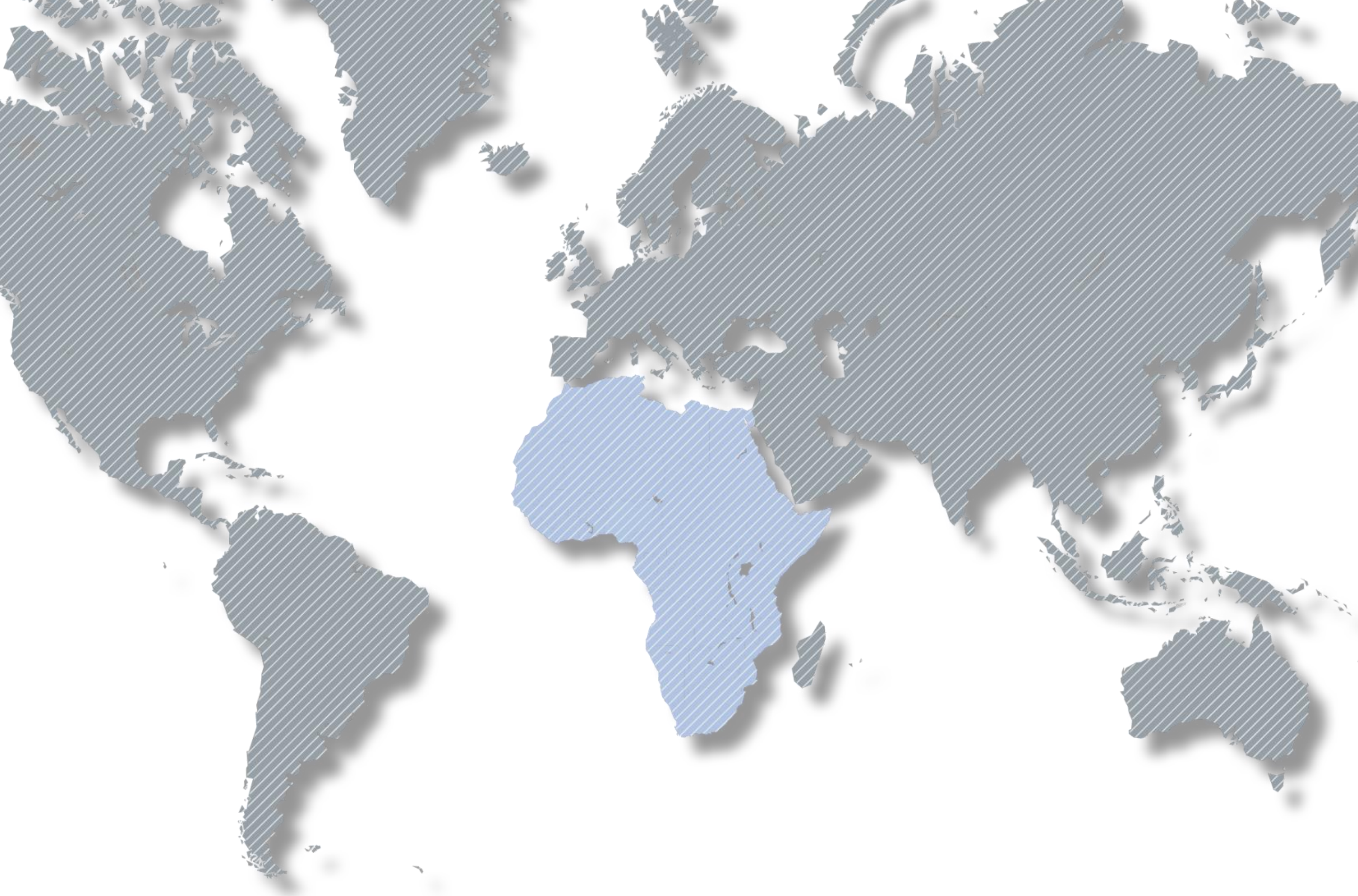


Private Debt Markets in Africa

#AfricanAllianceAlpha

African Alliance
Asset Management

Summary

In this report we consider the recent growth of the global private debt market and the implications thereof for the future of private debt across Africa's capital markets. We expect a similar growth trajectory in Africa's private debt markets over the next couple of years, albeit off a lower base and subject to the challenges inherent in less liquid and informationally inefficient regional markets.

We show that:

- Interest in the global private debt market has been growing due to the potential for higher returns in a low yield global environment as well as a more challenging regulatory environment for banks.
- Since 2007 assets under management focused on private debt have grown 12% CAGR to reach a current level of USD 638 billion.
- With the United States and Europe being relatively more mature markets there is an increased focus on private debt opportunities in emerging and growth markets.
- The private debt investment process has many nuisances that investors who are unfamiliar with this asset class may overlook.

An introduction to private debt

Private debt is a growing asset class which has seen increased investor interest over the past five years. The term “private” refers only to the credit instrument itself and not specifically to the borrower since publicly listed companies are active issuers of private debt. The debt issued by a borrower is generally not traded on an open market or organised exchange.

The term private debt is often used interchangeably with alternative debt, alternative credit, direct lending, private lending and private credit. Irrespective of the term used these all point to an asset class with the same characteristics, namely:

- Non-bank finance
- Not issued or traded on an open market or organised exchange
- Typically used to finance business growth, provide working capital or fund infrastructure development

What has led to the growth in private debt?

Following the Global Financial Crisis in 2008-2009 it was determined that banks were not following a sufficiently sound risk management framework and lacked the necessary capital to absorb losses in a highly stressed market environment. The resulting regulatory reforms that were subsequently implemented have constrained many banks’ ability to lend to the private market, creating a mismatch between the supply of and demand for funds in this market.

Declining yields across the globe – to near zero and, in some cases, below zero – has resulted in a search for yield in asset classes that may previously have been over-looked. As investors better understand private debt so they are finding attractive risk-adjusted returns.

Private debt offers investors the chance to own securities that bring unique characteristics to their portfolio, ensuring that they take advantage of what Harry Markowitz deemed to be “the only free lunch in investing” – namely diversification.

As private debt generally trades away from an organised exchange, it allows the terms and characteristics to be customised from both the borrower and the investor’s perspective.

As yields decrease borrowers become increasingly interested in refinancing loans. Private debt markets offer an increasingly viable opportunity to do this and for investors to participate therein.

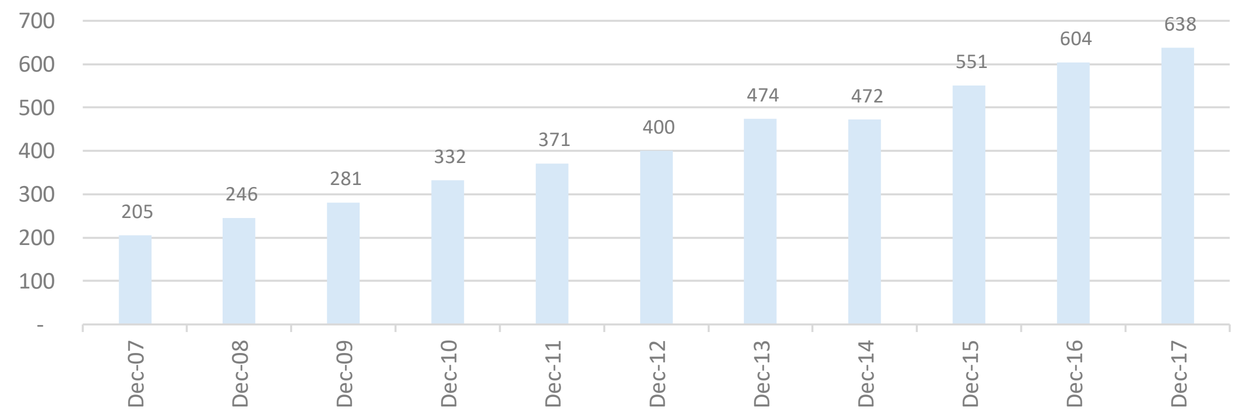
Pension funds globally are finding themselves to be in deficit. The historic use of defined benefit (DB) schemes, poor investment performance, low yields and aggressive accounting practices are some of the reasons for an increasingly precarious situation, with many funds underfunded even on the basis of unrealistic return expectations going forward.

For this and numerous other reasons private debt as an asset class has attracted the attention of institutional investors.

The global private debt landscape

Private debt assets under management (AUM) have grown significantly in the last 10 years.

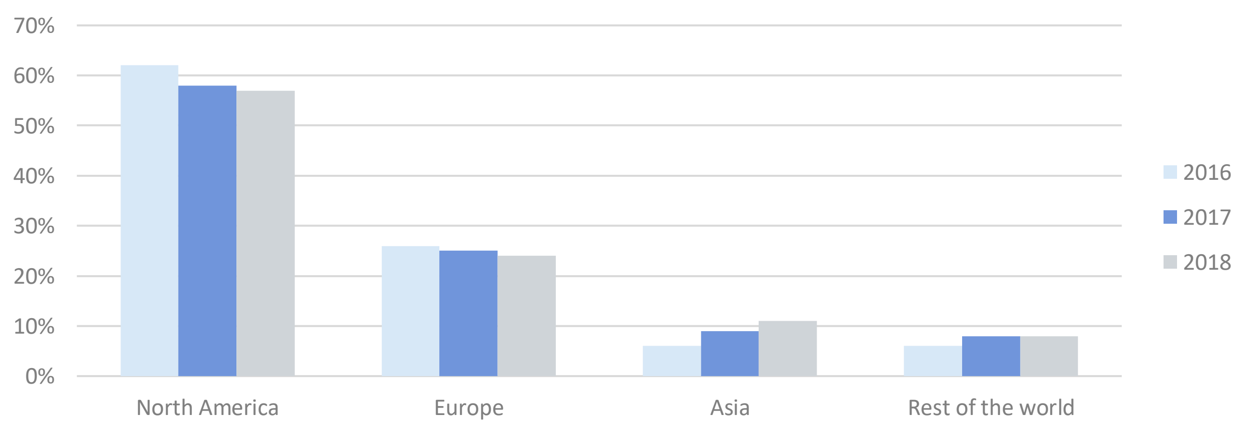
Private Debt AUM (USD bn)



Source: 2018 Preqin Global Private Debt Report

While the United States and Europe represent the largest markets based on assets under management (AUM), these markets are more mature and pricing has become more competitive. This has led to increased interest in opportunities in emerging and growth markets which are still relatively untapped.

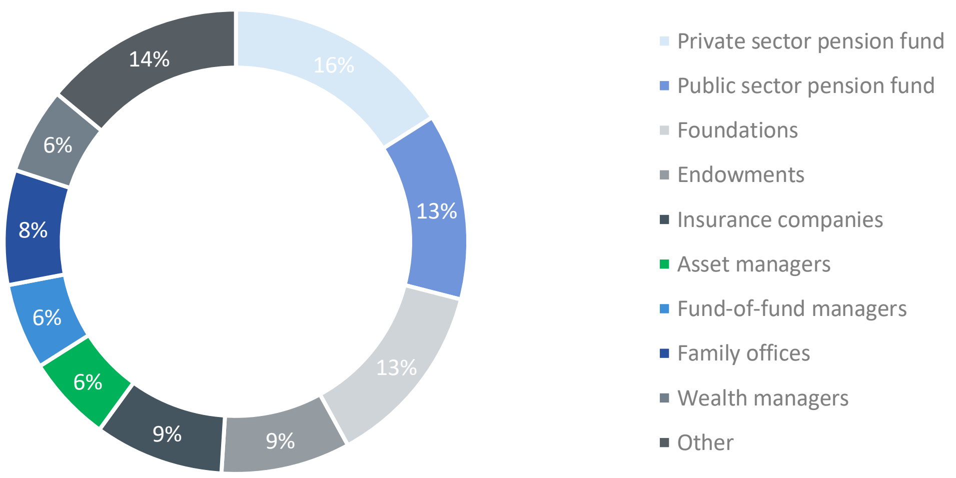
Regional Split of Investors



Source: The Outlook for Private Debt – Preqin

Globally pension funds – both public and private – are the largest investors in private debt, closely followed by foundations, endowments and insurance companies.

Investors in Private Debt



Source: The Outlook for Private Debt – Preqin

Comparison of investment characteristics

- While private debt is a relatively illiquid asset class, it offers investors the chance to earn a decent illiquidity premium.
- Given the lack of real-time market pricing, private debt instruments are generally managed on a buy-and-hold basis which has the advantage of lower measured volatility – a characteristic similar to that found in private equity.
- While comparisons are often drawn between private equity and private debt, private debt differs in that there is no need to attempt to exit or sell out of a position. In private debt, the exiting occurs naturally owing to the term of the debt extended reaching maturity or due to the amortising nature of the loan extended.
- Owing to the “private” aspect of the debt, most other terms and characteristics are negotiated and settled on between the borrower and the lender and these characteristics can be customised to either party’s requirements.

Narrowing in on private debt in Africa

Africa – owing largely to regional specific factors which we will explore further – is uniquely poised to benefit from the growth in private debt as it becomes a more “mainstream” asset class. The factors that we assess that make Africa ripe for a boom in private debt are:

- Capital markets in Africa are less deep and liquid relative to developed markets.
- As a result, public and private companies often struggle to obtain access to capital.
- The World Bank indicates that Africa has the lowest levels of domestic credit extended to the private sector by banks – c.32% of GDP.
- Local banks in Africa often generate relatively high returns on government securities. As a result, their requirement for more relatively risky assets is low.
- According to RisCura, only 33% of unlisted investment capital comes in the form debt. This contrasts to developed markets where this figure is closer to 67%.

The investor’s perspective of private debt in Africa

Our assessment is that there is an opportunity for investors to step in and meet the funding gap while capturing attractive returns on a risk-adjusted basis. Based on what we are seeing in our dealings across Africa, investors are in the early stage of considering private debt and this will likely develop as the range of financing solutions becomes more sophisticated – it is paramount to remember that private debt offers investors the ability to structure funding in line with their own requirements.

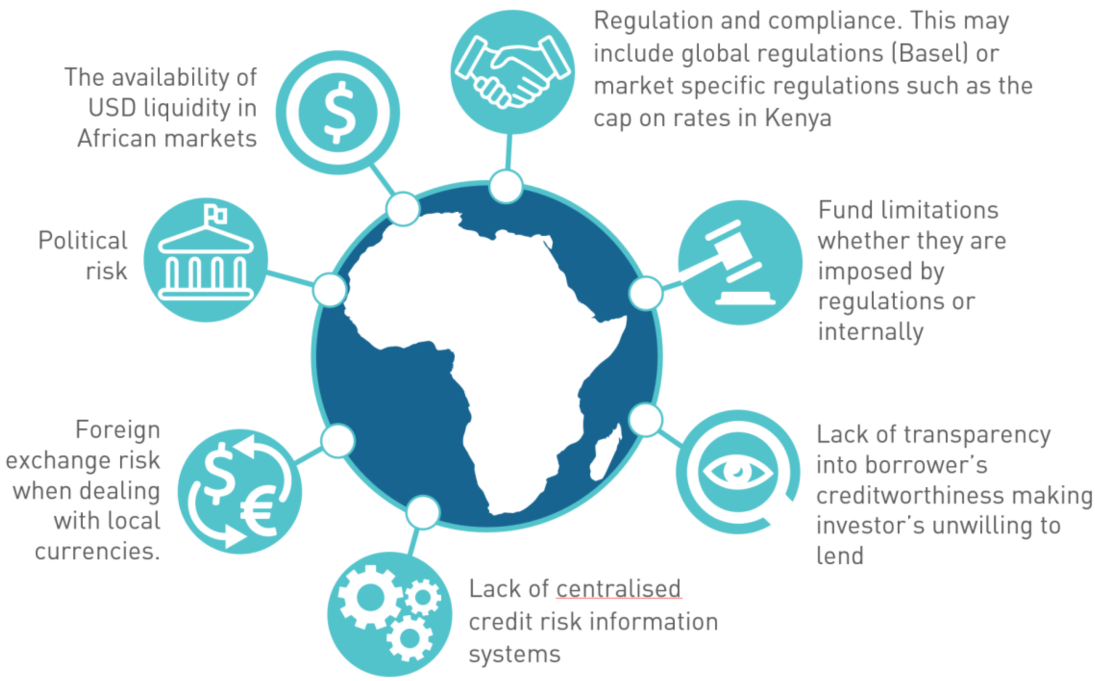
In terms of private debt, there are many forms. We observe that investors are beginning to take an interest in trade funding. While even this market is not yet saturated and there remains a sizeable funding gap – c. USD 110 billion per annum – there are other forms of private debt that investors can explore. Private infrastructure financing, working capital financing and small and medium sized enterprise (SMME) financing are among some of the alternate forms for investors to explore. As a further indication of the size of the opportunity set, the International Finance Corporation (IFC) estimated in 2019 that the credit gap for SMMEs was in the range of USD 70 – 90 billion per annum.

The opportunity, based on our view of the data researched and what we are seeing based on our daily dealings across Africa, is endless. The financing gap across the various forms of private debt is indicative of this opportunity. It is up to investors to acknowledge and begin to act on this by beginning to explore private debt market with greater intention.

Where are the challenges in the African context?

We are under no illusion that investing in African markets does not pose challenges to investors. While some are unique in an African context, others may not be:

Challenges of investing in private debt in Africa



Source: African Alliance

Given the potentially niche challenges investors face when navigating the private debt asset class and these markets, due diligence and deal structuring are two key elements to the investment process that should not be underestimated.

Mapping the way forward in private debt

As African Alliance Asset Management has operated in private debt markets for over 20 years, we have developed valuable experience and expertise in the space.

Each step is as critical as the next when investing in private debt. According to a 2019 McKinsey report, deal flow ranked second only to valuations as the greatest challenges going forward in private debt. Due diligence ranks highly in all investment scenarios. Deal and legal structuring go together and are key elements that investors who are unfamiliar with private debt may overlook.

While private debt allows for customisation, investors need to tread cautiously. In the search for yield we have seen growth in covenant-lite loan agreements – something that we assess with caution. Finally, given that the debt is not traded or regulated on an exchange, monitoring tends to be more hands-on. Maintaining a good working relationship with borrowers is key for investors in the world of private debt.

While managing private debt is a process that requires robust working relationships and a hands-on approach, the future lies in the integration of technology into the process. Automating and digitising portions of the investment process are key to achieving scale and remaining nimble in a dynamic investment environment.

As a summary, the African Alliance process remains robust and consistent when assessing private debt. Our focus points are:

- Sourcing high quality investment opportunities.
- Ensuring a robust due diligence process that is aided by our presence in Africa.
- Ensuring adequate and appropriate pricing that reflects the risks inherent.
- Comprehensive legal review and documentation.
- Continuous monitoring of operational and financial performance and milestones.
- Incorporating technology throughout this process to ensure replicability across deals and teams in various regions.

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