

CREDIT OPINION

2 June 2021

Update

✓ Rate this Research

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Africa Finance Corporation – A3 stable

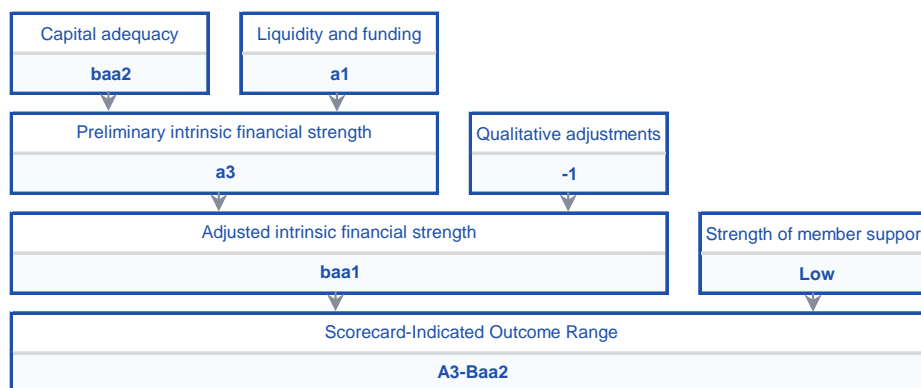
Update following rating affirmation, outlook changed to stable from negative

Summary

The credit profile of the [Africa Finance Corporation](#) (AFC) is supported by sound capital adequacy, as the deterioration in borrower quality and asset performance in recent years has been offset by continued profitability. AFC also maintains a solid liquidity position, and has significantly diversified its sources of funding in recent years. AFC's credit profile does not benefit from any uplift stemming from member support. The coronavirus outbreak did not translate for AFC into increased losses, including delayed loan repayments, despite AFC's borrowers facing a very severe economic shock.

Exhibit 1

AFC's credit profile is determined by three factors



Source: Moody's Investors Service

Credit strengths

- » Sound prudential framework
- » Ample liquidity enhanced by demonstrated access to market funding
- » Sustained profitability and sound provision levels that help preserve capital

Credit challenges

- » A challenging operating environment that has contributed to weak borrower quality and asset performance
- » Very low ability of its members to provide support if needed

Rating outlook

The stable outlook reflects AFC's demonstrated ability to avoid the erosion of its intrinsic financial strength despite the pandemic, which led to the worst recession on the African continent in decades. In particular, the oil price shock and asset price declines observed in the first part of 2020 have not resulted in anticipated significant losses and/or delayed loan repayments for the AFC.

Factors that could lead to an upgrade

Positive pressure on AFC's ratings would likely appear if the corporation is able to significantly strengthen its capital adequacy while maintaining strong levels of asset performance, liquidity and funding. This would reverse a trend of steady erosion of its capital adequacy over the years, except last year, as the corporation expanded its activities on the continent.

Factors that could lead to a downgrade

We would likely downgrade the ratings if we were to conclude that AFC was unlikely to maintain a track record of sound asset quality, leading to material losses. This will ultimately contribute to a weakening of capital adequacy. A failure to implement the corporation's strategy aimed at strengthening its capital base, would also be credit negative. Furthermore, a marked erosion of liquidity buffers and/or increasing signs that access to funding is durably weakened would also likely lead to a downgrade.

Key indicators

	2015	2016	2017	2018	2019	2020
Total Assets (USD million)	3,039.7	3,430.5	4,161.8	4,487.5	6,118.8	7,363.2
Development-related Assets (DRA) / Usable Equity [1]	106.7	114.1	127.9	130.0	176.2	163.0
Non-Performing Assets / DRA	0.5	0.0	13.5	2.9	1.3	2.4
Return on Average Assets	2.6	3.4	2.6	3.0	3.5	2.5
Liquid Assets / ST Debt + CMLTD	465.2	596.0	801.8	972.7	389.2	664.2
Liquid Assets / Total Assets	52.2	50.7	54.0	56.2	51.6	53.9
Callable Capital / Gross Debt	0.0	0.0	0.0	0.0	0.0	0.0

[1] Usable equity is total shareholder's equity and excludes callable capital

Source: Moody's Investors Service

Detailed credit considerations

On Wednesday 2 June 2021, we changed the outlook to stable from negative and affirmed AFC's ratings at A3. The stable outlook reflects the resilience of AFC's credit profile in the face of a significant shock. In light of developments during the past year, we expect AFC to maintain its intrinsic financial strength, with strong capital adequacy and asset performance, liquidity and funding.

We assess AFC's **capital adequacy** at "baa2", reflecting its ample, albeit declining, capital coverage as a buffer to ongoing and potential shocks to its assets, moderate leverage ratios, and track record of profitability. These strengths are balanced by a decline in borrower quality and weaker asset performance, as evidenced by the rise in loan loss provisions and a spike in past due exposures in its loan book in 2017 against the backdrop of a challenging operating environment in Sub-Saharan Africa. Since then, AFC's 3-year average non-performing assets (NPA) ratio (NPAs include non-performing loans, guarantees, and equity impairments) has continuously fallen.

Over the past seven years, AFC's development assets have rapidly expanded with gross loans multiplying by almost five to around \$2.5 billion as of end-2020 from \$518.7 million as of end-2013, mostly to the private sector. At the same time, its portfolio of non-treasury equity investments multiplied by more than six to over \$920 million from \$145 million over the same period. The AFC's leverage ratio, defined as the sum of development assets and treasury assets rated A3 and lower as a proportion of usable equity, has risen significantly to 2.7x in 2019 from around 1.2x in 2013, before slightly decreasing to 2.55x in 2020.

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Our assessment of capital adequacy also captures the potential for losses stemming from a multilateral development bank's (MDB) mandate activities through an assessment of its Development Asset Credit Quality (DACQ). Given the challenging operating environment that is proxied by lower sovereign ratings in Sub-Saharan Africa in recent years, the quality of the Corporation's lending exposures has deteriorated, leading to a rise in impairment charges to \$77.5 million in 2019 from \$20.8 million in 2018. The expectation that this trend would continue did not materialise despite the pandemic and the adoption of IFRS 9, and impairment charges fell to \$38.6 million in 2020.

Similar to other MDBs with a private sector orientation, AFC's development assets include a large proportion of equity investments, as well as exposures to debt securities outside of its treasury portfolio. These investments are more susceptible to large losses than loans to governments that typically account for a large part of MDB operations, pointing to potential losses in future years.

Despite these asset quality challenges, AFC's consistent profitability and adequate provisions have allowed it to preserve capital. It remains more profitable and similarly leveraged than most of its similarly-rated MDB peers.

Our assessment of AFC's **liquidity and funding** at "a1" incorporates our expectation that it will continue to adhere to its conservative liquidity policy, in doing so maintain a solid liquidity position, even as the Corporation expands its lending operations and, consequently, its leverage. The availability of liquid resources (ALR), defined as the ratio of liquid assets to net cash outflows over the next 18 months, increased to 120% at the end of 2019 due to large issuances to prepay 50% of an outstanding obligation that matured in April 2020. Despite difficult market conditions, the ALR was maintained at 125% in 2020.

AFC's liquidity policy establishes a minimum liquidity level of 18 months of the sum of borrowing repayments, operating expenses, and other non-cancellable debt and equity commitments. In addition, most of its treasury assets are held in a portfolio of cash and other highly liquid instruments, such as placements with central banks and investment-grade commercial banks.

Other measures of liquidity are similarly solid. As a proportion of short-term debt plus currently maturing long term debt, AFC's stock of liquid assets remains strong, at around 664% at the end of 2020. Liquid assets also comprise more than half of the Corporation's total assets.

AFC's liquidity is also supported by broadening access to financing. Since its maiden eurobond issuance in 2015, AFC has continued to demonstrate stable access to international funding markets despite pressures affecting Sub-Saharan Africa more generally, supporting our broader assessment of the Corporation's liquidity. At the same time, AFC has diversified its funding from bilateral and multilateral sources.

To better capture the risks from the challenging operating environment, we have applied a negative adjustment to AFC's preliminary intrinsic financial strength score. This adjustment is consistent with those applied to other MDBs whose operations are concentrated in Sub-Saharan Africa, including the [East African Development Bank](#) (EABD, Baa3 stable), the [ECOWAS Bank for Investment and Development](#) (EBID, B2 negative) and the [Eastern and Southern African Trade and Development Bank](#) (TDB, Baa3 negative).

Our "Low" assessment of the Corporation's **strength of member support** reflects the poor credit quality of its shareholders, thus providing no uplift to AFC's intrinsic financial strength. While AFC's charter has been recently modified to introduce callable capital to new shareholders if they want to, AFC's share capital is currently entirely paid-in. As a result, the Corporation's credit profile reflects its intrinsic financial strength, as represented by our assessments of capital adequacy and liquidity.

We have also considered the high likelihood of extraordinary support from AFC's largest shareholder, the Central Bank of Nigeria, as well as the Corporation's ongoing efforts to attract additional shareholders. However, the ability of its members to provide support is weak with a weighted average shareholder rating of "B2", which is further constrained by the high level of correlation between members and assets.

ESG considerations

How environmental, social and governance risks inform our credit analysis of the Africa Finance Corporation

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing supranational issuers' credit profile. In the case of the AFC, the materiality of ESG to the credit profile is as follows:

Notwithstanding environmental issues being material for many of AFC's borrowers and shareholders, **environmental** considerations do not have a material impact on AFC's credit profile at this stage given the Corporation's portfolio diversification and its capacity to mitigate the indirect effects of adverse environmental events on its balance sheet.

Similarly, **social** risk informs AFC's credit profile in so far that it affects the credit profile of countries in which it lends – some of which are affected by social and political unrest, low wealth levels, income disparity and low voice and accountability scores.

Governance considerations are material to AFC's credit profile, which reflects sound governance principles and risk management framework. This is evidenced by the Corporation's management of rising NPLs following the 2015-16 commodity price shock, which was followed by increased staffing of key risk management functions and the adoption of tools to measure risks more accurately.

All of these considerations are further discussed in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology [General Principles for Assessing ESG Risks](#). Additional information about our rating approach is provided in our [Supranational Rating Methodology](#).

Recent developments

AFC's intrinsic financial strength proved resilient to the coronavirus shock

The corporation's capital adequacy has strengthened due to a slight decrease of its leverage ratio (development-related assets (DRAs) + liquid assets rated A3 or higher / usable equity) to 2.55x in 2020 from 2.7x in 2019, a first decline since AFC's inception in 2007. This decrease is due to a more gradual expansion of AFC's activities last year as well as an increase in its usable equity. The latter includes \$60 million from new shareholders, the issuance of \$200 million equity warrants to the Central Bank of Nigeria (CBN), and a self-contribution of \$115.2 million to the reserves from 2019 profits.

In addition, the AFC was able to maintain its development asset credit quality (DACQ) stable despite the impact of the pandemic on the continent. The corporation has been proactive in managing the risks inherent to the projects it finances and had to restructure few of them last year, corresponding to 5% of the loan book. This process is likely to continue in 2021 to deal with the aftermath of the pandemic. Overall, assets under watch (stage 2) increased only slightly, to 19.0% of total loans in 2020 from 17.2% in 2019. The corporation has managed to maintain the weighted average borrower rating of its DRAs at B3, in particular with the use of non-payment insurance (24% of the portfolio is covered) and the ongoing reinforcement of its risk management department.

Concerning asset performance, AFC's 3-year average NPAs ratio has also continued to improve, reaching 2.2% in 2020 from 5.9% in 2019 despite a slight increase in NPAs year-on-year to 2.4% in 2020 from 1.3% in 2019, once past due non-impaired (PDNI) assets are included. The portfolio's concentration risk of the corporation has also fallen because of the assets' diversification planned by the AFC as it expands to new countries. In particular, AFC's exposure to the oil and gas sector has continued to decline, representing only 18% of the portfolio in 2020 compared to 20% in 2019 and close to 50% in 2016.

AFC's liquidity and funding indicators have also remained strong throughout last year despite markedly deteriorated market conditions at the onset of the pandemic and more generally funding pressures affecting Sub-Saharan Africa issuers. AFC's availability of liquid resources (ALR) which compares projected net cash outflows over the next 18 months to discounted liquid assets, has even improved to reach 125% compared to 121% in 2019. This is significantly above the median of A-rated MDBs which stood around 80%. Similarly AFC's ratio liquid assets to total assets at 54% at the end of 2020 compares favorably to the median of A-rated peers at around 50%. AFC's ample liquidity buffers results in part from the corporation's adherence to its stringent liquidity policy. AFC continues to demonstrate a solid access to international markets with successful global issuances and its first green bond in 2020 seconded by strong partnerships with commercial banks for syndicated loans and Development Financial institutions (DFIs) for concessional credit lines.

Finally, the AFC managed to prevent a material erosion of its intrinsic financial strength throughout the pandemic partly due to the rigorous implementation of its prudential framework.

AFC is seeking to boost capital by increasing its shareholder base, introducing callable capital, and issuing equity warrants among others

The AFC's has continued to expand its sovereign membership since 2019, with five more countries including Mali, Republic of the Congo, the Democratic Republic of the Congo, Burkina Faso and Morocco. While several of its members have expressed interest in becoming shareholders, the corporation is also trying to attract additional non-regional shareholders to boost its capital. However, we do not expect any significant improvements in the underlying creditworthiness of AFC's current shareholders, who for the most part are facing negative credit pressure. The AFC has a broader objective to expand its capital base including non-regional shareholders by \$1 billion by December 2023, of which \$110 million has been achieved since the capital raising effort commenced in the third quarter of 2019. This strategy will further support AFC's capital position, including its Basel II ratio which stood at 34.1% in 2020 against 32.9% in 2019.

In December 2020, the AFC's charter was modified to introduce callable capital to new shareholders if they want to. The creation of shares with a paid-in and callable components requires a two-thirds majority approval at the existing shareholders at a General Meeting of the corporation. Yet AFC's share capital is currently entirely paid-in, unlike most rated supranational institutions. As a result, the corporation's credit profile reflects its intrinsic financial strength, as represented by our assessments of capital adequacy and liquidity, and does not include any uplift from member support.

The AFC also issued \$200 million equity warrants to the Central Bank of Nigeria in December 2020. This illustrates the preparedness of CBN, AFC's largest shareholder, to provide extraordinary support if needed. AFC's board of directors may decide to not convert the warrants into shares at the end of the 5-year period, especially if the corporation is successful at boosting its capital base in the meantime and it wants to preserve the current structure of shareholdings where the majority of shares are held by the private sector. Another way the Nigerian authorities could provide support in times of stress would be to buy more of the corporation's authorised capital (the CBN Act authorises financial assistance for development initiatives). The CBN is also willing to see its shareholding diluted to a small extent if there is Pan-African interest, in the form of other African governments buying a stake in the AFC, as long as the corporation remains private sector-led.

Rating methodology and scorecard factors

Rating factor grid - Africa Finance Corporation	Initial score	Adjusted score	Assigned score
Factor 1: Capital adequacy (50%)		baa2	baa2
Capital position (20%)		baa1	
Leverage ratio	baa1		
Trend	0		
Impact of profit and loss on leverage	0		
Development asset credit quality (10%)		b	
DACQ assessment	b		
Trend	0		
Asset performance (20%)		a3	
Non-performing assets	a3		
Trend	0		
Excessive development asset growth	0		
Factor 2: Liquidity and funding (50%)		a1	a1
Liquid resources (15%)		aa3	
Availability of liquid resources	aa3		
Trend in coverage outflow	0		
Access to extraordinary liquidity	0		
Quality of funding (35%)		a	
Preliminary intrinsic financial strength			a3
Other adjustments			-1
Operating environment	-1		
Quality of management	0		
Adjusted intrinsic financial strength			baa1
Factor 3: Strength of member support (+3,+2,+1,0)		Low	Low
Ability to support - weighted average shareholder rating (50%)		b2	
Willingness to support (50%)			
Contractual support (25%)	ca	ca	
Strong enforcement mechanism	0		
Payment enhancements	0		
Non-contractual support (25%)		Medium	
Scorecard-Indicated Outcome Range			A3-Baa2
Rating Assigned			A3

Note: Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of an issuer's performance as well as for peer comparisons. Additional considerations that may not be captured when historical metrics are used in the scorecard may be reflected in differences between the adjusted and assigned factor scores. Furthermore, in our ratings we often incorporate directional views of risks and mitigants in a qualitative way. For more information please see our Multilateral Development Banks and Other Supranational Entities rating methodology.

Source: Moody's Investors Service

Moody's related publications

» **Rating Methodology:** [Multilateral Development Banks and Other Supranational Entities](#), 28 October 2020

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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