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Floating Exchange Rate: A Road to Perdition - CBN (Matters Arising)

The highlight of the first MPC meeting in 2019 was not the unanimous vote for maintaining the status quo, but the view of the committee on the risks associated with a free floating of the naira. The MPC Chair affirmed that reverting to a (free) market-based rate will wipe-out gains of a stable inflation environment, which could lead to a currency crisis. The CBN has used a managed-fixed exchange rate since the introduction of the IEFX window in April 2017.

Factors that determine exchange rate

Exchange rates are determined by a combination of internal and external variables.

Determinants	Impact	Nigeria's 2019 Forecast		Comments
Balance of Trade (BOT) ($'bn)		30.8	↑	Downward pressure in Nigeria's import value and boost in non-oil revenue will improve
Terms of Trade		25.4	↓	Lower oil revenue (due to lower oil prices) will worsen relative to import prices
Inflation/interest rate differential (%)		2.56	↓	Increased money supply will exert inflationary pressures
External Reserves		42	↓	Lower oil prices will weigh on forex earnings
Foreign Direct Investment (FDI)($'bn)		1.6	↑	Pick up in investment flows from lower political risk
Diaspora Remittances ($'bn)		25.7	↑	Important source of hard currency
Current account balance ($'bn)		19.8	↑	Surplus will emanate from FDI inflow and higher BOT
Political uncertainty risk premium				A hitch-free democratic transition will reduce the risks
Purchasing Power Parity (PPP)- N/$		345.88		Naira is undervalued by 4.5% (*crude analysis*)

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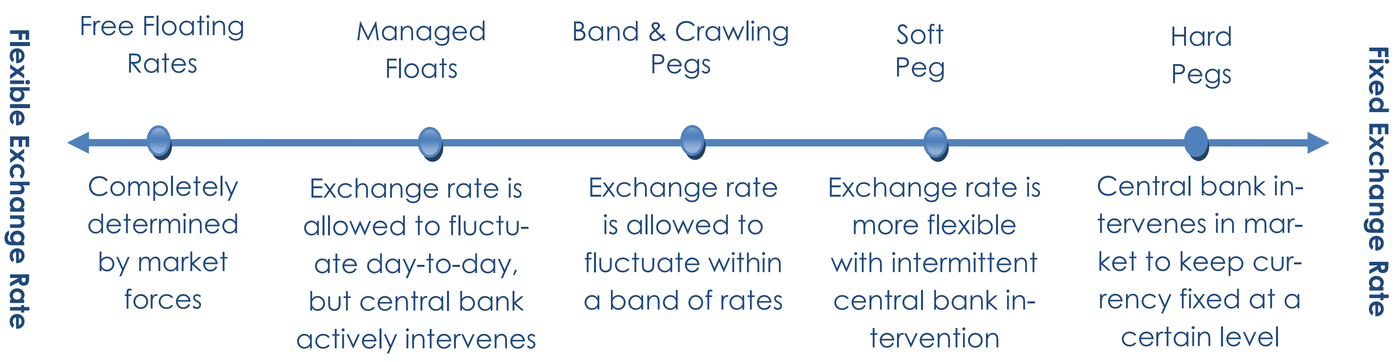
[1]FDC Think Tank

As an oil dependent economy, Nigeria is vulnerable to external shocks and the volatility of the oil market.



Like Nigeria, most economies operate within the intermediate points of a fixed and floating exchange rate. The slant towards either of the two regimes depends on the exchange rate policy of the country's monetary authority and the political manifesto the government seeks to achieve.

The International Monetary Fund (IMF) is a key proponent of a free floating exchange rate due to the benefits of an independent monetary policy. However, short-term speculation and inadequate fiscal discipline continue to undermine the potentials of a free floating exchange rate.

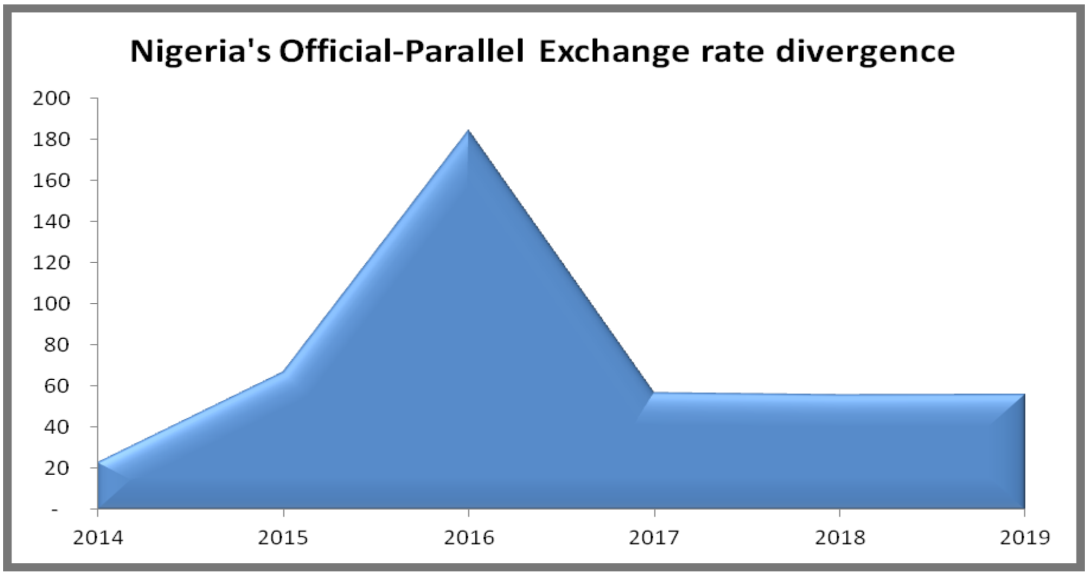
In the 1980s, more than 85% of economies adopted a fixed exchange rate which was pegged against the dollar, while the dollar was pegged against gold. Very few countries adopted a free floating exchange rate, as most transactions at the time were dollar-based. Today, the paradigm shift and the emergence of new world powers have tilted the exchange rate regimes in favour of a free floating and managed floating exchange rate. Fixed exchange rate regime is quickly losing its relevance, as it now accounts for less than 13% of exchange rate regimes in the world.

Unified vs. Multiple exchange rates

A multiple exchange rate regime is a systemic policy tool adopted by emerging markets to promote certain activities through subsidies. This price adjustment mechanism involves the use of different exchange rates for different transactions. This creates an official rate for selected transactions and a parallel market rate. For a unified exchange rate, only one market rate will be at play at which all transactions will be embarked on.

The number of countries that maintain more than one exchange rate has declined substantially since the early '90s. Countries that have successfully implemented a unified exchange rate include China, Egypt and Iran. Similarly, others such as Syria have cut the number of exchange rates to reduce economic distortions and inefficiencies of a multiple exchange rate.

Nigeria currently operates a multiple exchange rate system with seven different rates and attempts to unify these rates have predominantly been abortive. The difference between the extreme bands has narrowed in the last half decade. This suggests that the possibility of an exchange rate convergence is now less remote.



[2]

Currency convergence, better sooner than later

Like Nigeria, Venezuela maintained a multiple exchange rate regime and its oil revenue accounts for 95% of forex earnings. A move to hedge against exchange rate volatility prompted the monetary authorities in Venezuela to peg its currency against the dollar. This was also complemented by a multiple exchange rate policy to subsidize importation of basic amenities such as food and medicine. However, this created room for currency arbitrage as cabals sourced for the Bolivar at a subsidized rate and subsequently sold in the black market at a premium (forex round-tripping). The general shortage of forex and the lack of discipline led to the currency instability and the world's highest inflation rate of 1,300,000% in November 2018.

Similarly, the adoption of a multiple exchange rate regime also implies that some sort of subsidy exists, which is an indirect tax. When juxtaposed with the four canons of taxations, it only meets one criterion, economy. The fact that the bourgeoisie and proletariat are charged the same makes exchange rate subsidy unfair, inconvenient and uncertain.

[2]FDC Think Tank

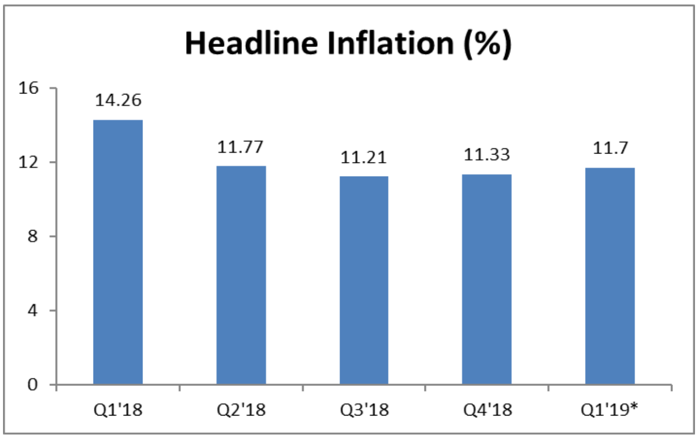
Way Forward

To jumpstart Nigeria's economic growth and sustain stability, the monetary authorities need to shift from a bailout provider to a proactive reformer. This emphasizes the need to anticipate financial market developments and provide incentives for market players. Similarly, transparency in exchange rate objectives will bolster confidence in the forex market. For instance, increasing market information on the sources and uses of foreign exchange will improve information symmetry, a move towards efficient market hypothesis. A well functioning forex market allows the exchange rate to respond to market forces and reduce market distortions.

In order to gradually move towards a unified exchange rate, the monetary authorities need to cut the seven-tier exchange rate system considerably. This will ease the capacity strain on manpower, and reduce compliance and enforcement costs of maintaining a multiple exchange rate. This will also reduce the pressure on Nigeria's external reserves and the frequency of the CBN's interventions.

A floating exchange rate remains a critical input towards achieving currency convertibility, which is poised to drive financial flows. A convertible currency also promotes international commerce and lifts barriers to investment flows. This would further deepen trade relations, improving Nigeria's prospect to reach its potential growth rate.

Headline inflation to maintain its upward trajectory in Q1'19



The Nigerian economy in 2019 is expected to witness major events that would influence the direction of inflation especially in Q1. The general elections will be conducted, the planting season would commence and the minimum wage review which has become a front burner issue is likely to be implemented. While election spending and minimum wage implementation are expected to boost naira liquidity, the commencement of the planting season will reduce agricultural output. A boost in currency liquidity without a corresponding increase in labor productivity (currently at -0.7%) and output will distort market dynamics, resulting in a higher inflation rate. The average inflation in Q1'19 is estimated at 11.7%, a 0.37% increase compared to 11.33% in Q4'18. Addressing power supply and other infrastructural challenges will go a long way in enhancing labor productivity.

Meanwhile, we expect headline inflation in January to remain flat at 11.4%. The flat lining in January would be partly due to the lull in economic activities and the drop in consumer spending post Christmas.

Implications

Higher inflation numbers would weigh on consumers' disposable income and reduce the yield (rate of return) on domestic investments. This is negative for economic growth.

In addition, the rising trend in inflation will be a cause for concern for policy makers given the declining inflation trend and interest rate normalization in developed economies. The combination of these factors would result in heightened capital flows reversal from emerging economies such as Nigeria. This could incentivize the monetary policy committee to move towards a tighter monetary policy stance at its meeting in May. This is because the committee would likely adopt a wait and see approach until the political picture becomes clearer.

Avoiding a double dip recession

The 2015/2016 crash in global crude oil prices amongst other things was responsible for sending Nigeria into a recession. The oil revenue shortfall and its attendant consequences mired Nigeria with external imbalances and a contraction in economic activities. Global crude oil prices started to recover in 2017 when the Organization of the Petroleum Exporting Countries (OPEC) cut their collective oil output, in agreement with Russia. In an agreement that cut production by 1.1mbpd or 1.13% of global output, Brent crude averaged $54.77pb in 2017, 22% higher than the 2016 average ($45pb).[3] Improved oil revenue helped bolster growth by 0.82% in 2017, compared to a 1.58% contraction in 2016.[4] The rally in oil prices continued into 2018, until November when another free fall in crude oil prices was triggered by 2019 forecasts of market disequilibrium, concerns of weak global economic growth and US pressure on Saudi Arabia to pump additional barrels of oil. Oil prices are currently trading around $60pb, 16.5% lower than the 2018 average of $71.82pb.[5] Average oil prices so far in 2019($59pb) is also approximately 2% below the 2019 budget benchmark of $60pb. The factors highlighted are likely to depress prices further in the near term.

The impact of the renewed oil price decline on Nigeria's economy is compounded by OPEC's decision to reduce the country's oil production by 6.7% to 1.68 million barrels per day. These factors could send Nigeria into another recession. The Central Bank of Nigeria (CBN) also shares the view that the economic growth is fragile and that the country could slip into another recession.[6] Avoiding a recession requires action by policymakers. A particularly critical step is to reduce the monetary policy rate in order to reduce lending rates, boost credit demand and stimulate production activities. This would fill the gap created by lower government spending due to lower oil prices and could prevent the Nigerian economy from the impending recession. The government could also, on its part, broaden its tax base and improve collection efficiency in order to block leakages and revenue shortfalls.

[3] Bloomberg, FDC Think Tank
[4] National Bureau of Statistics (NBS), 2018. "Nigerian Gross Domestic Product Report (Q2 2018)". Federal Government of Nigeria, http://nigerianstat.gov.ng/elibrary?queries[search]=gdp
[5] Ibid
[6] Central Bank of Nigeria, November 2018. "Central Bank of Nigeria communiqué No 120 of the monetary policy committee meeting of September 24 and 25, 2018, with personal statements of members". Federal Government of Nigeria, https://www.cbn.gov.ng/Out/2018/MPD/Central%20Bank%20of%20Nigeria%20Communique%20No%20120%20of%20the%20Monetary%20Policy%20Committee%20Meeting%20of%20September%2024%20and%2025,%202018,%20with%20Personal%20Statements%20of%20Members.pdf

Monetary policy vs fiscal policy

Typically, there are two broad policy tools that are used complementarily to boost the level of economic activity in a country: expansionary fiscal policy and expansionary monetary policy. An expansionary fiscal policy is targeted at raising aggregate demand through increasing government investment and/or cutting personal income taxes to increase the income available for household spending. An expansionary monetary policy, on the other hand, is an attempt by the central bank to stimulate economic activities through reducing interest rates or enforcing similar policies that would boost liquidity.

Both policies are needed to spur growth in any economy. However, fiscal policy choices are currently limited in Nigeria. This is because increasing government spending would hinge significantly on higher revenues (which may include borrowing) and Nigerian government revenue comes mainly from oil earnings. The decline in crude oil prices and the new quota imposed by OPEC would reduce oil earnings. A stellar increase in tax revenues may not be feasible in the near term as the government intends to limit tax rates in order to maintain Nigeria's attractiveness to potential investors. Equally, lowering the personal income tax rate to increase available income for households is unlikely. Nigeria's personal income tax of about 24% is currently well below Africa's average (32.4%)[7]. Meanwhile, the government could consider broadening its tax base and ensuring efficiency in its tax collection in order to shore up tax revenues and spending.

Given limited fiscal choices, an expansionary monetary policy should be employed to bridge the gap. This policy change should focus on reducing the monetary policy rate (MPR), which serves as a guide to other rates including lending rates to commercial banks. The central bank lends to commercial banks at the MPR plus the upper limit of the asymmetric corridor (currently at 2%). Given an MPR of 14%p.a., the CBN's lending rate to commercial banks comes in at approximately 16%.

Banks thereafter add their risk premiums to this rate before lending. Therefore, reducing the MPR would ultimately enable banks reduce their lending costs accordingly. A reduction in lending rates would entice individuals and private business organizations to borrow.

[7]KPMG, 2018. "Individual income tax rates table". Available at https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html

When borrowing increases, households have more to spend, and this increase in demand serves as an incentive for higher production by the business sector. Increased borrowing by businesses also increases their financial input and gives them ample space to increase output. This ultimately leads to growth. It is, however, notable that there is typically a lag between a lower MPR and growth. It takes a while before the cycle of a cut in MPR, lower lending rates, higher borrowing, increased demand and output, and economic growth is complete. The growth outcome, however, outweighs the delayed impact or the risk of entering into a recession if no action is taken at all.

Peer comparison experience with lowering the MPR

Empirical evidence from Nigeria's peers in the sub-Saharan African region supports a correlation between a lowered MPR and growth. In 2017, Rwanda reduced its MPR by 75 basis points (bps) to 5.50% per annum (pa) when quarterly growth was at an average of 4.03%.[8] In response, lending rates declined by approximately 66bps between 2017 and 2018. More importantly, the country's average quarterly growth rate quickened from 4.03% in 2017 to an average of 9.27% so far in 2018.[9] This experience also confirms the lag between a lower MPR (2017) and positive growth (2018). Zambia's experience was similar. In 2017, the country reduced its MPR by 525bps to 10.25% pa. Commercial banks' lending rates fell in tandem by about 113bps by the end of 2017 (the most recent data).[10] It is speculated that lending rates maintained a downward trajectory in 2018. Meanwhile, the IMF estimates the country's 2018 growth at 3.8% compared to 3.4% in 2017.[11] Ghana, an oil producing country like Nigeria, is yet another example. It took the decision to cut interest rates by 50bps in 2016.[12] The lending rate in the country fell by over 700bps. The country's average quarterly growth rate in 2017 quickened to 8.18% from 3.43% in 2016.[13] The evidence from peers reinforces the need for Nigeria to reduce its MPR in order to stimulate growth.

The Nigerian government needs to implement the idea of lowering interest rates, in addition to increased expenditure, in order to avoid another recession. Monetary policy makers might be concerned that reducing the MPR at this time would be inflationary. If that is the concern, they could wait until the second quarter of 2019 when the election season is over, political spending has reduced, and inflationary pressures are muted.

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[8] National Bank of Rwanda, December 12, 2018. "Interest rates structure up to November 2018". Available at https://www.bnr.rw/fileadmin/AllDepartment/FinancialMarket/MonthlyInterestRate/Interest_rate_structure_up_to_November_2018-.pdf
[9] Ibid
[10] Bank of Zambia, 2018. "Statistics". Available at http://www.boz.zm/statistics3.htm
[11] IMF, 2018. "World Economic Outlook, October 2018: Challenges to Steady". United Nations, https://www.imf.org/~/media/Files/Publications/WEO/2018/October/.../Text.ashx
[12] Bank of Ghana, 2018. "Monetary Policy Reports". Available at https://www.bog.gov.gh/monetary-policy/monetary-policy-reports
[13] Ibid

Oil and Gas: Nigeria's oil production quota cut by 3.04%

GLOBAL DEVELOPMENTS

In a bid to support crude oil prices, the Organization of Petroleum Exporting Countries (OPEC) and its non-OPEC allies decided to cut overall production by 1.2 million barrels per day (mbpd), effective January 2019, for an initial period of six months. The decision was made in view of the rising imbalance between global oil demand and supply. Oil demand growth is slowing – forcing OPEC to lower its forecast for global oil demand in 2019 by 70,000bpd to 1.29mbpd. OPEC will shoulder 800,000bpd while the non-OPEC contribution will be 400,000bpd.

Brent crude averaged $57.76 per barrel (pb) in December, 13.87% lower than November's average of $67.06pb. Oil prices briefly dipped below the $50pb mark in late December before recovering to close the month at $53.85pb. This was attributed mainly to an increase in global oil supply as top producers – Saudi Arabia and Russia – ramped up output in addition to an increase in US shale production. The US Fed also hiked interest rates in December and this, coupled with market anticipation of slower demand growth in 2019, contributed to the negative movement in oil prices. Oil prices have risen 12.6% to $60.66pb as of January 11th. The current positive sentiment in the market has been in response to the commencement of trade talks between the US and China. The cooling of tensions between the two largest economies in the world would lower concerns of a global economic slowdown in 2019, which would be positive for oil demand.

Outlook

The OPEC-led production cut of 1.2 million barrels is expected to significantly narrow the oil market surplus. It also takes away the uncertainty that has recently beset oil markets. The market will watch out for strict adherence to allocated cuts. However, market fundamentals remain weak as a glut still exists, particularly due to record output from US shale producers. The prospect of weaker global growth and a stronger US dollar will also weigh on oil prices in the near term. We therefore expect prices to remain around the current level of $53pb - $55pb in January.

DOMESTIC PRODUCTION

According to OPEC's November oil report, Nigeria's oil production decreased by 1.64% to 1.74mbpd in November, from a revised figure of 1.77mbpd in October. Nonetheless, crude oil production averaged 32.97mbpd in November, a decline of 11,000 bpd over the previous month. Crude oil output increased mostly in the UAE, Saudi Arabia, and Kuwait, while production declined in Iran, Venezuela, Iraq and Nigeria.

According to Baker Hughes, the global rig count for December 2018 was 2,244, down by 22 from the 2,266 in November 2018, and up 155 (7.4%) from 2,089 a year ago. The average US rig count for December 2018 was 1,078, up by one from the 1,077 counted in November 2018, and up 148 (15.9%) from the 930 counted in December 2017. In Nigeria, the number of operational oil rigs rose from nine in November 2018 to 11 in December 2018. This is after a steep drop from 15 in October. This is reflective of the commencement of production by Total from the offshore Egina oilfield located 150km off the coast of Nigeria.

Outlook

Nigeria, which has faced instability in its oil industry, was not granted an exemption in the new round of production cuts and it is expected to cut its output by 3.04% (53,000bpd) to 1.685mbpd for the first six months of 2019. This cut is equivalent to 4.4% of OPEC's planned cut of 1.2mbpd and 3.04% of Nigeria's November oil output level of 1.738mbpd. A lower quota means FDC expects a decline in oil production at least until June.

Implications

Oil proceeds represent a significant proportion of Nigeria's revenue. At $60.66pb, Brent oil is 1% above the proposed 2019 budget oil benchmark of $60pb. Oil revenue is projected to fall by at least the equivalent of the 3.04% fall in production unless it is offset by higher oil prices. Rising oil prices will be inadequate to completely offset lower oil production and would lead to an oil revenue shortfall of approximately 2%. This will have a negative impact on Nigeria's balance of trade, currently at a surplus of $1.87bn in the third quarter of 2018 - and will lead to increased naira weakness. This is coming at a time of growing vulnerability as capital flow reversals are expected to intensify as a result of a further interest rate hike by the US Fed. The CBN's ability to continue its aggressive interventions in the forex market will also be constrained. A decline in government revenue would negatively affect the Federal Account Allocation Committee's (FAAC) disbursements and some states may be unable to implement the anticipated new minimum wage.

Infrastructural Development gaining traction in the Construction Sector

Highlights

The construction industry was less eventful in the month of December. Nonetheless, it is noteworthy that the Federal Government of Nigeria (FGN) issued a N100bn Sukuk bond for the construction and rehabilitation of key roads across all of the geopolitical zones of the country. In Sub-Sahara Africa (SSA), Rwanda disclosed plans to raise $1.3bn to fund its portion of the Isaka (Tanzania) to Kigali (Rwanda) Standard Gauge Railway (SGR). Uganda is also expected to select the winning bidder to build and operate a $1.5bn road project under a public private partnership (PPP) model in 2019. On the global scene, the UK government intends to deploy micro-robot technology to road construction. This would reduce the demand for menial labor and also cut government spending on road construction.

NIGERIA

FGN issues N100bn ($328mn or 0.08% of GDP) Sukuk bond to fund infrastructure projects

The Federal Government of Nigeria issued a N100bn seven-year Sukuk bond on December 6 at a rental rate of 15.74%. The proceeds will be used for the construction and rehabilitation of key roads across the six geopolitical zones of the country. Some of the projects to be funded include the reconstruction of Bida-Lambatta road in Niger State, the rehabilitation of Gwoza-Damboa-Goniri-Ngamdu road in Yobe/Borno states and the construction of Ikom Bridge in Cross River State.

Implications

At a time of limited revenues and intense pressure to spend, it is not surprising for the Nigerian government to turn to the debt market. The construction and rehabilitation of the identified roads is expected to ease logistics and distribution of goods and services in the country. It is, however, expected that insecurity in the northern region would delay the rehabilitation of the Gwoza-Damboa-Goniri-Ngamdu road.

SSA

Rwanda to spend $1.3bn on railway project

Rwanda plans to raise $1.3bn to fund its portion of the Isaka - Kigali Standard Gauge Railway (SGR). This rail forms part of a six-phase SGR construction agreement between the two governments. The first two phases are underway in Tanzania. Phase one has a 300km stretch, while phase two is 422km long. The proposed rail in Rwanda would have a stretch of 130km. Rwanda is currently discussing possible financing options with Tanzania. Meanwhile, Rwanda's minister of infrastructure Clever Gatete disclosed that Rwanda has support from the African Development Bank (AfDB) to structure the financing arrangement.

Implications

If the imminent project is executed, it would be Rwanda's first railway line. A more developed transport system would help improve the country's attractiveness to foreign investors. An efficient transport system would also have a positive impact on the level of economic activities in the country. Rwanda is currently one of SSA's fastest growing economies.

Uganda to pick bidder to build and operate highway by year end

Uganda expects to select the winning bidder to build and operate a $1.5bn road project under a public private partnership (PPP) model by December 2019. The construction would cost approximately $1bn. The contractor would provide $600mn, while the Ugandan government is expected to contribute $400mn. Another $500mn would be required to fund land acquisition, debt financing and operating costs, but it is unclear which party would provide the funds. The proposed 95km highway will connect the capital Kampala with Jinja, an industrial city in Eastern Uganda.

Uganda National Roads Authority (UNRA) short-listed four joint bids in December 2018 including one led by German-based Strabag AG and another led by China's Communications Construction Company (CCCC). The successful contractor will design, build and operate the road for 30 years, earning revenue by charging tolls before handing it back to the Ugandan government. The road construction is expected to start in 2020. The Ugandan government is also currently conducting feasibility studies on two new expressways to be constructed under a PPP model.

Implications

The completion of the Kampala-Jinja expressway will improve distribution and logistics between the two cities. This would boost productivity and aggregate output. However, Uganda's public debt has grown rapidly over the last decade on the back of the country's increased uptake of Chinese credit to fund infrastructure projects such as roads, power plants, fibre cable networks and an airport expansion. It is speculated that the Ugandan government's contribution to the proposed expressway would be met through Chinese borrowing. The growing Chinese presence in Uganda could increase the government's vulnerability to exogenous shocks from China.

GLOBAL

UK deploys micro-robot technology to reduce spending on road construction

The United Kingdom government plans to reduce huge expenses on road construction and maintenance by deploying micro-robot technology. The micro-robot technology would allow for pipe work and tunnel repairs under roads in the UK without digging them up. University of Sheffield Professor Kirill Horoshenkov is leading a consortium of scientists from Birmingham, Bristol and Leeds Universities to develop the technology. The government has announced investments to the sum of £27mn ($34.35mn) for the research. The funding is part of the UK government's modern industrial strategy.

Outlook

We expect the Nigerian construction industry to be more eventful in Q1'19 as political parties attempt to entice electorates with their project delivery.


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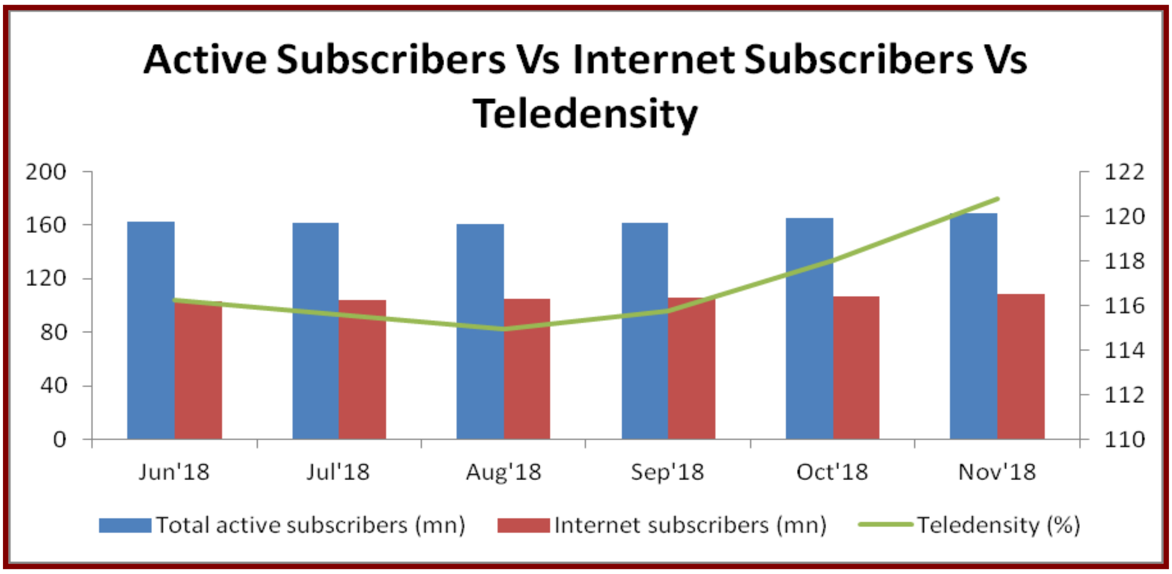
Telecommunication Sector: Nigeria surpasses its broadband penetration target

The Nigerian Communications Commission (NCC) released its November industry statistics report. The country surpassed its 2018 broadband penetration target of 30% in November. Broadband penetration was up 1.07% to 30.9% from 29.83% in October. This is expected to drive deeper penetration of 4G in 2019 and a possible rollout of 5G in subsequent years. It is also positive for the Mobile Network Operators' (MNO) mobile payment system launch in 2019.

In addition, the total number of active subscribers and teledensity were up 2.34% and 2.76% to 169.1mn and 120.79% respectively. Compared to October, the total number of internet subscribers increased by 1.27% to 108.46mn. While MTN, Airtel and Glo recorded an increase, Etisalat's share remained flat.



Some positive developments were also recorded in December. MTN settled its discrepancies with the apex bank and the NCC introduced harmonized short codes for the telecoms industry. However, Teleology Holdings has pulled out of the 9mobile deal.

RECENT DEVELOPMENTS IN THE SECTOR

MTN Nigeria settles out-of-court with the Central Bank of Nigeria

The telco giant has settled its dispute with the Central Bank of Nigeria (CBN) over illegal repatriation of dividends. The firm has agreed to remit a sum of $53mn, being 0.65% of the initial amount. In August, the CBN ordered the telco giant to refund a sum of $8.1bn as illegally repatriated dividends between 2007-2015. Four banks - Standard Chartered Bank, Citibank, Stanbic IBTC and Diamond Bank - were also sanctioned to the tune of N5.87bn. Following the announcement, the company's stock price lost 25% on the Johannesburg Stock Exchange on August 30th, reflecting investors' sensitivity to information.

Implications on the economy

The short-term impact of MTN's decision to settle was an 8.2% increase in its share price. The resolution will help douse investor concerns, especially at a time of perceived regulatory high-handedness. It will also pave the way for the telecom giant's listing on the Nigerian stock exchange, while supporting its mobile payment system launch in 2019.

NCC introduces harmonized short codes for telecoms industry.

The telecoms industry regulator, NCC, has introduced unified short codes for MNO. With this development, a single code will be used by customers across all networks to perform similar functions. For the next 12 months, the new codes will run concurrently with the old ones after which the latter would be disengaged. Meanwhile, the new codes are subject to approval after the NCC has compiled responses from value-added service (VAS) operators.

The regulator also reiterated its ban on auto-renewal of telecoms services despite the VAS operators' appeal for a reversal. The ban weighed on the performance of most VAS operators.

Implications

This new development is expected to provide customers with easy access to telecoms services. It will also increase the usage of telco services, raise average revenue per user (ARPU) by at least 5%, and expand the sector's growth.

Teleology to exit the 9mobile Deal

Barely two months after Teleology Holdings Limited was given the approval of no objection to take over the management of 9mobile, the firm has pulled out of the deal. This resulted from internal strife with the Nigerian stakeholders regarding 9mobile's business strategy. Adrian Wood, who heads the foreign division of the consortium, accused the Nigerian unit of deviating from the initial business plan. To this effect, he resigned from the board of Teleology Nigeria Limited.

Implications

Teleology's decision to exit the 9mobile deal has several implications for both Teleology and 9mobile. For Teleology, it may have to forfeit at least 16.6% of its $301mn investment in the distressed MNO, being the non-refundable payment ($50mn). More importantly, 9mobile will suffer some technical deficiencies, which could prompt the industry regulator, NCC, to annul the 9mobile sale. This means that a new technical partner needs to be sourced, which could delay or even truncate investment plans. The firms' quality of service could be impeded, leading to a reduction in its subscriber base. Furthermore, the firm's ability to compete with its peers would be limited especially with the imminent mobile payment launch by MNOs.

In addition, investor confidence in the telecoms sector would decline resulting in a significant drop in investment in the telecoms space. This would be a threat to the sector's growth as well as its contribution to GDP.

Real Estate Sector: The need to develop Nigeria's Mortgage Industry

The property market in Nigeria is yet to recover from the 2015/2016 recession. Buyers within the market are faced with challenges ranging from a decline in purchasing power to affordability and accessibility of mortgage loans, and security concerns amongst others. This has resulted in high vacancy rates in commercial hubs such as Lagos, Abuja and Port Harcourt.

Amongst the challenges crippling the real estate's performance is the under-developed mortgage industry, specifically in the areas of affordability and awareness. As a result, real estate's growth rate and its contribution to GDP has remained at a sub-optimal level. Developing Nigeria's mortgage industry would be useful in reducing the vacancy factors in cities across the federation.

DOMESTIC DEVELOPMENTS

Nigeria's Real Estate Market Outlook in 2019 [14]

The domestic real estate sector would be one to watch in 2019. A few noteworthy trends projected across the residential, commercial and retail sub-sectors include:

1. **Residential:** In the residential space, we expect developers to shift focus from bigger houses to studio apartments. This is on the back of rising demand for short let apartments. Another development in the residential sub-sector would be student accommodation. Many tertiary institutions are unable to meet the National Universities Commission's policy target of accommodating 33% of university students. The demand pressure for student accommodation is expected to lead to increased conversion of residential apartments to purpose-built student hostels.
2. **Retail:** The success of the retail market would depend on factors such as parking and entertainment facilities and accessibility. E-commerce will remain significant in the retail sub-sector in 2019. A few developments in the pipeline include:

Development	Location	Delivery Date
Bildiamo Mall	Sangotedo, Lagos	Q1'19
Twin Lakes Mall	Lekki, Lagos	2019

3. **Commercial:** In the commercial sub-sector, high vacancy rates are expected for Grade A offices, forcing landlords to remain flexible on tenancy terms. Moreover, the office market is expected to become more saturated in 2019 on completion of some projects in the pipeline. Amongst the projects due to be completed within the next two years include:

Development	Location	Delivery Date
Sogenal Tower	Ikoyi, Lagos	Q1'19
Atlantic Resort	Oniru, Lagos	2019
Dangote Head Office	Ikoyi, Lagos	2020[15]

[14]Northcourt Research
[15]Northcourt Research

Performance of real estate companies in Nigeria

Companies	Price as at November 30, 2018	Price as at December 31, 2018	Directional change
UPDC	N8.10	N6.60	↓
UAC Property	N1.77	N1.91	↑
Union Homes	N45.20	N45.20	↔
Skye Shelter Fund	N95.00	N95.00	↔

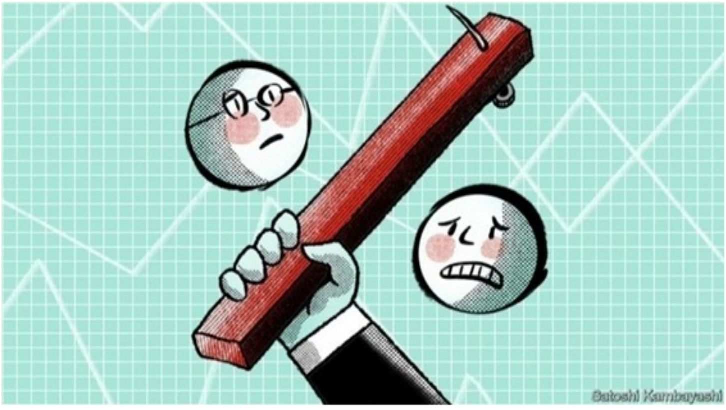
Currently, there are four real estate companies (UPDC, UAC Property, Union Homes and Skye Shelter Fund), listed on the Nigerian Stock Exchange. In the period between November 30 and December 31, there was mixed movement in share prices across the board. UPDC shares declined by 19% to N6.60 while UAC property share prices increased to close the period at N1.91. Union Homes and Skye Shelter Fund share prices remained flat at N45.20 and N95.00 respectively.

Outlook for real estate in January

Typically, there is a lull in economic activities in January due to lower private consumption following the Christmas festivities. Activities within the real estate sector are also expected to slow down in January as developers wait until after the elections to commence new residential and commercial developments. In addition, there is a 60% probability that the MPC will maintain the status quo at its January meeting. This would further limit activities within the real estate sector.

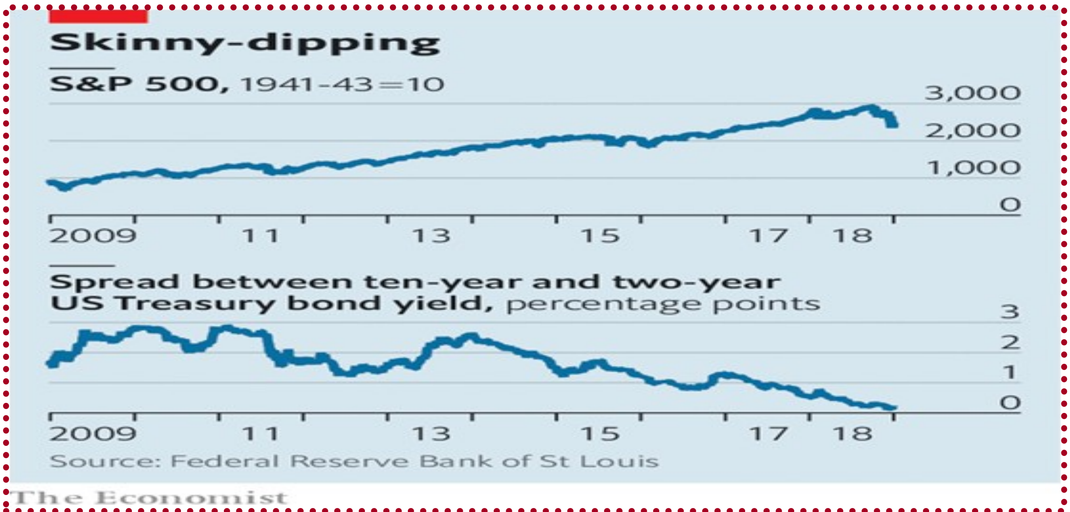
What the market turmoil means for 2019

Global Perspective: culled from The Economist



Fears that the Fed will tighten too much are among the reasons the stock market has fallen

AFTER A ROTTEN October and limp November, the S&P 500 tumbled in value by 15% between November 30th and December 24th. Despite an astonishing bounce of 5% the day after Christmas, the index finished the year 6% below where it started. The first trading day of 2019 extended the market wobble, with stocks closing down in Asia and gyrating in Europe. After markets closed in America, Apple warned that a sharp slowdown in China's economy, and weak sales in other emerging markets, meant revenues in the fourth quarter would undershoot expectations by up to 10%. Coming a day after news that China's manufacturing sector contracted in December that spooked investors globally. S&P 500 futures dipped before Wall Street re-opened on January 3rd.



That investors have become more risk-averse can also be seen in the bond markets. The high-yield spread, or excess interest rate over government debt, paid by companies with a poor credit rating has been rising. Meanwhile the yield on the ten-year Treasury bond has dropped from 2.98% to 2.63% over the past month, as investors have rushed to the safety of government paper. What is more the yield curve—the difference between yields for short- and long-dated government debt—is almost flat. The market's response to signs of slowing growth is itself a cause of jangling nerves. Economists at J.P. Morgan have developed a model based only on the historical predictive power of the stock market, credit spreads and the yield curve; that implies the probability of a recession in America in 2019 is as high as 91%.

There are other reasons for investors to be skittish. The effect of President Donald Trump's stimulus package, which came into force a year ago, is likely to fade soon. There are further signs of economic slowdowns in China and Europe. Tariffs, and the threat of further trade disputes, have probably deterred investment. Profit forecasts have been scaled back. According to Factset, a research firm, at the end of September analysts expected earnings to grow by 10.4% on average for companies in the S&P 500 in 2019. Now they reckon the figure will be 7.9%.

Missteps by the American administration have added to the sense of unease. The government shutdown may presage further political battles to come. A startlingly incompetent attempt on December 23rd by Steven Mnuchin, the treasury secretary, to calm market jitters by saying that banks have "ample liquidity" made things worse (bank liquidity had been nowhere among investors' worries until he mentioned it). And reports that Mr Trump was considering firing Jerome Powell, the chairman of the Federal Reserve, raised questions about the administration's competence to manage any downturn.

Perhaps the main concerns, though, are provoked by the Fed itself. On December 19th its Open Markets Committee (FOMC) delivered its fourth interest-rate increase of 2018, even though financial conditions have tightened to become less supportive of growth. Mr Powell also said he did not see an imminent change to the Fed's policy of running down its balance-sheet "on automatic pilot".

That added to fears that monetary policy will tighten beyond what the economy can bear. Of the forecasters surveyed by the Wolters Kluwer Blue Chip Financial Forecasts, 46% reckon the Fed's landing point for interest rates will be above their estimate of the long-run neutral Fed funds rate (a level at which the bank is trying neither to boost nor to slow activity). Only 10% thought it would be below. The median expectation of members of the FOMC for the number of interest-rate hikes in 2019 has fallen from three to two. The futures market suggests investors expect none at all.

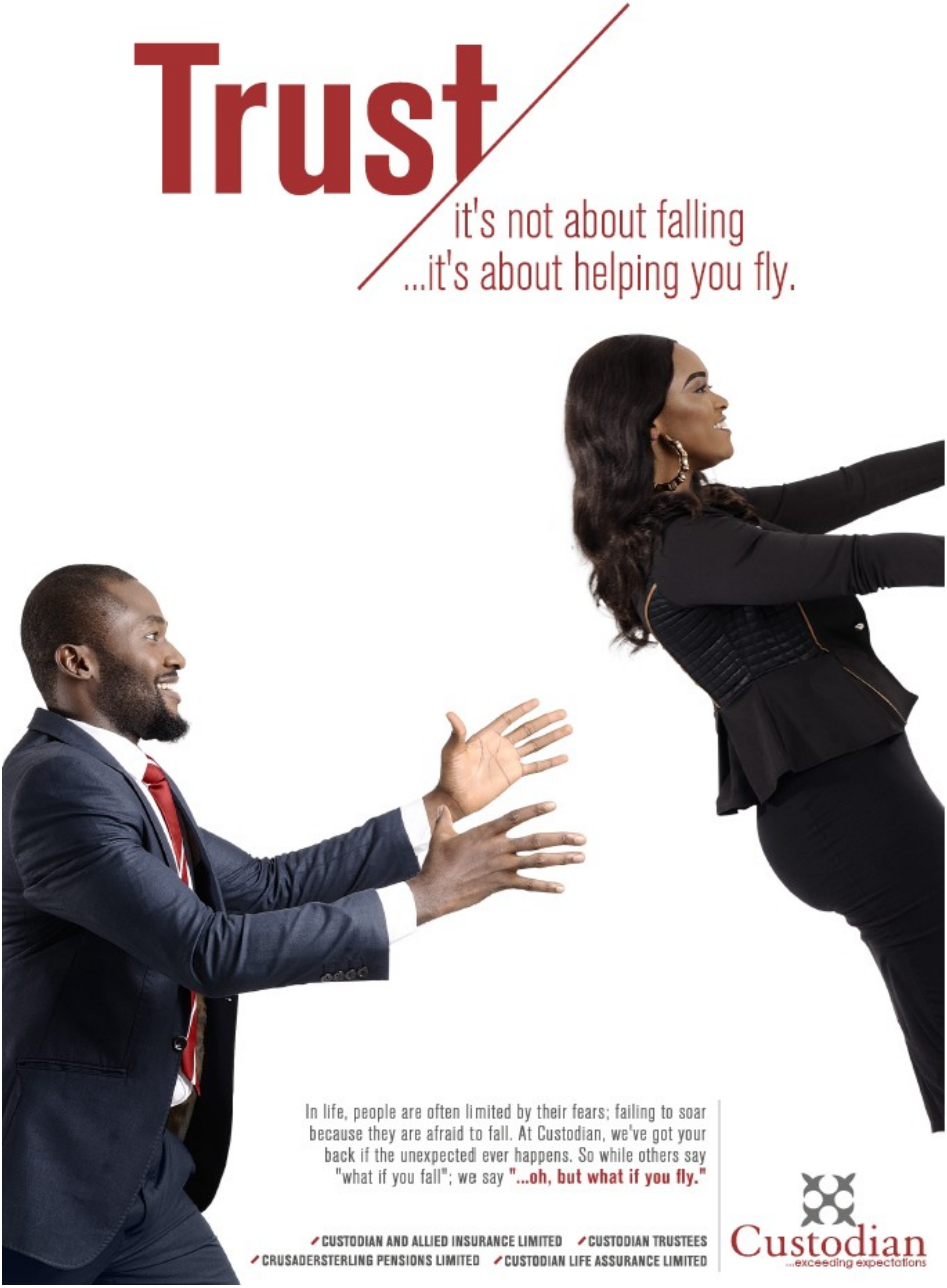
The reason monetary policymakers seem so blasé compared with investors is that, setting aside the financial indicators flashing amber, America's economy appears to be doing well. The labour market went from strength to strength in 2018, and most indicators of consumer confidence remain at ten-year highs. A different model built by J.P. Morgan analysts, this time based on short-term economic indicators such as car sales, building permits and the unemployment rate, put the probability of recession in 2019 much lower, at 26%.

There are several ways this disconnect between market jitters and robust economic indicators could disappear. The direct effect of stock-owners feeling poorer could cut spending. The plunging stock market could hit consumer and business confidence, crimping spending and investment. Predictions of recession based on markets and financial indicators could influence economic behaviour and thus become self-fulfilling.

Judging by the past couple of decades, if stock market turmoil persists the Fed will respond by lowering its forecasts for growth. That would feed into a looser policy stance. After announcing the rate rise on December 19th, Mr Powell reminded listeners that "some volatility" is unlikely to leave a mark on the economy, but also that the Fed had already lowered its forecast for growth and inflation "a little bit".

Fortunately for the Fed, inflation remains subdued, having come in at or below expectations in recent months. That gives the Fed's policymakers room to be lenient, meaning they can avoid the premature tightening they have often been criticized for. Investors may sense something the Fed does not. Playing it safe will give it time to correct course if needed.

There is a chance that the stock market will rouse itself from its slump in coming weeks. But even if it does, the Fed has re-emphasized its "data-dependent" approach to interest rates. That is central-banker speak for "less predictable". The coming year is likely to be bumpier than investors have become accustomed to.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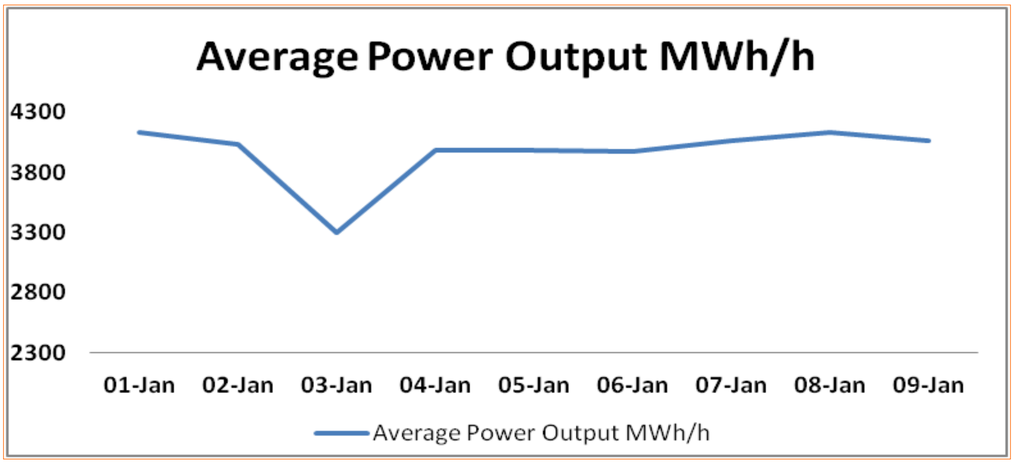
Macroeconomic Indicators

Power Sector

Average power output from the national grid was 3,962.44MWh/h in the period January 1st – 9th. This is 3.61% lower than the average of 4,105.4MWh/h in the corresponding period in December. Meanwhile, power output touched a two-week low of 3,303MWh/h on January 3rd due to insufficient gas supply. Morever, the national grid suffered 12 collapses in 2018 – one was partial and 11 were total.

A major constraint to power generation was insufficient gas supply. Total gas constraint during the period was 15,627.83MWh/h, 57.06% of total constraints. This is despite the nation's gas reserves level of 202trn standard cubic feet. Revenue loss during the period amounted to N13.12bn (N656bn annualized).



[16]

Outlook

We are currently in the dry season. Hence, we expect the level of power supply to be largely dependent on the availability of gas. Gas fired plants account for approximately 70% of the country's total power generation.

Impact

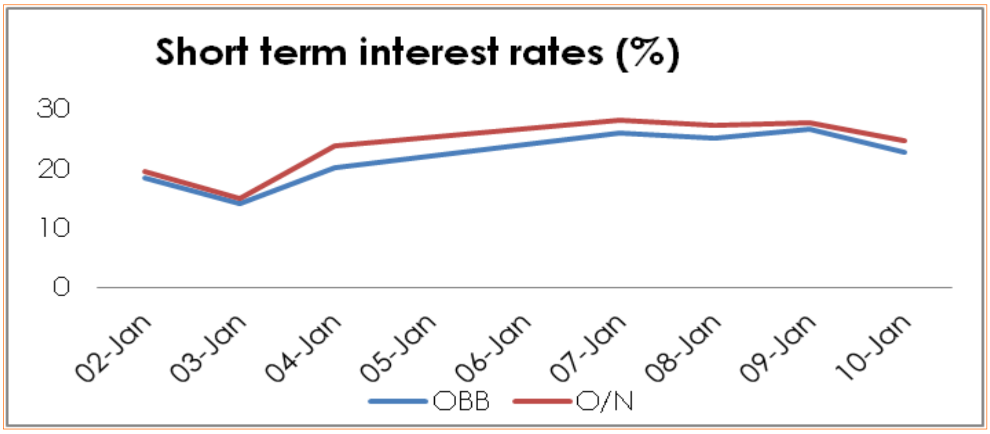
An improvement in power supply should cause a decline in demand for alternative energy sources, such as diesel generators. This would lead to a fall in operating expenses of firms.

[16] FG, FDC Think Tank

Money Market

The average opening position of banks from January 2nd – 10th fell sharply by 52.76% to N18.06bn long. During the period, the opening position was in a negative position for four days due to funding for the CBN's forex interventions and OMO sales. The sharp drop in market liquidity led to a spike in the average NIBOR rates (OBB/ON) to 22.73%pa, compared to 17.10% pa in the corresponding period in December.

The CBN issued OMO bills worth N590.19bn against a maturity of N957.02bn, leading to a net inflow of N366.83bn compared to a net outflow of N155.8bn in the corresponding period in December.



[17]

At the primary market, the 91-day and 182-day T/Bills tenors remained flat at 10.90% pa and 13.10% pa respectively, while the 364-day tenor increased by 5bps to 14.50%. At the secondary market, the 91-day, 182-day, and 364-day T/bill yields increased by an average of 56bps during the review period.

T/bills Tenor	Secondary market rates as at Jan 2nd (%pa)	Secondary market rates as at Jan 10th (%pa)	Direction	Primary market rates as at Nov. 28th 2018(%)	Primary market rates as at Jan. 2nd 2019(%)	Direction
91	12.24	12.82	↑	10.90	10.90	↔
182	12.41	13.40	↑	13.10	13.10	↔
364	14.87	15.00	↑	14.45	14.50	↑

The 30 and 90-day Nigerian inter-bank treasury bill true yields (NITTY) increased by an average of 94bps while the yield on the 180-day paper decreased slightly by 11bps.

[17]FMDQ

NITTY Tenor	Rates on Jan 2nd (%pa)	Rate on Jan 9th (%pa)	Direction
30	14.94	15.18	↑
90	12.62	13.49	↑
180	13.52	14.45	↑

Outlook

Interest rate movement is a function of market liquidity positions. We expect a boost in naira liquidity due to election spending and the anticipated minimum wage review. However, the CBN will continue to mop up liquidity using Open Market Operations.

Impact

Nominal interest rates move at variance with the level of liquidity and will continue to hover around an average of 12-15%.

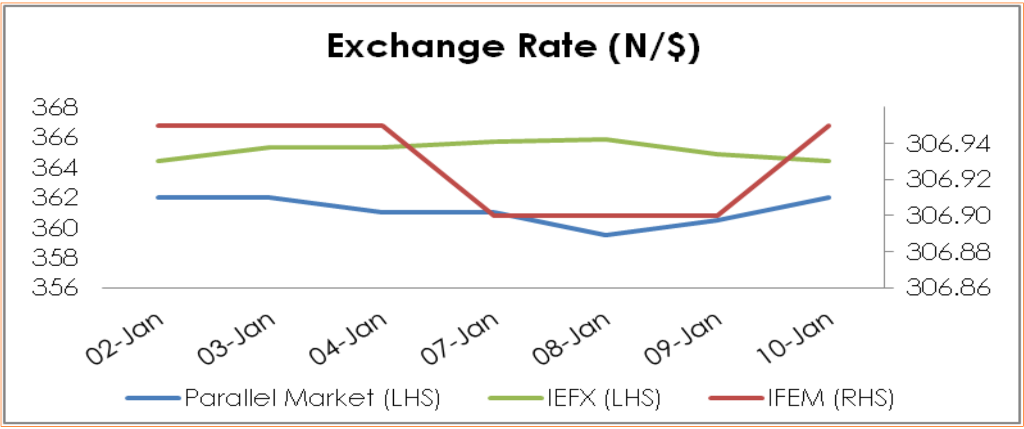
Forex Market

The Nigerian forex market is segmented with multiple exchange rates. The most important rate being that of the Investor and Exporters window. (IEFX). No less than 55%-60% of Nigerian forex transactions are traded at this window. The CBN and most exporters and investors patronize this window. It serves not only as a source of price discovery but also as a barometer for measuring potential and actual CBN intervention in the market. The exchange rate determinants are balance of payments, capital inflows and trade balance.

Exchange Rate

During the review period, the exchange rate at the parallel market appreciated by 0.69% to N359.5/$ on January 8th before depreciating to close the period at N361/$ on January 10th. Currency appreciation was supported by low demand from companies. At the interbank foreign exchange market, the naira traded consistently at N306.95/$ for three days then appreciated marginally by 0.02% to N306.90/$ for the remaining days in the period. Meanwhile, the IEFX exchange rate depreciated by 0.4% to N365.87/$ on January 8th then appreciated by 0.4% to close the review period at N364.41/$ on January 10th.

The value of the CBN's forex intervention fell slightly by 0.01% to $210bn from $210.02bn in the corresponding period in December. Total turnover at the IEFX window was down 31.76% to $1.01bn.



[18]

Outlook

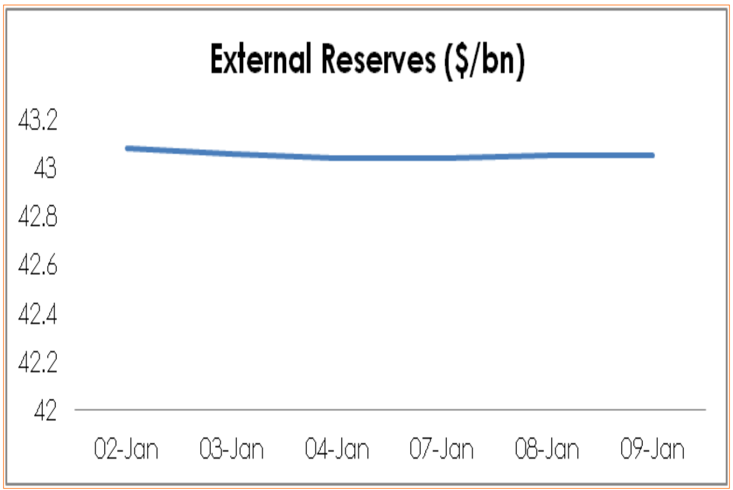
As companies commence business for the year and international students' resume, the demand for forex will increase significantly. We expect the currency to depreciate in subsequent months. Also, as the elections are less than a month away, we anticipate increased speculative activities which will affect the currency value. Nevertheless, the CBN is expected to continue its intervention in the forex market to stabilize the currency.

Impact

Currency depreciation will make dollar denominated loans costlier to finance. It will also raise the country's import bill, given its large dependence on imports. On a positive note, currency depreciation could boost the consumption of locally produced commodities as imported goods become more expensive and unaffordable.

External Reserves

In the review period, gross external reserves dropped 0.09% to \$43.04bn before slightly gaining 0.02% to \$43.05bn on January 9th. The increase was spurred by a drawdown of \$2.8bn Eurobond issued in November 2018. The import cover of 10.73 months as of January 2nd dropped to 10.72 months on January 8th.



[19]

Outlook

We anticipate a depletion in the gross external reserves on the back of lower oil revenue.

Impact

External reserves depletion would limit the CBN's ability to support the currency.

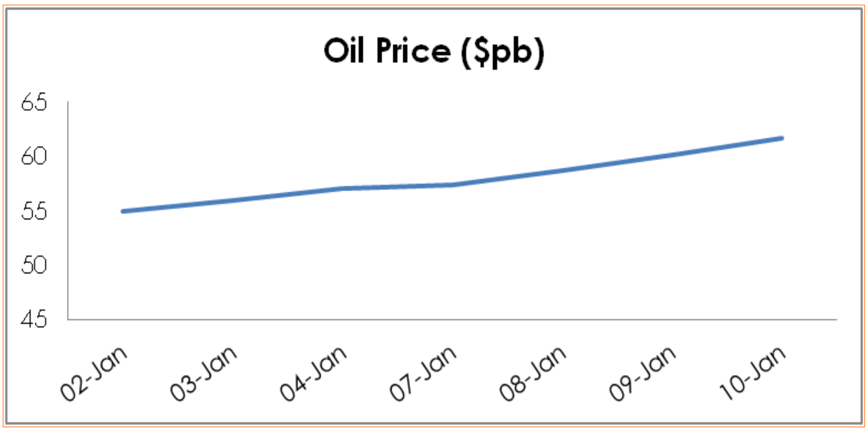
[18]FMDQ, CBN, FDC Think Tank
[19]CBN

COMMODITIES MARKET - EXPORTS

Nigeria is an export dependent economy. It derives over 80%-90% of its export revenue from crude petroleum and LNG.

Oil Prices

Oil futures surpassed the budget benchmark of $60pb by 2.8% at the end of the review period. It increased sharply by 12.33% to $61.68pb on January 10th from $54.91pb on January 2nd. This bullish sentiment was driven by the new output cut of OPEC and its allies.



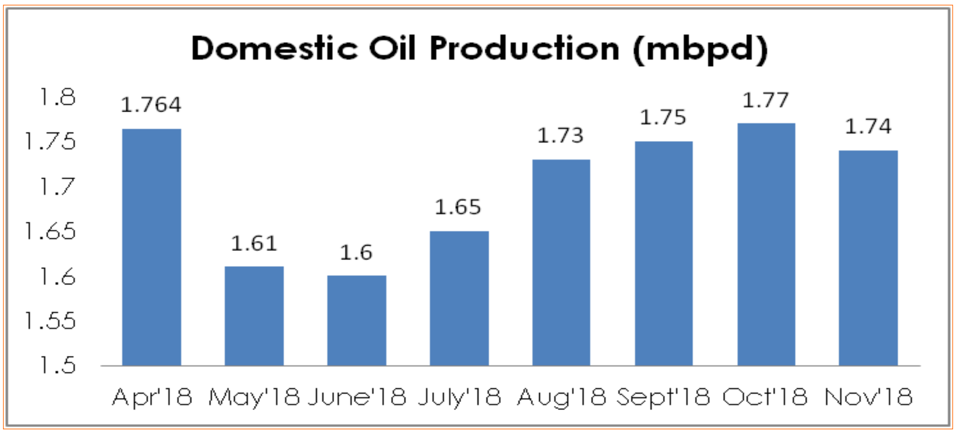
[20]

Outlook

We expect the bullish trend in prices to be sustained in the near term due to increasing global demand, commitment to the production cut, and investors' optimism over the outcome of the US-Chinese trade talk. Hence, prices are expected to stay between the ranges of $58pb - $63pb.

Oil Production

According to OPEC's latest oil report, Nigeria's domestic oil production was down 1.64% to 1.74mbpd in November from 1.77mbpd in October. On the other hand, Nigeria's oil rig count increased to 11 in December from nine in November.



[21]

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[20] Bloomberg
[21] OPEC

Outlook

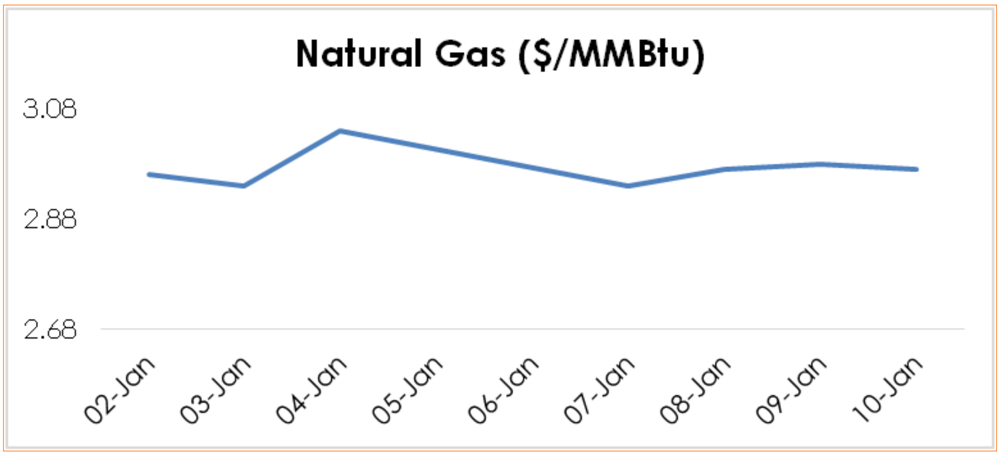
The increase in the oil rig count coupled with the expectation of output from the Total Egina oil field suggests a potential increase in oil production in the near term.

Impact

Crude oil accounts for approximately 90% of Nigeria's total export. A continuous increase in oil prices should offset the anticipated reduction in output. If this occurs, we should expect higher oil revenues. If the reverse is so, Nigeria would have a revenue problem, wider fiscal deficit and a higher debt burden.

Natural Gas

Natural gas prices averaged $2.97/mmbtu in the review period, 21.3% lower than the average of $4.44/mmbtu in the corresponding period in December. However, prices increased to $3.04/mmbtu on January 4th before dropping to close the period at $2.97/mmbtu. The fluctuations in prices could be attributed to mild weather and a projection of an increase in US natural gas supply.



[22]

Outlook

We anticipate an increase in demand for natural gas due to winter. This is expected to push up prices in the near term.

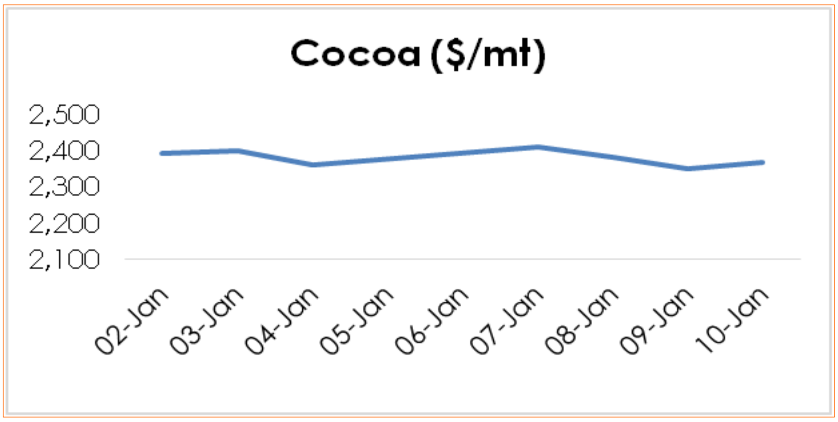
Impact

Nigeria is the world's second largest producer of natural gas. The projected increase in the price of the commodity is expected to boost export revenue. This could help to narrow the effects of lower oil prices on external reserves.

[22]Bloomberg

Cocoa

The average price of cocoa stood at $2,381/metric ton (mt) in the review period. This is 9.37% higher than the average of $2,177/mt in the same period in December. Cocoa prices increased to $2,410/mt on January 7th before declining to close the review period at $2,369/mt. This was despite concerns of unfavorable weather conditions in Ivory Coast, the third highest producer of cocoa in the world.



[23]

Outlook

We expect cocoa prices to be bullish in the near term due to the expectations of reduced export from Ghana as it increased its processing capacity coupled with unfavorable weather conditions in top producing states. Prices are thus expected to remain around $2,350/mt-$2,700/mt.

Impact

Nigeria currently produces 205,000 tons of cocoa, making it the world's fourth largest producer. An uptick in cocoa prices at a time when the government is focusing on economic diversification is positive for Nigeria's foreign exchange earnings.

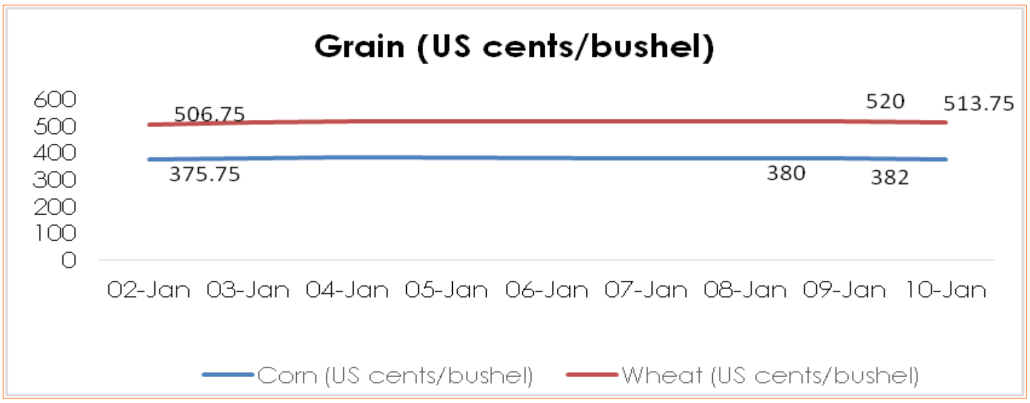
[23]Bloomberg

Wheat

Wheat prices rose by 1.38% to $5.14/bushel on January 10th, from $5.07/bushel on January 2nd. This was as a result of strong global demand and weak global supply of wheat.

Corn

The average price of corn decreased by 1.04% to $3.8/bushel from $3.84/bushel in the corresponding period in December. However, corn prices traded $3.83/bushel on January 4th before retreating to close the review period at $3.76/bushel. This was due to a projection of higher global supply.



[24]

Grains- Outlook

We anticipate an increase in grain prices in the coming weeks driven by higher global demand.

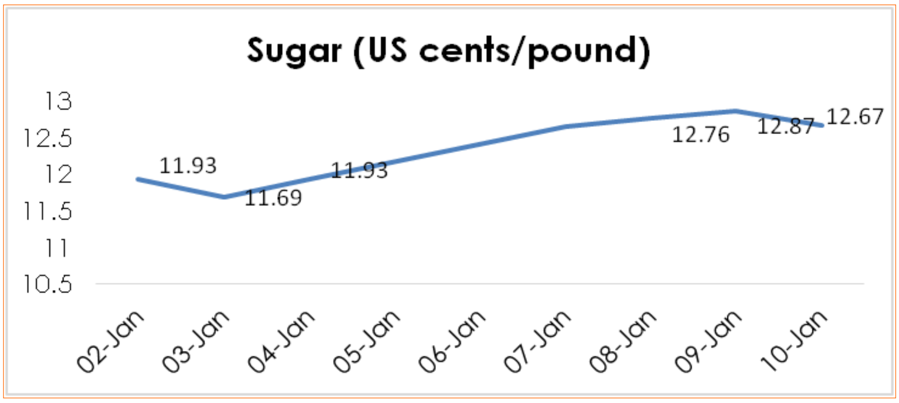
Impact

Nigeria is one of the top consumers of wheat in SSA. The country imported 4.8mn metric tons in 2017/18 with the expectation of a 4% rise in 2018/19. The increase in global wheat prices will drive up imported inflation, which will in turn reflect in the price of wheat dependent commodities such as bread, noodles and pasta.

[24] Bloomberg

Sugar

In the first ten days of 2019, the average sugar price was 17.71% lower at $0.1236/pound relative to the same period last year. Sugar prices increased by 7.88% to $0.1287/pound on January 9th from $0.1193/pound on January 2nd before retreating to close the review period at $0.1267/pound despite lower sugar output in Thailand.



[25]

Outlook

The price of sugar is expected to trend upwards in the near term due to expectations of lower output from top producers.

Impact

Sugar is an important ingredient in most consumable goods. Nigeria imports 1.87mn metric tons annually, making it the ninh largest importer. An increase in the global price of sugar signals a possible increase in the country's import bill.

[25]Bloomberg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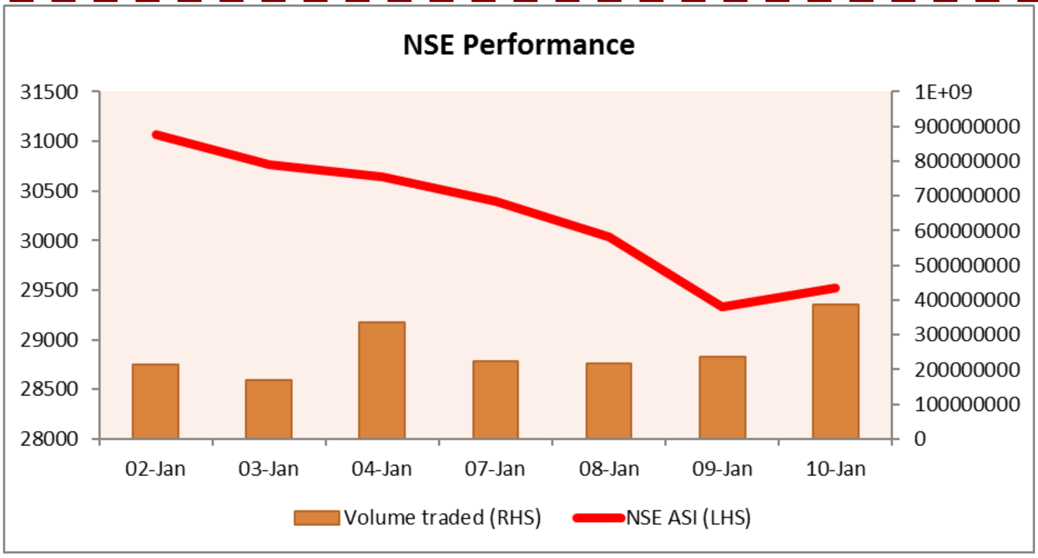
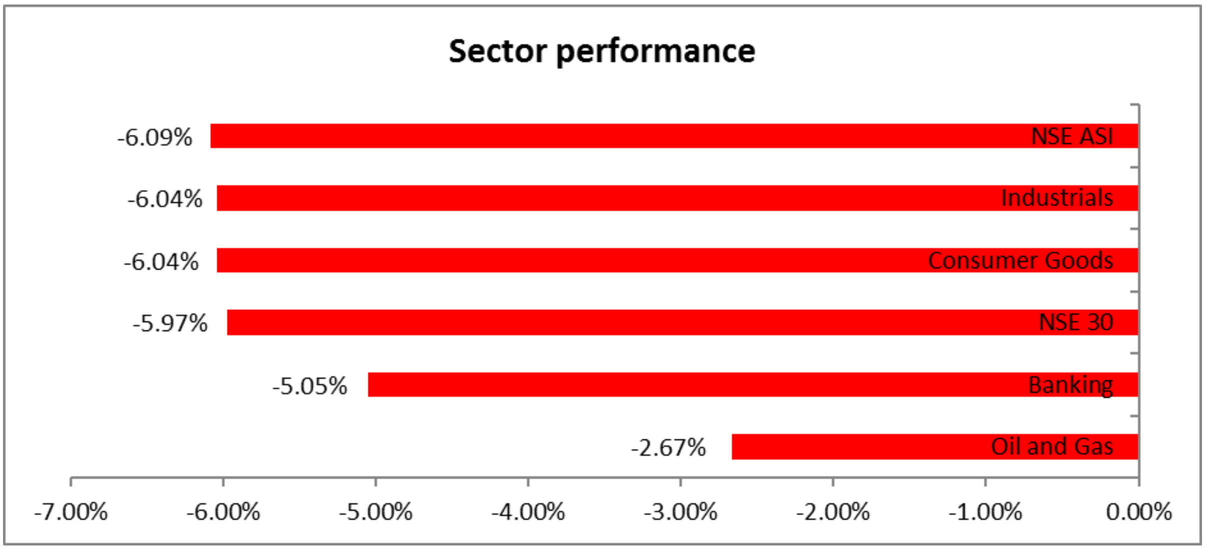
Stock market Update

The first ten days in January saw the Nigerian bourse maintain its bearish trend. The NSE All Shares Index (ASI) lost 6.09% to close at 29,517.73 points on January 10, 2019 compared 31,430.50points at the end of December 2018. At the same time, market capitalization fell 6.06% to N11.01trn. Continuous divestments across most sector indices weighed on the overall performance of the stock market.

Currently, the NSE is trading at a price to earnings (P/E) ratio of 8.52x, which is 1.29% lower than the close on December 31, 2018 (9.42x). The market breadth slipped into the negative territory at 0.23x, as 15 stocks gained, 88 stocks remained unchanged, and 65 lost. This is lower than the close of 1.88x at the end of December 2018.



The gloomy trend on the floor of the Nigerian Stock Exchange was also reflected in a sharp decline in the volume and value of trades. Average volume traded fell 58.53% to 385mn units while average value of trades was down 22.36% to N3.07bn.



All indices lost during the review period with industrial and consumer goods sub-sectors leading the decliners. The downward trend in these indices was on account of frequent sell-offs in large cap stocks, such as Dangote Cement Plc and Nigerian Breweries Plc.

The highest gainer was Julius Berger Nigeria Plc (41.29%), followed by Cutix Plc (9.76%), John Holt Plc (9.09%), Livestock Feeds Plc (8.16%), and Trans-Nationwide Express Plc (7.69%).

Top Gainers					
Symbol	Dec 31'18 Price	Jan 10'19 Price	Change	%Change	PE Ratio
JULIUS BERGER NIG. PLC.	20.10	28.40	8.30	41.29	7.87
CUTIX PLC.	1.64	1.80	0.16	9.76	3.73
JOHN HOLT PLC.	0.44	0.48	0.04	9.09	1.13
LIVESTOCK FEEDS PLC.	0.49	0.53	0.04	8.16	-
TRANS-NATIONWIDE EXPRESS PLC.	0.65	0.70	0.05	7.69	87.5

The laggards were led by NEM Insurance Plc (-36.30%), followed by Resort Savings & Loan Plc (-26%), Champions Breweries Plc (-22.11%), Access Bank Plc (-22.06%), and UACN Property Development Co. Ltd (-20.94).

Top Losers					
Symbol	Dec 31'18 Price	Jan 10'19 Price	Change	%Change	PE Ratio
N.E.M INSURANCE CO (NIG) PLC.	2.70	1.72	-0.98	-36.30	3.25
RESORT SAVINGS & LOANS PLC	0.50	0.37	-0.13	-26.00	-
CHAMPION BREW. PLC.	1.99	1.55	-0.44	-22.11	22.14
ACCESS BANK PLC.	6.80	5.30	-1.50	-22.06	2.18
UACN PROPERTY DEVELOPMENT CO. LIMITED	1.91	1.51	-0.40	-20.94	-

Corporate Disclosure

Earlier in December 2018, the majority shareholder of Forte Oil Plc, Mr Femi Otedola, announced his intentions to divest his 75% stake in the company's share capital. However, both the Nigerian Stock Exchange and the Securities and Exchange Commission are yet to receive a formal application to this effect. This has been a source of worry to many of the company's shareholders as the offer price of Otedola's stake has not been determined.

Outlook

Investors' apprehension of elevated political risks surrounding the forthcoming general elections is expected to continue. This is reflected in the frequent sell-offs in recent times. The negative sentiment will however be reversed as long as calm is restored in the country after the elections.

EQUITY REPORT: Cadbury Nigeria Plc

Analyst's note

Cadbury Nigeria (Cadbury) returned to its winning ways in the first nine months of 2018 (9M'18), after a challenging year in 2017. The combination of an aggressive revenue drive and containing operating costs helped the company report a decent profit in 9M'18, from its negative position in 9M'17. However, the high cost of production, at 80.32% of revenue, continues to suppress the milestones of the food company.

75.34% surge in export revenue buoyed recovery

Cadbury's revenue increased by 10.65% to N26.96 billion in 9M'18. This sustained the growth trend that it has experienced since 2016. Prior to 2016, revenue declined by 22.19% between 2014 and 2015, owing to the squeeze in consumers' disposable income. The introduction of more products and the diversification of Cadbury's portfolios in line with its parent company (Mondelēz International) aided revenue recovery.

Although domestic sales remained the dominant revenue source (85%), foreign sales, especially to Europe and other parts of Africa surged by 75.34% to N4.04bn in 9M'18. Likewise, revenue classification by product class showed that the intermediate cocoa segment recorded the highest revenue growth, rising 30.69% in 9M'18 to N4.25bn. The beverage segment recorded a 10.16% growth in revenue to N15.57bn and confectioneries, 2.3% to N7.14bn.

Analyst Recommendation: SELL

Market Capitalization: N18.69billion

Recommendation Period: 365 days

Current Price: N9.85

Industry: Consumer Goods

Target Price: N8.06

Cost of goods sold inched higher

Cadbury spent 80 kobo of every naira earned on raw material conversion in its 9M'18 period. The company's production cost increased by 14.34% to N21.65bn in 9M'18. Raw material sourcing, as well as packaging of finished goods have been the management's largest challenges. The congestion at the seaport remains a key limitation to effective control of these costs – emphasizing the need for more favorable sourcing policies.

Maintained tight hold on operating expenses

The company's operating efficiencies remain a highlight for the current management. Cadbury's operating expenses declined by 14.23% in 9M'18. The optimization across most cost centers helped achieve this feat. The management has adopted a number of measures to curtail its selling, distribution and administrative expenses.

Finance cost weighed on bottom line

The high interest rate environment continues to narrow Cadbury's profit margins. Its finance cost increased by 127.87% to N525.78 million in 9M'18. Before 2017, Cadbury maintained a positive net finance income, but this changed in 2017, as its net finance income moved to a negative position of N361.05mn. This trajectory was maintained into 9M'18, increasing by 315.1% to –N426.44mn. Nonetheless, profit for the period came in at N171.95mn and remained an improvement over 9M'17(-N64.45mn).

Cadbury's portfolios are dominated by business segments in the maturity stage. The intense competitive rivalry in the industry means the ability of players to gain additional market share would require radical changes, through product and market development. However, high customer loyalty has increased the cost of customer acquisition considerably, limiting Cadbury's upsides. As a result, we place a **SELL** rating on the company's stock.

Industry and company overview

Cadbury was incorporated in Nigeria in January 1965 and subsequently listed on the Nigeria Stock Exchange (NSE) in 1976. Before listing on the NSE, Cadbury predominantly re-packed imported bulk products, but with its listing it grew rapidly into a full-fledged manufacturer. The parent company, Mondelēz International (formerly Kraft Foods Inc.) has a majority equity interest of 74.97% in Cadbury through its holding in Cadbury Schweppes Overseas Limited. Mondelēz International is one of the largest confectionery food and beverage companies in the world. It remains a dominant player for chocolate, biscuits and gum and candy.

Cadbury Nigeria currently produces and markets branded fast moving consumer goods such as refreshment beverages and confectioneries. It also exports intermediate cocoa products to Europe and the rest of Africa.

The beverage segment accounts for 58% of revenue. Confectionery accounts for 26% and intermediate cocoa products 16%.

Cadbury Plc's rivals remain Nestlé and Unilever. Nestlé Nigeria Plc is currently the largest in the food and nutrition segment with bottom-line earnings over N33.12bn in 9M'18, compared to Cadbury's N171.85mn. Nestlé continues to benefit from a favorable volume-product mix, as it remains the dominant player in most of its segments.

Local players in the industry include UACN, SweetCo Foods and Promasidor, who are also diversified food companies. Like Cadbury, they have recorded lack luster performance due to a combination of production constraints and the intense rivalry in a highly price-sensitive market.

Income Statement for Cadbury Nigeria Plc

N'000	2013	2014	2015	2016	2017
Revenue	35,760,753	30,518,586	27,825,194	29,979,410	33,079,446
Cost of sales	(22,660,657)	(22,134,829)	(18,894,967)	(23,119,007)	(25,644,312)
Gross profit	13,100,096	8,383,757	8,930,227	6,860,403	7,435,134
Other income	59,032	38,151	21,263	76,434	99,337
Selling & distribution expenses	(5,970,810)	(4,878,200)	(5,621,160)	(5,595,702)	(5,228,425)
Administrative expenses	(1,467,631)	(1,488,817)	(1,909,714)	(2,073,988)	(1,594,681)
Operating profit	5,720,687	2,054,891	1,420,616	(732,853)	711,365
Finance income	1,770,124	331,000	156,796	187,780	186,915
Finance costs	(69,334)	-	-	(17,798)	(547,963)
Net finance income	1,700,790	331,000	156,796	169,982	(361,048)
Profit before tax	7,421,477	2,385,891	1,577,412	(562,871)	350,317
Income tax (expense)/credit	(1,398,258)	(248,572)	(424,117)	266,468	(50,319)
Profit/(loss) for the year (PAT)	6,023,219	2,137,319	1,153,295	(296,403)	299,998

Balance Sheet for Cadbury Nigeria Plc

N'000	2013	2014	2015	2016	2017
Non-current assets					
Property, plant and equipment	16,929,458	16,132,914	15,365,655	14,187,437	13,882,124
Intangible asset	11,698	342,076	283,218	397,439	300,635
Prepayments	-	-	23,148	-	-
Total non-current assets	**16,941,156**	**16,474,990**	**15,672,021**	**14,584,876**	**14,182,759**
Current assets					
Inventories	1,880,654	2,392,926	1,936,455	5,020,938	6,252,367
Trade and other receivables	6,390,008	6,093,315	5,166,194	4,968,703	4,890,318
Prepayments	211,649	164,950	234,118	823,169	499,656
Cash and cash equivalents	17,749,157	3,685,105	5,408,217	3,011,314	2,598,022
Total current assets	26,231,468	12,336,296	12,744,984	13,824,124	14,240,363
Total assets	**43,172,624**	**28,811,286**	**28,417,005**	**28,409,000**	**28,423,122**
Equity					
Share capital	1,565,187	939,101	939,101	939,101	939,101
Share premium	11,543,821	272,344	272,344	272,344	272,344
Other reserves	3,436,348	3,436,348	3,436,348	3,436,348	3,436,348
Share based payment reserve	35,201	42,492	30,266	42,634	49,698
Retained earnings	7,414,374	8,059,166	7,607,238	6,366,306	7,045,300
Total equity	**23,994,931**	**12,749,451**	**12,285,297**	**11,056,733**	**11,742,791**
Non-current liabilities					
Deferred tax liabilities	476,448	523,867	348,294	187,708	290,024
Employee benefits	4,314,464	3,235,863	4,131,780	4,328,231	3,860,721
Total non current liabilities	4,790,912	3,759,730	4,480,074	4,515,939	4,150,745
Current liabilities					
Trade and other payables	13,541,296	11,742,702	11,104,368	12,582,771	8,860,338
Current tax liabilities	845,485	559,403	547,266	102,192	69,488
Bank overdrafts	-	-	-	151,365	1,902,047
Short-term loan	-	-	-	-	1,697,713
Total current liabilities	14,386,781	12,302,105	11,651,634	12,836,328	12,529,586
Total liabilities	**19,177,693**	**16,061,835**	**16,131,708**	**17,352,267**	**16,680,331**
Total equities and liabilities	43,172,624	28,811,286	28,417,005	28,409,000	28,423,122

Management Overview

Cadbury's leadership team has been focused on three key initiatives: accelerating consumer-centric growth, driving operational excellence, and building a winning growth culture. The sustained clampdown on operating expenses over the last three years, despite the growth in top line revenue, alludes to management's improvement in the company's internal efficiencies. This stems from initiatives such as head count rationalization, control on advertising and sales promotion, and effective management of repair and maintenance costs.

Cadbury's management has also leveraged on the global brand's visibility and market acceptance to push volumes in the Nigerian market. However, production costs, which account for over 80.32% of revenue, remain the most potent bottleneck. The company's production cost increased by 14.34% in 9M'18, compared to a revenue growth of 10.65%. This surge in costs can be mainly attributed to raw material and packaging costs, as well as other production consumables. This strongly points to the need to optimize the company's raw material sourcing framework, as this continues to weigh on the company's profit margins and shareholder value.

The board of Cadbury is under the stewardship of Mr. Atedo Peterside, founder of Stanbic IBTC, a leading financial institution in Nigeria. He has also served on the board of several companies such as Flour Mills of Nigeria and Nigerian Breweries. Experiences and lessons from serving in these large corporations would help keep the leadership abreast of industry trends in Nigeria.

Mr. Muhammad Amir Shamsi has served as the Managing Director (MD) since February 1, 2017. He has worked in Mondelēz for over eight years as the MD in Pakistan and West Africa, and held a global role in the US, managing innovation for Kids Wholesome. He has worked with other multinationals including Imperial Chemicals Limited and GSK. His work experience from other emerging markets, as well as a better understanding of the local business environment, will be a key facilitator of recovery.

Chairman

Mr. Atedo Peterside

Managing Director

Mr. Muhammad Amir Shamsi

Bulls and Bears say

Bulls Say:

- Dominant player in the food and beverage space
- Household brand name in the Nigerian market
- Strategic alliance and support from parent company
- Aggressive route to market strategy
- Upward review of minimum wage to boost demand
- Experienced and talented management
- Innovative initiatives to improve appeal and customer satisfaction
- Operating expense control

Bears Say:

- High cost-to-income ratio – narrowing profit margins
- Intense competition from other leading players
- Persistent macroeconomic headwinds could dampen consumer demand
- Most strategic business units are in maturity stage
- Surge in cost of capital – both debt and equity

Risks and Outlook

The most potent risk faced by Cadbury would mainly pertain to non-systemic risks. This is tied to the ability of the Nigerian economy to maintain its economic recovery. Being a consumer goods brand, the fortunes of the company have a positive correlation with the economic viability of Nigeria. For instance, the upward review in minimum wage will increase the purchasing power of most consumers, which is positive for Cadbury. However, establishments that are not able to meet up with the increase in salaries may embark on head count rationalization, reducing the consumer base of Cadbury.

Likewise, the company has struggled to keep its production costs low, which have weighed on its margins. Given the need to improve shareholder value, cost containment is a critical success factor. The limitation on production cost containment may overwhelm management's efforts to drive sales.

The risks facing Cadbury could limit management's ability to drive growth and sustain returns. Even though the management has put structures in place to ensure sales growth and cost efficiency, the competition for a share in consumers' wallets will remain a double edge sword. This has to a large extent promoted innovation and learning among industry players. However, the increasing need for working capital continues to exert pressure on management. Nonetheless, the move to explore more opportunities, from the parent company's portfolio into Nigeria, could be key to delivering sustained growth.

Our Valuation

Using the Discounted Cash Flow (DCF) methodology, we estimated a stock price of N8.06, which is a 18.17% downside on the current price of N9.85 as at January 17, 2019. The discount rate (Weighted Average Cost of Capital (WACC)) of 17% was derived using a 15% risk free rate (FGN 5-year Bond as at October 2018), a Beta of 0.555, an after-tax cost of debt of 12%, and a market risk premium of 6.34%. The long-term cash flow growth rate to perpetuity calculated is 4%.

Based on our analysis above, we place a **SELL** rating on the stock.

DCF Valuation			
N'000	**2018**	**2019**	**2020**
EBIT	2,661,833	1,796,811	1,484,564
Less: Taxes	(638,840)	(431,235)	(356,295)
EBIAT	2,022,993	1,365,576	1,128,269
Plus: Depreciation & amortization expense	1,544,759	1,439,890	1,399,241
Less: CAPEX	(855,127)	(374,433)	(949,467)
Less: Change in working capital	1,085,677	2,672,213	(302,199)
Free Cash Flow (FCF)	3,798,303	5,103,246	1,275,844
WACC	17%	17%	17%
Present value (PV) of FCF	3,249,521	3,735,132	798,890
Terminal value @ perpetual growth rate	**2018**	**2019**	**2020**
Terminal value as of 2020			10,295,378
Present value of terminal value	6,446,612		

DCF Calculation	
PV of explicit period	7,783,542
PV of terminal value	6,446,612
Enterprise value	14,230,154
+ Cash	2,598,022
- Borrowings	(1,697,713)
Equity value	15,130,463
Share price	***8.06***