



Russia-Ukraine crisis; a ripple effect in view?

Following months of tension, Russian President Vladimir Putin ordered what he termed a “special military operation” against Ukraine on Thursday, 24 February 2022. A full-scale invasion followed, and Ukrainian President Volodymyr Zelenskyy has vowed that his country would defend itself. Based on media reports, Russia now has at least 50% of its estimated 150,000-strong invasion forces in Ukraine. If the war gets prolonged, how does Nigeria stand to gain or lose? Brent oil price passed US\$100/bbl. for the first time since 2014 following the announcement of the invasion. From the prospect of continued increase in oil prices to increase in prices of major commodities like wheat and to the movement of funds from equities and fixed income market into the commodities market, Nigeria, an import-dependent country, stands to see significant effects from a prolongation of the crisis. In this report, we postulate our views.

Effects of increasing oil prices- Perhaps, more negative than positive

Brent oil price passed US\$100/bbl. for the first time since 2014 and closed at US\$112.93/bbl. yesterday as a worsening of the Russian Ukraine crisis continues to spark fears of a disruption to the region’s energy exports. Russia is a key supplier of energy to global customers, with Europe relying on the nation for about a quarter of its oil supplies. The Ukraine invasion has worsened an already strained market, as oil supplies around the world continue to lag the strong recovery in demand from the pandemic.

Rising oil prices should bode well for the Nigerian budget, given its benchmark price for crude oil for the 2022 fiscal year is pegged at US\$62/bbl. Theoretically, the continued uptrend in crude oil prices, a major source of foreign exchange to the country, suggests FX accretion. However, the perennial issue of terminal shutdowns, vandalism and thefts continue to fuel sub-optimal oil output despite the relaxation of OPEC+ production agreements. Average daily oil production for the fourth quarter of 2021 was 1.50mbpd, lower than the third quarter 2021 production volume of 1.57mbpd and news reports point to still lower production in Q1 2022.

Again, increasing oil prices implies an increase in the landing cost of petrol and an increase in subsidy payments. The Federal Government has earmarked a sum of N3trn for subsidy payments in 2022. If oil prices continue to rise, the figure stands to increase substantially, resulting in a higher fiscal deficit. The NNPC boss, Mele Kyari, had in previous news reports put the comfort oil price zone for Nigeria at US\$58-\$60/bbl., saying that for the NNPC, anything above \$70-\$80 will create major distortions in the projections of the corporation and add more difficulties to the company. It suffices to say then that gains that would have accrued to government revenues from the crisis will be lost to hampered production volumes and an increase in the cost of PMS and consequently, high subsidy payments.

Beyond rising crude oil prices, it is expected that all other derivatives of petrol will likely begin to increase in price.

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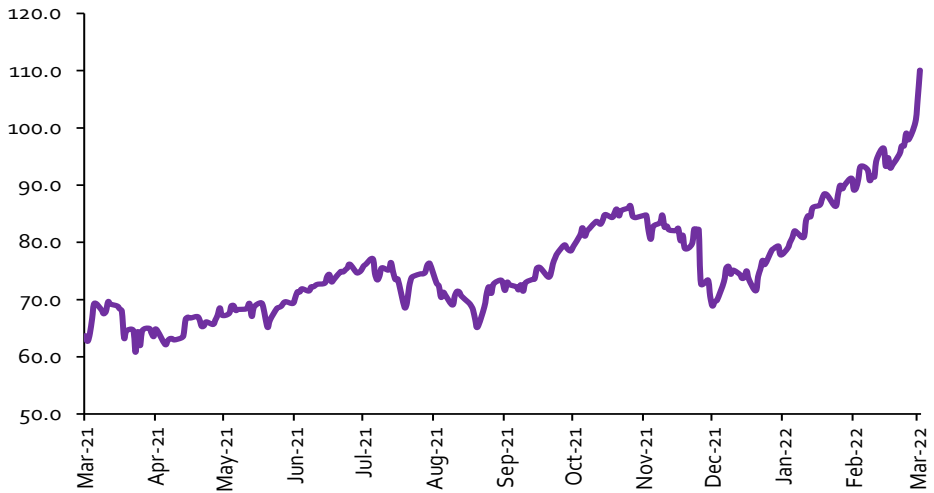
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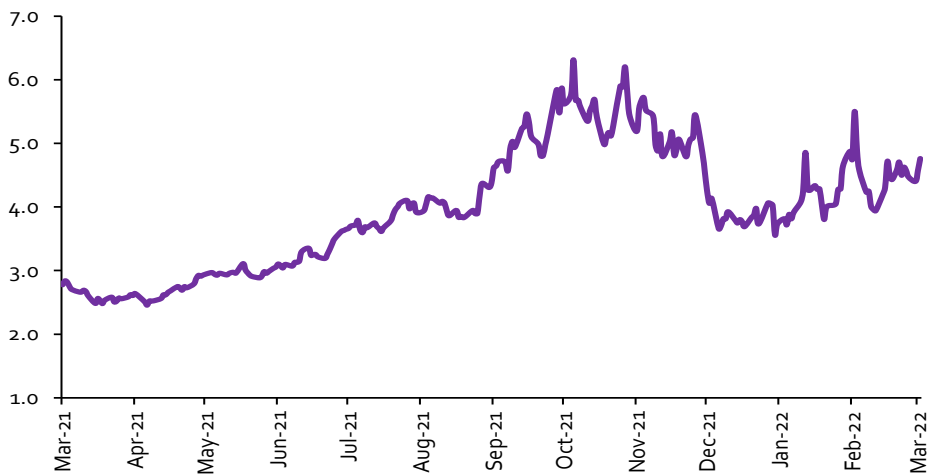
One-Year Brent Price (US\$/bbl.)



Source: Bloomberg, CSL Research

Gas prices: Russia is the world's largest gas exporter (c.25.0% of the global gas exports). US natural gas futures rose more than 4% to almost reach US\$4.6 per million British thermal units on expectations of stronger demand with intensifying energy crises. Also, domestic natural gas inventory levels declined last week. The cost of gas, both for cooking and gas-to-power, may increase significantly in Nigeria and other import-dependent countries, as the war between Russia and Ukraine intensifies and is prolonged. Nigeria, despite huge gas resources, relies on the United States, Algeria, Equatorial Guinea and others to buy Liquefied Petroleum Gas (LPG). Nigeria holds c.206 trillion cubic feet (Tcf) of proven gas reserves, making her one of the top six countries in the world with the largest gas reserves.

One-Year Natural Gas Prices (US\$/mcf)

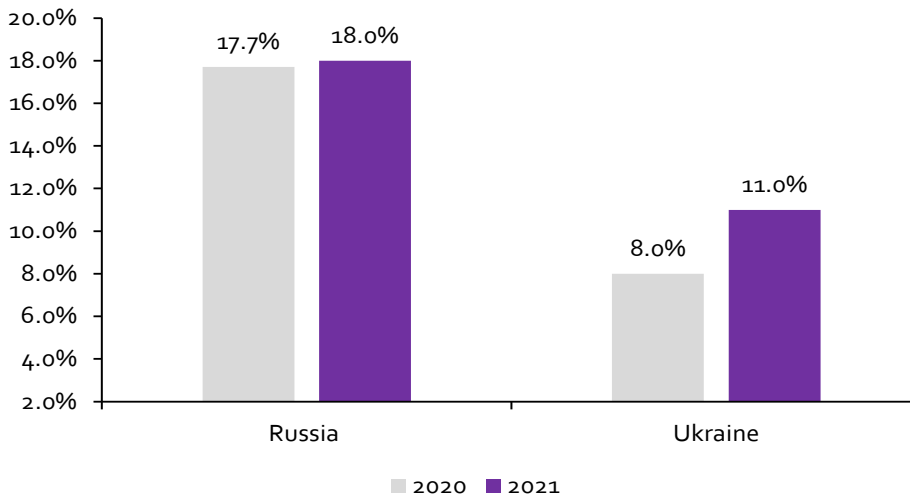


Source: Bloomberg, CSL Research

Impact on other commodities

Wheat: Russia and Ukraine are large exporters of wheat. Russia is the largest exporter of wheat and both countries accounted for about 29% of the global supply of the commodity in 2021. A drop in wheat supply could result in a substantial increase in wheat prices. Nigeria relies mainly on imported wheat, importing 640,000 tonnes in 2021 based on data from USDA. The volume of imports has been on the increase as local production continues to decline due to insecurity in regions known to produce wheat. In the first quarter of 2021 alone, Russia's wheat exports to Nigeria were valued at N37.2 bn based on news reports. Data from the United States Department of Agriculture shows that between 2010 and 2020, as the consumption level of wheat rose, production volumes failed to meet up, resulting in a significant rise in wheat imports. On average, the country produced just 2.1% of the total amount of wheat consumed during that period.

Percentage of world exports of wheat



Source: FAO Stat, CSL Research

There has been a surge in wheat consumption due to an increase in the demand for semolina, pasta, noodles, and bread. Flour based products are usually in high demand in the dry season when other food crops are in short supply. The rise in the prices of staples like rice and garri causes consumers to switch to wheat-based products that are relatively affordable. The unavailability of foreign exchange also compels flour millers to look to the parallel market for FX at prices significantly higher than the official rate. In addition, increasing freight costs also weigh on flour millers. These have been largely responsible for the increase in the price of wheat products, like bread. Any price increases of flour-based products in local markets impose an additional burden on the earnings of low and middle incomes consumers for whom bread represents a major part of their daily diet.

The price of wheat influences market share of major suppliers. Black Sea wheat exports to Nigeria have increased over the past years due to lower prices. To reduce the domestic price of wheat flour and sustain profitability, most Nigerian flour millers buy cheaper wheat from the Black Sea region and blend them with high quality wheat from the United States. Last year, Nigeria was the fifth largest importer of US wheat.

One-Year US Wheat Prices (US\$/bushel)



Source: Bloomberg, CSL Research

Impact on Inflation: Increased global energy prices will likely result in increased oil and gas prices. This, in addition to the lingering fuel scarcity, will cause a significant rise in utility costs. Given that the utility sub-basket constitutes 32.6% of the core inflation, core inflation may likely continue to rise in the short term. In addition, a rise in the global price of wheat will feed into an increase in the prices of bread, pasta, noodles, and all wheat-based products, further causing an increase in food prices and food inflation.

Balance of Payments: In our 2022 outlook “In Drips and Drabs” , we noted our expectation of a narrowing of the current account deficit to 2.0% in 2022 from 2.70% in 2021 on the back of increased crude oil prices as well as improved remittance inflows. As things stand now, the narrative may change given production restrictions that limit gains from higher crude oil prices. On the other hand, considering the high import dependence of the country, expectations of an increase in global prices of commodities amid improving consumption, could result in a significantly higher import bill compared with exports.

Impact on the Nigerian stock market

Expectations of an increase in commodity prices make us expect a possible movement of funds from the equities and money market to the commodities market. However, we have looked at a few sectors on the exchange to examine the impact of the various factors we have highlighted above on the players in the sector.

Consumer goods (Negative): The impact on consumer-facing companies in our view stems not only from further erosion of consumer purchasing power through increasing inflation and its impact on demand but also from increased costs via higher commodity prices. The Nigerian Consumer Goods sector is already confronted with the double whammy of high global commodity prices and FX depreciation, leaving the cards wide open for companies to pass some cost increments to the consumers in 2021. Major global commodities saw a sizable increase in cost last year. From Wheat (+23.7% y/y) to Barley (+29.2% y/y), Sugar (+37.6% y/y), Maize (+56.9% y/y), and Coffee (+30.7%). The significant cost pressures stemmed majorly from supply chain disruptions amid the recovery in consumer demand. Specifically, Russia and Ukraine control about 29.0% of

the world's wheat supply. In essence, a prolonged tension between Russia and Ukraine will further exacerbate the existing supply chain disruptions with attendant impact on wheat prices. With that, companies in the Food Processing industry may be close to contending with another bout of elevated commodity prices, which may not be successfully passed on to the end consumers.

Banks (fairly neutral): Many of the banks we spoke to are of the opinion that interactions between Nigerian banks and their Russian counterparts remain very limited. However, we believe rising oil prices will be positive for bank loans to the oil and gas upstream sector players. Many of the upstream oil and gas loans were restructured at the peak of the covid-19 induced economic crisis. At oil prices above US\$100, we believe these companies will be in good profit. That said, production remains a major constraint for these companies.

Industrials (Possibly negative): As the Russian-Ukraine conflict intensifies, the cement sector is also not spared from the possible surge in gas prices, as Russia is the largest gas exporter in the world. Even as other countries continue to show support for the Ukrainian government, the Russian government may want to weaponize gas supplies to its existing trading partners especially in European countries, etc. Specifically, Russia supplies about 40% of the EU's natural gas imports while the remaining 60% is sourced from Norway and Algeria. The building materials companies rely majorly on gas as an energy source to operate their plants. For context, it is estimated that gas accounts for about 60% - 65% of the energy mix of the cement players. Added to this is also the fact that it is priced against the dollar, making it another round of concern for the players. Although, there is an existing strong demand for cement in the country, if the conflict persists, a significant increase in energy costs could result in a significant increase in cement prices, which could impact demand if consumers can no longer withstand the spike. That said, many of these companies already have existing gas contracts that may mitigate against price increases.

Oil and gas upstream (Positive): In our view, the greatest beneficiaries from the ongoing crisis are the players in the upstream oil and gas sector especially Seplat Plc. Seplat's share price has been on the rise since its announcement of the acquisition of ExxonMobil's shallow water business in Nigeria. In our view, high oil prices will be positive for the business. We however reiterate that production remains a major constraint for these companies.

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