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Financing Africa's future

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On 5th July 2018, Hogan Lovells hosted its 5th annual Africa Forum themed “Africa Fit for the Future”. One of the key sector sessions was led by Shalini Bhuchar, an asset finance partner, who chaired a panel of leading industry experts in African banking and finance. The panel included Denys Denya, EVP of African Export-Import Bank; Adesuwa Okunbo, Partner and Managing Director of Syntaxis Capital Africa; Edward Marlow, Managing Director at Credit Suisse; Jean Craven, CEO of Barak Fund Management and the Forum’s keynote speaker, Mrs Ibukun Awosika, Chairwoman of First Bank Nigeria.

This panel represented views from across the banking and finance mix, which, as an industry, is critical for stimulating economic growth, especially in Africa. So when challenged with the task of deciding ‘Who is Taking the Lead in Lending?’ there was sure to be some healthy debate and discussions on the subject. This report takes a look at the key discussion points from this panel, coupled with our own assessment of the sector, highlighting some key areas to watch and future prospects for the continent.

With billions being pumped into infrastructure, energy, commodities and technology, what industries are being underserved and why? To plug the liquidity gap, the global debt market continues to see a shift from conventional bank lending to alternative forms of funding, ranging from debt funds to debt capital markets issuances – but is this trend sustainable in Africa? Development finance institutions (“**DFIs**”) and multilaterals have historically held a solid lending track record across the continent – but to what future impact? Are commercial banks being squeezed out as a result or is this a misnomer? Our panel provided their experienced views on the key trends in the African debt markets and offered invaluable insight into the future of funding.

The panel discussed alternative lending in the corporate lending context and adopted a wide interpretation, to include: non-banking lending to, for example small and medium sized enterprises (“**SMEs**”), to a multi-partner

approach on larger financings for corporates and to the use of the debt capital markets for both sovereigns and corporates.

Are the trends we are seeing in the alternative lending space being reflected in Africa?

According to Adesuwa Okunbo, from a private equity manager’s perspective, there is not enough availability of private credit investment in Africa – this creates opportunities as well as challenges. Private credit accounted for about 2% of the financings that occurred in Africa in 2017 – contrast this with Asia, which experienced investment of over \$7 billion worth of private credit. With respect to domestic credit expressed as a percentage of gross domestic product (“**GDP**”), the figure is 21% for sub-Saharan Africa. This figure is 192% and 134% for the United States of America and the United Kingdom respectively. It is apparent that there is limited lending in Africa on the commercial and the private credit side and the boom being experienced in the United States of America or Asia, for example, is not being reflected in Africa on a relative basis. The aim for public and private entities should be in ensuring that SMEs have alternative financing solutions apart from offering traditional equity, considered as a last resort by many smaller businesses.

Edward Marlow commented that there is a mismatch between businesses and banks as banks require a minimum annual turnover before committing to lend – it may be that this leads to a perception issue that influences private credit’s tendency to take a more cautionary approach to investment in such businesses. However Jean Craven considered that funds may be performing better than their private equity counterparts; in Asia, particularly in China, there is a movement away from private equity towards alternative credit. His view was that there is a similar increase of investment by alternative funds in Africa which is an indicator that alternative credit will be relevant for a significant period.

Our view – Spotlight on SMEs

The SME funding gap is well documented. The World Bank Group has conducted a number of studies on this, which estimates that globally the gap for formal SMEs is as high as US\$1.2 trillion, with half of formal SMEs having no access to formal credit.

Approximately 70% of all SMEs in emerging markets lack access to credit. The gap is particularly wide in sub-Saharan Africa and this has brought opportunities for alternative non-bank lenders to both lend and have a developmental impact across the continent.

According to the World Bank, formal SMEs contribute up to 60% of total employment and up to 40% of Gross Domestic Product in emerging economies and this is significantly higher when informal SMEs are included. With more access to finance SMEs can play an even bigger role in economic growth and development in the region.

The opportunities for alternative lenders in the SME space have been fuelled by attractive yields, increased bank regulation, more conservative credit risk appetites of banks and (in some instances) loosening of regulations that had restricted direct lending.

This can clearly be seen in trade and commodity finance transactions where there are a broad range of producers and traders looking to access capital quickly and flexibly on a short to medium term basis, fully collateralised, and to pay for this service.

For Denys Denya, DFIs have been able to contribute to dealing with the liquidity gap by encouraging and fostering improvement of, for example, peer-to-peer lending. The DFI focus is on facilitating medium to long-term financings, developing pension funds and investment markets and working with private equity and debt funds to increase the availability of credit.

Ibukun Awosika commented that commercial banks are key to the reduction of the liquidity gap with the challenge being to match the relevant type of capital required with the right business. As a result, it is important to be innovative and credit houses need to have alternative fund structures which cater to the relevant businesses seeking credit.



From a sector perspective, where is the biggest liquidity gap?

Jean Craven's view was that there is an almost unsurmountable need for funding in commodities, mining and energy, including as a result of growth in the area. There is demand in the technology sector but the challenge in that sector is the bankability of start-ups due to, among other things, the risk of failure and bankruptcy. Ibukun Awosika echoed this sentiment and also cited the reluctance of certain banks to invest in oil and gas, especially given that there have been notable instances where banks have been unable to recoup returns on their investment. There is no 'one size fits all approach' as situations differ by country and sector. Instead, there should be a micro-focus on business types rather than macro-sector focus. From a private equity fund perspective whether or not a fund provides growth capital to a particular sector depends very much on the fund's risk profile, opined Adesuwa Okunbo. For certain funds, technology and education are attractive from the perspective of diversification of investment; others may take the view not to back commodities or any strongly regulated sectors. In some instances, asset based lenders are reluctant to lend to technology businesses as these businesses do not offer the same collateral that the institutions require – the solution may be to focus on cash flow lending and to spend time with businesses in analysing and understanding the stability and predictability of cash flow generation to service debt obligations.

Denys Denya emphasised that the main difficulty is businesses being able to offer or present a bankable project – development banks such as Afreximbank need to invest in project creation and Afreximbank has set up a project preparatory fund and a fund for export manufacturing to combat these issues.

Our view - Power and infrastructure

The need and opportunity for power and infrastructure development in Africa is enormous.

In sub-Saharan Africa only approximately a third of people have access to electricity. This need for power across Africa has opened up specific opportunities for SMEs in the energy sector and for alternative lenders to fund power producers, fuel traders and producers and other energy infrastructure and logistic services.

Often, with this initial backing, an SME can feed into large established corporates and global traders to build a solid credit record.

Funding African SMEs can by its nature have a positive impact – growing businesses and increasing employment, allowing SMEs to step up their business to compete internationally and in accordance with best practice from a social and environmental perspective. There are many great stories, and this is an exciting space to be in.

What has driven the record corporate and sovereign issuances in the debt capital markets in 2017?

In 2017 corporate non-local currency issuances were at a three year high and sovereign issuances were at a five year high. The key focus is on obtaining yield, said Edward Marlow. One feature of the current markets is that the tenure of certain loans are approximately 30 years and therefore the capital advanced can be used for longer term projects. It will be interesting to see the steps that borrowers will take to arrange refinancings at the time that repayments are required for short term loans maturing in less than 10 years. An increased length of time or repayment period allows businesses to manage repayments in a realistic manner and there is space for amortising lending into sub-Saharan Africa. In particular, there is strong interest in the Nigerian and Kenyan technological communications sector which may result in further Eurobonds in the near future.

Has there been a crowding out of commercial lending in the credit market?

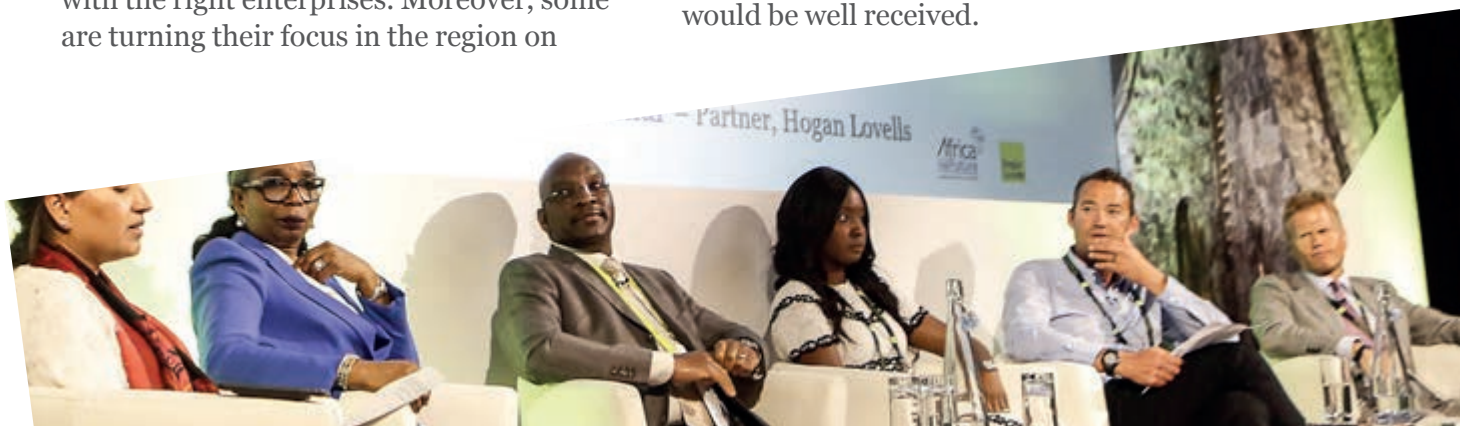
This is a misnomer, said Ibukun Awosika. There remains a strong demand for funding which allows room for all types of players in the market. Commercial banks are businesses that need to receive adequate comfort on how their resources are managed in any given investment. However, these banks play numerous roles including acting as collaborative vehicles working with global wholesale debt providers and linking them with the right enterprises. Moreover, some are turning their focus in the region on

driving “agency banking”, where each bank may have numerous agents travelling to various villages in Africa – this flexibility is to create a platform to facilitate access to alternative lending.

DFIs and multilaterals have always been key facilitators of investment on the continent. With whom have they been partnering over the last few years?

As Denys Denya emphasised, DFIs require the support of the financial community to create solutions, to amongst other things, plugging the liquidity gap. Afreximbank, for example, is a partnership organisation willing to work with any type of institution to create solutions to the problem of availability of credit in Africa. Afreximbank is increasingly working with a number of global banks, export credit agencies and equity and debt funds with a focus on long term structures across the continent. DFIs also provide collateral in the form of guarantees and similar credit risk support to encourage investment – such support can enable certain African businesses to issue bonds and this in turn facilitates growth.

Afreximbank has also attempted to develop a local currency programme, allowing them to lend in local currency. From Edward Marlow’s perspective, the focus has to be to diversify away from hard currency borrowing particularly as the International Monetary Fund prescribes limits to countries on amounts that can be borrowed in hard currency. Accordingly a programme such as Afreximbank’s local currency programme would be well received.



What are the individual unique selling points that credit funds can offer when investing in Africa?

For certain funds, the focus is on SMEs and the lower mid cap segment. Syntaxis Capital Africa, for example, has identified that the SME credit gap is creating significant opportunities for SME funds as large funds which control about 8% of the market are chasing much larger transactions. The focus for Syntaxis Capital Africa is to provide tailored growth capital solutions to established companies, especially family owned businesses, through innovation and hands on operational support. The aim is to work on medium to long term financings, meaning tailored credit and quasi-equity structures. One of the innovations is to assist businesses requiring financing with building an effective internal team and bench, enhancing decision making procedures through utilising key performance indicators and improving corporate governance so that there is a structure that can facilitate growth. By assisting with operational support and value addition, it minimises the risk of the return on investment and consequently maximises the equity value uplift of investment.

From the perspective of Barak Fund Management, a home-grown Africa fund, with the majority of capital raised outside of Africa with European, Asian and Middle Eastern investment, Jean Craven's view was that by playing a junior role in a facility, Barak

Fund Management is in a niche spot where it can provide bridge financing to senior and private equity funds. The regulatory environment in Africa is a concern but similar funds can assist with creating access to the market for other institutions.

In conclusion...

The panel agreed that whilst there remains a liquidity gap, alternative lenders are making significant progress in trying to plug the gap with sophisticated, targeted products and strategies at an individual institutional level and more broadly by partnering with co-creditors. The funding needs of borrowers are unique to the types and sizes of their businesses and the differences in demand facilitate lending solutions from conventional debt providers to alternative lenders – there is no crowding out of one lender type over another – the demand for liquidity outstrips this concern.

So, who is taking the lead in lending? Conventional commercial bank debt, DFI lending, debt capital markets solutions and private credit all have a role to play. Commercial banks will however continue to take the lead at a local and regional level and, together with DFIs, act as catalysts to facilitate sustained growth in liquidity in the loan and debt capital markets. Whilst the volumes of private credit deals may not be at par with the USA or Asia, private credit is a much needed alternative lending class in Africa and is indeed on an upward trajectory.



Our view – The right opportunity

There are many opportunities, but there are challenges as well.

The alternative lenders in Africa need to find the gems – the right deals, do their due diligence and build relationships with and through these borrowers. This is a big job with significant risk.

Funders need to understand not only their client's business but each relevant jurisdiction and market, amidst increasing competition with other alternative financiers. But as investors increasingly look to place their money with funds that can bring a return and an impact, the opportunity out there is still great.

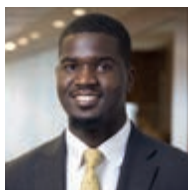
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