NCMI

NIGERIAN CAPITAL MARKET INSTITUTE

Dexterous in Human Capacity Building

27th September 2011

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TRAINING TOPICS:

DIFFERENCES BETWEEN EQUITIES & FIXED-INCOME SECURITIES

PUBLIC AND PRIVATE ISSUANCE OF BONDS

ROLE OF BONDS IN PORTFOLIO MANAGEMENT

COMPARING EQUITIES WITH FIXED-INCOME SECURITIES

Comparing Bonds and Equities Under:

- Covenants
- Ownership Interest/Control
- Repayment at Maturity
- Income Payment during Life
- Potential Capital Appreciation
- Price Determination Factors

Comparing Bonds and Equities Under:

Effects of Inflation/Interest

Equities and Fixed-Income Securities

Investment Coverage

- **Equity investments: Also known as stocks and shares.**

- **Fixed-income securities include: Bonds, Collateralised Debt Obligations (CDOs), ABS, MBS, Certificates of Deposits (CDs) and other interest-bearing securities like Bank Loans.**

- **Bonds are a variant of fixed-income securities.**

- **Focus now turns on equities and bonds.**

Differences Between Bonds and Equities

1. Covenants/Indenture

- **Certain debt instruments such as corporate bonds are often structured around covenants: rules by which a borrower must operate.**
- **There are no covenants in the case of equities.**

2. Ownership Interest/Control

- **Equities represent an ownership interest in a company that guarantees control through votes.**
- **While bonds represent only a debt to a company and no control in such a company.**

3. Repayment at Maturity

- **Bonds have repayment on a specific maturity date(s) or contingency.**
- **While equities have repayment only with winding up after all the priority debt obligations have been met.**

4. Income Payment during Life

- **Bonds have income payment at contractual rate unless it is zero-coupon bond.**
- **Equities' income arises from dividend payments which are at the discretionary of the Board. Also, capital appreciation is another form of income in equity investment.**

5. Potential Capital Appreciation

- Bonds have repayment at par at maturity. Price varies depending on the interest rate movements.
- Equities' prices can appreciate at any time depending on the company's fundamentals and the macroeconomic fundamentals e.g. interest rate.

6. Price determination Factors

- Bonds' prices are determined by the market based on the issuer's credit ratings, the coupon payment rate, term to maturity and market yield on other fixed income securities.
- Similarly, equities' prices are determined by the markets, but based on the company's fundamentals and the macroeconomic variables.

7. Effects of Inflation/Interest

- **Prices of the extant bonds usually fall when there is increase in interest rate from the MPR.**

  While the new bonds' prices will go up on the new high MPR.

- **Effects are two-fold:**

  1. **Equities' prices will fall as investors divest the capital markets to the money markets for the higher rate (MPR).**

  2. **Also, equities' prices may rise as companies: Increase their products' prices → Making more profits → Increasing their share value. Ceteris paribus, this takes time to happen.**

PUBLIC VERSUS PRIVATE ISSUANCE OF BONDS

Types Of Bonds By Issuers

PUBLIC ISSUANCE	PRIVATE ISSUANCE
Agency Bond	Corporate Bond
Emerging Market Debt	Distressed Securities
Government Bond	
Sovereign Bond	

Types of Bonds By Payout:

Accrual Bond

Callable Bond

Commercial Paper

Convertible Bond

Exchangeable Bond

Types of Bonds By Payout Contd:

Fixed Rate Bond

Floating Rate Note

High-Yield Debt

Inflation-Indexed Bond

Inversed Floating Rate Note

Types of Bonds By Payout Contd.

Perpetual Bond

Puttable Bond

Reversed Convertible

Zero-Coupon Bond

Auction Rate Security

Rationale for Issuing Bonds

1. **Capitalising on Prevailing Economic Conditions**
   - ► **Lower interest rate**
2. **Certainty of Funding Source**
   - ► **Higher assurance of subscription by investors due to its lower risk and guaranteed income stream vis-à-vis equities.**
3. **Cheaper Alternative Funding and Suitable for Projects**
   - ► **Cheaper alternative funds than bank loans.**
   - ► **Funding suitable for projects.**
4. **Avoidance of Ownership in Business**
   - ► **Where intention is not to create extra ownership in business.**

Public Issuance of Bonds

- **Public issuance of bonds transmits to government issuance:**
  Federal/State/Local Government/Municipal.

- **This type of bonds can be either:**

1. General Obligation Bonds – Capital Development

Principal and interest payments are secured by full-faith, credit and revenue generating ability of the issuer.

Public Issuance of Bonds Contd.

2. Revenue Bonds – Project Specific.

Principal and interest payments are secured by the revenues generated from the financed project(s).

A more risky transaction as they are not usually guaranteed by the issuer's revenue-generating ability.

Examples of State Bond Issuances:

1. Kwara State Bond Issuance in 2009.
2. Imo State Bond Issuance in 2009.
3. Niger State Bond Issuance in 2009.
4. Bayelsa State Bond Issuance in 2010.
5. Edo State Bond Issuance in 2010.
6. Kaduna State Bond Issuance in 2010.

Private Issuance of Bonds

- ✓ **Private issuance of bonds relates to corporate (business) issuance.**
- ✓ **Corporate bonds are quite similar to public bonds in terms of tenor and pricing, but generally differ in security structure.**
- ✓ **Several corporate entities in Nigeria have previously issued bonds other debt instruments such Debenture/Loan Stock:**

Access Bank, Guinness and Cadbury.

Recently, were: Lafarge, NAHCO, Tower Funding and Dana Group.

Private Issuance of Bonds Contd.

- ✓ **Corporate bonds are usually secured either on: Company's ability to make future payments – Reliability of Cash Flows**

  OR

  A Lien on Specified Assets

- ✓ **Corporate bonds are generally considered riskier than the government bonds.**
- ✓ **So, coupons on corporate bonds are often higher to attract prospective investors.**
- ✓ **The above rests on Mean-variance theory.**
- ✓ **Corporate bonds may be secured/unsecured and senior/subordinated.**

Documentations for Bond Issuance

- **Resolution:** Approval by State Executive Council and enabling Legislation; Board and Shareholder approval.
- **Offer Documents:** Prospectus – Shelf/Supplementary
- **Marketing Documents:** Teaser, Road Show Presentation and Adverts.
- **Trust Deed:** Agreement between the Issuer and Trustee(s); or Indenture for a Debenture issue.
- **Legal Due Diligence:** Outstanding Claims and Litigations, compiled and reviewed by Solicitors.
- **Agreements:** Vending Agreement and Underwritings.

Documentations for Bond Issuance Contd.

- **Financial Information:** **Audited financial reports for 5 years (including current year), 3-year profit forecast. Financials must not be more than 9-months old.**

- **Rating Report:** **Report provided by the Credit Rating Agency on issuer's ability to pay.**

Key Elements of Bond Issuance

- **Security Structure:** **The Bond must be secured by a Sinking Fund and an ISPO (State). Corporate bond is secured by a Sinking Fund and, usually, a lien on assets.**
- **Credit Rating:** **Rating by an accredited Credit Rating Agency. It is the instrument (Bond) which is rated, and not the issuer.**
- **Tenor:** **Depending on the purpose of the bond and could range from 3-10 years. Matched to the life cycle of the specific projects/expected cash flows: IGR and Statutory Allocations.**

Key Elements of Bond Issuance Contd.

- **Coupon:** Coupon may be zero, fixed rate or floating rate. Bench-marked against indices such as FGN bonds, NIBOR/LIBOR, MPR. Paid annually or semi-annually.
- **Liquidity:** Bonds may be listed on the Nigerian Stock Exchange or on the OTC market by the Primary Dealer Market Makers, ensuring liquidity.
- **Target Investors:** Bonds are generally targeted at HNIs, Insurance Companies, PFAs, Banks and other companies.

ROLE OF BONDS IN PORTFOLIO MANAGEMENT

Role of Bonds in Portfolio Management

Bond investment plays important role in a typical portfolio management.

- **Portfolio Diversification**

“Tis the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket.” – Miguel de Cervantes, Don Quixote de la Mancha, 1605.

Bond markets generally do not move in tandem with equity markets, so, they provide investors with the added diversification in their portfolios.

Investing in bond mutual funds allows individuals to diversify among many different bond issues, thereby reducing credit risk.

Bonds in Portfolio Management Contd.

- **Guaranteed Principal Repayment at Maturity**

Diversifying your portfolio into bond investment guarantees principal repayment at bond maturity. No other capital market security guarantees principal repayment at investment maturity.

- **Investment Safety Net**

Bond investment provides investment safety net for a portfolio of securities because it is less risky with steadier income stream than equities or other investment securities.

Bonds in Portfolio Management Contd.

- **Steady Income Stream**

Steady income in form of coupon, except in the case of zero coupon bonds.

More issues shall be clarified at question time.

Thank You.