Client Alert | **Newsflash** | Bank Finance / EMEA Banking

Developing Markets: loan and commodity finance considerations at a time of vulnerability

March 2020

At a time of vast capital outflows (withdrawals from emerging markets in the period 21 January – 24 March were reported by the Institute of International Finance at $83 billion), commodity price falls and wider global market and business dislocation, stakeholders in emerging market bank finance transactions face many challenges.

In this Client Alert, we highlight issues that may assist in navigating some of the immediate pressure points and anticipate some general themes to help clients to prepare responses and explore solutions.

1. Liquidity

1.1 The Financial Times reported on March 25 that 130 companies in Europe and the Americas have drawn at least $124.1 billion from their lenders over a space of just three weeks. We expect that EM corporate treasurers will similarly look to draw down RCFs to boost cash liquidity.

1.2 However, emerging market borrowers are likely to face greater complexities when seeking to utilise available revolving debt capacity:

(a) capital structures are more fragmented (single vertical bank debt structures are the exception) and few companies will have access to credit lines on the scale of large western corporates (General Motors drew $16 billion);

(b) FX issues will likely be a material consideration, depending on whether their revolving lines or liquidity needs are local currency or hard currency (and availability and cost of hard currency from local lenders will be under pressure);

(c) notwithstanding relationship and reputational pressures on lenders, broader events of defaults and tighter documentation terms may trigger drawstops on committed lines;

(d) pure trade lines are generally uncommitted so companies face uncertainties (and/or timing delays in utilisation / issuance) in accessing available amounts; and

(e) commodity prices and other asset valuation deterioration may constrain the amount available under trade lines or structured working capital structures that are to be collateralised against physical flows or other assets.

(f) All of this comes at a time when fiscal action will further reduce interest rates on deposits and widen (as risk premia rise for new money financing) the carry cost of keeping cash available on balance sheet.

1.3 What other sources of liquidity may be in play? Borrowers may explore the availability of alternative sources of funding (and check whether their third-party financings allow them to access them), such as:

(a) factoring and similar receivables purchase facilities: this may be a partial solution for at least short-term working capital (again, these would often be uncommitted); however, not all emerging markets have depth of supply in this product (and the volume of creditworthy underlying debtors may be more limited) even where the local legal and regulatory framework support it;

(b) advance payment (or, although longer term and/or large scale application would be limited primarily to capital assets and projects), deferred payment (vendor finance) arrangements;

(c) commodity prepayments, for those in the right sectors and with unallocated future production; while, as with structured trade finance, commodity price drops may compress the absolute amount available, commodity traders can be a source of liquidity in significant size;

(d) for both corporates and (especially) financial institution borrowers:

(i) structured monetisation of balance sheet assets (while this has execution risk and timing implications, many providers of capital have experience and willingness to fund against a satisfactory asset base); and

(ii) use of government windows and funding or credit support initiatives.

2. Financial reporting

2.1 Reporting (financial statements)

Recent statements and guidance from the likes of the FRC[1] underline many of the difficulties that companies face in completing the audit process for financial year ended 31 December 2019. Of course, further challenges apply in the context of 2020 periods. We refer you to our other alerts in this context.[2]

With an eye to engagement with lenders and other stakeholders more generally, the five investor questions in the FRC's COVID-19 infographic[3] merit mention as a basis for best practice in terms of what company disclosure is most helpful in the current environment:

(a) cash and other liquid resources;

(b) short-term availability (committed/uncommitted nature of financing lines, other support);

(c) management of short-term expenditure (*e.g.* reduction dividend policy, supplier finance, capex commitments, possibility of payment deferrals (*e.g.* tax), pension funding);

(d) other action to "ensure its viability" (government-backed support, stress-testing, intragroup support and commitments, board monitoring); and

(e) key assets and value drivers: revenue and cost forecasts, impact assessment of short-term decisions, employee support, management of commitments, adaptation of business model and strategy.

2.2 Other reporting

(a) All companies should expect (and therefore prepare for) lender requests for updates on its financial condition (which is the starting point from a creditor perspective in most EM loan documentation).

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1 https://www.frc.org.uk/news/march-2020-(1)/frc-guidance-for-companies-and-auditors-during-cov

2 https://www.whitecase.com/publications/alert/covid-19-legal-issues-and-considerations#leveraged-finance

3 https://www.frc.org.uk/getattachment/be8df00e-b0d8-4674-9a7f-104c2680af36/FR-Lab-infographic-250320.pdf

(b) Companies should be alert to the additional reporting requirements of performance risk structures especially. Often these will require reporting on underlying Sales / Commercial Contracts with third-party buyers and as part of this, notifying lenders of force majeure suspensions (see also 6.1(b)).

(c) Hybrid project finance structures may also have (historic) monthly or quarterly operating reports. Many of the practical and logistical considerations that apply to financial statements may be relevant here; see also 3.1(b) below.

3. Financial covenants

3.1 Balance sheet tests

(a) In contrast to mature leveraged finance markets and strong investment grade names, the starting point for EM loans will generally be financial maintenance covenants- usually (net) leverage and interest cover. Gearing (*i.e.* debt/equity) and/or Consolidated Net Worth may also feature.

(b) On certain types of (hybrid) EM loan transactions, financial covenants (classically, debt service) may be forward-looking (tested by reference to a financial model or other projections or forecasts); here, companies will already be faced with tackling covenant testing for 2020 measurement periods (in contrast to the usual corporate finance LTM historic basis for which the 12 months ending 31 December 2019 is currently the impending financial covenant testing period).

(c) In relation to financial covenants (or other provisions) where EBITDA is a factor, we anticipate that the main focus for all market participants for 2020 measurement periods will be on the definition of "**Exceptional Items**" (or similar) and whether or not, by the terms of the definitions in the loan documents, a company can add back costs incurred or losses (*i.e.* relationship between revenues and costs) recognised in those periods relating to the coronavirus. It is clear, however, that reduced revenue will not in itself constitute an "exceptional, one off, non-recurring or extraordinary item" or otherwise qualify for reversal under any usual formulation of this definition. We note for completeness that companies (*e.g.* medical or certain types of logistics) who benefit from a revenue bump in these unusual global conditions would have to reverse any exceptional gain.

(d) The difficulties for EM borrowers are again likely to be heightened by factors including:

(i) ***cure rights***: even where provided for, these are more limited and tend to be less favourable in terms of requirements to apply cure amounts against debt (and/or the application of the cure amount or amount prepaid through the calculation); well-organised borrowers may seek to pre-cure through equity and/or subordinated debt, to increase cash and reduce net debt (which may avoid breach and equity cure regime requirements to prepay loan outstandings); and

(ii) ***FX***: although hard currency exporters may benefit from lower local costs relative to the strengthening dollar (as in the last global downturn), for other borrowers, the reduced dollar value of local currency revenues and (for companies with Consolidated Net Worth or gearing ratios) the impact of FX translation (however labelled) on balance sheet may be a significant challenge.

3.2 Other tests

(a) *Performance risk structures* (by which we mean PXF, commodity prepayment and similar receivables-enhanced credits): these classically use DSCR and LLCR. It's important to remember that these measure not *actual* performance but rather the notional projected value of volumes committed by the exporter for delivery under the underlying commercial contract during the relevant forward-looking period. Assuming that the reference price "floats", for example, because it references the applicable benchmark price for the commodity as used in the pricing formula in the commercial contract, a falling commodity price may result in cover ratio breach. However, during the last downturn, many commodity exporters successfully cured through escalation (increased volumes added to the relevant contract). Commodity finance documents may also contemplate: increased committed volumes under pledge via additional contracts with acceptable new buyers, cash cover to the DSRA, or a right to prepay (permanently) loan outstandings.

(b) *Margin loans*: LTV triggers and margin calls are already a live issue.

(c) *FI credits*: as an alternative to (or sometimes in addition to) balance sheet tests, EM Financial Institution borrowers are measured against compliance with prudential ratios and potentially also NPL or loan loss ratios; in the current climate, the latter in particular are likely to come under strain.

4. EoDs

(a) FX issues (even for borrowers with a natural hedge) are likely to increase pressure on debt service capacity and many EM borrowers will have a greater proportion of amortising debt in their capital structures. Loan documents do not customarily include *force majeure* provisions (and English courts will not imply them) and doctrines of frustration or impossibility[4] are unlikely to assist a borrower seeking relief from its payment obligations under a facility agreement on account of cash flow issues deriving from the coronavirus.

(b) Leaving aside breach of general undertakings, misrepresentation, cross-default, insolvency and similar (again, FX and its impact on balance sheet could cause additional disruption for more fragile EM borrowers, few of whom remove balance sheet insolvency as an EoD trigger), we consider below some of the EoD provisions commonly included in EM loan documents that are already (or in our view are likely to come) under scrutiny:

(i) ***Suspension of payments***: at a time when even big businesses in mature markets have announced they will not pay rents, EM borrowers looking to preserve liquidity for business continuity by not paying certain liabilities should consider the need for waivers of any applicable "suspension of payments on its debts" trigger.

(ii) ***Suspension or cessation of business***: with many businesses shuttering operations (often on government advice), we are analysing this trigger in many agreements.

(iii) ***Audit qualification***: even if the qualification does not relate to viability / going concern, audit reports may be modified (for example, because of scope limitation in light of practical obstacles in carrying out site visits in lockdown jurisdictions).[5]

(iv) ***Currency controls and moratoria on foreign currency debt***: currency / capital controls are a means for governments to reduce capital flight (many market participants considered these in a potential **Gr**exit (*i.e.* Greece) scenario); a nationallyimposed moratorium on payments of interest or principal is a more extreme measure but was declared by Russia on 17 August 1998; developing market loan documents generally include as standard EoDs that will trigger in either of these scenarios; that said, interested parties may wish to review in particular the definition of "External Indebtedness", which is not uniform and often (most commentators would say correctly) does not cover hard currency debt originally incurred with domestic market participants.

(v) ***Expropriation***: this has been raised by many as a potential concern but where government bail-outs (by way of equity injection) are the rescue solution for business and proper value is given, in our view change of control (as for the Kazakh banking sector recapitalisations in the previous cycle) is the provision that may in fact be relevant; the LMA Developing Markets clause refers to "limitation or curtailment of a company's conduct of its business" as a result of governmental intervention and well-negotiated clauses explicitly reference the concept of expropriation without fair compensation. There may be discussions around formulations that refer to

4 The context of our alert in this link is primarily long-term commercial contracts: https://www.whitecase.com/publications/alert/suspending-contractual-performance-response-coronavirus-outbreak.

5 https://frc.org.uk/about-the-frc/covid-19/company-guidance-update-march-2020-(covid-19)

"displacement of management" where a government bail-out is accompanied by action to remove management, but generally that will be where the company wasn't being run appropriately pre-crisis.

(vi) ***Licences***: we see a very real risk of technical defaults as a result of expiry of key licenses due to the inability to renew being hampered by operational dislocations in relevant governmental ministries. We view this risk as higher in emerging markets.

(vii) ***Political and economic risk***: for a minority of (mainly frontier markets) transactions an EoD for a (material) deterioration in political and economic country risk may apply.

(viii) ***MAC***: market participants agree that the threshold for calling a MAC is high; however, there is at least one well-known example, albeit in an extreme fact pattern, of a MAC in an EM loan agreement being upheld in the English courts (and at summary judgment). More recent English case law[6] (in the context of a representation as to "no material adverse change in financial condition" from original financial statements) summarised the English law position on MAC clauses as follows:

(A) the interpretation of a "material adverse change" clause depends on the terms of the clause construed according to well established [English law] principles;

(B) an assessment of the financial condition of the borrower should normally begin with its financial information at the relevant times, and a lender seeking to demonstrate a MAC should show an adverse change over the period in question by reference to that information;

(C) the enquiry is not necessarily limited to the financial information if there is other compelling evidence;

(D) the adverse change will be material if it significantly affects the borrower's ability to repay the loan in question;

(E) a lender cannot trigger such a clause on the basis of circumstances of which it was aware at the time of the agreement; and

(F) it is up to the lender to prove the breach.

5. Forward planning and voting

5.1 Borrowers' strategies may involve any of the following: refinancing: new money financing; amend and extend; permanent financial covenant reset; PIK "toggles" to enable company elections to capitalise, rather than cash pay, interest (although in some developing markets (and some mature ones), capitalisation of interest is not legally enforceable); temporary holidays (whether relating to payment; financial testing and/or financial reporting).

5.2 It goes without saying that for discussions with lenders for any of these, the quality of borrowers' financial reporting, impact assessment and cashflow and revenue projections for different scenarios (given the difficulty of forecasts in the current environment) will be important.

5.3 For some borrowers, there may be opportunity in debt buybacks below par value; however, we anticipate less application for this in emerging markets than in mature ones.

5.4 Borrowers (especially) and lenders would be advised to review their loan documents to check:

(a) the definition of "**continuing**": *i.e.* can an EoD be cured post occurrence (*i.e.* post-expiry of any stated remedy period) or does the document purport to require lenders to waive the breach even where the underlying problem is fixed? This may be critical to the assessment of, among others: any Margin ratchet, drawstops, indemnities, information reporting, access

6 *Grupo Hotelero Urvasco SA v Carey Value Added SL* (formerly Losan Hotels World Value Added I SL) and another; [2013] EWHC 1039 (Comm).

or inspection rights, negative covenant permissions, application of cross-defaults into the affected financing, entitlement to accelerate / enforce security, and transferability;

(b) controls and procedures relating to Lender transferability; and

(c) voting provisions (in particular the scope of all-Lender decisions):

5.5 Another potential impediment for many EM financings is the absence of snooze-you-lose or yank-the-bank provisions, both being particularly critical where any form of payment relief or extension is contemplated (in the case of "snooze", at least where the loan documentation excludes its application to all lender decisions (or a sub-set)).

5.6 A final consideration on voting is the potential impact of credit insurance and CDS protection on (especially) all lender decisions. The dynamics here will be especially sensitive to circumstantial dynamics: the impact and behaviour of an ECA as a *de facto* single controlling voter on a syndicated buyer credit may be very different to that of a seller of CDS protection to an individual lender. The second scenario can be a particularly important one for both borrowers and other lenders to understand or anticipate.

6. Additional considerations for commodity finance

6.1 Commodity finance: performance risk structures (PXF/commodity prepayment)

(a) As noted at 3.2(a) above, the intended resolution to a commodity price fall is escalation (volume top-up); it's therefore critical that both creditors and debtors monitor:

(i) the continued availability of unencumbered volumes (and for creditors, police: (A) negative pledge and disposal provisions that "defend" volumes for this purpose; (B) obligations on exporters as to allocation of volumes to "their" contract); and

(ii) the ability to introduce (and the eligibility of) new Buyers on multi-contract structures.

(b) **Force majeure and delays / disruption offtake flows**: see our separate alert on this topic[7] and our observations at 2.2(b); in addition, market participants should be alert to documents which provide that a borrower/exporter can't invoke *force majeure* regarding its delivery/performance obligations without lender consent; where a DSRA is a feature of the structure, this will assist in continued debt service through payment periods (but will need to be replenished).

(c) Given force majeure concerns, we expect creditors (rightly) to focus on:

(i) exporter performance by monitoring the physical flows under not just the underlying commercial contract but also (where feasible) the exporter's other offtake arrangements; and

(ii) the preservation and exercise of rights by the exporter as against the offtaker.

Limited recourse structures behind (typically) trader prepayments have their own particular dynamics in an exporter non-performance scenario.

(d) Creditors should remember that supply is unregulated on the majority of performance risk structures and monitor the possibility that current trade dislocation may impact supply for exporters who are not vertically integrated.

6.2 Commodity finance: Borrowing Base: commodity working capital

(a) Even on structures where local currency sales mean local currency cash counts towards Borrowing Base value, FX risk should be less of an issue, since relevant benchmarks will generally be dollar based. However, the fall in collateral value resulting from commodity price movement will trigger re-balancing.

7 https://www.whitecase.com/publications/alert/suspending-contractual-performance-response-coronavirus-outbreak

(b) Operational dislocation is likely to create difficulties for borrowing base reporting; well-advised borrowers will have negotiated their loan documentation to mitigate the impact of inadvertent inaccuracy. Borrowers should also check asset eligibility (addition of assets to the borrowing base to mitigate reduction in available capacity due to commodity price falls) and their rights to automatic release of assets that are no longer in the Borrowing Base (enabling monetisation in other structures).

(c) Notwithstanding the heavy operational / reporting burden (weekly reporting and rollover is the norm for the European loan market variant), which requires particular attention at a time when personnel are challenged, we anticipate that borrowing base structures will be of interest to creditors seeking to impose discipline on RCF lines in a credit downturn and potentially to borrowers seeking new liquidity at a time when credit risk premium is on the up and availability is constrained.

7. Practicalities

7.1 Readiness, timetabling and timing will all be important at a time of personnel and logistical dislocation for all stakeholders in EM financing structures and the uncertain outlook; companies should verify their ability to pass corporate approvals via remote meetings; all participants should be prepared for the use of electronic signatures (and their effectiveness (or additional requirements for effectiveness) in their jurisdictions).

7.2 On EM loan transactions, local law security serves primarily a defensive purpose. For transactions where enforcement (especially offshore) is not value destructive, the practicalities (court closures, asset receivers being unable to access physical sites) may be difficult. By contrast, offshore bank account security enabling self-help remedies will be valuable.

8. Any grounds for optimism?

8.1 There are many hurdles to be overcome. There is some good news for borrowers and vulnerable emerging markets more generally in that:

(a) governments and regulators have been clear in their guidance to creditor institutions regarding waivers and/or potential forebearance;[8] we expect reputational concerns will be a major factor in driving creditor bank behaviour;

(b) unprecedented expansionary fiscal steps have been put in place by central banks; and

(c) multilateral institutions that play a major role in global or regional emerging markets have pledged support.[9]

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8 In the UK alone, for example:
https://www.bankofengland.co.uk/-/media/boe/files/letter/2020/covid-19-and-bank-lending.pdf?la=en&hash=2C9C1BDD88BBD0746F4049B985279913BA6B2344

https://www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants

https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/joint-statement-on-covid-19.pdf?la=en&hash=28F9AC9E45681F3DC65B90B36B5C92075048955F

9 https://www.imf.org/en/News/Articles/2020/03/26/pr20108-remarks-by-imf-managing-director-during-an-extraordinary-g20-leaders-summit

https://www.afreximbank.com/afreximbank-announces-3-billion-facility-to-cushion-impact-of-covid-19/

https://www.afdb.org/en/news-and-events/press-releases/african-development-bank-launches-record-breaking-3-billion-fight-covid-19-social-bond-34982

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