

## BENEFITS OF INVESTING IN A SPECIAL PURPOSE VEHICLE

The equities market has over time held sway for investors in Nigeria, with the fixed income securities occupying very small space in the total investment portfolio. Not until very recently and following the activities of the Debt Management Office (DMO) which brought the bond market back to life with series of sovereign bonds that have been issued. The breadth and depth of the fixed income security category is growing over time and emerging markets debt of which Nigeria is one has become a viable asset class of its own. On the one leg of the fixed income instruments are the securitized products which represent a somewhat complicated sector of the fixed-income market. These products are pools of financial assets. These assets are brought together to create a new security, which is then restructured into different categories and sold to investors. Because the value and cash flows, of the new asset are based on its underlying securities, these investments can be a bit difficult to analyze. A second leg of this asset financing structures is the use of special purpose vehicles (SPVs) to mobilise investments towards a particular project. Both securitized products and SPVs are investment models that will in the very near future assume very significant dimension as the financial market in Nigeria widens.

### Creating a Securitized Product in an SPV

The process of creating a securitized bond is straightforward. A company (the "issuer") with assets it wishes to securitize sells the assets to an SPV. For legal purposes, the SPV is a separate entity from the company or financial institution, but the SPV exists only to purchase the financial institution's assets. By selling the assets to the SPV, the issuer receives cash and removes the assets from its balance sheet, providing the issuer with greater financial flexibility. The SPV issues bonds to finance the purchase of the assets; these bonds can be traded in the market place and are referred to as securitized products.

One key feature of securitized products is that they are usually issued in tranches. This means that the SPV takes the assets which may be either loans (e.g. stream of expected cashflows or mortgages) and issues them in smaller pieces, each of which has different investment characteristics. The existence of different tranches makes securitized products appealing to a wide range of investors, because each investor can choose the tranche that best combines his or her desire for yield, cash flow and safety.

### Size of the SPV Securitised Products Market

The size of the SPV securitised product business in Nigeria is not yet determinable as that segment of the financial market is still at its trial stage of development. But it is an area that is expected to witness an investment boom of about \$38 billion in the next five years. The reason for this follows the opening of the highly capital intensive sectors of the economy such as the power and energy sectors, infrastructure development, oil and gas local content

MARKET UPDATE			
	15/01/13	15/12/13	30/05/14
Naira/US\$	157.65	159.94	161.45
Brent,US\$/BBL	109.78	107.84	111.8
COCOA, US\$	1487.82	2685.47	2760.56
MIPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	7.8
MORTGAGE RATE %	22.0	23.0	23.0

STOCKS CONSTITUTING GMA INDEX			
STOCKS	31/12/13 Price (N)	30/05/14 Price (N)	%Change in Price
OANDO	24.25	18.21	-24.91
GTBANK	27.02	29.92	10.73
OKOMU	44.00	33.10	-24.77
STANBIC	21.35	23.77	11.33
DANGSUGAR	11.70	9.99	-14.62
FIDSON	2.79	2.80	0.36
TRANSCORP	4.35	3.90	-10.34
CCNN	11.75	10.35	-11.91

	PRICE(N)	NAV (N)
	31/01/14	30/05/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	30/05/14	% Change
NSE ASI	41,329.19	41,474.39	0.35
GMA Index	1.50	1.52	1.18

Source: CBN, SEC and NSE

development, etc.

### Benefits of Securitized Products in an SPV

There are several key benefits that securitization provides to market participants and the broader economy: Securitization provides financial institutions with a mechanism for removing loan assets from their balance sheets onto the SPV which provides cash, thereby increasing the pool of available capital that can be loaned out. Also a corollary to the enhanced liquidity is that the rate required on loans is lower; and lower interest rates promote increased economic growth. Also assets that are otherwise not tradable become salable assets and increases liquidity in a variety of previously illiquid financial products. By pooling and distributing financial assets the SPV through

securitization is able to diversify risk and provide investors with more choice as to how much risk to hold in their portfolios. In securitized products, the financial market intermediaries benefit by keeping the profits from the spread, or difference, between the interest rate on the underlying assets and the rate paid on the securities that are issued. Purchasers of securitized products benefit from the fact that securitized products are often highly customizable and can offer a wide range of yields.

### Characteristics of Securitized Products

Key elements characterize the securitized products in an SPV. (1). There is the high yield element, but with a cashflow timing that is uncertain. This uncertainty is why investors demand higher returns. (2). There is also the element of diversification. Securitized products present fixed-income investors with an alternative to government, corporate or municipal bonds. (3). Equally of importance is that of safety of investment which is accounted for by the insurance enhancements. (4). Most securitized products have investment grade ratings that are supported through the process of internal credit enhancement. This is the safeguards that are built into the structure of the securitized product itself. Common forms of internal credit enhancement include subordination (where highly rated tranches receive cash flow priority over lower-rated tranches) and over-collateralisation (where the amount of bonds issued by the SPV is less than the value of the assets backing the deal).

The intended effect of any type of internal credit enhancement is that cash flow shortfalls due to losses in the value of the underlying assets do not affect the value of the safest tranches of bonds. This works well given relatively low levels of losses, but the value of the protection is less certain if losses on the underlying assets are substantial.

External credit enhancement occurs when a third party provides an additional guarantee of payment for bond holders. Common forms of external credit enhancement include third-party bond insurance, letters of credit and corporate guarantees. The main drawback to external credit enhancement is that the additional protection is only as good as the party providing it. If the third-party guarantor experiences financial hardship, the value of its guarantee may be negligible, leaving the safety of the bonds dependent on the bonds' underlying fundamentals.

### Conclusion

Securitized products structured on the platform of SPVs are veritable windows of investment that offers good yields with reasonable margin of safety. As with many other areas of the fixed-income marketplace, the main participants in the securitized products market are institutional investors. Major choice criteria are usually the size of the instrument, yield, safety and maturity. Because of the size and importance of the securitized products market, a basic understanding of the SPV securitized products will benefit even investors who have no intention of investing directly in securitized products.

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