Leicestershire County Council

INVESTMENT SUBCOMMITTEE – 24TH JUNE 2015

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED INVESTMENT IN MARKHAM RAE TRADE CAPITAL PARTNERS I

Purpose of the Report

1. To provide information in respect of a recommended investment in the Markham Rae Trade Capital Partners I LP (MRTCP).

Background

2. The Fund has a target allocation of 4 – 6% of total Fund assets to the 'Opportunity Pool' concept. In broad terms these should be considered as investments that are expected to produce returns that are at least as high as those expected from equities markets, but which will provide an element of diversification from broad-based equity markets. They will generally not fit comfortably elsewhere within the Fund's overall asset allocation strategy, and will almost always be investments that take advantage of market opportunities that exist at a point-in-time but that appear unlikely to persist indefinitely.

3. At present about 3.3% of the available Opportunities Pool funding has been deployed to two different strategies – specific opportunities within debt markets (via the M & G Debt Opportunities Funds) and exposure to undervalued areas of the commercial property market (via Kames Capital). The Fund retains a £32m investment within the Pictet Absolute Return Global Diversified Fund and this is the next source of financing for any further Opportunity Pool investments.

4. MRTCP has been set up to take advantage of opportunities within trade finance that have come about as a result of the changing regulatory environment that banks are operating under, and more specifically the way in which trade finance is currently treated within a bank's regulatory capital structure. It is now uneconomical for banks to retain the full risks associated with providing trade finance and they are willing to pay a healthy premium to investors that are willing to accept some of the risks, as this allows the bank to use significantly less of their own (expensive) capital.

What is Trade Finance?

5. Trade finance is the generic term used to cover the financing and risk mitigation of cross-border trade. It differs from other types of lending as the transactions are identifiable to a specific source of repayment, which is usually the cash payment for the underlying goods that are being traded.

6. Historically, banks have been a major player in the provision of trade finance as it has been a profitable and low risk form of lending for them. The transactions are short-term (averaging 150 days), identifiable to specific transactions and take

priority over most other forms of creditor in the event of a default. Nothing has changed to make trade finance any riskier, but changes to the way in which regulatory bank capital is assessed (particularly the implementation of the Basel III framework on bank capital adequacy) has made trade finance an activity that is barely profitable for banks. As a result banks are either exiting this market, or looking at ways of making trade finance more attractive to them.

<u>The investment opportunity</u>

7. Within the banking regulatory environment, trade finance is treated in much the same way as other commercial banking activities in terms of the amount of regulatory capital the bank needs to hold to support the activity. This makes the provision of trade finance unattractive unless it is possible to reduce the amount of regulatory capital that is required to back the transactions.

8. By arranging a mechanism for transferring some of the risk within trade financing deals, banks can receive approval from the regulators to hold less regulatory capital to support the activity. As this regulatory capital is expensive for banks (having averaged a cost of c.15% over the last 6 years), the bank can afford to pay a healthy premium to the counterparty that the risk is being transferred to. The risk transfer and the approval by regulators make trade financing an attractive activity for banks again.

9. In very simplistic terms, MRTCP will assume part of the risk on trade financing transactions and will receive a premium (in effect an insurance premium) for doing this. Typically the risk taken is between a 1% and 7% loss, and the historic loss rate is well below the 1% threshold at which an investor in MRTCP starts to see any capital erosion. The target investment return for the fund is 10% - 12% p.a. (net of all costs) and this is a highly attractive return to investors, and a return that fits in well with the expectations for the Opportunity Pool.

10. MRTCP is clearly not risk-free but the fact that defaults on trade finance remained low even in the midst of the Global Financial Crisis suggest that, with good selection of counterparties and expert management of the risks involved, the target return is achievable.

11. Markham Rae is a small investment manager with assets of $600m under management. They currently offer only two strategies – Macro Fixed Interest and Trade Finance. The individuals involved in managing MRTCP have significant experience in the area of trade finance and are well placed to be able to access appropriate opportunities. The company has ‘first mover’ advantage for this investment opportunity and is acutely aware that, if successful, the opportunity will be ‘arbitraged away’ by other investors accessing the market and being willing to take lower returns in order to gain exposure.

12. MRTCP is seeking to raise $750m from investors and already has commitments for about half of this amount, including a $200m commitment from a leading UK Pension Fund. Talks with a number of potential banking partners are at advanced stages, and they believe that speedy deployment of the capital to acceptable banks is highly probable.

Risks

13. Every investment carries risks, and MRTCP has a number of them. Some of these risks are listed below, together with comments about how these risks are mitigated:

Concentration risk
MRTCP are likely to invest with 3 – 4 different banks, and these banks will be chosen with due regard to the strength of their processes for assessing risk. The background of the Markham Rae managers means that they have a deep understanding of the risks involved and are able to form their own judgement on the adequacy of the banks' credit assessments.

Markham Rae will also impose eligibility criteria and replenishment rules for the portfolios received from the banks, which will ensure that there is no 'cherry picking' of the riskiest trade finance loans by the banks.

'Key Man' risk
A clause within MRTCP means that no further drawdowns of capital can be made for new investments if Luigi La Ferla (Senior Portfolio Manager with 30-years of industry participation in trade finance) is no longer involved with the fund. Were this to occur, monitoring of the existing portfolio would continue and *in extremis* investors may remove Markham Rae as the manager (without any compensation) if 50% approval for this is received from investors.

Reputational risk
Markham Rae incorporates ESG (Environment, Social and Governance) considerations into its investment decisions prior to transaction execution, and expects robust Office of Foreign Assets Control (OFAC) compliance as a basic ESG requirement. Its assessments go deeper than this and if the counterparty bank cannot satisfy Markham Rae that their ESG due diligence is sufficiently robust, they will not be used.

Default risk
There will almost undoubtedly be individual trade finance agreement defaults, and recovery rates on these average c.60%. The losses are, however, assessed on the whole of the portfolio from each bank and this mitigates the risks associated with individual losses. Historic trade finance losses have been well below the 1% level at which the fund starts to lose any capital and would probably need to average above 1.2% for returns below 10% for annum to be achieved.

Collateral risk
There is no 'gearing' allowed within MRTCP and the cash covering the risk that is being assumed is invested in short-dated US treasury instruments. As all the fund's assets will be denominated in US dollars, there is no currency mismatch between the assets and the collateral.

Fees

14. Fees paid within MRTCP are 1% p.a. of committed capital, plus a performance related fee of 15% on any returns to investors of above 8% p.a. These fees are high when compared to fees on quoted market investments but in line with those payable

on private market investments which involve the need to have deep, specialist knowledge of the investment opportunities that are available.

Summary

15. This report is not intended to be an exhaustive analysis of the investment opportunity, and the Hymans Robertson note that is attached as an appendix provides further details. Markham Rae has also produced a presentation and will be in attendance at today's meeting to explain the investment more fully.

16. The investment is via a closed-ended English Limited Partnership that will have 1 year to deploy the commitments and a further 5.25 years to return the capital to investors. In exchange for being willing to accept this illiquidity, there is a reasonable expectation of a 10% - 12% p.a. return. There is also evidence to suggest that returns from this strategy will have little correlation to returns in other investment markets. This investment fits extremely well into the purpose of the Opportunity Pool.

17. Most closed-end investment funds have an agreed term that is linked to the period taken to invest and then successfully realise the investments. The relatively short-term nature of individual trade finance agreements and the expectation that the capital can be invested relatively quickly should mean that the term could be much shorter than the intended 6.25 years. In the case of this particular investment opportunity, the bank's regulator requires assurance that the transactions achieve true risk transfer for a sufficiently long period of time in order to 'sign-off' approval to a reduction in the required regulatory capital. It is for this reason that the investment term needs to be for at, or above, 5 -6 years.

18. The intention is that every investment within the Opportunity Pool will be large enough to have a noticeable impact onto total Fund performance, and that there will be between 6 – 10 investments within it by the time that it is fully deployed. An investment of 0.75% (c. £25m) of the total Fund seems appropriate. As MRTCP is denominated in US Dollars, this equates to broadly $40m.

Supplementary Information Informing the Recommendation to approve a $40m commitment to invest in the Markham Rae Trade Capital Partners

An exempt presentation by Markham Rae Trade Capital Partners informing the proposed investment, which is of a sensitive nature, is included as item 10 on the agenda.

Recommendation

19. The Investment Subcommittee is recommended to approve a $40m commitment to invest in the Markham Rae Trade Capital Partners.

Equality and Human Rights Implications

None specific

Appendix

Markham Rae Trade Capital Partners – briefing note by Hymans Robertson.

Background Papers

Attached as appendix

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