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Bright ideas: DFIs up local currency lending

Development finance institutions (DFIs) are increasing their local currency finance as they look to alleviate borrowers FX risks and manage unsustainable hard currency reliance in emerging markets. But local currency financiers have lessons to learn as expensive bond issues can add to debt burdens, rather than solve them.

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Reporter 11 February 2019

PROJECT & EXPORT (/HOME/SECTOR/5488/PROJECT-EXPORT)

Hard currency funding still dominates financing flows from DFIs in emerging markets. For example, TXF Data captured a total volume of $16.8 billion in infrastructure financing from DFIs in Africa in 2018, with 75% of that figure denominated in dollar or euro funding. However, development banks are now increasing their focus on local currency financing to alleviate borrower's foreign exchange risks, particularly following the end of the commodity boom.

The EBRD has signed 722 loans denominated in 26 local currencies for a total value of €12.4 billion in the past 20 years, according to the development bank's latest figures. The IFC, the private sector arm of the World Bank, has committed nearly $13 billion in local currency financing across 60 currencies through loans, swaps, guarantees, and other risk sharing facilities

The significant – albeit slow – uptick in local currency bond issues and loans is promising for developing countries looking to reduce their unsustainable hard currency debt burdens. But for state-owned borrowers and power and water offtakers in developing economies, shouldering more local currency debt doesn't help solve the fact these countries have outstanding hard currency bond and loan repayments.

"More and more development banks have come to realise that loans in hard currency are simply the wrong product. An unexpected devaluation forces their borrowers, governments and private sector alike, into short term crisis management instead of the long-term planning that is so desperately needed. Their budgeting processes therefore become a function of exchange rate volatility," says Ruurd Brouwer, CEO at The Currency Exchange Fund (TCX), an FX hedging solutions company established by development banks in 2007.

Hard-currency dependency has meant borrowers in developing markets have had to become currency speculators. In response, MDBs are ramping up their local currency products and setting up currency hedging solution companies, as they look to de-risk financing packages and increase their development multiplier.

For example, in December 2018, Dutch development bank FMO arranged a five-year $32.5 million facility for ZOLA Electric to finance the companies Tanzanian operations. ZOLA electric borrowed the money in its local currency, Tanzanian shilling. Around the same time, the Ministry of Economy and Finance of the Republic of Ivory Coast closed a $279.9 million financing for a drinking water treatment plant in Abidjan. The financing included a 7-year XOF 65.17bn local tranche provided by Societe Generale and a 12-year XOF 65.17bn local tranche from the West African Development Bank.

DFIs have recognised the detrimental effects hard currency dependency has on developing economies, especially in debt markets currently awash with cheap Chinese style financings. The multi-sourced nature of large-scale project finance, with components from around the world, is increasingly requiring different pools of liquidity. And the answer from DFIs for now seems to be local currency finance. In fact, GuarantCo, which provides guarantees to support locally sourced local currency funding of infrastructure development, has a pipeline of new deals lined up across Africa in 2019.

However, while currency hedging solutions are beneficial in the short to medium term, domestic and development bank local currency funding over longer tenors is still rare. In the Democratic Republic of Congo local banks are unable to finance projects in Congolese Francs

with tenors above seven years. Therefore DFI support for local currency finance schemes are crucial to laying the seedbed for 10 to 15 year investments for large-scale projects in this region.

Last year, local currency loans to off-grid solar distribution companies included a seven-year $85 million Kenyan shilling facility from Kenyan and international banks to solar developer M-Kopa and a $20 million Rwandan franc loan by a Rwandan bank to energy utility Bboxx, $60 million 5-10 year Indian rupee and Philippine peso bonds were issued by a renewable energy developer and guaranteed by GuarantCo; a series of transactions supported by TCX hedges, including a 9-year $35 million Georgian lari loan to the Georgian water utility, a 9-year $50 million peso loan for a Argentinian public transportation project, an 8-year $20 million loan for a Nigerian university project and over $100 million of long-term local-currency loans to power utilities in Uruguay, Costa Rica and Jamaica.

Sovereigns bearing the brunt

Sponsors of large-scale project financings in developing markets will often hedge currency convertibility risk as a formality. But one market source says shortsighted financiers believe if they have a hard currency-indexed power purchase agreement (PPA) they are covered, "but this simply pushes the foreign exchange risk onto the offtaker," says Ruurd. And with offtaker agreements often involving state-owned utilities backed by sovereign guarantees, more often than not, the sovereign will bear the cost of local currency exchange risk. The ramifications can add to unsustainable debt servicing ratios and costs for developing countries.

At the end of 2018, the 420MW Nachtigal dam and hydro project in Cameroon (https://www.txfnews.com/News/Article/6620/Nachtigal-Development-finance-as-it-should-be) – a joint venture EDF, IFC, Republic of Cameroon, Africa50, and STOA – achieved a €916 million ($1.03 billion) heavily DFI-backed financing. Although the deal includes a seven-year Central African Franc denominated €171 million-equivalent tranche put up by commercial banks, the local currency funding is minimal compared to the portion of dollar funding on the scheme.

With a 35-year take-or-pay PPA with partially state-owned offtaker ENEO at a levelised tariff of €0.061 per kWh, lenders took comfort from the 17-year positive tail period on the 18-year tenor. However, while 80% of the tariff will be indexed in Euros, payments will be made in Central African Francs placing a foreign exchange risk on the sponsors, which was mitigated through currency swaps. ENEO also cannot achieve full cost recovery without a government subsidy to make up for the revenue shortfall.

Another large, long-term dollar-denominated financing involving local government sponsors is the 14-year $2.73 billion Corredor Logístico Integrado De Nacala (CLN) project financing (https://www.txfnews.com/News/Article/6320/Nacala-Logistic-Corridor-a-private-private-partnership) in 2017. The deal was sponsored by Vale owning 51% and state-owned operator Portos e Caminhos Ferro de Moçambique owning the rest. The dollar debt burdens for the state-owned sponsor are significant, especially given government debt in Mozambique stands at 82% of GDP.

Local currency bonds

There has also been a significant uptick in local currency bonds too, allowing countries to control debt servicing costs, become less exposed to the strengthening dollar while allowing institutional investors to participate in infrastructure development.

Programmes like IFC's local currency bond programme are essential for creating a pool of liquidity for 10 to 15-year investments and nurturing a long-term savings culture. TCX has supported the deepening of local capital markets with more than 50 new bond issues, with a combined value of almost $500 million, as well as partnering with the African local currency bond fund (ALCB). The ALCB Fund has already invested $81 million in 38 local bond issues.

Likewise, the ADB has established a $10 billion equivalent Asian Currency Note Programme which is dedicated to the issuance of ADB notes in local currencies in the Asean+3 bloc. And, more recently the ADB has raised 30.47 billion tenge ($80 million) from two new issues of local currency bonds in Kazakhstan.

But multilaterals are not alone in their local currency endeavours in emerging capital markets. ECAs have also begun to innovate their product suites by wrapping project bonds in domestic capital markets, however the cost of debt is not cheap. The $1.74 billion SERV-backed financing for the Centrais Eletricas de Sergipe (CELSE) liquefied natural gas-to-power project in Brazil (https://www.txfnews.com/News/Article/6421/Sergipe-Real-progress-on-local-currency-project-bonds) was the first involvement from ECAs in capital markets financings, as well as the country's local currency project bond market.

The BRL3.2 billion ($866 million) local currency issue wrapped by SERV, which was priced at 9.28%, was structured via special purpose vehicle Brazil Power Finance. The deal comprised a BRL745 million 15-year A loan from the International Finance Corporation, a BRL664 million local currency A loan from IDB Invest, a $38 million IDB Invest dollar A loan, and a $50 million dollar B loan from the IADB-managed

and People's Bank of China-funded China Co-financing Fund for the Private Sector of the Americas. The project benefits from local currency revenues and a 25-year PPA at a strike price of R$279/MWh.

A cookie cutter solution?

The local currency bond route is not a cookie cutter solution, especially for developing countries already heavily indebted. Local capital markets often spell high-yields for borrowers and it will take some time before the pricing on local project bonds tightens. And of course, local issuances still represent debt, and borrowers will look for the cheapest short term option.

"If you already have an unsustainable hard currency debt position then it seems a little unrealistic to think that issuing even more debt in local currency is going to ease your dependency on foreign currency because you still have to pay back those Eurobonds," an African-focused senior European development banker tells TXF.

In February 2018, the Kenyan government sold $2 billion in eurobonds. The $14 billion of heavily oversubscribed bonds attracted international players due to their high yields - a $1 billion 10-year bond with a yield of 7.25%, as well as a $1 billion 30-year bond with a yield of 8.25%. Although the bonds were aimed at financing infrastructure in the region, the country's infrastructure projects are failing to create sufficient revenue to meet debt servicing requirements.

Public debt in Kenya is projected to reach $58 billion this year and it is estimated over the next two years Kenyan taxpayers will finance close to Ksh100 billion ($1 billion) in interest payments on foreign loans and pay off maturing debt estimated at Ksh380 billion. While there is a push to raise funds using local Kenyan shillings in order to reduce dependency on foreign currency, the country will still be forced to back its eurobond obligations. Therefore, simply issuing more local currency debt is not going to solve developing countries debt burdens. However, it helps to de-risk financing packages and move borrowers away from currency speculation.

However, dollar funding over long tenors can be more expensive for borrowers than local currency finance, according to one development banker. Therefore, a long-term solution is within reach and development banks have a major role to play in helping emerging markets to nurture a savings culture through local currency finance.

Increased local currency lending and local bond issues should allow markets to deepen with increased involvement from both local and foreign investors. DFIs will bring confidence to local banks looking to

push out tenors and match international banks when they can, as the majority of domestic bank local currency deals are still over the short to medium-term.

Developments banks, already comfortable with currency hedging, have a long way to go before local currency finance can achieve the long tenors sponsors are looking for. As after all, DFIs are only just getting used to shouldering foreign exchange risk themselves.