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Diversification: From Oil to Tax

Diversification is used as a technique in risk management, whereby one's portfolio is made up of a wide range of investments. The reasoning behind this is to minimize risk and reduce sensitivity to market swings. Thus, negative performance by one stock will be neutralized by the positive performance of other stocks.[1] This idea of diversification can be applied to areas in macroeconomics ranging from national economic output to government revenue. It simply follows the oldest tip in the book: do not put all your eggs in one basket.

In terms of economic output, the Nigerian economy is already quite diversified. In Q3 2015, the non-oil sector contributed 89.73% of total real GDP while oil contributed only 10.27%. Amongst the top non-oil contributors were: agriculture, trade, and information and communication (Table 1).

Table 1 : The largest contributors to GDP in Q3 2015.

Sector	Contribution to GDP
Agriculture	26.79%
Trade	16.29%
Crude Oil & Natural Gas	10.27%
Information and communication	9.80%
Manufacturing*	8.49%
Real Estate	7.57%

Source : *NBS. 2015. GDP Q3 Report. * Minus activities in Oil refining*

[1] Investopedia. http://www.investopedia.com/terms/d/diversification.asp

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On the other hand, government revenue remains largely dependent on oil. This lack of diversification is all the more problematic because of the volatility of the oil sector. Commodities are notorious for their volatility (Chart 1).

This volatility affects prices, production and inventories.[2] The weak fundamentals are driven by an elastic demand. Thus, prices are extremely susceptible to changes in demography, climate, exchange rates, growth and policies in major economies.

Chart 1 : **The Reuters/Jefferies Commodity Index showing the volatility of the commodity market from 1980-2016.**

3

Currently, an estimated two-thirds of the government's budgetary revenue is derived from oil.[4] This dependency has been especially catastrophic for the government in the wake of falling oil prices. Oil prices have declined by 69.7% since June 2014 leading to a 32.24% fall in government revenue. In turn, federal allocations to the states have fallen by 48.7% (Chart 2).

It goes without saying that this dependency poses a significant budget risk. The 2016 budget released late last year was based on a benchmark price of $38pb and oil prices today hover around $30-35pb. Accordingly, budget revenue is projected to decline by 30% expanding borrowing by another 20%. The outlook for oil

[2] R. Pindyck. 2004. "*Volatility and commodity price dynamics*". http://web.mit.edu/rpindyck/www/Papers/Volatility_Comm_Price.pdf

[3] www.safehaven.com

[4] Bloomberg. 2016. "*Nigeria Sees $5 Billion Silver Lining to Oil Rout on Subsidy End*" http://www.bloomberg.com/news/articles/2016-01-21/nigeria-sees-5-billion-silver-lining-to-oil-rout-on-subsidy-end

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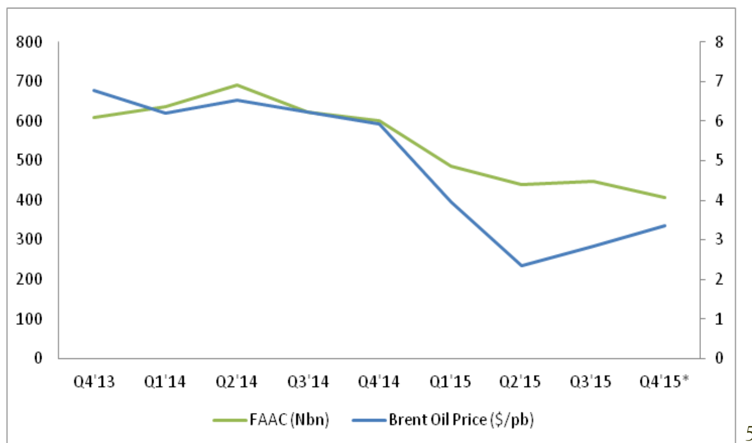
prices remains bleak as even the most optimistic forecast of oil prices this year is not close to pre-shock levels (Table 2).

Chart 2 : The relationship between FAAC and oil prices



[5]

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If dependency continues the result will be the retrenchment of government activities due to shortage of funds, increased deficit and higher debt from borrowing, further currency depreciation, depleted reserves and economic slowdown. We can either permit a continued downward spiral of the economy or make the necessary adjustments. The bottom line is that the diversification of the government's source of income is no longer an issue of choice. It has become paramount that the Nigerian government diversifies its source of income revenue.

[5] *Bloomberg; CBN Q3 2015 Statistical Bulletin*

Table 2 : Various projections for the average oil price in 2016, the highest being $56pb which is over 48% lower than the January 2014 average.

2016 Forecast	Oil Price ($pb)
EIU	42.9
EIA	38
World Bank	37
Goldman Sachs	20
IMF	20
Royal Bank of Scotland (RBS)	10[6]

The way out

Many advocate the revival of the agricultural sector as the messiah of the present crisis. This will diversify our exports and thus expand the supply source of foreign exchange. But such thinking is rooted in the belief that the shortage in supply of dollars is the reason why we find our economy in the middle of a slowdown. Rather, the shortfall in forex is only a result of an over-reliance on one source of foreign exchange revenue. Since agricultural products are commodities, their prices are not exempt from the volatility of the international market. While the development of agriculture will help reduce Nigeria's food import bill and provide a degree of self-sufficiency, in the end, if that is all that is done, the development and growth of the economy will still be dependent on an exogenous factor: the price of agricultural commodities in the world market.

A more sustainable option would be internal revenue generation through taxes.

Firstly, unlike revenue from oil and other exports, taxes have a very limited vulnerability to external pressure. Secondly, it takes less time, effort and cost to improve tax collection than to implement other long-term development plans such as agricultural reformation, construction of refineries that are expected to contribute to revenue.

[6] *EIU, IMF, Goldman Sachs, World Bank, RBS, EIA*

Problems to tackle

Currently, the Nigerian tax system is generating much less than its potential. In 2014, total tax revenue from the Federal Board of Inland Revenue was N4.69trn from N4.78trn in 2013. From this we can calculate that the tax to GDP ratio was 5.9% in 2013 and 4.3% in 2014.[7] This is substantially lower than the Sub-Saharan African average of 21% in 2014. This declining trend is not a problem of inappropriate policy but rather one of an inefficient tax collection system.

Because the tax officials are not well trained and equipped or well paid and monitored there has been inefficiency and corruption in the past In addition, the wide-spread perception that the government is corrupt and will not efficiently expend the collected revenue for the good of the general public, acts as a deterrent to tax payers.

This is further complicated by the unnecessarily onerous process involved in the payment of tax. According to PwC's report, Paying Taxes 2016, a research that measures the ease of paying tax, Nigeria ranks 181 out of 189 countries.[8]

Thus, the problem of inefficient mobilization of tax needs to be solved to improve internally generated revenue.

At the state level, Lagos offers a valuable lesson. As the nation's commercial hub, Lagos state has a population of about 21 million, of which at least 20% are in the working class. In 2012, the Lagos State government generated N219 billion internally, amounting to 55% of the proposed budget for that year.

Of this internally generated revenue, 78% stemmed from pay-as-you-earn taxes (income tax). [9]The state's success is due to its rigorous collection of tax at all levels of enterprise- even small scale businesses. This cumulative collection has funded Lagos' fast development and industrialization.

In conclusion, it is necessary to diversify the government's revenue base from oil proceeds, to more stable sources like taxes,

[7] FIRS. 2014. http://www.firs.gov.ng/Tax-Management/Pages/Tax-Revenue-Statistics.aspx.

[8] PWC. 2016. http://www.pwc.com/gx/en/paying-taxes-2016/paying-taxes-2016-appendix-3.pdf

[9] *NBS. 2012. Internal Revenue Generation Publication.*

which are dependent on the national income and can be stimulated by monetary and fiscal policies. Such diversification will reduce the level of exposure to external shocks and boost stability. Where there is economic stability, the country becomes more attractive to foreign investments which are what Nigeria needs in this critical moment to spur economic activity and output. Thus, diversification acts as a springboard for economic growth- the primary concern of every government for its economy.

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Potential Impact of Financial Inclusion on Economic Growth in Nigeria

At a time when Nigeria's economic growth is slowing down, financial inclusion could not be more important. Financial inclusion ensures that irrespective of income level, all individuals, households and businesses have access to appropriate financial services products. Given that low-income earners constitute a significant portion of the population and have a huge chunk of the economy's idle funds, increased access promotes capital accumulation, credit creation, increased economic activity, and increased investment.[10] It's estimated that Nigeria could even have a growth potential of 374% if 100% financial inclusion could be achieved (political and socioeconomic factors are kept constant).[11]

Nigeria has made significant progress in this area but 39.5% of Nigeria's adult population remains financially excluded, with an additional 11.9% only informally included.[12] Accordingly, the government has set financial inclusion as a key pillar of the Financial System Strategy 2020 to make Nigeria one of the major global economies by 2020. However, a number of challenges remain including low literacy levels, rising inflation, increasing poverty and poor salaries. The government and financial authorities need to take a more proactive approach to ensuring increased financial inclusion. Such an approach would involve eschewing any banking regulation or cost that could discourage people from saving or effecting banking transactions.

Financial Inclusion in Nigeria

Financial inclusion has been an integral part of Nigeria's financial industry reforms for over 30 years. From the rural banking program in 1977 to the establishment of community and microfinance banks in the 1990s and early 2000s, the government and

[10] Central Bank of Nigeria. 2013. "Financial Inclusion in Nigeria: Issues and Challenges". Occasional Paper No.45

[11] International Journal of Economics and Financial Issues, 2015. "Financial Inclusion and Economic Growth in Nigeria", Abiola Babajide et al

[12] Enhancing Financial Innovation and Access (EFInA). 2014. "Access to Financial Services Survey".

monetary authorities have delivered policies aimed at increasing financial inclusion. Progress made with these policies includes: the establishment of over 300 banks in rural areas in the 1970s and 1980s; the provision of N300million ($80 million) to small and medium scale businesses between 1988 and 1994; a significant increase in borrowing rates thanks to community banks and the government-run People's Bank; and additional initiatives since 2005 such as the National Microfinance policy, non-interest banking, a financial literacy campaign, electronic banking and the cashless policy that saw financial inclusion rise from 23.6% in 2008 to 48.6% in 2014. As a result of this nearly 5-decade long effort the ratio of currency outside the banking sector to narrow money supply has risen from 61.1% in the 1960s to 38.2% in 2005 and 20.8% at the end of 2015. However, the success has not been without challenges.

Moving Nigeria towards greater financial inclusion

A recent study by the IMF, which examined data from Uganda, Kenya, Mozambique, Malaysia, Philippines and Egypt, demonstrated that by leveraging three aspects of financial inclusion, a country can positively impact economic growth and affect income distribution.[13] The aspects of financial inclusion were access to credit, depth of credit and credit intermediation efficiency. Access to credit was determined by examining fees, transaction costs and documentation requirements. Depth of credit was determined by examining collateral requirements and borrowing costs while credit intermediation efficiency was determined by examining interest rate spreads as well as monitoring costs for banks. The data below shows that the GDP was impacted by a 1% increase in credit/investment ratio resulting from each of the segments of financial inclusion. The credit/investment ratio indicates how much the credit is growing compared to investments in an economy and this ratio has an impact on GDP. In essence, the credit/investment ratio is affected by a change in each of the aspects of financial inclusion and then the impact of changes credit/

[13] IMF. 2015. Identifying Constraints to Financial Inclusion and Their Impact on GDP and Inequality.

investment ratio on GDP is then measured.

Table 3 : Impact of dimensions of Financial Inclusion on GDP

	Uganda	Kenya	Mozambique	Malaysia	Philippines	Egypt
GDP Rise from 1% increase in Credit/Investment Ratio Due to more access to credit	0.39%	0.63%	0.39%	0.43%	0.29%	0.19%
GDP Rise from 1% increase in Credit/Investment Ratio Due to more depth of credit	0.35%	0.47%	0.51%	0.51%	0.26%	0.46%
GDP Rise from 1% increase in Credit/Investment Ratio Due to more effcient credit intermediation	0.12%	1.17%	0.60%	0.86%	0.41%	0.42%

Source : MasterCard Center for Inclusive Growth

In Nigeria, however, credit access barriers such as hidden charges, ATM withdrawal charges, email alert fees and other frivolous fees continue to be pervasive. The recent introduction of the account maintenance fee, introduced by the CBN to help cushion the impact of trade shocks in the banking sector, is yet another example of this.

In the case of the People's Bank and the community banks, documentation requirements, hidden fees, borrowing costs and interest rate spreads all act as deterrents to high success rates, even when these rates are lower than standard retail banks.

The IMF study provides a solid framework through which policy makers can evaluate Nigeria's financial inclusion initiative going forward. In order to optimally benefit from this study, it is imperative for the authorities to critically assess areas where previous financial inclusion drives did not succeed in the past and map out a practical strategy towards resolving the issues. This will provide the country with a solid platform with which to tailor a practical and forward-looking financial inclusion blueprint.

Opportunities for Nigeria's future of financial inclusion

The effort the Nigerian government and the CBN to increase fi-

nancial inclusion through the years has resulted in not just an increase in the number of people using financial services but also in the growth and sophistication of the financial system. The current macroeconomic policy aimed at improving lending to the real sector is a positive step but it is likely to benefit those that already use the financial services products, and therefore additional steps should be taken to ensure that there are favorable credit facilities to encourage participation by the poor and financially excluded. In addition, interest rates are still high and that will discourage poor business owners, who are not financially included, from seeking credit. Given the macroeconomic malaise Nigeria is currently facing, the government and policy makers are devising strategies to drive Nigeria towards sustainable growth. A coherent, effective and implementable financial inclusion roadmap has to be part of that plan.

A key catalyst in efforts to spur financial inclusion will be technology. With broadband projected to reach 30% by 2018, the government will have to leverage on the power of technology to achieve greater financial inclusion. Nigerian banks are already making it easier to utilize internet banking by making it possible to open an account from a mobile phone with internet without having to step into a banking hall. The financially excluded, mostly those in the rural areas, should be made aware of such developments. The Nigerian financial inclusion situation should be analyzed in the context of the IMF study while taking into account Nigeria's peculiar financial system and economy. An understanding of the past together with an insight into the present and future is required for have an effective financial inclusion strategy.

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2. 24hrs power supply
3. 24hrs security/CCTV/Alarm system
4. 24hrs Technician on duty
5. Fully equipped play area for children

Global Perspective - Downgrading long-term trajectory to neutral on erratic economic policymaking (*Culled from The Eurasia Group)*

Short-term trajectory: NEUTRAL

Long-term trajectory: NEUTRAL

- The Buhari administration will continue to take an ad-hoc approach to confronting the oil price shock.
- We still expect the central bank to adopt a new currency band in the first half of the year.
- Parliament will pass the administration's expansionary budget by April/May, despite partisan rancor.

We have held to a positive long-term trajectory for Nigeria, despite the oil shock, for several reasons. Buhari's historic election win in 2015 created a mandate for change on national security, anti-corruption and oil sector reform. On each of these dimensions, Buhari has made progress—and we expect continued progress on these fronts (informing our now-neutral assessment). With clear majorities for the ruling APC in parliament and in governors' mansions, the Buhari administration has political space to carry out its agenda (please see Upgrading long term trajectory to positive on Buhari's strong mandate and likely reforms).

Mixed signals in economic policymaking

Where the administration has struggled, and where it will continue to struggle, however, is in implementing a coherent economic blueprint to confront the oil shock. Until recently macro-economic policy has run a distant third to security and anti-corruption in the

government's policy priorities. In the absence of a clear policy framework, economic policymaking has relied on improvisation and economic nationalism, and will likely continue to do so despite Buhari's belated cabinet formation in September. This clouds the long-term policy outlook. While we expect the central bank to adopt a new (devalued) currency band in the first half of the year, it will probably keep import restrictions and some capital controls in place. The eventual policy response may not appease markets, given the central bank's erratic decision-making under Governor Godwin Emefiele. The bar to satisfy investors will be high; a 15-20% devaluation may not suffice. More than that, though, may not be politically feasible for an administration that frets over the inflationary impact to the common man. The naira problem will not be resolved via shock therapy, like the adoption of a free float. Instead we are likely to see grudging, incremental devaluation(s) of a widened currency band.

Faced with the oil shock the Buhari administration has resorted to unorthodox monetary policy, including capital and currency controls, to try to prop up the naira, which has recently slid to N385/$ on the parallel rate versus the pegged N197/$. The overvalued naira is poorly aligned with the government's plans to undertake countercyclical fiscal policy via borrowing and a mooted two-tier exchange rate system seems like an unlikely fix. Investors will demand a premium if the government continues to resist a devaluation. Partly for this reason, we think the central bank will eventually capitulate. Borrowing is central to the administration's infrastructure development and social spending, two central pillars of the 2016 budget. Nigeria's low debt to GDP ratio of just 14% will provide space to borrow, though its debt service to revenue is high, at over 30% (and these figures omit debt from states and state-owned enterprises like NNPC which owes oil companies about $5 billion).

The Buhari administration will not raise taxes in 2016 (the VAT will remain among the lowest in the world at just 5%), focusing instead on rigorous tax and regulatory enforcement, better oil revenue management and concessional loans to bolster revenues. Oil revenues will drop sharply but management of those revenues will likely improve. That will not be enough to offset the price drop, but it should help. The administration aims to keep its fiscal deficit at a 3% level. That may prove optimistic if the bearish oil

scenario persists, especially if contingencies arise like another federal bailout for the states (few states are adjusting to the new oil price environment). Still, by African frontier market standards Nigeria's deficit and debt are at the low end of the spectrum.

Oil price collapse may accelerate hydrocarbons reforms

The oil market rout looks especially dim for Nigeria (in particular for its light sweet crude amid growing competition from US shale). The prior Jonathan administration failed to save into the Excess Crude Account or sovereign wealth fund despite triple digit oil prices; together these finance vehicles barely have $3 billion. As a result, Nigeria has very thin fiscal buffers at a time when it is set to embark on countercyclical spending to bolster sagging growth prospects. On the positive side, the oil shock will likely accelerate reform of the Nigeria National Petroleum Corporation (NNPC) and the passage of a streamlined Petroleum Investment Bill (PIB). If the Buhari administration can pass an industry-friendly (or neutral) fiscal overhaul for the sector in 2016, it will help contain downside risks from the oil shock, especially if its recent renewal of the Niger Delta amnesty plan secures relative peace for onshore production. The restructuring of NNPC is likely to move ahead in 2016. Advancing other elements of the PIB, including the offshore fiscal terms, may take longer.

The Buhari administration's strategy for diversifying from oil rests on infrastructure development and import substitution in key sectors like agriculture and light manufacturing. Neither is a short-term fix, though we are likely to see some progress over a two year time horizon. There is an element of economic nationalism at work here, which resonates with President Buhari. The cornerstone of this policy is the restriction of foreign exchange to 41 categories of imports (including over 700 goods). As noted above, we expect the administration to retain these restrictions, with some modifications, even if it moves the currency band. The other pillar in its diversification effort, infrastructure spending, will rise sharply in the 2016 budget, both to provide economic stimulus and to bolster the non-oil economy. However, one unintended

consequence of the infrastructure drive is that it will probably increase imports substantially, at a time when foreign exchange reserves are just $28 billion and when the government is limiting imports. This points to another misalignment in the administration's economic policies as it balances competing priorities.

Signposts

Important signposts going forward include—the scope and timing of the devaluation; the possible establishment of a two-tiered exchange system and/or further capital controls; budget passage amid partisan rancor; renewed demand for another state bailout package; passage of the PIB (or PIBs as it will be broken into smaller pieces of legislation); the evolution of the security threat from Boko Haram and in the Niger Delta; whether the anti-corruption effort actually convicts former and current officials; progress, or not, in enforcing tax compliance in the oil and non-oil sectors; the continued rollout of the Treasury Single Account (TSA); and the likely breach of 10% inflation and possible breach of the 3% deficit target.

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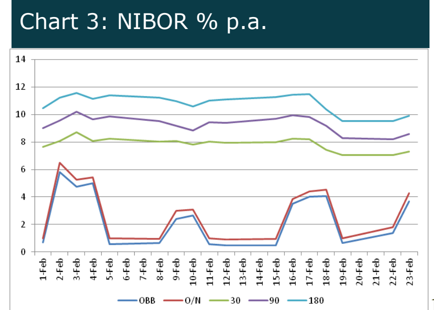
Macroeconomics Indicators

Money Market

The opening liquidity position in the money markets was considerably higher in the first half of February relative to the corresponding period in January. The markets opened at N404.30bn on the 23rd, 218.9% higher than N126.75bn long in the corresponding period in January. The increase in liquidity was as a result of the maturity of OMO auctions, which contributed to the increased inflow recorded in the market. Furthermore, the frequency of OMO auctions in the period under review was relatively less than the corresponding period in January.

Short term interbank rates (OBB, ON and 30-day) averaged 4.35% p.a. within the first 22 days in February, 37bps higher than the corresponding period in January. This was a result of the frequent intervention of the CBN in the month of January to mop up excess liquidity in the market through OMO auctions. As at February 23rd, the OBB and O/N rates rose to 3.67% p.a. and 4.29% p.a., 42bps and 62bps lower than their respective figures in the previous month, as a result of higher liquidity in the market.

Chart 3: NIBOR % p.a.



[14]

Outlook

The markets are expected to remain significantly liquid with interest rates trading between 0.5%-2% p.a., indicating an expansionary economic cycle with lower interest rates and higher liquidity. This is expected to stimulate economic growth through increased borrowings and investments. The difficulty in accessing forex implies that there is no outlet for funds which end up as idle cash in banks.

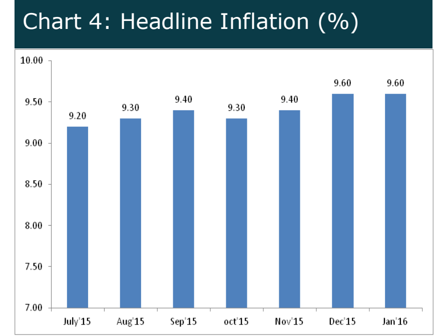
Inflation

In January, the headline inflation remained unchanged at 9.6%. The food index maintained the same trend, recording a similar pace of growth (10.6%). The core-sub index edged marginally higher to 8.8% in January from 8.7% in the preceding month.

[14] FMDQ

This was as a result of higher costs of road transportation and increased demand for books & stationeries due to the start of a new academic year.

Chart 4: Headline Inflation (%)



[15]

Outlook

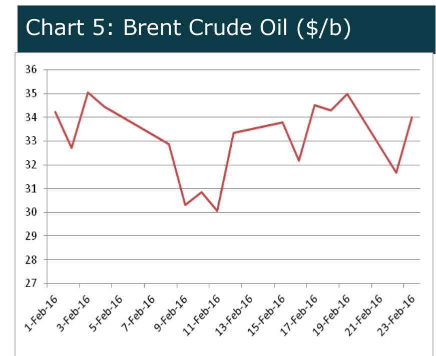
Price movement expected to resume upward trend in February given the liquidity in the market and the exchange rate pressures at the forex market. Furthermore, expectations of another period of fuel scarcity is in view as oil marketers express concerns over difficulty in accessing forex to import refined crude. Scarcity of forex is expected to push up the prices of domestic commodities with import content which will reflect in inflation rates. This is supported by the recent price increase seen in domestic commodities such as bread which has increased by 20% so far in February.

Oil Market

Oil Prices

Global oil prices (Brent crude) averaged $33.14pb between February 1st – 23rd 2016, 4.77% higher than the average of $31.63pb in the corresponding period in January. Oil prices trended higher, as prospects of an agreement to cut production amongst key oil producers (Russia and Saudi Arabia) increased in the period under review. In addition, the U.S oil rig count maintained a persistent decline in the period under review (currently at 541 on the February 20th from 650 recorded on the 20th of January). Furthermore, crude inventories recorded a decline of approximately 800, 000 barrels for the first time since September 2015.

Chart 5: Brent Crude Oil ($/b)



[16]

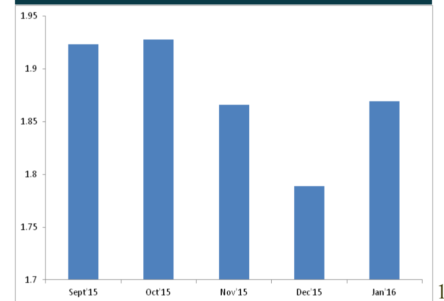
Outlook

The outlook on oil prices remains bearish as crude prices are unlikely to rebound in spite of the prospect of a decline in oil pro-

[15] NBS
[16] Bloomberg

duction from oil giants such as Saudi Arabia and Russia. This is because Iran and the US still pose a threat to supply in terms of production. Iran is expected to increase exports by 1.5mbpd in March and U.S producers are expected to maintain production given the sunk costs associated with shale production.

Chart 6: Oil Production (mbpd)



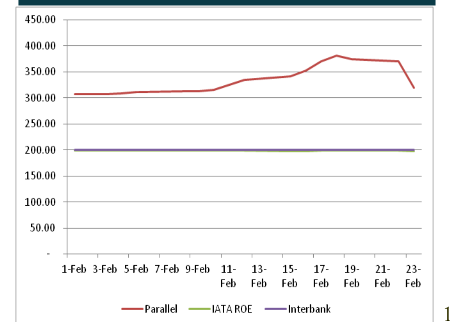
17

Oil Production

Nigeria's oil production level increased by 74,000bpd to 1.87mbpd in January from 1.795mbpd in December, as reported in OPEC's monthly oil market report. This is 15.05% below the 2015 budget benchmark of 2.2mbpd and 3.83% above Nigeria's OPEC quota of 1.8mbpd.

Forex Market

Chart 7: Forex (N/$)



18

Volatility in the forex market continued in the first half of February, as market panic heightened due to the uncertainty revolving an exchange rate policy. The naira reached record levels of N382/$ on Feb 18th before rebounding to close at N320.00/$ at the parallel market, as at February 23rd, - a 4.06% depreciation from N307.00/$ on February 1st. In contrast, the interbank foreign exchange market (IFEM) experienced a slight appreciation of 0.70% to N197.45/$, compared to N198.85/$ on February 1st. The IATA rate of exchange remained flat at N200/$ during the same period under review.

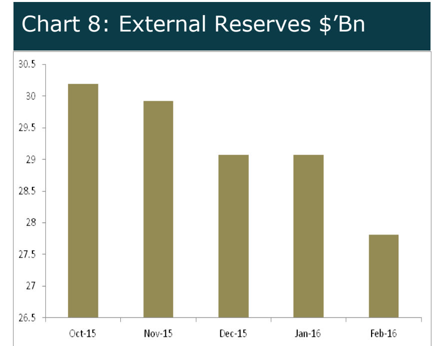
Outlook

The CBN is expected to maintain its stance on supporting the value of the naira at the interbank rate. However, as pressure mounts with increasing difficulty to purchase dollars, the naira may depreciate further pending an adjustment to the exchange rate policy.

[17] OPEC
[18] CBN

External Reserves

Nigeria's external reserves depleted by 0.6% ($170m) to $27.99bn as at February 19th. The level of import and payments cover is down to 4.50months from 4.56 months on February 1st. Year to date, the reserves level has declined by 3.81% ($1.11bn). Net external reserves level is estimated at $22.29bn, after deducting forward commitments and arrears due under letters of credit. This will bring the net reserves of import and payment cover to 3.61 months. There has been a steady decline in foreign portfolio funds coupled with lower oil prices, which have impacted negatively on the level of external buffers.



[19]

The external reserves level is 19.47% below 2015's peak of $34.51bn and 8.86% lower than 2015's average of $30.49bn.

Outlook

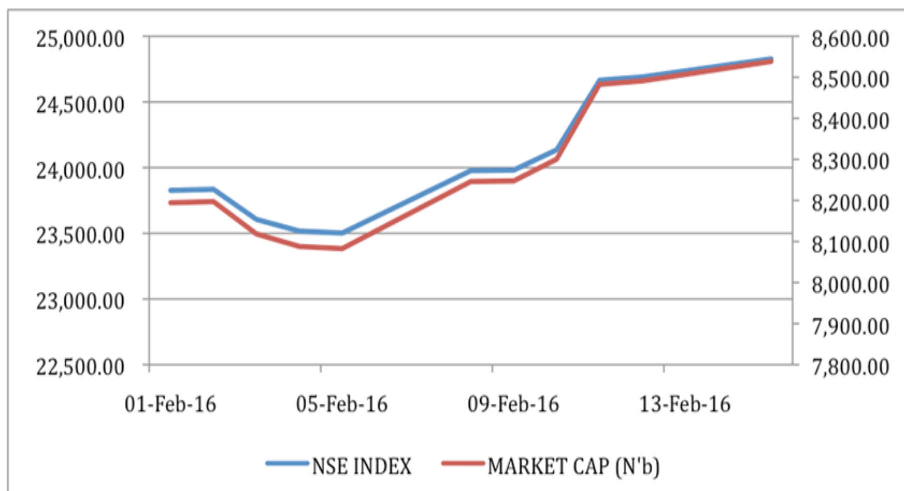
Currency pressures are likely to intensify due to the sharp fall in oil prices and Nigeria's high import dependency. The CBN will continue to intervene in the markets, running the risk of external reserves depletion.

[19] CBN

Stock Market Update

The Nigerian equities markets witnessed a net cumulative gain of 3.79% in the first two weeks of February. Following the global equities rout in January, stocks trading on the NSE were oversold and provided attractive pickings for speculators who tried to take advantage of underpriced stocks. Uncertainty surrounding the adjustment of the naira persisted through the first two weeks of February, keeping investors guessing and on the sidelines.

The bourse closed positive on 7 of the 11 trading days and reported marginal losses on the remaining days. The Nigerian Stock Exchange (NSE) All Share Index (ASI) gained 3.38% rising from 23,916.15 to 24,827.50 compared to a 19.45% loss in the same period last month. Market capitalization also gained 3.81%, rising from N8.22 trillion to N8.54 trillion during the period under review. Consequently, the year-to-date (YTD) return on the market was -13.32%.



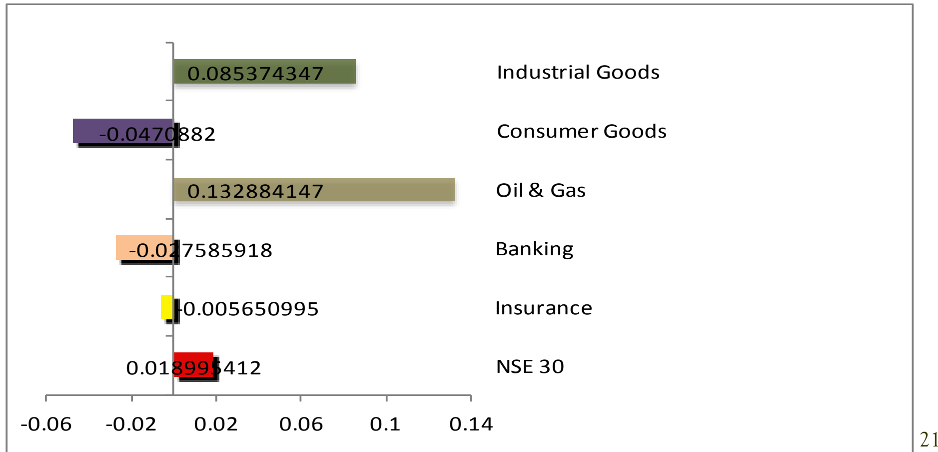
[20]

Sectors recorded mixed performance as the performance of a few stocks determined sectoral performances in the first two weeks of February. Seplat (up 34.52%) pushed the Oil & Gas Sector up to 13.29% after the Supreme Court ruling in favour or Seplat on the case brought forward by Brittania U. The industrial goods sector also recorded strong positive gains of 8.54% as Dangote Cement

[20] NSE

(up 17.90%) bolstered the performance of the sector. The consumer sector recorded the worst performance (-4.71%) as Nestle and Unilever shed 9.46% and 16.43% respectively. The banking sector recorded a loss of 2.76% as First bank and Zenith bank lost -4.07% and -8.01% respectively. The insurance sector recorded a marginal loss of only 0.57%.

Chart 10 : Bi-Monthly Sectoral Performance



[21]

During the period, financial services sector dominated activities on the exchange accounting for 53.48% of total value traded. Consumer goods sector accounted for 13.33% whilst industrial goods, oil and gas and conglomerates accounted for: 14.95%, 16.19% and 0.78% respectively. Total volume of shares traded within the period was 7.02bn, while market breadth increased to 0.65x as 30 stocks advanced against 46 stocks that declined. 114 stocks remained unchanged during the period under review.

The best performing stocks include SEPLAT 34.52%, INTERNATIONAL BREWERIES 19.63%, DANGCEM 17.90% and FORTE OIL 14.83%.

Top Gainers

Company	29-Jan	15-Feb	% Change
Seplat Plc	194.25	261.31	34.52%
International Breweries Plc	16.00	19.14	19.63%
Dangote Cement Plc	128.91	151.99	17.90%
Forte Oil Plc	297.83	342.00	14.83%
Mobil Oil Nig Plc	140.50	159.60	13.59%

[22]

[21] NSE
[22] NSE

Top price losers for the month were CONOIL (-29.59%), GLAXO SMITHKLINE (-22.60%), MAY&BAKER (-20.00%), UNILEVER (-16.43%) and UNITY BANK (-13.33%).

Top Losers			
Company	29-Jan	15-Feb	% Change
Conoil Plc	24.74	17.42	-29.59%
Glaxo Smithkline Consumer Nig. Plc.	26.99	20.89	-22.60%
May & Baker Nigeria Plc.	1.00	0.80	-20.00%
Unilever Nigeria Plc.	35.24	29.45	-16.43%

[23]

Corporate Disclosures

Nigerian Breweries released its full year 2015 results, which reflected an increasingly difficult business environment. Revenue grew by 10.3% from N266.37 billion to N293.91billion. Finance cost however also went up by 43.7% from N5.39billion to N7.71billion. Profit after tax declined by N4.47billion (10.5%) from N42.52billion in 2014 to N32.08billion in 2015

Flourmills of Nigeria Plc also recorded revenue growth of 7.94% in its 2015 Q3 results, which was released earlier on in the month. Finance costs also increased by 37.76% from N11.93billion in 2014 to N16.43billion in 2015. Profit after tax grew by 476.74% due to a one off gain of N23.73 from the disposal of investment in associate.

Seplat Petroleum Development Company Limited announced that a Supreme Court ruling in its favour on the litigation brought against it by Brittania U Nigeria Limited. The ruling will facilitate the transfer of OML 57 and OML 55 from Chevron Nigeria Limited and consolidate the company’s position as the preeminent supplier of gas in Nigeria.

Tiger Brands released its Q3 2015 results, which showed a remarkable improvement from the previous quarter. Gross Profit went up 8.49% to N1.27billion from N1.18billion in the preceding year. The group however recorded a net loss of N900million compared to N2.9billion loss in the same period of 2014.

[23] NSE

In Forte Oil's press release on its 2015 financial reports, an impressive profit before tax (PBT) of N7.01billion was reported. This indicates a 16.7% increase in PBT from N6billion in 2014. Profit after income tax increased 30.0% to N5.79bn compared N4.46bn same period in 2014.

Outlook

Activities in the last two weeks of the month will be largely dependent on full year results, which will be released during the period. We expect dismal results from the consumer goods sector and which will put some sell pressure on the Nigerian stock exchange. However, the results of some tier one banks would exceed analysts' expectations and offer some respite for the market.

Foreign investors will remain on the sidelines as the CBN grapples with an exchange rate policy, which will bring normalcy to the foreign exchange market. The bourse may trade sideways in the last 2nd half of the month, as results will send out mixed signals. We advice investors who wish to take long-term positions in the market to seek fundamentally sound stocks with attractive valuations.

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Exterior
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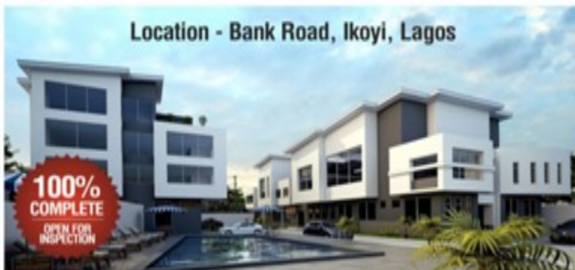

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Corporate Focus : Nigerian Breweries Plc (NB:NL)

Analysts Recommendation: BUY

Recommendation Period: 365 days

Target Price: N118.4

Analyst's Note

The palpable economic uncertainty facing Nigeria has turned many investors away from the Nigerian markets. This negative investor sentiment has seen investors sell off their stakes in companies listed on the Nigerian bourse, resulting in a YTD loss of 14.1%. Nigerian Breweries is one of the companies that has been affected by the general negative market sentiment as it has lost close to 10% in the last month since, January 22. In addition, Nigerian Breweries' latest financial result was less than impressive triggering further sell pressures. Though revenue increased by 10.3%, operating income and net income declined by 6.9% and 10.5%, respectively. The company was also affected by exchange rate pressures, which increased financing costs. However, despite these negatives there are many positives that investors need to take into account when evaluating Nigerian Breweries as an investment option.

Following the merger with Consolidated Breweries, Nigerian breweries stands to benefit from an expanded product base and improved operational efficiency. Furthermore, the addition of five new brands in the past 12 months indicates the company's investment towards innovative products that satisfy the consumers. Nigerian Breweries' highly talented and motivated sales force is also prepared to ensure that its products reach the market in the most optimal way. Besides enhancing its product lines and revenue base, Nigerian Breweries is also focused on ensuring that it controls its costs in line with its twin agenda of cost leadership and innovation. The recent launch of a three year N100 billion commercial paper program offers the company the flexibility to optimize its funding costs by allowing it to refinance borrowings with interest rates of between 15% and 16%. Given the dominant position that Nigerian Breweries holds in the

Nigerian brewery industry, as well as its revenue growth projections, it is a company with a framework designed to ensure sustainable growth. Accordingly, we place a BUY recommendation on Nigerian Breweries Plc**.**

Profile

Nigerian Breweries Plc is the leading brewing company in Nigeria. Incorporated in 1946 under the name Nigerian Brewery Limited, the company has grown into a behemoth in the Nigerian brewery industry through a series of strategic acquisitions. Following the recent acquisition with Consolidated Breweries, the company has widened its national reach as it now has 11 top-notch breweries. The company is a subsidiary of Heineken N.V, which holds a 54.3% stake in the company.

The company's primary business activities are brewing and the marketing and selling of lager, stout, non-alcoholic malt drinks and soft drinks. Nigerian Breweries' product portfolio includes brands, which are amongst the most popular in the Nigerian alcoholic and non-alcoholic products space. As the company continues to grow and invest in innovation, more product lines are likely to be introduced to the market.

Nigerian Breweries' growth can be seen through its financial results. Non-current assets had a compound annual growth rate (CAGR) of 13.84% between 2011 and 2015 just as the company's net assets had a CAGR of 30.27%. Profit after taxation (PAT) between 2011 and 2015 were down, however, due to unfavorable macroeconomics that made earnings decline from N42.5 billion in 2014 to N38.2 billion in 2015. These headwinds also affected its gross profit margin, operating margin and net income margin which decreased by 2.4%, 3.9% and 3.0%, respectively. Overall revenue increased by 10.3% for FY 2015, however, up from N266.4 billion recorded in FY 2014 (though FY 2014 results were based on Nigerian Breweries' result pre-merger with Consolidated Breweries). The cost of sales as a percentage of revenue was 49.2% in FY 2015, similar to 49.1% in FY 2014. Marketing and distribution expenses as a percentage of revenue were similar in FY 2015 and FY 2014 at 15.8% while administrative expenses as a percentage of revenue increased from 10.6% to 12.1%.

NIGERIAN BREWERIES PLC	2015 N'000	2014 N'000	2013 N'000	2012 N'000	2011 N'000	CAGR %
ASSETS						
Non-current assets	298,737,478	292,297,302	207,474,164	196,767,002	177,879,752	13.84%
Current assets	57,481,198	56,931,861	45,285,469	56,866,627	57,821,444	-0.15%
Total non-current liabilites	(43,818,068)	(63,239,328)	(40,104,733)	(73,351,269)	(66,805,903)	-10.01%
Total current liabilites	(140,079,105)	(114,025,572)	(100,295,715)	(86,834,468)	(91,116,384)	11.35%
Net Assets	**172,321,503**	**171,964,263**	**112,359,185**	**93,447,892**	**77,778,909**	**30.27%**
CAPITAL AND RESERVES						
Share capital	3,964,551	3,781,353	3,781,353	3,781,353	3,781,282	1.19%
Share premium	64,950,103	4,567,967	4,567,967	4,567,967	4,568,038	94.18%
Share based payment reserve	365,702	241,676	50,114	152,536	94,534	40.24%
Retained earnings	102,959,007	102,726,500	103,959,751	84,946,036	69,319,470	10.40%
Equity Contribution Reserve	-	60,565,334	-	-	-	
Non-controlling interest	82,140	81,433			15,585	51.52%
Total Equity	**172,321,503**	**171,964,263**	**112,359,185**	**93,447,892**	**77,778,909**	**30.27%**
COMPREHENSIVE INCOME						
Revenue	293,905,792	266,372,475	268,613,518	252,674,213	211,071,804	8.63%
Profit Before Taxation	54,514,973	61,461,821	62,240,317	55,624,366	56,397,878	-0.85%
Taxation	(16,458,850)	(18,941,568)	(19,159,968)	(17,581,652)	(18,347,122)	-2.68%
Profit After Taxation	38,056,123	42,520,253	43,080,349	38,042,714	38,050,756	0.00%

[24]

Management

Nigerian Breweries' massive growth through the years has been led by its effective management team. The company is led by experts that have a wide range of experience in finance, consumer goods, agriculture and government. Currently, the board of Directors is led by Chief Kolawole Jamodu. He became chairman in 2008 after his initial appointment to the board in 2006. He has previously worked in the consumer goods space as the Chairman and Group Chief Executive of the PZ Group. He has also led organizations including Universal Trust Bank Plc, Manufacturers' Association of Nigeria (MAN), and United Bank for Africa Plc. Chief Jamodu has also served in the public sector where he was a Minister of Industry and part of the National Economic Management team under former president, Goodluck Jonathan.

Mr. Nicholas Vervelde is the Managing Director of Nigerian Breweries. He has worked with Heineken in various capacities. Prior to becoming Managing Director in 2010, he served as a non-executive director of Nigerian Breweries as well as the director of Heineken Africa/Middle East. He has also held senior management positions in commercial and general management functions in Europe, Africa, Bahamas, Caribbean and Central America.

[24] Source: Nigerian Breweries Plc Annual Reports

Other key members of the Nigerian Breweries' management team include Hubert I. Eze, Franco M. Maggi and Hendrick A. Wymenga who serve as the sales director, marketing director and technical director, respectively.

Mr. Eze has worked in the company's sales department since 1992, and has served on international assignments for Heineken in the Caribbean, Central America and Latin America. Mr. Maggi worked with Heineken for over 15 years holding both finance and marketing positions prior to being appointed to the board of Nigerian Breweries in 2015. Mr. Wymenga worked with Heineken for over 15 years prior to joining the board of Nigerian Breweries in 2010. His technical expertise has been utilized in the packaging, brewing, production and supply chain units of the Heineken Group. Given the superior talent of the Nigerian Breweries' leadership team, the company will continue to be steered towards a path of sustainable growth.

The Bulls Say and the Bears Say

Bulls Say:

- Extensive product range for both alcoholic and non-alcoholic consumers
- Superior brand value that has resulted in a loyal customer base
- Highly trained and experienced sales force
- Dominance in the Nigerian brewery space through acquisition and merger with dynamic brewing brands
- Decreasing commodity prices of key raw materials such as sorghum
  - Increasing backward integration has enabled Nigerian Breweries to source over 47% of its raw materials locally

Bears Say:

- Intense competition from established brewery brands such as Diageo and SAB Miller

- Foreign exchange pressures could further weaken the naira and lead to higher finance costs
- Persistent macroeconomic headwinds have reduced consumer demand for products that use palm oil as a key ingredient
- Insecurity in northern Nigeria continues to dampen sales
- Increasing health-consciousness resulting in decreased sugar and alcohol consumption

Investment Thesis

FDC places a BUY recommendation on Nigerian Breweries Plc based on a comprehensive review of the company's intrinsic valuation and several factors such as the expected synergies accruing from the merger with Consolidated Breweries, its diversified product portfolio, extensive distribution network, cost management structure, investment in innovation, funding cost optimization and consummate management team. As a leader in the Nigerian brewery industry with a market share of about 65%, Nigerian Breweries is positioned to take advantage of its deep market presence and economies of scale towards ensuring market dominance, increased sales and cost savings. Though Nigerian breweries' latest results were not impressive, the company was able to keep most of its costs in check with the exception of administrative expenses. Nigerian Breweries' current price is due to overall negative investor sentiment in the Nigerian stock market, which has already lost about 13.8% YTD.

Given Nigerian Breweries' growth strategy of strategic acquisition, product diversification and market penetration, we expect the company to benefit from increased product lines and operational efficiencies resulting from the merger with Consolidated Breweries. In the past year, the company has grown its sales volume with the addition of five new brands. Furthermore, the company's decision to diversify its funding sources and restructure its finance costs through the launch of a three year N100 billion commercial paper shows the company's commitment to curtail costs. In summary, Nigerian breweries offers huge opportunities for investors willing to wait out the prevailing unfavorable market conditions.

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Bridget Chukwumah
bchukwumah@lbs.edu.ng
0701 990 0759/ 0802 478 2466

Application Deadline: February 29, 2016

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For more information:

Henry Etok
hetok@lbs.edu.ng
0708 007 0551 / 0708 007 0552

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oadenuga@lbs.edu.ng
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Financial Times, London.

Valuation

We derived our valuation for Nigerian Breweries Plc by using the discounted cash flow and the dividend discount methodologies. Our fair value estimate for Nigerian Breweries Plc is **N118.4**, which is an 18.4% upside on the current price of its share as at 19 February, 2016. The company's fair value is an average of the valuation derived from the discounted cash flow and the dividend discount methodologies, which recorded values of **N114.36** and **122.36**, respectively. The discount rate (weighted average cost of capital) of 14.3% is derived using a 12.17% risk free rate (the yield for a 5-year FGN bond maturing in February 2020), a beta of 1.11[25], a cost of equity of 18.8% (capital asset pricing model), an after-tax cost of debt of 8.7%, and a market risk premium of 6%. The long term cash flow growth rate to perpetuity used is 6.7% based on company and industry analysis.

Taking into account Nigerian Breweries' current investment, its expansion drive, diversified product portfolio, its extensive market reach, the growth prospects of its rich product lines and the prevailing economic condition, we forecast a five-year revenue growth CAGR of 13%. Furthermore, the company's earnings are projected to have a five-year CAGR of 21%.

NIGERIAN BREWERIES PLC	2016E N'000	2017E N'000	2018E N'000	2019E N'000	2020E	Terminal Value N'000
Revenues	320,004,931	368,005,671	423,206,521	478,223,369	540,249,064	
Cost of Sales	(157,314,299)	(180,911,444)	(207,371,195)	(229,547,217)	(259,319,551)	
Gross Profits	**162,690,632**	**187,094,227**	**215,835,326**	**248,676,152**	**280,929,513**	
Other income	1,623,836	2,120,548	2,256,304	2,320,561	2,449,173	
General & Administration Expenses	(50,518,715)	(60,154,864)	(69,816,109)	(78,899,185)	(90,793,609)	
EBITDA	**113,795,753**	**129,059,911**	**148,275,521**	**172,097,527**	**192,585,078**	
Depreciation & Amortisation	(30,398,978)	(33,005,057)	(35,139,108)	(37,309,093)	(40,486,914)	
EBIT	**83,396,774**	**96,054,854**	**113,136,413**	**134,788,434**	**152,098,164**	
Less: Taxes	(25,185,826)	(29,008,566)	(34,167,197)	(40,706,107)	(45,933,645)	
EBIAT (Unleveled Net Income)	**58,210,949**	**67,046,288**	**78,969,216**	**94,082,327**	**106,164,518**	
Plus: Depreciation Expense	30,398,978	33,005,057	35,139,108	37,309,093	40,486,914	
Less: CAPEX	(36,454,805)	(44,159,883)	(48,245,908)	(54,128,534)	(60,397,132)	
Less: Change in working capital	1,484,703	8,631,598	6,419,337	4,315,103	8,337,947	
Unlevered Free Cash Flow (FCF)	**53,639,825**	**64,523,059**	**72,281,753**	**81,577,990**	**94,592,247**	**1,331,046,485**
Discounting Period	1	2	3	4	5	6.7% long term cash flow growth rate to perpetuity
Discount Rate (WACC)	14.3%	14.3%	14.3%	14.3%	14.3%	
Discounting Factor	0.88	0.77	0.67	0.59	0.51	
Present Value of Unlevered FCF	46,936,064	49,403,030	48,426,896	47,824,481	48,523,501	682,794,181
Enterprise Value	923,908,154					
Net Debt	(17,108,097)					
Equity Value	906,800,057					
Shares Outstanding ('000)	7,929,000					
Price per share (N)	114.36					

[26]

[25] Financial Times
[26] Nigerian Breweries Annual Report

Risk

The major risks that could constrain Nigerian Breweries from achieving its investment goals of boosting earnings, increasing sales and improving operational efficiencies include persistent macroeconomic challenges, market risks, operational risks and continual security challenges.

Nigeria's seemingly unending macroeconomic headwinds have made both citizens and investors concerned about the country's economic direction. Nigerian Breweries' sales may be dampened by consumer resistance due to depressed discretionary spending and suppressed wage growth. Even though the company's effective sales team is capable of ensuring that its products are available at every location possible, consumers that view soft and alcoholic drinks as luxury goods may cutback spending on such items.

Market risks are also a factor, specifically currency risks and interest rate risks. Given that some of the company's debt is held in foreign currency, naira pressures could hurt its earnings by increasing the financing costs. Besides debt, Nigerian Breweries imports raw materials and machinery and a devaluation of the naira will increase operating costs. Furthermore, operational risks resulting from problems connected with the company's processes, technology, infrastructure and personnel could derail Nigerian breweries from actualizing its goal of improved operational efficiency.

In addition, the security challenges in the northern part of the country that have affected the company's sales so far may continue to have a negative impact on sales projections. Given that talented marketing and sales professionals may not be interested in conducting marketing drives in places affected by insurgency, the market penetration Nigerian Breweries' products will be subdued.

Though the risks facing Nigerian Breweries could limit the achievement of its long term objectives, the company has a robust risk management policy aimed at ensuring value addition to both customers and shareholders. The decision to raise funds through commercial papers at favorable interest rates underscores the company's determination to optimize funding costs. Given Nigerian Breweries' management record of steering the company towards growth even in times of negative economic conditions through the

years, we believe that the company's board and management will drive the company to flourish through the storm. Nigerian Breweries Plc is a company with a significant upside potential and immense growth prospects for the patient investor.

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