

AFRICA RISK CONSULTING**Zambia Monthly Briefing July 2015**

Zambia Summary 28 July 2015

Ratings agency Standard & Poor's (S&P) downgrades Zambia's sovereign debt rating to B from B+ and lists its outlook as negative. S&P cites a growing fiscal deficit. Zambian businesspeople blame the government's poor handling of finances for the downgrade. The finance ministry issues a \$1.25 billion 10-year bond at a yield of 9.375% as markets show their concern about long-term economic stability. Poor rainfall and low water levels in the Kafue and Zambezi rivers lead to regular electricity load shedding. The Zambia Electricity Supply Corporation (Zesco) cuts power to mining operations by 30% in order to shed 400MW from the grid. Mines and energy minister Christopher Yaluma says that the government will build a gas power plant and signs a deal with the International Finance Company (IFC) for two solar power plants.

Increased deficit worries lead to ratings downgrade...

The economy is deteriorating due to a combination of low revenues resulting from falling international copper prices, a devaluing currency, and loss of market confidence. The worsening economic situation has resulted in lowered ratings with **Standard & Poor's (S&P)** downgrading the economy to B from B+ on 1 July.¹ The new rating is five levels below investment grade. S&P also altered its outlook forecast from "stable" to "negative".² The agency cited the increased budget deficit as the primary reason for the downgrade. It opted not to downgrade in May when the government's finances were stronger, despite fellow ratings agency **Fitch** downgrading Zambia's outlook from positive to stable that month.³

Falling copper prices, which have decreased from \$6,250/tonne in January to \$5,225 at time of writing, have reduced government revenue and curbed growth. The kwacha, which has often mirrored moves in the copper price, has fallen 15% against the dollar across 2015 so far. S&P estimates that the deficit may reach 10% of gross domestic product (GDP) by December.⁴ This is higher than both the treasury's projection of 6% and the **International Monetary Fund (IMF)**'s projection of 7.7% released last month (see *ARC Briefing Zambia June 2015*).

The downgrade has cast doubt on the ability of president **Edgar Lungu's** (2015-present) administration to manage the economy.⁵ Senior business sources are sceptical of the government's ability to handle its own finances appropriately. This has led potential investors and the international markets to view Zambia with caution. An incident during the disagreement between the government and mining companies over value added tax (VAT) highlights these concerns:

"At the time when the VAT refund issue for mining firms was serious, the finance minister even suggested that since Zambia had about \$700m that was borrowed sitting idle they should as well use it to refund the mining firms that tax. This is the kind of misapplication of borrowed money we

¹ Bloomberg, 1 Jul 2015

² Bloomberg, 1 Jul 2015

³ Lusaka Times, 25 May 2015

⁴ Bloomberg, 1 Jul 2015

⁵ Lusaka Times, 5 Jul 2015

are talking about. How can money that was borrowed for capital projects be used to refund things such as taxes? It is the kind of irresponsibility that has cost Zambia a downgrade.”⁶

Others believe that international companies keeping their profits offshore is holding the economy back. A senior member of Lusaka’s business community believes that

“...the export earnings should be brought back and pumped into the local economy but instead, they are remitted elsewhere. If this money was brought back here, the kwacha would become stronger and [more] stable.”⁷

The ruling **Patriotic Front (PF)** party has a history of populist policies under former president **Michael Sata** (2011-2014). Lungu resorted to a number of anti-business promises in the run up to the January 2015 election. His current track record in power is mixed: he tried to implement sharp tax increases on mining, but then orchestrated a turn-around on the policy and consulted with mining firms (see *ARC Briefing Zambia* January, March and June 2015). However, with another general election scheduled for 2016 Lungu may resort to populist policies despite their economic risks.

...leading to poor yields on its \$1.25 billion bond auction

Observers agree that the government lacks sufficient funds to carry out its capital spending projects.⁸ In order to plug this fiscal gap, the government held a bond auction on 23 July that raised a \$1.25 billion 10-year Eurobond at a record high yield of 9.375%.⁹ Finance minister **Alexander Chikwanda** told potential bidders that the bond was to help cover some of the fiscal deficit, which the **Bank of Zambia (BoZ)** now believes could go as high as \$2.64 billion in 2016,¹⁰ about \$1 billion more than it predicted in June (see *ARC Briefing Zambia June 2015*). The auction had no fixed ceiling and the treasury had hoped to raise between \$1 and \$1.5 billion.

Demand for the bond was low. While most African sovereign bonds have had demand of two or three times their value in the last two years, Zambia’s July Eurobond was only just over-subscribed.¹¹ Investors cited Zambia’s uncertain political and economic future as reasons for the hesitancy.¹²

“With elections coming next year and an economy firmly tied to copper, which hasn’t performed well in the past few years, Zambia is a not a good bet on the 10-year markets.”¹³

The yields are considerably higher than when Zambia first entered the bond market in 2012 when it raised \$750m at just 5.9%, or in 2014 when it raised \$1 billion at 8.9%.¹⁴ The poor economy has also increased yields on Zambia’s existing bonds. The 2012 bond has now risen to an all-time high of 8.2%, an increase of 150 basis points from 6.7% in May.¹⁵

“Normally bond issues are over-subscribed...the market has great appetite for risk at the moment...this shows real investor caution...they want a higher pay-off in return for investing in a high-risk market.”¹⁶

The new bond brings the total value of sovereign bonds to \$3 billion. Senior figures in Zambia, such as former commerce minister **Felix Mutati**, have condemned the move as *“increasing the country’s debt burden too much”*.¹⁷ The combined value of Zambia’s domestic and foreign debt, including its current

⁶ Source, investor, London

⁷ Source, businessperson, Lusaka

⁸ Reuters, 23 Jul 2015

⁹ Reuters, 23 Jul 2015

¹⁰ Reuters, 25 Jul 2015

¹¹ FT, 23 Jul 2015

¹² FT, 23 Jul 2015

¹³ Source, bond trader, London

¹⁴ FT, 23 Jul 2015

¹⁵ Bloomberg, 18 Jul 2015

¹⁶ Source, bond trader, London

¹⁷ Zambia watchdog, 22 Jul 2015

bond obligations, will reach \$10 billion by December 2015.¹⁸ The annual interest that government has to pay on bonds alone will rise to \$920m from \$850m in December 2014. According to a senior business source, this is more than the budget of several key government ministries combined.

*"We are surely strangling our economy and there is no room for expansion."*¹⁹

Poor rainfall leads to power shortages in the mining sector

The mines and energy ministry estimates that the Zambian power grid will have to shed over 400 megawatts (MW) of electricity generation between July and December. Poor rainfall during the past season has resulted in low water levels in the **Zambezi** and **Kafue** rivers, sources of the hydro-electric power that accounts for the majority of the country's electricity generation.²⁰ The mines and energy ministry authorised the **Zambia Electricity Supply Corporation (Zesco)** to cut power to commercial and consumer customers on 7 July as prolonged drought has caused water levels at the hydro-electric projects on **Kariba Dam** to drop. **Zesco** shed 560MW of power that day, resulting in widespread blackouts. **Zesco** requested that the **Copperbelt Energy Corporation (CEC)**, which bulk purchases electricity on behalf of the copper mining sector, cut supply by 30% on 7 July.²¹ Copper producers consume about 60% of Zambia's energy.²²

Power outages have continued across July and the grid is functioning with an average deficit of 400MW in its 2,200MW capacity.²³ Zesco has asked mining companies to continue to use 25% less power than normal, and has carried out daily eight-hour cuts in power supply to households and businesses in eight of Zambia's ten provinces.²⁴ **Zesco** has also halted power exports as a result of the shortage.²⁵ It sells power, via the **Southern African Power Pool**, to regional neighbour **Botswana**.²⁶

Continuing blackouts will affect businesses and GDP. Sources within the business community say that the blackouts are already having a negative effect:

*"Our [business association] members have already lost business and revenue to this load shedding...if it continues then many will be faced with serious financial problems."*²⁷

Mining companies in Zambia have reported lost revenue due to the power restrictions. The **Zambian Chamber of Mines (ZCM)** reported that power restrictions to **Canada-based First Quantum Minerals' Kansanshi** mine and **London-based Barrick Gold's Lumwana** mine had resulted in an average of four days' lost production across July.²⁸ With copper accounting for 70% of Zambia's total export earnings,²⁹ a downturn in supply threatens Zambia's already precarious economic situation (see above).

Zambia relies on hydro-electric power plants for the majority of its electricity. Four of the five main power plants (accounting for 2,150MW of the country's 2,200MW capacity) generate hydro-electric power.³⁰ The **Ndola Energy** heavy fuel oil (HFO) 50MW power plant is the country's only thermal installation over 2MW.³¹ A new 150MW coal-fired power plant, **Maamba Collieries Power Plant**, is under construction. The government was due to commission it in September 2014 but construction

¹⁸ Zambia watchdog, 22 Jul 2015

¹⁹ Source, senior business executive, Lusaka

²⁰ Zambia Daily Mail, 25 Jul 2015

²¹ Zambia Mining News, 7 Jul 2015

²² Zambia Mining News, 7 Jul 2015

²³ Xinhua, 27 Jul 2015

²⁴ Zambia Mining News, 7 Jul 2015

²⁵ Zambia Daily Mail, 30 Jun 2015

²⁶ Africa Report, 13 Jun 2014

²⁷ Source, business association, Lusaka

²⁸ Reuters, 27 Jul 2015

²⁹ African Economic Outlook, 2015

³⁰ Zesco website, 2015

³¹ Zesco website, 2015

delays have pushed this back until August 2015. Mines and energy minister **Christopher Yaluma** believes that the Maamba plant will reduce the number of blackouts.³² However, it will not generate enough electricity to halt them completely.³³ An additional hydro-electric power plant, the 120MW **Itezhi Tezhi Power Project**, is currently being developed as a joint venture between **India**-based **Tata** and Zesco.³⁴ Yaluma said on 23 July that the government was considering building a gas-fired plant, powered with liquid natural gas (LNG) imported from neighbouring **Tanzania**, to generate power when water levels run dry.³⁵ Zesco has reportedly told mining companies that independent power producers will “procure” more power for the grid before the end of 2015.³⁶ However, it is not clear whether this refers to the LNG plant or to other government plans.³⁷

The mines ministry also signed a memorandum of understanding (MoU) with the **International Finance Company (IFC)** of the **World Bank** to develop two 50MW photovoltaic (PV) power plants on 26 July.³⁸ President Lungu released a statement saying that the government intended to raise finance from the IFC for 600MW of renewable energy plants. Renewable energy will primarily be from solar plants due to the ease of connecting them to the grid.

Implications

Zambia’s economic outlook remains tied to the copper price and the mining industry. The kwacha, as in 2014, has tracked the value of copper rising and falling within a short delay of the commodity. Copper producers successfully lobbied the government against tax increases when the copper price was low. President Lungu and ministers Yaluma and Chikwanda all conceded that the country needed the copper industry to function. However, a combination of low copper prices and low taxation means that the government’s revenues are negligible – hence the S&P downgrade due to a rapidly increasing deficit. Many Zambians see the tax turnaround as the cause of the current poor situation. However, if the government had raised taxes on copper, mines would have closed, leading to the same problem. However, faced with both popular dissatisfaction and low revenues, the government could be tempted to return to more resource nationalistic policies, especially with an election in 2016.

The bond auction shows that S&P’s concerns over an increased debt burden are justified. The government has taken on considerably more debt and at a highly unfavourable rate. Investors in the bond markets have been presented with a host of opportunities to invest in African frontier markets. In 2014 **sub-Saharan Africa** leveraged \$8.5 billion in bonds. However it may be that the markets have sated their appetite for risk and are now considering how best to recoup value. This could lead to rate increases across sub-Saharan Africa as investors watch political and economic events closely.

The power shortages are now into their third week. The country is currently running at around a 400MW deficit. The extra 120MW from the Maamba plant will not be enough to stem this entirely. Zambia’s rainy season is November to April so there is little prospect of rainfall in the short term. The government’s new plan is to turn to renewables, solar in particular, to solve its power problems. The IFC will provide funding and it is also likely that the government will tender out the development of these plants to private companies. This follows the model of other African nations, such as **Ghana** and **Morocco**, which have attracted considerable interest in their renewable energy sectors. The government’s swift response in attracting financing for new power generation may save it from the fate of **South Africa**, which has decreased its growth by an estimated 1.5% of GDP due to an ongoing power shortage. However, renewable energy sources will take time to develop and the ongoing power shortages will damage the economy in the short term.

³² Lusaka Times, 25 Jun 2015

³³ Lusaka Times, 25 Jun 2015

³⁴ Times of India, 25 Mar 2015

³⁵ Zambia Daily Mail, 23 Jul 2015

³⁶ Reuters, 28 Jul 2015

³⁷ Reuters, 28 Jul 2015

³⁸ Xinhua, 27 Jul 2015

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