AFRICAN HIGH YIELD CORPORATE BOND MARKET

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# AFRICAN HIGH YIELD CORPORATE BOND MARKET

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1 EXECUTIVE SUMMARY

1.1 Introduction

This report analyses the African corporate bond market, covering specifically the following aspects:

- Overview of “High Yield” Corporate Bond Market (HY = BB+ & below)
- Competitive Landscape: Bond funds which invest exclusively in “High Yield” issuances
- Who are the main “High Yield” Corporate Bond holders (direct and indirect)?
- Who are the main “High Yield” Corporate Bond holders in Latin America and Asia (direct and indirect)?

1.2 Research methodology

We have approached the research for the African Corporate Bond Market in the following ways:

- **Bottom up:** We have obtained all the African Corporate Bond issuances that are listed on Bloomberg. We are performing a detailed analysis of each of the individual bonds. We will then drill upwards to better understand who the investors are in each of these bond issuances.

- **Top Down:** We are performing searches using various research platforms in order to ascertain a list of the funds which invest in “High-Yield” bond issuances. Once this information has been obtained we will drill downwards in order to obtain a list of “High Yield” bond issuances.

We feel that by approaching this research in this way we will obtain a thorough understanding of the High Yield Corporate Bond Market.

1.3 Africa bottom-up analysis

The 1,573 bonds were separated into various categories relevant to our analysis and we have identified 230 sub-investment grade bonds ($34.5bn). We have also conducted a separate analysis excluding South African bonds returned 446 corporate bonds with a combined value of $33.4bn excluding South African Corporates, including 156 bonds in the extended sub-investment grade category ($21.9bn) excluding South African Corporates.

We have identified the following key take insights from the analysis:
Africa (including South Africa)

- The largest amount and number of issuances are from South African companies, followed by Mauritius and Egypt. Please note that the Liberian numbers are skewed by the $4.4bn of Royal Caribbean issuances, which is incorporated in Liberia but operates out of the United States.
- The majority of issuances are in EUR and USD, the largest categories of local currency issuances are EGP, ZAR, and MAD. Please note that the EUR and USD numbers are skewed by the $2.4bn of Royal Caribbean issuances in EUR and $2.0bn issued in USD, which is incorporated in Liberia but operates out of the United States.
- The majority of the bonds have fixed coupons. The default rates are 17.8% of total issuances when calculated based on the value of the bonds. These come from Mauritius and Egypt bonds that were issued before the year 2000.
- It seems that there has been a steady increase in issuances over the past few years, peaking in 2010. The year 2007 is abnormal due to the Edcon and Royal Caribbean issuances.
- It seems like the majority of the bonds issued have tenors of either, 7, 5 or 10 years.

Africa (Excluding South Africa)

- It seems like the majority of the bonds were issued from Mauritius and Egypt. Please note that the Liberian numbers are skewed by the $4.4bn of Royal Caribbean issuances, which is incorporated in Liberia but operates out of the United States.
- The majority of issuances by value were in USD, EGP, MAD, EUR, and NGN. Please note that the EUR and USD numbers are skewed by the $2.4bn of Royal Caribbean issuances in EUR and $2.0bn issued in USD, which is incorporated in Liberia but operates out of the United States.
- The majority of the bonds have fixed coupons. The default rates in Africa (excl. South Africa) are higher at around 28% when calculated as a percentage of bond value. These come from Mauritius and Egypt bonds that were issued before the year 2000.
- It seems that there has been a steady increase in issuances over the past few years, peaking in 2010. We also note a sharp drop in 2011 both in terms of value and number of issuances. The year 2007 is abnormal due to the Royal Caribbean issuances.
- It seems like the majority of the bonds issued have tenors of either, 7, 5 or 10 years.
1.4 Africa top-down analysis

Looking forward there remain a number of hurdles that stand in the way of a significantly deeper African corporate bond market (ex-South Africa), however, all interviewees expect the market to continue to grow over the next 3-5 years. Amongst interviewees most expected corporates to tap the LCY markets, with only the resource, infrastructure and banking sector looking to tap the FCY markets, Importantly the introduction of Basel III is expected to decrease the ability of banks across the continent to under-price bonds by a significant margin – and should lead to further development of the bond market across the continent.

South Africa has already started to see the development of LCY HY Corporate funds focused exclusively on the local market, with Investec starting to look to the rest of Africa for potential corporate bond issuance. Opportunity exists for a fund in the LCY space that is able to understand the credit risk behind various corporates (as most bonds are un-rated), and offer exposure to more risk seeking investors (i.e. HNW, Private Banking and potentially Sovereign Wealth Funds).

Please see section 3 for details on competitors active in in Africa, investors’ appetite and an overview of each of the African markets.

1.5 Latin America

The Latin America (LatAm) region experienced strong growth in corporate bond issuance from 2009 onwards, predominantly due to the increase in demand from overseas investors as seen by the large inflows of capital. The LatAm USD corporate bond market was c. USD280bn at the end of 2011.

The high yield bond market represents on average 20% of the total corporate bond issuance in the region. Local currency bonds are a small part of the market, reaching between 0.3% and 3.7% of the total market. The largest corporate bond markets (by value) in the region are Brazil and Mexico.

The strong growth in the corporate bond market can be attributed to macroeconomic stabilization and the privatization of pension systems in the region. In addition, regulatory restrictions and reforms have played an important role in corporate bond financing.

The region saw strong yields of over 5% for investment grade bonds and over 11% for high yield bonds prior to September 2011; however these yields have declined since to over 3% and 7%
respectively. The spread between High Yield and High Grade (HG) bonds from the CEMBI Broad Latin America index was 460bps in August 2012 and seen a tightening of 14bps to date.

There are 3 types of bond funds in the region: USD, local currency and those that can choose either such as The Fidelity New Markets Income fund. There are very few LatAm domiciled funds focussing purely on high yield LatAm corporate bonds including Moneda, Lv Deuda Latam, BTG Pactual, Celfin and Copernico. Majority of these funds are managed by the largest banks and top hedge funds. They are onshore funds, listed locally, either open or closed ended and have a Fitch Class 1 Level 4 rating. Investors in these funds tend to be local pension funds, insurance companies and family offices.

On the other hand there are several overseas funds (USD) that invest in high yield bonds in emerging markets including Latin America. Some of big name asset managers include BlackRock High Yield Bond Fund, Baillie Gifford HY Bond Fund, Pimco Emerging Market Local Bond Fund, AGF Global High Yield Bond Fund and Excel Latin America Bond Fund.

Local currency bond funds investing broadly into emerging market debt have done well over the last few years, but the returns are declining as the market matures. The top 15 largest local currency funds received returns of an average of 30% over the last 3 years, 12% over the last 1 year and 3% over the last 6 months.

1.6 Asia

The Asian financial crisis in 1997 caused Asian corporate bond markets to grow rapidly as Asian borrowers switched from short-term bank loans to longer term debt financing. Across Asia, bond market development varies considerably. In terms of amount of corporate bonds outstanding, Japan, China and South Korea are the largest markets. The Asian Development Bank has observed the emergence of a broader high yield corporate issuer base in Asia with companies in energy, commodities, transportation, telecom and real estate beginning to dominate the region’s high yield issuance base, as these sectors are experiencing strong growth. In late September 2012, the FT reported an uptick in global funds directed to Asian fixed income, as the higher growth and yields in Asia look increasingly attractive versus bond markets in the US or Europe. The two major Asian bond indices are the HSBC Asian Bond Index and the JPM JACI Index. The high yield portion of the JACI has grown from around 30% in 2006 to 39% in 2011. At the end of 2011, the global market for corporate bonds totalled about USD 4 trillion. However, Asia makes up less than 3% of this (USD 130 billion) – but this figure is
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growing. Despite a challenging year in 2011, including the downgrade of the U.S. and trouble brewing in the Eurozone, the JACI stayed positive and returned 4.12%. The investment grade rated portion (61% of the index) returned 4.92% and the sub-investment grade rated portion (39%) returned 2.85% - the index has returned 7% on an annualized basis between 2007 to 2011. The Asian bond markets can be broken down into two segments: (a) the regional bond market in USD-denominated instruments; and (b) local currency bond markets. Since 2008, USD 275 billion or 86% of Asian corporate bond issuances have been those denominated in local currencies.

The evolution of domestic (particularly local currency) bond markets in Asia has been a success story. The main drivers of growth in these bond markets have been economic performance and governmental promotion. Asian countries have weathered the global downtrend better than the West due to strong economic fundamentals (i.e. lower fiscal deficits, lower debt ratios, higher GDP growth) and Asian bonds provide for better yield n vs. developed markets. In addition, there are currently three major government-sponsored initiatives in play; APEC - which facilitates the development of securitization and credit guarantee mechanisms, ABMI - which is creating regional market infrastructure (ratings agencies and settlement procedures) and EMEAP - which pools and invests Asian forex reserves to stimulate local bond markets. However, during the global financial crisis, major economies in Asia experienced sharp capital outflows from their bond markets. Thus, Asian governments continue to consider ways to develop Asian bond markets. ACMF, a forum of securities regulators, has drafted an Implementation Plan for ASEAN member countries to achieve capital market integration. This three-phased approach, with key milestones, is due to complete in 2015. It also remains to be seen whether heightened interest in Asian high-yield corporate bonds is the outcome of the search for yield in a low-interest rate environment or a structural shift towards greater weighting of Asian bonds in global portfolios. Moreover, although domestic markets have been doing well, the regional Asian bond market has yet to develop as much. Based on 2010 data, 90% of bonds issued by ASEAN+3 borrowers are either held outside the region or in their own country. Consequently, at a roundtable in Manila in May 2012, Asian government representatives noted the following work still required to develop deep and liquid corporate bond markets in Asia:

- Linking payment systems to incentivize interregional trading, settlement and custody.
AFRICAN HIGH YIELD CORPORATE BOND MARKET

- The creation of a pan-Asian or regional credit ratings agency.
- Standardization of practices in terms of offering, documentation.
- Reciprocal regulatory approval to make cross-border issuance and marketing easier.
AFRICAN HIGH YIELD CORPORATE BOND MARKET

2 AFRICA BOTTOM UP ANALYSIS

For our bottom-up analysis of the African bond landscape we have analysed all the African corporate bonds listed on Bloomberg. The Bloomberg download returned 1,573 corporate bonds with a combined value of $120.2bn (We converted all non-USD bonds to USD).

For each bond we have downloaded the following categories:

- Bond Bloomberg ID and Short name
- Issuer industry and industry sub-group
- Country of issuer
- Currency of issue
- Issue date
- Maturity date and type
- Size of issue
- Coupon rate and type
- Fitch, S&P, Moodys and GCR rating (we included both national and international rating scales where appropriate)
- Current price
- Current yield
- Exchange where listed

2.1 Bond categories

The 1,573 bonds were separated into various categories relevant to our analysis. Refer to the figure below for a breakdown of the bonds listed on Bloomberg.

- Rated bonds: Out of the 1,573 corporate bonds, 179 bonds ($44.6bn) have ratings (all ratings, including Withdrawn and Not Rated). The rest do not have any ratings data in Bloomberg.

- Rated sub-investment grade bonds: Out of the 179 rated bonds, 93 bonds ($22.1bn) have been identified as sub-investment grade. When national rating scales were provided, equivalent international ratings were determined in order to identify sub-investment grade bonds.

- Assumed sub-investment grade bonds: We have classified an additional 137 bonds ($12.5bn) as sub-investment grade even though they did not have any ratings. These assumed sub-investment grade bonds where individually identified based on our knowledge of the individual companies or if they were issued from a country with a sub-investment grade sovereign rating.
Extended sub-investment grade bonds: This category includes both the rated sub-investment grade bonds and the assumed sub-investment grade bonds. Combined, we have identified 230 sub-investment grade bonds ($34.5bn).

We have also conducted a separate analysis excluding South African bonds. The information downloaded from Bloomberg returned 446 corporate bonds with a combined value of $33.4bn excluding South African Corporates. Broken down into the previously mentioned categories, 63 are rated bonds – all ratings ($14.5bn) and 54 are rated sub-investment rated bonds ($11.1bn). We also identified an additional 102 assumed sub-investment grade bonds ($10.8bn) giving a total of 156 bonds in the extended sub-investment grade category ($21.9bn) excluding South African Corporates.

**Figure 1: Breakdown of bonds listed on Bloomberg**

<table>
<thead>
<tr>
<th>African bond landscape</th>
<th>African bond landscape (ex South Africa)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount issued (USDm) # of bonds</td>
</tr>
<tr>
<td>Non-rated bonds</td>
<td>75,686 1,394</td>
</tr>
<tr>
<td>Rated bonds</td>
<td>44,592 179</td>
</tr>
<tr>
<td>Total</td>
<td>120,277 1,573</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>90,202 1,440</td>
</tr>
<tr>
<td>Rated subinvestment grade</td>
<td>22,075 93</td>
</tr>
<tr>
<td>Total</td>
<td>120,277 1,573</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>107,826 1,435</td>
</tr>
<tr>
<td>Assumed subinvestment grade</td>
<td>12,452 137</td>
</tr>
<tr>
<td>Total</td>
<td>120,277 1,573</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>95,751 1,343</td>
</tr>
<tr>
<td>Extended subinvestment grade</td>
<td>34,527 230</td>
</tr>
<tr>
<td>Total</td>
<td>120,277 1,573</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg.

### 2.2 Extended sub-investment grade bond category

We have focused our analysis on the 230 bonds in the extended sub-investment grade category. Figures 2 to 6 below highlight summarize the information downloaded from Bloomberg.
AFRICAN HIGH YIELD CORPORATE BOND MARKET

Figure 2: Extended sub-investment grade bond category by country

<table>
<thead>
<tr>
<th>Value of bonds by country (USDm)</th>
<th># of bonds by country</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOUTH AFRICA</td>
<td>EUR</td>
</tr>
<tr>
<td>MAURITIUS</td>
<td>USD</td>
</tr>
<tr>
<td>EGYPT</td>
<td>EGP</td>
</tr>
<tr>
<td>LIBERIA</td>
<td>ZAR</td>
</tr>
<tr>
<td>MOROCCO</td>
<td>MAD</td>
</tr>
<tr>
<td>NIGERIA</td>
<td>NGN</td>
</tr>
<tr>
<td>Others</td>
<td>Others</td>
</tr>
</tbody>
</table>

Source: Bloomberg.

Based on the above, the largest amount and number of issuances are from South African companies, followed by Mauritius and Egypt. Please note that the Liberian numbers are skewed by the $4.4bn of Royal Caribbean issuances, which is incorporated in Liberia but operates out of the United States.

Figure 3: Extended sub-investment grade bond category by currency

<table>
<thead>
<tr>
<th>Value of bonds by currency</th>
<th># of bonds by currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR</td>
<td>EUR</td>
</tr>
<tr>
<td>USD</td>
<td>USD</td>
</tr>
<tr>
<td>EGP</td>
<td>EGP</td>
</tr>
<tr>
<td>ZAR</td>
<td>ZAR</td>
</tr>
<tr>
<td>MAD</td>
<td>MAD</td>
</tr>
<tr>
<td>NGN</td>
<td>NGN</td>
</tr>
<tr>
<td>Others</td>
<td>Others</td>
</tr>
</tbody>
</table>

Source: Bloomberg.

Based on the above, the majority of issuances are in EUR and USD, the largest categories of local currency issuances are EGP, ZAR, and MAD. Please note that the EUR and USD numbers are skewed by the $2.4bn of Royal Caribbean issuances in EUR and $2.0bn issued in USD, which is incorporated in Liberia but operates out of the United States.
Based on this information, the majority of the bonds have fixed coupons. The default rates are 17.8% of total issuances when calculated based on the value of the bonds. These come from Mauritius and Egypt bonds that were issued before the year 2000.

Based on the above, it seems that there has been a steady increase in issuances over the past few years, peaking in 2010. The year 2007 is abnormal due to the Edcon and Royal Caribbean issuances.
Based on the above, it seems like the majority of the bonds issued have tenors of either, 7, 5 or 10 years.

2.3 Non-South African extended sub-investment grade bond category

Excluding South Africa from the analysis gives a clearer picture of the landscape in Africa. Figures 7 to 11 below highlight summarize the information downloaded from Bloomberg.

Based on the above, it seems like the majority of the bonds were issued from Mauritius and Egypt. Please note that the Liberian numbers are skewed by the $4.4bn of Royal Caribbean issuances, which is incorporated in Liberia but operates out of the United States.
Figure 8: Non-South African extended sub-investment grade bond category by currency

<table>
<thead>
<tr>
<th>Currency</th>
<th>Value (USDm)</th>
<th># of Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD</td>
<td>1,537</td>
<td>73</td>
</tr>
<tr>
<td>EGP</td>
<td>2,421</td>
<td>28</td>
</tr>
<tr>
<td>MAD</td>
<td>2,572</td>
<td>28</td>
</tr>
<tr>
<td>EUR</td>
<td>4,942</td>
<td>18</td>
</tr>
<tr>
<td>NGN</td>
<td>9,089</td>
<td>2</td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg.

Based on the above, the majority of issuances by value were in USD, EGP, MAD, EUR, and NGN. Please note that the EUR and USD numbers are skewed by the $2.4bn of Royal Caribbean issuances in EUR and $2.0bn issued in USD, which is incorporated in Liberia but operates out of the United States.

Figure 9: Non-South African extended sub-investment grade bond category by coupon type

<table>
<thead>
<tr>
<th>Coupon Type</th>
<th>Value (USDm)</th>
<th># of Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIXED</td>
<td>10,751</td>
<td>85</td>
</tr>
<tr>
<td>DEFAULTED</td>
<td>6</td>
<td>11</td>
</tr>
<tr>
<td>FLOATING</td>
<td>38</td>
<td></td>
</tr>
<tr>
<td>STEP CPN</td>
<td>16</td>
<td></td>
</tr>
<tr>
<td>VARIABLE</td>
<td>212</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg.

Based on this information, the majority of the bonds have fixed coupons. The default rates in Africa (excl. South Africa) are higher at around 28% when calculated as a percentage of bond value. These come from Mauritius and Egypt bonds that were issued before the year 2000.
Based on the above, it seems that there has been a steady increase in issuances over the past few years, peaking in 2010. We also note a sharp drop in 2011 both in terms of value and number of issuances. The year 2007 is abnormal due to the Royal Caribbean issuances.

Based on the above, it seems like the majority of the bonds issued have tenors of either, 7, 5 or 10 years.
2.4 Bondholder Analysis

In order to obtain information relating to the investors who hold sub-investment grade bonds, we performed the following analysis:

- **Bloomberg Data** - we were able to obtain bondholder information directly from Bloomberg;
- **Exchanges where bonds are listed** – we contacted all exchanges which have sub-investment grade bonds listed on them to request bondholder information;
- **Bond issuers** – we sent emails directly to those companies who have issued sub-investment grade bonds.

### 2.4.1 Bloomberg data

Out of the 230 extended sub-investment grade bonds that we identified using the Bloomberg information, there is bondholder information for 27 of these bonds. We include a breakdown of these bonds in the table below. In the case of the South African bonds, sub-investment grade status was determined using the equivalent rating on the international rating scale.

**Figure 12: Summary of bonds from Bloomberg**

<table>
<thead>
<tr>
<th>Rating Agency Rating Agency Rating</th>
<th>Number of bonds</th>
<th>Total Bondholder Information (Bi)</th>
<th>Bi/Amount (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>South African Listed Bonds</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MOMENTUM GROUP LTD Fitch national A(zaf)</td>
<td>10</td>
<td>949 095 000</td>
<td>96 968 388</td>
</tr>
<tr>
<td>FIRSTRAND BANK LTD Fitch national A(zaf)</td>
<td>2</td>
<td>125 917 200</td>
<td>27 083 399</td>
</tr>
<tr>
<td>INVESTECH BANK LTD Fitch National A(zaf)</td>
<td>1</td>
<td>27 117 000</td>
<td>3 212 303</td>
</tr>
<tr>
<td>METROPOLITAN LIFE Fitch National A(zaf)</td>
<td>1</td>
<td>58 950 000</td>
<td>7 939 504</td>
</tr>
<tr>
<td>SAPP SOUTHERN AFRICA PT Fitch National A(zaf)</td>
<td>1</td>
<td>117 900 000</td>
<td>2 323 809</td>
</tr>
<tr>
<td>ANGO AMERICAN FIN SA Moodys National A1.za</td>
<td>1</td>
<td>27 117 000</td>
<td>3 212 303</td>
</tr>
<tr>
<td>IMPERIAL GROUP PTY LTD Moodys National A2.za</td>
<td>1</td>
<td>176 850 000</td>
<td>9 475 269</td>
</tr>
<tr>
<td>NEDBANK LTD Moodys National A2.za</td>
<td>2</td>
<td>206 560 800</td>
<td>46 461 325</td>
</tr>
<tr>
<td><strong>South African Bonds listed offshore</strong></td>
<td></td>
<td>14</td>
<td>8 466 274 400</td>
</tr>
<tr>
<td>EDCON PROPRIETARY LTD Moodys B2</td>
<td>5</td>
<td>3 740 990 360</td>
<td>537 269 919</td>
</tr>
<tr>
<td>EDCON PROPRIETARY LTD Moodys Caal S&amp;P</td>
<td>3</td>
<td>383 785 560</td>
<td>29 363 833</td>
</tr>
<tr>
<td>EDCON HOLDINGS PROP LTD Moodys Caal S&amp;P CCC</td>
<td>2</td>
<td>1 525 456 800</td>
<td>146 226 168</td>
</tr>
<tr>
<td>FOODCORP LTD Moodys B2 S&amp;P B-</td>
<td>2</td>
<td>944 330 400</td>
<td>160 331 563</td>
</tr>
<tr>
<td>PEERMONT GLOBAL PTY LTD Moodys B3 S&amp;P B-</td>
<td>2</td>
<td>1 295 107 200</td>
<td>106 266 226</td>
</tr>
<tr>
<td>NEW RECLAMATION GROUP Moodys Ca2 S&amp;P CCC-</td>
<td>2</td>
<td>612 604 080</td>
<td>25 614 357</td>
</tr>
<tr>
<td><strong>Mauritius bonds listed offshore</strong></td>
<td></td>
<td>3</td>
<td>2 250 000 000</td>
</tr>
<tr>
<td>APP FINANCE VI MAURITIUS Moodys WR</td>
<td>1</td>
<td>1 250 000 000</td>
<td>665 000</td>
</tr>
<tr>
<td>APP FINANC VII MAURITIUS Moodys WR</td>
<td>2</td>
<td>1 000 000 000</td>
<td>4 765 000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>27</td>
<td></td>
</tr>
</tbody>
</table>

*please note that there is also bondholder information for Royal Caribbean bonds (8 bonds). Royal Caribbean is a Liberian domiciled company with bonds listed in New York. We have excluded these bonds from the bondholder analyses as we feel that the holders of these bonds would not be held by investors looking to take on African risk. Please note, that we have included this information in the master spreadsheet that is provided as a supplementary document to this project.*
It is important to note that this analysis is not exhaustive as the information in Bloomberg is limited (bond holder information only representing 10% of the total issue size). Based on this information, funds that hold investments greater than US$1 million are listed below:

- Metropolitan Income Plus Portfolio
- Nedbank Bond Fund
- Nedgroup Investments Optimal Income Fund
- Cadiz Collective Investment-Absolute Yield Fund
- Community Gilt Fund (managed by Old Mutual)
- Old Mutual Enhanced Income Fund
- Old Mutual Income Fund
- Stanlib Bond Fund
- Stanlib Income Fund
- Stanlib Multi-Manager Absolute Income Fund
- Stanlib Managed Flexible Fund
- Investec Absolute Income Fund
- Investec Opportunity Income Fund
- Momentum Diversified Yield Fund
- Momentum Maximum Income Fund
- Sanlam Absolute Return Income Fund
- Investment Solutions Income Fund
- Investment Solutions Pure Fixed Interest Fund
- Prudential Inflation Plus Fund
- Personal Trust Income Fund
- Allan Gray Balanced Fund

As can be seen, the list above is made up of the larger asset managers and institutions in South Africa. There is overlap between this list of funds as well as the funds that were identified during the interviews that were conducted.

It is also interesting to note that funds managed by BNP Paribas, Fortis and Swisscanto hold stakes in the Momentum Group Limited bond which is a LCY issuance.

We have also analysed the list of bond holders of South African sub-investment grade bonds which are listed offshore (FCY bonds). As before, it is important to note that the Bloomberg information is limited. We only have bondholder information for 12% of the bond’s total value. We have listed funds that have investments greater than US$10 million below:
AFRICAN HIGH YIELD CORPORATE BOND MARKET

- Franklin Templeton Investment Funds – Templeton Global Total Return
- Franklin Templeton Investment Funds – Templeton Emerging Markets Bond Fund
- Franklin Templeton Investment Funds – Templeton Emerging Markets Income Fund
- Sparinvest – High Yield Value Bonds
- Sparinvest Global Value
- Sparinvest High Yield Value Bonds UDB
- Alliance Bernstein – Global High Yield Portfolio
- Alliance Bernstein – High Income Fund
- Goldman Sachs Global Emerging Markets Debt
- Goldman Sachs Global High Yield Portfolio
- Goldman Sachs High Yield Fund
- Mellon Investment Funds ICVC – Newton Balanced Fund
- Mellon Investment Funds ICVC – Newton Real Return
- Legal & General High Income Trust
- Aberdeen Investment Services – Aberdeen Global – Euro High Yield Bond
- Blackrock Asset Management - iShares Markit IBOXX Euro High Yield Bond
- Swisscanto (CH) Institutional Bond fund – Global High Yield
- Petercam L-Bonds Higher Yield
- Artemis Strategic Bond Fund
- Pioneer Global High Yield Fund
- Pimco Global High Yield Bond Fund
- Pimco High Yield Spectrum Fund
- Picet-Euro Short Term High Yield

As can be seen from the above, most of these funds are managed by large global asset managers. Furthermore, it seems that the funds that invest in South African sub-investment grade FCY bonds do so as part of global (and in some cases, emerging market) focused funds. Accordingly, from this information it does seem that there are any funds which are purely focused on making high.

Finally, for the 3 bonds which are listed in Mauritius we obtained a list of the funds that have invested in these bonds. This analysis is very limited as there was only bondholder information in relation to 0.25% of these bonds. Nevertheless, we identified the following bonds using this analysis:

- Worldwide Investors – Emerging Markets Fixed Income
- Prudential Insurance Company of America
- UOB Optimix Asian Bond Funds
2.4.2  Exchanges where bonds are listed

We tried to supplement the above information by contacting 11 bond exchanges requesting information relating to the holders of the bonds listed on their respective exchanges. We requested bondholder information for the extended set of sub-investment grade bonds. This approach was not successful and we were advised by the various exchanges that they cannot release the information and suggested that we contact the respective companies individually in order to obtain this information.

2.4.3  Bond issuers

Accordingly, we have emailed 54 companies directly and we have requested details regarding their bondholders. These 54 companies have issued 104 bonds between them. We had tried to obtain contact details for 70 companies (representing 130 bonds) but we could not obtain contact email addresses or our emails were returned when we contacted these companies. The feedback that we have received thus far from the companies that we have contacted has not been positive. The companies that we have heard back from have stated that they do not track their bond holders or that they would not be prepared to share the bondholder information.

We have been successful in obtaining information in relation to bond holders from only one company which has bonds listed in Rwanda - Banque Commerciale du Rwanda. They have responding by stating that the holders of their bonds include 3 local insurance companies:

- Compagnie Rwandaise d'Assurances et de Réassurance
- Soras Group Limited
- Societe Nouvelle d'Assurances du Rwanda
- Rwanda Social Security Board which administers social security in Rwanda (equivalent of a national pension fund)
3 AFRICA TOP-DOWN ANALYSIS

3.1 Introduction & Methodology

The African Corporate bond market can be broken down into three distinct segments:

- South Africa, with a deep and established bond market (both FCY and LCY), a large and established investor base. The South African market has seen strong growth in HY Corporate bond issuance, with Investec analysts expecting the HY market to increase tenfold over the next five years (from a current ZAR1.5b per annum to a forecast ZAR15b in 2015) – largely in LCY issuance.

- Rest of Saharan African, where corporate bond activity has been mainly limited to Nigeria most recently, alongside Kenya and Botswana historically – currently only Botswana, Namibia and Mauritius have IG status amongst SSA nations, thus all corporate activity outside of these countries is HY by definition.

- North Africa: Led by Egypt these markets form a middle ground between the deeper South African market and newer SSA (ex-SA) market. Discussions with investors have indicated that North African debt is largely viewed as part of a MENA proposition and distinct from SSA. Additionally, recent and continued turmoil across the region have significantly limited investor demand for North African assets

For the purpose of this paper, we considered the development of the South African and Sub-Saharan African market only. We complemented desktop research with a total of 13 interviews with three specific segments of the bond market, specifically – interview notes from all participants will be made available:

- Debt Origination and Sales: Goldman Sachs, Standard Chartered Bank, Standard Bank, Investec, Rand Merchant Bank, Nedbank and one other international bank

- International Funds: Stone Harbor, Threadneedle and BlueBay

- South African Funds: Stanlib, FutureGrowth and Sanlam

Despite a growing appetite amongst investors for EM Corporate debt, Africa continues to lag the more established emerging markets of Asia and Latin America. Over a period of five years, through to the end of September 2011, Corporate Bond issuance across MEA (Middle East & Africa) contributed on average 2-3% of all emerging market issuance (c. $8-12b per annum) – See Figure 13. Across the continent, c.1500 bonds have been issued (both IG and HY) worth a
total of $120b as of September 2012. C.1,100 South African constitute the majority of all these issuances issued across the continent at 72% or $87b (Source Bloomberg). Corporates across the rest of Sub-Saharan African have issued a total of $15-19b of debt or 13-16% of the total – variability depends on inclusion or exclusion of American shipping companies issuing debt through Liberia due to tax incentives. Lastly North African corporate constitute the remaining $14b or 12% of total debt outstanding – see Figure 14 for a detailed breakdown.

Figure 13: Emerging market corporate bond issuance (USD Billions)

The HY component of the African market is estimated to be in the range of $35b (c.30%), with the South African market estimated at $13b outstanding (Bloomberg), and the rest of the continent contributing the remaining $22b, the bulk across Mauritius, Egypt, Morocco and Nigeria.

3.2 Overview of the SSA (EX-South Africa) corporate bond market

Outside of South Africa, Nigeria, Kenya and Botswana are the three largest issuers with a total of $1,737m, $733m and $396m of outstanding corporate debt respectively (both IG & HY in the case of Botswana). Looking forward Nigeria and Kenya are expected to continue to drive the SSA Corporate Bond market.
AFRICAN HIGH YIELD CORPORATE BOND MARKET

Figure 14: Total African corporate bonds, 2012 (USD Billions)

<table>
<thead>
<tr>
<th>All Corporate Bonds - by country</th>
<th>Amount issued (USDm)</th>
<th>% of total issuance</th>
<th># of bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALGERIA</td>
<td>435</td>
<td>0.4%</td>
<td>7</td>
</tr>
<tr>
<td>BENIN</td>
<td>11</td>
<td>0.0%</td>
<td>1</td>
</tr>
<tr>
<td>BOTSWANA</td>
<td>396</td>
<td>0.3%</td>
<td>30</td>
</tr>
<tr>
<td>BURKINA FASO</td>
<td>30</td>
<td>0.0%</td>
<td>2</td>
</tr>
<tr>
<td>EGYPT</td>
<td>5,567</td>
<td>4.6%</td>
<td>97</td>
</tr>
<tr>
<td>GHANA</td>
<td>25</td>
<td>0.0%</td>
<td>1</td>
</tr>
<tr>
<td>KENYA</td>
<td>733</td>
<td>0.6%</td>
<td>18</td>
</tr>
<tr>
<td>LIBERIA</td>
<td>4,676</td>
<td>3.9%</td>
<td>12</td>
</tr>
<tr>
<td>MAURITIUS</td>
<td>11,164</td>
<td>9.3%</td>
<td>41</td>
</tr>
<tr>
<td>MOROCCO</td>
<td>7,234</td>
<td>6.0%</td>
<td>116</td>
</tr>
<tr>
<td>MOZAMBIQUE</td>
<td>3</td>
<td>0.0%</td>
<td>1</td>
</tr>
<tr>
<td>NAMIBIA</td>
<td>321</td>
<td>0.3%</td>
<td>19</td>
</tr>
<tr>
<td>NIGERIA</td>
<td>1,737</td>
<td>1.4%</td>
<td>8</td>
</tr>
<tr>
<td>RWANDA</td>
<td>6</td>
<td>0.0%</td>
<td>1</td>
</tr>
<tr>
<td>SOUTH AFRICA</td>
<td>86,898</td>
<td>72.2%</td>
<td>1,127</td>
</tr>
<tr>
<td>SWAZILAND</td>
<td>9</td>
<td>0.0%</td>
<td>2</td>
</tr>
<tr>
<td>TANZANIA</td>
<td>9</td>
<td>0.0%</td>
<td>4</td>
</tr>
<tr>
<td>TUNISIA</td>
<td>934</td>
<td>0.8%</td>
<td>80</td>
</tr>
<tr>
<td>UGANDA</td>
<td>20</td>
<td>0.0%</td>
<td>3</td>
</tr>
<tr>
<td>ZAMBIA</td>
<td>20</td>
<td>0.0%</td>
<td>2</td>
</tr>
<tr>
<td>ZIMBABWE</td>
<td>50</td>
<td>0.0%</td>
<td>1</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>120,277</strong></td>
<td><strong>100%</strong></td>
<td><strong>1,573</strong></td>
</tr>
</tbody>
</table>

| SOUTH AFRICA                     | 86,898               | 72%                 | **1,127**  |
| SSA (EXC. SA)                    | 19,211               | 16%                 | **146**    |
| NORTH AFRICA                     | 14,169               | 12%                 | **300**    |

* Liberia issuance attributable to US shipping co. not underlying corporate demand

Source: Bloomberg.

3.2.1 Nigeria

**Market Considerations:** Five years is the “sweet-spot” in terms of tenor and the most liquid part of the long-end of the curve. Seven years is less liquid (particularly as the sovereign has not been issuing 7 year bonds for some time) but there could be a case to tranche issuance across different maturities if the funding requirements are sufficiently large. Indicative pricing is in the range of 14.5%-17.5%, with a maximum facility size of up to $100m. Outside of South Africa, Nigeria has been the most active market in SSA on both the LCY and FCY side. FCY issuance has been limited to banks, oil-sector corporates and the sovereign. Recent issues include GT Bank this year and Afren, a Nigerian Oil company, who placed one of the first foreign currency bonds in the market in 2011, and followed it up with a $300m placement in 2012 that was 13x
AFRICAN HIGH YIELD CORPORATE BOND MARKET

oversubscribed – to appeal to international investors the bond was listed in Luxembourg with the required RegS and 144A documentation.

The corporate LCY market is limited to local banks and pension funds, although investor demand is muted, local regulation limits foreign investors from accessing the market. Liquidity in the market is almost non-existent with most investors holding to maturity. See African LCY issuance PPT for a full breakdown of current Nigerian corporate bonds outstanding.

Looking forward: Strong growth on the LCY issuance side is expected in Nigeria, with interest rates expected to stabilize and exchange rates expected to hold flat with the dollar (c 161-163 NGN/USD). Nigeria is likely to join the JP Morgan Government Bond Index – Emerging Markets (GBI-EM) Government Bond Index-Emerging Markets towards the end of this year, early 2013. This is likely to drive a significant inflow of funds to the sovereign bonds, and increase investor acceptance of Nigerian paper. Key hurdle however, as with most countries outside of South Africa, is accounting and governance standards across the corporates who are looking to come to the market. Despite this the government continues to try and deepen the LCY bond market and in April 2012, NASD limited, who operate the Nigeria OTC platform, announced that they have shortlisted 3 vendors to develop an electronic trading platform by the end of 2012 / first quarter of 2013.

3.2.2 Kenya

Market Considerations: There is a preference for fixed issues as the market is liquidity driven. The market tends to be quite selective with a great focus is on the quality of the credit. Local Asset Managers tend to prefer longer tenors (can consider 5 to 10 years). When investing in this market, considerations need to be given to the approval of the Capital Markets Authority and NSE requirements. The market is significantly influenced by local funds managers and banks – largely due to the small size of the banking and investor community. Currently, the local market is awash with excess liquidity but despite this we are seeing rates tick up due to inflationary pressures. Import duty for wheat and maize for private millers have been removed to quell inflationary pressures. Government has attempted to issue a FCY sovereign bond since 2008, but without success thus far. 2010 saw the Kenyan government introduce an automated trading to support the corporate bond market (initially with 10 corporate bonds listed), reducing processing and settlement from seven to three days.
It seems that the preferred tenor is 3-7 years for local issuance in LCY, (although as highlighted up to 10 can be considered) The current reference rate is the 364 days T-bill (6.93%), with average spread in the range of 100-350bps over. Maximum facility size in the market is c. $90-330m thus far. The market is largely illiquid with most investors holding bonds through to maturity.

Looking forward: There has been limited bond issuance from Kenyan corporates due to high interest rates (combat inflationary environment), which has resulted in a lack of demand for bonds. There has only been one issuance over the last two years (Shelter Afrique). Action on behalf of the central bank seems to have gone some way to quell inflationary environment, and bankers expect a more robust issuance market from 2013 onwards. Local demand for corporate bonds remains healthy, with most local asset manager’s dedicating c.60% of AuM to fixed income. Bankers expect limited interest in the LCY Corporate bond market from International investors, partially due to risk appetite; lack of documentation at levels preferred by the international investor base (e.g. RegS and Rule 144a); and an continued weakening of the currency from 92 KES/USD to 104 KES/USD through to 2014. Interviewees expect the market to remain a key market outside of South Africa and the largest market in East Africa. A number noted that on average banks in the region continue to aggressively expand their loan book, with rates on bank debt often more competitive than the bond market, and requiring less disclosure, this is likely to somewhat mute bond issuance in the short-to-medium term. – see African LCY issuance PPT for a full breakdown of current Kenyan corporate bonds outstanding.

3.2.3 Botswana

Market considerations: The market preference is for floating rate issues. Banks do not usually hold corporate bonds on their books, hence it is probable that the issue will be marketed to the 6 major Asset Managers / Pension funds in the market. Investor preference is for bond proceeds to be utilized locally in the Botswana economy.

Rates have been on a downward spiral and general expectation is that this trend is almost played out and upward revisions should not be surprising. Last week the MPC left rates unchanged at 10% and spoke of a positive medium term inflation outlook. This was largely expected since BOB normally tracks South Africa and there are no expectations that rates will be cut at the next MPC there either. Reserve requirements on local deposits were however raised 150 bps to 6.50%. This is expected to bring a slight amount of tightness in to the market
AFRICAN HIGH YIELD CORPORATE BOND MARKET

– current reference rate is 91-day Bank of Botswana Certificates (BoBC) at c.6.97%. Preferred tenor in the market is 3-5 years, with less illiquidity towards the end of the range. Indicative pricing is in the range of 250-300bps over BoBC, with a maximum facility size of USD20-30m in the market.

**Looking forward:** Botswana saw two placements in 2011 (Standard Chartered Bank), and none thus far in 2012. Expectations are for a continued steady stream of issuance from a select group of banks and parastatals (e.g. Botswana Building Society, Botswana Vaccine Institute and the Water Utilities Corporation). Stable country ratings and a flat currency expectations (versus the USD) will continue to drive yields significantly below African peers - current coupons in the 8-9% range – see African LCY issuance PPT for a full breakdown of current Botswana corporate bonds outstanding. Finally, the Local stock exchange is in the process developing an electronic trading system to standardise pricing alongside a local bond index.

### 3.2.4 Others

#### 3.2.4.1 Ghana:

An expanding economy and recent oil finds are expected to position Ghana to become a more established player in the corporate bond market, specifically to finance increased infrastructure requirements. Historically, issuance has been limited to large state owned entities (e.g. Ghana Cocoa Board), although expectations are that private enterprises involved in the development of Harbours, Roads, Airports, etc. will look to tap the debt market over the next 2-3 years. Reforms and government actions are further bolstering the emerging debt market with the Ghanaian government having recently issued a 5 year note for benchmark purposes. Additionally, the government is looking to reform the local pension industry, from largely a monopoly (SSNIT), towards an increased number of asset managers each managing a portion of state funds. This is expected to increase liquidity and thus the viability of the local debt market.

Yields have already risen on the back of increased supply in the secondary market. A significant arbitrage between the bank lending (c. 22% p.a.) and a note issued as a FRN off the 182-day T-bill (c. 12% + spread) is likely to drive corporates towards the debt markets as a cheaper funding source. Indicative spread for corporates on LCY debt is in the range of 15-17% fixed, with a maximum facility of c.$30m in the market. Finally, limited depreciation of the local currency is expected (from 1.68 GHS/USD to 1.80 GHS/USD through to 2014) making offshore markets a
viable alternative as well for more established corporates (although likely to be only a pool of 2-4 names).

3.2.4.2 Uganda:
Currently, there has been limited issuance from Ugandan corporates, on the back of high interest rates to curb inflation, which hit an 18 year high in August at 28.3% (similar to Kenya), although interest rates are expected to ease back towards the second half of 2013, making the bond market a more attractive alternative for corporates. Assuming stabilization of the inflationary environment, economists are forecasting a slight appreciation of the local currency of c. 10-15% over the next 4 years - from 2,600 UGX/USD to 2,300 UGX/USD through to 2014. The Ugandan market is unique in that it does not allow any private placement of debt – all bond issuance needs to be listed – this partially limits the attractiveness of the local debt markets, as corporates are then required to provide an additional level of disclosure. Looking forward, bankers expect the market to recover and the debt markets to largely consist of bank and supra-national debt, with the odd high quality corporate name (likely to be on the back of financing infrastructure to realize recent oil finds).

3.2.4.3 TANZANIA and ZAMBIA:
Both countries have established benchmark government bond spreads that stretch out 15 years (Zambia) and 10 years (Tanzania). Corporate issuance in both markets has been almost non-existent over the last 2-3 years. However, the recent strong issuance of Zambian government debt is likely to increase investor awareness to Zambian debt and establish strong benchmark rates for corporates to issue against. A stable USD outlook for Zambia and slight deprecation for Tanzania (c. 5%) is likely to increase investor acceptance for some of the higher quality names in these countries. Indicative pricing in these markets is competitive with bank debt at 16-18% (or 200-400bps above reference rate) for 5 year fixed debt in Tanzania; and 16.5-18% (or 300-450bps above reference rates) for similar 5 years fixed debt in Zambia.

3.2.5 Hurdles to the development of the bond market across rest of Africa
All interviewees were positive about the development of Africa debt markets, however most pointed to a significant amount of hurdles that stood in the way of a market that was truly an alternative source to traditional bank funding, key amongst these were:
• Benchmark Yields: A number of countries (e.g. Ghana) have yield curves that cover 5 years or less significantly limiting the ability for corporate to issue debt

• Costs: Corporate coupons are often higher than bank funding once all costs have been included

• Size: Difficult for large international investors to consider tickets sizes below $50-100m limiting the available investor pool for corporate bonds

• Marketing: Significant investment required in internal controls and marketing prior to being able to issue debt into the market

• Regulators: In a number of countries regulatory hurdles can take a significant period of time to address, thus limiting the viability of bonds as an alternative financing source

• Disclosure: Bank debt reduces the level of disclosure required by corporates

• High Fees: Even in larger markets (e.g. Kenya), fees have been in the range of 3-4% for corporates versus 1-2% for bank loans. Nigeria has seen corp. bond fees in the range of 5-6%

• Secondary market Fees: Secondary market activities tend to be costly (Nigeria fees were 3.75% of notional as recently as 2006-7 for secondary trading)

3.3 Insights on the South African sub-investment grade corporate bond market

The South African market has seen a significant increase in the level of HY issuance coming to the market, with Investec analysts highlighting an expected growth in the market of over ten-fold over the by 2015 to $15b – such growth would significantly outpace the continent, and drive South Africa from a current estimated market share of c.70% to 85-90% of the overall market. Increase in supply is best demonstrated by a ZAR750m issuance in late 2010 by BrandCorp and more recently (July 2012) the ZAR1.6b issuance by Idwala Industrial holdings (Ethos backed), the largest HY issuance ever in the African market. In short, any African focused fund active in this area will need to ensure it is able to compete in South Africa in order to attract Western investors.

3.3.1 Current market environment

Currently, there is significant demand in the local market for sub-investment grade issuance. This demand has compressed yield quite significantly thus far. For example a recent listing by Idwala priced 4-year debt at 380-390bps over JIBAR, comparatively bank funding was available
in the market for c. 400bps over JIBAR for the same tenor. Some of the smaller funds (e.g. FutureGrowth) view the current pricing as not being reflective of the underlying credit risk, and have opted instead to focus on smaller private placement issues where they are able to negotiate rates more effectively. As with the two examples above, a significant amount of the volume is being by sponsor-led deals, with local bankers seeing a long list of first and second tier Private Equity shops turning to the bond market as a means to partially take some cash off the table given limited IPO environment. Gearing expectations in the market remain more conservative than international standards with c 3.5-4.0x seen as acceptable. Expectations are that the development of bank + debt market structures will allow c. ZAR4b+ issuances or more in the near future.

3.3.2 LCY versus FCY issuance

Historically South African corporates have provided the majority of African hard currency issues. Although industry experts continue to see South African corporates tap the international bond market, they believe that the majority of growth is likely to come from LCY issuances. FCY issuances are likely to continue from corporates with a history of placing hard currency debt (e.g. Anglo American, Old Mutual, SA Banks), or selective cases where issuance value is greater than the local South African market is able to absorb (currently industry experts believe that ZAR1.5-2.0b would be the largest transaction that could be placed locally). Finally, the one-side nature of the ZAR-USD exchange makes cross-currency swaps expensive, and thus limits the attractiveness of foreign funding for corporates with ZAR expenses.

3.3.3 Market Liquidity

A preference for liquidity was mentioned a number of time through interviews, with funds highlighting that the majority of global investors are moving towards requiring more – rather than less – liquidity. In contrast to this requirement all investors interviewed in the South African HY Corporate bond space noted that the majority – if not all – of their portfolio was held to maturity. A typical fund would review their bond portfolio on an annual basis, with some expectation that they would be able to trade out of undesirable bonds over the course of a year. Assuming nothing was wrong with the actual credit, funds would need to identify a buyer in the secondary market, with both buyer and seller running their own internal process prior to conclusion of any sale – in the HY market it is likely that such a process would take a
least a month. In terms of the offshore market, there exists significantly more liquidity, and asset managers would make use of an investment bank to offload any paper. However fees are significant (c. 1-2%) which limits the amount of turns on corporate paper.

In almost all cases, investors preferred bonds which were listed, despite the lack of liquidity as it at least made the process of any sales simpler, and provided increased transparency of current market prices. The listing of corporate bonds is likely to become market norm should laws be passed that exempt withholding tax only on listed instruments versus private placements. Finally, investors highlighted that a significant hurdle to both the development and the liquidity of the HY Corporate bond market was the lack of standardized docs. Experts highlighted that the market norm was to start with IG documentation and adjust to reflect the HY nature of the corporate. This delayed the time that corporates took to come to market, and the time to conclude secondary sales. SECA (The Stock Exchanges Control Act), is currently attempting to standardise terms across the HY bond market – the aim is for this to establish a broad understanding amongst banks on market norms for legal docs (although unlikely to enter legislation).

3.4 Insight on the investor base

There are a number of investors who are active in the African debt market. Currently, none except perhaps Investec Asset management, offer an exclusively pan-Africa HY Corporate Debt fund. For the purpose of segmenting these competitors we have broken them into three segments, namely:

- **South African Funds:** South African based funds that focus almost exclusively on LCY, and are active in the HY Corporate debt space, and to a very limited degree FCY HY Corporate debt

- **Rest of African Funds:** Real Money Funds (Pension, life insurance, Asset managers) based in Africa, who invest solely in HY Corporate bond issuance in their resident country, exclusively in LCY. Across most of the African market, banks will also be active investors in Corporate debt, and are counted in this segment

- **FCY focused International Funds:** Western funds split into either niche EM specific funds (e.g. BlueBay, Ashmore, etc) or large global asset managers that will invest a very small portion (c.1-3%) of global HY funds into predominantly South African debt.
3.4.1 South African funds

The South African market is highly concentrated with only 4-6 funds very active in the LCY HY space, and perhaps a further 4 smaller funds which would selectively consider LCY HY Debt. As such, despite bonds being listed the market largely works on a private placement basis. One expert interviewed highlighted that they are beginning to see smaller funds (largely family office type vehicles) selectively acquire HY corporate debt, but that thus far it has largely been the exception rather than the rule. Within South Africa seven funds have been highlighted as active or likely participants in the LCY HY Market – with Investec and OM being the most active players (i.e. able to write tickets in excess of ZAR500m, versus most investors targeting ZAR50-150m). The majority of these funds are open-ended funds investing solely in ZAR.

- Investec: Investec Asset Management has very strong demand for high yield bonds (and are the market leader in terms of acquiring and understanding LCY debt). Investec will consider each name as presented, but would generally stay away from the mining sector. They are willing to take tenors up to 7-years and are willing to underwrite bonds

- Old Mutual Special Situations: OM has funds available to invest in high yield and generally seek an above average yield i.e. >600 bps. Are active investors who are willing to restructure current loans and switch their exposure into the bond

- Sanlam Capital Markets: SCM are becoming increasingly active in the high yield market, and are willing to consider ticket sizes of up to ZAR150m, with target returns of over 400bps on sub-investment grade paper. Only focused on the South African market for HY, but are willing to consider any credit within the market

- RMB Asset Management: RMBAM are starting to show interest in the HY Market, although generally focusing on smaller tickets sizes (up to ZAR 50m)

- Future Growth: Offer a high yielding fund (HY Enhanced Geared BB STeFI+ Composite), which consists of funds with an average rating of BB+. Funds are usually acquired on a private placement basis, where greater flexibility on terms can be negotiated

- Cadiz: Starting to consider HY bonds, and looking to raise a fund focused on HY credit

- Coronation: Thus far have shown some willingness to invest in the HY segment, and are considering individual bonds on merit
Although fees vary significantly, interviews have highlighted an average of 2% management fee, with some form of inventive fee based on beating a specific hurdle rate. Interviews revealed that these funds have done relatively well (e.g., Investec Asset management has had returns well in excess of 10%) especially as the credit quality of South African corporates has held up quite well.

### 3.4.2 Rest of Africa funds

Across the rest of the continent (e.g., Nigeria, Kenya, Botswana, etc) the majority of the investor base in LCY debt are the local real money funds. Whilst relatively small, these funds are well positioned to understand the credit risk of individual corporates and have no exposure to the currency risk. Regulations are underway (e.g., Ghana) to increase the competitiveness and size (e.g., Nigeria) of this segment and it is expected that the investors will continue to provide the bulk of the investor base. All interviewees stressed that these players acquire the vast majority of any LCY issuance, and are almost exclusively “buy to hold” investors.

### 3.4.3 FCY focused international funds

Investors in the FCY HY bond issuances have been significantly more diverse (please see earlier section for full list from selected bonds). These funds can be broken into two specific segments.

**Large global full mandate funds:** Specifically these refer to funds such as Pimco, Franklin Templeton, Blackrock, Mellon, Aberdeen, etc. These funds will selectively acquire FCY debt from South African corporates as part of a global fund, e.g., Global HY funds, EM HY funds or EM Corporate funds. In all these cases, exposure to South African names is likely to be only a small part of their the overall fund (c. 1-3%) and acquired on an opportunistic basis.

**Niche international funds:** A number of “Western” funds have started to target EM HY FCY Corporate debt on a global allocation basis. In most cases these funds have only a small percentage of global allocation invested in African corporates and in these cases predominantly South African. Good examples of these funds include:

AFRICAN HIGH YIELD CORPORATE BOND MARKET

- Van Eck (Market Vectors) EM High Yield Corporate Debt ETF: Emphasis is on USD-denominated corporate debt, which now accounts for over 10% of the global high-yield corporate bond market
- iShares Emerging Markets High Yield Bond Fund (EM Corp Bond Fund): Both bonds have sub-investment grade bond allocation (although only a minority) on a global basis
- Bluebay Emerging Market High Yield Corporate Bond Fund: The Fund invests at least 2/3 of its assets in fixed-income securities rated below investment grade by issuers domiciled within an EM Country (http://www.bloomberg.com/quote/BEMHCIE:LX)
- Morning Star EM High Yield: The Morningstar Emerging Markets High Yield Bond Index includes below-investment-grade corporate and sovereign bonds issued in US Dollars (USD) by corporations and governments of emerging markets

Across these funds, the focus thus far has been almost exclusively on FCY issuance thus far, as western funds have been hesitant to gain exposure to the currency risk, and limited liquidity associated with LCY issuances. Within these funds, all are currently structured as open-ended funds with an management fee in the range of 80bps-125bps. Various interviewees stressed the need for liquidity as a pre-requisite to gaining investment from traditional western investors (e.g. pension funds, asset managers, insurers).

Ashmore was highlighted in a number of interviews as the leader in this market, and the likely benefactor of any shift towards EM debt by western investors. Importantly, they also seem to lead the way in product development, and have reportedly recently establishing a close-ended LCY HY EM Fund – although initial focus is largely going to be on Asian and LatAm LCY HY debt.

3.4.4 LCY focused international funds

Lastly, the smaller set of investors, are the international hedge funds and boutique investment houses that focus on acquiring corporate debt across the continent. Increasingly Private Equity houses in Africa are looking at establishing credit desks to take advantage of their on the ground presence and access to international investors in an attempt to tap this market. Some notable examples are:
AFRICAN HIGH YIELD CORPORATE BOND MARKET

- Helios: Looking to establish an Africa focused credit desk, which will target pan-African HY debt. Likely to provide a compelling option to their investor base which is already comfortable with the fund and their understanding of the African market
- Nubuke: Multi-asset Africa only fund, limited information but likely to be active on the LCY debt side across the continent
- Exotic: Strong African focused investor targeting illiquid and distressed bonds
- Renaissance Asset Management: Russian based asset manager / investment bank with operations across Africa. Likely to consider HY Corporate debt on an opportunistic basis

3.5 Looking forward and conclusions

Looking forward there remain a number of hurdles that stand in the way of a significantly deeper African corporate bond market (ex-South Africa), however, all interviewees expect the market to continue to grow over the next 3-5 years. Amongst interviewees most expected corporate to tap the LCY markets, with only the resource, infrastructure and banking sector looking to tap the FCY markets, Importantly the introduction of Basel III is expected to decrease the ability of banks across the continent to under-price bonds by a significant margin – and should lead to further development of the bond market across the continent.

South Africa has already started to see the development of LCY HY Corporate funds focused exclusively on the local market, with Investec starting to look to the rest of Africa for potential corporate bond issuance. Opportunity exists for a fund in the LCY space that is able to understand the credit risk behind various corporates (as most bonds are un-rated), and offer exposure to more risk seeking investors (i.e. HNW, Private Banking and potentially Sovereign Wealth Funds).
4 LATIN AMERICA

4.1 Development of corporate bond market: 1990s - 2004

Latin American (LatAm) countries have made some progress in the development of bond markets over the course of the last 15 years, however the region’s bond markets remain small compared to international standards, particularly the corporate bonds.

Figure 15: Corporate bonds as a % of GDP

![Graph showing corporate bonds as a % of GDP over time for various countries including Argentina, Brazil, Chile, Colombia, Mexico, and Uruguay. The x-axis represents years from 1990 to 2004, and the y-axis represents the percentage of GDP. The graph indicates fluctuations over time, with peaks and troughs for each country.]

Source: Eduardo Borensztein et al. 2008

Figure 16: State of bond markets in 2004

<table>
<thead>
<tr>
<th></th>
<th>Developed economies</th>
<th>East Asia</th>
<th>Latin America</th>
<th>Other emerging markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds issued as percent of GDP:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>70.9</td>
<td>22.0</td>
<td>9.0</td>
<td>3.9</td>
</tr>
<tr>
<td>Financial</td>
<td>44.6</td>
<td>11.8</td>
<td>4.8</td>
<td>2.6</td>
</tr>
<tr>
<td>Corporate</td>
<td>26.3</td>
<td>10.2</td>
<td>4.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Government</td>
<td>59.6</td>
<td>29.3</td>
<td>22.3</td>
<td>47.1</td>
</tr>
<tr>
<td>Total</td>
<td>130.5</td>
<td>51.3</td>
<td>31.3</td>
<td>50.9</td>
</tr>
</tbody>
</table>

Source: Eduardo Borensztein et al. 2008, calculations based on BIS and Dealogic Data

In addition, a comparatively low share of both government and corporate bonds is made up of long-duration, local-currency, fixed interest debt instruments, despite notable progress in a number of countries.
All countries except Chile had no corporate bond market in the early 1990s, although regulatory reforms allowing or fostering corporate bond issuance had been carried out during the 1970s and 1980s. During the 1990s, the development of the corporate bond market in the six countries followed different paths:

**Argentina**

Issuance began in 1991 and continued until the 1998 recession, following the reduction of inflation and a tax reform that levelled the playing field between bank and bond finance.

**Brazil**

Brazil is one of two countries where the corporate bond market grew the fastest (the other being Chile). In Brazil, growth was concentrated in the years that followed the reduction in inflation brought about by the Real Plan. Starting from less than 1% of GDP in 1990, the stock of corporate bonds reached 10% of GDP by 1994 and then remained stable at that level until 2004. However whilst local currency corporate bonds exist in Brazil, the market is not very deep.
Chile
Chile has enjoyed relative macroeconomic stability since the mid-1980s, and not surprisingly its corporate bond markets were the earliest to develop, reaching 5% of GDP by 1990—below developed country standards but substantially higher than other LatAm countries.
In Chile, the corporate bond market started expanding after 1998; this recent growth was due to factors affecting both the demand and supply of corporate bonds:
On the supply side, the two contributing factors were:
- Central Bank’s defence of the peso exchange rate in the aftermath of the Russian crisis in 1998 led to a sharp increase in short-term rates and a credit crunch, which increased the attractiveness of long-term, non-bank finance and encouraged borrowers to turn to the bond market
- Financial requirements of the large private infrastructure programs that were undertaken in the 1990s
On the demand side, placement of these bonds was facilitated by large local institutional investors who were forced by regulation to buy domestic assets and, in an environment of decreasing public debt, needed to find alternatives to their traditional strategy of investing most of their assets in government bonds.

Colombia
Colombia is the outlier as its corporate bond market experienced almost no growth over the period 1990s to 2004. The key reason cited by analysts is the crowding out by increasing public debt which played a key role in stunting demand for corporate bonds.

Mexico
Although the market for Mexican bonds grew continuously (if slowly) during the 1990s, that new regulations approved in 2001, especially the creation of a new flexible debt instrument (the certificados bursa´tiles) and improvement in corporate governance laws, stimulated growth in bond issuance in recent years.

Uruguay
The Uruguayan market had a brief renaissance following the enactment of the Securities Market Law in 1996, but financial scandals that erupted in 1998 halted issuance of new bonds. Lack of transparency and poor corporate governance are two of the key obstacles to the development of the Uruguayan corporate bond market.
4.2 Development of corporate bond market: 2007 – 2012

The LatAM corporate bond market grew outstandingly from 2007 to 2011 by a CAGR of 186%. This was largely due to large bond issuances by Brazil and Mexico in 2009 and 2010.

Figure 18: LatAM Corporate Bond Issuance (USD and Local Currency)

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Corporate Bonds (USD Billion)</td>
<td>15</td>
<td>17</td>
<td>72</td>
<td>164</td>
<td>179</td>
<td></td>
</tr>
<tr>
<td>Growth</td>
<td>12%</td>
<td>337%</td>
<td>126%</td>
<td>9%</td>
<td>186%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg, October 2012

The LatAM High Yield bond market grew by a CAGR of 192% between 2007 and 2011 and represented on average 20% of the total corporate bond issuance during that period.

Figure 19: LatAM High Yield vs. Investment Grade Corporate Bond Issuance (USD and Local Currency)

Source: Bloomberg, High yield bonds include only those that have a rating, October 2012
4.3 Factors contributing to development of corporate bond markets

The development of a well-functioning corporate and government bond market depends on key support systems being in place including: extensive infrastructure, payment and settlement systems, rating agencies and networks of brokers to sell the bonds, network of bond buyers. For corporate bond it also: requires rigorous disclosure standards and effective governance of corporations issuing publicly traded debt securities along with well-developed accounting, legal, and regulatory systems. These conditions take time to develop and are by-products of the larger process of economic and financial development.

A summary of the key factors contributing to the growth of the corporate bond market in LatAm including:

- On the positive side: macroeconomic stabilization and the privatization of pension systems have played an important role in the development of domestic bond markets.
- On the negative side: inflation fears, default episodes, corporate scandals, and the relatively small number of large firms (in the case of corporate bonds) are among the main obstacles to the development of the Latin American bond markets.
- Regulatory restrictions and regulatory reforms are also found to be important for hindering or promoting corporate bond financing. Of particular interest are the development of the flexible certificados bursátiles in Mexico and the deferred payment checks in Argentina as tradable debt instruments as discussed above.

4.4 Current corporate bond market characteristics

- The Latin American USD (hard currency) corporate bond market is one of the largest amongst the Emerging Markets (EM), totalling c. USD280bn at the end of 2011; in line with Asia with c. USD295bn and 14 times the size of Africa’s corporate bond market at USD20bn.
- Approx. 36% of all outstanding LatAm USD (hard currency) corporate debt is sub-investment grade (high yield) compared with 26% for Asia and 45% for Africa.
AFRICAN HIGH YIELD CORPORATE BOND MARKET

Figure 20: EM USD corporate bonds outstanding by region at the end of 2011 ($ millions)

Source: ING, Gramercy July 2012

- The local currency bond market has grown over the last 15 years as many LatAm corporations have shifted from syndicated loans to bonds, however remains a very small part of the overall corporate bond market

Figure 21: Local currency corporate bonds outstanding as of May 2012 ($ billions)

<table>
<thead>
<tr>
<th>Local Currency Issues</th>
<th>Amount ($)</th>
<th>% of Total Corporate Bond Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>$105.9</td>
<td>3.7%</td>
</tr>
<tr>
<td>Mexico</td>
<td>$42.7</td>
<td>1.5%</td>
</tr>
<tr>
<td>Chile</td>
<td>$9.0</td>
<td>0.3%</td>
</tr>
<tr>
<td>Colombia</td>
<td>$7.5</td>
<td>0.3%</td>
</tr>
</tbody>
</table>

Source: Barclays

- Nominal, fixed-rate debt is still rare
- Chile has issued most of its debt in a unit indexed to inflation; Brazil and Colombia tend to issue debt indexed to the interest rate; Argentina and Uruguay issue debt indexed to the dollar
- Larger firms substitute domestic bonds for bank credit, and the largest firms also rely on offshore bond issuance
- In most countries the firms that are most likely to issue bonds are large companies: with more tangible assets, higher profitability, and greater-than-average leverage
- Additionally the significant fixed costs (disclosure costs, underwriting fees) of bond issuance prevents smaller firms from issuing bonds
AFRICAN HIGH YIELD CORPORATE BOND MARKET

- Another commonly cited obstacle to bond issuance is market size, which finds that country size is one of the few variables that have a significant and robust correlation with the size of the corporate bond market.
- Additionally, investors agree that a yield curve is a crucial element for pricing corporate bonds, a key developmental function of government bond debt. Thus growth in the government bond market is critical to the corporate bond market.

4.5 Recent trends in corporate debt markets

4.5.1 Funds flow

LatAm emerging market bond funds have seen a net increase in funds flow of US$54bn over the 12 months to July 2012, bringing the total assets under management (AUM) by such funds to US$617bn. This is 6x the total AUM handled by LatAm equity funds and is over half of the total AUM for all mutual funds as shown below:

Figure 22: LatAm Mutual Fund Industry – Flows by asset class / Investment ($ billions)

<table>
<thead>
<tr>
<th>Top 10 Categories</th>
<th>7/12</th>
<th>6/12</th>
<th>5/12</th>
<th>4/12</th>
<th>3/12</th>
<th>2/12</th>
<th>1/12</th>
<th>12'11</th>
<th>11/11</th>
<th>10/11</th>
<th>9/11</th>
<th>8/11</th>
<th>7/12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond Emerging Markets</td>
<td>-1,014</td>
<td>3,811</td>
<td>1,380</td>
<td>4,014</td>
<td>12,242</td>
<td>7,284</td>
<td>8,235</td>
<td>-7,776</td>
<td>11,772</td>
<td>1,117</td>
<td>12,182</td>
<td>680</td>
<td>53,926</td>
</tr>
<tr>
<td>Money Market</td>
<td>-2,669</td>
<td>2,114</td>
<td>-3,221</td>
<td>4,142</td>
<td>2,855</td>
<td>2,351</td>
<td>2,120</td>
<td>508</td>
<td>-2,138</td>
<td>1,799</td>
<td>3,650</td>
<td>-4,769</td>
<td>6,723</td>
</tr>
<tr>
<td>Mixed Flexible</td>
<td>-1,791</td>
<td>1,973</td>
<td>1,524</td>
<td>109</td>
<td>4,685</td>
<td>1,668</td>
<td>1,118</td>
<td>2,760</td>
<td>1,013</td>
<td>-1,073</td>
<td>4,343</td>
<td>-2,351</td>
<td>14,046</td>
</tr>
<tr>
<td>Equity Emerging Markets</td>
<td>-335</td>
<td>2,190</td>
<td>2,873</td>
<td>2,204</td>
<td>941</td>
<td>333</td>
<td>-357</td>
<td>99</td>
<td>-6</td>
<td>-245</td>
<td>-267</td>
<td>245</td>
<td>7,674</td>
</tr>
<tr>
<td>Other Emerging Markets</td>
<td>-1,851</td>
<td>-1,361</td>
<td>-2,559</td>
<td>-4,726</td>
<td>3,209</td>
<td>1,257</td>
<td>3,137</td>
<td>5,548</td>
<td>4,742</td>
<td>-1,296</td>
<td>-8,386</td>
<td>498</td>
<td>-1,788</td>
</tr>
<tr>
<td>Mixed Conservative</td>
<td>-1,071</td>
<td>-1,828</td>
<td>-3,559</td>
<td>-1,741</td>
<td>1,507</td>
<td>-1,077</td>
<td>440</td>
<td>882</td>
<td>-1,405</td>
<td>-1,831</td>
<td>-1,019</td>
<td>-692</td>
<td>-11,592</td>
</tr>
<tr>
<td>Mixed Aggressive</td>
<td>-59</td>
<td>35</td>
<td>-179</td>
<td>-30</td>
<td>-5</td>
<td>184</td>
<td>156</td>
<td>129</td>
<td>480</td>
<td>-21</td>
<td>535</td>
<td>385</td>
<td>1,659</td>
</tr>
<tr>
<td>Guaranteed/Protected</td>
<td>24</td>
<td>120</td>
<td>-34</td>
<td>42</td>
<td>-528</td>
<td>47</td>
<td>-78</td>
<td>-165</td>
<td>149</td>
<td>-160</td>
<td>-51</td>
<td>-288</td>
<td>-924</td>
</tr>
<tr>
<td>Mixed Balanced</td>
<td>74</td>
<td>108</td>
<td>41</td>
<td>0</td>
<td>54</td>
<td>12</td>
<td>-21</td>
<td>29</td>
<td>-52</td>
<td>-94</td>
<td>35</td>
<td>-286</td>
<td>3,945</td>
</tr>
<tr>
<td>Total Above</td>
<td>25,066</td>
<td>12,178</td>
<td>15,380</td>
<td>2,065</td>
<td>14,461</td>
<td>3,940</td>
<td>14,667</td>
<td>1,932</td>
<td>14,324</td>
<td>-1,800</td>
<td>10,676</td>
<td>-6,262</td>
<td>68,840</td>
</tr>
</tbody>
</table>

- Bond Emerging Markets
- Money Market
- Mixed Flexible
- Equity Emerging Markets
- Other Emerging Markets
- Mixed Conservative
- Mixed Aggressive
- Equity Sector/Other
- Guaranteed/Protected
- Mixed Balanced
- Total Equity
- Total Mixed Assets
- Total Bond
- Total Other
- Total Long-Term Funds
- Total Money Market
- Total Industry

Source: Strategic Insight Simfund GL, July 2012

The 12 months to July 2012 saw a net inflow of US$68.8bn into the LatAm mutual fund industry, however July 2012 saw a net outflow of US$8.6bn from the industry. A significant majority of the funds flowing into LatAm were into Brazilian mutual funds. November 2011 to March 2012 saw a significant inflow of capital to LatAm funds, in particular Brazilian funds, which has slightly reversed from April 2012. Interestingly Mexico saw an influx of capital from April to June 2012. See figure below for further details.
4.5.2 The case for Latin America debt funds

Several reasons have been cited for the recent inflow of capital to LatAm funds including:

1. Depressed global environment and low fixed income yields in developed markets have led investors to searching for higher returns and this has led them to seek higher yield paying bonds in emerging markets and in particular LatAm countries (see figures below)

Source: TCW Funds, August 2012
2. Emerging market local currency debt is also offering attractive yields, with yields trading at 500bps above US Treasuries

3. Emerging markets are a source of value: similar rated companies have less leverage than their US counterparts and have higher spreads per turn of net leverage
Figure 27: Leverage and spread per turn of net leverage

Source: BoA Merrill Lynch Global Research, March 2012

4. Relative risk of emerging markets (including LatAm) compared with developed markets is changing:
   - Bond issuers: countries and companies in developing markets are maturing
   - Strong economic growth and fiscal and monetary discipline in emerging market (EM) countries have improved fundamentals relative to developed markets
   - Reduction in sovereign credit risk has expanded opportunities for EM issuers to tap global debt markets
   - The average debt level of emerging-market countries like Brazil and China is far lower than that of developed ones like the United States and Japan
   - Emerging economies have continued to surge, even as much of the developed world keeps struggling with the aftermath of the 2008 financial crisis. Today, emerging markets represent about one-third of world GDP and that share should increase in coming decades
   - The universe of EM debt is largely investment grade and provides diversity across regions, countries and issuers

4.5.3 The case for Latin America high yield (HY) debt funds

LatAm HY spreads are higher than those of US HY. However analysts view this difference being higher than the historical and excessive:
   - HY LatAm is trading at a spread of 693 bps, 109 bps above US HY spread (HY spread is calculated as difference in yield compared to investment grade corporate bonds)
AFRICAN HIGH YIELD CORPORATE BOND MARKET

Figure 28: LatAM HY vs. US HY spreads

Figure 29: LatAM HY vs. US HY returns

<table>
<thead>
<tr>
<th>Year</th>
<th>HY LatAm</th>
<th>HY US</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>9.0%</td>
<td>2.7%</td>
<td>6.3%</td>
</tr>
<tr>
<td>2006</td>
<td>10.4%</td>
<td>11.9%</td>
<td>-1.5%</td>
</tr>
<tr>
<td>2007</td>
<td>5.5%</td>
<td>1.9%</td>
<td>3.6%</td>
</tr>
<tr>
<td>2008</td>
<td>-19.3%</td>
<td>-26.2%</td>
<td>6.8%</td>
</tr>
<tr>
<td>2009</td>
<td>49.3%</td>
<td>58.2%</td>
<td>-8.9%</td>
</tr>
<tr>
<td>2010</td>
<td>13.7%</td>
<td>15.1%</td>
<td>-1.4%</td>
</tr>
<tr>
<td>2011</td>
<td>0.7%</td>
<td>4.9%</td>
<td>-4.2%</td>
</tr>
</tbody>
</table>

Source: Celfin, JP Morgan, Bloomberg, January 2012

- The HY LatAm creditworthiness exceeds the US HY, with financial coverage (EBITDA / Interest) vs. 4.2 x 3.8 x, and a debt of 2.0 x 1.3 x vs., respectively (calculated simple average LTM 3Q2011)

Figure 30: LatAM HY vs. US HY interest cover ratios

Source: Celfin, Capital IQ, January 2012
• The average rate of defaults of the last four years in LatAm was 1.7%, compared with the 3.8% rate US HY

Figure 31: HY defaults US (blue), LatAm (grey)

Source: Celfin, S&P January 2012

4.5.4 Yields and spreads of Latin America high yield bonds

The benchmark index to measure performance of high yield bonds in LatAm is The JPMorgan CEMBI Broad HY Index (corporate debt emerging high performance). Similarly the Investment Grade corporate bond index is the JPMorgan CEMBI Broad HG (corporate debt lower risk or emerging investment grade).

The yields for the CEMBI Broad HY Index fell from 11.4% in September 2011 to 7.6% in September 2012, compared to 5.3% to 3.9% for the CEMBI Broad HG Index.

Figure 32: Yields CEMBI HY vs. HG

Source: Moneda, September 2012
Similarly spreads for the CEMBI Broad HY Index declined from 947bps in September 2011 to 656bps in September 2012. There was a smaller decline for the CEMBI Broad HG Index from 480bps to 201bps.

Figure 33: Spreads CEMBI HY vs. HG

Source: Moneda, September 2012

4.6 High yield debt funds

4.6.1 Overview

There are 3 types of bond funds:

- Those that invest mainly in bonds issued in United States dollars: total return is influenced by the US interest rate
- Those that invest mainly in bonds issued in local currencies: subject to currency risk
- Those that can choose either e.g. The Fidelity New Markets Income fund

There are very few LatAm domiciled funds focussing purely on high yield LatAm corporate bonds.

4.6.2 US$ Local Latin American corporate high yield funds

The following funds US$ high yield funds domiciled in Latin America:

- Moneda Latam Deuda Local
- Lv Deuda Latam High Yield
- BTG Pactual High Yield Fi Multimercado
- Celfin High Yield Latin America
Copernico Latin America High Yield Fund

More details of the above funds are provided in the table below:

**Figure 34: Comparison of local Latin America USD HY funds**

<table>
<thead>
<tr>
<th>Fund</th>
<th>Manager</th>
<th>Portfolio Manager</th>
<th>Launch Date</th>
<th>Term (years)</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moneda Latam Deuda Local</td>
<td>Moneda AM</td>
<td>Javier Montero.</td>
<td>Aug-09</td>
<td>29</td>
<td>Closed End</td>
</tr>
<tr>
<td>Lv Deuda Latam High Yield</td>
<td>LarrainVial AM</td>
<td>Jaime Lizana</td>
<td>Apr-09</td>
<td>5 years, renewable successively for periods of 5 years each, by resolution passed at an Extraordinary Assembly of Contributors.</td>
<td>Closed End</td>
</tr>
<tr>
<td>Btg Pactual High Yield Fi Multimercado</td>
<td>Btg Pactual AM</td>
<td>Not available</td>
<td>Jul-97</td>
<td>n/a</td>
<td>Open Ended</td>
</tr>
<tr>
<td>Celfin H/Y Latin America</td>
<td>Celfin Capital SA</td>
<td>Hernan Martin / Albert Kwon Lee</td>
<td>Jan-12</td>
<td>10 years</td>
<td>Closed End</td>
</tr>
<tr>
<td>Copernico Latin America High Yield Fund</td>
<td>Copernico Partners</td>
<td>Argentinian Hedge Fund managed by Ricardo Maxit</td>
<td>Apr-12</td>
<td>n/a</td>
<td>Open Ended</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fund</th>
<th>Size (USm)</th>
<th>Currency</th>
<th>On-Shore vs Off-Shore</th>
<th>Domicile</th>
<th>Listed</th>
<th>Stock Exchange</th>
<th>Focus / Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moneda Latam Deuda Local</td>
<td>248</td>
<td>USD</td>
<td>On-Shore</td>
<td>Chile</td>
<td>Listed</td>
<td>Santiago</td>
<td>Latin American local currency-denominated corporate debt issue, which generates both interest rate and exchange rate opportunities</td>
</tr>
<tr>
<td>Lv Deuda Latam High Yield</td>
<td>42</td>
<td>USD</td>
<td>On-Shore</td>
<td>Chile</td>
<td>Listed</td>
<td>Santiago</td>
<td>Investing primarily in debt securities that are traded in the domestic market</td>
</tr>
<tr>
<td>Btg Pactual High Yield Fi Multimercado</td>
<td>257</td>
<td>USD</td>
<td>On-Shore</td>
<td>Brazil</td>
<td>Listed</td>
<td>Brazilian</td>
<td>Investing primarily in corp / govt high yiled debt securities that are traded in the domestic market</td>
</tr>
<tr>
<td>Celfin H/Y Latin America</td>
<td>40</td>
<td>USD</td>
<td>On-Shore</td>
<td>Chile</td>
<td>Listed</td>
<td>Santiago</td>
<td>Invests in fixed-income instruments with a rating lower than investment-grade, from issuers in developing countries, and primarily in Latin America</td>
</tr>
<tr>
<td>Copernico Latin America High Yield Fund</td>
<td>18</td>
<td>USD</td>
<td>Off-Shore</td>
<td>Cayman Islands</td>
<td>Listed</td>
<td>Cayman Islands</td>
<td>Seeks to achieve a high level of income, with the opportunity for capital gain, from a diversified portfolio of bonds. The Fund principally invests in debt securities of companies incorporated in Latin America</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fund</th>
<th>Fee Structure</th>
<th>Dividend</th>
<th>Credit Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moneda Latam Deuda Local</td>
<td>Fixed fee of 0.8% + VAT. Variable fee of 12% + VAT on earnings in excess of the ELMi index + Latin + 1%.</td>
<td>Annually, 50% of fund’s net realized capital gains</td>
<td>Fitch Rating Class 1 Level 4.</td>
</tr>
<tr>
<td>Lv Deuda Latam High Yield</td>
<td>0.952% per annum (VAT included)</td>
<td>annually as dividends 30% of the &quot;Net Benefits Perceived&quot;</td>
<td>International Credit Risk, 1st Class</td>
</tr>
<tr>
<td>Btg Pactual High Yield Fi Multimercado</td>
<td>1.25% pa on equity of the Fund</td>
<td>n/a</td>
<td>Fitch Rating Class 1 Level 4.</td>
</tr>
<tr>
<td>Celfin H/Y Latin America</td>
<td>The monthly flat fee is one-twelfth of 1.19% of the value of fund assets. The variable fee equal to 20% of the difference between the daily return fund accumulated over the cumulative daily</td>
<td>the fund distributed annually at least 30% of the &quot;Net Benefits Perceived&quot;</td>
<td>Fitch Rating Class 1 Level 4.</td>
</tr>
<tr>
<td>Copernico Latin America High Yield Fund</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>
AFRICAN HIGH YIELD CORPORATE BOND MARKET

4.6.3 Overseas high yield funds

However there are over 100+ US$ and € funds investing in high yield bonds in emerging markets including Latin America. Some of big name asset managers include:

- BlackRock High Yield Bond Fund
- Baillie Gifford HY Bond Fund
- Pimco Emerging Market Local Bond Fund
- AGF Global High Yield Bond Fund
- Excel Latin America Bond Fund

In addition there are a few funds that are in Brazilian Real, but non-domiciled in Brazil. For example:

- Sumitomo Mitsui US High Yield Bond Fund - Brazilian Real
- Dws Europe High Yield Bond Fund Brazil Real

4.6.4 Local currency bond funds

There are no local currency high yield corporate bond funds in LatAm. However there are several large local currency funds that invest in LatAm bonds, both sovereign and corporate. A list of the top 20 by AUM is shown below. The largest funds are located in Brazil and Mexico.
### Figure 35: Top 15 largest (by AUM) Local Currency Latin America Domiciled Bond Funds

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>Manager</th>
<th>Category</th>
<th>Launch Date</th>
<th>1m</th>
<th>3m</th>
<th>12m</th>
<th>Jul-12</th>
<th>1m</th>
<th>3m</th>
<th>1y</th>
<th>3 yr</th>
<th>Geograp hy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bradesco FI Ref DI Performance</td>
<td>Banco Bradesco</td>
<td>Bond Emerging Markets</td>
<td>Mar-06</td>
<td>987</td>
<td>977</td>
<td>12,611</td>
<td>12,106</td>
<td>2.1</td>
<td>10.3</td>
<td>33.2</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>Bram FI Referenciado DI Rubi</td>
<td>Banco Bradesco</td>
<td>Bond Emerging Markets</td>
<td>Jun-03</td>
<td>698</td>
<td>742</td>
<td>512</td>
<td>9,560</td>
<td>2.2</td>
<td>10.9</td>
<td>35.2</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>ITAU FRANCES RENDA FIXA FI</td>
<td>Itau</td>
<td>Bond Emerging Markets</td>
<td>Jan-96</td>
<td>190</td>
<td>491</td>
<td>3,136</td>
<td>6,840</td>
<td>2.1</td>
<td>11.3</td>
<td>35.9</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>Horizonte Banamex Tres SA de CV SIID B2-A</td>
<td>Citigroup</td>
<td>Bond Emerging Markets</td>
<td>Jun-85</td>
<td>110</td>
<td>571</td>
<td>992</td>
<td>6,761</td>
<td>0.5</td>
<td>1.9</td>
<td>6.5</td>
<td>Mexico</td>
<td></td>
</tr>
<tr>
<td>iShares NAFIRAC</td>
<td>Itau</td>
<td>Bond Emerging Markets</td>
<td>Jul-10</td>
<td>134</td>
<td>426</td>
<td>750</td>
<td>2,051</td>
<td>1.1</td>
<td>4.6</td>
<td>14.6</td>
<td>Mexico</td>
<td></td>
</tr>
<tr>
<td>CDRP REFERENCIADO DI FI</td>
<td>Itau</td>
<td>Bond Emerging Markets</td>
<td>Dec-02</td>
<td>89</td>
<td>414</td>
<td>466</td>
<td>3,607</td>
<td>2.2</td>
<td>10.8</td>
<td>35.1</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>SANTANDER FI FINANCIAL CURTO PRAZO</td>
<td>Santander</td>
<td>Bond Emerging Markets</td>
<td>Aug-10</td>
<td>0</td>
<td>2,468</td>
<td>2,702</td>
<td>3,277</td>
<td>2.1</td>
<td>10.3</td>
<td>-</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>ITAU RENDA FIXA FI</td>
<td>Itau</td>
<td>Bond Emerging Markets</td>
<td>Sep-09</td>
<td>121</td>
<td>499</td>
<td>2,155</td>
<td>2,054</td>
<td>3.2</td>
<td>-</td>
<td>-</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>Itau RF Vertice Inflation 5 Fi</td>
<td>Itau</td>
<td>Bond Emerging Markets</td>
<td>Nov-01</td>
<td>134</td>
<td>426</td>
<td>750</td>
<td>2,051</td>
<td>1.1</td>
<td>4.6</td>
<td>14.6</td>
<td>Mexico</td>
<td></td>
</tr>
<tr>
<td>INTGUB SA de CV SIID</td>
<td>Cerro</td>
<td>Bond Emerging Markets</td>
<td>Nov-02</td>
<td>374</td>
<td>787</td>
<td>1,427</td>
<td>1,980</td>
<td>3.9</td>
<td>18.1</td>
<td>44.6</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>ITAU RENDA FIXA PRE LONGO PRAZO FI</td>
<td>Itau</td>
<td>Bond Emerging Markets</td>
<td>Sep-09</td>
<td>89</td>
<td>417</td>
<td>1,419</td>
<td>1,860</td>
<td>3.1</td>
<td>18.1</td>
<td>-</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>Horizonte Banamex Uno SA de CV B2-C</td>
<td>Citigroup</td>
<td>Bond Emerging Markets</td>
<td>Nov-99</td>
<td>303</td>
<td>290</td>
<td>1,467</td>
<td>1,750</td>
<td>0.5</td>
<td>1.8</td>
<td>2.2</td>
<td>Mexico</td>
<td></td>
</tr>
<tr>
<td>RT NATION RENDA FIXA FI</td>
<td>Itau</td>
<td>Bond Emerging Markets</td>
<td>Sep-10</td>
<td>70</td>
<td>376</td>
<td>-413</td>
<td>1,669</td>
<td>2.1</td>
<td>10.4</td>
<td>-</td>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>Horizonte Banamex Cinc SA de CV SIID B2-B</td>
<td>Citigroup</td>
<td>Bond Emerging Markets</td>
<td>Nov-89</td>
<td>25</td>
<td>45</td>
<td>155</td>
<td>1,465</td>
<td>19.5</td>
<td>30.5</td>
<td>-</td>
<td>Mexico</td>
<td></td>
</tr>
</tbody>
</table>
5 ASIA

5.1 History and overview of the Asian corporate bond market

In the 1990s, emerging Asian economies experienced recurring financial crises associated with sudden reversals of capital flows and liquidity shortages due to their excessive reliance on short-term foreign borrowing. Consequently, the deep impact of the 1997 Asian financial crisis highlighted the urgent need to develop local-currency bond markets, as the source of longer-term financing, and reduce the vulnerabilities to double mismatches in maturity and currency in these economies. Nowadays, given stockpiles of foreign reserves that are close to two-thirds of the world’s reserves (Chaipravat, 2004), many commentators point out that a bigger problem is one of inefficiency - Asians are investing heavily in low-yielding foreign assets while foreigners are investing in high-yielding assets in the Asian domestic markets. As a result, Asian corporate bond markets have been growing rapidly as Asian borrowers switch from short-term bank loans towards longer-term debt financing.

During the global financial crisis, Asian corporate issuers with low ratings from the international rating agencies were almost completely shut out from the bond markets. In 2008, Asian high yield corporate bond issuances constituted only 3% of all bonds with international ratings. However, by 2011, Asia’s share of foreign currency denominated high yield corporate bond issuances rated by international agencies had come back to the level of 2005 (approx. 32%).

The two major Asian bond indices are the HSBC Asian Bond Index and the JP Morgan JACI Index. The Asian high yield corporate bond sector is dominated by China and Indonesia, but also includes South Korea, the Philippines and Singapore. The high yield portion of the above indices has grown over the years from around 30% in 2006 to 39% at the end of 2011. The development of the overall Asian bond market, meaning the bond market for both local and foreign currencies, has occurred at different speeds to date. The market for bonds denominated in local currencies totaled USD 5.6 trillion in 2011 (in 1995 this figure was at just USD 126 billion). However, this includes both corporate and government bonds. And, for example, government bonds make up almost 75% of the overall Chinese bond market.

Although the market for Asian corporate bonds is still in its relative youth, corporations from countries like India and South Korea have issued a large volume of bonds in the past few years. Further, in the past five years, Chinese companies have issued almost USD 14 billion in local
bonds – just under 30% of Asian corporate bonds issued over this period. At the end of 2011, the global market for corporate bonds totaled about USD 4 trillion. Asian countries, however, make up less than 3% of this (USD 130 billion). This primarily includes corporate bonds from countries like India (USD 31 billion) and South Korea (USD 46 billion), in accordance with their issue activity.

If Asian governments continue to move ahead with various initiatives, in future the market for Asian corporate bonds should continue - resulting in increasing issue activity. However, this structural change is not yet reflected in global capital markets credit ratings.

Figure 36: Corporate bond Issuance in Asia by country of origin (in USD billion)

* by issuers’ country of origin, until September 2011
Source: Bank for International Settlements (BIS), Allianz Global Investors Capital Markets & Thematic Research
In recent years, the governments of Asian countries have made serious efforts to encourage the development and deepening of local-currency bond markets by removing policy distortions that affect the allocation of domestic savings, enabled sovereign and quasi-sovereign issues to establish benchmark yield curves, and strengthened the regulation and supervision of capital markets. In addition, the actions of regional groups have also supported the development and deepening of Asian bond markets. Currently, there are three major government-sponsored international organisations in Asia actively involved in the development of a well-functioning regional bond market. First is the Asia-Pacific Economic Cooperation (APEC), which facilitates the development of securitization and credit guarantee markets. At the Bali meeting on May 3 2008, the ASEAN+3 Finance Ministers endorsed the establishment of the Credit Guarantee and Investment Mechanism (CGIM), as a trust fund of the Asian Development Bank, with initial capital of USD500 million. This mechanism will be useful to local currency issuers not well known to the market or constrained by a ceiling on their sovereign’s rating as it will provide a credit guarantee and therefore entice investors.
Second is the Asian Bond Market Initiative (ABMI), under the framework of the Association of South East Asian Nations plus South Korea, Japan and China (ASEAN+3). This group is focused on the establishment of regional market infrastructure, including the proposed creation of a regional credit ratings agency and standardized settlement procedure. The AMBI aims to raise investor interest in Asian bonds, mitigate impediments to investors and improve liquidity in the major government and corporate bond markets.

In addition, the Executive Meeting of East Asian and Pacific Central Banks (EMEAP) was established in 2003 to oversee Asian Bond Funds (ABFs) - the idea being to help expand Asian bond markets through the purchase of sovereign or quasi-sovereign bonds issued by the participants using all eleven members’ foreign exchange reserves. ABFs represent the first regional pooling of international reserves in Asia as member central banks attempt to stimulate investment activities in their respective local bond markets.

ABF1 was a closed-end fund managed by the Bank for International Settlements (BIS). ABF2 was launched to promote the development of index bond funds in the regional markets and to enhance the domestic as well as regional bond market infrastructure. ABF2 consists of two components: (i) one Pan-Asian Bond Index Fund (PAIF); and (ii) eight country sub-funds. The PAIF is a single bond index fund investing USD1 billion in local-currency denominated bonds in EMEAP economies and was made an open-ended fund in order to encourage private sector participation. It is managed by State Street Global Advisors Singapore Ltd. and listed on the Hong Kong Stock Exchange.

The Asia-Pacific Economic Co-operation Finance Ministers’ group and the Asia Co-operation Dialogue process have also been strongly supportive of Asian bond market development.

Figure 38: Asian bond issuance returns by issuer segment

<table>
<thead>
<tr>
<th>Year</th>
<th>Corporates (in USD)</th>
<th>Sovereign (in USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>15.1%</td>
<td>8.5%</td>
</tr>
<tr>
<td>2002</td>
<td>19.3%</td>
<td>15.6%</td>
</tr>
<tr>
<td>2003</td>
<td>9.2%</td>
<td>8.1%</td>
</tr>
<tr>
<td>2004</td>
<td>10.4%</td>
<td>7.3%</td>
</tr>
<tr>
<td>2005</td>
<td>5.7%</td>
<td>4.3%</td>
</tr>
<tr>
<td>2006</td>
<td>13.3%</td>
<td>5.8%</td>
</tr>
<tr>
<td>2007</td>
<td>8.2%</td>
<td>6.1%</td>
</tr>
<tr>
<td>2008</td>
<td>1.0%</td>
<td>-3.7%</td>
</tr>
<tr>
<td>2009</td>
<td>31.7%</td>
<td>28.9%</td>
</tr>
<tr>
<td>2010</td>
<td>12.2%</td>
<td>11.9%</td>
</tr>
<tr>
<td>2011 YTD</td>
<td>8.6%</td>
<td>7.3%</td>
</tr>
</tbody>
</table>

This chart represents the different market sector categories within Asia, ranked by returns, 2001 – 2011. Note: Past performance is not indicative of future results. For illustrative purposes only. JP Morgan Asia Credit Index data before January 2006 sourced from the discontinued JP Morgan Asia Credit Total Return Index series. Source: Bloomberg (Data as of 31 August 2011)
5.2 Current Asian corporate bond market characteristics, sentiment and activity

Across Asia, bond market development varies considerably. In terms of amount of corporate bonds outstanding, Japan, China and South Korea are the largest markets. In terms of relative to GDP, the largest markets are Korea, Malaysia and Thailand. The Asian Development Bank has observed an emergence of a broader high yield corporate issuer base in Asia with companies in energy/utilities, commodities, transportation, telecommunication and real estate beginning to dominate the region’s high yield issuance base, as companies in these sectors experience strong growth. Information with regard to dedicated Asian high yield corporate bonds is not easily available but presented below are some recent comments from a selected number of journalists and/or bond fund managers with some allocation to this asset class.

Figure 40: Selection of Asian bond indices

In late September 2012, the FT reported that international bond issuance from Asia, excluding Japan, burst past the USD 100 billion mark, outstripping by more than USD 20 billion the full-year record set in 2010, as companies and banks look to exploit cheap rates and a step-up in investor demand. The market has seen USD 106 billion worth of bonds in the three main international currencies – US dollars, yen and euros – so far this year, according to Dealogic. Terence Chia, co-head of debt syndicate for Citibank in Asia, said the USD 100 billion mark was a significant milestone for a market that was issuing just USD 10 billion annually a decade ago. Much of the new debt has come from companies, which have issued a total of USD 57.4 billion worth of deals, which is USD 20 billion ahead of the same time last year and USD 14 billion ahead of last year’s full-year total, which was itself a record. There has also been an uptick in global funds directed to Asian fixed income as the higher growth and higher yields available in Asia have looked increasingly attractive versus bond markets in the US or Europe.

Natasha Fukui of the WSJ reported in early 2012 that riskier Asian corporate-bond issuers are creeping back to the international market. Most of the region’s high-yield issuers have been priced out of the USD market for months, as concerns about the Eurozone and global economy made investors less risk seeking.

Analysts expect some companies to face liquidity issues if they can't sell bonds in the coming months. Philipp Lotter at Moody's noted that the ratio of Asian high yield companies with weak liquidity rose to 12.5% in January 2012, from 9.3% in December. "There was a notable turn going into 2012. Conditions vary depending on the type of company, but for every month that passes there will be a build-up in the refinancing required." China's property sector is experiencing the most serious liquidity pressures, he added.

However, investors also seem to be paying more attention to the merits and shortcomings of individual issuers rather than dismissing all speculative-grade borrowers as too risky. "Going forward, it'll be nice to see high yields more as a function of corporate balance sheets rather than of geography," said Jim Veneau at HSBC Global Asset Management. "In contrast to last year, in 2012 we expect to see performance at an individual bond level".

In China, yields on debt from top-tier high-yield companies have dropped significantly, making new issuance more affordable. But for a much larger group—including property
developers—yields will need to fall further still before issuers can consider coming back to market, bankers have said. At the moment most China property issues are rated BB or BB+ and yield around 9%.

- "Bond investors are still taking a cue from the European debt situation, and high-yield issuers will have to work around this to find windows," said Scott Bennett at Aberdeen Asset Management Asia. "They will likely issue sporadically over 2012”.

- However, according to Raymond Lee at Kapstream, Asian issues give you better returns with less risk. This year his Absolute Return fund, in the high-yield space, has bought China Oriental Group's 2015 bond rated BB+, which yields 6.38 percent and Singapore’s STATS ChipPac's 2016 bond rated BB+ with a 5.2 percent yield.

Figure 41: 10 year yields of Asian bonds versus developed markets

- Very few Asian issues defaulted last year, according to Tim Jagger, Head of Credit Strategy Asia Pacific, from RBS. And he expects this to continue because of strong company fundamentals. Credit in Asia is better, it has strong growth and the default rate is low,” says Kapstream’s Kumar Palghat. His corporate bond fund has increased allocation to Asian issues to 10 percent from nearly zero last year.

- However, some analysts are warning that large numbers of lower quality Asian companies are looking to take advantage of rising demand. Some of these companies could be
opportunist and have poor corporate governance, says Tanuj Khosla at 3 Degrees Asset Management, a Singaporean hedge fund that invests in Asian corporate bonds.

**Figure 42: Issuance of Asian corporate bonds split by rating (USD millions)**

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0.2%</td>
<td>0.0%</td>
<td>0.7%</td>
<td>0.0%</td>
<td>8.5%</td>
<td>8.1%</td>
<td>1.9%</td>
</tr>
<tr>
<td>AA</td>
<td>9.2%</td>
<td>8.4%</td>
<td>0.8%</td>
<td>12.3%</td>
<td>18.8%</td>
<td>12.5%</td>
<td>1.2%</td>
</tr>
<tr>
<td>A</td>
<td>15.9%</td>
<td>51.5%</td>
<td>22.2%</td>
<td>50.6%</td>
<td>46.3%</td>
<td>43.7%</td>
<td>43.8%</td>
</tr>
<tr>
<td>BBB</td>
<td>43.4%</td>
<td>20.6%</td>
<td>41.4%</td>
<td>34.2%</td>
<td>2.1%</td>
<td>18.5%</td>
<td>21.5%</td>
</tr>
<tr>
<td>BB</td>
<td>17.2%</td>
<td>9.8%</td>
<td>21.1%</td>
<td>3.0%</td>
<td>24.2%</td>
<td>11.5%</td>
<td>26.9%</td>
</tr>
<tr>
<td>B</td>
<td>10.9%</td>
<td>9.0%</td>
<td>13.8%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>5.8%</td>
<td>4.7%</td>
</tr>
<tr>
<td>CCC</td>
<td>3.3%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>D</td>
<td>0.0%</td>
<td>0.7%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Total (internationally rated)</td>
<td>15,286</td>
<td>13,378</td>
<td>6,208</td>
<td>4,147</td>
<td>11,628</td>
<td>10,456</td>
<td>12,451</td>
</tr>
<tr>
<td>Total (locally rated/unrated)</td>
<td>56,150</td>
<td>57,591</td>
<td>84,423</td>
<td>121,940</td>
<td>241,850</td>
<td>215,177</td>
<td>194,571</td>
</tr>
</tbody>
</table>

Despite a challenging year in 2011, including the downgrade of the U.S. and trouble brewing in the Eurozone, the JACI index stayed positive and returned 4.12%. The investment grade rated portion (61% of the index) returned 4.92% and the high yield portion (39%) returned 2.85%. The JACI index has returned 7% on an annualized based in the five years from 2007 to 2011. Further, Moody’s Asian High-Yield Corporate Credit Report dated 23 January 2012 says that, despite pressures, liquidity profiles for high-yield issuers in Asia remain strong. For example, high-yield corporate liquidity, as measured by the Asian Liquidity Stress Index, remains strong with just some 9.3% of the high-yield portfolio showing inadequate liquidity at 31 December 2011. In addition, the index is below the 2011 high of 13% - recorded in January 2012 - and is well below the 37% reading posted during October to December 2008, the height of the global financial crisis. And in terms of credit trends for the high-yield sector, defaults are likely to increase during 2012, having come off a no default scenario in 2011, while rating downgrades are expected to persist as demand slows and access to funds remains tight. Looking back at 2011, the report says that a bumper level of corporate bond issuance was evident in H1, almost exceeding the total for all of 2010. But in H2, almost no new rated bonds were issued for issuers rated Ba1 and below as conditions turned.
Many firms in Asia have access to both on-shore local currency bond markets and offshore foreign currency bond markets. For many emerging economies, the offshore bond market is relatively large and liquid compared to the domestic bond market. The choice between on-shore and offshore markets is effectively a choice of currency denomination and investor base. The factors influencing this choice include cost structure of each market and ability to hedge and manage currency risk.

Thus the Asian bond markets can essentially be broken down into two segments:

- the regional bond market in USD-denominated instruments; and
- local currency bond markets.
Investors in the Asian bond market are still mostly locally based. Foreign investors are allowed to participate in the debt market except for in the PRC. General investors include commercial and retail banks, government institutions, private corporations, as well as retail investors. The yield-hungry U.S. retirement funds make up a big chunk of the participants in the Asian high-yield bond market. This has been driven largely by lower yields in the U.S due to the Federal Reserve’s easy monetary policy.

As mentioned previously, since the endorsement of the Asian Bond Markets Initiative (ABMI), local currency-denominated bond markets in the region have achieved remarkable growth in terms of size and diversity of issuers. The Asian USD denominated bond market today, as measured by the market capitalization of the JACI index, has grown from USD 50 billion around a decade ago to over USD 300 billion in June 2011. This index includes sovereign, quasi-sovereign (majority-owned by the state) and corporate credit. Further, according to Dealogic, there are 52 corporate bond issuers (of which 13 are high yield) in Asia for which credit default swaps are available. For these 52 firms, bond issuances since 2005 have amounted to USD 413 billion. Since 2008, USD 275 billion or 86% of corporate bond issuance have been denominated in local currencies. In 2Q2012, the year-on-year growth rate of emerging East Asia’s corporate bond market was 15.2%. Growth leader countries in terms of corporate bond markets are Indonesia (67% year-on-year in 2Q12) and Philippines (131% year-on-year in 2Q12).

The development of individual local currency bond markets in the ASEAN+3 region has been independent of international ratings. The savings rate in Asia is c.20% to 50% of GDP annually; meaning that domestic demand for bonds has historically been sufficient to meet issuance supply. Thus, in developing their local currency bond markets, ASEAN+3 countries have utilized local credit ratings agencies. In terms of ASEAN+3 government or corporate bonds denominated in their local currencies, none of them are rated internationally.
In terms of USD issuances, Asian commentators have argued that prices in the bond markets certainly are not consistent with international ratings, which they have long since discounted. In Malaysia, Indonesia, Thailand etc., credit trades at levels that imply credit ratings as strong as, if not stronger than, sovereigns such as France and Italy, which are in actuality rated much higher.
However, there is ongoing discussion across Asian states with regard to rectifying this perceived lack of information asymmetry between the international ratings agencies and Asia’s actual economic fundamentals. Nonetheless, for domestic Asian corporates, the development and use of domestic or regional credit ratings and agencies appears to be the priority. Accordingly, many Asian central bank representatives have argued that the investment and credit committees of fund managers, pension funds, other central banks and commercial banks should give more recognition to Asian ratings agencies.

**Figure 47: Asian USD investment grade bonds universe**

Total size at USD 161 billion (as of 31 December 2010)

![Asian USD investment grade bonds universe](chart)

*Note: Estimated by using JP Morgan Asian Credit Index. For illustrative purposes only. Source: Morgan Markets.*

**Figure 48: Asian USD non-investment grade bonds universe**

Total size at USD 96 billion (as of 31 December 2010)

![Asian USD non-investment grade bonds universe](chart)

*Note: Estimated by using JP Morgan Asian Credit Index. For illustrative purposes only. Source: Morgan Markets.*
5.3 Factors contributing to the development of Asian corporate bond markets

The evolution of Asian local currency bond markets over the last decade has been one of the success stories of the Asian capital markets. To discuss the opportunities and challenges that lie ahead for local currency bond markets in ASEAN+3, influential representatives from the region gathered at the CIMB/Emerging Markets Roundtable in Manila in May 2012. A summary of the key factors contributing to the growth of the Asian corporate bond markets, as discussed at the round table, is set out below:

- Asian countries have weathered the global downturn far better than developed markets due to strong fundamentals and economic improvements (i.e. lower fiscal deficits, lower and stable debt ratios and higher GDP growth rates relative to developed economies).
- Asian long-term returns and current yields are attractive and compare favourably with developed market bonds - there has been an Eastern shift in capital flows due to the European debt crisis.
- Asia Bonds have been growing strongly as an asset class, and represent an increasingly deep and well-diversified opportunity set - continued issuance over time has enhanced diversification, liquidity and investment opportunities. Further, Asian currencies have strong potential for appreciation.
• Asian bonds provide for better yield compensation vs. developed markets and, further, provide better yields for similar credit ratings (investment grade Asian bonds have historically yielded higher vs. global bonds, particularly in the corporate issue sector).

• The main drivers of growth in Asian bond markets have been the promotion of long-term financing mechanisms, such as the Asian Bond Market Initiative (ABMI) launched by ASEAN+3. This growth is also being driven by reforms that Asian governments are introducing (private sector initiatives in areas such as payment and settlements) to encourage the deepening of capital markets and development of key market infrastructure.

• International financial institutions such as the IFC and the ADB have also been instrumental in providing an additional push to the development of the capital markets.

• The region is still largely bank-dependent but, by 2011, the share of Asian financing sourced through the bond market was more than 30% compared with less than 20% ten years ago. In the last five years, the fastest growing sector has been corporate bonds, underpinned by increased demand from pension funds, insurance companies and other contractual savings institutions.

Figure 50: Comparison of global sales and earnings growth in 2010

![Graph showing global sales and earnings growth](image)

Note: For illustration purpose only. Source: UBS Securities, data as of 12 January 2011

However, Asian governments and quasi-state entities continue to work on further developing Asian bond markets. For example, current discussions include an Asian equivalent of a fund pass-porting mechanism, such as the UCITS model that has been successful in Europe (currently, there is no mutual recognition regime for the approval of multinational bond offerings). In addition, the ASEAN Capital Market Forum (ACMF), a forum of securities regulators in ASEAN, has drafted an implementation plan that serves as roadmap for ASEAN
member countries to achieve capital market integration. This is a three-phased approach being rolled out between 2009 to 2015 - with key milestones and components – which is intended to facilitate cross border securities offerings, a reduction of restrictions on capital flows and infrastructure integration. The ACMF is aiming to harmonize regulations step by step or mutually recognize regulations among member countries.

In the meantime, the ASEAN Debt Disclosure Standard, as already adopted by Singapore, Malaysia and Thailand, aims to reduce issuers’ disclosure costs and alleviate the burden of having to comply with multiple disclosure requirements. Further, the ultimate aim of the aim of the ABMF is to facilitate cross-border bond issuance and investment by creating an Asian Multi-Currency Bond Issuance Programme (AMBIP) with regional standardization of documentation. Commentators have noted that all such initiatives should help reduce transaction costs and support a greater flow of cross-border investment.

However, it remains to be seen whether the indications of heightened interest in Asian high-yield corporate bonds by foreign investors is the outcome of a search for yield in a low-interest rate environment or a structural shift towards greater weighting of Asian bonds in global investment portfolios. Despite the launch of various initiatives, the smaller-sized economies of East Asia still pose a difficulty to the development of local bond markets because they cannot take advantage of economies of scale to lower issuance cost.

During the peak of the recent international financial crisis, almost all major economies in Asia experienced sharp capital outflows from their domestic bond markets. Accordingly to the Asian Development Bank, there are three main risks to the Asian high yield corporate bond market:

- the persistence of market volatility which could reduce the attractiveness of this asset class,
- a significant shock to the global financial system could again result in large capital outflows from local markets (with a direct impact on liquidity), and
- a spill over of any such global volatility leading to higher borrowing costs, meaning the Asian private sector predominantly staying out of this market.

Moreover, although individual Asian domestic bond markets have been doing well over the last 10 years, the regional bond market – meaning cross-border bond holdings across ASEAN+3 countries – has yet to develop as strongly. Based on 2010 data, cross-border holdings of ASEAN+3 bonds are still only around 8% or 9%. This means that more than 90% of bonds issued by ASEAN+3 borrowers are either held outside the region or in their own country – i.e. ASEAN...
AFRICAN HIGH YIELD CORPORATE BOND MARKET

investors have mainly either a local or global bias, but not a regional one. Over the last five years, trade between Asia and the Eurozone and the US has been declining sharply, whereas intra-Asian trade has been increasing (and is forecasted to continue). Therefore, the development of Asian regional bond markets is critical.

At the same roundtable in Manila on 2 May 2012, the various representatives noted the following work still required to continue the development of well-functioning corporate bond markets in Asia:

- Linking the regional payment system to create the infrastructure and economies of scale that incentivize inter-regional trading, settlement and custody.
- Modifying banking regulatory and foreign exchange systems in certain countries to allow financial innovations to take place.
- The creation of a pan-Asian or regional credit ratings agency - Asia needs a more standardized regional framework so that all its markets are treated with the same methodology. Commentators have said that this would reduce the ratings gap between Western and ASEAN markets and make it a more attractive destination for foreign investors. The first step would be establishing mutual recognition by Asian regulatory authorities of credit ratings assigned by agencies in other local jurisdictions. This would presumably require acceptable comparability of credit ratings assigned by agencies to the local currency bond issues in their respective jurisdictions. In support of this, ACRAA is now conducting a study entitled “Mapping National Scale Ratings across Sovereigns in Asia”, the objective of which is to establish ratings comparability measures across Asian jurisdictions.
- Standardization of practices in terms of offering, documentation etc., and more mutual recognition and reciprocal regulatory approval, to make cross-border issuance and marketing easier. Getting regulatory harmonization is key as, without this, you can’t issue on a cross-border basis. For example, an ASEAN+3 credit issuance in Reg S in USD dollars gets much quicker approval than an issuance in local currency. As a result, there is less familiarity of ASEAN+3 corporate credits in the region amongst ASEAN+3 institutional investors.

A recent World Economic Forum report (“Refining Emerging Market Opportunity”) states there are several barriers that need to be overcome to establish a functioning corporate bond market, including:
AFRICAN HIGH YIELD CORPORATE BOND MARKET

- shortage of sustained investor demand;
- weak business and legal environments;
- cost to issuers (in emerging markets the high costs of issuing corporate bonds dissuades companies from pursuing this financing instrument (i.e. management fees, registration, listing and legal fees, credit rating costs, marketing costs, taxes), and encourages them to opt for bank loans, instead); and
- illiquid corporate bond markets.

Asian economies have made strides in many of these respects but there remains work to be done.

*Figure 51: Key barriers to developing deep corporate bond markets in emerging economies*
6 SOURCES
Various website (a detailed list can be provided on request), Bloomberg, ADB publications, BIS working papers, selected financial press articles, other financial websites, Moody’s, Asiamoney, Dealogic, FT.com, World Economic Forum papers, Asian+3 working papers/reports, selected equity research, selected academic articles, IMF publications.