KEY RATING DRIVERS

The downgrade of Nigeria's IDRs reflects the following key rating drivers:

Nigeria's fiscal and external vulnerability has worsened due to a sharp fall in oil revenue and fiscal and monetary adjustments that were slow to take shape and insufficient to mitigate the impact of low global oil prices. Renewed insurgency in the Niger Delta in 1H16 has lowered oil production, magnifying pressures on export revenues and limiting the inflow of hard currency.

Fitch forecasts Nigeria's general government fiscal deficit to grow to 4.2% in 2016, after averaging 1.5% in 2011-15, before beginning to narrow in 2017. The government has adopted a fiscal adjustment strategy centred on raising non-oil revenue and has made some progress in raising tax revenue by improving revenue collection and improving the control over revenue raised by government departments and state-owned enterprises. Despite expected increases in non-oil revenue, the agency expects overall general government revenue to drop to just 5.5% of GDP, from an average of 12% in 2011-15. On the expenditure side, Nigeria has also cut fuel subsidies and adopted a number of public financial management reforms that have contained the growth of current expenditure, including the move to a Treasury Single Account and the implementation of information systems that have reduced the number of ghost workers.

Nigeria's low level of general government debt, forecast to be 14% of GDP in 2016, is well below the 'B' median of 53% and a rating strength. However, the fall in general government revenue represents a risk to the country's debt profile. Fitch estimates general government debt/revenue will rise to 259% in 2016 from 181% in 2015, higher than the 223% median for 'B' rated peers.
At end-2015, only 19% of central government debt was denominated in foreign currency.

Nevertheless, depreciation of the naira will increase the debt and debt service burden.

A weak policy response to falling external revenues has led to an increase in external vulnerabilities, slower GDP growth and a widening of the current account deficit. On 20 June, the Central Bank of Nigeria (CBN) commenced trading on the inter-bank foreign exchange market under a revised set of guidelines that will result in a more flexible exchange rate. However, the new regime will not be fully flexible as it will still involve a parallel market as importers of 41 items are excluded from the inter-bank market, which will continue to hinder growth, capital inflows and investment, in Fitch's view. Furthermore, the delayed change in exchange rate policy casts some uncertainty over the authorities' commitment to a more flexible system. The CBN's previous exchange rate policy of managing demand for hard currency and restricting access to dollar auctions at the official FX rate resulted in a significant shortage in dollar liquidity.

Fitch expects that some continued intervention in the FX market will reduce international reserves, which were below USD27bn before the new market began trading compared with USD34bn at end-2014. Fitch expects reserves to fall to 3.4 months cover of current external payments by end-2016.

Fitch forecasts GDP growth to fall to 1.5% in 2016, down from 2.7% in the previous year, after GDP contracted by 0.4% year-on-year in 1Q16, stemming partly from low hard currency liquidity. 2Q16 is likely to experience a further contraction, as the resurgence of violence in the Niger Delta has brought oil production levels down to around 1.5 million barrels per day (mbpd) in May, from approximately 2.1 mbpd in January.

Nigeria's 'B+' IDRs also reflect the following key rating drivers:

In the medium to long term, the move to a more flexible exchange rate mechanism, if implemented effectively, is likely to be supportive of economic growth and economic rebalancing in the face of the drop in oil revenues. The accompanying depreciation of the naira will also increase foreign currency denominated fiscal revenue in naira terms. However, the positive effects of naira devaluation will take some time to fully materialise and, in the meantime, Nigeria will be vulnerable to a number of downside risks.

Fitch expects the current account deficit to widen to 3.3% of GDP in 2016, from 2.6% in 2015 and compared with the median of 'BB' rated peers at 2%. Increased external borrowing will reduce Nigeria's position as a small net external creditor, although this will remain stronger than the 'B' range median.

The authorities' move to liberalise fuel prices has allowed more supply to come to market, but together with FX restrictions it has led to a rise in inflation to 15.6% in May. Inflationary pressures from the depreciation of the naira will be partly balanced by improved foreign currency access which should reduce supply constraints. Fitch forecasts inflation to end the year at lower than 12%.

Our base case for Nigerian banks is that regulatory total capital ratios will not decline significantly due to the effective devaluation. Any impact will be offset by still strong profitability and high levels of internal capital generation. The new FX regime crucially also provides access to US dollars for the banks to meet demand and their internal and external obligations.

Political risks include the insurgency by Boko Haram and ethnic and sectarian tensions in the Niger Delta and Biafra regions. Nigeria's ratings are constrained by weak governance indicators, as measured by the World Bank, as well as low human development and business environment indicators and per capita income. Nevertheless, there has been some progress in terms of the peaceful transition of power in 2015, the first in Nigeria's history, the new administration's gains in checking the Boko

Haram insurgency in the northeast as well as renewed anti-corruption efforts by the federal government.

The economy is heavily dependent on oil, which has accounted for up to 75% of current external receipts and 60% of general government revenues before the fall in oil prices. Ongoing reforms within the Nigeria National Petroleum Corporation and the power sector have the potential to increase efficiency within the oil and gas industry and improve the overall business environment through improvements to electricity generation and transmission.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Nigeria a score equivalent to a rating of 'B+' on the Long-term FC IDR scale.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria
hat are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that could lead to a downgrade are:

- A loss of foreign exchange reserves that increases vulnerability to external shocks.

- Reversal of key structural reforms and anticorruption and transparency measures.

- Worsening of political and security risks that reduces oil production for a prolonged period or worsens ethnic or sectarian tension.

- Failure to narrow the fiscal deficit leading to a marked increase in public debt.

The main factors that could lead to an upgrade are:

- A rise in non-oil revenues that leads to a reduction of the fiscal deficit and the maintenance of a manageable debt burden.

- A revival of economic growth supported by the sustained implementation of coherent macroeconomic policies.

- Increase in foreign exchange reserves to a level that reduces vulnerability to external shocks.

KEY ASSUMPTIONS

Fitch forecasts Brent crude to average USD35/b in 2016 and USD45/b in 2017