

OPINION **PREMIUM**

BRENTON LALU: Rethinking the risk-free rate to unlock Africa's true value

Why the world's favourite shortcut for valuing cash flows misprices an entire continent, and how investors can do better

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Market participants have capital and appetite. What they lack is a benchmark that respects local inflation, credits policy reform and measures default where it belongs, says the writer. (123RF/pookpiik)

Every discounted-cash-flow model begins with one deceptively simple input: the risk-free rate. In theory it captures the bare time value of money, the minimum return required to invest with absolute safety. In practice, it anchors the capital asset pricing model and sets the floor under a firm's weighted average cost of capital. Get that number incorrect and an otherwise investable project can look uneconomic, or vice versa.

For decades analysts have defaulted to the yield on long-dated US treasuries. Washington can tax the world's largest economy and issue debt into the deepest bond market on earth, so treasuries became shorthand for "zero risk". The habit stuck even as global finance spread far beyond the dollar zone.

A proxy is not reality; treasuries still carry inflation and duration risk. More importantly, they reflect the policy cycle of the US Federal Reserve, not the conditions of Lagos, Nairobi or Johannesburg. Copy that yield into an African valuation and you import America's monetary stance. If the Fed hikes to cool inflation, African discount rates jump, valuations fall and financing costs rise, regardless of local fundamentals.



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This imported volatility feeds a deeper structural weakness known as the original sin: the habit of raising long-term capital in dollars because local bond markets are thin or mispriced. Yet revenues arrive in naira, shillings or cedi. When the dollar strengthens after US tightening, local currencies sag and debt-service costs jump. The very model meant to measure risk becomes a factory that manufactures it.

Switching to local currency sovereign bonds sounds elegant until you look at the data. In many African economies sovereign default risk is real. Yields carry a credit premium and a liquidity premium because turnover is thin. In early 2025 the sovereign default spread over US treasuries hit over 7% for Nigeria and almost 9% for Ghana. Bond yields at those levels outstrip nominal GDP growth, signalling that they price more than pure time value.

Reference rate distortion

Liquidity makes the distortion worse. Thin trade means a handful of transactions set reference rates for months. Investors demand extra return to compensate for the chance they cannot exit quickly, pushing yields even

higher. The result: a “risk-free” anchor already stuffed with credit and liquidity risk, guaranteeing that every project model double-counts danger.

Beyond bond mechanics lies a subtler bias narrative. Western headlines often merge 54 nations into one story of volatility. Analysts translate that storyline into a blanket “Africa premium”, two to four percentage points tacked onto the cost of equity with little empirical support.

The data tells a different story. A Moody's Analytics study of infrastructure credit shows cumulative losses of Africa are far below that of Latin America and Eastern Europe. That gap is predicated upon perception and not probability, yet it diverts scarce revenue from classrooms, clinics and roads into excess interest.

Credit ratings amplify the cycle. During the pandemic more than half of rated African sovereigns were downgraded, double the global average. Spreads had widened just when counter-cyclical investment was most urgent.

The disconnect is stark. Capital shies from empirically safer African projects while flocking to riskier markets mislabelled as safer. If treasuries and local bonds both misfire, investors need a fresh anchor. Valuation scholars propose a three-step risk-free rate:

- **Start with a default-free base.** Use the yield on a mature-market bond, typically the US 10-year, to represent global real rates plus developed-market inflation expectations.
- **Add the sovereign default spread.** Isolate market perception of a government's credit risk through its dollar-bond spread or credit-default-swap quote. Keeping default in its own box stops it from polluting the base rate.
- **Adjust for inflation.** Convert the dollar yield into local currency by accounting for expected inflation differentials using interest-rate parity. The benchmark then reflects the spending power of project cash flows.

The rate remains an estimate, yet every assumption is visible. Analysts can debate each piece instead of fighting over one opaque number.

Country risk premiums need similar surgery. Applying the same premium to every firm within one border ignores business models and revenue mixes. For example, a Nigerian producer that exports to the Sahel is less exposed to local shocks than a pure domestic retailer. Scale the country risk premium by the

share of revenue generated domestically, inside an augmented capital asset pricing model. The method lowers hurdle rates for firms with diversified revenue, producing a more defensible cost of capital.

The long-term objective remains the development of deep and liquid local capital markets. Getting there requires aligned action. In this regard, governments must embed fiscal transparency and independent monetary policy; development finance institutions should scale local-currency guarantees.



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A proposed Africa Investment Guarantee Agency, offering cover for political, climate and currency risk, can break the original-sin cycle by making shilling or cedi debt bankable; and private investors must invest in genuine on-the-ground research. Granular insight can replace narrative discounts with hard evidence.

Valuation is as much craft as calculation. When the anchor is wrong, everything skews. Africa suffers from a convenient shortcut that understates its strength and oversells its weakness. The cost shows up in stalled solar plants, congested ports and underfunded classrooms.

Re-engineering the risk-free rate is more than a technical adjustment. It unlocks private capital, lowers sovereign borrowing costs and supports homegrown pension systems. It further aligns finance with empirical reality and gives investors a clearer map.

Market participants have capital and appetite. What they lack is a benchmark that respects local inflation, credits policy reform and measures default where it belongs. Transparent tools can provide that benchmark today.

Either way, the era of copy-pasting someone else's bond yield into African spreadsheets can end now. Once models see Africa as it is, not as headlines paint it, capital will follow and the continent's true value will surface.

- *Lalu is an Africa specialist at the Public Investment Corporation.*