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MEDIUM-TERM NOTES AND CAPITAL MARKETS DEVELOPMENTS IN LESOTHO: AN ALTERNATIVE FINANCING VEHICLE

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1. Introduction

The Central Bank of Lesotho (CBL), as the Registrar of Capital Markets in the country, launched the Maseru Securities Market (MSM) in January 2016. This advancement marked a step in the right direction towards the development of the country's financial sector as enshrined under the National Strategic Development Plan (NSDP) 2012/13- 2016/17 as well the Financial Sector Development Strategy (FSDS) of 2012. In general, the MSM's main objectives are: (i) to provide a secure environment for the trading of financial securities; (ii) to enhance market confidence; (iii) to facilitate the centralised trading of financial securities, and (iv) to foster market development. The launch of the MSM has created a suitable platform for the introduction of a wide array of exciting and flexible financial instruments that will prove beneficial to both issuers and investors (retail and institutional). One such financial instrument is the Medium Term Note (MTN), which has gained much prominence amongst financial market players in recent years due to its unique characteristics. The introduction of MTNs within Lesotho's capital markets will add greater diversity to the current menu of financial assets on offer while at the same time affording local institutional investors such as commercial banks, insurance companies and pension funds (that predominantly have their investment portfolios overweight in foreign assets) with a way to diversify their investment holdings to include more domestic financial assets. The objective of this article is to give a brief explanation of what are MTNs, what makes them a favourite among issuers and investors in the capital market space and how authorities in Lesotho can use them to further develop the country's capital markets. The rest of the paper is divided into three sections as follows; Section 2 presents a brief explanation of MTNs and an outline of some of their benefits. Section 3 gives an overview of the sub-Saharan African (SSA) Debt Markets from 2010 – 2016. Section 4 concludes and offers recommendations.

2. Brief Explanation of MTNs and their Benefits to Issuers and Investors

Medium Term Notes (MTNs) are debt securities that can be issued either by a corporation, a financial institution or government. They are mainly used as a way of filling the financing gap between short-term commercial paper and long-term debt . Even though MTNs typically have a maturity profile of between two to seven years, it is not a strict requirement that they have medium terms. In fact, it has become common practice for companies to issue MTNs along both a short-term and long-term maturity profile (the ten to thirty-year range) under an MTN program. MTNs have not only changed the way capital is raised by corporations, they have also transformed the way retail and institutional investors invest. In their early history, MTNs were issued as basic promissory notes and extensions of the issuer's commercial paper programme. As time went on and as investors demanded greater protection within the MTN space, practically all MTNs came to be issued under a trust indenture providing enhanced security terms ranging from negative pledges, financial performance covenants, cross-default provisions, voting privileges after default and other issuer specific terms and conditions. This progression has led to a significant expansion in the MTN investor base and has also brought with it considerable interest from the retail investor. Table 1 offers some features of MTNs that distinguish them from traditional debt securities such as corporate bonds. It also details a list of MTN benefits to issuers and investors.

Footer:

Commercial paper has a maturity profile of nine months or less. Long-term debt has a maturity profile of 30 years or more.

Table 1: Distinguishing Features of MTNs and their benefits to Issuers and Investors

Distinguishing Feature	Advantage to Issuer over Traditional Debt Securities	Advantage to Investor over Traditional Debt Securities
MTNs can be sold in relatively small amounts or large amounts and either on a continuous or on an intermittent basis.	Requisite funds can be raised to meet relatively small short-term obligations without having to issue large and discrete offerings typical in the bond market.	They can be offered in both smaller and larger denominations and therefore cater for the retail and institutional investor appetites, respectively.
MTNs are flexible, they can be issued with either floating interest rates or with rates that are tied to equity or commodity prices. In addition, they can have derivative features such as calls, puts and other options.		They present a much more diversified investment menu than that offered in a typical bond market. It means the investor is able to diversify risk and diversify into different industrial sectors while at the same time getting a relatively better return.
At the onset of a launch of an MTN program, a set of deal documents including a distribution agreement are negotiated and executed. The distribution agreement is designed to allow conditions offerings. This is contrary to an underwriting agreement that will have to be negotiated for a specific offering.	Mitigates against having to run the same lap twice should the issuer wish undertake additional issuances. Once initial documentation has been agreed, it forms the basis for a number of different future issues at very short notice. Issuer can thus take advantage of favourable market conditions.	
They offer discreet funding, since only parties to the transaction (issuer, agent and investors) need know about it. (could be of benefit to companies in financial distress)		They can have, built into their issuance, an opportunity for early redemption. For e.g. investors can be given the chance to redeem their holdings of the notes either in part or fully after a particular time after the issue date at a redemption price equal to 100% of their principal amount plus accrued but unpaid interest on the date of redemption.
They are effective tools for asset-liability management.	They are effective tools for asset-liability management. Due to their flexibility in terms of issue, the issuer is able to issue notes that mature the same time as when there will be a need for financing of liabilities.	They are effective tools for asset-liability management. Investors, just like issuers can make sure that the note they purchase matures the same time as their obligations. This helps with risk management in the period where one instrument matures and the investor is faced with the requirement to meet a liability.

NOTE:
In terms of tenure, corporate securities with a maturity of five years are referred to as short-term-notes while corporate securities with maturity of between five to twelve years are referred to as medium term notes. Those with a maturity higher than twelve years are denoted longer-term-notes.

3. Overview of sub-Saharan African (SSA) Debt Markets: 2010 – 2016

Deep, active and highly liquid domestic capital markets are essential to foster alternate financing of government development projects in priority areas such as infrastructure and housing. Contrary to the use of capital market financing, countries in the sub-Saharan African (SSA) region have remained heavily dependent on external grants and concessional loans for the funding of capital projects and the financing of fiscal deficits. Specifically, in 2010, gross official development assistance to the SSA region amounted to US$49 billion or 32 per cent of total government consumption expenditure with 83 per cent as grants and 17 per cent as concessional loans. Such traits imply vulnerabilities of SSA countries to external shocks in the donor community.

Figure 1: Bond Market Comparisons, 2010 (percent of GDP)

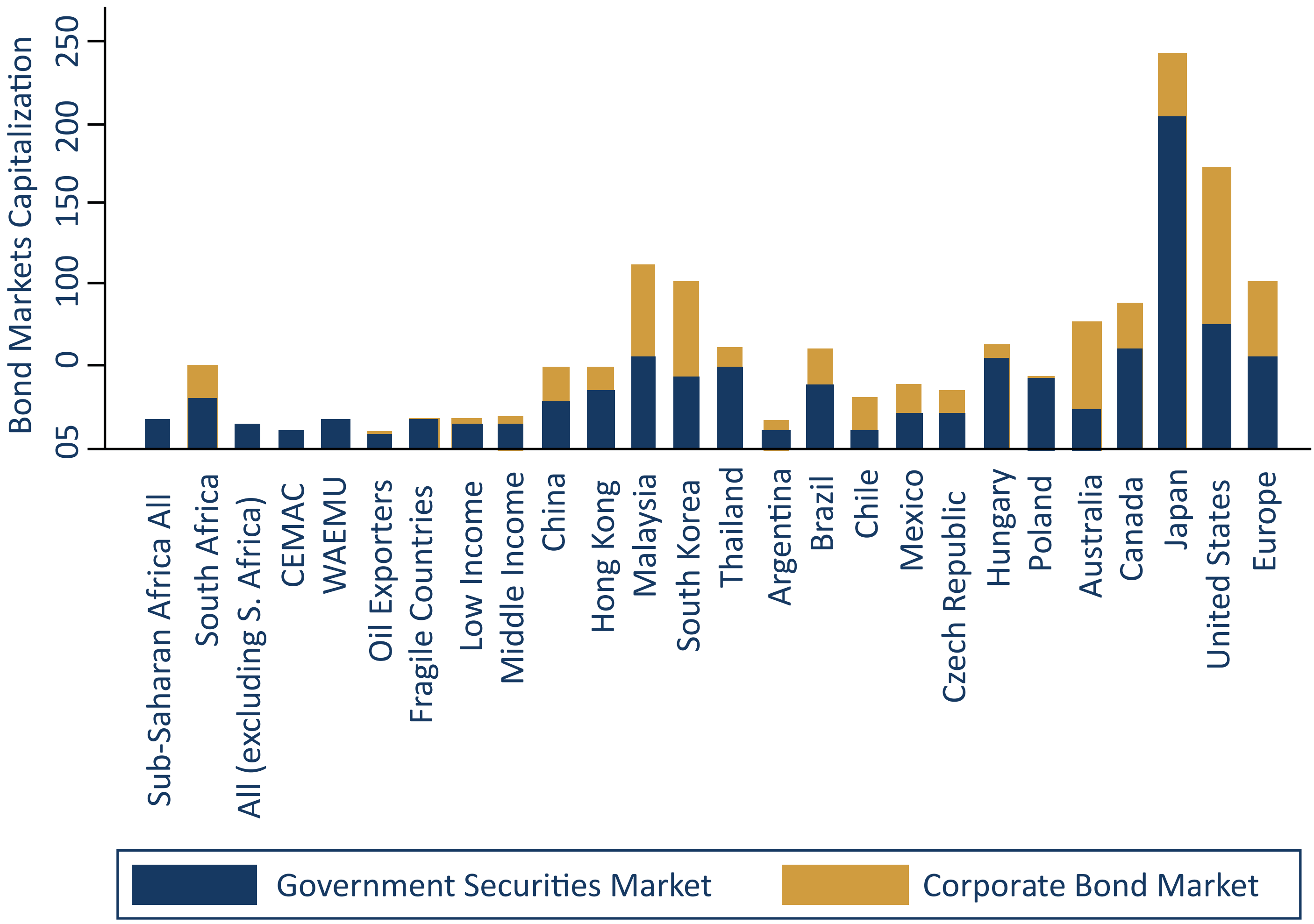

Figure 1 presents bond market comparisons (as a percent of gross domestic product - GDP) for SSA countries, countries in the Economic and Monetary Community of Central Africa (CEMAC) , countries in the West African Economic and Monetary Union (WAEMU) , oil exporting countries, Fragile countries , low income countries , middle income countries

Footer:
CEMAC countries in the sample include: Cameroon, Central African Republic, Chad, Republic of Congo, and Gabon.
WAEMU countries in the sample include: Ivory Coast, Guinea-Bissau, Mali, Senegal, and Togo. Oil exporters include: Angola, Cameroon, Chad, Republic of Congo, Gabon, and Nigeria.

and a host of other developing, emerging and advanced economies. From the Figure, evidence suggests that the SSA region's capital markets are mostly still in their nascent stage with government and corporate securities' market capitalisation lower than those in other developing, emerging and advanced economies. This underscores the need for expeditious development of the SSA capital markets.

In 2012 the International Finance Corporation (IFC) established its Pan-African domestic medium term note (DMTN) programme with the intention to help develop African capital markets. Since its establishment, the IFC DMTN programme has successfully contributed to the development of capital markets in countries such as Rwanda and Namibia to name a few. In Namibia, the IFC, through the DMTN program issued its first ever bond denominated in Rwanda francs in 2014. It managed to raise 15 billion francs (approximately US22 million) and contributed towards the revamping of the country's capital markets. In 2016, the IFC DMTN program in Namibia issued its inaugural bond with a five-year tenor denominated in Namibian Dollars (NAD). It managed to raise NAD180 million (approximately US$12 million). It was the first placement by a non-resident issuer in Namibia's domestic capital markets.

4. Conclusion and Recommendations

Access to finance is one of the key objectives of Lesotho's National Strategic Development Plan (NSDP). According to the NSDP, some of the ways this objective can be achieved is through the development of the country's money and capital markets coupled with the conduct of relevant research and development of appropriate financial innovations. The CBL's launch of the MSM in 2016 ties well with the strategic direction of the NSDP. Once issuer and investor participation in the exchange is heightened, it will embolden the steps already being taken by the country towards the creation of deep and efficient local markets that are the foundation for a thriving private sector and a key driver of jobs and growth. It is the recommendation of this paper that relevant government authorities continue to develop the private sector and capital markets by encouraging and facilitating the introduction of flexible financial instruments such as MTNs for listing on the MSM. Specifically, the Government of Lesotho could solicit the assistance of the International Finance Corporation (IFC) to help develop the domestic MTN market through the IFC's Pan-African Domestic Medium Term Note (DMTN) program. Through this program, the IFC may issue debt instruments with maturities of 3 months or longer denominated in local currency. The benefit will be an introduction of a new asset class that is of the highest credit quality that can be used as a risk-free benchmark. Such an issuance will also translate into a diversification benefit to domestic and foreign institutional and retail investors alike.

Footer:
Fragile countries include: Burundi, Central African Republic, Comoros, Democratic Republic of Congo, Ivory Coast, Eritrea, Guinea, and Guinea-Bissau.
Low income countries include: Ethiopia, The Gambia, Kenya, Madagascar, Malawi, Mali, Rwanda, Sierra Leone, Tanzania, and Uganda.
Middle income countries include: Botswana, Cape Verde, Ghana, Lesotho, Mauritius, Namibia, Senegal, Seychelles, South Africa, Swaziland, and Zambia.
The IFC, a member of the World Bank Group, is the largest global development institution focused exclusively on the private sector in developing countries.
The IFC's Pan-African Domestic Medium Term Note Program was launched in 2012 and currently the program includes Botswana, Ghana, Kenya, Namibia, Rwanda, South Africa, Uganda and Zambia.

5. References

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