Ahead of Next Bond Auction

SUMMARY OF PREVIOUS AUCTION

Marginal Rates:

12.50% MAR 2035	6.9450%
9.80% JUL 2045	7.0000%

Amount:

12.50% MAR 2035	NGN20.00bn
9.80% JUL 2045	NGN10.00bn

SUMMARY OF CURRENT AUCTION

FGN MAR 2027

Auction Date	20/01/2021
Settlement Date	22/01/2021
Maturity Date	17/03/2027
Next Coupon Date	17/03/2021
Clean Price	147.82

FGN MAR 2035

Auction Date	20/01/2021
Settlement Date	22/01/2021
Maturity Date	27/03/2035
Next Coupon Date	27/03/2021
Clean Price	132.72

FGN JUL 2045

Auction Date	20/01/2021
Settlement Date	22/01/2021
Maturity Date	24/07/2045
Next Coupon Date	24/01/2021
Clean Price	137.49

FGN Bond Auction Scheduled for 20th January 2021

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 January 2021. The total amount on offer is expected to amount to between NGN120bn and NGN150bn. All instruments on offer are re-opening issues.

16.2884% FGN MAR 2027	**NGN40-50bn**
12.5000% FGN MAR 2035	**NGN40-50bn**
9.8000% FGN JUL 2045	**NGN40-50bn**

Current Yield Analysis

At the last Primary Market Auction (PMA) held in December 2021, all instruments on offer were oversubscribed with bid to cover ratios of 4.54x and 4.32x across the **12.50% MAR 2035**, and **9.80% JUL 2045** instruments respectively. This reflected strong investor buying interest despite mounting inflationary pressures and the consequent negative real rates of return. Marginal rates however increased across board to 6.9450% and 7.0000% from 5.0000% and 5.7850% on the 2035s and 2045s respectively.

In the secondary market for government bonds, investor sentiment has remained largely bearish since the last PMA as average bond yield increased to 6.63% as at 15th January 2021, from 5.14% (recorded on the date of the last auction). This development is due to sustained low yields, high inflation and the bullish streak witnessed in the equities market during the period.

Although the global economy is not yet out of the woods regarding the COVID-19 plague, the increase in vaccination offers some glimmer of hope for a recovery. In Nigeria, the curve of the second wave has not yet flattened but the government has indicated that a total lockdown is unlikely. Hence business activities are not expected to be grounded in a bid to combat the virus. In addition, the outlook for oil price is positive with increased vaccination efforts and Saudi Arabia's voluntary pledge to further cut production by 1mn bpd in February and March 2021. These factors together bode positively for government revenue over the near term.

Inflation however rages on and continues to eat into real returns, making government bonds unattractive especially relative to equity instruments. Headline inflation rate increased to 15.75% YoY as at December 2020 from 14.89% in November 2020, effectively implying that average real returns on government bonds is -9.12%. Nonetheless, we expect strong participation by investors (especially pension fund managers who are required to maintain a significant portion of their funds in low-risk assets) at the upcoming auction given due to limited options.

Please refer to page 5 for our disclaimer notice and other relevant disclosures

Bond Absolute and Relative Valuation

In valuing the **16.2884% FGN MAR 2027**, **12.5000% FGN MAR 2035** and **9.8000% FGN JUL 2045** re-opening offers 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
16.2884% FGN MAR 2027	147.82	7.59%	3.95%
12.5000% FGN MAR 2035	132.72	8.90%	4.47%
9.8000% FGN JUL 2045	137.42	7.00%	3.51%

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.

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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