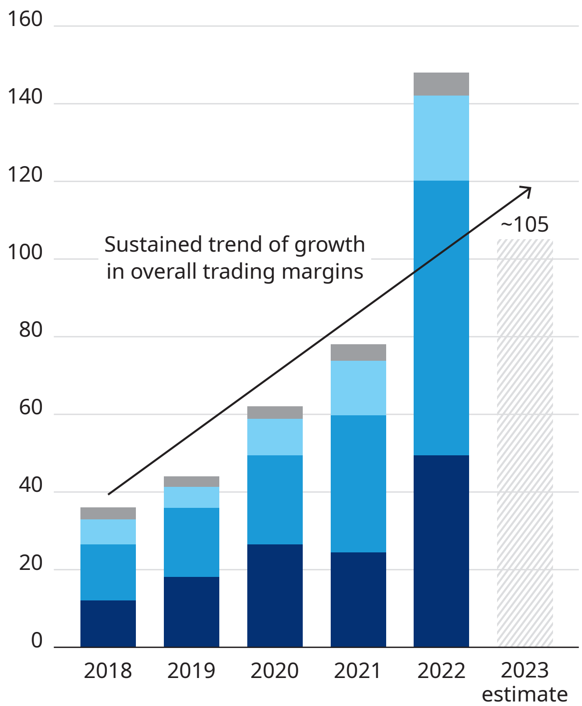
As flows rebalanced, total gross margin generated by commodity trading regressed to the mean, down from a peak of $150 billion in 2022 to around $100 billion in 2023

INDUSTRY REBALANCES AFTER RECORD 2022

The commodity trading industry rebalanced in 2023 following a period of fundamental disruptions in cross-commodity trade flows in 2022, when trading gross margins reached a record of about $150 billion. As commodity markets settled and supply chains stabilized, gross margin declined to around $100 billion in 2023 and reverted to the positive, if less extreme, trend it has followed for the past several years.

Exhibit 1: Total global commodity trading gross margin

US$ billion



Commodity type	Change 2022–2023	CAGR 2018–2023
Agricultural and food products	↘	5–10%
Metals and mining (including coal)	↘	15–20%
Integrated gas, power, and emissions[1]	↘	25–30%
Oil[2]	↘	25–30%
Player type		
Top five asset-backed traders[3]	↘	15–20%
Top five merchant traders	↘	20–25%
Financial players (banks, hedge funds)	↘	35–40%
Others	→	20–25%

Size of the decrease in gross margin from 2022–2023:

<20% 20–30% >30%

1. Integrated gas, power, and emissions consists of European power and gas, North American power and gas, global LNG, and niche products such as Asian power and gas and emissions.
2. Oil includes crude, products, chemicals, biofuels, and associated investor products.
3. Top five asset-backed traders adjusted 2022 figures to account for extraordinary losses.

Source: Oliver Wyman proprietary data and analysis

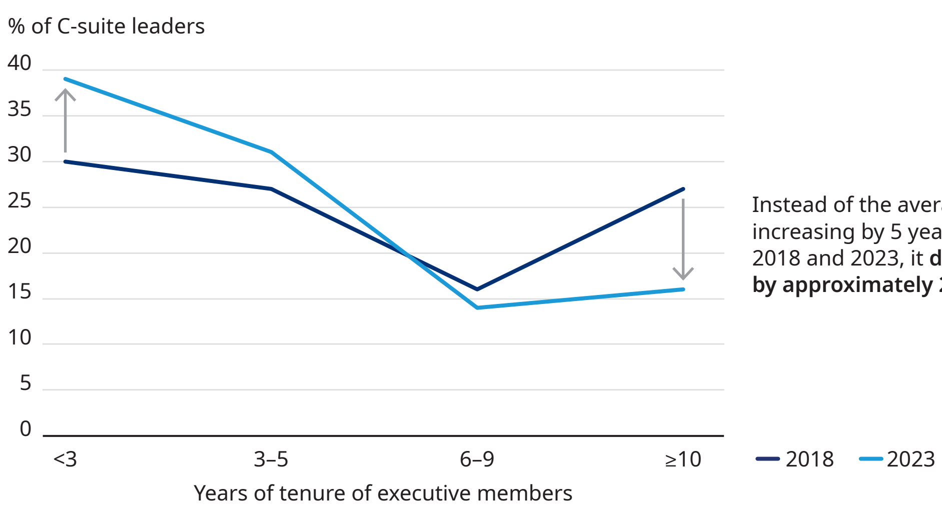
The reversion to this trend indicates two things. First, 2022 was a year dominated by idiosyncratic events, and record margins were not sustainable. But second, the structural factors that drive commodity trading profitability remain in place. Ongoing tightness of supply in major commodities means potential future shocks to commodity markets could cause extreme volatility.

While gross margins for crude trading declined due to lower volatility in 2023, product trading margins were often maintained due to continued inefficiencies and reconfiguration of trading flows. For power and gas, the gross margin decline can be attributed to the reduction in European power prices and in arbitrage opportunities for liquified natural gas (LNG) between eastern and western markets. Relatively mild winter conditions across the globe, coupled with increasing LNG capacities and availability, left countries with greater than expected natural gas stocks. Metals and mining showed the steepest decrease from the highs of 2022, mostly driven by the price of coal returning to 2021 levels, down 50% from 2022, reducing the potential for profits.

NEW EXECUTIVES HAVE SIGNIFICANT CASH TO INVEST IN LONG-TERM STRATEGIES

Commodity trading firms retained a significant portion of their rising gross margins as cash on their balance sheets during the last five years. The amount of earnings retained is likely about $70 billion to $120 billion for this five-year period, according to Oliver Wyman analysis. This huge reserve is shifting to the control of a new wave of leaders. Since February 2022, at least 20 senior executives in commodity trading firms have stepped into new positions, including the roles of chief executive officer, chief financial officer, and heads of trading divisions. Now, 75% of senior executives have tenures that are below the average tenure of their predecessors five years ago.

Exhibit 2: Tenure among senior executives at commodity trading firms today compared to five years ago



Source: Company press reports, Oliver Wyman analysis

With significant amounts of cash at their fingertips, the new guard of senior executives must now choose how to invest. Commodity trading firms could benefit most from investing across assets and in upgraded operating models, risk management, and culture. Investment in assets gives traders greater optionality and influence over the commodities they trade. Investment in their trading platforms will help traders manage the growing complexity of their businesses and remain agile and prepared to capture value from the next wave of volatility.

The role of commodity traders is steadily evolving toward trusted counterparts in the wider energy ecosystem, which comes with increasing scrutiny

THE ROLE OF COMMODITY TRADER IS EVOLVING

Not only must new executives decide on which long-term strategic investments to make, they must each navigate a course for their firm to thrive as the sector evolves to a more visible role in commodity markets.

Commodity traders are working more closely with governments to ensure security of energy supply and to support new green value chains. By doing so, the job of a trader transitions from a market broker to an investor reshaping supply chains.

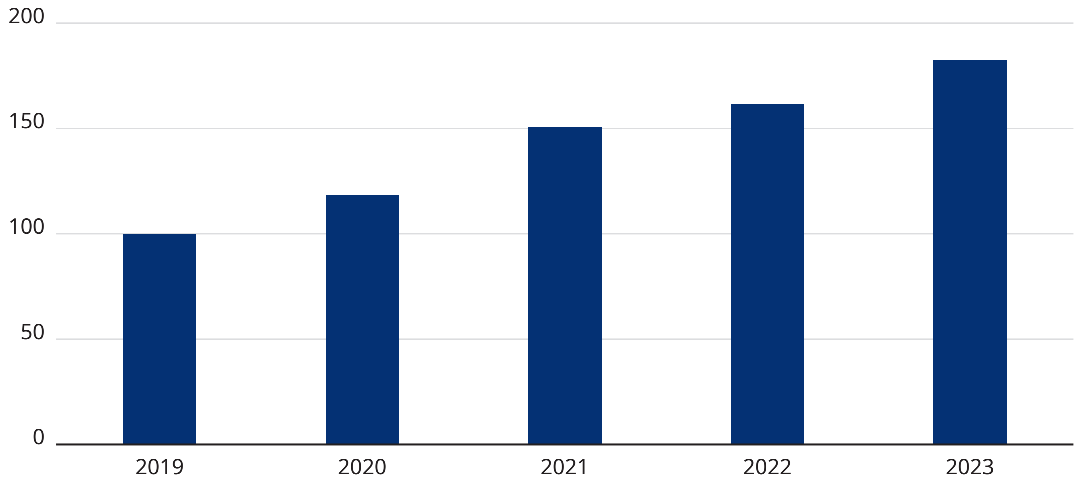
Examples include trading firms working with European governments to secure gas imports, thereby diversifying energy sources and playing a critical role in enhancing energy security. Similarly, traders can play a crucial role in bolstering metal recycling value chains, for example battery metals, which are expected to see tight supply markets due to years of under-investment in new mining projects. Recyclers and automakers will ultimately be prompted to create closed-loop supply chains by the substantial incentives in the US Inflation Reduction Act and the European Critical Raw Materials Act, and traders have the opportunity to step in and support these new supply chains.

Yet, while government incentives and the impact of sanctions create opportunities for commodity traders, the changes also impose expectations of new standards of scrutiny. Commodity traders are now increasingly required to operate with greater transparency to avoid public backlash. Due to the growing impact of these trade flows on geopolitics, governments are becoming more vigilant. The trading firms that have already shown success with government partnerships understand the importance of building trust.

Continuing to prioritize building long-term relationships — and the culture of collaboration and compromise this entails — will be a key success factor for trading firms as they take more visible partnership roles with states.

Traders bring the required strategies and capabilities to fulfill the role of trusted partner in the wider energy ecosystem. However, they must now navigate the inherent expectations that arise from working with governments and operating in the public eye. Recent trends indicate there has been a notable rise in media coverage of commodity trading companies (Exhibit 3), emphasizing the need for traders to adapt to this heightened visibility.

Exhibit 3: Number of media mentions of commodity trading companies
Number of company mentions indexed to 2019 (2019 = 100)



Source: Factiva, 1 January 2019–31 December 2023, Oliver Wyman analysis

TRADERS MUST INVEST IN ASSETS, CAPABILITIES, AND CULTURE TO THRIVE

With new leadership and significant cash reserves, commodity trading firms can seize the opportunity to revamp for the future. Thriving means adapting to the evolving role of shaping markets and supply chains and accepting the scrutiny that comes with playing a more visible role.

For tangible investments, trading firms should prioritize taking strategic asset positions and improving trading platforms. More broadly, they should invest in culture and capabilities and consider their operating model, risk management and talent strategies.

Strategic asset positions across legacy and emerging value chains

Asset-focused investments come in two kinds: strategic asset positions in legacy value chains, taking over from existing players; and start-up investments that help galvanize and accelerate nascent green and circular value chains.

Legacy and traditional value chains that are being reconfigured, such as gas, LNG, and oil and products, present new optimization opportunities. Here, traders can benefit by gaining access to shipping charters, gas offtake agreements, strategically located crude oil refineries with investment backlogs, and power plant and pipeline assets as well as downstream distribution networks.

In newer green and circular value chains traders can be early movers. This could involve investing in clean or low-carbon hydrogen production units against secured offtakes, integrated biomethane value chains, strategic liquid storage facilities, and batteries for power load shifting and firming. Some of the world's leading oil and gas companies have demonstrated this strategy in their recent renewable natural gas acquisitions. Strategic asset positions are effective investments in these value chains as they allow for control over the limited or constrained flows in illiquid markets and optimization opportunities in value chains that can be highly differentiated in supply and demand.

Widening risk management and steering at the desk and portfolio levels

Growing complexity in operations, especially with new and reconfigured supply chains and investments in a diverse set of physical assets, means commodity traders must upgrade their risk management processes. Holistic, portfolio-level risk management includes an explicit risk capital allocation and steering as traders consider long-term investments in reconfigured and greener value chains. These new market dynamics involve increased risk capital requirements and supply mandates in the context of rebalanced economic growth. Also, at the sub-portfolio and desk levels, risk management must adapt to normalizing market conditions in the short term, specifically for renewable power and green gas portfolios, which are highly complex for measuring and managing risk.

A collaborative, tech-enabled trading platform

Traders must also consider further investing in their trading platforms, preparing themselves for future opportunities — particularly as they move into markets that are about managing systems rather than shipping physical product. Investments should focus on enhancing underlying systems and processes that support agility and growth and strengthening business development and origination capabilities — especially regarding reconfigured and emerging supply chains. Furthermore, traders have been strategically using their cash reserves to buy back shares from the longer-serving trader population, providing an additional avenue for shaping the organization and platforms.

Firms must also make sure they can capture the full value of collaboration across desks. At top trading firms in 2023, power trading desks collaborated with gas and LNG desks to optimize risk management and ensure stable performance throughout the year. That held true even in a challenging macroeconomic environment in Europe and during weather-related disruptions in the US. Similarly, collaboration of oil, product, and gas desks with shipping and chartering desks helped firms navigate tight freight markets across major shipping chokepoints such as Panama and the Strait of Hormuz. Implementing such collaborations requires some critical adjustments to traditional operating models such as better interface management and incentive structures for traders to react and take decisions quickly.

Evolving trading platforms also requires investments in stronger analytical capabilities, with some trading firms already reviewing risk management trading platforms that support collaboration and experimenting with generative artificial intelligence. The new technology is designed to further enhance decision-making, for example, on an intra-day and 24/7 basis, foster scalability through even greater automation, and harbor resilience through efficiency and more standardized processes.

These investments in trading systems and analytical capabilities will require finding the right people to make the changes. Dedicated technology and development teams focused on embedding new software in trading will be key. Venture investments in start-ups that bring on new talent and data could be viable, low-risk alternatives to developing solutions in house. In some cases, commodity traders could also benefit from tapping outside talent to acquire skillsets and capabilities such as product and software development. Securing the best talent for technical roles will mean creating a culture that is more attractive than that of Big Tech companies — which is no easy task.

Investing in increased transparency, accountability, and a future-ready talent pool supported by improved portfolio management processes allows trading firms to position themselves for the future

SUCCEEDING IN THE LONG TERM

As new players, including several oil majors, national oil companies, small integrated oil and gas companies, and hedge funds, enter the market on the back of significant value created in the last two years, the need for trading firms to evolve becomes more critical than ever before.

To build further institutional value, leadership needs to look beyond short-term market swings by steadily investing in long-term market opportunities in reconfigured supply chains, the energy transition, and their trading platforms. To embrace new opportunities in emerging value chains, cross-desk collaboration, and automation, traders must adapt portfolio-level risk management and financial steering processes to a higher velocity and more complex trading environment. Further, traders need to implement newer operating models, invest in securing relevant talent, and adapt to the scrutiny that comes with a more visible role in energy market collaborations.

The opportunity is ripe for a culture shift as the industry rebalances from the highs of 2022 and as new leadership offers the vision and resources to invest in change.

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