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TRADE MARK EAST AFRICA
Growing Prosperity Through Trade

Opportunities to enhance trade finance in the construction sector across East Africa and the Horn of Africa

Focus note
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UKaid
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In a region that is rapidly urbanising, the construction sector is an important – and sometimes overlooked – potential driver of job creation and accelerated economic growth. However, suppliers and buyers of construction materials face substantial financing needs. As a result, the provision of effective and appropriate trade finance facilities for construction firms can serve as a key enabler for sector development and formalisation, helping to unlock the industry's full growth potential.

In this focus note, we summarize the current challenges before identifying two intervention opportunity areas – supporting risk mitigation facilities and developing innovative project finance solutions – th t we identify as high potential.

Key challenges

To date, four significant challenges have constrained the provision of trade finance in the construction sector across East Afri and the Horn of Africa:

Limited awareness of available trade financing option

Examples of options which suffer from low awareness among sector participants include factoring and forfaiting for increasing access to inputs; standby Letters of Credit (LCs) for providing comprehensive insurance and reducing the risks attached to lending to the sector; and shipment financing, which p ovides longer loan tenors.

Stringent trade finance term

Construction sector SMEs contend with high interest rates with few interest-only options, high principal repayments with limited balloon payment structures, as well as short amortization periods/tenors.

Limited availability of trade finance instrument tailored to the needs of construction SMEs

There is a lack of patient capital featuring larger ticket sizes, longer tenors and grace periods, and balloon payment structures.

Delayed payments from key sector clients

This issue arises in particular with government clients, a major client segment for construction firms. Thi undermines the use of receivable-based supply chain finance solution (such as factoring, forfeiting, or invoice discounting).

In addition, cutting across these specific issue areas, OVID-19 has exacerbated the challenges faced by SME construction firms, resulting in additional financing constraints and heightened risk aversion among banks.

Opportunity areas

Despite the presence of the above challenges – which together have undermined the growth of a healthy trade finance ecosystem in the construction sector – several exciting opportunities exist to address key bottlenecks:

Opportunity 1

Opportunity to increase project finance by promoting the developmen of secondary markets

A key opportunity to transform trade finance in the construction industry lies in the provision of greater support for project finance. Project finance is important for trade in the construction sector as it is mostly long-term and thus cashflows tend to match the long cash conversion cycles typical of many construction projects. It is also non-recourse, meaning that financin is secured by the cashflows generated by the project and is not dependent on the value of physical assets: this increases access for small SMEs that may lack the traditional assets required by Financial Services Providers (FSPs) as collateral. Project finance also incorporates guarantees that ensure timely payment of outstanding obligations, as well as risk sharing elements, which help boost lenders' confidence in providing this type of financing to the construction sector.

However, the availability of project finance is limited by the underdevelopment of the secondary markets in the region, given the inability of FSPs to de-risk their balance sheets through these markets. The construction sector is thus forced to operate with limited financing options (for example, mezzanine capital), high principal and interest rates, and short repayment terms, all of which are not favorable to SME competitiveness.

Construction firms also face exclusionary requirements in the use of capital market vehicles such as REITs (regulated real estate investment trusts that enable investors to pool their funds and collectively invest in real estate). For instance, REITs in Kenya demand a high minimum investable ticket size of KES 5 million (approximately USD 50,000).

Further, the lack of project financing impedes the growth of initiatives such as affordable housing, which are gaining interest across the region but are currently limited by existing policies and regulations. More generally, late payment by government (in terms of VAT refunds, and as a procurer of construction projects) further constrains trading activities across the region.

Against this historically challenging backdrop, viable opportunities do nevertheless exist to promote project financing ac oss the region, including:

Promoting collaboration across key stakeholders such as Capital Markets Authorities (CMAs) and FSPs to build awareness around products such as derivatives (including hedges and swaps), and to develop frameworks and regulations to aid the development of secondary markets, which would catalyze usage of project finance across the region. Such initiatives could be tackled in a phased approach, starting with countries like Kenya which have relatively well-developed capital markets, and these learnings later could later be replicated across the region.

Development partners such as multilateral development banks could also provide partial risk guarantee facilities to cover government payment obligations and boost investor confidence in the construction sector.

For TradeMark East Africa (TMEA) and Financial Sector Deepening (FSD) Africa, specifi intervention opportunities include:

FSD Africa could help build awareness around more sophisticated capital market instruments such as REITs and derivatives, as well as partnering with CMAs and other relevant groups to scale technical assistance to banks in designing and deploying these instruments.

TMEA could engage key affordable housing sta eholders, such as the Kenya Mortgage Refinance Company and National Housing Development Fund in Kenya, in order to reevaluate existing trade finance constraints faced by developers in this space (including exclusionary policies). Sector input when reviewing these policies is needed to ensure that they are as inclusive as possible.

Opportunity 2

Opportunity for use of risk mitigation facilities to increase available financing within the secto

A second key opportunity area lies in supporting risk mitigation facilities. Such facilities are required in the construction sector to unlock positive cascade effects whereby business risks are reduced, thus attracting greater capital which, in turn, increases cash flows and ultimately sustains project bankability.

The following opportunities to support risk mitigation in the construction sector exist:

Minimum revenue guarantees (MRGs), which are suitable for commercially viable projects that are unable to secure adequate financing due to uncertainty f future revenues (for example, toll roads). To help secure financing, multil teral development banks can provide MRGs to local construction firms, which guarantees them sufficie revenue to cover their debt payments at a minimum. Development partners can further support in the creation of a guarantee fund which helps back MRG commitments. Technical support is required for fund set-up, in addition to financial support th ough capital injections into the fund. An example of such a fund is the Indonesian Infrastructure Guarantee Fund, which increases the creditworthiness of a project by backing guarantees by contracting authorities.

Export credit guarantees, provided by export credit agencies (ECAs), cover political and commercial risks linked to the export of construction materials. Availability of these guarantees is often contingent on the nationality of the exporter, hence there is an opportunity to expand access to these guarantees through increasing support for Africa-focused ECAs such as the African Trade Insurance Agency.

Multilateral development banks can also play a role in risk mitigation by providing equity or debt investments with more favorable financing terms to reduce financing costs for construction firms, thus freeing up capital for other commitments. Key considerations in providing financing at more attractive rates than the market include ensuring that it is socially and economically justified and does not crowd out private investment. As such, this would be more appropriate for affordable housing projects. Financing projects with a blend of debt and equity without excessive leverage can effectively mitigate market and technical risks by reducing refinancing risk. It can also enhance project profitability by offsetting business risks.

In addition, the provision of credit support by multilateral and bilateral Development Finance Institutions (DFIs) through subordinated and mezzanine debt can mitigate broad political and market risks.

For TMEA and FSD Africa, specific intervention opportunities include

FSD Africa can provide technical support to government authorities to determine suitable projects for issuance of minimum revenue guarantees, and to set up a guarantee fund. There is also an opportunity to provide financial support through capital injections into a fund.

FSD Africa can also work with multilateral development banks and local banks to structure blended debt and equity financing with more favorable financing term for construction firms th t are developing affordable housing projects. FSD Africa is well-placed to work alongside multilateral DFIs to increase lending to state-owned banks that are supporting SMEs, as they are sometimes excluded from trade finance support programmes.

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