VETIVA
CAPITAL MANAGEMENT LIMITED

Vetiva Research

Nigeria H2'18 Outlook

In the shadow of the polls

June 2018

NIGERIA OUTLOOK

In the shadow of the polls

26 June, 2018

An economy slow out of the traps: The Nigerian economy did not fare as well as expected in the first half of 2018 (Q1'18 GDP growth: 2.0% y/y vs. Vetiva and Consensus forecasts of 3.4% y/y and 2.6% y/y, respectively). Weakness in the services sector (c.60% of Nigerian economy) was unsurprising in light of still-weak consumer wallets, but the slowdown in agriculture was a real concern – particularly as it may be reflecting the negative impact of escalating violence in the Middle Belt region. Admittedly, there were some important wins in the first half of the year; high oil prices maintained foreign exchange stability and supported FG revenues whilst inflation declined significantly in the first six months – assisted by a high H1'17 base, triggering yield moderation in the fixed income market. However, the overall narrative of the year has been an underwhelming one, best represented by a bear run in the equity market that wiped 14% off the market between February and May, almost eroding a 16% surge in January.

Dimmer outlook for rest of 2018: Many of our 2018 forecasts have been downgraded though remain above 2017 estimates. 2018 GDP growth is projected at 1.9% y/y (previous: 2.4% y/y), compared to 0.9% y/y in 2017. The dimmer picture begins with the oil sector as infrastructure integrity issues prevent Nigeria from producing at capacity whilst oil prices are expected to trend slightly lower in H2'18 on the back of rising output. We expect to see some policy support from the recently passed 2018 Budget (20th of June), though the imminent 2019 elections may complicate its effect. Indeed, we expect elections to dominate near-term activities, with election spending boosting the economy through government and consumer spending, but also inducing greater inflationary pressure. The latter effect underpins our view that monetary policy status quo will persist until the elections. Impending elections are also likely to induce greater economic uncertainty and distract policy and governance at the tail-end of the year, neither of which is positive for confidence or investment. In terms of electoral activities, we do not anticipate any unusual changes to peace and stability, even as we expect militant activity to increase ahead of the 2019 polls.

Election jitters sideline healthy market fundamentals: Despite an improving macroeconomic environment and a semblance of policy stability, Nigeria's financial markets would likely be steered by the fallout of electoral activities and rising global interest rates. The equity market has been hit by pre-election jitters, with foreign investors moving to the sidelines, and is expected to perform tepidly in H2'18. Comparable multiples with peers suggest the Nigerian equity market remains undervalued and we maintain a strongly positive post-election outlook on Nigerian equities. Meanwhile, as late budget passage, pre-election spending, and food price pressure induce higher inflation at year-end, we project a 100bps yield uptick in H2'18. Beyond 2018, the government's shift from the domestic debt market, Nigeria's potential re-inclusion into the JP Morgan Bond Index, and retreating inflation provide a case for longer-term yield moderation.

Vetiva Research

Olalekan O. Olabode, CFA
Head, Research
Financial Services
o.olabode@vetiva.com

Ifedayo Olowoporoku
Consumer Goods
i.olowoporoku@vetiva.com

Onyeka Ijeoma
Industrial Goods, Agriculture
o.ijeoma@vetiva.com

Michael Famoroti
Economic Research
m.famoroti@vetiva.com

Oluwasubomi Mosuro
Capital Markets
o.mosuro@vetiva.com

Sales

Dorcas Onyebuchi-Nnebe
Institutional Sales
d.onyebuchi-nnebe@vetiva.com

Zephia Ovia
Institutional Sales
z.ovia@vetiva.com

Folagbade Adeyemi
Head, Retail Sales
f.adeyemi@vetiva.com

Table of Contents

Global

Global Economy

World economy on the upswing

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. Advanced Economies (2017: 2.3% y/y, 2018F: 2.5% y/y; IMF) lead the charge and continue to grow above recent trend, supported by resilient consumer spending and ongoing monetary stimulus in the European Union (EU) and Japan. Growth should also quicken across emerging markets (2017: 4.8% y/y, 2018F: 4.9% y/y; IMF), propelled by strong commodity prices and healthy external demand. The risks to this outlook are three-pronged. Firstly, higher commodity prices are good for commodity exporters but pose a minor threat to global inflation – though we must point out that inflation in Advanced Economies remains rather stubborn. In addition, evolving trade tensions and financial market weakness, amid worries of emerging market debt or deviations in monetary policy, also dampen bullish sentiment for the next six to twelve months.

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.

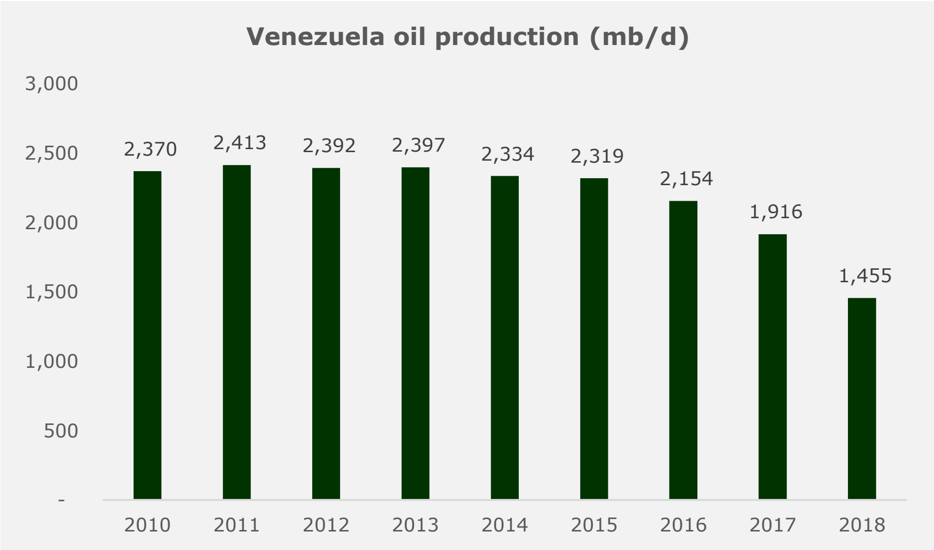
Good times set to last in the shale industry

Led by the shale industry, United States (U.S.) oil production has risen dramatically, breaching the 10.5 mb/d mark in April 2018 and taking the country within reach of Russia's title as the world's biggest oil producer. Notably, the U.S. shale industry is enjoying the best of both worlds as producers have been able to expand output (and tussle for market share) while also enjoying high margins not seen since late-2014 as oil prices have remained resilient despite U.S. shale growth. The industry is in a much better shape than in recent years, and with improved cash flows supporting capital expenditure, looks more resilient and able to withstand any downtrend in oil prices compared to 2015/2016. Production should remain strong for the rest of the year, though we expect growth to be constrained by declining well productivity and see U.S. production peaking just under 11 mb/d in this year.

Does the OPEC production increase mean the market has rebalanced?

OPEC producers have overshot their output cut targets in 2018 and this has supported the rally in oil prices. However, not all supply cuts have been intentional, with Venezuela being the largest inadvertent cutter. The country's production has been in a freefall as it battles a wider economic implosion. Output has slumped from 2.4 mb/d in 2010 to 1.4 mb/d in May 2018 and is likely to fall even further as the state-owned oil firm considers declaring Force Majeure on some of its major contracts. Amid this, along with stronger than expected oil prices so far this year, OPEC agreed to increase its production by 1 mb/d in the second half of 2018. Whilst this this looks like an existential challenge to the previous arrangement, we note that oil stocks have been severely depleted this year amid the output declines and rising global demand, and moreover, a number of countries would struggle to expand output even if they wanted to. Beyond Venezuela, Nigeria's production has suffered from pipeline leaks in the last month while Libya has been unable to expand output beyond the 1 mb/d mark. All of this means that the proposed 1 mb/d expansion would likely be driven by major players such as Saudi Arabia and Russia.

Moreover, the amended deal does not completely remove the OPEC price support from the market, but rather preempts the possibility of a market deficit in 2019. Nevertheless, the move signals that the balance in the oil market has tilted and accentuates the importance of global demand and geopolitics in propping oil prices. We expect prices to trend lower in H2'18 (average of $71/bbl by mid-June) on the back of the reduced OPEC market support.



Source: OPEC, Vetiva Research

Strong price outlook amid geopolitical tensions

All in all, global oil prices are unlikely to reach the heady days of $80/bbl briefly flirted with in late-May 2018, but can take solace from a positive outlook for global oil demand as the global economy chugs along. Moreover, geopolitics may assume an outsized influence in the event of weaker OPEC support. On this front, we can expect prices to remain firm in the near future, propped by the Iran sanctions and concerns about a global trade war. All things considered, we expect oil prices to average $67/bbl (average of $71/bbl in mid-June).

All in all, global oil prices are unlikely to reach the heady days of $80/bbl briefly flirted with in late-May 2018, but can take solace from a positive outlook for global oil demand as the global economy chugs along. All things considered, we expect oil prices to average $67/bbl (average of $71/bbl in mid-June).

Brent crude forecasts

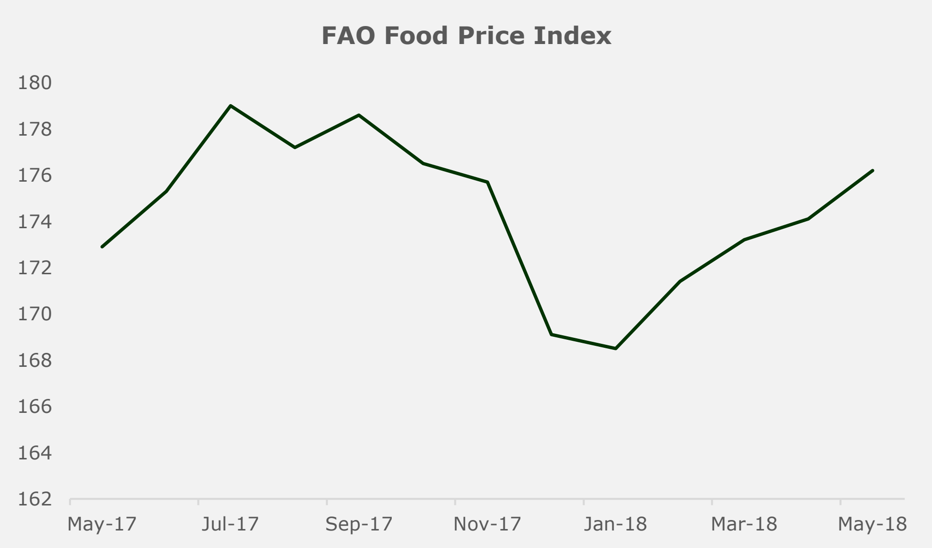
	2018	2019
IMF	62	58
World Bank	65	65
EIA	71	66
OECD	69	70
Average	67	65

Source: IMF, World Bank, EIA, OECD, Vetiva Research

Shiny prospects for metals and other commodities

Our initial bullish expectations for commodity markets in 2018 has played out and prices are expected to remain strong through the year. Food prices have rebounded strongly after their 2017 dip, helped by cereals and dairy products. Wheat prices are on an uptrend on the back of concerns over prolonged dryness in the U.S. and poor weather in the Europe, and lead the cereals charge whilst surging global demand for cheese and milk should support dairy products. In contrast, sugar prices fell to 3-year lows in April 2018 and are likely to remain depressed in 2018 as good weather and supportive government policy boost production in Thailand and India.

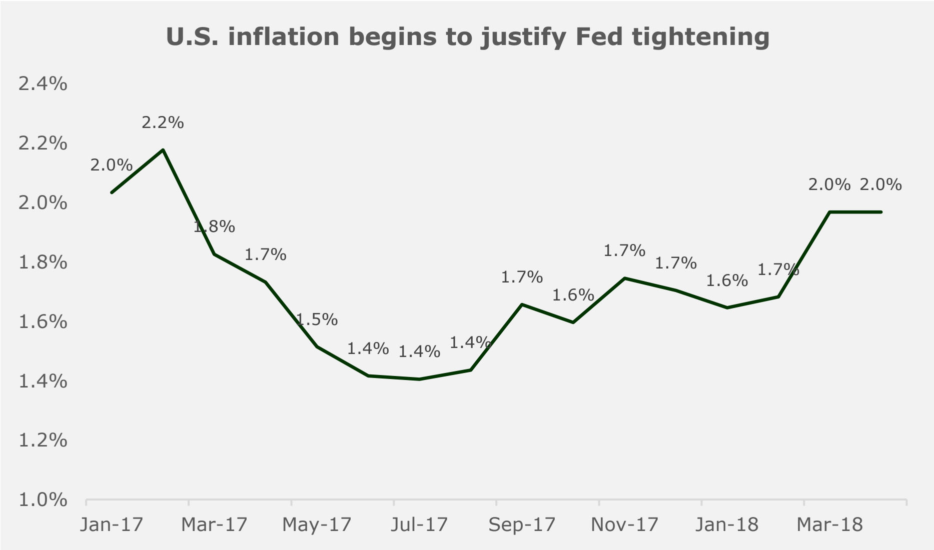
For non-agriculture products, metals are expected to do very well in 2018 – World Bank forecasts a 9% y/y rise in average metal prices – with copper, nickel, and aluminum projected to do particularly well. The major drivers for the healthy price outlook here are strong global demand and pollution-bashing policies in China that have hit metals supply. Meanwhile, the evolving trade war could put further upward pressure on metal prices. Whilst the overall outlook bodes well for commodity exporters, stronger commodity prices may stoke higher global producer price inflation.



Source: FAO, Vetiva Research

Trump's economic policies bring both good and bad to U.S. economy

The United States (U.S.) economy has picked up where it left of in 2017, growing 2.2% y/y in Q1'18, compared to 1.2% y/y and 2.9% y/y in Q1'17 and Q4'17 respectively. Amid this, President Trump has gone about implementing some of his major pre-election promises, from enacting tax cuts and amending the Dodd-Frank Act to kicking off a potential tariff war with key trading partners. Whilst the tax cut and Dodd-Frank amendment should boost the U.S. economy in the short run, trade developments are a bigger worry. President Trump has taken aim at the world's largest traders (and economies) such as the European Union (EU) and China, both of which have not been shy to retaliate – in June, the EU confirmed plans to target €2.8bn worth of U.S. products after President Trump imposed higher charges on aluminum and steel imports from the EU. Trade talks with China have see-sawed and an escalation of tensions and tariff implementation would feed into producer prices and depress consumer demand in the near to medium-term. Despite these threats, a hawkish U.S. Federal Reserve (Fed) has been encouraged by a resilient economy, low unemployment, and rising inflation (hit the Fed target of 2% in March) and should persist with its guided monetary tightening path going into 2019.



Source: Federal Reserve, Vetiva Research

EU growth to beat prior expectations

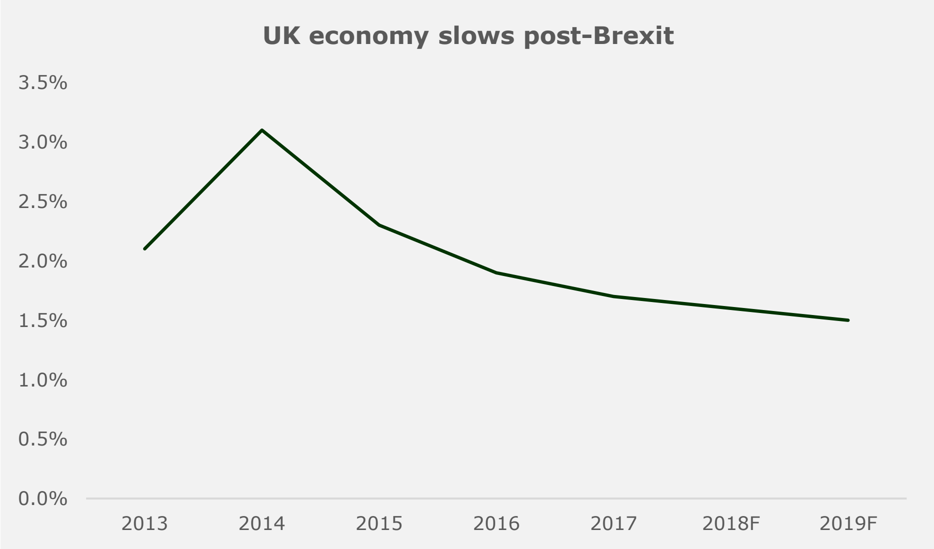
The International Monetary Fund (IMF) upgraded its growth projections for European Union (EU) countries in its April 2018 World Economic Outlook (compared to January projections), with sizable revisions across the largest economies in the region. However, Q1'18 GDP growth came in surprisingly weak – 0.4% q/q, slowest since Q3'16, pressured by a stronger euro. Nevertheless, growth for the rest of the year should be robust as consumer spending and net exports prop the economy. The primary risk to the healthy EU outlook is the political landscape in Italy where a new populist, anti-EU government threatens to derail the fiscal progress made in one of the region's largest economies. Away from that, inflation in the region is still low (once oil prices are stripped out) but the European Central Bank is likely to flip the monetary switch towards tightening in early 2019 – though developments in Italy would once again be key in determining the risk environment at the time.

UK economy slows, faces prospect of hard Brexit landing

The United Kingdom (UK) economy slowed in Q1'18 (from 0.7% q/q in Q1'17 and 0.4% q/q in Q4'17 to 0.1% q/q in Q1'18). Meanwhile, the Bank of England (BoE) continues to face a monetary policy dilemma; despite a slight recovery in the pound and strong base effects from 2017, annual inflation remains well above the Bank's target, limiting its scope to turn monetary policy towards stimulating a weak economy. This dilemma may be here to stay; even with a supportive global environment, household spending and investment are likely to remain sluggish on the back of Brexit.

The UK and EU agreed a transition period between the official Brexit date (March 2019), when the UK would leave the EU, and the end of 2020 – a period in which the UK would remain part of the customs union and single market despite being a non-EU country. As a member of the customs union, the UK would remain subject to EU regulations and could still benefit from easier trade access, but would lack the voting and decision-making rights of a full-fledged EU member, a potentially unattractive situation for the UK.

As a member of the customs union, the UK would remain subject to EU regulations and could still benefit from easier trade access, but would lack the voting and decision-making rights of a full-fledged EU member, a potentially unattractive situation for the UK.



Source: IMF, ONS, Vetiva Research

Meanwhile, the transition period mainly defers the big exit decisions till the end of 2020 (including the post-Brexit nature of the relationship between the two parties), but the positive is that the UK would be able to enter some level of trade negotiations with other countries during the period. All of this occurs against the backdrop of an impasse over the Irish border as neither party has devised a mutually appealing Brexit framework that would ensure no borders between Northern Ireland and the Republic of Ireland, despite many proposals and counter-proposals. We note that the Irish border issue has been a long-term sticking point, and given the nature of Brexit negotiations – all terms must be agreed on for the deal to be ratified – the socio-political precarity of the Irish border could seriously hamper Brexit negotiations, an uncomfortable reality as the UK heads towards the March 2019 Brexit point.

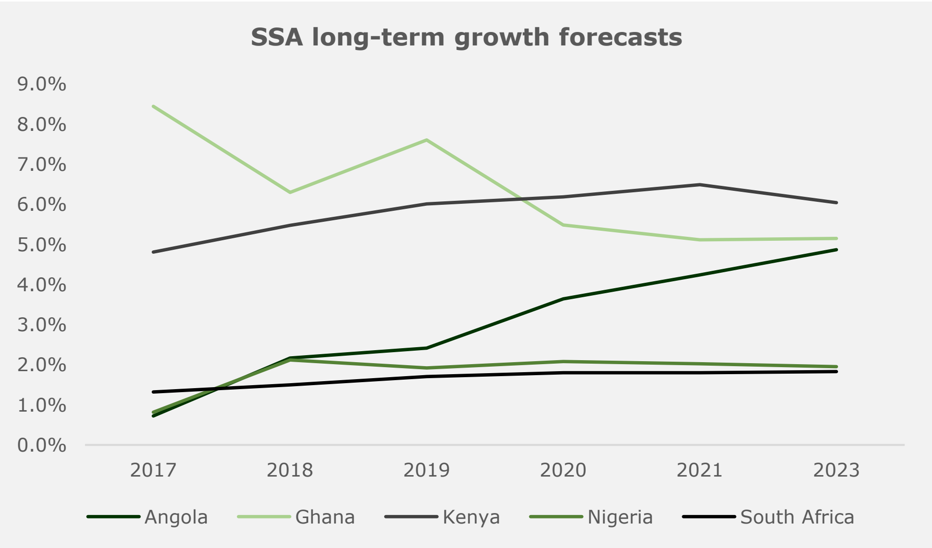
Asian giants to continue to set growth pace

The near-term outlook for major Asian economies is positive. The Chinese economy grew 6.8% y/y in Q1'18 as strong consumer spending – driven by e-commerce – overshadowed a continued slowdown in industrial activity. China's gradual shift away from industry-led growth is evidenced by the fact that the country experienced its first current account deficit since 2001 in Q1'18. Overall growth should remain strong, though the World Bank and International Monetary Fund expect a slowdown relative to 2017 as fiscal stimulus weakens and deleveraging kicks in across the economy – the World Bank and IMF project 2018 GDP growth of 6.5% and 6.6% respectively compared to 2017 growth of 6.9%. The primary risk to the Chinese economy is the escalating trade rift with the United States that could further worsen external balance. Meanwhile, the Indian economy has rebounded nicely from the missteps of demonetization and a botched implementation of a goods & services tax in 2017. The World Bank and IMF expect the country to grow by 7.3% and 7.4% respectively, and India should retain its position as the fastest-growing large economy for the near future, but still needs to work harder to achieve inclusive growth. Finally, the major Gulf states should be supported by healthy oil prices, while the primary risk comes from ongoing diplomatic rifts within the region that may hamper growth in smaller economies. On a final note, the Saudi Aramco listing has been effectively pushed until 2019 on account of "market readiness".

SSA growth economy buoyed by commodities

The International Monetary Fund (IMF) projects accelerating economic growth in Sub-Saharan Africa (SSA) as the region recovers from the 2014-2016 commodity shock. In particular, near-term growth prospects are boosted by firm commodity prices, particularly for the major regional economies – Nigeria, South Africa (SA) and Angola. Looking more closely at these, the SA economy underperformed in Q1'18 – shrinking 2.2% y/y in seasonally adjusted terms vs. a consensus projection of -0.5% y/y, its worst quarterly performance since 2009. In fact, the initial feel-good factor of the Ramaphosa presidency has made way for harsher realities, with the rand shedding over 8% of its value between the end of 2017 and mid-June. The IMF still expects 2018 to be a better year than 2017 (1.5% GDP growth vs. 1.4%), but the attainment of this level would depend on both political sentiment and commodity prices remaining healthy. The Angola story is more positive, mainly due to higher oil prices, but a more efficient allocation of foreign exchange, rising natural gas production, and improved business sentiment would help support the rebound in economic activity. Meanwhile, things are less promising for Ghana, the region's star in 2017. The IMF forecasts choppy growth in the coming years and public finances remain a significant worry. Finally, East African economies should remain resilient – Kenya is one of the few major SSA economies that the IMF predicts would experience accelerating growth through to 2023.

The International Monetary Fund (IMF) projects accelerating economic growth in Sub-Saharan Africa (SSA) as the region recovers from the 2014-2016 commodity shock.



Source: IMF, Vetiva Research

Are we heading towards a global trade war?

After over a century of being the undisputed economic consensus, we may finally be departing from a world of relative free trade and heading into an era of protectionism. Sitting at the centre of this shift is Donald Trump, President of the United States, which for so long stood as the intellectual centre of the "trade is good" doctrine. President Trump had often targeted China's large trade surplus with the U.S. in his 2016 campaign so it was unsurprising that he began to chip away at the U.S.' trade relations with the Asian behemoth – earlier this year, he imposed trade sanctions on a range of Chinese imports, before China retaliated.

However, global trade patterns truly came under threat at the end of May when President Trump pushed through additional tariffs on steel and aluminum imports from the European Union (EU), Canada, and Mexico. China has always been a popular target but is not the U.S.' main trading partner – U.S. trade with the EU was $720 billion in 2017, compared to $636 billion with China, whilst combined trade with EU, Canada, and Mexico rose above $1.1 trillion or 5% of the U.S. economy. Yet, Trump imposed steel and aluminum tariffs on the EU, Canada and Mexico (44% of US steel imports in Q1'18), citing national security threats and dumping concerns. These countries swiftly retaliated, with the EU highlighting €2.8 billion worth of U.S. imports for trade sanctions that member states would ratify, while Mexico imposed tariffs on a range of U.S. goods. Canada also outlined a tariff plan on $12.8 billion worth of U.S. raw materials and consumer goods, a development that may seriously threaten the North America Free Trade Agreement (NAFTA). Trade tensions came to a head in June as President Trump rejected a negotiated compromise agreement at the G7 summit, much to the chagrin of other Western leaders, with one particular photo highlighting the poor state of negotiations.

President Trump takes a stand against the Western trade consensus

Source: G7, Twitter, Vetiva Research

The threat to global trade comes at an inopportune time for a global economy where the EU continues to struggle with the euro's underlying existential crisis and member states resistance to further integration, the changing structure of the Chinese economy poses a challenge to global commodity markets, and many emerging markets are still recovering from the last commodity bust. Whilst it is hard to estimate the costs of a full-blown trade war, it is evident that the current trajectory may cause us to give up the primary gains from globalization – higher quality products at cheaper prices. Meanwhile, jobs and investment would be at risk under this new normal (the United Nations estimates that global FDI slumped 23% y/y in 2017 due to trade concerns) and the shift in economic consensus could hit long-term certainty and confidence as people adjust to the new rules of the global economic game.

Whilst it is hard to estimate the costs of a full-blown trade war, it is evident that the current trajectory may cause us to give up the primary gains from globalization – higher quality products at cheaper prices.

Most worryingly, we are in uncharted territory because of how interconnected global supply chains are – some estimates suggest that global supply chains account for one in five jobs on the planet – and it would be reasonable to expect a surge in global inflation as trade sanctions stack up. For Nigeria, it would be operating in a more hostile global economic environment, which would be particularly unfortunate given the country's aim to diversify exports. Ultimately, though the evolution and outcome of a trade war is hard to call, it is likely to lead to an arms race to the bottom and create losers all round.

Source: IMF, Vetiva Research

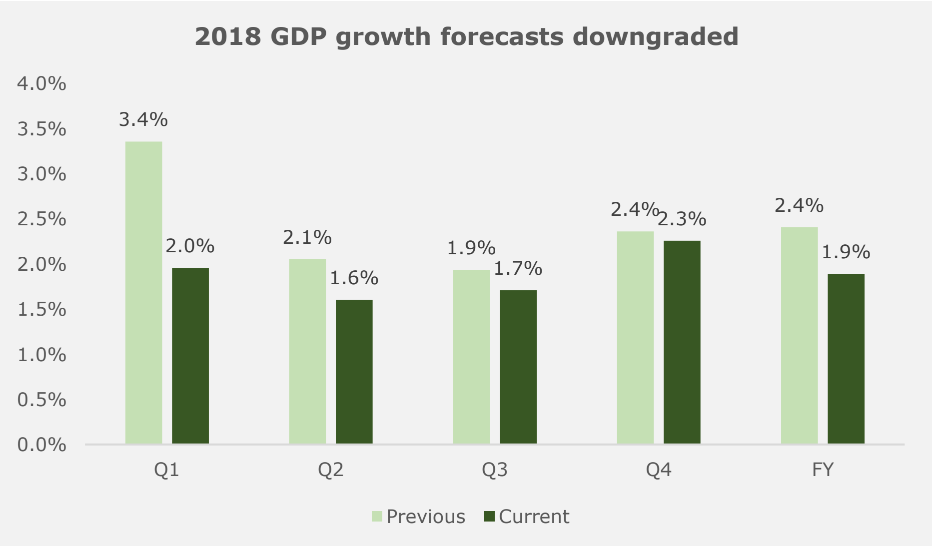
Domestic

Real Economy

Outlook dims slightly in second half

Nigeria's 2018 economic performance has been weaker than expected (Q1'18: 2.0% y/y vs. Vetiva and Consensus expectations of 3.4% y/y and 2.6% y/y respectively), albeit dragged by a few key sectors. Consequently, we downgraded our growth expectations for 2018 (2018F GDP growth: 1.9% y/y vs. previous: 2.4% y/y; 2017: 0.9% y/y) on weak Q1'18 performance and concerns over oil production. Nevertheless, we are cheered by moderating inflation (2018 revised average inflation forecast: 12.0% y/y vs. previous: 12.8% y/y), stronger than expected oil prices, and anticipated robust aggregate demand spurred by pre-election activities. However, we have altered our policy outlook for the year; we foresee only a constrained fiscal stimulus this year in light of the late passage of the 2018 Budget, and we no longer expect monetary easing in 2018 given our concerns that fiscal injections in H2'18 would pressure inflation. Meanwhile, we highlight a downturn in the oil sector (price or volume), fiscal slippage, and insecurity as the primary near-term risks to the economy. Overall, we retain our positive economic outlook – albeit slightly dampened – for the rest of the year. Furthermore, 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.

Overall, we retain our positive economic outlook – albeit slightly dampened – for the rest of the year. Furthermore, 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, Vetiva Research

Ongoing violence threatens sector growth

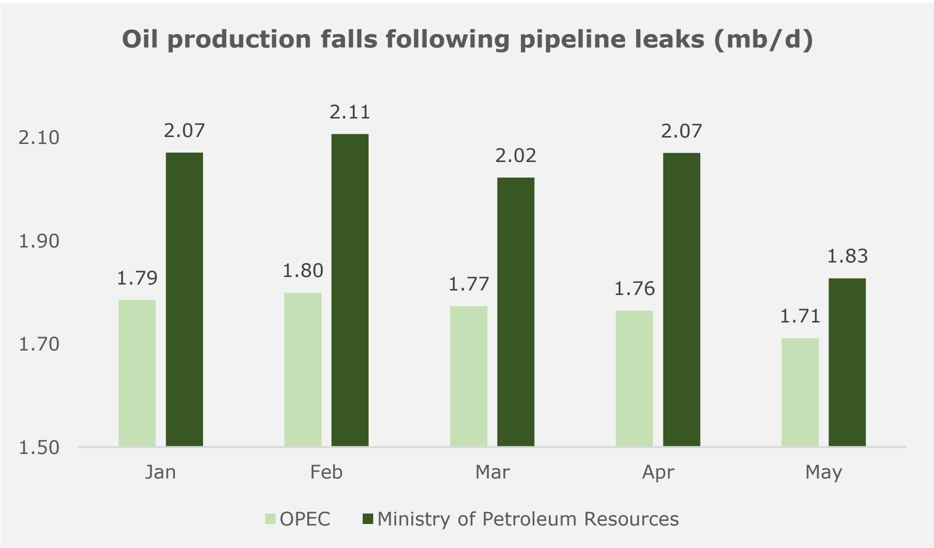
The agriculture sector underperformed in Q1'18, posting GDP growth of 3.0% y/y, the lowest since Q2'13. The sector had previously been propped by government policy to encourage import substitution and Central Bank of Nigeria development finance initiatives, but has suffered negative shocks in recent times. First, the Benue flooding in late August 2017, then a severe increase in the spate and severity of violent Herdsmen activities in the Middle Belt and North Central. The latter could be particularly damaging to agriculture output given the span of the affected area, and could worsen in the build-up to the 2019 elections. The Federal Government has taken some action, initiating a National Food Security Council in March 2018 and launching a military operation in May 2018 to defuse the situation.

However, we do not expect the issue to be quelled in one fell swoop given its scale and dispersion. The President also produced a National Livestock Transformation Plan to address longstanding issues around grazing and farmland in the country and we are hopeful that astute execution of the plan would move the region towards long-term peace and stability. All in all, the insecurity situation dampens our outlook for agriculture and we forecast GDP growth of 3.4% y/y in 2018, down from our 3.7% y/y expectation coming into the year. Despite this, we still expect agriculture (25% of GDP) to be one of the main drivers of GDP growth this year.

We expect the sector to further benefit from healthy oil prices – which may support investment – but note that legislative reprieve is still required to unlock long-term growth prospect. Our FY'18 average oil production forecast is 2.00 mb/d (2017: 1.89 mb/d), translating to GDP growth of 5.8% y/y (Q1'18: 14.8% y/y).

Bullish outlook dampened by leaky pipes

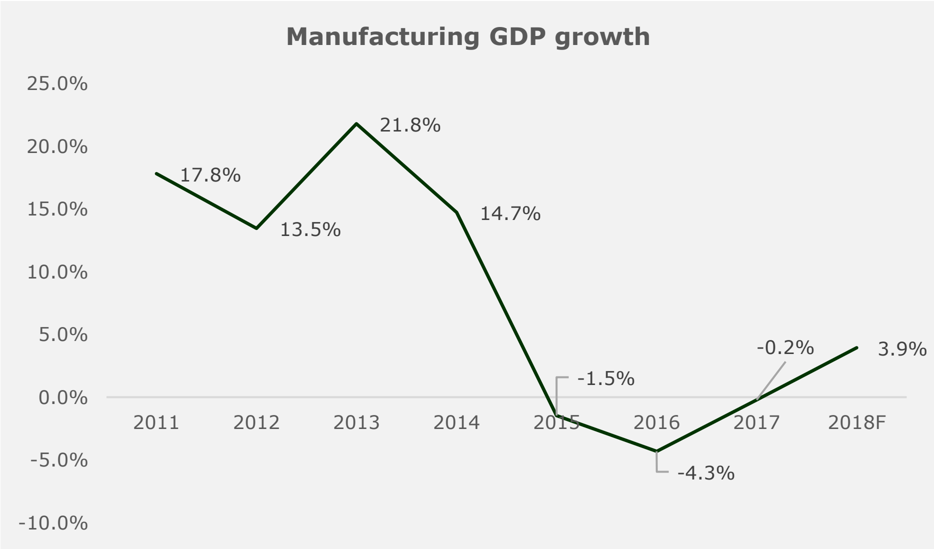
The recovery in Nigeria's oil production as a result of the calm in the Niger Delta region has been a huge plus for Nigeria in the past 18 months. Oil production has risen from a low of 1.61 mb/d in Q3'16 to 2.00 mb/d in Q1'18. We envisage oil output holding around these levels amid the constraint of the OPEC output cap (1.8 mb/d excl. condensates). We are aware of recent production issues; namely, the continued shut-in of the Nembe Creek Trunk Line and its effect on Bonny Light exports, as well as the delays to Forcados loadings as a result of pipeline leaks. Production should take a hit from these developments, but we anticipate resolutions to these challenges in the coming months as pipeline operators continue to take decisive actions, even as oil majors explore alternative routes to ensure production is not too affected. On another note, we are cautiously optimistic that the calm in the Niger Delta would persist through to the 2019 elections as we anticipate the Federal Government doing its utmost best to ensure that attacks are kept to a minimum – given the political and fiscal severity of a negative shock here. Finally, we expect the sector to further benefit from healthy oil prices – which may support investment – but note that legislative reprieve is still required to unlock long-term growth prospect. Our FY'18 average oil production forecast is 2.00 mb/d (2017: 1.89 mb/d), translating to GDP growth of 5.8% y/y (Q1'18: 14.8% y/y).



Source: OPEC, Ministry of Petroleum Resources, Vetiva Research

Industrial activity finding form

The manufacturing sector rebounded from three consecutive years of contraction to post impressive GDP growth of 3.4% y/y in Q1’18. The outlook for the sector is modestly positive, in line with the cyclical recovery in the wider economy. Firstly, strengthening consumer wallets and pre-election spending should support aggregate demand. In addition, we envisage manufacturers benefitting from continued foreign exchange stability and liquidity on the cost side, and see them being shielded from excessive import-switching because consumer wallets are still not strong enough to support substantial import expansion. The sector would also be boosted by moderating inflation, but would not cheer likely Central Bank of Nigeria decision to maintain the monetary policy status quo. Amid all these, we forecast annual growth of 3.9% y/y, making it the fastest growing non-oil sector in the economy, albeit a far cry from pre-2015 growth rates.



Source: NBS, Vetiva Research

Flat growth expected in services sector

Growth in services was disappointing in Q1’18 (-0.5% y/y) and the sector was the primary drag on economic performance in the quarter. Notwithstanding the negative performance, looking at services sub-sectors is informative. A number of sectors have performed well recently – Transport, ICT, Finance – and should continue to benefit from stable foreign exchange, moderating inflation, and improving business environment. On the other hand, key sub-sectors are faring much worse, with Trade, Real Estate, and Construction playing the role of ugly ducklings. These three sectors are key – account for over 25% of the Nigerian economy and 16% of employed workers – so weakness here has material repercussions. We are hopeful that pre-election spending provides a temporary boost to the services sector and project mild growth of 0.3% y/y in 2018.

Services Sub-sectors

	Q1'18 GDP growth rate	Contribution to sector
Construction	-1.5%	6.9%
Trade	-2.6%	29.0%
Transport & Storage	14.4%	2.6%
ICT	1.6%	21.1%
Finance & Insurance	13.3%	6.0%
Real Estate	-9.4%	9.6%

Source: NBS, Vetiva Research

Political Economy

Election will drive uncertainty, aggregate demand

The shadow of the 2019 elections looms ubiquitously over the Nigerian economy, with market jitters already manifesting in the first half of the year – even earlier than expected. We foresee elections having an outsized effect on the rest of 2018; electioneering in Q4'18 would inevitably distract from policy and governance, higher government spending would boost aggregate demand but spur inflation, and investment is likely to stall. We note that the impending elections introduce greater economic uncertainty in two ways. First, uncertainty over the stability of the business environment and economic activity in the run-up to the elections (due to political or policy disruptions), and then uncertainty about the shape of the post-election policy landscape. A victory for the incumbent government at the 2019 polls would assuage these concerns, but not completely eradicate uncertainty. Thus, we expect government and political activity to drive aggregate demand for the rest of the year, with the private sector assuming a secondary role, but project a mildly positive impact of election spending on near-term economic activity – barring any severe political or security shocks. In particular, we see insecurity as a primary risk to the economy in the near-term given Nigeria's combustible mix of ethnic politics and militant groups. Whilst we foresee continued stability in the Niger Delta as the government pulls out all the stops to ensure oil production remains unperturbed, we see the ongoing herdsmen conflict as a key pressure point and expect it to hit food prices and investor confidence while intensifying the political stakes. Previous concerns in the form of Boko Haram and Biafran secession are on the backburner but remain relevant in the insecurity matrix. Nevertheless, 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.

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.

Supply-side Policy

ERGP report-card shows below-average grade

The 2017-2020 Economic Recovery & Growth Plan (ERGP) has run for over a year. Despite some green shoots, sluggish implementation and a lack of clarity concerning funding have taken the sting out of the development plan. The ERGP identified key execution priorities:

- Stabilize economic environment: There have been notable positives here including exit from recession, declining inflation rate, the enactment of a market-reflective exchange rate window, and an improvement in the external balance. The primary negatives surround fiscal policy. Non-oil revenue growth has been sluggish, underlined by the underwhelming performance of the government's tax amnesty program despite a 3-month extension. Meanwhile, government spending has remained constrained by delayed budget passage, incomplete capital expenditure disbursements, and a high proportion of spending dedicated to recurrent expenditure (salaries and debt financing). More progress is needed in this area, although we are skeptical this would occur during the present fiscal year.
- Food security: Nigeria continues to make strides in attaining self-sufficiency in select staples, but food security has been threatened by the scourge of violence across the Middle Belt in recent years.

We note that the President enacted a Food Security Council in March 2018 to address this, and await updates on the committee's strategy for dealing with the issue.

- Energy security: Energy security remains a very distant reality for Nigeria as the country remains reliant on imports in the absence of functioning refineries. In fact, the situation has deteriorated in 2018 as higher oil prices increase the subsidy burden on the Nigerian National Petroleum Corporation. We do not expect this dynamic to change until the Dangote refinery comes onstream in 2019/2020.
- Transport infrastructure: According to the Ministry of Finance, public investment in roads rose from ₦19 billion in 2015 to ₦307 billion and ₦208 billion in 2016 and 2017, respectively. There have been further successes recorded through the ₦100 billion Sukuk issued for road finance, as well as in public-private partnerships (PPP) for rail investment. We expect transport infrastructure to continue to receive significant investment as the Federal Government focuses its spending here and commits to securing additional PPPs in this area.
- Drive industrialization to support SMEs: The picture here is mixed. Improvements in the ease of doing business have been a minor win and we expect the Presidential Enabling Business Environment Council to roll out further action plans in pursuit of a higher ranking on the World Bank Doing Business Rankings. Although there are legitimate concerns that not enough SMEs have felt the effects of the purported improvements, we do not ignore the confidence boost of Nigeria's rise in the rankings. In contrast, Special Economic Zones (SEZ) – the primary industrialization vehicle chosen by the government – are still a phantom presence in the country, despite the plan to set up a new SEZ in each of the six geopolitical zones. We do not expect much change here as budget and bureaucratic delays would likely prevent any notable progress in new SEZs before the 2019 elections. Given this, Nigeria's industrial base would remain fragile in the interim.

ERGP labs: The proof will be in the pudding

The Federal Government ran focus labs for the ERGP between March 12 and April 22, 2018. The labs were a workshop-style series of meetings between industry stakeholders and the public sector, aimed at identifying projects which would help achieve ERGP targets. The focus labs placed emphasis on projects with high private sector participation and were to devise clear implementation roadmaps. At completion, the focus labs had identified 164 projects across three strategic sectors of the economy (agriculture & transport, gas & power, and manufacturing & processing) which would rake in $22.5 billion in investment and create 500,000 jobs. We see this as a positive step towards actualizing ERGP recommendations, but are cautious of the ultimate impact as the focus labs would not be directly involved in project execution, with the responsibility falling on the relevant ministries.

Is now the time for a minimum wage hike?

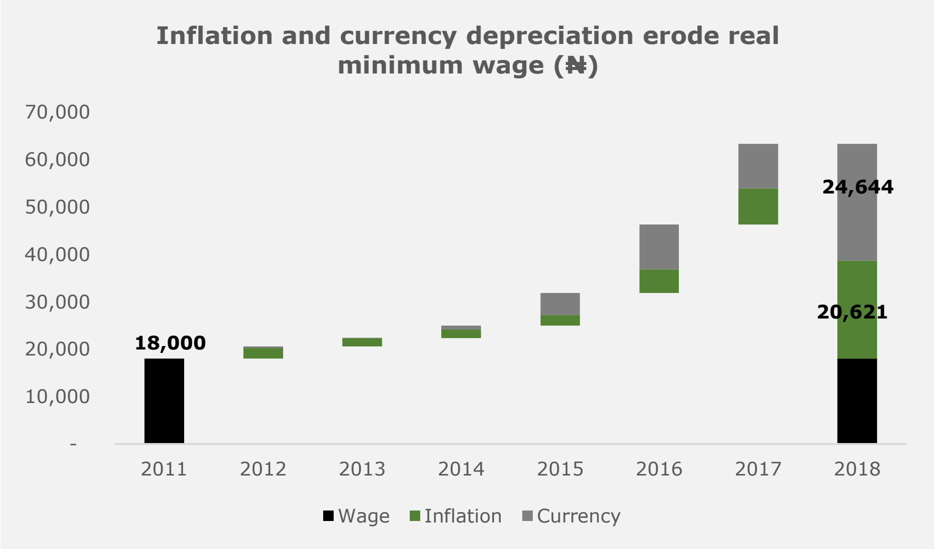
Nigeria is finalizing plans to increase its national minimum wage from ₦18,000, last amended in 2011 (previous: ₦5,500). Whilst the wage amount is yet to be determined, the National Labour Congress (NLC) has reportedly pushed for a wage floor as high as ₦66,500.

Furthermore, the NLC has pushed for a September roll-out of the new wage structure, but are likely to be disappointed on this front. The Minister for Labour & Employment, Senator Chris Ngige confirmed that the Minimum Wage Tripartite Committee would submit its recommendations to the Federal Government by September. Following that, the Executive arm of government would pass the recommendations on to the Federal Executive Council and National Economic Council, before a bill is finally transferred to the National Assembly to be enshrined into law. The National Assembly would also need to pass a supplementary budget for the implementation of the wage policy. Considering all this, we do not see the new minimum wage being rolled out in 2018, in line with the Minister's guidance that a year-end target would only be achieved if processes are fast-tracked. That said, we anticipate that the current administration would want to milk the goodwill potential of the new minimum wage and foresee increased traction in the run-up to the elections – though we do not expect the policy to be passed by then.

We anticipate that the current administration would want to milk the goodwill potential of the new minimum wage and foresee increased traction in the run-up to the elections – though we do not expect the policy to be passed by then.

Source: XE, Mimimumwage.org, Vetiva Research

As previously mentioned, the government would need to pass a supplementary budget in order to fund the resultant increase in recurrent expenditure. In fact, we are concerned about funding as the Federal Government (FG) is still struggling to reduce its wage bill while many state governments are still reliant on FG support to pay salaries. Moreover, the magnitude of the proposed hike gives pause. Admittedly, the jump may be in line with pricing changes since 2011 – our estimates suggest that once we account for post-2011 inflation and currency depreciation, ₦18,000 would be equivalent to ₦63,300 at the end of 2017, only slightly lower than the ₦66,500 proposed by the NLC. One way to salvage the fiscal picture would be to allow states to establish different minimum wages above a federal wage floor – a system being effectively used in the United States.



Source: NBS, CBN, FMDQ, Vetiva Research

The proposed minimum wage hike would have myriad effects on the economy. Whilst it should provide a material aggregate demand boost in the short to medium-term, the concern is that this would stoke long-run inflation if aggregate supply does not expand in tandem – a plausible situation given ongoing challenges in Nigeria's business environment and persistently low productivity. Meanwhile, the fiscal angle is unequivocally worrying as many state governments are in precarious fiscal positions, and this is before we account for the opportunity costs of spending more on salaries. We also highlight the usual concerns of higher unemployment on the back of minimum wage hikes, but note that empirical evidence is inconclusive on the matter. However, the magnitude of the proposed hike and the fragility of Nigeria's labour market means that higher unemployment is a fair possibility. Overall, although there is a clear need for a minimum wage increase given the erosion of spending power in recent years, implementation in the near future would have serious implications for Nigeria's labour market and fiscal stability.

Late passage and inconsistent execution would continue to constrain fiscal policy. We expect imminent elections to spur accelerated budgetary disbursements but are cautious over the long-term economic impact of pre-election fiscal policy.

Fiscal Policy

2018 Budget – just like 2017, 2016…

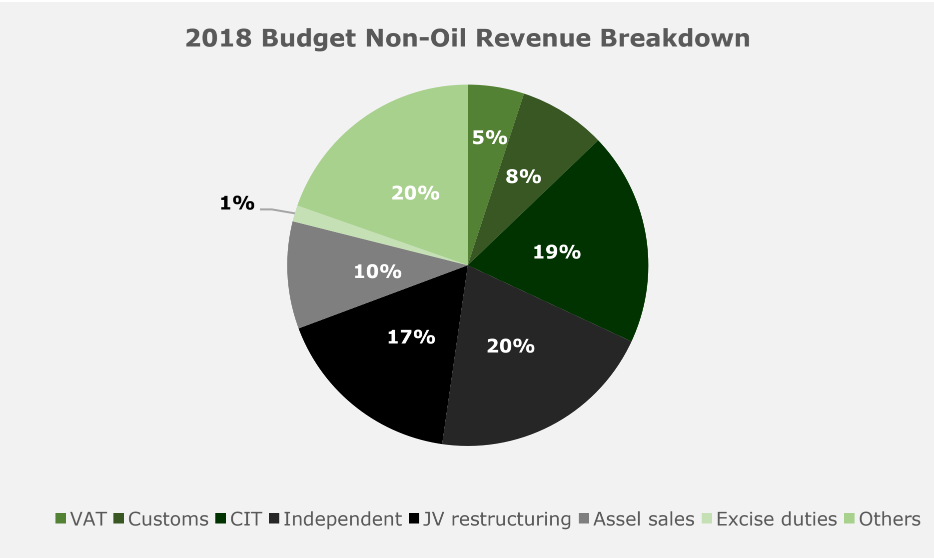
The 2018 Budget was passed on the 20th of June after the National Assembly increased expenditure spending from ₦8.6 trillion to ₦9.1 trillion, with the Ministries of Power, Works & Housing and Health the primary beneficiaries. We reiterate that the budget has the same theoretical fiscal benefits as previous iterations – it can provide a sizable aggregate demand boost and direct investment towards necessary infrastructure. However, late passage and inconsistent execution would continue to constrain fiscal policy. We expect imminent elections to spur accelerated budgetary disbursements but are cautious over the long-term economic impact of pre-election fiscal policy. We continue to stress that the efficacy of disbursement would determine the effect of the budget on the economy in 2018, especially as electioneering may lead to fiscal slippage.

Oil prices to support government revenues

We expect strong global oil prices to support government oil earnings and even compensate for inevitable shortfall in volumes during the year (compared to budget benchmark). We expect oil prices of $67/bbl and oil production of 2.00 mb/d in 2018, compared to the budget benchmarks of $51/bbl and 2.30 mb/d. We note that fiscal position would even be stronger with a more aggressive oil price benchmark, given the strong price outlook for the year, but expect some of the gains from high oil prices to accrue to the Excess Crude Account as a prudent measure to protect against future oil price shocks. This expected oil revenue outperformance would be key given the likelihood of a shortfall in non-oil revenues in 2018, but represents the frustrating persistence of the oil dependency of Nigeria's fiscal position.

Non-oil reality yet to match rhetoric

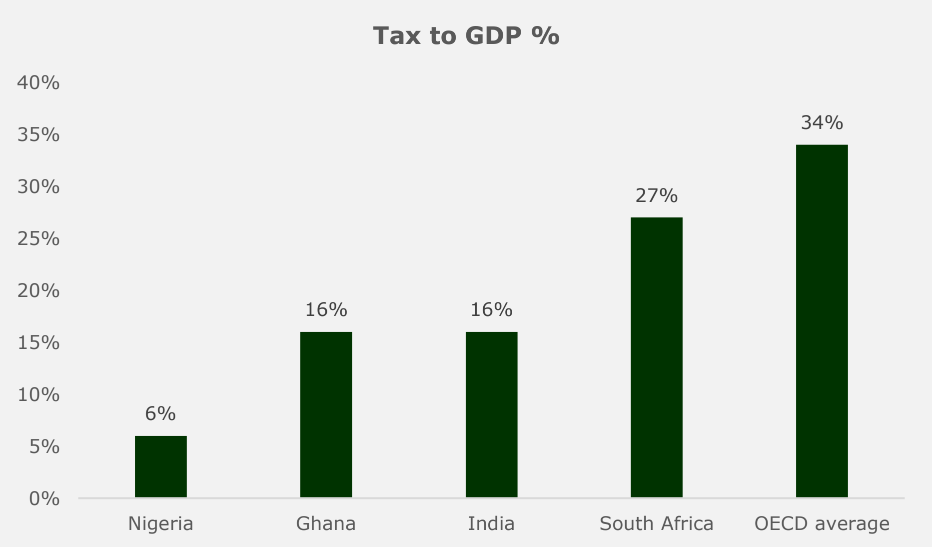
We are less optimistic about non-oil revenues (₦4.2 trillion), a view we shared at the start of the year, as we see some of the targets as slightly ambitious. This view has only been strengthened in the first half of the year as the outlook is unpromising for a number of non-oil revenue items. Joint Venture oil asset equity divestment is expected to generate 17% of total non-oil revenues but looks unlikely in light of the late passage of the 2018 Budget, pending petroleum sector reform, and the highly sensitive political clime of H2'18. Furthermore, other asset sales (via privatization) are to fund ₦400 billion of the budget and recent reports indicate that the government is looking to sell or lease assets ranging from power assets to sports stadiums, as well as sell part of its stake in the Nigerian Reinsurance Company. Meanwhile, independent revenues are likely to underperform once more due to inconsistent remittances from MDAs. Finally, the Voluntary Assets & Income Declaration Scheme (VAIDS) accrued only $100 million a month before the end-of-June deadline, despite a target of $1 billion and a three-month extension. Amidst all these, and with delayed budget passage likely to compound challenges, we harbor reservations about the performance of non-oil revenue this year.



Source: NBS, Vetiva Research

Nigeria's poor tax collection (tax-GDP ratio: *c.*6%) is a serious problem for the economy as it ties the fiscal cycle to global oil price movements and prevents the country from addressing its infrastructure gap or dealing with poverty. The trend is also persistent as non-oil revenues have been relatively sticky in recent years once we account for the cyclical effect of recessions. The International Monetary Fund suggests that Nigeria has a non-oil tax potential of at 16-18% of GDP given prevailing income levels and economic structure – so rising incomes would actually boost this figure – indicating that Nigeria is performing well-below potential. The Economic Recovery & Growth Plan targets a 15% tax-GDP ratio but efforts to reach this level have borne only sporadic fruit. We note that the Federal Executive Council approved two Executive Order and Five Bills related to tax policy in June (the Bills must be reviewed by the legislature and Executive before being signed into law). All things considered, we hold the view that whilst tax mobilization efforts are necessary for fiscal sustainability, the fiscal authorities must get their own houses in order. In particular, public spending needs to become more consistently efficient and transparent to entice additional taxes.

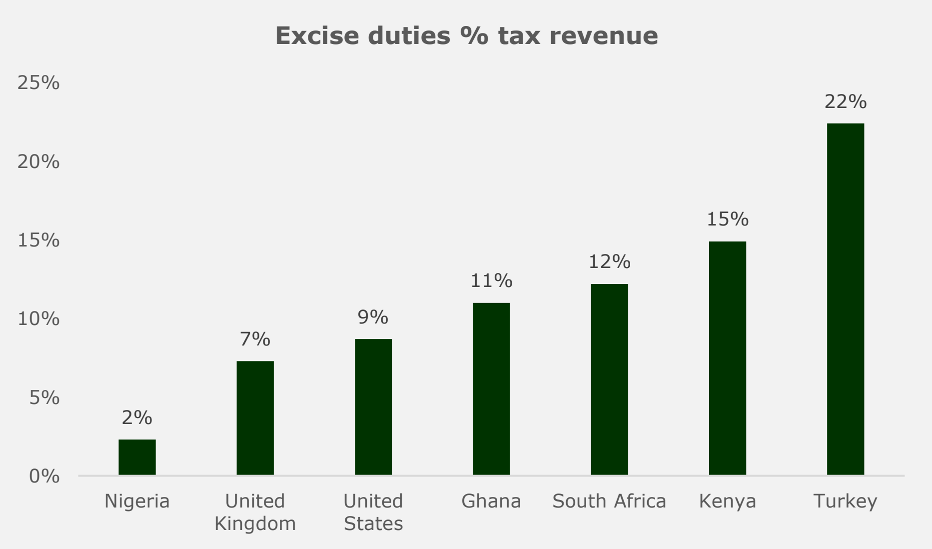
We hold the view that whilst tax mobilization efforts are necessary for fiscal sustainability, the fiscal authorities must get their own houses in order. In particular, public spending needs to become more consistently efficient and transparent to entice additional taxes.



Source: VAIDS, Vetiva Research

New excise duties set a good precedent

New excise duties on tobacco and alcohol came into effect on June 4th, 2018 and we see this as a positive development. Excise duties are a form of indirect tax (not self-reported unlike income taxes) so opportunities for avoidance are limited. Furthermore, although consumers switch frequently between brands, alcohol and tobacco demand is relatively inelastic. All of this points towards a good chance of the Federal government achieving its target of raising ₦60 billion through these duties. Nigeria has low excise duties compared to other countries – IMF estimates peg this at 0.1% of GDP vs. 2.9% and 3.5% in Kenya and South Africa, respectively, showing that the country has room to grow revenues in this area. In addition, international experience shows that the marginal cost of excise duty collection is significantly lower than other forms of taxes, and excise duties are also good for addressing the external costs of alcohol and tobacco consumption. The main downside of the policy is the effect it may have on still-weak consumer wallets.

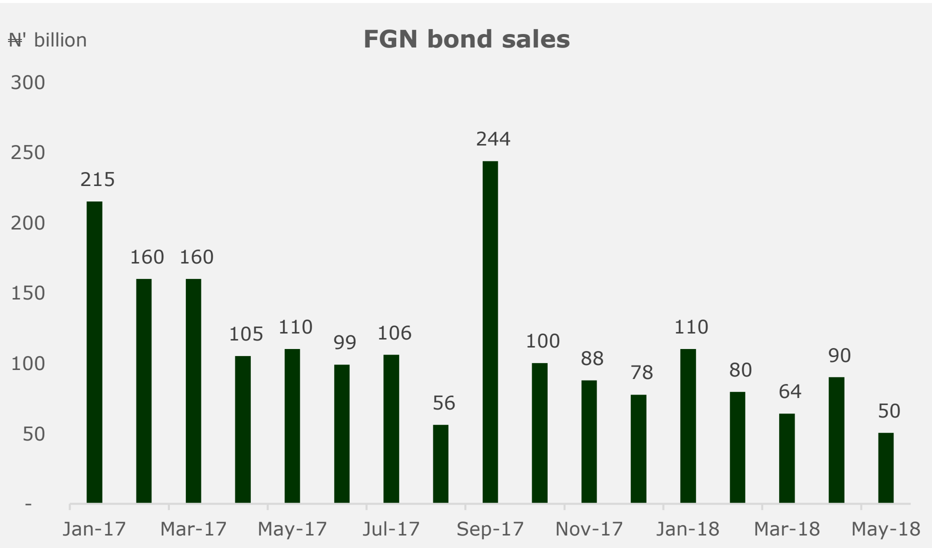


Source: IMF, Vetiva Research

FGN borrowing should moderate, pivot abroad

Federal Government borrowing should moderate from last year's levels. The 2017 Budget proposed domestic borrowing of ₦1.25 trillion and foreign borrowing of ₦1.1 trillion, whilst ₦1.52 trillion and ₦0.85 trillion ($2.8 billion for 2017 budget) was eventually raised in the domestic and international markets, respectively. Meanwhile, the proposed 2018 Budget estimates borrowing of ₦1.70 trillion split evenly between domestic and foreign sources. In our view, this reduction in borrowing is positive in light of the recent pressure on Nigeria's debt servicing costs – IMF estimates debt-revenue ratio of 70% in 2017. In addition, the shift from the domestic bond market would also reduce the crowding out of private sector credit, though it comes with exchange rate risks. We expect pressure to ease on government debt growth and servicing costs, and see the latter as a big positive as the IMF had forecasted debt servicing of 82% of revenues in 2023 at the previous levels of borrowing and borrowing costs.

We expect pressure to ease on government debt growth and servicing costs, and see the latter as a big positive as the IMF had forecasted debt servicing of 82% of revenues in 2023 at the previous levels of borrowing and borrowing costs.



Source: DMO, Vetiva Research

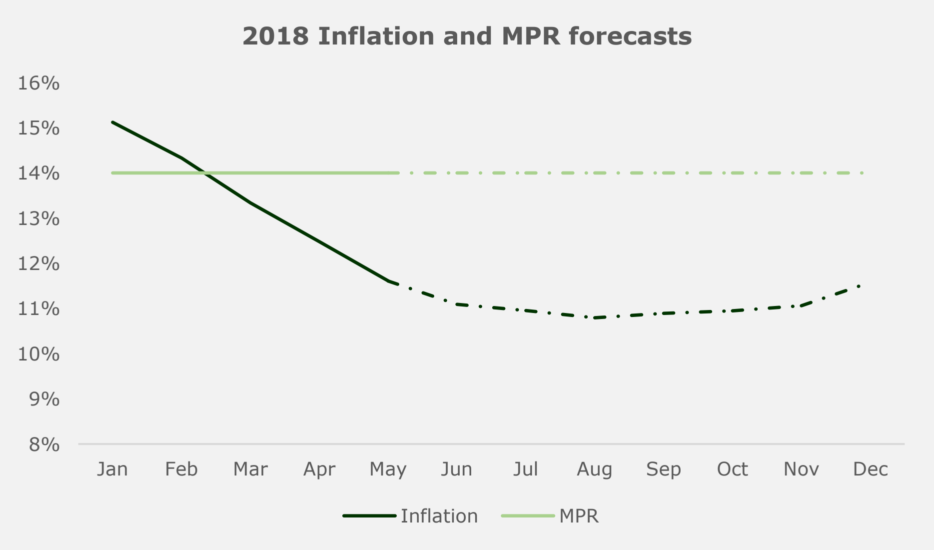
Monetary Policy

Inflation will trend down… until campaigns begin

The moderation in inflation observed so far in 2018 is impressive – annual inflation has moderated 376bps from December 2017 to May 2018 compared to 320bps between December 2016 and December 2017. This fall has been driven by abating food price pressure and continued exchange rate stability. In addition, base effects from high H1'17 inflation has amplified the decline in 2018 inflation, but this effect is expected to wane as the year progresses. As such, the pace of inflation moderation is set to fall. We note that Nigeria's inflation has largely been cost-push in recent years and the signs are positive on this front. Nigerian National Petroleum Corporation intervention should continue to stabilize petroleum product prices ahead of the elections and exchange rate stability should persist. However, there is a risk of a reversal in the food price trend as effects of August 2017 Benue flooding and ongoing Herdsmen violence kick in. In addition, the demand-side now presents a greater worry. Delayed budget passage and pre-election spending are likely to trigger sizable fiscal injections at the tail-end of the year and create a situation where too much money is chasing too few goods. Given this expected pattern, we project inflation to trend downwards in the coming months before reversing trend in September 2018 as government spending weighs on prices and base effects wear off. We note that this already manifested in May with month-on-month inflation registering at 1.1%, the highest since July 2017. Overall, 2018 average inflation is projected at 12.0% (2017: 16.6%).

Given the outlook of a near-term reversal in inflation, we do not consider it a good time for the Central Bank of Nigeria to cut interest rates. Indeed, this is a view shared by many members of the Monetary Policy Committee (MPC) who have flagged the inflationary potential of government spending at year-end.

Given the outlook of a near-term reversal in inflation, we do not consider it a good time for the Central Bank of Nigeria to cut interest rates. Indeed, this is a view shared by many members of the Monetary Policy Committee (MPC) who have flagged the inflationary potential of government spending at year-end. As such, we predict a hold decision at all MPC meetings for the rest of 2018.

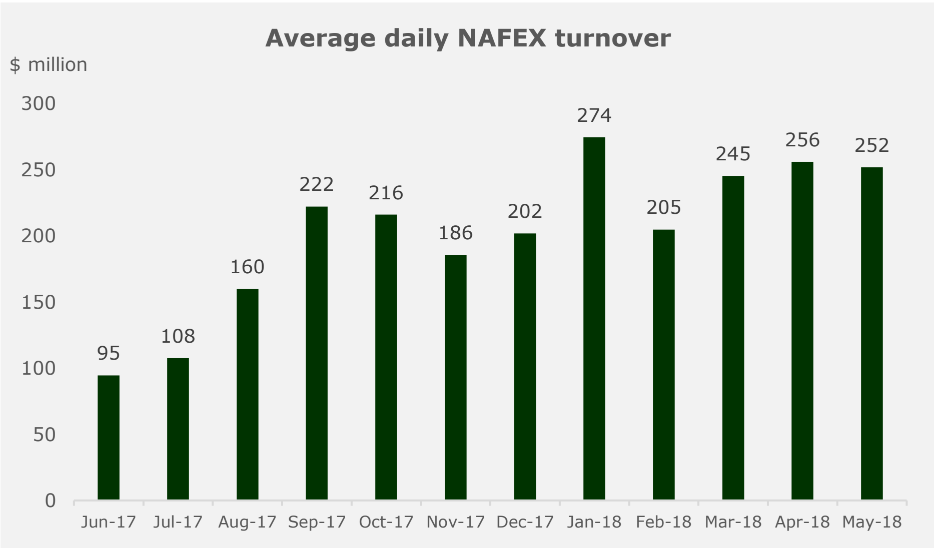


Source: CBN, NBS, Vetiva Research

Continued foreign exchange stability should not be underrated

Despite still operating a multiple exchange rate system, Nigeria's foreign exchange (FX) market has remained in a healthy position in 2018. The "Investors & Exporters" (NAFEX) window has fared particularly well, with increasing activity as the months have gone by – barring a spike in January during the mini equity market bubble, average daily FX turnover in April and May has been notably higher than previous levels, indicating resilient confidence in the window. In addition, the CBN has persisted with its regular currency sales across a range of retail and wholesale market segments without any deterioration in external reserves (risen from $39 billion in January to $48 billion in May). The outlook for the FX market is positive thanks to high oil prices which should lead to further reserves accretion and stable foreign currency supply. The outlook for capital inflows is less positive, however. U.S. Federal Reserve tightening could lead to capital reversal, and as investors focus on risk-adjusted returns, we are cautious that pre-election jitters may accentuate Nigeria's risk environment and discourage some inflows. Nevertheless, supported by strong oil earnings, we expect the NAFEX rate to remain stable around NGN360/USD. Furthermore, we do not anticipate any changes to the current FX market structure; the likelihood of devaluation is faint pre-elections and market would always impose a premium in floating segments because of the market demarcation. All in all, the FX market status quo should persist through to 2019, barring any shocks to oil prices or volumes.

Supported by strong oil earnings, we expect the NAFEX rate to remain stable around NGN360/USD. Furthermore, we do not anticipate any changes to the current FX market structure; the likelihood of devaluation is faint pre-elections and market would always impose a premium in floating segments because of the market demarcation.



Source: FMDQ, Vetiva Research

Nigeria clinches currency swap, will ease transaction costs

The Central Bank of Nigeria (CBN) and the People's Bank of China (PBoC) agreed a three-year currency swap (₦720 billion for 15 billion yuan) in a bid to ease trade flows. The swap is a bilateral loan agreement, which means the CBN would repay the 15 billion yuan in three years, either at a pre-arranged exchange rate or the prevailing rate at the time. The CBN would conduct bi-weekly yuan auctions to authorized dealers who would be able to sell to retail users. We note that annual Chinese imports are *c.*₦1.8 trillion so the swap is 40% of total annual Chinese imports whilst China has been increasing its investing in Nigerian infrastructure.

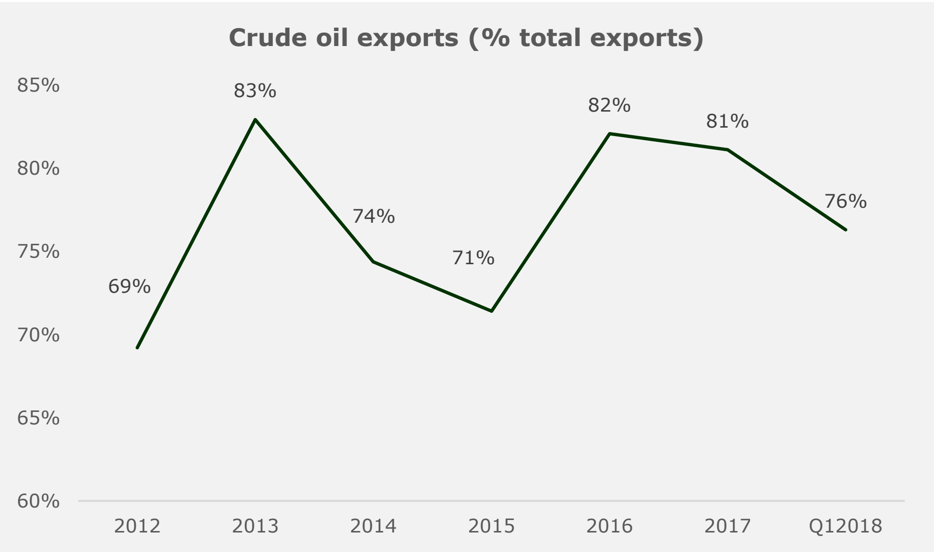
In our view, given the size of the swap compared to Nigeria's annual imports from China, the primary benefits would come in terms of reducing the exchange rate carrying risk by permitting direct naira-yuan conversation, a reduction in FX transaction charges, and overall easing of transacting with Chinese firms. These should improve the ease of doing business and help the competitiveness of Nigerian businesses.

International Trade

Petroleum exports to remain tale of trade

Trade developments in the first half of 2018 were dominated by Nigeria's refusal to sign on to the African Continental Free Trade Area and the Economic Partnership Agreement, two seminal multilateral trade agreements, a decision the President attributed to concerns over dumping. For the rest of the year, we expect the country's current account to wax strong as exports continue to outstrip imports. Current account surplus has risen for four consecutive quarters since Q2'17. Exports should be powered by steady crude oil sales, on the back of a positive outlook for crude oil prices and volumes. Imports should also remain steady albeit slightly dampened by continued import substitution. A stable foreign exchange market and rising aggregate demand should spur imports. We also note a recent uptick in petroleum imports (29% of Q1'18 total imports vs average of 18% across last eight quarters), a development that could partly be attributed to smuggling as a result of the arbitrage created by the current implicit subsidy regime. We foresee this uptick persisting through the year and inflating imports.

Looking at the ubiquity of oil & gas products in Nigeria's trade profile, it would be uncontroversial to say that the aforementioned trade agreements would have had very little impact in the near-term. The government has maintained its focus on export diversification, but we are yet to see this reflected in Nigeria's trade profile as non-oil exports are still small in both absolute and proportional terms.

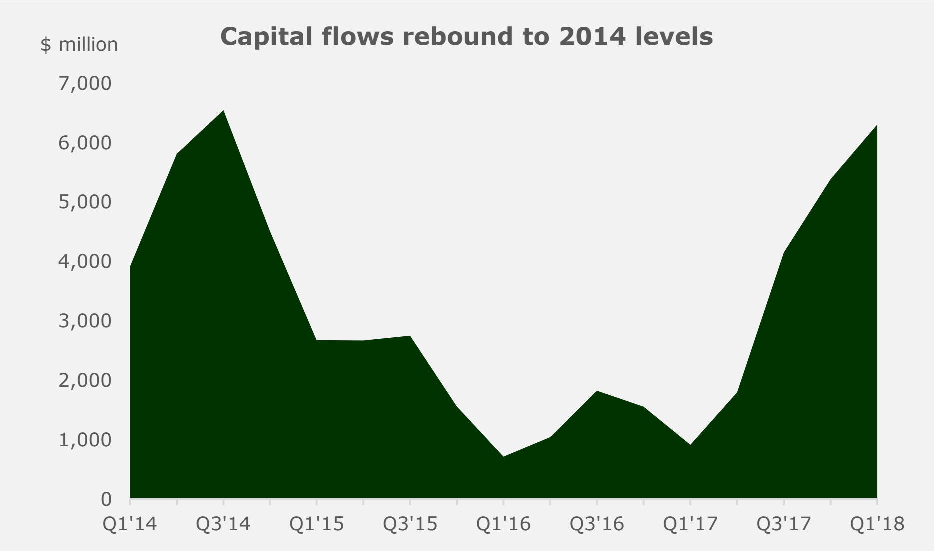


Source: NBS, Vetiva Research

Caution: tepid foreign sentiment ahead

Nigeria's capital imports have recovered strongly in recent quarters, rising from a low of $0.7 billion in Q1'16 to $6.3 billion in Q1'18, the highest since the 2014 oil price crash. However, we foresee this momentum slowing in the coming quarters as foreign portfolio inflows take a dip. On one hand, relatively high yields (and a less dovish monetary policy outlook than at the start of the year), improving macroeconomic conditions, and low equity valuations all indicate an attractive capital market environment. On the other hand, rising global interest rates as the Federal reserve persists with monetary tightening, and pre-election jitters are likely to induce capital reversals in H2'18. Meanwhile, we do not anticipate much help from government external borrowing even ahead of the elections. The Federal Government borrowed $4.8 billion in the external debt market in 2017 (for budget financing and debt rebalancing), while 2018 Budget estimates indicate external borrowing under $2.5 billion range. Finally, we note that H2'18 capital imports would not have the weak base support of H1'18 when looking at a y/y comparison and even expect H2'18 to compare unfavorably to H1'18.

The Federal Government borrowed $4.8 billion in the external debt market in 2017 (for budget financing and debt rebalancing), while 2018 Budget estimates indicate external borrowing under $2.5 billion range.



Source: NBS, Vetiva Research

Fixed Income

Fixed Income Market

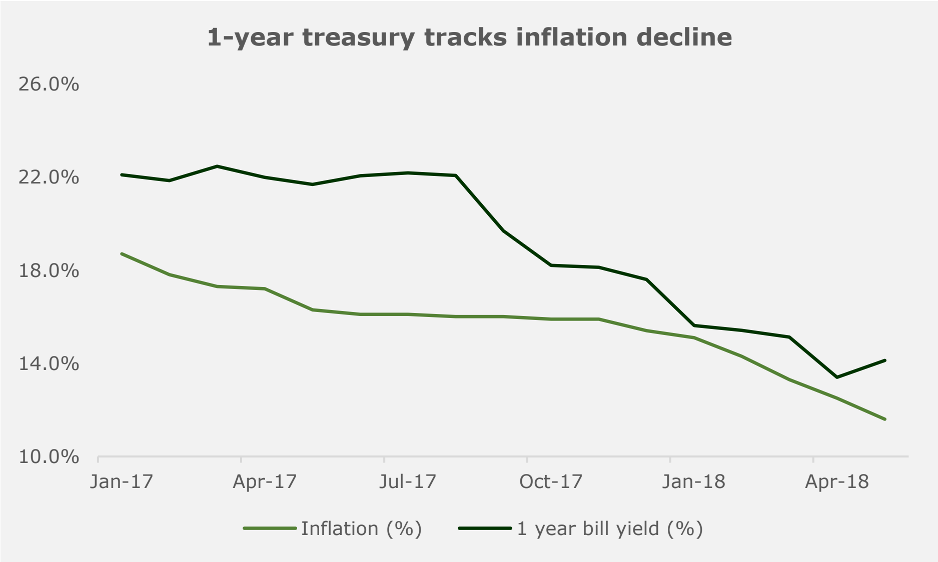
Election jitters to hit fixed income market

Although a modest economic recovery and strong oil prices ought to make the Nigerian economy an attractive destination, uncertainty ahead of the 2019 elections is likely to induce more bearish activity. Firstly, we anticipate higher political spending in H2'18 to fund electioneering activities. This spending will pressure year-end inflation, which would likely manifest in higher yields. As such, we anticipate a yield uptick in the latter parts of the year and foresee reduced market activity as some investors opt to sit on the sidelines.

We have revised our monetary policy expectation for 2018 on the back of prevailing economic realities and our outlook for the rest of the year. We had initially expected a 200bps rate cut in mid-2018 amid down-trending inflation and the need to stimulate economic growth in a pre-election year.

All monetary policy levers expected to hold steady in H2

We have revised our monetary policy expectation for 2018 on the back of prevailing economic realities and our outlook for the rest of the year. We had initially expected a 200bps rate cut in mid-2018 amid down-trending inflation and the need to stimulate economic growth in a pre-election year. Whilst we have observed inflation decline as expected (380bps from December 2017 to May 2018), monetary policy levers were unchanged in H1'18 and we expect that to persist in 2019. Our revised outlook is hinged on an expected uptrend in inflation later in the year as the effects of the high base in H1'17 inflation wear off. In addition, we expect increased pressure on food prices given the impact of the prolonged herdsmen violence in the Middle Belt, while election spending and other fiscal injections should spur demand-pull inflation. Amid this, we expect the Monetary Policy Committee of the Central Bank of Nigeria (CBN) to prudently hold interest rates for the rest of the year whilst the apex bank persists with Open Market Operations as its primary liquidity management tool. Given this view of a stable monetary policy, we see very few drivers for material yield moderation between now and year-end.

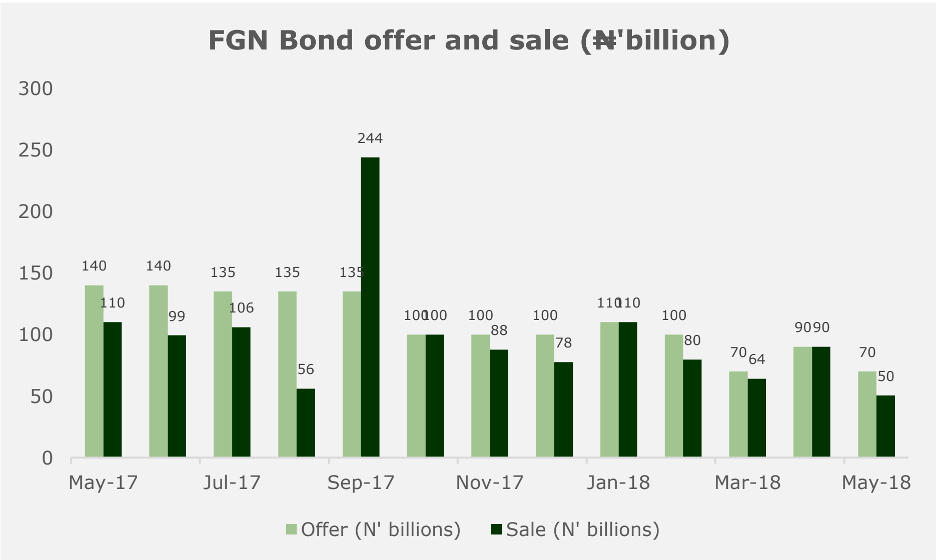


Source: NBS, FMDQ, Vetiva Research

Government spending will spur inflation, but not bond supply

We anticipate greater government spending in the second half of the year, based on late passage of the 2018 Budget, a higher proposed expenditure and electioneering activities. Despite the expansionary budget, we do not expect this to lead to a ramp up in domestic borrowing given the healthy oil earnings expectation (supported by positive oil price outlook) and government focus on external debt raising. The 2018 Budget stipulates domestic borrowing of ₦850 billion, a material drop from the ₦1.52 trillion raised in the domestic debt market for the 2017 Budget, and we expect the FGN to favour the external debt market even more. Moreover, we note that the government has not exhausted its $3 billion (₦915 billion) three-year T-bill refinancing facility obtained from the Eurobond market. So far, the government has refinanced ₦478 billion (₦198 billion at the end of December 2017 and ₦280 billion in Q1'18), leaving ₦437 billion to be refinanced within the next 2 years. We note that this is unlikely to happen in Q3'18 as the released Nigerian Treasury Bills (NTB) calendar suggests a complete rollover of maturing debt. That said, we foresee more corporate bonds and commercial paper issuances in the near-term amid a lower yield environment, however, the volumes would be insufficient to compensate for the expected decline in FGN borrowing – a trend already observed in H1'18 (₦50 billion sold in May 2018 vs ₦110 billion in May 2017).

So far, the government has refinanced ₦478 billion (₦198 billion at the end of December 2017 and ₦280 billion in Q1'18), leaving ₦437 billion to be refinanced within the next 2 years. We note that this is unlikely to happen in Q3'18 as the released Nigerian Treasury Bills (NTB) calendar suggests a complete rollover of maturing debt.

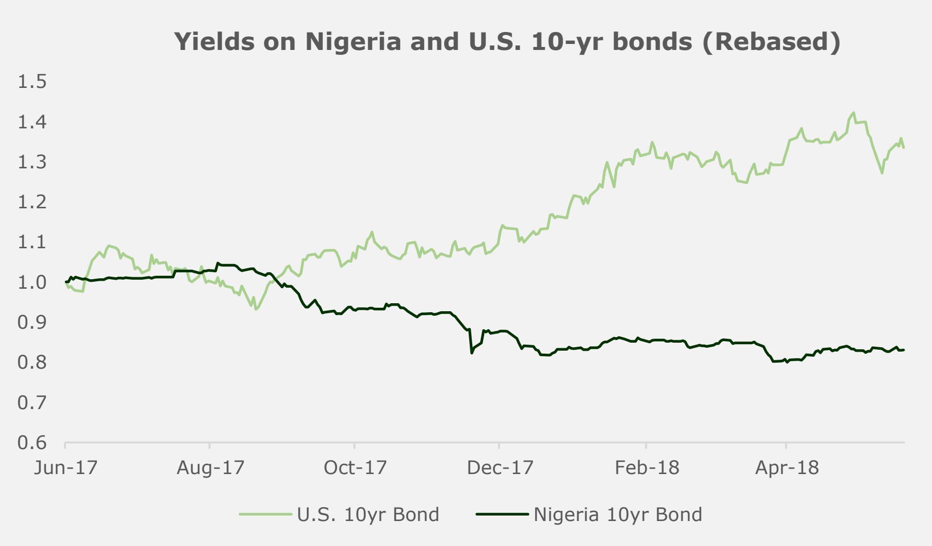


Source: DMO, Vetiva Research

Rising global rates and domestic uncertainty may dissuade FPI

Foreign portfolio inflows (FPI) to Nigeria's fixed income market have rebounded in recent times, rising from $30 million in March 2017 to $1.4 billion in March 2018 following the improvement in the foreign exchange market. Moreover, capital flows have stayed strong even amid yield moderation as the real rate of returns are attractive. However, ongoing monetary tightening in the U.S. is a growing concern to FPI in the fixed income market. The U.S. Federal Reserves hiked interest rates by 25bps to a range between 1.75% and 2.0% in June and is expected to deliver on two more hikes in 2018 whilst also persisting with balance sheet unwinding, both of which would push yields higher in the U.S. market and elsewhere – U.S. 1-year treasury yield has risen from 1.2% in June 2017 to 2.3% in June 2018.

We expect the usual trend of capital reversals from emerging markets as the spread between U.S. and emerging market yields shrink. The expectation of an improved risk environment in Nigeria would have caused us to be less disturbed by the closing spread in yields, however, with the risk environment heightened by imminent elections, we do not see any reprieve on this end. We note that Nigeria's re-inclusion in the JP Morgan Emerging Market Bond Index would offer a strong demand boost to FGN bonds, but are not optimistic of this occurring in 2018. All things considered, we anticipate reduced foreign demand for fixed income instruments in the near-term.



Source: Bloomberg, FMDQ, Vetiva Research

Not much room to go lower in fixed income market

In summary, despite the monetary policy levers remaining unchanged so far, we have seen yields moderate 169bps on average across the curve in the fixed income market this year, on the back of a looser liquidity tightening stance evidenced by the spotty spate of OMO auctions to mop-up liquidity compared to the same period last year. The primary drivers point to declining yields, led by moderating inflation (2017 average: 16.6% y/y, 2018F average: 12.0%) though we expect expansionary fiscal policy and fading base effects to cause a slight uptick in inflation in Q4'18. Moreover, bond supply is expected to moderate as the Federal Government (FGN) shifts focus to external debt issuance – the corporate and sub-national bond market remains too shallow to compensate for declining FGN bonds. However, the demand-side of the equation is less positive. Whilst we see the mooted re-inclusion in the J.P. Morgan Bond Index as a potential balm, we point to rising global interest rates and pre-election jitters as likely drivers of weaker foreign appetite for Nigerian debt. In particular, with the moderation in inflation likely to bottom out in Q3 we see elections looming larger at year-end weighing on demand in the fixed income market . Overall, we project a 25bps decline in yields in Q3 and a 125bps uptick in Q4 leading to a 100bps rise in yields for H2'18.

The primary drivers point to declining yields, led by moderating inflation (2017 average: 16.6% y/y, 2018F average: 12.0%) though we expect expansionary fiscal policy and fading base effects to cause a slight uptick in inflation in Q4'18.

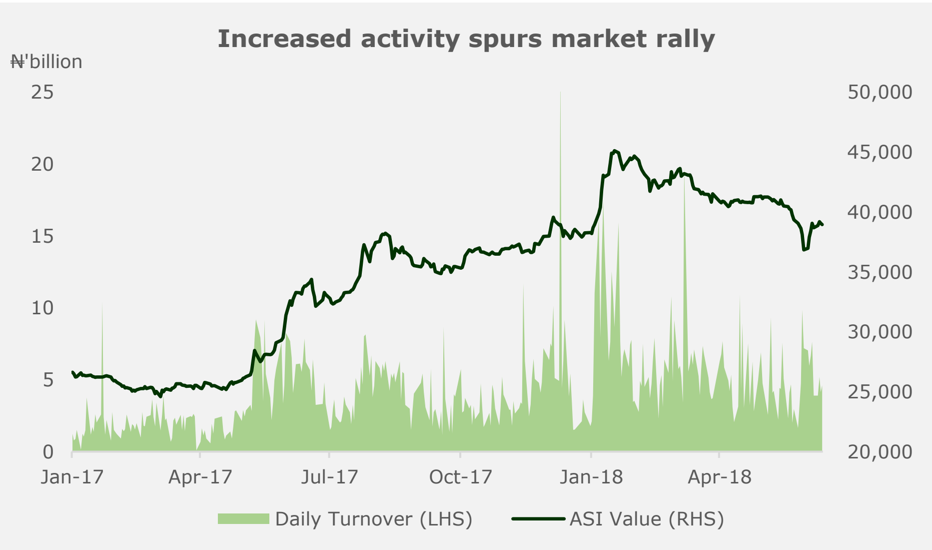
Equity

Equity Market

Mixed first half swings market returns

Coming off an impressive 2017 where the Nigerian Stock Exchange (NSE) All-Share Index (ASI) notched a 42% gain, we had expected 2018 to follow a similar albeit weaker positive path. This view was predicated on our positive oil price outlook and the anticipated domestic economic recovery, both of which were expected to buoy company earnings and support market sentiment. This trend played out in January as the ASI surged 16% amid significant foreign interest – foreign activity in equity totaled ₦166 billion in January. However, the post-January period has been generally downbeat as pre-election jitters and capital reversals weighed on the market. Whilst we had initially expected election effects to come into play towards the tail-end of the year, we revise our outlook to account for the heightened sensitivity of investors on this front. And although we are still relatively positive about the macro economy and corporate earnings, our H2'18 outlook is tilted bearish on the back of sustained tepid risk appetite ahead of the 2019 polls. Though we foresee a smoother and more peaceful campaign and electoral process, our conservative view is that foreign capital may sit on the sidelines – and enjoy rising yields in the global economy as well as stable political environment in other emerging markets – with domestic investors following suit. We are unconvinced that expected modest earnings growth would be able to sufficiently support demand in H2'18 and are cautious on the impact of new PFA mutli-fund rules given the rolling implementation deadline and concerns shown by the PFA crowd. Overall, we anticipate a bearish market in the second half of the year but highlight the underlying attractiveness of the market especially in light of soft gains seen this year.

Though we foresee a smoother and more peaceful campaign and electoral process, our conservative view is that foreign capital may sit on the sidelines – and enjoy rising yields in the global economy as well as stable political environment in other emerging markets – with domestic investors following suit.



Source: NSE, Vetiva Research

Macro support for market vanishes

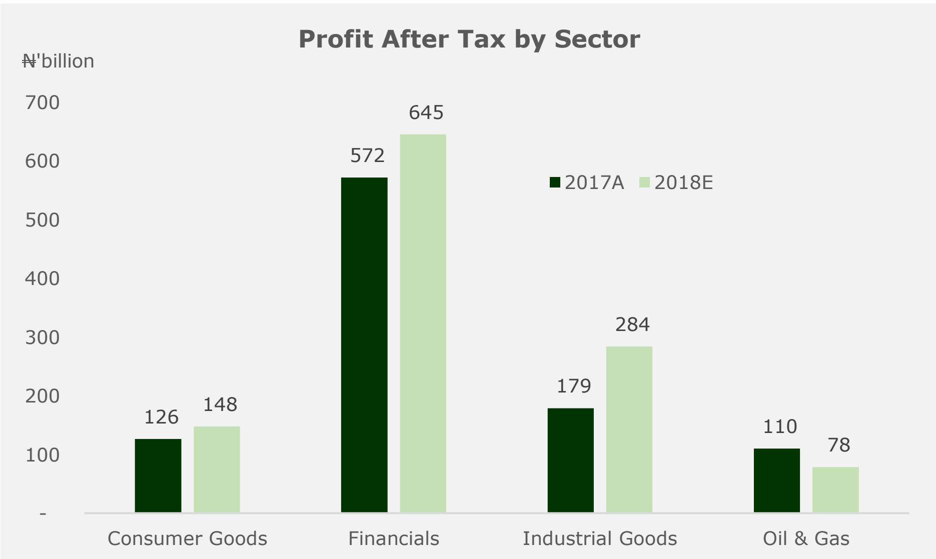
Our initial positive expectations for the Nigerian equity market were predicated on strong economic performance through the year. So far, the economy has slightly underperformed (Q1'18 GDP growth of 2.0% vs 2.6% consensus expectation), but green shoots have manifested in moderating inflation (January: 15.1%, May: 11.6%), strengthening industrial activity, and high oil prices (Brent crude peak: $79.80/bbl in May).

Nevertheless, the effects of this modest economic performance were little felt in the market in H1'18 as the market was on a downtrend for most of the first half of the year post-January (January return: 16.0%, Q1 return: 8.5%, Q2 return: -6.8%). In H2'18, the economic picture would provide a few things for the market to cheer; we expect inflation to continue to moderate to low double digits in H2'18 and ease pressure on manufacturers' costs and consumer wallets, whilst a stable foreign exchange market and strong government spending should support demand in the economy. However, we are slightly less upbeat about this year's economic performance, in light of enduring weakness in key sectors, delayed budget passage, and unexpected disruptions to oil production. As such, we do not see macro developments offering much support to the equity market in the second half of 2018.

In H2'18, the economic picture would provide a few things for the market to cheer; we expect inflation to continue to moderate to low double digits in H2'18 and ease pressure on manufacturers' costs and consumer wallets, whilst a stable foreign exchange market and strong government spending should support demand in the economy.

Stronger earnings expected. Will this help?

We anticipate stronger earnings across our coverage sectors in the second half of the year. In the Banking Sector, we still see the most value in Tier 2 names as earnings recover from recent lows – driven by modest real loan growth, moderating loan losses and contained operating costs. For the wider sector, pressure from lower yields on government securities and a likely moderation in derivatives income will be offset by a recovery in loan growth and expected increase in transaction velocity from improved economic activities. We forecast higher revenues across Consumer Goods names as recovering volumes compensate for price cuts, and expect the sector to benefit from recent deleveraging and moderation in funding costs. We have a similar strong volume outlook for the Industrials Good sector, in line with Q1'18 trend, and on the back of expected government infrastructure spending at the tail-end of the year. Finally, we expect strong oil prices and production to support the upstream oil & gas space – albeit with some caution following ongoing challenges with key pipelines. Meanwhile, the status quo should persist across downstream players, with margin support and earnings growth likely to come from increased play in deregulated petroleum products. Overall, we are cautiously optimistic about earnings for the rest of the year, and although we do not see it as a strong enough influence to steer market direction, we expect the top tier names with decent fundamentals to remain investors' toast in the second half of the year.



Source: NSE, Company Financials, Bloomberg, Vetiva Research

Listings can lift market

Weak market pricing and cautious investor sentiment have discouraged new offers in the last few years as most companies in need of funds maintained a watch and see approach. The space appears to be getting clearer in 2018 with a number of new listings, some of which include Skyway Aviation Handling Company (SAHCOL), Nigerian Reinsurance Corporation, Notore Chemical Industries, and most notably, MTN Nigeria expected to spring up soon. We consider the spate of new listings to be positive for the market and foresee the major listings boosting market activity and liquidity. Moreover, we see these listings having a knock-on effect with unlisted companies in similar sectors beginning to look more closely at the equity market. Furthermore, we are hopeful that an active primary market would engender greater investor interest in the equity market, particularly in a year when foreign investors are likely to tread cautiously ahead of the 2019 elections. We are particularly excited about the MTN Nigeria listing given its expected size and see it as a shot-in-the-arm for Nigeria's IPO space. The Telecoms giant entry into the market should aid in efforts to deepen and diversify the market.

We are hopeful that an active primary market would engender greater investor interest in the equity market, particularly in a year when foreign investors are likely to tread cautiously ahead of the 2019 elections.

Issuer Name	Offer Size ($Million)	IPO Date
Transcorp Hotels Plc	26	January-15
SEPLAT Petroleum Development Company	535	April-14
UPDC Real Estate Investment	169	July-13
Lekoil Ltd	48	May-13
Dangote Cement Plc	89	October-10
Union Homes Real Estate Investment	86	July-10
Afromedia Nigeria Ltd.	20	May-09
DAAR Communication Plc	78	September-08
Capital Hotel Plc	35	August-08
Starcomms Plc	796	July-08
Nigerian Bag Manufacturing Co	62	April-08
Dangote Flour Mills	159	February-08

Source: Bloomberg, Vetiva Research

Multi-fund structure – hope or hype?

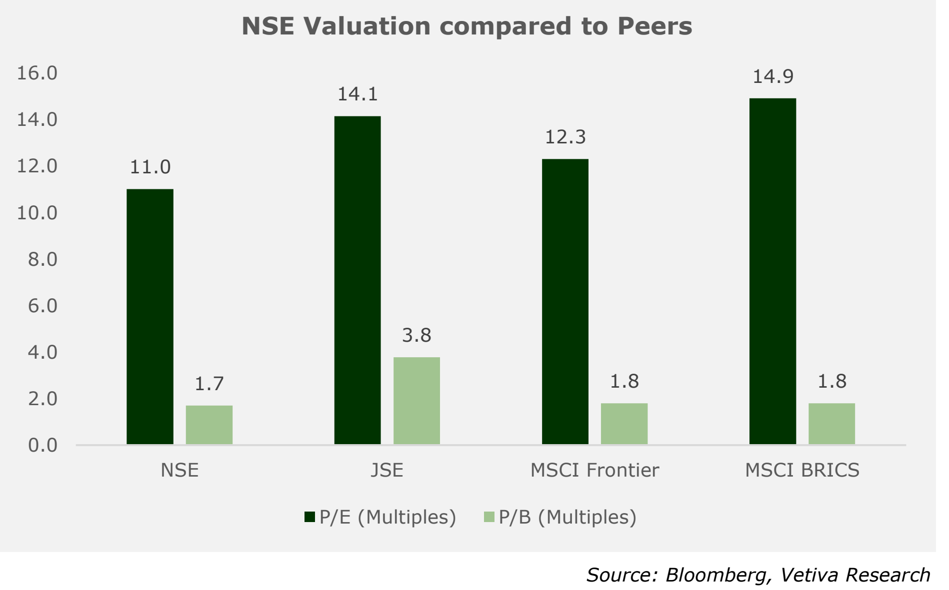
The multi-fund guidelines issued by the National Pension Commission (PenCom) have long since been heralded as the key to greater domestic investor activity in the Nigerian equity market. However, we have tempered our expectations of the near-term impact of the implementation of the new structure by Pension Fund Administrators (PFA) amid a series of postponements and skepticism over how much additional inflows the market would receive. PFAs have already began ramping up equity exposure in the last year – helped by a strong bull market in that period, increasing aggregate exposure from 7.4% in March 2017 to 8.9% in December 2017 and then to 9.3% in March 2018. Although we have seen increased activity around the implementation of the new multi-fund structure as we approach the 1st July 2018 deadline, we remain cautious given previous delays. Even as increased PFA activity could provide some market support during the period, we hold conservative expectations regarding the magnitude of this impact.

Although we have seen increased activity around the implementation of the new multi-fund structure as we approach the 1st July 2018 deadline, we remain cautious given previous delays.

Market valuation calls for long-term bet

The Nigerian market remains undervalued in comparison to peers. The NSE has lower P/E (11.0x) and P/B (1.7x) ratios than South Africa's JSE (14.1x and 3.8x), MSCI Frontier Markets Index (12.3x and 1.8x) and MSCI BRICS Index (14.9x and 1.8x). For us, this underscores the long-term appeal of the market. Moreover, we note that the equity market was in a similar position in early-2017; a combination of the oil price crash, recession, and foreign exchange scarcity had triggered large capital reversals which caused the market to lose 35% of its value from the start of 2014 to the end of 2016. However, once these factors assuaged (particularly the foreign exchange situation), we witnessed a market rally of 42% in 2017. We believe this offers lessons for the current market dynamics as the bearish near-term outlook is hinged on pre-election uncertainty whilst market and economic fundamentals continue to improve. Thus, our longer-term outlook for the market is positive, and we see Nigerian equities as a relatively cheap long-term bet for patient investors.

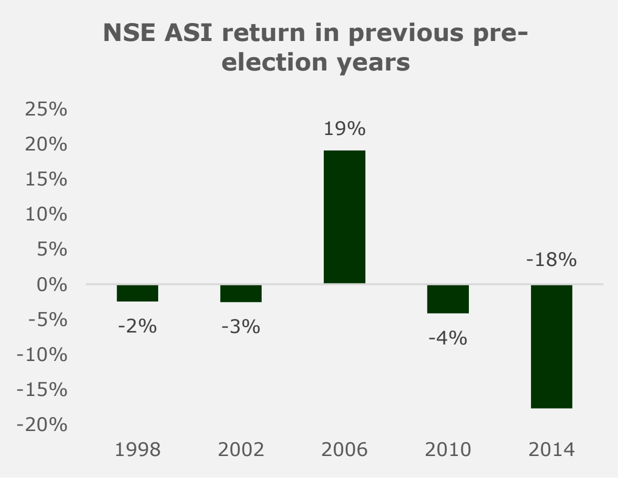
The Nigerian market remains undervalued in comparison to peers. The NSE has lower P/E (11.0x) and P/B (1.7x) ratios than South Africa's JSE (14.1x and 3.8x), MSCI Frontier Markets Index (12.3x and 1.8x) and MSCI BRICS Index (14.9x and 1.8x). For us, this underscores the long-term appeal of the market.



Source: Bloomberg, Vetiva Research

Outlook revised lower on election effects

Our outlook for 2018 is revised lower given the weight of the impending elections on market activities so far, a trend we expect to persist through the year. Furthermore, we note that developments in the political landscape would likely sway markets through the year; in particular, signs of heightened insecurity would depress investor sentiment whilst a strong likelihood of an incumbent victory (indicating continuity) would most likely reduce uncertainty. We foresee the pre-election narrative superseding other positive market drivers such as global oil prices and macroeconomic performance. Meanwhile, we expect foreign sentiment to be more affected by pre-election activities, with domestic investor activity propped by increased PFA equity play. Across sectors, we expect the top tier banking sector to be less impacted and expect the sector to slightly outperform the market. Overall, we project a market return ranging between -5% and +5% for 2018, down from our +15% to +20% expectation at the start of the year.



Source: NSE, CBN, Vetiva Research

10 High Conviction Stocks

Coming off an impressive 2017 – where the Nigerian equity market returned 42% – market performance has been unimpressive in the first half of the year, notching a slight ytd decline of 0.24% as at 21st June. Whilst strong oil prices, improving macroeconomic variables, and stronger corporate earnings ought to buoy market performance, pre-election jitters and a heightened insecurity risk are likely to weigh on the Nigerian equity market. As such, we are cautious on overall market performance for the year and forecast market return between -5% and +5% for 2018, down from our +10% expectation at the start of the year. Notably, the NSE remains undervalued compared to global peers. Particularly, the Nigerian equity market trades at a P/E ratio of 11.0x - below the MSCI Frontier Market index of 12.3x and also lagging other comparable indices such as MSCI BRICS (14.9x) and South Africa's JSE (14.1x). Whilst we expect the political uncertainties ahead of the 2019 elections to overshadow the value in the market, we remain positive about the medium to long term outlook of the equity market and see the market as a long-term BUY.

We revisit our top "10 High Conviction Stocks" presented at the beginning of the year, which represents key stocks on the NSE that we expect to outperform the market at the end of the year. The selection covers stocks that offer the strongest potential risk-adjusted returns for 2018 and also includes a few that also provide defensive play for portfolios given their limited downside risk. We maintain our confidence in Tier II banking names and expect them to outperform their larger rivals in 2018 as the continued economic recovery continues to support earnings – though Tier I banks will retain investor interest due to their premium status and lower risk. Also, strong and rising oil prices and healthy production volumes are set to support the upstream Oil & Gas sector. Though Consumer Goods stocks should underperform in comparison to other key sectors and the wider market, we expect a few Consumer names to retain their structural P/E premium to the market. We note that these high conviction stocks have so far outperformed the broad market index by 1.5% on a market cap-weighted basis and 7.0% in simple average returns, and maintain these stocks as key picks for 2018.

Vetiva's 10 High Conviction Stocks for 2018

Stock	Price	Target Price	Upside	Div. Yld. (FY'18E)	Expected Total Return
	₦	₦			
DIAMONDBNK	1.53	4.00	161%	0%	161%
FCMB	2.28	4.66	104%	7%	111%
FBNH	10.60	12.82	21%	5%	25%
ZENITHBANK	25.70	34.22	33%	10%	43%
GUARANTY	40.05	50.88	27%	7%	34%
FLOURMILL	31.40	45.45	47%	7%	54%
UACN	14.40	20.03	39%	3%	42%
WAPCO	40.00	57.63	44%	1%	45%
DANGCEM	230.30	289.45	26%	5%	31%
SEPLAT	685.00	970.18	42%	5%	46%

Vetiva's High Conviction Stocks outperform NSE ASI in FY'17 and HY'18

Vetiva's 2018 High Conviction Stocks Performance							
Stock	Year Open	Current Price	Return	Market Cap (Mil'₦)	Weight	Market Cap Weighted-Return	Simple Average Return
DIAMONDBNK	1.50	1.53	2.0%	35,435	0%	0.0%	0.2%
FCMB	1.48	2.28	54.1%	45,150	1%	0.3%	5.4%
FBNH	8.80	10.60	20.5%	380,490	5%	1.1%	2.0%
ZENITHBANK	25.64	25.70	0.2%	806,890	11%	0.0%	0.0%
GUARANTY	40.75	40.05	-1.7%	1,178,719	16%	-0.3%	-0.2%
FLOURMILL	29.00	31.40	8.3%	128,752	2%	0.1%	0.8%
UACN	16.90	14.40	-14.8%	41,491	1%	-0.1%	-1.5%
WAPCO	44.89	40.00	-10.9%	346,937	5%	-0.5%	-1.1%
DANGCEM	230.00	230.30	0.1%	3,924,429	54%	0.1%	0.0%
SEPLAT	626.22	685.00	9.4%	403,085	6%	0.5%	0.9%
				7,291,377	**100%**	**1.3%**	**6.7%**
				NSE ASI Return:		**-0.2%**	**-0.2%**
				Outperformance		**1.5%**	**7.0%**

Vetiva's 2017 High Conviction Stocks Performance							
Stock	Year Open	YTD Price	Return	Market Cap (Mil'₦)	Weight	Market Cap Weighted-Return	Simple Average Return
GUARANTY	24.70	39.8	61.1%	1,171,361	16%	10%	6.1%
ZENITHBANK	14.75	25.7	74.2%	806,890	11%	8.1%	7.4%
UBA	4.50	10.08	124.0%	344,730	5%	5.8%	12.4%
ACCESS	5.87	10.4	77.2%	300,851	4%	3.1%	7.7%
FLOURMILL	18.49	30.83	66.7%	80,905	1%	0.7%	6.7%
DANGSUGAR	6.11	21.7	255.2%	260,400	4%	8.9%	25.5%
DANGCEM	173.99	240	37.9%	4,089,722	55%	20.9%	3.8%
WAPCO	40.95	43.01	5.0%	239,814	3%	0.2%	0.5%
PRESCO	40.10	66.17	65.0%	66,170	1%	0.6%	6.5%
OKOMUOIL	40.17	71.25	77.4%	67,966	1%	0.7%	7.7%
				7,428,809	**100%**	**58.6%**	**84.4%**
				NSE ASI Return:		**42.3%**	**42.3%**
				Outperformance		**16.3%**	**42.1%**

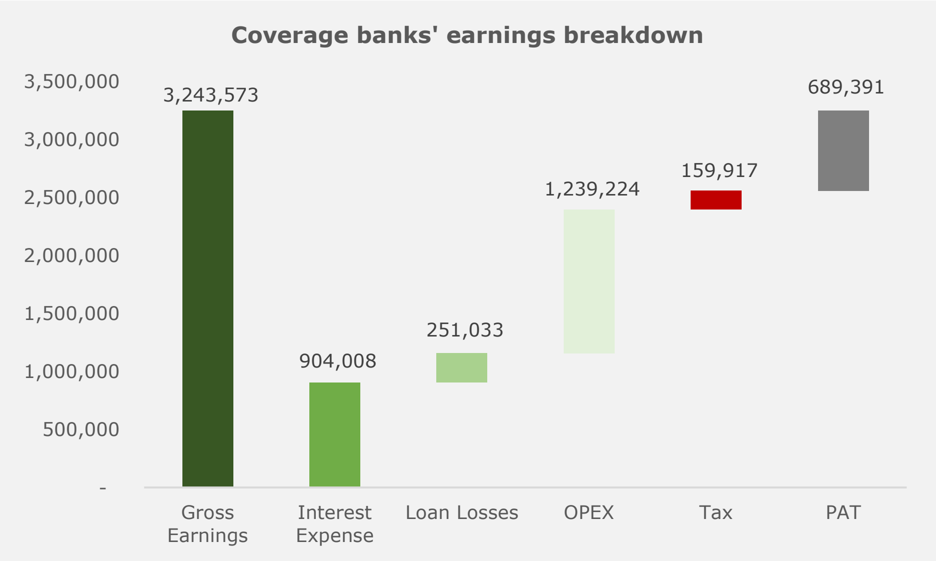
Banking

Banking Sector

Slow start to the year, 2018 outlook mixed across coverage

Although earnings came in largely in line with estimates across most of our coverage names in Q1'18, performance from tier II banks remained largely weak – save for a few names. Pressured by weaker yield on assets as well as contained credit growth, we have seen Interest Income come in relatively flat – a trend we expect to persist for the rest of the year. Our expectation for the Non-Interest Income is however more positive. We expect stronger transaction velocity amidst improving business environment to support Non-Interest Income despite moderating derivative income. Consequently, we anticipate a flat Gross Earnings growth on average across our coverage banks for FY'18 – with growth capped by a notably moderation from ZENITHBANK and FBNH (following high base from prior year) and flat performances from DIAMONDBNK and FCMB. Also, with funding cost moderating since the start of the year and expected to remain much lower than the levels seen in FY'17, we expect interest expense to come in softer in FY'18 and forecast a modest 5% y/y rise. Furthermore, our Operating Expense expectation across most of our coverage is positive. We highlight that the expense line has remained largely contained recently with growth averaging single digit across our coverage in the last few years. Hence, estimate an average 2% rise across our coverage names with STANBIC and ACCESS expected to post the top two y/y growth of 14% and 13% respectively. With the implementation of IFRS 9 - a more forward looking provisioning measurement, we believe loan loss provision will come in more volatile and subjective going forward. However, given our positive macro outlook and stable FX and oil price expectation, we estimate relatively more contained loan loss provision for FY'18 – translating to an average cost of risk of 2.4% for FY'18 (FY'17: 4.2%). Furthermore, whilst we expect PAT growth across the top tier banks to be mild given the high base from FY'17, we expect earnings growth from the lower tier banks to be more pronounced given the weak performance in recent years. Overall, we forecast an average 18% y/y PAT growth, with the bottom line translating to an average 21% profit margin across our coverage banks for FY'18.

We expect earnings across our coverage to remain strong. Despite our expectation of a constrained top line, moderating provision and stable efficiency should support bottom line

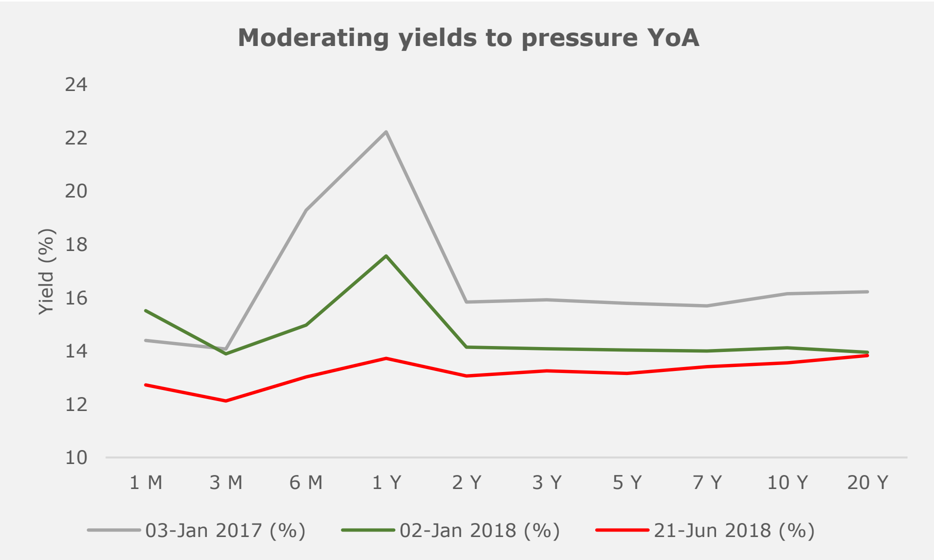


Source: NSE, Company data, Vetiva Research

Yield curve shift to constrain YoA, NIM to moderate marginally

Amidst the heightened risk environment, banks have maintained an increased risk aversion – overweighting high-yield, risk-free, tax-free government securities and cutting back on credit growth. Whilst this generated strong investment income for banks during the golden yield era of 2016/2017, the trend appears to have reversed with yield on government securities moderating over 139bps across the curve, even with more obvious moderation in the T-bills space over the last 6-months. With yields on government securities expected to be sticky for the rest of the year and investment in treasury securities accounting for over 25% of interest bearing assets across our coverage names, we anticipate y/y moderation in Yield on Assets across our coverage banks. We however highlight that yield on other interest-bearing assets have remained relatively sticky despite the sharp drop in government yield. Having said that, given our expectation of an uptick in inflation rate in the later part of the year as election spending intensifies, our expectation of monetary easing has been placed on hold until after 2019 general elections, providing some succor to yield on assets. However, we estimate an average 100bps moderation in YoA across our coverage banks. With cost of funds also trending lower from the start of the year, we estimate an average 75bps moderation in margin across our coverage.

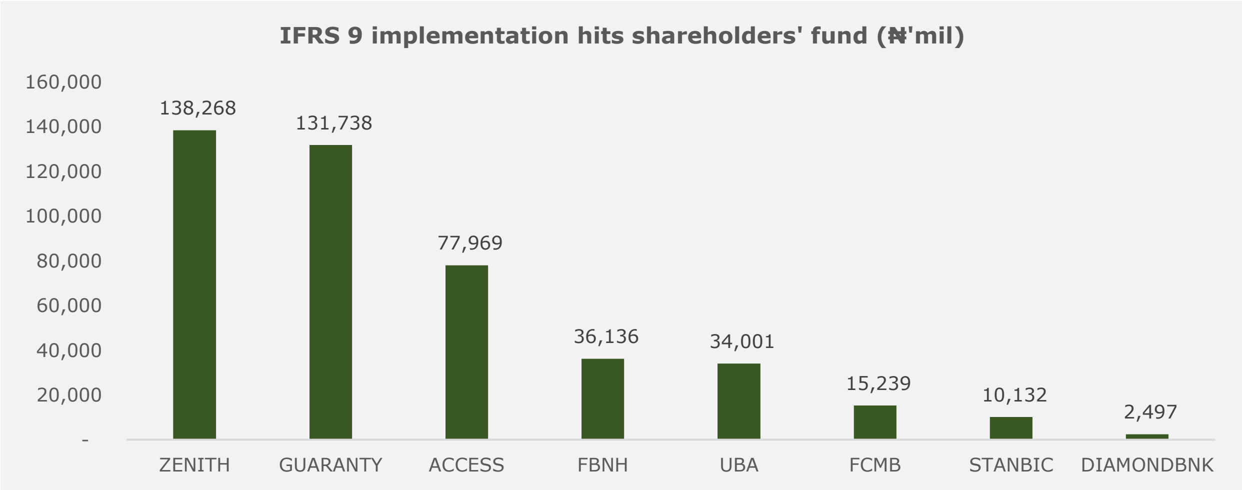
With yield on fixed income instruments moderating over the last one year – pressuring yield on assets, we estimate an average 75bps decline in NIM



Source: FMDQ, Vetiva Research

IFRS 9 kicks off, coverage banks take a cumulative ₦446 billion equity hit

The impact of the implementation of IFRS 9 has been largely mixed across our coverage banks. With a few banks taking significantly higher than expected charges against their shareholders' fund, the impact on some other banks has been much lower than we had anticipated. Given that the implementation has led to a one-time charge on equity without passing through the income statement, the effect on banks has gone largely unnoticed. However, we note that the common factor across the sector has been an erosion of shareholders' value at varied magnitude – leading to weaker capital adequacy ratio. Particularly, post the IFRS 9 implementation at the beginning of Q1'18, our coverage banks recorded a total of ₦446 billion write off against equity with ZENITHBANK and GUARANTY taking the highest hits. Consequently, Capital Adequacy Ratio (CAR) moderated 90bps on average within our coverage names to take average CAR to 19% - still a healthy headroom from the regulatory benchmark of 15%. Whilst we see this as a loss of shareholders' value, we expect to see reduced provisioning in the near term – particularly for the banks that recorded huge write offs following the implementation. Overall, we estimate a cost of risk of 2.4% for FY'18 vs. the average 4.2% recorded in FY'17.

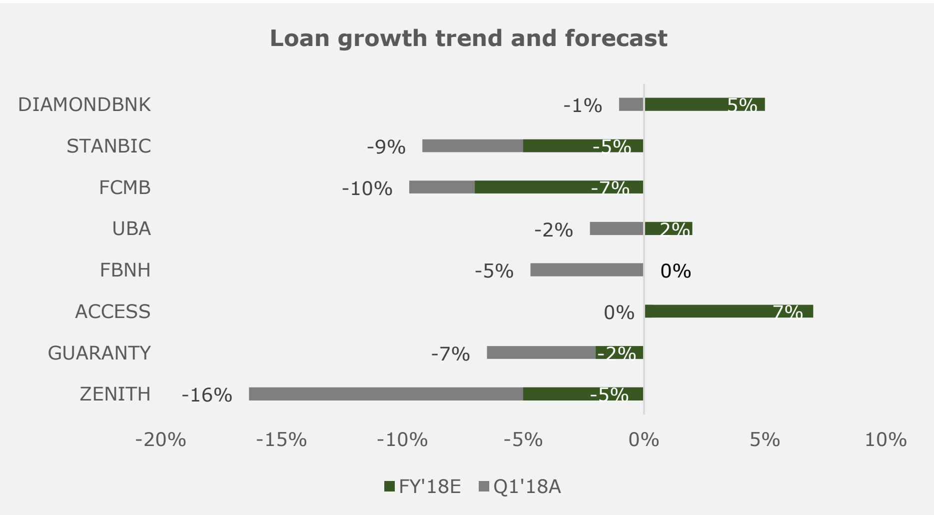


Source: NSE, Company data, Vetiva Research

Implementation of IFRS 9 to mask real loan growth

On the back of improving operating and risk environment as well as the expected moderation in yield of government securities, we had expected banks to be more deliberate about risk asset creation and anticipated a modest 8% loan growth across our coverage banks in 2018. Trend observed in Q1'18 suggests that credit growth has strengthened within the year with loan origination observed across some key sectors including manufacturing, general commerce, agriculture, and oil & gas. The impact has however been less obvious on loan book across the sector (down by an average 6% in Q1'18) as banks had to write off a significant portion of their credit portfolio following the one-time equity charge post the IFRS 9 implementation. Whilst we expect the improving macroeconomic environment to further support growth in risk assets, we expect the earlier write-offs in Q1'18 to offset some of the real growth expected for the year and estimate a flat loan growth on average across our banking coverage for FY'18.

As banks write off sizable assets following the implementation of IFRS 9, we revise of loan growth expectation for FY'18 to flat (Previous: 6%)



Source: NSE, Company data, Vetiva Research

NPL spikes as IFRS 9 kicks in

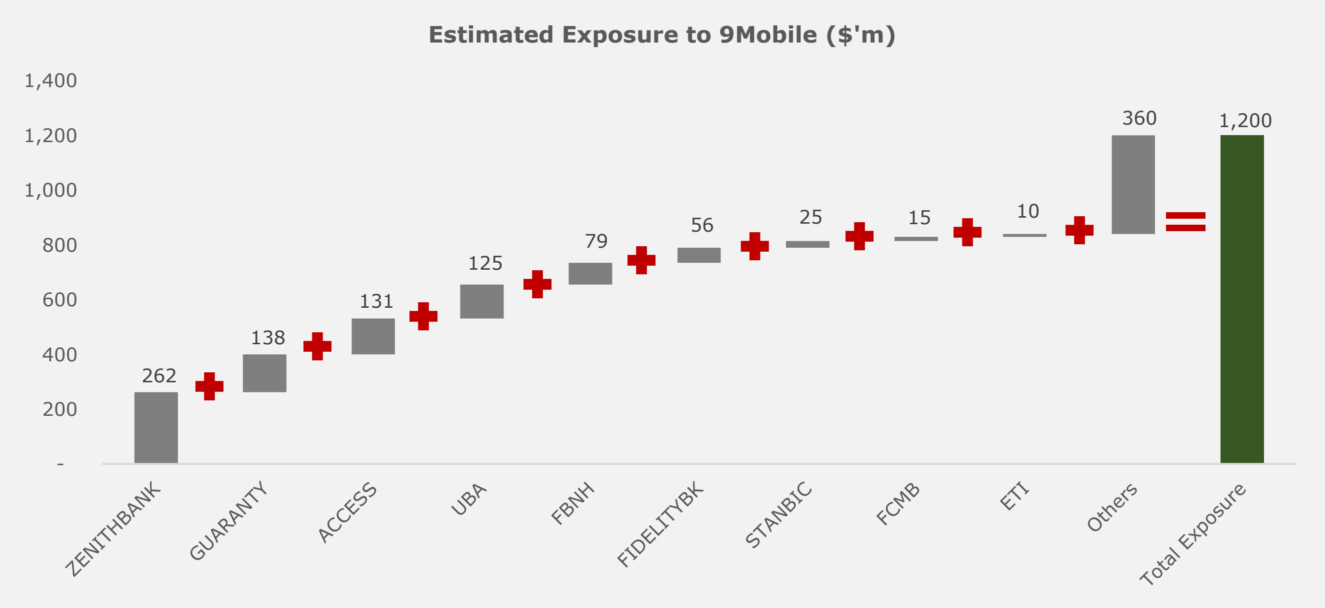
Despite improving operating environment within the last one year evidenced by strong oil prices, improving crude production volumes, as well as stable exchange rate, asset quality within the banking space has remained weak with NPL ratios deteriorating across our coverage names. Particularly, following the implementation of IFRS 9 we have seen NPL ratio spike from an average of 70bps across our banking coverage in FY'17 to 10.6% at the end of Q1'18. More surprising is the sharp rise in NPL ratio across the perceived less risky tier I names. Although we expect asset quality pressure to linger for a while as the restructuring of some of the large non-performing credit obligors get prolonged, we believe the improving macroeconomic variables will continue to support recoveries across the banking space in the medium term and estimate an average 120bps moderation in NPL ratio across our coverage between Q1'18 and FY'18.

NPL ratio rose 70bps q/q in Q1'18 following the implementation of IFRS 9. Anticipated restructuring and improving macro variables to support ratio.

Closure approaching, 9Mobile loan could provide some relief

In 2013, 9Mobile (formerly Etisalat) obtained a 7-year $1.2 billion loan facility from a consortium of Nigerian banks for the purpose of financing a major rehabilitation of its network infrastructure as well as refinancing an existing $650 million loan. Post the 2014 currency crisis and the resulting currency devaluation that bedeviled the Nigerian economy in 2016, the telecom company struggled to meet up with its debt repayment plan. As the debt crisis deepened and following a series of failed negotiation attempts, Etisalat Nigeria's largest shareholder, Mudabala Development Company pulled out of the company. Consequently, the consortium of lenders took control of the shares of Etisalat Nigeria and opted for a sale to new equity partners. We note that the banks have had to take a hit of varying degrees with the average bank within our coverage already making 30% provision on the obligor. Teleology emerged as the preferred bidder for 9Mobile and has paid a non-refundable deposit of $50 million as required in the bidding process. The company is believed to have executed a loan purchase agreement and has assumed the debt of 9Mobile. We understand that a debt restructuring is currently ongoing which might involve a haircut from the initial $1.2 billion loan amount. We expect the sale of the telecoms company to close shortly and the restructuring of the debt to gain momentum in the second half of the year. With our coverage banks already taking significant provision on the obligor, we do not expect to see significantly higher provisioning on this debt going forward. Consequently, we expect the loan performance to lead to improved asset quality across the sector in the near term.

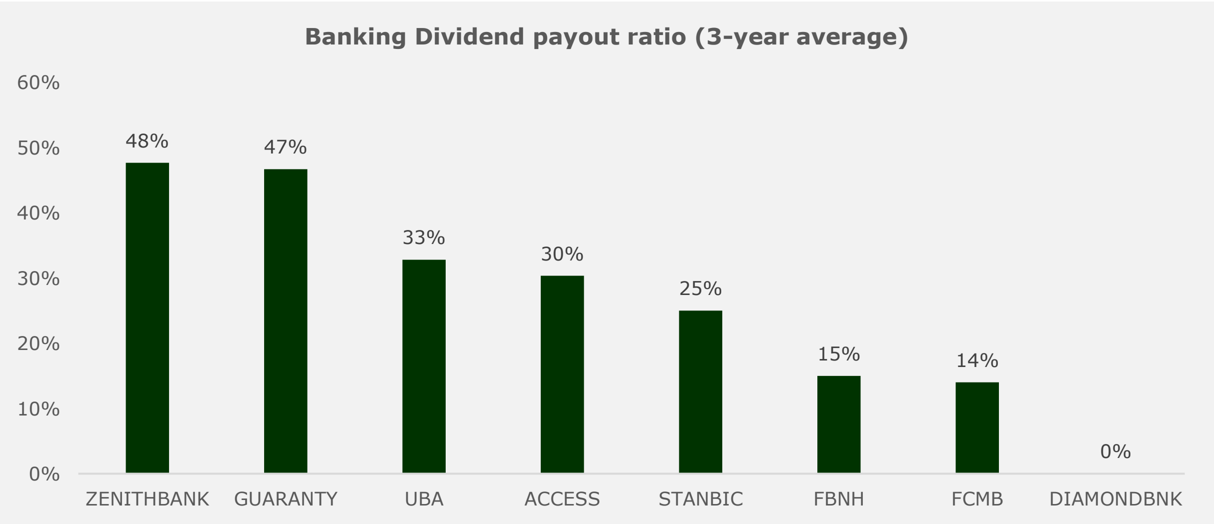
Coverage banks have made an average 30% provisioning on 9Mobile. Closure with Teleology to improve asset quality in the near term



Tier 1 to top on dividend payout

Banking stocks have historically outperformed the Nigerian market in dividend payout with our coverage banks distributing an average of 30% of earnings over the last 3-years - translating to an average dividend yield of 6%. Although we expect the recent spike in NPL ratio to constrain dividend payment across a number of banks – particularly the lower tier names, we believe payout from the top tier banks will remain strong. Across our coverage, we estimate a 42% payout ratio for the tier I (save for FBNH – 15% payout from other non-banking subsidiaries). Whilst we do not expect DIAMONDBNK to pay dividend in FY'18 given that the bank's NPL ratio breaches the regulatory dividend paying benchmark of 10%, we estimate 25% and 40% dividend payouts from STANBIC and FCMB respectively. We expect these to be supported by earnings from non-banking subsidiaries.

A most diversified earnings base makes tier banks well positioned to outperform the market in dividend payment with an average payout ratio of 39%. estimate



Source: NSE, Company data, Vetiva Research

Fundamentals is a warrior – it might lose the battle but never the war

The message across the banking sector remains the same – stocks have been over flogged and banking names appear cheap, hence, correction is imminent. With an average P/E ratio of 10.83x vs. the average P/E across frontier & emerging markets of 12.50x, the entire market appears undervalued when compared to other emerging and frontier markets. The banking sector appears even much more underpriced. The sector trades at a P/B ratio of 0.97x – a ratio largely skewed by the bigger banks – with average tier II names trading at weaker average multiples of 5.54x and 0.90x for P/E and P/B respectively. We believe that the sector is being punished for its weak asset quality post the oil price crash of 2014 and the consequent currency crisis. We came into 2018 with an expectation of recovery from the banking names. Whilst earlier signs had shown modest recovery across most banks, prices have slipped lower following political jitters ahead of the impending elections. However, we note that our fundamental valuation suggests that the banks have been over beaten, trading at an average 53% upside across our coverage names. We believe that whilst market valuations might deviate from fundamentals in the short run, convergence will happen in the medium to long term. Hence, we maintain our BUY recommendation on most of our coverage names.

Although political jitters may overshadow strong fundamentals in the short-run, we believe that the market remains largely undervalued

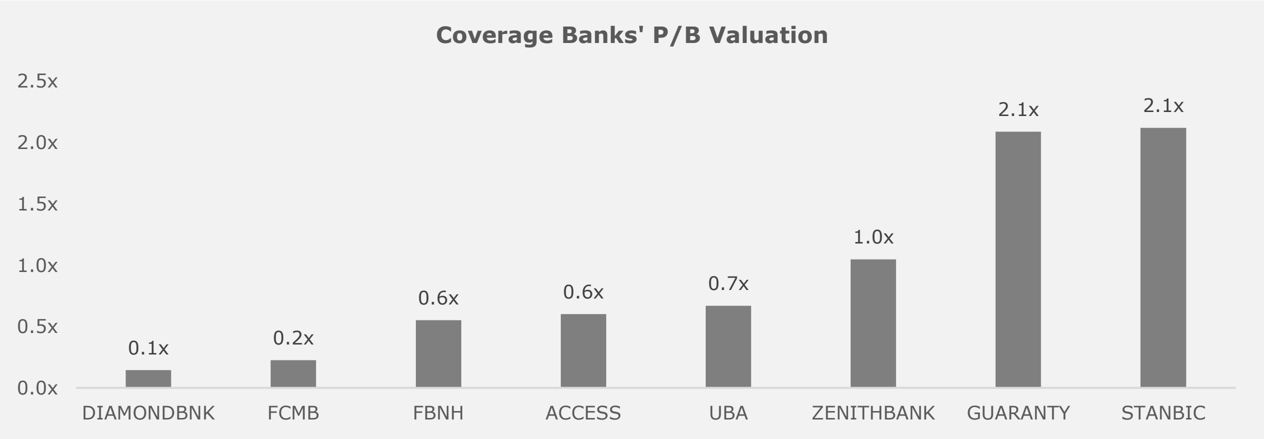
Source: Bloomberg, Vetiva Research

Go long on lower tier names if you have the guts

It is not surprising that the challenging operating and macroeconomic environment have come in much harder on the lower tier names. Their weaker asset quality, higher funding cost, lower margins, less liquidity and even relatively weaker capital adequacy have made them less appealing to investors. Consequently, amidst the heightened risk environment, there has been a switch to less risky banking names with more diversified earnings and stronger capital buffer. Whilst we expect earnings to remain pressured across the lower tier names and believe that the high NPL ratio across these banks will continue to impede their ability to pay dividend, we highlight that valuation of the lower tier banks remains weak.

Whilst we note that most banking name remain cheap, we see notable value within the lower tier names as they trade at an average P/B of 0.2x.

Although, as earlier highlighted, we believe the banking sector is largely undervalued, we believe that the tier II space has more potential upside. We recall that the market rally earlier in the year saw prices across these names double in weeks – indicating a strong positive sensitivity to the broader market. Although we expect the anxiety surrounding the forthcoming elections to keep market sentiment cautious in the near term, we are much more optimistic post elections even as the broader macroeconomic environment gets brighter. Whilst we note the above average risk of the lower tier names, we maintain our medium to long term BUY recommendation on the stocks.



Source: Bloomberg, Vetiva Research

FY'18 Forecasts for Coverage Universe

	TP (₦)	Upside	EPS	P/E	ROE	Div. Yld.	Rating
ZENITHBANK	34.22	32%	5.81	4.5x	22.8%	10.7%	BUY
GUARANTY	50.88	25%	6.18	6.6x	29.9%	7.0%	BUY
ACCESS	12.80	23%	2.90	3.5x	16.8%	8.7%	BUY
FBNH	12.82	20%	1.62	6.6x	8.4%	2.3%	BUY
UBA	14.42	36%	2.75	3.9x	17.9%	8.5%	BUY
FCMB	4.66	113%	0.71	3.0x	7.6%	4.7%	BUY
STANBIC	42.89	-12%	7.33	6.7x	34.0%	2.7%	HOLD
DIAMONDBNK	4.00	161%	0.48	3.1x	2.1%	0.0%	BUY

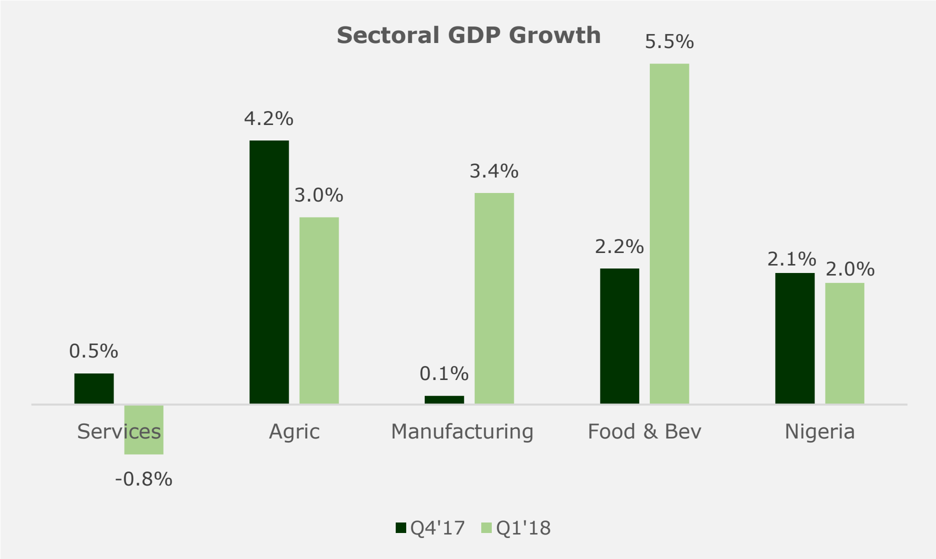
Consumer Goods

Consumer Goods Sector

Manufacturers thrive amid sluggish economic upturn

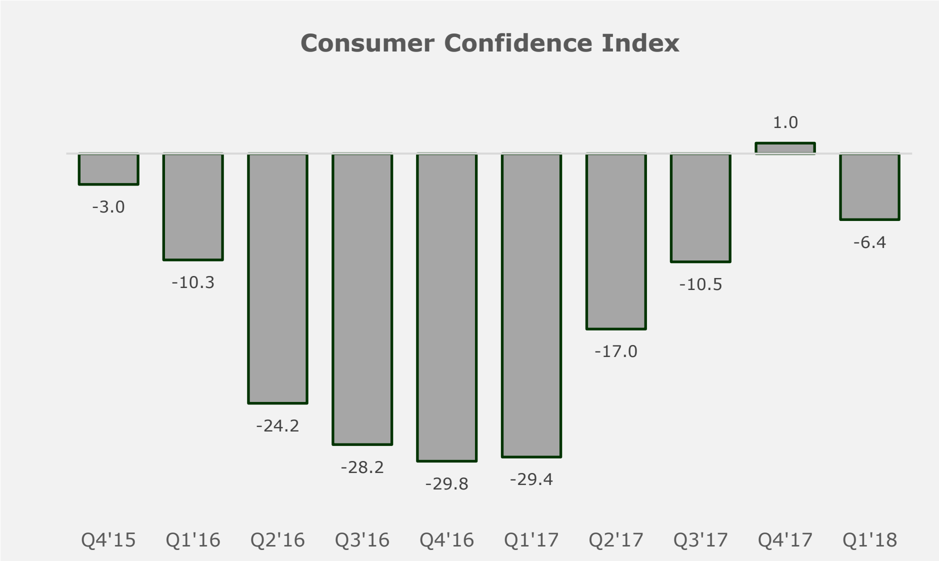
In line with our expectation, the Nigerian manufacturing sector has recorded renewed momentum so far in 2018. Notably, Q1'18 GDP figures showed a 5.5% y/y growth (Q4'17: 2.2% y/y) for the Food & Beverages sector, outperforming 3.4% y/y and 2.0% y/y growth for the Manufacturing sector and overall broader economy respectively. We believe the strong growth in sector has been specifically driven by easing production constraints and the multiplier effects from improving economic conditions on both consumers and producers. Given that the lifeblood of the consumer goods sector is the strength of consumer spending, we believe the notable moderation in inflation – from the 2017 average of 16.6% to the ytd average of 13.4% – would have a more substantial effect on stabilizing growth in the sector even as consumer wallets recover and majority of FMCGs are expected to keep price increases minimal.

We believe the notable moderation in inflation – from the 2017 average of 16.6% to the ytd average of 13.4% – would have a more substantial effect on stabilizing growth in the sector even as consumer wallets recover and majority of FMCGs are expected to keep price increases minimal.



Source: NBS, Vetiva Research

We expect our outlook of sustained stability in the macroeconomic environment to drive a full-year acceleration for the consumer goods sector, with potential positive developments outsizing downside factors. Most notably, we believe increased spending that accompanies budget passage, electioneering and the festive season will support spending in H2'18. Whilst the fiscal multiplier from these events did not noticeably materialize in H2'14, the last pre-election period, we believe a seemingly better economic outlook will drive a more visible effect. Particularly, the lower inflationary and stable exchange rate environment will provide a good cushion for the fragile but improving operating and spending environment. We also point out a potential wildcard for H2'18 – Minimum Wage Implementation. Earlier this year, the Federal Government announced that a new minimum wage (labour congress pushing for a 269% increase) could potentially be ready by the end of the of the year if bureaucratic processes are expedited amidst mounting pressures from labour unions. While developments on this proposal remain highly sparse and the timeline seems quite ambitious, we do not rule out the chances of sudden progress on this front noting the administration's high sensitivity to public opinion as elections draw nearer. On a more downbeat note, we highlight that consumer confidence in the economy remains weak and according to the CBN's Quarterly Consumer Expectations Survey, the consumer confidence index returned to negative territory in Q1'18 (-6.4 points vs an average -14.0 points in 2017), after a modest positive showing in Q4'17 (+1.0 points). Ceteris paribus, we forecast a stronger second half for the consumer goods sector in 2018 noting the earlier stated factors, with the major downside risk coming from demand driven inflation during this time.



Source: CBN, Vetiva Research

Muted price increases mean normalized revenue growth in 2018

In line with our expectations, revenue growth for consumer goods companies in 2018 has been more modest and volume-driven compared to the 2017 period that was characterized with double-digit price increases. On average, revenue across our coverage companies declined 4% in Q1'18, compared to our -5% y/y estimate amidst mixed drivers across the different sub-sectors in the industry. While muted price changes have been met with recovery in consumer spending and volumes in some segments, notable price cuts and other adverse revenue drivers have weakened topline in other sub-sectors. Save for the broad sector drivers however, company growth rates have also been differentiated by more internal strategies and investments.

We expect aggregate volumes to be supported by stronger spending from both public and private agents in H2'18 as consumer goods continue to account for the bulk of a lot of Nigerian's spending basket.

That said, we expect aggregate volumes to be supported by stronger spending from both public and private agents in H2'18 as consumer goods continue to account for the bulk of a lot of Nigerian's spending basket. Demand for non-durable consumer products will continue to outweigh that of durables, a characteristic of consumer behaviour during the period of economic recovery following a recession. Meanwhile, we expect the vast number of Nigerian consumers to continue to upweight value offerings available on the shelves. Overall, we forecast an average FY'18 revenue growth of 3% across our consumer goods coverage universe, with the consumer packaged goods and brewery sub-sectors outperforming the food sector.

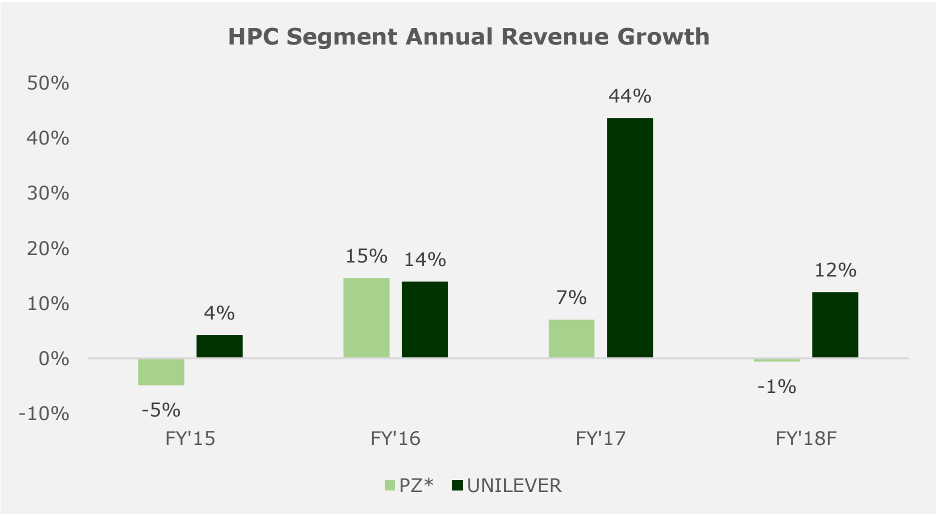
Consumer Packaged Goods – Innovative market strategies required to support growth

For this report, we define the consumer packaged goods sub-sector as the companies that produce home and personal care (HPC) products – a segment Unilever Nigeria (UNILEVER) and PZ Cussons Nigeria (PZ) fall into. Whilst we believe recovering consumer demand and improving spending pattern will be supportive of mild demand growth in the HPC segment, we expect strong performance across the companies to only be driven by innovative strategies and targeted investments, through promotional campaigns, product introductions or distribution channels to driver faster sales traction. Nigeria's HPC segment is generally characterized as highly competitive with a large part of the market dominated by imported products from independent retailers – particularly skin care, cosmetics, deodorants, etc – while localized multinationals strictly produce and dominate more "mass market" products which include bathing soaps, detergents, toothpaste, etc. Nonetheless, imported competition is expected to remain a major threat for the local producers, especially given improving FX liquidity. Amid heightened competition and less input cost pressures, we expect price increases to be very modest.

We expect strong performance across the companies to only be driven by innovative strategies and targeted investments, through promotional campaigns, product introductions or distribution channels to driver faster sales traction.

Notably, UNILEVER's HPC segment recorded a 24% q/q and 17% y/y revenue growth in Q1'18. Whilst this was supported by mildly higher prices on select products, volume growth was the major driver amidst introduction of new product lines, specifically on its top-selling Sunlight detergent, and higher activities from distribution channels. However, a trading update released on 14 June 2018 by PZ Cussons UK was less optimistic about its Nigerian subsidiary, stating that intense competition amidst subdued buying levels has pressured volumes and margins. The company recorded 7% y/y revenue decline in its Q3'17/18 period ended February 2018, below our 6% growth expectation. Whilst we expect PZ's 2018 revenue performance to come in weaker than its major peer (UNILEVER), the parent company stated new initiatives to support growth; including packaging reduction, a tactic already used by other market players to encourage patronage from cash-strapped consumers, and product mix rationalization. We believe these will support stronger output in H2'18. Overall, the HPC segment is expected to record a *c.*15% top line growth rate in 2018, solely driven by UNILEVER's expected strong performance.

The HPC segment is expected to record a c.15% top line growth rate in 2018, solely driven by UNILEVER's expected strong performance.



*represents PZ's FY'17/18E

Source: Company Financials, Vetiva Research

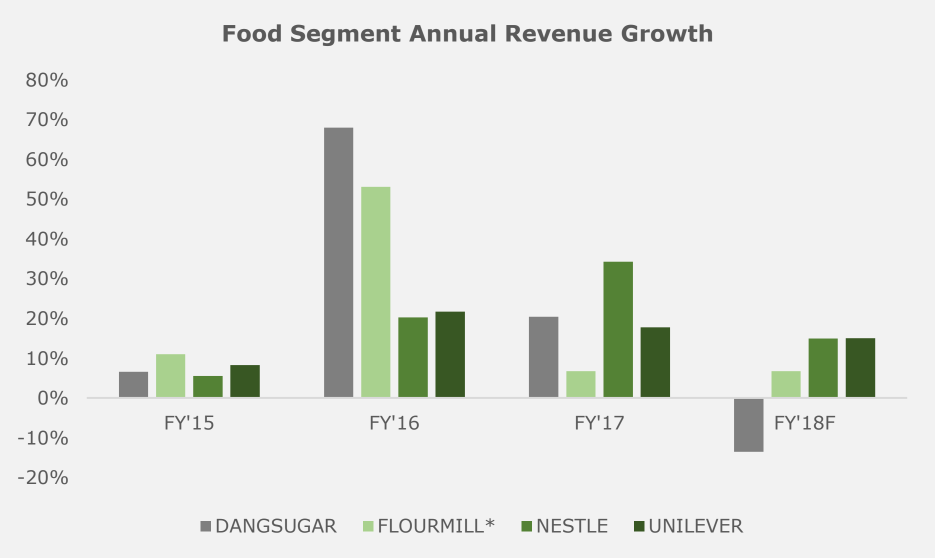
Food & Beverages – Stronger demand levels in H2 to provide a boost

The Food sub-sector is made up of the food and non-alcoholic beverage manufacturers under our coverage; these companies include Dangote Sugar Refinery (DANGSUGAR), Flour Mills of Nigeria (FLOURMILL), Nestle Nigeria (NESTLE) and Unilever Nigeria (UNILEVER). We are positive about revenue performance of the food sector in the second half of the year - primarily supported by our expectation of electioneering boost for staple food products and the usual festive demand closer to year end. Though we maintain our stance that sector revenue growth will be predominantly volume based, we anticipate an average of mid-single digit price hike for the year. Whilst we had expected the segment to be an outperformer in the first half of the year, the HPC and beverages sub-sectors have actually outperformed food on average so far in H1'18. The major drivers for this deviation have been higher than anticipated price cuts and/or sluggish volume roll-out. That said, revenue growth across this space has come in largely in line with our expectation – averaging -5% y/y in Q1'18 vs our -6% y/y estimate.

We are positive about revenue performance of the food sector in the second half of the year - primarily supported by our expectation of electioneering boost for staple food products and the usual festive demand closer to year end.

Among producers impacted by lower pricing was DANGSUGAR. The company reported a 31% y/y decline in revenue in Q1'18 following a 22% y/y and 20% q/q decrease in prices. This rollback was necessitated by intense competition from illegally imported refined sugar products which also partly impacted volumes sold (down 12% y/y). The impact on margin was however cushioned due to moderating global raw sugar prices (down 21% ytd). Though we forecast a boost from the company's stronger selling seasons (Q2 and Q4), we expect this trend to persist and culminate in a 14% moderation in FY'18 revenue. We expect the need to stay competitive with pricing and a high base to drive more modest sales growth for FLOURMILL. Thus, we forecast a modest 7% y/y revenue growth for FY'18/19, supported by expected rise in demand in H2 given its wide offerings of staple Nigerian food.

For Nestle Nigeria, we expect FY'18 revenue to grow 15% y/y, finishing as the top performer in the sector. We believe this will be largely driven by further volume gains from the company's ₦4.1 billion investment in a beverage production plant for its newly released Milo Ready-To-Drink variant, even as the beverage segment outperformed with a 17% y/y turnover growth in Q1'18. Furthermore, recent launch of other well-positioned food products is also expected to supplement demand for the company's household brand names despite intense competition (Q1'18: +7% y/y revenue growth). Furthermore, UNILEVER is expected to maintain notable sales momentum in its Food segment in H2'18 as the company's efforts to increase distribution capacity and also aggressively push its key brand (Knorr) continue to bear fruits. We expect the company's food segment to consolidate on the 16% y/y revenue rise recorded in Q1'18. However, we highlight that at the company's AGM in May 2018, shareholders reportedly approved UNILEVER's plans to divest its Spread's business (Blue Band). While the company had initially stated its parent company's intention to divest the business in April 2017, we were surprised by an announcement of a $12 million investment in a manufacturing line for Blue Band in November 2017. Whilst we await clarity from the company on details surrounding the deal, we believe that UNILEVER's margarine business makes up about c.7% of its total revenue – we only expect the company's financials to reflect the effect of this divestiture upon completion of the transaction.



*represents FLOURMILL's FY'17/18E

Source: Company Financials, Vetiva Research

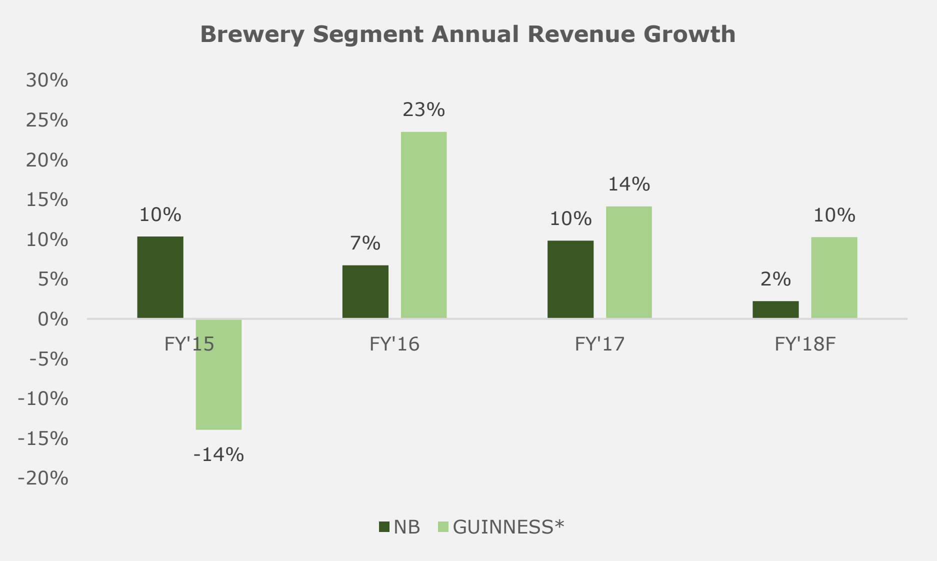
Brewery Sector – Higher prices to counteract weak beer volumes

The Brewery sub-sector is made up of the alcoholic beverage manufacturers under our coverage; these companies include segment leader Nigerian Breweries (NB) and a diversified beverage company Guinness Nigeria (GUINNESS). Like we expected, market conditions in the brewery segment were tough in the earlier part of 2018 as subdued consumer spending saw beer volumes decline sizably in the period. Notably, NB recorded a 9% y/y sales decline in Q1'18, worse than our 4% y/y decline estimate amid increasing competition from number 3 player in the market INTBREW. GUINNESS however reported a more decent performance – 15% y/y revenue growth in its Q3'17/18 period (Jan-Mar). The growth was however driven by a low production base from the previous year as well as a good performance from its spirits segment.

For H2'18, we expect market dynamics to be influenced by the first phase implementation of the FG's excise duties increase on alcoholic products. We recall that the government switched from a 20% ad valorem tax rate on alcoholic products to specific higher rates per centiliter. Given that we expect the brewers to at least partly pass on this effective tax increase to consumers, we believe revenue growth in the sector will be supported by increases in product prices in H2'18. That said, we also expect the higher selling prices to further discourage patronage and dampen volume performance. For Nigerian Breweries, we see revenue growth ending the year flat at best as expected price increases completely outweigh the rout in volumes. Worryingly, Heineken International, NB's parent company, stated that the negative beer volume growth was partly driven by some destocking by distributors. Meanwhile, top line growth for GUINNESS will normalize to mid-high single digit levels in its FY'18/19 financial year that starts June 2018, supported by its diversified product offerings and possible upside from a recent product launch, Royal Kingdom Lager beer; a mainstream regional beer brand. Given this, we expect competitive intensity to increase in the second half of the year even as INTBREW also ramps up beer supply, noting sizable capacity expansion scheduled to be completed in the period. Overall, cheaper beer products will remain the most appealing choice for most consumers, and

Conditions in the brewery segment have been tough in 2018 and we expect subdued consumer spending will see beer volumes decline notably in the period. Market dynamics in H2'18 will also be influenced by the first phase implementation of the FG's excise duties increase on alcoholic products.

despite volume contraction in the overall market, players with attractively priced portfolios could still grow market share.



*represents GUINNESS' FY'17/18E Source: Company Financials, Vetiva Research

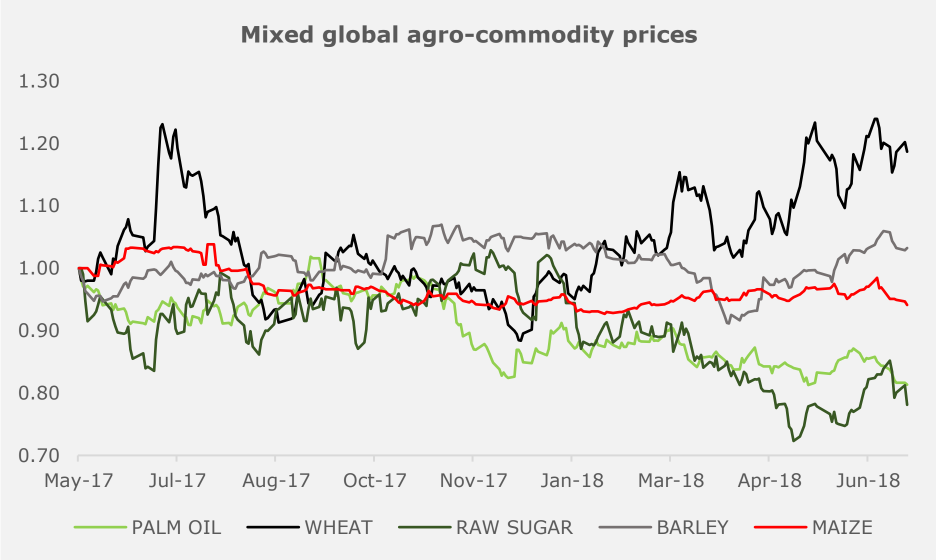
APPROVED EXCISE DUTY RATES			
YEAR	BEER (₦/Cl)	WINE (₦/Cl)	SPIRITS (₦/Cl)
2018	0.30	1.25	1.50
2019	1.25	1.50	1.75
2020	1.50	1.50	2.00

Source: Media Reports, Vetiva Research

Stable production costs amidst mixed commodity prices

Noting that Nigerian FMCG's are exposed to foreign and domestic commodity prices in a near 60:40 split, raw material costs for consumer goods companies have been flat to slightly bearish on average so far in 2018. Global agri-commodity prices are expected to remain mixed across board, with steady production levels, favourable weather conditions in select regions and strengthening demand across the globe expected to support prices whilst rising geopolitical and global trade uncertainty and strengthening U.S. currency remain the major risk factors. Having declined 21% YTD, raw sugar prices are expected to remain low for most part of 2018 as large production surpluses continue to support high inventory levels amidst steady weather patterns in Brazil. Similarly, palm oil prices have moderated *c.*10% this year and are likely to moderate further as strong production levels from Indonesia and Malaysia coupled with expected weak demand from India (largest consumer of CPO) amidst recent hike in import duties on both crude and refined palm oil as well as heightening global competition from other edible oils and oilseed. Contrarily, whilst prices of most cereal crops have traded sideways for most of the year, global wheat prices have recorded renewed uptick recently, rising 8% in 3 months and 14% YTD. Forecasts for wheat prices remain bullish for H2'18 on the back of lower supply from wheat exporting countries like Russia and Argentina amidst adverse weather conditions, lower acreage and yields in the U.S. and poor planting conditions in Australia. Overall, expect a mixed basket of commodities in H2'18 with raw sugar and palm oil users benefitting from lower prices whilst flour millers, brewers and feed producers are exposed to potential rises in input costs.

Global agri-commodity prices are expected to remain mixed across board, with steady production levels, favourable weather conditions in select regions and strengthening demand across the globe expected to support prices whilst rising geopolitical and global trade uncertainty and strengthening U.S. currency remain the major risk factors.



Source: Bloomberg, Vetiva Research

Amid a renewed drive by FMCGs to source more agro-inputs locally (especially cereals and grains), in a bid to reduce reliance on FX, domestic raw material prices have become more relevant for FMCGs. With Nigeria's agricultural sector however characterized by low productivity, structural constraints (transportation, storage) and high fragmentation, local sourcing has not necessarily led to lower production costs for all producers. Consequently, a number of firms within our coverage have invested significantly in building solid supply networks with smallholder farmers - rolling out specialized programmes to support the value chain, reduce price volatility and improve productivity. Compared to the prior year, raw material prices have come in more stable in 2018 with average food inflation printing at 16% y/y vs 20% y/y in 2017. Notably, according to a monthly publication from FEWS-NET, maize, sorghum and millet prices were down 29%, 23% and 17% respectively as at April compared to the previous year. Overall, whilst our gross margin forecasts vary across our coverage companies, we expect gross margin expansion on average across our coverage for FY'18. The largest risks in the H2'18 period would be increased insecurity and higher geopolitical/ trade uncertainty on the domestic and foreign front respectively.

Overall, whilst our gross margin forecasts vary across our coverage companies, we expect gross margin expansion on average across our coverage for FY'18.

Major Raw Materials for Consumer Goods Companies

Input	Source	Industry/Products
Sorghum	Majorly local	Malt for beverages, Substitutes wheat flour/barley
Barley	Majorly Imported	Malt for brewers and malt beverages
Wheat	Majorly Imported	Ball foods, Animal Feeds, Breads, Noodles, Biscuits
Maize	Majorly local	Cereals, Animal Feeds
Cassava	Majorly local	Cereals, Animal Feeds
Cocoa	Majorly local	Chocolate beverages
Soybean	Majorly local	Bouillon Cubes
Palm Oil	Mix of local and imports	Margarine, Soaps
Raw Sugar	Majorly Imported	Refined Sugar
Tallow	Mix of local and imports	Soaps, Margarine
Sauces & Seasonings	Mix of local and imports	Bouillon Cubes
Petro-Chemicals	Majorly Imported	Detergents

Source: Media Reports, Company Presentations, Vetiva Research

Winning with local sourcing

Nigeria's economic downturn and subsequent recovery has seen consumer goods companies make more targeted investments to navigate a volatile and difficult operating terrain in a bid to ensure a stronger buffer against future economic headwinds. In line with our expectation, FMCGs have significantly focused on backward integration projects in 2018 amidst a sector-push to localize raw material sourcing by investing in strengthening domestic production and overall agricultural value chain productivity. Amongst other projects, FLOURMILL recently announced a strategic partnership with Corteva Agriscience for high-performing hybrid maize seed development in Nigeria to improve maize yields and improve capabilities of small-scale farmers. The company also announced investments in fertilizer blending plants and a bid for silo complexes from the Federal Ministry of Agriculture and Rural Development. Also supported by enabling economic policies and government intervention, investments in increasing wheat production locally have started yielding fruits, with wheat production reported to have risen from less than 200,000MT to 900,000MT as at Q1'18. We understand that Nestle is in partnership with the International Fertilizer Development Centre (IFDC) through its Sorghum & Millet in the Sahel (SMS) project, the company has engaged thousands of farmers to source high quality sorghum, millet and soya. We have also seen FMCGs increasingly embrace locally available input substitutes; Nigerian Breweries replacing barley (largely imported) with locally sourced sorghum, others using cassava as a substitute for wheat. Whilst we believe these developments will lead to more sustainable raw material sourcing in the country, a more detailed plan to include all stakeholders in the agricultural chain (logistics, transportation, aggregators, processors) must be explored to ensure a broad-based and sustainable development of the sector.

FMCGs have significantly focused on backward integration projects in 2018 amidst a sector-push to localize raw material sourcing by investing in strengthening domestic production and overall agricultural value chain productivity.

Major Recent Local Sourcing Projects from Listed FMCGs

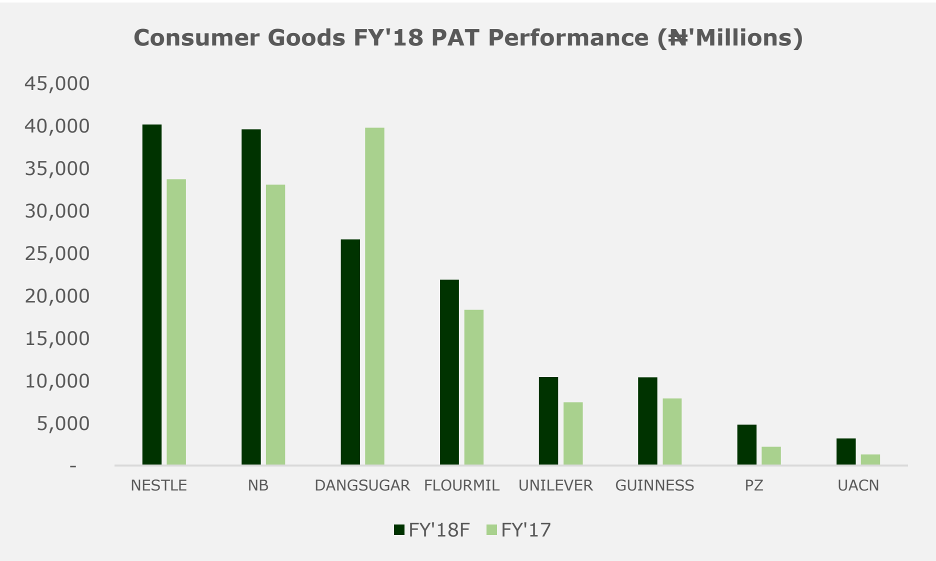
Company	Investment/Project
FLOURMILL	Strategic partnership with Corteva Agriscience for maize hybrid seed development
	Launched an ultra-modern ₦2 billion sorghum mill, 100,000 MT/annum capacity
	Commissioned ₦50 billion Sunti Sugar Estate with full annual capacity of 1 million MT of sugar cane and 100,000 MT of milled sugar
PZ	Investing ₦45 billion in oil palm plantations
NESTLE	Implementing the Sorghum and Millet in Sanhel (SMS) project to boost millet and sorghum farming in the North West

Source: Media Reports, Company Websites, Vetiva Research

Cost containment, lower borrowing costs to support margins, PAT

Improvement in operating costs and moderating interest expense supported profit margins in Q1'18, prompting a 70bps y/y profit margin expansion and supporting an average 10% y/y bottom line growth. Moderating inflation path and an improving economic landscape remain supportive of further operating cost containment for the rest of 2018 even as consumer goods companies sustain their internal efficiency plans. Furthermore, despite our expectation of an unchanged monetary policy rate through 2018, borrowing costs in the year are expected to trend lower y/y amidst lower debt balances across our coverage as well as reduced average cost of debt compared to 2017. We recall the substantial deleveraging recorded in the 2016/2017 period across the sector following sizable naira devaluation that bloated most debt balances. Meanwhile, some companies have also reported lower interest rates on loans so far in the year, moderating from as high as 22% to 19%. Persistent foreign exchange losses are however a major concern, with two-third of our coverage companies reporting notable exchange losses as at Q1'18. Despite a stable naira, FMCGs have continued to record these FX losses which are reportedly a result of exchange rate differentials between the carrying cost of dollar denominated liabilities and actual settlement rate. On a slightly more positive note, the losses have moderated compared with the trend observed in the last two years. Given the prior year's high base, we forecast an average 70% y/y moderation in interest expense for our coverage in FY'18. Amidst these positive cost developments, we forecast an average *c.*100bps profit margin expansion across our coverage. Supported by this and a modest topline growth, we forecast a 44% y/y average bottom line increase across our coverage companies, flattered by low bases across some companies.

Amidst the positive cost developments, we forecast an average c.100bps profit margin expansion across our coverage. Supported by this and a modest topline growth, we forecast a 44% y/y average bottom line increase across our coverage companies, flattered by low bases across some companies.



Source: Company Financials, Vetiva Research

Animal Feeds Sector: Disruptive competition changing market dynamics

Overview of the Animal Feeds Sector

Nigeria's agro-allied industry has been a more promising sector of the economy in recent years given the renewed diversification drive by both private and public stakeholders. The Animal Feeds sector has been one of the agro-allied businesses that has thrived, with the sector recording strong growth in the past three years while also significantly dispelling imported alternatives. Notably, supportive policies such as the outright ban on imported poultry and the CBN including tinned fish on its list of 41 items ineligible to access foreign exchange, and other independent state-driven policies have supported domestic demand for these animals as well as animal feeds. Meanwhile, currency devaluation over the past four years has seen price of imported feed brands rise significantly – giving local brand a strong leverage to compete. Data from Pind Foundation reported average price increases of 151% and 66% for imported and local feeds respectively in 2017.

The Animal Feeds sector has been one of the agro-allied businesses that has thrived, with the sector recording strong growth in the past three years while also significantly dispelling imported alternatives.

The Process

The Feeds business typically entails the process of producing and milling animal feeds (for poultry, aquaculture, livestock, pets) containing proteins, fiber, macronutrients and made from raw agricultural products such as maize, soybeans, groundnut, wheat, sorghum, etc. Currently, growth in poultry and aquaculture feed production has been the strongest in recent years, with livestock and swine at a distant second. As at 2016, Nigeria's total animal feed production capacity was reported at 5.3 million metric tons per annum according to Alltech, with fish feeds reportedly accounting for 13% of total feed production, and poultry feed production holding over 80%. Whilst local supply of poultry feeds is estimated to be at par with demand, a notable supply gap exists in the fish feed market, noting the sizable import bill of fish feeds amidst sustained rapid growth in local fish production and consumption. Notably, according to the PIND Foundation in its research done in December 2017, fish feed production is dominated by home/farm made and small and medium enterprises (*c.*70%) while only 10% of volume is provided by large feed producers and 7% from imports (major brands include Skretting, Coppens, Aller Aqua, etc). That said, UAC of Nigeria's Grand Cereals and Livestock Feeds subsidiaries (under Livestock and Vital Feeds brands), and Flour Mills of Nigeria's Premier Feeds (under its Top Feeds brand) are some of the largest feed producers in the country, both producing poultry and fish feeds, while UAC is more diversified with feeds for ruminants, livestock and even pets. We estimate Livestock Feeds capacity at 350,000MT/annum and Grand Cereals poultry and fish feed capacities at 150,00MT/annum and 30,00MT/annum respectively.

Whilst local supply of poultry feeds is estimated to be at par with demand, a notable supply gap exists in the fish feed market, noting the sizable import bill of fish feeds amidst sustained rapid growth in local fish production and consumption.

Changing dynamics mean tougher realities for existing players

Amid the earlier mentioned shift in demand from imports to locally manufactured feeds, the animal feeds sector has recorded a huge surge in capital expenditure by players previously represented by imported brands, new operators as well as expansions from already established players. Most significant of these was from Olam Nigeria in September 2017, the company opened two new poultry feed mills (under the brands Chikun and Ultima) each with an annual capacity of 360,000 metric tons in Kaduna and Kwara states – largest in Nigeria. Olam also opened a 75,000MT fish feed manufacturing facility in Kwara (under its value brand Blue Crown and premium range Aqualis). Olam's entrance into the market has been somewhat disruptive in the market for two reasons; (i) the Group's strategic positioning and scale across the feed value chain gives it a unique advantage, in terms of economies and margins, over peers; a strong value chain to supply raw materials to its feed milling facilities noting its well-established grains business in Nigeria and across the world, and also being vertically invested in hatcheries and poultry farms (ii) the Company's strong conviction that providing high-quality high-protein level feeds at highly competitive prices will further support overall growth in the animal production industry in Nigeria given that feeds account for *c.*70% of the cost of farmed fish production. Amidst this, Olam released its locally produced brands at prices below the current market levels. The company also actioned a renewed drive to improve productivity and also support animal production by training farmers and providing highly attractive credit and trading terms to customers and retailers, reportedly providing storage facility in some cases and attractive bonuses/commissions on sales for middle men.

Olam's entrance into the market has been somewhat disruptive in the market for two reasons; (i) the Group's strategic positioning and scale across the feed value chain gives it a unique advantage, in terms of economies and margins, over peers; (ii) the Company's strong conviction that providing high-quality high-protein level feeds at highly competitive prices will further support overall growth in the animal production industry

Though Olam's singular impact has been one of the most notable, we believe this only heralds the beginning of a more efficient market where players compete on both quality and price even as more production continues to ramp up in the market. This process will squeeze out less efficient producers as the average sector margin moderates and higher competition could mean lower market share for some, meanwhile other players would need to adopt more competitive pricing strategies to compete. Notably, Grand Cereals has released a new value brand, AquaBoom to respond to the market shift, reportedly priced 15% below its regular Vital Feeds brand, but at a slightly lower quality. UACN's operations have also been affected by the changing market dynamics, with the company stating fierce competition led to sizable gross margin moderation in Q1'18 with the company unable to raise prices to compensate for higher input costs given the intense competition. The sector also recorded a 42% y/y and 63% y/y moderation in revenue and operating profit respectively. Unlike its competitors, UACN does not have the edge of adjacent agro-allied business lines to support efficiencies and potentially temper input cost pressures.

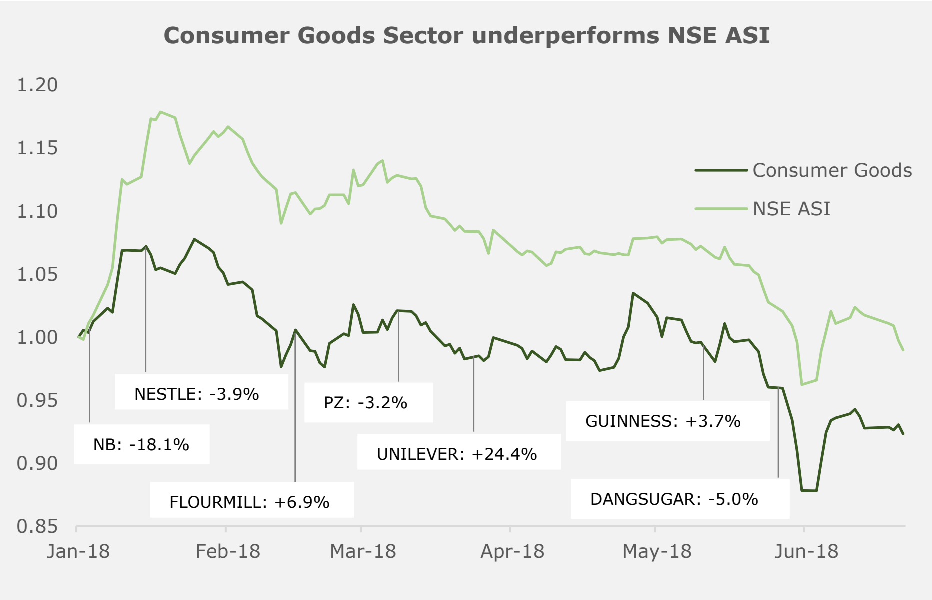
Overall, we expect mixed outcome from the new playing field in the Animal Feeds sector with some gainers and losers amidst heightened competitive intensity.

Overall, we expect mixed outcome from the new playing field in the Animal Feeds sector with some gainers and losers amidst heightened competitive intensity. In the short term, we expect companies' growth will be more significantly driven by market share gains while organic demand continues to ramp up slowly in line with aggregate demand levels in Nigeria. While the more stable and liquid exchange rate environment has reportedly began to re-stimulate demand for some select imported feeds, the scales remain tilted towards more domestic sourcing with potential upside coming from tighter trade policies surrounding animal importation. In the long run however, Nigeria's feed market just like the agriculture and agro-allied sectors remain highly lucrative with stronger growth rate forecasted amid relatively low levels of protein consumption and overall rise in domestic production.

Consumer Goods sector remains worst performing NSE key sector

We believe the Consumer Goods sector will underperform the broader market for the third consecutive year in 2018. The sector index has trailed the NSE ASI so far this year, posting a 7.5% YTD decline and standing as the only key sector in negative territory, underperforming the ASI's -1% return. The sector has debunked the textbook theory of defensiveness in consumer staples during and after a recession given the unique threats Nigerian FMCGs are exposed leading to subsequent dismal earnings and consequent loss of confidence in the sector. For H2'18, in line with the broader market, we expect positives from improving corporate performances and a stable macroeconomic environment to be overshadowed by the typical cautious and bearish sentiment that accompanies election cycles. Meanwhile, market developments relating to the brewery sector (excise duties, state bans on liquor, changing consumer behaviour) have also shed a downbeat sentiment on brewery stocks particularly, with the sector names shedding an average 23% from their peaks earlier in the year. Also, given our expectation of weaker earnings figures from sugar producers, we believe negative price trends may surface on sugar stocks in H2'18. Despite trading at significant premiums to the market however, multinational Food and HPC leaders, NESTLE and UNILEVER have been the major "safe haven" in the sector and have seen more positive, less volatile trading patterns so far this year as market participants focus on NESTLE's sector-leading profitability and UNILEVER's renewed above average revenue growth ability. Overall, whilst the Consumer Goods sector's performance will be highly driven by investor confidence, or the lack of it in the broader market in H2'18, we do not see the possibility of a positive close for the sector at year end. That said, we favour FLOURMILL, UNILEVER and NESTLE to be remain top picks for the sector in H2'18.

We believe the Consumer Goods sector will underperform the broader market for the third consecutive year in 2018. The sector index has trailed the NSE ASI so far this year, posting a 7.5% YTD decline and standing as the only key sector in negative territory, underperforming the ASI's -1% return.



Source: Bloomberg, Vetiva Research

FY'18 Forecasts for Coverage Universe							
	TP (₦)	Upside	EPS	Forward P/E	Div. Yld.	ROE	Rating
DANGSUGAR	23.30	23%	2.22	8.6x	5.8%	26.8%	BUY
FLOURMILL	45.45	47%	6.98	4.4x	6.5%	16.8%	BUY
GUINNESS	89.70	-8%	3.61	27.0x	2.1%	12.3%	SELL
NESTLE	1,275.76	-15%	50.67	29.5x	3.4%	89.6%	SELL
NB	130.68	18%	4.95	22.3x	4.0%	21.8%	BUY
PZ	24.37	22%	0.50	39.9x	2.5%	4.7%	BUY
UACN	20.03	43%	0.69	20.4x	2.8%	3.3%	HOLD
UNILEVER	34.15	-33%	2.40	21.1x	1.0%	13.1%	SELL

Agriculture

Agriculture Sector

The Cost of Insecurity

We see security challenges as the current biggest threat to Agricultural output and believe that the way we handle the challenges will be key to the sector outlook in the medium to long term. The Agriculture sector in Nigeria got off to a slow start in 2018, with real GDP growing at 3% y/y in Q1'18, the lowest quarterly real GDP growth rate since Q1'13. Whilst the exact driver of the slowdown is not clear, we highlight recent clashes between Farmers and Herdsmen in a few food producing states and the consequent destruction of crops and livestock alike. We believe that the slowdown is a lagged effect of the ensuing insecurity. Whilst there is a dearth of information regarding the extent of damages to agricultural output, we expect continued disruptions to negatively impact sector growth and elevate food prices. We have already seen offshoots of this in May, with m/m food inflation rising from 0.9% in April to 1.3% in May. Conflict over arable land is as old as farming and herding. However, with the population of both livestock and people growing over the years and the effect of climate change capping available arable land for either grazing or cultivation, competition and conflict has intensified in recent times. In the run up to the general elections, we expect increased pressure on the Federal Government to find a lasting solution to the issue. FG has already established a National Food Security Council and increased military activity across the middle belt (The most affected region). We however expect this phenomenon to remain a key issue in the near term, especially given the unique ethnic and religious undertones underlying the clashes. Amidst increased disruption to food production, we foresee higher food prices in H2'18.

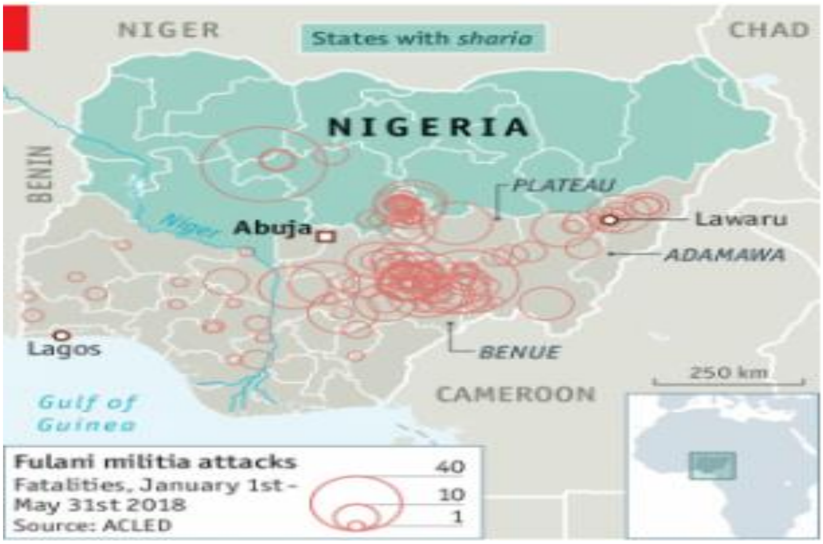
Conflict over arable land is as old as farming and herding. However, with the population of both livestock and people growing over the years and the effect of climate change capping available arable land for either grazing or cultivation, competition and conflict has intensified in recent times.

Effects of Conflict on Farmers and Herdsmen

Damages	Repercussions
Theft of cattle and goats	Loss of animals
Over grazing	Loss of fertile land
Destruction of crops	Loss of crop yield
Hardening of soils with cloven hooves	Increased labor in pre-farming activities
Destruction of reservoirs, infrastructure and source of drinkable water	Loss of water and resources
Physical fight	Loss of life and property

Source: Vetiva Research

Concentration of attacks



Source: Economist, ACLED, Vetiva Research

Development policies still key to capturing sector potential

As stated in our 2018 outlook, "Acta Non Verba", we expect Development Finance Initiatives by the CBN and other Government agencies to drive growth across the entire Agricultural value chain. Recently, the CBN directed commercial banks to set aside 5% of prior year's PAT as funding for the Agri-business Small & Medium Enterprises Investment Scheme (AGSMEIS). The scheme, which was first approved in 2017, is aimed at increasing SME access to finance, up to a maximum of ₦2 billion per business. The initiative is one of many initiatives by the CBN with the intent to drive activity in key sectors of the economy, particularly the agriculture sector. These initiatives have been key to driving growth in the Agric sector. The Anchor Borrowers program for one, has disbursed over ₦55 billion since 2015 to over 250,000 farmers at single digit interest rates. The program, targeted mostly at rice production (80% of funds committed to this), has recorded some progress, with the number of rice farmers rising from 5 million to 12.2 million since commencement and import of Rice reducing from 500,000MT in 2015 to 20,000MT in 2017. Other initiatives include the National Collateral Registry of Nigeria, which provides a web-based system for financial institutions to register their interest in any movable asset used as collateral. This is particularly important for Agribusiness MSME's as movable assets/property accounts for most of their capital stock and is usually the only asset type that can be encumbered by them. The registry is already proving popular, with 20,684 assets valued at ₦392 billion already registered on the platform as at September 2017 – four months after the registry was set up. We expect the registry to improve credit supply to the Agribusiness sector, especially given the success of similar systems in Mexico and China. Moreover, the National Assembly recently passed the Secured Transactions in Movable Assets act, changing the program from a CBN initiative to actual Federal law. We expect this to make the program more sustainable. Overall, we see these initiatives as a critical key to unlocking growth potentials of the Agriculture sector in the near term and over the longer term.

The ABP, targeted mostly at rice production (80% of funds committed to this), has recorded some progress, with the number of rice farmers rising from 5 million to 12.2 million since commencement and import of Rice reducing from 500,000MT in 2015 to 20,000MT in 2017.

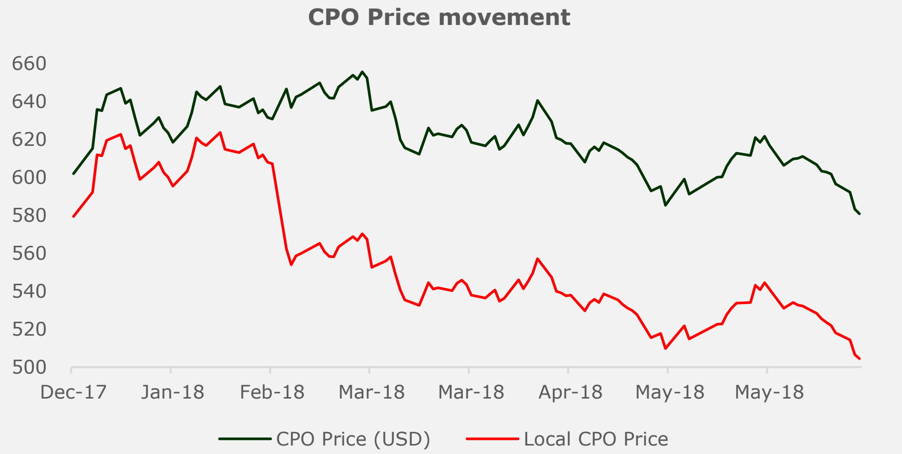
Oil Palm Sector

Expect lower CPO prices in 2018

The near to medium term outlook for global CPO prices is bleak, with production likely to outpace demand this year. The production upsurge is being driven by increased CPO output from Malaysia and Indonesia – two exporters which account for c.85% of global CPO supply – following increased planting in the mid 2010's. Demand dynamics are also threatening price outlook as China, the world's second largest consumer of CPO, looks to shift away from Oil Palm to Soybean Oil consumption. Also, India's decision to raise Palm Oil import taxes (CPO: 30% to 44%, Refined oil: 40% to 50% - highest in more than a decade) should reduce demand from the world's largest consumer, while the European Union has proposed a 2021 ban on the use of CPO as biofuel. So far, CPO prices have declined by c.6.5% ytd to RM2,444 and is likely to dip below it in H2'18.

In line with lower global CPO prices, we foresee weaker CPO prices in the local market, especially as parallel market rate (the other driver of local prices given that Oil Palm imports remain ineligible for Foreign Exchange at official rate) remains stable in the near-to-medium term – driven by continued CBN currency interventions. Furthermore, we expect increased CPO imports in H2'18 to weigh on prices, supported by stable parallel market rates. Amidst these, local CPO prices are expected to face downward pressure through 2018, reducing price support for local producers.

We expect increased CPO imports in H2'18 to weigh on prices, supported by stable parallel market rates.



Source: Bloomberg, Vetiva Research

Oil Palm investments will improve output in the medium term

In spite of the weak price outlook, we expect increased Palm oil supply in the medium term, driven by increased government and private investments in the sub-sector. Abia state for one, plans to distribute seven million improved Tenera seeds between 2017 and 2019 under the "Ikpeazu Oil Palm revolution". The seeds, which have a shorter gestation period, are expected to increase output yield. Also, Edo state plans to grow between 100,000-150,000 ha of CPO within the next three years as the state government targets increased production of palm oil. We also expect increased output from the corporate sector, as PZ-Wilmar (a JV between PZ Cussons and Wilmar Int'l) recently announced plans to acquire 50,000 ha of land to add to their existing 39,300 ha of land in Cross River for Oil Palm production. Whilst the relatively long gestation period of Palm fruits (5-7 years) mean that the effects would not be seen in 2018, we expect stronger CPO output in the medium to long-term as these projects come to fruition.

Whilst the relatively long gestation period of Palm fruits (5-7 years) mean that the effects would not be seen in 2018, we expect stronger CPO output in the medium to long-term, as these projects come to fruition.

FY'18 Forecasts for Coverage Universe							
	TP (₦)	Upside	EPS	Forward P/E	Div. Yld.	ROE	Rating
PRESCO	80.08	9%	7.01	10.5x	2.7%	9.0%	HOLD
OKOMUOIL	94.59	0%	10.32	9.1x	3.2%	35.0%	SELL

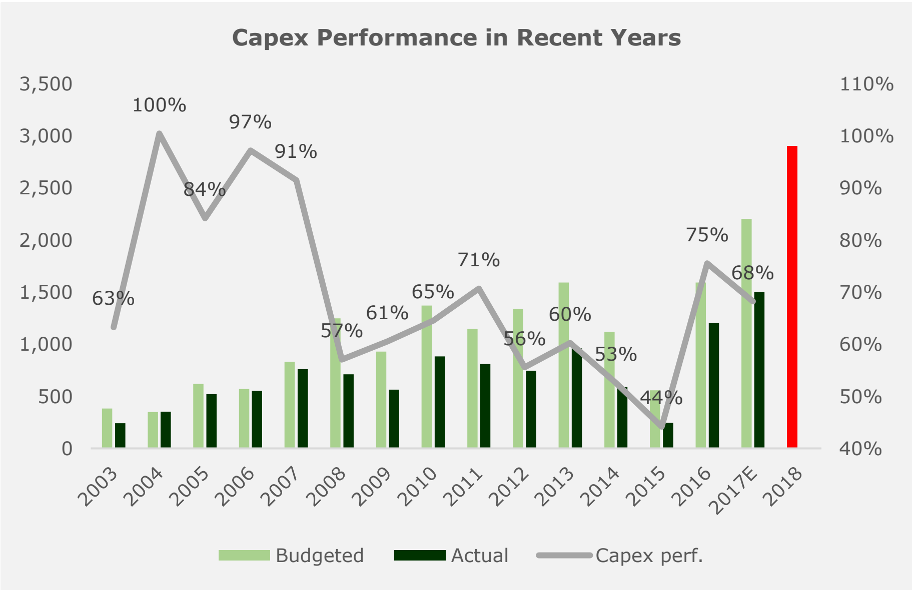
Industrial Goods

Industrial Goods Sector

Capex implementation will drive cement demand

The Nigerian cement market appears to be enjoying a renaissance, with Q1'18 performance coming in stronger y/y (Q1'18 real GDP growth: up 5.3% y/y). We recall that cement demand was weak in 2017 as high prices as well as a weak economic environment took a toll on cement consumption, down 19% y/y to 18.5 million MT. However, we highlight that volumes across our coverage have shown signs of recovery in Q1'18 – up 2% y/y and 26% q/q to 5.4 million MT within the quarter, even as prices remained stable. According to management, volume ramp-up was particularly supported by stronger public-sector demand for cement as government continues to push to plug Nigeria's infrastructure deficit. Following the budget passage, we expect stronger demand for cement through FY'18 as FG ramps up infrastructure spend, with a strengthened Capex budget of ₦2.9 trillion (FY'17: ₦2.2 trillion). That said, we note that improved Capex budget standalone does not necessarily translate to higher Infrastructure spend as we have seen in the past. So far, Capex implementation has not exceeded 75% in the past ten budgetary periods. However, we are more optimistic of Capex performance in 2018 due to the recent establishment of the Presidential Infrastructure Development Fund (PIDF). With seed capital of $650 million from the NLNG dividend account, the fund is expected to reduce financing challenges for critical power and road projects across the country. Also, with elections around the corner, we expect Capex execution to gain more traction as the government looks to deliver its election promises. Overall, we anticipate a relatively stronger cement demand in H2'18.

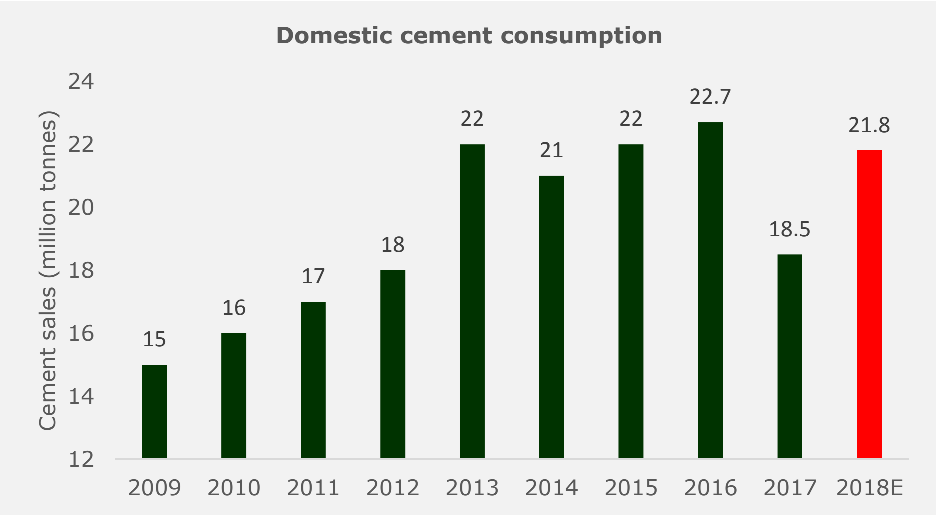
Improved Capex budget standalone does not necessarily translate to higher Infrastructure spend, as we have seen in the past. So far, Capex implementation has not exceeded 75% in the past ten budgetary periods. However, we are more optimistic of Capex performance in 2018 due to the recent establishment of the Presidential Infrastructure Development Fund (PIDF).



Source: CBN, Budget Office, Nairametrics, Vetiva Research

Improving private sector to support cement demand

Whilst private sector consumption slowed in 2017, we foresee stronger demand in 2018, as consumer wallets improve. Demand has already picked up in H1'18, with JBERGER's Q1'18 report indicating a gradual recovery in private sector construction activity – up 9% y/y. Buoyed by a strong macro outlook supporting economic activity – FY'18E GDP: 1.9% – we foresee continued recovery in H2'18 and expect this to support cement sales. All in, we anticipate an 18% y/y rise in cement consumption to 21.8 million MT.



Source: Company filings, Vetiva Research

Majors look to marketing to capture market share

To take advantage of the optimistic volume outlook, cement majors have been ramping up marketing spend in recent quarters, with a view to capturing market share especially in the private sector. DANGCEM in particular recently began a marketing campaign that aims to increase cement sales during the rainy season. Due to the chemical nature of cement and a lack of compensating adequate storage for smaller scale retailers, sale of cement is usually weaker in the rainy season. DANGCEM management has therefore begun distributing metal containers, large umbrella stands and tarpaulins to roadside retailers to protect their stock of cement. This strategy is supposed to deliver on two objectives; 1) Increase the willingness of retailers to stock up on cement in the rainy season and 2) Take advantage of the strategic location of the retailers (right by the roadside) to increase brand awareness as the containers, umbrellas and tarpaulins are all branded with DANGCEM logos. Lafarge Africa and CCNN have also raised marketing spend in recent quarters, with management commenting that the benefits are already being reaped in volume sales. Overall, marketing spend across our coverage (DANGCEM, WAPCO, CCNN) rose in Q1’18, with management anticipating a near-to-medium term payoff.

Source: Company filings, Vetiva Research

Road construction will drive cement sales in Nigeria

Come H2'18, the story of Nigeria's poor road infrastructure and its potential to drive cement consumption would not change much. Approximately 68% of Nigeria's road network remains unpaved, whilst a significant portion of the paved network is in need of rehabilitation. In a bid to improve this, the Federal Executive Council recently endorsed private sector participation in road construction, in exchange for tax concessions. The deal has gained some traction, with Flour Mills of Nigeria and AG Dangote Limited currently carrying out a joint rehabilitation of the Apapa road, in exchange for concessions of up to ten years. Going forward, we expect the policy to support private participation in road construction and consequently drive cement sales, especially with many other corporates showing interest. Specifically, we see demand for concrete road technology driving cement sales in Nigeria. One of the principal arguments for concrete roads is its durability (with an average lifespan of 30 years compared to Asphalt's 10 years), with concrete roads also requiring less maintenance. Given the poor state of Nigeria's current road infrastructure, we expect the relative durability of concrete roads to improve its attractiveness in the medium term. On the negative side however, the cost of paving concrete roads is estimated to be higher than asphalt, although the gap has closed up in recent times, post the devaluation of the naira. That said, we see the adoption of cement road construction as a major game changer in the sector going forward. Using the estimated 135,000km unpaved road network in Nigeria, total adoption of concrete road technology could potentially translate to additional 247.5 million MT of cement sales. Although, total adoption is unlikely, we expect a modest adoption to still pose strong upside for consumption of cement in Nigeria.

Using the estimated 135,000km unpaved road network in Nigeria, total adoption of concrete road technology could potentially translate to additional 247.5 million MT of cement sales.

Impact of concrete road adoption on cement sales

Total Road Network	200,000km
Total Paved Roads	65,000km
Total Unpaved Roads	135,000km
Cement Usage/km of concrete road	1,500 tonnes

Adoption Rate	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
Additional Cement volumes (million MT)	24.8	49.5	74.3	99.0	123.8	148.5	173.3	198.0	222.8	247.5

Source: NIIMP, ICRC, Vetiva Research

Domestic cement margins to remain healthy on Energy projects, pricing

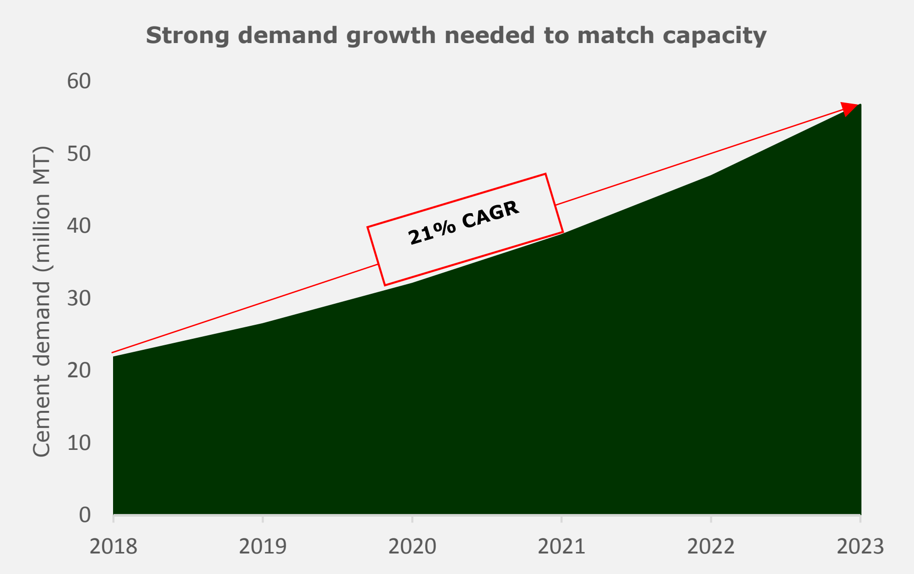
Most cement producers continue to invest in alternative energy sources to guard against the energy supply disruptions experienced in the 2014-2016 era. The diversification efforts began to ensure that cement majors have sufficient supply of important kiln fuels to mitigate against the risk of further gas supply shortages. However, aside from diversifying their energy sources, the alternative energy sources also come in relatively cheaper when compared to the traditional Gas and LPFO. Notably, coal is significantly cheaper than Gas and LPFO – 0.67x the cost of Gas and 0.27x the cost of LPFO. Over the last two years, we have seen dependence on the more expensive energy sources reduce, with over 43% of Dangote Cement's factory now running fully on coal. Consequently, DANGCEM's energy cost/tonne fell from ₦7,774 in Q3'16 to ₦4,753 in Q1'18, although still some way off ₦4,014/tonne pre-gas shortage quarterly average. Management is still optimistic of achieving an optimal mix, leaving room for further margin expansion. CCNN has also begun taking steps to cut its energy cost profile, with the new 1.5MT plant configured to run on multiple fuel sources including coal and LPFO. Supported by still-strong cement prices, we expect margins to remain healthy across the domestic cement market.

Will demand ever catch up with capacity?

At current installed production capacity of 43.7 million MT, capacity is still sizably higher than our estimated 21.8 million MT 2018 demand. Factoring in current expansion projects (DANGCEM: 9 million MT in Itori and Okpella, BUA: 3 million MT in Edo), capacity should increase to 56.7 million MT by 2020. If the status quo is maintained, a volume CAGR of 21% would be needed for demand to match supply in the next five years (2023). We see this as ambitious even after considering Nigeria's large infrastructure deficit, given that the sector is approaching maturity.

That said, we see the export market as a major long-term volume driver for cement majors. So far, cement majors have been exploring export opportunities, with all three listed producers currently exporting to one country or the other. Whilst Dangote Cement currently exports cement to Sierra Leone and Ghana, the cement giant also exports clinkers to Cameroon. We note that demand for cement is expected to improve in these regions. As Sierra Leone continues to ramp up on infrastructure spend, cement demand in Cameroon has strengthened as the country ramps up on stadium construction ahead of the 2019 African Cup of Nations. Also, we understand that CCNN has been taking advantage of its proximity to the Niger and Benin borders while Lafarge recently began exporting cement to Cameroon and Ghana. Much like Nigeria, these countries have large infrastructural deficits and do not have the major inputs locally in commercial quantities to enable full production of cement. The proximity to Nigeria coupled with relatively higher cement prices in these regions therefore make these countries attractive destinations for export. We note that in a bid to support its export, Dangote Cement plans to complete a jetty in Apapa in Q4'18 which would serve as an export hub to neighboring countries. Lafarge Africa is also rehabilitating a key road in Calabar which serves its major export routes, whilst CCNN has recently completed the expansion of the Kalambaina plant, with a view to ramping up exports.

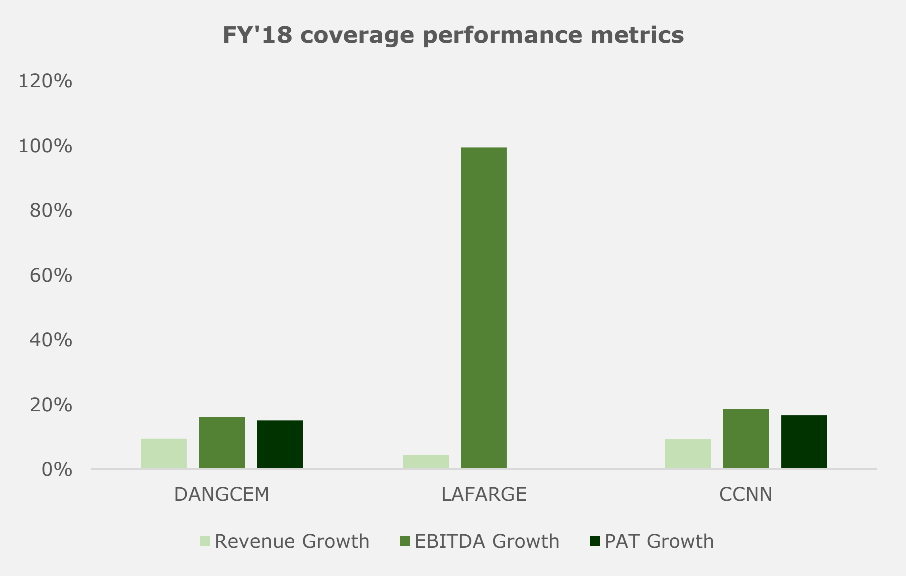
If the status quo is maintained, a volume CAGR of 21% would be needed for demand to match supply in the next five years (2023). We see this as ambitious even after considering Nigeria's large infrastructure deficit, given that the sector is approaching maturity.



Source: Company Filings, Vetiva Research

Stronger volumes, pricing to support strong FY’18 performance

Given our strong volume outlook, we estimate a 17% y/y rise in volumes across our coverage to 20.7 million MT. Also, we expect cement price to remain strong in FY’18, especially as management across our coverage companies have ruled out price cuts for the rest of the year as they look to protect margins. Consequently, we forecast an average 8% y/y topline growth across our coverage. Furthermore, we expect continued improvements in energy mix to support EBITDA margins across DANGCEM (FY’18E: 51%) and CCNN (FY’18E: 27%), with average margin expansion of 292bps in 2018. We remain cautious on WAPCO, given the recent industrial challenges in its South African operations (accounts for *c.*30% of business). However, given the low base from 2017, we anticipate a larger margin expansion of 828bps – taking the full year EBITDA margin to 17%. Overall, driven by stronger topline and margin, we forecast an average PAT growth of 39% across our coverage.



Source: Vetiva Research

FY'18 Forecasts for Coverage Universe

	TP (₦)	Upside	EPS	Forward P/E	Div. Yld.	ROE	Rating
DANGCEM	289.45	29%	16.33	13.8x	6.4%	34.1%	BUY
WAPCO	57.63	48%	0.23	169.6x	1.3%	7.5%	BUY
CCNN	11.12	-55%	2.99	8.3x	5.5%	24.3%	SELL
JBERGER	25.27	-8%	1.29	21.3x	0.3%	5.5%	SELL

Oil & Gas

Upstream Sector

PIGB miss shows regulation will continue to constrain sector

Regulatory reform remains the missing piece in Nigeria's oil & gas jigsaw and we were hopeful after the break-up of the Petroleum Industry Bill (PIB) into four separate bills and in particular, the progress made on the Petroleum Industry Governance Bill (PIGB) – approved by the National Assembly in April 2018, but it has been one step forward and another backward so far. There was brief joy when the National Assembly (NASS) approved the Petroleum Industry Governance Bill (PIGB) and directed it for transmission to the Presidency in April 2018. However, a review by the Directorate of Legal Services of the National Assembly found "fundamental issues" with the Bill, forcing it to be returned to the overseeing committee on Petroleum Industry and Governance. NASS did not disclose what these issues were so it is difficult to estimate how long the process would take before the PIGB is finally sent to the Presidency.

Smooth implementation of the PIGB proposals would also signal to industry stakeholders that the sector is primed to handle the changes to be imposed by the aggregated PIB. But at this stage, the PIGB is unlikely to see the light of the day before the end of the year, particularly as electioneering begins to vie with legislative governance.

The PIGB primarily deals with the regulatory framework of the oil & gas sector and proposes three key changes:

- Establish the Nigeria Petroleum Regulatory Commission (NPRC) as the single industry regulator in place of the Department of Petroleum Resources (DPR) and the Petroleum Products Pricing Regulatory Agency (PPPRA) to make regulation more transparent and coherent
- Unbundle the Nigerian National Petroleum Corporation (NNPC) into three commercial entities, with a view to partly privatise one of them (Nigeria Petroleum Company)
- Reduce the powers of the petroleum minister by restricting it to policy formulation and monitoring, with some of the minister's previous functions to be transferred to NPRC.

Passage of the PIGB would be beneficial to the sector as the governance bill would partially outline the new regulatory landscape, particularly with regards to demarcating the role of NNPC as industry regulatory and participant, and may help jolt quicker passage of the remaining bills. Smooth implementation of the PIGB proposals would also signal to industry stakeholders that the sector is primed to handle the changes to be imposed by the aggregated PIB. But at this stage, the PIGB is unlikely to see the light of the day before the end of the year, particularly as electioneering begins to vie with legislative governance.

Even PIGB passage would not be enough

We see some issues in the PIGB. Firstly, the bill is much less potent without the corresponding Petroleum Industry Administration Bill (PIAB) which acts as an operating manual for the NPRC and this could create a regulatory vacuum. On another note, the PIGB proposes that the Petroleum Equalisation Fund should be funded through a 5% levy on petroleum products sold in the country – as opposed to the current cross-subsidy approach where some marketers pay into the Fund. It is unclear how such a levy would work under the current pricing template and we do not think the levy would be imposed in the current subsidy climate. In short, passage of the PIGB without the PIAB may introduce further complications, particularly in the downstream sector.

Attention shifts to testier elements of original PIB – to no avail?

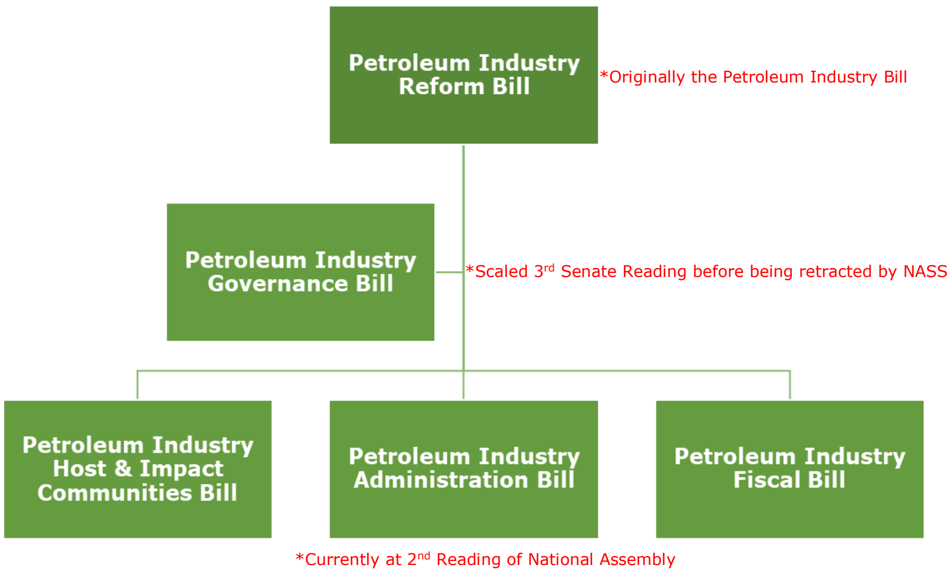
We note that some progress has been made on the other bills from the unbundled PIB – Petroleum Industry Host & Impact Communities Bill (PIHICB), Petroleum Industry Administration Bill (PIAB), Petroleum Industry Fiscal Bill (PIFB), with a 3-day public hearing held on their proceedings at the start of June. The respective bills are aimed at:

- PIHICB: Addressing Host communities mainly through a fund set up by IOCs with 2.5% of annual operating expenditure into the Trust
- PIAB: Setting out scope of NPRC particularly in terms of the power to grant and revoke licenses, liberalize downstream sector
- PIFB: Changing the taxes and royalty rates to be paid on oil & gas enterprises

Nevertheless, we do not expect these bills to make much progress until the Senate transmits the resolved PIGB to the Presidency. Moreover, public hearings have been held in previous years – original PIB in 2013, PIGB in 2016 – and in the PIGB case, preceded eventual NASS passage by over a year. These bills are still at the 2nd reading in the House and are likely to be dragged out for longer as they contain the most controversial oil & gas industry reforms. We consider it unlikely that these bills would make much headway before the 2019 elections and see the PIGB as the key reform pillar for the sector in the near-term – noting that the PIGB is not as potent on its own. In our view, electioneering brings added risk of legislative vacuum, and anticipate further delays to passage of all elements the PIB which still holds key to government revenues, regional development, and sector growth.

In our view, electioneering brings added risk of legislative vacuum, and anticipate further delays to passage of all elements the PIB which still holds key to government revenues, regional development, and sector growth.

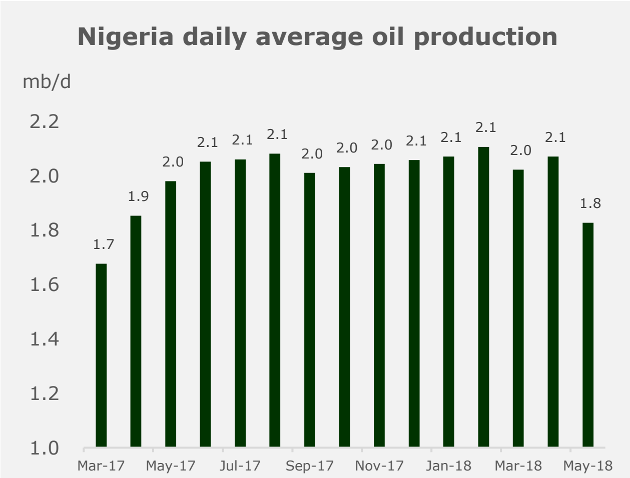
Breakdown of Petroleum Industry Legislature

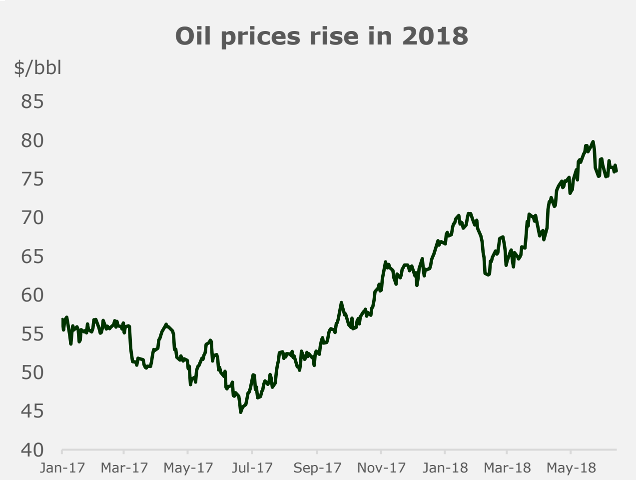


Source: NASS, Vetiva Research

Strong prices, stable production forecast for H2’18

We maintain a bullish outlook on oil prices for the rest of the year. Our H2’18 forecast is $67/bbl, compared to $70/bbl average in the first five months of 2018 and $55/bbl in 2017, and we expect this jump to spur topline growth across upstream players. However, we are more cautious about volumes given disruptions to crude evacuation and ahead of the 2019 elections. The Trans-Forcados Pipeline, the major trunk line in the Forcados Pipeline System that feeds the major Forcados Terminal, was shut-in for two weeks in May as the pipeline operator (Heritage Oil) declared Force Majeure as a result of a major leak, putting *c.*200,000 barrels of oil a day at risk. The Force Majeure has been lifted despite another leak, suggesting that the new leak is not material, though it may lead to higher reconciliation losses for operators that transport crude through the pipeline and continues to delay loadings to the Terminal. Meanwhile, Shell Petroleum Development Company of Nigeria (SPDC) also declared Force Majeure on Bonny Light exports after finding four major leaks on the Nembe Creek Trunk pipeline that feeds Bonny Light crude.





Source: Bloomberg, Ministry of Petroleum Resources, Vetiva Research

We highlight that a number of upstream players are better suited to handle these shocks as a result of adjustments made following the 2016 militant crisis. A few companies have explored a number of alternative crude evacuation arrangements in recent time. We highlight that SEPLAT has implemented multiple evacuation routes and reduced its reliance on Forcados lifting; Warri jetty route is functional though at a limited capacity and more expensive whilst the Amukwe-Escravos pipeline route is expected to come online in Q3’18 and would have comparable cost to Forcados. In the same vein, some majors may take advantage of current oil price outlook to invest in alternative evacuation arrangements. Despite the looming spectre of the 2019 elections, we are cautiously optimistic that 2018 would be a good year for oil & gas infrastructure and production. Though we expect election season to awaken militant threats, we foresee the Federal Government pulling out all the stops to quell any uprising – most likely through further appeasement – given the political and fiscal collateral damage of a negative production shock. Therefore, whilst we are slightly perturbed by persistent infrastructure integrity issues in the space, we are positive on the efforts made by industry players in mitigating these risks and expect these to yield fruit.

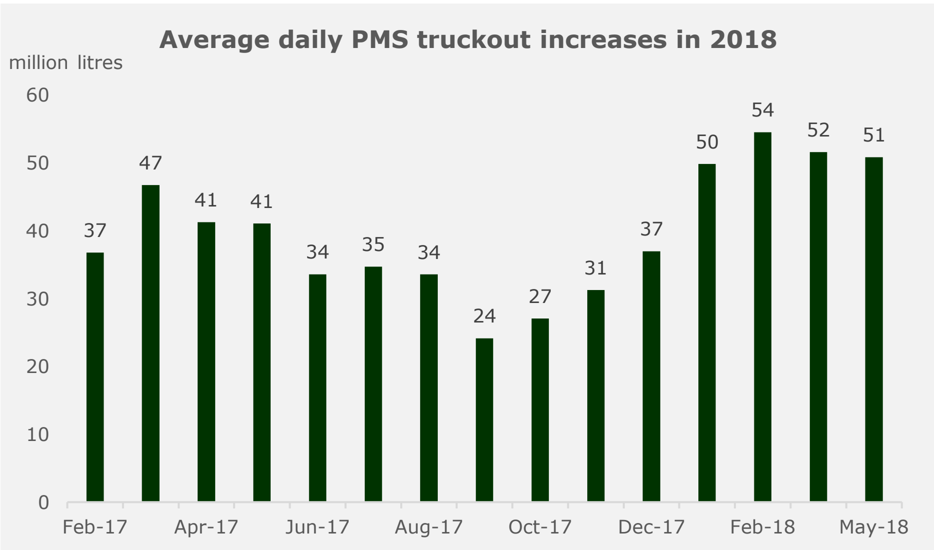
Though we expect election season to awaken militant threats, we foresee the Federal Government pulling out all the stops to quell any uprising – most likely through further appeasement – given the political and fiscal collateral damage of a negative production shock.

Downstream Sector

A tale of NNPC, subsidy, and smuggling

Strong oil prices should maintain the status quo in the downstream sector as it remains uneconomic for marketers to import products under the current pricing template (landing cost last estimated at ₦171 per litre with $65/bbl oil price) and the no subsidy re-imbursement era. Thus, we expect NNPC to remain the sole importer of petroleum products in the country – a fact confirmed by the Minister of State for Petroleum Resources in April, though he debunked the claim that the implicit cost of the NNPC subsidy had risen to ₦1.4 trillion. We expect marketers to continue to receive premium motor spirit (PMS) at a regulated thin margin with product supply being relatively stable given the strides NNPC has made in strengthening its distribution channels. Notably, PMS truck-out has risen steadily in 2018 and NNPC share of downstream petroleum market has reportedly risen to 14%. As NNPC is able to sell below-cost, its increased distribution reach may prove challenging to other marketers who would be vying for market share ahead of expected deregulation in 2019/2020 (post-Dangote refinery). Meanwhile, existing arbitrage opportunity sustains the appeal of smuggling to neighboring countries, a scourge that the Ministry of Petroleum Resources continues to combat. However, we do not expect the status quo to change, and despite the financial burden of the implicit subsidy regime and the occasional controversy it generates, it would be politically expedient for the government to ensure product supply and no sign of fuel queues ahead of the 2019 polls.

Meanwhile, existing arbitrage opportunity sustains the appeal of smuggling to neighboring countries, a scourge that the Ministry of Petroleum Resources continues to combat.



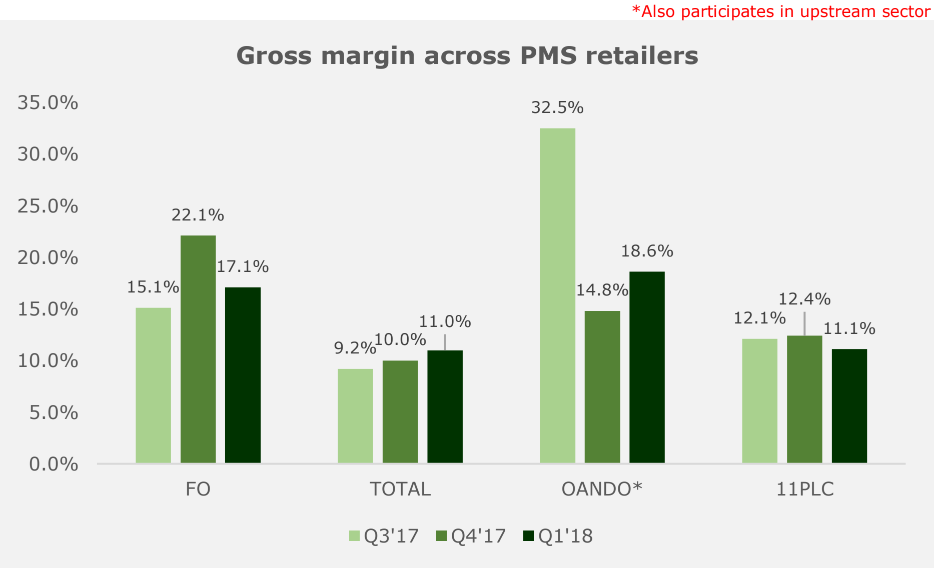
Source: Ministry of Petroleum Resources, Vetiva Research

Deregulated products to continue to provide margin support

Although we are less optimistic about the downstream space in the near-term given the reliance on NNPC and the current pricing regime, we see sector participants getting some joy from further diversification into deregulated petroleum products to support margins. This is a trend that has already been observed; 11 PLC's new core investor NIPCO investment had already intimated its intention to expand its deregulated product portfolio and has begun construction of a new ATK (diesel) 20,000MT tank farm after rerentering the diesel business – a decision that has begun to support margins.

Other marketers are toeing the same line and we expect expansion on this front as deregulated markets look more appealing than the current PMS market. For example, we note that Forte Oil (FO) may be poised to do this as its divestment plans and strategic focus on the petroleum downstream space may give it the financial and distribution clout to capture value in deregulated products. Finally, we expect industry players to look more closely at the Liquified Petroleum Gas (LPG) space give the FG's state ambition to drive domestic LPG use through the LPG Penetration Programme.

*Also participates in upstream sector



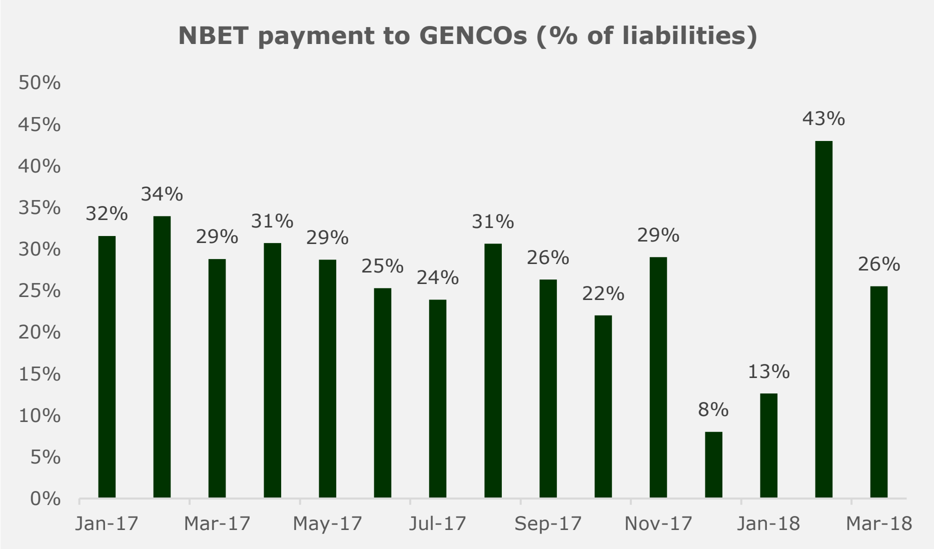
Source: Company financials, Vetiva Research

Power Sector

If the PAF has reached its limits, what next?

The ₦701 billion Power Assurance Facility (PAF) fund introduced from January 2017 to address the liquidity challenge depressing the Power Generation value chain has come under scrutiny in recent times. Nigerian Bulk Electricity Trading PLC (NBET) has disbursed facility obligations from January 2017 to February 2018, cutting payment delays down from five months to two months (March and April payments outstanding) as at the last check. But even apart from the delayed disbursements, the PAF has not fully addressed GENCO funding challenges. NBET data shows that GENCOs have only received payment on 27% of invoices billed in 2018 – similar to 2017 – with significant variation across different months. The development already looks to be weighing on company financials – Forte Oil power receivables rose from ₦14.6 billion in FY'16 to ₦32.6 billion in FY'17, ostensibly on the back of delayed payments to its Geregu power plant. We understand that this persistent liquidity challenge was one motivation for the company's decision to divest its power business (Amperion Power Distribution Company Limited) and see this as a worrying signal of the financial state of industry players.

Even apart from the delayed disbursements, the PAF has not fully addressed GENCO funding challenges. NBET data shows that GENCOs have only received payment on 27% of invoices billed in 2018 – similar to 2017 – with significant variation across different months.



Source: NBET, Vetiva Research

In our view, the size and consistency of NBET payments would need to significantly improve to have a material and sustained impact on liquidity in the space. Moreover, the FG may need to look beyond the PAF to other elements of the Power Sector Recovery Program (PSRP). In particular, the resolution to pay off historical MDA and state government debts and automate future payments holds significant value for GENCOs given the size of MDA power liabilities. There is also a need to address funding gaps further down the value chain to ensure that GENCO earnings are more resilient. For example, the eligible customers framework was conceived to permit eligible customers to purchase power directly from GENCOs, reduce reliance on the Transmission Company of Nigeria (TCN) and distribution companies (DISCOs), and enable GENCOs monetise excess power generated. However, implementation has stalled and it remains to be seen whether the modalities of the framework are practical in the current environment.

New regulation may finally close metering gap

Notable progress has been made on metering so far in 2018. The Meter Asset Provider (MAP) Regulation came into effect on April 3rd, 2018 and would shift the burden of meter installation from DISCOs to licensed third-party operators. The previous Credited Advanced Payment for Metering Implementation system (CAPMI) was supposed to allow willing buyers to purchase meters up-front from DISCOs, but paid-for meters were not provided by DISCOs, a situation that created a sizable metering gap (almost one in two electricity customers do not have meters) and erratic billing as DISCOs use an estimated billing approach for non-metered customers. The MAP system should address this by shifting the burden of meter provision to third-party operators and enable DISCOs to focus on their core business. According to the Nigerian Electricity Regulatory Commission (NERC), procurement would be via an open, transparent and competitive bid process and DISCOs have been given a July-end deadline to engage with MAPs for the purpose. We acknowledge reports at the end of May that 22 firms were approved to participate in the bidding process.

The MAP system should address the metering gap by shifting the burden of meter provision to third-party operators and enable DISCOs to focus on their core business.

Overall, whilst we back the decision to move metering provision away from DISCOs and see a narrowing metering gap as a key step in improving the power distribution sector, we are cautious about the near-term impact given the lack of clarity in how installed meters would be shielded from tampering and compromise by end-users. We also note the current discussions around criminalizing the practice of estimated billing and highlight the adverse effect of such a move if it comes before Nigeria closes its metering gap. Overall, the current challenges in the power sector (such as the lack of a cost-reflective tariff) may undercut the economic feasibility of the meter procurement plan.

A tariff hike is needed, but will not come

NERC commenced its biannual review of the 5-year electricity tariff structure in June 2018, but we do not anticipate any revisions to the current template ahead of the 2019 elections. We still consider hikes to be a necessary part of power sector reforms, a case most convincingly made by the size of naira depreciation in recent years. This is particularly important as improved DISCO liquidity would have a positive ripple effect on the entire value chain and we hope that improved metering transparency and electricity stability would make a tariff hike more tenable post-election. Nevertheless, we expect the tariff conundrum to be kept on ice until after the elections and see the new metering regulations as the primary near-term boost on the distribution front. Moreover, the government would likely prioritize regular power supply in the run-up to the elections to pushing through changes in electricity tariffs.

We expect the tariff conundrum to be kept on ice until after the elections and see the new metering regulations as the primary near-term boost on the distribution front. Moreover, the government would likely prioritize regular power supply in the run-up to the elections to pushing through changes in electricity tariffs.

Steady investment in Nigeria’s power infrastructure

Although reports in late 2017 suggested the FG was open to divesting its 40% stake in DISCOs, we do not foresee any imminent changes in the market structure. Instead, we expect the FG to persist in its efforts to create an enabling environment for DISCOs to thrive and we also foresee further investment in transmission infrastructure as the FG moves to beef up TCN capacity and performance. Most notably, we highlight the recent World Bank $486 million credit facility earmarked for transmission infrastructure among others. We are hopeful that technical support provided by the Bank would help address grid challenges and complement initiatives to strengthen power generation and distribution in the medium-term.

Disclosures Section

Disclosure

Analyst Certification
The research analyst(s) denoted by an "*" on the cover of this report certifies (or, where multiple research analysts are primarily responsible for this report, the research analysts denoted by an "*" on the cover or within the document individually certifies, with respect to each security or issuer that the research analyst(s) cover in this research) that: (1) all of the views expressed in this report accurately articulate the research analyst(s) independent views/opinions, based on public information regarding the companies, securities, industries or markets discussed in this report. (2) The research analyst(s) compensation or remuneration is in no way connected (either directly or indirectly) to the specific recommendations, estimates or opinions expressed in this report.

Ratings Definitions
Vetiva uses the following rating system:

Buy rating refers to stocks that we consider highly undervalued, but with strong fundamentals, and where potential return in excess of or equal to **15.00%** is expected to be realized between the current price and analysts' target price.

Hold rating refers to stocks that we consider correctly valued with little upside or downside, and where potential return between **+5.00**and**+14.99%** is expected to be realized between current price and analysts' target price.

Sell rating refers to stocks that we consider overvalued, but with good or weakening fundamentals, and where potential return below +**5.00%** is expected to be realized between current price and analysts' target price.

Rating Suspended: applies to a stock when investment rating has been suspended because there is no sufficient fundamental basis for determining, or there are legal, regulatory or policy constraints around publishing, an investment rating or target price.

Extra-normal situations: The standard rating methodology as defined above does not however apply in extra-normal situations. We define an extra-normal situation as one where mostly non-quantitative material considerations and factors which cannot be reasonably and reliably estimated are considered in providing a recommendation on a stock. In such cases, the analyst may use professional judgement at their own discretion to assign ratings which may contradict the expected rating based on the standard rating methodology.

Analysts' Compensation: The research analyst(s) responsible for the preparation of this report receive compensation based upon various factors, including the quality and accuracy of research, client feedback, competitive factors, and overall firm revenues, which include revenues from, among other business units, Investment Banking and Wealth Management.

Valuation and Risks: Please see the most recent company-specific research report for an analysis of valuation methodology and risks on any security recommended herein. You can contact the analyst named on the front of this note for further details.

Frequency of Next Update: An update of our view on the company would be provided when next there are substantial developments/financial news on the company.

Conflict of Interest: It is the policy of Vetiva Capital Management Limited and its subsidiaries and affiliates (individually and collectively referred to as "Vetiva") that research analysts may not be involved in activities that suggest that they are representing the interests of Vetiva in a way likely to appear to be inconsistent with providing independent investment research. In addition, research analysts' reporting lines are structured so as to avoid any conflict of interests.

For example, research analysts are not subject to the supervision or control of anyone in Vetiva's Investment Banking or Sales and Trading departments. However, such sales and trading departments may trade, as principal, on the basis of the research analyst's published research. Therefore, the proprietary interests of those Sales and Trading departments may conflict with your interests.

Company	Disclosure
ACCESS	
CCNN	
DANGCEM	h
DANGSUGAR	
DIAMONDBNK	
FBNH	
FCMB	
FLOURMILL	
FO	g,h,j
GUARANTY	
GUINNESS	
JBERGER	
MOBIL	
NB	c
NESTLE	
OANDO	h,j
PZ	
SEPLAT	
SKYEBANK	h,j
STANBIC	
TOTAL	
UACN	
UBA	
UNILEVER	
WAPCO	
ZENITHBANK	

a. The analyst holds personal positions (directly or indirectly) in a class of the common equity securities of the company
b. The analyst responsible for this report as indicated on the front page is a board member, officer or director of the Company
c. Vetiva is a market maker in the publicly traded equities of the Company
d. Vetiva has been lead arranger or co-lead arranger over the past 12 months of any publicly disclosed offer of securities of the Company
e. Vetiva beneficially own 1% or more of the equity securities of the Company
f. Vetiva holds a major interest in the debt of the Company
g. Vetiva has received compensation for investment banking activities from the Company within the last 12 months
h. Vetiva intends to seek, or anticipates to receive compensation for investment banking services from the Company in the next 3 months
i. The content of this research report has been communicated with the Company, following which this research report has been materially amended before its distribution
j. The Company is a client of Vetiva
k. The Company owns more than 5% of the issued share capital of Vetiva
l. Vetiva has other financial or other material interest in the Company

Important Regional Disclosures

The analyst(s) involved in the preparation of this report may not have visited the material operations of the subject Company (ies) within the past 12 months. Commission is the commission rate or the amount agreed with a customer when setting up an account or at any time after that. To the extent this is a report authored in whole or in part by a Non-U.S. analyst and is made available in the U.S., the following are important disclosures regarding any Non-U.S. analyst contributors:
The Non-U.S. research analysts (denoted by an * in the report) are not registered/qualified as research analysts with FINRA; and therefore, may not be subject to the NASD Rule 2711 and NYSE Rule 472 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account. Each analyst (denoted by an *) is a Non-U.S. Analyst and is currently employed by Vetiva.

Legal Entities

Vetiva Capital Management Limited (VCML) is an Ordinary Member of the Nigerian Stock Exchange (NSE) and is registered with the Nigerian Securities & Exchange Commission (SEC) to conduct Issuing House and Financial Advisory business. Through its subsidiaries duly licensed and regulated by the SEC, VCML also carries on the business of Fund/Portfolio Management, Brokerage & Dealing (on both the NSE and the NASD OTC), Market Making and Trusteeship.

General

This research report is based on public information which the research analyst(s) consider credible and reliable. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of Vetiva, including the Investment Banking team and the Wealth Management team, as Vetiva has established information barriers between its Research team and certain business groups. Whilst reasonable care has been taken in preparing this report, no responsibility or liability is accepted either by Vetiva, its officers or any of its employees for any error of fact or opinion expressed herein. No reliance should be placed on the accuracy, fairness or completeness of the information contained in this report as it has not been verified by the research analyst(s) involved or the companies whose securities have been referred to except as otherwise disclosed. Neither Vetiva nor any of its officers or employees including the research analyst(s) warrant or represent the accuracy or completeness of information set out in this report. Any ratings, forecasts, estimates and opinions set forth in this report constitute the analyst(s) position as at the date and time of this report and may not necessarily be so after the report date and time, as they are subject to change without notice. It is also instructive to note that a company's past performance is not necessarily indicative of its future performance as estimates are based on assumptions that may or may not be realized.

The value, price or income from investments mentioned in this report may fall, as well as rise, due to economic conditions, industry cycles, market indices, operational or financial conditions of companies or other factors. Thus, Vetiva and its officers and employees shall not accept liability for any loss arising from the use of this report or its contents in making investment decisions or recommendations. This report provides general information only. It is not intended to provide personal investment advice and does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investments and securities discussed in this report may not be suitable for all investors and certain investors may not be eligible to purchase or participate in some or all of them. Users of this research report should independently determine the suitability and evaluate the investment risks associated with investments and securities discussed in this report. All investors are solely responsible for their investment decisions. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report. Vetiva, through business units other than Vetiva Research, may have issued and may in the future issue trading ideas or recommendations that are inconsistent with, and reach different conclusions from, the information presented in this report.

Such ideas or recommendations reflect the different time frames, assumptions, views and analytical methods of the persons who prepared them, and Vetiva is under no obligation to ensure that such other trading ideas or recommendations are brought to the attention of any recipient of this report. Vetiva may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.
To the extent that this report discusses any legal proceeding or issue, it has not been prepared as nor is it intended to express any legal conclusion, opinion or advice. Information relating to the tax status of companies whose securities are discussed in this report is not intended to provide tax advice or to be used by anyone to provide tax advice.

By accepting and making use of this research report, you agree to be bound by the foregoing limitations.
No portion of this document may be reprinted, sold or redistributed without the written consent of Vetiva Capital Management Limited. Vetiva research report is disseminated and available primarily electronically, and, in some cases, in printed form.

Additional information on recommended securities/instruments is available on request.