Nigeria: Are we at the Bottom yet?

For many developing countries, and especially in Africa, secular reform (for example the gains to be had from better infrastructure, less corruption and the leapfrogging of old technology) can sometimes have a greater impact than cyclical developments even when, like Nigeria, the price of its main export, oil, halves.

"Never waste a good crisis" as Churchill said; Nigeria is now in its second since 2009. The first saw Lamido Sanusi at the Central Bank of Nigeria (CBN) rescue the bankrupt banking system (and the jailing of one bank CEO). This second has been prompted by the fall in oil but really stems from the wanton corruption and theft during Goodluck Jonathan's regimes. President Buhari intends to return Nigeria back to better days and, hopefully, his focus on reform will pay off.

The most obvious gains from reform could come from a regular supply of electricity. Coal and gas fired generating plants could easily reduce costs throughout the Nigerian economy by around half based on the difference in the cost of generating electricity by diesel generator of around 40-50 USc/kWh vs. a more normal 20 USc/kWh for residential tariffs in the developed world. Theft and corruption is also thought to reduce what the Nigerian Treasury receives from oil by roughly half too. Until recently, Nigeria was one of the world's biggest markets for cement, and still is for flour and fertiliser and probably a lot of other raw materials and intermediate goods that could be grown/processed in Nigeria. Petrol, diesel and fertilizer would be good examples. Nigeria is actually blessed with perfect growing conditions for a range of soft commodities including palm oil, rice, sorghum, cassava, gum Arabic, ground nuts and pineapple the export of which dwindled to pretty well nothing as previous governments interfered with pricing for gerrymandering purposes. Eliminate theft and corruption, get the lights on, focus on import substitution and agriculture, and the collapse in crude oil prices could easily be offset.

By not appointing a cabinet there has been no interference with Buhari's fairly bold attempts to change and fix some of these big structural problems although he has so far ducked reform that affects the public such as the petrol subsidy. Petrol subsidies tend to be strongly pro-cyclical and can easily wreck the finances of developing countries.

President Buhari's first target was the Nigeria National Petroleum Corporation (the NNPC). Emmanuel Ibe Kachikwu, who was general council for Exxon Mobil, was appointed just after the election and the latter's first move was to sack the corporation's entire board. His second was to initiate the publication of provisional monthly data on the finance and operations at the NNPC. He is now focussed on other areas that need changing. These include the contractual arrangements with buyers of Nigeria's oil, and Nigeria's gas industry. Gas is mostly flared (with losses of around US$1bn a year) - and has been for decades despite reserves that are some of the most plentiful in the world. Nigeria's gas is also some of the cheapest in the world too yet the gas-fired power stations often suffer from a lack of gas due to poor infrastructure. The International Oil Companies (IOC's) apparently need greater incentives in terms of pricing to do what is obviously a sensible thing for the country. Nigeria's oil refineries are also an obvious target; their current annual production is precisely zero; these need to be overhauled and better managed and a target date of end 2016 has been set for this. One major company told us recently that their total operating costs would fall by 60% if the refineries become operational; currently, this company has to import raw material from refineries in bulk by the boat load (18 months' supply) since stock-outs in the FMCG space are a major strategic issue. Finally, the Petroleum Industry Bill (PIB) looks like it could be dusted down as part of fixing the NNPC and the oil sector as a whole. There seems to be two issues: the first is that the NNPC is part regulator and part operator as it owns a majority share in all Nigeria's oilfields. A problem is that these oilfields are currently being operated via unincorporated joint ventures which means that the NNPC needs to find the cash for its share of each new well from the national budget. This means that even if the IOC's wanted to expand their drilling programmes they are limited by the size of Nigeria's fiscus. This is now a major constraint. A second issue is that the PIB is calling for an increase in taxation on IOC's despite the sharp fall in oil prices.

The movement of money between the various onshore and offshore entities is the source of Nigeria's corruption and the funding of the body politic. This is the jugular of the ancient regime and

no doubt explains why Buhari has retained the Petroleum Ministry for himself. The PIB if passed will re-set the relationship with the IOC's both in terms of royalty and tax take, but the crucial development will be the use of incorporated ventures whereby individual developments will be able to borrow money in their own right. This will simultaneously reduce the pressure on the fiscus and reduce corruption (since the actual operator on each well tends to be an IOC). It is interesting to note that the last four oil blocks were awarded on this basis.
Downstream, the NNPC manages to lose a substantial amount in the Pipelines and Product Marketing Company (PPCM) (US$1.7bn ytd excluding US$1.3bn for petrol subsides and US$600m for pipeline repairs and losses due to vandalism; this is around 1% of GDP in total annualised), but amongst the new leadership's "20 fixes", the PPCM will be unbundled along with the Nigerian Gas Company.

The second target is corruption; the new president stood on an anti-corruption ticket and seems to be living up to his no-nonsense reputation. On our recent visit to Nigeria the chatter in Lagos was about nothing else and with good reason; Buhari had just slapped a huge fine (of US$5.2bn) on MTN the day we arrived for failing to comply with regulations to cut off non-registered SIM card users. Lesser fines have also been handed down to two banks and to Guinness for seemingly relatively minor misdemeanours. To put this fine into perspective total Consolidated Government oil receipts look like they will fall from US$26bn in 2014 to around US$16bn this year. US$11bn is likely for 2016 vs. an IMF projection of US$22bn made as recently as March this year. The 2016 budget is rumoured to project a total expenditure of around US$35-40bn so raiding the corporate piggy bank could be seen as low-hanging fruit.

Buhari has also targeted the civil service. Apart from announcing an investigation into a US$5.5bn defence procurement fraud, the number of government ministries has been reduced sharply to 25 whilst 18 permanent secretaries (most of them) have been removed – especially those in charge of key state organisations associated with corruption including port and customs. Emmanuel Ibe Kachikwu on the other hand has been appointed the permanent secretary at the Ministry of Petroleum.

Overall, the key appointments to government are technocrats (from the South) with the less significant appointments balanced regionally in a traditionally Nigerian way. Essentially, Buhari has streamlined his cabinet with key positions filled by competent people. Any bickering will come on the fringes in the less important positions. Finally, in this respect, the head of the anti-corruption commission has also been dismissed.

The three other important positions of state have been filled by Mrs Kemi Adeosun at the Ministry of Finance, Babatunde Raji Fashola who is the Minister of Power, Works and Housing, and Udo Udoma (an Oxford Alumnus and lawyer) who is Minister of Budget and National Planning. Budget and National Planning came under the Ministry of Finance previously but is now regarded as critical to match national resources to the budget.

We knew Mrs Adeosun in her past life as an investment banker and we have no doubt she will be well advised, but it's a big job for such a young person especially in Nigerian politics. However as Kemi said at her hearing, Nigeria cannot keep spending 78% of its national budget on recurrent expenditures such as public wages. Babatunde Raji Fashola was governor of Lagos State following Bola Ahmed Tinubu. Both were highly successful in reforming and managing Lagos especially in the areas of taxation, infrastructure and education. Fashola's ministry, the Ministry of Power, Works and Housing is a new ministry controlling a large part of the budget and overseeing the all-important power sector.

We believe four other key reforms should be made: overhauling/improving the land registry so that land titles are clear and easily transferable; establishing a competition law to break down industrial concentration and associated tariff corruption and subsidy fraud; instigating a strong anti-corruption process that leads to people being jailed, and introducing a flat tax to reduce tax avoidance and evasion.

In the five months since the election while the focus has been on reform, managing the economy has been left to the Central Bank. This has meant a fiscal policy vacuum and a tight monetary policy (as outflows by foreigners and imports by locals have tightened money policy given the CBN's determination to hold the line on the exchange rate).

There seem to be three main issues on people's mind (the cognoscenti at any rate); the fall in oil revenues; a domestic naira credit crunch and a US dollar credit crunch.

Whilst non-oil revenues are now becoming larger in the budget thanks to the fall in oil revenues, non-oil revenue amounts to a mere 4.5% of GDP compared to 10-15% for other oil producers and 25% for sub-Saharan Africa. During the previous oil price collapse Nigeria's tax take was more in line with sub-Saharan Africa. With a recognition that the oil price fall is partially permanent and an initial suggestion that next year's budget may be expansionary with spending on infrastructure front-loaded to maintain economic growth, the focus is squarely on raising non-oil revenue: the question is how? Some suggest that plugging oil leakages could raise US$15bn whilst a rise in VAT to 10% with no exemptions (favoured by the IMF) could raise a further US$15-18bn. But an expansionary fiscal policy and current account deficit are a recipe for devaluation and higher interest rates (to encourage offsetting inflows) so it remains to be seen what choices the new administration makes for next year.

The naira credit crunch is a direct result of the introduction of the Treasury Single Account (TSA) which requires commercial banks to move all government deposits to the Central Bank. Two commercial banks have already been fined for moving too slowly but the TSA is seen as an important move to stem corruption in the use of public funds. [The withdrawal of government deposits will mainly affect the smaller, weaker banks.] Domestic interest rates rose sharply over the introduction of the TSA forcing the CBN to reduce the Cash Reserve Ratio to inject liquidity. Interest rates have now started falling sharply as a result with the 3 year government bond yield now at 9.2% from nearly 16% in September. The 90 day T-bill yield is 6.2% whilst CPI inflation is 9.3%.

The lack of US dollars in the system follows a policy directive in June 2015 whereby the CBN restricted the supply of US dollars for a list of banned imports ranging from private planes to toothpicks. This lack of US dollars is now affecting the entire industrial sector. One company told us they could only obtain 10% of the US dollars they needed each month for raw material imports. This was a big company in the queue for dollars like everyone else. The consequence will no doubt be a shrinkage in the numbers employed in formal employment. Companies are now talking about exporting and/or developing local sources of raw materials with a very high sense of urgency. Recent comments from the government suggest various items on the Central Bank's excluded items list, such as tomato paste, rice and fish are already starting to see increased local production.

An important part of Nigeria's problem is Dutch disease whereby the exchange rate is correct for the huge oil economy but too strong for non-oil manufacturers, agriculture and exports. Because of the strong exchange rate it pays everyone to import finished or intermediate goods. Over time, corporates with the political muscle to erect import tariffs and with access to capital have built up businesses that then have gone on to dominate their respective domestic markets. Devaluation normally sends the signal to switch from imported to domestic production, but in Nigeria's case there is little domestic production of intermediate goods since imports are too cheap and the cost of capital too high. The first moves to encourage import substitution were taken under the previous regime whereby commodities like palm oil were encouraged. Nigerian Breweries, for example, has managed to reduce its import content to around 13% of cost but many other big companies still import 50% or more of their raw materials. This will no doubt change in the years ahead spurred on not by the exchange rate but by a lack of foreign exchange.

Unlike 2009 when foreign banks pulled their lines of credit to Nigeria (and to everyone else), there is no panic this time over a lack of dollars; an external supply of US dollars is available but at a cost. Nevertheless, the lack of US dollars may easily cause Nigeria to go into recession in Q1 '16 as banks have ceased issuing letters of credit to reduce their own exchange rate risk; a slowdown is already evident; the economy grew by 2.8% in Q3 2014 vs. 3.4% in Q3 2013.

The fundamentals, then, reflect an economic slowdown but could easily be the trigger for just the kind of reform that Nigeria needs to diversify from oil. A study of non-oil economies in Africa suggests that for every 5-6% of GDP that a country diversifies away from commodities and towards manufacturing and services, per capita income rises by US$1,000. Debt, and foreign debt especially, is also low, which is a major plus in a heavily indebted emerging and developed world.

From a stock market perspective we believe the market is close to a bottom. Three pools of money tend to focus on the Nigerian equity market: foreigners, domestic pension funds and the retail public.

Foreigners anecdotally have been selling for some time having been spooked by the falling price of oil, the announcement by JP Morgan that they were dropping Nigeria from their bond index, the fear of a further devaluation and fears that US interest rates might start to rise. Evidence suggests South African investment funds have also been large sellers of Nigeria at a time when volumes of US$5-10m per day have fallen to virtually nothing. This is only slightly more than Kenya on a good day yet Lagos alone is the same size as Kenya. It is hard to escape the fact that external sentiment towards Nigeria is extremely poor. Unilever PLC and Diageo on the other hand have recently made bids to increase their stakes in their local subsidiaries to around 75% suggesting that

IMARA
Asset Management

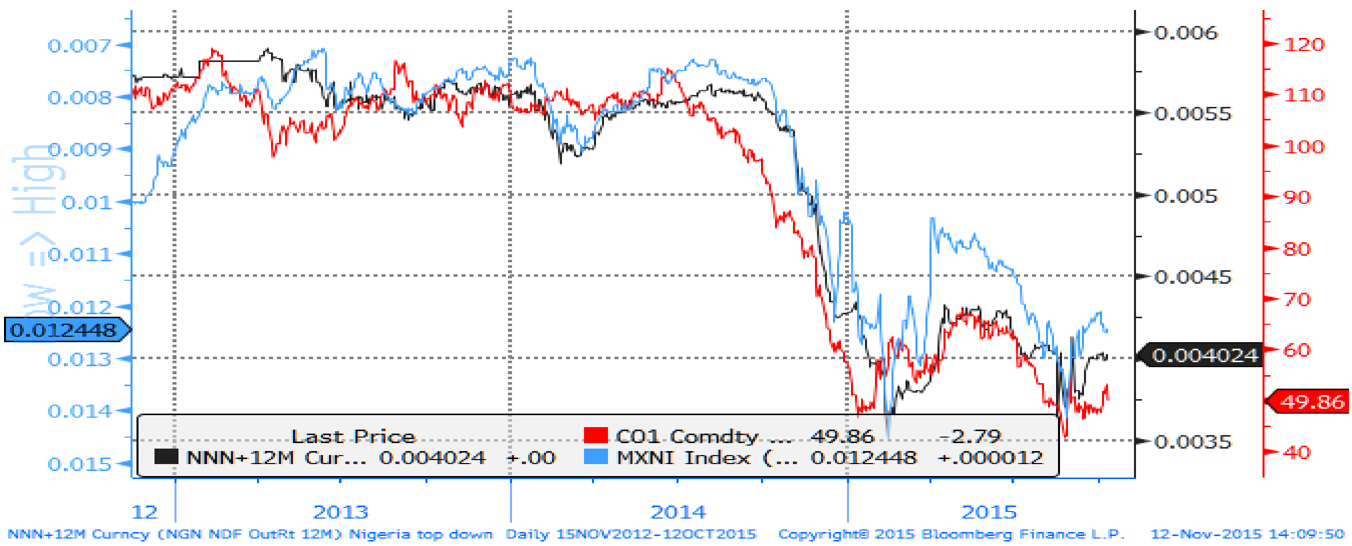
these insider's believe current valuations to be at their cyclical low.

The Nigerian pension funds have around US$25bn under management vs. a total stock market capitalisation of US$49bn. This is equal to 5% of GDP vs. 9.6% of GDP for the stock market – which is low by any standards. The weighting to equities is around 10-12% of overall funds under management. These funds have to beat a hurdle rate of inflation (at 9.3%) or the CBN bank rate which is 13% (recently raised from 12% during the devaluation). Historically, these funds have bought and held government bonds (the average 3 year Nigerian Government Bond yield has been 13.5% since the start of 2013) but these rates have now fallen to 9.2% as a result of the cut in the commercial bank's cash reserve ratio after peaking at 16% in September. Pension funds may therefore have to start looking at the equity market once again. In any case, assuming historic rates of growth in funds under management and a constant asset allocation, these pension funds would be buyers of about US$2m a day on average - which possibly explains why recent daily market reports now tend to say it is local buying that is dominating the market.

The public are able to access quite high deposit rates currently - 6 month rates are a whopping 10.85% - as banks struggle to replace cheap government deposits in their funding mix. This has meant the low-risk carry trade between cheap government deposits and high yielding fixed income has now been switched off so banks will need to focus on lending. Because there isn't the skills' capacity and because ROE's have been falling, we may well see banks shrinking balance sheets voluntarily. This would in turn lessen the pressure on retail funding and the pressure on deposit rates. The expected 2016 dividend yield in the equity market is 4.5% for consumer stocks (which are at a cyclical low) but 9-11% for banks like GT Bank and Zenith. We would argue that as these dividend yields are now the same as these high bank deposit rates the stock market looks to be fairly close to a bottom. [This is because an individual can get the equivalent annual income from the dividend and have a growth instrument that will keep up with inflation in the longer term.]

Finally, the Bloomberg chart below show three lines: the Nigerian stock market index in blue, the price of Brent in red and the 12 month forward naira rate in black. These lines have been moving together since early 2013 suggesting that the Nigerian equity market is currently a hostage to the price of oil rather than to the notion of reform and better economic fundaments and politics. Prior to 2013 the Nigerian index was moving independently of oil.

We believe that until investors see the impact of the new government the market will bumble along in line with the price of Brent. But once we do see the impact of reform, the market should finally rise.



Jonathan Chew,
Chief Investment Officer,
Imara Asset Management Limited