Sub-National Bond Financing in Africa

Case Study: LAGOS STATE

3 November 2011
Presentation Outline

Preamble

Sub-National Financing Overview

Nigerian Sub-national Bond Market

Issues and Challenges

Case Study
Preamble

Bond financing in sub-Saharan Africa has mirrored the rise of the bond market development with local treasury bonds in the vanguard. Treasuries are usually the largest and most liquid component of the market while the investor pool is dominated by banks, pension funds and asset managers (both local and offshore).

Successful development of a vibrant bond market is predicated upon:

- Stable macro-economic environment with relatively low (and stable) interest rates
- Market institutions and operating infrastructure including strong regulatory regime, experienced and knowledgeable intermediaries, independent audit and risk rating
- Development of a large, liquid and diversified treasury bond market (benchmark).
- Availability of a diversified pool of investors (Banks, Pension funds, Insurance, Asset managers)
- A well functioning secondary market.
- Large pool of prospective issuers representing diversified risk sources.

The primary rationale for developing local bond market is to deepen and diversify the financial sector by increasing the sources, availability and variety of financing while lowering the cost of financing. Sub-nationals have come into focus due to their unique challenges in securing term funding which matches their long-term investment requirements. These challenges include:

- Lack of resources and capabilities required to meet the stringent requirements of the capital market.
- A public sector mindset which often fails to evaluate critical projects on an investment returns basis (even where the returns are social and economic rather than financial).
- Market perception of sub-national risks and lack of financial tools to manage or mitigate such risks.

One of our aim is to address some of these challenges through sharing ideas and stimulating the right engagement with investors, capital market regulators and intermediaries, support institutions and governments.

1Debt Management Office website
Presentation Outline

- Preamble
- Sub-national Financing Overview
  - Nigerian Sub-national Bond Market
  - Issues and Challenges
  - Case Study

FBN Capital
Sub-National Funding Sources

Traditionally, sub-national entities derive revenue from a number of sources:

- Share of Federal Revenue or subvention from the Federal Government
- Tax revenue (income tax, property tax, fees, levies and fines)
- Rates and charges on local services e.g water rates, waste management rates,
- Assets Sale and Asset Concessioning
- Investment income (interest, dividend, rental income etc)
- Grants from DFI and NGO (usually project specific).

These sources are supplemented with debt. Principal sources of debt financing are:

- Bank credit and guarantees (direct or related entity/project financing backed by state guarantees).
- Multilateral and DFI soft loans and guarantees
- Bonds and debt securities.
- Federal Government and federal agencies sector/project specific credit programmes.

Debt Stock of Selected Nigerian States in 2008

Nigerian Sub-sovereign Statutory Revenue

<table>
<thead>
<tr>
<th>Source: FBN Capital Research</th>
<th>N’Billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Government</td>
<td>46.9%</td>
</tr>
<tr>
<td>State Government</td>
<td>23.8%</td>
</tr>
<tr>
<td>Local Government</td>
<td>18.3%</td>
</tr>
<tr>
<td>Revenue Derivation</td>
<td>9.7%</td>
</tr>
<tr>
<td>Finance (Control and Management) Act 2004</td>
<td></td>
</tr>
</tbody>
</table>

TAX JURISDICTION

Federal Consolidated Revenue

- All taxes on Companies
- Value Added Tax
- Mineral Rights Fees & Royalties (Incl. Oil & Gas)
- Petroleum Profit Tax

State Governments

- Personal Income Tax
- Land and landed property rights

Local Governments

- Property Tenement Rates
- Petty Trading rights
## Features of Sub-National Funding Sources

<table>
<thead>
<tr>
<th>Type</th>
<th>Source</th>
<th>Purpose</th>
<th>Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Revenue</td>
<td>Federal Revenue Share</td>
<td>Covers both revenue and capital expenditure with priority on revenue expenditure and debt service.</td>
<td>Limited by economic activity in the state. Economy of most states largely agrarian. Notable exception is Lagos State which is largely commercial/industrial</td>
</tr>
<tr>
<td></td>
<td>Internally Generated Revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Offshore &amp; Multilateral Grants</td>
<td>Project specific funding provided by multilateral agencies, donor countries and foundations.</td>
<td>Dwindled lately due to poor record of utilisation and accountability.</td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td>Direct Bank Loans</td>
<td>Short to medium term (up to 4 years) used largely in financing budget deficit.</td>
<td>Banks limit tenor to unexpired term of state administration. Attractive for bankers to state treasury.</td>
</tr>
<tr>
<td></td>
<td>MFI/DFI Loans</td>
<td>Long–term subsidized loans from DFIs (10 – 25 years) usually in foreign currency.</td>
<td>Subject to sovereign limits. Require federal approval. Foreign currency risk. Slow DFI approval process.</td>
</tr>
<tr>
<td>Assets &amp; Rights Transfer</td>
<td>Public Private Partnership</td>
<td>Concessions, Joint ventures (e.g property and commercial developments etc)</td>
<td>Few commercially viable projects. Often require state subsidy and guarantees.</td>
</tr>
<tr>
<td></td>
<td>Privatization</td>
<td>Sale of government commercial assets (Hotels, properties).</td>
<td>One–off cash injection. Round tripping. (Sale followed by repeat investment)</td>
</tr>
</tbody>
</table>
The principal source of financing in Sub Saharan Africa is bank loans.

Where there are well functioning bond markets, sovereign issues are pre-dominant. (57% in South Africa, 91% in Kenya and 92% in Nigeria)

Outside the sovereign, corporates are the largest issuers in South Africa and Kenya with 25% and 9% respectively. In Nigeria, sub-nationals constitute 6% while corporates are 2% of the bond market.

In 2006, 20% of outstanding corporate bonds in South Africa were issued by infrastructure providers. In comparison, in Chile, on average US$1 billion of infrastructure bonds a year were issued between 1996 and 2003, equivalent to 50% of all issues.

### Locally sourced infrastructure financing by financial instrument

<table>
<thead>
<tr>
<th>Country (US$ million)</th>
<th>Bank loans¹</th>
<th>Government Bonds²</th>
<th>Corporate Bonds</th>
<th>Equity Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benin</td>
<td>124</td>
<td>70%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>85</td>
<td>68%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Cape Verde</td>
<td>108</td>
<td>100%</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Congo, Dem. Rep.</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Côte d'Ivoire</td>
<td>335</td>
<td>72%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>248</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Ghana</td>
<td>178</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Kenya</td>
<td>575</td>
<td>14%</td>
<td>0</td>
<td>2%</td>
</tr>
<tr>
<td>Lesotho</td>
<td>21</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Madagascar</td>
<td>68</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Malawi</td>
<td>17</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Mozambique</td>
<td>61</td>
<td>82%</td>
<td>0</td>
<td>18%</td>
</tr>
<tr>
<td>Namibia</td>
<td>117</td>
<td>28%</td>
<td>0</td>
<td>72%</td>
</tr>
<tr>
<td>Niger</td>
<td>67</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>2,444</td>
<td>98%</td>
<td>47</td>
<td>2%</td>
</tr>
<tr>
<td>Rwanda</td>
<td>26</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Senegal</td>
<td>286</td>
<td>13%</td>
<td>93</td>
<td>4%</td>
</tr>
<tr>
<td>South Africa</td>
<td>6,275</td>
<td>10%</td>
<td>763</td>
<td>1%</td>
</tr>
<tr>
<td>Sudan</td>
<td>5</td>
<td>0%</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Tanzania</td>
<td>93</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Uganda</td>
<td>75</td>
<td>91%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Zambia</td>
<td>73</td>
<td>91%</td>
<td>0</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: Local sources of financing for infrastructure in Africa, The World Bank March 2009
The South African Bond Market

- **SA bond market (end 2010 in $m)**
  - Total Market Cap: USD 170,376
  - Treasuries: USD 97,374
  - State Owned Enterprises: USD 23,268
  - Munis & Water Authorities: USD 4,903
  - Securitizations: USD 11,251
  - Corporates Banks: USD 22,863
  - Corporates Non Banks: USD 9,335
- **Total Number of Issuers (end 2010)**
  - Total Issuers: 105
  - Treasuries: 2
  - State Owned Entp: 7
  - Municipalities & Water Auth: 7
  - Securitizations: 34
  - Corporates Banks: 12
  - Corporates Non Banks: 38

Source: IFC
The Kenyan Bond Market

- Kenya bond market (end 2010 in $m)
  - Total Market Cap: USD 8,880
  - Treasuries: USD 8,086
  - Supra Sovereigns: 25
  - Corporates Banks: USD 186
  - Corporates Non Banks: USD 584*
  - No Subnational/Municipal

- One issue (KenGen) was USD 330m

- Total Number of Issuers (end 2010)
  - Total Issuers: 19
  - Treasuries: 1
  - Supra Sovereigns: 2
  - Corporates Banks: 7
  - Corporates Non Banks: 9

Source: IFC
Requirement for a vibrant Bond Market

Enabling Environment
- Stable Macro Economic Environment
- Legal & Regulatory
  - Issuance Process
  - Market Rules
- Favourable Non-discriminatory Tax Regimes

Market Place
- Infrastructure
  - Trading, Clearing, Settlement, Depository
- Pre-trade and post-trade transparency
- Bond Market Structure

Capacity
- Bankable Projects & Sponsors
- Credible, Competent Intermediaries
- Informed Investors

1 Source: IFC Presentation, March 2011
Enabling Environment

Nigeria: Macro-Economic Environment

Pre–2005
• Inflation was historically relatively high.
• Exchange rate extremely volatile with periods of relative stability interrupted by sudden devaluation.
• Interest rate maintained at relatively high levels.
• High external debt and debt service requirements.

Post–2005
• Cancellation and repayment of external debt set stage for macro-economic stability.
• High commodity prices raised external reserves and enabled exchange rate stability.
• Inflation moderated and interest rate declined.

2011 and Future
• Fiscal imprudence pushing up inflation.
• Global crisis has spurred outflow of investments.
• Exchange rate and interest rates under pressure.

Source: World Bank/IFC

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Inflation Rates in Selected African Countries

Short Term (91-day) Interest Rates in Selected African Countries

Source: IFC

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FBN Capital
Enabling Environment

Tax Regime

Pre-2009
- Full tax waiver on Federal Government Bonds over 1yr tenor.
- Sub-national bonds may be granted tax waiver but at discretion of President.
- Corporate bonds subject to full tax provisions.

Post-2009
- Ten year tax waiver on sub-national and corporate bonds.
- Tax policy yet to be gazetted but acceptable to tax authorities.

Legal & Regulatory

Pre-2009
- Issuance process and documentation cumbersome and time consuming.
- Lack of trading rules for non-sovereign bonds.
- Issuance costs relatively high.

Post-2009
- Lower offer registration costs. Offer documentation/registration remain cumbersome.
- Efficient bookbuilding process adopted.
- New rules on custody, market making and investor communications.

Source: FBN Capital Research
## Market Structure

<table>
<thead>
<tr>
<th></th>
<th><strong>Federal Bonds</strong></th>
<th><strong>Sub-Sovereign Bonds</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Structure</strong></td>
<td>Liquid market. Managed by Debt Management Office under Ministry of Finance. Appointed primary dealers are required to offer two way quotes. Quotes available real-time on Reuters.</td>
<td>Illiquid secondary market. Memorandum listing on the Stock Exchange. No formal market.</td>
</tr>
<tr>
<td><strong>Issue Process</strong></td>
<td>Auction to primary dealers. Sovereign guaranteed issues may be offered through bookbuilding eg. AMCON bond.</td>
<td>Offered through bookbuilding. May be underwritten by syndicate. Pricing generally competitive.</td>
</tr>
<tr>
<td><strong>Trading</strong></td>
<td>Active OTC trading between primary dealers, other financial institutions and institutional investors (local and offshore)</td>
<td>Intermittent OTC trades. Willing buyer willing seller.</td>
</tr>
<tr>
<td><strong>Clearing &amp; Settlement</strong></td>
<td>Clearing and Settlement facilitated by Central Bank and CSCS.</td>
<td>Settlement of individual trades by designated banks and CSCS.</td>
</tr>
<tr>
<td><strong>Custody</strong></td>
<td>Central Securities Clearing System (CSCS)</td>
<td>Central Securities Clearing System (CSCS)</td>
</tr>
<tr>
<td><strong>Pre-trade and post-trade transparency</strong></td>
<td>Trading rules compliance monitored by self-regulatory body of traders. Inadequate pre-trade and post-trade transparency.</td>
<td>Non-existent.</td>
</tr>
</tbody>
</table>
Market Capacity – Historical Trend

- Historically banks have been predominant investor in sovereign and sub-national bonds.
- Outstanding Treasury bonds were N430 billion at the end of 2002 and N3.7 trillion in 2010.
- Sub-sovereign bonds outstanding at end of 2002 and 2010 were N24.5 billion and N249 billion respectively.
- Banks held 39% of treasury securities in 2002 and had a 57% share by 2010. By 2010, Non-bank institutions more than doubled their share from 15% to 32%.
- For Banks, sovereign securities offer liquidity, tax exemption and preferential treatment by Central Bank and Basle II.
- Sub-sovereigns are priced at a premium over Treasury bonds and with similar risk profile, are attractive to investors. Banks therefore have significant capacity for sub-sovereign bonds.

**Federal Government Bond Issues**

**FGN Bond Investors**

**2002**
- 39% Central Bank
- 46% Banks & Disc. Houses
- 15% Non-Bank Public

**2010**
- 32% Central Bank
- 8% Banks & Disc. Houses
- 3% Non-Bank Public

Source: Debt Management Office

**Bond Market in 2010**

- 92% Federal Govt
- 6% State Govt
- 2% Corporates
## Market Capacity – Investor Classes

<table>
<thead>
<tr>
<th>Investor Class</th>
<th>Issues with Sub-national Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks &amp; Discount Houses</td>
<td>Preference is yield and liquidity. Traditional underwriters of bonds and dominant OTC trader of FGN bonds. Significant appetite for sub-sovereign fueled by higher yield and tax benefit. Illiquidity offer benefit of not marking to market.</td>
</tr>
<tr>
<td>Pension Fund Managers (PFA)</td>
<td>Fastest growing investor class. Increased investment in bond assets from 6% to 22% in 2009. Preference for yield and low risk.</td>
</tr>
<tr>
<td>Institutional Investors</td>
<td>Marginal investor class with preference for liquidity and yield. Tend to stick to money market due to rate volatility.</td>
</tr>
<tr>
<td>Foreign Investors</td>
<td>Significant investor class in sovereign bonds but little exposure to other bond securities. Illiquidity is a critical concern as it constrains ability to hedge foreign currency exposure.</td>
</tr>
</tbody>
</table>

**Nigeria Bond market investor Profile 2008**

- **Banks**: 39%
- **Discount Houses**: 10%
- **Pensions Funds**: 6%
- **NBFI’s**: 10%
- **Foreign Investors**: 5%
- **Other Institutional Investors**: 0%
- **Individuals**: 0%

**Nigeria Bond Market Investor Profile 2009**

- **Banks**: 72%
- **NBFI’s**: 19%
- **Foreign Investors**: 8%
- **Other Institutional Investors**: 2%
- **Individuals**: 0%
- **Discount Houses**: 10%
- **Pensions Funds**: 22%
Market Capacity – Pension Funds

- Introduced in 2005. Asset under management in the industry stood at N2.2trillion at end Q3 2011, about 7% of GDP.
- 2nd largest investor in bonds with substantial and rising appetite for sub-sovereign issues.
- Industry capacity for sub-national bonds is 30% of portfolio i.e currently about N660 billion while current investment is about 3% of portfolio.
- Significant growth opportunity for PFA. Enrolment in RSA of about 5 million is 10% of estimated working population.
- Pension assets in Nigeria currently about 7% of GDP compared to 17% in Brazil and 72% in South Africa*.
- New Pencom rule forbid investment in bonds of subnationals who are yet to comply with Pension law.

*Source: Global Pension Assets Study 2011. Towers Watson

Profile of Investors in Selected State Bonds

FBN Capital
The old Bendel State (now Edo/Delta) was the first to float a N20 million Loan Stock in 1978. Its subscription level was 30%.

Between 1978 and 1993, six States & Local Governments accessed the market to raise a total of N315 million with subscription levels of between 30% and 100%

There was no bond issue by States or Local Governments between 1994 and 1999.

The Bond market came alive again in 2000 when Edo State Government floated N1 billion Revenue bond which recorded 203% subscription level.

The impressive performance of this Bond led to subsequent state bonds including the N4 billion Cross River States Tourism Development Bond and the Lagos State N15 billion Bond

Between 2000 and 2006, a total sum of N37.5 billion was raised via bond issues by state governments.

Key Drivers of Recent Bond Issues

- Total amount raised has exploded in past three years. Key drivers include:
  - Pension Fund assets under management rose from N680 billion in October 2007 to over N2 trillion by December 2010. Up to 30% of these funds may be invested in sub-national bonds.
  - Tax waiver granted by Federal Government on all associated taxes for ten years.
  - Central Bank agreed to act as settlement bank for trading platform.
  - Both SEC and NSE reduced regulatory fees by 50%.
  - Underwriting rates dropped from about 5% to 2% or less.
  - Low interest rates that prevailed in 2009/2010 and low appetite for equity also increased demand for bonds.

Selected State Revenue & Overhead Costs (2008)

Overhead costs absorb the lion share of State revenues. New minimum wage in 2011 has worsened fiscal outlook. Capital investment require debt issue.
A review of revenue profile of selected States in 2008 which was the best year on record for States’ revenue indicated that:

1. Most States remain dependent on federal statutory contribution with over 90% of revenue from this single source.

2. This dependence provides a major challenge to state administrations but also facilitates low risk financing.

3. Lagos State with 61% in internally generated revenue in 2008 remain exceptionally independent of federal sources.

Review of disbursement profile of selected states indicates that:

1. Revenue expenditure (i.e. overhead and personnel costs represents a significant portion of the state expenditure, varying from 25% to over 50%.

2. Capital investment is substantial but generally less than revenue expenditure with the exception of Ebonyi and Lagos State both investing over 50%.

3. Debt service may become a prominent payment obligation for states as they seek to expand capital investment.

4. It is instructive to compare the cash outflow of Lagos and Bayelsa states, both recording significant revenue in 2008.
## Typical Sub-National Bond Structure

<table>
<thead>
<tr>
<th>Feature</th>
<th>Structure</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorisation</td>
<td>Bond Law enactment by the State together with resolutions of the State Executive Council</td>
<td>Require approval of both the Legislative and the Executive arm of Government.</td>
</tr>
<tr>
<td>Amount</td>
<td>Limited by Investment &amp; Securities Act to 50% of State Revenue less Debts.</td>
<td>Crude measure of debt capacity.</td>
</tr>
<tr>
<td>Tenor</td>
<td>5-7 years. (Lagos State planning a 10 – 15 year issue)</td>
<td>Investor appetite for longer term limited to</td>
</tr>
<tr>
<td>Coupon</td>
<td>Fixed rate.</td>
<td>Trade-ability. No reliable benchmark for floating rate</td>
</tr>
<tr>
<td>Collateral</td>
<td>Secured on Consolidated Revenue of the state backed by a Sinking Fund with monthly payment from either Consolidated Revenue Account or Irrevocable Standing Payment Order (ISPO) or IGR. Administered by independent Trustee.</td>
<td>ISPO is often required to attract investment grade rating. Only exception is Lagos State.</td>
</tr>
<tr>
<td>Repayment</td>
<td>Bullet or amortising. No moratorium. Debt service occurs semi-annually.</td>
<td>Payment structure based on immediate repayment. Simplicity required in ISPO instruction.</td>
</tr>
<tr>
<td>Rating</td>
<td>Minimum of one investment grade rating for securities. Issuer rating also required. Rating must be reviewed annually.</td>
<td>Investor information and market signals. The Pension commission require a minimum of two ratings</td>
</tr>
<tr>
<td>Secondary Market</td>
<td>Must be listed on the Nigerian Stock Exchange. Trading is sporadic and OTC.</td>
<td>Liquidity requirement of investors. A number of on-going initiatives to create a trading platform.</td>
</tr>
</tbody>
</table>
## Challenges of Sub-National Bonds

<table>
<thead>
<tr>
<th>Issues</th>
<th>Comments</th>
</tr>
</thead>
</table>
| Regulatory Approvals | Approval process for bond issues is cumbersome and bureaucratic.  
  • Offer must be completed within 12 months of latest state accounts. This remains a challenge for most state governments.  
  • Process for procuring ISPO approval from Federal Government is subject to political interference and often beyond issuer’s control.  
  • Regulators have exhibited inconsistency in approval diligence and criteria applied. | ▪ For most issuers, a bank loan is often a more attractive option. Although of shorter tenor, it is much faster (in weeks rather than 12 – 24 months) and more flexible.  
  ▪ ISPO approval now streamlined but still subject to politics. |
| Transaction Cost | • Cost of issue though substantially reduced remains raltively high in primary market. It is a key constraint on secondary market take-off.  
  • Lack of compliant State pension scheme now bar PFAs from investing in state bond issues and raises cost substantially. | • Significant cost and coupon efficiency gains from adoption of bookbuilding process.  
  • New Central Bank ru;es forbidding underwriting by banks will reduce underwriting capacity and raise costs |
| Issuers Inefficiency | First-time sub-national issuers are often unprepared for the rigour of due diligence, compliance and documentation. Invariably, accounting records are incomplete and unreliable. Asset records are often missing or non-existent. | Expectation of state executives are often dashed by the time and effort required to achieve minimum compliance and documentation for approval. |
| Political Uncertainty | Unexpected political events and changes in executives mid-stream can delay and sometimes derail the transaction. Political affiliations may also interfere with approval process. | Often advisable to communicate implication of executive changes and effect such changes early in the life of the transaction. |
| Issuer Rating | State agencies and local governments are presently unlikely to achieve the minimum rating requirements for bond issuance unless backed by State guarantee. | Aside from Tinapa bond guaranteed by the Federal Government, there is no sub-national agency that has successfully issued a bond. |
| Debt Capacity | Statute defined debt limit for sub-nationals is a crude mechanism for managing debt capacity. | It has been effective so far but remains to be tested when state revenue declines. |
Future Expectations for Sub-National Bonds

Drivers of Growth

a. Decreasing cost of issue and a possible review of the ISA coupled with revised SEC regulations and streamlined offer registration.
b. Rising market rates due to inflationary expectation should widen gap between taxable and tax–exempted debt instruments.
c. Simplified documentation and filing procedures.
d. Increasing experience of issuers who find it easier to re-enter the market and have moderated expectations.
e. Availability of credit enhancement facilities to lower coupon rates and increase tenor to 10 years and more.
f. Central Bank introduction of foreign currency forwards, futures and options together with interest rate futures, appetite for fixed income securities will expand.

Constraint on Growth

a. Fiscal recklessness by the government undermines macro economic stability which underpins the growth of fixed income market.
b. Pencom’s new requirements will probably dampen appetite from sub–nationals who are yet to fully comply with pension regulatory requirements.
c. Existing limit on debt to 50% of Total Revenue may be retained particularly for states who are largely dependent on share of federal revenue.
d. Lack of an efficient secondary trading platform will continue to limit investors participation in primary issues due to illiquidity.
e. Similarly, lack of currency convertibility and hedging instruments will also constrain participation of offshore investors.
f. Regulatory oversight stretching beyond rule making and compliance to risk assurance. Limiting bond market to institutional investors should suffice.

The future of sub–national bonds remain bright. Rather than accept foreign currency loans, states are now more interested in using such credit lines to enhance local bond issues. With the imminent establishment of trading platform, introduction of hedging products and more robust market infrastructure, investor pool should be enlarged and more issuers will find the market attractive.
Presentation Outline

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- Sub-National Financing Overview
- Nigerian Sub-National Bond Market
- Issues and Challenges
- Case Study
Case Study - Lagos State

Most industrialised city state in sub-saharan Africa. Population estimated at 18 million. The State is currently rated A+ by Agusto & Co. a local rating agency. Also features an international rating at par with Nigerian sovereign rating.

The most sophisticated sub-national issuer in the country, the State entered the market in 2002 with a N15 billion issue and launched a N275 billion Notes Issuance programme in 2008 with two series already issued and a third scheduled for 2011.

- 2009 N50 billion 5 year fixed rate issue. Coupon at 13%. First tranche of N275 billion programme. Issued a partial ISPO for Series I.
- 2010 N57.5 billion 7 year issue. No ISPO backup. Bookbuilding achieved demand of N104 billion priced at 10%.

- Planned: N60 billion in 2012 (new series)

Lagos State has achieved a series of landmarks in issuing bonds in the capital market.

- First state administration to issue under a programme and complete 2 issues within a term.
- Only state to be exempted from ISPO requirement for bond repayment due to its IGR which exceeds 50% of its Total Revenue.
- Only state so far to be exempted from the statutory debt limit of 50% of Total Revenue.
- Citizen acceptance evidenced by growing tax compliance resulting in rising IGR.
- Success built on administrative efficiency, fiscal prudence and accessible government.

Lagos State has enjoyed rising revenue from internal sources and is the only state with IGR in excess of 20% of Total Revenue. Its success in the bond market may be attributed to:

1. Revenue mix (Federal and IGR)
2. Revenue growth especially IGR due to rising tax compliance.
4. Compliance, disclosure and administrative efficiency.