January 22, 2019

Nigeria Strategy Report

H1 2019

Domestic Economy and Policy Environment

Nigerian Fiscal: *More strain on FG finances*

Executive Summary

In our H2 18 strategy report, we had estimated fiscal deficit over 2018 to print at ₦1.8 trillion – from our revenue expectation of ₦5.1 trillion and expenditure of ₦6.9 trillion – which basically formed our domestic borrowing expectation of ₦388 billion over 2018 after adjusting for CBN funding of 50% of the projected domestic borrowing ₦775 billion. Coming into 2018, actual fiscal deficit in the first nine months of 2018 printed at ₦1.1 trillion as higher government outlay during the period exceeded FG receipts over the same period. In a deviation from the prior year wherein the deficit was finance solely by borrowings, domestic borrowing came in significantly lower (with net issuance of ₦84.5 billion, 9M 17: ₦969.6) with the remaining deficit largely financed by CBN as FGN far exceeded its statutory limit, with net increase in the apex bank's ways and means advances of ₦1.19 trillion.

In this report, we focus on developments in the fiscal space over 2018. We also delineate our view on the feasibility of FG's 2019 proposed budget and implications for government borrowing over 2019.

Coalescing our expected average crude oil price of $55.95/bbl. in 2019 and our forecast crude oil production of 2.07mbpd, we project oil revenue of ₦2 trillion relative to budget estimate of ₦3.69 trillion. On non-oil revenue, following the kick-off of the divestment process of FG's equity stake in JV oil assets in 2018, we see some room for completion during the year, albeit at a lower valuation. Overall, we estimate FG's total revenue of ₦4.36 trillion, compared to budget estimate of ₦6.97 trillion. With our modelled budget implementation of 82%, we estimate that fiscal deficit could range between ₦1.83 trillion and ₦3.76 trillion with our base case of ₦2.89 trillion. In terms of financing, on the sale & privatization of government assets where FG expects ₦210 billion, we forecast no sale and project foreign borrowing of $2.7 billion (₦825 billion) over the second half of the year. With regard the balance of ₦2.1 trillion which should ordinarily be financed through domestic borrowing, we assume 34%-part funding by the CBN which suggests that the government could possibly net issue ~₦1.4 trillion over 2019 under our base scenario.

A leapfrog in Federation account amid fudge in assumptions

The first-nine months of 2018 (9M 18) recorded a boost in federation account as gross federally-collected revenue expanded 32% YoY to ₦6.49 trillion, though lower than the prorated budget estimate of ₦9.8 trillion. The jump in finances cuts across both oil and non-oil revenue. Oil revenue stood at ₦4.1 trillion compared to ₦2.9 trillion in 9M 17 while non-oil revenue printed at ₦2.4 trillion compared to ₦2.1 trillion in the matching period of 2017. The drivers for the expansion in oil revenue are higher crude oil prices and relatively stable crude oil production which supported improved crude oil and gas sales, while expansion in VAT, custom revenues and CIT buoyed the increase in non-oil revenue. In terms of the deviation between the budget and actual, this was from both oil and non-oil assumptions. On the oil leg, the shortfall stemmed from petroleum profit & gas taxes, royalties (oil & gas), rent and gas flared penalty – all of which had fallen below the projected revenue by 35% over H1 18. Elsewhere, the shortfall was due to the aggressive assumptions on VAT, and Taxes & Custom duties both of which fell short of projection by ₦628 billion as at H1 18. Also, expected revenue from government's investment, mining, and surcharge on luxury items valued at ₦187 billion came in at zero. In terms of revenue distribution, net distributable revenue among the three tiers of government was ₦5.7 trillion, higher than ₦3.7 trillion in 9M 17.

Consequently, the Federal government's (FG) retained revenue over 9M 18 was ₦2.8 trillion[1], which is 12% higher than retained revenue in 9M 17 of ₦2.5 trillion. FG share of oil revenue printed at ₦1.5 trillion (+101% higher than ₦749 billion in 9M 17) on the back of higher oil receipts from stable production and higher prices. Similarly, FG share of non-oil receipts improved marginally by 12% to N793 billion propelled by improvements in VAT (+5% YoY), custom revenues (+20% YoY) and CIT (+23% YoY). That said, the deviation in projected revenue of ₦5.4 trillion to actual of ₦2.8 trillion was on the back of a ₦733.9 billion and ₦429 billion shortfalls in oil and non-oil revenue. The deviation stemmed from deductions for PMS under-recovery, delay in the restructuring of FG's equity ownership in JV oil assets, and other ambitious projections of one-offs in 2017 related to NNPC refund and exchange rate difference.

Fiscal Outlay on a breather

Total FGN expenditure of ₦3.9 trillion over 9M 18 came in below the level same period in prior year by 14% and fell short of the prorated budget estimate by 43%. On further breakdown, recurrent expenditure took priority in line with historical trends, with the lion share directed towards personnel cost and debt service (~56% of total 9M 18 revenue) with implementation of recurrent expenditure settling at 81% compared to 91% in 9M 17. Elsewhere, following the delayed passage of the 2018 budget, capital expenditure of ₦514 billion, came in far lower than the prorated budget

[1] share of the Federation account coming in at ₦2.3 trillion, Independent revenue of ₦265 billion and other financing sources of ₦272 billion

estimate by 76% and lower than same period in the prior year by 47% – actual implementation for the review period printed at 24% (25% in 9M 17).

Table 1: Historical Revenue and Expenditure Implementation in ₦'Billion

	Expenditure			Revenue		
Year	Budget	Actual	Deviation	Budget	Actual	Deviation
2010	5,159.66	4,046.98	-21.6%	3,142.89	2,958.73	-5.9%
2011	4,484.74	4,302.09	-4.1%	3,348.11	2,566.67	-23.3%
2012	4,697.21	4,131.24	-12.0%	3,561.02	3,131.09	-12.1%
2013	4,987.24	4,560.81	-8.6%	4,100.43	3,500.47	-14.6%
2014	4,695.19	4,123.42	-12.2%	3,731.00	3,242.30	-13.1%
2015	5,067.90	4,767.38	-5.9%	3,452.36	3,240.34	-6.1%
2016	6,060.48	5,141.95	-15.2%	3,855.74	2,947.51	-23.6%
2017	7,441.18	6,463.61	-13.1%	5,084.40	2,657.67	-47.7%
2018*	9,120.34	5,013.28	-45.0%	7,165.87	3,471.28	-51.6%

Source: Budget Office, ARM Research: 2018* estimate

Consequently, we estimate that FG's fiscal deficit amounted to ₦1.1 trillion (-59% YoY) tracking below ₦1.5 trillion allotted in the budget. In a deviation from the prior year wherein the deficit was finance solely by borrowings (domestic: ₦1.2 trillion and Foreign: ₦721 billion), domestic borrowing came in significantly lower (with net issuance of ₦84.5 billion, 9M 17: ₦969.6) due to treasury bills refinancing via $3.0 billion Eurobond issued between 2017 and 2018 which resulted in treasury bills total redemption of ₦849 billion as at June 2018. Notably, the remaining deficit was largely financed by CBN as FGN far exceeded its statutory limit, with net increase in the apex bank's ways and means advances of ₦1.19 trillion.

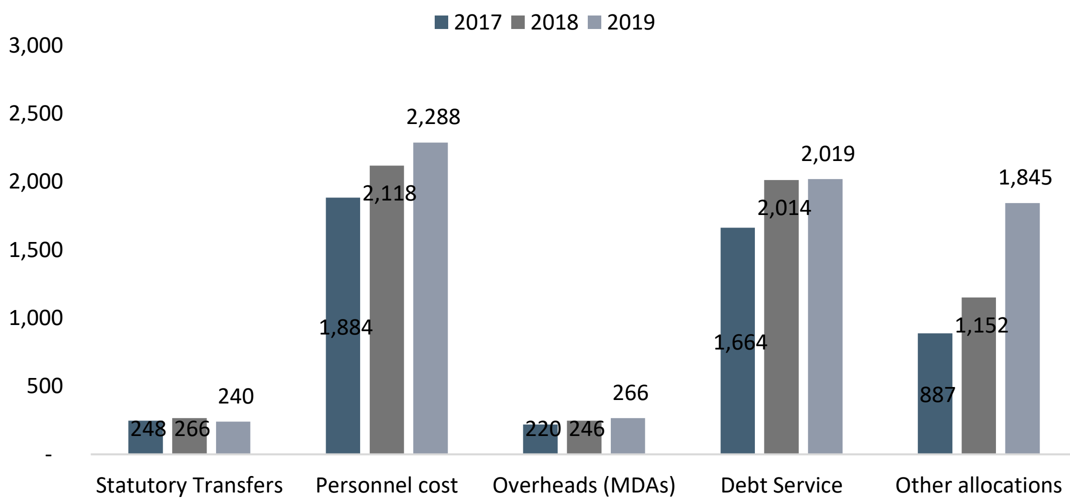
2019 Proposed Budget: Budget Fudge or Fiscal Splurge?

On the 19th of December, President Buhari presented the proposed appropriation bill for 2019 to the National Assembly. In the proposed budget (tagged "Budget of Continuity"), aggregate expenditure is projected to decline ₦294 billion to ₦8.83 trillion due to cut back in capital spending by 27.1%, while retained revenues is expected to decline marginally by 2.8% YoY to N6.97 trillion, translating to a proposed budget deficit of ₦1.86 trillion (2.6% of our forecast GDP vs 2018: 2.8%). In a slight twist to previous appropriation bills, the proposed 2019 budget incorporated expenditure and revenue by top nine government owned enterprises (GOEs) of ₦955.36 billion. Also, counterparty funding of key projects of ₦1.51

trillion was included in the proposed capital expenditure. Thus, including GOE expenditures and counterparty funding of some capital spending (capex), total proposed expenditure for 2019 is ₦10.34 trillion (+13.4% YoY) and revenue of ₦7.92 trillion (+10.6% YoY), with fiscal deficit of ₦2.42 trillion (3.4% of our forecast GDP vs 2018: 2.8%).

Distilling the spending numbers reveals total recurrent expenditure increase by 14% YoY to ₦6.3 trillion, largely reflecting higher budgeted spending for non-debt recurrent expenditure which expanded 14.9% YoY to ₦4.04 trillion (to account for 46% of total expenditure) while total debt service) is projected to grow modestly (+2.7% YoY to ₦2.26 trillion. Elsewhere, statutory transfers (excluding capital projects) declined by 9.9% YoY to ₦240 billion. Further breakdown of the non-debt expenditure showed an increase of 8% YoY to ₦2.6 trillion in personnel and overhead expenses (with the percentage proportion of non-debt recurrent expenditure of 63% from 67% in FY 17) and jump in "other allocations"[2] to ₦1.49 trillion (₦1.15 trillion in FY 18). While the budget presentation stated appropriate provisions have been made for the implementation of the proposed increase in minimum wage, we note that this is yet to be factored into the proposed budget. For context, following the increase in minimum wage by 140% in 2011 (from ₦7,500 to ₦18,000), personnel expense in the 2011 budget increased 85% (from ₦1.1 trillion in 2010 to ₦1.9 trillion in 2011). As such, we note that for the FG to implement the promised 67% minimum wage (from ₦18,000 to ₦30,000) in 2018, we estimate additional increase in personnel cost of ₦1.4 trillion from 2018 levels to ₦3.5 trillion.

Figure 1: Breakdown of recurrent expenditure (₦'billion)



Source: Budget Office, ARM Research

[2] including special intervention programme, power sector reform programme, presidential amnesty programme, basic health care fund and service wide votes

For the 2019 budget specifically, as stated above, the FG reduced its planned capital expenditure to ₦2.28 trillion (2017: ₦3.13 trillion) with capex contribution of overall spending declining by 848bps YoY to 25.9%. That said, including the capital spending for the top-nine GOEs (₦275 billion) and counterparty funded projects of ₦556 billion, capital spending increases to ₦3.03 trillion with capex contribution of overall spending of 30.1%. In line with trends over the last four years, the FG continues to prioritize capital spending on power, works and housing, transportation, defense and special intervention programme, which jointly constitutes 45% of proposed capital spending for 2019. While new projects are expected to be funded in the 2019 fiscal year, attention is expected to be focused on the completion of existing projects. Focus on transport reveals that all railway projects expected for counterpart funding in the 2018 budget[3] are still ongoing while new projects indicated in the 2018 budget for counterpart funding which were not funded[4] and now being included in the 2019 budget.

Table 2: Trend in Capital Expenditure allocation (N'billion)

Capital Expenditure (₦'billion)	2018	2019*	YoY
Power, Works & Housing	683.0	408.0	-40.3%
Transportation	251.4	194.2	-22.7%
Special Intervention Programmes	150.0	150.0	0.0%
Defence	157.7	158.1	0.3%
Agriculture	149.2	80.3	-46.2%
Zonal Intervention Projects	100.0	100.0	0.0%
Water Resources	147.2	73.6	-50.0%
Industry, Trade & Investment	105.2	61.1	-41.9%
Health	86.5	50.1	-42.0%
Interior	75.1	47.4	-36.9%
Education	102.9	47.3	-54.0%
Niger Delta	58.1	39.4	-32.2%
North East Intervention Fund	45.0	45.0	0.0%
FCT	32.3	30.7	-4.9%
Science and Technology	68.3	31.8	-53.4%

Source: Budget Office, ARM Research: 2019* Proposed Budget

[3] Lagos -Kano, Calabar-Lagos, Ajaokuta-Itakpe-Aladja

[4] Port Harcourt-Maiduguri, Kano-Katsina-Jibiya in Niger Republic, Abuja-Itakpe and Aladja-Warri port and refinery including Warri new harbour

Another Flowery revenue assumption

The FGN in the proposed 2019 budget projects oil revenue of ₦3.69 trillion, which is 30% higher than the budgeted oil revenue in the 2018 budget and 83% higher than annualized nine-month 2018 oil revenue of ₦2.01 trillion, due to oil price and production assumption.

Table 3: FGN's historical oil production and price assumptions vs. actual

	2015	2016	2017	2018
Crude Oil Price ($/barrel)				
Budget	53.00	38.00	44.50	51.00
Actual	52.66	43.87	54.09	72.24
Crude Oil Production (mbpd)				
Budget	2.28	2.20	2.20	2.30
Actual	2.13	1.82	1.89	1.92

Source: Budget Office, ARM Research

Further breakdown proposes total non-oil revenue of ₦3.28 trillion (84.7% higher than nine-month 2018 annualized numbers). The quantum leap in the projection stemmed from aggressive expectation on "other revenue" of ₦1.27 trillion (+305.6% YoY to 2018 estimate) following expected proceeds from the completion of restructuring of FG's equity ownership in JV oil assets of ₦710 billion, recoveries of ₦203 billion, signature bonus of ₦84.2 billion and grants of ₦209 billion. Non-oil revenue from the federation account is forecast to expand 25% from 9M 18 annualized numbers to ₦1.3 billion reflective of an aggressive expectation on VAT collections of ₦229 billion (71% higher than annualized 9M 18 number), CIT is expected to grow by 19.6% to ₦800 billion, while a modest decline of 1.2% is expected for customs remittance to ₦303 billion. Elsewhere, independent revenue is projected to touch an historic high of ₦624 billion (higher than 9M 18 annualized numbers by 76.4%) compared to average annual remittance of ₦246 billion.

Actual revenue will come in shy of projection

Following the kick-off of the divestment process of FG's equity stake in JV oil assets in 2018, we see some room for completion during the year, albeit at a lower valuation. However, in our base case scenario, we project a haircut from current valuation to ₦500 billion. On recoveries, with details of the source of such remittance unavailable and zero inflow as at 9M numbers, we do not expect any revenue on the line. Also, we expect zero balance on signature bonus and donor funding following absence of both in 2017 and nine-month 2018 numbers. On the positive, we expect positive values on VAIDS, and special levies. In sum, we project revenue from other sources at ₦813 billion which implies a 36% shortfall of FY 19 budgeted "other revenue".

Elsewhere, the deliberate efforts of the FG to increase the tax collection base amidst improving corporate profits have resulted in steady increases in FG's share of non-oil receipts (with 5-year CAGR of 5.9%). However, we think projected numbers are overly optimistic. In terms of realistic estimate, we are slightly more optimistic on custom revenue compared to the proposed budget as we expect the increase in excise duty rates on alcohol & tobacco which came into effect mid-2018 to take its full course in 2019 and additional increase starting 2019. However, we made slight downward revision to import duties following our expectation of lower imports ex-one offs (-6.9% to $35.45 billion). On VAT and CIT, we share a different view from the proposed budget estimates. While we are also bullish on CIT following our expectation of improved performance of the non-oil sector and consumption in 2019, the projected income on CIT and VAT suggests shortfall of 15.5% and 35.8% respectively in 2019 from our estimates. Overall, on our base case scenario, we project 2018 non-oil revenue at ₦2.3 trillion, which translates to a 29.1% shortfall of FY 19 budgeted non-oil receipts.

Oil revenue assumptions, a delusion of grandeur

We believe the oil price assumption is aggressive given the free fall in crude prices in the last few months and our expectation of mean crude oil price of $56/bl. in 2019. While noting the additional 200kbpd production from the new Egina oil field and the relative calm in the oil producing areas, we believe FGN's oil production assumption is highly optimistic. On OPEC's recent production cut agreement, we expect Nigeria's share of the cut of ~43,000bpd with full implementation expected from March 2019. Coalescing our expected average crude oil price of $55.95/bbl. in 2019 and our forecast crude oil production of 2.07mbpd, we project oil revenue of ₦2 trillion relative to budget estimate of ₦3.69trillion. Overall, we estimate FG's total revenue of ₦4.36 trillion, compared to budget estimate of ₦4.32 trillion.

Elsewhere, given the historical partial implementation of the budget (especially capital expenditures with average of 58.9%), we assume budget implementation of 85.7% (average: 85.8%). Thus, we estimate total expenditure of ₦7.57 trillion (excluding capital expenditures by top top-nine GOEs and counterparty funded projects) in 2019. Overlaying the projected expenditure on our revenue scenarios suggests that the fiscal deficit could range between ₦1.83 trillion and ₦3.76 trillion.

Table 4: 2018 Federation revenue budget vs. ARM estimates

	2019 Budget	2019 Budget (Excluding GOEs and Tied Loans)	Estimates		
(N' billion)			**Bear**	**Base**	**Bull**
Oil production (mbpd)	*2.30*	*2.30*	*1.84*	*2.07*	*2.21*
Oil price ($/bbl)	*60*	*60*	*49.7*	*55.95*	*65.95*
Exchange rate (N/$)	*305*	*305*	*305*	*305*	*305*
Oil and gas receipts	8,454	8,454	5,599	7,105	8,923
Net Oil Revenue	5,836	5,836	3,865	4,905	6,160
FG Share of oil revenue	3,688	3,688	1,603	2,034	2,555
Non-Oil revenue	1,386	1,386	1,042	1,158	1,216
FG independent revenue	644	644	371	354	424
Other revenue	2,203	1,247	469	813	1,223
FG Total revenue	**7,921**	**6,966**	**3,486**	**4,359**	**5,418**
FGN Expenditure	10,338	8,827	7,248	7,248	7,248
Fiscal deficit	**-2,417**	**-1,861**	**-3,762**	**-2,889**	**-1,829**

Source: Budget Office, ARM Research

Table 5: Historical Budget Implementation and 2019 ARM estimates

₦'Billion	FY 16	FY 17	FY 18*	2019 Budget	2019 Estimate
Retained Revenue	***2,948***	***2,658***	***3,785***	***6,967***	***4,359***
Non-debt Recurrent	2,412	2,765	2,078	4,039	3,716
Debt Service	1,385	1,824	2,115	2,264	2,264
Capital	173	1,440	686	2,284	1,028
Transfers	344	434	376	240	240
Total Expenditure	***4,314***	***6,464***	***5,255***	***8,827***	***7,248***
Fiscal Deficit	(1,366)	(3,806)	(1,470)	(1,860)	(2,889)

Source: Budget Office, ARM Research: 2018* Estimate

Optimal debt ratio, looks like a stone throw away

Following the issuance of the last Eurobond in 2018, the FG made an improvement in its debt mix to 33:67 split between external and domestic borrowings (vs 30:70 prior to the Eurobond issuances) from 31:69 split in 2017. The increasing optimal debt mix is in line with FG's Debt Management Strategy (2016-2019) aimed at rebalancing total public debt stock to achieve an optimal ratio of 60:40 for domestic to external debt, and moderate debt service costs. In financing the fiscal deficit of ₦1.86 trillion, the FG plans to improve on its optimal debt mix, with part funding via borrowings of ₦1.65 trillion expected to be funded 50:50 by domestic and foreign borrowings.

With the excess of ₦210 billion expected to be funded from the privatization of some non-oil assets by the Bureau of Public Enterprises (BPE).

Dissecting planned borrowings, the share of the external borrowings suggests additional $2.7 billion to the current foreign debt stock of $24.45 billion. We believe market reception at the last Eurobond in 2018 (with 3.2x over-subscription), suggests a successful issuance of the additional borrowing is achievable, even via the Eurobond, albeit at a relatively higher cost compared to the last issue. For context, despite the oversubscription at the last issue, average spread between Nigeria's Eurobond rates and comparable US treasury expanded to 576bps compared to 442bps at the February 2018 issue. Also supporting our view of relatively higher cost of borrowing is the free fall in crude oil prices and the possibility of two more rates hike in the US (after four hikes in 2018) in 2019, both of which could have severe impact on the gross external reserves (both from lower revenue and exits of offshore funds) which could overstate valuation for Nigeria's foreign issues. Also, concerns over the rising debt service to earned revenue ratio (55.9% as at 9M 18) in Nigeria, and the risk of default could drive Eurobond yields higher in 2019.

While noting the reported fiscal deficit by FGN, we played out different scenarios of possible domestic paper issuance to finance our estimated fiscal deficit under our base case scenario of ₦3.36 trillion for 2019. We estimate that to finance the budget, the net debt issue could range between ₦1.57 trillion and ₦2.23 trillion which is already higher than 2018 net issuance of ₦189 billion. In sum, our scenario analysis guides to a significantly higher domestic borrowings in 2019, which could in a deviation from the proposed debt mix.

Table 6: Scenario analysis of 2018 proposed borrowings

₦'billion	Asset sale + $2.70bn debt + Statutory Ways & Means	50% asset sale + $2.70bn debt + Statutory Ways & Means	No asset sale + $2.70bn debt + Statutory Ways & Means	Asset sale + $2.70bn debt + Av. Historical Ways & Means	50% asset sale + $2.70bn debt + Av. Historical Ways & Means	No asset sale + $2.70bn debt + Av Historical Ways & Means
Projected deficit	**2,889**	**2,889**	**2,889**	**2,889**	**2,889**	**2,889**
Sale of Assets	210	105		210	105	
Foreign Borrowings	825	825	825	825	825	825
Domestic Borrowings	1,854	1,959	2,064	1,854	1,959	2,064
CBN ways and means	189	189	189	698	698	698
Borrowings from capital market	**1,665**	**1,770**	**1,875**	**1,156**	**1,261**	**1,366**
2018 net issuance	290	290	290	290	290	290
2017 net issuance	1,277	1,277	1,277	1,277	1,277	1,277
2019 YoY increase	1,375	1,480	1,585	866	971	1,076
Total Borrowing	2,489	2,594	2,699	1,980	2,085	2,190
Debt Mix	33:67	33:67	31:69	43:57	41:59	39:61

Source: Budget Office, ARM Research

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