Developing Markets Conference – Broadening Horizons

30 April 2019

ETC Venues, St Paul's, 200 Aldersgate London, EC1A 4HD

Key themes

On 30 April 2019, the LMA hosted its sixth annual Developing Markets Conference at ETC Venues, St Paul's, London. The event was attended by over 300 industry professionals and featured presentations and panel discussions from over 30 senior market experts.

The panels and presentations covered a wide range of topical issues, including the general market outlook for syndicated lending in developing markets, analysis of the financing gap in Africa, key risk mitigation techniques, the future for developing markets, distressed investment and restructuring strategies and the role of financial technology. The conference concluded with a Q&A session at which a panel of experts answered questions posed by the audience on a number of commercial and legal hot topics.

In terms of key themes discussed during the course of the day, the Conference may be broken down into three primary areas of focus - all of which are summarised in this briefing. These themes are:

- trends, challenges and predictions for the future;
- risk management; and
- new opportunities for developing markets.

Trends, challenges and predictions for the future

In the first quarter of 2019, the syndicated loan market experienced a 30% dip in developing market loan volumes (125 billion USD), as compared to the first quarter of 2018, the lowest quarterly volumes in a decade. The key drivers underpinning this may be explained by recent macroeconomic and geopolitical challenges. The sentiment of uncertainty this has created has brought about additional pressure for developing markets, making underwritten deals less attractive and resulting in lenders engaging in more club transactions. The situation has, however, yielded certain benefits with respect to documentation and structuring. Similarly, bond markets remain volatile for emerging market issuers, although bridge to bond facilities are expected to increase, particularly in the sovereign space and in the Middle East. Overall, however, whilst developing markets can be very unpredictable, they are largely resilient, and this resilience is expected to continue despite existing pressures. That said, on this occasion, the general slowdown in activity has been experienced across all sectors and geographies. This is relatively unusual - normally institutions are able to "hedge" their exposures on a geographic/sectoral basis, due to spikes of activity in certain areas.

Looking specifically to Africa, in 2014, the fall in commodity prices negatively affected a number of African countries, particularly Nigeria, which was once one of the biggest oil producers on the continent. That said, Africa, economically speaking, is undergoing a transformation from being an export-led market to a consumer driven economy, as evidenced by the substantial growth of the middle class. However, whilst business continues to grow (such growth not necessarily translating, however, into syndicated loan statistics) there continues to be a large financing gap of approximately 120 billion USD per year. Rising populations in Africa continue to add to pressures, and an estimated 20 million additional jobs will be required by 2035 in order to sustain the demands of rapid population growth.

A large proportion of the financing gap in Africa may be attributed to the fact that many investors are reluctant to conduct business on the continent, not because of an assessment of actual risk, but on the basis of fears that are not always entirely rational. Whilst a number of experts noted there has been a rise in the presence of African and international banks actively engaged on the continent (especially in Nigeria, Kenya and South Africa), closing the gap between *actual* and *perceived* risks will be key to reducing the financing gap in the future.

In reality, investing into Africa is not necessarily as risky as people perceive: a 2016 report released by Moody's noted that project finance defaults in Africa were amongst the lowest in the world (although it should be noted that the nature of project finance means that investments are inherently strategic, and this could explain the low default level). Notwithstanding low levels of default, African infrastructure projects are nevertheless faced with numerous challenges that need to be overcome – primarily underinvestment caused by a lack of government engagement in support of public/private partnerships, a lack of institutional capacity to undertake the type of deals in question, and a lack of an enabling regulatory environment. It was observed that investors looking to invest in infrastructure deals should more readily engage with local regulators, who in turn should welcome feedback from and collaboration with market participants to create legislative environments favourable to lending transactions. Despite these challenges, the market should remain optimistic about the opportunities offered by Africa in an infrastructure context.

China's '*Belt and Road Initiative*' or '*China's New Silk Road*' offers one such opportunity, being a global development strategy adopted by the Chinese government involving infrastructure development and investments in 152 countries and international organisations in Asia, Europe, Africa, the Middle East, and the Americas. However, whilst there are a number of potential positive effects stemming from this initiative - for example, it may have the effect of boosting local employment given investments being made into specific projects - its future success depends on ensuring transparency, sustainability, and abiding by international standards and principles in areas such as human rights and the environment.

Development Finance Institutions ("**DFIs**") continue to provide a high level of financing to Africa, assuming greater financial risks on the continent than any other emerging economy by more than 50 billion USD per annum. DFIs therefore remain instrumental in Africa, offering commercial banks more flexibility in terms of structuring facility agreements and enabling them to open new lines of business.

They also provide vital access to finance in those countries/markets where commercial banks do not operate at all.

Looking to Europe, the influence of DFIs is not as prominent, perhaps as a result of the heightened levels of stability associated with Europe-based financial institutions and their understanding of their own domestic markets. Recently, the CEE market has been characterised by favourable lending conditions, experiencing growth in real estate and acquisition financing deals, particularly in countries such as Czech Republic and Poland. That said, a lot of growth in the CEE region passes unnoticed by international financial institutions and the financial press, given that business in CEE is generally conducted by local market participants who mostly operate in their respective local currencies. For example, a substantial portion of syndicated lending in Poland is driven by local banks and is therefore quite self-contained. However, competition has been on the rise as Chinese banks are starting to enter the market place. This, in turn, has had a key impact on how documentation is structured (i.e. a covenant-heavy as opposed to covenant-lite approach is generally adopted in facility agreements).

The Middle East remains a bifurcated market, with top tier borrowers retaining access to international banks and fine pricing, whilst second tier borrowers only have access to domestic banks. Furthermore, sanctions in certain Middle Eastern countries are proving particularly unattractive to investors. Meanwhile in Russia, the loan market has been much quieter since the imposition of sanctions, although some activity continues, particularly for the more established players. One key issue for Russia, however, continues to be the uncertainty arising from the ambiguous applicability of sanctions, which in turn has caused disruption in the broader syndicated loan market. In Turkey, loan market activity has restarted, but the dynamics have changed. Whilst financial institution activity is likely to continue, project finance will be less active. Corporate lending has also decreased compared to 2018 levels.

As an overarching theme, all loan market participants are advised to prepare for the discontinuation of LIBOR and a transition to alternative near risk-free reference rates ("**RFRs**") ahead of the end of 2021. As RFRs differ substantively to LIBOR and there is not yet an obvious alternative to transition, the LMA is engaged with a number of national working groups to facilitate the process. Market participants are urged to keep up to date with progress and to provide feedback in response to any relevant consultations (these are regularly featured on the LMA LIBOR microsite). Any feedback will be important in deciding upon a suitable way forward and any solutions adopted will have a direct impact on all loan market participants, particularly in developing markets were USD lending is rife.

Risk management

Investors are faced with numerous types of risk when considering investing in developing markets. These include credit risk, construction risk, geopolitical risk, currency controls, and other risks over which substantial control cannot be exercised. A range of mitigating products are available with these risks in mind, such as political risk insurance from the insurance market, enabling participants to get cover against turbulent political events and non-payment insurance, which allows firms to mitigate risks arising from a borrower non-payment event. This type of insurance may also be used as a credit risk mitigation tool under the Capital Requirements Regulation ("**CRR**") and is therefore particularly attractive to banks. Aside from insurance, investors can also access various other risk mitigants such as derivative products, guarantees (e.g. currency guarantees to protect against fluctuations in local currencies) and bespoke financial products provided by ECAs and DFIs.

Notwithstanding the variety of risk mitigants available, unsurprisingly, carrying out the correct due diligence is key to mitigating risks when engaging in developing market transactions. As a result, it is critical to have a good understanding of potential local issues and to identify which protections might apply to any given transaction across those jurisdictions which may be impacted. However, there are often cost barriers which prevent appropriate, in-depth due diligence from being followed.

New opportunities for developing markets

Financial technology ("**Fintech**") is increasingly becoming more sophisticated and user friendly and is seeing widespread adoption in developing markets. This is primarily driven by the ownership of mobile phones, which has grown by 540% in Africa in the last 7 years as compared with developed markets, which have seen very little change in the same timeframe.

The general consensus is that Africa's Fintech potential is unquestionable, especially given the considerable and continuing growth offered by that market. In addition, the adoption of Fintech across Africa via mobile technology has contributed substantially to giving consumers without bank accounts access to financial markets and payment systems for the first time. By facilitating data sharing, Fintech has also helped to solve certain issues with respect to proof of identity. Nonetheless, market participants should also be cautious as consumer right issues (which have been largely ignored in developing markets to date) are expected to rise in magnitude along with the growing sophistication of Fintech. For example, the attempt to introduce Uber in India failed in the face of consumer protection concerns. The issue of consumer protection against the backdrop of a growing data economy age will raise key issues for businesses going forward, and in particular, how they collect data.

China has been instrumental in facilitating greater availability of Fintech in Africa and is responsible for the majority of African digital infrastructure over the last 10-15 years. Indeed, China has started to emerge as the largest Fintech "hub" and is driving innovation in terms of scale. China's 'BAT' group (Baidu Inc, Alibaba and Tencent) are some of the most valuable companies in the world and control many of the messaging and payment channels used by over 1.5 billion consumers. Last year, for example, *We Chat Pay* and *Impesa* entered into a deal which is set to transform payment systems in Kenya by enabling payment to suppliers in China to take place directly over an app instead of having to use older technologies, which in turn will facilitate financial inclusion. China is therefore becoming increasingly influential not only in terms of political importance but also as the key driving force for future developments in the Fintech space.

Looking to other opportunities, the renewable energy sector has also seen increased interest as environmental concerns become increasingly publicised and firms see the reputational and financial benefits associated with doing green business. In turn, this is expected to exacerbate the demand for renewable energy more widely. Equally, greater emphasis on climate change in the future could see even more emphasis on green lending.

The LMA would like to give special thanks to the speakers who devoted their time to this year's Developing Markets Conference.