The Rise of **Alternative Financing Strategies**

TRADE RECEIVABLES SECURITIZATION

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Physical commodity merchants have traditionally looked to two main sources to fund their short-term working capital needs: trade credit – meaning the extension of payment terms from a seller to a buyer or vice versa – and bank credit, typically in the form of revolving lines of credit, letters of credit and bank guarantees. These funding sources complement shareholders' equity and can often result in significant leverage on a merchant's balance sheet. While these traditional sources of working capital finance have historically been considered flexible and efficient, in the past decade, periods of market stress and dislocation led to a dearth of liquidity when commodity trading firms needed it the most. The 2007/2008 financial crisis and 2012 European debt crisis intensified fears of a reduction in traditional sources of financing. In response to these disruptions, trading firms have sought to diversify their funding away from conventional sources. This search has been augmented by growing technological innovation in and around the sector.

Recent technological and financial developments have increased options available to commodity trading firms, both in how they manage their trading activity and optimize the end-to-end movement of their goods and cash,[1] as well as how they actually fund these trade flows.

Corporate treasurers at some of the larger, more sophisticated trading firms are increasingly looking to nontraditional liquidity sources to complement their traditional bank facilities and diversify funding sources as part of their approach to balance sheet management. One such alternative liquidity source is the securitization of trade receivables. While structures can vary widely, at a high level, a receivable securitization works as follows: A commodity trading firm sells goods to a customer on payment terms (for example, 60 days); the resulting trade receivable generated from the sale is transferred to an independent,

[1] For more details on these advancements, read this issue's article on blockchain, "Building Blocks: Digital Ledgers in Trade," and the *Commodity Markets Update's* May 2016 conversation with essDOCS, the world's largest provider of electronic bills of lading, "Interview with essDOCS Co-Founder Alexander Goulandris."

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bankruptcy-remote special purpose entity (SPE). The SPE's assets are the trade receivables, against which debt or equity can be issued to private or public investors in the capital markets. Alternatively, in some structures, the ownership interest in the SPE is retained by the commodity trading firm, and the interest is pledged as collateral to a lender. In either case, the capital provider is able to provide capital at a lower cost given that the assets securing the loan are legally protected from other creditors in the event of a bankruptcy.

The commodity trading firm (the issuer in this case) receives proceeds from the debt and/or equity issuance, thus expediting its cash conversion cycle on the trade by receiving cash for the receivable sooner than having to wait the full payment term provided to its customer (60 days in this example). If the issuer retains less than 20% ownership interest in the SPE, the securitized receivables and capital used to fund it are removed from its balance sheet. This is important when considering the equity value of a trading firm, which deducts balance sheet debt from enterprise value. If a commodity firm has an abundance of highly liquid, fungible assets such as trade receivables or fast-turning, hedgeable inventory on its balance sheet, it may be worth considering a sale of the assets to an SPE, which can then be financed off of the balance sheet.

Both issuers and investors have shown a healthy appetite for receivable asset-backed securities (ABS). In the first quarter of 2017, 52% of ABS issuance was in industries *outside* of the historical ABS standard-bearers of credit card, prime auto and student lending.[2] Historically low default rates – which remained comparatively low through the 2008/2009 economic downturn[3] – and fixed short-term maturities of commodities receivables make them particularly appealing to investors as underlying assets for some ABS structures. In fact, many commodity receivable securitizations have assets that are more liquid than the longer-dated liabilities funding them. The challenge in these structures is often less about liquidity risk and the need to roll over debt and more about replacing the portfolio of receivables as they mature to ensure they do not carry excess cash.

In an effort to refocus on core businesses and reduce regulatory compliance costs, many banks are pulling back from the trade finance market, stifling access to liquidity for commodity trading firms. However, the number of firms currently utilizing receivable securitization and the market's demand for receivable ABS are a testament to the alternative funding source's growing adoption. Receivable securitization is a prime example of how innovation and technology can be used to disrupt traditional funding sources and, in turn, solve liquidity issues for an industry that is vital to the world's economy.

Brown Brothers Harriman (BBH) is helping to fill this void by actively deploying capital in both the public and private markets. Our Investment Management business invests in structured fixed income and ABS subsectors. Our structured fixed income strategy's running yield draws from more than 30 distinct subsectors, including commodity asset securitizations, and we currently manage over $5 billion in high-quality ABS. Through our Private Banking business, we provide senior debt and junior capital and advice to premier, privately held businesses and their owners in the commodities and logistics industries. In addition, we are actively seeking to grow our portfolio of commodity finance loans as well as our junior capital investments through our private equity strategy, BBH Capital Partners.

[2] For more details, see the following article: "BBH Structured Fixed Income Quarterly Update Q1 2017."

[3] "ICC Register Report 2010." ICC - International Chamber of Commerce. https://iccwbo.org/publication/icc-register-report_september-2010/.

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