

STRUCTURED FINANCE: A HIGH-END FUNDING SOLUTION

In the past few years, the Nigerian capital market has been undergoing significant transformation that is not easily discernable by most operators and investors. It takes the deeper knowledge of experts to track the trend and tap into it. The clear line is that it is no longer a mass market, but one that now targets the high end on the sides of both the issuers and the investors.

The market collapse (particularly the equities segment) of the recent past left bare the primary segment which is yet to recover from the shock. There have been very few successful rights issues, but since 2008 not a single initial public offering (IPO) has been issued in the market. Also no private placement has really stirred the market except for the SEPLAT issue that hit the market last month, April 2014. Two reasons could be said to account for the success of the SEPLAT issue culminating in its dual listing on both the London Stock Exchange (LSE) and Nigerian Stock Exchange (NSE). First is that the issue originates from the upstream segment of the oil and gas sector where there have been a dearth opportunities for equities investment for the average Nigerian investor. The second reason is that the issue was designed to target the high end of the market where there is huge amount of liquidity chasing non-existent instruments. With reference to the second reason, it could be said that the issue was professionally packaged with clear understanding of the market where the institutional and high net worth investors hold now sway.

The understanding from the Seplat experience is that capital raising has become more tailor-made, with clear features that must satisfy the investment appetite of the target investors considering all the risk elements. This is totally different from the off-the-mill mass market that relied on very shallow fundamentals. Instruments needs to be structured with the objective of properly aligning the character of the issuer with investment appetite of the target investors. This is where expertise in structured finance comes to play.

STRUCTURED FINANCE OPTION

Structured finance seeks to substitute capital market-based finance for credit finance by sponsoring financial relationships without the lending and deposit-taking capabilities of banks, in other words, creating disintermediation. The issuer would simply raise funds by issuing certificates of ownership as pledge against existing or future cash flows from an investment pool of financial assets. This will increase the issuer's liquidity position without increasing the capital base. Alternatively, these reference assets can be sold to an SPV, which subsequently issues debt to investors to fund the purchase. Aside from being a flexible and efficient source of funding, the off-balance sheet treatment of structured instruments also serves to reduce both economic cost of capital and regulatory minimum capital requirements as a balance sheet restructuring tool, and diversify asset exposures especially interest rate risk and currency risk.

The generation of securitized cash flows from a diversified asset portfolio represents an effective method of redistributing asset risks to investors and broader capital markets transformation and fragmentation of asset exposures. As opposed to ordinary debt, a securitized contingent claim on a

MARKET UPDATE

	15/01/13	15/12/13	02/05/14
Naira/US\$	154.1	155.2	155.75
Brent, US\$/BBL	109.78	107.84	109.9
COCOA, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	7.7
MORTGAGE RATE %	22.0	23.0	23.0

STOCKS CONSTITUTING GMA INDEX

STOCKS	31/12/13 Price (N)	02/05/14 Price (N)	%Change in Price
OANDO	24.25	15.90	-34.43
GTBANK	27.02	27.15	0.48
OKOMU	44.00	33.50	-23.86
STANBIC	21.35	23.00	7.73
DANGSUGAR	11.70	9.26	-20.85
FIDSON	2.79	2.75	-1.43
TRANSCORP	4.35	3.42	-21.38
CCNN	11.75	9.25	-21.28

	PRICE(N)	NAV (N)
	31/01/14	02/04/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	02/05/14	% Change
NSE ASI	41,329.19	38,572.20	-6.67
GMA Index	1.50	1.39	-7.46

Source: CBN, SEC and NSE

promised portfolio performance affords investors at low transaction costs to quickly adjust their investment holdings due to changes in personal risk sensitivity, market sentiment and/or consumption preferences.

In the present state of the market, application of structured finance has become very necessary. First the critical areas of the economy such as the power, oil and gas, solid mineral sectors are being opened for investment through the enactment of various enabling laws. Secondly, the existing traditional methods such as debts, bonds, and equities are being stretched.

IMPERATIVE OF STRUCTURED FINANCE

Certainly, the capital market in Nigeria is tending towards the greater application of structured finance to design and develop capital raising or financing strategies that will ensure reasonable level of success. It is a strategy that encompasses all

advanced private and public financial arrangements that serve to efficiently refinance and hedge any profitable economic activity. It works beyond the scope of conventional forms of on-balance sheet securities such as debt, bonds, and equity. It has the good effect of lowering cost of capital and mitigates agency costs. In particular, most structured investments combine traditional asset classes with contingent claims, such as risk transfer derivatives and/or derivative claims on commodities, currencies or receivables from other reference assets. They also replicate traditional asset classes through a remodeling process to suit a particular financing need.

CRITICAL SECTORS

Structured finance instruments are used by financial and non-financial institutions in both banking and capital markets if established forms of external finance are either unavailable or depleted for a particular financing need, or traditional sources of funds are too expensive for issuers to mobilize sufficient funds for what would otherwise be an unattractive investment based on the issuer's desired cost of capital. Structured finance offer the issuers enormous flexibility in terms of maturity structure, security design and asset types. This allows issuers to provide enhanced return at a customized degree of diversification commensurate to an individual investor's appetite for risk.

The first form of structured finance is the capital market-based risk transfer, whose two major asset classes include asset securitization, which is mostly used for funding purposes; and credit derivative transactions, a hedging instrument that permit issuers to devise almost an infinite number of ways to combine various asset classes in order to both transfer asset risk between banks, insurance companies, other money managers and non-financial investors. It further helps to achieve greater transformation and diversification of risk.

STRUCTURED FINANCE AND CONVENTIONAL FINANCE

The flexible nature of structured finance shrouds the boundary between traditional fixed income products such as debentures and equity on one hand and derivative transactions on the other hand. Notwithstanding the perceivable difficulties in drawing a line, functional and substantive differences between structured and conventional forms of external finance seem to be most instructive in the way they guide a critical defining characteristics. However, the following provides a guide in making a comparison of two financial arrangements that share the same objective. First, it is taken that investment are motivated by the same or similar financial objective from both the issuer's and the investor's point of view, but they differ in legal form and functional implementation. They also might require a different valuation due to a varying or different transaction structure and/or security design. Secondly, instruments are substantively equivalent, that is they are evaluated exactly the same in line with certain price relation, but they differ in legal form and might require a different valuation due to a varying or different transaction structure and/or security design.

CONCLUSION

Structured finance contributes to a more complete capital market by offering trade-off along the efficient frontier of optimal diversification at lower transaction cost. However, the increasing complexities of the structured finance market, and the ever growing range of products being made available to investors, invariably create challenges in terms of efficient assembly, management and dissemination of information.

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