INVESTMENT

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

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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. ■