Navigating the Capital Markets: The Investor's Dilemma

Press Pack

Coronation House, 13 July 2020

Contents

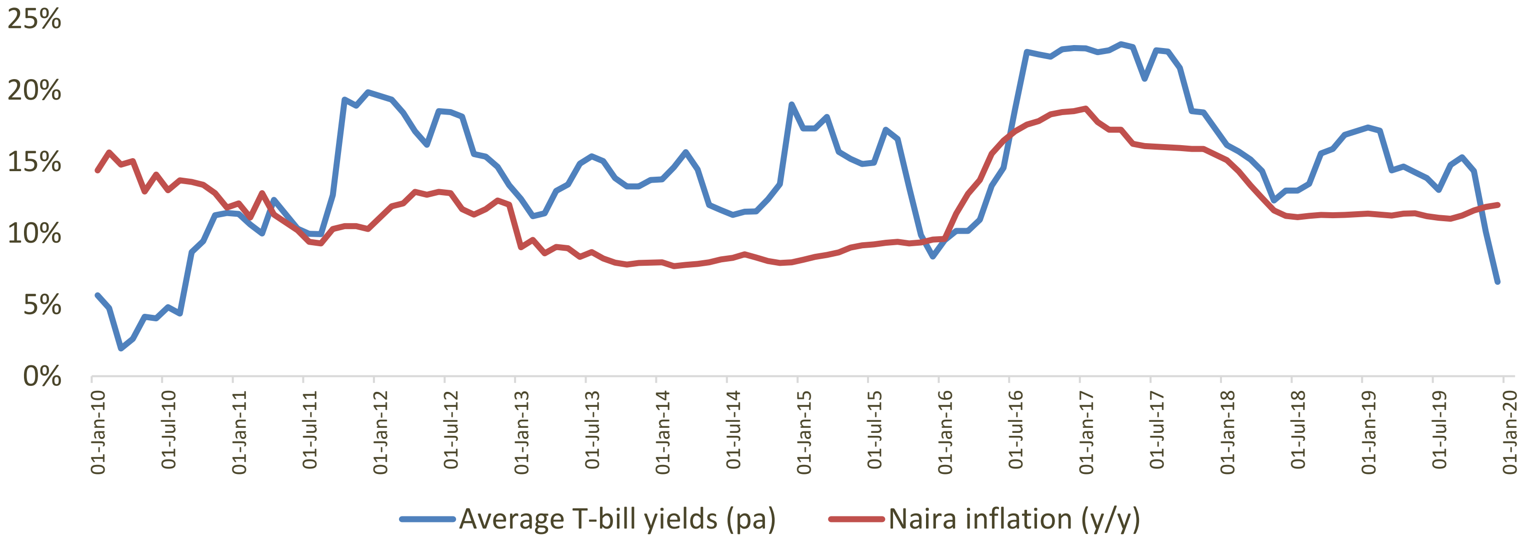
Things aren't like what they used to be

- For a long time it was easy for Pension fund managers, and mutual fund managers, to get a return higher than inflation. All they had to do was buy Nigerian Treasury Bills (T-bills), as these returned more than inflation. If you look at the period from 2010 to the end of 2019, Treasury Bills yielded more than inflation for most of that time. Over those ten years Treasury Bills yielded on average 2.57 percentage points (257 basis points) above inflation.

- Risk management, which includes managing the risk of equities and the duration of bonds, was not a highly-developed skill during this period. It did not need to be.

- Now, with Treasury Bill yields at close to 3.0% and inflation (for May) at 12.4% year-on-year, what can portfolio managers do?

Nigerian T-bill yields and inflation



Source: National Bureau of Statistics, FMDQ, Bloomberg, Coronation Research

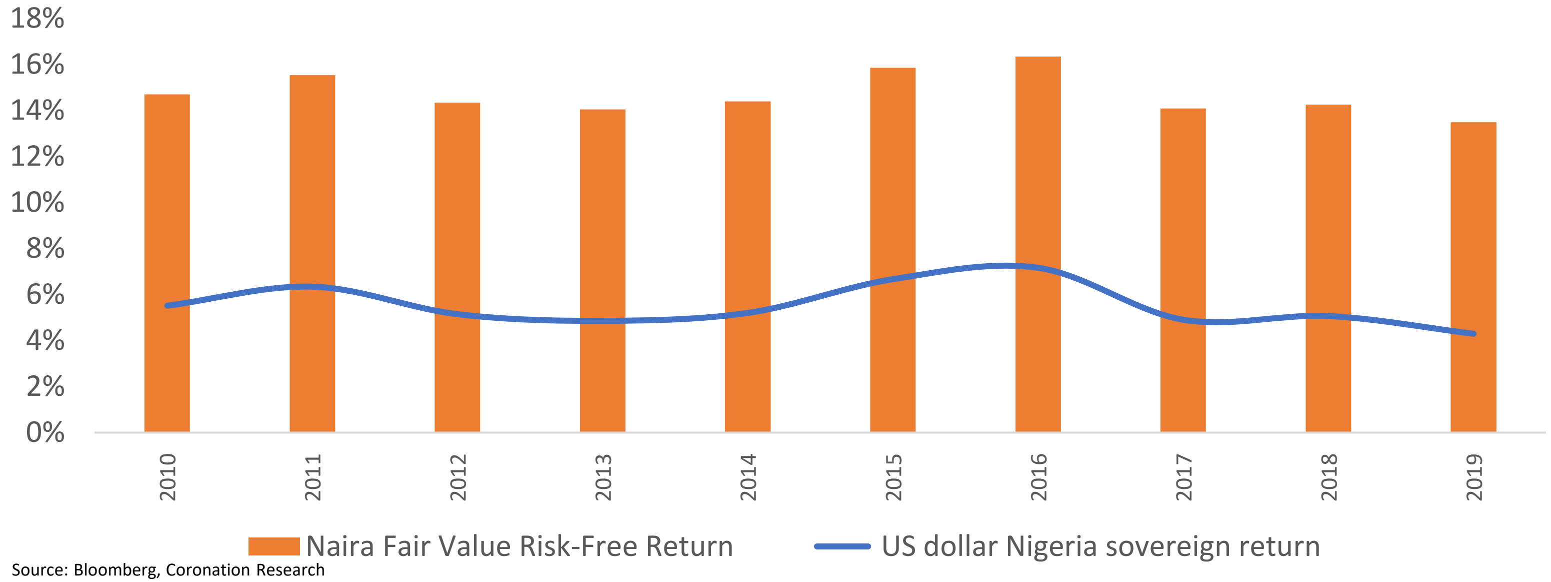
Target inflation or target currency?

- One way of answering this question is to find which investments beat inflation. But inflation is variable. Food inflation is higher than headline inflation, for example. Inflation varies from area to area, from State to State.

- Our approach is unconventional – though most Nigerians will understand it immediately. We target long-term currency depreciation, rather than inflation. What long-term return would you need to make in Naira, over ten years, to make up for devaluation of the Naira against the US dollar? The answer is 9.2% per annum. Add to this the average rate available on US dollar bonds issued by the Federal Government of Nigeria over ten years, which is 5.5% per annum, and you get to 14.7%. We call this the Naira Fair Value Risk-Free Return. And we think investors should target it.

- Why do Nigerians understand this? The answer is that 40% of their bank deposits are in US dollars.

The Naira Fair Value Risk-Free Return

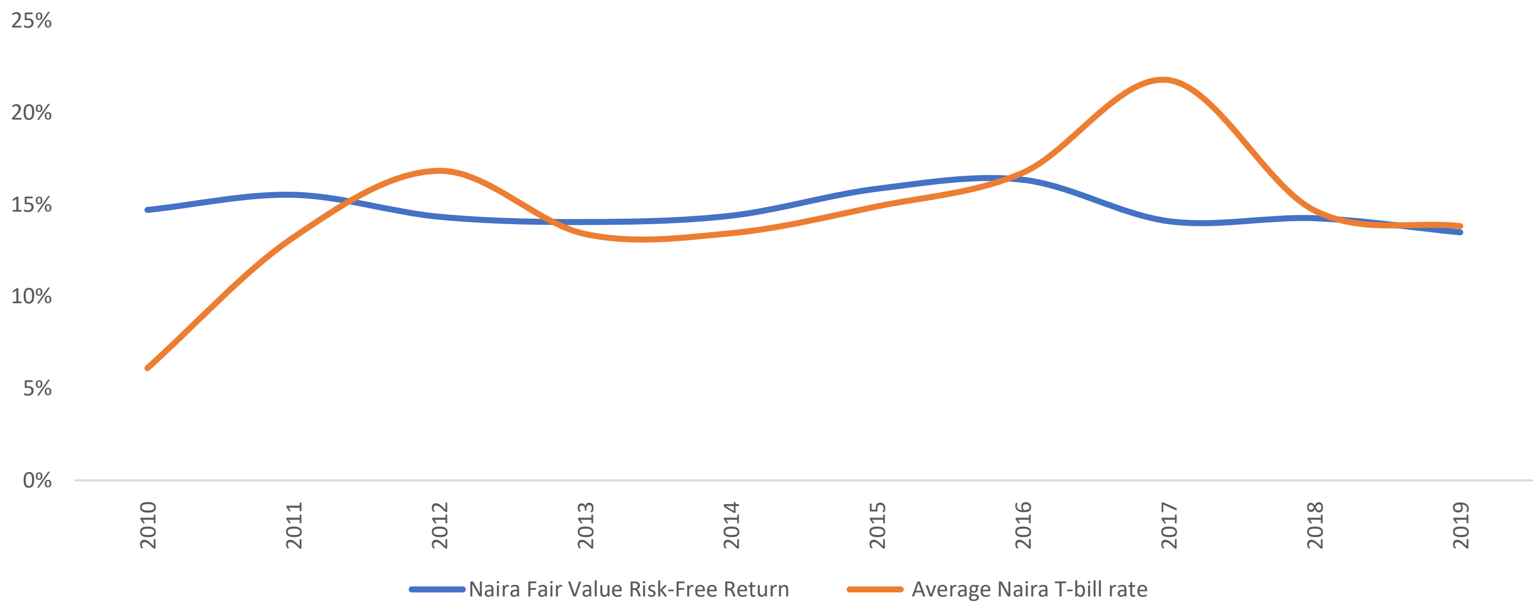


Source: Bloomberg, Coronation Research

Have Nigerian Treasury Bills met our target rate? (Naira FVRFR)

- The surprising thing is that, over the ten years 2010-19, Nigerian Treasury Bills came very close to matching our target risk-free rate (the Naira FVRFR).
- But, of course, Nigerian Treasury Bills have not come close to this rate in 2020.
- So, what can portfolio managers do? It seems they can do one of two things. The first is to build a portfolio of long-term Naira bonds that yield more that Treasury Bills. But no Federal Government of Nigeria bond – of any duration – yields more than inflation at 12.4% today. And it is risky to buy long duration bonds – if interest rates go up, then the value of these bonds will fall. The second solution is for portfolio managers to include equities in their portfolios.

Naira Fair Value Risk-Free Return and Average Naira T-bill rates

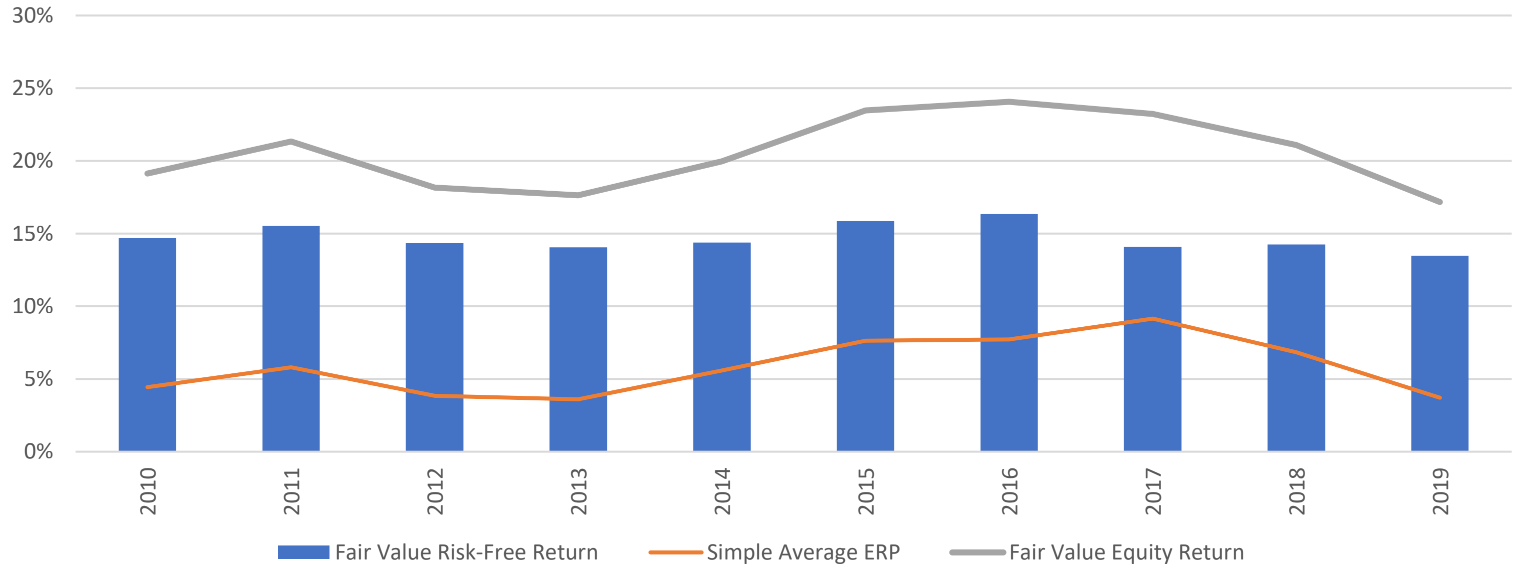


Source: Bloomberg, Coronation Research

And so, on to equities

- The returns of the Nigerian equity market have not been kind to investors. To see why this is the case, we need to set a benchmark, namely a target return on equity (RoE) for listed Nigerian companies.
- Since we already have a Naira Fair Value Risk Free Rate of 14.7%, it is a simple matter of adding an appropriate Equity Risk Premium (ERP), of 5.8%, to get to our Fair Value Equity Return (FVER). This comes to an average 20.5% over the ten years 2010-2019.
- This target, 20.5% per annum, represents what we require listed companies to return internally, i.e. their internal profitability, or return on equity (RoE). It also represents what we target as the equity return for the stock market.

The Fair Value Equity Return (FVER)

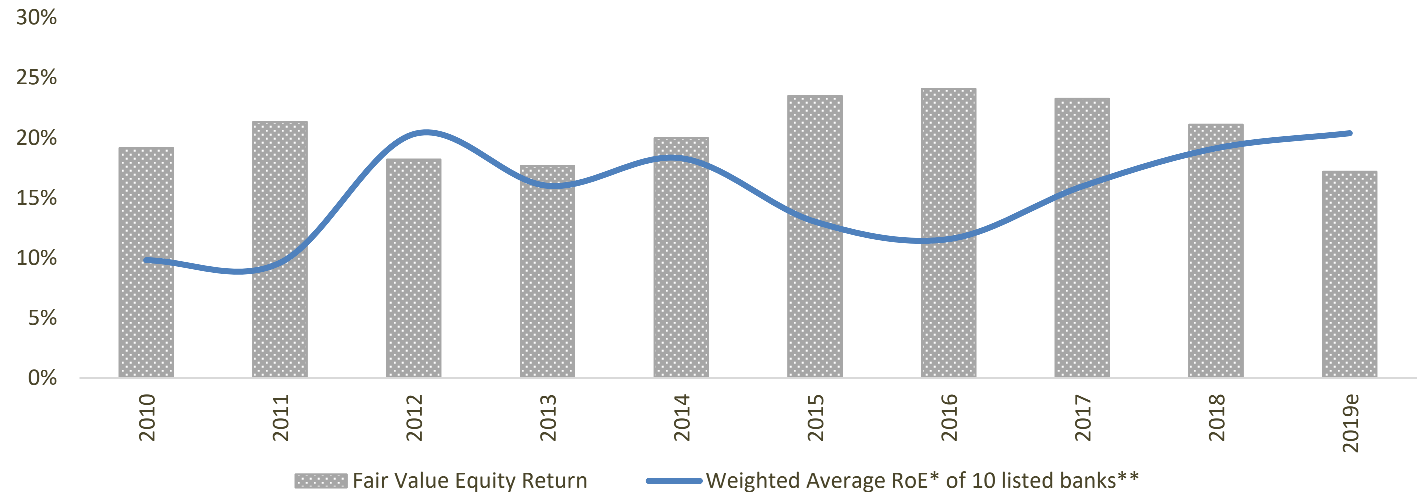


Source: Coronation Research

Do Stock Exchange listed companies return enough?

- The question, therefore, is whether companies listed on the Nigerian Stock Exchange deliver enough in terms of return on equity (RoE). Are their internal returns up to 20.5% per annum?
- The answer is that, by and large, they do not. This accounts for the poor performance of the Nigerian stock market over the years. In particular, fast-moving consumer goods companies, food manufacturers and brewers have seen their return equity fall over the past ten years.
- However, as a sector, the listed banks have not done too badly. In fact, their returns have been improving steadily over the past four years. The full report gives details of which banks actually beat our target Fair Value Equity Return. And, a little later, we will be publishing our views on how to trade these stocks.

Listed banks' RoEs versus the FVER



Source: Companies, Coronation Research. *for Return on Equity we calculate Return on Average Equity (RoAE) **These are Zenith Bank, GT Bank, ETI, Access Bank, FBN Holdings, UBA, Stanbic IBTC, Union Bank, Fidelity Bank and Sterling Bank (in descending order of total shareholders' funds) NB estimates for 2019e come from Coronation Research's published estimates

Thank you