

January 14, 2020



# Nigeria Strategy Report

H1 2020

Global Economy and Markets

## Contrasting fortunes for global soft commodity market

### Executive Summary

Over the 2018/19 market year, the S&P GSCI Agricultural index declined 3.31%. In line with our expectations, wheat which makes up 21.14% of the index, was down over its market year (MY). Moderation in wheat prices (-2.94%) outweighed the uptick in sugar prices (+2.89%) as sugar accounts for 19.45% of the S&P GSCI index. This was largely driven by improved weather conditions which boosted the harvest in top producing countries. Elsewhere, while cocoa production jumped, consumption rose faster translating to higher prices over its marketing year. Barley and Crude Palm Oil (CPO), both of which are not included in the GSCI Agricultural index, saw their prices rise over the period on the back of lower production in the former and higher consumption in the latter.

Going into the 2019/20 season, more favourable weather conditions in key producing countries such as EU, Argentina, Ukraine and China should lead overall wheat production higher by 4.69%. This alongside expectation of tamer wheat consumption (+2.59% YoY) should sustain the bearish run in prices. Sugar prices, meanwhile, are expected to rise as a result of a possible switch in global sugar market to a deficit due to a faster decline in production levels (-6.6%). Unfavourable weather in India; lower yields and extraction rates in EU and Thailand; and a diversion of sugarcane towards ethanol production in Brazil are the reasons for the fall in sugar production. Similarly, CPO prices are predicted to rise on the back of faster growth in consumption (+3% YoY) than production (+2% YoY). As barley production rises faster than consumption, the market is expected to move into its first surplus since the 2015/16 season which should lead to a moderation in prices. Finally, a decline in production for the largest producer—Ivory Coast, and sustained rise in demand in Asia should see cocoa prices rise.

***In this report, we look at the major themes that dominated the soft Commodities market in H2 2019 as well as our outlook for prices for 2020.***

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**Table 1: Average Price Movement across soft commodities**

Commodity	H2 19	H1 19	H2 18	FY 18	YoY change
Barley (\$/Tonne)	1943.1	1775	1674.3	1591.3	16.05%
Cocoa (\$/Tonne)	2430.1	2331.4	2251.2	2308.9	7.95%
Crude Palm Oil(\$/Tonne)	537.0	497.5	513.556	559.3	4.56%
Sugar (\$/Tonne)	12.2	12.4	11.8	12.2	2.89%
Wheat(\$/Bushel)	499.3	482.9	514.4	495.6	-2.94%

Source: Bloomberg, ARM Research

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

(Million Tonnes)	2019/2020			2018/2019		
	Commodity	Supply	Demand	Balance	Supply	Demand
Barley	156.8	153	3.8	139.6	140.9	-1.3
Cocoa <sup>1*</sup>	4.83	4.81	-0.21	4.65	4.60	8*
Crude Palm Oil	75.69	74.62	1.08	73.90	72.73	1.17
Sugar	174.14	174.68	-0.54	180.73	176.45	4.28
Wheat	765.55	755.17	10.38	765.23	755.11	10.12

Source: USDA, ICCO, ARM Research

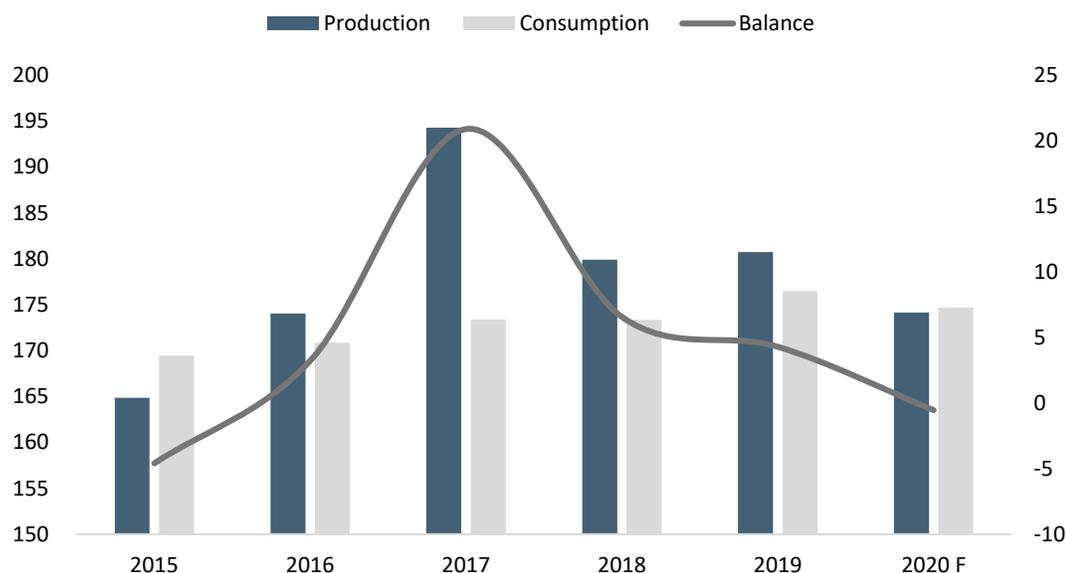
***Sugar - Market deficit knocks as global sugar output wanes***

Analogous to H1 2019, global sugar market remained over supplied in the second half of the year. However, in relation to the previous market year<sup>2</sup>, the glut in the global market moderated by 2.27 million MT to 4.29 million MT in 2019/2020 market year. The narrowing surplus was largely due

<sup>1</sup> ICCO provides data for grindings and not total demand, hence the disparity in balance.<sup>2</sup> Glut in global sugar market was 6.6 million MT in 2018

to increased demand. Precisely, growing population and increased sugar demand in major sugar consuming countries like India (+3.6% YoY), United States (+0.6% YoY), Pakistan (+3.7% YoY) drove an expansion in global consumption by 3.1 million MT to 176.4 million MT. On the supply side, production was relatively flat, advancing 0.47% YoY to 180.7 million MT. For context, Brazil’s production increased by 8% YoY to 32 million MT as more sugar cane (38% of total cane harvest was diverted to sugar production compared 2018/2019 marketing year, where only 35.9% was crushed into sugar. According to USDA, sugar production was more attractive relative to ethanol production during the period due to increased demand for sugar in the global market. Meanwhile, EU’s recovery from a drought in 2018 further supported the increase in output by 10% YoY to 19.4 million MT. Despite increased output in EU and Brazil, market remained relatively flat due to supply pressures from India. Precisely, India’s sugar supply dipped -12% YoY to 30.3 million MT as heavy rainfall and waterlogging adversely impacted yields. Overall, due to faster rise in demand relative to supply, the second half of the year saw a 2.9% YoY increase in sugar prices to 12.17 cents/lb on average as market surplus trimmed.

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



Source: USDA, ARM research

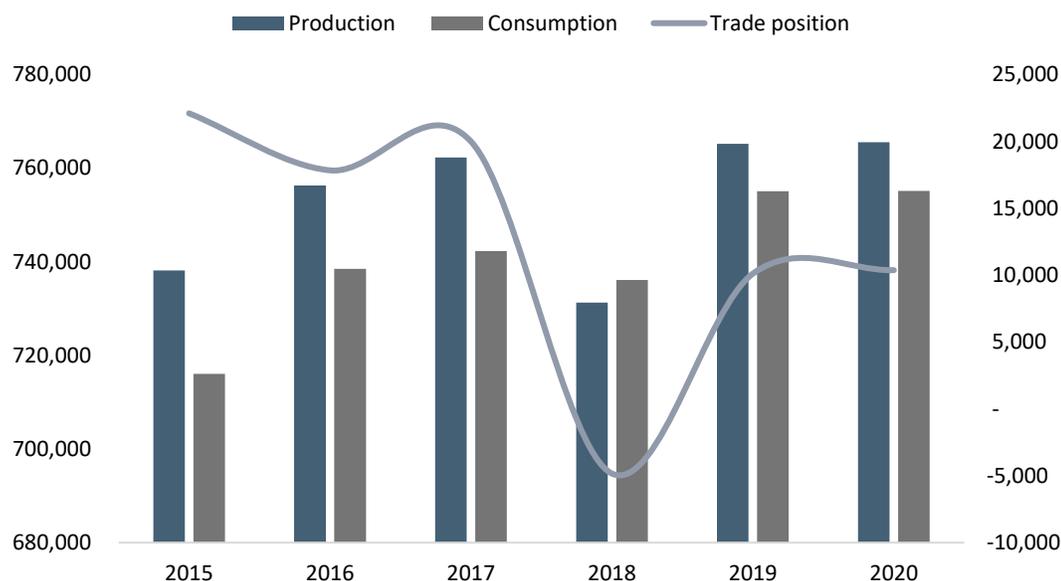
For the rest of the 2019/2020<sup>3</sup> marketing year, we expect a reversal in the global sugar market to a deficit position due to a faster decline in production levels. According to USDA, global production is expected to decline by 6 million MT to 174 million MT (-6.6% YoY) hinged on the anticipated drop in India’s production level on persisting weather concerns.

<sup>3</sup> Relative to May 2019/2020 period

Furthermore, lower sugarcane yields and sugar extraction rates in US, Thailand, Australia and Mexico could also further curtail output. For Brazil, less diversion of sugarcane towards sugar production (USDA estimates 35% of sugarcane will be used for sugar production) for the rest of the season could contribute to overall decline in production. Going forward, Brazilian producers are expected to favour more ethanol production over sugar as domestic demand for ethanol is expected to rise. That said, USDA projects an 8% decline in Brazil's sugar production to 29.4 million MT. Similarly, consumption is expected to decline, albeit on a softer pace by 1.7 million MT to 174.7 MT (-1.0% YoY) mirroring reduced consumption mainly in US, Mexico, Malaysia, Saudi Arabia and other countries, according to USDA. Overall, we expect the sharper decline in production to outweigh the moderation in consumption, bringing global sugar market to a deficit position of 540,000 MT – and a consequent rise in prices over the 2019/2020 season.

### ***Wheat - Faster growth in production spurs continuous surplus***

In line with our forecast for the 2019/2020 season which began in July, the global wheat market went into surplus following faster growth in wheat production (+4.64% YoY) than consumption (+2.58% YoY). Specifically, increased production in European Union (+11% to 152 million MT), Ukraine (+15% YoY to 28.7 million MT), Argentina (+5% YoY to 20.5 million MT), Australia (+4% YoY to 18 million MT) and Iran (+16% YoY to 16.8 million MT) buoyed supply. For context, in the EU and Ukraine, production came in stronger YoY (from a low base in 2018) following improved weather conditions. Similarly, Australia's production improved following an easing in drought conditions in some regions. Meanwhile, consumption firmed by 19 million MT to 755.1 million MT albeit slower relative to supply, following increased demand in China (+2% YoY to 128 million MT), EU (+3% YoY to 127.5 million MT) and India (+2% YoY to 98 million MT) amongst other countries. Against this backdrop, average wheat prices declined by -2.94% YoY in H2 19 to \$499.3/bu.

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

Source: USDA, ARM Research

For the rest of 2019/2020<sup>4</sup> marketing year, wheat production is forecast<sup>5</sup> to be up by 34.3 million MT (+4.69% YoY) to 765.5 million MT<sup>6</sup> mostly due to improved weather conditions from countries such as EU (+11% YoY to 153 million MT), Ukraine (+16% YoY to 29 million MT), India (+2% YoY to 102.2 million MT) and Argentina (+3% YoY to 20 million MT), encouraging modest expansion. Notably, widespread of rainfall in EU has eased soil dryness. This, in addition to good climate conditions in Ukraine and China leaves decent harvest expectation. On demand, global consumption is expected to increase by 2.59% YoY to 755 million MT relative to 2018/2019 marketing year, primarily due to higher consumption in EU, India and China. However, compared to H2 2019, consumption is expected to remain flat. Overall, with estimated global production of 765 million MT, compared to global consumption of 755 million MT, market is expected to remain in a surplus position of 10.4 million MT, implying a bearish run in wheat prices over the 2019/2020 season.

### ***CPO - Market surplus curtailed as consumption takes the lead***

The glut in global crude palm oil (CPO) market reduced to ~1.2 million MT<sup>7</sup> (vs revised 4.1 million MT recorded in the prior year) which consequently led to uptick in CPO prices over

<sup>4</sup> Marketing year for wheat begins July and ends in June.

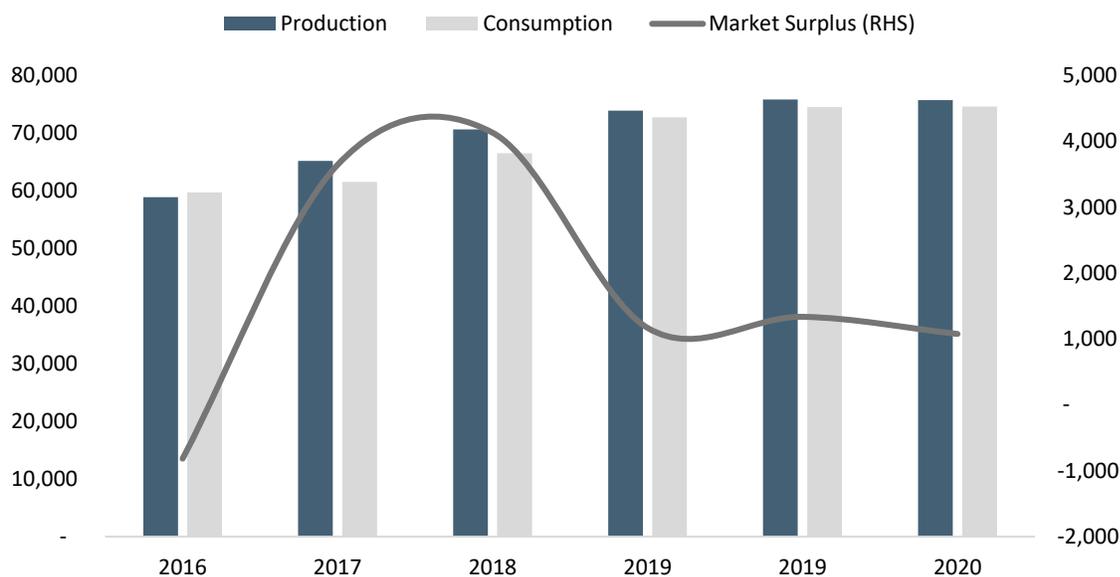
<sup>5</sup> By USDA.

<sup>6</sup> Compared to 2018/2019 marketing year.

<sup>7</sup> Surplus declined during the 2018/2019 marketing year which began in October 2018 and ended in September 2019.

the period (+4.6% YoY to \$536.9/million MT). The moderation in market surplus emanated from a higher CPO consumption in Indonesia, Malaysia, China and European Union which accounts for 50% of global consumption and 70% of the increase in CPO demand over the prior year. For Indonesia, the mandatory increase in palm oil content by 20%<sup>8</sup> in biodiesel continued to bolster demand. Furthermore, Malaysia’s improved trading deal with China to supply about 1.5 million MT of CPO by 2020 in addition to the implementation of B10 biodiesel mandate which kicked off earlier this year<sup>9</sup>, contributed to the uptick in global consumption. In EU, following the cut back on the use of palm oil transport fuels due to excessive deforestation, the European Commission recently<sup>10</sup> imposed temporary duties (ranging from 8% to 18%) on imports of subsidized biodiesel from Indonesia. Despite this development, EU’s consumption increased 4% YoY to 7.2 million MT. Meanwhile, the adverse impact of trade war on China’s soybean volume led to the substitution of crude palm oil. Consequently, China earlier this year, signed an MoU with Malaysia to expand purchase of CPO by an additional 1.9 million MT between 2019 and 2023, thus increasing demand. Overall, consumption rose 9% YoY to 72.7 million MT. On the other hand, global CPO output increased, albeit at a slower pace relative to demand (+5% YoY to 73.9 million MT). According to USDA, declines in output from other palm oil producing countries such as Colombia and Nigeria led to slower growth in output during the period under review.

**Figure 3: Trend in CPO Production, consumption and trade balance (Million tonnes)**



Source: USDA, ARM research

<sup>8</sup> Implemented in September 2018.

<sup>9</sup> February 2019.

<sup>10</sup> EU Tariffs on Indonesia was imposed on December 9th, 2019.

Through the rest of the 2019/2020<sup>11</sup> season, the surplus in global crude market is expected to decline further, albeit on a softer pace by 8% YoY to 1.08 million MT on the back of faster growth in consumption relative to supply. Precisely, we expect a tepid growth in production of CPO (+2% YoY to 75.6 million MT) due to dry weather conditions as well as low fertiliser application in the world's top producers – Indonesia and Malaysia. Concisely, fertilizer application in these countries was reduced in H1 2019 in order to cut production costs. On the other hand, consumption is expected to tick 3% higher to 74.6 million MT. For context, increased demand for CPO in Indonesia (+1% YoY to 12.8 million MT), India (+4% YoY to 10.2 million MT), China (+3% YoY to 7.2 million MT) and Malaysia (+5% YoY to 3.7 million MT) is expected to drive consumption during the period. Over in Indonesia, further increase of the palm oil content in biodiesel from 20% to 30% by January 2020 is expected to drive demand (+1% YoY to 12.7 million MT). While in China, the substitution of soybean for crude palm oil is expected to buoy consumption for CPO going forward. Furthermore, China's decision to remove import tariff on Palm oil raises prospects for increased global consumption. Consequently, USDA projects China's importation of CPO to grow by 6% YoY in 2019/20 season. Meanwhile in India, growth in general population suggests stable demand for palm oil.

We expect this to offset the impact of lower EU's consumption (-1% YoY to 7.1 million MT). For clarity, the impact of the recently imposed tariffs by EU (ranging from 8% to 18%) on imports of subsidized biodiesel from Indonesia is expected to kick-in going into 2020. In all, overlaying the faster increase in global CPO consumption relative to supply implies curtailed market surplus, paving way for increased CPO prices for the rest of 2019/2020 season.

### ***Barley - Major players to bounce back***

Over the past MY<sup>12</sup>, the deficit in the barley market narrowed by 58% to 1.3 million MT (2017/18: 3.1 million MT) as consumption dropped faster than production. Global production of barley fell 2.5% to 139.6 million MT (2017/18: 143.1 million MT) mirroring declines across the two largest producers – the EU and Russia. Specifically, production in the EU dropped by 4.7% YoY as drought affected the harvest in France and Germany, the two biggest producers in the bloc. Similarly, production in Russia slipped 17.2% as a result of bad weather conditions during spring planting and lower than expected yield from the top producing regions. With production declining, average price rose 20.3% YoY to \$1755.26 over 2018/19. Consequently, global consumption fell 3.6% YoY to 140.9 million MT

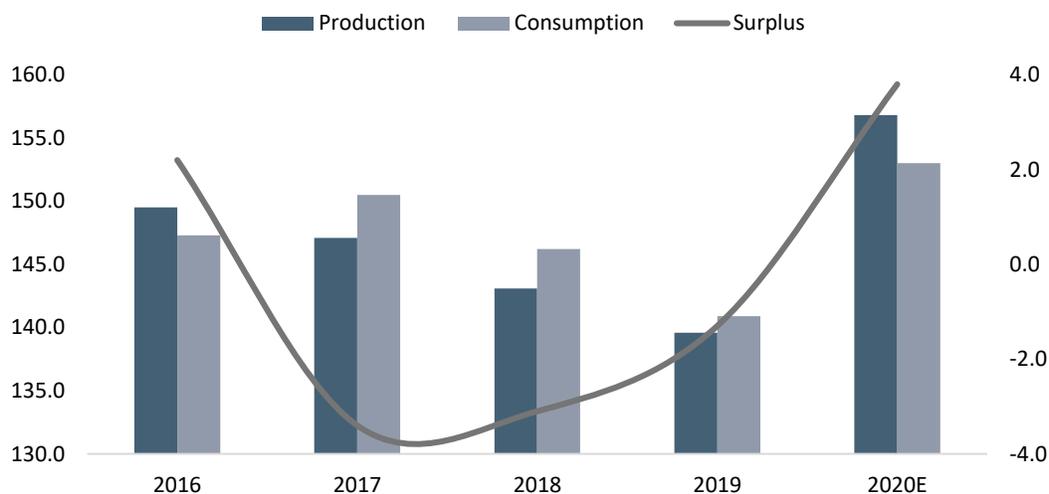
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<sup>11</sup> 2019/2020 season falls between October 2019 and September 2020

<sup>12</sup> Between October 2018 and September 2019

(2017/18: 146.2 million MT) as demand switched to cheaper substitutes such as corn, soybean meal and sunflower seed meal. The 2 largest consumers, EU and Russia, saw their combined consumption decline by 6.9%.

**Figure 4: Trend in Barley production, consumption and trade balance (Million Tonnes)**



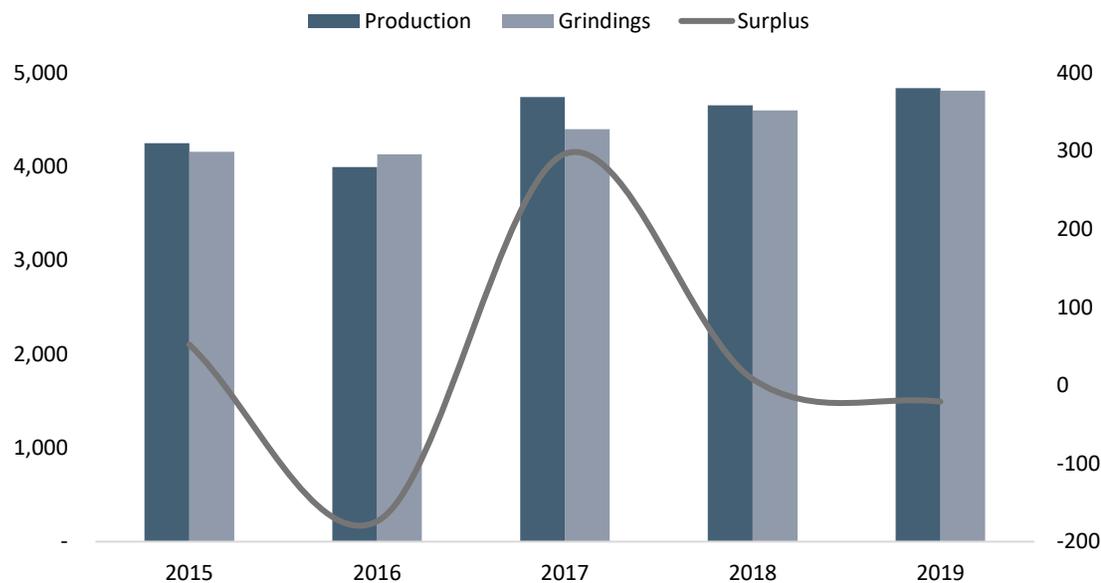
Source: USDA, ARM Research

Looking ahead to the 2019/20 season, the USDA expects the barley market to move into a surplus of 3.8 million MT, its first surplus since the 2015/16 season. This will arise from a faster rise in production than consumption. Global production is set to rise 12.3% to 156.8 million MT, the highest since the 1994/95 season. The EU, which accounts for 40% of global production, is predicted to grow 11.4% to 62.3 million MT which would be their largest crop since the 2015/16 season. This follows on from an increased total planted area in the four largest producers (France, Germany, Spain and UK) but also a recovery in average yield. France, for example, will be close to record yields due to good weather conditions throughout the growing season. After an off year, production in Russia is expected to return to average levels, rising 19.5% to 20 million MT. The improvement in Russia came as June rains aided production in the Black Soil and Volga regions ensuring that barley was unaffected by the drought that hit other regions. Global consumption, meanwhile, is expected to rise 8.6% to 153.0 million MT over 2019/20. This will be spearheaded by the EU where a recovery in feed use, largely due to increased domestic availability following the forecast rise in production, will see their consumption rise 6.4% to 54.9 million MT (2018/2019: 51.6 million MT). Further supporting the increase in consumption is a narrowing of the price gap between barley and corn which is making the latter a less attractive substitute. Given these factors, we expect barley prices to moderate this upcoming season.

**Cocoa – Market swings to deficit despite record year for top producer**

The ICCO estimates that over the most recent MY<sup>13</sup>, global production of cocoa rose 3.9% to 4.83 million tonnes (2017/18: 4.65 million tonnes). This increase was led by the world’s largest cocoa producer, Ivory Coast, where production reached a new record of c.2.16 million tonnes (previous record - 2016/17: 2.02 million tonnes). This marked a 10.7% increase from the previous season (2017/18: 1.95 million tonnes) and came amidst favourable weather conditions and new plantations. Increased production in Cameroon, by 8% to 270,000 tonnes, and in Ecuador, also by 8% to 310,000, further supported growth in overall global production. On the other hand, production in Ghana, declined by 8.2% YoY to 830,000 tonnes as output was severely constrained by a drought and an outbreak of the *Cocoa Swollen Shoot Virus Disease* (CSSVD). Global grindings, meanwhile, rose 4.6% to 4.81 million tonnes (2017/18: 4.59 million tonnes) reflecting a 14.3% YoY growth in processing activities in Asia and Oceania. According to the ICCO, demand outstripped supply over the past MY due to increased grinding in Asia and Oceania. This resulted in a market deficit of 21,000 tonnes, compared to a surplus of 8,000 tonnes in 2017/18. However, average price rose just slightly by 0.97% over 2018/19 to \$2,295.5.

**Figure 5: Trend in Cocoa production, consumption and trade balance (Thousand Tonnes)**



Source: ICCO, ARM Research

<sup>13</sup> Between October 2018 and September 2019

Looking ahead, the ICCO forecasts contrasting fortunes for the two largest producers. Ivory Coast's output is anticipated to fall by 7.4% to 2 million tonnes, while Ghana should bounce back from last season's difficulties to increase its output by 2.4% to 850,000. Overall, the expectation is for a lower output this upcoming season. On the consumption side, Cameroonian officials indicated that grindings should double this season following investments in their processing capacities and this should provide a boost to their consumption. Ultimately, global demand, and to a large extent the continuation of the market deficit, will be determined by whether Asian cocoa demand can hold up. Market research carried out and referenced by the Cocoa Association of Asia (CAA), refers to the Asia-Pacific as the fastest growing market for chocolates with an estimated CAGR of 6.3% during the forecast period (2019-2024), supporting the idea that demand can indeed hold up. This growth is simply being driven by the rise in wealthy people who consume more confectionaries and drinks, as well as growth in artisan premium chocolates. Additionally, Ghana and Ivory Coast have both increased their farmgate prices by 8% (to \$1,528) and 10% (to 1,394) respectively. The combined effect of all these should see a rise in average price in 2019/20.

### *Soft landing on the horizon for most FMCG players*

Given the foregoing, we examine the impact of our expectations in global soft commodity markets on corporates in the Nigerian FMCG sector. We expect lower cost and subsequently better margins for Flour Mills of Nigeria Plc as our forecast for lower wheat prices would curtail production costs from their food segment which accounts for bulk of flour mill's revenue. Events related to CPO both globally and locally are positive for local Palm Oil producers – Okomu and Presco. Globally, our case for tamer market surplus in global CPO market implies increase in global CPO prices going forward. Furthermore, domestic CPO prices is expected to reflect the upward trend in global CPO prices. This, in addition to border closure in the domestic scene which tapered smuggling of CPO into the country, encourages more consumption of local products, hence paving way for higher sales local palm oil producers.

Elsewhere, imported raw materials accounts for roughly 60% total of production costs for local Breweries sector. Given that barley is majorly imported, fluctuation in barley prices directly impacts the cost of production for local brewery companies. That said, our expectations on lower barley prices in 2019/2020 season indicates lower production cost and in turn improved margins for local companies including Nigerian Breweries, International breweries and Guinness Nigeria Plc.

Although our expectation on increased sugar prices adversely affects both local refiners (including Dangote Sugar and Golden Penny sugar), and smugglers, the closure of the domestic land borders makes smuggling of sugar unattractive, which bodes well for local refiners. While we expect

compressed margins for refined sugar manufacturers due to increased cost of production, we do not rule out expansion in market share owing to increased volumes. Our expectation on increased volumes is hinged on curtailed smuggling of sugar into the country. On prices, we do not expect local sugar refiners to significantly increase prices as this action may erode the impact of the border closure and subsequently encourage the demand for smuggled products. Also, we see scope for increased cost of production precisely for companies such as Nestle and Cadbury who use sugar as part of their raw material for production. This ultimately translates to lower margins.

Likewise, our expectation for increased cocoa prices signals raw material cost pressures for beverage producing companies such as Cadbury and Nestle due to their reliance on importation of cocoa for production.

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