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EMERGING MARKETS UPDATE

It isn't the financial crisis of 1997 by any means, but the economies in Asia are struggling—again.

The Japanese yen, Indian rupee, and the Indonesian rupiah have depreciated 30 percent on average in the last 24 months. Growth rates for India and Indonesia that were around 9 percent and 7 percent respectively two years ago have dropped off significantly, with India now at half that rate. Two of the once mighty BRIC economies (Brazil, Russia, India, and China) are now included as part of a group of countries (namely Brazil, India, Indonesia, South Africa, and Turkey) that have been dubbed by Morgan Stanley as the "Fragile Five."

This *Commentary* considers the implications of slowing growth, currency depreciation, debt exposure, and capital egress for emerging markets, in particular India, together with the connected legal issues.

TAPER TANTRUMS

In late May this year, the U.S. Federal Reserve (the "Fed") foreshadowed plans to taper its US$85 billion per month asset purchases, possibly from as early as October. While there have been fluctuations, the general market reaction was increased long-term interest rates in the U.S. and an egress of capital from developing countries, such as Brazil, India, and Indonesia. However, on September 18, Fed Chairman Ben Bernanke surprised commentators and markets by announcing that tapering of the Fed stimulus would not start yet because the economy was seen as too fragile to withdraw its support.

The Brazilian real, the Indian rupee, and the Indonesian rupiah have all fallen significantly against the U.S. dollar in recent months, and yields on bonds in emerging countries have jumped significantly. However, emerging markets did receive a boost from the news that tapering by the Fed will not commence in the near future. Nevertheless, the Fed's tighter monetary controls and a rising U.S. dollar predicated Latin America's crisis in the early 1980s and Asia's crisis in the 1990s, and there are suggestions that similar difficulties may still develop again. The machinations over Fed tapering have revealed some fundamental concerns regarding the status

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of certain emerging market economies, and these will not necessarily be resolved by the recent fillip provided by its postponement (especially as the delay was due to concerns regarding economic fragility).

The Asian currency crisis of the 1990s truly began when Thailand's central bank floated the baht after a run on the currency in July 1997. The decision triggered a financial and economic collapse that spread to other countries in the region, causing growth to plummet and companies to go bankrupt with the only solution being IMF-led bailouts.

The crisis of the late 1990s was exacerbated by a number of factors, including fixed or semi-fixed exchange rates, high domestic interest rates, heavy offshore borrowing, and large deficits. The present circumstances are different, not least because of the way in which Asian countries reacted after the previous crisis. Most Asian economies now have sizeable current account surpluses (including China, South Korea, Taiwan, Thailand, Malaysia, and the Philippines, although both Thailand's and Malaysia's balances have deteriorated recently) and foreign exchange reserves, and the proportion of non-performing loans on banks' balance sheets has generally declined. However, that is not to say all countries are in the same comparatively healthier position or that companies operating or investing in emerging markets are similarly protected.

Looking at India specifically, the country has a substantial deficit, the rupee has dropped by around 30 percent recently, and stock markets have flucuated dramatically. In particular, the shares of banks with balance sheets suspected to hold a significant proportion of bad debts or with deposit funding shortfalls have fallen sharply. Taking another example, Indonesia is experiencing slowing growth, high inflation, and a substantial deficit.

The deficits of India and Indonesia highlight the fact that in many emerging markets, as in Europe, the availability of "hot" money appears to have covered a multitude of sins. Upcoming elections in both countries also mean that the ability to address these problems may be limited as policy makers try to avoid losing electoral capital by implementing policies to address economic indiscipline and structural reforms.

DEBT DEPENDENCY

There are serious concerns that emerging market economies have been too dependent on debt. Such concerns are also mirrored at the company level, particularly in countries where companies, buoyed by strong domestic performance, have embarked on foreign investments or capital raisings.

The problems of company indebtedness are seen acutely in India. A significant number of India's industrial conglomerates are heavily in debt and suffering the ramifications of ambitious capital projects (often stalled in regulatory and bureaucratic mires). The fact that such debt is very often in U.S. dollars makes the plight of such businesses worse given India's depreciating currency. Indeed, recent research from Credit Suisse shows that 10 of India's most heavily indebted industrial conglomerates (including Reliance, Vedanta, and Essar) had combined debts in excess of US$100 billion at the end of the last financial year.

It is in this context that, in August, the Reserve Bank of India restricted overseas investment by companies to 100 percent of their net worth (down from 400 percent). This move made foreign investors fearful that their own funds could be trapped (as occurred in Malaysia when capital controls were imposed following the crisis of the late 1990s) and caused further capital egress from India. Furthermore, such restrictions have been mirrored for individuals as the level of permitted external remittances made by Indian residents was recently reduced to US$75,000 from US$200,000.

In an environment of reducing growth and returns, firms may struggle to meet their obligations, especially those in foreign currencies. The possibility of increased insolvencies for businesses will be a major concern for India's state-owned banks that already hold a large amount of bad debt. A warning sign for such banks is the rising level of credit default swaps on State Bank of India that reflect a sense of growing risk.

LEGAL CONSIDERATIONS

The difficult economic circumstances give rise to a number of legal considerations. Currency fluctuations may expose companies to the risk that they may be unable to

meet payment obligations. By way of example, this exposure could arise in the context of power supply contracts whereby a contractor or supplier has agreed to provide power at a fixed cost but is subject to flexible and, therefore, increasing input costs owing to currency changes. Other similar exposures may also arise in respect of joint ventures or acquisitions relating to emerging market investments, and in all such scenarios there will be a number of legal issues to address.

For example, firms may need to seek advice in relation to potential insolvencies (either on their own part or on the part of joint venture partners or other counterparties). Furthermore, where a firm's counterparty has reneged on its obligations, firms will need to seek advice on their enforcement rights and dispute resolution options (which may include direct negotiations, mediation, arbitration, or litigation). Alternatively, businesses will require assistance in navigating the legal requirements for terminating agreements and mitigating the related risks.

Issues Relating to Foreign Investment in Emerging Markets. A prime historical example is provided by the disputes relating to foreign investments in Indonesia to generate electric power that were made prior to the Asian currency crisis of the late 1990s. In 1994, Caithness Energy (U.S.) and Tomen (Japan) agreed to develop specific Indonesian geothermal sites, if they proved feasible, to produce electricity. Caithness, Tomen, Florida Power (another U.S. firm joining in 1996), and a local Indonesian partner (Sumarah Daya Sakti) incorporated Karaha Bodas Company ("KBC") to undertake the project. KBC was to deliver and sell the electricity produced to PT PLN (Persero) ("PLN"), the state-owned electricity company, on a take or pay basis at, initially, 8.46 cents (US$) per kwh.

After Indonesia was hit by the currency crisis and as demand projections fell, it became apparent that PLN did not need and could not pay the contracted price for all the power it had committed to take. Furthermore, the fact that the energy sales contract set prices in U.S. dollars meant that the rupiah payments would be around five times the amount contemplated when the contract was agreed. As a result, KBC served notice of arbitration in 1998 seeking the termination of the relevant contracts and damages for actual investments and expected future profits. Eventually, KBC was awarded approximately US$260 million. The present currency worries give rise to concerns that more recent projects may suffer in a similar way.

Considering such issues from another angle, it is not only those entities that owe obligations in stronger foreign currencies that should be concerned by recent developments but also those that are otherwise exposed to the same risk. For instance, foreign investors will be wary of investments exposing them to aborted projects and the possibility of extended dispute resolution and enforcement processes to realize hoped-for returns.

Indeed, terminating agreements for these types of breaches can be a particularly tricky area with many technical legal requirements to be satisfied. Companies that wish to terminate an agreement for a perceived breach by their counterparty should therefore seek initial advice on the subject. It is very likely that there will be formal stipulations relating to default and termination notices and cure periods, which, if not followed, may invalidate, or at least complicate, proper termination. Furthermore, companies should be aware that, if they have previously waived breaches but subsequently wish to terminate on the basis of further similar breaches, their counterparty may seek to argue that termination should be estopped.

Potential Problems Arising from Overseas Investment by Domestic Companies. Indian companies have grown increasingly frustrated by the failures of policymakers to carry out economic and infrastructure reforms over the past decade. For example, businesses in the energy and manufacturing sectors have often made foreign investments to offset unreliable power and water supplies at home (for instance, investments in Malaysia, where power and water are more abundant). Other companies have diversified to offset slowing domestic demand in other industries.

Furthermore, new land acquisition legislation in India may also cause Indian companies to consider making further investments overseas rather than at home. The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Bill 2013, which seeks to replace the Land Acquisition Act 1894, was passed by the

Indian parliament at the beginning of September. The new legislation is designed to ensure that people losing land will be adequately compensated and to streamline the existing rather chaotic process, but it is also expected to significantly affect the development of large infrastructure and other industrial projects to the extent that they fall within its scope.

The amount of compensation for land acquisition is now expected to increase by around three to five times, potentially making industrial projects unviable and raising costs in the overall Indian economy. In addition, the mandatory consent requirements (80 percent of landowners must agree to the acquisition for private projects and 70 percent of landowners for public-private-partnership projects) may also delay the process for land acquisitions and, in turn, the projects. Such legislative changes may not only result in reduced domestic investment but may also limit the future viability of infrastructure projects as the increased input costs, potential consent, and resettlement delays as well as continuing difficulties in monetizing such projects raise the inherent risks beyond acceptable levels.

Such overseas investment has a substantial economic cost for India. Overseas direct investment, including bank guarantees issued to overseas units, was approximately US$20 billion in the first seven months of 2013 (up around 40 percent from the same period in 2012). Foreign investment by Indian firms not only equates to the loss of domestic investment and a heightened dependency on foreign investors in India but also exposes Indian firms making such investments to related currency risks.

Indian companies will often implement foreign investments through the acquisition of established market players in foreign territories and may also choose to create joint ventures with overseas partners. In a cross-border acquisition context, one of the key terms of any transaction will be the purchase price. Commonly, forms of consideration include cash, shares, debt instruments, and/or an element related to future performance known as an earn-out. To the extent that the consideration is variable or payment is staggered, this might give rise to exposure to currency-related risks. Early advice should be sought in respect of such issues, especially in the current climate.

To the extent that a joint venture structure is used, an option agreement may be put in place in respect of shares in the joint venture entity. These provide parties with the right but also possibly the obligation to purchase the shares of another shareholder or vice versa, for example, in the case of disputes. Where the option price is set in a foreign currency (against which the rupee may have depreciated, such as the U.S. dollar), the obligation to purchase shares at a price that is effectively inflated by currency fluctuations may be very burdensome.

Difficulties Relating to Debt. Companies established in countries that have suffered recent currency depreciation (including India) could be hurt by their significant exposure under foreign currency bonds. Indeed, as the domestic currency depreciates, the effective burden for such exposed companies increases.

It is possible to protect against such fluctuations using hedging mechanisms, but not all emerging market companies have been careful to put such measures in place. Morgan Stanley has estimated that approximately half of India's US$225 billion corporate bond exposure is unhedged. Even those companies with the protection of overseas revenues (such as energy and commodity conglomerates) and/or with hedging insurance may suffer from the effects of currency depreciation. Indeed, at the very least, the cost of such insurance is likely to rise considerably. Firms should closely consider their hedging strategies, to the extent these are appropriate, with their professional advisors.

In light of such concerns, there are signs that international investors are growing wary of private sector debt exposure and are moving to protect themselves from potentially vulnerable markets. In the same way as companies and investors, banks are also exposed to currency risk. In India, the state-owned banks have high levels of bad debts, with infrastructure and project loans being particularly perilous, and they are exposed to the failure of their borrowers. In turn, foreign shareholders in such banks suffer exposure to related risks. If necessary, recapitalization of the banks would likely make them more attractive to foreign investors and facilitate more lending to boost any recovery. However, the funding for such recapitalizations would likely need to come, at least in part, from the government, which is already struggling with its own deficit.

That being said, if India has to seek an alternative, such as funding from the IMF, then this could be even worse both for India and other emerging markets given the potential domino effect that could take over in today's interconnected global economy.

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