CAPITAL RAISING HANDBOOK FOR EMERGING MARKETS IN AFRICA Vol. 1

Watershed Capital

PROJECT PREPARATION HANDBOOK

FORWARD

Having worked in the infrastructure space for more than a decade starting with rural community water and sanitation projects to advising Ministerial policy on water and sanitation and advising on project funding, preparing project information memorandums, I have come to realise and acknowledge that; Inadequate infrastructure remains the key obstacle impeding Africa's realisation of its full economic growth potential. Hence this handbook is a collection of the experiences, lessons learnt and conversations gathered across many infrastructure disciplines in Africa. It is the intention that these insights will facilitate assist the process of packaging bankable projects and in the process, closing the massive infrastructure gap that is holding Africa back.

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1. Section One: Introduction – Setting the Scene

Inadequate infrastructure remains the key obstacle impeding Africa's realisation of her full economic growth potential. Physical infrastructure relates to transportation (rail, road, and ports), power and communication whilst social infrastructure includes water supply, sanitation, sewage disposal, education and health – all of which have a direct bearing on the quality of life. Going forward, this infrastructure deficit will be further exacerbated by a number of key drivers: rising populations, growing urbanisation and increasing unemployment. It is anticipated that Africa's current population of 1 billion will double to 2 billion by 2050 while urbanisation projections indicate that, between 2010 and 2025, some African cities will account for up to 85% of their populations (African Development Bank, 2012). Africa is home to seven rapidly growing megacities: Cairo (Egypt), Accra (Ghana), Johannesburg-Pretoria (South Africa), Khartoum (Sudan), Kinshasa-Brazzaville (Democratic Republic of the Congo and Republic of the Congo), Lagos (Nigeria) and Nairobi (Kenya). By way of illustration, Lagos has grown from 300,000 in 1950 to an estimated 15 million by 2007, and the Nigerian government estimates that the city will have expanded to 25 million residents by 2015. This growth will usher in an exponential rise in the demand for the delivery of housing, power, water, roads, shopping malls, schools, hospitals and other physical and social infrastructure.

1.1. Why the Infrastructure Gap?

A number of factors provide explications for the Africa infrastructure deficit. Project bankability or, rather, the lack of it is often cited as the key impediment. To be bankable, a project or proposal should have sufficient collateral, future cash-flows and a high probability of success to be acceptable to lenders. Bankability, thus, refers to lenders being willing to fund the project. The paucity of bankable projects on the African continent, has often been linked, in turn, to the lack of appropriate skills on the continent and particularly in those institutions that especially need to attract funding where infrastructure delivery is part of their mandate. Examples of such institutions include state-owned enterprises and ggovernment ministries and local government. Whilst they are the key entities responsible for infrastructure delivery, they are also the ones most woefully lacking from a skills perspective. Consequently, as a result of poorly packaged project proposals, these institutions are unable to access the funds necessary to deliver their large, complex infrastructure projects.

In addition to the project packaging challenge, the very nature of African financial institutions themselves and their lending capacities inherently limit access to finance. The African financial landscape is, typically, dominated by banks that loan in the short term. Capital markets, defined as, "the market for long-term loanable funds as distinct from the money market, which deals in short-term funds" (Penguin Dictionary of Economics, 1998) are shallow on the continent. Deep, transparent, and accessible capital markets are a vital element of the financial sector… as a vehicle for long-term investment finance and for diversification of funding sources (MFW4A, 2014). In functioning capital markets, funding for project financing can be fixed rate with tenure of up to 20 years. The African pensions market is one that is yet to be leveraged for infrastructure funding. For example, the Nigerian pension fund industry has grown from US$7bn in 2008 to US$25bn. As at 2014, Ghana was expected to see growth of 400% in assets under management over the four years to 2018. In Namibia, pension assets are around 80% of GDP and 40% for Botswana.

Finally, there is a challenge that emanates from the policy and regulatory environment. Policy inconsistency, policy incoherence and policy misalignment often raise the risk levels of the operating environment and, in turn, that of the project. Because investments such as energy are long term in nature, investors would want their investments to be secure even as changes in regime and governments change.

While some of the above challenges relate to the macro-environment, there are certain challenges that can be influenced more directly by the project promoter/sponsor such as, for example, the packaging of project proposals in order to access funding. It is this challenge, specifically, that the handbook seeks to address. And whilst African capital markets remain shallow with pension funds not being leveraged, there are abundant capital flows from outside of the continent as will be seen in Section 1.4. overnment ministries and local government. Whilst they are the key entities responsible for infrastructure delivery, they are also the ones most woefully lacking from a skills perspective. Consequently, as a result of poorly packaged project proposals, these institutions are unable to access the funds necessary to deliver their large, complex infrastructure projects.

1.2. Economic Impact of the African Infrastructure Gap

The African infrastructure gap is pervasive and affects many facets of economic performance such as manufacturing and trade. Africa's share of global manufacturing value-added (MVA) and global manufacturing exports is low at 1.1% and 1.3 %, respectively. The reasons for low productivity are many and varied but include poor backward linkages in terms of poor security of power and water supply and poor infrastructure and road networks.

The Programme for Infrastructure Development in Africa (PIDA, 2011), estimated that the African road access rate is only 34%, compared with 50% in other parts of the developing world while transport costs are higher by up to 100%. This affects both the physical transportation of raw materials from source to factory as well as the distribution of finished goods from factory to retail outlets. These high costs - at different points along the supply chain - render the final manufactured goods uncompetitive from a cost perspective with the high costs typically passed onto the consumer (Chimhanzi, 2013). It is, therefore, evident that infrastructure is the foundation for viable and sustainable industrialisation.

Current adequate levels of connectivity between countries mean that African companies are unable to realize economies of scales by manufacturing for bigger markets beyond their own national borders. Delays at African customs are, on average, longer than in the rest of the world: 12 days in Sub-Saharan countries compared with 7 days in Latin America, less than 6 days in Central and East Asia, and slightly more than 4 days in Central and East Europe (Chimhanzi, 2012). To that end, African heads of states have prioritised tackling intra-Africa trade bottlenecks. South Africa is involved in the North-South Corridor, a multi-modal and multi-dimensional infrastructure corridor that includes road, rail, border posts, bridges, ports, energy and other related infrastructure passing through 12 countries - Tanzania, Congo, Malawi, Zimbabwe, South Africa, Zambia, Botswana, Mozambique, Kenya, Ethiopia, Sudan and Egypt.

Until the much needed infrastructure has been developed, a 2012 World Bank report showed how African countries are losing out on billions of dollars in potential trade earnings every year because of high trade barriers with neighbouring countries, and that it is easier for Africa to trade with the rest of the world than with itself. On average, only about 10 – 13% of African trade is with other African nations, whilst 40% of North American trade is with other North American countries, and 63% of trade by countries in Western Europe is with other Western European countries (African Union, 2012). The poor state of infrastructure in sub-Saharan Africa, that is, electricity, water, roads and information and communications technology (ICT), reduces national economic growth by 2 percentage points every year and cuts business productivity by as much as 40%. Addressing Africa's infrastructure gaps will help in creating the economic pre-conditions needed for longer-term growth enshrined in the goals of African Union and NEPAD as well as to foster poverty alleviation (African Development Bank, 2014).

1.3. Viewing the African Infrastructure Gap Differently

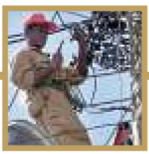
According to the IMF (2010), seven of the world's ten most rapidly expanding economies, in the foreseeable future, are located in sub-Saharan Africa. This optimistic outlook underlines the need for urgent infrastructure transformation and so, rather, than viewing the infrastructure deficit as an obstacle to doing business on the continent, a shift in mind-set is required that views the gap as a lucrative investment opportunity. It is estimated by the World Bank, that approximately US$93billion is required annually, over the next decade, to transform sub-Saharan African infrastructure. About two-thirds or $US60billion of that is needed for entirely new infrastructure whilst $US30billion is necessary for the maintenance of existing infrastructure. Only about $25billion annually is being spent on capital expenditure, leaving a substantial shortfall that has to be financed. On the other hand, the PIDA Priority Action Plan estimates that an amount of US$68 billion is required for project implementation till 2020, whilst an additional US$300 billion is needed for the project's implementation through to 2040.

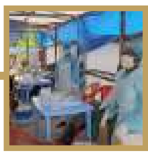
1.4. Rising interest in Africa

The importance of international investors for African markets has increased over the last few years. From an international investor perspective, most of the continent's markets are still considered to be frontier markets characterised by high risks but also high returns. The unintended consequence of the global financial crisis of 2008 was a willingness on the part of investors to engage with Africa as a viable investment destination. Whilst risky, it was not perceived as necessarily riskier than other global markets that were crumbling. The crisis, therefore, recalibrated perceptions of risk in favour of Africa. Since 2008, Sub-Sahara Africa has started to be noticed and has become an attractive destination of cheap capital from the developed countries. The region has experienced compelling positive GDP growth prospects with most of the region's exchanges performing exceptionally well in terms of returns, mainly driven by exchange activities which were in the form of acquisitions and organic expansions. According to the World Bank, net equity, FDI and portfolio equity inflows for 2014 were up by US$52.6billion, a significant increase on previous inflows.

The 2015 Deloitte African Construction Trends report shows an increase in the value of projects from US$222m in 2013 to US$326m in 2014 but a decrease in the number of projects from 322 to 257. These projects are spread across the private and public sectors as well as public-private partnerships (PPPs) as follows - 143, 88 and 26 - compared to 181, 127 and 14, respectively, in 2013. Infrastructure projects are included in the report on the basis that they are valued at over US$50 million and that they had broken ground and are physically under construction.

The dominance of stability and good governance in Sub-Sahara Africa has seen the strengthening of exchanges which have become the key engines for investments and capital-raising through listings by the private sector. Although some progress has been recorded in terms of African exchange activities, the seminal 2010 report by McKinsey, "Africa Report: The Progress and Potential of African Economies" identified the challenges for African economies. A key limitation relates to most economies needing to transition towards diversification and away from being largely dependant on one or two key resources. Of the countries that have reached a certain level of diversification, such as South Africa, they have lacked sophistication to advance the diversification to the levels that enables full beneficiation and industrialisation.
Through general observations of emerging markets in Africa, it has been observed that the economic performance is cyclical and largely dependent on the exportation of commodities. The seasonal cycles have a direct bearing on country exchange rates which trickle down to volatile interest rates and affect companies with exchange rate sensitive capital expenditures. Countries such as Zambia, Angola, Mozambique are likely to be affected by this diversification syndrome unless they move rapidly to





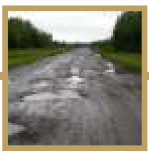

achieve diversification.

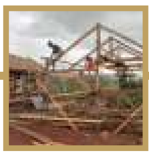
Although there has been marked improvement in GDP growth, averaging about 4.5% for a handful of countries on the African continent, a key question remains regarding the sustainability of this growth trajectory in the face of high and increasing levels unemployment in most emerging economies. It is for this reason that the capital raising handbook has been conceived to become the guiding tool to position governments, professionals and academia to be able to prepare and package projects in line with the expectations and requirements of funding institutions and to reduce long time frames in the financing and commissioning of projects.

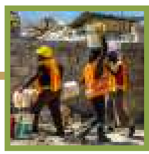
1.5. A Guidebook to Help Address the Challenges and Capitalise on the Opportunities & How it came about...

In attempting to close this deficit and engage with African infrastructure development opportunities, developers and investors face a number of challenges. It was seen in Section 1.1 that a key challenge relates to the paucity of bankable, well-conceived project proposals leading to the claim that "there is too much money chasing few deals on the African continent." Another issue relates to the planning process through which African Governments plan for infrastructure and its delivery and the process through which projects are conceived and conceptualised. Are these projects designed in a manner that can attract investors' capital when investors have competing investments vying for their monies – globally. Are African projects sufficiently competitive? Is the process of taking African projects to market effective?

These insights pertaining to the African infrastructure gap were corroborated by the many stakeholders involved in infrastructure deliver that were consulted in attempting to frame the African infrastructure challenge through empirical evidence and experiences. The consultations took place across a spread of countries in East, West, Central and Southern Africa - Kenya, Tanzania, Uganda, Mozambique, Malawi, Zambia, Zimbabwe, Nigeria and Ghana – whilst covering a broad spectrum of perspectives and experiences ranging from those of state-owned entities,



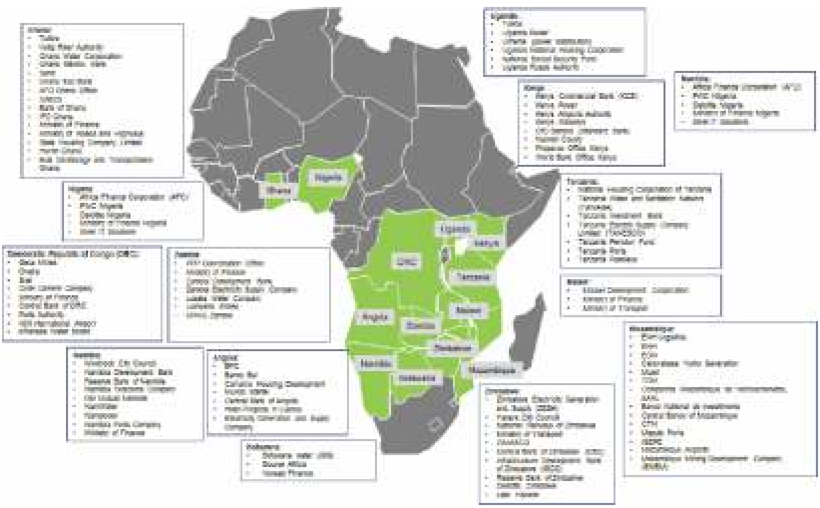


utilities, private sector companies and commercial banks to those of development finance institutions and multilateral finance institutions' representative offices. Figure 1 provides details of specific stakeholders in these various countries.

The investment climate recognizes that the primary engine of growth is the private sector and Watershed Capital will play a key catalytic role in enhancing investor confidence and private investment by providing innovative tools to support infrastructure, economic and urban development. By publishing this handbook, Watershed Capital aims to influence the African project infrastructure landscape by sharing with developers the process that financiers follow in appraising and funding projects. It is the intention that, by understanding the financiers' perspective, those preparing project proposals are better equipped to prepare bankable projects that meet funders' requirements. Watershed Capital recognizes that the emerging African project developer can only be empowered to take leadership in creating sustainable investments by understanding how to develop an idea into a structured bankable product.

Figure 1: Understanding the African Infrastructure Challenge through Stakeholder Engagements



While the handbook acknowledges that there are different types of financiers in the market – private equity, DFIs, funds, commercial banks – the requirements for a sound project proposal are similar. Most financiers do set targets of return for their investments, and also base the investment decision on a consideration of all the relevant factors involved. Additionally, for DFIs, more so than the commercial funders, the project must represent sound development returns. The broad criteria, against which prospective investments are judged, are as follows:

- The internal rate of return (IRR) is an important indicator and it is generally accepted that the IRR should be at least attractive in constant terms.

- The project must produce a reasonable financial internal rate of return (FIRR) and must also generate sufficient cash to service its financial liabilities and to provide a reasonable return to shareholders.

- The project must be technically, institutionally and managerially feasible in the actual circumstances in which it is to take place. It must not rely on unrealistic assumptions or the attainment of impractical objectives. In particular, the proposed management must be capable of implementing the project.

- The project must not be exposed to excessive risks, whether physical, political or financial. The financial structure should reflect the risk involved. For industrial or agriculture projects, a peak long term debt/equity ratio of 2:1 should not be exceeded.

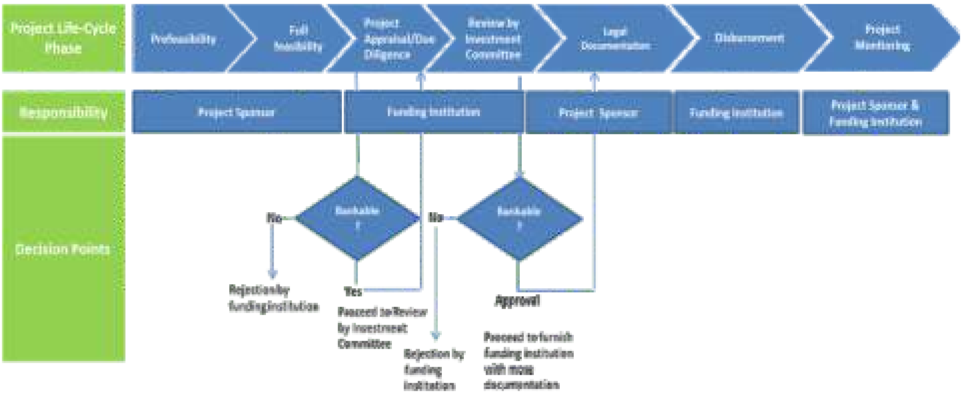
- The returns to the various participants in a project should be appropriate to the contributions of each party to the project.

- The project should be aligned with the regulatory and legislative requirements of Government.

- DFIs will also have a keen focus on sustainability and projects that create sustainable development, as opposed to those which exploit non-renewable resources or are of value only in the short term. Projects should be sustainable both in not deplete environmental resources and, more generally, in being or becoming self-reliant in financial, managerial and institutional terms.

1.6. The Audience

The guidebook is organised to provide practical insights into developing bankable project proposals for project sponsors, funders' potential clients, governments or state-owned enterprises with the mandate of delivering infrastructure and other social services. It is also a valuable resource for the African academic fraternity as it is critical for graduate and post graduate learners to master the art and techniques of developing bankable projects and to know the approaches to follow in raising capital to develop and to implement capital projects. The book is organised to mirror the key stages followed by funders in evaluating the attractiveness and viability – or otherwise - of project proposals for funding purposes.



1.7. Navigating the Guidebook

Section One: Introduction – Setting the Scene has provided the context of the African infrastructure context which is characterised by a massive gap in delivery. The infrastructure gap is less so as a result of a lack of funding and has been attributed to entities on the continent not being able to successfully take projects to market. Whilst admittedly African capital markets are shallow, there is significant interest in international capital looking to Africa as an investment destination. This handbook attempts to bridge the gap by assisting African governments and other players to successfully access this capital by developing attractive and bankable projects that attract the necessary capital.

Section Two: What does a Project Sponsor do? provides an outline of the role of a project and further distinguishes it from that of project manager. It is anticipated that project sponsors will be the key users of this handbook.

Section Three: Different Types of Appraisals provides an overview of the different types of project proposals that funders typically receive - project identification, feasibility studies, project appraisals and reappraisals. Each type of proposal has a predefined set of objectives which, in turn, determines how the funder appraises it and what the funder looks out for.

Section Four: How to Effectively Package your Project Proposal provides useful guidelines on how to package a proposal. It is written from the perspective of the funder based on what the funder's appraisal report would typically contain – once the project proposal has been appraised by the funder. It provides an overview of how funding institutions are typically internally organised, the various stages that the project proposal goes through and the different departments involved in the appraisal process. A checklist of key information requirements is provided.

The next set of sections deal with the analysis of specific aspects of the project proposal.

Section Five: Macro-Economic Analysis focuses on the broader operating environment of the project, in terms of, for example, the economy and important social indicators.

Section Six: Technical Analysis explains how the project should be assessed from a technical perspective to ensure it is sound and adheres to acceptable standards.

Section Seven: Market Analysis assists the reader in making the case for the project in terms of sales projections and the existence of a viable market.

Section Eight: Organisation and Management Analysis recognises that funders are keen to ensure the sustainability and growth of their investment and will, therefore, have a keen focus on the systems, structures, procedures and sound governance of the investee company. To that end, it provides a checklist of elements that need to be in place to reassure a funder.

Section Nine: Financial Analysis looks at the data requirements of the Financial Analysis component of a project feasibility, appraisal or investigation. Subsequent sections deal with funding institutions and instruments available to a project sponsor.

Section Ten: Capital-raising through Capital Markets provides an overview of the financial landscape, the different players and their roles. Sections Eleven and Twelve focus on the various financing instruments available in the markets and the terms and conditions to access them as well as funders' expectations in terms of returns.

Section Eleven: Debt Financing has a specific focus on debt instruments whilst ***Section Twelve:*** Equity Financing focuses on equity financing whereby the funder takes a stake in the project.

Once the project has been commissioned, it needs to be evaluated for effectiveness.

Section Thirteen: Development & Economic Impact Assessment focuses on the development returns that a development finance institution would typically require over and above the returns that a commercial bank, for example, would seek.

Section Fourteen: Capital-Raising for Public-Private Partnerships acknowledges the rise in PPP projects on the continent and the inherent challenges borne out of different partners with different mind-sets and outlooks having to work together. Whilst challenging, PPPs should be viewed positively as a means of mitigating risk given that the Government is on board with a key stake and vested interests in the project. The section is devoted to managing the challenges that present in managing the relationship.

Section Fifteen: Conclusion, a summary of the capital raising process is provided.

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