Private credit emerging in Africa

Asset class offers safer means to access growth markets across continent

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Private credit is a strategic, mainstream asset class in international portfolios. Its appeal centres around a constellation of desirable characteristics, including a yield premium, downside capital protection and lower duration sensitivity than competing credit sub-asset classes. Diversification into private credit can help optimise portfolio efficiency.

There is significant global interest from sovereign funds, pension funds, insurers and family offices. Most investment is directed towards developed markets in the US and Europe.

There are indisputable signs of maturity in developed markets. A 'wall of money' effect, high earnings before interest, taxes, depreciation, and amortisation multiples and intense competition seem to have compressed returns and diminished the appeal of private credit. Returns on vintages immediately after the European debt crisis offered returns of 13%-15% on an unlevered basis for senior debt. Industry observers note expected returns have compressed towards 7%-8%. In the US, net internal rates of return are closer to 6%-7%, with cash yields of 4% or less.

Industry-wide available capital is at a record $251bn, of which 95% is concentrated in the US and Europe. Research by Private Debt Investor indicates that 69% of loans in Europe and 75% in the US are 'covenant-lite'. Moody's has called these 'distressingly weak'.

Private debt in Africa

The opportunity for private debt in Africa is substantial. At its core is a shortage of adequate finance to mid-market corporate and financial institutions. The credit gap for small and medium-sized enterprises in sub-Saharan Africa is $140bn, says the International Finance Corporation.

This opportunity is augmented by structurally superior growth and investment prospects. SSA has been the fastest-growing region after developing Asia since 2000. A demographic dividend, growing labour force and rapid urbanisation underpin burgeoning demand. By 2034, Africa will have a larger workforce than China or India.

African leaders are focused on developing market-orientated policy. This year has witnessed the establishment of the Single African Air Transport Market and the Continental Free Trade Area, creating a market of more than 1.2bn people and GDP of $2.5tn. The World Bank's Ease of Doing Business rankings illustrate this shift. Countries like Rwanda (which ranks 42nd), Morocco (70), Kenya (81), Botswana (82) have comparable or markedly better scores than more familiar emerging markets like India (101), Brazil (126) and China (78). The direction of reform in Africa stands in stark contrast to protectionist tendencies in developed markets.

SMEs' ability in SSA to generate private sector growth and jobs is constrained. Local financial institutions and corporations find dollar funding a challenge because of high costs and lack of flexibility of local borrowing.

Private equity alone cannot fund Africa's economic diversification. Leaving aside recent performance challenges, in many cases ceding control is unattractive or premature. Limited exit opportunities deter investors from making allocations to Africa-focused funds.

Private credit is a more attractive route to accessing growth opportunities. It is a safer asset class offering downside protection through seniority and a contractual return component. The emergence of private credit funds testifies that investors are recognising this opportunity and committing significant capital.

Investors should prioritise sectors that governments deem strategically important to diversification, as well as businesses that benefit from urbanising populations with higher spending power.

Consumer spending in Africa is projected to reach $2.1tn by 2025, up from $1.4tn in 2015. Business-to-business spending will reach $3.5tn by 2025, an increase of around 50% from 2015. The World Investment Report 2018, published by the United Nations Conference on Trade and Development, forecasts African foreign direct investment inflows to rise by 20% to $50bn this year.

Investing for impact

Global investors increasingly expect managers to engage with stakeholders on environmental, social and governance issues throughout the lifecycle of investments. Aligning these with the UN's 2030 sustainable development agenda and the IFC's 10 environmental and social standards is integral.

Delivering sustainable transformation for African companies with respect to corporate governance and skills-transfer enables local companies to adopt international standards. This will benefit employment, productivity and growth.

Private credit offers investors the safest means to access growth markets, as well as the prospect of higher risk-adjusted returns in less efficient and less competitive environments. It also enables investors to diversify their private debt exposures and take advantage of different economic cycles and risk that is arguably more attractively priced. Undoubtedly, the private credit opportunity in Africa will become a crucial channel for accelerating economic development and closing the credit gap. ●

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