BROADRIVER INSIGHTS

Institutional Investment in Supply Chain Finance: Approaching a Point of Inflection

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Overview

Supply chain finance (SCF) has become increasingly fashionable in institutional circles since the financial crisis of 2007-2008.[1] Availability of the assets (i.e., commercial accounts receivable for sale at a discount) has surged, and a growing number of asset managers have embraced the prospect of attractive short-term yields subject to less volatility than those of other fixed income products. Though institutional capital still provides just a fraction of global SCF, an emerging class of funds has begun to help institutions lay claim to a greater share of the market's $20+ billion revenue pool.[2,3]

Today, as the coronavirus pandemic sends the global economy into recession, SCF funds face both a critical first test and precious opportunity. Whether these nascent investment vehicles can deliver consistent returns amidst financial market turbulence will weigh heavily on near- and medium-term institutional enthusiasm for the asset class. Historical data suggest that SCF assets, which enjoy a litany of inherent structural safeguards, should prove naturally resilient. But with the stakes high, portfolio managers are hesitant to make any such assumption. Rather, they are likely to implement defensive measures such as tightening underwriting procedures, installing liquidity lines, and obtaining credit insurance policies. Such measures should provide portfolio managers with downside protection and steady returns for their early investors, laying the foundation for future growth in assets under management.

Emergence of an Asset Class

The emergence of SCF as an investible asset class is largely a phenomenon of the past decade due to converging forces increasing the availability of SCF assets to 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, 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.[2,3]

1 "Supply chain finance," as used herein, refers to such portion of the global trade finance industry engaged in the purchase of accounts receivable, whether pursuant to supplier-initiated programs (often referred to as "receivables discounting") or buyer-initiated programs (often referred to as "payables finance" or "reverse factoring").

2 Ramachandran, Hanspal, Fisher and Garg, 2019

3 Sommer and O'Kelly, 2017

How is the Demand for Trade Finance Products Changing?

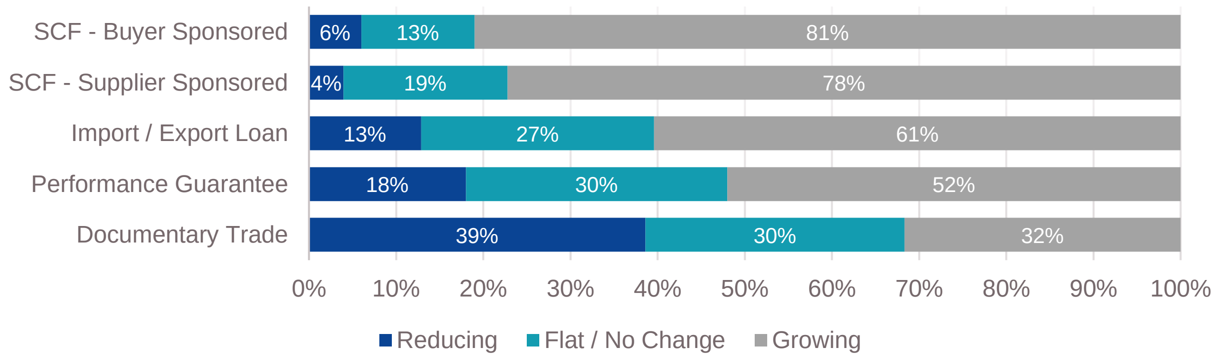

Exhibit 1. Responses of financial institutions and corporates surveyed in 2019 by Boston Consulting Group and SWIFT (with support from the International Chamber of Commerce).[2]

Increased demand for SCF was historically satisfied by multinational banks, which have long dominated the traditional trade finance market and, as recently as 2005, managed 95% of SCF programs.[4] However, post-2008 crisis regulatory rulemaking has increased capital and compliance costs of trade finance, causing banks to respond in two ways. First, banks have embraced an “originate and distribute” model under which banks structure trade finance programs and sell participations in the resulting assets to third-party investors. Second, banks have withdrawn from certain relationships, most often with small- and medium-sized enterprises, that generate insufficient revenues to offset rising compliance costs. Both actions have created opportunity for institutional capital to step in.

In response, specialized portfolio managers have begun to launch dedicated SCF funds targeting institutional investors. Early stage growth for these funds has been modest as portfolio managers have had to educate capital allocators, a majority of whom cite a “lack of understanding of the product and associated risks” as a “significant challenge” to entry into the asset class.[5] Though currently controlling less than $20 billion of a $1.0+ trillion market, evidence suggests that SCF funds are gaining traction.[6] Late last year, excess demand forced at least one new fund to close its doors to new subscriptions after assets under management swelled to more than $2.0 billion. Also, in 2019, the Alternative Credit Council found that the number of institutional investors planning to increase capital allocations to trade finance – a category of which SCF is a subset – exceeded the number planning to decrease such allocations by a ratio of 3:1.[7]

Institutional interest in SCF often reflects a willingness to trade liquidity for yield. Investors that hold 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. In exchange for extending their asset maturity profile by 90 days, or so, investors can potentially gain 200+ basis points of yield. It is important to note that SCF funds might target mid-single digit returns in a low interest rate environment.[8] This “trade” is rational, however, only on an assumption that SCF losses on default will be nominal.

Risk Profile

While trade finance has historically been regarded as a low-risk, routine operation, little empirical evidence existed prior to 2010 to justify this view. Until then, trade finance owed its reputation to the anecdotes of practitioners and confidence-inspiring structural safeguards. Trade finance, at a fundamental level, facilitates commercial transactions

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4 Herath, 2015

5 ICC Banking Commission, 2018

6 Not all institutional capital allocated to SCF is invested through funds. Some institutions, particularly specialty finance companies, invest directly.

7 Alternative Credit Council, 2019

8 Chaturvedi and Trabocco, 2018

between willing sellers and willing buyers. The underlying presence of parties eager to transact – often repeatedly, 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 attributes of the originated assets. SCF assets, specifically, 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).

Trade Finance Default Rates

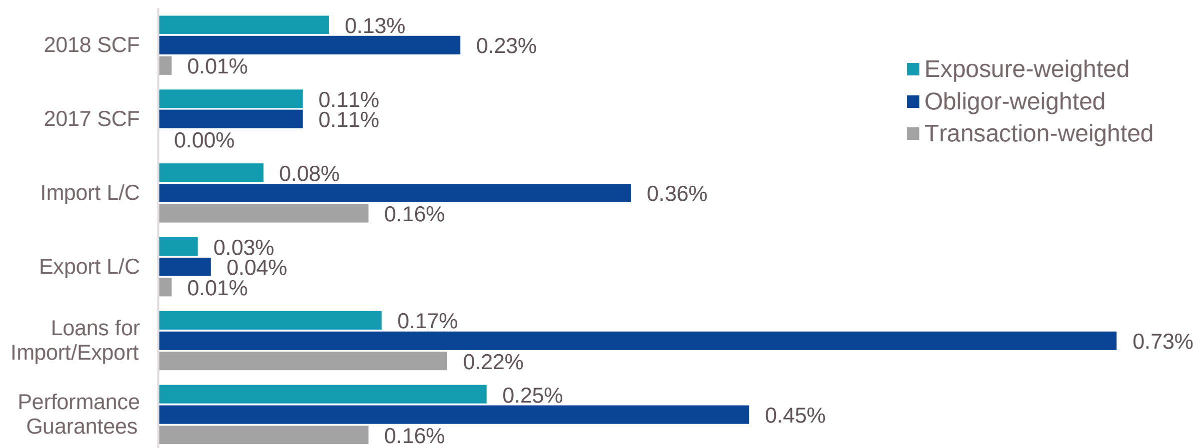

Exhibit 2. SCF (2018 and 2017) vs. traditional trade finance products (2008-2018). Figures based upon data contributed to the ICC Banking Commission by member banks of the International Chamber of Commerce.[9]

In 2010, the inaugural production and publication by the International Chamber of Commerce (ICC) of an annual report now known as the *ICC Trade Register* represented the first material effort to collect and disseminate empirical trade finance default data. The report is based upon data submitted by ICC member banks and initially covered only traditional trade finance products, including letters of credit, loans for import/export, and performance guarantees. In 2017, the ICC expanded the report to cover SCF. 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.[10] Reported SCF default rates have been even lower (Exhibit 2). Unsurprisingly, the *ICC Trade Register* has been widely cited in the promotion of institutional SCF funds.[11]

In this context, institutional entrants into the asset class have arrived with a view that SCF is a safe, though somewhat less liquid, alternative to lower yielding cash and money market holdings. The arrival of COVID-19 and the corresponding economic disruption will test this thesis and provide institutional SCF portfolio managers a first opportunity to demonstrate the resilience of SCF assets.

[9] ICC Banking Commission, 2020

[10] ICC Commission on Banking Technique and Practice, 2010

[11] Some commentators have questioned the quality and predictive value of the ICC data, which were compiled as part of an effort by the banking industry to lobby financial regulators for more lenient capital requirements on trade finance assets. These skeptics note that, in addition to being self-reported and susceptible to omissions that might enhance the statistics, the SCF data represent a small fraction of the market over just a two-year period.

Proving Resilience

SCF funds that avoid credit defaults and deliver steady returns through the pandemic and its aftermath will be well-positioned for post-crisis growth. The critical importance of building a recession-era track record consistent with investor expectations will not be lost on any portfolio manager. As mentioned earlier, portfolio managers will need to exercise an abundance of caution, actively taking appropriate defensive actions amidst uncertain economic conditions. The following are among the most important.

TIGHTENING UNDERWRITING STANDARDS

SCF assets, as short-term investments with multiple layers of recourse, should naturally show a degree of resilience during an economic downturn. That is not to say they will be immune from losses associated with credit defaults. As supply-side and demand-side shocks hit global markets simultaneously, companies across a range of industries face increased jump-to-default risk. During this time, the following underwriting matters deserve special attention:

Balance Sheet

- SCF portfolio managers generally consider the transaction history between the parties to a commercial transaction when making credit decisions. Even when a buyer (the obligor on an invoice for sale) does not have a robust balance sheet, the manager might be willing to purchase an invoice payable by the buyer if it has established a record of regular orders and timely invoice payments with its supplier.
- Under current conditions, though, portfolio managers should place little reliance on the continuation of "business as usual." They must anticipate decreases in buyers' sell-through rates and operating cash flows. The SCF asset underwriting procedures should begin to look more like those of a typical bank loan – almost exclusively focused on the obligor's financial statements (or collateral). Portfolio managers must be assured that a buyer's existing balance sheet has the necessary liquidity to meet its short-term obligations, even in the event of severe sales disruption.

Transaction Data

- Holders of SCF assets enjoy access to "real-time" procurement data that can send important signals. Changes in order quantities, production times, return allowances, and payment performance can provide portfolio managers with evidence of deteriorating asset quality months before an obligor defaults or provides evidence of hardship through the publication of financial statements. Portfolio managers should now be "reading the worst" into transaction data and investigating wrong-way movements.

Weighted Average Life

- The short-dated nature of SCF assets contributes to their historically low default rates. However, under current conditions, market forces will put outward pressure on the weighted average lives of SCF portfolios. As certain buyers begin to experience declining sell-through rates, they will request extended invoice payment terms from suppliers. Suppliers may feel compelled to accommodate such requests in order to maintain their own sales volumes, or out of recognition that their customers no longer generate the necessary working capital to make invoice payments under the prior terms. Portfolio managers should now be looking for changing invoice terms, considering their implications, and avoiding receivable purchases that will extend the weighted average lives of the portfolios beyond carefully considered parameters.

PREEMPTING INSURANCE CHALLENGES

Many SCF portfolio managers, by fund requirement or by discretion, purchase credit insurance to limit potential losses associated with obligor defaults on receivables held by their funds. Market conditions can adversely impact the availability and price of such insurance. As a preemptive measure, portfolio managers should now activate lines of communication with insurance underwriters and address underwriter concerns before policies come up for renewal. Proactive portfolio managers can have a material impact on insurance underwriting decisions by demonstrating diligent portfolio oversight and concern for the carrier's associated risk.

TAPPING LIQUIDITY LINES

The threat to portfolio returns posed by unutilized cash can be exacerbated in a recession. Most SCF portfolios will hold short-term receivables that self-liquidate upon the remittance by the buyer of the invoiced amount. In a stable or growing market, proceeds from asset maturities are reinvested into like-kind assets. In a contracting market, however, the availability of such like-kind assets may be delayed, causing an accumulation of (underperforming) cash in the portfolio. Portfolio managers can mitigate the risk of negative drag by diligently using revolving credit lines to fund a portion of revolving asset purchases.

Conclusion

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

The economic crisis ushered by COVID-19 presents an invaluable opportunity for SCF portfolio managers to demonstrate the resilience of the asset class by delivering stable returns amidst financial market turmoil. Portfolio managers will succeed by remaining vigilant and actively implementing defensive measures as dictated by the circumstances. Portfolio managers taking these active steps to mitigate risk will likely emerge from the crisis with stronger credentials, well positioned to grow assets under management.

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