SME investing focus:
THE TIME IS NOW

Financing the real economy, responsibly

Equities and bonds have been the mainstay for institutional investors seeking steady, consistent returns, but the tide is turning, says BNP Paribas Asset Management

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Time to invest in the real economy

As listed equities record their longest-ever bull run, some investors are getting jittery. Liz Pfeuti explores what this means going forward

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Financing the real economy, responsibly

For many years, equities and bonds have been the mainstay for institutional investors seeking steady, consistent returns — but the tide is beginning to turn. BNP Paribas finds out what this means for investors

WRITTEN BY STÉPHANE BLANCHOZ, HEAD OF SME ALTERNATIVE FINANCING AT BNP PARIBAS ASSET MANAGEMENT

The combination of continued low interest rates and erratic equity markets, which could become even more volatile as the risk of trade wars mounts, has meant investors need new options to meet their liabilities in a risk-managed fashion.

Instead of looking for answers in the traditional asset classes and indexes, investors need to take a wholesale re-evaluation of their existing processes and shift capital out of listed equities and bonds, much of which are running out steam.

There is a whole world of opportunity beyond listed assets that fit within institutional investors' risk budgets. The solutions BNP Paribas Asset Management (BNPP AM) has created offer a range of return profiles that match pension fund liabilities and cashflow needs well.

Our investments go further, too. By focusing on social and corporate governance factors, our investments help develop the real economy that operates outside financial markets.

We have pioneered investments into illiquid assets that not only fulfil the needs of sophisticated investors but also take step towards encouraging wider economic prosperity that, in turn, benefits us all.

The trillion opportunity

The term 'illiquid assets' covers a wide range of securities, not just bricks and mortar investments such as real estate and infrastructure.

Loans to unlisted companies also fall into this category as they are not traded on the highly liquid public market — and it is here that BNPP AM has uncovered a range of new options for investors.

Small to medium-sized enterprises are huge in number and make up the vast majority of global corporations.

Figures from the British Business Bank show the UK alone is home to more than 5.5 million SMEs, accounting for 99 per cent of all businesses by number and employing 60 per cent of the private sector workforce.

Providing loans to these companies allows them to flourish and make the next step in their corporate developments. These companies drive not only local and regional economies but are vital to national and global growth.

The loans they take on provide investors with predictable, diversified, stable and long-term cashflows, which are often uncorrelated to traditional equity and fixed income markets.

This low correlation makes them a good investment for pension funds wanting to match their liabilities with consistent income. Although these companies are not immune to general economic sentiment, they are not pummelled each day by listed market volatility that is unconnected to their own corporate strategy.

Opportunity knocks

Lending to SMEs is a relatively new venture for fund managers and their clients, and the opportunity has its roots in the financial crisis.

Capital requirements imposed on banks by the Basel III rules – produced to prevent another market meltdown - have made it make it uneconomical for them lend to this smaller end of the market. Once a buoyant – and lucrative – market for banks, lending to SMEs became a costly and time-consuming effort for

not enough reward.

Any large institution lending to an SME would have to hold extra cash on their balance sheets in case of a default, while additional, historical paperwork demanded from the SMEs themselves put applying for bank loans out of reach for many.

In the face of these new hurdles, many banks decided to exit the SME lending sector all together, concentrating their lending on larger, more established organisations with proven track-records.

This withdrawal of funding has made it harder for SMEs to grow, and it is having an adverse impact on the real economy more generally.

The European Union has set reviving this sector as a priority. Through the Capital Markets Union regime, EU regulators want to reduce the region's reliance on bank lending, and are encouraging others to step in.

At the smaller end of the scale, P2P (peer to peer) lenders and crowdfunding platforms have stepped up, directing most of their loan activity towards seeding micro-businesses or small start-ups.

For the larger companies, many private equity and hedge funds have established lending operations, concentrating on mid-tier enterprises and those exceeding the size of an SME.

This leaves an underserved segment of the marketplace that BNP Paribas Asset Management believes needs funding: Enterprises sandwiched between the micro-businesses and seed deals and larger borrowers that retain access to bank lending, or can tap into capital markets, private equity and hedge funds.

The SMEs we focus on typically have turnovers of between €2 million and €50 million and headcount of less than 250. They cover a wide range of goods and services across a spectrum of sectors.

Our experts analyse and research these companies to decide which should receive senior, unsecured loans. We lend anywhere between €500,000 and €5 million per transaction.

Through our carefully risk-managed strategy, institutional clients should expect to receive a gross IRR of between 8-10 per cent per year. These returns are better than many of the yields on offer from traditional fixed income strategies and are much less likely to be impacted by volatile public markets.

Lending to these companies is not risk-free and unlike listed companies, which must make a strict set of information publicly available, SMEs are under much less scrutiny.

However, we carry out significant due diligence on individual companies to ensure the business strategies make sense and confirm the financials are robust.

We use big data to fuel our in-house models to analyse the likelihood of default and the specific needs of the SMEs before we commit.

Responsible business

Unlike some fund managers, BNPP AM believes embedding ESG criteria to lending practices is vital. We know it reduces risk on both sides.

On a very basic level, we exclude sectors that do not meet these criteria, such as the production and trade of tobacco, alcohol, weapons and ammunition, palm oil and wood pulp; nuclear power; and some fossil fuel power generation.

All the companies to which we lend money are required to meet these ESG criteria, too. Empirical studies have shown ESG investing often outperforms traditional portfolio approaches. To us, it just makes good business sense.

It is worth noting that the European Commission is poised to introduce sustainable finance reforms that will require organisations to disclose how they apply ESG into their investment and risk management activities.

Something else sets BNPP AM apart from other lenders. As part of our ESG criteria, we acknowledge that we have responsibility both to the borrowers as well as to our clients.

While the interest rates we set for our loans correspond to the level of risk of the borrower, we strive to ensure they are fair and suitable. Lending to companies at excessive rates is detrimental and driven by short-term thinking. It can undermine investments as it makes it harder for them to turn a profit.

Also, unlike other lenders, we believe it is critical for companies to retain control of their businesses. We know we should not and must not fall into the trap of trying to unduly influence management on strategic matters. By sticking to these rules, we build up trust between us and the companies in our underlying portfolios, which ultimately enhances performance.

This is a new way of thinking for many investors, but it is really a return to the old days of responsible lending that can help create a stable economy for all – and now is the time to make the move.

The macroeconomic headwinds that are pushing back returns from traditional securities show no signs of abating, so investors need to rethink their strategy. Illiquid asset classes, such as SME lending funds, are key to obtaining cash-flow-matching income and by choosing a lender that acknowledges its responsibility on both sides of the transaction, investors can support the lifeblood of global growth.

With BNPP AM, investors can play a positive role in finance and bring real benefit to the global economy. ■

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Time to invest in the real economy?

As listed equities record their longest-ever bull run, some investors are getting jittery. Doom mongers are predicting another market crash, while some big brand names have suffered credit downgrades, finds Liz Pfeuti

WRITTEN BY LIZ PFEUTI, A FREELANCE JOURNALIST

Could it be time for investors to look outside of listed markets to the real economy? Despite being a good performance metric of how well the corporate world is doing, listed equity and debt markets tell just a fraction of the tale.

Millions of companies of all sizes exist outside listed markets, and while not immune to economic downturns, they are not pummelled by the daily volatility that trouble their listed counterparts.

And these companies need financing.

European banks, which had been these businesses' main source of funding, found new rules on lending imposed as the last crisis hit, restricted their lending. This left a gap that was filled by asset managers, whose investor clients were hungry for yield.

From just 17 funds raising $19.3 billion to lend to companies outside listed bond markets in 2008, last year a record 80 funds gathered $70.3 billion, according to data from Preqin. The amount was more than what was raised in the two previous years combined, and by the end of August this year, more than half that – $37.9 billion – had already been gathered.

Although it sounds like a huge amount of money, the scope of where it can be used is vast. While several of the large funds that have been raised over the past decade have concentrated on the larger end of companies looking for direct lending, there is plenty of opportunity elsewhere.

Going niche

Some 98 per cent of companies in the European Union are classed as small and medium-sized enterprises, according to data from the European Banking Federation.

They span all sectors, industries and geographies; they are responsible for employing three-quarters of the working population; and they make up more than half of the continent's GDP.

But despite their importance, banks have faced increased capital requirements when making loans to them, while demanding higher standards of administrative data. This has meant many of the long-standing relationships between banks and their small business partners have hit the rocks.

Fund managers are looking to this market as a credible income-yielding opportunity – but it is not without its pitfalls and due to the number and nature of these companies, strict due diligence is a must.

For Hermes Investment Management head of private credit and CLOs Patrick Marshall, the relative cushion between the volatile listed markets and performance of these companies is attractive for investors, aside from an illiquidity premium he says to be between 75 and 100 basis points.

Marshall, who led loan portfolio management and restructuring outside the Americas at Lehman Brothers for more than a decade in the 2000s, has just launched a European Direct Lending Fund, focusing on SMEs.

"Most loans are agreed on a floating, rather than a fixed, rate basis, so are a natural inflation

hedge," says Marshall. "And have a high recovery rate, depending where you are in the capital structure."

In a default environment, Marshall says this sector had around a 75 per cent recovery rate, compared to high yield debt – issued by larger companies through public markets – that offered between 20-30 per cent.

This recovery rate is an important point when considering the risk of lending to relatively small companies. Unlike listed bonds, direct lending contracts are usually not secured on company assets in case of default. Instead, they are based on cashflow predictions, which must be thoroughly examined by the fund manager.

Watch your exposure

While potentially leaving a lender exposed, this system can actually help both parties. Companies must give a quarterly update to their lenders to illustrate how their cashflow is going to be maintained, acting as an early warning system in times of trouble.

"The maintenance covenant tests every three months and if the company fails, it forces a discussion," says Marshall.

This discussion can help the company iron out any issues before they arrive and can increase the chances of avoiding default.

Working with small firms in this way ties into many fund managers' codes on environmental, social and governance investments, according to BNP Paribas Asset Management chief investment officer for alternative debt management Stéphane Blanchoz.

The French firm launched its SME lending strategy in June this year, taking the view that lending to this part of the market would help boost the real global economy, which is in line with its sustainable finance objectives.

For Blanchoz, the key to the fund's success would be to find the companies that are being missed by the large funds or "the real SMEs", he says.

"The smaller down the scale you go, the harder it is for fund managers," says Blanchoz. "It requires significant investment."

BNP Paribas AM has opted to build a data management system to standardise the processes to collect, model and analyse company information.

"It is not a six-month journey," said Blanchoz. "We are investing to build scale and as the first mover we think we will have the advantage."

BNPP AM has been supported with seed capital from its banking parent, which has also agreed to take liabilities onto its own balance sheet while the fund grows its investor base.

The move coincides with the European Union's Capital Markets Union plan, which contains aims to connect lenders to small, corporate borrowers around the region.

Blanchoz thinks there could be an added regulatory incentive to investors looking to put their capital to work for the long term and will benefit the economy more generally.

Both Hermes and BNPP AM have methods and partnerships to seek out SMEs that need funding. They use regionally-based service providers and even banks to identify which companies could be a good fit.

This is an essential check for investors looking to get into the sector, according to KPMG deal advisory partner Jeremy Welch.

"You have to know where you are investing and the quality of the company," says Welch.

He adds that investors should be aware that due to the relative novelty of the theme, many of the models being used had not been tested over a full market cycle – including the potential crash many are talking about.

"The space is changing rapidly," says Welch. "You have to pick you partner carefully."

This change is not limited to fund managers, however, according to Welch. The advent of open banking in the UK – which gives small business and retail clients more opportunities and choice to partner a range of providers – could bring the lending power back to its original home.

"Banks have not stood still," says Welch. "While a fund manager might be offering debt and nothing else, SME customers may soon prefer to access both loans and a range of other services through open banking – and their money is usually pretty sticky."

In Brussels, EBF head of financing growth Burçak Inel Martenczuk says the body was working with the region's banks to open up lending to SMEs more widely.

"In 2017, we made an agreement with SME associations for banks to provide better feedback when SMEs do not secure funding," says Inel Martenczuk. It was the first step on a path to get SMEs more integrated with the finance sector. Banks have absorbed the post-crisis changes and are back doing what they are good at: creating close relationships with a local presence and offering them to a full range of businesses."

Willis Towers Watson head of alternative credit Gregg Disdale thinks it is time for investors to look elsewhere already as banks will continue to dominate SME lending.

"A lot of capital has already been raised by fund managers, competition has increased and the liquidity premium has halved," says Disdale. "Investors have a range of other opportunities to consider where regulation is having the most impact now." ■

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