

Africa's capital markets get fit for the modern age

Kat Van Hoof | 1/08/2019 12:02 am

Africa has the world's richest concentration of commodities and natural resources, yet remains its poorest continent. This contradiction has intrigued the capital markets community for decades. Is Africa doomed to remain the land of promise, or can it make good on the potential for capital markets to bloom? Kat Van Hoof reports.



In September 2008, Paul Ford had been raising capital from Middle Eastern investors for an Africa-focused fund at private equity firm Ambata Capital. The funds would be used to invest in promising infrastructure projects and provide long-term financing in the region, a rare occurrence at the time. "It was a bold plan, but there was strong appetite for it, particularly from Abu Dhabi and Qatar," says Mr Ford. All that remained was to wait for the end of Ramadan to close the fund.

It was not to be. On his way to the meeting in question, having gathered \$2bn in commitments, Mr Ford learned of the collapse of Lehman Brothers. "It didn't take long for investors to start pulling their support, and the whole fund collapsed," recalls Mr Ford, who left Ambata soon after and is now CEO at risk and control data company Acin.

Many investment banking veterans working with sub-Saharan Africa are familiar with this 'one step forward, two steps back' scenario. At the top of an economic cycle, investors with an appetite for risk look

to frontier markets for yield, and momentum builds in the region. But Africa is always disproportionately punished in the event of any downturn because investors are quick to pull funds.

"A side-effect of the reliance on international funds is that Africa is very susceptible to macroeconomic issues and vulnerable to currency fluctuations," says George Asante, head of Absa's markets business in Africa (excluding South Africa). The region will continue to be dependent on international investors, he adds, which is why it is vital to build internal capacity for diversification of funding.

Fundamental building blocks

For decades, capital markets in sub-Saharan Africa have been under construction. There have been some notable, isolated successes, with certain countries pulling ahead of the pack. But time and time again, progress is hampered by deteriorating macroeconomic conditions or country-specific setbacks, such as internal political turmoil, hyperinflation or currency devaluations.

Sub-Saharan Africa is made up of hugely disparate economies, with the most developed – South Africa – at one end of the scale and the most impoverished – such as Chad and Niger – at the other. Most of the potential for capital markets development is in the layer just below South Africa, ranging from Nigeria, Kenya and Côte d'Ivoire to Ghana, Uganda, Mozambique and Zambia. While most of these have functioning equity markets, a huge amount of work remains to be done on the fixed income side.

Philip Buyskes has spent his career trying to make capital markets transactions in Africa run more smoothly. "I quickly realised that many of the fundamental building blocks for capital markets are missing in sub-Saharan Africa," he says.

In 2015, Mr Buyskes set up Frontclear, which aims to facilitate access to financial markets and stimulate interbank lending on the ground in frontier markets. "Our philosophy is to come up with practical strategies to build a functioning money market and address the lack of instruments to mitigate counterparty credit risk," he says. The company facilitates interbank market liquidity by providing structural support and by derisking transactions for the parties involved.

At the top of Mr Buyskes' wish list is a strong secondary market, which involves stimulating issuance of local currency debt, opening up a market for corporate credit and updating tax regimes, and legal and regulatory frameworks to allow for greater participation from local investors.

Tech advantage

Despite the long list of obstacles, there is reason for hope. The general lack of development of capital markets in sub-Saharan Africa (not counting South Africa) means there is no burden of legacy technology to update. This allows the region to leapfrog straight into state-of-the-art systems.

"On the back of the fast economic growth and need for infrastructure investment in most of the continent, there has been a desire to attract foreign investors," says Maryam Khosrowshahi, head of central and eastern Europe, the Middle East and Africa sovereigns, supranationals and agencies (SSA) debt capital markets origination at Deutsche Bank. There is renewed interest in and domestic political will towards the development of healthy, liquid capital markets as a way to improve Africa's infrastructure and boost the real economy. It is important to note that they all have unique political history and economic dynamics and are at different stages of development, according to Ms Khosrowshahi.

Arguably the most important shift has been one of mentality among local governments, issuers and regulators. Rather than trying to force a holistic solution on the entire continent, there has been a push to resolve issues specific to individual markets. The feeling is that energy is better spent focusing on some of

the strongest and most advanced capital markets in the region, which will pave the way for less mature markets to follow suit.

"When doing business in Angola, for example, the first question I get is: 'Is this an African solution for an African problem?'" says Mr Asante.

Sovereign supreme

Most of the growth in Africa's capital markets over the past decade has been in primary issuance, mainly on the SSA side, but the development of corporate and private credit has been sluggish. Most of the rapid capital markets development has been in this corner of the market because it is most accessible to the global flood of cash looking for yield, according to Megan McDonald, head of international investment banking at Standard Bank.

Sub-Saharan Africa is relatively new to the bond markets: the first government debt issued on the mainland was a \$750m offering by Ghana in 2007. It did not take long for other African countries to catch on, leading to a bonanza of hard currency notes issued in a major currency, usually the US dollar or euro. The financial crisis brought the boom to an abrupt end and issuance fell off a cliff in 2008.

The market only reopened in 2011 with a government bond from Nigeria, which was enthusiastically received. Since then, the market has grown much larger with a number of new issuing countries, such as Namibia, Rwanda, Ethiopia, Cameroon, Angola and recently Benin joining the fray.

With a total of \$15.8bn raised, according to data from analyst Refinitiv, 2018 was a record year for SSA bond issuers from sub-Saharan Africa. Though volumes have dropped by around 60% in the first half of 2019 due to jittery markets, the decision by the US Federal Reserve to stop cranking up interest rates could result in local governments tapping the market again towards the end of 2019.

Most of the paper has been lapped up by international investors, attracted by the juicy coupons without the need for a currency hedge. "Investors continue to enjoy ample liquidity and with these bonds they can lock in good returns," says Ms Khosrowshahi. In her experience, domestic participation in hard currency government bond offerings is low and the lion's share ends up with UK- or US-based emerging market funds.

She is keen to stress that these investors are not indiscriminate. "Debt sustainability has become more important than ever," she says. Many sub-Saharan African countries are under the supervision of the International Monetary Fund, which closely monitors and supports these economies. Investors have become increasingly sophisticated, going through the numbers with a fine-toothed comb and asking detailed questions about the use of proceeds from the bond offering in question as well as previous issuances.

Local versus hard

With so much international capital sloshing around to absorb hard currency sovereign bonds, there was little appetite on the part of African governments to develop local capital markets, according to Ms McDonald. But the prices of the commodities and natural resources many African economies depend on crashed in 2014 and have failed to recover, exacerbating currency devaluations.

"Debt-to-gross domestic product ratios shot up as hard currency debt became increasingly expensive. Now, there is greater willingness to grow a vibrant local market, but this takes time," says Ms McDonald.

Historically, it has been easier for African countries to issue longer dated debt in hard currency than to get longer tenor on local currency paper, which requires participation from local investors to fill the order

book. "This year Ghana issued a 30-year hard currency bond to great success, which is a first for such a long-dated instrument in the region," says Ms McDonald.

Ghana provides an interesting case study to show that it is indeed possible to extend the maturity of the yield curve for both hard and local currency debt, she continues. It recently made a concerted effort with investment banks to replace expensive dollar-denominated sovereign debt with longer-tenor local currency debt.

"There was a fear that there would not be enough demand for longer dated local currency bonds, but we did find strong appetite," says Ms McDonald. The pension fund and insurance industries are natural buyers for this type of debt, offsetting their own long-term liabilities. "It can be done, but domestic market conditions need to be right and it takes a lot of work," adds Ms McDonald.

On the whole, however, the maturity profile of government debt in Africa remains very low. "Most of the government debt issuance is for short-term budget support with a horizon of one to two years," says Absa's Mr Asante. There is a need to provide steady funding for infrastructure projects that usually have horizons of 10 years or more.

Some countries have issued project-specific government instruments to help stimulate the private sector. Kenya recently sold a 25-year local currency infrastructure bond to great acclaim, and Ghana attempted a similar move with an energy bond, aimed at supporting energy-related debt overhang, but was less successful. "There have been a couple of instances of excellence, but it is not enough to sustain growth," says Mr Asante.

Corporate crowded out

The most effective way to stimulate real economic growth is proving to be through corporate credit creation. From the issuer's perspective, it is cheaper and less risky to sell bonds in the local currency by minimising exposure to currency swings, but international investors are less likely to participate if a currency hedge is required. To attract foreign financing, the offering has to be of a benchmark size to tempt investors, according to Ms Khosrowshahi. "There are a set of ingredients that need to be in place for a successful issuance including market backdrop, investor liquidity and demand momentum, as well as credit story and future trends," she says. Not all markets are quite ready for this yet.

"There was the expectation that the boom in sovereign debt would be followed by more corporate bonds issuance," adds Ms McDonald. "Big banks in Nigeria came to market in 2015 and 2016, and in 2017 some of the big oil and gas, mining and telecommunications companies offered diversification for the wealth of government bonds, but corporate issuance stalled in 2018."

James Doree, managing director at investment bank Lion's Head Global Partners, says: "Core corporate issuers tend to be from the financial sector, but that is not bleeding into other sectors outside of perhaps Nigeria. Only a handful of utilities and companies in the real economy have issued bonds. Unfortunately, most of Africa is stuck at stage one."

Because nominal interest rates are so high in most sub-Saharan countries, government bonds have crowded out corporate debt. "Counter-intuitively, there is too much yield in local currency government bonds in Africa for corporate issuers to compete," says Frontclear's Mr Buyskes.

The lack of primary issuance on the corporate side has led to a lack of deal experience for local counterparties, according to Mr Doree, who also manages the African local currency bond fund at Lion's Head. "Much of what we do is overcoming a lack of awareness of domestic institutional investors," he adds.

Lion's Head not only acts as an anchor investor for first-time corporate issuers in sub-Saharan Africa, but also provides technical assistance. It works with local arrangers and initially takes up a large chunk of a company's bond offering, which lends credibility. The process is geared towards maximising local participation by decreasing the fund's involvement in any subsequent offerings. The bond fund now has \$140m invested across 18 countries.

There is local appetite for corporate credit, but investor education takes time. Good intermediation is key to building the capacity of counterparties on the ground and leads to improved standards, according to Mr Doree. "We provide feedback to issuers, arrangers and regulators on legal documentation, particularly where there is security, requesting amendments where necessary," he adds.

The liquidity conundrum

While some countries are beginning to actively stimulate primary markets for corporate bonds, post-deal illiquidity remains a huge problem. The lack of secondary trading increases credit risk in Mr Doree's investment portfolio, but so far there have been no defaults in his fund. "Increasing local currency debt and reducing foreign currency exposures and mismatch has a big derisking impact on issuers, making it a solid investment," he says, adding that Lion's Head hedges its currency exposure back to US dollars.

Outside South Africa, there is no real secondary market trading in sub-Saharan Africa. Without it, it is impossible to foster healthy and liquid domestic capital markets. "In order to stimulate secondary market liquidity in government and corporate bonds, there needs to be a repo market, which does not exist at the moment," says Mr Buyskes.

The liquidity problem is compounded by a lack of participation from international investors in the local currency corporate bond market. "Market access is a big issue because none of these bonds are traded on international platforms such as Euroclear. Free of payment transfers are difficult to achieve in repo transactions" says Mr Buyskes. Without finality of settlement and the appropriate legal framework, it is impossible to scale up trading.

"In most cases, there is a disconnect between buyers and sellers, which means they only really make a market for a certain instrument in times of distress," says Standard Bank's Ms McDonald. Data is scarce because of the general lack of trading, making benchmarking and price discovery challenging. "This is a chicken-and-egg issue," she adds. "If the last trade was a long time ago there is data, but it doesn't tell you much. If there is no data to use for benchmarking and pricing, investors are less likely to trade."

Some of the key economies in sub-Saharan Africa are actively trying to boost this type of trading: Kenya is planning to launch a derivatives exchange, and Nigeria aims to introduce a new derivatives market. "The swaps market in Nigeria is getting off the ground with more long-dated onshore repos available at better prices," says Mr Doree.

Regulatory issues

In theory, local investors would benefit from participating in repo markets and secondary trading of debt. In practice, however, the buy-side is equally inexperienced when it comes to capital markets transactions. National regulatory frameworks for financial markets seem inadequate, making it difficult for local investors to access securities in their own markets.

Since the 2008 financial crisis, sweeping pension reforms in countries such as Nigeria, Botswana, Kenya, Mauritius and Côte d'Ivoire have created a more liquid pool of local investors than ever, but further development is needed. "There is still an issue of poor investment capacity from local insurance companies, pension funds and asset managers," says Mr Asante. If the local investment community is further developed, he believes this will push secondary market trading.

Here, again, fundamentals for a functioning market are missing. "Investors don't know how to price new instruments, don't understand their function, can't assess the risk involved and often don't know where to buy securities," says Mr Asante. Central banks and regulatory authorities for the pension fund sector limit investor activity beyond local currency government debt, creating structural drag.

Many of the regulations are outdated and create inconsistencies in the legislative ecosystem. Regulatory change has to go hand in hand with shifts in the tax regime, according to Ms McDonald. In Zambia, for example, the regulator allows pension funds to invest in corporate debt, only for them to discover that under the tax regime they would be taxed at a higher rate if they did.

As it stands, the regulatory environment is not designed to make markets work. "There is a big fear of the unknown. Regulators are afraid that if they allow institutional money to be invested in a more diverse set of securities, then they are opening up pension savings to abuse," says Mr Asante. The regulatory process is so slow because regulators and market participants first need to understand the fundamentals of products, trading and capital markets dynamics.

As with most of the issues for sub-Saharan African capital markets, the regulatory framework will need to be built on the fly. "Don't wait for it to be perfect," says Ms McDonald. "When the market develops, the regulatory framework will catch up."



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