Nigeria FY’20 Outlook

A delicate sprout

December 2019
NIGERIA OUTLOOK

A delicate sprout

The need to attract FDIs: Since the start of 2019, we have observed a greater adoption of accommodative monetary policies by major advanced economies. This spurred foreign portfolio flows to Nigeria and other developing markets, with positive interest rate differentials. However, the same could not be said about foreign direct investments (FDIs) which have remained relatively tepid post Nigeria’s economic recession. The absence of FDIs is mainly due to a dearth of fiscal reforms required to taper the infrastructure deficit in the country and spur stronger, but sustainable economic growth. Specifically, this outlook report highlights how several challenges facing the real sector (ranging from inadequacies in power supply, budget implementation and transport infrastructure) have capped Nigeria’s economic growth.

Could a normal budget cycle make the difference? 2019 marked a record low capex implementation in Nigeria, amidst distractions from protracted election activities and appointments of ministerial heads. According to the Minister of Finance, the government has only disbursed ₦650 billion for capital spend since the start of the year, representing 22% of the capex budget—the weakest capex performance in over a decade. Looking forward, there is a growing hope of better capex performance in 2020, underpinned by the government’s drive to revert the budget plan to a normal (January-December) cycle, coupled with less political distractions. While we believe a normal budget cycle would facilitate a better capex spend in 2020, we posit that a suboptimal revenue performance could dilute this benefit.

A better yet delicate growth: Nigeria can expect modest growth in 2020 (Vetiva: 2.4% y/y, IMF: 2.5% y/y), driven by sturdier growth in agriculture (2020F: 2.7% y/y, 2019E: 2.4% y/y) and services (2020F: 2.4% y/y, 2019E: 2.0% y/y). On the flipside, we believe oil sector growth would slow to 3.0% y/y in 2020 from 4.5% y/y in 2019, given our underwhelming outlook for oil investments. Overall, while we expect Nigeria’s economy to strengthen in 2020, we opine that this growth is rather a delicate sprout, as shocks, such as lower-than-expected crude prices and disruptive policies, could dwindle our growth projections.

Improved sentiments for Nigerian Equities in 2020: In 2019, foreign portfolio investments to Nigeria were heavily skewed to the fixed income market, with loose monetary conditions in the developed economies driving demand for high yielding instruments. In stark contrast, portfolio investments avoided Nigerian equities this year, with the ASI recording a YTD loss of 15.5% as at December 12. We expect FPIs to remain overweight on fixed income in 2020, given concerted efforts by CBN to keep foreign investments “onside”, even at the cost of alienating some domestic investments. We however expect improved sentiment for equities, driven primarily by estranged domestic demand in the fixed income market and the lure of depressed valuations relative to other frontier markets.
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Global
Global Economy

World economies in synchronized slowdown

In its October economic report, the International Monetary Fund (IMF) projected global economic growth in 2020 to come in at 3.4% y/y, a downgrade of just 0.1% from its July 2019 forecast and higher than the 3.0% y/y growth expectation for 2019. The main drivers of this mild downwards revision are trade barriers and the rise of protectionism in Advanced Economies (AEs); increased geopolitical uncertainty; and tension between the world’s two largest economies. Growth for AEs is expected to remain at 1.7% in 2020, while growth in the U.S. is expected to drop from 2.4% in 2019 to 2.1% in 2020, due to trade and domestic policy uncertainties. Meanwhile, emerging markets and developing economies (EMDEs) are expected to grow at a much higher pace (4.6%) y/y. This is due to the expected recoveries in some developing markets (Iran, Turkey, Argentina, etc.), while broader recoveries are expected from others (Brazil, Russia and Saudi Arabia). Also, Sub-Saharan Africa (SSA) is expected to grow at 3.6% y/y, unchanged from previous reports, thanks to growth from middle-income countries (2.9% y/y) and low-income countries (5.9% y/y), while oil producers are expected to grow at the slowest pace of 2.4% y/y. Finally, the IMF expects global trade growth to recover to 3.2%, supported by an uptick in investment demand in EMDEs, especially SSA countries that are expected to benefit from stable commodity prices and an increase in investment demand for these regions.

Growth for AEs is expected to remain at 1.7% in 2020, while growth in the U.S. is expected to drop from 2.4% in 2019 to 2.1% in 2020, due to trade and domestic policy uncertainties. Meanwhile, emerging markets and developing economies (EMDEs) are expected to grow at a much higher pace (4.6%) y/y.

Source: IMF, Vetiva Research
Trade war millstone drags global sentiment

Economists have estimated that the trade war could cost the global economy c.$700 billion in trade should it last until the end of 2020. Although Sino-American trade tensions began pre-2019 with the first tariffs implemented on 06 July 2018, the effects on the global economy have been more prominent this year, with global demand and international trade taking a sizeable hit, declining from 3.6% in 2018 to 1.1% in 2019. While there was a truce at the start of the year and hopes of a swift resolution were high, the 01 March deadline came and went, with little progress made on a new deal to end tensions. The two largest economies have been locked in a back and forth over trade, with crude demand slowing, leading to both the International Energy Agency (IEA) and Environmental Investigation Agency (EIA) forecasting weaker crude demand growth y/y for 2019 and 2020. The Chinese economy has slowed down in 2019, growing at a pace of 6.1% (Expected), down from the 6.6% growth seen last year due to trade tensions, slowing local consumption and policy uncertainty.

Without even a preliminary trade deal in place, as well as the looming Presidential elections in the U.S. in 2020, we envision two potential scenarios:
1. The U.S. pushes for a quick deal with some concessions to Beijing in order to use the newly agreed deal as political capital for President Trump. In this scenario, investor sentiment is improved, and economic activity improves, as global trade stabilizes around the new trade reality.
2. The two parties are unable to agree to terms, further dampening investor sentiment while growth remains underwhelming and both economies continue to suffer the worsening effects of the trade war and the wider economy follows suit.

U.S. economy likely to see slower growth

The imposition of tariffs on $360 billion worth of Chinese imports has affected price levels in the premier economy, with consumer and investor sentiment weakened by the prolonged trade tensions. Also, expectations of an uptick in unemployment and weaker inflation in 2020 contribute to a mildly weaker growth expectation of 2.0% y/y. While industrial output was positively impacted by the federal tax reforms enacted in 2018, the effects are likely to wane in the coming year as the growth rate of industrial production continues to slow. It was against this backdrop that the U.S. Fed reversed their contractionary monetary policy, cutting rates to a band of 1.50% - 1.75% in October from the 1.75%-2.00%, the third cut of the year. However, expectations of further rate cuts, a move favoured by President Trump have been downplayed, with the Fed adopting a “wait and see” stance. We do expect the U.S. Fed to move to cut rates should the rate of economic growth slow further early in the new year.
Subdued growth in the EU prompts return to expansionary policy

The European Economic Area (EEA) has been in a state of subdued economic growth, low inflation and increased political uncertainty. Manufacturing has been affected by structural shifts and a less conducive external environment. The slowdown across the EEA has however failed to dampen employment levels, with unemployment across the region currently below pre-crisis levels (save for individual outliers like Greece and Spain). Individual states have enacted fiscal policies to boost growth, leading to expectations of mild economic growth for 2020. However, the uncertainty surrounding Brexit and future relations between the UK and the EU have been a looming spectre over both parties, with some investors remaining on the sidelines in order to monitor the progress. Added to all of this, inflation remained at sub-2% levels for the 12th straight month, as the decline in manufacturing and demand weighed on economic activity. With these issues in the backdrop, the European Central Bank (ECB) took the decision to restart their expansionary monetary policy, with negative interest rates and a new round of net asset buy-backs of €30 billion per month in 2018, aimed at kick-starting the regional economy and returning inflation to 2%. While the ECB slowed the pace of their buy-backs to €20 billion per month in September, economic growth in the region is projected to grow by 1.6% in 2020 (IMF), a slight improvement from the 1.2% y/y growth projection for 2019.
Brexit: An economic limbo

The topic of Britain leaving the European Union has been an unwelcome addition to the global economic and political spectrum. Investors have reacted to several false dawns, with the latest issue of a general election casting further doubts over the entire process. While the terms by which a member state can successfully exit the EU (Article 50) are firmly established, they were written to favour the Union and inconvenience the exiting party. The two-year time limit from the activation of Article 50 to the actual exit has proven to be too short for a nation to successfully negotiate new trade terms and implement them before leaving the EU. This two-year ordeal has the potential to linger indefinitely due to the issues surrounding the Irish Isles. While the door has been left open for Great Britain to revoke Article 50 and re-integrate into the Union, the political merry-go-round has created so much uncertainty among investors and speculators, leaving the country’s economy in a state of limbo, with the British economy growing by a mere 1.2% in 2019.

That said, we note that the victory of the conservative party in the most recently concluded general election bodes well for a near-term Brexit conclusion as a conservative majority in parliament is expected to support Prime Minister, Johnson’s Brexit push. A swift conclusion is necessary to get the economy out of limbo.

Sub-Saharan Africa S.A.

The growth forecast for the former largest economy in Africa has been cut by the IMF and World Bank to 1% in 2020, while the country’s debt is currently at risk of receiving a “Junk” rating from the three main rating agencies. Weak investor sentiment, policy uncertainty and weak exports have hampered
economic growth, while the overreliance on government spending to boost growth, various fiscal challenges and inefficient management of state-owned enterprises have raised debt servicing costs and weakened the economy further in 2019. Several labour disputes, especially in the mining sector have disrupted production of the country’s most important resources. With the IMF urging the South African Government to address these challenges, we expect some debt restructuring to occur in 2020, as well as fiscal reforms that may include the relinquishing of state-owned enterprises such as the public utility company Eskom to reduce government expenses and boost productivity. However, we do not foresee a significant recovery in economic growth in the near-term.

**Angola**

The value of Angola’s currency has been on a downward trend since the country floated its exchange rate in October 2019. Currently, the country is under an IMF programme focused on reducing public debt, which currently stands in excess of 71% of GDP, while the country’s reserves are currently c.$10 billion. Angola’s economy has been in a state of mild recovery in 2019, supported by stable crude oil prices, a hike in VAT to 14% and a new capital investment law designed to attract foreign investors. Overall, we expect Angola’s GDP growth rate to improve in 2020, driven by the continued passthrough of these and other reforms, as well as stable oil production and improvements in the country’s foreign reserves.

**Kenya**

One of the few growth stories of the past few years, growing by more than 5% y/y over the last five years, Kenya’s economy is projected to grow by 6.0% (IMF), an improvement from their 2019 5.8% projection. However, the mostly agrarian economy does have a substantial national debt which currently stands at 62.3% of GDP, a concern for potential investors. Furthermore, the country’s central bank currently operates an upward limit on commercial lending, which has stifled commercial lending. While the country’s economic growth is reliant on favourable weather conditions, the underlying risk of drought remains and could affect the country’s output in 2020.

**Nigeria**

With economic growth (2.1%) remaining below population growth (2.6%) in 2019, Nigeria’s economy underperformed in 2019 due to low capital expenditure and restrictive fiscal policies. The CBN introduced a minimum Loan to Deposit Ratio (LDR) for banks to boost lending to the real sector; however, the passthrough to the real economy has yet to be felt. With crude prices expected to remain around $60/bbl levels in the coming year and production likely to hover at 2.0 million bpd, as well as the newly introduced 7.5% VAT which comes
into effect on January 2, 2020, we foresee improved government revenue, impacting capital expenditure. Overall, we expect Nigeria’s economy to grow by 2.4% in 2020.
Domestic
Real Economy

Political activities suppress 2019 capex spend

Economic activities were considerably disrupted in the first half of 2019, a resultant effect of the political activities that dominated most of the period. Meanwhile, capital spending, which could have been used to offset these disruptions, was also halted during the period, as political office holders primarily adjusted their focus to strengthen their campaign goodwill ahead of the various elections. Capex spend further suffered in the second half, as a considerable amount of time elapsed before the President assigned portfolios to his nominated ministers. Given the aforementioned, Nigeria’s economic growth was subpar in the first three quarters, with GDP growth coming at 2.10% y/y, 1.94% y/y and 2.28% y/y in Q1’19, Q2’19 and Q3’19 respectively—all below consensus expectations. However, going into 2020, we foresee an improvement in capex spend, as the presidency and the National Assembly continue on their drive to ensure that the 2020 Appropriation Bill gets signed into law before the start of next year—a move that will revert the budget cycle to the normal cycle of January-December, compared to the existing cycle of May-April.

![Capex budget and implementation since 2018](image)

Going into 2020, we foresee an improvement in capex spend, as the presidency and the National Assembly continue their drive to ensure that the 2020 Appropriation Bill gets signed into law before the start of next year.

A record budget signing in 2020?

Although the 2019 budget received presidential assent in May, budget implementation in H2’19 was largely unimpressive, evidenced by a tepid real sector growth witnessed in Q3’19. This was evidenced by the lacklustre government spend witnessed during the period. Meanwhile, in October 2019, the President presented the 2020 budget (tagged ‘Budget of Sustaining Growth and Job Creation’) to the National Assembly, earlier than the 2019 budget
speech. The budget entails a total expenditure of ₦10.33 trillion and total revenue receipts of ₦8.16 trillion, with debt service and recurrent non-debt expenditure accounting for 71% (2019: 70%) of total expenditure. Given that the ruling party (All Progressives Congress) dominates the two chambers of the National Assembly, we foresee improved alignment between the presidency and the legislative arm in the medium term, translating to a relatively quicker signing of the 2020 budget into law before the start of next year, or at most, in January 2020. As such, we envisage a much better budget implementation in 2020, compared to the paltry performance in 2019. Nonetheless, we highlight that weaker-than-expected oil revenue in 2020, stemming from lower crude prices and potential disruptions to crude production, poses a major threat to our outlook.

**VAT hike: a boost for non-oil receipts**

Non-oil revenue has significantly underperformed budgeted figures over the last four years, a reflection of largely fragile economic diversification. Also, we note that tepid tax compliance across the different sectors of the economy partly accounts for the underperformance in non-oil revenue. Although the Voluntary Assets and Income Declaration Scheme (VAIDS), effected in 2017, helped to boost tax receipts in 2018, evinced by a 16% y/y uptick in tax revenue to ₦3.23 trillion, we note that income generation from various tax sources remains shy of potential. For instance, 2018 non-revenue performance showed a shortfall of ₦919 billion from budget estimate. In addition, Nigeria’s tax-to-GDP ratio printed at 5% in 2018, significantly lagging the ratios from its Sub-Saharan African peers—tax-to-GDP ratio currently stands at 27% and 18% in South Africa and Kenya respectively. In 2020, we expect the hike in VAT from 5.0% to 7.5%, which will take effect from January 2, 2020, to considerably support non-oil revenue. Nonetheless, we do not believe the growth in non-oil revenue would be strong enough to meet the budget estimate of ₦5.51 trillion, as economic growth in the near term remains tepid.

Meanwhile, in October 2019, the President presented the 2020 budget (tagged ‘Budget of Sustaining Growth and Job Creation’) to the National Assembly. The budget entails a total expenditure of ₦10.33 trillion and total revenue receipts of ₦8.16 trillion, with debt service and recurrent non-debt expenditure accounting for 71% (2019: 70%) of total expenditure.
Increased royalty charges for PSCs to support oil revenue

While we note that preliminary data on 2019 budget implementation is yet to be released by the Budget Office, we believe 2019 oil revenue receipts have underperformed budgeted figures, given the less than impressive crude output witnessed so far in the year despite additional crude flows from the Egina offshore field. We highlight that average crude production over the first three quarters came in at 2.0 mb/d—13% below budget benchmark; thereby subduing the effect of higher-than-budgeted average crude price (9M’19 average Brent price of $64/bbl versus budget benchmark of $60/bbl). Looking forward, we envisage a better oil revenue performance in 2020, given the government’s more realistic assumptions for oil revenue drivers in the 2020 budget—crude output and oil price are assumed at 2.18 mb/d and $57/bbl respectively. Furthermore, we expect the recently amended Deep Offshore and Inland Basin Production Sharing Contract Act (DOIBPSCA) to bode well for the government in the near term, as the Act effects higher royalty rates for offshore fields, which account for over 40% of Nigeria’s crude output. The revised offshore regulation stipulates a flat royalty rate of 10% for deep-water assets going forward, over four times the average royalty rate in 2018. In the long-term, however, upside potential in royalty revenue could be significantly affected, as the revised offshore fiscal policy would precipitate higher production costs in offshore fields, consequently weighing on investments in the deep-water sphere.
Will the government favour domestic debt market in 2020?

In 2017, the Nigerian government adopted the strategy of raising more foreign debt, which bears relatively cheaper service costs, compared to domestic debt. For example, in 2017, average yield on the five-year government bond was 16%, 900 bps higher than the yield on the five-year government Eurobond. The strategy was a move intended to ease the pressure of debt servicing on government’s revenue by rebalancing the nation’s debt portfolio to reflect 60% domestic debt and 40% foreign from a pre-2017 split of 70:30. Also along this line, the Debt Management Office (DMO) mentioned, at the start of 2019, its plan to take the nation’s debt mix to a 50:50 split between domestic and foreign debts. Meanwhile, the CBN firmed up its pro-growth stance in H2’19 by implementing a couple of expansionary monetary policies to spur lending to the real sector. Additionally, the CBN excluded domestic investors from participating in open market operations (OMO), resulting in excess liquidity chasing scarcely available treasury bills (T-bills). These policies have culminated in a sharp decline in treasury yields, with the yield on one-year T-bill dropping to 8.4% in November from 12.5% in June. Similarly, yield on the five-year government bond has declined 240 bps to 11.7%, bringing spread between the bond and five-year Eurobond to 600 bps. Given these steep yield declines in domestic debt notes, we believe the DMO could favour the domestic debt market in its 2020 debt raising programme, as the current spread does not justify the foreign exchange risk on USD denominated debt.

GDP growth to print at 2.4% in 2020

Nigeria’s GDP grew 2.3% y/y in Q3’19, depicting an improvement from the growth of 2.1% y/y in the preceding quarter; however, the growth underperformed consensus estimate for the quarter. We highlight that Nigeria’s Q3’19 economic growth was largely buoyed by a 1.9% y/y growth in non-oil sector, as oil sector growth slowed to 6.5% y/y in Q3’19 from 7.2% y/y in Q2’19.

Looking ahead, our outlook for Nigeria’s economy seems rather modest, with growth potential expected to be largely driven by anticipated stronger growth in the non-oil sector (2020F: 2.3% y/y, 2019E: 2.0% y/y), a reflection of sturdier growth expected in agriculture (2020F: 2.7% y/y, 2019E: 2.4% y/y) and services (2020F: 2.4% y/y, 2019E: 2.0% y/y). Meanwhile, we expect growth in the oil sector to slow to 3.0% y/y in 2020 from 4.5% y/y in 2019, amidst an underwhelming outlook for oil investments. All in, we project that the Nigerian economy will grow by 2.4% in 2020 (IMF: 2.5%, World Bank: 2.1%), up 20bps from the estimated growth in 2019.
The agriculture sector registered a growth of 2.3% y/y in Q3’19, an improvement from the growth (1.8% y/y) in Q2’19; by year end, annual growth in the sector is estimated to reach 2.4% (2018: 2.1%).

**Nigeria’s trade protectionism to shore up agriculture growth**

Agriculture sector growth was significantly hampered in 2018, due to year-long herdsmen-farmer clashes in the Middle Belt—a region that accounts for a significant portion of Nigeria’s crop produce. However, so far in 2019, the sector’s operating landscape has witnessed considerable respite, a reflection of the government’s continual drive to curb herdsmen conflicts and promote food security across major crop-producing states. That said, the agriculture sector registered a growth of 2.3% y/y in Q3’19, an improvement from the growth (1.8% y/y) in Q2’19; by year end, annual growth in the sector is estimated to reach 2.4% (2018: 2.1%).

In 2020, we expect agriculture growth to edge higher to 2.7%, as the CBN’s supportive initiatives continue to bolster farming operations amidst improved security conditions. Specifically, we highlight that the CBN’s Anchor Borrowers’ Programme (ABP), geared towards spurring credit facilities to the agriculture sector, has significantly helped to boost rice output across the country. Furthermore, the government’s recent trade protectionist stance against its neighbouring countries (Benin and Niger) is expected to shore up food output growth in the near term, as food (mainly rice) demand is completely channeled to local producers. Although this development is expected to pressure food price levels going forward, we believe the effect on inflation would be short-term, as volatilities in food prices are expected to ease in Q2’20. More so, we think the government would be required by its African peers to reopen the land borders by July 2020, when the African Continental Free Trade Agreement (AfCFTA) is expected to take full effect.
Textile operations revival to cushion manufacturing growth

The manufacturing sector recovered in Q3’19 to record a growth of 1.1% y/y, after a contraction of 0.1% y/y in Q2’19. Q3’19 growth was principally driven by a 3.0% y/y growth in food, beverage and tobacco output and 6.9% y/y growth in cement production, as textile output (second largest contributor to manufacturing GDP) contracted for the second consecutive quarter, albeit, at a slower pace.

As per the textile sector, poor energy supply, obsolete infrastructure and stiff competition from smuggled textiles have largely informed several textile manufacturers to shut down their factories in Nigeria. For context, the Textile Researchers Association of Nigeria (TRAN) recently revealed that the number of textile factories has fallen to 25 from 175 in 1980, with the surviving ones operating far below installed capacity. In a bid to revive the textile sector, the government is collaborating with the CBN for the injection of ₦100 billion across the cotton, textile and garment (CTG) value chain. So far in 2019, the apex bank has disbursed about ₦50 billion for the development of the cotton segment, with a ₦19 billion loan granted to finance nine cotton ginneries. Based on this, we foresee a mild recovery in the textile sector in the second half of 2020, which could consequently cushion the overall manufacturing growth.

On the food and beverage production front, while we expect Nigeria’s economy to strengthen in 2020, we believe overall consumer spend would remain frail next year, as inflationary pressures stemming from border closure and a possible hike in power tariffs are expected to weaken the purchasing power of the naira in the near term. Although the federal government has implemented the increase in minimum wage from ₦18,000 to ₦30,000, we do not think the impact would be sufficient to revive consumer spend in 2020. Similarly, the unrelenting Apapa traffic gridlock continues to hamper the transport of raw materials from the Apapa port, resulting in lower sales volumes across affected manufacturers. This is evidenced by the sustained downward trend in turnover across our consumer goods coverage since 2018. With no clear policy in view to resolve the Apapa congestion, we expect overall growth in the manufacturing sector to come in at 1.2% in 2020, slightly up from a 2019 growth estimate of 0.8%.
ICT to drive services growth in 2020

Growth momentum in the services sector has sustained a down trend since the start of 2019, slowing to 1.8% y/y in Q3’19 from a Q4’18 growth of 2.8% y/y. The lacklustre performance witnessed in services in Q3’19 is markedly a reflection of the contractions in trade (-1.5% y/y) and real estate (-2.3% y/y), which jointly account for 41% of services output. We note that real estate has been moving downhill since the naira devaluation in 2016, which precipitated a huge obstacle to the importation of materials and equipment essential for construction. With no clear interventionist fiscal policy in view to provide a support system for Nigeria’s real estate in the near term, we expect the sector to shrink further next year, amidst frail interest from foreign investors.

On the flipside, growth in information and communications (ICT) strengthened to 12.2% y/y in Q3’19 (Q2’19: 11.3% y/y), supported by a two-digit growth observed in telecommunications. Contributing more to Nigeria’s economy than the oil sector, ICT has emerged as a major driver of non-oil growth, supported by rising subscriber base and mobile internet services. In the mid-term, we believe ICT holds strong growth prospects, evinced by a rapidly growing smartphone penetration and increasing investments in mobile networks, as telco operators shift focus to data-driven growth models. Overall, we expect services growth to come in at 2.4% in 2020, an improvement from a 2019 growth estimate of 2.0%.

Source: NBS, Vetiva Research

Contributing more to Nigeria’s economy than the oil sector, ICT has emerged as a major driver of non-oil growth, supported by rising subscriber base and mobile internet services.
Delayed PIGB passage, crude theft to keep oil investments at bay

We believe growth expectation in the oil sector looks underwhelming next year, as potential investments in oil exploration remain on the sidelines amidst regulatory uncertainty. We note that delays in the passage of the Petroleum Industry Governance Bill (PIGB) have halted investment inflows into the oil and gas space over the last five years, with Nigeria’s crude production remaining predominantly constant at 2 mb/d, despite increasing oil reserves. The tepid outlook for oil investments is further dampened by the incidence of crude theft in the Niger Delta region. For instance, over 2,000 cases of crude theft were reported between July 2018 and July 2019. Amidst all the aforementioned factors, we believe growth in the oil and gas sector would fall short of potential next year. Overall, we expect oil sector growth to slow to 3.0% in 2020 (2019E: 4.5%), as the decent performance in 2019 would create a strong base for comparison.

Amidst all the aforementioned factors, we believe growth in the oil and gas sector would fall short of potential next year.

Source: NNPC, Vetiva Research
Monetary Policy

Global monetary conditions will remain accommodative in 2020

In recent years, Nigeria’s monetary policy stance has been overly influenced by monetary conditions in developed markets, with the Central Bank of Nigeria (CBN) relying on wide interest rate differentials with the United States to attract liquidity flows to achieve exchange rate stability and financial system stability. In 2019, Central banks in developed markets (US, EU and the UK) realigned their policy thrust to stimulate and encourage economic growth by lowering short term interest rates. The U.S. reduced its benchmark rate 3 times in 2019, with the UK and EU holding rates at lows of 0.75% and 0.0% respectively, while the CBN followed suite with a 50bps cut in the MPR. We also observed an increase in unconventional measures by Central Banks in 2019, with the Federal Reserve adopting technical measures to maintain stability in reserve balances, while the European Central Bank (ECB) relaunched its asset purchase program (APP) in November, with monthly net purchases of 20 billion euros. With global monetary conditions likely to remain accommodative in 2020 due to expectations of weaker than expected GDP growth in developed markets, we expect domestic monetary policy indicators to remain unchanged from current levels and expect the CBN will anchor its 2020 broad policy thrust on exchange rate stability.

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Source: CBN, Vetiva Research

Unorthodox measures to support conventional monetary policy

We expect the CBN to maintain conventional monetary policy tools at current levels for most of 2020, along with the divide between the OMO and T-bills markets for most of H1’20 in a bid to avoid capital reversals and attract more Foreign Portfolio Investments as QE increases in advanced economies.

In 2019, the monetary authority turned dovish with a 50bps cut in the Monetary Policy Rate (MPR) at its committee meeting in March. The apex bank also confirmed its pro-growth leanings by expressing concerns on the low levels of credit channeled to the real sector and its decision to explore alternate measures to lower interest rates and spur bank lending to the real sector. To achieve its desire for lower interest rates in Q2’19 and improve access to credit, the CBN reduced OMO rates by 100bps on average in May and July, effectively reducing yields by 200bps at the start of Q3’19. This triumph was short-lived, as FPIs
reacted swiftly by dumping bills in August to see yields close up by 260 bps on average. The CBN however required domestic rates to remain low at the short end to support its LDR initiative that also commenced in Q3. To achieve this, the apex bank issued a directive to banks, restricting participants in OMO bills to banks and FPIs, thereby reducing the supply of short-term debt instruments to non-bank domestic investors (PFA$s, Domestic Corporates HNIs etc.) by c.85%. Consequently, yields eased in excess of 300bps across treasury bill rates due to a dearth of supply of risk-free instruments to the domestic market.

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<tbody>
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<td>DMBs were directed to maintain a minimum Loan to Deposit Ratio (LDR) of 60% by September 2019, with a sector weighting of 150% to priority sectors namely: SMEs, Retail, Mortgage and Consumer Lending. A penalty debit of 50% on the shortfall to CRR at 0% was also included.</td>
<td>Jul-3-2019</td>
<td>DMBs increased loans in excess of ₦800 billion between Q2’19 and Q3’19. CBN debited additional CRR from banks that failed to comply by the September deadline.</td>
</tr>
<tr>
<td>DMBs do not require prior approval from the CBN to offer mobile money wallet services. DMBs are however, expected to notify the CBN before the commencement of mobile wallet services and are required to operate within the extant regulations on mobile money operations.</td>
<td>Jul-4-2019</td>
<td>There was a marked increase in mobile wallet service provision in H2’19.</td>
</tr>
<tr>
<td>CBN required all DMBs to attain a minimum LDR of 65% by December 31. Failure to meet the new minimum will result in a levy of 50% of CRR- same as the previous directive</td>
<td>Sep-29-2019</td>
<td>DMBs’ loans are expected to grow further by year-end and going forward</td>
</tr>
</tbody>
</table>

**Increase government borrowing crowds out private sector credit**

Money and credit statistics reveal that while credit to the private sector (CPS) increased by 12.4% YTD to ₦25.8 trillion in October 2019, credit to government surged by 58.6% to ₦9.6 trillion in the same period. The increasing levels of credit to government reached record highs in 2019 from a 12-month average of ₦3.7 trillion in 2018 to ₦8.1 trillion on average thus far this year. In absolute terms, credit to government has increased by ₦3.3 trillion while CPS increased by ₦2.8 trillion between January and October this year. We attribute this development to inefficiencies from our irregular budget cycle and shortfalls in budgeted revenues for 2019. Hence, we expect a marked improvement in 2020 credit to the private sector on the possibility of a return to the January – December budget cycle and improved revenue collection to fund public spend.

*Source: CBN, Vetiva Research*
Inflation

2019 Base will cushion inflationary pressure in 2020

Inflationary pressures were tame for a larger part of 2019, supported by a high consumer price index base (CPI) base in H1’18 and slower economic activity (GDP averaged 2.1% in 9M’19). In 9M’19, CPI movement was more visible on a m/m measure as the high base of 2018 largely muted y/y inflation. A land border closure in September lifted headline inflation by 36bps to 11.61% in October and we expect this effect on inflation to persist till Q1’20, when prices settle and subsequently moderate from improved food supply. In our view, the key threat to inflation in 2020 is a spike in core inflation by Q2’20, driven by an anticipated hike in electricity tariffs. We also foresee pressure on general consumer prices due to expected increments in VAT and other government taxes, as these forces will be largely muted by H2’20 due to the pressured base of Q4’19. Consequently, our 12-month average inflation forecast for 2020 indicates a y/y moderation of 12 bps to 11.27%. Given the CBNs pro growth agenda, the relatively tame core inflation base and our headline inflation outlook, we do not expect the monetary policy committee to become extremely worried over the headline index in 2020.

Lower recourse to reserves will stabilize exchange rate in 2020

Nigeria’s liquid reserves averaged $42.5 billion in 2019, moving from $43.1 billion as at end of December 2018 to $45.1 billion by end of June 2019, due to improved domestic oil production and favorable oil prices ($66/bbl) during the period. Lower average crude oil prices in H2’19 ($61/bbl), FPI exits and speculator demand saw reserves fall by $3.0 billion to $39.0 billion by December with an average daily decline of $50.7 million in H2’19 vs an average daily
accretion of $19.3 million in H1’19 (Q2 averaged $41 million). We expect reserves to hover around the $38.0 billion mark in 2020, due to stable outlook for crude oil production and improved FPI flows. The CBN also reduced its recourse to reserves in 2020, as interventions by the apex bank at the NAFEX window in 2019 YTD declined by 51.8% y/y to $4.6 billion (2018 - $9.4 billion) from a total supply of $31.0 billion (2018 - $33.4 billion). Given our expectations for stability in reserves next year, we do not expect the CBN to supply more than $5.0 billion at the NAFEX window with improved portfolio flows expected to provide the bulk of supply. As such we expect the Naira to trade stable at the NAFEX window with a ± 5% volatility band.

Source: FMDQ, Vetiva Research
Fixed Income
Fixed Income

Fiscal, Monetary policies shape yield environment

Whilst we had expected yields to moderate in 2019, based on lower inflation and increased bond and bill supply, the level of moderation seen in the Fixed Income (FI) market has been substantial. The Central Bank of Nigeria (CBN) set the tone for the year by cutting the Monetary Policy Rate by 50bps in March. Before then, interest in the Fixed income market was buoyant, with both Primary and Secondary markets seeing yield declines across the curve (Yields declined 183bps on average in Q1’19). However, investors continued to favour the FI market over equities, with average yield declining by a further 32bps in Q2, as inflation continued to decline, and the FX market remained stable. Also, the lack of clear policy direction and delay in constituting a cabinet did not dampen local borrowing, as the DMO sold ₦1.1 trillion of government bonds in 2019, a 44.5% y/y increase. Furthermore, the CBN’s decision to restrict OMO activity to banks and international institutions in October caused the decline in yields to accelerate, dragging average yields 200bps lower in Q3, with some investors even returning to the equities market to place matured funds. With the Federal Government proposing a ₦2.2 trillion budget deficit in the 2020 budget and the emphasis on concessional loans to fund the deficit, we expect bond supply to decline mildly in 2020.

As such, we expect demand for Treasury Bills to remain high in the near term despite the weaker yield environment (the 91DTM bill sold at 7.80% in November’s first PMA). However, supply is likely to remain limited, as the CBN continues to restrict participation in OMO activity.

Investors continued to favour the FI market over equities, with average yield declining by a further 32bps in Q2, as inflation continued to decline, and the FX market remained stable.
FPI Inflows improve amid policy uncertainties

FPI inflows into the Nigerian market remained strong for the first half of the year, with loose monetary conditions in the developed economies driving significant flows into the Nigerian market. During this period, Forex reserves also increased by 4.8%, rising to as high as $45.2 billion as at the end of H1’19. However, the second half of 2019 saw a slight improvement in investor sentiment, as FPI inflows increased by 13% q/q to $262.1 billion in Q3 from $231.8 billion in Q2. In 2020, we expect slight improvement in FPI inflows amid attractive policy stance from the CBN, like the OMO restrictions.

The risk to foreign reserves is offset by our stable oil price outlook, as well as the anticipation of some resolution in trade-war tensions in 2020.

FX stability hinged on pressured reserves

Whilst the exchange rate has remained stable through 2019 (it has only moderated 0.26% in the I&E FX window ytd), the current yield and policy environment has driven a reversal in net foreign flows, with net outflows for October at $665 million, down from a net outflow of $1.3 billion in September. Unfortunately, this has increased the pressure on our foreign reserves, which have declined 7.39% ytd to $39.9 billion. Whilst the Governor of the CBN has assured international investors that the currency will not be devalued unless reserves fall below $30.00 billion, harkening back to 2017 when reserves fell as low as $23.0 billion, investors may begin to exit the market at a higher rate before they reach that psychological barrier. The risk to foreign reserves is offset by our stable oil price outlook, as well as the anticipation of some resolution in trade-war tensions in 2020. Should economic growth improve, crude demand may also follow suit (but only to a point), which could provide a cushion for reserves. However, this is only the bull scenario. In a bear-case, reserves could come under increased pressure amid worsening trade and economic conditions,
while further policy controls discourage investors and drive further exits from the capital market.

![Gross reserve movement in the last decade ($ 'billions)](image)

**Record 2020 deficit presents unique quandary for FG**

The government’s current public spending plans have seen the budget deficit rise from ₦1.7 trillion in 2015 to ₦2.2 trillion (budgeted) for 2020. In that time, the FG’s strategy for funding the deficit has been to increase the proportion of foreign debt to domestic debt to 50:50 from 19:81 in 2015; as of H1’19, the ratio stood at 32:68. While the servicing cost of the ₦8.3 trillion foreign debt is much lower (the 30-Year Eurobond was sold at a stop rate of 7.69%) than the domestic alternative, total debt servicing costs have risen by 45.5% in the last five years. Due to lower Brent prices ($64.00/bbl in 2019 vs $72.01/bbl in 2018) and lower-than-expected crude output, government receipts have been underwhelming, leading to underperformances in capital expenditure. With the Government expected to return to a regular budgetary cycle in 2020, the normal expectation would be an increase in borrowing to fund capital expenditure. However, as we have observed a reluctance to return to the international capital markets for further funding in 2019, albeit partly due to electioneering activities and the lack of a full cabinet. Thus, we foresee the issuance of some foreign government debt during the year, while the options of concessionary loans and public-private partnerships will remain a priority. Ultimately, we expect the bulk of Government primary activity in 2020 to remain local.

*The risk to foreign reserves is offset by our stable oil price outlook, as well as the anticipation of some resolution in trade-war tensions in 2020.*
New yield environment to boost commercial papers/bond activity?
Due to the CBN restriction on OMO activity, local investors across the spectrum have seen significant OMO maturities that they are unable to reinvest. Some of the funds were observed to have flowed into other securities in the Fixed Income space as well as equities, the jump in demand for bonds and T-bills has dragged yields substantially (average yield has declined 200bps since the restriction). Meanwhile, OMO maturities have continued to enter the market with few options for placement. This creates an ideal environment for local corporates to return to the market with Commercial Papers and bonds. However, the amount required from the debt market by corporates is insufficient to soak up the liquidity in the FI space, with the total amount raised by corporates through CP issuances in 2019 is a mere ₦201.2 billion, an indication of the level of capital that local corporates have used. Based on the current yield environment, we expect to see an increase in capital raises in the near-term, for as long as the CBN continues to restrict OMO activity.

Monetary easing in developed economies to persist in 2020
The slowdown in economic growth experienced by the developed economies (US GDP growth: 2.4%; EEA: 1.5%), exacerbated by the ongoing trade tensions, has seen various central banks soften their monetary policy stances. Amid this the U.S. Fed cut rates by a total of 75bps, while the European Central Bank (ECB) restarted their asset buy-back program and implemented negative interest rates in order to boost economic growth and inflation. With the IMF and ECB both forecasting global economic growth of 3.4%, higher than the 3.0% figure for 2019 but below 2018 levels (3.6%), we expect further rate cuts by the Fed (two more cuts are expected in 2020) while the ECB are likely to extend their asset buy-back program.
their asset buy-back program. This is a positive for federal borrowing, as any potential foreign debt to be issued later in the year is likely to command a slightly lower rate. However, while the overall perception of Nigeria's debt remains favourable, current policy uncertainties and pressured foreign reserves could dampen sentiment, causing potential investors to demand a higher premium for our debt. Thus, any likely Eurobond issuance will have to be preceded by a change in perception of the Nigerian economy and political landscape, in order to avoid worsening our current debt profile.

<table>
<thead>
<tr>
<th>Country</th>
<th>Current rate</th>
<th>Previous rate</th>
<th>Change</th>
<th>Date of change</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>1.75%</td>
<td>2.00%</td>
<td>25bps</td>
<td>31-Oct-19</td>
</tr>
<tr>
<td>U.K.</td>
<td>0.75%</td>
<td>1.00%</td>
<td>25bps</td>
<td>02-Aug-18</td>
</tr>
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<td>Kenya</td>
<td>8.50%</td>
<td>9.00%</td>
<td>50bps</td>
<td>25-Nov-19</td>
</tr>
<tr>
<td>S.A.</td>
<td>6.50%</td>
<td>6.75%</td>
<td>25bps</td>
<td>18-Jul-19</td>
</tr>
<tr>
<td>Turkey</td>
<td>14.00%</td>
<td>16.50%</td>
<td>250bps</td>
<td>24-Oct-19</td>
</tr>
<tr>
<td>Nigeria</td>
<td>13.50%</td>
<td>14.00%</td>
<td>50bps</td>
<td>26-Mar-19</td>
</tr>
</tbody>
</table>
Equity
Equity Market

A stuttering year draws to a close

Coming off a sustained downtrend (the market has lost more than 14% since December, 2018), expectations of a post-election rally proved unfounded, as the ASI floundered for most of 2019. Pre-election activity was tepid, with average daily turnover of ₦3.6 billion and periods of investor apathy. The postponement of the presidential polls further provoked doubt among investors, leading to a delayed reaction following the conclusion of voting and the announcement of results. Despite the straightforward process, investors failed to return to the equities market with any enthusiasm. Other drivers (the merger between ACCESS and Diamond Bank, the listing of MTNN and AIRTELAFRI) did provide investors with some reason to return to the equities market, but these were opportunistic forays rather than a concerted change in sentiment. Looking forward, we expect 2020 to provide a more attractive market for investors, amid a more stable political backdrop, increased capital expenditure, currency stability and slightly stronger economic growth (2020E GDP Growth: 2.4, IMF: 2.6%).

Risk-off internationals eye investment options

International investors traded cautiously in Nigerian equities throughout 2019, as the uncertainty of the ongoing trade war, weaker oil prices, domestic economic weakness and political uncertainty dampened sentiment. As of October 2019, total foreign investment activity had declined 26.2% y/y to ₦1.628 billion, while total foreign inflows into the market was 29.8% lower y/y at ₦363.85 billion. This reflects the weak perception of international investors towards the Nigerian market, while the OMO and T-bills markets remained more attractive through most of the year. In the final quarter, the CBN’s OMO policy, which was intended
to boost real-sector lending has pushed some investors into the equities space; however, this activity was led by local investors (according to NSE data, foreign inflows declined by 20.7% m/m in the period of the new policy, while outflows jumped 41.01% m/m). Further interventionist policies in the capital market are only likely to dampen foreign investor confidence, especially amid a less than bullish economic growth outlook and mounting pressure on reserves.

Emerging, Frontier markets provide near-term opportunities

Nigeria’s market performance compared to other Frontier Market names was poor; Egypt, Turkey and Kenya’s markets have all returned in the double digits so far in 2019. The general sentiment towards Emerging and Frontier Names has been positive, with investors taking advantage of the stronger yield environment of some of these markets. Also, the reversal of Monetary Policies in Developed markets proved a boon for Emerging Market borrowing. However, Frontier equity markets have generally lagged developed markets, with the MSCI EM index returning 6.4% ytd and the MSCI FM index gaining 9.5%, while the MSCI World Index for Developed Economies advanced 21.3%. Looking forward, foreign investor participation in Emerging and Frontier markets is likely to increase (even across equities), although the bulk of inflows will generally be to the Fixed Income space, amid dovish policy stances from developed economies and weaker global prospects. However, Nigeria is unlikely to be the main destination for investors, as comparable frontier markets currently present more attractive prospects. Having said that, without some guaranties over foreign exchange stability and regulatory policy direction, FPIs could remain risk-off with regards to the Nigerian market specifically. Economic variables in other Sub-Saharan economies could appear more attractive to foreign investors considering the challenges that our
The economy is currently facing. For example, Egypt’s economy has experienced a strong recovery since the free float of the local currency in 2016, with a Q3’19 GDP growth forecast of over 5% and a 2.4% y/y inflation figure for October, while their Equity market is currently trading at a P/E of 11.8x and dividend yield of 2.23% (Nigeria P/E 9.8x; Div Yield: 4.93%). The country also has higher FI yields (their 1-year paper has a 14.69% yield while Nigeria’s T-bill yield stands at 9.17%*), placing the market in a good position to compete for FPI’s. However, political instability has thus far stifled investor interest, though some less risk-averse investors may be more inclined to pursue opportunities in the market. Overall, unless the Federal Government can fully pacify foreign investors and assure them of Nigeria’s viability as an investment destination, foreign investor interest in the general equities space could remain limited outside of bellwethers.

**FX position less secure amid net FPI outflow**

Whilst we foresee a stable currency regime in the coming year, we remain cautious due to the increased pressure on foreign exchange reserves. Forex reserves began the year in an upward trajectory, accruing to $45.18 billion by June. However, towards the end of the year, reserves came under increased pressure amid a net FPI outflow in the months of September and October, dragging reserves to $39.66 billion by November. Thus far, the messaging from the CBN indicates that the Naira will not be devalued unless reserves fall below $30 billion. Investors will continue to monitor reserve levels, with inflows likely to remain limited amid weaker oil revenues and an uncertain policy environment. In a bearish scenario where foreign reserves drop below $30 billion and crude prices fall below $60/bbl, foreign investors may begin to exit the market over fears of a possible devaluation; however, this remains unlikely in the near term.
Primary activity dwindles in bearish market
In 2019, the NSE took further steps to demutualize the exchange, setting up the possibility of listing the company. However, this has been in progress since 2016. Other steps to deepen the market, through further listings and regulatory incentives could serve to renew interest in the Nigerian equities market. The listing of MTNN briefly drove the market into positive territory in May 2019, proving the attractiveness of certain companies and industries. Further representation of the telecoms sector or other frontier sectors underrepresented on the exchange (FinTech, Power, Mining and Quarrying etc.) could boost interest in the equities market. However, volatile policy direction and mild economic growth could stifle any diversification progress. Meanwhile, 2019 saw a significant decline in rights issues, with the total raised from the capital market by existing companies reaching ₦13 billion, compared to over ₦100 billion in 2018 (Including the WAPCO issue which opened in December 2018 and closed in January 2019). We expect this trend to continue in 2020, with the capital restructuring in the insurance sector likely to induce more capital raising in 2020.

Earnings fly under the radar...
2019 has been a mixed bag for company earnings, with the Banking sector one of the best performers, recording 12% y/y profits growth (across our coverage banks) and posting encouraging results. However, other sectors such as Consumer Goods and downstream Oil & Gas were largely unimpressive, while increased competition in the Industrial Goods sector gave little indication to investors of the short-term growth trajectory. However, the general reaction from investors was rather tepid, with the bourse remaining negative throughout the H1’19 earnings season. Save for a few isolated cases of buying recorded after...
particularly strong figures were reported in Q3, especially from the Tier-I banks, investors were unmoved by company performances and only bought names with the strongest results. Looking forward, we expect investors to remain subdued in their reactions to earnings releases in the new year, although we foresee a more positive reaction y/y. Savvy investors are likely to take positions in anticipation of stronger performances, especially in the banking space; however, the overall effect on market performance may be slight.

**Sectors**

**Banking:**
We expect Interest Income to improve on the back of the current CBN policy on OMO restrictions, while the LDR requirement raising loan-book could have an adverse effect due to the lag in booking of revenue from new loans generated by the regulation. In terms of Non-Interest Income, we expect improved economic activity and deeper mobile/internet penetration to provide an upside to banks’ fees and commissions, whilst a stable currency environment will not favour forex trading, thus we expect trading income to suffer. Overall, we expect mildly weaker y/y growth in profits in 2020

**Consumer Goods:**
We foresee stronger (y/y) economic growth, increased consumer spending and capital expenditure boosting firms in the FMCG space, while we expect the increased competition in the Breweries space could have an adverse effect on companies’ profits.

**Industrial Goods:**
With the expectation of increased capital expenditure from the federal government, we foresee an increase in demand for cement products and construction services. However, the increased competition could weigh on prices, limiting revenue. Also, increased exports to neighboring countries and higher capacity overall will likely mean an increase in overall income.

**Oil & Gas:**
in the upstream sector, between sluggish oil demand growth, pressure from the U.S. to increase supply and Increased shale output, we foresee a further moderation in Crude prices in 2020. Meanwhile, we expect the border closure to trim overall PMS imports, although we do expect the slim margins in the space to improve on the back of weaker crude prices y/y, lowering landing costs. However, we do still expect revenues to remain relatively weak, barring any deregulation of PMS product prices.
PFA activity remains underwhelming

Recently, Pension Fund Administrators’ activities have favoured the equities market as a result of the CBN restrictions on OMO activities, with their total allocation to the capital market inching up from 5% in September (Pre-restriction) to 7% in October. However, should the policy be reversed in the near to medium term, and international investors remain standoffish towards the market, we may see a reversal, or at least a return to the pre-restriction levels (6%). Typically, PFAs favour less risky assets over equities; hence, they stringently gauge overall sentiment on equities before taking positions despite attractive valuations. Given the lag in investment observed since the institution of the multi-fund structure, we do not expect this cautious approach to change in 2020 and foresee a similar trading pattern from PFAs in 2020. Furthermore, the reconstitution of the Pension Commission (PENCOM) board, which has been mooted, could be a driver for investment growth, should they reintroduce a minimum exposure to equities.
Something to look forward to...

Recently, the SEC announced plans to regulate the use of crowdfunding by businesses to raise capital. While crowdfunding is a popular source of funding in more developed markets, it is still a relatively new concept in Nigeria. The most popular examples of this are linked to agricultural investments, with some ventures promising returns as high as 30% p.a. As a means of raising capital for a business venture, and with the unfavourable conditions in the equities space, this could prove a threat to any future equity opportunities for specific businesses; with Agriculture and Real Estate currently the most popular in Nigeria. Given that crowdfunding has not yet been popularized among traditionally formal businesses, the threat to the equities space is limited. Also, given the types of projects such capital raising attracts, this may ultimately prove more of a threat to commercial CP’s for smaller companies than equity. However, should the SEC create a standardized platform for this crowdsourcing, investors could be tempted to favour such a market over the equities space, given the difficulties currently being experienced. In the long-term, we believe that this would deepen the Nigerian capital market and drive investment.
Banking
Banking Sector

Asset size will be the key differential for earnings in 2020

Post the 2006 industry consolidation, deposit money banks (DMBs) with relatively larger scale (total assets) have continued to perform better than their smaller peers measured by market share (deposits, loans), absolute profits (PAT) and returns to investors (ROAE). These tier-1 banks also account for c.70% of industry assets and liabilities and have fared considerably better than DMBs in the lower tier thus far. The operating environment in 2019 was plagued by underwhelming economic growth as Nigeria’s population growth rate of 2.8% outstripped the GDP growth of 2.3% recorded in Q3’19. A sluggish start to fiscal setup due to elections, amid little to negligible capital expenditure, dragged economic activity in H1’19, while a partial implementation of the public sector minimum wage, a late Q3’19 land border closure and rapid unconventional regulation from the Central Bank of Nigeria (CBN) shaped the landscape for H2’19. Although DMBs showed a certain degree of sensitivity to the aforementioned factors, the antecedents of the CBN with regard to its pro-growth leanings and regulatory tinkering were by far the most sensitive factors to DMBs operations in 2019. For perspective, the CBN’s implementation of a minimum LDR of 60% saw DMBs expand loan book by over N800 billion in just 3 months, while the segregation of participants in OMO bills saw yields moderate in excess of 3.0 percentage points by Q4’19. Banks with total assets in excess of ₦3.0 trillion remain best poised to benefit from these directives in 2020, with the marked improvements in ACCESS’ profitability ratios demonstrating the essence of scale in 2019.

Banks with total assets in excess of ₦3.0 trillion remain best poised to benefit from the CBN 2019 directives in 2020, with the marked improvements in ACCESS’ profitability ratios demonstrating the essence of scale in 2019.

![Total Assets and Return on Assets](image)

Source: Company Filings, Vetiva Research
CBN to have greater influence on operating environment in 2020

The CBN played a large part in shaping the banking landscape in 2019 and we see them stepping up a notch in 2020, in an attempt to achieve the goals set in its 5-year policy thrust. The apex bank demonstrated early dovish leanings in H1’19, beginning with a 50bps rate cut in the Monetary Policy Rate (MPR) in March, while continually expressing its concerns on the low levels of credit to the real sector. It followed up with a series of unconventional measures to get DMBs to lend to “priority sectors” and keep interest rates relatively low.

We expect the CBN to continue to influence the banking landscape in 2020 with additional directives and regulation; however, the regulator could struggle to maintain low rates at the short end of the yield curve through the year, given our outlook for higher y/y inflation in H1’20 and increased government borrowing to finance the projected budget deficit.

With Nigeria’s economic growth likely to remain anemic in the near term, due to anticipated lower oil prices and a dearth of reforms and capex required to boost non oil sector growth, we expect the CBN to maintain conventional monetary policy tools at current levels for the first 9 months of 2020. We also see the apex bank maintain the divide between the OMO and T-bills market for most of H1’20 in a bid to avoid capital reversals and attract more FPIs, amidst ongoing monetary easing in advanced economies. Finally, we see scope for one final review of the minimum LDR in Q2’20 to a possible cap of 70% and the possible introduction of sector specific NPL ratios to improve credit to priority sectors.

Source: Company Filings, Vetiva Research

With Nigeria’s economic growth likely to remain anemic in the near term, due to anticipated lower oil prices and a dearth of reforms and capex required to boost non-oil sector growth, we expect the CBN to maintain conventional monetary policy tools at current levels for the first 9 months of 2020.
Policy Reforms still required to unlock broad credit growth in 2020

The CBN's LDR regulation has seen banks increase credit to some retail (priority) sectors in 2019; however, the following sectoral reforms are required to achieve greater credit growth needed to boost economic activity in 2020:

- Liberalization of the Oil & Gas sector via the passage of the PIGB and complete deregulation of PMS.
- Power sector optimization by implementing a cost reflective value chain to attract investment to the sector.
- The adoption of a PPP/JV approach to plug infrastructure deficits in Housing and Transportation.

In our view, these reforms are critical for broad economic growth and could spur an expansion of over ₦3 trillion in industry loan book by FY’20.

Asset Yield to remain depressed in H1’20

Yield on assets within our coverage banks averaged 13.0% in 9M’19, moving from highs of 14.6% in Q1’19 to a low of 11.2% in July driven largely by reduced stop rates at OMO and T-bill auctions. Yields then adjusted upwards by over 200bps to settle at 13.5% on average in September before easing below 10% levels following the CBN’s restriction of patronage by non-DMB local corporates and individual investors in OMO bills. Following this, a low interest rate regime developed in Q4’19 and we expect this to linger through Q1’20 before inflationary pressures and budget borrowing weigh on rates by Q2’20. Thus our outlook for asset yield in 2020 varies across the two halves, with H1’20 asset yield expected to average 10%, while H2’20 should average 12%. As a result, we expect Net Interest Margins for our coverage banks to ease by 100bps y/y on average to 5.8% by FY’20. Our yield outlook supports both interest expense and net-interest income for DMBs in 2020, with our loan growth projection compensating for the lower asset yield. Hence, we forecast a 4.8% y/y increase in interest income for our coverage banks to ₦2.6 trillion by FY’20. DMBs will also benefit from a moderation in average Cost of Funds, due to a repricing of term loans and short term borrowing to spur a 3.5% y/y reduction in the interest expense of our coverage banks to ₦950 billion. Finally, we expect Net interest income to come in stronger y/y by 5.6% to ₦1.6 trillion for FY’20.

LDR regulation to remain key driver for Loan growth in 2020

The CBN recorded decent success with its initial LDR initiative, as industry gross credit increased by ₦829.40 billion or 5.33% from ₦15.6 trillion in Q2’19, to ₦16.4 trillion as at Q3’19. The LDR floor was subsequently reviewed to 65% with a December 31, 2019 cut off and this could see industry loans increase by 3% to ₦16.9 trillion by FY’19 and 6% to ₦17.4 trillion by FY’20. We also expect to see a sectoral rebalancing in banking sector credit by FY’20, given the current
levels of credit to priority sectors. Asset quality continued to improve in 2019, with industry NPL ratio declining consistently over the last 7 quarters to 9.8% in Q3’19. The main factor that supported the moderation in industry NPL ratio was a marked improvement in the asset quality of FBNH that saw its NPL ratio decline to 12.6% in Q3’19 (FY’18: 25.9%) due to significant progress in the resolution of its legacy portfolio. Going into 2020, we do not see scope for significant improvement in industry NPLs given the swift ramp up in loans required to meet the December 31 deadline and the default risk on loans to priority sectors. Our FY’20 NPL ratio forecast is thus 9.4%, with FBNH expected to improve to borderline single digits (9.9%) while ACCESS’ NPL ratio will remain elevated at 11% in 2020. We also expect our coverage banks to outperform the broader sector in this regard with a FY’20 NPL ratio forecast of 8.1%.

Coverage banks will remain adequately capitalized by FY’20
As of Q3’19, the average CAR for our coverage banks was 22.1%, representing a 2% y/y improvement and well above the 16% regulatory requirement for Systemically Important Banks (SIBs). We however note that FBNH could require additional Tier-1 capital next year to improve CAR from its current level of 15.1%. Outside our coverage universe, banks in the lower tiers will also require some capital injections to maintain their “going concern” status with Unity Bank the most prominent and this could spur considerable M&A activity within the space. Asides the need to raise capital, other key drivers for business combinations in 2020 are the need for scale to boost profitability levels and indications from the CBN of a probable recapitalisation that could see banks increasing their capital base above the current ₦25 billion minimum level. Nonetheless, we see scope for
M & A activity outside our coverage banks due to the gulf in earnings between Tier-1 lenders and other DMBs.

Asides the need to raise capital, other key drivers for business combinations in 2020 are the need for scale to boost profitability levels and indications from the CBN of a probable recapitalisation that could see banks increasing their capital base above the current ₦25 billion minimum level.

Digital Banking to support FY’20 Non-interest Income growth
DMBs have continued to enjoy substantial growth in digital and mobile banking transactions, with respective q/q increments of 3.7% and 78.6% in the volume of internet (web) and mobile payment transactions in Q3’19. Growth in alternative financial technology solutions (FinTech) has prompted banks to deliver essential financial services through cost-effective digital avenues, with mobile applications becoming attractive alternatives to traditional banking operations. We believe that fees and commission from banking transactions, especially digital banking, will have greater impact on the earnings of DMBs with a larger deposit base and customers in FY’20 (DMBs with deposits in excess of ₦2 trillion). This is further supported by the CBN’s cashless policy drive via cash withdrawal/lodgment fees. Additionally, we see Tier-1 banks exploiting arbitrage opportunities in the fixed income market, in a bid to grow their trading income—on average, we expect trading income to advance 11% y/y across our coverage. All in, our FY’20 estimate for Non-interest income across our coverage banks is up ₦991 billion (+9% y/y), with GUARANTY, UBA and ACCESS outperforming others.
Renewed focus on efficiency ratios required to boost DMB profitability

Cost containment and operational efficiency will remain differentiators amongst DMBs to ensure enough operating income trickles down to PAT. Banks under our coverage have managed costs considerably better than other DMBs with an average cost-to-income ratio of 57% for our coverage banks vs 78% for other DMBs. The superior efficiency displayed by our coverage banks also translated into profitability with our coverage banks achieving an average ROAE of 22.2% vs 15.6% by other DMBs. Going by the Q3’19 run rate, our coverage banks are on track to spend 9.2% more y/y on operating expenses in 2019, largely due to a 31% spike in ACCESS’ opex post consolidation. We however estimate a 5% y/y decline in ACCESS’ opex in 2020 due to the absence of one-off M&A related costs and a moderation of staff and other operating expenses. As such, we expect our coverage banks to spend just 5% more on operating expenses in FY’20 with a total opex estimate of ₦1.4 trillion.

Non-interest income to support 2020 earnings growth

We expect modest improvement in the macroeconomic environment of 2020, with a higher GDP growth, improved government spending and regulatory driven private sector lending. As such, we project average Gross Earnings growth of 6.2% across our coverage banks by FY’20. While this growth rate is lower than the 10.2% expected for FY’19, it is solely organic with the bulk of earnings expected from asset creation via loans. We still expect non-interest income to grow faster than net interest income y/y in 2020 (9% vs 5.8%) and highlight that growing consumer dissatisfaction from onerous charges on POS and digital banking channels could have adverse impact on non-interest income.
We also expect our coverage banks to improve efficiency in FY’20 with a cost-to-income estimate of 54.1%, 30 bps better y/y, which should support our FY’20 ROAE projection of 23.4%.

DMBs quoted on the Nigerian stock exchange have fared relatively better than the other sectors (ex-Insurance), with a YTD loss of 10.1% as at November 28, 2019 (NSE ASI -14.7% YTD). ACCESS is on track to close as the best performer in regards to capital appreciation with a YTD gain of 44% as at November 28, 2019. The sector average P/B multiple remains attractive at 0.71x, representing a 57% discount to MSCI EM banks (1.9x). We see value across tier-1 banking counters but note that Nigeria’s modest GDP growth outlook for FY’20 and growing speculation on foreign exchange rate instability weighs on current investor sentiment.
Oil & Gas
Upstream Sector

Economic recoveries to support oil demand growth in 2020

Oil demand growth has considerably decelerated since the start of FY'19 amidst signs of stress in the global economy. Specifically, economic weakness in Europe and the Sino-American trade dispute remain the leading contributors to world economic slowdown, resulting in a sizable decline in oil demand growth. While weaker consumer spend in Europe has been the major drag on OECD oil demand, the persisting trade war between China and the U.S. has narrowed the prospects for improved oil demand in the non-OECD region. Considering the aforementioned, the International Energy Agency (IEA), in its October Oil Market Report, trimmed its forecast for oil demand growth in FY'19 to 1.0 mb/d y/y, down from a previous estimate of 1.1 mb/d in September—this marks the weakest growth rate since 2012. In FY'20, the Paris-based agency expects oil demand growth to improve to 1.2 mb/d y/y, supported by anticipated recoveries in notable emerging and developing economies; this is, however, lower than its previous growth projection of 1.3 mb/d y/y.

OPEC+ mull deeper supply cuts

Although the OPEC+ coalition has maintained an impressive compliance (over 200% as of September) with a 1.2 mb/d supply cut agreement reached in December 2018, the impact on the oil market remains somewhat diluted due to a weaker growth in oil demand and increasing shale operations by U.S. frackers. Notably, while OPEC oil supply dropped to 28.5 mb/d in September 2019 from a December 2018 output of 31.6 mb/d, average Brent price (64/bbl) year to date remains significantly shy of the 2018 average of $72/bbl. In their latest meeting held in December 2019, members of OPEC+ agreed to implement an additional cut of 500 kb/d in the first quarter of 2020, in a bid to cushion crude prices amidst rising U.S. supply. However, some members have hinted at complying with deeper cuts only if countries like Nigeria and Iraq reach 100% compliance with the current agreement. As such, we believe the bulk of the additional cut would be borne by Saudi Arabia and Russia, as these two countries are the major drivers for deeper cuts.
Trump’s push for lower fuel prices amidst U.S. presidential election
As 2020 draws close, participants in the oil market will keep an eye on the U.S. presidential election scheduled to hold in November 2020. Typically, President Trump, in a bid to strengthen his political campaign ahead of the election, would want to keep fuel prices at relatively low levels for Americans. That said, we expect Trump to continually mount pressure on Saudi Arabia to increase crude supply, given that the country currently has a spare capacity of about 2 mb/d—the equivalent of Nigeria’s total output. We believe this could limit Saudi’s ability to further cut its crude output in 2020. Also along this line, Trump might consider tempering his diplomatic tussle with sanction-stricken Iran, in a bid to induce more crude supply from the Middle Eastern country, or at worst, ensure crude supply from the country remains at current levels (2.2 mb/d) in 2020.

Better rig productivity drives shale output
With cost of shale having dropped by more than 25% over the last five years, U.S. tight oil frackers are continually strengthening their focus on boosting shale output. Notably, 2019 marked a record year for Texas shale producers, as shale output from the Permian basin reached an all-time high of 4.7 mb/d in November, accounting for 36% of U.S. total crude output. Although the number of rigs drilling new wells in the Permian basin has moderated since the start of 2019, output from the basin continues to rise, as the productivity of those rigs—amount of new oil wells produced per rig—has significantly improved over the course of 2019. That said, U.S. oil inventories have risen to 450 million bbls from 390 million bbls in 2014, as tepid refining activities continue to yield supply overhang. Given the improved productivity of active of rigs in the Permian region, the U.S. Energy Information Administration (EIA), in its short-term
energy outlook, expects U.S. crude production to average 13.2 mb/d in 2020, up 900 kb/d from 2019 estimate. On this note, we expect Brent prices to average $60/bbl in 2020, 5% lower than the estimated average for 2019.

Amended PSC Act may weigh on offshore investments
In November, the President of Nigeria, Muhammadu Buhari signed a Bill amending the Deep Offshore and Inland Basin Production Sharing Contract Act (DOIBPSCA). The amendments to the Act include a flat royalty rate of 10% for deep offshore fields with depths greater than 200 metres and a 7.5% rate for Inland Basin PSCs. The revised Act marks a turnaround from the previous regulation that stipulated graduated rates for different depth levels. Furthermore, the revised Act also stipulates extra royalty rates that reflect current oil price movements; this is contrary to the previous Act which required an unclear review of royalty rates whenever oil price exceeds $20/bbl.

While the amended Act comes with the potential benefit of shoring up government’s oil revenue, it could, on the other hand, weaken investment appetite in Nigeria’s oil and gas industry as it can potentially raise production costs at major offshore fields (over 1,000 metres deep). For context, budget implementation reports show that PSC operators paid an average royalty rate of 2.3% in 2018; thus, the implementation of a flat royalty rate of 10% implies that the royalty charges incurred by these operators will more than quadruple henceforth. We believe this could further reinforce the planned move by some oil majors to reduce their footprint in Africa (Nigeria inclusive) and focus on growing their shale operations in the U.S. All in, the new offshore regulation may weigh on investment inflows to the Nigerian oil and gas sector, leaving

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Could PIGB be passed in 2020?
The Petroleum Industry Governance Bill (PIGB), meant to overhaul Nigeria’s oil and gas industry governance, has languished over the last decade, as it has continually darted back and forth between the National Assembly and the Presidency. Although the rhetoric surrounding the bill has not materially changed, 2020 looks promising for a possible passage, following comments made by the Speaker of the House of Representatives in July to prioritise the bill’s passage. We believe the bill could not be reviewed by the lawmakers in 2019 due to the political activities that dominated the first half of the year, while the President’s cabinet selection and 2020 budget talks engulfed the most of H2’19. Looking ahead, given the absence of major political constraints, coupled with a better level of harmony between the legislature and the executive, we expect the National Assembly to revisit the bill in 2020 and possibly pass it for presidential assent by Q2’20. An eventual signing of the bill into law would help curb the regulatory uncertainty that has halted investment inflows into Nigeria’s oil and gas industry over the last five years.

Nigeria’s oil output to average 2.17 mb/d in 2020
As expected, increasing production from Total’s Egina offshore field considerably strengthened Nigeria’s oil output in H2’19, while exports through major pipelines remained largely unconstrained during the period. Preliminary data from OPEC shows that Nigeria’s oil production (excluding condensates) improved to 1.87 mb/d in August—the highest it has attained since the start of the year. With the inclusion of condensates, current crude output is estimated at 2.16 mb/d,
underperforming the 2019 budget crude output benchmark of 2.3 mb/d. Going into 2020, we expect production to be sustained at current levels and forecast an average crude output of 2.17 mb/d in 2020, implying an improvement from 2019 estimated average of 2.10 mb/d. We, however, highlight that prolonged downtime at the two major pipelines (Trans Forcados Pipelines and Nembe Creek Trunk Line) bears a risk to our outlook. On the OPEC cuts front, we expect the other members of the cartel to sidestep Nigeria’s non-compliance with the pact, given the country’s economic woes—Nigeria’s crude output per capita is the lowest among all the OPEC+ countries.

**Downstream Sector**

**Border closure to trim imports of fuels**

In our earlier oil and gas report, we highlighted government’s persistent concerns over the smuggling of premium motor spirit (PMS) through porous borders into neighbouring countries where the price of this commodity is significantly higher than the regulated pump price of ₦145/litre in Nigeria. That said, in a surprising move in September, the government took the decision to close all the land borders indefinitely, till exporters in neighbouring countries begin to comply with ECOWAS ‘rules of origin’. In our Oil and Gas report published in April, we estimated that PMS demand in Nigeria currently stands at 42 million litres a day, whereas the NNPC’s PMS imports in Q3’19 averaged 55 million litres a day. With the borders fully closed, we expect the smuggling of regulated products to drop significantly in the coming quarters. Hence, we expect PMS imports into the country to fall below 50 million litres a day in the near term, translating to lower PMS sales across the downstream space.

**IMO 2020 may pressure landing costs**

In 2016, the International Maritime Organisation (IMO) announced a new regulation tagged ‘IMO 2020’, to reduce global air pollution caused by the high Sulphur content in marine fuels. The new regulation, which is expected to take effect on January 1, 2020, stipulates a cap of 0.5% Sulphur content in marine fuels—a steep drop from the current limit of 3.5%. That said, marine carriers will either resort to low Sulphur fuels or the use of exhaust-cleaning equipment (called scrubbers) in 2020; either option, however, comes with additional shipping costs. On this basis, we envisage a considerable rise in the landing costs of petroleum products in 2020, which could result in higher subsidy expenses, should the government decide to absorb the additional costs. However, if the land borders remain closed for the most of 2020, the expected fall in subsidy costs stemming from lower fuels imports could help offset the anticipated effect of higher landing costs induced by the new IMO regulation;
thus, PMS pump price could be left unchanged at ₦145/litre. Contrariwise, in a scenario where the borders are reopened early 2020, the government could be induced to pass the additional costs caused by IMO 2020 to consumers, given the government’s struggle with revenue generation amidst rising expenditures.

**Improved lubricants contribution to support margins in 2020**

Business climate in the downstream sphere has remained predominantly harsh for the oil marketers since 2017, as margins continue to drop across our downstream coverage, despite the lower landing costs of PMS witnessed over the course of 2019. For context, average gross margin across our downstream coverage declined to 9% in 9M’19 from 12% in 9M’18. Meanwhile, given our expectation of lower sales of petroleum products in 2020, stemming from the border closure, we envisage an increase in lubricants contribution to the revenue mix of most downstream players. As such, we expect margins to improve slightly in 2020, as lubes operations, on average, offer a gross margin of about 25%, significantly higher than an estimated gross margin of 7% from petroleum products.

![Aggregate lubricants contribution for TOTAL & FO](chart.png)

*Given our expectation of lower sales of petroleum products in 2020, stemming from the border closure, we envisage an increase in lubricants contribution to the revenue mix of most downstream players.*

*Source: Company Filings, Vetiva Research*
Industrials
Industrial Goods

Reduced political distractions will drive cement market growth in 2020

Amidst a continually expanding infrastructure gap, the Nigerian cement market continued to expand in 2019, with estimates putting market size at 16.3 million MT in 9M’19, 5% higher y/y. Notably, cement consumption has continued to expand in spite of hiccups to business activity in the first quarter of 2019 due to a protracted election period and the accompanying insecurity in several regions. However, compared to the corresponding period in 2018, market growth has decelerated by over 50%. Economic data also reflects this, with real cement GDP growth coming in at 4% in the 9M’19 period, compared to 6% in 9M’18. Interestingly, while we note that the distractions to business activity in Q1 negatively impacted cement sales, we believe that the drop in consumption growth was mostly driven by weaker public sector consumption as a result of unimpressive capex disbursement. According to the Minister of Finance, only ₦650 billion has been disbursed for capex thus far in 2019, with an extra ₦250 billion expected before the 2019 curtain call. The weak spend has generally been attributed to political distractions and the delayed appointment of the executive cabinet. This was reflected in the “absolute zero” capex rollout in H1’19 (revealed by the Budget office of the Federation) before the ministers were appointed in H2’19. Notably at 22% capex performance, this represents Nigeria’s weakest capex disbursement in over a decade, with the country averaging an equally unimpressive 63% in the past 10 years. Interestingly, despite the still widening infrastructure deficit and weak rollout in 2019, the FG plans to spend just ₦2.1 trillion on capital expenditure in 2020, barely three quarters of the 2019 budget. That said, due to the weak 2019 base and amidst a dearth of political distractions expected in 2020, we foresee actual capex disbursement in 2020 overtaking spend in 2019. Furthermore, in spite of our base expectation of another delayed budget passage, we expect consistent capex spend in 2020 as MDAs continue to utilize largely unspent 2019 capex allowances. That said, while we expect improved actual capex spend in 2020, we believe the extent of the improvement would be limited by the country’s weak revenue generation track and financing constraints. We comment that the poor capex performance in recent years has been largely driven by financing challenges, amidst persistently wide fiscal deficit and the de-prioritization of capex versus recurrent spend. Even after including another ambitious revenue target, the 2020 fiscal deficit still comes in at ₦2.1 trillion, marginally higher than the capex plan. With debt service charges gradually expanding (accounted for 54% of revenue in 2018), we foresee more financing challenges this year,
capping the extent of public sector cement consumption in 2020. Overall, we forecast mild growth in cement consumption from the public sector in 2020.

Continuous economic growth should further drive Private sector growth

We remain optimistic about private sector cement consumption, driven by sustained albeit fragile economic growth expectations (2020 GDPE: 2.4%) and a positive corporate performance outlook. Economic theory suggests that private sector capital spend is driven by major economic and sector outlooks. We believe this theory has held true in the past 8 years, with PPE spend on listed companies hitting a peak in 2014 (the height of crude prices) and dovetailing afterwards amidst projected economic headwinds, before promptly rising again in 2018 following the country’s recovery from recession.

...due to the weak 2019 base and amidst a dearth of political distractions expected in 2020, we foresee actual capex disbursement in 2020 overtaking spend in 2019.

Economic theory suggests that private sector capital spend is driven by major economic and sector outlooks.
Using Julius Berger as a proxy, we believe that private sector Capex spend has remained impressive in 2019, with revenue from Private sector construction contracts jumping 70% in the 9M period, as opposed to a 65% increase in revenue from government contracts. Overall, with economic growth expected to come in positive in 2020 and remain positive in the medium term, we expect private sector capital spend to remain impressive and consequently, cement consumption to improve. In 2020, we forecast a 5% y/y growth in cement consumption to 22.6 million MT in Nigeria.

Price competition unlikely to let up in 2020

The intense competition across the major cement producers in Nigeria was glaring in 2019. While some levels of competition had been present in the industry, the recent jump in industry production capacity and an inequivalent quid pro-quo in demand has seen this intensify, with a focus on pricing. Specifically, after a c.55% increase in average revenue/tonne between 2016 and 2018, prices have dropped by c.1% this year in reaction to the introduction of 4.5 million MT of capacity into the Nigerian cement market by the BUA group last year. With the outlook for cement consumption markedly weaker than expected additions to supply, we do not expect the competition on pricing to let up in 2020 and forecast another c.1% drop in average revenue/tonne. Specifically, Dangote cement is expected to commission another 6 million MT capacity plant in 2020, taking production capacity in Nigeria to 56.0 million MT.

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The rising competition has also seen increased pressure on marketing spend across industry players. Notably, industry selling and distribution expenses have jumped 26% y/y as at 9M'19 as the key producers battle for market share. Combined with the expected reduction in price, we foresee further EBITDA margin erosion in 2020.

**Finance costs set to moderate on delevered books, refinancing**

Following the divestment of Lafarge South Africa Holdings (LSAH) to Lafarge Holcim, Lafarge Africa’s debt balance has fallen from ₦266 billion in 2018 to ₦66 billion, slashing potential finance charges as well as eliminating potential FX losses on financial obligations. Specifically, we forecast a 52% y/y drop in Net finance costs to c.₦10 billion in 2020. We forecast a 39% y/y drop in Net finance costs for Dangote Cement as the cement giant continues to refinance expensive debt with cheaper commercial papers. While commercial papers accounted for 24% of borrowings at the end of 2018, it now accounts for 34% of debt.

Overall, while we expect lower prices and increased marketing spend to pressure operating margins, we expect the reduced finance charges to provide some relief for earnings below the EBIT line.

**A curtain call for CCNN, an introduction to Obu cement**

Recently, CCNN released a notice on the NSE, stating that it has received approvals-in-principle to carry out a scheme of merger with sister company, Obu cement company (Obu). Upon completion of the merger, CCNN’s assets and liabilities would be assumed by Obu after which the company would be dissolved and consequently delisted from the NSE. In its place, Obu would be listed on the NSE. This represents the final consolidation of all BUA cement operations in Nigeria, following the 2018 merger between CCNN and Kalambaina Cement.
company (KCC). Obu cement company boasts two 3.0 million MT cement production lines in Edo state, capable of running on multiple fuel sources including gas and LPFO. The kilns utilize gas fed through a pipeline that connects to the Ajaokuta gas line and both lines are powered by a 50MW captive power plant. Post-merger, Obu cement would possess a production capacity of 8.0 million metric tonnes, giving it a capacity share of 17% in the Nigerian market, a close third behind Lafarge Africa’s 10.5 million MT.

As consideration for the merger, Obu plans to issue one share for each current CCNN share held at a projected valuation of ₦35.00/share. With the new entity expected to have 33.9 billion share units, we estimate the listing market cap at ₦1.2 trillion.

We believe that the merger portends a host of benefits for Obu, with the company having access to stronger economies of scale and increased operational efficiencies as a result of the expansion. We also believe that this move places Obu in a stronger position to exploit long-term opportunities in the Nigerian and West African cement markets.
Agriculture
Agriculture

Border closure: Production boost or Inflation accelerant?

In September, Nigeria closed off its land borders with neighboring countries, Benin Republic, Niger and Cameroon. According to the Federal Government, the decision was made to reduce the rate of smuggling as well as support local production, especially in the agriculture sector. The FG has long decried the rate of smuggling that occurs across Nigeria’s porous borders, citing its negative impact on local production as the products smuggled in are usually cheaper than local counterparts. Notably, while rice importation has fallen 27% since the launch of the Anchor Borrowers’ Programme to stimulate production of priority crops, rice imports into Benin, Niger and Cameroon combined accelerated by 50% in the same period, even as population has expanded at a rate slower than 4%.

The closure has had an immediate impact on food prices, amidst a shortage of food supply since the border closure. Specifically, m/m food inflation rose to 1.33% (second-highest this year) in October from 1.30% in September. Speaking at the post-MPC briefing, the CBN governor expressed the committee’s expectation that food prices would subsequently stabilize as food supply increases to plug the shortage. However, we take a more conservative approach and expect food inflation to creep up even further until February, when the border is expected to have been re-opened. This is because, we believe that the core problems of the Agriculture sector are more structural. Specifically, the sector suffers from weak power, storage and transport infrastructure, poor access to credit, outdated land tenure policies etc. With the FG once again putting forward a weak spending plan for the sector in 2020, we do not see...
these factors improving in the short term and thus foresee a cap on production boost driven by the border closure.

That said, we highlight some wins that have occurred from the border closure. First, the closure is expected to put pressure on neighboring countries to step up border control efforts in an effort to curb smuggling. Notably, Nigeria has recently set up a joint border patrol force with Benin and Niger republic which is expected to resume operations upon re-opening of the borders. Furthermore, an intra-regional trade committee was also set up to promote legal trade between the countries.

**CBN initiatives, not budget will drive sector growth**

For a sector that is tagged as the nation’s key route to revenue diversification, budgetary allocations to the Federal Ministry of Agriculture and Rural Development continues to underperform. Of the ₦10.3 trillion national budget, only ₦138.5 billion has been allocated to the sector, accounting for a little over 1% of total budgeted spend. This once again falls below the prescribed 10% minimum sector allocation prescribed by the 2003 AU Maputo declaration.

![Weak Agric budget not enough to drive sector growth](image)

For a sector that is tagged as the nation’s key route to revenue diversification, budgetary allocations to the Federal Ministry of Agriculture and Rural Development continues to underperform.

However, we see some positive prospects for the sector, driven by CBN initiatives, rather than budgetary allocations. In recent years, the CBN has launched a number of initiatives aimed at increasing credit to the agriculture sector as well as reducing the risk profile of the sector. One of such initiatives is the Anchor Borrowers’ Programme (ABP), which was set up in 2015 to connect smallholder farmers with ready off-takers who process the crops and also provide access to credit below market rates. According to the CBN, the
programme has impacted a total of c.1.3 million smallholder farmers, providing credit facilities of c.₦205.8 billion across seventeen commodities.

Rice particularly has been a major beneficiary. While the 2018 target of self-sufficiency in rice production was missed, significant progress has been made in rice production since the inception of the ABP. Specifically, milled rice production has expanded at a CAGR of 5%, while rice importation dropped at a CAGR of 7% since 2015. Moreover, a series of tweets sent out in November by the CBN which hinted at more intervention funds to rice farmers, bodes well for the sector.

Source: CBN, Vetiva Research

According to the CBN, the program has impacted a total of c.1.3 million smallholder farmers, providing credit facilities of c.₦205.8 billion across seventeen commodities.
Sector expected to expand more meaningfully in 2020

Overall, while we estimate a 2.4% y/y real GDP growth for the Agriculture sector in 2019, we are more optimistic about the sector potential in 2020, especially given the level of support expected from the CBN initiatives. However, at 2.7% y/y, growth will remain capped below the 3% level by still-existing structural issues. That said, we remain optimistic of the sector’s long-term potential amidst a growing youthful population, currently low consumption per capita, availability of unutilized arable land, weak fertilizer penetration and long-term expectations of infrastructure improvement.

Sector focus: Oil Palm sector

After trading in a volatile manner for the first part of 2019, Global palm oil prices have been on an uptrend since July, rising 42% since the end of June amidst a surge in demand from the world’s largest importers. Specifically, global demand was boosted by an extended monsoon season in India, the world’s largest CPO importer. Furthermore, while China had previously emphasized a plan to reduce imports of CPO in favour of Soybean, the communist nation has ramped up CPO purchase in recent months following a Swine flu outbreak that has drastically reduced its pig population (Soybean oil in China is typically gotten as a byproduct of crushing the Soybean seeds to feed pigs). With China’s pig population still largely recovering, demand is expected to remain healthy. Furthermore, rising biodiesel demand from Indonesia and Malaysia is expected to offset the reduction in CPO demand from the EU amidst ongoing subsidy disputes. Overall, while demand from India could soften in 2020 following plans by the government to change import regulations at the start of the year, global demand for CPO should remain healthy as the other large Asian nations ramp.

Overall, while we project a 2.4% y/y real GDP growth for the Agriculture sector in 2019, we are more optimistic about the sector potential in 2020.
up CPO purchase in the same period. Local CPO prices should fare even better as the combination of higher global CPO prices and a base expectations of reduced smuggling support prices in 2020. Thus, we see an upside to revenue for domestic CPO producers in 2020.

Source: Bloomberg, Vetiva Research

Local CPO prices should fare even better as the combination of higher global CPO prices and a base expectations of reduced smuggling support prices in 2020.
Consumer Goods
Consumer Goods

Expect still slightly stunted growth in the manufacturing sector

Whilst the economy has continued to expand this year, real economic growth has remained fragile, with GDP growth still coming in sub 3%. While the oil sector has continued to expand post-Niger Delta militancy, the Non-oil sector has remained weak as real sector investments stagnate. The manufacturing sector has been particularly weak this year, averaging a 0.6% growth in the past three quarters (Q1-Q3’18 average: 2.0%), and even retracting by 0.1% y/y in Q2. We believe that this has been driven by a combination of still-weak consumer purchasing power and a jump in demand for cheaper imported alternative products. Notably, while Nigeria exited recession in 2017, we believe that consumer purchasing power has remained fragile, as subsequent economic expansion has continued to lag estimated population growth. Furthermore, consumer spending power has remained limited by sustained (but declining) double-digit inflation figures, weak retail credit access and insufficient fiscal stimulus. Expectedly, the Food and Beverage sector has also weakened, with growth falling to an average of 2.0% in the first three quarters of 2019 from an average growth of 3.2% in 2018. Apart from weak consumer spending, the subsector has been dragged by the prominence of cheaper imported food alternatives such as bouillon cubes, sugar, and crude palm oil. With this, we believe that many local food producers lost market share to cheaper imported substitutes in 2019, especially packaged food items. All in, Food & Beverages and Manufacturing are expected to grow at 12.3% and 1.2% y/y respectively in 2020, much lower than 13.6% and 0.8% in 2019.

Apart from weak consumer spending, the subsector has been dragged by the prominence of cheaper imported food alternatives such as bouillon cubes, sugar, and crude palm oil.

Source: NBS, Vetiva Research
Admittedly, the outlook for 2020 is brighter, if only marginally. First, we expect reduced pressure from cheaper imported/smuggled goods in 2020, amidst an expectation of stronger border security. We recall that the FG had closed off the land borders in September in response to increased incidences of smuggling and set a potential re-opening timeline of January 2020. However, the re-opening conditions attached to the re-opening provide an upside to domestic producers as they create a base expectation of reduced smuggling. Notably, Nigeria, Benin and Niger have created a Joint Task Force to tackle the issue of smuggling.

**Border Reopening Conditions**

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<tr>
<th>Condition</th>
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<tr>
<td>There should be no modification whatsoever to the packaging on those goods imported into an ECOWAS member state destined for Nigeria</td>
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<tr>
<td>With the original packaging they must be escorted from the port directly and transferred to the Nigerian Customs Service</td>
</tr>
<tr>
<td>For goods predominantly produced in ECOWAS Member States, the rules of origin must be certified, to avoid any possibilities of dumping</td>
</tr>
<tr>
<td>So, if goods are produced in ECOWAS member states, those goods must be in majority produced in those countries or if they are coming from outside ECOWAS the value addition made by an ECOWAS country must be over 30%</td>
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Furthermore, we foresee an upside to consumer disposable income in the form of minimum wage implementation. While the implementation of the much-heralded c.67% increase in minimum wage has so far been fractured, we expect above average compliance next year (at least from the FG) following the Federal Executive Council directive which mandated full compliance and back payment by December 2019. We believe this will support consumer spending, albeit modest given the size of the estimated impact relative to economy size.

Finally, we note the increasing drive by the CBN to improve retail loan access. Notably, the CBN recently placed a minimum Loan to Deposit ratio for Deposit Money Banks at 65%, with the intention being to drive credit to the real sector. With industry LDR still falling below minimum regulation, we foresee further upside to retail loan growth, potentially providing support to consumer spending.

On the flip side however, we see two factors as major detractors from consumer spending: a potential VAT rate hike and inflationary pressure from the border closure. First, we recall that in a bid to shore up its non-oil revenues, the FG recently announced a plan to increase VAT rate from 5% to 7.5%. The increase

*Source: BBC, Vetiva Research*
was spelt out in a Finance bill presented to the Legislature in October. While basic food items and certain products remain exempt from VAT charges, we still expect the 250bps rate hike to pressure disposable income, potentially capping any growth in consumer demand.

Furthermore, while we have seen the effect of the border closures on CPI in October, with food inflation climbing 1.33% m/m and 14.09% y/y, the highest increases this year, we expect food inflation to moderate to 12.31% in 2020 from a projected average of 13.66% in 2019, driven by an expectation of a slight reduction in demand pressure from open, albeit strictly monitored land borders and we see limited scope for consumption growth, based on our 11.27% CPI projection from an expected 11.39% average in 2019.

**Increased prices to drive revenue growth next year**

With consumer purchasing power still weak despite the exit from recession and demand still largely price elastic, FMCG producers have been hesitant in recent years to pass on rising costs to consumers. Notably, prices in the beverage industry have remained largely stable and have been cut in some cases despite higher costs. Coca cola, the last price holdout in the 60cl soft drinks industry recently reduced its 60cl RRP by 33.3% to ₦100/bottle. Even the excise duties imposed on beer, spirits and tobacco producers have driven minimal changes in retail prices amidst intense competition. Notably, with consumer wallets depressed and competition rife among industry players and cheap imported products, consumers have had a stronger grip on bargaining power. In recent months, following the closure of the border, we have seen a jump in headline inflation, driven by food inflation amidst a shortage of food supply. However, we believe that this increase was mostly driven by basic food items as prices of

![Headline Inflation](Image)

*Source: NBS, Vetiva Research*
packaged foods and HPC products have been largely stable. That said, we see scope for some price increases in 2020. First off, we see increased input cost pressure arising from potential increases in energy cost tariffs and an outlying possibility of a PMS price increase. Furthermore, given a base expectation of increased border security, we expect the reduced competition from smuggled products to improve producers’ bargaining power on prices, supporting price increases in the year. Finally, we expect the proposed increase in the VAT rate from 5.0% to 7.5% to drive an immediate price adjustment in 2020.

Overall, while we expect consumers to remain price sensitive in 2020, we foresee a series of price increases in 2020, especially in the beverage sector that will be hit by a final excise duty increase on spirits in June. Thus, we foresee a price driven revenue growth for our coverage producers in 2020.

**Stunted margin growth amidst increasing input prices**

Whilst price increases should drive revenue gains across board, we foresee increased pressure on margins amidst higher expected raw material costs. For example, while we expect price of wheat to remain stable in 2020, driven by stable supply levels and healthy demand, we foresee a jump in Barley prices in 2020 as demand from Saudi Arabia and North Africa weigh on pricing. Palm oil and Sugar prices are also set to increase in 2020 as strong Asian demand drives CPO price and reduced sugar supply supports sugar prices. While many local FMCGs are looking to localize sourcing of raw materials, inputs are still largely sourced outside the country, in an estimated domestic to foreign split of 60:40. With this, we expect increased margins for producers in the flour space but renewed pressure on beer, sugar and HPC manufacturers.
Disclosures Section

Disclosure

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