Manufacturing Africa

Ethiopia's Currency Landscape and Outlook

Guidance for Investors

June 2024

This study has been funded by UK aid from the UK Government; however, the views expressed do not necessarily reflect the UK government's official policies

Disclaimer

The analyses and conclusions contained in this report are based on various assumptions that we have developed based on interviews with companies, investors, banks, and other stakeholders in the Ethiopian financial market conducted in April and May 2024, as well as analysis from the secondary research. These findings may or may not be correct, dependent upon factors and events subject to uncertainty; future results or values could be materially different from any forecast or estimates contained in the analyses, and no portion of the analyses is a recommendation with respect to price or a recommendation with respect to whether any person should proceed with any proposed investment or acquisition.

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Although much of the deal structuring will depend on the company strategy and its risk appetite, there are a number of important considerations when investing in Ethiopia. All the points listed in the deck have been chosen for their applicability to one of the possible future exchange rate regime scenarios that may materialize.

Context and objectives

Background and context

Context

Manufacturing Africa (MA) is a UK-government funded programme that aims to attract £1.2 billion of FDI and create 90,000 jobs by providing manufacturing companies and investors with transaction facilitation support. The programme currently operates in Ethiopia, Kenya, Rwanda, Tanzania, Senegal, and Nigeria. MA team was commissioned to produce a brief for investors operating or planning to operate in Ethiopia in the current foreign exchange constrained environment.

The Ethiopian Birr has been experiencing enduring decline in value against major international currencies, most notably the US dollar. Forex reserve levels have been at their lowest in recent years due to poor export performance and reduced inflow of external finance.

This situation leads to constraints with foreign investments coming into the country, due to repatriation and importation concerns. There is increased pressure on the Government of Ethiopia to devalue the Birr to better reflect market realities. This guidance document will provide an analysis of macroeconomic and regulatory context for FX and potential future landscape for FX.

Objectives

The work was carried out according to the following sections:

Section 1
Assessment of Current Landscape and Future Policy Direction for FX in Ethiopia

This section covers the following:

- Current FX realities, including official models of exchange; unofficial channels and usage; institutional landscape
- Historical exchange rate regime in the country
- Scenario building according to 3 policy options: 1) no change 2) gradual change; and 3) significant change (floatation).

Section 2
Operating in Ethiopia with Considerations of the FX Issues

Under this section we provide recommendations to investors on:

- Deal structuring in light of FX and repatriation issues (inc. timing of release of funds – e.g. phasing; debt, equity, and other instrument adaptations; buyback and other exit mechanisms)
- Potential use of funds pre-exit (current investment areas in Ethiopia, and their liquidity, given reparation issues)

And close with International comparisons – approaches to the above topics in countries with similar currency challenges (Nigeria, Egypt, Kenya, Tanzania, Rwanda).

Executive Summary (1/2)

In this section, we present summery of key findings, our analysis, and recommendations.

Current FX landscape

The National Bank of Ethiopia closely manages the value of the Birr to the US $ to maintain the purchasing power of the Birr. However, this leads to perpetual overvaluation and a **shortage of foreign exchange in the official market**.

- 80% of the value of the formal remittances flow is transacted through informal channels, compared to 50% a few years ago.
- Export of services (mainly transport) is the biggest contributor to FX inflows in Ethiopia, where the Ethiopian Airlines plays a major role (with revenues upwards of $6bn).
- Majority of FX (~66%) is used to import goods, although its share is on the decline as portions of FX used in debt repayment and service imports rise.
- The real effective exchange rate (REER) index has shown a significant decline since 2019/2020, indicating that exports have become relatively more expensive.
- Inflation has been tracking the parallel market exchange rate.

Impact on investment

Our interviews with over 15 companies, investors, and banks; as well as findings from secondary research have identified several adverse impacts on business and investment in Ethiopia.

- The cost of accessing FX is also increasing and further constraining businesses. For example, companies reported that significant deposits are being required to open letters of credit, and delays in approvals of supplier credits are also resulting in increased interest rates.
- Ethiopia accounted only for 2% of M&A deals made in East Africa in 2022 (lowest in the region).
- The number of licenced investment projects has decreased by 6 times for foreign investors and 21 times for domestic investors over the past 4 years.

Executive Summary (2/2)

In this section, we present summery of key findings, our analysis, and recommendations.

Overview of future policy scenarios

We relied on government commitment statements, reports on the on-going negotiations with the IMF, an analysis of macroeconomic markers to estimate the likelihood of a significant policy change (floatation) taking place.

- The likelihood that there will be no policy change is low, if this occurs however it would lead to the FX situation remaining the same and the premium between official and the parallel exchange rate will continue to grow.
- Gradual devaluation of the Birr maybe a preferred option in minmizing the shock to the economy, but there is growing consensus that it will not significantly improve FX availability and convertibility issues, and the parallel market will remain active.
- Ongoing discussions between GoE, IMF and other multilateral institutions, as well as government commitment statements and actions (e.g., reducing broad money supply and lowering inflation) signal appetite towards floatation. No agreement has yet been reached, however.

Recommendations for deal structuring

Based on experience from existing investors in Ethiopia and learnings from other countries where investors operated in FX constrained environments, we recommend several pre-exit and exit strategies under the possible future policy scenarios.

- In a scenario where there will be no or slow policy change, we recommend investors to consider pre-exit strategies such as; investing in vertical/horizontal supply chains, export businesses, or other areas of the economy.
- For exiting investments under a no or slow policy change scenario, we recommend (among other things) to structure deals for strategic/long term investors to come in.
- De-risking instruments and tools (equity/debt mix, guarantees, grants, insurance, and tax benefits) can also be used to mitigate against capital, liquidity, currency and exit risks.
- Floatation is expected to broaden options for repatriation, repayment, and exit.

Contents

01 Assessment of Ethiopia's current Foreign Exchange (FX) situation and impact on investments

Ethiopia's Foreign Exchange Landscape (1/4)

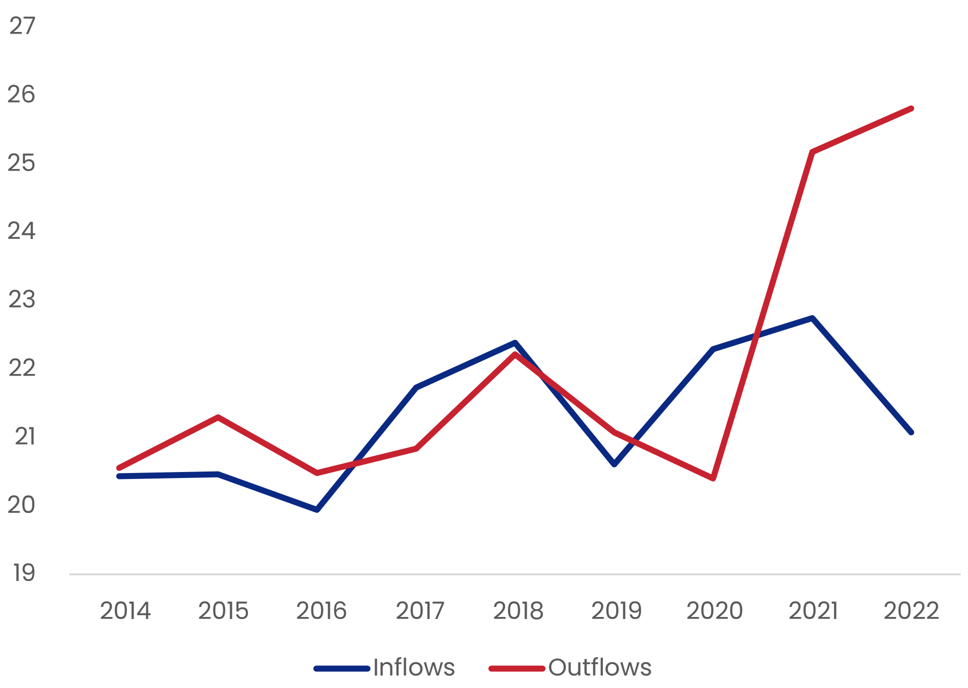
Background and context

The National Bank of Ethiopia closely manages the value of the Birr to the US $ to maintain the purchasing power of the Birr. However, this leads to perpetual overvaluation and a **shortage of foreign exchange in the official market**.

Inflows of foreign exchange (such as remittances) are incentivised to flow mostly through unofficial routes while outflows tend to use official exchange rates. **An estimated 80% of the value of formal remittances is transacted through informal channels, compared to 50% a few years back, creating a continuous excess demand for foreign exchange**.

As a result, **trade has become highly regulated**, with all payments abroad requiring permits and all transactions with foreign parties using foreign exchange being restricted to transactions through authorised dealers.

Foreign Exchange inflows and outflows through official channels



Source: National Bank of Ethiopia (NBE)

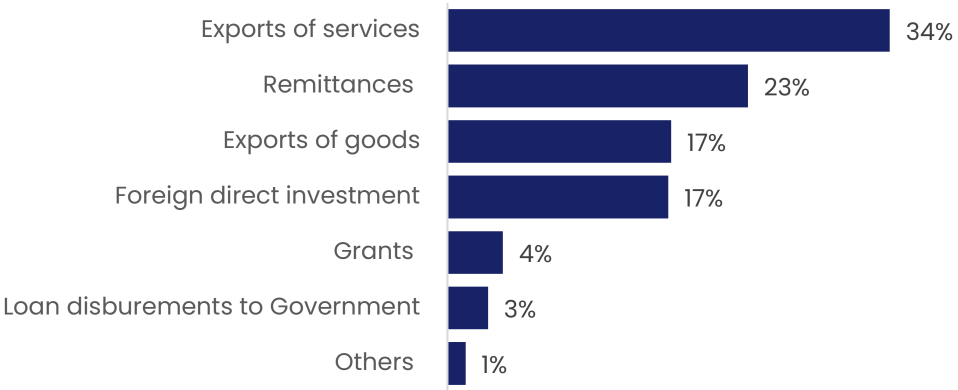
80%

Of the the value of the formal remittance is transacted through informal channels, compared to 50% only a few years ago.

Ethiopia's Foreign Exchange Landscape (2/4)

The majority of forex comes from service exports while 22% is used for the import of petroleum products

Sources of FX (%)



Main Uses of FX(%)

11% Debt repayment

22% Service imports

66% Imports of goods

Source: NBE

Sources of FX

The main sources of FX are service exports (e.g., air transport) holding 34% of the total inflows, followed by remittances (23%) and goods exports (17%). Few years back, remittance was the largest source of FX.

Transport is the main source of service exports, contributing a significant 76% of the total. Ethiopian Airlines is a major player, with its revenue reaching $6 bn as of June 2023.

Uses of FX

Imports account for the largest share of FX transactions (about 2/3) and are primarily made up of petroleum products and industrial goods.

The **share of goods imports has declined over the past decade, dropping from 80% to 66%**, coinciding with a rise in the share of service imports and debt service.

Ethiopia’s Foreign Exchange Landscape (3/4)

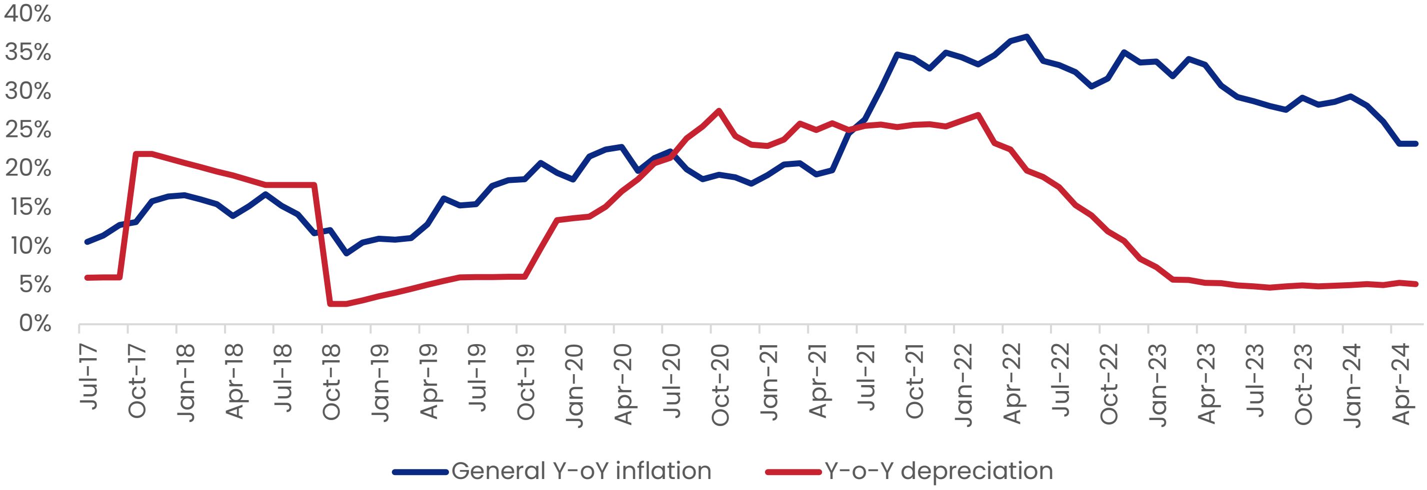
A look back at the exchange rate regime

Overview

Ethiopia formally maintains a **crawling peg as an exchange rate regime, with the Birr pegged to the US dollar.**

A parallel, unofficial exchange market has started operating as the Birr became overvalued due to a lower rate of depreciation compared to rate of inflation. This has led to **shortages of forex reserves.**

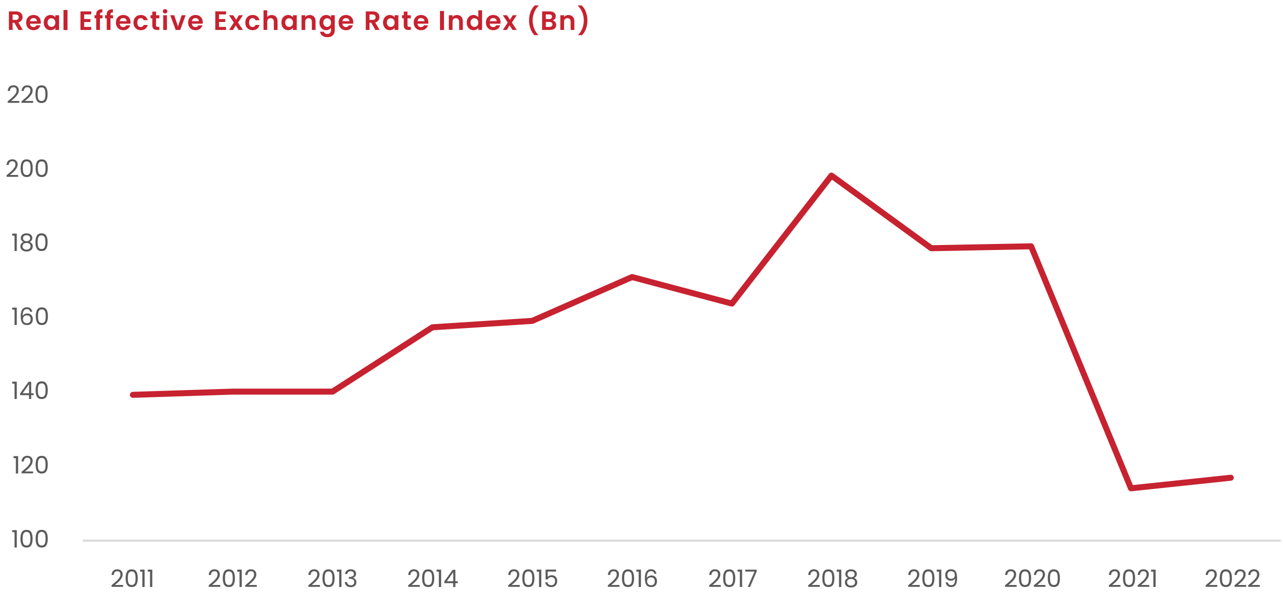
Y-o-Y Rate of Depreciation and Inflation (%)



Source: CBE exchange rate, ESS

Ethiopia's Foreign Exchange Landscape (4/4)

10 year look back at the exchange rate regime



Source: CBE exchange rate, ESS

Key insights

01

Despite the significant currency devaluation over the past years, inflation has outpaced the depreciation rate.

02

The real effective exchange rate (REER) index has shown a significant decline since 2019/2020, indicating that exports have become relatively more expensive.

03

Ethiopia's FX reserves have declined significantly in recent years, falling below $1bn as of July 2023 (which covers less than 2 weeks of imports).

Overview of the Current Forex Access Mechanisms (1/3)

Stock take of the current foreign exchange mechanisms available to businesses operating in Ethiopia

Letter of Credit (LC)

More on this on page 13

Commitment by the Ethiopian importer's bank to pay once the international supplier ships the goods and presents the required documentation to the international supplier's bank. Local bank is obligated to **pay within 5 days** of receiving documents.

Most widely used FX mechanism.

Process

- Application is sent to NBE, where it will wait in queue
- Upon availability of funds, importer is contacted to cover full LC value plus fees in Birr along with relevant documents
- Bank notifies supplier & bill of lading sent to importer's bank before payment is made. LC has to remain open until goods arrive.

Cost

- NBE fees include fixed rate of 2% LC value
- Commercial bank fees vary between

9-12%

Timelines

- ~3-6 months
- Waiting periods vary widely across banks depending on FX available and classification of imported goods
- Even when importers have FX, they can still face processing delays up to 90 days.

Cash against document (CAD)

Requirement for an international supplier to present an invoice and shipping documents through its bank to the Ethiopian importer's bank. Local bank is **not obligated to pay** until importer deposits 100% of goods' value plus fees.

Second most common mechanism for accessing FX. Typically used where Ethiopian importer and supplier have a strong relationship.

Process

- Local bank effects payment upon receiving documents (i.e., bill of lading, certificates of origin, and packing list etc...) from the exporter's bank.
- Local banks required to collect full purchase amount plus fees in Birr before approving CAD requests.

It is less administratively onerous than a LC.

Cost

- NBE fees are 2% value of NBE payment
- Commercial bank fees vary between 9-12%.

Timelines

- ~3 to 6 months
- Waiting periods vary widely across banks depending on FX available and classification of imported goods.

Notes: 1. Outside of the listed official access mechanisms, it is important to note that banks and clients use parallel market and other exceptions to access FX.
2. These process are frequently changing, and we therefore recommend consulting with a financial advisor for the latest information.

Overview of the Current Forex Access Mechanisms (2/3)

Stock take of the current foreign exchange mechanisms available to businesses operating in Ethiopia

	Process	Cost	Timelines
Franco-valuta arrangements License to import goods on which FX is not sourced from the banking system. Only applicable for qualifying Ethiopian importers on agreement with EIC/MoF and Customs Authority. • GoE passed a directive allowing imports of essential food commodities without permits (2021) • MoF lifted minimum threshold of $250K making it more accessible (2022)	• Request made to EIC/MoF for importation permits • Final approval made by Customs Authority. Ministry of Foreign Affairs issues importation permits to diplomatic missions.	• Providers of the hard currency ask for premiums of up to 100%. • Importers make payments from off-shore bank accounts (the accounts need not necessarily be theirs) • The FX may also be sourced from retention accounts or the parallel market.	• No waiting time for FX to be allocated, but processing time for approval can vary.
Supplier's Credit Agreement under which an international supplier will supply goods or services to an Ethiopian importer on credit terms. Supplier gets paid on sight or as per the payment terms by international supplier's bank, while the Ethiopian importer gets a credit period to make payment from importer's bank. **This mechanism is riskier for local banks and NBE as FX payments are payable on demand.**	• Application is sent to NBE for use of Supplier's Credit Scheme, including relevant customs documents and loan terms • Appointment of local bank to act as advisor • Deferred FX payments are then payable on demand.	• 7.5% interest (could double to 15% due to delayed payments by commercial banks).	• ~3 to 6 months.

Notes: 1. Outside of the listed official access mechanisms, it is important to note that banks and clients use parallel market and other exceptions to access FX.
2. These process are frequently changing, and we therefore recommend consulting with a financial advisor for the latest information.

Overview of the Current Forex Access Mechanisms (3/3)

Stock take of the current foreign exchange mechanisms available to businesses operating in Ethiopia

Telegraphic Transfer (TT)

A method of transferring funds electronically that is most commonly used when transacting internationally.

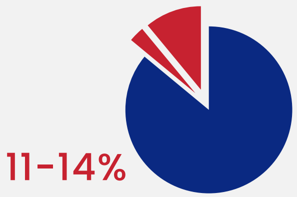
Maximum transfer limits of $5000 US dollar limit the demand for TT for large-scale importing businesses.

Process

- Application is sent to bank alongside pro forma invoice
- Applicant’s bank then adds application for FX to its system and forwards request to NBE
- When FX is allocated, bank will transfer funds to supplier's bank.

Cost

- NBE 2% fee
- Commercial bank fees vary between 11-14% of import value.



Timelines

- ~3 to 6 months.

Notes: 1. Outside of the listed official access mechanisms, it is important to note that banks and clients use parallel market and other exceptions to access FX.
2. These process are frequently changing, and we therefore recommend consulting with a financial advisor for the latest information.

Zoom into the process for obtaining a Letter of Credit

We provide more detail on the process for obtaining a LC as it is the most commonly used mechanism.

Letter of Credit

01

The importer applies for an LC through a commercial bank once they have negotiated terms with the supplier and the supplier has issued the pro-forma invoice.

02

The commercial bank reviews the details of the pro-forma invoice focusing specifically on the price of goods ordered to confirm that they are market related.

If approved, the request for the required foreign exchange is submitted to the queue.

03

The application is forwarded on to the National Bank of Ethiopia (NBE) and the importer is required to pay the initial fees.

04

The importer is required to wait until the requested foreign exchange has been allocated.

05

Once the foreign exchange has been allocated, the importer will be contacted by the bank to cover the full LC value plus fees in Birr after which the importer will be required to submit relevant import documents to the bank.

06

The bank will then notify the supplier and the exporter would then send the bill of lading to the importer's bank.

07

Once the importer's bank receives the bill of lading, payment is then made to exporter's bank.

It is recommended that investors work with financial advisors as processes change regularly.

Views from the business community in Ethiopia

We carried out 25 interviews with a range of stakeholders in Ethiopia to understand how they manage the current FX situation (April 2024).

We selected a range of businesses and financial institutions already operating in Ethiopia with a focus on import dependent industries.

15 businesses

6 local banks

4 investors

"A continued foreign exchange shortage would force us to shut down production, impacting the livelihoods of 129 employees."

Steel manufacturer

"While I remain hopeful for a positive outcome, I will be forced to shut down if the existing conditions continue. I will utilise the proceeds from the sale of machinery to fulfill outstanding loan obligations and return to my home country to look for other opportunities."

Plastics manufacturer

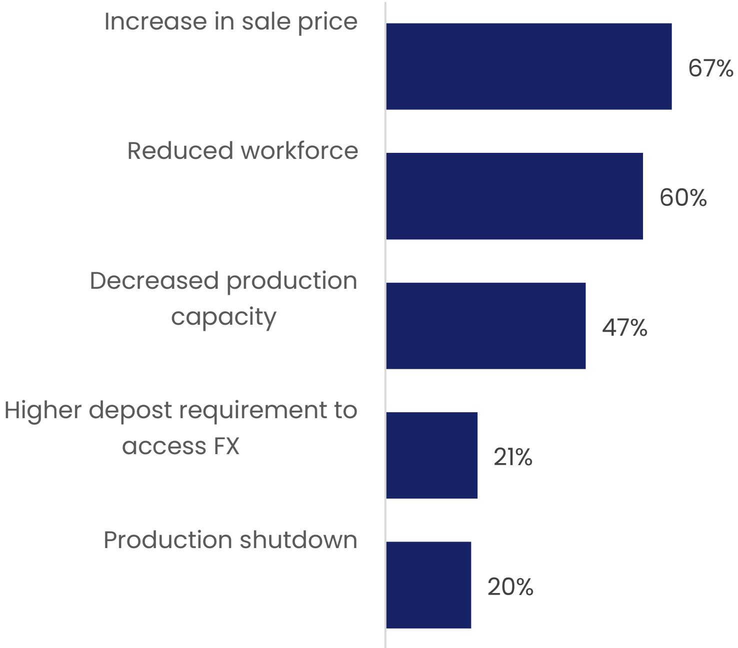
"Securing LCs through official channels has become extremely difficult, forcing us to explore alternative source of FX despite being classified as a priority sector."

Pharmaceuticals manufacturer

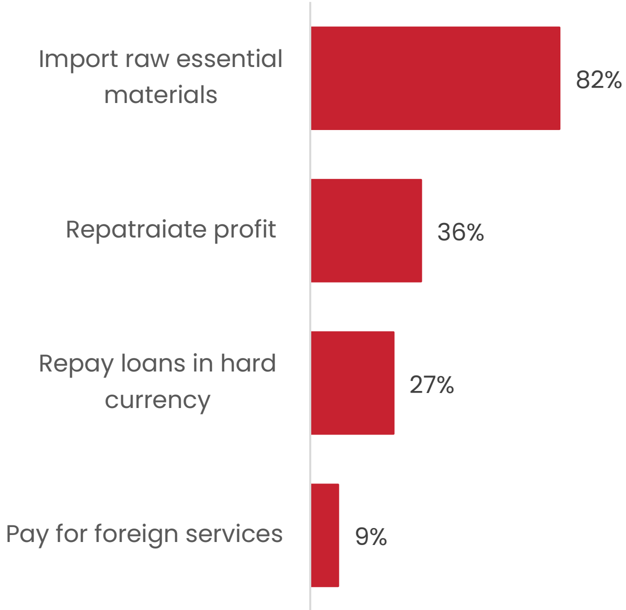
Impact of foreign exchange shortage on firms

We gathered the following insights from interviews carried out with companies operating in Ethiopia

Impact on companies' operations due to the FX situation



interviewed firms reported experiencing limited ability to:



Based on interviews with 15 companies operating in Ethiopia (April/2024)

Key insights from interviews

01

High costs of importing raw materials have resulted in layoffs and reduced production capacity. Some factories have been forced to close.

02

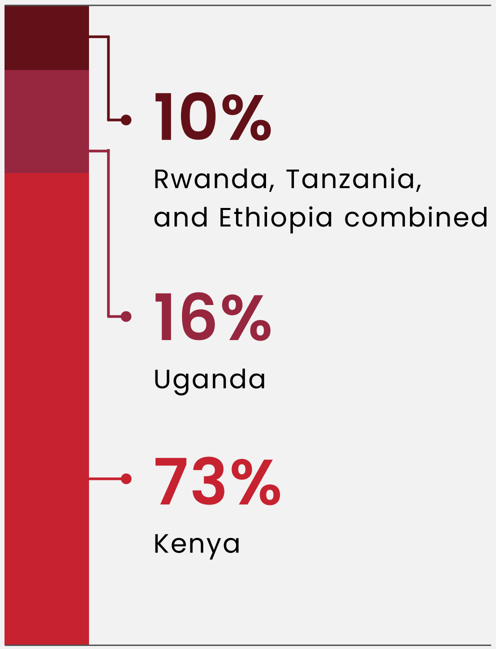
The cost of accessing FX is also increasing and further constraining businesses. For example, companies reported that significant deposits are being required to open letters of credit, and delays in approvals of supplier credits are also resulting in increased interest rates.

03

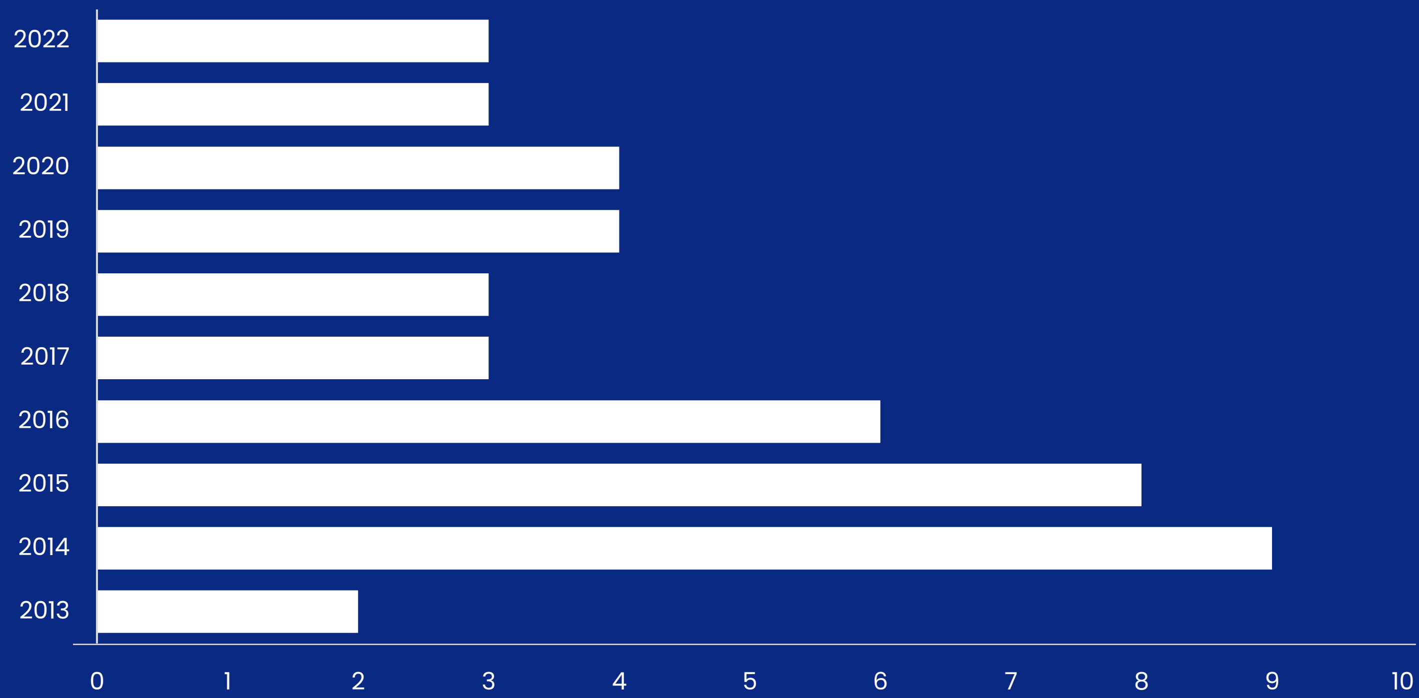
Businesses are increasingly using alternative markets to access FX (exporter's FX retention accounts, transfers from abroad etc.)

Ethiopia only accounts for 2% of the M&A deals made in East Africa in 2022 (lowest in the region)

Despite its attractive demographics, Ethiopia's economy faces challenges due to recent conflicts, currency limitations, and difficulty repatriating investments



Number of M&A deals in Ethiopia over the past decade



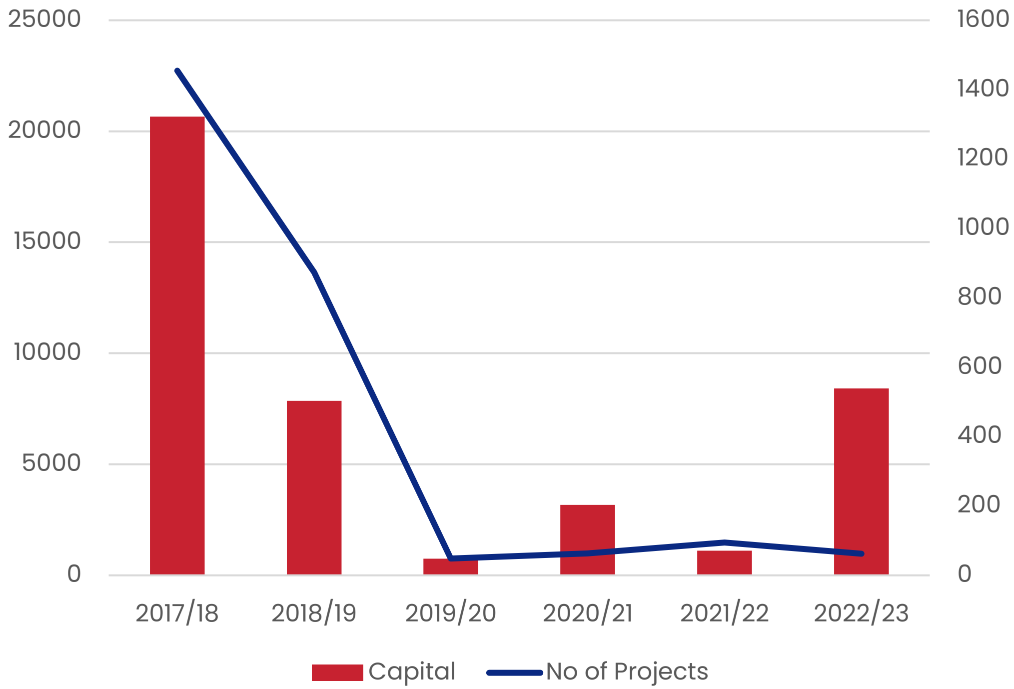
Source: East African Venture Capital Association (EAVCA)

Investment licences

The number of licenced investment projects has decreased by 6 times for foreign investors and 21 times for domestic investors over the past 4 years. However, foreign investor share has been on the rise.

Despite a 34% decline in total operational investments compared to June 2022, foreign investments have seen a 7% increase.

Capital and the number of operational investments



Key Insights

01

Reduction of investment from FX-dependent firms.

02

Focus on companies that have a foreign affiliate or parent company able to provide supplier credit.

03

Prioritisation of companies that have access to export markets.

04

Creation of market instability, hindering competitiveness both locally and internationally.

05

The situation is challenging mainly for equity investment, due to repatriation concerns.

Source: Central Bank of Ethiopia

Regional exits over the past decade

Relative to the region, Ethiopia has seen a very low number of exits in the last 10 years

Over the past decade, a total of 51 exits have occurred in East Africa.

Kenya has the highest share with 72% of exits in the past decade, followed by Uganda and Rwanda.

Ethiopia holds only 2% of the total exits from the region, highlighting the challenges faced by investors in country.

The trend can partly be attributed to the current challenging forex environment. Investors may expect improved returns and/or better valuation should there be a policy change.

Number of private equity exits over the past decade in East Africa

Despite the difficult operating environment, investments continue to materialize

Below we present successful PE/VC and DFI-backed investments that were disclosed in Ethiopia in 2023. Additionally, greenfield investments from large international industrials (China, India, Turkey) continue to occur.

Investor	Sector	Company	Deal size (US$m)	Type
54 Capital/Norfund	Fast-moving consumer goods	Samanu	21	PE-DFI
IFC-MIGA	Information and communication technology	Safaricom	257	PE-DFI
Zoscales Partners	Healthcare	Pioneer Diagnostic Center	Undisclosed	PE
Inclusion Japan	Information and communication technology	Gebeya Inc	Undisclosed	PE-VC
Renew Capital	Information and communication technology	Teraki	Undisclosed	PE-VC

Future Outlook: Current policy discussions

Current context

Ongoing discussions with IMF

Ethiopia is reportedly requesting roughly $11.5 bn from the IMF to be disbursed in instalments. The first tranche is expected to be around $3.5 billion. Negotiations with the IMF are ongoing, and an agreement is expected by June 30, 2024. The extension of the debt restructuring deadline to June also suggests an imminent announcement.

The government is considering two main exchange rate strategies:

- **Partial devaluation followed by a gradual transition to a floating exchange rate system:** This approach would involve an initial devaluation of the Birr by a significant amount, followed by a controlled movement towards a market-determined exchange rate over a predetermined period.
- **Full adoption of a floating exchange rate system:** This option would eliminate any government control over the exchange rate, allowing it to fluctuate freely based on supply and demand in the foreign exchange market.

In the next section, we will present these two scenarios + no change scenario and provide an analysis of what the implications would be for investors.

Divergence between official and parallel exchange rate

Official and Parallel Exchange Rate (Birr/USD)

02 Overview of potential future FX policy direction

Signals of a potential currency float

Ethiopian government has signalled in the Homegrown Economic Reform (HGER 2.0) Framework its intention to transition towards market-based system.

Negotiations with the IMF in first half of 2024 to secure a loan deal are yet to be resolved and speculation in the market is that Ethiopia's government is reluctant to agree to a deal that includes currency reform measures resulting in a free-floating Ethiopian Birr. This is not due to the liberalisation itself, but rather due to the timing of such liberalisation and the fact that floatation could result in significant depreciation of the birr which would fuel inflation in an already elevated inflation environment.

Regarding the timing of any potential floatation of the exchange rate, there are a number of factors to consider. With inadequate foreign currency reserves available, the IMF deal is critical to the stability of the Ethiopian economy and the ability of government to hold out in terms of its planned policy reform is limited over medium term.

The government is implementing a tighter monetary policy to curb the inflation, aiming to bring it down to the low-to-mid 20s by the end of June 2024 (by raising the credit cap to 14% and restricting broad money growth.)

> The Government will "prioritise reforming the existing monetary policy and exchange rate frameworks, transitioning towards a more modern and market-driven approach." (1)
>
> *Ethiopia's Homegrown Economic Reform*

> … (we) are working towards currency liberalisation, (…) the market should determine the value of the Birr and (we) are currently arranging things such as stabilising the interest rates. (2)
>
> *The Governor of the Central Bank of Ethiopia*

> Ethiopia's foreign exchange problems will be fully addressed within the coming two years, at maximum. (3)
>
> *Ethiopian Official*

(1) Ethiopian Homegrown Economic Reform 2.0, p.42
(2) No Ethiopia deal as IMF visit ends. African Business. 8 April 2024. https://african.business/2024/04/finance-services/no-ethiopia-deal-as-imf-visit-ends
(3) IMF notes "substantial progress" in dragging Ethiopia bailout negotiations. The Reporter. 18 May 2024. https://www.thereporterethiopia.com/40049/

Overview of FX policy scenarios in Ethiopia

Our analysis looks across three potential scenarios.

1. No change scenario
If GoE maintains the current policies related to FX.

2. Gradual policy change
If GoE strategically devalues the currency and implements a gradual policy shift.

3. Significant policy change
Full transition to a market-determined, floating exchange rate system

	1. No change scenario	2. Gradual policy change	3. Significant policy change
Inflation	Projected to continue declining, potentially reaching around 20% by the end of 2024.	A significant devaluation is likely to push inflation higher in the short term, as essential imports like fertilisers, capital goods, and fuel will become more expensive.	Cross-country comparisons suggest that inflation will likely spike for several months in countries heavily reliant on imports. However, this surge could be temporary if the government effectively stabilises the exchange rate.
Foreign exchange	Importers likely to continue relying on the parallel market, widening the gap between the official and parallel exchange rates. This could make exports less competitive and hurt the profitability of exporters (e.g., reduced profit margins).	Devaluation may modestly narrow the gap between the official and parallel market exchange rates. However, a persistent foreign exchange shortage could still lead to a gradual widening of the gap in the medium term.	The expected $11bn injection, including debt restructuring, could alleviate the FX shortage, provided the central bank consistently auctions foreign currency as needed.
Investment climate	Exiting the market or reducing investment may become more challenging for businesses due to factors like limited access to foreign exchange and a potentially less predictable economic environment.	While devaluation may incentivise exporters by making their goods cheaper on the global market, it also presents challenges for importers who will face higher costs due to the limited availability of FX.	A floating exchange rate can attract international investors by making dividend repatriation, exits, and investments more attractive.
Repatriation & repayments in FX	Repatriating profits (dividends) earned and external debt repayment will continue to be a challenge	FX reserve levels can be expected to improve slightly due to increase in exports and remittance flow through formal channels. Resulting in relative ease for repatriation and repayments in FX.	Repatriation and repayment challenges can be expected to ease significantly or disappear under this scenario.

Future Forex scenarios

Our approach

	Scenario 1: No change	Scenario 2: Gradual policy change	Scenario 3: Significant policy change

Description	Short description of the scenario and high-level macroeconomic conditions.
Features	Outline of the key market mechanisms that occur in that situation and the required government policies that would lead to the scenario.
Early markers	Scale of how many features within each scenario are being met.
Impact on investors	Assessment of each scenario that outlines the likely impact it will have on investors operating in Ethiopia.

Future Forex scenarios

Scenario 1: No change

The National Bank of Ethiopia (NBE) continues to manage the value of the Birr exchange rate against the US dollar with deliberate depreciation enforced over time. To maintain the value of the Birr, policy would continue to focus on the management of foreign exchange reserves.

Key features

Value of the Birr is pegged to the US$ by the NBE with devaluation being applied systematically over time.

Shortage of FX in the official market continues and/or grows.

Lower volatility on official exchange rate but continues to diverge from parallel market rate.

Unofficial parallel market is very active and grows

Trade and foreign currency flows are highly regulated by the Government of Ethiopia.

Inflation remains high as companies raise prices to offset the rising imported input costs resulting from managed devaluation.

Early markers

Low	Medium	High
△		

A no change policy scenario would lead to the FX situation remaining the same and the premium between official and the parallel exchange rate will continue to grow.

Given the ongoing negotiations with IMF and the constrains on the business environment there is a low likelihood that no change will be maintained. Nevertheless, an agreement is yet to be reached between GoE and the IMF.

Impact on investors

- Businesses that do not have access to export earnings to source foreign exchange would need to reduce production, lay off workers or even consider closure of operations.
- Continued high inflation increases investment costs and discourage investment spending.
- Working capital shortage caused by credit cap and reduced liquidity further impact access to foreign exchange.

Future Forex scenarios

Scenario 2: Gradual Policy Change

The NBE would continue to manage the value of the Birr exchange rate to the US dollar with deliberate depreciation over time until a decision is made to change to market based floating exchange rate.

Key features

Up until the decision is taken to float, the exchange rate the premium between the official and parallel exchange rates would remain.

The shortage of foreign exchange would continue and potentially get worse.

Continued devaluation would increase import costs for raw materials, leading to higher prices for finished goods and inflation.

Unofficial parallel market remains very active and grows.

Trade and foreign currency flows are highly regulated by the Government of Ethiopia.

Early markers

Low | Medium | High

GoE's continued efforts to control inflation is an early marker of potential policy change (drop from 34% in April 2023 to 23% in April 2024).

Any further improvement on FX features would continue to signal a potential of gradual change in the build-up to floatation. These could include:

- Increase rate of currency devaluation to close gap with parallel market premium (often unsuccessfully).
- Accumulation of FX reserves by the NBE.

Impact on investors

- Continued shortage of FX adds costs to trade, investment and growth initiatives, and limits repatriation of profits until float
- Continued devaluation increases import costs of raw materials, leading to higher prices for finished goods and inflation
- Devaluation would incentivise exporters and disincentivize importers, strengthening the balance of payments.

Future Forex scenarios

Scenario 3: Significant Policy Change

GoE would allow the Birr exchange rate to be determined by interaction of supply and demand factors internationally while managing domestic money supply. A free-floating exchange rate would allow a continuous adjustment of the exchange rate to shifts in the demand for and supply of foreign exchange.

Key features

Volatility of the exchange rate immediately following floatation with risk of depreciation, but greater stability over medium to longer term and buffer of international shocks.

Greater availability of foreign exchange.

Parallel market for foreign exchange would reduce in significance and could disappear.

Less regulation of trade and foreign currency flows required.

Early markers

Low	Medium	High
	△	

Ongoing discussions between GoE, the IMF, the World Bank and other multilateral institutions signal appetite towards floatation. However, any agreement is yet to be reached.

An accumulation of foreign exchange by the NBE was also recorded at the end of 2023 which could signal preparation towards a float.

Impact on investors

- Initial Birr volatility and potential depreciation following floatation could impact investment returns.
- Greater availability of foreign currency would mean increased freedom to trade, invest, grow and distribute profits
- Once inflation stabilises, it may incentivise economic activity, and encourage further investment.
- Greater cost competitive environment for firms due to elimination of costly transaction costs and processes.
- Easier dividend repatriation.
- Foreign exchange surrender requirements lifted.
- Exiting market through initial public offering (IPOs) and buy-outs would become viable.
- Exporters would not face effective export tax (through forced conversion at official rate) anymore.

It would take at least 1 month to enact any policy change after a decision to float is made.

03 Deal structuring in light of FX and repatriation issues

Deal Structuring in Light of FX risks and repatriation issues

There are 4 key risks that investors should be aware of when structuring deals in an FX constrained environment and consider the relevant de-risking and mitigating methods for each of the risks.

Capital Risk

Risk of loss of part or all of the investment

Exit Risk

Inability to sell or transfer assets

Currency Risk

Risk of depreciation of local currency

Liquidity Risk

Inability to cover operational expenses

Capital risk

Risk of not being able to repay some, or all of company debt.

Mitigation method

- Blended finance consideration using debt/equity mix. Stacked debt/equity and first loss (summary of options available in Ethiopia is in Annex 3).
- Combine financing instrument with differing risk return expectations.
- Collateralization which can take many forms (real estate, plant and equipment, accounts receivable, promissory notes, but also includes guarantees, loss insurance, tax benefits)

De-risking tools and instruments used currently

- Mix of debt/equity with different risk return profiles so that any losses impact most risky tranches first.
- Collateralization to mitigate the risk of funders losing their investment.
- Tax benefits can lower the total risk of the project and thereby reduce risk of losing investment.

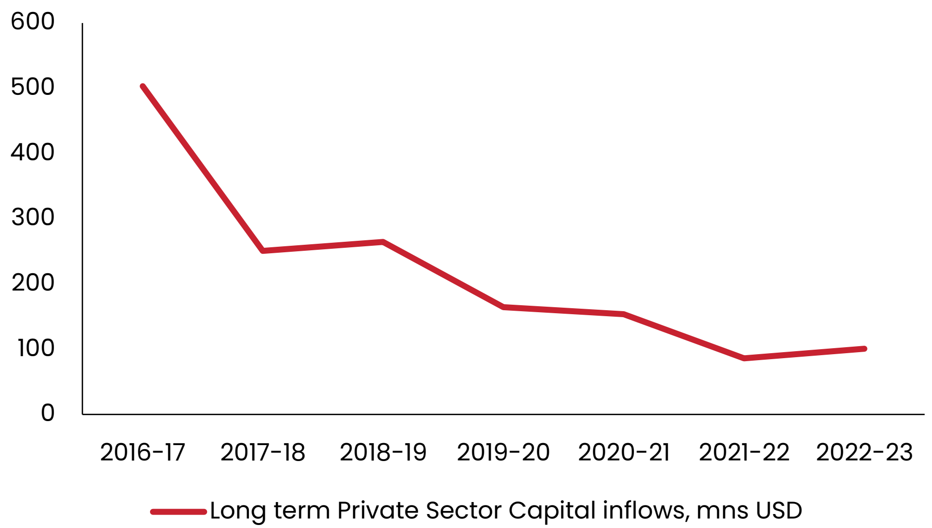
De-risking tools and instruments that may become available under a floatation scenario

- Mezzanine debt
- Junior/Senior debt
- Guarantees (partial or full)
- Loss insurance

Trends in Ethiopia

Long-term capital inflows to the private sector have been declining, primarily due to uncertainties in the FX market.

Long term Private Sector Capital inflows, mns USD



Case study

International Business Company (IBC) wants to invest in an Ethiopian business but understand that the current shortage of foreign exchange as well as other normal business risks may put some or all of its capital at risk. In order to mitigate this, the IBC needs to consider the structure of its investment and use one or more of the following mitigating factors.

Mitigation strategies

Use a mix of equity and debt to fund the investment since where debt would require a frequent payment of foreign exchange to service that debt, equity can be structured to be less demanding of foreign exchange on a regular basis.

Use different seniority (junior versus senior) in terms of debt and equity funding so that investors with different risk appetites can be part of the investment. This would result in any potential losses affecting the higher risk and return tranches first (i.e. first loss clause) while leaving the rest of the investment intact and with the ability to recover from those losses without losing everything.

Put up assets as collateral (e.g., real estate, machinery, plant and equipment, cash receivables etc.) They can all be used to collateralise the investment and reducing the attributable risk. This can be supplemented with other mitigating tools such as getting a guarantee on the foreign exchange required to service the debt or insuring against potential early losses from certain possible but improbable events. Negotiating tax benefits, such as reduced or deferring taxes for first few years of the investment would ensure more funds are available to build and grow the business and therefore mitigate loss events.

Exit risk

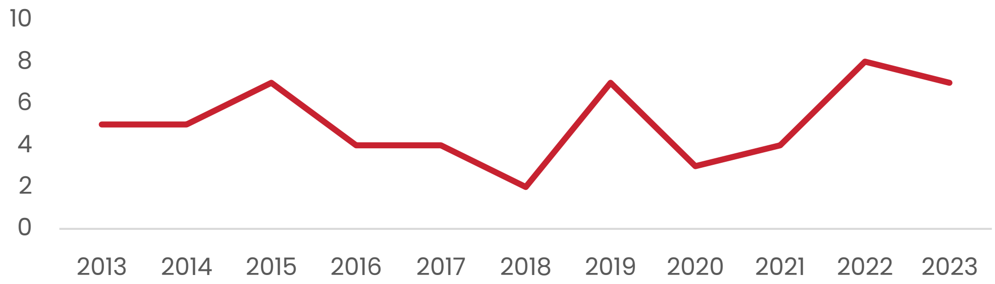
Inability to sell or transfer assets.

Mitigation method	• Investor must consider exit path even though at outset this would not be high on medium- to long-term strategy priority • Investor can influence liquidity of business through application of tools listed below • Management buyouts as the transaction can be done by local currency
De-risking tools and instruments used currently	• Quality and type of legal transfer documents • Consideration of transaction costs and market transparency of the business • Right of first offer • Drag along rights
De-risking tools and instruments that may become available under a floatation scenario	• Same as above • Increased availability and interest from strategic buyers

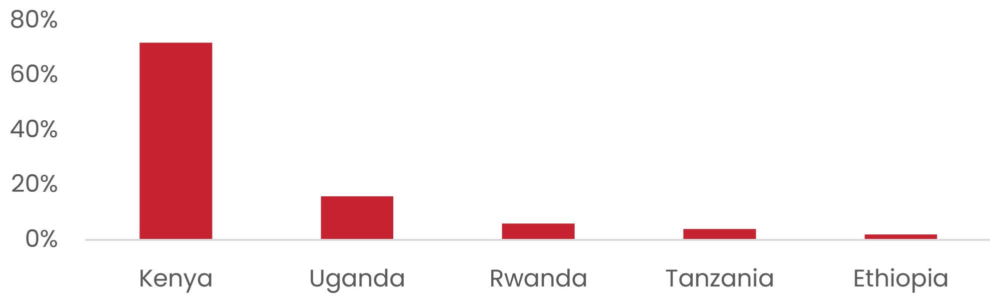
Trends in Ethiopia

Exits have been a challenge for East African private equity firms. Despite the challenges, Kenya has registered the highest share of exits, while Ethiopia has had the fewest.

Number of private equity exits over the past decade in East Africa



% share of exits in the past ten years in the East Africa region



Currency risk

Risk of depreciation of the local currency.

Mitigation method

- Financial hedging strategies
- Local currency lending, where lenders lend to funds that can provide local currency lending through grant diversification
- Using exchange rate risk guarantees (e.g., MIGA)

De-risking tools and instruments used currently

- Local currency lending
- Entering an export market with a more competitive price
- Diversification of the business by entering multiple markets

De-risking tools and instruments that may become available under a floatation scenario

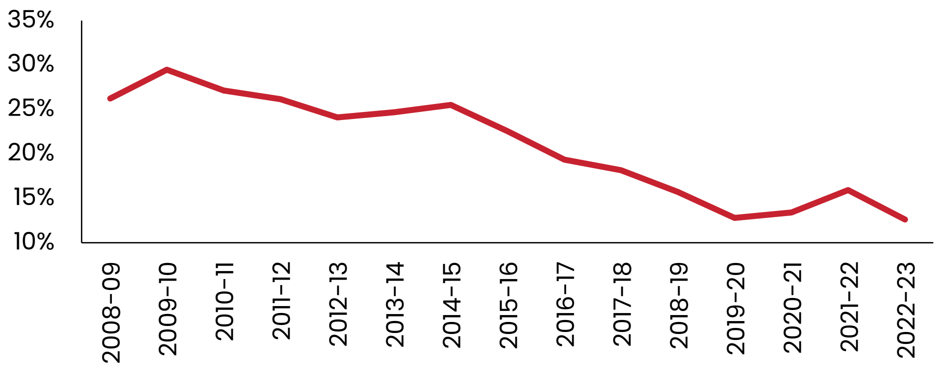
- Hedging instruments i.e. forward contracts and currency swaps (e.g., TCX FX Risk hedging facility, currently not in use in Ethiopia due to difficulties in pricing)

Trends in Ethiopia

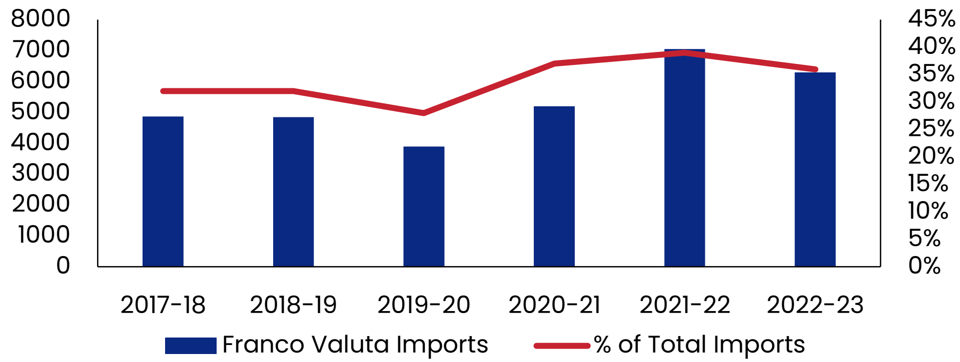
Strapped by FX shortage, the country's import ratio to GDP has plunged dramatically as the currency crisis intensifies.

One method of importing goods is through Franco Valuta, where importers use their own foreign currency. Notably, Franco Valuta imports have grown by 1.5x in the past three years, now accounting for more than one-third of total imports.

Imports (% of GDP)



Franco Valuta Imports



Liquidity risk

Inability to cover operational expenses.

Mitigation method

- Ensuring management function of the business make provision for times when liquidity is under pressure
- Accessing grants (KFW and GIZ are giving grants in Eastern Africa with a minimum of 1 million euro)

De-risking tools and instruments used currently

- Over-collateralisation
- Grant and public funding

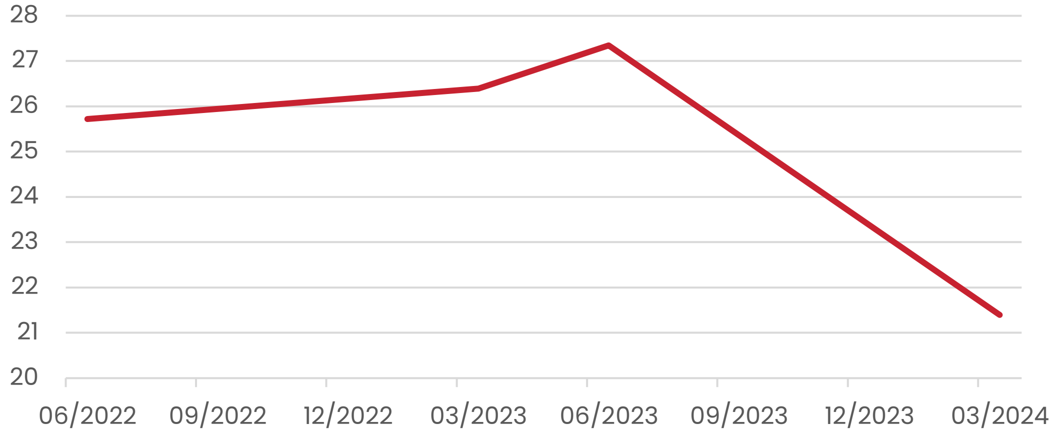
De-risking tools and instruments that may become available under a floatation scenario

- Holding debt service reserve account, excess spread accounts, contingency equity etc.
- Liquidity support facilities through stand-by letters of credit
- Grant and public funding

Trends in Ethiopia

Ethiopian commercial banks' liquidity ratio stands at around 21% as of March 2024. This represents a notable decline compared to June 2023 levels. However, it remains above the National Bank of Ethiopia's (NBE) minimum requirement of 15%.

Liquidity Ratio



Financing behaviours/de-risking strategies

Certain financing behaviours and strategies contribute to successfully operating under an FX constrained environment.

No policy change/gradual change

- Phase hard currency outflows to match expected delays in processing requests through official channels
- Develop a strategy to expand your local sourcing options (to reduce foreign exchange demand)
- Avoid taking in external debt without significant debt servicing enhancement provisions (e.g. grace period, fixed rates) or de-risking (insurance when available) mechanisms built in
- When raising foreign capital, structure deals with larger equity than debt components
- Where possible, plan to cover project costs (construction and working capital) using local currency funds. Loans in local currency from local banks have generally negative real interest rates
- Create partial or full export business lines
- Access hard currency through parent or subsidiary currency outside of Ethiopia.

Significant policy change

- External debt considerations can be made based on the absorption capacity, risk appetite, and other considerations of the business
- Easier to price and hedge against foreign exchange risks as market dictates fluctuations in currency prices
- As market matures, we expect financial institutions and currency hedging platforms to start offering currency risk hedging products under this scenario
- Fully import substitution focused businesses can operate viably, even if importing a large portion of their raw materials from abroad
- With the establishment of the Ethiopian Asset Management Corporation and the Ethiopian Securites Exchange, asset-based financing options such as invoice factoring, leasing, and discounting can be used

Disclaimer: Although much of the deal structuring will depend on the company strategy and its risk appetite, there are a number of important considerations when investing in Ethiopia. All the points listed have been chosen for their applicability to one of the possible future exchange rate regime scenarios that may materialize.

Pre-exit strategies

Given repatriation challenges investors may consider the following strategies for investment pre-exit under the two scenarios

No policy change/gradual change

- Expand local footprint through further investments in horizontal and vertical supply chains
- Invest in other areas of the economy
- Invest in property (commercial, industrial, office etc.) in Ethiopia to preserve value of business proceeds and generate additional returns
- Invest in exporting businesses (to generate hard currency)
- Structure deals for long term strategic investors to come in

Significant policy change

- Funds can be repatriated, returned to shareholders or allocated for further growth opportunities within Ethiopia.
- Hard currency funds can be raised through external debt and/or equity from international financial markets to fuel growth and expansion.
- Deals can be structured to allow for PE funding with a relatively short timeframe for exits.
- For companies that fulfil criteria, raising capital through issuance of bonds on the ESX platform could be an option in the near to medium term.

Disclaimer: Although much of the deal structuring will depend on the company strategy and its risk appetite, there are a number of important considerations when investing in Ethiopia. All the points listed have been chosen for their applicability to one of the possible future exchange rate regime scenarios that may materialize.

Exit strategies

Given repatriation challenges investors may consider the following strategies for exiting investments under the two scenarios

No policy change/gradual change

- Expect exits to be difficult and consider reinvestment options (e.g., expansion or diversification projects within Ethiopia) that are available to you ahead of time. Also refer to use of funds pre-exit.
- Structure deals for gradual exit (dilution of ownership shares overtime)
- Explore opportunities for exiting to MNCs/conglomerates that have cash and long-term view (e.g., Unilever, Moenco, Dangote, Coca Cola, Pepsi etc...). However, some may be reluctant to invest before significant policy changes take place.
- Look for buyers from source countries such as China (investment flows from China continue to flow – even if mostly into greenfield projects)
- Sale of assets to other businesses within Ethiopia.
- Sale of business through mergers and acquisitions (M&A) or through local private equity (PE) fund.
- Allowing a partner business or joint venture partner to buy out our portion of the business.

Significant policy change

- Funds can be repatriated, returned to shareholders or allocated for further growth opportunities within Ethiopia.
- Exit can be structured with combinations of both debt and equity using international financial markets
- Deals can be structured to meet various risk return expectations; preferred equity, junior/senior debt, and mezzanine structures.
- Deals can be structured to allow for PE funding with a relatively short timeframe for exits.
- For companies that fulfil criteria, listing on the Ethiopian Securities Exchange could be an option in the near to medium term.

Disclaimer: Although much of the deal structuring will depend on the company strategy and its risk appetite, there are a number of important considerations when investing in Ethiopia. All the points listed have been chosen for their applicability to one of the possible future exchange rate regime scenarios that may materialize.

04 Lessons from other African contexts

Lessons learned from Egypt, Nigeria, Rwanda, Kenya, and Tanzania.

There has been a trend for increased demand for FDI and internal investment following a period of capital flight immediately after floatation.

Pre-floatation

- Debt markets were characterised by narrow variety of pre-floatation originating lending products, reduced liquidity, and the need for pairing with costly hedging products to counter currency risk
- Most common instruments are LC and CAD.

Floatation

- Debt and equity markets increased, with equity markets benefiting most initially
- Issuing bonds in foreign currency
- Selling shares on stock exchange
- Increased demand for local currency lending
- Use of derivative instruments was post-floatation to counter currency and political risk.

Rwanda and Nigeria case studies

In floatation scenarios, this is what happened in other contexts

Rwanda

Currency hedging mechanisms to mitigate exchange rate risks, and specifically forward contracts and currency swaps were used to lock in favorable rates over the deal duration. Deals were structured to facilitate investor exits. Specifically for insurance and commercial banking-based deals. investors in Rwanda relied on structured exits such as put options, buyback agreements, or convertible instruments. These mechanisms provided investors with flexibility as well as access to liquidity for the exit process.

Nigeria

In post-floatation Nigeria there was a lot more interest in both investment through equity and debt markets. However, private debt markets had virtually dried up due to various local issues including high inflation and heightened security issues around farmland allowing growth in equity markets.

There was widespread use of derivative products to counter the exchange rate risk components of investment deals following floatation. These products were offered by several multinational African banks; however, these came at a cost to the investor and needed to be balanced as part of structuring the deal. In addition, deals were structured like leases using offshore agreements, for example for machinery and equipment purchases, which allowed smaller forex payments to be made. This was popular in the agriculture and mineral extraction sectors which benefitted most post floatation.

Lessons learned from Egypt, Nigeria, Rwanda, Kenya, and Tanzania.

There has been a trend for increased demand for FDI and internal investment following a period of capital flight immediately after floatation.

Considerations for investors

01 Both debt and equity markets experienced greater demand for financing post floatation.

02 Business experienced cost reductions and increased competitiveness.

03 Allowed expansion and maturation of financial sector given the increased financing options available and new risks exposure.

04 Sectors characterised by import substitution post floatation benefited most from access to foreign exchange. These included agriculture, certain manufacturing industries, consumer goods and export orientated industries.

Wider macroeconomic considerations

01 Exchange rate flexibility (unification) decision needs to be accompanied by monetary and fiscal alignment to ensure stability after unification.

02 In the medium-term current account balances show improvements after unification particularly after moving to a flexible exchange rate regime.

03 Inflation increased after unification but stabilised in after a while. In countries where inflation tracked the parallel market rate before unification increase in inflation was modest.

04 Foreign exchange reserves improved after unification.

05 Annexes & Glossary

Annex 1

List of interviewed companies and sector.

No.	Type of Business	Sector
1	Importer	Pharmaceutical Import
2	Manufacturing	Plastic
3	Manufacturing	Water
4	Agriculture	Coffee
5	Manufacturing	Food processing, Pasta
6	Importer	Cars
7	Manufacturing	Plastic
8	Manufacturing	Water
9	Manufacturing	Plastic, Furniture
10	Manufacturing	Leather
11	Importer	Furniture and manufacturing of textiles
12	Importer	laboratory, Medical and Educational products
13	Manufacturing	Steel
14	Manufacturing	Leather Products
15	Manufacturing	Paints

Annex 2

Questionnaire for companies.

This questionnaire is aimed at delving into the repercussions of the ongoing foreign exchange shortages on Ethiopian manufacturing firms. It seeks to uncover the detrimental effects experienced by companies, especially those reliant on imported raw materials, due to the prevailing currency challenges.

1. Brief description of the company
    - Company Name:
    - Industry:
    - Products:
    - Raw Materials: [Percentage]% of raw materials that require foreign exchange.
    - Exports:
2. Has your company been affected by the foreign exchange shortage in Ethiopia? if so, please describe the specific challenges ...
    - Lower number of employees
    - Shut down production
    - Raised selling prices
    - Other
3. How has the forex shortage impacted your company's ability to:
    - Import essential raw materials?
    - Pay for foreign services?
    - Repatriate profits?
    - Repay loans in hard currency?
4. What is the typical processing time for foreign exchange requests at the central bank?
5. Will you receive the requested amount, or is approval subject to a quota system?
6. What is the typical validity period for Letters of Credit (LCs) issued by banks you work with?
7. Are there any alternative options available to access foreign exchange? (FIs) What are the main options for accessing foreign exchange?
8. What is the cost of accessing foreign exchange through alternative markets?
9. What's your view on Central Bank's current surrender requirements on FX earnings? How is it affecting your business? [if an exporting business]
10. Assuming the foreign exchange situation remains unchanged, how do you anticipate the current shortage impacting your company's operations?
11. Considering the current foreign exchange shortage, what are the potential advantages and disadvantages of implementing a floating exchange rate or a partial devaluation on your company?
12. Do you have any recommendations for the government to address the forex shortage?

Annex 3: Blended finance options available in Ethiopia.

Blended finance is a combination of public and private finance, involving a wide range of providers and instruments such as equity, debt, grants, guarantees, and insurance.

Below are a range of blended finance options and providers available in Ethiopia

Equity

By product / instrument

Unlisted equities
- Grant funding
- Conventional equity investment

Listed equities
- SPACs
- Yieldco's

By source

- Family offices
- Infrastructure funds
- Pension funds
- Insurance companies
- Asset managers
- Strategic corporates
- Sovereign wealth funds
- Multilaterals and donor-funded entities
- Impact investors
- Donors, DFI's, Export Credit Agencies

Illustrative financing sources

Swedfund, Norfund, FMO, Sida, JICA, Proparco, China Development Bank, KFW, CDC, EKF, Veris Investments, Acumen, Mastercard Foundation, LeapFrog, Phatisa, 8 Miles, The Rockefeller Foundation, Dub equity, IFC, Green Climate Fund, European Commission, IDA, IFAD, The World Bank, European Investment Bank, African Development Bank Group

Debt

By product / instrument

Unlisted debt
- Commercial debt facilities
- Concessional debt facilities
- Project preparation facilities
- Project finance
- Revolving credit facilities

Listed debt
- Commercial senior debt
- Commercial subordinated debt
- Project bonds

By source

- Commercial lenders
- Debt infrastructure funds
- Export credit agencies
- Sovereign wealth funds
- Insurance firms

Illustrative financing sources

Standard Chartered, Standard Bank, Rabobank, Zemen Bank

Glossary (1/2)

Bill of lading – a document issued by a carrier to a shipper confirming the goods were received in an acceptable condition and are ready to be shipped.

Buyback agreement – an agreement between the company and the shareholder(s) whose shares are being bought back, whereby the company agrees to purchase those shares.

Debt service reserve account – a cash reserve which works as an additional security measure for the lender as it ensures that the borrower will always have funds deposited to cover future debt service.

Depreciation – decline in the value of one currency to another due to changes in economy that act through market forces like supply and demand (associated with a freely floating exchange rate).

Devaluation – international reduction in the value of one currency to another through the actions of a government or central bank (associated with a managed exchange rate).

Drag along rights – enables a shareholder to force another shareholder to join in sale of a business.

Excess spread- the difference between the interest rate received on the underlying collateral and the coupon on the issued security.

Exporter's foreign exchange retention account – foreign currency accounts maintained by eligible exporters of goods and services and recipients of inward remittances.

First loss – the amount which is exposed to first to any loss suffered.

Mezzanine debt – A hybrid debt structure that contains subordinated debt from the same lender. Mezzannine has embedded equity (warrants) that enhance the attractiveness of the subordinated debt.

Right of first offer – grants the holder the right to issue the first bid on the sale of property (shares).

Glossary (2/2)

Initial public offering (IPO) – process of offering shares of a private corporation to the public in a new stock issuance.

Put options – options contract that gives the owner the right, but not the obligation, to sell a certain amount of the underlying asset, at a set price within a specific time.

Real Effective Exchange Rate (REER) – nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs.

Adrian Mertens

Country Lead for Ethiopia - Manufacturing Africa | McKinsey and Company

+251 94473 4891 / +254 72564 8245

adrian_mertens@mckinsey.com

Amdework Berhanu

Country Manager for Ethiopia - Manufacturing Africa | BDO

+251 91 106 5198

amdework.berhanu@bdo-ea.com

Faheem Chowdhury

Portfolio Lead – Manufacturing Africa | BDO

+44 7879636955

faheemus.chowdhury@bdo-ifi.com

https://manufacturingafrica.org/

42025860