Loan Market Association
the authoritative voice of the EMEA market

LMA Developing Markets Conference – Key Themes

The LMA Developing Markets Conference was held at the Grange Hotel in London on 26 April 2016. The conference consisted of a series of panel discussions and presentations spanning a wide range of topical issues impacting developing markets across EMEA, particularly CEE and Africa.

The Conference may be broken down into three key themes, all of which will be summarised in this briefing. They are as follows:

- Key investment barriers
- Potential solutions
- Opportunities

KEY INVESTMENT BARRIERS

Despite the fact that developing markets equate to a large number of non-homogenous countries, the region remains an increasingly popular destination for investment. However, despite a recent rally stemming from improved fundamentals, and continued opportunities for the region long-term, there remain numerous risk factors impacting investor sentiment looking to the second half of 2016. These are: 1) China and its implications for global growth; 2) oil and commodity prices; 3) Fed monetary policy; 4) geopolitical risk; 5) sanctions and regulation; and 6) micro factors pertinent to individual countries and regions. All of these factors help to explain the never-ending roller-coaster that emerging markets have been facing in recent months.

China

China's growth is indicative of a key structural change taking place within the global economy. Over the last 14 years, China's percentage of world nominal GDP has been progressive, accounting for 15-17% of GDP in 2015, compared with only 2% in 1991. China has thus become a "base" country in competition with the US (whose own percentage of world nominal GDP has exhibited a gradual decline since 2001). As a result, China's recent economic turmoil has unsurprisingly presented a challenge for developing markets, particularly for those commodity-producing countries from which China imports.

Oil and commodity prices

The issue of commodity prices is important for developing markets because the countries within the region are split between net exporters (such as Nigeria) and net importers (such as Kenya). Commodity prices therefore affect emerging economies either positively or negatively. Oil and commodity prices are of even greater concern for net producers and exporters that are exposed directly to China.

From an investment point of view, oil prices will be the main driver of developing market sentiment going forward, with factors such as the lifting of Iran's sanctions continuing to make oil prices very vulnerable. In the GCC countries, high oil prices are the most obvious challenge impacting investment, although this has affected the bond market more than the loan market to date.

Fed monetary policy

The Federal Reserve raised interest rates for the first time in nine years at the end of 2015. Its actions have had a profound effect on investment to emerging markets. Whilst interest rates were low, investors sought yield in developing economies, boosting lending and consumption and allowing such economies to grow. Now, as interest rates are set to rise, so too will borrowing costs for these countries. In addition, as the global economy slows, some investors are exiting the market altogether.

Geopolitics

Geopolitics, whilst very difficult for markets to price, remain a key risk factor for developing markets. Events such as the Brexit vote should be looked at not just in the context of the UK, but also from the perspective of CEE and the EU more generally. If Brexit were to occur, CEE member states would be particularly exposed, since these countries are net recipients of EU funds. Accordingly, if there were to be an exit from an EU member net payer such as the UK, this could spark a debate about the annual contributions of other members. This is coupled with other geopolitical situations such as the Syrian refugee crisis - the impact of which has been largely ignored for the past 10 years. Until such impact is assessed and tackled, it will continue to contribute to the rise of geopolitical risk from an investment perspective.

Sanctions and regulation

In Russia and Eastern Europe, from a regulatory perspective, sanctions are the biggest challenge to the market, with business trade opportunities being restricted as a result. Sanctions and financial crime compliance have also added an extra layer of complexity to deals and increased the timeframe needed for a transaction to complete. Approximately 52% of SMEs have had trade finance requests turned down due to compliance checks and costs, illustrating just how powerful sanctions have become.

Micro and regional factors

Developing markets are by no means a homogenous group and many barriers are specific to individual countries or regions. For example, North African countries, such as Egypt, continue to have difficulty accessing international financial markets, even though demand may be high. High taxation is an obstacle to investment in countries such as Poland and Hungary. In Francophone Africa, meanwhile, the region suffers from cultural differences and language barriers (a particular impediment to intra-regional trade – for example, Nigeria's three largest African export destinations make up only 5.8% of its total exports, while the EU accounts for 42%). Furthermore, port infrastructure is often constrained. In Nigeria, the FX foreign exchange controls imposed by the new government have also been a factor in stifling investment and creating distress within the traditional bank lending market. In South Africa, political uncertainty has severely curtailed the syndicated loan market, whilst other African countries have been negatively impacted by isolated events such as terrorist threats.

SOLUTIONS TO THESE BARRIERS

To overcome the barriers facing developing markets, commercial deals often need to have greater DFI, ECA and MIGA involvement, or benefit from other types of risk mitigation tool. With regards to Infrastructure finance, the "B" loan market is becoming increasingly attractive (to Chinese investors in particular), and agencies such as MIGA and other DFIs are taking an even greater role in supporting bank debt, leading to greater innovation in financial product offerings. There has also been a rise in ECA direct lending, an increase in Islamic finance loans in North Africa and the Gulf and a rise in Chinese investment (both via equity stakes in domestic financial institutions and direct lending to corporates).

A further important risk mitigation tool stimulating investment has been Credit and Political Risk Insurance (CPRI), which covers the insured against losses arising from civil and political violence, or credit risk. While this began as a niche area, its capacity has increased by 106% between 2012 and 2016, with the number of insurance companies offering CPRI cover increasing from 33 to 50 in four years. CPRI has now become an increasingly sophisticated market and remains in abundant capacity.

In addition to risk mitigation products, the market has opened up to alternative lending, particularly in Sub-Saharan Africa. As a result, there is now greater flexibility in financing (particularly with regards to repayment options, deferred interest payment and tenor). The challenge is now to unlock the high volumes of local currency liquidity "locked up" within insurance companies, pension funds and high net worth individuals. Historically, these types of investor adopted a passive approach to meeting future liabilities via savings accounts or investment in low yielding government paper and treasury bills. Since the financial crisis, there has been a move away from this tradition towards, for example, investment in longer-dated infrastructure projects. This now extends to investment in asset classes such as high yield, property/real estate, project finance and renewable energy projects. The most recent evolution has been to invest into sovereign and corporate credit, telecoms, and oil and gas.

DISCOVERING NEW OPPORTUNITIES

Despite short-term challenges, there continues to be long-term optimism for lending to developing markets. In addition, whilst certain economies have been severely impacted by the risk factors outlined above, others may be seen to have benefitted. For example, in Central Europe, the rise of liquidity and of local bank club deals continues to be significant. In addition, the loan market is not as exposed to economic headwinds as other financial products such as bonds.

In the GCC countries, opportunities are overcoming the challenges. The return of sovereigns to the loan market has increased demand, which has in turn brought about lower pricing. At the end of 2015, the pipeline in GCC countries was estimated to be US$30bn and is expected to remain in double digits. Whilst GCC countries such as Oman and Bahrain may suffer, other are likely to have adequate reserves to provide them with a safe haven in a challenging economic environment.

The lifting of sanctions on Iran in January 2016 has opened up trading avenues for Iranian companies. Furthermore, the introduction of Islamic structured loans provides for an alternative source of financing to conventional bonds for large corporate entities. This is having a positive impact on the Islamic capital markets and fund management industries.

In Russia, local infrastructure has been developed thanks to the influence of Chinese banks, which will stimulate the economy and more jobs, leading to much needed growth. Large PXF transactions also continue to take place and deal volumes are considerable as a result. The group of lenders willing to join such deals is also on the increase.

Francophone Africa, dominated by the CFA Franc Zone, has benefitted from unifying factors that arise from doing business in this Zone. These include a single, stable currency pegged to the Euro, a single, reliable legal regime (OHADA) and intra-regional trade. Whilst intra-regional flows could be much improved, the opening up of new corridors will likely lead to further developments (such as 'one-stop' border posts planned by 2040).

Across Africa as a whole, there has been a diversification away from European syndicates and towards new pools of liquidity (Chinese banks, institutional investors and credit funds) as well as a growing appetite to lend to African sovereigns. The bond and loan markets are also supporting sovereigns indirectly by assisting with public infrastructure projects, supported by partial guarantees. This is partly due to the influence of Chinese bank investment. In Sub-Saharan Africa, mezzanine lending has also become a popular form of bank lending. Finally, over-capacity in the metals space (especially copper) suggests potential for consolidation and potential acquisitions. These could present interesting opportunities for lenders in the short to medium term.

From an economic perspective, there remains great potential for lending. By and large, private sector debt to GDP is low in many developing countries. Secondly, there has been a secular drop in inflation (deflation) over the last 36 years, and levels have remained at an all-time low since 2000. Finally, emerging markets have a much younger population than their developed market counterparts and will be the drivers of future investment, consumption and growth.

The LMA would like to give special thanks to the speakers who devoted their time to this year's Developing Markets Conference. To view further information about the event, please visit the LMA website: www. lma.eu.com and click on Education & Events/ Past Events.