

Nigeria Strategy Report

H1 2020

Domestic Economy and Policy Environment

Nigerian Fiscal: Same old story

Executive Summary

In a seemingly unusual fashion, the 2020 budget was passed by the National Assembly in December— ~five months earlier than the norm over the past few years. While the early passage of the budget provides cause for cheer as it bodes well for FG’s fiscal cycle and its fiscal deficit financing, concerns regarding the realistic nature of specific line items in the budget lingers. That said, taking a look at the budget’s performance over the first nine months of 2019, actual federal retained revenue fell short of prorated budgeted estimate by 19%, however it is 64.8% higher than same period in the prior year. The shortfall emanated largely from lower than projected oil and non-oil receipts. On expenditure, despite lower retained revenue, FG was able to disburse 87% of its budgeted spend over the period. Bulk of this came from higher disbursement for non-debt recurrent expenditure (~96%) and debt service (~100%) while capital expenditure spends (~16%) remained frail.

Going into 2020, we remain bearish on FG’s oil revenue estimate and expect oil receipts to print at ₦1.4 trillion which captures our expectation for lower oil production and oil prices (\$61.3/bbl.). Akin to 2019, this could spell doom for FG’s finances over the period. Similarly, we expect the underperformance in non-oil receipts to linger into 2020 due to FG’s overly ambitious estimates. On expenditure, assuming 100% implementation of recurrent expenditure and much lower capital expenditure of 45.2% (5-year average of 59%, and FY 18 of 57%), we estimate total expenditure of ₦7.88 trillion in 2020, which overlaid on our projected revenue scenarios suggests that the fiscal deficit could hover in excess of ₦3 trillion (Base fiscal deficit: ₦3.7 trillion). In financing its proposed fiscal deficit of ₦1.85 trillion, the FG has penned down different financing sources. FG’s expects to source ₦744.9 billion locally, ₦850 billion via foreign sources and ₦328 billion from Multi-lateral / Bi lateral loan draw down. That said, while we see room for a Eurobond issuance this year as FG appears keen, we do not rule out sizeable domestic paper issuances—particularly at the long end to cater for possible short fall in revenues and need to take advantage of the lower interest rate environment.

In this report, we focus on developments in the fiscal space over H2 2019 and delineate our view on the FG’s 2020 Budget.

Approved 2020 Budget: Any difference?

In a seemingly unusual fashion, the 2020 budget was passed by the National Assembly in December— ~five months earlier than the norm over the past few years. While the early passage of the budget provides cause for cheer as it bodes well for FG’s fiscal cycle and its fiscal deficit financing, concerns regarding the realistic nature of specific line items in the budget lingers. Compared to the proposed outlay in 2019 (₦8.91 trillion), planned budget for 2020 (₦9.7 trillion) is 8.9% higher than prior year. The higher fiscal outlay in 2020 emanated from higher debt service (+20.92% to ₦2.7 trillion) and non-debt recurrent expenditure (+10.43% to ₦4.84 trillion). The increase in non-debt recurrent expenditure reflects higher personnel cost; which in our view, points to the minimum wage increase by the FG. Furthermore, the higher debt service mirrors accretion of external debt over the last few years. Away from recurrent expenditure, the FG projects a 3.62% YoY slump to ₦2.27 trillion in budgeted capital expenditure. This appears surprising given the dearth of infrastructure in the country and the need to attract foreign capital.

On the revenue side, the FG projects a 10.87% rise in budgeted federal retained revenues to ₦8.4 trillion. Akin to prior periods, the revenue picture is driven by higher independent revenue (+34.7% YoY to ₦849 billion), other revenue and FG’s optimistic expectation for its non-oil revenues (+28% YoY to ₦1.8 trillion) which offsets declines in Oil revenues (-28.5% YoY to ₦2.6 trillion). Further breakdown reveals that the jump in non-oil revenue reflects higher custom revenues which almost doubled to ₦618.6 billion. In our view, the higher customs revenue is on the back of closure of Nigeria’s land borders in August 2019 and its rebounding effect on boosting custom duties collection. Elsewhere, FG anticipates higher signature bonuses in 2020 which is expected to bolster its other revenues line. For us, this is reminiscent of renewal of oil licenses by IOCs over the period. For clarity, media reports late last year reveal that the Federal Government plans to renew licenses for 42 oil blocks held by the IOCs. Overall, the sum of FG’s upbeat revenue expectations translates into slimmer budgeted deficit (-3.73% YoY to ₦1.85 trillion) than prior year.

Table 1: Key highlights of the 2020 approved budget

	Approved 2020 budget	2019 Budget	9M 2019 Actual
Oil production (mbpd)	2.18	2.3	1.96
Oil price (\$/bbl.)	57	60	64.02
Exchange rate (₦/\$)	305	305	305.9
FG Share of oil revenue (₦' billion)	2,638	3,688	1,441
Total Non-Oil revenue (₦' billion)	5,102	3,310	2,811
FG Total revenue (₦' billion)	7,866	6,998	4,253
FGN Expenditure (₦' billion)	9,712	8,917	5,811
Fiscal deficit (₦' billion)	-1,847	-1,918	-1,559

Source: Budget office, CBN, ARM Research

9M 2019 Budget Implementation; Federal retained revenue remains a drag

Over the first nine months of 2019, actual federal retained revenue fell short of prorated budgeted estimate by 19%, however 64.8% higher than same period in the prior year. The shortfall emanated largely from lower than projected oil and non-oil receipts. On oil revenue, according to the budget office of the federation, budget implementation report for the first nine months revealed that actual oil receipts fell short of expectation by 62.6% due to lower than anticipated crude-oil and gas exports, domestic crude oil and gas sales, and PPT/Royalties. Relative to FG's projections, the slow-down in constituents of oil receipt largely reflects sizable shortfall in crude oil production (~2.02bpd average vs budgeted estimate of 2.3bpd) as prices were 8% higher than FG's budgeted estimate over the review period. However, when compared to the prior year, oil revenue was up 0.5% which in our view mirrors higher crude oil production compared to the prior period. For context, while crude oil production over the first nine months of 2018 printed at 1.93bpd, it was 5% higher in 2019. On the non-oil side of things, revenue slightly underperformed by 5.7% to ₦996.3 billion. The decline relative to budgeted estimate stemmed from lower company income tax (-2.4% to ₦595.3 billion) and lower value added tax collection (-31.2% to ₦118.3 billion). Contrarily, compared to prior period last year, FG's actual non-oil revenue largely outperformed by 18.7% YoY. This is reflecting impressive revenue collection from value added tax (+8.2%), company income tax (+19%), customs revenue (+23.8%) and higher special levies (+13.1%).

On expenditure leg, despite lower retained revenue, FG was able to disburse 87% of its budgeted spend over the period. Bulk of this came from higher disbursement for non-debt recurrent expenditure (~96%) and debt service (~100%) while capital expenditure spends (~16%) remained frail. Although the capital expenditure spend appears abysmally low and provides a cause for concern, we highlight the late passage of the budget as possible cause and do not rule out implementation of 2019 full year budget gravitating towards historical average of 45/50% by the end of the budget cycle. Overall, given the massive shortfall in federal retained revenues, fiscal deficit printed at ₦1.6 trillion compared to 9M budgeted estimate of ₦1.4 trillion.

Table 2: Implementation of the 2019 budget approved between January – May

(₦' billion)	2019 Approved Budget	Prorated Jan - Sept	Actuals (Jan - Sept 19)	Actuals (Jan - Sept 18)
Retained Revenue	6,999	5,249	4,253	2,797
Oil Revenue	3,688	2,766	1,441	1,604
Non-Oil Revenue	1,409	1,057	996	814
FGN Independent Revenue	631	473	507	311
Others	1,270	952	1,308	68
Expenditure	8,917	6,688	5,811	4,854
Recurrent	6,320	4,740	5,092	4,114
Capital	2,095	1,571	372	398
Surplus (+)/Deficit (-)	-1,918	-1,439	-1,559	-2,057
Borrowings	1,606	618.6	636	909

Source: CBN, ARM Research

Source: CBN, ARM Research

2020 Budget; Higher fiscal deficit still a stain

Going into 2020, we remain bearish on FG's oil revenue estimate and expect oil receipts to print at ₦1.4 trillion which captures our expectation for lower oil production and oil prices (\$61.3/bbl.). Akin to 2019, this could spell doom for FG's finances over the period. Similarly, we expect the underperformance in non-oil receipts to linger into 2020 due to FG's overly ambitious estimates. Thus, while we forecast other revenue of ₦950 billion over the period, we expect a sizeable underperformance in 2020 non-oil revenue (₦1.29 trillion) relative to budgeted estimate of ₦1.8 trillion. For context, although the recent increase in VAT (from 5% to 7.5%) provides some support, Nigeria's tax net which remains abysmally low (with tax to GDP of 4% in 2018), makes sizeable expansion in other non-oil revenue difficult.

Elsewhere on expenditure, assuming 100% implementation of recurrent expenditure, which typically runs January – December and much lower capital expenditure of 45.2% (5-year average of 59%, and FY 18 of 57%), we estimate total expenditure of ₦7.88 trillion in 2020, which overlaid on our projected revenue scenarios suggests that the fiscal deficit could hover in excess of ₦3 trillion (Base fiscal deficit: ₦3.7 trillion).

2020 Fiscal deficit financing: External borrowings to the rescue

In financing its proposed fiscal deficit of ₦1.85 trillion, the FG has penned down different financing sources. FG's expects to source ₦744.9 billion locally, ₦850 billion via foreign sources and ₦328 billion from Multi-lateral / Bi lateral loan draw down. For us, given the current lower interest rate environment in the country which affords the FG ample opportunity to trim its cost of borrowings, we find the expectation for higher external borrowings worrisome. Especially, given looming risk of potential naira devaluation which could make servicing future dollar debt obligations a strain. That said, while we see room for a Eurobond issuance this year as FG appears keen, we do not rule out sizeable domestic paper issuances—particularly at the long end to cater for possible short fall in revenues and need to take advantage of the lower interest rate environment. Our view is premised on 1.) the lower interest rate environment 2.) little reliance on CBN's back door funding given sizeable slash in CBN's OMO issuances 3.) need to cover funding gaps that could emanate from underperformance of its revenue estimate.

ARM Securities Contact

Research	234 (1) 2701653	<u>research@armsecurities.com.ng</u>
Institutional Sales & Trading	234 (1) 448 8833	<u>trading@armsecurities.com.ng</u>
Customer Service	234 (1) 4488282	<u>customerservice@armsecurities.com.ng</u>

Copyright © 2020 Asset & Resource Management Company Limited (“ARM”).

All rights reserved. Unauthorized use, reproduction, distribution, or disclosure of this document is strictly prohibited.

This material has been issued by Asset & Resource Management Company Limited (“ARM”), a Company regulated by the Nigerian Securities and Exchange Commission. The analyst(s) primarily responsible for preparing this research report, in whole or in part, certifies that with respect to each security or issuer covered; all of the views expressed accurately reflect his/her personal views about the subject securities and issuers and no part of his/her compensation was, is, or will be, directly or indirectly, related to the inclusion of specific recommendations or views in the report.

This research report is based on information from sources that ARM, and its analysts believe to be reliable. Neither ARM nor any of its research analysts, nor any member of the ARM Group, gives any representation or warranty, express or implied, or undertaking of any kind or assumes responsibility or liability of any kind with respect to the accuracy or completeness of the information set out in this report or any third party’s use (or the results of such use) of such information. This report is provided solely for informational purposes and is not to be construed as providing advice, recommendations, or endorsements of any kind whatsoever. The investments and strategies discussed here may not be suitable for all investors; counsel of investment advisor should be obtained with regard to such investments and or strategies. This research report is not a replacement for advice from an accountant, lawyer, personal finance advisor or other category of investment advisor. The investments discussed in this report may oscillate in price or value. Opinions and information provided are made as of the date of the report issue and are subject to change without notice. This research report is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Reference herein to any specific security or financial instrument does not necessarily constitute or imply its endorsement or recommendation by ARM, its directors, officers, employees, or designated agents. Members of ARM may act as broker, advisor, or lender, or make a market in any investments or issuers referenced in this report. Further information on any of the securities discussed herein may be obtained upon request to ARM. By accepting this document, you agree to be bound by the foregoing limitations.

