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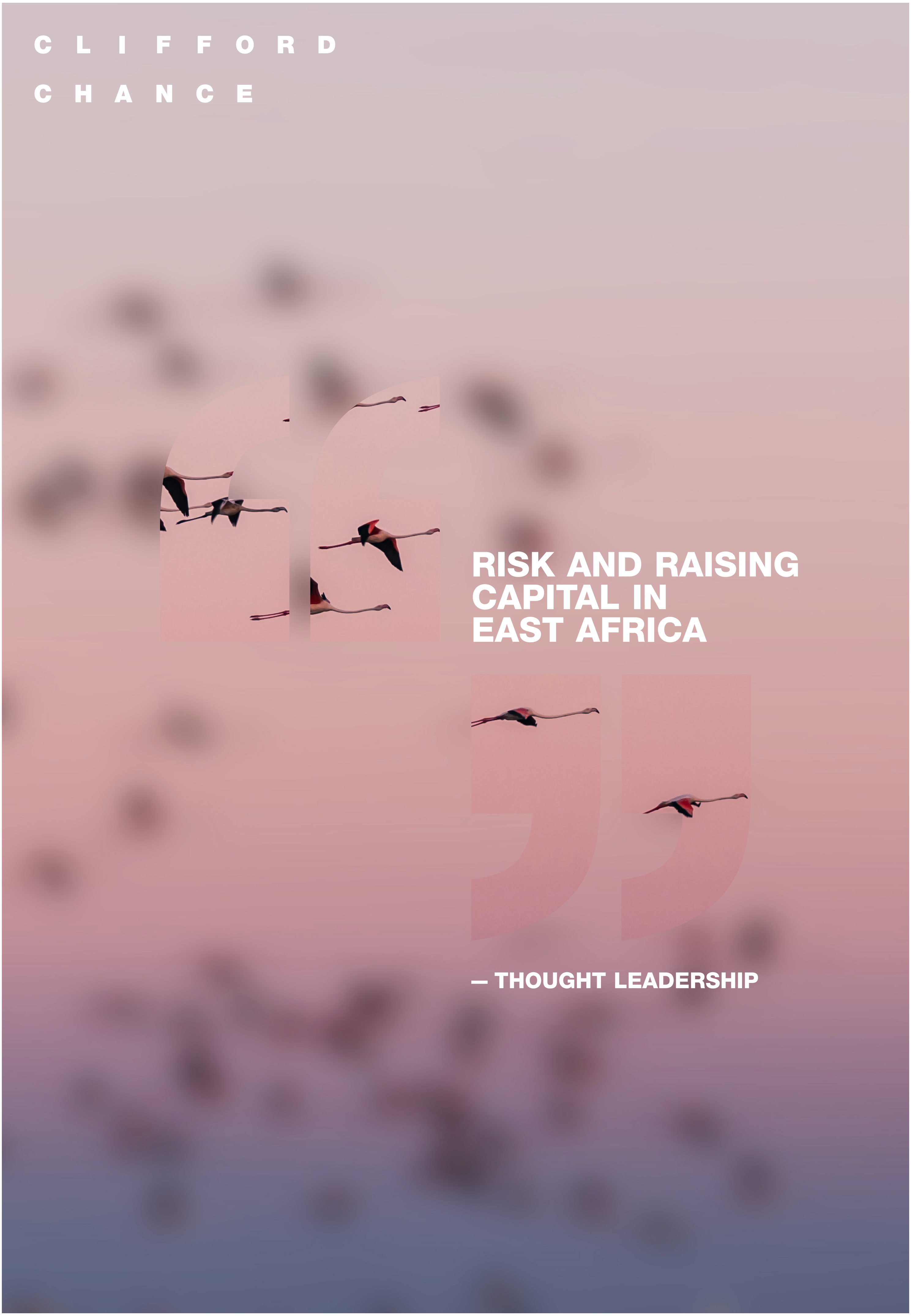

RISK AND RAISING CAPITAL IN EAST AFRICA

— THOUGHT LEADERSHIP

RISK AND RAISING CAPITAL IN EAST AFRICA

The future role of Africa in international trade and the challenges and risks that banks and corporates in East Africa face in successfully raising capital were just some of the topics that were covered during Clifford Chance's Risk and Raising Capital Conference 2017 in Nairobi.

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— **NIC HAILEY,**
British High Commissioner to Kenya

In this extract from a series of panel discussions, our guest speakers – Nic Hailey, the British High Commissioner to Kenya; Admassu Tadesse, the President and Chief Executive of TDB (formerly trading as PTA Bank); Kihara Maina, Chief Executive Officer of I&M Bank; Abubakar Ali, Chief Financial Officer of Gulf Power; Hoda Atia Moustafa, Africa Regional Head of the Multilateral Investment Guarantee Agency; Pradeep Paunrana, Chief Executive Officer of ARM Cement; Joseph Githaiga, Head of Compliance: Commercial, Corporate and Institutional Banking, East Africa, Standard Chartered Bank; and John Njenga, General Manager, Legal Services, Equity Bank – and panellists from the Clifford Chance East Africa Group explore the issues that will have a significant impact on the region.

Africa's future role in international trade

Global trade is at a turning point. As Africa and Asia seek to expand and enhance their free trade policies, the US is taking an America first approach and is tearing up trade deals such as the Trans-Pacific Partnership and planning to renegotiate others. This has created an element of uncertainty in East Africa. Brexit is adding to that uncertainty, and is being blamed for the current delays in the adoption of the East African Community's trade deal with the EU which has been under negotiation for some nine years. However, Nic Hailey does not believe that the UK Government's policy response to Brexit will be driven by protectionism, rather he regards Brexit as giving the UK the freedom to negotiate a greater number of international trade agreements and on more flexible terms.

Against that backdrop, Mr Hailey commented on the very strong trade ties that exist between the UK and Kenya – "One in two cups of tea drunk in the UK and one in three roses bought in the UK are the direct result of exports from Kenya." As a number of exports from Kenya to the UK are routed through the EU, he noted that companies would need to examine their supply chains to ensure that tariffs and other frictions as goods cross borders are mitigated in a post-Brexit world. It will also be crucial for the UK and Kenya to work together and put in place a progressive trade agreement creating the conditions to enable trade between the two nations to flourish. In terms of what can be expected post-Brexit, Mr Hailey highlighted that "the UK government is likely to prioritise negotiating trade agreements with the biggest markets and those that it believes will be the quickest to agree."

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There is a strong political desire to boost intra-African trade (currently accounting for only 12% of African trade). A Tripartite Free Trade Area agreement (TFTA) was signed in 2015 between three existing trade blocs (the Southern African Development Community, the East African Community and the Common Market for Eastern and

Southern Africa). If fully implemented, the TFTA would create an integrated market of 26 countries with a combined population of over 600 million people and a total GDP of over US$1.3 trillion. The TFTA has so far been signed by 18 member states with more member states expecting to sign and ratify it in the near future.

The African Union has greater ambitions – to create a Continental Free Trade Area (CFTA) covering all 54 member states by 2017. In 2012, the Heads of State of the African Union member states adopted a decision to establish the CFTA with the main objective of creating a single continental market for goods and services ultimately resulting in a customs union. Negotiations started in 2015, but progress has been slow. However, Admassu Tadesse expressed a degree of optimism on the future prospects for Africa in international trade: the creation of larger African trading blocs (if not a single trading bloc) would no doubt enhance intra-African trade and place the continent in a better position to negotiate international trade deals.

The role of development agencies and DFIs in raising capital for projects

One of the main obstacles to the development of intra-African trade has been the need for significantly improved infrastructure in the region. Abubakar Ali emphasised that government support for a particular infrastructure or energy project in the East Africa region is often crucial to the success of a transaction. As Lori Bean (Partner in Clifford Chance's Energy & Infrastructure group in Washington) noted, development agencies and development finance institutions (DFIs) also have an important role to play and often bring a "golden halo" to transactions, together with long tenors and sometimes concessional pricing.

Hoda Atia Moustafa questioned whether the agencies and DFIs have been overreaching their role on these transactions and argued that there needs to be a change in the mindset as to how concessional financing is used. "DFIs and agencies should be acting as lenders of last resort…concessional financing should not be used to fund projects that can access private funding," she said. She argued that concessional financing should only be used to plug holes which cannot be covered by private investment and that it is critical for this mindset to change so that commercial banks (in particular those from the region) are not squeezed out of these important transactions by the DFIs and development agencies.

Challenging outlook for capital raising in the international capital markets

With its economy growing by approximately 6% each year, Kenya needs capital to support its growth. However, the lack of savings in Kenya means it needs to seek investment from abroad. Can Kenya (or Kenyan banks/corporates) step into the international capital markets space to raise the capital needed to support big investment?

Recent global macro-economic and political events have ushered in an era of uncertainty for the international capital markets, which has led to an increase in interest rates and to a significant shortening of execution windows for capital markets transactions.
The strength of the US dollar has also increased the exchange rate risk for many potential issuers who wish to borrow US dollars on the international capital markets. As Admassu Tadesse said: "There has been a change in terrain for international capital markets issues in recent years." David Dunnigan (Partner in Clifford Chance's Capital

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Markets group in London) emphasised that the shorter execution windows mean that it is even more critical for new entrants to the international capital markets to be fully advised and prepared upfront on the transaction process and documentation and the issues that investors will focus on when deciding whether to invest.

Can private equity fill the gap?

Commenting on the role of private equity, Nicholas Hughes (Private Equity Partner and Head of the Clifford Chance East Africa Group) noted that a number of the largest energy projects which had been developed across the continent recently had private equity backers. These private equity investments span the entire power sector value chain including conventional generation, renewable generation, transmission and distribution. In East Africa, a surge of investment in off-grid solar companies has cemented the region's reputation as a global leader in this rapidly growing industry. Outside energy, the agribusiness, education and financial services sectors have remained particularly active. Mr Hughes said: "Despite some high profile bank failures in the region, businesses active in the insurance and broader financial services sector continue to attract new capital".

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> Private Equity Partner and Head of the Clifford Chance East Africa Group

The panel noted that the difficulties in deploying sufficient capital in a single transaction had historically held back international private equity investment in the region. However, multiple years of significant economic growth and larger energy and infrastructure projects have now made Kenyan companies operating in many sectors appealing targets for international private equity houses. Mr Hughes noted that with deals competing for a fund's capital, those which sit favourably on the risk/return matrix and offer a clear path to an eventual exit for the private equity house are most likely to attract capital.

Kenyan banking sector: on the rebound?

It is not just the global macro-economic and political environment that has created an uncertain environment for capital raising in East Africa. Admassu Tadesse admitted that it has been a difficult last year for the Kenyan banking industry which has been adversely impacted by interest rate caps and floors. There have also been several incidents of high profile specific bank failures in the region, including Kenya, but this has been accompanied by strong regulatory measures to address the problems, especially in Kenya and Uganda.

The interest rate caps imposed by new legislation have led to banks paring back their lines of credit, particularly with respect to borrowers that are classified as "higher risk." Public confidence in the banking sector has been knocked which has led to a flight to quality, with a number of customers moving their deposits to the larger banks with longer track records. This has also led to an increasing focus on the country's inter-bank market, especially inter-bank repos. Kihara Maina said: "The recent issues in the banking sector have amplified the shortcomings of the inter-bank market in Kenya."

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> Chief Executive Officer of I&M Bank

The Kenyan regulatory authorities have since been working hard to develop financial markets infrastructure to promote inter-bank liquidity. As Habib Motani (Global Head of Clifford Chance's Derivatives and Structured Products practice) put it, this new infrastructure would act as the "oil that is needed to keep the financial system flowing". The Kenyan Capital Markets Authority is working on the introduction of new netting laws, which would significantly enhance Kenyan banks' ability to access funding and risk management

The Clifford Chance Africa Academy hosted a series of training programmes for lawyers from its relationship law firms and clients in East Africa alongside the Risk and Raising Capital Conference. This included:

- A corporate academy training session for lawyers covering transactional issues in M&A and Private Equity transactions.
- A finance academy training session for lawyers covering loan documents, bond issuances, derivatives and structured products, structured trade finance and project finance.
- A capital markets roundtable seminar involving the CMA and senior representatives from certain Kenyan law firms focussing on listed company investments and exits and debt capital markets transactions.

opportunities both domestically and in dealings with international banks.

The wider banking sector in Africa has also seen a decline in correspondent banking relationships (CBRs), with an increasing number of overseas banks choosing to de-risk from jurisdictions perceived as high risk. This decline in CBRs has had unintended consequences such as the emergence of funding gaps in parts of the continent where that funding is most needed, causing key stakeholders to question whether de-risking is indeed the right approach to take.

Increasing regulatory risk for businesses and investors

The approach to business risk is changing as banks, financial institutions and corporates become more sensitive to compliance as the international and regulatory landscape continues to evolve and expand. This has led to both international and local businesses seeking to implement a robust internal compliance framework to guard against breaching the increasingly complex regulations. A critical element involves having a strong team of compliance experts in place and Joseph Githaiga emphasised the need to invest in high quality individuals who are able to implement and update the compliance framework on an ongoing basis. This is expensive but the cost of fixing a problem is often far greater than the cost of getting things right in the first place. "The hidden cost to remedy a regulatory breach is often two to three times the value of any fine that may be imposed by a regulator," he said.

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— **JOSEPH GITHAIGA,**
Head of Compliance: Commercial, Corporate and Institutional Banking, East Africa, Standard Chartered Bank

Investors have also been particularly sensitive to regulatory issues around anti-money laundering, sanctions and anti-bribery/corruption. This increasing sensitivity has seen investors pulling out of sectors, geographical areas and specific transactions which are considered to be high risk. While discussing ARM Cement's various capital raisings over the past few years, Pradeep Paunrana talked of a "meticulous due diligence process" leading up to an investment and noted that these processes had become far more comprehensive requiring businesses to be well prepared. Developing this theme, Megan Gordon (Partner in Clifford Chance's White Collar & Regulatory group in Washington) commented that "African businesses are increasingly instructing us to conduct a compliance gap analysis testing the extent to which the business meets global standards before embarking on an international capital raising process".

Emerging business risks

While significant investment in technology is critical to developing a strong risk compliance framework, it can also increase the risk profile of a business, with cyber security being a particular area of concern for businesses and investors. John Njenga also discussed the need for businesses to put in place "digital real estate teams" to monitor social media content and to control any adverse social media publicity which could threaten the stability of the business.

"There are enormous opportunities for investment and expansion in East Africa. However, the ever-changing political, regulatory and macro-economic landscape, both regionally and globally, will continue to present new challenges for businesses."

— **MALCOLM SWEETING,**
Senior Partner, Clifford Chance

The relationship between business and human rights is also becoming an area of focus. Historically, local businesses have had to address environmental, social and governance requirements as part of the conditions for accessing concessional/DFI financing. However, as Jessica Gladstone (Partner in Clifford Chance's Litigation and Dispute Resolution group in London) observed, global legal developments in this area mean that international financial investors and corporates (not just DFIs) will be more focused on how businesses, and their supply chains, are respecting human rights when assessing investment opportunities in the future.

What's the outlook?

In his closing remarks, Malcolm Sweeting (Senior Partner, Clifford Chance) commented that it was clear from the day's discussions that "there are enormous opportunities for investment and expansion in East Africa". However, the "ever-changing political, regulatory and macro-economic landscape, both regionally and globally, will continue to present new challenges for businesses". Organisations which anticipate these emerging risks and which are sufficiently flexible to adapt to the ever changing market, place themselves at a competitive advantage in the search for new capital. The conference emphasised that by coordinating with all relevant stakeholders and drawing upon the right expertise to find solutions, businesses can grasp the opportunities for Kenya and East Africa.

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J20170902171925