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IMPORT SUBSTITUTION IN NIGERIA: FEASIBILITY AND PATH TOWARDS REDUCED IMPORT CONTENT

The current exchange rate crisis facing Nigeria stems from the country's high import content. Almost everything in Nigeria is imported from toothpicks to refined petroleum products. The reliance on imported items has led to a huge demand for foreign exchange and a depreciation of the naira through the years. The country's external reserves, which have been used to defend the naira from spiraling out of control, have been on a free fall in recent years. Though some argue that the gross mismanagement of the country's external reserves is what brought it to its present low level, it is instead the intense pressure from Nigerians' utilization of imported products that has led to a dearth in external reserves as and a low import cover of less than five months. This dire economic position has been further complicated by the significant drop in export revenues from crude oil, resulting in external reserves being depleted without being refilled.

Besides negatively impacting the country's exchange rate and external reserves level, excessive importation has led to a near decimation of the country's manufacturing industry. The comatose state of manufacturing is reflected in the country's high unemployment and underemployment numbers. In order to curtail Nigeria's reliance on imports as well as reduce the deleterious effects of excessive importation, the government has developed an import substitution strategy that on one hand, limits access to forex (which then makes it difficult to import) and on the other hand, supports the country's manufacturing sector.

The intent is noble. Import substitution has many benefits including improved employment and forex preservation. However, there are many factors that relevant authorities must consider to ensure that import substitution is effective, and that it does not lead to unnecessary economic woes for Nigerian businesses. For example,

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many businesses, especially those that require key imported raw materials, are still counting losses incurred due to the CBN's forex restriction. Additionally, the broad based import substitution that is being implemented in Nigeria lacks the focus necessary to develop a comparative trade advantage. As a result, any advancement in the manufacturing sector as a result of the program will not be self-sustaining. Thus, it is imperative that the government has a clearly pragmatic approach towards import substitution and that it learns from countries that failed at successfully implementing import substitution.

IMPACT OF IMPORT SUBSTITUTION ON A COUNTRY

Import substitution is a strategy to reduce a county's dependence on foreign markets through the local production of goods, especially basic necessities. Even though it may seem like a viable economic step towards tackling import dependency and conserving foreign exchange, it does not always result in a positive outcome. In general, countries that practice import substitution are usually characterized by trade protection and overvalued exchange rates, which increase domestic prices and make exports less competitive. As a result, import substitution countries are often unable to export enough to purchase required imports. Thus, government authorities restrict imports to certain essential goods while the currency is devalued to make imports more expensive and exports attractive. The economy faces budget deficits due to government spending on industrial investments outpacing its revenue. More money is printed to cover the budget deficit, thereby stoking inflation, making domestic goods more expensive and reducing exports further.[1]

One example is India's import substitution strategy between the 1950s and 1980s. The Indian authorities were pessimistic of the country's ability to boost its export earnings and decided to embark on an import substitution policy.[2] It implemented a range of import bans, quotas, high customs duties (sometimes as high as 200%), and harsh foreign exchange restrictions. These protec-

1 Nimal Sanderatne, 2011, Import substitution: Is it a pragmatic economic policy?, http://www.sundaytimes.lk/111106/Columns/eco.html

2 Subho Mukherjee, http://www.economicsdiscussion.net/international-trade/policy/foreign-trade-policy-import-substitution-vs-export-orientation/10773

tionist policies led to a decline in India's share of world export markets from 2% in the early 1950s to 0.53% 40 years later due to loss of export opportunities. India also faced balance of payment problems due to the growth of its import substituting industries, which required large quantities of imported raw materials, machinery and capital goods. Another consequence of import substitution was the creation of inefficient and obsolete products that could not compete in the international market.

There were also instances when import substitution worked well in a country. Sri Lanka's agricultural sector recorded increased production due to import substitution policies. Protectionist policies led to the increase in production of rice and several food crops . However, it is important to note that import substitution supported by input subsidies, effective marketing plans, guaranteed prices and research.

Though countries usually undertake import substitution in order to enhance domestic production and reduce foreign dependence, import substitution may actually create economic problems pressures that were not envisaged. These policies sbecomes viable if it is complemented with government support and adequate infrastructural investments.

IMPORT SUBSTITUTION IN NIGERIA

Import substitution is not new in Nigeria as several past administrations have attempted various import substitution strategies. Some of these include the 1972 Indigenization Decree, which led to the development of the petrochemical plants, the iron, steel, textile, breweries, agriculture and cottage industries, and the establishment of assembly plants that used imported processed materials in the automobile and cement industries. Though these attempts met some degree of success, it is mainly the cement industry that has been able to fully actualize the benefits of import substitution. Nigerian cement companies not only meet local demand for cement, they also export cement to neighbouring African countries.

In 2012, the Jonathan Administration introduced the Nigeria Industrial Revolution Plan (NIRP) in order to enhance local production of goods that were imported as well as chart a comprehen-

sive course for turning Nigeria from a country that only exports raw materials (crude oil) to one that has a solid manufacturing base. The current Buhari Administration has repeatedly stated its intention to revolutionize agriculture, manufacturing and overall infrastructure. The decision by the current administration to implement this highly comprehensive and strategic NIRP, developed by the past administration, should help reposition the country's manufacturing industry in the medium term.

The case for import substitution is strong given data from the National Bureau of Statistics (NBS). In 2015, Nigeria spent approximately N1.6 trillion on importing "boiler, machinery, appliances", N1.3 trillion on "mineral products" and over N600 billion on "vehicles, aircrafts and associated parts". Spending such huge amounts to import has led to a dearth in local manufacturing and a steep decline in the foreign exchange earnings conserved.

Though import substitution has the benefit of increasing domestic employment, enhancing resilience against global shocks, conserving foreign exchange and protecting domestic infant industries, it is not without its drawbacks. Nigeria's protectionist and import substitution strategy of import bans, quotas, and the restriction of foreign exchange allocation to the importation of select items are reminiscent of India's import substitution blueprint. The blanket policy approach of banning or restricting the importation of a wide range of intermediate goods and finished products without ascertaining the feasibility of producing such items has led to increased production costs and rising inflation.

The Lagos Chamber of Commerce and Industry (LCCI) recently released a document highlighting the impact of the CBN's tightened foreign exchange policy on businesses and the economy. The sectors that have been heavily affected include: financial services, manufacturing (food and household products), the tire and rubber industry, pharmaceuticals, oil and gas, and furniture and foam manufacturing sectors.

Sectors	Impact of Forex restrictions
Financial services	- Lower transaction volumes - Restrictions on foreign credit lines
Manufacturing	- Reduced manufacturing due to lack of raw materials - Lower profits and slower consumer demand
Tire and Rubber	- Default on repayment agreement with foreign suppliers and banks
Pharmaceuticals	- Unavailability of key raw materials not locally produced - Increased production cost
Oil & gas	- Settlement of outstanding obligations are difficult and banking charges are being incurred
Furniture and Foam manufacturers	- Lack of key raw materials - Shut down of factories

Generally, the impacts of the CBN's extremely restrictive foreign exchange policy include:

- a significant reduction in manufacturing output given that many of the products on the list of the 41 items with forex allocation restrictions are intermediate goods, which are critical inputs to several manufactured products;
- lower profitability and higher production and operating costs;
- higher credit defaults with foreign suppliers due to the lack of forex to settle obligations;
- increased inflationary pressures;
- higher unemployment due to the closure of several manufacturing companies; and
- negative perceptions of the country as an investment destination.

Hence, there is a need for a critical examination of the import substitution policy.

WAY FORWARD

Given the need for Nigeria to reduce its over reliance on imports and improve its global trade competitiveness, it is imperative for the country to have a feasible plan to lower its import content and develop its export potential. Despite the merits of import substitution and protectionism of local industries, choosing such an economic approach underscores a lack of clear economic vision. The current import substitution strategy in Nigeria seems to be borne out of fear and capricious thinking rather than clear economic rationalization. For instance, the CBN's shutting official access to forex for the importation of selected items uses import substitution as a smokescreen for the real exchange rate issue of currency misalignment and forex scarcity facing the country. In addition, rather than have a blanket policy towards import substitution and trade controls, a case by case approach that limits the importation of goods based on a comparative advantage analysis should be used. In essence, a temporary import substitution for select commodities in which Nigeria has potential comparative advantage should be pursued.

The country should also have an export-oriented economic vision to spur growth and development while also reducing dependence on imports. Countries such as Japan, South Korea and China that have used an export promotion approach attained a fast rate of economic growth despite beginning from a state of underdevelopment. This outward-looking strategy to development has led to growth not just in primary products and raw materials segment, but also in manufacturing.

Additionally, incentives and governmental support are required for successful reduction in import content and export development. The success in the development of the cement industry to its current state, where it is dominated by local cement manufacturers that also export, can be replicated in other sectors. This is especially necessary in agriculture where government can provide subsidized financing, inputs and machinery. There could also be incentives to attract foreign investors as they respond positively to favourable trade and forex policies. It is critical to make the business environment attractive to foreign investors so that they can bring their capital, technology, managerial and technical experience to the country. A combination of temporary selective protectionist restrictions, innovation, governmental support, human

capital development and an effective export-driven master plan is required to catalyze Nigeria's economic and industrial development. This will save Nigeria from the claws of import dependency.

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THE INTERVENTION OF THE BANK OF INDUSTRY: A SUBSTITUTE OR A DELAY OF EQUITY INJECTION

The recent spiral of economic events in Nigeria has been a source of concern to everyone. With the drop in oil prices to less than $40 per barrel, the resulting effect in the depletion of the nation's foreign reserves and the subsequent depreciation of the naira, the question remains: as an import-dependent nation how will businesses strive in this economic environment? Manufacturers, who depend on imported raw materials, are at a halt in carrying out production activities. This challenge has led to businesses needing more capital to enable them to weather the storm.

The Bank of Industry is seen as a solution for many of these companies. Of recent, there has been a growing demand for funds from the BOI due to the low cost of the loans given and the ease of accessing these loans. However, businesses often fail to assess if the BOI funds suit their optimum capital structure and business strategy ahead of accessing these funds. As a result, the funds can end up doing more harm than good by sending businesses into a spiral of debt that cannot be serviced.

DEBT TO SERVICE DEBT LEADS TO A DOWNWARD SPIRAL

Debt as a source of capital is mostly used as a strategy to pursue aggressive growth. The underlying principle of which is that there is an expectation of future cash flows to be used to pay down the debt plus the interest. In contrast, many of the companies seeking BOI loans today are in financial distress. They take on additional loans to service past loans without making efforts to solve the underlying issues. Other businesses take on the loans to finance projects without sustainable plans for continuity. All of this simply leads to a spiral of future bad debts for the company.

China serves as a very strong warning for why this practice can lead to disaster. In a bid to boost the economy, and revive growth after the 2008 global financial crisis, a series of low cost bank loans were given to Chinese businesses and the public sector. Some of these loans were put into unprofitable business ventures

or non-income generating projects such as the financing of unneeded infrastructure by local governments. Fast-forward to today, and a lot of these borrowers are still unable to pay back these loans. According to recent estimates by McKinsey, the result has been a doubling of the debt to GDP ratio to 282% in 2014 as at the 158% recorded in 2007.[3]

The lesson is not that debt itself is a bad thing; debt is a strategic choice of funding for companies when it is used to finance projects that will earn income in the future. However, when debt is poorly planned and managed, it can be a careless move for less strategic companies, particularly as it has to be repaid with interest irrespective of the financial performance of the borrower. Accumulation of debt without strategic considerations puts the company in a very sensitive position, and at a very high risk of bankruptcy.

EQUITY FINANCING AS THE WAY FORWARD, BUT ACCESS REMAINS A BARRIER

Equity financing, the process of financing through selling company shares, addresses some of the problems of debt financing. First and foremost, there is less strain on the company's cash flow as the funds do not have to be repaid at any specific interval. The fact that the investors can only benefit from the company when the company actually makes a profit also puts less strain on the company's cash flow. Lastly, the risks and liabilities of the business will be shared with the new equity investors.

The major reason companies shy away from equity financing is the fact that they have to split ownership of the business with the investor. Yes, there will have to be a split in ownership of the business and yes, the owners will have less autonomy to make decisions. However, if the business is already in a lot of debt with operational inefficiencies and a possibly weak cash flow, sharing the decision making function with a new investor may not be such a bad idea for proper governance.

That said, there are two major challenges that make it difficult for

3 SOURCE: MGI Country Debt Database; Mckinsey Global Institute Analysis

businesses to tap into the equity space. First is the issue of availability of equity investors. With the current economic situation in Nigeria, equity investors have become more skeptical about putting funds into businesses. The recent degree of volatility in the economy makes it difficult and almost a waste of time for investors to attempt to value companies, since these valuations have their foundations on historical performances and forecasts, at this time, are far from certain. Secondly, there is the issue of the viability of the business in question. Businesses that show less potential will be hampered in their search for equity both due to their poorer performance and a higher likelihood that the existing owners are less inclined to relinquish some control.

ENABLING EQUITY INVESTMENT IN NIGERIA REQUIRES GOVERNMENT SUPPORT

In light of all this, there is a lot to be done to encourage equity investments for businesses in need of it. One major strategy would be to create an enabling and stable business environment. Policies should ensure that, even in a period of economic instability, measures are in place to grant some degree of cover to equity investors. This could be in the form of a bail out by the government in periods of economic downturn, targeting specific types of investors, most importantly those within the first few months of the investment. Such a policy would encourage equity investors and to an extent reduces the risk perception of investing in periods of economic downturns.

Also, the government can directly support these equity investors' financially through grants or subsidies, loan financing or acting as guarantors of debt during the early periods of the projects.

With inflation at 11.4% as at February 2016, an 18% rise as against 9.6% recorded in January 2016 coupled with the recent depreciation of the naira to the dollar, it is clear that more businesses will still be left with a weak cash flow position making it more difficult to meet up with their financial obligations. Considering there is still no certainty regarding neither significant increases in oil prices in the near future nor a short term diversification strategy to boost foreign revenue, it is important for businesses to take the issue of equity investments more seriously.

What businesses require currently, are long term strategic investors to enable them stand the test of time not just by bringing funds but also expertise where necessary.

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2. 24hrs power supply
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4. 24hrs Technician on duty
5. Fully equipped play area for children

GLOBAL PERSPECTIVE – *CULLED FROM THE ECONOMIST*

BUSINESS IN AFRICA

1.2 billion Opportunities

The commodity boom may be over, and barriers to doing business are everywhere. But Africa's market of 1.2 billion people still holds huge promise, says Daniel Knowles

For a look at the African boom at its peak, do as a multitude of foreign investors have done and fly into Abidjan, the capital of Ivory Coast. Visitors arrive in an air-conditioned hall where a French-style café sells beers, snacks and magazines. There is advertising everywhere, for mobile-phone companies, first-class airline tickets and a new Burger King. The taxi into the city smoothly crosses over a six-lane toll bridge. On the way to the Plateau, the city's commercial core, cranes, new buildings and billboards jostle for space on the skyline. In the lagoon, red earth piles up where yet another new bridge is under construction.

Just five years ago, Ivory Coast seemed like a lost cause. Having been defeated in an election at the end of 2010, the then president, Laurent Gbagbo, refused to leave office. The victorious opposition leader and now president, Alassane Ouattara, mounted a military offensive to force Mr Gbagbo out. French troops seized the airport to evacuate their citizens (the country used to be a French colony). Protesters were gunned down by troops, foreign

businesses were looted and human-rights activists gave warning about mass graves being dug.

Ivory Coast still has problems, as shown by a terrorist attack in March that killed 22 people. But its economy is the second-fastest -growing in Africa (after Ethiopia, which is much poorer), expanding by almost 9% per year. Foreign investment is pouring in. As well as the Burger King, Abidjan now has a Carrefour supermarket, a new Heineken brewery, a Paul bakery and plenty of new infrastructure. Sharp-suited, French-educated ministers explain in perfect English what they are doing to "open up", "improve the ease of doing business" and "sustainably grow the middle class". Expensive hotels, such as the reopened $300-a-night Ivoire, are booked up; their bars are full of affluent people striking deals. The country's three port terminals, the biggest of which is being expanded by Bolloré, a French industrial firm, are working at full capacity, importing cars and electronics and exporting cocoa, coffee and cashew nuts.

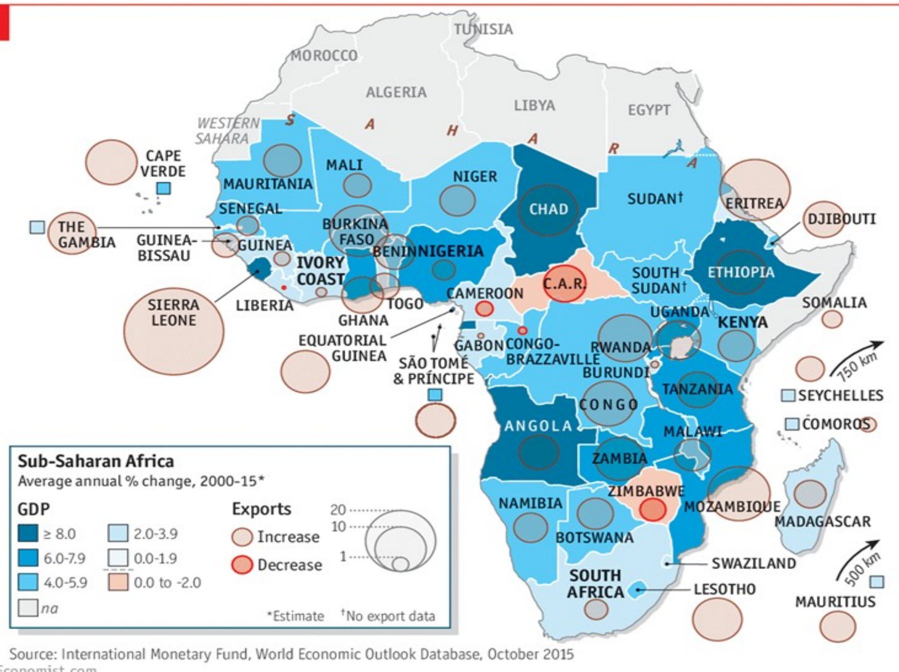
This is the Africa of business magazines and bank ads: a continent that is rising at a prodigious pace and creating profitable new markets for multinational firms. But Abidjan also has plenty of reminders that it has been here before. For all of the new buildings springing up, its impressive skyline is still dominated by crumbling 1960s and 1970s concrete modernism. The roads may be new, but the orange taxis that ply them are still ancient fume-spewing Toyota Corollas, remnants of an earlier boom. For the two decades after independence from France in 1960, Ivory Coast enjoyed an economic miracle. Then, quite suddenly, the price of cocoa and coffee plunged and the boom faded as quickly as it had begun.

REASONS TO WORRY

The deepest fear of today's investors in Africa is that it may be happening again. In Ivory Coast's neighbour, Ghana, thousands of government workers have been marching in the streets in the past few months to protest against their rising cost of living. Ghana relies on oil and gold, both of which have fallen in price, as well as cocoa. That, plus prodigious government borrowing, has

caused a crisis. One US dollar now buys 4 cedi, the local currency; in 2012, it bought not quite two. Growth has halved since 2014, and Ghana is running a budget deficit of 9% of GDP and a current -account deficit of 13%.

According to the World Bank, in the year to April last year the terms of trade deteriorated in 36 out of 48 sub-Saharan African countries as the price of their commodity exports fell relative to the cost of their imports, mostly manufactured goods. Those 36 countries account for 80% of the continent's population and 70% of its GDP. Eight countries, including two giants, Angola and Nigeria, derive more than 90% of their export revenues from oil, which has recently plummeted far below the price needed to draw in new investors. Growth across sub-Saharan Africa dropped to 3.7% in 2015, far below East Asia's 6.4% and nowhere near enough to create enough jobs for the continent with the world's youngest and fastest-growing population. The World Bank expects it to tick up again, but only to 4.8% in 2017.



Source: International Monetary Fund, World Economic Outlook Database, October 2015
Economist.com

Countries that happily borrowed from international investors over the past few years have now found themselves shut out of the markets. The stock of outstanding sovereign bonds in the region had risen from less than $1 billion in 2009 to over $18 billion in 2014. If growth continues at a decent clip, that should be man-

ageable. But if it stops, interest rates of 10% or more on dollar-denominated bonds will make refinancing difficult.

Unspectacular

GDP, % change on a year earlier

Source: IMF *2013-15 estimates †Estimate

Economist.com

The continent's two biggest economies, Nigeria and South Africa, are already in deep distress. The reasons are different, but both have suffered from commodity-price falls as well as from atrocious economic management. The IMF, although loathed in much of Africa, is back, providing a $ 1billion loan to Ghana and preparing another for Zambia. Some fear a return to 2000, when this newspaper described Africa as the "hopeless continent".

Yet despite that, Nairobi's thriving malls and Abidjan's humming ports show that there are plenty of reasons to stay optimistic. The economic conditions have got worse, but this is a very different continent from two decades ago, when troops from eight African countries were fighting in Congo alone. Wars still rage in South Sudan, Somalia, Mali and northern Nigeria, and violence bubbles in places like eastern Congo, the Central African Republic and Burundi. But broadly speaking, most of sub-Saharan Africa is now peaceful. Elections seem increasingly less likely to result in strife, even if they still generally return incumbents, and more and more often for unconstitutional third terms. The governments that come to power are still often corrupt and inefficient, but far less brazenly so than those of cold war despots such as Mobutu Sese Seko of Congo or Jean-Bedel Bokassa of the Central African Republic.

Africa's 1.2 billion people also hold plenty of promise. They are young: south of the Sahara, their median age is below 25 everywhere except in South Africa. They are better educated than ever before: literacy rates among the young now exceed 70% everywhere other than in a band of desert countries across the Sahara. They are richer: in sub-Saharan Africa, the proportion of people living on less than $1.90 a day fell from 56% in 1990 to 35% in 2015, according to the World Bank. And diseases that have ravaged life expectancy and productivity are being defeated—gradually for HIV and AIDS, but spectacularly for malaria. Some of the gains may seem modest, but given that living standards across Africa declined during the 30 years after independence they are sufficiently established to prove lasting.

And for all that oil and metals have come to dominate economies such as Nigeria's and Congo's, the boom broadened beyond natural resources. Mobile telephones have transformed commerce across Africa, and now smartphones and feature phones (which are halfway between dumb and smart) are taking hold. In 2014, the latest year for which figures are available, 27% of Nigerians owned a smartphone. In many African countries 4G mobile-phone infrastructure is the only thing that works well, but it works at least as well as in much richer countries, and a lot can be built on it. What began with mobile-money systems such as Kenya's M-Pesa is now branching into bank accounts, savings accounts, loans and insurance. That in turn is helping people rise out of poverty and invest in their future.

This special report will argue that despite some deep and entrenched problems, African businesses offer hope too. It is clearly risky to make sweeping judgments about an entire continent with 54 countries and 2,000 languages. This report draws on visits to various countries in sub-Saharan Africa, but four in particular: South Africa, Nigeria, Kenya and Ivory Coast, all coastal, urbanised and relatively rich. They certainly do not represent the whole of Africa, but your correspondent picked them because they each illustrate a different aspect of business across Africa as a whole. The businesses covered have not yet transformed the continent, but they show that African firms are capable of extraordinary innovation—if only they can be set free.

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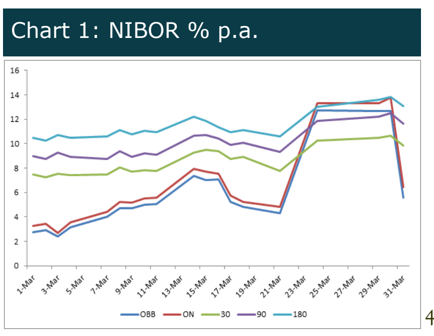
MACROECONOMICS INDICATORS

MONEY MARKET

The opening liquidity position in the month of March was significantly less than that of February. March's opening position was N390.5bn, a 60.61% decline from February's opening position of N991.4bn. Average opening position in March stands at N306.48bn compared to February's average of N542.6bn. This can be attributed to a number of reasons. However, the event that stands out is that of the MPC's upward revisions of Cash Reserve Requirement to 22.5% from 20% in mid march. This contributed significantly to the decline in liquidity in the market. FAAC allocations shared for the month of February declined to N345bn from the N370.3bn shared for the month of January. The CBN maintained its stance on mopping up liquidity via OMO auctions.

Short-term interbank rates (OBB, O/N, 30-DAY) averaged 7.06% p.a. for the month of March compared to February's average of 4.28% p.a. Interest rates moved in tandem with market liquidity. The OBB and O/N rates opened at 2.75%p.a. and 3.25%p.a. on the 1st of March before closing the month at 5.58%p.a. and 6.42%p.a. respectively. Closing rates for OBB and O/N rates for the month of March were 454bps and 504bps higher than those of the previous month. Mid month, the OBB and O/N rates spiked to highs of 12.67%p.a. and 13.75%p.a. respectively, following the MPC's March meeting. The average 91-day Treasury bill rate increased by 114bps to 5.99%p.a. in March from 4.85%p.a. in February.

Chart 1: NIBOR % p.a.



[4]

Outlook

Interbank interest rates are expected to continue to move in tandem with the liquidity position of the market. The release of funds once the budget has been assented would increase liquidity, pushing down interest rates. This also feeds into higher demand for forex and increases the inflationary pressure through demand-pull inflation. The CBN is expected to continue its intervention in the market to mop up liquidity in the economy with OMO and Primary Market auctions. FAAC allocation for March is estimated at N350bn.

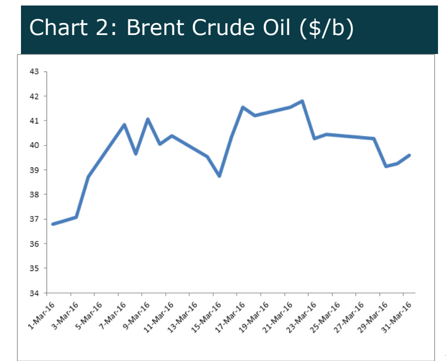
4 Source: CBN, FDC Research

OIL MARKET

Oil Prices

Global oil prices (Brent crude) averaged $39.78pb for March 2016, 18.57% higher than the average of $33.55pb in the corresponding period in February. Brent crude traded above $40pb for three weeks before easing to $39.6pb. Oil prices trended higher due to optimistic outlook of investors about the Doha April 17th meeting, where talks to freeze oil production at January production levels would take place. Gasoline demand spike in the U.S. is sipping through to crude production, where oil and gas manufacturers are focusing more on gas to take advantage of this increase in demand. However market optimism about the output freeze is slowly ebbing as Iran is unlikely to attend the meeting.

Chart 2: Brent Crude Oil ($/b)



[5]

Outlook

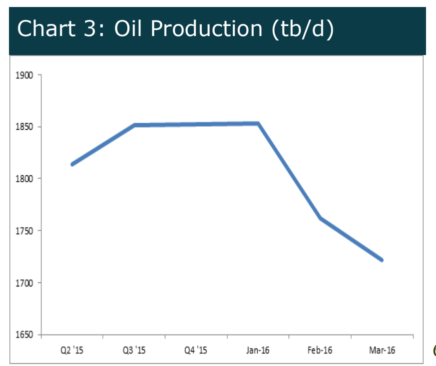
The outlook on oil prices remains bearish and is subject to the outcome of the Doha meeting. Analysts believe that the global market is still oversupplied with a production surplus of 1-2mbpd. Hence, the bearish trend in prices is likely to occur unless a significant cut in production is implemented.

OIL PRODUCTION

Production- Slow but steady increase

Nigeria's oil production level declined by 40,000bpd to 1.72mbpd in March from 1.76mbpd in February, as reported in OPEC's monthly oil markets report. This is 21.8% below the 2015 budget benchmark of 2.2mbpd and 4.4% below Nigeria's OPEC quota of 1.8mbpd. The decline in oil production can be linked to the force majeure on oil liftings from the Forcados export terminal in Delta State, as a result of a leaking pipe on the 21st of February. This resulted in shut-in of about 400,000bpd

Chart 3: Oil Production (tb/d)



[6]

5 Source: Bloomberg, FDC Research

6 Source: OPEC monthly report

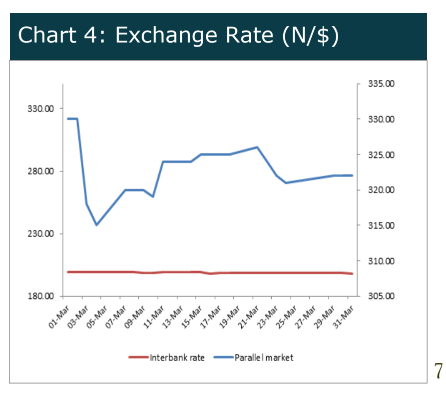
Outlook

Production is to remain at January levels of production if the oil freeze agreement realizes. Total oil production is still under threat due to the looming socio-political unrest, which persists in the Niger-Delta region. Investment dollars are still needed to strengthen production in the oil and gas sector through infrastructural development.

FOREX MARKET

As at march 31st, the naira traded at N322.00/$ at the parallel market, a 0.92% appreciation from N325.00/$ as at 29th February. Interbank Foreign Exchange Market (IFEM) appreciated by 0.63% to N198.11/$ on the 31st of March from N199.37/$ on February 29th. These slight appreciations can be attributed to the uptick of oil prices in the global market. Following the MPC meeting of March 21-22, the committee was silent on exchange rate policy. The economy underwent one of the worst fuel scarcities in record history as well as acute power shortages. Trade and investment restrictions are also observed and attributed to the stance of policy makers on the naira. The pressure to adjust the currency is overwhelming and would continue to linger until pressure on the naira is eased through effective policy making. The IATA rate of exchange remained flat at N200/$.

Chart 4: Exchange Rate (N/$)



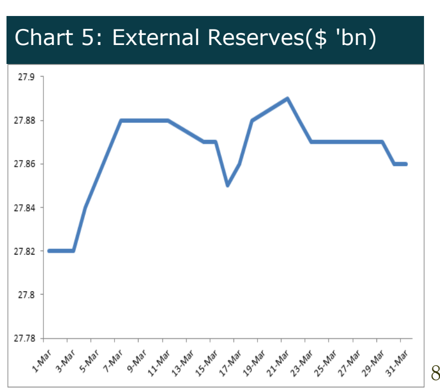
[7]

Outlook

The tightening of money supply through an increase in MPR to 12% is likely to boost an appreciation of the naira. However, once the budget is assented to and contracts are awarded, the demand for forex to import raw materials to deliver on set projects intensifies. Hence, exchange volatility is introduced once again into the system.

7 Source: FMDQ database, FDC Research

EXTERNAL RESERVES



[8]

Nigeria's external reserves increased by 0.14% ($40m) to $27.86bn on March 31st, 2016. This is the first time in 3 months that reserves recorded an increase. This was because of reduced outflows and higher oil prices. Year to date, the reserves level has declined by 4.16% ($1.2bn). The external reserves level is 19.3% below 2015's peak of $34.51bn and 9.8% below 2015's average of $30.89bn. The level of import and payments cover is up to 4.52months from 4.50 months as at March 1st. Net external reserves level is estimated at $22.36bn, after deducting forward commitments and arrears due under letters of credit. This will bring the net reserves of import and payment cover to 3.63 months.

Outlook

Compared to year-to-date rates, external reserves have declined but the current upward tick in oil prices is gradually beefing up reserves. However, the outcome of the April 17th meeting is uncertain and as such reserves might be taking a bad hit if oil output production is not fixed at January levels. As mentioned above, by reason of government spending as a result of contract awards, dollar demand for the purchase of raw material for production would depress the forex reserves available.

8 Source: CBN database, FDC Research

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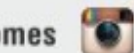


STOCK MARKET UPDATE

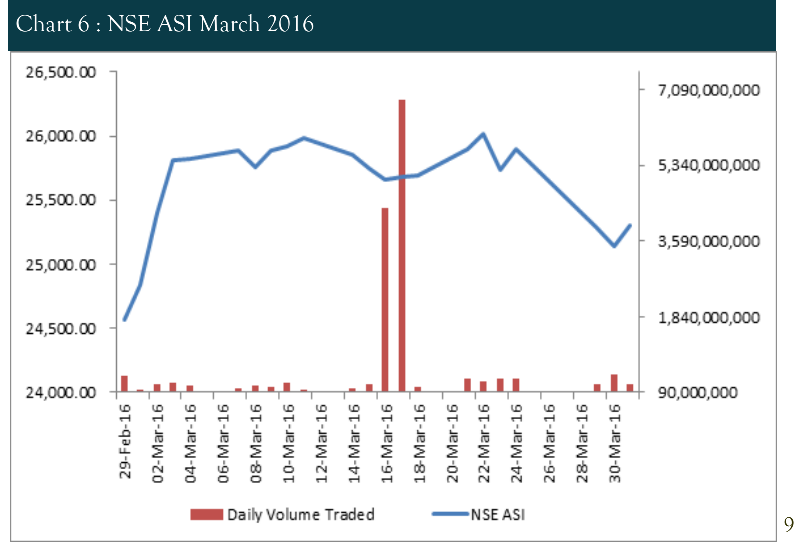
The month of March ended with the Nigerian equities market sustaining the uptrend that characterized February. The NSE ASI advanced by 2.99%, moving above the 24,000 points psychological threshold, to close at 25,306.22 from last month's close of 24,570.73. The gain recorded on the bourse is mainly attributable to the somewhat attractive dividend yield; the highest being 26.92% by UCAP, notwithstanding the spell of profit warnings and largely unimpressive full year 2015 results. In addition, the month of March saw increased bargain hunting sentiment as investors took position in stocks with a history of value preservation.

The year-to-date return on the index improved to (11.65%) from (14.22%) while market capitalization was N8.70trn having gained N252.41bn in the review period.

The liquidity weighted SFNG Blue Chip 30 Index declined by 1.89% in the month of March compared with the 2.08% loss recorded in February 2016. The dividend yield and trailing PE ratio for the Blue-Chip 30 were 4.27% and 5.13x respectively while the 30-day volatility was 19.99%.

Activity on the bourse was positive as the 21 trading days in the period resulted in 14 days of gains against 7 days of losses. Daily changes, representing volatility on the ASI, ranged between -2.40% and 2.25% in the month.

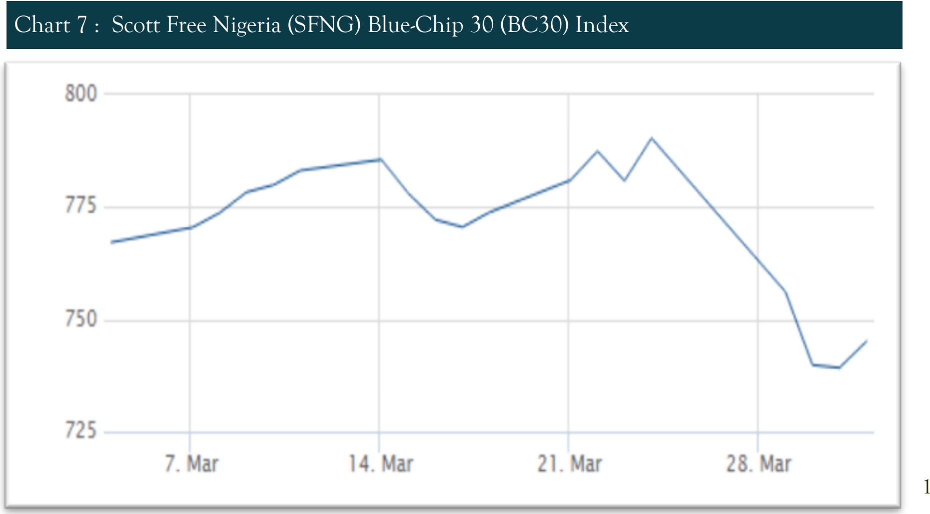
Chart 6 : NSE ASI March 2016



[9]

[9] Source : NSE, FDC Research

Chart 7 : Scott Free Nigeria (SFNG) Blue-Chip 30 (BC30) Index



[10]

Market activity for the month declined by 17.87% to N48.16bn from the N58.63bn reported in the Month of February. The average daily turnover for the period was N2.29bn, 4.58% below the year-to-date daily average of N2.40bn.

Inspite of the positive close on the ASI, market breadth remained negative at 0.78x in the review period as 35 stocks advanced against 45 stocks that declined while 110 stocks remained unchanged. The best performing stocks include TIGERBRANDS 68.12%, OANDO 40.74%, FIDELITYBK 21.82%, DANGCEM 18.38% and VITAFOAM 18.34%.

TOP 5 GAINERS

Company	16-Mar	16-Feb	% Change	Absolute Change
TIGER BRANDED CONSUMER GOODS PLC	2.32	1.38	68.12%	0.94
OANDO PLC	4.18	2.97	40.74%	1.21
FIDELITY BANK PLC	1.34	1.1	21.82%	0.24
DANGOTE CEMENT PLC	167.8	141.75	18.38%	26.05
VITAFOAM NIG PLC.	5.42	4.58	18.34%	0.84

Top price losers for the month were FBNH (19.02%), IKEJAHOTEL (18.12%), DIAMONDBNK (16.67%), FO (14.26%) and CADBURY (14.13%).

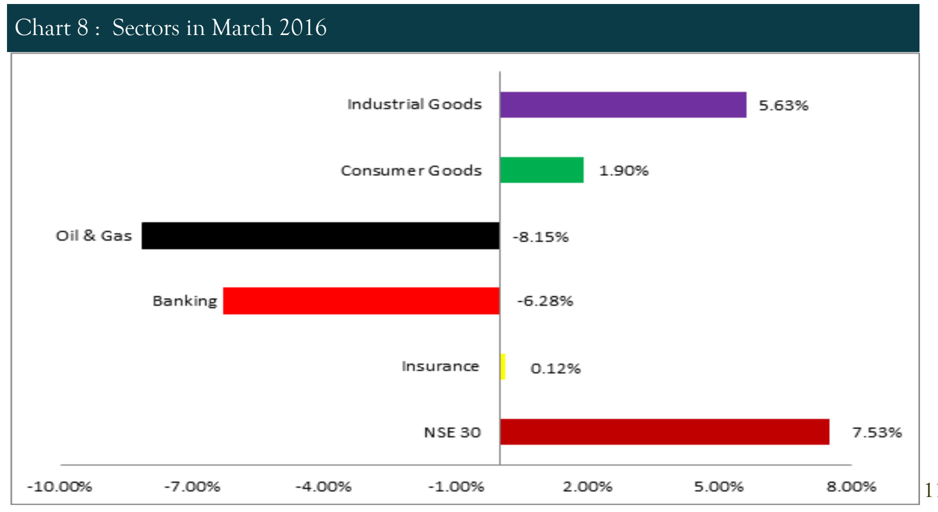
10 Source: Scott free Index

TOP 5 LOSERS				
Company	16-Mar	16-Feb	% Change	Absolute Change
FBN HOLDINGS PLC	3.15	3.89	-19.02%	-0.74
IKEJA HOTEL PLC	2.35	2.87	-18.12%	-0.52
DIAMOND BANK PLC	1.15	1.38	-16.67%	-0.23
FORTE OIL PLC.	293.23	342	-14.26%	-48.77
CADBURY NIGERIA PLC.	14.77	17.2	-14.13%	-2.43

5 MOST CAPITALIZED STOCKS			
Company	16-Mar	16-Feb	% Change
DANGOTE CEMENT PLC	167.8	141.75	18.38%
NIGERIAN BREWERIES PLC	107	101	5.94%
NESTLE NIGERIA PLC	700	715	-2.10%
ZENITH BANK PLC	10.75	11.07	-2.89%
GUARANTY TRUST BANK PLC	14.3	16	-10.63%

The NSE Industrial Goods index was the best performing sector in the month being reviewed, increasing by 5.63%. The performance of the sector was buoyed by the 18.45% and 7.60% increases in the share prices of DANGCEM and CAP. The Consumer Goods and Insurance sectors also gained 1.90% and 0.12% in the period under review. The Oil and Gas sector emerged the worst performer in the month as it lost 8.15%. The NSE Banking also performed woefully in the month of March, losing 6.28% inspite of the largely impressive full year 2015 earnings released during the month. The loss however came as no surprise given the number of profit warnings and huge impairment losses booked amid tougher economic environment.

Chart 8 : Sectors in March 2016



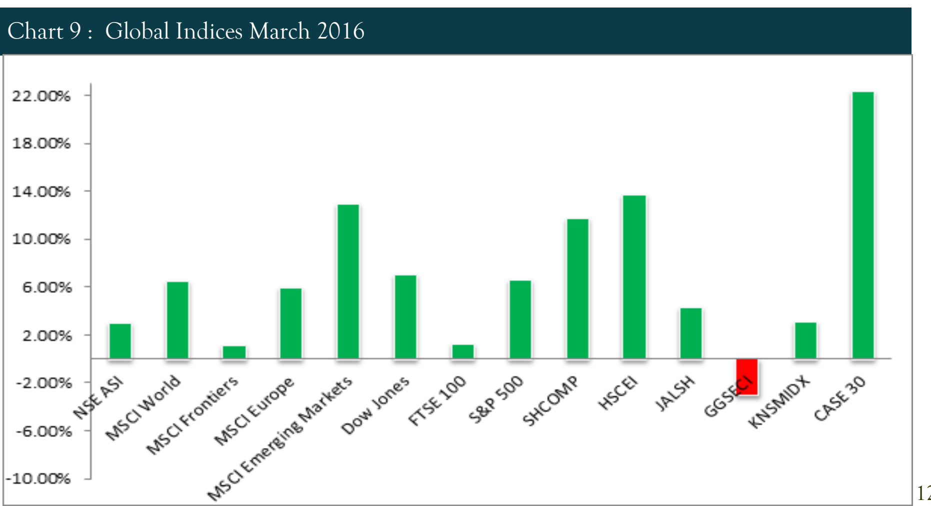
[11]

11 NSE, FDC Research

The performance of the global equities market in the month of March was largely positive as key indices around the world ended the month higher, amid weak investor sentiment driven by concerns about global growth, softer commodity prices and policy responses in key markets. In the developed markets, the S&P 500 and FTSE 100 gained 6.60% and 1.28% respectively, attributable to an improvement in investor sentiment following g the FOMC's comments that it would be cautious on rate hikes.

Key indices in Africa all moved in tandem with the NSE ASI, except the GGSECI, which declined by 3.05% in the period being reviewed.

Chart 9 : Global Indices March 2016



[12]

Total transactions at the Nigerian Stock Exchange increased by 39.44% from N84.10bn recorded in January 2016 to N117.27bn in February. In comparison to the same period in 2015, total transactions decreased by 36.44% from the N184.49bn recorded in February 2015. Domestic investors significantly outperformed foreign investors by 27.04%. Domestic transactions increased from 48.43% in January 2016 to 63.52% in February, while FPI transactions declined from 51.57% to 36.48% over the same period. Monthly foreign outflows outpaced inflows, which was consistent with the same period in 2015. Foreign outflows increased by 20.79% from N26.36bn in January 2016 to N31.84bn while foreign inflows declined by 35.68% from N17.01bn in January to N10.94bn in February.

12 Source: Bloomberg, MSCI, FDC Research

CORPORATE EARNINGS

The full year 2015 earnings season which commenced in the month of February, ended in March. The season witnessed a mix of poor and impressive results by companies, as well as a series of profit warnings. Many companies compensated their shareholders with cash dividends as dividend yields ranged from 0.17% to 26.92%.

Five of the 15 depository money banks have issued profit warnings, with the most recent being from Diamond Bank Plc and Ecobank Transnational Incorporated (ETI). ETI warned investors to expect FY 2015 profit (in dollar terms) to be lower than that reported in the nine-months to 2015, while DIAMONDBNK cited rising impairments charges in energy and commercial business loans as threats to asset quality and profits.

Tier 1 banks remained resilient inspite of macroeconomic headwinds as average gross earnings advanced by 17.64% in 2015, while average PBT, which was helped by the 87.99% and 21.80% reported by ACCESS and UBA respectively, grew by 29.59% in the same period. However, rising provision for loan loss, from N42.38bn in 2014 to N55.42bn in 2015, is a source of worry. The asset quality of Tier 2 banks remains a concern as the deteriorating economic condition impact negatively on SMEs.

Outlook

In the month of April, we expect the equities sell-offs that characterized the Nigerian equities market to persist as Foreign Portfolio Investors continue to stay at the sidelines awaiting clear economic policy directions on forex and budget implementation. The MPC's decision to tighten monetary policy by an increase of the 100bps and 250bps in MPR and CRR respectively is expected to stem inflationary pressure. In addition, the negative correlation between interest rate hikes and equities will see investors seek better returns in high yielding fixed income instruments in the short term.

The consumer goods sector may likely continue to struggle due to the difficulty in sourcing foreign exchange for raw materials as currency misalignment remains a downside risk. Furthermore, the sector is expected to face bottleneck as they re-align their busi-

ness models to present challenges of local raw materials substitutes.

In line with the afore-mentioned, we advice investors to remain cautious in their activities on the bourse while taking advantage of stocks with good fundamentals currently trading below their intrinsic values.

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CORPORATE FOCUS - BERGER PAINTS PLC

Sector: Chemical and Paint **Ticker Symbols:** NSE:BERGER
Bloomberg: BERGER:NL **Reuters:** BERGER:LG

FT: BERGER:LAG **Shares Outstanding:** 289.823m

TP Upside: 17.31% **Target Price:** N10.53

Market Cap: N2.69b **2015 Annual Dividend:** N0.75

2015 Annual Dividend Yield: 8.77% **Price:** N8.55

BERGER PAINTS PLC: ***Near-term outlook hinges on government infrastructure spend as a catalyst***

Analysts Recommendation: BUY **Recommendation Period**: 12 months

ANALYSTS NOTE

Nigeria's chemical and paint industry has not been isolated from the ongoing economic downturn as demand shocks heighten. However, the 2016 budget promises a significant increase in infrastructure spending, by way of capital expenditure, which should help mitigate the impact of the demand shock. Capital expenditure for the 2016 budget is N1.7 trillion as against N557 billion in 2015, representing 215.9% increase. This makes CAPEX as a percentage of the total budget in 2016 to be 30% as against 12% in 2015.

Berger Paints Plc is expected to benefit from this investment in infrastructure increased spending in road construction and housing projects. The company partnership with KCC to supply high quality and durable protective paints to the oil and gas and marine sectors, capital injection of N543.42 million via a rights issue has helped the company reposition itself in the industry. Its profits at a four compound average growth rate (CAGR) surged by 17.29% to N330.3 million in FY'15 aided by its pull sales strategy to grow revenue.

Additionally, Berger Paint's management decision to outsource its depots and franchise appointments in the country makes strategic

sense. This will enable the company to have an extensive market reach, which might translate to market dominance and increase name recognition. Our outlook for the sector remains positive, and we expect sustained earnings growth over the medium term. We recommend a BUY.

PROFILE

Berger Paints Nigeria Plc was incorporated in Nigeria on January 9, 1959 as British Paints (W.A.) Limited and was the first paints manufacturing company quoted on the Nigerian Stock Exchange (NSE). Its portfolio includes decorative and industrial paints, marine and protective coatings, automotive/vehicle refinishes and allied products manufacture. The company has a strong international partnership with the largest heavy duty coating manufacturer company in South Korea, KCC Corporation.

Overall, the company’s FY’15 result was great with the costs coming under control. However, exports have been a problem and we do not expect an improvement in operating costs to be sustainable over the medium term as the impact of currency alignment takes effect. The latest released results of Berger Paints (FY’15) reported a revenue decline of N60.66 million, from N3.08billion to N3.02 billion. The decline is due to the complete evaporation of export sales in 2015. Whereas Berger Paints had N199.08 million of export sales in 2014 contributing 6% of revenue. That said, the cost of sales as a percentage of revenue has consistently improved within the past five years from 62.35% in 2011 to 54.39% in 2015. Thus attesting to management efforts of improving the company’s efficiency through cost optimization/process re-engineering. However, distribution expenses as a percentage of revenue have steadily risen in the past three (3) years from 5.32% in FY’13 to 7.18% in FY’14 to 12.58% in FY’15, signifying the company’s drive to grow earnings. Administrative expenses as a percentage of revenue declined in FY’15 to 22.59% from 30.43% in FY’14. This decrease is the lowest in five years.

Berger Paints Nigeria PLC (BERGER NL) - Standardized						
In Millions of NGN except Per Share	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	CAGR
12 Months Ending	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	%
Assets						
Total Current Assets	1,458.20	1,453.90	1,978.80	2,075.70	2,168.30	8.26%
Total Long-Term Assets	1,214.80	1,293.90	1,557.80	1,564.40	1,727.60	7.30%
Total Assets	2,673.00	2,747.80	3,536.60	3,640.10	3,895.90	7.83%
Liabilities & Shareholders' Equity						
Total Current Liabilities	727.6	810.9	877.2	816.5	1,143.70	9.47%
Total Long-Term Liabilities	168.9	181.8	223.7	363.8	164.8	-0.48%
Total Liabilities	896.4	992.8	1,100.90	1,180.30	1,308.50	7.86%
Total Equity	1,776.60	1,755.00	2,435.70	2,459.80	2,587.30	7.81%
Total Liabilities & Equity	2,673.00	2,747.80	3,536.60	3,640.10	3,895.90	7.83%
Comprehensive Income						
Turnover	2,574.40	2,509.30	2,708.40	3,082.90	3,022.30	3.26%
Pretax Income	391.7	263	356.1	249.3	565.2	7.61%
Income Tax Expense	141.5	88.4	104.8	100.5	234.9	10.67%
Net Profit (Loss)	250.2	174.5	251.3	148.8	330.3	5.71%

[13]

MANAGEMENT

Berger Paints saw a management reshuffle in 2015. Mr. Tor Nygard, the former Managing Director, disengaged from the company's service following the expiration of his contract in January 2015. His tenure was associated with a number of reforms, including the expansion of the Color World Centers and a factory modernization project. Mr Peter Bababunmi Folikwe currently leads Berger's Paints management. He has garnered 24 years of experience in marketing, sales/distribution and general management spanning manufacturing and telecommunications. Dr. Oladimeji Alo leads the board of Berger Paints. He was appointed Chair of the Board in July 2014 after joining the board in December of 2012. He has served on the board of several companies including managing director/CEO of FITC, non-executive director of Nigeria Capital Market Institute, chairman of One World Communications Ltd and chairman of the School of Banking Honors. He is currently a non-executive director of ARM Life Plc.

Other key members of the Berger Paints' management team include Mr. Ajayi Kola and Jagdale Rahul. Mr. Ajayi Kola is the General Manager Finance. He is a graduate of Accounting and Busi-

13 Source: Bloomberg, Copmpany Data, FDC Research

ness Administration from both Ogun State University and Ambrose Ali University and a Fellow of both the Institute of Chartered Accountants of Nigeria (ICAN) and Chartered institute of Taxation of Nigeria (CITN). His industry experience spans across the finance and building and materials sector. He joined the company in April 2014.

Mr Rahul Jagdale joined Berger Paints in September 2012 as the Head of Manufacturing. He has over 17 years experience in the paint and coating field including research and development, production, quality and technical services. He is a professional surface coating technologist from India.

In sum, the company's executive management team comprises of individuals who bring with them, a great depth of knowledge and experience to steer the company towards attaining its value proposition of being a dominant marketing company in the coating and allied business industry and improving operational efficiency alongside enhancing its competitive position.

WHAT THE BULLS AND BEARS SAY

The Bulls Say:

- Diversified product range in the chemical and paint industry
- The company is expected to ride on the back of government-led growth in the building and construction industry
- The fixed interest rate agreement in a tightening cycle by the Central Bank will allow the company to reap lower interest payment alongside enable for planned cash and working capital management. As a 100 basis points change in interest rate would see an increase in equity by N892,000 after tax or vice-versa.

The Bears Say:

- Near-term cost inflation could resurface and constrain Berger Paint's ability to post profit expansion
- The poor CAPEX implementation in the past amidst delays in budget approval might dim some of the positive expectations

INVESTMENT THESIS

Berger Paints target price of N10.03 offers a 17.31% upside on the current market price and we expect an increase in revenue by 2.13% to N3.08 billion and profit before tax decrease by 24.94% to N424.4 million for the full year of 2016 financial results. However, we are cautiously optimistic about the company's growth prospect given the possible devaluation of the naira in the coming years. As such we estimate revenue and PBT to grow by a compounded annual growth rate (CAGR) of 2.99% and 12.41% respectively between 2016 and 2018.

The management's strategic action of outsourcing depots and appointment of franchisees in various other locations of the country where the company's presence is non-existent is valiant, as this will help enhance accessibility and visibility of its products while also enhancing the company's efficiency and improving bottom-line. That said, what gives us concern are the pervasive risks is emanating from macroeconomic conditions, which include increasing inflation and slowing economic activity in addition to the naira devaluations. Further, we would like to see how the management outsourcing move plays in years ahead since revenue-inhibiting factors are reducing consumer disposable income and aggregate consumption

BERGER PAINTS NIGERIA PLC VALUATION USING DCF/FCFE

Our intrinsic value for Berger Paint Nigeria Plc was arrived at by using a Discounted Cash Flow (DCF) valuation method. Key assumptions included:

- A DCF valuation method based on a three year forecasted financial statement;
- A terminal growth rate of 3.26% in estimating the company's future cash flows;
- A cost of equity of 12.08% (capital asset pricing model), a beta of 0.3203[14], a risk free rate of 10.48% (the rate for a 3-year FGN bond maturing in 2018), an after-tax cost of debt of 11.9%, and a market risk premium of 5%;

[14] Financial Times Data

- The valuation took into consideration a near term outlook such as the company's growth and profitability, value creation from the strategic franchising, industry trends and the prevailing macroeconomic conditions. We forecast a three-year revenue growth CAGR of 2.99%.
- The target price of Berger Paints Nigeria Plc is N10.03, which is at a 17.31% upside to the current price of N8.55 as at April 7, 2016.

3 Year Free Cash Flow to Equity Projections			
UAC of NIG. PLC	2016 N'mn	2017 N'mn	2018 N'mn
Turnover/Revenue	3086.7	3206.4	3371.9
EBITDA	565.6	639.6	684.3
EBIT	441.2	501.1	527.3
Less: Cash Taxes @ 30.874%	-183	-208	-219
Tax-effected EBIT (NOPAT)	257.9	292.8	308.1
Plus: Depreciation & Amortization	124.3	138.5	157.1
Less: Capital Expenditures	-200	-222	-262
Less: Change in Net Working Capital	113.2	68.2	-12
Unlevered Free CashFlow	295.1	277.6	190.9
WACC @ 12.08%	12.10%		
NPV of Unlevered Free Cash Flow	619.9		

Perpetuity Growth Rate				
		Undiscounted	Discounted	EBITDA Multiple
Perpetuity Growth Rate @ 3.26%	3%	3,609	2,287	5.27
DCF Range (Implied Enterprise Value)			2,907	
Equity Value			2,907	
Implied Price Per Share			10.03	

Risks

The chemical and paint industry is fragmented thus the threat of competition from rival companies such DN Meyers Plc, Premier Paints Plc, Portland Paints and Products Nigeria Plc, and African Paints (Nigeria) Plc is a big risk. As well, most of the product category is generic and as such barriers to entry are generally low, which could hinder volume growth and subsequently profitability.

Market risks are also a factor, specifically currency risks and interest rate risks. Given the current currency conundrum, naira pressure could hurt its earnings as purchasing power takes a hit. In addition, the country's slowing gross domestic product (GDP) and high unemployment might warrant policy reversal from its tightened stance to an accommodative monetary stance thus incurring more finance costs.

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