

## Investment Guide

December 11, 2009

### Bonds vs. Equities

#### Diametric tale of twin investment windows

#### Synopsis

Bond Yields	
10-year	7.71%
20-year	8.16%
Inflation rate(y/y)	11.6%

Bonds	
Market Cap (N' trillion)	2.31
YtD return <sup>1</sup>	22.2%

Equity	
Market Cap (N'trillion)	5.08
YtD Return <sup>2</sup>	-33.1%
Market P/E <sup>3</sup>	25.9x
Dividend Yield <sup>4</sup>	7.34%

**Note:**

- 1: Return is computed based on the level of Access Bank FGN Bond Index
- 2: Based on the return on NSE ASI
- 3: Meristem Research estimate (market cap weighted average P/E multiple of 125 companies with a combined market cap of N4.5tr (USD35bn), representing 90% of the NSE market Size
- 4: Meristem Research estimate of historical dividend based on average dividend yield for 90 dividend paying stocks representing 87% of NSE Market cap. This yield does not reflect expected dividend yield.

Anecdotally, we understand that the flight to bond investment has been crafted as a “coping strategy” which at best could be regarded as a short term measure to sail through the challenging investment climate. Hence, it would not be unexpected if bond prices retrace their steps any moment as the investment horizon gets clearer.

It is instructive to note that the performance track record of Nigerian bonds has been strongly influenced by the dominance of sovereign debts which command a material proportion of 95% of outstanding issues. Hence, the bond market appears structurally ring-fenced against the impact of corporate failures as opposed to the vulnerability of the equities market.

As at December 2009, FGN bonds are trading at significant *premium* of 20% to their face value with the 10-year FGN bond yielding 7.71% and the 20-year bond commanding a yield level of 8.16%.

The budding bond market in Nigeria has a huge capacity for growth over the medium to long term as corporate appetite shifts towards exploring this financing window. But with increased depth, especially fuelled by non-sovereign bonds, comes the emergence of risk since corporate performance would assume increasing relevance in bond pricing and yield behaviour.

**With the average cost of equity of banks in the neighborhood of 19%-20%, despite less stringent conditions for delivering returns to equity holders, investors need to critically analyze the drivers of firms’ appetite for bonds.**

Please see page 11 for a Refresher Discourse on basic bond terminologies

## Nigerian bonds: size and structure

### Bonds market still trudges behind equities

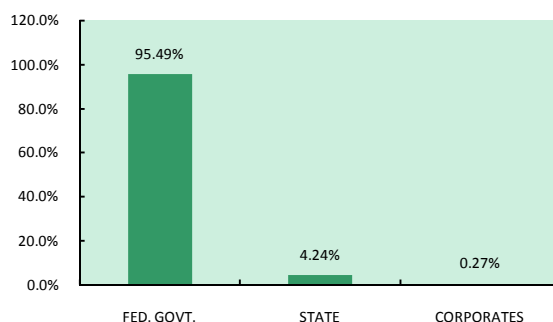
The Nigerian local currency (LCY) bond market is still 'unpatronised' relative to the equity segment of the capital market. As at November 2009, the market capitalization of FGN bonds totaled 2.3.6trillion, representing 46% of the market capitalization of the Nigerian equities. This value of bonds relative to equities has shown significant uptrend compared to the opening ratio of 21% in January 2009. The growth feat shown in the bond market has largely been driven by government fiscal operations. For instance, the resolve of the FGN to issue domestic debt instruments to offset the deficit implicit in the 2009 budget which is c3% of GDP has engendered activity in the primary segment of the bond market.

In a typical emerging marketplace like Nigeria, trading in bonds is unpopular especially with retail and middle-class investors. From the demand side, the market is dominated by institutional investors such as financial institutions (banks and insurance), fund managers, Pension Fund Administrators (PFAs) and a few sophisticated high networth investors (HNIs). The supply side is structurally skewed to government issues which command 95% of total exchange listed bonds. Corporate bond issue is just an emerging phenomenon.

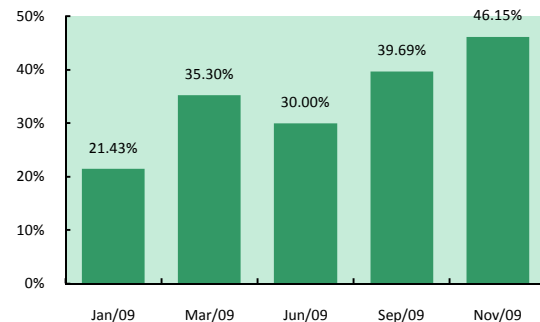
While the Debt Management Office (DMO) is primarily responsible for FGN bond issuance through an auction process, Primary Dealers and Market Makers (PDMMs) provide the needed secondary liquidity through a 2-way quote system. The maturity profile of outstanding issues ranges from the minimum of 2 years to the maximum of 20 years.

#### Exhibit 1:

Split of Nigerian bond market



Size of Nigerian bond market relative to equities



Source: DMO, FDHL Analytics, Meristem Securities

## Debt market depth: Nigeria vs. Others Far behind the peers

Putting the domestic bond market into perspective relative to other Emerging economies, our stance on the infancy of the market is further re-enforced. The depth of the bond market proxied by its size relative to the GDP currently stands at c5%. At this level, it is dwarfed by all the other countries in comparison (as shown in Exhibit 2 below). This is also indicative of the level of economic development witnessed in these economies.

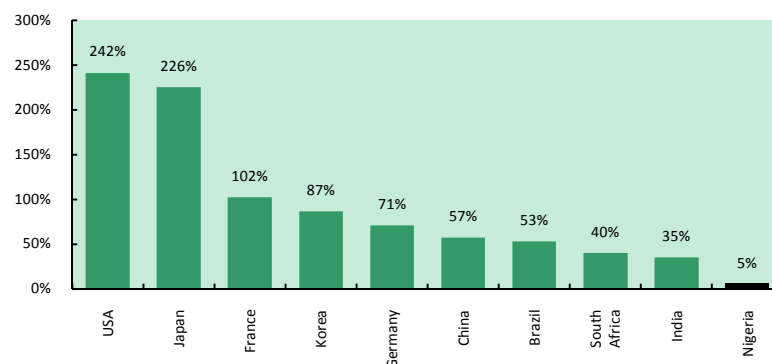
Exhibit 2 below graphically highlights the growth opportunities in the Nigerian bond market when we place its depth with those of BRIC countries. If we are to narrow our analysis down to Africa, the current size pales into insignificance as the Nigerian bond market would have to grow by 626% over the current level to catch up with the depth of South Africa which is 8x that of Nigeria.

The assumption of a catch-up period of 5 years with South Africa, for instance, implies that debt issuance in Nigeria (corporate and sovereign) must grow by a compound annual growth rate of c50% in the next 5 years. Much more encouraging is the significant upside to this growth estimate if we are to relax the blue sky assumption of flat GDP growth rate for Nigeria over this catch-up period.

The question is not whether we will see more bond market development going forward; rather the question is how quickly can this growth potential be realized given the current bond yields, regulatory capabilities and how well the relevant institutions play their roles in directing attention to the huge potentials in this market for rational investors (domestic and foreign). Interestingly, the re-ignition of corporate appetites for debt instruments as against equities creates a fertile ground for the market to thrive.

### Exhibit 2:

The depth of Nigerian bond market relative to other markets



## Emergence of corporate bonds

### Brewing paradigm shift

After years of dormant corporate bond market, Nigerian corporates seem poised to revive the debt financing option, perhaps as an asylum against the depression in equity values which has dried-up the primary segment of the equity market. As volatility persists in the market, investors remain aloof to risky asset class despite at seeming bottom levels, thus accentuating the impetus to alternative investments, particularly the fixed income instruments. While equities are apparently risk-laden, the presumption of close-to-zero risk in the bond market demands a diagnosis.

The recent move by the regulatory authorities to de-skew the capital market through reduction in the currently provoking cost of debt issuance and enhancing bonds tax advantage is a reinforcing catalyst to the attractiveness of the bonds market. If the proposals on tax incentives (both capital gain and withholding taxes) and cuts in issuing cost of debt financing sail through requisite approvals, corporate bonds will most likely gain more traction going forward. **However, there is the need for investors to be cognizant of traffic lights in the imminent herd behaviour race.**

Recognizing the shift in investment paradigm, firms are increasingly responding to the demand signals as the market heavyweights set the ball rolling with avalanche proposals. Our estimates, based on corporate newsflows and due diligence, reveal that a blend of equity cum debt finance proposals worth N2.1tr (US\$14.3bn, close to current FGN bonds market capitalization) are in the pipeline. The bulk of this estimate (>80%) is gathering the requisite thrust to hit the corporate bond market, though in tranches (see table 1 below for details). As we perceive more of such debt finance moves, particularly within the banking universe, the risk of market absorption continues to be on the upturn.

**Table 1: Corporate bonds in the pipeline**

Issuers	NGN'bn	USD'bn
First Bank of Nigeria Plc. (FBN)	500	3.38
United Bank for Africa Plc. (UBA)	500	3.38
Zenith Bank Plc.	300	2.03
Access Bank Plc	200	1.35
Guaranty Trust Bank Plc. (GTB)	200	1.35
Diamond Bank Plc.	200	1.35
Oando Plc.	200	1.35
National Aviation Company (NAHCO)	5.0	0.03
C&I Leasing Plc	2.2	0.02
Thomas Wyatt Plc	2.0	0.01
<b>Total</b>	<b>2,109</b>	<b>14.25</b>

With pension funds administrators (PFAs) and banks being the traditional domestic players in the bond markets, we see an increasing level of risk in the ability of the market to mop the imminent corporate bonds. PFAs, having an estimated Assets Under Management (AUM) of N1.25trillion with a maximum exposure of 30% to corporate bonds, can mop less than 18% of the expected issues. While we understand that banks could invest actively in the corporate bonds, it may spur cross-default risk with grave contagious effect. Hence, the apparent weakness in domestic demand turns the searchlight to foreign investors who are just regaining confidence in the Nigerian financial system.

Given the looming competition, issuers may have to offer appealing coupon and structures which may however, impound their ability to service the debt. With the FGN presumed risk-free 10-year bond currently offered at an average coupon rate of 10%, the corporate issuers may have to offer attractive yield spread not less than 500 basis points given the current industry credit ratings. **With the average cost of equity of banks in the neighborhood of 19%-20%, despite less stringent conditions for delivering returns to equity holders, investors need to critically analyze the drivers of firms' appetite for bonds.**

## Performance of Nigerian bonds: Playing the "low return but safe" game

Investors' drift to government-backed securities is explained by the strong volatility in the equities market which, has been accompanied by hazy outlook.

The return trajectory of Nigerian bonds have taken the exact opposite of the return on equities as investors flee for safety in less risky asset class for the duo objectives of capital preservation and competitively moderate returns. Investors' (specifically PFAs and Fund Managers) drift to government-backed securities is explained by the strong volatility in the equities market which, at best, has been accompanied by hazy outlook.

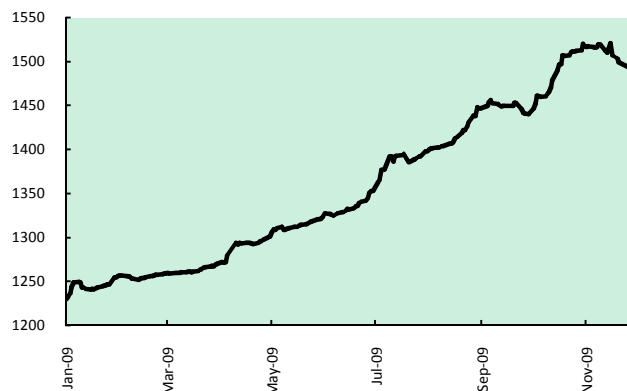
... FGN bonds have outperformed Nigerian equities by 55%; an astounding level by any global standard!

On year to date basis, Nigerian bonds have performed strongly, trending up in a slow and steady fashion. Using the Access Bank FGN Bond Index as a proxy, the bond market has ridden on the softness in benchmark interest rates (6% vs. 9% a year ago), falling inflation rate (October 2009: 11.6% vs. 15% in December 2008) and market-wide risk aversion to deliver attractive returns of 22.2%. Putting this return profile in the perspective of the return of equities over the same time horizon, it implies that FGN bonds have outperformed equities by 55%; **an astounding level by any global standard!**

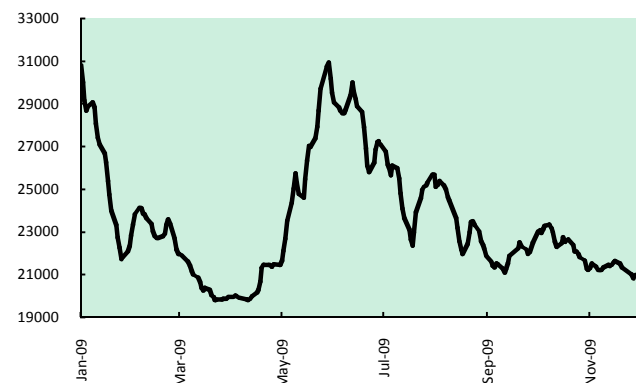
On a relative basis, the bond market is gaining more standing in the Nigerian capital market with a current market capitalisation of N2.35trillion (US\$15.6billion). At this level, the bond market is approximately 46% of the size of the equities market; a ratio that was barely 21% in January 2009.

### Exhibit 3:

2009YtD performance of bonds: **ABBI up by 22%**



2009YtD performance of equities: **NSE ASI down by 33%**



Source: FDHL Analytics, NSE, Meristem Research

## Bond yields have gone depressed

... 10-year FGN bond yields 7.71% (509 basis points below the value it opened in January) while the 20-year bond commands a yield level of 8.16%

Market yields on FGN bonds across all maturities have trended downward setting historical low levels. This is predicated on the strong and positive runs of bond prices and perfectly explains the inverse relationship between bond prices and yields. As at December 2009, FGN bonds are trading at significant *premium* of 20% to their face value with the 10-year FGN bond yielding 7.71% (509 basis points below the yield level in January) and the 20-year bond commanding a yield level of 8.16% (512 basis points drop compared to 13.28% yield when trading began on 20-year maturity in March this year).

### The currently depressed yield environment has been fuelled by:

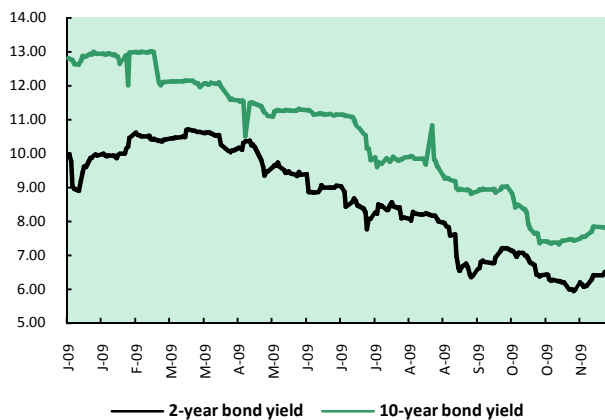
- Rampant risk aversion for equities by local institutional investors and once-active Nigerian retail investors stemming from the extreme volatility and collapse experienced in equity values.
- The removal of the 10% regulatory cap on the bond portfolios of Nigerian banks and the cautious stance of these banks in creating risk assets to maintain balance sheet liquidity. We expect this disposition to weigh significantly on yield knowing that banks, PFAs and discount houses are the largest investors in FGN bonds controlling more than 90% of outstanding issues.

Protraction of risk-aversed disposition and the huge negative investor sentiment towards equities are the likely downside risks to the re-birth of risk appetite

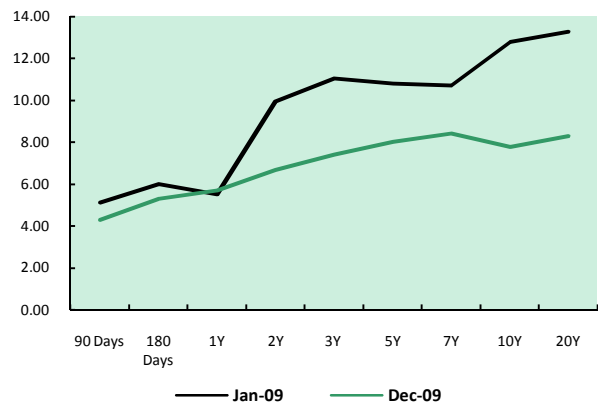
Hence, protraction of this risk averted disposition and the huge negative investor sentiment towards equities are the likely threats to the re-birth of risk appetite, as they dim the chance of an aggressive **yield recovery momentum in the near term.**

### Exhibit 4:

Trend in yields on FGN bonds; yield in %



FGN bonds yield curve: Jan vs. Dec 2009; yield in %



Source: FDHL Analytics, Meristem Research

## Investment imports

It is pertinent to ask if the current uptrend in the bond market is a sustainable phenomenon

Unarguably, the investment world is replete with cycles and phases, and the current trend in the Nigerian capital market is much in favour of bond investment as reflected in its fabulous return profile and investors' shifting preferences. Nonetheless, it is pertinent to ask if the current uptrend in the bond market is a sustainable phenomenon. No doubt, weak investor confidence and the search for 'safe investment haven' have fuelled the strong penchant for bond investment by institutional investors.

...it would not be unexpected if bond prices retrace their steps as the investment horizon gets clearer

Anecdotally, we understand that the flight to bond investment has been crafted as a "coping strategy" which at best could be regarded as a short term measure to sail through the challenging investment climate. **Hence, it would not be unexpected if bond prices retrace their steps any moment as the investment horizon gets clearer.**

...with increased growth, especially fuelled by non-FGN bonds, comes emergence of risk since corporate performance would assume increasing relevance in bond pricing and yield behaviour

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The budding bond market in Nigeria has a huge capacity for growth over the medium to long term as corporate appetite shifts towards exploring this financing window. However, with increased depth, especially fuelled by non-sovereign bonds, comes the emergence of risk since corporate performance would assume increasing relevance in bond pricing and yield behaviour.

## The risks in bond investment

### Any safe haven?

As we welcome the startling development in the fixed income segment of the Nigerian capital market, it is apt to diagnose the close-to-zero risk presumption of bonds. While the FGN bonds are fully-backed by sovereign guarantees, corporate bonds are backed by the firms' assets. However, equity holders stand a higher risk since bond holders have preference over shareholders in the event of insolvency. Hence, equity holders demand some premium in form of higher cost of equity to compensate for increasing leverage.

These guarantees, though mitigate the default risk of bonds (both sovereign and corporate), cannot eliminate the inherent risks in bond investment as investors seem to perceive.

If the Russian default, following the oil price plunge of 1990s, is historic, the recent default by the highly revered Dubai World raises alarm on the inherent risk in the implicit government guarantees; let alone corporate bonds which are apparently more risky in periods of downturn. An interesting case is the current scenario in the Nigerian banking industry where most of the banks posted losses in the wake of unprecedented provisionings for toxic assets. If these banks have been leveraged through debt, the probable default risk is clear.

Though bonds are fixed income instruments, the risk of interest rate volatility is far above zero-level depending on interest rate environment and the structure of the instrument. In addition to the above risks is the inevitable risk of inflation which may erode the interest payment on bonds. Bond holders stand an implicit risk of inflation particularly when acquired during periods of deflation or contained inflation levels. Given the effect of inflation on purchasing power of money, inflation erodes the purchasing power of the interest payment and in fact the principal when it is paid.

Another hushed source of bond risk is the event risk, particularly the possibility of ratings downgrade in the event of doubtful outlook on the issuer's fundamentals. This increases the liquidity risk of the instrument and may also warrant price plunge as investors run on it.

However, astute investors may allay these risks through market intelligence and due examination of the issue's risk-adjusted returns. A good start is the consideration of the interest-coverage and capitalization ratios of the issuer. While the interest-coverage ratio will give a glimpse of the issuer's ability to service its debt through the bi-annual interest payment, the capitalization ratio is a proven indicator of the firm's long-term stability and ability to

withstand losses and business downturns within the maturity horizon. However, this should be complemented by the credit ratings of the issuer by reputable agencies such as Standard & Poor's, Moody's, Fitch IBCA and Augusto & Co, though skepticism on credit ratings remains high with regards to how proactive the agencies are in reading the signals of corporate defaults.

It is also crucial that investors remain cautious while analyzing the credit risk inherent in a bond issue, more importantly, of the possibility of a bond having multiple issuances with each issuance having varying ratings due to their differing structures and conditions. Investors' acquaintance with the inherent SWOT of this emerging instrument and reliance on brokers' intelligence guide, may better position them for the imminent opportunities.

# Bond basics 101

## A refresher discourse on bond terminologies

**Bond:** A corporate bond is a debt instrument that obligates the issuer (a corporate entity) to pay a specified percentage of the bond's par value (the coupon payments) on designated dates and to repay the bond's par value at maturity. If the bond is issued by corporate entity it is called a **corporate bond** and if issued by a government it is referred to as government or **sovereign bond**.

**Indenture:** This is a document that details the promises (covenants) of bond issuers and the rights of investors who buy them (the bondholders).

**Trustee:** This is a third party to the contract either a bank or trust company who acts in a fiduciary capacity for investors by ensuring that the issuer complies with all the covenants in the indenture.

**Maturity:** A bond's maturity is the date on which the issuer's obligation to satisfy the terms of the indenture is fulfilled and the principal is repaid with any premium and accrued interest that may be due.

**Face value:** Also called principal value; it is the nominal value of a security. For a bond, the face value is the amount repaid to the bondholder at maturity.

**Coupon:** The coupon is the amount the bondholder will receive as interest payments. Most bonds pay interest semi-annually, but it is possible for them to pay monthly, quarterly or annually. The coupon is expressed as a percentage of the par value.

**Yield-to-maturity:** This is the single rate such that discounting all the bond's cash-flows at that rate results in the market price.

**Par yield:** The par yield for a certain bond maturity is the coupon rate that produces a bond price equal its par value.

**Coupon effect:** The impact of coupon level on the yield-to-maturity of coupon bonds with the same maturity.

**Yield curve:** A plot of the relationship between yields and maturities for a set of similar bonds with equal credit ratings.

**Premium to par:** When coupon rate exceeds the yield to maturity, then the bond sells at a premium to par (that is for more than face value) and for receiving an above-market coupon rate, investors are willing to accept less than their initial investment at maturity.

**Discount to par:** If the coupon rate is less than the yield to maturity, then the bond sells at a discount (that is for less than face value) and for receiving a coupon rate below market, investors demand to be paid more than their initial investment at maturity.

**Pull to par:** The effect of time on bond prices such that the price of a premium bond falls over time while that of a discount bond rises until they are worth par at maturity.

**Straight-coupon bonds:** These are also called fixed-rate bonds and have an interest rate set for the life of the issue.

**Zero-coupon bonds:** These are bonds without coupons or an interest rate and they pay only the principal portion at some future date. These bonds are issued at discounts to par with the difference constituting the return to the bondholder.

**Floaters/floating rate bond:** A floating rate bond is a bond whose interest rate varies with an assumed benchmark interest rate.

**Bond options:** Bonds sometimes offer options to the parties, either the issuer or the bondholder. A **callable bond** gives the issuer the right to call i.e. redeem the bond prior to its maturity, a common phenomenon in a declining interest rate environment. A **puttable bond** on the other hand is a bond that allows the holder right to sell back or have the issuer repurchase the security at specified dates before maturity. Another option available to the holder is the right to convert the bond to equities of the issuing company; such bonds are called **convertible bonds**. If convertible into the common stock of a corporation other than that of the issuer, such issues are called **exchangeable bonds**.

**Plain vanilla bonds:** These are the traditional, most basic and standard version of bonds that are free of embedded option.

**High-yield bonds:** These are bonds rated below investment grade by the ratings agencies. These issues are also known as junk bonds. Investment grade bonds are those with credit ratings of BBB- or Baa3 and above.

**Debentures:** These are bonds not secured by any specific pledge of designated asset but have the claim of general creditors. This does not imply that they have no claim on the property of issuers or on their earnings.

**Mortgage bond:** A mortgage bond grants the holders a first-mortgage lien, substantially on all the issuer's assets. The additional security provided for the bondholder enables the issuer to borrow at a lower rate of interest than if the debt were unsecured.

**Duration:** Duration is a measure of how long on the average a bond holder waits before receiving cash payments and gives the percentage change in the value of a bond for a unit change in rates. It is the weighted average of the times when payments are made, with the weight applied to a certain time (say  $t_1$ ) equal to the proportion of the bond's total present value provided by the cash flow at that time.

**Yield spread:** This represents the difference between the yield on a corporate bond and a risk free yield.

**Convexity:** This measures how interest rate sensitivity changes with rates and is used to improve on duration by accounting for the second order effects. It tends to be greatest with uniform payment over a long period of time and least with payment concentrated at a point in time.

**Bond credit ratings:** A bond credit rating is a grade given to a debt to indicate the credit worthiness or quality of the bond issues.

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