February 2024

SA Corporate Credit – A Bridge Too Far?

As investors, we tend to view the world through a listed equity lens. Not only is it easy to find information on companies like Nvidia, Microsoft or Naspers, buying shares in these companies is also quite seamless.

In stark contrast to listed equity markets, the world of corporate credit is slightly more opaque and not as easy to access. Although many big companies actively participate in corporate credit markets, how they do so is less clear to many investors. However, not only do income funds invest meaningfully in corporate credit, but income funds also account for over 10% of South African unit trust assets, ~ R300bn[1].

A credit asset is really just a loan that one party provides to another that bears interest over a set period of time. In the world of investment management, that 'loan' is provided by asset managers to 'issuers', who are generally banks or companies. Credit assets are typically less risky than equity investments because holders of a company's debt are not considered investors, but creditors of the business which means that they have preferential access to the company's cash flows (i.e. if the company goes bankrupt, creditors will be compensated before equity holders). The full universe of investable credit is called corporate credit and it's best to think of it as its own asset class, like bonds, equities or properties.

Like all of those asset classes, corporate credit has its own unique characteristics that make it an attractive diversifying investment in certain portfolios. As we previously mentioned, it's generally less risky than equity and it also provides investors with a steady income stream. For that reason, it is quite a popular investment in income portfolios.

However, like all investments, it is by no means riskless. At the end of January, the JSE issued a cautionary SENS announcement to the market notifying investors that bought corporate credit in a company called Bridge Taxi Finance (Bridge) that an event of default had occurred on some of the debt that Bridge had issued.

Investors in corporate credit take on different risks, with the most prominent being credit risk. Credit risk is the possibility that a lender experiences a loss because a borrower cannot repay a loan. When credit risk actually materialises, it results in something called an event of default. In simple terms, an event of default occurs when a borrower is supposed to pay interest or capital to a lender but doesn't.

Every debt agreement that a borrower enters into with a lender has something known as 'debt covenants' written into the agreement. These covenants lay out restrictions that the lender places on the borrower to protect the lender from losing their money. When these covenants are breached, that can result in an event of default. The cautionary SENS announcement, which is really just an urgent notice that the JSE sends to the market, detailed the specifics of those covenant breaches.

One of the investors in the Bridge credit asset was a unit trust called the MiPlan Enhanced Income Fund. The fund had around R950m invested in the Bridge debt that the JSE was now telling the market the company was struggling to pay back. As an income fund manager, this is a tough situation, given that income funds generally look to provide investors with a decent level of capital protection. Ultimately, the JSE announcement was the first official piece of information that suggested that MiPlan's R950m investment was probably worth a lot less than that now because Bridge couldn't pay back its debt.

In times like these, as a fund manager, the last thing you want to do is cause panic. So, in an effort to provide their investors with some level of assurance, they released a note to investors. In this note, they told investors that they were monitoring the situation very closely, and to be safe, they were going to side-pocket the Bridge assets in a separate fund. Side-pocketing is a practice used by unit trust fund managers where they separate out illiquid assets (assets they can't sell at fair value) from the other assets in a fund and they create a new fund that only holds those illiquid assets.

The side-pocketed fund is called the MiPlan Enhanced Income Retention Fund and its only 'investment' is in the Bridge debt and its only investors are the investors in the MiPlan Enhanced Income Fund, that were invested in the fund when the assets were side-pocketed. The investors in the Retention fund cannot redeem their investments in the fund and the fund is not open to new investors. Part of the reason for this is that no one actually knows how much the Bridge debt is worth, because it is technically in

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default. The side-pocketed fund and the original fund are two separate vehicles, so selling out of the one does not mean that investors automatically sell out of the other, they are not currently able to sell their units in the side-pocketed fund.

As it stands today, MiPlan and the underlying asset manager, Vunani Fund Managers (Vunani), have taken the decision to write down the value of the debt from R950m to R650m, but in truth that is just an estimation. Because they have not received any repayments back from Bridge at this stage, the real value of the debt could be a lot less than R650m.

The rate of interest on a corporate credit is quoted as a spread over the Johannesburg Interbank Agreed Rate (JIBAR). JIBAR is really just the rate of interest that the South African Reserve Bank charges other banks to lend money from them. Because all other institutions in South Africa (all companies included), are riskier than the Reserve Bank, they borrow money from one another at a rate equal to JIBAR plus a bit more. To compensate for that risk, the extra interest is known as a spread. In summary, the wider the spread, the riskier the borrower, which makes sense. Investors should be paid higher returns for taking on more risk.

Listed equities trade regularly, with a willing buyer and a willing seller ultimately determining the fair price of the equity they are trading. In comparison, non-bank corporate credit has fewer buyers and sellers and does not trade as often as equities do. Changes in the ability of borrowers to repay their debt are not reflected in the price of the credit if it does not trade, i.e. the price of the credit is not marked-to-market.

The Liquidity Conundrum

We previously mentioned that MiPlan's Bridge debt that was worth R950m was now worth a lot less than that, and although Vunani currently values it at R650m it may well be worth less than that. In addition, because the debt is quite bespoke, there aren't many parties in the market buying and selling Bridge debt. Unfortunately, this liquidity problem isn't uncommon across the South African corporate credit market.

Indeed, South African credit markets have a liquidity problem. Most investors in this market tend to buy and hold their debt until maturity which means there aren't that many parties buying and selling debt which would lead to price discovery. Price discovery is the practice of buying and selling assets to establish how much they are worth. Listed equities are generally traded on a daily basis so prices for them are set several times a day, or when they trade.

Illiquidity in South Africa's corporate credit market is something that has concerned us for some time. And, while it doesn't seem to be endemic at this stage, i.e. there are more and less liquid parts of the market, its important to choose your investments wisely. The ability to choose credit investments wisely is something that we look for in the income managers we rate.

The illiquidity problem has been compounded by the fact that over the past decade we have seen substantial inflows into income generating assets within both the retails and institutional savings industry. Ultimately, what this means is that an increasingly large pool of assets is being allocated to a relatively illiquid asset class.

Let's take a closer look at the specific example of Bridge Taxi Finance and how the business landed up in such a mess.

Bridge Taxi Finance – An Overview

Founded in 2013, Bridge Taxi Finance is a business that provides affordable credit facilities to South African taxi drivers looking to buy mini-bus taxis. Essentially, how the company's business model works is they raise capital from investors, they then use that capital to import mini-bus taxis from China which they then sell (on finance) to taxi drivers in South Africa. The debt that the MiPlan fund bought was issued by Bridge through two different structures. How those structures work is relatively complex but what is important to know is that they were called RedInk Rentals (RedInk) and Martius RF Ltd (Martius). The covenant breaches that we spoke about previously are shown below.

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Bridge Taxi Finance – Covenant Breaches

Issuer	Date	Comment
RedInk Rentals Transaction 7	30 Sep 2023	Interest Cover Ratio* (ICR) breached in respect of the Revolving Loan Facility Agreement. Subsequently remedied by 20 November 2023.
	31 Dec 2023	ICR breach reported. Breach not remedied. Interest cover ratio (minimum required = 1.75x), as at end December 2023 this was reported at 0.75x (meaning there was insufficient cash to service interest).
	17 Jan 2024	R18.36m of interest was due to lenders, of which a partial payment was made of R10.2m. The balance was settled late on the 23rd January.
Martius RF Ltd	30 Nov 2023	ICR breached in respect of the Revolving Loan Facility Agreement, this was subsequently remedied by 20 November 2023.
* An interest coverage ratio is a financial ratio that helps determine whether a company can pay off its debt, the higher the ratio the easier it is for the company to pay their debt.		

Source: JSE, Ninety One

Finding information on the RedInk and Martius structures is tough because the debt was privately placed, which means it wasn't distributed to investors publicly but directly, and its relatively concentrated in a few holders (only two asset managers that we know of had exposure). However, we do have some information on how one of the RedInk transactions was structured.

From a structuring perspective, it's a relatively clean transaction, with the big risk being, what if the taxi drivers can't pay back their car loans? Well, that is exactly what has happened.

The asset or 'security' that underlies the funding structure is the taxis that the company imports from China. What that means is that if the mini-bus taxi drivers who buy the taxis are unable to pay their instalments on the vehicles (defaulting on their payments) the taxis are repossessed by Bridge. The taxis can then be sold to honour the commitments to the note holders. The average yield on the RedInk notes was a spread of 785bps above 3m JIBAR for notes with a 3-year maturity, which is about 4x higher than the average spread on similar non-bank corporate credit. This should give you some indication of their riskiness.

Bridge Taxi Finance is one of a few companies that operates in the Taxi Finance industry in South Africa with the major player being SA Taxi, part of the JSE Listed Transaction Capital Group. Although their business models are similar, the one notable difference between the two businesses is the underlying quality of the taxis they import. While SA Taxi imports Toyota taxis, Bridge imports cheaper taxis that don't have a great resale value. So, when they are repossessed, they aren't worth as much.

Some Final Thoughts on the Corporate Credit Market

As we previously mentioned, liquidity in the South African corporate credit market is an issue that has concerned us for some time. While exposure to the Bridge notes was relatively contained among two asset managers (Vunani and Saffron Wealth) and some multi-managed funds, it has led to some questions around the broader health of the corporate credit market.

None of the Income funds that we rate positively or any of the funds we use in model portfolios had exposure to the Bridge credit assets largely because they felt it was too risky for those mandates given the spread. In addition, the income fund managers we rate positively tend to position themselves quite cautiously in corporate credit and are aware of the liquidity risks that the asset class faces.

Ultimately, the fact that non-bank corporate credit is not marked-to-market means that the true level of riskiness embedded in these investments is not known. As the Bridge example shows us, everything tends to be fine with non-bank corporate credit until it isn't anymore.

[1] Association for Savings and Investments South Africa (ASISA), 31 December 2023

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MARKET REPORT

29/02/2024

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
SA Equity	ZAR	-3.6%	-5.4%	-3.5%	6.8%	8.5%	7.0%	17.1%	14.2%
SA Listed Property	ZAR	15.1%	4.8%	17.1%	14.1%	0.2%	3.2%	27.0%	21.3%
SA Bonds	ZAR	1.5%	0.1%	7.1%	6.6%	7.1%	-	8.4%	-
SA Cash	ZAR	2.1%	1.4%	8.3%	6.0%	6.0%	6.5%	0.5%	0.4%
Balanced Benchmark	ZAR	0.8%	-1.3%	4.8%	8.4%	9.2%	8.2%	11.8%	9.7%
SA Inflation (1 month lag)	ZAR	0.0%	0.1%	5.3%	6.0%	5.1%	5.1%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity	USD	10.7%	5.2%	25.1%	8.8%	11.8%	9.2%	18.0%	15.0%
Emerging Markets Equity	USD	3.9%	-0.1%	8.0%	-6.6%	1.5%	2.7%	19.1%	17.4%
Global Property	USD	4.4%	-5.6%	0.5%	-1.3%	-0.2%	2.7%	20.6%	16.7%
Global Bonds	USD	1.4%	-2.6%	3.0%	-5.5%	-1.1%	-0.2%	7.5%	6.2%
US Cash	USD	1.4%	0.9%	5.4%	2.5%	2.0%	1.4%	0.6%	0.5%
MAJOR INDICES BASED TO RANDS									
SA Equity	ZAR	-3.6%	-5.4%	-3.5%	6.8%	8.5%	7.0%	17.1%	14.2%
Global Equity	ZAR	12.0%	9.3%	30.7%	17.7%	19.0%	15.7%	15.9%	15.7%
Emerging Markets Equity	ZAR	5.2%	4.8%	12.9%	1.0%	8.0%	8.9%	14.4%	13.8%
Global Property	ZAR	5.7%	-1.9%	5.0%	6.7%	6.2%	8.8%	18.7%	17.1%
SA Bonds	ZAR	1.5%	0.1%	7.1%	6.6%	7.1%	7.1%	8.4%	8.0%
Global Bonds	ZAR	2.7%	2.1%	7.7%	2.2%	5.3%	5.8%	13.4%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	0.6%	-0.7%	12.1%	5.4%	9.0%	4.2%	14.4%	13.5%
Gold (Rands)	ZAR	1.8%	4.1%	17.2%	14.0%	16.0%	10.4%	17.8%	16.9%
CURRENCIES									
Rand / Dollar	ZAR	-1.8%	-5.0%	-4.8%	-8.3%	-6.4%	-6.0%	14.3%	14.7%
Rand / GBP Pound	ZAR	-1.8%	-4.1%	-9.2%	-4.8%	-5.4%	-3.0%	12.3%	14.2%
Rand / Euro	ZAR	-1.0%	-2.8%	-6.7%	-4.4%	-5.3%	-3.4%	11.6%	13.0%

KEY

Asset Class	Represented By:
SA Bonds	Satrix Bond Index Tracker
SA Cash	STeFi
SA Equity	Satrix ALSI Index Tracker
SA Listed Property	Satrix Property Index Tracker
Emerging Markets Equity	iShares Emerging Markets Equity Index Tracker
US Cash	Fidelity Institutional Liquidity The United States Dollar
Global Bonds	iShares Core Global Aggregate Bond ETF
Global Equity	iShares Developed World Index Tracker
Global Property	iShares Developed Real Estate Index Tracker

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REDFIN WEALTH

INVESTMENT - RETIREMENT - FINANCIAL PLANNERS

February 2024

Spot Rates		29-Feb-24	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	19.2	18.3	18.4	14.1	10.7	6.7
Rand/GBP	Rand	24.3	23.3	22.2	18.7	18.0	12.3
Rand/EUR	Rand	20.8	20.2	19.5	16.0	14.8	8.3
RATES							
SOFR 6m $	US$	5.7	5.6	5.3	2.7	0.3	1.2
Repo Rate	Rand	8.25	8.25	7.25	6.75	5.50	8.00
Prime	Rand	11.75	11.75	10.75	10.25	8.50	11.50
All Bond Index Yield	Rand	10.4	10.3	11.6	9.5	8.7	9.7
COMMODITIES							
Gold ($/oz)	US$	2 045.5	2 065.5	1 826.0	1 315.7	1 325.7	395.3
Platinum	US$	887.0	1 006.0	951.0	871.0	1 455.0	877.0
Oil (Brent Crude) $	US$	83.8	77.7	84.0	66.0	109.1	33.2
INFLATION							
SA Inflation	%	5.3	5.5	7.0	4.0	5.8	9.4

data provided by FE Analytics

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