NIGERIA

February 2019

ELECTION PREVIEW

MiFID II compliant: Contains no investment recommendations

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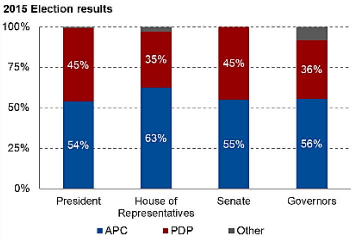
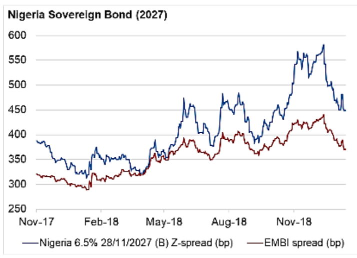
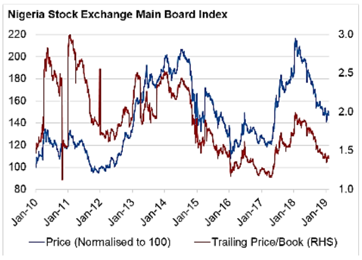
Credit and equity performance







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Elections: status quo versus a pro-market push

- **Greater differences between candidates than we first anticipated.** Nigeria's general election is scheduled for 16 February and there is no clear favourite. Given that the challenger (Atiku Abubakar) and his key backers were the key backers of the incumbent (Muhammadu Buhari) in 2015, we believed it was unrealistic to expect material deviation in manifesto or ultimate policy implementation. However, greater differentiation in policy promises has emerged than we previously expected. In this report, we compare the different approaches Buhari and Atiku could bring to Nigeria's challenge to mobilise the capital expenditure needed to drive diversification away from oil, while raising the greater revenues needed for fiscal consolidation.
- **Status quo (Buhari) versus a pro-market push (Atiku).** Although both presidential candidates are likely to face the same structural constraints as their predecessors (vested interests related to zonal interests and patronage networks) in implementing policy, it has become clearer that Buhari (of the APC) represents the status quo (focus on anti-corruption, security and a very conservative economic policy that prioritises FX-reserve rebuilding and inflation control over growth) whereas Atiku (PDP) promises a push to pro-market economics (more flexible FX regime, change of central bank leadership, looser fiscal stance and oil sector reform). As such, an Atiku victory is likely to be more positively received by investors frustrated by Nigeria's anaemic growth (despite higher oil revenues than expected since mid-2017).
- **Macro outlook in brief.** We expect growth in 2019 to be largely driven by the non-oil sectors, which should be supported by greater consumer demand as consumer confidence further improves, the minimum wage increase is implemented and the potential for lower interest rates and improved credit availability (albeit weak) rises in H2. Inflation rate should pick up, but we see scope for a slowdown in 2020. Minimum wage increases and ongoing disruptions to the agriculture sector due to farmer-herdsmen conflicts are sources of short-term inflationary pressure; possible premium motor spirits (PMS) and electricity tariff rate increases, more likely under an Atiku government, could be longer-term areas of pressure.

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2019 election: status quo vs. a pro-market push

President and vice-president candidates

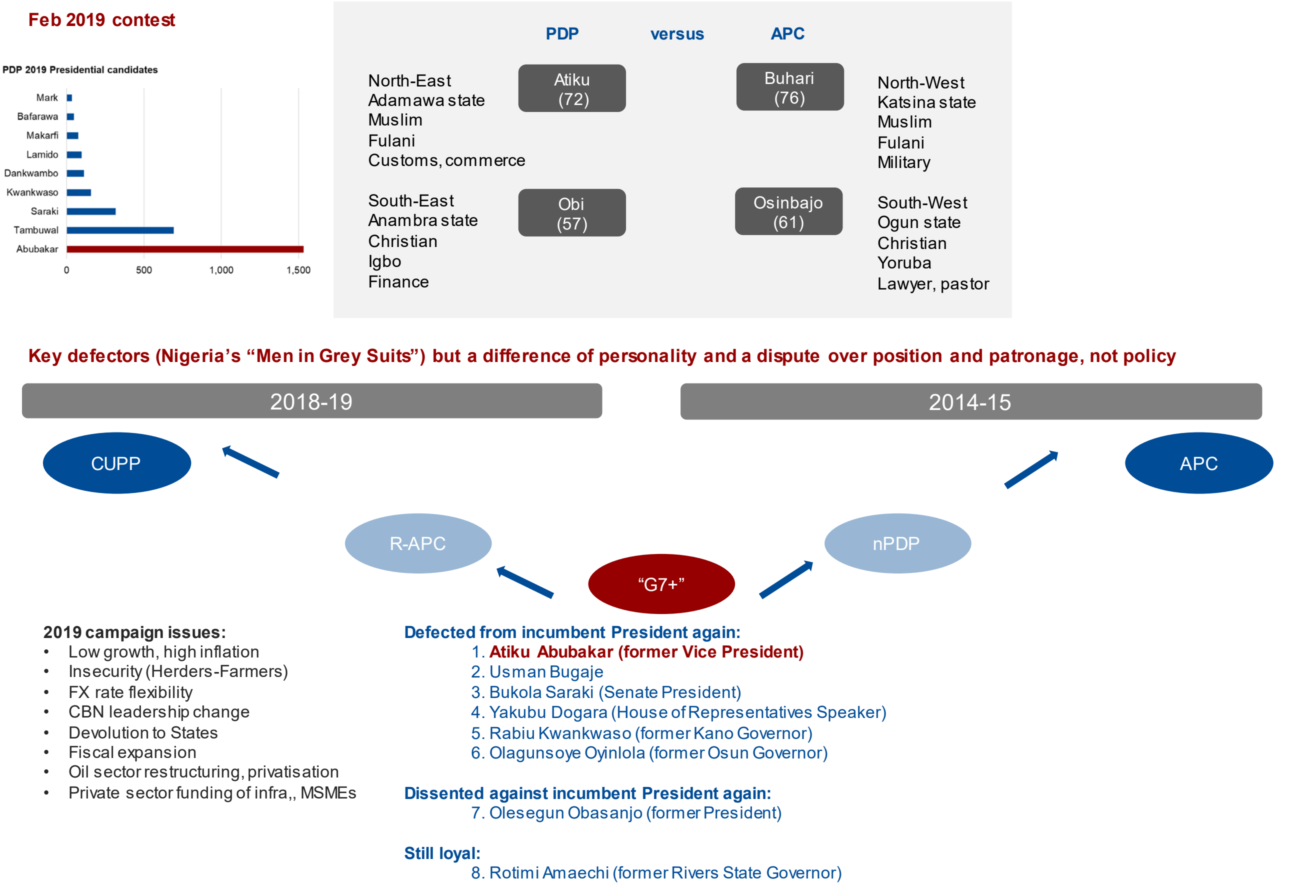
The Nigerian presidential election on 16 February will see the incumbent President Muhammadu Buhari (of the All Progressives Party, APC) face off against former Vice President Atiku Abubakar, widely known as Atiku (of the People's Democratic Party, PDP); both are northern Muslim candidates.

The current vice president, Yemi Osinbajo (a Christian from the southwest), who is, arguably, both more popular and more technically inclined than the president, will face an equally strong contender in Peter Obi (a Christian from the southeast and a former governor of Anambra State), who is running alongside Atiku.

Ultimately, both candidates' choices of vice president should be seen as a positive, but also provide insight into the likely platforms of each presidency, something that is often difficult as Nigeria's political parties have frequently been accused of lacking defining ideals rather than providing platforms for individual leaders to emerge from.

Throughout 2018, there has been a multitude of defections across party lines by members of the APC and PDP in order to consolidate individual power, which initially led us to believe that it was unrealistic to expect material differences in policies between the parties. However, in recent weeks, greater differentiation in policy promises has emerged than we previously expected. We discuss these in the following section of this report.

Figure 1: The "G7" swing voters and defectors… from PDP to APC in 2014 and from R-APC to CUPP (PDP) in 2018



Source: Exotix

APC vs PDP – no distinct ideological differences, but key areas of policy/reform could vary

Although the manifestos[1] for both parties come across as very similar, we think key variances in their campaign/economic platforms reflect the APC's more socialist leanings compared with the PDP's capitalist tendencies. However, we stress again, that many differences are driven by individual candidates rather than the party itself. On that basis, we highlight key areas where policy could differ under the different parties:

APC policies and rhetoric: anti-corruption, concessionary lending

Buhari's successful 2015 campaign championed the notion of bringing a greater degree of transparency and a fight against corruption to the country (which has been part of Buhari's agenda since he led a military government for 20 months between 1983 and 1985). The APC line-up generally regards the anti-corruption drive during its current administration as successful, and is basing its re-election campaign on moving Nigeria to the 'Next Level', with a renewed focus on growth, job creation and infrastructure development to counter the PDP's pro-market stance.

The APC's anti-corruption angle is being pushed less during this campaign, and we attribute this to the widespread perception that the president has favoured his allies throughout the clean-up as well as the effort to combat claims of economic stagnation during the current term.

We would expect a continuation of the APC's social intervention programs and concessionary lending (particularly targeting agriculture and MSMEs) if it retains power. Overall, the economic recovery and growth plan (ERGP) should continue to form the basis of the APC's policy actions.

PDP policies and rhetoric: pro-market

The PDP, on the other hand, is aggressively pushing its pro-market rhetoric on the back of Atiku's former private sector experience, with promises to liberalise the FX markets, privatise the Nigerian National Petroleum Corporation (NNPC) and other state agencies, deregulate the downstream oil and gas sector, and facilitate a federal restructuring that shifts more powers and responsibilities from the federal government to the sub-nationals.

Atiku also intends to 'Get Nigeria Working Again' by heavily leveraging private sector partnerships, drawing from his and Obi's (formerly the chairman of Fidelity Bank) experiences in the private sector.

Although the APC uses corruption accusations against the PDP as a campaign weapon, feedback from some international and local investors suggests that the notion of a 'corrupt' PDP in power is preferred to a perceived ineffective APC on reforms and growth. In fact, in a simplistic sense, the election could be framed as a trade-off between a restoration of economic activity and growth at the expense of a higher degree of perceived corruption – although we caution that this is indeed an overly simplistic representation of the nuanced approaches taken by both candidates.

Monetary policy and the Central Bank of Nigeria leadership

Atiku has repeatedly announced his intention to move the naira to a free float, although, in our view, the likelihood of this materialising is greatly limited by considerations around inflation, financial stability, global market conditions and the political backlash that comes at the risk of a potential currency devaluation. That said, we do see prospects for a more flexible FX environment, and hold the view that the country's ability and willingness to make a move towards this would be increased under an Atiku presidency.

There remains great uncertainty regarding succession at the Central Bank of Nigeria (CBN) when Governor Godwin Emefiele's current term ends in May 2019. The markets are likely to react positively to a replacement (which is a certainty under a PDP government, and highly likely under an APC government), given the perception of weak

[1] *APC Party manifesto: https://www.allprogressivescongress.org/manifesto/*

PDP Party manifesto: https://peoplesdemocraticparty.com.ng/?page_id=713 guidance that many investors have taken issue with under this leadership. We discuss the CBN's future leadership in more detail on page 11.

Regardless of the CBN governor appointment, we think a loosening of liquidity conditions is imminent from Q3 19, on the expectation that the CBN's concerns around the currency easing and stimulating growth regains priority. We expect this to occur through a reduction in the issuance of government securities (both Treasury notes and CBN OMOs), as well as a possible normalisation of the artificiality high cash requirement ratio for the banking sector (reported to be 35-40% by the banks versus the 22.5% advertised), which could support credit growth. That said, there could be greater downside risks to inflation under the PDP, going by their fiscal expansion and downstream deregulation plans.

Federal restructuring

Atiku strongly supports a restructuring of the federation, with the view that the states and local governments should be handed more power over issues such as their development priorities, wage structures and revenues from minerals and mines. The restructuring should ultimately provide the Niger Delta states with a higher allocation of oil revenues than they currently have, which the PDP expects will put an end to the agitation in the region.

In our view, improving the states' fiscal position could serve as a key catalyst for more sustainable future growth, although we note that issues around the federal restructuring will likely remain politicised, and this could limit its progress. There could also be fiscal pressure from the commitment to provide the states with grants to incentivise them to generate more internally generated revenues (matching grants of up to US$250mn have been promised to states that make notable progress). Comments from the APC suggests a preference for the status quo to be maintained, based on the national disunity that the current administration claims could emerge.

Fiscal policy

Under the current APC government, fiscal policy implementation has been weak, particularly relating to non-oil revenue generation, capex spending and compression of the interest bill (although the latter, as the IMF correctly points out, is largely driven by an increase in CBN OMOs that has kept supply of government securities high, effectively keeping yields elevated). That said, the oil price decline that started in 2014 – and ultimately resulted in the recession of 2016 and Q1 17 – would have probably significantly hindered any administration with fiscal buffers as weak as Nigeria's. Overall, a more conducive external environment could support an improved performance by the APC if it retains power, although execution continues to be a downside risk. The ERGP should continue to form the basis of the Buhari administration's policy actions.

The opposition has ambitious expansionary fiscal policy plans outlined in its 'Get Nigeria Working Again' policy document. These include lowering tax rates (and widening the tax base), cutting the country's debt burden (by leveraging more private sector partnerships), and allocating more of the country's oil revenues to the sub-nationals (based on the Federal Restructuring plans). These are all in addition to a number of social intervention programs similar to the APC's. With some transfer of power and responsibilities from the federal government to the sub-nationals and the planned privatisation of some government assets, the federal government workforce is likely to be trimmed, although the extent could be limited by political considerations. Moreover, the minimum wage increase that was finally implemented in Jan 2019 could mean a minimal overall impact on recurrent expenditure.

Oil sector reforms

Although expectations were high when President Buhari appointed himself Minister of Petroleum at the start of his current administration, a lot remains unchanged as there continue to be delays in effecting reforms in the sector. The Petroleum Industry Bills could see more speedy passage under the PDP, particularly if the party retains control of the National Assembly, which it gained following the mass defection of lawmakers in July 2018 (about 15 Senators and 37 Reps defected from the APC in one day).

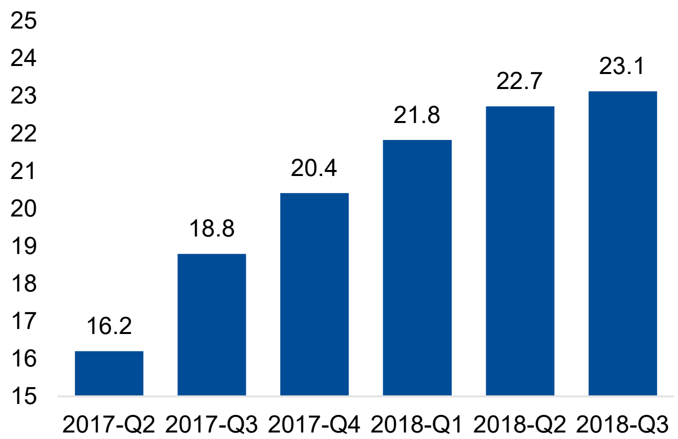
Atiku is a strong proponent for a sale of government oil assets and a privatisation of the NNPC, which would eliminate fuel subsidies (now reported as 'under-recoveries' by the Buhari government). We expect political pushback on the asset sale, contrary to the easy execution that the PDP currently appears to anticipate. Under a Buhari administration, it is unlikely that we would see a full deregulation of the downstream sector, instead a simple reduction in the size of the subsidy (currently cNGN20/litre or 14% of the pump price) is more likely, which could contribute to improvements in the country's fiscal accounts (although would pose downside risks to inflation).

Private sector initiatives

The APC is likely to continue to provide stimulus through concessionary loans (particularly targeting agriculture and MSMEs) and social intervention schemes, as a way of spurring economic activity. The Buhari government has also placed strong emphasis on improving the ease of doing business, as contained in its ERGP policy document. Since the establishment of the Presidential Enabling Business Environment Council in May 2016 anchored by VP Osinbajo, key achievements include a streamlining of the business registration process, the establishment of credit bureaux (to improve MSME's access to credit and risk management), and improvements to the visa application and airport experience for travellers. These have contributed to Nigeria moving up 24 places on the World Bank Ease of Doing Business index since 2015, to 146 in 2019 in fact, the country posted the third largest improvement of any country between 2017 and 2018, however progress has since stalled.

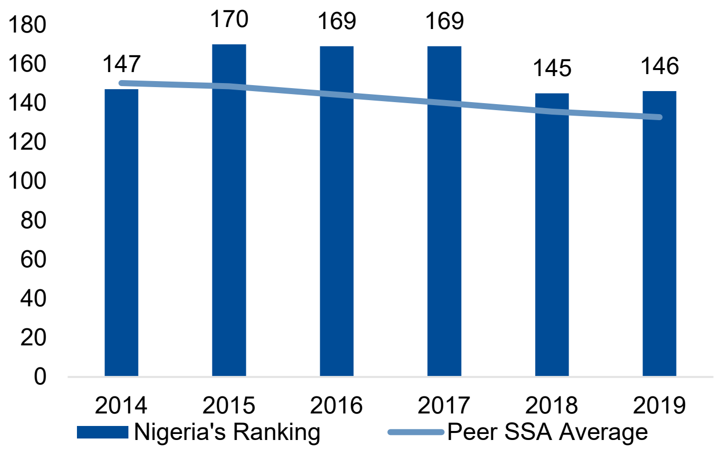
The CBN's latest consumer confidence report suggests that most consumers expect a further increase in the unemployment rate (from 23% in Q3 18) over the course of the next year, which could draw support for Atiku's more capitalist skew, with promises to open up the economy to the private sector and attract FDIs (partly by achieving the lowest corporate income tax rates in Africa – currently at 15% in Mauritius vs Nigeria's 30%). In addition to similar social intervention plans to the APC's and planned tax incentives, Atiku intends to promote private-sector led economic growth. Examples include plans to facilitate private-sector led investment vehicles to fund MSMEs and infrastructure projects.

Figure 2: Nigeria's official unemployment, % of workforce



Source: Nigeria National Bureau of Statistics, Exotix

Figure 3: Nigeria's Doing Business report rankings



Source: World Bank, Exotix

Corruption

The APC's anti-corruption angle is being pushed less during this campaign, and we attribute this to the widespread perception that the President has favoured his allies with the clean-up, by targeting those that may support the opposition and accusing these individuals of offences that members of the APC may also guilty of. That said, we expect Buhari's hard-line approach to corruption to be maintained, irrespective of the disruptive impacts on the economy or governance. Conversely, Atiku intends to take a more preventive approach to tackling graft (in addition to maintaining the corrective measures being implemented by the Buhari government, primarily by improving controls in the government agencies through civil service reforms and improved automation of admin processes. He has also spoken of separating the functions of the government, contractors and the private sector, further consolidating the government's accounts, such that all federal government revenue and expenditure is managed through a single window.

Security

The Boko Haram insurgency is widely believed to have weakened due to efforts of the Buhari administration, although there has been a pickup in attacks in recent months. The current president intends to continue to provide resources to the military and intensify their efforts, while Atiku believes that the high poverty levels in the affected regions have been a major reason for the emergence of the terrorist activity, although it is unclear what his approach to resolve this speedily would be.

The farmer-herder/Fulani Herdsmen conflicts which have impacted food production could be more quickly and easily tackled than the terrorist issues. There has been backlash on Buhari's (who is himself a Fulani) perceived poor handling of the issue, which has contributed to the changes in the power structure in the north-central region of the country (where most of the attacks have occurred) with a swing more to PDP. The Buhari administration approved a National Livestock Transformation Plan in Jan 2019 that creates a ranching scheme for herders, although this could continue to face pushback from some of the larger food producing states, as the issues has become widely politicised. Atiku has also made comments suggesting that the creation of grazing reserves could resolve the conflict, although his manifesto lacks detail on a plan.

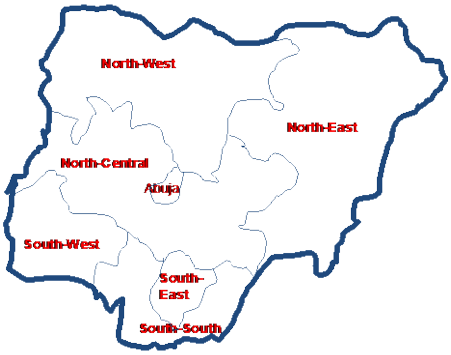
Countdown to the polls – PDP has momentum, but still too close to call

Without reliable polls to give some indication of the possible outcome, and the APC and PDP each wielding the strength of the incumbency and perceived greater competence respectively, we think Nigeria's 2019 election race could be tighter than in 2015.

Data from NOIPolls shows a steady decline in President Buhari's approval rating, which fell to 40% in December 2018 from an average of 73% during his first six months in office in June-Dec 2015. Respondents have cited economic performance, job creation and poverty alleviation as key areas of underperformance. Atiku has long-standing accusations of corruption to contend with, although we believe the perception that he comes with more competence could offset this. The VP candidates are also key considerations for voters, with many strategically considering the possibility of Buhari's health issues re-emerging and an Osinbajo takeover, as a preferred outcome over a PDP win.

Regional power structure matters a great deal

Figure 4: "Zoning" binds Nigeria (but hampers policy execution)



Source: Exotix

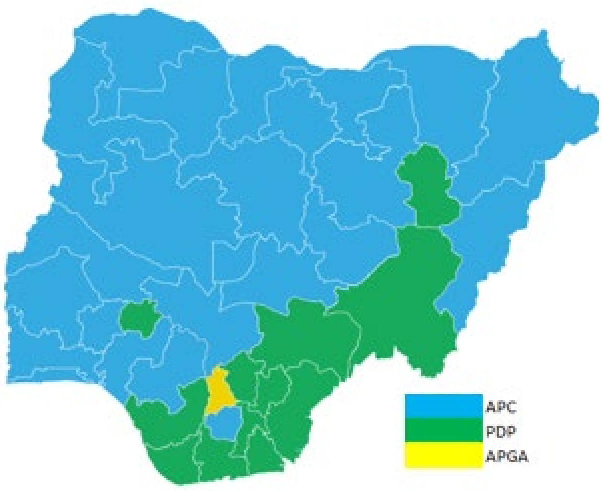
Based on recent developments in the political space, we highlight the following points regarding changes to the power structure in the various geopolitical zones:

1. **South East and South South:** The PDP has historically won both of these regions and is likely to retain control, particularly with Obi (a Christian from the South East) on the ticket and the perception that the Niger Delta remained largely marginalised under the Buhari government. This is in spite of the defection of Goodwill Akpabio (former Akwa Ibom Governor and minority Senate Leader) who was a major PDP stalwart, to the APC.
2. **South West:** Drawing strong support from former Lagos State Governor, Bola Tinubu, the APC has historically controlled this region. Because this region has a high concentration of the educated voters/the elite, it is likely that the votes swing more in favour of the PDP than has been the case in the past, due to the perception that Atiku will deliver a stronger economy. We think both parties are on broadly equal footing in this region.
3. **North Central:** Although the APC drew strong support from this region in 2015, there has been a major shift in power towards the PDP, following the defections of key politicians from the region led by Senate President Bukola Saraki, and the President's perceived poor handling of the farmer-herdsmen conflict in some states in the region. Consequently, we think this region is likely to swing to the PDP.
4. **North East and North West:** Buhari has historically drawn strong support from these regions, even prior to his 2015 victory, likely due to the profile of his opponents who have mostly been Christian Southerners. PDP's Atiku is also a Northern Muslim, which changes the dynamic in this year's polls.

The APC currently controls 24 of the 36 states, while the PDP has 11 sitting governors (Figure 5 below). Also, during the 2015 elections, the APC drew strong support from the North East, North West, North Central and South West regions, while the PDP dominated in the South South and South East.

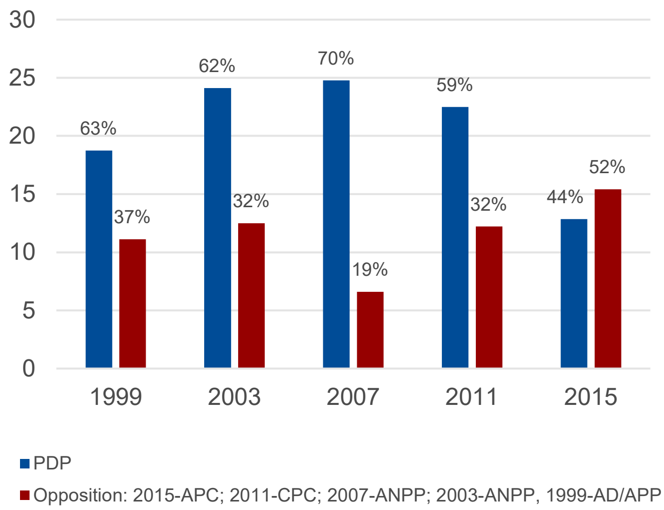
As shown in Figure 6 below, the PDP has historically gathered a c60% minimum of the presidential votes, with the exception of 2015 when the party's internal divisions and defections to the APC at the time (including Senate President Saraki and Atiku) supported the APC in gaining the upper hand. With the PDP team appearing to have done a better job of banding together after regaining some of its key influencers, the APC does appear to be facing a revived force. Also, it is worth highlighting that even in 2015, when the PDP lost, it still gathered more votes than its major contenders have historically.

Figure 5: Current Governors' political parties



Source: Nigerian Embassy DC, Thisday, Exotix

Figure 6: Voting pattern, PDP vs APC



Source: INEC, National Democratic Institute; APC numbers in 1999-2011 are based on the results for the merged political parties from which it was formed

Unfolding political drama reveals a still fragile electoral process

Our broad view is that the Nigerian democratic system has matured markedly since the military handover in 1999, with the peaceful transfer of power by the PDP (under Goodluck Jonathan) improving the perceived credibility of the country's electoral process. That said, there are a renewed concerns around the upcoming polls, which we think is attributable to a number of dramatic events that have occurred recently. We chronicle some of these below:

1. Ekiti state elections in July 2018, in which there were allegations of fraud, misconduct and vote buying. Both the APC and PDP were accused, with APC allegedly paying more. The APC candidate emerged as the winner.
2. Reports of voting irregularities in the Osun state elections in September 2018, which were initially declared inconclusive, and had to be re-run. Here as well, the APC candidate was eventually instated.
3. The Economic and Financial Crimes Council (EFCC) re-opened a case regarding transactions which occurred between Nov 2014 and March 2015, under the previous PDP administration. The CEO of Fidelity Bank was called for questioning several times as part of this case; however the bank has since received an affidavit from the office of the Attorney General clearing it from prosecution. Note that Peter Obi, the candidate for Vice President in the PDP was Chairman of Fidelity Bank in the past.
4. Delays in the confirmation of Walter Onnoghen as Chief Justice of Nigeria in 2017, and his removal by the President in Jan 2019, for failing to disclose assets as required of Nigerian public officials. His suspension is widely thought to be politically motivated due to the timing, given that the Supreme Court could be required to weigh in on disputes regarding the elections results. That said, it is important to note that Justice Onnoghen had previously been accused of failing to declare his assets, and had been asked to resign, but refused.
5. Reports saying the PDP presidential candidate could not travel to the US were followed by his much-publicised visit in January. Nigeria's Minister of Information has since accused Atiku of playing a part in the collapse of a lender called Bank PHB.
6. The launch of Trader Moni, a collateral-free loan scheme targeting petty traders and artisans, by the current administration. Transparency International has said this is a form of voter inducement.
7. As part of efforts aimed at fighting corruption, the current administration has (a) introduced Executive Order 6, which allows the government to take various actions against persons suspected of corruption, including restricting travel and freezing assets; and (b) introduced a 35% tax on Nigerians' foreign assets in October 2018. There's a 12-month grace period to declare such assets.

The main concerns around these events are that in the context of the upcoming elections, the timing might be seen as questionable, and the current administration appears to be targeting those that may support the opposition and accusing these individuals of offences that members of the APC may also guilty of. It is possible that the prosecution of former Secretary General of the Federation, Babachir Lawal (who is close to Buhari) is an attempt to counter the anti-corruption bias that currently plagues the APC camp.

Worst case scenario – what to expect in a standoff

Based on the Nigerian constitution, a presidential candidate will be elected after attaining both the highest number of votes and receiving at least 25% of votes in at least 24 of the 36 states and the Federal Capital Territory (FCT).

In the event that no candidate meets this criterion, a second election will be held between the two leading candidates within seven days of the pronouncement of the first results. A run-off election could give the ruling APC party the opportunity to tilt the results in their favour, based on the outcome of elections held in Ekiti and Osun States recently (see preceding section). It could also create the opportunity for both parties to negotiate for support from other parties, although we believe that the PDP is likely to gather greater support, having already received endorsement from the Coalition of United Political Parties (CUPP).

Election result disputes would be settled in the courts, and although in practical terms the lower courts usually decide on the cases before it reaches the Supreme Court, there are concerns that the recent moves against the Justice Onnoghen (who could in theory influence junior colleagues) is the APC's attempt to secure a victory at all cost.

Overall, we do not expect a breakout of violence over the elections. Atiku promises to accept the election results, while Buhari has made recent statements commending ex-President Jonathan for a peaceful handover.

The CBN's future leadership rests on politics

In our view, a change in leadership at the CBN could pose substantial risks (both positive and negative) to the broader economy and, specifically, to financial stability. Assuming a base case where there is a change in the bank's leadership, a shift towards a more flexible but managed exchange rate regime may be associated with somewhat less regulatory forbearance towards the banking sector, especially as it relates to risk asset and liquidity concerns.

There remains great uncertainty regarding succession at the Central Bank of Nigeria when Governor Godwin Emefiele's current term ends in May 2019. In our view, the markets are likely to react positively to a replacement (which is a certainty under a PDP government and highly likely under an APC government), given the perception of weak guidance that many investors have taken issue with under this leadership.

Given the single-tenure of the recent permanent CBN governors (table 1 below), we see a strong likelihood of Emefiele being replaced. In the following sections, we discuss the implications of the change in leadership on the macro and the banks.

Table 1: Central Bank of Nigeria governors

Governor	Previous role	Tenure	Regional zone
Godwin Emefiele	CEO, Zenith Bank	Jun 2014 - date	South South
Sanusi Lamido Sanusi	CEO, First Bank of Nigeria	Jun 2009 - Feb 2014	North West
Charles Soludo	Chief Executive, National Planning Commission	May 2004 - May 2009	South East
Joseph Sanusi	CEO, First Bank of Nigeria	May 1999 - May 2004	South West

Source: CBN, Exotix Research

Implications for macroeconomics

Regardless of the CBN governor appointment, we think a loosening of liquidity conditions is imminent from Q3 19, on the expectation that the CBN's concerns around the currency ease, and stimulating growth regains priority. We expect this to occur through a reduction in the issuance of government securities (both Treasury notes as well as CBN OMOs), as well as a possible normalisation of the artificiality high cash requirement ratio for the banking sector, which could support credit growth. That said, there could be more downside risks (higher) to inflation under the PDP, going by their fiscal expansion and downstream deregulation plans.

Implications for banks

We take a binary approach to assessing the impact on the banking sector, depending on whether the incoming governor is an ex-banker or not. The appointment of another ex-banker could mean continued implicit support for the banks, as has been the case under the current leadership (although judging by feedback from the banks, regulatory conditions have tightened under this governor). Instances of such support are:

1. In 2017, the banks were allowed to translate their balance sheets at the CBN rate of cNGN306/US$ (although the realisable rate was NG360/US$ based on trades at the IEFX window), which limited the impact of the devalued currency on asset quality and capital positions.
2. In 2016, the CBN permitted the banks to write-off fully provisioned NPLs without having to wait the mandatory one-year period – the NPL trend actually deteriorated during that year, but numbers could have been worse without the forbearance.
3. The Skye Bank (now Polaris Bank) bailout and liquidity support granted to some of the smaller banks.

With a non-ex-banker at the helm of the CBN, the focus could shift more towards stimulating growth with the adoption of policies that could further disrupt the current operating models of the banks. Overall, the elevated headline risk has at least five potential implications for Nigerian banks, in our view:

1. **Subdued credit growth.** Firstly, we expect risk aversion (particularly as government securities remain attractive) and weak credit demand from corporates (itself a consequence of poor consumer demand) to continue to limit loan volumes in the short term. Secondly, regulations around the artificiality high cash requirement ratio for the banking sector (reported to be 35-40% by the banks vs the 22.5% advertised) are unlikely to be reviewed until a new CBN governor is appointed, and this could dictate the ability of some of the banks (particularly within Tier 2) to lend aggressively.
2. **Increased focus on non-interest revenues.** Although the weak penetration of consumer/retail credit in Nigeria also presents opportunities for the banks to chase high-yielding retail assets, the focus for most banks' retail strategy is on building deposits, from which a steady stream of transaction volumes can be generated. With CBN's refreshed plans to improve financial inclusion, we could see the non-bank financial institutions gain greater access to the financial system, building on the establishment of payment service banks (PSBs), which could include the telcos. In our view, the commercial banks are still largely protected, particularly because the PSBs are restricted to rural areas, and we believe that the most commercially viable customers have been captured in the financial system. This explains why the CBN is taking the lead on driving financial inclusion rather than the banks, in our view.
3. **Capital and liquidity requirements could become more stringent.** We expect the initial focus of the CBN governor to be on running stress tests on the individual banks and the sector to determine areas of weakness. This should be followed by the implementation of BASEL III, which could be introduced as early as in Q2 this year, according to reports. The Nigerian banking sector is currently in compliance with BASEL II requirements, with some adoption of the capital definition and regulations aspects of the BASEL III accords already in place for the domestic systemically important banks (including all within Tier 1). The major changes could come from the liquidity and leverage-related regulations, and it is possible that the CRR is adjusted to manage the impact of the new regulations on the banks' growth prospects. We could see further M&A activity on the back of this development, and already standing liquidity and capital constraints facing the Tier 2s in particular.
4. **Further NGN weakness is not all negative:** There are concerns that the election cycle and investor outflow could lead to a weaker currency. While this would result in an increase in the banks' risk-weighted assets (as some of these are foreign currency denominated), it should also lead to income statement gains as many of the banks are long foreign currency.

Contact radsales@exotix.com for our detailed stock-level conclusions.

Macro outlook in brief

GDP growth

- We should see a moderate improvement in GDP growth in 2019f to 2.4%, largely driven by the non-oil sectors (c90% of total GDP). We expect a pick to 2.6% in 2020f.
- Activity in the non-oil sector should be supported by an improvement in consumer demand as consumer confidence improves and the minimum wage increase is effected (at least at the Federal level). The potential for lower interest rates and improved credit availability (albeit weak) in H2 19 should also be supportive.
- The agriculture sector (28% of GDP in 9M 18) suffered from drought conditions and farmer-herdsmen clashes in 2018 in some food producing areas. The clashes remain on-going and pose downside risks to the sector, with a negative though impact on food inflation.
- The trade sector (16% of GDP) was in recession in H2 16-H1 18, finally recording 1.0% growth in Q3 18 and should continue to support growth particularly FX liquidity issues now appear to be in the past, and as consumer spending picks up and commerce improves after the elections. This should also support manufacturing (9% of GDP)
- Oil sector growth may be restricted by lack of investments and a possible adherence to OPEC production cuts to stabilize oil prices, although the start of production at the Egina Oilfield in Dec 2018 (adding 0.2mbpd to production) presents upside.
- Key risks include an escalation of disruptions to activities in the agriculture sector, resurgence in militancy activities in the Niger Delta and lower oil prices hindering the availability of FX in the economy, and sustained weak credit growth.

Lower oil prices and production cap may limit revenue growth

- While the 2019 budget has yet to be passed, we point out the proposed benchmark oil price of US$60pb may be aggressive given current market conditions.
- Revenue disbursement by the Federation Account Allocation Committee in 2018 were 36% higher yoy, driven by higher oil prices and production.
- However, with the cap on production (1.68mbpd vs the 2.3mbpd budgeted) and the recent slide in oil prices, further improvements in 2019 may be reliant on stronger growth in the non-oil sector and the government’s tax collection efforts.
- Furthermore, the administration’s spending capacity may be hindered by the slight reduction in the size of the proposed budget (3% lower than approved 2018 budget), and higher borrowing costs to finance the deficit as a result of higher yields domestically and offshore.

FX stability is the CBN’s primary focus, but NGN is close to fair valuation

- The CBN has defended the NGN by increasing its intervention at both the parallel and IEFX window, with support from the recent US$2.9bn Eurobond issuance, which halted the decline in foreign currency reserves and pushed it to cUS$43.3bn currently (9 months of import cover).
- While inflation differentials result in an overvaluation of the Real Effective Exchange Rate (REER) by c11% (implying a fair valuation of the NGN/US$400), our internal EBA/REER blend model suggests an overvaluation that is just below 5% (fair valuation of NGN380/US$).[2]
- This suggests that a move towards a floating FX regime would be unlikely to lead to a significant depreciation of the exchange rate, and could actually show an

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[2] The EBA (External Balance Assessment) is the IMF’s internal FX valuation methodology, which considers both inflation differentials as well as BOP flows to establish a fair valuation of the nominal currency.

appreciative trend if capital inflows (both FDI and FPI) were to increase after the election.

- Under an Atiku led government, it is likely that we see a CBN work towards a managed float of the naira (and eventual move towards a free float) – the same is likely under a Buhari led government, albeit at a much slower pace.

Inflationary pressures to remain in the near term; interest rates should begin a downtrend in H2 19

- We forecast a pick up in the inflation rate in 2019f, but see scope for a slowdown in 2020f.
- Minimum wage increases and on-going disruptions to the agriculture sector due to farmer-herdsmen conflicts are sources of short-term inflationary pressure. Possible PMS and electricity tariff rate increases, more likely under an Atiku government could be potential longer-term pressure areas.
- A loosening of liquidity conditions is imminent, on the expectation that the CBN's concerns around the currency ease, and stimulating growth regains priority.
- We expect this to occur through a reduction in the issuance of government securities (both Treasury notes as well as CBN OMOs), as well as a possible normalisation of the artificiality high cash requirement ratio for the banking sector (reported to be 35-40% by the banks vs the 22.5% advertised).
- We think the expected 50-70bps average drop in market interest rates will have a stronger impact on risk pricing, and should support growth expectations and the fiscal side. A cut in the MPR is likely through 2019f, although it continues to have a weak transmission rate to the economy.

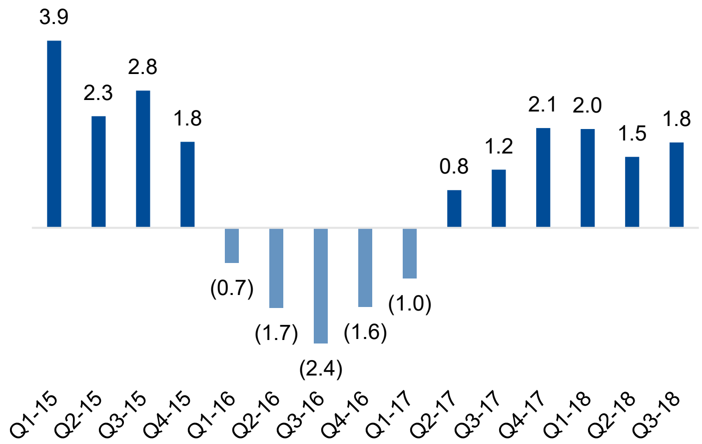
Beyond the elections: some critical reform areas

GDP – diversifying the economy and sources of growth remains key

While there have been a few positives on the macro front in recent years, Nigeria's economic recovery remains frustratingly stagnant. A decline in global oil prices beginning in 2014, combined with production issues in 2015 and 2016, led to the country's first recession in 25 years. While both prices and production have recovered since then, resulting in the country posting positive growth numbers starting in Q2 17, the economic recovery remains frustratingly slow – growth has averaged a mere 1.5% over the past six quarters. This number is all the more disappointing when considering that Nigeria's population, already the largest in Africa, is projected to grow at c1.9% over the medium term, suggesting that real per capita growth is actually declining.

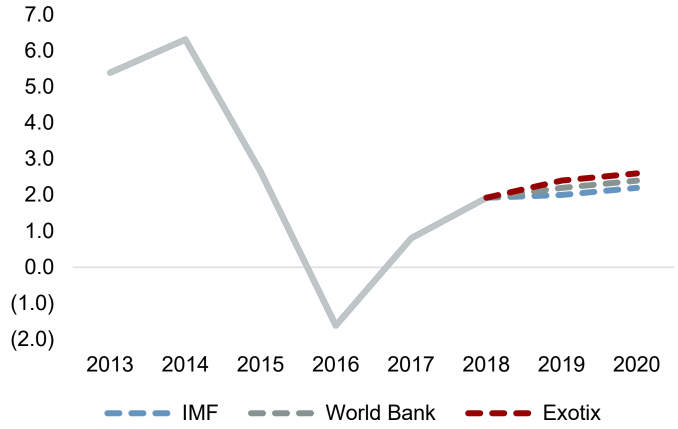
We remain slightly more optimistic, albeit only marginally, than both the IMF and the World Bank, currently projecting 2019 growth of 2.4%, largely driven by the non-oil sector. We expect a pick in growth to reach 2.6% in 2020.

Figure 7: Quarterly real GDP growth, yoy %



Source: Central Bank of Nigeria, Exotix

Figure 8: Real GDP growth forecast



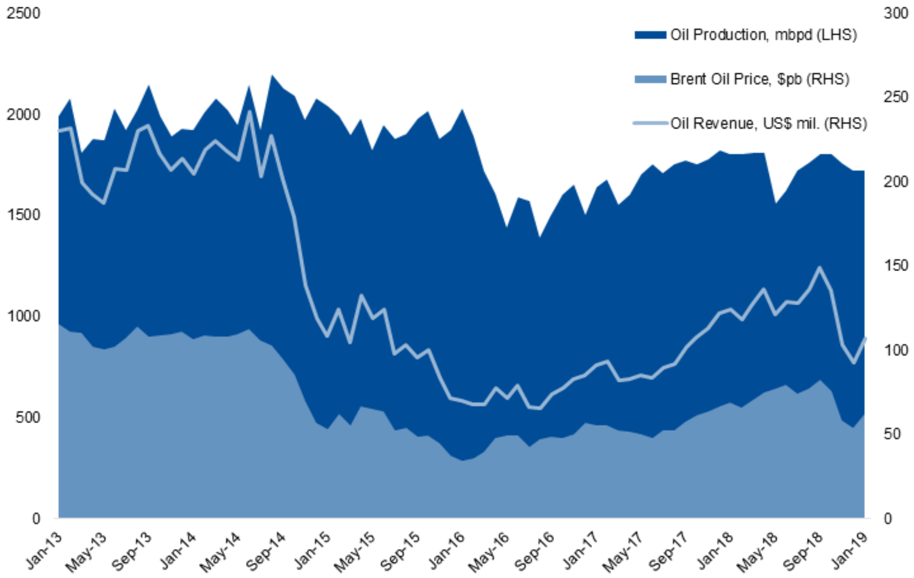
Source: IMF, World Bank, Exotix

In our view, Nigeria's structural challenge will be to diversify not only its economy but its sources of growth. With the commencement of the production at the Engina Oilfield in Dec 2018, potential output is higher by 0.2mbpd vs the c1.9mbpd production level achieved in 9M 18. While this is positive, it is important to keep in mind that the oil sector only comprises c10% of total economic activity and, oil alone will be insufficient in driving Nigeria's economy in the future. While some incremental progress has been made in developing domestic agriculture, many sectors remained hampered by lack of consumer and producer confidence as well as a lack of private sector credit that has suffered a sharp squeeze through government crowding out as well as the high rates of cash reserve requirements held at the central bank.

Oil revenues

Declines in oil prices and production beginning in 2014 led to a massive deterioration in the country's oil revenue, ultimately resulting in a recession. While prices fell again in Q4 of last year, we have seen a 20% increase in oil prices from the low in December, with current oil prices of cUS62pb (though they remain c15% lower than the 2018 average), and c30% lower than the high of over US$86 recorded in October. Higher oil prices are obviously a boon for the country, but there are two natural hedges built into the Nigeria oil arena; the first being the country's lack of refining capacity. While higher oil prices result in higher export revenues, they simultaneously increase the country's import bill on the back of higher expenditures to reimport the refined product (Nigeria consumes c400k bpd). The second hedge built into this system is the final pump price paid by consumers, currently set at NGN145/litre – making it one of the lowest in the world. The reason this price is so low results from a subsidy provided by the NNPC which results in the federal government being forced to provide a larger effective subsidy (currently cNGN20/litre or 14% of the pump price) to consumers, the higher the global price of refined petroleum is. That is, so long as the subsidy remains in place.

Figure 9: Oil price and production

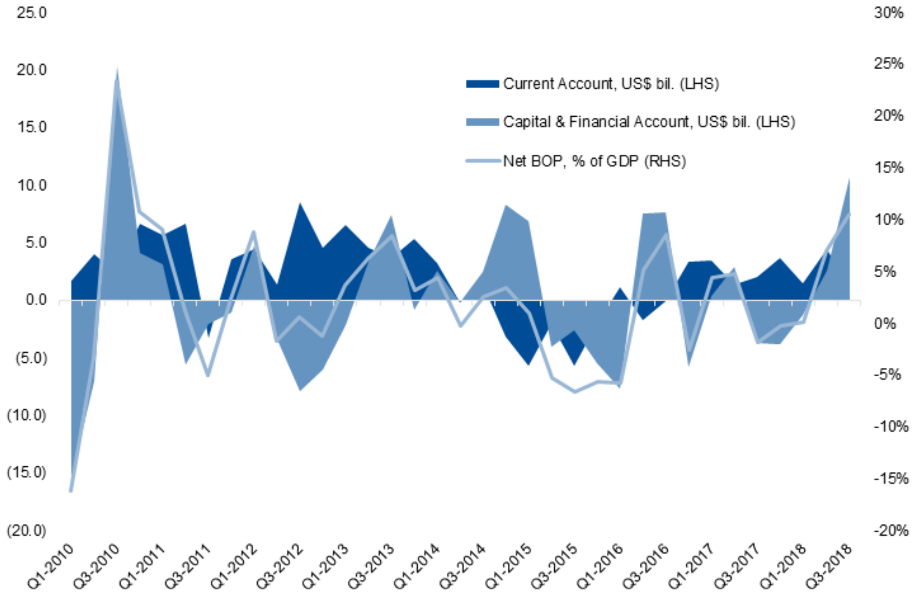


Source: Bloomberg, Haver Analytics, Exotix

Atiku has spoken openly about perceived corruption within the "black box" organisation of the NNPC and has called for a full privatisation of the Nigerian oil sector, thus eliminating the subsidy in so doing. We believe that it will be necessary to reform the fuel subsidy regardless of who wins the upcoming election, although it is unlikely that there will be a full privatisation under a Buhari administration. Much more likely is a simple reduction in the size of the subsidy, which could make a significant improvement to the country's fiscal accounts.

Anyone following the Nigerian oil sector will be paying very close attention to the ongoing construction of the Dangote refinery, which when online, is expected to refine c650,000 barrels per day, making it the largest oil refinery in Africa and one of the largest in the world. Although some sources have suggested that the refinery will not be online until 2022, based on recent progress being made, we estimate production will begin during the latter half of 2021.

Figure 10: 2018 showed a net surplus in the country's BOP



Source: IMF, Haver Analytics, Exotix

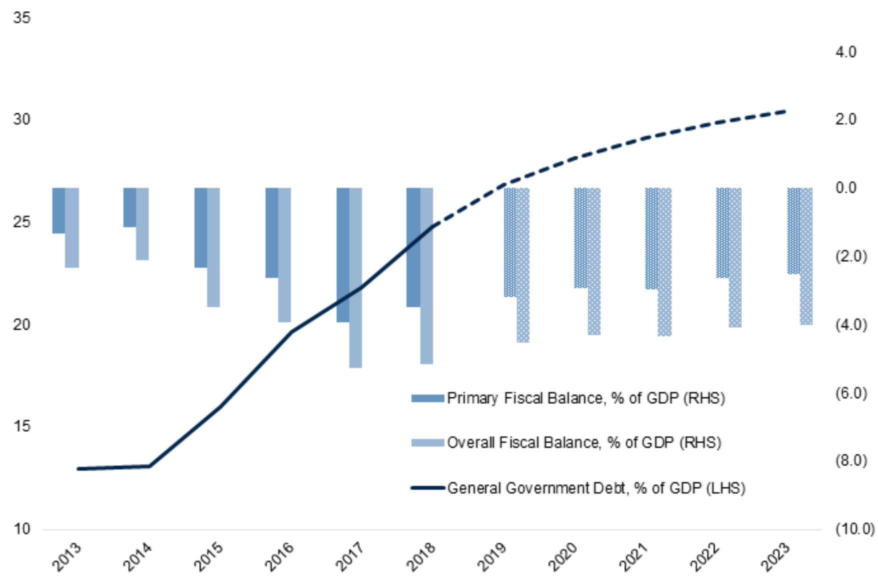
The other area where we would like to see reform, or at least a short-term adjustment in prioritisation, would be to see additional revenue flow into the TSA (Treasury Single Account) rather than into the Excess Crude Account (ECA) and Sovereign Wealth Fund (SWF). As we have written in the past, many of the nominal benefits of higher oil prices are not actually being accrued by the Federal Government in terms of increased revenue, as any revenue above the budgeted oil price and production levels ($60bpd and 2.3mbpd for 2019) is siphoned away from the TSA and into various other accounts. While the SWF has very strict legal limitations on how spending can be conducted, the ECA lacks any formal mandate that dictates how spending can and should be conducted, which has frequently led to political debates regarding its existence. While commodity-based SWFs and stabilisation funds offer clear macroprudential benefits, we believe that it is important to weight them fairly against their costs, that is the counterfactual fiscal stimulus that would otherwise be achieved.

Conversations with the CBN suggest a strong preference for the mandatory saving mechanisms of the SWF for two reasons. The first is a visible commitment to saving (although one must question this commitment so long as it is not voluntary) and secondly, the CBN obviously favours fiscal buffers that ultimately help to insulate them from necessary action in the case of future shocks. The CBN is clearly not wrong to hold these beliefs, however, as previously stated, one must carefully examine the costs and benefits, and thus we question both the need and timing of the SWF. Firstly, the country's tightly managed FX regime already prevents any appreciation of the exchange rate, effectively removing the sterilisation gains normally associated with SWFs, and secondly, given the current concerns about fiscal sustainability, one must certainly question the timing of a fund that cuts into the desperately needed federal revenue.

Fiscal policy

Despite the aforementioned rebound in the oil sector, the federal government has been unable to mobilise these additional revenues in terms of an improvement in fiscal accounts. This is partly to blame on the ECA and SWF that cut into any "excess" revenue generated from the sector – effectively putting a ceiling on potential returns, while also increasing subsidy being provided by the NNPC. However, the main drag on the government's fiscal accounts, unfortunately, remains a simple lack of revenue mobilisation through tax receipts.

Figure 11: Large fiscal deficits lead to increased debt levels



Source: IMF, Exotix

Nigeria's fiscal revenue to GDP ratio currently averages c5%, one of the lowest in the world. As mentioned earlier, there could be a distinct difference in revenue mobilisation under a Buhari-led government vs that of Atiku. The latter has announced his intentions to lower taxes, ultimately leading to a question of whether fiscal multipliers are likely large enough to generate a revenue increase through increased economic activity.

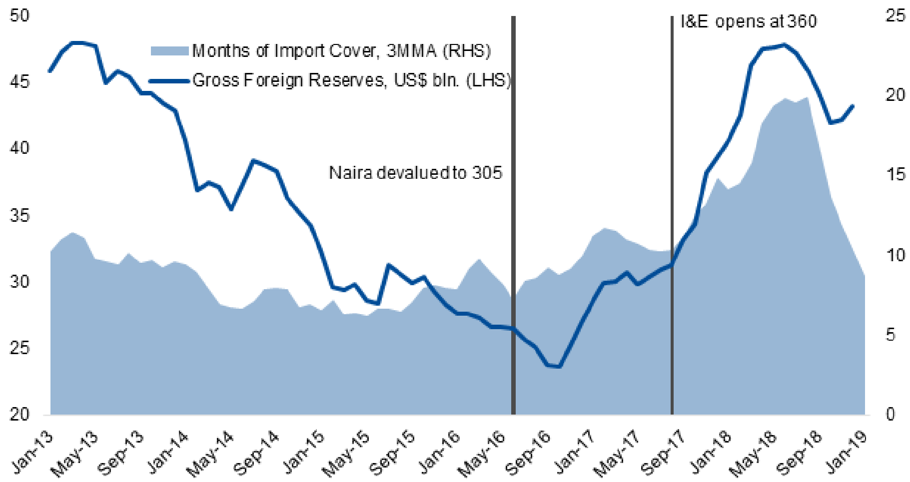
A second issue faced by the country is the often-cited debt service to revenue ratio, which the IMF currently projects to be 51% in 2019, i.e. for every NGN100 that the federal government collects in revenue, NGN51 is used to cover the interest on its debt stock, severely limiting the federal government's non-interest expenditure. After interest costs are accounted for, roughly 85% of government expenditure is being spend on meeting current, or recurring expenses, to which a chronic underfunding of infrastructure development can be attributed. Regardless of whichever candidate is elected, longer term capital expenditure would need to be prioritised.

Monetary policy

Nigeria still operates a multiple exchange rate system, which creates a distortionary effect on production and consumption across the country. The primary rates/windows that are currently operating are:

- IEFX Window (NGN362.5/US$) – based on the NAFEX indicative rate, and used in c70% of all non-official transactions
- Special Market Intervention Systems window (retail/wholesale) (NGN356-359/US$) – used for forward contracts and FX intervention sales to corporates and individuals; this rate was at the NGN323/US$ until a convergence was achieved in Q2 2018; the rates depend on the tenor of the forward contracts.
- Black Market/Bureau du Change (NGN360/US$) – parallel market rate.
- CBN official window (NGN306/US$) – primarily used for oil-related import and exports and official government transactions.

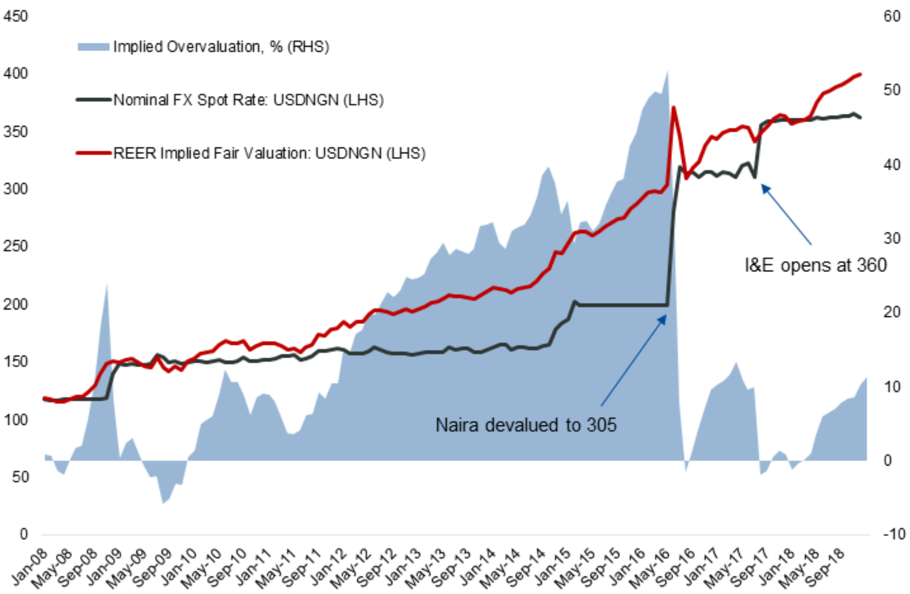
Figure 12: Reserve balance vs. months of import cover



Source: IMF, Haver Analytics, Exotix

It is important to state the relative success of the CBN's convergence of windows, the official FX devaluation in 2016, and the introduction of the IEFX window in 2017 – which all led to significant increases in capital inflows, also reflected in the market capitalisation of the Nigeria Stock Exchange All Share index increasing 42% throughout 2017, before reversing course and tumbling 18% in 2018. The attractiveness of the currency also helped the CBN more than double its stock of foreign reserves between October 2016 and June 2018, in addition to the stronger oil revenues. Despite these positives, however, the prevailing view amongst market participants is further convergence of FX windows combined with greater FX flexibility will be required to in order to achieve long- term competitiveness.

Figure 13: Nominal vs REER implied fair value of the Naira



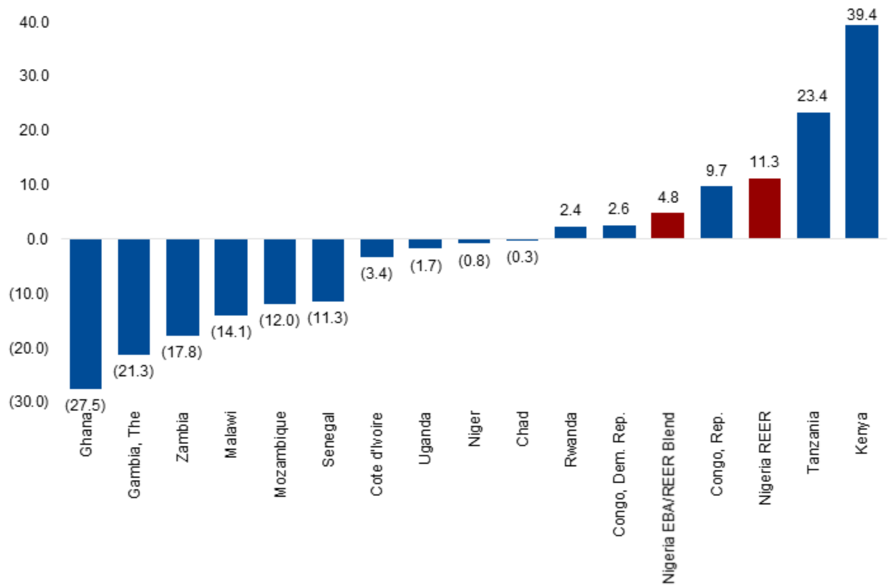
Source: Bruegel, Bloomberg, Exotix

Atiku has repeatedly announced his intentions to move the naira to a free float. The country's willingness and ability to make this move is greatly increased under an Atiku presidency, in our view. However, even under a Buhari-led government, there is likely scope for improvements, albeit at a significantly slower pace. The issue is further complicated as there remains great uncertainty as to whether Godwin Emefiele, the CBN Governor, will stay in his position or be replaced when his current term ends in

June 2019. We believe that markets would react positively to a replacement (which is a certainty under a PDP government, and merely likely under an APC government) as otherwise we are likely to suffer from the lack of guidance that many investors have taken issue with throughout his reign.

In terms of FX valuations, there is debate as to whether a managed, or free, float would lead to currency devaluations. While inflation differentials result in an overvaluation of the Real Effective Exchange Rate (REER) (by c11% implying a fair valuation of the NGN/US$400), our internal EBA/REER blend model suggests an overvaluation that is just below 5% (fair valuation of NGN380/US$). This suggests that a move towards a floating FX regime would be unlikely to lead to a significant depreciation of the exchange rate, and could actually show an appreciative trend if capital inflows (both FDI and FPI) were to increase after the election.

Figure 14: Naira REER overvaluation vs select SSA currencies, %



Source: Bruegel, Bloomberg, IMF, Exotix

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