Insight INVESTMENT

THE TRILLION-DOLLAR TRADE FINANCE OPPORTUNITY

OCTOBER 2019

> We believe the trade finance market is emerging as a compelling private debt opportunity for institutional investors seeking sources of attractive risk-adjusted returns. We look at how they can seek to exploit the growing funding gap faced by businesses worldwide.

BNY MELLON | INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

- ‘Trade finance’ is private debt financing that investors offer to businesses to help them overcome the mismatch between when they expect to receive payments from their clients, and when they need to pay their own suppliers or spend money elsewhere
- Trade finance can offer yields ranging between 50bp and 800bps above Libor (well above commercial paper yields of 3bp to 6bp above Libor) for short-dated credit exposures of between 30 and 150 days
- Default rates since 2008 have been 2bp per year. When factoring in recoveries, actual credit losses have been just 0.5bp per year
- Trade finance investments underpin a substantial proportion of the $18.5trn market for international trade (c$5trn to c$10trn depending on measurements)
- Research indicates that $1.5trn of the trade finance market is subject to a funding gap, driven by the retrenchment of banks from lending markets due to regulatory considerations
- Broadly, there are two types of trade finance structures that we believe investors should consider investing in:
  - **Supply chain financing**: providing funding to the suppliers of a large corporate
  - **Receivables financing**: providing funding to a supplier, secured by receivables from its customer base
- Insight currently sees trade finance as a short-duration yield enhancer within secured finance portfolios, multi-credit investment mandates and absolute return strategies

THE TRILLION-DOLLAR TRADE FINANCE OPPORTUNITY

TAKING ADVANTAGE OF THE TRADE FINANCE FUNDING GAP

As banks continue to retrench from certain lending markets, a substantial funding gap has emerged within trade finance which institutional investors can selectively look to fill for potentially compelling rewards.

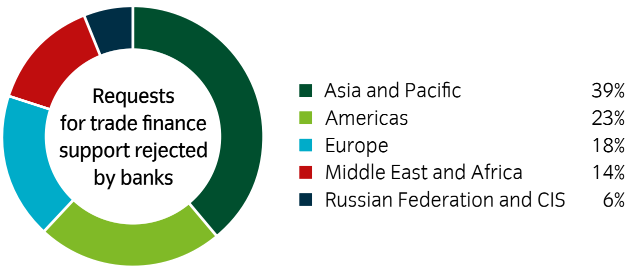
We believe trade finance provides a compelling source of value for investors that can unlock the complexity premium of the asset class, without adding significant credit risk relative to more traditional credit assets. This private-debt market investment can offer yields ranging between 50bp and 800bps above Libor for short-dated credit exposures of between 30 and 150 days (well above commercial paper yields of 3bp to 6bp above Libor). This is despite historical losses having amounted to less than a basis point per year[1].

THE SCALE OF THE TRADE FINANCE MARKET

Trade finance investments underpin a substantial proportion of the $18.5trn market for international trade[2]. The most conservative estimates (using the narrowest definitions of trade finance) suggest that trade finance underlies around a third of global trade (c$6.2trn[3]), whereas using wider definitions estimates are at around two-thirds[4] (c$12.3trn).

Research indicates that $1.5trn of the trade finance market is subject to a funding gap[5], which disproportionately affects small- and medium-sized enterprises (SMEs) and unrated or non-investment-grade firms in both developed and lesser developed markets (the largest emerging players in global trade). Figure 1 demonstrates the global nature of the market by breaking down geographically the rejected requests for trade finance support (deals that are not honoured even if they are considered viable). This is a gap that institutional investors can selectively look to bridge where the best value presents itself.

Figure 1: The $1.5trn trade finance funding gap – a global opportunity[6]



[1] World Trade Organisation - 2018 ICC Trade Register Report, Global Risks in Trade Finance. [2] World Trade Organisation - 2018 ICC Trade Register Report, Global Risks in Trade Finance. [3] Global Supply Chain Finance Forum (citing Bank of International Settlements), "Standard Definitions for Techniques of Supply Chain Finance", 2016. [4] WTO, "Trade Finance and SMEs" 2014. [5] Asian Development Bank, 2019. [6] Asian Development Bank, 2019.

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The potential supply of opportunities is so large, institutional investors may be well-placed to selectively step in to access the most attractive deals in the market.

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THE EMERGENCE OF TRADE FINANCE

Trade finance developed to align the interests of corporate buyers and suppliers. Whereas suppliers prefer to be paid at the time of sale (or shipment), buyers prefer to pay after receiving their goods or raw materials (typically after standard intervals such as 30, 60 or 90 days). This creates a natural conflict that a financier can resolve. The financier can fulfil the supplier's invoice at the time of sale, at a discount to the full value of the invoice. The financier then becomes the beneficiary when the buyer pays the full payment in the future.

This can benefit all parties. The financier earns a spread as profit, while the supplier and buyer are able to receive and pay amounts respectively according to their preferred timeframes, and thereby optimise their working capital. Suppliers also tend to receive trade finance at a cheaper cost than other debt as it is the (often superior) credit quality of the buyer that is the concern of the financier.

These arrangements can help strengthen relationships within a supply chain, which is why trade finance is often considered an essential lubricant of the global trade machine.

The automobile manufacturing sector was the first to use financing within its supply chains in the 1980s. In the subsequent decades, demand for trade finance boomed as an increasingly liberalised global economic order resulted in surging global trade and ever-more complex global supply chains.

OPPORTUNITIES FOR INVESTORS TO HELP FILL THE GAP

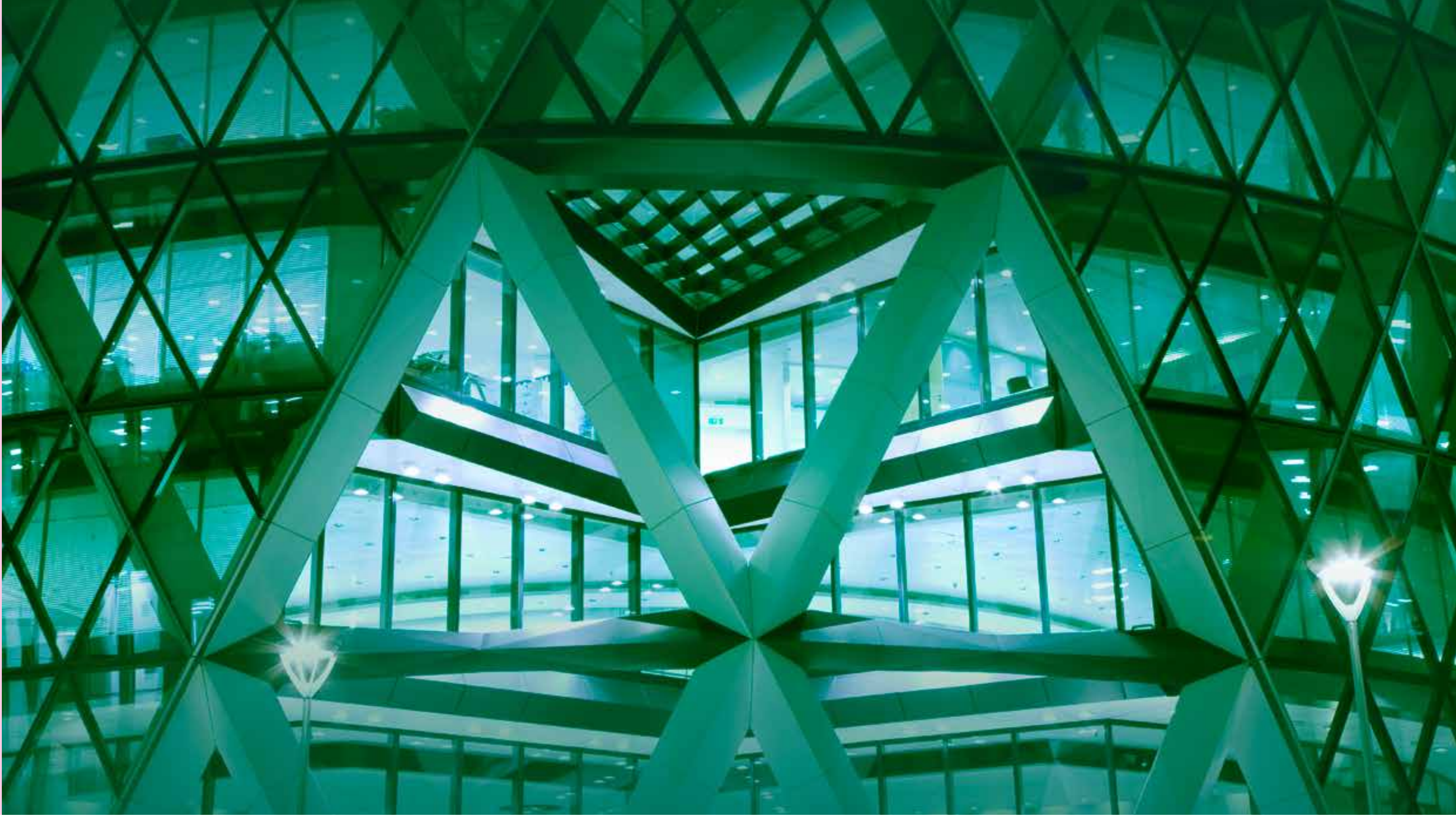
For the last 40 years, the provision of trade finance has been dominated by banks. However, since the 2008 global financial crisis, banks have scaled back their activity in response to regulatory considerations, at a time in which demand has continued to rise. This has exacerbated the growing funding gap for businesses worldwide.

Banks are still the main providers of trade finance to their larger corporate banking clients, particularly multi-national investment grade corporates, but they are far less active in financing SMEs. Notably, bank retrenchment has come at a time in which SMEs or non-investment-grade rated firms are increasingly benefitting from technological innovations, such as digital trade finance networks and industry platforms, which are reducing many of their barriers to accessing trade finance.

According to a McKinsey study[7] surveying 250 suppliers across 21 countries, only 10% of the demand for supply-chain finance is being met globally. SMEs are the growth drivers of international trade, accounting for 60% of total employment in advanced economies and 80% in developing countries[8].

The potential supply of opportunities is so large, institutional investors may be well-placed to selectively step in to access the most attractive deals in the market.

[7] McKinsey, "Supply-chain finance: The emergence of a new competitive landscape", 2015. [8] World Bank, 2013.



The market offers the following range of risk/return opportunities across the full breadth of the market.

- **Large investment grade multinational**: This is the lowest-risk end of the scale and is still dominated by banks. It results in relatively tight pricing, around **50bp to 150bp** above Libor.
- **SME non-investment-grade seller:** In our view, institutional investors can find more value by targeting SME risks where yields can range between **150 and 250bps** above Libor for (in our view) AA quality credit risk.
- **Non-standard or higher seller**: Similarly, trade finance programmes of A-rated credit quality originated from non-standard sellers can offer around **180bp to 350bp** above Libor
- **Commodity or emerging market seller**: These transactions tend to be small size and low volume transactions offering returns ranging from **400bp to 800bp** over Libor. In our experience, this part of the market currently offers less of a compelling opportunity when the materially higher risks are taken into account.

We believe that many of the most compelling opportunities occur in financing opportunities to entities such as SMEs with relatively complex needs or non-standard sellers.

TRADE FINANCE CREDIT LOSSES: LESS THAN ONE 1BP PER YEAR

In our view, the credit spreads in trade finance substantially over-compensate investors for the credit risks, as highlighted by the exceptional fundamental performance of the market.

The International Chamber of Commerce's dataset[9] of $12trn of trade finance exposures from 2008 to 2017 shows a cumulative default rate of only 0.15%. This is a default rate of just 2bp per year. However, these defaults are often fully recovered (known as a 'cured default' in the industry). Actual credit losses over the period were a mere 4bp. Overall, this means that credit losses have amounted to only half a basis point per year.

This performance partly reflects the short-term nature of the credit exposures. It also reflects the fact that corporates tend to prefer to pay suppliers before other creditors to maintain their key business relationships and continue operating as a going concern. Furthermore, trade finance often does not count as debt on a supplier's balance sheet, and is not subject to the constraints of its capital structure.

[9] World Trade Organisation - 2018 ICC Trade Register Report, Global Risks in Trade Finance.

TRADE FINANCE INVESTMENT STRUCTURES

Broadly, there are two types of trade finance structures that we believe investors should consider investing in: supply chain financing and trade receivables financing.

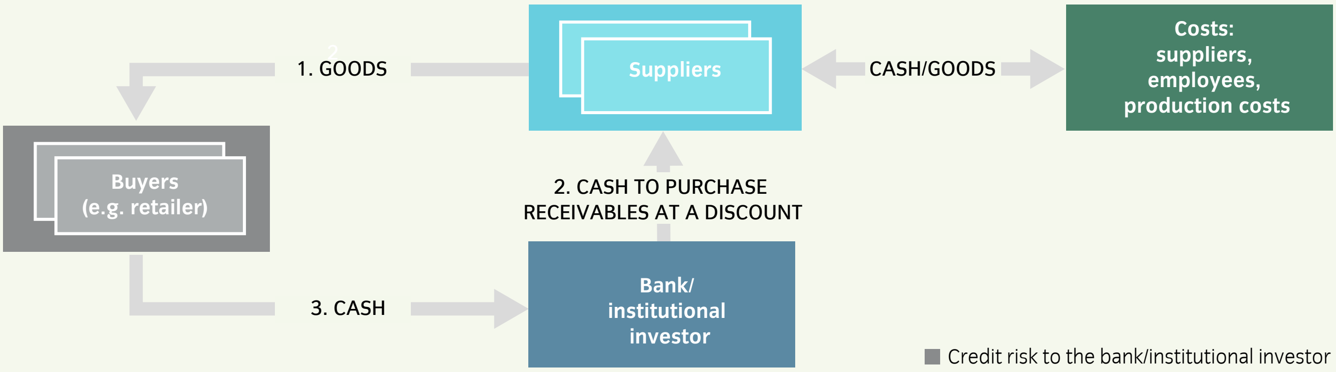
Supply chain financing

Supply chain financing allows suppliers to receive payments earlier than contractually agreed with a buyer under their standard payment terms, and allows them to better manage their working capital requirements (see Figure 2).

The credit risk for the finance provider is to the end buyer, rather than the suppliers. For the same credit risk, a finance provider can typically achieve a higher yield through providing supply chain finance than if it provided finance direct to the end buyer through, for example, the bond market.

A manager can invest in supply chain financing through either a 'committed' or 'uncommitted' loan facility. A committed facility, unlike an uncommitted facility, specifies the conditions and time period in which the financing is made and typically comes with structural protections or termination provisions to help protect the investor.

Figure 2: How supply chain financing works[10]



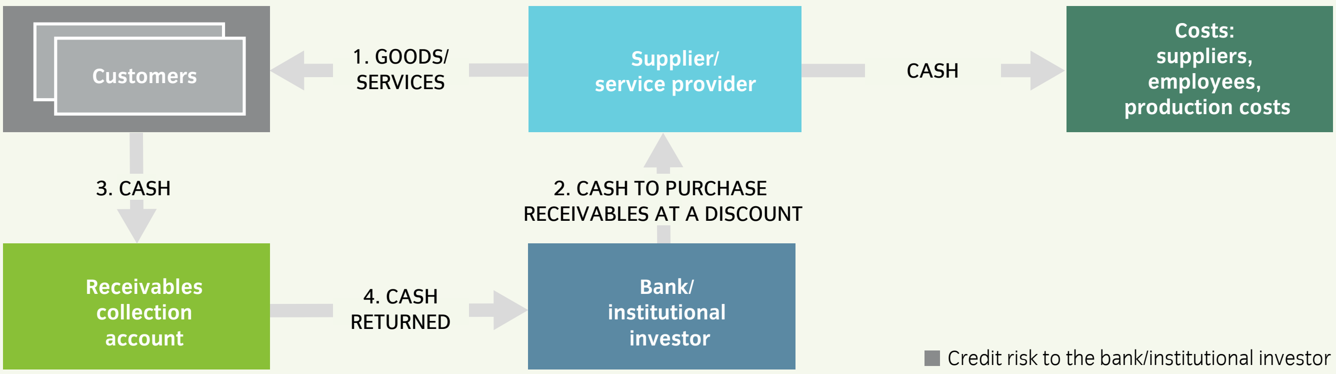
Receivables financing

Receivables financing allows companies to receive early payment on a pool of their customer invoices. Financing is secured against the pool, and does not count as debt on the supplier's balance sheet (see Figure 3).

Receivables financing can offer a compelling spread above public debt markets. The underlying pools can be highly diversified and the revolving facilities can be structured with dynamic credit enhancement and/or the use of credit insurance. The facility can also feature structural protections that reduce credit exposure if collateral underperforms or servicing issues arise.

Managers can typically invest in receivables as part of a multi-year (often three- to five-year) privately structured revolving loan facility with strict eligibility requirements and structural protections. Given the short-dated underlying risks, they tend to self-liquidate quickly if programme termination triggers are hit. Receivables can be sold into special purpose vehicles, with cashflows flowing into 'waterfall' structures (similar to asset-backed security structures). These allow investors to purchase lower-risk 'senior' tranches with high levels of credit enhancement or higher-risk 'junior' tranches.

Figure 3: How receivables financing works[10]

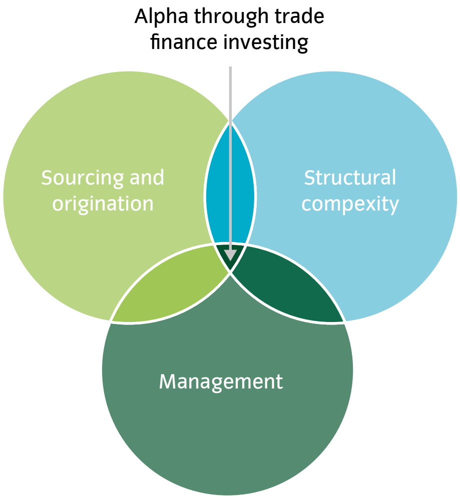


[10] Source: Insight Investment. For illustrative purposes only. Numbers illustrate typical sequence of activity.

UNLOCKING THE TRADE FINANCE COMPLEXITY PREMIUM

Trade finance investors need access to specialised skill-sets in order to unlock the complexity premium in trade finance. The burden on the investor is far greater than it is in more mainstream markets such as corporate bond investing. In our view, there are three broad drivers of alpha in the market. These are highlighted in Figure 4.

Figure 4: The key drivers of alpha in trade finance[11]



Sourcing and origination

Investors need to source and originate deals themselves, often without banks playing the usual intermediary role. The upside is that deals can be sourced with bespoke structural protections. The quid pro quo is the need to perform underwriting and bottom-up credit analysis as well as monitoring, governance and the management of transaction risks throughout the life of the arrangement.

For non-bank investors, significant barriers to entry therefore exist. Structures and legal documentation can be complex and time-consuming to negotiate. Sourcing diversified and global opportunities also requires developing relationships with potential partners who have origination capabilities and can provide the necessary technology and expertise required to manage and monitor trade receivables pools and financing programmes, or to build these resources in-house.

In recent years, trade finance has seen a great deal of technological advancement and the entry of new market participants. Vast supply chain finance networks and peer-to-peer supply chain financing platforms have emerged. Independent financial services firms and corporate finance advisors also play a greater role as banks scale back their activities.

Access to the market has therefore improved as investors are more able to source opportunities in close partnership with a number of these third-party operators. Lending opportunities also exist in providing finance to the peer-to-peer platforms that help match those requiring finance with potential lenders. Due diligence on these partners, with regards to their know-your-customer and collection policies is essential. Investors need to work closely with their partners in order to gain access to the most robust deals. Deals can also be sourced by working direct with suppliers on an opportunistic basis.

Structural complexity

Investors also need to understand the likely legal treatment of claims under stressed debt situations. Legal frameworks often differ in their treatment of trade finance compared to other corporate credit. For example, France is sometimes considered as one of Europe's less creditor-friendly jurisdictions. However, French regulation tends to be favourable for trade finance, as prioritising payments to suppliers helps keep companies operating and thus workers employed. Given the global nature of trade finance, knowledge of regulatory frameworks is essential so an investor can execute its enforcement rights in the event of stressed situations.

[11] Source: Insight Investment. For illustrative purposes only.

Risk management

A number of risks are specific to trade finance. Dilutions are a notable example. A dilution is any non-credit-related reduction in the value of a receivable; examples would include when credit notes are issued as a result of product returns, pricing disputes, cash discounts for early payment or volume rebates. Receivables financing facilities need to be structured to adequately account for dilutions; typically this will be achieved by building in a combination of recourse back to the seller for diluted receivables and building a reserving mechanism in the structure to cover dilution risk.

There are also risks associated with servicing receivables. Collections are often done by the seller, particularly if they have an on-going relationship with the buyer; in these cases, servicer termination provisions and covenants need to be carefully structured and a back-up servicer may be required. In other cases, separate servicing agents may be needed to collect on outstanding payments from day one. Investors need to perform in-depth due diligence on the partners and work closely with them to ensure that all risks are being mitigated in an optimal fashion.

Figure 5 illustrates the key capabilities that can help investors to successfully invest in private debt markets such as trade finance.

HELPING BRIDGE THE GLOBAL TRADE FINANCE GAP

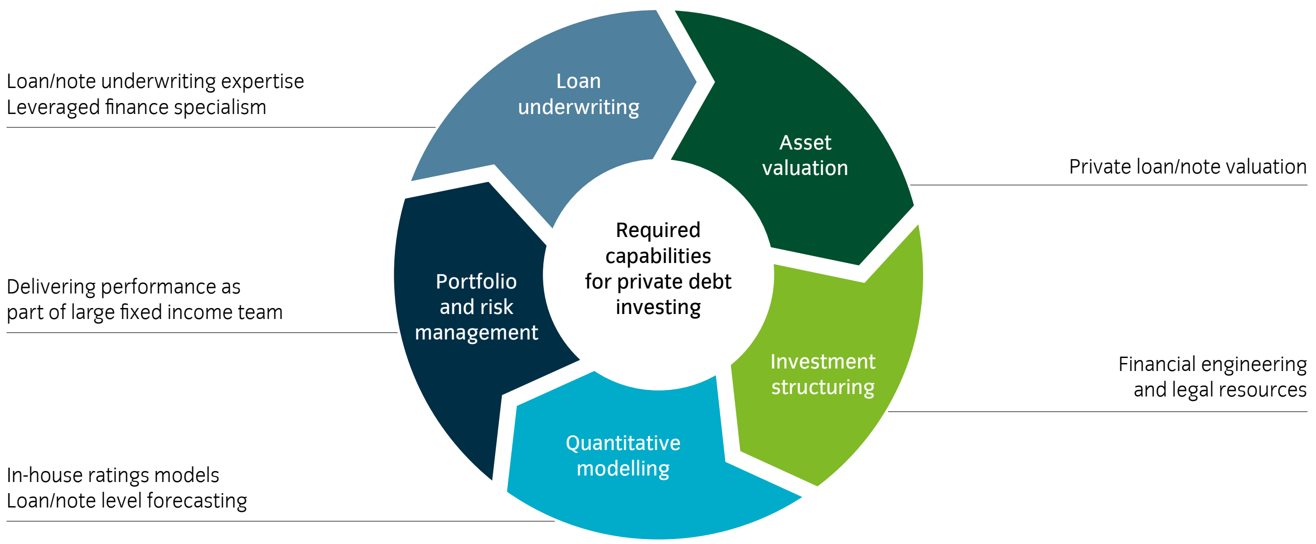
The trade finance market has developed a growing funding gap. The scale of the opportunity may be well-suited to investors to selectively pinpoint the most attractive areas of this funding gap to earn a complexity premium, for short-dated (and limited duration) credit exposures.

However, in order to adequately access these opportunities, investors need to focus on more complex areas of the markets. Unlocking the complexity premium is challenging, requiring access to managers with the capabilities and relationships to source, model, structure and continually manage the transactions.

THE ROLE TRADE FINANCE CAN PLAY IN A PORTFOLIO

In our view, the natural barriers to entry of the asset class and its attractive characteristics make it a potentially powerful portfolio tool and a structural source of yield enhancement with low correlation to other traditional asset classes. We currently believe trade finance can play an effective role as a liquid, short-duration yield enhancer in secured finance portfolios, multi-credit investment mandates and absolute return strategies.

Figure 5: Key capabilities at Insight for investing in trade finance[12]



[12] For illustrative purposes only.

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IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

ASSOCIATED INVESTMENT RISKS

Investment in any strategy involves a risk of loss. Trade finance exposure is complex and is exposed to credit and other risks. It is not actively traded and this may impair the ability of a portfolio to realise full value in the event of the need to liquidate such investments.

FIND OUT MORE

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