

January 11, 2019



Nigeria Strategy Report

H1 2019

Global Economy and Markets

Mixed fortunes trail global commodity market

Executive Summary

Over the second half of 2018, following declines in prices of major soft commodities the S&P GSCI Agricultural index declined by 2.4%, extending the bearish trend observed in H1 18 (-49bps). Specifically, Cocoa, Crude palm oil (CPO) and Sugar led the declines, overshadowing uptick in Barley and Wheat prices. As expected, CPO and Sugar prices remained in the bearish terrain on the back of widening market surplus. However, the movement in cocoa prices came as a surprise as we expected a weather induced decline in market supplies to drive prices higher over the second half of the year. Nevertheless, optimism on increased market supply in the 2018/ 2019 crop season, hinged on improved weather in the world's top cocoa producer— Ivory coast, drove the decline in prices. On the flipside, the support for barley and wheat prices stemmed from weather induced decline in crop yields as major producers experienced weather extremities in the review period.

Going into 2019, the latest update from the World Meteorological Organization (WMO) which reveals that the occurrence of an El Niño is imminent provides some respite for global CPO prices. Hence, we remain somewhat optimistic on local CPO prices albeit, moderated due to subsisting market surplus and India's decision to hike tariff charges on imported CPO. Similarly, our expectation for subsisting deficit in the global wheat market owing to tamer plunge in global consumption and faster plunge in global production (-5% YoY to 679.6 million tonnes) is positive for global wheat prices. For barley, the faster decline in consumption relative to supply translates to a lower deficit and invariably lower prices over the 2018/2019 season. Lastly, Cocoa prices are expected to rise over 2019 as consumption is expected to outpace production.

In this report, we look at the major themes that dominated the Commodities market in H2 2018 as well as our outlook for the market and commodities prices for 2019.

Mixed fortunes trail global commodity market

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Table 1: Average Price Movement across soft commodities

Commodity	H2 18	H1 18	FY 17	
Barley (\$/Tonne)	1674.3	1448.3	1502.7	+15.6%
Cocoa (\$/Tonne)	2237.9	2395.6	2005.4	-6.6%
Crude Palm Oil(\$/Tonne)	502.3	617.8	647.6	-19%
Sugar (\$/Pound)	12.3	12.7	15.8	-3.1%
Wheat(\$/Bushel)	514.4	476.5	435.8	+8%

Source: Bloomberg, ARM Research

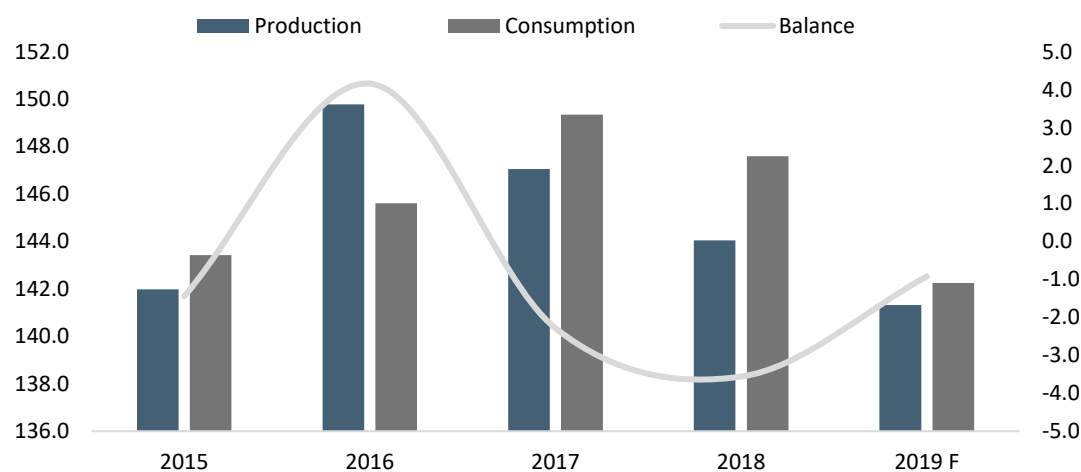
Table 2: Summary of movements in supply and demand across major commodities

(Million Tonnes)	2018			2017		
	Supply	Demand	Balance	Supply	Demand	Balance
Barley	144.0	147.5	-3.5	147.1	150.4	-3.3
Cocoa	4.6	4.6	0.08	4.7	4.4	0.3
Crude Palm Oil	72.3	68.8	3.5	65.1	61.9	3.2
Sugar	194.6	174.0	20.6	173.9	170.8	3.1
Wheat	679.6	711.5	-31.9	715.4	713.9	1.4

Source: USDA, ARM Research

Weather induced supply shortfall props barley prices

Contrary to our expectation of a moderation in barley prices over the first half of the 2018/2019¹ season, prices increased on the back of a weather induced decline in market supplies. For clarity, our stance on lower prices was hinged on improved barley yields from Australia, India and Turkey which was expected to overshadow the flat movement in consumption. To our surprise, global production fell sharply by 3.0million tonnes to 144.0 million tonnes as extreme dry weather conditions in Australia and Europe neutered increased production in Russia and India. For clarity, barley crops are generally intolerant to extreme dry conditions as it tends to hurt the quality of yields ready for harvest. Consequently, prices ticked higher by 15.6% in the period under review relative to the 1.4% decline in prices observed in the 2017/2018 season. Given the uptick in prices, consumption declined by 1.7 million tonnes to 147.6 million tonnes as stakeholders look to cheaper alternatives such as maize feed. Across the regions, softer demand in Saudi Arabia, EU region and U.S led the declines, muting the pick-up in demand from turkey, Iran and China.

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

Source: USDA, ARM Research

Over the 2018/2019 season which ends in July 2019, the USDA estimates a further decline in supply to 141.3 million tonnes (-2.7 million tonnes) hinged on bad weather conditions during spring planting season which affects the quality of barley yields. Across the regions, EU, Australia, and Russia are expected to lead the declines. On consumption, significant declines would likely stem from EU and Ukraine, with global demand expected to print at 142.6 million tonnes (-5.4 million tonnes) reflecting the increase prices. Thus, the impact of a faster decline in consumption relative to supply translates to a lower deficit and invariably

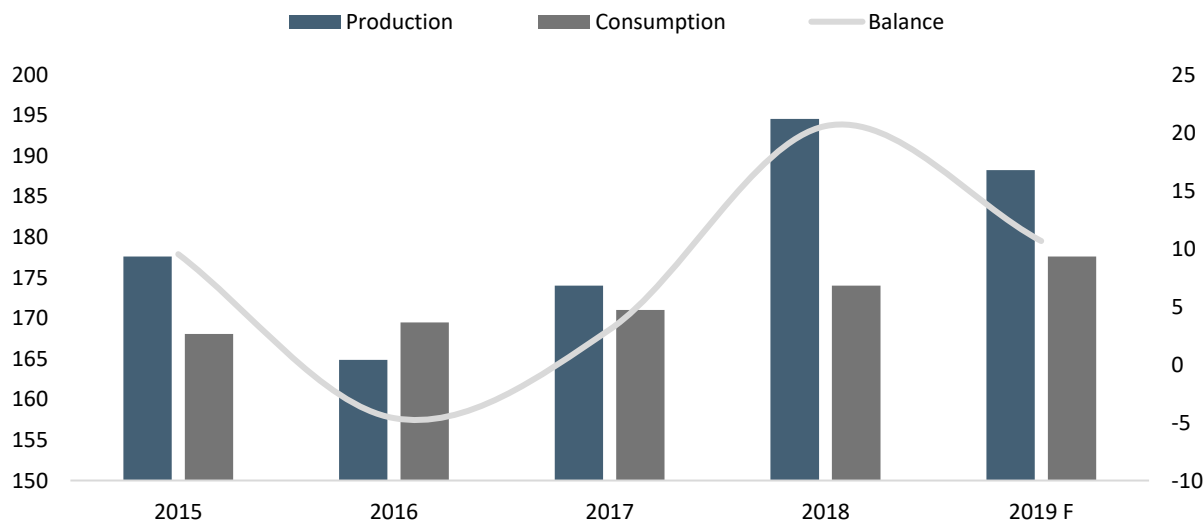
¹ Marketing year commenced in June 2018 and ends July 2019.

moderation in barley prices with USDA’s projection \$4.15/bushel (2017/2018E: \$4.47/bushel).

Soft demand for sugar strengthens market surplus

The glut in the global sugar market persisted this season, with a surplus of 20.6 million tonnes (higher than 3.0 million tonnes in 2017/2018 season which ended in May) in the 2018/2019² season. Concisely, increased production in India, EU and Thailand drove the sugar surplus, with global production up by 20.5 million tonnes to 194.6million tonnes in the 2018/2019 season – taming the decline in Brazil³ production as sugar producers switched to the production of ethanol due to unattractive sugar pricing. In India, favourable weather coupled with recently introduced government incentives in key producing states drove the increase in sugar production. In Thailand, it was a case of higher output in which was supported by expanded acreage as farmers substituted cassava planting for cane sugar due to attractive pricing. At the same time, additional sugar mills with improved crushing capacity further induced production in the review period, while removal of export quotas at the end of 2017 pushed production higher in the EU region. On the demand side, increased demand from India and UAE drove sugar consumption higher by 3.0 million tonnes to 174.0 million tonnes – albeit slower than the supply growth – following growing population and strong demand from food processors.

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



Source: USDA, ARM Research

² Marketing year started in May and ended in April 2019

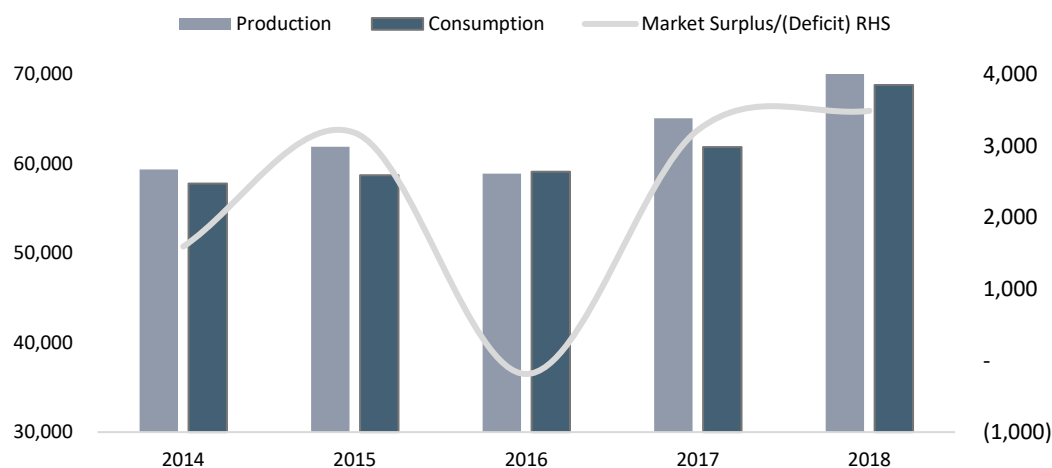
³ Brazil is the biggest producer of sugar

Going forward, global sugar production is estimated to drop by 6.3 million tonnes to 188.3 million tonnes, coming majorly from Brazil. Unfavourable weather conditions and diversion of cane sugar into the production of ethanol fuels the expectation of further declines in Brazil’s production. Also, consumption is expected to rise by 3.6 million tonnes to 177.6 million tonnes, with India being the major consumer. Strong demand from food processors and growing population is expected to support demand in India. Thus, leaving the market in a surplus of 10.6 million tonnes albeit lower than 2017/2018 surplus (17.7million tonnes) and a consequent decline in prices.

Prospect for resurfacing El nino provides respite for CPO prices

The surplus in the global crude palm oil (CPO) market widened further to 3.5 million tonnes (vs 3.2 million tonnes in 2017) in the ongoing 2018/2019 season, which accentuated the decline in prices by 28% YtD to \$430.6/million tonnes over 2018. The widening surplus stemmed from an increase in production by 2.98 million tonnes to 72.3 million tonnes following recovery in fresh fruits bunches as weather conditions improved in major Palm oil producing countries, and the waning effect of El nino (which dampened production in 2016), the impacts of both which raised higher palm produce in Indonesia (+4.5 million tonnes) and Malaysia (1.6 million tonnes) – both accounts for ~84% of global production. On the demand side, although EU’s decision to gradually phase out the use of palm oil in transport fuels from 2030 dampened Palm oil consumption in Europe, global consumption still rose 6.9 million tonnes to 68.8 million tonnes largely driven by growth in Indonesia (+2.2 million tonnes), India (+970 thousand tonnes) and China (+770 thousand tonnes).

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



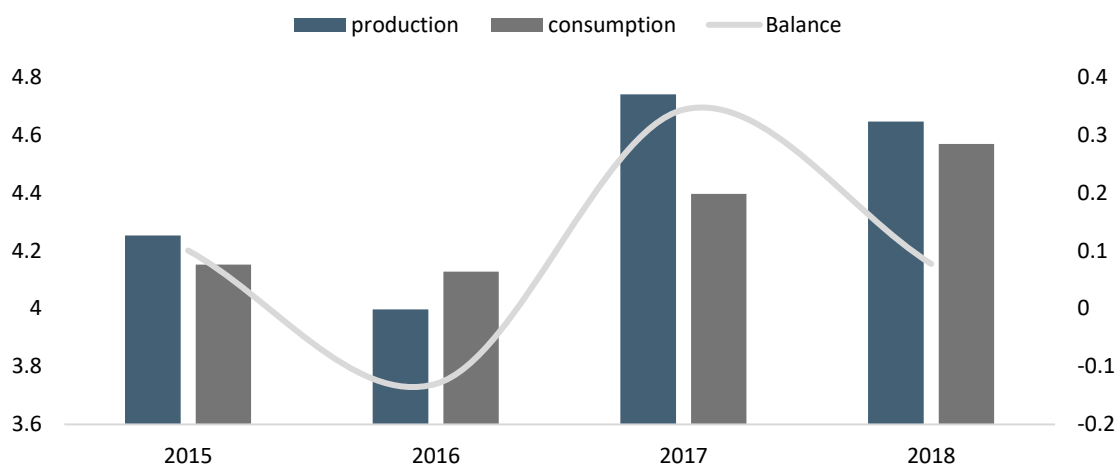
Source: USDA, ARM Research

Going into 2019, the demand picture is expected to weaken further following India’s decision to raise tariff charges on imported CPO to 44%, while refined CPO was raised to 54% from 40%. For context, India is the global leader of imported CPO with 22% of total global import. As a result of the tariff increase, the United State Department for Agriculture expects India’s import for 2018/2019 season to be 100 thousand tonnes shy of last year’s import (10.5 million tonnes). Overlaying this with the current supply picture points to widening CPO surplus (3.5 million tonnes) and a further depression in CPO prices. However, latest update from the World Meteorological Organization (WMO) reveals that there is a 70% chance of an El Niño developing by the end of 2018/2019 season. Although, its intensity is currently uncertain, the occurrence of it could propel prices higher over the short to medium term. That said, the confluence of a widening CPO surplus and possibility of an El nino taper our optimism for sizeable pickup in CPO prices, hence, we see room for marginal uptick in CPO prices over 2019.

Falling supply trims Cocoa Market surplus

The surplus position in the cocoa market trimmed in the 2018/2019 season to 77 thousand tonnes (2017/2018 surplus: 343 thousand tonnes) mirroring decrease in production. For clarity, production during the period printed at 4.6 million tonnes, down by 94 thousand tonnes – reflecting significant declines in Ghana and Cote D’ivoire due to poor rains and extreme hot weather during the main crop harvest. Consumption at the other end remained strong, up by 172 thousand tonnes to 4.5 million tonnes as increased processing margins – a fallout of the downtrend in cocoa prices encouraged higher cocoa grindings which supported increment in Netherlands and Cote D’ivoire.

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



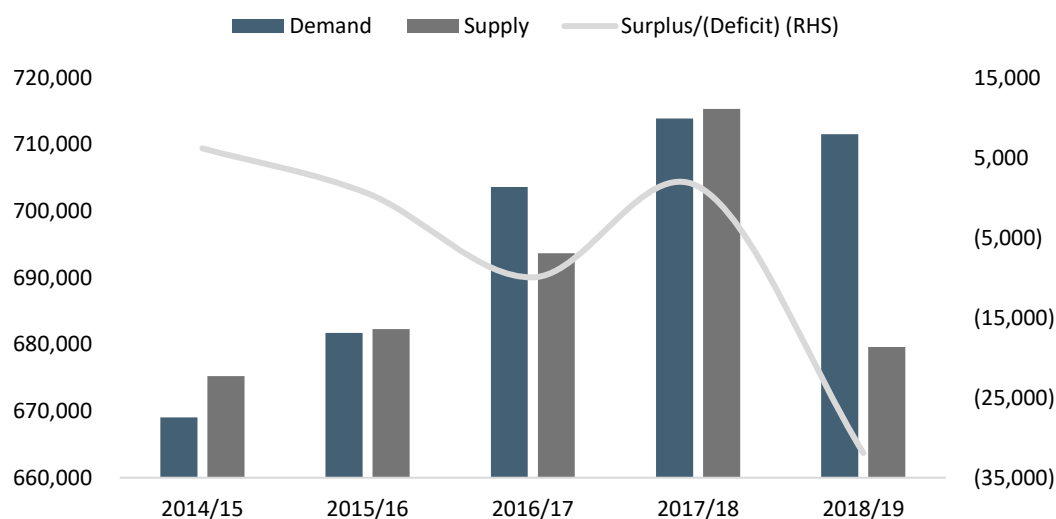
Source: ICCO, ARM Research

Going forward, cocoa prices are expected to gain 2% in 2019 according to USDA, as growth in consumption is expected to outpace production. Most of the cocoa production growth is expected to come from West Africa, notably Côte d’Ivoire, the world’s dominant cocoa producer due to the projected bumper crop. On consumption, improved processing margins would continue to encourage cocoa processing growth in Africa, Asia, and Europe, muting the decreases in America.

Faster plunge in Wheat production switch market condition

Coming into the 2018/2019 season, we anticipated a bullish run in wheat prices over H2 18 hinged on expectation of a market deficit following higher consumption from China, India and US. In line with our expectation, wheat prices rose in H2 2018 (+8% to \$514/bu). However, as against our prediction for higher consumption as underpinning for the bullish run in prices in the second half of the year, bulk of the pressure emanated from the supply side where weather related concerns are taking a toll on global production. To expatiate, whilst drought and heat waves are withering crops in Northern Europe, thereby leading to tight grain supplies in EU, unfavourable weather conditions during spring planting, dryness in major grain producing areas and uneven pace of harvesting decreased production and lower yields in Russia. This picture is further exacerbated by China’s decision to stock pile most of its wheat production to help meet a growing appetite for high-protein varieties for products like bread and other baked products as diets become Westernized.

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



Source: USDA, ARM Research

Going forward, the outlook for global wheat supply appears bleak owing to lower production in Australia, China, European Union and Russia. To buttress, for the three countries, USDA

projects a cumulative decrease of 37.9 million tonnes on continued dry conditions, possible frost damage and ongoing trade war. Specifically, Australia (18.5 million tonnes) is expected to record its smallest production since 2007/08 season on extreme weather condition. Furthermore, Russia's wheat production is expected to reduce by 18% YoY to 70 million tonnes on account of lower than expected yields in some spring wheat areas. On demand, global consumption is expected to decline 0.3% YoY to 711 million tonnes, primarily due to lower consumption in EU, Russia and Ukraine. Overall, with estimated global consumption of 711 million tonnes, compared to global production of 679.6 million tonnes, market is expected to switch to a deficit of 31.9 million tonnes, implying a bullish run in wheat prices over the 2018/2019 season.

Mixed commodities prices: varied impact on Nigerian FMCGs

On balance, the latest update from the World Meteorological Organization (WMO) which reveals that the occurrence of an El Niño is imminent provides some respite for global CPO prices. Hence, we remain somewhat optimistic on local CPO prices albeit, moderated due to subsisting market surplus and India's⁴ decision to hike tariff charges on imported CPO. Similarly, our expectation for subsisting deficit in the global wheat market owing to tamer plunge in global consumption and faster plunge in global production (-5% YoY to 679.6 million tonnes) is positive for global wheat prices. For barley, the faster decline in consumption relative to supply translates to a lower deficit and invariably lower prices over the 2018/2019 season. Lastly, Cocoa prices are expected to rise over 2019 as consumption is expected to outpace production.

That said, delineating the impact of trends in global soft commodity markets on corporates in the Nigerian FMCG sector, our bearish price outlook for raw sugar in 2018 guides to lower costs of sales and higher 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. Similarly, our expectation for lower barley prices bodes well for brewers including Nigerian Breweries, Guinness Nigeria, and International Breweries. Especially, given the intense bout for market share in the brewery sector, we think lower barley prices which could translate to margin expansion for sector players provides momentary respite against further increases to the excise duty scheduled to commence in January 2019 (+17% to ₦0.35). Furthermore, the prospect for slight uptick in global CPO prices is positive for palm oil manufacturers, Okomu Oil and Presco, given the direct pass-through of international CPO prices to domestic prices.

⁴ India is the largest importer of Crude palm oil in the world

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