

Markham Rae Trade Capital Partners (MRTCP)

Addressee

This note has been prepared by Hymans Robertson for the Investment Sub-Committee of Leicestershire County Council Pension Fund (LCCPF).

Introduction

Markham Rae is a specialist London based credit manager. The firm is currently in the process of raising capital for its Trade Capital Partners strategy (MRTCP), which we believe would be a suitable investment for the LCCPF Opportunity Pool.

This paper provides a brief summary of the firm, an overview of trade finance and the MRTCP strategy and proposed Fund, and Hymans Robertson's view.

This paper constitutes a summary of what we believe to be the key investment considerations; it is not designed to be exhaustive and therefore should be considered in conjunction with the Fund documentation itself. We note that our comments are restricted to an investment perspective, and that we cannot give a legal view on the documentation supporting the Fund, nor the legal or tax aspects of investing in the fund. In preparing this paper we have relied upon documentation provided by Markham Rae.

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Firm Background

Markham Rae was formed in 2010 as a spin out from BNP Paribas investment bank's London proprietary trading desk. The firm now employs 20 people, 8 of whom are investment professionals. Markham Rae has £400m in assets under management, of which £200m is managed on behalf of BNP Paribas London, since early 2011. The remainder is managed through two sub-funds for a number of clients.

The Markham Rae Trade Capital Partners (MRTCP) business was setup in early 2014 by partners Luigi La Ferla, Jonathan Martin (one of the co-founders of Markham Rae) and Cameron Christie. MRTCP is a distinct strategy which will seek to provide bank capital relief exclusively to banks' trade finance operations. All three partners of MRTCP previously worked together at BlueCrest, a London based hedge fund manager. Luigi and Cameron were responsible for managing BlueCrest's Mercantile Fund, a hedge fund that invested in bonds and loans associated with trade finance and trade finance bank capital relief transactions. Jonathan was head of risk management and a member of the operating committee at BlueCrest.

MRTCP is currently seeking to raise £500 – £750m in capital from institutional investors for a closed-ended fund which will invest in a bespoke portfolio of trade finance bank capital relief trade opportunities. To date the strategy has received £250m in committed capital from a small number of UK pension funds; the manager has said a further £150m is in the due diligence stage by potential investors. They expect to hold the first close of the Fund at £500m when they will start to deploy capital and expect to hold the final Fund close at £750m which they think will take a further 3 – 4 months, they will then have a 12 month period to fully deploy the money.

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Key features of the proposed investment

The Fund	Markham Rae Trade Capital Partners Fund I
Investments	A concentrated portfolio of 3-4 private transactions providing capital relief on bank's trade finance portfolios only
The Fund size	maximum £750 million
Legal Fund structure	English Limited Partnership
Term	1 year investment period (extended to up to 6 months) plus a 5.25 year term – should be viewed as illiquid for the entire term
Fees	1% p.a. management fee, plus a 15% profit share over a 8% hurdle rate
Target return	10-12% (net of fees) per annum
Distributions	The premium is paid out to investors in the form of quarterly coupon payments
Minimum investment	£15 million
Leverage	The Fund is not permitted to employ leverage to make investments
Fund currency	USD

What is trade finance

Trade finance is the generic term which covers the financing and risk mitigation of cross-border trade. It refers to the debt that banks provide to be used to finance the global export of goods and services between countries. Trade finance differs from other types of lending as transactions must have an identifiable source of repayment, e.g. cash payment or title to the underlying goods. The debt is self-liquidating, short dated (averaging 150 days), and includes letters of credit, short term loans, guarantees and other instruments. In the event of bankruptcy, trade finance transactions have priority payment ahead of all other creditors.

Historically, commercial banks have been the sole intermediaries in the trade finance market. However, increasingly stringent bank regulation, principally in the form of Basel III, has meant banks are being forced to hold increasing amounts of capital against their risk-weighted assets. Under the current regulatory requirements the method of calculating risk-weighted assets is to treat trade finance as the same level of risk as other forms of corporate lending. The calculation does not take into account the fact that trade finance has historically exhibited a lower default rate and loss experience relative to other corporate lending. This regulation has had the effect of making trade finance activity significantly less profitable for banks, despite it being a core part of many of these banks' business activity. Banks are increasingly withdrawing from this area of the market. The result is a concentrated number of banks operating in the space coupled with disintermediation as other non-banks lenders are entering the market.

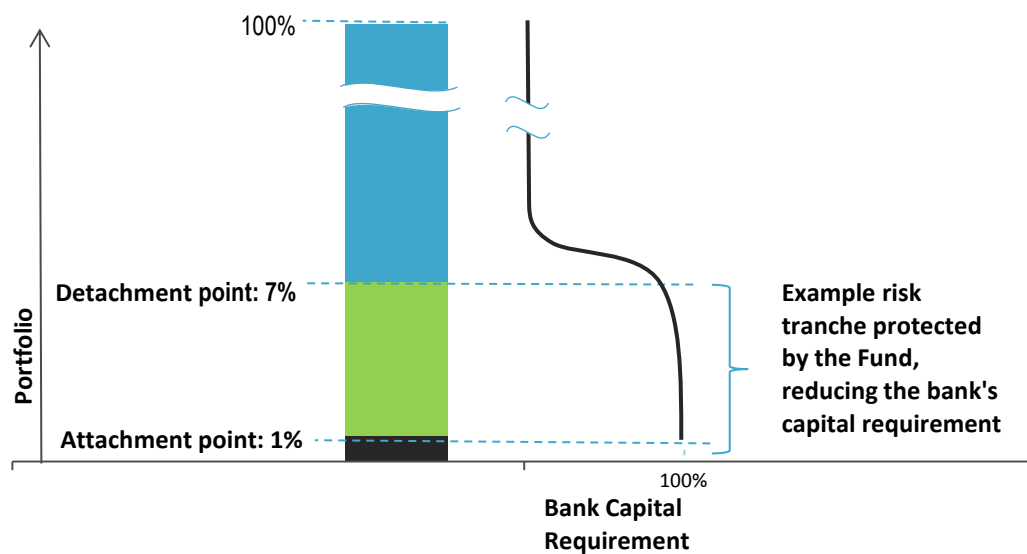
Overview of the strategy

The MRTCP strategy will privately negotiate transactions with 3-4 primarily European banks to provide a mechanism of risk transfer to significantly reduce the cost of capital relating to each banks' trade finance operations.

Each transaction must be approved by the regulators before the transacting bank can receive capital relief. MRTCP will use the Fund's investor capital to underwrite the loss risk associated with a sub-set of the transacting banks' trade finance business. The strategy essentially provides a 5 year insurance policy to the bank (the term of the agreement), underwritten against the risk of default loss within the sub-set of transactions.

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The manager has said that they expect a typical transaction would see the bank retaining the first 1% of losses and the next 1% - 7% would transfer to MRTCP (illustrated in the example below). MRTCP has said that the trade-off between the transaction's attachment and detachment point, the transaction premium, and the risk-weighted asset relief afforded to the transacting bank suggests to them that the 1% - 7% deal structure is the most probable for the Fund. However, the Fund is not restricted to a 1% - 7% tranche.



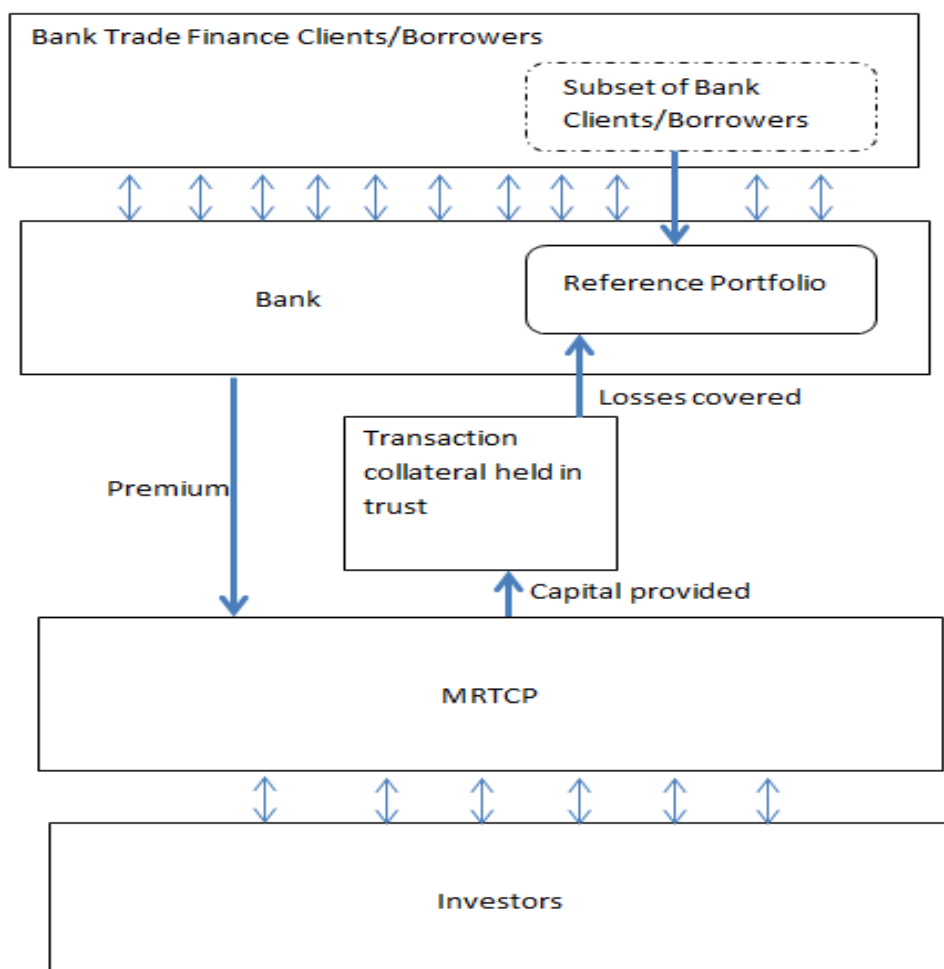
One of the attractions of this strategy is that there is a strong alignment between the bank's underwriting quality and investors through the bank retaining the first (1%) loss tranche.

The bank is willing to pay a premium to MRTCP in order to transfer this risk and free up capital on its balance sheets. This premium is the return to investors in the Fund, less management fees. The premium will be distributed to Investors on a quarterly basis. Assuming no losses, the investor's capital will be paid back at the end of the Fund's term less management fees and the manager's carry, over an 8% preferred return.

Over the 5 year term the Fund's capital will be held in a secure account invested in US treasuries. Trade finance is typically expressed in US dollars, and hence this avoids currency risk within the Fund (although we note that there is no sterling share class, and hence we suggest hedging the currency exposure at the Fund level back to sterling).

The Fund's investor capital will provide the overall level of cover. For example, if the Fund raises \$500m, then this will be the total level of cover provided for all transactions entered into. In other words each transaction is fully collateralised and there is no leverage employed by MRTCP.

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Portfolio structure**Market size**

There is a natural capacity constraint given that there are a limited number of banks operating trade finance businesses and the size of their trade finance business is limited. MRTCP would never want to offer 100% insurance on a bank's trade finance business as then the bank would lose all motivation to maintain standards within the business. MRTCP estimates that approximately 5% of the global bank-intermediated trade finance capital requirements could be provided through the regulatory capital relief strategies, suggesting a potential market of \$5bn.

Key drivers and risks for the strategy

The MRTCP Fund's exposure is equivalent to the preferred equity of the counterparty banks rather than the overall credit risk associated with traditional debt investing. The success or otherwise of the strategy is therefore fully dependent on the strength of the transacting bank's trade finance operating platform.

There is a risk that MRTCP fails to negotiate attractive transactions with banks. However, they have said that they have already had a number of in depth discussions with potential counterparty banks and do not foresee getting the Fund capital invested as a serious risk.

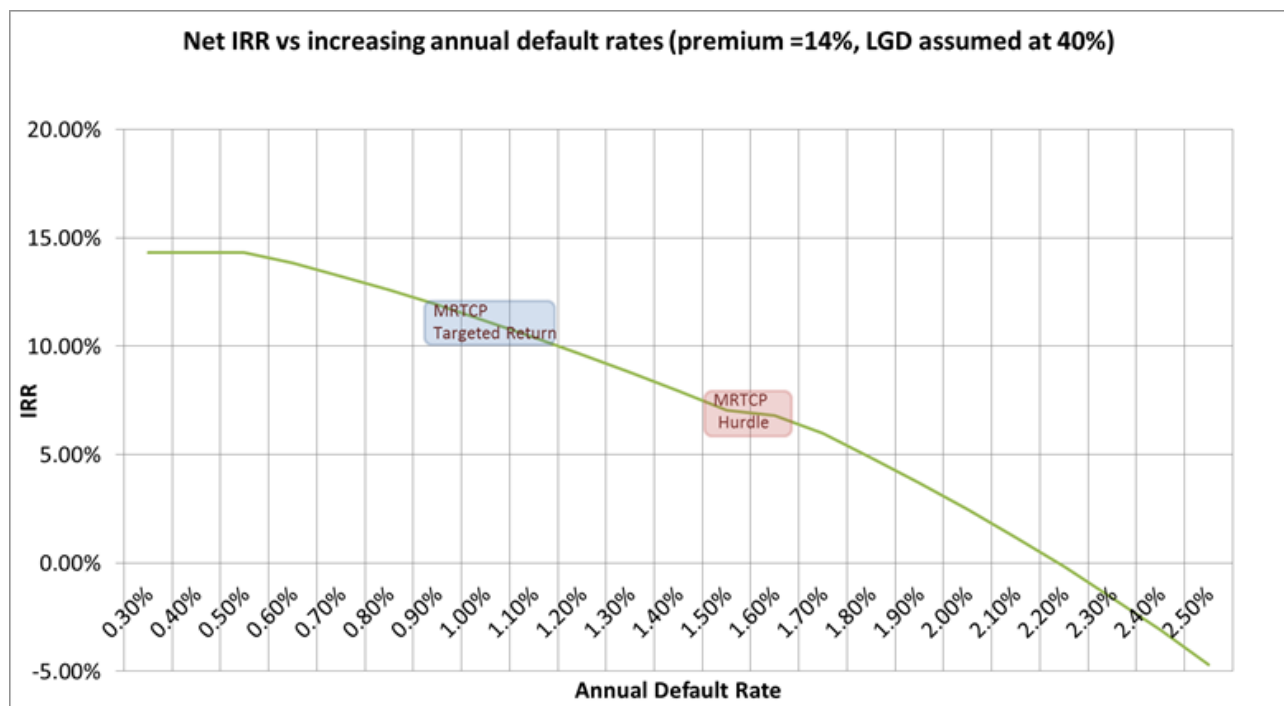
The principle risk of loss to the Fund is a deterioration of asset defaults within the sub-set of trade finance transactions, and in particular when the accumulated losses exceed the attachment point, when the Fund will start to experience capital erosion.

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Using the example illustrated on page 3, simplistically, if cumulated 5 year losses after recovery are 2% (equivalent to default of 1% per annum and recovery rate of 60%), investors will lose 16.7% of capital (i.e. $(2\% - 1\%) / 6\%$).

However, this capital loss would be compensated by premiums paid over the term of the transaction. So, if the premium is 14% flat per annum and by the end of the 5 year term losses are at 2%, resulting in a capital loss of 16.7%, the net capital gain over the five years is still $5 * 14\% - 16.6\% = 53.4\%$ or just over 10% per annum.

This is illustrated by the following chart, which illustrates an example transaction paying 14% over a risk free rate, and a loss given default rate (LGD) assumed at 40%, i.e. recovery rate of 60%.



Source: Markham Rae

Note that for an annual default rate of less than 0.50% with recovery of 60%, there is no capital erosion, and the return to investor is the 14% premium plus a small amount of risk-free rate.

For an annual default rate of between 0.90% and 1.2%, with recovery of 60%, the partnership Target Return of 10%-12% is still met. If the annual default rate exceeds 2.2% per annum with recovery of 60% the Fund return goes negative.

MRTCP's case study transaction assumes a weighted-average rating of the portfolio underlying of BB, and assumes this credit risk rating for public debt markets equates to an annual probability of default of approx. 1.1%, which in the above example would mean the strategy could still expect a return to investors in the return target mid-range (11%) per annum.

There is also a risk of early repayment of capital; if the transacting bank fails to fully replenish the portfolio within the agreed limits (this could be as a result of insufficient business within a set region, sector etc.) during the 5 year cover period and therefore the bank terminates the policy cover. This would mean capital coming back to investors and given there may be only 3 transactions this could be a third of total investment. There would be no capital loss but the total yield on the investment would be much lower.

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To mitigate these risks MRTCP implements a rigorous due diligence process. The process begins with identifying appropriate banks to transact with. Pre-investment analysis includes but is not limited to; an assessment of a bank's internal credit rating system, the bank's credit process, the robustness of the bank's trade finance operating platform, the trade client adoption process and product offering and the client base in terms of industry, country and credit instruments used.

The second stage involves the structuring of the reference trade finance portfolio. MRTCP requires the transacting bank to provide details of a sub-set of their trade finance business along with the bank's historic default and LGD experience within its trade finance business. This is the starting point for negotiating the transaction; MRTCP will seek to ensure that the reference portfolio meets a set of strict criteria as to the creditworthiness of the underlying transactions and is diversified to over 10,000 individual obligations, over 100 entities, and 15 different countries, across multiple sectors. The reference portfolio is then stress tested to predict the outcomes in extreme scenarios. Crucial to the investment process is setting the replenishment rules for the reference portfolio given the short term nature of this lending and the overall term of the cover, this involves not allowing replenishment for companies, countries or industries which are on watch or which have been downgraded at the bank level.

By placing parameters around loan book, MRTCP aim to manage the level of expected defaults to fit the intended risk/return profile of the Fund. This is important as there is not a published market default rates for trade finance due to the private nature of the transactions.

However, based on proprietary research, MRTCP identify that trade finance typically exhibits lower cumulative defaults and realised losses than outright unsecured loans of the same credit rating due to:

- The short tenor and self-liquidating nature of trade finance transactions (average of 150 days for all products) significantly reduces downgrade risk when compared to other longer dated corporate lending. As typically credit fundamentals take longer to deteriorate and the strict replenishing rules mean any credit at risk of downgrade (on a watch list) cannot be replenished back into the sub-set portfolio;
- Companies usually have total dependency on the products financed by trade finance (raw materials, goods for sale, etc.); these products which are not released until the trade finance credit is fully paid. Therefore, repayment is critical to the success of a borrowing business.

Trade finance instruments have full lien on the underlying transactions' assets. The insurance provided will only cover credit events in a portfolio limited to bankruptcy, failure to pay and restructuring at the underlying borrower level. Cover is not provided if the bank is in breach of replenishment rules.

There are a number of key benefits for a bank to consider regulatory relief transactions for its trade finance business, the most notable being:

- It provides synthetic equity in a cost effective non-dilutive basis to existing shareholders for the bank. And provides a true risk transfer mechanism making the counterparty bank more resilient in times of financial stress. Regulators in the main markets (US, UK, Finance and Germany) are supportive of these transactions.
- While the cost to the bank is approximately 5% of the bank's pre-tax underlying net income of the nominal amount of the transaction, the overall cost reduction to the risk-weighted asset capital requirement associated with the bank's trade finance operations is significant, between 70% and 75%. Transactions will significantly increase the return on equity for a bank's trade finance operation.

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Fees

The management fee of 1% on committed capital is deducted as a General Partner Share callable by the Fund General Partner each quarter.

Performance fee is only payable to the Founder Partners of the partnership once investors have had all capital commitments returned to them, plus the 8% Preferred Return, plus the General Partner Share of 1% plus any partnership costs and expenses. In practice, this can only occur at the termination of a transaction, as it is only then that there will be enough returned funds from the transaction collateral account to the partnership to allow it to repay investor capital commitments. So performance fee is not payable until transaction termination – effectively the fee is subordinated to the investor receiving their capital back, the Preferred Return, any General Partner Share back, and any partnership costs back. Only then is any performance fee paid, and there is a catch-up at 100%, beyond which any remaining funds received by the partnership for distribution are paid 15% to the Founder Partner, 85% to investors.

Hymans Robertson's View

We think there is a strong case for an investment in this strategy for those clients who can give up medium term liquidity. Due to the positioning of the investors' provision of cover in the insurance structure it should be considered as a higher risk lending strategy with elements of equity like exposure rather than risks associated with secured debt.

Perhaps the greatest current hurdle to demand is that investors do not have the luxury of seeing a tangible portfolio upfront. Instead, they rely on the skill of the investment manager in structuring these private transactions, and in the market environment being such that enough attractive opportunities are available. In our view there is a valid investment thesis for the opportunity set. Increasingly stringent regulatory requirements will continue to place pressure on banks to increase capital on the balance sheet. The benefit to the bank of transferring the risk to MRTCP is that they continue to operate trade finance, typically a core business activity, whilst increasing the return on regulatory capital.

We believe that MRTCP is well positioned to manage this strategy. Luigi and Cameron have a proven track record in sourcing, structuring and managing regulatory capital relief trades backed by bank trade finance operations. The short term self-liquidating nature of a trade finance as an investment strategy has historically shown to be uncorrelated to the factors influencing a pension fund's existing assets, namely broader economic, equity market, interest rate and inflation risk.

The BlueCrest Mercantile Fund, which Luigi and Cameron previously managed, had over \$3billion exposure to the strategy during the period 2008 – 2010 and the cumulative default amount for this period was below the 1% first loss threshold retained by the counterparty bank.

The high level of return MRTCP target cannot be achieved without taking meaningful risk. In this instance the Fund would face the operational risks associated with the banks it enters into a transaction with. This risk is mitigated through the careful selection of each counterparty bank, the creation of the model portfolio and replenishments rules.

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For and on behalf of Hymans Robertson

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HYMANS ROBERTSON LLP**General Risk Warning**

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.