Trade Finance: A Vital Global Need Creates an Exceptional Investment Opportunity

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Raison D'etre

A seller (exporter) of goods wants the buyer (importer) to prepay for those goods, to eliminate the risk of non-payment after delivery. The importer wants the goods to be shipped prior to payment, to eliminate its risk that the goods will not be delivered.

There is a solution to these opposing needs. A trade-finance intermediary can remove both parties' risk by, for example, extending credit to the importer and paying the exporter for the goods prior to delivery.

Trade finance offers less-obvious advantages, as well. Cash flow is improved and businesses can run more efficiently knowing that payment will be received on a specific date, or that goods will be received without delay. "Pre-export financing" can provide cash to exporters using buyers' orders as collateral, allowing them to make sales that they otherwise would not be able to fulfill. "Factoring" enables exporters to sell accounts receivable at a discount for immediate cash flow, preventing financial hardship or perhaps insolvency.

Babylonian clay tablets dating to 3000 B.C. represent the first known examples of promissory notes and letters of credit; Babylonians are believed to have traded with civilizations as far away as Egypt and present-day Turkey. The modern trade finance concept began in the fifteenth century with banks opening new branches at international-trade junction points. These banks initially facilitated the exchange of promissory notes between trading partners, then began issuing letters of credit to guarantee payments. This led to the great expansion of global trade that continues today.

Trade finance is critical to the global economy and a key driver of economic development. It plays a crucial role in practically all sectors' supply chains, particularly agriculture and extractive industries such as mining. The World Trade Organization (WTO) estimates that more than 80% of global trade, representing over $10 trillion U.S. dollars, relies on some form of trade finance.

Opportunity

Large banks are the traditional providers of trade financing, but shifting regulatory requirements have decreased their role. Since 2008, banks have been subjected to additional capital and liquidity constraints. The reduction in available capital and the eroding profitability of trade financing has caused many banks to reduce their exposure or even withdraw completely from the sector. The "Basel III" international banking regulations, first implemented in 2013, caused further reductions in bank-intermediated trade finance.

This exit of traditional lenders has created investment opportunities in the private markets for alternative (non-bank) lenders. For investors, trade finance offers a short term (generally one- to six-month) investment with attractive returns, uncorrelated performance, strong collateral and historically low default rates.

"… trade finance is a reliable and low-risk asset class that should be looked upon favorably by regulators, industry stakeholders and investors." – Daniel Schmand, Chair of the ICC Banking Commission and Global Head of Trade Finance at Deutsche Bank.

Types of Trade Finance

The umbrella term "trade finance" takes a variety of forms, which include:

- Insurance
  - Trade credit insurance is purchased by exporters to insure against non-payment by the importers of their products. Policies can cover specific transactions, but usually cover entire groups of importers. Insurance protects against importer insolvency/default as well as country-specific political risks.
- Letters of Credit
  - The importer's bank provides a letter of credit to the exporter's bank that guarantees payment upon confirmation that the shipment was made. The letter of credit in effect substitutes the bank's credit for the purchaser's credit.
- Bank Guarantee
  - The bank acts as guarantor of the transaction payment via a surety bond or other means. Unlike a letter of credit, payment is only made if the bank's client (importer or exporter) fails to meet its obligations under the contract.
- Forfaiting
  - Forfaiting derives from the French word forfait, which means to relinquish a right (in this case, the exporter's right to receive payment from the importer).
  - A third party purchases receivables from the exporter at a discount and assumes all risk of non-payment by the importer in exchange for the negotiated discount rate. The exporter attempts to recover the full forfaiting cost (discount) from the importer in exchange for the credit terms extended to the importer, effectively allowing the exporter to receive up to 100% of the invoice value for goods shipped.
- Factoring
  - Exporter's account receivables are sold to a third party at a discount
  - Differs from forfaiting in a number of ways:
    - Factoring finances 80% - 90% of the invoice value; forfaiting can be 100%.
    - Forfaiting is without recourse to the exporter; factoring can be recourse or non-recourse.
    - Cost of factoring is borne by the exporter (seller); cost of forfaiting is borne by the importer (buyer).
    - Factoring is short-term (less than 180 days); forfaiting is medium- to long-term.
- Lending Facility (the remainder of this article will primarily focus on this form)

- Pre-export financing: Exporter obtains a loan needed to produce goods, utilizing orders from buyers as collateral.
- Prepayment financing: Importer receives a short-term loan from lender that is repaid upon receipt of goods from exporter; exporter receives cash upon shipment; the loan is secured by the goods themselves as collateral.

Risks and Challenges

Asset-backed global lending is subject to inherent uncertainties, but proper controls and structuring can mitigate the risks involved.

Collateral depreciation is the risk that the underlying collateral (shipped goods) will decrease in value during the transaction term. This risk is mitigated primarily by the short-term nature of the loans (usually less than six months). Additionally, the "loan-to-value" (LTV) ratio (loan amount divided by collateral value) is typically less than 100%, which allows for principal depreciation - for example, an 80% LTV allows the collateral to depreciate by up to 20% before principal impairment. The value of most commodity goods can also be hedged in the futures markets at a reasonable cost, but the trade finance provider must still arrange for an off-taker to purchase the goods.

As interest rates continue to rise from 40-year lows, *interest rate risk* can be eliminated through a floating rate loan structure (although fixed rate loans only have modest risk due to their short-term nature).

Currency risk arises when the importer and exporter are in different countries with different currencies. For example, if a buyer in Country B agrees to pay for a shipment from Country A, and the value of Country A's currency relative to Country B's currency falls prior to the payment date, the exporter will receive less in its local currency than originally expected. (If Country A's currency appreciates relative to Country B's, however, the exporter will receive more than expected). The same risk applies to the trade financier – if loaning in U.S. dollars to a borrower who repays in its local currency, the lender may receive less than projected when converted back to dollars. The simplest way to avoid this risk is by denominating all transactions in the lender's currency. This passes the burden of currency exchange, and any fluctuation risk, onto the borrower. The disadvantage of this approach is that it could result in lost opportunities from borrowers who don't want to assume this risk – and may instead give their business to a competitor willing to finance transactions in the borrower's own currency. It may also increase the risk of default if there is a significant currency devaluation of the borrower's currency versus the lender's currency. Alternatively, currency risks can be hedged via futures, swaps or forwards (however, at an additional cost).

Political risk stems from political factors that may prevent payment or delivery of goods. A government may confiscate a shipment due to claims of non-licensing or some other reason, or expropriate a shipment for its own use. Political upheaval may grossly devalue a currency or cause limits to be imposed on sending money out of the country. Even a third, unrelated, country through which cargo travels can introduce additional risks. Cultural misunderstandings may occur in transactions negotiated between parties in different time zones, with different languages and varying cultural practices and ethical values. No risk can be completely eliminated, but lenders can address these issues through careful due diligence and by employing best practices from their experience with prior transactions. Political risk insurance is generally available and probably a must if the lender desires to work with certain high-risk countries (typically this is paid for by the borrower). Currency conversion and devaluation risks can be reduced as discussed above.

Counterparty and custody risk include loan default, fraud, theft, documentation errors or omissions, quality control, warehouse liens and natural disasters. These risks are primarily addressed through insurance, SPV structures (see below) and, of course, careful due diligence by the lender.

There are a number of additional ways a trade finance lender can further reduce its risk.

The lender may screen opportunities based on the characteristics of the underlying collateral, rejecting loans against goods that are not readily marketable, highly perishable, or critical to a country's economic stability.

Deals should be structured with bankruptcy remoteness to protect against bankruptcy of the financed party. Transactions can be made off-balance-sheet via a separate "special-purpose vehicle" (SPV) in a tax-favorable jurisdiction. In addition to creating legal separation from the parent/borrower, the SPV is structured to limit its right to file bankruptcy, requiring the consent of a neutral third party. The SPV also agrees that it will not incur any additional debt - and bankruptcy courts are generally inclined to dismiss cases that are essentially two-party disputes (one borrower and one creditor).

Loan agreements can include covenants that, if triggered, accelerate principal repayment. Such triggers can act as an early warning of financial difficulties at the borrower, such as a decline in the debt service coverage ratio, a decline in EBITDA, or default on another obligation.

Investment Characteristics

For investors, trade finance is a compelling opportunity versus traditional investments and even compared to other areas within the alternative (non-bank) lending space.

Short-Term: Loan terms of generally less than six months reduce exposure to interest rates and other risks.

Collateralization: 70% to 100% advance rate = 100% to 143% collateralized by real goods.

High Return: Trade finance offers high yield in a low-yield environment. Investors can achieve returns in the high-single and low-double digits, very favorable for short-term, collateralized loans.

Low Default/Loss Rates: The 2017 International Chamber of Commerce (ICC) Trade Register reports that default rates across various types of trade finance ranged from only 0.03% to

0.24% between 2008 to 2016. Even during the 2008 – 2009 financial crisis, the ICC indicates that a mere 445 out of 2.8 million transactions defaulted. Default rates must be considered in the context of each transaction type – higher-yielding trades come with higher risks.

Low Correlation: Trade finance performance is tied to individual collateralized loans and does not directly relate to any type of marketable security. Its historically-steady return stream is a valuable component to any portfolio.

Modest Competition: Despite growing demand and very favorable investment characteristics, the trade finance sector is largely overlooked by traditional capital markets. Industry estimates range from only 12 to 20 investable funds worldwide that are dedicated wholly or partially to trade finance.

> **"It's one of the most predictable cash flow investments that an investor can make today... a differentiated return stream that has virtually zero correlation to the financial markets. It is a true alternative investment." – Kristofer Tremaine, Founder & CEO, Kimura Capital**

Conclusion

The world has truly become a global marketplace. 2017 trade growth of 4.7% was the highest in six years, and preliminary estimates from the WTO suggest 2018 was similar. Developed countries have experienced faster growth but in the past decade, developing economies' share of international trade flows has grown from one-quarter to one-third.

Trade finance supports 80% - 90% of these transactions; the diminishing role of traditional banks continues to fuel demand for non-bank solutions.

> **"The amount of demand for trade finance is extraordinary. If all the funds out there raised a billion dollars each, it wouldn't even scratch the surface."**
> **– Mead Welles, Portfolio Manager, Octagon Asset Management**

Trade finance is not an undertaking for an individual investor as it requires domain knowledge and experience in sourcing, due diligence, deal structuring and risk management. This is best left to the experts via an allocation to a non-bank investment vehicle, which often concentrates on a specific geography and, importantly, has a physical presence in that area.

The opportunity for investors is clear. Trade finance offers distinct advantages and protections versus traditional investments. It is a non-correlated complement to most investment portfolios via short-term, collateralized loans with well-defined, addressable risks and negligible historical default rates.

