Investment Research – Alternative Credit

Ferguson Hyams – Trade Logistics

AMAL Trustees Pty Ltd as trustee of FHIM Trade Logistics 2021-1

USD $40 million Notes – 4.50% August 2025

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Security Summary

On 4 August 2021, Ferguson Hyams Investment Management ('FHIM') launched the Ferguson Hyams Trade Logistics 2021-1 USD 4 Year Bond ('FHIM Bond', 'AMAL Bond' or 'the Bond') seeking to raise USD $40 million. **We note our report is based on preliminary Information Memorandum documentation**. The Issuer will use the proceeds to invest in an investment grade bond (Kroll: BBB) ('the Underlying Bond') which will form part of the Underlying Fund's portfolio, managed by the Underlying Manager. The Underlying Bond will rank senior to all other Unitholders in the Underlying Fund.

BondAdviser has conducted due diligence on the Underlying Fund and is aware of the entity and key individuals. However, BondAdviser is under a non-disclosure agreement with regards to identifying the Underlying Manager. Whilst this is unorthodox, we understand this is for intellectual property purposes of Ferguson Hyams. This is with respect to the facilitation of the transaction, given in some ways the Bond can be thought of as investment in the due diligence of Ferguson Hyams. Investors are welcome to contact BondAdviser for further information on the Underlying Fund. Details may be acquired if investors are willing to execute appropriate non-disclosure documentation.

The AMAL Bonds are secured by an all-assets guarantee from the Issuer, although we note this is ring-fenced and does not include an interest over the underlying assets and other assets of FHIM, the manager. The Bonds will be sold to wholesale investors only, with no prospectus being issued. The Bonds will not be listed on the ASX and there is not expected to be a secondary market for the Bonds. Distributions are non-discretionary, fixed rate, paid on a quarterly basis in arrears until redeemed on maturity with a coupon of 4.50%. Bondholders are protected by an event of default mechanism and underlying leverage restrictions. If the Underlying Bond is downgraded, Noteholders have the right to request redemption at par plus accrued interest.

Key Characteristics			
Product Type	Bonds	**BondAdviser Risk Score**	High
Issue Amount	USD $40m	**Security Recommendation**	Subscribe
Minimum Parcel Size	$25,000	**Outlook**	**Improving**
Par Value	$100	**ISIN**	[TBC]
Fixed / Floating	Fixed	**Issuer**	AMAL Trustees Pty Limited as trustee of FHIM Trade Logistics 2021-1
Distribution Frequency	Quarterly	**Trustee**	AMAL Trustees Pty Limited
ASX Listed	No	**Manager**	FHIM
I-Spread / G-Spread*	3.89% / 3.86%	**Legal Final Maturity**	25 August 2025
USD Coupon / AUD ASW**	4.50% / 4.00%	**Next Payment Date**	25 November 2021

** As of 4 August 2021. Based on USD 4-year swap and on-the-run USD treasury rates of 0.605% and 0.644% respectively. **ASW based on USD to AUD fixed-to-float margin over swaps margin.*

Recommendation

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The FHIM Trade Logistics 2021-1 Bonds provide investors with a source of fixed income derived from a typically inaccessible part of the market, even to wholesale investors. Benefiting from the complexity, illiquidity and scarcity premia that are embedded into trade finance, the bond offers an excellent source of diversification to an otherwise vanilla fixed income portfolio.

Trade logistics financing as an asset class has several features which give it an attractive risk profile from a credit perspective. Historic default rates are better than those of SME financing whilst the asset-backed nature of the financing mechanism means that historic loss given default rates are similarly impressive. Moreover, because these assets are fungible commodities, historic time to recovery is well below that of lending to SMEs and financials. The credit at the Underlying Fund level is also considerably strengthened through the use of all risk marine insurance policies which comprehensively limit the downside loss in the event that the goods are damaged or otherwise lose value whilst in transit (when owned by the Fund). This effectively means that the most significant exposure for the Fund, and therefore Bondholders, is commodity price risk, which the Fund can also mitigate through hedging strategies.

This issuance is uncommon in a number of ways. Exposure to the underlying strategy – trade financing – is rare in the Australian market, even for wholesale investors. It is even less common for exposure to this asset class to come in the form of a bond. Thus, the structure of the bond and the mechanism for exposing investors to the Underlying Strategy, via a USD Bond at the Fund level, presents unique risks. However, we note that recently we have seen a number of domestic managers raise capital for their investment portfolio via the issuance of convertible notes. In a broad sense, this is a similar transaction – executed for similar purposes – minus the optionality.

Thus, this transaction presents some unique risks for investors. Firstly, the complicated structure of the transaction gives rise to legal risks around execution, insurance and the capacity of investors to enforce their interests in an adverse situation. In addition, the uniqueness of the Underlying Fund's trade financing strategy means that it is difficult to comprehensively evaluate. In particular, the international nature of the underlying transactions means tail risks are difficult to quantify.

Despite the Underlying Fund having what we would call an investment grade equivalency, we have assigned a **High** risk rating. This also is in alignment with our relative value analysis, particularly with respect to the private credit and securitisation market, which places the implied rating as being between BBB and BB. Whilst our quantitative analysis would suggest the Bond is an investment grade product, given the broad range of assumptions and estimates involved, we cannot assign the same weight to the analysis as would be otherwise typical. We notch the risk rating downwards as a result of contractual subordination (effective HoldCo status) and a complex legal structure, alongside a track-record that is less than five years. In time, alongside continued performance and de-risking of the portfolio in terms of counterparties, we expect the credit profile to improve. Accordingly, we have assigned an **Improving** outlook.

Whilst there are credit enhancements that provide a mild benefit to the AMAL bond credit profile, these are insufficient to notch the portfolio upwards in current form. This is because we consider them a requirement, rather than a compromise, given the nature of the transaction, which, in many ways, is funding the due diligence of Ferguson Hyams – hence creditors should not be first liable for any partial analysis on behalf of Ferguson Hyams.

From a relative value perspective, our analysis is split across three levels, all of which have no direct comparable due to the Bonds' unique offering. The most similar security to the FHIM Bonds is the NCC Convertible Notes (ASX: NCCGA), given the equivalent purpose of the funds raised from each issuance. There is a discount here of approximately 120bps as NCCGA was issued at an option adjusted spread of 520bps, while the sub investment Grade curve has since compressed 46bps. We see fair value at this level as the FHIM Bonds have a better underlying credit profile and are subject to less volatility. When looking to the securitisation market, the FHIM Bonds sit at a level between BBB- and BB-rated. We view this pricing of the Bonds to be on par with our internal assessment of the credit risk profile. Relative to the private credit markets, however, the Notes appear marginally rich with little buffer above the investment grade syndicated market. It is worth noting that the FHIM Bonds are being offered at a 5.4x multiple of the AUD BBB-rated corporate curve. This is a significant delta considering that both our internal assessment of their risk, and their pricing, sit marginally outside of the IG credit rating.

The coupon of 4.50% sits 80bps above the USD single-B credit-rating yield curve. We see the credit profile being distinctly superior than that of single B and the optics on value are attractive through such a lens.

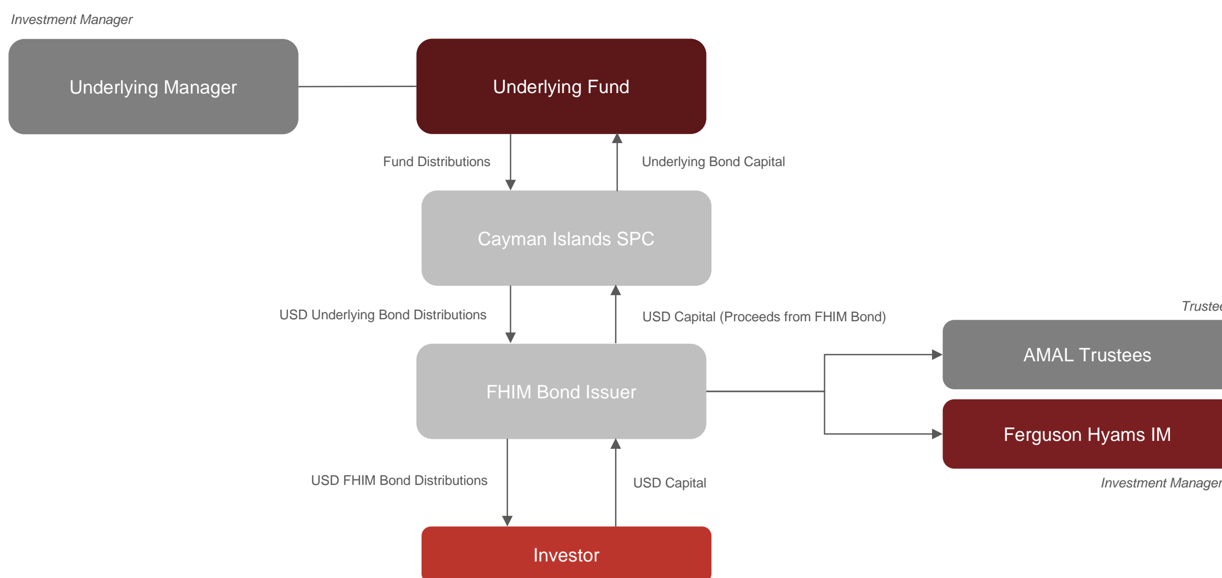
We note this Bond is complex and the compensation reflects this. We do not see the Bond as a single solution for fixed income exposure and expect wholesale investors to be otherwise diversified across counterparty and sub-asset classes. Whilst historical data is reflective of low risks, a true tail risk scenario (collapse of insurer, kinetic geopolitical conflict) is yet to be encompassed in the dataset and we would expect recoveries to be low in such an event.

Ultimately, the Bonds offer an exceptional source of portfolio diversification, given the low correlations to other asset classes at the Underlying Fund performance level. Even during a period of distress with COVID, instead of correlations increasing, as would be theoretically expected, correlations for the Underlying Fund actually diverged from US equity returns. While complex, we are comfortable with the credit profile and expect it to improve over time with further diversification and additional track record. From a valuation perspective, the bond is robustly priced compared to Investment Grade alternatives and fairly priced to upper sub-investment grade alternatives. Accordingly, we recommend investors **Subscribe.**

Legal Structure

The FHIM Bond utilises a complex legal structure to provide investors with exposure to the Underlying Fund. As illustrated in Figure 1 below, the Bond will be issued by AMAL Trustees Pty Ltd (ABN 98 609 737 064) as trustee of FHIM Trade Logistics 2021-1, a special purpose entity established to raise funds on behalf of FHIM. AMAL Trustees has appointed Ferguson Hyams Investment Management Pty Ltd as the Manager and AMAL Trustees will also act as the Placement Agent.

Figure 1. Trade Finance Transaction



Source: BondAdviser, Ferguson Hyams

The proceeds of the Bond will be applied by FHIM to invest in an investment grade bond (the 'Underlying Bond') issued by a Special Purpose Company (SPC) domiciled in the Cayman Islands. The Underlying Bond will be in USD. The SPC has entered an investment advisory agreement with the Underlying Fund, under which the proceeds of the issue will be deployed by the Underlying Fund into its investment strategy. The Underlying Bond, however, will rank senior to other Unitholders in the Underlying Fund. We also note that if the Underlying Bond is not acquired with the proceeds of the FHIM Bonds within 5 days of issuance, the Bonds will be redeemed.

As the Underlying Fund generates returns from its trade financing transactions, it will pay distributions on the Underlying Bond, which will in turn be paid out to investors under the FHIM Bond in accordance with the Investment Memorandum, minus fees at both the Underlying Bond and FHIM Bond levels. Similarly, upon the redemption of the Underlying Bonds, proceeds will be used to redeem the FHIM Bond.

Unlike an ordinary bond, this legal structure presents some unique legal risks for investors. Primarily, FHIM Bondholders do not have recourse directly at the Underlying Fund level. Rather, their interests are represented through an intermediary, the Cayman Islands SPC. Although the structure raises some unique risks, we do not anticipate that it will impede on the ability of Bondholders to protect their interests in the rare case that it is necessary. In addition, the independence of the trustee from the manager is a positive from a noteholder perspective.

Positive Risk Factors

Structural Protection at the Underlying Fund. The Underlying Bond ranks senior to equity Unitholders in the Underlying Fund. This is supported by a mandate which requires the Underlying Fund maintain a sub 2:1 debt to equity ratio (pro-forma 1:1), which effectively provides an equity buffer equal to half (pro-forma equal to the full quantum) the amount of the Bonds (albeit the size of the buffer depends on capital flow in and out of the Fund). Although we note the possibility of the Underlying Fund taking on further leverage, which would, at least, rank pari-passu to the Underlying Bond and thus dilute the structural benefit.

Underlying Credit Quality. Despite the fund not taking lending-like credit risk, there is market and contractual risk embedded. Positively, any risk here is managed at a counterparty level but arguably more importantly is the mandated use of marine insurance on the underlying contracts. This improves expectations of recovery in both idiosyncratic and systematic-type risk possibilities.

Uncorrelated Risk and Return. The nature of the underlying strategy means that it will deliver returns uncorrelated to global equity markets. As such, the Bonds are structured to deliver stable returns even amid a deterioration in global markets.

Regulatory and Competition. The trade logistics financing market is supported by international banking regulations which make allocating capital to the space comparatively less attractive. In conjunction with the fact that it is a highly specialised market which relies on strong bank networks, there are structural factors which support the competitiveness and pricing power of the Underlying Fund.

Independent Trustee. In light of the legal risks described below, the independence of the Trustee from the investment manager is a positive for Bondholders. In this respect, we note that it is common for the Trustee in wholesale funds to be a related entity of the investment manager.

Negative Risk Factors

Event of Default. The key risk to Bondholders is that there is an event (or events) of default at the Underlying Fund level which means distributions cannot be made at all (or in full) under the Underlying Bond and therefore the FHIM Bond.

Short Track Record. Both the Underlying Fund and Ferguson Hyams Investment Management have relatively short track records of performance. The Underlying Fund has been operating for ~3 years whilst FHIM launched its first Multi-Strategy Fund in 2020 (although it has operated since 2015). As we note, following an additional two years of meeting target returns, our confidence in the Underlying Fund would increase.

Structural Subordination. The Bond itself is secured at the Issuer level. However, this in effect is not an operating entity structure. Rather, the underlying cashflows are generated in an operating company that is not part of the Guarantor Group. The same point is true of the underlying assets in relation to security. Rather than up-streamed dividends, the coupons are up-streamed through an underlying bond structure. This is pass-through in nature, expect for some fees and Underlying Fund operating expenditure which must be paid first. Trustee and Servicing fees. Positively, Issuer and Manager fees are paid subsequently to Bondholders. Despite not strictly being of HoldCo nature, we effectively view the Notes as such.

Key Person and Due Diligence Risk. FHIM is a small investment manager which fundamentally depends on the operational capacity of its two key personnel, Luke Ferguson and Gideon Hyams. Moreover, the ability of the Bond to successfully return its distributions to Bondholder's is premised on FHIM's due diligence of the Underlying Fund. Given BondAdviser's due diligence is limited in assessing the due diligence of FHIM, there is an unusual risk for Bondholders compared to the typical fundamental corporate cashflow analysis process.

Liquidity Risk. It is expected that the Bonds will have a very limited (if any) secondary market. This means Bondholders will be unable to exit their investment before maturity other than through a specified redemption event.

Legal Risk. The legal structure of the Bond and its mechanism for exposure to the underlying strategy is complex. Therefore, there is larger than usual exposure for Bondholders to legal risk in the construction of the strategy, given there can be no guarantee any legal advice is correct, nor of Bondholders' ability to protect their interests in an event of default given the existence of a foreign intermediary. In addition, the Underlying Fund's strategy itself presents complex legal risks in relation to insurance and counterparty default. The price of the bond reflects this complexity premium.

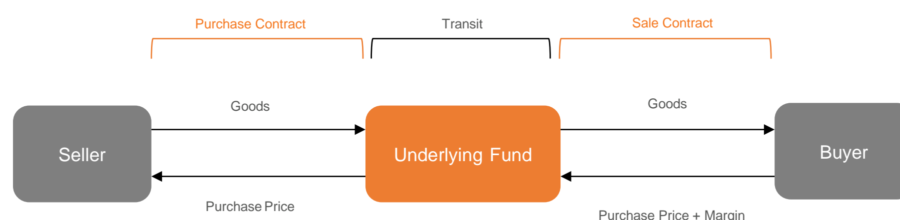
Strategy Overview

The FHIM Bond will be exclusively invested in trade logistics financing instruments through exposure to the Underlying Fund. *BondAdviser has conducted due diligence on the Underlying Fund and is aware of the entity and key individuals. However, BondAdviser is under a non-disclosure agreement with regards to identifying the Underlying Manager. Whilst this is unorthodox, we understand this is for intellectual property purposes of Ferguson Hyams. This is with respect to the facilitation of the transaction, given in some ways the Bond can be thought of as investment in the due diligence of Ferguson Hyams.* The Underlying Fund operates a trade financing strategy which invests into pre-booked, self-liquidating physical commodity-backed trade finance transactions.

Mechanics of Trade Logistics Financing

The Underlying Fund targets short term, asset-backed transactions usually between 15 – 120 days. The Fund generates a return by simultaneously executing a buying and selling contract and taking a positive margin between the two contracts which reflect the implied balance sheet cost charged by the fund for holding the commodity during the duration of the transaction. The Fund provides transport of the underlying cargo, taking ownership of the asset, *at the place of port,* for the duration of the transit. This means the Fund is not exposed to credit risk of the purchaser per se, although exposure to commodity price risk is triggered by the buyer defaulting on the transaction. However, in the event of default, because the Fund owns the asset, it will enter an alternative sales contract in a relatively liquid market. Transactions are executed, and title over the asset managed, using standard trade finance instruments such as Letters of Credit, Bank Guarantees and Bills of Lading. Additionally, comprehensive marine insurance coverage mitigates the Fund's exposure to physical damage (or other physical deterioration) to the asset during transit. Thus, because the Fund will either hold title over the commodity or cash, it is not exposed to credit default risk in the same way as a more traditional trade finance *lender*.

Figure 2. Trade Finance Transaction



Source: BondAdviser

The Fund's primary risk, therefore, is that it is unable to recover the full purchase price via an alternative buyer due to a fall in the price of the commodity. We note there is also a possibility that it cannot source any buyer for the asset (therefore wearing the full loss of the price paid), however, we expect this risk to be minimal. Additionally, it will bear transaction costs in relation to finding a secondary purchaser, executing the contract, and costs of storing or warehousing the commodity during the delay. These risks are partially mitigated by the Fund demanding a Trade Facilities Fee (TFF) calculated as a portion of the purchase price from the buyer before transit. This fee will ordinarily cover the transaction costs of the secondary contract and provide a buffer margin to cover any deterioration in the price of the commodity. It is a variable fee calculated by reference to the underlying commodity, the tenor of the transaction and the destination of the commodity. The minimum TFF is 10% and there is no maximum. During the 2020

COVID-19 period, the fee was as high as 60% in some transactions. Typically, the fee is ~20%. Alternatively, it is possible, albeit unlikely, that a beneficial price movement will result in a windfall gain for the Fund whilst it retains the TFF.

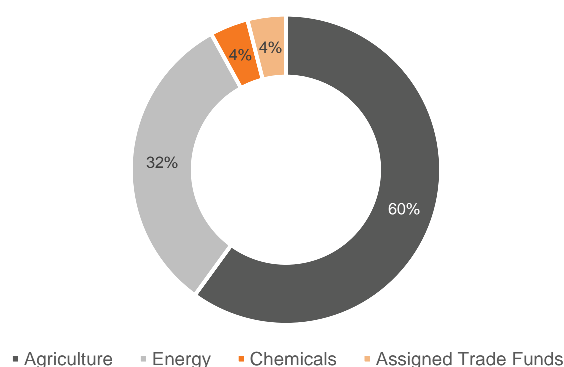
A key part of the trade logistics financing strategy is using insurance policies to cover the risk of physical damage to the commodities during transit and storage. Whilst successful coverage dramatically limits the scale of loss in an adverse situation, it introduces new legal and financing risks. Positively, the Underlying Fund is mandated to ensure that it has All Risk Marine Insurance from an investment grade-rated insurer for every cargo which it invests in. This mitigates against a considerable downside risk for Bondholders arising from the inability of the Underlying Fund to reinsure for the duration of the Bonds.

Underlying Fund's Investment Strategy

Trade financing is a critical component of global trade, facilitating ~80% of international trade transactions. The nature of international trade means that secure, stable financing facilities are integral to enabling client firms to trade and scale. However, the introduction of the Basel III banking reforms has driven many traditional banks out of the trade finance market as heightened regulatory burdens have made trade financing comparatively unattractive from a regulatory capital perspective. This funding gap has been met by firms such as the Underlying Fund, which offers more cost-effective financing along with more flexible risk management strategies that can manage credit and commodity risk in a timelier manner. The Underlying Fund achieves this through a standardised, digital, end-to-end platform which enables it to be scalable and manage the large volume of short-term deals. Digitalisation also reduces transaction costs and mitigates against fraud.

The Underlying Fund partners with trade finance banks and its own network to source a pool of high-quality transactions. These banks introduce the clients to the Underlying Fund, which then facilitates the international transaction, including any warehousing or storage needs. The Fund targets SME firms transacting agricultural, metals and mining, chemical, energy, and industrial commodities, avoiding perishable goods due to the heightened risk of value destruction in the event of delay.

Figure 3. Underlying Portfolio by Sector and Commodity

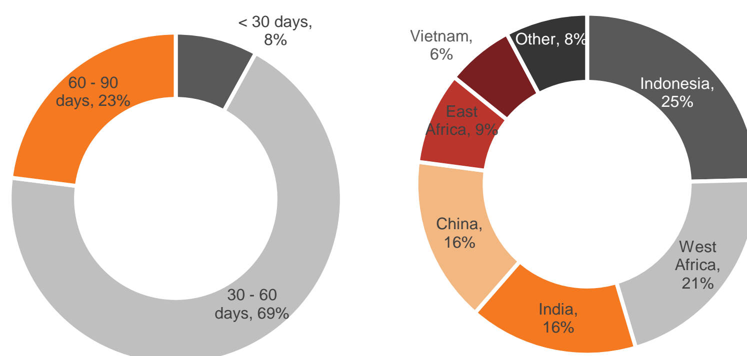


Source: Underlying Fund, as at 31 April 2021.

Because the Underlying Fund is not a lender, it does not adopt a traditional credit analysis of clients. Rather it adopts a scorecard model which examines the operational capabilities and track record of the company, although this analysis also includes quantitative assessments of the client. The Underlying Fund has an exceptional track record in its risk assessment, with historical buyer default rate of 0.00% across over 700 transactions. The Underlying Fund's transaction size is typically in the range of

US$200,000 to US$3 million, with an average of US$370,000 as at April 2021. During April 2021, the Fund held 93 live contracts, of which 17 were successfully settled, with 11 key counterparties. Concentration of counterparts is an important risk from a credit perspective. At current levels, the degree of diversification seems appropriate, especially given the short-term nature of the transactions and the desire to transact with previous clients – with whom a proven track record limits the risk of fraud and general default. In addition, we note that the mechanics of the finance strategy means that the Underlying Fund does not take on direct credit exposure and rather is exposed to commodity price and geographic risk. As Figure 4 illustrates, this port risk is well diversified. The Fund is primarily exposed to the ASEN, Africa, MENA regions, although it has a growing presence in Europe and South America. The Fund is also prudent in its approach to target destinations, avoiding, at either end of the transactions, sanctioned or embargoed countries. Whilst this real-world risk represents the explicit exposure, we note that it is triggered by a default of the purchaser, and thus counterparty concentration should not be ignored. We therefore caution that there remains a risk that as the Fund ramps up following the injection of capital from the Bonds, counterparty diversification may deteriorate – this is mitigated by a maximum trade size of US$15 million.

Figure 4. Underlying Portfolio by Tenor and Delivery / Storage Location



Source: Underlying Fund, as at 31 April 2021.

Default and physical risk to each commodity is also mitigated geographically, with the Fund primarily exposed to the ASEN, Africa, MENA regions, although it has a growing presence in Europe and South America. The Fund is also prudent in its approach to target destinations, avoiding, at either end of the transactions, sanctioned or embargoed countries.

Strategy Performance and Correlations

Since its inception in May 2018, the Underlying Fund (the name of which, as noted, we are unable to disclose) has consistently delivered target returns to Unitholders of the Fund (5.00% target net of all fees). As illustrated in Figure 5 below, besides the month of inception – when it can take time for investments to ramp up – the Fund has recorded a loss in only a single month and has not recorded a loss in the 30 months since. Positively, the loss in October 2018 was attributed to a one-off delay in executing funding with a shipping company, an event which has not occurred since and which we do not expect to repeat. Moreover, the returns exhibit low volatility, demonstrating the inherent strength of the underlying portfolio to deliver consistent returns (in line with targets). Especially notable is the **absence of any material fluctuation in the Underlying Fund's returns through the COVID-19 pandemic** and consequent economic crisis. The pandemic was a major disruption for international trade; hence it is supportive to see that the Underlying Fund was able to maintain target returns with little volatility over the period. This consistency gives confidence in the processes of the underlying manager, a key support of its credit profile.

Given the consistency of performance, especially during one of the most disruptive periods for international trade, notwithstanding operating tail risk-like events (i.e. fraud), we foresee no major impediments to the Underlying Fund delivering target returns for the duration of the Bond.

Figure 5. Underlying Fund Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	0.41	0.52	0.45	0.40									**1.78**
2020	0.45	0.45	0.45	0.56	0.59	0.57	0.52	0.43	0.42	0.41	0.46	0.47	**5.93**
2019	0.69	0.70	0.45	0.45	0.25	0.42	0.46	0.43	0.52	0.54	0.48	0.46	**6.01**
2018					-0.38	0.15	0.24	0.18	0.18	-0.20	0.29	0.49	**0.97**

Source: BondAdviser, Underlying Manager. As at 31 April 2021.
** Return is monthly net total return based on NTA plus dividends.*

A core investment objective of Ferguson Hyams and the FHIM Bond is to deliver consistent returns with little to no correlation to broader markets. As illustrated in Figure 6 below, this has largely been achieved over the history of the Underlying Fund. As the correlation matrix shows, the monthly returns of the Underlying Fund exhibit minimal correlation to domestic and international equity, commodity and credit markets. Over the past three years, the Fund does not have a correlation coefficient above 0.40 for any major index and records a negative coefficient for a number of major credit indices. And notably, compared to other fixed income indices, the Underlying Fund has demonstrated far weaker correlation to equity markets. It thus shows the strength of the Underlying Fund's trade logistics strategy as inherently consistent and undisturbed by recent fluctuations in global financial markets, a point also demonstrated by the Fund's monthly returns through the pandemic period. Such a performance history therefore supports the view that the Bonds may serve as a highly valuable instrument for portfolio diversification – a key tenant to our recommendation.

We have also assessed the correlation of returns to the S&P500 to understand the how the Underlying Fund is exposed to equity markets. We note that this is merely tracking one index – the S&P500 – although given the global nature of the underlying strategy we believe this gives a reasonable approximation of the correlation of the strategy to broader markets in conjunction with the correlation matrix below.

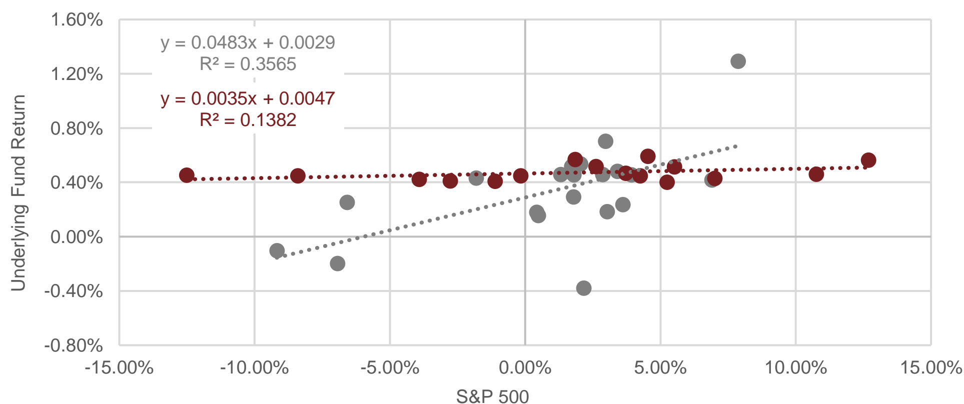
Figure 6. Monthly Return Correlation Matrix

	Underlying Fund	BBG C'mdty Ind	Crude	Wheat	Iron	Gold	US Gov	AU Gov	AusBond Credit FRN	Global HY	VIX	ASX
Underlying Fund	1.000											
BBG C'mdty Ind	0.306	1.000										
Crude	0.268	0.734	1.000									
Wheat	-0.042	0.162	-0.216	1.000								
Iron	-0.051	0.294	0.304	0.303	1.000							
Gold	0.126	0.089	-0.038	0.070	0.070	1.000						
US Gov	-0.102	-0.536	-0.465	0.090	-0.187	0.401	1.000					
AU Gov	-0.029	-0.050	0.196	0.068	0.076	0.299	0.268	1.000				
AusBond Credit FRN	0.089	0.352	0.598	-0.295	0.157	0.150	-0.240	0.473	1.000			
Global HY	0.328	0.733	0.856	-0.067	0.297	0.221	-0.355	0.393	0.781	1.000		
VIX	-0.356	-0.440	-0.477	0.021	-0.081	0.033	0.368	-0.043	-0.286	-0.493	1.000	
ASX	0.222	0.508	0.760	-0.154	0.189	0.015	-0.347	0.423	0.768	0.845	-0.530	1.000

Source: BondAdviser, Underlying Manager, Bloomberg. Indices: BCOM Index, CO1 Comdty, W 1 Comdty, IOE 1 Comdty, GC1 Index, BCEY4T Index, BCIA4T Index, BAFRN0 Index, LG30TRUU Index, VIX Index, AS51 Index

As illustrated in Figure 7 below, the Underlying Fund's correlation to the S&P500 Index has decreased since the outbreak of the COVID-19 pandemic. In the period from inception until the end of 2019, 36% of the Underlying Fund returns can be explained by returns in broader US equity markets. Since 2020, this has fallen considerably to 14%. Moreover, with a Beta close to zero, it is evident that the Underlying Fund has exhibited minimal correlation to US equities in this time. This is impressive given, in times of distress, it is expected that correlations will usually increase as broader crisis conditions permeate across all asset classes and instruments. Although we caution that the data sets for the respective periods of pre-COVID and COVID are small, 20 and 16 months respectively, the results nevertheless evidence that the underlying strategy is largely insulated from movements in global equity markets. Moreover, when the two data sets are collated (n = 36), the R^2 is a minimal 16%.

Figure 7. Monthly Return Correlation Matrix



Source: BondAdviser, Underlying Manager.
***Gray** represents the 1 June 2018 to 31 December 2019 time series regression. **Red** represents regression from 1 January 2020 to April 2021.*

Company Background

Ferguson Hyams Investment Management Pty Ltd (FHIM) is an investment manager which focuses on generating returns with a low or negative correlation to global equity markets. Based in Brisbane, it is a regulated company, operating under an Australian Financial Services License. Ferguson Hyams adopts a meticulous and highly technical investment methodology which targets liquid, scalable strategies across global equity, foreign exchange, and alternative investment markets. In addition to facilitating the Opportunities Strategy USD 4 Year Bond, FHIM currently operate six strategies including a multi-strategy Fund and wholesale Managed Discretionary Accounts. For this Fund, Ferguson Hyams sources strategies with verifiable trading histories from portfolio managers located globally. FHIM performs the role of administering this platform, selecting the strategies and managers according to its investment methodology. Ferguson Hyams derives its income from management and performance fees.

Ferguson Hyams was established in 2015 by founders Luke Ferguson and Gideon Hyams and operated predominantly in the managed accounts space and launched its Multi-Strategy Fund in 2020.

Luke Ferguson

Luke Ferguson is Chief Executive Officer and Responsible Manager for the AFSL. Prior to founding FHIM, Luke was a Director of a global alternative and automated trading fund. Luke holds RG146 qualifications in Derivatives, Foreign Exchange, Securities and Managed Investments.

Gideon Hyams

Gideon Hyams is the Chief Investment Officer. Prior to founding Ferguson Hyams, Gideon worked at UBS as a Managing Director in Zurich, serving in several roles over 17 years at firm. Gideon managed one of the largest FX derivatives portfolios in the market with excess of 10,000 option and cash positions representing a notional value of several billion dollars. Under Gideon's leadership, his team was awarded the Risk Magazine Currency Derivatives House of the Year Award. Gideon holds an Honours degree in Physics from the University of Oxford and professional qualifications in Financial Planning, Derivatives and Risk Control.

Scott Charaneka

Scott Charaneka is the Corporate Adviser of FHIM. Scott is the Head of Superannuation & Wealth at Thomson Geer with an industry leading practice in financial services working for many private and public sector financial institutions. He has experience in licensing, governance, administration, restructuring and funds management. Scott has previously served as an in-house counsel at Legal & General and ING. Scott holds a Bachelor of Arts and Laws from the University of New South Wales, a Graduate Diploma in Applied Finance and Investment, and is a Fellow of the Association of Superannuation Funds of Australia.

Case Study: Greensill and Supply Chain Finance

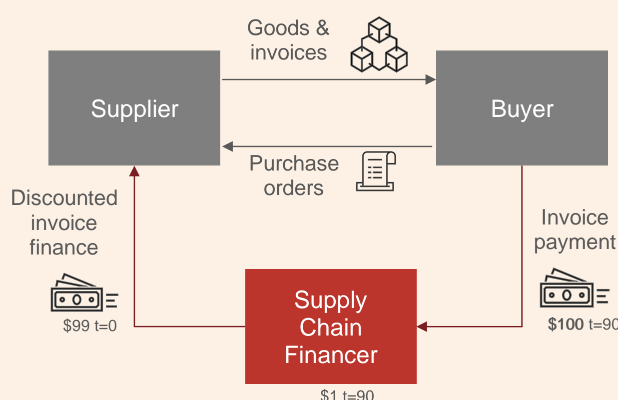
The recent collapse of Greensill Capital has put the spotlight on supply chain finance, triggering widespread debate about its possible systemic weaknesses. As such, it is important to detail how trade financing is a fundamentally different strategy.

Supply Chain Finance: Greensill as a Lender

At its core, supply chain financing is invoice financing. This involves the supply chain financer, for example Greensill, purchasing invoice receivables from a mid to large size corporate supplier of goods at a discount in exchange for immediate and certain payment. The invoice receivables then become payable by the buyer of the good to the supply chain financier, often under more flexible terms such as an extension of the due date for payment. The supply chain financer's income thus reflects the credit risk of the buyer, which becomes its debtor.

The supply chain financier thus assumes credit risk exposure to the buyer. The success of its strategy is contingent on the debtor meeting its payment obligations. Therefore, as with any lender, prudent risk management demands that a supply chain financier diversify its exposure to underlying debtors. Yet, Greensill's portfolio was highly concentrated to a small number of debtors and relied on insurance policies covering the risk of default for its own financing. Perhaps what really caused Greensill's downfall was the more aggressive and unconventional *prospective* invoice receivable financing.

Figure 8. Supply Chain Finance Diagram



Source: BondAdviser. Indicative numbers only.

The Trade Financing Strategy of the Underlying Fund

Conversely, the Underlying Fund does not act as a credit to underlying debtors. Rather, the Fund enters simultaneous purchase and selling contracts for physical commodities, taking full ownership of the assets during the time of transit and storage. Thus, although the Fund is exposed to the purchaser defaulting on its commitment to pay, unlike Greensill, the Underlying Fund owns the underlying commodity enabling it to locate an alternative buyer and recoup the loss. As detailed in *Strategy Overview*, the Fund secures this through ordinary trade financing instruments.

The Underlying Fund's primary risk is therefore physical and price risk of the commodity, which can be more effectively priced and insured against, as opposed to ordinary credit risk of the debtor. In addition, the Underlying Fund's portfolio is appropriately diversified across trade financing transactions and underlying counterparts and has a demonstrated track record of risk management, with a 0.00% rate of buyer default across over 700 transactions.

Relative Value

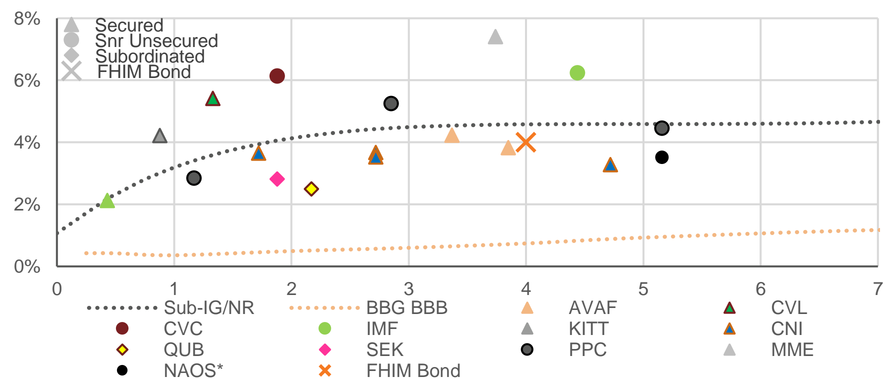
Assessing relative value for this Bond is difficult as the uniqueness of a trade finance strategy in the domestic bond universe means there are few comparables. To best evaluate the Bonds, we look to three universes for comparison: 1) the AUD public credit markets, both investment and sub-investment grade, 2) AUD private credit, 3) the AUD securitisation market including ABS and RMBS.

Public Credit

Domestically, the unrated / sub-IG market is spread across a range of industries, seniorities and credit quality. The COVID-19 outbreak has resulted in material widening in some securities, many of which remain above pre-COVID lows. Some of this can be attributed to inefficiencies including frequency of trading and pricing variation. At an offered margin of ~400 basis points on an Australian dollar swap basis, the Bonds sit around 60 basis points below the Sub-IG / NR curve. The Bonds also price at a multiple of 5.4x above the AUD BBB curve, indicating significant value for an underlying portfolio that, as highlighted in *Quantitative Analysis*, is likely to be investment-grade due to credit enhancement (pre-payment fee and insurance benefit).

In the non-rated universe, the security most similar to the Bonds are the NCC Convertible Notes (ASX: NCCGA). NCCGA are senior unsecured convertible Notes, providing debt financing in the NAOS Emerging Opportunities Fund (ASX: NCC). Whilst the underlying structure and securities are different, they are similar in the sense that they are providing senior ranking unsecured debt finance to an investment strategy. NCCGA, pricing in March 2021, offers 4.5% cash payments per annum until September 2026 and thereafter has ramp up features if not redeemed. Due to the NCCGA convertibility, the margin based on yield alone is insufficient as a comparator. Instead, at issuance, the option adjusted spread of 520 basis points, which originally sat above the sub-IG curve by 10bps. Noting the curve compression since March of 46bps, this difference of ~120bps appears nominally rich, however when accounting for a superior underlying credit profile, it is more on the richer side of fair value.

Figure 9. Sub-Investment Grade / Non-Rated Universe



Source: BondAdviser, Bloomberg. As at 3 August 2021.
**NAOS margin calculated on a cash spread basis.*

Private Credit

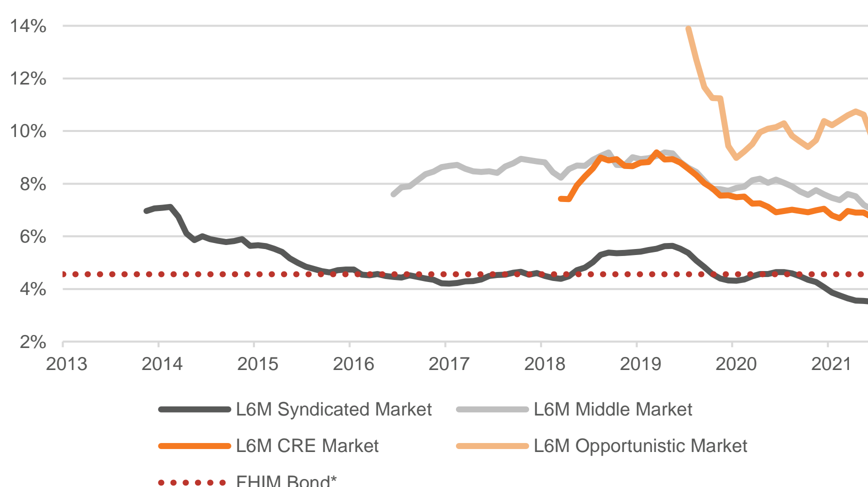
We turn next to Australian Private Credit markets, in a comparable analysis that accounts for similarities in 1) liquidity; private credit is illiquid, 2) complexity; private credit, like trade finance requires specialist operators, 3) duration; or rather lack-thereof, the high turnover in trade finance and floating rate structure of loans in private credit means that neither derive return from interest rate risk, 4) capital scarcity; much of the alpha present in trade finance and private credit is due to the withdrawal of traditional banks. This is an uncommon analysis, however, pertinent given the opportunity cost.

Noting the similar underlying generation of yield, the Bonds sit between trailing net returns in the syndicated and the similarly priced middle and commercial real estate (CRE) markets.

As the syndicated private debt market is predominantly investment grade and first-lien, it is logical to see yields that are higher on Ferguson Hyams' Bonds, which are HoldCo in nature and have no direct recourse to the Underlying Fund. That said, we did expect to see a larger gap here.

The CRE and middle market space is typically sub-investment grade from a stand-alone credit profile perspective. These loans are typically bullet and bilateral in nature. With the Bonds sitting 220-250bps below the six-month average yield, it appears relatively rich, however, there should be some discount here given: 1) the greater diversity of the Underlying Fund, to that of a relatively concentrated bi-lateral portfolio and 2) the Bonds have an underlying credit profile that we place between the syndicated and middle markets. The combination of a spread under CRE market yields of 220bps and only a 100 basis point premium above the syndicated market indicates the Bonds are, at worst, marginally rich relative to alternatives in the private credit market.

Figure 10. Australian Private Credit Last Six Months Annualised Returns



Source: BondAdviser. As at 30 June 2021. Syndicated Market is represented by Metrics Credit Partners Diversified Australian Senior Loan Fund. Middle Market is represented by the average of both Metrics Credit Partners Secured Private Debt Funds I and II. Commercial Real Estate (CRE) Market is represented by the average of Qualitas Real Estate Income Fund and Metrics Credit Partners Real Estate Debt Fund. Opportunistic Market is represented by Metrics Credit Partners Credit Trust.
**AUD yield calculated using cross-currency forward swap.*

Securitisation

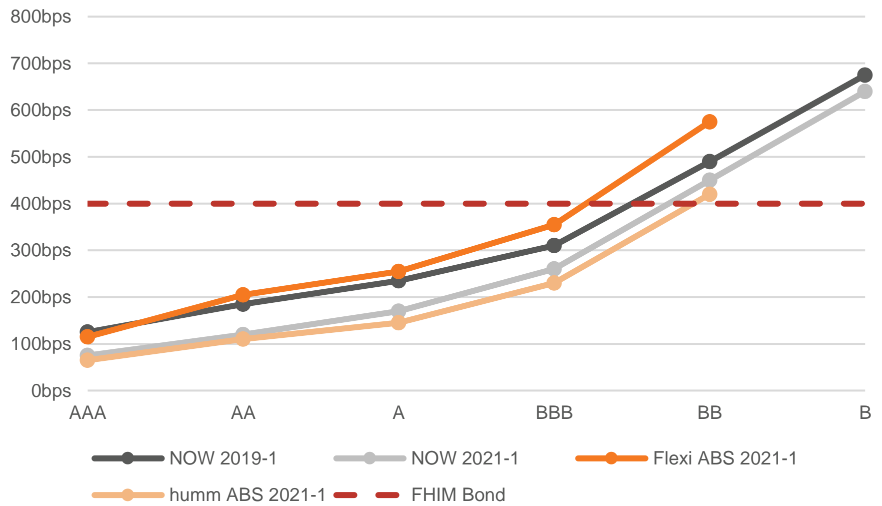
The securitisation market is different to public and private credit in structure and participants. We typically avoid securitisation markets as a relative value tool, noting the pitfalls of doing so in the GFC, however for the purposes of this analysis, like private credit, in the junior, non-repo eligible tranches of the securitisation market, there is a complexity, liquidity and scarcity premium.

We view the ABS market as being a better comparable (in contrast to the RMBS Market) for the Notes for four main reasons: 1) RMBS are portfolios of loans collateralised against houses while the "Asset" in Asset Backed Security (ABS) typically consists of more eccentric credit, similar to how the assets involved in the underlying strategy will also be unique; 2) Prime borrowers at a mortgage level are typically quite safe due to the lending itself being secured, however for ABS, loans are typically unsecured; 3) Asset Backed Securities, especially at junior tranches are a less liquid portion of the market which is more reflective of how the Ferguson Hyams Bond will trade. 4) The margins in ABS

markets also incorporate an additional complexity premium compared to the still complex, but better standardised RMBS market. As noted above this better normalises the pricing for niche markets.

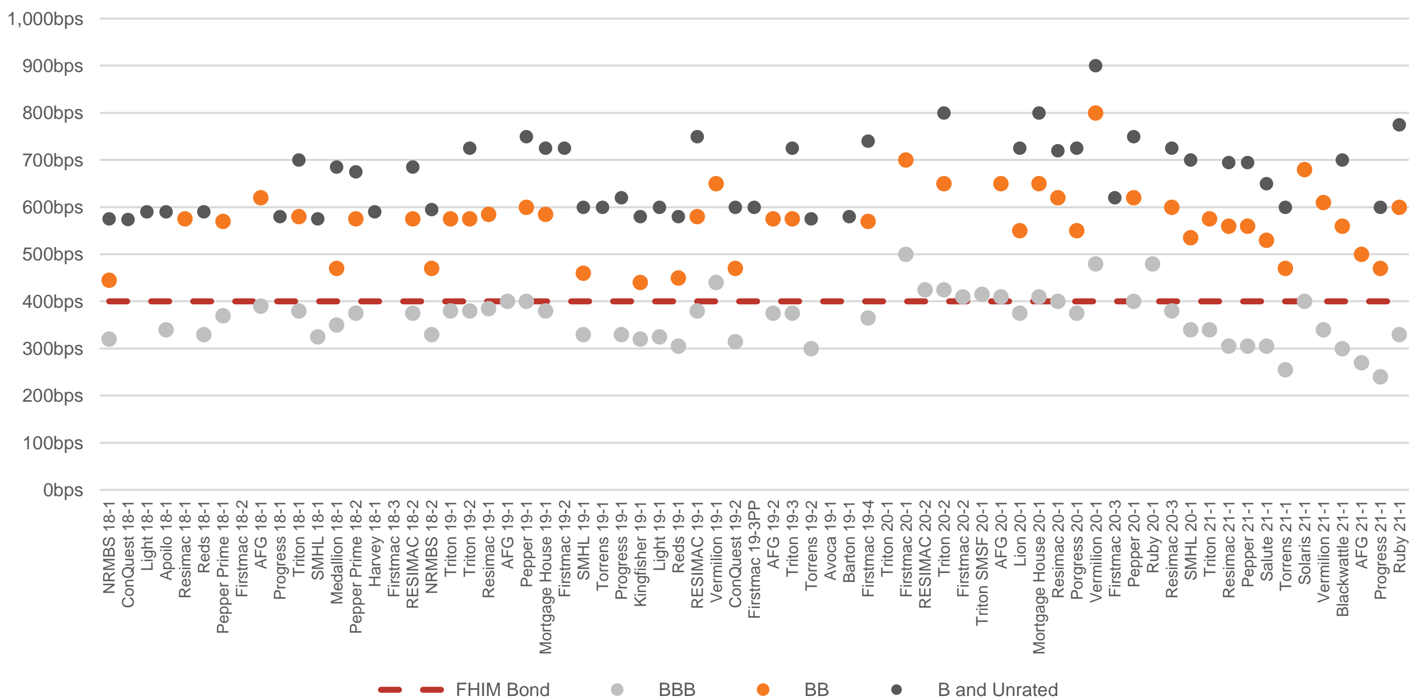
As indicated below in Figures 11 and 12, when looking to the personal loan ABS and prime RMBS markets the margin on the Ferguson Hyams Bonds prices slightly higher than BBB-rated but under BB-rated – we recognise term is not accounted for here but note the WALs are generally not materially different to that of the term of the Notes. Given this sits within our expectations of the underlying credit profile, the Bonds appear fairly priced.

Figure 11. Personal Loan ABS Margins



Source: BondAdviser, Westpac. As at 5 July 2021. FHIM uses AUD ASW rate at 4-year tenor.

Figure 12. Prime RMBS Margins



Source: BondAdviser, Westpac. As at 5 July 2021. FHIM uses AUD ASW rate at 4-year tenor.

Credit Profile

Assessing the credit profile of the investment presents significant difficulties. This is not only because the underlying trade finance investments raise difficulties in respect of evaluating credit quality, but these issues are exacerbated by the complex legal structure by which it gains exposure to these investments.

Default Risk at the Underlying Fund Level

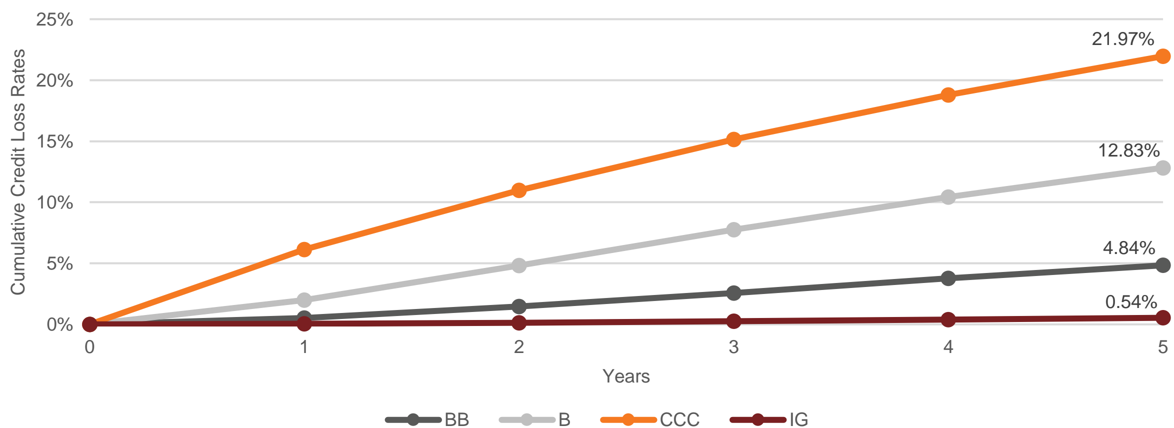
The starting point is at the Underlying Fund level – as the underlying generator of the FHIM Bond distributions, it is the key source of default risk. As noted earlier, the Underlying Fund has recorded no buyer defaults through its operating history. This supports the strength of the Underlying Fund's investment process, especially in relation to counterparty due diligence and transactional risk assessments. However, this record is supported by the fact that trade financing as an asset class has an attractive risk profile. As demonstrated in Figure 13, the default and loss metrics of trade financing compare well against other asset classes. Historic default rates are considerably lower for commodity trade finance than SME lending, and the asset-backed nature of trade finance means that loss given default is lower than all other major lending classes. In addition, given these assets are largely fungible commodities traded on highly liquid spot markets, time to recovery is also comparatively short.

Figure 13. Trade Finance Default and Loss Metrics

	Weighted Default Rate	Loss Given Default	Weighted Expected Loss	Time to Recovery (days)
SME	1.62%	27%	0.44%	393
Banks & FIs	0.25%	28%	0.07%	427
Commodities Finance	0.68%	24%	0.16%	350

Source: International Chamber of Commerce; calculated for 2008-2018.

Figure 14. Average Cumulative Credit Loss by Credit Rating Band, 1983-2020*



Source: BondAdviser, Moody's.
** Based on average default rates and senior unsecured bond recoveries measured on issuer-weighted basis.*

Figure 14, which charts average cumulative credit loss by rating across all industries, also supports the view that trade finance as an asset class measures well compared to alternatives, though we note they are measuring differing time periods. Nevertheless, historic trade financing loss rates rank alongside those of the investment grade-rated band, in line with our expected assessment of the Underlying Fund credit profile.

These historic data should be approached with some caution, however, given they exclude the COVID-19 period. And as the International Chamber of Commerce have indicated, preliminary analysis of the COVID-19 period identifies an increase in defaults across most trade finance products above long-term averages. The ICC reported that obligor-weighted default rates rose by 40-50% in 2020 compared to the prior year. This lift can be attributed to a low base, liquidity constraints for SME buyers and COVID-19 related shifts in supply and demand dynamics. However, this increase must be viewed within the context of higher default rates in other asset classes, which, as Moody's data shows, experienced a much more significant deterioration in risk metrics. For example, the monthly average global speculative grade (Ba to Caa) default rates – which offer a comparison to the FHIM Bonds from a return perspective, although not a pure risk perspective – rose 113% from 2019 to 2020. Similarly, US loan defaults rose 128% in the same period. Additionally, the downgrade rate on global CLOs – which offers a useful comparison as a structured product – rose 92%, although we note this is not a default rate.

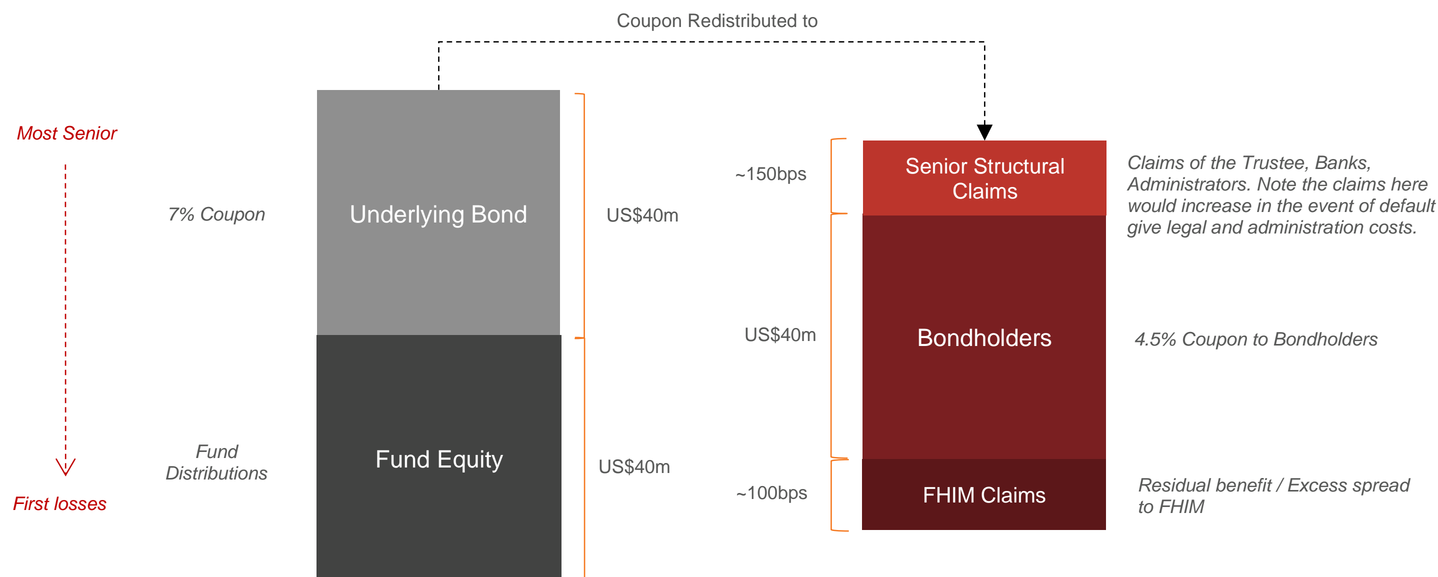
Moreover, as mentioned, the nature of the Underlying Fund's strategy – by which it takes ownership of the assets – limits the downside risk in the event there is a buyer default. Thus, although loss will always be triggered by an event of default, the primary risk exposure is to commodity risk: both risk of physical risk of damage to the commodity and price risk in the event of default.

Positively, the strategy takes steps to mitigate against both sources of risk. In relation to physical damage, the fund is mandated to be covered by All Risk Maritime insurance for all transactions, which provides comprehensive (full value) insurance coverage against loss in value of the goods. Whilst there can be no guarantee that the policies will be effective in all circumstances, there is still legal risk especially in a novel situation, we are comfortable with the coverage. This is supported by a mandate undertaken by the Underlying Fund that its insurance be provided by an institution with an investment grade rating (≥AA-). Secondly, as we explained in *Strategy Overview* the imposition of a trade facilities fee mitigates against the scale of downside loss in the event that a buyer default causes the Fund to go to the spot market to sell the commodity.

Structural Protection

In addition to mitigating against risk of default at the Underlying Fund level, the FHIM Bond is embedded with several features of structural protection. Primary among these is the fact of the Underlying Bond ranking senior to all other funds (units) in the Underlying Fund. This means that in the event of the Underlying Fund defaulting or winding up, the Underlying Bond's claim will rank at least equal to any other credit and superior to any claim of equity Unitholders. However, we note that additional claims, such as those of the Underlying Bond Investment Manager, Adviser, Trustee, Banks and Administrators will rank senior to the FHIM bond. At the date of launch the pro-forma debt-to-equity ratio of the Underlying Fund will be 100% (with the Underlying Bond comprising the whole debt component) and it is mandated that the Underlying Fund cannot exceed 200% of this ratio. This effectively gives Bondholders a loss absorbing equity buffer.

Figure 15. Underlying Fund Capital Structure



Source: BondAdviser.

These default risk and structural features of the Underlying Bond support an investment grade rating (from Kroll Bond Rating Agency) of "BBB". The Underlying Bond is dependent on the maintenance of this BBB rating and it is expected that this will be reassessed by Kroll on a quarterly basis. In the event that the rating is downgraded, the Underlying Bonds will be immediately redeemed at par including any accrued interest, which will pass through to the FHIM Bond through a right of Bondholders to demand redemption of all Notes. This means that if the Underlying Bond is downgraded, the FHIM Bond will be redeemed in full.

There are also structural features at the FHIM Bond level which support its credit profile. Primarily, claims of Bondholders will rank senior to all fees earned by Ferguson Hyams. This adds a degree of excess spread protection and also aligns interests. Given that in many ways, investors are lending on the ability of Ferguson Hyams to conduct due diligence, it is sensible that Ferguson Hyams should only be paid if that due diligence performs.

Quantitative Analysis

We have performed extensive analysis, which is only summarised below. A separate 23 page report, which outlines the method, discusses key simulations and provides a complete breakdown of summary statistics for all 54 simulation can be accessed on request.

Executive Summary

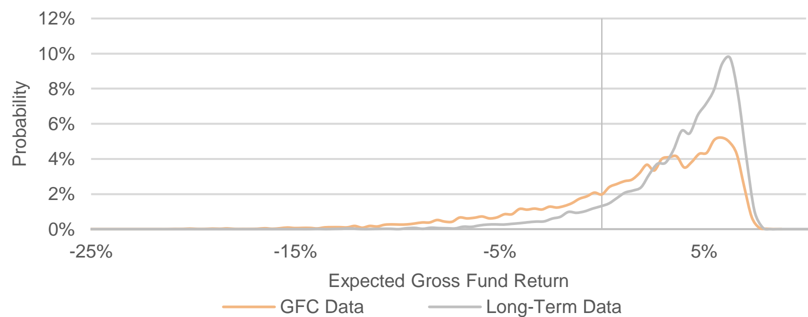
We utilise two models across our 54 simulations, our standardised expected credit loss (ECL) framework and a custom-built embedded structural protection (ESP) waterfall.

Empirical data for trade finance that is representative of the Underlying Strategy has a historically low risk of loss. On top of this, protecting against idiosyncrasies are two forms of credit enhancement, (1) a pre-payment fee and (2) maritime insurance coverage. These enhancements are significant and reduce potential losses further. This forms a key tenant to our credit comfort.

The Underlying Fund performs extremely well in almost all cases except severe distress, where we use securitisation default data during the GFC. On a single-year basis, out of all our simulations, this is the only scenario where a default occurs at the AMAL bond level. This is firstly a function of credit enhancement and secondly a function of a material loss absorbing equity buffer. Whilst our recovery values for the AMAL bond are low in a default event, the impact to expected loss is offset by the small default likelihood.

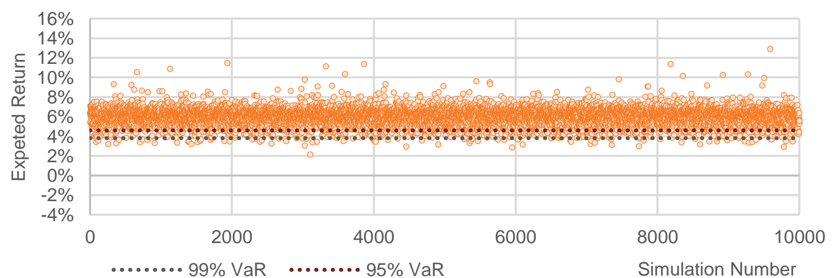
Based on our analysis, we assign the AMAL bond a risk score of '**High**'. The Underlying Fund's credit profile is arguably investment grade due to its significant levels of credit enhancement, however we notch the AMAL bond downwards due to (1) a short track record of the Underlying Fund, (2) a small Underlying Fund size, (3) the degree of opacity between look-through borrower and bond lender, (4) expected illiquidity and (5) a complex legal structure that embeds contractual subordination.

Figure 16. Sim 7 & 9. Corporates (BB/B) – Underlying Fund Returns*



*Source: BondAdviser Estimates. ECL Methodology. *Gross return basis. 20 asset portfolio. Weighted average credit rating of ~BB-.*

Figure 17. Sim 14. ESP Complete Insurance Benefit – Underlying Fund Returns*



*Source: BondAdviser Estimates. ESP Methodology. *Gross return basis. No limit of insurance benefit in an event of default.*

Research Methodology

Overview

Every research report prepared by BondAdviser includes a clear recommendation on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

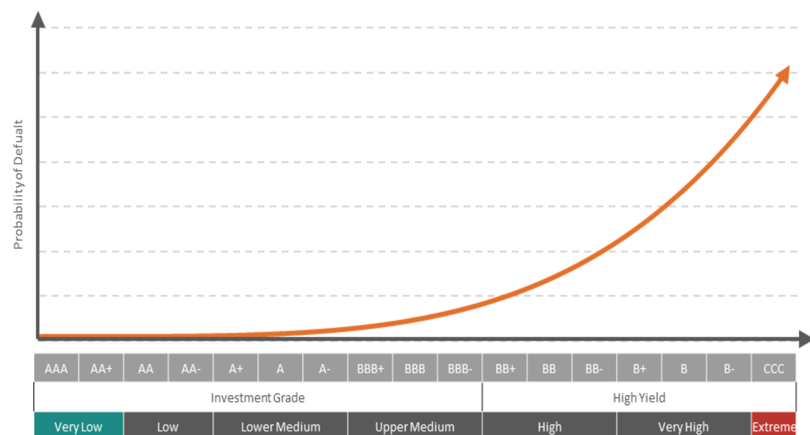
The guide below may help you understand our research opinions. For further information on our research approach, you can refer to our RG79 statement by clicking here.

Research Opinions Key:

- Buy - Over the next 12 months, the analyst expects the security to outperform the current yield due to credit spread tightening or favourable movements in the underlying yield curve.
- Hold - Over the next 12 months, the analyst expects the security to provide stable returns broadly in line with the current yield but with little credit spread tightening.
- Sell - Over the next 12 months, the analyst expects the security to underperform the current yield due to credit spread widening or adverse movements in the underlying yield curve.
- Suspended - The recommendation has been suspended temporarily due to the disclosure of new information or market events that may have a significant impact on our recommendation. This also includes situations where we have been given non-public information and we need to temporarily suspend our coverage in order to comply with applicable regulations and/or internal policies.
- Not Rated - A security that has not been assigned a formal recommendation.
- Ceased Coverage - The recommendation has ceased due to issuers failure to disclosure necessary information or coverage is subjectively removed in accordance with our Research Governance Statement.

Issuer and Security Risk Assessment Curve

The issuer and security risk assessment curve is our primary measure of the likelihood that an investor could lose capital value on an investment due to default and/or conversion. The risk scale consists of seven ratings – Very Low, Low, Lower Medium, Upper Medium, High, Very High and Extreme. Each security is tagged with an issuer risk and respective security risk (which may or may not be the same).



This security risk assessment has a respective measure of default or conversion which is shown in the orange line. This curve is an extension of the APRA (Australian Prudential Regulation Authority) PAIRS (Probability and Impact Rating System) model which has been successfully managing regulated entities in Australia since October 2002.

Important Information

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