

August 7, 2018



Nigeria Strategy Report

H2 2018

Domestic Economy and Markets

The divergence... fundamentals or sentiment?

Executive Summary

Coming into 2018, the Nigerian equity market opened on a positive note hinged on a confluence of factors – rising commodity prices, production and the pro market FX policies. The interaction of these factors boosted investor's confidence with the outcome seen in January wherein the equities market gained 16% MoM. However, the bull run reversed in subsequent months hinged on the possibility of an aggressive policy tightening by the US Fed. Consequently, we saw foreign flows into the Nigerian equity market gradually dissipate. For context, the equities market in the first half of 2018 saw a net foreign outflow of ₦38.4 billion relative to the net foreign inflow of ₦335 billion in H2 17. Nonetheless, the market ended the first half of the year in the positive, gaining 0.1%.

Over the rest of the year, direction in the equities market will be determined by developments on the global front. Specifically, the U.S. Federal Reserve guides to two more rate hikes before the end of 2018 even as the economy witnessed impressive economic growth of 4.1% in Q2 18. Therefore, the confluence of continued monetary policy normalization and improving growth picture in the U.S. guides to significant moderation of foreign portfolio inflows into the equities market. Further limiting flows is the uncertain political landscape ahead of the 2019 elections. Against this backdrop, we estimate flows to the equity market to decline to \$950 million over H2 2018 (H1 18: \$1.42 billion, 2018: \$2.38 billion). Accordingly, with our outlook of shrinking participation by foreign investors, the focus should remain on how local investors are well positioned to keep the market lubricated. On this wise, our view regarding higher FGN government borrowings and rising U.S. treasury yields raises the prospect for higher yields on FI instruments which could extinguish appetite for risky equity assets.

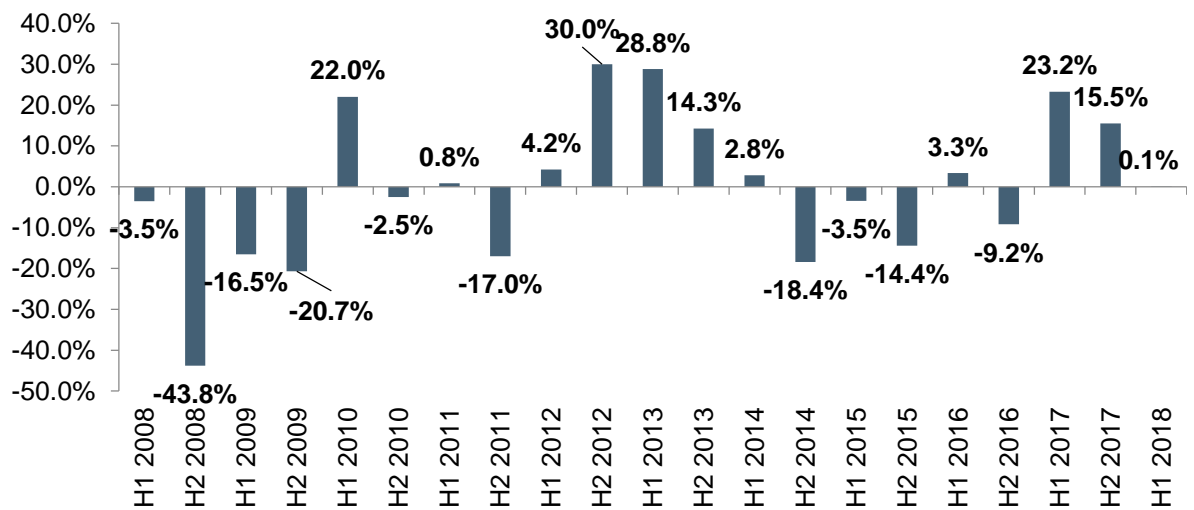
This report focuses on trends in Nigeria's equities market and our outlook for same over the rest of the year.

NGSEASI: Narrow escape from the Red sea.

The Nigerian equity market started 2018 on a positive note hinged on a confluence of factors including rising crude oil price and production as well as pro market FX policies. The interaction of these factors boosted investor's confidence with the outcome seen in January wherein the equities market gained 16% MoM. However, the bull run reversed in subsequent months hinged on the expectation of an aggressive policy tightening by the US Fed. Consequently, we saw foreign flows into the Nigerian equity market gradually dissipate. For context, the equities market in the first half of 2018 saw a net foreign outflow of ₦38.4 billion relative to the net foreign inflow of ₦335 billion in H2 17. Nonetheless, the market ended the first half of the year in the positive, gaining 0.1% with much of the support stemming from the double-digit gain in January.

Splitting the market performance into quarters, the NGSE returned +8.7% in Q1 18 with the gains seen in the month of January (+16%) neutering the impact of the losses recorded for the month of February (-2%) and March (-4.7%). However, the market closed the second quarter on a negative note (-7.7%) despite the positive economic data released during the period including Q1 18 economic growth of 1.95% (vs. Q1 17: -0.9%; Q4 17: 2.1%) and continued expansion in the PMI¹ (above benchmark of 50 index pts) which combined indicated a steady pickup in economic activities within the economy. Clearly, foreign investors chose to ignore these economic fundamentals alongside rising crude oil price, looking to the developed market in the light of on-going monetary tightening policies and uncertainties about the impending elections. Overall, excluding the strong performance recorded in January, the Nigerian equity market would have close negative in the first half of 2018.

Figure 1: NSEASI Half year returns



Source: NSE, ARM Research

¹ Purchasing Managers Index

In terms of sector drivers, the return of 8.7% in Q1 18 was largely driven by positive returns in the banking, cement, personal care, and oil & gas sectors. Starting off with the banking (+13.8%) sector, the positive sentiment was buoyed by the expectation of a reduction in loan provisioning as the pick-up in oil prices was expected to help reduce the bad debts carried in their loan books. On cement, the sector gained 12.5% over Q1 18 driven by CCNN² which gained 96.8% on the back of the expectation of its new cement plant in Sokoto which held the prospect of adding 1.5 million MT to its existing capacity. Over in the oil & gas sector, the modest gain of 2.95% stemmed from the upstream O&G sector, specifically SEPLAT and ETERNA which gained 6.2% and 63.8% respectively. Surprisingly, investors bought into the shares of some of the downstream players – MRS (+3.2%) and TOTAL (+8.3%) – despite weak fundamentals for the sub-sector. For clarity, margins for the downstream players has remained depressed as the companies continue to suffer from input cost pressures. On personal care, the positive return of 30.1% was supported by dissipating concerns on FX illiquidity and the expectation for volume induced revenue growth with PZ Cussons (+13.8%), Unilever (+34.2%) and GSK (+57.3%) returning positive over the period.

Elsewhere, the brewery and food producer sectors lost 1.2% and 3.6% respectively. For the brewery sector, the negative return was driven by Nigerian Breweries (-3.6%), mirroring increased industry competition which posed a threat to the company's market share while the negative return for food producers was driven by Nestle (-11.3%), notwithstanding the strong FY 17 earnings reported.

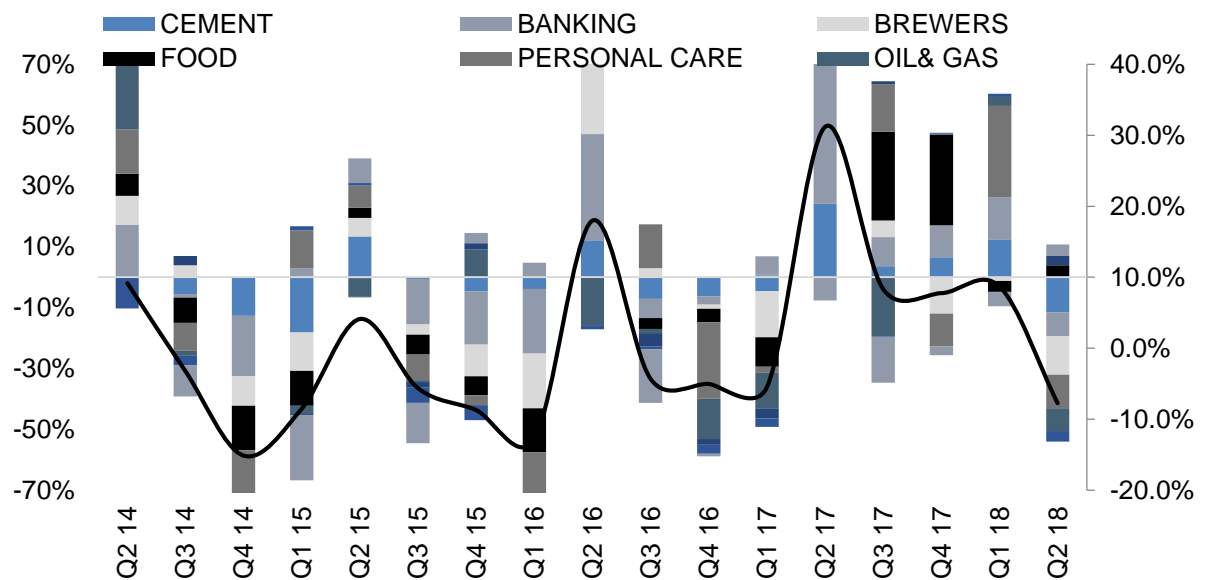
To our surprise, the shed extended into Q2 18 (-7.7%) reflecting declines across the sectors excluding the Food (+3.9%), construction (+3.7%) and Insurance (+3.1%) sectors. We note that the losses in the other sectors reflected slowdown in foreign appetite for domestic equities during the quarter, particularly in the month of May when the equity market registered a negative return of 7.8% over the month.

Focusing on the insurance sector, we believe recent policies to drive growth therein led to the renewed interest we've seen in the insurance sector. For clarity, the industry regulator recently approved new risk-based capital structure, effective from January 2019. The structure is aimed at ensuring that industry players are only able to underwrite risks that aligns with their capital base. Consequently, firms with higher capital base would be able to get higher deals as it implies they have higher capacity for the implied risks. That said, the minimum capital base for any insurance company who wants to underwrite all risks is ₦6

² Cement Company of Northern Nigeria Plc

billion (Prior: ₦2 billion) for life insurance and ₦9 billion (Prior: ₦3 billion) for non-life insurance companies. The regulator noted that the existing insurers who currently operate under the old capital structure would not be forced to recapitalize but would be restricted to underwrite only certain classes of products and risks. For us, we believe this new structure could bring about a repeat of the events which unfolded in 2007 where we saw a few merger and acquisition in the industry. Therefore, foreign investors are buying the big names in the industry who are likely withstand the new force that is likely to sweep the insurance sector.

Figure 2: Component of FG's Deposit to CBN vs CBN's Claims to FG (₦'billion)

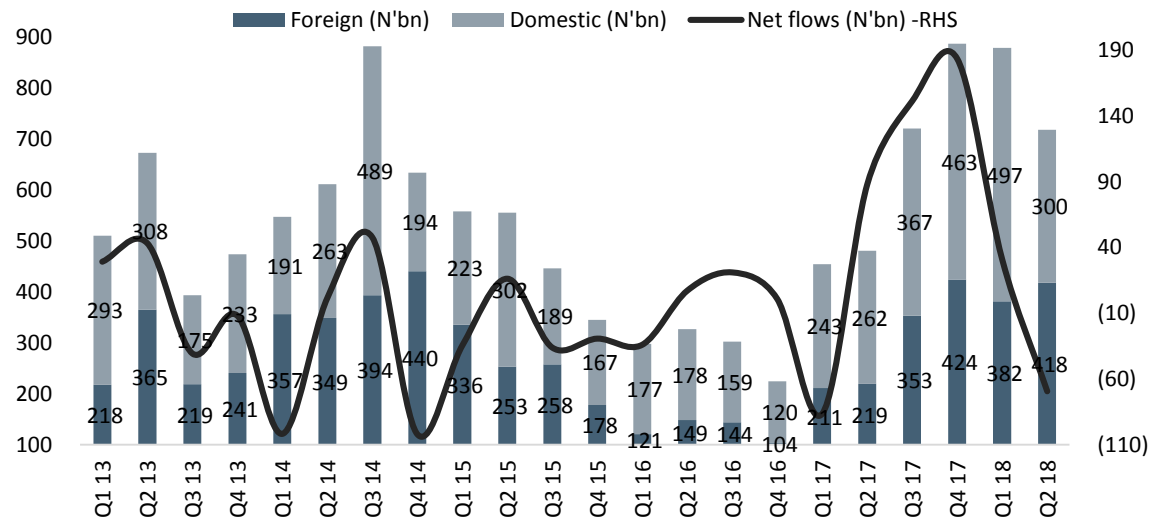


Source: NSE, ARM Research

Foreign investors dropped stocks like bad habit.

Dissecting investment pattern across domestic and foreign fund managers over the period revealed that both foreign and local transactions witnessed sturdy participation – foreign transactions rose 83% YoY to ₦799.71 billion while domestic transactions surged 71% YoY to ₦797.54 billion – flattered by the low base of H1 17, a period wherein the restriction of FX limited foreign participation (24% of total value traded) in the market with local investors accounting for 76% of total value traded. Flipping the coin to focus on activity in H1 18, revealed that participation by foreign asset managers and local investors leveled over the review period with a 50:50 share of the market value traded, compared to H2 17 wherein domestic investors (52% of total value traded) exceeded foreign participation of just 48%. For context, the increased transaction largely reflected outflows by foreign funds over H1 18, which increased 89.6% to ₦419.1 billion, leaving the market with a net outflow of ₦38.4 billion.

Figure 3: Foreign and domestic share of transactions



Source: NSE, ARM Research

Going by quarterly breakdown, over Q1 18, foreign transaction constituted just 43% (vs. 50% as at Q4 17) of total value traded as transaction declined 10% QoQ to ₦381.8 billion compared to ₦424.2 billion in Q4 17. Reflecting the contraction in participation, net flows into the market also weakened to just ₦30 billion (compared to ₦183.7 billion in Q4 17) as outflows increased 46% QoQ to ₦175.5 billion while inflow declined 32% QoQ to ₦206.4 billion. Furthermore, while local participation took the reign over Q1 18 (constituting 56% of market value), breakdown revealed that the activity was dominated by institutional investors (which accounted for 58% of total domestic transaction) despite a 20% QoQ decline in transaction to ₦288.9 billion, compared to retail transactions of ₦208.2 billion (+102% QoQ).

The table turned in Q2 18, as foreign investors dominated activity in the market with total transaction of ₦417.9 billion (+9.4% QoQ) to account for 58% of total value traded. Notably, the increased transaction broadly reflected outflows from the market as a total of ₦243.6 billion was sold off by foreign investors leaving the market with a net outflow of ₦69.3 billion. Also, domestic transactions declined 39.6% QoQ to ₦300.4 billion, as both retail and institutional transactions declined respectively by 49% and 33% QoQ. Overall total value traded in Q2 18, reached the lowest in four quarters to ₦718.3 billion.

The divergence... fundamentals or sentiment.

Over the rest of the year, direction in the equities market will be determined by developments on the global front. Specifically, the U.S. Federal Reserve guides to two more rate hikes before the end of 2018 even as the economy witnessed impressive economic growth of 4.1% in Q2 18. Therefore, the confluence of continued monetary policy normalization and improving growth picture in the U.S. guides to significant moderation of foreign portfolio inflows into the equities market. Further limiting flows is the uncertain political landscape ahead of the 2019 elections. Against this backdrop, we estimate flows to the equity market to decline to \$950 million over H2 2018 (H1 18: \$1.42 billion, 2018: \$2.38 billion). Accordingly, with our outlook of shrinking participation by foreign investors, the focus should remain on how local investors are well positioned to keep the market lubricated. On this wise, our view regarding higher FGN government borrowings and rising U.S. treasury yields raises the prospect for higher yields on FI instruments which could extinguish appetite for risky equity assets.

Scanning across the various sectors beginning with cement, we believe the confluence of higher government capex implementation – including the federating units – and its transmission to private domestic income will spur both public and private cement consumption over H2 18. Furthermore, with the relative stability in gas supplies and more efficient utilization of alternative energy sources, the scope of further upside in earnings should make the sector a toast of investors. Despite our positive outlook on the sector, on portfolio allocation basis, our top picks in the industry are DANGCEM and CCNN. We believe DANGCEM will continue to benefit from its wide penetration across Nigeria (by extension its Pan-African presence) and improved energy flexibility. For CCNN, the newly commissioned 1.5mmt per annum plant by the parent company underpin our attraction to the company given the potential for higher volumes and earnings. Specifically, while CCNN had struggled with high energy cost per tonne amidst a high vulnerability to price changes given its limited capacity, we believe the new plant will instigate a higher volume by the company with the energy efficiency associated with the new plant further supporting margin.

Undertaking a similar exercise for banks, we think 2018 will be a turning point for the Tier 1 banks. ROE growth is likely to have topped in 2017, and we now factor in a slower growth over the next few years. In the face of lower interest rate environment, cautious loan growth, and capital preservation, we think benign funding cost, asset quality improvement, lower provisioning, and resilience in non-interest revenue (NIR) will be central to earnings over 2018. Also, in a low-growth revenue environment and faced with digital disruption, cost discipline and efficiency improvements will be key drivers of earnings growth and profitability, longer term, for the banks, in our view.

Elsewhere in the cyclical universe, for oil and gas upstream, sentimental buying associated with rising crude oil prices and stable production should continue to drive interest in Seplat. For the Oil and Gas downstream, the FGN strong grip on PMS price, whilst the importation cost continues to soar would leave margins suppressed for most players in the sector over H2 18 and by extension to H1 19, as any upward adjustment before the election is highly unlikely.

For the traditional defensive names in the food, brewery, and personal care space, our expectation of stable currency impact on cost and increasing consumer spending implies possible upside across the space. However, expensive valuations for basic food producers and brewers, and still weak pricing power implies the segments could witness more aggressive investors apathy in the months ahead.

Lastly, our outlook for palm oil producers is slightly bearish as the mix of declining domestic CPO prices emanating from falling global CPO prices as well as weaker volumes emanating from lower yields palm plantation would weigh on sector revenue over H2 18. The aforementioned combined with higher operating expenses paves way for lower earnings over the rest of the year.

Despite the mixed outlook across sectors, aside sentiment and global monetary policy normalisation, the fundamental underpinning the broader NSE remain largely positive going by the improved macroeconomic picture and liquidity of the foreign exchange market. For primary market activities, NSEASI could still find respite from the listing of MTN scheduled for Q4 18. Given that Nigeria accounts for 35% of MTN's group operating profits and using JSE market capitalization of \$14.2 billion, we estimate that the listing could account for 20% of NSE market capitalization at issue. Elsewhere, seasoned issues and corporate actions are likely to further keep market activity bubbling over H2 18. Specifically, we expect the merger of CCNN and Kalambaina to further spur activity on the stock, while for Lafarge, the thin market liquidity and further dilution concerns could stoke sell-offs in the stock over H2 18.

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