



Nigeria Strategy Report

H2 2015



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SUMMARY

Global economic growth disappointed over H1 15, as an unexpected contraction in US GDP growth coupled with sustained economic weakness across EM countries more than offset economic expansion in Europe and Japan. The continuing slowdown in EM economies, with China's growth slowing to its lowest in six years, heaped more pressure on commodities, as over-supply picture ensured commodity prices remained at a significant discount to 2014 levels. Despite lower energy prices which induced deflationary pressures, uptick in economic activities in the euro-zone bolstered by commencement of ECB's €60 billion bond buying program ensured that the region come out of a four-month deflation in April, but the same could not be said for UK whose inflation turned negative in April, for the first time in 55-years while Japan's core inflation dipped further.

Following the weak macro-economic picture, the Federal Reserve postponed interest rate normalization, whose timing as well as growing concerns of a possible Grexit was responsible for a contraction in FPI flows to EM countries. The contraction which was most evident in EM Europe, despite ECB's sustained monetary easing, reflected concerns over Greece and continued tensions in Russia-Ukraine, crises while economic challenges in Africa ensured a slowdown of capital flows to the region. The macro-economic challenges which drove reduction in capital flows to Africa included weaker commodity prices, Ebola epidemic, political uncertainty, rising insecurity and weaker growth among its trade partners – it also necessitated multiple credit rating downgrades by relevant agencies. The resultant effect of reduced autonomous flows as well as lower export proceeds (a direct consequence of softer commodity prices) delivered significant pressures on the region's currencies and financial market performance. Focusing on the region's largest economy, Nigeria, where reduction in oil proceeds (₦1.5 trillion oil income in the first four months of 2015 is the lowest in five years) and contraction in oil production combined with deceleration in non-oil GDP to drive lowest quarterly GDP growth rate since Q4 12. The weak economic growth as well as heightened political uncertainty following the postponement of the general election in February weighed on equity and bond markets, in addition to inducing significant

pressures on the Naira. Consequently, to stem the falling currency, the CBN initially embarked on both monetary tightening and utilization of administrative measures, before restructuring the FX market to an order based 2-way quote (OB2WQ) which resulted in improved naira fortunes thereafter. Compounding the dour economic picture was sustained acceleration in inflation, which hit a twenty eight month high of 9.2% in June 2015 (mean H1 15 inflation: 8.7% vs. 7.9% in corresponding period of 2014).

Going forward, the battle among OPEC members to maintain market share as well as potential resolution of sanctions imposed on Iran which would see its 30mb of crude inventory flow into the market keeps current supply overhang picture intact. Tying the glut with subdued global demand outlook as a result of slowing growth in China, excess supply gap should widen, keeping oil prices at current range over the rest of 2015. The bearish outlook for oil prices, and its wider commodity family, poses daunting challenges to economic managers of commodity exporters in the absence of fiscal buffers to smoothen government expenditure. Further complicating H2 15 outlook is the prospect of greater monetary policy divergence as the US looks set to normalize interest rates whilst the ECB and BoJ continue to hold tight on their monetary easing policies to stave off the threat of deflation. With rising concerns of a Grexit, volatility in global financial markets looks set to worsen over H2 15. An interest rate hike in US should impact capital flows to EM with domestic vulnerabilities (trade and fiscal deficits). Focusing on the impact on Africa, capital outflows and commodity induced weakness to current account positions should continue to underpin currency depreciation with implications for fiscal balances and financial markets. Coming home, economic growth in Nigeria is set to remain slow as outlook for both oil and non-oil GDP remain tame. Furthermore, given a combination of softer crude receipts, rising inflation, currency pressures and policy uncertainty post inauguration of the new government, domestic asset classes should remain bearish. Overall, a more volatile external environment, weak economic fundamentals and uncertain domestic policy trajectory dims outlook for a respite in the financial markets performance over the rest of 2015.

INTRODUCTION

The far-reaching commodity price declines of H2 14 and the impact across markets already set the tone for what was to come in H1 15 and in that respect key outcomes seemed all too predictable. However, markets still found a way to throw a few curveballs. Indeed, for a poorly anticipated event, at least in terms of scale and extent, the apparent confidence surrounding expectations for immediate and remote impact of the regime change in oil prices, specifically, spoke to markets' perpetual overconfidence when it comes to assessing key economic drivers. The surprise did not stop with oil, which touched new lows early in 2015 before posting an unexpectedly sustained rebound, as the US Federal Reserve, despite reasonably robust data failed to commence long anticipated rate hikes. The latter appeared partly to reflect stock-taking as to any fallout the new world reality might have directly on the US and partly in consideration for other countries as dollar strength in some ways already delivered much of the expected rate hike impact. Regardless of the Fed's motivation, what was clear was the shambles in most economies as they struggled to grapple with the myriad of aftershocks to the oil price earthquake as fiscal balances, currencies and growth variously came under pressure (with Greece and China as important examples).

Domestically, navigating these global headwinds along with a political transition threatened to prove far too much for domestic markets, more so, as Nigeria had appeared particularly impacted by the H2 14 oil collapse. This was in line with our preliminary assessment, at the time, of a significant vulnerability beyond that in the broader EM space which still found a few bright spots (India, Kenya) to shine a light on the murky path the less well adjusted countries still have to navigate. In that wise and as our analysis reaffirms, the domestic recipe remains simple and the will to push through the required reforms remains as important as, if not more important than, coming up with new means to tackle existing problems. Hence, extending the thoughts from our H1 15 report, reform progress where they have occurred, gaps where reforms are still slow to materialize, and the implications of both

remain an important feature of this piece and our ultimate prognosis is dependent on our inferences in this regard.

The part about political will is perhaps a bit more tricky and bears further attention: whilst markets appeared to roundly applaud the switchover of government—and belief in the will to deliver change must have played a big role given the new leader is hardly a seasoned economic manager, there seems to be a significant shortage of patience in seeing the fruits of that switch in leadership materialize. In many respects, the very scale of problems that underpinned the deep clamour for change should have indicated it would take a lot of time and effort to tackle same, yet markets appear to be sorely disappointed by the 'lack' of activity from government and, in particular, the absence of a ministerial list. Granted, prevailing global uncertainty (Grexit, Iran, further oil downside) also ties neatly into the newfound restiveness in domestic markets. Nonetheless, whilst not discounting influence of government on economic activity—indeed that influence is a key recurrent feature of our analysis of the economic landscape—the pressure on domestic markets seems to have an undertone of jitteriness that suggests that challenges still lie ahead. In this wise, the key assessment parameter for the new government is identified: Will the time taken by the Buhari government and initiatives that come out of the process be bold and insightful enough to change the tide of current challenges and help cope with the inevitable next wave (likely including further downside from oil)? At this point, it would seem very much a waiting game in terms of timing and in what direction that trigger will point, and our recommendations and prognoses very much take cognizance of that.

REVIEW OF GLOBAL ECONOMIC MARKETS

STALLING US MOMENTUM LEAVES GLOBAL GROWTH STUCK ON THE RUNWAY

US slowdown frontruns tamer global growth prospects

Coming into 2015, IMF expectations were for sustained improvement in the US economy and tamer oil prices to over-ride adverse impact of EM growth deceleration on global GDP growth. Whilst oil prices remained soft relative to 2014, momentum in US GDP floundered in Q1 15, allowing further downdraft across EM to dampen global macro-economic conditions. Consequently, the IMF lowered global 2015 GDP growth expectations 30bps, from prior forecasts, to 3.5% YoY.

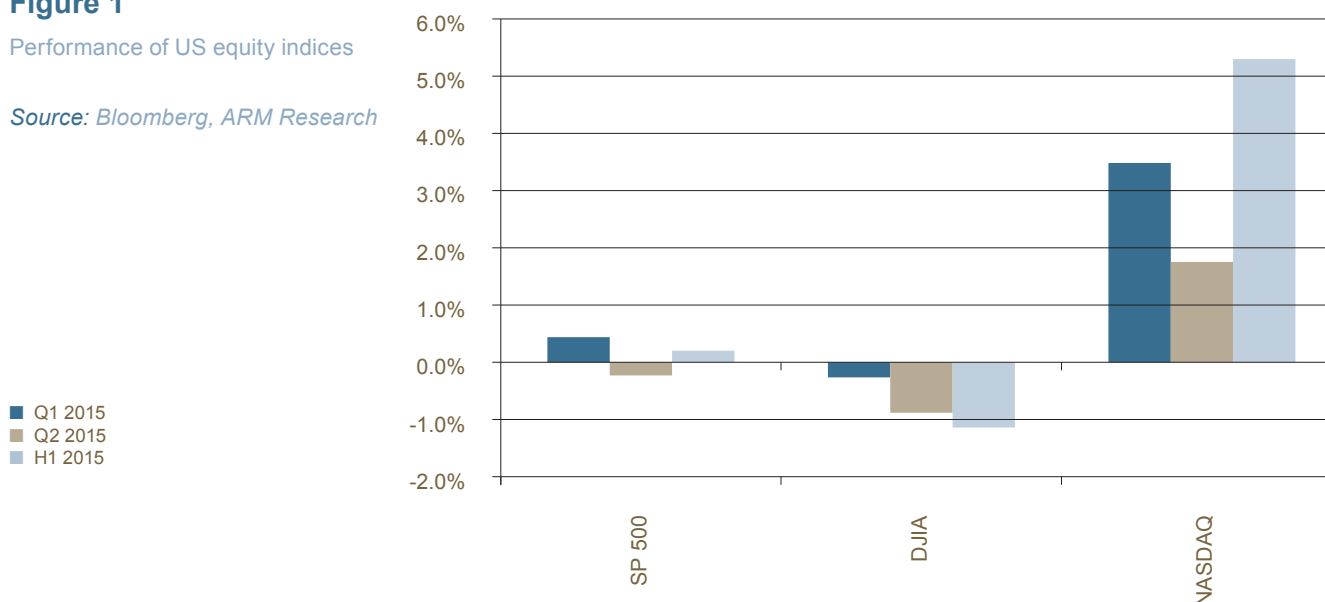
In Q1 15, U.S. GDP contracted 0.7% YoY on account of several factors: slowdown in exports due to continued dollar strength (Q1: +6%, 2014: +11%); port congestion issues following labour disputes at the large West Point shipping terminal; reduction in oil and gas capital spending; and, for the second consecutive year, adverse weather shocks. Other economic metrics also showed signs of weakness with the pace of job creation shrinking to an average of 208k new jobs over the first six months of 2015 vs. H2 14 mean of 281k (2014 avg: 260k)⁽¹⁾. The flaccid signals from unemployment and GDP combined to put off fears of interest rate hike by US Federal Reserve and largely account for the less-than-stellar performance of US equity indices over H1 15.

(1) Though US unemployment dipped to 5.4% in June

Figure 1

Performance of US equity indices

Source: Bloomberg, ARM Research



Across the Atlantic, European Q1 15 GDP printed at 0.4% QoQ (+1.4% YoY), underpinned by strength in France (+0.6% QoQ), Germany (+0.3% QoQ), Spain (+0.9% QoQ) and Netherlands (+0.3% QoQ) which offset weakness in Greece (-0.3% QoQ). The uptick in economic activity also saw the region

come out of four-month deflation in April when CPI came in flat YoY before climbing 0.3% YoY in latest reading in May. The rise in consumer prices despite deflationary impact of lower energy costs provide early evidence of the stimulatory impact of ECB's bond buying program which began in March.

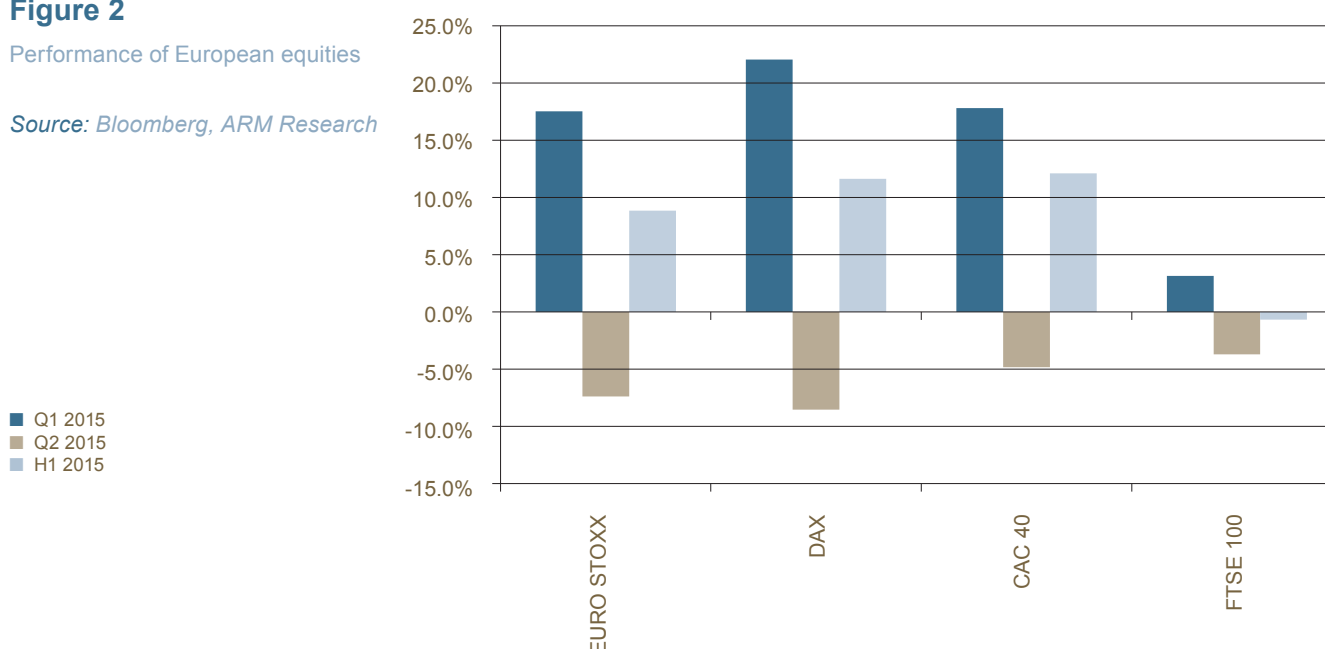
The commencement of the LSAP program provided welcome distraction to European equities (Q1 15: Eurostoxx +17.5%) despite fresh turmoil in Greece, after January's election brought the left-leaning Syriza party to power. Consequent brinkmanship by the Alexis Tsipras-led Syriza government, on structural reforms previously agreed with Greek creditors, has re-awakened prospects for a 'Grexit' which has intermittently weighed on market sentiment across the euro area – in particular over Q2 15. Largely reflecting investor concern over the Greece debacle, Euro-area financial markets gave up some of Q1 15 gains, nonetheless they have outperformed US equities YTD

Outside the euro zone, the UK economy expanded 2.4% YoY in Q1 15, though on a QoQ basis, real GDP rose at its slowest rate in three years (+0.3%). Concerns over underlying economic conditions heightened after UK inflation turned negative in April, for the first time in 55-years, on lower transport costs. The deflationary pressures and slowing economic growth tempered previous optimism about BoE rate hike. Whilst surprise on the political front following a majority victory in polls by the Conservatives provided uplift for UK financial markets, heightened possibility of 'Brexit' together with spillover from 'Grexit' acted to dampen market expectations over Q2 15.

Figure 2

Performance of European equities

Source: Bloomberg, ARM Research



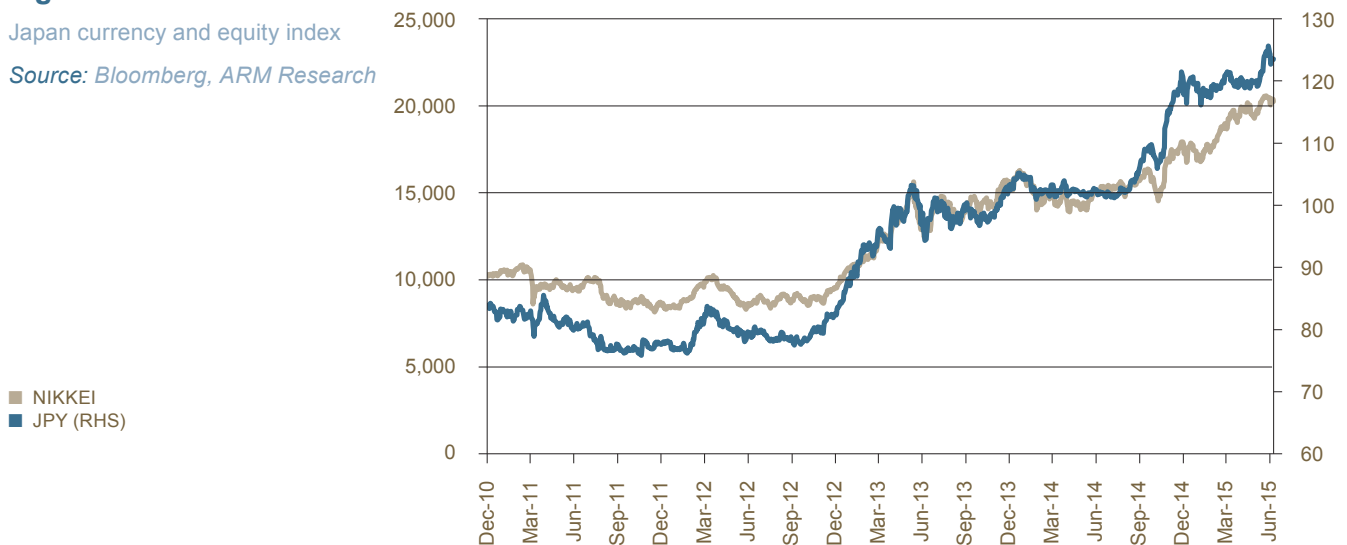
Japan recovered from recession in Q1 15 with GDP printing at 3.9% YoY driven by recovery in household consumption (+0.9% YoY) and capital spending (+2.7% YoY). The improvement in consumption largely reflects lesser drag on household spending from the April 2014 sales tax hike whilst increased profits of Japanese companies on yen weakness provided the platform for higher capital spending. Nonetheless core inflation readings dipped to 0.6% in April as base effects from the VAT hike in 2014 dropped off the chained CPI readings. Whilst sub-par inflation readings raised prospects of increase in BoJ's 80trillion yen LSAP program, the BoJ

maintained status quo throughout H1 15, in line with comments by Governor Haruhiko Kuroda that current yen levels (YTD: 3.4% to 123.54) were close to historical real effective exchange rate lows. The rebound in economic growth and continued earnings support from a weak yen helped underpin 16% jump in Japanese equities in H1 15 to 15-year highs.

Figure 3

Japan currency and equity index

Source: Bloomberg, ARM Research



EM economies slow further

Similar to 2014, the slowdown across EMs continued with Chinese GDP growth clocking a six-year low of 7% in Q1 2015. Slowdown was evident across key growth metrics with fixed-asset investment rising 13.5% YoY - the slowest pace since 2000, while at 5.6% YoY, industrial output grew at its weakest since the global financial crisis in 2008. Similarly, power output, a proxy for economic activity in China, declined 3.7% YoY - the largest fall since the 2008 crisis. The progressive stream of weak economic data drove the PBoC to twice slash policy rate by 25bps to 5.1% and cut reserve ratio requirements three times in H1 15 to 18.5%. The monetary policy accommodation was complemented by fiscal actions as China's central authorities instituted a 1 trillion yuan debt swap which would see local municipal papers exchanged for central government bonds. Despite the moderating economic fundamentals, Chinese equities continued to outperform major global equity indices climbing 51% from 2014 year end till mid June, spurred by the prospect of greater policy accommodation by Chinese authorities. Nonetheless, a sharp correction starting in mid-June which pared H1 15 equities performance to 32% exposed the fragile nature of the market rally and raises concerns over China's economy.

Similarly, Brazil's recovery from recession in Q4 14 proved to be short-lived with GDP shrinking

1.6% YoY (-0.2% QoQ) in Q1 2015. The negative headline reading was driven by weakness across household consumption (-1.5%), investment (-1.3%) and government consumption (-1.3%) which offset growth in the external sector. The shrinkage in fiscal expenditure stems from new Finance Minister Joaquim Levy's drive to turn a fiscal deficit of 6.5% of GDP in 2014 to a primary surplus in 2015 via cutback in welfare benefits. Other indices of economic activity also emitted adverse signals with depreciation in the Brazilian real (YTD: -15%) underpinning an uptrend in inflation over H1 15 to 8.47%— above the target range of 2.5% to 6.5%. Consequently, the Brazilian Central Bank hiked its key Selic rate 275 basis points over the first half of 2015 to 13.75%. In line with the economic pressures and tighter fiscal conditions, Brazilian equities posted a modest performance (+6%) over H1 15.

Elsewhere, a combination of weaker oil prices and western sanctions drove 2.2% YoY contraction in Russian GDP in Q1 15. Akin to Brazil, lagged impact of 2014's 85% depreciation in the Russian rouble resulted in inflation climbing 440bps over H1 2015 to latest May 2015 reading of 15.8% YoY. Nonetheless, as sanctions rhetoric cooled with a fragile truce holding up in Ukraine, the Russian rouble has started to stabilize (YTD: +12%), providing cover for the Russian central bank to aggressively ease monetary policy with cumulative interest rate cuts of 275bps

over H1 15 to 11.5%. Largely reflecting the rebound in the exchange rate, firming oil prices and thaw in geo-political tensions Russian equities rallied 18% over H1 15.

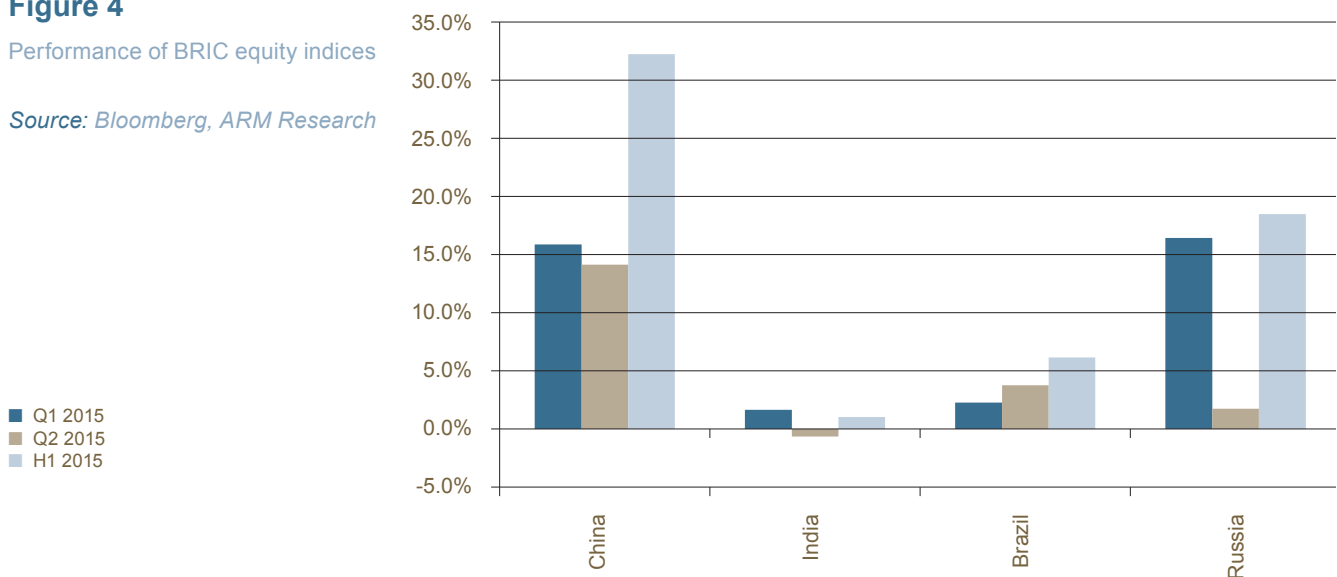
In contrast to the weak economic picture across other BRICs, India's economy rose 7.5% YoY in Q1 15 spurred by increased business confidence

from the reform-minded Modi's government and gains from lower energy prices. The latter was evident in inflation which declined to 5.1% YoY providing ambit for the RBI to ease interest rates over H1 15 (-75bps to 7.25%). Nonetheless, Indian equities put in a lackluster shift (+1%) over H1 15, largely reflecting net short FPI positions.

Figure 4

Performance of BRIC equity indices

Source: Bloomberg, ARM Research



Tightening financial conditions and spillover from Greek drama dim growth outlook

Into the second half of 2015, prospect of lift-off in US interest rates amid continued monetary accommodation in other DMs and concerns over 'Grexit' should dominate sentiment across financial markets. Whilst previous bullish forecasts of US growth have tapered following the disappointment in Q1 15 with the US Fed's target range now at 1.8%-2% vs. 2.3%-2.7% previously, comments at June 2015 FOMC suggest that the US Fed views the depressed growth picture as largely transient. Nonetheless, the reduced number of FOMC members calling for a greater than 25bps rise in interest rates using the FOMC dot plot⁽²⁾ at the June meeting, and emphasis by Fed Chair Janet Yellen about no preset tightening cycle, speaks to a symbolic vs. significant rate hike in H2 15.

Set against the backdrop of sustained policy accommodation in Europe and Japan, a rise in US

interest rates and even further USD appreciation raise scope for heightened volatility akin to the 'taper tantrum' of June 2013 as investors frontload reaction to the changing interest rate differential.

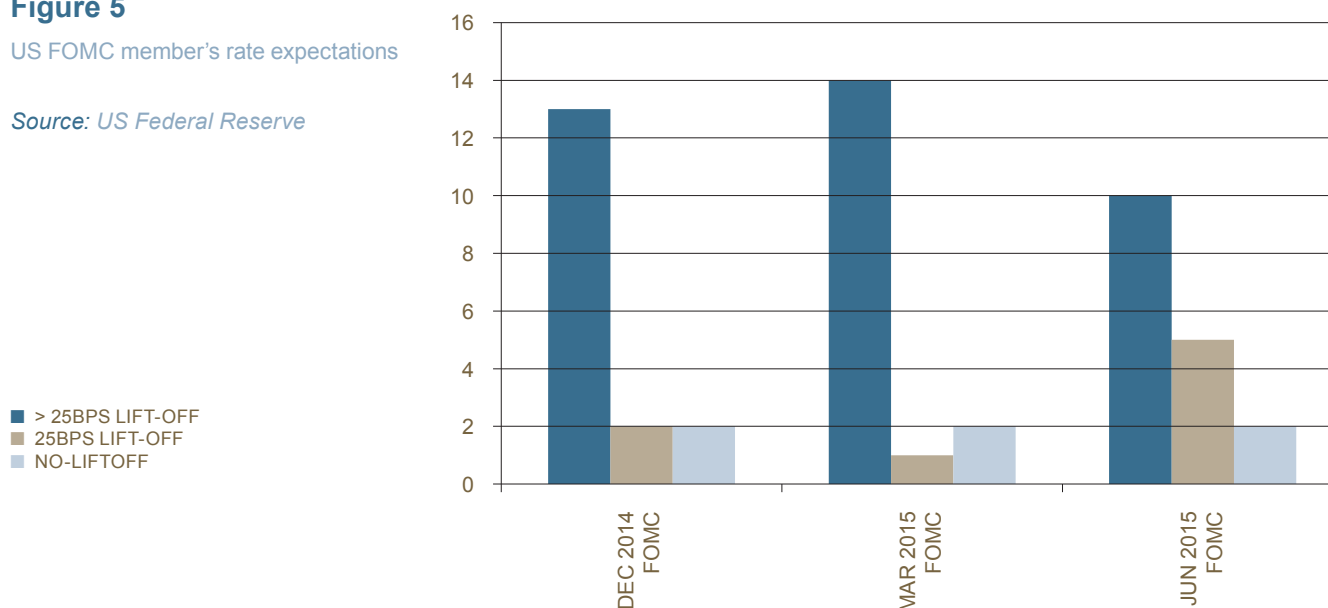
Outside the US, whilst Europe appears to have turned the corner, the recurring Greek debt debacle continues to pose risks to financial markets in the euro area. Over H2 15, the prospect of 'Grexit' draws closer as lack of progress on negotiations to permit release of funds to Greece raises prospect of default on €18.7billion worth of payments falling due in the period. Most Greek debt due over H2 15 are to the IMF & ECB (64%) with the remainder comprising of short term t-bills largely held by Greek banks. Whilst IMF debt ranks highest in seniority, the absence of a cross-default clause on the IMF obligation and administrative procedures which could technically delay default definition lessens risks. Beyond a freeze on future funding, main risks to the global economy stem from a default on ECB obligations due over July 2015. Here, a default should result in a freeze in emergency lending assistance (ELA) to Greek banks

(2) The dot-plot produced by the US Fed shows FOMC member expectations of interest rates as at year end.

Figure 5

US FOMC member's rate expectations

Source: US Federal Reserve



which could pave way for abandonment of the euro and the return of the old Greek Drachma – a scenario which could significantly roil global financial markets. In this event, the Euro-zone stands most at risk as, via all its agencies: ECB, various governments and the EFSF⁽³⁾, the region collectively holds 68% of Greece's outstanding €312 billion debt. Of this figure, private creditors, largely Euro-zone banks, hold about 11% with the rest held by multi-lateral organizations like the IMF.

On the face of the debt concentration holdings, as Greece's main creditors are official (not private) entities with no obligation to subject themselves to accounting

(3) European Financial Stability Fund

rules requiring mark-to-market valuation or minimum capital requirements, direct fall-out from the crisis appears limited. Nonetheless, indirect contagion to global markets could arise from the emergence of anti-establishment/austerity bashing parties like Syriza in periphery countries such as Ireland, Spain, Portugal and Italy⁽⁴⁾. Amid commencement of negotiations by the Conservatives over UK's status in EU (so called 'Brexit' talks) the actualization of 'Grexit' raises the prospect of similar departures which could undermine market confidence in the euro project leading to increased volatility across global markets

(4) Elections are to take place over H2 in Spain and Portugal

(5) <http://www.ft.com/sites/2015/greek-debt-monitor/>

Figure 6

Greece: Debt payments schedule over H2 15 (€'million)

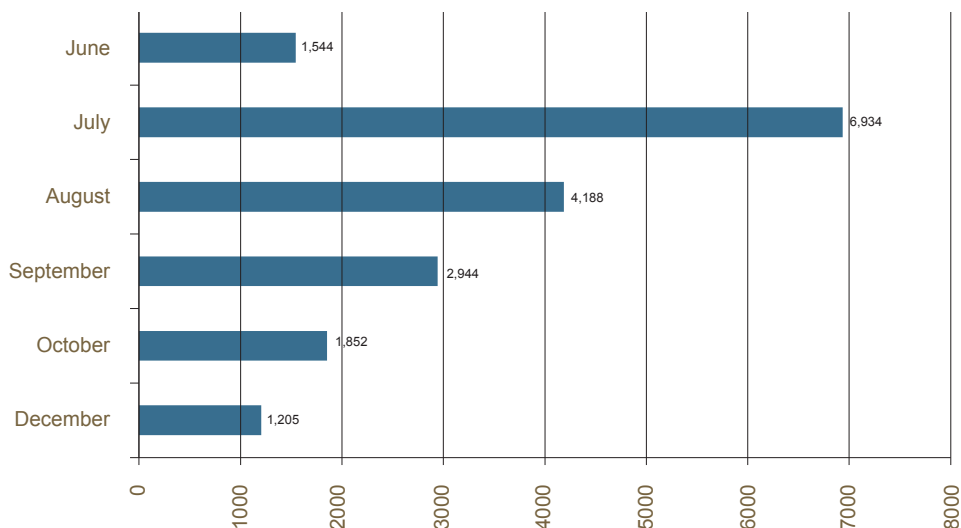
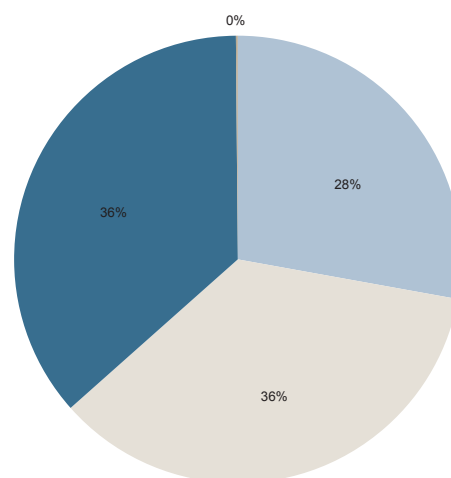
Source: FT⁽⁵⁾, ARM Research

Figure 7

Holders of Greek debt facing debt exposure over H2 15

Source: FT, ARM Research

■ T-BILL HOLDERS
■ EIB
■ IMF
■ ECB



Over in Japan, after three years of Abenomics, focus now shifts to Shinzo Abe's third arrow as comments by the BoJ which hint at limited yen downside from current historical lows suggest scant scope for expansion in the QE program. On this wise, progress on legislative bills before the Japanese Diet aimed at loosening Japan's restrictive labour laws and tax changes aimed at incentivizing Japanese corporates to increase capital spending are going to be closely watched by markets. Aided by sustained recovery in GDP numbers from the weaker base induced by 2014 VAT tax hikes, Japan's economy should show improvement over H2 2015.

On the other hand, the tightening financial environment and still bearish energy prices drive scope for extension of EM growth slowdown. The newfound determination by Chinese authorities to prevent a hard landing suggests further growth deceleration would be met by more loose monetary policy—in the form of interest rate cuts and reduction in reserve requirements—and fiscal stimulus via more swaps of local government paper for central government bonds. In addition, following the sharp correction towards the end of June, Chinese authorities should implement measures to smoothen the pace of market downturn

Russia's economic outlook remains hinged on developments around Western sanctions. Whilst a truce continues to hold in Eastern Ukraine, increasingly belligerent rhetoric by Russia and US-EU over troop and weapons movements suggests scope for imposition of stringent sanctions persists. Incorporating still subdued oil price outlook, a

recessionary prognosis for the Russian economy over H2 2015 does not seem far-fetched. Similarly, the outlook for Brazil's economy remains dour due to subsisting commodity price weakness and fiscal consolidation. Sustained tightening by the monetary authority in response to inflationary pressure and greater prospects for exchange rate weakness post hike in US interest rates burnish a cloudy outlook for Brazilian equities over the rest of 2015. Contrary to tepid outlook across other EMs, India's growth outlook remains robust, hinged on structural reforms and tamer oil prices.

In sum, the shrinking US growth optimism drives a moderation in IMF's forecasts of DM growth to 2.4% YoY, while ongoing deceleration in China, prospect of 'Grexit' spillover and tighter financial conditions due to US rate hike leads to 60bps cutback in IMF's EM growth expectations to 4.3% YoY.

SOFTER COMMODITY PRICES AGGRAVATE AFRICA'S SLOWING GROWTH...

Against the backdrop of weaker commodities prices, Ebola epidemic, political uncertainty, rising insecurity and weaker growth among its trade partners, Africa's economy has so far witnessed tepid growth. The pace has been so stunted as to necessitate multiple downward credit ratings review by relevant agencies. The weaker economic activity in the continent also compelled IMF to revise its earlier (October 2014) growth forecast for SSA downwards (-130bps to 4.5%) while mean North African growth was projected 246bps slower than previous at 3.7%.

Table 1

African Countries whose credit ratings were downgraded

COUNTRY	PREVIOUS RATING	NEW RATING	RATING AGENCY	REASON FOR DOWNGRADE
Nigeria	BB-	B+	S&P	Oil weakness
Angola	BB-	B+	S&P	Oil weakness
Gabon	BB-	B+	S&P	Oil weakness
Congo	B+	B	S&P	Oil weakness
Ghana ⁽⁶⁾	B3	B2	Moody's	Fiscal Instability

Source: S&P, Moody's, ARM Research

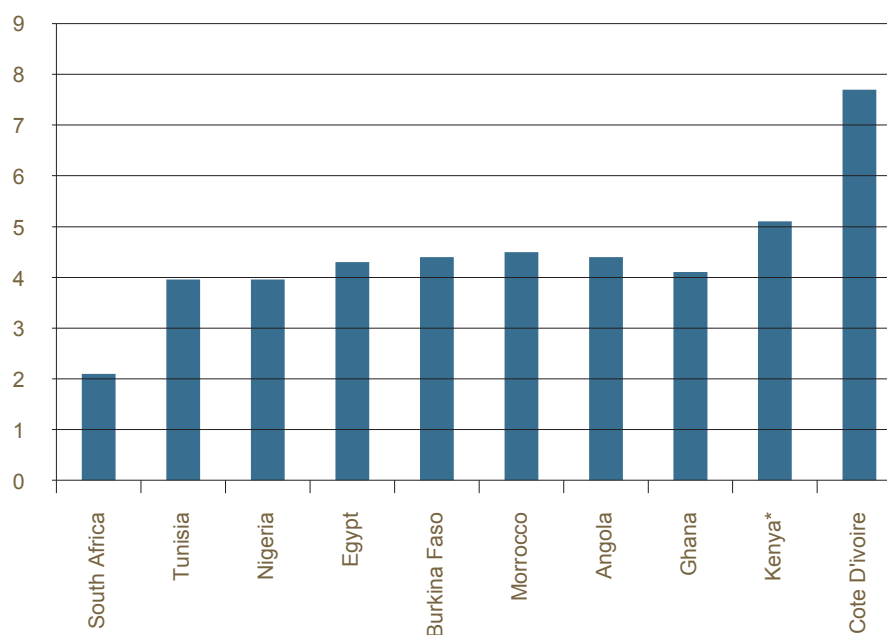
The West-African sub region has been the most hit with economic challenges, battling with the impact of Ebola epidemic which grounded commerce, agricultural, services, travel and transportation sectors in the three worst affected countries. The impact of the Ebola Virus Disease (EVD) was felt among neighbouring countries, with Gambia's tourism sector (40% of annual economic output) the most affected. Economic woe of the region was further compounded by the pressures on Africa's biggest economy (Nigeria) underpinned by weaker oil prices, while the region's second largest economy (Ghana) continued to slow given the fiscal reforms the country is implementing. Amidst the dampening effect of continued political

imbroglio in Libya and oil-induced weakness in Algeria, North Africa's economy was further affected by deceleration among its trade partners, reducing the region's export proceeds. In central Africa, economic activities were curtailed by lingering political impasse in CAR and South Sudan, member countries were also impacted by softer commodities prices. Finally, the Southern part of the continent, similar to other regions, witnessed slowdown driven by weakness in commodities prices at Angola (oil) and Zambia (Copper), which more than offset a pickup in South Africa's Q1 GDP (80bps to 2.1% QoQ).

(6) Moody's has a negative outlook on Ghana, citing worsening fiscal picture and concerns about near term liquidity position despite an agreement between the Ghanaian government and the IMF for a three year \$940 million financial assistance programme designed to restore fiscal stability.

Figure 8

Q1 2015 GDP Growth Rates (%) for Select African Countries

*Source: Trading Economics, ARM Research, *Q4 14 Figures*

Exchange rate pressures: current and capital account deficits outweigh tightening measures

Amidst commodity price pressures, heightened political risks trailing the election cycle, as well as US Fed hints at an interest rate hike, capital flows

to the African region subsided. Similarly, lower export proceeds underpinned by bearish commodity prices worsened current account position⁽⁷⁾, with the deterioration along with reduced capital flows resulted in the weakness of currencies across board.

(7) IMF forecasts 1.3pps and 6.3pps YoY expansion in SSA and North Africa (mean) current account deficit as a percentage of GDP to 4.6% and 16.3% respectively.

Figure 9

Current Account balances for Select African Countries

Source: IMF, ARM Research, *2015 Estimate

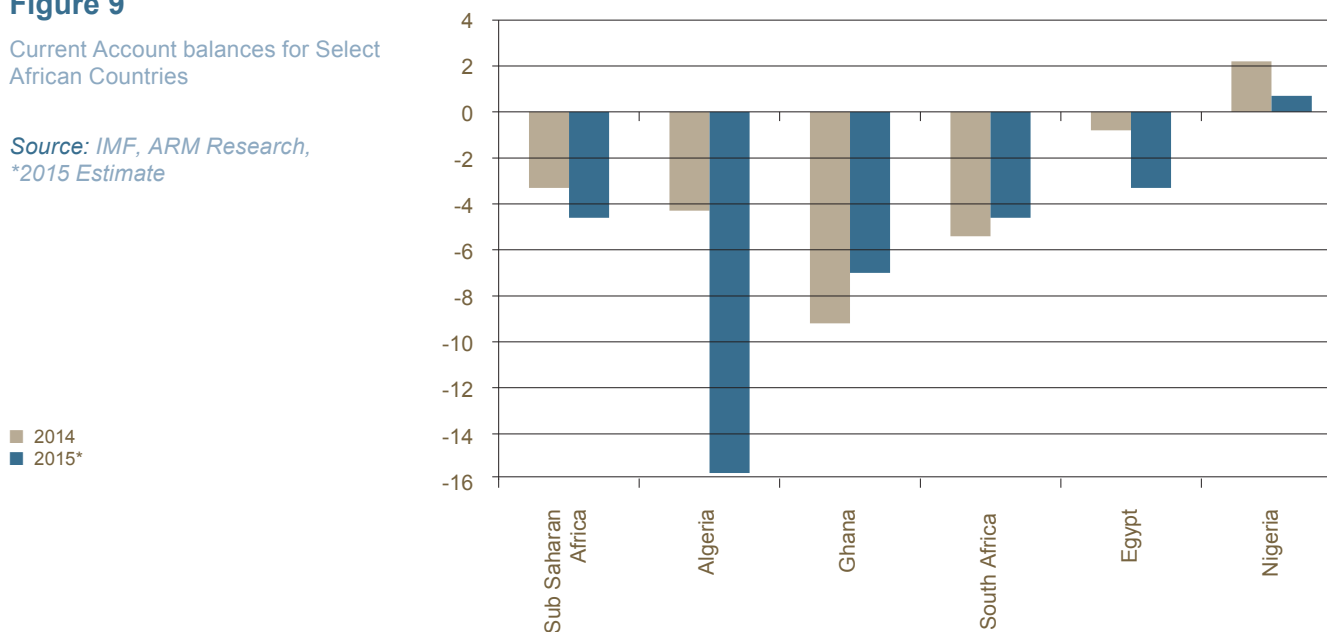
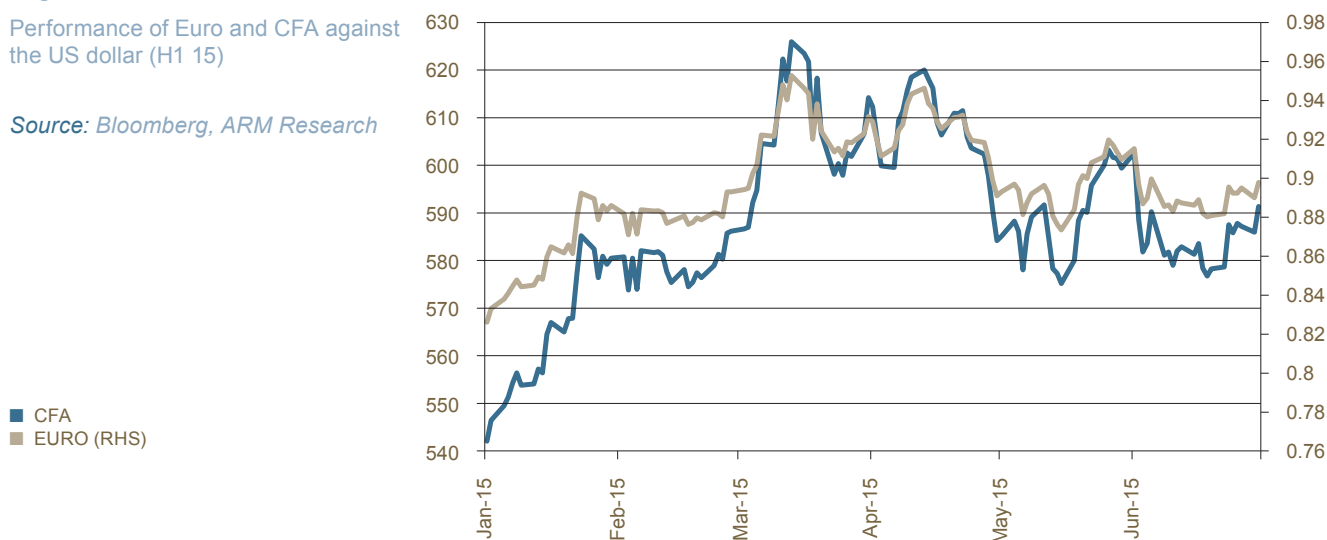


Figure 10

Performance of Euro and CFA against the US dollar (H1 15)

Source: Bloomberg, ARM Research



The Ghanaian Cedi has however remained the worst performing currency in Africa, depreciating 36% YTD⁽⁸⁾, while Zimbabwe formally ditched its local currency following years of hyper-inflation which made its currency worthless⁽⁹⁾. Meanwhile the CFA franc which is the major currency among central African countries continued to dip (-9% YTD) though this mostly reflected pass-through from its Euro peg – EURUSD (YTD: -8.6%) which fell following the commencement of the ECB's bond buying program.

(8) June 30, 2015

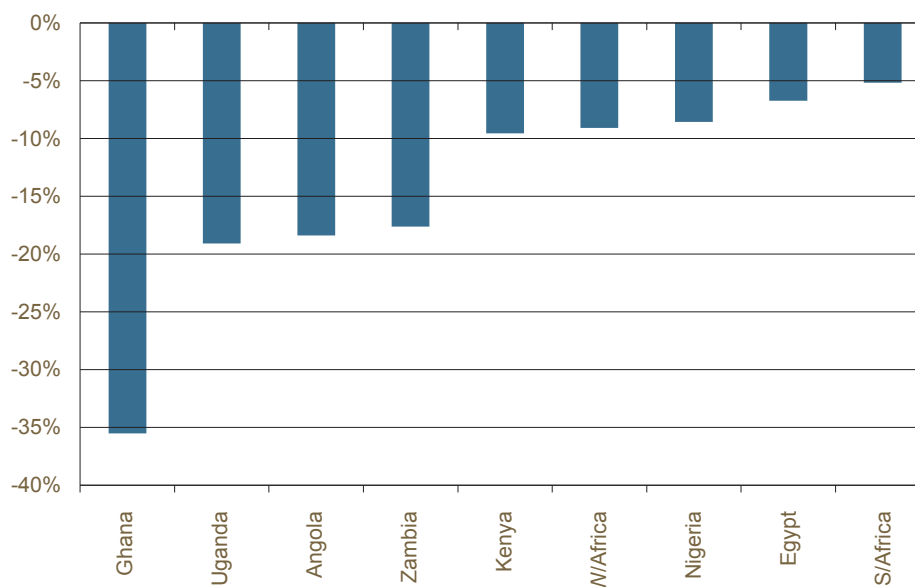
(9) 35 quadrillion of Zimbabwean dollars will be converted to 1 USD, while the country will also rely on South African rand for transacting business.

In response to the currency weakness, African central banks intensified monetary policy tightening with the Central Bank of Kenya and Bank of Ghana both raising key interest rate by 150bps and 100bps to 10% and 22% respectively. Similarly, the Bank of Uganda hiked interest rate by 100bps for the second time this year to 13%. Elsewhere, the Central Bank of Nigeria raised statutory reserve requirement 11pps to 31% while Bank of Angola raised its benchmark Basic Interest Rate (BNA) by 25 basis points to 9.25%.

Figure 11

H1 15 Performance of major African currencies

Source: Bloomberg, ARM Research



As Africa's inflation maintains its discordant tempo

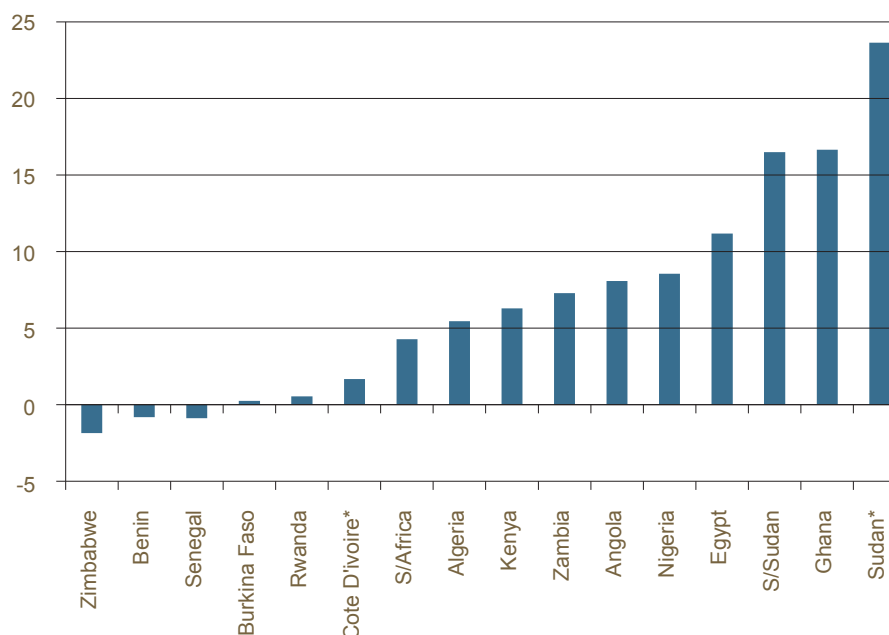
Notwithstanding the monetary tightening across the region, currency weakness underpinned higher inflation across Nigeria, Algeria and among CFA Franc users (Burkina-Faso, Cote D'Ivoire and CAR). In addition to the currency depreciation, spike in energy costs driven by a cut in fuel subsidy pushed inflation higher in Angola and Egypt. However, the bearish trend in commodities prices ensured divergent inflation picture

with South Africa and Zambia's inflation respectively falling 70bps and 100bps to 4.6% and 6.9%YTD, while Zimbabwe mired further into deflation (-190bps to -2.7%). Weaker energy and food prices were also responsible for the moderation of Ghana's inflation figure (-10bps to 16.9%).

Figure 12

2015 Mean Inflation Figures (%) of
Major African Countries (Jan-May)

Source: Bloomberg, ARM Research, *-
Jan-April 2015



Macro-economic headwinds weigh on equity indices

In tandem with the slowdown in economic growth, equity markets recorded losses over H1 15, with the S&P All Africa index⁽¹⁰⁾ falling 2%, underpinned by weakness in Egypt (-11%), Nigeria (-3.5%), Mauritius (-4.5%) and Zambia (-5%) which, combined, more than offset gains in South Africa (+4.1%), Botswana (+12.5%), Tunisia (+12.4%) and Ghana (+4%). The decline in Nigeria's equity market reflects foreign sell-offs following depressed oil prices, rising political tensions leading up to the March 2015 election as well as policy uncertainty post election, while temporary introduction of capital gains tax as well as MSCI's removal of one of the four stocks representing Egypt in the MSCI-Egypt Index drove weakness in that country's broader bourse. As for the Mauritian bourse, the downtrend reflects deteriorating investors' confidence following a \$693 million (Sh63.7 billion) scam which rocked the country's banking system. Meanwhile, the Ghanaian equity index' gain over H1 15 was largely underpinned by the emergency aid deal obtained from the IMF (\$918 million) which boosted investors' confidence. In South Africa, the Johannesburg Stock Exchange (JSE) benefited from slower than expected hike in US interest rates, as

well as surge in equity capital (+29% YoY to R92 billion in the first five months of 2015) raised by listed companies on the index.

Monetary tightening and slower growth to stoke further economic slowdown

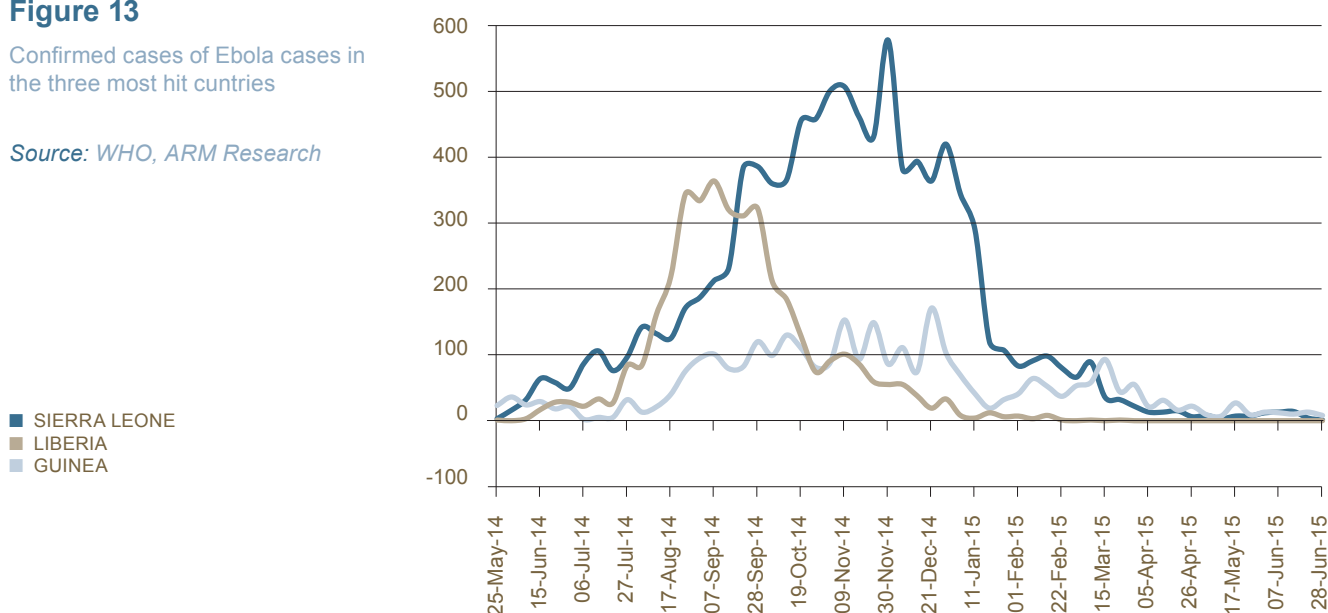
Macroeconomic stability among Africa's countries could be further threatened should growth amongst its major partners (Europe and China) further weaken, portending further downtrend in commodity prices and exacerbating current account pressures to resource exporters across the continent. While an Ebola-free Liberia and containment of the epidemic for much of 2015 would ordinarily have been a good omen, rising occurrence of new cases as well as those arising from unknown sources of infection, and in new locations to boot, have triggered fears of a second wave of the outbreak, highlighting the challenges still faced on this front.

(10) The S&P African index is a comprehensive benchmark including stocks from 13 African Markets which includes Botswana, Cote d'Ivoire, Egypt, Ghana, Kenya, Mauritius, Morocco, Namibia, Nigeria, South Africa, Tunisia and Zambia and Zimbabwe

Figure 13

Confirmed cases of Ebola cases in the three most hit countries

Source: WHO, ARM Research



In addition, recent declaration of a cholera outbreak in South Sudan should further compound economic activities in the country which is still battling with lingering political crises. Further posing pressures to economic growth within the African region is the less accommodative outlook of US monetary policy⁽¹¹⁾ which could crimp capital flows to the continent, adding further strains to the already weak currencies. The

(11) The US Fed and the Bank of England are looking to raise interest rate over H2 15

consequent impact on foreign-currency-denominated debt-service costs will further burden fiscal and current accounts positions among member states. Overall, the broadly weak growth picture, currency concerns, potential capital outflows, mounting security threats and policy uncertainty trailing the heavy political cycle herald sustained pressures for African economies and markets over the rest of 2015.

Table 2

2015 election date for African Countries

COUNTRY	TYPE OF ELECTION	DATE
Burundi	Presidential, Senatorial	July 15
Burkina Faso	Legislative and Presidential	October15
Guinea	Presidential	October15
Cote D'Ivoire	Presidential	October15
Tanzania	General	October15
CAR	Constitutional Referendum, Presidential and Parliamentary	2015
Chad	Parliamentary	2015
Egypt	Parliamentary	2015
Mauritania	Legislative	2015
Libya	Constitutional Referendum	2015
Mali	Municipal	2015

Source: NDI, ARM Research

FPI FLOWS YET TO FIND CLEAR PATTERN

Accommodative monetary policies and reduced risk appetite drive volatile FPI flows

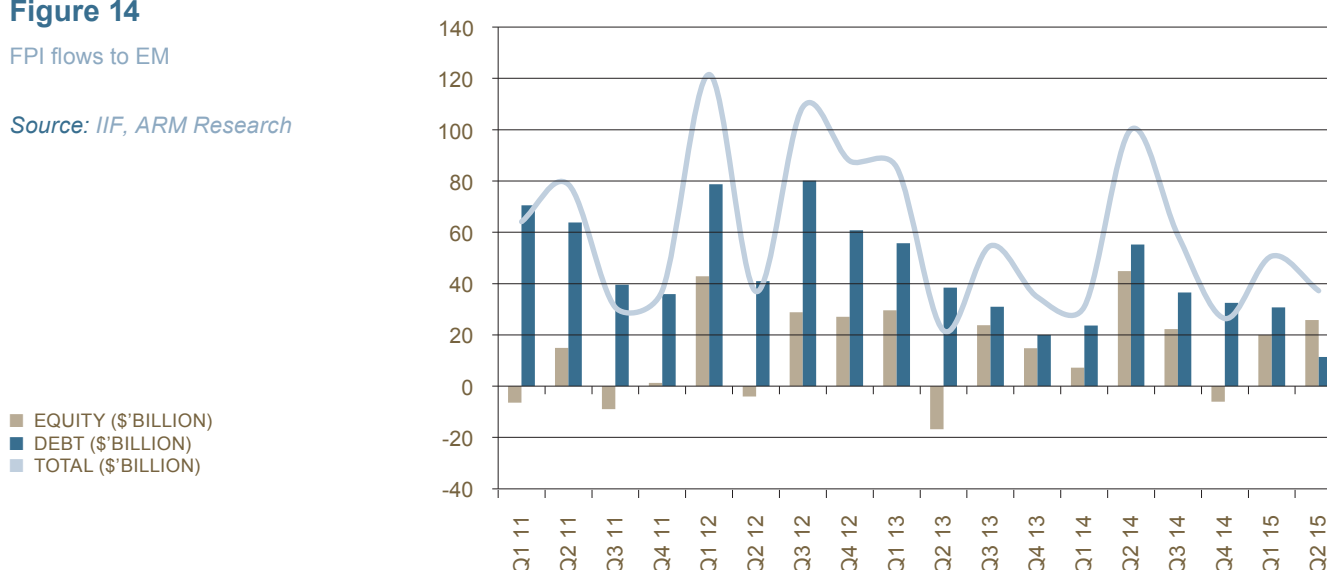
Following a dovish message from the US Fed regarding normalising interest rates and commencement of ECB's bond buying program which exceeded market expectations, FPI flows to EM rebounded strongly

in Q1 15 to \$52.9 billion (+70% YoY and nearly doubled QoQ), according to the IIF reports. However, diminished risk appetite of investors on prospects of an interest rate hike in the US as well as growing concerns of a possible Greek exit from the euro-zone drove a retrenchment in portfolio flows over Q2 15 (-63% YoY and -30.5% QoQ to \$36.7 billion). Largely reflecting capital outflows in Q2 15, IIF estimates a 32% YoY contraction in H1 15 net FPI flows to EM.

Figure 14

FPI flows to EM

Source: IIF, ARM Research



The delay in normalization of interest rate by the Fed stemmed from weaker macro-economic data, including: GDP deceleration (-0.2% QoQ in Q1 15); dip in consumer confidence; weaker consumer spending; slowing growth of trading partners and non-impressive inflation figures. Focusing on the latter, despite a 0.4% MoM rise in May's inflation figures (biggest increase in more than two years), inflation figure over 2015 is flat YoY, dragged by lower energy prices, and remains elusive of the Fed's target of 2%. Consequently, at the June FOMC meeting, the Fed chair, Janet Yellen stated interest rate hike would be underpinned by further improvement in inflation, wage increases, and ability of part-time workers to find full-time jobs.

While monetary tightening in US was postponed, the euro-area expanded its monetary easing by launching its bond buying program which is in

addition to the purchase of asset-backed securities and covered bonds that began last year. According to the ECB, the decision to purchase government bonds and other assets worth €60 billion every month until September 2016, or as determined by the bank's Governing Council, was necessary to stem deflationary pressures as well as boost its slowing economy. Similarly, BoE which also looked to tighten left key policy rate unchanged at 0.5% (lowest on record) on deflationary pressures. Elsewhere, the BoJ maintained its purchase of assets worth 80 trillion yen (\$670 billion) to boost inflation which slid to its lowest in 2 years in May, notwithstanding the second consecutive GDP expansion since the country experienced recession last year. Meanwhile amidst slowing growth, Chinese monetary authority (PBoC) cut interest rates for the fourth time since November 2014 to its lowest on record at 4.85% while one-year deposit rate was reduced by 25bps to 2%.

Divergent macroeconomic picture underpins varying flows to EMs

Aside from the discordant monetary policies across the developed world, heightening concerns about Greece debt crises as well as divergent growth picture across EM contributed to the volatile FPI flows over H1 15. Decomposing FPI patterns on a geographical basis reveals strong FPI flows to Asia driven by sustained flows to India, Indonesia and China. In particular, shrugging off concerns about the country's slowing growth, capital flows to China remained strong as liberalization of the country's financial market which began with the launching of the Hong Kong-Shanghai Stock Connect last year and inclusion of equity funds in the cross boundary investment channel continue to attract investments. Furthermore, policy stimulus to prop up growth has also sustained investors' confidence of the market. As for India and Indonesia which both elected pro-reformist government last year, the euphoria as well as visible reforms has continued to boost capital inflows to both countries. Economic reforms implemented in India such as raising ownership limits for insurance, defense, pensions as well as opening up of railways projects alongside tax reform propelled a net FPI flow of \$15.6 billion in the first five months of 2015. Similarly, the decision of Indonesia's government to cut gasoline subsidies as well as implement tax reforms sustained investors' interest, spurring a net FPI flow of \$7.4 billion in Q1 15 with 95% of this amount flowing into the country's bond market with the government benefitting the most (87% of bond portfolio flows are government related borrowings).

In contrast, EM Europe continues to witness a retrenchment in capital flows over H1 15, with June marking a fifth consecutive month of net capital outflows. The weakness in net FPI flows was largely driven by outflows from Russia, which rose to \$31 billion during Q1 15 from \$24 billion a quarter during H2 14, as well as concerns about a possible Greece exit from the euro-zone. Capital outflows from Russia continue to be affected by the crises in Ukraine and resulting impact of western sanctions on the Russian economy which is expected to enter recession in 2015. As for Greece, a lack of progress in the negotiation of a third bailout program with its European lenders raised concerns of Greece ability to meet its debt repayment promise as well as government spending stoking fears of a possible exit from the euro-zone.

Meanwhile, amidst a slowing economy leading up to parliamentary election in June, intensified concerns about the Turkish central bank's ability to resist pressures from the government to ease monetary policy led foreign investors to reduce their exposure to Turkey's securities with FPI outflows over the first four months of 2015 at \$16.4 billion, reflecting selloff of both equity and local government bonds. Overall, the region's capital outflows were mainly equity based, as euro-bond issuance by Russian companies⁽¹²⁾ as well as ECB's bond buying program ensured relatively stronger bond inflows.

Capital flows to the middle-east and North African region appears to have subsided following the crash in oil prices. However FPI flows to Egypt was sustained on the back of political stability and economic reforms such as cutting fuel subsidies by a third, introduction of new taxes and allowing the Egyptian Pound to depreciate. Meanwhile the opening of Saudi Arabia's \$590 billion stock market to foreign investors has continued to attract foreign portfolio flows to the country while capital flows to Tunisia was largely underpinned by the country's issuance of a \$1 billion Eurobond which was more than four times oversubscribed.

Latin America continued to witness strong portfolio flows (both equity and fixed income) on receding market fears of further depreciation of local currencies with Brazil, Mexico and Chile benefitting the most. FPI flows to Brazil's bond market surged over 2015 as the central bank progressively raised interest rate (+200bps to 13.75% YTD) to its highest level since December 2008 even as fiscal policy, underpinned by cut in government spending and higher taxes, embarked on a consolidation path. In addition, the release of the 2014 audited financial statements of scandal-hit Petrobras' boosted investments to the country's stock market; the delay of the report had contributed to increasing uncertainty about Brazil's economic growth prospects. Altogether, net FPI flows to the country over Q1 15 amounted to \$3.1 billion. Similarly, increased reform-related opportunities in key sectors of the Mexican economy attracted capital inflows worth \$9 billion to the country with a huge chunk flowing to its equity market. As for Chile, reiteration by its central bank's president of a possible hike in interest rate towards the end of the year, after

(12) IIF stated that euro-bond issuance by Russian companies rose to \$19 billion during Q1 15 from \$7 billion a quarter during H2

over-estimating the output gap in the economy, has boosted bond related inflows into the country as banks and other corporations pre-financed themselves in anticipation of higher borrowing costs.

Capital flows to Africa reflect economic challenges

As with the broader EM grouping, FPI flows to Africa showed diverse trends as the continent faced a confluence of shocks ranging from bearish commodity prices, Ebola epidemic, heightened political environment, increased insecurity concerns and electricity supply constraints. In South Africa, net portfolio flows surged, more-than-tripling to 39.3

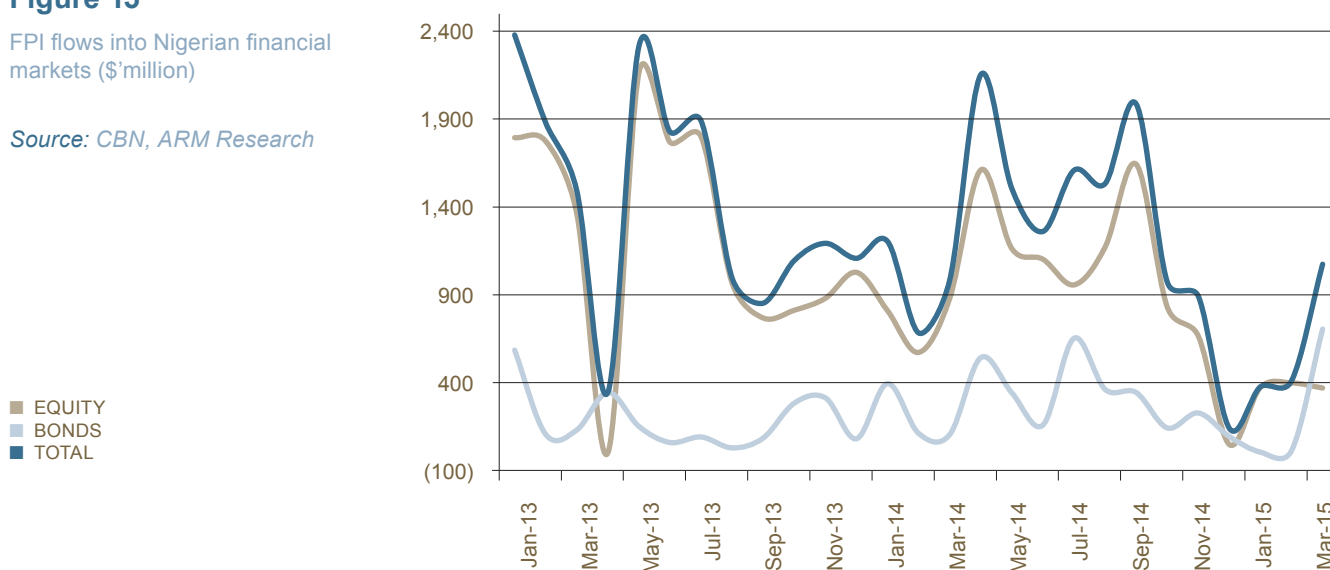
billion Rand in Q1 15 with both the equity and debt markets benefitting. The South African debt market benefitted from Eskom's international bond issuance worth US\$1.25 billion while FPI flows to the JSE benefited from primary listings of majorly industrial-sector companies which contributed 93% of the R92 billion equity capital raised in the five months to May 2015. In contrast, capital flows to Nigeria slumped 35.2% YoY to \$1.9 billion in the first three months of 2015 reflecting cutback in equities (-49.6% YoY to \$1.1 billion). The retrenchment reflects investors' discomfort with falling oil prices⁽¹³⁾, heightened political risks in the run-up to the 2015 general election as well as policy uncertainty post the election.

(13) Oil contributes 70% of Nigeria's government revenue

Figure 15

FPI flows into Nigerian financial markets (\$'million)

Source: CBN, ARM Research



For the rest of the African region, FPI flows which have largely been in the form of international bond issuance appears to have subsided partly due to deterioration in economic growth and fiscal deficits as well as advance of the dollar against African currencies. Nonetheless, 4x oversubscription of Cote D'Ivoire's \$1 billion euro-bond issuance indicates that apathy to the African market is not general as countries with strong economic growth such as Cote d'Ivoire (2014 GDP: 7.5%, Q1 15 GDP: 7.7%) would attract investors' interest.

FPI flows to remain slavish to Fed Interest rate tune and Greece concerns

Prospects for EM portfolio flows hinge crucially on the trajectory of an interest rate hike in the US as improved economic data such as accelerating wage gains, rising incomes, and growing household spending set the stage for an interest rate hike in September 2015. We continue to expect normalisation of monetary policy in the US should shrink the potential quantum of FPI flows into EM regardless of the sustained asset purchases by the BoJ and ECB's

bond-buying. In addition to a US interest rate hike, possible Greece default of its ECB loan would raise global risk aversion to EM countries especially those within Europe, further compounding portfolio outflows from the region. The reduced risk tolerance should also impact portfolio flows to countries with high current account deficit as investors will more likely favour higher quality investment. Nonetheless, nations with strong economic outlook, favourable external positions and credible reform programs should attract strong inflows.

Capital flows to EM Asia is at particular risk of a sharper-than-expected slowdown in Chinese growth, while capital flows to Malaysia and Indonesia will likely be impacted by an interest rate hike in the US as both countries have large foreign holdings of domestic bonds. Meanwhile, India's economic policies should continue to attract FPI flows to the country. As for the European region, the debt negotiations in Greece and Ukraine-Russia crisis should continue to determine direction of capital flows. Nonetheless, dissipation of political uncertainty that trailed June parliamentary election in Turkey should lead to increased inflow to the country. Elsewhere, Saudi-Arabia's opening of its equity market to foreigners should continue to underpin FPI flows to the middle-east region. In contrast, FPI inflows to Sub-Saharan Africa will likely remain subdued following slowing economic growth, political uncertainty, rising current account deficit and depreciating currencies. However, plans by Ghana, Tanzania and Kenya to each raise \$1 billion Eurobond could deliver some support. In summary, FPI flows will remain wary of EM countries with domestic vulnerabilities such as credit growth and debt burdens, implying portfolio flows will remain volatile over the rest of 2015.

COMMODITY STABILITY: INEVITABLE REPRIEVE OR AWAITING THE NEXT WAVE?

Considering the depths plumbed by commodity prices in H2 14, it only appears logical that the markets pause for breath sometime after. Whilst the recurrent theme of early signs of recovery suggests a floor is being found, demand supply dynamics remain broadly bearish for prices and indicate downside risks may not be fully washed away.

DEAD-CAT BOUNCE IN OIL MARKET?

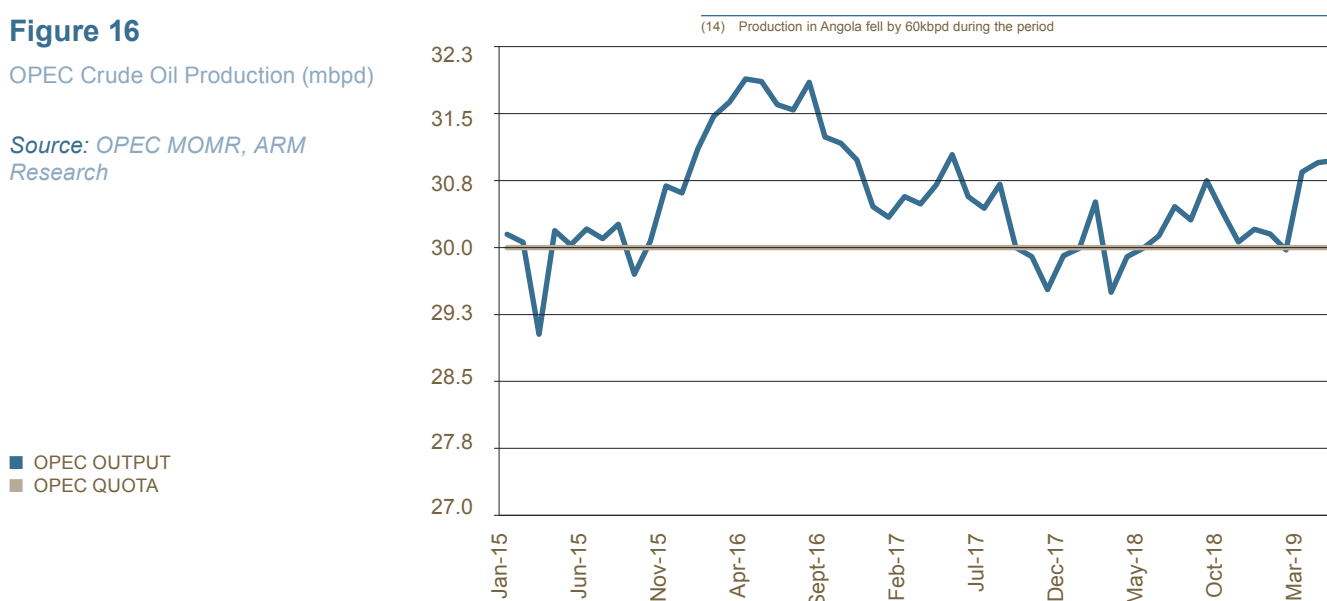
Surging Iranian production sends OPEC production higher

OPEC supplies rose 1.1% from H2 14 to 37.41mbpd in H1 15. The increase was primarily driven by higher output from Iran and Saudi Arabia. Iran benefited from lessened sanctions and saw its output hit a three year high of 2.8mbpd in April, even as Saudi Arabia maintained production levels above 10mbpd after a high of 10.3mbpd in March. Similarly, in Libya, production levels held steady despite tensions in the country, touching a high of 600kbpd mid H1 15. These increases offset production pressures from other OPEC nations such as Angola⁽¹⁴⁾, allowing aggregate OPEC output to push above the 30mbpd benchmark in H1 15.

Figure 16

OPEC Crude Oil Production (mbpd)

Source: OPEC MOMR, ARM Research



As non-OPEC output shrugs off declines in parts of North America

Non-OPEC production rose 0.35% to 57.9mbpd in H1 15 (H2 14: 57.7mbpd) as higher output in the US, Russia and China—more than offset declines elsewhere. Interestingly, despite increased idling of oil rigs in response to depressed oil prices, US output—still driven by light tight oil—hit a 40 year high of 9.6mbpd in H1 15 as producers focused on the cheapest (and highest) yielding shale formations. In addition, with a large share of shale output hedged at elevated oil prices, producers were better able to weather the low oil prices, even as industry breakevens trended lower. In Russia, output broke previous threshold levels to reach 11mbpd and China continued to increase production following the oil spill at its Penglai field in 2011. Meanwhile, high breakevens on tar sands played a part in moderating production in Canada while an explosion at the Pemex's Abkatun Permanente platform in the Gulf of Mexico on April 1 weighed on Mexican output. Overall, total crude oil supply remained relatively flat (+0.6%) at 95.31mbpd relative to H2 14 and increased 2.93% YoY.

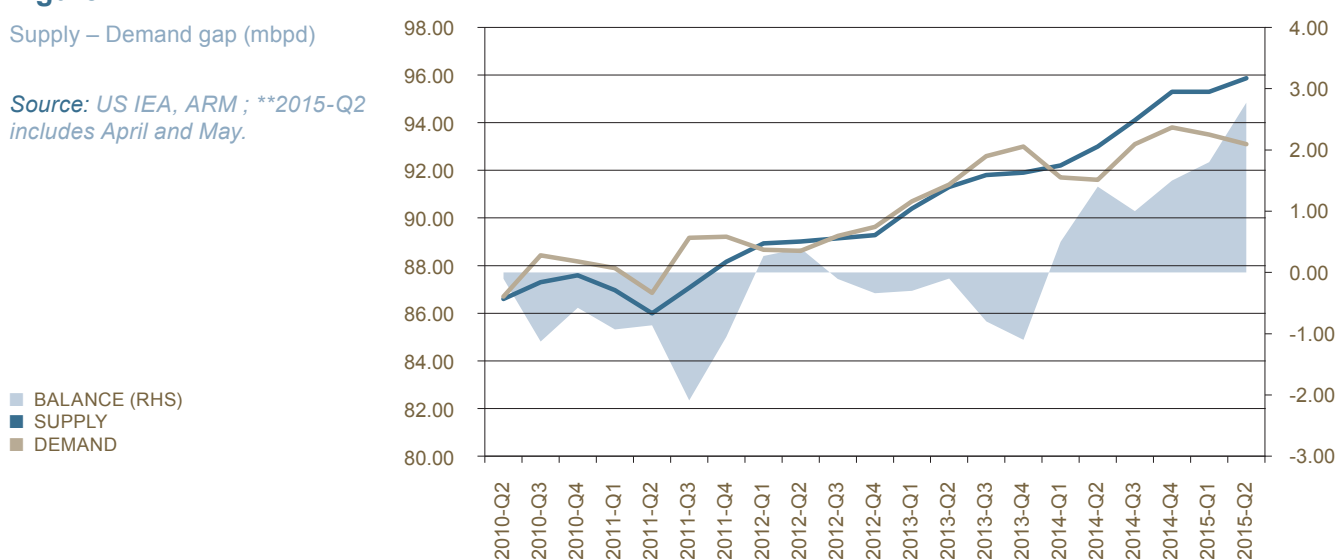
Demand slows relative to H2 14 but improves YoY

Global demand in H1 15 shrank 0.64% from H2 14 to 92.85mbpd, but increased 1.33% YoY, with lower oil prices positively impacting car sales in Europe and US. With lower transportation costs, Europe's oil demand growth hit a twenty year peak of 3.9% YoY in Q1 15 and in the US, auto sales hit a 13 year high at 17.79 million with pickup trucks and SUVs making up a majority of the gains. Asian regions mainly followed the path led by Europe and US, with India's demand for crude oil peaking at 4.2mbpd, benefiting from a combination of strong economic growth and lower oil prices. Meanwhile, China's demand rose as the government increased offshore and onshore reserves and was further bolstered by increase in diesel oil for infrastructure projects. In contrast, demand in Japan decreased as the country moved away from dependency on fuel and crude oil to alternatives such as natural gas, whereas in Mexico, oil demand fell due to the decreased use of fuel oil in the power sector. Nonetheless, the increase in demand on a global front was not enough to narrow the excess supply which increased 97% from H2 14 to 2.46mbpd (H1 14: 0.95mbpd).

Figure 17

Supply – Demand gap (mbpd)

Source: US IEA, ARM; **2015-Q2 includes April and May.



Despite the persisting oversupply, oil prices inched higher in H1 15 after bottoming at \$53.52/bbl in January, for Brent Crude. In many ways, the recovery reflected a bet that oil would rebound from the sharp fall in H2 14 with money managers, in particular, maintaining their bullish outlook on rising oil prices by increasing their net long positions by 39% from H2 14 to 222,357 lots as at May 2015. The steady

spread between Brent Crude and WTI Crude over H1 15, at an average of \$6.37/bbl, suggests the positive sentiment was broad-based and non-sensitive to the supply vagaries in diverse regions. In contrast, the premium typically enjoyed by Nigerian Bonny light over Brent crude collapsed to become a \$0.06/bbl discount in H1 15 (H2 14: +\$0.46) with implications for domestic revenues.

Figure 18

Crude Oil Prices (US\$)

Source: Bloomberg

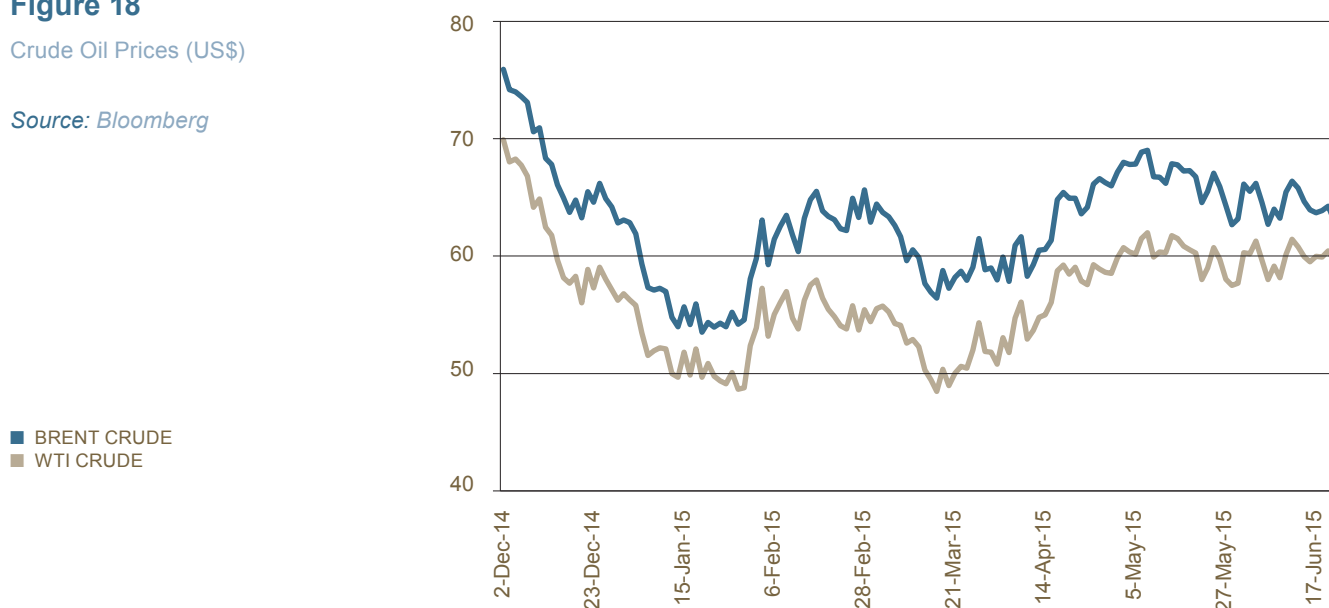
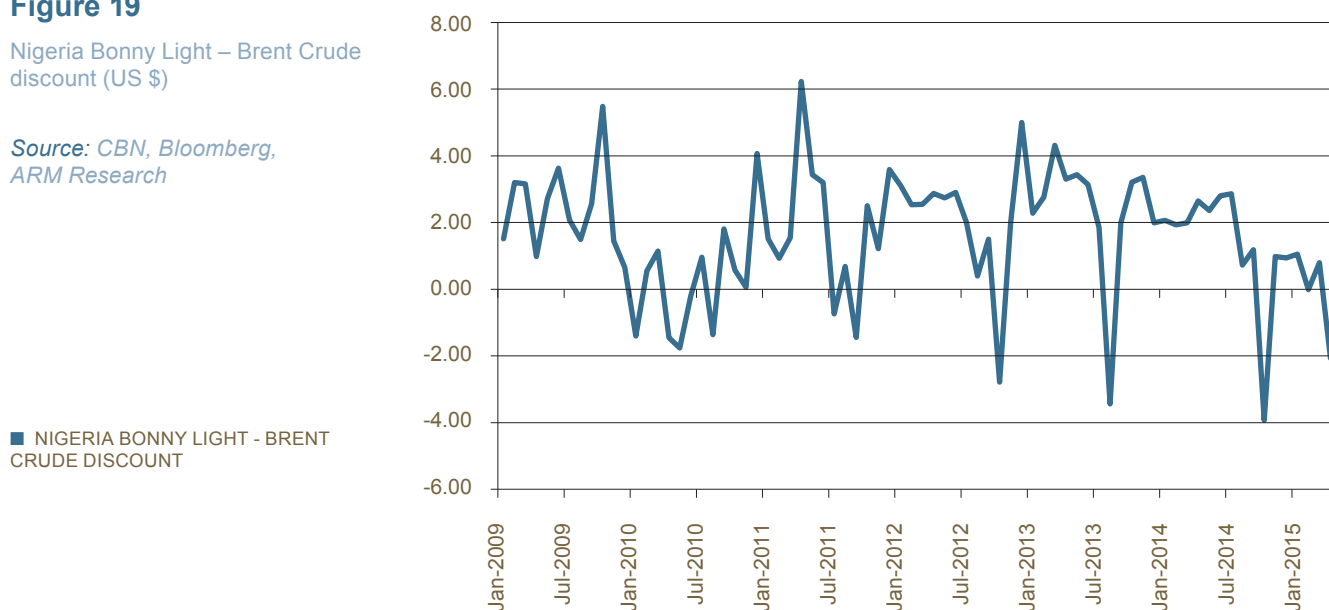


Figure 19

Nigeria Bonny Light – Brent Crude discount (US \$)

Source: CBN, Bloomberg, ARM Research



Iran and new shale dynamics could boost supply further

Going into H2 15, OPEC is likely to boost crude oil production in a bid to maintain its market share even as the date set to resolve the issue on Iranian sanctions approaches⁽¹⁵⁾. As Iran waits on the decision, it currently has 30mb of crude on tankers⁽¹⁶⁾, waiting to be shipped should the

(15) The initial deadline was June 30th and was extended to July 10th. At that meeting, a deal has been reached which would allow Iran to slowly release its crude oil into the market.

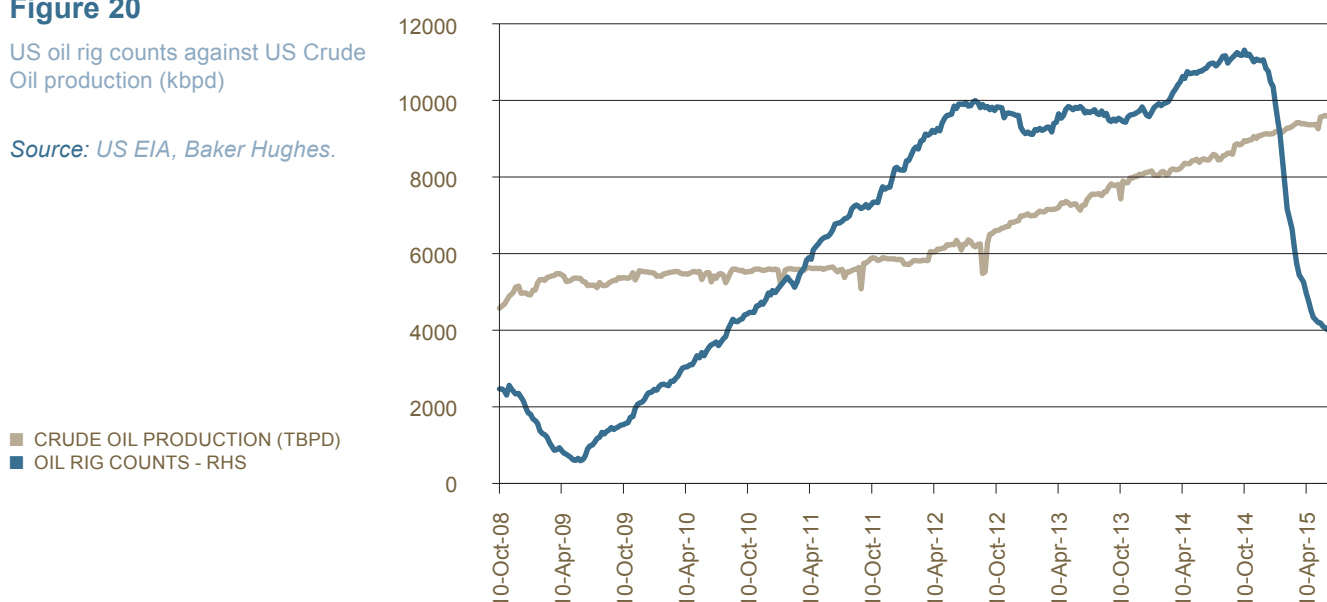
(16) IEA Report

sanction be lifted. Evidently, the recent 3-year high could easily be surpassed and we expect production to increase by 1mbpd over the next 8 to 12 months. Similar expectations are attached to US crude oil production, given the prolonged cutback in rig counts did not appear to interfere with further production rises. However, this partly reflected the usual lag (~23 weeks) between when rig counts fall and the impact on crude oil production materializes, similar to the pattern in 2008 when production levels initially rose slightly before tempering.

Figure 20

US oil rig counts against US Crude Oil production (kbpd)

Source: US EIA, Baker Hughes.



Nonetheless, as oil rig counts broke their 29 week decline in July, factors other than the lag suggest recent production gains might not be so fleeting. First and foremost, while the widely accepted ~\$80/bbl breakeven for shale oil had been central to expectations that shale production will wilt after the crash, more recent indications are that shale production is sustainable at as low as \$60/bbl. The lower breakeven prices stemmed from technological advancements by shale producers as they moved away from less efficient to more efficient oil wells and rigs, implying more is being done with less. In addition, producers reduced labor costs, allowing some key players to slowly return to the market. This is not to say that the impact of oil price crash has not materialized at all; however in-the-

money hedges supported cash flows and provided operations lifelines⁽¹⁷⁾. Nonetheless, with high debt levels, little chance of recreating similarly profitable hedges and likely financing challenges for smaller fields imply that the reprieve might be temporary, as five shale companies declared bankruptcy in this same period of overall improvement in production. Hence, the key takeaway is that aggregate prognosis for shale producers appear better than initially feared with a couple of other factors boosting the central support from lower breakevens. In all, whilst lagged rig count impact means production will likely fall by Q4 15 in the US, it will likely regain traction in H2 16 as shale producers adapt to the low priced

(17) SandRidge Energy Inc. for example earned 64% of its revenue from payments from this insurance hedge which guaranteed minimum prices of \$90/bbl

oil environment, with breakevens expected to fall further as a result of technological improvements. Whilst OPEC and, in particular, Saudi Arabia's strategy might impair the least efficient producers, in conjunction with likely on-streaming of Iranian output we envisage aggregate supply will remain elevated going forward.

Even as demand hotspots cool off

Despite revisions to its projected growth, China overtook the US as the world's largest oil importer in May 2015 as it continued to build reserves during H1 15. Whilst we expect demand to increase in China, we believe the rate of increase will slow, due to the difficulties the country faces as it changes the structure of its economy to be more consumption driven vs. investment driven. Similarly in Europe, the tensions in Greece following its default on its IMF loan could result in a ripple effect across the continent's economy, thereby weighing negatively on demand. However, like China we only expect the rate of increase in demand to slow the extension of low oil prices and the peak driving season in the summer months providing support. In India, which recently passed Japan as the third largest oil importer in the world⁽¹⁸⁾ even as it also surpassed China as the world's fastest growing economy, the uptrend in economic growth is expected to continue into H2 15. This positive growth would support demand as the country continues investments in infrastructure and refineries.

Competition for market share will extend excess supply into H2 15

The competition for market share in H2 15 could widen the excess supply gap as OPEC pushes crude production levels higher and shale producers become more efficient in extracting their product. Whilst the potential boost to supply from shale could be short-lived, based on reports that indicate conventional oil fields depreciates by 2%-5% (life can average 100 years) following the first year of production, compared with shale fields could depreciate up to 70% YoY (life can average 3-30 years). The development of new fracking methods which essentially extend the well life means this is another layer of the fabric expected to smother shale output fraying away. At the very least, shale

supply boost should continue into H1 17 and possibly beyond if mergers & acquisitions come back on the table. Earlier M&A expectations largely failed to pan out because most companies were valued using oil prices above \$90/bbl based on the higher oil prices. With the expected regime of prolonged depression in oil prices, it is logical to expect valuations to compress in tandem, allowing M&A plans to resume possibly as early as H1 16. This should in turn fuel the competition for market share, drive the exploitation of scale and ultimately keep oil supply flowing. The weather forecast adds to the gloom. In H1 15, in addition to higher car sales, increased demand was aided by the longer and colder-than-expected winter season. Given the shorter winter season in H2 15 relative to H1 15, demand could be even weaker and further weigh negatively on prices. Accordingly, we expect oil prices to resume declines in H2 15 possibly back to the January lows of \$40-\$45/bbl.

SOFT COMMODITIES POST FLEDGLING RESISTANCE ON NARROWER GLUTS

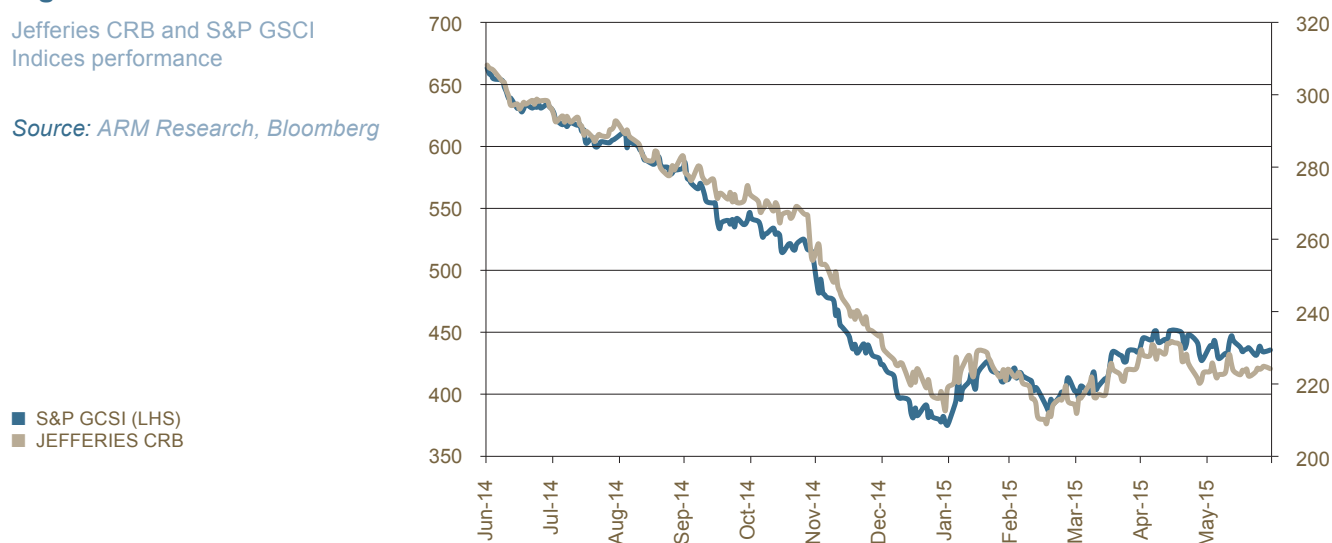
The decline in commodity prices that began four years ago continued into Q1 2015, however, prices rallied through the second quarter with both the Jefferies CRB and S&P GCSI indices slightly up at 1.7% and 2.8% respectively in the first half of 2015 (-27.2% and -34.3% YoY). Upon closer examination, the uptick appears driven by recovering soft commodity and energy prices, with the SPGCSI Agriculture and Energy sub-indices up 1.3% and 11.7% respectively, in the first half of 2015. Generally speaking, prices remained at relative lows, driven by a persistent supply glut cutting across most commodities, and exacerbated by relatively weaker global demand. On the whole grain prices have been the most affected by the supply overhang. Wheat output has exceeded consumption again in H1 15, further weakening its price, while falling Barley output has helped it find some support. Sugar and Crude Palm Oil (CPO) prices have also shown resilience in the first half of the year and look promising for the remainder of it.

(18) In June 2015

Figure 21

Jefferies CRB and S&P GSCI
Indices performance

Source: ARM Research, Bloomberg



Wheat oversupply to persist amid favourable weather
Winter wheat harvest for 2014/15 season is currently under way and CBOT Wheat prices are down 6% in 2015 to \$5.72/bushel⁽¹⁹⁾. The trend confirms our projections in our last report and our reasons, namely: continued oversupply relative to demand. On the supply side, favourable weather conditions in major planting regions over the season have resulted in record levels of global output. Although the US (8% of global supply) witnessed lower output on account of crop switching for better priced cash crops and excessive rains in some wheat producing states, this reduction was offset by improving yields in other major regions, specifically

Ukraine and Russia. In the EU, poor harvests induced by prolonged dry weather in Spain did little to hamper regional output as favourable weather boosted yields in the UK and France. Unsurprisingly, the US Department of Agriculture (USDA) estimates global output for 2014/15 season to have increased 9.5 million tonnes to 726 million tonnes (+1.4% YoY), close to the International Grains Council's (IGC) 721 million estimates. On the demand side, the USDA estimates wheat consumption for the 2014/15 season at 716 million, 12.1 million tonnes higher YoY. Whilst this narrows the supply gap, markets remain in surplus as global inventories climbed 10.43 million to 200 million tonnes.

(19) Winter wheat harvest last from mid-May to mid-July and overlaps with the spring planting season which lasts from mid-April to mid-May. Spring planting marks the beginning of a planting year i.e. 2015/16.

Figure 22

CBOT Wheat Prices

Source: Bloomberg, ARM Research



Over the coming season, the National Oceanic and Atmospheric Agency (NOAA) predicts good growing conditions in wheat growing regions across Europe which will boost crop yields in Russia, Ukraine and the EU. Nonetheless this is expected to be offset by lower output for the US, Argentina, much of the Middle East and North Africa. Consequently the USDA forecasts global output for 2015/16 to decline by 4.8 million tonnes. On the other hand, driven by increased demand for wheat based feed for livestock farming in Asia, Middle East, and North Africa, global demand in the new season is projected to grow marginally by 4 million tonnes –further narrowing the supply gap. Hence, we expect wheat prices to find some support in the near to medium-term, though likely capped by large inventories.

Barley prices begin recovery on account of declining output

At \$3.80/bushel, Barley prices are flat (-0.7%) in the first half of 2015 as a 5.4% decline in Q1 15 was mostly offset by a 5.2% increase in Q2 15. Relative to other grains, the better performance of barley prices is a result of supply falling below demand levels. Both the IGC and USDA estimate 2014/15 Barley output at 140.7 million bushels, 3.2% lower than the previous season. Boosts in output in EU and Russia (57% of global output) were insufficient to offset weather induced declines in output in other major producers like Canada, Argentina, US, and Turkey. In contrast, global consumption for the season remains unchanged at 141 million –as our prior expectation of a decline in demand for Barley-feed failed to materialize. Accordingly, global inventory levels dropped 1% to 25 million bushels.

For the 2015/16 season, though the IGC projects barley consumption to decline a further 3% due to the substitution of feed wheat for barley in near-east Asia, it also expects output to decline by a wider margin of 3.5% due to crop switching in Canada and the US and lower harvests across Europe. Based on this, our outlook is for Barley prices to continue trending upward over the remainder of the year.

Sugar prices steeply depressed on high inventories, but promising road ahead

Sugar prices have declined by a steep 22.2% in the first half of 2015 to \$11.93/lb. The bulk of the decline came in Q1 15 with prices down 19% over the quarter as the expectation of a fifth consecutive season of surplus weighed heavily on prices. The surplus continued into Q2 15 as prices slid further by 5.9% (-40% YoY) and global inventories rose 0.57% YoY to 44 million MT. According to the USDA, global sugar output for the 2014/15 season declined 0.7% to 174 million metric tonnes, as dry spells early in the planting season caused crop yields to suffer in Brazil, China, and the US (who collectively account for 31% of global supply). Nevertheless in confirmation of our expectations in prior reports, production levels remained above global consumption even as the latter rose 2.3% to 171 million MT in 2014/15– marking the fifth consecutive season of growth in global consumption.

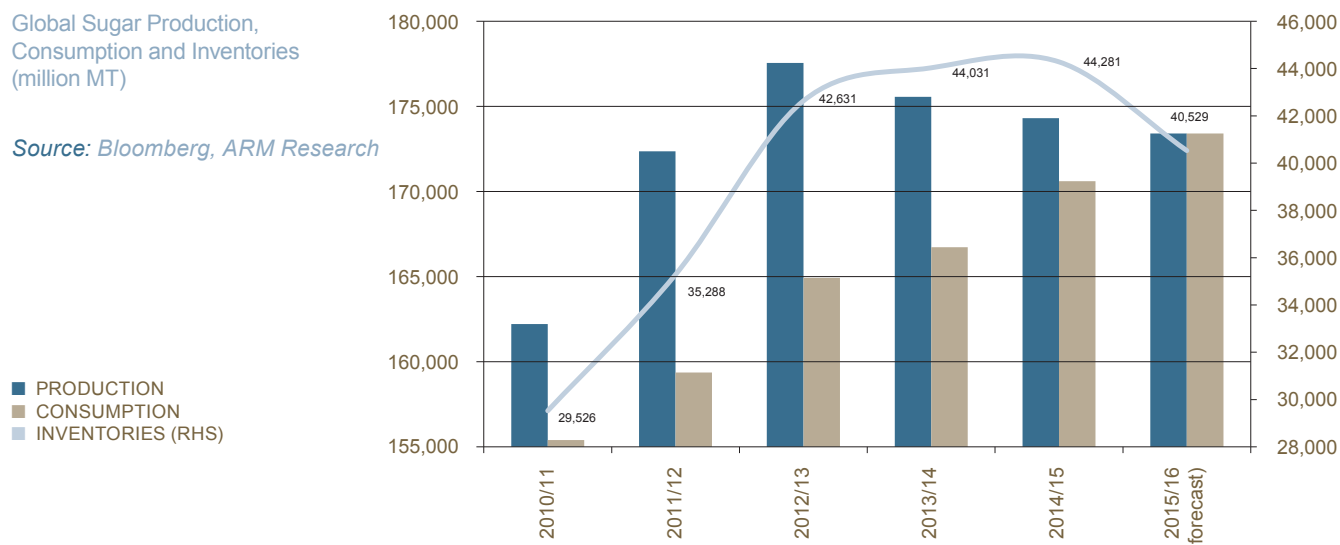
By all indications the convergence between declining supply and increasing consumption bodes well for sugar prices as we go into the 2015/16⁽²⁰⁾ season. Output for the next season is projected to decline further as increases in Brazil and Thailand are expected to be more than offset by declines in other key regions: Water shortages in Maharashtra have cut output forecast in India, and low prices continue to discourage sugar farming in EU and US. On the other hand, growth in use of sugar for ethanol refining in Brazil, and in food processing in India and China are expected to keep consumption trending upwards over the next season. For these reasons, our outlook is for the decline in sugar prices to slow to a halt over the remainder of the year, and recover thereafter.

(20) Planting started in April

Figure 23

Global Sugar Production,
Consumption and Inventories
(million MT)

Source: Bloomberg, ARM Research



CPO down but perhaps not out...

In the first half of 2015, CPO prices have applied the brakes to their four year long decline and trended sideways. Nonetheless prices remain 23% lower YoY at \$600/MT (-5.5% YTD). Having declined 9% in the first quarter of 2015 alone, prices fared better in Q2 by gaining 4%. The fall in demand for CPO as a source of biodiesel in India and China which pushed prices lower in Q1 15 was offset by renewed demand in both those markets for CPO to compensate for falling stocks of other edible oils, in particular vegetable oils. Furthermore a string of regulatory decisions in key producing countries that came in Q2 helped prices recover and improved the scope for future uptick in demand. First, the US Environmental Protection Agency (EPA) announced new regulation requiring all diesels produced in the US to have a biomass content of 50% by 2017. Second, the US Food & Drug Administration (FDA) has placed a ban on hydrogenated (Trans) fats in food manufacturing processes⁽²¹⁾. Further regulations in key producing countries add to the upside for demand. In a bid to support the market for their key export, the governments of Malaysia and Indonesia, like the US, have respectively raised the biomass blend requirement of domestically refined fuels to 10% and 20% respectively. Though fraught with implementation difficulties, these policies are set to

boost demand for CPO in the short to medium term. On the supply side, unusually dry weather patterns towards the end of May have raised concerns about the impact of El Nino activity on crop conditions in south-east Asia. Nonetheless, the USDA has left its supply estimates for the 2015/16 season the same whilst raising its projections for demand – output and consumption are respectively projected to grow 5.7% and 5.9% YoY in the 2015/16 season⁽²²⁾. The change in the fundamentals underpinning demand in the market underpins the reconsideration of our prior position on CPO prices. Now, our outlook is for prices to improve over the remainder of the year spurred mainly by higher demand.

Locally, the bearish outlook for oil prices suggests government and personal spending will remain subdued, keeping the corporate space under pressure. Whilst the broad theme of convergence of supply and demand suggests softer commodities could be finding support, translating into higher input costs for some commodity processors and consumer goods, the net impact could yet be positive as the reflation allows better pricing and margin recovery. Nevertheless, any potential boost from commodity prices will likely be insufficient to offset the general impact of oil prices on domestic consumer demand.

(21) Hydrogenated (Trans) fat is manufactured by artificially saturating fat by infusing it with hydrogen atoms. Palm oil saturates naturally and is a popular substitute.

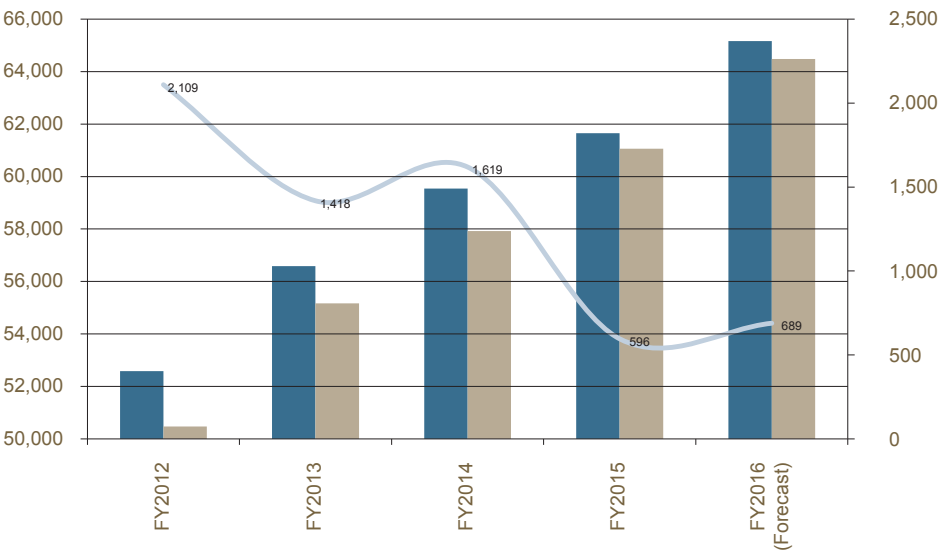
(22) El Nino tends to produce dryness across SE Asia where 85% of the world's CPO is produced. The extent of impact is difficult to predict as the phenomenon varies in intensity.

Figure 24

Global CPO production and consumption (Million MT)

Source: USDA, ARM Research

■ GLOBAL OUTPUT
■ GLOBAL CONSUMPTION
■ NET DIFFERENCE (RHS)



KEY DEVELOPMENTS IN DOMESTIC ECONOMIC AND POLICY ENVIRONMENT

The early part of 2015 was quite turbulent as political risk via the general elections coincided with a time of decided fiscal strain induced by depressed oil prices. As the uncertainty built and long-standing problems of insecurity remained intractable, the response of global risk monitoring agencies had a feel of inevitability to it. In the self-same manner, the peaceful handover of power and surprising but welcome commitment to adjust to new realities had little choice but to dispel the gloom and raise the outlook for the remainder of the quarter. Having had its macro-vulnerabilities ruthlessly exposed in the past year or so, the somewhat brisker pace of reforms in the country appears set to lend firm backing to that optimism, though the markets remain watchful as the new government finds its feet. To the latter point, we believe some new numbers from the NBS embody some pointers that could reinforce the thrust of economic policy and we discuss these in our feature report.

A TALE OF TWO COALITIONS: ONE A MILITARY SUCCESS, THE OTHER A POLITICAL TUG-OF-WAR

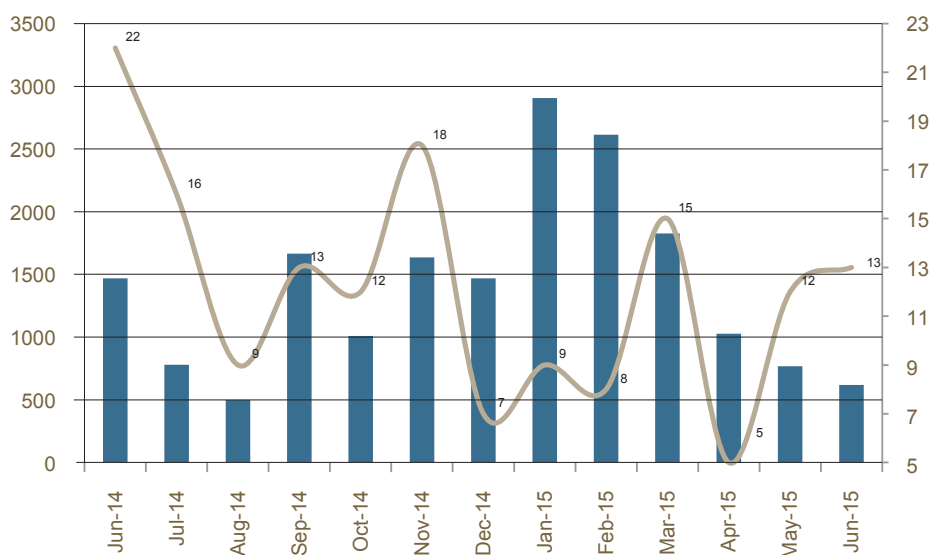
Boko Haram down but needing knockout punch

After the massive escalation of Boko Haram (BH) activities in 2014, 2015 appeared set for a turn for the worse as the year started out with the Baga Massacre in Borno State where 2,000 civilians were left dead. Given the ominous start (with a number of subsequent attacks), it seemed unsurprising that the then-administration was perceived as being more preoccupied with the political realities of falling oil revenues, in an election year. Ironically, it was the same insurgency which provided the caveat for the February 7th presidential postponement of the general elections with the official line being a need to ensure security and facilitate completion of permanent voter card (PVC) distributions. As can be expected, the opposition roundly condemned the move as election engineering, marketing it as a sign of jitters in the camp of the incumbent. What was beyond debate however was the undeniable successes the ensuing military campaign yielded with BH driven from much

of the territory it had acquired in its brief phase of ISIS-inspired land grabbing.

In many respects, the contrast with the preponderant theme of military ineffectiveness at the time reflects the impact of the collaboration between Nigerian and foreign military forces which was a new tack we identified in our last report. Whilst the impact of the sect began to wane from that point on, the direct economic challenges induced by the crisis continue to demand attention. According to estimates by the UN Refugee Agency (UNHCR) and FEWSNET, the crisis has caused the internal displacement of over 1.4 million Nigerians, and has crippled the local economy by disrupting farming and trading activities in much of the region. Consequently, the region has been embroiled in a state of food insecurity which is expected to persist. Even the positive posed by the rescue of 300 women and children in the first major military gain, and the subsequent rescue of 250 more, constitutes a challenge in terms of the need to provide adequate care.

Whilst the new administration has sought to consolidate these gains by moving the military command HQ to Maiduguri, closer to the crisis epicenter and as a sign of commitment to defeating BH, there is a need to avoid complacency. Although the impact of the insurgents has clearly waned, their determination appears intact as the number of attacks remains little changed (and still elevated over last year). In that regard, confronted by a more equipped and organized military presence, the reduction in the sect's casualties would appear to simply reflect a reversion in tactic, back from territorial acquisition to guerilla warfare, which still necessitates the full force of military might.

Figure 25Deaths attributable to the
BH insurgencySource: Council on Foreign Relations,
ARM Research■ MONTHLY DEATHS
■ MONTHLY ATTACKS (RHS)

Peaceful elections, calm delta: is everything now rosy?

Orchestrated by a much more cooperative opposition which had the interest of a number of parties well aligned, the 2015 presidential elections marked the first time in Nigeria's 55 year history that an incumbent president was removed by the vote and not by coup. In the run up to the elections, tensions rose to a fever as increased fears of political volatility caused the NSE to decline 8% over the week that followed. Increased political risk only added to the list of things that weighed unfavourably on investor's mind as Nigeria's credit rating was downgraded to B+ by Standard & Poor's. Nonetheless, with the peaceful conclusion to the elections, investor skittishness seems to have abated (NSE +5.54% in Q2 15).

In our last update, we alluded to the security risk posed by Niger Delta militant activity in the event of a Buhari victory. Fortunately that risk did not materialize and the Niger Delta has stayed peaceful in the early months of the new administration – perhaps precautionarily, due to the perception of President Buhari as a seasoned military leader. As unfolding events with the Niger Delta and BH fit into belief in the new leader's ability to deliver discipline, attention shifts to the other important plank of the platform that brought him to power—economic revival; even as extant challenges mean a sense of urgency is already building.

Coalition victories needing final touches

So far the Presidency has not been forthcoming with guidance, and the delay in moulding a government has been a serious cause for concern as many facets of the economy remain on pause pending some inkling into policy thrust. Incidentally, the President's lauded military background led to the belief that in light of his economic inexperience, the economy would be managed by a caucus of technocrats galvanized from the ruling party. Unfortunately, just over a month into the new administration, events in the upper and lower houses of the legislature already undermine the union that delivered electoral victory. The drama surrounding the appointment of the Senate President, and the bouts of physical altercations between ruling party law makers in the lower house suggests rifts run deep within the party. Just as with the optimism surrounding recent military gains against BH, the positive vibes engendered by a much-demanded change of government will be of little use, if pressing economic and social issues allowed to fester by years of mismanagement and insecurity do not start to receive immediate attention.

Rating agencies act on worsened outlook for Nigeria

In Q1 15 the impact of the escalation of BH activity echoed beyond the confines of Nigeria. Beyond heightening domestic security concerns, it also provided a basis for the big three rating agencies,

in March, to make adjustments to their views on Nigeria with Standard & Poor's leading the pack by downgrading Nigeria's credit rating to B+, while Moody's and Fitch (Ba3 and BB-) maintained theirs and instead switched their outlooks from stable to negative. Also adding to the rationale for the downgrade was the heightened state of political risk brought on by the general elections which, it was thought, would lead to sectarian violence and undermine state security, especially if it were to be postponed for a second time. However, the foremost factor influencing the status relegation was the deterioration of economic prospects as a consequence of the downdraft in crude oil prices. The drop in oil prices has placed considerable strain on the government purse, greatly reducing oil receipts (which accounts for over 70% of government revenues), and in particular, constraining the apex bank's capacity to defend the Naira. Nevertheless, as we opined at the time, investors had already priced in the aforementioned risks prior to the downgrade as evinced in the average 30bps fall in yields across Nigerian Eurobonds in the following week⁽²³⁾. It is worth adding that the actual downgrade came at a time when the first clear signs of progress in the BH campaign had become apparent, and the country was just a week away from the appointed election date with minimal risk of a postponement, which suggests some over-weighting of these factors.

Upon present analysis, we find more reason to deemphasize some of the aforementioned factors. The BH campaign has been further consolidated in the months since (though they remain active), and the post-election period was marked by anti-climax as a peaceful transition stood in place of much expected partisan violence. Consequently, we maintain our view that the economy and the government's fiscal position remain the key issues facing any possible change in our ratings going forward. Specifically, though we remain bearish on oil prices, we are encouraged by government activism in response to the dire fiscal conditions including, passing a more realistic budget qualified by sizeable cuts in expenditures and a more reasonable \$52/bbl oil price assumption. Nevertheless, the direction in which the Buhari government will take its economic policy remains to be seen, and JP Morgan's postponement of its decision on Nigeria's status in its GBI-EM index underlines the importance of the market's assessment of the new economic team's ability to guide the country through the still uncertain terrain that lies ahead.

MAJOR ADJUSTMENTS KEEP FISCAL HOUSE TOGETHER... JUST FOR NOW

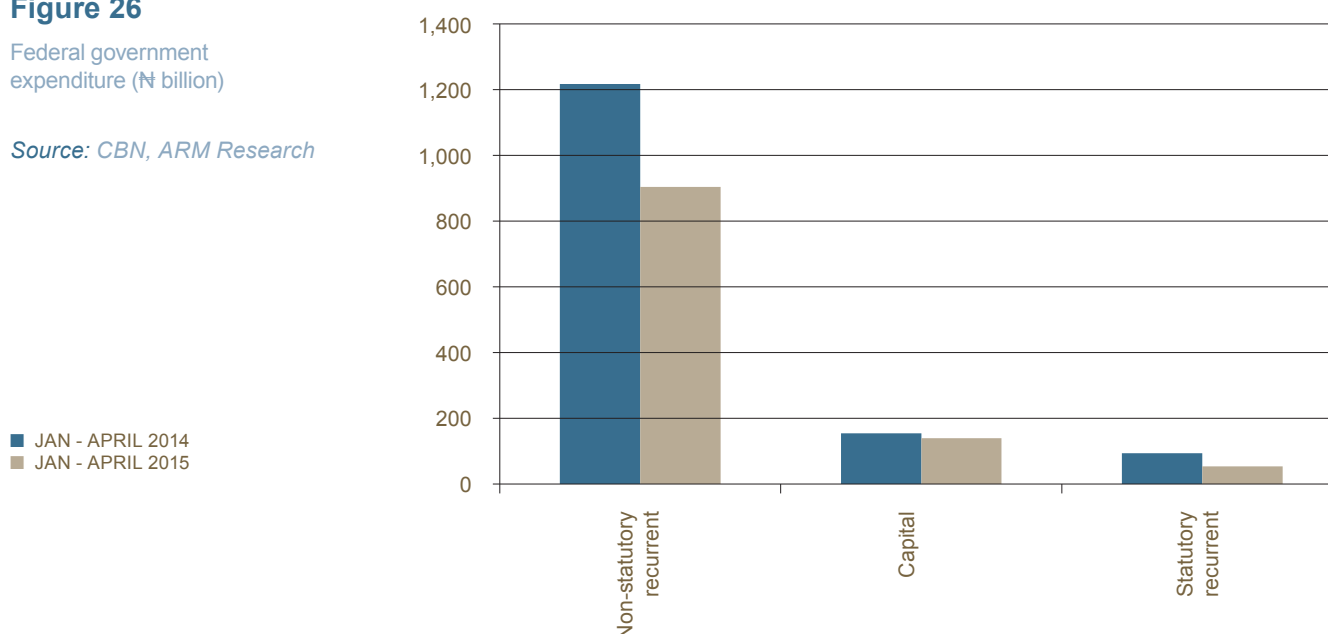
Depressed oil price exposes Nigeria's vulnerabilities

Gross federally collected revenues fell to multi-year lows of ₦2.4 trillion (-28% YoY) over the first 4 months of 2015 on the back of softer oil receipts. Deviating from recent norms where weak oil output had been the drag on oil proceeds, low oil prices was the main culprit over this period. Nonetheless, the impact of oil price which averaged \$55.28/bbl (Jan – April), 50% lower than the corresponding period in 2014, was compounded by 3% YoY shrinkage in oil output to 2.1mbpd, plunging oil proceeds to a 5 year low of ₦1.5 trillion (-40% YoY). On the other hand, driven by record high FGN independent revenue (FIR) in excess of ₦290 billion in April 2015 (April 2014: ₦21.6 billion), non-oil receipts rose 21% YoY to ~₦1 trillion year through April, even as company income taxes softened (-9%) to ₦214 billion. Although breakdown of the components of FIR are unavailable, based on ~90% of this FIR being accrued to the FG, we believe the jump could be early outcome of the recent drive by FG to enforce the policy which requires MDAs to remit 25% of gross revenue. Accordingly, though the fiscal challenges dragged FG's FAAC allocation 22% lower YoY, cumulative Federal government revenues stayed flat YoY at ₦1.2 trillion through April 2015, buoyed by FIR. Interestingly, the FG posted a budget surplus of ₦106 billion over the period by responding to the deteriorating fiscal position with a 25% YoY cut in expenditure. The cut largely emanated from non-statutory recurrent expenditure, which is ₦300 billion lower (-26% YoY), and statutory allocation—₦40 billion below 2014 levels. On the former, despite no major report of unpaid salaries at the Federal level, the non recurrent expenditure which barely covers budgeted personnel expenses suggest MDAs experienced delayed salary payment. Incidentally, the capex spend trails corresponding period last year by only 9%, but after averaging ₦45 billion monthly in Q1 15, the sharp plunge in capex to ₦4 billion in April suggests our prognosis, as set out in our H1 15 report, that capex budget is set to suffer under current conditions could yet pan out.

(23) Please see our previous report: "Ratings downgrade behind the beat"

Figure 26Federal government
expenditure (₦ billion)

Source: CBN, ARM Research



ISPO deductions compound states' weak IGR

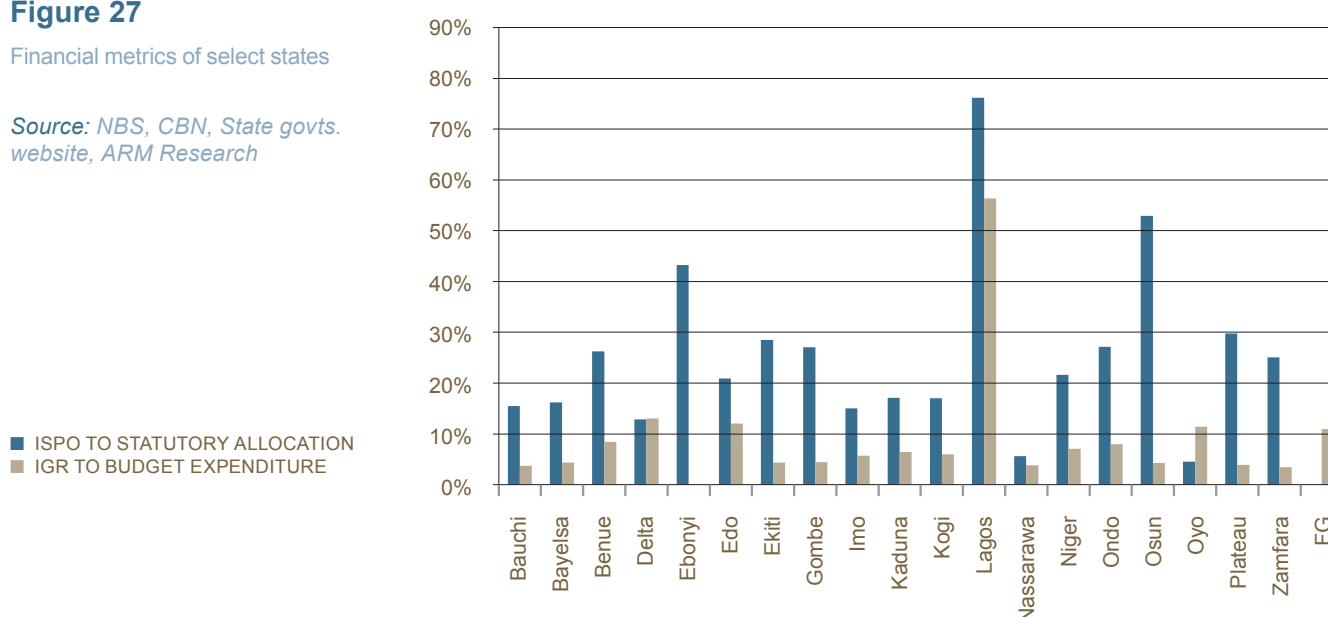
Although there is limited timely information on states' financials, media reports that half of the 36 states owe salaries hints at precarious fiscal position of a number of states. In our view, this is primarily reflective of weak IGR which funds less than 10% of states' expenditure—a risky state of affairs we highlighted in our last report—but compounded by stable irrevocable standing payment order (ISPO) deductions on debt obligations. In Lagos state for instance, high IGR to expenditure ratio (2014:56%) masked significantly

low net statutory allocation of ₦600 million in April after a ₦2 billion ISPO deduction. On the other hand, although a similar ISPO deduction trimmed Osun state's net statutory allocation by 41% YoY to ₦841 million that same month, weak IGR to expenditure ratio (2014:4%) meant there was little alternative boost to offset the relatively small deduction, exposing the state's financial vulnerability. As an immediate measure, the FG has agreed to the distribution of part of the Excess Crude Account, but long-term, ramping up IGR appears the only way to go⁽²⁴⁾.

(24) The FG approved the disbursement of ₦700 billion (NLNG CIT: ₦400 billion and structured CBN loan: ₦300 billion)

Figure 27

Financial metrics of select states

Source: NBS, CBN, State govts.
website, ARM Research

Is the approved 2015 budget nearer reality?

With crude oil prices hovering around multiyear lows, and fast fading prospects of a sharp rebound in the near-term, the FG revised key assumptions in the earlier version of the 2015 budget to better reflect current environment. The downward revision in the crude oil price benchmark to \$52/bbl (\$65/bbl previously) trimmed revenue expectations, but importantly, widened projected deficit to ₦1.1 trillion, which in our view is more realistic than ₦755 billion in the earlier proposal and in line with the ₦1 – ₦1.2 trillion expectation outlined in our Q1 15 Strategy update. Similar to prior budgets, the 2015 deficit is set to be financed via traditional sources; borrowing (80%), ECA (10%) and other sources, including sale of FGN signature bonus and sale of properties. However, in a slight deviation from the recent tack, where borrowing was largely domestic, 25% of 2015 borrowing is expected to be foreign-sourced, in form of \$2billion budget support from the World Bank and African Development Bank. Although the FG links the move to a deliberate attempt not to crowd out the private sector from the debt market, we believe it is a reflection of FG's sensitivity to high interest rates domestically, with average interest rate on FGN debt at 12% as at year end 2014. To buttress this point, the H1 15 refinancing of the ₦535 billion 2015 4% FGN bond that matured in April, at an average marginal rate of 15%, adds roughly ₦60 billion to estimated 2015 debt service. On other sources of funding,

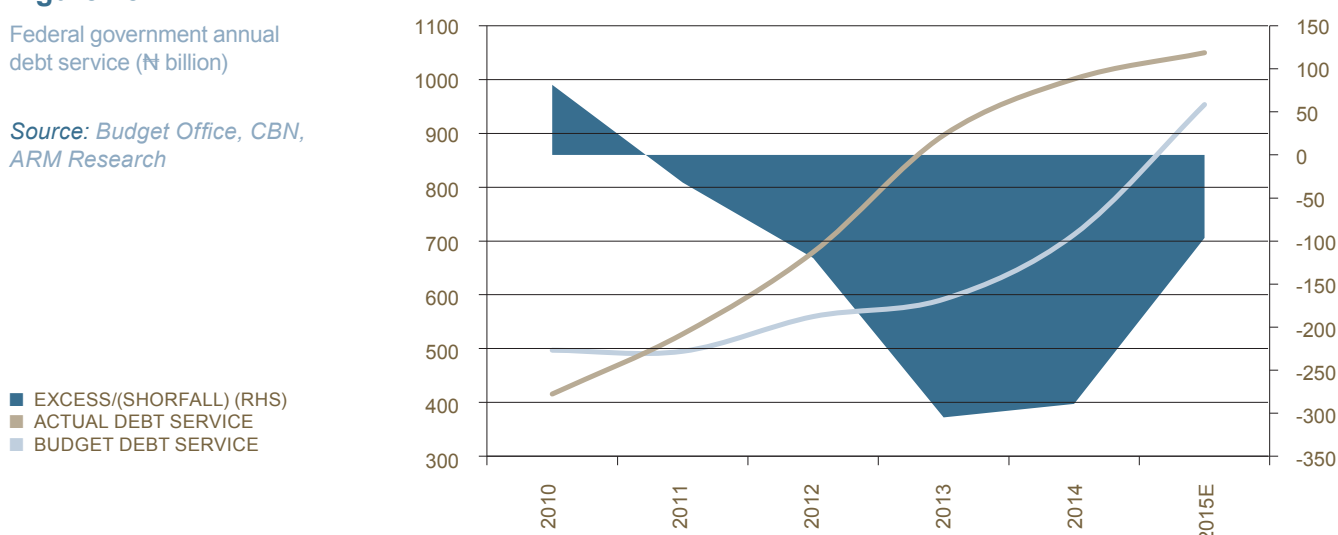
although the \$2.6 billion in the ECA should cover its 10% share of the projected deficit, soft oil prices, which diminish the odds of the oil field licensing round occurring, likely eliminates signature bonuses as a credible income source. In any case, these bonuses have been absent in the last few budgets.

Although the foregoing suggests the financing of the budget is largely sorted, two developments suggest 2015 deficit is set to exceed even the seemingly more realistic estimates. First, the halving of the 2015 PMS and kerosene subsidy budget to ₦100 billion and ₦45 billion appears not to incorporate the changes in dynamics, including the 10% reduction of PMS prices and further naira devaluation in February. Combined, these events have driven subsidy per litre to levels (between ₦30 and ₦50) only previously obtainable in periods of high oil price. Our estimates, given current oil price and daily consumption of 45 million litres and 8 million litres for PMS and HHK, implies subsidy bill of ~₦850 billion (PMS: ₦600 billion HHK ₦150 billion). Another finding that could magnify 2015 budget deficit is the provision for debt service. In particular, high interest rate environment over the last few years have kept actual debt service persistently above budget, with 2014 debt service of ₦1 trillion about 40% in excess of budget. Admittedly, while this reality underpinned the ramp up in projected 2015 debt service to ₦954 billion, the continuous substitution of lower cost debt with higher suggests debt service is likely to exceed target this year, as in 2014. Indeed,

Figure 28

Federal government annual debt service (₦ billion)

Source: Budget Office, CBN, ARM Research



annualising current run rate of 2015 debt service and adjusting for higher interest rates over H1 15, we expect debt service to exceed budget by at least ₦100 billion. Plugging both (subsidy and debt service)

estimated overshoots into the FG's template, whilst leaving other assumptions unchanged, implies 2015 budget deficit in excess of ₦1.4 trillion, excluding the ₦260 billion subsidy arrears.

Table 3

2015 budget estimates (₦ billion)

Metric	2015 B old	2015B Approved	*2015B Estimate
Oil production (mbpd)	2.28	2.28	2.28
Oil price (\$/bbl)	65	53	53
Oil and gas receipts	6,065	5,431	5,431
JV cash calls	1,219	1,404	1,404
Subsidy (PMS)	200	100	600
Subsidy (DPK)	91	46	150
Net oil revenue	4,554	3,882	3,277
13% derivation	591	505	505
Federation account	3,963	3,377	2,771
FGN share (48%)	1,922	1,638	1,344
Non-oil	1,124	1,325	1,325
Independent	450	489	489
others	110		
FGN revenue	3,606	3,452	3,158
FGN 2015 BUDGET	4,357	4,493	4,593**
Budget (deficit)/surplus	(755)	(1,041)	(1,435)
Exchange (N/\$)	160	190	190

Source: Budget Office, FMF, ARM Research * ARM Research estimate **incorporates additional ₦100 billion in debt service

...what import for lofty plans of the new government

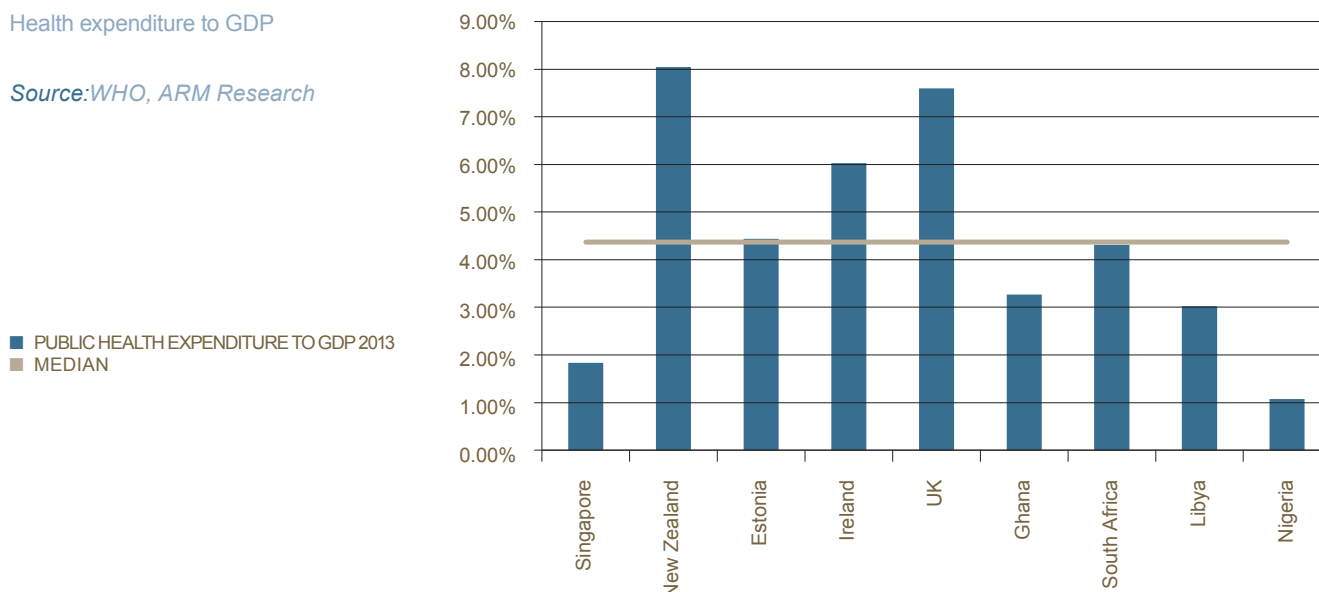
The prospects of the budget deficit exceeding projections, even if revenue estimates are met, is set to create all sorts of challenges for the new government as it could mean that a sizeable portion of the campaign “promises” are likely to be deferred. Amongst other initiatives, the new government proposed a range of social welfare programs such as free health care education and safety net for every citizen as well as conditional monthly social security payment of ₦5,000 for poorest 25 million in Nigeria which, combined, are sure to cost trillions. To put into context, current

public health expenditure in Nigeria of ~1% of GDP or ~\$5.6 billion (₦1.1 trillion) is the lowest amongst select African countries that provide free health care services to citizens. Matching Nigeria's health care expenditure with average of 3.5% for these African countries (South Africa, Ghana and Libya) and assuming the FG bears approximately half, in line with trend elsewhere, implies an additional \$6.4 billion (₦1.3 trillion) annual expenditure. Overlaying the foregoing with an estimated ~₦1.5 trillion, based on sums to be paid to the 25 million poorest Nigerians, it is easy to see why these promises might remain just that without rapid boost in revenue base and cost curtailment, both of which cannot be achieved without major reforms.

Figure 29

Health expenditure to GDP

Source: WHO, ARM Research



Broad based reforms must start with low hanging fruits...but subsidy must go

Although the President is yet to set out his policy thrust, gleaned from media reports, reform of the oil and gas sector, possibly via reorganisation of the NNPC, appears to top the list. This makes sense, particularly at a time where profligacy will be more costly than ever, and after numerous audit reports, by sources ranging from PWC to NEITI and senate committees, indicting the corporation for non-remittance of oil and gas proceeds. However, being established by law, the NNPC cannot be disbanded without legislation. This again brings to the fore the importance of speedy passage of the Petroleum Industry Bill (PIB) that has languished at the legislature for over 7 years. Unfortunately, the importance of the bill diminishes the odds of passage in the current form, as we expect some alteration by the new government which could delay the bill for at least another year. That said, quick fixes abound in the form of better surveillance of water ways and crude infrastructure to reduce crude oil theft as well as halting or capping direct deduction of expenses and capex by NNPC to a certain percentage of revenue. Regarding the latter drive, relating to its discretionary deductions, the NNPC has typically found one form of expense or the other to excuse the numerous instances of under-remittance it has been fingered for. For instance, the last NEITI audit report stated that ~\$11.6 billion (₦2.3

trillion) NLNG dividend between 2006 and 2011 is yet to be remitted to the Federation Account, to which the NNPC responded that dividends had been utilised to fund gas related projects. Similarly, details of the PWC audit report show that the corporation tied half of the missing \$20 billion (₦4 trillion) to defrayment of subsidy on regulated petroleum products—another area in need of urgent attention in its own right. However, subsequent reconciliations have resulted in the corporation having to make one refund or the other, with the current ~₦7 billion paid monthly since H1 2012 being a case in point. This clearly indicates something is amiss and highlights the potential impact of capping the adhoc deductions which could help the FG free up billions of dollar simply by ensuring proper scrutiny of the NNPC.

In light of our belief that subsidy bill could match 2014 levels, at least, we struggle to see how the new government can sustain the subsidy regime without significantly ramping up borrowings, more so, with the liability likely understated in the budget. Notably, lessons from climes where sustenance of subsidy programmes, even in the face of weak revenue, partly contributed to worse fiscal positions with higher debt to GDP⁽²⁵⁾ gives a glimpse into probable consequences. While Nigeria still maintains healthy debt ratio, funding such consumption at 14% interest rate could easily drive the ratio to unsustainable levels. In

(25) Egypt and Ghana have debt to GDP ratio of 80% and 55% respectively

any case, as part of reforms, more countries—including India, Egypt, Ghana and Argentina—in the last few years commenced phased removal of subsidies on petroleum products and that seems the reasonable option at this time. However, after the backlash that trailed the botched attempt to fully deregulate in 2012, we believe, for any removal to be successful, the buy-in of the labour union and larger public is critical, particularly as incessant fuel shortages that commenced weeks to the elections have—persisted and—created a thriving shadow market where PMS sells as high as 3x regulated price.

One other option to ramp up income is via the sale of interests in some oil and gas JV agreements. However, given depressed oil prices, valuations of these interests are likely to be low in the current environment even as bearish outlook for oil prices means there are no guarantee of improvements in the long term, especially considering limited scope for improvement in oil output—which has been flat to lower in more than a decade. To our mind, pursuing the reform of the oil and gas sector with the required vigour is likely to deliver similar and, importantly, more sustainable benefits to fiscal receipts.

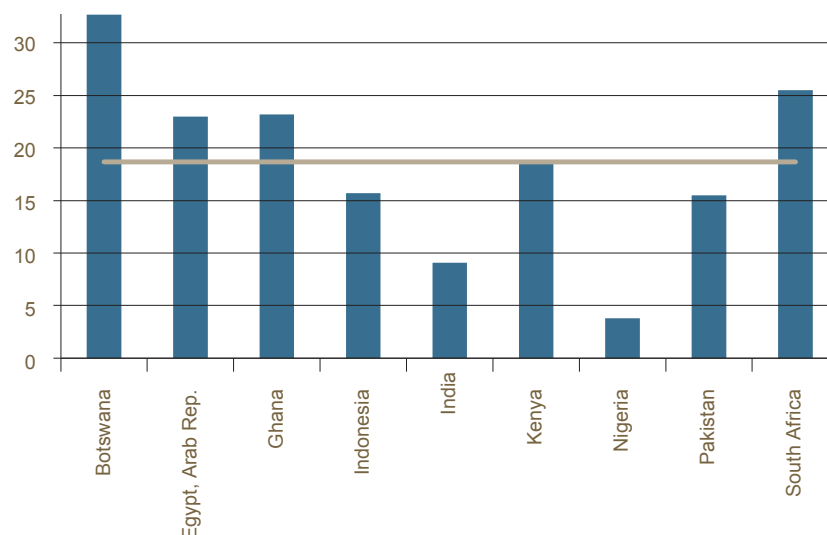
Ordinarily, with Nigeria's tax to GDP significantly below peer average, the government would look to bolster its tax base at such a time as this. However, a woeful track record of putting national funds to use curtails its wiggle room at the time its needed most. For instance, perhaps the quickest way to improve non-oil revenue is via a hike in VAT to 10% or 15% which by our estimates could see an additional ₦200 to ₦300 billion accrue to the FG. However, beyond the usual justification that Nigeria has one of the lowest rates in Africa (5%) there is little justification for the hike going by the quality of service in the country. Furthermore, coming at a time when imported inflation continues to pressure disposable income, there is likely to be strong resistance, similar to 2007. In the same vein, whilst raising other non-oil taxes hold ample potential to boost revenues, of necessity, it's likely to remain a medium to long drive which is unlikely to alter the fortunes of the FG over 2015. Nonetheless, measures to broaden and diversify the economic base must commence now such that taxes grow even without an increase in the rate.

Figure 30

Tax to GDP ratio of select countries

Source: CIA Fact book, ARM Research

■ 2014
■ AVERAGE



Power Sector: CBN, NBET, and FGN grease reform tracks...

In February 2015, in the first and second tranches of the Nigeria Electricity Market Stabilization Facility (NEMSF), the CBN disbursed ₦57.79 billion to 11 power companies

comprising 5 DISCOs and 6 GENCOs with the loan payable within 10 years of receipt. According to the apex bank, the funds were to support generation plant maintenance, transmission upgrades and distribution networks – including transformers and better metering for end consumers. With this, stakeholder optimism for

an eventual resolution of some power sector revenue monitoring challenges received a boost. In particular, the total sum rolled out in the first two legs of the scheme already outstrips the legacy debts of ₦36.9 billion owed to gas suppliers while the excess could be utilized to improve metering system – as highlighted by CBN – and positively reinforce NERC's recent effort to clamp down on customers who tamper with domestic meters and crimp sector revenues in the process.

On other fronts, FGN's formal provision of guidelines for efficient signing of Power Purchase Agreements (PPA) with Nigerian Bulk Electricity Trading (NBET) Company in January 2015 – aimed at fast-tracking the entire process of signing PPAs – appears to hold a few promises. Notably, the rules aim at improving clarity on issues relating to contractual frameworks for power generation, risk allocation, and tariff considerations. For its part, NBET continued to add to its long list of PPAs signed with GENCOs in 2015. It entered into PPA agreements with 10 new thermal generation companies (GENCOs) of the National Integrated Power Projects (NIPPs) late in H1 15, in furtherance of its quest to increase predictability and durability of expected returns from future power sector investments.

... but power value chain remains in knots

Despite the efforts of NERC and CBN, with the former providing incentives for adequate gas supply by hiking benchmark gas to power price 67% to US\$2.50 per thousand cubic feet (mcf) and the latter helping to stamp

out pending debts to gas suppliers, gas supply for power generation failed to improve in H1 15. As noted by Ministry of Power, only an insufficient 8% of the entire five billion standard cubic feet of gas produced per day was directed to power generation in the period, with ~80% exported to foreign markets and the balance 12% used up by other industries. While explaining the improving preference for gas supply to industry relative to gas supply to power, the immediate past Minister of Power noted that gas suppliers' reluctance to make gas available to GENCOs is largely underscored by fear of repeat of past experiences of delayed debt repayment. This underpinned suppliers' insistence on long term letters of credits as guaranties for supplies to GENCOs which incidentally exposed the latter's struggles as they largely failed to meet payment obligation. However, credit-worthiness was not the only concern as disturbances to Trans Forcados Pipeline (TFP), which reportedly accounts for ~50% of gas supplied to domestic gas market, and Escravos-Lagos Pipeline (ELP) further hindered supply. According to presidential task force on power generation, whilst the TFP reportedly suffered from oil theft and sabotage almost daily in the period, the ELP was blown up 4 times between January and March 2015 alone. Away from security-related concern, shutdowns in major gas plants such as Shell's Alakiri Creek gas plants and 10 NIPP power plants – including Ihonvor and Geregu 1 & 2 – also affected gas supply in the period. These shut downs were particularly linked to strike actions by Petroleum and Natural Gas Senior Staff Association of Nigeria (PENGASSAN) and National Union of Petroleum and Natural Gas (NUPENG) – branch of Nigerian Petroleum

Table 4

Recent Incidences of Vandalism & Impact on Gas & Power

Incident Date	Pipeline	Gas Plants	Gas Volumes (MMScf/d)
29-Dec-14	TFP	Oben, Sapele, Oredo	200
4-Jan-15	TFP	Oben, Sapele, Oredo	200
7-Jan-15	TFP	Oben, Sapele, Oredo	200
30-Jan-15	ELPA	CNL	150
5-Feb-15	TFP	Oben, Sapele, Oredo	200
9-Feb-15	ELPA	CNL	150

Source: Ministry of Power, ARM Research

Development Corporation (NPDC) which accounts for ~30% of gas used in generating Nigeria's electricity – over transfer of rights over Oil Mining Lease (OML) 42 to two indigenous companies in the period.

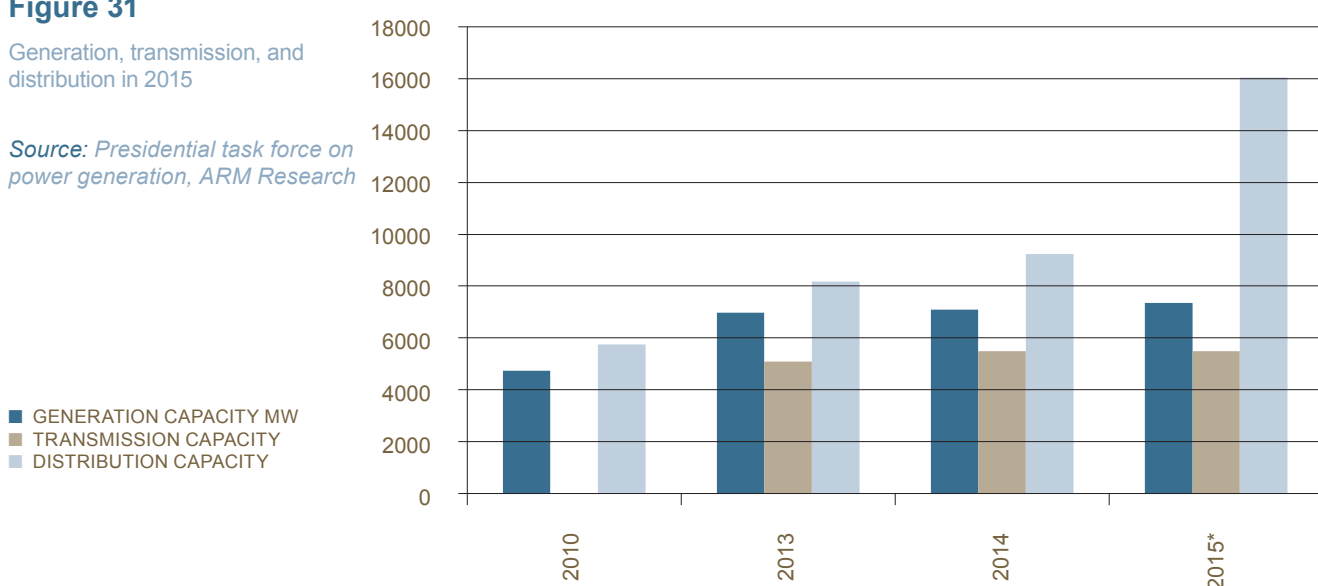
Unsurprisingly therefore, whilst generation capacity is predicted to remain fairly stable at 7348MW in 2015 relative to YE 2014 numbers, the aforementioned gas supply challenges has restricted GENCOs capacity to raise actual power generation over H1 15. To

buttress on the linkage with the aforementioned factors, Ministry of Power explained that a loss of 200 MMscf/d due to gas pipeline vandalisation could translate to ~700MW reduction in power generated while noting that pipeline vandalism led to a loss of 900 MMscf/d between January and February 2015 alone. This confluence of events led to decline in actual energy generated to ~2391.31MW in May 2015 from peak of 3,841.05MW in early February, before eventually recovering to 3655MW in June.

Figure 31

Generation, transmission, and distribution in 2015

Source: Presidential task force on power generation, ARM Research



The weak generation relieved transmission of being the key constraint on power supply, though YE 15 capacity is likely to remain flat from 2014 at 5500MW—clearly looking off the pace in reaching set target levels of 10,000 MW by 2017 and 20,000 MW by 2020. This is in spite of the reported deployment of ~ \$2.7 billion of funds from World Bank, African Development Bank (AfDB), and French Development Bank, amongst others, into construction of new transmission lines and substations across the country. As has been the case in prior years, poor coordination with other players in the value chain i.e. GENCOs and DISCOs as well as bureaucratic delays in the execution of projects hampered power transmission in the country. Nonetheless, the very low generation meant current transmission capacity was able to support onward transmission of 98% of power generated in the last two months of H1 15.

For the DISCOs end, possibly reflecting the impact of CBN funding via NEMSF and the rise of several NIPP DISCOs, installed capacity is expected to jump 74% from YE 14 numbers to 16,050MW in 2015. However, frequent meter tampering by consumers remains a significant weight on revenues. Importantly, while noting the entire value chain's ultimate reliance on DISCOs for effective revenue collection, NERC recently issued a directive on meter reading, billing, cash collection and credit management to guide operators on the issue of revenue collection. In addition, the institution recommended disconnection and penalty – in form of a fine – to serve as deterrent to future offenders.

... will coal power Nigeria to the goal?

From the foregoing, the myriad of constraints, in particular, gas supply challenges remain a major clog in the wheel of progress on the power reforms. In addition, while measures such as NEMSF presented sparks of positives, the sheer size of the target yearly capital investment of ~ ₦520 billion earlier earmarked by Ministry of power for the realization of power generation capacity of 13000MW within a 3 year period and current economic realities necessitate the promotion of further partnerships with non-government institutions and pursuit of alternatives. To this point, FGN's recent memorandums of understanding with Milhouse and One Nation Energy on the development of Enugu coal reserve and its subsequent utilization for power generation in March 2015 are pointers to newer efforts at galvanizing alternatives to gas-based power. This drive was further bolstered by African Development Bank's recent pledge of US\$200m as Partial Risk Guarantee (PRG), specifically for coal-to-power projects. Interestingly, this development positively complements earlier plans for substantial investments in nuclear power plants in the country as both are geared towards reducing dependence on the erratically-supplied gas. In passing, we note that, on the urging of International Atomic Energy Agency (IAEA), Nigerian Atomic Energy Commission (NAEC) recently announced plans to commence detailed evaluation and characterization of the nuclear power sites for the proposed 4000 megawatt power plants at Geregu and Itu – respectively in Kogi and Akwa Ibom states.

In our view, coal to power looks a relatively easier path in terms of managing environmental and regulatory constraints. Whilst the use of coal for energy generation could also engender some concerns about environmental hazards, the case for its suitability in the country is supported by Ministry of Power's resolve to seek out and encourage clean coal technology that would see possibility of emissions significantly reduced. In addition, AFDB's PRG offers a measure of reassurance and backing for long term solution to incessant gas infrastructural challenges in Nigeria. Given recent accentuated investments in this area and the Ministry's guidance for an expected 500MW from planned coal-propelled energy generation from the South East over the long term, we see scope for

significant gains in overall outcome of the current fuel to power campaign of the ministry.

That said, in the near to medium term, we expect disruption of gas pipelines and vagaries of production to continue to underpin erratic power generation in the country. Notably, after an assessment of potential impact of industry changes on key players in the sector, we note that sub-optimal power generation is likely to stoke shortages, narrow down the amount of power delivered to consumers and stimulate fear of possible re-appearance of cash flow worries for DISCOs. This, together with reported frequent meter tampering by end users, could impact negatively on fees and service charges collected and, ultimately, hamper revenue numbers in the near to medium term. Thus, with the earlier noted NBET's PPA agreement looking likely to drive increased scope for faster cash returns to GENCOs in the medium to long term, these emerging revenue worries at the DISCOs end could return them as the weak link in the entire process going forward.

PIB and deregulation considerations dampens interest in mini refineries

Perhaps one fall-out of the controversial PwC audit report⁽²⁶⁾ is the new government's apparent prioritization of NNPC and oil sector reforms over other restructurings. Interestingly, even as speculations that the President could eventually take on responsibility for the oil ministry underscores the weight of emphasis placed on the issues, the more recent dissolution of the board of NNPC on June 26, 2015 suggest political will to go even deeper to root-out traces of unaccountability in the institution. The need for a more transparent NNPC had already re-invigorated the long dragging debate over passage of the PIB, which was meant to revamp everything (i.e. from fiscal terms to the overhauling of NNPC, environment rules, and revenue sharing). However, whilst the lower chamber of the 7th National Assembly managed to pass the PIB on its last day of seating (June 3, 2015), the upper chamber – Senate – were unable to see the bill through.

On a positive note, work on Dangote Lekki refinery appears to be progressing, with the reported

(26) Following allegations of unremitted Funds into the Federation Accounts by NNPC, FGN contracted PwC to embark on a forensic investigation of the allegations. Following the investigations, PwC drew attention to irregularities in the operations of the NNPC, which included unverified demurrage costs, and unsubstantiated NPA charges.

selection of Honeywell Technologies, whose sister company – UOP technology – has been championing the development of the refinery, as eventual facility operator upon completion. In turn, UOP recently disclosed that its process technology, catalysts and proprietary equipment would form the basis for Dangote refinery. Besides this, expected production from the facility was scaled up to 650,000bpd (vs. 450,000bpd initially planned) whilst planned capacity for the petrochemical plant project was increased by over four folds to 3.6 million tonnes. This would comprise 2 million tonnes for polypropylene and 1.6 million tonnes of polythene. Overall, whilst renewed political will on the part of the new government bolstered early hopes of a quickened pace in Nigeria's oil sector reforms, concerns over policy framework means the Dangote Refinery represents the only potential game-changer with its benefits likely longer-term, suggesting frequent domestic shortages and reliance on importation of refined crude will subsist in the interim.

On other fronts however, DPR's recent downward review of the \$1 million (now \$50,000) prospective modular refinery owners were supposed to deposit with it appears to have increased the ease of setting up mini refineries in the country. Specifically, the move reduces both the cost and time to completion of mini refinery projects. More importantly, DPR expressed hopes that the current affordability should forestall a repeat of past experiences such as in 2002/2003 when the issuance of 18 licenses for the establishment of private refineries was stifled by prohibitive requirements. Thus, with capacity utilization in Nigerian refinery at ~ 21%, given its small size and greater flexibility, mini or modular refineries are better able to adapt to meet dynamic local demand and clutch value from marooned hydrocarbons in remote locations and marginal fields. In addition, with importation of refined fuel constituting significant part of Nigeria's import, a re-direction to modular refinery could lead to substantial forex savings for the country.

However, despite aggressive campaigns to stimulate interest in modular refineries, investors remain cautious of the impact of government's price regulation of the downstream sector as well as that of the long-dragging debate on passage of the PIB on private refinery business. In particular, with government stalling on complete deregulation of the downstream sector, continued enforcement of price ceilings could make meeting cash and debt obligations difficult for potential modular refinery investors who might rely heavily on bank funding. In addition, while commenting on investors'

reluctance to pick up modular refinery opportunities in Nigeria, DPR highlighted lack of funding as principal restraint on investor interest. In particular, government's insistence that modular refinery operators obtain local crude oil at international market prices while holding firm to the proviso of sales at the official rates (i.e. PMS: ₦87/litre) stokes fears of unattractive returns for would-be investors. The overall obscure commercial framework for both borrower and lender, with local banks having grown wary of funding oil-related businesses, appears to have underpinned stakeholders' recent clamour for sovereign guarantee on foreign loans.

PENSION REGULATOR DELIVERS ON PENDING INITIATIVES AND FORCES INDUSTRY IMPROVEMENT

Multi-fund structure resurfaces...but does it really change the status quo?

In continuation of recent reforms in the pension industry, the National Pension commission released a draft amendment to the investment regulation of pension fund assets with the major change being the introduction of regulations for the multi-fund structure. The multi-fund structure is expected to afford pension contributors the opportunity to generate returns commensurate with their risk tolerance by allocating them into four funds which have different exposures to variable income (VI) securities. According to PENCOM, the VI securities include Ordinary Shares and participation units of Open, Close-ended and Hybrid Funds; Real Estate Investment Trust; Infrastructure Funds; and Private Equity Funds. While the announcement of the multi-fund structure is not new, the initial 2012 guideline was aborted due to "operational hiccups". Though PENCOM did not provide details on the exact nature of the hiccups, its decision to proceed suggests greater confidence in the workability of the current guidelines. The 2015 version differs from the previous in some major areas including: exclusion of the Islamic focused fund, alteration of the age bracket for the various funds, and modification of maximum and minimum exposure to VI securities. Furthermore, while the opportunity to switch between funds was retained, it is now restricted as pension scheme participants can only move between their default zone and a riskier fund, and exercising that right which will only be free if done not more than once in every three years.

Table 5

Comparison of Multi-Fund structure according to 2012 and 2015 guidelines

	2015				2012		
	FUND 1	FUND 2	FUND 3	FUND 4	FUND 1	FUND 2	FUND 3
Maximum exposure to variable income instruments (% of fund value)	75%	55%	20%	10%	70%	50%	30%
Minimum exposure to variable income instruments (% of fund value)	20%	15%	5%	0%	10%	5%	0%
Default Zone (Age bracket)	N/A	Below 50 years only	50 years and above	Employees ready to retire	35yrs and below	Between 36yrs and 45yrs	46yrs and above
Active choices		Can switch to Fund I	Can switch to Fund II	N/A	Can switch among Funds	Can switch among Funds	Can switch among Funds

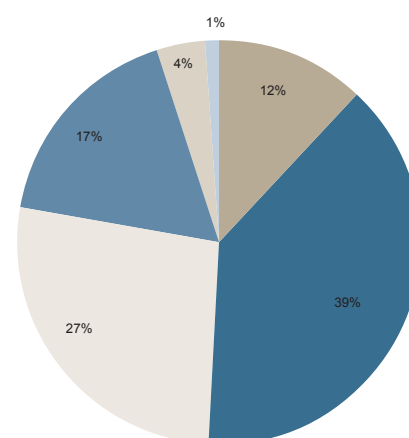
Source: PENCOM, ARM Research

In assessing the potential impact of implementing the multi-fund structure on asset allocation and future investment decisions, we made some assumptions within existing constraints. For instance, PENCOM only provides demographic information related to RSA participants but not contribution of age brackets to the total RSA assets, making a direct attribution of how much assets will fall into each of the new fund categories difficult (especially as the age bracket definitions under the current and new schemes also don't exactly fit). According to the PENCOM's demographic data, 78% of the 6.3 million RSA scheme participants are below the age of 50 years,

17% are between 50 and 60 years, while 5% are above 60 years. For starters, we have matched this latter age bracket, and specifically the existing RSA Retirees Fund (which wholly houses participants in this category with the new Fund IV), which is for those who are retired or ready to, as we believe the difference is only in nomenclature. Based on the fact that this 5% currently contributes 12% of the ₦3.54 trillion total RSA assets, we estimate an RSA contribution of ₦1.4 million per person. Taking cognizance of the disproportionate contribution of the retiree category and basing it on their likely longevity in service and seniority/earning power, we

Figure 32

Age distribution of pension fund contributors

Source: PENCOM, ARM Research

- LESS THAN 30 YRS
- 30 - 39 YRS
- 40 - 49 YRS
- 50 - 59 YRS
- 60 - 65 YRS
- ABOVE 65 YRS

proceeded to estimate the potential size of Fund 3 by discounting the per capita contribution of Fund IV by 20% and applying that figure (¥1.1 million) to the available demographic information for the number of people who fall into that age bracket. This means the balance of ¥1.96 trillion pension assets then fall to Fund 2 pension contributors who are below 50 years of age and the implied per capita contribution of ¥401,000 appears reasonable given that a significant proportion of those within this age bracket are likely still early in their careers. In sum, our analysis indicates that Funds II, III and IV would respectively be allocated 55%, 33% and 12% of total RSA assets should the multi-fund structure take effect today.

After estimating asset size in each category, we then proceeded to overlay this with guidelines on maximum and minimum exposures for each fund to determine if, and in what way, RSA asset allocation will be impacted by the multi-fund structure. We considered four extreme scenarios which are:

A) All pension contributors elect to stay in their default zone (i.e. those below 50 years stay in Fund II, those above 50 stay in Fund III, and retirees stay in Fund IV) with all the funds having maximum exposure to VI securities

B) All pension contributors elect to stay in their default zone with all the funds having minimum exposure to VI securities

C) All pension contributors elect to switch to the riskier fund zone (i.e. those below 50 years move to Fund I, those above 50 move to Fund II, and retirees in Fund IV) with all the funds having minimum exposure to VI securities and

D) All pension contributors elect to switch to the riskier fund zone with all the funds having maximum exposure to VI securities.

The calculation of A is $(0.55 \times 55\%) + (0.33 \times 20\%) + (0.12 \times 10\%) = 38\%$.

Similarly, scenario C is calculated thus: $(0.55 \times 20\%) + (0.33 \times 15\%) + (0.12 \times 0\%) = 16\%$

Table 6

Possible VI allocation based on Multi-fund structure

	Pension fund manager minimizes exposure to variable income securities	Pension fund manager maximizes exposure to variable income securities
if all Pension Contributors stay in default zone	10% (B)	38% (A)
If all Pension Contributors switch to the riskier fund	16% (C)	61% (D)

Source: *PENCOM, ARM Research*

We could consider less extreme scenarios by assuming not all contributors in a given Fund switch with the implied start-off allocations obviously at levels

in-between those in the extreme scenarios, though Fund IV remains unchanged all through. The table below shows data for percentage contributors

Table 7

Possible VI allocation based on 25%, 50% and 75% switches by Pension Scheme Participants

Exposure to VI securities 25% of contributors switch	Maximum	Minimum
Fund I	10.4%	2.8%
Fund II	27.3%	7.5%
Fund III	4.9%	1.2%
Fund IV	1.2%	0.0%
Total	43.8%	11.4%
50% of contributors switch		
Fund I	20.8%	5.5%
Fund II	24.2%	6.6%
Fund III	3.3%	0.8%
Fund IV	1.2%	0.0%
Total	49.4%	13.0%
75% of contributors switch		
Fund I	31.1%	8.3%
Fund II	21.1%	5.7%
Fund III	1.6%	0.4%
Fund IV	1.2%	0.0%
Total	55.0%	14.5%

Source: ARM Research estimates

Importantly, In all the foregoing scenarios, (except for the extreme B), allocation to VI securities is above the current for RSA assets. Having previously highlighted a herd mentality based, overly risk averse, asset allocation by PFAs, our analysis suggests some change to that might be in the offing as the multi-fund structure brings a higher floor allocation to VI securities. Perhaps more importantly, the wide range of possible investment allocation gives

room for PFAs to implement views more forcefully and perhaps deviate from the mentality that has seen PFA allocations find safety in similarity of strategy---regardless of whether it is optimum or not. Irrespective of how PFAs allocate this increased VI exposure, one asset class that is sure to benefit from the multi-fund structure is the infrastructure fund, which must be earmarked at least 5% of Fund I and II's total asset allocation.

Table 8

Historical RSA Allocation

Security Type	2007	2008	2009	2010	2011	2012	2013	2014	2015*
Variable Income Securities	16%	10%	11%	14%	15%	14%	13%	11%	11%
Fixed Income Securities	84%	90%	89%	86%	85%	86%	87%	89%	89%

*Source: PENCOM, ARM Research, *May 2015*

Table 9

Global Portfolio limits for Multi-Fund Structure and RSA active Fund

	2010	2011	2011	2012	2013
	FGN & CBN Securities: 60%	FGN & CBN Securities: 70%	FGN & CBN Securities: 80%	FGN & CBN Securities: 80%	FGN 80%
	State and Local Governments:	State and Local Governments:	State and Local Governments:	State and Local Governments:	State and Local Governments:
Government Securities (including Sukuk, Mortgage Bonds and Eurobonds)	i. 10%, if issue is backed by ISPOs/ Guarantees ii. 3%, if issue is not backed by ISPOs/ Guarantees	i. 15%, if issue is backed by ISPOs/ Guarantees ii. 3%, if issue is not backed by ISPOs/ Guarantees	i. 20%, if issue is backed by ISPOs/ Guarantees ii. 3%, if issue is not backed by ISPOs/ Guarantees	i. 20%, if issue is backed by ISPOs/ Guarantees ii. 3%, if issue is not backed by ISPOs/ Guarantees	i. 20%, if issue is backed by ISPOs/ Guarantees ii. 3%, if issue is not backed by ISPOs/ Guarantees
Corporate Debt Securities (including Sukuk, ABS, MBS, GDNs, Eurobond and Infrastructure Bonds)	35%, subject to a maximum of 15% in Infrastructure Bonds.	40%, subject to a maximum of 20% in Infrastructure Bonds.	45%, subject to a maximum of 20% in Infrastructure Bonds.	45%, subject to a maximum of 20% in Infrastructure Bonds.	35%, subject to a maximum of 15% in Infrastructure Bonds.
Supranational bonds/Sukuk	20%	20%	20%	20%	20%
Money Market Instruments (including Certificates of Deposits; Bankers Acceptances; and Commercial Paper of corporate entities)	30%	30%	35%	35%	35%
Ordinary Shares (including GDRs) Infrastructure Funds	30%	25%	10%	5%	25%
Infrastructure Funds	10%	5%	0%	0%	5%
Private Equity Funds	10%	5%	0%	0%	5%
Open, Close-end and Hybrid Funds (including REITs and ETFs)	25%	20%	10%	5%	20%

*Source: PENCOM, ARM Research***Finally an appropriate equity index appears**

Considering the restrictions of the National Pension Commission (Pencom) which regulate amount of equity holdings (5% or less of AUM) in any company as well as illiquidity/limited free float of a number of stocks, the NSE-ASI—which is highly skewed to five stocks which account for 55% of index weighting—has been inappropriately used to evaluate equity performance of pension fund managers. Thus, the announcement of the FTSE Nigeria Investable Pension Fund (IPF) Benchmark⁽²⁷⁾, an equity benchmark which is investable, and complies with all Pencom restrictions in May 2015, is a welcome development for the pension industry. Similar to NSE, the FTSE IPF is a market capitalization weighted

index whose components are comprised of FTSE Frontier Index companies listed on the Nigerian Stock Exchange. More pertinently, the IPF additionally screens companies for free float, taxable profits, dividend payment, liquidity, sector and individual stock weighting. To be included in the benchmark, companies must have taxable profits in, at least, three out of five preceding years prior to an index review and must have paid a dividend or issued bonus shares in at least one of the five years prior to an index review. The index also addressed the problem of liquidity as companies in the benchmark must trade at least 0.4% of its issued shares based on its velocity trade⁽²⁸⁾ per month for at least eight of the twelve months prior to the review period, otherwise it will be removed. Stocks in the index are also adjusted for free float

(27) Pencom stated that the FTSE benchmark would enable it better assess the equities portfolio of individual pension funds.

(28) The velocity trade is calculated by dividing the sum of daily trades for each month by the free float adjusted shares on the last day of the month

restrictions. The launching of this benchmark which will be reviewed on a semi-annual basis in June and December along with available bond indices⁽²⁹⁾,

should facilitate informed and optimal decisions by pension contributors about their pension asset in the case the transfer window is implemented.

(29) The velocity trade is calculated by dividing the sum of daily trades for each month by the free float adjusted shares on the last day of the month

Table 10

Characteristics of top ten constituents on FTSE-IPF and the NSE-ASI

FTSE IFF			NSE		
Constituent	Market Cap (N'Million)	Weight (%)	Constituent	Market Cap (N'Million)	Weight (%)
SEPLAT	225	4.80	Dangote Cement	2,930	26.55
Lafarge Africa	221	4.71	Nigerian Breweries	1,107	9.65
ETI	221	4.71	Guaranty Trust Bank	783	7.07
Forte Oil	220	4.7	Nestle	674	6.18
Dangote Cement	216	4.61	Zenith	599	5.46
Unilever	214	4.57	ETI	351	3.14
Guaranty Trust Bank	213	4.55	Lafarge Africa	469	2.78
Nestle	213	4.54	FBN Holdings	286	2.62
Nigerian Breweries	212	4.53	Stanbic	278	2.48
Guinness	205	4.37	Unity	29	2.46
Total	2160	46	Total	7506	68

Source: FTSE, Bloomberg, ARM Research

Table 11

FTSE Nigeria IPF Industry Breakdown

Industry	No. of Constituents	Market Capitalisation (N'M)	Weight %
Oil & Gas	4	574,399	12.25
Industrials	4	560,245	11.95
Consumer Goods	11	1,383,334	29.51
Health Care	1	88,167	1.88
Financials	17	2,081,044	44.4
Total	37	4,687,189	100.0

Source: FTSE

Pension Reconciliatory issue eases with EPCCOS

In a bid to address the lingering reconciliation challenges encountered with the remittance of employees' pension contributions, the Nigerian Inter-Bank Settlement System (NIBSS) in collaboration with Pension Operators (PenOp) Association of Nigeria developed a web based e-Payment Collections platform named Electronic Pension Contribution Collection System (EPCCOS). Hitherto, employers who subscribed to the contributory Pension Scheme (CPS) make payments to Pension Fund Custodians (PFCs) and manually fill employee schedule forms which are to be submitted to Pension Fund Administrators (PFA's). However, a significant portion of employers either fail to present the required schedules or submit schedules that contain errors. As a result, employees' RSA accounts are not credited and there would be a slow build up of un-reconciled funds lying with PFCs. Hence, the implementation of EPCCOS, which is intended to drive seamless pension contribution remittance and schedules collection, minimise reconciliation issues and ensure timely crediting of employee's RSA and Straight Through Processing (STP), was deemed necessary, with EPCCOS also facilitating prompt notification to all parties (employers, PFAs and PFCs). Employers are now only required to upload contribution schedules prior to payment, with the platform generating unique reference number and amount payable based on schedules uploaded. The PIN digits will then be used by the employer to make payment using any of the platform's e-banking facilities. Meanwhile, the PFCs and the PFAs are only expected to verify the uploaded schedules with the amount remitted by the employer. In sum, implementation of EPCCOS will greatly assist employers to comply with the Pension Reform Act guideline which stipulates that employers must remit employees' Pension Contributions within 7 days of staff salary payments.

In sum, the aforementioned reforms (operational, benchmark and allocation changes) should address constraints imposed on the industry by regulatory restrictions on one hand and inadequate systems and procedures on the other hand, with scheme participants' benefitting from the improved service delivery. Furthermore, the transfer window which remains on the horizon, should fast-track improvement of internal challenges, as pension contributors who

are disgruntled with the quality of service from their pension houses (investment and operational), will likely change PFAs. However, in terms of asset allocation, the desire to differentiate performance, rather than the mechanics from the new fund structure, might be more instrumental in driving an embrace of more risky instruments. On a different note, Pencom's conclusion of plans to provide guidelines in facilitating the implementation of "Pension Protection Fund⁽³⁰⁾" which should address operations of the fund, fund management, custody and eligibility criteria and ultimately provide an additional measure of safety for pension contributors. In all, the regulator continues to show signs of commitment to setting the industry on a long-term sustainable path, a trend which bodes well for the industry at large and is worthy of emulation by other regulators.

MARKET REPOSITIONING STILL IN PROGRESS

WACMIC continues march for improved region-wide market liquidity...

West African stock exchanges took another stride in their resolve to promote greater market liquidity with the ongoing roll out of the second face of West African Capital Markets Integration Council (WACMIC) propositions. Dubbed "passport stage", the second phase is structured to enable qualified brokers in West Africa access jurisdictions within the region they wish to trade in directly. According to WACMIC, capital market operators will be provided with common passports that would be mutually recognized by WACMIC member security exchanges, securities commissions and depositories (CSDs). Ultimately, this phase is expected to permit issuers of securities in any member country to take advantage of other West African markets with greater liquidity. Interestingly, the attendance of representatives of regional economic bloc – ECOWAS – at WACMIC's 5th ordinary meeting in March 2015, wherein they reinforced support for the initiative, bolstered hopes of successful actualization of the programme. In particular, they noted that the regional power is poised to assist WACMIC in resolving issues requiring high level political approvals.

Whilst Nigeria's relative market size and liquidity makes it a logical hub, in the interim, lack of standardization of regulations on mandatory reporting by companies, with

(30) The Pension Protection Fund is meant to guarantee minimum pensions to pension scheme participants

Burkina Faso, Togo, Senegal, and Côte d'Ivoire of the BRVM yet to adopt IFRS, will likely remain a constraint as investors find it difficult to judge the financial health of

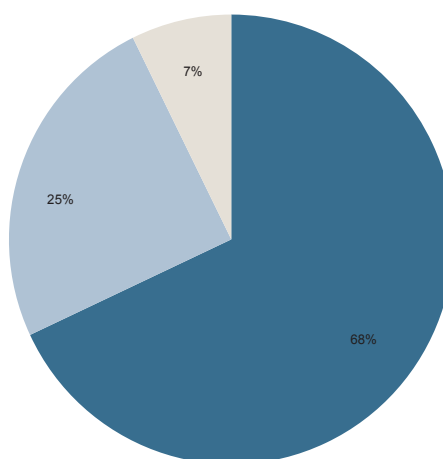
companies in neighboring markets. This will likely restrict the improvement in market liquidity and free flow of funds across the constituent exchanges in the near term.

Figure 33

Classification of West African stock markets by market capitalisation

Source: EFINA Quarterly Review (Jan-Mar 2015); ARM Research

■ NIGERIA
■ GHANA
■ BRVM



... as SEC's par value review stokes mixed expectations

On other fronts, sequel to the recommendation of the Rules and Adjudication Committee of the NSE on 21 October 2014, SEC recently reviewed par value for securities trading on the Nigerian exchange to 1kobo (from 50 kobo). Whilst an effective date is yet to be announced, eventual implementation would see 1kobo become new price floor, as well as allow forces of demand and supply determine share prices. .

Ultimately, we believe the new rule has the potential to kick-start trading in ~48 hitherto inactive stocks which constitute 1.3% of equity market capitalization. Drilling down to specific names, we note that apart from stocks such as FTN Cocoa Processors plc and UTC Nigeria plc that have been dormant at 50kobo for a while, insurance stocks look set to be more affected by the proposed adjustment with the sector accounting for more than half of the affected names. In view of their long dragging illiquidity and investors' pessimism on the stocks, holders have reportedly had to offload these stocks at significant discounts to par value in the past and the new rule should facilitate price discovery and enhance liquidity.

Furthermore, to the extent that this rule could ultimately lead to significant collapse of market capitalisation of affected companies and perhaps encourage takeovers

(hostile or otherwise) and significant restructurings of the companies. In any case, that should be a positive though the likelihood that any price hits would more greatly impact retail investors and dampen their gradual re-interest in the equity market remains of some concern.

FEATURE REPORT: PRODUCTIVITY DATA HIGHLIGHTS CONSTRAINT ON NIGERIA'S GROWTH POTENTIAL

Growing GDP; declining productivity: a Nigerian paradox

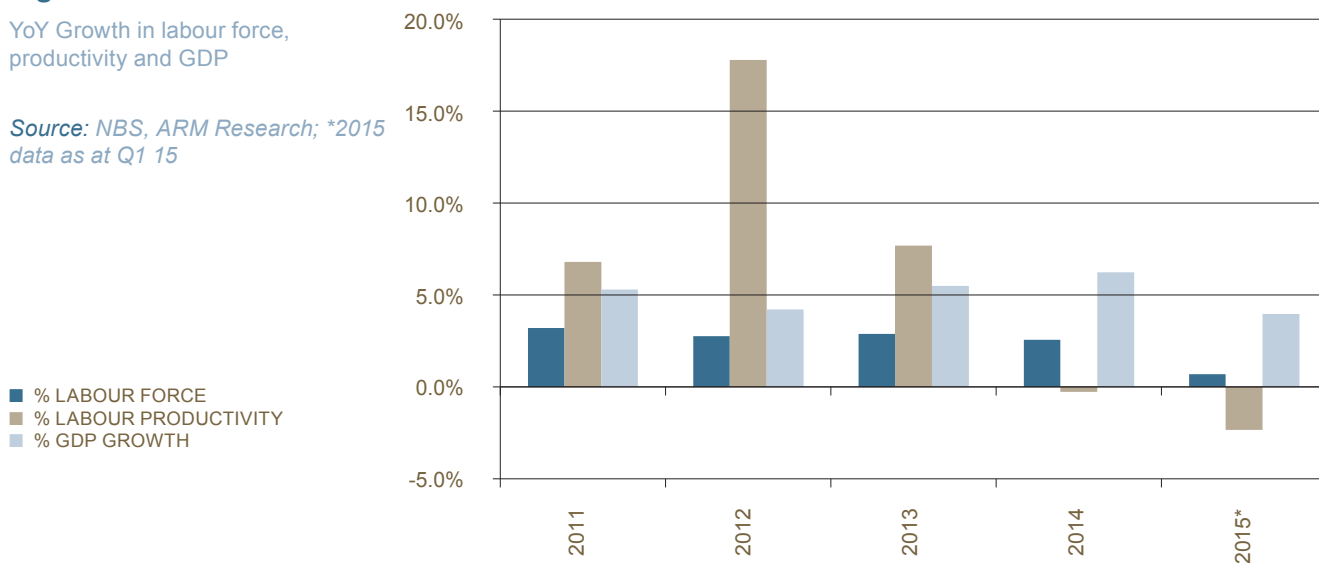
Although GDP growth has been high and stable in recent years, save for Q1 15 growth slowdown to 3.96% YoY, rising unemployment and slowing labour productivity have posed major limitations to economic growth sustenance in Nigeria⁽³¹⁾. Worse still, recent NBS releases paint an even grimmer picture for productivity; as despite GDP growth of 6.22% YoY in 2014, labour productivity – as measured by GDP per labour hours worked – contracted 30bps YoY to \$3.77 (vs. an average of \$15 and \$11.2 for select frontier and emerging market countries) over the period. In addition, Q1 15's 2.4% decline, relative to the average over the four quarters of 2014, dampens hopes of a possible rebound in the near term.

(31) Labour productivity, as measured by NBS, is the ratio of nominal GDP and total hours worked.

Figure 34

YoY Growth in labour force,
productivity and GDP

Source: NBS, ARM Research; *2015
data as at Q1 15



Furthermore, whilst Nigerian productivity per person employed towers above those of some African nations such as Zambia and Malawi, it lags those of South Africa, Egypt, Tunisia, Morocco, Algeria, and Angola. Additionally, despite having a slightly quicker growth rate between 2011 and 2014, Nigeria's productivity remained ~ 3 times

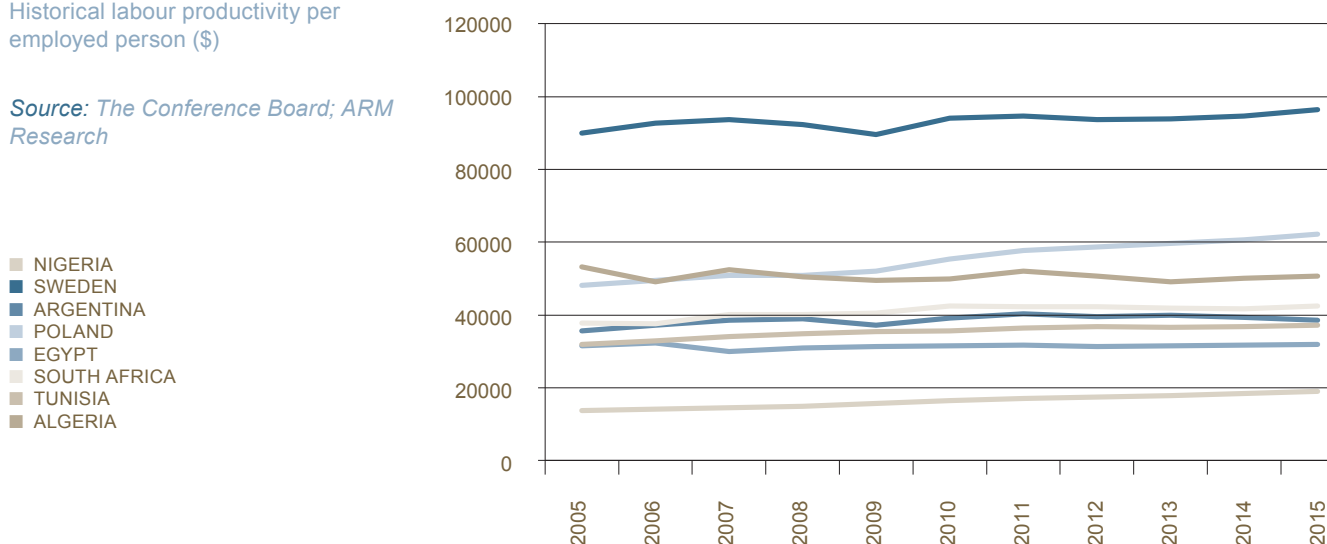
smaller than the average for countries whose economies are of similar size to Nigeria using most recent estimates of The Conference Board⁽³²⁾. Put differently, compared to these select nations, the sizes of Nigerian GDP over the years have failed to adequately compensate for the large number of persons engaged in work.

(32) Countries with nominal GDP +/- 5% of Nigeria's 2014 GDP

Figure 35

Historical labour productivity per
employed person (\$)

Source: The Conference Board; ARM
Research



The reason for this is not farfetched. NBS' report suggests that nearly half of Nigerian output is driven by low skilled employment and underemployment, with 84% of Nigeria's labour force population contributing ~48% of output, suffering significant skills deficiency. In further evidence, NBS also points out that only ~11% of Nigeria's labour force population has post secondary school education. Indeed, the challenges facing not only education (in terms of quality and availability) but also power and infrastructure are well documented, manifesting in the acute lack of science and technological capabilities (and possibly even average financial savvy). This is exacerbated by the prevailing labour skills vs. labour market requirements mismatch as well as an excess supply of labour that stokes high unemployment and forces a number of persons into low wage/low skilled subsistence jobs. Unsurprisingly, using the alternative GDP per capita approach to labour productivity, National Productivity Centre (NPC) reports that Nigeria's level of productivity of \$3184.6 in 2014 was far below target level of \$5,370, corroborating the general trend from NBS' numbers.

Incidentally, the poor productivity number also manifests as an even bigger paradox when overlaid with the structure of the economy. Nigeria's rebased GDP series attributes average weights of 35.7%, 12.8%, and 51.5% weights to primary, secondary, and tertiary class output. Specifically, given large weight of services in the nation's GDP basket, the mismatch between low productivity and a largely tertiary economy—as implied by Services' domination—

is in stark contradiction to the directly proportional relationships between productivity and economic development stage in most countries. In particular, though Nigeria ranks amongst nations with tertiary production of more than 50% of GDP, The Conference Board annual data suggest that its productivity – measured in terms of GDP per persons employed – remains significantly lower compared to most emerging market counterparts (See figure 35 above).

New definitions, same old problem as unemployment rate accelerates to 7.5%

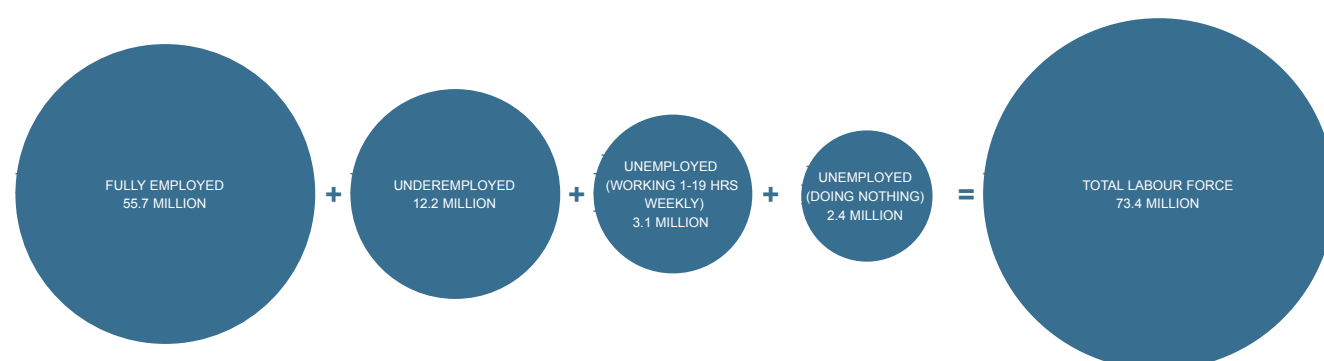
Aside the productivity numbers, the NBS also released new set of data for unemployment which even if they don't raise as many questions reinforce those that already arise from the productivity data. Until Q4 14, Nigeria's labour force classification methodology, which categorized people working below 40 hours per week as economically unemployed, ran contrary to International Labour Organisation's definitions and was reportedly both outdated and unreflective of actual economic realities. This prompted NBS to revise definitions and methodology for computing labour force statistics. the latest numbers indicate 0.69% QoQ increase in Nigeria's labour force to 73.4 million in Q1 15, corresponding to new entry of ~0.5 million economically active and willing persons into the market⁽³³⁾. Despite shrinking government involvement since advent of oil price plummet in Q3 14, further analysis still revealed a 0.88% QoQ growth in the

(33) This revision led to a redefinition of labour force categories principally based on the amount of hours put into work per week.

Figure 36

Composition of labour force Q1 15

Source: NBS, ARM Research



number of persons in full employment (i.e. working at least 40 hours a week) to 55.7 million. At the other end, whilst the number of underemployed persons (i.e. those working between 20 to 39 hours a week or have skills or competencies that are grossly underutilized) was 6.46% lower QoQ at 12.2 million, the number of unemployed persons surged 18.43% QoQ to 5.5 million – leaving underemployment and unemployment rates at 16.6% and 7.5% respectively (vs. 17.9% and 6.4% in Q4 14).

According to NBS, the greater increase in unemployed population (i.e. ~ +0.9 million persons) relative to the aforementioned number of new entrants into the labour market is indicative of some job loss to hitherto underemployed and/or fully employed persons in the labour market. Save for outright job loss for some of the former – underemployed persons, NBS noted that a few persons in the category saw their weekly job hours trimmed down to below 20 hours per week – making them effectively unemployed by definition.

Table 12

NBS labour force classification

Definition	Work at least 40 hours a week	work 20 - 39 hours a week or grossly underutilized	work 1-19 hours a week	Do nothing
Category	fully employed	underemployed	unemployed	unemployed

Source: NBS, ARM Research

New numbers frame economic challenges in newer perspective

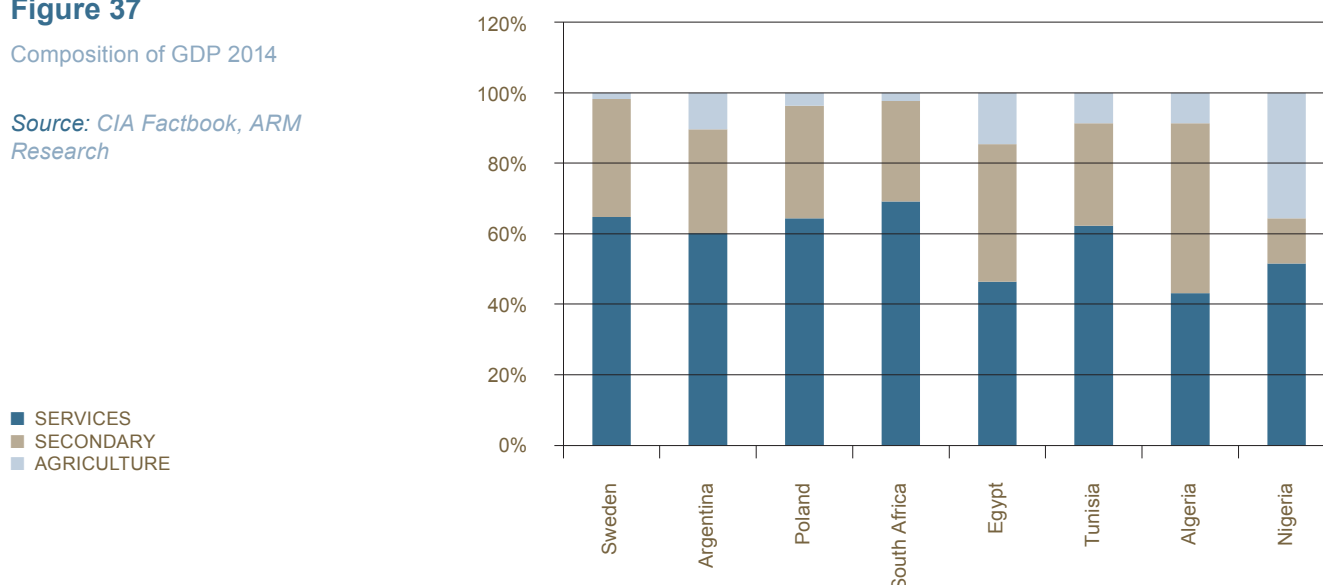
The overall theme of under-enabled labour force fits into the already established outcomes from the poor productivity numbers, and importantly the role of weaker output from lower quality labour in delivering that result. The causative factors we earlier adduced on the skill, infrastructure, and power fronts are easily reinforced by extending the comparison of Nigeria's economy with those of other countries along the lines of the parameters already explored. In resolving the above paradox, we note that relative to most nations with contribution of

services to GDP of ~50% and above, such as. South Africa, Tunisia, and Egypt, Nigeria boasts a relatively weaker secondary output segment of the economy; a weakness that has persisted over the years. To put it another way, the new numbers reinforce an old surmise that the entire value adding segment of Nigeria's economy which should serve as the bridge between raw inputs (primary) and final output (tertiary) is hardly existent. This, as we had always highlighted, is also indicative of the real loss from stunting of sectors like manufacturing. In particular, inadequate power, requisite technical knowhow and infrastructure have frustrated manufacturing activities in Nigeria over the years.

Figure 37

Composition of GDP 2014

Source: CIA Factbook, ARM Research



Incidentally, the issue may not just be the gaps in the existing structure but also in what could be the lost potential. For instance, CBN noted that labour productivity in agriculture continues to be held back by slow technical progress, with over 50% of the population using rudimentary technology and operating at the subsistence level. To our point, the question is whether the demands of an industry that refined the raw inputs—if such existed domestically—have necessarily forced an upgrade on the quality and quantity of agricultural produce, and by extension, the adoption of the technology to meet those new standards. Similar questions might apply to how functional industries could have forced a more in-depth look at the exploration/mining of other minerals, especially now that oil's problems continues to wreck havoc on state and federal finances. These are the possibilities that make it seem the real loss from the historical stunting of sectors like manufacturing might not be fully appreciated.

One other inference relates to answering the question of whether currently slowing GDP growth rate, amidst significant macro headwinds, would stoke further productivity concerns going forward. Whilst current challenges suggest that scenario is quite plausible, we feel this necessarily ought not to be so. To turn the paradox on its head, how did Services become this

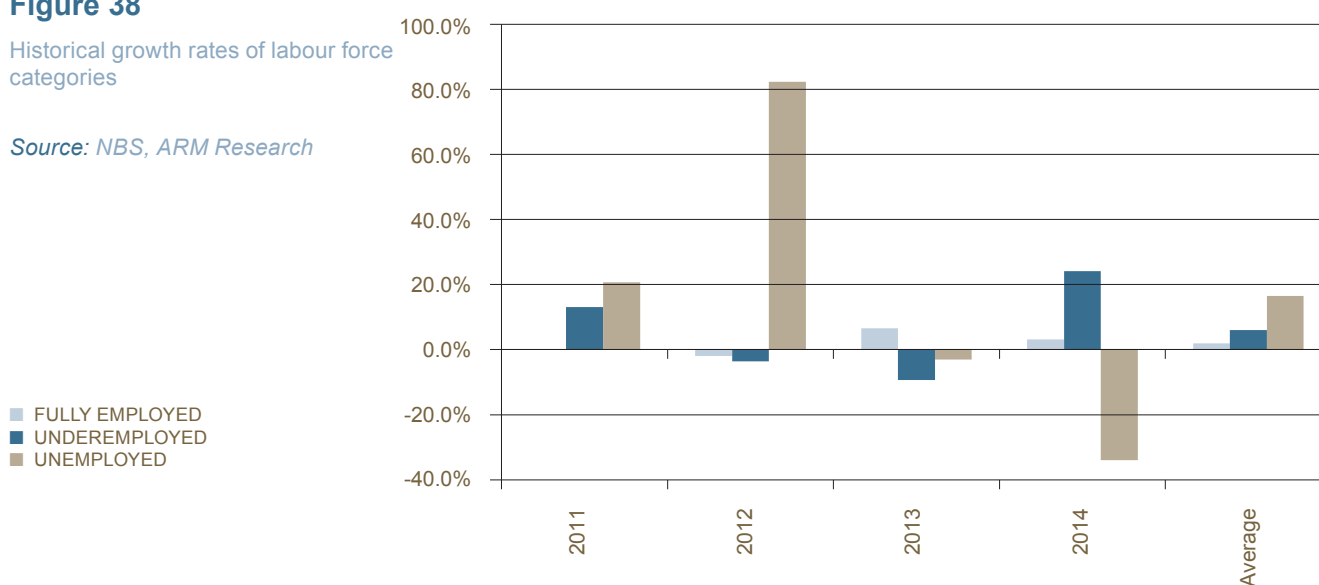
big and contribute so much even when the economic base is not so developed? Noting that the obvious answer to that is the significant boost from telecoms and financial services the implication is encouraging development in other segments and the concomitant services that could be built on those new bases, could totally breathe new life into an economy that seems ready to wilt post-rebasing. In other words, restoring the value-adding phase could impact both primary and secondary output such that there's a mutually reinforcing cycle that could boost overall output growth, (and) potential GDP—with the existing gap suggesting that even the years of prior 'rapid' growth still represented some serious underperformance, relative to potential.

For policy makers, the scenario clearly underscores where the focus and direction will be. On one hand, the foregoing documentation of some traction with reforms, and signs that this could accelerate, amidst fledgling improvement in manufacturing and power, suggests that some of the necessary readjustment is already happening. On the other, the ravaged landscape in the subsequent economic review suggests that, in terms of protection against shocks, the road ahead is still long. Perhaps the real benefit from NBS new numbers is to reinforce the drive of economic managers to make the necessary push.

Figure 38

Historical growth rates of labour force categories

Source: NBS, ARM Research



ECONOMIC REVIEW AND OUTLOOK

GDP GROWTH LOSES GROUND IN UPHILL CLIMB

Economic wheel continues to slow

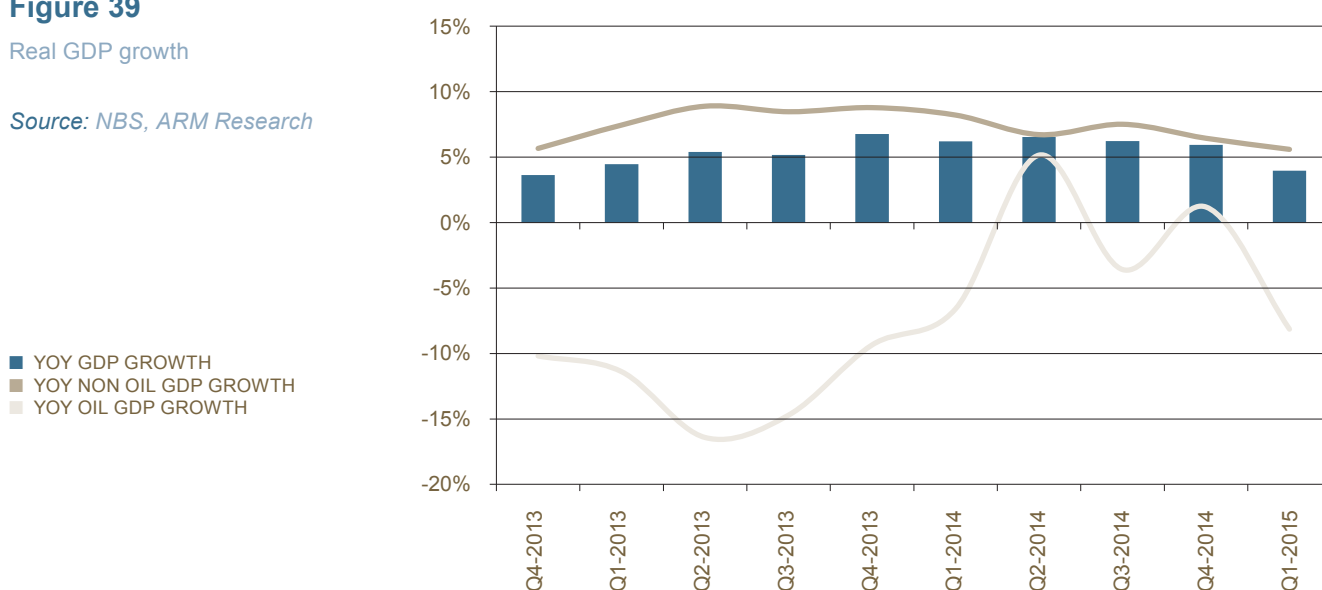
The Nigerian economy expanded 3.96% YoY in the first three months of 2015, the slowest growth since the last quarter of 2012. This marked the third straight quarter of slowdown as lower oil prices and supply

constraints dragged the oil sector down. Q1 15 YoY real GDP growth was lower by 198bps and 225bps relative to Q4 14 and Q1 14 figures, respectively. Drilling into components, YoY non-oil GDP growth was the slowest in ten consecutive quarters at 5.6%--260bps lower than growth recorded in corresponding quarter of 2014 and 80bps softer than in Q4 14, whilst oil GDP growth reversed the expansion of Q4 14, falling 5.1% YoY in Q1 15.

Figure 39

Real GDP growth

Source: NBS, ARM Research



As oil's lubrication proves short-lived.....

The Q1 15 contraction in oil GDP was largely driven by supply-side constraints. According to OPEC, among member countries, Nigeria recorded the second sharpest drop in rig counts in Q1 15 with production of 1.76 mbpd in the quarter (vs. 1.89mbpd in the corresponding quarter of 2014) representing a 7% drop. The slump in exploration, development, and production activities mirrors the rising insecurity in

producing areas (i.e. oil theft and pipeline sabotage) and, more importantly, NNPC's funding cuts on JV projects (-40% YoY to \$8.1 billion for 2015) with the agency's key partners also forced to scale down on capital expenditure and production. Of particular note, NNPC's inability to meet cash call obligations to JV partners appears to have been largely tied to the steep slide in oil revenue as Brent crude, at \$64.88, continue to trade well below 2014's \$100 average (price as at June 1st, 2015 stood as \$64.88).

Figure 40

Sectoral real GDP growth

Source: NBS, ARM Research



And non-oil GDP becomes an even bigger clog

Touching on non-oil GDP, Q1 15's slowdown mainly mirrored contraction in manufacturing as well as decelerations in Agriculture and Services components (which jointly account for 63% of non-oil GDP). Manufacturing GDP fell 1.8% YoY whilst growth in Agriculture and Services slowed 80bps and 30bps YoY to 4.7% and 7.3% respectively, in the quarter. Contraction in the manufacturing sector stemmed from 54% and 28% YoY declines in oil refining and electricity and gas supply segments, respectively, as well as a 5% slowdown in the textile, apparel and footwear segment. Essentially, we believe the decline in the electricity and gas supply segment cannot be disconnected from the force majeure declared on gas production in January as a result of pipeline vandalism alongside its attendant effect on power generation. Furthermore the subsector was spontaneously plagued with strikes by prominent labour unions in the industry.

Hinged on improved YoY growth in the crop production, livestock and fishing sub-sectors relative to Q4 14, Agriculture sector output growth in the first quarter of 2015 stood at 4.70% YoY, 106bps above YoY growth reported for Q4 2014 (Q1 14: 5.53%) . Specifically, despite its 29% QoQ dip as we move further away from the harvest season, Crop production was the main driver of growth in

the sector accounting for 390bps of sector growth and representing 87% of Agriculture GDP. Still on a QoQ basis, livestock and forestry sub-sectors respectively shrank 9% and 15% in Q1'15.

Although the Services sector withstood exchange rate pressure to post a growth rate of 7.04% YoY, 89bps above the 6.15% YoY growth reported in the preceding quarter, the sector slowed relative to the corresponding quarter of 2014 (services sector real GDP was recorded at 7.6% YoY in Q1 14). The main driver of Q1 15 growth for the Services sector was the Telecommunications and Information Services sub-sector, followed by the "Other Services" sector. Of total real GDP, the Telecoms sector contributed 11.5% in Q1 2015, higher than respective 10.89% and 11% share in Q1 and Q4 2014. Accommodation and food services sub-sector led the services sector growth rate as it more than doubled Q4 14's 11% growth to record 27% growth for Q1 15. However, the sub-sector's contribution to Q1 15 GDP (1.2%) is relatively insignificant when compared to telecoms. However, relative to the corresponding quarter of 2014, Services' slower growth rate was driven by 12.5% YoY contraction in its public administration sub-component. Further decelerations were recorded in the real estate sub-sector as growth halved over the period to settle at 3% while health and social services sub-sector lost velocity with its 2% growth (its lowest since 2010).

More bumps ahead

First quarter real GDP has historically emerged the slowest, reflective of softer growth in the Agriculture sector as the cycle changes from harvest to the planting season. Thus, we expect Agriculture output to ramp up in the course of the remaining quarters, providing some support to GDP growth. Going forward, we think the Services sector could be the main casualty of expected sticky growth in household and government expenditure as softer oil price continues to strain government revenue which remains a significant factor in individual and corporate money supply. This dynamic is reinforced by the relative inactivity of the new government which implies even the available funds are not flowing round. Similarly, Manufacturing which has historically been an important driver of domestic demand, growing at a little over 10% on average from 2011 to 2014, should experience more muted growth as we anticipate increasing sensitivity of investments to continued exchange rate pressures would slowdown manufacturing activity, particularly in sectors that are susceptible to rising import costs e.g. the Construction and Energy sectors. Added to this, production downtime across companies in key sectors such as telecommunications, manufacturing, and banks following the recent fuel scarcity and oil marketers' strike action also have negative connotations for non-oil GDP with the possibility of the adverse impact extending depending on direction, and implementation manner, of new government's policies.

For Oil GDP, akin to H1 15, lower oil prices should continue to drive moderation in E&P capital spending as access to financing becomes more difficult under current prices. Furthermore, current production should come under pressure on mounting NNPC receivables to oil producers as the state oil production company is unable to fund JV cash calls for oil production. Compounding an already dire outlook is the increasing difficulty of selling Nigerian crude cargoes which has resulted in shrinkage in Bonny-light's premiums to dated Brent, with with Bonny Light even at a discount at some point, as intense competition for Asian markets emerges from Arab grades. Consequently, we see scope for downtrend in oil GDP over H2 15.

In sum, though 2014 headline GDP growth (5.96%) reading stayed fairly healthy, recent trends across both oil and non-oil sectors point to softening output underbelly, a development likely to be compounded by recent events. This outcome fits our prior expectations for GDP weakness in 2015 and, despite Q1 typically being the slowest quarter, the extent of weakness in the latest numbers motivates a revision of our FY forecast to 4-4.5% range for 2015.

TRADE BALANCE SEES RED

Beleaguered oil exports drive negative trade balance

In line with our dour outlook for trade surplus, Nigeria recorded a trade deficit of \$982 million over the first five months of 2015. On a quarterly basis, exports weakness (-45% YoY, -26% QoQ to \$12.3 billion) offset cutback in imports (-14% YoY, -27% QoQ to \$13.6 billion) resulting in trade deficit of \$1.3 billion over Q1 15. However, despite 44% YoY moderation in exports to \$8.5billion and commencement of ECOWAS common external tariffs (CET) in April 2015, stronger import contraction (-33% YoY to \$8.2billion) underpinned positive trade balance of \$326million over Q2 15⁽³⁴⁾.

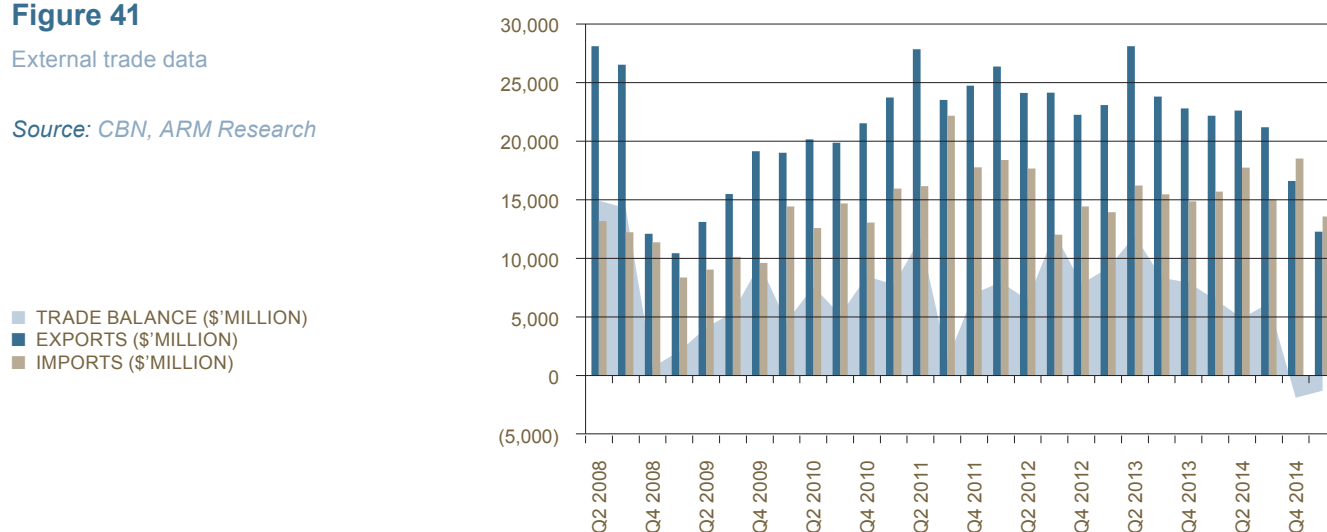
Adducing the drivers, historically dominant role of oil in total exports remained in place as depressed Brent Crude prices over the period (-50% YoY) and slightly lower average oil production(-2% YoY to 2.18mbpd in Q1 15) largely accounted for export weakness. On the import side, breakdowns provided by the NBS reveal cutbacks in fuel and lubricants (-9% YoY) and transport, equipment & parts (-35% YoY) underpinned slowdown in import demand. On the latter, weakness in passenger motor cars (-40% YoY) following the raised tariff regime and 50% QoQ. However, the drop in the fuels and lubricants appears subdued especially in light of slash in PMS import allocation to 1.5millionMT, difficulties in obtaining financing from banks on mounting uncertainty over the PSF scheme and lower refined product prices, suggesting our expectations of the impact of these drivers may be yet to materialise.

(34) CBN data is available for April and May 2015 only

Figure 41

External trade data

Source: CBN, ARM Research



Rising US shale production and changing global refinery architecture moderate appetite for Bonny light

Before the quantitative impact of oil price plunge on crude oil exports, rising shale oil production which progressively insulated US market from imports had driven changes in Nigeria's export destination. As the shale phenomenon then became entrenched, with output reaching an all-time high in H1 15 despite low oil prices, and amid rising dominance of Asian and Middle-Eastern refineries in the global market (ex-US) and lack of investment in Europe's refining industry,

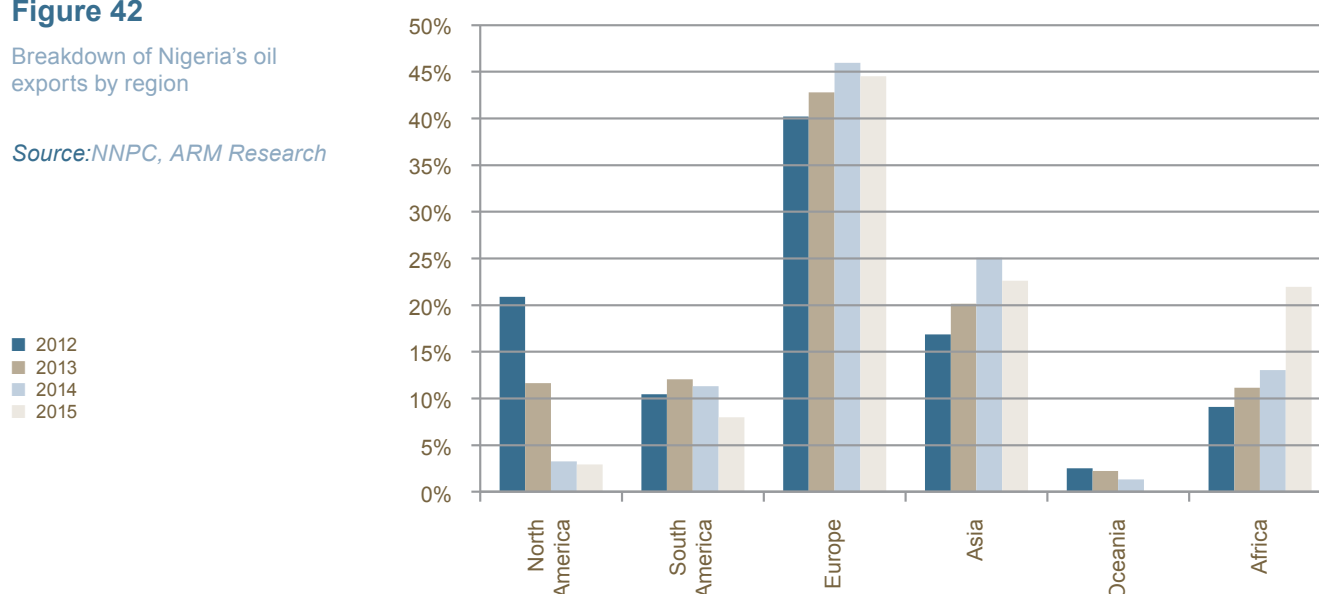
pervasive price discounting among market-share seeking OPEC members on crude exports to Asia is now driving crude oil inventory overhang in Nigeria.

Dissecting NNPC data over Q1 15, impact of rising shale production was evident as US share of oil exports extended declining trend since 2012 by shrinking 100bps QoQ to 3% of total exports. Elsewhere, weak economic growth in Q1 15 and increasing energy independence on rising domestic production in Brazil, which drove slower oil imports, resulted in 3pps QoQ contraction in South American share of Nigeria's oil exports.

Figure 42

Breakdown of Nigeria's oil exports by region

Source: NNPC, ARM Research



Whilst European share continued to rise (+2pps QoQ to 44%) with actual exports rising 8% from Q4 14 to 87.3mbpd, crude shipments to Asia contracted 9% QoQ to 44.4mbpd with export share declining 2pps to 23%. The decline in Asian share of exports and higher off-take of Middle-Eastern crude grades partly reflects lower freight costs due to geographical distance and changing refinery architecture towards processing of complex crude grades which contain more petrochemical extracts. Growing demand for these complex grades reflects advances in technology which permit higher extraction of inputs for manufacturing and industrial complexes in China and India, in contrast to previous preference for light oil such as Nigeria's.

Compounding oil export woes for Nigeria is the halt in exports to Oceania since Q4 14 due to the mothballing of several refineries in Australia which has resulted near total dependence on imports for refined fuel supply. Over the last seven years, all of but four of Australia's refineries have either been idled or converted into fuel terminals, largely driven by stiff competition from Indian refineries.

On a positive note, African share of Nigeria crude climbed 4pps QoQ to 22% driven by increasing exports to Cote d'Ivoire and South Africa. Overall greater preference for more complex crude oil grades and collapse in light sweet crude market in the US has resulted in Bonny light pricing to dated Brent swinging from a premium of \$0.46/b to a discount of \$0.06/b as at April 2015.

CET implementation holds upside to import demand

On the import side, following several postponements over the last decade, agreement by ECOWAS Heads of state in December 2014 and subsequent finance ministry approval at the end of Q1 15 saw the Nigeria Customs Service (NCS) commence CET implementation in April 2015. The CET harmonizes the tariff framework across Anglophone ECOWAS members with existing customs union in WAEMU countries into a five tier system with the first four outlined below.

Table 13

CET regime

Categories	Percentage of Duties	Goods Description
0	0%	Essential social goods.
1	5%	Goods of primary necessity, raw materials and specific inputs.
2	10%	Intermediate goods.
3	20%	Final Consumption goods.

Source: ECOWAS, ARM Research

To counter local industry protection concerns, largely voiced by Nigeria, a fifth tier to be taxed at 35% was created for 177 "specific goods for economic development" which would be determined at country level. Under the new tariff regime, previous import prohibition lists will now apply to non-ECOWAS

goods henceforth. The merged tariff rates eliminates incentives provided by tariff disparity for import duty shopping by importers among ECOWAS countries and subsequent smuggling to beat higher tariffs in countries like Nigeria. Already the move has resulted in FGN lifting the ban on furniture and textiles subject

to a 35% tariff in April 2015. The tariff harmonization should incentivize coastal countries to work towards making their ports preferred import destinations to attract greater trade flows and by extension fiscal revenues. In addition, the lower tariff regime implied in the CET raises scope for uptick in ECOWAS share of Nigerian imports which has averaged 2% of total imports over the last three years⁽³⁵⁾.

Intensifying competition in export markets and tame oil price outlook keep trade balance outlook negative

In line with our subdued base case for oil prices in H2 15, resumption in exports of Iran's two crude grades (light and heavy crude oils) adds fresh layer of concern to Nigeria's export markets. Postthe 2011 round of sanctions which shut-in 1-1.2mbpd of exports, the

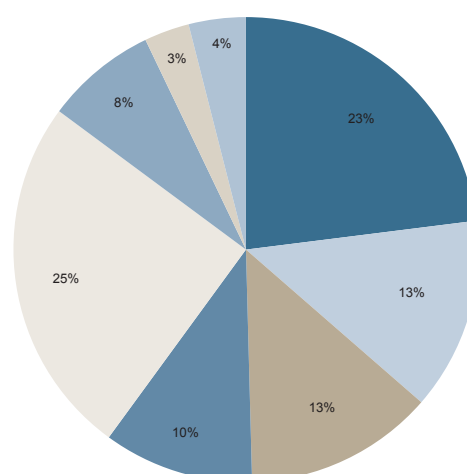
(35) NBS

EU which mostly purchased Iranian light crude oil (25% of Iranian shipments) substantially increased imports from Nigeria and Saudi Arabia. Similarly, Asian countries (ex China which preferred heavier grades) replaced Iranian volumes with Nigerian crude grades. Whilst preconditions included in the P5+1 deal delay on-streaming of Iranian exports to 2016, markets could commence pricing in an estimated 20-30mb of Iranian crude inventory. Furthermore, recent discussions with European energy producers, Eni-Agip, Statoil and Total, who operated much of Iran's oil wells prior to sanctions, point to erosion of Nigeria's European export market. Elsewhere, we see continuing economic weakness in Brazil, US energy independence and aggressive discounting by Arabian oil producers driving an extension of H1 15 trends with sustained pressure on both Bonny-light prices and total oil export volumes.

Figure 43

Iranian oil exports: Market share

Source: EIA, ARM Research



On the import front, clarity by the Buhari administration that fuel subsidies will continue to exist in the interim even as fuel import allocation has been increased 6% QoQ to 1.6millionMT for Q3 15 indicate there could be a recovery in fuel imports. Nonetheless, recent CBN circular proscribing FX access to 41 items (including rice, textiles, furniture etc) and rising parallel market FX rate should temper import demand, especially

amid funding constraints. Similarly, whilst lower tariff implicit in CET implementation provides incentives for importers, small size of ECOWAS imports narrow scope for this avenue to significantly stoke import demand. On balance, subsisting weakness in oil export account should continue to offset largely restrained import picture to drive negative trade balance over H2 15.

STORM CLOUDS OVER USDNGN ALLOW GAP BUT YET TO DISSIPATE

Downdraft in oil prices extends bout of currency volatility

On the heels of 12% depreciation in Q4 14, interbank USDNGN weakened 8.6% over Q1 15 to ₦199.28/\$ largely on account of CBN termination of the RDAS market in February. The subsequent implementation of an order based 2-way quote (OB2WQ) system which effectively proscribed banks from trading on the naira helped steady the exchange rate over Q2 15 (+0.2% QTD). Dissecting performance on a monthly basis, fundamental concerns stemming from sustained moderation in oil prices (-7.6% MoM) in January underpinned 2.3% MoM depreciation in

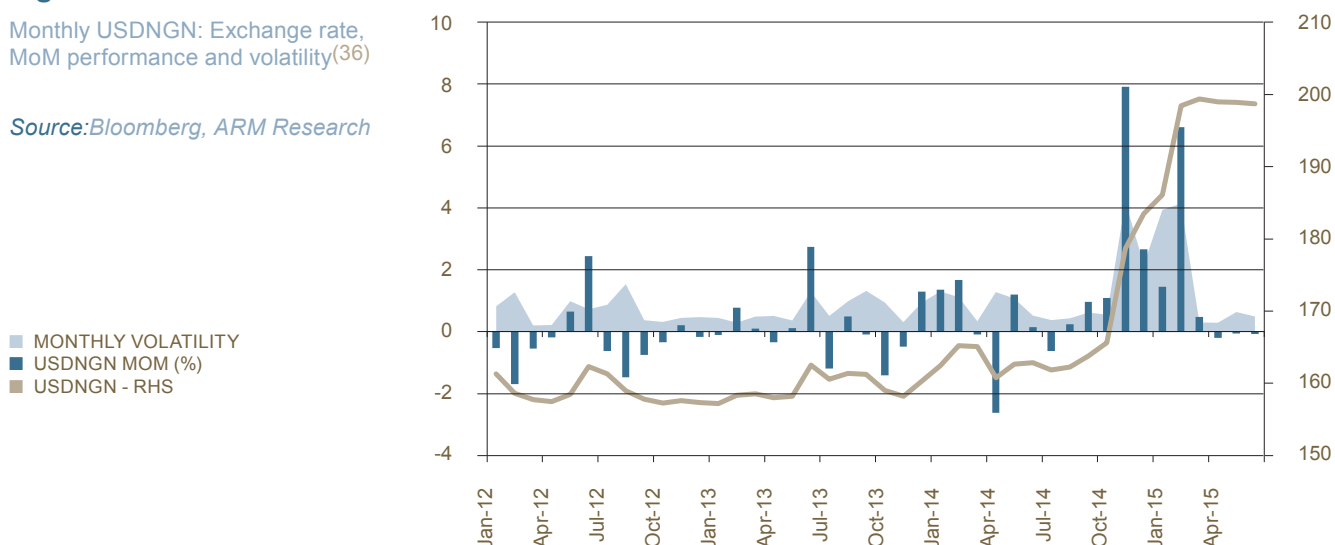
USDNGN to ₦187.60/\$. During the month, market volatility hit fresh highs (See Figure 44) as CBN FX policy became fluid starting with 50bps increase in net open positions (NOP) to 0.5% of bank shareholder funds in response to J.P Morgan placing Nigeria's status on its EMGBI on a negative watch. In addition, the apex bank proscribed interbank FX sales to BDCs, introduced a 72-hour holding period for utilization of proceeds from interbank FX purchases and increased frequency of rendition of bank NOP positions from monthly to daily. The net impact of the foregoing resulted in increased demand front-loading which spilled into the BDC segment resulting in a 620bps MoM expansion in the segment's premium over interbank USDNGN rate to 10.6% in January—highest since June 2009.

(36) One month standard deviation

Figure 44

Monthly USDNGN: Exchange rate, MoM performance and volatility⁽³⁶⁾

Source: Bloomberg, ARM Research



Surge in political risk premium triggers collapse of 3-tier exchange rate regime

Despite easing fundamental concerns in February as Brent crude prices rebounded 18% MoM, political uncertainty around the 2015 general elections scheduled for earlier that month continued to induce heightened USDNGN volatility. Events came to a head on the heels of an announcement of six-week deferment of 2015 general elections with FX markets joining other domestic financial markets in witnessing a sell-off.

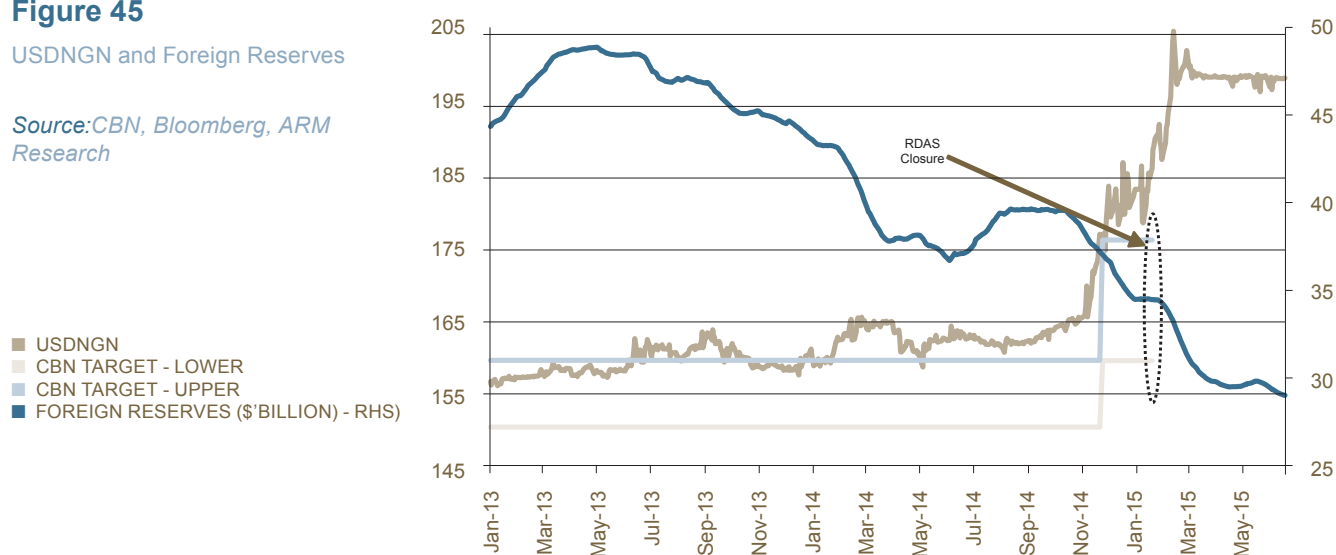
Post the announcement, heightened local and foreign investor uncertainty about political risk drove naira to a record low of ₦206.32/\$ intraday⁽³⁷⁾, breaching the 2% circuit breaker agreed by FX traders and forcing two days of market shutdown. Faced with the prospects of depleting reserves—which, in the same month, fell at the quickest monthly pace (\$3 billion) since April 2006 to a nine-year low (\$31.5billion)—CBN collapsed the RDAS into the interbank market resulting in a second devaluation of the USDNGN in four months.

(37) 12th February 2015

Figure 45

USDNGN and Foreign Reserves

Source: CBN, Bloomberg, ARM Research



CBN attempts to end currency skirmishes with OB2WQ

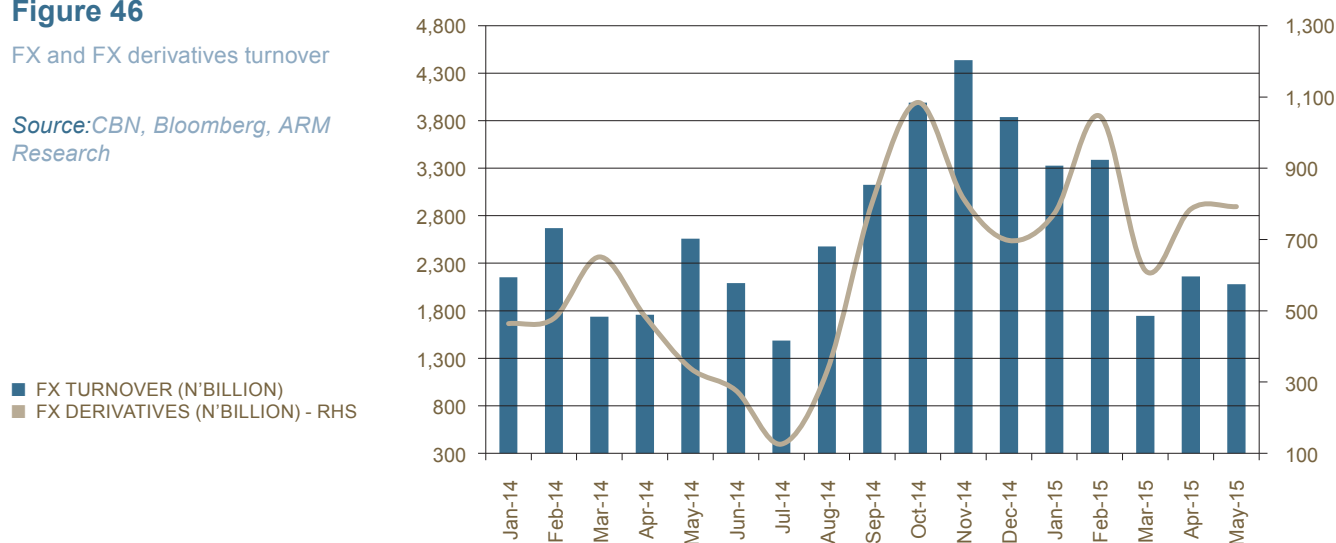
Following the closure, the apex bank, in liaison with FMDQ OTC, introduced the OB2WQ under which banks were supposed to provide two way quotes, but unlike in their 'currency dealers' position in the previous interbank OTC were under no compulsion to do so; in the new system, quotes are to reflect client orders which effectively left banks as 'currency brokers'. In the event of supply mismatch, the CBN intervenes to clear the market at the close of trading

each day to eliminate uncertainty over guaranteed execution. Thus, in contrast to the previous regime of a declared naira peg, the CBN would no longer provide forward guidance on the target range for the currency but intervene to clear market disequilibrium on its own terms. Aided by increase in frequency of CRR debits from monthly to bi-weekly and threats of prosecution to management of erring banks, introduction of the OB2WQ drove a cutback in USDNGN from record peak to ₦202.77/\$ at the end of February. The Naira strengthened further in March (+2% MoM to ₦199.28/\$) as, in addition to CBN

Figure 46

FX and FX derivatives turnover

Source: CBN, Bloomberg, ARM Research



support, a more-than-double MoM jump in FPI inflows to a 6-month high of \$1.07billion helped temper pressures. In Q2 15, USDNGN stabilized at ₦198-199/\$ whilst market volatility remained subdued, aided by tailwinds from peaceful conclusion to the 2015 general election and J.P Morgan's stay of execution on Nigeria's EMGBI status.

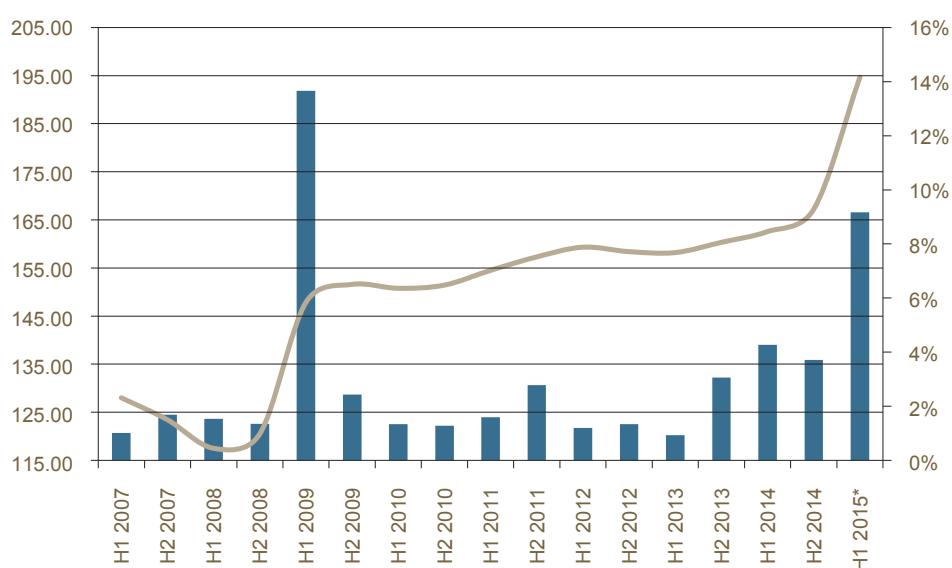
In sum, the OB2WQ system curtailed the risk of a disorderly breakdown in FX markets and, supported by admin measures the apex bank imposed on eligible transactions: daily NOP computation; 72-hour window for FX utilization; annual and daily USD withdrawal limits; 90-day repatriation of FX proceeds for exporters; stringent documentation requirement ; among others, helped keep currency markets stable.

Figure 47

Interbank USDNGN and
BDC spreads

Source: CBN, Bloomberg, ARM
Research *Jan-May

■ BDC PREMIUM - RHS
■ INTERBANK USDNGN



But not yet uhuru for naira

Despite the 'calm' across FX markets post implementation of OB2WQ system, with FX market turnover shrinking to levels pre-November devaluation, trading in FX derivatives remains elevated which suggests continued unease over current naira levels among market participants. Furthermore, recent comments in the media⁽³⁸⁾ and discussions with currency traders at banks hint at demand overhang in the interbank market, in part reflecting the ejection of BDC demand from interbank and CBN rationing of daily forex clearance sales. This spillover from interbank market has resulted in persistence of the wider BDC-interbank spreads seen thus far in 2015. Subsequent demand

curtailment measures by the apex bank (which includes a list of 41 items now barred from accessing FX and several admin measures) have pushed the spreads wider. In addition, similar to the build up to the last devaluation, increased frequency of circular revisions adds another layer of doubt to CBN's ability to support the naira. Reinforcing the theme, after 17pps shrinkage to 19% post the elections, yields on USDNGN non-deliverable forward (NDF) contracts again began to rise at the end of June implying off-shore markets share domestic sentiments about vulnerable naira outlook. Placing these domestic and offshore expectations side-by-side with movement in the fundamental driver of USDNGN anchor (oil prices have declined ~40-45% from June 2014) and cumulative naira devaluation from November (28%), implied markets are pricing further currency down leg in the latter half of 2015.

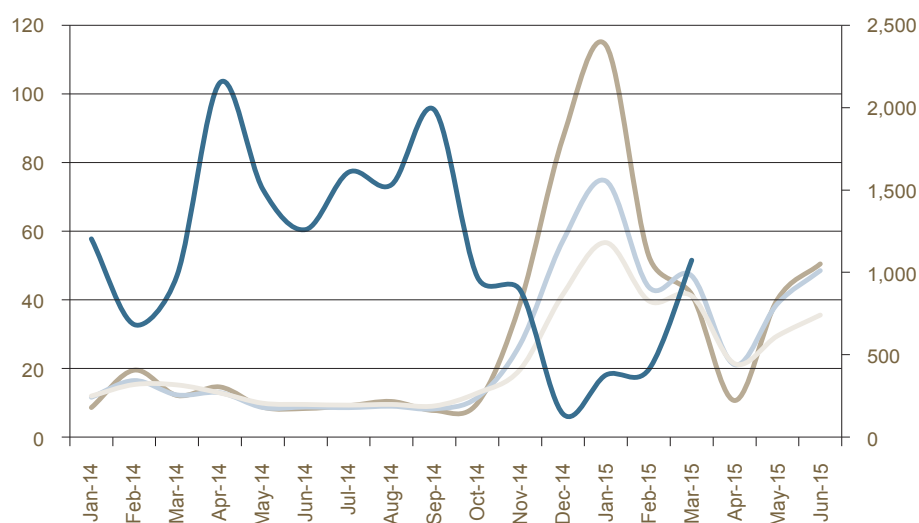
(38) <http://www.bloomberg.com/news/articles/2015-06-25/first-bank-ceo-calls-for-nigeria-to-devalue-currency-after-curbs>

Figure 48

FPI and Implied Naira Yields on NDF contracts

Source: CBN, Bloomberg, ARM Research

■ NDF-1M
 ■ NDF-3M
 ■ NDF-6M
 ■ FPI (\$'BILLIONS) - RHS



NNPC reforms to provide interim offset for weak fundamentals?

Going into the second half of 2015, bearish oil price outlook and difficulty selling Nigerian crude point to tempered scope for FX reserve inflows. Similarly, possible normalization of US monetary policy over the period which should result in stronger USD, dampens scope for autonomous portfolio flows to EM assets. Nonetheless, some reform initiatives highlighted by Buhari administration around the opaque nature of NNPC handling of export proceeds could in the interim hold potential for driving modest improvement in FX reserves. From the PwC report which covered January 2012 to July 2013; Nigeria suffered revenue under-reporting of \$2.34billion and under-remittances to Federation account of \$4.24billion on account of at-source deductions by the NNPC and its upstream subsidiary NPDC⁽³⁹⁾. Similarly, first line deductions for payments to JV operations, PMS/DPK subsidies, pipeline maintenance and NNPC operations accounted for ~46% of domestic crude oil lifting during the period (\$67billion). Thus, reforms which block leakages and engender increased transparency around NNPC operations should hold expansionary benefits for FX reserves, possibly over the tail end of H2 2015. However, depressed oil prices progressively weaken scope for any gains from the NNPC reforms to provide anything beyond near term support for FX reserves as quantum of oil receipts are lower relative to the period of the PwC investigation.

Set against a largely weak fundamental backdrop,

market focus should remain on apex bank's ability to interminably underwrite the OB2WQ status quo. On this wise, the CBN's posture: refusal to loosen curbs on FX trading, recent flurry of circulars aimed at demand management and its recent spat with The Economist, point to its reluctance to take a third bite at the devaluation pie. In its own defense, the CBN cites a need to stimulate local production as rationale for its decisions; however, aside the question of whether exchange rate is the best medium to achieve that long term, the potential import benefits from stable naira pale in comparison with scale of supply-side constraints facing domestic manufacturing: inadequate power supply, poor logistics and transport networks, access to low cost financing, to name a few. Constraints which, by the way, already ensure that locally produced goods are non-competitive relative to imported substitutes. In that wise, CBN's apparent inflexibility over the naira (despite what would appear to be non-transitory changes to oil price regime) is at odds with the medium to long term time frame required to address the issues which drive strong domestic import demand. Furthermore, examining recent experience in Japan, where BoJ aggressively weakened the yen exchange rate (56% since October 2012) in a bid to stimulate exports, and empirical work at the World Bank, where using a sample of 92 developing countries, sizable exchange rate depreciation was found to bolster manufacturing exports,⁽⁴⁰⁾ CBN argument is in a minority.

(39) Cumulatively both figures amount to 20% of RDAS sales during the period

(40) Freund, C. and M.D. Pierola. (2008), Export Surges: The power of a competitive currency. World Bank. "Using a sample of 92 developing countries, the authors show that increases in manufacturing export growth that are sustained for at least seven years tended to be preceded by sizable real exchange rate depreciation".

Trends in balance of payments and weak market architecture point to softer naira outlook

Farther out, factors influencing import demand, in particular, progress on ramp-up in domestic refining capacity are pivotal to reining FX demand for fuel imports (~30% of imports) as are initiatives aimed at increasing local share in the consumption value chain; these should buoy trade balance anchor for USDNGN. Nonetheless, two developments in balance of payment (BoP) trends are worth noting. First, whilst much attention has been paid to resuscitating the local manufacturing in the aim to curtail import demand growth, foreign dominance of shipping and air transportation and increasing pursuit of educational pursuit overseas have resulted in Nigeria

being a net services importer⁽⁴¹⁾. Akin to slack fiscal effort to address the underlying issues with domestic manufacturing, sustained growth in service imports (~20% CAGR growth) could temper scope for gains from ongoing import substitution policy thrust.

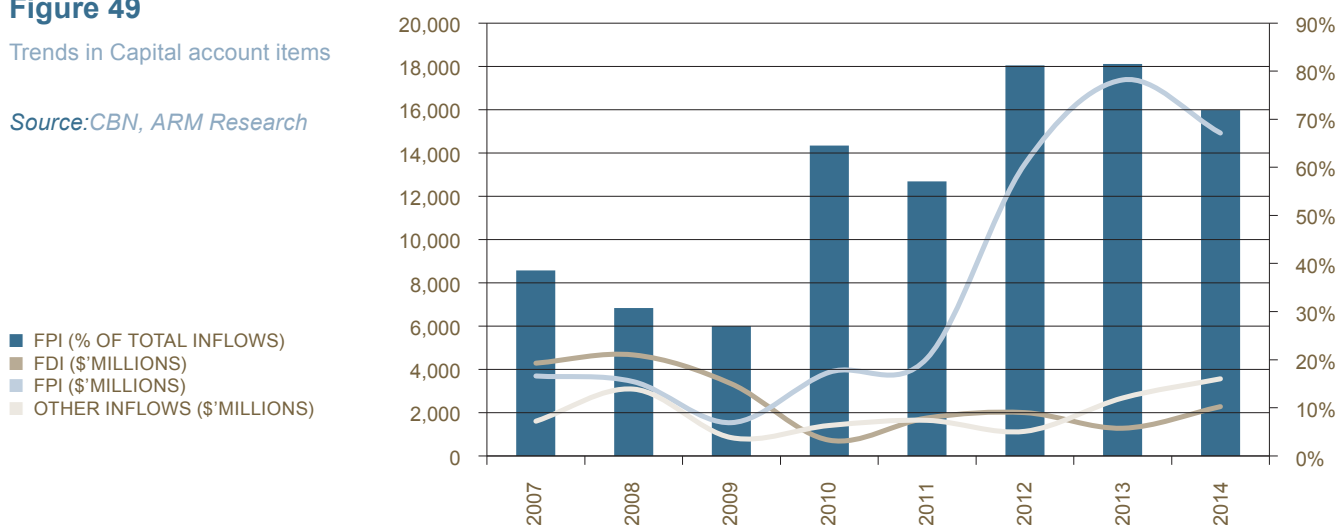
Second, unabated pace of globalization which is driving increasing financial integration to major financial centres is resulting in greater FPI flows to EM. Aided by lure of potential diversification of risk-adjusted returns and increased visibility of the Nigerian economy post rebasing, FPI flows have accounted for over half of total foreign inflows into Nigeria since 2010. The growing share of these FPI inflows increase the reserve requirements CBN would need to hold to temper possible capital account pressures in the future.

(41) Services-import ratio has averaged 36% over the last five years

Figure 49

Trends in Capital account items

Source: CBN, ARM Research



Beyond these long term macro-economic trends, the uncertain nature of current market structure and anchoring of interbank USDNGN to largely static CBN daily clearing rate has done little to inspire market confidence in naira in the presence of tempered outlook for crude oil receipts. In addition, constant fine tuning and re-editing of stream of FX circulars creates the impression of knee-jerk policy responses, further stoking market uncertainty. Furthermore, heavy reliance on CBN for supply and knowledge of CBN rate broadly ensure retention of moral hazard problems pervasive under old market system. Amid difficulty in diversifying export base, to cushion

FX reserves from impact of shocks to crude oil prices, an inflexible exchange rate stance would only come at the expense of reserve growth. Pending full structural reforms to fully address demand side issues—deregulation of downstream oil industry and development of domestic manufacturing, the CBN would appear to only be playing for time. Indeed with the J.P Morgan review set for the end of H2 15 and the apex bank's stated goal to keep Nigeria on the EMGBI, currency skirmishes should resume after four-month long hiatus. In all, we see enough risks on the horizon to expect the CBN to further raise daily clearing rate by 10-15% over H2 15.

EXPECTED PRESSURE POINTS TRIP OFF TO DRIVE INFLATION UPTHURST

Inflation accelerates to twenty-eight month high...

Headline inflation accelerated in the first six months of 2015, averaging 8.7% (vs. 7.9% in corresponding period of 2014).⁽⁴²⁾ Headline pressures were largely driven by increases in mean core inflation which quickened 30bps from H1 14 to 7.6% YoY in H1 15 (+120bps over H2 14 mean). In turn, core inflation itself was driven by increases in the prices of most

(42) In particular, our surmise of 20bps and 30bps jump in headline to twenty three and twenty four months highs of 8.7% and 9% YoY in April and May respectively, were spot on.

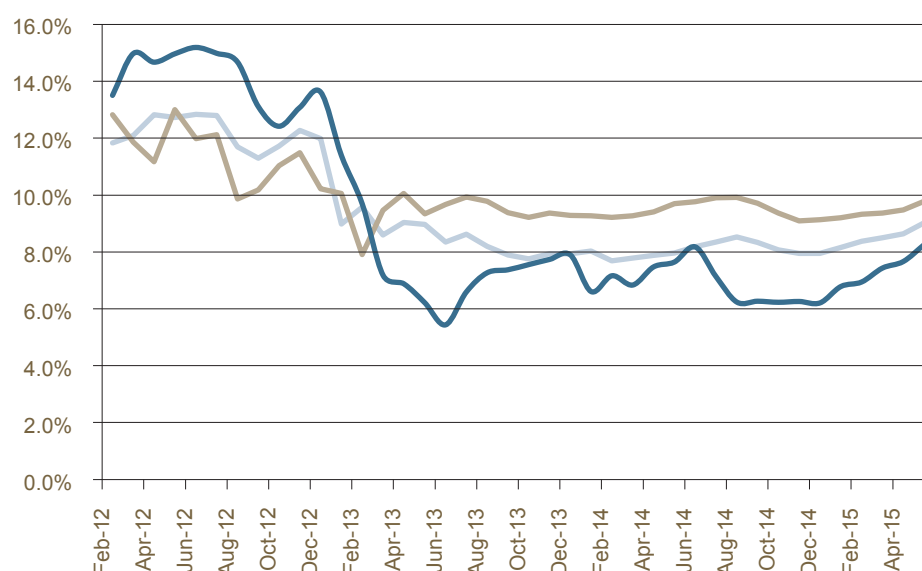
divisions of the sub index with pressures on 'housing water, electricity, gas and other fuels' recurring over 2015. In contrast, mean food inflation in H1 15 rose only 9bps from H1 14 to 9.53% YoY, same as H2 14 mean. FEWSNET attributes the subdued growth in food prices in the first four months of 2015 to the moderating impact of carryover stock from previous periods' harvest as well as constrained institutional and private demand that kept farm produce prices largely restrained. In particular, in most millet and white maize producing areas, prices of the staple cereals declined significantly between February and March. Perhaps another telling influence on the early restraint of farm produce prices was the 10.3% slash in PMS price to ₦87/litre in January 2015 which eased cost of food transportation around the country.

Figure 50

Trends in YoY CPI readings

Source: NBS, ARM Research

■ HEADLINE
■ FOOD
■ CORE



Food pressures to ramp up on higher farm and processed food numbers

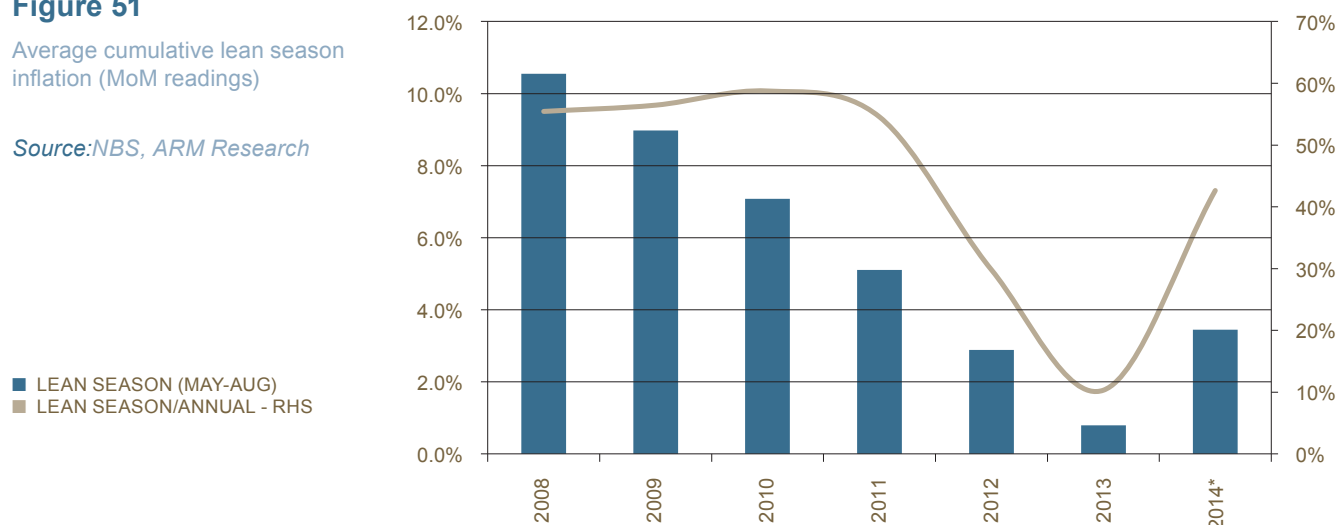
However, whilst farm produce prices came in slightly tapered in the first third of the year, with a 30bps MoM contraction to 9.74% YoY in February 2015 being the highlight, CPI data for May and June appear to corroborate our surmise of gradual pick up in farm produce pressures in the agricultural lean season (May-Aug). As the decline in household and market stocks stoked demand pressures, farm produce recorded 13bps and 24bps increases from previous months' readings to 9.9% and 10.2% YoY in May and June respectively. Importantly, increased

military operations by coalition forces and guerilla attacks by insurgents which intensified in the three months leading to May 2015 saw access to food decline in the North East, while also leading to a 250,000 MoM increase in the number of displaced Nigerians to 1.65 million. On the supply side, poor dry season harvest, higher transportation cost on the back of trade route disruptions as well as fuel scarcity, and fear of insurgent attacks restricted distribution of food and exacerbated price pressures in the northern region. Within a context of rundown of carryover food stock from 2014 and poor 2015 offseason harvest, it is unsurprising that prices of staple cereals have also begun to trend upwards in the south.

Figure 51

Average cumulative lean season inflation (MoM readings)

Source: NBS, ARM Research



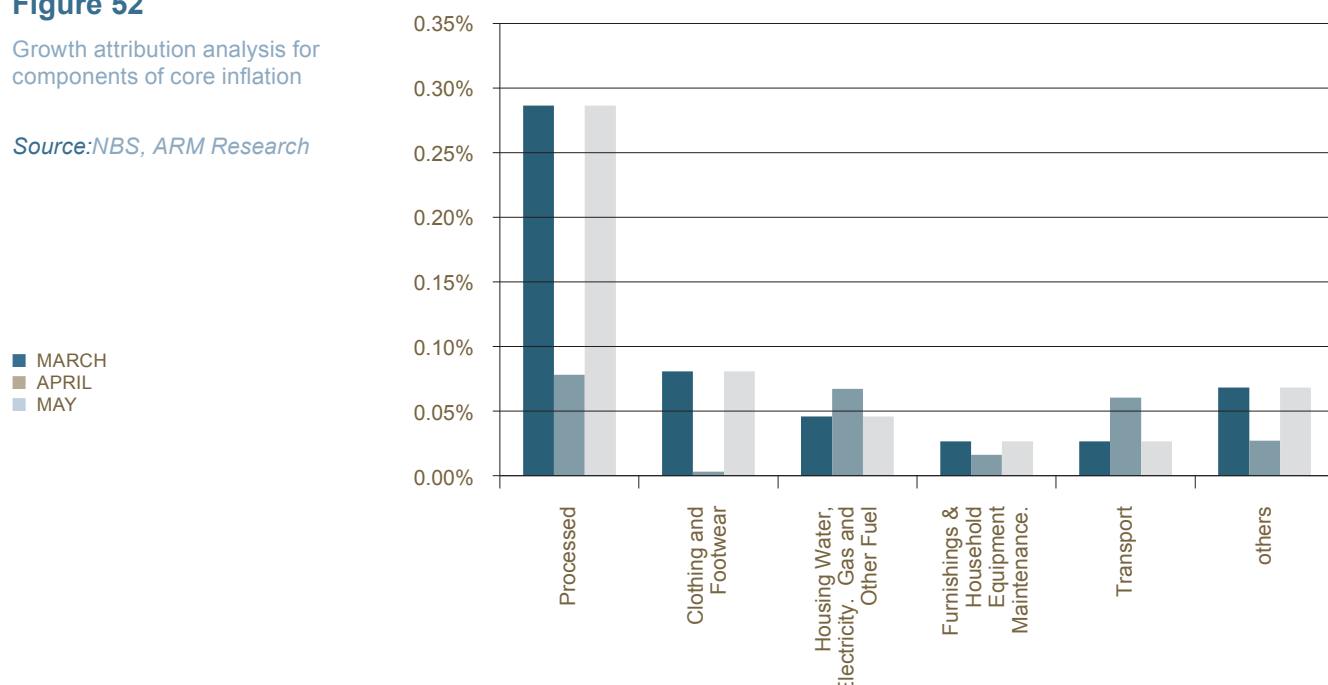
Incidentally, as is the case with food inflation, a chunk of the pressures that manifested on core inflation also arose from processed foods (though the impact on food was blunted by tame farm produce).

Perhaps more pertinently, the surges in processed food really started to manifest in March 2015, mainly as pass-through from currency devaluation.

Figure 52

Growth attribution analysis for components of core inflation

Source: NBS, ARM Research



Thereafter, YoY processed food surged 97bps and 210bps MoM to 6.3% and 8.4% in April and May 2015, accounting for 8bps and 17.4bps of the 11bps and 30bps rises in YoY food prices respectively. Importantly, whilst the latest readings appear to retain knock-on effects from naira weakness, we note that

rising production costs on the heels of reported drops in power generation as well as added pressures from fuel scarcity that stoked sharp price hikes in informal markets may have also contributed significant pressures in April and May. This is particularly evidenced by the 50bps jumps in both 'transportation'

and 'housing, water, electricity, gas and other fuel' components of core inflation in May. Going forward, continued erratic supply of PMS across major cities in June and July as well as CBN's recent ban on sale of FX for the importation ~41 items at the interbank should see pressures on processed food sustained in the near term. To the latter point, latest survey by News Agency of Nigeria (NAN) already reveals ~35%

surge in the prices of frozen chickens and turkeys following the implementation of CBN's directive. Added to this, we expect resurging farm produce to amplify the impact of processed food pressures on overall food numbers in the coming months. In particular, and as noted previously, lower household stock should induce a pickup in market demand this lean season, driving farm produce higher.

Table 14

Growth attribution analysis for components of food inflation

	Weight	March Reading	April Reading	May Reading	increase from prior month (April)	increase from prior month (May)	April growth Attribution	May growth Attribution
Farm	91.5%	9.7%	9.8%	9.9%	0.03%	0.13%	0.03%	0.12%
Processed food	8.5%	5.4%	6.3%	8.4%	0.97%	2.06%	0.08%	0.17%
							0.11%	0.30%

Source: NBS, ARM Research

Re-assessing the double-digit headline proposition

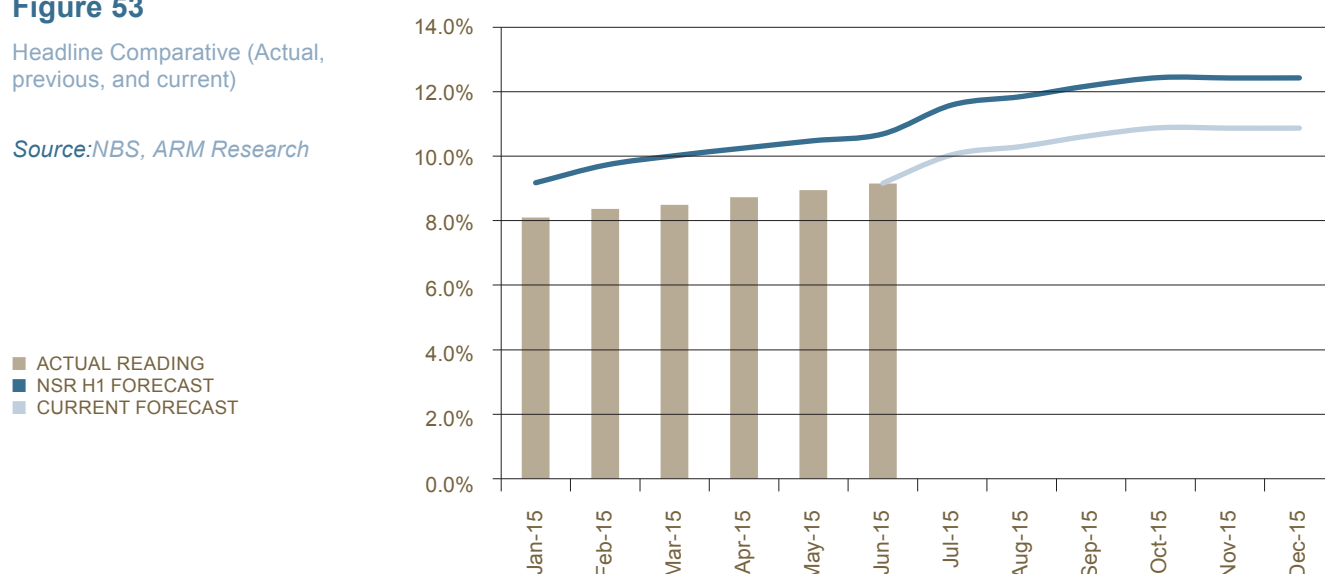
Inspired by the consistency of the outcomes of naira devaluations in 2008 and 2011 with results of past empirical studies, we had earlier hinted at a return to double digit (mean) headline reading for 2015. This was principally on the back of ~8% currency

devaluation in November 2014. However, contrary to expectation and despite further devaluation in February 2015, naira depreciation has had relatively tamer impact on headline than was initially envisaged – largely due to significant reduction in PMS prices in January and the moderation in growth of farm produce prices already explained. To re-emphasize, despite a further 17% devaluation in February 2015,

Figure 53

Headline Comparative (Actual, previous, and current)

Source: NBS, ARM Research



headline inflation rose only 110bps from November 2014 to 9% YoY in May 2015 (vs. our 10.5% forecast).

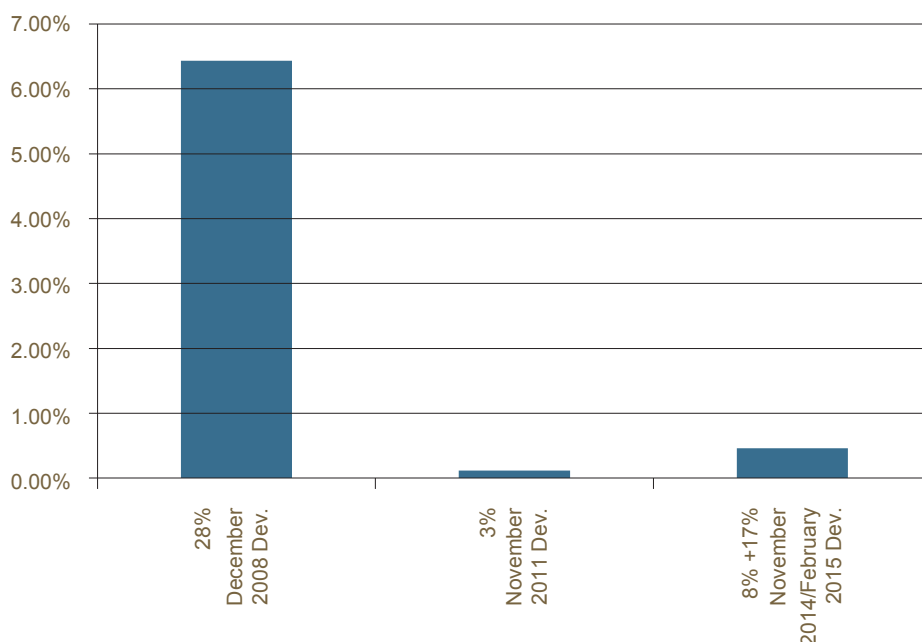
To put things in perspective, in stark contrast to the 643bps and 11bps YoY jumps in mean headline reading in the five months after 28% and 3.3% naira devaluations in November 2008 and November 2011 respectively, November 2014 and February 2015 devaluations (8%

and 17% respectively) only led to 46bps rise in headline reading as at April 2015. Importantly, we believe that output from main season harvest which led to high household and institutional stock of food in the first four months of 2015, significantly moderated pass-through effect from currency pressures. The improved sufficiency was also aided by drop in post harvest losses due to better food storage facilities in the current period, relative to 2008 and 2011.

Figure 54

Comparative impacts of naira devaluations on headline inflation

Source: NBS, ARM Research



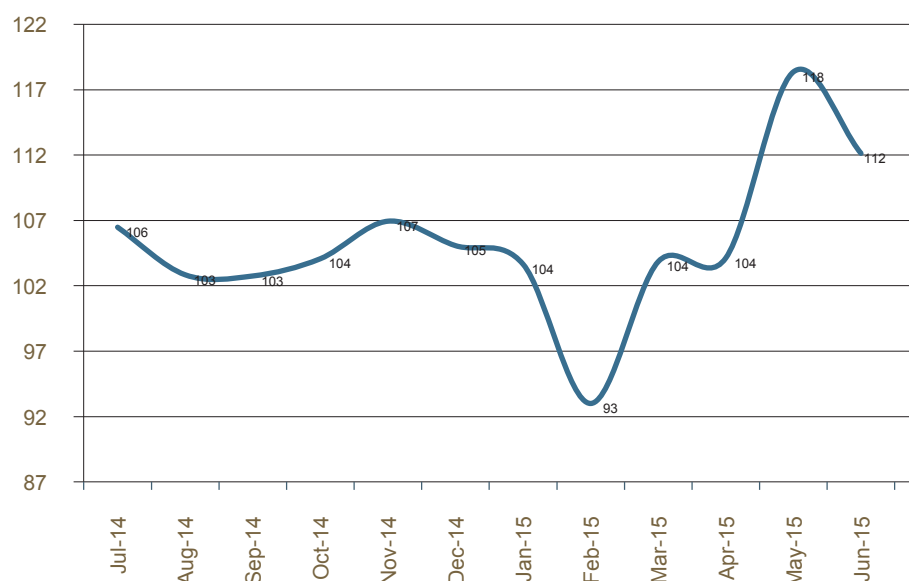
Nonetheless, there are other inflationary pressures. The fuel crisis, for one, influenced the 50bps jumps in both transportation and housing, water, electricity, gas and other fuel in May to 8.3% and 7.3% relative to their previous months' reading. The fuel price increases which extended into June would have been expected to elicit some parallels with the case in January 2012. At that time, a 50% jump in PMS prices to ₦97/litre dovetailed to a cumulative 250bps increase in headline over the ensuing 6 months period. However, though petrol prices across the country have already jumped 29% from year start to ₦112/litre in June, according to NBS data, with fears of further fuel scarcity still looming and adding to the clamour for subsidy removal, which could come with another bout of near term price increases, we still do not expect as strong an impact as in 2012. In many respects, this reflects the differing 'context' of the inflationary environment: indeed it seems the impact of the 2013 structural break in inflation readings which we pinpointed is even stronger than we allowed

credit for. The same drivers which drove that view: strong improvements in the food output context, enhancement of the agricultural value chain especially storage and backward integration remain key elements of the headline inflation's apparent unlimited ability of absorbing the key inflationary shocks, first devaluation and then price increases. This long-lasting improvement in the major component of the basket, food, appears central to explain why the same shocks are having less of an influence than in prior periods. Hence, even as we continue to expect some form of subsidy removal, despite FGN not appearing to be in a rush for same, and still anticipating that such removal will deliver fuel price increases (potentially reaching ₦137/litre) and Core inflation pressures, we are significantly more sanguine on inflation outlook for 2015. Overall, aided by the influence of the main harvest, we forecast mean inflation of 9.4% +/- 50 bps for 2015 which is still much higher than the 8.1% average in 2014 but represents a significant cutback from our 11% forecast coming into 2015.

Figure 55

Average PMS prices in Naira (N/litre)

Source: NBS, ARM Research

**Monetary aggregates on the rise...**

Broad money supply (M2) and narrow money (M1) increased by 14.5% and 9.2% respectively year through April 2015 compared with 7.3% and -10.9% recorded in 2014. The annualised growth rate of 43.9% in Broad money, for the first time in 4 years, surpassed the CBN's benchmark growth rate which is at 15.3%

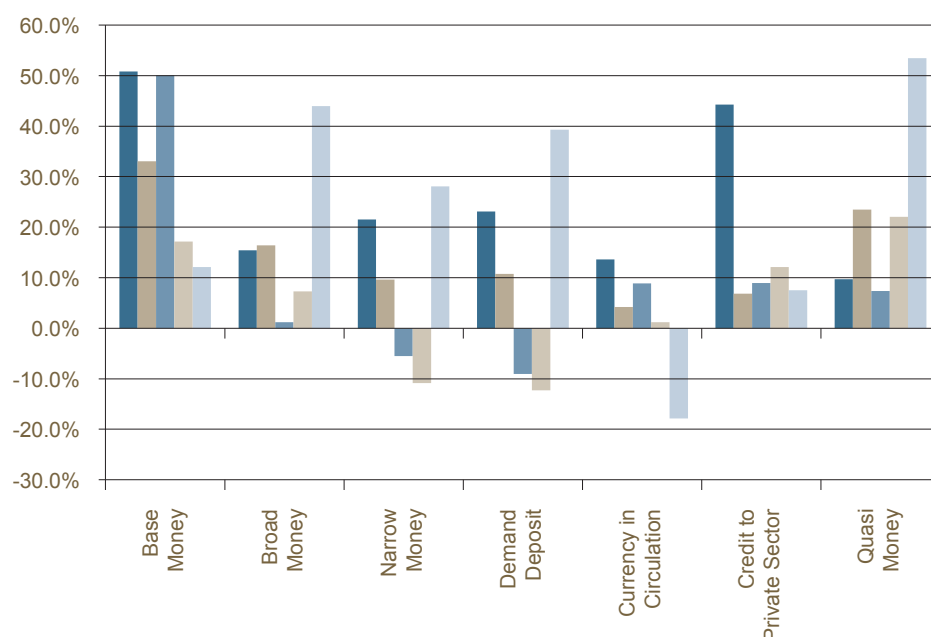
for the 2015 fiscal year (2014: 7.3%). The gains in M2 largely reflect uptick in quasi-money (+17.6%) and demand deposit (+12.9%), with the former sufficient to offset decreases in currency outside bank (-4%). After running flat for most of H2 2014, Net domestic credit increased by 28.3% January through April driven mainly by improved credit to government. For its part, credit to the government increased by 204%, posting

Figure 56

Growth Rates of Money Supply Components

Source: CBN, ARM Research

■ 2011
■ 2012
■ 2013
■ 2014
■ 2015 ANNUALISED



positive numbers in March and April after series of net credit figures largely reflecting increased borrowing where the DMO raised ₦91billion in March (19% and 26% up from February and January auctions respectively). On the other hand, credit to the private sector increased by just 2.4% reflecting the lack of lending to the private sector by banks. Overall, annualized growth in net domestic of 86.1% tracks significantly ahead of the 29.3% CBN target for 2015 in line with the pattern in other key items.

Tight monetary policy and sequestration of federal funds drive market rates higher

OMO Maturity levels declined 8% QoQ to ₦1.7trillion in Q1 15 increasing by 35% in Q2 2015 to ₦2.3trillion putting H1 maturities slightly lower than H2 2014 by

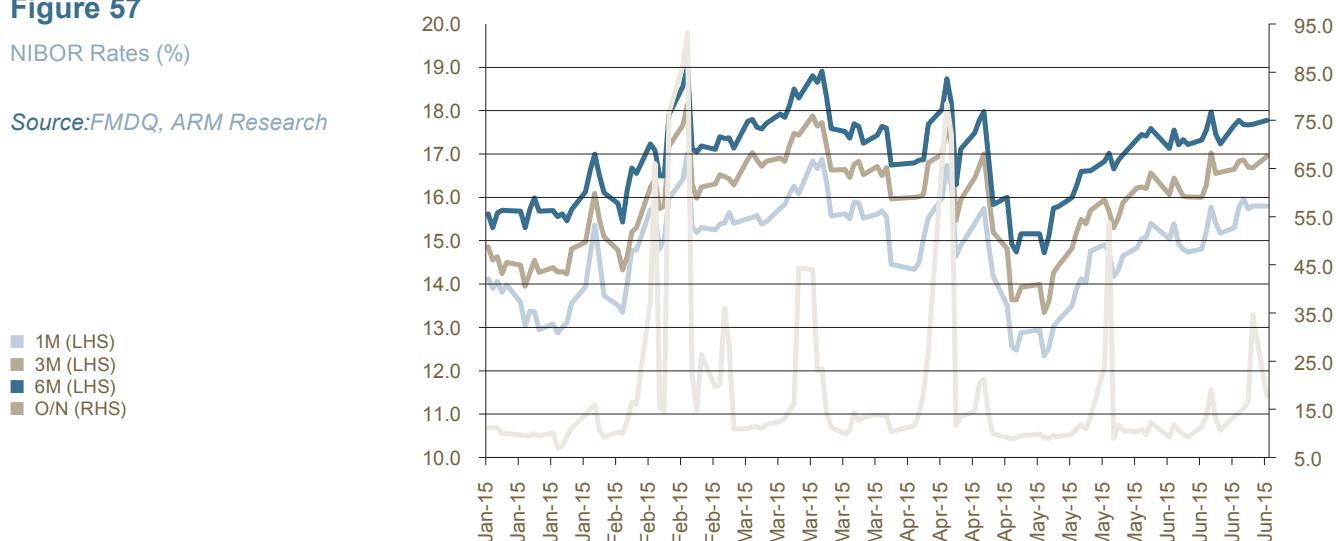
-2.4 % on aggregate with another ₦535billion in redemption of FGN APR 2015 bond.

Interestingly, despite the thinner inflows of maturing paper, currency worries, aggressive monetary tightening emerged in the form of a jump in OMO issuance in January to ₦1.3 trillion (December: Nil) and was complemented by reduction in the cycle for CRR computation/debit to bi-weekly (from monthly) as the CBN resorted to its usual tactic of limiting dollar demand by squeezing liquidity. In addition, (with the) commencement of Treasury Single Account implementation in Q1 15, money markets rate hovered between 14% and 15.5% in the month of March. The TSA implementation culled ₦689 billion from the financial system in February driving NIBOR rates higher to about 93%

Figure 57

NIBOR Rates (%)

Source: FMDQ, ARM Research



post announcement. However, the subsequent upswing in maturity levels in Q2 15, aided by the bond redemption in April, boosted system liquidity levels driving a pull-back in money market rates (75bps MoM) with OBB and NIBOR declining 421bps and 378bps respectively to year lows of 9.25% and 9.9% respectively.

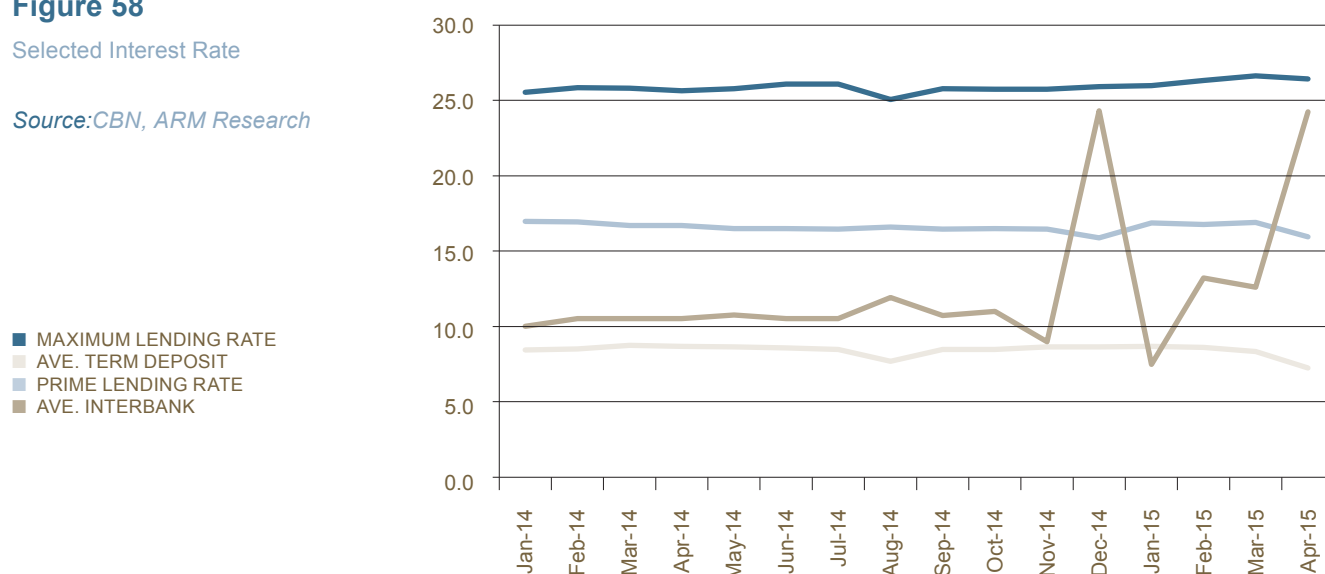
In line with improved market liquidity in Q2 2015, average term deposit rate declined to 7.23% in April, average interbank rate on the other hand

was relatively volatile with April average at 24.24% (last recorded in December 2014). The volatility in interbank movement was driven by largely by the dispersed OMO maturity date which led to short lived liquidity squeeze. Prime and maximum lending rates were relatively stable largely reflecting (limited credit activity as evidenced in) the stable numbers in credit to the private sector which have remained stable/flat at ₦18trillion from December 2014.

Figure 58

Selected Interest Rate

Source: CBN, ARM Research



CRR harmonization more of a tightening than easing

With the MPC believing that the major monetary policy actions taken in November 2014 had not fully permeated the economy, the committee left its monetary policies unchanged at the first two meetings held in 2015. In its third meeting for the year, the committee reached a decision to harmonise the CRR to 31%, respectively from 75% and 20% for Public and Private sector deposit. The committee stated that the regime wherein the computation for the two sectors differed was

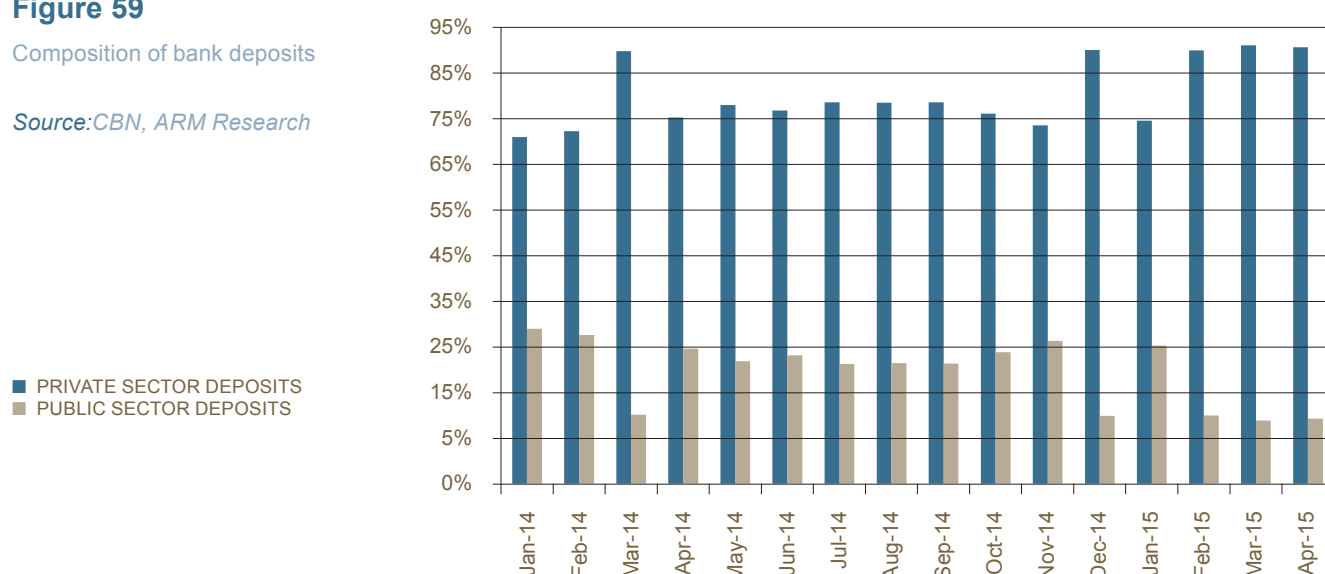
discriminatory and would allow unwholesome practice thereby impairing the CBN's ability to cap every form of speculative actions by the players given easy access to liquidity.

To our thinking, and communicated at the time, this rationale was simply a camouflage for further tightening. Deeper analysis showed that the implementation of the TSA in February had already shrank public deposit (-15pps MoM) to 10% (2014 average of 22%) of total banking deposit of ₦13 trillion. This meant that private sector deposit stood at 91% of total bank deposit as at

Figure 59

Composition of bank deposits

Source: CBN, ARM Research



April 2015 (and averaged 87% YTD) and the blended CRR of 31% further drained the system of ₦800 billion, by our estimates.

Supporting that view, overnight rates touched 53.6% while average Treasury bill yields accelerated 53bps to 14.5% on 21st of May before eventually tapering off following additional OMO maturities and eventual peaceful change of government.

Lower maturities and tight-lipped FGN to keep money market rates range bound/volatile

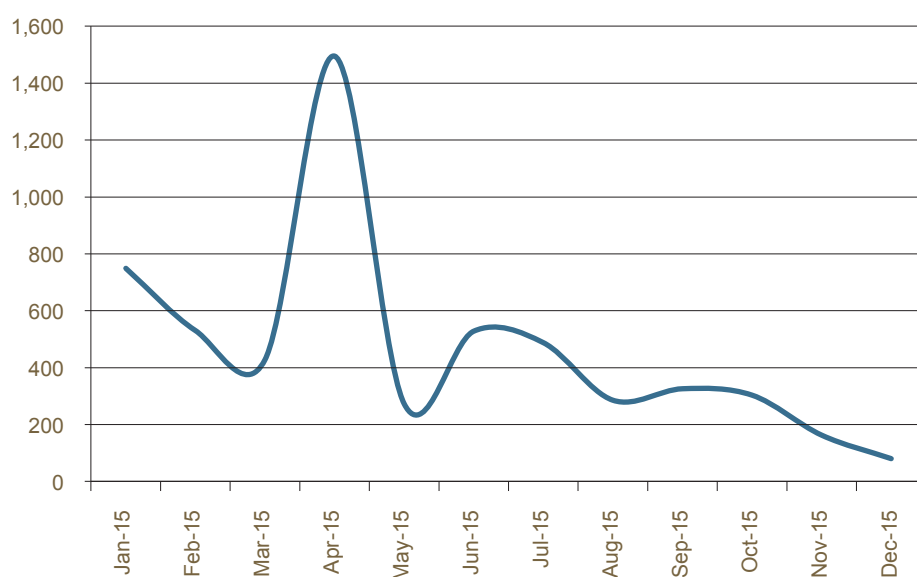
Looking ahead, lower OMO maturities in H2 2015 of ₦1.3trillion, compared to H1's ₦4 trillion, suggests more tightness. Furthermore, because of the depletion in reserves, the CBN's commitment to keeping the currency stable will likely focus on liquidity curbing measures, and the postponement of a decision on

Nigeria's inclusion in the JPMEBI allows it more time to experiment, pointing to higher yields from current levels as base level of liquidity shrinks. Along this same line, the lull in government activities as the new government settles appears set to further impair liquidity and suggests much of the upward pressure will be concentrated early in H2 15. Nonetheless, lower borrowing profile going by recently released issuance calendars which depict QoQ slowdown in bond issuance (-₦10billion) and a net repayment of ₦92billion of treasury bills should temper scope for rate uptick. Indeed, should the new government successfully pursue its offshore borrowing plans, the release of pressure on the domestic market could coincide neatly with actual commencement of government spending and release of liquidity in driving an even more marked moderation in money market rates before year-end.

Figure 60

OMO Maturity Profile (₦'billion)

Source: FMDQ, ARM Research



CAPITAL MARKET REVIEW AND OUTLOOK

CHOPPY HALF YEAR FOR FI MARKETS

The turmoil that trailed the domestic fixed income market on the heels of the precipitous drop in oil prices in H2 2014 lingered into the first half of 2015, forcing the apex bank to step up regulatory oversight in a bid to stabilise the deteriorating currency. From the elimination of the NOP to reinstatement of same shortly after JP Morgan's "threat" of possible expulsion of FGN bonds from its index, from the change in interbank forex market architecture to eventual closure of the RDAS, investors—foreign

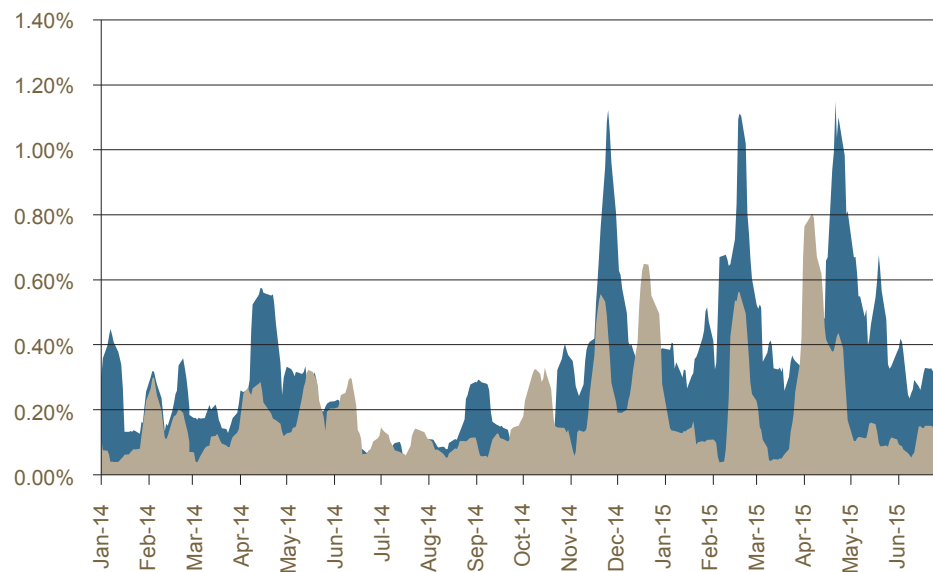
and local—were faced with a progressively unstable monetary policy. Amidst heightened apprehension due to the gloomy fiscal picture, the torrid political atmosphere—which in part led to the S&P rating downgrade—climaxed with the sell-off that pushed the yield curve more than 200bps higher to a multi-year summit in the middle of the first quarter. Despite the retracement that trailed the successful conclusion of the election, with yield curve only 20bps higher on average (T-bill: 13.93% and Bond yields: 14.78%) by the end of H1 15, the environment was largely unpredictable over H1 15 as indicated by the elevated rolling 30day yield volatility.

Figure 61

30 day rolling volatility (standard deviation) of yields

Source: FMDQ, ARM Research

■ T-BILLS
■ BONDS



Political and currency concerns outweigh monetary influence on yields

In line with our expectation, the apex bank extended its hawkish monetary tone from Q4 14 with tweaks to CRR and ramp up in OMO issuance over H1 15 to curtail liquidity influence on the currency. However, aside the occasional spikes in call rates, triggered by the shortening of the CRR debit cycle— from monthly to bi weekly and then weekly—the liquidity mop-up of ₹1 trillion over the period (relative to ₹770 billion net repayment in H2 14) resulted in only a 20bps increase in average yields to 14.41% as other events appeared to have

dominated investors' considerations. Top on this list was political risks with the sharpest one day spike in yields (+61bps) in H1 15 coming on the heels of the postponement of the general elections in February. In fact, the sell-off was so severe that rates climbed progressively over the next five trading days (+257bps) to touch a peak of 16% on average. The exchange rate was another key driver of yields with the subsequent pull back in rates post-February coinciding with the closure of the RDAS. While yields trended lower in subsequent months, further buoyed by the peaceful conclusion to the general elections, a re-emergence of forex risk at the tail end of H1 15 triggered another round

of selloff with yields jumping 125bps over the last trading days in June. Indeed, currency impact was visible in the trajectory of the non-deliverable forward (NDF). Specifically, the implied yield on 1 month NDF contracted from pre devaluation record levels of 114% to 52% post the devaluation easing further to 10% in April, before rebounding to 45% in June as monetary manoeuvres in late June.

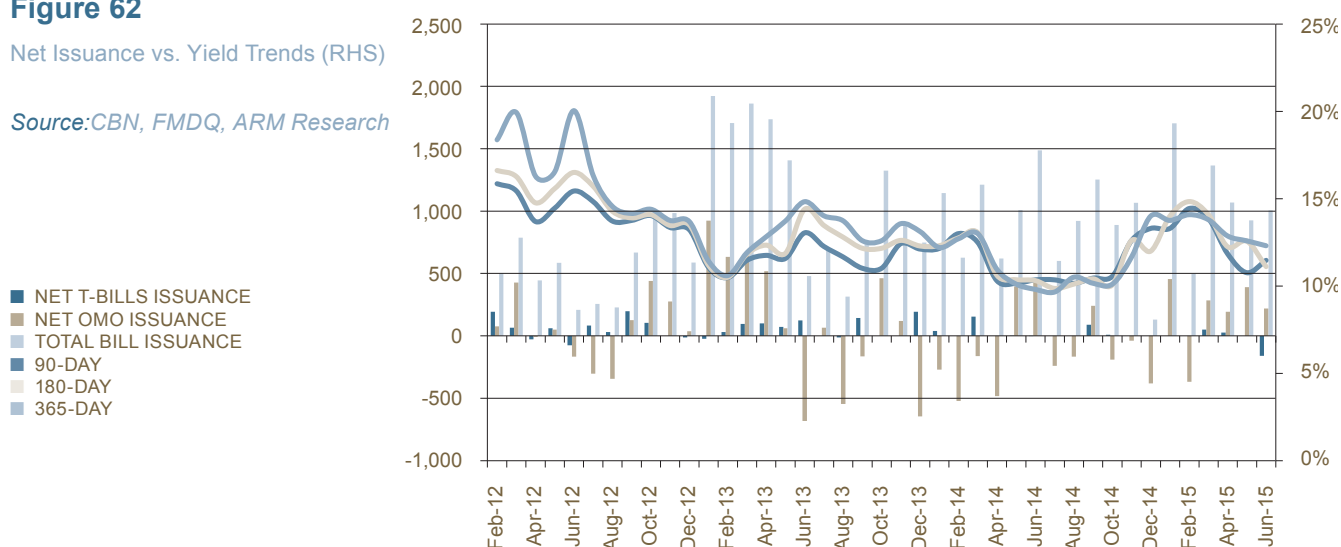
Eurobonds respond to heightened global risks

Investors in Nigeria's Euro bond also responded to domestic events, particularly political risks, with sell-off driving yields to hit a 1 year peak of 7.05% days after the postponement of the general election in February. Eurobond yields retraced soon thereafter largely in lockstep with local

Figure 62

Net Issuance vs. Yield Trends (RHS)

Source: CBN, FMDQ, ARM Research



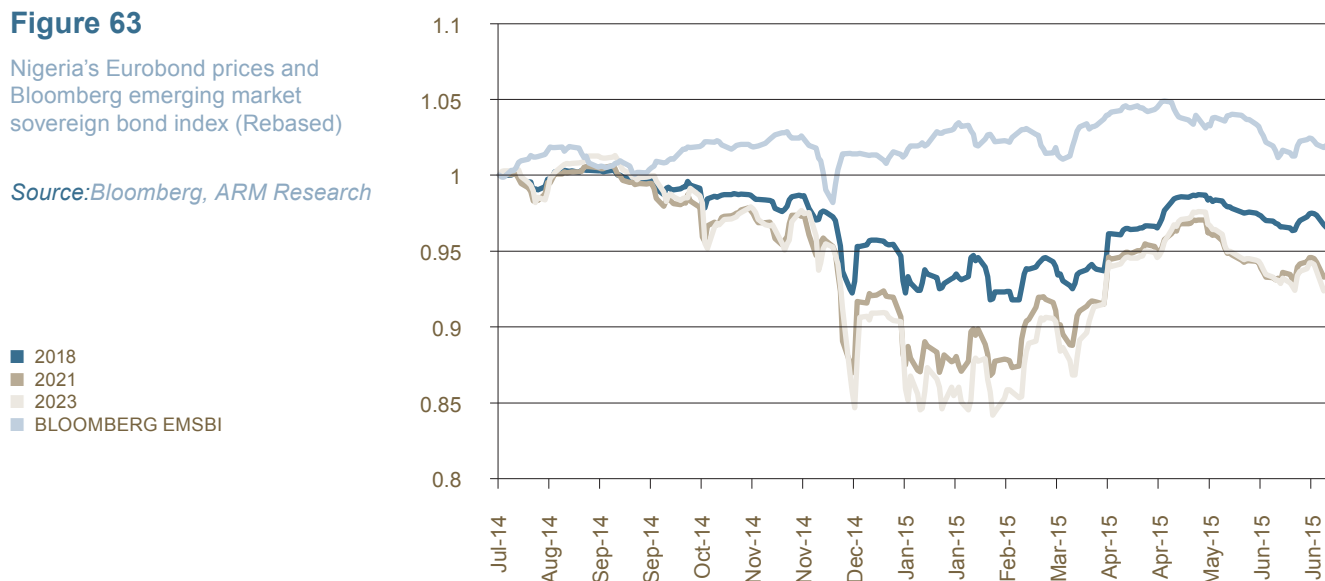
currency bonds, before bucking the trend with another round of ascent from May, though this time in tandem with other emerging market Eurobonds, likely in reaction to the Greece standoff with Eurozone. While the risk of a Greek contagion cannot be ruled out, the risk to Nigeria appears

remote, thus we believe the sell-off is a reflection of broader strategy by global portfolio managers to underweight EM markets in view of the possible crises, rather than a deterioration in credit quality of the Nigerian government.

Figure 63

Nigeria's Eurobond prices and Bloomberg emerging market sovereign bond index (Rebased)

Source: Bloomberg, ARM Research



DMO unfazed by fiscal pressures

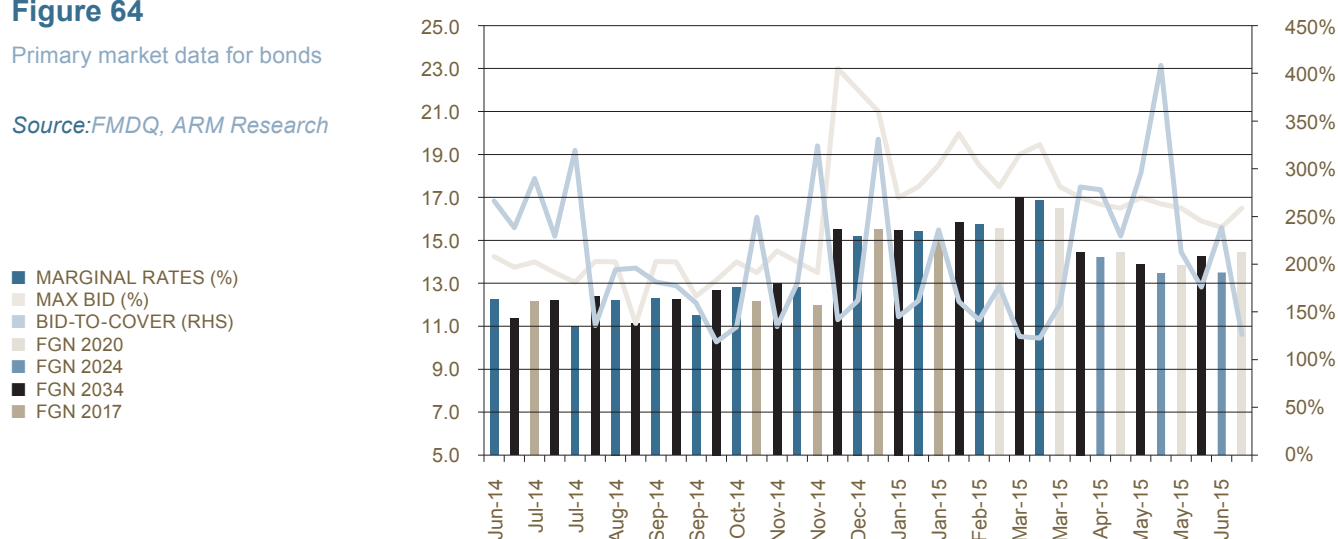
Interestingly, in spite of the fiscal straits, the DMO trimmed bond issuance (-18% YoY) to ₦450 billion in H1 2015. However, it extended issuance at the long end (10 and 20 year papers), with the switch to the 2020 bond in February apparently triggered by the bulging outstanding volume on the FGN 2017 of ~₦600 billion—which appears to be an unwritten cap. The focus on the 2020 thereafter saw it account for a third of total issuance in H1 15. The overall lower issuance is reflective of softer issuance programme as well as rejection of offers by the DMO given exorbitant bid rates—as high as

20%—which forced the DMO to sell only 85% of its February offer at in contrast to its usual practice of 100% sales. The scale of restraint indicated by the DMO's cutback in issuance is underscored by the fact that the agency had to finance the redemption of the ₦535 billion that matured in April. On a net basis, the DMO repaid ~₦90 billion in H1 15 with the lack of actual borrowing fitting into our view that key agencies were awaiting a clearer political landscape to dictate direction for their activities. The DMO was not the only one taking their cue from the March 28 elections as investor appetite significantly improved in Q2 15 with bid to cover jumping to 2.5x from 1.5x in Q1.

Figure 64

Primary market data for bonds

Source: FMDQ, ARM Research



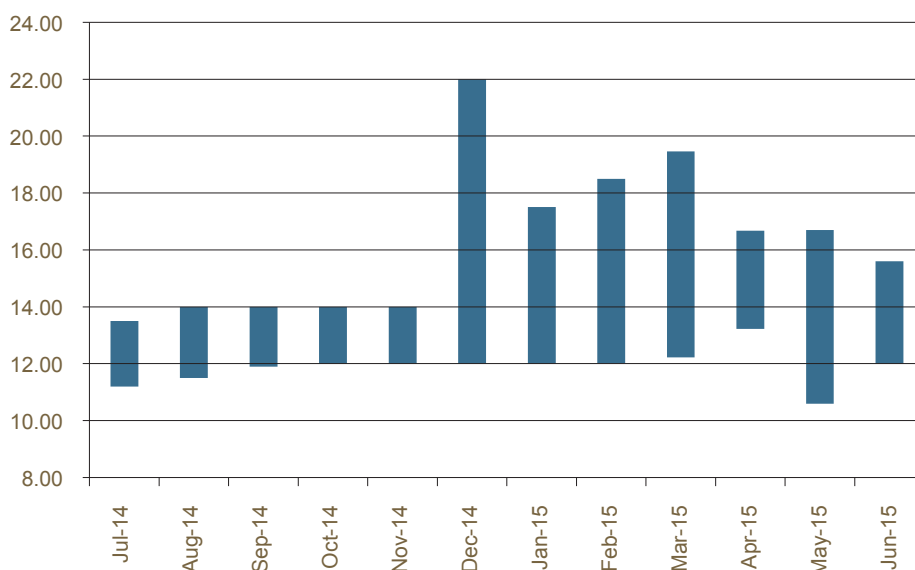
Unsurprisingly, given the prevailing risks, this renewed appetite was domestic investor led. Combined bond purchases by pension fund and banks were nearly 1.4x the cumulative bond issuance in Q1 15. While the PFAs took advantage of the elevated yield environment, with 76% of their ₦200 billion Q1 15 bond purchases occurring in February, 85% of bank purchases occurred the following month. Although overall impact of these purchases on yields trajectory was relatively mute,

the bank angle, which incidentally coincided with rebound in FPI, suggests that banks took the advantage of their mediating role for FPI demand to use those flows as a barometer of the fixed income market. However, the simple fact that the dominant domestic demand had a minimal impact on yields not only reinforces our perception of the buy-and-hold inclinations of domestic investors but also underscores the extent of uncertainty that permeated the environment in H1 15.

Figure 65

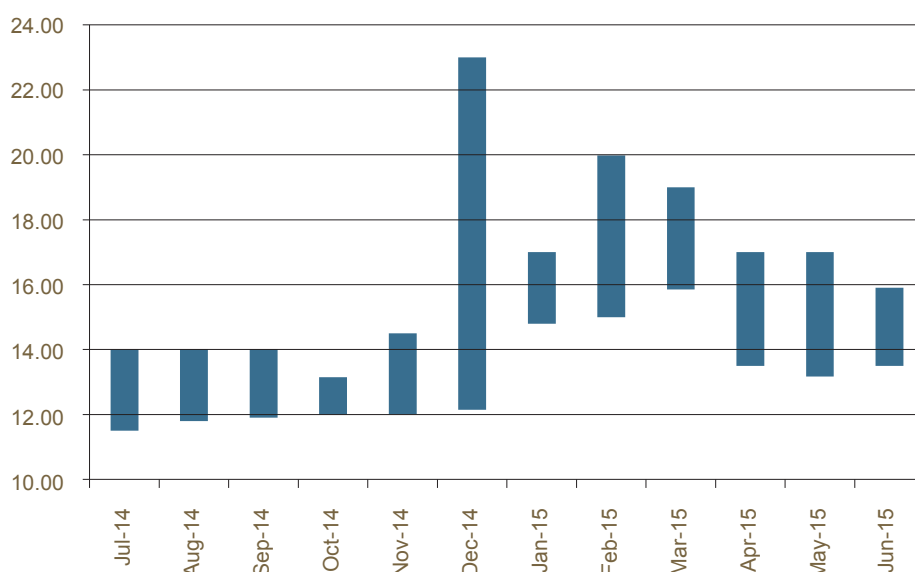
Bid range at primary auction for 10 year FGN bond

Source: FMDQ, ARM Research

**Figure 66**

Bid range at primary auction for 20 year FGN bond

Source: FMDQ, ARM Research



Fixed income market awaiting the fiscal nod

Of all the drivers of yield trajectory in H1 15, political and monetary response to currency risk appeared to have dominated, with global dynamics and fiscal pressures largely on the back burner. In this regard, with political atmosphere calmer, unabating forex pressures suggests monetary manoeuvres will remain key in setting the tone for rates over H2 15 and we expect the apex bank to follow the same tack

using a combination of some of monetary tightening via OMO and administrative measures. However, high costs and limited impact of paper issuance on liquidity, which over the years tilted monetary policy in favour of direct cash sequestration and administrative measures, suggest paper issuance in H2 15 will be softer than in the first half of the year. Interestingly, despite evident pressures, the tale on the fiscal side appears to be similar. Although, as anticipated, the President affirmed that the treasury was virtually empty, subsequent assurance that the FGN will do

its best to recover loot, alongside disbanding of board of NNPC, dims scope of a sizable ramp up in domestic paper. Buttressing this disposition is the recent ₦700 billion bailout package sourced from NLNG proceeds and CBN. Juxtaposing our expectation for monetary activity to continue to favour direct liquidity-capping tools, with the body language of fiscal authorities, points to overall tamer paper supply over H2 15. However, this could be balanced by weaker demand. On the global stage, though the prospects for US rate normalisation and Greek crises are important drivers for capital flows to EM, we believe, domestic considerations are likely to dominate investment actions. On this front, subsisting currency pressures, with interbank/parallel forex spread at record levels, should see FPI appetite for naira yields remain dry over the coming months. On the home front, while buying power is set to be weaker due to the step-down (-27% to ₦2.4 trillion from H1 15) in OMO maturities in H2 15, we see flight to safety in response to wavering macro fundamentals still buoying local demand. Nonetheless, uncertainty on probable economic direction of the new government is likely to keep the expression of that demand cautious. That said, with key fears—political risks—effectively off the table, the upper band for rates appear capped, around pre-postponement levels of under 15.50%, in our view.

CHANGING POLITICAL LANDSCAPE AMID STAGNANT ECONOMIC FUNDAMENTALS POSES FRESH HURDLES TO NSEASI

Fluid economic and political factors drive heady half-year for equities

Extending bearish pattern in Q4 14, NSEASI shrank 8.4% over Q1 15 as softening economic fundamentals following oil price plunge combined with heightening political risk to drive elevated foreign and domestic aversion to naira equities. However, and in line with the general pattern for domestic markets, on the heels of the peaceful conclusion to the 2015 elections and modest improvement in oil prices, sentiment turned positive over Q2 15 (+5.4%) which helped pare YTD market weakness (-3.5%).

Parsing through index performance on a monthly basis, NSEASI opened 2015 with its widest MoM loss (-14.7%) since March 2009 in January as Brent Crude oil prices (-7.6% MoM) reached a six-year low and meshed USDNGN (-2.3% MoM) worries and fundamental concerns over corporate earnings. Sentiment darkened further in February following announcement of six-week postponement to 2015 elections which placed heavy political risk premiums on naira assets and drove NSEASI to a three year low of 27,585 points in the aftermath of the INEC announcement⁽⁴³⁾. Nonetheless, NSEASI recovered by end of February (+1.8% MoM), in part reflecting improving economic fundamentals on the heels of 18% MoM recovery in Brent crude and bargain hunting following the sell-offs. Equity market performance improved further in March (+5.5% MoM), led by banks, after FY 14 earnings beat broadly bearish market expectations and the USDNGN stabilized at ₦198-199/\$ range.

The unanticipated peaceful conclusion to the 2015 general elections saw Nigerian equities record strongest monthly performance since May 2013 in April (+9.3% MoM) with biggest one-day gain of 8.3% on the day after former president Goodluck Jonathan conceded the ruling party's defeat at the 2015 poll. Thereafter, uncertainty following the change in political leadership dominated markets over the rest of H1 2015 with lack of clarity over policy direction, in particular, swinging three-month bull run to modest bear trends over May (-1.1% MoM) and June (-2.5%).

Overall, closure on the political front and a measure of stability on oil prices helped draw a line on the strong bearish sentiments towards Nigerian equities at the start of 2015.

Deteriorating fundamentals exacerbate bearish equities performance

In addition to political and macro headwinds, weak earnings outlook across NSEASI contributed to bearish market sentiment over Q1 15 before the tailwinds from the benign closure to the elections cast market attention off fundamentals during Q2 15 and towards policy trajectory of incoming Buhari government.

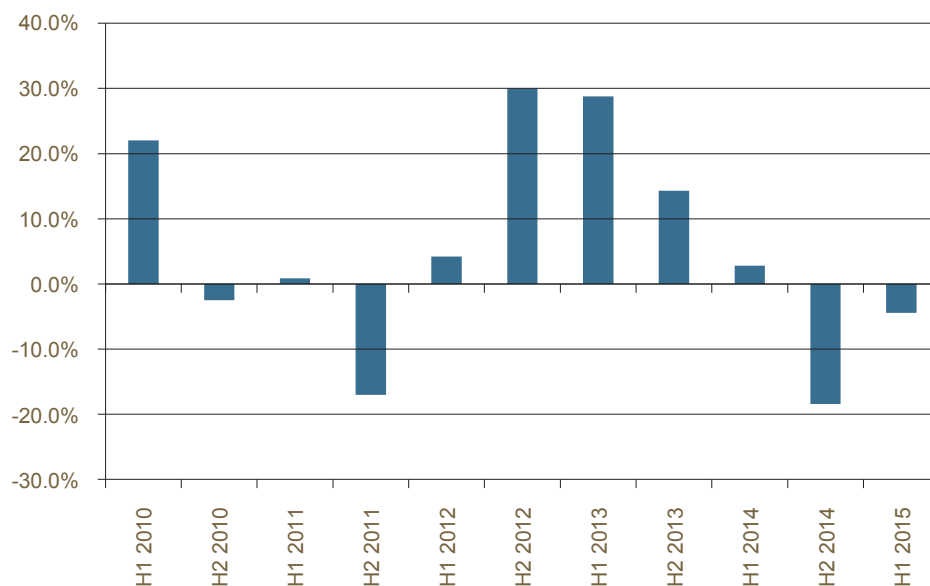
(43) 13th February 2015

Figure 67

NSEASI Half-yearly returns

Source: Bloomberg, ARM Research

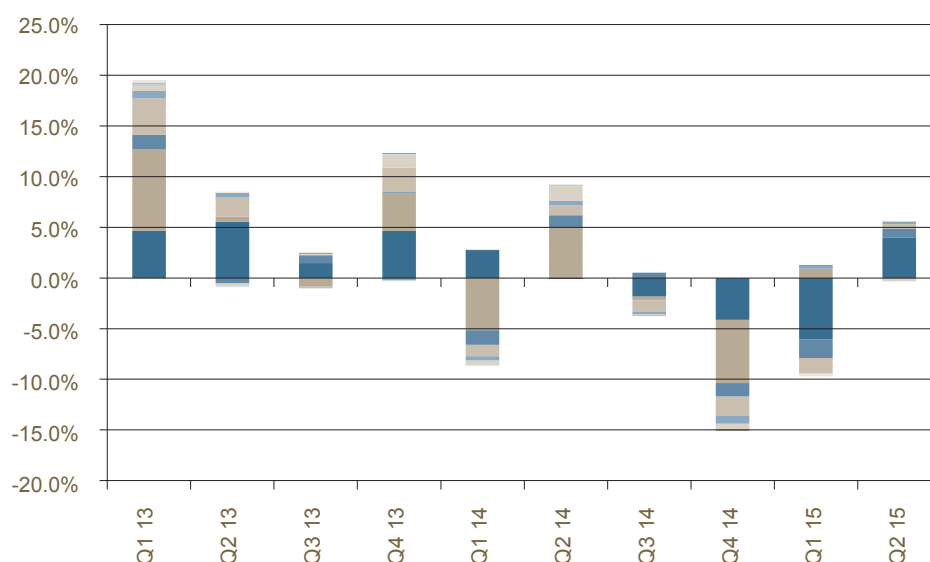
■ NSEASI RETURN

**Figure 68**

Attribution analysis of quarterly sectoral performance

Source: Bloomberg, ARM Research

■ CEMENT
 ■ BANKING
 ■ BREWERS
 ■ FOOD
 ■ PERSONAL CARE
 ■ OIL & GAS
 ■ INSURANCE
 ■ REAL ESTATE



However, going back to disaggregate market performance by sector, our call for negative price movement by consumers, on adverse investor reaction to slowing revenue growth and adverse impact on naira devaluation, largely panned out as market capitalization of food producers and brewers shed 12% and 13% respectively. For personal care manufacturers, where we saw scope for more favourable sentiment as effect of tamer oil price on margins offset impact of weaker naira, our positive call panned out with the sector positing a 12.4% gain. Nonetheless, our thesis was largely aided by movement in sector heavyweight Unilever on the heels of tender offer by its Dutch-based parent to raise ownership stake by 25pps to 75% at a 34% premium to share price as at the date of the announcement⁽⁴⁴⁾.

Upstream oil and gas (O&G) names were weighed down by fundamental concerns with net lower oil price driving weakness in Oando and Seplat. However, downstream petroleum marketers negatively surprised relative to our upbeat expectations. Our positive outlook for petroleum marketers was unhinged by 10% reduction of PMS pump price to ₦87/litre in January and second USDNGN devaluation in February. Jointly, these re-inflated subsidy per litre from ₦10.9/litre at 2014 year end to ₦50.5/litre by the end of H1 15. Consequently, widened exposure to PSF receivables amid weakened fiscal ability to meet payments dampened investor sentiment over earnings outlook, leading to sell-offs. Overall, O&G sector shrank 3% and 6% over Q1 15 and Q2 15 respectively.

(44) March 25th 2015

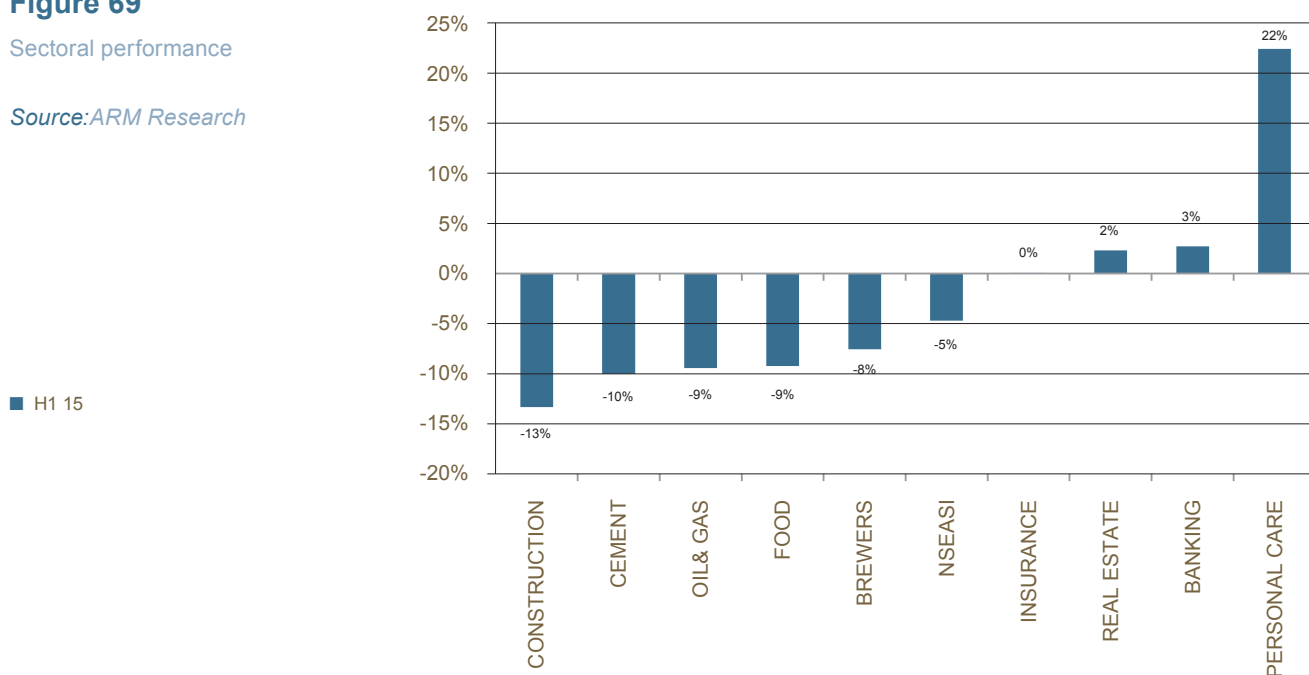
Banks also bucked our expectations, but this time in a positive direction as strong FX income following elevated naira volatility and CBN relaxation of stringent provisioning requirements underpinned better-than-expected earnings which helped drive a recovery

over March (+12%). Furthermore, CBN deferment of the Basel II/III CAR requirements to June 2016 bolstered sentiment around banks resulting in the sector clocking a 2.7% return over H1 15.

Figure 69

Sectoral performance

Source: ARM Research



Elsewhere, cement stocks buckled over Q1 15 (-18%), as concerns over impact of reduced FGN capital spending on their top-line combined with

fears over inflationary impact of devaluation shocks to energy costs especially considering the dollar-priced nature of their gas supply contracts.

Figure 70

Valuation multiples across defensives and cyclicals

Source: Bloomberg, ARM Research



Nonetheless, as earlier stated, aggregate sentiment turned positive over Q2 15 driving a recovery in multiples across the NSEASI. This was most evident in banks where the Q1 earnings boost helped drive upward rerating of price-to-earnings multiples which, on average, recovered from 4.9x in Q1 15 to close H1 15 at 6x. On the other hand, a recovery in pricing over Q2 15 despite weak underlying earnings drove consumer P/E multiples 41% higher to 39x (Q1: -3%). For oil and gas companies, despite negative price movement over H1 15 (-9%), multiples tracked higher (+51% to 76x)⁽⁴⁵⁾ largely reflecting earnings compression in downstream heavyweight, Forte Oil.

Challenged investment landscape drives compression in transactions

A second-order implication of heightened investor edginess over NSEASI in H1 15 was the contraction

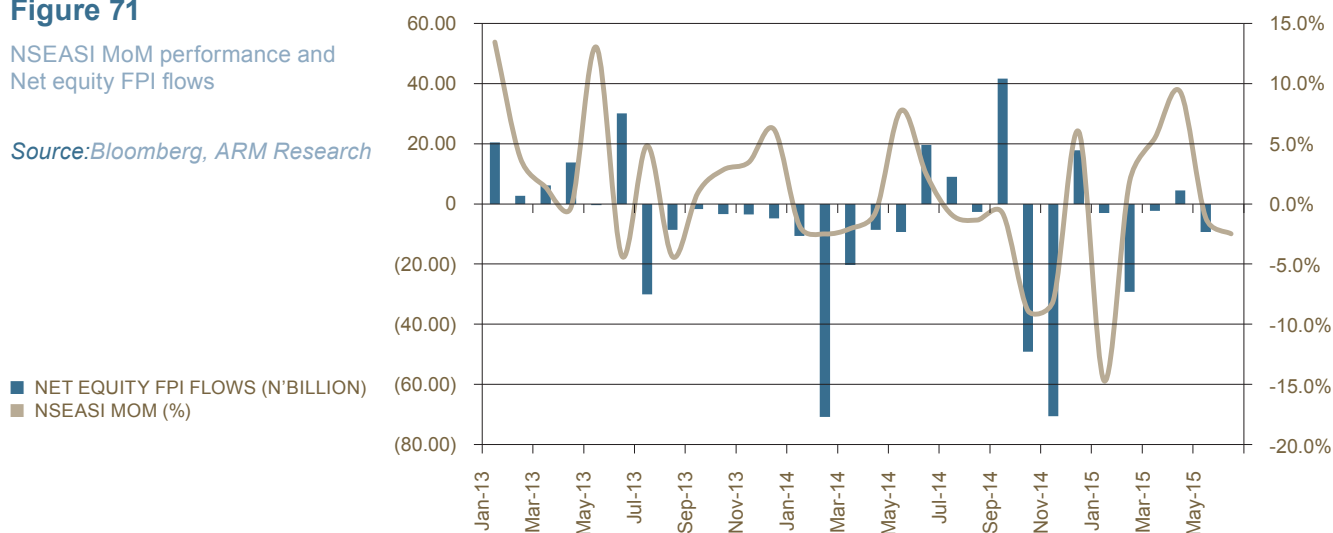
(45) Bloomberg P/E: Forte Oil (132x), Oando (52x), Conoil (9x), Mobil (9x) and Total (15x)

in total value traded (-8.7% YoY) to ₦1.05 trillion for the first 5 months, as domestic and foreign investors adopted cautious position on equities. On the heels of ₦101 billion net short position in Q4 14, foreign investors remained averse to the equity market with net outflow of ₦34 billion over Q1 15. This pattern extended into Q2 15, though as in Q1 15, net short positions continued to shrink (₦4.87 billion). Delving through the numbers on a monthly basis, multi-year lows for oil price and USDNGN in January underpinned FPI outflows of ₦51 billion over the month (December 2014: ₦53 billion). The sustained negative FPI position in January combined with cutback in local investors' activity on the bourse (domestic transactions shrank 32% MoM to ₦90.6 billion) to drive 15.3% MoM plunge in NSEASI. Corroborating our inferences on the influence of key drivers, a further upsurge in FPI outflows in February (+60% MoM to ₦81 billion) and 44% MoM reduction in domestic trading activity to ₦51 billion that same month, watermark the political risk that was peaking at the time.

Figure 71

NSEASI MoM performance and
Net equity FPI flows

Source: Bloomberg, ARM Research



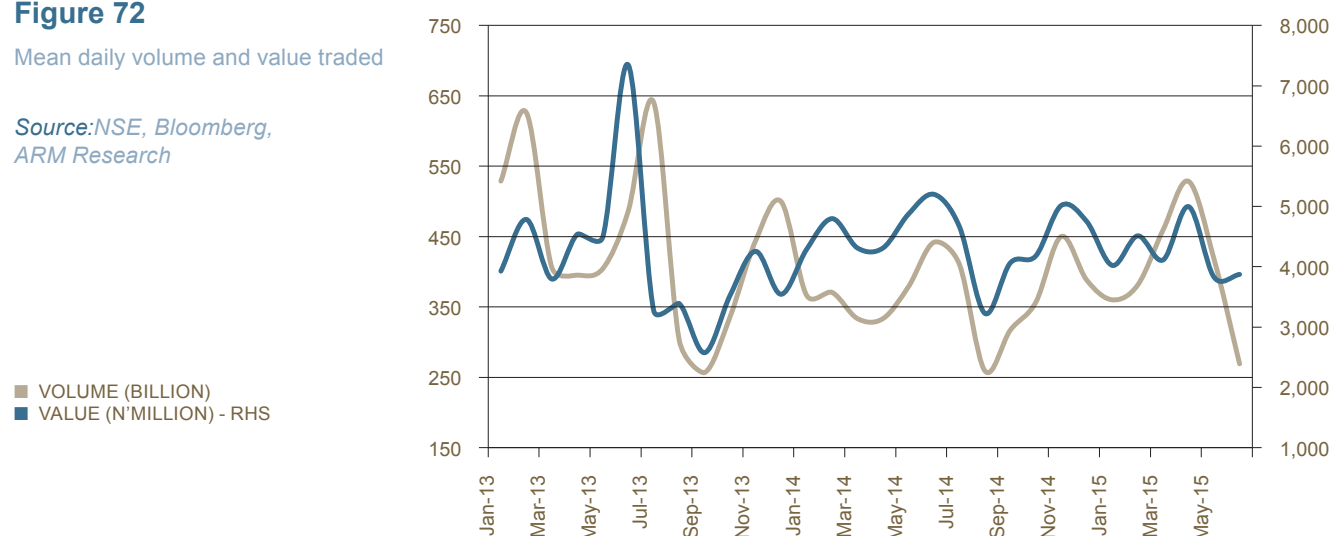
Nonetheless, increased bargain hunting due to compelling valuations drove a 61% recovery in local transactions activity and 98% MoM reduction in foreign net short positions in March to ₦2.2 billion. Subsequent easing in political tensions resulted in the year's first positive FPI net flows of ₦4.4 billion in April 2015. However, uncertainty on the

likely policy trajectory of the new government quickly swung FPI back into negative territory with net short positions of ₦9.3 billion over May 2015. Overall investor activity largely tracked our thesis about heightened investor sensitivity to political and economic uncertainty on the domestic front.

Figure 72

Mean daily volume and value traded

Source: NSE, Bloomberg, ARM Research



Attractive alternative and limited primary market activity accentuate moderation in equity exposure

Beyond fundamental issues, continued absence of primary market activity and slew of dilutive capital raising secondary issues by banks ⁽⁴⁶⁾ can help investor buying appetite for NSEASI over H1 15. Indeed, elevated yield profile and renaissance of local CP-market acted to sap domestic liquidity from equities over the period. The allocation switch is evident in asset class holdings of domestic pension funds with industry

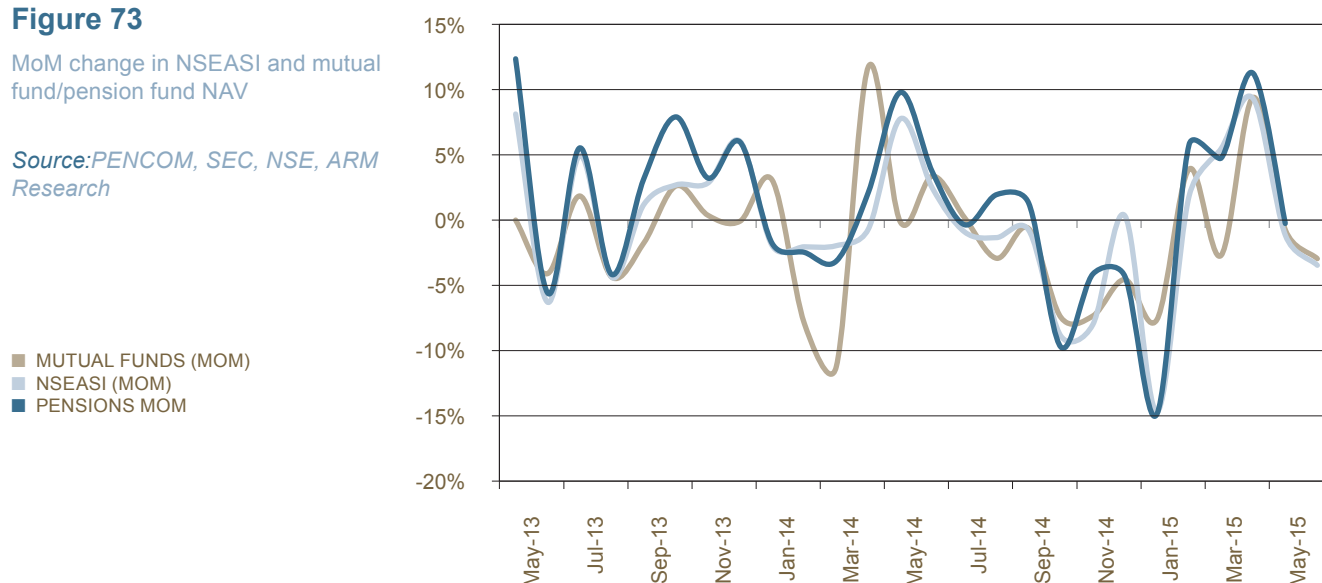
(46) Oando (₹49billion), UBA (₹13billion) and Access Bank (₹52billion)

wide equity share of NAV shrinking to 12% (2014: 15%, 2013: 15%) whilst FI holdings climbed 4pps to 65% (2014: 61%, 2013: 58%). For equity mutual funds, stock market holdings were more actively managed over February and March, with monthly movement in NAV at variance with MoM NSEASI performance suggesting caution towards NSEASI. Nonetheless with markets stabilizing post elections in April, equity mutual funds' MoM NAV resumed tracking NSEASI in Q2 15. In sum, similar to foreign investors, domestic institutional investors moderated exposure to NSEASI over Q1 15 before subsequently dropping equities aversion stance as political tensions eased over Q2 15.

Figure 73

MoM change in NSEASI and mutual fund/pension fund NAV

Source: PENCOM, SEC, NSE, ARM Research



As improvement in key indices methodology flies under the radar

In addition, one market development during the period is worth noting. The NSE announced an agreement with global index provider MSCI to takeover computation of its flagship NSE 30 and NSE 50 indices, which would subsequently be referred to as MSCI NSE 30 and MSCI NSE 50 indices respectively. The initiative, which seeks to bring these indices in line with the global benchmarks for index construction by taking into account issues such as free-float, holds potential to draw a wider array of global index tracking funds to the domestic bourse. In addition, the possibility of greater investability of the index should spur development of more sophisticated instruments such as ETFs. Whilst this development holds limited near term impact, in conjunction with the amendment of minimum trading price from 50kobo to 1kobo, the initiative brings market architecture more in line with global practices which should hold positive prospects for boosting market liquidity over the medium term.

Global and domestic uncertainty cast dull clouds over equities outlook

Whilst the dark cloud of 2015 general elections has passed over, investors focus appear to be shifting to another unresolved issue on the domestic landscape: weak government revenues. Drawing inference from market movement in May and June, clarity on how the new Buhari administration and the various economic managers co-ordinate to manage the new economic reality of subdued oil prices and its ramifications for

the economy should prove pivotal in market outlook for H2 15. As we established in our discussion on oil prices, softening demand growth amid sustained strength in global crude production continues to drive tempered outlook for oil prices. Thus, with no reprieve on the fundamental picture and the deferment of ministerial appointment till September 2015, investors' sentiment could be distracted by uncertainties on the global front.

On this wise, two events should vie for foreign interest in NSEASI over H2 15. Firstly, prospect of spillover from on-going Greek-Eurozone crisis should heighten investors' aversion to EM/FM assets in the event of Grexit. Whilst our base case sees limited chance of Greece leaving the euro, markets are likely to be roiled by intermittent bouts of uncertainty as brinkmanship by Greece and its Euro-zone creditors push negotiations to the precipice. Secondly, as the US Federal Reserve increasingly creeps towards rate lift-off over H2 15, we see increasing possibility of global investors moderating EM/FM exposure for less risky US assets. With the country being one of the worse hit EMs from recent global shocks, FPI stance towards Nigerian assets will likely stay cautious in H2 15.

On the domestic front, akin to H1 15, bearish sentiment should continue to dim scope for resumption of primary activity on the domestic bourse with no planned listing for H2 15. Nonetheless, with a year left to raising CAR to regulatory standards, a slew of rights issues across banks among others should keep the market for seasoned issues warm over H2 15 providing more cautious approach to trading.

Table 15

Seasoned offerings scheduled for H2 15

Rights	Size (N'Billions)
Skye Bank	30
Ecobank	80-100
FCMB	40
Stanbic	24
Wema Bank	Yet to be decided
Flour Mills of Nigeria	40
Presco	3.5

Source: Various companies, ARM Research

Beyond these negative headwinds to foreign sentiment, impact of oil price shocks should continue to reverberate across earnings outlook for the various sectors weakening appetite for NSEASI. For FMCGs, impact of macro shocks should continue to reverberate across board with weak fiscal spending, delayed salary payments across two-thirds of the states and weaker real purchasing power underpin negative topline growth. Whilst some FMCGs, flour millers and sugar refiners have sought to raise prices to pass-on devaluation shocks to input costs, the price hikes significantly tail the scale of USD/NGN devaluation implying forced margin compression. Assisted by increasing spending on route-to-market to shore sales weakness we see an extension of earnings weakness (and losses) across FMCGs.

For O&G sector, depressed oil price environment over 2015 sets the stage for price induced contraction in revenue for upstream firms SEPLAT and Oando. In addition, production outlook is equally weak as difficulty in meeting JV cash calls should result in higher NPDC receivables to upstream players firming up revenue weakness. Similarly, weak fiscal position is driving increased discussion about plugging fiscal leakages which, among other possibilities, raises spectre of a roll-back in pioneer tax holidays for E&P companies. This argument is pertinent to Oando as it seeks to obtain tax concessions on recently COP acquisition and SEPLAT whose tax holiday comes up for renewal by the end of the year. Downstream, despite intransigence by the Buhari regime towards deregulation, payment uncertainty should continue to drive weaker volumes by major petroleum marketers. Tying the weak volumes push to lower YoY PMS price following January's cut, revenue growth across the sector should extend negative H1 15 trends. Compounding outlook is the widening impact of naira devaluation on subsidy per litre which should underpin higher PSF receivables and by extension higher financing outlay. Overall, amid limited prospects for PIB passage, negative oil price shocks should drive sector earnings lower over H2 2015.

Elsewhere, strained federal/state financial positions should continue to induce lower construction activity limiting scope for revenue increases over the rest of the year. Furthermore, higher cost of gas supply contract post NGN devaluation and erratic gas supply, which has resulted in switch to more expensive LPFO, should combine to drive margin

compression. On balance, the double whammy across top-line and bottom-line retains bearish outlook for cement over H2 15.

For banks, challenged macro climate following the decline in oil price should drive moderation in loan origination over H2 15 on account of three factors. First, the tamer oil price provides a less compelling story for lending to upstream oil and gas which, by our estimates, accounted for 40% of 2014 credit growth. Second, naira softness and uncertainty over government payments should result in aversion to downstream oil and gas lending. Finally, reduced capital adequacy ratios post commencement of Basel II/III and the need to maintain buffers over regulatory thresholds amid tight forward guidance on monetary policy has resulted in several coverage banks generally guiding to single digit loan growth in 2015. Hence, we see mean sector loan growth over 2015 between 9-12% over H2 15. Whilst there has been some re-organization towards raising securities portfolio to capture higher yield environment, halving of COT charges to ₦1/mille and CBN curbs on FX trading should temper accrual of gains to top-line in 2015, industry-wide. In addition to the pass-through from slower top-line, the pressured macro landscape raises prospect of higher provisioning for stressed segments of the loan book: oil and gas, general commerce and consumer loan exposure to state government employees. Hence, despite attractive valuation levels, we see higher prospect of further earnings compression dampening investor appetite for bank stocks over H2 15.

In all, we see the balance of factors examined and uncertainty over domestic policy direction in particular melding into broadly weak earnings outlook across the market driving scope for market downside.

CAPITAL MARKET STRATEGY

FI MARKETS FINDING NEW NORMAL

At the end of 2014 we shared the significant role we expected technicalities of insurgency and political concerns, in the buildup to the election, to play in our expectation for yields to rise in 2015—a call that was fundamentally underpinned by factors that seemed certain to force the government to issue significantly more paper. Both of those technicalities unsurprisingly droned louder coming into 2015 and while other factors like oil and capital flows continued to stake a claim, it was clear the influence was from domestic factors. In our Q1 strategy update just post-elections, we clearly zoomed in on political risk as the primary influence on markets. Data which emerged thereafter corroborates just how pervasive the influence of electioneering was on markets with currency volatility, FPI flows, FI market transaction volumes, amongst others, clearly highlighting the pressures in the domestic environment at the time. However, at the time and in the heat of the events, the main signal we had to go on was the primary market bid data which show rates rose steadily through the March auction. In contrast, despite still subsisting concerns as evidenced in the yield jumps late in June, rates were quite lower in Q2 and the question is whether the overall Q2 moderation means that risks in the domestic environment have significantly reduced.

On the global front, with the actual rate hike yet to commence and with signs that the crude oil market is not yet fully settled, the answer is a clear no, even if the long lead time means a lot will have been priced in, reducing market impact when both events actually materialize. On the domestic front, the question of whether risk in the environment is lower is perhaps not so straightforward. On the one hand, as captured in our review of fiscal situation, the weakness in crude oil market continues to wreck federal revenues and, with difficulty in selling Nigerian crude, speaks to continued pressures especially as Iran whose market share Nigeria essentially took slowly comes back on-stream. Indeed, whilst our conclusion from the fiscal section is that the adjustments to the budget continue to bring it closer to reality, the deficit remains a

moving target and how it will be plugged central to the issue. It in this regard that the real positive surprises manifested. First, the FG is showing remarkable fiscal restraint. Whilst the pressures on fiscal balance remain evident, the FG via DMO has not reacted as usual, with the net repayment in H1 15 especially in stark contrast with our expectations for a ramp up in borrowing. In addition, we had earlier acknowledged the potential positive from foreign currency borrowing and it looks like that angle is gaining traction by the day. Perhaps the confidence from this is also feeding into the fiscal restraint (though a focus on recovering looted funds and plugging fiscal leakages appear to be the primary driver). Furthermore, to help meet urgent needs the FG and states recently shared a ₦400 billion NLNG proceeds and aim to source an additional ₦300 billion from the CBN representing alternative and unexpected funding sources. We find this latter point in particular significant, since our yield outlook and strategy was significantly influenced not just by the fact of deficit, which remains in place, but crucially the apparent lack of options, beyond paper supply, to finance it. On the states' front, while restraint has not been as noticeable as the FG's, they have simply curtailed expenditure and refused to pay salaries. Notwithstanding, they have also benefited from the fund distributions and that could be enough to keep things ticking over. As such, the overall restraint is a clear departure from the hands-tied situation we expected the FG (and states) to be in and thus represents a fundamental change in how we view the FI environment.

Hence, while investor concerns appear to have shifted to the perceived lack of government direction, with the new government taking its time to make definitive pronouncement, in our view, this new flavour of domestic concern is not nearly as bad as the combination of politics and insurgency. For us, with the latter seemingly under greater control than at any time in recent history and the former unlikely to play as strong a role for another four years, it would appear that markets could recover very quickly from the current malaise.

Interestingly, even our acceptance that global risks remain intact does not hold as dire implication for yields. Indeed, the speed with which FPI inflows resumed post March suggested that foreign investors felt those levels sufficiently compensated for all the existing risks and it's somewhat unsurprising that those Q1 peaks have not been tested since. Hence, while the weak oil revenue outlook suggests there might be some opportunities to lock in higher yield (than Q2 levels) in Q3 15, the expected release of ministerial list in September could be the trigger that delivers another round of moderation. Either because markets would have what they want after reacting so badly to delayed government pronouncements, or because government efforts focused on plugging leakages should have shown signs of bearing fruit by then, if they ever will, there seems to be scope for downside in Q4.

In that regard, the flexibility focused strategy we started the year with remains very much on the money with our recommendation for duration building around the election time likely to have paid out handsomely with subsequent Q2 15 declines. Similarly, the technicals raising some possibility of a modest yield rise in Q3 and the subsequent expectation of declines in Q4 favour a similar strategy. However, given the overall current dynamic, we recommend investors forget about expecting Q1 15's yield levels to re-appear. In this respect, the key thing is the apparent total shift in the government's fiscal mindset evidenced by the complete and unyielding refusal to borrow. Indeed, it would seem foolhardy to bet against a government that was elected principally on the will to make a change. The ultimate implication if this new dynamic becomes entrenched is that H2 15 levels on average could yet mark the final chapter of still elevated yields as newfound fiscal prudence and leakage plugging deliver a new normal of possibly 200-300bps lower rates than recent history. Investors would do well to act accordingly.

A CASE FOR BALANCING RISK AND REWARD

The influence of political risk was also evident in the equity market in H1 15. Perhaps more so, and somewhat unsurprisingly, as domestic investors felt even less comfortable than with FI and foreign investors largely stayed out except for the April surge

which was in response to the depths markets plumbed in Q1 15. In some ways, the extent of bearishness also reflects the fact that, political risk aside, the key effect of the weak global environment, ravages of oil and domestic challenges (infrastructure and market), manifested decisively in form of earnings compression. Indeed, unlike the manner in which the FG-dominated FI market found a way to circumvent the worst effect of the funding pressures that we expected to drive oversupply, corporate earnings found no such magic parachutes. If anything, the 'success' of the FG which was based on both securing alternative funding (for basic expenditure) and flatly refusing to actually spend on nearly anything else broadened the scope of pressure on the corporate space. Hence, while banks and consumer goods had been the focus of our negative earnings expectation, the lack of government activity meant industrials also succumbed.

The curbs on flow of government funding (affecting mostly capital projects but also salaries), and likely aided by individuals' adjustment of their own spending in the realization of the challenges, manifested in weaker aggregate demand and compounded the issues facing the consumer companies. For instance, FMCGs practically buckled under the weight of multi-faceted earning pressures as higher route-to-market and operational costs also impacted. Similarly, currency devaluation and higher input costs dampened the performance of traders. For their part, banks had to grapple with regulation that not only took away the cheap pool of government funds but imposed even higher costs on more competitively sourced deposits. Even petroleum marketers that we felt could be in a sweet spot failed to live up to billing as government inactivity and uncertainty over subsidy, in particular, limited their capacity to do business. In many ways, the particularly dour outcomes affirm our view that combining the political risk with the weakness induced from macro-picture "sets new hurdles for the scale of headwinds facing equities"

In all these (and with the weakness so far helping gauge the extent of what is to come), we again revisit the issue of to what extent equity prices compensate for the risks in the market. Whilst our conclusion at end 2014 was that despite relative attractiveness of the equity market (as a whole compared to historical levels), second order risks remain unpriced, for one particular sector the additional declines now suggest

that situation may have reversed. Over H1 15, PE multiples on cyclical-banks, according to our stock classification, compressed a further 15%. This is in stark contrast to flat multiples in cyclical-industrials (cement & construction) and massive expansions of 37% and 51% in defensives (consumer goods) and petroleum marketers respectively. Overlaying this with price patterns indicates that earnings actually held up relatively better for banks, whereas the PE multiple expansion for consumers, despite similar price pressures as banks, underscores the scale of earnings compression in that space. Petroleum marketers embodied this latter dynamic even more completely as one-off earnings boost from 2014 dropped off even as price pressures were somewhat less pronounced. Industrials however held the middle ground as price pressures largely kept pace with earnings declines with no major shift in either.

Maintaining our efforts to understand the market's pricing in the context of risks (and using the extent of current weakness as a gauge of what is to come), the adverse pricing impact on banks appears to reflect a view that somewhat tamer earnings pressures is a consequence of asset quality issues being masked by restructurings, after revised provisioning guidelines.

Whilst we fail to understand the need for punishment for being extended a lifeline, the key point is that even factoring in aggressive provisions under our stress-test scenarios fails to dislodge the simple fact of the much more attractive fundamentals of banks relative to the other sectors. At current PE levels of 6x for banks and 39.8x for consumers, we estimate banks can still take a 40% YoY hit to earnings by year-end (average H1 15 PAT performance: -12%) and still remain, not only best priced sector on the NSEASI but also relative to banking sector multiples of most other major EM/FM economies whereas, even sustaining no further earnings damage, the defensives are more expensive than peers from the same climes.

Evidently, on risk-reward balance, we strongly favour banks in the current environment and are neutral to slightly negative on the cyclical-industrials whereas we continue to expect a long-term repricing of the value proposition of most consumer names. Whilst our bearish view on oil, and the fact it perhaps remains the single most important factor, means there remains a major risk overhang over the NSEASI, and the banks in particular, we see long-term value at current prices either for long-term or trading positions.

ABBREVIATIONS

ABS	Asset Backed Securities
AfDB	African Development Bank
AFS	Available for Sale
AGO	Automotive Gas Oil
AMCON	Asset Management Cooperation of Nigeria
ANC	African National Congress
ATC&C	Aggregate Technical, Commercial and Collection
AUM	Assets under Management
BDC	Bureau de Change
BFT	Beverage, Food and Tobacco
BJP	Bharatiya Janata Party
BPE	Bureau of Public Enterprises
CAGR	Compound Annual Growth Rate
CBN	Central Bank of Nigeria
CEMAC	Central African Economic and Monetary Community
CMEC	China Machinery Engineering Cooperation
CPI	Consumer Price Index
CPO	Crude Palm Oil
CPS	Credit to Private Sector
CRB	Commodity Research Bureau
CRR	Cash Reserve Ratio
DANGCEM	Dangote Cement
DG	Director General
DIL	Dangote Industries Limited
DM	Developed Markets
DMO	Debt Management Office
ECA	Excess Crude Account
ECB	European Central Bank
ECOWAS	Economic Community of West African States
EIA	Energy Information Administration
EM	Emerging Markets
EMGBI	Emerging Market Government Bond Index
EPSR	Electric Power Sector Reform
EPSR	Electric Power Sector Reform
ETF	Exchange Traded Fund
EU	European Union
FAAC	Federation Accounts Allocation Committee
FAO	Food and Agriculture Organisation
FCT	Federal Capital Territory
FDI	Foreign Direct Investment
FEWSNET	Famine Early Warning Systems Network
FG	Federal Government
FGF	Future Generation Fund
FGN	Federal Government of Nigeria
FI	Fixed Income
FM	Frontier Markets
FMARD	Federal Ministry of Agriculture and Rural Development
FOMC	Federal Open Market Committee
FPI	Foreign Portfolio Investment
FRC	Financial Reporting Council
FX	Foreign Exchange
GBP	Great British Pound
GDP	Gross Domestic Product
H1	First Half of the Year
H2	Second Half of the Year
HHK	House Hold Kerosene

HTM	Held to Maturity
ICT	Information Communication Technology
IEA	International Energy Agency
IFRS	International Financial Reporting Standards
IGC	International Grain Council
IIF	International Institute of Finance
IMF	International Monetary Fund
IOC	Independent Oil Cooperation
IPO	Initial Public Offer
IPS	Investment Policy Statement
ISO	International Sugar Organization
Kpbd	Thousands of Barrels Per Day
LSAP	Large Scale Asset Purchase program
LTRO	Long Term Refinancing Operating
M1	Narrow Money Supply
M2	Broad Money Supply
Mbpd	Millions of Barrels Per Day
MDA	Ministries, Departments and Agencies
MENA	Middle East and Africa
MMscf	Million Standard Cubic Feet
MoM	Month on Month
MT	Metric Ton
MW	Mega Watt
NBET	Nigerian Bulk Electricity Trading Company
NERC	The Nigeria Electricity Regulatory Commission
NIF	Nigeria Infrastructure Fund
NNPC	Nigerian National Petroleum Corporation
NSEASI	Nigerian Stock Exchange All Share Index
NSIA	Nigeria Sovereign Investment Act
OECD	Organization for Economic Co-operation and
OPEC	Organization of Petroleum Exporting Countries
PBoC	Peoples Bank of China
PENCOM	Pension Commission
PFA	Pension Fund Administrator
PHCN	Power Holding Company of Nigeria
PMI	Purchasing Managers Index
PMS	Premium Motor Spirit
PPT	Petroleum Profit Tax
PRG	Partial Risk Guarantee
SARB	South African Reserve Bank's
SF	Stabilization Fund
SG	State Government
SME	Small and Medium Enterprises
SPGSCI	S&P Goldman Sachs Commodity Index
SPM	Single Point Moorings
SSA	Sub-Saharan Africa
SWF	Sovereign Wealth Fund
TAM	Turn Around Maintenance
TCN	Transmission Company of Nigeria
TLTRO	Targeted Long Term Refinancing Operating
U.S	United States
UK	United Kingdom
US Fed	United States Federal Reserve
USDA	United States Department of Agriculture
WAEMU	West African Economic and Monetary Union
WTI	West Texas Intermediate

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