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Vetiva Research

Nigeria FY'19 Outlook

As the dominoes fall

December 2018

NIGERIA OUTLOOK

As the dominoes fall

20 December, 2018

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Nigeria needs to look within: The major developments in the global scene—deteriorating Sino-American trade relations, increasing interest rates across large developed markets, and tightening commodity markets—represent bearish scenarios for Nigeria. The effects of these changes were apparent in 2018 as we observed significant capital reversals from emerging & frontier markets, and 2019 would bring similar challenges. Even with an improvement in any of these areas (a distinct possibility on the trade front given the 90-day truce), Nigeria must embrace the responsibility of driving economic growth and development from within. As the dominoes fall, the decisions made at the polls in Q1'19 assume greater significance given the importance of getting economic policy right.

Pivotal elections give Nigeria a chance to set down marker: The 2019 elections are finally upon us, and we are cautiously optimistic that the electoral process would emulate the 2015 edition in delivering a peaceful and transparent process, but we anticipate a further slowdown in policy and investment until after the elections. Looking at the potential outcomes, the incumbent offers stability and policy consistency whilst the primary challenger has positioned himself as an ardent supporter of deregulated markets. Although 2019 economic performance is unlikely to be materially affected by the outcome of the elections, investor confidence can be significantly boosted by a favourable outcome and smooth process.

Modest economic growth anticipated in 2019: Looking at economic fundamentals, Nigeria can expect modest growth in 2019 (Vetiva: 2.7% y/y, IMF: 2.3% y/y), driven by continued recovery in industrial activity and services. However, our base scenario projects relatively weak growth in agriculture (2.6% y/y, the slowest in 25 years) and oil & gas as Nigeria's oil production would likely be constrained by the OPEC output cut agreement and recent underinvestment in the upstream sector. One key issue in 2019 would be the foreign exchange market, given recent pressure on the naira amid a slide in oil prices and external reserves. Although we appreciate that the Central Bank of Nigeria is in a stronger reserve position than in recent years, we anticipate a mild depreciation of the naira to NGN390/USD in the NAFEX window by year-end in order to stem net capital outflows from the economy.

A muted capital market outlook: In the fixed income market, rising global interest rates and consequent capital outflows, investor jitters caused by the elections, rising inflation, and tightening monetary policy all point towards higher yields. We project that similar factors would drive the equity market and anticipate a post-election boost to the market but expect overall market performance to remain soft, as underlying economic conditions would still be the same. Our market return projection is between -5% and 5%, with a point estimate of 2.5%. Looking at the major sectors on the Nigerian Stock Exchange, we predict the greatest joy in the banking sector, noting that in recent years, investors have been quick to over-weight Nigeria's banking sector during periods of market recovery.

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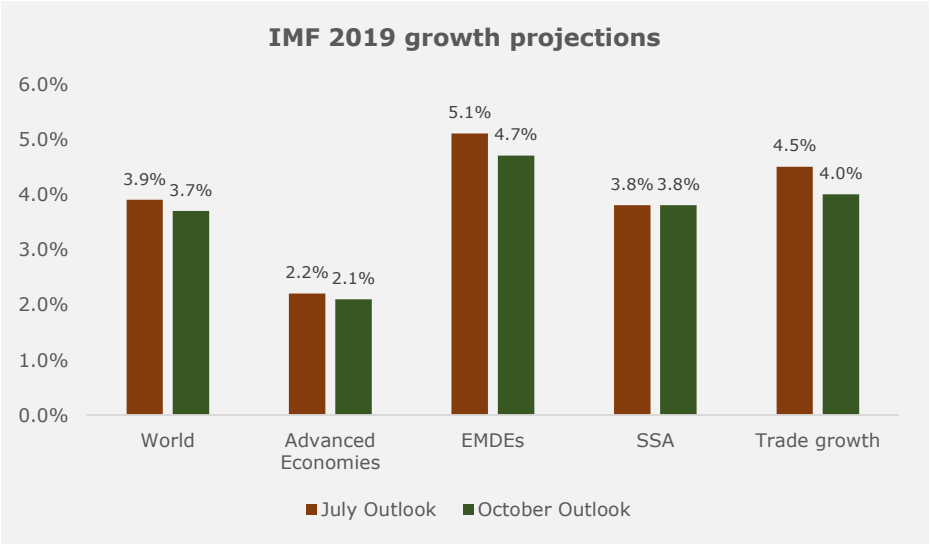
Global

Global Economy

Lower growth prospects amid trade tensions

The International Monetary Fund (IMF) expects the global economy to grow by 3.7% y/y in 2019, down 0.2 percentage points from its July 2018 outlook. This is driven by unwinding of fiscal and monetary stimulus in Advanced Economies (AE), capital reversals from Emerging & Developing Economies (EMDE), and trade tensions between the United States and China. The Fund projects 2.1% y/y GDP growth in AEs, 0.1 percentage points lower than its previous outlook, and 4.7% y/y GDP growth in EMDEs, 0.4 percentage points down from its previous outlooks. The IMF also downgraded growth expectations for the world's two largest economies—and the main protagonists in the trade war—U.S.: 0.2 percentage points lower to 2.5% y/y; China: 0.2 percentage points lower to 6.2% y/y. Meanwhile, the 2019 outlook for Sub-Saharan Africa is unchanged at 3.8% y/y GDP growth, thanks to Nigeria as South Africa's forecast is 0.3 percentage points lower at 1.4% y/y. Finally, the IMF expects global trade growth to slow and forecasted a 4.0% y/y rise in trade volumes, 0.5 percentage points lower than in the July outlook. For SSA countries, they must navigate their economies in 2019 against the backdrop of weaker commodity prices, prolonged capital reversals, tepid investor sentiment, and geopolitical uncertainties.

Global growth prospects for 2018 remain positive, with the International Monetary Fund (IMF) and World Bank retaining their GDP growth projections of 3.9% y/y and 3.1% y/y respectively, compared to estimated 2017 growth of 3.8% y/y and 3.1% y/y.



Source: IMF, Vetiva Research

Tensions likely to persist beyond truce

The U.S.-China trade war hit the brakes after Presidents Donald Trump and President Xi Jinping agreed a 3-month "ceasefire" at the G20 summit to give negotiators time to hammer out a mutually-beneficial agreement. Despite at least $200 billion worth of tariffs imposed by the U.S. so far, it has been hard to tease out the effect on Chinese exports. Chinese net exports are actually up year-on-year, possibly due to lags in supply chain adjustment and consumer frontloading ahead of the tariff implementations. With global growth expected to cool, Chinese export growth should slow down in the near-term. Unsurprisingly, the International Monetary Fund sees world trade growth down to 4.0% y/y—0.7 percentage lower than its April 2018 outlook. The best-case scenario in 2019 is that the two parties negotiate a deal in a like manner to the new U.S.-Canada-Mexico agreement, as this should placate President Trump without severely altering the trade landscape.

Global interest rates trend north

The United States Federal Reserve (Fed) increased interest rates four times by 25bps in 2018 and projected three rate hikes in 2019. Likewise, the European Central Bank (ECB) called a close to its four-year quantitative easing program in December 2018 amid market expectations that it would tighten monetary policy in 2019. This trend of monetary tightening in Advanced Economies comes on the back of recent rises in previously rock-bottom inflation prints across major markets. In our view, the U.S. monetary tightening is closer to its end whilst the ECB would just be commencing, but the overall effect is higher global interest rates. This would pressure Nigeria's external debt costs—as seen in the 8.75% coupon on Nigeria's 12-year Eurobond in November 2018, compared to 7.143% on a similar 12-year bond raised in February 2018. In addition, rising interest rates in stabler markets would continue to induce capital outflows from emerging markets, especially as investors seek safe havens in a volatile geopolitical and trade environment.

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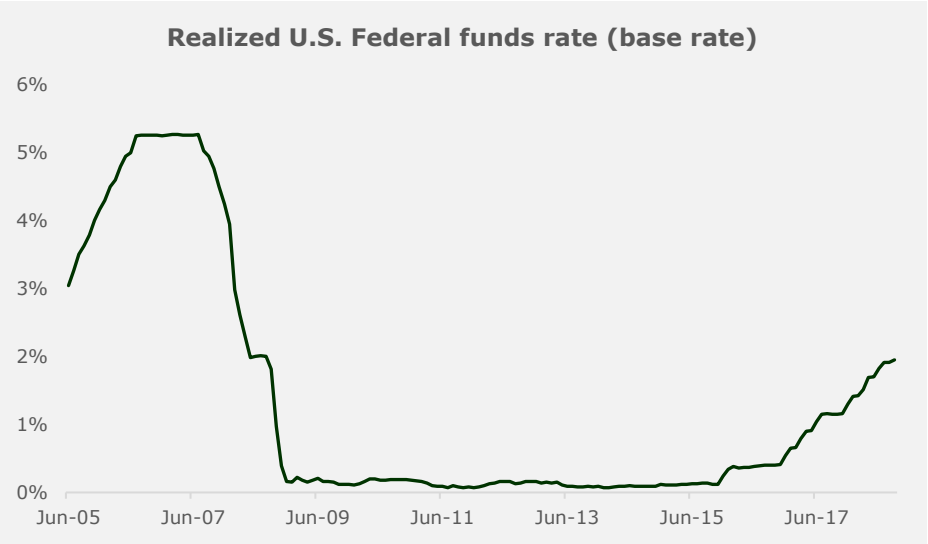

Source: St Louis Federal Reserve, Vetiva Research

United Kingdom plays high-risk Brexit game

The picture remains unclear as we approach March 2019, Brexit date. Incredibly, both a second referendum and a no-deal Brexit remain distinct possibilities. Prime Minister Theresa May would present her Brexit deal to parliament in December in a very weak position following a raft of cabinet departures through 2018, and on the back of becoming the first UK government to be held in contempt of parliament. Uncertainty around the resolution of the political brouhaha is so high that the cost of insuring against pound volatility has soared to its highest level since the 2016 referendum. The most likely outcome is that parliament rejects Theresa May's deal and takes a more active role in directing the terms of Brexit themselves—a right they won at a recent vote. Should this happen, we are likely to witness a softer Brexit agreement as pro-EU lawmakers are the dominant group in the commons.

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China battles myriad economic developments

Disruptions to global trade are expected to hit China where it hurts, with the IMF projecting 6.2% y/y GDP growth in 2019, down from 6.4% y/y in its previous reports in 2018. Nevertheless, the impact of the trade war would be most keenly felt in the medium-term as there is a substantial lag before global supply chains adjust. Notably, China's net exports have still surged in 2018, though this may also be due to firms frontloading shipments ahead of tariff implementation. More positively, there is a distinct possibility of the trade brouhaha reaching a more amicable resolution as President Trump and President Xi Jinping recently agreed a 90–day truce to focus on negotiations. Therefore, the key issue for the Chinese economy in 2019 is whether policy-makers will turn to other tools to compensate for the expected decline in net exports. Structural rebalancing has reduced the influence of investment (now a fifth of Chinese GDP) but state-led investment remains the most viable short-term stimulus. However, this option is complicated by China's worrying debt burden as the country's debt has grown by the size of the entire economy within a decade. The government has enacted policies to drive deleveraging, but this has been painful for many sectors of the economy. The capital and housing markets have struggled whilst there was also a record number of corporate bond defaults in the first half of the year, many of which were state-backed companies that hold a chunk of Chinese debt. Amid this slowdown, policy-makers may be tempted to reverse track and permit the flow of cheap credit again to cushion the economy. If so, they would simply be delaying necessary structural adjustment to reduce growth dependence on net exports and investment.

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Source: IMF, Vetiva Research

South African economy faces tough 2019

The South African economy entered its first recession in a decade in Q2'18 as economic output was pressured by weaker household and government expenditure, along with a decline in agriculture and trade brought about by drought conditions and widespread industrial action. The economy grew 2.2% q/q in Q3'18 to exit recession, helped by a recovery in industry and trade and a boost from the financial sector. However, the near-term economic picture is unattractive.

Unsurprisingly, IMF projections for South African economic growth between 2019 and 2022 is c.350bps lower than its estimate at the end of 2017.

We anticipate a continued slowdown in government spending—as a revenue shortfall widens the fiscal deficit, persistent political upheaval (South Africa has had five finance ministers in three years), and enduring weakness in government-owned enterprises such as Eskom (state-owned utility) and South African Airways (national carrier). Recently, the government revealed that the national carrier would receive another $350 million in bailout funds. Looking further ahead, we foresee material uncertainty over proposed land reforms, although we do not expect this to crystallize in 2019 as it would require constitutional change (which requires a two-thirds parliamentary majority) and elections hold in the middle of the year. Unsurprisingly, IMF projections for South African economic growth between 2019 and 2022 is *c.*350bps lower than its estimate at the end of 2017.

U.S. and OPEC+ struggle for swing producer status

In its October 2018 World Economic Outlook, the International Monetary Fund (IMF) cut its growth projections for 2019 from 3.9% y/y to 3.7% y/y. Emerging markets were particularly hit, with the IMF trimming its 2019 GDP growth forecast for Emerging Markets and Developing Economies (EMDE) and China from 5.1% y/y and 6.4% y/y to 4.7% y/y and 6.2% y/y. These trends are key for the global crude oil market as emerging economies have accounted for the greatest proportions of global oil demand *growth*, with China alone accounting for 40% in 2017. The yo-yoing U.S.-China trade war is chiefly responsible for the expected slowdown in global growth, along with the end of the cheap money era in developing economies. On the back of this, we expect modest global oil demand in 2019—OPEC forecasts 1.3 mb/d growth in 2019—which would pressure oil prices.

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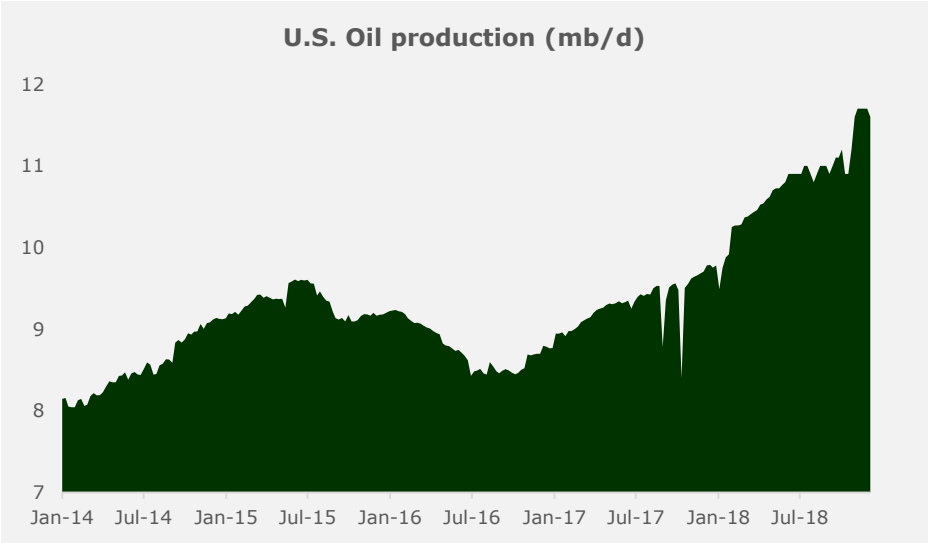
Within the space of a year, the U.S. has pumped an additional two million barrels of oil a day to seize the crown as the world's top oil producer at 11.7 mb/d. The U.S. Energy Information Administration (EIA) projects output above 12 mb/d by mid-2019, though we see some of this production being constrained by limited pipeline capacity in the Permian Basin and New Mexico, leaders of the recent surge in output. However, this constraint should clear sometime in H2'19 as additional pipelines are commissioned, and shale producers also have a backlog of uncompleted wells that can be completed at roughly half the cost of a fresh well (this represents a low-cost method of boosting short-term output). All in all, rising U.S. production is likely to keep the oil market well-supplied in 2019, though the health of the shale industry itself should take a hit amid lower oil prices and greater shareholder pressure to generate cash flows higher than expenses and capital investment.



Source: EIA, Vetiva Research

OPEC aggregate production has increased steadily through 2018, rising from 32.3 mb/d in January to 33.0 mb/d in November, primarily driven by the groups' decision in June to reduce its output cap. Nevertheless, the simultaneous surge in U.S. production and weakening global demand has tilted the balance towards an over-stocked market, putting pressure on OPEC to once again cut production. As a result, the cartel, along with its allies, agreed to cut production by 1.2 mb/d (from October levels) for the first six months of 2019. Iran may be exmept from the deal as it continues to haemorrhage output following the imposition of export sanctions by the U.S. government, whilst Venezuela and Libya are also hopeful of securing exemptions. Iran got a recent reprieve as the U.S. granted 180-day waivers to eight countries that account for 75% of Iranian exports, which diminishes the short-term impact of U.S. sanctions on Iranian output. Meanwhile, Venezuelan output continues to fall as economic crisis deepens (down from 1.9 mb/d in 2017 to 1.1 mb/d in November 2018). Finally, Qatar announced its decision to leave OPEC, but we do not see this having a material impact on near-term oil prices. The wealthy Gulf nation accounts for less than 2% of OPEC output and is a much more relevant player as the leading natural gas exporter in the world. Moreover, the exit decision was likely also influenced by an ongoing rift between Qatar and its previous Gulf allies, led by Saudi Arabia, the de facto leader of OPEC.

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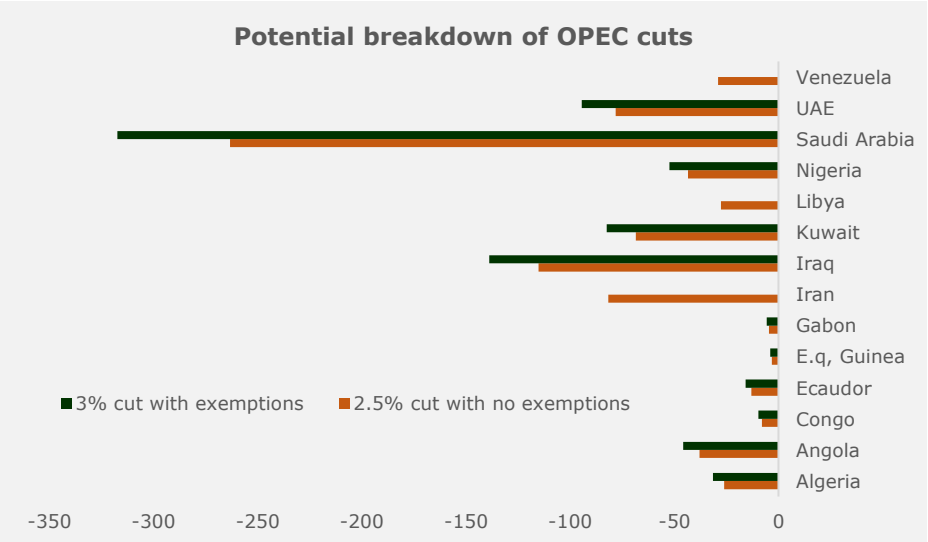


Source: OPEC, Bloomberg, Vetiva Research

2018 oil prices confounded analysts' expectations coming into the year; the IMF and IEA had forecasted $51/bbl and $56/bbl respectively, and yet Brent crude averaged $73/bbl in the first eleven months of 2018. Volatility was also significant during the year. Oil prices traded at four-year highs in October 2018, yet the next month, Brent crude and West Texas Intermediate suffered their worst monthly decline in a decade. We expect this sharp volatility to persist as geopolitics—President Trump's tweets, Arab politics, and Russia's posturing—continue to sway the market. But looking at the near-term demand and supply equation alone, the outlook for 2019 is bearish as the output growth is expected to outpace weak demand growth. Our forecast for 2019 oil prices is $60/bbl, partly supported by the OPEC+ agreement.

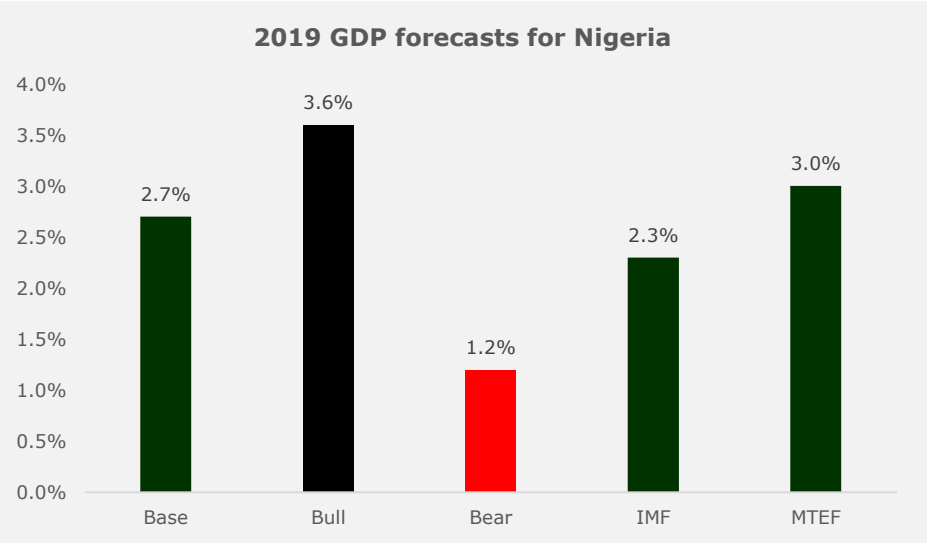
Domestic

Real Economy

Modest recovery to continue as politics hogs the limelight

Nigeria's post-recession recovery has been slow and below potential. Between 2010 and 2014, the economy grew at a CAGR of 4.8% y/y, but has grown just 0.8% y/y and 1.8% y/y in 2017 and 2018E. We attribute this to the structural weakness of our mono-commodity economy and a struggle to recover from the stagflation and foreign exchange (FX) crisis of 2016. Consumer wallets are still severely weak amid a significant loss of spending power since the end of 2015 and industries must still battle high costs and high interest rates. Federal Government spending has been substantial thanks to a series of record budgets, but the fiscal multiplier has been weak due to the lag time of capital expenditure projects and the underperformance of social investment programs. Unsurprisingly, our near-term outlook is muted as the structural weakness meets political uncertainty in early 2019. Overall, we project growth of 2.7% y/y in 2019, just about equal to estimated population growth, and look beyond 2019 for true structural adjustment that can transform Nigeria's economic growth trajectory. Meanwhile, the key economic headwinds in 2019 are currency volatility, policy instability, and severe fiscal strain as a result of excessive spending.

Contingent on a smooth electoral process, we are more positive about the post-2018 economy as wider aggregate demand recovers, and forecast GDP growth of 1.9% and 3.2% y/y in 2018 and 2019 respectively.



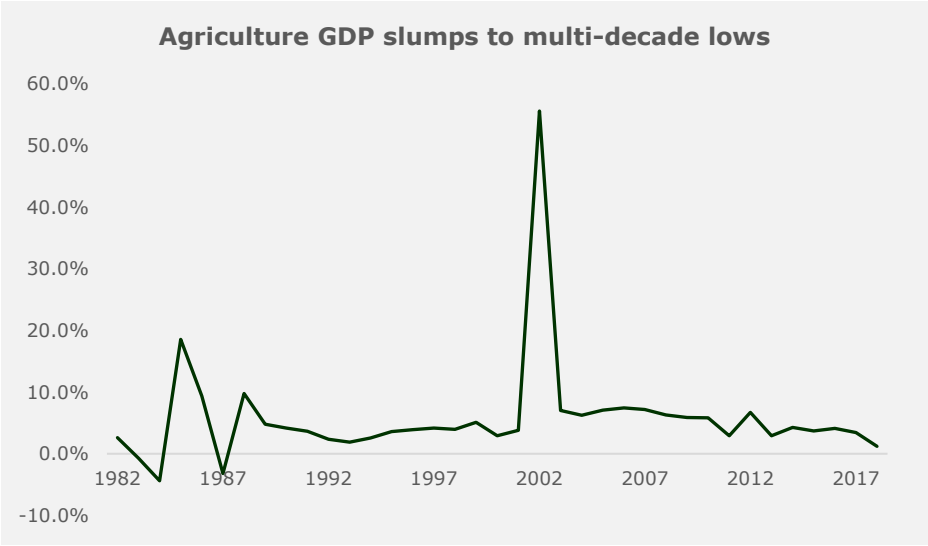
Source: NBS, IMF, MTEF, Vetiva Research

Ongoing violence threatens sector growth

Nigeria's agriculture sector has been ravaged by intensified farmer-herdsmen clashes over the past eighteen months. The effect was most pronounced in Q2'18 when GDP growth fell to a 30-year low of 1.2% y/y and monthly food inflation peaked at 1.6% m/m in June. Notably, Q3'18 data was more positive as GDP growth rose to 1.9% y/y as food price pressure abated. It is difficult to determine the lasting damage of the Middle Belt conflict on Nigeria's agriculture output, but it is prudent to assume that disruptions would persist even as violence abates as a result of the permanent displacement of farmers and loss of farmland. As a result, our 2019 growth outlook is still restrained, with just 2.6% y/y growth expected (2018E: 2.0% y/y), which would be the lowest in 24 years. Beyond 2019, fundamental issues around agricultural productivity and access to markets must be addressed in order to unlock the sector's growth.

It is difficult to determine the lasting damage of the Middle Belt conflict on Nigeria's agriculture output, but it is prudent to assume that disruptions would persist even as violence abates as a result of the permanent displacement of farmers and loss of farmland.

The Economic Recovery & Growth Plan (ERGP) outlines attempts to tackle these, by revitalizing the Nigerian Commodity Exchange, establishing a Staple Crop Processing Zones Authority, promoting state-led crop specialization, etc. but traction seems to be slow on all these. Unfortunately, failure to deliver on the ERGP outline would continue to limit the growth potential of Nigerian agriculture



Source: NBS, Vetiva Research

Oil & Gas sector output constrained by OPEC, underinvestment

Barring a dip in Q2'18 amid key pipeline and terminal shut-ins, Nigeria's oil production has been relatively stable through 2018, averaging 1.93 mb/d up to September according to the National Bureau of Statistics. We note that this remains well-below 2018 budget target of 2.3 mb/d and pre-2016 militancy level of 2.12 mb/d in 2015. As there has been no notable disruptions to production in the last eighteen months, it seems that the militant uprising of 2016 has had a lasting impact on Nigeria's production capacity. Thankfully, we note the entrance of the EGINA FPSO (Floating, Production, Storage, Offloading) which has a capacity of *c.*200,000 barrels a day and may partially come online at the tail end of 2019. But beyond the FPSO, we note that in recent years, investment in the upstream oil & gas sector has been constrained by low oil price, heightened security risk, and legislative uncertainty.

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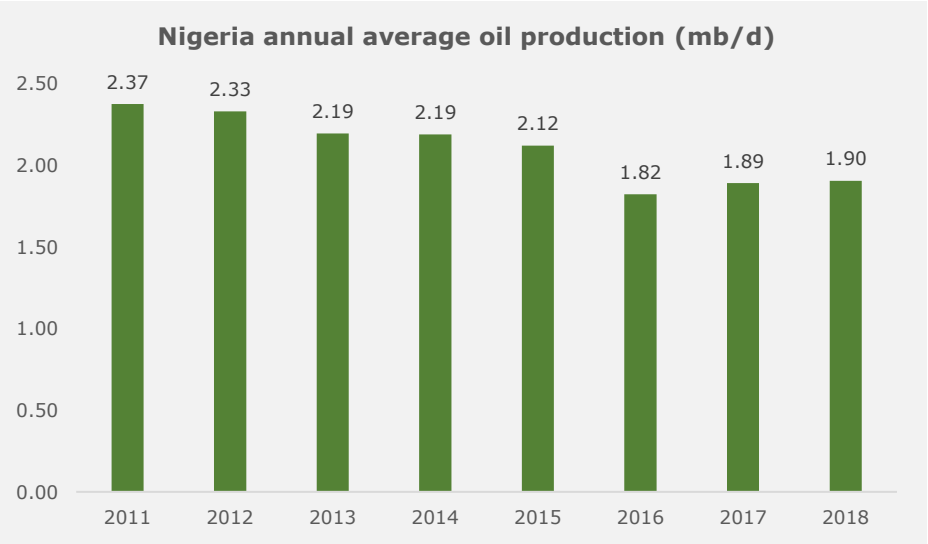


Source: NNPC, Vetiva Research

One key variable for 2019 is the OPEC deal which assigns Nigeria a production quota of roughly 1.7 mb/d (based on October production) excluding condensates production. Nigeria's condensates production has been volatile and difficult to estimate. Data from the Nigerian National Petroleum Corporation (NNPC) and JODI Oil Database estimate condensates at nearly 0.5 mb/d between 2010 and 2015, but NNPC and OPEC estimates suggest that 2018 condensates production has been closer to 0.2 mb/d. Our base projection is for condensates production of 0.3 mb/d in 2019, which would bring total crude oil production to 2.0 mb/d, much less than the government's 2019 target of 2.3 mb/d. With 2018E oil production of 1.95 mb/d, oil sector GDP growth is expected to be a weak 2.8% y/y. Finally, we highlight that all of this is contingent on continued stability in the Niger Delta region for the entirety of 2019.

We expect growth in the manufacturing and services sectors to accelerate slightly, from 2.1% y/y and 1.7% y/y in 2018 to 3.7% y/y and 2.6% y/y in 2019.

Manufacturing & services growth to accelerate in 2019

We expect growth in the manufacturing and services sectors to accelerate slightly, from 2.1% y/y and 1.7% y/y in 2018 to 3.7% y/y and 2.6% y/y in 2019. This view is predicated on our expectation of higher aggregate demand in an election year and as a result of the likely minimum wage hike. However, we are cautious about the pricing and exchange rate environment in 2019 as most indicators point towards higher inflation and exchange rate instability. Thus, we expect margins in the manufacturing and services sectors to be squeezed in the coming year. Meanwhile, we do not anticipate any material impact of the Real Sector Support Facility or schemes aimed at incentivizing lending to manufacturers and SMEs.

2019 GDP growth projections

	Bear	Base	Bull
Oil	-2.2%	2.9%	8.1%
Agriculture	1.9%	2.6%	3.1%
Manufacturing	1.8%	3.7%	4.2%
Services	1.3%	2.6%	3.1%
Overall	1.2%	2.7%	3.6%

The domineering shadow of the polls

We anticipate that economic activities in the first quarter of 2019 would be overshadowed by the polls and expect slower economic and policy momentum on the back of the political uncertainty. We foresee a close two-horse race for the Presidential ticket but do not anticipate any major security incidents. Victory for the incumbent should bring certainty and consistency—which are favourable to investors—as his policy thrusts continue, but the worry here is that growth momentum would not significantly pick up in the medium-term. Moreover, Nigeria's precarious debt burden would be of greater concern, especially if the proposed minimum wage hike goes through. Victory for the main challenger could be accompanied by more uncertainty and we see both a higher upside and lower downside in this scenario. The upside is driven by the market-friendly reforms promoted as the challenger's key policy thrusts, and although we do expect them to have limited impact in 2019, if implemented, such reforms would significantly boost investor confidence.

We anticipate that economic activities in the first quarter of 2019 would be overshadowed by the polls and expect slower economic and policy momentum on the back of the political uncertainty.

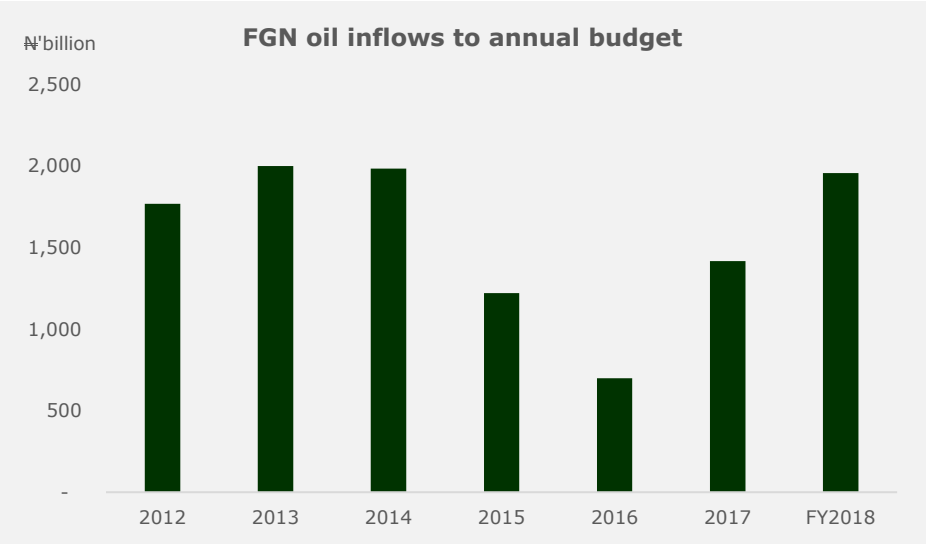
However, the downside comes from a greater likelihood of political instability and insecurity in the event of a botched or reluctant transfer of powers. Overall, the Nigerian economy in 2019 would not be affected as much by who wins but by the build-up to and fallout from the elections. Of course, the long-term trajectory of the economy is tied to the figure voted in come Q1'19.

	BUHARI WINS			ATIKU WINS		
	Bear	Base	Bull	Bear	Base	Bull
GDP Growth	1.2%	2.7%	3.6%	0.3%	2.7%	4.0%
Average Inflation	13.4%	12.6%	10.3%	13.4%	12.6%	10.3%
NGN/USD (year-end)	430	390	365	460	390	365
MPR	16.0%	14.5%	13.0%	16.0%	14.0%	13.0%
Average Brent price ($/bbl)	50	60	75	50	60	75
Equity market return	-10.0%	2.5%	15.0%	-15.0%	5.0%	20.0%

Fiscal Policy

Fiscal position improves in 2018, but trouble lies ahead

After remaining sticky in recent years, 2018 has been a relatively bumper year for FGN revenues, according to data from the Medium-Term Expenditure Framework 2019-2021 (MTEF). Based on data covering the period from January to August, FGN revenue-GDP ratio is on track to reach a four-year high of 2.94%. This has been driven mainly by a recovery in oil earnings—from 24% of revenues in 2016 to 53% of revenues in 2018—which are on track to be the healthiest since 2014, the year of the oil price crash. Non-oil revenues have also fared better, with annualized non-oil revenues (% GDP) of 1.24% the highest in at least seven years.

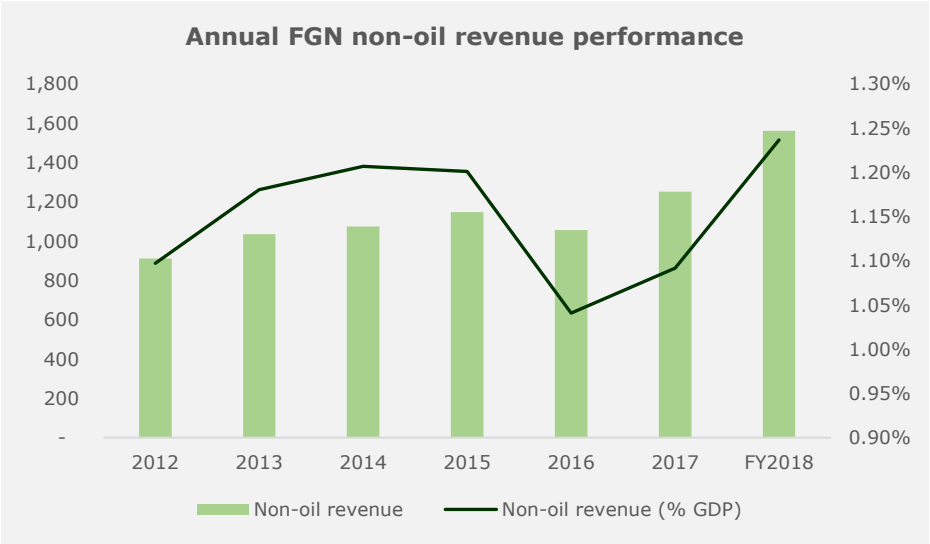


Source: Budget Office, Vetiva Research

We see the demand effect of stronger government spending outweighing its inflationary impact, and do not expect to see any major political or security shocks before votes are cast in February 2019.

However, FGN revenues are still weak, and annualized revenue for 2018 would be *c.*52% of target. The Federal Government has not delivered on intended asset sales in recent years, nor has it been able to successfully restructure Joint Venture agreements in the oil sector to boost revenues. Meanwhile, oil receipts are likely to be lower in 2019 given our bearish oil price outlook (2018 11-month average: $73/bbl, 2019 forecast: $60/bbl) whilst non-oil growth has still been too tepid to make a significant difference.

This is because tax accretion policies such as the Voluntary Assets & Income Declaration Scheme (VAIDS) have been relatively unsuccessful, even as the FGN looks towards other policies such as recent excise duty hikes (implemented in H2'18) and the Voluntary Offshore Assets Regularisation Scheme (VOARS). Overall, we are doubtful that FGN revenues would improve materially in the next year as any uptick in non-oil earnings would be eroded by weaker FGN oil receipts.



Source: Budget Office, Vetiva Research

Will aggressive borrowing continue as FGN reaches thresholds?

Nigeria's debt has climbed steadily in the past decade, rising from 13% of GDP in 2015 to 19% of GDP in 2017. Part of this is due to depreciation of the naira within that period, as, for example, FGN external debt jumped 65% in naira terms between 2015 and 2016 amid significant currency depreciation. However, debt escalation has also been due to increased sovereign borrowing. In 2017, the Federal Government borrowings were *higher* than inflows into the budget. Meanwhile, the FGN has successfully reduced tilted its debt portfolio away from domestic debt; in 2015, domestic debt represented 83% of sovereign liabilities and that proportion declined to 73% in 2017. However, both domestic and external debt have grown in recent years. In 2016, FGN domestic bond sales were ₦1.0 trillion, but had risen to ₦1.5 trillion in 2017. Likewise, the FGN has raised nearly $10 billion in Eurobonds since 2016. Nothing in the MTEF suggests that borrowing would reduce in the medium term, particularly as revenues continue to underperform.

Meanwhile, the FGN has successfully reduced tilted its debt portfolio away from domestic debt; in 2015, domestic debt represented 83% of sovereign liabilities and that proportion declined to 73% in 2017.

Source: DMO, NBS, Vetiva Research

High debt servicing cost poses longterm fiscal risk

Even more worrying is FGN debt servicing which rose from 29% in 2014 to 66% in 2018. We note that absolute debt servicing costs are set to rise further on the back of higher FGN debt, rising domestic and international interest rates, and anticipated naira depreciation. This puts the spotlight on the Federal Government to ensure that retained revenues grow fast enough to contain debt servicing costs, which have already breached local and international sustainability thresholds. As a result, we are genuinely concerned about an impending debt spiral if FGN borrowing and revenue trends persist as expected.

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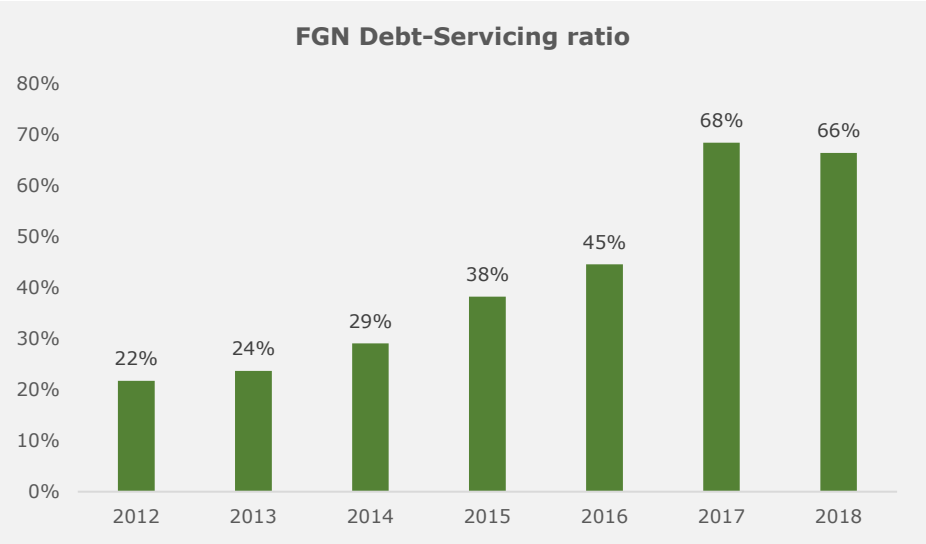

Source: DMO, Budget Office, Vetiva Research

Expansionary fiscal policy still on track

Even as FGN expenditures are on track to match or better 2017 (based on MTEF figures), spending patterns are concerning. Just like debt servicing costs, personnel costs (as a % of revenues) have risen in recent years albeit dipping to 51% in the first eight months of 2018. Should a new minimum wage kick in soon, we expect personnel costs to jump. Meanwhile, judging by MTEF figures, FGN capital expenditure (capex) approach looks to be changing in the coming years. Whilst capex (% revenues) rose from 22% in 2015 to 54% in 2017, the MTEF forecasts a drop in this ratio to 33% in 2021.

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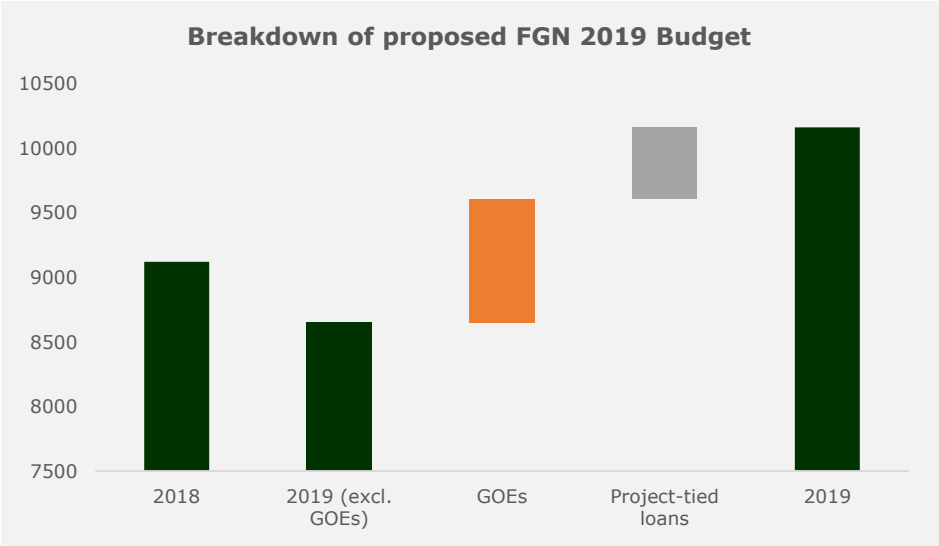
Moreover, absolute budget allocation to capex would also fall—from ₦3.1 trillion in 2018 to ₦2.6 trillion in 2021. Whilst we believe this may suggest a more prudent approach to financing infrastructure away from the FGN balance sheet, the reduction in capex compares unfavourably with our anticipated rise in personnel costs. In addition, we do not see signs of a more prudent approach to general government spending as the MTEF projects constant increases in the FGN budget during the forecast period. Once all of this is put together, Nigeria's fiscal health is one of our key worries in 2019.



Source: MTEF, Vetiva Research

Proposed minimum wage must scale political hurdles

A minimum wage hike is on the horizon as the presidency and labour unions have agreed a new wage of ₦30,000. However, the Nigerian Governors' Forum must still accept this, and the group has proposed a lower wage of ₦22,500. We expect the minimum wage issue to become increasingly politicised ahead of the 2019 elections and even if an agreement is reached, we do not see the issue scaling through the legislature before the polls. Notably, our previous analysis has shown that the proposed numbers would not even restore the spending power of the average Nigerian—once we account for post-2011 inflation and currency depreciation, ₦18,000 in 2011 is equivalent to *c.*₦63,000 in 2018. Nonetheless, fiscal indicators show that the FGN would barely be able to afford any material wage hike, and neither would the states, even as many of them continue to struggle with a backlog of unpaid salaries. Looking at the effect of a minimum wage hike on prices, we believe that demand-pull pressure may be contained by previous erosion in consumer spending power, but see a material risk of cost-push inflation as increased wages push up the cost of production. Overall, our analysis suggests that even as a wage hike is needed to restore lost consumer spending power, the public sector can ill-afford higher personnel costs, and the wage hike would be detrimental to price stability. However, should the wage hike go through eventually—as expected—a clever political manoeuvre would be to use the opportunity to push through unpopular reforms such as the liberalisation of the downstream petroleum sector.

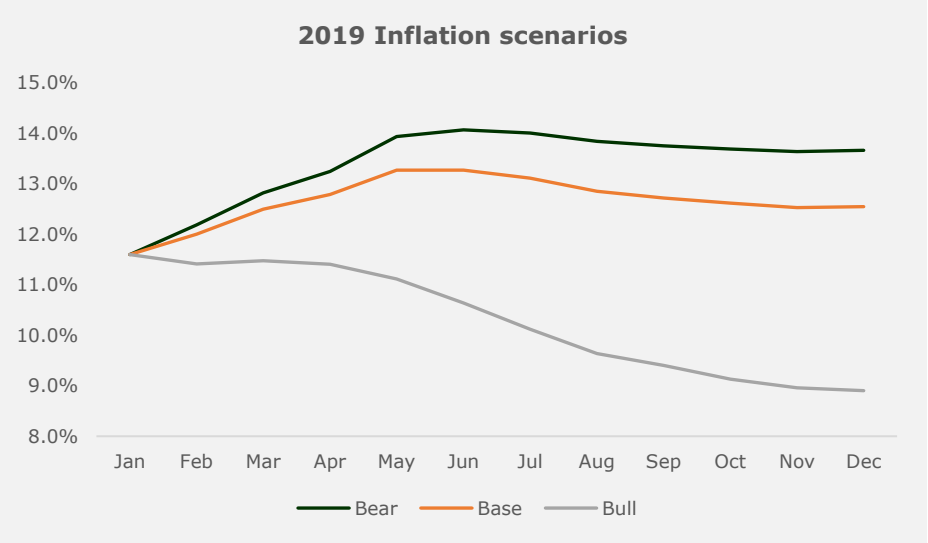
Overall, our analysis suggests that even as a wage hike is needed to restore lost consumer spending power, the public sector can ill-afford higher personnel costs, and the wage hike would be detrimental to price stability.

Monetary Policy

Slightly higher inflation expected in 2019

We expect residual domestic food price pressure in the first half of 2019 (post-2018 harvest) as Nigeria feels some of the effects of the disruption to farming activities caused by recent flooding and herdsmen violence. Likewise, we anticipate an uptick in global food prices, which have been relatively tame in 2018. Thus, we foresee food inflation coming under pressure once again after its recent reprieve—month-on-month food inflation down from 1.6% in June to 0.8% in October. On the core inflation front, we expect election spending to induce greater substantial pressure in Q1'19 even as we note that 2019 inflation would have the weakest base in recent years (as 2018 inflation was relatively mild). However, the deciding factor for 2019 inflation would be the implementation of the proposed minimum wage hike, which has been agreed by the presidency and labour unions but must be adopted by the Nigerian Governors' Forum. Our base scenario includes the effect of a minimum wage hike in H2'19 and brings our 2019 average inflation forecast to 12.6%. In comparison, our bull forecast (no minimum wage hike) is 10.3% and the International Monetary Fund projection is 12.4%.

On the core inflation front, we expect election spending to induce greater substantial pressure in Q1'19 even as we note that 2019 inflation would have the weakest base in recent years (as 2018 inflation was relatively mild).



Source: NBS, Vetiva Research

CBN to dominate FX market as autonomous inflows dry up

It is clear that there is substantial depreciation pressure on the naira as capital inflows dry up. The exchange rate in the parallel market has inched up at the end of 2018 and the apex bank has gradually increased its activities in the "Investors & Exporters" window (NAFEX). Between April and December 2017 (the first nine months of the NAFEX window), the CBN contributed 8% of dollar inflows into the market whilst foreign portfolio inflows (FPI) accounted for 51%. Between January 2018 and October 2018, the CBN was supplying 25% of the market and FPI contribution had dropped to 41%.

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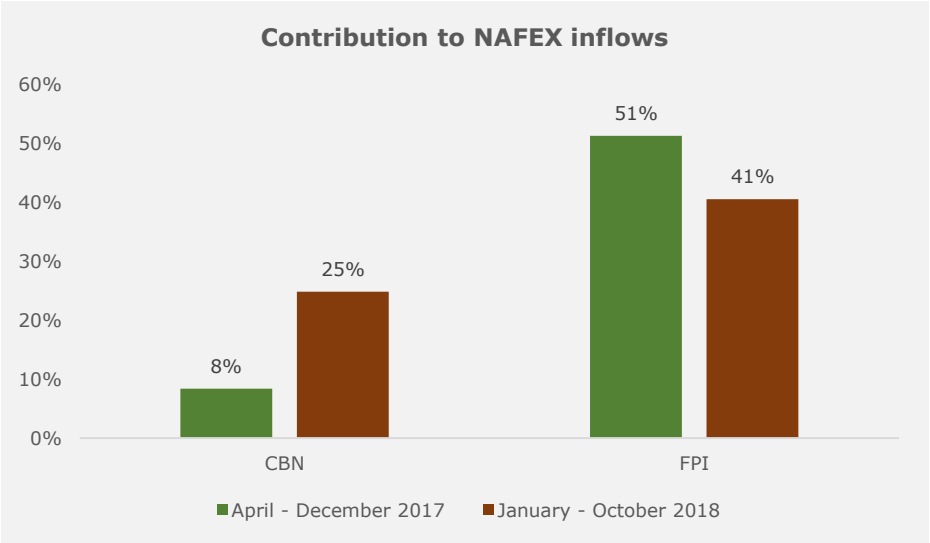

Source: FMDQ, Vetiva Research

It is apparent that the naira is trading above its "fair" market value and has been supported by the CBN via its external reserves. Determining the path of the exchange rate in 2019 is therefore a case of determining whether such CBN support is sustainable. We note that whilst global oil prices have plunged recently and are expected to be weaker in 2019, the Federal Government recently secured a $3 billion Eurobond and this would prop reserves in the near-term. The CBN is likely to enter 2019 at a reserve position of *c.*$42 billion, the highest head-start since 2014. Meanwhile, we consider $30 billion as a psychological barrier where the apex bank would be deemed unable to support the currency at its market-determined level—this is approximately the reserve level at which the NAFEX window was opened in April 2017 and also the average level for 2015, the preamble of Nigeria's last currency crisis. Although we anticipated continued capital reversals from Nigeria in the coming months, we do not see reserve levels dipping below the $30 billion mark. In addition, we note that the CBN could bolster its position by hiking interest rates to encourage capital inflows or by implementing FX-demand management policies, though the latter could further erode market confidence. Overall, we believe that currency depreciation is a matter of when, rather than if, once the demand-supply equation of the currency and inflation differential between the U.S. and Nigeria are accounted for. However, we do not anticipate this depreciation till the second half of the year, and we forecast a mild year-end depreciation of 7.5%, to bring the closing exchange rate to c.390/$1.

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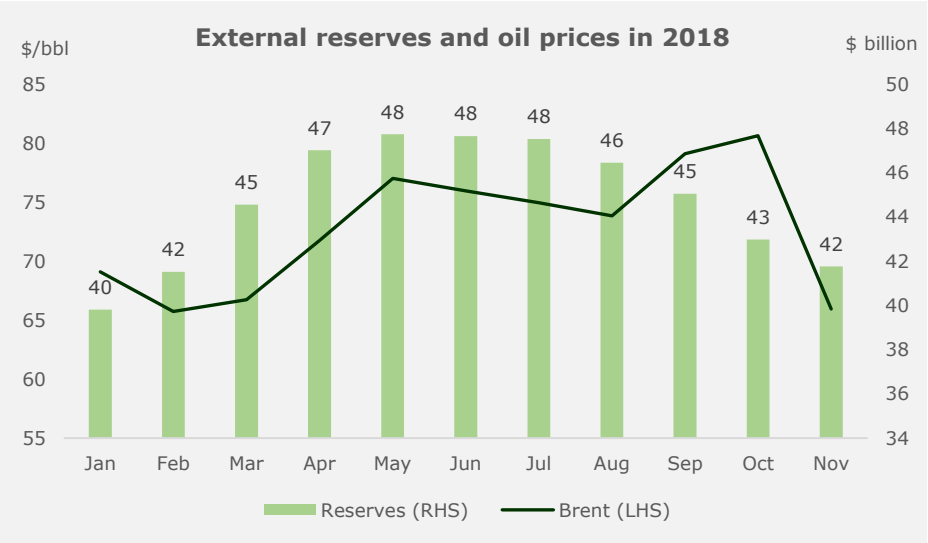

Source: CBN, Bloomberg, Vetiva Research

Tighter monetary policy expected in 2019

We do not foresee any monetary easing in 2019 as price and exchange rate stability would remain atop the CBN agenda. Moreover, in our base scenario of mild currency depreciation and a minimum wage implementation in H2'19, there is a fair chance that the apex bank would increase its monetary policy rate to 14.5% by year-end in order to maintain positive real interest rates. Finally, we anticipate continued focus of the Monetary Policy Committee on getting commercial banks to extend credit to the real sector on the back of its Real Sector Support Facility (RSSF).

Adverse external and domestic conditions to keep FPI on sidelines

After staging a recovery from the low of $0.7 billion in Q1'16 (severe dollar shortages and a contracting economy) to reach $6.3 billion two years later, capital inflows have trended south in recent quarters, falling to $2.9 billion in Q3'18 amid monetary tightening in the U.S. and a simmering trade war between the world's two largest economies. We note that these factors have only deteriorated since then and the weakening attractiveness of emerging & frontier markets is seen in the IMF downward revision of economic growth in those regions. Meanwhile, Nigeria's attractiveness has been reduced by uncertainty emanating from the imminent 2019 elections and resultant concerns over security and policy distortion. Finally, the pressure on the domestic currency and widening gap between official and parallel market rates continues to erode confidence and dissuade capital inflows. We expect this trend to persist in the coming year and foresee weaker autonomous capital inflows into the country.

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Lower oil prices gives bearish outlook on current account

Nigeria's current account profile remains heavily tilted towards oil & gas (accounted for over 95% of visible exports in Q2'18) and so will be swayed by the health of oil & gas sales in 2019. This can be seen in the way the current account recovered from -₦0.1 trillion in Q3'16, when oil production and oil prices averaged 1.6 mb/d and $47/bbl respectively, to ₦2.1 trillion in Q2'18 when production and prices averaged 2 mb/d and $75/bbl respectively.

We note that Q3'18 current account was substantially lower at ₦0.7 trillion due to recorded import of the EGINA FPSO which bloated Nigeria's imports. We expect production to be stable moving forward (2019F: 2 mb/d) and any effect of an OPEC quota can be navigated by focusing on expanding condensates production (not included in OPEC quotas). However, oil prices are expected to be weaker in 2019 (forecast: $60/bbl) as we head towards an oversupplied market. On the import front we do not anticipate any material change in Nigeria's import profile, though we foresee the Central Bank of Nigeria (CBN) implementing stricter foreign exchange policies to restrict certain imports and manage external reserves. Notably, given our expectation of some currency depreciation by the end of 2019, Nigeria's trade account may be larger by year-end, particularly as a weaker naira bloats oil receipts.

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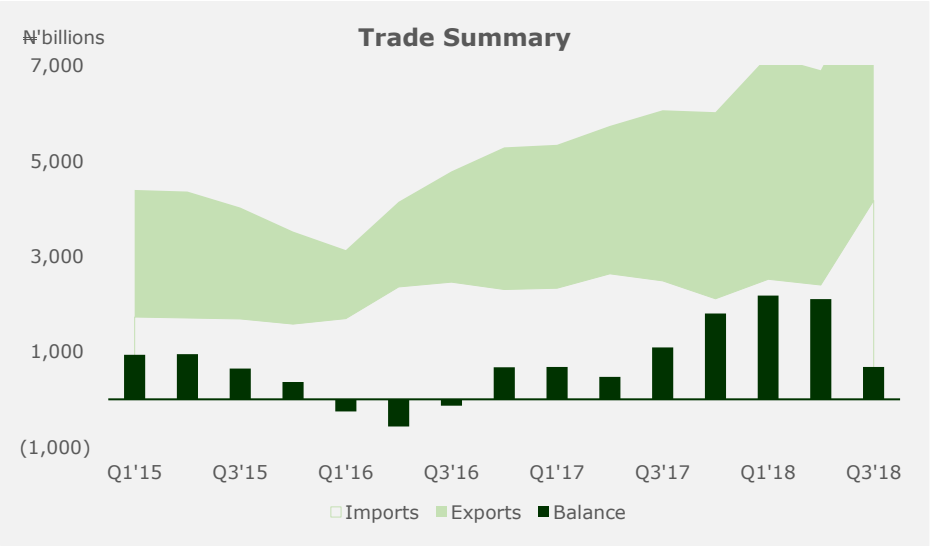


Source: NBS, Vetiva Research

Fixed Income

Fixed Income

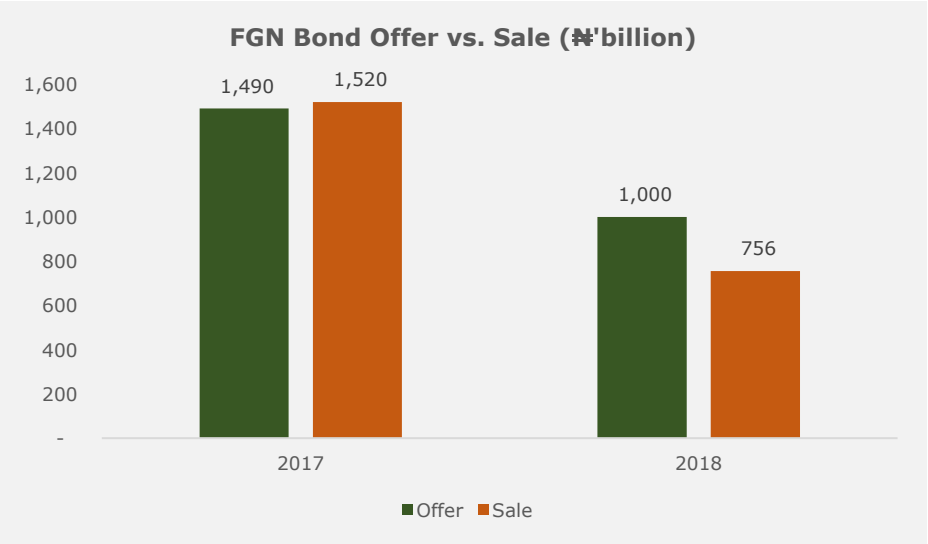
Expectation of higher yields in 2019

Whilst our expectation for lower yields materialized in the first half of 2018 amid lower inflation rates, fixed income yields had risen 113bps between the end of December 2017 and the end of November 2018. This was as a result of sell offs in emerging market and a rise in global interest rates combined with political uncertainty that coloured the second half of the year which led to significant capital exit. We foresee higher yields in 2019 with an increased budget financing gap supportive of bond supply and also driven by a contractionary monetary policy higher inflation expectation. Whilst moderate economic fundamentals and political stability post-election is expected to drive a return of foreign investor interest, we highlight that expected slowdown in global economic growth due to trade wars and continued monetary tightening across major world economies.

Government expenditure plans to support bond supply

Amid the considerable increase in actual government expenditure in the past few years, from ₦4.8 trillion in 2015 to ₦5.5 trillion (projected) in 2018, Nigeria's budget deficit has also grown from ₦1.5 trillion in 2015 to ₦1.7 trillion (projected) in 2018. The 2019 budget outlines an even larger budget size (₦10.2 trillion) and deficit (₦2.3 trillion). Coupled with a weak oil price outlook which would reduce government oil receipts and no little improvement in non-oil revenues, we foresee the need for higher deficit financing in 2019. 2018 saw a continuation of the government's plans to up-weight foreign borrowing to optimize its debt profile—$5.3 billion (₦1.6 trillion) sourced from Eurobond market vs. ₦0.8 trillion sourced in the domestic bond market. While the government maintains this debt strategy, we anticipate a less bullish stance on foreign borrowings in 2019 given rising global interest rates and amid a somewhat more precarious revenue position. Notably, Nigeria issued a 12-year Eurobond in November 2018 at a coupon rate of 9.25%, compared to 7.143% on a similar 12-year Eurobond in February. As such, we anticipate a stronger focus on actual sales at domestic bond auctions in 2019 and expect steady bond supply. That said, we highlight the possibility of a markedly different strategy to funding Nigeria's fiscal deficit post-2019 in the case of a change in government brings the main opposition candidate who seems to favor public-private partnerships (PPP).

Coupled with a weak oil price outlook which would reduce government oil receipts and no little improvement in non-oil revenues, we foresee the need for higher deficit financing in 2019.



Source: DMO, Vetiva Research

CBN to persist with monetary tightening

We anticipate a rise in average inflation in 2019 (forecast: 12.6% vs 12.2% in 2018) as a result of anticipated pre-election spending at the beginning of the year, as well as a potential minimum wage hike which could lead to a wage-price spiral. Furthermore, we foresee increased domestic food price pressure due to lasting effects of recent flooding and violence in the Middle Belt. In addition, we anticipate greater currency pressure due to lower oil prices and persistent net capital outflows. We note that the apex bank has drawn down reserves to defend the currency in recent months and we expect this trend to persist. In addition, the CBN has tightened monetary policy in the latter part of 2018 through a series of OMOs as the apex banks adopts a more aggressive liquidity management stance. Given all this, we expect tighter monetary policy in 2019, with the CBN persisting with its frequent OMO sales, as well as a 50bps rate hike in H2'19. Amid this, we project higher yields in the fixed income market, and foresee a greater increase in the T-bills space as a result of CBN liquidity tightening.

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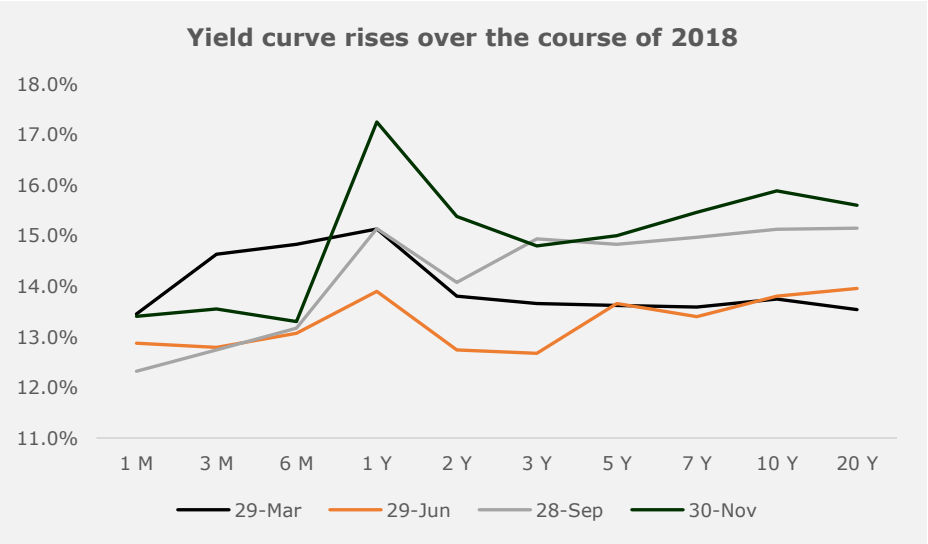

Source: FMDQ, Vetiva Research

Corporate debt raising to be dampened by higher yields

The bond and Commercial Paper (CP) markets experienced a high level of activity in 2018, with increased participation of corporates thanks to a more attractive yield environment due to moderated yield. Following our expectation of higher yields in 2019 as a result of hikes in global rates and tighter monetary policy stance, we expect activity in the CP and bond market to dip below 2018 levels. We highlight that the CBN recently initiated a Real Sector Support Facility which permits triple-A rated corporates to issue 7-year bonds which the apex bank would purchase at single digit rates. The scheme could reduce the pool of investible corporate bonds for many investors as premium corporates take advantage of the RSSF. We expect this facility would eventually encourage more corporate bond issuance but note that there has not been much traction so far.

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Alternative debt financing on the rise

Federal Government bonds have long-since dominated the fixed income market, accounting for *c.*66% of all issued securities in 2018. Notably we have seen an increase in issuance of alternative instruments in recent times, such as the ₦100 billion Sukuk bond issue in 2017, a $29 million Green bond issuance in 2018, and the commencement of a monthly retail savings bond programme in March 2017. The different instruments have had mixed results. Whilst the sukuk and green bond received a healthy investor reaction (another sukuk issue to be completed by the end of 2018), interest in the retail savings bond has been weak, with under ₦10 billion raised so far. We expect the debt management office to keep driving the inclusion of alternative fixed income instruments and judge this to be positive for market deepening and diversification.

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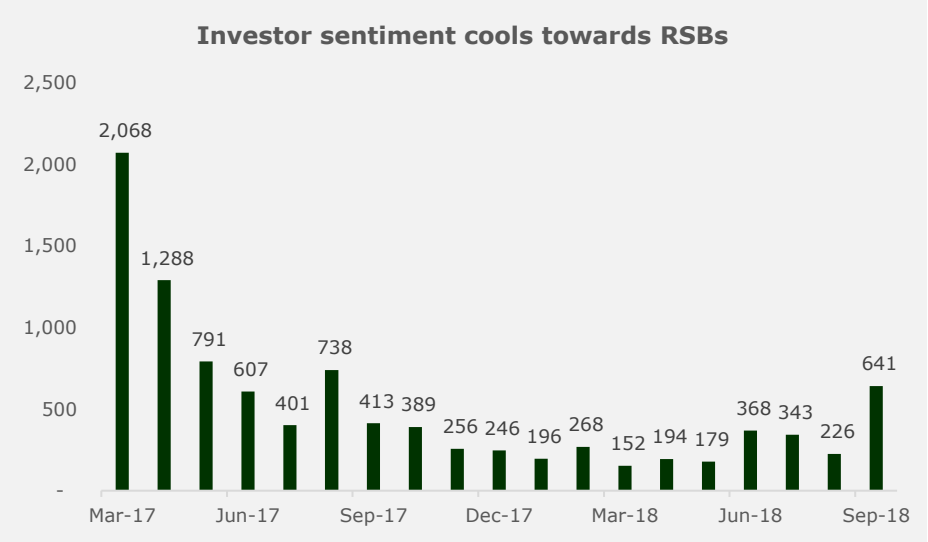

Source: DMO, Vetiva Research

PFAs maintain bias for fixed income instruments

Pension fund administrators are a dominant domestic investor group. Following the release of new National Pension Commission (PenCom) regulations that came into effect in June 2018, there was anticipation of a gradual shift from fixed income to equity. However, the share of PFA assets held as fixed income instruments has remained relatively flat through 2018, opening the year at 70.4% (₦5.3 trillion) and registering at 70.7% (₦5.9 trillion) in September 2018, driven by the recent decline in the Nigerian equities market and PFAs adopting a more conservative investment policy in a high-risk environment. As PenCom has given PFAs a January 2, 2019 deadline to comply with the new regulation, we anticipate a bit of a shift towards variable income instruments. In addition, we highlight IFRS 9 standards which instructs PFAs to make fair value adjustments on fixed income assets held for trading purposes. We foresee our expectation of higher yields in 2019 to result in a reduction in the value of fixed income instruments held by PFAs and drive a more strategic decision-making process for PFAs. That said, we do not anticipate a mass exodus as the yields on government securities continues to offer an attractive risk-return profile.

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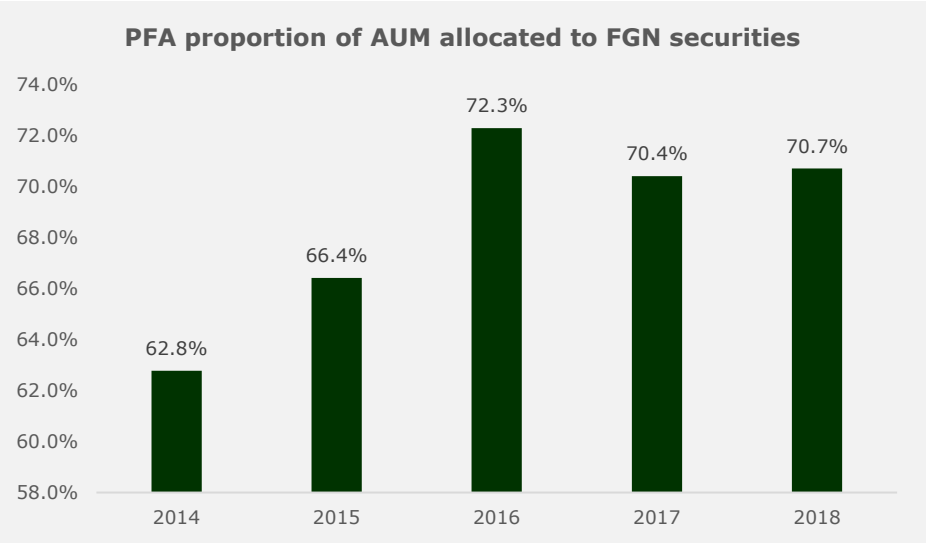

Source: PenCom, Vetiva Research

FPI to remain weak in 2019

Monetary tightening in the U.S. and a deterioration in trade relations between the world's two largest economies, China and the U.S. dampened the outlook for global growth and cooled sentiment towards emerging & frontier markets. As a result, we saw a sizable sell-off across emerging market assets, with the JP Morgan Emerging Market Sovereign Bond Index shedding *c.*11% of its value between end of December 2017 and end of November 2018. Whilst we are hopeful that the current 90-day truce between the U.S. and China would be the precursor to a permanent reprieve, we note that external conditions would likely remain unfavorable as a result of monetary tightening across major developed economies and lower year-on-year oil prices. With local elections adding another layer of uncertainty we expect foreign investors to sit on the sidelines in the early part of the year. We foresee modest recovery in investor interest post-election, the magnitude of which would be determined by political stability and economic fundamentals. Overall, we are bearish on foreign inflows into Nigeria and this would impact the fixed income market by driving yields higher. Finally, we note the distinct possibility of Nigeria's re-inclusion in the aforementioned JP Morgan Bond Index which would spur demand for Nigeria's bonds, but have not included this in our analysis as there has been no indication of this occurring anytime soon.

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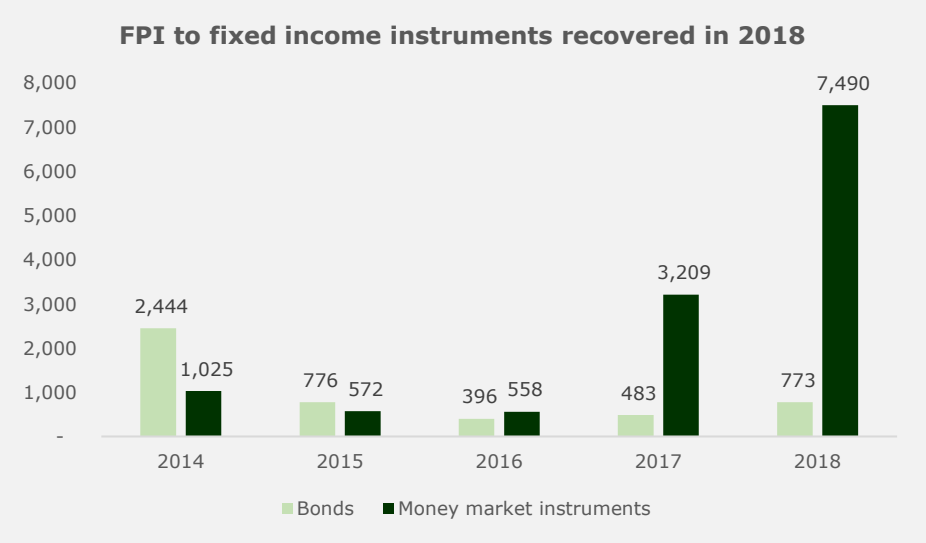

Source: NBS, Vetiva Research

Equity

Equity

Downside factors may diminish post-election euphoria

2018 began on a positive note as the Nigerian Stock Exchange All-Share Index (NSE ASI) notched a 9% gain in Q1'18 amid significant foreign interest, a trend which surfaced in Q2'17 following the introduction of the NAFEX window (NSE ASI gained 42% in 2017). However, investor uncertainty emerged in subsequent quarters, with the ASI dipping 8% and 14% in Q2'18 and Q3'19 respectively, driven by pre-election jitters and weak emerging market sentiment. In addition, fears over an over-supplied oil market in 2019 drove Brent crude price below $60/bbl in November, just a month after a four-year peak of $86/bbl, raising concerns over the medium-term stability of the exchange rate. We see three major drivers for the Nigerian equity market in 2019: the local political landscape, global sentiment towards emerging markets, and domestic macro-economic fundamentals.

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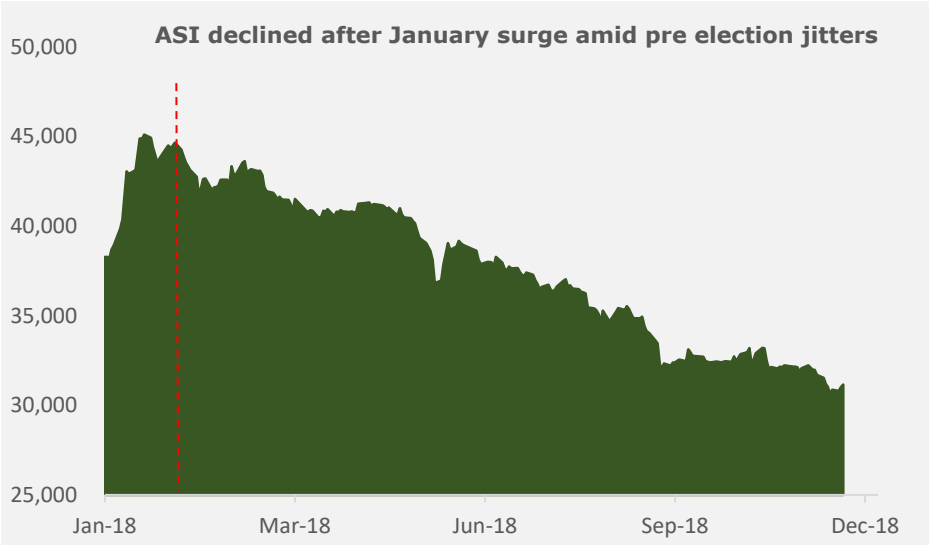

Source: NSE, Vetiva Research

On the political front, we anticipate a rocky start to trading in the equity market as elections draw near. Historically, the periods before major elections in Nigeria have been characterized by a "steer clear and monitor" approach by foreign investors and local investors. Unsurprisingly, the ASI shed 4% on average in Q1'11 and Q1'15, the previous election years. We expect a similar trend in Q1'19, particularly as foreign investors monitor developments in the global oil market and Sino-American trade negotiations. We note that foreign investors accounted for *c.*49.38% of market activity in 2018, despite sizable capital outflows. Finally, we expect currency pressure to persist through the year and forecast only modest economic performance (2019 GDP growth: 2.7% y/y) and do not expect macroeconomic developments to provide much market joy in 2019. Coupled with our expectation of adverse external conditions in 2019, we anticipate modest post-election equity market performance and project a market return between -5% and 5%, with a point estimate of 2.5%.

Finally, we expect currency pressure to persist through the year and forecast only modest economic performance (2019 GDP growth: 2.7% y/y) and do not expect macroeconomic developments to provide much market joy in 2019.

General elections to remain centre of attention

Equity markets are known to be vulnerable to political activity especially in the build up to major elections. We highlight that the ASI has enjoyed a post-election rally in the two most recent election years, with an average return of 3% in the quarter following the past two general elections. Post the 2019 we expect reduced political and policy uncertainty to placate investors but note that investor sentiment could remain muted until the official swearing in (June 2019) as attention turns to prospective policy and security risks. In our view, significant security threats are unlikely as Nigeria's democracy matures. That said, we recall that in 2015, investors reacted poorly to the new administration's failure to appoint a cabinet for over six months after swearing in. We expect greater clarity in policy direction this time around, regardless of the eventual outcome of the election.

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In terms of prospective candidates, we note that the incumbent holds the upper hand in his ability to provide the stability craved by financial markets whilst the primary opposition candidate has been touted as a more pro-business figure could generate stronger enthusiasm. We assess scenarios below:

Incumbent Win		Opposition Win	
Scenario 1	**Scenario 2**	**Scenario 1**	**Scenario 2**
Incumbent wins in an election generally regarded as free and fair Challengers accept defeat and a smooth handover is expected No material security issues flare up	Incumbent wins a contentious election Primary opposition party dispute the results Notable escalation in insecurity	Challenger wins in an election generally regarded as free and fair Incumbent accepts defeat and a smooth handover is expected No material security issues flare up	Main opposition victory is trailed by some form of insecurity or contention Incumbent disputes the result and refuses to cede authority Temporary breakdown in law and order
Fallout 1	**Fallout 2**	**Fallout 1**	**Fallout 2**
Business as usual in the markets and economy; investors brace for another four years under current policy Market performance and activity are muted; key policy thrusts on the exchange rate and borrowing persist	Foreign investors stay on the sidelines as political turmoil deepens Economic performance weakens and pressure on the currency worsens Weak market performance anticipated	Significant post-election rally similar to 2015 Investors observe policy direction of incoming administration Strong market performance in H2'19	Investor confidence plummets and market volatility spikes Very negative performance through the year

Adverse external environment dims equity market prospects

The Nigerian equity market was buffeted in 2018 by heightened trade tensions between the U.S and China, volatile commodity prices, and monetary tightening in the United States. We expect these factors to remain relevant in 2019. On the trade front, we acknowledge the 90-day truce between the two parties but still expect some level of discord during the year. Meanwhile, our outlook for the crude market also remains weak, with a forecast of $60/bbl for Brent crude, as OPEC cuts are unlikely to fully address the oversupply in the market. Finally, we anticipate higher global interest rates, with the U.S. Fed expected to implement three rate hikes and as a fallout of the end of quantitative easing in the Eurozone, which would induce further net capital outflows from emerging & frontier markets like Nigeria.

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In summary, global sentiment towards the Nigerian market is likely to be weaker in 2019 due to slowing global economic growth, fears over trade tensions, stronger policy rates in the U.S. and Europe and lower crude prices. Given the significance of foreign portfolio flows, we anticipate muted market performance in 2019.

Source: Bloomberg, MSCI, Vetiva Research

Corporate performance to provide little market boost

We anticipate acceleration in both economic growth (1.8% in 2018 to 2.7% in 2019) and inflation (12.2% in 2018 to 12.6% and 2019) and expect only modestly positive economic performance in 2019 and corporate performances will continue to mirror the sluggish economic recovery. Amid this, we do not see much macro support for the equity market as investors are unlikely to be swayed by improvements in the broader Nigerian economy without improvements in corporate performance.

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Banking

The banking sector has been the strongest performer in the market this year, with banking stocks posting the lowest declines (-16%) in a bearish market (-20% YTD), and retaining their status as the top-traded stocks. Nigerian banks are underpriced compared to other African countries—the sector trades at a P/E of 4.54x and has the highest dividend yield among key sectors on the domestic bourse at 7.70%. We expect continued recovery in the economic climate will continue to support growth in non-interest income, amid stronger economic activity, while growth interest income will remain subdued as banks remain weary, with flat growth in banks' loan books.

Consumer Goods

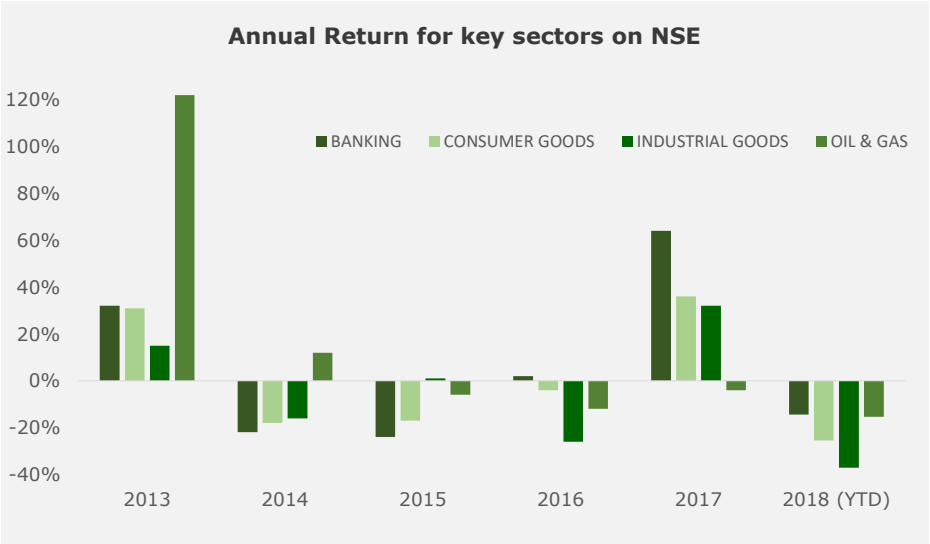
Consumer spending in 2019 is expected to be marginally bolstered by election spending and the proposed increase in minimum wage. As such, we expect modest growth in the Consumer Goods sector, further buoyed by better financial performances from food producers such as FLOURMILL and DANGSUGAR. However, expectations for the sector are dampened by the prospect of a weaker currency in the latter part of the year.

Industrial Goods

Driven by stronger earnings performances, we anticipate a recovery in the Industrial goods sector, which has been the worst-performing key sector so far in 2018 (-73.38% YTD). Specifically, we see the recovery heaviest on WAPCO as earnings growth is oversized by a particularly weak 2018.

Oil & Gas

In the Upstream sector, we expect slightly lower revenues amid lower oil prices and stable production volumes. Meanwhile, in the downstream sector, barring partial or full deregulation of the sector, margins will remain slim and potential for growth also limited, meaning no likely improvement in investor perception of the sector.

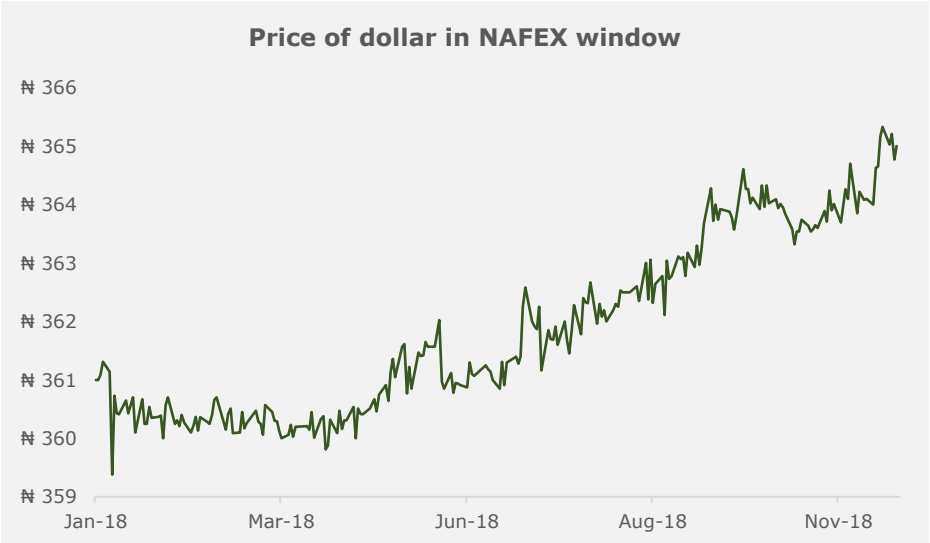


Source: Bloomberg, NSE, Vetiva Research

The NAFEX window: a microcosm of investor sentiment?

Notwithstanding minimal currency depreciation in 2018—exchange rate moved from NGN361/USD in January to NGN364/USD in November—there has been visible pressure on the currency amid sizable capital reversals. In 2017, the Central Bank provided just 8% of inflows into the NAFEX market while foreign portfolio inflows (FPI) accounted for 51%. In 2018, the apex bank supplied 25% of the dollar inflows whilst FPI contribution dropped to 41%. We recall the significance of NAFEX window in influencing investor sentiment: the NSE ASI rallied 36% within two months of the window opening, compared to a -5.36% performance previously. In 2019, we expect the CBN to be a more prominent supplier in the market as it seeks to minimize currency depreciation, but we highlight that investors would be concerned about the perceived inflexibility of the market-determined exchange rate, as well as stability in supply. Under our base assumption of a currency depreciation to NGN390/USD, we foresee decent investor confidence in the integrity of the NAFEX window through the year, which would support equity market performance.

We anticipate acceleration in both economic growth (1.8% in 2018 to 2.7% in 2019) and inflation (12.2% in 2018 to 12.6% and 2019) and expect only modestly positive economic performance in 2019 and corporate performances will continue to mirror the sluggish economic recovery.



Source: Bloomberg, Vetiva Research

Weak market could see primary activity dry up

The primary market segment of the equity space was relatively healthy in 2019 as we saw the listing of two new companies on the exchange (NOTORE and SAHCO) and a combined market capitalization of *c.*₦130 billion added to the market. However, the total value raised from rights issues in declined from ₦340 billion in 2017 to ₦130 billion in 2018 (including the proposed ₦90 billion WAPCO issue). We attribute this to the post-January slump in the Nigerian equity market (ASI 30.97% down since the end of January) which discouraged corporates from raising additional share capital even as cost of debt moderated through the year. We expect the 2019 primary market to be drive by Bureau of Public Enterprises-led listing of privatized state-owned enterprises (SOEs) including Indorama Eleme Petrochemicals, Nicon Insurance, and Nigerian Machine Tools. More importantly, we are doubtful about a quick resolution of the disputes that have dogged the proposed MTN Nigeria listing which had been expected in 2018. In addition, we do not anticipate much activity in terms of rights' issues as company valuations would still be relatively depressed for most of 2019 and we also highlight the significant deleveraging that occurred across key sectors in 2017/2018.

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PFAs and the multi-fund conundrum

The new National Pension Commission (PenCom) regulation on a multi-fund structure for Pension Fund Administrators (PFA) came into effect in July 2018, with PFAs granted a 6-month grace period to comply with the new rules. The multi-fund structure is targeted at increasing PFA exposure to variable income investments such as equities as PFAs have long-since favoured FGN securities, investing 73% of Asset under Management (AUM) in this asset class in 2016, compared to 8% in equities. Whilst PFAs have slowly increased equity exposure—10% of AUM in March 2018—the slump in the Nigerian equity market has eroded holdings to 7% of AUM in September 2018. We note that PFA sentiment towards the equity market has been weak amid adverse external conditions and a slow-growing economy, and we see regulation as the primary driver of near-term additional equity exposure.

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And although we expect PFAs to increase their equity holdings to comply with the multi-fund deadline, we note that PenCom has been reticent in enforcing prior iterations of the deadline. However, we highlight growing PFA participation in the equity market as a major equity market driver in the long run.

Banking

Banking Sector

Minimal loan growth amid stalled economic performance

Partly driven by the impact of IFRS 9 implementation on credit portfolios (following the one-time write off), as well as a still cautious stance on risk asset creation, average loan book growth across our coverage was negative for most of 2018, with loan portfolios down -4% on average as at 9M'18. We expect the conservative approach to credit growth to persist in 2019. Particularly, amid the upcoming election season we believe lenders will remain majorly on the sidelines through the first half of the year as the political scene takes center stage and also given the possibility of policy reversals in the economy should there be a change in leadership. Meanwhile, though Nigeria continues on a recovery, the sluggish pace and weak non-oil sector performance also puts a dampener on credit creation in the high risk operating environment. Furthermore, we expect banks to remain cautious in extending credit to the oil and gas sector given the recent bearish trend in oil price. We identify this as a quagmire for the economy where on one hand, strong credit extension to the private sector is a prerequisite to sustainable and inclusive economic growth while on the other hand banks continue to await a stronger recovery and a less volatile environment before investing their assets. As such, banks will remain selective in growing risk assets in 2019 while keeping their universe of obligors small and restricted to larger corporations. The Central Bank of Nigeria continues to strive to jumpstart credit growth to the economy, with the apex bank recently actioning a Real Sector Support Facility (RSSF) and differentiated cash reserve ratio system for the banks. These schemes don't appear to have garnered much momentum so far. Overall, we forecast a low single digit credit growth on average across our coverage names driven by a mildly stronger economic blueprint – GDP growth of 2.7% y/y for FY'19 – and healthy deposit growth.

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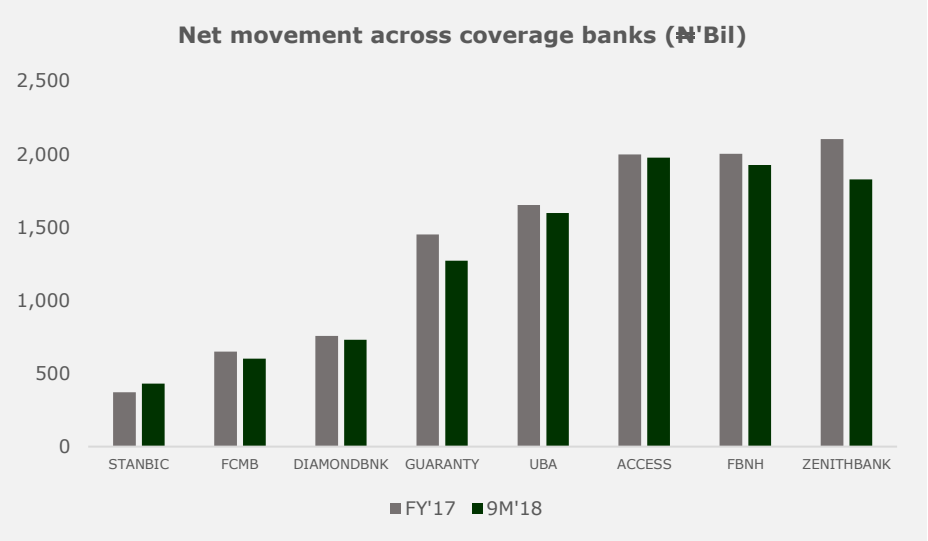

Source: Company Fillings, Vetiva Research

Meanwhile, despite the low penetration and growth potential from Nigeria's population size, we expect retail loan growth to remain the "bottom of the barrel" option for commercial banks in the near term. We believe banks will remain skeptical about opportunities in this segment given the inherent risk. As such, the risk adjusted return on these loans become less attractive when compared to risk-free high yielding and tax-free government securities.

We however expect stronger traction in the medium-long term driven by broader government policies to create visibility for customer's credit profile and possibly a central database across the country. We also believe the deployment of more advanced digital banking tools will serve as a boost to this segment as it could produce a more efficient, transparent and even secure platform for both the customers and the banks.

Uptick in yields to support modest growth in interest income in 2019

In line with our expectations coming into the year, average yields in the fixed income space moderated in the first half of the year, down 63bps as at H1'18. Notably, this was significantly driven by declines in the T-bills space (secondary market yields moderated as much as 300bps YTD as at 31 July). In the second half of 2018 however, yields began to inch up as bearish sentiment across emerging markets became more evident – spurred by capital reversals following more aggressive interest rate normalization in developed markets. Average yields in the secondary market rose from 13.3% in June to 15.5% as at December. Amid sustained pressure from capital outflows and mild resurgence in inflationary pressures in 2019, we expect the MPC to hike rates by 50bps by the second half of the year while the CBN's sustained liquidity tightening will support higher yields in the fixed income market through the year. With this, we expect stronger yield on assets in FY'19 supported both by an uptick in income from investment securities as well as a potential marginal upward repricing of loans to customers – with a stronger increase to be recorded from short-term debt options such as Bank Overdrafts. Furthermore, we expect a stronger boost from income on treasury instruments as the banks maintain a pattern of keeping a substantial portion of their total assets invested in risk-free government securities in the place of risk assets. Driven by this, and our forecast single digit loan growth expectation for FY'19, we expect the interest income line to buck the downward trend recorded in 2018 to deliver notable growth in FY'19.

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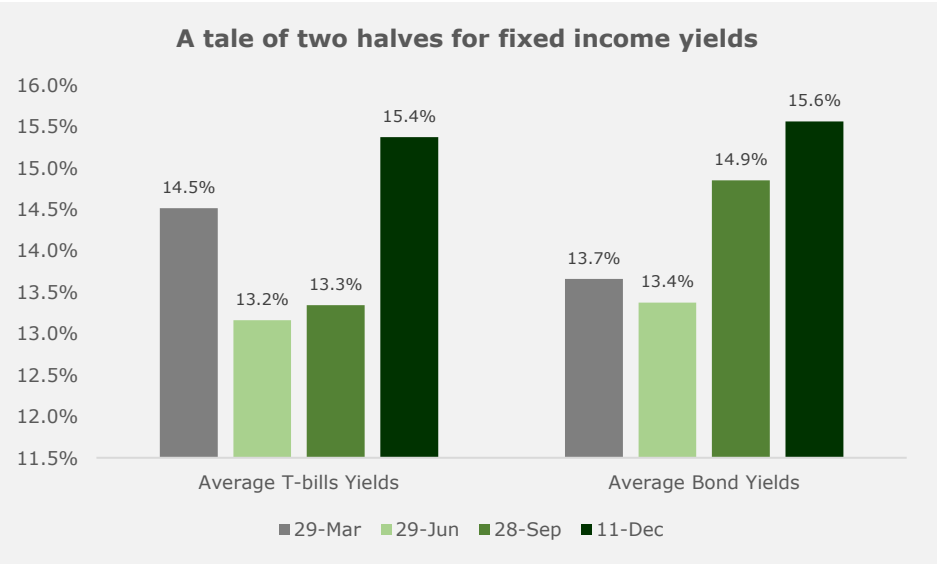
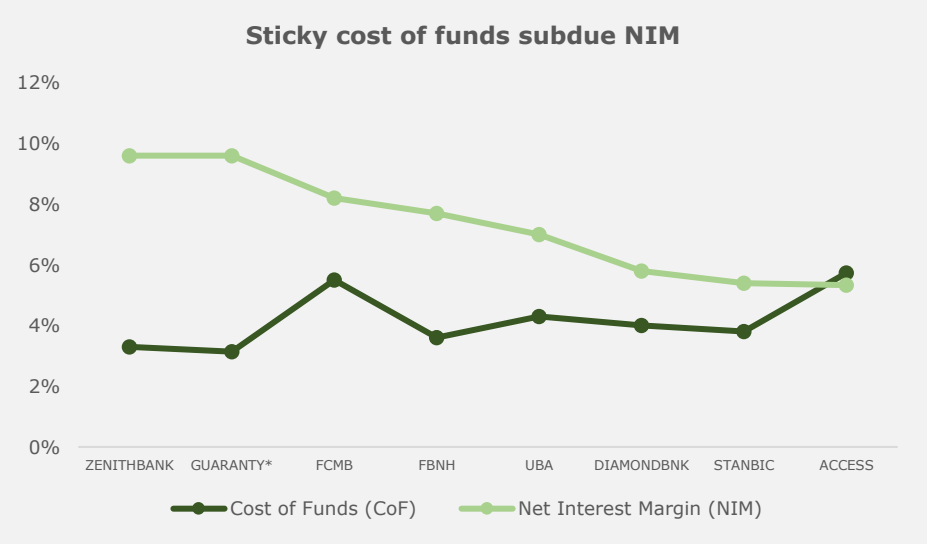


Source: FMDQ, Vetiva Research

Net Interest Margin not out of the woods on higher Cost of Funds

Contrary to our expectation of a moderation in funding costs in the banking sector, Cost of Funds (CoF) across our coverage remained sticky for most of the year. As such, net interest margins came under pressure in FY'18 given that the moderation in yield on assets (YoA) was not met by a visible decline in CoF. Specifically, net interest margin across our coverage came in 76bps lower as at 9M'18, diminishing growth in net interest income across the banks. We note that the major outliers to this trend were a few Tier I banks (such as ZENITH) that leveraged their strong liquidity positions and other smaller banks (FCMB) that recorded growth in low-cost funding. We believe the elevated funding costs were driven by intensifying competition for deposits across the industry as banks attempt to keep deposit rates attractive to customers.

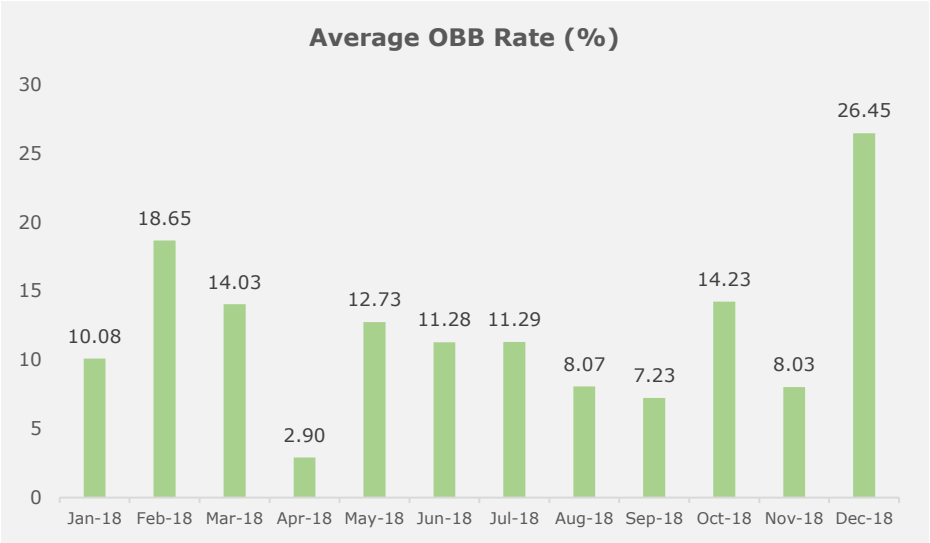


Source: Company Presentation's, Vetiva Research

GUARANTY figures as at H1'18

Net interest margin across our coverage came in 76bps lower as at 9M'18, diminishing growth in net interest income across the banks.

With interest rates expected to inch up in 2019, we expect cost of funding to also rise in the year. Notably, amid efforts to keep prices and currency stable, the CBN has accelerated the pace of open market operations in the very latter part of 2018 with an average OBB rate in December of 26% compared to 11% previously. We expect the apex bank to maintain this liquidity squeeze going into 2019 given our expectation of sustained currency and price pressure through the year which will also put an upward push on cost of funds as banks scramble for liquidity – a downside for the lower tier banks. Given the aforementioned, and continued stiff competition for depositors, we expect the rise in CoF to wholly offset projected uptick in YoA on average across our coverage names in 2019 – thus implying that net interest margins will remain flat on average in the year. While the lower tier banks will be most impacted by higher funding cost from inter-bank lending, we note possible respite from a sustained push in growing low-cost deposits.



Source: FMDQ, Vetiva Research

More tangible currency risk, banks reduce exposure to FCY liabilities

Following a period of over 12-months of reduced worries about the stability of the naira, the strength of the NGN/USD has been tested more severely since the second quarter of 2018 amid increased supply pressure from a surge in capital outflows. While the peaceful and transparent completion of the elections is expected to remove the political cloud diminishing foreign sentiment, further interest rate hikes in the U.S and lower commodity prices will continue to put pressure on the currency.

While we expect the CBN to continue to defend the naira stable at the official market, we predict a mild depreciation in the other windows – where most corporates access their dollar needs – in the latter part of the year to NGN390/$ from an average NGN362/$ in 2018. Given the substantial portion of our coverage' banks loans that are denominated in foreign currency, we expect the weaker currency to pressure asset quality amid the diminished ability of obligors to meet up with their obligations. That said, we expect effects of this to become relevant in the fourth quarter of 2019. We also note the expected rise in interest expense on dollar-denominated liabilities for the banks in the event of this currency depreciation. An important trend also worth highlighting is the recent uptick in banks calling/redeeming their foreign currency liabilities – particularly Eurobonds. While GUARANTY had redeemed two of its foreign bonds early in 2016 and 2017, FBNH called its $300 million Eurobond in August 2018 (previous maturity of 2020). In November, ACCESS joined the train and announced its plan to redeem its $400 million Eurobond (previous maturity in 2021). Given the banks' predisposition to hedge FCY assets with FCY liabilities, we believe these redemptions indicate a few things; lower distribution of FCY loans by the banks, cautiousness in holding on to dollar liabilities amid still shaky naira fortunes, and current buoyant USD liquidity in the market and banking system to repay these loans. With a few Tier I bank Eurobonds still in issue (ZENITH, UBA), we believe there could be an extension in this trend into 2019 as the aforementioned factors still hold true.

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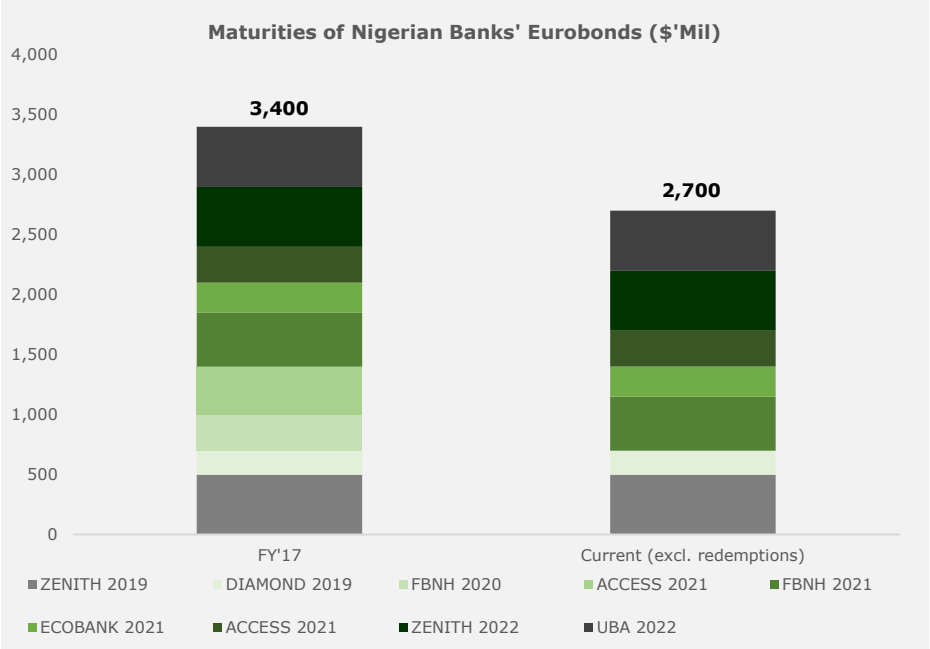
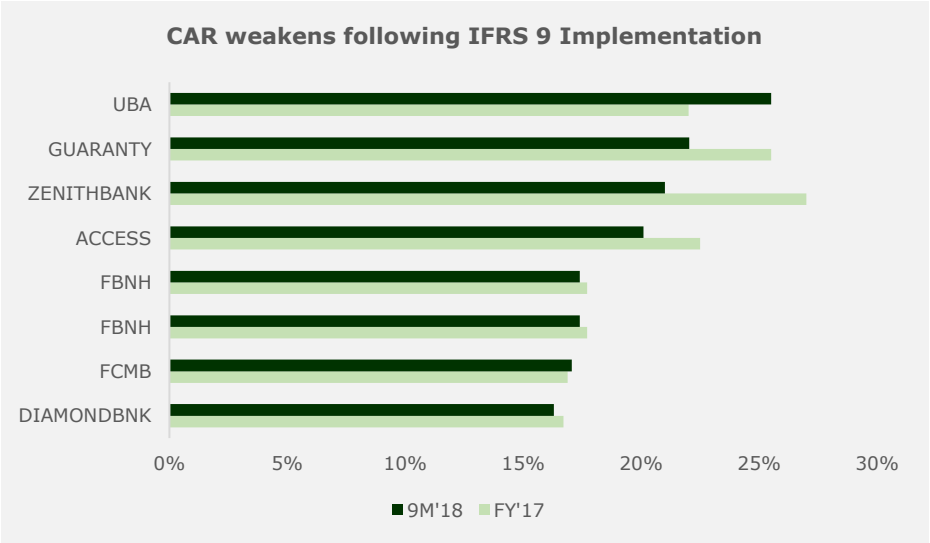


Source: FMDQ, Vetiva Research

Need for capital raising persists, but banks may still stall

Following the 2016 economic shock that led to a spike in non-performing loans and a deterioration in capital buffers across the banking sector, banks have been looking to raise additional capital to shore-up their base. While a few issues have come through the markets, we believe the need to raise funding has risen following the implementation of IFRS 9 in 2018 which saw banks take huge loan loss charges against their shareholder's funds (₦446 billion across our coverage), leading to a moderation in average capital adequacy ratio (CAR) in the sector. While CAR of all the Tier I banks (save for FBNH) remains at a somewhat healthy 500bps headroom to the 15% regulatory benchmark, Tier II bank across our coverage have an average 17% CAR as at 9M'18, indicative of the importance of additional funding for these banks. Notably, we attribute some of the major corporate actions reported in 2018 as an offshoot of the weak capital adequacy in the lower tier banking segment – the sale of Diamond Bank's Non-Nigerian business operations, set up of a bridge bank, Polaris, to takeover Skye Bank and Diamond Bank eventually putting itself up for acquisition, with Access Bank emerging the successful bidder.

In line with 2018, capital raising from the Eurobond market is expected to be quiet particularly given the upward trend in global interest rates and amid questionable path of the currency in 2019. Meanwhile, even though sentiment in the equity market is expected to pick up only marginally in the coming year, banks could look to the market as a preferred funding source – specifically by way of Rights Issues. Overall, while the banks' sluggish stance towards credit extensions may defer capital raising plans in 2019, we believe shoring up the capital base is essential for the banks to ensure a lower risk of breaching minimum prudential liquidity and solvency benchmarks in the case of any future economic turbulence. Away from raising external funds, we also highlight the possibility of banks increasing proportion of retained earnings to support their CAR.



Source: Company filings, Vetiva Research

Company focus: A combination to shake up the banking sector

The Board of Directors of Access and Diamond Bank recently announced a proposed merger of the two banks. Following weeks of speculation on the strategic investor Diamond Bank was looking to bring on board, both banks released statements stating that Access Bank would acquire the entire issued share capital of Diamond Bank in a transaction that is expected to be completed in the first half of 2019. Preliminary details from the transaction show ACCESS is expected to buy the Tier II bank for a total of $200 million, of which the company will be looking to raise $250 million in Tier 2 capital and an additional ₦75 billion by way of Rights Issue in H1'18. The acquirer has stated that this capital raising is being undertaken to ensure its capital adequacy ratio remains at or above its internal target of 20%. Meanwhile, looking at Diamond Bank's book value per share of ₦9.15 (as at 9M'18) the Tier II bank was valued at 0.34x its book value for this transaction – higher than the bank's 3-year average price/book value of 0.18x.

Following weeks of speculation on the strategic investor Diamond Bank was looking to bring on board, both banks released statements stating that Access Bank would acquire the entire issued share capital of Diamond Bank in a transaction that is expected to be completed in the first half of 2019.

Away from pricing, the combination is expected to make the New Access Bank the largest commercial bank in Nigeria by deposits – ₦3.54 trillion in total vs ₦3.26 trillion of FBNH, current largest. The enlarged entity is also expected to boast of total assets and loan book of ₦6.1 billion and ₦2.8 trillion respectively, potentially the largest in the industry. Meanwhile, in a bid to ensure strong asset quality for the enlarged entity, Diamond Bank is reportedly expected to record additional impairment losses before the transaction is completed given the bank's high NPL ratio of 12.6% (as at 9M'18) – above the regulatory benchmark of 5%. Furthermore, we expect synergies and benefits realized from the larger scale and market share of the New Access Bank to be a significant advantage with the stronger liquidity position expected to support potential moderation in cost of funds and possibly stronger margins as well. The New Access is also well suited to benefit from Diamond Bank's strong retail footprint, with consistent and notable growth recorded across its retail banking channels and boasting of over 3.3 million customers on its mobile app as at 9M'18. While this transaction may be a surprise, we note that it is well in line with Access Bank's aggressive growth strategy to become the number one bank in Africa as outlined in its 2018-2022 Strategy presented to stakeholders this time last

year. Though post-acquisition integration will be challenging, we highlight (i) Access Bank's historical experiences from when it acquired Intercontinental Bank in 2012 and (ii) the similarities in both banks operations, as both utilize the Oracle Flexcube as their core banking solution. That said, downside risks persist and the medium-long term gains from this transaction will mostly accrue sufficiently on a well-executed integration process. Overall, we expect a positive reaction from market participants to the news as the market awaits more traction in approvals.

Continued recuperation in asset quality, albeit modestly

Supported by improving macroeconomic variables and the IFRS 9 accounting standard implementation, NPL ratios across our coverage companies moderated marginally in 2018, down 120bps on average to 8.1% as at 9M'18, though still above the regulatory benchmark of 5%. While sustained economic stability is expected to support earnings capacity of obligors within select sectors (such as Manufacturing and Telecommunications) for most of 2019, we foresee pressure on the Oil & Gas sector – upstream especially – given projected soft oil prices and contained oil production amid the OPEC oil supply cut. Given that the Banking sector remains highly exposed to the Oil & Gas sector, we see the potential for renewed uptick in non-performing loans driven by a weaker cashflow for oil borrowers to better service their borrowings. On a positive note however, we expect a reprieve for asset quality in the banking sector from conclusions of loan restructurings that started since 2017. Notably, following the successful completion of the Etisalat sale to Teleology Holdings, we believe banks with exposure to the telco will begin to record loan recoveries. Nonetheless, we expect average NPL ratios across the sector to remain above the recommended limit of 5%.

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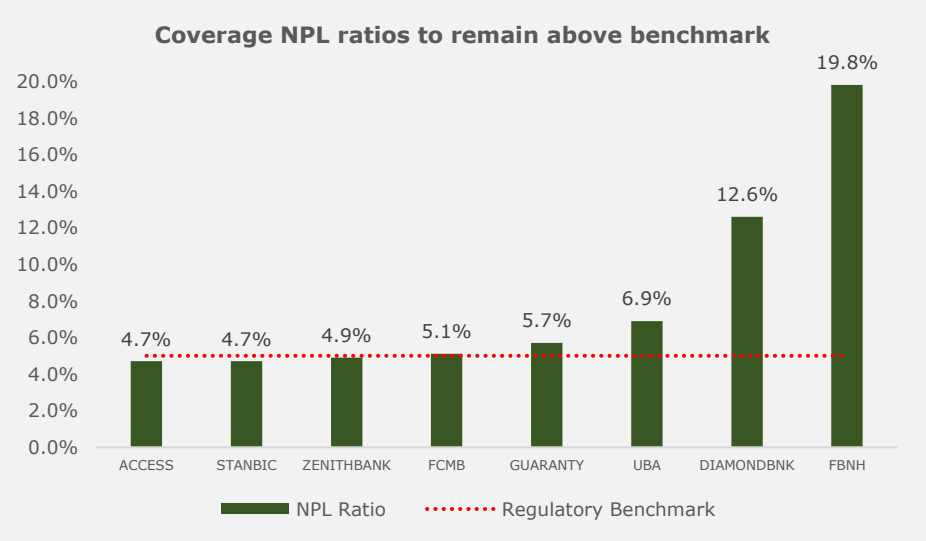

Source: Company filings, Vetiva Research

Expect another year of improvement in PAT for Banking sector

Despite weakness in interest income in 2018, growth in gross earnings still came in at modest levels, average 4.5% y/y rise across our coverage as at 9M'18, supported by strong performance in the non-interest line. We expect even stronger growth in gross earnings in 2019 will be driven by sustained robust performance in non-interest income as well as a recovery in the interest income line. Notably, stronger business activity – more so in the

Q1'18 election period – is expected to buoy income from fee & commissions as well as e-business revenue. Meanwhile, higher interest income in the year will be driven by our expectation for marginal uptick in loan growth and stronger yield on assets. While the net effect of higher interest rates will vary across the banks, depending on their efficiency and scale, taking a cue from 2018, we expect the rise in interest income to be potentially doused by an stronger growth in interest expense on average. Overall, we forecast sustained sturdy growth in bottom line across our coverage in FY'19 driven by higher income, modest movement in NPLs and contained operating expenses amid relatively benign inflationary pressures.

We believe stock market investors will continue to favour banking stocks amid the tested resilience of their corporate performances in the past few years as well as the attractive potential returns and liquidity of these counters. Notably, dividend yield across the sector has averaged 8.2% in the last three years, above the market average of 5.1%. In line with the Nigerian equity market, valuations in the banking sector remain highly attractive with banks trading at an average 0.79x P/Bv compared to 1.13x of peers in emerging markets. We believe the downside on our coverage names will remain limited looking at current valuation and given the expected improvement in sentiment on the broader market post-elections in 2019, we expect an uptick in investor interest to drive some correction in market pricing, with the sector also extending the trend of outperforming the ASI.

We believe the downside on our coverage names will remain limited looking at current valuation and given the expected improvement in sentiment on the broader market post-elections in 2019

Source: NSE, Vetiva Research

Consumer Goods

Consumer Goods Sector

Expect a protracted, sluggish recovery in consumer demand

In spite of improvements recorded on a number of economic fronts, Nigeria's economic recovery remained sluggish and mild in 2018. Consistent disinflation, stronger external reserves and stable oil production were all unable to support growth stronger than 1.8% y/y as at Q3'18. This underperformance remains primarily driven by sustained weakness in the real economy as a weak fiscal stimulus, negative domestic credit growth and rigid productivity levels continued to subdue aggregate demand in the economy. With this, FY'18 GDP is expected to print at 1.8% y/y. Expectedly, consumer sentiment and confidence remained frail across most sectors of the economy. Specifically, GDP growth for Trade sub-sector (which accounts for c.30% of the Services sector and c.16% of the total economy) printed at 0.98% y/y in Q3'18, the first positive showing in the year. We however highlight slightly stronger performance in the relatively defensive fast moving consumer goods sector wherein growth remains supported by the growing population and volume stability arising from price moderation across select product categories. Notably, the Food & Beverages sub-sector – which contributed 45% to the manufacturing sector – recorded 2.9% y/y growth in Q3'18, above 1.9% recorded for the broader sector. Meanwhile, according to the Central Bank of Nigeria's Consumer Expectations Survey, the Consumer Confidence Index in Q3'18 printed at +1.5 pts (Q2'18: -6.3pts) in Q3'18 as survey respondents indicated a mild improvement in sentiment which was attributed to the positive developments in economic conditions.

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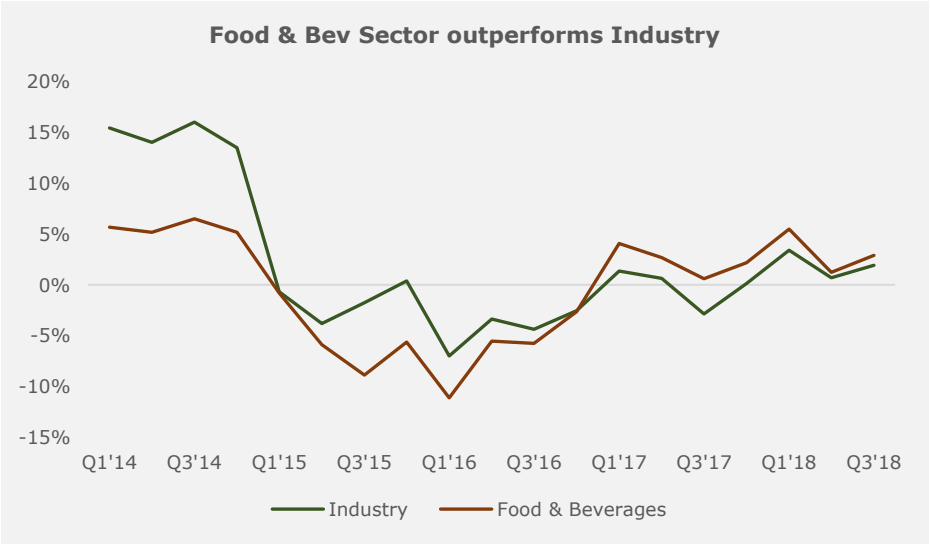
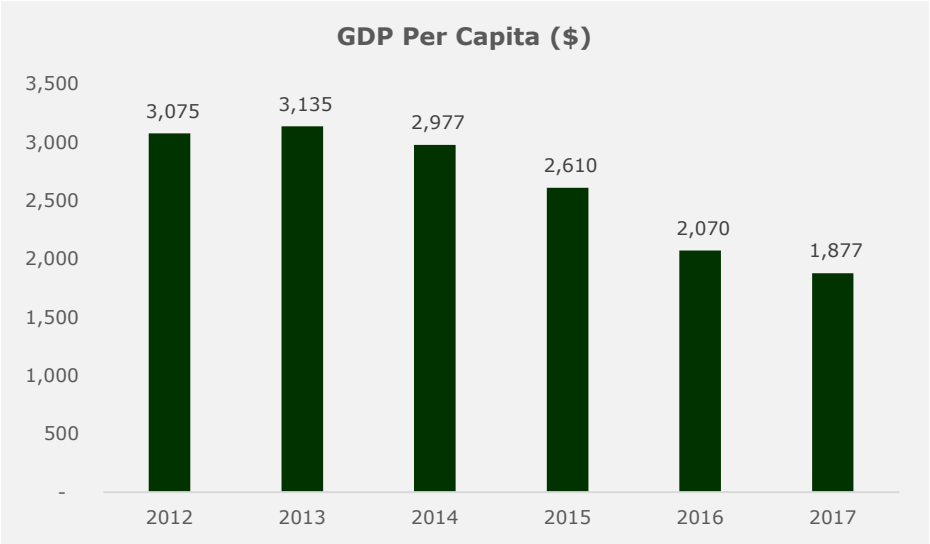


Source: NBS, Vetiva Research

While we expect domestic demand to continue to recuperate at a slow pace in 2019 in the absence of the required catalysts, we note a few wildcards that could support consumer spend in the year. Specifically, we expect a sturdy start to the year with economic activity supported by expected ramp-up in electioneering spending. While the impact of this on aggregate demand levels will be somewhat marginal and confined to the first quarter of the year, strong indications of a national minimum wage hike could potentially have a stronger multiplier effect on income levels and eventually consumer spending in 2019. Despite these tailwinds, the terrain remains fraught with challenges as possible security concerns and heightened economic volatility –

particularly on the price & exchange rate fronts – could undermine fragile consumer confidence and recovery. Nonetheless, we forecast a 2.7% y/y GDP growth for 2019 (FY'18E: 1.8% y/y). In the near to medium term, we expect consumer purchasing power to remain weak and economic growth confined to population growth rate levels in the absence of the necessary fiscal boost – effectual government spending and targeted policy changes – that can transform Nigeria's growth trajectory.



Source: NBS, CBN, Vetiva Research

Truth or Tale: Electioneering supports consumption levels

Election cycles in Nigeria bring about significant fund-raising activities for campaign financing across thousands of positions up for contest on the federal level. As such, it is a widely pedaled notion that consumer spending picks up in election years supported by electioneering spend during the political season. While it is difficult to find any conclusive evidence of an uptick in disposable income around election periods, we believe the quantum of finances reportedly spent in the election process contribute at least a marginal, but short-lived, uptick in consumption. Although this may be more evident across select sectors relevant to the process such as advertising, technology infrastructure & equipment, logistics, non-durables. Notably, while the Electoral Act stipulates a ₦1 billion maximum spending ceiling for presidential campaigns, this limit is largely unenforced even as traceable media expenses from the two major political parties was reported at ₦11.7 billion in the 2015 elections according to the Center of Social Justice. Meanwhile, the Independent National Electoral Commission (INEC) reportedly estimates that political parties spent about ₦196 billion in total to contest for various offices in 2015. We expect election spend to remain elevated going into 2019, and even potentially increasing given that registered political parties have increased from 44 in 2015 to 91 currently. Overall, we believe the effect of election spending on aggregate domestic demand is not particularly strong in Nigeria and will remain marginal in 2019 - limited to Q1'19. In fact, we highlight a possible downside to consumer confidence and spending in the case of heightened political uncertainty in the run-up to or as a fallout of the outcome of the elections.

We believe the effect of election spending on aggregate domestic demand is not particularly strong in Nigeria and will remain marginal in 2019 - limited to Q1'19.

S/no	Description of media expenses	PDP/Goodluck Jonathan	APC/Muhammadu Buhari
	Campaigns and Rallies	N1,280,374,879.00	N671,062,200.00
	Expenses on Billboard	N473,160,000.00	N190,380,000.00
	Electronic Media Campaign	N532,100,000.00	N410,050,000.00
	Electronic Media Adverts	N3,988,822,125.00	N1,064,706,850.00
	Print Media Campaign	N2,475,228,301.00	N579,647,687.00
Total		**N8,789,685,296.00**	**N2,915,846,737.00**

Table 4: PDP and APC media expenses for the 2015 elections (source: Centre for Social Justice)

A minimum wage increase is our base scenario for FY'19

An upward review of the national minimum wage has been on the table for a few years now, especially given that the last increase in the wage floor (from ₦5,500 to ₦18,000) was implemented about eight years ago - after which inflation has averaged 12% annually and the currency depreciated c.49% since then. While previous efforts to introduce a higher wage had been somewhat futile, a more concerted effort by the labour congress at a seemingly advantageous time garnered stronger commitments and traction from the government in 2018 which forms the basis of our expectation of a minimum wage review by Q1'19. While figures as high as ₦60,000 were discussed during the negotiation process, latest update from the tripartite committee recommends a ₦30,000 wage figure – 67% rise. While the proportion of wage increases may taper across higher worker cadres, nor improve compliance with the wage floor outside the federal government, we expect an increase in salaries of low-wage workers to boost income levels and potentially support modest growth in consumer spending. Notably, workers earning at this income level are most likely to spend the additional income directly into the economy given the economic load they had been subjected to. Nonetheless, we note that potential downside economic factors may accompany a minimum wage hike. Specifically, we predict modest inflationary pressures resulting from the salary increase – demand pull & cost push – and a tangible impact on unemployment particularly in the recessionary environment.

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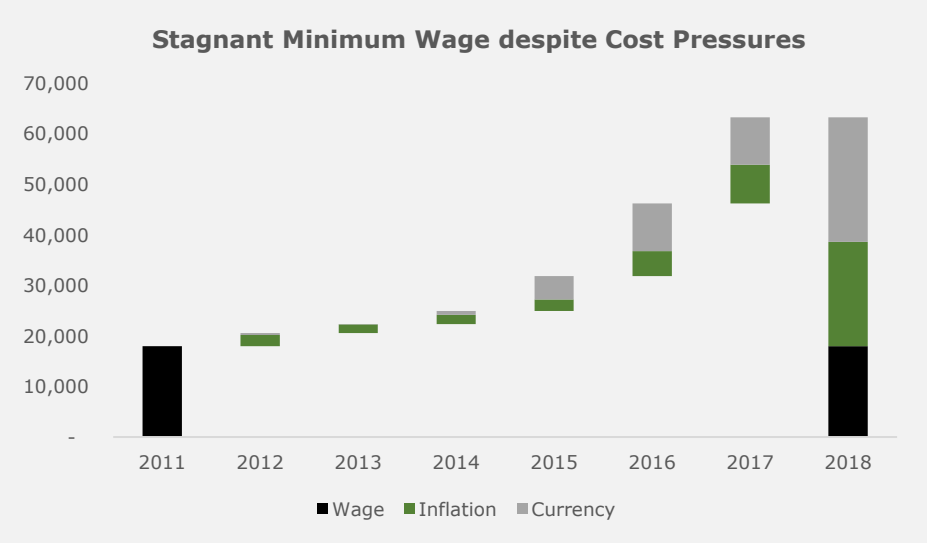

Source: NBS, CBN, Vetiva Research

Growth in durables to remain on the backburner

Given that spending on durables and capital goods are highly correlated with economic and business cycles, we expect growth across companies that produce these products to remain subdued even as Nigeria remains at the nascent stages of an economic recovery. Notably, most households will continue to defer purchases of durables even as disposable income growth and consumer financing options in Nigeria will remain limited. Notably, the dichotomy in the performance of durable & non-durable product companies listed on the Nigerian Stock Exchange has been quite evident. For instance, while revenue growth (inclusive of pricing) in the mostly Home & Personal Care company UNILEVER has risen 67% since 2015, average topline growth for PZ printed at 10% in the same period, dragged by a 15% decline in its White Goods segment. Meanwhile, for capital goods, sales in UPDC – the real estate arm of Conglomerate UACN – has moderated 67% in the past four years. For 2019, the economy is expected to expand at a slightly healthier pace in the second year of the recovery – albeit not strong enough to drive growth for non-durable goods.

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Sustained stability in macro conditions, operating terrain still rough

With a forecasted growth estimate of 3.7% for FY'19, we expect the manufacturing sector to continue to drive economic growth next year. Specifically, in line with the trend in FY'18, we expect continued output growth from Food & Beverages to buoy the sector in FY'19 – Food sub-sector recorded 3.2% y/y growth as at Q3'18 and contributes 45% to the Manufacturing sector. Nigeria's Purchasing Manager's Index (PMI), a leading indicator of business activity, has continued to show improvement in productive activity in over 12 months with November PMI printing at 57.9 from 56.8 in the previous month. The expectation for a stable macro environment is further supported by our expectation of a scant uptick in average inflation for the year (FY'19E avg. inflation; 12.6%, FY'18E; 12.2%). Despite the stable macro environment, Nigeria's rough operating environment is something FMCGs will continue to navigate – characterized by a fragmented currency market, weak road infrastructure (Apapa gridlock more so), unstable power supply etc. That said, we are quick to highlight two major downside risks to operating conditions in 2019; (1) resurgent currency pressure (2) political uncertainty/unrest in the wake of the election season. While we expect the apex bank to keep a tight lid on the currency by burning through reserves to support FX liquidity for most of the year, we see the likelihood of a currency depreciation – specifically at the I&E FX window – towards the latter part of the year as the reserve bank potentially reaches its threshold. Given the timing however, we do not expect effects of this adverse movement in the currency to be evident on Consumer Goods companies' books in FY'19 with potential negative impact on gross margin and FCY liabilities evident in the next year. While the 2019 general elections seem less likely to incite political unrest, we emphasize the risk of upheaval and insecurity during election years.

Turnover growth remains majorly hinged on volume performance

Revenue growth across our Consumer Goods Coverage was considerably mixed in FY'18, with average topline growth of -3% as at the 9M'18 period. Notably, in the absence of price-driven growth in the year, positive topline growth across select names was majorly driven by resurgence in consumer demand & thus a modest uptick in volumes, with growth any stronger than mid-single digit further supported by internal investments and strategies by individual companies. Specifically, UNILEVER and NESTLE recorded the strongest revenue performances across our coverage with 9M'18 revenue up 11% y/y and 10% y/y respectively. Meanwhile, a more difficult operating terrain affected the Brewers & Sugar producers amid a more competitive environment and weaker pricing power from the companies. For FY'19, we forecast a similar revenue trend as the previous year however with a slightly more positive tilt. We expect revenue growth to remain majorly hinged on volume performance and thus forecast an average mid-single digit topline growth for the sector driven by continued improvement in consumer demand across most FMCG product categories and population growth. As mentioned earlier, the sluggish recovery in demand is expected to receive a modest boost from election spending and a possible minimum wage hike.

That said, one major theme that continues to negatively impact revenue growth for some consumer companies is intensifying competition. While the dominant brewers continue to contend with aggressive investment and beer supply ramp-up from International Breweries, sugar producers such as Dangote Sugar have had to deal with competition from illegal importation of refined sugar flooding their major consumer markets. For the Agro-Allied sector (Flour Mills & UACN), competition remains fierce following significant capacity expansion and disruptive entrance of Olam Nigeria in H2'17. We note that the increased competitive pressure has had an even stronger impact given subdued consumer spending and weak volume growth – which has also contributed to the weaker pricing power of these companies in the year. While we expect a y/y improvement in revenue for sugar producers, supported by the lower 2018 base, the Brewery sector will continue to face pressure from a further increase in excise duties in 2019 – from ₦0.30/CL to ₦0.35/CL – which will reflect on the net revenue line. We thus forecast further y/y moderation in net revenue for the brewers even as passing on the higher cost remains difficult for them.

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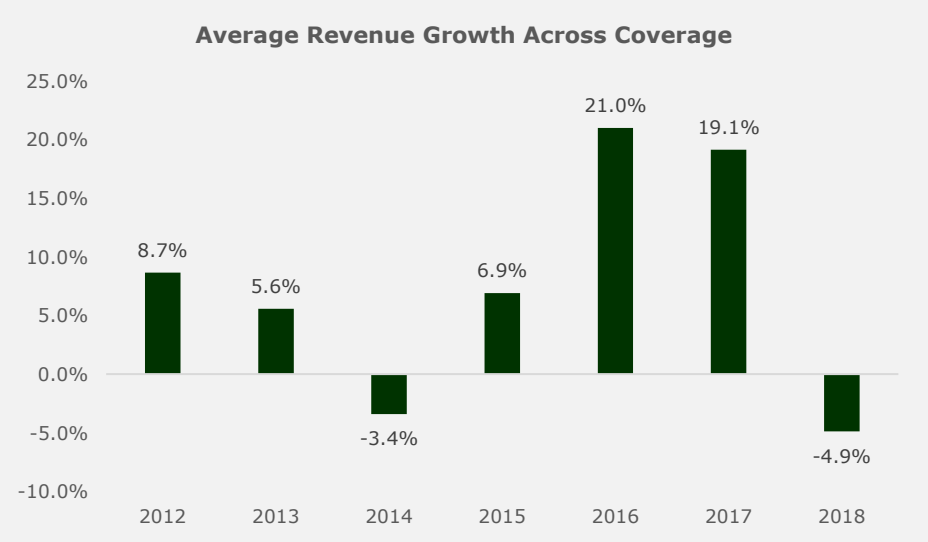
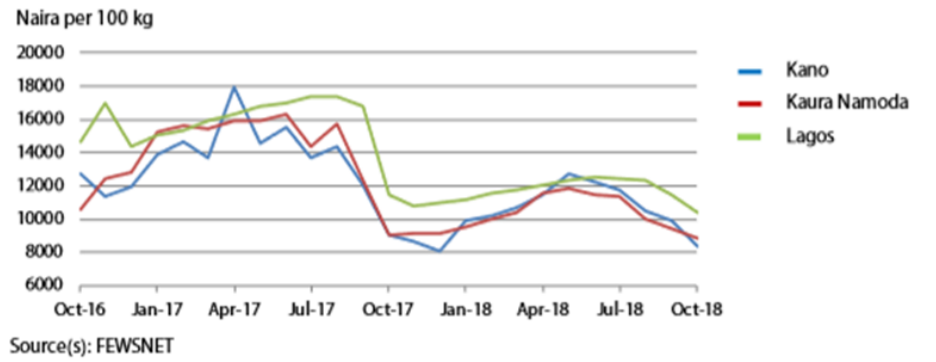


Source: Company Filing's, Vetiva Research

Raw material prices to stabilize in FY'19 season

While the disinflationary trend in 2018 saw domestic food prices remain stable for most of the year, a combination of flooding and herdsmen attacks across major food producing states in the middle belt put pressure on food prices in the middle of the year. This disruption in food production however does not seem to have noticeably impacted the large multinational FMCGs whose local raw materials are sourced more from the Northern parts of the country. Given this, while the risks to food disruption from flooding and civil conflict in the Middle Belt persist going into 2019, we believe domestic input prices for FMCGs across our coverage will remain broadly stable. Meanwhile, even though Consumer Goods companies continue to invest in stronger domestic local sourcing (see H2'18 Outlook *In the Shadow of The Polls*), we only expect substantial traction from this to accrue in the medium term and upon stronger capital investments in backward integration projects. As such, the foreign component in raw materials utilized by these firms will remain at an average 60% in FY'19.

Wholesale prices of maize in Nigeria



Source(s): FEWSNET

Similar to the domestic trend, global food commodity prices trended lower in 2018 with the FAO Food Price Index falling 5% from the start of the year to November – driven by declines across all major sub-indices (Sugar, Oils, Dairy) save for Cereals/Grains (impacted by drought in Europe and Central Asia & higher energy prices. Global agri-commodity prices are expected to reverse direction in 2019, with prices of key staple foods predicted to stabilize from current levels and at best edge up marginally in the year albeit with current trade and energy clashes expected to remain the biggest risks for food prices. Specifically, sugar is expected to remain in a bear market even as the current surplus extends into the new season (October 2018 – September 2019). That said, with sugar production from Brazil and other parts expected to moderate in 2019 – an offshoot of a larger share of sugarcane directed towards ethanol production - raw sugar prices will mildly rise from 2018 lows. Meanwhile, prices of energy-intensive crops such as grains and oilseeds are forecasted to rise slightly in 2019, with the World Bank Grains Price Index projecting a scant 1% uptick amid volatile energy and fertilizer prices. Overall, the World Bank Food Index forecasts a 1.5% y/y rise for 2019 with key risks to this outlook listed as escalation of trade clashes, continued strengthening of the U.S. dollar, further currency depreciation of commodity exporters, volatility of energy and fertilizer prices and diversion of food commodities to biofuels.

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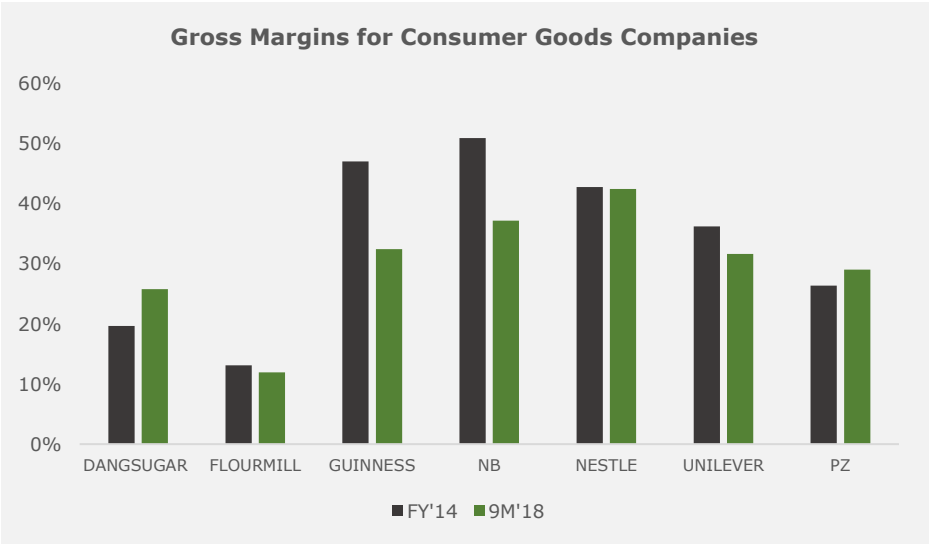
World Bank Price Forecasts			
Commodity	**2018E**	**2019F**	**2020F**
Palm Oil ($/mt)	570	592	615
Sugar ($/kg)	0.28	0.28	0.29
Wheat ($/mt)	210	212	215
Barley ($/mt)	125	130	135
Soybeans ($/mt)	410	419	428

Source: World Bank, Vetiva Research

Historical gross margin evolution shows negative trend

Stripping out the Brewers, gross margin across our coverage companies expanded 50bps y/y on average as at 9M'18, supported by the earlier mentioned price moderation on select raw materials. The brewing companies – NB and GUINNESS – recorded an average 233bps y/y gross margin moderation as at Sept 2018 stifled by a weaker price mix and input costs and amid the new excise duties regime. Notably, we highlight the negative evolution of gross margins across the Consumer Goods space in the last five years, wherein average gross margin across our coverage has contracted 366bps from 2014 to date. This drop has been driven more by the margin erosion witnessed in the brewing segment – 14.2 percentage points decline – amid consumer down trading as well as inflationary & exchange cost pressures that have not been adequately passed on to consumers. We believe the overall downward trend and a lack of recovery in these margins also reflects a weaker pricing power amid pressured consumer wallets and intense competition. For 2019, we don't expect any significant improvement in margins given the benign movement expected in raw material prices, expected sticky inflation and limited price increases from FMCGs.

The brewing companies – NB and GUINNESS – recorded an average 233bps y/y gross margin moderation as at Sept 2018 stifled by a weaker price mix and input costs and amid the new excise duties regime.



Source: Company Filings, Vetiva Research

Not much margin catalyst for bottom line growth in 2019

We do not see much room for a margin boost supporting bottom line growth in 2019 and foresee the profit line mirroring revenue growth more. After a two year period of embarking on cost optimization programmes to rid operations of inefficiencies and successfully keeping operating expenses contained, we foresee little to no more upsides from these cost cutting projects as FMCGs capitalize on the efficiencies discovered in this process. Notably, we see room for a resurgence in marketing budgets which could prove more efficient now as consumer wallets begin to recover. Furthermore, while stable inflation is expected to keep overheads in check in 2019, we see the possibility of higher administrative costs driven by the expected minimum wage hike. While it is possible not even a minor portion of the employed workforce across our coverage is earning at current minimum wage levels, we believe the domino effect of a shift in the lowest salary tier in the nation could put upward pressure across the band.

In terms of financing costs, Vetiva forecasts an increase in the benchmark borrowing rate (+50bps) and an uptrend in money market rates in 2019. We expect this to drive a modest rise in financing expenses. This comes in contrast to the notable moderation recorded in net finance costs in 2018, supported by declining market rates for most of the year and benefits from the significant deleveraging exercises in 2017 to early 2018. In tune with this, most consumer goods companies will continue to enjoy relief from any debt burden despite the mild uptick in rates on borrowing. We however highlight the potential for cheap credit from the CBN's Real Sector Support Fund which is aimed at providing capital at single digit interest rates to companies such as the FMCGs.

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Meanwhile, firms will continue to refinance maturing short-term obligations from the commercial paper market in spite of the rate trajectory. Away from this, the most volatile line on the books of most consumer goods companies – and manufacturers operating in the Nigerian market at large – will remain foreign exchange losses. Though size of these losses have reduced substantially, expected currency pressure in the coming year could bring a renewed uptick in FX losses amid the fragmented currency market structure. That said, we do not expect the potential devaluation (naira forecasted to depreciate to ₦390/$ by Q4'19) to visibly impact consumer goods companies' books in 2019. Overall, the downsides to profit margin evolution in the coming year are more significant and as such we forecast profit after tax to grow at a single digit rate on average, mostly in line with sales growth. While we expect subdued growth from the brewers to persist, we forecast a recovery in bottom line for sugar company, Dangote Sugar supported by the low base from 2018 (PAT down 37% y/y in 9M'18). We are more bullish on the growth capacity of NESTLE and UNILEVER given the strong revenue and profitability in the past two years. Meanwhile, PZ's earnings performance is expected to remain weak in the year as its White Goods segment (c.30%) continues to underperform.

Another year, another underperformance

As expected, the Consumer Goods sector continued to underperform the broader market in 2018 with the sector recording a 26% ytd decline (as at 14 Dec) compared to a 20% loss for the NSE All-Share Index. With expectations of still skittish sentiment in the equity market for 2019, we believe this trend will persist with the Banking Sector remaining more preferred given the perceived stability. Also, modest earnings growth expectation for the sector will see investors continue to cherry pick across stocks that outperform in financial performance and some cheaply priced counters that have been beaten down. Specifically, while UNILEVER and NESTLE will remain investor's haven in the Consumer Goods sector, we also foresee an uptick in interest and recovery for DANGSUGAR and FLOURMILL on the back of decent earnings and attractive valuations. Meanwhile share performance on PZ and UACN (major food & agro-allied conglomerate) may remain unencouraging as earnings recovery is not fast enough. Investors will remain wary of downside factors affecting brewers, Nigerian Breweries and Guinness in 2019 although we do not expect the stocks, particularly NB, to fall below multi-year lows seen in 2018. Taking from our 2.5% point estimate return for the NSE in 2019, we predict a -5% to 0% return for the CNS sector. The Consumer Goods sector currently trades at a P/E of 19.58 (ASI: 9.27x) with dividend yield of 3.5% (ASI: 5.4%).

Source: Bloomberg, Vetiva Research

Agriculture

Agriculture Sector

Cautiously optimistic on conflict resolution

Whilst the Agriculture sector expanded at a pace of 1.9% y/y in Q3'18, up from 1.2% y/y in Q2'18, the growth rate still fell significantly below the 5-year Q3 average of 3.5% y/y. Our projected GDP growth for FY'18 is 2.0%, the slowest sector growth since 1993. The weak sector GDP comes on the heels of heightened insecurity in food producing regions, mostly by herdsmen competing for arable land with farmers. The conflict has had a negative impact on food prices, with food inflation staying at double digits (13.3%) in spite of a high base, even as core inflation has moderated to a single digit figure (9.8%) in November. Clashes have actually ameliorated in recent months, with Armed Conflict Location Event Data Project (ACLED) reporting an 88% drop in herdsmen related violence from a January peak. That said, we note that movement of cattle is usually lower in the rainy seasons and highlight an outlying possibility of resurgent violence in 2019, though we do not anticipate a repeat of 2018 levels. To tackle this, the FG has unveiled a National Livestock Transformation Plan aimed at resolving some of the major grazing problems and reducing conflict between farmers and herders. Here, they attempt to propose a holistic solution, which entails investing c.₦179 billion over 10 years under key themes; economic investment, conflict resolution, law and order, humanitarian relief, information, education, strategic communication and cross-cutting issues. As part of the scheme, large ranches (to be jointly funded by FG and states) would be set up in 10 key states, identified as frontline states. We are cautiously optimistic that this plan, along with intensified security measures across affected areas would go a long way to reducing conflicts. However, we note that implementation would be key. Specifically, we would like to see provisions for this plan in both the states' and FG's 2019 appropriation bill.

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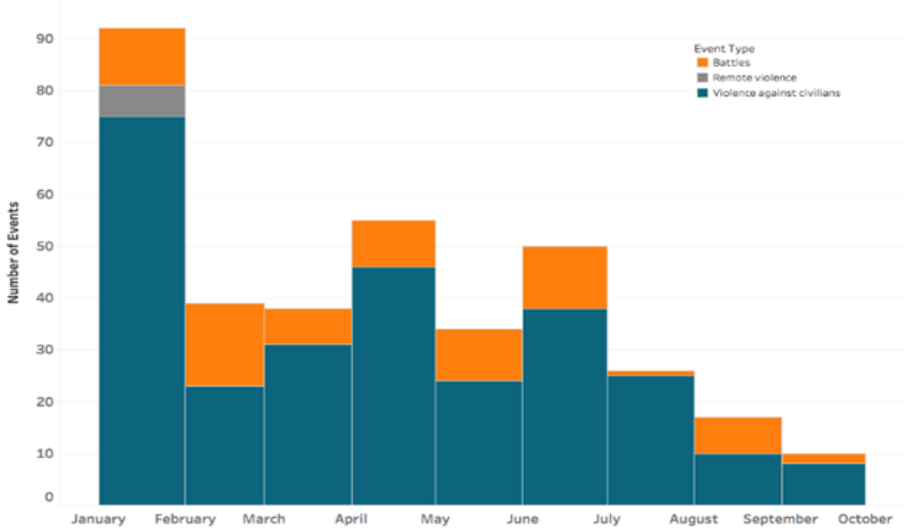
Number of Violent Events Involving Fulani Militias in Nigeria by Type (1 January 2018 - 29 September 2018)



Source: ACLED

Flooding presents another cause for concern

Another cause for concern on Agricultural output is flooding. In the past 2-3 years, we have seen an increasing amount of rainfall and consequently, flooding in several key states in Nigeria. The National Emergency Management Agency (NEMA) recently declared a national disaster in 9 states in September due to flooding. NEMA estimates that c.156,000 ha of cropped land were damaged, with Yams, Cassava, Rice, Maize and Sorghum crops the worst affected. Interestingly, a report from the National Agricultural Extension and Research Liaison Services (NAERLS) puts this estimate at a much higher figure and also reports that some farmers have been displaced by the flooding. To put this in perspective, total cropped land in Nigeria is estimated at 33 million ha. We expect flooding to remain an issue in the near term as the NAERLS has predicted that rainfall would remain at these levels and with Nigeria's dams already at capacity, this should cause excess water to flow beyond the river banks. In October, the FG received $400 million from the European Union to assist victims of flooding and help sensitize dwellers in flood prone areas about safe waste disposal practices to curb the occurrence of flash flooding.

Anticipating another weak FMARD budget

Meanwhile, even as the FG embarks on another expansionary budget in 2019, we do not foresee a significant enough increase in the expenditure plan for Federal Ministry of Agriculture and Rural Development (FMARD) in 2019. Taking a cue from the 12% proposed increase in total spend, we estimate a 2019 FMARD budget which translates to c.2% of total spend, still lower than the prescribed 10% minimum agreed to by signatories to the 2003 AU Maputo declaration. Given the sector's tag as the country's major route to revenue diversification, we see this budget as contradictory and not robust enough to make any significant impact. The sector remains populated by smallholder farmers (estimated at 80%), with low yields, poor agriculture education, scarce access to storage, markets and other support services as well as still weak – though steadily improving – access to funding to increase scale. Government intervention and support will be key to unlocking the sector potential and eliminating the structural problems hindering sector advancement.

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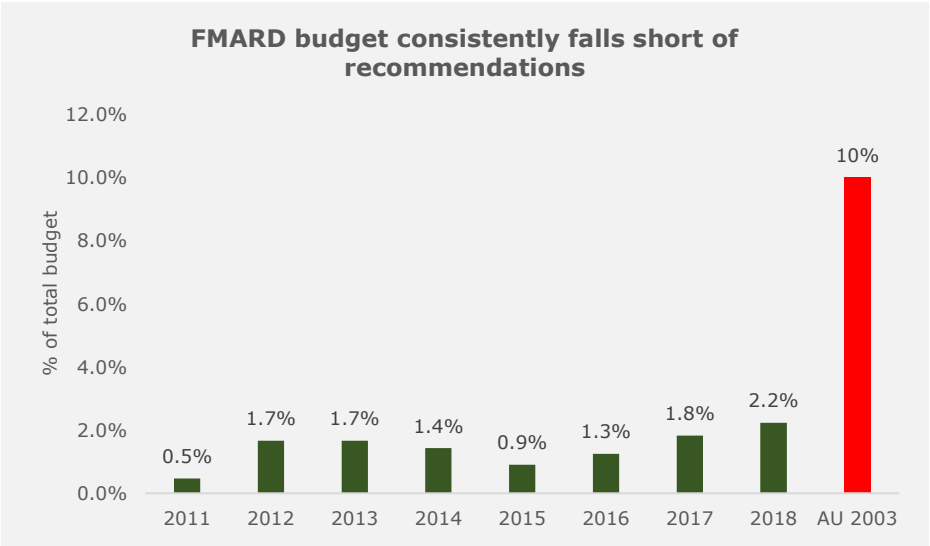

Source: NBS, Vetiva Research

Fragile recovery expected in 2019

Overall, we are cautious on the growth prospects of the agriculture sector in 2019 and anticipate a base growth of 2.6% y/y, higher than 2018 expectation (2.0%) but lower than 5-year average growth rate (3.7%). That said, we still highlight the long-term growth potentials of investing in the sector, given the country's c.3% population growth rate, c.60% unutilized arable land, low consumption per capita across most major crops, weak mechanization rate and fertilizer penetration. However, we note that for the sector potentials to be fully realized, adequate investments have to be made across the entire agribusiness value chain in concert with supporting policies and structural improvements.

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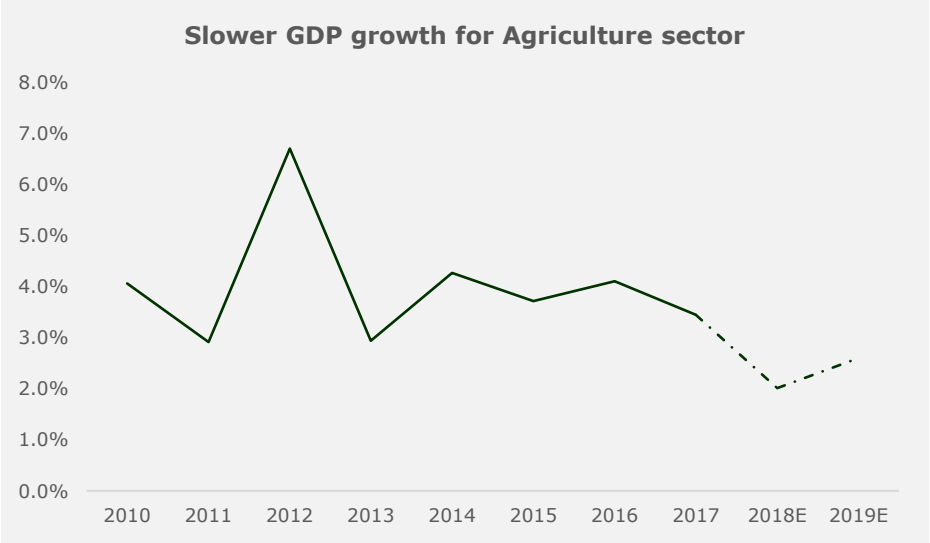


Source: NBS, Vetiva Research

Crowdfunding in Agriculture: Trend or disruption?

With many Nigerian lenders still risk averse with regards to lending to the agriculture sector, Nigerian farmers are now increasingly looking to retail investors for expansion capital, by way of crowdfunding. Traditional crowdfunding in itself is not a new concept in the Nigerian financial system. However, its incorporation into the Agricultural financing chain is a phenomenon which until a couple of years ago was limited to smallholder farmers financing agriculture projects by raising small amounts of cash from family, friends and co-operative societies. Today, there are online platforms dedicated to raising funds for smallholder farmers looking to expand production. These platforms have grown in popularity in recent times, with one of the more popular sites claiming to have raised capital for over 7000 farmers since inception. Investors are reeled in by above-average returns on investment, while feeling a sense of pride from contributing to the nation's agricultural aspirations. Farmers on the other hand, are happy with the access to funds, otherwise unavailable from traditional lenders as well as the training and extension facilities extended by the platforms. It appears that the crowdfunding programs operate models similar to either Project Finance or ordinary equity investments, supported by contract production and lease of operating equipment.

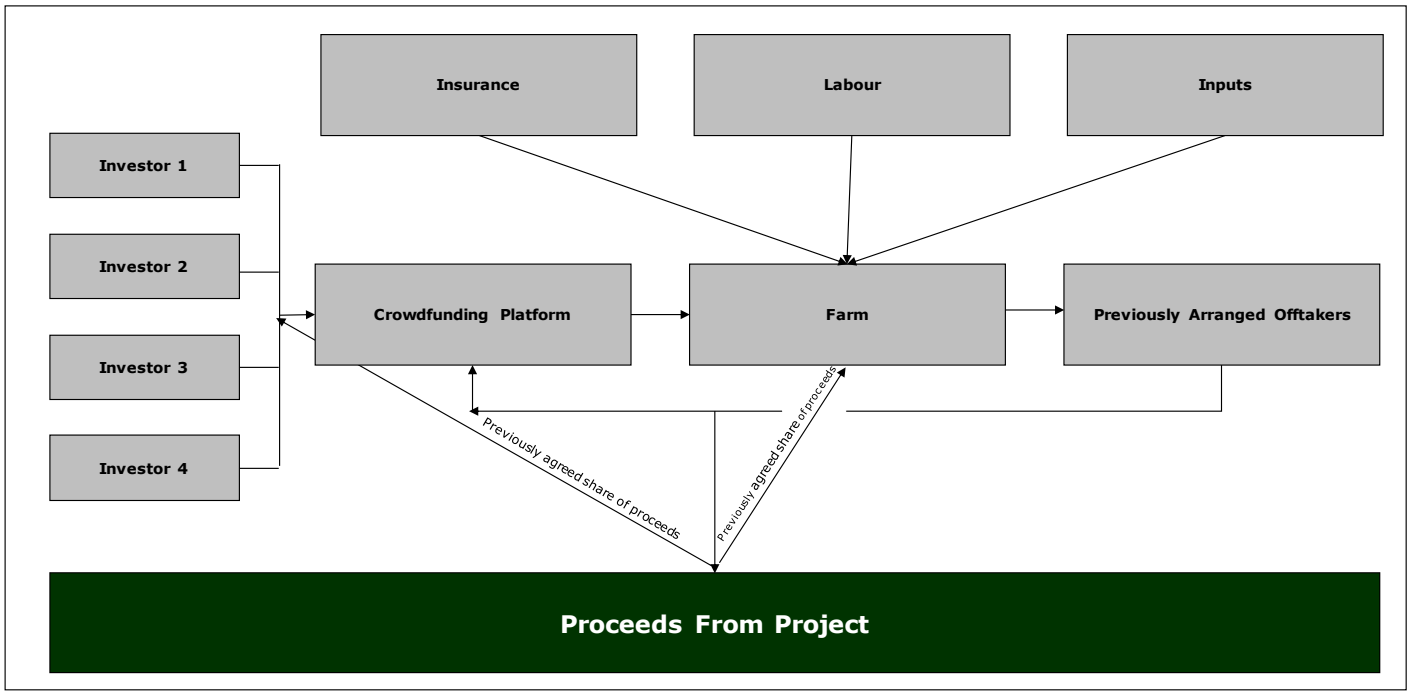
The Project Finance Model: This is the simpler and more popular of the two models. Here, investors provide capital and earn returns only from the income generated from the project.

At the end of the investment cycle, the investor is repaid their principal with interest and holds no further claims on future cashflows from the farm. As with most capital raises, there are three key parties each bringing something to the table;

i) The surplus spending unit – These are the providers of capital, mostly comprising retail investors. Their major responsibility is to provide information required by the intermediary and funds when requested. Here, the investor is basically a debtholder and earns returns after the project has been completed and the produce sold, whilst risk is usually limited to returns.

ii) The Intermediary – These are the crowdfunding platforms themselves. In addition to connecting the investors with the farmers, the platform also provides extension services to the farmers and insurance coverage on the farms. Also, most claim to connect the farmers to willing buyers before planting begins, creating a ready market for products post-harvest.

iii) The Deficit spending unit – These are the farmers in need of capital. Their only major responsibility in this venture is to cultivate the crops that are to be sold.



Source: Vetiva Research

The Equity model: Here, the platform sells the farm to the investor and then provides input, training and labor at a cost. The crops/livestock produced belongs to the investor, who retains most of the profit. On the flip side, all the risk is also borne by the investor. This model is typically called virtual farming and is a relatively new concept across the globe.

Given the relatively untapped potential across Nigeria's Agriculture value chain as well as continued support for the sector from FG, we believe that Agro-crowdfunding in Nigeria still has significant room to expand and could be instrumental in opening up new funding channels across the agri-business value chain as well as improving access to markets.

Oil Palm sector

There is still oversupply…. but it's dwindling

The outlook for Crude palm oil prices in 2019 is relatively positive. On one hand, amid a weak global growth outlook and an ongoing subsidy dispute between Indonesia and the EU, demand for biofuels (with oil palm-based fuels accounting for a significant portion) could be slightly weaker even as product oversupply remains present. On the other hand, a drought in key producing areas in Indonesia and Malaysia in Q3'18 – average rainfall 50% and 35% lower than in 2017 respectively – made cultivation more difficult. The drought has continued well into Q4, with November rainfall in Indonesia coming in 65% below the 5-year average. The reduced rainfall is expected to lead to lower harvests in H2'19, which should support prices. Furthermore, prices are expected to be supported by expected increases in demand from India and Indonesia, the largest consumers of CPO. The boost in India is driven by an expected reduction in import duties for CPO and Refined oil while Indonesian consumption should improve amidst an increased focus on biofuel use. Overall, we see slightly higher global CPO prices in 2019. Currently, CPO prices have fallen 17% YTD to $511.53. In line with Fitch ratings, we project a *c.*6% y/y rise in CPO prices in 2019. We also expect this to translate to local prices, as the expected c.7% currency devaluation in 2019 should make imports of CPO and refined oil a little less attractive.

Overall, we see slightly higher global CPO prices in 2019. Currently, CPO prices have fallen 17% YTD to $511.53. Fitch ratings however projects a c.6% y/y rise in CPO prices in 2019.

Source: Bloomberg, Vetiva Research

In the longer term, we see more support for CPO prices, driven by an impending shortage of supply from Indonesia. Following widespread condemnation of local oil palm farming practices, the government of Indonesia instituted a freeze on new production licenses in September 2018. The freeze, meant to last for three years, also extends to projects that are in the process of obtaining the license but had not been granted as at the time of announcement. Indonesia is currently the largest oil palm producer in the world and a freeze in licensing new plantations is expected to have a significant impact on global production and we foresee this development supporting prices up until 2021 when this freeze will end.

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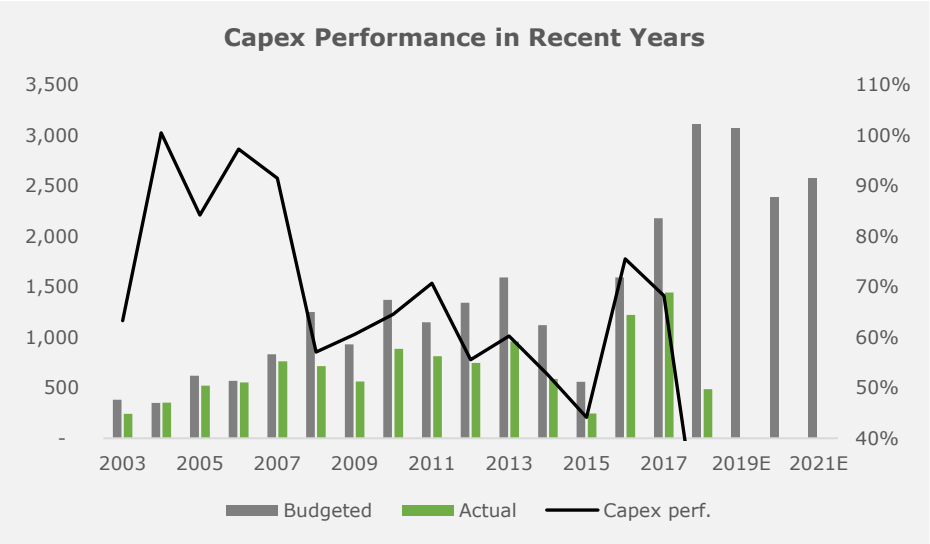
Industrial Goods

Industrial Goods Sector

Heightened political climate could distract from capex disbursement

After a weak 2017 for cement demand driven by high cement prices and a harsh economic environment, 2018 was a renaissance year for the Nigerian cement market, with 9M'18 consumption estimated at 15.6 million MT, 10% higher than the same period in 2017. Despite consumption slowdown in the latter parts of the year, due to higher than usual rainfall, Q3'18 volumes (4.4 million MT) still came in 10% higher than Q3'17. According to most producers, this revival has been spearheaded by increased demand from Federal Government (FG) projects and Public-Private Partnerships (PPPs), amidst another expansionary capex budget (₦3.13 trillion). The renewed demand has been echoed in the GDP figures, with the cement sector expanding y/y in all three quarters this year (Q1'18: 5.3%, Q2'18: 3.8%, Q3'18: 8.1%), compared to the same period in 2017 (Q1'17: 1.8%, Q2'17: -4.2%, Q3'17: -4.6%). According to the 2019-2021 Medium Term Expenditure Framework (MTEF) document presented to the National Assembly, the FG is proposing a near-flat (2% lower y/y) Capex spending plan of ₦3.1 trillion in 2019. That said, actual capex disbursement, not the budget standalone, would be key to determining FG's impact on cement demand. Historically, Nigeria has mostly underperformed capex budget, with implementation peaking at 75% in the last 11 budgetary sessions. Capex disbursement has been weak since 2018 budget passage in July, with only ₦486 billion of a possible ₦3.1 trillion rolled out. Overall, FG consumption in 2018 was mostly driven by 2017 budget spend in the first half of the year. In light of the upcoming general elections, we are understandably not optimistic about disbursement in the first half of 2019, especially with the seemingly tight nature of this race and we draw comparisons to 2015 – the year of the previous, also keenly contested election. Capex disbursement in 2015 stood at 44%, the weakest in over 12 years, especially considering that the budget was the lowest since 2004. We however anticipate better capex rollout post H1, following the conclusion of all major political events. Overall, we expect weaker growth in cement demand from the public sector in 2019.

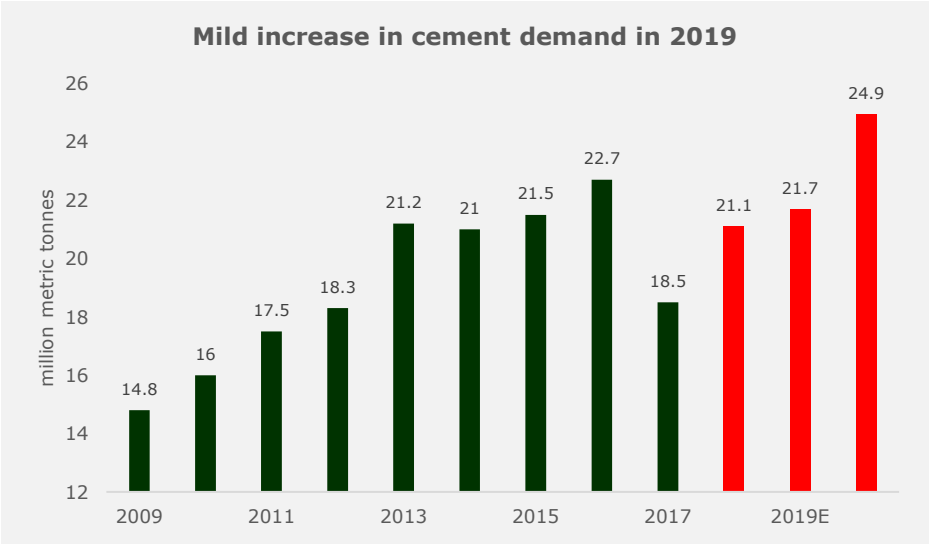
In light of the upcoming general elections, we are understandably not optimistic about disbursement in the first half of 2019, especially with the seemingly tight nature of this race and we draw comparisons to 2015 – the year of the previous, also keenly contested election.



Source: Budget office, MTEF, Vetiva Research

Private sector demand to support cement consumption in 2019

Meanwhile, in line with the general economy, private sector cement consumption has also improved in 2018. Taking a cue from Julius Berger's 9M'18 financial statements (private sector construction up 9% y/y), we believe private sector demand also expanded in 2018. Given our expectation of continued economic advancement in 2019 (2.7% y/y), we foresee further support for cement demand from the private sector in 2019. That said, we see a mild improvement in overall cement consumption in 2019 to 21.7 million Mt, with stronger private sector demand watered down by mildly weaker public sector consumption growth.



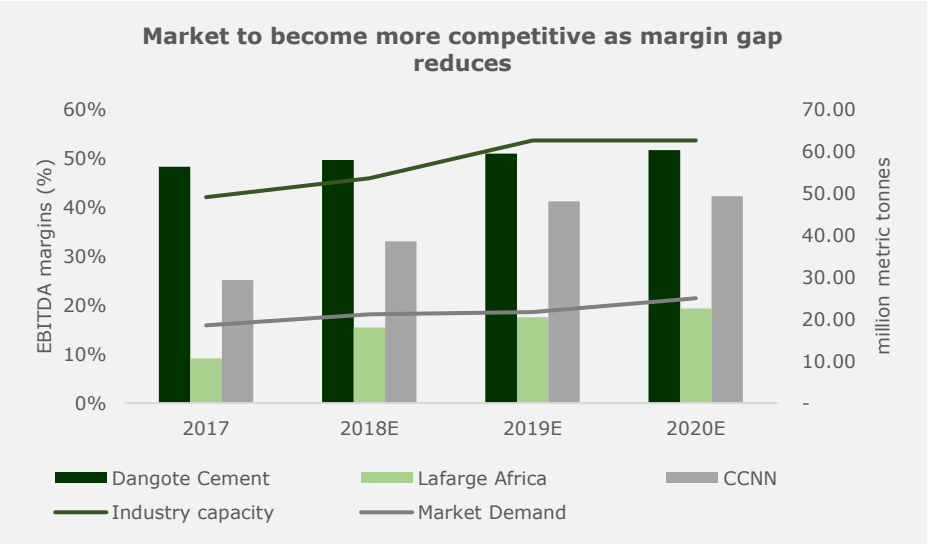
Source: Company filings, Vetiva Research

Will increasing competition drive prices lower?

After several years of competing for market share, we note that the focus of major cement producers in Nigeria shifted from volume to profitability after the devaluation of naira in 2016 drove energy costs higher. In line with this, we note a series of price increases over the past 3 years, with average revenue/tonne steadily increasing from ₦29,263 in 2015 to ₦43,821 as at 9M'18, mostly tracking inflation and currency devaluation. The price increases have been spearheaded by the largest producer assuming price setter status due to superior scale and the relatively weaker operating margins of its competitors. That said, we see a possibility of the dynamic shifting slightly in 2019 as cement majors ramp up their capacity and strive to improve efficiency. Specifically, the BUA group, currently the third largest cement producer in Nigeria, has added c.7.5 million MT to its annual production capacity in the last two years, moving from 1.0 million MT capacity to 8.5 million MT. More important is the switch from solely relying on expensive LPFO (2.0x to 2.9x the cost of gas) to diversified kilns, capable of running on coal (0.7x to 1.1x the cost of gas). Also, whilst Lafarge Africa has had its fair share of operational issues recently, the cement giant has embarked on a new initiative, with a focus on reducing logistics costs and improving operational efficiency. The new initiative has some potential, with average trip turnaround per month already improving from 5.3x in 2017 to 5.9x in 2018. Meanwhile, Dangote Cement also plans to expand production capacity in Nigeria, with a planned combined expansion of 9.0 million MT (6 million MT in Itori and 3 million MT in Okpella) in 2019 – as at last communication.

After several years of competing for market share, we note that the focus of major cement producers in Nigeria shifted from volume to profitability after the devaluation of naira in 2016 drove energy costs higher.

Overall, given the increasing scale of smaller cement players as well as the expected improvement in margins from cost containment, we see the market slowly moving towards a more competitive pricing environment. We believe we have seen a tilt towards lower pricing, with the introduction of the slightly cheaper Falcon 32.5 brand to cater to lower cost cement consumers. That said, apart from the product diversification, we do not foresee a direct price cut to any of the product lines in 2019, especially given our base expectation of a c.7% currency depreciation and 12.6% inflation in the year.



Source: Company filings, Vetiva Research

Expect some Primary Market activity in 2019

We see a strong probability of each of the three major cement producers hitting the primary equity market at some point in 2019, for capital raising or other reasons. First, Lafarge Africa has announced a plan to raise ₦89.21 billion via rights issue, at a price of ₦12/share, by issuing six new shares for every seven held by a shareholder. The issue proceeds would be used to pay down local currency debt and $22 million of shareholder loans as well as fund working capital. The issue opened on December 16, 2018 but is due to close on January 23, 2019. Also, CCNN recently obtained shareholder approval to carry out an acquisition of Kalambaina Cement Company (KCC), a sister company set up by BUA Group for the construction of a 1.5 million MT plant. The transaction would be carried out by means of share exchange, with 19,811,372 new CCNN shares exchanged for every 100,000 KCC shares. Considering KCC's 60,000,000 outstanding shares, 11,886,823,000 new CCNN shares would be issued to KCC shareholders, increasing CCNN's shares outstanding to 13,143,500,966. The original CCNN shareholders would effectively hold 9.6% of the enlarged entity. Given that free float of CCNN is currently at 34%, we project that it would fall to 3% post consolidation, significantly below NSE regulations – 20% minimum free float for listed companies. We note that management is in talks with the NSE to resolve this and we expect a series of Offer for sale of shares in the coming years. Whilst management has given no clear timeline, we see a possibility of one in 2019. Dangote Cement on the other hand has long announced plans to raise *c.*$1 billion in a foreign bourse, specifically the London Stock Exchange. The issue is expected to happen in H2'19 and according to management, would likely be an offer for sale.

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Company Analysis

Stronger 2019 outlook supported by efficiency, deleveraging

Dangote Cement: 2018 has been a strong year for Dangote Cement, with topline up 14% y/y across the Group. Topline growth was driven by strong cement consumption in the Nigerian business and stable volume offtake across Pan African operations, with volumes up 12% in Nigeria and flat y/y across Pan African region. Also, whilst EBITDA margin has stayed flat in Nigeria at 65%, stronger pricing as well as improved operations in the Pan African businesses have seen EBITDA margin for the region expand 140bps y/y to 18.3%, driving 9M'18 Group EBITDA 15% higher to ₦337 billion. Overall, 9M'18 Group PAT printed at ₦158 billion, 3% higher than 9M'17, watered down by higher effective tax rate.

We forecast a FY'18 Group topline growth of ₦921 billion, translating to a 14% y/y growth. Furthermore, we project an 18% y/y growth in EBITDA to ₦457 billion, with a margin expansion of 140bps y/y to 49.6%, driven by price increases across select Pan African operations. We note that whilst effective tax rate was around 36% in 9M'18, management has guided a mid-20% for the FY, as they expect to receive positive news on outstanding pioneer status applications. Amid this, we forecast a 22% jump in FY'18 PAT to ₦249 billion. For 2019, we anticipate a 5% and 7% y/y rise in Group Revenue and EBITDA respectively, with EBITDA margin also expanding 130bps y/y to 50.9%. We also project a 10% growth in bottom line to ₦273 billion. We value DANGCEM at a one year target price of ₦259.31 and place a BUY on the stock.

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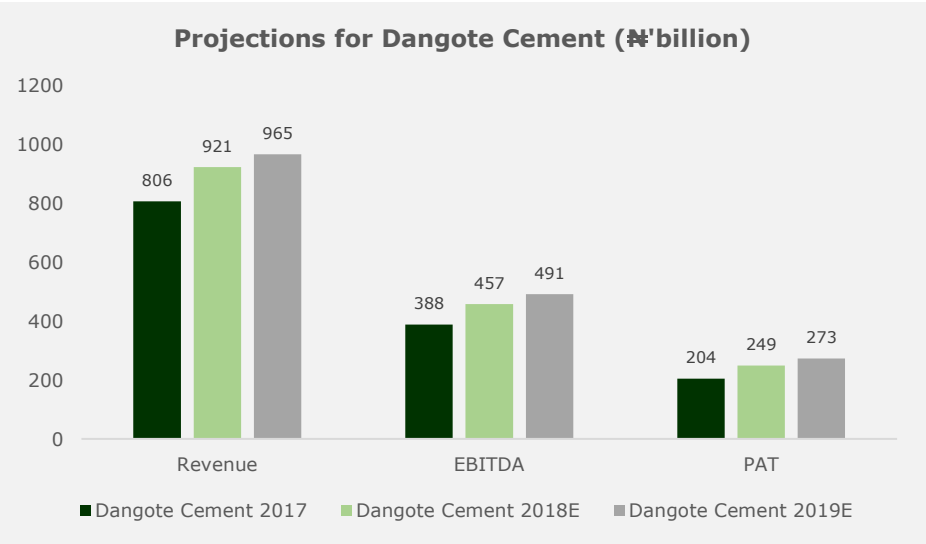
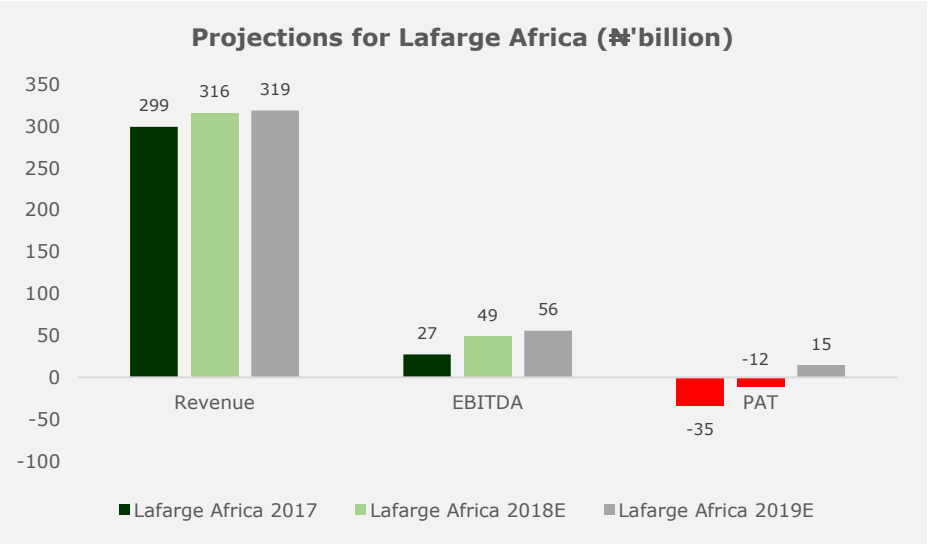


Source: Company filings, Vetiva Research

Lafarge Africa: Whilst Group topline rose 5% y/y to ₦234 billion, the cement producer reported another loss of ₦10.3 billion in 9M'18, with the poor performance driven once again by the usual culprits. Specifically, Group Operating Profit came in at ₦19 billion, with Lafarge Nigeria's ₦32 billion EBIT watered down by a ₦12 billion operating loss in the still ailing South African business. Furthermore, the Group reported a 21% y/y jump in Net Finance costs to ₦33 billion, driven by higher borrowing costs as well as an FX loss of ₦7 billion.

For 2018, we forecast a 6% y/y growth in Revenue to ₦316 billion and a 79% y/y jump in EBITDA to ₦49 billion, translating to a margin of 15.4% (FY'17: 9.1%). However, we estimate another loss in FY'18 (-₦12 billion), driven by a 4% rise in Net Finance cost to ₦44 billion, from an already bloated 2017. Meanwhile, we expect Lafarge to return to profitability in 2019, mostly driven by an expected reduction in Finance costs. Whilst we project modest growth in Topline (1%) and EBITDA (14%), we expect Group bottom line to swing to a profit of ₦15 billion, supported by a 72% moderation in Net Finance costs to ₦12 billion post-rights. To recap, Lafarge is currently seeking to raise ₦89.2 billion from shareholders via a Rights Issue to pay down local currency debt and $22 million of Related-Party loans, as well as fund working capital. Apart from this, the company has also obtained shareholders' permission to restructure the balance of Related-party loans, extending the repayment timeline to 2026, inclusive of a 2-year moratorium on interest payments. After taking the Rights Issue into consideration, we value WAPCO at ₦14.68 and maintain a HOLD on the stock.



Source: Company filings, Vetiva Research

CCNN: CCNN reported a strong 9M'18 performance, with topline rising 44% y/y to ₦19.6 billion and bottom line almost doubling to ₦4.0 billion. Notably, PAT for 9M'18 has already surpassed FY'17 PAT of ₦3.2 billion, itself a record PAT at the time. The strong performance was driven by an impressive topline and cost containment, with EBIT growing from ₦3.0 billion in 9M'17 to ₦5.6 billion in 9M'18 and EBIT margin expanding 762bps y/y. The company recently obtained shareholder approval to carry out a merger with KCC, a sister company set up by BUA Group to construct a 1.5 million MT cement plant. The new plant features a diversified kiln, capable of utilizing both LPFO and coal as fuel, an upgrade from CCNN's prior reliance on LPFO. The plant also boasts a 32MW coal-fired power plant. Post-merger, CCNN would absorb all the assets of KCC, effectively lifting production capacity from 0.5 million MT to 2.0 million MT. We believe this move places CCNN in a position to exploit long-term opportunities in the Nigerian cement market as well as take advantage of export opportunities. In fact, management has stated plans to leverage its proximity to the Niger border to ramp up exports to other West African countries.

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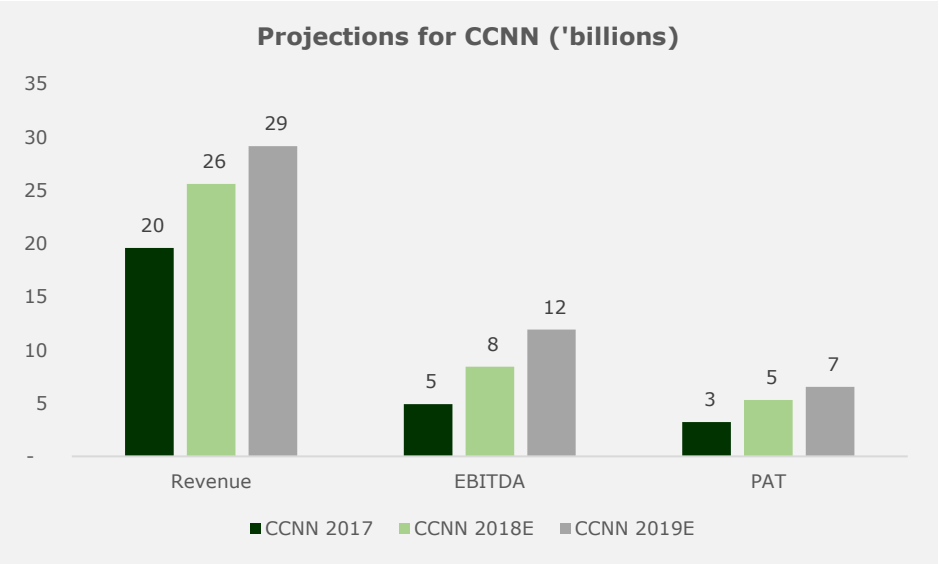
Post-merger, we see CCNN no longer limited by capacity constraints and project a 14% Revenue CAGR to ₦33.5 billion in 2020. Furthermore, taking into account the improved fuel efficiency from use of coal, we see EBIT margin expanding 420bps from 2018 to 34% in 2020. Overall, we forecast a 23% PAT CAGR to ₦8.0 billion in 2020. We value CCNN at ₦22.38 and place a BUY rating on the stock.



Source: Company filings, Vetiva Research

Oil & Gas

Upstream Sector

Further delays expected in PIB timeline

The Petroleum Industry Governance Bill (PIGB), a portion of the segmented Petroleum Industry Bill (PIB) was approved by the National Assembly in early H2'18 and sent to the president, who withheld his assent, citing constitutional and legal concerns. In particular, President Buhari expressed concern that the proposed reforms to the Petroleum Equalization Fund—which would be funded by a 5% levy on petroleum products as opposed to the current format where petroleum marketers pay into the fund—would unduly expand the scope of the Fund. Also, the president was concerned that the proposed new regulator (Petroleum Regulatory Commission) would be allowed to retain revenues in excess of what is beneficial to the three tiers of government. Considering the sensitive nature of the contents of the PIGB, we expect further delays in assent and anticipate a similar fate for the other three elements of the original PIB which remain at the 2nd reading stage in the House. We note that the primary opposition to President Buhari in the 2019 elections may have more appetite to assent to the PIGB (as outlined in his policy document), but the challenge of pushing through the PIB has always looked more surmountable from outside. Our base scenario is further delays in the PIGB timeline, with a late-2019 passage the best possible outcome, but we acknowledge the possibility of a change in leadership speeding up the process. We expect the legislative vacuum to discourage substantial investment in Nigeria's oil & gas sector for the foreseeable future.

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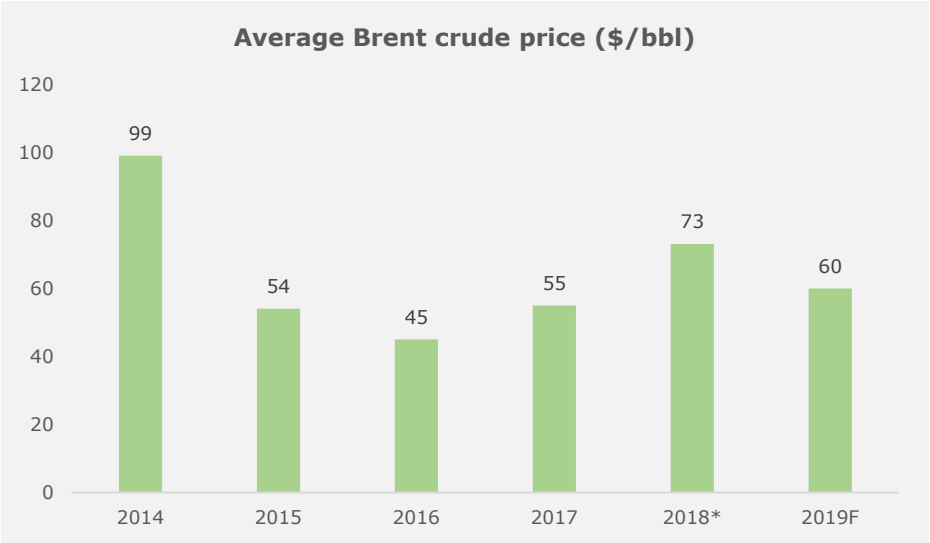
Weaker oil prices to hit upstream revenues

Our forecast for 2019 average Brent crude price is $60/bbl, compared to $73/bbl in the first eleven months of November. The agreement between OPEC and its Russia-led allies (OPEC+) to cut output by 1.2 mb/d in 2019 would support oil prices whilst rising U.S. production would once again exert downward pressure. The U.S. ramped up production by nearly two million barrels a day in 2018 to become the world's top oil producer (11.7 mb/d), and we expect output to rise further albeit somewhat limited by pipeline constraints which should only be resolved by H2'19. On the demand side, slowing global GDP growth is set to impact global oil demand even beyond 2019. Notably, we expect oil price volatility to persist throughout 2019 given the multiplicity of influencing variables—U.S.-Iran relations, internal Saudi politics, pipeline progress in the U.S., and so on. In summary, prices are likely to be much less attractive than in 2018, but 2019 should be the second-best year for oil prices since the 2014 crash. We note that upstream players are more accustomed to the new-normal lower oil prices and may benefit from hedges made over the course of 2018 when oil prices were higher. Despite this, we expect declining prices to hit topline across the upstream segment.

*January to November



Source: Bloomberg, Vetiva Research

Upstream players seek flexibility to hedge pipeline risk

The OPEC+ deal means that Nigeria must cut its output by between forty and fifty thousand barrels a day from October level of 1.76 mb/d. Given the recent trend of condensates production (between 0.02 and 0.03 mb/d), that gives an effective cap of *c.*2 mb/d in 2019. The positive is that we do not expect any significant production shocks amid calm in the Niger Delta region. However, we anticipate minor disruptions to product transports as Nigeria's pipeline infrastructure continues to suffer from wear & tear, legacy effects of the 2016 militancy, and low investment in recent years. We recall that production declined from 2.0 mb/d in Q1'18 to 1.84 mb/d in Q2'18 due to major pipeline shut-ins to repair leaks. That said, we believe that recent efforts to diversify excavation routes would protect firms against reliance on key pipelines that may be shut-in for any repairs. Going by statements made in 9M'18 results, SEPLAT should be able to use the Escravos pipeline as a secondary evacuation route to the Forcados pipeline which was temporarily down in Q2'18. We are therefore slightly more positive on the stability of production and export volumes in 2019 and expect this to support topline across upstream players. Going forward, we expect the commencement and ramp up of operations on the EGINA FPSO to boost Nigeria's output, particularly in the latter part of 2019 (FPSO expected to commence operations by early 2019).

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Midstream Sector

Refinery underperformance leaves Nigeria reliant on imports

Performance of Nigeria's public refineries has been poor in 2018, with average capacity utilization falling from 37% in January 2017 to 3% in August 2018. The chief reason for this is the Kaduna refinery which has been out of commission since January 2018. Part of the refinery's struggles can be attributed to its distance from the oil-producing region, as the refinery is reliant on crude oil piped from the Niger Delta and only has storage capacity for one month's worth of oil, making operations particularly volatile. However, the Port Harcourt refineries have also underperformed. In 2017, the two Port-Harcourt refineries were down for only two months and achieved capacity utilization of 24%.

In contrast, they were down for three of the first eight months of 2018 and operated at just 13% capacity. The failure of Nigeria's public refineries shifts attention to private and modular refineries, but good news here for 2019 is equally scarce. The Dangote refinery is unlikely to be up before 2020 and whilst some modular refineries have made material progress, they hold little capacity to make a tangible difference. The result is that Nigeria will remain heavily reliant on imported petroleum products in 2019. Meanwhile, the Minister of State for Petroleum has outlined the newest plan for Nigeria's public refineries: raise finance from private investors to fund the revamp of the refineries and settling debts through the offtake of finished products—to start in early 2019.

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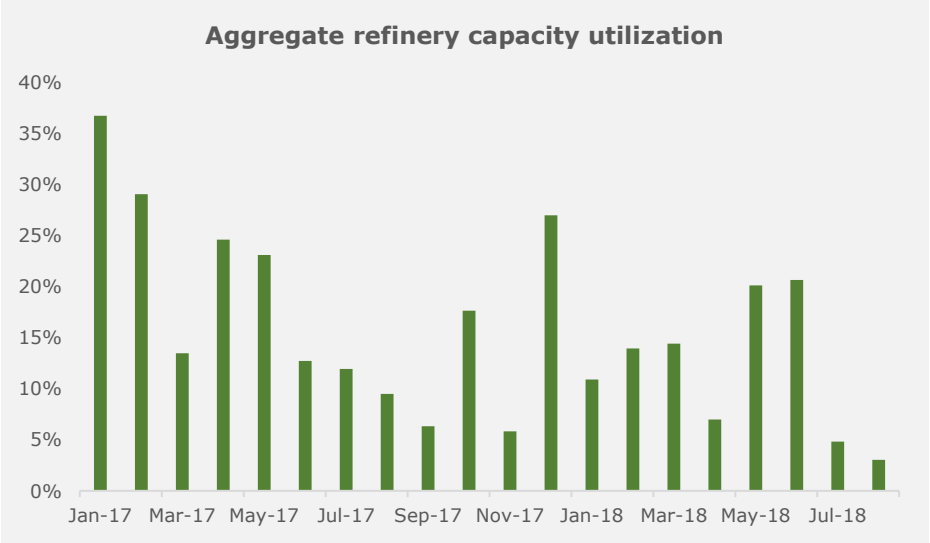

Source: NNPC, Vetiva Research

Downstream Sector

Tight margins to remain in PMS market, no deregulation in sight

Expected lower crude oil prices would usually be good news for petroleum marketers, but we note that the Nigerian National Petroleum Corporation (NNPC) has been the sole importer of premium motor spirit (PMS) for the last eighteen months as the rise in crude oil prices made importing uneconomic for marketers. We note that the landing cost of PMS in Nigeria potentially rose as high as ₦200 per litre in October 2018 (retail price still ₦145/litre). We do not expect this dynamic to change with crude oil prices at $60/bbl, and the main positive is that the implicit subsidy borne by the corporation would decline. Therefore, we still expect marketers to receive PMS at a discounted price and earn very thin margins on retail sales of the product. As a result, downstream players would find more joy in the sale of deregulated products such as diesel, a trend observed throughout this year.

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The key variable in the downstream segment is market deregulation. The incumbent administration has shown an unwillingness to deregulate the market if it would lead to higher pump prices. We have long since highlighted that it would require functional domestic refineries for market deregulation to become a possibility, and we do not see the former occurring before 2020.

That said, we acknowledge that the primary opposition in the 2019 elections has outlined downstream sector deregulation as a key policy thrust but note that the likelihood of him emerging victorious and following through on this promise in 2019 is slim given the likely economic environment in 2019. However, a change in policy direction would buoy marketers and encourage them to position ahead of market deregulation post-2019.

Source: GlobalPetrolPrices.com, Vetiva Research

Disclosures Section

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