MADAGASCAR SCOPING STUDY:

Assessing the Potential to Issue Non-Sovereign Local Currency Bonds

ALCB FUND

1. THE MACRO ENVIRONMENT

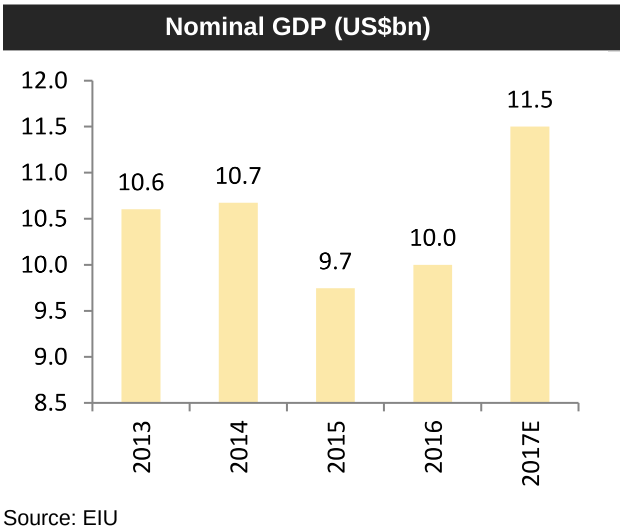
Economic Overview

Agriculture, including fishing and forestry, is a mainstay of the economy, accounting for 23.7% of GDP and employing about 80% of the population. **Madagascar produces around 80% of the world's vanilla and its reliance on this commodity for most of its foreign exchange is a significant source of vulnerability**. Industry accounts for 16% of Madagascar's GDP.[1] The remaining 60% of the economy is represented by services.

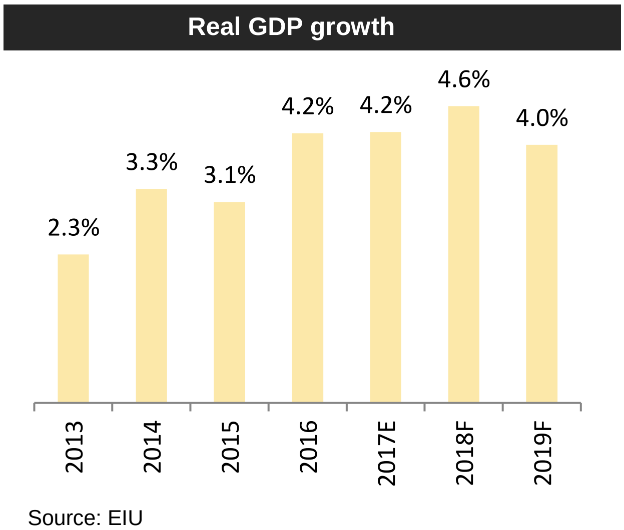
Remittance inflows from migrants are a very important part of the Madagascar economy. In 2017, the country recorded US$ 262 million in inflows, and a total of US$ 1.37 billion from 2013 to 2017. This level of currency inflows corresponds to 11% of the country's earnings on export of goods. However, it should be noted that the **dynamics of remittance inflows has been subdued over the last five years.** France (88%) is by far the largest sender of remittances.[2]

The Malagasy economy has been steadily improving since the return to constitutional order in 2014. The upturn in public investments, the resumption of external aid, and the opportunities presented by access to external markets have boosted local activities, especially the public works, construction and manufacturing sectors. The economic growth rate exceeded 4% since 2016, reflecting this positive trend (compared to an average annual growth rate of 2.7% during the political crisis of 2009-2013).

Real GDP growth is set to accelerate from an estimated 4.2% in 2017 to 4.6% in 2018, as projects launched in a number of sectors in 2017 come on stream. Mining which currently accounts for about 3% of the GDP, only, is set to expand. Although international prices of metals will experience a lower growth than in 2017, demand will remain high, expanding by 7.5%. Export processing zones (EPZs) will also benefit from the restoration in 2015 of US trade privileges under AGOA and plans to create a joint special economic zone in southern Madagascar with Mauritius should help to encourage new investments in the country.



Source: EIU



Source: EIU

GDP growth is forecast to slow to 4% in 2019 and several downside risks persist. It is possible that the Trump administration in the US will either revise the terms of the African Growth and Opportunity Act (AGOA), or simply disregard its provisions, posing threats to the textile sector, in particular. Political instability also

[1] Industries include: meat processing, seafood, soap, beer, leather, sugar, textiles, glassware, cement, automobile assembly plant, paper, petroleum, tourism and mining.

[2] Source: www.worldbank.org.

poses risks to future growth: forecasters assume that the political situation will not deteriorate to such an extent as to jeopardise donors and investors inflows.

Fiscal Policy

The 2018 budget projects a 17.6% increase in tax revenues (on 2017 levels) to MGA 4.81trn (US$1.37bn), with non-tax revenues estimated at MGA90.1trn (US$26bn), and donations from external partners at MGA1.21trn (US$350m). According to the authorities, the fiscal deficit will be financed by external loans of MGA1.25trn (US$360m). Those revenue forecasts appear optimistic given that 2018 is an election year, and **the depreciation of the ariary is likely to have a negative impact on customs revenues**. Overall, IMF expects the fiscal deficit to rise to 3.2% of GDP in 2018—from an estimated 2.7% of GDP in 2017. The deficit will ease slightly in 2019, to 3.1% of GDP, as a new administration makes further efforts to contain public-sector wage bill growth, and reduce transfers, notably to Jirama, the State-owned electric utility. The shortfall will be covered through a mix of domestic and external (largely concessional) borrowing.

Monetary Policy

The Banque Centrale de Madagascar (BCM) will continue to pursue a monetary policy stance that takes into account the need for sustained economic growth, while seeking to keep inflation below 10% and providing support for international reserves. **BCM tightened its base rate twice in 2017, from 8.3% to 9.5%,** amid inflationary pressures caused by unfavourable weather, and the depreciation of the ariary. We note that inflation grew sharply in 2017, reaching 9% in December, the highest price increase in seven years. BCM has kept the base rate unchanged so far in 2018.

Rate cuts are likely in 2019 if inflation moderates as the impact of adverse weather conditions on food prices eases.[3] However, given the lack of financial depth in Madagascar, monetary policy has only limited capacity to influence inflation—which is largely determined by fluctuations in local agricultural outputs and world commodity prices—or, indeed, lending. In the medium term, with the support of the IMF, BCM aims to develop more sophisticated frameworks and tools for liquidity management and development of the foreign-exchange market. Notably, legislation to promote repo (repurchase) transactions is due to be submitted to parliament by the end of 2018.

Exchange rate

Madagascar switched to a floating exchange rate regime in 1994. The ariary appreciated by 1.9% against the US dollar during 2017, but the currency is expected to resume its depreciation in 2018-19. Despite continued support from the IMF and other donors, which will support the inflow of foreign-exchange receipts into the country, EIU expects the ariary to continue to slip throughout the forecast period, reaching an average of MGA 3,247/US$1 in 2019, from MGA3,116/US$1 in 2017.

Hedging options for US$/EUR investors

There are no hedging options available in Madagascar for medium- and long-term exposures in local currency. BCM is working alongside the IMF on a new currency exchange law which will include the possibility for local banks to offer forwards and currency swaps. Depending on the outcomes of the elections, the new law might see the light during the course of 2019.

[3] EIU expects inflation rate to stand at 5.8% in 2019.

Exchange rate controls[4]

Exchange rate controls are in place in Madagascar: financial transactions between foreign investors and investees in Madagascar are subject to preliminary approval from the Ministry of Finance[5]. An exception is represented by foreign direct investments in equity of Malagasy firms which are free and not subject to preliminary approval.[6] Investees that have recently applied for an authorisation to borrow from international sources at the Ministry of Finance reveal **that it can take up to six months to obtain the authorisation**.

2. FINANCIAL SECTOR

Banks

Banks are the largest providers of financial resources to the economy. There are currently 11 banks in Madagascar, mostly controlled by foreign investors and by international banking groups. However the State of Madagascar retains minority stakes in three of the "big4" (Bank of Africa, BNI, BFV-Societe Generale and BMOI). Out of the 11 banks, the "big4" account for 88% of the total assets of the industry. The other banks are relatively small. Three of them– Baobab (formerly Microcred), Access Banque Madagascar (Access) and Sipem Banque (Sipem) – are specialised in lending to micro, small and medium enterprises.

Large banks in Madagascar have excess liquidities but most of their deposits are short term. This makes it difficult for banks to finance medium to long term projects.

Deposit rates vary significantly across banks. Large banks with extra liquidities pay low rates (0%-3.5%, depending on the maturity of the deposit), while **smaller banks which are growing their loan book at exponential rates tend to pay much higher rates to depositors (7.5%-15.0%, depending on the maturity).**

On the credit side, **prime rates across banks vary widely**. It goes from 14% for large banks to 24% for smaller MSME banks. However, if collaterals are sufficient to cover the full loan amount**, many corporates are able to borrow with large banks at below prime rate: 10%-11% over the medium term (7 years).** On the other side of the spectrum, smaller banks charge up to 60% a year for short-term loans to SMEs and 45% a year for medium-term loans to semi-formal or informal micro-enterprises.[7]

Insurance Companies

There are currently five insurance firms in Madagascar: ARO, Ny Havana, Allianz, Saham and Mama. The largest two (ARO and Ny Havana) have a market share of about 75% and have the State as the largest shareholder. The annual turnover of the industry is relatively small at about MGA 250 billion (US$ 72m) in 2017, but it is growing at 10% a year.

The pension industry

Caisse Nationale de Prevoyance Sociale (CNAPS) is a State-owned national social security fund in charge of collecting and investing employees and employers' contributions, both from the private and the public sectors. CNAPS has assets totalling over MGA 1 trillion (about US$ 300 million), 80% of which is invested in T-bills and banks' term deposits. To diversify its positions, it also invests overseas (bonds and stocks). **There**

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[4] Ex-rate controls modalities are established by Decree N. 2009-048 of 2009.

[5] The transaction needs to be authorised by the Service Financier Exterieur (FINEX), a department of the Treasury.

[6] See articles 2 and 4 of Decree N. 2009-048 of 2009.

7 Source: Central Bank of Madagascar.

are no private pension funds in Madagascar. Some insurers (e.g. ARO, NY HAVANA) offer retirement insurance products, to a limited extent.

Other State-owned financial institutions

The **Caisse d'Epargne de Madagascar** (CEM) is a State-owned financial institution created in 1918 to foster savings habits across low-income Malagasy households. Currently not supervised by CSBF, CEM collects retail deposits and invests them largely in T-bills and term deposits with banks and MFIs.

Paositra Malagasy (**La Poste**) is one of the largest investors in Treasury Instruments (BTAs/BTFs). Fully owned by the State, La Poste collects retail deposits and invests them in T-bills but also in term deposits with local banks and MFIs. The interest rate received for a 12-month deposit at a small bank, for instance, is of 10%.

Other asset managers

Given the absence of a stock market and of private pension schemes, the only other asset managers in Madagascar are **private equity and venture capital investors**. The largest players managing foreign capital are Adenia, Madagascar Development Partners and Investisseurs and Partenaires. Among the Malagasy fund-managers, the largest are Sonapar, which is largely managing resources of the State of Madagascar, and Fiaro, an offspring of ARO, the insurance group.

3. PUBLIC NOTES

T-Bills (BTAs)

The Treasury - Tresor Public Malagasy - regularly issues T-bills (**Bons du Tresor par adjudication - BTA**) to finance its activities. BTAs are issued via an auction system. The Treasury publishes a quarterly calendar of bond issuances with indicative amounts sought for each maturity of BTAs. Maturities of these short term notes vary from 4 weeks to one year.

Bidders on the primary market are financial intermediaries – mainly banks - that have received a special agreement from the Ministry of Economy, Finance and Budget. Agreements are for a two-year period and the intermediary has the obligation of subscribing to at least MGA 4 billion (US$ 1.2 million at current exchange rates) worth of BTAs. Potential non-bank subscribers can also be eligible to participate in the auctions, but they are required to put down 5% guarantee deposits alongside each bid.

There is also an "after-bid market" in which the Treasury offers BTAs at a weighted average rate to registered financial intermediaries, only.

BTA yields are extremely volatile. If we look at 52-week BTA's issued over the last five years, we see that yields ranged from 6% to 14%, while inflation rate ranged from 6% to 9%.

Bonds (BTFs)

Since 2015, the Treasury - Tresor Public Malagasy - regularly issues bonds (called **Bons de Trésor FIHARY – BTF**). BTFs have maturities of one, two and three years. Unlike BTAs, BTFs' rates are determined by Treasury and the investors can buy BTFs directly at Treasury's tellers. Interests and principal are paid at maturity. **BTFs rates have been steadily increasing throughout 2018: in the most recent issuance (Oct 2018), coupon rates ranged from 11.15% for the one-year note to 13.15% for the 3y.**

4. THE STATE OF THE CAPITAL MARKET

Overview

Madagascar lacks an ad-hoc law on financial markets. There is no stock-exchange currently in place, nor any ad-hoc supervisory authority to oversee financial markets activities. In 2017, the State of Madagascar signed an MoU with the London Stock Exchange to receive technical support in the setting up of a stock exchange, but the activities included in the agreement are yet to take off.

SIPROMAD Tower – the only successful case of corporate bond issuance in Madagascar

In spite of the lack of a proper regulatory framework, back in 2012, BGFI, a bank, successfully structured a private placement of MGA 33 billion (US$ 9.5 million) to finance the construction of a commercial complex by SIPROMAD, a local conglomerate. The 5-year bond paid a coupon of 8.5% and it was subscribed almost entirely by CEM[8]. The bond was pre-paid as the issuer managed to find a cheaper source of finance outside the country. The transaction was vetted by the Central Bank given that, back then, its articles of incorporation (AoI) gave it the authority to approve capital markets transactions. In 2016, the AoI of the BFM were modified and that specific article/activity was suppressed. This means that, since 2016, BFM is no longer responsible for authorising bond issuances in Madagascar.

The only other attempt to raise funds via the capital market, was made in 2017 by **BNI,** a bank, that tried unsuccessfully to issue a private placement of MGA 30 billion (US$ 9.1 million at current exchange rates). Lessons learned by BNI during this unsuccessful attempt to raise funds via a bond placement were the following:

- **Lack of local investors' interest.** The coupon rate offered was considered too low compared to risk-free instruments. Intentions to subscribe received by the issuer were for about 30% of the bond (MGA 10 billion). So, BNI decided not to issue the instrument.
- **Coupon rate more important than guarantees:** During the road-show, investors were extremely focused on the coupon rate and paid less attention to the guarantees proposed by the issuer.

Legal and Regulatory Framework for non-sovereign issuances

Public and Private Placements

Corporate bonds issuances in Madagascar are regulated by **Law 36 of 2003** (Loi 2003_036 sur les sociétés commerciales). Law 36 sets the conditions for non-sovereign bond issuances. **Article 77 defines a public placement in Madagascar** as an instrument which is:

a. Listed on the local stock exchange;
b. Offered to the public either via a financial intermediary (établissements de credit), broker or directly using any form of marketing;
c. Proposed to more than 50 individuals

The article is not clear on whether the above conditions need to occur <u>jointly</u> for the transaction to be classified as a "public placement" or as "a private placement".

[8] According to our meetings on-site CEM was essentially the only investor. BGFI took a symbolic portion of the issuance.

According to article 4.2 of this decree, in the absence of a supervisory body of the local stock exchange, **the notice needs to be submitted to the Ministry of Economy, Finance and Budget for approval.**

Additional key provisions of Law 36 are the following:

a. Only limited liability companies (sociétés anonymes) whose **subscribed capital has been entirely paid** are authorised to issue a bond (art 794);
b. Only the **General Assembly of shareholders** can decide upon a corporate bond issuance and can delegate the board to proceed with one or various issuances within a 2-year timeframe (art 796);
c. Investors in a given issuance are collectively represented by a representative (art 798) – a physical or moral person **resident in Madagascar**. The remuneration of this representative is set by the assembly of investors or indicated in the investment prospectus.

The regulatory framework does not prevent local corporates to issue bonds in foreign currency.

Tax regime

There are no fiscal incentives for issuers nor for investors in a bond. All investments in Madagascar are subject to a capital gain tax (Impot sur les revenues des capitaux mobiliers – IRCM) of 20%. Madagascar signed a double taxation treaty with Mauritius which covers CGT.[9] Technically, interests received by entities registered in Mauritius are not taxed in Madagascar. However, in some cases, investors based in Mauritius might be subject to a lower IRCM rate (10%).[10]The country also signed a double taxation treaty with France.

Investments in BTAs and BTFs are not exempted from IRCM.[11] In case of a sale of a bond to another investor, the buyer needs to pay a tax of 0.5% of the residual value of the bond.[12]

Key to note that coupons are exempted from VAT.

Costs of Issuing Corporate Bonds

Estimating the cost of issuing corporate bonds in Madagascar is not straightforward, particularly when it comes to **structuring costs**. A knowledge-transfer process – from HQ to Madagascar – on structuring and placing bonds on the local market will have to occur for the first transactions. This knowledge-transfer from HQ will likely have an impact on the structuring costs of the first transactions with the risk of making the bond uncompetitive vis-a-vis alternative financing instruments (loans, term deposits). In the absence of a stock exchange, there are no listing costs for bonds issued in Madagascar.

Reasons for lack of corporate issuances

Beyond the issue of pricing, these are the main reasons for the absence of corporate bonds in Madagascar:

- **Lack of political willingness.** Corporate issuances could partially drain the liquidity available in the market with dire consequences for the public finances
- **Lack of a modern financial markets law,** which creates a stock exchange where bonds are traded (secondary market) and establishes clear rules for public issuances
- **Lack of interest from local banks** which prefer to syndicate instead of structuring a bond
- **Absence of structuring expertise across local banks**
- **Lack of fiscal incentives to issue (and invest in) bonds**

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9 Convention fiscal avec la Republique de Maurice signed on 30/08/1994.

10 Source: PwC.

11 See article 01.04.03 of Code General des Imports 2018

12 Source: Meeting with PWC.

- **Lack of transparency and poor corporate governance across Malagasy corporates.** Many corporates in Madagascar are still family-owned businesses. Corporate governance is poor: the founder takes key decisions and manages the company with little accountability. Many of these firms (not all of them) are not yet ready to open themselves up to the market.

5. POTENTIAL ISSUERS

Banks

MSME banks are growing at exponential rates and their capacity to collect local deposits to finance their growth does not keep pace with the expansion of their loan portfolios. **Term deposits from local institutions (insurance firms, SoEs, privately-owned corporates) are attractive sources of finance but they are limited in volume and capped to 1-2 years**. The interest rate offered to institutional investors is dependent on the evolution of T-bill rates.

Larger banks do not finance smaller players.

Deprived from medium-term sources of finance, **MSME banks resort to international borrowing to finance their growth**.

Microfinance Institutions

Alongside small banks, microfinance institutions could also be potential issuers of bonds to finance their growth, provided that the transaction is vetted by CSBF.

The sector is by far not homogenous: well-run institutions operate alongside poorly-run MFIs. The supervisory capabilities of the CSBF, the industry regulator, are limited which makes it difficult for investors to trust information coming out of the industry and investments require an extra effort in terms of due-diligence.

However, the sector is gradually restoring its reputation: a new microfinance law was issued in April 2018 to, among other things, strengthen the regulatory and supervisory framework for the industry, particularly for deposit-taking MFIs[13].

Non-FI Issuers

Non-financial corporates could also be potential issuers of bonds, although amounts needed might be too small for ALCB. Non-FI issuers include promoters of real estate projects, as well as local agri-businesses, provided that coupon rates and the repayment structure of the bond will be in line with their cash-flows.

[13] Loi 2017-026 sur la Microfinance

6. ASSESSING THE APPETITE FROM LOCAL INVESTORS

Banks do not have the resources to invest in medium-term instruments: it is unlikely that they will take a position on a 3-year note. Some of them might not be willing to finance a "competitor".

The insurance industry is quite small in Madagascar and largely controlled/influenced by the State**. For it to be of interest to the largest insurers the investment would need to be relatively small (i.e. below 8 billion) and for a maximum of 3-years.**

CEM and Paositra Malagasy (La Poste) also expressed an interest to invest provided that the issuer is solid, that the coupon rate is above Treasury instruments and that maturity is of 3-year maximum. The maximum ticket size for both institutions is of MGA 5 billion (US$ 1.4m).

CNAPS is looking to diversify its investments and it is liquid. In principle, it could invest in maturities of up to 5-years for a maximum ticket size of MGA 5 billion (US$ 1.4m). Similarly to other potential investors, it will carefully examine the guarantees provided by the issuer.

According to a potential issuer, **Malagasy corporates are liquid** and might be interested in investing in a corporate note.

Financial cooperatives such as Otiv Tana, Otiv Diana and Otiv Tamatav- also have available resources to invest but the inexistence of a secondary market and a relatively long commitment (3-year) might not make the investment suitable for these entities which might need to sell the instrument under a relative short notice to keep on disbursing loans.

7. CHALLENGES TO STRUCTURE CORPORATE BONDS IN MADAGASCAR

- **Finding a good quality issuer willing to pay a relatively high coupon rate to have access to longer tenures.** Good quality corporates in Madagascar have access to multiple refinancing options: i) in hard currency via headquarters outside of Madagascar (i.e. Mauritius); ii) banks loans; or iii) syndicated loans. if the amount is too high for one bank. I-rates for large corporates vary between 9% and 12% in local currency.
- **Finding foreign investors willing to subscribe to relatively low coupon rates.** At those rates, it might not be feasible for foreign investors (i.e. ALCB) to subscribe to an issuance, given that those rates might be too low to cover hedging costs and make a margin.
- **Finding local investors willing to subscribe to a medium-term bond.** Most institutional investors in Madagascar take short term positions (1-2 year maximum). It will be challenging to convince them to invest in a longer term instrument, unless: i) the quality of the issuer is outstanding; ii) the guarantee provided by the issuer cover the 100% of their position; and, possibly, iii) there is a buy-back mechanism in place to guarantee the liquidity of the investment.
- **Finding a bank willing to arrange a relatively small transaction at a relatively low cost.** There are a limited number of corporates whose business models allow them to borrow at high rates, which is a disincentive for banks to invest in bringing expertise from overseas to create a structured finance department. Structuring fees on small transactions will be too small for most banks to be incentivised to structure a corporate bond. The risk is that, on top of the coupon rate to be paid to investors, the arrangement and placement fees proposed by the arranger will be simply too high for a potential issuer to be incentivised to issue a bond in Madagascar.

8. ISSUING A CORPORATE BOND IN MADAGASCAR: NEXT STEPS

The number of good quality corporates whose business model make it possible for them to issue a relatively sizeable bond (MGA 30-40 billion, US$ 8.5m-11m) at a relatively high coupon rate (11.5%-12.5%) is limited and the absence of a secondary market represents a strong disincentive for local investors to invest in a corporate bond.

Despite these challenges, and even in the absence of a stock market, it is possible to issue a corporate bond in Madagascar with the right incentives in place to catalyse local market participation.

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