

Trade receivables: an investment alternative in a world with low but rising rates

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Summary

Monetary policy and regulation post the Global Financial Crisis have created a challenging investment environment, particularly in the U.S. debt market. With limited high quality, short-term products available due to a lack of diversity in corporate bond issuance, investors have been increasingly dependent upon investing in U.S. Treasury securities and government and prime Money Market Funds with their short-term money. Investors therefore need to seek diversification away from government and financial exposed products through alternative forms of investment. One product for investors to consider is confirmed receivable purchases, which is a form of trade finance that offers high quality, corporate credit risk in a floating rate, short-term product.

Introduction

Monetary policy and regulation post the Global Financial Crisis (GFC) have created a challenging investment environment, particularly in the U.S. debt market. Low interest rates have resulted in an increase in fixed rate, long-term product issuance and a decrease in floating rate, short-term product issuance. This has left investors exposed to reduced asset prices and potential mark-to-market losses, as well as increased default risk as interest rates rise. With limited short-term product available, investors have been forced to manage short-term money primarily through investments in U.S. Treasury securities and Money Market Funds (MMFs); however, due to changes in the Federal Reserve's monetary policy and commercial bank re-regulation, investors are facing increased competition with central and commercial banks for access to U.S. Treasury securities, as well as reduced options for investments in MMFs due to Money Market reform – rules implemented by the Securities Exchange Commission (SEC) as a result of the failure of prime MMFs to meet redemption demands during the GFC.

These changes have created a gap in investment portfolios, leaving unmet demand for floating rate, short-term products that are non-financial or government exposed. Investors therefore seek diversification away from fixed-rate, long-term products, U.S. Treasury securities and MMFs through alternative forms of investment. One area of consideration for investors is trade finance, specifically the purchase of confirmed receivables. This product offers investors the opportunity to invest in high quality, short-term, non-financial credit risk in a floating rate product, which makes it particularly attractive for institutional investors in today's challenging investment environment.

Changes in debt issuance

Post GFC, the Federal Reserve System (Fed) has held interest rates at historically low levels, helping create an extraordinarily accommodative credit environment that has led to near-record levels of debt issuance. In 2016, there was about \$1.5 trillion of issuance in the U.S. corporate bond market, up from \$1.1 trillion in 2006.

For investors, the increase in fixed rate bond issuance coupled with the decrease in floating rate bond issuance from 2006 to 2016 has created an unfavorable investment environment, particularly in the current rising interest rate environment as the value of a previously issued fixed rate instrument decreases as interest rates rise, therefore leaving

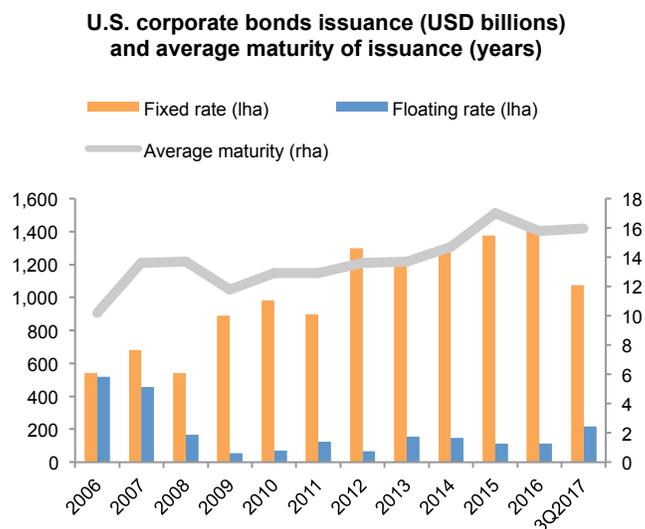


Figure 1. Fixed rate issuance grows as floating rate issuance decreases, as the average maturity of issuance rises. Source: SIFMA.

investors exposed to mark-to-market losses. In 2006, fixed and floating rate U.S. corporate bond issuance were both about \$500 billion, however by 2016 fixed rate issuance grew to \$1.4 trillion while floating rate issuance shrunk to \$100 billion (Figure 1). Given further Fed rate increases, investors will be seeking diversification away from fixed rate products to help protect themselves against reduced asset prices; however due to the lack of floating rate bond issuance over the past decade, traditional markets will struggle to meet investor demand for floating rate assets.

Another characteristic of U.S. corporate bond issuance that has changed over the past decade is the average maturity of issued bonds. As interest rates have been held at low levels, issuers took advantage by increasing the amount and duration of their bonds. The average maturity of U.S. corporate bonds issuance rose from 10 to 15 years from 2006 to 2016 (Figure 1). This change has further contributed to the unfavorable environment as the risk of increased market volatility, caused by rising interest rates and a decrease in money supply as the Fed begins to unwind its balance sheet, creates greater demand for shorter duration products.

Competition for assets

As part of quantitative easing (QE), the Fed has considerably increased holdings of U.S. Treasury securities post-GFC. The Central Bank held close to \$780 billion in Treasury and Federal Agency securities before the GFC. From 2008 to 2014, they employed aggressive QE in an effort to stimulate the U.S. economy, increasing holdings to \$4.2 trillion in Treasury and Federal Agency securities by year-end 2014. They have since sustained this level through the third quarter of 2017 (Figure 2).

Also adding to the demand for U.S. Treasury securities are regulatory changes affecting commercial banks (such as Basel III), which has required U.S. banks to hold more high quality liquid assets. This has led to an increase in U.S. Treasury and Federal Agency securities holdings at U.S. commercial banks, doubling from 2006 to third quarter-end 2017 (Figure 2).

Fed and U.S. commercial banks holdings of U.S. Treasury and Agency securities (USD billions)

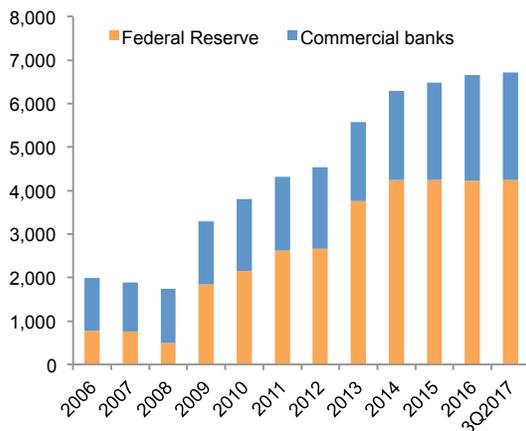


Figure 2. The Fed and commercial banks have increased their holdings of U.S. Treasury and Agency securities over the past decade. Source: Federal Reserve Bank of St. Louis.

Foreign official entities holdings of U.S. Treasury securities (USD billions)

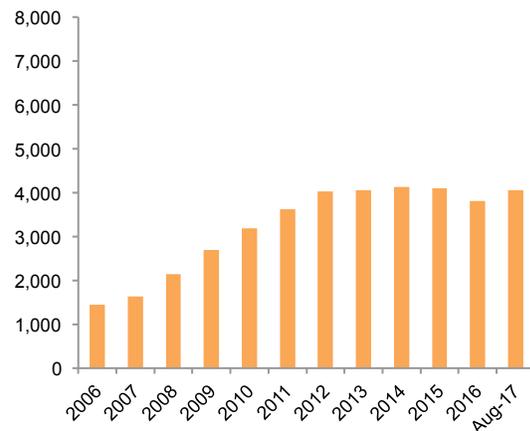


Figure 3. Foreign official entities (as defined by Treasury International Capital System) have increased their holdings of U.S. Treasury securities over the past decade. Source: U.S. Department of the Treasury.

Furthermore outside of the U.S., foreign central banks have also increased their holdings of U.S. Treasury securities from pre-GFC levels. In 2006, foreign central banks held close to \$1.5 trillion in U.S. securities. Their holdings have since more than doubled, totaling around \$4.0 trillion as of August 2017 (Figure 3).

These changes have made accessing U.S. Treasury securities more difficult for investors as they are forced to compete with central and commercial banks, as they all struggle to find high quality, liquid assets.

A natural consequence of this increase in demand for U.S. Treasury securities, and further exacerbated by the low rate environment, investors have been plagued with low Treasury rates for the past decade (Figure 4). This has made the competition for U.S. Treasury securities more painful for investors, as it has been difficult for investors to pick up yield through these investments and has forced them to seek more attractive yields through non-government exposure investment products, such as prime MMFs.

U.S. Treasury constant maturity rates

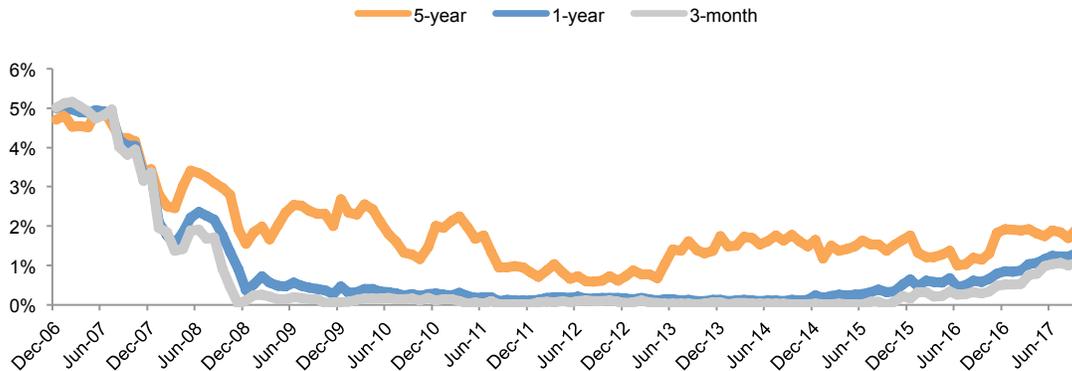


Figure 4. U.S. Treasury constant maturity rates have been depressed post-GFC as a result of low interest rates and increased demand. Source: Federal Reserve Bank of St. Louis.

Shifts in Money Market Funds

Another major post-GFC shift affecting investors is the transition of money from prime MMFs to government MMFs due to Money Market reform. During the GFC, a large prime MMF (the Reserve Primary Fund) was forced to reduce its net asset value (NAV) below \$1 per share and was unable to meet redemption demands. This broke the perception that prime MMFs could maintain a stable NAV, which created panic amongst investors and ultimately led to a run on the Fund. As a result, in 2014 the SEC issued Money Market reform rules in an effort to enhance MMF stability. These rules took effect

Prime and government MMFs total net assets (USD billions)

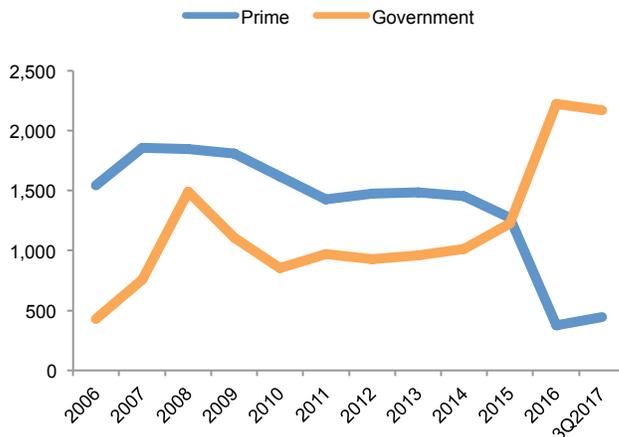


Figure 5. Due to Money Market reform, prime MMFs total net assets have dropped to about 25% of their 2015 year-end level by year-end 2016. Capital has flowed into government MMFs as a result. Source: ICI.

in October 2016 and made two major changes. The first is that institutional prime and municipal MMFs were required to migrate from a stable to floating NAV, exposing investors in these MMFs to the risk of mark-to-market losses. The second is that all (both institutional and retail) prime and municipal MMFs had to adopt redemption gates and liquidity fees, which greatly increases the liquidity risk to investors as they may be hit with a fee for redeeming, or may be prevented from redeeming all together. This has made prime MMFs considerably less attractive to investors, and has resulted in a major shift in MMF investment starting in late 2015¹.

¹For more information on the effects of MMF reform, refer to the "Investors' Appetite for Money-Like Assets: The Money Market Fund Industry after the 2014 Regulatory Reform" by Marco Cipriani, Gabriele La Spada, Philip Mulder from the Federal Reserve Bank of New York.

In anticipation of the new rules, investors pulled money out of prime MMFs and shifted into government MMFs, causing total net assets in prime MMFs to reduce from \$1.3 trillion at the end of 2015 to \$380 billion at the end of 2016, and total net assets in government MMFs to increase from \$1 trillion at the end of 2015 to \$2.2 trillion at the end of 2016 (Figure 5).

This shift has further reduced investors' ability to diversify away from government exposure and further limits their options for investing short-term money, while at the same time further increasing demand for U.S. Treasury securities.

An additional concern for investors that continue to utilize prime MMFs is that prime MMFs are principally concentrated in financial, specifically commercial bank, exposure. This, coupled with the large demand for U.S. Treasury securities, has made it very difficult for investors to find high quality, short-term credit products that are not financial or government exposed, creating a niche for alternative forms of investment that can offer diversification to investors.

Trade finance investments

Trade finance broadly describes activities that involve financing and risk mitigation related to import/export², one flavor of which is account receivable and payable financing, commonly via purchases of receivables, loans against receivables or insurance against receivables. A specific form of trade finance, commonly referred to as confirmed receivable purchase (CRP), provides an attractive form of alternative credit investment for investors to consider.



Figure 6. Sample confirmed receivable purchase transaction. Source: Fermat Capital Management.

In a CRP, an account receivable is typically created as the result of a commercial trade transaction between a corporate obligor and supplier. An investor then agrees to purchase the receivable from the supplier early at a discount and upon the maturity of the receivable the investor is paid directly by the obligor (Figure 6). Additionally, the obligor typically waives their right to set off against the supplier and commits to paying the investor in full upon maturity. This is the "confirmed" part of the CRP, whereas an unconfirmed receivable purchase is one where the obligor does not acknowledge the sale of the receivable and therefore payment upon maturity flows through the supplier, introducing additional layers of risk to an investor. CRPs are most commonly structured as private placement investments with a maximum maturity of one year; however, due to the nature of commercial trade transactions, these investments are typically recurring.

²For more information on trade finance, refer to the "Standard Definitions for Techniques of Supply Chain Finance" by the Global Supply Chain Finance Forum.

The primary feature of CRPs that make them an attractive alternative credit investment is the yield – the discount rate for most CRPs is structured as a margin over the prevailing LIBOR. This floating rate structure allows for investors to diversify from the fixed rate products that have saturated most debt markets and to take advantage of the relative attractiveness of LIBOR based products versus Treasury based products (Figure 7).

Additionally, CRPs tend to offer an attractive risk-adjusted yield. One way to determine this relative value is to compare CRPs with corporate bonds for a single obligor.

In order to compare an obligor’s floating rate CRP yield to their fixed rate corporate bond yields, the component of corporate bond yield that is attributed to interest rates needs to be stripped from the corporate bond yields. This can be estimated by subtracting the current fixed rate swap rates from the corporate bond yield to maturities. For example, if an obligor’s corporate bond has 3 years to maturity and a yield to maturity of 130 bps, and the U.S. 3-year fixed swap rate is 110 bps, the corporate bond is paying an implied 20 bps (130 – 110 bps) over the prevailing benchmark interest rate.

Using the above methodology in the analysis of eight investment grade U.S. corporate obligors, CRPs (one year exposure or less) priced around the 3 – 9-year corresponding corporate bond for all eight obligors (Figure 8).

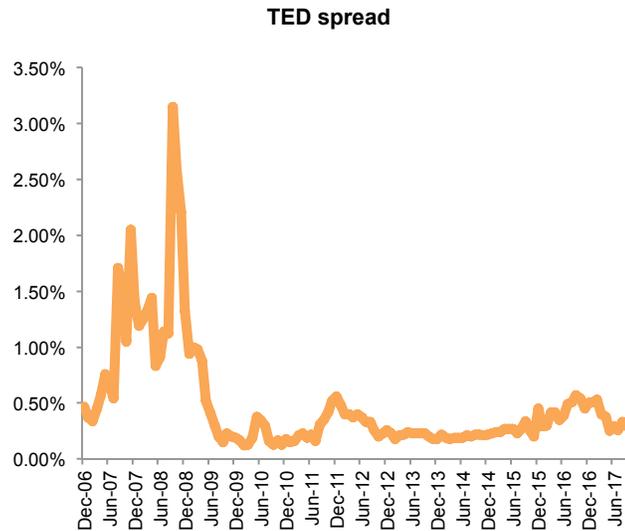


Figure 7. The TED spread measures the difference between 3-month USD LIBOR and the 3-Month U.S. Treasury Bill rate. The TED spread has historically been positive; this indicates that LIBOR has been higher than the comparable Treasury Bill rate. Source: Federal Reserve Bank of St. Louis.

Single obligor: AA- U.S. consumer goods corporate

Asset	Years to Maturity	Yield (bps)
Corporate bond 1	5.96	L + 26
Corporate bond 2	8.47	L + 56
CRPs	0.25	L + 35

Figure 8. Sample analysis of an AA- U.S. consumer goods corporate obligor (anonymized due to confidentiality) as of 29 Sep 2017. The CRPs for this obligor have a typical WAM of 90 days and margin of 35 bps, which prices between a corporate bond with about 6 years to maturity and a corporate bond with about 9 years to maturity for the same obligor. Source: FERMAT Capital Management, Bloomberg.

There are two primary factors driving this attractive relative value. The first is that pricing for CRPs is not solely linked to the primary credit risk of the obligor. This is because the discount rate at which an investor offers early payment to a supplier is linked to a number of factors, including the cost of capital of the supplier as well as the obligor,



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while the credit risk is solely that of the obligor. Using the example presented in Figure 6, Wilmar most likely has a higher cost of capital than Kellogg's (Wilmar is unrated while Kellogg's has an investment grade rating), therefore investors are paid a higher discount rate than if they were providing an early payment to Kellogg's.

The second factor driving the excess spread in CRPs relative to corporate bonds is that CRPs are structured as private placement transactions, with non-uniform structures across different asset providers and obligors. This essentially amounts to a higher barrier to execution relative to corporate bonds, which are primarily public securities with well-defined structures. Investors are thus typically compensated (indirectly through favorable relative pricing) for this higher barrier to execution.

With limited high quality, short-term products available, CRPs can offer high quality corporate credit risk in a floating rate, short-term form. And while there are significant and individualistic considerations that still must be taken into account, these features along with their attractive risk-adjusted yield make CRPs an appealing alternative product for institutional investors to consider, particularly in the difficult environment investors currently and will continue to face.