

July 23, 2019



Nigeria Strategy Report

H2 2019

Global Economy and Markets

Mixed bag for global soft commodity market

Executive Summary

Over the first half of 2019, the S&P GSCI Agricultural index declined by 14.1% YoY, extending the bearish run observed over the second half of 2018 – largely reflecting price declines across key commodities. In line with our expectation Cocoa, Sugar and CPO prices sustained bearish trend due to market glut necessitated by the favorable weather condition. Further worsening the situation in the CPO market is the increased tariffs on India's CPO imports, which has constrained export from other countries to India. On the flipside, wheat and barley prices increased, occasioned by weather induced decline in production, leaving the market in a deficit position.

Going forward, following expectation of a switch in market condition to a surplus from a deficit, we see room for lower wheat prices barring resurfacing adverse weather conditions. Similarly, juxtaposing the sharper rise in consumption with (+3.4% YoY to 75 MMT) the mild uptick in global CPO production, we see room for pick-up in CPO prices over the rest of the year. Furthermore, with market surplus expected to print at 3.1 million MT in the 2019/2020 MY from deficit recorded in the prior year, we see scope for lower Barley prices over the rest of the year. For cocoa, the interplay of the demand and supply guides to a higher surplus of 84,000 metric tonnes (2017/2018 surplus: 55,000 metric tonnes), implying decline in prices over the rest of year. Lastly, with Sugar market expected to remain in a surplus position, albeit moderated at 4.3 million MT, we expect global sugar prices to remain bearish going forward.

In this report, we look at the major themes that dominated the soft Commodities market in H1 2019 as well as our outlook for the market and commodities prices for 2019.

Mixed bag for global soft commodity market

Over the first half of 2019, the S&P GSCI Agricultural index declined by 14.1% YoY, extending the bearish run observed over the second half of 2018 – largely reflecting price declines across key commodities. In line with our expectation Cocoa, Sugar and CPO prices sustained bearish trend due to market glut necessitated by the favorable weather condition. Further worsening the situation in the CPO market is the increased tariffs on India’s CPO imports, which has constrained export from other countries to India, leaving the market oversupplied. On the flipside, wheat and barley prices increased occasioned by a weather induced decline in production, leaving the market in a deficit position.

Table 1: Average Price Movement across soft commodities

Commodity	H1 19	H2 18	H1 18	FY 18	YoY
Barley (\$/Tonne)	1775.0	1674.3	1448.3	1591.3	+14.5%
Cocoa (\$/Tonne)	2331.4	2251.2	2396.2	2308.9	-2.7%
Crude Palm	497.5	502.3	617.8	559.3	+19.5%
Sugar (\$/Pound)	12.4	11.8	12.7	12.2	-1.5%
Wheat(\$/Bushel)	482.9	514.4	476.5	495.6	+1.4%

Source: Bloomberg, ARM Research

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

(Million Tonnes)	2019/2020			2018/2019		
	Supply	Demand	Balance	Supply	Demand	Balance
Barley	152.1	149.0	3.1	140.0	142.4	-2.1
Cocoa	4.8	4.8	0.8	4.6	4.6	0.5
Crude Palm Oil	75.5	75.0	0.5	73.5	72.5	1.0
Sugar	180.7	176.4	4.3	194.5	173.6	20.9
Wheat	780.8	757.6	17.8	731.7	736.1	-4.4

Source: USDA, ARM Research

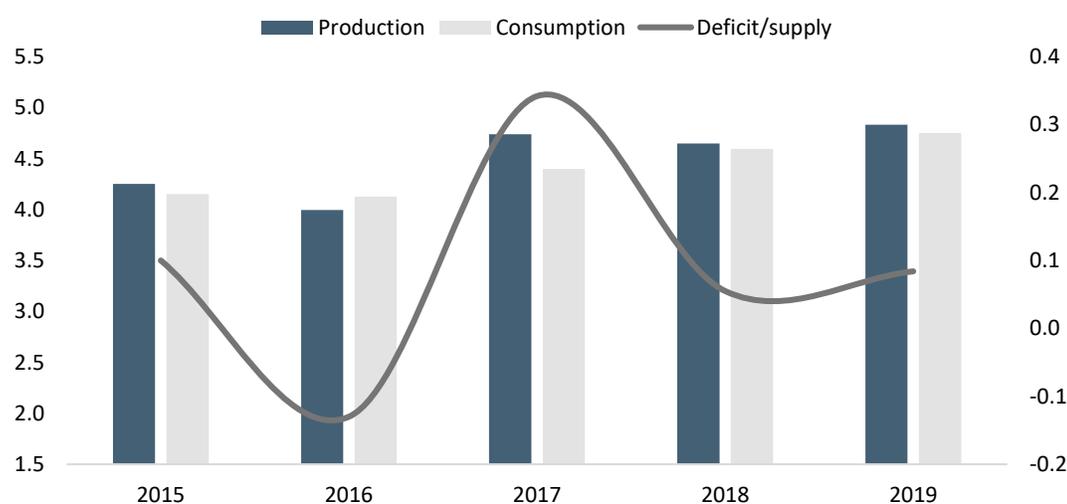
Unanticipated cocoa supply truncates the bullish run

Cocoa prices remained in the bearish territory, following the conclusion of the 2017/2018 MY¹, which ended in a surplus of 55 million MT. To begin, the cocoa market started off on a bullish run in January, gaining 3.3% MoM, supported by the anticipation of slowing supply in the cocoa market as weather conditions in Ghana and Nigeria were unfavorable. Specifically, the dry and hot climate

¹ Cocoa season typically runs from October to September.

conditions which prevailed in Ghana’s main cultivating areas and harmattan in Nigeria drove the expectation of thinning supply. However, actual production data from top cocoa producing countries turned the tide, causing prices to nosedive. For context, supply in Ivory Coast expanded by 19% YoY to 1.9million MT as at May, while Ghana’s production grew by 6.2% YoY to 698 thousand MT and Cameroon production grew by 19% YoY to 250 thousand MT. Consequently, average cocoa prices declined by 3.3% YoY. Demand at the other end remained in line with expectation, with cocoa grindings data for the first quarter in key consuming countries picking up. Precisely, in Europe cocoa grindings expanded by 3.3% YoY, Ivory coast by 5.5% YoY and North America by 1.98% YoY, supported by the growing chocolate confectionary market.

Figure 1: Trend in Cocoa Production, Consumption and Trade Balance (Million tonnes)



Source: ICCO, ARM Research

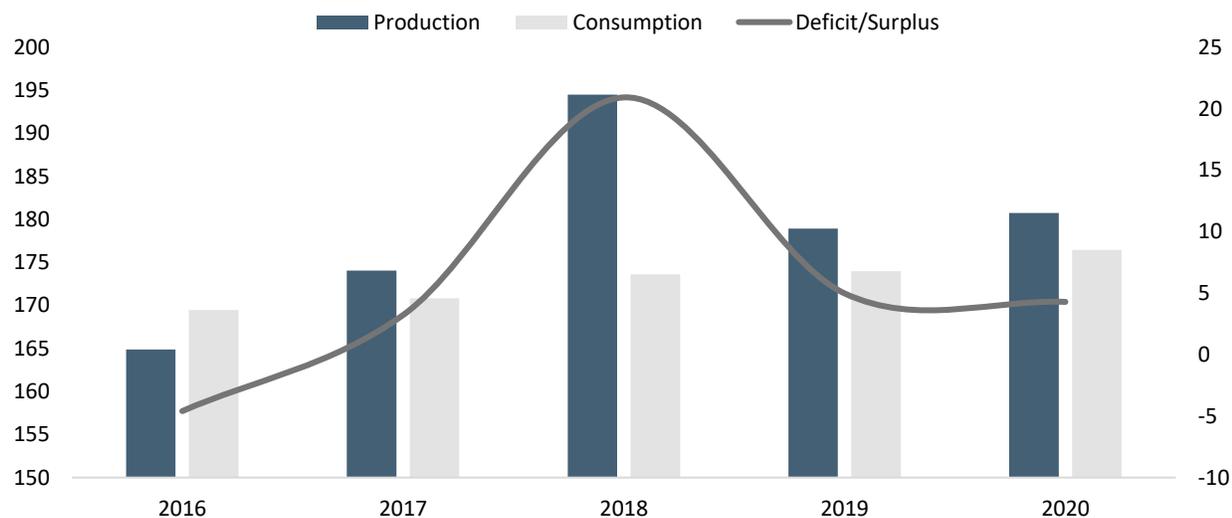
Going forward, the cocoa market is expected to remain in a surplus position over the 2018/2019 harvest season. According to ICCO, production is expected to print at 4.83 million MT (+4% YoY) largely driven by increased output in Ivory coast as weather conditions remain favorable. Though Q1 19 output exceeded expectation in Ghana, production is forecast to remain unchanged, relative to the prior year hinged on the dry weather and pest outbreak which has resulted in crop failures. Consumption at the other end is expected to rise by 3.4% YoY to 4.75 million MT, mirroring the steady growth in the confectionary market as demand for chocolates with high cocoa content persists. Drilling to top cocoa consuming countries, demand in Europe is expected to increase by 1.6% YoY to 1.737 million tonnes, 4.3% to 1.096 million tonnes in Asia and Oceania, 1.9% to 981,000 tonnes is anticipated in Africa and 3.1% YoY expansion in America to 899,000 tonnes. The interplay of the demand and supply guides to a higher surplus of 84,000 metric tonnes

(2017/2018 surplus: 55,000 metric tonnes), implying a decline in prices over the rest of year. However, the price appreciation seen in few months over the first half of 2018/2019 would leave average prices for the year flat or slightly higher relative to the prior year.

Market surplus trims as “sweetener” margins thins out

Over the first half of 2019, average sugar prices continued downtrend, albeit at a much slower pace relative to the prior year, following moderation in market surplus. The sugar 2018/2019 marketing year² which ended in April 2019, finished in a surplus position of 4.97 million MT down from a surplus of 20.9 million MT recorded in 2017/2018 marketing year. Consequently, sugar prices averaged 12.5 cents/lb (-1.5% YoY). Precisely, the moderation in market surplus stemmed from a decline in sugar supply. For the recently concluded 2018/2019 season, global supply dropped by 8% to 180.7 million MT stemming from decline in Brazil’s sugar production due to diversion of cane mills into the production of ethanol and unfavorable weather during the period. For clarity, following the price erosion over the last two years, sugar producers diverted resources into ethanol production to earn relatively higher income. Demand at the other end was relatively flat, expanding by 0.21% YoY to 173.95 million MT, as consumption remained largely flat for most key sugar consuming countries. In US and China, demand expanded by 0.6%, India (+3.8%) while EU’s demand contracted by 0.3% - all accounting for almost 50% of the global sugar demand.

Figure 2: Trend in Sugar Production, Consumption and Trade Balance (Million tonnes)



Source: USDA, ARM Research

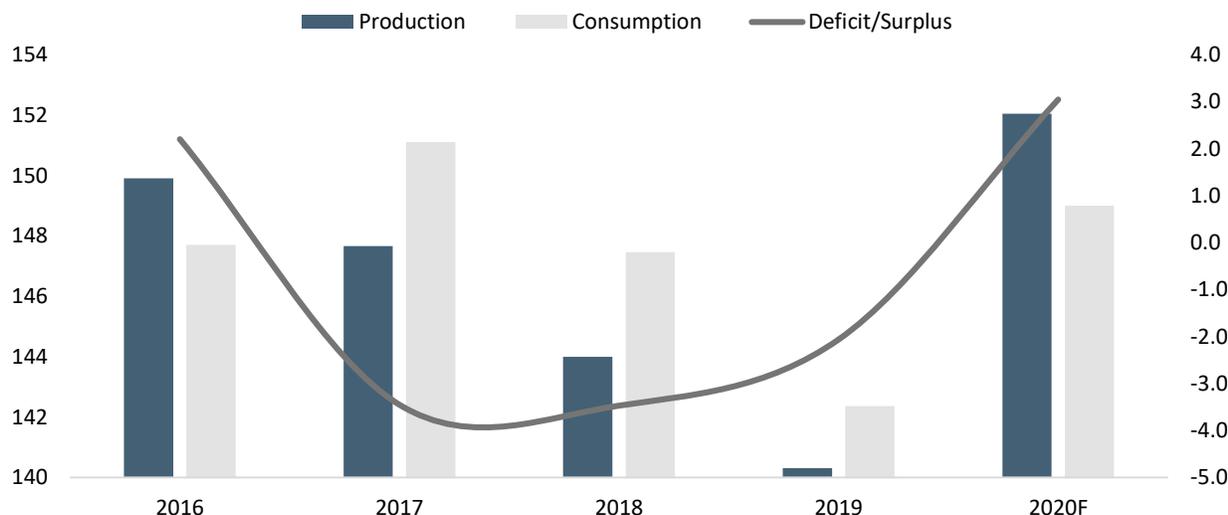
² Sugar marketing year runs from May to April.

For the 2019/2020 marketing year, we expect surplus in the sugar market to further moderate, supported by pick up in consumption. According to USDA, global production is expected to print at 180.7 million MT (+1% YoY) hinged on increased production in EU and a modest recovery in Brazil which would overshadow the anticipated decline in India's supply. Improved weather conditions in EU and Brazil is forecast to drive the increase in production while severe drought which hit key growing region would drive the decline in India's supply. Consumption at the other end is expected to grow at a faster pace, relative to supply. Specifically, demand is expected to grow by 1.4% YoY to 176.4 million MT, reflective of increased consumption mainly in India, Pakistan, Indonesia and Egypt. That said, we expect the market to remain in a surplus position, albeit moderated at 4.3 million MT – which guides to prices remaining bearish going forward.

Improved weather condition shifts the market into a surplus

Barley prices maintained its bullish run over the first half of 2019, rising by 15% YoY, following reduced supply in the market. Over the 2018/2019 marketing year³, total barley production declined by 2.6% YoY to 140.3 million MT following the weather induced drop in yields in EU and Russia – the top producing countries. For clarity, these regions experienced extreme dry weather conditions (i.e droughts and rising temperature) which are typically averse to the barley quality and yields available for harvest. Following the reduced supply and unattractive pricing of barley relative to maize, beer production reduced, and consumers switched to the use of maize as animal feed in place of barley. Consequently, barley consumption declined even faster, by 3.5% YoY 142.4 million MT. Delving into the regional consumption, Europe, China and Russia recorded the largest declines. As a result of the interplay between demand and supply, the market closed the 2018/2019 MY with a deficit of 2.1 million MT.

³ Marketing year runs from June to May annually

Figure 3: Trend in Barley Production, Consumption and Trade Balance (Million tonnes)

Source: USDA, ARM Research

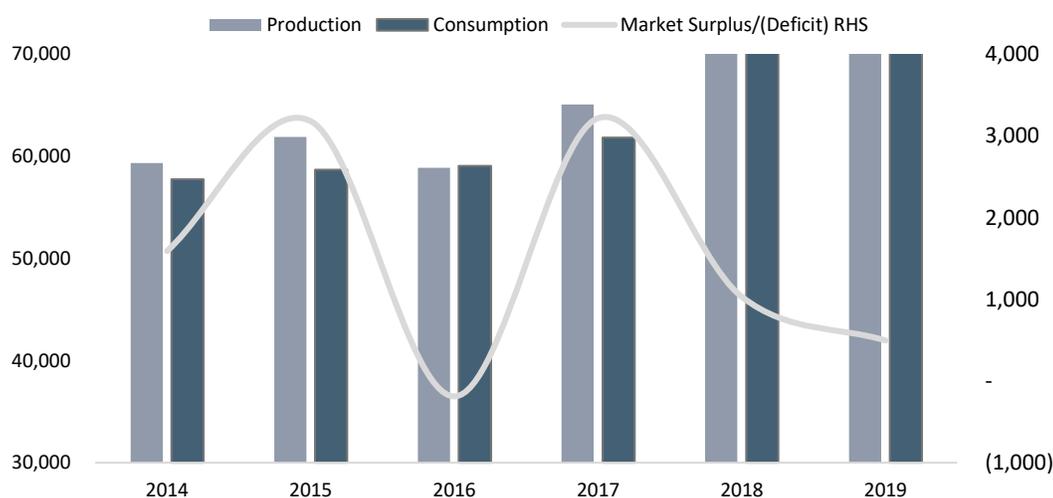
Going forward, the barley market is expected to switch to a surplus position following recovery from last year's adverse weather in key producing areas such as Europe and Russia as well as smaller producers like Australia, Canada, Middle East, and Ukraine. To buttress, according to USDA, barley area is projected to increase in the Middle East (Iraq, Syria, Iran, and Turkey), due to favorable weather, even in areas with perpetual low precipitation. That said, global supply is expected to increase by 8.4% YoY to 152.1 million MT. Also, consumption is expected to pick up on expectation of increased supply and invariably lower prices. For clarity, barley has higher nutrient content (i.e protein) and its malting process for beer production is easier relative to alternatives, making it the more preferred choice for animal feeds and beer production. That said, global demand is expected to increase by 4.7% YoY to 149 million MT, albeit at a slower pace when compared with supply, stemming largely from China and EU. Consequently, market surplus is expected to print at 3.1 million MT in the 2019/2020 MY from deficit recorded in the prior year.

Market surplus persist in global CPO market

Akin to H2 2018, the surplus in the global CPO market persisted over the first half of 2019 (1 MMT vs 3.2MMT), albeit slower, paving way for downtrodden CPO prices over the period (-19.5% YoY to \$497.5/MT). The market surplus stemmed from higher CPO output in Indonesia and Malaysia which accounts for over 70% of global CPO production and 84% of the increase in CPO output over the prior year. For both countries, the rise in CPO production is anchored on the so-called high cycle of production that started from August 2018 to March 2019, an offshoot of favorable weather over the period. Overall global CPO production jumped 13.1% YoY to 72.5 MMT. On the demand side, although global consumption grew 17% YoY to 72.5 MMT over the prior year,

the growth was curtailed by India’s decision (largest CPO importer) to raise tariff on imported raw and refined CPO to 44% and 54% (from 30% and 40%) respectively.

Figure 4: Trend in CPO Production, Consumption and Trade Balance (Million tonnes)



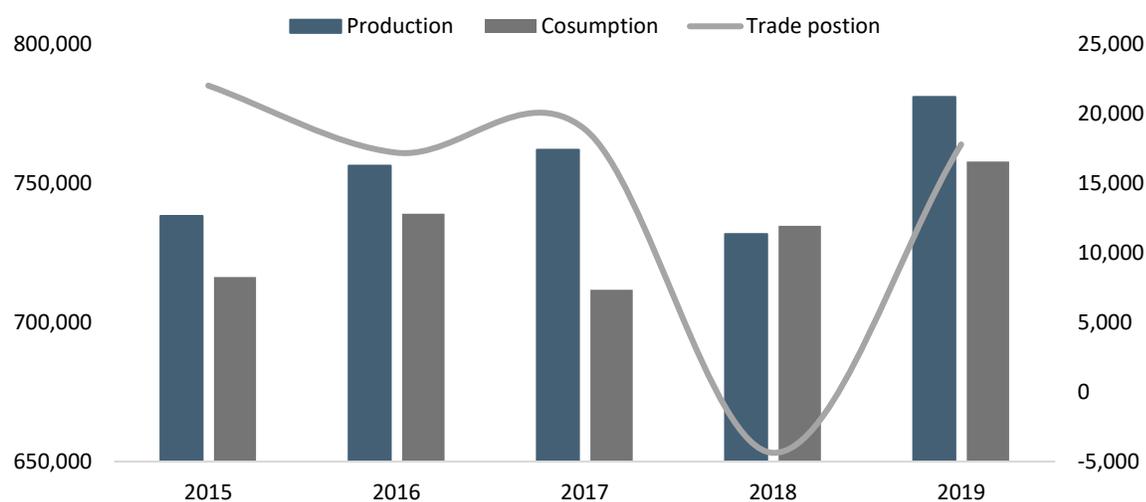
Source: USDA, ARM Research

Going into the 2019/20 season, the United State Department for Agriculture now forecast a sharp contraction in market surplus by 52% YoY to 496 KMT, driven by faster rise in CPO consumption in compared to supply. For context, whilst buyers of CPO in Europe have cut back on large, long term palm oil orders due to push back against the edible oil which is linked to deforestation, Palm consumption in China, India and Indonesia are expected to pick up. For China, USDA forecast 8.9% YoY increase in consumption, to account for ~31.9% of overall increase in global consumption. The higher demand for palm oil in China mirrors slowdown in its Soybean imports, especially from the US due to delays in trade negotiations. More so, China recently struck a palm oil supply deal that would see her import additional 400,000 tonnes of palm oil from Malaysia. In addition, following the sharp increase in consumption of industrial CPO for conversion to biodiesel, industrial palm oil consumption will continue to be the leading driver of palm oil demand in Indonesia, with USDA estimating 3.7% YoY increase to 13.3 MMT. Meanwhile in India Growth in both the general population and in disposable income suggests strong demand for palm oil (+3.1% YoY to 10.9 MMT). Juxtaposing the sharper rise in consumption with (+3.4% YoY to 75 MMT) the mild uptick in global CPO production, we see room for slight pick-up in CPO prices over the rest of the year.

Bullish run in Wheat prices surface

Coming into the first half of the year, we projected a bullish run in wheat prices anchored on expectation of deficit in the global wheat market. Our pessimism was fueled by anticipation of lower global production emanating from extreme weather conditions and escalating trade rift between US and China. True to our expectation, average wheat prices rose 1.35% YoY to 482.9/bu. The deficit picture stemmed solely from the supply side (-4% YoY to 731 MMT) which slid faster than the jump in consumption (+3.2% YoY to 734.6 MMT). Further breakdown reveals that the slowing production level was mainly driven by slowdown in wheat production in EU (-5.6% YoY to 123 MMT) which largely weighed on overall global wheat production. The slowdown in wheat production in Europe is reminiscent of drought and higher than normal temperature throughout most of northern Europe. As a result, this depleted scant soil moisture, accelerated crop development and lowered crop yields.

Figure 5: Trend in Wheat Production, Consumption and Trade Balance (Million tonnes)



Source: USDA, ARM Research

Going forward, the global wheat market is expected to switch to a surplus of 17.7 MT in 2019/20 from deficit of 4.4 MT in the prior period due to faster growth in supply relative to demand. The bloated supply picture is largely driven by higher wheat production in the European Union (+12.1% YoY to 153.8 MT), Australia (+30.1% YoY to 22.5), Russia (+13% YoY to 78 MT) and Ukraine (+10% YoY to 30 MT) which cumulatively account for more than half of total production. Starting with the EU, in a significant turnaround from the drought shortened crop production in 2018/19, EU's wheat harvest is forecast to reach its highest in four years this season. This largely reflects good planting conditions on an enlarged area alongside mild winter and timely rainfall. Elsewhere in China, wheat production is forecast to be higher on account of better yields. Similarly, India is on the verge of harvesting its third consecutive record wheat harvest in the coming season due to

favorable planting conditions from evenly distributed rains and extended winter in major wheat growing areas. Akin to the supply side, we expect uptick in wheat demand over the rest of the year. This is largely driven rise increasing production in heavy weight: China, EU, India and Russia which jointly accounts for a large chunk in overall production (~51.7%). For context, Chinese consumption of higher grades of wheat continues to soar as high- and middle-income earners continue to embrace greater consumption of convenient and healthy foods. Elsewhere in India, after successive years of decline, wheat consumption over the coming harvest year is set to recover to 97 MMT on expected rise in supplies and strong take off by government under the Minimum support price (MSP) program for wheat. Likewise, in EU, the rosy demand picture is largely on the back of increased intra EU trade and swing back to domestic wheat in Feed use over that of imported grains. Overall, following expectation of a switch in market condition to a surplus from a deficit, we see room for falling wheat prices barring resurfacing adverse weather conditions.

Trend in global soft commodities emit mixed signals

On balance, following expectation of a switch in market condition to a surplus from a deficit, we see room for falling wheat prices barring resurfacing adverse weather conditions. Similarly, juxtaposing the sharper rise in consumption with (+3.4% YoY to 75 MMT) the mild uptick in global CPO production, we see room for pick-up in CPO prices over the rest of the year. Furthermore, given that market surplus is expected to print at 3.1 million MT in the 2019/2020 MY from deficit recorded in the prior year, we see scope for lower Barley prices over the rest of the year. For cocoa, the interplay of the demand and supply guides to a higher surplus of 84,000 metric tonnes (2017/2018 surplus: 55,000 metric tonnes), implying decline in prices over the rest of year. Lastly, with Sugar market expected to remain in a surplus position, albeit moderated at 4.3 million MT, we expect global sugar prices to remain bearish going forward.

That said, examining the impact of our expectations in global soft commodity markets on corporates in the Nigerian FMCG sector, our forecast for lower wheat prices provides legroom for better profitability margins for Flour Mills of Nigeria Plc – given that ~50% of overall revenue comes from Food segment which is predominantly sale of Flour. Contrarily, while our case for slimmer market surplus in the global CPO market provides cause for cheer for global CPO prices and bodes well for local Palm Oil producers – Okomu and Presco – we rule out sizeable price increases in the domestic scene as sector players are still faced with influx of smuggled CPO into the country. Elsewhere, we see gross margin improvement by brewers – Nigerian Breweries and Guinness – as Barley prices are set for a downward spiral

owing to a switch in market conditions from a deficit to glut over the period (3.1 million MT in the 2019/2020 MY). Regardless, given the intense competition in the sector that has kept prices unchanged, we see limited pass through of cost savings cascading into lower product prices over the rest of the year. Similarly, following our expectation of bearish Sugar prices, we expect lower costs of sales and higher gross margins for refined sugar manufacturers including Dangote Sugar and Golden Penny Sugar – a subsidiary of Flour Mills of Nigeria – given that around 98% of their raw sugar requirement is imported. We expect similar traits for Beverage producer – Cadbury, who relies on importation of cocoa for production of its flagship product Bournvita and other chocolate beverage.

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