Structured High Yield Investment Products – The Next Frontier in East Africa

We first wrote about structured high yield investments products in the [Cytonn Weekly Report #19] on 17th May, 2015. We revisit the topic in depth this week following social media enquiries in the public domain where we continue to get questions as to how one of our Structured Products, Cytonn Cash Management Solutions (Cytonn CMS), is able to deliver an 18% per annum return to investors. *Please note that this Focus Note is meant for general information only and has been prompted by the need to provide more information about structured products and respond to questions we are getting from the general public; it is not a warranty, representation, advice or solicitation of any nature. Readers are advised in all circumstances to seek the advice of a registered investment advisor.*

In this Focus Note, we deal with a couple of key issues about structured high yield products:

1. What is a Structured Product (SP), and specifically a Structured High Yield Product?
2. What is the history of SPs, and their experience in the Kenyan market?
3. Why do we need SPs in the Kenyan market? What are the opportunities and challenges to SPs in the Kenyan market?
4. What is the regulatory framework for SPs, and associated legal jurisprudence around Structured Products?
5. We then use our own Cytonn CMS as an example of a local SP, including FAQs.

What is a Structured Product?

Typically, investments can be broadly classified into two categories:

- **Traditional Investments** – These are also sometimes called 'public markets investments'. The traditional investments are the commonly known and easily accessible investments such as stocks, government and corporate bonds and bank deposits. Anyone can easily call their broker or stop by a bank and access them. They are usually in the public domain and can be distributed through public avenues such as TV, newspaper ads, and banking halls, hence are highly regulated, and,
- **Alternative Investments** – As an "alternative" to traditional / public market investments, there are alternative investments, which typically include private equity, real estate, commodities and Structured Products. These investments are usually not in the public domain, they tend to be complex and illiquid, but also tend to have higher and more stable returns compared to traditional investments. They tend to be distributed through private avenues such as pre-screened investors and investment clubs.

As per the definition of Alternative Investments, Structured Products are a subset of Alternative Investments. Simply defined, a Structured Product is a highly customized / tailor made investment product that is packaged by investment professionals to enable the investor access returns or meet investment objectives that are not accessible in the traditional / public / conventional markets such as stocks, bonds and bank deposits.

The process of structuring starts by traditional products such as equities, bonds and bank deposits, either alone or in combination with a non-traditional product, such as real estate, and creating cash flows and returns that are supported by the underlying products, but whose features are different from the underlying product because of the structuring that is done.

Here is a very simplified example of two scenarios of how a Traditional / Conventional Transaction can be structured to become a Structured Transaction:

Traditional / Conventional Transaction Scenario: A saver with money takes it to the bank and gets little to no return on their deposit. The bank in turn lends the money to, say, a developer and charges market rate cost of borrowing. The bank enjoys the difference between the cost of the deposit paid to saver and the yield on loan received from the developer. This is illustrated below:

- Mr. Saver has Kshs. 10 million; he can go deposit it in a bank and get at best 7% per annum return on the deposit,
- Mr. Developer can then go to the bank and borrow the Kshs. 10 million from the bank. Remember the bank will be lending to Mr. Developer the same Kshs. 10 million that the bank got from Mr. Saver, but the all-in cost after all bank charges and loan fees comes to about 18% per annum,
- Mr. Developer will then use the money to develop a house and sell it for Kshs. 12.5 million, essentially making a gross return of 25%, or Kshs. 2.5 million on the Kshs. 10 million loan,
- Mr. Developer will then pay to the bank the Kshs. 10 million loan plus 18% total cost of loan, equal to Kshs. 1.8 million, so a total of Kshs. 11.8 million goes back to the bank, leaving Mr. Developer with Kshs. 0.7 million of profit.

A Structured Transaction Scenario: In the structured scenario, the facts remain essentially the same, except that the intermediary is not a bank but an investment vehicle; the saver with money takes it to an investment professional, through an Investment Vehicle, who gives the money directly to the developer. The developer will still pay the usual cost of borrowing, but instead of paying it to the bank, it will be paid to the Investment Vehicle, which will pass the returns to the saver. By structuring out the bank, the saver has been able to increase the returns from the typical rate of return given on deposits, to the typical rate of borrowing paid by developers. This is illustrated below:

- Mr. Saver has changed to Mr. Investor and channels his Kshs. 10 million to an Investment Vehicle managed by an investment professional,
- Mr. Developer can then go borrow the Kshs. 10 million from the Investment Vehicle and pay the same 18% per annum they would have paid to the bank in the conventional scenario,
- Mr. Developer will then use the money to develop a house and sell it for Kshs. 12.5 million, essentially making a gross return of 25% or Kshs. 2.5 million on the Kshs. 10 million loan,
- Mr. Developer will then pay to the Investment Vehicle the Kshs. 10 million loan plus 18% total cost of loan, or Kshs 1.8 million, which will be paid to Mr. Investor,

- As a result, a total of Kshs 11.8 million goes to Mr. Saver turned Mr. Investor, leaving Mr. Developer with Kshs 0.7 million of profit.

The difference between the Traditional Transaction and the Structured Transaction is that the parties with money have come up with a private Investment Vehicle to be able to transact directly, by structuring out the bank. For the party with money, they get a much higher return, and for the party needing the money, the developer, they are able to transact very quickly and move faster than other developers relying only on conventional bank funding; that is the key essence of a Structured Product / Transaction: Using highly customized features, it brings together two parties through innovative features and delivers to them superior results than they would otherwise get in conventional channels.

The History of Structured Products Globally and Locally:

Structured Products originally became popular in Europe and then gained acceptance in the United States (U.S.). Because they are now well known and accepted, they are now frequently offered as products registered by regulators such as the Securities and Exchange Commission (SEC) in the U.S., which means they are accessible to retail investors in the same way as stocks, bonds, and other traditional products. But globally, Structured Products are still marketed mainly to high net worth individuals through targeted wealth management platforms and private banks. They are usually not listed on any securities exchange, but may trade on secondary markets offered by the issuer.

In Kenya, the most commonly known example of Structured Products are publicly placed structured notes, such as Centum and ARM’s Equity Linked Notes, which are Structured Products featuring traditional assets such as corporate bonds and an equity link. However, Structured Products in Kenya and in developing markets remain exceedingly rare. Other examples of privately placed Structured Products include structured notes backed by high yielding assets such as real estate and commercial paper. The most common examples in this market are real estate backed notes and Cash Management Solutions, which yield anywhere from 12% p.a. to 18% p.a. depending on the underlying alternative asset class and the duration of the investment. Common examples of underlying alternatives are investment grade real estate, which yields 20% - 25% returns per annum.

In both local and developed markets, Structured Products have been a welcome alternative to banks for businesses seeking capital for growth. They have been better received in developed markets where the ratio of businesses seeking financing from banks versus capital markets funding is 60% to 40%; which means banks finance up to 60% of business funding, the balance comes from capital markets. In developing markets such as Kenya, capital markets – whether public / regulated capital markets or private capital markets – remain under-developed, hence businesses are forced to source up to 90% of funding from banks, leaving only 10% of funding from the capital markets. In fact, the entire 10% of funding from capital markets is coming from regulated capital markets such as Capital Markets Authority registered offerings and SACCOs, with local private capital markets providing negligible funding. Given the need for funding businesses in a growing economy where SMEs create majority of jobs, private markets such as Structured Products offer a compelling alternative for investors to seek financing. Their adoption would enable businesses to grow and create jobs. They also offer local investors access to above average returns in opportunities that are often unavailable in public markets.

Thus far, Kenyan markets have seen little adoption of Structured Products due to their esoteric nature and the lack of investor education on Structured Products. Recent corporate governance concerns have also dented the investing public's confidence in private markets investments, especially structured solutions.

The Regulatory Framework Governing Issuance of Structured Products:

Having now clarified how Structured Products generate superior returns, the next question tends to be the regulatory framework governing the issuance of Structured Products. Given the many types of Structured Products, we shall limit ourselves to High Yielding Structured Products, such as Cytonn CMS.

When dealing with the regulatory framework, we first have to figure out what is the appropriate governing law, and then, once we figure out the governing law, then how do we issue under that appropriate governing law?

What is the Governing Law? The law regulating financial instruments more often than not overlaps and usually has a couple of grey areas. A look at the definition of Securities in the CMA Act, Kenya (the Act) shows that promissory notes (IOUs), Bills of Exchange e.g. Cheques and certificates of deposit issued by banks are expressly excluded from consideration as Securities for the purposes of the Act. The age-old tussle has however been the constant conflict between securities and banking law, and to better illustrate this we shall use the example of certificates of deposit issued by banks and the evolution of the law that lead to their exclusion from the definition of Securities.

Certificates of Deposit are instruments that originated in the United States banking industry in 1978 to stem the steady outflow of bank deposits by introducing a high-yield time deposit. In addition to the offering of these instruments by banks, they were also offered by savings and loans associations, which are the equivalent of our SACCOs. As shown in this focus, the United States, unlike Kenya, is an economy where the securities and investments industry rather than the banking industry sets the pace. The players in the securities and investments industry therefore lead the way in terms of the 'go to place' for the placing of funds by potential investors. It is therefore not surprising that in order to woo investors the American banks advertised the certificates as 'investments' and depositors characterised as 'investors', a clear parallel with Kenya where the certificates would gain more traction as banking rather than investment products.

With the Certificates gaining public confidence (banks issued some USD 9.5 billion during the first 30-days of availability) litigation followed with the SEC adopting the position that the Certificates were securities and therefore should be under their jurisdiction, while the Banking Lobby took the position that the same was squarely within the jurisdiction of banking laws. Well, with United States Courts persistently holding that these Certificates were indeed Securities, the matter was finally settled by the Supreme Court in *Marine Bank vs Weaver, 1982,* in a unanimous opinion holding that the Certificates of Deposit at issue did not fall within the statutory definition of "security" because *"the holders of bank certificates of deposits are abundantly protected under the federal banking laws*". This was indeed the premise that the Kenyan Act adopted on the passing of the Capital Markets Authority Act 7- years later in 1989.

It is clear that it is a thin line when it comes to determining where a financial instrument falls, as even in the above case, the Court did not conclusively answer the question as to whether the Certificates were Securities but chose to adopt a position that sought to avoid the over-regulation of the banking industry and inter-agency conflict. The Court however held that the rule of thumb is that the instrument in question must be analysed in light of:

i. The content of the instrument in question – Does the investor, directly or indirectly, purchase investment assets and what participatory rights do they have? A right to participate in decision making of the venture as a typical shareholder for example through Annual General Meetings (AGMs)? The right to vote and view financial statements? Or they are just a mere consumer?... as in the case of a depositor in a bank? In the case of Cytonn CMS, investors can appoint their Investment Manager, they elect and have a Board of Directors, they have to be accepted into the Investment Partnership by an existing Partner, and they hold AGMs; a whole host of participatory rights that depositors do not have.
ii. The purpose intended to be served – Was the advancement of money in reliance of the entrepreneurial skills for successfully forming and operating a successful business in pursuit of profits, or are the tasks, for example, loan monitoring tasks that generated no expectation of profit? and,
iii. The factual setting as a whole – How is the product offered? Was it in an investment context e.g. was the Investor approached with the purpose of securing an investment for the Investor? The use of words such as *'your funds are going to be used to promote one of the greatest stock developments ever heard of'* for example have been used to hold that short term instruments with fixed returns are securities.

In conclusion, Structured Products, except for the cases of Certificates of Deposits, regardless of whether the Investors may have bargained a return or that the same may be structured to make regular payments, such as monthly or quarterly payments, are Securities. This is provided they meet the test as summarized in *SEC vs W. J Howey Co* (i) they are an investment of money, (ii) in a common enterprise, (iii) with profits, (iv) to come solely from the efforts of the manager. That Structured Products are securities rather than banking products is now a firmly settled matter in pretty much all jurisdictions. The same has never been litigated locally, but the legal jurisprudence on the matter is ample.

If Structured Products are Securities, how then do you issue Structured Products under Securities Law? Having seen that structured offerings are in their true form securities, we then examine the various ways through which the same are offered. Securities are issued in Kenya by way of either private or public offerings.

- Public offers are defined in the Capital Markets Act, Sections 30A, 30B and 30C, as read together. So an issuer or Investment Manager of a Structured Product can issue it under the public offers regulations. The challenge is that public offers tend to be highly standardized, and that is why public offers work well for standardized products such as equities, bonds, and unit trust funds. Structured Products by their nature, are highly customized and that is why they tend to be offered to high net worth investors through private offers. To provide for private offers, Section 30A (3) of the CMA Act then goes ahead to specify that *"An offer shall not be considered a public offer if – (a) the offer is not calculated to result, directly or indirectly, in the securities of the company being available to persons other than those receiving the offer; or (b) otherwise being a private concern of the person receiving the offer and the person making the offer"*. So it is clear that the CMA Act contemplates offers that are not public, hence private offers.

- The meaning of Private Offers is then provided for in The Capital Markets Regulations, 2002, Section 21, which provides conditions under which an offer will be deemed a private offer.

Structured Products have typically been offered in the private markets through the enterprising efforts of persons looking for a cost efficient, effective and flexible mode of fundraising.

While we may be familiar with public offerings because we encounter them on a day-to-day basis (the government bonds, securities trading in the stock exchange, money market funds in our daily newspapers), Private Placements may seem new, despite them being as simple as offering 1 or 3 of your friends or family a chance to invest in a business idea you want to pursue. This is because in the true nature of Securities Law nothing is concretely defined, and many definitions remain flexible with the clear objective being to be able to extend investor protection to the largest extent possible. Securities Law in general runs away from boxing itself in a corner as can be seen from the definition of 'Securities' as discussed above; there is no specific definition of 'security', it just depends on the features and circumstances. The same applies to 'Private Offers' or 'Private Placements'.

Private Placements the world over have therefore generally been interpreted in contrast to public offerings, and by referring to the exemptions from either (i) the requirement to publish a prospectus, or (ii) the requirement to procure approval by the investment / asset manager running the privately placed fund. This is the position in the United Kingdom, United States, Australia and at least thirty-one (31) members of the European Union. Our own Kenyan laws, The Capital Markets Regulations, 2002, Section 21 envisions Private Placements. The Laws in these countries provide for the marketing or offering of certain investment offerings and particularly Structured Products to a class of investors i.e. clients who possess the experience, knowledge and expertise to make their own decisions and properly assess the risks thereof. The restrictions are therefore with regard to the nature of the investors, minimum investment or number of investors as exemplified in the American Supreme Court decision of *Securities Exchange Commission vs Ralston Purina Company 346 US 119 Supreme Court*, where it was held that '**An offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering.'**

In conclusion, Structured Products are securities, as opposed to bank deposits, not only due to the Investor's expectation of a return higher than the market average but also that the Investor's depend on investment teams with the requisite knowledge and experience for the structuring of the products to deliver exceptional returns.

Cytonn Cash Management Solutions, "Cytonn CMS":

Having discussed Structured Products, why they are essential to funding businesses, their history and the regulatory product, we now discuss Cytonn CMS, our own structured note product, which has been highly discussed in the public domains, as an example of a structured note. *(This example is meant for general information only and has been prompted by the need to provide more information about structured products and respond to questions we are getting from the general public; it is not a warranty, representation, advice or solicitation of any nature. Readers are advised in all circumstances to seek the advice of a registered investment advisor.)*

Cytonn Cash Management Solutions (Cytonn CMS) is a privately placed high yield product that offers investors higher returns than they would get in other competing investment cash management options. CMS is structured as a Limited Liability Partnership, and investors come in as Investment Partners. The Cytonn CMS investors have their elected Board where they elect Partners among themselves to represent them in the Board. The Board then directs investment decisions. Cytonn Investments Management Plc, the group company, serves as the Principal Partner mandated to execute the decisions of the Board. The Board is responsible for convening the Annual General Meeting, which discusses and ratifies the Audited Annual Financial Statements and makes other decisions and passes resolutions; for example, a resolution by 70% of the investors can appoint another investment manager that is not Cytonn Investments. Additional oversight of Partner assets is provided by a custodian, Standard Chartered, while an annual audit of the fund is prepared by Grant Thornton.

The high returns on CMS are supported by:

- **Alternative Investments in the Portfolio:** Alternative investments such as real estate have historically outperformed traditional asset classes such as shares (equities) and fixed income. Real estate, for example, has generated 25%-28% p.a. over the past 10-years, comprising 5% rental yield and 20% - 23% capital gains, p.a.
- **Consolidation**: Private client funds are aggregated and then invested. The economies of scale lead to the Investment Manager having a greater bargaining power with financial institutions than if the investor approached a bank themselves,
- **Disintermediation / Structuring**: CMS cuts out the middleman, passing maximum value to the client. Banks, for example, will finance loans to developers at 14% - 18% p.a. These loans are funded by deposits sourced from retail clients at a 7% p.a cost of deposits, at best. Through Cytonn CMS, the investor can now access the same returns earned by the bank on loans to developers, (referring to our example earlier, disintermediation / structuring effectively turns Mr. Saver to Mr. Investor)
- **Market Knowledge:** Investment Managers are able to understand liquidity needs in the market for banks and corporates, and hence place funds where they would attract the highest risk-adjusted return,

- **Quick Decision-Making**: Some investment opportunities require quick decision-making capability, and with Investment Managers having analysis and dealing capabilities, it is easy to execute faster hence taking advantage of the glaring opportunities,
- **Credit Analysis**: Some privately placed opportunities such as high yielding private commercial paper and real estate mezzanine notes require specialized analytical capability to incorporate into a portfolio. For example, a portion of the funds in Cytonn CMS are invested as mezzanine notes in The Alma in Ruaka, a 450-unit mixed use development in one of Nairobi's fastest growing satellite towns. The Alma is a Kshs. 3.0 billion, 3-year project with an annualized return of 25% p.a. The high IRR also supports CMS' returns at 12% to 18% p.a.

Because a portion of CMS funds is invested in long duration real estate backed mezzanine debt, liquidity risk is a key concern. Cytonn's CMS mitigates this risk by:

- **Liquid Pre-Sale Contracts:** Purchasers of our projects such as The Alma, a 450-unit development in Ruaka, typically pay in instalments on units bought off plan. The instalment payments are used to make regular interest payments to the investors of Cytonn CMS. This creates a liquid and high yielding structure despite the investment in illiquid brick and mortar real estate. Essentially the underlying asset is not the illiquid brick and mortar real estate, ***but*** the liquid off plan sales contract behind each real estate unit. For this model to work, the development has to be sold off plan and the sales have to be ahead of the development. For example, in The Alma, sales are at 55% and construction is at 35%. Off plan sales require heavy investments in sales and marketing,
- **Project Management & Research**: Earlier in the project management cycle, Cytonn Real Estate identifies commercially viable areas and real estate themes (residential, commercial, mixed use etc.), making accurate assessments of demand through area research and assessing project risks through a team of on-site professionals and consultants. Once the project is approved by the Investment Committee, the development is launched to the public at the pre-sales / off plan phase, during which interested buyers make reservations and commit to purchasing units in customized payment plans. So in addition to heavy sales and marketing, differentiated market research and project management is key,
- **Conservative Asset Allocation**: The Investment Policy Statement mandates that 30% of CMS funds are invested in liquid public markets investments such as bank deposits and shares. Additionally, the fund has a retention rate of 80%; such that withdrawals are minimized, reducing the need for an aggressive liquidity buffer.

Frequently Asked Questions

Rather than respond to each public interest enquiry in social media, we have aggregated the questions we have often received:

- **Are you a bank?** We are not regulated by the Central Bank of Kenya and are not licensed to take deposits from the public. As discussed above, Cytonn CMS is an investment product not a banking product. Our investment solutions are privately offered investments through the private offers regulatory framework

- **Who regulates CMS?** Cytonn CMS is currently a privately offered solution, offered exclusively to high net worth individuals and is "self-regulated" through its own governance structure of the board, custodian, auditor and principal partner, Cytonn Investments, that is rated by Global Credit Rating (GCR) a credit rating agency
- **What happens when there is a default?** To evaluate a default, we need to look at the probability of default and the loss given default. The portfolio contains a highly diversified set of investment grade real estate assets that is selling off plan and liquid investments. Additionally, the corporate guarantee empowers investors to recover any amounts due from the promoter, Cytonn Investments Management Plc. A recent example is the minimal investments Cytonn CMS had in Imperial Bank and Nakumatt Commercial Paper; the defaults were taken up by the promoter, Cytonn Investments Management Plc, hence shielding our investors from any losses
- **How are you able to offer 18% yet banks offering much lower rates?** Cytonn CMS rate is priced off the loan price market, not off the money markets. Because the funds are mainly used for real estate development, which is mainly sold off plan, the appropriate benchmark is the cost of loans, and the typical real estate developer accesses bank financing at 14% - 18% per annum
- **How come no one else is offering these rates?** Offering higher than average rates requires a comprehensive platform; the Investment Manager has to have the asset yield that can support the return. The Promoter has to have an investment function that interfaces with investors (Cytonn Investments), and a yield generating function that generates the yield (Cytonn Real Estate). Cytonn is the only brand in this market that has coupled up investment management and real estate development onto one platform. A promoter cannot offer high returns without a high yielding asset to support the return
- **Why does my bank or relationship manager talk badly about CMS?** First is possible that RMs don't understand how structured notes work. Secondly, CMS offers a very competitive private alternative to fixed term bank deposits, hence can be construed to be in direct competition. It is not the first time established players have opposed new products. The banking industry was hesitant when M-Pesa was introduced 10-years ago as a new means for money transfer, but today M-Pesa is the leading means to transact cash. Taxi owners and drivers opposed the introduction of Uber, but today Uber is the most used means of cabbing in Nairobi. And established banks ridiculed the transformation of Equity Bank from a building society to a commercial bank, and today it is the largest bank by market capitalization. History is littered with examples of established order talking down innovation and emerging technologies that are perceived as threatening
- **What is the difference between a deposit offering a rate and an investment offering a rate?** Deposit rates are fixed and guaranteed by the bank, which is regulated by the Central Bank of Kenya. The rate a bank can offer is largely determined by the rate at which they can lend the funds and still keep a margin. On the other hand, an investment rate is determined by the profit returns generated by the commercial enterprise in which the funds are invested, such as real estate development
- **Who does Cytonn CMS target?** Cytonn CMS targets high net worth individuals and institutions with the capacity to understand the risks and complexity of the investments. They have to go through a prequalification process and be admitted by an existing Partner into the Partnership. It is privately offered

- **How come other fund managers at some point stopped issuing CMS?** CMS is an unregulated investment solution offered through private channels. Our understanding is that Fund Managers, themselves CMA regulated entities, were issuing CMS in contravention of Section 26 (1) (b) of the Capital Markets Act, which prohibits carrying out *"any activity outside the scope of the licensed or approved activities"*. The placement has to be structured to conform to the private offers regulations. It is our understanding that other competitors are restructuring their offerings
- **What is the profile of investors in Cytonn CMS?** Cytonn CMS investors include local high net worth individuals, Kenyans and other East Africans in the Diaspora, local institutions such as SACCOs and chamas, as well as international institutional investors. The leading investor is Taaleri, a USD 7 billion investor based in Finland, whose representative also sits on the Board
- **Is CMS a Ponzi Scheme?** A Ponzi scheme involves offering high returns that are not supported by any underlying economic activity or enterprise. Essentially returns are paid out of cash flows from new investors. Any offer of above market returns has to be able to demonstrate the actual assets / underlying economic activity that supports the returns. In the case of Cytonn CMS, the returns are supported by the 10 ongoing and largely pre sold developments

By and large, Structured Products are critical to our economy, as they:

i. Provide funding for businesses that have trouble accessing funding from traditional bank funding sources. They also offer a compelling alternative to bank funding, even as banks retreat from lending to the private sector as a result of the interest rate cap. The growth of the economy also creates several opportunities for funding through Structured Products as businesses source capital for growth,
ii. They also provide investment opportunities for yield-hungry investors. These investment returns go into securing the financial well-being of retirees, families and individuals trying to improve themselves.

However, despite these clear advantages, their little availability in Kenyan markets can be attributed to a lack of investor education and limited industrywide experience and adoption. To support the growth of Structured Products, we propose the creation of the East Africa Association of Structured Products & Alternative Investments, an industry association to spearhead education initiatives and the creation of a standardized framework for issuing and classifying Structured Products.

To learn more about Structured Products, we invite you to attend our wealth management training sessions that are run by the Cytonn Foundation under its financial literacy pillar. You can book attendance by writing to wmt@cytonn.com or book through this link Wealth Management Training.