

29 January 2018

## Nigeria Strategy Report – H1 2018 Excerpts

Domestic Economy and Markets

### Nigerian Fiscal: Sharper Picture but still blurry

The summary of our sensitivity analysis suggests that the fiscal deficit could range between ₦2.9 trillion and ₦4.8 trillion if the planned expenditure of ₦8.6 trillion is fully implemented. However, we do not foresee full budget implementation as in recent years when it has hovered around 75%. Thus, in 2018, we look for a budget implementation of 85% given that the year is the last chance for the Buhari administration to meet the expectations of the electorates before the 2019 elections. This, under our base scenario, implies an expenditure of ₦7.3 trillion and a fiscal deficit of ₦2.9 trillion (+45% increase over budgeted deficit of ₦2.0 trillion).

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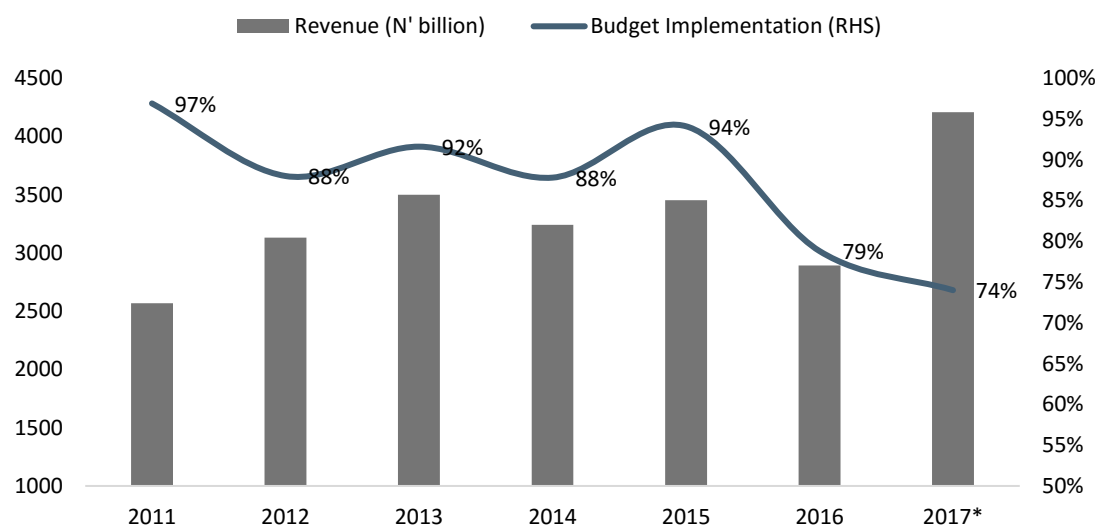
### *Federal revenue growth shows signs of life*

Over the first nine months of 2017, federal retained revenue surged to ₦3.2 trillion, approximately 49.5% higher than actual revenue in 9M 16 (₦2.1 trillion), although 17% lower than the pro-rated budget projections. Looking through provided breakdowns, robust federally retained revenue can be largely attributed to higher oil receipts stemming from recovery in oil prices (average 2017: \$58/bbl. vs 2016: \$45/bbl.) as well as improved crude production relative to the prior year (2017: 1.9 mb/d vs 2016: 1.8 mb/d). Similarly, non-oil receipts improved marginally by 12% underpinned by improvements in VAT (+18% YoY), custom revenues (+15% YoY) and CIT (+9% YoY). Furthermore, the FG's

retained revenue was also supported by one-off receipts of ₦33.22 billion, ₦49.79 billion and ₦466.82 billion from Miscellaneous Credits, TSA/Pool A/C, and Refund of Paris Club over deduction, respectively. Excluding the impact of these one-off transfers, federal retained revenue printed at ₦1.9 trillion (+41% YoY) over the review period, a 31% shortfall from budgetary estimates.

Similarly, total expenditure of ₦4.1 trillion (+26% YoY), 26% lower than pro-rated budget estimate and in line with historical trends was tilted towards recurrent spending (+21% YoY) with the lion share directed towards personnel cost and debt service (actual: 60% vs 50% allotted in the budget). Pertinently, in terms of implementation, total recurrent expenditure stood at 96% for the nine-month period. Elsewhere, capital expenditure over the nine-month period printed at a meagre ₦377 billion (+2.3x YoY), 77% lower than pro-rated budget estimates for the review period with implementation for the nine-month period at 25%. Against this backdrop, the FG's fiscal deficit amounted to ₦1.1 trillion<sup>1</sup> (-27.4% YoY) vs. ₦1.8 trillion allotted in the budget and was largely financed by domestic borrowings i.e. FGN bond issuances of ₦1.2 trillion (62% of total) and foreign borrowings of ₦721 billion (38% of total). Despite the improved revenue picture, the FG failed to fully implement the 9M 2017 budget, with annualized budget implementation at 74%.

**Figure 1: Historical revenue and budget implementation rates**



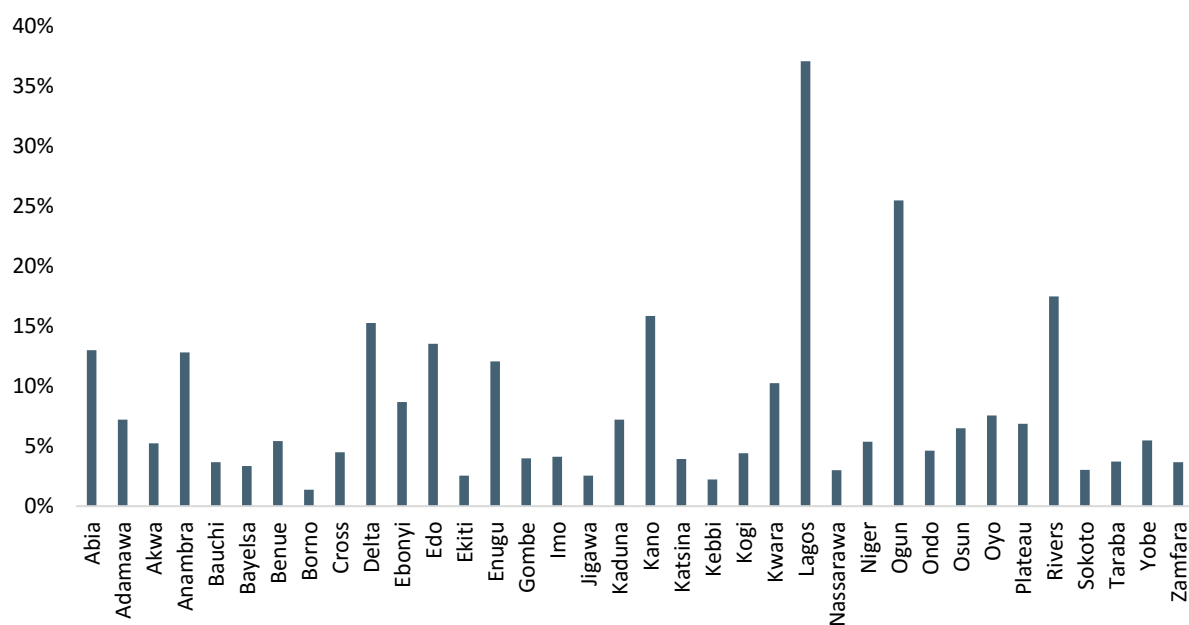
Source: CBN, Budget office, ARM Research, 2017\* estimate

<sup>1</sup> Excluding the income from one-off revenue transfers, the deficit will have printed at ₦2.2 trillion on an annualized basis.

## *States' financial performance worsen despite higher FAAC allocations*

In sync with the improved revenue picture underpinned by higher oil prices and production, FAAC disbursement to state government came in higher by 40% YoY to ₦1.4 trillion over January to October 2017. However, annualizing the FAAC allocation comes to only 25% of cumulative state government budget for 2017 (2016: 26%). In our view, weaknesses in finances of sub-nationals is also reflective of poor internally generated revenue which culminates in overdependence on FAAC allocations for budget implementation and meeting obligations. These setbacks, in our view, made it difficult for states to pull out of the challenge of an ever-rising accumulation of unpaid salaries. Against this backdrop, arrears of unpaid obligations remained rife despite FG's disbursement of outstanding London-Paris Club Loan refunds (~₦760 billion) to states with the proviso that a minimum of 50% be directed towards the payment of workers' salaries and pensions.

**Figure 2: IGR-Budget ratio for states**



Source: BudgIT, NBS, ARM Research

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### *FG pushes to stimulate the economy with another record high budget*

At an earlier timing than usual (7th November 2017), president Buhari presented the 2018 appropriation bill to the National Assembly in a bid to speed up passage before the commencement of 2018 and return the budget cycle to the January-December calendar. The proposed 2018 budget, dubbed the “Budget of consolidation”, has the objective to reinforce and build on the achievement of the last two budgets. To realize this, the FG proposed a 16.0% YoY increase in aggregate expenditure to ₦8.6 trillion while retained revenue is planned to rise by 30.0% YoY to ₦6.6 trillion which translates to a fiscal deficit of ₦2.0 trillion (-15.6% YoY).

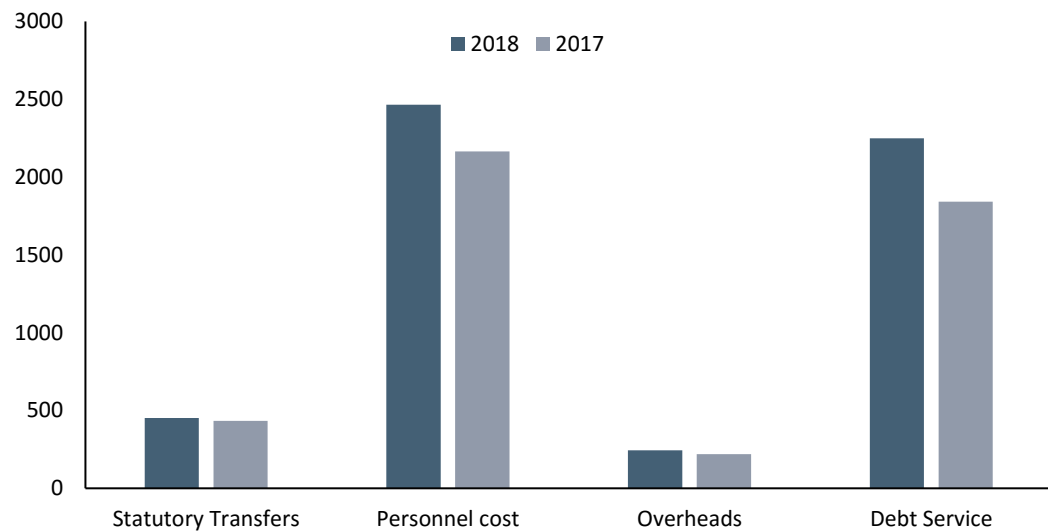
Focusing on expenditure, the increase, to a large extent, is planned to go into debt service (+21.3% YoY) and non-debt recurrent expenditure (+16.8% YoY) even as other expenditure components including capital expenditure and Statutory Transfers are projected to increase, albeit modestly. The increase in debt service<sup>2</sup> is most likely explained by the elevated yield environment (+430bps YoY to 17.6%) and high domestic issuance (+49% YoY to ₦1.3 trillion) over 2017. On non-debt recurrent expenditure<sup>3</sup>, the breakdown reveals an increase of 12.2% YoY to ₦2.1 trillion in personnel expenses earmarked to meet promotion arrears and recruitments by the Military, Police Force and Para Military agencies. Other allocations under non-debt recurrent expenditure include special intervention programmes, Power Sector Reform programme, presidential amnesty programme and service wide votes which combined increased by 37.7% YoY to ₦1.2 trillion.

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<sup>2</sup> Debt service accounts for 23% of aggregate expenditure

<sup>3</sup> Non-debt recurrent expenditure accounts for 43.5% of aggregate expenditure

**Figure 3: Breakdown of recurrent expenditure (N'billion)**



Source: Budget Office, ARM Research

Elsewhere, in a bid to complete ongoing projects and consolidate on the recovery, the FG increased its planned capital expenditure by 11.7% YoY. Of the total planned expenditure, capital expenditure (inclusive of capital in transfers) accounted for 30.8%, lower than 31.7% in the prior year. Even with the marginal drop in contribution, the allocation remains in line with the federal government objective to set aside minimum 30% of total expenditure for capital projects every year. In terms of allocation, the FG continued to prioritize ministries such as Power, Works and Housing, Transportation, Special Intervention Programmes, Defence and Agriculture which combined accounts for 67% of planned capital expenditure. Key projects and programmes, that are expected to be implemented in the 2018 fiscal year include;

- Mambilla hydro power project - ₦9.8 billion (inclusive of ₦8.5 billion counterpart funding)
- Transmission lines and substations - ₦12 billion (counterpart funding)
- National Housing Programme - ₦35.41 billion
- 2nd Niger Bridge - ₦10.00 billion
- Construction and rehabilitation of the strategic roads - ₦300 billion

**Table 1: Trend in Capital Expenditure allocation**

Capital Expenditure (N'billion)	2017	2018	YoY
Power, Works & Housing	553.7	555.9	0.4%
Transportation	241.7	263.1	8.8%
Special Intervention Programmes	150.0	150.0	0.0%
Defence	139.3	145.0	4.1%
Agriculture	103.8	119.0	14.6%
Zonal Intervention Projects	100.0	100.0	0.0%
Water Resources	104.2	95.1	-8.8%
Industry, Trade & Investment	81.7	82.9	1.5%
Health	55.6	71.1	27.9%
Interior	63.8	63.3	-0.8%
Education	56.7	61.7	8.8%
Niger Delta	34.2	53.9	57.6%
North East Intervention Fund	45.0	45.0	0.0%
FCT	30.4	40.3	32.6%

Source: Budget Office, ARM Research

### *Ambitious non-oil revenue relative to realities*

From the revenue breakdown, the FG is proposing non-oil revenue of ₦4.2 trillion (+40.6% YoY) split into non-oil (1.1% YoY to ₦1.4 trillion), independent revenue (27.8% YoY to ₦1.1 trillion), and “other revenue” (133% YoY to ₦1.7 trillion). Consequently, “other revenue” accounts for almost half of the projected non-oil revenue. On this leg, the FG is proposing to generate ₦710 billion for restructuring of Joint Venture (JV) oil assets and review of oil production Sharing Contract (PSC). Pertinently, the FG aims to reduce its equity stake in JV assets as well as reduce its financial commitments under the PSC. FG hasn't guided to the stake it intends to sell in the JV assets - currently owns around 60% in joint venture oil assets. Also, in terms of pricing, we think valuations would be favorable given the improved outlook on oil price and production. However, it is unlikely it materializes in 2018 given the lengthy process involved in divesting from a government owned asset as noticed during the sale of power assets in Nigeria. Thus, in our base case scenario, we project zero receipts from oil assets ownership restructuring. Further, the

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government plans to raise ₦512 billion from recoveries which in our view is ambitious given the high unpredictability of receipts even as nine-months 2017 actual revenue revealed zero inflow from recoveries. On the other hand, we hold optimistic views on other components under “other revenue” including signature bonus (₦114 billion) and donor funding (₦200 billion) with the former looking promising given tough sanctions<sup>4</sup> that would be imposed on companies that fail to remit signature bonuses following successful bids on oil marginal fields. In sum, we project revenue from other sources at ₦705 billion which implies a 57% shortfall of FY 18 budgeted “other revenue”.

Elsewhere, the modest growth in non-oil receipts (+1.1% YoY) was driven by cut backs in Value Added Tax (-1.6% YoY to ₦208 billion) and Company Income Tax (-14.1% YoY to ₦795 billion) which, previously, were aggressive in prior years, while budgeted custom receipts rose 17% YoY to ₦325 billion. In terms of what can be fully achieved, we view the planned custom budget as feasible due to a mix of factors including its plan to raise excise duty rates on alcohol & tobacco in 2018, our expectation of higher imports (+8.0% to \$36.6 billion) this year and FG’s improved ability to collect custom taxes<sup>5</sup>. On VAT and CIT, despite cutbacks, we hold a pessimistic view on full collection. Precisely, while our expectation for a modest recovery in non-oil output and consumption in 2018 suggests respective increases in CIT and VAT, we think currently low tax compliance<sup>6</sup> would be drag on FG’s ability to receive its planned tax revenue from these non-oil categories. We acknowledge that there are ongoing reforms<sup>7</sup> to improve compliance and expand the tax base, however, we do not think that it would be substantial to generate FG’s 2018 estimated revenue from VAT and CIT. Overall, we project 2018 non-oil revenue at ₦991 billion, which translates to a 29% shortfall of FY 18 budgeted non-oil receipts.

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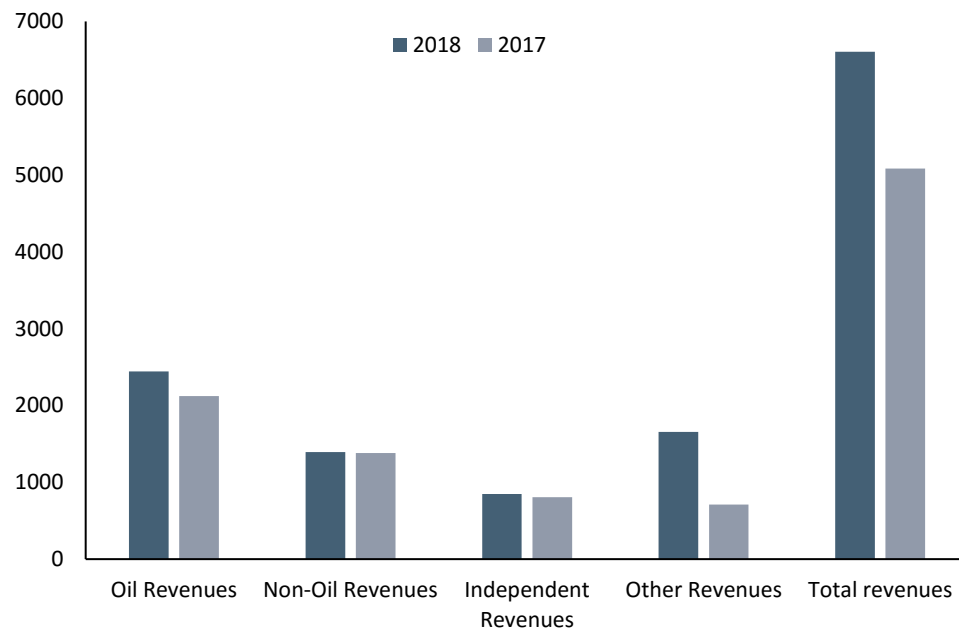
<sup>4</sup> According to the guidelines for marginal oil field bid scheduled for 2018, any successful company that fails to remit its signature bonus after 90 days will be issued a temporary revocation notice for 30 days which could be full if payment is not made after 30 days

<sup>5</sup> The federal government achieved around 92% of its 9M’17 pro-rated custom budget versus 64% for FY’16 budget

<sup>6</sup> Nigeria’s rate of compliance for VAT and CIT is less than 12% and 9% respectively

<sup>7</sup> The FG introduced a Voluntary Assets Income and Declaration Scheme (VAIDS) to improve tax collection and capture non-taxpayers

**Figure 4: Fiscal Revenue Projections (N'billion)**



Source: Budget Office, ARM Research

***Higher oil production and price underpin robust oil revenue projections***

On the oil revenue leg, the FG projects a 15.0% YoY increase to ₦2.4 trillion, based on assumptions which include a benchmark oil price of \$45/barrel (+1.1% YoY), oil production estimate of 2.3million barrels per day (+4.5% YoY) and exchange rate of ₦305/USD – which remained unchanged from the 2017 budget. The oil price assumption is conservative given current price level of \$70/bbl. and our expectation of crude oil prices to average \$60/bbl. in 2018. On the flip side, FG's oil production assumption is slightly optimistic particularly considering Nigeria's implementation of the OPEC cap of 1.8million bpd (excluding condensates<sup>8</sup>) in 2018 which implies crude production (inclusive of condensates) of 2.0million bpd. Having modelled our base oil revenue using an average crude oil price of \$60/bbl. and oil production of 2.0mbpd in 2018, we project FG retained oil revenue at ₦2.4 trillion, at par with the budgeted amount. Overall, we estimate fiscal receipts at ₦4.9 trillion (26% short of budget estimate).

<sup>8</sup> We estimate Nigeria's condensate production is estimated at 250-300mbpd



**Table 2: 2018 Federation revenue budget vs. ARM estimates**

	2018 Budget	Estimates		
		Bear	Base	Bull
<b>Oil production (mbpd)</b>	<b>2.3</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>
<b>Oil price (\$/bbl.)</b>	<b>45</b>	<b>50</b>	<b>60</b>	<b>70</b>
<b>Exchange rate (N/\$)</b>	<b>305</b>	<b>305</b>	<b>305</b>	<b>305</b>
Oil and gas receipts (N' billion)	4,955	4,787	5,749	6,702
Net Oil Revenue (N' billion)	4,955	4,787	5,749	6,702
FG Share of oil revenue (N' billion)	2,091	2,020	2,426	2,828
Non-Oil revenue (N' billion)	1,395	881	991	1,028
FG independent revenue (N' billion)	848	251	287	450
Other revenue (N' billion)	1,654	846	705	1,450
<b>FG Total revenue (N' billion)</b>	<b>6,607</b>	<b>3,786</b>	<b>4,408</b>	<b>5,756</b>
FGN Expenditure (N' billion)	8,612	7,320	7,320	7,320
<b>Fiscal deficit (N' billion)</b>	<b>(2,005)</b>	<b>(3,534)</b>	<b>(2,912)</b>	<b>(1,564)</b>

Source: Budget Office, ARM Research

In addition to our base case scenario, we sensitize for other revenue possibilities. Our bull scenario considers a case where oil prices average \$70/bbl. in 2018 underpinned by higher compliance by OPEC and its allies as well as increasing geo-political tension. This, coupled with an average production of 2.2million bbl. is expected to drive oil revenue higher and, by extension, non-oil revenue – on the back of higher profitability from oil and gas companies and other corporates who rely on foreign exchange for production. Our bull scenario also examines a situation where Nigeria raises ₦710 billion from the sale of its ownership in JV oil assets which should provide an additional boost to non-oil revenue. For our bear scenario, we consider a case where oil prices fall to an average of \$50/bbl. on account of higher shale oil production as well as poor compliance by OPEC members. The summary of our sensitivity analysis suggests that the fiscal deficit could range between ₦2.9 trillion and ₦4.8 trillion if the planned expenditure of ₦8.6 trillion is fully implemented. However, we do not foresee full budget implementation as in recent years when it has hovered around 75%. Thus, in 2018, we look for a budget implementation of 85% given that the year is the last chance for the Buhari administration to meet the expectations of the electorates before the 2019 elections. This, under our base scenario, implies an expenditure of ₦7.3 trillion and a fiscal deficit of ₦2.9 trillion (+45% increase over budgeted deficit of ₦2.0 trillion).

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***Despite preference for external debt, local borrowing is still likely to run ahead***

In financing the fiscal deficit (budgeted deficit: ₦2.0 trillion), the FG plans to raise ₦306 billion from the privatization of some non-oil assets by the Bureau of Public Enterprises<sup>9</sup> (BPE) while the balance (₦1.7 trillion) would be financed by borrowings split evenly between domestic (₦850 billion) and external sources (\$2.8 billion). On the sale of non-oil assets, we see delayed commencement of the sale and lower than expected valuations as likely factors that could drive proceeds lower than the planned amount. On borrowings, starting off with external sources, the planned amount of \$2.8 billion (₦850 billion) in addition to \$2.5 billion – which was approved by the National Assembly to be raised in 2018 – suggests that the FG could possibly raise \$5.3 billion this year. We believe a successful issuance of the funds is achievable in view of 2017 when the FG tapped the Eurobond market three times and raised \$4.8 billion in total with a bid-cover size of 2.4x. Also supporting our view is the sustained improvement in crude oil prices and output which bodes well for improved foreign investor optimism towards Nigeria's assets. However, it would most likely come at a higher premium than was obtainable in 2017 given new factors such as the recent hikes in the United States benchmark interest rate and the possibility of further hikes in the region in 2018. Also, concerns over the rising debt service to revenue ratio (47%) in Nigeria, and the risk of default could drive Eurobond yields higher in 2018. With the above-mentioned established, we played out different scenarios in the table below to forecast the potential size of domestic paper issue using our estimated fiscal deficit (₦2.9 trillion) for 2018. We estimate that to finance the budget, the net debt issue could range between ₦1.5 trillion and ₦2.4 trillion which is already higher than 2017 net issuance of ₦1.3 trillion. In sum, our scenario analysis guides to higher domestic borrowings in 2018 despite the federal government preference towards foreign borrowings<sup>10</sup> to finance its fiscal deficit.

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<sup>9</sup> The federal government plans to sell National Integrated Power Plant (NIPP), National Parks, Tafawa Balewa Square, and National Arts Theatre and some selected power plants under the National Integrated Power Projects

<sup>10</sup> Split between domestic and foreign borrowing was 50:50 in 2018 versus 60:40 in 2017

**Table 3 Scenario analysis of 2018 proposed borrowings**

N'billion	(Asset sale + \$2.78 bn foreign debt)	Asset sale + \$1.5 bn foreign debt	Asset sale + \$1 bn foreign debt	50% asset sale + \$2.78bn foreign debt	50% asset sale + \$1.5bn foreign debt	50% asset sale + \$1bn foreign debt	No asset sale + \$2.78 bn foreign debt	No asset sale + \$1.5 bn foreign debt	No asset sale + \$1 bn foreign debt
<b>Projected deficit</b>	<b>2,912</b>	<b>2,912</b>	<b>2,912</b>	<b>2,912</b>	<b>2,912</b>	<b>2,912</b>	<b>2,912</b>	<b>2,912</b>	<b>2,912</b>
Sale of Assets	306	306	306	153	153	153	-	-	-
Foreign Borrowings	850	458	305	850	458	305	850	458	305
Domestic Borrowings	1,756	2,149	2,301	1,909	2,301	2,454	2,062	2,455	2,607
CBN ways and means	221	221	221	221	221	221	221	221	221
<b>Borrowings from capital market</b>	<b>1,535</b>	<b>1,928</b>	<b>2,080</b>	<b>1,688</b>	<b>2,080</b>	<b>2,233</b>	<b>1,841</b>	<b>2,234</b>	<b>2,386</b>
2017 net issuance	1,268	1,268	1,268	1,268	1,268	1,268	1,268	1,268	1,268
YoY increase ((N billion)	267	660	812	420	812	965	573	966	1,118

Source: Budget Office, ARM Research

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