THE GLOBAL ECONOMY'S SECRET ENGINE:

MIDDLE MARKET TRADE FINANCE

TRILINC GLOBAL
INVEST WITH IMPACT

ABSTRACT

Trade finance, defined as short-term financing to facilitate the movement of goods, is a $17.7 trillion industry, with world merchandise trade volumes historically growing around 1.5 times faster than world real gross domestic product ("GDP").[1] The industry offers large investment potential with an estimated $1.5 trillion funding gap,[2] and trade finance exhibits attractive characteristics such as U.S. dollar-denominated transactions, non-correlation, strong collateralization, and extremely low default rates, along with other risk mitigants. Middle market companies, also known as Small and Medium Enterprises ("SMEs"), are vital players in the sector, accounting for 40 percent of exports from Organisation for Economic Co-operation and Development (OECD) countries, and a somewhat smaller share in developing countries worldwide.[3] The trade finance gap affects SMEs disproportionately,[4] which creates potential for attractive risk-adjusted returns from trade financing to SMEs in select high-growth economies with stable political environments and reliable legal systems.

THE GLOBAL ECONOMIC ENGINE
The Importance of SMEs

SMEs play a major role in the world economy, accounting for 95% of registered firms and a large share of employment.[5] SMEs historically generate more than 50 percent of jobs worldwide, contribute over 35 percent of the GDP in many emerging markets,[6] and new research indicates that nine of 10 new jobs worldwide are created by small businesses.[7] Small businesses also diversify a country's economic base, promote innovation, help deliver goods and services, and integrate women and youth into the economic mainstream.

The importance of an SME's economic activity goes far deeper than its national impact – each business typically has myriad effects on its local economy. In short, SMEs employ local workers, buy from local companies, serve local customers, and they traditionally support local civic development, including schools and cultural organizations. The Small Enterprise Assistance Funds, or SEAF, which has over 20 years' experience investing in developing economy SMEs, has found that every $1 invested in an SME generates an additional $13 in the local economy. Such economic stimulus is crucial to increasing global economic development and reducing socioeconomic inequality,[8] yet there remains a lack of capital invested in SMEs, particularly in developing economies.

THE PROBLEM
SME Access to Affordable Capital

In general, SMEs are often at a disadvantage to larger firms in accessing finance due to various factors, including asymmetric information, higher transaction costs, under-collateralization, limited credit history, and lack of skill to produce sophisticated financial statements.[9]

1) World Trade Organization. World Trade Statistical Review, 2018. **2)** Asian Development Bank. ADB. **3)** OECD, http://www.oecd.org/std/its/trade-by-enterprise-characteristics.htm. **4)** World Trade Organization. Trade Finance and SMEs, 2016. **5)** Alibhai, Salman; Bell, Simon; Conner, Gillette. 2017. What's Happening in the Missing Middle?: Lessons from Financing SMEs. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/26324 License: CC BY 3.0 IGO. **6)** Idem. **7)** IFC. MSME Finance Gap Report, 2017. **8)** Idem. **9)** OECD. Enhancing SME access to diversified financing instruments.

The global economic and financial crisis in 2007-2008 further exacerbated the financial constraints experienced by SMEs, especially in developing economies. Following the crisis, the third installment of the Basel Accords (Basel III) was developed to strengthen bank capital requirements, increasing bank liquidity and decreasing bank leverage, beginning in 2013.

While additional regulatory requirements have helped improve risk management, they have spurred many banks to shift their focus to clients with the lowest compliance risk.[10] As a result, banks remain as primary lenders to large corporate clients but are far less active in financing SMEs. The reduction in credit supply increases financing costs, driving SMEs to rely on internal funds, or friends and family, to finance their enterprises.[11]

An estimated 75% of SMEs are concentrated in developing countries, with 25% in developed economies.[12] Despite their prevalence, developing economy SMEs suffer from staggering unmet financing needs. According to the International Finance Corporation, the potential demand for finance is estimated at $8.1 trillion, compared to the current credit supply of $3.6 trillion, resulting in a $4.5 trillion finance gap for formalized SMEs in developing countries.[13]

Within this lopsided equation, and as banks continue to pull away from certain lending markets, a substantial funding gap has emerged in the global trade finance market, in particular. According to the Asian Development Bank, the global trade finance gap is estimated at $1.5 trillion, disproportionately affecting SMEs.[14]

For local SMEs that continue to seek trade finance from banks, 57% of their requests are rejected, compared to only 10% of requests by multinational companies.[15] Know Your Customer (KYC) concerns are the biggest factor for banks in rejecting trade finance deals, with around 70% - 80% of bank survey respondents indicating that they "agree" or "strongly agree" that Anti-Money Laundering (AML), KYC requirements, and Basel III regulations are barriers to providing trade finance.[16]

10) Cambridge Trade Finance. An Expanding Opportunity for Institutional Investors. **11)** World Bank. SME Finance. **12)** TriLinc estimate using various data sources: IFC, U.S. Small Businesses Administration, OECD Japan Policy Brief, Research Briefings UK, Statista. **13)** IFC. MSME Finance Gap Report. 2017. **14)** Asian Development Bank. ADB. **15)** 2017 ICC Trade Register Report. **16)** 2017 ICC Trade Register Report.

TRADE FINANCE

Benefits and Impact in the Local and Global Economy

Companies engaged in import or export need timely, innovative short-term financing at all stages of the supply chain that is tailored to their production and distribution cycles. Through trade finance, importers, on the one hand, can procure inventory and maintain production schedules, while exporters, on the other hand, are able to deliver products to international buyers.

At its core, international trade has the potential to deliver important short-, medium-, and long-term economic development benefits for SMEs and the developing economies in which they operate, as follows:[17]

Immediate Term Benefits

- Creates employment opportunities by promoting sectors that create stable jobs and typically higher incomes
- Opens markets for local companies through trade agreements
- Improves product quality, labor, and environmental standards through competition and exchange of best practices
- Facilitates export diversification
- Expands choice and lowers prices for consumers

Medium-Term Benefits

- Enhances global competitiveness and encourages innovation
- Encourages governments to procure from cost-efficient suppliers

Long-Term Benefits

- Generates growth in countries' economies and trade activities
- Reduces poverty, as open trade boosts economic growth with 1-to-1 growth in incomes of the poor
- Strengthens ties between countries and promotes economic integration

In 2017 exports from developing economies grew by 12 percent, totaling just over 43 percent of world trade. More than half of this trade took place with other developing economies, with an increasing share of trade in manufactured goods.[18] Despite these growth figures and macroeconomic benefits, access to trade finance for SMEs in developing economies is a rising concern. Globally, over half of trade finance requests by SMEs are not funded.[19] According to a survey conducted by the Asian Development Bank, if SMEs were to experience an average 25% increase in their accessibility to trade finance, there would be, on average, a corresponding 30% increase in their production capacity, 20% increase in their labor force, and 19% increase in investment in new businesses.[20]

17) European Commission. 10 Benefits of Trade for Developing Countries. 2010. **18)** World Trade Organization, World Trade Statistical Review, 2018. **19)** World Trade Organization. Trade Finance and SMEs. 2016. **20)** Asian Development Bank. Trade Finance Gaps, Growth, and Jobs Survey. 2016.

THE INVESTMENT OPPORTUNITY IN TRADE FINANCE
Favorable Characteristics

Alongside its contributions to economic development, trade finance presents attractive investment features, such as U.S. dollar-based transactions, non-correlation, extremely low default rates, short-term facilities, low interest rate risk, high collateralization levels, and insurance. Some specific benefits for lenders include:

Interest Rate and Credit Risk Mitigation – By definition, trade finance facilities have a one-year maximum maturity, and are typically issued at margins over LIBOR. The self-liquidating, short duration of trade deals reduces exposure to both interest rate and credit risk.

Collateral Coverage – Besides the primary collateral coverage of the underlying goods being exchanged, lenders to SMEs in developing economies, specifically, can generally also negotiate secondary collateral coverage from the company as well as guarantees from its owners.

U.S. Dollar Denominated – Trade finance transactions are conducted across the globe predominantly in U.S. dollars.

Third Party Collateral Managers – Importantly, reputable collateral managers can be hired for transactions, to assure compliance with the terms of each deal.

Insurance – Typically, various stages in the transaction cycle of a trade finance are insured to mitigate exogenous risks. Coverage can include:

- All Asset Insurance (In Warehouse): Provides coverage for assets in an event the products are lost or damaged.
- Professional Indemnity (Collateral Manager): Protects collateral managers from bearing the full cost of defending potential negligence claims made by clients.
- Goods In-Transit Insurance (In-Transit): Covers goods against loss or damage when being delivered by a third party carrier.
- Credit Insurance (Receivables Stage): Used to obtain loss payee endorsement when the lender is assigned proceeds from invoices.
- Political Risk Insurance (Various Stages with Political Risk Exposure): Used to protect against expropriation, terrorism, and other political risks.

Diversification - Trade finance has exhibited a low or negative correlation with major asset classes, with low volatility and high Sharpe Ratios.

Historically Low Default Rates - Notably, trade finance historical default rates are low and recoveries are high. According to the International Chamber of Commerce 2017 Trade Register Report, the cumulative transaction default rate on short-term international trade credit (issued by banks) during 2008–2016 was 0.16%, a default rate of just 0.02% per year. It is important to note that a majority of defaults are often fully recovered through the sale of the underlying asset (the merchandise). Actual credit losses during 2008-2016 were 0.04%, a default rate of just half a basis point ("bp") per year.[21]

21) 2017 ICC Trade Register Report.

Total Exposure and Default Rate by Exposure, by Product, 2008-2016

PRODUCT	TOTAL EXPOSURES (USD K)	DEFAULTING EXPOSURES (USD K)	DEFAULT RATE BY EXPOSURE (%)
Import L/Cs	2,466,312,181	1,748,126	0.07%
Export L/Cs	1,488,669,003	488,847	0.03%
Loans for Import/Export	4,824,223,699	10,420,011	0.22%
Performance Guarantees	1,683,654,997	4,124,653	0.24%

Source: 2017 ICC Trade Register Report

Recovery Rates and Time to Recovery – Recovery performance is also generally favorable versus comparable asset classes since the lender can take ownership of underlying goods and sell them relatively quickly (depending on the product). This results in the exposure being held on the balance sheet for a short time, reducing the discount factor on the potential loss.

Attractive Financing Rates – Lenders who are able to navigate the inefficiencies of SME trade finance in developing economies can often generate LIBOR + 600-1000 bp returns,[22] compared to unconstrained trade financing by banks to larger companies in developed economies, at rates generally closer to LIBOR + 200 – 400 bps.

UNLOCKING THE RETURN

Trade Finance is an attractive investment opportunity; however, unlocking the return can be challenging and requires access to specialized skill sets. Generally, trade finance investors need origination, underwriting, structuring, and specialized servicing capabilities as well as legal and jurisdictional expertise to minimize risk.

On the other hand, a less competitive environment can permit lenders to be more selective, and empower them to demand more security for their investment, including greater and more liquid collateral coverage. This advantage has helped tilt the risk-return ratio in lenders' favor as banks in developing economies report lower default rates for their SME portfolios than banks in developed economies, yet realize substantially higher average interest rates than the developed economy average.[23]

22) Based on TriLinc's lending experience. 23) International Finance Corporation (IFC). 2010b. "The SME Banking Knowledge Guide." IFC. Washington, DC.

As outlined in "The Missing Middle White Paper,"[24] investing effectively in SMEs in developing economies poses unique challenges and benefits. Finding the right businesses to invest in is critical, requires deep local networks, and a firm understanding of the local culture and regulatory environment, which usually only a local presence can provide. Underwriting and structuring requires efficient due diligence and bottom-up credit analysis combined with the know-how and flexibility to structure an investment tailored to the capital needs of the borrower. Typically, bespoke structural protections are also included to manage risk throughout the life of the transaction. Specialized servicing is also often required at various steps in the transaction depending on the type of financing. Examples include lock-box management and collateral manager oversight. Lastly, to build a diversified global portfolio requires legal and regulatory expertise in many jurisdictions.

While challenging, the opportunity is significant, and with its favorable investment characteristics we believe the potential is worth the challenge.

LESSONS LEARNED

Boots-on-the-Ground Investment Partner Model in Select Developing Economies

In over five years of trade finance experience lending to select developing economy SMEs, TriLinc has utilized its unique investment partner model as a means to: a) access private investment opportunities with lower risk; b) mitigate idiosyncratic local market risk; c) execute "double" underwriting to ensure adherence to risk standards and specific client mandates; e) gain emerging market exposure without the volatility of public markets; f) pursue comprehensive diversification such that no single macro-economic factor significantly affects the portfolio; and g) achieve the benefits and diversification of a fund-of-funds, but with greater ongoing oversight and customized investments, and without the additional layer of fees.

For the model to work effectively, TriLinc has determined investment partners must meet specific, institutional quality criteria including demonstrated track records, years of experience in their asset class, independent risk controls, and established networks in their specific regions, countries, and local markets.

In TriLinc's experience, country selection is of utmost importance. Its proprietary Macroeconomic Analysis Platform is a forward-looking tool that evaluates 30 data points sourced from the World Bank, United Nations, and World Economic Forum, among others. Country selection begins with this top-down analysis, and is augmented by bottom-up expertise from local investment partners to identify countries with strong growth fundamentals, favorable legal and political frameworks, and unrestricted capital access.

TriLinc's SME, developing economy, trade finance portfolio analysis yields the following risk/return data over a five-year track record:

[see following page]

24) TriLinc Global Impact Fund, "The Missing Middle White Paper," 2013.

Private Debt Plus® Trade Finance Risk/Return Statistics (as of 9/30/18)

Volatility (since inception 6/30/13 - 9/30/18)

	US Bonds[25]	Global Stocks[26]	S&P 500[27]	Trade Finance[28]
Average Quarterly Returns (%)	0.46%	2.51%	3.42%	1.70%
Std. Deviation of Returns (%)	1.49%	3.97%	3.55%	0.38%
Sharpe Ratio[29]	**-0.05%**	**0.49**	**0.82**	**1.16**
Average Annualized Returns (%)	**1.86%**	**10.03%**	**13.67%**	**6.78%**

Correlation (since inception 6/30/13 - 9/30/18)

Asset	US Bonds[25]	Global Stocks[26]	S&P 500[27]	Trade Finance[28]
US Bonds[25]	1.00	-0.03	-0.15	0.17
Global Stocks[26]	-0.03%	1.00	0.86	-0.28
S&P 500[27]	-0.15	0.86	1.00	-0.23
Trade Finance[28]	0.17	-0.28	-0.23	1.00

25) iShares Core US Aggregate Bond ETF (AGG) seeks to track the investment results of an index composed of the total U.S. investment-grade bond market. **26)** iShares MSCI ACWI ETF (ACWI) seeks to track the investment results of an index composed of large and mid-capitalization developed and emerging market equities. **27)** 3SPDR S&P 500 ETF (SPY) seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500® Index which is a diversified large cap U.S. index that holds companies across all eleven GICS sectors. **28)** Private Debt Plus® Trade Finance Net IRR Estimate. **29)** Sharpe Ratio was calculated using 3M U.S. Treasury Rate as the risk free rate.

Performance displayed does not reflect the reinvestment of distributions and is net of Fund expenses. Results reflect the performance of Private Debt Plus® which consists of asset based weighted returns of TriLinc Global Impact Fund (TGIF) and TriLinc Global Sustainable Income Fund (TGSIF) and does not reflect the performance of the Funds individually (except as noted) or other investment vehicles. Cash flows from TGSIF are added to cash flows from TGIF as of the end of each month and not as of the actual transaction date of the cash flow as in the case for the TGSIF standalone IRR calculation. No investor actually received the returns shown.

Methodology: The volatility and correlation analysis was conducted using quarterly returns (%). Average annualized returns (%) are displayed for reference, and were calculated using average quarterly return (%) results. The analysis was conducted from 6/30/13 to 9/30/18, providing 21 data points for each asset class. While 30 samples is generally considered a boundary between small and large samples, TriLinc Global Impact Fund is limited by historical return results.

CONCLUSION

SMEs are the engine of global economic growth, but it can be difficult for them to access timely and affordable capital and bank regulations have seemingly exacerbated the already significant SME finance gap. This supply-demand mismatch has created what TriLinc believes to be a compelling opportunity for investment, but due to inefficiencies in SME trade finance, there are substantial barriers to entry for investors. With the appropriate approach, the favorable characteristics of trade finance can allow for extensive risk mitigation and empirical evidence indicates trade finance can enhance investment models with high Sharpe Ratios and low correlations. Additionally, trade financing for SMEs in developing economies contributes to global economic growth, job creation, and greater socioeconomic equality.

ABOUT TRILINC

TriLinc Global, LLC ("TLG") is a holding company and an impact fund sponsor that seeks to generate competitive financial returns PLUS positive economic, social, and environmental impact by providing financing to SMEs in select high-growth developing economies with a stable political climate and reliable legal system. TriLinc Advisors, LLC ("TLA") is a majority-owned subsidiary of TLG, and TriLinc Global Advisors, LLC ("TLGA") is a wholly-owned subsidiary of TLG. TLA and TLGA are SEC registered investment advisors. Unless otherwise noted, TLG, TLA and TLGA are collectively referred to as "TriLinc." SEC registration does not indicate a certain level of skill or training.

Private Debt Plus®, TriLinc's private debt investment strategy, aims to deliver market-rate returns through private debt loans to Small and Medium-sized Enterprises (SMEs) in select developing countries PLUS positive impact that is measurable and reportable through the Global Impact Investing Network's (GIIN) Impact Reporting & Investment Standards (IRIS). Depending on the vehicle, the strategy combines private financing investment opportunities to meet the investment objectives.

This paper is for informational purposes only and does not represent a recommendation or offer of any particular security, strategy, or investment. There is no guarantee that TriLinc's investment strategy will be successful. Prior performance is no guarantee of future performance. Investment in a pooled investment vehicle involves significant risk including but not limited to units are restricted; no secondary market; limitation on liquidity, transfer and redemption of units; distributions made may not come from income, and if so, will reduce the returns, are not guaranteed and are subject to board discretion. TriLinc is dependent upon its advisors and investment partners to select investments and conduct operations. TriLinc is not suitable for all investors.

The information on which this paper is based has been obtained through industry contacts and publicly available sources. Although TriLinc has reason to believe the information to be true, TriLinc has not independently verified such information and no representation or warranty is given that it is up-to-date, accurate, and/or complete.