

Goldman Sach's new money machine: warehouses

By stockpiling aluminum, Goldman is profiting, and creating tension

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In a rundown patch of Detroit, enclosed by a cyclone fence and barbed wire, stands an unremarkable warehouse that investment bank Goldman Sachs has transformed into a money-making machine.

The derelict neighbourhood off Michigan Avenue is a sharp contrast to Goldman's bustling skyscraper headquarters near Wall Street, but the two operations share one important element: management by the bank's savvy financial professionals.



A string of warehouses in Detroit, most of them operated by Goldman, has stockpiled more than a million tonnes of the industrial metal aluminum, about a quarter of global reported inventories.

Simply storing all that metal generates tens of millions of dollars in rental revenues for Goldman every year.

There's just one problem: much less aluminum is leaving the depots than arriving, creating a supply pinch for manufacturers of everything from soft drink cans to aircraft.

The resulting spike in prices has sparked a clash between companies forced to pay more for their aluminum and wait months for it to be delivered, Goldman, which is keen to keep its cash machines humming and the London Metal Exchange (LME), the world's benchmark industrial metals market, which critics accuse of lax oversight.

Analysts question why London's metals market allows big financial players like Goldman to own the warehouses which store huge quantities of metal even as they trade the commodity. Robin Bhar, a veteran metals analyst at Credit Agricole in London says the conflict of interest is so acute he wants U.S. and European anti-trust regulators to weigh in.

"I think it makes a mockery of the market. It's a shame," Bhar said. "This is an anti-competitive situation. It puts (some) companies at an advantage, and clearly the rest of the market at a disadvantage. It's a real, genuine concern. And I think the regulators have to look at it."

Goldman said its warehouse subsidiary Metro International Trade Services has done nothing illegal, and abides by the LME's warehousing rules. "Producers have chosen to store metal in Detroit with Metro," a Goldman spokeswoman said. "We follow the LME requirements in terms of storing and releasing metals from our warehouses."

The London Metal Exchange defends its rules. "There is a perception that consumers have not been able to get to their metal when the reality is that it is big banks, financing companies and warehouses that are not able to get to their huge tonnages of metal fast enough," said LME business development manager Chris Evans.

Business model

Goldman's warehouse business relies on a lucrative opportunity enabled by the LME regulations. Those rules allow warehouses to release only a fraction of their inventories per day, much less than the metal that is regularly taken in for storage.

In the year to June 30 Metro warehouses in Detroit took in 364,175 tonnes of aluminum and delivered out 171,350 tonnes. That represented 42 percent of inventory arrivals globally and 26 percent of the metal delivered out, according to the London Metal Exchange said.

The metal that sits in the warehouse generates lucrative rental income.

Little wonder that so many want in. Metro was acquired by Goldman in February 2010, while commodities trading firm Trafigura nabbed UK-based NEMS in March 2010, and Swiss-based group Glencore International acquired the metals warehousing unit of Italy's Pacorini last September.

Henry Bath, a warehousing firm and founding member of the London Metal Exchange in 1877, has been owned for about 40 years by traders or banks including Metallgesellschaft in the 1980s and failed U.S. energy trader Enron at the turn of the century. It now comes under the umbrella of JP Morgan, which bought the metals trading business of RBS Sempra Commodities in July last year.

Despite its rental income, Goldman's warehouse strategy apparently hasn't been enough to snap a slumping performance in commodity trading, with the company reporting a "significant" drop in revenues from a year ago in its latest quarter, the sixth time in the past 10 quarters that it has failed to expand.

Consumers fume

The long delays in metal delivery have buyers fuming. Some consumers are waiting up to a year to receive the aluminum they need and that has resulted in the perverse situation of higher prices at a time when the world is awash in the metal.

"It's driving up costs for the consumers in North America and it's not being driven up because there is a true shortage in the market. It's because of an issue of accessing metal ... in Detroit warehouses," said Nick Madden, chief procurement officer for Atlanta-based Novelis, which is owned by India's Hindalco Industries Ltd and is the world's biggest maker of rolled aluminum products. Novelis buys aluminum directly from producers but is still hit by the higher prices.

Madden estimates that the U.S. benchmark physical aluminum price is \$20 to \$40 a tonne higher because of the backlog at the Detroit warehouses. The physical price is currently around \$2,800 per tonne. That premium is forcing U.S. businesses to fork out millions of dollars more for the 6 million tonnes of aluminum they use annually.

It has also had a knock-on impact on the global market, which is forecast to consume about 45 million tonnes of the lightweight, durable metal this year.

Also pushing aluminum costs higher are bank financing deals, which are estimated to have locked up about 70 percent of the 4.4 million tonnes of the metal sitting in LME-registered warehouses around the world. ME inventories hit an all-time record above 4.7 million tonnes in May.

In a typical deal, a bank buys aluminum from a producer, agrees to sell it at some future point at a profit, and strikes a warehouse deal to store it cheaply for an extended time period.

The combination of the financing deals and the metal trapped in Detroit depots, means only a fraction of the inventories are available to the market. Premiums for physical aluminum -- the amount paid above the LME's cash contract currently trading at \$2,620 a tonne -- in the U.S. Midwest hit a record high of \$210 a tonne in May, up about 50 percent from late last year. In Europe, the premium is at records above \$200 a tonne, double the levels seen in January 2010.

The ripple effect into Asia has seen the premium paid in Japan increase 6 percent to \$120 a tonne in the third quarter from the previous quarter, the first rise in nearly six quarters.

The rent

You won't hear banks like Goldman complaining. Rental income continues to pour in at the 19 Detroit area warehouses run by Metro as of June.

From the outside one recent afternoon, a depot in the Detroit suburb of Mt Clemens appeared to be deserted. But neighbors say the place is a whirl of activity in the early hours of the morning when metal is usually delivered for storage.

The LME says the current maximum rent, set by warehouse operators, is 41 U.S. cents per day per tonne. At that rate, Goldman's warehouse operation in Detroit -- said to be holding more than 1.1

million tonnes -- could be generating as much as \$451,000 per day or about \$165 million a year in revenue.

An exact figure cannot be calculated because many clients negotiate lower rental rates and Goldman declined to detail its income from its warehouse business. But when Swiss-based trading company Glencore listed earlier this year it revealed that its metals warehousing unit generated \$31 million in profit on \$220 million in gross revenue in 2010.

Long history

Caught between consumers and warehouse operators is the 134-year old LME, one of the world's last exchanges with open-outcry trading. Sessions take place in a trading ring with red padded seats while visitors can watch from a gallery. Traders juggle multiple telephones and use archaic hand signals to fill orders from consumers, producers and hedge funds.

The ring is a perhaps more civilized version of the tumultuous trading pits made famous in Chicago. Each of six major industrial metals including copper and nickel are traded for five minute bursts in the morning and afternoon. Only 12 firms have access to the ring, arranged in fixed positions in a circle, with many others involved via the ring dealers and on the LME's electronic trading system.

Longer sessions in the late morning and afternoon allow trading of all metals simultaneously and are known as "the kerb" from the days when dealers continued to trade on the kerb, or sidewalk, after leaving the exchange.

The LME certifies and regulates the Detroit sheds as part of a global network of more than 640 warehouses. The network is meant to even out swings in volatile metals markets. During recessions, surplus metal can be stored until economies recover and demand picks up, when the metal can be released.

But that function is now being undermined by the backlog in Detroit.

LME rules stipulate that warehouses must deliver a certain amount of metal each day. However the rules apply not to each warehouse but to each city that a company has warehouses in. At the moment, a warehouse operator needs to deliver just 1,500 tonnes a day per city, whether it owns one warehouse there or dozens. That means each of Metro's Detroit warehouses need to release only 79 tonnes of aluminum a day. At that rate, it would take two years to clear the stocks held by Goldman's Detroit warehouses.

The backlog sparked outrage last year, prompting the LME to task London-based consultancy Europe Economics to look into its rules. Europe Economics recommended the exchange raise its minimum delivery rates and earlier this month the exchange announced a new regime for operators with stocks of over 900,000 tonnes in one city.

From April 2012 the minimum delivery rate will double to 3,000 tonnes a day.

Critics dismiss the move as too small to have any real effect, especially because of the delay until it comes in.

"The move is too little and too late to have a material effect in the near-term on an already very tight physical market, particularly in the U.S.," Morgan Stanley analysts said in a July note.

A senior executive at a metals brokerage told Reuters "the recommendations won't change anything. The problem will still be there six, nine months down the line." "If Detroit has 1.1 million tonnes at the moment, what's to say it won't have 2 million tonnes next year," he said.

Moving more metal

One obvious solution would be to impose minimum delivery requirements per warehouse or per square meter of warehouse space rather than per city. It's not as if the warehouses can't cope with delivering more stock: large operations can shift much more than 3,000 tonnes a day, warehousing sources say. An experienced forklift driver takes about 20 minutes to load one 20-tonne truck with aluminum in the United States. That means one warehouse in Detroit with two doors, two forklifts and an eight-hour working day could move out as much as 1,920 tonnes of metal every day.

"If you take Detroit in particular, those warehouses historically extracted metal at a faster rate ... the infrastructure is there," a senior analyst in the metals industry told Reuters.

Madden at Novelis said: "I don't know the specific details of every warehouse but our view is that they seem to be able to absorb metal coming in at almost an infinite rate and so we feel there's a lot more they can do on the output side to push up the (load out) rates."

The LME could also crack down in the same way it did in 1998 when it banned Metro from taking any more copper into its Long Beach and Los Angeles warehouses. Then the complaints were said to have come from copper consumers worried that 80 percent of total copper stocks in LME-approved warehouses were held in California. The exchange argues that any change right now might disrupt the market.

"Changes to the delivery out rate have required careful consideration because it will impact the cost structure for those holding metal, and were those costs to rise sharply it could affect the way that metal is stored and traded," said the LME's Evans.

The exchange could also rule that a warehouse cannot charge rent once aluminum has been purchased, no matter how long it takes to ship it. But a change like that would hit the LME itself as it receives about 1 percent of the rental income earned by the warehouses it approves.

Legal fears

Nobody at the LME will say whether the Europe Economics study -- industry sources said it talked to more than 40 companies -- advised more radical measures, arguing that such information is "proprietary." In any case, say metal markets sources, LME officials may be hesitant to make bigger changes because they fear legal action from the likes of Goldman, which could argue that Metro's business model has been based on existing LME warehouse rules.

The LME declined to comment on possible legal challenges, but its Chief Executive Martin Abbott said at a recent briefing that the warehouse delays were not causing market and price distortions.

"No, I don't believe it is," Abbott said, when asked if the situation was causing distortions in the market. Abbott said the exchange had received no official complaints from consumers about bottlenecks at warehouses. The LME also dismisses concerns about banks trading metal and owning the warehouses where it is stored.

While a British parliamentary committee raised the issue in May, Britain's Office of Fair Trading declined to open a probe. The U.S. Commodity Futures Trading Commission, which regulates the futures and options markets, said it would not comment. Britain's Financial Services Authority, which regulates exchanges where commodity futures are traded but not warehouses that store physical material, declined to comment.

What to do?

The lack of real change has some in the industry questioning the very structure of the LME, which, unlike its publicly owned U.S.-based rival commodities exchanges, is owned by many of the financial institutions that trade there.

"The belief is that they are focused on serving their shareholders; most of them being the banks ... We see our clients and contacts trying to avoid the LME as much as possible now," said Jorge Vazquez, Managing Director of the Aluminum Intelligence Unit at HARBOR Commodity Research.

That concern is growing. Critics of the exchange point to a potential problem with zinc supply through New Orleans, where inventories now account for 61 percent of total LME-registered stocks. Most of the warehouses in New Orleans are owned by Goldman and Glencore.

Metal industry sources believe regulators should take a closer look at the possible conflict of interest that arises when trading houses also own the warehouses.

"If the whole thrust of regulation and regulatory reform is increased transparency and open and above board operations, letting banks own warehouses seems to run entirely counter to that," said Frances Hudson, global thematic strategist at Standard Life Investments said.

The LME says it enforces a strong separation between warehouses and the trading arms of their owners. Just this week it proposed that companies which own warehouses should engage an independent third-party to verify the robustness of Chinese walls.

"We enforce it through regular audits of warehouses," said the LME's Evans. "If people say Chinese walls are leaking then they should bring us evidence and we'll investigate."