UK Lending Funds in the Post-Brexit Environment

Investment funds will need to play a greater role in business finance

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While the Brexit vote might have injected a note of political uncertainty into the future of the United Kingdom, and while the falling pound has raised the spectre of inflation again, many of the fundamental investment stories that support inward investment to the UK remain in place.

Interest in the UK as a market for investment does not seem to have dissipated: speaking purely from the Prestige perspective, we have continued to see enthusiasm for lending strategies focused on the UK in the wake of the Brexit vote, with both website traffic and site visits from foreign investors reflecting an interest in both the uncorrelated nature of lending, and the stability of the value of the assets against which lending is secured (e.g. British farmland).

Foreign clients, if anything, see an opportunity from the weaker British pound to increase their exposure to the UK. While we have seen this in the short term from the rise in the price of UK-listed companies, there is also considerable interest in the long-term prospects for the UK economy and yields to be earned from effectively managed lending strategies. Interestingly, enthusiasm for UK lending strategies from abroad far outstripped domestic demand throughout the Brexit news cycle. But why is this the case?

The UK as a destination for loan finance

The UK has always been regarded as one of the top prospects for foreign direct investment – international money flowing into the property sector is just one indicator of this. Lending funds, which have been expanding their share of the alternative assets market as government bond yields have hit correspondingly negative territory, represent both an uncorrelated source of returns and, in the case of the rural sector, bring the additional attraction of loans often secured against prime UK farmland.

The case for the overall health of the UK economy still seems like a solid one, particularly for the non-UK investor. Comparisons with other EU countries are helpful. Despite the large numbers of immigrants that have moved to the UK, it still has one of the lowest unemployment rates in the European Union: better than France, Ireland, Italy, Spain, Portugal or Greece. This is testament to the growth and diversity of the UK economy over the past decade.

More than 8 million inhabitants of the UK were not born here. More than 1,000 people move to the country every day. It is one of the fastest-growing economies in Europe and ranks fourth in the world for Foreign Direct Investment (FDI), before the weakening pound is factored in, which stands to make UK investment even cheaper. The UK also has a strong and long reputation for the rule of law and frequently ranks high in Anti-Corruption League tables.[1]

The latest numbers seem to be pointing to a much more benevolent environment than previously forecast, even as recently as January. End-of-year economic data supports a picture that includes a narrowing trade deficit, a pickup in manufacturing output and higher turnover in production and services, led by export demand.[2]

But with all this good news, Brexit will also mean a rethink for some UK business sectors as they seek to address systemic problems that the withdrawal from the EU has the potential to exacerbate.

Too much food

The UK remains dependent on food imports: the weaker pound is putting pressure on the margins of many companies, including supermarkets. The UK currently imports approximately 30% of its food and, with a weaker currency, food security will inevitably creep onto the agenda.

Food wastage is going to become a major issue in coming years as the country seeks to detach itself from Europe. Britain wastes more food per week than any country in Europe, with the average household throwing away 13 pounds of food per week. British households have been found to squander more than £12 billion in avoidable waste every year, which works out at £480 per household.[3]

This brings with it environmental implications. Meat production, for example, uses many resources in the first place. Even a small amount of wasted meat already has major implications in terms of lost resources. According to a study by the European Commission's Joint Research Centre, overzealous sell-by dates and over-ordering by middle-class households must shoulder much of the blame, not just in the UK, but across Western Europe.

Food waste will need to be addressed. With higher taxes being levied on traditional forms of waste disposal, businesses in the food industry have to embrace new technologies. The UK is lucky to be on the cutting edge of many aspects of R&D in the agriculture sector, including the development and deployment of anaerobic digestion plants. These tackle the management of waste, but also have the useful by-product of bio-gas, which can be employed by farms as a source of alternative energy or turned into biomethane for use in the national gas supply network.

At Prestige we are already actively involved in the financing of anaerobic digestion plants in the UK. These are digesting organic waste – e.g. from food wastage – while generating an ultra-low carbon fuel which can replace more expensive fossil fuels, as well as providing a source of natural fertiliser from the digestate (potentially substituting for increasingly expensive imported ones, which may also be priced in euro or US dollars).

Bio-gas is just one source of alternative power that lending funds can help to develop – there are many others, and their development is essential if the UK economy is not to be undermined by a potentially more critical threat than Brexit: namely, a power shortage.

Not enough power

The UK's issues with electricity did not go away with the Brexit vote. The country is still struggling to cope with the integration of green energy into its power mix – alternative energy sources currently constitute approximately 20% of power generating capacity (and the UK often has to import more from France).

Since the last election, the UK government's energy policy has been somewhat uncertain; in particular, plans to replace ageing power plants are short on specifics. While energy security is a priority, Brexit is unlikely to improve the situation – nor is reliance on decreasing volumes of natural gas from North Sea reserves. Earlier plans to rely on the EU to provide up to 30% of the UK's power requirements may have to be shelved or become a hostage to Brexit talks with Brussels.

Within the rural economy, higher electricity prices will not be helpful: one senior executive at Ofgem (the power regulator) has already warned that households may be forced to pay extra to keep their lights on, but let's not forget the impact on business, and in particular companies responsible for food production. The closure of coal-fired power stations will mean that the distribution of power across the UK will be irregular. This has implications for farmers, who are turning to alternative and localised power sources to ensure they can continue to operate.

Ofgem has said it is committed to maintaining power supplies, but even the chancellor has admitted that the country will need to invest "eye-wateringly large sums of money" to keep the lights on. Many farmers have traditionally turned to banks for loans to help them invest in such projects on their properties, but sadly this energy crisis comes at a time when EU funding, and bank finance, often remain restricted.

Not enough banks

The UK high street has been subjected to a relentless drive by the major banks to cut costs by closing branches. Unlike many other countries, the

UK does not have specialist agricultural or farmers' banks that were founded to lend specifically to rural businesses. While it may be difficult to gauge from the perspective of major towns and cities, the loss of lending institutions in smaller communities could have significant implications for businesses in the farming and food-processing industries.

The sheer number of bank closures is startling: the Co-operative Bank alone has closed 117 branches since January 2015, over half of its network, and has now put itself up for sale (having been bailed out by hedge funds in 2013). HSBC has shuttered more than 300 branches, over one-quarter of its total UK retail banking network, in the last two years alone. This trend is part of a wider cost-cutting strategy which also reflects the banks' eagerness to reduce their lending liabilities. It represents a general retreat from active lending operations in key areas. It also reflects a widespread reduction in branch footfall as more retail consumers turn to online or telephone banking.

Looking at the national picture, some of the hardest-hit areas are, predictably, the rural ones. Wales, the southwestern counties like Cornwall and Dorset, the northwest of England and the Scottish highlands have all seen a considerable reduction in bank branches.

While this reflects commercial reality, there has been little done to replace lost branches within the public sector. The sudden demand for financing for infrastructure by farming and food-related industries is not going to be met by the traditional lenders. How, then, can farms remain viable, especially when food security is so critical?

Rural businesses struggling without financial support

According to the National Farmers Union, many dairy farmers are facing a financial crisis, and eating into their savings, with as many as 20% anticipated to exit the industry in the near future. Ten years ago, the National Farmers Union (NFU) estimated there were approximately 20,000 dairy farms in the UK – now there are slightly north of 10,000. Part of the issue has been a decline in the wholesale price of milk, which has dropped from about 31 pence per litre to about 24 pence in 2016, while numerous costs have risen significantly.

The Agriculture and Horticulture Development Board estimates that up to 75% of British dairy farms are operating at a loss and it is entirely possible, according to industry analysts, that the UK will have less than 5,000 dairy farms in ten years from now. This has significant implications for food security and prices in the UK, particularly in light of the Brexit vote.

What needs to be avoided is a situation in which a combination of debt and falling earnings forces many farmers to simply sell their land and retire. Farmers are unable to make sufficient profit to be able to reinvest in their businesses, which can modernise them and make them more dynamic.

The UK (often via the EU) continues to pay farmers subsidies that are partly linked to the way that farms benefit their communities – including keeping certain livestock, and tending to land maintenance of wildlife habitats.

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As a result, many farms are starting to diversify their businesses as they look for additional streams of income – for example, selling organic produce locally at higher prices than at the major supermarkets. New crops like Chinese cabbage have come under cultivation in greenhouses, at cheaper prices than imported alternatives. Farmers are also starting to invest more heavily in infrastructure that will help them cut costs, not only by generating green energy on-farm, but also through other innovations like raw milk vending machines and higher-margin, organic-related produce.

In January, the Environment Secretary announced £120 million of funding to support farmers, grow businesses and hopefully generate thousands of jobs in rural communities. The government recognises that in England alone, one-quarter of businesses are located in the countryside and will likely continue to consider initiatives that will support investment into this strategically important sector.

Loan finance and the UK's agricultural economy

The ongoing financing of the farming sector in the UK remains shrouded in uncertainty in the run-up to an eventual Brexit, although two things are certain: everyone will still need to eat and small businesses will still need to borrow money in order to invest in productivity. There is increasing emphasis being placed on secured lending from alternative sources to banks, and lending funds are well placed to play an important role.

According to the Financial Stability Board, in 2015-16, by far the biggest category of non-bank lending globally was being carried out by investment funds. It estimated that in 2016 alone, 60% of global non-bank credit intermediation was formed by investment funds.

Interest in lending finance from institutional investors in 2016 was increasing steadily: research from Willis Towers Watson indicated that investor appetite for illiquid credit was burgeoning to compensate for lower yields in public markets. With the European specialist illiquid credit manager market now approaching the size of its US counterpart, investors also have a wider range of strategies to choose from, and given that the UK has one of the largest finance industries in the world, the pool of talent from the commercial banking world is significant, enabling private debt operators such as Prestige to grow their businesses significantly over the next few years.

For the UK agricultural economy, lending funds will provide a more important source of investment going forward. With less (and slower) access to bank finance to modernise facilities, farmers and other rural businesses will need to turn to alternative sources of finance. Farmers seeking to fund medium-term projects such as vital infrastructure modernisation or alternative power generation will require the support of investment funds in helping them to achieve their business goals. **THFJ**

FOOTNOTES

1. *Transparency International* newsletter; *Daily Express* newspaper
2. Barclays, Office for National Statistics.
3. *Daily Telegraph* newspaper; Barclays, Office for National Statistics