



PAN AFRICAN CAPITAL GROUP, LLC

Research Note

December 4, 2008

**The Forefront of
Investment
Banking Services
in Africa**

The Global Financial Crisis and the Extent of the Impact on Africa

Global financial markets have entered into a vicious cycle of rapid deleveraging, asset price declines, and investor redemptions. This has sharply exacerbated the cyclical slowdown in global growth already underway, which in all likelihood will be deeper and more prolonged than previous slowdowns.

Since 2002, emerging markets have proved remarkably resilient, with investors shrugging off natural disasters, political scandal, economic populism, coups, and macroeconomic slippage that in the past were met with a swift and lengthy retrenchment of foreign capital. Remarkably, during this time of benign risk, emerging market sovereign bond spreads (on a weighted average basis) declined from 800 basis points to below 200 basis points in 2007. The out-performance of emerging market equities during this period was even more substantial. Returns in Africa over the period were among the most impressive. Databank's Epa@k Fund¹, a proprietary mutual fund investing in 19 African equity markets that has returned over 30 percent per annum on average since its inception in 1996.

While foreign investment was emboldened by improved macroeconomic management, strong growth, and relative political stability in emerging markets, the unprecedented amount of foreign capital being invested in emerging markets were certainly motivated in large part by low investment yields in the advanced economies and by the depreciating dollar. This search for yield and currency diversification opened up markets previously only on the radar of frontier investors like Pan African Capital Group to foreign capital flows.

¹ <http://www.databankgroup.com/index.php>

Given the resiliency of emerging markets during the period of 2002 to mid-2008, it is not surprising that in the end it was a crisis manufactured in the advanced economies (or perhaps it is more appropriate to say it was a crisis financially-engineered in the advanced economies) that finally brought an end to the boom for emerging markets. The end of the party has been abrupt. Since the beginning of October, emerging market equities are down more than one-third in local currency terms and even further in U.S. dollar terms due to widespread currency depreciation against the suddenly in vogue again U.S. dollar.² Spreads on sovereign debt have returned to 2002 levels, with more than a third of the countries in the benchmark EMBIG index now trading above 1,000 basis points. The impact of the sharp blowout in bond spreads has been most pronounced in the more advanced emerging markets that had been financing fiscal deficits via international capital markets. With debt service costs mushrooming and export revenues coming under pressure, pro-growth fiscal spending will inevitably come under pressure.

In many ways we are in uncharted waters. Prospects for global growth have deteriorated significantly in the last few months, with the IMF now projecting global growth of just 2.2 percent in 2009. Economists will readily concede that global growth below 3 percent is the equivalent of a deep global recession. Advanced economies are expected to contract in 2009, the first time this has happened in the postwar period. Economists will also concede that the downside risk to their already lowered forecasts is much greater than in the recent past.

House View

At a minimum, we expect the next 18 months to be extremely challenging for Africa, as spigots of capital – whether from private investors, donor flows, worker remittances, or philanthropists – inevitably slow down and economic growth weakens. The ability of Africa's nascent democracies and economic technocrats to manage this downturn will undoubtedly be tested, but we are optimistic that many are up to the challenge.

Undoubtedly, the poor state of global financial markets is worrying for all classes of investors regardless of geography or risk orientation. In terms of direct impact on Africa, the financial crisis itself will have limited impact due to fact that Africa largely stands outside looking-in on global capital markets. This isolation can be comforting during periods of global stress, but ultimately for Africa to prosper it will need to become part of the global capital market.

Global portfolio investment flows are difficult to measure, particularly with large pools of unregulated capital sloshing around the system. But in 2006, the most current year we have reliable and comprehensive data for, Africa accounts for just 0.38 percent of total cross-border portfolio investment assets (this includes equities and both sovereign and corporate debt). Of this small amount, South Africa, which ranks 35th in the country rankings, accounts for two-thirds of all portfolio investment assets in Africa. Put another way, there are 34 countries that alone have

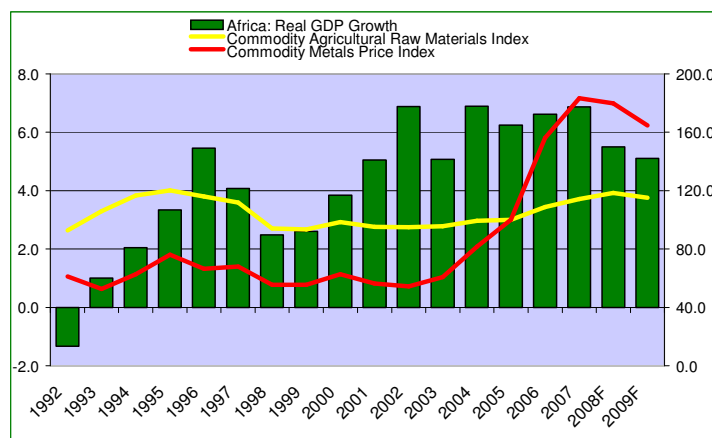
² WEO Update, November 6, 2008 (International Monetary Fund)

more cross-border portfolio investment than the entire continent of Africa, and this includes small economies like Singapore.

We are confident that Africa's share of these investment flows increased in 2007 and the early part of 2008, we are equally confident that with the exception of South Africa, a handful of rated sovereigns, and perhaps for a brief period of time Nigerian banks, Africa remains largely outside of the global financial markets. Thankfully, this isolation means that African financial institutions have little direct exposure to the toxic illiquid assets that have caused so many problems for financial institutions elsewhere in the world. Now, that is not to say that African bankers can sleep easy at night, because bank loan books and proprietary trading accounts (which for some Nigerian banks we estimate account for as much as one-quarter of total assets) contain their own risks and areas of deep concern which will need to be worked out.

While the impact of the financial crisis on Africa in itself will be limited, where we think the impact will be felt in Africa is that the current financial crisis will prolong and deepen the cyclical downturn in global growth. We anticipate that the macroeconomic shock will be substantial for most African countries; however, we do not anticipate that the transmission channels will be radically different than in previous global downturns, therefore the existing macroeconomic playbook for dealing with economic shocks is still in play.

1. Lower growth in the advanced economies unavoidably means less demand for African commodities, which means less tax revenues and less national income as a whole. While many of our own private equity investments are geared towards taking advantage of Africa's emerging middle class with disposable income for banking services, mobile phones, and intermediate goods, we still acknowledge that Africa's growth cycle is invariably tied to commodity prices.



Source: IMF

2. With liquidity concerns quickly spiraling into solvency concerns, investors are becoming increasingly risk averse. Although the emerging market world is not the cause of the global financial crisis, investments in emerging markets will undoubtedly decline as investors move into traditional stores of value like U.S. Treasuries and gold, and away from less liquid emerging market investments. With liquidity an issue in many African markets at the best of times, the withdrawal of foreign capital can increase volatility and cause significant currency depreciation. Take for example, the Ghanaian stock market and the paradox of relative isolation from global capital flows. Ghana's stock market is still up over 40 percent in local terms and 17 percent in U.S. dollar terms thus far in 2008, making it one of the best

performing markets in the world. Yet, market liquidity has effectively dried up as foreign investor interest in the Ghanaian market has virtually disappeared. Portfolio gains in Ghana, and other African markets, are mere paper gains as they currently cannot be monetized without offering a substantial discount of the quoted price of listed equities.

3. As a result of reduced exports and less investment capital, African governments and businesses are likely to face higher interest rates both externally and locally (assuming risk-based pricing is in effect). Facing lower revenues and higher debt service costs, governments and businesses in Africa are likely to reduce investment in new infrastructure, manufacturing capability, and human capacity, areas which I deem as essential to the continent's emergence from the boom & bust commodity cycle. The real risk for Africa is that hard fought gains from the past decade are lost. For all of its cheap labor and resources, Africa remains a very expensive place to do business due in large part to its inadequate infrastructure, which, along with poor access to healthcare and education, explains in large part Africa's low productivity. Investment in all three of these areas is critical for Africa to prosper, and while local pools of capital are increasingly available to finance these investments, foreign governments, philanthropists, and private capital will still have a critical role to play, providing guidance, leadership, and capital.
4. Depending on the depth of the crisis and the costs imposed on the advanced economies to resolve it, a second wave of transmission effects may impact Africa and the rest of the developing world. While there are few certainties in forecasting, one thing we can probably all agree is that the U.S. fiscal deficit will get larger as a result of the costs imposed on the government to resolve the current crisis. On top of the \$700 billion bailout package for financial institutions (the definition of which seems to expand daily, with GMAC now trying to convert itself into a bank holding company to avail itself of government support), the tax base is unlikely to expand and the Democratic-controlled Congress is likely to pass an additional household stimulus package that may top \$100 billion. A soaring U.S. fiscal deficit poses a number of challenges for Africa; but perhaps most worrisome is undoubtedly the budget for U.S. foreign assistance is likely to be curtailed significantly and may remain so for a substantial period of time. Justifying foreign assistance during difficult economic times is difficult, and the Obama Administration will face tough choices as to where it commits its limited resources.

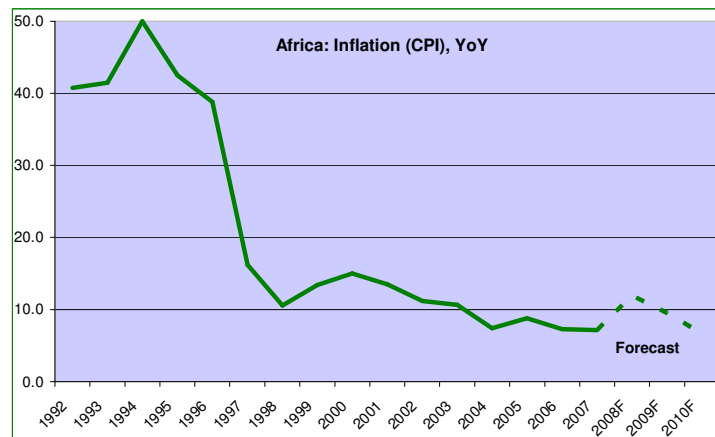
President-elect Obama is building a strong team of foreign policy and economic advisors. Reading the tea leaves, we suspect that the new administration's focus in Africa will be slightly different than that of outgoing President Bush. Critically, the Obama Administration needs to continue some of the more successful policies of his predecessor, for example, PEPFAR and the Millennium Challenge Corporation have been very positive for Africa, with the latter focusing on the countries that exhibit a strong commitment to good governance, sound economic management, and democratic ideals. The Administration might also consider expanding the Clinton-era AGOA to include incentives for American companies investing in Africa, while further expanding Africa's access to American markets. While we laud President Bush's initiatives and focus on Africa's relative success stories, we want to highlight the need for stronger U.S. engagement in dealing with Africa's failed and fragile states, such as Darfur, the D.R.C., Zimbabwe to name just a few. For too long, Africa's failures have superseded its

successes, and until we meaningfully address Africa's weakest states, the continent will continue to be viewed in a negative light. The recent discussion of the introduction of a cabinet-level post to coordinate our development spending in a comprehensive manner to insure more streamlined effective programs deserves strong consideration. An integrated approach will only help strengthen Africa's markets.

Some Reason for Optimism

Like the rest of the world, Africa's economies will need a stimulus package to capitalize on the growth opportunities and minimize the impact of Africa's failed states on the rising stars. While a slowdown in African growth is all but inevitable, there are a number of factors in Africa's favor that may allow the continent to emerge in better shape than in past slowdowns.

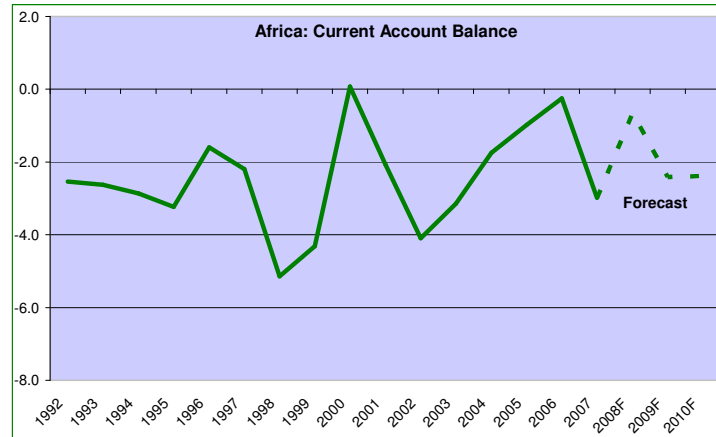
1. Contrary to the negative image the media constantly gives Africa as bedeviled with wars, poverty and corruption, there are many success stories on the continent that most are unaware of. Political reforms in several countries are beginning to bear fruit and a new generation of democratically-elected African leaders with market oriented economic policies are emerging. Twenty years ago, dictatorial and undemocratic governments existed in 37 out of 53 countries but this figure has trickled down over the years to only 10 countries. In the 1960s and 1970s no African ruler was voted out of power. In the 1980s one leader was voted out. Since 1990, 18 leaders have been voted out of power. This reflects a changing climate in Africa and this is spurring economic freedom and has bolstered hopes for sustainable economic growth. This weekend we look forward to the outcome of another vibrant election in Ghana – an election that we fully expect to be fair and free and an outcome, no matter who wins, that is accepted peacefully by all sides.
2. Economic reforms over the past 20 years are beginning to bear fruit in many African countries. These have taken the form of structural adjustment, financial market reforms, privatization and liberalization. Today in many African capitals, foreign-trained technocrats make up the majority of civil servants, diminishing the impact of political and tribal patronage.
3. Better macroeconomic management in Africa is reflected positively in monetary indicators. Inflation during this decade, which has been an endemic problem in sub-Saharan Africa for several decades, has been on a consistent decline. After peaking at 15% in 2000, inflation declined to 7% in 2007. Earlier in 2008, inflationary pressures reemerged



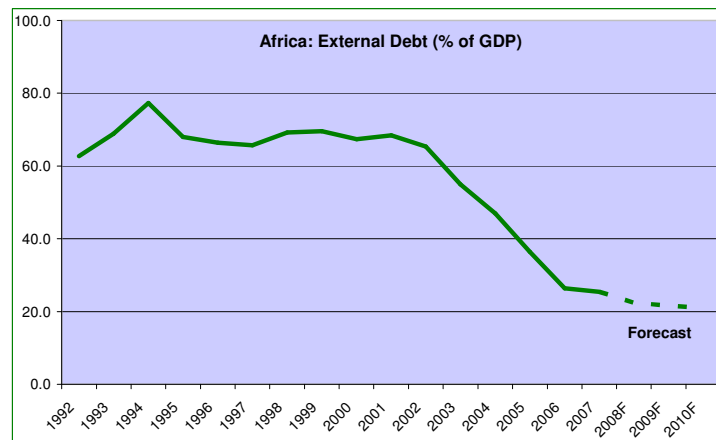
Source: IMF

due to global increases in fuel and food, the most significant components of Africa's import bill. Through appropriate macroeconomic responses, inflation in a number of markets was already coming down in the later part of this year before the global economic contraction further tempered inflation expectations.

4. There has been significant improvement in government's fiscal discipline on the continent and this has helped to reduce the region's debt burden. Overall fiscal deficit has declined consistently from an average of -3% of GDP between 1997 and 2001 to almost in balance in 2006. 2007 saw some fiscal slippage, as import bills soared, but again, the correction has been prompt and even with heightened uncertainty over economic growth, fiscal discipline is expected to remain.
5. Better financial management and discipline, coupled with debt relief and repayments has allowed the African continent to deleverage, with external debt to GDP declining from 67% in 2000 to under 25% in 2008.



Source: IMF



Source: IMF

Conclusion

Throughout the advanced economies, the fear of a breakdown in commercial and household credit markets has led to most significant government intervention in the financial sector since the Great Depression. Such is the fear of living in a credit constrained environment that billions upon billions have been pledged globally to keep the credit pump primed. Yet, in most Emerging Markets, credit constraint is a fact of life; and in Sub-Saharan Africa it is most pronounced, with our research estimating that credit to GDP is just 20 percent in the region. In many countries on the African continent credit to GDP is in the low single digits.

Unlike the advanced economies where much of the credit outstanding supports household consumption, credit in Sub-Saharan Africa is almost exclusively growth capital. Without capital to unlock nascent growth opportunities and entrepreneurship in Sub-Saharan Africa the continent will never be able to fulfill its potential. Africa needs both better access to international capital

markets as well as better credit risk management by African institutions so that they can be critical drivers of economic growth. This is where the International Community and the IFIs could play a critical role in improving Africa's access to and use of credit.

For many years now, we have been proponents of integrating Africa into global financial markets through the increased use of sovereign credit ratings. Sovereign credit ratings, even if they are well below investment grade, can be an important signal to the international financial community of a country's readiness to participate in the global economy through prudent macroeconomic management and economic and political reforms. Critically, sovereign credit ratings establish a benchmark against which future progress can be measured. In Sub-Saharan Africa since 1998, the number of rated sovereigns has increased from two to fourteen currently. Armed with a credit rating, even single-B rated countries like Ghana have been able to access international capital markets on fair terms in the past few years. Granted, this was during the aforementioned benign environment for Emerging Markets. As we have entered a much more difficult credit environment, sovereign credit ratings, we suspect, will become much more critical for countries seeking debt financing.

While we are right to focus on access to international capital markets, we often overlook the pools of local capital in Africa that can be critical sources of investment capital. For too long, African banks and financial institutions have been inadequate intermediaries of credit. This reflects both the crowding out effect of local governments, which turned to banks to finance government spending, and the historically conservative nature of African bankers.

Picking up on global trends, in many African markets local credit growth has seen a rapid rise, albeit from a low base, in the last couple of years. This rapid expansion in credit has not been accompanied with improved credit risk management practices which raises grave concerns and is likely to result in an abrupt correction as banks severely restrict new credit as losses from their existing loan portfolios rise. In this regard, African banks are no different than financial institutions elsewhere in the world. Absent an investment in improved credit risk management tools – such as credit referencing agencies – better legal protection for banks in the form of commercial courts that evenly enforce timely foreclosure on delinquent borrowers, and stronger prudential oversight from the continent's banking regulators, we suspect that the expansion in local credit markets will be highly cyclical and exacerbate the boom and bust commodity cycle that drives Africa's economic growth. The international community, by providing technical assistance to Africa's bankers, regulators, and judicial courts, can play an important role in improving the credit environment and infrastructure in Africa.

Pan African Capital Group, LLC (PACG) is a US-based investment company focused exclusively on investment opportunities in Sub-Saharan Africa. PACG provides investment banking and advisory services, asset management, and private equity across the region. The firm is primarily focused on the financial services, telecommunications, manufacturing, and agribusiness sectors, and manages a diversified private equity portfolio.

Most recently, PACG, alongside partners Databank (Ghana) and Trust Bank Limited (The Gambia), acquired majority control of International Bank (Liberia) Limited, Liberia's oldest commercial bank and the preeminent business-focused financial institution.

PACG and its affiliates maintain a nexus of offices throughout West Africa and have strategic alliances in East Africa, North Africa and the United Kingdom.

For more information, please contact:

*Pan African Capital Group, LCC
1100 Connecticut Avenue, NW
Suite 330
Washington DC 20036
Phone: +1-202-887-1772
Fax: +1-202-887-1788*

www.panafricancapital.com

*Stephen D. Cashin, Founder & CEO
Stephen B. Murray, Investment Officer
Wyanie A. Bright, Investment Officer
Eric Smucker, Investment Analyst
Linda Yougna, Investment Analyst*

*sdcashin@panafricancapital.com
sbmurray@panafricancapital.com
wabright@panafricancapital.com
esmucker@panafricancapital.com
lyougna@panafricancapital.com*