

## Economic Outlook

### A quarter of drifting ahead

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#### No recovery of note before 2018

We see the economy contracting by -1.7% y/y in Q3 and flattish in the fourth quarter. For the full year we expect a rate of -1.0% y/y, and very modest growth for 2017. The thinking is that the authorities have no choice but to reach a deal of sorts over the Niger Delta, and that the fiscal provides some boost.

#### Some cheer from revenue collection

There has been a trend increase in FAAC payouts over the past three months, driven by the devaluation and stronger non-oil revenue collection. This should allow a pick-up in the FGN's capital releases.

#### A risk from fiscal expansion to flag

The 2016 budget has domestic debt service at 34% of revenues. The FGN sees net domestic issuance of a further N2.5trn in the 18 months to end-2017. A potential trap lies ahead, and it is as well that domestic institutional demand for FGN bonds is solidly based.

#### Fx market not functioning as planned

We struggle to see autonomous fx inflows on a scale to complement the CBN's small daily offerings and create a fully functioning market in the quarter ahead. The various solutions are either not large enough to make an impact or politically unacceptable. The exchange-rate regime should be characterised as drifting rather than floating.

#### An inflation focus for monetary policy

The MPC/CBN have seemingly abandoned tightening to entice offshore portfolio investors. Their narrative is that their ammunition is almost exhausted, and fiscal/structural measures must lead the economy out of recession. Their next steps will be to track inflation on its downward trend.

#### Central economic indicators

	2014	2015	2016E	2017E
Real growth (in per cent)	6.2	2.8	-1.0	2.0
CPI (in per cent; y/y Dec)	8.0	9.6	18.0	10.3
Monetary policy rate (%; year-end)	13.0	11.0	14.0	11.0
Current account/GDP (in per cent)	0.2	-3.2	-3.8	-2.0
Bonny Light (end-period spot; US\$/b)	65	35	53	60
Bonny Light (average spot; US\$/b)	100	53	45	57
Official fx reserves (in US\$ bn)	34	29	20	18
N/US\$ (end-period)	185	197	325	365
N/US\$ (average)	165	196	256	350

Sources: CBN, NBS, Bloomberg; FBNQuest Research

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## The policy and political backdrop

### Approaching mid-term, and time to deliver

#### *Expectations of change in the country*

Almost 18 months have passed since the formal handover of power from the previous administration in May 2015. President Muhammadu Buhari, the victorious All Progressives Congress (APC) and the Federal Executive Council (FEC) therefore face mounting pressure to manage the expectations of the change which their election campaigning pledged to deliver.

#### *Fickleness of sentiment*

Their inheritance was poor, which provided the “window of opportunity” for their programme of reforms. In their defense, we note that the oil price took another downward leg in its long-term slide after their election victory, and so added to Nigeria’s familiar fiscal and balance-of-payments weaknesses. That said, the patience of voters everywhere is finite. It does not take long for positive sentiment to turn sour.

#### *An executive with some big names and achievers*

Critics and cynics might point to fuel, power and fx shortages, and become almost nostalgic about the Jonathan era. On safer ground, they can argue that the slow pace of decision-taking stems from the highly centralised system of government. It appears at times that almost all decisions have to be rubber-stamped at the presidency. We do not despair of delivery. We point to the presence of some big-hitters in the FEC appointed by Buhari in November. The most striking name in the council is Babatunde Fashola, the former governor of Lagos State, and now the federal minister for power, works and housing.

The council does not have a coordinating minister for the economy (like Ngozi Okonjo-Iweala, the finance minister in the outgoing Goodluck Jonathan administration). The vice president, Yemi Osinbajo, has the informal coordinating role for the economy. He is surrounded by reform-minded technocrats but does not always get his way. Investors should note the sharing of responsibilities between Udo Udoma at budget and national planning, and Kemi Adeosun at finance. Adeosun has been particularly active in her role of super-accountant supervising federal finances.

#### *Benefit of the doubt for Buhari’s strong mandate*

Many Nigerians will give Buhari the benefit of the doubt because of his convincing electoral mandate. In the most significant presidential election in the country’s history in March 2015, the turnout may have disappointed, at 43.7% of registered voters according to the Independent National Electoral Commission (INEC). In all other respects, the conduct and outcome of the exercise did not. The APC, a coalition of four opposition parties, secured 54% of valid votes cast, and Jonathan of the Peoples Democratic Party (PDP) 45%. Jonathan’s share of the vote in 2011 was 57%.

Buhari, born in 1942, was a military head of state from 1983 to 1985, and is best remembered for his asceticism and focus on governance. This was his fourth electoral challenge for the presidency.

#### *Strong base in the assembly too, and with state governors*

Further the APC now has a majority in the National Assembly and two thirds of the 36 state governors. This commanding victory was to be expected once it became

clear that the coalition had held together. Basic arithmetic suggested that an alliance of the north (Congress for Progressive Change) and the south-west (Action Congress of Nigeria, ACN) would deliver the presidency, and so it proved. The greater concern was whether the incumbent would accept defeat, and Jonathan called Buhari to congratulate him even before the final results had been announced by the INEC.

*International community also onside with Buhari*

This defeat for the ruling party is a first for Nigeria, a step forward widely praised by the US, the UK and most of the international community, along with the conduct of the polls and the role of INEC. In our view this represents a sea-change because a precedent has now been set: if a politician/party fails to deliver, he/it knows that it can be voted out of office by the electorate.

*The APC's electoral call well packaged and received*

We offer some reasons other than the arithmetic why the APC secured a resounding win and so dislodged the party in power since the return of civil rule in 1999: that the APC's call for "change" struck a chord; that the PDP made very little impression on the advance by Boko Haram in the north east (and indeed showed limited interest in the area); that governance, particularly in the oil industry, was widely seen to have deteriorated during the Jonathan presidency; that the slide in the oil price exposed the failure of the FGN to build the necessary fiscal buffers; and that social media facilitated the monitoring of the election by Nigerians.

*Fissiparous nature of all coalitions*

This coalition, like all others elsewhere, is always at risk from falling apart. Some tensions have emerged, which is evident from public remarks by the leading ACN kingmaker, Bola Tinubu. They can develop rapidly in the assembly, which has an institutional identity stronger than party political allegiance. We flag these risks in passing and note that the fragmentation of the PDP is the greater political story of the moment.

## The APC's reform agenda

The Buhari presidential campaign focused on three themes: security, corruption and growth (to create employment). On security, he pledged that Boko Haram would become marginal and that Nigeria would lead the military response in the north east, supported by regional partners where appropriate.

*Clear progress in the fight against Boko Haram*

A Muslim commander-in-chief and head of state with a lengthy military career brings skills to the table which were not previously available. Another early step by Buhari was to shift the operational headquarters of the fight against Boko Haram from Abuja to Maiduguri. Most territory under the control of Boko Haram has now been recovered.

This year another test has arisen in the form of the re-emergence of large-scale sabotage in the Niger Delta. Oil production has declined by between one quarter and one third at times due to sabotage of onshore pipelines, compounding the impact of the slide in oil prices since August 2014. An earlier sharp fall in output in 2008 and 2009 was stemmed by an amnesty under the presidency of Umaru Yar'Adua and by generous funding for the former militants under the Jonathan administration.

The authorities have threatened a military solution, held talks with unnamed militant groups in the delta and hinted at an economic plan for the oil-producing states which

brings employment, investment and environmental improvements for the local communities. As a northern presidency has an advantage in tackling the Boko Haram insurgency in the north east, so it has to overcome the suspicion of the population in the delta. Significantly in our view, it has dropped plans to halt the funding of the militants, acknowledging that it has to make payments it does not like to reverse the decline in crude output.

*Election-winning message on corruption*

As for corruption, the Buhari campaign struck a popular chord with the electorate and the international community. This is something of a personal crusade for the president. Previous administrations had attempted to slay the dragon that is corruption, and all have abandoned their mission in the face of powerful vested interests.

*Social pledges to be delivered on the plugging of leakages*

The campaign team identified very substantial leakages from the annual budget of up to N3trn. These would be a combination of revenue due to the federation account and not paid by the oil industry and the non-oil economy, and expenditure that is wasteful or worse. The underlying idea is that the plugging of leakages over time will enable the administration to deliver the social pledges in its manifesto. That plugging has started if we monitor the results of the Treasury Single Account (TSA) and the trend of payments into the federation account (see Monetary and fiscal policy).

*Selective pursuit of poor conduct*

We have to note one caveat. The new government will not reverse all the deals under the old regime it does not like because that would consume all its time and energy. This was the mistake of the Yar'Adua presidency. Adeosun has stressed the fine balance between prosecutions and recoveries, indicating that priority will often be given to the second. She has also created an efficiency unit within her ministry.

*A new face at the top of the NNPC, and a new style too*

Since the oil industry is the largest source of leakages, the president appointed a new head of the Nigerian National Petroleum Corporation (NNPC) in August 2015 and subsequently made himself the petroleum minister. The first step of Emmanuel Kachikwu, a senior employee of an oil major with a legal background, was to remove the eight executive directors of the corporation.

Kachikwu, who is also minister of state for petroleum and stood down as group managing director of the NNPC in June following organisational changes, has been busy: experimenting with self-financing oil joint-ventures (jvs); appealing for outside investors in its depots and pipelines; achieving substantial savings from remodeling the offshore processing agreements; making substantial cuts in the corporation's cost base; and outlining a new-look corporation with four autonomous units, each with its own chief executive. The ytd operational loss through to July amounted to N117bn, compared with N152bn in the year earlier period.

*New initiatives and sharing of information*

While his predecessors at the corporation withheld critical information they regarded as in-house property, Kachikwu has enjoyed the limelight and shared news. The NNPC releases a monthly report on its operations and finances. He has taken on board the reality that the corporation is unloved almost universally, and wants to get Nigerians onside as he explains his plans.

*The private sector to lead in the economy*

On growth and employment, the narrative is that the private sector must take the lead. This is not the role of government, which does not have the necessary skills set. Public agencies, led by the Central Bank of Nigeria (CBN), do make available credit lines for sectors the commercial banks tend to avoid such as agriculture. (The

expansion of the CBN's balance sheet over the past five years would make a good study.)

The FGN is pursuing diversification of the economy through import substitution and backward integration. We may not make ourselves popular by noting that there is common ground with the outgoing administration's transformation agenda. The oil sector has a small share of GDP of about 10% but dominates the FGN's revenue collection and the generation of fx inflows into the economy.

*A step forward on the retail fuel price*

The FGN set a new ceiling for the retail price of premium motor spirit (PMS, petrol) of N145 per litre (l) in mid-May. The increase of almost 70% on the previous fixed price was a response to fuel shortages, which had arisen because independent marketers had been unable to access fx at the then quasi-fixed exchange rate of N197 per US dollar. It was made as a last resort, not that the presidency had abandoned its view that a regime of subsidies was somehow "pro-poor".

It does not amount to deregulation, but does open the door to it at some point or at least further adjustments to the ceiling (when warranted, as currently, by movements on the international market and the naira exchange rate).

*The largest import substitution of them all*

The advantages of deregulation (such as job creation and fx savings) would be felt over time. Yet we are heartened by progress in the construction at the Dangote Group's US\$14bn refinery and petrochemicals complex in Lagos State, the largest current import substitution project. Refining capacity should reach 650,000 barrels per day (b/d) when the complex opens in early 2018. This is a game changer for fuel supplies, the balance of payments, the public finances, Dangote Group and the consumer. There are several other privately owned refineries on the drawing board.

*A change of thinking on the PIB*

In contrast to the PMS price, there has been little, if any movement under the present administration on the petroleum industry bill (PIB), which has languished for eight years in the National Assembly. Kachikwu indicated (see above) that the NNPC is to be divided into four autonomous units, and a fifth for the corporation's residual interests, and that it will act on the structure of the industry before its fiscal regime. The idea of an "omnibus" bill is no longer in official favour.

*Legislation of some sort now overdue*

The trend of crude oil production has been downward since the mid-2000s because of underinvestment by both the NNPC and the oil majors as well as the recent sabotage of pipelines. Without a new framework such as the PIB, that trend will continue. The passage of a new law(s) would allow the authorities to test investor appetite for new acreage and hold the first bidding round since 2007. The slide in the oil price and the sharp fall in oil exploration budgets globally have, however, removed the urgency of new laws.

*Largest hurdle to reform institutional*

This highlights a recurring constraint. The PIB is a complicated piece of legislation and may be tackled in several tranches. Putting the complexities aside, we find fault with the productivity of the assembly. The primacy of its institutional interests over any party considerations provides the largest challenge to the APC's reform plans.

The weaker the vested interests, the more scope the FGN has to implement its reforms. So progress with transformation under the PDP government was more visible in agriculture and power, for example, than with the PIB or the legislation for the sovereign wealth fund (SWF).

Our final point on the substance of APC policy (and the make-up of the FEC) is that they are not driven by a vigorous free market agenda. This became clear with the resistance to fuel price reform (see above) and the prevarication over changes to the exchange-rate regime between February 2015 and June 2016, when the liberalisation took effect (see The exchange rate).

## Attaining stability in national security

### *Military and social steps to overcome Boko Haram*

The current national security challenges have severely affected Nigeria's business climate, particularly in the north east. At its peak, the Boko Haram insurgency occupied around 20,000 square miles of Nigerian territory. Interviews granted by members of President Buhari's inner circle show that the priority is to fund and equip the armed forces adequately to recover lost territory and restore peace to the worst affected areas within the shortest time frame possible. The analysis is that military action must be accompanied by measures to address unemployment, inequality and illiteracy.

### *Substantial recovery of lost ground*

Massive improvement has been seen as the FGN has managed to reduce the terror group's capacity to make coordinated strikes. As already noted, Buhari relocated the country's military command centre from Abuja to Maiduguri, the capital of Borno State. In his Independence Day speech earlier this month, Buhari said that Boko Haram had been defeated and reduced to carrying out cowardly attacks on soft targets. (The president added that the FGN is confronting other long-running security issues such as attacks by herdsmen, cattle rustling and kidnappings.)

### *The embarrassment of Chibok*

In 2014 the kidnapping by Boko Haram of more than 200 girls from a school in Chibok was given widespread coverage by domestic and international media. In early July Buhari approved a new investigation into the kidnap of the schoolgirls. According to its ambassador to the UN, the US aims to provide Nigeria with required intelligence that could assist in locating the missing schoolgirls

### *External support for the FGN forthcoming*

In 2015 about 130 military personnel were deployed from the UK on a wide range of training tasks to assist the Nigerian armed forces. While we do not see the elimination of the group because its genuine underlying origins have not been tackled, we do expect the efforts of the new administration to reduce further the influence and frequency of its operations.

### *Underdevelopment in the north east clearly a factor*

There is little that can be said with certainty about Boko Haram beyond its Islamist elements. The north east, its base, has previously been a focal point for anti-government groups. Economic development generally has been lower in the north than the rest of the country. According to the Gender in Nigeria Report 2012, poverty rates had more than doubled since 1980 in 16 of the 19 northern states. (In contrast, World Bank research published in 2013 suggested that the poverty rate in Lagos State had fallen from 44% in 2004 to 23% in 2010.)

### *An elusive and opaque foe*

The sophistication of its activities suggests that the group receives some external support. There is also the strong probability that it works with local criminal interests and unscrupulous politicians. Similar to the armed opposition groups in the Niger Delta before the amnesty under the Yar'Adua administration (2010), Boko Haram

does not practice conventional public relations, so it is not generally clear whether it, or another grouping, is responsible for a particular crime.

Attacks by Niger Delta militants on oil and gas pipelines and related infrastructure have intensified in recent months. The sabotage has had a huge negative impact on gas supply to the country's power stations. The militants have claimed responsibility for a series of devastating attacks on the NNPC as well as international oil companies, which have reduced national oil output drastically; at least 250,000 barrels in crude oil production are lost per day, and as much as 750,000 barrels on occasions.

### Job generation: an ache in need of a cure

*Sharp decline in job creation in Q1 2016*

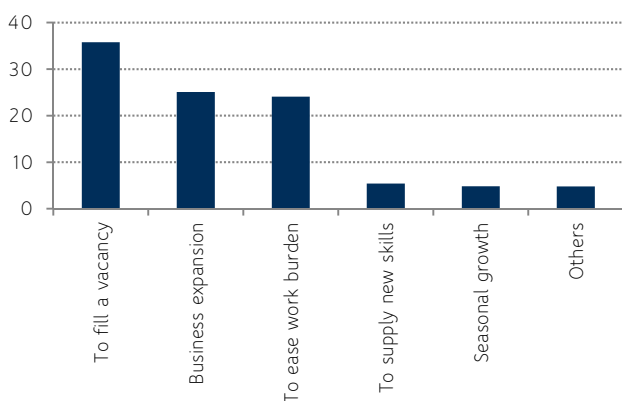
In view of the macro challenges, the country's business environment has deteriorated and this has been reflected in the labour market. The National Bureau of Statistics (NBS) data for Q1 2016 shows that only 79,500 jobs were created, consisting of 21,500 in the formal sector and 61,000 in the informal sector. Meanwhile the direct opposite was the case for the public sector, which recorded 3,000 job cuts. When compared with the previous quarter, total job creation declined sharply by 84%.

We observe that senior management, professional and technical positions accounted for 33% of formal-sector jobs generated. For the public sector, 5,700 jobs were generated in Q1 2016, outweighed by 8,800 in the same quarter. Compared with Q4 2015, which recorded total job losses of 10,200 and net employment of -4,300, retrenchment was at a slower pace.

*Unemployment rate now officially above 13%*

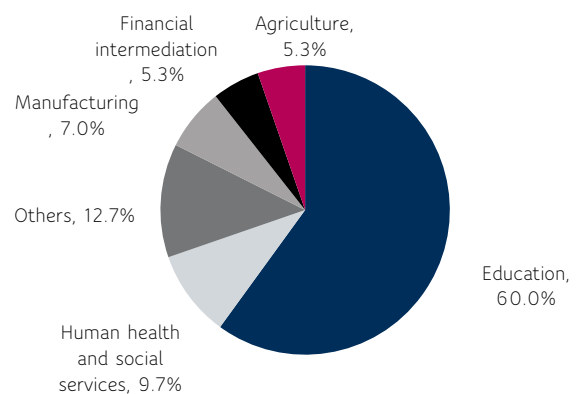
Another data series from the NBS, the quarterly unemployment/underemployment watch series for Q2 2016, reveals that the labour force (population of working age between the ages of 15 and 64) had increased to 79.9 million from 78.5 million recorded in Q1. At the same time, the unemployment rate accelerated to 13.3% from 12.1%. The global unemployment forecast rate of 5.9% for this year and 2017 by the International Labour Organisation implies that Nigeria's unemployment rate is already significantly higher than the global average. Within the labour force, 26.1 million people were either unemployed or underemployed, compared with 24.5 million in Q1 2016.

Reasons for hiring (%) in Q3 2015



Source: National Bureau of Statistics (NBS); FBNQuest Research

Jobs created by sector, Q1 2016 (% share of total)



Source: National Bureau of Statistics (NBS); FBNQuest Research

A less recent figure of unemployment is an annual rate of 23.9%, released in 2011 by the NBS. To reconcile the two series, we note that the new unemployment figures are based on a re-classification of the labour force where individuals working more than 20 hours per week are regarded as employed.

*FGN's own job creation schemes*

The FGN has reiterated its commitment to boosting job creation. Its social investment programme aims to hire 500,000 candidates into the direct teacher jobs scheme with a monthly stipend estimated at N23,000 (US\$75). In addition, the national directorate of employment has designed a vocational skills acquisition programme to equip young graduates for entrepreneurship. However, in Nigeria, job generation efforts across the public and private sector are largely uncoordinated. Training programmes are usually delivered without a direct link to market demands, resulting in a dearth of employable skills. Additionally, reliable data for workforce planning are not available.

Empowering small and medium scale enterprises (SMEs) can transform the job market, and is one of the FGN's priorities. However, structural issues seen in the lack of basic infrastructure need to be addressed as this stands a major roadblock for SMEs and effectively job generation. A recent welcome development has been the proposed reduction in income tax rates payable by SMEs. This should encourage more start-up companies and essentially boost job generation.

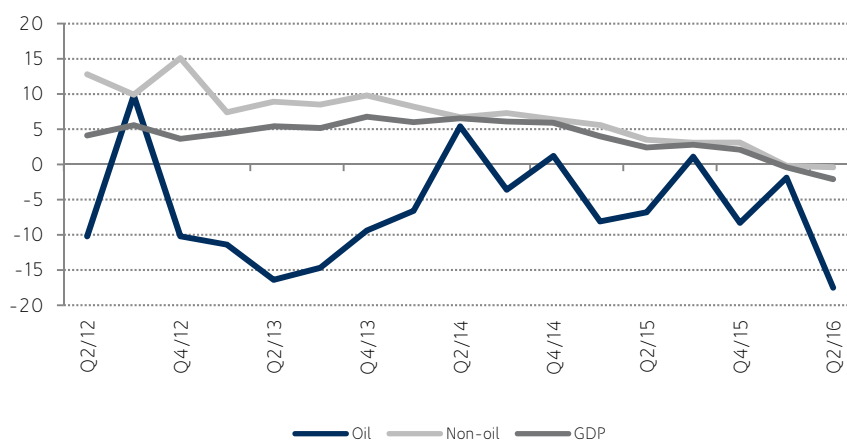
## Drivers of the economy

### Predominance of the non-oil sector

*Growth in 2015 the lowest this century*

GDP growth exceeded 4% each year from 2000 through to 2014 but slumped to just 2.8% last year under the many pressures created by the oil price slide. It contracted in Q1 2016 by -0.4% y/y and then in Q2 by -2.1%, so the economy is now formally in recession. Population growth slowed to 2.3% in 2012 according to CBN data. (We look forward to the first national census in a decade due this year and stress that the current series has many detractors among policymakers.)

GDP, oil and non-oil growth (% chg y/y)



Source: National Bureau of Statistics (NBS); FBNQuest Research

*Non-oil economy still the driver*

Non-oil growth has averaged 3.6% y/y in the past eight quarters, admittedly on a downward trend due to pressures on household budgets. The falling oil price, the squeezing of government spending and the emergence of public salary arrears have together taken the shine off the story of robust private demand.

*Agriculture in the driving seat in Q2*

The NBS report for Q2 2016 shows that the primary sector (agriculture) expanded by 4.5% y/y in the quarter while the secondary (principally oil) contracted by -9.5% and the tertiary (services) by -1.3%. Manufacturing contracted by -3.4% y/y, and its largest segment (food, beverages and tobacco) shrank by -5.5%. Fx shortages continued to bite, although less strongly than in the previous quarter. Construction output shrank by -6.5% y/y, reflecting largely delays in approval for the 2016 budget.

*Crash in the oil sector due to sabotage*

In contrast to the non-oil economy, oil GDP contracted by -17.5% y/y in Q2 2016 as a result of increased sabotage in the Niger Delta, and by an average of -5.5% over the past eight quarters. Underinvestment by the unincorporated joint-ventures (of the NNPC and the oil majors), the vacuum created by the non-passage of the PIB and the steep increase in production leakages all contributed.

*Faded impact of earlier reforms*

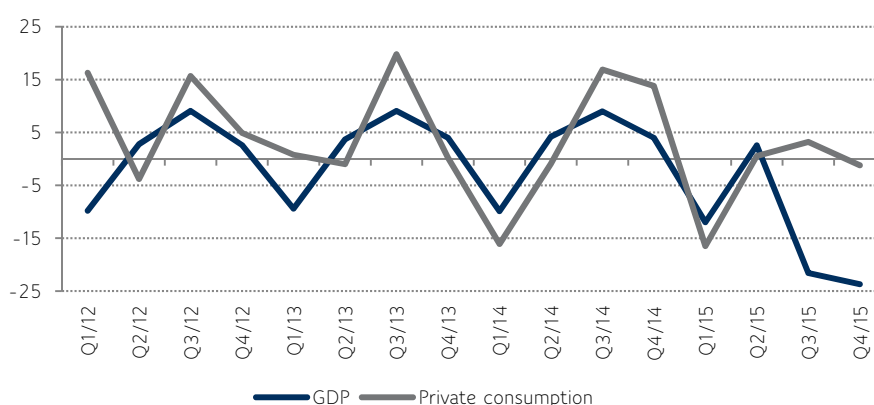
The solid GDP growth through to 2014 was driven by the non-oil sector. It stems from reforms introduced by the second Obasanjo administration (2003-07) and in

some sectors such as agriculture by the Jonathan presidency (2011-15), favourable weather conditions, the trickle-down from high oil prices (until June 2014) and low interest rates in developed economies.

*Still visible signs of robust demand*

In expenditure terms, the driver was robust consumption. Its influence is fading although still visible: the growth in mobile telephony, the early days of mobile banking and e-commerce, the expansion of the financial sector (despite the twin bailouts of 2009), infrastructure spending by state governments such as Lagos, residential development, hotel building in the main cities and the construction of shopping malls.

Trends in real GDP (% chg; q/q)



Source: National Bureau of Statistics (NBS); FBNQuest Research

*Seasonality of household consumption*

We have written of historic healthy consumption although there are very few supportive indicators. The series for the national accounts by expenditure shows happily that at least since 2013 changes in real private consumption expenditure (PCE) have been tracking those of broader GDP. It also shows marked seasonality, with pronounced declines q/q in the past two years in the first quarter. Average q/q growth in real PCE of 2.8% over the past year would not have been the driver for investors in search of exposure to Africa's largest market.

*Mobile telephony one of the few indicators*

The starting point among measures of consumption has to be the data series provided by the Nigerian Communications Commission (NCC, the industry regulator). Five times as many Nigerians have access to a mobile phone than to a bank account.

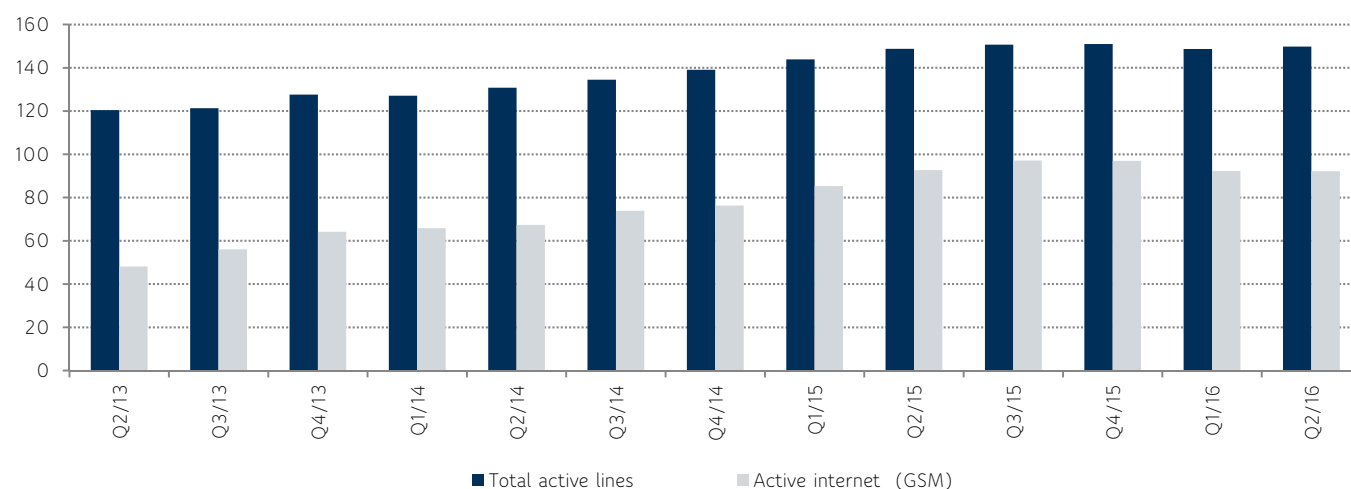
*The industry a model for strong growth*

There were 500,000 active lines in 2001 when the operating licenses for mobile telephone companies were first awarded. The number had reached 150 million in June 2016, of which just 183,000 were fixed lines. This success is often cited by reformers as a model for industries such as petroleum refining once the dead hand of government is removed.

*Maturity of its voice market*

The growth in active lines slowed dramatically to 0.7% y/y in June 2016, compared with 2.3% for the population. The maturity of the market for voice is a core factor. Teledensity has risen to 81% on a population currently estimated at 185 million. The mandatory registration of SIM cards and the large fine imposed on MTN Nigeria, the leading operator, for non-compliance by the NCC was another factor. We comment on this industry at some length not just because it offers a rare data source for consumption but also because MTN is the largest company outside the oil industry.

## Telecoms and internet access (end-period; million units)



Source: Nigerian Communications Commission (NCC), FBNQuest Research

The operators have therefore redoubled their efforts to sell new data services and so boost their average revenue per user. Unlike mobile telephony, broadband penetration is low at around 20%. Submarine cables into Nigeria have about 340 gigabyte bandwidth capacity: most are redundant, however, because the necessary infrastructure has not been built to connect with the coastal terminals.

#### *Possibilities in mobile money*

As a boost to consumption, we stress the potential growth from a low base of mobile banking following the award of operating licenses by the CBN, and the establishment of partnerships between IT companies and banks. The value of e-payments by mobile reached N442bn in 2015, equivalent to 0.5% of the year's GDP.

#### *Industry lessons to be learnt from Kenya*

Kenya is the leader in Africa, and probably globally, in mobile banking. Mobile penetration of 89.2% in Q1 2016 was not much greater than in Nigeria. However, once we move beyond vanilla products, the stories diverge. Mobile money transactions in Q1 amounted to KES840bn (US\$8.4bn), equivalent to more than 50% of GDP. The fastest growing segment of transactions was mobile commerce of KES318bn. (Person-to-person transfers accounted for KES390bn.)

#### *Not least the regulatory model*

This is where the potential lies. The mushrooming of the industry in Kenya has spawned a number of initiatives with a strong developmental angle such as the provision of low-cost solar power to off-grid communities in rural areas. This last area has become the darling of the private equity industry, DFIs and also philanthropists. The Kenyan model for mobile telephony is different to Nigeria's, being driven by the private sector, and more flexible: the partnerships are between mobile operators and banks.

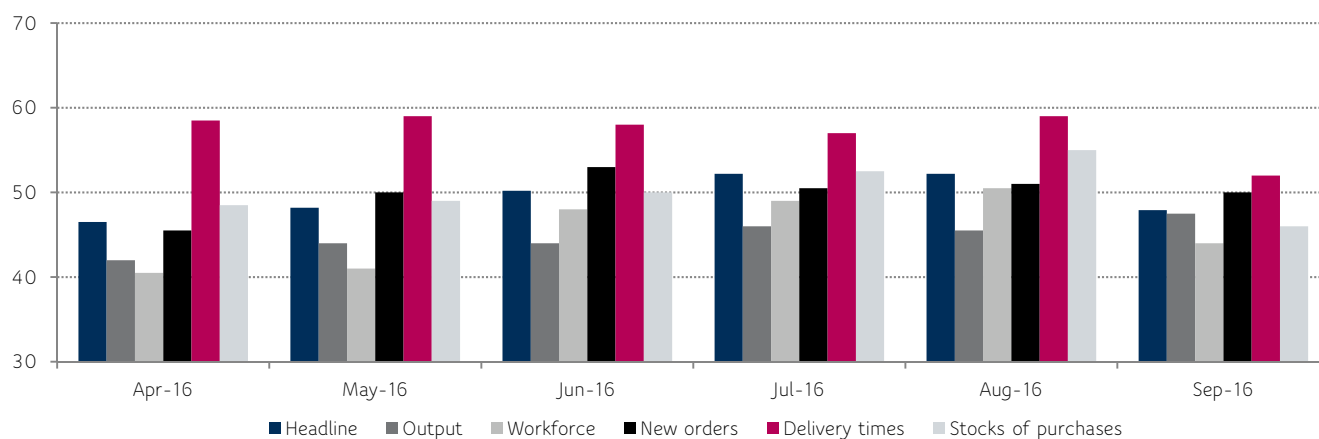
The NCC data gives us a rare take on discretionary spending. Additionally, the NBS has launched a useful series on air passenger traffic. We would welcome further measures of private consumption.

#### *Our in-house contribution to the indicators*

Into this near-void we launched a manufacturing PMI (purchasing managers' index), Nigeria's first, in April 2013. The range of respondents is a representative snapshot of manufacturing companies by size. Our index has gradually matured and has now

passed its three-year mark. It has developed into a useful addition to the limited supply of forward economic indicators.

FBNQuest manufacturing PMI readings (50 = neutral)



Source: NOI Polls, FBNQuest Research

*Encouragement in our readings for new orders*

Generally positive headline readings for manufacturing (i.e. above 50) are to be expected for an economy growing by more than 4% per year through to 2014 and driven by non-oil sectors. We have had seven negative headline readings since our launch: not surprisingly, four have been this year. The readings for output in 2016 are well below water but we take encouragement from the more positive story told by the new orders sub-index.

*Comfortably the largest economy in Africa until 2016*

Following the rebasing of the national accounts in Q2 2014 by the NBS, which was produced with input from multilateral institutions, nominal GDP was revised upwards to the naira equivalent of US\$457bn in 2012 and US\$509bn in 2013. The increase from the figure for 2013 in the old series (base year 1990) was 89%. The exercise made Nigeria comfortably the largest economy in Africa and raised its profile considerably in the international financial media. It has probably lost this ranking since the effective devaluation in June this year.

*An accurate picture, at last*

The main benefit of this data revision in our view is the accurate snapshot of the size and diversity of the economy. Potential investors now have a far better view of the economy, in which the services sector became the leading component with a 50% share, and many will be drawn by its overall size.

The oil economy represented just 9% of GDP in Q2 2016, which helps to explain why the predicament of Nigeria is not quite as troubled as, say, Angola or Russia. The rebasing has also brought a dramatic change in the core indicators monitored by ratings agencies. The public debt indicators are much improved but more of the changes are for the worse: revenue collection, current account (when in surplus), credit extension and market capitalisation of the bourse, to name but four.

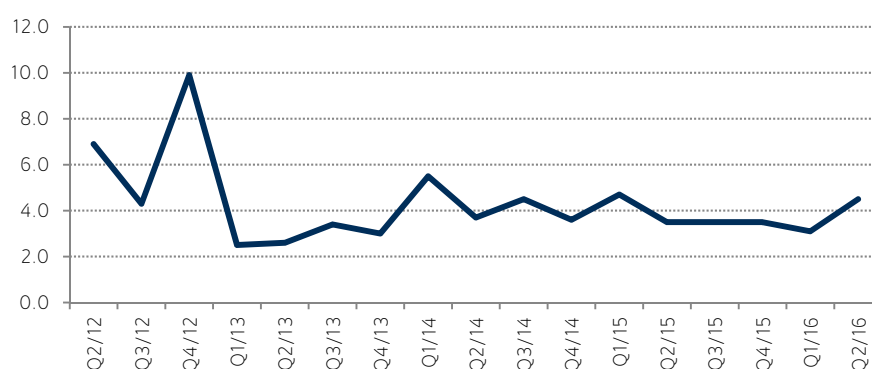
## Agriculture in transformation

Agriculture accounted for 23% of GDP in 2015. While it employs about 70% of the country's labour force, its record for job creation is poor. The NBS data series shows that it contributed just 5% of the total number of formal jobs created in Q1 2016.

### *Impact of insecurity on farm output*

On an annual basis the sector's growth slowed to 3.7% y/y in 2015 from 4.3% the previous year. The NBS commentary cited lower crop output due to the insecurity in the north east as an explanation for the slower growth. The security challenges have driven away farmers, transporters and middlemen.

**Agricultural GDP growth (% chg y/y)**



Source: National Bureau of Statistics (NBS); FBNQuest Research

### *A new roadmap from the ministry*

In July the federal ministry released a new roadmap for the sector entitled the *Agriculture Promotion Policy*. The new policies aim to build upon the successes of the transformation agenda under the previous administration. The target is to double the growth rate of agriculture, relative to overall GDP, through to 2020, hence doubling agricultural household income over the period.

For the purpose of this report we will highlight three major agric related products in Nigeria.

### *Second largest importer of rice globally*

The first is rice. Nigeria remains both the largest producer in West Africa and the second largest importer globally. This seeming anomaly is due to the inability of local production to meet high demand. FGN estimates show demand at 6.3 million metric tons per year (mmt/y) while supply is estimated at 2.3 mmt. Industry sources estimate annual average spending on rice importation at US\$2bn. Currently, Nigeria has no fewer than 24 integrated mills to bolster the production process.

The FGN raised the tariff on brown and imported rice in July 2012 to 100% duty and 10% levy. One positive consequence was the start-up of new rice mills but this was overshadowed by large-scale smuggling from neighbouring countries and a noticeable fall in customs revenue.

### *Changes in tariff policy*

A revised tariff policy was then approved in late 2014, with duty waivers for existing millers as well as new investors with a verifiable domestic rice production plan. Both groups can import brown or finished rice at a 10% tariff and a 20% levy. Rice traders

*Pick-up in investment in the segment*

are required to pay a higher levy of 60% but the same tariff. The president of the African Development Bank and former Nigerian agriculture minister, Akinwunmi Adesina, has said that the FGN's rice policies have attracted more than US\$1.6bn in private sector investment.

*But a surge in smuggling, too*

The Nigeria Customs Service (NCS) recently reintroduced its ban on the importation of rice through land borders following reports of an upsurge in smuggling. It has reported a pick-up in seizures since January 2016. There has been a corresponding increase in demand for locally produced rice across the country, which has also led to a hike in price.

*And now a soaring cost for the consumer*

We gather that a bag of local rice is now sold at about N18,500 to N20,000 per bag, compared with N6,000 previously. Meanwhile, the imported substitutes now cost about N23,000 to N25,000. The federal ministry of agriculture has warned that the cost of a bag of rice could rise to N40,000 by the end of the year if there is no boost in rice production within the next three months. Given the current economic downturn, this will certainly weigh heavy on household wallets.

*Aquaculture constrained by fish feed costs*

A second area (after rice) to highlight is fisheries, one of the fastest growing segments of the agric sector. According to the FGN, annual imports of N125bn meet the domestic shortfall estimated at 1.9 mmt. Industry sources estimate Nigeria's per capita fish consumption at 11kg; this is significantly lower than the global average of 21kg and just less than the estimate of 13.5kg for Côte d'Ivoire. The high cost in fish feeds has been cited as a core reason for low aquaculture yields in the country.

*Support from the CBN circular of June 2015*

The structure and economics of the segment, as many others, have been theoretically transformed by a CBN circular in June 2015 ruling that 41 imported goods were no longer eligible for fx from either the interbank market or the bureaux de change: the list includes tinned fish in sauce/sardines, and fish. If the circular is enforced and borders are protected against smuggling, then the benefits for the industry could flow.

*Potential of mass production of fruit juice*

A third area to underline is horticulture. Industry sources indicate that about 930,000 tonnes of citrus fruits are produced annually, and that Nigeria spends N165bn on fruit juice importation annually. There is domestic juice production currently but the segment lacks the technology and machinery for mass production of domestic inputs. Additionally, storage is inadequate and fruit often rots en route to processing.

*As well as tomato paste, a staple of the diet*

As for vegetables, tomatoes and tomato paste are core elements of the Nigerian diet. According to the new roadmap document, local tomato production only meets 36% of total demand. Earlier this year, there was a slowdown in paste production due to attacks on tomato farms by a crop pest. Based on anecdotal evidence, US\$400m is spent annually on the importation of tomato paste.

Generally, despite the slowdown in Nigeria's economy, the FGN remains committed to its import substitution strategy in order to cut the country's import bill as well as achieve the much needed economic diversification.

## Power sector in need of coordination

Steady power supplies are a basic necessity for growth and development in any economy. In a study in late 2013, we estimated that if “full power” is attained and made routinely available to businesses and households, it could add two percentage points to annual GDP growth. To this end, the sector requires an estimated US\$3.5bn in annual investment until the year 2020.

### *Unbundling of the PHCN in 2013*

The FGN completed the unbundling of the state-owned Power Holding Company of Nigeria (PHCN) with the sale of generation companies (GENCOs) and distribution companies (DISCOs) to the private sector in 2013. The assets were 70% sold to private investors. The unbundling created 11 DISCOs and six GENCOs, which, it emerged, had very little opportunity to carry out due diligence on their assets.

### *New owners, old problems*

The new owners quickly faced several challenges including: dilapidated power assets due to infrequent maintenance and outdated technology; cash flow shortfalls due to non-cost reflective tariffs, inability of the DISCOs to collect payment for electricity consumed; and difficulties in raising funding from the banks due to the volume of debt used to finance the initial acquisitions.

### *CBN into the fray with another intervention fund*

The FGN, through its supervising MDAs, has responded to these challenges in several ways. The CBN set up a N213bn intervention fund to aid settlement of the DISCOs' outstanding invoices (N107bn has been disbursed to date). The industry-wide funding issues have not been resolved, however. In July 2016 the umbrella body for the DISCOs disclosed that the overall funding gap in the power sector exceeded N300bn.

In addition, the existing grid can only attain a maximum wheeling capacity of 5,075 megawatts (MW) and its operator, the Transmission Company of Nigeria, requires about US\$7bn to construct a new 10,000 megawatt (MW) grid and another US\$1.2bn to upgrade the existing grid.

### *More power to the DISCOs on tariffs*

In June 2015 the Nigerian Electricity Regulatory Commission (NERC) announced a review to transfer the responsibility for determining appropriate tariffs in part to the DISCOs. This new tariff structure also removed the fixed capacity charge paid by consumers and adjusted tariffs to ensure customers only pay for electricity consumed; it came into effect in February 2016 with a substantial increase. The net effect of the tariff review has not resolved the liquidity challenge. The adjusted tariff will need to be adequately metered and collected, assuming that the GENCOs are able to supply electricity to the DISCOs for onward distribution.

### *New focus on alternative energy sources*

The government's thinking on power is tilting towards developing alternative sources of power, given the issues with sabotage and vandalism of pipelines in the Niger Delta. The Nigerian Bulk Electricity Trading Company (NBET) has approved an entry price of 11.5 US cents (currently about N35) per kilowatt hour (kWh) for 14 pioneer solar power stations due to be built. The plants should collectively generate 1,125MW for distribution to the national grid.

Pan Africa Solar recently announced that it has signed a power purchase agreement (PPA) with the FGN through the NBET to develop a 75MW solar PV power project, which will be located in Katsina State at an estimated cost of US\$146m. Additionally,

another solar plant projected to generate 80MW of power will be located in Jigawa State and due for completion by 2018.

### The oil sector in long-term decline

*New investment reduced to a trickle*

There was a short-lived boost to output in 2009 and 2010 due to an amnesty for militants in the Niger Delta under the Yar'Adua presidency but oil GDP has since continued to contract. The last bidding round for new acreage was held in 2007 (and was highly flawed). Investment by the oil majors has slowed to a trickle while the PIB remains with the assembly; the industry therefore operates without a new legal framework.

*Majors in selling mode onshore*

Rather, they have been sellers of onshore and shallow offshore leases to indigenous production companies. E&P in the deep offshore has fallen off in the absence of a new fiscal framework for the industry, and drilling rigs have been relocated to Angola, Ghana and elsewhere. Crude oil is not an exception from the rule that the output of goods and services will decline in the absence of investment.

#### Central energy indicators

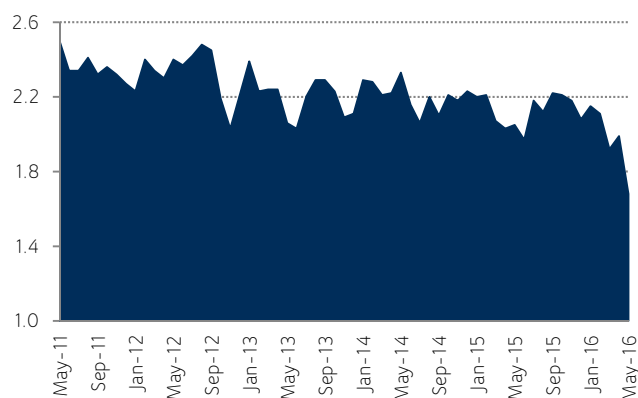
	2014	2015	2016E	2017E
Crude oil output (mbpd; incl condensates)	2.21	2.13	1.90	2.05
Bonny Light (average spot; US\$/b)	100	53	45	57
Oil and gas exports (US\$ bn)	76.5	42.4	36.7	48.8
Total merchandise exports (US\$ bn)	82.6	45.9	40.7	53.3
N/US\$ (end-period)	185	197	325	365
N/US\$ (average)	165	196	256	350

Source: CBN, IMF, Bloomberg, FBNQuest Research estimates

*Unprecedented scale of production leakages*

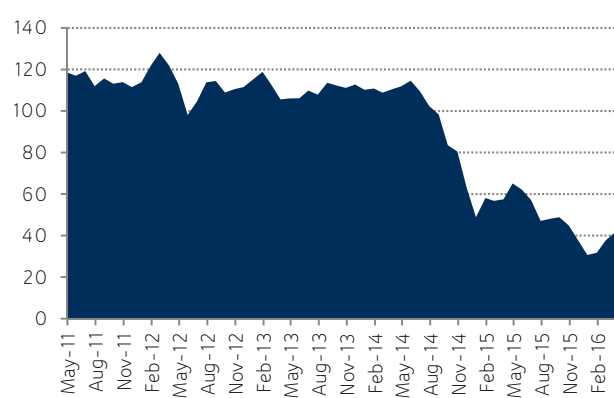
Production losses (leakages) are unparalleled for a leading oil producer. In 2014 they reached up to 300,000 bpd, which would have been equivalent to the entire production from, say, Gabon. This year losses have soared with an upsurge in sabotage and militancy, climbing to 750,000 bpd on occasions. For the uninitiated, we should explain that these huge losses are a combination of artisanal theft and larger criminal operations. A local act of “bunkering” can lead to the closure of a main pipeline and the declaration of *force majeure*.

Average crude oil output (mbpd)



Source: CBN, FBNQuest Research

Average spot price for Bonny Light (US\$)



Source: CBN, FBNQuest Research

We see average output (including condensates) this year at 1.90 mbpd, and so well below the 2016 budget assumption of 2.28 mbpd. We assume a modest recovery in 2017 to 2.05 mbpd on measures by the administration to tackle some of the worst production leakages and tighten security in the Niger Delta. Our thinking is that the broader impact of the leakages has reached the point where the administration will have to swallow its principles and consider a deal of sorts with the militants.

There is metering of production in operation but it is carried out at export terminals by several agencies employing different methodologies. Consequently there is no single unified official data source for production. This makes Nigeria again unique among large-scale oil producers. It also places question marks around the end-product of all official planning and budget activity.

## The remains of the industry bill

*Eight years in the assembly*

The PIB has been eight years in the National Assembly. Charitably, we could explain that the proposed legislation is complicated and would bring about the most dramatic changes to the industry since the 1970s. We would add that the bill would reduce the influence of the most powerful institution in the country.

*Watering down of good intentions*

The latest draft of the PIB submitted to the assembly under the previous administration represented a scaling down of the FGN's ambitions. The NNPC was to be transformed into an autonomous legal entity, comparable to Petronas of Malaysia, removed from the FGN budget and able to tap the markets for financing. Its reality was somewhat different. The draft created national oil and gas companies which are independent of government. Further, it set a timetable for these companies to float on the Nigerian Stock Exchange (NSE).

However, it established a third organisation, the National Petroleum Assets Management Corporation, and it seems that this body would house the NNPC's interest in the unincorporated joint ventures with the oil majors. The present unsatisfactory funding arrangements through the FGN would continue, and the new organisation would struggle to meet its cash calls (its share of the investment programmes in the joint ventures). An important patronage network would remain intact.

*Oil majors indignant over tax proposals*

This "omnibus" bill had its opponents. The assembly did not like a proposed increase in the powers of the oil minister, while the oil operators were opposed to the sharp rise in taxes planned for gas producers and the cut in permitted allowances for oil companies under production sharing contracts (PSCs). The majors argued that many of their proposed investments, notably in the deep offshore, would become unviable.

*An omnibus PIB now off the agenda*

This administration has its own plans for the industry. We have already noted that the president appointed a new group managing director of the NNPC and that he (Kachikwu) subsequently authorised an experiment with self-financing joint ventures. He also hinted that the PIB should be submitted to the assembly in tranches, with the structure and the fiscal regime separate. An omnibus solution is off the table.

*A glimmer of hope for the industry*

The industry has sunk to an unprecedented low. That said, the potential discovery prospects are highly rated by geologists, the cost of seismic data has fallen sharply with the international oil price and there are many oil companies unrepresented in Nigeria which have shown interest in the province. Many of these companies are based

in Asia, including but not exclusively China. If the FGN and NNPC are able to “get it right”, there is no reason why prospects cannot be turned around over the term of this Buhari presidency.

*Major asset sale unlikely to materialise*

Most forecasts see late 2017 or early 2018 as the point where the global balance of supply and demand again becomes favourable to producers. Investors will want to position themselves accordingly. Our analysis assumes that the current talk of a fire sale of state-owned assets, most of which fall under the umbrella of the NNPC, will come to nothing. The presidency does not like the idea, the authorities would be selling from a point of market weakness and obvious governance issues arise about a transfer of ownership.

## Our take for 2016 and beyond

The healthy GDP growth through to 2014 was based in expenditure terms on robust household consumption. Given the paucity of indicators, we have noted the difficulty in testing this statement. The manufacturers are guided by their own very detailed and private research into consumption trends.

*Slowing of consumption growth*

Consumption growth has slowed as a result of insecurity in the north east, fiscal pressures arising from the slide in the oil price, salary arrears across the public sector, currency devaluations (in November 2014, February 2015 and June 2016), and dull global growth. Unfortunately for Nigeria, the developed economy with the best growth prospects is the US, which has become self-sufficient in oil production.

*Compelling reasons for the FGN to share any good news*

We continue to give the Buhari administration the benefit of the doubt, albeit with reservations. The pace of reform has been slowed by virtue of the APC being a coalition, and by institutional and other vested interests. Decision-taking is overly centralised in the presidency. Expectations are high and many of the plans will only have an impact over time. This points up the need for the FGN to communicate better its policies and its successes. At present, the good news is shared in bits, and without any coordination.

*And there is some too*

There are some achievements to trumpet. In this context we point to the recapture of almost all territory held by Boko Haram, changes at the top of the NNPC, the corporation’s greater transparency, its planned experiment with self-financing jvs in the oil industry, the fuel price reform in May and the exchange-rate reform in June. The last three distributions by the Federation Account Allocation Committee (FAAC) highlight a trend improvement in non-oil revenue collection.

*A “counter-cyclical” budget policy*

The administration will be judged on its fiscal policy because it has pushed an expansionary agenda with ambitious capital spending plans (when governments in Ghana, Angola and elsewhere in similar circumstances have opted for austerity). The 2016 budget assumes an average oil price of US\$38/b, which now appears sound. We cannot say the same for the output assumption (of 2.28 mbpd), given the pick-up in sabotage.

*Based upon sharply higher non-oil revenue*

To make good the fall in revenues from the oil industry, and to attain its capital spending plans of N1.6trn in 2016 without a soaring deficit, the FGN has to hit its aggressive target for its tax take from the non-oil economy. Total revenues collected in H1 fell well short of target according to the budget and national planning ministry. The

trend in the payout by the FAAC, driven in good part by the devaluation, is therefore very welcome. For 2017 the FGN has pencilled in another expansionary budget, with total spending projected to rise from N6.1trn this year to N6.7trn.

*Limited impact of OPEC production accords*

We see an average price for this year for spot Bonny Light of US\$45/b, with US\$53/b at end-year. The price was below US\$30/b as recently as January. Our take is that the market had oversold following the international deal with Iran. We do not see much upside from either OPEC agreements on production restraint or its putative cooperation with leading non-members such as Russia and Mexico. A sustained recovery in price will therefore be slow in coming since the global supply and demand dynamics will not be supportive until late 2017 at the earliest. For next year, therefore, we project Bonny Light at US\$57/b (average) and US\$60/b (end-year).

*A little outside the global village*

Nigeria is, of course, a member of the global village, and vulnerable to negative movements in world financial and trade flows. Its credit event in 2009 was, however, home-grown and caused by the failings of its own banks rather than borrowings from foreign banks. It also enjoys some insulation from those movements by virtue of its low external indebtedness, both public and private sector.

*Yet Nigeria making a well-timed Eurobond issue*

These are selling points for a sovereign Eurobond issuer at any time. The FGN's proposed launch in Q4 2016 coincides with favourable market conditions. An estimated one third by value of all sovereign paper in issue has fallen into the negative yield category. Emerging and frontier market bond investors are therefore buying US dollar-denominated bonds almost regardless of credit quality. The Nigeria story has some quality: that of Ghana has far less, and it got its issue away successfully despite its recurring twin deficit and an IMF credit programme that appears effectively frozen.

In production terms Nigeria is a non-oil economy, so the damage from the slide in the oil price has been less acute than in, say, Angola or Russia. The economy contracted in Q1 and Q2 2016, and we expect a repeat in the third of -1.7% y/y. We see Q4 flattish, and contraction for the full year of -1.0% y/y.

*Strong recovery in GDP after 2017*

Fiscal policy, as we have noted, will be decisive this year and next, and we are confident of substantial capital releases (if not on scale of the budget). Agricultural output has picked up nicely on substitution, and some important projects such as the Dangote Group complex in Lagos State are having an impact. In time the exchange-rate reform in June will result in a fully functioning fx market in which autonomous inflows will play a large part. We forecast growth of 2.0% for next year, and a robust turnaround thereafter.

## Monetary and fiscal policy

### Limited financial deepening

Nigeria achieved robust growth through to 2014 despite a lack of financial deepening. Private-sector credit extension in South Africa in 2015 was close to four times that in Nigeria, as a percentage of GDP (78% vs 20%).

*Lending concentrated in a few sectors*

In addition to this limited deepening, we can see from the lending data by sector for March 2016 that the deposit money banks (DMBs) focus their loans on industry, oil and gas, and manufacturing. Much of the growth in the non-oil economy, therefore, can be traced to sectors with limited access to credit from the DMBs such as agriculture and small-scale construction. We have to remember also that the vast majority of jobs are provided by SMEs. Microfinance is developing from a low base. In Nigeria it is unrecognisable from the model Grameen Bank in Bangladesh and its Nobel prize-winning inspiration, Muhammad Yunus.

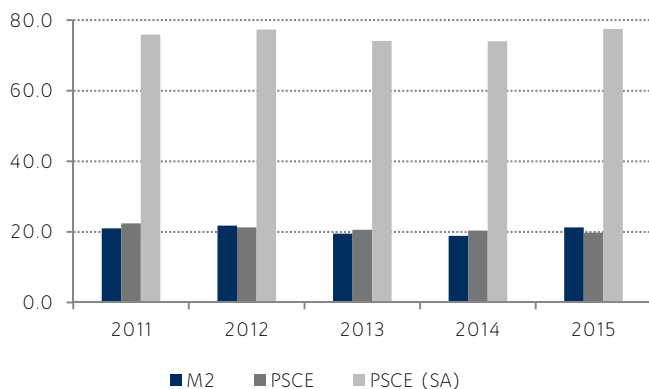
*Monetary policy blunted as a result*

This tells us that: the impact of monetary policy is blunted; the gathering of data on the informal sectors of the economy is challenging, suggesting a margin of error; and, given the reluctance of the DMBs to lend to agriculture, we can understand why the CBN has entered this field with several schemes. Banks' lending to the sector outside the scheme has increased from about 1% of their loan books to 4% in the past three years.

*Tearful ending of an earlier loan bubble*

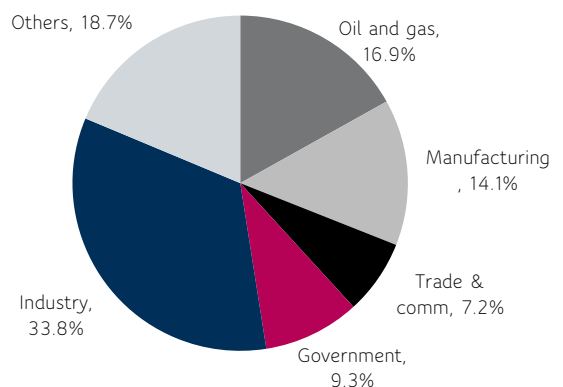
Lending to the private sector did grow very strongly following the mandatory capital increase at banks in 2005 and their subsequent raising of additional funds in the market. It soared by 96% y/y in June 2008, led by margin lending, petroleum marketing loans and, to a lesser extent, real estate credit. All three turned sour, and necessitated the CBN bail-outs of August and October 2009. We have euphemistically termed these events Nigeria's domestic credit event, which has led to far tighter regulation by the CBN.

Financial deepening ratios (% of GDP)



Source: CBN, South African Reserve Bank, FBNQuest Research

Sectoral distribution of DMBs' loans, Mar 2016



Source: CBN, FBNQuest Research

Banks have generally preferred the returns from the debt markets. This is still the case even though yields on FGN paper are now at least five percentage points lower than banks' lending rates for the real economy with the exception of blue-chip borrowers. Holding government paper carries less risk and requires less maintenance on the part of the banks.

*The steadying hand of AMCON*

The lending environment has been transformed by the Asset Management Corporation of Nigeria (AMCON). The corporation's remit was to cleanse banks' balance sheets by exchanging their bad loans for its bonds, and then maximise its return on the disposal of those bad debts. The first part of its work has been completed. AMCON issued bonds with a face value of close to N5.7trn in exchange for eligible bank assets totalling N4trn, and for funds injected to restore rescued banks' capital shortfalls to zero (in return for a shareholding). With one exception, the rescued banks all have new owners. As for recoveries, the corporation has a recovery rate target of 80%, which it expects to achieve.

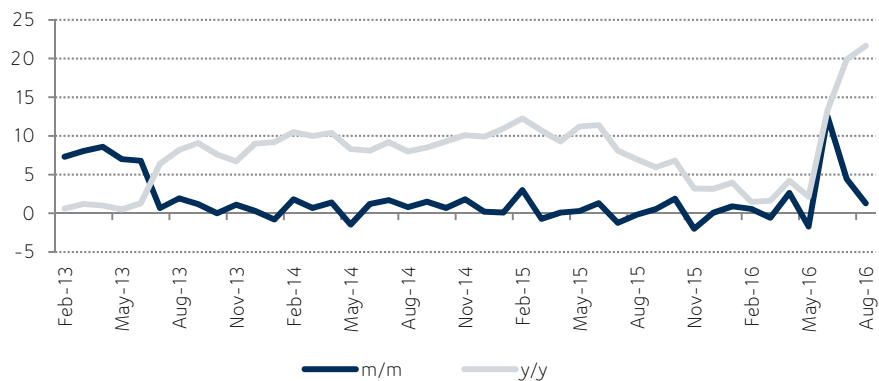
*The newer risk for banks from the oil price slide*

The slide in the oil price since August 2014 has not escaped the DMBs. While we are not seeing a second credit event, the balance sheets of the smaller institutions are under pressure. The CBN has put new management into one (Skye) and is monitoring the others. Loans to the oil and gas sector, mostly made in foreign currency, have turned sour in many cases, leading to a sharp increase in NPLs. The CBN can show flexibility on provisioning policy and is unlikely to allow a bank to fail in our view.

*Lending growth in single figures (without devaluation)*

Loan book expansion predictably slowed in line with the economy. Our chart does show a pick-up in loan growth since June this year. However, this does not point to a rise in risk appetite. It merely reflects the reality that an estimated 35% of DMBs' loans are fx denominated, that the CBN "liberalised" the exchange-rate regime in June and that the data series is naira-based.

Credit to the private sector (Y/y & m/m chg, %)



Source: CBN, FBNQuest Research

*Mobile loans for another day*

Robust GDP growth has, therefore, been achieved over the past decade (until 2015) despite low financial intermediation. Over time, the DMBs will contribute to growth by boosting their loan books. We should also mention the belated arrival of mobile money in Nigeria as a way to reach the unbanked (and expand the formal, tax-paying economy.)The CBN licensed 16 mobile payment companies in 2011. This lags the rapid development of mobile money in East Africa. However, mobile payments can become mobile loans, so there are clear benefits for financial intermediation and the tax authorities (as a result of the larger recorded economy).

## Monetary policy in transition

### *A tightening bias*

The CBN has traditionally pursued price stability, and therefore favoured a stable naira because the exchange rate is the largest single input into inflation. This has pushed policy towards a tightening bias, which we saw most clearly at the extraordinary meeting of the MPC in October 2011 when the committee hiked the policy rate by 275bps to 12.00% and doubled the cash reserve requirement (CRR) for banks to 8%.

### *Policy driven by exchange-rate objectives*

Recent monetary policy has been guided by the CBN’s exchange-rate objectives. It increases the CRR in part because it considers the banks to be fx speculators when market liquidity becomes excessive in its view. It favours a policy rate that is positive in real terms and likely to attract the offshore portfolio community to its naira debt markets. Hikes of 100bps in March this year and a further 200 bps in July can be explained on this basis.

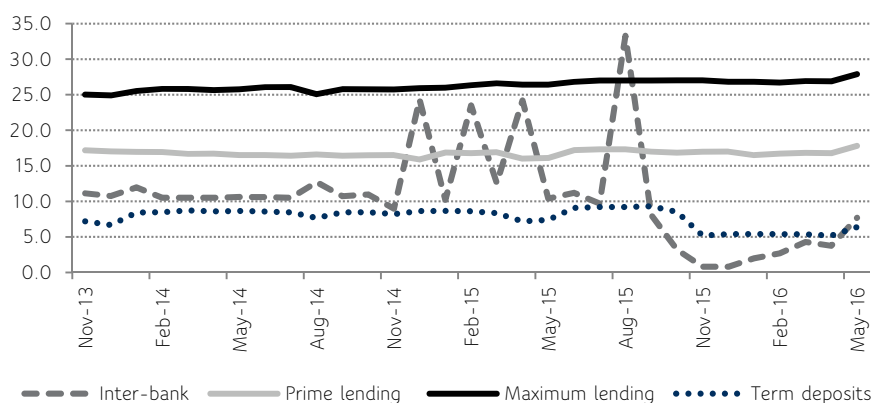
### *Devaluation as the last resort*

The CBN also defends the exchange rate with administrative measures. When it can defend the naira no more, it devalues, as in November 2014, February 2015 and June 2016. The first two were intended as new market levels for the CBN to manage.

### *June 2016 no exception*

The last was packaged as a liberalisation of the exchange-rate regime, leading to a unified interbank rate, market driven and said to be floating. The official agenda has changed because the current oil price slide has already lasted more than two years and could well continue for another 12 months. The authorities had found themselves in a similar position in Q4 2008 but the oil price recovered within nine months.

Selected interest rates (%)



Source: CBN, FBNQuest Research

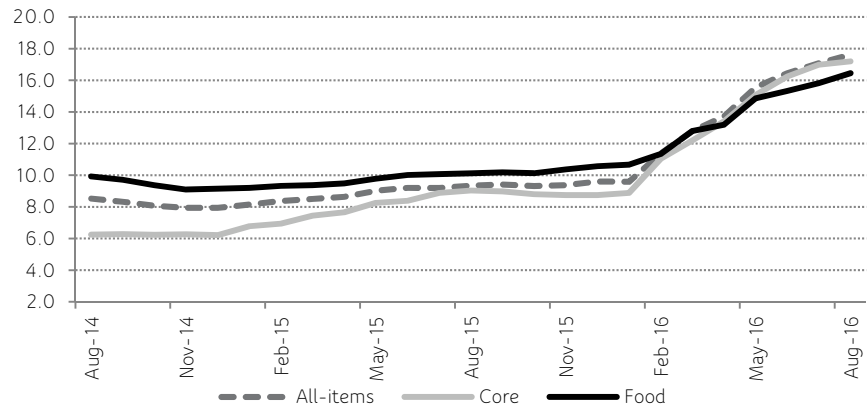
We have to mention other inputs into monetary policy which we view as secondary. In September the monetary policy committee (MPC) was again confronted with a surge in inflation and an economy in contraction. A newcomer to Nigeria might have identified a choice for the committee between a hike to combat inflation or a cut to encourage growth.

### *The disconnect with the real economy*

Rather, it did not alter its stance. It argued that the contraction was little influenced by its policy. We include our chart above on selected interest rates to highlight the “disconnect” between monetary policy and the real economy, which is itself a function

of the low financial intermediation. It will be seen that only interbank rates have responded to monetary policy changes over the past three years.

Consumer price inflation (Y/y chg, % )



Source: NBS, FBNQuest Research

*Headline inflation far above its reference range*

The CBN does not have a formal inflation target: rather, it applies monetary targeting. It operates a “reference range” of between 6% y/y and 9% for headline inflation. However, the headline rate broke out of this range in June 2015, and had accelerated to 17.6% y/y by August 2016.

Initially, this reflected the twin devaluations of November 2014 and February 2015. The driver then became the acute shortage of fx, and the liberalisation of June. Most importers cannot source fx from the CBN, and so have the choice of trying to tap the parallel market at far greater cost or scrapping the transaction; either way, inflation has ticked upwards.

*Rate of 18.0% y/y seen at year-end, and a rapid decline to follow*

In the past three months, the m/m increases in the headline rate have slowed significantly. Our take is that the major adjustment in the exchange rate has taken place, the size of the parallel market is often overstated and squeezed household demand is becoming the main driver of inflation. We see headline inflation at 18.0% y/y in December, and retreating to 10.3% one year later on positive base effects.

The last MPC communique tells us that the cycle of tightening has ended. Its next moves on the policy rate will be downwards as it tracks the decline in inflation next year. The committee does not consider itself responsible for the contraction of GDP, as we have noted, and is looking to fiscal measures and structural reforms to lift the economy out of recession.

*Authorities blameless for the surge in inflation*

Similarly, the MPC and the CBN argue that the sources of the surge in inflation are supply-side and transient, citing the electricity tariff hike in February and the new ceiling for retail fuel prices in May. They also mention import costs in this context, overlooking the fact that they do have some responsibility for the exchange rate.

## An overhaul of fiscal policy underway

*Annual tussle with assembly over the budget*

The FGN’s macroeconomic policy has long underperformed on the fiscal side, for which the CBN and the MPC have felt the need at times to overcompensate. We highlight three central issues. Firstly, the tensions between the executive and legislature are such that the to-ing and fro-ing over the annual budget has taken as long as eight months (as in 2011). Delayed approval of the budget disrupts planning by MDAs as well as providers of services to those bodies, not to mention capital releases.

*Control over spending at its heart*

It complicates what should be monthly, formula-driven distributions by the FAAC to the three tiers of government because the formulae are centred on the annual budget’s oil assumptions. The tensions can be explained by control over spending. In the budget negotiations for 2014, for example, the FGN had to give ground on some core areas such as the assembly’s insistence on a higher oil price threshold of US\$77.5/b.

Put simply, an increase in the threshold (the FGN had proposed US\$74/b) means more money to be spent by the MDAs, the assembly and other public bodies, and less to be saved for the proverbial rainy day. One negative consequence of the annual tussle, which is generally won by the assembly, is the very high level of recurrent non-discretionary expenditure. This year the budget process was not concluded until May. The federal finance minister, Kemi Adeosun, argues that the delay was worthwhile because the executive prevailed on the core procedural issues.

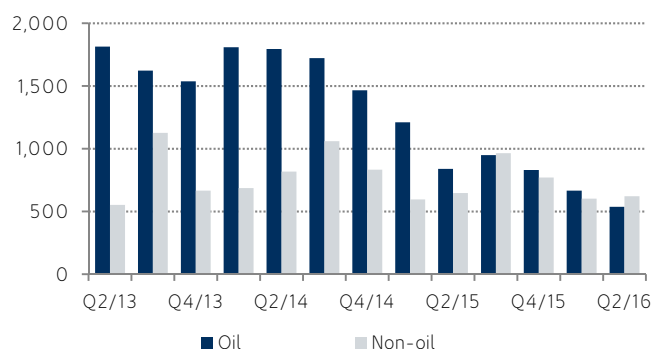
*Pitiful record in tax collection, both oil and non-oil*

A second issue is that oil has generated a dangerously high proportion of federal government revenues (and of foreign-exchange inflows), amounting to a 67% share in 2014. The slide in the oil price brought the share down to 56% in 2015, and strengthened the resolve of the administration to boost revenue generation from the non-oil (and far larger) economy. The collection of these dues has been constrained by overly generous tax exemptions, inadequate pay for the officials and a poor culture of paying tax in the population at large. It represented just 3.3% of GDP in 2015 (and a pitiful 7.3% when we add gross oil revenues).

*Cash call arrears another fiscal flaw*

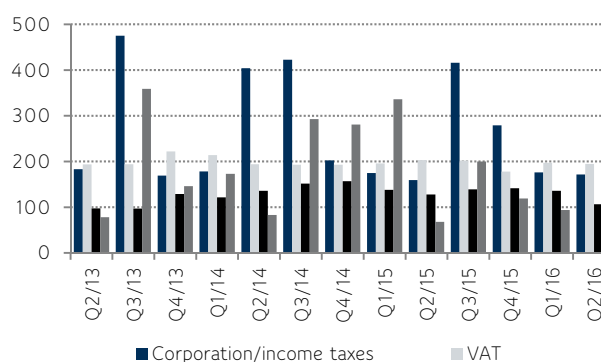
A third weakness of fiscal policy is the inclusion of the NNPC in the federal budget. The corporation cannot meet its obligations to its joint-venture partners (“cash calls”) because of delays in disbursements from the federation account. The arrangement also undermines accountability. Its arrears are estimated at US\$10bn by the industry.

Federally collected revenue (gross; N bn)



Source: CBN, FBNQuest Research

Federally collected non-oil revenue (gross; N bn)



Source: CBN, FBNQuest Research

In the 2016 budget, FGN total spending is projected at N6.1trn, with shares of 44% for recurrent items, 26% for capital spending, an alarming 24% for debt service and the small balance for statutory transfers. The deficit is set at N2.2trn. The core assumptions are 2.20 mbpd and US\$38/b for average oil production and prices.

*Expansionary 2016 budget but fiscal responsibility too*

This is an expansionary budget and the FGN's contribution to economic recovery. The greatest challenge is to hit gross non-oil revenue generation of N5.7trn, which has become even more important due to the increasing sabotage of oil installations. It is clear from revenue collection in H1 2016 that the FGN will have to choose between trimming its capital spending and allowing the deficit to grow. Adeosun is adamant that it will take the former course. The expansionary stance is to continue into 2017, for which total spending has been set provisionally at N6.7trn.

*Welcome signs on non-oil revenue collection*

There are signs that non-oil revenue collection has picked up markedly despite the contracting economy. The FAAC distribution of June revenues from the federation account was the first to meet the monthly *pro rata* target in the 2016 budget. The achievement was repeated in August, helped by the impact of the effective devaluation on petroleum and customs dues. The minister has several times highlighted a strong performance by the Federal Inland Revenue Service (FIRS), which is now headed by the former finance commissioner from Lagos State.

*And other steps forward in fiscal discipline*

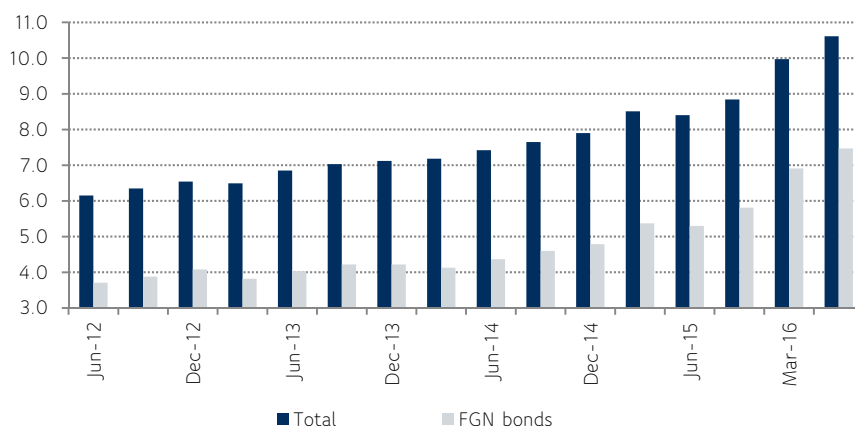
Other achievements include additional pruning of ghost workers and pensioners from the payroll, computerisation, a reduction in official travel costs, recoveries of looted funds and the establishment of the treasury single account, which obliges all public bodies to maintain their bank accounts with the CBN (and therefore accessible to the finance ministry). It emerged that many bodies had chosen to spend their allocations rather than surrender 80% of their operating surplus, as statutorily required.

### A still favourable debt legacy

*Modest FGN deficits*

Despite the poor collection of non-oil revenues and the heavy burden of recurrent spending, the FGN has been able to contain its deficit at 0.9% of GDP in 2014 and 1.1% in 2015. The loser has been its capital spending, hence Nigeria's huge infrastructural deficit.

FGN domestic debt (N trn)



Source: Debt Management Office (DMO), FBNQuest Research

The FGN's domestic debt burden amounted to N10.6trn in June 2016, or 11.3% of 2015 GDP. When we add FGN external debt of just US\$11.3bn, as well as public debt obligations which are not sovereign and state government debt, the total burden could rise to 25% of GDP under a worst case scenario. Under this highly pessimistic scenario, we assume, for example, that AMCON will make no more recoveries from the bad debts it has acquired.

#### *Enviably debt stock ratios*

Even if Nigeria's debt overhang was 25%, it would still compare favourably in an emerging market context. These ratios, actual and theoretical, have of course been transformed by the new national accounts.

#### *Story of domestic debt service very different*

While the stock of public debt is modest, the FGN is alert to the soaring cost of its domestic debt service, which is projected at 34% of its revenues in the 2016 budget. In the short term this cost is set to increase since the FGN's preliminary budget workings point to an additional N2.5trn in net domestic debt issuance in the 18 months to December 2017. (The burden of external debt service is negligible since about 70% of obligations are contracted on concessionary terms from multilateral agencies, notably the World Bank.)

#### *A new strategy from the DMO in response*

This growing burden was the background to the release of a new medium term strategy by the Debt Management Office (DMO) in June. The strategy aims for a 60/40 mix between the domestic and external debt obligations of the FGN because of the far higher cost of servicing the former. The blend was 84/16 at end-December. It had improved to 77/23 in June because of the exchange-rate liberalisation in June (rather than any shift in new borrowing commitments).

## State government finances: restoring stability

#### *A boost for the states from the devaluation*

For many months the drop in oil receipts due to the slide in oil prices and domestic oil production was very visible in the Federation Account Allocation Committee (FAAC) payouts to the three tiers of government. However, the payout increased to N510bn (US\$1.63bn) in September (from August revenues). It is therefore above the projected pro rata monthly average of N477bn per the 2016 budget.

#### *Customs receipts one clear beneficiary*

The devaluation in June has given a boost to federation account inflows. A rise in dutiable imports was highlighted as one reason for the rise in the total monthly payout for September. It appears that an improvement in compliance translated into an increase in dutiable imports. Anecdotal evidence supports this view. Separately, collections by the Federal Inland Revenue Service are on an upward trend.

#### *IGR collection to support states' development*

Even if this payout by the FAAC can be repeated, and we feel that it can, state governments need to develop their internally generated revenue (IGR). If it cannot, they may have to wait a long time before a recovery in the oil price comes to their rescue. They have to clear salary and pension arrears, and most would like to secure inward investment and employment.

#### *Lagos pre-eminent in the field*

CBN data for 2014 reveal that IGR provided 22% of the total revenues of the 36 states and the Federal Capital Territory, compared with 15% the previous year. Lagos achieved a rate of 67%, Ogun 40% and Rivers 32%.

We stick with the CBN series for ease of comparison although it is dated. Several states posted less than 5% including an oil producing state with access to the 13% derivation formula, which is applied before the monthly division according to the set formula (52.7% for the FGN, 26.7% for the states and 20.6% for the local governments). Lagos has achieved an IGR/total revenue ratio of over 50% for the past five years, and is viewed as something of a model in the Buhari inner circle.

*Yet Delta the most indebted*

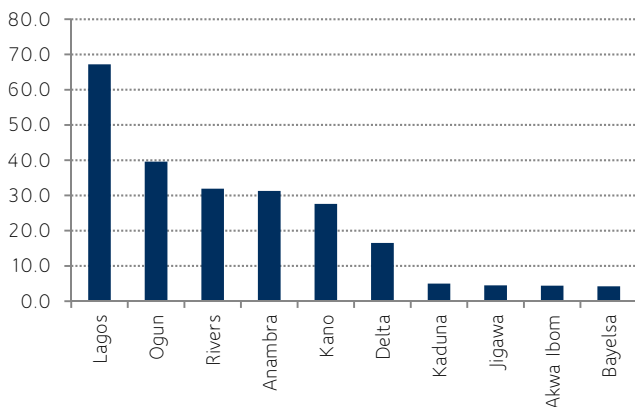
According to the DMO, states' domestic debt at end-2015 amounted to N2.5trn. Delta State was the largest debtor among the states, with total domestic obligations of N320bn.

*Debt refinancing and low-cost CBN credits in 2015*

Arrears in salary and pension payments by state governments soared due to the oil price slide. The FGN's first response to the arrears in up to 30 states was announced by the president in July 2015, consisting of the conversion of some states' bank borrowings into FGN long bonds (N620bn) and long-term credits at single-digit interest rates from the CBN (up to N300bn in aggregate).

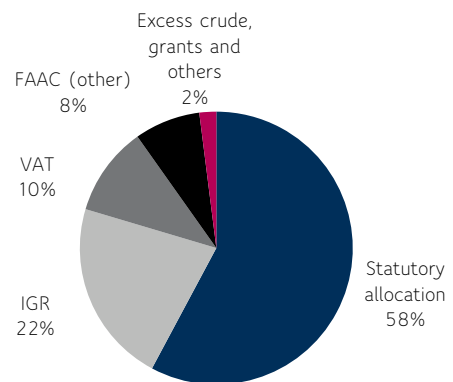
More help was forthcoming this April, when the FAAC payout to states was made without the usual deduction of their debt servicing costs on naira bond issues and external loans guaranteed by the FGN. The saving amounted to N11bn. The FGN has not ruled out a repeat.

State governments: IGR/total revenue, 2014



Source: CBN, FBNQuest Research

State governments' sources of revenue, 2014



Source: CBN, FBNQuest Research

*Followed by FGN loan relief*

The FGN is now in the process of disbursing a third programme of fiscal relief for state governments. This is a N90bn loan facility, and is to be shared among qualifying states at a 9% interest rate. The caveat, however, is that this will not be disbursed when the FAAC payout exceeds N500bn, as was the case with the distribution from June revenues.

### The FGN bond market

We observed earlier that monetary policy has limited impact on lending rates to the real economy because of the low level of financial intermediation and high cost base of the banks. The story can be different in the short term for the money market, one example being the brief spike in 90-day interbank money after the hike in the CRR for public-sector deposits in August 2013. These rates

are naturally sensitive to policy changes by the MPC that have an impact upon market liquidity.

*A market boost from JP Morgan (since reversed)*

We highlight three relatively recent movements in the Nigerian fixed-income market. The first was driven by the announcement in August 2012 by JP Morgan that three FGN bonds would be included in its government bond index with effect from October (2012). It was estimated that index investors would have to commit about US\$1.5bn merely to give Nigeria a market weight. In reality, the inflow proved far higher as JP Morgan brought Nigeria onto the radar screen of other categories of offshore portfolio investors. Yields narrowed by up to 500 bps by end-year.

*Oil price crash, FGN bond yield spike*

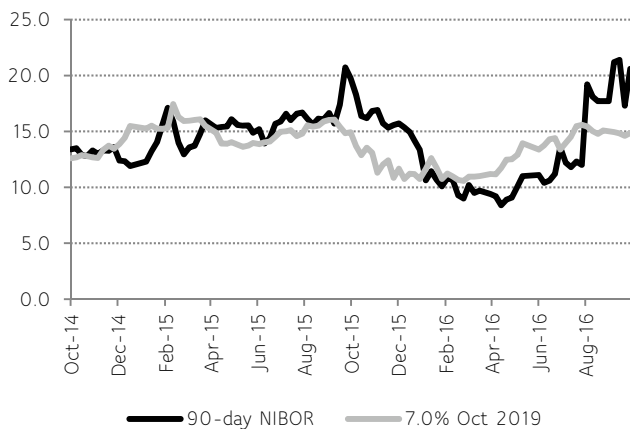
The second was a yield widening of about 400bps between October 2014 and March 2015 (see chart) on the macro fallout from the slide in the oil price. Yields moved south of the point immediately before the JP Morgan statement more than two years earlier. It became brutally clear that the FGN had not prepared for the proverbial rainy day, leading to a slump in fiscal revenues, the exit of many offshore investors and naira pressure.

*Pension funds the base of the FGN bond market*

The third has been a flattening of yields to between 14.50% and 15.50% since July. The market has absorbed the removal of JP Morgan’s Nigeria weightings from its indices with effect from October (2015) and the FGN’s ambitious issuance programme this year including net domestic borrowing of N940bn. The pension funds (PFAs) have become the core players at the FGN bond auctions. Their holdings of the instruments amount to 59% of their assets under management, and they show no sign of losing their appetite.

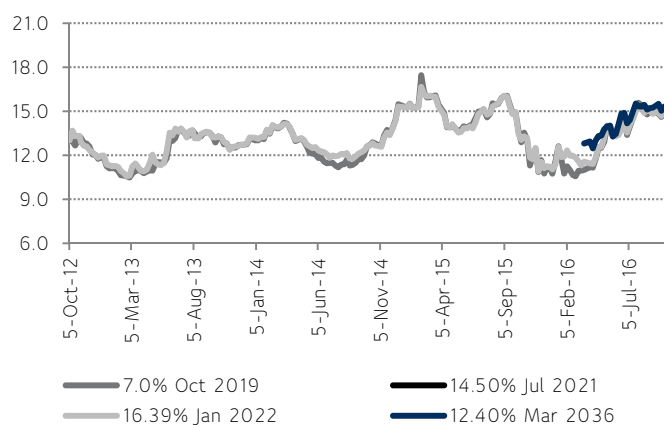
We think that the FGN will be fiscally responsible over the deficit and we are also confident that the DMO will be able to sell the required paper at auction.

90-day NIBOR vs FGN Oct 2019 yield (%)



Source: FMDQ, FBNQuest Research

FGN bond yields (%)



Source: FMDQ, FBNQuest Research

There has been a trend decline in auction demand, which we can attribute to the offshore exit and the creation of the TSA. Since October 2015 the total monthly bid has averaged N190bn, compared with average sales of N87bn over the same period. The

*Solid cover at FGN bond auctions*

aversion of most PFAs to Nigerian equities has been helpful to the DMO cause. The cover at auction remains comfortable, and has a solid foundation.

*PFAs managing close to US\$20bn equivalent*

The PFAs are important players in the market, particularly at the long end of the bond curve where they are able to match their liabilities. Their assets under management totalled N5.82trn (US\$19.1bn) at end-July, and were growing by 20% per year until the emergence of arrears in pension contributions by most state governments and many public agencies.

## The exchange rate

### Dynamics of the market

*Oil earnings still the series to track*

As with budget revenues, so with foreign exchange inflows are oil earnings pivotal. Oil and gas provided US\$34bn or 87% of merchandise export earnings in 2015. A second point about the fx market is that certain sectors such as manufacturing have a hearty appetite for imported goods and services.

*Demand for fx less fluid than its supply*

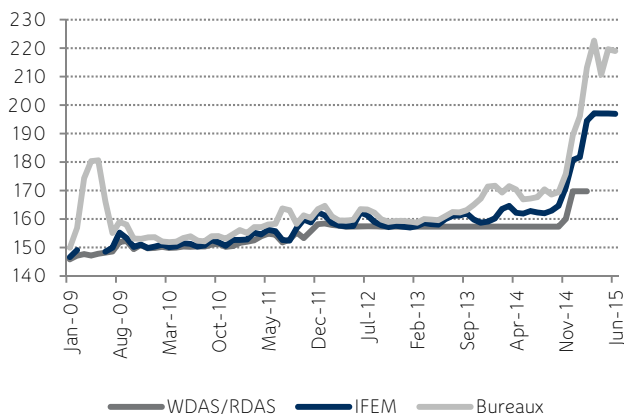
This ranges from agricultural products which the country could produce itself (such as sugar and rice), to non-consumer products which Nigeria has tried and largely failed to produce (such as steel and refined petroleum products), and to services sought after by the emerging middle class (such as cable television fees). Since the start of the slide in the oil price in mid-2014, this demand has held up better than expected while the supply of fx from oil and gas export revenues has more than halved. In addition, there is demand which the CBN classifies as not related to imports and speculative.

*Devaluation traditionally the last resort for the CBN*

The authorities have traditionally devalued as a last resort when they have exhausted all available policy options and administrative measures. They have favoured a managed rate to contain both import costs and inflationary pressures. The trigger has generally been oil price weakness, and the liberalisation (not officially termed a devaluation) in June 2016 is no exception. The earlier weakness in 2008 and 2009 lasted nine months whereas the current version is already more than two years and shows no sign of ending.

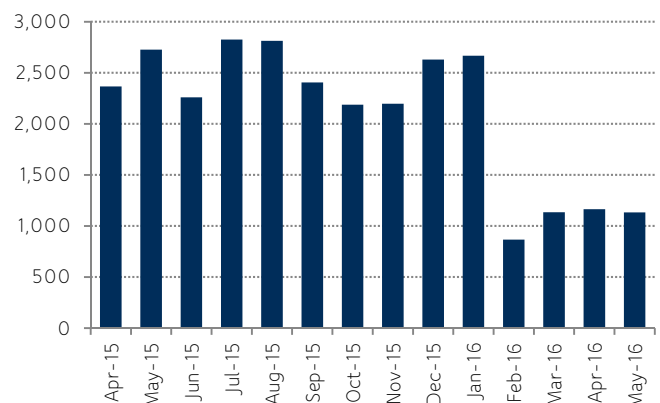
Since the start of the latest price weakness, there have been three devaluations. In November 2014 the MPC moved the mid-point for the naira at its auctions from N159 to N170 per US dollar and extended the corridor to +/-5%. The upper point of the new corridor was effectively set at the then interbank rate.

N/US\$ (monthly averages)



Source: CBN, FBNQuest Research

Sales of fx by the CBN (US\$ m)



Source: CBN, FBNQuest Research

This proved inadequate because the oil price continued to fall, and so the pressure on the public finances and the exchange rate deepened. In February the CBN announced

the scrapping of the auctions, which amounted to a *de facto* devaluation, and then started to intervene at its “clearing” rate of N199 per US dollar.

*Objective this time a floating regime*

There followed an array of administrative measures in an attempt to hold the line and, from the start of 2016, fx rationing. Offshore investors and domestic market participants complained, and the IMF had harsh words on the exchange-rate policy. The monetary authorities, supported by the political leadership, were very reluctant to move. When the third devaluation finally came in June, it was different from the two earlier adjustments. The new unified rate is market-driven and said to be floating.

The CBN is to be one of many players in a fully functioning market. It is still really the only player. The 200bp tightening by the MPC did not have the impact on offshore investors the committee intended, and further hikes are off the agenda in our view.

*No obvious saviours at hand for the CBN's purpose*

To create a fully functioning market, the CBN needs a very substantial fx inflow from autonomous sources. We cannot see the source of such an inflow. To consider some possibilities: an oil price recovery is at least 12 months away in our view; the mooted asset sale would not raise the necessary funds, given current valuations; a huge IMF credit line is available but not politically acceptable; and foreign direct investment will likely pick up but not at a rapid pace.

*Drifting an accurate description for the regime*

This leaves us with a rescue by the offshore portfolio community. The MPC reached the same conclusion, hence the unsuccessful rate hike in July. Some of these investors have returned but the majority sit on the sidelines and will re-enter in stages, we suspect. So we have a drifting not a floating regime. Daily fx sales are small; the rate is therefore effectively managed by the CBN and unmet demand accumulates. We currently see an end-year rate of N325/US\$.

## Reserves and the SWF

*Six months' import cover*

Gross external reserves, which include the balance in the excess crude account (ECA), stood at US\$24.3bn in September 2016 on a 30-day moving average basis. This figure includes the large forward sales of about US\$4.0bn made by the CBN on 20 June to clear the backlog accumulated during the period of rationing. They are sufficient to cover about six months' merchandise imports, based upon the balance-of-payments for the 12 months to March 2016.

Ordinarily, this current level would be considered an adequate cushion in the context of the informal international threshold of three months, were it not for the huge demand for fx in Nigeria, both related and not related to imports.

*Near exhaustion of the ECA*

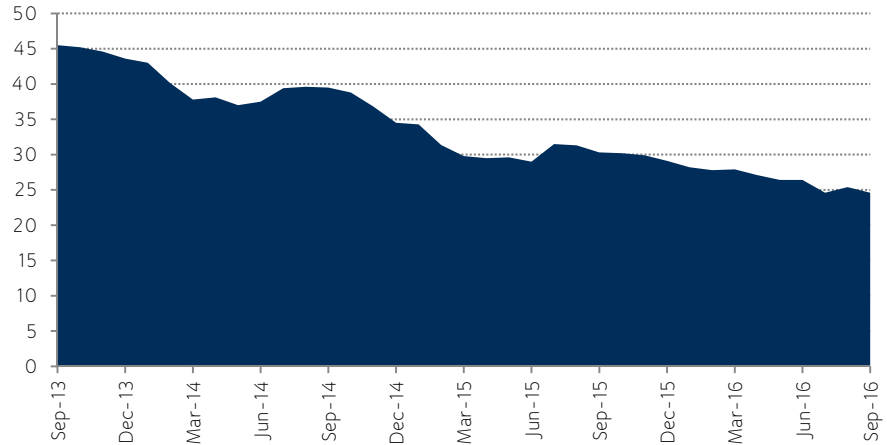
The ECA, a special purpose vehicle introduced in 2004 for the purpose of saving and managing above-threshold revenue from crude oil sales, has been depleted considerably. The balance was US\$2.9bn as at September according to the federal finance ministry.

*Nigeria's own sovereign wealth fund*

The Nigeria Sovereign Investment Authority (NSIA) was established by law in 2011 to achieve three broad mandates: to build a savings base for the Nigerian people, enhance the development of Nigerian infrastructure and provide stabilisation support in times of economic stress. Its investments are made through three

distinct vehicles: the Stabilisation Fund, the Future Generations Fund, and the Nigeria Infrastructure Fund.

Official reserves (US\$ bn)



Source: CBN, FBNQuest Research

The authority is currently collaborating with various ministries to stimulate growth in specific sectors of the economy; namely, mining, agriculture, healthcare and housing just to mention a few.

The NSIA commenced operations with seed capital of US\$1bn in 2012, it received US\$550m from the FGN in February 2014 to manage as third party assets and also US\$250m from dividends from Nigeria LNG earlier this year. Although assets under management (AUM) have grown to US\$1.80bn, inflows have not materialised on the scale envisaged.

*Its mission thwarted by state governors*

The authority is intended to replace the ECA but state governors have blocked the transition. Until the FGN is able to break this impasse, the AUM held by the authority will remain negligible and Nigeria will not have the buffer to resist external shocks (such as the current slide in the oil price).

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