The return of African Bank

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In 2014, the South African Reserve Bank (SARB) placed African Bank under curatorship following the largest bank and corporate default in South Africa's financial market history. After two years of uncertainty, African Bank resumed trading on 4 April 2016. This time around, the bank seems to be moving away from only targeting the unsecured lending segment of the market. It is offering a range of additional financial products and services, including a range of new bonds. In light of the ongoing political and economic tension triggered by the 'Nenegate' fiasco that started in December 2015, we believe the sales of these bonds should initially exceed demand. However, once the bond spreads have widened to enable the market to clear, we believe these bonds might offer value.

Two years after Abil was placed under curatorship, African Bank is trading again

On 10 August 2014, Abil was placed under curatorship by the SARB, a surprise move that stunned local credit markets. The SARB then committed approximately R17 billion worth of capital to guarantee and support Abil, and split the entity into a 'Good Bank' and a 'Bad Book', which still resides at the SARB.

After two years of uncertainty, legal wrangles and bad press, the Good Bank was granted a new banking licence by the South African Banking Regulator in March 2016, and resumed trading on 4 April. The Good Bank will be offering additional financial products and services and will expand to retail deposits in 2017. The dual objective is to offer transactional banking products to clients as well as to facilitate the direct deposit of wages into customer accounts.

The Good Bank has a different approach to funding and its target market

These changes represent a distinct shift in both the funding strategy and target market mindset of African Bank. It suggests that the Good Bank may move away from purely targeting the unsecured lending segment of the market. The bank resumed operations with R10 billion worth of equity and R24 billion worth of cash, as well as a reasonably diversified basket of debt instruments, spread out across the shorter sections of the nominal and real yield curves. This basket was determined by the terms of the restructure. Importantly, the first of the Good Bank's bonds will mature in May 2018, which provides a bit of breathing room before the onerous task of returning principal (capital) payments to bondholders.

The Good Bank has successfully listed a range of new bonds

For the sake of simplicity, we list two fixed-rate senior bonds and two floating-rate senior bonds below. There are several other bonds, including inflation-linked senior bonds and subordinated unsecure floating-rate Tier 2 notes, which we can discuss in future.

- ABK1 is an 11.50% senior unsecured fixed-rate note maturing on 7 November 2018, with R360 million in issue.
- ABK2 is a 9.50% senior unsecured fixed-rate note maturing on 24 May 2018, with R420 million in issue.
- ABK3 is a floating-rate note maturing in November 2018, with R400 million in issue – it will pay a set coupon of 10.38% (the Johannesburg Interbank Agreed Rate (JIBAR) + 315 basis points = 7.23% + 3.15%) for its first quarterly coupon.
- ABK4 is a floating-rate note maturing in May 2018, with R304 million in issue – it will pay a coupon of 9.73% (JIBAR + 250 basis points).

Comparing these yields to a cash return of 8.7% and a two-year sovereign bond yield of 8.3%, these higher yielding bonds offer an attractive return to investors.

The biggest risk is that existing bondholders sell all their debt

The biggest risk facing the curator is that the existing Abil bondholders, who are now new bondholders in the Good Bank, may collectively decide to sell all their debt. This would effectively show that they have no faith in the long-term sustainability of the refloated business. While we think it's unlikely that this will happen, it is possible, considering that the South African government's sovereign credit rating is at risk of a downgrade.

In such an environment, sub-investment grade and (marginal) low-quality investment grade issuers are generally spurned by investors seeking certainty, safety and liquidity from their fixed-income investments. Even supposedly AAA rated South African government bonds faced a zero liquidity environment at the height of the now notorious Nenegate crisis. This crisis was triggered by President Jacob Zuma's finance minister reshuffle in December 2015 and culminated in the reappointment of Pravin Gordhan. In the days surrounding Nenegate, also known as South Africa's 15-12 event, the R186 yield recorded its largest ever one-day sell-off, with yields rising by an eye-watering 147 basis points in one trading session. The R186 government bond is the most liquid South African bond, with R153.9 billion nominal in issue. Yet, under these circumstances, it was simply not possible to find a 'decent' bid in the R186. It goes without saying that if one can't trade in the R186, it is impossible to trade in the debt instruments of a credit like Good Bank, which is rated zaBB- by Standard & Poor's and that defaulted so recently.

We currently demand higher-than-usual credit risk premiums on all corporate and bank credits

A return to Nenegate is unlikely, especially in light of the groundbreaking judgement from the Constitutional Court of South Africa against President Jacob Zuma and in favour of Public Protector Thuli Madonsela on 31 March 2016. However, it is possible that the South African credit rating could be downgraded further, and that sovereign credit spreads could either widen gradually or rise sharply. As a result, we currently demand higher credit risk premiums on all corporate and bank credits than we ordinarily would.

The sales of the Good Bank's bonds may initially overwhelm demand for the bonds

Our analysis suggests that the spreads on the Good Bank's bonds will widen in the period immediately following the resumption of trading. How much they will widen depends on many factors, but the forces of demand and supply will dominate. We expect that the market will establish a clearing spread within the first month or two of trading, with a wave of selling initially overwhelming the demand for the bonds. The factors that contribute to this scenario include:

- the drawn-out delays in establishing the Abil resolution regime,
- the significant legislative changes that had to be enacted by Parliament,
- the size of the so-called 'Bad Book' (which still resides on the SARB's balance sheet), and
- the estimated and actual calls for cash from the thousands of small- and medium-sized investors whose capital was reduced due to mandatory haircuts (reductions in the market value of their assets), and then had their reduced capital stuck in retention funds at almost every large asset manager in the country.

We believe the Good Bank's bonds can potentially offer value and we'll consider these for our holdings

However, once the salient details of the flotation become more widely known and a clearing spread is established, we suspect that value might emerge in some of the bonds. At this point, we may consider increasing our holdings in the Good Bank's senior debt, subordinated Tier 2 debt and/or equity. Any such decisions will be subject to detailed analysis by our analysts and in-house approval from our Credit Committee.

Regardless, the flotation of the Good Bank should prove to be an interesting and groundbreaking chapter in the history of the South African corporate bond market. In fact, it will undoubtedly be taught to university students at commerce faculties around the country for many years to come. ■