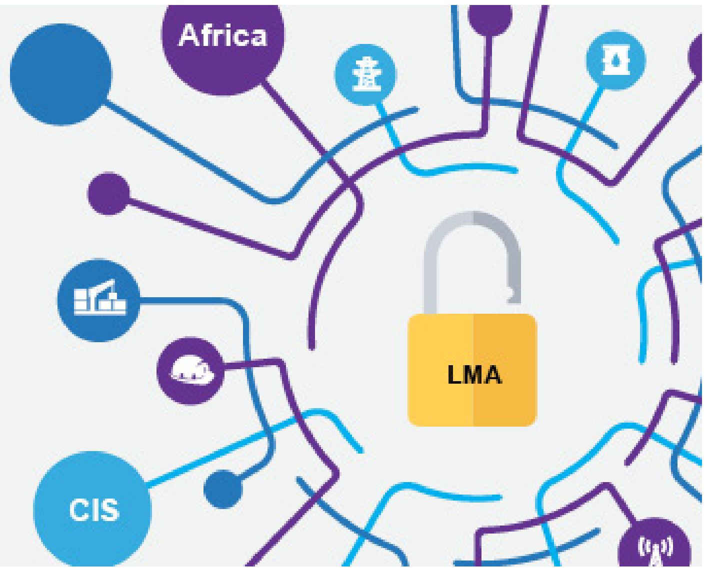
Developing Markets Conference
26 April 2017
London

Unlocking Value



LMA Developing Markets Conference – Key Themes

INTRODUCTION

On 26 April 2017, the LMA hosted its fourth annual Developing Markets Conference at ETC Venues Bishopsgate in London. The event was attended by over 200 industry professionals and featured presentations from, and panel discussions with, over 40 senior market experts. Following feedback from delegates who attended the 2016 conference, two separate breakout sessions were also held, with specialist insights on Africa, and CEE/CIS and the Middle East. The event was a great success and reflects the LMA's ongoing commitment to promoting liquidity in developing markets.

The panels covered a wide range of topical issues, including how loan practitioners can mitigate risk when investing in developing markets, options for dispute resolution and enforcement, the role of FinTech, and how political and security risk may shape investment decisions. In the breakout sessions, speakers gave economic updates for the regions and discussed recent market trends in each of Sub-Saharan Africa, Francophone Africa, CEE/CIS, Turkey and the Middle East.

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

- Recent trends
- Relationships being key to unlocking value
- Importance of risk management and dispute resolution mechanisms
- Future outlook and opportunities

RECENT TRENDS

Despite the availability of large pools of local liquidity and participation from Chinese, Middle Eastern and European investors remaining strong, growth in the syndicated loan market has become somewhat subdued over the past year. The general short-term outlook is therefore slightly negative, but longer term forecasts envisage a more active market, as investors begin to unlock greater value from the region and work through the volatility.

Economic uncertainty

Economic uncertainty has been a significant challenge and a key risk factor for investors in developing markets. Slowdowns in Africa and some parts of eastern Europe have resulted in political frustration; certain African governments have targeted foreign investors and locked down outflows of capital in light of currency reserve problems; CEE/CIS have become increasingly exposed to global market volatility; and an oil price crisis in the Middle East has forced public bodies to cut back on loan issuance. Despite this, institutions have remained robust and continue to build the foundations for a more prosperous market by increasing the use of standard documentation and well structured transactions, encouraging participation from local finance providers, developing appropriate risk mitigation tools and engaging proactively with FinTech initiatives.

Liquidity

Liquidity is available, but polarised across the developing markets. That said, many developing market countries have seen a steady increase in local currency financing and more participation from local institutions which, through greater perceived market confidence, have brought more private sector capital and hopes of greater institutional capital. Financing in local currency is also attractive to borrowers since (although historically more expensive) it avoids foreign exchange risk, hence why the region has seen a recent push by ECAs, DFIs and international banks working with local lenders to fund projects. Although pension funds remain the most obvious source of local currency, long-dated lending, very few have the mandate under their regulatory regimes to enable such investment, and this source of financing remains largely untapped.

That said, certain countries in Sub-Saharan Africa, have faced either a foreign currency shortage (Nigeria and Egypt being prime examples) and/or severe currency depreciation (e.g. Mozambique and Ghana). Currency depreciation has, however, resulted in high interest rates payable on both local and external debt, resulting in certain (albeit risky) investment opportunities for those who understand the FX implications.

A particularly interesting trend in South Africa has been recent large acquisitions of US targets by South African businesses – an indication of strong South African businesses looking for foreign denominated assets and foreign currency revenues. However, this is fairly unique to South Africa – whilst acquisitions do take place in other Sub-Saharan African countries, they take place on a much smaller scale and tend to be family owned businesses.

Francophone Africa, meanwhile, has continued to benefit from unifying factors that come about from operating in the CFA Franc Zone including a single currency, a common language, a reliable and coordinated single legal regime (OHADA) and strong intra-regional trade. There is still much to do to develop the market, and, whilst language remains a barrier for many origination teams who would otherwise have the risk appetite to invest, with the more established Anglophone African countries experiencing economic difficulties, opportunities for smaller countries within the region are becoming increasingly apparent.

Fragmentation in CEE/CIS, meanwhile, and resource reallocation towards central Europe have created a two-tier market where countries such as Poland, the Czech Republic, Slovakia and Romania have abundant liquidity, particularly for five-year deals, while other Balkans remain very much illiquid. The perceived political risk in the region has not however deterred investors and good deals continue to be oversubscribed.

UK, French and Asian investors have provided much of the liquidity in the Middle East since local banks have struggled to compete and source the necessary capital to lend.

FinTech

FinTech has driven positivity in developing markets as technologists leverage on the lack of legacy infrastructure that inhibits progress in developed economies, take advantage of the lower value people place on privacy and utilise the much higher risk appetite of regulators in order to create better functioning markets for the future. This does not come without its challenges, one of which includes the reliance on trust between counterparties.

Non-performing loans

The CEE market has been the predominant region for NPL activity, where the ratio of NPLs across the total lending book has risen to 20% in some countries. However, in comparison to countries such as Italy, the volume is still very low. Opportunistic investment banks and private equity funds have been the dominant presences in this space, in partnership with local debt collection firms on smaller deals. By contrast, the secondary market in Africa is still very much under-developed.

PRICING, DOCUMENTATION AND RELATIONSHIPS

In Western Europe, intense competition between lenders and the downward pressure this has put on pricing have made developing markets much more attractive from a yield perspective, despite the uncertainty surrounding economic and political stability. In CEE/CIS the search for yield has pulled institutional investors to the region, and political risk has compounded the potential benefit by pushing yields a little higher. However, unlike the Middle East where international banks have lower funding costs and therefore dominate the market, local banks in CEE/CIS can fund more cheaply than international lenders, and this has led to increasingly aggressive pricing. The focus for international lenders has therefore been the Middle East, where parallel loan markets for local and international investors have been created to reflect differences in their lending capacity and style of relationship management.

A common theme across the developing markets is that relationships are the major driver of deals and are key to unlocking value from the region and the borrowers within it. In many situations, these relationships are equally important between lenders, particularly where local, international and development banks participate in the same transactions.

For relationship driven deals in CEE/CIS and Turkey, lenders have moved away from negotiating heavily on all aspects of documentation and tend to focus only on the main economic drivers in order to cultivate better relationships and extract much needed ancillary business. In these situations, yield plays less of a part in a deal, since take and hold relationship opportunities can make up for any shortfall in pricing. From a structuring perspective, whilst the regulatory environment in each jurisdiction is different, resulting in differences in preferred deal structure and documentation practices, the market has seen greater use of project finance structures to attract liquidity. In central Europe, Schuldschein is expanding, and Sharia compliant financing is becoming more common in the Middle East and North Africa. In Africa, meanwhile, to provide liquidity for family-owned businesses which are reluctant to dilute equity, mezzanine debt is becoming more common, as are innovative funding structures designed to provide more flexible forms of support. Smaller projects continue to struggle to find finance, but DFI programmes have been introduced, aimed at resolving some of these issues. Standardised documentation remains highly desirable for the majority of lenders on cross-border transactions, but less so on domestic deals.

Reflecting the increased liquidity for top borrowers in the CEE region, there has been a growing tendency for documentation in these countries to become more aggressively negotiated, for example in the form of relaxed equity cures and fewer covenants.

RISK MANAGEMENT AND DISPUTE RESOLUTION

Risk Management

Recent trends indicate a growing appetite for emerging market risk, especially from non-bank lenders. Despite this, there remains considerable concern in relation to managing economic and political risks, as opposed to credit risk, when investing in developing markets. Furthermore, there are significant pools of liquidity available from local banks and institutional investors who may not have tapped these markets before. However, given that this capital has not previously been invested in loans, investors are particularly cautious. In this respect, mitigating the risks for new lenders is imperative in order to capitalise on these liquidity pools and drive growth in emerging markets.

In terms of risk mitigation tools, these come in various guises, from products provided by ECAs and DFIs to MIGA insurance guarantees and private commercial insurance. Financial products such as derivatives (CDS/TRS) and capital market instruments can also be used to mitigate credit risk, and can also be a regulatory "light" solution if bespoke and privately placed.
Currency risks are also regarded as an area of concern for investors. In Africa, it has been suggested that this risk should be mitigated through infrastructure investment being conducted in local currencies, rather than absorbing additional FX risk. In this respect, a number of DFIs have also prioritised financing in local currencies, as a means by which to mitigate exchange rate volatility. Finally, the market continues to see the use of B-loan products (or a blend of B-loan accompanied by a MIGA guarantee), by which commercial banks seek to reduce convertibility and transferability risk for certain transactions.

Dispute Resolution

There are additional risks prevalent within developing markets in relation to dispute resolution. One key issue relates to political interference in local litigation matters, where local courts may face undue pressure to rule in favour of state-owned entities, thereby facilitating corruption and injustice within the legal system. Litigation in emerging markets is also hindered by a lack of expertise on behalf of the local judiciary, particularly in relation to complex financial products, as well as the difficulty in enforcing local judgments internationally.

Given these issues, unless the transaction in question is entirely domestic, parties may wish to consider arbitration as an alternative means of dispute resolution. The ability to choose the tribunal enables parties to guarantee that decision-makers will have the requisite expertise, and eliminates the risk of unfair decisions being imposed by the local judiciary. Furthermore, the majority of countries are signatories to the New York Convention, with some exceptions, for example Sierra Leone and Namibia. This allows for arbitral awards to be enforced internationally, and provides a degree of certainty and consistency in relation to the international recognition of decisions made within developing markets.

Despite these benefits, there are some disadvantages to arbitration. Whilst the process is generally considered to be quicker and cheaper than litigation and parties may therefore be encouraged to pursue this form of dispute resolution as a more efficient and economical alternative to lengthy litigation proceedings, this is not necessarily the case: finding a tribunal with the necessary experience can be time-consuming and cost-intensive, and the appeal process has been a significant cause for contention. These problems are exacerbated by the absence of emergency injunctive relief or a summary judgment procedure, making arbitration an unlikely choice for parties where urgent relief is needed; however, there is evidence that this may change in future. In addition, some courts are quick to invoke a public policy exemption, which can result in arbitral awards failing to be enforced in countries in which they should be recognised.

There is a third form of dispute resolution which is rarely used by parties, but which can resolve some of the issues associated with litigation and arbitration: this form is known as investment treaty arbitration, and differs from commercial arbitration. This option does not need to be provided for within the loan agreement. Further, the claim can be made against related entities and is therefore not restricted to the debtor. However, this form of dispute resolution should be agreed upon at the time of making the investment, and before any dispute or event of default is anticipated, in order to ensure that it can be used effectively.

Finally, one of the key recommendations when planning for potential disputes is to instruct a dispute lawyer early on in the process. If a claim is served outside the jurisdiction of choice, challenging this can be a slow and expensive process. Moreover, failure to do so could leave parties defending claims in unfamiliar courts. There have also been instances of defaulting borrowers successfully applying for injunctions, thus preventing their lenders from taking important recovery steps. In this situation, the lender would need to request that the injunction be set aside; but this provides the borrower with the opportunity to appeal, during which time they can seek to remedy the default or remove secured assets. Finally, lenders should also be wary of inadvertently waiving defaults as a result of delayed action.

The key point to note is that these risks should be analysed at the outset of the transaction, through careful consideration relating to the type of borrower (sovereign immunity can come into play with regards to sovereign borrowers and waivers from immunity should be carefully drafted), the location and identity of any secured assets, the desired form of dispute resolution, the availability of emergency interim relief, the nature of process rules for the relevant country and the cost of enforcement. Ultimately, the goal for any lender is to maximise recoveries – consequently a negotiated settlement may be the better option.

FUTURE OUTLOOK

A recurrent message highlighted throughout the conference was the positive future outlook for developing markets, and the degree of opportunity available for borrowers and lenders located in, or transacting with, developing market economies. There is a significant capacity for growth across the region, facilitated by an increasing appetite for (and understanding of) developing market risk, heightened global political tension, causing lenders and borrowers to consider less mainstream economies for investment opportunities, and the increasing technical expertise of leading FinTech economies such as China and India driving growth in these markets.

Africa

The African markets currently rely on three main economies to drive growth in the region: South Africa, Nigeria and Egypt. However, in order for sustainable growth to be maintained, there needs to be increased consistency within these countries, which can be partially achieved by stabilising the exchange rate within these key economies, in the hope that this will result in a consequential knock-on effect on other local African markets. In the LMA's developing markets survey, participants identified energy and telecoms as the two sectors fundamental to driving future growth in the region. However, speakers at the conference suggested that, while telecoms has been instrumental in Africa's development in the past, this progress has become stagnant, and agriculture and energy are likely to be the key sectors of focus going forward.

Although Africa has traditionally been seen as the remit of DFIs, the continent is starting to see interest from investment funds. The key challenge to remedy going forward is that, despite an availability of capital, there are insufficient project volumes. Furthermore, secondary markets do not exist in some of the smaller countries and there is therefore significant potential for these countries to develop.

Francophone Africa, or the CFA Franc Zone, consisting of UEMOA and CEMAC, has been highlighted as a key area for investment opportunities. Currently, one third of capital market issuance is done by

Francophone countries, as are some significant sovereign, commodity finance and infrastructure finance transactions, and Moroccan (followed by French) banks lead the way in relation to market share by assets and profitability. Further growth in this region is expected (there are predicted to be 500 million French speaking Africans in 2050) but could be further facilitated by a uniform contract under the OHADA regime, supported by more extensive case law on its interpretation. There have also been recommendations for a uniform tax code. The availability of standardised documentation would encourage those who do not presently invest in the region to do so, although the current demand for such documentation from existing lenders is questionable. Furthermore, the fiscal pressure on CEMAC is enormous and there are some fears that CEMAC will exit the CFA Franc Zone.

CEE/CIS

There is hope for increased deal activity for CEE in 2018 and the potential for greater bank consolidation. In particular, activity in Romania is likely to remain consistent, Hungarian corporate activity will slow, lending to Russia is likely to improve and Turkey's activity will be credit and borrower dependent (with lending to FIs likely to remain attractive). The latest market indicators suggest falling inflation expectations in the CEE/CIS region more generally, and the likelihood of FED rate increases is also falling, providing a positive outlook for future growth in these economies.

Middle East

Challenging economies within this region include Oman and Bahrain, whose ratings are lower (with potential for further downgrading) and where the capacity of local banks is limited and NPLs are growing. Further, the pipeline is weaker and volumes will only be sustained by some large ECA deals. However, the loan market is expected to be supportive in the medium term.

Within the Middle East, the sectors of focus going forward are expected to be sovereign and GREs and oil and gas, with potential for growth in real estate. In relation to the key markets, the country with the lowest credit default swap (CDS) levels, strongest credits and minimal oil dependency was UAE, although the latter of these points is disputed somewhat within the market. Similarly, in Qatar, which is now rated AA, oil accounted for only 48% of government revenue. In contrast, Kuwait had the lowest breakeven oil price. Saudi Arabia is undergoing privatisation of key industries.

The LMA would like to give special thanks to the speakers who devoted their time to this year's Developing Markets Conference. Click here to view the agenda, speakers and video clips from the event. Click here to view the presentation slides.