International Insight: Pre-Export Financings and How To Mitigate Structurally Certain Related Risks

In these difficult financial markets, many financial institutions are battening down the hatches and substantially reducing their lending activities. This can be even more tempting in those markets where political and legal risks add to the difficulties faced by lenders.

However, lenders in such jurisdictions, particularly in emerging market jurisdictions, are well used to structuring transactions to mitigate the risks that difficult economic, political and legal environments generate. Such structures typically rely on the cash flows generated by the trading operations of the relevant obligors, and capturing these cash flows can often result in the creation of a lending opportunity where none would otherwise exist.

When lending against cash flows, lenders will typically consider two main categories of risk:

- **Production and delivery risk:** Cash flow is generated by the production and sale of goods, but what happens if the goods are either never made or, once made, not sold and delivered? Production and delivery risk is often key to any lender's decision to lend; and

- **Payment risk:** The risk that, once the relevant goods are delivered, payment is either not made, not liable to be made or is reduced. There may also be a risk that payment is made but is unable to be applied in repayment of the loan.

In addition (albeit with varying degrees of diligence depending on the jurisdictions involved in the transaction), lenders will also evaluate:

- **Political risk:** The risk of matters such as expropriation, sanctions, moratoria, discriminatory change of law and, ultimately, war; and

- **Legal risk:** Local laws can impact any transaction in many ways, whether through the impact of local insolvency law, security perfection requirements, enforcement procedures or the risk of attachment of payments.

Of the many techniques that emerging market lenders have developed to mitigate these risks, one of the most enduring, and most popular, is the pre-export finance ("PXF") structure. Such structures are increasingly being used outside the sphere of traditional "trade finance" with many borrowers seeing such structures as a way to raise additional finance in difficult markets in order to support acquisitions or other event-driven activities.

A typical pre-export finance structure

At its most basic, pre-export finance is simply secured lending to a producer of goods. The loan will be secured by:

- A security assignment of the relevant delivery contracts (which will ideally be long-term committed contracts) between the producer and the purchaser (or "final offtaker") and the receivables generated under that delivery contract following the delivery and sale of the relevant goods; and

- A charge over the collection account (in the producer's name) into which the proceeds of sale are paid by the final offtaker.

This basic PXF structure can be complicated in any number of ways.

If commodity price (or interest rate) protection is required, hedging arrangements can be entered into (and assigned for the benefit of the lenders).

In addition, many PXF structures will involve an SPV-borrower set up for the sole purpose of the financing in order to avoid, for example, existing contractual restrictions that may apply to the relevant producer or to "move" the transaction offshore. Such an SPV will apply the proceeds of the loan made to it in prepayment for goods to be delivered to the SPV (by the relevant producer) under a primary delivery contract. The SPV will then on-sell those goods to final customers pursuant to secondary or final delivery contracts. Such structures are often known as SPV prepayment financings.

In this structure, the security required for the transaction is created by the SPV-borrower, and so could avoid any contractual restrictions on, for example, creation of security by the actual producer and any legal issues that may arise (in relation to the enforcement of security, for example) in the producer's own jurisdiction.

Prepayment structures can also be entered into on a limited recourse basis to enable, for example, a commodity house to enter into a loan to fund a prepayment of goods to be delivered by a producer. In such a scenario, the commodity house may be unwilling to put its balance sheet at risk and, therefore, will want any borrowings by it to fund the relevant prepayment to be limited recourse to the security provided for the loan (although there will be certain exceptions if, for example, the commodity house has failed to perform its obligations under the relevant purchase contract entered into with the producer).

More commonly, sophisticated producers, particularly those producing commodities, will have their own captive trading entities. In such a scenario the PXF structure has to accommodate several contractual levels. For example, the producer (which will normally be the borrower) may sell goods to another group member (often known as the "trader," who will, most likely, be incorporated in a tax-friendly jurisdiction). The trader will, in turn, on-sell those goods to other group members incorporated in relevant target markets ("local traders" or "local offtakers"). These entities will finally sell to the ultimate purchasers (final offtakers).

Such "triple-decker" structures, whilst more complex from a contractual perspective, retain the same essential factors and risks as the more basic PXF structure. As a result, for the purposes of this article, we will focus on the more basic structure, referring to more complex structures where required.

Mitigation of risks:

1. Production and delivery risk

In PXF structures, production and delivery levels are central to the trading performance of borrowing companies and, given that the essence of a PXF structure is that lenders are lending against the cash flow generated by that trade, it is clear that if the production and delivery levels fall, the lenders are much less likely to get their money back. As a result, production and delivery risk is fundamental to pre-export financings.

Examples of factors which contribute to production and delivery risk include:

- The reliability of the supply of raw materials, and the workforce required, for the production process;
- The technical capability of the production facilities (and their reliability) and their operators;
- Competing demands on production (i.e., over-commitment of goods to delivery contracts); and
- The reliability of offtake arrangements (influenced, for example, by their duration and the level of commitment of the final offtaker) and the final offtaker itself.

How can production and delivery risk be mitigated?

From a structuring perspective, there is relatively little that can be done to mitigate production and delivery risk.

It may be possible for contractual prioritization to be incorporated into relevant delivery contracts so that any goods which are produced by the producer are contractually bound to be delivered under those contracts (as opposed to other competing contracts). This should help mitigate the risk that production levels drop and goods are delivered to another offtaker under a competing (and unsecured) contract.

However, comfort in the face of these risks is mainly provided by the lender's due diligence (in relation to items such as the borrower's production record, its reserve profile and reserve replacement record (if applicable) and its historical customer default rates). The involvement of trusted international players, whether as a supplier of necessary materials, operator of production facilities, final offtaker or minority shareholder, and the political or economic imperative (particularly in the context of commodities such as oil) for continued production can all increase the level of comfort that production and delivery will occur as required to repay any financing.

2. Payment risk

Payment risk is, of course, fundamental to all financings, and can appear in a PXF structure in a number of ways, including:

- Credit risk: In addition to the usual borrower credit risk (which is itself mitigated by the PXF structure as repayment can also be achieved through receivables collected in the secured collection account), lenders will also want to consider the risk that the final offtaker does not, cannot, or indeed is not liable to pay for the goods delivered to it;

- Attachment risk: Assuming that the final offtaker is liable to pay, there is a risk that any proceeds generated by the sale of goods can be diverted by competing creditors of the producer; and

- Commodity price/interest rate fluctuations: Will any value generated under dedicated delivery contracts be sufficient to meet the debt service requirements of the underlying financing?

Additionally, foreign exchange regulations (for example, in Russia or Angola) may require that hard currency earnings be repatriated by the producer rather than retained offshore.

How can payment risk be mitigated?

As always, there is no substitute for a thorough credit analysis of the final offtakers. If their credit standing is not thought to be sufficient, appropriate credit enhancement, through the use of letters of credit or bank guarantees, is a common feature of PXF structures. The use of documentary letters of credit also ensures that any disputes in relation to compliance (or otherwise) with the underlying delivery contract supporting the financing (or indeed any other contractual arrangements between the parties) are divorced from the financing arrangements.

We have already mentioned that taking security over receivables and bank accounts is a key feature of PXF structures. Such security should, subject to local insolvency laws, be sufficient to overcome attachment risk.

Hedging is, of course, an obvious way to mitigate against fluctuating commodity prices and interest rates. However, hedging can be expensive and there will be a balance to be struck between the benefits of flooring a commodity price or capping an interest rate payment and the cost of doing so.

Attention should also be paid to the nature of the payment flows under the relevant derivative instrument; ongoing two-way payment flows can lead to a risk of termination by a hedge counterparty for non-payment. If ongoing two-way payments are unavoidable, hedging counterparties may also seek to share in security, which can substantially reduce the value of any security to the lenders.

A feasible alternative is the use (subject to offtaker agreement) of value-based, rather than volume-based, delivery contracts. Such contracts should ensure that sufficient quantities of goods are delivered to repay any underlying financing (provided, of course, the value specified in the delivery contract is sufficiently high to cover any increased interest payments arising from increased interest rates).

3. Political risk

The importance of political, or country, risk will, of course, depend on the jurisdictions involved in the transaction. Again, there is no fail-safe structural solution, although, as already mentioned, lenders will often take comfort from the political or economic imperative of continued production of the relevant goods.

Having said that, governments can, and often do, enter into contractual undertakings in relation to matters of concern to lenders (such as non-interference in production) if the relevant assets are of strategic or political importance. The involvement of multilateral financial institutions or export credit agencies also often provides comfort to lenders (due to their perceived increased political influence).

Political risk insurance (either from an export credit agency or a private insurer) may also be employed to mitigate political risk, although concerns about cost and the perceived difficulty of making successful claims (given general insurance principles such as the duty of utmost good faith) ensure that such insurance remains a relatively rare feature of PXF structures.

Most important, however, in the mitigation of political risk is the use of the PXF structure itself. As we have already seen, payment risk can be moved from the borrower (and its jurisdiction of operations) to the final offtaker, who will usually, if goods are being exported, be located offshore and who will, subject to applicable foreign exchange regulations, be able to pay offshore. As a result, the simple use of a secured offshore collection account is often sufficient to provide the necessary comfort. In particularly problematic jurisdictions, the use of an offshore SPV prepayment financing can also help mitigate against country risk.

4. Legal risk

The level of perceived legal risk will also vary from jurisdiction to jurisdiction. However, the main legal concerns are common to all jurisdictions and include:

- The risk of conflict with existing contractual arrangements (e.g., any negative pledge) of the producer (or indeed its parent companies). This can be of particular concern when lending to state-owned entities, which may be subject to the World Bank negative pledge;
- Applicable insolvency rules, in particular in relation to the avoidance of security and hardening periods and the number and identity of preferential creditors (and any limits on preferential claims);
- The ability for parties or insolvency officers to avoid or disclaim contracts and/or security;
- Delays in the enforcement of security and/or the processes through which security must be enforced (whether by public auctions, private sale or self-help);
- The risk of attachment of assets or receivables;
- The risk of a change of law (or its interpretation) — even in mature legal jurisdictions, the impact of ever-evolving case law, not to mention legislative change, can impact a transaction; and
- Environmental risk: often more perceived than real, “deep-pocket” syndrome can be an issue, particularly for financings supported by exports of goods such as crude oil.

How can legal risk be mitigated?

Again, one of the key weapons against legal risk is due diligence. Before a risk can be dealt with, it must be identified and there can be no substitute for thorough knowledge of local laws and their potential practical application. Often the act of taking effective security will be sufficient to mitigate against these risks, although, in some circumstances, it may be necessary to adopt an offshore SPV structure in order to ensure that the risk profile of the deal falls within acceptable boundaries.

Due diligence is also key in understanding any existing contractual restrictions that may impact on the relevant transaction. Once these are identified, they can either be structured around or, if necessary, consents can be sought and obtained.

Finally, the choice of law, and of lawyers, is fundamentally important to the mitigation of legal risk, particularly in emerging market jurisdictions.

Summary

Lenders involved in PXF transactions clearly face a number of varied and unpredictable risks, some of which can be mitigated better than others, but none of which can be completely avoided. What is certain, though, is that limiting risk exposure, to the extent possible, to that of production and delivery risk is key, and that well-structured deals are far more likely to survive market fluctuations. Provided that the underlying receivables can be generated, a true PXF structure should be self-liquidating (if other appropriate structural features are included) and that could turn out to be a key selling point in today's markets.

About Curtis

Curtis, Mallet-Prevost, Colt & Mosle LLP is a leading international law firm. Headquartered in New York, Curtis has 17 offices in the United States, Latin America, Europe, the Middle East and Asia. Curtis represents a wide range of clients, including multinational corporations and financial institutions, governments and state-owned companies, money managers, sovereign wealth funds, family-owned businesses, individuals and entrepreneurs.

For more information about Curtis, please visit www.curtis.com.

Please feel free to contact the person listed below if you have any questions on this important development:

Jean Norbert Pontier
Partner
jpontier@curtis.com
France: +33 1 42 68 72 38