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CHINA'S BELT AND ROAD INITIATIVE: THE INFRASTRUCTURE CHALLENGES

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China's Belt and Road Initiative (BRI) unveiled by President XI Jinping in 2013, is one of the most ambitious development projects in history. It aims to boost global trade between Asia, Europe and Africa and create vibrant economies along its route, which covers 74 countries. Six years on from its launch, our experts assess the opportunities and challenges that lie ahead.

BRI is notable not only in terms of its scale, geographical reach and the political will behind it, but also for the lack of any roadmap. This has led to criticism that it is vague, lacks clear direction and its success is difficult to predict. What is clear is that the focus of the initial phase of BRI is firmly on infrastructure, particularly transportation, energy and communications.

The majority of BRI projects that have been completed to date, or that are under construction, are in the transportation sector, mainly ports and railways. These include:

- China to London Railway Project
- Gwadar Port, Pakistan
- Jakarta–Bandung High-Speed Train
- China–Laos Railway
- Ethiopia–Djibouti Railway
- China–Europe Freight Train Services, connecting 32 cities in 12 European countries.

According to the Ministry of Commerce (MOFCOM), China signed USD144.32 billion worth of construction contracts with 61 countries along the belt and road routes in 2017. This compares with USD126.03 billion and USD92.40 billion in 2016 and 2015 respectively.

Where is the money coming from?

By the end of 2016, China's two state policy banks, China Development Bank (CDB) and The Export-Import Bank of China (CEXIM) had extended USD200 billion in loans to BRI projects, whereas China's three stated-owned commercial banks (the Industrial and Commercial Bank of China, Bank of China and China Construction Bank) had extended USD250 billion in total. BRI, if fully realised, is likely to cost some trillions of US dollars over the next decade. Popular estimates for Chinese investments under BRI range from USD1 trillion to USD8 trillion, but there does not appear to be any publicly available official estimate. In any case, even based on the lowest estimate of USD1 trillion, China is unlikely to be able to finance the capital costs of BRI projects on its own.

A number of programmes have been developed to either invest in, or lend money to, BRI infrastructure projects. These include:

- a USD124 billion pledge to the Silk Road Fund
- China is empowering numerous smaller development funds for various regions, which total over USD76 billion
- CDB and CEXIM are setting up special lending schemes worth RMB150 billion and RMB130 billion to support the implementation of BRI.

Issues and challenges

There are a number of common challenges facing BRI projects:

Political risks

Many countries on the Belt and Road routes are subject to political upheaval, which can have a huge impact on the development and success of infrastructure projects. A number of Chinese infrastructure developments in Sri Lanka, for example, have not gone according to plan owing to the intractability of local politics. China Export & Credit Insurance Corporation (often known as Sinosure) plays a key role in BRI, providing much-needed political and commercial risk insurance cover to investors and financiers on Belt and Road projects.

According to Sinosure, the total insured amount under Sinosure insurance policies attributable to exports to and/or investments made in Belt and Road countries amounted to nearly USD510 billion by the end of Q3 of 2017, with the aggregate number of claims paid approximately USD2 billion. The Sinosure insurance policy is a single bank product and is not designed for syndicated financing deals. We believe that, in the long run, given the wide usage of Sinosure insurance products on BRI deals and the desire to mobilise private capital and international funding to jointly support BRI projects, the Sinosure insurance policy will need to be reformed and developed in line with some of its overseas counterparts, such as UK Export Finance or Japan's JBIC, in order to be more easily acceptable to international financiers.

Legal and regulatory issues

The legal system and local law in some Belt and Road countries have not been tested for foreign investments or large-scale infrastructure projects before. The USD5 billion Jakarta–Bandung high-speed rail line is currently on hold owing to land ownership issues affecting nearly 40% of the land. The project began in January 2016 and was expected to be completed by 2019. The current target for completion is now 2024. Another example is the USD5.2 billion China–Thailand railway project, which is currently facing delays owing to issues with environmental approvals in Bangkok. The same project previously suffered delays related to investment sharing and development rights.

Stranded assets

Certain forms of security customary for project finance transactions (e.g. account security, security over contractual rights, floating charge) may not have an equivalent under PRC security law. Importantly, most large-scale onshore Chinese projects are carried out by state-owned enterprises (SOEs), and Chinese financiers are used to seeking recourse directly from SOEs (instead of the project itself). Hence, project finance is not a common form of financing in China, and Chinese banks do not have as much experience in analysing and allocating risks on infrastructure projects when compared with international commercial banks and multilateral development banks. The lack of expertise in this regard may result in deals with less robust commercial and financing terms, which may, in turn, give rise to issues further down the line, resulting in stranded project assets. Such a domino effect can be disastrous. The sustainability of the Belt and Road hinges upon the attractiveness and recyclability of project capital, which is particularly important given the huge capital needed to achieve the BRI vision.

It is clear that China cannot, on its own, finance the BRI or bring it to success. Whilst the BRI has been much criticised for benefiting only the Chinese, that applied to the embryonic stages of BRI and more opportunities should naturally and logically open up for foreign investors in the years to come, particularly when there are more successful BRI stories to provide a track record.

The role of private investment funds

The scale of the BRI means that its funding will need international cooperation and innovative solutions. In private funds, there has been a noticeable increase in fund formation activity where funds' investment objectives are linked to BRI. Examples include: Silk Road Fund, Sino-Central and Eastern European Fund, China-Central and Eastern European Fund, China-ASEAN Investment Cooperation Fund, China-ASEAN Maritime Cooperation Fund, China UAE Joint Investment Fund, China-Eurasia Economic Cooperation Fund, China-Africa Development Fund, and the China Latin America Industrial Cooperation Investment Fund.

Here are some of our observations:

- Current BRI initiatives are mostly being led by Chinese state-owned banks, policy banks and governmental bodies. Relatively speaking, it appears that private capital is less enthusiastic about investing in BRI-focused funds and is very much adopting a "wait and see" approach at this stage. This might be due to a higher risk premium being required to encourage private capital to invest in BRI countries, many of which are generally considered to be sub-investment grade.

- In terms of structure, although many of these funds are structured as traditional closed-ended blind pool private funds, it is quite common for transactions to be club deals with significant capital commitments from each co-sponsor. Shareholders of the general partner/manager (Manager) of the fund are often also investors (and sometimes the only investors) in the fund. Increasingly, we have seen Managers established as joint ventures between Chinese state-owned/policy banks or Chinese-backed investment cooperation funds (Chinese SOEs) and foreign investors/sponsors.
- Aside from blind pool funds, we have also seen a marked increase in the formation of single asset funds which invest in pre-identified BRI-related portfolio assets, with a limited number of investors. There seems to be a wide belief that attaching the "BRI" label will more likely secure funding from Chinese SOEs and backing from the relevant Chinese regulatory bodies.

There is undoubtedly significant interest among international private fund managers in BRI, and provided that the government-led projects prove successful, we expect this interest will grow.

Attracting private capital

BRI will no doubt present many opportunities, but financing currently remains a challenge. While existing Chinese government-backed banks and investment cooperation funds (including Asian Infrastructure Investment Bank and the Silk Road Fund) have extended funding to BRI investments, the amount remains very small relative to funding requirements.

According to the Asian Development Bank, government reforms could only bridge up to 40 per cent of the financing gap, while the remainder needs to be filled by the private sector. Filling this funding gap will require more private international capital; mere government/state investment is not sufficient. China's increased measures to tackle shadow banking (including the recent ban on China investment funds from making loan investments) could further increase this funding gap.

However, in order to attract the necessary private international capital, changes are needed in the way in which international private investors perceive risks in many of the emerging markets in the BRI countries. There also needs to be transparency on costs and returns. Fund economics are important – beating the hurdle and ensuring that there is the potential for a decent distribution of carry is key to the success of an investment fund and hereby attracting more private capital.

International collaboration and good corporate governance

We expect to see more collaboration between Chinese SOEs and foreign investors/ sponsors to capitalise on the potential and opportunities arising from BRI. Through cooperation arrangements with Chinese SOEs, foreign parties can gain access to "Chinese elements" (for example, financing from Chinese institutions; cooperation opportunities with Chinese equipment manufacturing, engineering, procurement, construction (EPC) contracting, operations and maintenance services and other types of enterprises; potential Chinese buyers in a portfolio sale, etc) while Chinese SOEs can gain access to the technology and/or knowledge of local conditions which the foreign parties can often offer. Cultivating a good corporate governance culture is vital to this collaboration and will make BRI investments more palatable.

What happens if there are problems with projects?

BRI encompasses countries and territories with significant political and economic risks, and the types of projects (in particular, their large scale and the deep involvement of government or state-owned enterprises of the host state) further enhance the risks.

Chinese companies are giving increasing thought as to how best to protect their interests as BRI gathers pace. Previously, Chinese companies were mainly concerned with defending potential claims from foreign investors in relation to inbound investments. However, the increase in the level and scope of outbound investment (especially in light of BRI) has led Chinese companies to consider more carefully the various dispute resolution alternatives as they make their investments.

Chinese negotiators are now more savvy about issues such as the relative merits of arbitration compared with litigation and the choice of arbitral seats. In addition, Chinese courts are losing some of their traditional reserve about enforcing foreign judgments, and there are policy initiatives afoot to ease the recognition and enforcement of court decisions across Belt and Road countries. It may take some years for disputes to play out, but Chinese government and companies are putting in place the mechanisms necessary to smooth the path for cross-border dispute resolution in Belt and Road projects.

CONTACTS

Nicholas Wong
Partner
Singapore
T: +65 6410 2218
E: nicholas.wong@
cliffordchance.com

Mark Shipman
Partner
Hong Kong
T: +852 2825 8992
E: mark.shipman@
cliffordchance.com

Terence Foo
Co-Managing Partner
Beijing
T: +86 10 6535 2299
E: terence.foo@
cliffordchance.com

Maggie Lo
Partner
Hong Kong
T: +852 2826 3568
E: maggie.lo@
cliffordchance.com

Dauwood Malik
Partner
Hong Kong
T: +852 2826 3485
E: dauwood.malik@
cliffordchance.com

Cameron Hassall
Partner
Hong Kong
T: +852 2825 8902
E: cameron.hassall@
cliffordchance.com

Paul Sandosham
Partner
Singapore
T: +65 6661 2055
E: paul.sandosham@
cliffordchance.com

Maggie Zhao
Partner
London
T: +44 20 7006 2939
E: maggie.zhao@
cliffordchance.com

Huw Jenkins
Consultant to
Clifford Chance
London
T: +44 20 7006 1392
E: huw.jenkins@
cliffordchance.com

Vicky Ma
Partner
Hong Kong
T: +852 2825 8995
E: vicky.ma@
cliffordchance.com

Viola Lui
Consultant
Hong Kong
T: +852 2825 8842
E: viola.lui@
cliffordchance.com

Lei Shi
Partner
Shanghai
T: +86 21 2320 7377
E: lei.shi@
cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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