Altica Perspectives:

The Case for Private Credit in Africa

Africa: Diversified

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At the core of the African private debt opportunity is a fundamental demand/supply credit imbalance of c.USD140 billion. There is a shortage of adequate finance to mid-market corporate and financial institutions.

SMEs are profoundly constrained in their ability to generate private sector growth and job creation. This is important because SMEs represent a significant employment source in emerging economies, contributing up to 60% of total employment and up to 40% of GDP in the formal sector alone.

These circumstances are augmented by Africa's structurally superior investment and growth prospects.

- Sub-Saharan Africa has consistently been the **second fastest-growing global region** after developing Asia since 2000.
- **Burgeoning consumer markets driven by urbanisation**. The UN forecasts SSA's urbanisation rate to reach 46% by 2030, up from 36% in 2010.
- A **structural demographic dividend and a growing labour force** underpin higher and sustained long-term demand for goods and services.
- **Consumer spending** in Africa is projected to reach USD2.1 trillion by 2025, up from USD1.4 trillion in 2015.

Access to a **diverse set of economies with distinctive economic/political systems and financial cycles**, as well as unique institutional, linguistic and cultural differences serve to increase diversification appeal. Moreover, African private credit markets offer **higher yields and more attractively priced risk than in developed economies**.

Challenges facing investors in Sub-Saharan Africa

Investors in Sub-Saharan Africa encounter a range of challenges, including:

- Sub-Saharan African financial institutions and corporations continue to find **USD funding a challenge** due to high costs of local borrowing and a range of barriers to accessing international capital.
- **Local financial institutions often lack the flexibility to provide the right tenors and structures**, and are often ill-suited to providing credit solutions to African businesses in the mid-market.
- Lines of financing still broadly follow traditional **colonial and linguistic routes** creating a barrier to more efficient allocation of capital in the region.
- Many **African companies find their growth potential inhibited** because they lack access to technical expertise, professional advice and global trade partners.
- An **opaque operating environment** with legal, cultural and tribal nuances can expose foreign investors to unanticipated credit and execution risks.
- The profiles of African investments are particularly vulnerable to **environmental and social risks** due to often overstretched bureaucracies.

We believe these challenges are not insurmountable. Indeed, they actually help to define the investment opportunity in Sub-Saharan Africa.

Defining The Optimal Investment Route: Private Equity vs Debt?

Many investors have invested in Sub-Saharan Africa via private equity vehicles, attracted by high return prospects which seemingly compensated for risks. However, in recent years, the African private equity industry has generated lower than expected returns due a combination of factors including rich valuations, challenging macro conditions, substantial currency depreciations (eg: South Africa, Nigeria, Ghana, Tanzania, Egypt and Algeria) and a misapplication of the well-established western private equity model to African markets. Other challenges have included:

- **Limited exit opportunities** deter LPs from making allocations to Africa focused PE funds and funds themselves are often hampered in committing capital to otherwise well-run businesses for the same reason.
- **Origination methods** in African private equity are often mirrored on those used in developed markets. These are inefficient and expensive in our view.
- **A lack of understanding of the impact of macroeconomic and political headwinds** such as commodity price volatility and the impact of political cycles, results in a miscalculation of investment risk by many foreign investors.

Crucially, we are observing that private equity alone cannot fill the gap required to fund Africa's recovery and diversification. A large number of companies in the critical mid-market often lack the organisational maturity to take on significant PE and in many cases ceding control is unattractive or premature.

We believe that **private credit is a more attractive route to accessing African growth opportunities than private equity** because it is a fundamentally safer asset class offering downside protection through seniority and a contractual return component.

For investors, **the manager selection criterion is a vital consideration**. Particularly with respect to Africa, we believe it is important for investment managers to comprise staff who have a deep familiarity with not only the continent's economic and business environment, but also who understand the geopolitical risks and cultural nuances. Investment processes should also integrate country-specific frameworks with a consideration of macro factors in order to help identify a sufficiently broad range of risk factors.

Private Credit: Asset Class Attractions

Private credit is a structurally attractive asset class due to:

- Exposure to idiosyncratic opportunities which offer the potential for **attractive risk-adjusted alpha**.
- **Diversification** via private credit strategies can help optimise the efficiency of investors' portfolios.
- **Downside capital protection** via:
  - **Contractual cash yield**: provide an ability to generate returns in range-bound markets, and can act as a capital buffer in adverse market environments. They are a distinguishing feature of private debt vs private equity markets.
  - **Relatively low loss rates** congruent with the priority order of claims and covenant protection.
  - **Low mark-to-market volatility** during more volatile market regimes.
- **Less duration sensitivity** than competing assets (IG, HY, DM sovereigns) as loans are typically based on floating rates.
- **Lower correlation/beta** to major risk assets.
- An **embedded liquidity premium** compensates investors for lower liquidity.

We believe the asset class offers an **appealing trade-off** between **capital security** and earning a **respectable return** to meet long-term – and in some cases, rising – under-funded liabilities and challenging return targets with **'sleep at night' risk tolerances**.

Private debt in International Portfolios

- Private debt has become recognised as **a strategic, mainstream asset class** in international portfolios, especially since the 2008 global financial crisis.
- The evolution of the asset class has been driven by **compelling intrinsic fundamentals**. It has also been galvanised by the prevailing **low interest rate regime** where public market securities offer an insufficient level of yield at historically elevated prices.
- The asset class is attracting a multitude of investor types on its fundamental merits, with **significant interest from both state and private sectors globally**, and including sovereign wealth funds, pension funds, insurers, and family offices.
- The preponderance of institutional investor interest in private debt in recent years has been directed towards the more developed **US and European private debt markets**. Yet there are **heightened concerns that a 'wall of money' effect, high valuation multiples and intense competition have materially compressed returns**. With covenant quality declining, the attractions of the asset class are becoming less attractive in these markets.
- In response, we believe that investors will increasingly turn their attention to **better opportunities available in emerging markets** as they continue to diversify their private debt exposures and seek higher risk-adjusted returns in less efficient growth markets.
- A recognition that **international portfolios are structurally underweight EM fixed income** is catalysing these developments.

We believe that investors will increasingly turn their attention to other areas in emerging markets as they continue to diversify their private debt exposures and seek higher risk-adjusted returns in less efficient markets.

Opportunities for African Institutional Investors in Sub-Saharan Africa

PricewaterhouseCoopers has estimated African institutional investors will manage assets of USD 1.8 trillion by 2020, up from USD670 billion in 2012 (source: AFDB AEO 2018).

We are encouraged by a series of **progressive pension reforms** in countries such as **Nigeria**, **Kenya**, **Botswana** and **South Africa**. For example, 2018, the FSB (South Africa pensions regulator) in 2018 relaxed ‘regulation 28’ investment restrictions permitting pension schemes to invest 10% of their portfolios into the African continent. In 2016, Kenya allowed pension funds to invest up to 10% of their portfolios into venture capital funds. In Botswana, up to 70% of assets are permitted to be invested offshore.

Investment Risks

Frontier markets in general pose similar, albeit accentuated risks to more established emerging markets, in part to their smaller size, less well developed and tested institutional frameworks, less liquid capital markets and overall level of development. Frontier countries typically have non-investment grade credit ratings. Key risks can result from: less liquidity, currency depreciations/controls, commodity prices, higher economic volatility, inflation, less predictable geopolitical and policy environments, as well as capital outflows, amongst others.