

Expensive domestic debt whets appetite for more Eurobonds.

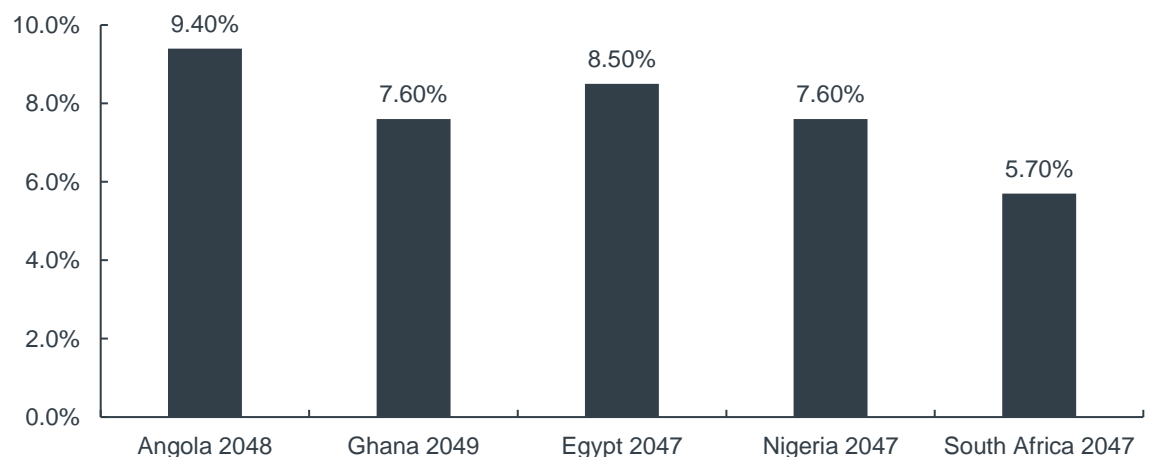
Last week, the Senate approved President Buhari's proposal to issue USD2.8 billion worth of foreign currency denominated paper to help finance the 2018 budget. Barring an eleventh-hour backpedal, we expect the FGN to hit the Eurobond waters – anytime from now – and glide successfully, despite sustained foreign investors' apathy towards Nigeria's debt and equities markets in recent times.

Nigeria's macro landscape is currently less appealing from an investor's perspective compared with the beginning of the year – only higher crude oil price holds sway. That, together with continued monetary policy tightening in the US (which has pushed long term interest rates 69bps higher YTD) and trade war concerns that have both raised bond yields across FM region, suggest that a relatively expensive pricing is on the card. Hence, we believe the combined impact of weaker domestic picture and rising U.S yield will fuel investors' thirst for higher yield. In any case, we look for a yield of sub 10% levels.

For comparison, at the heart of the economic malaise in February 2017 wherein (1) Nigeria lingered in dire economic recession and (2) sustained unmet demands for FX significantly widened the premium between parallel and official exchange rates, Nigeria successfully closed a USD1 billion Eurobond offer with bid-to-cover of nearly 8x. What's more, irrespective of the poor economic landscape at the time, the DMO secured fair pricing of 7.87% for the issue

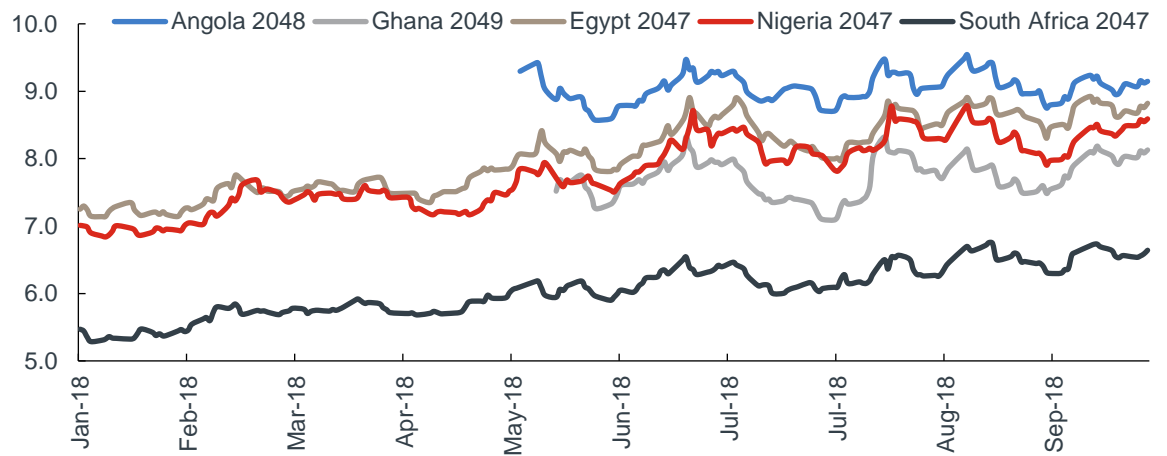
To underscore our views, Ghana raised a total of USD2.0 billion in May 2018 with a subscription of over 4x. The country split the issue into 10-year and 30-year tranches of USD1.0 billion apiece, with coupons printing 7.625% and 8.627% respectively. This was achieved at time of rather stormy global capital markets triggered by rising U.S yields and brewing trade war between U.S and China, together with a currency crisis in Argentina. To that end, we reiterate that Nigeria's international bond will be fairly priced; at a yield below 10% levels.

Figure 1: Nigeria 2047 at issue vs. peers



Source: Bloomberg, Cordros Research

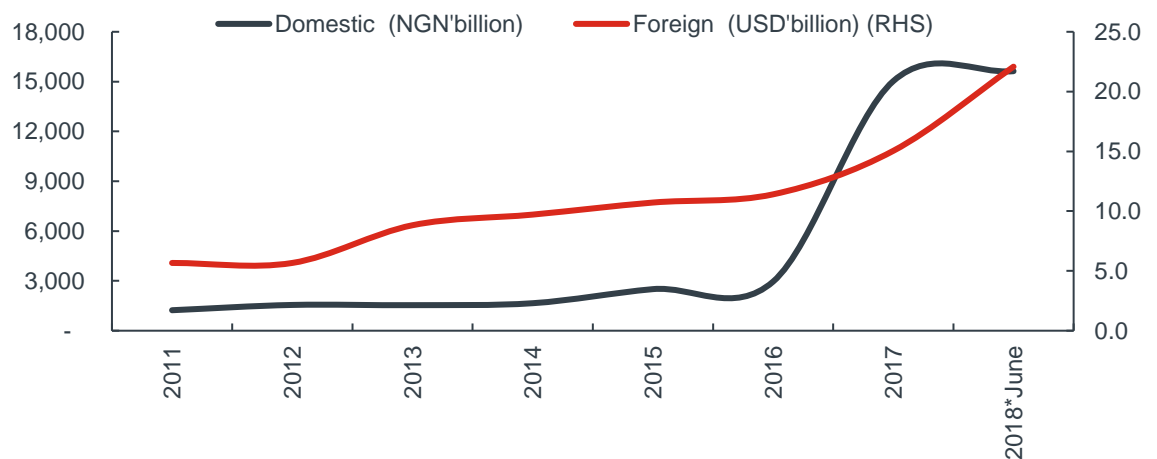
Figure 2: Nigeria 2047 at issue vs. peers



Source: Bloomberg, Cordros Research

That said, over the past few months, concerns have been raised on the sustainability of the burgeoning debt profile of the Nigerian government, with the IMF stressing the need to cutdown on excessive borrowing. Notably, at the end of H1-18, FGN debt stock stood at USD73.2 billion, with foreign debt accounting for 30% (USD22.4 billion) of the total, while the balance is naira denominated. From an extensive view, it seems quite alarming that the FGN's naira and USD borrowings have grown by 21% and 44% CAGRs respectively between 2011 and H1-2018.

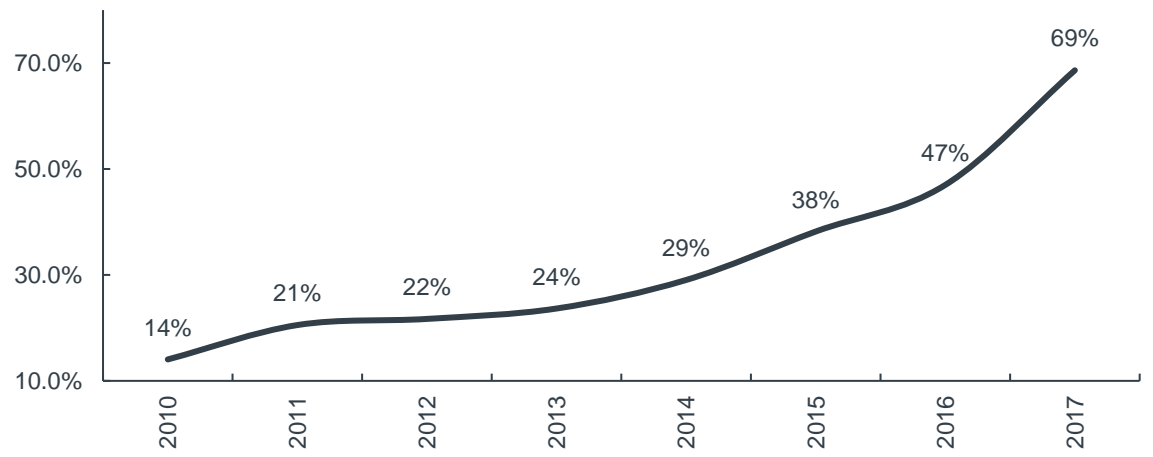
Figure 3: Movement in Nigeria debt profile



Source: DMO, NBS, Cordros Research

In fact, the snag becomes more worrisome when the number is viewed in terms of debt service-to-revenue ratio. Instructively, as at FY-2017, FGN's total debt service amounted to NGN1.82 trillion, equating to 69% of total retained revenue. Notwithstanding the foregoing, our views align with the DMO's which advocate that the FGN still has a little more room to take in additional borrowing, particularly from the external leg.

Figure 3: Movement in Nigeria debt profile



Source: DMO, NBS, Cordros Research

First off, we are less concerned about domestic debt as (1) we do not see any circumstance that is huge enough to occasion domestic debt default and (2) Nigeria's debt profile is largely denominated in local currency, hence, we do not think possible currency depreciation could drive servicing cost higher. Instructively, of the total amount earmarked to service debt in 2017, only 9.9% of the total was channelled into servicing foreign debt obligations, hence the need to substitute expensive domestic borrowing for cheaper foreign loans. More importantly, as a percentage of FGN's foreign currency earnings, external debt service only sipped 6.2% in 2017.

Secondly, we highlight that 60% of the foreign debt stock as at H1-18 stated above is in the form of concessionary non-Eurobond debt, while the balance are commercially priced international borrowings (Diaspora bond and Eurobond). This, in our view, explains the exceptionally low-level foreign debt service ratio relative to domestic debt.

Thirdly, we think foreign borrowing, at this time, will serve as a buffer to the depleting foreign reserves (H2 to date: -11% to USD42.8 billion) following the recent foreign sell-offs of naira assets. Though inorganic in nature, we believe an inflow of USD2.8 billion, together with higher inflows from rising crude prices, will give the CBN extra legroom to boost dollar supply across all segments, and thus, keep the naira relatively range-bound.

Fundamentally, the fiscal authorities need to address Nigeria's revenue challenges. With actual revenues consistently underperforming budget. In our views, (1) approaching the debt market to finance its budget deficit could lead to spike in the yield curve – potentially sabotaging FGN's effort to cutdown on borrowing cost – and risks crowding out the private sector and (2) the trend of capital expenditure under-implementation will persist on revenue shortages. On balance, in spite of the growing concern around debt sustainability, we believe the benefits outweigh the cost. Overall, we do not see full blown crisis, at least, in the near term.

Disclosures.

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