



CARDINALSTONE



CONSOLIDATING
RECOVERY
2022 Outlook

JANUARY 2022



Executive Summary

Nigeria appears on course to surpass its pre-COVID 5-year peak growth of 2.21%. Precisely, we project growth rates of 2.65% and 2.70% for 2021 and 2022, respectively. However, these projected economic outturns still lag the long-run trend growth of 4.0% on the impact of inadequate structural and policy responses to the plunge in oil prices in 2015 and 2020.

This dichotomy makes it hard to situate Nigeria's economic evolution on the business cycle. Do you, for instance, assume that the emergence of COVID-19 interrupted the growth trajectory following the 2016 recession and that the economy is now back on track towards its long-run mean growth? Or that the 2015

oil crash signaled a regime change and that pre-2015 growth rates are no longer feasible in the medium term, making 2.0% to 2.8% growth range the new normal?

In line with the latter, we posit that structural incumbrances place a cap on near-to-medium term growth, with the country's unconventional FX market management the clearest example of these impasses. These concerns may likely continue to irk foreign investors amid the growing burden of subsidies and importation on reserves.

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Growth and Economy

Stagnant per capita despite continued economic recovery

Economic recovery gained momentum in Q3'21, as the low base in the non-oil sector supported output and secured a growth level of 4.0%. In particular, positive momentum was seen in heavyweight sectors like trade and real estate (21.0% of the economy), both of which are on the path to their first yearly growth in 6 years. The latter may have fed off prolonged periods of low-interest rates, while the former likely benefited from improved cross-country business activities upon border re-opening and less stringent COVID restrictions. However, Nigeria still lagged SSA peers from a growth perspective (see figure 2), with the oil sector shaving off c.1.0% of real GDP growth due to low crude oil production linked to terminal shut-ins and weaker investment.

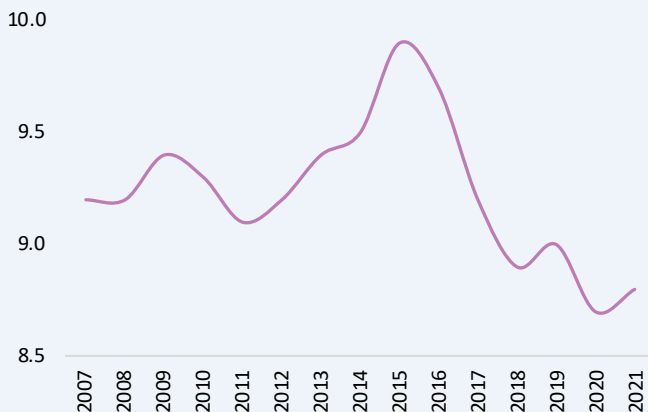


Non-oil could remain the primary growth fulcrum

In our view, non-oil GDP could rise by 2.5% YoY in 2022, supported by telecoms (2021E: +8.1% YoY; 2022F: +10.8% YoY), manufacturing (2021E: +3.8% YoY; 2022F: +3.2% YoY), and agric (2021E: +1.7% YoY; 2022F: +2.3% YoY). According to IMF, Nigeria's wireless telecommunication and IT services industry had an over 30.0% labour productivity and revenue CAGR in the past decade. This momentum is likely to persist on the growing digital needs of the country's young and dynamic population. The rise of mobile money, 5G technology, broadband penetration target of 70.0% by 2025 (vs 45% currently), and NCC's 5-year Strategic Vision Plan (SVP) to drive digital literacy and service infrastructure are also likely to be supportive going forward.

Elsewhere, we expect the agric sector to expand by 2.3% in 2022, supported by continued CBN intervention and relatively benign weather conditions. Nonetheless, sector growth is unlikely to reach its potential level of 4.0% (10-year average from 2008 to 2017) in the medium-term due to the prevailing security challenges in the country.

Figure 1: Nigeria's security index is hovering around its lowest point in at least 15 years



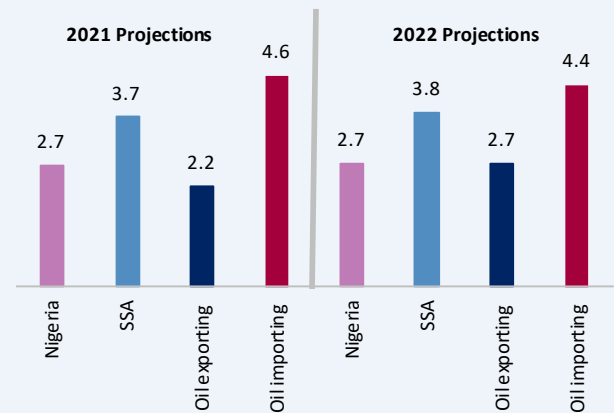
Source: Fund for Peace, CardinalStone Research

Credit growth and Dangote Refinery are potential manufacturing tailwinds

Despite concerns over the crowding out effect of government borrowings, private sector credit ballooned to a historic high of N33.8 trillion in Q3'21, helping manufacturing GDP to a 5-year peak of 3.8%. We expect the lagged impact of credit allocation to remain supportive in 2022 but we note the risk of a potential slowdown on pre-election year concerns.

Furthermore, the scheduled commissioning of Dangote Refinery could prove to be a strong tailwind to sector growth. By our assessment, the facility could add about 30bps to GDP growth, assuming 30.0% capacity utilisation. It could also boost refined petroleum exports and support FX liquidity. Our industry intelligence indicates that the facility could commence operations in H1'22.

Figure 2: Nigeria's growth is expected to lag those of SSA peers



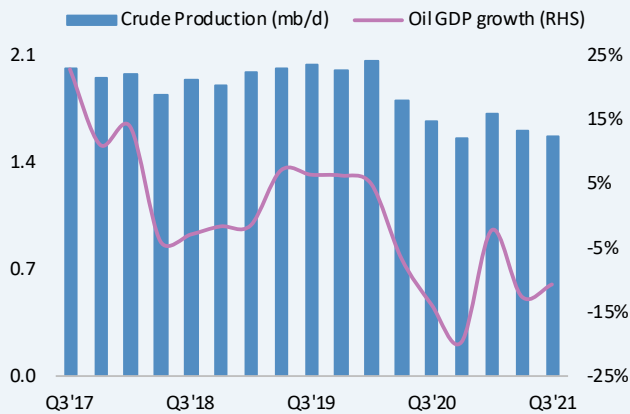
Source: NBS, World Bank, IMF, and CardinalStone Research



Oil sector to return to growth

We project Nigeria's crude oil production (including condensates) 7.8% higher at 1.72 mb/d in 2022E, with the related oil GDP growth forecast at 7.24% YoY. This view is supported by the ongoing impact of elevated oil prices on drilling activities, cascading to increases in rig counts. We are also constructive on the imminent operationalisation of the 160,000 Amukpe-Escravos export terminal, an alternative to the often epileptic Trans-Forcados pipeline that could encourage production. According to our industry intelligence, the construction of the entire pipeline system is effectively complete, and hydrocarbons lifting through the channel should commence in early 2022.

Figure 3: Nigeria crude oil production remains depressed



Source: NBS, CardinalStone Research

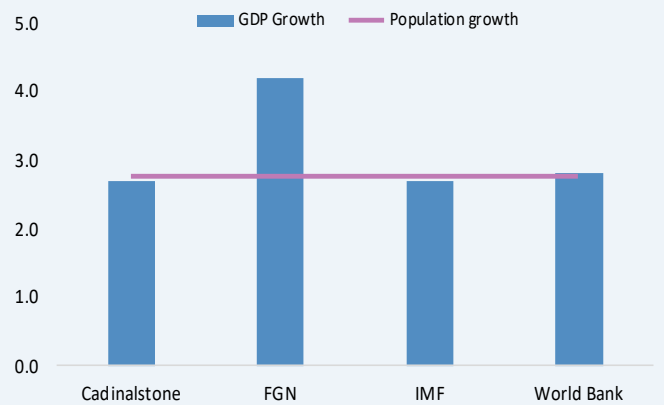
+49bps

Projected 2022 growth out-performance relative to previous 5-year peak

We project a 2.7% GDP growth in 2022

Over the medium term, we expect growth to range between 2.0% and 2.8%. The upper band of the growth range is almost at par with the population growth, implying a flat-to-falling per capita in the near term.

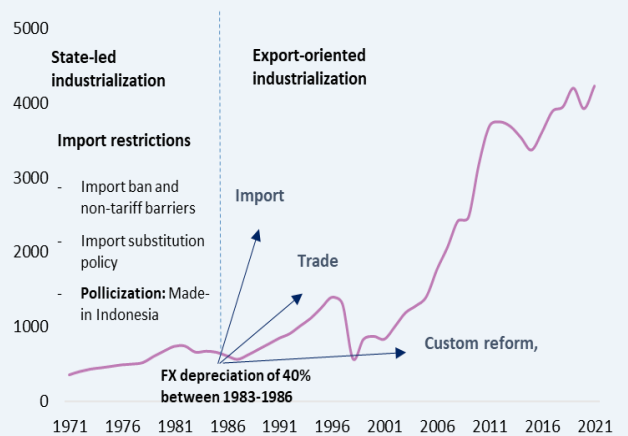
Figure 4: Projected growth is almost at par with the population growth rate, implying stagnant per capita in 2022



Source: CBN, IMF, World Bank, CardinalStone Research

Farther out, we think economic and structural reforms that focus on enabling private investment are necessary to accelerate growth to the 2015 level of about 6.7%. Indonesia's policy shift in 1985/86 could serve as a lesson for Nigeria (see figure 4 below).

Figure 5: Indonesia policy shift in 1985/86 (per capita income)



Source: IMF, CardinalStone Research



Will Nigeria take the path of rebasing the GDP?

In 2020, FGN, in collaboration with the World Bank, IMF, and AfDB, commenced work on GDP rebasing for Nigeria. However, the process was halted due to the outbreak of the COVID-19 pandemic. The project could come back in 2022 and help narrow the informal sector through improved capturing. Also, better capturing could enhance the efficacy of policy and direct interventions, expand the tax net, and boost related revenues.

New COVID variants are a downside risk to Nigeria's GDP growth

Although the government has sustained efforts to boost vaccine access, inoculations (less than 3.0% of the population) continue to assume a slow pace. The worry over slow vaccination is exacerbated by the emergence and rapid spread of the new COVID variants. Lessons from 2020 suggest that an uncontrolled spread of the virus may materially undermine the services and manufacturing sectors of the economy.

Figure 6: Vaccination rate in Nigeria remain relatively low

	2021	2022
Goal (% of population)	40.0%	70.0%
Vaccinated so far (% of population)		
Fully vaccinated	1.5%	
At least one dose	2.7%	
Doses of vaccines delivered (millions)		
COVAX	22.8	
African Union	1.8	
Donations	0.4	

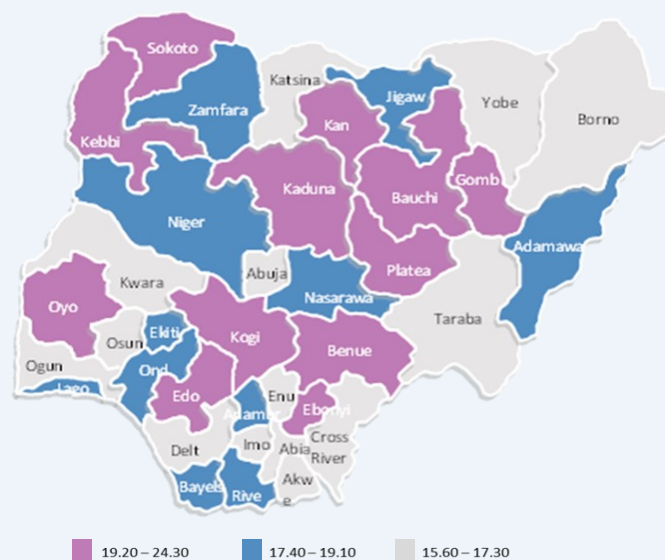
Source: IMF, CardinalStone Research

Inflation: a tale of two halves

Headline inflation rose sharply during the pandemic, peaked at 18.2% in March 2021 and subsequently moderated to 15.4% in November 2021. The deceleration was helped by high base effect and land border re-openings. Despite the moderation, Nigeria's inflation remained the 7th highest in Africa. According to the World Bank, this elevated inflation has pushed about 8 million Nigerians into poverty between 2020 and 2021.

Inflationary burden remains uneven across the country, with pressures more pronounced in the north. In our view, this inflation chasm is corroborated by Famine Early Warning Systems Network (FEWS NET), which highlighted that widespread conflict has led to human displacements in food-producing communities that are primarily in the north. Also, Nigeria remains on the World Bank's list of Fragile and Conflict-Affected Situations mostly due to repeated civil unrest, inter-community violence, and insurgency in the region.

Figure 7: Inflation is unevenly distributed across the country



Source: NBS, World Bank, CardinalStone Research



Base effect may wane in H2'22

We expect inflation to extend its moderation for most of H1'22 on the impact of high base effect. However, the base effect should begin to wane in May 2022, leaving legroom for MoM price worries to become more evident. These MoM pressures could reflect a projected naira depreciation to c.N440/\$ at the I&E, continued parallel market premium, heightened security menace, and, more importantly, a likely increase in PMS and electricity prices.

Talks on subsidy removal is gaining momentum

According to the NNPC, the government is still open to a possible subsidy removal that may drive PMS prices to between N320 and N340 per litre in 2022. In our view, eliminating subsidies could free up about N1.0 trillion in fiscal space annually, lead to notable dollar savings, and de-incentivize PMS smuggling. However, election worries and ambitions will likely test and limit the political will to see the plans through. Hence, we assume that PMS prices will only be raised by c.25.0% to N208 per litre in 2022 to slightly compensate for the impact of higher crude oil prices and mounting FX pressures.

Overall, we expect the negative passthrough from higher PMS adjustment to pressure core inflation, with a possible spillover effect on the food basket through higher transport costs.

Figure 8: Inflation expectation for 2022

<u>Scenarios</u>	Bull Case	Base Case	Bear Case
Currency Adjustment	6.5% devaluation	7.0% devaluation	9.4% devaluation
PMS Adjustment	No adjustment	25% adjustment	50% adjustment
Core Inflation	12.3%	13.0%	15.4%
Food Inflation	13.6%	14.8%	15.8%
Headline Inflation	13.0%	14.1%	17.5%

Source: NBS, CardinalStone Research



Fiscal policy

Bankrolling a N17.1 trillion budget

Between January and November 2021, Nigeria recorded a fiscal deficit of N7.0 trillion (vs the 2021 deficit projection of N6.4 trillion) following the significant underperformance of oil revenue and non-oil revenue (excluding tax). Oil revenue came in 47.4% below the government target due to weak oil production, which masked gains from high oil prices. Also, other non-oil revenues (N2.8 trillion) remained depressed, falling short of the budgeted by 30.8%. On the flip side, continued economic recovery supported tax revenue (N1.6 trillion) which outperformed its target by 18.8%.

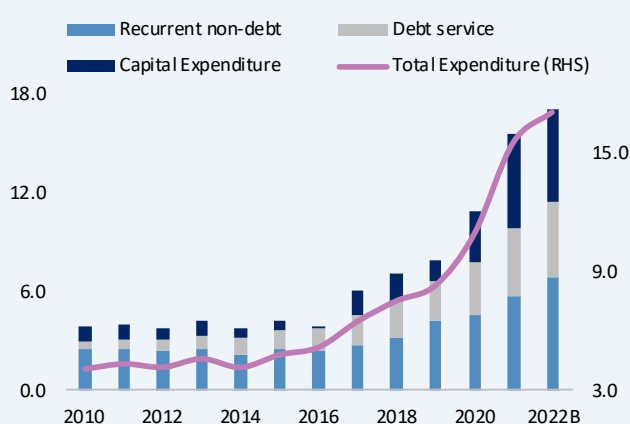
By our estimate, an 84.0% budget implementation could result in a fiscal deficit of N7.6 trillion (4.1% of GDP) in 2022, assuming average crude production and price of 1.7mb/d and \$70bbl, respectively. We view the budget benchmark oil price (\$62bbl) as largely conservative, but we are less optimistic on the production front due to the likelihood of unforeseen production disruption in volatile producing areas. To close up the potential 2022 funding gaps, the government is aiming to raise c.N2.6 trillion apiece from the domestic and foreign markets and N1.2 trillion from international project-tied loans.



Record spending for 2022

Total spending for 2022 was estimated at N17.1 trillion, with a recurrent and capital expenditure split of 67.4% and 32.6%, respectively. In our view, the all-time high expenditure target reflects the incremental nature of Nigeria's budget and increasing allocation to security. Elsewhere, data suggests an average increase in expenditure of 15.9% in four of the last five pre-election years.

Figure 9: Total expenditure at an all-time high



Source: Budget office, CardinalStone Research

Figure 10: Persist deficits calls for fiscal consolidation

Fiscal balances 2022 (N billion)	Budget	Bull case	Base case	Bear case
Total Expenditure	-17.12	-14.72	-14.35	-14.03
Recurrent non-debt	-6.83	-6.83	-6.83	-6.83
Debt service	-3.61	-3.74	-3.79	-3.87
Capital expenditure	-5.35	-2.82	-2.41	-1.99
Others	-1.33	-1.33	-1.33	-1.33
Total Revenue	10.66	7.85	6.79	5.72
Oil	3.40	3.19	2.85	2.52
Tax revenue	2.06	2.06	1.85	1.65
Others	5.20	2.60	2.08	1.56
Fiscal deficit	-6.46	-6.88	-7.57	-8.30
Deficit (% of GDP)	-3.5%	-3.7%	-4.1%	-4.5%

Source: Budget office, Ministry of finance, CardinalStone Research

Economic recovery may support non-oil revenue

The government is likely to remain aggressive on growing non-oil revenue, with the budgeted amount estimated at N5.3 trillion (62.0% of the total revenue). Available breakdowns indicate that 28.4% of non-oil revenue is expected to be raised from taxes. Specifically, VAT, CIT, and custom are billed to contribute N313.6 billion, N909.3 billion, and N834.1 billion, respectively. We view these tax revenue targets as largely achievable given continued economic recovery and the introduction of N10/litre tax on carbonated drinks. Nonetheless, tax buoyancy, which measures the efficiency of revenue mobilisation in line with economic growth, will likely remain low due to inefficiencies in the Nigerian tax system.

Fiscal financing gap to remain elevated due to persistent spillage

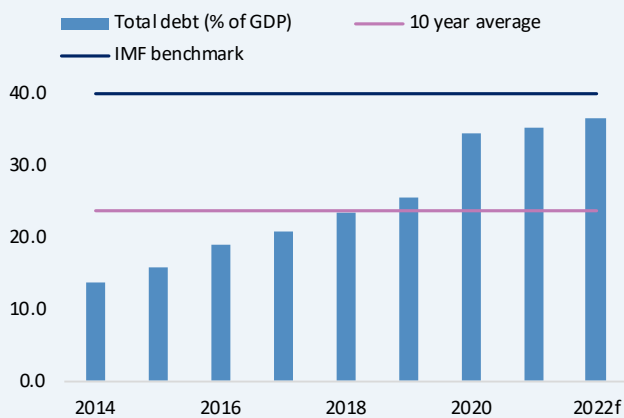
Actual deficit may be higher than the FGN's projected N6.3 trillion (3.4% of the GDP) in 2022 due to subsidy cost, spending on COVID vaccines, and huge allocation to security. In particular, subsidy continues to split opinions across stakeholders. While a few regard it as Nigeria's form of social security, others perceive it as an inefficient allocation of scarce resources and a depletor of fiscal space. *An estimate by the World Bank reveals that a \$10 increase in the price of a barrel of oil could reduce the fiscal deficit by 0.4% of GDP in the absence of fuel subsidy, while a 10% decrease in oil price could widen the fiscal deficit by more than 0.4% of GDP if subsidy persist.* Consequently, the extension of subsidy could lead to continued heavy reliance on debt in Nigeria. According to IMF, Nigeria's debt stock could reach 36.9% of GDP by 2022 (vs 35.7% currently).



CBN financing is the new norm

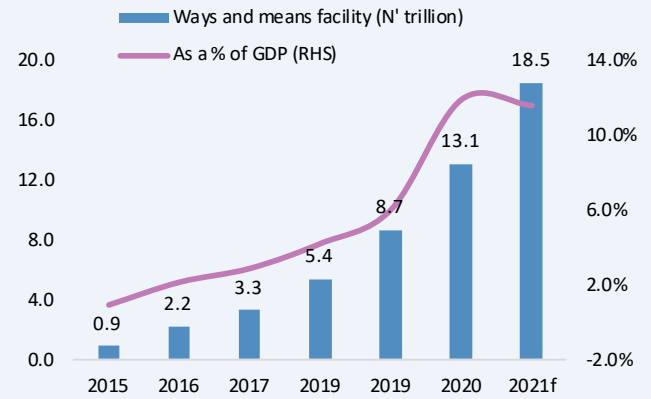
Total CBN ways and means was estimated at N16.5 trillion as of August 2021, after rising by a monthly average of N248 billion. If this pace is sustained, the total liability could reach N18.5 trillion by the end of 2021. The projected net disbursement of N5.4 trillion (121.1% of FGN’s prior year revenue) elicits worry, considering the CBN Act of 2007, section 38(2), which stipulates that the total amount of advancement to the FG (from the CBN) shall not at any time exceed 5.0% of the previous year’s actual revenue of the FG. In our view, a likely key consideration for the FG in using ways and means financing is its lower cost (c.4.9% in H1’21 vs the 6-month average yield on a one-year OMO bill of 5.5%).

Figure 11: Total public debt (% of GDP)



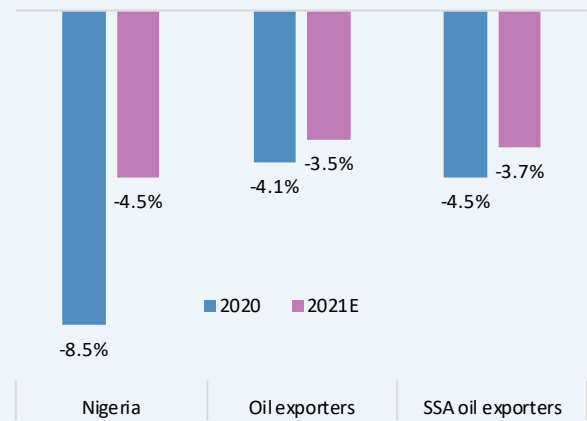
Source: World Bank, IMF and CardinalStone Research

Figure 12: FGN’s liability to the CBN



Source: CBN, CardinalStone Research

Figure 13: Nigeria has a higher fiscal deficit to GDP ratio compared to oil-producing peers



Source: World Bank, IMF and CardinalStone Research



Monetary policy

CBN is unlikely to adopt market-driven FX price discovery

The CBN is likely to ease its accommodative stance following the economy's positive response to easing of COVID-19 concerns in 2021. In our view, the apex bank could potentially shift its key policy rate upwards within a range of 50-100 bps in 2022.

Elsewhere, indicators of FX valuation suggest that the Naira remains overvalued and could weaken to N440.00/\$ in 2022. While a weaker currency regime could encourage foreign inflows, the issue of dollar demand backlogs would need to be addressed, and the overall FX liquidity framework improved to enhance investors' confidence. In addition, foreign investors may require an enhanced carry trade that reflects Nigeria's risk environment, especially in the pre-election year 2022.



CBN's accommodation appeared more like a "smokescreen" in 2021

Despite intensified exchange rate pressures, the MPC left policy parameters unchanged in 2021, aided by moderating inflation, perceived fragility of growth numbers, and sustained dovishness in advanced economies. On the face of it, the CBN maintained a dovish posture that coincided with the tolerance of net OMO maturities of c.N4.6 trillion in 2021 (vs net repayment of N6.5 trillion 2020). Yet, when overlaid against an arbitrary cash reserve ratio (CRR) debit of N9.0 trillion to N10.0 trillion over the last 2 years, the open show of accommodation appears more like a "smokescreen". In line with our previous outlook, "[The Big Bounce](#)", the MPC is merely switching its liquidity management tool from expensive OMOs to the materially cheaper CRR debits, while remaining tight enough to leave OPR and OVN rates elevated.

CBN may turn fully hawkish in 2022

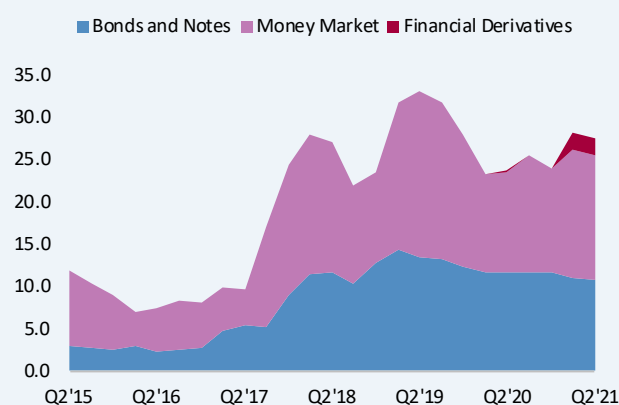
In our view, the MPC may implement a symbolic MPR increase of 50bps to 100bps in 2022. This view is supported by projected sustenance in growth numbers and the normalisation of interest rates in advanced economies. Importantly, rate increases in advanced economies may drive sell-offs in Nigerian OMOs and intensify FX pressures as foreigners seek to cut down on Naira risks as pre-election worries heighten. To curtail the FX impact of such a risk-off sentiment, the apex bank may adjust OMO rates higher to appease foreign investors — a move that may inadvertently drive sell-offs in the domestic fixed income space as banks attempt to rotate into OMOs.

In addition, the CBN is likely to continue deploying ad-hoc measures (given weak monetary policy transmission) in its fight to defend the Naira and support economic growth, even though the emphasis on the latter may wane as growth numbers remain stable.

Nigeria's external position is on the path to recovery from Covid-19 induced pressure

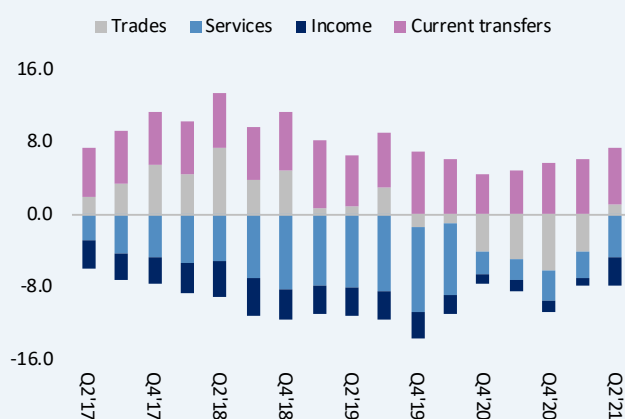
In Q2'21, the current account deficit narrowed to \$423.4 million (0.44% of the GDP), the lowest since Q3'18, thanks to improved crude oil prices and rebound in remittances. The oil price recovery reflected resurgent global demand, driven by robust fiscal stimulus in advanced economies, as well as the OPEC+ production agreements. Elsewhere, remittance flows improved as global economic recovery strengthened the foreign labour markets.

Figure 14: Foreign holdings of local debt securities (\$'billion)



Source: CBN; CardinalStone Research

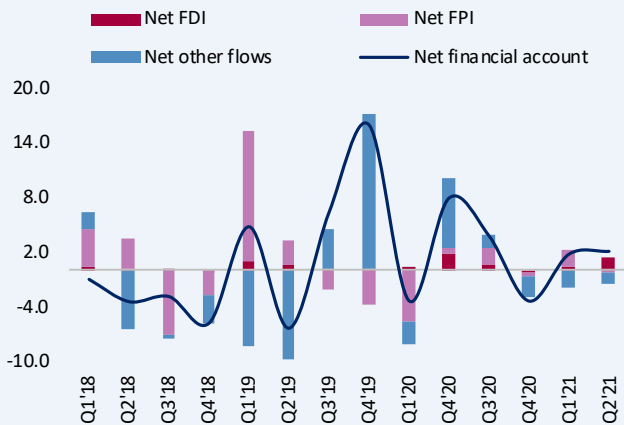
Figure 15: Current account Sub-Components (\$ billion)



Source: CBN, CardinalStone Research



Figure 16: Composition of financial account balance (\$ billion)



Source: CBN, CardinalStone Research

However, the cumulative impact of previous deficits and concerns over FX management policies saw currency remain a topical investment issue in 2021. Yet, CBN's FX rationing and inflows from SDR & Eurobond prevented a material external reserve hemorrhage. FX reserves remained above \$33.0 billion or 5.2 months import cover (or 2.7 months of imports cover of goods and services).

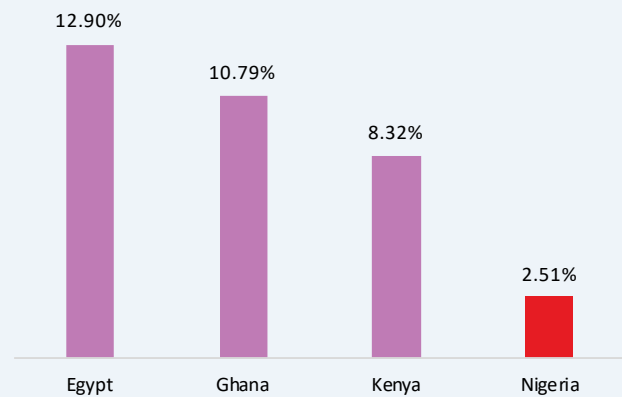
Foreign investors may need better convincing before making big bets in 2022

While foreign reserve has accrued in recent months, capital inflows into the country remain weak due to slow FX reforms and uncertainties surrounding dividend and profit repatriation. In our view, the issue of dollar demand backlogs would need to be addressed, and the overall FX liquidity framework improved to enhance investors' confidence. In addition, foreign investors may require an enhanced carry trade that reflects Nigeria's risk environment, especially in the pre-election year 2022. The hawkish rendition of developed market central banks is likely to increase the risk of capital reversals in the pre-election year.

External imbalances and tepid inflows will likely result in further currency adjustments in 2022

Based on the latest data as of Q2'21, the CBN estimated the fair value of Naira at N462.00/\$, which implies a 12.3% overvaluation versus the I&E rate. To curb inflationary pressures and avoid a worsened currency position, we think that the CBN is unlikely to adjust the Naira to N462.00/\$. Hence, we project a Naira FVE of N440.00/\$ in 2022.

Figure 17: Carry trade in Nigeria and some African peers



Source: Bloomberg, CardinalStone Research

USD – still a hedge against domestic inflation

2021 was an odd year for the US following energy-driven inflationary pressures. However, the country's latest inflation reading of 7.0% in December 2021 is c.8.4ppts lower than Nigeria's. In addition, the medium-term inflation targets for both countries (i.e. 2.0% for the US and 9.0% upper band for Nigeria) suggest that USD investments could remain veritable hedges against domestic inflation in the medium-to-long term.



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