Nigeria

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS February 27, 2014

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Solid growth, receding inflation, high yields and relatively sound macroeconomic balances is an attraction to foreign investors to enter the domestic capital market despite weak business climate and rule of law. That said, the political climate has hardened after the central bank governor was fired having notified Parliament that the national oil company is $20bn. short on its account with the bank.

Country Risk Analysis

Healthy growth at 6,5% continued last year driven by the non-oil sector while oil production remained flat. Consumer price inflation fell into single digit numbers supported by tight monetary policies and a reasonably stable exchange rate, while the government kept the fiscal deficit within 3%/GDP. External balances upheld well including a current account surplus that offset the reversal of capital flows after surging inflows in 2012. As such, reserves remained steady at nine months of import.

Over the last couple of years investors have focused on Nigeria's growing prospects bestowing it with investments including in sovereign euro-bond issues at reasonable yields and maturity up to 10 years. This has also helped strengthen domestic banks which by now have mostly recovered from the financial crisis in 2009 as seen in a sharp drop of non-performing loans to 5%.

In contrast, the country is gripped by large scale corruption and allegations of embezzlement of government assets at high levels of the polity. The much respected central bank governor was recently fired after disclosing that the national oil company had an accumulated shortfall of $20bn. on its account with the bank. Illegitimate money may even fuel longstanding ethnic and religious conflicts that simmer in the countryside and compromise security for people and business.

Election campaigns for the 2015 polls will take off in the second half of the current year and limit chances for near term reform policies. That includes the long awaited Petroleum Industry Bill which is needed to restore confidence among oil majors in the government's commitment to provide a stable and fair legal framework for operations. In return, the government has made progress on efforts to privatize and restructure the power industry, high on the wish-list of would-be entrepreneurs.

The rating agencies have kept the sovereign unchanged in relatively strong non-investment grade risk classes (BB-, Ba3) reflecting overall reasonably healthy government finances in terms of budget policies and low debt. Country risk however, must also take into account a difficult business environment, limited respect for the law and slow reforms due to vested interests as well as downside risk to political stability and the oil price.

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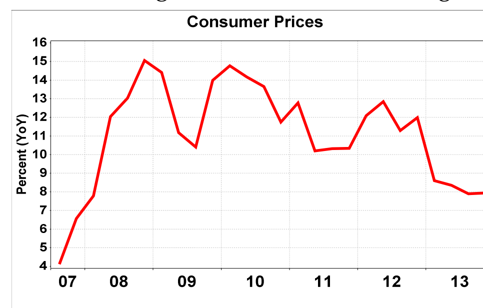
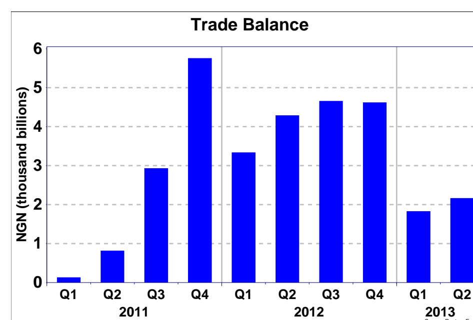
Recent developments

Strong non-oil growth: Indications are that the non-oil economy last year maintained strong momentum growing by around 8% in line with the average of past years. That achievement was spearheaded by double digit growth rates in telecommunications, construction and real estate services. Agriculture and manufacturing also showed decent results, rising around 4%, while output of oil and gas remained almost flat. As such they reduced overall growth to 6,5% reflecting the sector's share of GDP at around a seventh. Unfortunately, non-oil growth has done little to reduce unemployment standing at 23% according to strict Nigerian statistical definitions.[1] That may have helped ease price pressure to single digit levels last year. The consumer price index (CPI) fell to 8,5% after having shot up to 12% the year before following administrative price hikes.



Oil and gas: Even if output has stalled, Nigeria's petroleum sector is still significant in a global perspective pumping an average of 2,2mbpd (million barrels per day), a level that can continue for decades at the present rate of exploitation. At 37bn. barrels, proven reserves are the 10th largest in the world. However, lawlessness and theft, the latter allegedly financing political election campaigns, are estimated at an annual cost up to 10% of production including shut-downs for repair after vandalism. For several years, this has discouraged new investments by the oil-majors in particular in on-shore fields.

Halving of the current account surplus: In 2013, rising domestic consumption of oil and gas continued eating into stagnant supply leaving less for exports. With oil and gas representing all but 3% of the total, the effect was a sharp 8% cut in export revenues. The import bill, in contrast, rose 8% despite stepped-up import substitution including of agricultural products. In the event the surplus on the trade balance fell $11bn. and reduced the current account surplus by more than a half to $9,4bn. -- 3% of GDP.



Portfolio inflows turn to outflows: The weaker current account surplus was compounded by net capital outflows in particular in the second half of 2013. These partly offset earlier inward portfolio investments in particular the hefty inflows that occurred in 2012 into local equity and bond markets. They occurred after the authorities had eased some capital restrictions and were also boosted when the inclusion in JP.Morgan and Barclays EM indices had made Nigeria an investor darling over-night. Inward foreign direct investment, by contrast, held up quite well last year, rising $1bn. to $8bn. of which one half went to the oil and gas sector and a quarter to manufacturing. In the event reserve building at the central bank slowed to an estimated $4bn. That was less than the $10bn. growth of 2012 but still enough to

[1] ILO, the International Lobor Organization, , by contrast, sees it at less than 2% reflecting less stringent definitions.

maintain reserves at a healthy level of almost $50bn. -- equivalent to 9 months of import cover or four times larger than total external debt.

Policies:

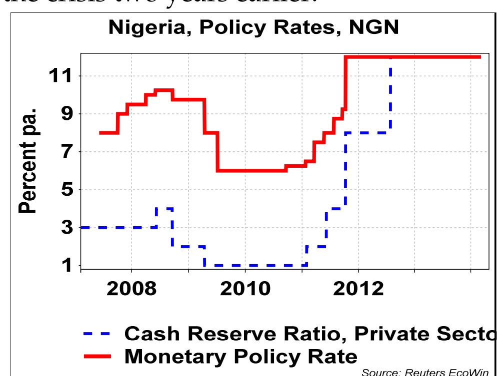
Fiscal policies remain beholden to oil revenues. Even though the oil and gas sector is not dominant in Nigeria, 75% of budget revenues derive from taxation and royalties imposed on oil companies. With the total budget at about 27% of GDP, that means other revenues, including regular taxation, comprise less than 6% of GDP. At $107/barrel, as calculated by the IMF, the "break-even" oil price is high and without oil revenues the primary budget of 2013 would have been in a deep deficit of around 30% of non-oil GDP – also high compared with other oil producers.

But fiscal presentation is complex: According to many observers, including the rating agencies, the government's presentation of its fiscal accounts is complex and may give rise to various interpretations. However, taken at face value they show a deficit within 2-3% of GDP as mandated by the Fiscal Responsibility Law. That deficit apparently includes regular tapping of the "Excess Crude Account" (ECA) which is recorded off balance. The ECA is supposed to be replenished as long as the real sale price of oil is higher than the budget oil price as has been the case in recent years. In 2013, the budget price was set at $79/barrel, some $25/barrel lower than realized.

Hard to establish a Sovereign Wealth Fund: The problem is, however, that being outside the budget, the ECA can be used much at the discretion of politicians including for popular causes such as subsidization of fuel prices, political pet projects etc. To address such potential problems, last year the government launched a new national savings vehicle, the Nigerian Sovereign Investment Authority with more well-defined rules as regards allocations and withdrawals. It has so far been allocated a total of $1,5bn. However, the new fund has not become popular with many state governors who apparently prefer the more discretionary approach of the old ECA. At the present the two funds exist in parallel but the regular allocation to NSIA appears to be pending.[2]

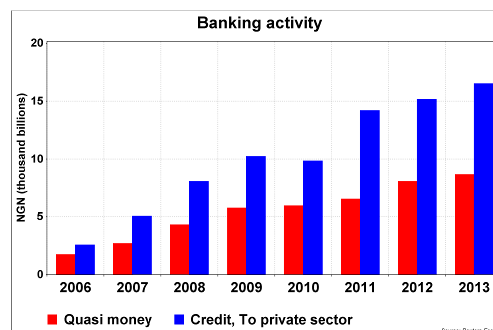
Government debt is low and well managed: After Paris Club treatment in 2005 Nigeria's government debt to bilaterals was reduced from 55% to 17% of GDP. It has since grown to 20% of GDP which is still moderate compared to peers. In addition, most of it, 85%, is in domestic currency and on concessional terms except for three Eurobond issues since 2012 for a total of $1,5bn. They achieved reasonable yields as evidence of acceptable market access. The government's largest contingent liability, valued at about 10% of GDP, is to AMCON, the asset management company established in 2010 to help lift banks out of the crisis two years earlier.

Tight monetary policies: Under the now suspended central bank governor, Mr. Sanusi, in office since several years, monetary policies have been held reasonably tight with the aim to guide private sector inflation expectations. In 2013, these policies succeeded in bringing inflation down to single digit numbers



[2] NSIA's website (http://nsia.com.ng/) does not provide information about its resources.

for the first time since 2007. The governor is also credited with an effective rescue operation when the bank system almost collapsed in 2009 following prior years' loan binge before Mr. Sanusi's watch. This operation included the establishment of AMCON (Asset Management Corporation of Nigeria) in 2010 which has helped banks unload bad loans as these soared to 35% of the total. Banks are now in a position to begin redeeming part of this support. For several years the monetary stance was supported by capital controls which were subsequently eased in 2011 when the central bank abolished the requirement that portfolio investors keep their investments for at least a year. That measure contributed to the surge of inflows in 2012.



Banks regain strength: Although mostly recovered from the crisis in 2009 banks are still cautious. Credit growth last year stayed below 11% (September yoy), reflecting also weak lending opportunities with the result that banks' share of GDP dropped from an already low level at only 30%. However, as non-performing loans has decreased to 5%, hopes are growing that banks will explore market opportunities more intensely including to the benefit of SMEs which so far received only 5% of total credits but could be key to continued and diversified growth of the economy.

Structural reforms make advances but remain stalled in key areas: Recent years' reorganization of the power sector has yet to show a surge in new investments but a doubling of production since 2009 has much helped reliability by reducing brown-outs. The privatization process started as the state electricity company was broken up into 15 separate firms while the government retained its majority hold on the distribution net. In 2012, electricity tariffs were hiked to near cost recovery and last April private bidders for five generator companies made the mandatory 25% down payment.

The Petroleum Industry Bill: The PIB, by contrast, is by all probability set to languish for the sixth year in the National Assembly, with limited prospects of meaningful progress before general elections in 2015. This bill is key to reducing regulatory uncertainty which deters investors including the international oil majors from expanding onshore and offshore activities. Smaller companies often fill the space left over but are unlikely to contribute with the same expertise. One main sticking point with the PIB is the issue of how much of revenues should be allocated to the oil producing states.

A large informal economy is an issue often pointed out by observers who note that unregulated activities can also feed into general lawlessness reflected in Nigeria's scoring among the worst decentil of countries on the World Bank's "rule of law" index. The World Bank's "ease of doing business" places Nigeria in the weakest quarter among 180 countries mainly because of poor access to credits and electricity for many companies. "Corruption prevention" scores are equally poor.

Politics

Heating up for general elections: primaries are likely to begin in 2014 for the presidential and legislative elections scheduled for the following year. While the incumbent Pres. Jonathan has overseen macroeconomic stabilisation he has not been

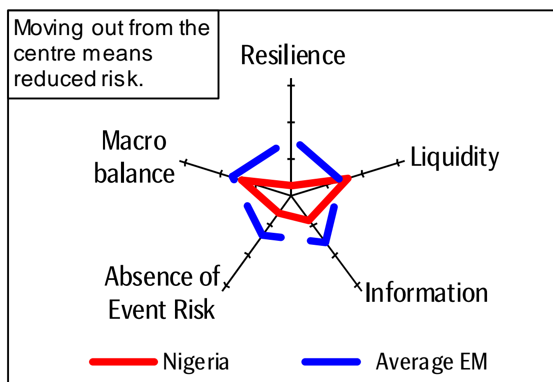
equally successful in building bridges over religious and ethnic divisions. The Boko Harem insurgency is holding the Northern States in a grip of terror with the result to intensify the conflict between local Christians and Muslims. In the National Assembly allegiances are shifting rapidly, but last year the opposition was finally able to form an election front, the *All Progressive Congress*. Last week's firing of the central bank governor for pointing out to the National Assembly that $20bn. was missing from the accounts of the national oil company with the central bank could mark the beginning of a dirty campaign.

Outlook:

More as usual: For 2014 and the next few years the economy is likely to follow along recent years' trajectory, driven by the non-oil economy. The dynamics of this is, in return, dominated by telecommunications, construction and real estate, activities that are largely fuelled by excess oil revenues and subsequent off-budget spending by the government. The incipient stabilization of electric power supply could be a game changer and lay the basis for more diversified activities including a larger manufacturing sector. However, that is not a given, and the oil sector, the basis for government revenues and export earnings, is in dire need of a new push. That is why passing by parliament of the long overdue Petroleum Industry Bill (PIB) remains paramount for Nigeria's development beyond the next couple of years.

Downside risks to this scenario are deteriorating **political stability** and a sudden fall in the **oil price**. The first is unlikely to be addressed in a serious manner before elections are over next year and provided a clear election result accepted by all parties. The second may prove increasingly tenuous should the global oil price collapse under the weight of rising US production and the risk of softer demand from East Asia. (For a further analysis of the global oil market we refer to Appendix 1.)

Key figures	**2012**
Population (millions)	167
GDP/capita ($)	1 584
GDP (% change)	6.5
Inflation (%)	12.2
Curr. acc. balance (% of GDP)	4.2
Reserves (months of imports)	7.8
Budget balance (% of GDP)	-3.1
Government debt (% of GDP)	14.9



External Ratings:
Fitch: BB- / Stable
Moody's: Ba3 / Stable
S&P: BB- / Stable

Peers:
Angola
Bangladesh
Sri Lanka

Graph: Nigeria's risk profile is weaker than the average of EM countries accept for its strong reserve position, which has been boosted by oil revenues and capital flows into the stock market.

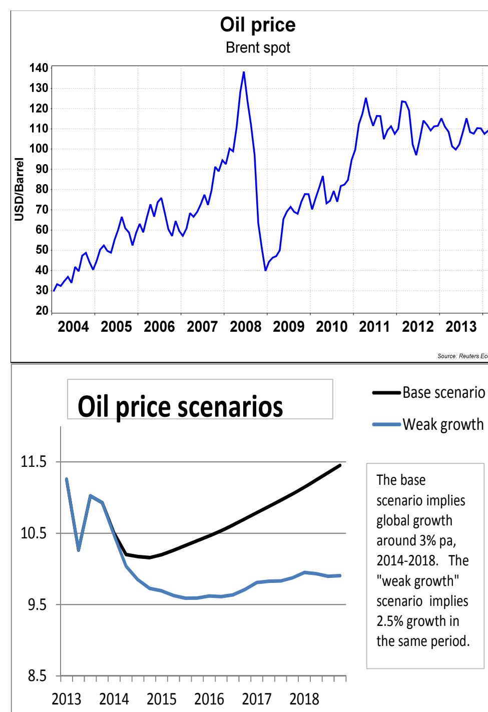
Appendix 1

The global oil market – growing resilience?

Since 2008 the oil price has remained remarkably stable in face of many negative events. One may ask: Has it become more resilient? Our answer is NO, as explained below.

We have run three events on the Oxford Global Model.

1. New intensification of the euro-crisis reducing annual growth by 1 percentage point (pp) pa. in the euro-zone
2. Annual growth in China down 2 pp pa. as the country rebalances its economy
3. Financial instability in Japan (Abenomics fail) cutting growth by 1 pp a year.



Results on the global oil price as shown in the chart on the right demonstrate that the combined effect of these shocks affecting about a third of the world economy is not negligible. The oil price falls by an average of $10 over the five years period but with a gradually widening gap.

However, the effect in our scenario on world growth is a drop of only 0,5pp annually (average 2014-2018). That is moderate compared with the standard deviation of 1,3pp of world growth for the period 1994-2013. A linear extrapolation of our results, which may underestimate the true fallout, suggests that the oil price could fall by more than $25/barrel in a not unreasonable down-case scenario of one standard deviation of world growth. As such, it is premature to conclude that the global market has become more resilient. In addition, market sentiment could also exaggerate short term variations. The reason the oil price has not exhibited more volatility since 2009 is that global growth has been more stable.

The price effect would be compounded by a negative volume effect of about 1,5%. That implies very high price elasticity on the demand side in the vicinity of -17. Combined with a high price elasticity on the supply side (of opposite sign) would underpin the argument that the oil price will continue to experience periods of extreme volatility in the future. Supply shocks could come from new finds of hydrocarbons, like the shale gas in the US, or events that would open fields now closed for political or strategic reasons in the Middle East.

For an oil-dependent country like Nigeria, already consuming most of its oil revenues each year, a loss of double digit drops of the oil price would likely have immediate effects on macro-economic performance and balances.

Key data:	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
GDP (Bill. US$)	169	230	245	268	303	341	381	422
GDP/capita (US$)	1096	1449	1507	1603	1772	1942	2120	2288
GDP (change)	6.9%	7.9%	7.4%	6.5%	6.5%	6.1%	5.5%	5.3%
Investments/GDP	13.0%	14.2%	12.7%	12.7%	12.7%	12.7%	12.7%	12.7%
Budget balance/GDP	-3.2%	-4.9%	-2.9%	-3.1%	-4.1%	-4.1%	-3.0%	-1.9%
Govt debt/GDP	15%	15%	17%	18%	20%	21%	22%	21%
CPI inflation (%)	11.5%	13.7%	10.8%	12.2%	8.5%	8.0%	8.0%	8.0%
Money demand (%)								
Stock prices (%change)								
Interest rates	11.9%	4.0%	10.5%	13.9%	11.5%	9.5%	8.0%	7.0%
Exch. Rate ($)	208	199	215	201	212	212	207	208
Trade/GDP (%)	51%	54%	64%	56%	48%	44%	42%	42%
Oil price (Brent)	$62	$80	$111	$112	$109	$103	$103	$106
Billions US $								
Export of goods	56.2	77.9	96.4	95.7	89.0	87.8	92.4	100.1
Imports of goods	30.8	46.4	61.7	53.4	57.5	61.6	68.3	75.5
Other:	13.8	14.4	12.5	20.3	9.4	3.6	0.3	-0.2
Current account	**13.9**	**14.5**	**12.6**	**20.4**	**9.4**	**3.6**	**0.4**	**-0.2**
(% of GDP)	8.2%	6.3%	5.1%	7.6%	3.1%	1.1%	0.1%	0.0%
FDI	8.6	6.0	8.8	7.1	7.9	8.6	9.4	10.3
Loan repayments	-0.4	-0.2	-0.1	-0.3	-0.4	-0.4	-0.5	-0.6
Net other capital flows	-32.6	-30.3	-21.0	-16.0	-13.0	-7.6	-5.2	-5.7
Balance of payments	**-10.6**	**-10.0**	**0.3**	**11.2**	**4.0**	**4.2**	**4.0**	**3.8**
Reserves	42.4	32.3	32.6	43.8	47.8	52.0	56.1	59.9
Total debt	6.8	7.3	9.0	10.1	11.5	13.2	15.1	16.5
o/w short term debt	4.2	3.5	4.3	4.5	4.7	4.9	5.2	5.4

Sources: Oxford Economics and SEB estimates

Rating history

	2011	2012	2013	2014
Fitch (eoy)	BB-	BB-	BB-	BB-
Moody's (eoy)	N.R.	N.R.	N.R.	N.R.
S&P (eoy)	BB-	BB-	BB-	B+

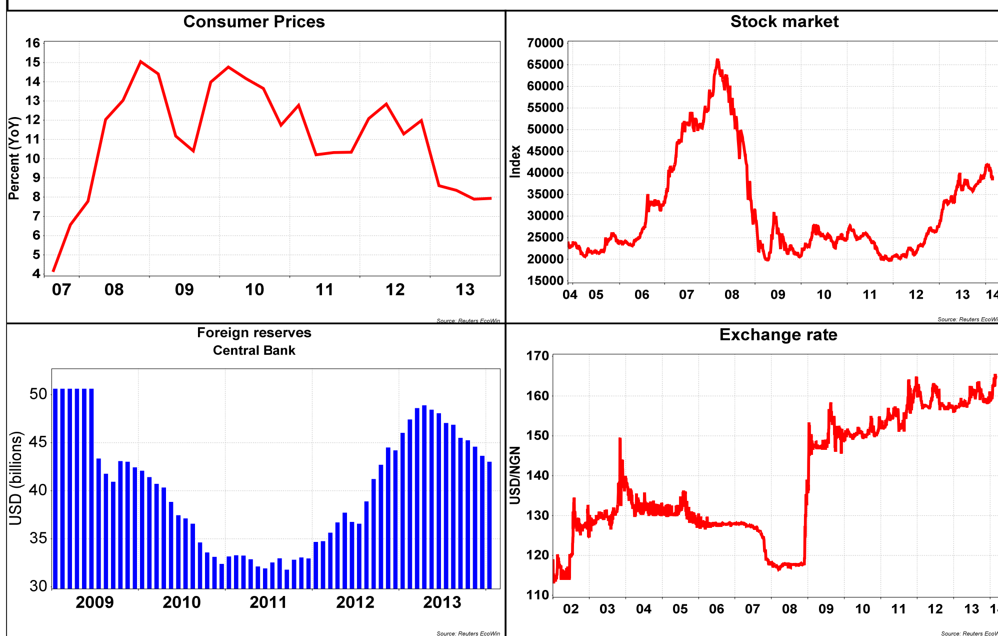
Type of government:

Next elections: Presidential and legislative, 2015

Other:

Latest PC deal: 2005

Latest IMF arrangement: Policy Support Instrument (PSI) 2005-2007



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