Sector in Brief:

Trade Finance

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Resource

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What's new?

For most asset owners, trade finance - a quiet and esoteric member of the alternative credit family - has only appeared on the radar as a potential investment strategy during the past five years.

Its appeal has been intuitive: short duration in the later stage of a credit cycle, real assets underpinning a substantial proportion of loans, and relatively high resilience to market cycles. It also ticks different boxes for different asset owners: an investment-grade substitute for insurers; a yield booster for pension funds; a structure that lends itself well to Shariah-compliant vehicles for Islamic institutions.

2012-2015 saw papers and press articles touting trade finance as a hot new asset class, often playing on the same themes that underpinned the wider growth of private debt, such as bank retrenchment from lending amid tougher regulatory measures. Trade finance for SMEs and firms in emerging markets, where the supply of lending is weaker relative to demand, proved particularly lucrative.

Yet interested investors encountered a severe lack of data, a limited group of managers - many of them boutique specialists rather than familiar names - and a high degree of opacity from those managers regarding the performance of their underlying book. Commentators and providers pointed to impressive-but-irrelevant numbers from the International Chamber of Commerce - "$7.6 trillion market size," "default rates of 0.22%" - despite the reality that funds comprised less than 0.001% of that pie and that their slice was not representative.

The sector, however, has evolved substantially. There are now more than 20 viable asset managers for institutional investors to consider, nearly half of which have set up funds in this space since 2010. Their AuM has grown from under $5 billion in 2015 to more than $7 billion. Based on bfinance engagement figures, investor appetite has risen rather than declined, although the space has been subject to some yield compression, as has been the case across the alternative credit spectrum.

Facts & figures

- 30 - 360 days: duration of most trade finance loans.
- 0.01 - 0.3%: default rates, according to often-quoted ICC data. bfinance analysis points to default rates of 1-3% with recovery rates of 50-70% among asset managers.
- $7.6 - 8.5 trillion: size of trade finance market according to various sources (ICC, Bloomberg). We estimate asset manager AuM at >$7 billion.
- < 25: number of asset managers now offering trade finance funds appropriate for sizeable institutional allocations.
- 3 - 5% p.a.: returns (over LIBOR, net of all fees) being targeted by roughly half of managers, with a handful aiming for 7-8% and outliers north of that.

Although the lack of data and relative immaturity of the sector still represent obstacles, manager analysis now helps to fill the gap by providing more representative data for default rates, volatility and performance, among other things. It also helps to dispel certain myths, such as the notion that trade finance is purely a low-risk alternative to investment-grade credit or that floating rate loans dominate the universe.

This note provides a brief overview of the trade finance space and highlights key issues for investors. Further questions would be welcome.

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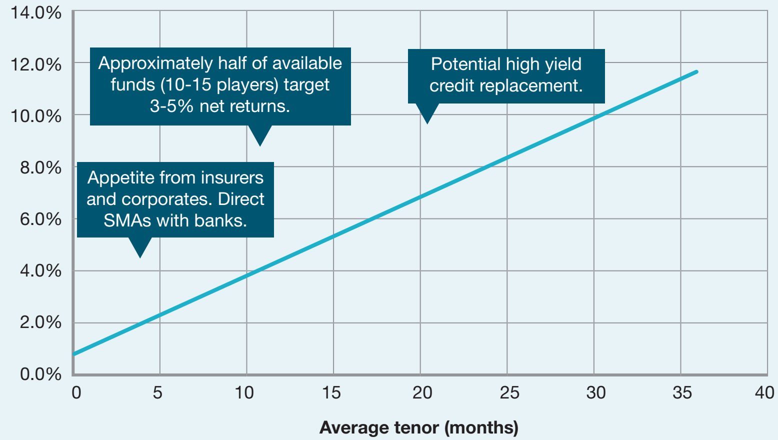
What is it?

In its simplest form, trade finance relies on a time lag: producers and exporters want to be paid when they release their products; buyers and importers want to pay when they receive the goods, usually weeks or even months later. Lenders can reconcile these timing lags by intermediating the process, providing short-term credit facilities.

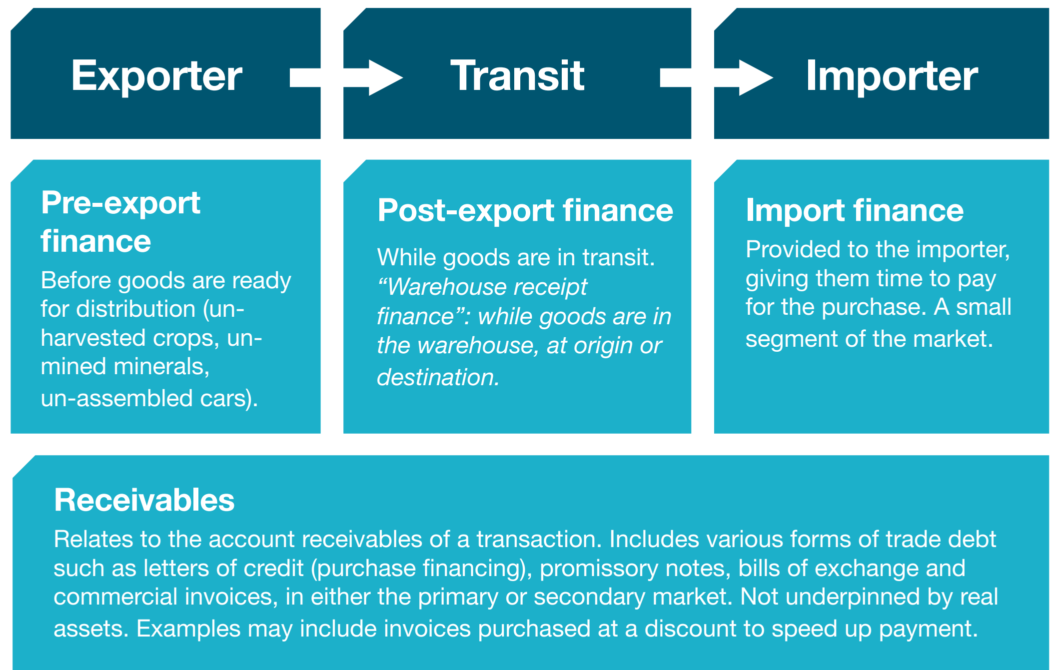
This massive industry - a key function of many commercial banks - enables timely payments, provides liquidity for both importers and exporters, and mitigates idiosyncratic risks. The market can be divided into three broad categories with **receivables** at the short-duration end of the spectrum, **pre-export** trade finance at the longer-duration end and **post-export** trade finance in the middle. Some managers define the universe in two camps: "transactional financing," which includes receivables and purchase financing (letters of credit, or "LCs"), and "specialised financing" such as pre-export financing and reserve-based lending. As a rule, they tend to be **self-liquidating** credit exposures denominated in **USD**, with a mixture of fixed and floating rate instruments.

In the case of inventory financing, traded goods act as the collateral, hence why this is sometimes referred to as a "real asset" investment. Protection is enhanced through additional guarantees and, at the longer-duration end of the spectrum, further safeguards such as trade credit insurance can be used to reduce risk. That being said, the sector does have some vulnerability to commodity prices - a key contributor to losses observed in manager portfolios.

Estimated net returns over LIBOR, based on trade finance asset manager analysis



Source: bfinance manager selection analysis in August 2017. Net returns are purely illustrative and vary considerably based on type, geography and sector.



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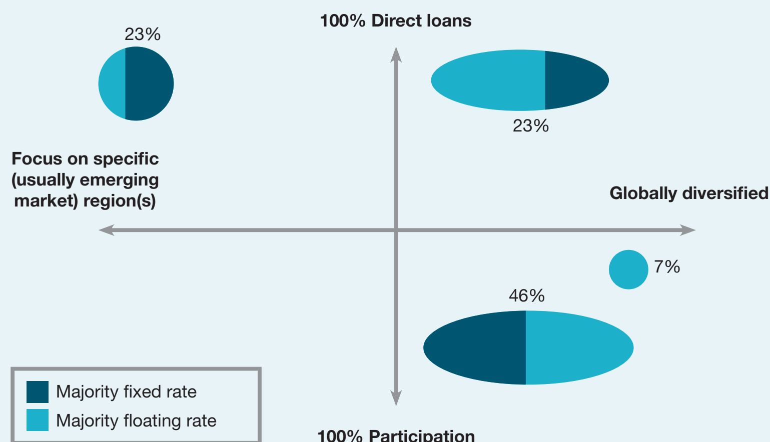
Investing in trade finance

Although the sector is dominated by commercial banks, for whom trade finance is not only lucrative in itself but also supportive of broader relationships with importers and exporters, asset managers have made significant inroads since 2010. In a recent manager selection engagement in this space, 64% of managers involved had first launched trade finance funds in 2010 or later, mostly staffed by ex-bank teams. There has also been some consolidation, such as EFA Group taking over management of Trafigura's Galena Commodity Trade Finance Fund in 2016.

Among the managers analysed for recent bfinance searches there is a roughly even split between funds that do direct loans and funds that participate in loans syndicated by third parties (e.g. banks), with a small minority doing both. Those targeting a specific emerging market region are more likely to go direct than those with a globally diversified portfolio, although there are exceptions. The handful of "higher yield" players looking for net returns of LIBOR+7-8% are virtually all direct originators, with syndicated loans providing more modest spreads.

The specific expertise, sourcing, systems and controls required means that trade finance is not generally accessible through broader alternative credit products and requires a dedicated mandate. Indeed, the majority of the managers themselves are still trade finance boutiques, with a handful of "mainstream" names in the mix. Most managers offer pooled vehicles, although SMAs are available. At the lower-yield end of the spectrum, insurers and others can be found establishing SMAs directly with banks or through intermediaries, especially where there is a considerable scale requirement.

Managers at a glance: trade finance funds assessed for a mandate in August 2017



Source: bfinance manager analysis in August 2017 (final stage)

Asset managers looking to establish trade finance funds during recent years have discovered high barriers to entry, even if the major challenge - sourcing appropriate dealflow - can be overcome by recruiting experts and building appropriate relationships. The underwriting style differs considerably from longer-dated loans, while the small universe and bespoke nature makes benchmarking and price comparison more difficult.

Manager selection challenges

Aside from the obvious difficulties suggested by the points above, such as the changing universe and the diversity of product offerings, there are other - perhaps more gritty - challenges for allocators.

If this sector was something of a cottage industry five years ago, it must be said that this is still the case today. The quality and level of data provision, even at RFP stage, is relatively patchy, making strong due diligence particularly vital. Alignment of interest is not as strong as we expect among other types of private debt, with most portfolio managers not investing in their funds, although one could make an argument that this is slightly less crucial given the shorter duration of the loans. Fees are all over the map, with a variety of flat fee and performance fee structures, and hurdle rates for carry arrangements are often lower than we would like to see given the target returns. In addition we do not see managers offering discounts for larger mandates.

Ultimately, after a healthy period of fundraising, many are not in 'asset-gathering mode' and have little incentive to make significant changes to practices as a result. AuM for these funds tends to be $100-500 million and, to be frank, the intensive nature of trade finance investing and its lack of scaleability means that they do not have the capacity to add a great deal more cash to the pool. Interested investors must therefore be proactive in finding these managers, discovering how they operate and, if necessary, timing deployment tactically in order to gain access to the right vehicles.

Contact:

Niels Bodenheim, Senior Director – Private Markets, nbodenheim@bfinance.com
Guy Hopgood, Senior Associate – Private Markets, ghophood@bfinance.com
Kathryn Saklatvala, Director – Investment Content, ksaklatvala@bfinance.com

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Office locations

Amsterdam
Symphony building-26th Floor
Gustav Mahlerplein 109-115
1082 MS Amsterdam
The Netherlands
T +31(0)20 794 61 00
www.bfinance.com

London
36 Queen Street
London
EC4R 1BN
England
T +44 20 7747 8600
www.bfinance.co.uk

Sydney
Level 13
135 King Street
Sydney
Australia
T +61 2 8973 7503
www.bfinance.com

München
Promenadeplatz, 8
D-80333 München
Deutschland
T +49 89 55 29 59 00
www.bfinance.de

Paris
49, avenue d'Iéna
75116 Paris
France
T +33 1 45 02 64 00
www.bfinance.fr

Montréal
1250 René Lévesque Blvd. W
Suite 2200, Montréal QC
Canada H3B 4W8
T +1 514 393 4899
www.bfinance.ca