

July 17, 2018



# Nigeria Strategy Report

## H2 2018

Global Economy and Markets

# Peaks and Troughs across soft commodities

## Executive Summary

After a decline of 1.6% in 2017, the S&P GSCI Agricultural Index shed more weight in the first half of 2018 (-49bps) against the backdrop of subsisting declines in the price of key soft commodities. Major commodities that drove the decline include barley, rubber, crude palm oil (CPO) & raw sugar, while wheat and cocoa prices tracked higher, limiting the drop in the index. To buttress, the price of raw sugar and CPO plunged to its lowest in three years while rubber declined to a 2-year low, reflecting excess supply in the respective commodity markets. On Barley, it was a case of moderating deficit, and a heightened possibility of a switch to surplus balance, from sustained rebound in production that led to a relapse in prices. In terms of gainers, wheat prices hit a two-year high in the review period, reflective of high demand for the commodity and muted rise in supply. Lastly, cocoa prices sustained its rally over the first half of 2018, owing to unfavorable weather in West Africa which induced tighter cocoa supplies.

On balance, against the backdrop of high yields, expanded acreage area, and favourable weather conditions, which suggests higher supplies, we retain our lower price outlook for raw sugar and crude palm oil over the rest of 2018. Against our previous prognosis, we now expect barley and rubber prices to moderate over 2018, as we expect sufficient market supplies to depress prices. While, we retain our positive view for cocoa, we now predict an uptrend in wheat prices, as we expect the combination of high consumption and muted production to create tighter supplies.

***In this report, we look at the major themes that dominated the Commodities market in H1 2018 as well as our outlook for the market and commodities prices for the rest of the year***

### *Peaks and Troughs across soft commodities*

After a decline of 1.6% in 2017, the S&P GSCI Agricultural Index shed more weight in the first half of 2018 (-49bps) against the backdrop of subsisting declines in the price of key soft commodities. Major commodities that drove the decline include barley, rubber, crude palm oil (CPO) & raw sugar, while wheat and cocoa prices tracked higher, limiting the drop in the index. To buttress, the price of raw sugar and CPO plunged to its lowest in three years while rubber declined to a 2-year low, reflecting excess supply in the respective commodity markets. On Barley, it was a case of expected lower deficit, and a heightened possibility of a switch to surplus balance from sustained rebound in production that led to a relapse in prices. In terms of gainers, wheat prices hit a two-year high in the review period, reflective of high demand for the commodity and muted rise in supply. Lastly, cocoa prices sustained its rally over the first half of 2018, owing to unfavourable weather in West Africa which induced tighter cocoa supplies.

**Table 1: Average price movement across key soft commodities**

Commodity	H1 2018	FY 2017	%
Barley (\$/Tonne)	1448.3	1502.7	-3.6
Cocoa (\$/Tonne)	2395.6	2005.4	19.5
Rubber (\$/Kg)	179.6	238.68	-24.8
Crude Palm Oil (\$/Tonne)	2436.5	2787.3	-12.6
Sugar (\$/Pound)	12.7	15.8	-19.6
Wheat (\$/Bushel)	476.2	435.7	9.3

Source: Bloomberg, ARM Research

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

Commodity	2018			2017		
	Supply	Demand	Balance	Supply	Demand	Balance
Barley	143.4	147.9	<b>-4.5</b>	147.1	150.4	<b>-3.3</b>
Cocoa	4.6	4.5	<b>0.1</b>	4.7	4.4	<b>0.3</b>
Crude Palm Oil	69.7	65.1	<b>4.6</b>	65.2	61.5	<b>3.7</b>
Sugar	191.8	174.1	<b>17.7</b>	173.9	170.8	<b>3.2</b>
Wheat	758.2	743.2	<b>15.0</b>	751.9	738.9	<b>13.1</b>

Source: USDA, ARM Research

### ***Barley deficit narrows on higher production***

The just concluded barley season – 2017/2018<sup>1</sup> – ended in a deficit of 4.5MMT<sup>2</sup> as production fell short of consumption. Precisely, relative to the previous season, consumption declined 2.6MMT over the season to 147.9MMT although, at a much slower pace when compared to a production decline of 3.7MMT to 143.4MMT. The drop-in consumption, reflected soft demand in Europe and Saudi Arabia despite high orders from China and Turkey. In the Euro area, higher prices in the Middle East relative to price in the Euro area strengthened export demand for European barley, leading to shortages of the commodity in the region. Consequently, consumers switched to other feed<sup>3</sup> alternatives such as wheat and corn with an attendant negative impact on barley consumption (-1.4MMT). Over in Saudi Arabia where barley is mainly used for animal feed, weak demand (-1.0MMT) reflects increased consumer switch to cheaper processed animal feed products. To add, improved growing conditions allowed producers to graze their animals longer hence, further reducing barley consumption. On the supply side, the decline in production was majorly from Australia<sup>4</sup>, Ukraine and the United States (U.S.), where less favorable seasonal conditions impacted on output.

Over the next season, the USDA<sup>5</sup> estimates barley production to rebound to 146.9MMT (+3.6MMT) while global consumption for the season remains unchanged at 147.8MMT. Broadly, the expected upturn in production is predicated on high yields, a combination of higher barley prices relative to substitutes, and stronger Chinese demand. Regions where higher production is expected include Australia, India, and Turkey. On consumption, high demand in China, Euro area and Turkey is expected to subsist in the next season although, not strong enough to offset slow consumption anticipated in Russia and Ukraine, hence, the muted consumption growth over 2018/2019 market year. Specifically, in Ukraine, the elevated price of barley relative to other feed ingredients is pushing animal producers to switch away from the commodity to wheat and corn. Overall, the estimated high supply and flat demand translates to a reduced deficit of 814KMT (vs. deficit of 4.5MMT in the prior season). Against the backdrop of higher production, we expect barley prices to moderate over the rest of the year. Reflecting the expectation of lower deficit, barley prices moderated 3.6% over H1 18.

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<sup>1</sup> Marketing year commenced in July and ended in June 2018.

<sup>2</sup> Million metric tonnes

<sup>3</sup> Barley is predominantly used for animal feed in the region.

<sup>4</sup> Output in Australia, Ukraine and the U.S. combined declined 7.9MMT to 19.8MMT.

<sup>5</sup> United States Department Agency.

### *CPO oversupply to persist amid favorable weather*

Over the ongoing 2017/2018<sup>6</sup> season, CPO<sup>7</sup> production is expected to rise 4.5MMT to touch a three-year high of 69.7MMT, as fresh fruit bunches have steadily recovered from the effect of El Nino. Juxtaposing the production with estimated consumption (+3.6MMT to 65.2MMT) suggests a record surplus of 4.6MMT, the expectation of which has kept prices depressed since the beginning of the year (-6.1%). In terms of region drivers, estimated higher production over the period sprung from Indonesia (+2.5MMT) and Malaysia (+1.6MMT) – accounting for 85% of world production – wherein harvest has been strong owing to improving weather conditions. On the demand side, confidence surrounding strong economic growth, rising urbanization and disposable income, is expected to drive growth in consumption with much of it coming from India (+1.3MMT), Malaysia (+432KMT) and U.S. (+307KMT) which should offset soft demand in the Euro area and Egypt.

Going into the 2018/2019 season, production is also projected to expand 2.9MMT to 72.6MMT while consumption is expected to increase to 68.1MMT (+2.9MMT), indicating a surplus of 4.5MMT (vs. surplus of 4.6MMT in the ongoing season). On supply, the increase is on the back of improved weather patterns as well as large oil extraction from high yield seedlings with Indonesia (+2MMT) and Malaysia (+5KMT) still accounting for much of the growth. On the other hand, the higher consumption would stem from India, Indonesia, and Malaysia with combined increase of 1.9MMT. The foregoing suggests that the surplus position would persist further hence, we expect CPO prices to sustain its downtrend over the remainder of 2018. In fact, global CPO inventory level has grown to a four-year high of 10.8MMT which further guides to lower CPO prices.

### *Excess sugar supply continues to impact prices*

As expected, global raw sugar prices continued its free fall in the first half of 2018 (-20%), reflecting the +17.8MMT jump in production to 191.8MMT over the 2017/2018<sup>8</sup> season. This combined with a modest increase in consumption (+3.3MMT to 174.1MMT), lifted the surplus position to a four-year high of 17.6MMT (vs. surplus of 3.2MMT in the prior season). On supply, the increase in production stemmed largely from India, Euro area and Thailand.

Higher growth in India (+10.2MMT) resulted from a 10% jump in average cane yield as well as receding sugarcane arrears<sup>9</sup> from earlier seasons which increased availability of cane for supply to mills. Over in the Euro area, boosted output reflected higher yields from favourable planting

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<sup>6</sup> Marketing year commenced in October and expected to end in September 2018.

<sup>7</sup> Crude Palm Oil

<sup>8</sup> Marketing year commenced in May and ended in April 2018.

<sup>9</sup> Reduction in debts owed by millers to sugar cane farmers

conditions which drove sugar production to rise +2.8MMT while in Thailand (+3.7MMT), farmers substituted planting of cassava with sugarcane due to relatively attractive returns which in turn improved output within the region. On the demand side, the consumption growth of 3.3MMT stemmed from higher orders in India, United Arab Emirates and Bangladesh with a combined increase of 2.2MMT over the period.

Going forward, global raw sugar production is estimated to drop 3.6MMT to 188.3MMT due to lower production in Brazil, Euro area and Pakistan which more than offset output growth in India, Thailand, and China. Importantly, raw sugar production in Brazil – world largest sugarcane producing country – is forecasted to decline by 4.7MMT in the next season owing to higher ethanol prices relative to raw sugar which is prompting diversion of sugarcane towards ethanol production rather than raw sugar. Elsewhere in the Euro area, a return to average yields compared to last year's record yield level drives the expected output decline (-850KMT) in the region while in Pakistan, forecasted decline of 900KMT is due to delay in sugarcane payments which combined is stirring farmers to switch to other crops. On consumption, against the backdrop of growing population and strong demand from food processors in India<sup>10</sup> and Pakistan, consumption is forecasted to rise 3.5MMT to 177.6MMT. Net impact of the supply and demand projection translates to a narrow surplus of 10.7MMT (vs. surplus of 17.7MMT in the prior season). Irrespective, given the strong surplus picture and growing ending stocks (+7.5MMT to 49.5MMT), we expect raw sugar prices to remain lower over the rest of 2018.

### ***Wheat prices set to push higher***

Despite ending the 2017/2018<sup>11</sup> marketing year in a surplus of 15MMT, wheat prices over H1 18 pushed northwards (+9.3%), as market players priced in expectations of a deficit market, driven by an expected surge in consumption amidst higher income induced demand for wheat flour and wheat-based products. Focusing on the review period, the surplus of 15MMT was the result of higher production (+6.2MMT to 758.2MMT) which stemmed from India, Russia, and the Euro area. While a rebound in yield to normal level<sup>12</sup> backed the output growth in the Euro area (+6.2MMT), it was the case of expanded acreage and higher yield that underpinned output growth in India (+11.5MMT) and Russia (+12.5MMT). However, weak output in U.S. (-15.5MMT) and Australia (-10.3MMT)

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<sup>10</sup> India (+1.0MMT to 27.5MMT), Pakistan (+300KMT to 5.7MMT)

<sup>11</sup> Marketing year commenced in July and expected to end in June 2018.

<sup>12</sup> In the 2016/2017 season, poor weather in France impacted yields and led to a 30% drop in wheat production, affecting overall output in the Euro area.

moderated the abovementioned growth. On demand, global consumption over the review period rose +4.3MMT to 743.2MMT with the Euro area, Indonesia, and Russia accounting for much of the increase in demand.

Going forward, the global wheat market is expected to swing into a deficit of 6.2MMT (vs. surplus of 15MMT in the prior season), driven by higher consumption (+7.7MMT to 750.9MMT), particularly in China, India, and US. Currently in China, there is growing interest in specialized flour for pastries and baked goods. This backdrop drives the increase in demand for wheat within the region (+3.0MMT to 120MMT). Over in India, amidst higher wheat prices, government continued support in the form of supply of subsidized wheat is expected to allay price inflation concerns which in turn would drive sustained consumption of the commodity with projected growth in wheat consumption (+2.2MMT). Elsewhere in the U.S., higher wheat consumption (+1.4MMT) is premised on expected growth in real personal consumption expenditures, driven by rising incomes which should support growth in food service expenditures. On the other hand, global production of wheat is expected to drop 13.5MMT to a two-year low of 744.7MMT with pressure on supply predominantly from the Euro area, India, and Russia whose output combined is expected to decline 20.2MMT to 314.9MMT. Given the demand-supply picture as well as the expected shift to a deficit market, we expect wheat prices to push higher over the rest of 2018.

### ***Cocoa prices climb higher on the rung of tighter supplies***

In line with our prediction at the start of the year, cocoa prices surged in the first half of 2018 (+19.5%) due to concerns over the dry and hot weather prevailing in West Africa which in turn impacted cocoa output, particularly in Cote d'ivoire and Ghana – the world's top cocoa suppliers. On the back of this, over the ongoing 2017/2018 season, the ICCO<sup>13</sup> forecasts a 157KMT decline in production to 4.6MMT with demand projected to rise 131KMT to 4.5MMT, indicating a modest surplus of 10KMT. Further on the supply side, output from Ghana is expected to decline 272KMT to 700KMT while cocoa supply in Cote d'ivoire is forecasted to drop 20KMT to 2MMT.

On the demand side, the growth in world grinding of cocoa beans is due to low international prices which attracted cocoa processors in a bid to drive up processing margins. Going forward, the persistence of the current hot weather in major cocoa growing regions could have a negative impact on the development of output. Hence, in view of tightening supplies, cocoa prices are expected to edge higher over the rest of 2018.

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<sup>13</sup> International Cocoa Organization

### ***Supply overhang pressure natural rubber prices***

Natural rubber prices have been largely subdued since the beginning of the year, due to supply overhang of the commodity stemming mostly from the previous year wherein global natural rubber ended in a surplus of ~500KMT. Further exacerbating the pressure on rubber prices was the increase in supply from Thailand, Malaysia, and Indonesia<sup>14</sup>, as the 350KMT export curb agreement, which took effect January 2018, expired on the 31st March 2018. On the other hand, demand slowed over the first half of 2018, owing to soft orders from China following weak auto retail sales which in turn impacted on auto and, by extension, tire production. Interestingly, over 2018, the ANRPC<sup>15</sup> forecasts world consumption in 2018 to increase 923KMT to 14.3MMT while production is estimated to increase 816KMT to 14.2MMT which suggests a balanced demand-supply situation for 2018. However, given high inventory levels, we expect rubber prices to remain bearish over 2018.

### ***Mixed commodities prices: varied impact on Nigerian FMCGs***

On balance, against the backdrop of high yields, expanded acreage area, and favourable weather conditions, which suggests higher supplies, we retain our lower price outlook for raw sugar and crude palm oil over the rest of 2018. Against our previous prognosis, we now expect barley and rubber prices to moderate over 2018, as we expect sufficient market supplies to depress prices. While, we retain our positive view for cocoa, we now predict an uptrend in wheat prices, as we expect the combination of high consumption and muted production to create tighter supplies. Overall, we maintain a varied outlook for commodity prices over 2018.

Distilling 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, bearish barley prices should be positive for brewers including Nigerian Breweries, Guinness Nigeria, and International Breweries while lower global CPO prices is negative for palm oil manufacturers, Okomu Oil and Presco, given the direct pass-through<sup>16</sup> of international CPO prices to domestic prices. Consequently, we expect low CPO prices to limit revenue growth for the palm oil companies over 2018. With regard expected soft rubber prices, we believe this would also limit rubber revenue growth,

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<sup>14</sup>Thailand, Malaysia, and Indonesia jointly supply 70% of global natural rubber

<sup>15</sup> Association of Natural Rubber producing countries

<sup>16</sup> Local palm oil manufacturers take the prices of importers, due to the demand-supply imbalance which must be plugged by imported CPO

particularly for Okomu given that the company exports all its rubber products and thus, exposed to international prices of rubber. Elsewhere, our positive price outlook for wheat suggests gross margin pressures for Flour Millers including Flour Mills of Nigeria, Dangote Flour, Honeywell Flour and Northern Nigerian Flour Mills. Our view is premised on the fact that these millers import a sizable chunk of their wheat requirement owing to limited domestic supply. Rounding up our coverage, high cocoa prices in 2018 should be negative for Cadbury's gross margin and earnings.

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