Banking, Finance & Projects

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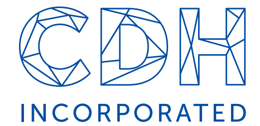

In this issue

SOUTH AFRICA

Local and regional trends in the bank, institutional and general debt markets

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Local and regional trends in the bank, institutional and general debt markets

The banking, finance and projects space is a dynamic environment with market positions and the required legal advisory roles changing continuously. In recent months we have noticed increases in lending margins, a willingness to lend at upstream holding company levels on a basis which results in structural subordination to lenders at subsidiary operating cash flow level and the shift towards alternative lender finance. This article highlights some key aspects of these developments and the options available to both lenders and borrowers.

Structural subordination to group operating cash flows

The acceptance of bank and institutional funding exposures on a structurally subordinated basis is gaining increasing momentum among South African investment banks. The concept of subordination determines the order in which claims held by different classes of creditors are repayable. It creates priority in favour of one creditor over another, which can be achieved in one of two ways. The conventional manner is through contractual subordination, i.e. where so-called *"mezzanine"* and other junior creditors commit contractually to a subordination and deferral of claims until all prior-ranking (*"senior"*) claims have been discharged in full. The other way of doing this is where banks and institutions that are prepared to lend at a junior level, provide finance at holding company or intermediate holding company level, on the basis that senior lenders are permitted to lend directly at the level of subsidiaries where the operational cash flows of the group are generated. In this case, the senior lender has claims directly against operating assets and cash flows, while the junior lenders at an upstream holding company level are dependent on dividend cash flows to service their debt. The difference in credit exposure is clear.

It follows that funding provided at ultimate parent level is structurally subordinated to funding at intermediary level, which in turn is structurally subordinated to funding provided at operating subsidiary level. Lenders providing finance at operating subsidiary level are structurally *"senior"* to the lenders with exposures higher up in the corporate structure. Lenders at upstream holding company level will always get repaid after lenders with exposures at operating subsidiary, regardless of the priority and ranking of debt at parent level in relation to the debts of the parent generally. The parent lender will not have access to the subsidiary's assets until all the subsidiary's creditors have been paid. Contractual subordination used, for example, in the traditional European and US mezzanine funding structures, is not prevalent in the market at the moment and has not been for a number of years. As the name suggests, it occurs where the junior debt of a debtor is contingent on the senior debt of the same debtor being repaid in full, based simply on contractual subordination provisions as between senior and junior debtors. The factors to consider when structuring include the seniority of the existing debt, the risk profile of the borrower, the size of the loan and the type of the lender.

Structurally subordinated lending is not for the fainthearted.

Local and regional trends in the bank, institutional and general debt markets

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It is a specialized investment banking business and unlikely to happen in the general corporate banking divisions of the banks. As the name suggests, it allows banks and institutions to lend at a level which moves away from the "*super-senior*" debt side of the capital spectrum more in the direction of what is effectively a hybrid capital exposure, i.e. an exposure in this case based on a debt claim, but with certain equity-like features. These equity-like features include higher risk but, importantly for the investment bankers, also substantially higher returns. Returns come by way of margin increases and in some case equity warrants, i.e. an ability to convert a portion of the debt into equity on the scheduled repayment date at the end of term. Where credit margins on senior operating cash flow level generally will hardly exceed 1,75% to 2% (except for project or real estate finance with development risk), these margins increase to 5,5% to 6,5% (or higher in some cases) for structurally subordinated loan funding outside of investment grade lending.

This type of lending exposure generally requires strict negative pledge provisions through the group, i.e. little flexibility, if any, for additional debt and encumbrances over assets. Structural subordination also occurs where security and cash flow support are weak, and often affected by the industry or sector of the borrower and reputation of management team. (At a purely technical level, structural subordination can of course be undone or avoided for exposures at holding company level, simply by obtaining upstream guarantees from a group's operating subsidiaries – but this is general senior lending and not what is referred to above.)

Margin variations

Lenders, forced indirectly by the ability of the South African Reserve Bank to manage interest rate levels through the repo rate as a counter-inflationary measure, respond to economic vulnerability and decreases in the purchasing power of the rand by increasing the rate at which they lend. This affects base rates, i.e. lender's cost of capital with market benchmark rates such as JIBAR or the prime rate and the levels at which those base rates are passed on to borrowers. It also results in increasing lending margins as a result of increases in the cost of debt and equity capital in a higher risk economic environment where lenders have to deliver higher returns to the shareholders.

General economics aside, we also see transactions where because of higher investment banking risk appetite, for example, an increased willingness to lend on a structurally subordinated basis, lender margins are seeing an increase for this type of lending, supplemented by alternative "*equity-type*" earnings participation mechanisms such as profit-participating loans or preference shares, call warrants built into lending instruments (effectively just an option to swap debt for equity at favourable conversion rates) and even direct equity holdings (where we have seen small investment banking stakes in for example a portfolio of renewable energy plants).

Local and regional trends in the bank, institutional and general debt markets

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On a pure senior lender level, EBITDA-based "*margin ratchets*" i.e. where the credit margin is directly linked to the earnings levels and leverage of the operation is nothing new. Also, ESG-based margin reductions to reward borrowers for ESG compliance continue to find their way into loan agreements.

Alternative finance

More options outside of commercial banking and capital markets are now available to borrowers. Some of the options are not new and include equity instruments such as private equity and venture capital finance, alternative debt instruments such as corporate bonds, securitized debt, covered bonds, private placements and asset-based finance. When deciding which financing option to go with, borrowers need to understand the desired level of control, the financing situation, the health of the business, the growth potential and the cost of the capital presented by a particular option. Equity or equity-line capital brings with it potentially substantial costs, often in the form of dilution of shareholding positions and the resulting forfeiture of equity returns. Non-traditional financing models allow capital investments to be made to companies that are not publicly traded.

The economic consequences of the COVID-19 pandemic that followed after the outbreak of the pandemic in 2020 gave rise to concerns of another possible financial crisis and prompted central banks to add to regulatory burdens already applicable to banks in a number of jurisdictions, so as to encourage more cautious lending practices. In Europe and the US, commercial banks have faced challenging prudential requirements and increases in minimum capital requirements. This has had a significant effect on specific lending sectors formerly considered the almost exclusive domain of commercial and investment banks. The prime example here is of course commercial real estate finance which is especially hit by capital and prudential regulation in Europe. Such were these additional restrictions and implied capital costs, that several commercial banks in Europe took the decision to scale down their real estate finance operations or close them down altogether. We know of cases where banks required a minimum credit margin of at least 4,5% on regular senior level commercial property finance for investment property without any construction or development risk. The effect of this was to drive the real estate bankers across Europe away from their traditional homes at commercial and investment banks to the private funds industry which is not subject to the minimum capital and other prudential requirements imposed by the European Central Bank and other central banks on banking operations.

Leading examples of private debt funds with a focus on commercial real estate finance and which took over the commercial real estate lending businesses, some banks almost on wholesale basis, include Allianz Real Estate in Germany and Generali's real estate funds business

Local and regional trends in the bank, institutional and general debt markets

CONTINUED

operating out of Italy. Real estate debt funds that have replaced commercial banks as senior lenders on real estate financings, are going from strength to strength in Europe and offer reduced public market volatility, added flexibility on loan terms where central bank regulation does not affect matters, better pricing because of the absence of central bank-level minimum capital requirements and credit lines diversification benefits. It withstands elevated liquidity risks, enhances portfolio resilience and is inflation-linked. Alternative finance has become a priority.

International and regional debt finance in Africa

Project finance remains a priority to support infrastructure backlogs, especially on the African continent. For example, the Batoka Hydro-electric Scheme located across the boundary between Zambia and Zimbabwe, 54km downstream from Victoria Falls and straddling the border between the two nations, has reduced the cost of the power system. The Nzilo II solar and hydro-electrical power plant on the Lualaba review in the DRC is an example of a project where our Banking, Finance & Projects team was able to contribute to efforts that address this infrastructure backlog. Our prediction is that this will remain the case for years to come and the development of skills and transaction teams which can support these transactions on a fully integrated basis out of our Nairobi and Johannesburg offices remain an integral part of our strategy. To make these deals a success, we need to be alive to, and deepen our relationships with, alternative funding providers such as development finance institutions. We also need to be alive to alternative funding models such as "*offtake pre-finance*" arrangements with end-user corporates which have existing investment exposures to the jurisdictions in which these projects are carried out and which stand to benefit substantially from factors such as certainty of supply.

We continue to see South African banks following their international private equity investor clients into continental jurisdictions either through private equity fund-level finance structures or portfolio company finance structures (i.e. "*limited partner undrawn commitment cover*" as well as portfolio company "*NAV*" deals).

With commercial banks willing to lend on a structurally subordinated level, rather than only in a traditional senior lender "*margin earner*" role, we are seeing banks targeting real investment bank returns through fee structures, higher lending margins and in some cases, limited equity participations, in a portfolio by the same sponsors. This also signals a return to the importance of sponsor credibility, management reputation and relationship banking.

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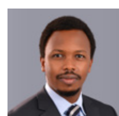

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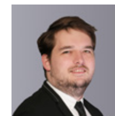

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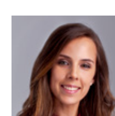

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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