Rhombus Advisors LLC

Precepts for policy-makers - a perspective on portfolio capital

Presentation to Capital Markets Program, IFC-Milken Institute

Dec. 8th 2016

★ Overview

A series of insights distilled from the Rhombus case files of executed trades and sovereign-advisory assignments.

★ Goals

- ⇨ Enable Fellows to visualize the deployment of portfolio capital from the *fund manager's perspective*;

- ⇨ Provide a *context* for thinking about such flows; evaluating their potential *costs as well as benefits*; and, deciding on their *appropriate treatment*.

❶ *Crisis is often synonymous with opportunity ...*

... At least in the eye of the portfolio manager: hence the famous Rothschild maxim, "Buy when the cannons thunder".

Case studies:

⇨ **The Kwanza trade**

- ***Context:*** The end of Angola's decades-long civil war had set the stage for a period of rapid growth accompanied by external account surpluses; solid reserves and a stable currency.

- ***Opportunity:*** Participate in this *'peace dividend'* by going long the currency and capturing the high real interest rates being maintained to prevent the economy from over-heating.

- ***Host country benefits:*** Entry of offshore investors attracted *greater participation in the money-market by local financial institutions* which had been shipping their excess cash to London and Switzerland – a habit developed during the war years.

- ***Outcome:*** *USD return of 15.5% p.a.* over a holding period of 20 months.

⇨ The Dalasi recovery trade

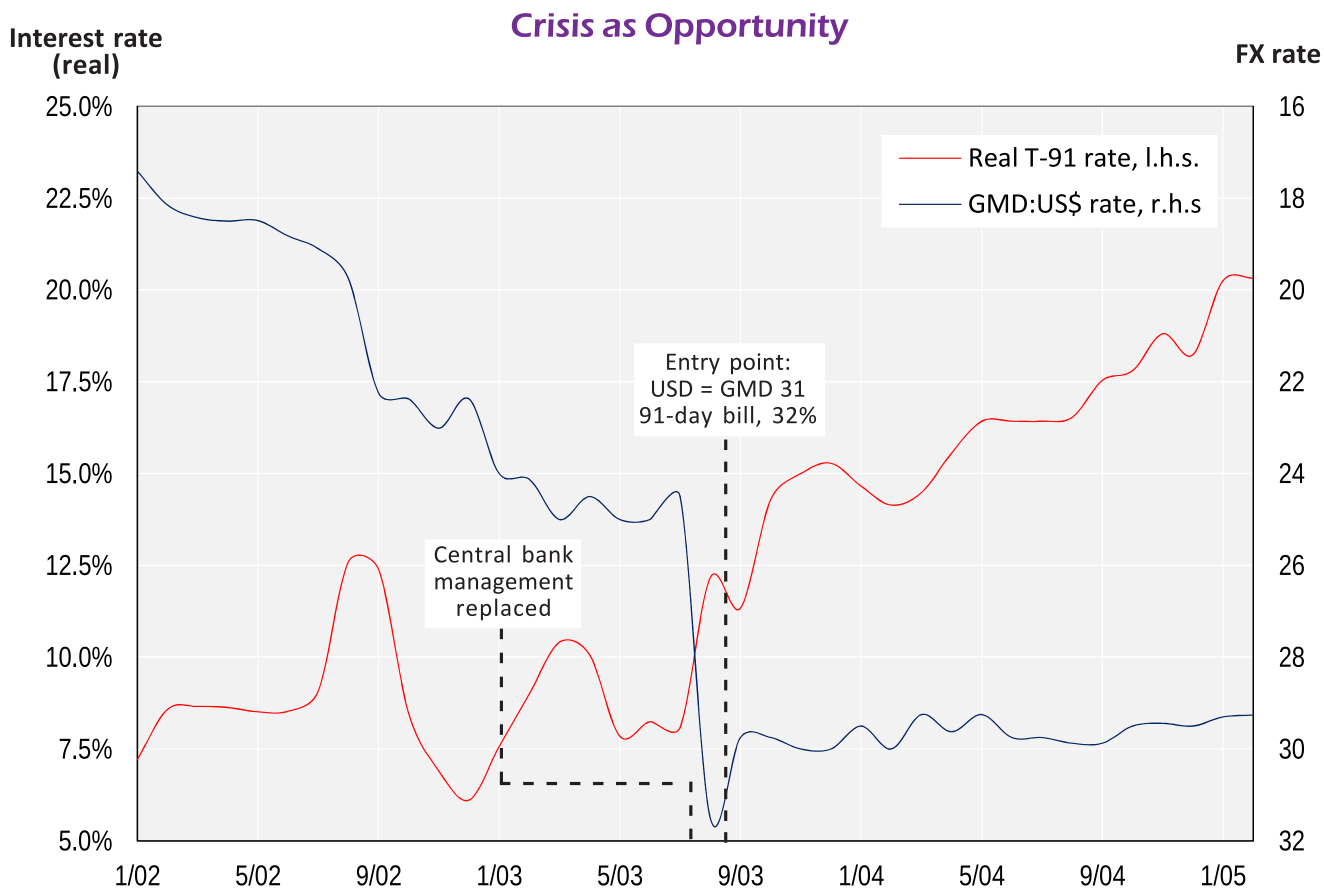
- ***Background***: The currency's multi-year depreciation resulting from declining export revenues was exacerbated by a scandal at the central bank of The Gambia in 2003. This pushed GMD's cumulative loss over a 19-month period to 45%, triggering a violent spike in inflation.

- ***Entry signal:*** A belated, but *forceful policy response* from the authorities - CBG management replaced; dramatic hike in interest rates.

- ***Opportunity:*** Capitalize on *high real interest rates and the prospect of currency appreciation* (from inevitable reversal of a classic Dornbusch overshoot).

- ***Host country benefits:*** FX inflow a clear *vote of confidence in the Dalasi* - describe rapid stabilization and subsequent appreciation.

- ***Outcome:*** *USD return of 22.3% p.a.* over 34 months.


Crisis as Opportunity
Interest rate (real)
FX rate
25.0%
22.5%
20.0%
17.5%
15.0%
12.5%
10.0%
7.5%
5.0%
16
18
20
22
24
26
28
30
32
1/02
5/02
9/02
1/03
5/03
9/03
1/04
5/04
9/04
1/05
Real T-91 rate, l.h.s.
GMD:US$ rate, r.h.s
Entry point: USD = GMD 31 91-day bill, 32%
Central bank management replaced

❷ *Portfolio capital is agnostic in the extreme*

Fund managers are driven by the pursuit of high risk-adjusted returns for investors, <u>not</u> financing development in the host country. [Share Angolan finance minister's bemused question.]

***Case studies** (contrasting reactions to same Rhombus presentation delivered three days apart):*

⇨ **Nigeria resists the siren call**

- ***Scenario:*** Nigerian authorities immediately recognized logic of Rhombus' argument against eurobond issuance in 2007 -
  "If you are already accumulating reserves, why borrow USD at 7% only to invest proceeds at 3% (the highest return available on liquid, risk-free instruments in which reserves are held)?"

- ***Outcome:*** The Federal Republic did not issue its first eurobond until 2011.

⇨ **Ghana succumbs**

- ***Scenario:*** 2007 being the 50th year after its independence, *Ghana succumbed to the temptation* of issuing SSA's first eurobond, promptly baptized the *Jubilee bond*. [Recall Minister's inability to explain the intended use of proceeds when asked during road-show presentation].

- ***Outcome:*** *11.8% fiscal overshoot* – a result of the eurobond proceeds having burned hole in the exchequer's pocket.

⇨ Zambia's finance minister left at the altar

- ***Scenario:*** Drawing the wrong inference from the success of his country's first two sovereign eurobonds, Mr. Chikwanda had declared that the *2016 budget would be financed primarily in the international market* on better terms than available domestically.

- ***Outcome:*** The erroneous assumption of an unlimited supply of cheap capital set the stage for the current fiscal crisis. The 2016 budget is now on track for a deficit of 10.5%, of which *7% will have been 'financed' by accumulating payment arrears to suppliers of goods and services*.

❸ *Be aware of the power of financial engineering*

Policy-makers' most valiant attempts at regulating portfolio flows can be foiled by structured transactions.

Case studies:

⇨ **The Pula 'carry' trade**

- ***Objective:*** Provide clients with *exposure to the currency of A-rated Botswana* (same as Japan), with interest rates at 13.5%.

- ***Constraint:*** No Government debt issuance, the result of a 10-yr run of budget surpluses. The only public-sector debt securities available were central bank notes *(BoBCs)* issued for liquidity management and therefore *off-limits to non-resident investors*.

- ***Strategy:*** Circumvent the central bank restriction by purchasing *shares in an insurance company fund invested almost completely (95%) in BoBCs* .

- ***Outcome:*** *Synthetic BoBC position produced a USD return of 15.25% p.a*. over 21 months.
  [N.B. reliance on a legal opinion.]

⇨ The 'SCOREs' transaction

- ***Objective:*** Provide client with *(quasi) sovereign money-market exposure in Ghana*.
- ***Constraint:*** Purchases of sovereign securities by offshore investors are *restricted to maturities of three years* or longer.
- ***Strategy:*** *Securitize payments due from the Ghana Cocoa Board* to create a short-duration instrument.
- ***Outcome:*** Securitized cocoa receivables (SCOREs) yielded 28.5% p.a. in Ghana Cedi. With FX hedging via NDFs then available at a cost of 19.25% p.a., investors were able to lock in a *USD return of 8.25% p.a*.
- ***Host country benefit:*** Injection of *additional liquidity* into the cocoa supply chain.

Transaction Structure & Mechanics

❶ *LBC delivers cocoa beans.*

❷ •*CMC issues Ctor acknowledging delivery.*

❸ *LBC submits invoice and Ctor for processing.*

❹ *LBC sends Domiciliation Letter instructing Cocobod to issue relevant payment in favour of Finance house.*

❺ *LBC provides copy of Domiciliation Letter to Finance house, pledging pending Cocobod payment as collateral.*

❻ *Finance house sends Domiciliation Letter instructing Cocobod to issue relevant payment in favour of Investor.*

❼ *Finance house formally transfers its interest in Cocobod receivables to Investor.*

❽ *Cocobod issues Letter of Undertaking, acknowledging payment instructions in favor of Investor.*

❾ *CMC's Accounts department validates payment request then forwards it to Cocobod for processing.*

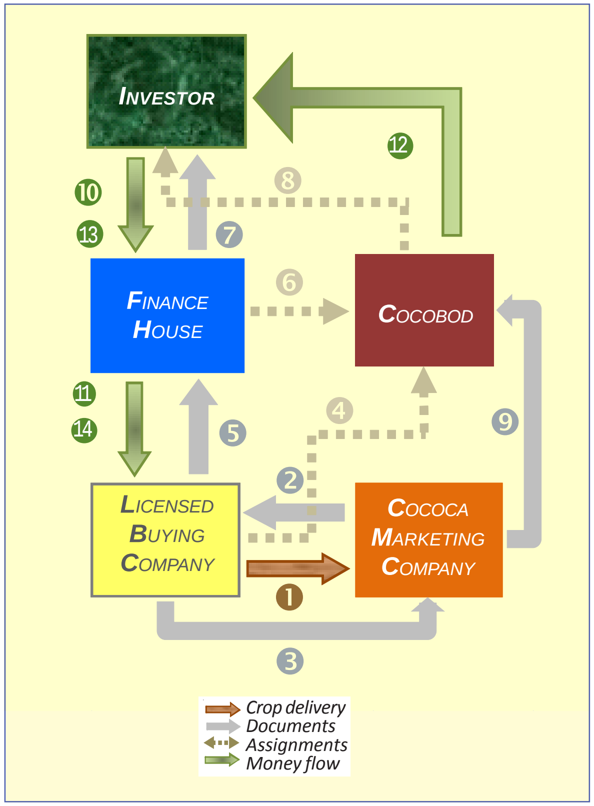
❿ *Investor extends Finance house a 60-day loan secured by pledge of Cocobod receivables.*

⓫ *Finance house advances loan proceeds to LBC for an identical 60-day term.*

⓬ *Cocobod settles invoice by check in Investor's name.*

⓭ *Investor's local custodian deducts principal and interest due on secured loan, then pays balance of check proceeds to Finance house.*

⓮ *Finance house deducts principal and interest amounts owed by LBC, then pays balance of proceeds to the latter.*



❹ *Portfolio capital may simply be responding to the push of global liquidity conditions ...*

... Rather than the pull of your respective economies. Portfolio managers are under inordinate pressure to deploy funds under management, which can lead to the most irrational - often surreal - outcomes.

Case studies:

⇨ **The 'Republic of Pangea' eurobond**

- ***Context:*** During the summer of 1997 elevated liquidity conditions in the financial markets, encouraged investors to *'reach for yield'*.

- ***Incident:*** A jocular conversation on the trading floor, one lazy Friday afternoon, sparked the rumour that the *imaginary Republic was due to launch its debut eurobond*, unrated but supposedly equivalent to a B- credit, with price talk in the range of T+350 b.p.

- ***Outcome:*** Within the space of 3 hours, yield-hungry investors had soft-circled *USD 100 million in bids for the completely fictitious issue*.

⇨ The Crane Bank fiasco

- ***Background***: Uganda's third largest lender, *Crane Bank was looking for a strategic investor* and had attracted the attention of a swash-buckling private equity fund.

  Pursuing its vision of building a pan-African banking organization through acquisitions, *Atlas Mara had valued the bank at USD 250 million*, and was now haggling with the majority owner, whose own valuation was USD 300 million.

- ***Outcome:*** Two weeks into these negotiations, the central bank determined that *Crane bank was significantly under-capitalized and needed to be placed under administration*.

  Somehow Atlas Mara's due diligence had missed the fact that *Crane alone accounted for 20% of all non-performing loans* in Uganda's banking system and that the size of their 2015 loss amounted to 50% of the combined earnings of the 5 most profitable banks.

❺ *Details matter*

Devoting an extra hour to reviewing the fine print in a draft agreement, the footnotes to a report or the statistical annexe to an economic analysis will pay enormous dividends.

Case study:

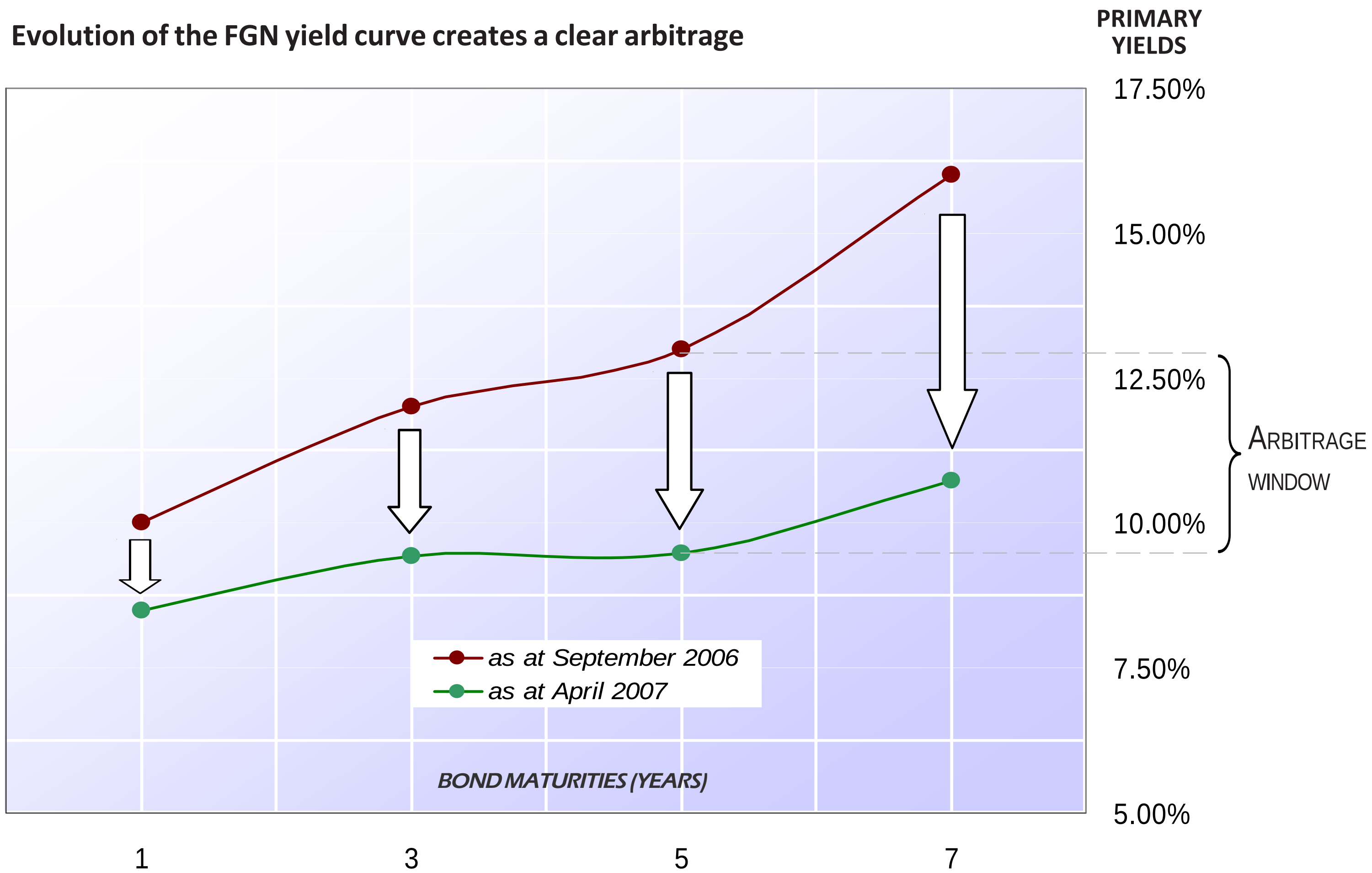
⇨ **Nigeria's Special Contractors' Bond**

- ***Background:*** Responsible for managing the liabilities of the Federation, the *DMO had overlooked the early-redemption option* embedded in this instrument issued to capitalize arrears payable to local contractors in an amount equivalent to USD 717 million.

- ***Issue:*** This oversight was *costing the Federal government the Naira equivalent of ca. USD 29 million in excess interest payments each year*.

- ***Resolution:*** Rhombus identified the negative arbitrage window and recommended exercising the call option, which was already deep in-the-money. The DMO promptly acted on this recommendation, thereby *realizing PV savings equivalent to USD 107 million* (over the instrument's remaining life).

Evolution of the FGN yield curve creates a clear arbitrage



❻ *Unforced errors inflict the greatest damage ...*

... Like John Boye's own-goal in Ghana's quarter-final match vs Portugal during the 2014 World Cup. They should be avoided at all costs.

Case studies:

⇨ **The collapse of Kenya Airways**

- ***Background:*** In 2011 Kenya's flag-carrier announced *Project Mawingu,* a 10-year programme aimed at *extending its route network from 58 to 115 destinations, and the expansion of its fleet from 42 to 119 aircraft.*
- ***Policy blunder****:* The initiative was launched shortly after the entry into force of IATA's deregulation directive, *guaranteeing fierce competition along KQ's routes from deep-pocketed international carriers* like Emirates and Qatar Airways.
- ***Outcome***: The company has now recorded sizable losses for four consecutive years, with the figures for 2014-15 and 2015-16 each topping USD 250 million. In March 2016, the Kenya Government was forced to announce *a USD 690 million reorganization plan that included a capital infusion of USD 250 million*.

⇨ Nigeria's self-destructive Naira policy

- ***Background:*** The 24 month period commencing in June 2014 witnessed a *57% decline in the price of Brent crude* which accounts for almost 90% of Nigeria's export earnings and a significant share of its fiscal revenues.

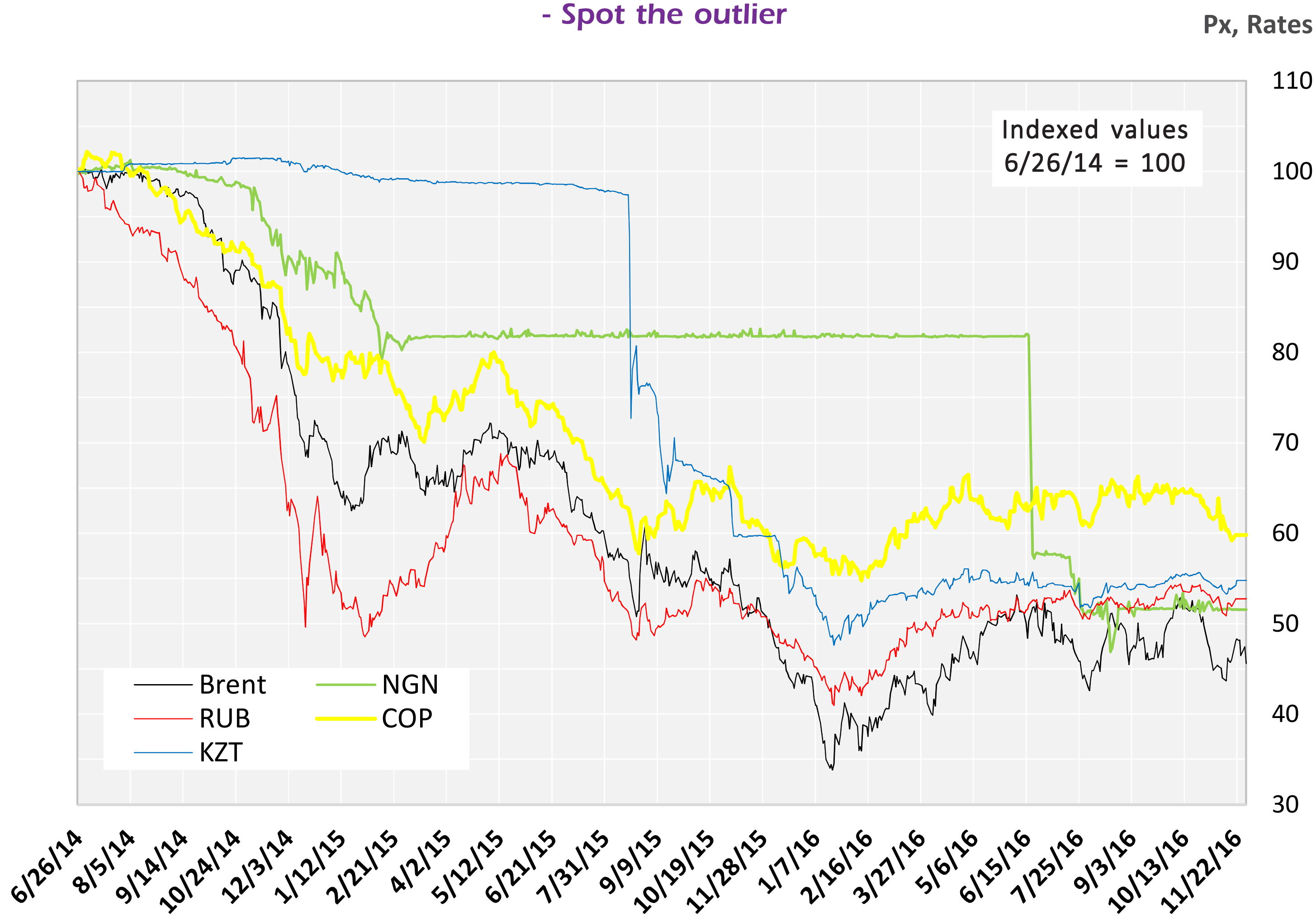
- ***Policy blunder:*** Instead of allowing the exchange rate to play its natural role as a shock-absorber, *policy-makers insisted on defending the overvalued Naira*. As external reserves began to shrink, increasingly restrictive capital controls were implemented in a desperate attempt to contain the demand for foreign exchange.

- ***Outcome:*** *Stagflation.*

  - The *de facto* rationing of FX has created a number of bottlenecks - in particular, shortages of imported equipment and spare parts - pushing the economy into recession. During *Q3 GDP contracted by 2.24%, its third consecutive decline*.

  - Consumer *inflation is now running at 18.3%* (y/y), propelled by the Naira's 65% depreciation on the parallel market - increasingly the only available source of hard currency.

Petro-currencies adjust to the oil price collapse - Spot the outlier



⇨ Mozambique’s debt debacle

- ***Background:*** Mozambique’s *debt-servicing capacity was significantly undermined* when the major oil and gas operators responded to the 2014 collapse in oil and gas prices by putting on hold their plans to develop the Republic’s *offshore gas reserves of 85 trillion s.c.f.*

  The problem was compounded when it emerged in April 2016 that the *government had issued guarantees covering USD 1.2 billion in previously undisclosed loans*. The IMF, World Bank and Mozambique’s bilateral donors reacted by suspending their respective support programs.

- ***Policy blunder:*** In October 2016, the Republic announced that it was *seeking to restructure its external commercial debt* in order to satisfy the IMF’s debt-sustainability criteria. Reportedly, this is one of the Fund’s pre-conditions for reinstating the suspended program.

- ***Outcome:*** This curious decision has jeopardized *an inflow of capital investment many times greater than the approx. USD 400 million* potentially available under the IMF programme.
  - In the weeks before this bombshell, *the Italian giant ENI had signaled that it was finally ready to start developing its offshore Coral project*, a USD 15 billion LNG venture.
  - ExxonMobil had been in advanced talks with both ENI and Anadarko (the operator of offshore Area 1), about acquiring a 20% stake in their respective offshore concessions. If consummated, *each such transaction could generate a tax windfall of as much as USD 1 billion* for Mozambique’s fiscus.

Conclusion

Take-away

If one had to try and condense this afternoon's insights into a single lesson it might run as follows:

Regard portfolio flows as neither asset nor liability; instead, judge each case entirely on its merits or lack thereof.

Valediction

The last word - part exhortation, part challenge - goes to the pan-Africanist, surgeon, novelist, playwright, and poet, the late Lenrie Peters:

It is time for reckoning, Africa,
time for taking stock.
Never mind New York, London -
it's ours; is here, and running short.

[…]

Between Alpha and Omega
is now, Africa; this
is the lost and future time.

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