Baker McKenzie.

A CHANGING WORLD

New trends in emerging market infrastructure finance

TRANSACTIONAL POWERHOUSE

Leading and closing three deals a day

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Contents

Foreword

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Global challenges such as ever-changing geopolitical conditions, fluctuating commodities prices, urbanisation, population growth and climate change are sometimes more keenly felt in emerging markets than in developed markets. Key to achieving the robust economic growth and the regional and domestic market stability required to overcome these challenges – and to enable emerging market economies to make the most of their opportunities – is infrastructure.

'A Changing World: New trends in emerging market infrastructure finance' is the third in a series of reports Baker McKenzie has sponsored taking an in depth look at trends in infrastructure finance. It shows development finance lending as the single most important factor in the funding of infrastructure projects in Africa. It also discusses how the battle for influence on the continent between development finance institutions from China and the US looks set to heat up as the continent continues to bridge its vast infrastructure gap.

As advisors on some of the largest infrastructure deals in the world, we believe that alternative structures and innovative financial instruments, stable regulatory environments and greater support for private equity investment will be essential in closing this gap. Although much remains to be done, there are also many reasons to be optimistic: we have seen governance improvements in some areas and an increased focus on countries' governance track records; innovative approaches are being taken by both global and regional development finance institutions; and there is greater cooperation between development finance institutions, export credit agencies and commercial banks which is leading to more projects being financed.

We hope this report inspires all market participants to think progressively about this evolving investment landscape as we seek to unlock infrastructure's full potential.

Introduction

Storm clouds are gathering over some emerging market economies, with fears of debt crises growing. Meanwhile, macroeconomic and geopolitical conditions are challenging, with uncertainty in international relations and worrying moves towards a trade war between some leading economies.

As macroeconomics, geopolitics and financial markets change, so the development community's strategies evolve.

While the fallout for many emerging markets could be significant, this should not detract from their achievements in recent decades. Millions of people have escaped poverty, businesses have been created, and there has been investment in infrastructure, which drives long-term economic growth.

This report looks at emerging markets infrastructure and those that facilitate it, including multilateral development finance institutions (DFIs), such as African Development Bank (AfDB), bilateral DFIs, such as Overseas Private Investment Corporation (OPIC) of the US, and export credit agencies (ECAs). These institutions work alongside commercial banks and play different roles. Multilaterals can plant the seeds for local capital markets, for example, while commercial banks bring additional capacity.

The interaction between DFIs, banks and other market participants is complex. Moreover, as macroeconomics, geopolitics and financial markets have changed in the decade since the financial crisis, so the development community's strategies have evolved. For example, in the aftermath of the crisis, DFIs assumed a greater importance relative to commercial banks. While commercial banks' appetite for emerging markets infrastructure has returned, DFIs have retained their elevated role and many have become more flexible in the type of support they provide.

At the same time, China's increased economic and geopolitical importance is vividly reflected in its emerging market infrastructure activity. Africa is in the spotlight as China – and in response, the US – jockey for influence. China's Belt and Road

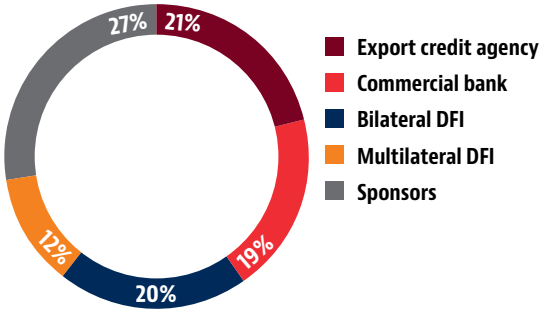
Initiative (BRI) is already beginning to transform a large swathe of the world. And while the basic infrastructure needs of emerging markets – such as roads, ports and clean water – remain constant, the technology and the expectations of project sponsors and communities are changing: renewable energy, and sustainability more generally, have gained prominence as a result.

Infrastructure can transform lives and pave the way to future prosperity. This report aims to provide insights about emerging trends that contribute to market participants working together more effectively to accelerate emerging markets infrastructure development.

Methodology and key findings

For *A changing world: New trends in emerging market infrastructure finance*, a total of 434 executives from DFIs, ECAs, commercial banks and project sponsors (including developers, institutional investors and infrastructure funds) completed a 20-question survey. Participants were drawn from 105 countries worldwide, with 122 from the Americas, 192 from Europe, the Middle East and Africa, and 120 from Asia Pacific.

Survey respondents by institution type



In addition, we invited twelve senior experts representing a global mix of DFIs, commercial banks, sponsors and their advisors to participate in in-depth interviews, to add their insight and expertise to this report.

A wealth of deal data by IJGlobal, the project finance intelligence service, was analysed to identify trends and emerging themes.

The findings of our research reveal that the world of emerging markets infrastructure finance has evolved significantly in the decade since the financial crisis.

The macro-economic, regulatory and financial sector repercussions of that crisis will continue to shape emerging market infrastructure in the coming decade:

1

Fiscal constraints mean emerging market governments are increasingly seeking external assistance from DFIs, commercial banks and other institutions.

93% of survey respondents expect the market share of DFI and ECA-backed loans in emerging markets projects to grow.

2

Multilateral DFIs remain critical to emerging markets infrastructure, in particular for larger projects.

But survey respondents say that creditor governments increasingly support deals backed by bilateral DFIs and ECAs.

3

The scale and scope of China's investment in Africa is shaking up its infrastructure sector, but the US is upping its game.

The US is setting up a new $60 billion agency to invest in developing countries while China has targeted Sub-Saharan Africa (SSA) with $8.7 billion in infrastructure projects in 2017 alone. Survey respondents are evenly split on whether US or Chinese DFIs and ECAs will be the most active lenders for African power projects over the next decade.

4

China outbound lending is booming.

Africa is just one part of China's ambitious emerging market infrastructure plans. Following a steady increase in emerging markets investments since 2013, Chinese lenders participated in 44 deals last year. This compares to no more than twenty deals annually in the period 2008 to 2012. The BRI has experienced some teething troubles. But it could be a game changer for many emerging market countries in the coming decades.

5

The average tenor of DFI and ECA debt has increased and reached more than 16 years in 2017.

Market observers have long hoped that lending would more closely reflect the projects it underpins. The increased role of DFIs and ECAs has helped to get tenors to appropriate levels: 59% of survey respondents believe tenors are now as long as required and expect them to plateau.

HOW INFRASTRUCTURE FINANCE IS CHANGING

93%

expect the market share of DFI and ECA-backed loans in emerging market projects to grow.

Global challenges such as urbanisation, population growth and climate change are sometimes more keenly felt in emerging markets than in developed markets. The key to overcoming these challenges – and enabling these countries to make the most of their opportunities – is infrastructure.

Defining the challenge is straightforward. Delivering infrastructure is not. According to McKinsey Global Institute, the world must invest 3.8% of GDP, or $3.3 trillion a year to 2030: emerging markets account for around 60% of this requirement. McKinsey notes that if the current rate of underinvestment continues, the shortfall will be 11%, or $350 billion a year. The size of the gap triples if the additional investment required to meet the UN sustainable development goals is included.

Government finances around the world are under pressure – and nowhere more than in emerging markets. According to the IMF, public debt in emerging markets and middle-income economies is close to 50% of GDP – levels last seen during the 1980s debt crisis. For low-income developing countries, average debt-to-GDP ratios have been climbing at a rapid pace and exceeded 40% in 2017.

A shifting balance

As James Cameron, co-head of infrastructure and real estate group, Asia Pacific at HSBC notes, fiscal constraints on governments mean there is increasingly a need to turn to third parties such as DFIs: 93% of survey respondents expect the market share of DFI and ECA-backed loans in emerging markets projects to grow.

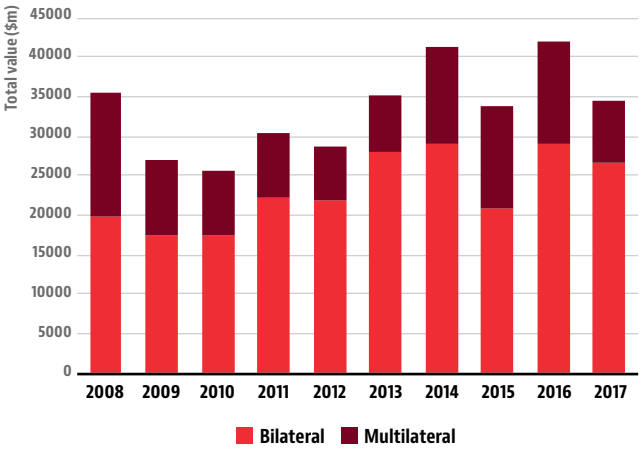
DFIs have long played a crucial role in financing infrastructure. But the relative importance of various types of institutions, their strategies and their interactions with commercial banks are changing.

For example, the balance between multilateral and bilateral DFI lending is shifting. Lending by multilaterals remains important – especially for large projects, says James O'Brien, chair, global projects practice group at Baker McKenzie. They also have a special role in opening up capital markets, points out Giorgio Gamba, head of public sector group, Asia Pacific, HSBC.

However, figures from project finance intelligence service IJGlobal show that bilateral lending, which it defines as DFI and ECA-backed cross-border deals where at least 50% of the lending group and at least one of the sponsors are from one country, has far out-weighed multilateral lending over the past decade.

In 2017 – after a sharp annual decline relative to bilateral DFI and ECA lending – multilaterals represented just 22% of a $35 billion market. A total of 69% of survey respondents expect multilateral lending to decline relative to bilateral DFI and ECA lending as creditor governments become increasingly supportive of the latter and make more funding available.

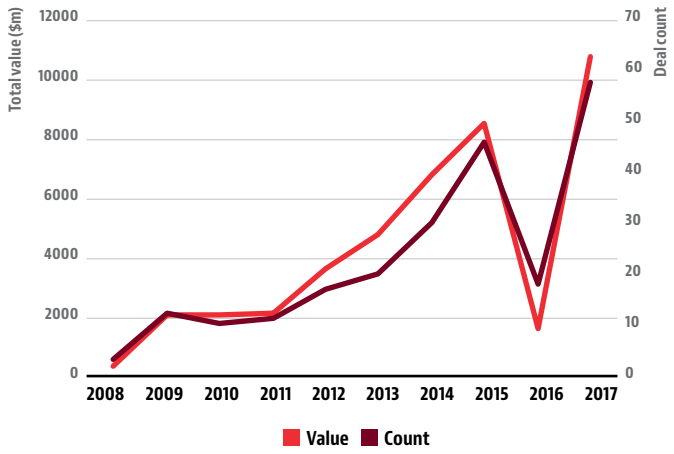
Bilateral and multilateral DFI and ECA lending 2008–2017



Michael Foundethakis, global chair, banking and finance practice group at Baker McKenzie says part of the relative increase in this form of bilateral lending derives from an ECA surge following the credit crunch of 2009/2010. "ECAs from large manufacturing countries, such as Germany and Italy, were encouraged to support exports from their home countries," he says. "However, there was a realisation [by borrowers] that this lending was, in many instances, cheaper and more efficient [than lending from commercial banks]. As a result, despite liquidity now being available, ECA-backed financings remain popular."

Another reason for the increase in bilateral DFI funding is the growth in renewable projects, which are often supported by bilateral DFIs, says O'Brien. The value of renewable deals backed by bilateral DFIs and ECAs soared from $271 million in 2008 to $10.77 billion in 2017 (albeit with a calamitous drop in 2016) and the number of deals grew from three to 58.

Renewable deals backed by bilateral DFIs and ECAs 2008-2017



A further strong driver of bilateral DFI and ECA lending growth is China, which "is likely skewing the figures given the scale of its policy lending," according to Thierry Déau, founding partner and CEO of asset manager Meridiam. IJGlobal data shows the number of Chinese outbound loans to lower and middle income countries has surged from 20 in 2008 to 44 last year while China Development Bank and China Exim ranked first and second for bilateral DFI lending in 2017.

The impact of this activity – a large part of which now falls under the BRI (see separate chapter) is profound. "Policy lending by China is different compared with other countries," says O'Brien. "Much of it has been directed towards projects China procures itself, including the provision of labour."

China's ambitious plans have spurred greater activity by other countries. "The pledge in 2015 by [Japanese] prime minister Shinzo Abe to invest in high quality infrastructure across Asia – seen by some as a countermeasure to China's BRI" has increased the activity of Japan's JBIC and NEXI, says Hiroshi Shibata, general manager, Asian investment banking division at MUFG Bank. "Japan's ECAs are now perhaps leading private sector companies rather than the other way around (as was the case before the financial crisis)."

Having given mixed signals about the importance of development finance on Trump taking office, the US, in October, announced plans to create an agency called the International Development Finance Corporation. This new organisation will replace OPIC, which some in the Trump administration had sought to scrap, and also take over some functions of the United States Agency for International Development. With a portfolio cap of $60 billion – roughly double that of OPIC – and greater flexibility to invest in equity and lend in local currency, most observers see the International Development Finance Corporation as a clear US response to China's growing prestige in emerging markets development.

Multilaterals, while not explicitly responding to China's growing role, are also broadening their activity to better compete with the flow of money from the country. "The Asian Development Bank (ADB) is expanding its role in Asia," explains Shibata. "It not only provides debt but makes equity investments, which are a valuable risk mitigant for commercial banks." To participate more fully in ADB activities, MUFG has made strategic investments in partner banks in Thailand, Indonesia, the Philippines and Vietnam in Asia to gain access to their SME client base, which is a key target for ADB support.

NEW DEVELOPMENT BANK

We complement existing multilaterals

Sergio Suchodolski is director general of strategy and partnerships of the New Development Bank (NDB), which was set up in 2014

Why was the NDB established?

Sergio Suchodolski: Brazil, Russia, India, China and South Africa (BRICS) are G20 members and four of world's 10 largest economies; together they are larger than the G7 in terms of GDP and they represent a large share of global population. But there has been limited success in reforming the Bretton Woods institutions to reflect the BRICS' coming of age.

Meanwhile, there is huge demand in emerging markets for infrastructure, especially sustainable infrastructure: many people still lack access to clean water, transportation and energy.

How is the NDB different to other multilaterals?

Our five equal shareholders drive the NDB's goals. Secondly, we aim to provide local currency lending: we have already done this in renminbi by issuing green bonds equivalent to $450 million. Thirdly, sustainable infrastructure development accounts for around two-thirds of resource allocation so far. Fourthly, we aim to approve projects in six months. Finally, we use countries' own regulatory and legal frameworks where they align with our policies.

Will NDB work with other multilaterals?

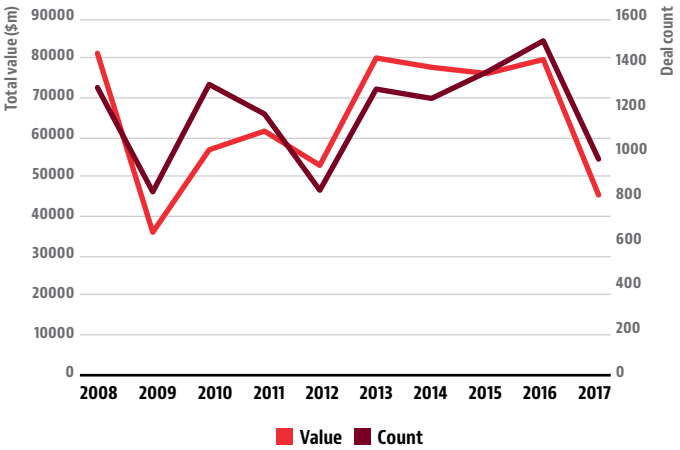
We complement existing multilaterals: the infrastructure gap is so large that even 10 more multilaterals wouldn't fill it. We have signed MoUs with all major multilaterals and have already co-financed projects with CAF, the development bank of Latin America. Many multilaterals have helped us shape our core functions through knowledge sharing and many of our hires and secondments are from existing multilaterals.

"There has been limited success in reforming the Bretton Woods institutions to reflect the BRICS' coming of age."

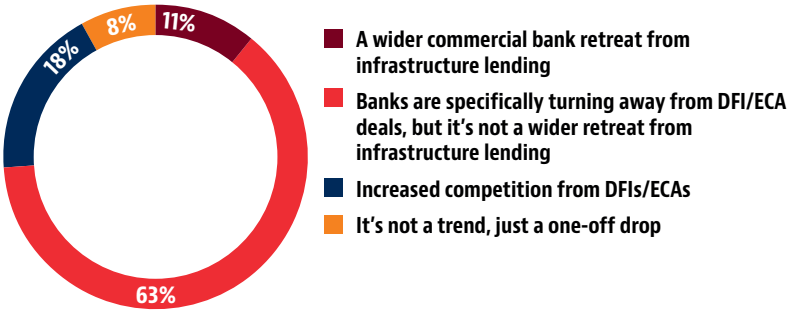
Where do commercial banks fit in?

Five years ago there were widespread discussions regarding the implications of increased regulatory capital requirements on banks' long-term lending in the infrastructure market, says HSBC's Cameron. "However, in reality the impact has been limited." The number of commercial banks participating in DFI/ECA transactions dipped last year (after increasing from 2012-2016), bringing overall lending down from almost $80 billion in 2016 to $45.5 billion the following year. But 63% of survey respondents (and 71% of banks) said that banks are turning away from DFI/ECA deals rather than infrastructure lending overall.

Participation of commercial banks in DFI and ECA deals 2008–2017

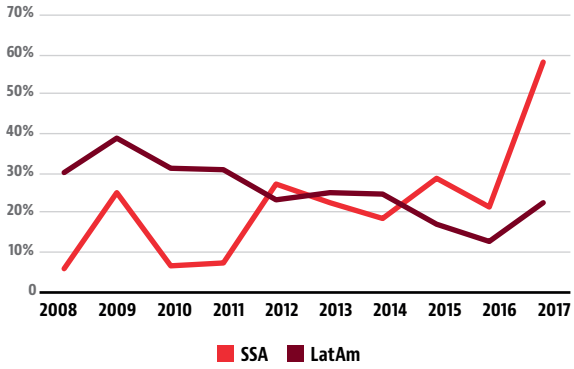


Q: What best explains the recent decline of commercial bank participation in DFI/ECA transactions?



Relationships between DFIs/ECAs and commercial banks tend to reflect changing risk: when it is decreasing, commercial banks avoid DFI deals, which tend to be less lucrative. This trend is evident in recent years in declining commercial bank participation in DFI/ECA deals in Latin America (as risk decreased) while the opposite occurred in SSA.

DFI share of total infrastructure lending by region 2008-2017



"Chile draws on public-private partnership models for infrastructure finance but few countries in Africa can," explains Hippolyte Fofack, chief economist of Afreximbank: consequently DFI activity in SSA is relatively higher. Given Latin America's recent travails, increasing risk aversion could result in higher DFI/ECA activity in the future.

Perhaps more significantly, DFIs and commercial banks are interacting in new ways, with a growing emphasis on partnerships, especially on larger projects. Sixty percent of survey respondents who see room for even more collaboration between DFIs and banks argue this would lead to more projects being financed. A further 24% note cooperation allows commercial banks to participate in deals too risky to do alone.

"Deals may be fronted by, or may have tranches provided by, multilaterals or [bilateral] DFIs – thereby giving further support to commercial lenders," agrees Baker McKenzie's Foundethakis. "It's important to remember that DFIs are able to go where commercial banks may fear to tread, such as Zimbabwe."

HSBC's Cameron says that risk allocation has changed and multilaterals have become more nimble in terms of guarantees and the risks they will absorb to mobilise commercial bank funding. MUFG's Shibata agrees: "JBIC and NEXI now offer a wider menu of options than in the past and are more flexible in their support. For example, in June JBIC launched its new global facility to promote quality infrastructure investment for environmental preservation and sustainable growth, which provides a range of flexible financing tools, and highlights the growing importance of the renewable sector following the Paris agreement."

JBIC and NEXI now offer a wider menu of options than in the past and are more flexible in their support.

HIROSHI SHIBATA
General manager, Asian investment banking division at MUFG Bank

The trend among DFIs and the development community generally is towards much greater use of blended finance solutions to de-risk projects, increase the involvement of private investors and maximise the impact of DFIs' resources, says Déau. Meridiam was the sponsor of a project that used a European Bank for Reconstruction and Development (EBRD) enhancement facility

and World Bank Multilateral Investment Guarantee Agency (MIGA) political and contractual risk insurance to enable the financing of a hospital in Turkey with a bond rated two notches above the sovereign. Similar approaches are being deployed in Africa by OPIC, the European Investment Bank (EIB), Development Bank of Southern Africa and others to finance projects by increasing leverage while reducing DFIs' exposure. "It can be invaluable in projects like geothermal energy, where there is a three-year period before power is generated – a risk that commercial lenders are often unwilling to take without some risk mitigation," says Déau.

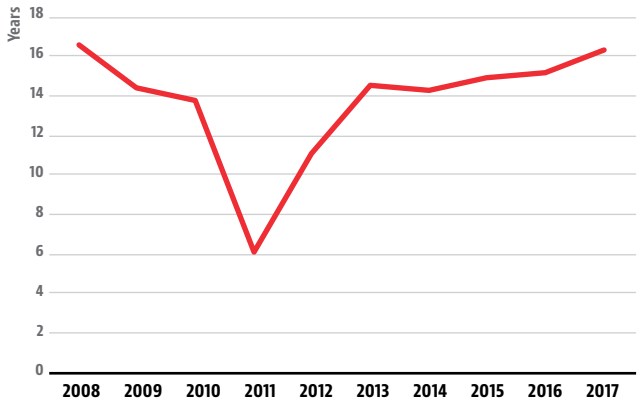
Positive long-term momentum

One notable trend in infrastructure financing in recent years is the growing importance of sustainability, according to Cameron. He interprets the buzzword in the broadest sense, covering "credit, commercial viability, and social and environmental credentials, as well as a greater emphasis on local materials, employees and sensitivities". He adds: "Risk management of local stakeholders is now seen as important."

Baker McKenzie's O'Brien agrees that there are increasing environmental and social provisions in DFI loans and expects this trend to grow. "Green bonds, like the recent BHP Billiton-supported International Finance Corporation (IFC) deal, which had interest payments payable in climate credits, will become increasingly important in the coming years," he says. "China's commitment to the Paris Agreement is vital and will prompt other countries to follow and generate momentum in green financing."

More prosaically, following a market low in 2011 the average tenor of DFI and ECA debt has rebounded and reached above 16 years in 2017: that is in line with market expectations, according to 59% of survey respondents. The 16.3 year average compares to 11 years for all infrastructure transactions, and 13.5 years for primary project financings.

Average tenor of DFI and ECA debt 2008-2017



> **China should collaborate more with global institutions to standardise lending standards.**
>
> **WALE SHONIBARE**
> **Director, energy financial solutions, policy and regulation, African Development Bank**

"For years, it has been said that investment in emerging markets needs to be longer term," says Foundethakis. "DFIs have a longer investment horizon, a different raison d'être and a different risk appetite. As they have become more active in some developing markets, they have been able to provide the deal structures, including longer tenors, that projects in such developing markets require."

Moreover, policy lenders appear to be addressing a perennial problem: 53% of those surveyed said that non-Chinese DFIs and ECAs have become less bureaucratic in their lending processes while 38% expect progress in the next few years.

Working on 'cookie cutter' solar PV projects has resulted in more efficient processes and faster decisions. "The IFC's Egypt solar programme, for example, was efficient and transparent," says O'Brien. "They listened to feedback and incorporated it into the process." More generally, multilateral DFIs have become more customer-focused, says Cameron. He cites the ADB's credit guarantee and investment facility, which provides guarantees on local currency denominated bonds as evidence of greater willingness to engage with stakeholders to improve processes and innovate risk allocation.

Meanwhile, (somewhat slower) progress is being made in improving Chinese DFIs and ECAs' due diligence: 53% of respondents believe it has improved and 41% expect improvements in the coming years. With Chinese policy lenders' reputation for lax due diligence and Western DFIs' and ECAs' reputation for bureaucracy both diminishing, a sweet spot in terms of due diligence and efficiency could yet emerge for both sets of institutions. Certainly, many observers would like to see greater commonality between global lenders: "China should collaborate more with global institutions to standardise lending standards," notes Wale Shonibare, director, energy financial solutions, policy and regulation at AfDB.

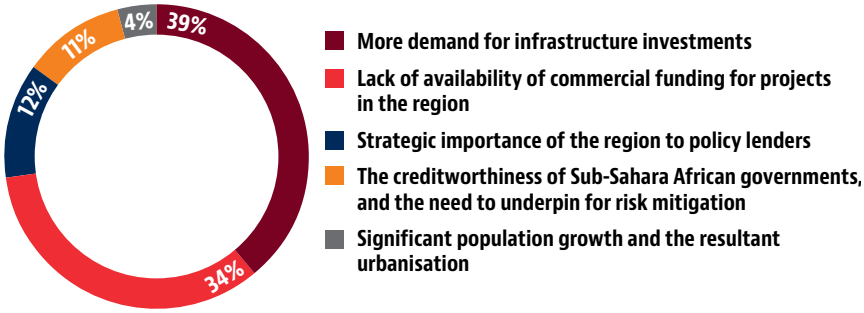
SUB-SAHARAN AFRICA: A NEW LANDSCAPE

The infrastructure investment landscape in Sub-Saharan Africa (SSA) has changed beyond recognition in the past decade.

The continent still suffers from massive under investment – the World Bank estimates an infrastructure financing gap of $93 billion a year while McKinsey calculates $1 trillion from 2016-2030. Afreximbank chief economist Fofack says the gap in the power sector alone subtracts 2%-4% from African countries' GDP every year.

A shortage of government firepower, combined with what Fofack describes as a "high-risk perception by risk-averse [private] investors who set high targets for returns on investment" means DFIs are the most important infrastructure players in SSA. Survey respondents rightly attribute the significance of ECA/DFI-lending to SSA to growing demand (39%) and lack of availability of commercial funding for projects in the region (34%).

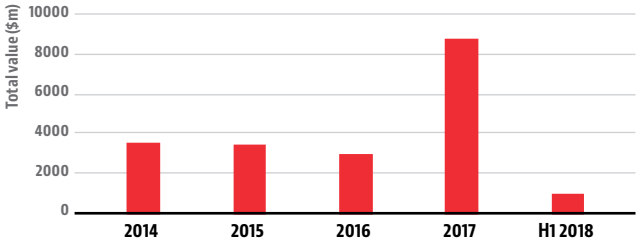
Q: What best explains the significance of ECA/DFI-lending to Sub-Saharan Africa?



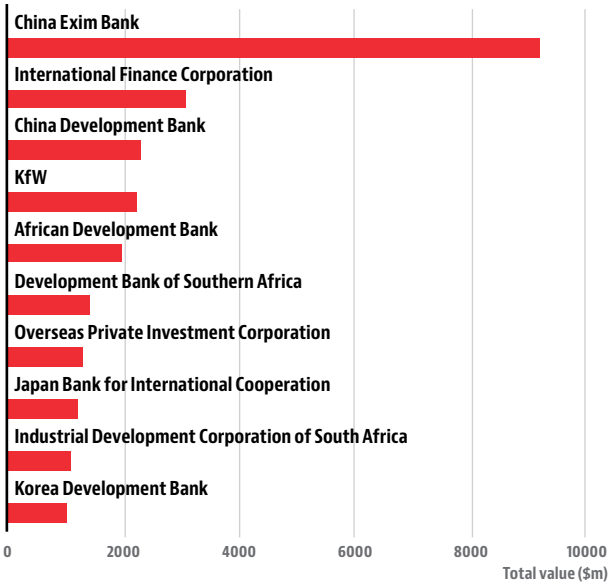
These challenges remain. But the context is now different. Many countries' governance has improved, which has accelerated growth – GDP increased by 3.6% in 2017 and countries such as Ethiopia and Ghana enjoyed some of the world's fastest growth. Perhaps most importantly, China has targeted SSA (largely as part of the BRI); its banks loaned $19 billion to energy and infrastructure projects in the region from 2014-2017, almost half of which in 2017.

China Exim Bank has been the largest policy lender by far in the region in the period 2008-17, and China Development Bank was the second largest bilateral DFI during this period, closing in on multilateral lender IFC.

Lending by Chinese banks into energy and infrastructure projects in Sub-Saharan Africa 2014–H1 2018



Top policy lenders in Sub-Saharan Africa 2008-2017



> **China has changed the narrative of Africa.**
>
> **WALE SHONIBARE**
> **Director, energy financial solutions, policy and regulation, African Development Bank**

"China has changed the narrative of Africa," says Shonibare at AfDB. "Until it came along, the West focused on aid and issues like corruption; they didn't see the business opportunities. China wants to invest and transact for mutual benefit: it needs natural resources and new export markets and African countries require investment to develop their infrastructure."

China does business differently. "As many large Chinese firms are state-owned they typically prefer to engage directly with governments to secure infrastructure contracts," says Shonibare. Other aspects of Chinese lending can have drawbacks, according to Meridiam's Déau. "Some countries have concluded that the strings attached may be too great and have adverse social and political consequences, especially when labour is concerned," although he adds that China is changing its approach as it recognises the risks of over-exposure without the security of adequate covenants.

80

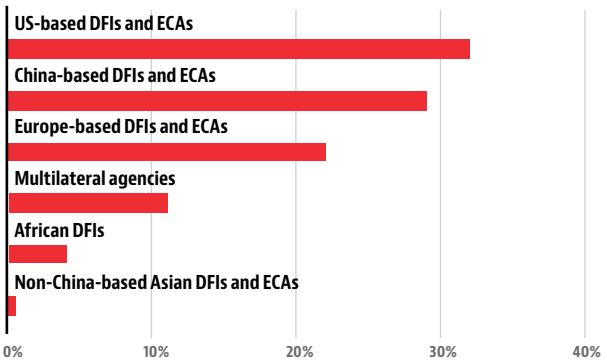
Number of transactions funded by the US Power Africa programme since inception in 2013

The US remains in the game

The US is not standing on the sidelines watching. Despite early misgivings about the benefit of development finance in Africa, a perception of US disengagement would be inaccurate, says O'Brien at Baker McKenzie, noting that the US Power Africa programme remains fully funded, for example. Indeed, the Power Africa programme reported recently that since its inception five years ago it has funded 80 transactions valued at more than $14.5 billion that are now either online, under construction, or have reached final close.

Survey respondents certainly view the US as a match for China. They are evenly split on whether US or Chinese DFIs and ECAs will be the most active lenders for African power projects – a critical part of infrastructure activity – over the next decade.

Q: Which DFIs and ECAs do you think will be the most active lenders into African power projects over the next 10 years?



Moreover, survey respondents did not take into account the US decision to turn OPIC into the International Development Finance Corporation and double its lending ceiling to $60 billion – a move that became public after the survey had closed only. The decision is widely seen as a counter to Chinese largesse in Africa and other emerging markets. The US is reportedly concerned about the security implications of China gaining control of strategic assets as a result of unsustainable borrowing by some developing countries.

Competition for influence

While the International Development Finance Corporation move shows that the Trump administration recognises the importance of countering China's growing influence in Africa – both to promote economic development that can help to make the US more secure and to create markets for US companies – it will have its work cut out.

As the chart on page 17w shows, the highest ranked US DFI in SSA by investment from 2008 to 2017 is OPIC in seventh place. And in the power sector, where the US places an especial emphasis,

IJGlobal data shows that out of all DFI investment flowing into African power projects in the past 10 years, Chinese lenders provided more than half of it (53%), followed by multilaterals (22%). US-based DFIs and ECAs only contributed 3% of the funding. The newfound US enthusiasm for Africa could result in a very different set of figures in five years' time, however.

Nor should Europe be ruled out in the competition for influence in Africa, according to Meridiam's Déau. He points out that Europe has a deep relationship with its southern neighbour thanks to its historical links and the salience of the refugee crisis in southern Europe, which emphasise the importance of peace, stability and growth in Africa. Undoubtedly, the heightened focus on the region by China, the US, Europe and other countries will increase the flow of finance to the region. Ultimately, it should provide a timely boost to infrastructure activity in the region, benefiting its businesses and citizens, as the region's demographic challenges become increasingly acute.

AFREXIMBANK

Supporting intra-African trade

Hippolyte Fofack is chief economist of Cairo-headquartered Afreximbank

How are multilateral development banks changing and why?

Hippolyte Fofack: As Africa's trade finance bank, Afreximbank's role has evolved significantly. The bank increasingly pushes for economic diversification and industrialisation to boost African trade, which remains dismally low – less than 3% of world trade – and reduce the risks of recurrent balance of payment crises, which have been associated with long-term deterioration of commodities' terms of trade.

The bank also supports the development of regional value chains to expand the production of value added goods and services and enhance African countries' integration into the global economy where manufactured goods have become the leading drivers of growth and trade.

Why are regional value chains important?

African intra-regional trade is still low despite an increase from 8% to 15% in 2017; it is 68% in Europe and 58% in Asia. Greater intra-African trade would mitigate the region's exposure to global shocks and risks such as volatility and accelerate industrialisation and export diversification. To accelerate this process, Afreximbank and the African Union will hold the first Intra-African Trade Fair, hosted by the Egyptian government, in December.

What part does infrastructure investment play in this strategy?

In addition to raising cross-border trade, increasing infrastructure financing to address infrastructure constraints will enhance the competitiveness of African economies and accelerate the process of structural transformation by allowing investors to take full advantage of excess natural resource endowments and low labour costs.

"Increasing infrastructure financing will enhance the competitiveness of African economies and accelerate the process of structural transformation."

New structures or fundamental change?

Despite the torrent of Chinese money, SSA's infrastructure gap remains vast – how can it be narrowed? Jen Stolp, partner and head of project finance at Baker McKenzie says there are three priorities: "A move away from traditional funding, and recognition that alternative structures and new financial instruments are needed; increased focus on project preparation funding and the creation of credible and predictable regulatory environments; and increased support for private equity investment."

Both global and regional DFIs are becoming more innovative. Recently the AfDB bought insurance on a $1 billion loan portfolio from hedge funds, reducing the amount of capital it holds against loans and freeing up lending capacity. Meanwhile, Afreximbank has introduced an African fund for export development to attract more private equity, and a project preparation facility (PPF) to address project development-related constraints. "The PPF will fast-track the supply of bankable projects and crowd in private sector to bridge financing gaps in both project and infrastructure development," explains Fofack.

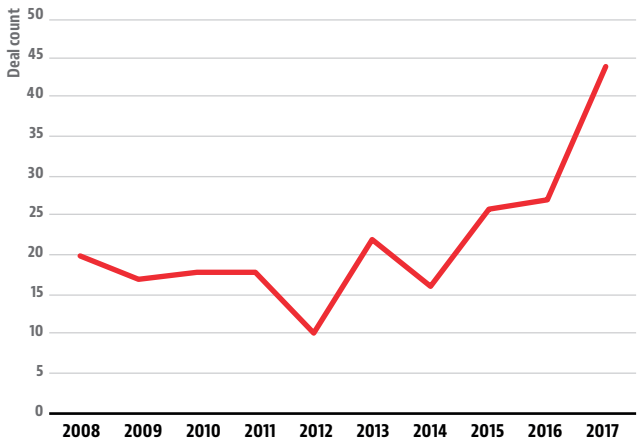
However, fundamental change remains essential, says Shonibare. "Local banks need access to long-term capital so they can lend long-term," he explains. "That takes time and requires a government benchmark yield curve to facilitate local bank debt issuance and reduce reliance on short-term international hot money (as the sukuk market has done in parts of Asia). It also needs a major growth in privately managed assets and savings, which are below 10% of GDP in most SSA countries."

CHINA: THE NEW FORCE IN INFRASTRUCTURE

China plans to transform a swathe of the world with its $1 trillion BRI infrastructure programme. Land-based 'belt' projects, such as roads, bridges, rail and pipelines, and sea-based 'road' projects such as ports, cover around 70 core countries in South and South East Asia, the Middle East, East Africa, and Central and Eastern Europe, representing around 60% of the world's population and 30% of global GDP. However, BRI projects are also starting to appear in an even greater expanse of nations, including parts of Latin America.

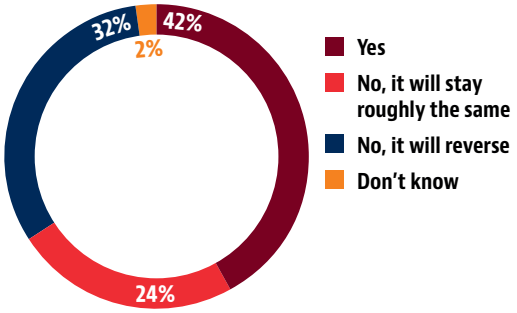
It can be tricky to define a BRI project. But IJGlobal figures show that the number of transactions globally which feature at least one Chinese lender has risen from 31 in 2012 to 105 in 2017. Looking at emerging markets, Chinese outbound lending jumped from 20 to 44 transactions between 2008 and 2017: Indonesia, Brazil (joining the BRI), Mexico (not yet part of BRI), Vietnam and Pakistan have benefited most from Chinese outbound lending.

Chinese emerging markets lending (deals with at least one Chinese lender) 2008-2017



Given this background, it is surprising that just 42% of survey respondents expect Chinese outbound lending to continue to rise, with a further 24% believing it will remain the same (although 63% of respondents in Asia expect increased lending). Policy changes or increased competition from other lending nations are cited most often by those expecting a fall in lending.

Q: Do you expect Chinese outbound lending to emerging markets to continue to rise?



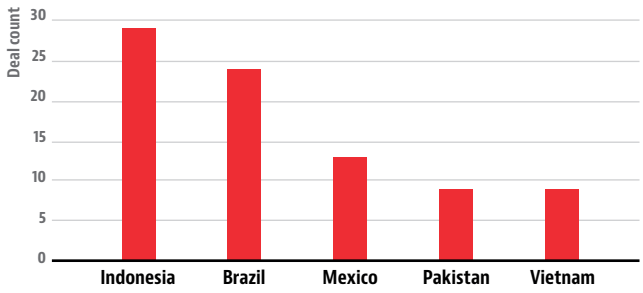
While investment may not have an ever-upward trajectory, most observers believe the BRI is still in its initial phases. "It will take time to develop," explains Simon Leung, partner at Baker McKenzie in Hong Kong. "Outbound investment from China began to increase 10 years ago, with a focus on natural resources. Now attention has moved to infrastructure, such as power plants, roads, railway and ports. As development in BRI countries accelerates, industrial parks and new markets for Chinese suppliers and retail goods will open up, starting a new phase for the initiative."

A Chinese or a global project?

BRI projects are often characterised by Chinese contractors and Chinese bank funding. One reason for this is that in many local jurisdictions there is insufficient capital available for projects. "In addition, Chinese sponsors see considerable value in equity investment and hence it is common for Chinese sponsors to participate in a project in multiple capacities, such as engineering, procurement and construction contractor, equity investor, feedstock supplier and operation and maintenance contractor," says Leung.

In some markets this is beginning to change with saturation in the power sector in Pakistan, for instance. Kim Hock Ang, principal in the finance and projects team at Singapore member firm, Baker McKenzie Wong & Leow says that there are also concerns in countries such as Malaysia about the scale of Chinese financing; Beijing will no doubt be watching carefully.

Top five destinations for BRI investment by number of deals 2008-2017



Despite its current dominance of BRI, China does not view it as a China-only initiative, according to HSBC's Gamba: "The authorities see it as a multilateral and multi-tiered initiative that, given its scale, requires the collaboration of a large number of diverse entities." The ADB, the Asian Infrastructure Investment Bank (AIIB), the EBRD, the EIB and the World Bank signed an agreement with China's ministry of finance on BRI last year. And Japan seems to be warming to some sort of constructive engagement with BRI while still pressing ahead with its own initiatives in Asia.

"Greater selectivity will not slow the growth of BRI-related projects but will improve their quality and investor friendliness.

JAMES CAMERON
Co-head of infrastructure and real estate group, Asia Pacific, HSBC

It is important to note that BRI is still evolving. "Large-scale investing is not simple: there is a need to invest in the right project with the correct risk allocation so that projects work both for investors and the people who use them," explains Cameron at HSBC. "Some projects have not gone as initially expected. But the selection, design and execution process has improved as a result. Greater selectivity will not slow the growth of BRI-related projects but will improve their quality and investor friendliness in order to mobilise capital from a wider variety of sources."

Indeed, despite spending hundreds of billions on BRI, the long-term impact of China's greater involvement in emerging market infrastructure investment is still largely unknown – and may remain so for years. "Chinese investment is no longer just about commodities and infrastructure but includes technology, retail and almost everything else," says Baker's Foundethakis. "Clearly, a shift is taking place, but is it permanent and, as importantly, is it sustainable given evident risks in Pakistan and elsewhere?"

Conclusion

The way that DFIs, ECAs and commercial banks fit together is shifting. This is as a result of short-term changes in risk appetite by commercial banks and in borrower countries themselves, and longer-term strategic changes such as BRI and the growing importance of sustainability, which inform the relative strength of particular countries' DFIs and banks, and the way that projects are structured and financed.

In reality, it was ever thus: macro-economics, geopolitics and markets are dynamic; infrastructure financing is therefore always subject to new pressures and influences. For example, while there has recently been a shift in the balance between bilateral and multilateral DFI lending, this may not be permanent. As AfDB's Shoniware notes, the big issues of our time, such as climate change are best tackled at a multilateral level. A changed political environment in a few years could see greater emphasis on multilateral DFI lending.

One aspect of today's infrastructure financing environment does appear to represent a break with the past. The vigour of China's activity in Africa and the audacity of the BRI mean there is a clear pre- and post-China period for many emerging market countries' infrastructure development. China had to learn lessons on the way, but it has much to offer and is recalibrating its approach. Its lending process is quick, efficient and has fewer restrictions than other countries, and its lenders are willing to provide finance in countries where others are not, notes Baker McKenzie's Foundethakis.

China's ascendancy has also injected welcome competition into the DFI world. All major institutions, from the US's new International Development Finance Corporation and Japan's DFIs and ECAs to European bilateral DFIs and regional and global multilaterals, have been prompted to reassess their activities and strategies. For citizens and businesses in emerging market countries that desperately need infrastructure, this process – and the increase in finance that should eventually result – will for the most part be very welcome.

Ultimately, to those having to live without essential infrastructure – like running water or decent roads – what matters most is not the source of funds but tackling the global infrastructure gap, which is so vast that it overshadows all other developments. Meridiam's Déau says that there has been a realisation that however much multilateral or bilateral policy investment increases, it will never be enough. "The only solution is to bring in other sources of funding," he says. "The ratio of DFI lending to private capital is currently approximately 10:1. Ultimately, it needs to switch to 1:10." The route to that destination is, as yet, unclear.

Appendix

About the research

A changing world: New trends in emerging market infrastructure finance was commissioned by Baker McKenzie and produced by Euromoney Thought Leadership Consulting in conjunction with IJGlobal.

In the period 10 August to 18 September 2018 Thought Leadership Consulting surveyed 434 senior executives working in the field of infrastructure finance, including chief investment officers (22% of respondents), heads of infrastructure investments (11%), principal investment officers (12%), and chief executives or other c-level of relevant institutions (19%).

Twenty-one percent of participants work for export credit agencies, 20% for bilateral finance institutions, 12% for multilateral DFIs, and 19% for commercial banks. The remainder works for sponsors, including developers, infrastructure funds, and institutional investors.

Forty-four percent are based in Europe, Middle East and Africa, and 28% each in the Americas and in Asia Pacific.

In addition, in-depth interviews with 12 senior industry executives and experts were held throughout August and September 2018.

Unless otherwise stated all deal data is based on IJGlobal's project and transaction database.

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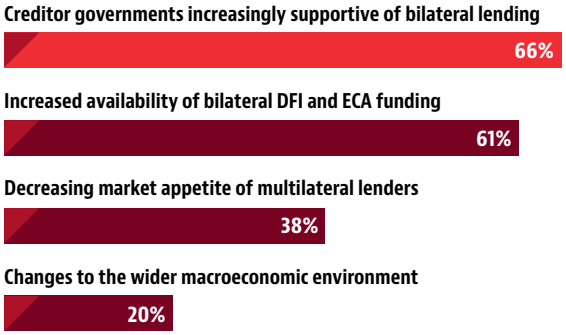
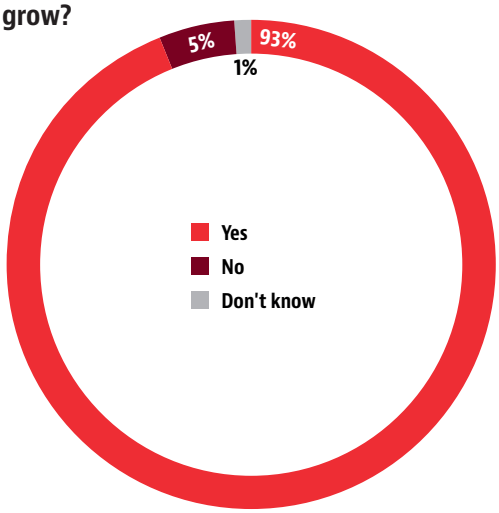
Survey results

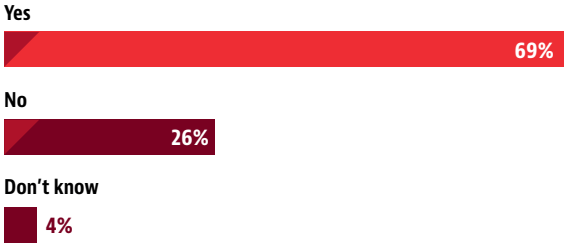
Q1. What best explains the rise of bilateral policy lending? (Select up to two)



Q2. Do you expect the market share of DFI and ECA-backed loans in emerging markets projects to grow?



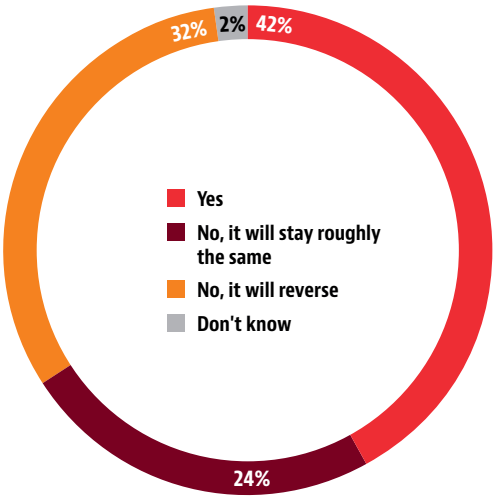
Q3. With the relative importance of bilateral policy transactions on the rise, do you expect the importance of multilaterals (e.g. EIB, IFC) in emerging markets to decline?



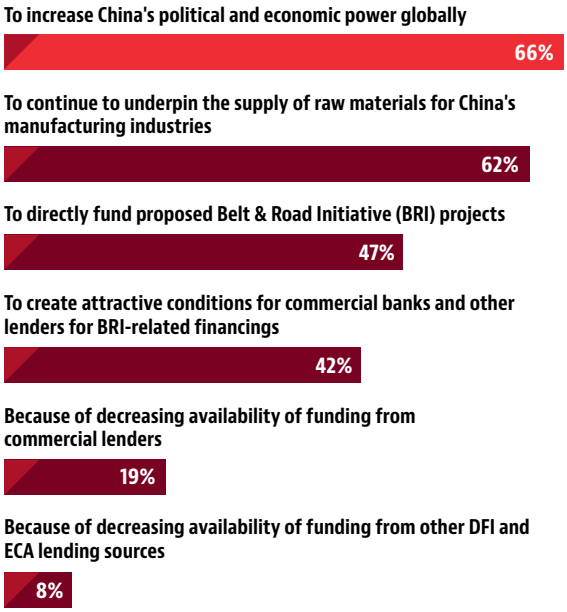
Q4. Why do you think the importance of multilaterals will decline?

Survey participants answering "yes" to question 3 only

Q5. Do you expect Chinese outbound lending to emerging markets to continue to rise?

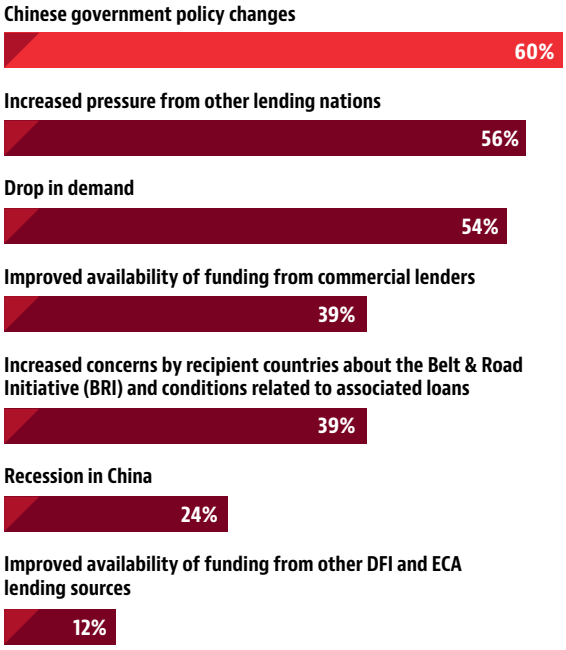


Q6. Why do you expect Chinese outbound lending to emerging markets to continue to rise? (Select up to three)



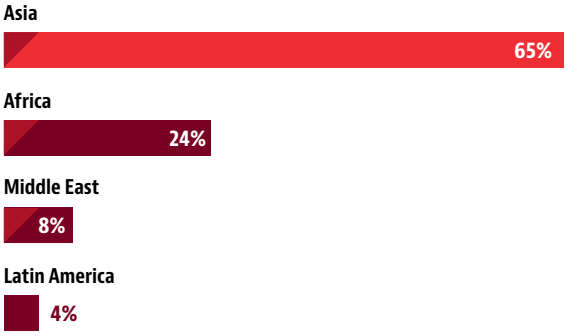
Survey participants answering "yes" to question 5 only

Q7. Why don't you expect Chinese outbound lending to emerging markets to continue to rise? (Select up to three)

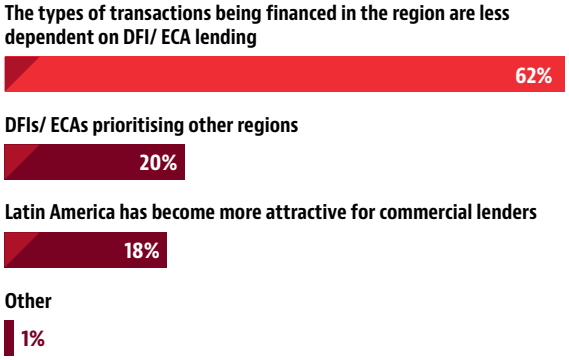


Survey participants answering "It will stay roughly the same" or "It will reverse" to question 5 only

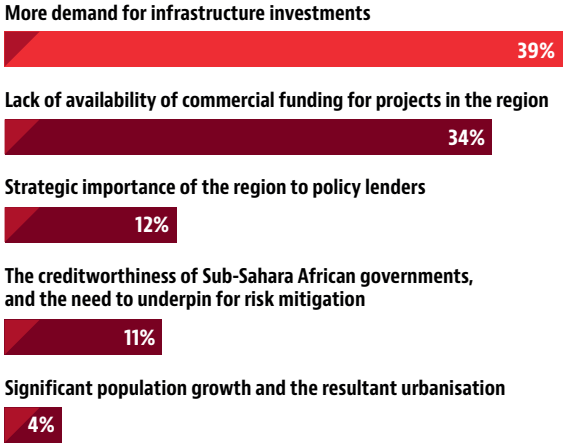
Q8. In which of the following regions do you expect Chinese policy lenders to be most active in the next five years?



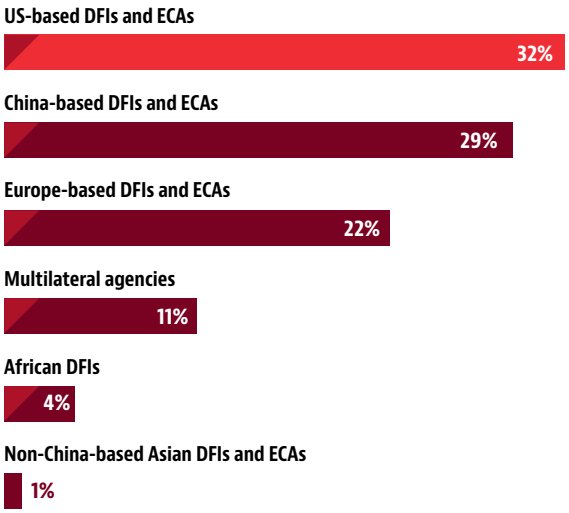
Q9. Why is ECA/ DFI-lending in relative decline in Latin America?



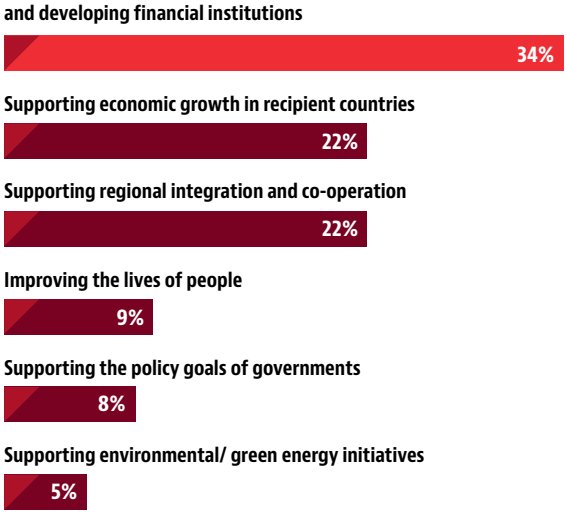
Q10. What best explains the significance of ECA/ DFI-lending to Sub-Saharan Africa?



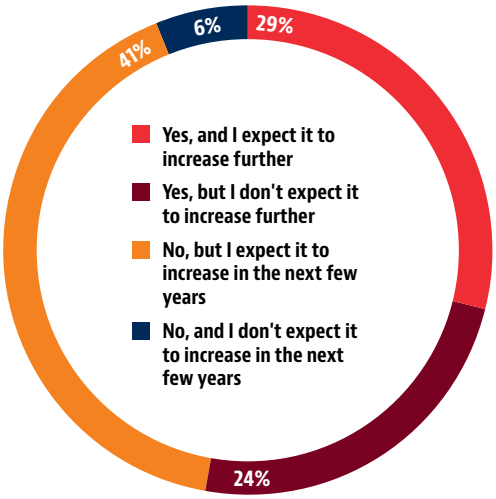
Q11. Which DFIs and ECAs do you think will be the most active lenders into African power projects over the next 10 years?



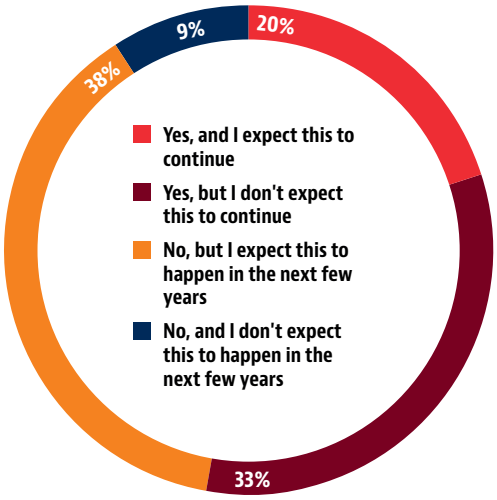
Q12. What is the biggest influence on lending by DFIs in the current market?



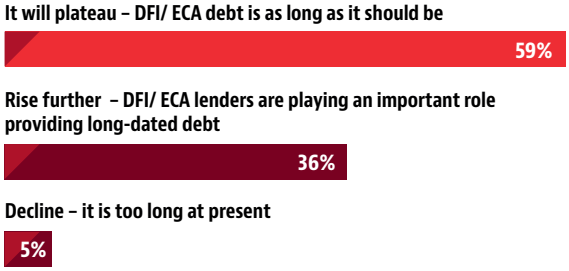
Q13. Do you think the level of due diligence required by Chinese DFIs and ECAs has been increasing in recent years?



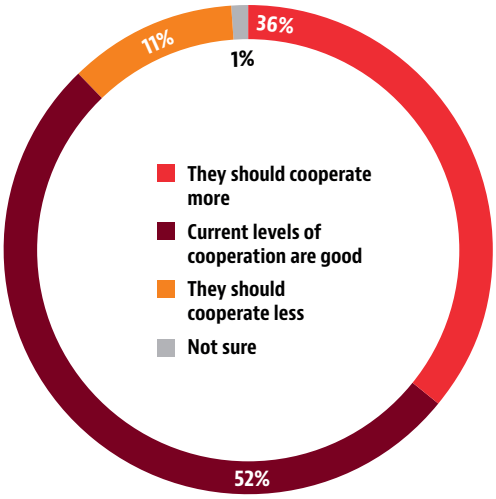
Q14. Do you think non-Chinese DFIs and ECAs have become less bureaucratic in their lending processes?



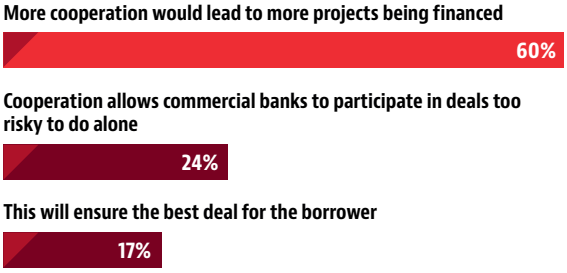
Q15. How do you expect the average tenor of DFI and ECA debt to change going forward?



Q16. What are your views on current trends of cooperation between DFIs/ ECAs and commercial banks?

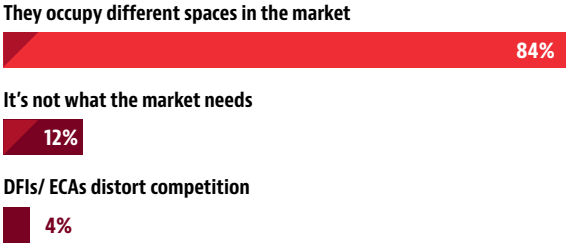


Q17. Why should DFIs/ ECAs and commercial banks cooperate more?



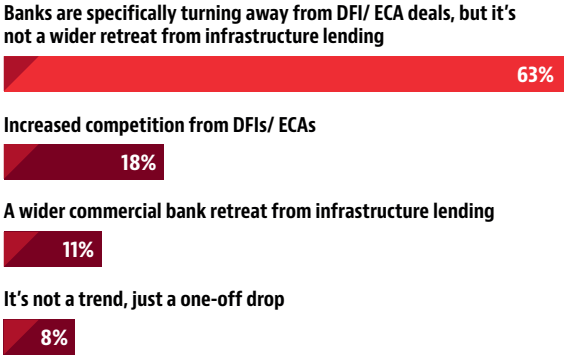
Survey participants answering "should cooperate more" to question 16 only

Q18. Why should DFIs/ ECAs not cooperate more with commercial banks?

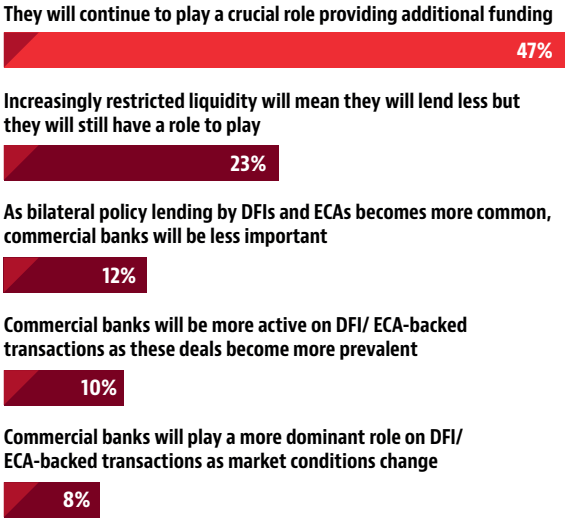


Survey participants answering "current levels are good" or "should cooperate less" to question 16 only

Q19. What best explains the recent decline of commercial bank participation in DFI/ ECA transactions?



Q20. What is the future role of commercial banks in DFI/ ECA-backed transactions in emerging markets?



Note: Due to rounding, some totals do not equal 100%

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