TRANSACTIONS & TECHNOLOGY

# Plugging the funding gap in trade

Joy Macknight | 1/11/2016 10:55 am

**Asset managers are showing greater interest in providing much-needed financial support for global trade, as greater digitisation opens up the market to these new players. Joy Macknight reports.**


Despite weak growth in the volume of world trade in goods and services over the past five years, there continues to be strong demand for financing. According to the World Trade Organisation, up to 80% of global trade was supported by some sort of financing or credit insurance in 2015.

Yet demand is far outstripping supply. In its 2016 Trade Finance Gaps, Growth and Jobs Survey released in September, the Asian Development Bank (ADB) identified a $1600bn shortfall in global trade finance in 2015. These findings are backed up by the recent International Chamber of Commerce (ICC) Global Survey on Trade Finance report, which saw just over half (52%) of bank respondents reporting an increase in overall trade finance activity during 2015, down from 63% in 2014.

**A growing gap**

The financing gap grew during the global financial crisis and continues today as banks rethink their business strategy in light of persistently low interest rates. The cost and complexity of compliance with banking regulations has also contributed to the banks' retreat. Ninety percent of banks in the ADB's recent report cite anti-money laundering and know your client requirements as obstacles to expanding trade finance, while 77% of respondents point to the Basel III banking regulations, which set liquidity requirements for bank finance.

And while investment-grade multi-national companies (MNCs) may not be feeling the pinch, small and medium-sized enterprises (SMEs) are facing significant hurdles in accessing trade financing. According to both ADB and ICC reports, more than half of trade finance requests by SMEs are rejected, compared with about 10% by MNCs.

Yet SMEs play a critical function in an economy. According to the ICC, they represent 95% of enterprises globally and make up about 60% of private sector jobs. "Our research shows that the enormous potential of small businesses to create jobs and growth is being held back by increasingly limited access to trade finance," says the report.

**Specialist asset managers**

Historically trade finance has been a bank-to-bank activity. However, a few specialist asset management firms have stepped in; some work directly with the banks while others originate transactions themselves. Most are stacked with trade finance specialists from banks.

For example, Federated Investors, a Pittsburgh-based investment manager, focuses on structured and secured transactions in the pre-export space. “We don’t originate trade finance transactions, but invest alongside mandated lead arrangers,” says Robert Kowit, senior vice-president, product specialist, at Federated Investors. The company maintains relationships with a range of commercial, supranational and development banks to ensure enough flow to populate a diversified portfolio.

At the other end of the market, Barak Fund Management, Kimura Capital and Maseco Asset Management specialise in SME financing. For example, in February 2009 Barak launched a fund to provide trade finance for smaller companies in agriculture and soft commodities in the sub-Saharan Africa region.

Investor relations officer Giles Hedley says Barak maintains good relationships with banks, which provide the firm with references because it operates in a space where they have little or no interest. “It takes a bank the same amount of effort and resources to provide $5m as $50m in funding,” he says. Many clients also prefer Barak because it can usually complete due diligence and provide funding within a month, instead of the banks’ normal three-month timescale.

Kimura Capital, which launched in the third quarter of 2016, focuses on commodity trade finance for SMEs, typically companies with a balance sheet of less than $100m. Kristofer Tremaine, founder and chief investment officer, says while banks may look solely at a company’s balance sheet, Kimura focuses on the underlying transaction.

“Many smaller, less financially robust companies are carrying out sounder transactions than some large MNCs, but are forced to pay more because of where they sit in the credit stack,” he says.

Maseco AM, a separate and independent entity from Maseco Private Wealth (MPW), manages a five-strategy fund that launched on January 1, 2016, with one of the underlying funds focusing on trade finance in Africa. The fund works with specialist portfolio managers that lend short term, for example 45 to 90 days, mostly against fast-moving consumer goods, commodities and so on in south and south-east Africa.

With African SMEs desperate for trade finance support, MPW managing partner Josh Matthews believes that one of biggest challenges for the small fund, with just a few hundred million dollars in assets under management, is to fill the void left in the wake of large banks exiting the continent. It is understood the fund may soft-close in the next 12 months.

**Barriers to entry**

As an asset class, trade finance has a number of strengths, including its stability, limited correlation to the financial markets and low default risk – one-tenth of Moody’s default rate, according to the 2015 ICC Trade Register report.

Federated Investors had first-hand experience of the asset’s performance through the financial crisis. Its domestic fund managers saw the value of trade finance as an alpha source uncorrelated to most financial assets. “On the basis of an audited track record, we started going out to institutional investors to show trade finance as a free-standing strategy, as opposed to solely part of our existing line-up of funds,” says Mr Kowit.

However, the challenges cannot be underestimated. These include the general market mechanics, where each deal is custom designed to finance a specific trade flow and accompanied by reams of documentation. “With many moving parts and the element of bespoke structuring in every deal, trade finance has the appearance of being a bit hairier than other asset classes. However, it is vanilla and conservative, should you be able to deliver on the operational aspects," says Mr Tremaine at Kimura Capital.

The market is also fragmented without a central source of information for investors. "In reality, the data has always been there but not in a format where an analyst could just tick a box," says Mr Tremaine. "A lot of what we have been doing over the years is to provide investor education. Trade finance is highly operationally intensive but once you have all the links in the chain put together, it flows fluidly."

André Casterman, former global head of corporate and trade markets at Swift and current chief marketing officer at financial technology start-up Intix, agrees the industry needs to do more to educate investors, similar to the role the ICC Trade Register has played in educating the regulators since its launch in 2009.

He says: "The next step for the ICC and industry is to show the attractiveness of trade finance as asset class to short-term investors, who often have the risk appetite or liquidity to invest in trade finance but don't have the origination capabilities." He suggests that trade finance indices could go some way to help investors quickly assess the viability of this asset class for their own business.

**Platform push**

Enrico Camerinelli, senior analyst at research firm Aite Group, stresses the role digitisation is playing in opening up the market to alternative investors, particularly in the area of supply chain finance (SCF) with platforms such as C2FO, Demica, Orbian, PrimeRevenue and Taulia.

These platforms are not just digitising existing flows but the whole ecosystem involving buyers approving supplier invoices so that the latter can be paid earlier, adds Mr Casterman.

Fundamentally, digital platforms allow SCF transactions to be uncoupled from the banking world, according to Matt Wreford, chief executive of Demica. And while bank-to-corporate funding continues to make up the vast majority of the estimated $80bn market, he notices a trend towards bank-independent platforms, which opens up opportunities for asset managers and others to participate.

In addition, he believes that the nature of SCF programmes is changing. "A large part of the market is investment-grade, or near-investment-grade, buyers. The supplier's motivation to participate in a SCF programme has been to be paid quicker and improve their working capital," says Mr Wreford.

Today, a new market is evolving where the buyer is non-investment grade and the suppliers' motivation is risk mitigation. "Suppliers are selling their receivables because they want to reduce credit risk," he says. "As the SCF market evolves to non-investment grade counterparties and risk increases, asset managers are more interested because the yield increases alongside the risk."

These platforms are also driving innovation within the market, which Intix's Mr Casterman believes will ultimately benefit the banks. "It won't be a single bank portal, but a multi-funder SCF proposition in future. Banks will be critical in facilitating these structures and all the cash management functions that go with them."

Ad van der Poel, senior vice-president, financing services, at Basware, a purchase-to-pay solutions, e-invoicing and financing services provider, agrees. Those banks with their own platforms may worry about disintermediation, "but in the end they will realise that this innovation will help them," he says.

Interestingly, some asset managers have joined forces with the digital platforms. For example, Pemberton, an independent alternative asset management group that is 40% owned by Legal & General, recently partnered Global Supply Chain Finance.

Similarly, alternative investment manager Arrowgrass Capital Partners teamed up with Basware to launch Clear Funding, a joint venture to provide a new invoice financing service for UK SMEs. Mr van der Poel, acting chief executive of the joint venture, says Basware's role is to leverage the data from its platform to initiate financing, "because an approved invoice is the start of a payment process, as well as the start of a funding process".

**Build it and they will come**

While Mr van der Poel is unconvinced that asset managers should develop a platform themselves – mainly because it is outside their core business and requires a lot of investment – Groupama AM did exactly that in Italy. Following a change in Italian law in March 2015 that allows asset managers to provide finance directly to companies, the French insurance company's Italian asset management arm worked with Fifty Finance Beyond to build its own platform.

Groupama AM created a reverse factoring fund (the Supply Chain Fund), which passes a large buyer's good credit rating on to its smaller suppliers so that they can access cheaper funding. Today it invests €50m in Italian SMEs.

According to Alberico Potenza, director-general at Groupama AM Sgr in Italy, the firm built the platform itself because its business model was different to other platforms operating in Italy. It designed a financing programme between a large client and its strategic suppliers specifically on a recurring basis. "We eliminate the risk of false trade receivables and the possibility that the goods delivered by the supplier are not 100% in line with the client's expectation," he says.

Groupama AM is the only investor in the platform, but Michele Ronchi, managing director at Fifty Finance Beyond, believes a growing interest in this asset class will likely generate a new birth of funds akin to Groupama Supply Chain Fund. "It is in the interest of Groupama AM to develop the platform business and potentially be open to other players, in order to capitalise on the first-mover advantage," he says.

Barak, for one, is exploring the platform option. "Prospective investors aren't necessarily looking to invest directly into the fund but are interested in a co-investment strategy, which is inherently where platforms make sense," says Mr Hedley. He recently met with EFA Group, an independent specialty finance house in Singapore, to discuss a collaborative approach.

"Our fund is about $400m and has a soft close of $500m, so we are thinking about how we are going to deal with the eventuality of a soft close, probably towards the end of next year," he says. He believes creating a platform with a partner is a potential way forward.

**Future of trade financing**

Aite Group's Mr Camerinelli is looking at how new technologies will impact supply chain management processes. He believes that blockchain, or distributed ledger technology (DLT), will change the landscape in what he calls "SCtech", or supply chain technology. Currently he is tracking close to 20 companies looking at DLT, both large ones such as IBM and SAP, as well as small ones, such as Provenance and Fluent. A number of banks are also exploring blockchain proof of concepts in the trade finance space.

Mr Wreford believes that the trend of digitisation will move beyond SCF to pre-export finance, replacing physical documentation with electronic letters of credit (LCs) and bills of lading (BLs). "The pre-export market using electronic LCs and BLs are coming at digitisation from one end and SCF platforms like ours are coming at it from the other end – at some point we will meet in the middle," says Mr Wreford. He adds that Demica has already been approached to extend its platform to add pre-export functionality.

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