Applying ESG to trade finance: why it is good for business

Gerry Afentakis, head of strategic development at **EFA Group**, talks *Alt Credit* through some real life examples of how trade finance can work for businesses, but also improve ESG, even in some of the most sensitive commodities and regions

ESG considerations are an increasingly important factor for institutional investors such as pension funds and family offices when allocating across asset classes. Not just because they are frequently a requirement from their underlying clients who might wish to 'do good' or rather 'do no bad', but also because they can help to mitigate business and reputation risk, and perhaps more importantly in the current low-yield environment, they can often help to boost investment returns.

Trade finance investments are no exception. This asset class, historically dominated by international banks and inaccessible to the investment community, involves financing the supply chain for goods and services and has grown in importance as demand for capital has outstripped supply. It is estimated that the unmet need for trade finance exceeds $1trn. Meanwhile, banks and other traditional lenders are reluctant to increase financing to companies, predominantly SMEs, because rising regulatory costs and burdens make it uneconomical for them to do so.

This reluctance creates opportunities for specialist fund managers with 'boots-on-the-ground' in key commodity markets globally, such as EFA Group. Having a local team that can build relationships with domestic partners is crucial, as it builds trust and understanding, and provides invaluable insight and market intelligence, which together lead to better lending decisions and further business opportunities. This in turn means better returns and fewer losses for underlying investors. This 'partnership' approach also helps to create jobs and wealth along the entire value chain, sustaining local communities.

This is especially important in the world of soft commodities. Cocoa and coffee, for instance, are two of the world's most important cash crops, owing to the size and underlying growth of their respective markets. As emerging markets grow richer and adapt to western tastes, demand for coffee and chocolate is rising. In China for example, Starbucks has grown its presence from one store in 1999 to 3,600 across 150 cities today. Meanwhile, food crops are predominantly grown in emerging or frontier markets. Ghana and Côte d'Ivoire for example are the world's top two cocoa-producing nations. Their cocoa industries are very reliant on networks of small farmers who often lack the business skills and financing to improve their productivity and commercial output, and therefore their income.

Responsible trade finance can make a difference here. Indeed, the trading companies who buy and increasingly process the farmers' cocoa, are helping them to learn new skills, access working capital, and boost output and income.

Touton SA

Touton SA is one example. This top five global cocoa trader has operated in Ghana and Côte d'Ivoire for over 25 years. EFA has worked with Touton for more than eight years, providing working capital and capex finance. As Ghana's cocoa industry is driven and sustained by tens of thousands of smallholder farmers, Touton can use its scale to provide these farmers access to competitively priced tools, fertilisers, pesticides and other key inputs. In 2008, Touton launched its Ghana sustainability programme, aiming to help farmers produce cocoa in a more sustainable way, and also to boost their opportunities. Today, the company increasingly aims to work with partner farmers through the 'Farm Development Plan' approach. This involves assessing the farmer's economic circumstances and creating a roadmap and business plan to lay out achievable goals for them.

With 80 staff across numerous rural service centres, Touton now reaches 60,000 farmers across Ghana and Côte d'Ivoire. They are taught about: land rehabilitation (land is a finite resource, and end clients such as Nestlé and Mars rightly oppose deforestation); crop diversification to ensure farmers are not over reliant on just one cash crop; productivity – or how to improve yields as well as business and finance skills. Touton also utilises local radio and SMS messaging to remind local farmers about training times, advise on best planting dates, and inform about weather conditions.

So rather than just buying their crops, Touton's intensive, close-working and nurturing relationship with farmers helps them to produce more, grow their income, learn new skills, and plan for the future. All this helps to sustain income, jobs, and local communities.

Relationships are key

Building this close, symbiotic relationship makes good business sense for Touton. It strengthens the firm's relationship with its underlying suppliers. It fosters a better understanding and connection with their supply chain. Working closely with the farmers gives Touton better access to data, more competitive pricing and supply visibility. It also creates new business opportunities: Touton sells pesticides and fertilisers, a new revenue stream for the company, and the economies of scale it offers mean better prices for farmers. For Touton's end customers, global food companies such as Nestlé and Ferrero, it helps them to demonstrate commitment to their sustainability goals. Lastly, the relentless focus on sustainability and good business practices also creates value; the sustainability cachet helps to create a premium product that middle-class consumers in end markets increasingly want to buy.

Just as Touton has strong relationship with its farmers, EFA has a strong, trust-based relationship with Touton. Because EFA understands Touton's business model and practices, it has meant a long-standing commercial relationship between the two firms, with EFA providing not just working capital finance, but also funding for longer-term capital investment.

The evolving dynamics of the global food market mean that blue-chip food producers want their suppliers to become more nimble, more integrated and more efficient. In effect, this means that where previously confectionery producers such as Mars were happy to buy, for example, raw cocoa beans from a company like Touton and would subsequently process these raw beans themselves, now the food producers want cocoa that is further along the value chain: semi-processed as cocoa paste, or cocoa butter or liquor. So for Touton, it has had to move up the value chain and process the cocoa beans it previously just traded. But acquiring processing plants is expensive.

Increasing regulation means banks often offer lending terms that are too onerous, their internal due diligence and investment processes often exceeding the timeframe available for the borrower to close the investment. Building on our strong working relationship with Touton, EFA stepped in and helped finance the firm's acquisition of a $16m cocoa processing plant in Ghana. Today, Touton's factory in Tema, Accra, has the capacity to process 32,000 tons of beans a year into cocoa liquor, and 25,000 tons into cocoa butter, key feedstock for the global confectionery markets.

Palm oil

ESG considerations also apply to other soft commodities and their producers. Indeed, one particular crop that has attracted concern is palm oil. This edible vegetable oil comes from the fruit grown on the African oil palm tree. It is mainly grown on plantations in Indonesia and Malaysia and can be found in a huge variety of consumer products across the world such as bread, ice cream, and other processed foods, as well as some cosmetics and even soap.

To feed growing demand for palm oil, irresponsible and illegal palm oil farming has led to the destruction of large areas of tropical rainforests rich in biodiversity, with the subsequent loss of habitat for endangered species such as orangutans and tigers. Furthermore, converting rainforest into plantations can result in the release of high amounts of carbon emissions.

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Once again, however, international food companies and consumers are rightly growing intolerant of these actions, creating an opportunity for trade finance providers to back more sustainable practices and companies. One such example is a Singapore-based integrated palm oil business with plantations in Indonesia and a downstream refinery and edible oil business in Malaysia. The palm oil company is a RSPO (Roundtable on Sustainable Palm Oil) member, the global standard-bearing palm oil industry group formed in 2004 to address environmental concerns. EFA has provided working capital finance that has enabled it to continue producing RSPO-certified, sustainable palm oil, as well as implement a number of further sustainable initiatives.

The company enforces a zero burning policy for all its land clearing activities and has committed to not developing areas of forest and peat that contain rich carbon stocks. Further, by using boilers powered by renewable organic waste materials, it has significantly reduced the levels of greenhouse gas emissions usually associated with palm oil production. It also avoids the need to send waste to landfill by recycling digested POME (palm oil mill effluent) and other organic waste, such as empty fruit bunches to produce organic fertiliser.

So, trade finance isn't just about funding trading in commodities in faraway lands. It is about having boots on the ground to help build and sustain relationships with local partners and provide insights and know-how about underlying markets. It is about providing robust solutions to complex and dynamic financing problems. It is about helping companies to grow. It is about creating jobs and sustaining communities. It is about doing all of these in a sustainable way. It is also good business sense. In a low-yield investment environment, trade finance has continued to deliver consistent, uncorrelated and low-volatility returns with very low default rates. A widening funding gap and growing demand for commodities means this asset class will be needed ever more in the future. ◻

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