Sector in Brief:

Trade Finance

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Resource

What's new?

Investor demand for trade finance strategies has soared in recent months. Among bfinance clients, 2020 brought more manager searches in this asset class than the previous five years combined. Appetite is being supported by the 'even-lower-for-even-longer' rate climate, while Covid-19-related turbulence has seen some banks and asset managers retreat from the space, enhancing the potential opportunities available to those that remain.

Bank retrenchment has been a long-term tailwind for 'alternative capital' (e.g. asset managers) in trade finance, as with other asset classes such as private debt. For the most part, this trend has been driven by regulations which raise minimum capital requirements, with Basel III now followed by Basel IV. **Basel IV** is likely to have a stronger impact on trade finance, since it can force banks to use a standard approach for exposures to large corporates and reduces the extent to which they can benefit from the collateral which trade finance often involves (page 2).

Investors pursuing this asset class seek a combination of characteristics including **improved returns**, a healthy **yield** or regular distributions, **low volatility** and moderate **liquidity**. Trade finance can also be **Sharia compliant**, since it often doesn't involve interest but instead takes the form of a payment for receivables at a discount. Trade finance can be used to compliment a fixed income portfolio and can even compete for private credit allocations. We see particularly high demand from **insurers**: those operating under the Solvency II framework typically treat trade finance as unrated assets with a duration of less than one year, giving a very low Solvency Capital Requirement.

We now see a very credible set of strategies available in this space: there are more than 30 institutional-quality managers offering solutions to investors (page 3), while segregated accounts are also very popular. There is also considerable variety: more than half of funds target returns of 6-8% net of fees but many are aiming below or above that band. Investors seeking investment grade-type (IG) exposure can find a subset of appropriate offerings: some explicitly offer IG underlying positions; some are IG-rated at portfolio level; some offer solutions using credit insurance to bring ratings back to IG.

Facts & figures

6-8% p.a.: net returns targeted by more than half of trade finance managers, though more conservative and more aggressive strategies are available.

60 days: approx. average maturity of positions in trade finance funds, with most deals written at 90-180 days.

>$5 trillion: estimated annual flows in the global trade finance market ($1.3 trillion outstanding at a given time if we presume average duration of 90 days).

>30: number of institutional-quality trade finance managers, with sizes ranging from under $50 million to more than $1 billion.

52% of bfinance trade finance manager search activity in 2020 was for **insurer** clients (by volume).

	Trade Finance	IG Bonds	HY Bonds	Equities	Corporate Direct Lending	Real Estate Debt
Overall expected return	✓✓	✓	✓✓	✓✓✓	✓✓✓	✓✓
Reliable cash generation	✓✓✓	✓✓✓	✓✓✓	✓	✓✓✓	✓✓✓
Liquidity	✓✓	✓✓✓	✓✓	✓✓✓	✓	✓
Low volatility	✓✓✓	✓✓	✓	✓	✓✓✓	✓✓✓
Regulatory capital usage	✓✓✓	✓✓✓	✓✓	✓	✓	✓✓
Sharia compliance	✓✓✓	✓	✓	✓✓✓	✓✓	✓✓

Contact:
Trevor Castledine, Senior Director Private Markets, tcastledine@bfinance.com
Thibault Sandret, Director Private Markets, tsandret@bfinance.com

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Understanding the asset class

On the face of it, trade finance – which can be viewed as an alternative to either liquid fixed income or private debt – is an extremely attractive strategy. It is nearly as liquid as bonds, with redemptions typically allowed on a quarterly basis although shorter terms can be negotiated for an SMA. Yet it offers much lower volatility and generates higher returns when compared to investments of similar credit quality (yield pick-up of ~100bps, and sometimes significantly more, at the investment grade end of the spectrum) and a low annualised loss rate. It is, however, vital to be cautious with implementation: although returns are attractive, they are not high enough to tolerate meaningful losses or significant cash drag arising from inefficient capital deployment.

Trade finance includes a variety of different transaction types designed to finance commerce. Typically, the Borrower – a supplier or trader – may have sold goods to a much larger purchaser (Obligor) but the purchaser, who is of better credit quality than the supplier, won't pay for a period of time because the goods are in transit or payment terms allow for a delay. The Lender will make a loan to the supplier (Borrower), the repayment of which is secured by the purchaser's (Obligor's) payment for the goods. The Lender can actually charge a higher price than the Obligor's credit quality might actually justify, but still cheaper than that which Borrower could otherwise access. Credit quality is often enhanced by a charge over the goods in question. These are generally very short-duration loans (90-180 days), hence the low volatility.

The massive global trade finance market has traditionally been serviced by banks – especially European banks, for historical reasons. An obligor may wish to use an alternative lender (e.g. an asset manager) for certainty of execution, flexibility of terms or simple capital availability. As noted on the previous page, bank retrenchment from the sector has opened the door for institutional fund managers to fill the gap. This is the ongoing direction of travel for Banks: Basel IV will further inhibit their trade finance activities as discussed; Know Your Customer (KYC) and Anti Money-Laundering (AML) regulations provide additional bureaucratic obstacles; operational requirements continue to evolve, are increasingly costly to resourse, and only ever get tougher.

Trade finance types

Pre-export / inventory finance	Loans secured on commodities in storage or other commercial stock.
Export and goods in transit finance	Loans secured on the payment that will be received once a shipment of goods is delivered. Often supported by some enhancement e.g. bank letter of credit or credit payment insurance (documentary credit).
Receivables and supply chain finance	Loans where the funds are advanced to a party but are repaid by the settlement of an invoice payable by someone else. Also known as factoring or supply chain finance.

Key risks

	Risks	Potential mitigation strategies that asset managers may use
Position-level risk	Fraud	Rigorous processes. Physical checks on goods; independent validation of documentation. Avoid jurisdictions with high corruption.
	Adverse selection of deals from the sourcing partner	Where not originated directly, make your sourcing partner (typically a bank) keep skin in the game; only participate in vertical slices.
	Lost cargo	Insurance.
	Obligor default	Rigorous underwriting, Letters of Credit, Credit Payment Insurance, charges over goods, reduced advance rates (thereby improving recovery).
	Commodity value risk	Finance pre-sold goods where price is agreed, over-collateralisation in case of default.
	Late delivery (or port closed for Covid-19)	This is a risk that generally has to be borne, but crystallisation of the risk leads to reduced liquidity and return, rather than losses to principal.
Market-level risk	Cyclical reductions in trade	Ensure a broad origination network. Finance a variety of transaction types across different jurisdictional pairs.
Fund-level risk	Fund liquidity	Careful portfolio construction and matching the underlying assets to fund withdrawal terms. Avoid excessive concentration to one investor. Utilise segregated accounts.
	Cash drag	Wide network of origination channels. Effective treasury management.

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Investment implementation

There are now more than 30 managers offering trade finance strategies to institutional clients, thanks to recent launches from both major international asset managers and smaller boutiques. They span a wide range of different **risk/return profiles**: while most target returns of 6-8% net of fees, lower-risk strategies are available and there are still a few managers shooting for the stars – particularly in Emerging Markets.

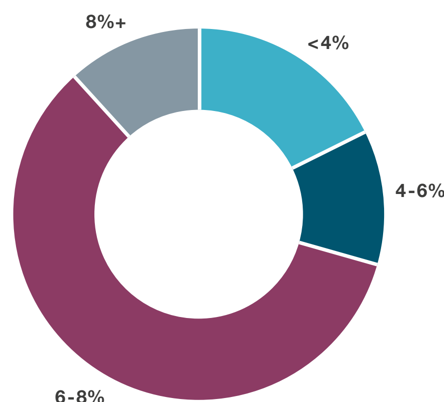
In terms of geography, more than 80% of trade finance strategies have a multi-regional or global scope. However, most of these do have a distinct bias (>50%) to a particular region. We would classify nearly a quarter of strategies as genuinely 'global'. Managers have little exposure to the US (although many funds are denominated in US$) – that market is still dominated almost entirely by banks with few **pure-play** funds available.

Fund sizes are typically smaller than one might expect for a major institutional asset class, but for good reason: to deploy a dollar for five years in this space can require more than ten transactions, versus just one transaction for a direct lender. Returns can be greatly impacted by cash drag where the portfolio is not fully invested. As such, asset managers generally need to access a variety of routes to **originate trades** and stay reliably invested including bank partnerships, broker networks or 'exchanges', or e-commerce routes that match borrowers and lenders. Portfolios typically consist of fifty-plus positions and that figure can be significantly higher in the case of e-commerce-fed platforms. Due to the effort and resources required, we find that cost ratios are typically quite high and **fees** are broadly comparable with – or slightly greater than – those found in private debt.

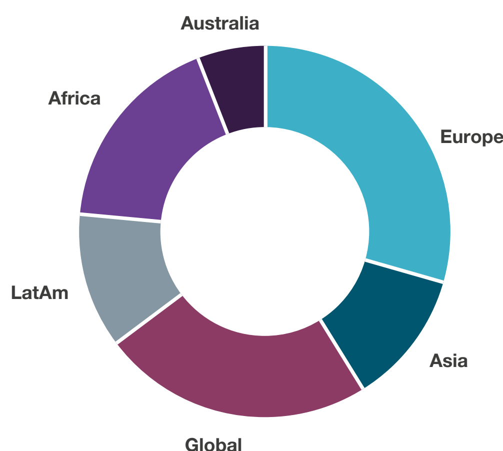
Segregated accounts are very popular. This allows for a risk/reward profile that is tailored to the client. It can also provide greater liquidity: most funds allow quarterly redemptions but different arrangements might be negotiated in SMAs. Importantly, segregation also insulates investors from the potential damage that can be caused when other investors exit the strategy – an issue thrown into focus by the turbulence of 2020. SMAs can also, depending on the manager and the strategy, help clients to address ESG issues. Attractions notwithstanding, it is crucial to examine the terms of any SMA very carefully, including the cost of implementation and how potential conflicts of interest are handled in the allocation or co-investment policy.

ESG can be a considerable challenge for some strategies, but more ESG-sound options are certainly available. Trade finance can involve financing cargoes of commodities or cargoes where there can be issues with production methods and labour workforce rights. Impact can be hard to trace and the capacity for influence is limited. On the other hand, receivables finance is generally more ESG-friendly, and Factoring can be seen as having genuine positive impact in terms of supporting the global and local supply chain.

Trade finance managers, by target net return

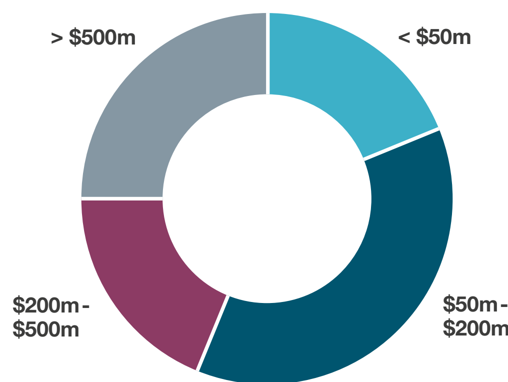


Trade finance managers, by primary geographic focus



This chart illustrates the primary geographic focus: e.g. if a fund has 60% Europe, 20% Asia 20% Africa then this would be classified here as 'Europe'.

Trade finance managers, by AuM in the asset class



Source: bfinance manager research

Identifying skeletons in the closet: four areas on which to question prospective asset managers:

- Fund structuring choices that might lead to suspension of liquidity;
- Underwriting and fraud risks and how these are being avoided;
- Deployment issues that can lead to cash drag on performance;
- Regional variations in the underlying asset types and risks.

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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

Chicago
220 N. Green Street
Chicago IL 60607
USA

T +1 (312) 829-4353
www.bfinance.com

Hong Kong
Level 20, Infinitus Plaza, 199
Des Voeux Road Central,
Sheung Wan. Hong Kong

T +852 3953 7874
www.bfinance.com

London
36 Queen Street
London
EC4R 1BN
England

T +44 20 7747 8600
www.bfinance.co.uk

Montréal
1250 René Lévesque Blvd. W
Suite 2200, Montréal QC
Canada H3B 4W8

T +1 514 393 4899
www.bfinance.ca

Munich
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

Rome
Piazzale delle Belle Arti 2
00196 Roma
Italy

T +39 06 6940 2500
www.bfinance.com

Sydney
Level 8, 99 Elizabeth Street
Sydney, NSW 2000
Australia

T +61 (0)2 8052 3930
www.bfinance.com

Toronto
88 Queens Quay West
Suite 2500, Toronto
Ontario M5J 0B8Canada

T +1 (416) 560-7275
www.bfinance.ca

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