INSIGHT

FROM PROJECT FINANCE TO SMES: WHY NBFIS WILL FUEL ASIA'S FUTURE

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WITH BANKS BUSY SEARCHING FOR INNOVATIVE WAYS TO 'SURVIVE THE SQUEEZE' BETWEEN NEW REGULATIONS ON ONE SIDE, AND TECHNOLOGICAL DISRUPTION ON THE OTHER, NON-BANK FINANCIAL INSTITUTIONS (NBFIS) ARE WELL-PLACED TO FILL THE FUNDING GAP. THAT'S ESPECIALLY TRUE IN ASIA, WHERE ATTRACTIVE GROWTH RATES PERSIST, BUT STRUCTURED LENDING IS UNDERDEVELOPED COMPARED TO THE WEST.

The hard fact remains: Asian finance is still bank-dominated, suffering from an overabundance of conservatism and an array of mismatches that act as headwinds to finance the region's investment opportunities.

These mismatches include:

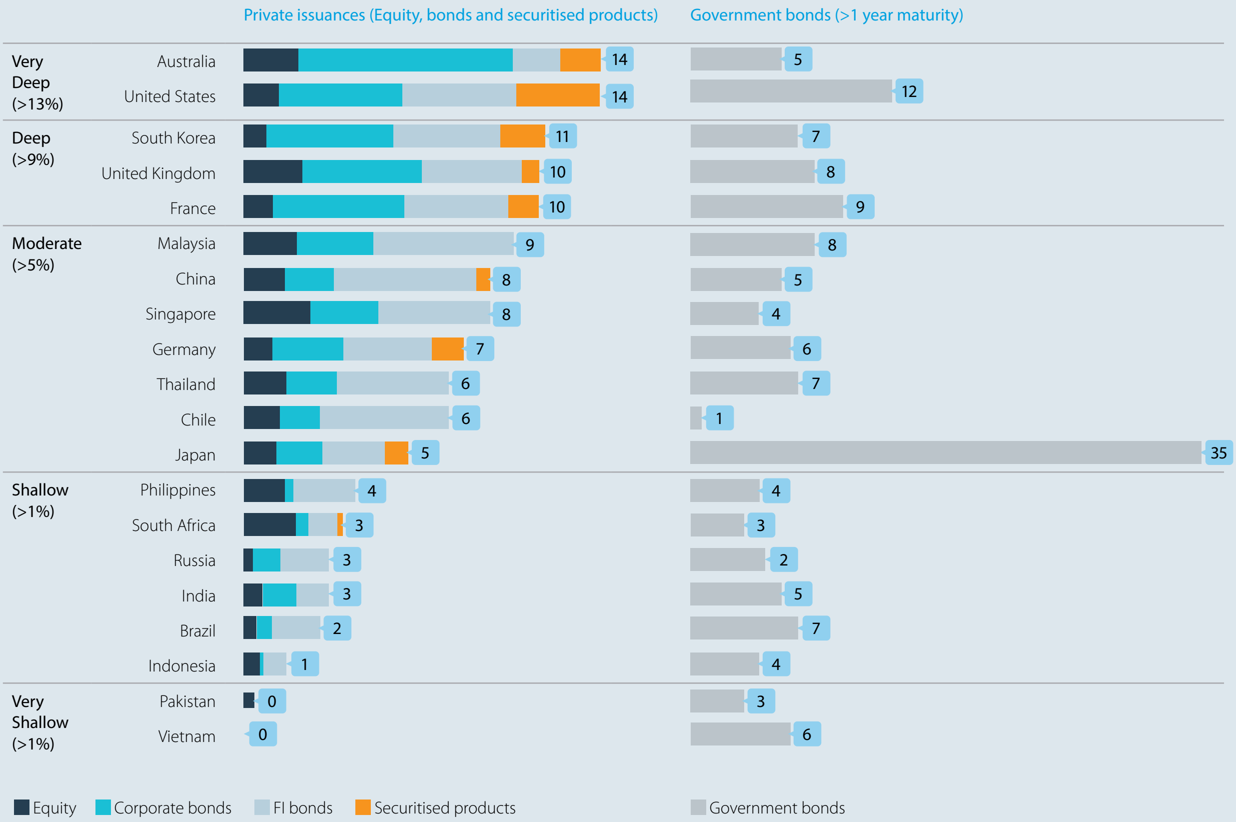
- Maturity mismatches: companies are overly dependent on short term bank loans whilst financing needs are longer term
- FX mismatches: insufficient FX reserves to meet needs from trade and capital account flows
- Debt/equity mismatches: loans dominate – there's too much debt relative to equity due to underdevelopment of equity markets and an over-reliance on bank loans
- Governance imbalances: a silo mentality persists across Asian countries and regulatory regimes, resulting in a fragmented regulatory landscape

These mismatches mean both regional and global NBFIs – from insurers to pension funds – are now positioned to play a pivotal role in Asia's emergence as a standalone strategic investment destination for the long-term, whether that's directly financing a new infrastructure project as part of China's ambitious One Belt, One Road (OBOR) initiative, or issuing loans to potentially industry-changing SMEs. However, it is observed that whilst NBFIs have been active in the Asian equity and bond markets, their participation in the loan space have so far been rather limited. (Figure 3) As such, whilst loan or structured financing opportunities may be available, NBFIs may not be familiar with the loan asset class, or their operating models may not be set up to deal with such structures.

The problem, however, is that many of Asia's financial institutions are content to ride the region's growth trajectory via passive investment strategies, targeting either governments or established players. To build a self-sustaining investment climate in Asia, NBFIs need to step up to the proverbial plate and finance the region's growth from a more pro-active and selective posture. NBFIs can work with banks to explore and structure the financing opportunities, whilst more actively participating in engagements with regulators and policy making entities to shape regulatory regimes to ensure NBFI interests are taken in to consideration.

Asia's shallow capital markets, largely bank-dominated

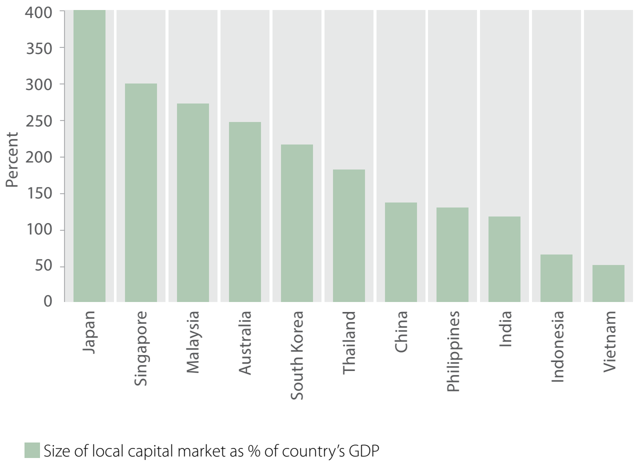
FIGURE 1:
Financial depth of primary market
3-year average issuances of equity, goverment bonds (>1 year maturity), corporate and FI bonds, and securitised products/GDP
Percent (round off to nearest integer), 2013-2015



Source: McKinsey, April. "Deepening Capital Markets in Emerging Economies."

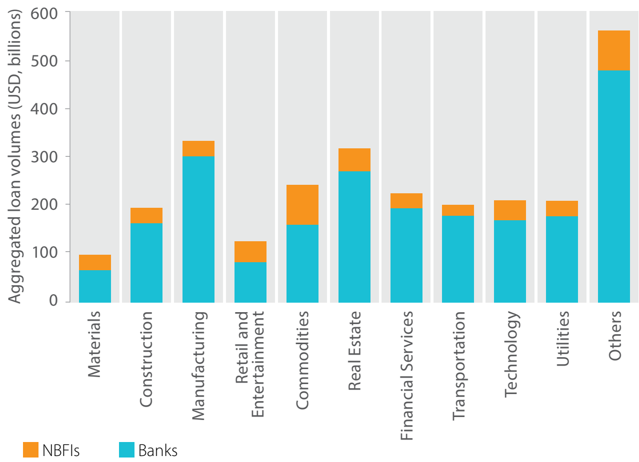
Asia puts large part of their savings in bank deposits and real estate, small pension funds

FIGURE 2:
Market depth by countries, 2016



Data source: McKinsey
Note: Includes outstanding equity, financial and corporate bonds, government bonds and securitised products.

FIGURE 3:
Asia loan issuance volumes by sector, period 18 Jul 2014 – 18 Jul 2017, participation of banks vs. NBFIs



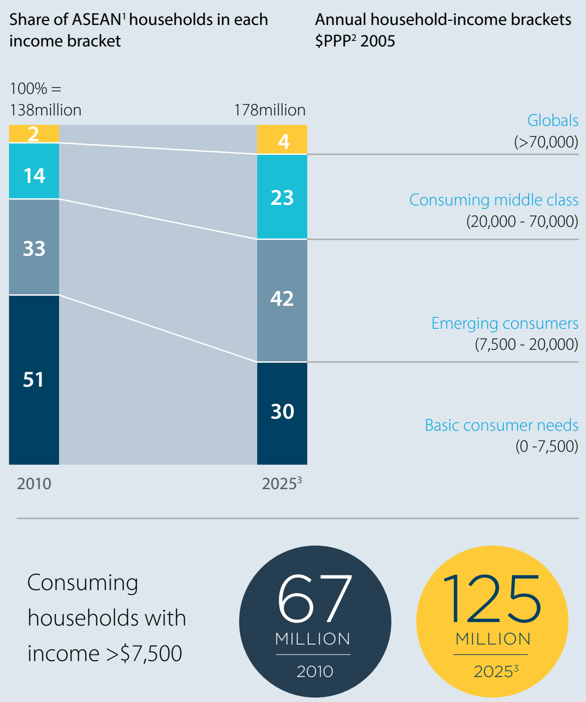
Source: Thomson Reuters LPC LoanConnector. 'Others' include aerospace and defence, agriculture, other services, government, healthcare, media, broadcasting, textiles and wholesale.

1. THE BIG PICTURE: ASIA IS HARD TO IGNORE

As always, there is a diversity of views regarding Asia's long-term growth prospects, and major questions linger. Will China's shadow banking segment trigger a 'hard landing' in the world's second largest economy? Will Asia's regulators eventually find a way to harmonise the region's fragmented regulatory landscape? Despite these questions, Asia's key macroeconomic indicators paint a compelling investment opportunity that is hard to ignore.

For starters, Asia ex-Japan saw GDP growth of between 5-6 percent in 2016-2017, compared to the below 2 percent range for many developed markets in the same period. In addition, disposable income and spending power is on the rise across the region: By 2025, 125 million ASEAN households are projected to attain middle-class status – with consumption rates projected to rise accordingly. (Figure 4)

FIGURE 4:
By 2025, 125 million ASEAN households attain middle-class



Data sources: Mckinsey Global Institute Cityscope database; McKinsey Global Institute analysis.

Source: Vinayak, Thompson & Tonby. 2014. "Understanding ASEAN: Seven Things You Need to Know" McKinsey & Company.

1 Association of Southeast Asian Nations, excludes Brunei.

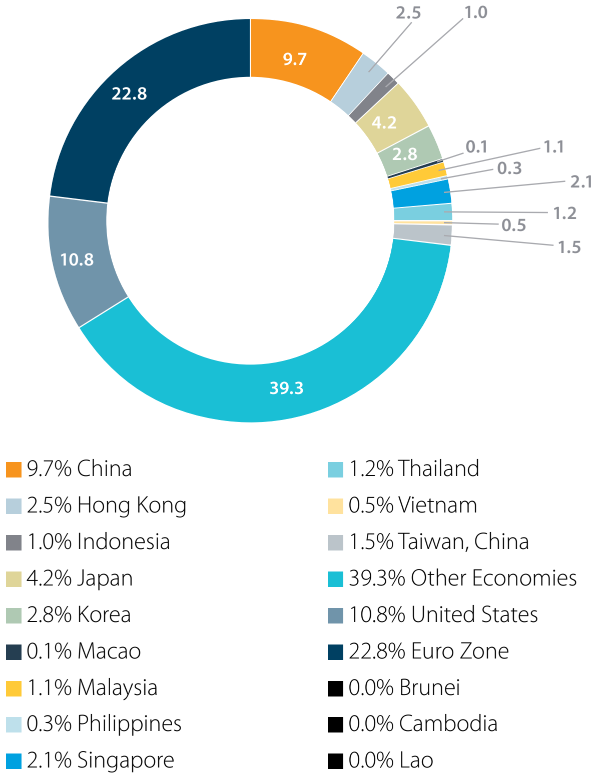
2 Purchasing power parity adjusts for price differences in identical goods across countries toreflect differences in purchasing power in each country.

3 Forecast; figures may not sum, because of rounding.

At the same time, Asia's share in world trade is significant and growing: China's share alone is 9.7 percent, while the whole of ASEAN is at 6.2 percent. Combined, that figure easily surpasses the US's share of global trade at 10.8 percent. (Figure 5)

What is more, yields in China and other Asian capital markets are now more nimbly responding to tightening liquidity across the region. That means that there are fewer distortions in the market, and risk is more accurately priced. (Figure 6)

FIGURE 5:
Share in World Trade: China (9.7%) and ASEAN (6.2%); combined surpasses U.S. (10.8%)



Source: Lau Meeting 2014 and 20th Anniversary Seminar. China Development Bank.

FIGURE 6:
China's interest rates and yields are responding to tightening liquidity

	7 day interbank repo	3M SHIBOR	1Y treasury yield	10Y treasury yield	1Y CDB bond yield	10Y CDB bond yield	Yu'eBao deposit rate	WMP product exepected return
Average May-2005	1.10	n.a.	2.18	3.95	4.14	4.93	n.a.	n.a.
Average Jan-2009	0.90	1.51	1.10	2.91	3.56	3.96	n.a.	n.a.
September 1, 2016	2.39	2.79	2.14	2.76	2.30	3.19	2.31	3.93
July 26, 2017	3.44	4.25	3.37	3.61	3.59	4.21	4.05	4.46*

*Dated May, 2017
Data sources: Wind Info, CICC ResearchSource: CICC. 2017. "Production Showed for B&R Summit, Gradual Monetary Tightening."

2. THE NITTY GRITTY: WHERE ARE THE REAL OPPORTUNITIES FOR NBFIS?

From project finance to SME loans, the opportunities for NBFIs to finance Asia's growth are abundant. Naturally, each type of NBFI has its own unique risk appetite profile. Insurers are looking for one set of returns driven by regulatory hurdles, while pension funds aim for long-term stable returns and hedge funds for returns showing outperformance to specific benchmarks.

To get started on their Asia investment strategy, NBFIs should first develop their own internal risk appetite profile in order to put themselves in a position to seize the available opportunities. Importantly, they need to evaluate and decide where in the capital structure they want to be represented.

As for attractive sectors, one place to start is the areas that banks are avoiding due to the tightening regulatory environment. (Figure 7) On that note, the most prominent underfinanced sectors include SMEs, specialised lending, and shipping, mining – each of which will continue to play a key role in Asia's growth trajectory.

Also, China's massive One Belt, One Road (OBOR) project – which by some estimates could attract cumulative investment of up to US$8 trillion – offers NBFIs a range of infrastructure-related investment opportunities across Central, West and South Asia – everything from bridges to rail links to pipelines. In addition to OBOR, a massive infrastructure investment gap is gripping Asia – estimated at US$8 trillion between 2010-2020 by some estimates – leaving the region in need of new road, electricity and sanitation projects. (Figure 8)

To seize these opportunities, NBFIs should work with major banks to evaluate a range of structured loan options (Figure 9) that address the NBFI's investment objectives and risk management needs, while also granting the NBFI a much more direct and tangible connection to Asia's growth potential.

FIGURE 7:
Basel "IV" standardised credit risk proposal – punitive risk weights ≥100% for certain assets

Exposure	Category	Comments	Risk Weight
SME classified under Corporate Category	External Ratings allowed	Below BB-	150%
		• BBB+ to BB- • Unrated	100%
	External Ratings Disallowed	Add-on Risk Weight for currency mismatch - 50%	85%
SME classified under Retail	Retail	Add-on Risk Weight for currency mismatch - 50%	75%
Specialised Lending (Issue specific rating is not available)	Object & Commodities finance		120%
	Project finance	Pre-operational phase	150%
		Operational phase	100%

Source: BCBS Second consultation on Standardised approach for credit risk

THE MOST PROMINENT UNDERFINANCED SECTORS INCLUDE SMES, SPECIALISED LENDING, AND SHIPPING, MINING – EACH OF WHICH WILL CONTINUE TO PLAY A KEY ROLE IN ASIA'S GROWTH TRAJECTORY

FIGURE 8:

Top 5 Belt & Road opportunities by value and sector OROR highlights and key projects announced so far

Key highlights

- The OBOR blueprint encompasses over 60 countries, which account for 60% of the world's population and a collective GDP equivalent to 33% of the world's wealth
- 6 economic corridors are proposed as the framework of the OBOR initiative outside China:

  1. Eurasian Land Bridge
  2. China - Mongolia - Russia Corridor
  3. China - Central Asia - West Asia Corridor
  4. China - Indochina Peninsula Corridor
  5. China - Pakistan Economic Corridor (CPEC)
  6. Bangladesh - China - India - Myanmar Corridor
- Economist magazine estimates there are 900 deals under way, worth USD 890bn under OBOR program
- China has committed to invest a cumulative USD 4trn in OBOR countries
- China has set up Silk Road Fund worth USD 40bn to exclusively fund OBOR projects
- AIIB set up with USD 100bn of initial capital will also fund OBOR projects although not exclusively

Major projects under OBOR

- China has signed a series of infrastructure agreements worth USD 25bn with Belarus, Russia and Kazakhstan on high-speed rail, energy infrastructure and aerospace, as well as industrial parks
- China is investing USD 5.8bn in Laos to contruct a railway line connecting Vientiane with China border
- China is investing USD 1.4bn in developing a financial district in Sri Lanka
- China has already invested USD 360m in developing a port in Sri Lanka and plans to further invest USD 800m in the port
- China plans to invest USD 62bn in Pakistan as part of the CPEC corridor
- As part of CPEC Shanghai Electric acquired majority stake in Pakistan's K-Electric for USD 1.8bn and plans to invest further USD 9bn in the company
- Under CPEC initiative China will invest USD 8bn to upgrade railway network in Pakistan
- China is investing USD 1.9bn in developing Gwadar port in Pakistan

Sources

1) OBOR report by China-Britain Business Council;
2) China-Britain Business Council's report - 'One Belt One Road';
3) The Economist - 'Our bulldozers, our rules' (2 Jul 2016);
4) Xinhua - 'China-Laos railway construction progressing well' (17 May 2017);
5) CNBC - 'China, India tussle for influence as Sri Lanka seeks investment' (24 Apr 2016);
6) The Sunday Times Sri Lanka - 'Major changes in Hambantota deal, signing likely this month' (16 Apr 2017);
7) Livemint - 'China's CPEC investment in Pakistan reaches $62 billion' - (12 Apr 2017);
8) The Express Tribune - 'Shanghai Electric unveils $9b investment plan for K-Electric' (7 Dec 2016);
9) The Economic Times - 'China to invest $8.5 billion to upgrade Pakistan's rail network, build gas pipeline' (9 Jun 2016);
10) NewsIn - 'Nawaz Sharif inaugurates Gwadar port built by China at a cost of US$ 46 billion' (13 Nov 2016)

FIGURE 9:

Types of structured loan financing

Acquistion Finance
- Senior Unsecured/ Secured Loans
- Bridging Facilities
- Limited Recourse Financing

Project Finance & Advisory
- Project Finance
- Limited Recourse Financing
- Reserves Based Financing
- Borrowing Based Facilities
- Structured Corporate Loans

Structured Export Finance
- ECA Buyer Credit Finance
- ECA Project / Asset Finance
- ECA United Finance
- ECA Supplier Finance
- ECA Prepayments / Pre- Exports

Structured Asset Finance
- Secured Corporate Loans
- Finance Leases
- Structured Operating Lease
- Limited Recourse Financing

Structured Trade Finance
- Warehouse Finance
- Borrowing Based Finance
- Transactional Secured Loan
- Prepayment
- Pre-Export

3. JOINING THE DISCUSSION ON REGULATION

Of course, NBFIs also face significant risks as they embark on a more aggressive Asia investment strategy. Specifically, NBFIs must evaluate the political risk of the investment country, as well as legal and regulatory regimes, to ensure sufficient protection before diving in.

For example, a multi-stage infrastructure project in a politically unstable country may encounter difficult – and in some cases insurmountable – challenges during the project's execution stage.

To better navigate these potential risks, NBFIs can proactively make it easier to invest in Asia by playing a part in the region's regulatory evolution.

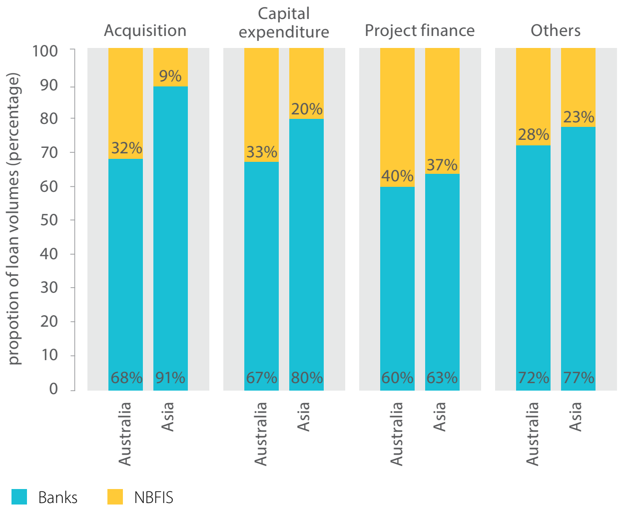
Currently, Asia's loan structures are 'vanilla' and optimised for banks. On that basis, NBFIs should get involved in discussions with the region's regulators to lobby for the framework they need to make an investment decision and help fund the region's long-term growth potential. Knowing up front how they want to be represented in the capital structure – and what protections and structures need to be in place – will help in this regard.

NBFIs can also point to Australia as a leading light in Asia in terms of structured loan solutions, and lobby the rest of the region's regulators to learn from the example set Down Under. (Figure 10)

Given the above factors and considerations, it is more important than ever for NBFIs to partner with banks – which are now more constrained by regulation – to originate desired credit exposures and execute strategic transactions. Only then will Asia realise its full potential as a self-sustaining investment destination.

FIGURE 10:

Participation of banks vs. NBFIs in loans issued in period 1 Jan 2016 – 31 Dec 2016, Australia vs. Asia loan markets



Source: Thomson Reuters LPC LoanConnector

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