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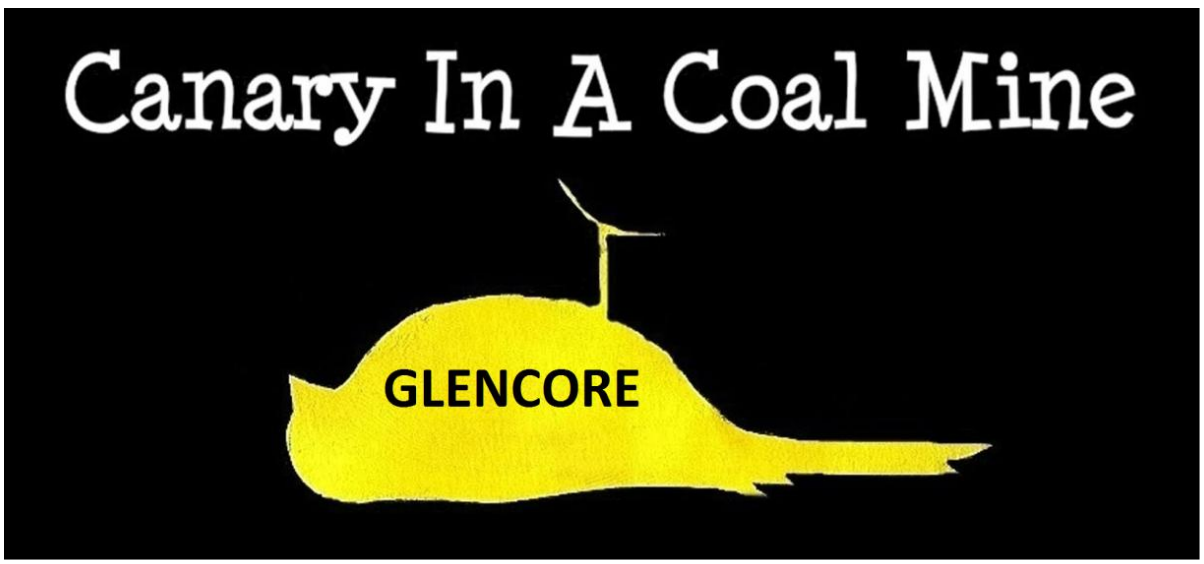
GLENCORE: Canary in a Coal Mine

ANALYTIC INSIGHTS



Gordon T Long
10/12/2015

GLENCORE: Canary in a Coal Mine

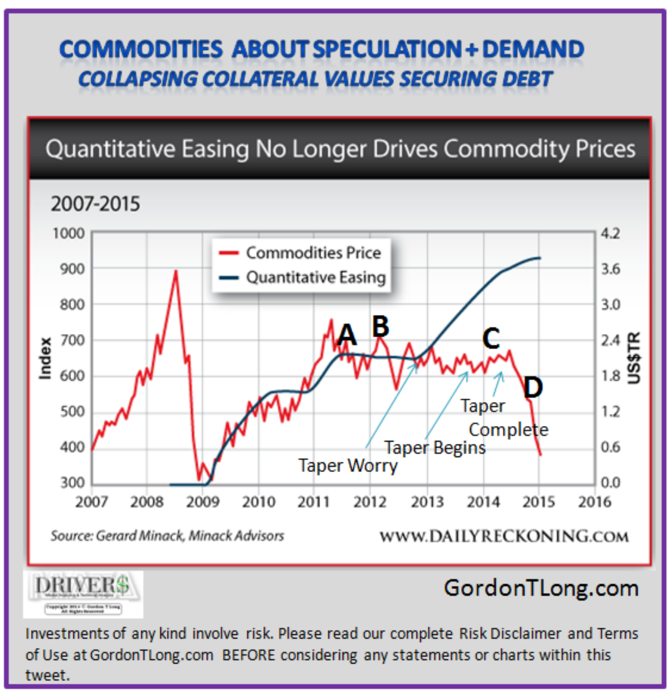
THE GLENCORE CANARY – *The Corporate Debt Shocker*

A HIGHLY LEVERED PLAYER – *In a Highly Levered Industry Tied to a Highly Levered China*

We have felt since the announcement by the US Federal Reserve of its "TAPER" program that an inevitable collapsing commodity market in Emerging Economies would be the catalyst for the next crisis. We concluded in our Thesis paper "The Globalization Trap" that a good proxy for a slowing China would initially be commodity prices and in turn the levered players behind the massive commodity run-up.

Make no mistake about it; China is in the process of a hard landing which is being once again temporarily camouflaged by credit expansion!

Buying the Credit Default Swaps of Commodity Trading Giant Glencore, has been an ideal way to trade the Chinese hard landing and there is a lot we can learn from Glencore about how the current environment will unfold.



A - Glencore Dips Below IPO Price On Second Day Of Trading,

B - $82 Billion Glencore Xstrata Megamerger Near,

C - Spot The Goldman And Glencore Aluminum Warehouses,

D - Depression-Level Collapse In Demand: In Historic First, Glencore Shuts Coal Mines For 3 Weeks

Glencore is currently the commodity trading firm getting most of the press because:

It is a Highly Levered Player, in a Highly Levered Industry, Tied to a Highly Levered China

Be aware however, that it could just as easily have been the Vitol Group, Trafigura, Gunvor Group Ltd Mercuria Energy Group, Louis Dreyfus Commodities or Noble Agri… and there are more.

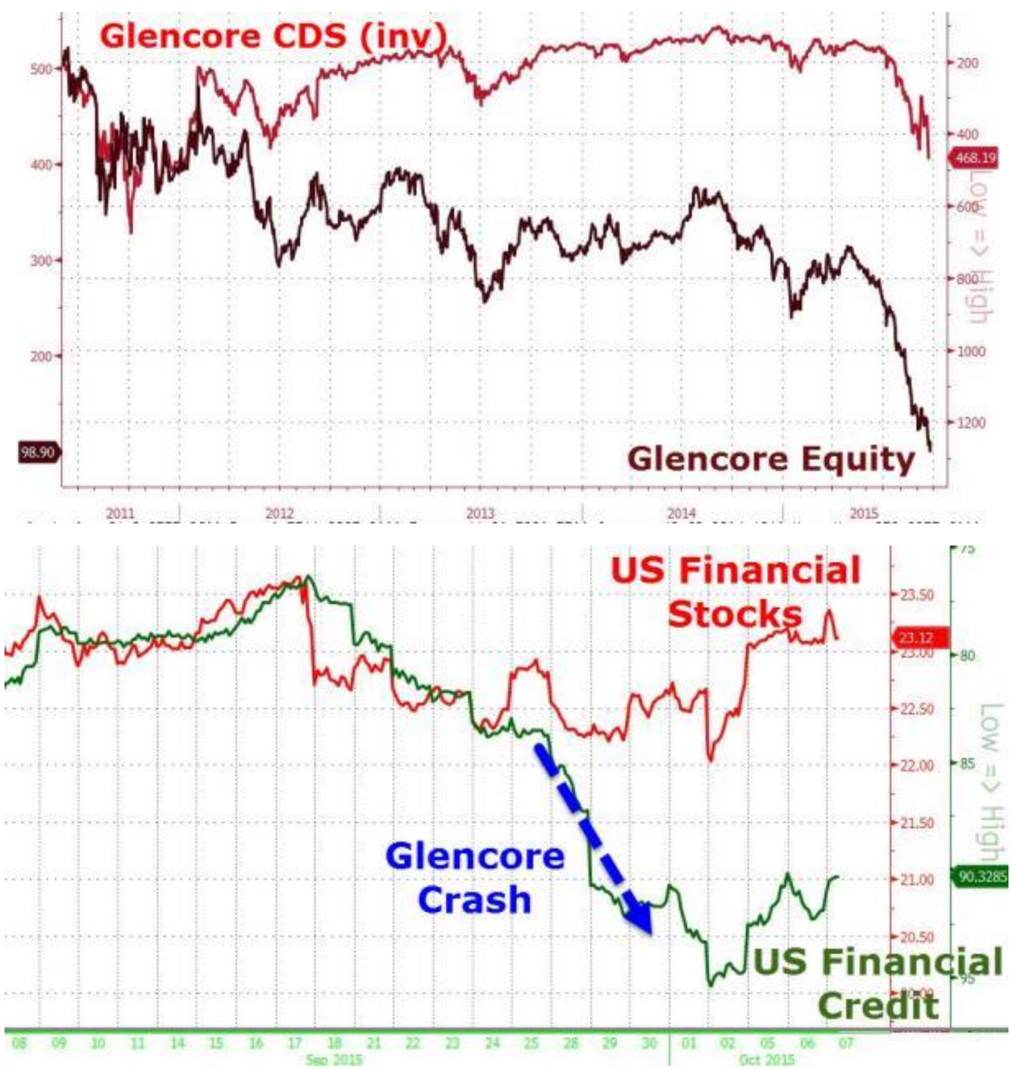
This group alone has recently raised at least $125 billion of debt … Why?? What is the panic?

A TRADING DESK – *Counterparty Risk*

You must appreciate that Glencore for example is first and foremost a trading desk which serves as a counterparty with trillions in derivatives notional exposure to virtually every other commodity using and trading entity in the world.

Why is Glencore's IG (Investment Grade) rating so critical?

Glencore is really not so much the Lehman as the AIG of the commodity world: **without an investment grade rating, a self-reinforcing collapse will begin that could ultimately terminate Glencore's trading desk, in the process liquidating one of the world's biggest commodity trading counterparties.**



ENRON – *We Have Seen This Play Before!*

The long story short: if and when Glencore loses its Investment Grade rating, it's more or less game over, if not for the company's already "shuttered" mining operation then certainly for its trading group, where having its bonds rated as junk level would lead to numerous collateral shortfalls and margin call waterfalls, reminiscent of the ratings agency downgrade of AIG that culminated with the US bailout of the insurer.

As I mentioned, commodity traders have raised at least $125 billion of debt, of which about $75 billion is loans. In other words, there is about $75 billion in secured debt, collateralized by either inventory and/or receivables collateral whose value has cratered in the past year and as a result the LTV on the secured loans has soared. It is this that is prompting the panicked banks to be more eager to provide funds to the suddenly distressed energy-trading sector than even the borrowers themselves.

A CONTROLLED DEMOLITION – *"Well-choreographed and carefully scripted"*

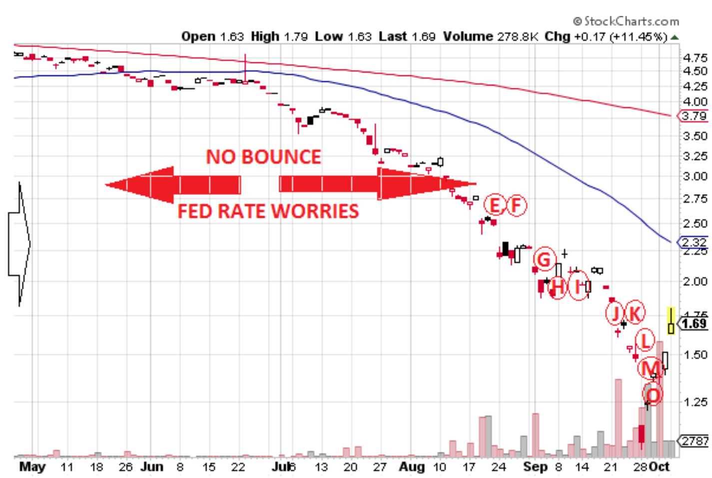
Zero Hedge [recently reported](#) that:

> "One of the more "unmentionable" conspiracy theories surrounding the demise of Lehman Brothers in 2008 is that this "shocking" event was in fact a well-choreographed and carefully scripted "controlled demolition", with the Lehman Bankruptcy - the event that officially unleashed the Great Financial Crisis - getting the express prior permission of both Ben Bernanke and Hank Paulson, a former Goldman employee, whose motive was the elimination of the one firm that was then Goldman's biggest competitor in the FICC space, and whose subsequent bailout of his former employer (Goldman Sachs and all other insolvent banks) would lead to the preservation of trillions in worthless equity courtesy of the biggest taxpayer funded bailout in history, and with billions in excess reserves parked on Goldman's balance sheet smoothing the bank's transition through a historic recession.

A CONTROLLED DEMOLITION – *"Well-choreographed and carefully scripted"*

Fast forward to the recent surge in its Credit Default Swaps. A potential "doomsday" scenario for Glencore is now on the table, because the market suddenly realized that Glencore's most valuable asset, not its mines, or its trading operations, but its investment grade rating, could be stripped away.

If the company is downgraded from investment grade to junk, watch as the "commodity Lehman" scenario for Glencore, which much more than a simple copper miner just happens to be one of the world's biggest commodity trading desks, comes full circle leading to waterfall collateral liquidations and counterparty freeze-outs as suddenly the world is reminded that there is a vast difference between a real and a rehypothecated commodity, and that all collateral rehypothecation chains are only as strong as the weakest counterparty!



E - The "Best Way To Play The Chinese Credit-Commodity Crunch" Is About To Pay Off Big,
F - The Next Leg Of The Commodity Carnage: Attention Shifts To Traders - Glencore Crashes, Noble Default Risk Soars
G - The Beginning Of The End For Glencore, And How To Trade It
H - Glencore Capitulates: Scrambles To Avoid Default By Selling Equity, Dumping Assets, Cutting Dividend,
I - Glencore's "Doomsday" Plan Disappoints As CDS Resumes Rise; Question Emerges: "What Happens If Company Fails"
J - "Doomsday" Cometh For Glencore: Mining Giant's Default Risk Just Exploded Higher,
K- Is Goldman Preparing To Sacrifice The Next "Lehman",
L- Glencore Implodes: Stock Plunges Most Ever, CDS Blow Out To Record Up On Equity Wipeout Fears,
M - Commodity Carnage Continues Amid Fears Of Glencore Liquidation,
N - Glencore Default Risk Surges Above 50%,
~~Q~~- With $19 Billion In Derivative Liabilties, Some Observations On Glencore's "Counterparty Risk"

Goldman, released a report which is essentially a blueprint for not only how to take away Glencore's precious investment grade rating, but taken a few steps further, how to unleash this cycle's commodity

"Lehman event and taken to the extreme, how to "force" the Fed to finally unleash the helicopter money should Glencore's failure be the catalyst the pushes the entire world into a deflationary recession, if not outright depression.

Goldman said in a note titled "Much progress made but the song remains the same"

> *We update our estimates for Glencore following the completion of its equity placement on September 16, in which it raised its target of $2.5bn. We also update our estimates to incorporate our commodity analysts' lower thermal coal forecasts and lower met coal forecasts* ***which impacts Glencore's 2016/17/18E EBITDA by c.15-18%... On lower estimates we reduce our 12-month price target to 130p (was 170p).***

Glencore has a few levers left – further lowering Capex, signing streaming deals and releasing more working capital. This would however take time.

From Goldman:

> *Glencore's trading business relies heavily on* ***short-term credit*** *to finance commodity deals and its financing costs would increase if it were to lose its Investment Grade credit rating. In addition, it could even lose some counterparties due to increased counterparty risk.*

What a junking of Glencore would do, is start a collateral demand waterfall cascade that the cash-strapped company simply would not be able to sustain.

Goldman explains just what would take for the Investment Grade trap to slam shut: **it would only take a c.5% fall in spot commodities prices for concerns about its credit rating to resurface.**

Goldman's straw man for the next mega bailout goes roughly as laid out here:

1. Commodity prices drop another 5%
2. The rating agencies get a tap on their shoulder and downgrade Glencore to Junk.
3. Waterfall cascade of margin and collateral calls promptly liquidates Glencore's trading desk and depletes the

Exhibit 7: A 5% fall in spot commodity prices and flat spot FX rates would quickly see concerns over Glencore's credit rating resurface

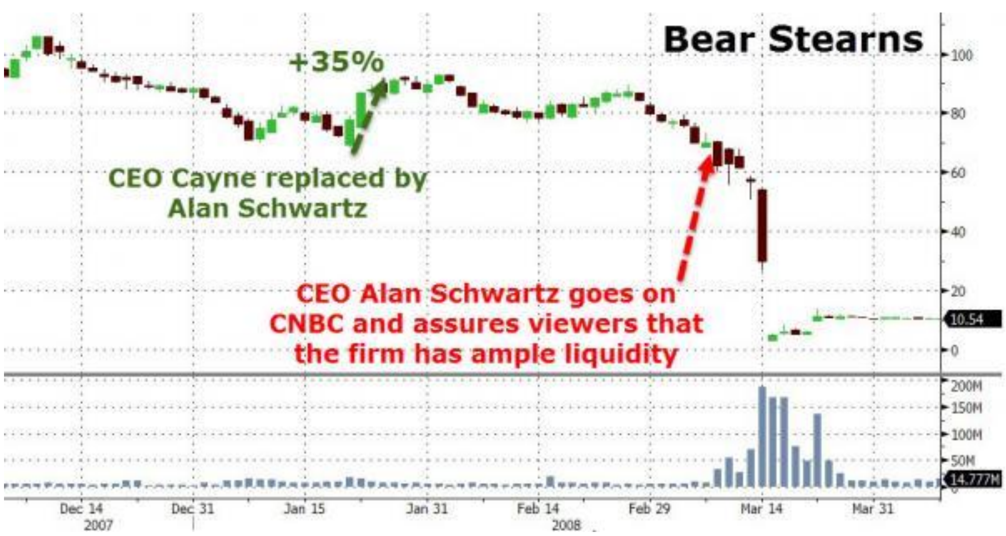
Scenario 3: Glencore key leverage metrics using 5% lower than spot commodity prices and flat spot FX rates (2015E-18E)

Glencore's leverage metrics on Commods Spot less 5%, Spot Fx	2015E	2016E	2017E	2018E
Copper (US$/t)	5,392	4,835	4,835	4,835
Zinc (US$/t)	1,833	1,532	1,532	1,532
Thermal Coal (US$/t)	58	55	55	55
Oil (US$/bbl)	51	45	45	45
Total Capital (US$ mn)	139,172	135,949	134,453	133,477
Net Debt (US$ mn)	43,513	41,763	40,885	39,382
RMIs (US$ mn)	15,457	14,321	14,232	14,362
Discount rate for RMIs (%)	30%	30%	30%	30%
Net Debt ex-RMIs (US$ mn)	32,693	31,738	30,923	29,328
EBITDA (US$ mn)	8,051	6,567	6,425	6,501
EBIT (US$ mn)	1,517	275	-36	-264
Interest Expense (US$ mn)	1,343	1,301	1,259	1,213
FFO (US$ mn)	6,514	5,975	6,039	6,274
CFO (US$ mn)	6,982	5,577	5,545	5,713
Dividend (US$ mn)	2,387	0	-113	-388
Moody's & S&P Metrics (required ranges to remain Investment Grade)				
Net Debt / EBITDA (2x-3x)	4.1	4.8	4.8	4.5
Net Debt / Total Capital (40%-50%)	23.5%	23.3%	23.0%	22.0%
(CFO - Dividends) / Net Debt (25%-35%)	14.1%	17.6%	18.3%	20.8%
EBIT / Interest expense (4x-7x)	1.1	0.2	0.0	-0.2
FFO / Net Debt (25%-40%)	19.9%	18.8%	19.5%	21.4%

Source: Company data, Goldman Sachs Global Investment Research.

company's cash, leaving trillions of derivative contracts in limbo. Always remember: **the strongest collateral chain is only as strong as its weakest 7counterparty.** If counterparty liquidates, net exposure becomes gross, and suddenly everyone starts wondering where all those "physical" commodities are.

4. Contagion spreads as self-reinforcing commodities collapse launches deflationary shock wave around the globe.
5. Fed and global central banks are called in to come up with a "more powerful" form of stimulus
6. The money para-drop scenario proposed by Citigroup , becomes reality



Stay tuned, things could get out of control fast!!

Gordon **T Long**
Publisher & Editor
general@GordonTLong.com