South Africa Syndicated Loans Conference – key themes

The LMA's South African Syndicated Loans Conference was held at the Hilton Hotel in Sandton, Johannesburg on 12 July 2016. The conference consisted of a series of panels and presentations provided by a variety of senior loan market professionals, spanning different sectors and locations and covering a wide range of different issues and challenges impacting the loan market in South Africa and the wider African region.

The conference itself may be broken down into several key areas for discussion, all of which will be summarised in this briefing. They are:
– economic considerations;
– factors impacting lending; and
– legal risk

Economic considerations

In an environment where record downgrades are expected to be announced by the rating agencies this year, yield curves in countries such as Japan, the UK, the US and Switzerland are flattening, China is demonstrating falling GDP and a reduction in growth, and corporate profitability is declining, there are clear signs that the economy is headed, once again, towards a downturn. Whilst other data such as low US unemployment figures and the high value of global equity markets may suggest otherwise, these types of indicator may be viewed as misleading, particularly in a zero interest rate environment which distorts the market and the fair value of assets. If an economic downturn does materialise, 2017 is likely to witness the return of the central banks to the market, to prop up the global economy via the cutting of interest rates, quantitative easing or, in the case of the Federal Reserve, the scaling back of interest rate hike expectations.

From a pure emerging market perspective, there is some positivity, with portfolio flows into developing markets continuing to hold up. This may be attributed not only to the global search for yield, but also the weaker trade linkages of many SSA countries (excluding SA) with their developed counterparts.

From a macro perspective, the global economic downturn is likely to have a greater impact on South Africa (SA) than other Sub-Saharan African (SSA) regions, because SA has greater links to the global economy. For example, 50% of foreign direct investment into SA comes from the UK, meaning that events such as Brexit cannot be ignored. From a micro perspective, South Africa is also experiencing its own economic challenges, which could result in the country losing its investment grade status. To retain this, it needs to demonstrate an average

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1% GDP per capita growth over a ten year period. Unfortunately, growth forecasts are unlikely to improve in the near future unless important structural adjustments are made. These include reforms, amongst other things, in respect of energy/electricity, labour, and mining. The repercussions of SA's present social instability in particular, should not be ignored. For example, inflation amongst low-income groups is forecast to be 10% by the end of 2016, spelling trouble for wage demands and increasing the likelihood of strike action. Labour reform is therefore urgently needed, perhaps above all else. In addition, whilst the economy as a whole has de-levered, lower income groups have not, incurring large amounts of personal debt at high fixed rates of interest. Individuals within these groups have no job security and are unlikely to receive wage increases that match inflation. Again, this emphasises the need for urgent labour reform.

Factors impacting lending

There has been a significant slowdown in syndicated loan transactions over the course of 2016 and deal volumes are nowhere near the levels of the previous 2-3 years. This can be attributed in part to the slowdown in Western African countries such as Nigeria and Ghana, as well as commodity-linked transactions in general. However, whilst syndicated loan volumes have dropped across SSA, overall loan volumes remain stable, with local banks increasingly providing bilateral facilities in local currencies. East Africa remains a jurisdiction of choice for many lenders look to provide finance outside SA. Other countries such as Ivory Coast, Mozambique and Zambia are also attractive, assuming currency concerns can be alleviated.

In terms of lenders, present sources of liquidity are diverse, ranging from South African banks, international banks (European, US, Japanese and Chinese) and domestic/regional SSA banks. Insurance companies continue to be active, particularly in SA, where banks are often disintermediated. Asset managers are also emerging, but have a tendency to focus on investment grade credits (with risk management strategies outweighing the search for yield). DFIs and ECAs are also becoming more inventive in their credit enhancement strategies as the economic environment becomes more challenging.

Looking to the DFIs more closely, co-operation between these institutions and commercial banks is often seen on project finance transactions, particularly given the present volatile economic environment in which many borrowers are struggling to operate. Whilst there is theoretically a large amount of liquidity available for African borrowers, the enabling environment is often such that commercial banks find it difficult to lend to them. This is one area where DFIs can truly provide a beneficial service, in line with their mandates and lending objectives, by using their political influence to

implement change, assisting governments with the legal and regulatory framework, as well as the establishment of basic infrastructure necessary to enable bankable projects to get off the ground. DFIs can also act as a catalyst for commercial funders, by providing funding guarantees and other incentive mechanisms to encourage commercial banks (and, once the construction phase has been completed, pension funds and asset managers) to lend. Finally, DFIs can also operate in sectors which are traditionally less attractive for commercial banks, such as schools and social housing. Similarly, some sectors are less appealing to the DFI community, for example mining, simply as a result of their strict ESG policies. It is in these sectors that local banks remain the most active.

Whilst there should be enough space for both DFIs and commercial banks, in reality, there can be competitive tensions when they operate in the same lending environment. Understandably, borrowers will pick the most attractive financing solutions, and will choose DFI funding over commercial banks in the event that they are able to offer longer tenors and lower pricing. In these instances, it is important to ensure that commercial banks are not crowded out of the market.

Outside SA, one of the main liquidity challenges relates to the supply of currency, whether from a convertibility or general accessibility perspective. For example, in countries such as Mozambique and Ghana, it is very difficult to access foreign currency. By contrast, there are local currency liquidity issues in countries such as Zambia. Currency

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depreciation in certain countries is also causing problems when it comes to debt service. In addition, many funds lend in US Dollars and wish to receive the same currency in return. They are not in a position to take local currency risk. Whilst borrowers may seek to borrow in foreign currency and then service the debt by converting local currency revenue streams at a later date, this should not be seen as a solution as a result of the volatile rate environment in many local jurisdictions. Problems such as these restrict lending to certain African jurisdictions, regardless of the creditworthiness of the borrower. This is making borrowers increasingly frustrated and is an area in which all parties need to work together to find a solution, particularly because it is a problem endemic across the entire market, regardless of sector.

SA has continued to lead the way for syndicated lending, taking advantage of the surplus liquidity available for top-rated borrowers. That said, competition on strong credits continues to put downward pressures on pricing. There has also been a sectoral shift away from oil and gas, towards, for example, retail and healthcare. Real estate finance, meanwhile, remains an active sector of the market, particularly in SA where there is an established judicial and land system and plenty of Rand liquidity. That said, REF funds are also targeting the rest of Africa, despite challenges relating to regulation, tax and convertability/accessability of currency.

The real estate finance market both in SA and SSA is not large in terms of syndicated facilities, with many transactions being bilateral. In terms of sector, in SA, there are new developments for retail centres, residential and financing of property companies more generally. Office developments are currently less prevalent. Deal flow has slowed throughout Africa as a result of the economic environment with many funds unable to take a long-term view. The deals that are taking place are aggressively priced, and borrowers are pushing for higher levels of gearing and lower levels of pre-lets. Existing deal flow predominantly relates to secondary buy-outs of existing developments, rather than new buildings and therefore the sector, at present, is not assisting with growth from an economic perspective.

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Legal risk

From a legal perspective, as is always the case in many SSA jurisdictions, an understanding of the legal framework is vital before undertaking any form of investment activity. Matters such as transferability of funds, withholding tax, stamp duty taxes, bank licensing requirements and general legislative requirements relating to corporate activity are different from country to country, and make local legal advice a necessity, rather than a luxury. The ability to enforce legal judgements and arbitral awards can also vary, and uncertainty can exist even in those countries where foreign judgements and arbitral awards are legally recognised, particularly where courts pay particular regard to public policy, and choose to apply such considerations broadly. In addition, in common law jurisdictions, much can rest on the individual judge assigned to a particular case. Whilst the use of English law is common on cross-border transactions to mitigate a certain amount of legal risk (English law is seen as particularly beneficial in those countries based on the English common law legal framework) the local legal regimes of different countries cannot be ignored, particularly in the context of land law and security. Speed of execution is often an issue on cross-border transactions, simply as a result of the large number of legal and regulatory issues that lenders need to mitigate or overcome. Time expectations of borrowers, as a result, can occasionally be unrealistic, particularly given that local legal markets are not always deep, and can lack expert counsel. Language barriers can also impact the time it takes for deals to complete.

Whilst local legal counsel is at least available in many jurisdictions, there is also a need for improved skill sets outside legal due diligence, such as surveyors and other types of technical expert. Certain countries which offer real opportunities for lenders often lack this kind of expertise, and are often not easy countries in which to do business e.g. Ethiopia. Nevertheless it is hoped that there will be opportunities in countries such as these in the future as their governments recognise the opportunities that foreign investment can bring. ■

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