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Nigeria Strategy Report – H1 2018 Excerpts

Global Economy and Markets

Commodity prices crater from supply glut

We maintain a mixed outlook for commodity prices over 2018. Our expectation for barley and cocoa prices remain bullish buoyed by wider deficit while our outlook for CPO, sugar, and wheat are bearish underpinned by favorable weather conditions which guides to higher production, elevated inventory levels as well as persisting market surplus.

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The weakness in commodity prices, that began earlier in the year, continued for the rest of the year as major commodities faced supply glut. Consequently, the S&P GSCI Agricultural Index posted a decline of 9%, largely driven by surplus positions in Wheat, Rubber, Crude, Palm Oil (CPO), Raw Sugar and Cocoa, excluding barley where a deficit picture stimulated the rally in prices.

Table 1: Average price movement across key soft commodities

Commodity	2017	2016	%
Barley (\$/Tonne)	153.5	150.4	2.1
Cocoa (\$/Tonne)	2011.8	2852.7	-29.5
Rubber (\$/Kg)	2.1	1.6	32.7
Crude Palm Oil (\$/Tonne)	650.4	641.8	1.3
Sugar (\$/Pound)	15.9	18.2	-13.0
Wheat (\$/Bushel)	486.1	535.2	-9.2

Source: Bloomberg, ARM Research

Table 2: Summary of movements in supply and demand across major soft commodities

('Million MT)		2017			2016		
Commodity	Supply	Demand	Balance	Supply	Demand	Balance	
Barley	147.1	149.2	-2.1	149.6	147.5	2.0	
Cocoa	4.7	4.2	0.4	4.0	4.1	-0.2	
Crude Palm Oil	62.3	60.0	2.3	58.83	59.28	-0.4	
Sugar	171.5	171.6	-0.2	164.7	169.2	-4.5	
Wheat	753.9	739.6	14.3	735.3	711.7	23.6	

Source: USDA, ARM Research

Market rebalancing props up Barley prices

Barley prices bucked the bearish trend across the soft commodity market over 2017 as the market switched to a deficit position of 2.1MT in the period. The deficit picture, which reflected the combination of lower production and higher consumption, sent barley prices higher by 2.1% over 2017. For context, global barley production declined by 1.7% YoY to 147MT on the back of lower supply in the Euro area, Turkey, and Morocco¹. Output decline in Turkey and Morocco reflected smaller planted area as well as low yield in the review season while poor weather conditions in France and Belgium impacted the supply of the commodity in the Euro area. While on the demand side, global barley consumption expanded by 1.1% YoY to 149MT, largely underpinned by rising demand in Euro area, Russia and China². The modest uptick in consumption was driven by increased usage of barley for feed as consumers switched away from other alternative feed ingredients such as wheat and corn.

For the 2017/2018 season, despite expectation of lower demand, production, which is expected to fall faster than demand translates to a wider deficit in the barley market. Based on USDA estimate, global barley production is projected to contract by 3.7% YoY to 141.7MT, hinged on decline in production from Australia, Canada, and US. Unfavorable weather condition in Australia, return to normalized yield in Canada from abnormal high in prior year, as well as lower acreage in major planting regions in US are the drags to production. On the other side, global barley consumption is estimated to decline marginally

¹ Euro area (-3.6% YoY to 60MT), Turkey (-35.8% YoY to 4.8MT) and Morocco (-81.8% YoY to 0.6MT)

² Euro area (+4.3% YoY to 53.6MT), Russia (+7.3% YoY to 14.7MT) and China (+24.1% YoY to 9.8MT)

by 1.4% YoY to 147MT on the back of lower consumption in China (-9.2% YoY to 8.9MT) as well as Saudi Arabia and Ukraine³. China's lower consumption of barley is attributed to favourable prices for domestic corn which is an alternative ingredient for feed. On balance, the wider deficit picture (5.5MT) and consequent decrease in inventory (-22.5% YoY to 18.8MT) creates scope for a sustained bullish price outlook over the 2017/2018 season.

CPO shakes off the lasting effect of El-Nino

Following the El-Nino, which hit palm's fresh fruit yields and lowered output, major crude palm oil (CPO) producers have shrugged the El-Nino effect with production hitting elevated levels. Consequently, the CPO market switched from a deficit of 0.4MT in the past crop cycle to a surplus of 2.3MT in the 2016/2017 cycle. According to USDA, the surplus in the global CPO market emanated from increased production (+5.9% YoY to 62.3MT) on the back of favorable conditions for major producers - Indonesia (+6.3% YoY to 34MT) and Malaysia (+6.6% YoY to 18.9MT). On the demand side, growth in consumption was benign (+1.2% YoY to 60MT) due to weaker demand in Indonesia, Euro-area, and Malaysia⁴ to offset rising demand from India, Pakistan, and Egypt⁵. Accordingly, CPO prices declined by 5.2% over the second half of 2017.

Going into 2018 (2017/2018 season), CPO prices are expected to be subdued as post El-Nino production growth will likely persist. USDA projects a 7.3% increase in production to 66.9MT while demand is projected to rise at a slower pace of 4.9% to 62.9MMT, thus indicating a record surplus of ~4MT (+70% YoY). On supply, Indonesia and Malaysia are expected to increase production by 6% and 8% relative to prior season to 36MT and 21MT respectively largely underpinned by favorable weather condition. On the demand side, the growth will largely stem from India (+4.3% YoY to 9.8MT) as the economy recovers from the impact of demonetization. Also, demand in Indonesia and Malaysia is expected to pick up by 5.6% and 30.5% to 9.1MT and 3.6MT respectively.

³ Saudi Arabia (-4.8% YoY to 9.8MT) and Ukraine (-10.2% YoY to 4.4MT).

⁴ Indonesia (-4% YoY to 8.6MT), EU (-5% YoY to 6.4MT) and Malaysia (-8% YoY to 2.7MT).

⁵ India (+3% YoY to 9.4MT), Pakistan (+6% YoY to 3.0MT) and Egypt (+13%MT).

Sugar deficit narrows on higher production

Raw sugar prices stayed depressed in 2017 (-13% YoY) reflecting higher production (+4.1% YoY to 171.5MT) which significantly narrowed the deficit to 0.2MT (deficit of 4.5MT in prior season). The rise in production stemmed from Brazil, Euro area, and Russia⁶. Consequently, global sugar production expanded 4.1% YoY to 171.5MT. Brazil has been clearly focused on maximizing the allocation of cane to sugar, which stands at 45% from 43% in prior season, reflecting the view that sugar prices will offer better return than ethanol. Elsewhere, the surge in Euro area production stemmed from anticipated liberalization of sugar markets across the region after a decade of tight output quotas and export limitations. Also, higher output in Russia reflects the impact of favorable weather conditions, high yields, improved processing, and storage technologies as well as high prices for imported raw sugar⁷. On the demand side, consumption was marginally flat over the season (+1.5% YoY to 174.2MT) hinged on lower consumption in India and China⁸ which neutered higher consumption from other key buyers – Indonesia, Nigeria, and Pakistan⁹.

Looking further ahead, global sugar production is estimated to expand by 8% to 184.9MT in the 2017/2018 season. The expansion will stem from forecasted rise in production from India, Euro area, and Brazil with a combined increase of 88.0MT to bring combined output to 184.9MT. In terms of the drivers, favorable weather and production maximization are the propellers of Brazil and India's growth in sync with prior season. For the Euro area, common agricultural policy reforms – which will, among other things, lift restrictions on production and exports imposed on sugarcane growers – will drive higher production. On the other leg, global sugar consumption is estimated to increase slightly by 2% YoY to 174.2MT underpinned by higher demand from India, UAE, and Pakistan¹⁰. Higher demand in these countries is hinged on economic rebound, robust consumer spending, and a fast-growing domestic food processing sector. On balance, the supply and demand projection indicate a transition to a surplus market in this season of 10.8MT relative to a deficit of 0.2MT in prior year which underpins our bearish outlook on the commodity.

⁶ Brazil (+13% YoY to 39.2MT), EU (+16% YoY to 16.5MT) and Russia (+19% YoY to 6.2MT)

⁷ Import taxes were implemented in 2014 which encouraged firms to continually invest in making sugar beet refining more efficient

⁸ India (-4.10% YoY) and China (-1.3% YoY)

⁹ Indonesia (+21% YoY), Nigeria (+20% YoY) and Pakistan (+6.3% YoY)

¹⁰ India (+3.9% YoY to 26.5MT), UAE (+28.3% to 2.0MT) and Pakistan (+5.9% YoY to 5.4MT).

Wheat prices take a pounding from surplus market

Wheat prices extended the deceleration seen in 2016, declining 9.2% over 2017 as the market remained in a surplus position. Pertinently, despite a faster rise in consumption (+4% YoY to 739.6MT), the high production level (+2.5% YoY to 753.9MT) upheld the supply glut and pushed ending stocks to a three-year high of 256MT (+5.9% YoY). Rising consumption was driven by higher demand in major countries like China, India, Russia with a combined increase of 18.1MT to bring their cumulative consumption to 255.6MT. The increase in demand for wheat as feed ingredient largely supported higher demand in China and Russia, while India's sale of wheat at subsidized prices to local millers through the Open Market Sales Scheme (OMSS) and public distribution system (PDS) underpinned the demand picture. Elsewhere, the increase in global wheat production was underpinned by output expansion in Russia, Australia, and US with a combined increase of 29.4MT to bring their cumulative output to 168.9MT. Favorable weather condition and acreage expansion were the drivers for the rise in output.

Going into the 2017/2018 season, USDA estimates a relatively unchanged global wheat production picture (-0.3% YoY to 752MT) as expectation of tight supply in US, Australia and Canada (-32.2MT to 95.9MT) is expected to offset high-yield induced output growth in the Euro area, India, and Russia (+27.9MT to 332.9MT). The forecasted decline in Australia is predicated on poor rainfalls and high temperature in Australia while output decline in US and Canada is hinged on lower acreage relative to the prior year as well as poor weather conditions. On the demand side, the USDA also estimates wheat consumption to remain unchanged (+0.1% YoY to 740 million MT). Increased usage of wheat for feed is expected to support demand in India and Russia (cumulative: 5.0% YoY to 144MT) while China's demand is estimated to decline by 2.1% YoY to 116MT amidst abundant corn supplies driving a switch to corn as a feed ingredient. On balance, with production of 752MT and consumption of 740MT, the surplus picture looks set to shrink, albeit, modestly to 11.9MT (prior year: 14.3MT). The foregoing leaves scope for moderate gains in prices. However, bearish sentiment trailing the growing inventory level (+4.7% YoY to 267 million MT) may limit scope for a rebound, as seen in previous years, and thus extend the bearish run in the price of the commodity.

Cocoa prices set for a bullish H1 18

Following the bearish trend over H1 17, where cocoa prices declined by 10.5%, prices have rebounded to a modest growth of 0.7% over H2 17. The marginal rebound came amidst concerns about the current wet weather conditions in West Africa which may cause the spread of black pod disease into the 2017/2018 season and restrain output. Nonetheless, at the end of the 2016/2017, the International Cocoa Organization (ICCO) estimates a faster rise in global cocoa production (+18.5% YoY to 4.7MT) than consumption (+5.4% YoY to 4.4MT), implying a surplus of 0.3MT (2015/2016: 0.2MT deficit). The robust output was largely driven by conducive weather conditions in Cote D'Ivoire – world largest supplier of cocoa – where output rose 18.1% YoY to 2.0MT. From the consumption side, in the third quarter of the review season, data from ICCO showed a broad-based increase in cocoa grindings across Europe, North America, and Asia¹¹. The double-digit growth in Asian markets was the direct result of depressed domestic cocoa prices in the region which boosted demand for the commodity.

According to ICCO, the 2017/2018 season started off slowly as excessive rains impacted on output supply. The organization noted that production in the first 50 days from Cote D'Ivoire contracted by 9% YoY to 0.3MT. The build-up in inventory by cocoa grinders is forecasted to drive demand lower, albeit, at a slower pace than production. This guides to a deficit and underpins our outlook for cocoa prices to sustain its bullish trend in the first half of the 2017/2018 season.

ITRC's push for production quota underpins for bullish outlook for rubber

In contrast to the bullish trend over H1 17 where rubber prices rose 37%, prices maintained a descent over the second half of the year (-27% YTD) amid oversupply in the global markets following the decision of Thailand, Malaysia, and Indonesia – which account for about 70 percent of global natural rubber production – to abstain from implementing further quotas on rubber output¹². Further exacerbating the bearish price performance for

¹¹ Europe (+3.0% YoY to 0.35MT), North America (+0.7% YoY to 0.13MT) and Asia (+12.9% YoY to 0.19MT).

¹² Past implementation of quotas such as in February last year when the big three said they would reduce output by a total of 615,000 tonnes, equivalent to about 6 percent of global supply, have resulted in only a brief spike in prices.

rubber was the prevalence of excess rubber inventory alongside muted global demand from key consumers such as China, India, and Japan.

Going forward, International Tripartite Rubber Council (ITRC) comprising top rubber producers in Asia have agreed to cut exports of natural rubber starting from December in a bid to address declining global prices. That said, bearish sentiment surrounding muted demand from major consumers should moderate the expected increase in prices.

Mixed outlook for commodities portend varied impact for Nigeria

Tying it all together, our expectation for barley and cocoa prices remain bullish buoyed by wider deficit in the market as unfavourable weather implies constrained production and lower inventory levels. Similarly, we are cautiously optimistic on our outlook for rubber prices premised on ITRC's decision to support prices by imposing a quota on production. Elsewhere, our outlook for CPO, sugar, and wheat are bearish underpinned by favorable weather conditions which guides to higher production, elevated inventory levels as well as persisting market surplus. Overall, we maintain a mixed outlook for commodity prices over 2018.

Dissecting the impact of trends in global soft commodity markets on corporates in the Nigerian FMCG sector, our bearish price outlook for wheat in 2018 should be gross margin positive for Flour millers including Flour Mills of Nigeria, Dangote Flour and Honeywell Flour Mills, given that they import a sizeable portion of their raw wheat input. Similarly, higher rubber prices should be positive for Okomu's revenue from exports while lower sugar prices should support Dangote Sugar's gross margin. On the other hand, our expectation of further upticks in barley prices suggests gross margin pressures for brewers including Nigerian Breweries, Guinness Nigeria and International Breweries while higher cocoa prices in 2018 should be negative for Cadbury's gross margin. Rounding up our coverage, lower CPO prices should be negative for revenue of palm oil producers (Okomu and Presco).

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