MOODY'S
INVESTORS SERVICE

Rating Action: Moody's assigns first-time Baa2 rating to the ALCB Fund, outlook stable

21 May 2019

Paris, May 21, 2019 -- Moody's Investors Service ("Moody's") has today assigned a first-time Baa2 foreign currency long-term issuer rating to the African Local Currency Bond Fund (ALCB Fund). The outlook is stable.

The ALCB Fund is focused on developing domestic capital markets in Africa by investing in private sector bonds issued domestically in local currency. It was created by Kreditanstalt fuer Wiederaufbau (KfW, Aaa stable) in 2013, which acts on behalf of the German Federal Ministry of Economic Cooperation and Development, with the development mandate of pursuing financial inclusion and capital market deepening. KfW is the main shareholder, owning 87% of the Fund's shares, mostly in the form of redeemable shares. The Fund's total shares relative to total assets was 61% in 2018 and operates with a statutory limit for leverage of 40%.

The Baa2 rating of the ALCB Fund -- derived using Moody's Multilateral Development Banks (MDBs) and Other Supranational Entities rating methodology -- balances credit strengths such as ample liquidity and demonstrated commitment of financially strong shareholders against a challenging operating environment, risks associated with large derivatives positions, and the absence of contractual support enjoyed by other more highly rated supranational entities.

Moody's assessment of ALCB Fund's methodological factors underpinning the Baa2 rating are:

1. "Low" capital adequacy due to very low usable equity (which does not include the Fund's redeemable shares), and thus very high leverage under Moody's methodological calculations. It also reflects low borrower quality amid a challenging operating environment inherent to the Fund's mandate.

2. "Medium" liquidity, which balances the Fund's currently ample liquidity position against Moody's expectations that the Fund's cash position will decline and that it has yet to establish a track record of accessing funding from diversified sources. Moody's assessment also takes into consideration the large derivatives positions which involve liquidity risks related to margin calls.

3. ALCB Fund benefits from support from its financially strong shareholders. Moody's assumes that financial and technical support from ALCB Fund's shareholders, in particular KfW, will continue even under potential stress scenarios and notwithstanding an absence of contractual support that otherwise points to a "Low" scorecard-indicated Strength of Member Support.

The stable outlook reflects Moody's expectation that the Fund will manage to maintain robust credit metrics consistent with its Baa2 rating through the expansion of its portfolio in the next few years, even as its leverage and the liquidity position weaken in line with the Fund's expansion strategy. The stable outlook is also based on Moody's expectation that the shareholders will continue to provide financial and technical support.

RATINGS RATIONALE

RATIONALE FOR THE Baa2 RATING

LOW CAPITAL ADEQUACY, WITH VERY HIGH LEVERAGE AND WEAK BORROWER QUALITY

Moody's assesses ALCB Fund's capital adequacy to be low overall due to low usable equity and borrower quality in a challenging operating environment, inherent to the Fund's mandate.

At year-end 2018, the Fund's usable equity solely consisted of $1.2 million of management shares. In its assessment, and in line with its definition of usable equity, Moody's does not treat as usable equity the redeemable shares provided by KfW and Financial Sector Deepening Africa (FSDA, unrated), these are instead factored in the rating as a form of support, being that they are unlikely to be redeemed in Moody's view. The subordinated loan granted by the FSDA, which is itself funded by Department for International Development (DfID), the Government of the United Kingdom's (UK, Aa2 stable) development agency, is also excluded from the equity base.

As a result, the Fund's asset coverage and leverage ratios are very weak under Moody's calculations, at 3% and 1,517% respectively on average in the three years to 2018. Under the Fund's definition of leverage that includes the redeemable shares and the subordinated loan, leverage reached 66% in 2018, well-above the limit of 40%.

Moody's assessment takes into account the Fund's planned expansion over the coming years. In line with its mandate, the Fund seeks to optimize its capital structure so as to maximize investments, within the limits set internally and by its loan covenants. The Fund expects to grow its bond investments to $172 million by 2020 from $97 million in 2018. To that end, the Fund plans to deploy its existing resources so that the equity-to-assets ratio -- as defined by ALCB Fund with redeemable shares and the FSDA loan counted as equity -- will fall to 52% by 2020, from 66% at end 2018. While the Fund expects its financial metrics to improve after 2020 as it reaches a steady state, the improvement is dependent on a number of factors including steady earnings growth. While Moody's expects ALCB Fund will remain in adherence to its statutory leverage limit, under Moody's definition ALCB Fund's asset coverage and leverage will remain very weak.

Moody's assesses average borrower quality to be low, reflecting elevated country- and firm-specific risks present in the Fund's portfolio of bonds. Through its investments in private sector bonds, the Fund is exposed to weak socio-economic environments and investor protections.

Since its start in 2013, the Fund has not faced any default on the bonds it has invested in. However, this track record is relatively short -- in 2017, the Fund had only around $50 million of investment or 24 outstanding bonds. Moreover, the Fund has once sold a bond at a loss in anticipation of a deterioration in the creditworthiness of the issuer. While such occurrences may be rare, they are illustrative of the risks that the Fund faces on its investments.

MEDIUM ASSESSMENT OF LIQUIDITY DUE TO AMPLE DEBT SERVICE COVERAGE BUT EXPECTED DRAW-DOWN ON CASH AND SO FAR LIMITED RANGE OF BORROWING SOURCES

Moody's assesses ALCB Fund's liquidity as "Medium" to reflect the high share of liquid assets balanced against Moody's expectations that the Fund's cash position will decline, that the derivatives portfolio poses some liquidity risk and that the Fund's borrowing sources are lowly-diversified.

The Fund currently holds ample unencumbered liquid treasury assets, well in excess of annual debt service requirements. In 2018, the 3-year average of the debt service coverage, the ratio of short-term and currently maturing long-term debt by liquid assets, stood at 12%, denoting very strong coverage compared to other MDBs. As the Fund increases its operations, Moody's expects the Fund to draw down its existing cash and to reduce its internally defined-debt service coverage ratio from 5.6x at end 2018, to closer but still well-above its covenant ratio limit of 1.2x.

The Fund extensively uses currency and interest rates swaps, which subject it to regular margin calls and for which the Fund has set liquidity requirements of 6% to 7% of notional. The liquidity risk emanating from margin calls is proportionate to the volatility of the underlying interest and foreign exchange rates and would especially arise from a depreciation of the US dollar against the currencies of denomination of the bonds it is invested in.

Moody's assesses ALCB Fund's funding position as "Low", given the Fund's has yet to establish a track-record of securing diversified sources of borrowing. So far, the Fund's debt is limited to loans from investors such as Calvert (specialized in responsible investing), commercial banks such as Investec or from official lenders such as the African Development Bank (AfDB, Aaa stable).

ASSUMED ONGOING FINANCIAL AND TECHNICAL SUPPORT FROM FINANCIALLY STRONG SHAREHOLDERS, NOTWITHSTANDING AN ABSENCE OF CONTRACTUAL SUPPORT

Moody's assesses that ALCB Fund benefits from support from its financially strong shareholders and assumes that support would remain present even in the event of stress.

Without contractual support, in particular no callable capital, and given high shareholder member concentration (with KfW representing 87% of the Fund's total shares), the scorecard-indicated strength of member support is "Low".

However, Moody's assesses and takes into account stronger support in its rating of ALCB Fund. Tangibly, support is provided in the form of redeemable shares (60% of total assets in 2018), which KfW and more recently FSDA have added to in recent years.

Moody's assessment of member support assumes a very low likelihood that the existing shareholders will withdraw from the Fund. The redeemability of the shares is constrained by existing covenants with lenders that restrict the ability of shareholders to redeem those. This is further supported by Mauritius law that requires participating shares to meet a solvency test in order to be redeemed.

Moody's assumes that financial and technical support from ALCB Fund's shareholders, in particular KfW, will continue even if the Fund were to experience repeated financial losses. In particular, Moody's assesses both the ability and propensity of member support as very high, the former related to KfW's very strong financial position and Aaa rating, the latter owing to KfW's active involvement in the Fund's funding and governance. Since 2013 KfW has invested $66 million in capital, through multiple installments. KfW is significantly involved in the Fund's governance and retains directly or indirectly control over the Fund's main decisions, including for investment. The Board is the Fund's main decision making body and is composed of two members from KfW and one from FSDA, in addition to two local Mauritian directors as representatives of the Fund Administrator.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's expectation that the Fund will manage to maintain robust credit metrics consistent with its Baa2 rating through the expansion of its portfolio in the next few years, even as its leverage and the liquidity position weaken in line with the Fund's expansion strategy. The stable outlook is also based on Moody's expectation that the shareholders will continue to provide financial and technical support.

WHAT COULD CHANGE THE RATING UP/DOWN

Moody's would likely downgrade the ALCB Fund's rating if asset quality looked likely to deteriorate significantly, pointing to an increased risks of losses. Higher and more persistent than anticipated margin calls that would affect the ability of the Fund to meet its liquidity covenant limits would also put downward pressure on the rating. Over time, and while seen as very unlikely at this stage, signs that the Fund's members are less committed to ensuring it can continue to operate and honour its debt commitments would point to a downgrade.

Positive pressure on the rating would arise if the Fund built a track record of managing credit and liquidity risks, including through periods of economic and financial tensions in the region. Indications that the Fund is increasingly able to access diversified financing sources would also put upward pressure on the rating.

ISSUER PROFILE

The ALCB Fund is focused on developing domestic capital markets in Africa by investing in private sector bonds issued domestically in local currency. It fulfils a development mandate of pursuing financial inclusion with the primary goal of increasing funding from local investors to domestic companies. The Fund is sponsored by KfW and FSDA.

At end of 2018, the Fund was invested in 15 countries and in 12 currencies across the African continent. The ALCB Fund development activities are solely related to bond investments that are generally held to maturity given the shallowness of the markets and the resulting illiquidity of the bonds.

KfW is the Fund's strategic shareholder since inception in 2013 and is expected to remain so in the future. The FSDA entered the Fund's capital in 2018 and is the other, minority, shareholder. The equity participations of both KfW and FSDA represent in total 61% of the Fund's assets, composed of redeemable shares (98%) and management shares (2%).

The ALCB Fund is domiciled in Mauritius. Most of its core functions such as management and accounting are externalized to third-party specialized institutions through a medium-term mandate. For 2015-25, LHGP Asset Management (unrated) is the Fund's manager.

The principal methodology used in this rating was Multilateral Development Banks and Other Supranational Entities published in September 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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