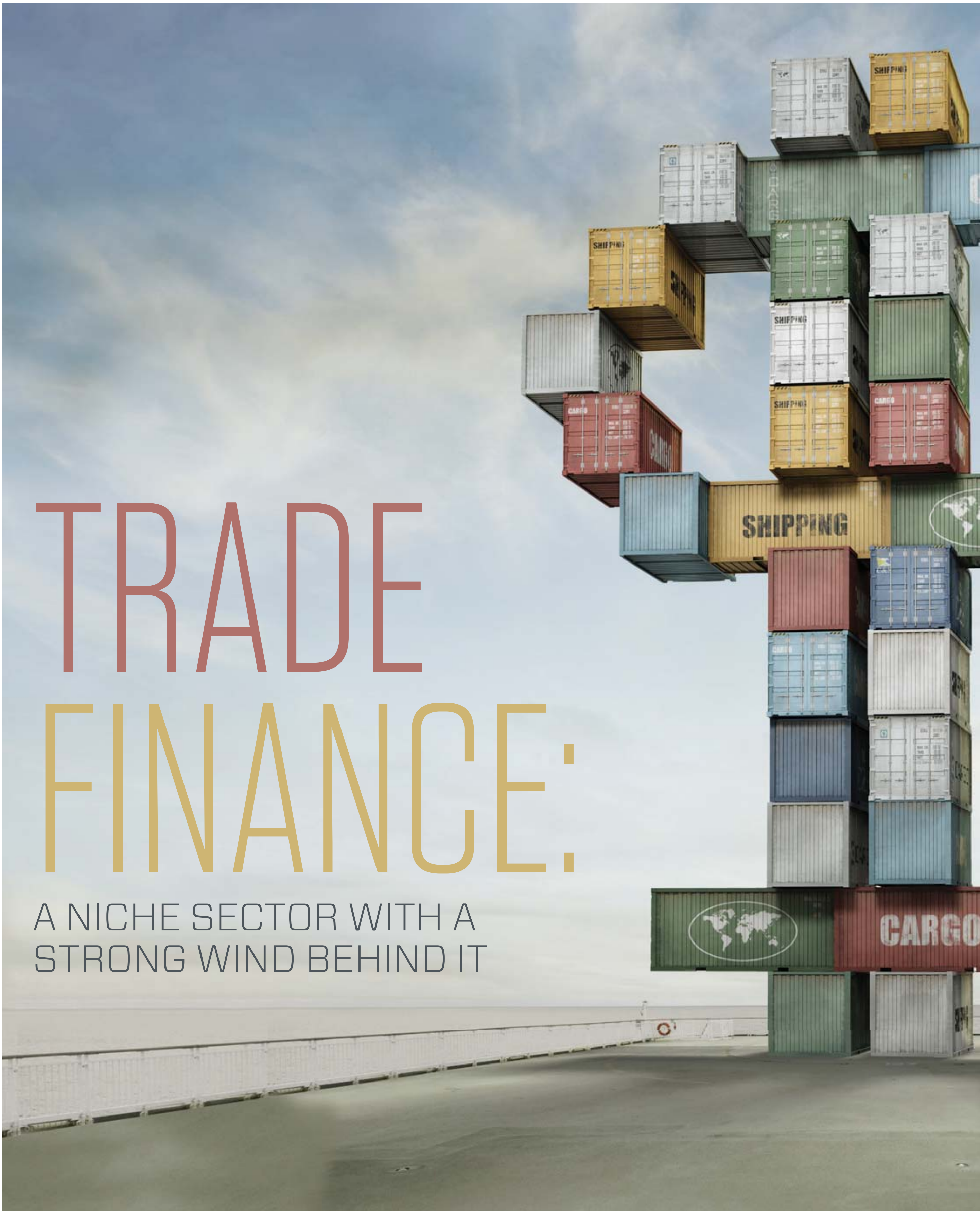

TRADE FINANCE:

A NICHE SECTOR WITH A STRONG WIND BEHIND IT

Experts predict a steady stream of launches as banks retreat and managers spot new opportunities in the space
By Sophie Segal

Investors seeking shelter from more volatile areas of the credit market are taking a close look at the growing number of trade finance funds being launched. The niche strategy, with only 20 funds globally according to industry estimates, offers steady, uncorrelated yields at a time when market instability has negatively impacted hedge fund performance, according to trade finance asset managers.

Advisers suggest that trade finance-focused funds offer 5% to 14% returns with low default rates. But the market remains in its infancy, partly due to the fact that banks have been the historical lenders of trade finance. Like many other industries, post-Global Financial Crisis regulation is impacting the ability of banks to provide funding for their traditional borrowers.

Some trade finance funds have been in existence for some time. For instance, Africa-focused Scipion Capital was originally established in 2007 in anticipation of the effect Basel II regulations would have on banks' capital requirements. The London-based fund provides short-term, asset-backed loans and provides additional lines of credit to commodity producers, processors and traders.

However, it is a new generation of managers looking to take advantage of a gap in the market left by the banks retreating, often run by former staff of these institutions that are catching the eye of investors.

For instance, ex-Goldman Sachs energy head Neil West and former Phoenix Partners global commodities head Kristofer Tremaine are launching a new commodity trade finance hedge fund expected to launch with $110m in Q2.

"It's the one of the most predictable cash flow investments that an investor can make today," says Tremaine. "Deals are usually short term and asset backed. The product creates a differentiated income stream that has virtually zero correlation to the financial markets. It is a true alternate investment."

The fund will provide small and medium-sized businesses in the energy, base metals, softs and agriculture sectors with alternatives to bank funding for commodity trades.

Kimura will initially launch a managed account proposition with $100m and require capital committed for three years, as well as a five-year closed-ended vehicle with initial partner capital of $10m. A more liquid version of the fund with 180-day liquidity is being prepared.

The impetus for launching the fund now is the exit of traditional lenders to companies in the commodity sector. Because banks are further tightening their belts, it takes them longer to sign off deals. As a result, Tremaine says companies higher in the credit stack are willing to pay a premium to get funding from alternative lenders now.

"Mid-market companies, particularly in real economy sectors, are looking for alternative sources of liquidity because the banks have had to reduce the amount of financing they put out there. The mid-market is the first to feel that," says EFA Group's new direct lending portfolio manager Xavier de Nazelle.

EFA Group currently provides close to $2bn of short-term, revolving trade finance loans to more than 100 mid-market companies annually. In addition to its two established trade finance funds which have a combined AuM of about $500m, the Singapore-based firm just launched a new vehicle.

Last month, EFA Group announced a new

What is trade finance?

Global and local banks support international trade through a wide range of products that help their customers manage their international payments and associated risks, and provide needed working capital.

The term "trade finance" is generally reserved for bank products that are specifically linked to underlying international trade transactions (exports or imports). As such, a working capital loan not specifically tied to trade is generally not included in this definition.

Trade finance products typically carry short-term maturities, although trade in capital goods may be supported by longer-term credits. The focus of this report is on short-term trade finance, both because it funds a much larger volume of trade and because of its interactions with bank funding conditions.

Source: Committee on the Global Financial System, "Trade finance: developments and issues", January 2014.

Companies with trade finance funds

Name	Established	Headquarters	Focus
Amerra Capital Management	2009	New York	Target agriculture and metals companies in the Americas
BAF Capital	2012	Basel, Switzerland	Finances of agribusiness exporters in Latin America
Barak Fund Management	2009	Johannesburg	Provides funding to trade finance value chain in over 30 countries in Africa
Blackstar Capital Partners	2012	Luxembourg	Identifies irrevocable payment contracts and combines them with collateralised loan instruments to fund pre-determined cash flow events between corporate counterparties
EFA Group	2003	Singapore	Provides alternative investment solutions in credit strategies, with a focus on real economy businesses. Has funds that are focused on Asian and global investments
Galena Asset Management	2003	Geneva	An asset manager affiliated with commodity-trader Trafigura Group supplying funding to companies in the commodity trade finance supply chain
IIG Trade Finance	1996	New York	Has financed over $7.5 billion of trade finance transactions since its inception in 1996
Inoks Capital	2004	Geneva	Promotes sustainable growth by financing emerging markets and commodity value chains focused on companies in CIS, Africa, Latin America and Central and Southeast Asia
Kimura Capital	2015	London	New launch based in London set up to provide securitised trade finance to SME's in the commodity market
KVR Trade Finance	2011	Miami	Finances importers and exporters under served small- and medium-sized enterprises (SMEs) found primarily in Latin America
Octagon Asset Management	1998	New York	Octagon offers alternative structured finance in global trade, commodity finance and transportation
Scipion Capital	2007	London	Provides short-term self-liquidating asset-backed loans African companies

asset-backed direct lending fund, the EFA Real Economy Income Trust, to address the growing need for middle-market lending during a time when traditional lenders like banks are pulling back due to regulatory pressure.

The fund will provide senior-secured loans to mid-market real economy companies targeting returns in excess of 10%.

To understand the annual funding needs of the trade finance sector, most industry experts cite an *International Chamber of Commerce's Global Risks –Trade Finance Report* from 2013 which identified $18trn of trade finance flows in 2011. The report also stated the average default rate of trade finance deals was 0.02%. However, the size of the trade finance fund market is difficult to estimate.

Galena Asset Management – part of Trifigura, one of the largest commodity traders in the world – estimated in an August 2015 report that there are approximately 20 investable funds worldwide which focus wholly or in part on trade finance transactions, with combined assets not exceeding $5bn.

Tremaine, who has spent 18 years of his career at the crossroads of banking and trade finance, estimates the market is nearer to $8bn with only about 12 commodity-focused trade finance funds.

Banks have traditionally supported trade finance borrowers and experts expect this figure to grow significantly in the coming years as traditional lenders continue to pull away from the sector. Mead Welles, a portfolio manager at Octagon Asset Management, has noticed an uptick in the number of new funds entering the market. "The amount of demand for trade finance is extraordinary," he says. "If all the funds out there raised a billion dollars each, it wouldn't even scratch the surface."

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> **Mead Welles, Octagon Asset Management**

Octagon Asset Management is a New York-based investment adviser focused on alternative structured finance in global trade, commodity finance and transportation. Octagon currently has a number of managed accounts that focus on trade finance investments.

The firm is planning to raise $100m in its latest fund – the Octagon Global Trade Fund – in the next few months. Octagon will look to grow the fund to more than $300m over the next year. "Today is the time for this strategy," says Welles. He says that prices for many commodities are at cyclical lows, while freight rates are at unsustainably low levels which cannot last forever.

London structured credit shop CedarKnight Partners placed its bet that the bottom of the cycle is near when it launched a container leasing business last month to capitalise on the low asset prices. The firm is considering a Ucits fund to raise funding after it builds a track record.

Trending up

Maximilian Tomei, who manages Galena Asset Management's $105m fund, says that commodities are at the bottom of the cycle, which is good for margins as a lender.

"What happens is a paradox at the junction between price and foreseen value of these companies. When you're at the bottom of the cycle it becomes very hard to buy into these companies because owners expect prices to increase. So they're going to add a premium which is not legitimate for a buyer at these levels. And, since borrowers have been able to survive, they don't want to give a piece of equity at this point. So, you're seeing that at bottom of the cycle, there are a lot of borrowers coming to financing markets to raise cash."

He adds that the risk-adjusted returns are better in a depressed market because borrowers are keener to pledge additional securities.

The Galena fund consists of a multi-strategy portfolio made up 60% of bank loan syndications, while the remaining 40% is comprised of direct loans to companies in the trade finance supply chain.

Part of the bank syndications are leveraged through a fully committed line agreed by a European bank. Tomei explains there is an advantage in using the consistency of the cash flows generated by longer-term syndications to finance shorter term business. Tomei says it is likely the fund will be up over 5% this year given increasing opportunities and more efficient cash management.

Risk-adjusted returns vary depending on firm and lending structure, however. Blackstar Capital Partners, for instance, advertises double-digit returns for its €109m ($120m) open-ended fund launched in 2012. The fund provides short-term, secured funding to companies in the commodities supply chain. On the other hand, EFA Global offers three funds with different geographical focuses and strategies targeting returns between 4% and 12%, while Octagon Asset Management targets returns between 8% and 12% net of fees with little leverage.

Welles says that trade finance deals trade independently of the equity, fixed income or even commodity markets in most cases. "There is some interest rate correlation because trade finance is a Libor-based business, but we're at the lows of the cycle, and a rising rate environment is a positive one for us.

"It couldn't be a better time to enter than where we are in the cycle because if interest rates rise, then you get higher all-in yields."

Educating investors

Trade finance asset managers highlight that exposure to commodity prices is mitigated by secured collateral or working with companies or commodities that are essential even under social or political pressures.

"We're not taking directional views on commodities – we're using the commodities in addition to purchase contracts and other guarantees as collateral to support our transactions," says Welles.

Some loans are extended on the basis of defined margins, therefore, whether the commodity prices rise or fall does not impact the transaction. "Trade finance has an advantage because you're hedging duration," says Tomei. "Even in an increasing rate environment you're okay because you're floating on three-months Libor. In fact, in the current environment with the Fed slowly tightening, the advantage doubles."

Alongside the prospect of steady returns there can also be issues, such as delays on payments and even restructurings. He adds that losses associated with lending to top-tier commodity producers are rare since strategic producers in emerging economies tend not to go bankrupt.

Low default rates

Even at the height of the global financial crisis, between 2008 and 2009, total defaults were 445 out of 2.8 million transactions, according to the International Chamber of Commerce's 2015 trade finance report. That is an average of less than 0.02%. Given the low volatility and decent returns in today's credit environment, Welles says the firm has had to do very little marketing for the new fund. Investors have been attracted to the 8% to 12% targeted returns advertised and have decided to allocate money from their fixed income buckets.

Investors in the Octagon Global Trade Fund already include FoHFs, European family offices, endowments and pension funds. This is reinforced by sentiments from direct-lending arranger, Michael Romanek who helps structure debt financings through his London-based firm Rise Partners.

"Investors are throwing money at lending funds right now. It's the easiest game in town to raise money for a direct lending fund at the moment. The same applies to trade finance and infrastructure." Romanek says that a number of investors, particularly family offices, he deals with have expressed a desire for real businesses exposure over trading strategies.

If you are a new fund, however, things can be tough. Most credit start-ups are facing headwinds and raising capital for a commodity trade finance fund adds complexity because it is not a typical fund product. "A lot of what we're trying to do is investor education," says Kimura's Tremaine. "To hedge fund style investors, it's a relatively new asset class. It's one of the oldest most proven mechanisms in finance today. It formed the cornerstones from which many banking dynasties grew."

Tomei agrees that speaking to potential allocators can be difficult. "The most challenging thing is an investor that looks at trade finance with credit spectacles," says Tomei, who says these transactions cannot be analysed like bonds because the real value drivers and risks are different.

Galena is seeing increased interest out of the US-based family offices and small insurance companies, and Tomei adds that most of Galena's investors understand the asset class and appreciate the consistency of cash returns associated with trade finance.

EFA Group, which launched its direct lending fund last month, says that appetite has been strong from investors looking for attractive but steady yields. "There's a nice role for us to play where we can match the investors' search for uncorrelated yield with the borrowers search for alternative sources of liquidity. We address both needs with this product," says portfolio manager Nazelle.

Several managers suggest that the trade finance fund market has been slow to develop because it requires a local and industry expertise which is a barrier to entry for new funds.

One fund that has solved this handicap is impact-investor Trilinc Global, which has made about $95m trade finance-related direct loans to companies in Africa and Latin America through its $131m Global Impact Fund.

According to information on its website, the Missouri-based retail fund, which had an annualised distribution of 7.22% in 2015, engages local sub-advisers to make the loan, while the fund's portfolio managers oversee the investments and sub-advisers.

While this market is still in its infancy, one manager says that trade finance bankers who have been laid off due to bank's scaling back their lending, are looking to start funds. The expertise will be welcome in an industry that has such huge financing requirements.

Sophie Segal
Head of content, *Alt Credit Intelligence*
s.segal@pageantmedia.com