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Institutional investment in supply chain finance: approaching a point of inflection

Supply chain finance (SCF) has become increasingly fashionable within institutional investment circles since the financial crisis of 2007-2008. Though non-bank capital still provides just a fraction of global SCF, an emerging class of funds has begun to help a broad array of institutional investors lay claim to a greater share of the market's USD 25+bn revenue pool.

Today, the COVID-19 pandemic's continued assault on the global economy offers SCF funds both a critical first test and precious opportunity. Whether these nascent investment vehicles deliver consistent returns throughout a period of sustained financial market turbulence will weigh heavily on near- and medium-term institutional enthusiasm for the asset class. Success would serve to many investors as validation of the SCF investment hypothesis and set the stage for dramatic growth in SCF fund assets under management.

Recognising that the COVID-19 era is poised to become a point of inflection for their young class of funds, we expect SCF portfolio managers to buttress the downside protections inherent to their asset class through the employment of increasingly conservative credit underwriting strategies.

Emergence of an asset class

The emergence of SCF as an investible asset class is largely a phenomenon of the past decade, over which time converging forces have materially increased the availability of SCF assets (commercial accounts receivable for sale at a discount) to non-bank institutional investors.

The most fundamental of these forces has been a shift in international trade toward 'open account' terms, under which goods are shipped before payment is due, and suppliers assume the credit risk of their customers. Made possible by maturing trading relationships and enhanced transparency throughout global supply chains, open account transactions, by definition, forgo the risk mitigation solutions provided by traditional trade finance products (i.e., performance guarantees, letters of credit, documentary collections, etc.). Yet, the need for trade finance solutions to bridge the gap between the time at which the suppliers want to be paid (at the time of shipment) and the time at which buyers want to make payment (perhaps 30, 60,

How is the demand for trade finance products changing?

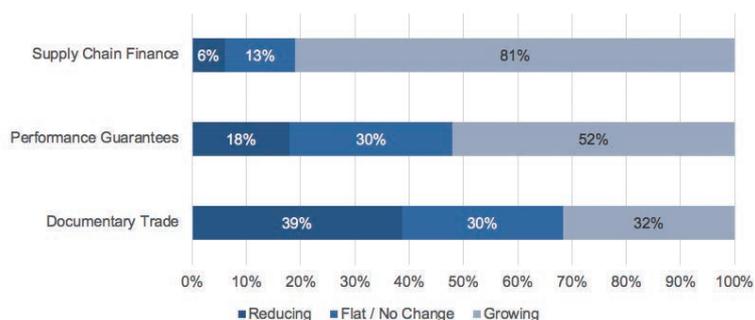


Exhibit 1. Responses of financial institutions and corporates surveyed in 2019 by Boston Consulting Group and SWIFT (with support from the International Chamber of Commerce).

Trade finance default rates

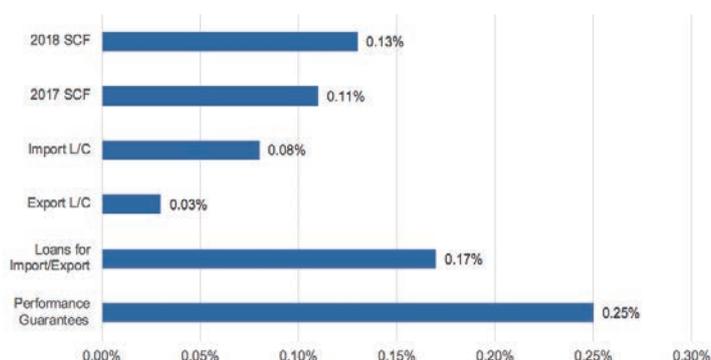


Exhibit 2. SCF (2018 and 2017) and traditional trade finance products (2008-2018). Figures based upon data contributed to the ICC Banking Commission by member banks of the International Chamber of Commerce.

or 90 days after delivery) has remained. This demand has increasingly been met by SCF, which now represents approximately half of the trade finance market.

Increased demand for SCF might have been adequately satisfied by multinational banks, which have long dominated the traditional trade finance market and, as recently as 2005, according to McKinsey & Company, managed 95% of SCF programs. But post-crisis regulatory forces have increased capital and compliance costs of trade finance, causing banks to respond by embracing an 'originate and distribute'

model and withdrawing from relationships, most often with small and medium-sized enterprises, that generate insufficient revenues to offset rising compliance costs. Both have created opportunity for other sources of institutional capital.

Seeing an opening, specialised portfolio managers have begun to launch dedicated SCF funds targeting non-bank institutional investors. Early-stage growth for these funds has been modest as managers have had to educate capital allocators, a majority of whom (according to a 2018 survey by the International Chamber of Commerce) consider a 'lack of understanding of the product and associated risks' as a 'significant challenge' to entry into the asset class. Evidence suggests, though, that SCF funds are gaining traction.

Investor interest in SCF often reflects a willingness to trade liquidity for yield. Institutions holding more capital in cash or money market positions than truly needed in same-day liquidity might allocate a portion of such holdings to a SCF fund. Whilst such a trade might also increase credit risk held by the investor, trade finance has historically been regarded as a low-risk, routine operation.

At a fundamental level, trade finance facilitates commercial transactions between willing sellers and willing buyers. The underlying presence of parties eager to transact, often regularly over the course of months or years, suggests, on its own, that financed transactions should generally enjoy a high completion rate. Credit risk to financiers, though, is further mitigated by structural attributes of the originated assets. SCF assets, in particular, are short-term (often maturing in less than 90 days), self-liquidating (converting to cash upon payment of an invoice in the ordinary course of business), and associated with multiple layers of recourse (potentially to the seller's assets, the invoiced goods, or credit insurance proceeds).

The ICC's Trade Register is the industry's primary source of empirical data on trade finance default rates. The annual reports have largely substantiated the 'safe and secure' reputation of the asset class. Reported exposure-weighted default rates for traditional trade finance products have consistently ranged from .03% to .25% and showed no evidence of deterioration during the global financial crisis. Reported SCF default rates (added to the Register in 2017) have been even lower (see Exhibit 2).

In this context, initial investors have entered SCF funds expecting to enjoy a safe, though somewhat less liquid, alternative to lower yielding cash and money market holdings. The arrival of COVID-19 and the economic disruption associated therewith will challenge this thesis, while providing SCF portfolio managers a first opportunity to demonstrate the resilience of the asset class.

Demonstrating the resilience of SCF assets

SCF funds that avoid credit defaults and deliver steady returns through the COVID-19 recession and its aftermath will be well-positioned for post-crisis growth. The importance of building a recession-era track record consistent with investor expectations has not been lost on portfolio managers, and we expect them to be increasingly attentive to principles and procedures of conservative asset management.

SCF assets carry credit risk. That is to say, if the obligor on an accounts receivable is unable or unwilling to pay the amount due on the date that such amount comes due, the owner of the accounts receivable will generally experience financial loss. Among commonly employed credit underwriting procedures, portfolio managers are most likely to alter those related to the following in account of current economic conditions.

1. Balance sheet

The short-term nature of trade receivables (most have lives of 90 days or less) and the fact that SCF investors rarely make forward purchase commitments allow for the credit underwriting process to focus on the obligor's jump-to-default risk. Here, underwriters evaluate two favoured metrics; the first is the obligor's current ratio, defined as short-term assets divided by short-term liabilities. While satisfactory ratios vary by industry, underwriters generally consider ratios of 1.5 or higher to be indicative of an entity's ability to meet short-term cash needs.

The second, a bit more subjective in nature, is the strength of the relationship between the supplier and the obligor. Underwriters prefer to see a sustained period of transaction history and both parties occupying a position of relative importance to the other. Specific matters of significance include the length of time over which the parties have transacted, the volume of current transactions between the parties relative to their overall sizes, whether transactions

between the parties involve the purchase and sale of products core to their businesses, whether the parties have established a regular pattern of order, fulfilment, and timely invoice payment, and other matters of the sort.

Under ordinary market conditions, SCF portfolio managers give great weight to the second metric. Where a supplier and obligor have established a sufficiently solid relationship, portfolio managers are often lenient in their review of the obligor's balance sheet. The disruption brought by the pandemic has led one major credit rating agency to project a 35% increase in global insolvencies from 2019 to 2021. As a result, we expect SCF portfolio managers to place less reliance on a continuation of 'business as usual'. Instead, they are likely to increase the rigor of their balance sheet reviews, looking for sufficient liquidity to meet short-term obligations, even in the event of severe sales disruption.

2. Transaction data

SCF funds generally acquire assets pursuant to a program under which a certain supplier regularly sells accounts receivable, payable by a certain obligor, to the fund. Though programs generally do not involve commitments by either the supplier (to sell) or the fund (to purchase), they can run for years, with the supplier selling a receivable to the fund upon each sale of product to the obligor. In fact, without an expectation

Changes in insolvencies by 2021

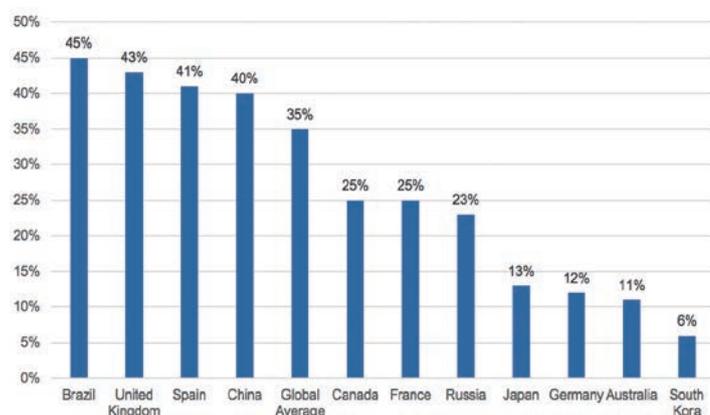


Exhibit 3. Changes in insolvencies by 2021 for selected countries (2021 data compared to 2019 data). Figures based upon data collected and reported by Euler Hermes.

of a continued stream of receivables available for purchase, portfolio managers would generally find the cost of underwriting and documenting the initial investment to be prohibitive.

Because of the regular, repeating nature of receivable sale and purchase transactions pursuant to SCF programs, SCF funds enjoy access to 'real-time' procurement data that can send important credit-related signals. SCF portfolio managers are privy to changes in order quantities, production times, return allowances, and payment performance. Such data can provide evidence of an obligor's deteriorating ability to meet its short-term obligations months before evidence of hardship arises through the publication of financial statements or actual credit default.

In late 2020, a survey conducted by Euler Hermes of American and European executives found that, of the approximately 1,200 represented companies, almost all (94%) had experienced coronavirus-induced disruptions to their supply chains, and for several (17%) such disruptions had been 'severe'. We expect portfolio managers will rely upon transaction data to identify those supply chain disruptions that threaten the credit quality of their portfolios.

3. Weighted average asset term

The term of an accounts receivable (the number of days until payment is due) affects its credit quality, and – all else equal – SCF portfolios with the shortest weighted average asset terms are the safest. Regrettably, accounts receivable terms have begun to face outward pressure as customers increasingly demand longer payment terms from their suppliers to help finance growing liquidity needs.

Fearing supply chain disruptions, firms are stockpiling inventory. At the same time, weak end-user demand (in certain industries) has negatively affected product sell-through rates. The result has been a substantial uptick in global firm working capital requirements. As estimated by Euler Hermes, global days working capital (the number of days it takes for a company to convert its working capital into revenue) will increase by 5 days to 74 days during the first year of the pandemic.

Commercial necessity often compels suppliers to grant the invoice term extension requests of their customers, particularly amidst a recession. As the ripples of such concessions begin to shake SCF portfolios, we expect portfolio managers to increasingly focus on the

maintenance of their assets' weighted average term in the selection of receivables for purchase.

4. Credit insurance

Holders of accounts receivable often purchase credit insurance to limit potential losses associated with obligor defaults. Economic conditions, though, can materially impact the availability and price of such insurance. The industry is dominated by a small number of carriers, with three – Euler Hermes, Atradius and Coface – sharing approximately 80% of the market. Bearish sentiment by one can materially alter the market landscape.

SCF funds regularly purchase credit insurance, sometimes as required by their constituent documents, other times at the discretion of the portfolio manager. In either case, credit insurance is an important component of SCF fund risk mitigation. As the big three carriers publicly express their expectations of increased default rates in 2021 and a return to pre-crisis economic conditions no earlier than the fourth quarter of 2022, we expect portfolio managers to be increasingly engaged with the underwriters of their insurance policies. Proactive managers can have a material impact on underwriting decisions by demonstrating diligent portfolio oversight and concern for the carrier's associated risk.

Conclusion

SCF has emerged as an investible asset class in the decade following the global financial crisis. Attracted by the prospect of secure, short-term yields in excess of money market alternatives, a modest, but growing, pool of non-bank institutional capital has entered the market through a collection of young SCF funds.

Portfolio managers of these (mostly) fledgling funds recognise the opportunity provided by the COVID-19 recession to demonstrate the resilience of accounts receivable to an institutional community only beginning to embrace SCF as a short-term investment alternative. We expect these managers to implement increasingly conservative investment underwriting procedures as the economic disruption endures. Should they succeed in maintaining asset default rates near historical averages for the asset class, the COVID-19 recession will likely become a point of inflection for institutional investment in SCF.