Lending Risks in Emerging Markets
When Things Go Wrong – Practical Examples

Roselyne Renel
Stigler Centre, Chicago University Booth Business School
14th of October 2019
About Me

- Career risk officer with 25 years of experience in global financial services across Emerging and Developed Markets in all areas of corporate and institutional banking, focussing on derivatives and capital markets execution, structured products, commodities, corporate finance, private equity, as well as retail and private banking.

- Specialist in credit, market, liquidity and strategic risks across broad range of asset classes, products and client segments.

- 16 years at Deutsche Bank as the Chief Credit Officer for Global Emerging Markets, Global Banking and Global Trading & Sales Divisions, leading global teams with diverse cultures.

- 6 years at Standard Chartered Bank (UK) as Chief Credit Officer and Group Head of Enterprise Risk Management.

- Member of the Supervisory Board and Chair of the Risk Committee for Eurex Clearing, largest European and world’s largest listed products and OTC clearer.
Taking Risk is OK ...

- Banks are in the risk management business, therefore taking risk is what banks do.

- Risk **cannot be eliminated**, but it **can be mitigated**, and is often **initially underestimated**.

- Key is to ensure strong analysis of the obvious and of the non-obvious, be compensated for the risk taken and ensure diversification to mitigate concentrations.

- The case studies included in the following slides are extreme examples of what can go wrong. However they are all true.

- Problems will occur. That is for sure. Detection of the problem and how you react when problems are identified is critical.

- No one lends with the intention of suffering a loss ... but they do happen. Each situation needs to be looked at from bottom up and top down:
  - **Bottom Up**
    - Know your client
    - Importance of fundamental thorough credit analysis should not be underestimated. Be on top of your data!
    - Well structured. Strong documentation. Up to date valuations.
  - **Top Down**
    - Portfolio approach with “What If” scenario analysis – size exposures appropriately
    - Be aware of and many correlations
    - Ensure you are getting paid for the risk across the book – Balance Risk vs Reward
Case Studies

- Case studies covering different transaction structures, geographies and industries.
- These are real transactions and situations, most of which I have personally led and ultimately was responsible for underwriting and approving.
- Details of the transactions are provided and you will have an opportunity to ask questions at the onset.
- Split the audience in 2 teams. Your mission is to review the ask, suggest the structure to come up with what you think happened.
- Points will be awarded and the winners might even be lucky to get a prize!
- I will then run through what happened.

*Remember “hindsight is an exact science”*
Case Study #1

Oil & Gas Sector
Russia
## Case Study # 1

### Background

- Privatised oil producer with 16bn barrels of proven oil reserves, or life reserves of 25 years.
- Became Russia’s largest oil exporter within 5 years of privatisation.
- One of the largest global oil companies, voted most transparent EM Corporate and the darling of EM investors.
- Listed in Moscow and NY (ADRs).
- Highly experienced international bankers and technical specialists appointed in key executive roles to provide confidence in governance.
- Most operations, plants and refineries located in remote regions of Russia.
- Very visible CEO.
- Newly elected President.

### Transaction

- US$ 1bn 365 days pre-export finance facility (ie financing the export contract before the export has taken place).
- Bank to sole-underwrite the transaction.
- Bank also acted as lead manager of the transaction.

**Questions:**

- What are the key due diligence considerations?
- What are the key structuring features required to support such a transaction?
- Would you recommend, approve or decline the transaction?
What went wrong ...

- Yukos Oil Company privatised in 1996 in the controversial 2nd round of privatisation under President Yeltsin, alongside other large state industrial assets.
- Privatisation was through conflicted auction won by Bank Menatep, whose CEO was Mikhail Khodorkovsky (MK), who also became CEO of Yukos Oil Company.
- MK was one of 7 oligarchs who acquired privatised assets, and effectively “controlled” Yeltsin.
- 1999: Putin elected. Oligarchs allowed to keep assets, but warned to stay out of politics.
- 2000: MK became a vocal advocate of democracy, international co-operation and Russian reform.
- 2003: Yukos was Russia’s most successful company. MK Russia’s richest man and world’s 16th.
- July 2003: MK’s business partner arrested for tax evasion and received a 10 yr prison sentence.
- October 2003: MK arrested for tax evasion and received a 10 yr prison sentence.
- Q4’03/04: Yukos hit with US$27bn bill for unpaid taxes, broken up and “sold” to state-own oil company and eventually bankrupted in 2006.
- While loan remained current on interest payments, material adverse change meant loan became immediately repayable.
- New owners refused to repay unless haircuts were applied. Bank refused. Underlying oil contracts were diverted so cash flows no longer came through the bank first.
What did we learn ...

- Leave politics to politicians!!
- Money may well be a substitute for power, but it is not true power: The rise in oil prices increased Khodorkovsky’s (and other oligarchs) wealth and power to dangerous levels – too rich, too powerful, too fast.
- Change in governments always bring heightened, and very often not visible, risks: New President determined to assert power over the oligarchs.
- Country risk is real! The ability to change laws and make onerous demands does not have to be fair.
- Politicians will do what they want, when they want.
Case Study #2

Metals & Mining
Mongolia
# Case Study # 2

<table>
<thead>
<tr>
<th>Background</th>
<th>Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Physical copper trading company.</td>
<td>• 3 term loan towards pre-payment on a 5 year supply contract, for general corporate purposes.</td>
</tr>
<tr>
<td>• Long term supply contracts with state-owned copper producer in Mongolia.</td>
<td></td>
</tr>
<tr>
<td>• Producer is one of the largest and most established copper producers globally, with very low cost of production and less than 30% of its production committed against long-term pre-paid supply contracts.</td>
<td></td>
</tr>
<tr>
<td>• Relationship with the copper trading company via an introducing broker.</td>
<td></td>
</tr>
<tr>
<td>• Mongolia holds the world’s 12th largest copper deposit.</td>
<td></td>
</tr>
<tr>
<td>• Commodity exports account for 96% of the country’s exports, with copper representing nearly 40%.</td>
<td></td>
</tr>
</tbody>
</table>

Questions:

- What are the main due diligence areas?
- What are the key structuring features required to support such a transaction?
- Would you recommend, approve or decline the transaction?
• The Copper Trading company was politically connected and lost its political influence and support after the electoral defeat of the ruling party.

• This resulted in the trading company (i) being subject to an investigation by the new government for corruption; and (ii) developing financial difficulties.

• When the challenges faced by the trading company came to light, deliveries from the producer stopped.

• The bank commenced enforcement action over the export contract and the guarantee.

• Producer claimed its signatures on the documents had been fraudulently obtained.

• Transpired the trading company had been entrusted with getting the Producer to execute and sign all relevant supporting legal documents.
What did we learn ...

• Always stay close to and be in control of: your source of repayment, your borrower, your documentation.

• Lending one or more steps away from your source of repayment always requires closer assessment.

• No assessment of political risk of our borrower – given importance of underlying commodity to the country, this is a vital consideration.

• Use of intermediaries and introducing brokers requires greater oversight. Understanding their motivation and what additional credit and compliance risks arise as a consequence are key considerations.

• A lender should always retain control over the documentation execution process. Third party involvement should be restricted or supervised by legal advisers.
Case Study #3

Real Estate Construction
Russia
Case Study # 3

**Background**

- **Early 2000’s**: Mandate awarded for complete modernisation of Hotel Moskva, landmark building in the centre of Moscow.
- **Project received very strong support from the local authority. “Four Seasons” franchise.**
- **High profile project, strategically located in Red Square meant many lenders bidding for the mandate.**
- **Promoters included key decision makers in the City and the country providing comfort in feasibility of the project.**
- **2004**: Demolition began after tender for reconstruction was awarded to unknown firm headquartered in the US who agreed to finance US$ 350m of the project in return for a 51% equity stake.

**Transaction**

- **US$ 150m 2 year bilateral staged construction loan.**
- **Funds to be released as project milestones are achieved.**
- **Full security package to be made available in line with standard construction type loans.**
- **Borrower is a Special Purpose Vehicle set up specially for the project. Documentation signed by all promoters who are jointly liable for the debt.**

? What are the key structuring features required to support such a transaction?
? What are the key risks or considerations?
? As the credit officer, would you approve or decline the transaction?
What went wrong …

• 2005: Construction was halted due to stage completion certificates not being issued.
• Coupon payments stopped as construction stopped.
• 2006/07: Loan formally put in default and debt recovery efforts start.
• Promoters blame each other for the project delays.
• Further due diligence revealed convoluted shareholding structure with Politically Exposed People (PEP) shareholders.
• 2008: Bank recovered the debt, but only just!
• Post 2009: promoters fled the country, liquidation efforts by Russian authorities to bring them back to Russia.
• 2014: Four Seasons Moscow finally opens
What did we learn ...

• Appearance is not everything!
• Understanding of ultimate beneficiaries behind an SPV structure is a must.
• Doing business with PEPs is not always bad, but key is to understand background of the PEP.
• Don’t be fooled by the perceived “charm” of a project or deal.
• Do not rely solely on your collateral and remember that your collateral is your last way out, not the first!
Case Study #4

Coal Mining
Indonesia
Case Study # 4

<table>
<thead>
<tr>
<th>Background</th>
<th>Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>• London Stock Exchange (LSE) listed company with two major coal mining assets in Indonesia.</td>
<td>• US$ 1bn working capital facility to the LSE holding company. Final hold US$ 250m.</td>
</tr>
<tr>
<td>• Company is co-owned by heir of one of Europe’s pre-eminent banking dynasty, and Indonesia’s prominent family owned conglomerate with interests including media, mining, agriculture and insurance.</td>
<td>• Operating companies to provide partial guarantee.</td>
</tr>
<tr>
<td>• Fall out of shareholders results in Chairman (Indonesian) to step-in and acquire majority shareholding in listed holding company.</td>
<td>• Structured recourse to underlying coal production.</td>
</tr>
<tr>
<td>• Indonesia 5th largest coal production and 9th largest coal reserves globally.</td>
<td></td>
</tr>
</tbody>
</table>
What went wrong ...

- 2012: Fall out of shareholders turned into an acrimonious dispute which dragged on for over 3 years in the London courts.
- Court saga provided a background of complete shambles of corporate governance, including details of “missing” US$1bn cash.
- 2013: Shareholder public fall-out = failed syndication - bank stuck with 90% of the transaction.
- 2014: Coal prices fall – +40% between origination and shareholder fall out.
- Coal price drop = revenue impact = loan default.
- Loan default = provisions = higher capital requirements.
- 2015: Further softening of commodity prices and inability to generate any meaningful cashflow to make the company a viable enterprise able to attract potential investors.
- 2016: Company files for bankruptcy.
What did we learn …

• Initial poor understanding of the client and poor lending structure escalated into a very bad situation. When the market environment got tough, the client got even more acrimonious.

• The due diligence was very poor – understanding the promoter better would have given a different take on the proposal.

• Looking at through the cycle cash-flow is important. Not only the peak. Applying “what-if” scenarios would have given a view of potential downside scenarios.

• Again and again … Get closer to controlling the cash. Cash is Queen!

• Jurisdiction risk – repayment of debt in an option. Need to have a relevant partner take the risk alongside the bank.

• Avoid over-sized lending positions, and if you must, then be disciplined and quick with distribution and sell-down of risk.

• There is no glory in being the hero!