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COVID-19: Impact and Remedies
Emerging Markets will suffer the most

We are certainly living in unprecedented times and more interestingly, the “We” means the entire globe. Nobody is immune! The COVID-19 pandemic has shaken all of societes’, governments and economies and clearly nobody can predict where or how this crisis will be resolved. Health has proven to be the priority of all, rightly so, as it impacts human capital and labor markets. Facing a total and unprecedented freeze, the restrictions on movements have clearly impeded the functioning of almost all markets. The supply and demand function has been put under stringent testing and it has been failing. What does it mean for companies who employ people who were told by their governments to stay home? What does it mean for governments who, on one hand, are restricting the movement of people out of cautious containment measures, and on the other hand want to protect their economies and jobs? Economic fear is the new contagion and now seems to be spreading as fast as the virus itself.

In this paper, we will analyze some of the early impacts caused by this pandemic and the economic responses announced by some governments.

Huge impact, early “global” response and darker outlook

Ray Dalio of Bridgewater estimates the corporate losses to be in the vicinity of USD 12 trillion globally. If you assign a 60%[1] share of those losses to emerging markets (EMs), one can imagine the scale of the hole the crisis will leave companies in.

Poor and middle income countries will face tremendous challenges. The crisis has caused demand for the commodities on which many EMs depend upon to collapse. From crude oil to metals, from agricultural products to tourism, demand has simply vanished overnight. According to the Institute of International Finance, investors have pulled USD 83 billion from emerging

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[1] Equivalent to the share of EMs in the global GDP as of 2019 (OECD)

markets since the start of the crisis[2]. The MSCI Emerging Markets Index which ended 2019 up 18.4% has fallen by 30% so far due to the COVID-19 sell-off.

The flight to safety and announced quantitative easing (QE) programs remind us of the 2008-09 crisis aftermath and should increase liquidity in developed world's financial and money markets, making credit more available for borrowers. However, in EMs that much needed liquidity will fund the worsening budget deficits and will leave potential borrowers thirsty for much needed financing.

Several governments in EMs imposed confinements on their population, certainly the right thing to do in order to flatten the curve of contagion. However, it has choked economic activity in the process and the supply chain of goods and services has been grounded to a halt. Short of salaries, a large segment of these businesses in EMs will run out of cash to buy essential goods. The question is how long this can be sustained for? How can governments ensure the provision of the liquidity needed by private sector companies before it causes permanent structural damages? The lessons we learned from the 2008-09 crisis taught us that when credit intermediation is disrupted and capital stock doesn't grow, recovery is slow, workers exit the workforce, skills are lost and as a result productivity goes down. The issue becomes structural.

Commercial banks are notorious for their risk aversion. Prior to the COVID-19 crisis, more than 50% of small and medium size enterprises (SMEs) in EMs did not have access to appropriate financing in their markets. I wonder what that number is today. Whilst SMEs in Africa, as an example, are estimated to contribute to more than 60% of GDP, the finance gap is estimated at USD431 billion for the 50+ million micro, small and medium-sized enterprises across the continent, according to IFC's report on Micro, Small and Medium Enterprises published in 2017. That gap must be close to USD1 trillion today!

The economic and financial responses to COVID-19 have been loud and quick but without a doubt nationalistic. Each government, nation and country reacted to protect its borders and its local economy. Contrary to the values they hold, many countries such as those in the EU, are turning inward and are prohibiting the export of certain critical medical goods and in some cases food. This however is an exaggerated hysterical reaction!

To cite a few examples of government assistance in the developed world, the US has announced a USD 2.2 trillion rescue package (11% of GDP), France put in place more than USD 375 billion (14% of GDP) package in the form of guarantees of the credits to SMEs, tax breaks and employee benefits and the UK has put forward more than USD 430 billion (16% of GDP) of a rescue package in the form of guarantees and direct cash payment to citizens. The IMF Managing Director Kristalina Georgieva said "emerging market countries will need at least USD 2.5 trillion in financial resources to get through the crisis, and their own internal reserves and market borrowing capacity will fall short of meeting this need. It is now clear that we have entered a recession as bad or worse than in 2009". The worst is yet to come for many emerging market countries, which she said have not yet been hit hard directly by the virus, but are

[2] As of March 10, 2020. That figure must be higher today

suffering from capital outflows, reduced demand for their exports and a steep global drop in commodity prices. Asked whether the global economy needs more than the USD 5 trillion in new rescue spending pledged by G20 countries last Thursday, Georgieva said: “Our advice is go big. This is a very big crisis and it’s not going to be sorted out without a very massive deployment of resources".

In contrast, African countries’ responses have been “small”. To cite a few examples, Nigeria announced USD 136 million worth program (0.03% of GDP) and a reduction of interest rates on specific lending programs, Kenya announced a few measures that are aimed to increase the liquidity in the banking sector including a reduction of 100 basis points (bps) of the overnight lending rate, a reduction of the reserve requirements and others. Tunisia announced a set of measures for a total of USD 850 million (2% of GDP) with an aim to support SMEs with short term liquidity and a reduction of fiscal obligations as well as a 100 bps reduction in the key money market rate. Clearly, the response is dismal compared to that of the developed world.

What these EMs companies need is not a policymaker’s symbolic reduction of the overnight rates or a delay in tax payments, these companies need meaningful capital that supports them to get back on their feet once the crisis is over. These companies need urgent liquidity otherwise the risk of insolvency becomes imminent! Take a country like Tunisia with a GDP of around USD 42 billion (2019 estimate) and a private sector contribution of about 65%, one month of an economic shutdown will result in more than USD 2.2 billion of lost revenues for the entire private sector. If you assume just a 50% working capital need from that lost revenue, the liquidity needs would amount to more than USD 1 billion for one month. If you extrapolate those numbers to the African continent, the immediate liquidity needed would be around USD 341 billion per month. Who will be providing that liquidity to these private sector companies? These figures are for illustrative purposes only.

Solution - Private capital (credit, mezzanine, equity)

Unlike the slow recovery from the 2008-2009 global financial crisis, the IMF Managing Director said there could be a “sizable rebound” in 2021, “but only if we succeed with containing the virus everywhere and prevent liquidity problems from becoming a solvency issue”.

Post COVID-19 crisis and as Africa’s economies recover and start to grow fast, the need for sophisticated and bespoke financing options is likely to increase. The penetration of private capital, in general, is low compared to that of more developed markets and many emerging markets. According to a study by the World Bank, corporates in Africa have the lowest amount of bank debt when compared to corporates in other regions. Conservative African banks historically prioritized financing large corporates and GSEs[3], while private African companies and especially SMEs and Midcap companies face even more obstacles in accessing finance. The African lending interest rates offered by banks are higher than in many developed markets (14% and 8% in local currency, respectively, in Nigeria and Kenya against very low single digit or zero in the developed economies). However, issues such as timing, bureaucracy, and the

[3] Government Sponsored Entities

small size of many of these enterprises can complicate their ability to receive direct funding from multilaterals and international lenders.

Pre COVID-19, there was already a substantial funding gap in Africa's financing market. This crisis will only exacerbate the problem. I have always argued that part of the solution to the funding gap in EMs and in Africa specifically, was a vibrant alternative private capital market. Private equity, mezzanine, private debt and direct lending are just a few examples of what our markets need more than ever. That argument can only be made stronger after this global COVID-19 crisis. Anecdotally, a colleague has shared with me a new concept she called EBITDAC - earnings before interest, tax, depreciation, amortization and coronavirus. This concept really drives home the point. Whether you are in manufacturing, tourism, commodity trading, transportation or education, your earnings have substantially been slashed by the COVID-19 crisis.

Today, policymakers need to focus more than ever on creating the suitable macroeconomic environment for the recovery to take place and should not be administering liquidity for private sector companies. That role should be left to financial intermediaries and asset managers. Governments should pump liquidity and create rescue funds (credit, mezzanine, equity) to support SMEs but should not manage those funds!

Given the lack of financing alternatives for SMEs and Midcap companies, including asset-light companies with solid business fundamentals, good potential for cash flow generation and promising growth prospects, investors like DFIs[4], pensions funds and SWFs[5] should be well positioned to benefit from the current situation and obtain attractive risk-adjusted returns both in the short and medium-term. In contrast to traditional asset-backed lending practices that prevailed in Africa, the opportunity lies in companies with strong fundamentals and growth characteristics, rather than relying solely on the availability and size of fixed assets to serve as collateral. This crisis has created even more opportunities to invest in good and well managed companies that simply suffer from temporary liquidity issues caused by this crisis. Pre crisis, SMEs and MidCap companies have had limited access to credit. According to the IFC (2017) only 20% have debt on their balance sheet. It is time to increase that percentage through private capital solutions (mezzanine, private debt, direct lending, etc) and give businesses the resources they need to stay solvent and save jobs.

To conclude, I believe that EMs have a chance to respond loud and find the resources needed to support SMEs. Those resources should be given to professional fund managers who understand the long term prospects of those businesses that have suffered from the extreme impact of COVID-19. Historically, for instance private credit and private equity, have been a very small asset class in Africa compared to other emerging markets, raising only USD 2 billion of capital during 2019 compared to more than USD 93 billion for EMs. The time has come to change that.

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[4] Development Finance Institutions

[5] Sovereign Wealth Funds

Walid Cherif is the Founder and Managing Director of BluePeak Private Capital (www.bluepeakpc.com). He has more than 24 years of experience in international finance in emerging markets. Walid has raised and invested more than US$ 800 million of capital for private credit and equity funds and has structured and executed numerous transactions on the investment and divestment sides.

Walid spent ten years at the International Finance Corporation before heading the GSC Group - NBK Capital Mezzanine Fund. In 2011, he joined Gulf Capital where he founded and headed the private credit business focused on private credit investments across Africa, the Middle East and Turkey.

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