East Africa Syndicated Loans Conference – key themes

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The LMA's East Africa Syndicated Loans Conference was held at the Windsor Hotel in Nairobi, Kenya on 16 August 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 impacting the loan market in the East African and wider Sub-Saharan African (SSA) region.

The Conference itself may be broken down into three key areas of discussion, all of which will be summarised in this briefing. They are:
– the economic impact;
– the lending environment; and
– market challenges.

The economic impact

Three economic considerations are worthy of mention that are likely to impact the development of the syndicated loan market in East Africa in the second half of 2016 and beyond. These are:

Foreign currency illiquidity and FX volatility

As a result of falling commodity prices and lower demand in destination regions such as the EU, export receipts have fallen across SSA. This has resulted in a general shortage of foreign currency in certain SSA economies, as well as the depletion of foreign currency reserves. Consequently, many local banks are unable to participate in foreign currency transactions and borrowers are looking to international lenders to provide this liquidity (historically provided at lower pricing to local currencies as a result of the lower cost of funds). That said, the provision of USD by international lenders to borrowers may create problems surrounding both convertibility and transferability, especially given the volatility of FX markets in 2015 and 2016. This may well result in further currency controls in certain economies.

Finally, from a syndicated loan perspective, local banks are anticipated to increase their foreign currency borrowings and this could be a source of activity for the market in the coming months.

Global macro-economic factors

Factors include monetary policy decisions by the US Fed, economic slowdown in China, falling commodity prices and Brexit. Events such as these are likely to impact foreign direct investment (FDI) into SSA going forward. That said, any reductions in FDI are unlikely to be consistently applied across individual countries, but rather will vary depending on the country. For example, whilst FDI is expected to decrease in some countries, including Nigeria, FDI into Kenya is growing at a faster pace than in any other country in Middle Africa.

The macro-economic factors listed above are also impacting tax receipts across East Africa and widening fiscal deficits. According to Ecobank research, the fiscal deficit across East Africa is expected to increase to 8% in 2016, from 7% in 2015. That said, the deficit remains less than in certain Western African economies such as Ghana, and Southern African economies such as Mozambique and Zambia.

Weakening asset performance of commercial banks
Commercial banks are expected to see increased non-performance of assets in 2016, as a result of macro-economic challenges. This may result in a period of subdued lending activity in the coming months, as banks seek to manage their portfolios rather than engage in new issuance. There is also likely to be a continued move away from certain sectors where bank lending concentration has historically been high – oil & gas for example.

The lending environment

The last seven to eight years have seen some interesting developments in the East African loan market, most notably increased capacity for larger deal sizes (two deals of $500 mn and $750 mn recently closed, albeit both for state-owned enterprises (SOE)). This has led to the development of a genuine syndicated loan market, with both international and local banks participating. However, whilst the pipeline remains plentiful, there continues to be a relatively low conversion rate. In addition, transactions continue to take longer than desired to complete.

From a lender perspective, there is large appetite from international banks to participate in syndicated loan transactions in East Africa, with such banks able to offer borrowers access to USD liquidity. As a result, the syndicated loan market remains predominantly a USD market. Whilst the syndicated loan market market remains relatively new to local banks, knowledge is improving, and the increased demand for local currency tranches has led to greater participation by local lenders. Local banks are certainly active in the loan market generally – of the US$55bn of assets within the East African banking sector, loans make up over 57% of that total.

From a borrower perspective, the largest recent deals have been from SOEs, as opposed to the private sector. Private sector borrowing is expected to pick up, as borrowers experience the positive impact of improved infrastructure. In the interim period, investment grade borrowers are tapping the bond market, whilst smaller corporates are satisfying their capex requirements via local bank bilateral funding in local currency.

From a country perspective, Kenya, as the largest economy in East Africa, benefits the most from syndicated lending. However, other jurisdictions such as Tanzania, Uganda and Rwanda are also seeing the advantages. For example, eight to nine years ago, Rwanda was a very nascent market. However, efforts to improve its legal framework, registries, government efficiency and its business and financial environment more generally have greatly assisted its development. As a result, it is not uncommon for local banks to be in a position to fund $100 mn transactions and local syndications are also taking place.

Looking to sectors, unsurprisingly, infrastructure continues to produce investment

opportunities (particularly in the form of power-related projects). In addition, fast-moving consumer goods (FMCG), construction, agriculture, healthcare and manufacturing remain active. Direct loans to SOEs are also evident (i.e. outside the project finance structure), as is direct investment into multilateral organisations and development finance institutions (DFI).

Although the secondary loan market remains in its infancy, the market is developing, and cross-regional activity is increasing. In addition, some investors are participating in loans that have been repackaged into structured products – however, these tend to be assets which may be easily benchmarked and traded. More commonly, straight loan transfers are between banks and these are often centred on existing relationships. Non-bank lenders such as debt funds and insurance companies are also seeking out loan assets, either via participation in the primary market, or new innovative structures. Non-bank lenders in their various guises are now becoming an established and valued source of supplementary liquidity, with great potential for flexibility. Furthermore, some non-bank lenders are capable of being much more inventive with regards to matters such as pricing, structure and exit strategy, and in that respect they differ in many respects to banks. Such investors are also often able to see investment opportunities outside those which traditional lenders would view as bankable. That said, such deals do need to be actively sourced and researched, and both patience and an understanding of the local market is vital to ensure such ventures are a commercial success. Finally, whilst there is a huge amount of liquidity in pension funds, statutory limitations placed on their investment activity often curtail their ability to invest in loans.

Market challenges

Despite the fact that numerous positive developments are taking place in the loan market, challenges continue to exist. From a commercial perspective, issues surrounding currency volatility remain at the forefront and ways should be found to mitigate FX risk, whether that be via the development of the local FX derivatives market or otherwise (e.g. via greater DFI involvement in this area).

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From a legal risk perspective, the greatest concerns centre on the perfection and registration of security, notably in relation to land. In particular, registries (such as those set up to deal with land or security registration) may be cumbersome and even inaccurate. Documents may have been lost and prior (unregistered) charges may exist. Lenders should be aware of these types of issues, undertake detailed due diligence alongside local counsel, and ask appropriate questions of the borrower. Whilst efforts are taking place to improve the situation (Rwanda is a positive example of this, where a recent land census has resulted in an electronic registry for both land ownership and security) many registries remain in disarray.

Continuing with the theme of legal risk, certain East African jurisdictions have also implemented new legislation, which occasionally presents problems from a lending perspective. For example, Tanzania has seen significant changes to its tax regime, including the implementation of VAT on service-related charges by banks. Whilst this does not apply to interest payments, there is still uncertainty surrounding bank fees, including the extent to which the VAT on such fees can be passed on to customers. In Uganda, meanwhile, new company and insolvency legislation is now operational, but remains largely untested. Amendments are anticipated to the country's Land Act, which could result in a lending environment that is more debtor friendly. Currently, the one legislative issue causing particular difficulty from a practical perspective (where the borrower is an individual) is the requirement to obtain spousal consent to mortgages. In Kenya meanwhile, all administrative, constitutional, company and insolvency laws have been replaced in their entirety in recent years – over 800 new laws and regulations in total. In addition, further legislative changes are anticipated, including a potential cap on interest rates. Whilst a large number of these laws are experiencing teething problems, there are some positive signs, with the legal community uniting in some cases to lobby for resolution.

More generally, deal execution remains problematic, particularly for infrastructure transactions that require long-tenored funding and carry construction risk. Many deals remain 'unbankable ' whether because of poor structure, lack of quality technical advice, poor governance or a lack of sponsor/off-taker/management track-record. All things combined, the risk of lending to such projects is often too high for banks to get comfortable and borrowers often fail to find ways to circumvent problems (particularly the social aspects of ESG) at the very beginning of a project. In addition, in the current economic environment, many banks have a lower risk appetite than has historically been the case – this has resulted in tighter covenant packages, heightened due diligence and requirements for greater sponsor support in the form of equity or otherwise.

Looking specifically to project finance, regulatory frameworks in certain jurisdictions are not easy to comply with, and more needs to be done to centralise government decision-making processes. Whilst the role of government in project finance varies from project to project, its role in some guise is often vital, even if not in the capacity of a legally enforceable guarantee. At the very least, government can provide valuable comfort to lenders, particularly regarding the removal of political risk. Where such support is not adequate, various insurance products are also available. At the present time, (with the exception of certain key successes such as Kenya Power, South Africa's renewable energy programme and the Get FIT programme in Uganda) the process is not generally conducive to lending or doing business. Some of these issues can be mitigated via insurance, or the participation of DFIs, export credit agencies, or multilaterals, via co-financing arrangements with local banks, technical assistance programmes, local currency tranches and even equity funding. These types of institution are of particular assistance to borrowers in jurisdictions that have a low credit rating, or in sectors where commercial banks are not able to participate.

Finally, since syndicated lending is still in its infancy compared to the European market, there remains a lack of understanding amongst some borrowers, local law firms and even lenders regarding the syndication process and the workings of the international finance markets generally. Unnecessary delay can therefore be caused by all counterparties to a transaction. Greater education would undoubtedly be helpful, not just in relation to documentation, but the syndication process more generally. Furthermore, greater technical and professional expertise is required, and accounting and governance practices should also be improved. Lenders could also do more to market the benefits of the syndicated loan market and the advantages it can provide to borrowers seeking to develop and grow their businesses.

The LMA would like to give special thanks to the speakers who devoted their time to this year's East Africa Syndicated Loans Conference. To view the agenda, speakers and presentations, please select the conference under Education & Events/Past Events on the LMA website: www.lma.eu.com.