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FEASIBILITY OF SME DEBT FUND

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FINANCIAL SECTOR PROGRAM

FEASIBILITY OF SME DEBT FUND

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ACRONYMS

ABET	Adult Basic Education and Training
ALBI	All Bond Index
ASB	Asset Backed Securities
ATM	Automatic Teller Machines
BEE	Black Economic Empowerment
BBBEE	Broad-based Black Economic Empowerment
BESA	Bond Exchange of South Africa
BMA	Bond Market Association
BSM	Business Sophistication Measure
CAPEX	Capital Expenditures
CDFI	Community Development Financial Institution
CDO	Collateralized Debt Obligation
CGT	Capital Gains Tax
CLO	Collateralized Loan Obligation
CRB	Credit Review Board
DBSA	Development Bank of Southern Africa
DCA	Development Credit Authority
DFI	Development Finance Institution
DFID	UK Department for International Development
DJSI	Dow Jones Sustainability Index
DTI	Department of Trade and Industry
ED	Enterprise Development
EDD	Department of Economic Development
EIF	Enterprise Impact Fund
EOI	Expression of Interest
ESG	Environment, Social, Governance
FI	Financial Intermediary
FOF	Fund of Funds
FSP	Financial Sector Program
FSB	Financial Services Board
FTSE	Financial Times and Stock Exchange
GDP	Gross Domestic Product
GOVI	Government Bond Index
IDC	Industrial Development Corporation
JIBAR	Johannesburg inter-banking borrowing rate
JSE	Johannesburg Stock Exchange
IDC	Industrial Development Corporation of South Africa
IDZ	Industrial Development Zones
IT	Information Technology
MFI	Microfinance Institutions
NBFI	Non Bank Financial Institution
NCA	National Credit Act
NCR	National Credit Regulator
NEXII	NeXus for Impact Investing
NPAT	Net Profit After Tax
NPL	Non Performing Loan

OTC	Over the Counter
OTHI	Other Bond Index
RI	Responsible Investment
RSA	Republic of South Africa
SA	South Africa
SABC	South African Broadcasting Corporation
SARB	South African Reserve Bank
SARS	South African Revenue Service
SASIX	South African Social Investment Exchange
SBCS	Small Business Credit Scoring
SECO	State Secretariat for Economic Affairs
SED	Socio-Economic Development
SEDA	Small Enterprise Development Agency
SIB	Social Impact Bond
SME	Small and Medium Enterprise
SMME	Small, Medium and Micro Enterprises
SOE	State Owned Enterprises
SIB	Social Impact Bond
SPV	Special Purpose Vehicle
SRI	Socially Responsible Investing
STRIP	Separate Trading of Registered Interest and Principle
STRATE	Share Transactions Totally Electronic
UNISA	University of South Africa
US	United States
VAT	Value Added Tax
VCC	Venture Capital Company
VC	Venture Capital
VR	Viability Ratings
YoY	Year-on-Year
YTM	Yield to Maturity
ZAR	South African Rand

EXECUTIVE SUMMARY AND RECOMMENDATIONS

International experience shows that SME access to financial services at affordable cost is strongly conditioned by the overall business environment and frequently requires pro-active policy support to stimulate and sustain SME economic growth. In particular, the overall business environment in South Africa has many implicit biases against SMEs: infrastructure constraints, constraints on market competition, labour market constraints, financing constraints, concentration of ownership and control, macroeconomic and real exchange rate volatility, a protectionist trade policy, an inefficient trade logistics system, information externalities and coordination failures, and social and environmental regulations that work at cross-purposes.

Biases in the business environment drive smaller enterprises to the informal sector and even formal SMEs are tempted to take part of their operations to the informal sector. In general, formality, bank credit and an improved business environment go hand in hand, although the SME sector is thought to deserve special policy focus. In South Africa lack of access to credit is perceived as the most binding constraint on SMEs. In fact, the World Bank's most recent Investment Climate Assessment states that "access to finance topped the list of reported obstacles to growth by micro and small enterprises."[1]

The primary purpose of this investigation was to determine how the USAID FSP could make more effective use of its Global Triple A-rated DCA credit guarantee to unlock capital for debt investment into South African SMEs.

The FSP's experience over the last year has been that despite having this guarantee facility available to them, Non-Bank Financial Institutions (NBFIs), which are an important sources of financing to SMEs, have been unable to access capital from banking institutions to on lend to SMEs. These NBFIs reach a wide universe of SMEs, but capital constraints limit their ability to expand their services. Many are specialized financial services firms with strong track-records and the credibility, management expertise, and credit risk management procedures to asses, lend, and profitably manage an SME loan portfolio. Despite this, NBFIs have continued to face a tight and risk averse credit market with limited options for accessing capital.

Thus this research sought to understand whether there was sufficient risk appetite within the South African fixed income market for the raising of a debt fund, secured by a partial credit guarantee, to meet this purpose. In addition, it wanted to determine what the preferred investment vehicle structures could be; what features, incentives and benefits it may need to include for optimal uptake and what regulatory benefits or constraints may affect investors into the fund. Lastly, it wanted to understand the profile of the asset manager best placed to raise the capital and manage on-lending applications and also get a rough idea of the size of the demand amongst NBFIs in the market place.

Key findings

Overall there is definite evidence of a healthy investment appetite for bond issues in South Africa. Indeed, all interviews reported that there is currently more capital available than there are bond issues so the market is hungry for this kind of investment vehicle. However, this

[1] FSP Regulatory Reforms

appetite is mostly limited to minimum investment grade (A-) or higher, preferably listed, preferably vanilla bond structures. With such a risk rating, appetite would not necessarily be dampened if there was no guarantee facility, but of course it was indicated that the presence of the guarantee would make it more attractive – especially at the lower A- grade investment level.

That being said, however, there are strong indications that this appetite falls off entirely – indeed, does not exist – within the formal institutional capital market for what is perceived to be a risky "venture capital like" bond issue, especially one that is issued by a new company or special purpose vehicle (SPV), or a company without a clear performance track record.

The DCA credit guarantee, in such an instance, while obviously being an attractive feature, will not, however, be of sufficient value to support the overall required credit enhancement of the bond. This is because a partial guarantee requires that investors and asset managers take a view of the underlying investment risk (which in this case could be a BBB grade) and the market would typically discount the entire issue to this lower rate, requiring a massive return compensation that would price on-lending activity too high to meet the purpose of the bond.

Beyond the guarantee, indications are that appetite (or lack thereof) is not necessarily going to be significantly affected by further incentives or other benefits at the investment grade level, and there is little by way of regulatory constraints that asset managers believe would negatively affect appetite. Indeed, even if the bond was unlisted, asset managers believed there would still be uptake – though it would be limited to the current pension fund regulation regarding unlisted investments (which is in the process of being increased significantly to the level of a maximum of 30%).

At the same time, however, our discussions did indicate that the "development finance" profile of the bond and related benefits such as the accrual of BBBEE Enterprise Development points could be an attractive bonus feature for investors in that it would enable them to demonstrate commitment to a "responsible investment" portfolio. These benefits would not, however be sufficient on their own to encourage uptake of the bond if it remained below minimum investment grade.

Our conclusion is therefore that a partial guarantee is going to be insufficient to overcome strong risk aversion in the capital markets given the nature and grade of investment targets – both in terms of size of capital allocations sought and in terms of return levels that would be possible within the mission of the bond. Thus we believe additional surety will need to be found to further enhance the credit risk.

We do believe, however, that the bond should be vigorously pursued through one of the possible options because, as conceived, the Enterprise Impact Fund bond issue at this time could – and probably should – fulfill a "demonstration" role and have the primary purpose of establishing track record and confidence in SME lending. Without this, we believe the market will continue to avoid SME investment except in the more VC structure portfolios which would require returns defeating the objectives of the USAID FSP.

As such, we believe the structure of a first bond instrument or investment vehicle created for the Enterprise Impact Fund should have minimal risk, sufficient market rates of return and, indeed, a sweetener (despite the minimal risk) that would truly demonstrate the potential for SME lending to be a profitable investment activity. Additional benefits beyond this are not truly necessary, though of course any additional value could further add to the attractiveness of a minimal risk, market rate return bond whist also providing powerful advocacy support for the sector's maturation.

With the above in mind, we believe of the six identified possibilities for structuring the EIF, the first two should be excluded whilst the last four all present options (in what we believe is ascending order of appeal to the market) that could be considered. Additional testing of these options could be undertaken during the asset manager tendering and selection process and, of course, that process may itself elicit further structuring options to be considered.

Enterprise Impact Fund structuring options:

1. Retain the status quo; USAID gives guarantee directly to NBFIs as it does at present.
2. Issue a traditional vanilla bond to capitalise a debt fund underpinned by the AAA partial guarantee.
3. Issue a collateralized loan obligation in addition to the USAID credit guarantee to ensure minimum investment grade is achieved.
4. Extend the guarantee directly to one (or more) asset managers for use as credit enhancement in their existing portfolios to support their activity in SME lending and establish a track record and market demonstration effect.
5. Similar to the above, establish a Fund of Funds giving the guarantee directly to an institutional FoF manager to underwrite the bond issue and distribute capital to a number of asset managers per option 4.
6. Partner with an institutional issuer who would take the remaining risk and/or underwrite all or part of the remaining issue to give a full 100% guarantee. The partner would issue a straight vanilla bond, which would have a return and provide the opportunity for a track record and proof of concept to be demonstrated to facilitate future issues with less credit enhancement based on increased confidence and experience within the SME sector.

With regard to a parallel and related SME development fund, we believe that such a fund would be extremely valuable for the sector development overall and these options should therefore be considered. However, we do not believe the market would require that this be implemented at the same time or that associating it with the EIF is necessary because the EIF, in and of itself, will already have a "responsible investment" profile. In addition to this, it is our understanding that the EIF as conceived will, in fact, already provide investors with ED points where these are desired without an SME development fund. Thus the EIF alone – with sufficient risk removal – should provide sufficient incentive for the market to allocate capital to it.

Nevertheless, we believe that the SME Development Fund would not only provide for field building and a future pipeline for the EIF (or future funds), but it could play a significant advocacy and educational role for the market – further building track record, trust and investor confidence for the future. As importantly, we believe that this development fund could be innovatively structured so as to build on the objectives and commitments of government but incentivize private sector participation through establishing performance

based benefits for success. Such “pay for success” bonds are increasingly being tested globally and there is a very strong global appetite amongst impact investors for such vehicles, as well as amongst governments for the opportunities to test them.

We strongly recommend, therefore, that in addition to the establishment of an EIF, one (or more) of the options for the SME Development Fund should be pursued. Our first recommendation would, in fact, be for an SME impact bond structure as this combines both the grant-based opportunity with the potential for a financial return based on level of success achieved.

Turning our attention to the potential size of the NBFI market’s demand for capital to on-lend to SMEs, the study, though limited, has identified a demand of almost R2 billion amongst just the 9 NBFI respondents alone. The scale of the target market reached by these respondents varies greatly with the range of loans averaging from R17, 000 on the one hand to R5 million at the other extreme and a total sample average of R130, 000. We believe further research and even potentially a mapping analysis of NBFIs and the nature of their SME lending practices, performance records and default rates would be of huge value in the long run, further adding to the advocacy efforts of the USAID FSP. asset managers

SECTION 1: INTRODUCTION

The most widely used framework for defining Small and Medium Enterprise (SMEs) in South Africa is that of the National Small Business Act 102 of 1996, which identifies five categories of businesses in South Africa. The definitions use the number of employees per enterprise size category combined with the annual turnover categories, the gross assets excluding fixed property. The definitions for the enterprise categories are given as follows:

1. Survivalist enterprise: The income generated is less than the minimum income standard or the poverty line. This category is considered pre-entrepreneurial, and includes hawkers, vendors and subsistence farmers.
2. Micro enterprise: The turnover is less than the VAT registration limit (that is, R150 000 per year). These enterprises usually lack formality in terms of registration. They include, for example, spaza shops, minibus taxis and household industries. They employ no more than 5 people.
3. Very small enterprise: These are enterprises employing fewer than 10 paid employees, except mining, electricity, manufacturing and construction sectors, in which the figure is 20 employees. These enterprises operate in the formal market and have access to technology.
4. Small enterprise: An upper limit of 50 employees. Small enterprises are typically more established than very small enterprises and exhibit more complex business practices.
5. Medium enterprise: The maximum number of employees is 100 - 200. These enterprises are often characterized by the decentralization of power to an additional management layer.

This report concerned itself only with points 4 and 5 above, i.e. small and medium enterprises.

It is well established that SMEs have significant potential to drive economic growth and poverty reduction. Often described as efficient and prolific job creators, the roots for big businesses and the fuel of national economic engines, it is found that even in the developed industrial economies, it is the SME sector rather than the multinationals that is the largest employer of workers[2].

In their research journal entitled "Issues in SME Development in Ghana and South Africa (2010), Joshua Arbor and Peter Quartery report that 91% of formal business entities in South Africa are SMEs contributing between 52 and 57% to GDP and about 61% to employment[3].

In addition to the positive correlation between the size and establishment of the SME sector and economic development, many case studies reveal that investment in SMEs does realize financial return for investors and has substantial additional benefits and ripple effects flowing to other stakeholders in the ecosystem.

[2] Mullinuex, A. W. 1997
[3] Joshua Abor and Peter Quartey, 2010. *Issues in SME Development in Ghana and South Africa*. http://www.eurojournals.com/irjfe_39_15.pdfhttp://www.eurojournals.com/irjfe_39_15.pdf

These benefits are generated through both job creation and the delivery of products and services to new customer groups which extend further to the broader ecosystem within which SMEs reside and operate.
However, despite these social and economic benefits, the formal small business sector in developing countries is small compared with that observed in developed economies. Significant research into understanding the reason for this absence of a strong and vibrant SME sector has been undertaken and the literature[4] suggests that some of the factors that constrain SME growth in emerging markets and developing countries have been identified as:

1. Access to markets: availability of, and access to information required to establish linkages with suppliers and customers; in the form of, e.g., business associations, relevant and reliable statistics and market knowledge to inform business activity
2. People and training: the existence of support with training and/or mentoring to develop business leadership with appropriate talent and skill sets
3. Access to finance: appropriate and affordable capital to grow businesses activity
4. An enabling operating environment and supportive infrastructure for business development: e.g. the regulatory and policy environment, business environment, hard infrastructure such as transportation, communication etc.

Collectively these requirements cover the need for both hard and "soft" infrastructure and empirical research has indicated both are critical for success because together they establish a robust and business-friendly environment. In effect,

> *"the existence of suitable infrastructure reduces transaction costs, improves trade reliability and creates opportunities for business networking, which generates economies of agglomeration in information and transaction management. All these are critical aspects of business operations, particularly for start-up and small businesses".*[5]

South Africa's financial services sector

Unlike many other developing countries, South Africa has a relatively well developed capital markets system with numerous players in the investment market. The financial services sector is backed by a sound regulatory and legal framework with dozens of domestic and foreign institutions providing a full range of services - commercial, retail and merchant

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[4] Dalberg, (July 2008). *Aspen Network for Development Entrepreneur. Background Analysis.* http://www.aspeninstitute.org/sites/default/files/content/docs/aspen%20network%20of%20development%20entrepreneurs/ANDE_SGB_BACKGROUND_ANALYSIS_JULY_2008%5B1%5D.PDF; Investigation into collateral options for lending to micro and small enterprises. Finmark Trust, September 2009; The Task Group of the Policy Board for Financial Services and Regulation, 2001. *SME's Access to Finance in South Africa. A Supply-Side Regulatory Review.* http://www.treasury.gov.za/publications/other/Access%20to%20Finance%20in%20South%20Africa%20-%20A%20Supply-Side%20Regulatory%20Review.pdf; Joshua Abor and Peter Quartey, 2010. *Issues in SME Development in Ghana and South Africa*. http://www.eurojournals.com/irjfe_39_15.pdfhttp://www.eurojournals.com/irjfe_39_15.pdf; Economic Commission for Africa (February 2011), *Enhancing the Competitiveness of Small and Medium Enterprises in Africa: A Strategic Framework for Institutional Support Economic*. http://www.uneca.org/gpad/SME%20Strategic%20Framework.pdf

[5] The Task Group of the Policy Board for Financial Services and Regulation, 2001. *SME's Access to Finance in South Africa. A Supply-Side Regulatory Review.* http://www.treasury.gov.za/publications/other/Access%20to%20Finance%20in%20South%20Africa%20-%20A%20Supply-Side%20Regulatory%20Review.pdf

banking, mortgage lending, insurance and investment. In addition, South Africa's banking sector compares favorably with those of industrialized countries. Foreign banks are well represented and electronic banking facilities are extensive, with a nationwide network of automatic teller machines (ATMs) and internet banking facilities available.

The Financial Services Board (FSB) oversees the regulation of financial markets and institutions, including insurers, fund managers and broking operations but excluding banks, which fall under the South African Reserve Bank (SARB). The Johannesburg Stock Exchange (JSE), incorporating the Bond Exchange of South Africa (BESA) is an independent, licensed exchange, constituted as a public company, and responsible for operating and regulating the equity, debt securities and interest-rate derivative markets in South Africa. The JSE and BESA have been at the forefront of market developments in South Africa for a long period of time.

SME financing

More recently, various efforts to establish a dedicated exchange board for SMEs and "Impact Investments"[6] have emerged and are focused on establishing a regulated framework and intermediation infrastructure to offer a variety of services and product offerings that are designed to increase access to capital for businesses and organizations in these sectors. The Impact Board, a new board on the Stock Exchange of Mauritius, has now been formally approved and is open for listings from SME's whose mission is social or environment. Other platforms are anticipated to come on line during the course of 2011 or in early 2012.

Without fail most research into the barriers faced by SMEs also indicate that access and cost of finance are significant constraints to small businesses in developing countries. The Dalberg[7] analysis of the World Bank Enterprise Survey illustrates the significant percentage of businesses in lower income countries that rate access to finance and the cost of finance as a major constraint to current operations as illustrated in the graph below.

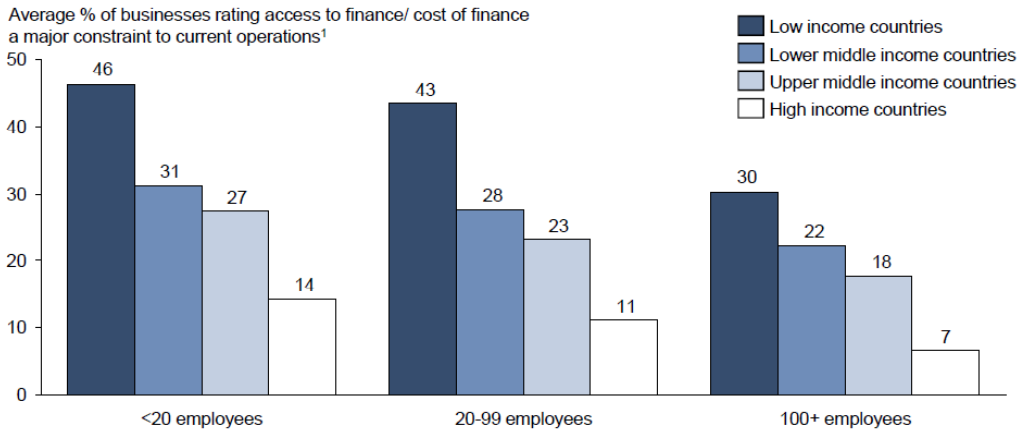

Figure 1: Rating of access to and cost of finance as a constraint to business activity

[6] An Impact Investment is an investment in a company, organisation or business enterprise that has the primary intent of addressing a social or environmental financial need and achieves this by applying a sustainable business model using market based income generating strategies. Such enterprises can deploy capital investment and provide financial returns in addition to social and environmental performance and impact.
[7] Dalberg, (July 2008). *Aspen Network for Development Entrepreneur. Background Analysis.* http://www.aspeninstitute.org/sites/default/files/content/docs/aspen%20network%20of%20development%20entrepreneurs/ANDE_SGB_BACKGROUND_ANALYSIS_JULY_2008%5B1%5D.PDF

(Note: Countries weighted equally within income groups to calculate overall average)

SMEs especially in developing countries face a “missing middle” for both debt and equity financing and are often limited to obtaining finance from family and friends or as personal finance in their personal capacities from the banking sector or from brokers in the micro-lending industry who offer relatively small amounts of capital though likely charge high interest rates. These interest rates as well as collateral requirements are typically high due to small loan size and the perception of high risk associated with SME lending. Smaller enterprises are also unlikely to use commercial banks for financing because of the costs. Banks typically lack incentives to serve SMEs due to limited competition and perceive SME lending as high risk because of a lack of credit information, financial records or detailed business plans.

In addition, whilst microfinance institutions (MFI's) are active in developing countries, most do not serve the SME sector where the capital needs are typically larger than most MFI loans and the differences in lending processes and requirements generally limit MFI’s abilities to service this market. It is in light of the very real difficulty that SMEs face in accessing *affordable* capital that has informed part of the USAID FSP.

However, whilst it is tempting to reduce the problem of SMEs in South Africa to the issue of finance and access to capital only, this would be misleading. Indeed there are a range of other factors, as has been indicated above, which impact on the success and growth of SMEs in the country.

The USAID FSP thus goes beyond simply promoting affordable access to capital and aims to address the range of barriers to SME growth, including non-financial actions. Indeed, it has a variety of initiatives in place to do just this. This study is, however, focused specifically on determining how access to capital can be improved both by increasing capital available for lending and understanding the policy and regulatory framework as it impacts upon this behavior, thereby possibly presenting opportunities for advocacy and even lobbying for changes in policy.

The USAID Financial Sector Programme

USAID FSP supports the accomplishment of the U.S. Government’s Economic Growth Objective in South Africa. This task order is one of three main vehicles to promote vibrant growth of historically disadvantaged SMEs and reduce unemployment and poverty.
The objectives of this program are to:

- expand access to financial services and lower financing cost for SMEs through reforming the legal and regulatory framework affecting the financial sector and business environment
- improve the commercial viability of lending to historically disadvantaged SMEs in South Africa, thereby expanding SME access to a range of high quality and affordable financial services.

Activities under the FSP focus on improving and expanding financial services and products; managing and mitigating financial risk and transaction costs; improving bankability of SMEs and business services by linking financial services with business service activities that can

build SME capacity, productivity and competitiveness, as well as improve the capacity of financial advisory services to serve SMEs; support the emergence of an efficient credit industry regulator that promotes an enabling environment for financial intermediation and risk management, and boosts the private sector's role and participation in the provision of financial services to SMEs; promote reforms to commercial laws, regulations, and administrative practices affecting the private sector and SME development; and, improve knowledge management through an accessible repository of knowledge about SMEs and finance in South Africa.

As part of the access to capital initiative, the USAID Credit Review Board (CRB) approved Development Credit Authority (DCA) Guarantees and Portable Guarantees for three FSP Non Bank Financial Institution (NBFIs) partners who support the credit needs of SMEs in June and July 2010. The NBFIs began discussions with potential lenders well before the CRB approval dates. The NBFIs approached a wide variety of lenders, including large and medium sized banks, insurance companies and specialized lenders. However, none of them succeeded in securing loans because of tight credit market conditions in South Africa and a general reluctance of South African banks to assume the risk in their balance sheets, despite the offer of a U.S. Government 50% guarantee.

Access to finance remains one of the key constraints of SME NBFIs, and tight credit market conditions are likely to continue limiting access in the medium-term. To address this situation, FSP has embarked on this research in order to explore alternative funding sources for the three NBFIs currently holding a portable guarantee as well as other similar NBFIs servicing SMEs.

There are effectively three aspects to the process which would need to be successfully completed in order to ensure the success of this project, namely:

1. Advisory – a role which establishes the correct framework for the participants, investment parameters and fund structure.
2. Structuring and Raising – setting up the legal and compliance infrastructure, marketing and documentation, establishing the correct mandate and investment process, culminating in a credible and successful capital raising.
3. Fund Management – investing the capital in accordance with the fund mandate and ensuring the successful deployment of capital to the target market. Managing and reporting on the investments of the fund on an ongoing basis.

Research brief

To determine how to move forward with this process, the FSP commissioned NeXii to do this study to assess the feasibility of setting up a bond fund underwritten with a partial guarantee facility that would raise capital in support of NBFIs working with SMEs.

Broadly, this study should help the FSP to: assess the overall regulatory environment as well as hurdles and opportunities in the development of an Enterprise Impact Fund (EIF). The EIF is the latest working title for what was previously known as the SME Debt Fund or SME Bond.

Scope of work

Identify profile and rank possible partner firm(s) that could use the bond guarantee to raise capital and manage on-lending applications to NBFIs. This information was presented separately to USAID.

1. Understand the risk appetite of the South African fixed income market:

    — Compile a summary of the last three years of non-sovereign bonds segmented by risk rating. Within each risk rating, identify the average amount of bond, tenor and pricing.
2. Define the potential demand of target applications of the fund:
    — Estimate the financing need of NBFIs8 in the market place to determine potential market demand for on-lending capital to meet SME credit needs.
3. Understand the regulatory benefits and constraints for investors buying the bond and for partner firm managing the fund:
    — ndertake an analysis of the regulations to identify the hurdles and opportunities. Determine what regulatory aspects are needed to make the issue more attractive to investors. Specifically consider:
        - Potential impediments
        - Potential benefits (tax, BEE points etc)
        - 5% of set asides for development purposes (prescribed lending)
        - Enterprise Development Funds

Research methodology overview

The primary questions this report seeks to answer are:

1. Identify profile and rank possible partner firm(s) that could use the bond guarantee to raise capital and manage on-lending applications to NBFIs.
2. Understand the risk appetite of the South African fixed income market.
3. Define the potential demand of target applications of the fund.
4. Understand the regulatory benefits and constraints for investors buying the bond and for partner firm managing the fund

Research was conducted as follows:

1. Face to face meetings and telephonic discussions were held with a range of fixed income and debt origination professionals in South Africa.
2. Non-sovereign bond data was obtained from the Johannesburg Stock Exchange (JSE) (focusing on the period 2008 to 2010) and was analyzed.
3. A literature review of SMEs, corporate bond markets, the South African Bond Market and existing SME financing structures and schemes was undertaken.

Fixed income appetite

The research methodology for the fixed income section included:

[8] A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency.

- Compiling a detailed summary of the last three years (2008-2010) of non-sovereign bonds segmented by risk rating and analyzed according to the average amount of bond, its tenor and pricing;
- Analyzing the historical data to detail bond issues that could be comparable to the purpose and/or structure of the bond facility envisioned for the Enterprise Impact Fund (EIF) using the DCA guarantee; and
- Understanding the appetite and structural preferences through one-on-one interviews with key asset managers in the South African fixed income market.

Scope, limitations and key assumptions for the fixed income section

1. The JSE non-sovereign bond data was filtered per bond issue year for the period under review. Bonds issued before 2008, even if listed, are not included in the analysis. The JSE bond data details 3,471 bonds issued from 1978 to 2011 (see Annexure 3: Overview of bonds per year of issue). By filtering according to issue year, the sample size of bonds considered for this analysis is detailed in the table below:

Table 1: Bonds issued per year (considered for the study)

Issue Year	Number of Bonds Issued per Issue Year	% of Sample Size
1978 – 2006	389	12%
2007	463	13%
2008	1093	31%
2009	688	20%
2010	690	20%
2011 Q3	148	4%
Total	**3,471**	

2. "Corporate bonds" on the Bond Exchange is a broad category that includes Banks, Other Corporates, Securitization and Commercial Paper9. This same categorization was used for the analysis.
3. Because the data was aggregated to create an annual overview, the actual listing status (i.e. listed, matured or redeemed) per month per bond is not considered. Any matured bonds in the period under review are detailed in the tenor analysis.
4. The JSE bond data focuses on non-sovereign bonds, thus it was not possible to get an overall view of all the bonds listed and traded on the Bond Exchange. Data pulled from the literature review supplements any such analysis.
5. The pricing of bond market activities was not reviewed.
6. Data relating to private placements of bonds was not available and hence this was excluded from the analysis. The literature review was also limited regarding private bond placements.
7. Investor bond data was not available and hence this information is excluded from the analysis.
8. Some knowledge of corporate capital structure decisions and corporate bonds, including maturity, tenor, pricing, ratings and risk, is assumed. A brief overview of debt corporate financing can be found in Annexure 5: Corporates and corporate bond overview.

[9] Greubel, G. (2008). *New Developments in Bond Markets: A South African Perspective.* BESA

Market demand from NBFIs

To broadly understand the market demand from NBFIs for the proposed EIF, NeXii designed and distributed a questionnaire to 49 intermediaries deemed to be prospective applicants. This component of the research specifically sought to understand:

- Who the potential applicants to the fund would be,
- Who they currently on-lend to (the nature of their beneficiaries/SME end users),
- Whether their clients would meet any other criteria that could provide added incentives (such as BBBEE qualification as Enterprise Development beneficiaries), and
- What the potential financing need of their overall loan portfolios would be in order to get an estimate of the overall market size.

Responses to the questionnaire were captured and categorized as follows:

- Applicable (meeting the criteria of NBFIs (or institutions) who are (i) lending/investing in SMEs, and (ii) needing access to capital market funding);
- Not applicable - as they do not provide SME loans (either as part of their core business or it is not currently operational) or they on-lend to intermediaries who in turn on-lend and provide support to Micro-businesses rather than SMEs
- Not applicable - they did not submit, indicating they do not require additional funding, do not provide finance to their SME clients (refer to third party providers), focus is on growth equity or they target and lend to micro-businesses rather than SMEs
- Delivery failure - problem with the contact e-mail addresses and resultant delivery failure in sending the information
- No response submitted

Scope, limitations and key assumptions for market demand from NBFIs

Due to time constraints, a limited number of responses were received. In addition, the relative but important differences between the respondents, and their applicability to the research, means that the primary research analysis is qualitative in nature. We therefore cannot make definitive qualitative assumptions on the potential applicant market and their related needs and absorptive capacity but have attempted to extrapolate some indication of market size based on qualifying respondents and their capital requirements.

Regulatory issues and incentives

A literature review was undertaken and key stakeholders were emailed and interviewed in order to understand the regulatory environment and how this might hinder or incentivize investors and fund managers to participate in the fund.

About NeXii

Based in Cape Town South Africa, NeXii's foundations in the impact investment sector stretch back more than a decade as a result of the work it has achieved with the GreaterGood group and specifically the experience and learnings achieved through establishing and

operating the South African Social Investment Exchange (SASIX), GreaterCapital and the South African Network for Impact Investing (SAII).

NeXii's goal is to radically improve the capital marketplace for impact investment by establishing the meeting place for investors and investments that are social, environmental or sustainable in nature with a maximum emphasis on those investments referred to as impact investments.

We believe that scaling the systems for trust, transparency, credibility and comparability across countries, regions, enterprises and investment options, and strengthening the various individual pieces and their connection to the impact investment ecosystem, is key to growing the flow of impact capital to address the world's social and environmental challenges. Overall we aim to make impact investing a reality at scale by connecting communities, capital and change and by providing impact investors with the right solutions to facilitate more and improved capital flows to high impact social and environmental initiatives.

SECTION 2: RISK APPETITE OF THE SOUTH AFRICAN FIXED INCOME MARKET

A key component of the activity informing this report focused on determining what kind of risk appetite exists in the South African fixed income market and what the nature of the model for establishing a capital fund should be in order to effectively utilize the DCA Guarantee whilst encouraging a significant level of uptake amongst investors. This is of fundamental importance in order for the USAID FSP to make an informed decision on whether or not to proceed with the development and issue of a specific and dedicated bond, or whether an alternative route for increasing SME lending using the DCA Guarantee exists and would be more successful.

Overview of the South African corporate bond market

Given the current globally recognized status of BESA, it is humbling to review its historic advancements of the last twenty years. Compared to the size and activity on the global bond exchanges in the 1980's, South Africa was a very small player. By 2008, the local bond market was the fourth largest bond market in the world by total value of bonds traded, and the sixth most liquid bond market in the world. Today, BESA is the largest African bond market overall[10].

It was a very different picture in 1992, when financial experts in South Africa questioned the viability and feasibility of a local corporate bond market in South Africa, conducting feasibility studies to understand the market's demand and appetite for such a market (Davey & Firer, 1992)[11].

Corporate bonds are bonds issued by quasi-government institutions, such as the Development Bank of South Africa (DBSA), and private corporations such as Sasol, ABSA or Imperial. These bonds are not covered by a government guarantee and thus trade at a yield premium compared to government bonds reflecting their additional credit risk.

The first official corporate bond was listed in 1992 by SA Breweries. Prior to this listing, the 7 listed bonds that are now categorized as corporate bonds were issued by the Transkei Administration Board, Eskom Holdings Limited, Telkom Sa Limited, Development Bank Of Southern Africa, and The Land And Agricultural Bank.

In 2002, the number of issued corporate bonds for a given year went into double-digits (12) for the time. The market peaked in 2008 with 1,093 bonds and notes issued, of which 762 were Collateralized Debt Obligation (CDO) notes. The global sub-prime financial crisis affected the issued amount of the CDO notes issued as well as caused a contraction in the growth of listings in CDOs on the exchange.

By 2010, the corporate bond market was well established showing strong year-on-year (YoY) growth in terms of listings, nominal bond value and market capitalization. In addition, most

[10] Greubel, G. (2008). *New Developments in Bond Markets: A South African Perspective.* BESA
[11] Davey & Firer (1992). *A corporate South African Bond Market?* Investment Analysts Journal

of South Africa's major companies had a corporate bond in the market and foreign appetite for these bonds was strong[12].

The growth of the corporate bond market is particularly evident when comparing it against the size of the total bond and the sovereign bond markets. Indeed, it accounted for 5% of the total bond market at the end of 2001 to almost 30% by 2006, reaching a peak of 34% in 2008. In terms of the sovereign bond market, while it was nearly 1% of market size in the 1980's, the bond market is now split 37% corporate: 63% sovereign.

The relatively slow growth of the local bond market up to 2002 is mainly attributable to the regulatory constraints, including the prescribed minimum investment in public sector debt. Until 1989, pension funds had to keep a minimum of 53% in public sector debt or cash. By 1992, given the "free the market" recommendations from the Jacobs Committee Report (1988), pension funds prescribed investments in public sector debt was reduced to a minimum of 10%[13].

Other factors which facilitated the growth in the depth and breadth of the local corporate bond market include:

- Advances in the market structure and available infrastructure:
  - the Bond Market Association (BMA) was created in 1989,
  - BESA was licensed in 1996,
  - the market was demutualised in 2000,
  - JSE and BESA merged in 2009, and
  - the Yield-X Interest Rate market was set up in 2010.
- The growth in number and type of participants, ranging from market makers to rating agencies for corporate bonds.
- The easing of the macro-economic variables that characterized the 1980's and 1990's in South Africa, specifically double-digit inflation and the value of real interest rates.
- The increase in corporate merger and acquisition activities and privatization of South African state-owned enterprises 1990's.
- The increase in innovation in this space: from vanilla bonds to introduction of convertible debt instruments, floating rate corporate bonds, inflation-linked bonds, securitization, commercial paper, and the Separate Trading of Registered Interest and Principle (STRIP) Programme.
- The introduction of bond indices: the Other Bond Index (OTHI), the Government Bond Index (GOVI) and the All Bond Index (ALBI).
- The decreasing cost of bond finance, including no stamp duty on issue.

General fixed-income appetite

Given the comparative current level of market sophistication, the appetite for fixed income instruments is, in general, strong with most investors pursuing a buy-and-hold strategy. This strong appetite is not diminished by the characteristically low liquidity and low trading activity in the secondary bond market.

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[12] Fin24. (December 14, 2010). *A Corporate Affair.* http://www.fin24.com//Special-Reports/Investment-Series/Bonds/A-corporate-affair-20101029

[13] Davey & Firer (1992). *A corporate South African Bond Market?* Investment Analysts Journal

The fixed income appetite build-up started around 2001. The appetite at that time can be derived from RMB's report detailing six fundamental strengths that would define the corporate bond market for the following 2 years[14]. These six fundamental strengths are (ranked in order of strength):

1. South African Corporates are under leveraged (strong)
2. The cost of bond finance has dropped dramatically (strong)
3. There is an ever decreasing supply of new government debt (strong)
4. Banks are under pressure to price corporate loans correctly (medium)
5. SA Institutions are underweight in bonds (medium)
6. Corporates will need more debt (uncertain)

In general, these strengths criticize institutions' and corporates' limited use of debt in capital structuring decisions, especially if the cost of debt financing is decreasing, the demand for corporate bonds is increasing, and - compared to equity - bonds have lower volatility and longer terms. The capital structuring decisions of corporates are further explored in Annexure 5: Corporates and corporate bond overview.

By 2010, the appetite for fixed income strengthened, as evidenced by:

- Bond professionals stating that the market currently does not have enough bonds available, especially issued by South Africa corporations, given the demand for bonds, the universe of investors and the current capital available (opinions from face to face meetings with Stanlib, Standard Bank and RMB).
- The sophistication and maturation of investor appetite, as evidenced from the range of corporate bond products available for trade.
- The increase in desire of diversification in corporate bonds listed; for example, by 2006, market commentators were saying that the market is fatigued by the huge vehicle securitizations which make up about 80% of outstanding issues by value and retail mortgage securitizations (AR Management, 2006)[15].
- The compensatory higher rate of corporate bonds compared to government issued bonds; for example, in 2007 an AA-rated corporate bond from Bidvest (BID01) was offering 11.1% (or 2.5% over the comparable government R201 bond), compared to 10.0% (or 1.4% over the R201)." (FA News, 2009)16
- The increase in corporate bond trading volume as illustrated in the graph below by T. Hove (2008)[17]:

[14] Rand Merchant Bank and Bond Exchange of South Africa. (June 2001). *The Development of the South African Bond Market*. http://www.oecd.org/dataoecd/30/47/29878705.pdf
[15] AR Management. (2006, December 08). *Allen Jones Secure boost for Bond Exchange.* Retrieved 2011 April , from AR Management: http://ar-management.tmcnet.com/news/2006/12/08/2153709.htm
[16] FA News. (2009, October 20). *Corporate bonds to offer superior returns.* Retrieved April 2011, from FA News: http://www.fanews.co.za/article.asp?Investments;8,Bonds;1019
[17] Hove, T. (2008). *Bond Market Development in Emerging Economies: A Case Study of the Bond Exchange of South Africa (BESA).* Rhodes University

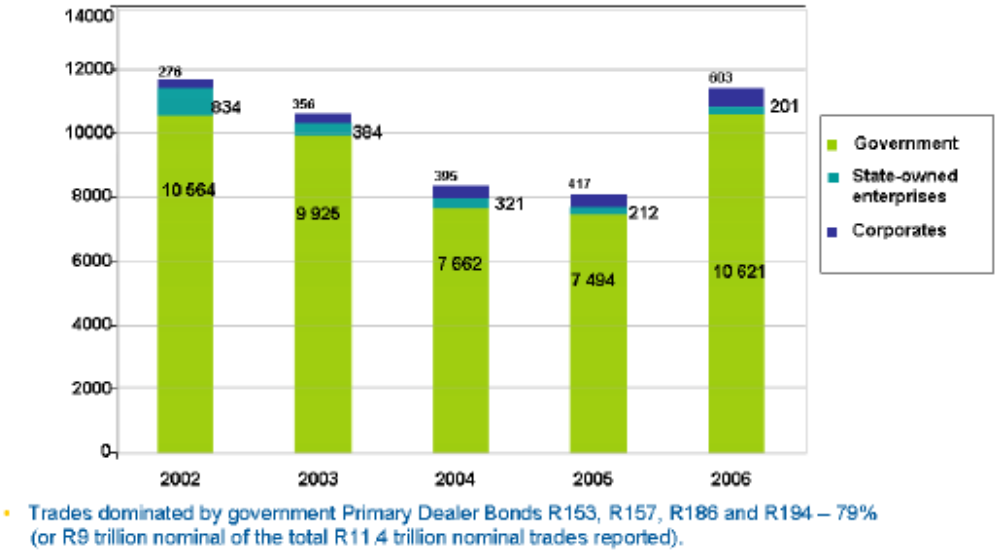

Figure 2: Bond trading growth (2002 – 2006)

- The increase of year-on-year growth in number of listed corporate bonds and issuers;
- The growth in the nominal value of listed bonds as a percentage to total value of listed bonds per time period:

  — 1% in 2000
  — 16.9% in 2003
  — 34% in 2008
  — 31% in 2009
  — 27% in 2010

While the growth of securitizations contracted after a strong growth period up to 2008 (which can be attributed to the sub-prime crisis in 2008), net corporate and bank issuance continued to grow, as evidenced in the graph below.

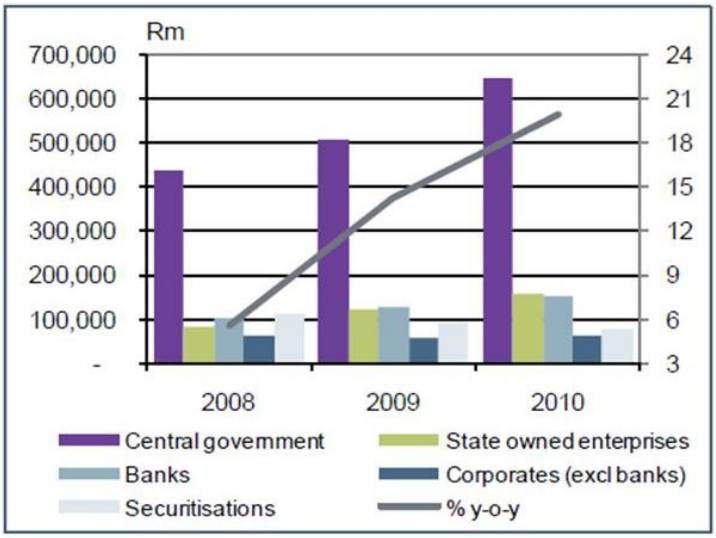

Figure 3: Listing of Bonds by Nominal Value 2008 – 2010 (as at end of year)

In general, three main factors will always influence corporate bond appetite:

1. Government bond issuance – Up to 2006 there was a reduction in the supply of government bonds but in 2009 and 2010, Government implemented an expansionary fiscal policy and issued large Eskom bonds. The increase in the value of the government bonds decreased the size of the corporate bond market.

2. Business confidence - For a given period, business confidence influences the volume of corporate bonds issued. Business confidence in South Africa was at a high during 2005 and 2006, which helps to explain the growth in listings of corporate bonds on BESA. 2007 to 2010 showed a steady decline in business confidence, as illustrated in the SACCI Business Confidence Index 2010[18] below.

Table 2: The SACCI Business Confidence Index 2004 – 2010

Month	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
January	96.2	99.0	103.1	101.5	93.8	82.4	81.2
February	95.0	99.8	100.1	100.5	94.0	84.5	83.0
March	95.9	100.3	100.9	99.5	93.9	78.9	83.2
April	97.5	100.1	103.1	101.9	93.4	81.9	84.2
May	97.2	99.9	101.4	100.2	93.0	81.8	82.0
June	96.8	100.8	99.4	99.1	92.6	83.1	84.8
July	96.4	101.5	99.1	99.6	92.8	83.2	84.3
August	100.5	99.2	99.0	98.1	90.5	83.0	87.6
September	103.0	99.0	97.7	98.7	89.9	85.5	87.8
October	99.5	99.1	99.5	96.9	84.2	82.2	85.9
November	98.4	99.5	103.2	95.8	86.7	84.1	87.0
December	97.7	101.8	103.5	94.8	83.8	83.5	87.6
Average	**97.8**	**100.0**	**100.8**	**98.9**	**90.7**	**82.8**	**84.9**

3. Macro-economic conditions - The market conditions at the time of listing the bond, as well as current market conditions, such as the sub-prime crisis, affect the yield and appetite for corporate bonds. Below is a table of the commonly used macroeconomic indicators against which corporate bond yields are compared.

Table 3: Comparison of corporate bond yields against macroeconomic indicators

Economic Indicator	2008	2009	2010
JIBAR 3 Month	11.43%	7.23%	5.55%
R186 10-Year bond	7.67%	9.15%	8.04%
R157 Benchmark bond (medium term)	7.20%	8.40%	7.40%
Repo Rate %	11.50%	7.00%	5.50%
Prime Rate %	14.00%	15.00%	9.00%
GDP Growth Rate (last Q of year)	-1.80%	3.20%	4.40%
Inflation Ave Per Year	11.52%	7.14%	4.29%
T-Bills (91 days)	10.80%	7.10%	5.60%

[18] South African Chamber of Commerce and Industry (2010) *South African Chamber of Commerce and Industry Business Confidence Index December 2010.*

Risk, Amount and Tenor Analysis

To understand the risk appetite of the South African fixed income market, the JSE non-sovereign bond data was summarized and segmented according to:

- Tenor – short-term, medium term, long term and matured (bonds which were issued and that matured within the period under review)
- Risk rating per Fitch[19]
- Corporate bond category and sectors per BESA classification
- Coupon rate indicator
- The % of Issued (or outstanding) value compared to the authorized amount
- The number of bonds that make up this sample
- The total sum of the authorized and issued amounts, as per selected filters
- The average of the year-end coupon, as per selected filters

This analysis only includes the bonds rated by Fitch, because the majority of the bonds in the data source were rated by this rating agency. All supporting tables and graphs for this analysis are in Annexure 4: Fixed income analysis.

Investor Appetite - Analysis of Long Term Prime Investment Grade Bonds

- Based on analysis of the data, investor appetite for AAA bonds is very healthy. In nearly all instances of the sample data (regardless of tenor, bond structure or amount) there was a 100% uptake of the authorized amount. Uptake was less than 100% for state owned enterprises (Eskom and DBSA).
- The average amount is around the ZAR1, 000m mark, which is nearly two thirds higher than the average amount for High Grade bonds.
- Issuers are predominantly from institutions from the banking industry and state owned enterprises (Eskom).
- The larger special purpose vehicles (SPVs) (average amount of ZAR500m) are rated AAA.

The average floating coupon rate is approximately 1-2% higher compared to the macro-economic indicators.

[19] International ratings agency providing issuer and bond ratings, and research banks, corporations, sovereigns, structured and municipal finance.

Table 4: Long Term Prime Investment Grade Bonds: Average and standard deviation

Issue Year	Average Authorized Amount (ZAR Rm)	Standard Deviation	% Issued/Authorized
2008	778	1,997	Average uptake of 98%
2009	1,683	2,616	Average uptake of 99%
2010	961	2,350	100% uptake

Table 5: Long Term Prime Investment Grade Bonds: Authorized vs. Issued per category (across all tenors)

	2008	2009	2010
Securitizations	100%	100%	100%
Banks	Average uptake of 92% (DBSA)	100%	100%
Other Corporates	N/A	N/A	100%
State Owned Enterprises (SOE)	N/A	Average uptake of 97%	98%

Table 6: Long Term Prime Investment Grade Bonds: Coupon

	2008	2009	2010
Simple Average Coupon	13.08%	8.71%	7.44%
JIBAR 3 Month	11.43%	7.23%	5.55%
R157 Benchmark Bond (Med. term)	7.20%	8.40%	7.40%

Investor Appetite - Analysis of Long Term High Investment Grade Bonds

- High investment grade bonds are rated AA+, AA, or AA- by Fitch. Similar to the Prime assets, investor appetite for High Grade bonds is strong across all three ratings available.
- Regardless of tenor, bond structure, issuer or amount, there was a 100% uptake of the authorized amount.
- Overall, the average authorized amount for this rating category is approximately two-thirds of the Prime assets.
- The range in amounts is tighter compared to Prime assets. This is possibly not due to the rating of the bonds between these two rating groups but rather due to the outliers in the Prime data set – maximum authorized amounts range from ZAR50m (securitization issue) to ZAR10,500m (Eskom vanilla bond).
- Although there are outliers in the High investment grade bonds data set as well, the range between the highest and lowest authorized amount is less compared to Prime bonds.
- The issuer blend consists of banks, other corporates (vehicles) and state owned enterprises (Eskom).

- The SPVs are typically smaller in size compared to the Prime-rated SPVs – less than ZAR200m compared to an average of ZAR489m for Prime-rated SPVs. The outlier for the SPV data set is the asset-backed securitization note issued by the Airports Company issued in 2008 and matured in 2009.
- Similarly to the Prime bonds, the average floating coupon rate is approximately 1-2% higher compared to the macro-economic indicators.

- The bond issuance from the state owned enterprises have an RSA Shareholder guarantee.
- The majority of bonds and notes are secured and/or asset backed.
- The issuances with fixed coupon rates are unsecured.

Table 7: Long Term High Investment Grade Bonds: Average and standard deviation (across all tenors)

Issue Year	Average Authorized Amount (ZAR Rm)	Standard Deviation	% Issued/ Authorized
2008	480	485	100% uptake
2009	952	745	100% uptake
2010	640	533	100% uptake

Table 8: Long Term High Investment Grade Bonds: Authorized vs. issued per category

	2008	2009	2010
Securitizations	100%	100%	100%
Banks	100%	100%	100%
Other Corporates	100%	NA	100%
SOE	100%	100%	NA
Municipalities	100%	NA	NA

Table 9: Long Term High Investment Grade Bonds: Coupon

	2008	2009	2010
Simple Average Coupon	13.60%	8.84%	7.33%
JIBAR 3 Month	11.43%	7.23%	5.55%
R157 Benchmark Bond (Med. term)	7.20%	8.40%	7.40%

Investor Appetite - Upper Medium Investment Grade Bonds: Appetite

- Upper Medium Investment bonds are rated A+, A, or A- by Fitch. As per the definition of what constitutes an investment grade asset (see Annexure 5: Corporates and corporate bond overview – Credit Rating), this rating level includes the lowest rating possible for a listed investment grade asset: A-. Because the data sample for this investment grade is small, the range analysis spreads across the bonds' tenors.
- There isn't a dominant issuer category for this rating range, although the City of Johannesburg had the largest amount authorized for the period under review. This bond is an unsecured municipality bond but uses a bond sinking fund to ensure that bond holders can be repaid.
- This rating category has a dramatic drop in average authorized amount from 2008 to 2009 and 2010. It is not clear from the available data whether this is attributable to the 2008 sub-prime crisis.
- Apart from the City of Johannesburg issue (which can be seen as an outlier in this data set), the bond amounts tend to the mean.
- The SPVs in this rating category have an authorized amount of less than ZAR150m and most are residential mortgages. The average floating coupon rate for the bonds and notes in this rating group is approximately 2-3% higher compared to macro-economic variables.

- The City of Johannesburg's issuance did not have a guarantee. Other bonds and notes in the upper medium rated sample data are secured against assets (equipment and residential property) or senior, unsecured floating rate notes.

Table 10: Upper Medium Investment Grade Bonds: Average and standard deviation (across all tenors)

Issue Year	Average Authorized Amount (ZAR Rm)	Standard Deviation	% Issued/ Authorized
2008	457	889	100% uptake
2009	103	88	100% uptake
2010	138	114	100% uptake

Table 11: Upper Medium Investment Grade Bonds: Authorized versus issued per category

	2008	2009	2010
Securitizations	100%	100%	100%
Banks	100%	NA	NA
Other Corporates	N/A	100%	100%
Municipalities	100%	NA	NA

Table 12: Upper Medium Investment Grade Bonds: Coupon

	2008	2009	2010
Simple Average Coupon	14.82%	9.81%	8.53%
JIBAR 3 Month	11.43%	7.23%	5.55%
R157 Benchmark Bond (Med. term)	7.20%	8.40%	7.40%

Investor Appetite - Lower Medium High Yield Bonds

- Lower Medium Investment bonds are rated BBB+, BBB, or B- by Fitch. These are non-investment grade or high-yield bonds. Because the data sample for this high yield grade is small, the range analysis spreads across the bonds' tenors.
- The appetite seems to be very strong for the high yield bonds because these is a 100% update of the sample bonds regardless of amount issued, rating, issuer, or bond structure.
- The high yield bonds issued have authorized amounts ranging from a low end of ZAR3m for a securitization issuance to ZAR3, 518m for a vanilla bond.
- The issuers are banks issuing floating rate notes and SPVs (mainly equipment-back securities).
- The average annual floating coupon rates on these bonds are approximately 3-4% higher than comparative macro-economic indicators with the spread contracting over the period under review.
- The high yield rated bonds and notes in the sample data are either asset backed (equipment or residential property) or unsecured floating rate notes.

Table 13: Lower Medium High Yield Bonds: Average and standard deviation (across all tenors)

Issue Year	Average Authorized Amount (ZAR Rm)	Standard Deviation	% Issued/ Authorized
2008	282	509	100% uptake
2009	383	600	100% uptake
2010	28	9	100% uptake

Table 14: Lower Medium High Yield Bonds: Authorized versus issued per category

	2008	2009	2010
Securitizations	100%	100%	100%
Banks	100%	100%	N/A

Table 15: Lower Medium High Yield Bonds: Coupon

	2008	2009	2010
Simple Average Coupon	15.02%	10.19%	8.62%
JIBAR 3 Month	11.43%	7.23%	5.55%
R157 Benchmark Bond (Med. term)	7.20%	8.40%	7.40%

Investor Appetite - Short Term Prime / High Grade Investment Grade Bonds

- Short-term bonds that are investment grade are rated F1+ by Fitch. Apart from two issues, all the other issues are classified as mature, because the note was issued and matured within the period under review. The majority of short-term issues have a fixed coupon.
- The listings from 2008 dominate this data set. Issuers are predominantly SPVs, followed by state owned enterprises (Airports Company) and corporates (vehicles). Investor confidence and the impact of the 2008 sub-prime crisis potentially account for the low investor appetite for the SPVs issuances in 2008 in particular. The authorized amount of the short term notes for securitization are much larger compared to both High grade and Upper Medium grade; but the uptake appetite is similar in amount to High grade rated SPVs.
- The short-term rated bonds and notes in the sample data are all senior unsecured floating rate notes.

Table 16: Short Term Prime / High Grade Investment Grade Bonds: Average and standard deviation (across all tenors)

Issue Year	Average Authorized Amount (ZAR Rm)	Standard Deviation	% Issued/ Authorized
2008	836	251	55% uptake
2009	463	96	100% uptake
2010	470	53	100% uptake

Table 17: Short Term Prime / High Grade Investment Grade Bonds: Authorized versus issued per category

	2008	2009	2010
Securitizations	53%	N/A	N/A
Other Corporates	55%	100%	100%
SOE	100%	100%	100%

Risk appetite conclusions

From the above analysis, a clear appetite for bonds is evident, across the spectrum of credit ratings. This analysis supports the opinions in the general appetite for fixed income section, namely that the corporate bond investor is a sophisticated investor with an appetite for diverse products. The analysis also supports the expressed opinion we received that there is a mismatch between the demand for and supply of bonds.

Bond ratings, as issued by one of the four credit rating agencies, are a good overall source of information about the bond and largely a predictor of appetite and uptake. Indeed, the above analysis suggests that as the rating drops from AAA to A-, the amount issued that the market will accept drops. There is a consistent appetite for pick up and credit enhancement by securitization notes across the ratings. These two factors will influence appetite and therefore should influence the bond structure, especially as the demand for, what is perceived to be high risk, SME exposure is untested against broad based investors' appetite and portfolio compositions.

In addition to the risk aversion in the local corporate bond market, and despite the growth that it has evidenced over the last 25 years, there are still some challenges surrounding the issuing of traditional corporate bonds. These include:

- Each corporate bond trades at different spreads because of the characteristics: structure, calculator, rating grade, industry, amount outstanding. This makes it difficult to create comparative analysis at times.
- Pricing of bonds is derived theoretically as opposed to being set by market-driven forces.
- Data availability and data transparency remains a challenge. Details of the structure of bonds are not readily available – for example, what guarantees underpin the bond.
- Expansionary fiscal policies by Government crowd out the corporate bond market.
- The corporate bond market is more sensitive to macro-economic variable movements.

South Africa's bond market – like its attitude towards and appetite for financing socio-economic development opportunities – is in need of innovation and new financial products on par with global trends. European and Indian SME financing markets are about 20 years ahead of the South African situation and much of the world is ahead of South Africa in all aspects of socio-economic and development financing activities.

This call for local market maturity is an echo of the call made to the corporates in 1992 when the corporate bond market was investigated and tested for viability. We believe USAID could significant support this development through defining an innovative mechanism with sufficient security to garner support and establish a clear and unequivocal track record of the multiple benefits and blended value that can be achieved by supporting SME lending.

Given the above commentary and the input from various discussions about the appetite for risk in South Africa, this section considers some of the possible structuring options and related issues that could be considered in approaching the development of the EIF. In general, the SME market is perceived to be a high-risk market and is therefore expected to provide above market returns to compensate. However, this defeats the object of the USAID FSP which is looking to provide affordable access to finance and to broaden the case of capital accessible to SMEs. The following section has tried to address this by conceptualizing possible structures. These should be further tested with debt origination specialist and the potential asset managers of the Fund.

We should emphasize that these options are stand-alone options and do not necessarily require additional incentivization by a development fund such as a Challenge Fund or Social Impact Bond. Whilst we would recommend that such a parallel fund should be pursued and believe it could play a hugely important role in supporting SME development and provide significant opportunities for education and advocacy, we believe that the bond structure itself should provide sufficient incentive to the market.

As such, we are cognizant of the fact that we should be cautious of basing the EIF specifically on incentivization by other external factors such as Enterprise Development (ED) points or tax benefits, which to some extent are subjective and readily open to change. We believe investors are looking for a real, material offering in and of itself that is simple to understand, and with a clear line of sight to the value proposition it provides. This is not to say that having a related and parallel structure is a disadvantage. Rather it is simply to point out that the architecture and value proposition of the bond must be very clearly articulated and transparent.

The key factors, therefore, that we believe have to be taken into consideration when structuring the bond are:

1. The perception of risk: in this regard, SME lending is considered high-risk investment and so requires credit enhancement. This would be offset to some extent by the USAID guarantee (a triple A global rating); however it should be emphasised that given it is only a partial guarantee, the market has indicated that it is the remaining investment that will largely determine the risk and rating. This means that this could still only be a BBB investment opportunity that is not investment grade, and will therefore be excluded from portfolios. We have therefore considered the potential for additional guarantees, most especially given the need for and potential of this bond to provide proof and a track record to the market for future investment action in this sector.
2. The market conditions at the time of listing /launching the bond: in this regard our research has suggested that now is a very good time to launch a bond because there is a significant lack of good investment grade bond structures and portfolios are actively seeking these investments (assuming the risk rating issue is resolved). In addition to this, there is active pressure on asset managers and pension funds to engage in more “development finance” investment activities and this could provide additional support for the uptake of this bond if it was of sufficient investment grade to get around risk aversion in pension fund portfolio managers.

3. The extent of demand for exposure to SMEs in investor portfolios: this would include whether there are additional benefits of inclusion of this kind of exposure and it is

here that the issue of incentives may come into play. Reputationally, as mentioned, it will build the responsible investment portfolio of the asset manager and could overall support the sector in its striving to demonstrate no need for asset prescription but there do not seem to be any formal benefits currently available for inclusion of SME lending in portfolios. Our scheduled conversation with the Department of Economic Development and Treasury may provide additional insight into this matter by understanding whether there are any intended carrots (or sticks) in the offing that may promote the desire for this exposure. This could also provide a key advocacy point for USAID FSP to pick up with government.

4. Any additional reporting requirements on the bond including, for example, significant and measurable development impact that can be reported upon. In this regard we do believe it would be important that an independent evaluation, distinct from the fund manager's impact reporting role, should be considered to ensure that an objective assessment of the impact actually achieved on the ground could be verified and provided as an additional on the bond performance overall.

Some remaining questions regarding the fund characteristics include the following which should potentially form part of the tender presentation by asset managers:

- Should the fund be an open or closed fund?
- What is the duration of the fund: 3, 5, 7 or 10 years?
- What is the minimum investment size into the fund?
- What is the average investment size into NBFIs and from them to SMEs?
- Should foreign investment be allowed – and targeted – into the fund?
- What is the timeline to invest the fund?
- Should the sector exposure be limited? For example, should a maximum of 30% be invested in an identified and designated SME sector?

General Proposed Characteristics of the EIF

Given the research informing this report, below are the general characteristics of the EIF that we believe should be considered. The EIF options are fully explored in the following section.

Target Companies

The USAID program's objective is to facilitate access to finance for historically disadvantaged SMEs. The EIF's core mission, therefore, is the growth and competitiveness of SMEs, particularly those serving, employing or owned by historically disadvantaged South Africans. There is obviously a related expectation that such SME growth will translate into jobs and economic prosperity and so it is true to say that a related goal is sustained and decent work as well as new employment opportunities or job creation.

Other key impact indicators may include the sum of loans taken up, the number of SMEs engaging in lending practices and the purpose of that lending (e.g. growth, consolidation, and expansion), SME business growth in turnover, salary levels and other such indicators.

Target companies are thus likely to be those that are beyond the start up stage, already financially viable but in growth stage with sustainability and expansion plans and capital requirements.

Fund Size

It has been suggested that the minimum fund size should be ZAR50 million though other indications suggest this should be more in the region of ZAR500 million. The potential absorptive capacity indicated the NBFI respondents also suggest that a ZAR500 million fund would easily be absorbed and deployed to SMEs capital requirements. Most recent information from Department of Economic Development has placed the economic growth financing target at ZAR1.2 billion (SABC News, 13th April 2011, much of which will come from the Industrial Development Corporation.

Additional Underwriters

Partnerships with underwriters could create the additional safety net to facilitate uptake in this innovative financing structure targeting SMEs. It would also help to build a track record and encourage uptake in the EIF, given the government's focus on SMEs and untested waters.

Investors

Investors would include pension funds, institutional investors and other money managers with long-term savings pools available for investment. The EIF should also target retail investors as a small percentage of the fund's investors to begin engaging the man-on-the-street and facilitating access and knowledge at that level of SME financing.

Challenge Fund

All the proposed EIF structures could or do incorporate a link to the social venture development fund – whether this be a Challenge Fund or Social Impact Bond or other.

Rating

The USAID guarantee has a Global AAA credit rating. This may be diluted depending on the EIF structure chosen if there is only a partial guarantee. Indications are that with only a partial guarantee, asset managers may downgrade the whole issue to the unguaranteed portion which is anticipated to be a BBB rated non investment grade bond and therefore not attractive for uptake in traditional pension fund portfolios.

Return

The average cost of finance for SME loans from NBFIs is priced between 12% - 15%. We have assumed that interest rate cannot be raised without jeopardizing the mission of the bond. This limits the potential return on the EIF but with sufficient guarantees in place could be sufficient for the ultimate risk rating. For example, suppose that the SME loan is priced in the range of 12%-15% with 5% being the fee due to the NBFI. The bond will then earn between 7% and 10% return.

From our research, the following potential returns for the EIF were proposed:

- JIBAR plus 4.5%-6.00%

- With 50% guarantee from USAID on the invested fund capital, the target rate of return for the Fund could be between 12% -18%, net of fees, in the current financial environment. (i.e. The cost of capital to SMEs is likely to be in excess of 20%, which could significantly affect mission delivery.

SECTION 3: ENTERPRISE IMPACT FUND STRUCTURING OPTIONS

Based on all of the above, we have identified six possible structuring options that could be conserved for the Enterprise Impact Fund. These are discussed in detail below together with the various advantages and limitations we believe they provide.

General advantages of the EIF Options

In general, the EIF options will realize these benefits for the various stakeholders:

Advantages for USAID

- Offer USAID the position to drive financial innovation by leveraging existing financial vehicles, experience, and networks.
- Create innovative financial structure and a track record that will facilitate access to finance for SMEs and build the market in South Africa.
- Deepen the network access to and working relationships with the local market.

Advantages for SMEs

- Access to previously untapped capital from the capital markets.
- Increase in accessible, affordable capital for growth – a lower cost of debt with interest deductible on tax.
- Enhanced capital structure decisions and improved return on equity.
- Improve SMEs' ability to demonstrate and build a track record and credit history to unlock capital for expansionary growth.
- Increase the breadth and depth of the finance options available to SMEs.

Advantages for NBFIs

- Further, build SME lending experience and performance track record.
- Enhance debt finance for SMEs by increasing the lending capacity of NBFIs and FIs through the widening and diversification of their funding base.
- Offer opportunities to build more sophisticated financial systems to underpin future growth.

Enhance and increase the loan assets available to SMEs – the targeted range, size and duration of loans.

EIF Option 1 - Status Quo Guarantee on SME Loan Assets

This is the status quo position for USAID. Under this option, USAID continues to provide a credit guarantee to selected NBFIs perhaps with some additional advocacy, education or lobbying support to banks and other financial institutions. As multiple NBFIs are chosen, the guarantee is apportioned accordingly. The guarantee leverages the ability of NBFIs with good track records to increase their loan books in order to address the issue of financial inclusion and additionality for banks providing SMEs with access to finance. This credit guarantee could remain a concurrent option with the EIF on an ongoing basis, although this does place

an administrative and due diligence onus on USAID. The guarantee structure can be depicted as follows:

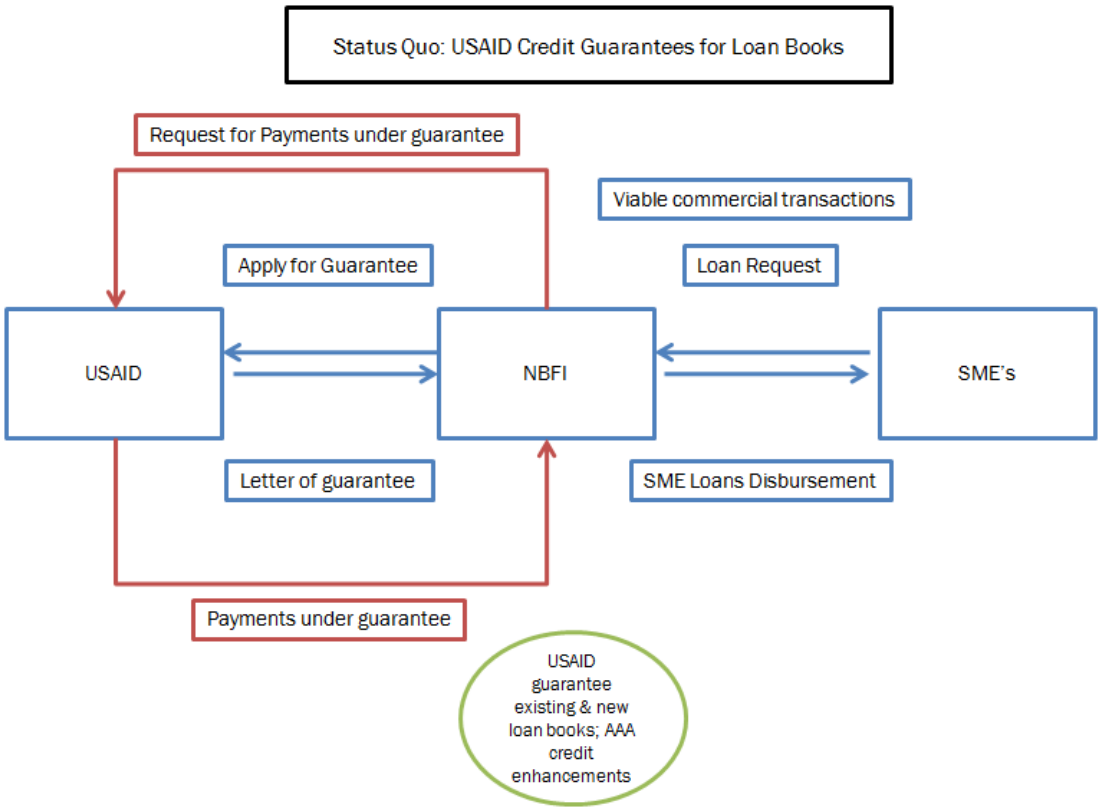

Figure 4: USAID Credit Guarantee for Existing Loan Books

Limitations

The limitations of this structure include:

- Experience has indicated that there is no – or slow – uptake, with the banks still resistant to making SME loans, even with the guarantee extended. As a result, no credit is forthcoming.
- The NBFI has to raise capital and service capital that he on lends. In effect, this means he is trying to access capital from new sources rather than having an available pool of capital that is ready to allocate.

Appetite for this product

Based on history there has been little appetite for this product amongst the banks as key lending institutions. Potentially providing the guarantee to Asset Managers for use with their assets under management could be a better way to structure this. This alternative option is explored as Option 4.

EIF Option 2 - USAID Vanilla Bond

USAID issues a traditional, low-risk, vanilla bond structure under pinned by the AAA guarantee on 50% of the issue. The bond may be listed or be privately placed and may have

an additional incentive through a link to the Challenge Fund. Multiple asset managers can still manage the capital.

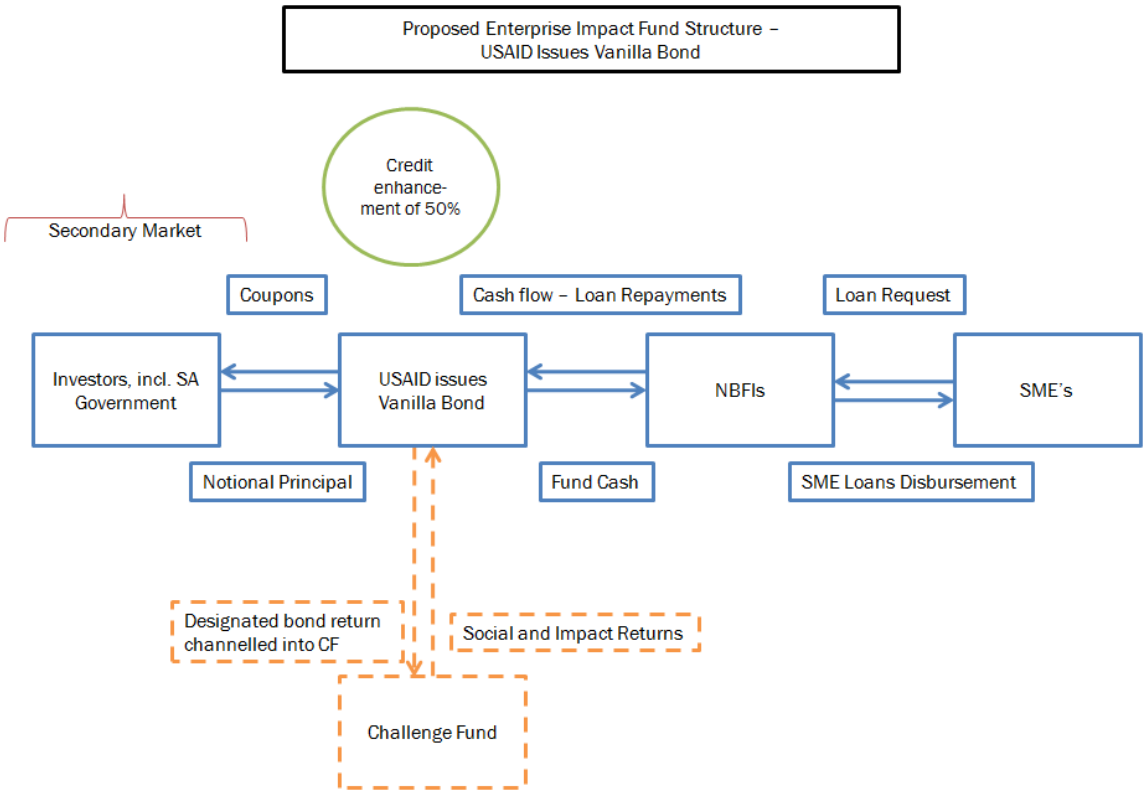

Figure 5: USAID Vanilla Bond Issue

Risk

Even with the 50% USAID guarantee, the issue may still be seen as too risky. This is because the market may not know how to price the value of the unsecured 50%. This partial guarantee may reduce the overall bond rating from AAA to BBB.

Return

If the partial guarantee drops the bond rating, the return required may be too onerous on the EIF structure. The coupon should have a floating rate and a sufficient sweetener of at least 100-200 basis points over the 3-month JIBAR (though this will not be sufficient if the overall rating is reduced to a BBB.

If this bond was connected to a Challenge Fund, then the return could be structured to include a performance floor with the surplus to a ceiling flowing to the Challenge Fund in return for incentive BBBEE points or tax benefits. This would then look as follows:

- A floating rate bond with a fixed floor (e.g. 6.65% determined today as 110 basis point over; spread to 3 month JIBAR with 3-month JIBAR at month-end December 2010 at 5.55) and with any return over 6.65% to a maximum of, for example, 10% goes to the capitalize the Challenge Fund in return for an appropriate incentive (tax deduction, BBBEE points etc.) to the investor. Any return over 10% goes as a "bonus" back to the investor.

Term

The bond's maturity is most likely medium term (6-12 years).

Appetite for this product

Given that the guarantee is only partial, the bond's rating may be reduced and this could negate investor appetite. However, if coupled strongly with the development fund option, this bond could give investors a potential vehicle for scoring BBBEE points on companies' scorecards given that this bond focuses on Enterprise Development.

To make this bond more attractive to investors, the bond can be callable and/or have an early redemption feature. These features are considered for bonds with a medium to long term maturity.

Callable bond

If USAID issues a callable bond, it would retain the privilege of redeeming, or buying back, the bond before the bond reaches the date of maturity. The bond would be redeemed at a defined call price.

Early Redemption

Early redemption refers to the repayment of the loan (principal and interest) before the maturity of the loan. There are two main types of loan redemption: partial redemption and full redemption.

These features make holding the bond more risky for investors; this risk would be reflected in higher coupon and the call premium (as worked into the bond's price). If the bond's rating drops to BBB (due to the partial guarantee, for example), the call premium would be higher on the high yield bond market compared to the prime investment grade market.

Banks, state owned enterprises, securitization, and other corporates can all issue bonds that are callable and/or have early redemption. Annexure 5: Bond Features: callable bonds and early redemption gives an overview of a selection of the bonds with these features (as from the JSE data set).

EIF Option 3 - Collateralized Loan Obligations / Securitization

Collateralization or securitization is a means to enhance the risk rating of the EIF alongside the USAID guarantee and could go some way towards ensuring that the rating does not fall below investment grade. USAID could therefore work with a bond issuer and the NBFIs to create an SPV for the SME loans that would be underwritten by both the guarantee and by collateral or securities that the NBFI puts in place as part of the loan agreement.

Collateral is an asset pledged by a borrower to a lender until a loan is repaid. If the borrower defaults, then the lender has the right to seize the collateral and sell it to pay off the loan[20]. Collateral assets may be physical assets, such as land, buildings, equipment, or vehicles;

[20] Balkenhol B and Schutte H, "Collateral, Collateral Law, and Collateral Substitutes", Social Finance Programme, Working Paper No. 26, 2001, Employment Sector, International Labour Office, Geneva,

financial, such as a bank deposit or share certificates; or intangible assets, such as a personal guarantee.

For the most part, there is general agreement[21] that collateral plays three important roles in lending:

1. It demonstrates the commitment of the borrower prior to disbursement of the loan.
2. It concentrates the mind of the borrower during the life of the loan.
3. It partially mitigates the loss in the event of default[22].

The taking of collateral is just one of several risk management strategies which can improve the quality of a loan portfolio and reduce risk of lending. As such, it could effective address the issue of perceived high credit risk in SMEs as well as the lack of homogeneity in SME loans (variation in size, companies with different legal forms, variety of collateral or assets backing the loan etc.). These SME loans would then be repackaged into a Collateralized Loan Obligation (CLO) vehicle and then sold on the market.

However, whilst collateral plays an important role in possible credit enhancement, it must not replace the due diligence assessment of the viability of a business. It should also be understood that collateral does not remove all the risk specifically because a key challenge with collateral or asset back securities is that the value to be realized from appropriated assets may not be commensurate with the loan itself as assets are often sold at prices significantly below market value. Nevertheless, we believe it is a very strong option that could meet the limitations imposed by having a partial USAID guarantee and thus increase the rating of the EIF at the time of issue.

SME Securitization can be implemented by a bank or NBFI(s) (the "originator") extends loans to SMEs ("primary market") and these issued loans are then bundled into a portfolio which is sold to investors in the capital market through the issuance of notes by an SPV. These notes are effectively asset-based securities (ABS) supported by the underlying collateral assets that the bank and/or NBFI secures from the SMEs it lends to. Each ABS note is classified into a risk category and represented in a tranche in the underlying portfolio. The tranches ensures that assets are not co-mingled, and that impact and specific use of capital by the lenders can be tracked. Investors buy the note tranches. The SPV will be further enhanced by the USAID credit guarantee.

Europe, Latin America and Asia have been securitizing SME loans for over the last decade. Various institutions in South Africa since 2001 have theoretically explored SME securization, but, as at the time of writing, there is no such securitization offering in the market. Securitization in South Africa, particularly when compared to Europe, is still an emerging industry. SASFIN's "South African Securitization Program" pioneered the local securitization market in 1991. Listings of securitizations on BESA started in 2002 with the listing of eight issues. A snapshot of the securitizations listings on the market, as at time of writing, can be seen in Annexure 5: Securitization notes listed on the bond market.

[21] Investigation into collateral options for lending to micro and small enterprises. Finmark Trust, September 2009.

[22] Related to this final point is the advantage of lower loan loss provisions and therefore better risk ratings for loans with collateral

The CLO / securitization structure can be depicted as follows:

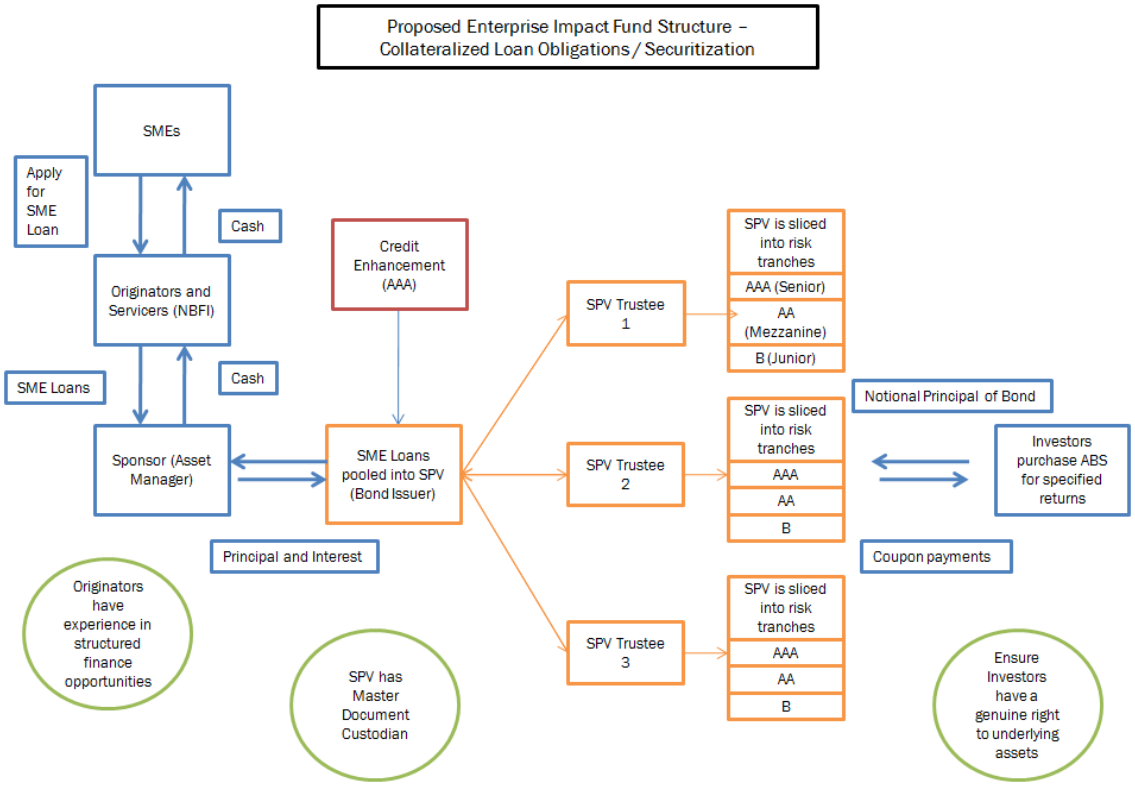

Figure 6: Collateralized Loan Obligation

Risk

Low – Medium. With both the partial guarantee and securitization in place, it should ensure that the bond would be effectively fully underwritten though with the risk remaining on the value of assets realized should they have to be liquidated.

Return

In general, the spread of securitized notes in South Africa has decreased over the last 5 years. The return value is still relative to the risk and corporate bond market.

Term

Tenors of the guarantees could range from short-term (less than a year) – up to 10 years.

What are the advantages of this structure?

- One of the better tools to address the credit risk of SME loans and entice investor interest into this market.
- Collateral improves the credit even more alongside the guarantee to improve a risk rating of an EIF bond.
- Improvement of the credit supply to SMEs.
- Creation of secondary markets and access to capital markets.

- The collateral provision SMEs would have to be very clear on the risks of defaulting on loans and this may provide additional support to focused business activities and performance.

Advantages for the NBFIs

As the market matures in South Africa, and given the volume of securitization bonds already listed on the JSE, the advantages for NBFIs include:

- Processing standardised structure and documentation.
- Cost reductions due to securitization template and investor familiarity.
- Easy execution due to high degree of familiarity of all parties involved (originator, investors, rating agencies, lawyers).
- Enhanced debt finance for SMEs by increasing the lending capacity of NBFIs and financial intermediaries (FIs) through the widening and diversification of their funding base.

Advantages for USAID

- Assumes the role of primary risk taker in the transfer of credit risk from originators (commercial banks) to the capital markets.
- Play an important role as catalyst for other investors to take subordinated SME risk.

Appetite for this product

Locally, the appetite for securitization notes has grown significantly over the last five years though it is not yet comparable to global markets. Globally, the appetite is mature and market size is large with multiple countries already using SME securitization techniques, including.

- Latin America – especially Argentina and Brazil -since 2003
- Korean primary collateralized bond obligation (P-CBO) - launched in 1999
- The Spanish FTPYME scheme – launched May 1999 with market size in 2008 of EUR62.2bn
- The Portuguese Fundo de Garantia de Titularização de Créditos (FGTC) Securitisation Scheme with market size of EUR5.5bn in 2009
- The KfW Promise Securitization Programme in Germany – launched in December 2000; market size 2008 EUR83bn
- European Investment Fund (EIF) created in 1994 (in capacity as offering guarantees for securitised SME financing instruments)

The appetite for this type of financial product would be influenced by the latest report from the South African Central Bank about looking into laws to allow the sale of covered bonds to help reduce borrowing costs for lenders.[23] Covered bonds are similar to securitizations with the main difference that the covered bond remains on the issuer's consolidated balance sheet. Accordingly, covered bonds could also be a viable option for the EIF, instead of a securitization structure.

[23] "South Africa Considering Covered Bonds to Lower Bank Costs, Regulator Says" Bloomberg April 2011

EIF Option 4 - Guarantee Directly to Asset Managers

This structure has the benefit of tapping into “pools” of capital already under management which, by offering a credit enhancement, could be placed using the credit risk assessment and expertise of asset managers directly with their clients to meet their unlisted responsible investment portfolio allocations. Importantly because it speaks into offerings already in the making and reduces the risk for asset managers, it will also reduce the time taken for SMEs and NBFIs to access capital because it is already in the funds under asset management.

Under this option, USAID extends the guarantee directly to an asset manager (or to multiple asset managers) for use in their existing portfolios to expand into responsible investment unlisted space.

Risk

The risk would depend on the depth of understanding and due diligence of partners and their track records.

Return

For investors the typical and reasonable returns of a bond fund which could range from "at" to "above market" without charging SMEs excessive interest.

Term

Tenors of the guarantee could range from short-term (less than a year) – up to 10 years.

Guarantee Range

The guarantee can be applied to single loan transactions or loan portfolios or, probably most effectively, to a maximum quantum for the asset manager provided the guarantee was ring fenced and utilized only for SME lending – with appropriate reporting and impact assessments done on application and of the guarantee. The single loan transactions may be administratively burdened.

What are the advantages of this structure?

- This is an a attractive option that could give multiple asset managers the necessary risk reduction required in order for them to build their capacity and track record within the sector of SME lending. It would enable track record development and go a long way towards education and advocacy of both the actual financial benefits and the social impacts of this investment activity.
- This structure does not suffer from the limitations of a partially guaranteed, low rated bond structure because it operates outside of the formal bond market.
- It speaks to capital already raised and enhances its allocation to what is otherwise perceived as high-risk investment. Because it taps into pools of capital readily available, it could have a more efficient route to placement.
- Monitoring and tracking could make this less risky.
- Ultimately, this structure may then start unlocking credit from the banks based on the performance of the asset managers and the NBFIs they lend to.

Advantages for NBFIs

- Loan book credit enhancement.
- The credit guarantee reduces SME borrower risk, insures the NBFI against default.
- Targeted lending and second level of SME screening (as from USAID eligibility criteria).
- Increase the loan assets – the targeted range, size and duration of loans offered to SMEs, and create a vehicle for long-term financing in particular.
- Because of better credit information and performance track record – can possibly look at securitization options in the future.
- Mutual addressing of information asymmetry (given USAID's experience).

Advantages for USAID

- USAID can work with the NBFIs to understand their SME credit scoring and create a national SME Credit Information Database that can help inform on and develop SME Statistics (viable and recognisable credit information sharing and credit scoring).
- USAID could use the credit guarantee performance as incentive to other financial intermediaries to pack their SMEs loan portfolios into collateralized debt obligations.

Appetite for this product

We believe certainly amongst the asset managers who are developing a responsible investment profile – and at least the eight asset managers responding to the EoI with high interest in managing this fund, that there will be a good appetite for this offering. Local competitors' performance influences and informs the general market's appetite for, and perception of, a credit guarantee scheme and this has not necessarily been to the benefit of the sector. However, this provides an opportunity to look at a higher level of investment activity and due diligence. This scheme aligns to the Government's initiatives to increase funding to SMEs.

It is important to note that the partial guarantee may come into play again and not provide sufficient assurance to risk aversion under this option. However, it is possible that the asset managers themselves can work with NBFIs to add collateralization to this option as presented earlier or find additional guarantees for these portfolios.

EIF Option 5 - Fund of Funds

A "fund of funds" (FOF) is an investment strategy of holding a portfolio of other investment funds rather than investing directly in shares, bonds or other securities. This structure is applicable to USAID given that they can extend the credit guarantee over existing loan books or funds. The FoF approach is useful in addressing one of the key limitations of issuing a bond with a single asset manager because a single asset manager is unlikely to want to be the issuer or take the risk of the remaining 50% of the capital raised through the bond issue.

Instead of using a single asset manager, the FoF would identify a larger number of financial institutions that has the size, the equity on balance sheet, a sound track record and the ability and willingness to stand for the balance of the capital not underpinned by the guarantee that is raised into a Fund of Funds structure. USAID and the FoF partner can then select a number

of asset managers who receive the mandate to manage a portion of the funds raised in the Fund of Funds.

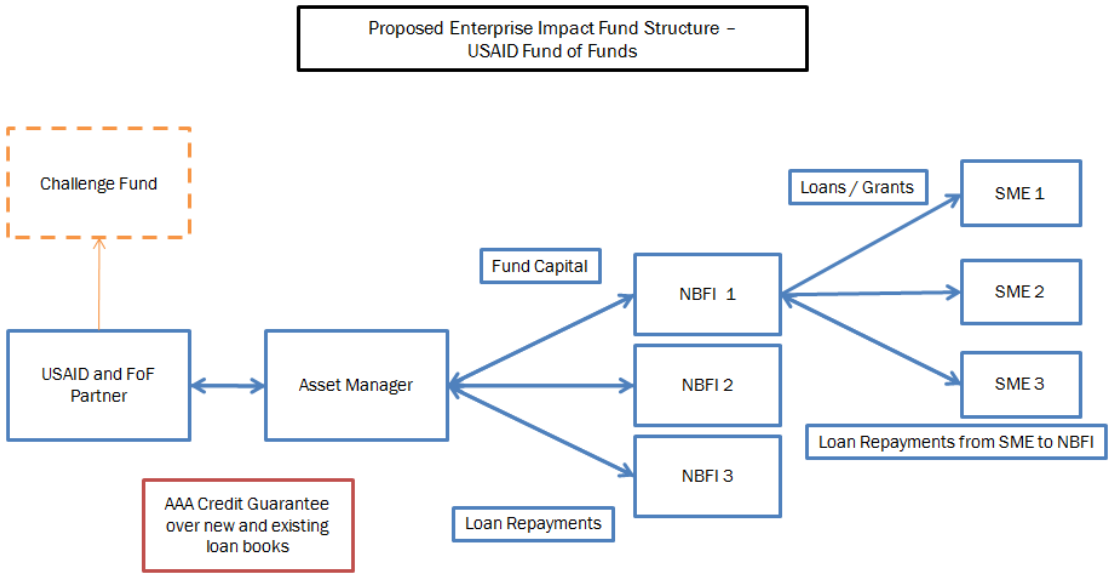

Figure 7: Fund of Funds

Risk

Low risk - the risk, already lowered by the guarantee, any risk should be managed between the NBFIs.

Return

Dependent on performance. Part of the return may be channeled into the Challenge Fund.

Term

Tenors of the guarantees will range from short-term (< one year) – up to 10 years.

What are the advantages of this structure?

- Uses existing financial vehicles and structures and speak into existing institutional investors with significant diversity of risk through a multi-manager approach with large institutional oversight which brings additional confident to the bond issue.
- Appoint and work with multiple asset managers to channel SME loans.
- A better tool to combine and grow the varying levels of experiences and skills of asset managers in South Africa to ensure that the playing field in this space is more level.
- Build a broader capacity of asset managers to manage SME loans.

Advantage for NBFI

Because this is a multi-manager investment, NBFIs can network and leverage expertise, skills and SME loan information.

Appetite for this product

The appetite for this product should be high, especially given the advantages of creating such a structure.

EIF Option 6 – Institutional Partner issues Vanilla Bond coupled with USAID guarantee

USAID enters into a risk-sharing partnership with an institutional partner. This partner would take the risk and/or underwrite all or part of the remaining 50%. The partner would issue a vanilla bond. The bond may be listed or be privately placed. Returns come from the interest payments flowing from NBFI's SME loans. The vanilla bond may also have the Challenge Fund aspect attached to it. The vanilla bond structure can be depicted as follows:

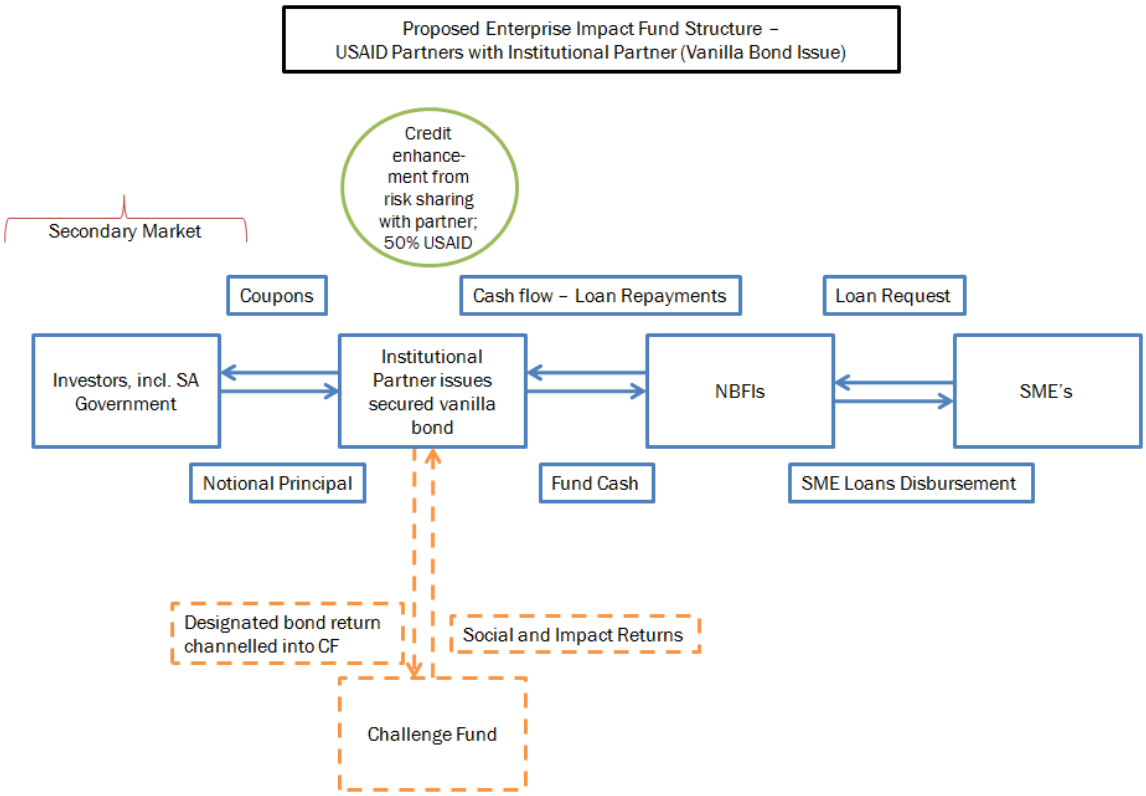

Figure 8: Institutional Partner Vanilla Bond Issue with USAID 50% Risk-Sharing Guarantee

Risk

The vanilla bond would have low to zero risk depending on the risk-sharing agreement. The overall rating of the bond may drop from AAA to a lower notch due to this rating mix.

Return

If the bond has a 100% guarantee through a combination of USAID and other guarantors, investors would anticipate a lower return (due to no risk in the bond). This would enable the issuer and USAID to determine whether in fact the return could be split to create capital flows to a Challenge Fund or Social Impact Bond component. If this bond was connected to a Challenge Fund, then the return could be structured as follows:

Assume that the coupon should have a floating rate, for example, 100-200 basis points over the 3 month JIBAR, and could range from 6%-8%, given the maximum SME loan cost of finance of 15%. Issue a floating rate bond with a fixed floor (e.g. 6.65% (determined today as 110 basis point over; spread to 3 month JIBAR with 3-month JIBAR at month-end December 2010 at 5.55). Any return between 6.65% up to 10% goes to capitalize the Challenge Fund and gives appropriate incentives (tax deduction, BBBEE points etc.) to the investor. Any return over 10% goes as a "bonus" to the bondholder.

Term

The bond's maturity is most likely medium term (6-12 years).

What are the advantages of this structure?

- The perception of risk (as from SMEs lending) can be mitigated giving investors "nothing to lose" in this sector which could ultimately build understanding and confidence.
- Use the low risk vanilla bond to create a track record in this space and accustom the market to these types of development bonds.
- Because it is a vanilla bond, the bond structure is relatively simple. The bond will also feed into the existing NBFI / SME / USAID network.
- The bond offers diversity in investors' portfolio but this depends on the demand for this type of exposure per portfolio.
- The secondary market, although relatively illiquid overall for the corporate bond market in South Africa, does offer investors exit opportunities.
- The bond can include additional social returns, as derived from significant and measurable development impacts.
- Capital could still be managed by a number of asset managers

Advantages for USAID

- If the institutional partner has corporate bond market experience and relationships, this can be leveraged by USAID.
- Avoid launching a new (perceived risky) product into the market with an issuer who has no previous track record.
- Create a track record of creating diverse financial vehicles to support and facilitate access to finance to SMEs, as well as other impact criteria and measures.

Appetite for this product

Given the collaboration with the institutional partner and the vanilla bond structure coupled with the credit enhancement, the investors should react well to the bond. The bond's rating may influence investor appetite.

This bond also gives investors a potential vehicle for scoring BEE points on companies scorecards given that this bond focuses on Enterprise Development.

SECTION 4: ASSESSMENT OF THE POTENTIAL DEMAND OF TARGET APPLICATIONS OF THE FUND

Profile and potential absorptive capacity of prospective applicants to the EIF

NeXii conducted qualitative research in order to broadly understand the market demand from NBFIs for the proposed EIF. Based on analysis of the 9 applicable responses, the data would suggest that there is a broad range of players within this field in terms of:

1. products and services offered;
2. scale of target market reached (beneficiary end users);
3. average loans sizes provided;
4. scale of finance provided to the SME market

It is worth noting the specific information offered in feedback from some of the NBFIs who were not necessarily applicable[24] to this research. This feedback is valuable in understanding the reasons why they did not submit an expression of interest. These reasons may be of particular interest in considering options around potentially broadening the target of applicants to the EIF or altering the nature of the financing mechanism – either of the EIF itself or of its accompanying socio-development focused SME Start-up Challenge Fund or SIB. These NBFIs tend to on-lend to micro businesses; operate equity-based funds (in conjunction with debt) or provide bridging finance.

Again, this information is qualitative in nature, but indicates areas worth investigating further in terms of needs and gaps in the market. These key points are as follows:

- Three NBFI respondents provide finance either directly or indirectly to micro entrepreneurs rather than SMEs with positive results and impressive track records;
- One indicated that their focus and core competence is on managing growth equity funds (although there is a debt portion in most of their SME transactions) and that they would be interested and, they believe well-positioned to assist with an equity fund in the SME space;
- Three do not provide finance as part of their service offering and so would rely on other third party providers for this (one of these indicated that they need a reliable source to refer SMME clients to and would enjoy feedback on the fund and its NBFI applicants accordingly);
- There was also a specific need indicated for bridging finance to enable the securing of large tenders with municipalities. This gap in finance provision for bridging capital has been echoed in conversations that the NeXii team has had with WC Department of Economic Development and Tourism and a Khayelitsha based business providing non-financial support to SMEs.

[24] Either as they do not provide SME loans (either as part of their core business or their business is not currently operational); they on-lend to intermediaries who in turn on-lend and provide support to Micro-businesses rather than SMEs; they do not require additional funding; do not provide finance to their SME clients (refer to third party providers); focus is on growth equity; or they target and lend to micro-businesses rather than SMEs.

Products and services offered

Although all of the applicable respondents provide loans/finance directly to the end user, the range of products and services on offer is diverse. These include:

- SME Loan Finance (between R10,000 and R3 million) and finance sourcing where unable to meet financial needs
- Financial and business mentorship services to funded SMEs (including business linkages between small enterprises and big businesses)
- SME loans to franchises and other businesses in the retail, service and manufacturing fields
- Invoice factoring and debtors management
- Bridging loan finance to contractors and developers who are undertaking subsidy housing projects, infrastructure/community facilities projects or affordable housing projects
- Construction management support to the emerging contractors ('Very Small Enterprises' and 'Small Enterprises') in conjunction with loan finance
- Debtors factoring products and specialized short-term (including: factoring; invoice discounting; supply chain finance; trade/purchase order finance)
- Import and local trade finance
- Debtor finance
- Asset-based/Capital Expenditures (CAPEX) finance
- Expansion/development capital; working capital finance; mezzanine and equity finance.
- SME training courses
- Mentorship/after-care service
- Long-term rental finance of Information Technology (IT) hardware and/or software over a three year period (average), plus value added products and services (insurance, maintenance & asset management, end of term service)
- Short-term hire of IT equipment from 1 day to 12 months; re-rental or sale of certified refurbished IT equipment, plus value added products and services (insurance, maintenance & asset management, end of term service)
- Capital (private equity, corporate finance, property private equity)

Most of the respondents are registered with the National Credit Regulator (NCR). One indicated they are not required to register, but that they are a member of the Banking Association Debtor Financing Committee[25] and another indicated that they are not NCR registered, but their service offering is similarly related to invoice factoring and debtors book management so they are also not necessarily required to be registered.

Scale of target market reached (beneficiary end users) and related finance provided

The scale of the target market reached by the applicable respondents varies greatly, with the number of loans disbursed in the last period (FY2010) ranging from 7 loans averaging R1.5mill/loan to 20,815 loans averaging R177, 207/loan.

Target Market Profile

[25] The Banking Association Debtor Financing Committee is an industry body representing all registered banks in South Africa. These include both South African and international banks. The Debtor Financing Committee of the Banking Association represents the specialist divisions of commercial banks and other financiers that finance debtor invoices. www.banking.org.za.

Most of the end user beneficiaries would likely constitute qualifying Enterprise Development beneficiaries as per the Codes of Good Practice on Broad-Based Black Economic Empowerment[26]. However, from the responses (specifically how these were reported) it seems that the respondents do not currently profile or classify their beneficiaries in this way and consequently do not likely have the relevant supporting documentation in place for securing ED points towards BBBEE.

This should be noted and considered for negotiations with EIF applicants further down the line in order to ensure that these points can be secured if this is indeed finalized as an added value benefit of investment in the Fund. In this regard it would be important to understand what systems of reporting the various asset managers are using in order to produce social impact performance statements and perhaps this component of capacity building as part of SME lending support can be put in place for longer term tracking and benefit to future lending activity.

Potential Financing Needs of NBFIs in the Market Place

As mentioned above, given the diversity of the respondents and the relatively small sample represented here, it is currently not possible to provide an accurate estimate of the potential absorptive capacity of NBFIs in the broader market place. Six of the applicable respondents here submitted specific[27] information on their absorptive capacity to place capital in qualifying SMEs, which is collectively estimated at **R1, 957,432,460**[28]. The figures that this sample submitted range from R177million to R1billion with an average in the region of R130, 000 across the total loan amount and number of loans made.

We would strongly commend further research with longer timeframes into this market in order to further develop the list of potential applicants to the SME Fund and specifically assess their absorptive capacity to effectively deploy funds into the SME market. Most importantly we believe that initiating this research once the EIF is actually launched is likely to deliver the best results as NBFIs will be aware of the real – as opposed to potential – promise of funds becoming available.

[26] Department of Trade and Industry. 2007. *Broad-Based Black Economic Empowerment Act (53/2003): Codes of Good Practice on Black Economic Empowerment*. www.thedti.gov.za/

[27] One respondent simply indicated that they would apply for whatever funds they could draw from the proposed SME Bond Fund; one indicated that their absorptive capacity is 'very good', but supplied no figures to support this assertion; and one indicated that this does not apply to them.

[28] This is exclusively a cumulative estimate of their own absorptive capacity and does not constitute a representative sample of the general market capacity at this stage.

SECTION 5: ASSESSMENT OF THE REGULATORY BENEFITS AND CONSTRAINTS FOR INVESTORS BUYING THE BOND AND FOR PARTNER FIRMS MANAGING THE FUND

> *One key constraint that hampers the growth potential and the development of decent work in small and medium sized enterprises (SMEs) is the prevailing ineffectiveness of the rule of law and the general lack of respect thereof. This problem can be summarized into three important parts: generally inappropriate regulations for the SMEs (e.g. outdated and unnecessary regulations causing adverse effects such as unnecessary cost on business and growth traps); secondly, the inappropriate design of institutional structures and their insufficient capacity to support SMEs in their compliance with current laws and regulations; and thirdly, inadequate representation of the SMEs in policy formulation processes*[29].

The economic performance of SMEs can be hampered or fostered by many different factors. Whilst some may be internal or specific to the enterprise itself or its sector, others belong to the macro-economic and social environment in which they operate. Within this environment, these factors could either be directly targeted through government intervention, or they may be more effectively addressed using prevailing market forces. Whichever it may be, institutional support is a key external factor that can and does affect SME performance. This includes the regulatory and policy environment provided by the State and the range of support services provided by public agencies and/or private organizations.

SMEs can benefit from both of these types of support, viz. government's role in creating an enabling regulatory and policy environment – including tax and other investment incentives, and the private or public sector's support in providing financial and technical assistance as well as market access for SMEs. In the case of government, it is generally accepted that providing an enabling regulatory and policy framework is critical. Such a framework should contain:

- A stable fiscal and monetary policy with reasonable interest rates, a financial market system that provides incentives to save, and mechanisms to channel savings into investments. For instance, a lower tax rate on initial profits allows firms to retain some earnings and to increase investment as appropriate.
- Policies that minimize the cost of business licensing and registering while safeguarding public interests.
- Policies that facilitate business transactions such as infrastructure development.
- Policies that promote financial support of SMEs through subsidies, credits or soft loan guarantee schemes provided by commercial and development banks.
- Equally as important as macroeconomic stability is the prevailing legal framework for the business enterprise promotion. South Africa currently ranks 34th out of 183 countries in the World Bank's 'Doing Business 2011′30 report, slipping two places from the 32nd position in the 2010 survey. Recent regulatory changes should enhance this in the future as South Africa increasingly addresses the issues hampering business development.

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[29] http://www.ilo.org/public/english/region/afpro/lusaka/download/jobs/jobadverts2011.pdf
[30] World Bank. 2011. *Doing Business 2011: making a Difference for Entrepreneurs.* http://publications.worldbank.org/

In this regard, global surveys of SME development have repeatedly demonstrated that the basic elements of a favorable legal framework for business promotion include:

- Well-entrenched property rights (legal tenure)
- Efficient business registration procedures
- Simple and transparent rules for operations
- Supportive taxation policies
- Effective and cost-efficient contract enforcement
- Streamlined systems of arbitration and dispute resolution
- Effective law enforcement and crime prevention.

The objective of this part of the research was to gain an overview of some of the key regulatory benefits and constraints that would apply specifically to investors buying the bond and/or for the fund manager of the EIF.

Overall it is clear that lending to SMEs is seen as a high-risk business especially given that most of these enterprises lack collateral. However, the problem does not appear to be a lack of capital in the market but rather, how to make capital accessible to SMEs by reducing the credit risk to investors or providing other incentives to encourage investment in this perceived "high risk" area. Specifically our research here focused on understanding what regulatory aspects were in existence that would make the issue more attractive to investors.

Key findings

International and local research literature suggests that there currently exist barriers to, as well as potential drivers and enablers of, increased SRI generally. These barriers are largely based on perception, a lack of understanding and inexperience within the sector. Indeed, despite general consensus that a strong business case for responsible investment practices exists, skepticism amongst financial intermediaries and asset managers still persists.

The strong business case for SRI is supported by a significant and growing body of international research that has demonstrated strong track records of SRI fund performance, indicating that consideration of ESG issues in portfolio management is of at least as much importance in evaluating the potential and actual performance of investments in the long term[31]. Furthermore, this has demonstrated that funds incorporating ESG factors do not under perform relative to traditional investment targets. This business case is in turn echoed by the *Principles of Responsible Investment*, which are "based on the premise that ESG issues can affect investment performance and that the appropriate consideration of these issues is part of delivering superior risk-adjusted returns and is therefore firmly within the bounds of investors' fiduciary duties."[32]

The South African financial services sector manages a national endowment of approximately R3 trillion in life and pension fund savings. Only a very small proportion of this - around R10 billion or just 0.33% - is directed towards investing in a socially responsible manner; this despite compelling international evidence of the strong nexus between investment performance and performance on ESG issues. The global precedent shows South Africa to

[31] Noah Financial Innovation, UNEP FI, and the UNISA Centre for Corporate Citizenship. 2007. *The State of Responsible Investment in South Africa*. www.unepfi.org/
[32] www.unpri.org

be lagging significantly behind international trends in the use of commercially viable responsible investments for investment, savings and pension fund portfolios. In the US, Mercer Consulting estimated that almost 16% of retirement assets were invested in SRI strategies in 2007. This figure is around the low double digits in the UK, Australia, and slightly lower in Continental Europe.

A South African study by UNISA's Centre for Corporate Citizenship published in 2007/2008 considered the state of Responsible Investment (RI)[33] in South Africa and specifically sought to understand the state of RI within institutional investment circles in South Africa. Towards this end, they designed a survey to address what the then levels of awareness of; demand for inclusion of (demand side); inclusion of (supply side); and future prospects for inclusion of ESG issues into investment frameworks in South Africa are[34].

This survey, in summary, indicated that principal officers of pension funds generally suggest that the most important barriers were related to the belief that RI necessarily meant lower financial return. Asset managers and advisors generally suggest that their most important barrier was a lack of demand from customers (institutional and retail)[35].

This local research is supported by international, US-based research on Community Development Financial Institutions[36] (CDFIs) and the Socially Responsible Investor Community[37], which identified similar key barriers, which are outlined as follows:

Table 8: Barriers Limiting Investment in CDFIs

Barriers Limiting Investment in CDFIs	
Lack of Awareness	Clients don't ask; professionals don't recommend. Thus almost 80% of funds placed in Community Investment go to banks or credit unions
Below Market Rate Return	Lower financial return makes CDFI investment less attractive than other Community Investment[38] alternatives, many of which offer a superior return.
No Financial Incentives	CDFIs offer no monetary compensation to investment professionals.
Unstructured Terms	Unique CDFI investment structures require a sophisticated, motivated investor.
Not Electronic	Manual systems make it harder to buy, sell, and report on CDFI investments.

[33] "**Responsible investment (RI)** or investment that incorporates an active consideration of environmental, social and governance issues into decision-making and ownership". Noah Financial Innovation, UNEP FI, and the UNISA Centre for Corporate Citizenship. 2007. *The State of Responsible Investment in South Africa*. www.unepfi.org/

[34] Noah Financial Innovation, UNEP FI, and the UNISA Centre for Corporate Citizenship. 2007. *The State of Responsible Investment in South Africa*. www.unepfi.org/

[35] ibid.

[36] **CDFIs** are Community Development Finance Institutions and effectively the equivalent of NBFIs as addressed in this research.

[37] Cates, R.S. and Larson, C. (Sponsored by the Ford Foundation). 2010. *Connecting CDFIs to the Socially Responsible Investor Community*. http://www.hks.harvard.edu/hauser/

[38] **Community Investing** directs capital from investors and lenders to communities that are underserved by traditional financial services institutions. Community investing provides access to credit, equity, capital, and basic banking products that these communities would otherwise lack. In the US and around the world, community investing makes it possible for local organizations to provide financial services to low-income individuals and to supply capital for small businesses and vital community services, such as affordable housing, child care, and healthcare. www.socialinvest.org

Barriers Limiting Investment in CDFIs	
Higher Perceived Risk	CDFI due diligence is more difficult, CDFI investments are not FDIC insured, and CDFIs lack diversification.
Lack of Liquidity	In general, investors prefer liquidity so they choose shorter maturity dates.

Figure 9: Barriers Limiting Investment in CDFIs

In a nutshell, it seems the problem is not that investors are against investing in high social value outcomes per se, but that there is too much uncertainty and misunderstanding of how, why and where to do so to stop them actually doing it. Such uncertainty translates into avoidance, which translates into a lack of demand for products, which in turn, translates into a shortage of supply of appropriate products.

Overall, three primary suggested enablers or drivers that emerged from this research include[39]:

1. pressure from investors (in the case of asset managers and investment advisory service providers);
2. belief that RI will increase financial returns (i.e. dispelling myths surrounding the business case); and
3. more stringent – or more incentivizing - regulation or legislation. In this regard, the discussion of prescribing asset allocations to development finance has been topical in South Africa over the last year but has since been shelved in favour of regulatory reform as a mechanism to promote growth in investment[40] (see below discussion of Regulation 28 Amendment)

Some additional enablers were identified as follows[41]:

- Co-operative initiatives such as the Enhanced Analytics Initiative[42]
- Mainstream responsible investment benchmarks (e.g. JSE SRI Index, Bovespa SRI Index, FTSE 4 GOOD, DJSI)
- Collaboration with civil society organizations
- Responsible investment short courses
- Facilitated industry "conversations"

Regulatory policies of note that could influence bond uptake

The 2011 Budget considered a range of reforms that could alleviate constraints to growth and development and incentivize greater investment in small and medium sized businesses as a key pathway to economic growth. The following table[43] provides an overview of some of the micro-economic reforms identified and how they relate to the South Africa situation. These

[39] ibid.
[40] The research team has been conversing with Treasury and EDD and is trying to get further detail on any forthcoming reforms or incentives that may further add to this understanding
[41] Noah Financial Innovation, UNEP FI, and the UNISA Centre for Corporate Citizenship. 2007. *The State of Responsible Investment in South Africa*. www.unepfi.org/.
[42] **The EAI is an international collaboration between asset owners and asset managers aimed at encouraging better investment research,** www.enhancedanalytics.com
[43] 2011 Budget Review, National Treasury. http://www.treasury.gov.za/documents/national%20budget/2011/review/Budget%20Review.pdf

issues were all taken into consideration by the Minister of Finance when developing the 2011 South African Budget:

Microeconomic reforms to promote sustainable growth

Microeconomic reforms can help alleviate constraints to rapid growth and draw more people into employment.

The Commission for Growth and Development* identified underlying policies that helped a range of countries to achieve average annual growth rates of 7 per cent for a quarter-century. Applied to South Africa, these microeconomic lessons can be distilled as follows:

- Develop transport, telecommunications and community infrastructure that supports productivity by lowering costs and crowding-in private investment.
- Reduce regulatory barriers and promote competition in all sectors, including transport and energy.
- Use skills development and employment incentives to encourage businesses to hire and expand.
- Monitor the impact of regulation on the cost of doing business and consumer welfare. Adjust rules and regulations to minimise tax and compliance burdens for small business. Ease access to finance.
- Ensure that trade reforms lower costs for businesses and consumers, and redesign industrial development zones to support exports and job creation.
- Improve incentives for research and development.

**The 22-member international commission sought to identify policies and strategies underlying sustained economic growth and poverty reduction.*

Figure 10: Microeconomic reforms to promote sustainable growth

The 2011 Budget[44] has proposed a range of measures, including various tax incentives, to accelerate small business development and employment creation in the year ahead. Of specific potential relevance are the following:

- R9 billion has been set aside over the next three years for a Jobs Fund to co-finance innovative public- and private-sector employment projects.
- The expanded public works programme is R73 billion over the next three years, including community-based projects, environmental and social programmes and maintenance of roads and infrastructure.
- Tax incentives have been renewed for manufacturing investment of R20 billion, with a focus on job-creation potential.
- Initiatives are under way to promote rural employment, and provide stepped up support for agricultural producers.
- Funding is allocated for renewable energy, environmental protection and "green" economy initiatives.
- Additional allocations in support of industrial and economic development over the period ahead include:
  - R600 million for enterprise investment incentives,
  - R250 million to the IDC to support agro-processing businesses
  - R282 million to the Micro-finance Apex Fund, and
  - R55 million to Khula Enterprises to pilot a new approach to small business lending.

Other taxation or investment incentives that could apply to SME lending activities include:

[44] 2011 Budget Speech, Minister Pravin Gordhan, http://www.treasury.gov.za/documents/national%20budget/2011/speech/speech2011.pdf

Industrial development zones

The 2011 Budget Speech has also indicated its support for the New Growth Path and the objectives of the industrial policy action plan by incentivizing businesses making greenfield and/or brownfield investments through qualifying tax relief. Greenfield investments in industrial development zones (IDZs) qualify for additional relief over and above normal taxation and government will consider further expanding incentives for labour-intensive projects in IDZs.

Venture capital tax incentives

On 20 October 2009, the South African Revenue Service (SARS) approved the first Venture Capital Company (VCC) application in terms of section 12J of the Income Tax Act, which grants investors a deduction of their equity investments in VCCs. This concept of a "flow through share", whereby the initial costs are effectively passed on to the investors, has been particularly successful in Canada for mining exploration companies. South Africa introduced this incentive in order to encourage investment in small and medium-sized businesses and junior mining exploration companies obtain equity finance.

Whilst further details of the venture capital tax incentive are given below, it should be pointed out that in the 2011 Budget Speech, Minister Gordhan indicated that the response to the venture capital tax incentive has been poor and therefore provisions will be reviewed in 2011/2012 to consider additional ways to incentivize investment in small and medium-sized businesses and particularly facilitate greater access to equity finance by SMEs and junior mining companies that find it difficult to access such risk capital.

The venture capital company is intended to be a marketing vehicle that will attract retail investors. It has the benefit of bringing together small investors as well as concentrating investment expertise in of the small business sector. In normal circumstances, when an investor purchases shares in a company, the investor is not allowed a deduction for tax purposes because the expenditure incurred is regarded as being of a capital nature. However, a deduction will be allowed for expenditure incurred when shares issued by a venture capital company are acquired by any of the following:

- A natural person.
- A listed company.
- A controlled group company in relation to a listed company.

A natural person may claim the full cost of the investment against their income to a maximum of R750,000 per annum and up to R2,250,000 cumulatively (3 x R750,000). Should an investment in a VCC be sold then the proceeds up to the initial investment will be a taxable recoupment; any excess gain above the cost would be treated under the normal capital or revenue rules. A recoupment may however be subtracted from the cumulative balance of R2, 250,000 thus allowing for further VCC tax deductions. Therefore, for example, a taxpayer who attracts tax at the maximum marginal rate of 40% may enjoy an annual saving of up to R300, 000 limited to a lifetime benefit of R900, 000.

A listed company may deduct VCC investments subject to a ceiling which is significantly more generous than the limitation for individuals. This cap is a proportional amount rather than an absolute, being 40% of the equity shares in the VCC. The limitation for listed

investors has purposely catered for potentially large investments so as to attract anchor investors. However, the total amount of the shares acquired by the listed company, together with any other company forming part of the same group of companies as the listed company, cannot represent more than 10% of the share capital of the venture capital company.

It should be noted that such investments cannot be made in a *single* small or medium-sized company as the venture capital company's investments must be diverse and varied. Accordingly there are specific requirements for the venture capital company's investment portfolio. As the purpose of the deduction is to encourage investment by venture capital companies in small and medium-sized enterprises and promote the growth of the economy as a whole, these requirements ensure that venture capitalists invest in "start-up companies". To date, venture capital investment in small and medium-sized businesses has been relatively small in SA due to the high risk attached to such businesses. It is sincerely hoped that this allowance stimulates appropriate investments in SMEs. If so, the benefits could far outweigh the cost to the fiscus.

There are strict requirements for a company to qualify as a VCC. Subject to formal SARS approval they should meet the following criteria:

- Must be SA-resident and cannot be part of a group (50%-rule);
- Gross income exclusively from financial instruments (dividends, capital gains tax (CGT), share-dealing);
- Must have minimum gross assets of R30m (or R150m if investee companies include junior mining/exploration);
- At least 80% of gross assets must be investments into small & medium-small companies (maximum asset value of R5m or R10m);
- Must have a maximum of 15% of VCC's investment expenditure invested into one investee company.
- The VCC together with any connected company may not control the qualifying company
- There are also restrictions on which investee companies can be targeted by the VCC (e.g. must be SA-resident; not listed; certain trades disqualified like land-dealing, financial services, gambling, etc.; cannot be a controlled company in a group (50%-rule); tax affairs must be in order; etc.).
- The allowance is limited to shares purchased before 30 June 2021.

Environmental fiscal reform

Whilst not exclusively or necessarily relevant to all SMEs, it should be noted that considerable tax benefit and support for environmental investment activities is in place, including three year accelerated depreciation allowances for investments in renewable energy and bio fuels production and additional allowances for investments by companies in energy efficient equipment of up to 50% of the cost. This allowance would apply on condition that there is documentary proof of the result in energy efficiencies after a two or three-year period, certified by the Energy Efficiency Agency. Given the number of SMEs focused on new forms of energy, this is a potential consideration to be taken account of.

Tax disincentives

A possible impediment to additional "debt like" investment could be the amendment to the dividend tax legislation originally considered to be a potential route for the EIF to take. Indeed, given the discussion between the research team and the FSP about the possibility of using preference shares that have had a tax benefit in the lack of taxation on dividends, it should be pointed out that the 2011 Budget Speech has identified various dividend schemes as undermining of the tax base. These include: the use of dividend cessions where taxpayers effectively purchase tax-free dividends without any stake in the underlying shares; the receipt of dividends from shares in which the taxpayer has no meaningful economic risk (e.g. has an offsetting derivative position) and/or the use of preference shares that generate allegedly tax free dividends, while the dividends are indirectly generated from interest yielding debt. All these schemes will be closed by treating the dividends at issue as ordinary revenue. Dividends tax thus becomes effective from 1 April 2012 and Secondary Tax on Companies will be discontinued from that date.

This effectively rules out the consideration of the preference share route, which in fact various discussions had indicated would not be a good option to pursue, would require equity based activity and therefore fall outside of the DCA, and would not provide SMEs with the advantage of having debt, the interest on which is tax deductible in their hands.

BBBEE potential benefits and incentive mechanisms

The benefits that investors would enjoy through securing points towards their BBBEE ratings may well act as a value-add for the proposed EIF, but these are unlikely to act as a sufficient incentive for investment in and of itself. The applicable Codes that investors would be able to earn points towards are: Code Series 600, the Enterprise Development Element and Code Series 700, the Socio-Economic Development Element of BBBEE[45].

The Enterprise Development Element measures the extent to which measured/contributing entities carry out initiatives intended to assist and accelerate the development and sustainability of qualifying beneficiary enterprises. This element accounts for 15 points in the Generic Scorecard, with a target compliance spend of 3% NPAT on which contributors are measured.

In terms of the proposed EIF, the general principles for measuring ED identify the following relevant qualifying contributions:

- Grant Contributions to beneficiary entities
- Investments in beneficiary entities
- Loans made to beneficiary entities
- Guarantees given or security provided on behalf of beneficiaries
- Credit facilities made available to beneficiary entities
- ED or developmental capital advanced to beneficiary entities
- Preferential credit terms granted by a Measured Entity to beneficiary entities

[45] Department of Trade and Industry. 2007. *Broad-Based Black Economic Empowerment Act (53/2003): Codes of Good Practice on Black Economic Empowerment*. www.thedti.gov.za/

- Facilitating access to credit or beneficiary entities without access to similar credit facilities through traditional means owing to a lack of credit history, high risk or lack of collateral
- Provision of preferential credit facilities to a beneficiary entity by a Measured Entity may constitute an ED Contribution. Examples of such contributions include without limitation:
  - Provision of finance to beneficiary entities at lower than commercial rates of interest
  - Relaxed security requirements or absence of security requirements for beneficiaries unable to provide security for loans[46]

The Socio-Economic Development Element[47] measures the extent to which measured/contributing entities carry out initiatives that contribute towards Socio-Economic Development or Sector Specific initiatives that promote access to the economy for black people. This element accounts for 5 points in the Generic Scorecard, with a target compliance spend of 1% net profit after tax (NPAT) on which contributors are measured. For 100 percent recognition under this code, at least 75% of the contributions must be directly benefiting black people. Relevant Socio-Economic Development Contributions include:

- Development programmes for women, youth, people with disabilities, and people living in rural areas
- Training in communities, skills development for unemployed people and Adult Basic Education and Training (ABET)

Relevant Accepted forms of Socio-Economic Development Contributions to qualifying beneficiaries include:

- Grants
- Guarantees or security provided

Impact of Proposed Regulation 28 Amendment

Regulation 28[48] of the Pension Funds Act is accepted to be outdated (it was publicized in 1962 and last amended in 1998)[49]. As a consequence it is currently undergoing amendment, with comments invited on the proposed amendments of Draft 2 of the Regulation having closed on 28 January 2011 and to all intents and purposes a new regulation is anticipated to be formalized soon. Broadly, the proposed amendments provide asset-spreading requirements intended to diversify pension fund assets across asset categories and investments.

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[46] ibid.

[47] The Socio-Economic Development Element is included here as a potential value-add, though qualifying Enterprise Development contributions will likely provide investors with more value given its larger points and target allocations within the generic scorecard. Also, the primary purpose of an SME Bond Fund would align more closely with the intention of the Enterprise Development Element, that is, to assist and accelerate the development and sustainability of qualifying beneficiary enterprises.

[48] Regulation 28 of the Pension Funds Act empowers the Minister to define asset-spreading requirements for pension funds. Of the R5.2 trillion total household savings in South Africa, Regulation 28 applies to all private pension funds, which constitute about R1.1 trillion.

[49] National Treasury. 2010. *Explanatory Memorandum on the 2nd Draft Regulation 28 that gives effect to Section 36(1)(bB) of the Pension Funds Act 1956, 2010.* www.treasury.gov.za

In its current form, the Regulation does not, for example, stipulate what allocation pension funds can make to private equity or unlisted debt. Consequently, most investors who have included private equity or unlisted debt in their portfolios included it under the Act's guidelines for either "Other Assets" which allowed a 2.5% allocation, or "Unlisted Equity", which allowed a 5% allocation. However, due to the general lack of legislative clarity, many trustees and consultants were not prepared to allocate any funds to private equity[50].

Comparatively, international pension fund allocations to alternative assets (unlisted equities, private equity, hedge funds, etc) tend to range from around 5% to 30%, with some regions applying no restrictions to private equity[51]. The proposed amendment will allow up to 10% allocation to Private Equity.

In terms of 'Debt Instruments', which are of particular interest here, the revised proposal in Draft 2, proposes:

> *This asset category is significantly expanded, to incorporate short- and long-dated debt, and raises certain limits. Pension funds can hold up to 75% of their assets in debt issued and backed by South African banks (to include money-market instruments), up to 25% in quasi-government entities, and up to 25% in other corporate debt. A tighter limit of 15% is applied for unlisted debt in the corporate debt category, and this category is subject to strict investment diversification and valuation requirements*[52].

With respect to 'Other Assets, To Include Alternative Investments', the revised proposal is as follows:

> *Significantly more flexibility is afforded to pension funds with this limit raised to 15%. For greater certainty, certain alternative investments like private equity funds and hedge funds are explicitly defined and included in the Table of limits.*
>
> *Rather than entirely prohibit alternative and unregulated assets (like unlisted equity, unlisted/unrated debt, private equity, investments into Africa and hedge funds), Regulation 28 is proposed to enable contained and monitored investment into these products, supported by strict asset and investment diversification limits and appropriate valuation procedures (for which the Pension Fund Registrar should give guidance).*
>
> *The Registrar may impose additional requirements to investments made through a partnership or trust structure.*

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[50] OMIGSA: Alternative Investments/Private Equity. 2011. '*Proposed Reg 28 amendments make Private Equity no longer an "Alternative".* www.oldmutual.co.za/

51 ibid.

[52] National Treasury. 2010. *Explanatory Memorandum on the 2nd Draft Regulation 28 that gives effect to Section 36(1)(bB) of the Pension Funds Act 1956, 2010.* www.treasury.gov.za

SECTION 6: ESTABLISHING AN INCENTIVE FOR THE EIF: THE POTENTIAL OF AN SME DEVELOPMENT FUND

One of the aspects that USAID wanted to consider in parallel to an EIF is the idea of a separately capitalized social venture capital fund to support SME development on a grant basis, such as a Challenge Fund or SME Impact Bond. This financing vehicle is intended promote socio-economic development through the provision of additional support for SME development either as grants or as high risk social venture capital. Linking the socio-economic development financing options to the EIF could potentially also provide additional incentive mechanisms to investors in the EIF (such as tax benefits or BBBEE / SED credits as well as pipeline development for NBFIs or SMEs to access the EIF).

Both a Challenge Fund and a Social Impact Bond (SIB) could create opportunities to build track records, capacity and confidence in SME lending, these financial structures could help foster the USAID's mission to facilitate the growth and competitiveness of SMEs. We believe that these funds would – or should – support start-up and early stage SMEs development or expansion as opposed to innovation because their core purpose is to grow SME activity overall.

The successful start-up SMEs would also, ideally, become part of the pipeline able to access the EIF for expansionary capital requirements. Ultimately, it is hoped that this fund could further propel the development of successful, established SMEs and translate into secure job creation and economic prosperity.

Whichever option is pursued for investing in the start up and development of SMEs, additional components in USAID's economic opportunities programme could add value to the grants by providing, for example, technical assistance, capacity development or access to finance.

There are two characteristics of a Challenge Fund or SIB that need to be considered when determining the duration or nature of the commitments being made.

- Firstly, because both a Challenge Fund and SIB are based on the use and allocation of grant-based capital, they are effectively non-replenishable.
- Secondly, both tend to be based on shorter-term interventions –between 3 and 5 years as opposed to the 7 to 10 years of an EIF.

Both of these characteristics could potentially be addressed by establishing a replenishing financing mechanism between the Challenge Fund or SIB and the Enterprise Impact Fund or bond issue. The following outlines make suggestions as to how these could work.

SME Development Fund Option 1 - Challenge Fund

Challenge Funds typically involve the use of capital (public or private) to catalyze innovation or expansion by established private businesses, and/or to promote profitable ways of improving service delivery and market access for the poor. The kind of development, innovation or business activity targeted by a Challenge Fund is often unlikely to happen without some kind of initial external stimulus but the strength of a Challenge Fund lies in its ability to provide opportunities for focused, entrepreneurial, opportunistic and cost-effective interventions to be tested, i.e. to function as a temporary market development catalyst.

An SME Start-up or Growth Challenge Fund could provide the use of one-off grants to private companies (or to consortia led by private companies) matched by private company contributions in cash or in kind, to support SME start-up and development. By seeking to build alignment between the core business strategies of companies and their development outcomes, a Challenge Fund aims to stimulate private sector investment and risk-taking, and discover new ways of working, where the costs and risks of specific ventures may not be well known, but where the social impact may be significantly larger than through conventional approaches.

Compared to other structures available, a Challenge Fund can be categorized as follows:

Figure 11: Challenge Fund categorization

The specific attributes and core operating principles of a Challenge Fund are[53]:

- It is a form of risk sharing with the private sector and/or SMEs, in that Challenge Fund grant eligibility includes a matched funding component (in either cash or kind).
- It has a clear purpose: Grants are typically made in recognition of a specific objective or purpose which becomes the objective of the grant (e.g. establishing SMEs by providing startup capital; expanding SMEs with expansion capital; expanding markets / innovation etc.)
- It is based on competition: The two stage filtering process to identify successful grant applicants is an open, competitive process. This encourages focus, good ideas and comparability.
- The intervention needs to demonstrate additionality: Challenge Fund grants need to target activities and investments which would not have happened without them, and where the uncertainty and risks involved preclude access to conventional sources of funding.
- It requires a portfolio approach within the requirements of a sectoral and/or regional focus, Challenge Funds need to pursue a portfolio of investments, diversified according to risk, participating partners, and social and market development impact.
- It is based on once-off, limited duration grants: Challenge Fund grants need to target specific risks, barriers and opportunities which are clearly defined and which require limited, temporary support.

[53] http://www.btrust.org.za/index.php?id=110

The Challenge Fund could be used to catalyze or incentivize interventions, test new models or look at innovation or simply provide startup capital to establish a viable and successful SME and ensure its ongoing growth. This fund could act as an incubator or accelerator and effectively feed pipeline SMEs to the EIF fund. The fund can also focus on specific geographies or growth sectors key to SME or economic development. As importantly, because the Challenge Fund has a shorter term of 3-5 years compared to a bond's maturity of (7 to 10 years), it is possible that SMEs may "graduate" from the Challenge Fund into the bond. This, in effect, creates a pipeline for the bond's loan book.

The Challenge Fund could be linked to the EIF or exist as a stand-alone fund and simply operate separately as a USAID initiative irrespective of the choice of investment vehicle for the Enterprise Impact Fund. The potential, however, to establish longevity for the Challenge Fund by linking it to the Bond should not be overlooked, to this end there are opportunities to consider how an Enterprise Impact Fund or Bond could provide a stream of revenue on an ongoing basis to the Challenge Fund. These include the following thoughts:

1. Different risk / return structures within the application of a bond or different bonds by nature, risk, return and additionality, could produce an interest differential between the bond rate payable to investors and the earned interest rate from SME lending. This could flow into the Challenge Fund.
2. Investors could be given an option to split a portion of their investment to the Challenge Fund based on accrued benefits (e.g. BBBEE or SED points).
3. The Fund could be set up as a social impact bond structure so that performance would be rewarded through the receipt of Government / Foundation sourced performance-based rewards which could provide a return in the future to the fund. For example, 5,000 start-ups may "earn" R5million in terms of the future value of that contribution to the economy. This means the Fund (and potentially its "investors") could receive financial returns on their original investments. Alternatively, these returns could up a perpetual financing motion if this initial contribution is made. The initial contribution by investors could be further incentivized with a Venture Capital allowance per the tax act. (This probably falls more within the structure of a SIB discussed in the following section).

A Challenge Fund Management Company would be appointed to manage the Fund, applications and performance management.

The Challenge Fund structure can be depicted as follows:

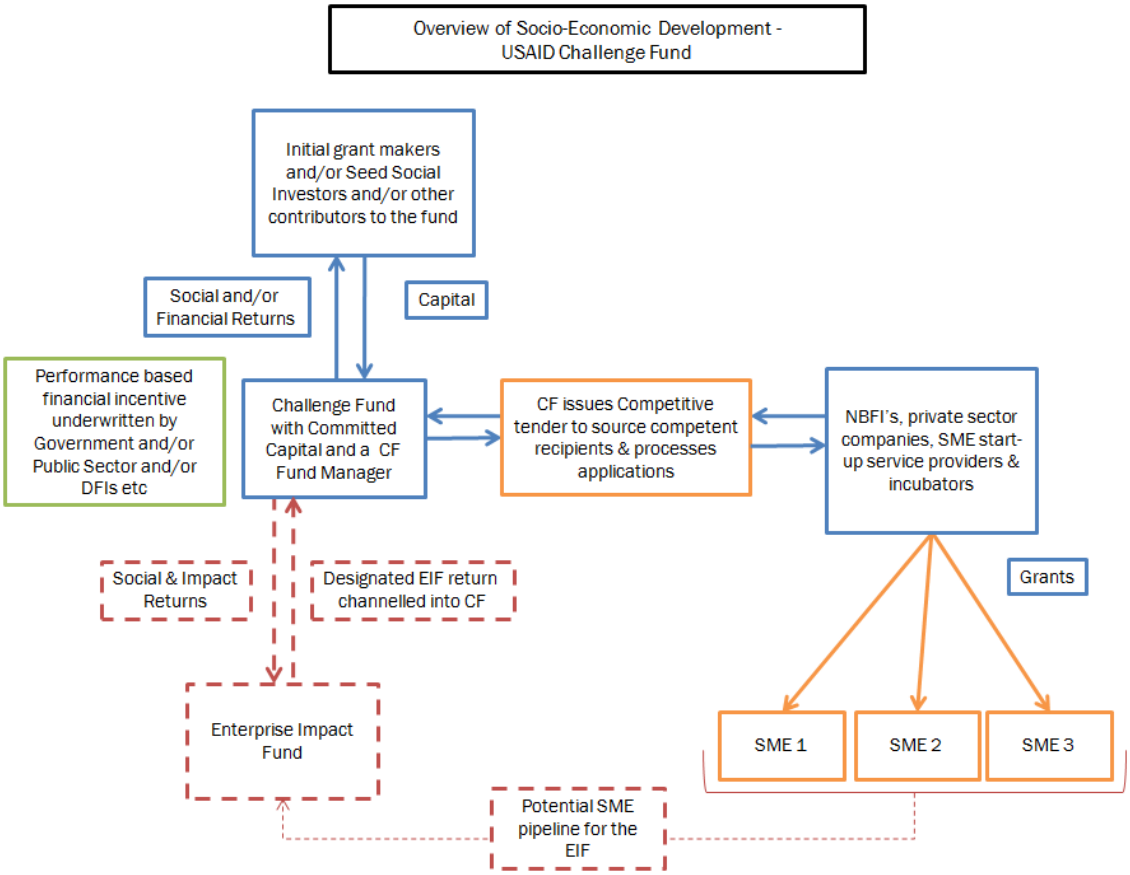


Figure 12: The USAID SME Challenge Fund possible structure

Risk

Depending on the structure taken, the risk will differ. However, based on a challenge-fund being a grant based vehicle, it is based on a return of -100% loss of principal at the outset though there is the possibility that "investors" would get tax benefits or SED points. If there was a possible return component it could be structure as BBBEE ED points. In both instances, however the nature of the Fund's purpose would be high risk.

Return

The financial return due to investors is dependent on the structure taken and the performance guarantees in place, for example, if the Challenge Fund was used for tax credits, as a grant it could have no repayment; as a BBBEE investment or venture capital investment, it could have some return.

Term: 3-5 years

Investment Range: As determined by the fund structure.

What are the advantages of a Challenge Fund?

- A relatively small capital contribution can be leveraged to have large social impacts most especially when matched with private sector contributions.
- Social returns are likely and financial returns are possible, dependant on the fund's structure.
- Social, sustainability and impact results will have metrics and can be comprehensively reported on.
- Promote greater knowledge sharing and world-wide cross-learning among NBFIs and SMEs bidding for grants supported by the Challenge Fund Management company.

What's in it for the SME?

- Encouragement for SMEs to establish themselves in a favourable start up climate and make inroads into job creation and economic prosperity
- Public tender / competition for funds ensures that the most competent and intended recipients are granted funds.
- The tender process also encourages innovation and private sector engagement.
- Because of the matched funding, the SME shares the project risk with the Challenge Fund.
- The matched funding also improves SMEs' capital structure decisions.

What's in it for the NBFI and the Challenge Fund Management Company?

An opportunity to engage in their own pipeline of prospects and build their success in SME startups.

What is in it for USAID?

- Use the Challenge Fund as a vehicle to achieve the stated SME objectives.
- Financial innovation to achieve financial and non-financial returns.

Appetite for this product

The general, global market appetite for this type of product is very strong, as evidenced from multiple global research results into impact investment, SRI, SIBs and other social investment vehicles. Furthermore, as from AECF: "Challenge Funds are a proven instrument in stimulating private sector innovation, increasingly used by DFID and other donors over the last 5 years. Their comparative advantage is their ability to be a powerful, lean, light-touch instrument that stimulates private sector to test new ways of working where the returns and risks are unknown."[54]

[54] AECF 2011

SME Development Fund Option 2 - Social Impact Bond

A Social Impact Bond (SIB) can be created as an alternative to a Challenge Fund. SIBs are privately placed instruments that raise funds from investors to pay for the provision of services. These services may already be offered to the community and financed by government or other institutions, and hence the success of these services may already be reported on (using the applicable metrics). If under the SIB, the services make a difference and defined social outcomes improve, as measured as a percentage above the reported results, investors receive success payments from the savings resulting from their provision. The size of these payments depends on how successful the services are.

SIBs are typically used to address a catch-22 situation in society. In the case of SMEs, this can be defined as:

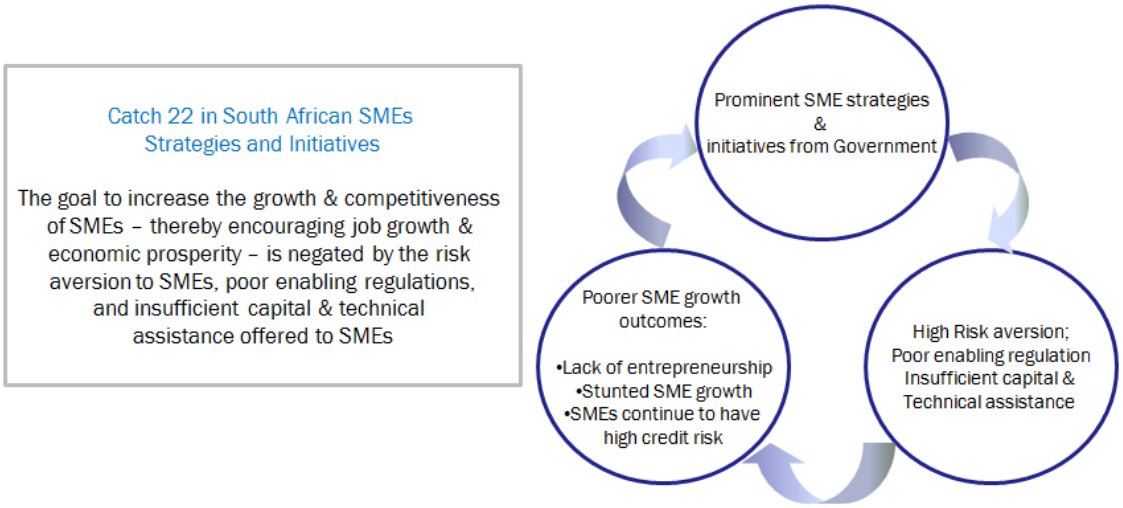


Figure 13: The Catch 22 for SMEs in South Africa

There are multiple ways to structure and capitalize a SIB, for example:

- Initial contributions could be received through a percentage of the initial investment in the Enterprise Impact Fund flowing to the SIB (e.g. a 5% strip) with either a tax benefit (grant) or possible SIB performance benefit return being provided, if achieved.
- Grants could be sourced from DFIs and other Corporate Social Investment Foundations committed to SME growth.
- "High risk" social venture capital investors could be sought to capitalize the fund and receive returns based on performance-based payments from Government or DFIs based on achievement. The venture capital allowance could provide additional support under this model.
- Replenishing capital could be underwritten by the public sector based on performance targets.

Similarly to the Challenge Fund, a SIB Management Company could be appointed to manage the Fund, applications and performance management. The applicants would be SME service providers, NBFIs or other technical support, incubator or capacity development organizations committed to growing from start up stage to establishment stage, successful SMEs. Service partnerships agreements would be entered into with service providers who focus on supporting and growing SMEs. Beneficiaries are obviously the start-up SMEs. This results in

a potential double-win of achieving SME growth with all its related socio-economic objectives as well as producing social outcomes.

The focus of the SIB in this instance would likely be SME start-ups with the social outcome of growing the number of start-ups by a specific annual target over the period of the bond (e.g. 5% annual growth to a total of 500,000 SME start-ups by 2015). This outcome can be measured by the number of start-ups registered within a stipulated period. Traditionally this social performance is judged based on the expected number of registrations in the absence of a SIB compared to number of registrations with the SIB in place. If there is a positive variance – typically around 10% - then a social outcome has been achieved with the SIB. Additional metrics and ratings could be in terms of jobs created, employees' salaries etc.

The SIB structure can be depicted as follows:

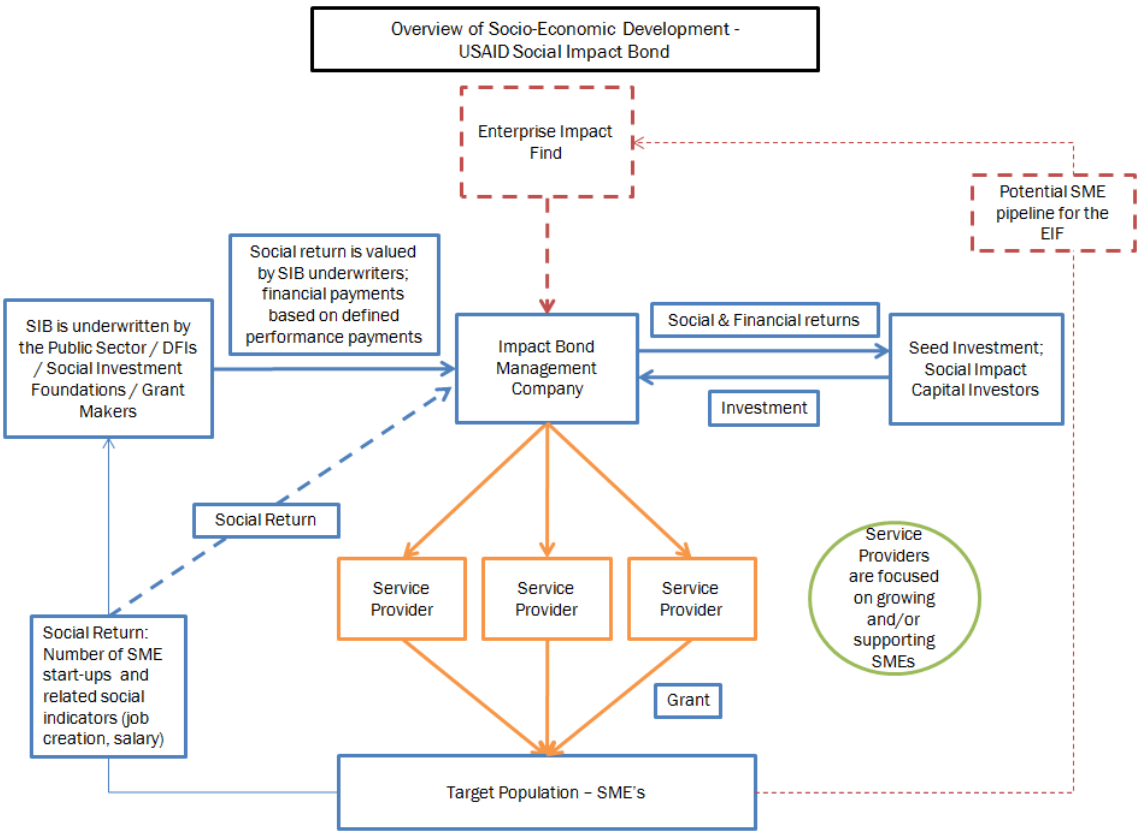


Figure 14: The USAID SME Social Impact Bond possible structure

Risk

The risk is commensurate with other a social venture capital instrument because the return of capital is based on the quantum of performance achieved and the value of future savings derived from that performance. The risk may be higher given that start-up SMEs are targeted. Again, however are the possibilities that "investors" would get tax benefits or BBBEE ED points.

Return

The blended return would be similar to that of the Challenge Fund. The size of the return would be based on the performance and success of service delivery.

Term

A SIB's duration is on par with the duration of the benchmark government bonds (5-10 years). It is possible though to pin the social impact outcome and reporting on the outcome to the average time it takes for a start-up SME to become established – 3-5 years. After 5 years, the performance and social outcome will be used to inform on the return.

Investment Range: Defined by the bond's structure.

What are the advantages of a SIB?

- Social return forms the basis on which financial return is realized.
- A SIB repackages existing financing structures and attaches a performance sweetener to the return. For example, a Government tender would have designated service providers; a SIB repackages the financial and social incentives and returns for Government, service providers and SIB investors.
- Service providers are incentivized to deliver better SME growth results.

What's in it for the SME?

- The opportunity cost of sourcing financing is lowered.
- SMEs can focus on running and growing their business.
- SMEs have a stronger relationship with the service provider.

What's in it for the Service Providers and Impact Bond Management Company?

An opportunity to engage in their own pipeline of prospects and build their success in SME start ups.

What is in it for USAID?

The benefits are similar to those realized by a Challenge Fund.

Appetite for this product

The first SIB was introduced to the UK market last year to applause. The idea of a SIB has taken the international community by storm, to the extent that President Obama is now looking at creating equivalent SIB in the United States of America. Local appetite may be a bit more muted, given the perceived track record of Government Service Providers (unless another partner is sourced) and the risk inherent in SME business.

SME Development Fund Option 3 – Venture Capital Company

For the sake of inclusivity the notion of a Venture Capital Company standing alongside an EIF could be considered although the structure can only manage equity investment and therefore would not be covered by the USAID credit guarantee. Nevertheless, there could be an opportunity to consider implementing this structure along the lines of a SIB and have investors benefit from the VC deduction. The potential for getting government support for this, given the low level of uptake of the VC allowance, also exists and it could provide a significant opportunity in the future.

SECTION 7: CONCLUSIONS AND NEXT STEPS

In conclusion, we believe this research and analysis has reinforced the USAID FSP's experience that there is a definite and critical need for access to affordable capital amongst NBFIs and SMEs. Indeed, if we extrapolate the demand amongst NBFIs based on 7 respondents able to absorb R2 billion within 12 months, we could comfortably assume that there is a significant market for capital which, even an EIF at US$200m, would not necessarily meet. We do believe that it would be important for the tender process to explore what understanding asset managers have of the size of this market and its absorptive capacity as this could potentially shed more light on this question.

At the same time, however, it is equally clear that there is a strong and general reluctance to extend unsecured, ***and*** even partially secured, credit to NBFIs or SMEs for their growth and expansion plans because of the perceived risks associated with this sector. In this regard, we do believe that the USAID FSP's strategic approach to overcoming this, viz. by establishing a debt fund sufficiently enhanced by a credit guarantee, would be very effective not only in providing the security to establish the confidence necessary to attract institutional investors to this field of investment, but also, and perhaps as importantly, to enable asset managers, NBFIs and the SME sector to establish a solid track record that would clearly demonstrate the investment potential in this sector. This would significantly support future investment activity – and potentially with lower credit enhancement requirements – given that it will provide both a clear performance record and a greater understanding of the sector, its risks and its return potential.

However, we also strongly believe that the success of an EIF will depend on the investment fund structure that is finally decided upon, and whether this can sufficiently reduce the perception or risk to encourage institutional investment in SME lending. In this regard, we think that Option 3 or Option 6 may be most preferred by institutional investors given that these options are premised on minimum risk. At the same time, however, Option 4 and 5 would, we believe, be strongly favored by Asset Managers as these provide them more specifically, and directly, with a credit guarantee that will immediately enhance their own portfolio investment activity. To the extent that they can meet the objectives of the EIF this is not at all a bad thing and may, in fact, be precisely what is needed to begin to build a track record and greater understanding of the real potential of the SME sector. In both instances, however, we would strongly recommend that the guarantee is spread across asset managers as this will have the greatest developmental impact in building the field in South Africa and ensuring diversity and risk spread which would also potentially maximize the potential for demonstrable success.

Under either scenario 4 or 5, however, the key question is going to revolve around whether selected asset managers do, in fact, have real understanding of, and access to the NBFI and SME market, whether they can truly maximize the potential allocation to this market and whether they can successfully demonstrate a positive track record that will unlock future capital allocations with less security requirements. These are the key issues that need to be explored in the tendering process.

With regard to additional benefits and/or incentives to encourage institutional investors to engage with, and invest in the EIF, we do not believe that additional "soft" incentives such as BBBEE Enterprise Development points or grant-based SED points are going to overcome the lack of strong fundamentals underlying the bond itself. Thus, unless the EIF, with its USAID

partial guarantee, is limits its investor target to specific and specialized patient, educated and experienced impact investors or impact investment funds (of which there are few – if any – within South Africa), we do not believe the EIF will achieve sufficient uptake. Thus, while the incentives may add a "nice to have" benefit that could well be appreciated and add to reputational kudos as a responsible investor, they will not necessarily overcome risk aversion or mitigate the fundamentals of the investment itself it these do not meet the minimum demands of an investment grade financing structure.

On the subject of an SME development fund we believe that this could make a key and indeed critical contribution to the sector notwithstanding the fact that it is unlikely to be sufficient for enhancement of an EIF that is below investment grade.

Finally, we believe that the USAID FSP is extremely far-sighted in terms of considering innovative financing mechanisms to unlock capital that could significantly impact on the lives of many and enhance efforts to achieve critical developmental outcomes. This matters because:

- Better intermediation infrastructure supports more efficient and effective access to capital markets (providing *new channels for socio-economic development*);
- New organizational forms (e.g. SMEs, NBFIs) and security structures (e.g. EIFs, SIBs) bring new talent and new strategies to development (creating *new forms and expertise for socio-economic development)*
- Unlocking untapped institutional capital would achieve an order of magnitude growth in these new organizational forms by enabling them to tap into new capital (investing *new money for socio-economic development*)

SECTION 8: ANNEXUS

ANNEXURE 1: OVERVIEW OF BONDS PER YEAR OF ISSUE

Issue Year	Major Division	No. of Bonds	Sum Authorised Amount (ZAR Rm)	Sum Issued Amount (ZAR Rm)	Sum Market Cap Clean (ZAR Rm)
1978	Government	2	9	9	9
1980	Government	1	18	18	18
1982	Parastatals	2	740	299	299
1983	Parastatals	2	7,176	5,320	5,287
1988	Parastatals	1	5,000	4,616	4,606
1990	Parastatals	2	3,232	3,232	3,363
1991	Parastatals	1	2,188	1,840	1,876
1992	Parastatals	1	20,000	11,807	15,609
1993	Government	4	74	74	66
1994	Government	6	346	346	262
	Parastatals	1	1,000	75	77
1995	Government	1	500	500	363
1996	Government	1	150	150	76
	Parastatals	2	7,535	4,494	4,944
1997	Government	1	1,099	1,099	717
	Parastatals	2	2,680	1,352	1,544
	SPVs	1	2,515	2,515	2,575
2000	Financials	1	177	177	196
	Parastatals	2	6,000	1,633	1,976
	Services	1	2,500	2,500	2,117
2001	Financials	1	2,000	2,000	2,000
	Parastatals	2	17,000	13,224	18,713
2002	Agriculture	1	619	1	1
	Financials	2	3,615	3,615	3,637
	Services	1	1,200	1,200	1,201
	SPVs	8	1,994	1,994	2,022
2003	Agriculture	3	934	934	934
	Financials	2	1,078	1,078	1,079
	Manufacturing	3	3,000	3,000	2,986
	Mining	1	2,000	2,000	1,989
	Parastatals	8	20,030	11,603	11,997
	Services	1	1,000	1,000	1,007
	SPVs	11	993	993	966
2004	Agriculture	3	707	234	234
	Financials	12	9,090	9,090	9,187
	Government	2	2,000	2,000	2,083
	Manufacturing	1	1,500	1,500	1,529
	Parastatals	2	8,500	6,800	7,337
	Services	1	900	900	900
	SPVs	10	1,769	1,769	1,757
2005	Agriculture	7	2,932	2,932	2,932
	Financials	36	19,068	18,715	19,257
	Government	1	700	700	715
	Services	2	1,400	1,400	1,395
	SPVs	38	10,793	10,737	10,719
2006	Agriculture	15	2,670	2,670	2,667
	Financials	84	68,432	28,877	28,421
	Government	1	1,733	1,733	1,609
	Manufacturing	3	4,000	4,000	4,006
	Parastatals	3	22,017	18,338	16,304
	Services	2	6,300	6,300	6,408
	SPVs	87	20,333	19,229	19,234
2007	Agriculture	46	23,549	17,371	17,494
	Construction	2	850	850	855
	Financials	106	41,669	33,369	36,190
	Manufacturing	5	4,900	4,900	5,023
	Mining	2	697	697	757
	Parastatals	8	32,697	32,407	30,780
	Services	3	3,000	3,000	3,041
	SPVs	291	78,686	66,983	66,354
2008	Agriculture	23	10,439	5,333	5,227
	Financials	194	36,646	35,911	38,810
	Government	3	4,168	4,168	4,638
	Manufacturing	33	18,565	18,565	18,511
	Parastatals	42	39,730	36,557	39,321
	Services	4	5,575	2,795	2,968
	SPVs	794	237,529	197,247	195,020
2009	Agriculture	4	1,770	1,543	1,565
	Construction	1	45	45	45
	Financials	129	48,264	48,264	51,455
	Government	4	2,806	2,806	2,934
	Manufacturing	54	28,938	26,788	25,763
	Mining	17	4,783	4,783	4,785
	Parastatals	42	44,392	42,057	43,891
	Services	23	3,064	3,064	3,036
	SPVs	414	135,368	109,502	108,330
2010	Agriculture	23	15,809	8,853	8,760
	Construction	3	750	750	750
	Financials	179	38,492	38,492	43,720
	Government	8	6,217	6,217	6,420
	Manufacturing	53	21,833	21,833	21,290
	Mining	30	7,095	7,095	7,093
	Parastatals	39	29,265	28,734	30,463
	Services	18	9,988	9,988	10,018
	SPVs	335	126,791	91,609	90,598
	Wholesale Trade	2	750	750	750
Grand Total		**3323**	**1,368,364**	**1,135,947**	**1,157,863**

Figure 15: Overview of Bonds

ANNEXURE 2: FIXED INCOME ANALYSIS

The following tables support the analysis and graphs that describe the Fitch graded bonds, as from the JSE data set.

Table 19: Prime Long Term Investment Grade Bonds: Range of amounts authorised (all amounts in ZAR Rm)

	2008				2009				2010
	Short term	**Medium term**	**Long term**		**Short term**	**Medium term**	**Long term**		**Long term**
Maximum authorized amount	2,000 (vanilla bond by African Development Bank) of which 2,000 was issued (100% uptake)	10,000 (vanilla bond by DBSA) of which 7,227 was issued (**72%** uptake)	625 (floating rate note by Blue Granite) of which 625 was issued (100% uptake)		1,300 (CPI note by ABSA) of which 1,300 was issued (100% uptake)	8,500 (vanilla bond by Eskom) of which 7,950 was issued (**93%** uptake)	845 (CPI note by ABSA) of which 845 was issued (100% uptake)		10,500 (vanilla bond by Eskom) of which 10,255 was issued (**97%** uptake)
Minimum authorized amount	202 (floating rate securitization note by South African Securisation Programme) of which 202 was issued (100% uptake)	7 (CPI note by ABSA) of which 7 was issued (100% uptake)	50 (floating rate securitization note by Fintech) of which 50 was issued (100% uptake)		1,300 (CPI note by ABSA) of which 1,300 was issued (100% uptake)	3,000 (CPI note by ABSA) of which 3,000 was issued (100% uptake)	50 (floating rate securitization note by South African Securisation Programme) of which 50 was issued (100% uptake)		1(floating rate securitization note by Nqaba Finance) of which 1 was issued (100% uptake)

Table 20: High Long Term Investment Grade Bonds: Range of amounts authorised (all amounts in ZAR Rm)

	2008				2009				2010			
	Short term	**Medium term**	**Long term**		**Short term**	**Medium term**	**Long term**		**< 1 year**	**Short term**	**Medium term**	**Long term**
Maximum authorized amount	420 (floating rate note by Standard Bank) of which 420 was issued (100% uptake); rating AA+	941 (floating rate note by Investec) of which 941 was issued (72% uptake); rating AA-	1,712 (vanilla bond by Airports Company South Africa) of which 1,712 was issued (72% uptake); rating AA-		1,000 (CPI note by Airports Company of South Africa) of which 1,000 was issued (100% uptake); rating AA-	1,800 (CPI by Standard Bank) of which 1,800 was issued (100% uptake); rating AA	32 (floating rate securitization note by Nqaba Finance) of which 32 was issued (100% uptake); rating AA		1,300 (floating rate note by Mercedes) of which 1,300 was issued (100% uptake); rating AA	2010: 1,552 (floating rate note by Nedbank) of which 1,552 was issued (100% uptake); rating AA-		184 (floating rate securitization note by Home Obligors Mortgage Enhanced Securities) of which 184 was issued (100% uptake); rating AA
Minimum authorized amount	55 (CPI note by Standard Bank) of which 55 was issued (100% uptake); rating AA+	100 (floating rate note by Standard Bank) of which 100 was issued (100% uptake); rating AA+	31 (floating rate securitization note by Fintech) of which 31 was issued (100% uptake); rating AA		100 (CPI note by Standard Bank) of which 100 was issued (100% uptake); rating AA+	1,150 (floating rate note by Standard Bank) of which 1,150 was issued (100% uptake); rating AA	32 (floating rate securitization note by Nqaba Finance) of which 32 was issued (100% uptake); rating AA		700 (floating rate note by Mercedes) of which 700 was issued (100% uptake); rating AA	150 (floating rate note by Mercedes) of which 150 was issued (100% uptake); rating AA+		1(floating rate securitization note by Nqaba Finance) of which 1 was issued (100% uptake); rating AA

Table 21: Upper Medium Long Term Investment Grade Bonds: Range of Amount Authorized (all amounts in ZAR Rm)

	2008	2009	2010
Maximum authorized amount	2,268 (vanilla bond by the City of Johannesburg) of which 2,268 was issued (100% uptake); rating A+, long term	250 (floating rate note by Bidvest) of which 250 was issued (100% uptake); rating A+, short term	334 (floating rate note by Barlow) of which 334 was issued (100% uptake); rating A+, medium term
Minimum authorized amount	22 (floating rate note by Sanlam) of which 22 was issued (100% uptake); rating A, long term	5 (floating rate note by South African Securitization Company) of which 5 was issued (100% uptake); rating A, long term	5 (floating rate note by Nqaba finance) of which 5 was issued (100% uptake); rating A, long term

Table 22: Lower Medium Term High Yield Bonds: Range of Amount Authorized

	2008	2009	2010
Maximum authorized amount	3,518 (vanilla bond by FirstRand) of which 3,518 was issued (100% uptake); rating BBB+, medium term	1,280 (floating rate note by FirstRand) of which 1,280 was issued (100% uptake); rating BBB+, medium term	46 (floating rate note by Home Obligors Mortgage Enhanced Securities) of which 46 was issued (100% uptake); rating BBB, long term
Minimum authorized amount	6 (CPI note by FirstRand) of which 6 was issued (100% uptake); rating BBB+, medium term	100 (CPI note by FirstRand) of which 100 was issued (100% uptake); rating BBB+, short term	5 (floating rate note by Nqaba finance) of which 5 was issued (100% uptake); rating BBB, long term

Table 23: Prime / High Grade Short Term Investment Grade Bonds: Range of Amount Authorized

	2008	2009	2010
Maximum authorized amount	1,500 (floating rate note by Mercedes) of which 1,500 was issued (100% uptake)	1,000 (commercial paper by the Airports Company) of which 1,000 was issued (100% uptake)	the Airports Company issued three 500 notes; all issues have 100% uptake
Minimum authorized amount	27 (commercial paper by Asset Backed Arbitraged Securities) of which 27 was issued (100% uptake)	110 (commercial paper by Mercedes) of which 110 was issued (100% uptake)	50 (commercial paper by the Airports Company) of which 50 was issued (100% uptake)

Investment Grade High Grade Analysis

Investment Grade High Grade

Issue Year	Tenor Classification	Rating	Category	Major Division	Subsector	Coupon Rate Indicator	% Issued / Authorised	Values No. of Bonds	Sum Authorised	Sum Issued	Coupon 2010	Coupon 2009	Coupon 2008
2008	Long Term	AA zaf	Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	1	31	31		8.23	13.42
					Residential Property Backed Securities	FLOATING	100%	1	34	34			13.93
		AA- zaf	Banks	Financials	Banks	FLOATING	100%	1	200	200	9.66	10.95	16.10
			State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	1	1,712	1,712	11.68	11.68	11.68
						INFLATION-LINKED	100%	1	1,191	1,191	3.64	3.64	3.64
	Matured	AA zaf	State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	1	440	440			12.93
		AA- zaf	Securitisations	SPVs	Collateral Debt Obligation	FIXED	100%	3	1,568	1,568			12.33
		AA+ zaf	Banks	Financials	Banks	FIXED	100%	6	595	595	11.47	7.88	7.88
			Other corporates	Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	3	1,160	1,160	8.02	8.62	13.29
	Medium Term	AA- zaf	Banks	Financials	Banks	FLOATING	100%	1	941	941	6.95	8.63	12.83
			Municipal Government	Government	Municipals	FIXED	100%	1	900	900	10.82	10.82	10.82
		AA+ zaf	Banks	Financials	Banks	FIXED	100%	2	1,273	1,273	6.25	6.25	9.04
						FLOATING	100%	1	100	100	6.91	8.58	13.68
	Short Term	AA+ zaf	Banks	Financials	Banks	FIXED	100%	2	130	130	8.63	8.63	8.63
						FLOATING	100%	2	520	520	6.20	7.98	12.40
			Other corporates	Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	1	165	165	6.56	8.13	13.18
2008 Total								28	10,960	10,960	8.11	8.46	11.46
2009	Long Term	AA zaf	Securitisations	SPVs	Residential Property Backed Securities	FLOATING	100%	1	32	32		9.13	
	Medium Term	AA zaf	Banks	Financials	Banks	FIXED	100%	2	3,400	3,400	8.29	8.29	
						FLOATING	100%	1	1,150	1,150	7.74	9.33	
		AA- zaf	State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	1	1,729	1,729	10.86	10.86	
	Short Term	AA- zaf	State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	1	1,000	1,000	5.50	5.50	
		AA+ zaf	Banks	Financials	Banks	FIXED	100%	1	100	100	2.50	2.50	
2009 Total								7	7,411	7,411	7.20	7.70	
2010	<1 year	AA zaf	Other corporates	Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	2	2,000	2,000	6.46		
	Long Term	AA zaf	Securitisations	SPVs	Residential Property Backed Securities	FIXED	100%	3	145	145	9.86		
						FLOATING	100%	5	264	264	7.51		
	Matured	AA zaf	Other corporates	Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	1	1,000	1,000	6.26		
		AA- zaf	Other corporates	Agriculture	Forestry	FLOATING	100%	1	120	120			
	Short Term	AA zaf	Other corporates	Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	3	2,000	2,000	7.63		
		AA- zaf	Banks	Financials	Banks	FIXED	100%	1	478	478	9.68		
						FLOATING	100%	2	2,579	2,579	7.60		
			Other corporates	Services	Wireless Communications	FIXED	100%	1	1,500	1,500	7.80		
		AA+ zaf	Other corporates	Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	3	746	746	7.81		
2010 Total								22	10,832	10,832	7.77		
Grand Total								**57**	**29,203**	**29,203**	**7.79**	**8.24**	**11.46**

Figure 16: Investment Grade High Grade Analysis

Prime Investment Grade Analysis

Investment Grade Prime

Issue Year	Tenor Classification	Rating	Category	Major Division	Subsector	Coupon Rate Indicator	% Issued / Authori	Values No. of Bonds	Sum Authorised	Sum Issued	Coupon 2010	Coupon 2009	Coupon 2008
2008	Long Term	AAA zaf	Securitisations	SPVs	Collateral Debt Obligation	FLOATING	100%	1	625	625			12.63
					Equipment Backed Securities	FIXED	100%	1	50	50		11.67	11.67
						FLOATING	100%	2	606	606		7.93	13.02
					Residential Property Backed Securities	FIXED	100%	1	79	79			12.33
						FLOATING	100%	1	445	445			13.28
	Matured	AAA zaf	Banks	Financials	Banks	FIXED	100%	8	911	911	4.16	4.10	5.42
						FLOATING	100%	2	900	900			11.78
			Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	2	525	525	7.37	8.63	13.64
	Medium Term	AAA zaf	Banks	Financials	Banks	FIXED	100%	3	1,098	1,098	6.25	6.25	6.25
				Parastatals	Banks	FIXED	72%	1	10,000	7,227	9.45	9.45	9.45
	Short Term	AAA zaf	Banks	Financials	Banks	FIXED	100%	1	2,000	2,000	9.53	9.53	9.53
				Parastatals	Banks	FIXED	80%	1	2,000	1,600	10.06	10.06	10.06
			Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	1	202	202	7.67	8.93	14.12
2008 Total								25	19,441	16,268	7.59	7.58	9.34
2009	Long Term	AAA zaf	Banks	Financials	Banks	INFLATION-LINKED	100%	1	845	845	5.50	5.50	
			Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	5	720	720	7.90	9.55	
					Residential Property Backed Securities	FLOATING	100%	1	696	696		8.53	
	Matured	AAA zaf	Banks	Financials	Banks	FIXED	100%	1	140	140		14.00	
	Medium Term	AAA zaf	Banks	Financials	Banks	FIXED	100%	1	3,000	3,000	6.00	6.00	
			State owned enterprises	Parastatals	Electricity	FIXED	94%	1	8,500	7,951	9.25	9.25	
							100%	1	5,000	5,000	3.00	3.00	
	Short Term	AAA zaf	Banks	Financials	Banks	FIXED	100%	1	1,300	1,300	4.00	4.00	
2009 Total								12	20,202	19,652	6.43	8.17	
2010	Long Term	AAA zaf	Banks	Financials	Banks	INFLATION-LINKED	100%	1	1,000	1,000	5.50		
			Other corporates	Agriculture	Cash Grains	FLOATING	100%	2	1,670	1,670	6.74		
			Securitisations	SPVs	Residential Property Backed Securities	FIXED	100%	4	1,173	1,173	9.59		
						FLOATING	100%	11	3,924	3,924	7.56		
			State owned enterprises	Parastatals	Electricity	FIXED	98%	1	10,500	10,256	10.00		
2010 Total								19	18,268	18,023	7.72		
Grand Total								**56**	**57,910**	**53,943**	**7.38**	**7.88**	**9.34**

Figure 17: Prime Investment Grade Analysis

Upper Medium Investment Grade Analysis

Investment Grade Upper Mediu Grade

Issue Year	Tenor Classification	Rating	Category	Major Division	Subsector	Coupon Rate Indicator	Values						
							% Issued / Authorised	No. of Bonds	Sum Authorised	Sum Issued	Coupon 2010	Coupon 2009	Coupon 2008
2008	Long Term	A zaf	Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	1	44	44		9.43	14.62
					Residential Property Backed Securities	FLOATING	100%	1	22	22			14.43
		A+ zaf	Banks	Financials	Banks	FIXED	100%	1	200	200	13.74	13.74	13.74
			Municipal Government	Government	Municipals	FIXED	100%	1	2,268	2,268	12.21	12.21	12.21
	Short Term	A zaf	Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	1	86	86	8.97	10.23	15.42
		A- zaf	Banks	Financials	Banks	FIXED	100%	1	120	120			13.62
2008 Total								6	2,740	2,740	11.64	11.40	14.00
2009	Long Term	A zaf	Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	2	70	70	8.14	9.40	
					Residential Property Backed Securities	FLOATING	100%	1	32	32		9.73	
	Short Term	A zaf	Other corporates	Services	Transportation Integrated	FLOATING	100%	1	100	100	9.04	10.05	
		A+ zaf	Other corporates	Manufacturin	Diversified Industrials	FIXED	100%	1	100	100	11.20	11.20	
						FLOATING	100%	1	250	250	8.90	10.04	
2009 Total								6	552	552	9.08	9.97	
2010	Long Term	A zaf	Securitisations	SPVs	Residential Property Backed Securities	FIXED	100%	3	83	83	10.19		
						FLOATING	100%	5	145	145	7.90		
	Medium Term	A- zaf	Other corporates	Services	Transportation Integrated	FLOATING	100%	1	200	200	9.04		
		A+ zaf	Other corporates	Manufacturin	Diversified Industrials	FIXED	100%	1	91	91	9.94		
						FLOATING	100%	1	334	334	8.68		
	Short Term	A+ zaf	Other corporates	Manufacturin	Diversified Industrials	FIXED	100%	2	144	144	8.52		
						FLOATING	100%	2	431	431	7.60		
2010 Total								15	1,428	1,428	8.55		
Grand Total								**27**	**4,720**	**4,720**	**9.09**	**10.54**	**14.00**

Figure 18: Upper Medium Investment Grade Analysis

Lower Medium High Yield Grade Analysis

Investment Grade Lower Mediu Grade

Issue Year	Tenor Classification	Rating	Category	Major Division	Subsector	Coupon Rate Indicator	Values						
							% Issued / Authorised	No. of Bonds	Sum Authorised	Sum Issued	Coupon 2010	Coupon 2009	Coupon 2008
2008	Long Term	BBB zaf	Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	2	52	52		9.88	14.79
		BBB+ zaf	Banks	Financials	Banks	FIXED	100%	2	658	658	12.00	12.00	12.00
						FLOATING	100%	1	440	440	8.55	10.23	14.43
			Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	1	14	14		13.13	18.32
	Matured	BBB+ zaf	Banks	Financials	Banks	FIXED	100%	10	1,079	1,079	9.13	8.16	9.51
						FLOATING	100%	15	1,300	1,300	6.85	8.53	12.76
			Securitisations	SPVs	Collateral Debt Obligation	FLOATING	100%	1	50	50			14.09
	Medium Term	BBB+ zaf	Banks	Financials	Banks	FIXED	100%	2	3,524	3,524	5.88	5.88	5.88
						FLOATING	100%	2	275	275	10.63	12.58	16.37
	Short Term	BBB zaf	Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	1	29	29	9.47	10.73	15.92
		BBB+ zaf	Banks	Financials	Banks	FLOATING	100%	6	721	721	7.34	8.54	13.50
2008 Total								43	8,142	8,142	8.28	9.18	12.29
2009	Long Term	BBB zaf	Securitisations	SPVs	Equipment Backed Securities	FLOATING	100%	1	3	3	9.67	10.93	
	Matured	BBB+ zaf	Banks	Financials	Banks	FLOATING	100%	1	150	150		8.33	
	Medium Term	BBB+ zaf	Banks	Financials	Banks	FLOATING	100%	1	1,280	1,280	7.72	8.98	
	Short Term	BBB+ zaf	Banks	Financials	Banks	FIXED	100%	1	100	100	2.27	2.27	
2009 Total								4	1,533	1,533	6.55	7.63	
2010	Long Term	BBB zaf	Securitisations	SPVs	Residential Property Backed Securities	FIXED	100%	1	34	34			
						FLOATING	100%	4	86	86	8.77		
2010 Total								5	120	120	8.77		
Grand Total								**52**	**9,795**	**9,795**	**8.15**	**8.94**	**12.29**

Figure 19: Lower Medium Investment Grade Analysis

Non-Investment Grade Analysis

Investment Grade Non-Investme Grade - Speculative

Issue Year	Tenor Classificatio	Rating	Category	Major Division	Subsector	Coupon Rate Indicator	% Issued / Authoris	Values No. of Bonds	Sum Authorised	Sum Issued	Coupon 2010	Coupon 2009	Coupon 2008
2010	Long Term	BB zaf	Securitisations	SPVs	Residential Property Backed Securities	FIXED	100%	1	15	15			
2010 Total								1	15	15			
Grand Total								1	15	15			

Figure 20: Non-Investment Grade Analysis

Comparison of Fitch's Investment Grade Bond Ratings and Outstanding Bond Values For Banks, Corporates and Securitization

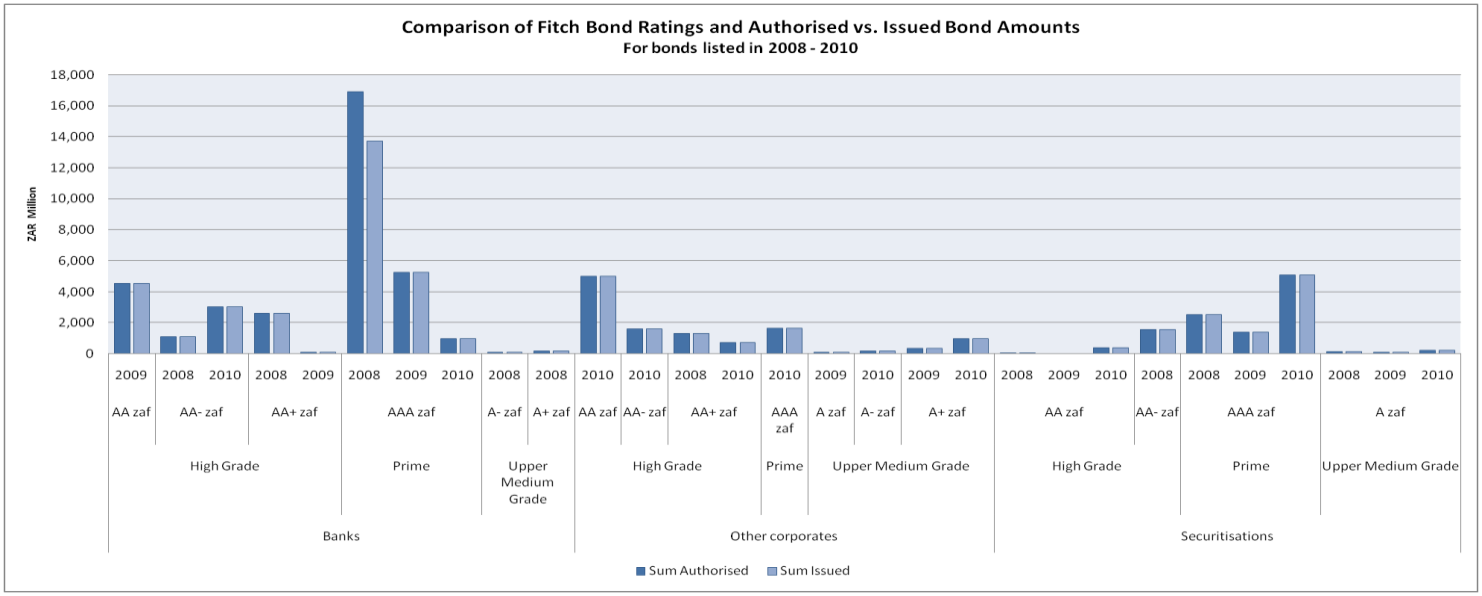


Figure 21: Fitch Comparison

Comparison of Fitch's Investment Grade Bond Ratings and Outstanding Bond Values for Other Non-Sovereign Bonds

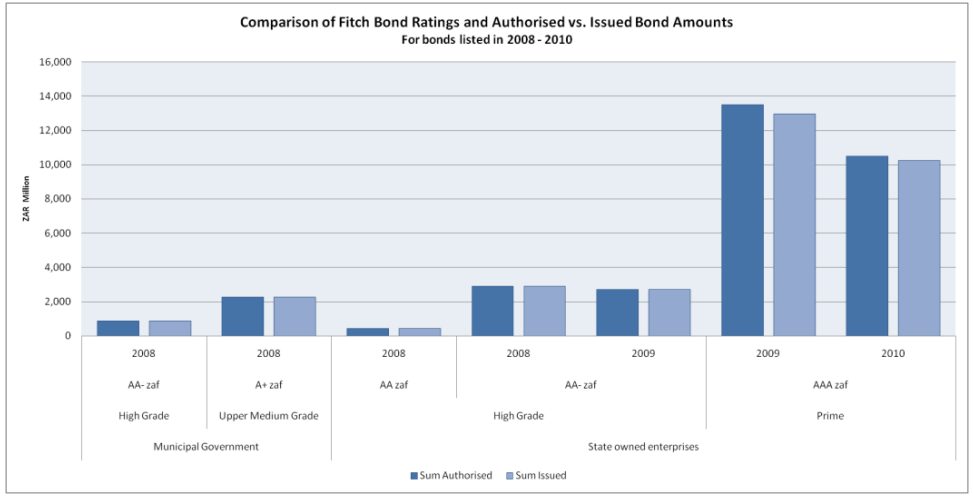
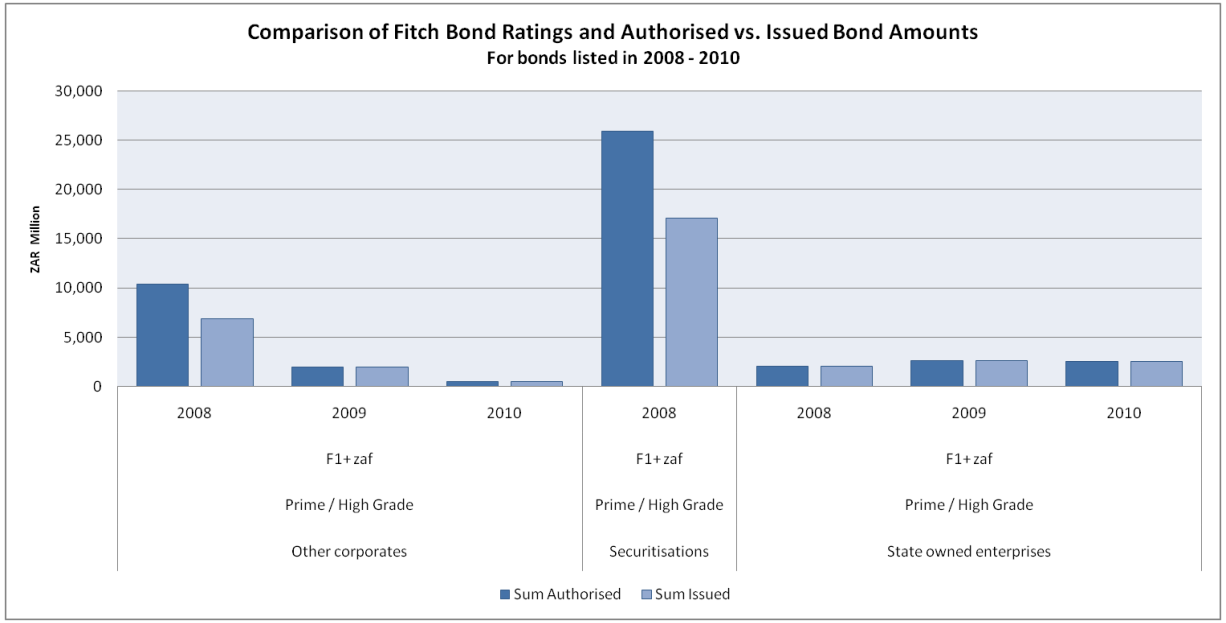


Figure 21 and 22: Fitch Comparisons


Comparison of Fitch Bond Ratings and Authorised vs. Issued Bond Amounts
For bonds listed in 2008 - 2010
ZAR Million
30,000
25,000
20,000
15,000
10,000
5,000
0
2008
2009
2010
2008
2008
2009
2010
F1+zaf
F1+zaf
F1+zaf
Prime / High Grade
Prime / High Grade
Prime / High Grade
Other corporates
Securitisations
State owned enterprises
Sum Authorised
Sum Issued

Short-Term Investment Grade Analysis

Investment Grade Prime / High Grade

Issue Year	Tenor Classification	Rating	Category	Major Division	Subsector	Coupon Rate Indicator	% Issued / Authorised	Values No. of Bonds	Sum Authorised	Sum Issued	Coupon 2010	Coupon 2009	Coupon 2008
2008	Matured	F1+ zaf	Other corporates	Agriculture	Cash Grains	FIXED	1%	1	750	8			
							27%	1	750	200			
							29%	1	1,000	293			
							39%	1	1,000	387			
							40%	1	1,000	403			
							60%	1	750	447			
							100%	6	1,418	1,418			
				Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	1	1,500	1,500			12.68
					Motor Vehicles	FLOATING	100%	3	2,250	2,250			12.82
			Securitisations	SPVs	Collateral Debt Obligation	FIXED	8%	1	750	59			
							11%	1	750	81			
							16%	2	1,500	240			
							18%	1	1,000	177			
							32%	1	1,000	318			
							33%	1	1,000	327			
							46%	1	750	342			
							52%	1	750	390			
							56%	1	1,000	557			
							57%	1	1,000	570			
							57%	1	750	429			
							58%	1	750	433			
							68%	1	1,000	675			
							81%	1	1,000	806			
							84%	1	1,000	840			
							87%	1	1,000	865			
							88%	1	1,000	879			
							100%	30	7,368	7,368			
							3493%	1	15	524			
							47%	1	750	350			
							37%	1	750	275			
							37%	1	750	278			
						INFLATION-LINKED	100%	1	261	261			
			State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	2	2,027	2,027			
2008 Total								71	38,339	25,977			12.78
2009	Matured	F1+ zaf	Other corporates	Manufacturin	Motor Vehicle Parts and Accessories	FLOATING	100%	5	1,975	1,975		8.46	
			State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	5	2,656	2,656		8.23	
2009 Total								10	4,631	4,631		8.35	
2010	<1 year	F1+ zaf	State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	1	500	500	6.21		
	Matured	F1+ zaf	State owned enterprises	Parastatals	Aerospace and Defence	FIXED	100%	5	2,050	2,050	6.05		
	Short Term	F1+ zaf	Other corporates	Services	Wireless Communications	FLOATING	100%	1	500	500	6.79		
2010 Total								7	3,050	3,050	6.35		
Grand Total								**88**	**46,020**	**33,658**	**6.35**	**8.35**	**12.78**

Figure 23: Short-Term Investment Grade Analysis

ANNEXURE 3: CORPORATES AND CORPORATE BOND OVERVIEW

Capital Structuring Decisions by Corporates

Capital structure is described as the mix of debt and equity that a company uses to finance its operations and create shareholder value.

The theoretical principles underlying capital structure are described in terms of the static trade-off theory by Modigliani and Miller, the agency theory by Jensen and Heckling and the pecking order theory by Myers.

Modigliani and Miller posited a number of propositions about what the optimal capital structure should be. Proposition I – often referred to as the "irrelevance theorem" – suggests that, in perfect equilibrium markets, a company's assets determine the value of company and not the method in which these assets were financed. However, a perfect market does not exist, and the cost of financing assets includes taxes. Since interest on debt is tax-deductible, thereby creating tax savings for the borrower (or bond issuer), it becomes possible for companies to minimize their costs of capital and maximize shareholders' wealth by using debt.

However, the use of debt for capital structure was limited in South Africa during the 1990's, with companies borrowing from banks instead of issuing bonds. The explanations given for this borrowing preference included the need to match project requirements (bank loans give such flexibility) and the perception that South African banks are more efficient than the existing bond market. This financing preference occurred even though corporates had the correct attributes needed for issuing corporate bonds (Davey & Firer 1992)[55]:

- Tangible assets against which to secure bonds if necessary
- A net tax base against which the interest payments can be offset
- Companies need a broader range of financial instruments
- Institutions need greater instrument diversification

This sentiment from corporates has changed over the last decade with the preference swinging to external finance, in particular external debt. By 2006, the average external finance ratio was 79%; the contribution of external debt to total assets growth was 71%. (Yartey, 2006[56])

Greubel[57] (2008) depicted how capital structure decisions changed for corporates over the last two decades:

[55] [55] Davey & Firer (1992). *A corporate South African Bond Market?* Investment Analysts Journal
[56] Yartey, C. A. (2006). *The Stock Market and the Financing of Corporate Growth in Africa: The Case of Ghana.* International Monetary Fund Working Paper.
[57] Greubel, G. (2008). *New Developments in Bond Markets: A South African Perspective.* Bond Exchange of South Africa

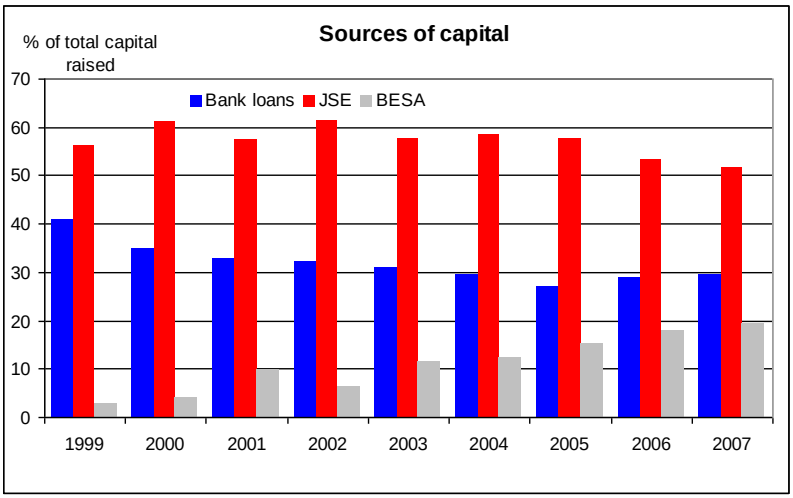


Figure 24: Sources of Capital for Corporates 1999 - 2007

This change in attitude about capital structure decisions was mainly attributable to the:

- decrease in the cost of debt as corporates tailored their assets and liability profiles to reduce the risk of maturity and currency mismatch on their balance sheets
- increase in the cost of bank debt
- tax-deductible interest payments to debt holders while dividend payments to equity holder are not
- dilution in earnings and shareholding structure that occur with rights issues

Bond maturity and tenor

The term of a bond is its maturity. Bond maturity can be any length of time, although bonds with a term of less than one year are generally designated as money market instruments. Tenor is the amount of time left for the repayment of a loan or contract or the initial term length of a loan. Tenor can be expressed in years, months or days.

Maturity definitions can be used to describe the tenor of the bonds:

- short term (bills): maturities between one to five year
- medium term (notes): maturities between six to twelve years
- long term (bonds): maturities greater than twelve years

Coupon Rate

The coupon or coupon rate of a bond is the amount of interest paid per year expressed as a percentage of the face value of the bond.

Coupons can be fixed or floating, or a combination of both. In the JSE data, the floating rate variables used are:

- 1 month JIBAR
- 3 month JIBAR
- 6 month JIBAR

- Prime Lending Rate

By taking the average of the year-end coupon per bond listed in each sector, a snapshot of the coupon rate per sector can be created:

Tenor Classification	Sector	Ave 2010	Ave 2009	Ave 2008
<1 year	Aerospace and Defence	6.41		
	Agricultural Production Crops			
	Asset Backed Securities			
	Banks	7.45		
	Building Construction	7.72		
	Communication			
	Local	6.80		
	Shipping, Ports, Rails and Roads			
	Transportation Equipment	6.45		
<1 year Total		**6.88**		
Long Term	Aerospace and Defence	7.66	7.66	7.66
	Agricultural Production Crops	8.31		
	Asset Backed Securities	8.01	9.28	13.33
	Banks	7.83	11.26	14.72
	Electricity	10.00		
	Local	11.89	12.13	12.39
	Shipping, Ports, Rails and Roads	8.81	9.91	10.08
Long Term Total		**8.24**	**9.75**	**12.92**
Medium Term	Aerospace and Defence	10.86	10.86	
	Agricultural Production Crops	9.45	11.27	
	Asset Backed Securities	8.59	8.67	13.30
	Banks	8.75	10.34	13.54
	Communication	11.02	11.90	11.90
	Durable Goods	10.79		
	Electricity	6.13	6.13	
	Financials	9.45	9.45	9.45
	Industrial	10.10	11.67	11.67
	Local	10.69	10.82	10.82
	Other Finance	8.34	9.67	11.94
	Shipping, Ports, Rails and Roads	9.60	9.60	9.25
	Transportation	9.66		
	Water	10.70		
Medium Term Total		**8.89**	**10.12**	**12.99**
Short Term	Aerospace and Defence	5.50	5.50	
	Agricultural Production Crops	6.60		
	Asset Backed Securities	7.87	9.25	13.85
	Banks	8.18	9.27	12.83
	Building Construction	9.66		
	Chemicals and Allied Products	9.55	11.52	13.22
	Communication	9.10	12.45	12.45
	Durable Goods	10.54		
	Electricity	7.75		
	Financials	8.24	9.13	10.06
	Forestry and Paper	12.13	12.13	
	Industrial	9.09	9.41	
	Metal Mining	11.87		
	Other Finance	8.30	11.34	12.56
	Shipping, Ports, Rails and Roads	6.52	7.88	12.96
	Transportation	8.28	10.05	
	Transportation Equipment	7.37	8.53	13.18
Short Term Total		**8.30**	**9.36**	**12.95**

Figure 25: Average Coupon at Year End 2008 - 2010

Credit Ratings

Corporate bonds are rated according to the perceived quality of the issuer. The rating indicates the overall creditworthiness and likelihood of default of the corporate issuing the bond. If it is a large corporation, such as one of the Big Four banks or multinationals, like Bidvest, Steinhoff and SABMiller, the grading will be high. Smaller, less well-known companies will attract a lower grading. Government and Municipality bonds are typically not rated because they are considered to have the highest credit rating.

A corporate bond's credit ratings affect a company's access to finance and may result in a change of bond covenants (coupon rates and forced repurchase of bonds).

Types of Risks in the Corporate Bond Market

The types of risk that the corporate bond market and its participants are subject to include: interest rate risk and credit risk, inflationary risk, currency risk, duration risk, convexity risk, repayment of principal risk, streaming income risk, liquidity risk, default risk, maturity risk, reinvestment risk, market risk, political risk, and taxation adjustment risk.

The two main risks that the corporate bond market and its participants are subject to are:

- Interest rate risk – this is the risk of the market value of a bond changing in value due to changes in macro-economic variables, such as the structure or level of interest rates or credit spreads or risk premiums.
- Credit risk – this risk refers to the probability that firm-level financial factors are responsible for a credit event that would affect the bond. Credit events include defaults on scheduled payments, bankruptcy, or the bond is restructured. Credit risk is also the probability that a credit quality change is issued by a rating agency.

Credit Spreads

Bond investors are compensated for the higher risks inherent in corporate bonds. The level of compensation can be measured by the credit spread in the spot rates between corporate bonds and Government bonds.

Credit spreads include a:

- Default premium –to compensate for the expected loss arising from payment default
- Tax premium – to compensate for any tax payable on interest payments
- Risk premium – to compensate for the higher risk, compared to Government bonds
- Liquidity premium – to compensate for low liquidity levels in secondary markets due to buy-and-hold strategies

Rating Agencies

A credit rating agency attempts to describe the risk of a corporate bond with a credit rating such as AAA. To get to this rating, a credit rating agency balances qualitative and quantitative analyses; includes country risk, industry factors, competitive position and profitability (with a heightened focus on cash flow) Two companies with identical financial metrics can be rated very differently to the extent that their business challenges and prospects differ.

Currently there are four credit rating agencies used by the local corporate bond market:

- Fitch
- Standard and Poor’s
- Moody’s

- CA Ratings

The rating scales used to rate South African corporate bonds are:

Table 24: National Rating Scales for Corporate Bonds

NATIONAL RATING SCALES FOR CORPORATE BONDS OF RATING AGENCIES

	S&P		Moody's		Fitch Ratings		CA-Ratings		GCS	
Rating Band	Long term rating	Short term rating	Long term rating	Short term rating	Long term rating	Short term rating	Long term rating	Short term rating	Long term Rating	Short term Rating
1	AAA	A-1+	Aaa.za	Prime 1.za	AAAzaf	F1+zaf	zaAAA	zaA1+	AAA	A1+
	AA+	A-1+	Aa1.za	Prime 1.za	AA+zaf	F1+zaf	zaAA+	zaA1+	AA+	A1+
	AA	A-1+	Aa2.za	Prime 1.za	AAzaf	F1+zaf	zaAA	zaA1+	AA	A1+
	AA-	A-1+	Aa3.za	Prime 1.za	AA-zaf	F1+zaf	zaAA-	zaA1+	AA-	A1
2	A+	A-1	A1.za	Prime 1.za or Prime 2.za	A+zaf	F1+zaf or F1zaf	zaA+	zaA1	A+	A1
	A	A-1	A2.za	Prime 1.za or Prime 2.za	Azaf	F1zaf	zaA	zaA1	A	A1
	A-	A-2	A3.za	Prime 1.za or Prime 2.za	A-zaf	F1zaf or F2zaf	zaA-	zaA2	A-	A1-
3	BBB+	A-2	Baa1.za	Prime w.za	BBB+zaf	F2zaf	zaBBB+	zaA2	BBB+	A2
	BBB	A-2	Baa2.za	Prime 2.za or Prime 3.za	BBBzaf	F2zaf or F3zaf	zaBBB	zaA2	BBB	A2

Investment Grade vs. High Yield Bonds

Once a rating is assigned to a bond, it can be described as either an investment grade of high-yield bond.

Investment Grade

An investment grade bond has one of the highest ratings possible for the credit rating agency. AAA and AA (high credit quality) and A and BBB (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations (BB, B, CCC, etc.) are considered low credit quality.

In South Africa, very few institutional buyers are permitted to buy corporate bonds with credit risk rated below A. There are issuers with triple B, but institutional buyers have to be very judicious in buying them. (Equinox, 2005)

High yield bond

A high-yield bond (non-investment-grade bond, speculative-grade bond, or junk bond) is a bond that is rated below investment grade at the time of purchase. These bonds have a higher risk of default or other adverse credit events, but typically pay higher yields than better quality bonds in order to make them attractive to investors.

Credit Concentrations of Bonds

To analyze the credit concentrations, the JSE Data was filtered according to issue year in the graphs below), tenor, and rating. The “Number of Bonds” is the number of

bonds issued in a particular year. The decrease in credit concentrations per issue year is due to the decrease in the number of bonds issued, and not reflective of any rating downgrade.

Overall, the majority of long term and all of the short-term bonds are classified as investment grade.

Credit Concentrations – Fitch Ratings

Fitch's rated the majority of bonds in the JSE Data sample.

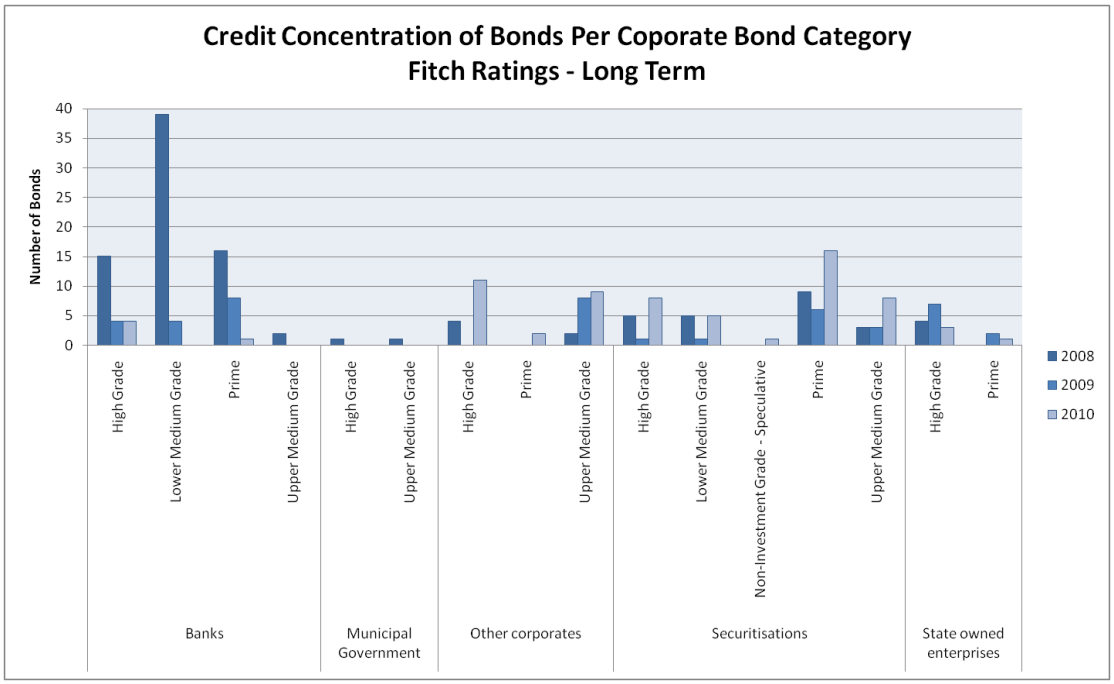


Figure 26: Credit Concentration - Fitch Ratings Long Term

Credit Concentrations – Standard and Poor's Ratings

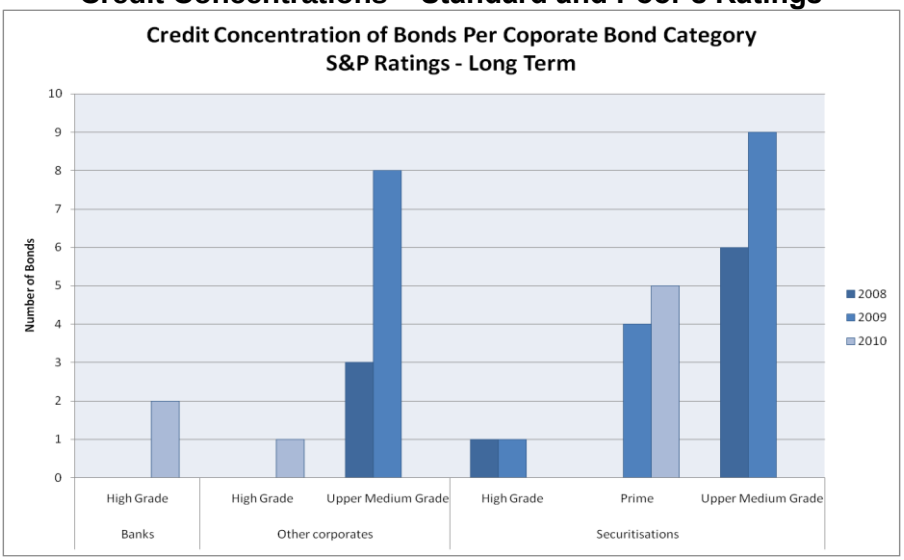


Figure 27: Credit Concentration - Standard & Poors Ratings Long Term

Credit Concentrations – Moody's Ratings

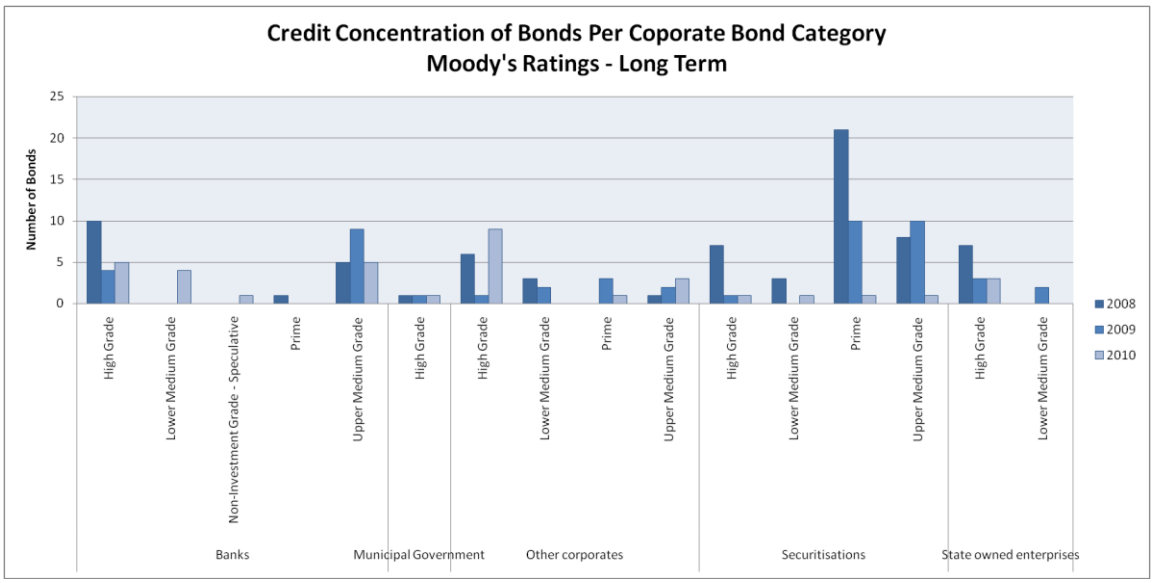


Figure 28: Credit Concentration - Moody's Ratings Long Term

Credit Concentrations – CA Ratings

CA Ratings	Issue Year	Tenor Classificatic	Major Division	Investment Grade - CA	No. of Bonds
Long Term Rating	2008	Long Term	Government	Upper Medium Grade	1
		Medium Term	Financials	Lower Medium Grade	2
Short Term Rating	2008	Matured	SPVs	Upper Medium Grade	10
		Short Term	Financials	Upper Medium Grade	1
	2010	Short Term	Financials	Upper Medium Grade	1
Grand Total					**15**

Figure 29: Credit Concentration – CA Ratings

ANNEXURE 4: SECURITIZATION NOTES LISTED ON THE BOND MARKET

Major Division SPVs
Sector Asset Backed Securities

No. of Issues				
Issue Year	Tenor Classifica	Subsector	Investment Grade - Fitch	Total
2008	Long Term	Collateral Debt Obligation	Prime	1
		Equipment Backed Securities	High Grade	1
			Lower Medium Grade	3
			Prime	3
			Upper Medium Grade	1
		Residential Property Backed Securities	High Grade	1
			Prime	2
			Upper Medium Grade	1
	Matured	Collateral Debt Obligation	High Grade	3
			Lower Medium Grade	1
			Prime / High Grade	221
		Equipment Backed Securities	Prime	2
	Short Term	Equipment Backed Securities	Lower Medium Grade	1
			Prime	1
			Upper Medium Grade	1
2008 Total				243
2009	Long Term	Equipment Backed Securities	Lower Medium Grade	1
			Prime	5
			Upper Medium Grade	2
		Residential Property Backed Securities	High Grade	1
			Prime	1
			Upper Medium Grade	1
	Matured	Collateral Debt Obligation	Prime / High Grade	113
2009 Total				124
2010	Long Term	Residential Property Backed Securities	High Grade	8
			Lower Medium Grade	5
			Non-Investment Grade - Speculative	1
			Prime	16
			Upper Medium Grade	8
	Matured	Collateral Debt Obligation	Prime / High Grade	24
2010 Total				62
Grand Total				**429**

Figure 30: Securizations listed on the Bond Market

ANNEXURE 5: BOND FEATURES: CALLABLE BONDS AND EARLY REDEMPTION

Ave Coupon 2010							Issue Year		
Category	Subsector	Tenor Classification	Callable Features	Early Redemption	Coupon Rate Indicator	% Issued / Authorised	2008	2009	2010
Securitisations	Commercial Property Backed Securities	Long Term	CALLABLE ON 20 DECEMBER 2011 AND COUPON STEP UP RATE WILL BE 210 BPS	TRUE	FLOATING	100%	7.30		
			CALLABLE ON 20 DECEMBER 2011, COUPON STEP UP RATE WILL BE 120 BPS OVER 3M JIBAR.	TRUE	FLOATING	86%	6.55		
			CALLABLE ON 20 DECEMBER 2011, COUPON STEP UP RATE WILL BE 144 BPS OVER 3M	TRUE	FLOATING	100%	6.75		
			CALLABLE ON 20 DECEMBER 2011. COUPON STEP UP RATE WILL BE 270 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%	7.80		
			CALLABLE ON 20 DECEMBER 2011. STEP UP COUPON RATE WILL BE 540 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%	10.05		
		Short Term	CALLABLE 7 NOVEMBER 2013 LEGAL MATURITY 7 NOVEMBER 2015.	TRUE	FLOATING	100%			7.57
			CALLABLE 7 NOVEMBER 2013 LEGAL MATURITY DATE 7 NOVEMBER 2015	TRUE	FLOATING	100%			7.95
	Credit Card Backed Securities	Medium Term	CALLABLE 30 APRIL 2013, STEP UP 120 BPS	TRUE	FLOATING	100%			8.73
			CALLABLE 30 APRIL 2014, STEP UP 120 BPS	TRUE	FLOATING	100%			8.83
			CALLABLE 30 APRIL 2017	TRUE	FIXED	100%			10.09
			STEP UP MARGIN OF 50 BASIS POINTS	TRUE	FLOATING	100%			8.31
	Equipment Backed Securities	Long Term	CALLABLE 15/8/2013, STEP UP 300BPS OVER 3M JBAR	TRUE	FLOATING	100%			8.00
			CALLABLE 15/8/2013, STEP UP 420BPS OVER 3M JIBAR	TRUE	FLOATING	100%			8.80
			CALLABLE 15/8/2013, STEP UP 487.5 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%			9.25
			CALLABLE ON 15 AUGUST 2009, COUPON STEP UP RATE WILL BE 90 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 15 AUGUST 2009, STEP UP COUPON RATE WILL BE 260 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 15 AUGUST 2011, COUPON STEP UP RATE WILL BE 11.970 NACS.	TRUE	FIXED	100%			
			CALLABLE ON 15 AUGUST 2011, COUPON STEP UP RATE WILL BE 140 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 15 AUGUST 2011, COUPON STEP UP RATE WILL BE 270 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 15 AUGUST 2011, STEP UP COUPON RATE WILL BE 110 BASIS POINTS OVER 3M JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 15 AUGUST 2011, STEP UP COUPON RATE WILL BE 315 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 15 AUGUST 2013, COUPON STEP UP RATE WILL BE 750 BASIS POINTS OVER 3M JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 17/11/1012 COUPON STEP UP 100 BPS	TRUE	FLOATING	100%		9.67	
			CALLABLE ON 17/11/2010 COUPON STEP UP 100 BPS.	TRUE	FLOATING	100%		7.24	
			CALLABLE ON 17/11/2012 COUPON STEP UP 100 BPS	TRUE	FLOATING	100%		9.17	
		Short Term	CALLABLE ON 17/11/2011 COUPON STEP UP IS 220 BPS	TRUE	FLOATING	100%	7.67		
			CALLABLE ON 17/11/2011 COUPON STEP UP IS 420 BPS	TRUE	FLOATING	100%	9.47		
	Residential Property Backed Securities	Long Term	CALLABLE 15 SEPT 2013, STEP UP 204 BPS.	TRUE	FLOATING	100%			6.85
			CALLABLE 22 MAY 2020, COUPON STEP UP RATE WILL BE 225 BPS OVER JIBAR	TRUE	FIXED	100%			10.44
			CALLABLE ON 15 JUNE 2011 AND COUPON STEP UP RATE WILL BE 70 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%	5.96		
			CALLABLE ON 15 JUNE 2011, COUPON STEP UP RATE WILL BE 11.59% (NACS)	TRUE	FIXED	100%	11.30		
			CALLABLE ON 15 JUNE 2011, COUPON STEP UP RATE WILL BE 99 BASIS POINTS OVER 3M	TRUE	FLOATING	100%	6.26		
			CALLABLE ON 15 JUNE 2013, CALLABLE STEP UP RATE WILL BE 350 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%	8.56		
			CALLABLE ON 15 JUNE 2013, COUPON STEP UP RATE WILL BE 109 BASIS POINTS OVER 3M JIBAR.	TRUE	FLOATING	100%	6.36		
			CALLABLE ON 15 JUNE 2013, COUPON STEP UP RATE WILL BE 166 BASIS POINTS OVER 3M JIBAR.	TRUE	FLOATING	100%	6.86		
			CALLABLE ON 15 JUNE 2013, COUPON STEP UP RATE WILL BE 266 BPS OVER 3M JIBAR.	TRUE	FLOATING	100%	7.76		
			CALLABLE ON 15 JUNE 2013, COUPON STEP UP RATE WILL BE 80 BASIS POINTS OVER 3M	TRUE	FLOATING	100%	6.06		
			CALLABLE ON 22 MAY 2020 AND COUPON STEP UP RATE WILL BE 275 BPS OVER JIBAR	TRUE	FIXED	100%			10.64
			CALLABLE ON 22 MAY 2010, FINAL MATURITY DATE 22 MAY 2042, STEP UP COUPON RATE: 3M JIBAR PLUS 45 BPS.	TRUE	FLOATING	100%			
			CALLABLE ON 22 MAY 2010, FINAL MATURITY DATE 22 MAY 2042, STEP UP COUPON RATE: 3M JIBAR PLUS 85 BPS.	TRUE	FLOATING	100%			
			CALLABLE ON 22 MAY 2010, FINAL MATURITY DATE 22 MAY 2042, COUPON STEP UP RATE: 3M JIBAR PLUS 100 BPS.	TRUE	FLOATING	100%			
			CALLABLE ON 22 MAY 2011 AND STEP UP RATE WILL BE 270 BASIS POINTS OVER JIBAR.	TRUE	FLOATING	100%			7.41
			CALLABLE ON 22 MAY 2011 AND COUPON STEP UP RATE WILL BE 260 BASIS POINTS OVER	TRUE	FLOATING	100%			7.41
			CALLABLE ON 22 MAY 2011, STEP UP 220 BPS. MATURITY 22 MAY 2043	TRUE	FLOATING	100%			7.16
			CALLABLE ON 22 MAY 2011, STEP UP 3 MONTHS JIBAR 140 BPS. MATURITY 22 MAY 2043	TRUE	FLOATING	100%			6.66
			CALLABLE ON 22 MAY 2012, STEP UP 171BASIS POINTS OVER, MATURITY 22 MAY 2044	TRUE	FLOATING	100%			6.87
			CALLABLE ON 22 MAY 2013 AND COUPON STEP UP RATE WILL BE 415 BASIS POINTS OVER	TRUE	FLOATING	100%			8.56
			CALLABLE ON 22 MAY 2013, COUPON STEP UP RATE WILL BE 335 BASIS POINTS OVER JIBAR	TRUE	FLOATING	100%			7.91
			CALLABLE ON 22 MAY 2020 AND STEP UP COUPON RATE WILL BE 340 BPS OVER JIBAR	TRUE	FIXED	100%			10.84
			CALLABLE ON 22 MAY 2020, COUPON STEP UP RATE WILL BE 12.54%	TRUE	FLOATING	100%			8.81
			CALLABLE ON 22 NOV 2011 AND COUPON STEP UP RATE WILL BE 295 BASIS POINTS OVER	TRUE	FLOATING	100%			7.61
			CALLABLE ON 22 NOV 2011, STEP UP 3 MONTH JIBAR 240 BPS. MATURITY 22 NOV 2043	TRUE	FLOATING	100%			7.31
			CALLABLE ON 22 OCTOBER 2009, COUPON STEP UP RATE WILL BE 323 BASIS POINTS OVER 3MNTHS JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 22 OCTOBER 2009, STEP UP COUPON RATE WILL BE 248 BASIS POINTS OVER 3 MNTHS JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 22 OCTOBER 2009, STEP UP RATE WILL BE 150 BPS OVER 3MNTHS JIBAR.	TRUE	FLOATING	100%			
			CALLABLE ON 22 OCTOBER 2009,STEP UP COUPON RATE WILL BE 150 BPS OVER 3MNTHS JIBAR.	TRUE	FIXED	100%			
			CALLABLE ON 22NOV1011, STEP UP 150 BASIS POINTS OVER, MATURITY 2043	TRUE	FLOATING	100%			6.71
			STEP UP - 3 MONTH JIBAR PLUS 300 BPS -19 JULY 2015	TRUE	FIXED	100%			9.09
			STEP UP - 225 BPS - 19 JULY 2013	TRUE	FLOATING	100%			7.69
			STEP UP - 247.5 BPS - 19 JULY 2015	TRUE	FLOATING	100%			7.64
			STEP UP - 247.50 BPS - 19JULY 2015	TRUE	FIXED	100%			8.74
			STEP UP - 3 MONTH JIBAR PLUS 412.5 BPS	TRUE	FLOATING	100%			8.74
			STEP UP - 3 MONTHS JIBAR PLUS 217.5 BPS -19 JULY 2013	TRUE	FLOATING	100%			7.44
			STEP UP - 367.5 BPS - 19 JULY 2015	TRUE	FLOATING	100%			8.44
			STEP UP - 3MONTHS JIBAR PLUS 367.50 BPS	TRUE	FIXED	100%			9.54
			STEP UP - 450 BPS - 19 JULY 2015	TRUE	FLOATING	100%			8.99
			STEP UP 3 MONTH JIBAR - 300 BPS	TRUE	FLOATING	100%			7.99

Figure 31: Bond Features: Callable and Early Redemption Bonds listed on the Bond Exchange