Africa's yield appeal faces rising challenges

By Miranda Abraham

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Investors in search of higher yields have been channeling funds into the continent. However, Africa now faces a new challenge as rising interest rates have made it possible for investors to obtain higher returns without the need to venture into the African market.

Source: Supplied. Miranda Abraham is the head of loan syndications at RMB in London.

Even US treasuries are now yielding far more attractive yields than just a month ago: three-month government bonds offer 5.32%, and two-year bonds offer a yield above 5%. Yields have risen in part in response to Fitch's recent downgrade of the US from AAA to AA+, echoing S&P's move in 2011.

African bond issuers, spooked by the high-interest rate environment and refusing to issue bonds above the psychological barrier of double-digit yields for sub-Saharan African bonds, continue to wait it out on the sidelines.

But with interest rates continuing to climb, the wait-and-see strategy is no longer looking like a sensible approach. Issuers are running out of cash and the more stable and resilient syndicated loan market – with its heavily relationship-driven pricing, is increasingly proving to be an alluring alternative to the bond market.

African governments should therefore bring forward planned borrowing before the capital shifts away, as it is already starting to do, and the cost of borrowing rises further still.

The syndicated loan market is dominated by relationship banks, who will consciously and willingly price a loan at very low yields, in order to secure a lead mandate and lock in the ancillary opportunities and revenues that come with being a core relationship bank.

Banks do this knowing that they will also be able to persuade other relationship banks to join the deal as well. This is why syndicated loans always tend to price at a subsidised level when compared to bonds – where investors are more agnostic and definitely less loyal – focusing instead on the relative value of opportunities across the market.

However, while bond prices have skyrocketed, the loan market has hardly moved in terms of pricing. Yes, base rates are higher, resulting in higher all-in costs for borrowers, but on an all-in basis, when compared to bonds, issuing a syndicated loan is definitely the less-expensive option for borrowers.

But why have African issuers managed to price debt at such attractive levels for so long?

There are three main reasons:

- **Finite supply:** There is a limited supply of investable assets in Africa and those banks with an African focus are eager to support their key clients and to get exposure to the African market, which is seen as having strong growth potential.

- **Difficulties in assessing risk:** It can be difficult to assess the credit risk of African borrowers. This is because there is less historical data available, and the political, legal and regulatory environment is often complex. Joining a syndicated loan or bond that has been oversubscribed and so carries the stamp of endorsement from the market can be an attractive solution to this challenge.

- Those issuers that are active in the loan market tend to bring with them an array of other ancillary opportunities (e.g. IPO, Eurobond, and Advisory mandates), in a region where businesses that are succeeding are usually experiencing high growth.

So finite supply leads to fierce competition for these prestigious African clients and the fact that these credits are complex and difficult to understand exacerbates the problem.

As a result of these factors, African risk is often not being priced fairly. South Africa is a good example of how African risk can be underpriced. Despite losing its investment grade rating in 2017, South African corporates and State-Owned Enterprises (SOEs) continue to price their debt like they are in Western Europe. This is because there is a limited pool of opportunities for banks that prefer to lend in ZAR to invest in.

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Balancing risk and returns in African financing

Relationship pricing works for the banks because they are able to use the revenues from ancillary business to subsidise their commitment to the loan, but for regular investors (who are typically looking on an asset play basis) they can end up being short-changed. This means that investors may be taking on more risk than they realise, for a relatively low return.

However, instead of adjusting pricing upwards, the imbalance is being addressed another way - by adjusting risk.

Reducing the risk keeps pricing low and so addresses issuers' concerns around paying double-digit yields.

Risk-mitigation tools (in the form of ECA wraps, DFI guarantees or insurance wraps) are being embedded into loans and so while pricing remains low, investors improve their returns through adjusting the risk.

These types of credit-risk mitigated deals, result in investment grade ratings, but with a substantial African premium. In the EUR 1bn Bank of Industry deal, BOI/AFC pays a yield of about 200 bps versus an average yield of 75% for an A3 rated credit in Europe. It is the only way for many international and European banks – who typically shy away from low BB or single B African risk - to fill their African buckets.

Supply and demand dynamics in African investments

These investors have a whole world of investment opportunities available to them, from AAA through to single B risk, usually across the globe, so they can pick and choose their deals. Consequently, in order to attract their investment into Africa, pricing on these credit-enhanced deals has to be highly attractive relative to other similar opportunities globally.

However for those emerging market investors or African banks focused on Africa, their return hurdle requirements mean that the credit-enhanced deals do not work for them.

Instead, they are obliged to find African opportunities that represent real, uncovered African risk. However, the market paralysis created by a difficult credit environment, combined with the fact that a large proportion of those deals that do come to market include some form of credit enhancement, means that the pool of deals offering pure, uncovered African risk is now much smaller.

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And this is where supply and demand dynamics take over.

African banks and investors are desperate for assets and are very comfortable assessing and understanding sub-investment grade African risk. However this dynamic of fewer deals but strong investor demand has led to plentiful pent-up liquidity down the credit curve.

Ironically, once African investors get over the hurdle of higher return requirements (often driven by higher cost of funding) there is such relief that pricing works from a returns perspective, that they can then end up effectively under-pricing the actual credit risk. So we end up with BB- loans paying only 450 bps versus BB average bond yields of 12%.

Investors in Africa are a finite pool who know and understand African risk. They deserve to be fairly compensated for the risk they take.

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