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**ADDIS ABABA UNIVERSITY COLLEGE OF LAW AND
GOVERNANCE STUDY SCHOOL OF LAW**

**THE LEGAL SPACE FOR MOBILIZATION OF CAPITAL FOR INVESTMENT
IN ETHIOPIA: ANALYSIS OF THE LEGAL AND PRACTICAL CHALLENGES
IN ACCESSING THE NEW EMERGING ALTERNATIVE DOMESTIC DEBT
FINANCING**

**A THESIS SUBMITTED TO THE SCHOOL OF LAW, ADDIS ABABA
UNIVERSITY, IN PARTIAL FULFILLMENT OF MASTER OF LAWS
DEGREE (LL.M) IN BUSINESS LAW**

BY:

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ADDIS ABABA, ETHIOPIA

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Addis Ababa, Ethiopia

November 2024

Addis Ababa University

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**The Legal Space for Mobilization of Capital for Investment in Ethiopia: Analysis of
the Legal and Practical Challenges in Accessing the New Emerging Alternative
Domestic Debt Financing**

By

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November 2024

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Declaration

I hereby declare that the thesis titled “*The Legal Space for Mobilization of Capital for Investment in Ethiopia: Analysis of the Legal and Practical Challenges in Accessing the New Emerging Alternative Domestic Debt Financing*” is my original work and has not been submitted for the award of any degree in this or any other university. All sources of information used in the preparation of this thesis have been duly acknowledged.

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Verification

I, Dr. Solomon Abay, the thesis advisor for Robel Beyene, hereby verify that the thesis titled “*The Legal Space for Mobilization of Capital for Investment in Ethiopia: Analysis of the Legal and Practical Challenges in Accessing the New Emerging Alternative Domestic Debt Financing*” is the original work of him. To the best of my knowledge, this work has not been submitted elsewhere for the award of any degree.

Advisor Name: Dr. Solomon Abay

Signature: _____

Date: _____

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Acronyms

AWAS	Ansett Worldwide Aviation Service
NBE	National Bank of Ethiopia
OMPLC	One Member Private Limited Company
OSCOLA	Oxford Standard for Citation of Legal Authorities
PLC (PLCs)	Private Limited Company (Private Limited Companies)
SC (SCs)	Share Company (Share Companies)
VAT	Value Added Tax

Abstract

Capital mobilization is vital to attain necessary funds for investors to initiate and maintain business, and access to capital is quite instrumental. In this context, debt financing represents the most critical form of finance. However, the traditional modes of debt financing recognized in Ethiopia are not without their problems, hence ineffective. Therefore, the paper tries to look into the status of the country's recognition of the importance of new, emerging alternative debt financing sources in providing more innovative and diversified methods of accessing debt capital. This paper tries to provide insights into the recognition of new, emerging alternative debt financing in Ethiopia by analyzing inefficiency and incompleteness of the already recognized traditional debt financing sources. This would, in particular, analyze the legal constraints that come into play in the context of recognition regarding these innovative sources of finance in the Ethiopian landscape.

Key Words: Domestic Sources of Capital Mobilization, Traditional Debt Financing, New Emerging Alternative Debt Financing

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CHAPTER ONE

Introduction

1.1 Research Background

The mobilization of capital through debt financing has formed one of the cornerstones of economic activity in Ethiopia for many years.¹ Conventional mechanisms of debt financing have dominated the financial landscape, thereby providing the capital bases needed to underpin business growth and economic development in the country.²

However, the traditional system of debt financing in Ethiopia faces a number of challenges. These have rendered this form of financing ineffective in allowing investors to access the capital needed for their various businesses. In this respect, most investors find it difficult to acquire the needed capital base necessary to expand and diversify their investments, which in turn acts as a barrier to the overall growth and development of an economy.

All these challenges raise the need to explore newer emerging alternative sources of debt financing that are more innovative, and suitable to better address the diverse needs of businesses across sectors in Ethiopia. In addition, such mechanisms of finance could be vital in achieving sustainable economic growth when they are recognized and integrated into the country's diligent efforts to make its financial landscape truly inclusive and vibrant.

This paper outlines the inefficiencies and shortcomings of traditional sources of debt financing while exploring the emergence of new alternative debt financing options in Ethiopia. It further discusses the legal and practical limitations of recognizing such innovative financial sources within the Ethiopian landscape.

¹ Gulilat Lemi, 'Effects of Debt Financing on the Financial Performance of Small and Medium Enterprises in Addis Ababa' (In Partial Fulfillment of the Requirements for the Degree Master of Science in Accounting and Finance), Addis Ababa University College of Business and Economics Department of Accounting & Finance, Addis Ababa, 2023) 5.

² *ibid*

1.2 Research Problem

While debt financing is important for the mobilization of capital, the traditional mechanisms for loan financing, lease financing, and debentures in Ethiopia have a host of challenges that render them ineffective to meet investors' needs. In many instances, these traditional forms of financing are confronted with many challenges, all combining to limit their effectiveness in mobilizing capital. These inefficiencies meant that the much-needed capital to grow and expand could not be found by investors. It is, thus, becoming pertinent to search for and trace newly emerging alternative debt financing sources such as trade credit, sale and leaseback, and corporate bonds. These are more likely to provide new innovative solutions to the pitfalls of traditional debt financing, affording investors with the capital they need to move forward with their activities.

These innovative debt financing options, however, face legal and practical hindrances towards their recognition and application in Ethiopia. Among the key legal challenges is that no supporting legal framework ensures such financing options. Besides, various practical challenges face parties concerned with such alternative means of financing.

Therefore, this thesis tries to address these challenges by analyzing the legal and practical issues associated with recognizing new alternative sources of debt financing in Ethiopia. It aspires to provide a comprehensive understanding of the integration of alternative mechanisms into the Ethiopian financial landscape that might serve as a panacea to the shortfalls of traditional debt financing mechanisms in Ethiopia and could eventually help in the economic development of the country at large.

1.3 Research Questions

1. What are the traditional debt financing sources available to investors in Ethiopia, and what challenges limit their efficiency?
2. What are the potential new emerging alternative debt financing sources available in Ethiopia, and what are the legal and practical challenges that impede their recognition and implementation?

1.4 Research Objectives

General Objective

To analyze the challenges associated with traditional debt financing in Ethiopia and explore the potential of new emerging alternative debt financing sources as viable solutions.

Specific Objectives

The research aims to accomplish the following specific goals under the above-mentioned general objective:

1. To identify the traditional debt financing mechanisms in Ethiopia, and to examine the challenges associated with them.
2. To investigate the new emerging alternative debt financing sources in Ethiopia, and to assess the legal and practical challenges in recognizing and implementing these financing sources.
3. To propose legal reforms and practical recommendations to support the recognition and implementation of alternative debt financing sources in Ethiopia.

1.5 Literature Review

This literature review focuses on the existing body of research in the area of debt financing in Ethiopia, relating to both the traditional mechanism and emerging alternatives. It addresses the limitations of existing financial frameworks, in addition to theoretical underpinnings that may inform the emerging evolution of debt financing practices. This review identifies the gaps that exist in literature with regard to the integration of alternative debt financing options into traditional sources of loan financing, lease financing, and debentures. The aim is to deliver a comprehensive understanding of the challenges facing traditional methods of financing, while at the same time proposing innovative solutions that will ensure the capital mobilization landscape in Ethiopia is improved.

1.5.1 Existing Literature and Theoretical Frameworks

The existing literature extensively covers traditional debt financing mechanisms in Ethiopia, including loan financing, lease financing, and debentures. In the paper "*Debenture as an Alternate Scheme of Raising Investment Fund and Its Prospects under Ethiopian Company Law*," Lantera Nadew, for instance, discloses the possibility of raising capital from the general public privately through the issuance of debentures.³ He says that debentures can be a good source of capital for investors instead of loan financing. The author has used the descriptive and explanatory methods to analyze the basic rules and principles as well as the statutory requirements concerning the issuance of debentures under the Ethiopian commercial code. He thereby draws the inference that the code's rules governing debenture have never been applied practically because of lack of familiarity among potential investors concerning this financial tool. He proposes a campaign to change this perception.

Lantera regards the debentures as a suitable mechanism of financing. His work primarily deals with the overcoming of obstacles in the way of their applicability rather than finding its alternative sources that may complement debentures.

In a paper titled "Regulating Domestic Financing to Foreign Investment in Ethiopia," Yigrem Minda discusses the various options of domestic financing, including the traditional ones like bank loans, debt financing, and lease financing.⁴ According to Yigrem, the institutional and legal framework is inadequate and cannot firmly regulate domestic sources of financing. He adopts both the doctrinal and empirical methods to analyze various laws and scholarly works. The paper concludes that some of the laws are restrictive and thus bottlenecks, while others were not comprehensive, to which all combine and reduce the effectiveness of these sources of finance. Yigrem also faults institutions in the sector for their inability to ensure that these sources function effectively. The author postulates that the effectiveness can be improved through the amendment of certain laws and putting in place an institutional framework that outlines the necessary steps needed towards their resolutions.

³ Lantera Nadew Anebo, 'Debenture as Alternate Scheme of Raising Investment Fund and Its Prospects Under Ethiopian Company Law', (2019) Mizan Law Review Vol. 13 No.3 338

⁴ Yigrem Minda, 'Regulating Domestic Financing to Foreign Investment in Ethiopia' (In Partial Fulfillment of Master of Laws Degree (LLM) in Business Law, Addis Ababa University College of Law and Governance Study School of Law, Addis Ababa, 2021)

Although Yigrem's paper discusses multiple traditional sources of finance, like the work of Lantera, it discusses regulatory challenges in a large capacity and does not discuss the quest for alternative sources that could alleviate the issues involved in traditional financing methods.

1.5.2 Innovative Work of This Research to Tackle the Existing Literature Gap

➤ The New Emergence of Alternative Debt Financing

This research incorporates the innovation concept, which holds that the financial legal framework in Ethiopia should keep abreast of the dynamism in market needs. It is felt under this concept that there is the need to explore alternative sources of debt financing such as trade credit, sale and leaseback and corporate bonds, besides the traditional forms.

However, there is a lack of scholarly research in the way the sources of traditional debt finance relate to these emerging alternatives. Up to this date, no academic studies have indeed discussed how such new alternatives could resolve some of the challenges related to traditional sources or how their recognition might further expand the existing financing landscape.

This research, therefore, advocates for the need to recognize and adopt new alternative debt financing options, having analyzed the challenges traditional sources of debt financing face in Ethiopia. In particular, it also investigates the legal and practical problems linked to the recognition and implementation of the new alternative debt financing sources in the country. The paper addresses these issues in detail with a view to providing an in-depth understanding of the related legal implications and the need for reform in order to create an effective and attractive environment for investors who are interested in such alternative sources of finance.

1.6 Scope of the Research

The research focuses on the analysis of sources of traditional debt financing currently recognized in Ethiopia. Though there are various types, such as sources of traditional debt financing, the research will focus on loan financing, lease financing, and debentures in order to give substantial discussion about these sources. By focusing on these selected sources, the research will not be too broad and it will be able to investigate in-depth how those financing mechanisms work and what are the challenges that affect their efficiency.

This research extends to investigate the status of new emerging alternative debt financing sources in Ethiopia. While several alternative debt financing sources are emerging, the research will focus on trade credit, sale and leaseback, and corporate bonds to obtain an idea of their recognition as well as implementation in the country.

Finally, the study examines legal and practical challenges presented by the alternative sources of financing, and also provides recommendations for integrating alternative debt financing into the financial landscape of Ethiopia. This research is geographically limited to Ethiopia.

1.7 Research Methodology

The research seeks to investigate the inefficiencies and inadequacies of traditional sources of debt financing, while exploring the emergence of new alternative debt financing options in Ethiopia. It specifically examines the legal and practical constraints associated with recognizing these innovative financial sources within the country. A qualitative research method is used to achieve this.

1.7.1 Nature of the Research

The research is both examining and analytical. It falls under doctrinal legal research, as it involves a collection and analysis of data for understanding the traditional and any evolving alternative sources of debt financing under the legal system in Ethiopia. It also entails practical aspects to understand the challenges associated with these financial sources.

1.7.2 Sampling Techniques

The research targets trade credit, sale and leaseback, and corporate bonds as alternative sources of finance to examine their recognition and application in the country. This has been done because, in the study, these sources are analyzed to assess their potential for being appropriate alternatives to the traditional sources that have been studied in order to provide the solution needed based on the identified challenges in the traditional sources of debt finance.

Interviews were conducted based on a selective sampling technique. Legal experts having academic and practical experience in finance had been deliberately selected for interviewing. Besides, selected investors doing business in Ethiopia, particularly those with profound knowledge of the local business environment, had also been preferred depending on the industry background. The interview questions were well-articulated, tailor-made for each candidate.

1.7.3 Types of Data to be used

The research obtained data from both primary and secondary sources of data.

Primary Sources

- ✓ **Legal instruments:** The research used different laws of Ethiopia, which have mandatory authority. The research assures that the legal rules it has determined to apply to the research are still operative.

Secondary sources

- ✓ Foreign Laws
- ✓ Published books, articles journals, reports, websites and others which can serve as persuasive authorities.

1.7.4 Instruments of Data Collection

The instruments of data collection may include document analysis, which involves examining legal documents and relevant literature to extract pertinent information. Additionally, interviews with experts in the field are used as another instrument of data collection.

1.7.5 Method of Data Analysis

The research will employ a qualitative method of data analysis to examine the legal landscape for capital mobilization in Ethiopia. It will conduct a detailed analysis of legal documents and relevant literature, extracting information related to domestic debt financing sources. Furthermore, the research will analyze the interview data collected from experts in the field, examining the insights and perspectives shared regarding the issue.

1.7.6 Method of Data Interpretation

The interpretation of data shall be through the exploratory and analytical technique. The research will look into the efficiency of conventional debt financing and analyze the state of emerging alternative debt financing legal framework for capital mobilization in Ethiopia. Interpretations shall look at and analyze the relationships of analyzed data and findings of research to arrive at a conclusion; it shall therefore rely on inductive inference.

1.8 Significance of the Research

This research is, therefore, relevant to the pressing issue of capital mobilization in Ethiopia, which is yet needed for the growth of businesses and attendant economic development. The paper thus aims to contribute to the development of a more inclusive and dynamic Ethiopian financial environment by highlighting the inefficiencies of the traditional modes of debt financing and exploring alternatives. These findings and recommendations will be very useful to the legislature and investors in terms of guiding them into alternative financing solutions that are clearer in attracting economic growth and development within the country.

Moreover, given that this research has placed greater emphasis on Ethiopia, this study will definitely add significantly to the existing volumes of knowledge on capital mobilization for investment in the country. This study will, therefore, form a foundation upon which future studies of new emerging alternative sources of debt financing can be based, hence broadening our knowledge about the topic and its implications.

1.9 Limitation of the Research

The research is limited by literature availability on alternative debt financing in Ethiopia. Most of the available literature focused towards traditional financing mechanisms, which could skew the analysis towards more familiar financial practices.

The research also faces a major challenge in the scheduling of interviews. Scheduling convenient times has proved very difficult in this matter, considering that the interviewees have busy schedules and limited availability.

The research is done within a limited timeframe. It means that it is impossible to conduct or even carry out longitudinal studies or fieldwork in great depth. Long-term trends and the comprehensive effects of legal reforms on alternative debt financing are not captured.

1.10 Research Organization

The research is organized into five chapters, each dealing with different aspects of traditional and alternative debt financing sources for the mobilization of capital in Ethiopia. This was done by outlining the areas of focus needed in the study.

Chapter one is the framework upon which the succeeding chapters are supported. The overall view of the research background, research problem, research questions, research objectives, literature review, research scope, research methods, research significance, research limitations, and research organization, are discussed here.

Chapter two considers the sources of debt financing in Ethiopia for capital mobilization through mechanisms such as loan financing, lease financing, and debentures. Various drawbacks are highlighted that are associated with these sources, showing how they have limited capacity to meet the increasing financial demands of businesses and investors. The chapter concluded by emphasizing how inefficient conventional sources call for alternative financing sources in view of the changing economic frontier in Ethiopia.

Chapter three explores the need for new emerging alternative sources of debt financing in Ethiopia and highlights mechanisms like trade credit, sale and leaseback, and corporate bonds as innovative ways to break through traditional methods of finance. The chapter therefore proposes that with an understanding and adoption of such financing options, investors may be better placed to navigate the financial landscape and uncover opportunities at a faster rate in economic development.

Chapter four discusses the legal and practical challenges brought forth by new emerging alternative debt financing sources discussed under chapter three. It identifies key legal and practical hurdles for the successful adoption and implementation of those alternative financing mechanisms in Ethiopia.

Chapter five provides the conclusion and recommendations from the analysis done on new emerging alternative debt financing sources in Ethiopia, based on legal reforms and practical measures so as to satisfy the challenges raised under chapter four.

1.11 The Preferred referencing and Citation Style

According to the LLM Thesis Guidelines of the school, the footnote approach and OSCOLA referencing style are utilized to acknowledge reference materials.

CHAPTER TWO

Analysis of Traditional Debt Financing Sources of Capital Mobilization in Ethiopia

2.1 Capital and Capital Mobilization

The meaning of capital varies by usage context. Defining the various meanings ascribed to capital becomes important in an articulate understanding of the subject. From a financial viewpoint, capital specifically refers to the financial assets used to raise value or benefits for business operations.⁵ Anything that has value can be classified as capital. It can be in the form of money or any other liquid asset that are easily to convert into funds that business organizations used it to generate revenue.⁶

Capital is needed by most start-up businesses in order to cover the initial costs.⁷ It provides the nucleus around which the start of the business can be set up. The existing businesses also take concern over capital in order to stay competitive in their respective industries.⁸

Capital mobilization is the process of identifying various means of raising capital for the purpose of achieving operational objectives of businesses.⁹ It is a process of collecting available funds and making them available for investment. To enable investors to invest in investment opportunities, it has to be undertaken so that the resources are made available to finance an investment activity to achieve goals. Capital mobilization involves the actual

⁵ Marshall Hargrave, 'Capital: Definition, How It's Used, Structure, and Types in Business' (Investopedia 2022) < <https://www.investopedia.com/terms/c/capital.asp> > accessed 10 September 2023

⁶ Indeed Editorial Team, 'What is liquid Capital? (With Definition and Examples), 2002, Career Development, Indeed Career Guide < <https://www.indeed.com/career-advice/career-development/what-is-liquid-capital> > accessed 11 September 2022

⁷ C.Paramasivan and T. Subramanian, *Financial Management* (New Age International (P) Limited) 26.

⁸ *ibid*

⁹ Ngo Thi Huong THAO, 'Capital Mobilization For Small and Medium Business Development in Hanoi, 'Ministry of Education and Trading, Ministry of Finance, Academy of Finance, 2021, 6.

mobilization of various potential sources of funds to make their allocation to worthwhile projects a viable proposition.¹⁰

2.2 Financing Sources for capital mobilization in Ethiopia

Investors in Ethiopia can identify various sources of financing to provide them with funds for meeting financial obligations. Such sources would imply how their business could raise capital and manage the economic structure of the business. Investors must assess the appropriateness of each source while considering the particular needs and conditions of their business.

Capital mobilization financing of the capital in Ethiopia may be viewed to fall into a number of categories, based on the type of funding required and the means through which it is obtained. The main focus of this section will fall under domestic debt financing sources in the Ethiopian context. This generally provides the very vital funds that are required for businesses and economic developments within the country.

2.2.1 Domestic Debt Financing Sources

Domestic financing sources, also referred to as national finance, involves the ways in which investors make use of funds accessible within Ethiopia in order to meet their financial needs.¹¹ It aims to identify and make use of locally available funding sources within the country.

Under domestic financing sources, debt financing refers to raising capital by borrowing funds from third-party owners.¹² It requires the obligation of repayment of the principal amount along with any interest or fees.¹³

¹⁰ Nguyen Khanh Ly, 'The Enhancement of Capital Mobilization in Bank for Investment & Development of Vietnam (BIDV)' (In partial Fulfillment of the Requirements for Bachelor Degree in Economics Major in Management, Faculty of Business President University 2014) 11.

¹¹ Eszter Mogyorosi, 'Overview of Financial Sources at National Level', (2019) International Urban Cooperation European Union, A European Union Programme, 4.

¹² J.B. Maverick, 'Equity Financing vs. Debt Financing: What's the Difference?' (Investopedia 2024) <<https://www.investopedia.com/ask/answers/042215/what-are-benefits-company-using-equity-financing-vs-debt-financing.asp>> accessed 10 July 2024

¹³ ibid

2.2.1.1 Traditional Debt Financing Sources

This section refers to the sources, which the research has developed as "traditional" because they remain the main and dominating method of raising debt capital for investors in Ethiopia. These financing methods have become deeply ingrained in the country's financial landscape and are widely recognized and accepted as conventional ways of accessing debt financing.

While there are many kinds of debt financing sources that are classified as traditional, the section will select only a few sources in order to delve deeper in the discussion. By focusing on those particular sources, it shall discuss how those mechanisms of financing work and issues affecting their effectiveness.

i. Loan Financing

One of the major traditional sources of debt financing that investors could obtain to enhance business operation activities in Ethiopia is loan financing from financial organizations, particularly banks and microfinance institutions, in Ethiopia.¹⁴ According to the Banking Business Proclamation in Ethiopia, a loan is taken as a financial agreement whereby a bank commits itself to lending an amount to a person, who receives it, and such a person must repay the amount borrowed with interest before the due date.¹⁵ Loans are a valuable method for mobilizing capital in which investors can raise capital to finance their business activities.

The NBE has established a Financial Consumer Protection Directive that guides the professional conduct of financial institutions like banks and microfinance providers, and borrowers alike.¹⁶ Therefore, pursuant to this directive, investors have the option to discuss and negotiate specific terms and conditions of a loan, such as the interest rate, collateral requirements, loan tenure, and other loan conditions, when they want to borrow.¹⁷

¹⁴ Asrat Tessema, 'Prospects and Challenges for Developing Securities Markets in Ethiopia: An Analytical Review', (2019) African Development Review Journal Vol. 15 No.1 1.

¹⁵ Banking Business Proclamation, 2008, Art 2(13), Proc. No. 592, Neg. Gaz. Year 14, no.57.

¹⁶ Financial Consumer Protection Directive, 2020, Directives No. FCP/01

¹⁷ *ibid*

Upon successfully navigating these conditions, investors could get loan funding, one that still happens to be a strong instrument for capital mobilization, and which supports the expansion of business activities in the country.

ii. Lease Financing

Another acknowledged traditional debt financing is lease financing. It is explained as a financing transaction in which a lessor grants a lessee the right to use identified capital goods for a defined period.¹⁸ The lessee bears the obligation of paying periodic installments or payments against the lessor throughout the lease period.¹⁹

Investors may conserve their liquid cash through lease financing, as they could elect to delay the full amount required to purchase those assets, and at the same time employ their capital effectively by employing the use of the assets.²⁰

Leasing finance has grown broadly in Ethiopia and it is becoming very important for the country in terms of tackling its financial needs and promoting economic development.²¹ Despite its difficulties, some leasing companies are still interested in working in this industry.²² Thus, leasing companies have become popular for investors seeking to raise capital.²³

iii. Debentures

Debentures represent another form of traditional debt financing that is considered a type of security financing in Ethiopia. A debenture is a negotiable instrument in which the holder shall pay the par value as upfront, while the company which issued it will repay the holder with the original par value of its debenture, together with accrued interests if any, upon the maturity

¹⁸ Capital Goods Leasing Business Proclamation, 1998, Art 2 (1), Proc. No. 103, Neg. Gaz. Year 4, no 27

¹⁹ *ibid*

²⁰ Tpoint Tech, Advantages and Disadvantages of Lease Financing, Javatpoint <<https://www.javatpoint.com/advantages-and-disadvantages-of-lease-financing>> accessed 10 March 2024.

²¹ Bededa Gudeta, 'Determinants of Lease Financing Practice and Its Effect on Income of Small and Medium Enterprises: In case of Jimma and Bench Sheko Zones' (In Partial Fulfillment of the requirements for the Degree of Master of Science in Development Economics (MSC), Jimma University College of Business and Economic Department of Economics, Jimma, 2020) 10.

²² *ibid*

²³ *ibid*

date of the debenture.²⁴ In this light, debentures become one of the means by which a business company can generate external cash from investors.

Under the Commercial Code of Ethiopia, only investors who participate in business through SCs are authorized to issue debentures as a way of raising their capital, per the rules of the Code.²⁵

There are two key prerequisites for a company to issue debentures:

1. The company's capital must be fully paid up; that is, the shares issued by the company to its shareholders have been paid by them.²⁶
2. The company must have been in operation for at least one year.²⁷

These requirements imposed by the commercial code seek to ensure a certain level of financial stability and track record of operation before companies can use debentures as a debt financing mechanism in Ethiopia.

2.2.1.2 Challenges of Traditional Debt Financing Sources

i. Loan Financing

As identified above, loan financing is one of the most efficient traditional methods of capital mobilization in Ethiopia.²⁸ Although the legal framework for this type of financing is relatively well-developed and regulated by the NBE, there are a number of challenges that restrain its efficiency. Some of these include:

➤ Regulatory Impositions

The NBE imposes a number of regulations that may stifle the capacity of financial institutions to grant credit. These have included the imposition of credit ceilings, which bind the quantum

²⁴ Commercial Code, 2021, Art 407(1), Proc. No. 1243, Neg. Gaz. Year 27, no.23.

²⁵ *ibid* Art 408

²⁶ *ibid* Art 408(1)

²⁷ *ibid* Art 408(2)

²⁸ *Lantera Nadew Anebo*, (n 3) 338

of credit available for the banks to lend to their borrowers.²⁹ The NBE has recently imposed fresh loan discernment quotas for each bank based on a cap that has been adopted.³⁰ Once banks reach their credit ceiling, they cannot lend anymore, and this cripples the mobilization of capital through loans.

Another imposition by the NBE is the policy that requires all commercial banks to invest 20% of their respective loan and advance disbursements in treasury bonds.³¹ This is to support the fiscal policy of the country.³² However, when banks are obligated to use a significant portion of their deposits to invest in treasury bonds, this then reduces the availability of funds for the banks to create loans.³³ These types of restrictions constrain available credit to investors and, therefore, dampen their ability to mobilize capital via loans.

➤ **Liquidity Constraints**

Most Ethiopian banks and microfinance institutions face insufficient funds, normally less than the demand for credits.³⁴ This could be due to deposit shortages, issues with loan repayments at maturity, and regulatory limitations on accessing external liquidity sources, among other factors.³⁵ If there is a problem with the liquidity of such institutions, the level at which they can provide loans becomes so limited, therefore limiting the level of capital mobilization for the investors.

➤ **Collateral Requirements**

Banks and microfinance institutions in Ethiopia usually demand collateral as security against loans.³⁶ This may pose some challenges to investors involved in small businesses, which are

²⁹Capital, NBE's New Quota Stifles Fresh Banks' Capital (2023) Ethiopia <<https://www.capitalethiopia.com/2023/09/25/nbes-new-quota-stifles-fresh-banks/>> accessed 11 August 2023

³⁰ ibid

³¹ Samuel Bogale, Fed in Deep as Banks Treasury Bond Stock Nears 50 bln' The Reporter (2023) Ethiopia <https://www.thereporterethiopia.com/38006/#google_vignette> accessed 11 August 2023

³² ibid

³³ ibid

³⁴ Interview with Mr. Bereket Asamnew, Legal Credit Manager at Bank of Abyssinia Share Company, Addis Ababa, Ethiopia (18 February 2024)

³⁵ ibid

³⁶ Interview with Mr. Belete Lemesa Dadi, General Manager of Belete Netsehety and Friends Blocket Manufacturing Partnership, Addis Ababa, Ethiopia (11 February 2024)

believed to be characterized by a lack of substantial financial operations.³⁷ For that reason, they are often unable to access loans because of inadequate collateral.

➤ **High Interest Rates**

Interest rates on loans in Ethiopia may be relatively higher compared to other countries. For example, the average current commercial banks' lending rate for medium and large business in Kenya stands at about 14.63%.³⁸ This percentage is considerably less than the average interest rate of private banks operating in Ethiopia. For instance, the average current interest rate for loans granted for business purposes at Bank of Abyssinia, one of the well-known and reputable private banks operating in the industry, currently stands at 20.33%.³⁹ These high interest rates translate into very expensive borrowing and thus place huge financial burdens on investors. This situation may make loan repayment difficult for them, hence severely affecting their capital mobilization through loan financing.

ii. **Lease Financing**

Ethiopia acknowledges the very contribution of lease financing to capital mobilization for businesses. The country has enacted the Capital Goods Leasing Business Proclamation, which aims to empower lessors of capital goods to address the existing issue of insufficient capital, an issue that cannot be solved solely by the current financial institutions.⁴⁰ The proclamation has laid down a general legal framework that might go a long way in facilitating the lease financing market in the country. Yet, even with its potentials, lease financing faces numerous challenges. Some of these are:

➤ **Legal and Administrative Complexities**

The number of established lessors in the market may be relatively small. This limitation can be traced from the legal requirement stipulating that the nature of the form of business

³⁷ *ibid*

³⁸ Trading Economic, 'Kenya Bank Lending Rate' <<https://tradingeconomics.com/kenya/bank-lending-rate>> accessed 11 August 2023

³⁹ Bank of Abyssinia, 'Approved Conventional Banking Credit Product Prices and Charges' (2024) Internal Memo

⁴⁰ *Capital Goods Leasing Business Proclamation* (n 18) 2nd Paragraph of the Preamble

organization that a lessor would take shall be a share company and no other form of business organization according to the directive of the NBE.⁴¹

The legal and administrative complexities arising out of forming and operating as a share company are likely to deter the entities from playing the role of a lessor. It complicates the entry in the leasing market since lessors must be established as SCs. This may discourage potential lessors due to the difficulties associated with setting up and operating a share company. It therefore reduces the number of lessors who are willing to advance leasing finance to investors in the lease finance sector, hence making it less effective in capital mobilization.

➤ **Financial Constraints**

Many lessors may not have adequate funds to make capital goods available for investors.⁴² Usually, those capital goods which are leased are machinery, equipment, and vehicles.⁴³ Their prices are normally higher, and these goods fall under the category of not being in easy reach, both for lessees and lessors.⁴⁴ In this way, the financial constraints on the lessor's part hamper them from making lease financing an operative method of mobilizing capital for investors.

iii. **Debentures**

While there is an indication of debentures being a potentially good source of finance, its operation as an instrument of finance is faced with numerous challenges that reduce their effectiveness as a good source of finance to investors in Ethiopia. Some of the impediments facing debentures as a way of finance include the following:

➤ **Legal Restrictions on Debenture Issuance**

As mentioned above, only SCs are allowed to issue debentures under the Ethiopian Commercial Code, keeping it off from other business organizations such as PLCs and OMPLCs. Since it is possible to appreciate what exactly the code is trying to do, prohibition

⁴¹ Requirements for Licensing of Capital Goods Finance Business, 2013, Art 5.1, Directives No. CGFB/02

⁴² Interview with Mr. Chombe Kalifa Deputy Managing Director of Oromia Capital goods Finance Business Share Company, Addis Ababa, Ethiopia (20 February 2024)

⁴³ *ibid*

⁴⁴ *ibid*

from issuing debentures in PLC and OMPLCs can be attributed to the following factors. First, these types of companies are usually much smaller in scale and typically have a few shareholders who are often related or associated with the company, which is not the case with SCs.⁴⁵ The prohibition against issuing debentures reduces the risk of debt financing obligations such as interest payments and obligations upon repayment for third-party debenture holders.⁴⁶ Allowing only equity financing for such companies ensures a more stable financial position and avoids potential financial burdens.

The other important reason for prohibition on issue of debentures in such companies is to safeguard the interest of existing shareholders and their ownership within the company.⁴⁷ Since the code restricts the number of shareholders in both PLCs and OMPLCs, introducing debenture holders as shareholders will dilute the ownership and control of existing shareholders.

However, with regard to PLCs, different jurisdictions may permit such companies to issue debentures under certain conditions. For example, in the United States, private companies can sell and offer debentures to qualified investors under exemptions that are availed through Regulation D, which is issued under the Securities Act.⁴⁸

It is worth noting that in practice of Ethiopia, there are investors who engage business through PLCs that have strong financial conditions and can be managed by a board of directors, as stated in Article 513 of the commercial code.⁴⁹ These companies resemble SCs with their financial strength. In such cases, the law may have failed to accommodate these types of PLCs in raising capital through issuing a debenture.

To address this issue, the law could consider allowing debenture issuance for raising revenue for such PLCs under strict conditions. One measure could be setting specific financial capital requirements to mitigate associated risks. This would ensure that only financially stable

⁴⁵ Interview with Mr. Abraham Rega Kassa, former Associate at Mehrteab Leule and Associates Law Office, Addis Ababa, Ethiopia (15 February 2024)

⁴⁶ *ibid*

⁴⁷ *ibid*

⁴⁸ Will Kenton, 'SEC Regulation D (Reg D): Definition, Requirements, Advantages,' (Investopedia 2023) <<https://www.investopedia.com/terms/r/regulationd.asp>> accessed 20 October 2023

⁴⁹ For instance, Sunshine Construction Plc, Addis Ababa, Ethiopia <<https://www.sunshineinvestmentgroup.net/front-page/construction/>>

companies are eligible to issue debentures. Additionally, specific rules could be implemented to protect the interests of existing shareholders, such as limiting the number of debenture holders based on the general number of members allowed for PLCs. This limitation would prevent dilution of ownership and maintain the balance of control among existing shareholders.

Furthermore, the law could extend the application of specific rules mainly regulating the financial conditions of SCs, to PLCs. However, careful supervision and enforcement of the applicable rules would be crucial in ensuring compliance and safeguarding the interests of all stakeholders involved.

However, as mentioned earlier, in the current regulatory environment in Ethiopia, investors are confined to using SCs as the only avenue to raise capital through debenture issuance. This means that debentures are a limited and restricted source of debt financing in the country, rather than an extensive one.

➤ **Lack of Investor Awareness**

The establishment of a securities market has been a great stride taken by Ethiopia by providing the Capital Market Proclamation, which contains comprehensive provisions with regard to security exchanges and specific enforcement mechanisms.⁵⁰ Such a step taken by a country's legislative house is notably important in establishing a regular and systematic platform where the concerned companies would have well-defined rules and procedures regarding the issuance of securities through an appointed authority.

However, there is a practical problem in that not many potential investors are even aware of the existence of such instruments as a debenture.⁵¹ Many potential investors might not be fully aware of the processes and benefits pertaining to investment in debenture securities. Hence, relatively low demand for such instruments may exist within the country.⁵² Consequently, SCs

⁵⁰ Capital Market Proclamation, 2021, Proc. No. 1248, Neg. Gaz. Year 23, no 33

⁵¹ *Asrat Tessema*, (n14) 37.

⁵² *ibid*

that have been accorded this privilege by law may keep themselves away from offering debentures as a means of raising capital.⁵³

2.3 The Inefficiency of Traditional Debt Financing in Ethiopia: A Call for Alternatives

As already discussed, traditional sources of debt financing have constituted the primary source of business capital in Ethiopia. Though such sources of finance have played a significant role in promoting economic activity, they are nevertheless facing important challenges which tend to compromise increasingly their effectiveness and reliability as instruments of capital mobilization.

All these challenges clearly indicate that traditional debt financing alone is not sufficient to meet the rising need for business and investors in Ethiopia.⁵⁴ The dynamic character of the economic environment demands a change in the way capital is mobilized.⁵⁵ In line with increasing innovative demands, financing solutions should have sufficient flexibility for unique situations and demands by businesses. It is, thus, of the highest importance to investigate and adopt new alternative debt financing options which can avail better access, sustainability, and adaptability to dynamic market demands.

⁵³ Workneh Alemnew Alula, 'Debentures and Bonds under the Ethiopian Law' (2017), the International Journal of Ethiopian Legal Studies Vol. 2:1 25.

⁵⁴ *Lantera Nadew Anebo*, (n 3) 335

⁵⁵ *ibid* 336

CHAPTER THREE

Accessing New Emerging Alternative Debt Financing Sources in Ethiopia

3.1. The Need for the New Emerging Alternative Debt Financing Sources

Given the limitations of traditional debt financing sources in Ethiopia outlined in the previous chapter, it's about time they were supplemented with the introduction of new, emerging alternative debt financing mechanisms that are equally innovative and more flexible to meet various needs of businesses from different sectors.

Such development of these alternative mechanisms of finance may boost innovation by emboldening investors into new ideas, free from apprehensions about unavailable finance.⁵⁶ These could be means whereby businesses are better equipped with funds to invest in various directions and hence achieve growth and competitiveness in the market.⁵⁷ The development of such alternatives may also create an inclusive financial environment. By expanding access to various sources of finance, they can open up avenues for a range of different business types to prosper and drive economic growth.

While there are various types of emerging alternative debt financing sources, this section will focus on specific sources that more appropriately serves as alternatives to the traditional sources discussed in the previous chapter. In focusing on these selected alternative sources, the chapter will be able to shed light on how these financing mechanisms operate and their relevance to businesses in Ethiopia.

i. Trade Credit

Trade credit is a source of finance whereby, in the course of buying goods or services, suppliers extend credit to a business and agree to receive payment after some time.⁵⁸ In this form of credit, an investor who owns a business does not pay for the goods supplied at the time

⁵⁶ *ibid*

⁵⁷ *ibid*

⁵⁸ Vicente Cunat and Emilia Garcia-Appendini, 'Trade Credit and its Role in Entrepreneurial Finance' 2012, Oxford Handbook of Entrepreneurial Finance, Oxford University Press, New York 526.

of delivery but agrees to settle the debt later, as determined by the transacting parties.⁵⁹ This arrangement provides a source of short-term finance, allowing the investor to access the goods or services supplied without having to pay for them in immediate liquid cash.⁶⁰

In Ethiopia, there is no clear recognition or dedicated law to govern trade credit. To find some legal basis for such transactions, one might refer to the civil code provision regarding loans. From the essence of the definition provided for loans in the code, trade credit can be understood as a transaction undertaken through a contract in which a seller agrees to deliver and transfer ownership of a business asset to an investor, with the condition that the investor will return the consideration to the seller.⁶¹

Trade credit is emerging as an alternative to traditional debt financing, particularly loan financing. It shares common attributes with loans, as it involves credit, with sellers effectively acting as lenders. Trade credit has the potential to address the inefficiencies of conventional loan financing in Ethiopia. If adopted, it could serve as a valuable alternative source of financing, offering several competitive advantages over traditional loans.

- **Avoiding Liquidity Constraints of Financial Institutions:** Trade credit is usually an arrangement between an investor and a seller whereby the seller agrees to be paid later by the investor for goods or services received. The arrangement does not depend on the liquidity of financial institutions since this is a form of supplier financing.⁶² Investors can, therefore, evade the liquidity constraints of the limited financial institutions by negotiating trade credit with various sellers, which are financially enabled.⁶³

- **Outsider of the Strict Regulatory Framework of NBE:** Trade credit falls outside the direct control of the banking system and hence does not fall under the strict regulatory requirements imposed by the NBE.⁶⁴ This is mainly a private contract between two

⁵⁹ *ibid*

⁶⁰ *ibid*

⁶¹ Civil Code of the Empire of Ethiopia, 1960, Art 2471, Proc. No. 165, Neg. Gaz. Year 19, no.2

⁶² *Interview with Mr. Bereket Asamnew* (n 34)

⁶³ *ibid*

⁶⁴ *ibid*

parties, thus being faster and more straightforward for financing.⁶⁵ Thus, it gives room for investors to access this source of finance with ease and convenience from the strict regulatory requirements set by the NBE.

- **Collateral-Free Financing:** Unlike traditional bank finance, which is always collateral-based, trade credit is based on the credibility of the investor and the relationship developed with the seller.⁶⁶ This facilitates business, especially for the small businesses that may not have significant substantive assets, having access to finance without needing collateral.⁶⁷
- **Lower Interest Financing:** As mentioned above, loans from financial institutions within Ethiopia have very high interest rates. In this regard, trade credit has a comparative advantage in that interest rates can be mutually agreed upon between the investor and the seller; therefore, investors are in a position to negotiate and get better rates of interest.⁶⁸ In this respect, the Ethiopian Civil Code provides an interest ceiling that stipulates that parties cannot set an interest rate exceeding 12% for such transactions involving credit.⁶⁹ Thus, it may be argued that the interest ceiling imposed by the Civil Code is below the higher interest rates that financial institutions usually demand. This characteristic of low-interest financing in trade credit may turn out to be a less expensive type of short-term financing for Ethiopian businesses.

By embracing trade credit, Ethiopian investors might significantly enhance access to finance and better navigate challenges from traditional loan financing.

ii. Sale and Lease back

Sale and lease back is a financial arrangement that involves both selling and leasing activities. In Ethiopia, it could possible to say that such activity could be governed by sale and lease law of the country. The preliminary transaction of sale activity may be governed by the civil code of the

⁶⁵ *ibid*

⁶⁶ *ibid*

⁶⁷ *ibid*

⁶⁸ *ibid*

⁶⁹ *Civil Code* (n 61) Art 2479(1)

country. Under the Ethiopian Civil Code, sale is a transaction made by a contract whereby the seller undertakes to deliver a thing and transfer its ownership to the buyer in consideration of a price that the buyer undertakes to pay.⁷⁰ The subsequent transaction of lease may fall under the definition of lease provided in the Capital Goods Leasing Business Proclamation, as discussed in the previous chapter.

Through sale and lease back process, investors still have the right to use the asset for their organizational activities even after they sell it.⁷¹ They can take advantage of accessing the selling price's immediate cash while also continuing to profit from its use and generate further capital through output.⁷² Thus, selling the asset and concurrently gaining the right to lease it back might be done as a way to raise capital.

The practice of sale and leaseback is not extensively known or utilized by business organizations in Ethiopia. However, certain organizations with substantial capital and international exposure have been observed to engage in such transactions. Ethiopian Airlines is a prominent sample. One example was the announcement made by Ethiopian Airlines and AWAS of a sale and leaseback arrangement.⁷³ Ethiopian Airlines had originally ordered two new 737-800 aircraft directly from the manufacturer; under the terms of the agreement, AWAS would buy the aircraft and then lease it back to the airline.⁷⁴

However, if sale and leaseback is widely recognized and implemented by investors, the transaction would become an alternative source of financing for their business and offer an effective option for remedies against the limitations of lease financing.

⁷⁰ *ibid* Art 2266

⁷¹ Nur Lesya Firsya Johaimi Ling, 'Analysis of Factors and the Impacts of Sale and Leaseback Transaction, (2012), SciVerse Science Direct, Procedia- Social and Behavioral Science, Volume 36, Department of Estate Management, Universiti Teknologi MARA, Malaysia 503.

⁷² *ibid*

⁷³ The African Aviation Tribune, Ethiopia: AWAS, Ethiopian sign buy/leaseback deal for two 737-800s, the first of which has been delivered, 2013 <<http://www.theafricanaviationtribune.com/2013/06/ethiopia-awas-ethiopian-sign.html>>

⁷⁴ *ibid*

- **Overcoming Financial Constraints of Lessors:** Sale and leaseback arrangements provide immediate liquidity to lessors.⁷⁵ After a lessor buys the asset, it may generate a secure and ongoing income stream through lease payments, which can alleviate one of the main challenges in lease financing, financial constraints.⁷⁶ For instance, the lessor may secure the lease payment in advance. This structure is particularly attractive to lessors who may be cash-strapped and unwilling to lease their property due to liquidity issues. Thus, the willingness of lessors to provide leases may create an advantage for investors to mobilize capital.

- **Improvement of Liquidity for investors:** Sale and leaseback financing enables investors to convert illiquid assets, such as buildings and machinery, into cash by selling their assets while still retaining their use through leasing.⁷⁷ This can significantly enhance investors' liquidity positions, offering advantages that are often lacking in lease financing.⁷⁸

By utilizing sale and leaseback practices, Ethiopian investors could enhance their financial flexibility and better address the challenges presented by traditional financing options.

iii. Corporate Bonds

Investors may raise capital by having their companies issue corporate bonds to third parties, enabling themselves to raise funds from potential buyers in the bond market.⁷⁹ No law in Ethiopia specifically defines what a corporate bond is. However, the Ethiopian Capital Market Proclamation acknowledges bonds without distinguishing them as corporate bonds. It recognizes bonds as any instrument in any legal form that represents ownership in a financial transaction and is negotiable as a security.⁸⁰ Since the proclamation limited its definition only to bond, it is possible to say there is a lack of a specific definition for corporate bonds in the country.

⁷⁵ Interview with Mr. Hileleule Getachew, Legal Analyst at Afghan Credit Guarantee Foundation (ACGF), Cologne, North Rhine-Westphalia, Germany (30 June 2024)

⁷⁶ *ibid*

⁷⁷ *ibid*

⁷⁸ *ibid*

⁷⁹ *Workneh Alemnew Alula* (n 53) 11

⁸⁰ *Capital Market Proclamation* (n 50) Art 2(62) (c)

In order to establish a clear definition, within the financial domain, a corporate bond would be deemed a sort of financial instrument that works as a certificate of debt.⁸¹ When a corporate issues a corporate bond, it is promising the bondholder a certain rate of interest for a determined period of time, as well as to return the principal when the bond expires.⁸² It's essentially a way of borrowing from investors, whereby one is meant to pay interest regularly and return the initial investment amount at the end of the term of the bond.⁸³

Although both debentures and corporate bonds share common features, in many jurisdictions, there are substantial differences between the two instruments. One important difference relates to security. In most legal systems, bonds are secured by collateral from the issuing company, while debentures are usually unsecured, relying on the company's creditworthiness.⁸⁴ However, the Ethiopian legal system follows a different approach. Article 413(6) of the Commercial Code reflects that the law recognizes security-backed debentures, which appear to share features with corporate bonds. In such cases, it is recommended that the law confine itself to recognizing debentures in their proper character, allowing for both secured and unsecured types, without conflating them with corporate bonds. Instead, the law should distinctly recognize corporate bonds as a separate category, specifying their nature as secured by collateral, which makes them a relatively safer investment for potential investors.

Another major difference between debentures and corporate bonds is tenure. Debentures usually have shorter tenures, often extending up to five years, whereas corporate bonds are generally considered long-term investments, with longer maturities.⁸⁵ This longer tenure could provide issuing companies with more time to repay, offering them relief.

⁸¹ *Workneh Alemnew Alula* (n 53) 11

⁸² *ibid*

⁸³ *ibid*

⁸⁴ BYJUS., 'Difference between Bonds and Debentures' <<https://byjus.com/commerce/difference-between-bonds-and-debentures/>> accessed 11 August 2024

⁸⁵ *ibid*

Even though Ethiopian practice currently tends to treat debentures similarly to corporate bonds, the legal framework is advised to distinguish corporate bonds as a separate instrument, clearly defining their differences and recognizing them as an important alternative source of additional financing, especially if they become well-established.

- **Diversified Sources of Finance:** Corporate bonds offer investors another form of investment available aside from the typical types of debentures. Investors are able to have diversified sources of finance by integrating corporate bonds into their investment plans; this will provide a wider scope for flexibility toward the investors from traditional types of debentures.⁸⁶ Diversification of various financial instruments also allows them to distribute risk across more than one financial instrument, and therefore their net financial gain can be maximized.⁸⁷

By recognizing and utilizing corporate bonds, investors in Ethiopia could create a viable alternative to debentures, thereby improving their ability to raise additional capital for their businesses.

⁸⁶ *Interview with Mr. Abraham Rega Kassa* (n 45)

⁸⁷ *ibid*

CHAPTER FOUR

Examining Legal and Practical Challenges in the New Emerging Alternative Debt Financing Sources in Ethiopia

4.1 Trade Credit

Legal Challenge:

➤ **Lack of Specific Legal Framework**

Trade credit plays a significant role in the business markets of many jurisdictions. Accordingly, countries often have specific laws regulating trade credit; for instance, South Africa's National Credit Act 34 of 2005 governs trade credit by allowing suppliers to extend credit to their customers through deferred payment for goods and services.⁸⁸

In Ethiopia, trade credit is not widely practiced but is observed to some extent. However, there is a legal challenge associated with it. The primary legal challenge is the lack of specific laws or provisions addressing trade credit, which can hinder the regulation of these transactions.⁸⁹ Various issues that might arise from these transactions, such as payment terms, interest rates, default procedures, risk of loss of the asset, enforceability, and dispute resolution, are not regulated.⁹⁰ This can lead to a lack of standardized practices and clarity regarding the rights and responsibilities of investors and suppliers in trade credit transactions.⁹¹

Potential Practical Challenge:

➤ **Limited Availability of Financially Stable Suppliers:**

Even though there is lack of legal framework for trade credit, this practice is rarely seen in Ethiopia.⁹² The scarcity of financially stable suppliers in Ethiopia poses a significant potential

⁸⁸ South African National Credit Act 34, 2005

⁸⁹ *Interview with Mr. Bereket Asamnew* (n 34)

⁹⁰ *ibid*

⁹¹ *ibid*

⁹² *ibid*

practical challenge.⁹³ This financial constraint discourages suppliers from offering trade credit options, leading to a preference for immediate payment.⁹⁴ As a result, investors in Ethiopia may struggle to find suppliers willing to offer favorable trade credit terms.⁹⁵ Consequently, they face difficulties in utilizing this financing source as an option.

4.2 Sale and Leaseback

Legal Challenges:

➤ Lack of Specific Legal Framework

As mentioned earlier, in Ethiopia it is possible to govern sale and leaseback transactions by using the separate sale and lease laws. However, this approach could lead to an inconsistent set of rules, as the two types of laws might have provisions that are specifically applicable to these types of transactions.⁹⁶ This could result in potential conflicts or gaps when trying to piece together the relevant provisions from the two different laws.⁹⁷

Therefore, a specific and dedicated law governing such transactions is essential. Currently, sale and leaseback transactions face considerable legal challenges in Ethiopia due to the lack of explicit recognition or dedicated laws governing these arrangements. The existing legal framework does not provide specific provisions for sale and leaseback transactions. Specific issues that might arise from these transactions, such as title transfer, the seller's retention rights, the risk of asset loss, tax implications, and enforceability, are not specifically regulated.⁹⁸ This leads to difficulties in regulating and standardizing this form of financing, as well as in clearly articulating the rights and responsibilities of each party involved in both the sale and lease components of the transaction.⁹⁹

⁹³ *ibid*

⁹⁴ *ibid*

⁹⁵ *ibid*

⁹⁶ *Interview with Mr. Hileleule Getachew* (n 75)

⁹⁷ *ibid*

⁹⁸ *ibid*

⁹⁹ *ibid*

➤ **Restriction by the NBE**

The NBE imposes restriction on the organizational structure of lessors, requiring them to adhere to a specific form of SC. This restriction can complicate lease financing and limit the participation of potential lessors in sale and leaseback transactions.¹⁰⁰ While they may have the capacity to purchase business assets, they are constrained to the SC format, which entails various legal and administrative complexities from the outset.¹⁰¹ This limitation may deter potential buyers from engaging in leases, ultimately hindering investors' ability to secure capital after selling their business assets for leaseback purposes.

➤ **Tax Congestion**

According to the existing tax framework in Ethiopia, capital gains taxes may apply when an investor sells their asset under the Income Tax Proclamation.¹⁰² Investors are required to pay such tax on the profits derived from the sale of their assets in the context of a sale and leaseback transaction.

Furthermore, the VAT Proclamation imposes VAT on the supply of goods, which includes asset leasing.¹⁰³ VAT is typically charged on the leasing activities of the lessor involved in the subsequent sale and leaseback transaction, who initially purchased the asset in the sale and leaseback arrangement, which is considered taxable under the proclamation. Consequently, under the VAT Proclamation, the lessee, who is the investor, becomes the ultimate VAT payer.

Additionally, the lessor who purchases the asset may incur rental income tax due to the lease transaction.¹⁰⁴ The income derived from the lessee through the lease agreement is subject to rental income tax. Thus, it can be said that a single sale and leaseback transaction could trigger three different types of taxes, leading to what is often referred to as tax congestion.

¹⁰⁰ *ibid*

¹⁰¹ *ibid*

¹⁰² Federal Income Tax Proclamation, 2016, Art 59(1), Proc. No. 979, Neg. Gaz. Year 22, no 104

¹⁰³ Value Added Tax Proclamation, 2016, Art 2(40)(b)& Art 7(1), Proc. No. 1341

¹⁰⁴ *Federal Income Tax Proclamation* (n 101) Art 15(2) (a)

However, countries in other jurisdictions use different mechanisms to avoid such tax congestion. For instance, they ensure that rental payments under the lease are fully deductible for rental income tax.¹⁰⁵

Potential Practical Challenge:

➤ **Tax-Induced Deterrence of Involved Parties in the Transaction**

The tax law's imposition of multiple taxes, such as capital gains tax, VAT and rental income tax, on parties involved in a single sale and leaseback transaction, could affect both investors and those interested in such transactions. This accumulation of taxes could deter both investors and interested parties from using sale and leaseback as a viable alternative for debt financing.

4.3 Corporate Bonds

Legal Challenge:

➤ **Lack of Specific Legislation**

Corporate bonds are a well-known source of financing in many jurisdictions. Some countries regulate these instruments under their company acts or securities laws, dedicating specific provisions to govern them. In contrast, some countries, such as China, have enacted specific corporate bond laws to address this source of finance.¹⁰⁶

In Ethiopia, however, there is no specific law governing the issuance of corporate bonds. The anticipated legal framework in the new commercial code does not expressly recognize corporate bond issuance as a means of raising capital, unlike the provisions for debentures. While the Ethiopian Capital Market Proclamation acknowledges bonds, it does not differentiate them as corporate bonds and lacks detailed rules. Thus, there is a lack of a comprehensive legal framework for corporate bonds that would regulate specific issues that might arise, such as the nature and terms of the bond, interest, redemption terms, default procedures, and tax

¹⁰⁵ Kenneth L. Stewart, 'Taxation of Sale and Leaseback Transactions - A General Review' (1979), Vanderbilt Law Review, Volume 32: 945, Issue 4 95

¹⁰⁶ Regulations on the Administration of Corporate Bonds (People's Republic of China), China Securities Regulatory Commission, 2008

implications.¹⁰⁷ These aspects are not specifically regulated, which hinders the definition of the rights and obligations of the issuing companies and potential investors interested in buying such instruments.¹⁰⁸ As a result, investors are not seen utilizing corporate bonds as a means of raising capital for their companies.

However, regarding government bonds, there are laws that govern these transactions. Under the previous regime, the Ethiopian government issued Government Bonds Proclamations No. 172/1961 and No. 262/1969, respectively, with the intention of financing various projects, infrastructure development, and budgetary needs.¹⁰⁹ In the recent regime, for instance, the government announced the issuance of the Special Government Bonds Proclamation in order to raise funds for the DBE.¹¹⁰

Potential Practical Challenge:

➤ Limited Awareness Among Potential Investors

As it is believed that potential investors do not have adequate knowledge about the mechanisms and underlying benefits associated with investing in corporate bond securities, the demand for these instruments tends to remain relatively low within the country.¹¹¹ Relating to this, investors might also get discouraging towards the investment of such instruments because there would be a lack of laws that could provide guidance about these instruments.¹¹²

On the other hand, it can be said that the government of Ethiopia has shown substantial awareness of the potential for corporate bonds to finance various infrastructure development projects. For instance, the government announced the issuance of the first sub-sovereign corporate bond targeted at the diaspora, with the aim of providing funds to the Ethiopian Electric Power Corporation for investments that will increase the country's power supply.¹¹³

¹⁰⁷ *Interview with Mr. Abraham Rega Kassa* (n 45)

¹⁰⁸ *ibid*

¹⁰⁹ Governments Bonds Proclamation, 1961, Proc. No. 172, Neg. Gaz. Year 20, no.11 and Governments Bonds Proclamation, 1969, Proc. No. 262, Neg. Gaz. Year 28, no.12

¹¹⁰ Special Government Bonds Proclamation, 2016, Proc. No. 937, Neg. Gaz. Year 22, no 66

¹¹¹ *Interview with Mr. Abraham Rega Kassa* (n 45)

¹¹² *ibid*

¹¹³ Sanket Mohaparta, 'Ethiopia Announces First Diaspora Corporate Bond,' 2009 People Move <<https://blogs.worldbank.org/en/peoplemove/ethiopia-announces-first-diaspora-corporate-bond>> accessed 11 July 2023

CHAPTER FIVE

Conclusion and Recommendations

5.1 Conclusion

This research has explored the critical role played by debt financing within the Ethiopian financial landscape, highlighting a need for novel and diversified means of access to capital. While traditional modes of debt financing have long existed and have been understood, they are increasingly incapable of meeting the emerging needs of business enterprises and their investors within the country. Their inefficiencies and limitations, in turn, bring to the fore the importance of studying and integrating new alternative sources of debt financing.

This paper's analysis reveals that innovative debt financing approaches have great potentials to address the shortcomings of the traditional approaches; however, there are a number of legal and practical hurdles for their complete adoption and effectiveness. The current legal framework is not sufficiently endowed to accommodate these new forms of debt financing in Ethiopia; more importantly, there are concerns of legal uncertainty and regulatory obstacles. Although such innovative financings are rarely used, this research discusses some of the practical challenges that may be considered barriers to the use of such methods.

Though the emergence of new alternative sources of debt financing has opened a bright avenue for mobilizing capital in Ethiopia, complete realization necessitates wide-ranging legal reforms, and a willingness to create an enabling environment for innovation within its financial sector. This study underlines the urgency of addressing the legal and practical challenges and calls for an active response from the relevant stakeholders to ensure that the financial system in Ethiopia is indeed able to serve the diversified needs of the economy in Ethiopia.

5.2 Recommendations

I. Recommendations to Address Legal and Practical Challenges of Trade Credit in Ethiopia

➤ Establish a Specific Legal Framework

The legislature should consider developing and implementing a comprehensive legal framework that specifically addresses trade credit. This framework could regulate various issues that may arise from these transactions, as well as outline the rights and responsibilities of both suppliers and investors, ensuring clarity and standardization in trade credit practices. Such legislation would enhance legal certainty and encourage more businesses to engage in trade credit.

➤ Promote Financial Stability Among Suppliers

To enhance the availability of financially stable suppliers, the government and financial institutions could create programs to support supplier financing. This could involve providing access to credit facilities specifically designed for suppliers, enabling them to offer trade credit options to investors.

II. Recommendations to Address Legal and Practical Challenges of Sale and leaseback Transactions in Ethiopia

➤ Establish a Dedicated Legal Framework

The legislature should create and implement specific legislation that explicitly recognizes and regulates sale and leaseback transactions. This framework should clearly address key issues that may arise in these transactions by outlining the rights and responsibilities of all parties involved, thereby ensuring standardization and legal certainty.

➤ Streamline Regulatory Requirements

The NBE should consider revising the organizational structure requirements for lessors. Allowing more flexible organizational forms could encourage broader participation in sale and leaseback transactions, simplifying the legal and administrative processes.

➤ **Tax Reform**

To alleviate tax congestion, the government should explore ways to streamline the tax obligations associated with sale and leaseback transactions. This could involve:

- ✓ **Introducing Deduction:** Develop a deduction rule for either the sale or lease transaction involved in the sale and leaseback arrangement to reduce the tax burden from both transactions.

Implementing this tax reform could help alleviate the deterrence faced by investors and interested parties due to tax-induced challenges. This would encourage greater participation in these transactions.

III. Recommendations to Address Legal and Practical Challenges of Corporate Bonds in Ethiopia

➤ **Establish Specific Legal framework**

The Ethiopian government should provide comprehensive legislation specifically governing corporate bonds. This legislation should clearly regulate various issues that may arise under it by outlining the rights and responsibilities of issuers and investors. Such clarity would encourage investor confidence and market participation.

➤ **Enhance Awareness and Attract Potential Investors**

Once the legal framework for corporate bonds is in place, companies should actively promote the benefits of corporate bond financing. This involves educating potential investors about how corporate bonds work, their advantages compared to other investment options, and the specific benefits of investing in bonds issued by their companies.

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6. Interviewees

- Interview with Mr. Abraham Rega Kassa, former Associate at Mehrteab Leul and Associates Law Office, Addis Ababa, Ethiopia (10 July 2024)
- Interview with Mr Belete Lemesa Dadi, General Manager of Belete Netsehety and Friends Blocket Manufacturing Partnership, Addis Ababa, Ethiopia (11 February 2024)

- Interview with Mr. Bereket Asamnew, Legal Credit Manager at Bank of Abyssinia Share Company, Addis Ababa, Ethiopia (29 July 2024)
- Interview with Mr. Chombe Kalifa Deputy Managing Director of Oromia Capital goods Finance Business Share Company, Addis Ababa, Ethiopia (20 February 2024)
- Interview with Mr. Hileleule Getachew, Legal Analyst at Afghan Credit Guarantee Foundation (ACGF), Cologne, North Rhine-Westphalia, Germany (30 June 2024)

Interview Questions

➤ ***For Mr. Bereket Asamnew***

1. What challenges do Ethiopian banks and microfinance institutions face in terms of liquidity, and how do these challenges impact their ability to extend loans to investors?
2. What advantages has trade credit offer to investors in Ethiopia compared to loan financing methods from financial institutions?
3. What are the main legal and practical challenges associated with trade credit in Ethiopia, and how do these challenges impact investors?

➤ ***For Mr Belete Lemesa Dadi***

4. What types of businesses in Ethiopia are most adversely affected by the collateral requirements imposed by banks and microfinance institutions?

➤ ***For Mr. Chombe Kalifa***

5. What financial factors may limit lessors' ability to provide lease financing for capital goods to investors?

➤ ***For Mr. Abraham Rega Kassa***

6. What are the main reasons for the prohibition on issuing debentures by PLCs and OMPLCs?
7. How do corporate bonds serve as an alternative to debentures for investors seeking to diversify their financing sources?
8. What are the main challenges associated with the lack of specific legislation for corporate bonds in Ethiopia, and how does this affect investors' ability to raise capital?

➤ ***For Mr. Hileleule Getachew***

9. What are the key financial advantages of sale and leaseback arrangements for both lessors and investors in Ethiopia compared to traditional lease financing methods?
10. What are the legal challenges and regulatory restrictions affecting sale and leaseback transactions in Ethiopia, particularly regarding the role of the National Bank of Ethiopia?