Developing Markets Conference - key themes

26 April 2018

ETC Venues, 155 Bishopsgate, London, EC2M 3YD

On 26 April 2018, the LMA hosted its fifth annual Developing Markets Conference at ETC Venues, Bishopsgate, in London. The event was attended by over 230 industry professionals and featured presentations and panel discussions from over 35 senior market experts. During the afternoon, two separate breakout sessions were held, with the first focusing on Sub-Saharan Africa and the second on CEE/CIS and Turkey.

The panels and presentations covered a wide range of topical issues, including the general outlook for the developing markets, predictions for foreign investment flows, commodity price volatility, ECA financing and the impact of fintech and disruptive technology. In the breakout sessions, speakers gave economic updates for the applicable regions, and discussed recent syndicated loan market trends in each of Sub-Saharan Africa (including Francophone and Lusophone Africa), CEE/CIS and Turkey.

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

- Trends, challenges and "hot spots"
- External challenges currently faced by the market
- New horizons and innovations

Trends, challenges and "hot spots"

There is continuing strong lender appetite and a good level of liquidity seen across the developing markets. This can be credited partly to a recent rise in oil prices and high levels of asset availability. The Middle East and GCC have seen an upturn in commercial lending activity as a consequence of the bounce-back in oil prices over recent months. This uptick in the commodities cycle has also benefitted several key African jurisdictions. Nevertheless, a handful of key geographies and sectors are experiencing geopolitical constraints and tensions caused by fluctuations within the commodities markets, creating cyclical pressures for certain sectors. These pressures are accompanied by the backdrop of additional sanctions imposed by the US on Russia. Notwithstanding these frictions, investor interest in developing markets continues to increase as the 'hunt for yield' widens in scope and depth. The nature of such interest tends to vary according to lender type, with DFI appetite continuing in the more challenging jurisdictions, regional and domestic banks stepping up to support mid-market borrowers and international banks focusing on higher quality credits.

Despite geopolitical challenges, growth is still prevalent in the emerging market economies. Furthermore, economists are predicting increases in world trade volumes. Nevertheless, there are economic headwinds which will need to be overcome. Aggressive tightening in central bank policies, the escalation of trade tariffs and cross border tax competition is likely to flatten growth rates. In CEE and CIS, for example, structural reforms will impose change on the market, in the form of labour reforms, tax levels and heighted internal macroeconomic policies.

In countries where political instability remains, or has become, an issue, some commercial lenders are holding off on extending credit to new borrowers, and even suspending existing relationships. In addition, whilst certain jurisdictions and borrowers are becoming more sophisticated, other countries are being overlooked. This is primarily due to their comparatively "riskier" lending profile, along with a lack of commercial lender involvement to date. This, in turn, is making them less attractive propositions for lenders, despite their fast growth and general potential. This has resulted in local banks having to step into certain transactions, for example, to provide support for longer term financings. Even in those countries where there is some international bank support, it is often the domestic banks who assume the greatest degree of risk. Finally, although liquidity levels are positive, the rise of debt levels in developing markets needs to be managed with caution. If debt comes in too early in a developing country's economic lifespan, this can affect the jurisdiction's capability to implement effective policies. Higher global interest rates, in particular, may lead to destabilisation of those economies where foreign debt levels are highest.

CEE/CIS and Turkey

Central Eastern Europe (CEE) is rapidly moving away from being considered a "developing" market. Demand for deals is surging, and borrowers are becoming more sophisticated. This is leading to increasingly borrower friendly terms, for example tenors for as long as six years and sub-investment grade loans without covenants. In addition, real estate is becoming a more attractive sector for lenders in the region, especially now that pricing is decreasing for corporate transactions. This may be seen to be partly as a result of Russian liquidity permeating the CEE region (Russian banks having emerged as true global players, lending in multiple currencies), coupled with the fact that there is a lot of local bank, local currency liquidity. CEE is also experiencing actual growth exceeding potential growth, a positive sign for the market. There is still concern, however, over levels of inflation, with inflation likely to accelerate this year due to the demand-pull of domestic inflationary pressures and the cost-push of higher wages and imported inflation from the Euro area.

The Commonwealth of Independent States (CIS) and CEE have, in the last year, experienced a combined 7% increase in lending. For the CEE region, this is framed by a backdrop of high economic growth between 2007 and 2017 in Poland (33.3%), Czech Republic (14.5%) and Hungary (10.9%). However, compared to pre financial crisis, overall volumes are lower: in 2008, in CEE, there were €157bn of transactions, whereas in 2016 there were €66bn. When comparing the current markets in CEE and CIS to the markets ten years ago, it is evident that they are now more contained, with a smaller lender pool, but are also more relationship driven, with a greater focus on ancillary business within the local markets. However, the factors which have remained largely unchanged throughout are those relating to deal terms, pricing and overall liquidity levels.

In Turkey, GDP growth picked up in 2017 following the introduction of stimulus measures, however, general overheating of the economy (and depreciation of the lira) led to a surge in inflation. External imbalances remain a growing vulnerability for the country (external debt as a percentage of GDP now stands at over 50%) but on a positive note, public debt remains moderate and the banking sector is largely healthy.

Africa

Looking to Africa, in the South African market, international banks are lining up to provide M&A financing. Indeed, several key South African corporates have now outgrown their domestic markets, and the promise of further ancillary business has piqued the interest of the international banking community. Despite several credit events having taken place in the South African debt market in recent months, international credit institutions have continued to put capital to work, by providing shorter tenors and greater flexibility within documentation. In tandem with this, local banks have

weathered the storm of recent political and economic uncertainty and have been plugging liquidity gaps by offering long-term financing in local currencies for infrastructure and development financings, meaning that external events have not had as much of an impact on core borrowing needs as was originally feared. Domestic banks are also more comfortable with domestic geopolitical risks, because they have a much firmer understanding of South African borrowing needs, and are also capable of maintaining stronger and lasting banking relationships. Many South African corporates have domestic "lenders for life"; however, the more corporates grow, the more likely it is that they will turn toward the international debt markets. Finally, South Africa has also recently become a focus for Japanese investment.

In addition to South Africa, there are two other countries which have made up a significant proportion of African loan volumes historically. Both of these, at the present time, has its own distinct challenges to overcome: Nigeria, having suffered as a result of dwindling oil prices and a reduction in foreign currency reserves; and Egypt, which has gone through substantial political turmoil and is at the tail end of a sizeable IMF rescue package. However, the displacement of capital across the developing markets, with sanctions and geopolitical events causing capital bound for Russia, and to a lesser extent Turkey, to be diverted, has meant that additional liquidity is increasingly headed towards these countries once again. As a result, some large M&A deals are expected to take place in Nigeria in 2018/2019, and private sector investment is anticipated to increase in Egypt, allowing DFIs to take a step back from the country. Such increased liquidity is a positive sign, especially since a great deal of investment potential remains untapped on the continent, with an estimated US$120bn of unmet demand in respect of trade finance, and a further shortfall of US$60bn in relation to infrastructure projects.

In the context of African "frontier" markets, there remain many opportunities, but a lot that needs to be done by lenders to enable them to understand and "de-risk" viable opportunities. A key issue, however, is that many firms still do not have a viable 'Africa Strategy': awareness of opportunities may be at an all-time high, but loan origination lags considerably behind. Whilst Africa may be a perceived high risk in terms of lending, basic knowledge of the relevant market is often key to mitigating such risk.

Francophone and Lusophone Africa, in particular, remain challenging for international lenders. In the context of Francophone Africa specifically, around 60% of businesses are enterprises who do not see the need for loans, and in terms of bankability there is often difficulty with poor accounting systems, although this is slowly improving. For Lusophone Africa, a general lack of knowledge continues to be problematic: often African banks know less about Lusophone Africa, and as with Francophone Africa, the language and lack of cultural understanding creates barriers. This does not mean to say that such countries are necessarily riskier, but they do require a better understanding of the market.

External challenges for the market

Geopolitics

Geopolitical issues in CEE, Russia and Turkey have resulted in some lender retrenchment. In these circumstances, local banks have plugged the gap to finance mid-sized companies. These pockets of behaviours are event driven - for example in Turkey, where political turmoil has meant that activity for the international banks in this jurisdiction has been limited. Nevertheless, Turkey saw growth of 7% in 2017, partially due to the government injecting liquidity. However, whilst political risk should not be overlooked, it is also important to avoid over-inflating or over-estimating the scale of risk in jurisdictions like Turkey, and investors and rating agencies must also learn to educate themselves in country specific behaviour and the tie to credit risk.

Sanctions

In countries such as Iran and Russia, sanctions have posed serious issues for global lenders active in the jurisdiction. This has led in some cases to investors resorting to indirect financing options which, in turn, can cause problems when carrying out due diligence. However, when compared to 2014, the latest round of US sanctions is expected to be less disruptive to the Russian economy, since external funding needs are now much smaller. Estimates are that the latest sanctions list will impact, at the

maximum, approximately US$32bn of dollar denominated Russian corporate debt, either directly or indirectly. By contrast, post-2014 sanctions, Russia’s gross external debt fell by US$200bn.

US-China trade war

An additional challenge for developing markets is the growing trade tensions between the US and China. With the leader of the 'free world' being seen to advocate a more insular economic stance, and a communist state seemingly renewing efforts to increase globalisation, confusion as to the ultimate direction of global trade is understandable. With such uncertainty, it is essential to consider the impact that these tensions may have for less advanced economies. Growth in Africa, for example, is reliant upon, in many respects, demand for key commodities such as aluminium, gold and oil, such demand providing incentives for lenders to invest in a variety of economically beneficial projects, including long-term investment in infrastructure. A trade war between the US and China could spell disaster for global growth, reducing demand for commodities, and resulting in cost-push inflation for key developing economies. This would cause lenders to become more risk averse, and would lead to a general slowdown in economic growth due to reduced credit availability. This is likely to hit developing economies hardest, due to a lack of economic diversity and a reliance on commodities trading to provide economic stimulus. In order to avoid such challenges, it is important to remember the need for economic diplomacy and for the international community to engineer tailored solutions to assist developing jurisdictions in building more sophisticated and diversified economies. This may be achieved through continued investment in infrastructure and other projects.

New horizons and innovations

Whilst innovation is being seen in the corporate loan markets to a greater extent, it has been slower to catch on for businesses than it has been for consumer products. This may, in part, be due to reluctance from the industry as opposed to lack of opportunity. However, whilst perhaps slow to catch on, fintech does pose interesting opportunities for developing markets, including improving access to liquidity. One such example is the creation and implementation of an 'e-bartering' system for SMEs, enabling them to use escrow accounts to connect separate trade flows and allow them to be paid in local currency, via Blockchain. Creations such as Blockchain and the "Cloud" are also ideally placed to provide solutions to other types of problem inherent to developing and fragmented markets, for example, by resolving issues relating to AML checks and the satisfaction of KYC requirements. Use of sophisticated AI and other technology could make AML and compliance checks much more robust and enable documentation to be shared amongst lender institutions. One such initiative is the 'African Customer Due Diligence Repository', an online platform which extracts data from central banks and other registrars to enable faster compliance checks and to lower the costs involved in conducting them.

There is little doubt that fintech solutions are needed now more than ever, particularly in the context of compliance: a key concern for many institutions is that the costs of failure to meet compliance standards are simply too high to be sustainable. For example, since the global financial crisis, banks have paid over US$320bn in fines. The international community must therefore work to find solutions to these issues, not only by working with regional banks and more sophisticated borrowers to develop better relationships, but by embracing fintech solutions and thereby bring about lasting results to what are often very complex issues.