Mind the gap

There's been a changing of the guard in commodity financing in Asia. *Finbarr Bermingham* talks to some of the funds hoping to gain a slice of the pie.

A perfect storm occurred in the 1970s that allowed Switzerland to become the centre of gravity for commodity trading. The famously neutral country was already viewed as one of the most politically and economically stable in the world, and was also home to a favourably opaque and competitive tax regime. But it was after the oil crisis and the establishment of relations with the Middle East's oil companies that things really exploded. Now, scattered across Geneva, Lugano and Zug, there are hundreds of trading companies, handling an estimated 20% of the world's commodities each year.

It is more difficult to pinpoint a big bang moment for commodity trading in Asia, but most will concur that the shift has been underway for some time. The financial crisis, and subsequent eurozone omnishambles have played their part – as has the tightening up of accounting measures in the Alpine cantons of Switzerland. But the primary reasons appear to be more straightforward than that.

In Australia, Indonesia and Mongolia, to name but three, Asia Pacific is home to some of the largest commodity producing nations in the world. In China, Japan and South Korea – again, to merely scratch the surface – it has some of the biggest consumers of said commodities. So it's natural the trade would shift eastwards.

Hong Kong and Singapore have been making overtures to the market in an effort to become the Asian hub of choice. The Hong Kong Exchanges and Clearing paid around £1.4bn to purchase the London Metal Exchange, in an effort to race to the front of the queue, while International Enterprise, in Singapore, has been dangling carrots before traders' noses for years.

It would be logical to assume that financiers would follow. But the commodity trade finance market in Asia is a gossip column of ins and outs, of arrivals and departures. It's little wonder the executive lounges at the international airports in Hong Kong and Singapore are so well patronised.

In the past few years alone, we've seen some of the major global players in trade rethink their Asian and commodities exposure, sometimes in tandem. Jolyon Ellwood-Russell, partner at Simmons & Simmons, describes it as "a long line of banks since the 1980s that come into and exit the physical metals financing arena".

Standard Bank sold its commodities unit to ICBC in 2014, while Barclays and Deutsche Bank followed it out of the commodity business around the same time. Standard Chartered has recently exited physical metals trading, after losing an estimated US$175m in the Qingdao fraud, and Citi, still caught up in legal proceedings with Mercuria after the repo fraud in Qingdao, seems to be in review mode and has denied reports that it is exiting the metals trade in China.

"We continue to invest in the Asia region to support our clients and commodity trade finance is an important part of our business supporting clients in the region," a spokesperson tells **GTR**, but rumour has it that compliance issues and a slowdown in the Chinese market is forcing it to consider its options.

"Some banks are scaling back on Asia, particularly EU banks. Generally banks are becoming more careful in their lending, doing more due diligence to avoid Qingdao scenarios. Of course it's not always impossible to avoid a deliberate fraud, but you can do due diligence. Against that, some banks are going out and all banks are being careful," Philip Gilligan, finance and litigation partner at Deacons, a Hong Kong law firm, says in a telephone interview.

The Asia Pacific Loan Markets Association (APLMA) in June said that syndicated loans in Asia, excluding Japan, are down by 40%. Borrower appetite, the APLMA said, is lacking and this may help explain the decision of some major banks to exit the business. But there is still trade to be financed. Given the cheap commodity prices, traders are keen to lock in long-term contracts as a way to make hay while the sun shines. This, we understand, has led to an increase in pre-export financings and pre-payment deals. However, there is clearly a gap in the market, and there are plenty of contenders to fill it.

New players

Banks such as ANZ, DBS and Bank of China have been expanding their commodity business in the region, sensing a window of opportunity. One trader describes it as "a changing of the guard". Indeed, it was no surprise to see Bank of China top the APLMA's syndicated loans table for 2014. And whispers have been growing for some time about the growing presence of funds in the region, across sectors, but with increasing interest in commodities.

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"Funds are growing very rapidly and filling the space left by traditional lenders in many areas, I suspect it will happen in commodities too," says Gilligan, who regularly fields calls from operations hoping to get involved in the cross-border metals trade from Hong Kong to China.

Funds in trade – particularly commodities – are not a new thing, of course. It's often said that their growth commenced due to the liquidity problems experienced by banks post-2008 and in the Basel III era. But it's also said that many of the largest banks have become less specialised, providing clients with packaged solutions, with teams so big that bespoke products are a thing of the past. Many of the former commodity behemoths – BNP Paribas, Société Générale, ABN Amro – have fewer lines for traders, and are able to offer less leverage too.

"It's created a market for alternative finance in Asia," Daniel McGrath, a director at Blackstar capital, a fund trying to grow its Asian book, tells **GTR**. "There's an inherent mechanism within global trade, in that people need to move products. Trade won't stop because of the Chinese slowdown. It still goes on, at some level."

Commodity trade finance funds by their very nature shouldn't do anything that the commodity trade finance desk at a bank does – or did in the past. They just do it faster and more flexibly. These funds are often staffed by former commodity bankers or traders, and typically work on a deal-to-deal basis, looking at the transactional quality, which they claim is of equal importance to the balance sheet and borrowing history.

One fund which has been here for a while is Eurofin Asia, which specialises in commodity trade finance.

"You have pockets of commodity trade finance managers emerging all over the place," says head of origination, François Dotta. "We do our business in the same way. The DNA is the same, but everyone has their own variations. There are a couple of ways to cook an omelette but you need the same ingredients."

Eurofin, like Blackstar, does not take exposure on commodity pricing, and will only lend to a transaction on which there is a clear buyer on the other side of the transaction. And it's around these deals that the fund bases its business model.

"We don't categorise by commodity or country. For us, it is more about the company. We don't wake up in the morning and say let's do coal, or let's do Indonesia. We're company focused. We are transactional people," Dotta says. "Yes, track record is important, but number two equivalent to the credit is the quality of the transaction we can structure, to see if we can find an agreement with the company, whether it's an acceptable risk-reward, whether we can structure it properly, which is to take collateral on the commodity and have self-liquidation of the loan by the sales of the specific commodity."

Out with the old?

Much has been made of bank disintermediation in recent years, particularly given the strides made by technology in trade finance. Vendors such as Alibaba are offering lines of credit directly to their clients, bypassing the banking sector, in a manner that has caused much consternation in the board rooms of banks around Asia. Funds are still but a drop in the ocean when it comes to trade, but the question of leaving the banks behind is often raised in conversation, and just as quickly dispatched.

Most of those involved are realistic. Funds get clients precisely because they are not banks. To try to replace the banking system would be impossible and counterproductive. Instead, funds are reliant on banks to provide them with the tools to do their business.

"On the face of it, it may seem as though it is better for the funds to see the banks pulling out of Asia," McGrath says. "But international trade revolves around trading documents: LCs must be issued by banks, so they can't be disintermediated on this."

The so-called changing of the guard is viewed as beneficial by funds: those with less grounding in the space are more likely to be collaborative, and fund managers will often talk of working with banks to get a commodity out of Asia and into Australia, for example, when the bank doesn't have the requisite contact base in the market to make the connection itself.

It's also reasonably common for a commodity fund to work on a financial footing with a bank. If a bank has reached its limit with a client, it can ask a fund to top this up, or simply send the borrower their way. Furthermore, it's more and more common to see a fund take a slice of a bank-arranged syndicate, providing the borrower with extra capital at a blended rate of interest.

"Banks will always remain the main liquidity provider," says Dotta. "They will not be the only ones any more, but will, by and large, be the biggest ones."

Heavy metal

Hong Kong is awash with tales of fly-by-night funds raising money in the Special Autonomous Region and funnelling it onshore to China in warehouse financing deals. Their double-digit premium is attractive to a whole raft of borrowers who are struggling to find the capital elsewhere in the post-Qingdao environment. One trader countered the Qingdao problem by setting up their own warehouse chain. Unfortunately this is not an option open to most.

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Neither of the funds interviewed for this article has dipped into this market yet, though McGrath says Blackstar has not ruled it out. After all, a warehouse financing transaction, conducted properly and with due diligence, is one of the most straightforward tenets of trade finance, requiring a bill of lading, a storage contract and a sales agreement. What happened at Qingdao was fraudulent and the verdict of the High Court judge in the Citi vs Mercuria case in London seemed to verify the validity of the repurchasing agreement (repo) which underpinned the transaction.

"We're looking at the Chinese market," McGrath says. "In the case of Qingdao, the metal simply wasn't there. It's not to do with the financing model, you just have to make sure you're on top of it."

It's this sort of step into the unknown which funds arguably must take if they're to take a serious foothold in Asia. For those who invest in the funds, which in turn invest in commodity deals, it is also unchartered territory. It has traditionally been the domain of the banks, with little investor exposure to such transactions in the past. This educational barrier has been faced by alternative financiers in Europe and the US, many of which have ploughed money into commodity deals in parts of Africa that, on the face of it, seem much riskier than certain parts of the Asian market. But these markets have made decent headway in recent years. It remains to be seen whether their success can be emulated in Asia. GTR