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JULY/AUGUST 2019

MEASURING AND PRICING INTANGIBLES

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From The Editor

Dear Reader,

As global trade tensions ease, monetary policymakers continue to sing from the same dovish hymn sheet, the macro environment began to stabilise after a mixed Q2, with EM asset prices showing signs of improvement – particularly on the local currency credit front – as we move into to second half of the year.

But underneath the surface, cracks are beginning to emerge in developing (real) economies; one need look no further than the BRICS countries which, for the first time in many years, saw synchronised flatlining or negative growth.

Against that backdrop, understanding risk – both how to measure it, and how to exploit it – becomes more important than ever, something we explore in the opening pages of this issue. We also look at how CFOs and treasurers who find themselves in softer economic contexts get on with funding innovation.

We hope you enjoy reading the July/August issue of the Bonds & Loans magazine.

Kind regards,

Jonathan Brandon
BONDS & LOANS

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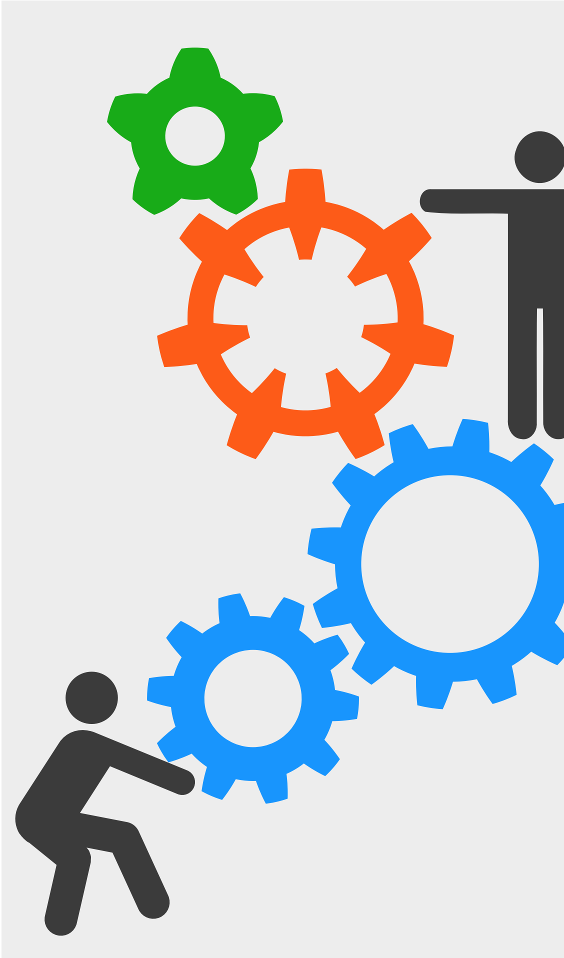
GLOBAL THEMES

MIDDLE EAST & TURKEY

Capturing Human Risk's Influence on Credit Risk Remains Elusive – But That Might Be About to Change



ESG – shorthand for environmental, social and governance – considerations are increasingly being prioritised by organisations, investors and lenders alike. But quantifying its influence on credit risk and funding is proving to be quite elusive. A group of former finance professionals and academics is trying to change that by putting "intangibles" like human risk, corporate culture and values at the centre of that relationship.

For some, ESG is a way of generating non-financial benefits and outcomes; for the more cynical, it's a means to appease shareholders, investors and regulators. ESG has become a catchall for myriad business practices aimed at delivering non-financial outcomes – improvements to the environment, community and social health, or improved organisational culture, for example – while at the same time improving shareholder value.

Indeed, a growing body of research suggests there is a positive correlation between long-term capital gains among organisations, and their prioritisation of ESG factors – one of three reasons it has become something of a fad for investors.

The other two: regulation, with governments increasingly compelling companies to disclose greenhouse gas emissions and submit to other non-financial reporting obligations; and reputation, whereby investors can gain a competitive edge by playing to the shifting moral sentiment of new – younger – capital holders.

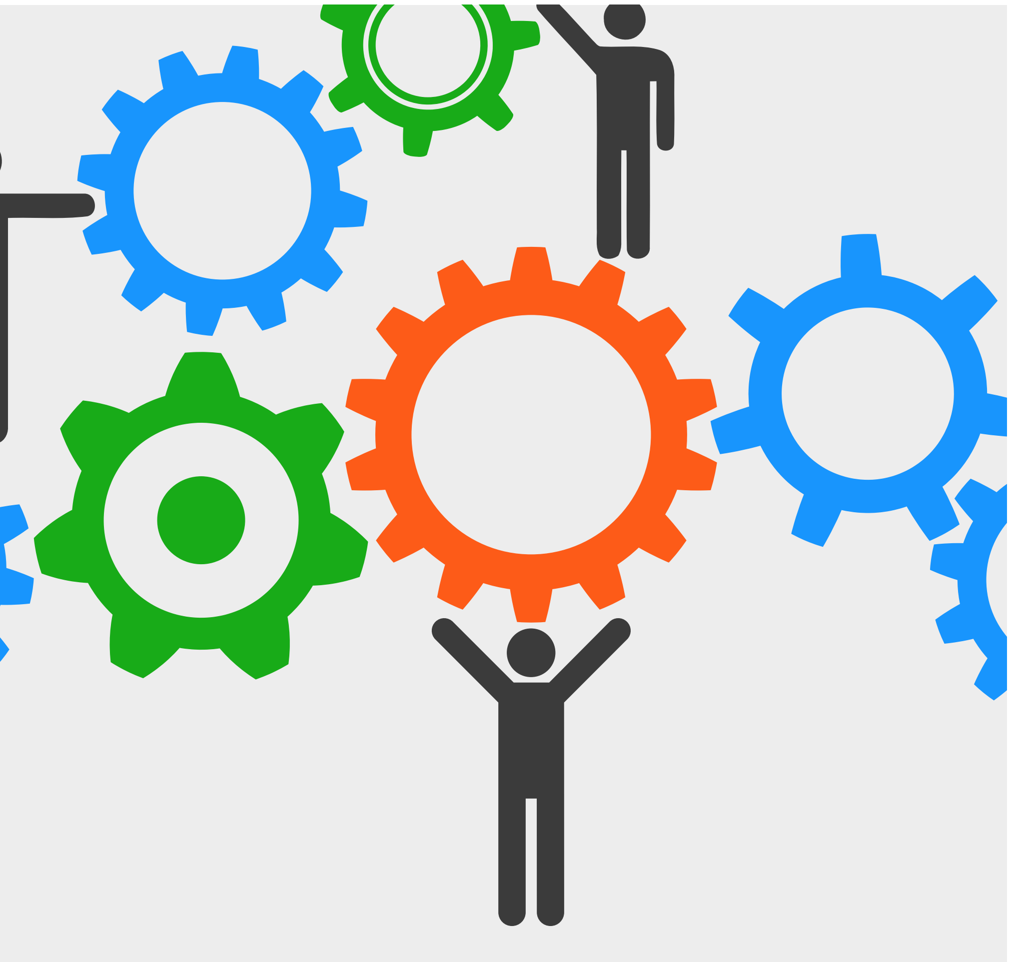
To that end, a wide range of ESG rating and ranking service providers have emerged to guide borrowers – on how to improve their scores, whether it be in the form of using more renewable energy to power their operations, or to introduce internal policies aimed at making the workplace more diverse – and investors on which organisations are taking tangible steps towards becoming more sustainable.

Yet these rankings are often backwards-looking and superficial, analysts argue, and don't really get at the heart of the kinds of risks that punctuate corporate scandals. Perhaps more importantly, they fall short when it comes to providing investors, CFOs and corporate boards with a forward-looking assessment of how non-financial factors – particularly those related to corporate culture and decision-making – feed into financial risk.

Are we Measuring the Right Stuff?

While the going view is that greater prioritisation of ESG often leads to better long-term financial returns, everywhere we look in both emerging and developed markets – whether the UK's Carillion, the US's Wells Fargo and Goldman Sachs, Brazil's Vale or South Africa's Eskom or Steinhoff, to name a few – we seem to consistently find potent examples of events that materially damaged shareholder or investor value, events that ultimately seem to stem from types of risks that are extremely difficult to quantify or simply aren't effectively captured by current ranking systems.

Global Themes



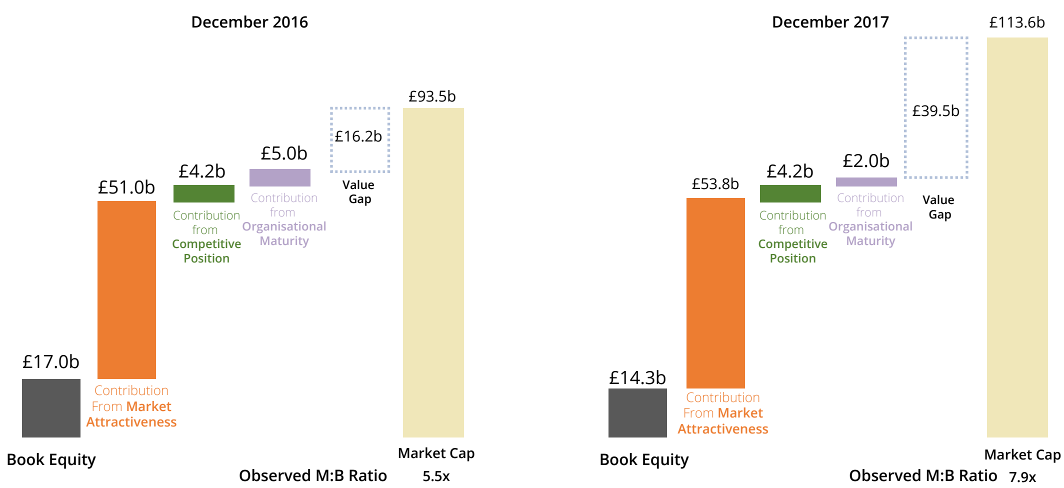
Take Goldman Sachs as an example. "At Goldman Sachs, we view the consideration of Environmental, Social and Governance (ESG) factors as an important driver of the way we advise clients and conduct our business," reads the organisation's 2017 sustainability report. The investment bank, which consistently rates at the top end of the spectrum on fulfilling various ESG criteria, was recently rapped for its complicity in the 1MDB scandal; the investment bank helped the Malaysian development fund raise USD6.5bn through three bond offerings in 2012 and 2013, of which prosecutors allege USD2.7bn was embezzled in the following years to bribe various government officials.

It was a massive bribery and money laundering scheme that reverberated throughout Malaysia, arguably taking down then-Prime Minister Najib Razak; led to the investment bank being blacklisted by Abu Dhabi's sovereign wealth fund, Mubadala, pending the outcome of litigation; and saw at least one of its bankers alongside senior Malaysian government officials charged for their involvement.

1MDB was one of the most "controversial" companies of 2016, according to a report published by RepRisk, a respected and widely used ESG ranking provider, and the threat of related lawsuits in Malaysia, the US and elsewhere has prompted Goldman Sachs to warn investors of the potentially serious balance-sheet implications of the penalties it may face as a result.

Recent events involving Brazilian miner Vale vividly illustrates the limits of using these ratings to extrapolate future risk of incidents. In July 2018, Vale's combined CSRHub rating – a composite of 25 ESG and CSR data providers – had Vale at 75 out of 100, putting it on the higher end of the ESG-compliance spectrum, and above the industry average. Following a January breach at the Brumadinho dam, which led to the deaths of more than 300 people and which preliminary reports suggests may have resulted from executives' efforts to quash a safety audit on the structure, its rating slipped 30 points to 45.

Components of Unilever's Market Capitalisation



Source: The Maturity Institute

Measuring Intangibles

Investigations in both 1MDB's and Vale's cases are ongoing. But while these organisations, like many others before and likely many after, inevitably end up pointing to "a few bad apples" as the cause of their tribulations, others see nebulous, but no less important things like uncooperative corporate culture and poor social values, as key ingredients that create the conditions for bad – or in extreme cases illicit – behaviour to thrive.

Stuart Woollard, Managing Partner of Organizational Maturity Services LLP and co-founder and council member at the Maturity Institute (MI) says that most ESG ratings frameworks don't take into account the complex web of internal and external relationships contributing to an organisation's health, value, and risk.

"Whether you look at companies like ENRON or you look at European banks tied to money laundering scandals, find me a massive corporate failure with subsequent severe market and financial repercussions that wasn't caused one way or another by our inability or unwillingness to appreciate and protect against human systems failure and risk," Woollard explains. "The challenge is that if you don't know what to measure, you are in no position to quantify value and risks; and if you can't really quantify value and risks, then how can you expect to change the behaviour of organisations – and by extension, investors and regulators?"

"[ESG] has become supremely important, and financial stakeholders and regulators agree with varying levels of sincerity. Yet when we talk about governance, corporate culture and values, internal or external relationships, leadership – most organisations, and regulators and investors, don't really have a clue what to measure, and how it feeds into our overall sense of value and risk. There is clearly a gap here."

The Maturity Institute (MI) is a multi-disciplinary non-profit organization pioneering a way to plug that gap. Broadly speaking, it tries to provide a coherent framework for understanding risk and value in organisations (Total Stakeholder Value, to use its language); above all, Woollard says it's about harmonising the needs and demands of capitalism (i.e. growth of shareholder value) with the needs and demands of society (i.e. sustainable well-being), two competing objectives most market observers and practitioners know don't always converge but which they nevertheless, increasingly agree, should.

Underpinning this is the view that people – and the relationships between them, organisations, and society – are at the heart of that junction, and to that end it has created an organisational maturity index (OMI) based on what it calls the OM30, a composite measure encompassing 32 different factors with different weightings and values that together paint a picture of an organisation's 'maturity'.

The MI looks at factors like 'coherence between market and human values' (i.e. To what extent is the organization's business and/or operating model predicated on reconciling its (market) value with changing societal values?); Trust (i.e. To what extent are the leadership and management team trusted by customers, employees, and other key stakeholders?); Value potential (i.e. To what extent does the organization seek to maximise the value it generates from all of its human capital – both directly employed and within its supply chain and wider society?); Never-ending, continuous improvement (i.e. To what extent is the philosophy and practice of never-ending improvement embedded throughout the whole organization?); Authenticity (i.e. The size of the gap between the organization's statements, external communications and claims of success, relative to the reality found in the evidence); and people risk (i.e. To what extent does the organization have a comprehensive system for measuring and assessing the current level of human capital management risk within the organization?).

The index also tries to capture how much an organisation values open and frequent communication, how enthusiastic and cooperative an organisation is – from the mail room to the Board room, and the extent to which high-level decision-making in an organisation is 'collegiate' or aligned within the business.

Its relevance in the credit world, and particularly in emerging markets, was clear from the outset. In 2014, it worked with Chile-based Feller Rate – at the time, an S&P affiliate – on the early stage development of its organisational maturity rating system, a precursor to the OMI.

Pricing Intangibles – And the Search for the Holy Grail

The MI is working with a number of academic institutions to flesh out the relationship between the OM30, current ESG frameworks, and credit risk. While much of that research is currently under wraps, early indications suggest it is starting to bear fruit.

Last year, using three research case studies on large publicly traded organisations like Unilever and Barclays, the MI and Australian consulting firm KBA Consulting Group developed a framework to measure a company's intangibles – factors including corporate governance, company culture and the management of human capital – and value them as a portion of overall market capitalisation. They looked closely at Unilever before and after the 2017 bid by Kraft-Heinz to establish a direct link between the OMINDEX and a company's ability to create wealth for shareholders on an ongoing basis.

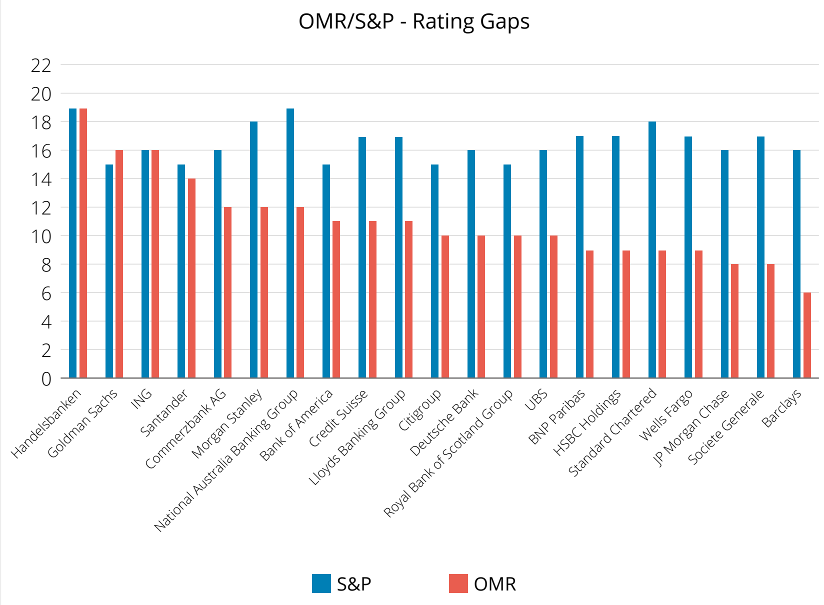
The preliminary analysis demonstrated "how this episode has led to the market value of Unilever increasing significantly, yet its capability to deliver on this increase in market capitalisation deteriorating as a consequence of the actions taken by Unilever to secure its independence," the organisations argue in Aligning the Interests of Business and Society, a jointly-authored paper exploring the findings.

"Unilever's OMINDEX rating spanning the period [end 2016 to end 2017] was downgraded from BBB- to BB+ and the impact of this in market value terms was negative GBP3bn... More worryingly, this deterioration, together with higher market value arising from increased investor expectations opened up a much bigger value gap of GBP39.5bn (measured as at 31 December 2017)."

Crucially, the organisations were able to assign a dollar value to intangibles – something ESG-focused market participants looking beyond carbon emissions have struggled to do.

Further preliminary research looks promising. Another project involved overlaying the OMINDEX's rating scale measuring governance and culture risk with traditional credit ratings provided by S&P for global investment banks to see how closely both approaches harmonised.

Banking Governance & Culture 2017: Risk-Ratings Gaps (OMINDEX & S&P)



Source: The Maturity Institute

The results showed some fairly stark deviations between the two ratings, and indeed raise new questions about whether we are missing something when looking deeper at some of the high-profile scandals that have unfolded at a number of the world's largest investment banks in recent years. According to a recent Cambridge Judge Business School study which looked further into the correlation between the OM30 factors, ESG, and risk events:

"...there is very strong negative association between OMR [Organisational Maturity Rating] and all aggregated indexes of not only S, G but also E risks/incidents/controversial issues.... This strong negative association remains when investigating further into each specific issue. OMR and TSV [Total Stakeholder Value] are significantly negatively correlated with all 30 controversial issues. Two of the strongest issues for banks are "Fraud" and "Violations of National Legislation"."

Woollard says further work with academics, financial institutions and investors will be needed to really cement the relationship between risk in a holistic sense and asset prices – but there need to be detailed, unified and coherent underlying standards for terminology and measurement if it is to be successfully realised. As alluded to at the outset, that detail, coherence and unification – or the lack thereof – seems to be one of the key issues at present (and one we've written about elsewhere).

Traditional credit rating agencies are looking closely at this as they roll out their own ESG ratings frameworks for investors and seek to understand how credit ratings are influenced by environmental, social and governance factors. For instance, Fitch recently published a set of "ESG relevance scores" to help quantify the scale of influence each factor has on credit ratings.

Given the weight traditional credit ratings have in determining asset pricing, pinning down these relationships is crucial. Fernanda Rezende, Senior Director, Corporates at Fitch Ratings says the industry still has some way to go – but things are heading in the right direction.

"Currently, these relevance scores add another dimension to the information available to investors, but they don't yet provide a clear linkage between the credit and the price. That said, we are starting to produce data and research that helps to understand how ESG risk is incorporated in traditional credit risk. We have a better understanding of how this data impacts ratings, but it will take a bit more time before we understand how these relevance scores influence pricing."

"We are at the point where we have a better understanding of how the lack of prioritisation of ESG-related characteristics – strong corporate governance, for instance – impacts risk, rather than how the prioritisation of these factors enhances a borrower's risk framework... As more information about the linkage between ESG and credit quality emerges, however, this could change."

If the price of assets is to reflect risk in a deeper, more holistic sense – and, at a higher level, if the convergence between the needs of capitalism and those of society is as necessary as many increasingly believe it to be, establishing these linkages is of paramount importance; while they may have remained shrouded in darkness until now, it is encouraging to see a broad swath of industry stakeholders start to cast them in new light.

"Society has come around to the fact that companies need to be more responsible to it, and investors to the fact that companies need to be less vulnerable to corporate scandals because they adversely skew market performance. The link between price and risk is in dramatic need of correction, and intangibles are at the heart of that," Woollard concludes.

As the Economic Cycle Begins to Turn, Distressed Debt Opportunities Remain Limited

It has been a slow year for investors eyeing distressed debt opportunities. With distressed funds worldwide securing substantially lower volumes than in 2018, and a potential reversal in US interest rate rises on the horizon, many investors currently view conventional strategies more favourably. Against a backdrop of continued volatility and a growing number of warning signs in both developed and local economies, it's unclear just how soon such opportunities will arise.

Generally defined as any asset trading at a spread of over 1000bp or more – though not necessarily a defaulted credit – distressed debt opportunities tend to grow during economic downturns. And according to a survey by Preqin, a data provider, in the eyes of many investors such a downturn may soon be approaching, with 35% of respondents to a recent survey administered by the firm believing that the market has peaked and a correction may be imminent - 12 months away, possibly sooner.

Yet despite this, distressed debt is not viewed as the most effective investment strategy by the majority of investors, with only 36% believing it to be the most effective investment strategy. By comparison, 44% of respondents see direct lending as the most effective means of investment currently, and 43% favour special situations funds.

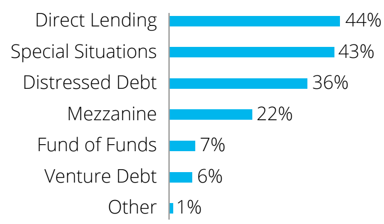
This is likely a reflection of the relatively poor returns offered by distressed debt compared with other private debt strategies throughout 2018, with distressed debt funds losing an average of 1.14%, compared with mezzanine funds and direct lending vehicles, which gained 16.1% and 6.6% respectively. It is perhaps unsurprising, then, that between January and May this year, just four distressed debt funds closed, totalling USD2.5bn, in stark contrast with 2018 which saw 25 funds secure USD23bn.

Sectoral Breakdown

In the sovereign space, dollar opportunities remain large but highly concentrated. Argentina, Venezuela, Zambia, and to a lesser extent Turkey, were all points of interest. However, one distressed debt manager, speaking to Bonds & Loans on the condition of anonymity, argued that only Venezuela was truly distressed, and that Argentine credit, for example, straddles the borderline between stressed and distressed with spreads of around 800-1100bp.

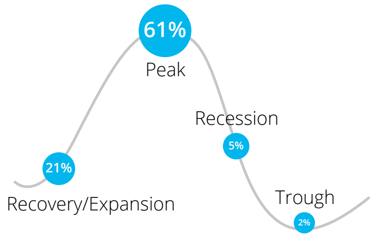
Corporate credit is markedly different. Smaller but more diversified, there are currently around 25 bonds trading below 50 cents on the dollar, including Digicel, the Caribbean telecoms provider, and a number of Turkish banks. But the corporate space remains a two-tiered market for distressed debt. European and American-based high-yield investors often tend

Investor Views on the Fund Types Presenting the Best Opportunities in Private Debt in H1 2019



Source: Prequin

Alternative Assets Investor Viems on Where We Are in the Current Equity Market Cycle



to favour industries with which they are more familiar. Distressed credit from so-called 'overlap industries' – such as energy and telecoms – are significantly more liquid, than those from industries with which there is no comparable Western counterpart, such as sugar and ethanol.

"While the unrealized value of assets held by distressed funds has grown by 19% since 2013, dry powder has ballooned by 82%. Investors may be waiting for managers to put some of their USD87bn in dry powder to work before committing further capital," argues Tom Carr, Head of Private Debt at Preqin.

For Jeff Grills, Co-Head of Emerging Market Debt at Gramercy, whilst distressed debt remains important, there are more opportunities in direct lending.

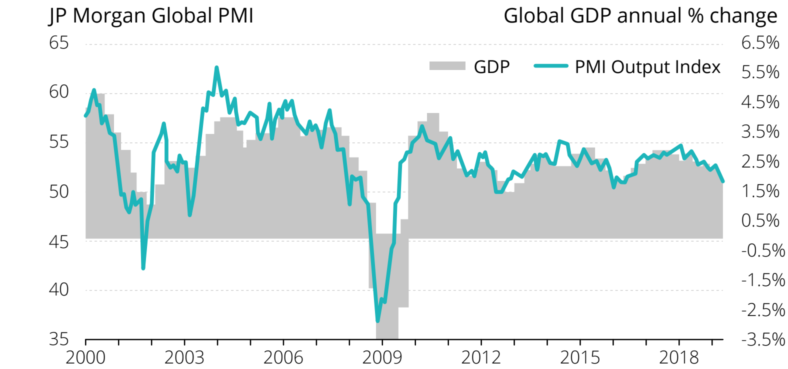
"In some cases, it can be more attractive to do private direct credit. In many cases this includes collateral that enhances the loan package in a way that provides a more secure form of investing for our clients. We're currently seeing this across the board – in Latin America, and even in Asia. With the economic cycle still in flux right now, there are fewer opportunities in pure distressed. Although the US-China trade war has increased uncertainty, growth is still around 3.1% in the US and forecast to remain positive."

Downhill From Here?

But there may well be storm clouds on the horizon for the global economy – which, for distressed debt investors, can look more like sunlit uplands.

Alarm bells are sounding across developing and developed markets alike. Throughout May, the US produced just 75,000 new jobs, far short of the 185,000 jobs originally forecast, according the Bureau of Labour Statistics. In Germany, uncertainty around Brexit and trade wars were at least partly responsible for a drastic fall in the IHS Markit Purchasing Managers' Index. The index, which measures sentiment among German manufacturers, slumped to 44.1 in May – its lowest point since July 2012, and significantly below the reading of 47.6 recorded in February. The Bundesbank has already revised down its 2019 GDP projection, made in December 2018, from 1.6% to 0.6%.

Global PMI and Economic Growth



Source: IHS Markit, JP Morgan.

Despite this, an uptick in the service sector has managed to marginally offset the slump in manufacturing.

May was also a difficult month for the UK, with the construction sector shedding jobs at the fastest rate since 2012 as the IHS Markit/CIPS construction PMI fell to 49.4, down from 53.1 a month prior. The manufacturing sector faced an even sharper downturn. Despite a brief sugar-high the month prior, driven by the impending threat of a no-deal Brexit, a slump in both domestic and overseas new order inflows saw the manufacturing sector PMI slide from 53.1 to 49.4 in May.

Key emerging market jurisdictions are also struggling. South Africa was jolted by an unexpectantly severe contraction in early June, with GDP falling 3.2%, more than double the 1.5% contraction originally forecast earlier this year.

So far, 2019 has been no easy ride for Russia either. Year-on-year GDP growth in Q1 2019 stumbled to 0.5%, a marked step down from the 2.7% reported Q42018. Whilst this deceleration has been caused at least in part by the recent hike in VAT from 18% to 20%, the largest force behind the slowdown is likely an interval between large state-backed construction projects, argues Dmitriy Dolgin, Chief Economist for Russia at ING Bank.

Despite a flurry of foreign inflows sparked by Narendra Modi's thumping election victory, India is also showing potential signs of a downturn. The Jefferies Activity Index tumbled to 1.3% in April, its lowest level since 2013. Recent defaults by Infrastructure Leasing & Financial Services Limited, one of the country's largest lenders, have also sparked concerns about the entire non-bank financing company sector, with fears that further defaults may follow.

"Growth is expected to be lacklustre (or even worse) in large emerging markets such as Russia, South Africa, Turkey, Brazil, and Mexico. In the latter two countries, uncertainty about the policies of new governments is also giving both domestic and foreign investors pause. All this means emerging markets will not be able to offset the weakness in developed market," explain IHS Markit's Chief Economist Nariman Behravesh and Sara L. Johnson, Executive Director of Global Economics in a note published earlier this year. "Growth is slowing everywhere, but it is far too soon to run for the exits. Barring a policy or other type of shock, the world economy is likely to muddle along for at least another year," Behravesh and Johnson conclude.

But despite these warning signs, the pause in US interest rate hikes since December 2018 – and the potential reversal of interest rate trajectories in the US and other major markets – may carry the global economy through for another year. Whilst 2019 looks set to offer a shallow range of distressed debt opportunities, this could quickly change. Policy-driven events, such as Brexit, trade wars, and sanctions, have created a backdrop of extreme uncertainty.

It appears likely that global economy will continue forward for another year before eventually sputtering out, but the lingering possibility that political events may derail growth sooner is here to stay.

Media! What is it Good for?

Investors in Emerging Markets (EM) often get their news from proprietary research, conventional media and social media. There is no substitute for proper propriety research, but journalists can add value by unearthing valuable insights about far-flung EM investment grounds at a lower cost than the price of an airline ticket. Unfortunately, the unique capacity of media organisations to reach very large numbers of investors and shape sentiment with their choices of stories and style of coverage means that the media can also exploit its audience by sparking exuberance or panic and by adding fuel to fire, thereby increasing demand for media. Given this conflict, who knows if media coverage of EM actually adds value to investors?

Jan Dehn, Head of Research, Ashmore Group

To try to answer this question, we analyse two datasets on the volume of EM mentions in conventional and social media outlets to quantify the investment implications of investing directly in response to media frenzies and troughs. We find that investors make positive alpha if they buy EM bonds and stocks during frenzies in EM coverage in the conventional media. Such frenzies revolve around bad news, so it is likely that the media over-hypes bad news so much that many investors are wrongly drawn into selling, thereby creating value. It is also possible that media and investors wrongly extrapolate from bad news in a few countries to the whole universe of EM opportunities, thus selling the wrong securities and creating value that way. We do not find that investors make alpha by buying during lulls in media coverage. However, they should not liquidate positions in lulls either, because the opportunity cost of leaving the EM bond market is too high, given yields. We only find weak and less intuitive linkages between investment returns and social media activity. More data may be required to get a clearer picture of how social media and investment in EM interact, if at all.

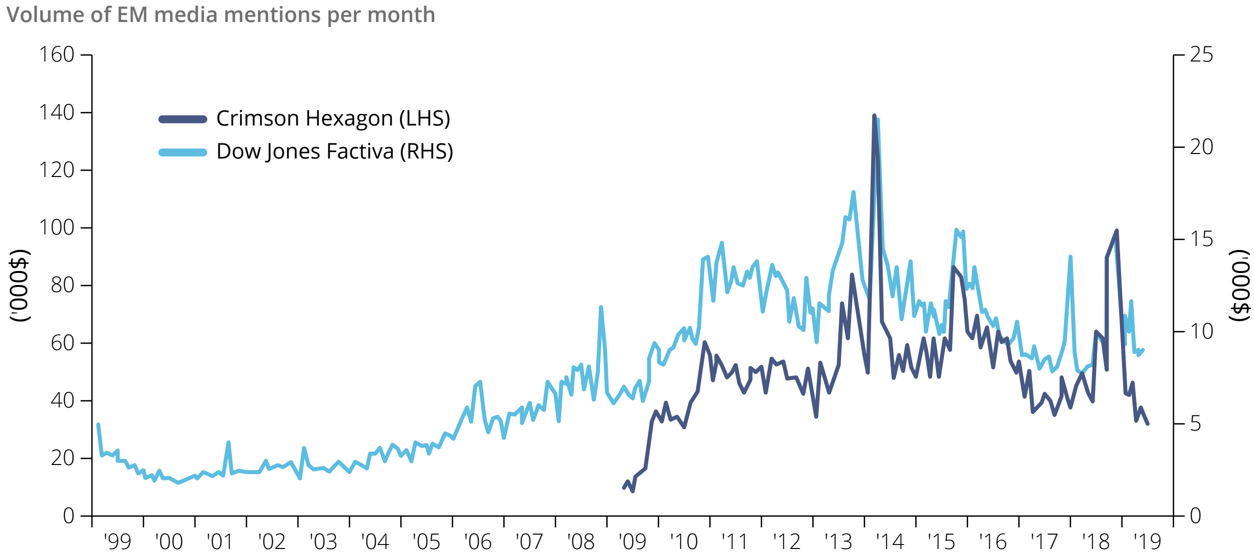
a) Dow Jones Factiva counts the number of media mentions across more than 33,000 conventional media outlets and compiles them into a data set with 244 monthly observations ranging from January 1999 to April 2019;

b) Crimson Hexagon is a social listing tool, which scans for EM mentions across publicly available social media sites, such as Twitter, Reddit and most online blogs and forums. The Crimson Hexagon data set, which excludes private social media pages, has 123 monthly observations from February 2009 to April 2019.

EM Media Mentions Contain Independent Information

Why even look at media activity? The

Fig.1: EM media coverage



Source: Ashmore, Dow Jones Factiva, Crimson Hexagon.

volume of EM media coverage appears to be independent of and distinct from traditional EM risk indicators, such as sovereign debt spreads. This can be seen from Figure 2, which shows correlations between EM media mentions and EM sovereign debt spreads. Correlations are very low. Granted, correlations are higher between spreads and mentions for conventional media than for social media, but this is due to spurious trends. When the trends are removed ('1st difference' in Figure 1) correlations collapse. In other words, EM mentions in social and conventional media potentially offer new information of value to investors.

Methodology

To determine the value of investing in response to EM media frenzies and troughs, we contrast two strategies. Suppose we have two identical pension funds, which each receive a Dollar a day in contributions. One of the pension funds invests the contributions every day, regardless of what the media has to say about EM. This pension fund ends up buying expensively on some days and cheaply on others, but in the end just reaps the index return. The other pension fund pays attention to the media. It sits on its daily contributions until the media attention either surges into a frenzy or subsides into a trough. At these times, the pension fund invests the accumulated contributions in full. This pension fund's return is the average of the 12 month returns following each media frenzy/trough across the full range of the dataset.

The difference in the two returns is the alpha (positive or negative) arising from investing in response to media frenzies and troughs relative to ignoring the media. We conduct this analysis for sovereign Dollar-denominated bonds, corporate Dollar-denominated bonds, local currency government bonds and stocks.

How to Make Money from Media Activity

Our main result is that investors can significantly increase alpha versus benchmark returns by investing across all EM asset classes specifically in response to media frenzies in the conventional media. The average annual alpha is 2.7% for external debt, 3.3% for corporate debt, 3.0% for local currency bonds and 10.2% for EM equities relative to passive strategies that ignore EM media coverage (Figure 3).

Fig.2: Coefficient of variation and correlations with EM spreads

	Conventional media (Dow Jones Factiva)	Social media (Crimson Hexagon)
EMBI GD spread correlation in:		
Levels	-53%	-7%
1st difference	-7%	10%
Other descriptive statistics		
Maximum	21,750	138,818
Minimum	1,651	7,198
Median	7,369	49,409
Average	7,535	50,569
Standard deviation	4,378	19,090
Number of observations	244	123

Source: Ashmore, Bloomberg, JP Morgan, Dow Jones Factiva, Crimson Hexagon.

Fig.3: Investing in response to conventional media frenzies and troughs: alpha generation

Conventional media: Alpha versus media-agnostic strategy	External debt (EMBI GD)	Corporate debt (CEMBI BD)	Local currency government bonds (GBI EM GD)	Equities (MSCI EM)
Buying in media frenzies	2.7%	3.3%	3.0%	10.2%
Buying in media troughs	-1.1%	-0.3%	-5.1%	-1.3%
Return in media-agnostic strategy	8.8%	7.1%	6.6%	4.1%

Source: Ashmore, Bloomberg, JP Morgan, Dow Jones Factiva.

Fig.4: Investing in response to social media frenzies and troughs: alpha generation

Conventional media: Alpha versus media-agnostic strategy	External debt (EMBI GD)	Corporate debt (CEMBI BD)	Local currency government bonds (GBI EM GD)	Equities (MSCI EM)
Buying in media frenzies	-0,6%	0.0%	-0.7%	0.4%
Buying in media troughs	-6.6%	-3.6%	-10.6%	-1.4%
Return in media-agnostic strategy	9.8%	7.1%	6.6%	4.9%

Source: Ashmore, Bloomberg, JP Morgan, Crimson Hexagon.

On the other hand, it is not optimal to enter EM during lulls in media coverage, although investors should remain invested at such times if they already have exposure. Putting fresh money to work during media lulls leads to negative alpha of 1.1% for external debt, for example. However, since EM bonds return roughly 350bp over Treasuries after subtracting default-related losses over the long term it clearly pays handsomely to remain invested.

Investing in response to social media frenzies has less impact (Figure 4). Alpha is mixed and relatively modest across the four asset classes. Buying external debt leads to negative alpha of 0.6%, there is no alpha in corporate debt, negative alpha of 0.7% in local currency bonds and positive alpha of 0.4% in EM equities.

These small additional returns barely cover the bid offer spread of trading. Hence, we think investors should ignore social media frenzies. Buying during troughs in social media mentions appears to be a bad idea with negative alpha across bonds and stocks. However, this result may simply reflect a very dominant negative beta for EM over the relative short period of the social media time series. Of course, the index return was positive over the period, but anyone who bought EM specifically in response to media troughs made less money.

Finally, we find that equity investors are more richly rewarded for paying attention to media frenzies than bond investors. The alpha from buying stocks is larger than the alpha from buying bonds in frenzies, both in the conventional and social media data. This is insightful. After all, all EM media frenzies in the data set centre exclusively around macroeconomic events, which suggests that equity investors should pay serious attention to macroeconomic developments. Pure bottom-up stock picking strategies

make sense for a single postcode, but in the context of cross-border investment the unique FX and business cycle dynamics of different post codes should be taken into account. For example, what is the point of being great at picking a stock in, say, Brazil if the gains from stock selection are neutralised by a lower BRL when the funds invested in Brazil are repatriated?

Discussion

Investors watch financial TV, read financial newspapers, follow Twitter and pay good money for media services. This is because information is critically important for making good investment decisions. In principle, the media can help investors make better informed judgements by bringing previously unknown facts to light. Over time, this should have a meaningful, positive impact on asset allocation, economic outcomes and investment returns. The media can also act as a watchdog, which exposes abuse of power by governments or corporations, thus incentivising those in power to act with greater integrity.

Yet, media companies clearly serve their own private interests too, whether political or fiduciary. This creates a conflict between their private interests and the public interest they purport to serve. Media organisations will exploit prejudice and ignorance to increase circulation. Bad news sells better than good news, which is why coverage is biased towards negative stories.

EM is especially prone to exploitation by media organisations. Remote, unfamiliar, seen by many as threatening (think China) and generally perceived as very risky, EM lends itself particularly well to media hyperbole. Nothing delights an editor more than a juicy EM crisis. Almost all high profile EM stories revolve around bad news, be it contagion, debt defaults, corruption, hard landings in China, collapsing commodity prices, currency crises, trade tariff disasters, Fed hikes, the surging Dollar or the misguided policy actions of some hot-headed EM dictator.

The results presented in this report should therefore raise eyebrows. Whatever utility the media confers upon conventional readers, it is clearly not conferring the same value to investors. If investors are able to buy EM profitably in the middle of bad news frenzies, this can only be the case if either the news is wrong (unlikely, though not unheard of) or if the media so hypes up the bad news that some investors are sucked into selling and the associated selling goes way too far. The same situation can arise if the media – and many investors – wrongly extrapolate from bad news in a few countries to the entire asset class, leading some investors to wrongly liquidate exposures across perfectly healthy markets.

What is the conclusion? Does the media add value or cry wolf? The answer is both. The media loves a bad news day in EM and cries wolf all day long. The associated hyperbole leads to overselling as weak hands cave in. Investors with cool heads can make significant alpha by buying during such events. In fact, the worse the news the better the subsequent alpha, particularly for stocks.

Middle East & Turkey

Alternative Finance Key for Mid-Tier UAE Property Companies as Banks Channel Liquidity to the Top

With the local economy starting to turn a corner and new regulations and incentives coming on stream, UAE-based property developers have much to celebrate. But looking beyond the large publicly-traded Emaars and Damacs of the region, many smaller developers appear caught in a low liquidity environment unlikely to ease anytime soon. This is prompting many to hunt for alternative sources of funding, often for the first time.

Last year was tough for UAE-based property developers, with subdued growth and flatlining oil prices intersecting with a heavy residential and commercial property supply.

Dubai, the country's most diversified economy, grew just 1.9% in 2018, down from 3.1% the year before, according to the UAE Central Bank, the slowest rate of growth since 2010. Abu Dhabi, where oil accounts for nearly half of all economic output, grew 1.9% - up from a contraction of 0.9% in 2017, and driven in part by the Emirate's AED50bn stimulus programme which, among other things, slashed business license fees and accelerated their approval while increasing jobs for Emiratis and accelerated payments for government contractors.

Against that backdrop, mainstream residential unit prices in Dubai fell by an average of 4.1% between January and November 2018, while prices for villas tumbled 6.1%, according to the Property Monitor Index developed by Knight Frank, a real estate agency and commercial property consultancy. Rental rates across the Emirate fell by 7.7% through the same period, while apartment rents fell 8.4% and villas 8.3%. In Abu Dhabi, sale prices and rents also trended downward at similar rates.

In Dubai alone, less than half – around 43% – of the 45,000 new housing units estimated to be completed by the end of 2018 were finished on time.

A Tale of Two Tiers

With oversupply remaining a critical issue in a soft and uncertain economic environment, some larger developers – Emaar most notably – have turned to the strength of their own balance sheets to furnish higher sales and aggressively claw market share; others – like Damac – are taking a more conservative approach focused on capital preservation.

"In the large listed real estate space, what we've seen is a tale of two strategies, probably best exemplified by Emaar and Damac. Emaar is going for growth through aggressive marketing, pushing pre-sales and offering generous payment plans to lock-in buyers, getting waivers for land fees... they are pulling all of the strings to maintain and grow market share," explains Sharif Eid, a senior portfolio manager at Franklin Templeton in Dubai.

Emaar has also set its sights for further expansion abroad in a bid to counter slower domestic demand. Last year, the company announced a strategic partnership with Aldar, one of Abu Dhabi's largest property

Middle East & Turkey

developers, to jointly target both local and international projects. The companies initially plan to collaborate on two domestic developments: the Saadiyat Grove development, located on Abu Dhabi's Saadiyat Island, and the Emaar Beachfront project, a private island in Dubai located near Jumeirah Beach Residence and Palm Jumeirah, but both companies are looking further afield for new co-development opportunities. In June this year, Emaar signed an agreement with Beijing New Aeropolis Holdings (BNA) to jointly develop a business and tourism complex located in a special economic zone near Beijing Daxing International Airport, which upon completion will be the largest airport in the world.

"Damac, on the other hand, seems more cautious and conservative, pulling back somewhat in a bid to preserve liquidity."

Overall, developers have been increasingly cautious about flooding the market with supply, with the latest 2019 figures for off-plan unit deliveries starkly contrasting with the those seen in 2018. In the first five months of this year, just over 3,200 new off-plan units were released, compared with more than 13,600 during the same period the year before, according to Reidin, a provider of property price and supply analytics. About 7,000 homes and units have been completed and handed over during that period, compared with over 8,900 during the same period the previous year.

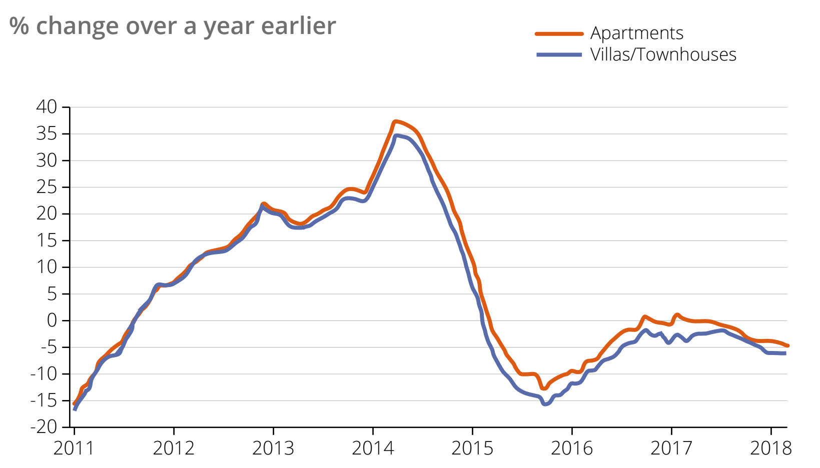
Against that backdrop, Emaar and Damac (and Union Properties) have seen their fortunes stratify to opposite ends of the spectrum.

Emaar recorded USD1.62bn in sales during the first quarter of the year, one of its highest quarterly sales results ever – and a 53% increase from the same quarter in 2018. Pre-sales were also impressive. The company's sales backlog (recognised as revenue over the next few years as units are delivered) rose to more than USD13.6bn at the end of the quarter, up from UDS10.3bn at the end of Q1 2018.

By contrast, Damac saw its profitability take a big hit in the first quarter of 2019, with the company reporting a 94% decline in net profit compared with the same period last year, while total revenue dropped 53%. Union Properties started the year on much the same footing, with net profits dropping more than 99% in the first quarter of 2019 and revenues dropping 11% during the same period.

The impact of the reduction in liquidity in the real estate sector was most acute towards the second half of 2018 through to the first weeks of 2019, sending bond spreads wider and loan premia higher, with some developers looking to sell assets in a bid to free up cash and bolster their balance sheets. Some regulatory measures – like the UAE Central Bank's removal in November of the 20% lending cap to the real estate firms – have helped ease some of the

House price change (Dubai)



Source: Knight Frank

liquidity concerns that spread through the market late last year and into the early months of 2019.

"Liquidity is tighter, but it seems the worst has already come to pass. They are also in a far better position to weather declining demand than was the case 10 years ago; regulations have helped a fair bit, creating more robust accounting structures and reporting – giving investors more transparency."

But as you go start to look to smaller mid-cap and privately-held developers, many of which aren't aren't purely property focused, that's where things get tricky, Eid explains.

"Generally speaking, our sense is that some of these players are encountering liquidity issues," Eid says. "We have seen a spike in these types of players approaching asset managers for alternative finance, and we expect that to continue in the near term."

While the financials for most of these companies are held under lock and key, interviews with a handful of treasury professionals working at mid-sized, private and family-owned property development firms based in Dubai and Abu Dhabi echo that sentiment. Several of those who spoke with Bonds & Loans, on the condition of anonymity due to the sensitivity of the topic, say they have had to accept haircuts of up to 40% on sales in some cases, discounts that are reverberating through balance sheets which are often fairly diversified and could include holdings in a combination of leisure and hospitality, automotive, entertainment, technology or healthcare sectors.

That diversification would in any other environment be seen as a strength that could insulate these companies from any sector-specific shock, but the broad-based slowdown in the domestic economy has in fact exacerbated their challenges. Without the balance sheet strength to offer potential customers generous payment plans, which in the case of some of the larger players extend out to ten years and charge zero interest, or the resources to aggressively market their residential or commercial offerings,

some are beginning to question their conviction to remain active in the sector.

"Our primary focus is ensuring working capital is adequate and that we can retain enough liquidity to take on key strategic projects as they arise. Overall, it's about maintaining a market position – and that's so much more challenging to do when you have a diverse set of businesses that are all trending flat or downward [in terms of growth] and each have very different funding requirements," explains one treasury funding specialist.

"We are looking at scaling back in some segments, and potentially selling off and exiting in others. Real estate – among other [sectors] – fits into at least one of those categories."

A Competitive Loan Market May Exacerbate the Issue

Most of those who spoke with Bonds & Loans say they are generally seeking longer-tenor loans with more flexible payment terms – shifting from 7 to 10-year horizons to 12 to 15 years, with double or triple the length of repayment moratoriums (typically one year). Some say their relationship banks have trimmed credit lines in recent months but haven't ceased funding altogether, pushing them to seek out capital among non-bank financing companies and alternatives-focused asset managers. For many, it's the first time they've had to look beyond their traditional lender base – which in itself brings a host of new issues.

"[Banks] are more cautious, diving deeper into the fundamentals, because they need to do extra work to convince their credit committees given some of the stresses being experienced by some players in the sector. I wouldn't say they've stopped [funding], but I wouldn't say they are eager to extend balance sheets to us in a way they might with some of the larger players, either," another group treasurer says.

"We are not used to working with fund managers, so there is a bit of a learning curve in terms of the setup we need internally. Our governance framework and approach to reporting is going to be a bigger focus for us, and the feedback has been helpful and constructive."

A senior banker at a state-owned UAE-based lender who leads lending to property companies says the region's banks are in a tough spot. Syndicated loan volumes in the region are down by more than 17% year-on-year, with the debt capital markets absorbing some of the funding that would have otherwise come from lenders directly. With growth targets to meet and a lot of banks chasing new business and a fairly illiquid secondary property sales market, lenders are increasing the average ticket size of the loans they extend, but are being more selective about who they lend to.

"It's a tricky market right now. We need to be very careful about extending our balance sheet, especially in the property sector because the fundamentals are currently challenged. But at the same time, like any other business, we have internal targets we need to achieve, which in practice often means taking a deal on a bilateral basis that two or three years ago would have been split between four or five lenders, but banking a fewer number of top-shelf clients," the banker says.

A competitive lending market may seem at first glance like a potential tailwind for the sector, but with banks increasingly looking to take larger tickets rather than clubbing together and sharing the risk, and with lending criteria becoming much more stringent, developers are inherently exposed to fewer funding decisions from bank credit committees – often limiting their funding opportunities while at the same time pushing up pricing and fees.

"Underwriting and funding these deals has changed dramatically throughout the past couple of years. Two years ago, if Jumeirah [Hotels and Resorts] sought a sizeable loan from domestic lenders, they would probably get away with limited sponsor support and completion guarantees. If you took that very same deal out to market now, as a base requirement, you would be looking at statements of guarantees for nearly every aspect of the project including a range of pre-leasing milestones up to final unit delivery… in addition to steeper funding costs. The lending criteria has become more robust."

Tailwinds in Sight – But No Quick Short-Term Fixes

Although the near-term outlook seems to provide little respite for property developers, some of the regulatory changes being pursued by Emirati authorities could provide substantial tailwinds for the property sector in the medium and long-term.

Chief among them are various rules designed to entice entrepreneurs and certain specialists to stay in the country on a long-term or even permanent basis. In January, the UAE issued the first 10-year visas to academics and researchers, and in May this year, the government began issuing five-year visas for business people that own or operate a business with capital of more than AED500,0000 (approx. USD136,000), which can be renewed on a rolling basis.

More recently, and for the first time in its history, the government unveiled a permanent residency scheme for high-net worth individuals and investors; the full qualification criteria has yet to be released, but at the end of May the UAE government said it has awarded permanent residency to an initial batch of investors with assets totalling AED100bn (approx. USD27bn).

Making it easier for foreign buyers to own land or property will also help. In April, Abu Dhabi introduced new rules allowing first-time foreign buyers to secure freehold properties, a shift from leasehold-only ownership they were previously resigned to, with the first freehold sale for a foreign buyer taking place just weeks later.

The ability to retire in the UAE – or stay for long-periods untethered to an employer – could be a game changer for the region's property sector, bolstering demand for real estate while at the same time increasing the pool of domestic long-term liquidity through mortgages, pensions, and savings, capital that could find its way into burgeoning domestic long-term assets linked to the property sector – like real estate investment trusts (REIT) – among others, catalysing a virtuous cycle that has remained largely absent from the region by comparison with other global hubs.

Anyone hoping for a quick reversal of fortunes, particularly in a sector so deeply linked with the real economy, is likely to be disappointed. Taimur Khan, a research manager at Knight Frank cautions that while things are headed in the right direction, it will likely take some time for theses changes to manifest in additional demand; the nature of that demand is also likely to change as middle-income earners constitute a growing share of the buyer base.

"This is an important stepping stone given that more than 90% of UAE residents are expats. But the government also needs to make progress on making the region more affordable for both businesses and the residents they employ. This, too, is something the authorities in the region are deeply focused on… if the UAE is to really exploit its geographic position and make good on its ambitions to remain a leading, competitive hub for business, it has no choice but to make it a more affordable place to live and do business."

Some of the more recent moves to expand the business benefits previously reserved for free zones out to the wider economy is where Khan sees more near-term wins. In November last year, the government introduced a law that would allow up to 100% foreign ownership of companies in the UAE, transitioning away from a long-held policy of forcing foreign companies to team up with Emirati nationals or businesses when operating in the country. The list of sectors currently exempt from the law is long and includes key pillars of the economy, like oil & gas exploration and production, banking and finance, telecoms and utility infrastructure – but there is a provision in the law allowing the UAE Cabinet to add or remove sectors, with the expectation that property investment in both commercial and residential real estate will rise as a growing number of industries is gradually opened up.

Together with an expansion of the dual-licensing rules introduced by the Abu Dhabi government, allowing companies to operate in both free zones and the wider economy simultaneously under a harmonised set of regulations, and other regulatory measures introduced by both the Abu Dhabi and Dubai governments, the forces bolstering the long-term prospects for the sector are gaining momentum. But the big question for many in the property development industry is whether there will be space in the market – stimulated in one way or another by generous government spending – for the numerous and diverse firms vying for development projects, and whether smaller and more diversified organisations playing in the property space can retain enough balance sheet flexibility to remain agile in the face of competitive behemoths.

"Access to credit drives this market – whether in terms of mortgages or in terms of property development itself. Without that element, growth will remain limited, and it may be tough for certain [companies] to compete," Khan concludes.

The Case for Diversification: Why CFOs Shouldn't Wait for the Next Liquidity Crisis to Act

In the face of relatively abundant banking sector liquidity and stabilising oil prices, CFOs and treasurers have rightly questioned the need to shift their funding focus away from the region's deep-pocketed lenders. With the global growth outlook looking more uncertain, new trade wars becoming a near daily feature of the global policy discussion, and in light of recent moves to bolster the development of the domestic financial sector, should borrowers wait for the next liquidity crisis before de-risking their funding strategies and orienting themselves towards greater financial diversification?

Ludovic Nobili, Head of Investment Banking, Abu Dhabi Commercial Bank

The Outlook is Slowly Stabilising

Despite rising global uncertainty and political volatility more recently, and after years of challenged growth on the back of broadly lower oil prices, the economic outlook in the GCC appears to be moving in the right direction.

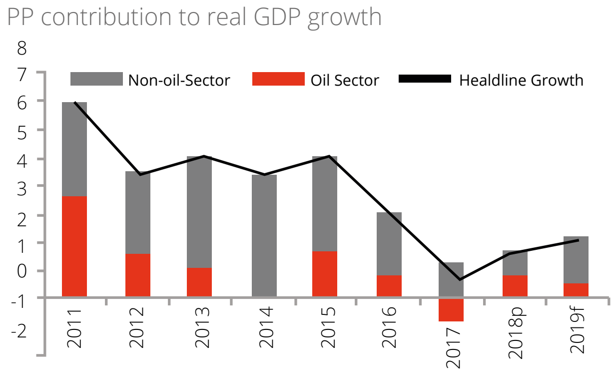
Headline real GDP growth accelerated to 1.7% in 2018, up from 0.5% the previous, and is set to rise to 2.2% in 2019, according to Monica Malik, Chief Economist at ADCB, with a gradual yet tentative pick-up in non-oil growth driven by stronger investment activity, further normalisation of household consumption, and a more supportive fiscal backdrop.

Corporate Borrowers Are Missing Out on the Rise of GCC's Debt Capital Markets

In both the UAE and in Saudi Arabia, a rise in business confidence in key domestic sectors, blended with uncertainty over the trajectory of interest rate rises in the US and Europe towards the end of 2018 inspired GCC borrowers like Saudi-based dairy giant Almarai, Abu Dhabi-based district cooling leader Tabreed and healthcare leader NMC Healthcare, and Dubai-based commercial property developer Majid Al Futtaim to move into the international capital markets, testing the market with new transactions.

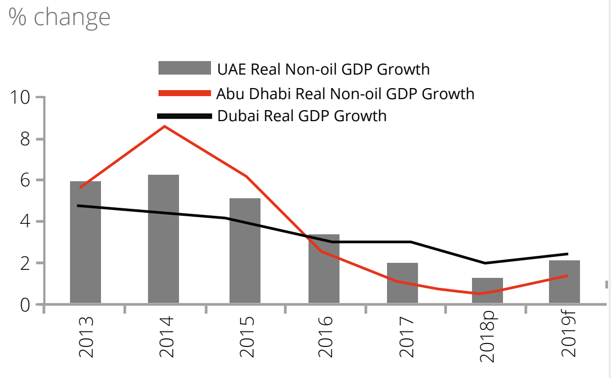
Over the past 15 years, the GCC bond and sukuk universe has grown from virtually nothing into a near USD400bn asset class, roughly doubling in size since 2015, when a crash in the oil price prompted regional sovereigns to orient themselves outward towards new pools of investors to help finance ambitious domestic development initiatives. GCC bonds and sukuk now account for approximately 15% of outstanding emerging market hard currency fixed-income assets, with exposure to a broad group of investors in a number of geographies.

Fig.1: UAE: Real GDP growth accelerated in 2018 with oil sector contributing positively



Source: Federal Competitiveness and Stantistics Authority, ADCB estimates

Fig.2: UAE: Real non-oil growth decelerated for fourth year in 2019; we see some uptick in 2019



Source: Federal Competitiveness and Stantistics Authority, ADCB estimates

With nearly USD54bn in bonds and sukuk issued in the first half of this year, an all-time high for the period, and with nearly USD17bn of debt still to mature in 2019, the probability that full year deal volumes could exceed 2018 and record 2017 volumes – which reached USD83.8bn – is rising.

But closer inspection of the composition of that asset class reveals an important reality missed by many when assessing our progress on the development of the region's markets: corporate borrowers account for just 4% of public GCC bond and sukuk issuance (and about 60% of those are issuers based in the UAE). It is a startling statistic to say the least, and important in a number of ways.

Why aren't more private sector companies taking advantage of international funding diversification opportunities?

The GCC countries and the UAE specifically are home to a high proportion of government-related entities (GRE). These GREs were formed to play a crucial role in catalysing economic development and cement the region's leadership in key industries like oil & gas, utilities, transportation and travel, real estate and logistics, key pillars of the real economy that continue to attract a broad range of global talent and fuel growth.

They also account for a substantial share of the region's borrower base in global markets. GREs, many of which benefit from a credit rating perspective from their close links with government in their respective countries, account for about 25% of GCC hard currency fixed-income assets, according to Bloomberg data.

Large domestic financial institutions, which have been active borrowers in international markets for a number of years and account for about 24% of the GCC fixed-income asset class, have focused on leveraging their strategic expertise to address ever-evolving capitalisation requirements, diversifying their capital base and at the same time catering to the shifting financing needs of clients in the local market.

A lack of options is also a leading factor. One of the biggest constraints imposed on the region's borrowers has been the lack of a deep and liquid domestic credit market. This is driven in part by the nascent state of the domestic long-term institutional investor base, typically composed of pension funds and insurers, and the absence of a robust yield curve.

Despite the significant wealth found across the GCC, the size of assets managed by the region's pension funds is frighteningly small – all told, just under USD400bn between the six countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE) as of April 2017, according to estimates by Ernst & Young, a consultancy. To put this in perspective, pension funds in the UK – a country with very deep domestic capital markets and roughly the same size population as the whole of the GCC – amounted to about USD2.8tn in assets, according to OECD Global Pension Statistics.

With such a large number of institutions vying for business and historical challenges accessing new funding markets, the domestic corporate borrower base has become accustomed to satisfying their financing needs primarily through domestic lenders, leveraging banks' strong balance sheets and knowledge of the local market to secure cost-competitive solutions.

Banks, Regionally and Globally, are Becoming More Rigorous

That domestic private-sector borrowers have largely continued to rely overwhelmingly on relationship banks to support their diverse funding and financial services needs is not in itself problematic. But the banking sector is changing in a variety of ways.

Bank lending criteria has become more rigorous in recent years. This is part of a broader shift in the global banking community that sees lenders optimise their capital structure to ensure greater financial stability, but is also the result of various domestic and international shocks, including high-profile corporate governance failures here in the UAE and abroad.

Banks are also increasingly seeking to leverage economies of scale through strategic mergers that will over time reduce the number of regional lenders.

In the UAE and more broadly, government support of the real economy remains essential. But the nature of that support is also changing in line with the need to strike the right balance between fiscal responsibility, market development, and generating economic growth.

As I have written to elsewhere, intimations by Saudi Arabian and UAE authorities to partially privatise regional powerhouses like Saudi Aramco and Abu Dhabi National Oil Company are part of broader fiscal rebalancing agenda, and a conscious decision to open a range of new capital corridors to stimulate new foreign investment into the economy and galvanise the local institutional investor base.

Fiscal consolidation has also meant promoting the role of the private sector through public-private partnerships and fostering a supportive business environment through measures like streamlining licensing regimes, reducing costs and red tape. It also implies the gradual introduction of VAT, which in the UAE and Saudi Arabia was introduced in January 2018.

Markets are Becoming More Accessible

Against that backdrop, the region's governments continue to make impressive progress on financial market development, and have bolstered their inclusion in global financial markets to complement the GCC's embeddedness in global trade, helping to create new opportunities for domestic borrowers to diversify their funding base.

The ability of GCC governments to tap diverse pools of liquidity through international bond and sukuk transactions, putting the region on global investors' map, was critical in ensuring their budgets are financed appropriately and spending on key strategic initiatives, including the continued growth and development of the private sector, could continue. They also helped lay the foundation for others in the region to secure capital from further afield.

As I have written about elsewhere, numerous structural factors and trends – like growing international investor appetite from Asia and other regions, or the growing inclusion of GCC credits in widely-tracked global investment indices – increasingly position regional borrowers prioritising diversification quite well. More recent moves aimed at deepening of the local market are also important to consider in the context of growing and diversifying the domestic long-term investor base, and creating deeper domestic capital markets, providing more opportunities for borrowers in the meantime.

In the UAE, Dubai International Financial Centre's decision earlier this year to move away from an 'end of service' gratuity for expat workers (a one-off payment funded by uninvested accruals) and adopt an employee-funded savings scheme with the proceeds invested on their behalf, akin to a pension fund, seems likely to set a precedent for other companies to follow suit. It may be a watershed moment for an economy where expats make up the vast majority of the working population, many of whom currently position their savings in long-term investments outside the region.

Central to growing and diversifying the domestic long-term institutional investor base is the ability to settle in the region over the long term. Here, too, the UAE authorities are making significant strides.

Earlier this year, the government introduced renewable longer-term year visas that allow certain candidates to live and work in the country without having a national sponsor, and retain up to 100% ownership of their businesses in the UAE. In May, it also launched the country's first permanent residency scheme, known colloquially as the 'Golden Card' programme, which aims to grant permanent residence to investors and highly-skilled professionals.

While the short-term economic impact of these moves is likely to be limited, these reforms highlight both countries' recent focus on deepening and strengthening their business environment, encouraging the development of new industries, and attracting entrepreneurs.

Also underpinning these policy changes is the principle that securing long-term participation in the economy is crucial for guaranteeing the region's financial sustainability and market development. Being able to reside on a long-term basis or settle permanently in the region is a crucial step towards ensuring expats feel they have 'skin in the game'.

Other moves aimed at supporting domestic financial market development are encouraging, both in the UAE and across the GCC more broadly, and will lead to greater market access through a diversity of new instruments. The UAE debt law enacted in October 2018 has laid the foundations for the federal government to create, for the first time, a risk-free government yield curve at the national level, facilitating greater issuance in local currencies for both government and corporate entities – and mirroring similar shifts elsewhere in the region.

Saudi Arabia has steadily built up the Saudi Riyal-denominated sukuk market over the past five years, with the government's April issuance this year extending the local-currency curve out to 30-years, providing an important foundation for borrowers traditionally funded by the government as well as private sector corporates to move into the capital markets. Bahrain, which has seen its access to global markets curtailed in recent years due to widening deficits and credit rating downgrades, has incentivised more local issuance to plug funding gaps; in 2018 and 2019 year to date, Bahraini Dinar borrowing has actually outpaced US dollar-denominated issues.

The creation of a domestic long-term institutional investor base coupled with the creation of a local-currency benchmark has the potential to deepen the local credit market, provide more funding options for the region's corporates, and create a platform for these entities to access a broader range of markets – a virtuous cycle of domestic reinvestment and growth.

Risks and Costs of the 'Status Quo' are Rising

Despite its relative resilience when compared with other emerging markets, the UAE (and the GCC more broadly) is not immune to global shocks.

The 2009 financial crisis and the oil price crash of 2014 both had very distinct catalysts and structural implications for the region's economies. The acute crisis experienced in 2009 challenged the capacity of the public purse, saw vastly reduced domestic bank funding and banking sector liquidity, and incurred steep losses on domestically-focused investors, triggering solvency issues among the region's small and mid-sized companies – a crisis exacerbated by a lack of diversification.

Thanks to the foresight and prudence of regional authorities, the economy was is in a stronger position to manage the challenges experienced since 2014, which was much more diffused in its effects. The GCC region has successfully inserted itself into global supply chains as a crucial trade (and increasingly, capital) corridor between East and West, while the region's governments and a number of pioneering organisations established a foothold in global funding markets. This comes with benefits as well as risks – including, more recently, the potential to get ensnared in an escalating trade war between Eastern and Western powers, which has threatened the global growth outlook.

Nevertheless, as the GCC continues on the path towards greater global integration, the risks posed by a failure to diversify funding through a carefully considered long-term strategy are only growing more numerous, but the environment necessary for a broader group of organisations to move down the path of funding diversification is becoming progressively more supportive. For many organisations, given the strong liquidity environment and local expertise available to them, the bank market remains a good option. Organisations that can proactively move down the path of diversification sooner rather than later stand to be rewarded with lower long-term borrowing costs, greater financial stability, and perhaps most importantly, improved financial sustainability.

Once a Mirage, An Asset Class Begins to Emerge: GCC Local Currency Bond Markets

The growth of the GCC debt capital markets in the first decade of this century was reasonably stunted as the region's need for debt funding was negligible in the face of abundant liquidity ensuing from high oil prices. Due in large part to its sources of revenue and the prevalence of currency pegs, the region's borrowers have predominately relied on US dollar funding. But as GCC corporate entities grow and become more sophisticated, requiring deeper and more diverse domestic funding markets, that looks set to change – with regional governments taking the lead.

Anita Yadav, Head of Fixed Income Research, Emirates NDB

Since 2014, GCC sovereigns have been experiencing substantial problems in balancing their budgets as oil revenues dropped, while expenditures are structurally difficult to curtail. Therefore, tapping the capital markets for funding government budget deficits became the need of the hour, consequently creating the environment for rapid growth of the debt capital markets in the region.

GCC debt markets have traditionally been dominated by US-dollar denominated bonds. However, local governments have recently made notable advancement for deepening the local currency debt markets (LCY) by creating public debt management units, articulating debt management strategies and launching benchmark issues for building yield curves. There has also been substantial improvement in market infrastructure and regulations.

As of April 2019, total outstanding debt in the GCC bond market (USD + LCY) is circa equivalent of USD519bn, excluding short term securities (i.e. securities issued with less than one year to maturity, and T-bills issued by local central banks). Of the total, 63% is issued in USD (USD327bn), 33% in local currencies (approx. USD170bn), and the remainder in other currencies such as EUR, JPY, CNH, and AUD. Saudi bonds account for 38% of the market, followed by UAE at 25% and Qatar at 20%.

Though GCC LCY markets have seen material growth in the last five years, the development is uneven across the six nations. As a percentage of GDP, those in Bahrain and Qatar are the largest and relatively the most developed, while those in UAE and Kuwait have lagged behind. Of the USD170bn in the LCY bond market, Saudi Arabia accounts for 66% (USD112bn) of the market while UAE is less than 1% (USD1.04bn).

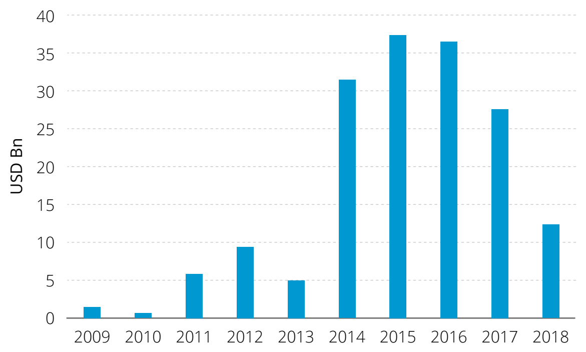
So far issuance in the domestic debt market has remained skewed towards government debt as governments have sizeable funding needs, while borrowing needs of large corporates remain limited in the face of slow economic growth in the region. Though capital market borrowing by local corporates has increased, large firms find it cheaper and more convenient to raise money in global markets (or the domestic loan markets) than in the local currency markets.

Most issues in the LCY market are unrated but expected to have credit quality better than average found in other emerging economies given their linkage with highly-rated governments.

KSA Dominates the LCY market

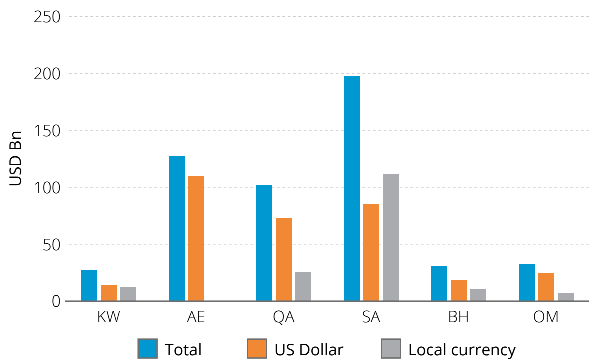
Though as a percentage of GDP, Bahrain has the deepest LCY bond market, in sheer size, the SAR-denominated market dwarfs all others in the GCC. This is attributed to several factors: The KSA is the largest economy in the region, representing circa 47% of the GCC's total GDP followed by the UAE at about 26%; KSA had, and continues to have, the largest budget deficit in the region, requiring it to tap bond markets aggressively to fund expenditures; KSA government-owned entities that traditionally were funded by the government are now having to rely on capital markets

GCC LCY Market - New issues



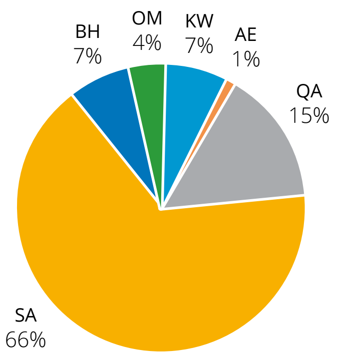
Source: Bloomberg, Emirates NBD Research

USD dominates the GCC debt markets

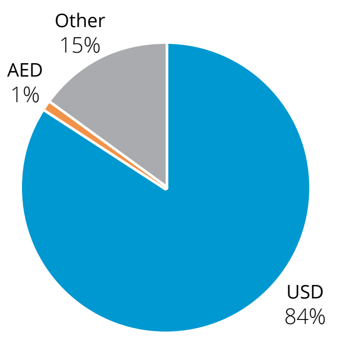


Source: Bloomberg, Emirates NBD Research

GCC LCY bond market outstanding

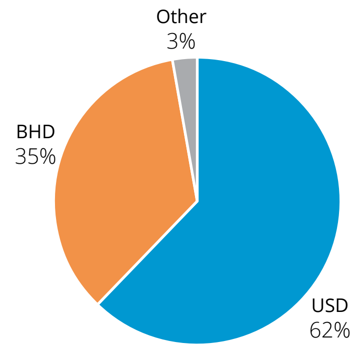


UAE bonds currency distribution



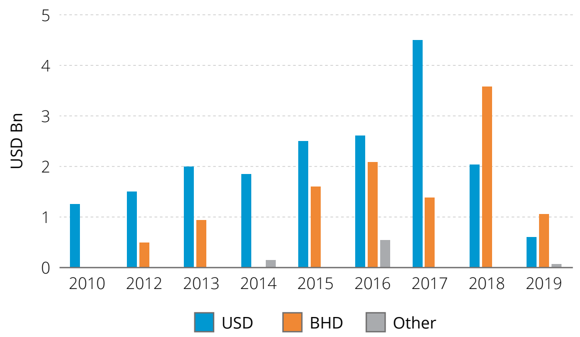
Source: Emirates NBD Research, Bloomberg

Bahrain bonds currency distribution



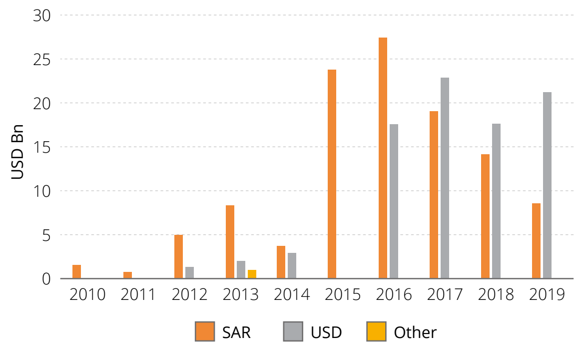
Source: Emirates NBD Research, Bloomberg

BHD issues picking up pace



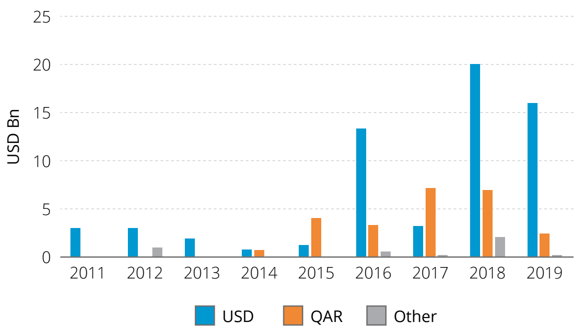
Source: Emirates NBD Research, Bloomberg

KSA new issues: SAR vs USD



Source: Emirates NBD Research, Bloomberg

New issues in QATAR



Source: Emirates NBD Research, Bloomberg

for their funding needs and are therefore increasing their bond and sukuk issuance in the SAR market.

UAE is the Late Starter

UAE's Dirham-denominated market was, and continues to be, negligible. The United Arab Emirates is a federation of seven individual emirates that have their own budgets and own finance departments. Until 2017, there was no law facilitating issuance of debt at the federal level, which made it difficult to create a risk-free government yield curve. However, the UAE government finalized the federal debt law in 2018 and Emirates Development Bank issued the maiden federal level bond under the new law in early 2019, albeit denominated in USD.

Looking ahead, the federal government plans to establish a Debt Management Office, get a federal-level credit rating and have several federal-level institutions involved in issuing Dirham-denominated debt. The Emirates Development Bank expects to commence issuing in Dirham and then follow through with regular issuances in order to create the benchmark government yield curve.

Issuers from the UAE have been the most prolific in tapping markets in non-USD G-7 currencies. Nearly 15% of the current outstanding debt is attributed to other currencies in which EUR, GBP and AUD are the most dominant.

BHD Market Growing Faster than USD in Bahrain

Bahrain's financial markets are the deepest as a percentage of GDP. Total outstanding bonds account for roughly 77% of GDP and the local currency market is roughly 28% of GDP.

Bahrain's fiscal budget deficits began widening before the oil price decline in 2014, mainly as a consequence of increased government expenditure in the aftermath of the Arab spring in 2011. Therefore, Bahrain has been an active issuer of bonds for most of this decade.

With continuous downgrading of its credit rating in recent years, Bahrain's access to international bond market has become prohibitively expensive, thereby incentivizing the government to issue more in the local BHD market. Consequently, total issuance in BHD has begun to dwarf the USD issuance.

Nearly 80% of Bahrain's bond market is attributed to bonds issued by the government and government-owned entities.

OMR Market Evolution

Unsurprisingly, 77% of the Oman debt market is currently denominated in USD and 23% in OMR. Circa 82% of the market is represented by government issues.

The government has relied more on the USD funding than in OMR in order to preserve liquidity in the local banking system for the corporate sector. OMR new issues have remained range-bound around the equivalent of circa USD1.3bn per annum compared with average circa USD5bn in the USD market by the government per annum.

QAR Market is Second Largest in GCC

Qatar's bond market outstanding is around USD107bn, comprising of 71% in USD bonds, 25% in QAR-denominated bonds and 4% in other currencies. Current QAR outstanding of circa USD26bn equivalent is entirely from the government.

Leverage in Qatar's banking system is higher than other GCC, with the average loan-to-deposit ratio being higher than 110%. Consequently, Qatari banks are active issuers in the bond market. However almost all of Qatari banks' bonds are denominated in non-QAR currency, mostly in USD and more recently in CNY.

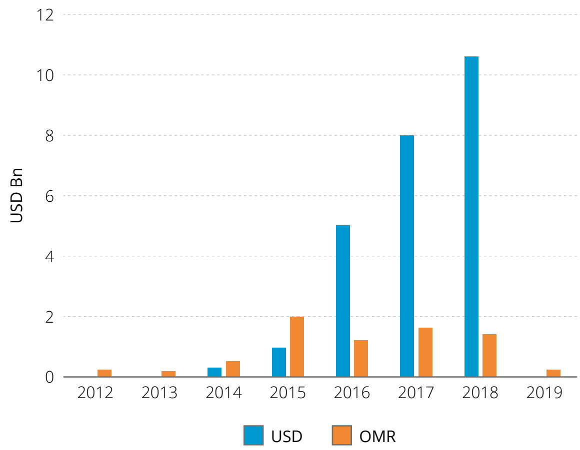
Kuwait

Though Kuwait does not have pressing needs to fund budget deficits via debt, it has chosen to opportunistically issue bonds in order to deepen its capital markets. With no pressing agenda, the development of USD and KWD markets has kept pace with each other. Current KWD-denominated bonds outstanding of circa USD13.3bn is comparable with USD-denominated issues of circa USD14.7bn.

The Kuwaiti government and GRE-related issues account for circa 78% of KWD-denominated bonds, with the remainder coming from banks and financial institutions. Though there is a reasonable spread of government bonds across maturity tenors, creating an effective risk-free curve, no corporate in Kuwait has tapped the KWD market for bonds yet.

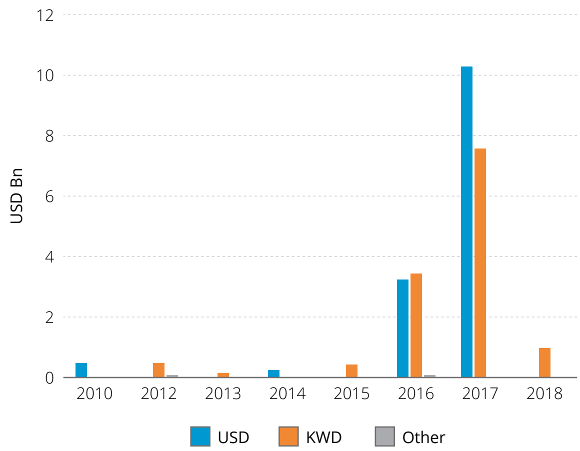
All in all, GCC LCY bond markets have more than doubled in the last five years and while the pace of growth may slow, we expect them to continue registering strong growth over the medium to long-term. Government efforts in addressing factors such as creation of risk-free yield curves, allowing foreign issuers to issue in GCC currencies, promoting repo market in LCY bonds and others are expected to continue providing a resilient platform for growth.

New issues in Oman: OMR vs USD



Source: Emirates NBD Research, Bloomberg

Kuwait



Source: Emirates NBD Research, Bloomberg

Turkcell CFO: Building Resilience to Market Volatility is Core Treasury Objective

After enduring significant volatility in 2018, many Turkish corporates are struggling to keep their balance sheet in order and retain access to affordable financing. Some, however, like Turkcell – the country's largest telecommunications operator – are bucking the trend. Bonds & Loans speaks with Osman Yilmaz, Chief Financial Officer of Turkcell about the company's shift towards an asset-light business model, hedging strategies, and green borrowing.

Q Bonds & Loans: Can you give us a sense of the company's key focus areas over the next 6-12 months? What are the Treasury's key priorities over this period?

A **Osman Yilmaz:** At Turkcell, we will continue to focus on building our resilience to volatility in financial markets, particularly during times of extreme global uncertainty, both globally and locally – this will be a priority.

In Q1 2019, Turkcell delivered a strong set of financials, with Group revenues of TRY5,675mn, up 19.2% year-on-year; Group EBITDA of TRY2,281mn, with an EBITDA margin of 40.2%, and group net income of TRY1,224mn on the back of strong operational performance, disciplined financial risk management and the sale of Fintur.

Encouraged by our first quarter performance, we revised our guidance for 2019 - we now target revenue growth of 17-19%, up from 16-18% and an EBITDA margin of 38-40%, compared to a previous target of 37-40%,

We've undergone a digital transformation over the past four years, from being an infrastructure provider to a digital experience provider. We've enriched our value proposition to our customers through our wide portfolio of digital services. Moreover, through Lifecell Ventures, a subsidiary of Turkcell based in the Netherlands, we help other telecom operators in the world to become digital operators and we also distribute our digital services and solutions globally.

Another focus will be Turkcell's asset-light strategy, – we became as asset-light as possible as a telecom operator, and we have transformed our international business from fixed-asset dominant business to a digital-driven business model. In that sense, we have recently decided to exit our stake in Fintur, with the sale concluding this year. Rather than investing in physical assets outside of Turkey, we are looking to develop digital products and services that we distribute both at home and abroad. This push away from a fixed-asset business model towards a digital one is now being driven by Lifecell Ventures. Turkcell currently has no plans to expand with telecom assets outside Turkey.

At Turkcell, we have a complete business model hedging, based on inflationary pricing, FX and interest rate hedging and liquidity management. The average payback period of our investments is five to seven years, and we ensure that any fresh borrowing bears a similar maturity, which prevents exposure to liquidity risk – a major problem for many Turkish corporates last summer.

Q Bonds & Loans: What are Turkcell's funding plans over the coming months? If you are looking to borrow, what format, size and tenors is the company looking at?

A **Osman Yilmaz:** Currently, the credit environment is not supportive for Turkish borrowers and we do not want to pay excess premiums in this environment. Given that we have secured substantial funding, we do not have a significant plan for an international funding. However, for our local operations we are planning to issue asset-backed securities in the domestic market. So far, we have issued four asset-backed securities specifically in Turkey and we will continue to offer new asset-backed securities over the coming months. Our asset-backed securities include our consumer finance receivables; we have a separate consumer finance company which is subject to banking regulations in Turkey. Currently it is the largest consumer finance company in terms of customers. We often use domestic market for shorter-term borrowings, especially for consumer finance and working capital, and we use international markets for longer term borrowings. We are hedging our liabilities in international markets back to the Turkish lira using derivatives like cross-currency swaps.

Local funding sources are scarce for telecom operators in our region. Telecom and infrastructure companies usually borrow on longer tenors because their investments are long-term. Local banks tend to provide local currency funding with a maturity no longer than a year. Thus, we must finance ourselves in hard currency from different sources such as international banks, export credit agencies and the debt capital markets, which typically provide longer term funding.

At Turkcell, we prefer to borrow even when we are not really in need of financing if conditions are favourable, which results in greater interest from potential financiers and thus much better cost and tenor alternatives.

Q Bonds & Loans: Turkcell recently signed its first sustainability linked loan agreement with BNP Paribas. What were the proceeds of this loan used for? Are you looking to do more green financing deals in the future?

A **Osman Yilmaz:** The Sustainability Linked Loan agreement with BNP Paribas shows Turkcell's intention to incorporate sustainability concerns into its financing strategy. This three-year term loan of EUR50mn has further strengthened our leading position in the loan market with our first-ever sustainable corporate finance transaction. We are continuously looking for alternative funding options, especially in sustainable finance, to not only diversify our sources but also to achieve greater corporate governance and transparency.

The agreement includes a few KPIs such as electronic waste recycling, solar energy use and a reduction in paper consumption. We also aim to reduce environmental effects at Turkcell through our digital services and we build our infrastructure with the future of climate and environment in mind.

As part of our transition towards becoming a digital operator, our digital publishing app 'Dergilik' prevents thousands of trees being cut down by enabling customers to read magazines and newspaper online. Turkcell's smart agriculture Internet-of-Things device Filiz allows farmers to use water resources more efficiently. Furthermore, we continuously track our carbon footprint to fight climate change and aim to lower carbon emissions through the increased use of renewable energy in business processes, while focusing on energy saving with process improvements to reduce waste.

Turkcell also built the Turkish Republic of Northern Cyprus's first solar power plant which will prevent 906,000,481 kg carbon emissions within a year. In addition, Turkcell's energy subsidiary Enerjicell has opened its first solar power plant located in Adana. In the future, we are planning to increase the number of solar power plants we operate, particularly to power our headquarters.

We intend to preserve natural resources for future generations and create value for our customers in a sustainable manner. In this sense, sustainability practices are at the heart of our corporate social responsibility projects.

Q Bonds & Loans: What is the biggest constraint or challenge facing the Treasury department at the moment?

A **Osman Yilmaz:** As liquidity continues to tighten around the world, the main challenge faced by financial and money managers is to manage their liquidity. As such, our priority is to maintain a robust liquidity profile as well as preventing our balance sheet from FX and interest rate fluctuations. As such, we have established a hedging strategy with three pillars.

The first pillar is FX risk management and interest rate management. As an emerging market telecom operator more than two thirds of our capital expenditures are in hard currency investments, and our revenues are around 95% local currency. This creates a mismatch which we eliminate with the help of derivative products such as cross-currency swaps and hedging tools.

The second pillar is liquidity risk management, which is particularly relevant given the increasingly challenging funding environment. We always hold substantial amounts of cash sufficient to secure out short- to medium- term debt payment needs. For example, today the cash balance we have is sufficient to cover three years of debt servicing, even without any further borrowing and even during the most depressed financial scenarios.

The final pillar, which is particularly pertinent in countries like Turkey, is inflationary pricing. This creates natural hedging tools and opportunities within balance sheets.

Fluctuations in foreign currency can be seen as another challenge for many industries at the moment – Turkcell, however, has exhibited strong resilience to these fluctuations and has delivered robust results thanks to its solid business model.

Q Bonds & Loans: With conventional bank funding becoming more difficult to access, are you looking at alternative lenders, such as ECAs, to plug this gap?

A **Osman Yilmaz:** We are indeed looking for alternative sources in the loan and capital markets. For instance, Turkcell has utilised ECA financing from time-to-time and very recently, in February, we signed a 10-year loan agreement of USD150mn covered by the Swedish Export Credit Agency (EKN) and funded by SEK. We are also working with other suppliers in order to benefit from their home countries' policy banks – ECAs, development banks, multilaterals and the like, which traditionally provide financing at very competitive terms. Debt capital markets is another reliable funding source for Turkcell, as evidenced by our two 10-year, USD500mn issuances in 2015 and 2018.

At Turkcell, we are confident that our approach to funding is coherent and strategic – when market conditions are favourable, we can take swift action. With risk premiums currently very high, we intend to ensure that Turkcell's growth plans remain fully-funded through cost-effective short and long-term loans.

Q Bonds & Loans: What is the mix between local and hard currency funding at Turkcell currently? Are there any plans to tweak the proportions over the coming quarters given the ongoing volatility?

A **Osman Yilmaz:** The vast majority of our borrowing is in hard currencies – competitive, long-term, local currency funding is not available. This has long been a typical problem for Turkish corporates as the local banking system relies primarily on short-term deposits. This mismatch inevitably pushes corporates seeking long-term funding to borrow in foreign currency, which is available at a lower cost and in longer tenors. However, even though Turkcell predominantly borrows in foreign currencies, we give utmost importance to managing our open FX position properly. Our Board of Directors has already set at USD500mn limit on Turkcell's open foreign currency position, which is being closely monitored on a monthly basis. Our Q119 net foreign currency position was USD216mn long thanks to our hedging arrangements and foreign currency reserves.

Q Bonds & Loans: How are you managing your exposure to FX swings?

A **Osman Yilmaz:** Macroeconomic and political uncertainties in global markets are affecting global risk appetite and pose significant risks for companies carrying FX assets and liabilities on their balance sheet. We closely follow currency and interest rate risk on our balance sheet and take relevant measures before risks manifest themselves. Recent fluctuations in the global financial markets allowed many companies to discover the importance hedging strategies. This is one of the most important features distinguishing us from other companies.

In addition,advance payment agreements with our suppliers also help us manage our FX risk effectively. At Turkcell, we also give importance to local currency trading which was initiated in 2017. Trading in local currency with some of our suppliers, we are able to eliminate the foreign exchange risk.

Buoyed by Low Global Rates, African Sovereign Bond Sales Rise – But Debt Capacity Hasn't

In May, Kenya became the latest African sovereign to take advantage of relatively subdued global rates and tap international bond investors for fresh funding, but a closer look at debt sustainability metrics suggest the country, and some of its peers, may be slowly running out of room to borrow.

The East African nation's latest Eurobond issuance – split between a 7-year and 12-year tranche that both priced 50 basis points inside initial price thoughts – raised USD2.1bn for the Treasury and saw the books reach USD9.5bn at their peak, according to a statement from Treasury Cabinet Secretary Henry Rotich, who described the response as "overwhelming."

A fund manager who participated with deal says the government exercised prudence in the end, dropping a 31-year weighted average life tranche after investors asked for a steeper concession.

"The transaction was all about pricing," the fund manager says.

"Investors also understood the authorities were under a bit of pressure to refinance their USD750mn June 2019 maturities… They missed an opportunity to issue cheaper."

The country plans to raise up to USD3.2bn in the international markets and approximately KES289.2bn during the next fiscal year starting in July.

Underpinning the transaction's success was Kenya's solid growth story. On the back of improving weather conditions, which boosted electricity production and agricultural output, GDP rose at an enviable rate of 6% in Q4 2018 and deficit projections have fallen from 6.1% of GDP to 5.6% for the forthcoming fiscal year.

The transaction also comes at a time when, for many, the benign interest rate outlook, blended with relatively low rates prevailing in the US and Europe, is creating new opportunities to tap international capital markets up to six months after what was already a record year for Eurobond issuance out of the region.

Debt is Rising

Between 2013 and 2017, countries in Sub-Saharan Africa (excluding upper middle-income countries) issued a total of USD4.5bn annually at an average issuance size of USD1bn, according to data from the World Bank and Bloomberg. In 2018, more than USD17bn of bonds at an average issuance size of USD3bn were placed by governments in the region, and on top of securing near record pricing in some cases, several countries – Nigeria, Côte d'Ivoire, and Kenya – were able to extend maturities on their debt out to 30 years.

With its most recent issue, Kenya now joins Benin, which made its international

Africa

Other borrowers have sought fresh, sizable funding in the loan markets, where some highly liquid banks – particularly European lenders – are competing hard for tenders.

In March, Côte d'Ivoire revealed it would opt to raise up to XOF500bn (approx. USD854mn) in offshore loans with commercial banks, deferring initial plans to place Eurobonds and euro-linked notes until later this year or 2020 at the earliest. The Republic of Angola in April began negotiating a EUR1bn loan with Deutsche Bank, the proceeds of which would go towards "stimulating the private sector", according to a statement from the Office of President João Lourenço.

"There is still robust appetite for sovereign debt out of Africa, particularly for the highly-rated credits," says one London-based syndicated loan banker who covers Sub-Saharan Africa (SSA). "But liquidity isn't available to everyone. Banks are selective."

The World Bank says debt accumulation in the region is rising to worrying levels. Median debt-to-GDP in the SSA region more than doubled from an average of 24% in 2012 to 53% in 2018; during the same period, publicly guaranteed debt as a percentage of GDP grew from 18% to over 27%.

It also believes the changing composition of that debt should raise concerns over debt serviceability. Between 2010 and 2017, the share of SSA public debt made up of commercial bank loans, bonds and bilateral lending from non-Paris Club member countries increased 5%, 10% and 6% respectively while the share of Paris Club member country loans and concessional loans from multilateral lenders dropped 9% and 12%.

debut in March and raised EUR500mn in notes maturing 2026 with a coupon of 5.75%, and Ghana, which in the same month raised USD3bn in notes spread across three tranches (2027s at 7.875%; 2032s at 8.125%; and 2051s at 8.95). The region's pipeline is expected to swell to make room for other sovereigns to come to market, including South Africa, which recently saw incumbent President Cyril Ramaphosa and the ruling ANC retain their majority in national elections; the country's National Treasury may look to capitalise on positive market sentiment by raising up to USD2bn – a third of its external borrowing requirements over the next few years – in a fresh bond sale.

At the same time, average growth since 2010 has largely trended downward, dropping from just over 6% to between 3% and 4% - marginally better than global growth, which has largely remained within a narrow band of 2% to 3.5% over the same period.

A shift towards greater reliance on more expensive international liquidity is partly a symptom of these countries' efforts to deepen integration with international markets; easing off concessional and donor funding comes with the territory of market development and evolution.

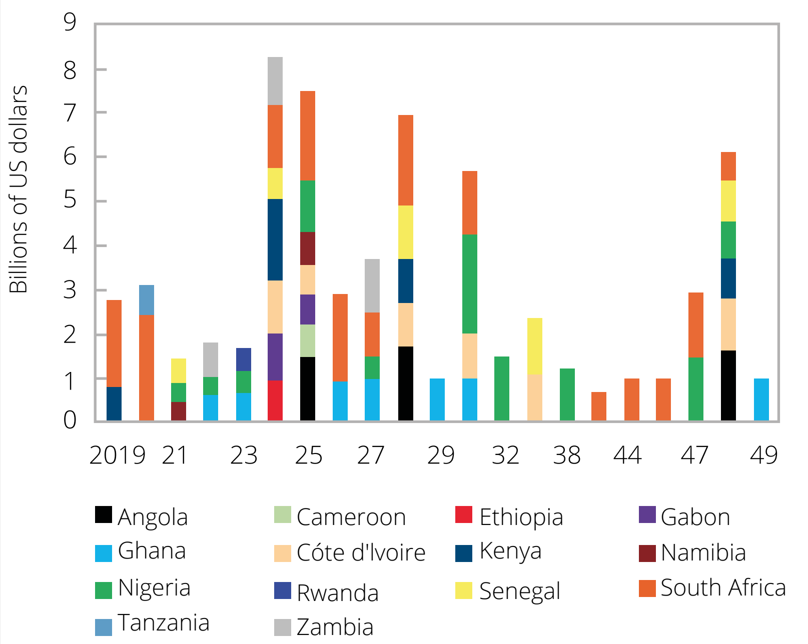
Perhaps more concerning is the region's increasing reliance on Chinese loans, which are often sought by governments in the region because they can be executed more quickly than alternatives (i.e. IMF funding, or bilateral concessional loans from OECD countries) and often come with less stringent fiscal and monetary policy conditions attached.

Chinese lending to Africa has jumped tenfold in the last five years, according to Moody's, and about 20% of African government external debt is now owed to China according to IMF estimates, making it the single largest donor country for African states. For resource-rich countries like Angola, the DRC, Djibouti and Zambia, which have leaned on Chinese funding to increase resource extraction and production and help ease logistical constraints inhibiting market access, the proportion of public debt sourced from China is much higher – in some cases reaching over 70%.

From a credit risk perspective, the lack of transparency around the terms and conditions attached to these funding agreements makes the outcome of any sovereign debt restructuring very difficult to predict. The nature of the collateral for many of these bilateral arrangements is also unclear; in some of these countries, the extent to which China could seize control of natural resources in the event of a loan default could have a significant impact on their ability to repay other creditors.

Those concerns among others have started giving African nations pause. The Kenyan government recently decided to shelve a planned extension of the Standard Gauge Railway, a large rail project connecting the strategically important Indian Ocean port city of Mombasa to the Kenyan capital, after encountering significant delays and cost overruns. The project has also been marred in corruption. Leaked term loan agreements from 2014 between the Export-Import Bank of China and the Kenyan government, which controversially includes a waver on the sovereignty of assets, have also served to stoke local resistance to the USD8bn Chinese-funded project.

Sub-Saharan African Frontier and Emergind Market Economies: Maturity of International Sovereing Bonds



Source: Bloomberg

Late last year, Sierra Leonean government cancelled contracts with Chinese firms to build a USD318mn airport outside the capital of Freetown, after the current President Julius Maada Bio deemed the project "uneconomical." The move came after both the World Bank and IMF warned the project would impose a heavy debt burden on the country.

Should We Be Worried?

That depends on where you look. Cases of short-term distress, save in a few instances where economic challenges or shortcomings are fairly well-known (i.e. Zambia, Republic of Congo, Mozambique, Zimbabwe, Sudan), are less prevalent today than a decade ago – and appear less prone to regional contagion.

External pressures are also easing. Global growth and tightening global monetary policy, two extremely influential risk factors for SSA, appear to be working in the region's favour – at least for now. The US Federal Reserve has proven itself to be much more cautious about future rate rises, while analysts are even beginning to price in rate cuts in 2020; US growth continues to defy all odds, jumping to 3.2% during the first quarter of 2019, while growth in the European Union appears to finally be lifting off lows of 1.5% seen during the same period.

But the longer- term trend in the SSA region's debt sustainability and debt capacity tells a more ominous story. Despite the rising prevalence of the IMF on the continent, debt servicing costs as a percentage of revenue have risen since 2010, in some cases by as much as 24%. The median government revenue as a percentage of GDP across the region has also fallen from 25% in 2011 to 19.9% in 2018, underscoring challenges a number of countries have with fiscal leakage, economic informality, and ongoing consolidation efforts, explains Jan Friederich, a senior director at Fitch Ratings.

"There is a fundamental tension between a very obvious gap in infrastructure and social development relative to these countries' aspirations and needs, and the capacity of the revenue base to support the kind of infrastructure and social development spending needed. This is a coherent – and alarming – theme in almost every SSA country we rate."

Africa's infrastructure gap is well-known, and the negative impact of that deficit will continue to be magnified by climate change. The African Development Bank estimates the continent is underinvesting in infrastructure by as much as USD170bn annually, reducing the region's potential output by roughly 2% each year.

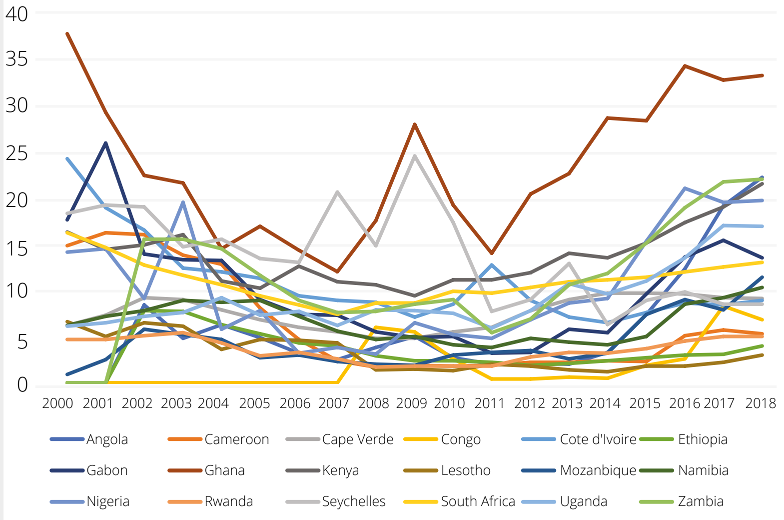
Climate shocks, like the drought that wreaked havoc on eastern Africa in 2016 and sent food prices skyrocketing, have become more prevalent in recent years, in some cases decimating physical infrastructure while also weighing heavily on agricultural output and power production. Cyclone Idai, a tropical storm which made landfall in southeast Africa in March this year, tore through roads and waterways while destroying vital farmland in Mozambique, Zimbabwe, and Malawi, killing more than one thousand people and displacing up to 2.6 million, according to the United Nations.

Political strife – the source of nearly half of all sovereign defaults, according to research from Moody's, and a key factor behind Côte d'Ivoire's 2011 default – seems to rest at the margins, but that may change as pressures mount in some countries.

In Cameroon, mounting tensions in the country's two western Angolophone provinces, coupled with a conflict with Boko Haram on its northern borders, have refocused the government's attention on security. In Côte d'Ivoire, a fractured alliance between the country's two largest parties could manifest in the form of rising political violence in the run-up to the country's 2020 elections. Clashes in Ethiopia's northern Amhara state, often the result of land feuds between farmers and at times cut across ethnic lines, have claimed nearly 100 lives so far this year, while clashes along its southern border with Kenya are also on the rise. In the Democratic Republic of Congo, a large backlog of government arears on wages and pensions has yet to be cleared by the country's recently (and controversially) elected leader, Felix Tshisekedi, following a promise abandoned by the previous government, threatening the country's stability.

"There are deeper, fundamental issues that need to be resolved before debt capacity can increase," Friederich says.

Sub-Sharahan Africa Sovereign Debt Servicing Cost as % Revenue



Source: Fitch Ratings, National statistics

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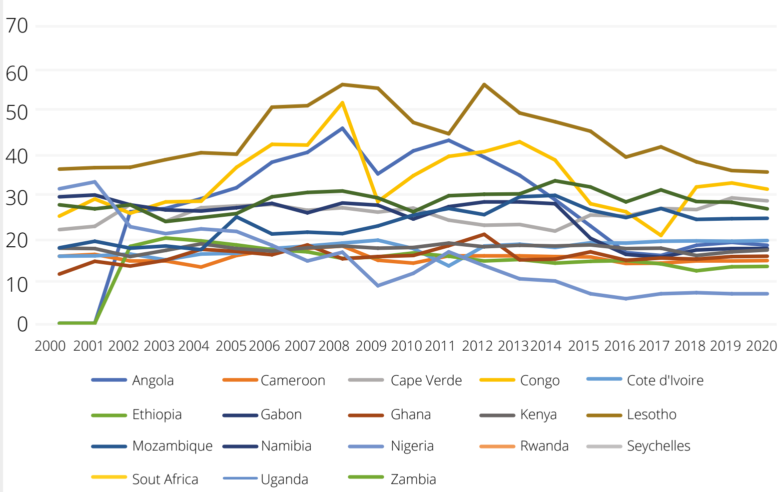
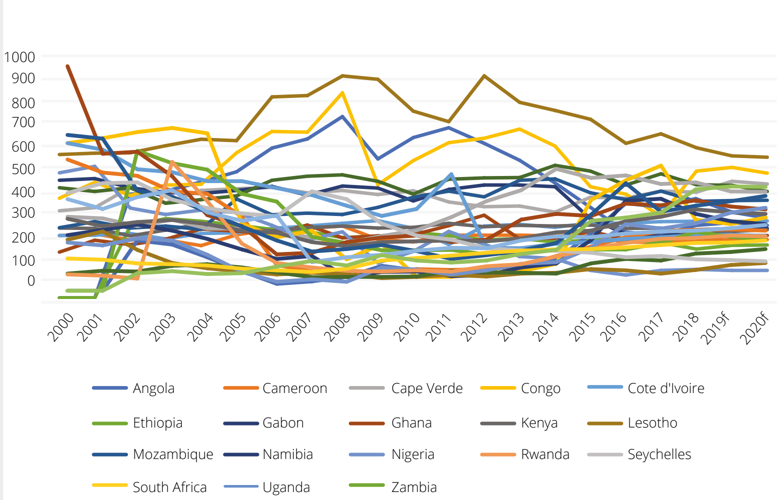


Source: Fitch Ratings, National statistics

Sub-Sharahan Africa Government Debt % Revenue



Source: Fitch Ratings, National statistics

Growthpoint SA Group Treasurer: Internationalisation, Funding Innovation in Focus as SA Economy Stays Soft

When the economy suffers, real estate is often among the first sectors to feel the pinch – and South Africa, where growth has stagnated amidst a hitherto volatile political landscape, is no exception. As the country's recent election outcome heralds renewed optimism in the economy, we speak with Dirkje Bouma, Group Treasurer at Growthpoint Properties Limited, one of the country's leading real estate companies, about its approach to funding innovation and generating new revenue streams in a tough market.

Q Bonds & Loans: What is the outlook for the property sector in South Africa for the remainder of the year? What are some of the major factors influencing that outlook?

A Dirkje Bouma: South Africa is in the midst of a challenging economic environment, stretching some tenants quite thinly; the fundamentals are weak at present, meaning the demand for real estate is somewhat subdued. Because of the lack of growth domestically, the office segment is starting to come under pressure, while at the same time, the tough economic environment translates either into consolidation or increased demand for shared office space, both of which lead to reduced demand for square meters. There has been overdevelopment in some metropolitan areas, which has also led to a rise in vacancies.

The retail sector (mall segment) is also struggling, in large because South African consumers are currently quite constrained. Consumer demand is low, which is having an impact on shopping centres. The market is currently highly saturated, with relatively loose public town planning rules leading to a number of competing retail centres in some areas.

One of the bright spots is the industrial segment – particularly the areas where we

focus, such as warehouses and logistics. The segment is relatively stable despite occasional spikes in vacancies, but we benefit from export into the rest of Africa.

We don't see e-commerce having a significant impact on the industry over the next five years, but it's clearly a long-term trend we can't ignore, especially the opportunities for it to drive demand for logistics and warehousing. There are challenges in the near term; currently, just 60% of South Africans have access to internet, and with large rural populations where the e-commerce model struggles due to logistical bottlenecks. But there is a growing number of e-commerce companies looking at last-mile delivery, and there has been a rise in collection points.

Q Bonds & Loans: What are some of the main strategic initiatives in place for the company and the treasury department over the near term? What is the treasury most focused on at the moment?

A Dirkje Bouma: There are three main components to our broader strategy: internationalisation, optimising and streamlining our existing South African portfolio, and adding new revenue sources. As per our last reporting period, just over 31% of our assets are located offshore, and around 23% of our earnings are generated from offshore sources. Our ambition is to increase those numbers –but at the same time maintain balance sheet strength. If we are going to grow, considering the state of the South African economy over the next few years, we need to grow offshore while improving our portfolio locally in South Africa. Growthpoint Australia, our subsidiary which is listed in Australia, focuses on office and industrial assets; we own 65% of that business. We also own 29.8% of Globalworth Real Estate Investments, which is present in Romania and Poland, and focuses mainly on office property.

As part of our drive to introduce new revenue streams, we are aiming to build a R15bn funds management business over the next few years. This is essentially a capital-light strategy where we will raise third-party funding in each fund, introduce gearing, and where Growthpoint retains a small stake but also earns fees on 100% of the assets under management. These funds will all be separate and distinct to Growthpoint's existing South African portfolio, either by way of asset type or geography.

To date, we have two funds: Growthpoint Investec African Properties (GIAP) and Growthpoint Healthcare Property Holdings (GHPH). GIAP is investing in commercial real estate in the rest of Africa, using USD212mn already raised to date. GHPH is a specialised healthcare property-focused unlisted real estate investment fund focused on acquiring assets such as hospitals, medical chambers, labs, pharma warehouses, and other healthcare-related property assets. The fund is roughly ZAR2.5bn in size, and we're looking to grow that.

Third-party property development and trading will never exceed 5% of the value of our South African portfolio and any once-off income of a non-rental nature, including trading and development fees and profits, will contribute a maximum of 1% to 2% of distributable income. That said, as part of unlocking new revenue streams, we are leveraging our well-established property skills to take advantage of the opportunity to earn development fees from third parties as an agile partner for our clients.

Ultimately, the treasury is most focused on managing our debt maturities and securing a lower cost of funding. We often finance the company through bullet-repayment structures, and we want to maintain a good balance of debt and equity. Often, we are only able to secure 3 to 5-year financing from banks, but we have issued bonds allowing us to raise 10-year money. The weighted average term of our book is just over 3-years, and one of our strategies is to raise that well above the 3-year mark. We are also constantly looking to increase our unsecured debt – without raising the cost of debt too much.

Investor relations and relations with credit ratings agencies is hugely important for us. Our global scale rating is constrained by the South Africa sovereign rating, in large part because real estate in general and Growthpoint specifically is strongly linked to the performance of the South African economy.

Q Bonds & Loans: Given the state of the South African economy and the credit outlook – particularly from an international funding perspective – how is the treasury looking at funding diversification?

A **Dirkje Bouma:** We continuously explore new pockets of funding. In line with our globalisation strategy, we issued a USD425mn Eurobond in April last year. It was a little more expensive than what we would find when using our ZAR base and swapping into dollars, but this was a decisive strategy to ensure we diversify our debt investor base. We also intensified our international debt investor relations in line with a greater focus on debt capital markets further afield.

Q Bonds & Loans: You have previously emphasised the importance of funding innovation in achieving the treasury's and company's broader objectives, but how do you approach that in a downturn?

A **Dirkje Bouma:** We want to stick to the principle that we don't raise hard currency funding for our South Africa ZAR-earning operations for two main reasons: the first is that we have exchange control regulations, which in our case means that there is strict control on the use of hard currency funding. Further, we would not like to service hard currency debt with a currency that is expected to depreciate. We have seen South African companies financially battling as their balance sheets and income statements were not correctly matched from a currency point of view. We also have an AAA.za national scale rating from Moody's, so we have access to quite a large investor base domestically, both from banks and the debt capital markets, and there is still enough liquidity available to satisfy our needs. Local investors can only take up to 25% of their assets under management offshore, but the rest has to stay here in South Africa. So we benefit from a strong liquidity pool because they can't take money out of the country as easily – in fact, these exchange control regulations were a big reason why the South African economy was so resilient throughout the global financial crisis ten years ago.

We recently issued our maiden inflation-linked bond, which we were able to swap back to an attractive Jibar-linked interest rate. We believe we are the first South African REIT to issue an inflation-linked bond. This speaks to the innovation: by issuing an inflation-linked bond, we were able to tap liquidity pools that have currently no exposure to us and that have limited exposure to corporates. There seems to be a shortage of inflation-linked products in the South African debt capital markets. We privately placed R600 million for 10 years, where we would probably struggle with a vanilla bond to raise this volume in the current market.

Q Bonds & Loans: Growthpoint became one of the first corporates in South Africa to list a green bond on the JSE. What were some of the drivers of going green, and what was the company hoping to achieve by issuing green vs. conventional? Do you anticipate more green issuances in the future?

A **Dirkje Bouma:** Sustainability is core to what we do. We have a sustainability department in Growthpoint, mainly focused on the green building side, but across the company there is a big focus on sustainability, especially on water and energy savings. More than 80 of our properties – accounting for more than 1 million square metres of office space - is certified by the Green Building Council of South Africa and they boast 100-plus Green Star ratings.

We want to play an active role in the country's – the world's – transition towards a low carbon future, in line with South Africa's broader climate change mitigation commitments, and that extends to the funding market as well.

When we saw that the City of Cape Town issued a green bond, we instantly began to discuss whether there were opportunities to link our green building assets with green capital via the capital markets. We did realise that we wouldn't get a huge funding benefit from it, but because we already have the green assets, it wouldn't be a huge effort to test the waters with an issuance. We didn't see much of a pricing benefit, but the marketing you get out of it – the 'tick of approval' from investors – has enabled us to get quite a bit of mileage out of the sustainability journey the company has taken, and has raised awareness around the quality of the company's fundamentals.

There were also diversification benefits. That green bond was the first time we publicly placed 10-year notes in the market, and we secured reasonably strong demand. The green factor made us more confident as we looked to hit the market and raise funding. It was also the first time an international investor came into our bond issue, an investor that had specific objectives in terms of promoting climate change mitigation.

The challenge domestically is that there aren't enough dedicated green bond funds in Africa and specifically in South Africa. Many of them focus on sustainability – like Futuregrowth, which always wants to see an ESG or developmental angle, but there no dedicated green bond funds in the region. The other challenge you encounter is that the secondary market for corporate debt in South Africa is very illiquid. This also needs to mature.

The green market is developing – we saw Nedbank recently issued its debut green bond. The market will expand, but we need to see it deepen and broaden; it would be good to get greater diversification in terms of names.

Q Bonds & Loans: That being the case, does Growthpoint plan to tap the loan or capital markets over the coming year? If so, what kinds of liquidity pools or markets is the company looking to tap into?

A **Dirkje Bouma:** We are constantly looking at refinancing our loan book – so continuously interacting with our banks on a bilateral basis. We recently did a bond issue for ZAR1bn in April, and we hope to do a further ZAR bond issue before the close of our financial year at 30 June. Tapping the international bond market largely depends on our internationalisation strategy.

Q Bonds & Loans: To what extent do you believe the economy will begin to stabilise following the recent election result? Are there any potential policies contained within the ANC manifesto that could provide tailwinds for the sector?

A **Dirkje Bouma:** I recently attended a conference where President Ramaphosa was speaking, and it is clear he is focused on economic growth and reducing unemployment. To hear him say "what keeps me up at night is jobs" is important at a time when the South African unemployment rate sits above 25%. It's also important for us because real estate is a barometer for the economy – if it isn't growing, it's real estate companies that are among the first to feel the affects. The mood in South Africa is positive and we are hoping that an economic recovery will follow soon.

Off the Record in Kenya: Private Equity, Banking Consolidation, and a Blossoming FinTech Sector

The last three years have been tough for Kenyan banks and corporates. The introduction of the interest rate cap in 2016 sapped liquidity, leaving many corporates deprived of financing. But the last few years have also seen the blossoming of new liquidity pools including private equity and mobile lenders, which are beginning to claw market share away from banks, according to CFOs and bankers who spoke with Bonds & Loans on a recent research trip to Nairobi.

Unsurprisingly, the interest rate cap was a frequent topic of discussion. Introduced in 2016 by President Uhuru Kenyatta, the cap limits lending to 4% over the Central Bank Rate, with the intention of making funding more affordable. Instead, liquidity quickly dried up, partly due to banks' inability to accurately price risk. While access to funding for large and medium-sized corporates has been hindered, SMEs – which make up around 60% of Kenya's GDP – has been severely inhibited.

When the cap was implemented, many were quick to predict that it would be short-lived. Three years on, the cap remains, and a recent motion to remove it in the National Assembly was resoundingly defeated.

Still, neither the longevity of the cap, nor the defeat of a recent bid to remove it, have been able to dent market optimism. There was a near-consensus during our meetings with well-placed sources that the cap will be loosened within a year. Some pointed to the Nairobi High Court's recent ruling that the cap unfairly discriminates against banks. Others highlighted the fact that the IMF has demanded the government remove the cap in order to receive a standby facility in advance of its next Eurobond issuance – without which, capital raising will be far more expensive. Many argued that the government's costly 'Big Four Agenda', which includes an ambitious Affordable Housing programme, will fail unless the government allows capital-intensive sectors such as construction to borrow more easily.

Until the cap is changed or removed, however, banks' profits will continue to be squeezed. One banker argued that whilst banks once made solid returns, the rate cap has cut margins nearly in half. Whilst the cost of funds was once around 3% and banks could lend to an SME at around 18%, the cost of funds has since climbed to 7% and lending is capped at 14%.

For many Kenyan corporates, access to conventional corporate funding remains out of reach. This is particularly true for SMEs, which make up around 60% of Kenyan GDP. Some corporates even berated DFIs, who they argue offer financing based on the volume of collateral provided, rather than the quality of individual projects. The value of partnering with organisations capable of extending credit insurance is perhaps more crucial than ever, and one of the driving factors behind the ascension of firms like Guarantco and African Trade Insurance (ATI).

Unfortunately for Kenya's borrowers, the regulation governing pension funds only serves to exacerbate a liquidity shortage. Unlisted loans can make up no more than 10% of a pension fund's assets under management (AUM). Currently, unlisted debt only accounts for around 2% of most pension funds' AUMs.

Mobile Lending

A cautious banking sector has acted as a catalyst for a boom in mobile lending platforms in the region. Given East Africa's high mobile penetration and heavily underbanked population, the region is fertile ground for the evolution of digital lending platforms. While Safaricom has consolidated its position as market leader – making up around 64% of all digital lending in Kenya – conventional banks have been aggressively expanding their mobile lending platforms.

For FinTechs, such partnerships allow them to optimise their spending decisions. Safaricom's agreement with Kenya Commercial Bank (KCB), for example, allows them access to KCB's customer spending data, more effectively informing lending decisions. For banks, partnerships like these allow them to retain their existing customer base – even if such ventures are not immediately profitable.

For traditional FinTechs, partnering with banks is no longer a luxury but a necessity. Some we spoke with felt that, unless traditional digital lenders are not able to better inform their lending decisions and bear greater risk (by working with banks primarily), they will not survive. Whilst Branch, for example, can lend at a rate of 15%, M-Shwari can extend credit at rates of around 7%. Similarly, Safaricom is able to access customer data from the banks it partners with, supplementing its lending decisions, whereas some FinTechs rely on metrics as crude as a potential borrowers' social media usage.

Private Equity

The last five years has seen a massive influx of private equity firms in East Africa, with many setting up pan-African operations in Nairobi. Many pinned this shift on a generational divide: as the corporate base has shifted away from a concentrated number of large, family-owned conglomerates, many younger, smaller corporates are more open to selling-on their businesses or searching for strategic investors.

Whilst banks tend to offer senior credit, PE firms tend to fill the gaps, with many specialising in sectors where banks do not. Regardless, the blossoming PE industry still offers banks opportunities if they are willing to co-invest in these funds. Currently, many smaller corporates see PE funding to be a more viable alternative to conventional bank financing.

Some voiced concern over the sheer number of PE funds entering the region, citing a lack of viable corporates. Others highlighted that the traditional five-year timeframe in which a PE firm seeks to flip a company is often exceeded in the region.

The growth of PE has also posed a problem for the Capital Market Authority's ambitious Ikuba programme, an incubator programme intended to guide SMEs towards becoming listed entities. As part of the programme, the CMA aids corporates in maintaining governance standards and assistance is preparing the necessary documents for capital raising. However, some argued that the project's goal – an eventual IPO – is a far less appealing option for capital-raising than turning to the PE market.

Although an array of reasons was cited for the lack of primary activity in the bond market, some feel that the CMA's requirements for market players looking to issue are too high; key thresholds prescribed by the regulator, such as gearing ratios, are very strict. There was muted optimism over the recently created short-form prospectus, however this was seen more as a small step on the road towards an active primary market.

Banking consolidation was one topic of discussion where the regulator received its share of praise. Following the defaults of Chase Bank and Imperial Bank, the CMA sought to raise the capital requirements for banks. However, following appeals from some Tier II and III banks, the implementation of these thresholds was delayed, slowing the process and offering smaller banks a degree of reprieve.

The Africa-Middle East Corridor

East Africa is increasingly drawing the interest of Middle Eastern banks and investors, according to one source, who mentioned that several institutions are looking to expand into the region over the next two to three years.

A Yemeni insurance company and a large Bahraini bank are among those looking to expand their operations in the region, whilst a number of Egyptian banks are eyeing potential acquisitions in sub-Saharan Africa. Whether this newfound interest from Middle Eastern institutions will begin to reshape East Africa remains to be seen.

It has been a challenging few years for the East African market, as regional idiosyncrasies, such as the Kenya's rate cap, crossfed into broader emerging market volatility and weak commodity prices. But as the economic cycle begins to bottom-out, it seems unlikely that East Africa will return to business-as-usual. In many ways the region is in flux, with rapidly evolving sectors such as mobile banking and private equity already reshaping the region's markets.

MTN Group CFO Targets Capital Structure Optimisation in Nigeria and Ghana as New Opportunities Emerge

South Africa-based pan-African telecoms operator MTN Group has been at the forefront of the industry's transition towards data-centricity and, in Africa specifically, it is leading the region's bid to use mobile technology to bolster financial inclusion and connect ever greater numbers of users to the internet. We speak with Ralph Mupita, MTN's Group CFO, about the funding strategy underpinning the company's bid to make mobile connectivity ubiquitous in Africa.

Q Bonds & Loans: What are some of the major strategic initiatives in place at MTN Group, for the company and the treasury?

A **Ralph Mupita:** We are very focused on building the leading digital operator in Africa and the Middle East. Only one third of the population in our markets is connected to the internet; also, only a third of the population is formally banked or has access to financial services. Leveraging our brand and resources, we see and are executing on an opportunity to play a meaningful role in delivering digital and financial inclusion in our markets.

With the release of our 2018 results, we announced the outcome of our portfolio review, where we are looking to simplify the Group, reduce risk and improve returns. An outcome of the review is that we looking to monetize our e-commerce and tower investments, where we expect to realise ZAR15bn of proceeds over the next 3 years (Asset Realisation Programme), excluding the IHS tower investment, that at the end of December 2018 was valued at ZAR23bn.

From a treasury perspective, we have the following priorities: Stabilise the holding company leverage, keeping it within the 2.0x to 2.5x range; optimize the capital structures within the company's subsidiaries, with a focus on Nigeria and Ghana; shift the mix of holding company debt towards 60% Rand denomination and balance our US dollar and euro-denominated debt range whilst optimising leverage at the subsidiary level, where the balance sheets are under-levered; and, execute on the Asset Realisation Programme to accelerate the stabilisation of net debt.

Q Bonds & Loans: We note MTN Group's bid to increase local ownership of the Nigerian subsidiary. What's driving that, and what can the market expect in terms of debt issuance specifically? Is there a sense of transaction size and tenor, or certain markets the company wants to prioritize fundraising through?

A **Ralph Mupita:** MTN Group believes that the sustainability of subsidiaries is enhanced by having meaningful local ownership. We have completed a listing by introduction for our Nigeria subsidiary, where we currently hold 79%. For multi-national firms such as ours that are listed, we have seen that the free-float they have is approximately 35%. MTN Nigeria's current free-float is 21%, and market conditions being conducive, we would look to do a public offer to get towards the free-float of 35% and be in-line with the market. Proceeds from such a public offer would be used to further manage the holding company debt as well as other capital allocation priorities.

Q Bonds & Loans: What other markets is MTN looking to expand or pull-back in? What are some of the key factors guiding those decisions?

A **Ralph Mupita:** Ethiopia is a market that is of interest to the MTN Group, so we are following the developments in that market closely. At the right investment level and related licence conditions, Ethiopia has the potential to be a major growth market.

Q Bonds & Loans: What are some of the key challenges and risks facing the company from a markets or fundraising perspective?

A **Ralph Mupita:** The regulatory environment will always be challenging from an operations perspective, given the maturity of legislations in our markets. We have put in place extensive processes and controls over the last two years to manage risk and compliance better. Operating in emerging markets means that currency volatility, cash upstreaming challenges and FX conversion are some of the key risks we need to manage and mitigate across our markets and at the holding company level.

Q Bonds & Loans: What is the most disruptive force in the telecoms industry today, in your view?

A **Ralph Mupita:** I see three major disruptive forces, all of which are interrelated. Firstly, traditional telco players like MTN Group are evolving into digital operators to directly provide digital and financial services. Secondly, low-cost smartphones will enable the a billion more users to access the power of the internet and financial services. Thirdly, the current low cost of data access, which is being driven even lower.

Brazil Corporate Borrowers Roundtable: Special Report

Despite a Challenging Outlook, the Local Market Grows Leaps and Bounds

It has not been an easy 12 months for Brazil's corporate sector, which faces a multitude of challenges, both internal and external. Bolsonaro's victory in the elections, though divisive, at least provided some reprieve from the political uncertainty that has weighed on Brazil's markets in the run up to the vote. Still, many questions remain around the direction of policy, and the new government's ability to push it through congress, as well as broader shifts in the macro-economic environment.

External pressures persist. Emerging market assets have been battered by US tariffs, prolonged and rarely successful trade negotiations, and geopolitical flare-ups that at various points through the year threatened to upend the global economy. As a result, the Brazilian real, like many EM currencies, experienced significant volatility in the past year; spooked by rising FX risk and the increasing cost of borrowing on the international markets, borrowers and issuers in Brazil (and indeed through much of Latin America) have been retreating to the domestic market, which has boomed since the start of the year. Corporate CFOs reduced international debt sales almost 40% in 2018, partly to avoid additional expenditure on hedging against a strong US dollar. Locally, sales held steady amid record low interest rates, marginally improved GDP growth expectations and still ample domestic liquidity in Brazil, and Latin America more broadly.

It is in this peculiar, yet promising, environment that many corporate CFOs, Treasurers and finance managers found themselves in as they convened for an exclusive roundtable discussion with Bonds & Loans and HSBC in Sao Paulo in June and ahead of the Bonds, Loans and Derivatives 2019 conference.

Some of the discussions, key themes and learnings drawn therefrom will be summarised in this report, which – we hope – will help other CFOs and Treasurers navigate a challenging economic environment and increasingly complex funding landscape.

Political Landscape: Challenging, but Promising

While the consensus among corporate finance managers was that political uncertainty diminished tangibly with the passing of the elections, few of them have been able to push politics to the back of their minds entirely. Most of their concerns currently revolve around the progress on the reform of Brazil's pension system. As the revised (and likely watered down) draft of the proposal is about to be unveiled, many questions remain unanswered.

How much of the total savings will be lost to revisions? Will the draft automatically include the states and municipalities? And will this draft glide through all the

Americas

necessary hoops and be passed by the Lower House before mid-year recess?

Furthermore, as one participant pointed out, much more work will need to be done beyond the pension reform.

"The government has a big task ahead in terms of fiscal targets. The fact that the fiscal gap is being addressed through pension reform is a positive factor. However, the reform – even if passed – will not be a panacea, but only the first step," said Felipe Bomfim, CFO of Patria Infrastructure.

Most CFOs agreed that the uncertainty over reforms has been weighing on market sentiment in Brazil, negatively impacting issuers' ability to secure funding. But this is where the banks – especially international ones – can introduce solutions that are tailored to the idiosyncrasies of the local corporate sector.

"In the big scheme of things, the current short-term outlook for the economy is much better than it has been in past decades; there is less pressure on balance accounts, and the country's long-term prospects are appealing to investors worldwide," added Bomfim.

Infrastructure in Brazil – Next Steps

According to the World Economic Forum, Brazil ranks 108th out of 137 countries in the "quality of infrastructure" category, well below even some of its smaller regional peers. Yet it is this very gap that holds much of the country's vast growth and investment potential, particularly as infrastructure investors tend to look for windows of at least 10-15 years for ROI.

"The appalling state of infrastructure in Brazil is actually a huge opportunity, especially now, as historically large-scale infrastructure development programmes formed a big part of any post-recession cyclical recovery in economies world over," Bomfim pointed out.

The new government, headed by a "strong team of regulation and privatization specialists," is driving this development; while this is still a tough market, the iterative progress on formulating and reforming regulatory frameworks is seen as encouraging. IPP, the public-private linkup initiated in 2016, has already achieved significant results: of the total of 193 projects picked up by the programme, 136 have been successfully

Meet The Participants

Claudio B Matos, Head of Debt Capital Markets, Brazil, **HSBC**

Yevgeny Kuklychev, Deputy Head of Market Insights, **GFC Media Group**

Alexei Remizov, Managing Director of Latin America Global Capital Markets, **HSBC**

Fernando Gusmao, Vice President, Global Banking, **HSBC**

Camila Abel Correia da Silva, Director of Treasury, **AES TIETE**

Joelmir Silvestre Baumgratz, Senior Treasury Manager, **Azul Linhas Aéreas Brasileiras**

Antonio Jose de Aguiar, Director de Investimentos, **BASF**

Carlos Gradim, Treasury Director, **Biosev**

Odivan Cargnin, CFO and Investor Relations, **Celulose Irani**

Lara Monteiro, CFO, **Echoenergia**

Henrique Alexandre Mazzardo, CFO, **Fiagril**

Julio Cesar Maciel Ramundo, Corporate Finance Director, **Grupo Suzano**

Marcio Lewin, CFO & Investor Relations, **GRU Airport**

Ricardo Eguchi, CFO, **Kion**

Marcus Giraldes, Financial Manager, **Natura**

Leandro Nunes, Treasurer, **Omega Energia**

Felipe Bomfim, Director, **Patria Infrastructure**

Marcelo Gallioto, Financial Director & Regional Treasurer, Latam, **Scania**

Luiz Torres, Head of Treasury & Finance, **TechniPFMC**

Clara Borges, Senior Economist, **Ultrapar**

Raul Cadena, CFO, Votorantim **Energia**

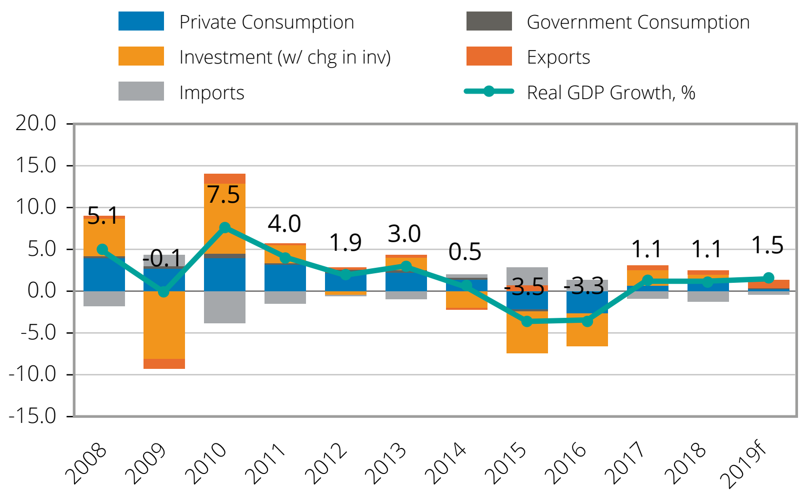
auctioned off and could translate into nearly USD68bn of investments over the next few years.

New regulations in this sector will also have to be part of the government's toolkit of fiscal solutions, alongside pensions and tax reforms, participants agreed. In the meantime, the BRL20bn (approx. USD5bn) fiscal stimulus package proposed by the government in early June should be sufficient to revive short-term growth and prevent another recession.

While the recent surge of activity in the local markets is facilitating investment in projects, it is also increasingly the case that local lenders are becoming more discerning, willing to put capital towards high quality projects and ventures, but reluctant to gain exposure to riskier ones. But this creates an opening for international banks and multilaterals to provide alternative funding channels.

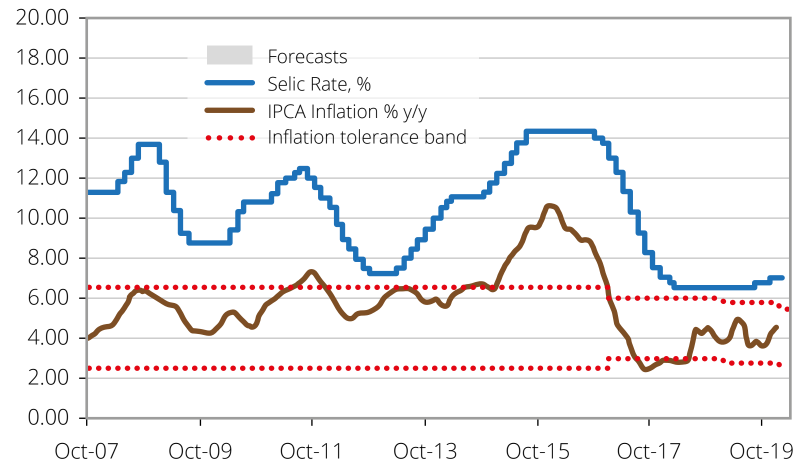
Innovative structured finance instruments could help plug the gap; over the past year, ECA and IDB-guaranteed wrapped infrastructure debentures have allowed some borrowers to secure longer maturities even in periods of severe volatility or uncertainty. It is still seen as a rather exotic, out-of-the-box solution that is offered by a select few global lenders, but may become more common, particularly in a more accommodating regulatory landscape.

Brazil - GDP Growth Contributors, %

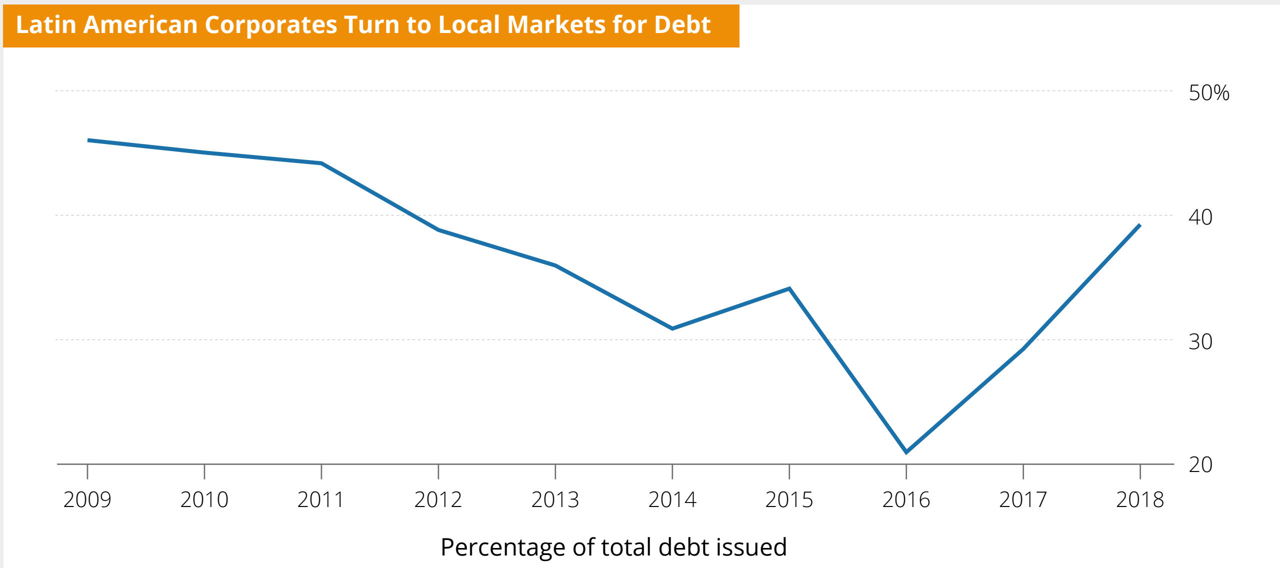


Source: Bulltick

Brazil - Headline Inflation & Selic Rate, %



Source: Bulltick



Source: Fitch Ratings and Bloomberg
*Data compiled on companies based in the region's six-langest countries

Bright Spots Amid Scarce Deal Flow

The pace of growth in the local capital markets – often at the expense of cross-border borrowing – has taken many participants and observers by surprise, and remains a key theme in Brazil's – indeed the wider region's DCM space in recent months. Almost 40% of the USD140bn in corporate bonds issued in the region last year were denominated in local currencies, the highest percentage since 2012, according to Fitch Ratings.

"Now that the cost of funding in BRL – compared to borrower dollars and swapping into local currency – has become so appealing, it makes more sense for some issuers to tap the local markets and take advantage of this arbitrage," said Claudio B Matos, Head of DCM Origination, Brazil at HSBC.

Corporate chiefs participated a spate of bond buybacks and local currency refinancing transactions over the past three quarters, with one participant sharing a positive experience in being able to push sizes and tenors on their transaction to new levels rarely seen in previous years.

"Treasury bonds are now less appealing to local investors compared to four or five years ago, and we are seeing banks being more willing to extend tenors on debentures – from four to six years on average two years ago, to between seven and ten years now. The cost of issuance has also come down quite a bit amid historically low rates, and the country's investment index relative to the curve has also improved," they noted.

That said, following the Lava Jato scandal, local banks are really focussing on solid projects and strong names, which has the effect of stratifying the market – with liquidity being channelled towards high-end corporates, making things more difficult for high-yield and mid-sized corporates struggling to source funding.

Top-tier borrowers like Suzano, Ultrapar and Klabin, have tapped the cross-border bond markets without much friction over the past year, but as exporters they have the advantage of sizeable dollar-denominated revenues.

These types of corporates have made a concerted effort to increase both the share of their dollar-denominated debt and the share of bonds in their overall debt composition in recent years. In Suzano's case, within a span of five years, bonds went from 10% to 40% of overall debt, which means the company is able to access international markets even during downturns or periods of volatility.

"Over the last 9 months we've issued USD3.2bn in USD capital markets instruments. But it has taken the company many years to build up the reputation to do so, and it's a great business case for Brazil's corporate market. We now have the longest average debt maturity in Suzano's history, around seven years, and the lowest average costs," commented Julio Ramundo, Corporate Finance Director, Suzano.

Other corporates are finding new ways of diversifying their investor base; for example, some are looking to tap Asian or European funds, but few have actually sought to access alternative currency funding such as EUR or JPY as yields have been less attractive from an investor perspective than in USD markets; instead, Asian and European investors gain exposure to Brazil's corporate sector via the USD markets.

Still, banks are confident that broader access to international market will return and in the meantime are encouraging CFOs and Treasurers to continue diversifying capital structures and FX exposure given the right conditions.

"The international markets continue provide a much deeper wallet for Brazilian corporates in the long run, and will come back into the picture as the current flurry of "arbitrage-driven deals" fades," Matos concluded.

Commodity Prices, Rates, and Other Roadblocks

While the current trend towards

tapping local markets appears to stretch across the board, challenges and risks preventing some corporates from accessing international capital pools are often sector-specific.

In April, industrial production surprised to the downside, at 0.3% month-on-month. Mining and manufacturing sectors have underperformed, with the latter expanding a mere 1.1% in the last quarter, while core retails sales contracted 0.1% month-on-month.

This slowdown is exacerbated by idiosyncratic challenges in other sectors. Take the sugars and ethanol sector, for example, which has been plagued in recent years by a double-whammy of price instability and poor governance.

Over the past few years, sugar has become extremely cheap, while ethanol, as a commodity with a strong seasonal characteristic, saw severe price volatility. Given the fact that there is no real futures market for this commodity, the resultant lack of hedging options leaves industry giants completely exposed to the vagaries of commodity trade – in an already very volatile macro environment.

Additionally, within the industry there has for the past decade been a huge imbalance between the expansion of sugarcane crushing capacity in Brazil, on the one hand, and stagnant growth in the availability of sugarcane, on the other.

"The tug of war for raw material means that farmers retain an overwhelming portion of the margins at the expense of other production chain participants," lamented Treasury Director at Biosev Carlos Gradim.

Meanwhile, the expanded capacity has a lot of leverage associated with it, and was hit by price controls and prolonged bear markets, which led to a number of defaults. The four largest sector players have defaulted in recent years, presenting an unfavourable track record to international investors.

All of this means that remaining market participants are starting off from a highly leveraged position, and with investors

unable or unwilling to treat the sector in a more discerning way, they are mostly refinancing and rolling over existing debt, with trade finance-related US dollar-denominated products as the only real alternative to the bond markets – which are in turn challenging to roll over unless underlying commodity prices improve.

Many of the smaller sector players have been entirely shut out of the international markets since 2013, and have instead been forced to go to the bank markets, mostly to borrow in US dollars, as local lenders continued to shy away from the industry. Barring a major rebalancing of supply chain margins in the industry, or a prolonged rally in sugar prices, breaking this vicious cycle will remain difficult.

What to Hedge? And by How Much?

These types of bear markets have an unpleasant tendency to spread across interdependent sectors: a struggling agricultural sector tends to undermine fertilizer, farm equipment and trucking industry players. In the trucking sector specifically, which for the past two years has been recovering from a previous crisis, the focus has been on upgrading and renewing existing fleets, rather than investing into additional capacity. But as the policy landscape continues to evolve following the new government's ascension last year, the market is hopeful that it will see renewed public sector support for the agriculture sector.

Likewise, the ability (or lack thereof) to hedge commodities essential to the business is a cross-sector challenge. In the aviation space, for example, fuel price is a key market variable, yet hedging 100% of that risk is far too expensive for airlines. That is down to two factors: oil price is prone to large and increasingly unexpected swings, which means a full hedge could be as dangerous as no hedge at all; secondly, it is also not always clear which products need to be hedged – crude oil, its refined biproducts or a mix of both?

Some airlines decide against hedging altogether – that trend in particular has been set by US-based carriers. "If no one hedges, then no one will need to start hedging when the market readjusts," explained one CFO. Some airlines instead choose to do a partial hedge, often around 30% of fuel purchases, mostly via a combination of market derivatives and FX instruments.

In order to minimize those risks – and avoid additional FX exposure – some of Brazil's airlines have avoided the international markets this year in favour of bilateral debentures with banks. Market access windows, while fleeting, appear more numerous than those found in the international markets. This is applying some pressure on the local banking sector to reduce costs, particularly as investors' interest in the local markets heats up.

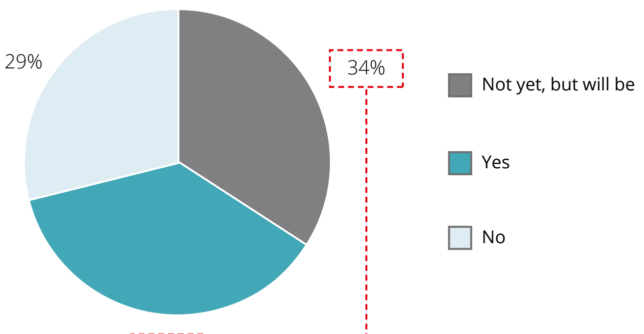
ESG & Sustainability Potential

Amid the shortage of traditional fixed income solutions, more and more corporates are also turning to innovative alternative funding sources.

ESG-linked borrowing and other types of sustainable finance is becoming increasingly prevalent; it is a demand-driven market, with demand for these assets far outstripping supply, and with dedicated portfolio allocations to sustainable assets rising every year.

According to a recent study, a total of 71% of investors believe that asset values are – or soon will be – influenced by ESG ratings, while 31% of investors have requirements to report information relating to environmental or social impact and risk of their portfolios.

Do you believe that the Asset Values is influenced by the ESG Rating?



Source: Santander

While there have been few ESG-linked transactions out of Brazil, corporates are increasingly responding to this surge in investor demand by "testing the waters" in this market. One recent green bond issuer, for example, noted that while tapping the local green bond market did not offer them a visible price advantage, the process also was also far less complicated than expected and will be even easier to replicate, thus laying the groundwork for an "ESG story" for the company.

The local ESG markets can offer sufficiently long tenors and attractive pricing – in some cases only 30bp wide of comparable sovereign notes, so there is no urgent need to access alternatives in the international markets.

Other participants observed that, while there is no clear primary market advantage, ESG assets tend to perform better on the secondary markets, which amounts to an incentive for issuers and borrowers to issue "green" (or "social") if they want to maintain market access. Still, other prospective issuers admitted that while the improved transparency and reputational advantages of sustainable financing are tempting, it remains a difficult proposition to pitch internally without a clear cost benefit.

A Glass Half Full – and Filling Up

It is perhaps a testament to the strength of the Brazilian market and the resolve of her practitioners that, despite an evident lack of clarity and engagement from the new administration, a still fragile macroeconomic environment and a clouded outlook for emerging markets and the global economy – both shaken by tariffs and trade wars, the bulk of the corporate financiers that took part in the CFO roundtable were cautiously optimistic about the economy.

While sector-specific challenges continue to present themselves, policy uncertainty lingers and capital market windows open and shut in a blink of an eye. Top-tier Brazilian corporate names have established such a strong and permanent foothold in the global capital markets that investors will continue to pile into their bonds regardless of the immediate difficulties facing the country.

The small and mid-tier companies, on the other hand, have indeed found it more challenging to source funding when global markets find themselves in the rougher waters, but have found ways of adapting their strategies by either tapping into the domestic capital pools or exploring less orthodox alternatives such as ECA-backed structures or sustainable finance formats.

"Brazil is always a glass half-full, half-empty type of situation; but the longer you wait, the fuller it becomes. After all, look how far we've come in the past 15 years!" concluded one of the session's participants.

HSBC Sees Growing Regulatory Capital Supply out of Latin America

As the first wave of securities issued under Basel III rules start to approach or eclipse key call dates, testing the market for the relatively nascent asset class, banks across the Americas are finally coming to grips with rapidly evolving and increasingly complex regulatory capital requirements in their respective jurisdictions. With new rules providing regulatory clarifications coming onstream and legacy capital instruments requiring refinancing, new supply for additional Tier 1 and Tier 2 securities – particularly in the Andean region – should be forthcoming.

Brazil and Mexico, which along with Argentina are full members of the Basel Committee on Banking Supervision, are the most advanced in terms of Basel III implementation. The relevant authorities in each of those countries adopted the framework in 2013, with both Mexico and Brazil ending their transitional periods at the end of 2018.

Banks in these two countries were, perhaps unsurprisingly, the first to move into the international markets to raise Additional Tier 1 (AT1) capital in a bid to top up their non-core capital buckets, led by Banco do Brasil's USD2.5bn hybrid perpetual issuance in 2013. Brazil's Banco Votorantim, Itau and Banco Santander, as well as Santander Mexico and Banorte, have since followed.

Other regional lenders – including Caixa Economica Federal, BBVA Bancomer, Santander Mexico, Banco de Galicia, and Bancolombia – have also tapped into the international markets to boost their Tier 2 capital.

Against a backdrop of incremental regulatory capital supply growth across the Americas and emerging markets more generally, investor appeal for these assets has grown substantially – despite the volatility seen across a broad range of emerging market assets over the past year – with the sizeable spread over senior issuances and broadening understanding of how these assets trade attracting a broad range of fund managers to the asset class.

"The spread differential between sovereign or even senior issuances from the same [bank] can be quite dramatic, which certainly lends to the attractiveness of Additional Tier 1 assets," explains Marcelo Tramontina Peixoto, a Sao Paulo-based Latin American credit portfolio manager at Santander Asset Management.

"These tend to be higher beta-performing assets because of how intrinsically linked the banking sector and sovereign performance are, so they can often experience more volatility than senior issuances. It underscores the need to ensure you are comfortable with the risk and understand their unique attributes. Credits are obviously chosen on a case-by-case basis, but in countries like Mexico and Brazil, where the banks are strong and well-managed, these assets tend to be quite attractive."

Varied Adoption Across the Americas Previously Held Back Supply – But This is Changing

Implementation in Chile, Peru and Colombia, however, has lagged or varied, which has so far translated into muted supply of regulatory capital issuances in these countries.

Progress is being made on these fronts, likely leading to incremental supply out of the Andean region over the next two years as banks and investors gain additional clarity on regulatory requirements, capital treatment and key contractual triggers, explains Jonathan Gray, a director in the Capital Solutions Group at HSBC Global Banking and Markets.

"Regulatory clarity is key for borrowers, especially given the ramp-up period required to ensure senior management understand and are comfortable with these instruments' role in their overall capital structure, and that they are aware of the benefits these issuances carry compared with more costly alternatives for raising capital," Gray says.

"It is crucial for investors as well, given some of the nuances around how each jurisdiction treats elements like coupon deferral and loss absorption triggers. Understanding elements like the degree of losses that would need to be absorbed before there would be any principle loss absorption on these securities; parameters around coupon suspension and the triggers for coupon suspension; the distance to the maximum distributable amounts – and what borrowers are legally able to distribute."

"These are nuanced and specific concerns related to the asset class that both borrowers and investors need to be cognisant of."

Chile has yet to set a firm deadline for Basel III implementation, though it did reach an important milestone in October last year when the country's Parliament approved a new and expansive banking law. Among other things, the new rules set the adoption of Basel III capital requirements for banks, aligning Chilean capital requirements with international standards, and will see the country's securities and insurance regulator, the Committee for Financial Markets (CMF), lead the development of standard definitions and models for understanding risk weighted assets (RWA) and any additional capital requirements for banks that struggle to mitigate risks associate with minimum capital requirements.

Colombia began transitioning towards Basel III in 2011, and while the regulatory framework for the country's lenders is fairly robust, with more demanding capital adequacy and solvency ratios than those found within it, the country still has some way to go on adopting regulatory standards on capital conservation, counter-cyclical and systemic buffers. In May last year, the Ministry of Finance and Public Credit outlined plans for a new five-year transition period for banks to comply with specified capital requirements, bringing its banking regulation rules further in line with international standards, starting in 2020.

"Colombian banks' risk-weighted asset density, which is the ratio of RWA to total assets, is amongst the highest globally, due largely to nuances in the Colombian regulatory capital framework. Our expectation is that these lenders will receive some capital relief on that front, which will – all things being equal – reduce RWAs and bolster their capital positions, offsetting some of the capital deductions under the Basel III framework, and therefore may limit the amount of common equity Tier 1 capital that these lenders might want to build over the coming years," Gray explains.

Peru's banking regulator, Superintendencia de Banca y Seguros del Perú (SBS), has already raised capital requirements for banks in two phases, between 2009 and 2016; in 2016, the government took a big step forward by establishing the criteria for eligible capital instruments. However, with details of the calibration of minimum capital requirements for banks requiring congressional approval, and given the political volatility experienced in recent years, any movement on the regulatory front will likely have to wait until after the next elections.

Another area all regional regulators need to address, and which could give borrowers and investors alike more comfort, is rules around bail-in bank resolutions, which unlike jurisdictions in Europe, the US and Canada, are lacking.

Basel III

While its origins date to the mid-1970s, the Basel framework is at its core an outgrowth of the Latin American Debt Crisis of the early 1980s, which shifted the attention of policymakers globally towards minimum capitalisation standards as a key measure of banking system stability.

Basel III, the third iteration of the framework, consists of standards on banks' capital adequacy, stress testing, and market liquidity risks, formulated in 2010 and 2011 by the Basel Committee on Banking Supervision in a bid to minimise structural and systemic risks of the kind that in large part exacerbated the credit crisis and brought global markets to a standstill in 2008, and reduce the need for state-funded bailouts.

The framework aims to increase the quality, consistency, and transparency of a bank's capital base to help them better absorb shocks and to mitigate the risk of insolvency. It introduces countercyclical buffers to protect banks from periods of capital stress and macroeconomic events; strengthens capital requirements and management requirements around counterparty risk; limits the amount of leverage banks are allowed to accumulate; introduces new liquidity standards and enhances reporting and governance standards.

Under the Basel III framework, regulatory capital requirements for banks now consist of the following:

- Common Equity Tier 1 ratio (CET1 ratio) must be at least 4.5% of risk-weighted assets (RWA), up from 2% in Basel II CET1 capital is composed of common shares and retained earnings
- The Total Tier 1 ratio, which includes Common Equity Tier 1 and Additional Tier 1 Capital (AT1) must be at least 6% of risk-weighted assets, up from 4% in Basel II
- The Total Capital ratio, which includes Tier 1 Capital and Tier 2 Capital (T2), must be at least 8% of risk-weighted assets

Credit Growth, Legacy Asset Refinancing to Generate Supply – But Headwinds Remain

The most influential supply drivers for regulatory capital issuance out of the Americas in the near to medium term are likely to be a combination of rising loan growth and legacy capital instrument refinancing.

Credit growth is one of the major headwinds facing domestic markets in the Americas. With sizeable dips in lending growth and flatlining or negative economic performance among some of the region's larger economies through much of the latter half of 2018, monetary policymakers in countries like Peru, Brazil, Mexico and Colombia are signalling a preference for keeping interest rates on hold – and where possible, cutting – in a bid to boost growth and stimulate credit demand.

This is in line with a broader monetary policy reversal in large developed markets like the US, UK and Europe, which has seen a rising rate trajectory shift quite quickly in the opposite direction.

"If economic growth doesn't pick up over the next 12 to 18 months, we could see loan growth continue to stagnate, which could lead to lower regulatory capital supply out of the region," Gray says.

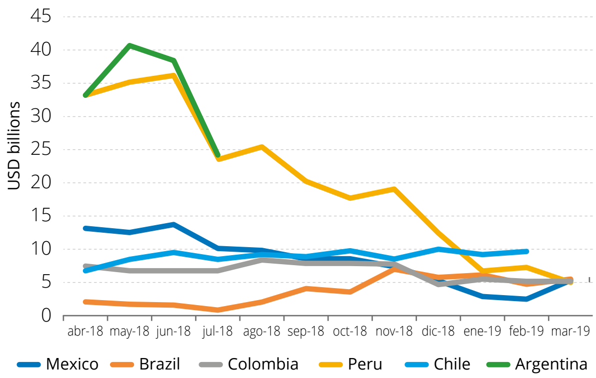
The retirement of legacy instruments as key phase-in dates approach is also likely to drive regulatory capital supply, both internationally and, in the event market conditions are favourable, domestically.

According to Bloomberg data, financial institutions in Brazil have approximately USD1.3bn and USD18.2bn in legacy Tier 1 and Tier 2 instruments, respectively, outstanding in the international markets; FIs in Colombia have USD3.3bn in legacy Tier 2 instruments; FIs in Mexico have USD4bn in legacy Tier 2 instruments; and FIs in Peru have USD700mn and USD2.3bn in legacy Tier 1 and 2 instruments.

These figures do not account for legacy capital instruments placed in the local capital markets, which in the future may not be able to absorb the issuance of loss-absorbing Basel III instruments. Brazil is one country where, over the next few years, this could become a going concern. Given the scale of outstanding international market legacy Tier 1 and 2 instruments amongst Brazilian financial institutions, and the increasingly attractive local debt capital markets in that country, we may start to see a wholesale shift into the domestic market.

At the tail end of 2018, the domestic capital markets [in Brazil] very much came alive – a function of historically low domestic interest rates in Brazil and a supportive inflation environment. But against that backdrop, we've also seen lenders like Itau and Bradesco issue sizeable AT1 securities into the domestic BRL-denominated market instead of coming to the international markets. As long as the environment remains supportive, we may continue to see the cost advantages of issuing in the domestic market influencing more borrowers to stay local instead of placing securities abroad, Gray concludes.

Domestic Credit Growth in Select Countries in the Americas



Source: CEIC

Additional Tier 1 Capital

In addition to changing the way banks look at the capital stack, the framework also led to the advent of new kind of subordinated security – Additional Tier 1 (AT1) perpetual hybrid securities. These perpetual securities have a minimum 5-year call date from the date issued, and are known as contingent convertible bonds because they contain a contractual provision that allows them to be converted to ordinary shares or written-down if a bank breaches its minimum capital requirements, or if banking regulators believe a bank has reached a point of non-viability.

AT1 instruments are attractive for banks because it allows them to meet capital requirements while limiting capital disbursements (unlike equity shares), and enables them to defer or even write down coupon payments in the event capital requirements are breached.

Apart from their tenor and equity-like characteristics, they also come with other unique parameters: holders of AT1 instruments will be paid after holders of Tier 2 instruments; coupon cancellation is not considered as default on investors' payment; holders of AT1 instruments must absorb losses on a going-concern basis, for instance, in the event an issuing bank breaches its minimum capital requirements or reaches the point of non-viability.

As a result, AT1 instruments tend to garner higher yields to compensate for additional risk when compared with Tier 2 or vanilla senior securities, making them particularly attractive for investors.

Brookfield Americas Infrastructure Debt Head Sees New Opportunities in Telecoms, Renewables

Hadley Peer Marshall, Managing Director of Infrastructure Debt at Brookfield speaks with Bonds & Loans about managing local currency constraints when investing in infrastructure in Latin America, and new sectors generating investment opportunities

Q Bonds & Loans: Geographically or in terms of sector, where are you seeing new and attractive investment opportunities emerging in the infrastructure segment in the Americas? What major projects are underway or being planned currently?

A **Hadley Peer Marshall:** I primarily focus on our mezzanine debt efforts, and within Brookfield we focus on both North and South America. Within South America, we focus on Chile, Colombia, Peru and Brazil. We have been very active in Brazil, both on the debt and equity side.

In terms of sectors, we are seeing more interest and opportunities in telecoms – in terms of build-outs needed to move and store data, so data centres, fibre, and towers. We continue to see opportunities to invest in renewable energy projects across hydro, solar, and wind as countries continue to advance their renewable energy target goals. The transportation and energy sectors are also very interesting and continue to present good opportunities.

Q Bonds & Loans: What strategies or structures are you seeing borrowers look more closely at in order to help channel more foreign private investment into their projects?

A **Hadley Peer Marshall:** The structures tend to be heavily influenced by the country in which that project is physically based, and where the capital is coming from. There's no 'one size fits all'. In general, we've found it to be fairly straightforward to invest in these countries though there are always areas of focus like securing cost-competitive local currency funding for the debt component of our investments.

Q Bonds & Loans: That brings us nicely to our next question. A number of countries where there is perhaps highest demand for new projects – countries like Brazil, for instance – tend to rely overwhelmingly on local currency investment to finance projects. This can be both challenging and costly from a market access perspective given the tenor requirements and cost or availability of hedging instruments. What do you think regulators, policymakers and market stakeholder could do to enhance access for foreign investors in these markets?

A **Hadley Peer Marshall:** That's a fair point – within the context of a debt fund, it can be very hard to raise US dollar funding and then deploy it in local currencies when there isn't a cost-efficient way to hedge. As a result, we tend to look at deals with US dollar cash flows, which generally means we focus on the energy sectors, and with some exceptions on the transportation sector.

As a borrower, we seek debt financings in local currencies to match the currency of the underlying cash flow, so a strong local capital markets is ideal for non-US dollar transactions.

Q Bonds & Loans: How deep or liquid is the infrastructure debt space in the Americas? What do you think can be done to make the asset class more accessible for a broader range of investors in South America?

A **Hadley Peer Marshall:** When I think about the US and Canada, there is a deep market on the financing front, but not as much liquidity in the secondary market. A majority of these transactions trade very thinly. The documentation is often immense, and the terms tend to be quite customized deal-by-deal, so until we arrive at some kind of system that can quickly illuminate the structure and key trade-offs embedded within a deal, it's always going to be a challenge on the liquidity front in the secondary market.

Looking more broadly at South America, five years ago, there was a lot of capital looking to enter the region. Since then, we've seen a range of different factors play out which have driven some of that capital away, especially in Brazil, where we saw a pullback from international lenders. It feels as though that is now starting to change. Infrastructure lenders have become much more thoughtful about getting back into the South America, especially given the higher margins that can be achieved there.

In terms of making these markets more liquid or accessible, I would probably look at some of the things we previously discussed: simply put, if it's dollarized or if cost effective to hedge, it becomes much easier to finance.

Q Bonds & Loans: Do you see borrowers' increasing embrace of ESG or focus on sustainability as an element that can help attract more capital into infrastructure projects in the Americas? Is ESG a differentiator when it comes to competing infrastructure investment opportunities?

A **Hadley Peer Marshall:** For fund managers, it's extremely important – we look at it from both an investment standpoint as well as an asset management standpoint as it's a part of our business. As a lender, I wouldn't necessarily say there is less capital for projects that are ESG-neutral or 'brown', but in general, you do see more lenders attracted to initiatives with a strong ESG component. In the United States for instance, there is an extensive list of lenders or investors that will finance renewables as they have more appetite for initiatives with a sustainability angle.

Ukraine's PrivatBank: Bailin' on the Bail-In?

A recent court ruling to reverse the National Bank of Ukraine's decision to nationalise ailing lender PrivatBank sent the country's banking system into disarray and even raised doubts over the country's EU ascension prospects. The case, which some see as one of the first test-drives for the post-crisis era EU Bank Recovery and Resolution Directives, is significant not just for the country's economy and its new president, Volodymyr Zelensky, but also for the European banking industry more broadly.

In a potential blow to Ukraine's central bank, the country's the Sixth Appellate Administrative Court in May turned down the NBU's appeal against a Kyiv District Administrative Court's decision to satisfy a lawsuit filed by the Cyprus-based company Triantal Investments Ltd, controlled by Ihor Kolomoyskyi, former co-owner of PrivatBank, the country's then-largest lender, which was nationalised in late 2016.

"On 18 April 2019, the District Administrative Court of Kyiv declared unlawful and overruled the decision to conduct the government-assisted removal of the insolvent CB PrivatBank from the market," the NBU tells Bonds & Loans in emailed responses to questions. "On the same day, the District Administrative Court of Kyiv also overruled NBU Decision dated to 13 December 2016, which established the list of PrivatBank's related parties. On 24 May 2019, the NBU filed appeals against both court decisions. The said court decisions are currently effective with no legal consequences."

According to the central bank's statement, the decision to conduct the government-assisted removal of the insolvent PrivatBank from the market was made "in compliance with the applicable law and supported by the government" and the National Security and Defence Council of Ukraine to ensure financial stability and to safeguard public funds.

"The legality of this decision is obvious, and there are no legal or economic grounds to reverse it," the governing body stipulated.

Still, pending further appeals, the latest court ruling essentially means that the court is upholding a roll-back of the nationalization of one of the country's biggest private lenders, which came under state control in 2016 after the authorities accused it of failing to implement a pre-agreed financial rehabilitation program and alleged that its shareholder, Kolomoyskyi, was "fleecing" his own bank. Kolomoyskyi, in a controversial recent interview with the FT, called on the country to default on its debt, which did little to help Ukraine's – or his former bank's – reputation among investors and the international community.

The oligarch and PrivatBank are now at loggerheads, with lawsuits filed in London and New York among several other jurisdictions; the drawn-out case is unlikely to be resolved soon, but it is worth addressing its main points of contention in more detail.

Suits and Countersuits

In essence, the Ukrainian government accuses Kolomoyskyi of grand theft in the management of PrivatBank, which rendered the bank insolvent, and is seeking an international freeze on and repatriation of his assets after the bank required USD5bn in recapitalization (most of which was sourced from a previous IMF programme). Kolomoyskyi countersued the government in multiple international courts, via numerous SPVs

Russia, Europe & Asia

and shell companies, over the allegedly unlawful nationalization of his bank, and is seeking USD2bn in damages.

The matter is complicated further by the fact that Kolomoyskyi is widely considered to be the influential figure behind the country's newly-elected president Volodymyr Zelensky, and some have accused the judiciary of kowtowing to the country's new leader, who, they allege, is acting to protect his mentor and chief sponsor.

The scandal, while far from a resolution, is already weighing on market sentiment: following the ruling the ailing bank was hit by more than USD300mn of outflows from deposits across multiple currencies. Meanwhile, the escalating court battle is taking a financial toll, as nearly 10% of the bank's operating costs now reportedly go towards covering legal fees, which could undermine the already fragile banking sector and economy.

"PrivatBank-related litigation will test the durability of banking sector clean-up and anti-corruption reforms," Moody's Ratings Agency explains in a recent note. "We consider the banking sector clean-up, including the PrivatBank move, to be one of the biggest economic reform successes of the last five years. Any threat to that progress – such as the potential that the new president would interfere in favour of Kolomoyskyi's appeal of the PrivatBank nationalization in local courts – would constitute a serious setback to the reform agenda. While not our base case, as we attach a low probability to such a scenario, it would have a material adverse impact on Ukraine's credit profile if it were to materialize."

Despite some criticism about execution, the decision to bail-in the troubled bank was largely welcomed by the international community. With much of the IMF's tranche to Ukraine disappearing down the rabbit hole of shell companies of the bank's previous owners, backtracking on the nationalization also risks undermining Ukraine's agreements with the IMF and future support.

The bail-in was the proper course of action, in line with EU directives, argues John Pollner, author and a World Bank economist, but doing so via a nationalization was simply one of the options – including limited bail-ins and restructurings – and not necessarily the best one.

"A less politically charged way to do this would have been to do the bail-in and create a so-called bridge bank – on a temporary basis – that would be state owned, but could be eventually be transferred back to the private sector; but they didn't do it," admits Pollner. "So they did the right thing, but question is, did they do it in the right way?"

How to RescEU a Bank

In the aftermath of the 2009 banking crisis and the following implementation of the Basel III framework, there have been only a handful of cases in Europe where a collapsing bank had to be rescued – and none presented a uniform solution.

The first test of the newly introduced bail-in mechanism came 2013, when Cyprus's two biggest banks were hit by massive losses from the Greek PSI and needed to be rescued by the state, with costs estimated at 57% of GDP. With the federal budget stretched, the IMF had to step-in and, unsurprisingly, insist on a solution that involved a bail-in of the creditors and depositors, with significant write-offs and a one-time "deposit levy" on all deposits in the country's banking system.

The case also helped to expose some weaknesses in the new resolution framework. The first unintended consequence of the bail-in of uninsured depositors was a chaotic development for the bank's ownership: in the Cypriot case, the largest shareholders turned out to be politically-exposed oligarchs who generated toxic headlines for many months. Another more long-term consequence was the undermining of the Central Bank's independence, with multiple amendments passed the following months by the Cypriot Parliament, transferring some power from the CBC to the government.

Pollner points out that the Cyprus case had some resonance in the CEE banking industry and legal landscape for two reasons.

First, it demonstrated that in some countries, major financial institutions don't actually have that many bondholders, so it may be that they have to spread some of the pain onto the small and medium-sized deposit holders, who just don't have the capacity to analyse a bank's finances and risks. "Is it fair to bail-in those depositors versus bondholders – who are likely to be more informed about a bank's finances?"

Second, the bond interest rates are still very deflated in many parts of Europe, especially those tied to the Euro, though it is not quite the case for Ukraine, which largely remains a high-yield market.

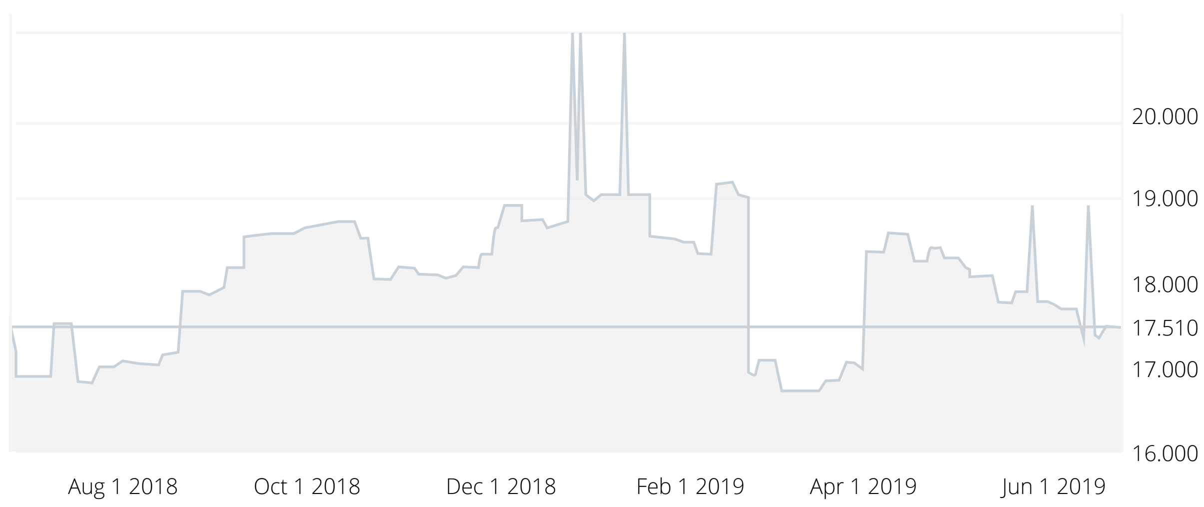
"A bail-in is good to do even as it can affect smaller depositors, which was the case in Cyprus where there were not many bondholders, so they had little choice but bail-in the depositors. And technically, a bail-in doesn't preclude a bail-out, it just means the former has to happen first before you even consider the latter," Pollner says.

"Bail-Out Dressed as a Bail-In"

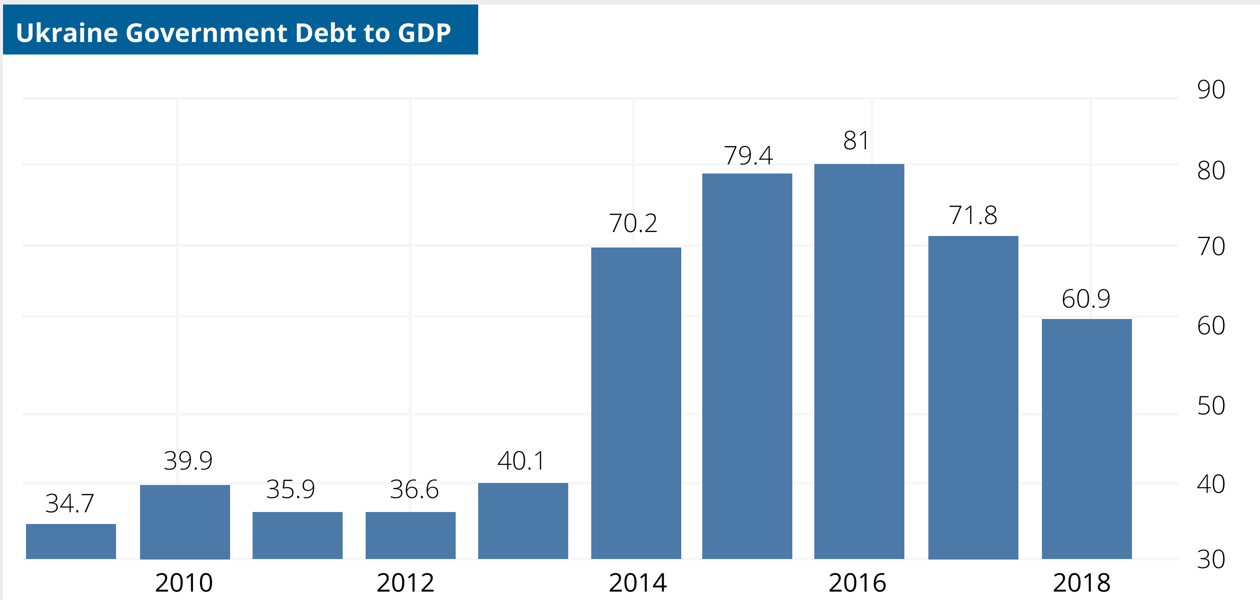
Two more recent EU-based bank failures may serve as more apt comparisons to Privatbank's rescue: Banco Popular in Spain and Banco dei Paschi di Siena in Italy.

The first accumulated billions of euros worth of Spain's toxic real estate assets over the years following the crisis and had to be rescued after posting a USD3.5bn loss in 2016. The ailing lender was eventually sold to Santander for just 1 euro, while Popular's convertible bondholders and shareholders took huge losses (bonds were converted to

Ukraine 3-Year Bond Yield



Source: Investing.com



Source: Trading Economics

shares prior to the sale), with little to no impact on the taxpayers or depositors.

The second case presents more of a compromise. An EU-sanctioned rescue package included a USD6.6bn "precautionary recapitalization" hand-out from taxpayers, which was negotiated due to concerns that a full bail-in could destabilise the country's struggling banking industry. Banco dei Paschi, in turn, agreed with private investors to sell EUR29bn of bad debt. Still, some have criticized the government's half-measured approach and labelled the whole debacle a "bail-out dressed as a bail-in."

PrivatBank thus presents a third major test of post-crisis regulatory frameworks and directives. As Pollner points out, the Ukrainian legislation is adopting the most part of the Bank Recovery and Resolution Directives (BRRD), which were launched in Spring of 2014.

"That is why they implemented the bail-in - but the devil is in the details," he explains.

While a bridge bank may have been more in line with EU's conflict resolution toolkit, Ukraine's authorities appear to have determined that PrivatBank was insolvent.

The NBU told Bonds & Loans that its use of the bail-in instrument is regulated by Bank Recovery and Resolution Directive 2014/59/EU, which sets the framework for recovery and resolution of credit institutions and investment companies in EU countries.

"The NBU is working to introduce provisions of Directive 2014/59/EU in Ukraine's banking laws with the technical assistance from the World Bank as part of the project on improving the mechanism for resolution of insolvent banks. In Ukraine, the use of bail-ins is stipulated in Article 411 of the Law of Ukraine On Households Deposit Guarantee System, which provides for the specifics of the government-assisted removal of an insolvent bank from the market," the monetary authorities noted.

However, that argument was rejected by the courts, which ruled that owners still had claim to those assets.

This is where the intersection of banking and economics becomes hazy, notes Pollner: "If the property has zero value as they ran up debt, can it still be considered an asset? Presumably, the NBU in this case has the right to change administration."

Devil in the Details

Some have argued that the whole discussion about setting precedent for post-crisis resolutions is a red herring because Ukraine has not yet implemented the EU frameworks, and the decision to list legal entities that fall under the bail-in is not aligned with European standards.

"I don't quite agree that this relates to Basel III bail-in provisions," notes Roman Kornev, Director, Financial Institutions, Fitch Ratings. "The reason is that these Eurobonds weren't written off due to a bail-in clause, but rather as a simple case of default."

According to the expert, there were two types of notes – both senior and subordinated bonds - but neither of them included the Basel III-compliant clauses, which are not yet present in any issues out of Ukraine. Instead, the stated reason for partial write-offs was that authorities concluded that both debt obligations and certain deposits were held by entities thought to be connected to the former owners.

"In fact, regardless of this legal framework, we believe state support to banks in Ukraine, sufficient to avert losses to senior creditors, should not to be relied on."

The new BRRD guidelines (though technically not yet implemented in Ukraine) provision for two possible conditions for a write-off: either capital adequacy ratio falls below a certain threshold, or if a central bank decides to intervene for whatever reason. But they also included a transition period, meaning that there are still longer-dated bonds on the market for which those rules don't apply to – legacy notes that will over time need to be retired or refinanced.

Kornev notes that in other CIS markets the state support in various cases was seen as somewhat arbitrary. “Fitch ceased to differentiate the ratings of “old” and “new” style subordinated debt instruments, [in the case of Russian state-owned banks] because we took a view that state support would be available to both cohorts of creditors with equal probability.

But in Ukraine, were the case to go to the Supreme court – and were the bondholders to win – the ruling would set a much higher bar for implementing any new BRRD-compliant banking regulations in the country.

While it is somewhat puzzling that the court is interpreting property rights as a legal title, and at the same time not taking into account the economic value of the assets, the NBU has alternative tools at its disposal. Among other things, it could insert a provisional administrator to run the day-to-day of the PrivatBank, and thus wrest shareholder control from the owners.

Enough Problems Already

Whether or not the PrivatBank case proves pivotal for the country’s banking system is yet to be seen, but it is by no means the only challenge. The NBU is facing an uphill struggle, and is the first to admit a multitude of risks surrounding the economy and its banks.

“On the economy side, the biggest risk is the slow nature of post-recession recovery. Growth is subdued, around 3%, and there are lingering risks on the heavily indebted sovereign, which is heavily dependent on the IMF and international aid. The National Bank of Ukraine is holding the base rate very high, at 17.5%, which is further undermining credit market activity,” Kornev explains.

The overarching worry for the Finance Ministry is that the entire financial sector and the economy need to be urgently reintegrated into the cooperative processes of international financial institutions.

“It is essential to guarantee Ukraine sufficient financial resources during the peak repayment of external debt and restore the confidence of foreign investors,” the NBU notes. “Such cooperation will promote a stable macroeconomic environment with lesser risks for financial institutions.”

According to the NBU, results of a recent evaluation of the banking sector’s resilience under a baseline macroeconomic scenario confirm that banks are sufficiently capitalized for now, but Ukrainian banks need to improve business and governance model and create substantial buffers – ideally, beyond the minimum requirements for Tier 1 capital adequacy (7% as of the start of 2019) and overall regulatory capital adequacy (10%) thresholds set under Basel III. From early 2020, a capital conservation buffer of 0.625% is set to be introduced for all banks in addition to the Tier 1 capital adequacy ratio.

Among other concerns is the overreliance of the sector on predominately short-term deposits from households and businesses, which is prone to shocks. To mitigate liquidity risks, the NBU introduced the new liquidity coverage ratio (LCR) requirement in December 2018 and plans to introduce a net-stable funding ratio (NSFR) requirement in 2020 to motivate banks to attract longer-term funding.

Finally, banks must also continue to work on reducing the volume of non-performing loans on balance sheets. NPL ratio continued to decline in 2018, although slowly, driven by new retail lending that is gradually “diluting” the existing loan portfolio.

“Banks like Privat and some of its peers are very active retail lenders, where the regulations remain fairly soft and enabling, and high borrowing rates don’t compromise fast paced growth of credit. This is a potential positive factor for banks’ profitability in the early cycle, although it is worth keeping an eye on the risks arising from this surge of retail credit,” the Fitch analyst says.

Regulatory and structural problems also abound, which are being tackled in cooperation with the IMF.

These include reforming state banks, with gradual withdrawal of the state from board selection and a general reduction in state influence. This is acutely relevant in the PrivatBank case, with three foreign and independent members of the new supervisory board all refusing to take their posts in June – ostensibly due to excessively strict declaration requirements, but, some suspect, potentially because of a perceived regression to poor governance practice under Zelensky and the return of Kolomoyskyi.

The second key focus area, therefore, is developing a strategy and a roadmap for future privatizations of state-owned lenders.

And finally, finding solutions to technical and structural problems, such as addressing balance sheet gaps, cleaning-up bad loans and creating a system of independent verification of restructuring terms.

“But all of these new regulations will take time to develop and fully implement, and require other fundamental institutions for support – such as a strong independent judiciary, land ownership laws and the like,” Kornev concludes.

An IMF Weakness?

How the Privatbank fiasco is to be concluded, what the impact will be on the country’s banking sector, and whether or not it is going to influence how bank failures are resolved in Europe going forward, remains to be seen.

However, the case also highlights the problems – and may lead to some reforms – in how the IMF approaches its “rescue missions” in struggling economies.

“Multilaterals such as the IMF tend to follow their directives to the book, but those are often put together with large economies in mind, and can be inappropriate or irrelevant for smaller ones. So this leads to a question: should Basel IV be recalibrated for smaller and less developed countries?”, Pollner asks.

This question may become pertinent as the global economic cycle heads downwards, and growing cries for help from the likes of PrivatBank would demand a more discretionary, tailored and nuanced approach from the Fund.

Case Study: Russian Railways' EUR500mn Issue is Russia's First Green Eurobond

In May, Russian Railway's issued the country's second green bond - and the first in hard currency - by raising EUR500mn in 8-year notes. Capitalising on a warmer funding environment, as well as the company's strong track-record in the capital markets, the transaction also marked the lowest-ever yield on a Russian issuance.

Background

Russian Railways (RZD) is no stranger to the capital markets. Since its debut in the Eurobond market in 2010, the state-run monopoly has issued across the curve in currencies including USD, EUR, RUB and CHF. As part of a broader drive to 'green' the company's operations, RZD is phasing out older, diesel-powered locomotives and electrifying its operations. Over the coming three years, it plans to purchase an additional 1,000 new electric locomotives at a total cost of around EUR2bn

Transaction Breakdown

The proceeds of the transaction are earmarked to finance/refinance the acquisition of Lastochka train – an electrical train dedicated exclusively to passenger transportation, and which falls into the 'Eligible Green Project' category of Clean Transportation under the Green Bond Principles. Financing the purchase of rolling stock for passenger use exclusively simplified the process verifying that the transaction is indeed green, as freight vehicles in Russia are often used for the transportation of fossil fuels.

Prior to the issuance, Russian Railways sought certification from the Climate Bonds Initiative, which required third-party verification of the use of proceeds – in this case, from Sustainalytics – in order to produce an assurance report. By obtaining CBI certification, Russian Railways was able to more effectively market its paper towards ESG-conscious investors abroad.

Following a three-day deal roadshow in London, Frankfurt, and Munich, initial price thoughts were announced early morning London-time on 16 May at approximately 2.500% for a benchmark transaction. Strong investor interest – with the order book peaking at EUR1.7bn (over 3.5x subscription) allowed for price guidance to be tightened to the area of 2.375%, before being lowered even further, to around 2.150-2.250%.

Riding a wave of investor demand, the issue was launched the same day. More that 130 accounts participated with the deal, securing a yield of 2.200%, not only reflecting a zero new issue premium but also achieving the lowest ever coupon from a Russian issuer and a tightening of 300bp from IPTs.

Around 25% of the bond's buyers are estimated to be ESG investors. For exclusively green investors, Russian risk was a novelty. Consequently, some were able to participate straight away, whilst some first needed to go through internal discussions prior to placing orders.

Deal At A Glance

Deal Type: Green Bond

Format: Reg-S

Issuer: Joint Stock Company Russian Railways

Deal Size: EUR500mn

Issue Date: 16 May 2019

Maturity Date: 23 May 2027

Tenor: 8 year

Coupon: 2.200% fixed, annual

Re-Offer Price: 100

Bond rating at issue: Baa2 (Moody's) / BBB- (Fitch)

Issue Spread vs Midswaps: MS + 194bp

Governing Law: English Law

Listing: Euronext Dublin

Bookrunners: UniCredit, JP Morgan, VTB Capital

Legal Adviser to Bookrunners: Linklaters

Use of Proceeds: Financing/refinancing purchase of electric rolling stock

Despite the ever-present threat of sanctions, this did not weigh heavily on the minds of investors during the roadshow. As the sanctions regime enters its fifth year, investors have become accustomed to the new status quo. Since the removal of sanctions against aluminium giant Rusal in April 2018, Russian issuers have enjoyed tight spreads in the secondary market, following a prolonged period of volatility.

"This is a landmark transaction. I think it is extremely important that Russian corporates join the growing family of green bond issuers, and I think they [Russian Railways] were the perfect opener – they have a long history of DCM appearances and they are addressing a 'Use of Proceeds' category that many green investors are longing for," added Antonio Keglevich, Head of Sustainability Bond Origination at UniCredit.

Asset Managers took the bulk of the issuance (61%), whilst banks and private banks took a sizeable proportion (39%).

By geography, German and Austrian buyers took the lion's share of the paper (34%), followed by Russia (22%), the United Kingdom (15%), other areas of continental Europe (14%), Switzerland (11%) and Asia (4%).

Case Study: Armpower Energy Plant Marks First Greenfield Project Finance Deal in Armenia

Not only was the transaction a major step forward for private sector participation in Armenia's energy sector, but the deal marked the first greenfield energy project financing in the country. With the involvement of four multilateral development institutions and a number of investors via the IFC's innovative Managed Co-Lending Portfolio Programme (MCPP), the total financing cost amounted to USD163mn.

Deal At A Glance

Deal Type: Project Finance

Borrower: Armpower CJSC

Sponsor: Renco Spa

Deal Size: USD163mn

Issue Date: 15 February 2019

Governing Law:

Location: Armenia

MLA: IFC

Legal Adviser to Borrower: Gowling WLG

Legal Adviser to Banks: Hogan Lovells

Use of Proceeds: Support the development and construction of a 250-megawatt combined-cycle gas turbine power plant in the south of Yerevan

Background

Armenia's power generation assets include aging thermal plants, which are inefficient and costly to operate, exacerbating the country's dependence on fuel imports.

To address this, the government is seeking to revamp the energy sector; encouraging the installation of cost-effective generation facilities, whilst decommissioning out-dated plants and harnessing renewable energy.

The IFC has been active in this area since 2016, when it arranged a landmark USD140mn financing package for the Vorotan Hydropower Cascade, helping a private operator acquire, rehabilitate, and operate the facility. Following its subsequent upgrade, the facility now has an operational capacity of over 404MW.

Currently expected to begin production in 2021, the 250MW combined-cycle gas-fired thermal power facility will alleviate a number of problems Armenia faces in relation to energy production. Because the new plant will be around 50% more efficient than its predecessors, it is not only forecast to reduce the annual cost of imported gas by around USD2.5mn, but it will also improve the reliability and security of the country's energy supply.

Economic reforms in Armenia, promoted by the World Bank, have significantly improved the financial sustainability of the power sector in Armenia, thus enabling the IFC and MIGA to support private sector investment. The reforms resulted in an unbundling of the vertically integrated utility, establishment of an independent regulator, and improvement of the creditworthiness of the off-taker, Electric Networks of Armenia (ENA).

Transaction Breakdown

The project fits into the World Bank Group's broader fundamental efforts to help ensure the construction of a reliable energy supply in Armenia. In turn, this will facilitate access to basic services, economic growth, job creation, and poverty reduction.

The involvement of the private sector in the transaction, with the support of the IFC and MIGA, also helps to modernise the country's power generation capacity, while limiting the government's financial obligations.

In order to facilitate project finance funding, the IFC team worked to improve a suite of legal documents supporting the project by working alongside two successive governments.

Such an approach – with multilaterals working closely with the government in order to facilitate project finance agreements – sets a precedent in Armenia for the greenfield energy projects in the future.

Due to the novel nature of the project – being the first greenfield project-financed power plant in Armenia – and the long tenor required, the IFC as the sole Mandated Lead Arranger, turned to other development finance institutions.

Through its innovative Managed Co-Lending Portfolio Programme (MCPP), the IFC also engaged a number of investor funds in the transaction. The MCPP is a Syndications platform, which allows investors to access diversified portfolios of EM private-sector loans, facilitates entry into the asset class. Investors looking to access the platform sign an agreement with the MCPP outlining the eligibility of assets, after which the MCPP will build a portfolio mirroring an IFC portfolio – similar to the way an ETF mirrors an index.

In total, the loans from the IFC and the MCPP totalled USD73mn, with parallel loans committed by the Asian Development Fund (USD44mn), the OPEC Fund for International Development (OFID) (USD25.3mn), and DEG (USD20.5mn). MIGA provided a guarantee of up to USD39mn in order to help Renco Spa, the Italian developer leading the construction of the project, to manage non-commercial risks.

Asian Investors Continue to Look to GCC Despite Rising Geopolitical Risk

For Asian investors searching for returns across emerging markets, the GCC has long been considered a relatively low-risk, higher-yielding option. But with geopolitical tensions reaching a boiling point, and a number of GCC states fiscally exposed to oil price swings, former safe havens could become a riskier bet.

With ultra-low rates becoming the norm across many parts of Asia, institutional investors are looking further afield for high-yield opportunities, often turning to emerging markets.

Enter the GCC. Large bond and sukuk markets dominated by sovereign and quasi-sovereign names – which account for approximately 80% of issuance – have increasingly drawn the attention of both fund managers and institutional investors across Asia.

That institutional investment base is large and growing. According to a report from Willis Towers Watson, a consultancy, Japanese pension funds held USD3.05tn worth of asset as of 2017, resulting in an assets-to-GDP ratio of 62.5%. South Korea also boasts a sizeable pensions industry, with USD725bn worth of assets, with a 47.4% assets-to-GDP ratio. Hong Kong's pension system, meanwhile, manages USD164bn worth of assets, which equals a 41.9% assets-to-GDP ratio, and Malaysian funds hold USD227bn with a ratio of 73.4%.

But by comparison with many of their peers, Asian pension funds have typically been more conservative in their investment approach. As of 2017, for example, 56% of total Japanese pension fund assets were invested in bonds, with 30% in equities and the rest in cash and alternative investments such as real estate. Australian pension funds, by comparison, have just 14% of their assets invested in bonds and 49% invested in equities.

"Historically, the GCC has been a natural place for Asian investors to engage with," argues Todd Schubert, Managing Director and Head of Fixed Income Research at Bank of Singapore. "To a large extent, this is because of the ligatures with the sukuk market – there is a large Malaysian buyer base in Asia. Most roadshows from the GCC will come to Singapore and other parts of the region."

For risk-averse institutional investors in the East, the strong local bid within the GCC – where buy-to-hold strategies remain prevalent – is an additional benefit, insulating GCC credit from the volatility that often thwarts borrowers based in other EM jurisdictions. With around 60-70% of all credit in Asia originating from China, the GCC is a healthy avenue through which life insurers and pension funds can diversify.

According to one senior portfolio analyst, who handles institutional funds for a major Taiwanese life insurer, credit that is inherently tied to the sovereign is particularly appealing because of its implicit or explicit guarantee – hence the preference for the GCC, alongside select Latin American sovereigns and quasi-sovereigns.

Although GCC debt is well-received by Asian investors, there are not enough regular issuers in the GCC to fulfil demand from the east. In part, this is because of local banking sector is easily able to provide cheaper funding. But as sovereigns look to stretch the tenors they seek, they are increasingly being forced to look externally.

One fixed income analyst at Nippon Life, the largest life insurance company in Japan, explained that GCC sovereigns were appealing, and that over the medium- to long-term they plan to look in greater detail at GCC corporate debt. Currently, their mandate only allows a relatively slim proportion of their portfolio to be invested into the region – though the analyst noted that they are pushing internally to expand this limit

The long-term liabilities borne by Asian institutional investors are also beginning to dovetail with the longer-dated paper issued by GCC sovereigns as they continue to grapple with deficits and wide-reaching reform programmes that require robust external borrowing.

Growing Heterogeneity

Until around 2014, the GCC was often viewed as a relatively homogenous region. But the crash in oil prices exposed the degree to which economies across the region were dangerously yet unevenly unbalanced. Since then, as states have embarked upon ambitious reform programmes (or didn't, in some cases), the GCC is viewed with far more granularity than it previously had been.

But according to one senior portfolio manager, a number of Asian institutional funds often do not explore the idiosyncrasies of GCC debt; credit ratings remain a lynchpin of the investment process, dictating the portfolio selection process to a large extent.

As geopolitical risks in the Gulf continue to build, it is unclear whether these investors are cognisant of the potential economic damage on the horizon. One London-based fixed income analyst noted with alarm that geopolitical risk was yet to be priced into GCC credit and argued that it is politics, not fiscal issues, that poses the greatest issue to the GCC.

Geopolitics is the main driver that can potentially derail the region, Schubert argues.

"If geopolitical tensions continue, then we will see outflows, not just in terms of buying but also real investment; this is the wild card. The rhetoric over Iran in recent weeks is something altogether different."

"From a ratings perspective, the GCC [credit] is cheap; from a geopolitical perspective, it is fairly valued," noted another analyst.

One senior portfolio manager pointed to a spate of problems that could destabilise the region further. The murder of Jamal Khashoggi, rapidly escalating tensions with Iran, crises of succession in Saudi Arabia and Oman, alongside broader vulnerabilities to oil price fluctuations and a tepid real estate sector in the UAE all have the potential to tip the region into crisis.

Whether Asian investors, who often lean heavily on credit ratings in the investment process, will react early enough to this cocktail of potential threats remains to be seen. In the meantime, the GCC looks set to remain a sweet spot for the Asian investors looking eastwards.

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