

Ahead of Next Bond Auction

FGN Bond Auction Scheduled 20th May 2020

Issue on Offer/Summary

The Federal Government of Nigeria (FGN), through the Debt Management Office (DMO), will be conducting a bond auction on Wednesday 20th of May 2020. The total amount on offer is expected to fall within the range of NGN30bn to NGN60bn. All three (3) instruments on offer are re-opening issues.

12.75% FGN APR 2023	NGN20bn
12.50% FGN MAR 2035	NGN20bn
12.98% FGN MAR 2050	NGN20bn

Current Yield Analysis

Investors at the last FGN bonds primary market auction sustained the bullish momentum from the March auction, as evinced by the bid-to-cover ratios of 1.65x, 1.49x and 2.21x on the 12.75% APR 2023, 12.50% MAR 2035 and 12.98% MAR 2050 instruments respectively. This was occasioned by over-allotments as the three maturities were issued beyond the anticipated offer range of NGN10bn — NGN20bn.

The bearish sentiment which has reigned in the bond market since the spread of the global pandemic has remained strong. Since the last primary market auction (PMA), the average bond yield has risen from 9.98% to 10.55% as at 15th of May 2020. This, we attribute to the continued selloffs in the market, coupled with a relative liquidity squeeze, following the debit of commercial bank balances by about NGN1.4trn and the recent OMO auction which gulped NGN100bn. In addition, market participants are relying heavy on cash and liquidity in these times, pressuring yields further.

On the domestic front, economic activity is slowly gaining traction following the relaxation of the lockdown rules. We believe that this move will slightly improve the earning prospects of government. Similarly, the global economies are slowly reopening and the oil supply deal from April has triggered a 60.00% rise in crude oil price over the last three weeks to USD32.50/ barrel as at 17th of May 2020. This bodes well for Nigeria as proceeds from crude oil remains a crucial source of revenue for the economy.

The Nigerian government is increasingly making efforts to meet its fiscal responsibilities without pressuring future earnings viz-a-viz debt servicing costs. This is evident by switch in borrowing plans from a mix of both domestic and external funding sources to solely domestic sources, as it avails a cheaper debt. In addition, the government has further revised budget oil benchmark downward to USD25/barrel. A development which moderated the budget deficit to NGN5.37trn.

We expect Investors patronage at the auction to be encouraging, even as they demand for high rates to compensate for increasing local economic vulnerabilities amid the lingering impact of COVID-19

SUMMARY OF PREVIOUS AUCTION

Marginal Rates:

12.75% APR 2023	9.00%
12.50% MAR 2035	12.00%
12.98% MAR 2050	12.50%

Amount:

12.75% APR 2023	30.07bn
12.50% MAR 2035	72.52bn
12.98% MAR 2050	53.74bn

SUMMARY OF CURRENT AUCTION

FGN APR 2023

Auction Date	20/05/2020
Settlement Date	22/05/2020
Maturity Date	27/04/2023
Next Coupon Date	27/10/2020
Clean Price	NGN108.68

FGN MAR 2035

Auction Date	20/05/2020
Settlement Date	22/05/2020
Maturity Date	27/03/2035
Next Coupon Date	27/09/2020
Clean Price	NGN107.01

FGN APR 2050

Auction Date	20/05/2020
Settlement Date	22/05/2020
Maturity Date	27/04/2050
Next Coupon Date	27/09/2020
Clean Price	NGN103.32

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Bond Absolute and Relative Valuation

Valuing the 12.75% FGN APR 2023, 12.50% FGN MAR 2035 and 12.98% FGN APR 2050 re-openings with the current yield curve as the basis for discounting, we arrived at the following fair value, implied yield and an IRR for the instruments:

Instrument	Fair Value	Implied Yield	IRR
12.75% FGN APR 2023	109.62	9.29%	4.68%

Instrument	Fair Value	Implied Yield	IRR
12.50% FGN MAR 2035	108.98	11.50%	5.75%

Instrument	Fair Value	Implied Yield	IRR
12.98% FGN APR 2050	105.37	12.55%	6.10%

Our valuation gives a fair-trading price ex coupon payment, the expected return on the bond considering its periodic interest payments and the expected return on the bond's periodic payments. We analysed the issues on offer given the current yield environment, market liquidity, as well as a review of the recent past auctions, whilst also introducing market sentiment factor into our valuation, on which we advise bid yield ranges for both issues on offer

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About Bonds

A bond is a fixed income debt instrument issued by the government (federal or state government) or corporate institutions with a definite date of maturity and a fixed interest payment (known as coupon) payable either semi-annually or annually. Unlike equities, bonds are issued with a guarantee of the initial investment and can have tenors as long as 20 years.

A treasury note refers to a government bond instrument with a term to maturity of 1 to 10 years while a treasury bond has a maturity of 10 years and above. Bonds issued by state governments of a country are referred to as municipal bonds while those issued by organizations are corporate bonds.

The government usually issue bonds at the primary market to raise domestic funds to meet its fiscal responsibilities. This can be done from time to time as the need arises. Nigerian FGN bond instruments are named by their maturity, coupon, tenor etc. such as 13.05% FGN AUG 2016 instrument.

How is Return Determined?

Bonds are mostly issued with a coupon otherwise known as **the periodic interest payable**. Bond instruments are usually issued at par; that is, N100 or N1,000 as is the case with Nigerian bonds. A 2-year bond issued at 12% annual coupon with a par value of N1000 implies that the issuer will make 3 semi-annual payments of N60, and a final N1060 on the maturity date.

Bonds can be purchased at both the primary and secondary markets, they are either quoted in price or yields. **There is an inverse relationship between the price of a bond and its yield to maturity (YTM).** At issuance, the yield on a bond instrument is most likely the coupon on that instrument. At the secondary market therefore, an investor can trade bonds by quoting a yield that reflects the variance between the par value and the current price based on the current market dynamics.

How does the Auction Process work?

Bond instruments are issued through a competitive bidding process at auctions as conducted by the Debt Management Office which serves as the representative of the government. An existing government instrument can be re-issued also at the primary market in which case the DMO re-issues based on the current market yield to maturity.

Bonds are auctioned at established rates which determine the return to investors.

Purchasing these instruments in the primary market and holding it till maturity would mean that the investor gets a fixed interest payment, however, there is a secondary market in which investors can trade these bonds to meet their immediate liquidity needs.

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