Industry Overview

Trade Finance: A Catalyst to Global Commerce

Alternative Income Group

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Ninepoint Partners Industry Overview
Trade Finance: A Catalyst to Global Commerce
Alternative Income Group

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Executive Summary

Trade finance has been facilitating global trade since the early 1800's, and as world trade becomes more intertwined, trade finance will continue to serve as an integral part of growth. Global trade reached $39 trillion[1] in 2018 with steady growth in most forecasts continuing for the foreseeable future. The global economy has become reliant on trade finance with approximately 80-90%[2] of global trade facilitated through a trade finance lender.

Small to medium-sized enterprises drive the largest demand for trade finance, however, they also face the highest rejection rate for receiving financing. This has been a product of traditional lenders' extremely strict evaluation and underwriting procedures which has caused them to overlook low risk transactions and has generated opportunities for private investors and non-bank lenders to seize market share.

The high level of rejection faced by SME's has also given life to a widening $1.5 trillion trade finance gap. Over the next 2 years this gap is expected to expand as traditional lenders continue to step away from participating in trade finance transactions. The perceived riskiness of the asset class is a result of its short-term nature and unfavorable capital regulations brought about by Basel III requirements.

Private market and non-bank lenders have come to try and fill the gap through thorough underwriting processes which can be tailored and specialized to specific businesses. Typically, these lenders source transactions from existing relationships, developing relationships, or through an intermediary such as a broker. Underwriting criterion for non-bank lenders primarily focuses on strong business operations and longstanding relationships in order to mitigate the risk of fraud in a transaction and also accounts for factors such as: business/market characteristics, management team strength and financial capabilities, ability to provide suitable collateral, and geography, which form the basis of how a transaction is assessed.

COVID-19 has had a fundamental impact on trade around the world with shutdowns impacting a wide variety of industries. The global slowdown is weighing down on global trade which is expected to see significant declines for 2020. Prior to COVID-19 trade had already been experiencing weakness given the current political tensions between the US and China. However, the virus is also expected to make lenders more conservative and force them away from many businesses creating more transaction potential for non-bank lenders.

As a result of the current environment, many governments have created stimulus measures for individuals and businesses in order to sustain the economy. Specifically, for trade finance, the ICC has moved to paperless trade in order to reduce Basel III risk factors, governments and central banks have also moved to purchase trade finance assets. However, in the long-term trade is expected to make a strong rebound which will stabilize the use of trade finance, pricing on transactions and revenues.

What is Trade Finance?

Trade finance is the provision of capital for international trade flows[3]. It works to facilitate the flow of capital and reduce the investment required in a transaction. There are two parties in a transaction:

1. **Seller –** The individual or business that expects payments for their goods and services.
2. **Purchaser –** The individual or business who expects to receive the designated goods that they have paid for in both quantity and quality.

The role of trade finance is to ease capital requirements for either the purchaser or seller by advancing funds through the invoice grace period. Most transactions are done with a specified payment term. A trade financier can facilitate the transaction by paying the seller, or advancing cash to the purchaser on invoice date as opposed to the prescribed payment date. This reduces the amount of cash the transaction participants must have to operate and instead allows them to invest in growing their business.

The risks involved in a trade finance transaction include payment risk, corporate risk, and political/country risk. Trade financiers such as bank and non-bank lenders work to provide solutions such as supply chain financing and working capital factoring which are typically short-term transactions that mature in less than one year. These processes involve buying a company's trade receivables at a discount to provide them with short-term liquidity and then earning their cash flow back by collecting the par value of the receivables upon maturity.

How does Trade Finance facilitate global commerce?

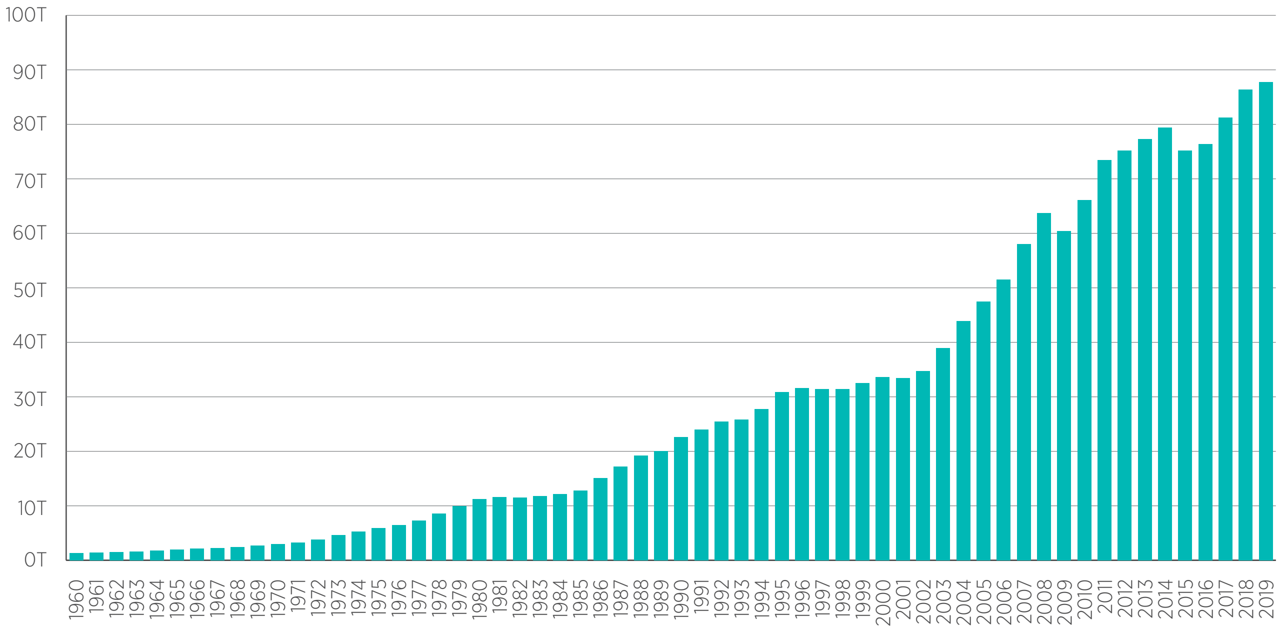
International trading activities typically involve large upfront costs and long time horizons which can which can hinder the working capital positions of businesses[4]. Trade finance serves a fundamental role to relieve the pressure on business' working capital issues so that they can continue to trade without compromising their business operations. By freeing up cash flow and ensuring that suppliers earn their money promptly, trade finance provides a solution for both businesses and suppliers to encourage growth and stability in global commerce[5].

Global Trade Landscape

Introduction

The Global Trade Network is a product of centuries of globalization and local economies becoming intertwined with each other. As economies grew to rely on one another, the contributors became more specialized and efficient driving growth to the global economy. International diplomacy and broad reaching trade agreements have allowed these global supply chains to thrive. The real economy has grown steadily in modern history, this is thanks in part to the globalization facilitated by trade finance.

Figure 1: Global GDP in current US$ (1960-2019)



Source: The World Bank.

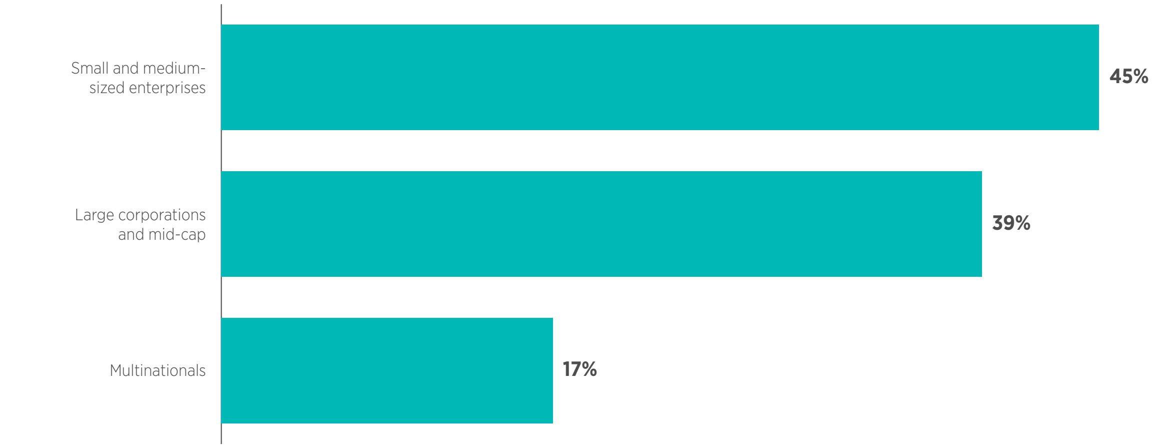
Trade Finance is a key contributor to global growth, with approximately 80-90%[6] of global trade being dependent on financing through one or multiple channels. The typical lenders in trade finance are Banks, Business Development Companies (BDCs), and private lenders. Banks and BDCs represent the largest market participants, with private trade finance funds in a relatively nascent stage.

While there are certain advantages to a Global Trade Network, it is not without challenges. Smaller businesses that cater to a local need often find themselves boxed out of the largest sources of working capital. This lack of funding is a product of the inefficient allocation of global capital on a local stage, which leads to unrealized value in local economies. Private markets are where this unrealized value is uncovered and collected for the benefit of investors.

Small to Medium-Sized Enterprises (SMEs)

Small to Medium-Sized enterprises are a dominant factor in today's global economy. They account for 90% of businesses and over 50% of all employment worldwide[7]. This contribution to global economic development is done without adequate financing from traditional lenders. SMEs are responsible for 37% of demand for trade finance yet face the highest rejection rate out of all businesses for trade finance credit at 45%[8]. This leaves nearly 20% of world trade finance demand left unmet and additional GDP growth left unrealized.

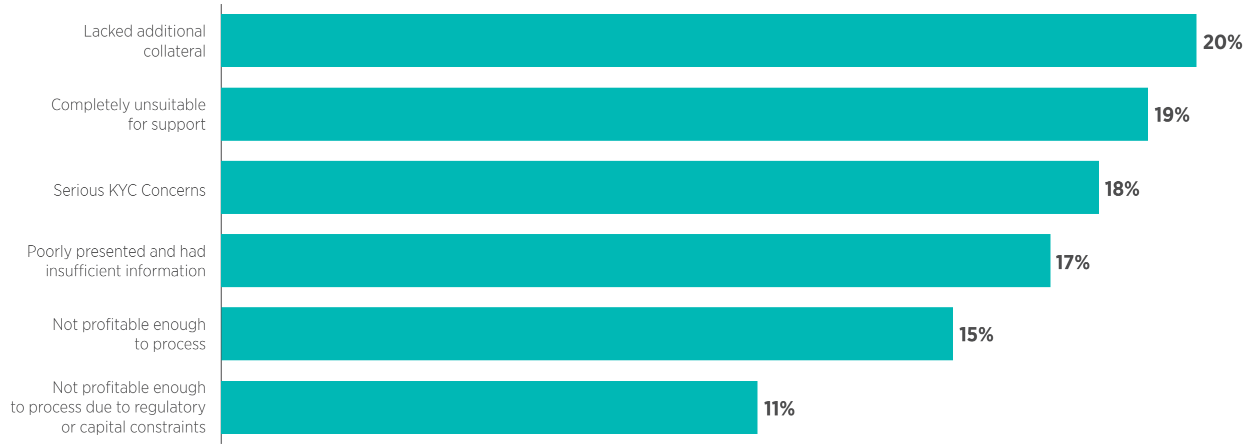
Figure 2: Trade Finance Rejections by Firm Size (% of applications, average across bank responses)



Source: Asian Development Bank: 2019 Trade Finance Gaps, Growth, and Jobs Survey.

SME's are typically rejected by traditional lenders that follow a framework that filters financing candidates based on strict guidelines. These guidelines focus on factors such as accounts receivable concentration, business operating history, and specific sectors from which they evaluate the risk of an investment. While these frameworks create an efficient allocation of capital on a global scale, thorough underwriting can uncover low risk transactions that provide value for both the SME and investors.

Figure 3: Reasons for rejection of Trade Finance Proposals



Source: Asian Development Bank: 2019 Trade Finance Gaps, Growth, and Jobs Survey.

Trade Finance requires extensive due diligence by the lender prior to funding. This is due in part to the short-term nature of the transaction and the somewhat ambiguous status of the collateral. As trade finance loans are underwritten with the expectation of a specific transaction taking place, the onus is on the lender to verify that the receivable is in fact valid and they can expect to collect. Lenders to SMEs need to go through the same level of detail that they would for a larger transaction and this leaves many SMEs overlooked with capital allocated towards name brand borrowers.

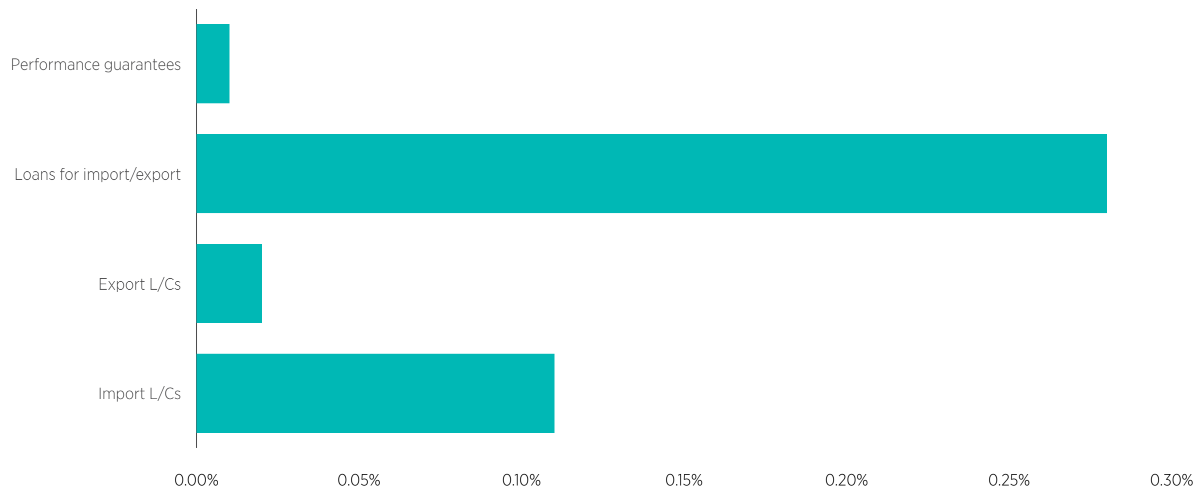
The Trade Finance Gap

The trade finance gap is the shortfall in capital provided to businesses from lenders relative to the amount that businesses require for sustainable and efficient operations. Trade finance serves a fundamental role in propelling global trade, business growth, economic prosperity, and financial inclusion[9]. Therefore, the trade finance gap contributes to negative macroeconomic effects across the globe while further burdening businesses from expanding their capabilities.

According to the Asian Development Bank, the estimated global trade finance gap is $1.5 trillion[10]. According to the ADP's 2019 Trade Finance Gaps, Growth, and Jobs survey this gap is expected to increase over the next 2 years[10]. As lenders focus on clearing risk from their own balance sheets, trade finance transactions are among the first to be removed due to their short-term nature.

The risk associated with lending continues to drive the gap despite the average default rate and recovery rate from 2013 – 2017 being 0.46% and 52% respectively[11]. With an expected loss of 0.20%, trade finance transactions are a relatively low risk investment.

Figure 4: Expected Loss on Trade Finance Products

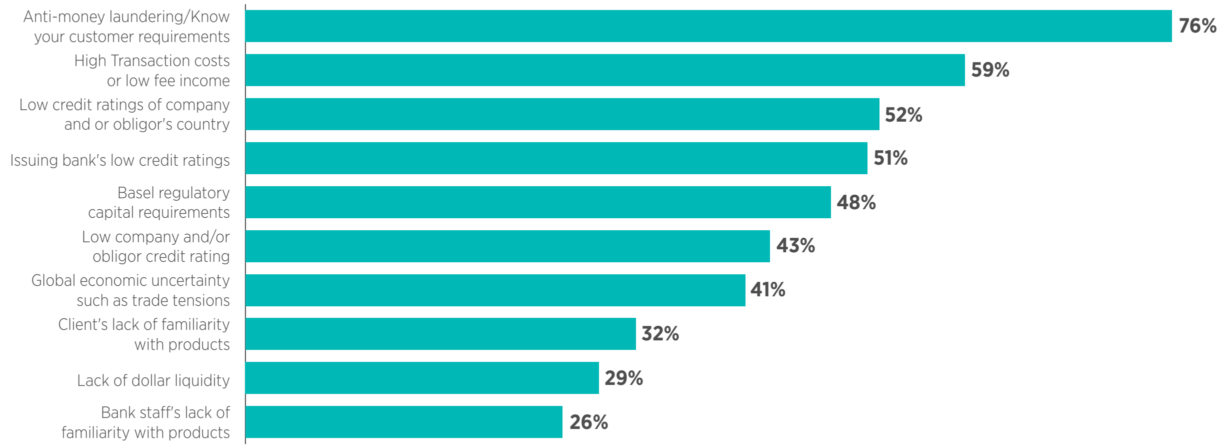


Source: International Chamber of Commerce (ICC): 2019 Trade Register Report, Global Risks in Trade Finance.

Anti-money laundering concerns and KYC requirements have been the largest cause for concern amongst banks and have been the largest barrier to trade finance. The Global Trade Network has made it more difficult than ever for a lender to truly know their customer and satisfy KYC requirements.

SME Trade Finance is best suited to a local approach where the lender or originator has a history with the borrower, knows the owner of the business, and knows where the revenue is coming from. This prevents larger lenders from achieving scale in the SME market, further driving the financing gap.

Figure 5: Barriers to Trade Finance



Source: Asian Development Bank: 2019 Trade Finance Gaps, Growth, and Jobs Survey.

The Role of Private Markets

The primary function of private market transactions is to identify value and provide access to such investments for investors. After the implementation of the Basel III capital requirements, Banks were subject to heightened regulation resulting in lower participation in trade finance transactions. With large institutions stepping away, lenders got negotiating leverage to enhance their return and perfect security on the underlying collateral.

According to ICC's 2019 Trade Register Report, default rates in trade finance transactions from 2008-2018 were between 0.04%-0.73%[12], compared to 1.30% for corporate bonds in 2019[13]. Private lenders saw the opportunity to drive value for clients by taking advantage of a capital drought. Private trade finance transactions will often enhance the credit quality of their borrower by taking additional security against their investment. This can be done through a variety of products such as letters of credit, credit insurance, political risk insurance, surety bonds, and guarantees[14].

Letter of Credit – A Letter of Credit entails taking a letter from an issuer's bank as additional collateral. This Letter of Credit provides the lender with an assurance that the bank will repay the loan from an account in the issuers' name, should there be a problem with collection. Having a Letter of Credit in place is known as a credit enhancement and can have a material impact on the default rate of the borrower.

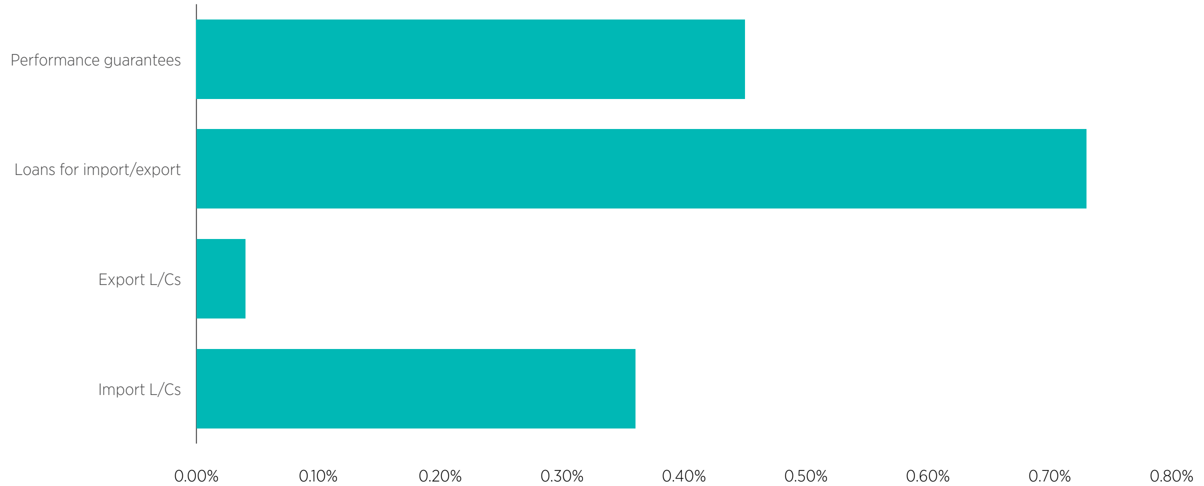
Credit Insurance – Credit insurance provides cash flow protection against non-payment and credit loss so that in the event of default receivables are still covered for around 90%[15] of their value by the insurer. This coverage is provided up to a certain period depending on the policy.

Political Risk Insurance – Government policies and political events can have negative impacts in trade finance transactions. Political risk insurance financially insures investors against any losses resulting from unlawful government action against them varying from expropriation, war, political violence and even sovereign debt defaults[16].

Surety Bonds – A surety bond provides a guarantee between contracting parties that the bank will pay one party if the counterparty fails to comply with the terms of their contract, ceases trading, or becomes insolvent[17].

Guarantees – A financial guarantee is a non-cancellable contract provided by a bank, insurer, or other party which underwrites a contract by fulfilling payments to one party if the counterparty fails to follow or meet the terms of their contract[17].

Figure 6: Default rates on trade finance products from 2008 – 2018



Source: International Chamber of Commerce (ICC): 2019 Trade Register Report, Global Risks in Trade Finance.

Note: Rates presented are obligor-weighted.

Competitive Landscape

The competitive environment of trade finance is dominated by global banks, however, non-bank lenders have recently been increasing their market share. In the past year, trade finance lenders have been faced with challenges such as the US-China trade war which has caused operational problems due to the rerouting of supply chains amongst their clients. The global players across the trade finance market have been primarily concentrated in Europe, Africa and Asia where activity is most prominent. Some large bank lenders have a minimum transaction size requirement of $50 million for trade finance loans[18]. As a result, many alternative financiers have emerged to fill the void across the globe. Alternative lending in trade finance is becoming much more accessible for businesses than before. Most non-bank players provide financing for SMEs as opposed to large and multinational corporations.

Table 1: Global non-bank trade finance players

Firm	Profile	AUM	Structure
Greensill	Greensill is the leader of non-bank supply chain finance. In 2019 alone, they completed $143 billion dollars of financing. They have completed transactions in over 175 countries with over 8 million customers and suppliers.	$150B*	Private Co.
Sarona Fund Management	Sarona Fund began in 1953 as an alternative lender focused on sustainable development and impact investing. Sarona's Trade Finance Fund provides operating working capital for SMEs in Asia, Africa, Latin America and Europe and aims for a Target IRR of 8-12%.	$120M	Limited Partnership
RiverRock European Capital Partners	RiverRock European Capital Partners is a Europe only focused fund engaged in direct lending, working capital, real assets, and liquid strategies. Their trade finance fund finances the entire supply chain for SMEs and is committed to ESG principles.	$928M**	Independent
Hitachi Capital	Hitachi Capital is a longstanding financial services company with a focus on asset-based lending and trade finance solutions. They have established presences throughout Japan, China, ASEAN, Europe and the Americas.	¥9,983M ($94M)****	Public Co.
Barak Fund Management	Barak Fund Management is a short, medium and long-term credit provider with 3 trade finance funds. The company has been able to complete transactions across 30+ countries in Africa.	$1B	Private Co.

Firm	Profile	AUM	Structure
Channel Capital Advisors	Channel Capital Advisors, based out of the United Kingdom, manages both debt and equity funds and has provided working capital and trade finance solutions for over 13 years. Channel has a global presence across the United States, Europe, Africa, and Asia. They have financed $6 billion in working capital since inception.	$6B*	Private Co.
Highmore Group Advisors	Highmore Group Advisors offers alternative investment solutions across a wide range of liquid and illiquid platforms including real assets, liquid alternatives, and trade finance. Highmore manages and advises on over $2 billion in assets.	$2B+***	Private Co.

Source: Sarona Fund Management, RiverRock European Capital Partners, Hitachi Capital, Barak Fund Management, Channel Capital Advisors, and Highmore Group Advisors corporate websites and filings.

* Financing issued since inception.

** Fundraising in the past 10 years.

*** Assets under management/advisement.

**** Converted from Japanese Yen (JPY) to USD on 8/21/2020, 2019 number reported by Hitachi Capital.

Table 2: North American non-bank trade finance players

Firm	Profile
Latitude 20 Capital Partners	Latitude 20 Capital partners is headquartered in New York City and provides trade credit solutions for SMEs with a focus on emerging markets businesses. The firm specializes in asset origination, monitoring, operations, portfolio and fund management.
Elevate Export Finance Corporation	Elevate Export Finance Corporation aims to boost global trade and grow SMEs through providing trade financing solutions to Canadian exporters.
Trade Finance Solutions Inc.	Trade Finance Solutions Inc. provides short-term financing solutions such as factoring, supply chain financing, asset-based lending, and purchase order financing to SMEs, startups and established enterprises. Since 2006, the company has financed trade across many global markets.
Allam Advisory Group	Allam Advisory Group provides global trade consulting by helping businesses examine long-term loans, export credit, working capital and trade finance. They possess an expanded global network of commercial and investment banks, development banks, multilateral financial institutions, investment funds, and export agencies which they introduce businesses to depending on the type of financing they are seeking.

Source: Latitude 20 Capital Partners, Elevate Export Finance Corporation, Trade Finance Solutions Inc., and Allam Advisory Group corporate websites and filings.

Non-bank trade finance providers can be divided between investment managers and BDCs that execute and underwrite trade finance loans to businesses, however, it is also comprised of fintech players who act as intermediaries between borrowers and lenders to connect businesses through a large network of bank and non-bank lenders to be able to find the most suitable trade financing solution. The fintech space is concentrated with a blend of underwriters and companies that use technology to match borrowers and lenders.

Table 3: Global fintech trade finance players

Firm	Profile	Funding Network
Tradeteq	Tradeteq has financed over 25,000 invoices with a network of 5,000+ corporates funded. It offers an integrated solution for banks, non-banks and institutional investors to carry out their trade finance practices.	5,000+*
Demica	Demica has connected 500 corporations to over 50 global banks through its automated financing and risk management platform. Their funded programs have grown at 40% per year for the past 5 years to reach $16 billion in 2019.	500*

Firm	Profile	Funding Network
Trade Finance Global	Trade Finance Global offers access to an online network of over 270+ banks, funds and alternative financiers to help meet a variety of financing solutions and structures for business trade credit needs.	270**
Stenn	Stenn provides online financing for up to $15 million. The average decision time for receiving financing is 48 hours with a fully automated process.	178+***

Source: Tradeteq, Demica, Trade Finance Global, and Stenn corporate websites and company filings.

* Corporates Funded.

** Relationships with financiers including banks, funds, and alternative finance houses.

*** Buyers and suppliers across 178+ countries.

Private lenders typically source trade finance transactions through existing relationships; however, lenders can generate transactions through agents and brokers as well. Larger managers in the space have client relationship management teams who specialize in understanding specific businesses and industries and can therefore work to propose ideal transactions for current or prospective clients. These brokerage and origination relationships have become more commonplace as funds grow beyond the capacity of an individual manager's relationships.

Due to the SME funding gap there are many challenges faced in the number of deals that can be originated; for example, poor deal quality and low transparency[19]. This makes deal sourcing even more important to a Trade Finance manager's success. Transactions must be made with businesses that have strong operating histories and a good relationship with the originator to mitigate the risk of fraud through the investment cycle. Having a deep origination network with a "boots on the ground" approach of working closely with borrowers is the best way to find good credit in local economies.

Underwriting criterion play a fundamental role in trade finance transactions. These criteria typically differ between bank and non-bank lenders as a result of banks having more lengthy and specific processes, whereas, a non-bank lender is able to offer tailored solutions to businesses. Trade credit providers typically look for fundamentally robust businesses where they believe that collection is reasonably certain. Some criteria include:

- **Business/Market Characteristics:** Borrower should have a recurring customer base and revenue streams, proven history of strong operations, and sustainable business practices. Ideal businesses should also operate in a stable industry with easily predictable demand.
- **Financial Information/Statistics:** Strong financial statements with high balance sheet liquidity, overall low risk of default, and creditworthiness. Short-term receivable invoices should have a good payment history. The company should not be highly leveraged.
- **Experienced Management Team:** Management teams should have strong credentials and experience in the business with proven performance.
- **Collateral:** The lender should possess the most seniority in the capital structure. Viable assets should be used as collateral in the event of default, assets should be stress tested to assess their value in different scenarios.
- **Geographic Considerations:** National/local laws must be considered to determine any risks regarding tariffs and political instability.
- **Transaction Risk:** Verifying customer credit history and certainty of payment is essential to minimize transaction risk.

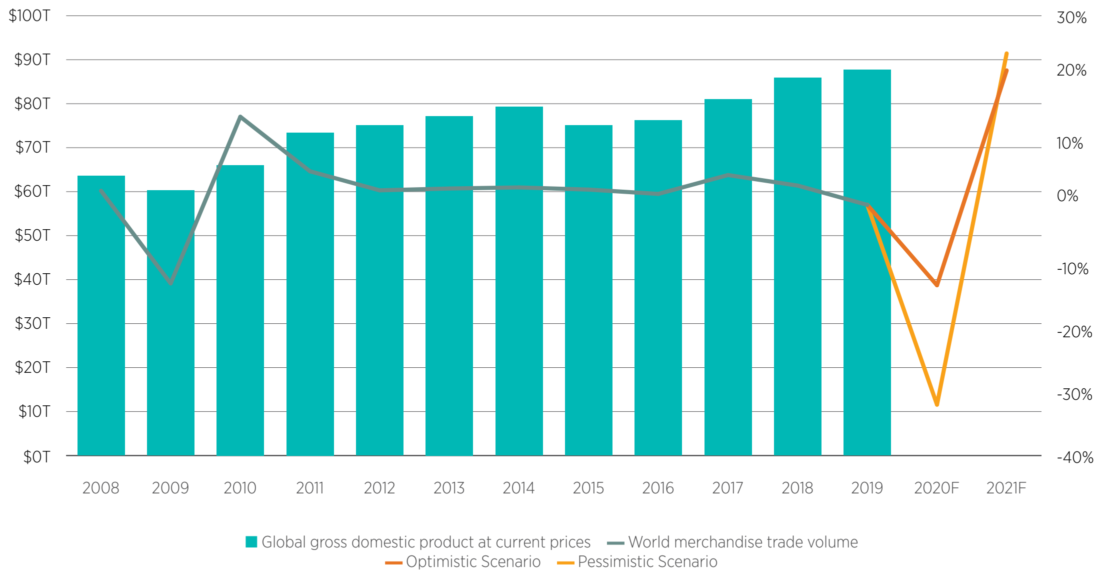
Recent Market Developments

COVID-19 Impact

Amidst the economic fallout caused by a global pandemic, many economies have suffered from slowing production and growth. Due to new social distancing rules, businesses such as transport and travel are suffering along with employees working in affected industries. The shutdowns have resulted in businesses such as restaurants, hotels, non-essential retail trade, tourism and manufacturing ceasing or reducing operations.

Prior to the COVID-19 pandemic, trade was already beginning to stagnate as a result of global tensions and economic slowdown. The World Bank expects global real GDP to contract by 5.2%[20], more than double the impact of the Great Financial Crisis and one of the worst recessions seen in years. Global merchandise trade is expected to face a decline between 13-34% in 2020. However, under the assumption that the virus is controlled by 2021 and business/household uncertainty is reduced, trade is expected to rebound quickly back to pre-virus levels, showing double-digit growth by around 21-24% in both optimistic and pessimistic scenarios.

Figure 7: Merchandise trade forecasts



Source: World Trade Organization Press Release: Trade Set to plunge as COVID-19 pandemic upends global economy, The World Bank Database.

During the Global Financial Crisis of 2008, the decrease in trade finance was estimated to be US$1 trillion[21]. The current pandemic is expected to create an increase in demand for trade credit from SMEs as more lenders move to shelter their balance sheets.

Trade Finance is often reliant on paper-based processes, as required by law. COVID-19 social distancing measures and business shutdowns have added additional hurdles to these processes. The most agile industry players, such as private lenders, have been able to adapt to this new environment by switching to electronic processes and capturing additional market share.

Trade Tensions and Economic Slowdown

The US-China trade war began in 2018 when the US government set tariffs on Chinese consumer and industrial products which resulted in China retaliating with the same measures. To date, the US has imposed tariffs on US$550 billion worth of Chinese products and China has set tariffs on US$185 billion worth of US goods[22]. In 2019, the trade war affected many sectors facing a 20% decline in the value of goods imported between China and the United States[23]. In early 2019, a phase 1 deal was signed by both countries, however, this plan did not move towards resolution and simply delayed select tariffs from being implemented. In 2019, trade between the US and China fell by 12% leading to an overall 5% fall in trade between the US and Asia[23].

Currently the US-China trade deal is expected to remain intact based on indications from US government officials. However, any next steps after coming to a phase 1 resolution have not been discussed. The relationship between US-China has frayed recently due to the COVID-19 pandemic and the China-Hong Kong conflict. Any tension between the US and China can be perceived to contribute to a negative outlook for trade between the two countries.

Outlook for Trade Finance

Including a material predicted decline in merchandise trade, the International Chamber of Commerce predicts that stimulus of US$1.9-5.0 trillion will be required in order to foster a V-shaped recovery from COVID-19 in the trade finance market[24]. In addition to cash stimulus, there are regulatory changes that could drive recovery in the trade finance market. The ICC recommends taking steps such as using paperless trading, reducing Basel III risk weights for MSMEs from 100% to 75-85%, and the purchase of trade finance assets by governments and central banks[24].

While policy makers and central bankers struggle to agree on appropriate stimulus measures, the capital supply to trade finance is dwindling. Private lenders can deploy capital to high quality borrowers at very attractive pricing. This market dislocation is not expected to last in the long term, according to the Boston Consulting Group's revised Trade Finance Model, which predicts global political uncertainties will contribute a 1% annual decline in trade flows until the end of 2020[25].

In the long run, trade flows are expected to rebound and reach a high of $25 trillion by 2027 implying a CAGR of 3.3%. This slowdown implies flat or slightly declining revenue for large bank lenders in the near term. This decline in revenue is a direct result of them withdrawing capital from the trade finance market, leaving more opportunity for private lenders. However, as the banks recover and pricing begins to stabilize, revenues will increase once again and are expected to reach $57 billion by 2027. Approximately 80-90% of global trade is dependent on trade finance[26]. The steep 2020 declines will significantly lower trade finance revenue for the year, which implies a broad range of opportunity for private lenders. ■

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FOOTNOTES

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