FDC Bi-Monthly Update

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In This Issue …

Is a negative Fitch outlook a kiss of death?

Fitch, a global credit rating agency, has revised downwards its economic outlook for Nigeria from stable to negative. This comes less than 2 weeks after Moody's reduced Nigeria's outlook to negative. The downward revision reflects the country's increasing vulnerability to domestic and external headwinds and foreign investors' growing wariness of the Nigerian economy.

Rating Drivers

- Increasing vulnerability from the current macro-policy setting
- Central bank's complex regulatory measures
- Rising debt
- Low fiscal revenue
- Rising inflation

According to Fitch, Nigeria's macroeconomic challenges are underscored by the increasingly complex regulatory measures taken by the CBN to attract foreign investments in OMO bills and spur bank lending. The agency is of the opinion that low OMO market liquidity is likely to have dampened foreign portfolio investments, contributing to a rapid depletion of external reserves. Fitch also noted that Nigeria's low fiscal revenues and structural shortcomings in public finance management would continue to constrain the federal government's ability to support a rising debt burden. According to Fitch, Nigeria's public debt to revenue ratio is particularly high at 333% and is expected to rise to 400% in 2021. The agency also expects the government debt to exceed 30% of GDP in 2020.

Impact of a negative rating

The rating downgrade could spook investors' already dampened confidence. Furthermore, we could see an increase in the borrowing costs for Nigerian financial institutions, an increase in interest costs on debt for Nigerians looking to borrow from foreign countries and further pressure on the naira.

Central Bank of Nigeria (CBN) slashes bank charges and leaves the Telcos hanging

In recent times, the CBN has intensified its consumer protection drive. This is evident in the review of the Consumer Protection Regulations as well as the Guide to Charges by banks and other financial non-bank financial institutions. In its circular titled *'CBN Slashes Bank Charges, Protects Customers in Revised Guidelines',* the CBN introduced the following changes:

1. A cancellation of the card maintenance fee on current accounts. In addition, the card maintenance fee on savings accounts is slashed to N50 per quarter from N50 per month.
2. Reduction in annual card maintenance fee on Foreign Currency (FCY) denominated cards to $10 from $20.
3. ATM withdrawal fee slashed to N35 from a previous charge of N65.
4. The flat fee of N50 on electronic transfers will now be replaced with a fee scale: transfers below N5,000 will attract a maximum charge of N10; transfers between N5001-N50,000 will attract N25 and transfers above N50,000 will attract N50.

In addition to these revised charges, the apex bank has also clarified its stance on the N50 POS service fee that has sparked outrage amongst many Nigerian consumers. According to the CBN, the service charge is to be paid by merchants and not by the final consumer. Merchants are at risk of being sanctioned by the apex bank for passing the burden to consumers if they fail to comply. In another development, the CBN would reportedly fine some banks for using the wrong documentation for domiciliary account transactions. This signals the possibility of more stringent regulatory controls – especially on foreign currency accounts in the face of depleting external reserves.

The long standing battle between the Telcos and banks over the Unstructured Supplementary Service Data (USSD) charges is likely to continue into 2020. While the CBN was notably silent on the issue, the Telcos have voiced their grievances about their inability to charge for the use of their own infrastructure. In view of the downward review of bank charges and the intensified consumer protection drive of the CBN, it seems highly unlikely that any additional charge will be placed on the consumer but rather a sharing mechanism will be devised to appease both parties.

Impact

The revision of the Guide to Charges and the Consumer Protection Regulation is necessitated by a continued evolution of the financial industry, which has resulted in the introduction of new products and channels over the past few years. These recent developments would have an impact on both the banking industry and consumers.

On the banking industry, a downward review of bank charges would result in a decline in the fees and commission income of deposit money banks. On average, transaction costs account for approximately 20% of banks' gross earnings.

On the other hand, consumers are on the winning side of these revisions. Lower transaction costs will ease the strain on consumer disposable income and could boost financial inclusion, as consumers are encouraged to transact more and keep money in the banks without fear of erosion.


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Poverty and the Nobel Prize laureates: What can Nigeria learn?

Poverty has served as a conundrum for policy makers and governments across the world for decades. According to the World Bank, extreme poverty is defined as a state of consuming less than \$1.90 per day. It is estimated that 8.6% of the world's population live on less than \$1.90per day.[1] The Sub-Saharan Africa region is also severely affected by the poverty problem, as 40% of the region's population consume below the international poverty line.

This year, three worthy economists – Esther Duflo, Abhijit Banerjee and Michael Kremer - were awarded the prestigious Nobel Prize award for their extensive work on poverty alleviation. The unique choice of winners for this category extends beyond the fact that Esther Duflo is the youngest recipient of the award. It is also because the three economists have redefined the field of development economics. They have successfully tackled the issue of poverty, which many economists hitherto believed to be an insurmountable challenge, by breaking it down into smaller and more precise sub-components touching on areas such as education and healthcare amongst others. This led to the adoption of an experimental approach to poverty alleviation, which is commonly termed the randomized trial in the medical sciences. The idea was to understand which policies work in the real world fight against poverty. By so doing, the economists expanded the scope of economics from merely a world of theoretical modeling to real world examples.

[1]United Nations. 2019. "World Economic Situation and Prospects: October 2019 Briefing, No. 131". https://www.un.org/development/desa/dpad/publication/world-economic-situation-and-prospects-october-2019-briefing-no-131/

What the Nobel Prize winners teach us about poverty alleviation

In their book, 'Poor Economics: a radical rethinking of the way to fight global poverty', the husband and wife duo – Abhijit Banerjee and Esther Duflo – highlight the importance of poor economics, which is simply an understanding of the economic existence of the poor. Over the years, the economics of poverty has often revolved around social intervention programs. The Nobel Prize laureates instead chose to actually reach out to the poor not through issuing fancy policies from oval offices but by interacting with them and learning about the economic intricacies of their world. The unconventional methods adopted offer two key takeaways for developing countries like Nigeria in the fight against poverty:

#1: Impactful intervention is crucial

The first point of call for the economists was to question the typical top-down intervention, which many governments adopt to fight poverty. They challenged the 'give more money to the poor population' principle, which several governments adopt in the fight against poverty. Esther Duflo countered this principle by suggesting that the solution of poverty does not depend solely on the free flow of foreign aid to developing countries but the impact of these funds on their lives. In the Primary School Deworming Project (PSDP), carried out by Michael Kremer and Edward Miguel, the researchers sought to solve the low school attendance in Kenya by simply carrying out a deworming exercise in 75 primary schools. This inexpensive intervention resulted in a reduction in infection rate among schoolchildren, which led to increased school attendance.

#2: Nudges are a key part of poverty alleviation

According to the economists, the poor population is often not in the best position to 'do the right things' despite being aware of what to do. The tendency to postpone costs and lack of information questions their judgment. The Nobel Prize laureates believe that this is the role 'nudges' play in that they compel the poor to do the right thing at the right time. Invisible nudges are a common feature in advanced economies. For instance, parents are forced to immunize their children as public schools will not admit them otherwise and health insurers often reward citizens for joining the gym and adopting a healthy lifestyle. Michael Kremer displayed an understanding of the impact of nudges in developing countries when he provided a free supply of chlorine at local water sources in Kenya. The rising epidemic of diarrhea diseases in rural Kenya was resulting in child malnutrition and fed the poverty cycle. The installation of chlorine dispensers increased usage by 53% as people were reminded to use the chlorine treatment when fetching water.

Poverty in the Nigerian context

Poverty in Nigeria has been on the rise over the last decade and in 2018, Nigeria overtook India to become the country with the highest poor population. According to the World Bank, the poor population in Nigeria could increase by more than 30 million by 2030 and the country is at risk of housing 25% of the world's extremely poor population.

Past governments have attempted to solve the poverty problem using social intervention programs such as the National Home-Grown School Feeding Program, the Conditional Cash Transfer Program, N-Power, and Trader Moni initiatives, amongst others. However, these programs have failed to translate into equal distribution of economic prosperity to all Nigerians. Looking forward, the specifics of how President Buhari will lift 100 million Nigerians out of poverty in the next 10 years remains sketchy.

Incorporating the lessons learnt into Nigeria's poverty alleviation schemes

The models adopted to solve the rising poverty rate in Nigeria vary significantly from the example set out by the Nobel Prize winners. Replicating the lessons learned from the Nobel Prize laureates will take some deliberate re-learning by policy makers on the efficient and effective ways of poverty alleviation.

The first lesson point for Nigeria lies in who handles lending to the poor and vulnerable within the society. According to Duflo and Banerjee, microcredit schemes in developing countries are often driven by political reasons rather than economic need. Instead, they propose that governments should not be in the business of subsidized lending as the loans have the potential to end up in the wrong hands. Their solution was for Microfinance institutions to step up and fill the lending gap. They suggested a joint liability system for microfinance banks to help them reduce the risk of default. The system, which has already been adopted by Bangladesh, involves the coming together of a group of borrowers to receive credit on a rotational basis and share the risks and responsibilities.

The second lesson point is the need to design nudges to fit the specific contexts of individual developing countries. Nigerian policy makers have partially incorporated the nudges model adopted by the laureates through the Home-Grown School Feeding Program. The program, which was launched in 2016 and targeted especially towards the vulnerable, initially set out to feed over 24 million schoolchildren. Poor parents are indirectly nudged to send their children to school where they can enjoy a free meal. However, with approximately 11 million children aged five to 14 years still out of school, there is a need for policy makers to do more.[2] In November 2018, the FGN introduced the deworming exercise as a component of the school feeding programme. This is proof that poor parents in Nigeria need more incentives to send their children to school. Going forward, other potential nudges that can be explored include free textbooks, free immunization amongst others.

Way Forward

If left unaddressed, the increasing rate of poverty will keep both growth and development at a sub-optimal level in the medium to long term. Nigeria's success in fighting poverty will depend on the willingness and ability of policy makers to do things differently and block the loopholes in its existing poverty alleviation policies. The models adopted by the laureates provide a good starting point.

[2]UNICEF. 2013. https://www.unicef.org/nigeria/education

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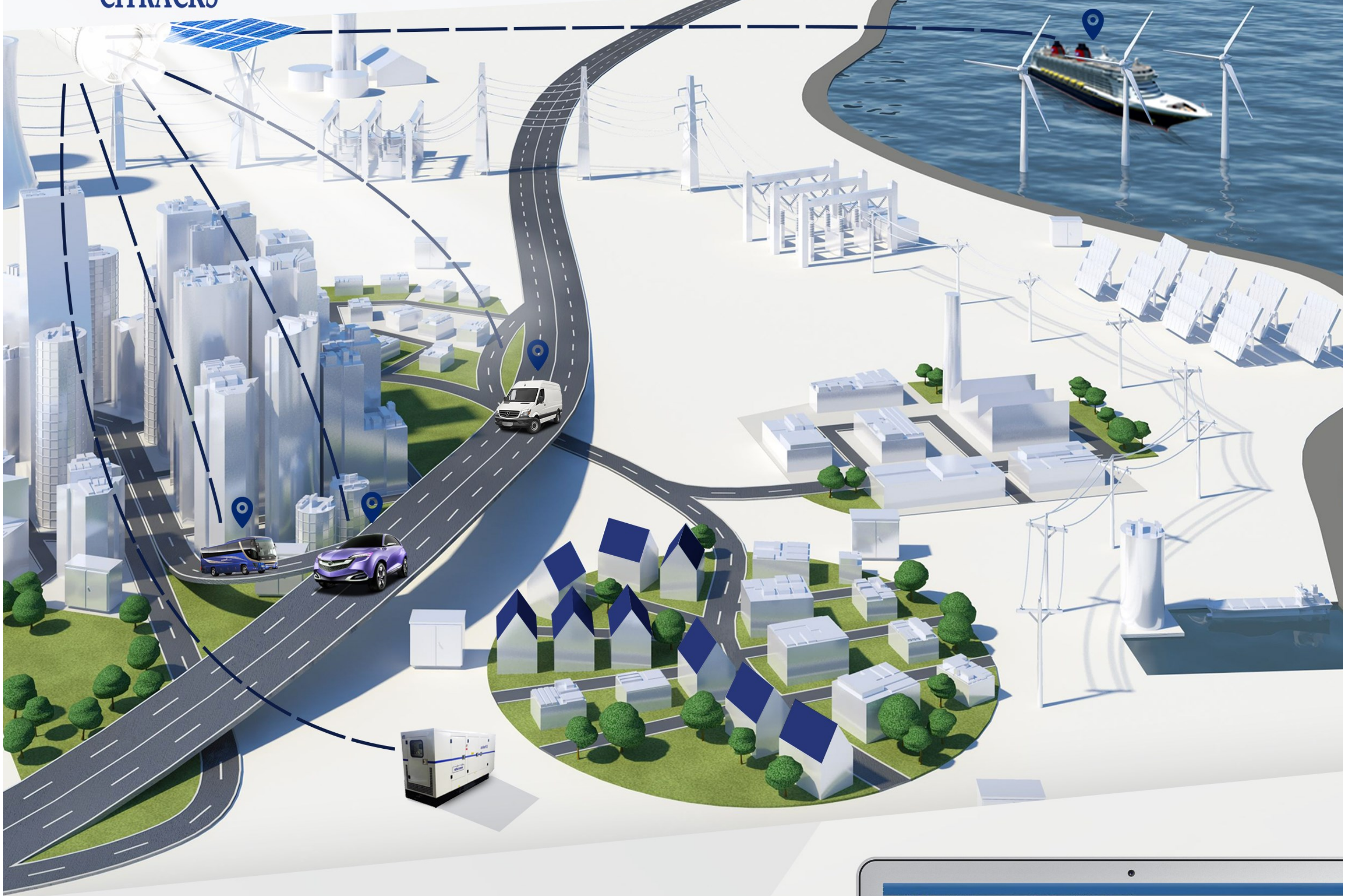

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France loosens Supervision of 'Colonial' West African currency

CFA franc countries will no longer keep half their reserves in Paris

France has bowed to popular pressure in West Africa by agreeing to scrap the name of the CFA franc and loosen its supervision of the currency union as Paris seeks to reshape relations with its former African colonies.

Established in 1945, the CFA franc has been used in two African monetary zones, one for eight west African countries and the other for six mostly petro-states in central Africa. Critics say the currency is a "colonial relic" that preserves the dominance of Paris and French companies in the region by removing French currency risk at the cost of monetary and fiscal independence.

The monetary revamp, which will initially only be implemented in the west African monetary area, was announced on Saturday during a visit by Emmanuel Macron to the Ivory Coast, where the French president also said that colonialism had been "a profound mistake".

Mr Macron has said he wants to dismantle the "Françafrique" sphere of influence with former African colonies in favour of more normal, business-oriented relations free of any colonial taint. He has also sought to encourage French business interests in non-francophone states such as Nigeria and Ethiopia.

"The question of the CFA franc crystallises numerous debates and criticisms of the supposed role of France in Africa," Mr Macron said in Abidjan, Ivory Coast's economic hub.

The French president said he welcomed the launch of the "eco", which will replace the CFA franc in West Africa in 2020. "I see your youth criticize us in a way for continuing an economic and monetary relation that they judge to be, and I quote them, postcolonial."

Ivorian president Alassane Ouattara said it was an "historic day for West Africa".

"The CFA franc is dead," French newspaper Le Journal du Dimanche declared.

Since 1999, the CFA franc has been pegged to the euro and members have had to keep half of their foreign reserves in France. A French official has sat on the board of the regional central bank in both zones.

Announcing the new arrangement on Saturday, Mr Macron said the renamed eco would still be pegged to the euro and guaranteed by France. However, countries using the currency will no longer have to keep half of their reserves at the French treasury, nor will there be a French representative on the currency union's board. Further details have not been disclosed.

"France is leaving the governance of the whole system in West Africa," said a French finance ministry official. "It's a significant move as through our presence in institutions we had an influence on the decisions taken by the currency union."

The official who declined to be named because details have yet to be firmed up, stressed that daily information sharing with Paris would continue, including on reserves. If reserves were to fall below a certain level, France would be entitled to request the reintroduction of its seat on the eco's monetary policy committee, the person said.

France will also have the right to nominate one "independent" member of the monetary policy committee. The chosen candidate would not officially represent the French government and would have no reporting role, the official insisted.

Supporters of the currency union, including Mr Ouattara himself, have argued that it has provided stability even in times of severe political stress such as during two civil wars in Ivory Coast, the latter from 2010-11.

French finance minister Bruno Le Maire said "a good balance" had been found in the new regime: "The zone keeps the exchange rate fixed with the euro…guaranteeing currency stability and protection against inflation."

Opponents of the currency say it prevents countries from devaluing to counter external shocks and has hampered industrialization by keeping the exchange rate artificially high. Some regard it as a useful arrangement — to the detriment of the poor — between France and the moneyed elites of francophone Africa, whose spending power is inflated.

The obligation for member states to keep half their reserves at France's central bank has been a particularly sore point.

The renaming of the currency is symbolic: CFA originally stood for Colonies Françaises d'Afrique, or French Colonies in Africa.

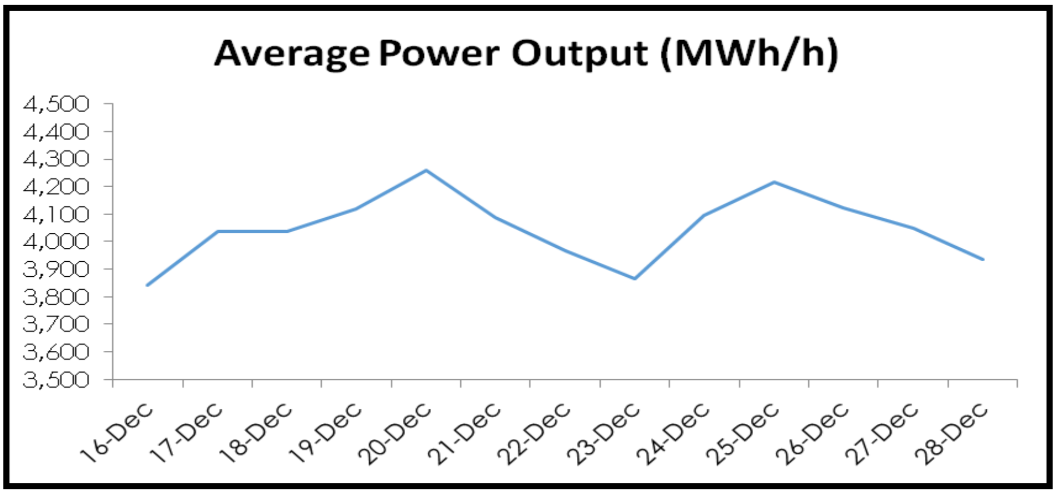
The eight countries in the West African region had already intended to rename the currency as the eco and have long discussed a single West African currency that could eventually include other Anglophone states, such as Nigeria and Ghana.

The six countries using the central African CFA are expected to decide how they wish to proceed next year, French officials said.

Macroeconomic Indicators

Power Sector

The average power output sent out from the national grid within the period December 16th -28th was 4,049MWh/h, 1.94% higher than the average of 3,972MWh/h recorded in the second half of November. The major constraint experienced during the review period was the gas constraint, predominantly in Afam VI and Sapele NIPP plants. During the review period, total constraint averaged 3,799MWh/h resulting in a total revenue loss of N23.7billion (annualized at N6.54 trillion).



[3]

Outlook

We expect average power output to rise in coming weeks as the significant decline in gas constraints outweighs the slight increase in grid constraints.

Impact

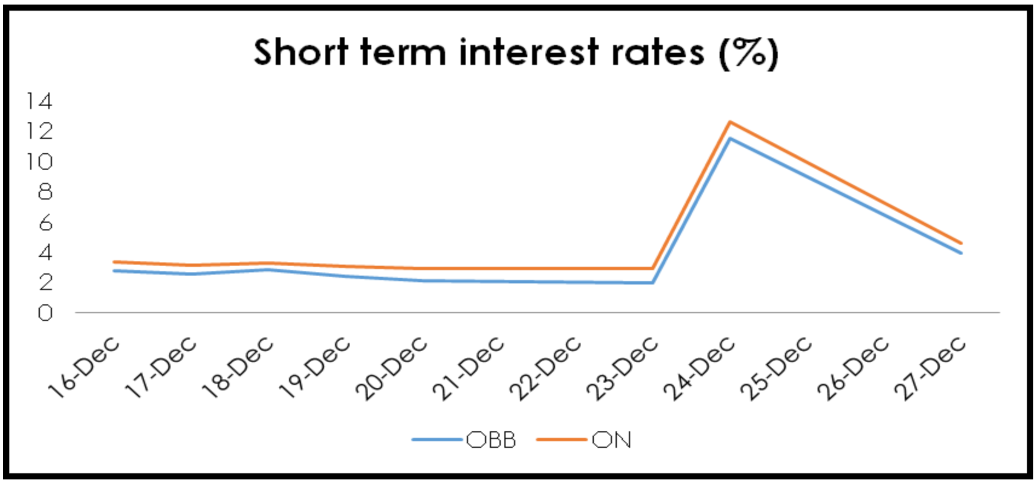
The increase in average power supplied would reduce spending on alternative power supply by businesses that depend heavily on power, such as factories. This translates to reduced cost incurred in running such companies.

Money Market

The average opening position at the interbank market spiked up by 121.38% to N547.37bn between December 16 and 30 from N247.25billion in the second half of November. Average short term rates, NIBOR (OBB, O/N) spiked up by 116bps to 4.14% p.a. from an average of 2.98% p.a. within the review period. On average, OBB and O/N were 3.78% pa and 4.49% pa respectively.

[3]FG, FDC Think Tank

Total OMO sales for the review period amounted to N814.6bn while no OMO repayment was recorded between December 16 to December 30. However, in the corresponding period last month, the reverse was the case, i.e there was no OMO sale, while total OMO maturities amounted to N743.5bn.



[4]

At the primary market, there was an auction of N7billion on December 18th with yields declining across all tenors. It decreased from 5.00%, 6.19% and 6.88% on December 11th to 4.00%, 5.00% and 5.50% on December 18th for 91-day, 182-day and 364-day t-bills respectively. In the secondary market, the yields on the 91-day and 182-day bills rose to 5.10% and 6.19% respectively from 5.00% and 5.35% on December 16. The yield on the 364-day bill however declined to 5.88% from 6.62% at the beginning of the review period.

Primary Market

T/bills Tenor	Rate on Dec 11th (% pa)	Rate on Dec 18th (% pa)	Direction
91	5.00	4.00	↓
182	6.19	5.00	↓
364	6.88	5.50	↓

Secondary Market

T/bills Tenor	Rate on Dec 16th (% pa)	Rate on Dec 27th (%)pa	Direction
91	5.00	5.10	↑
182	5.35	6.19	↑
364	6.62	5.88	↓

[4]CBN

Outlook

We expect short term interest rates to decline further in coming weeks as banks experience mounting pressures from the CBN to maintain a minimum loan-to-deposit ratio of 70%.

Impact

Sustained Increase in market liquidity will cause a continuous decline in short term interbank rates further, reducing the cost of borrowing.

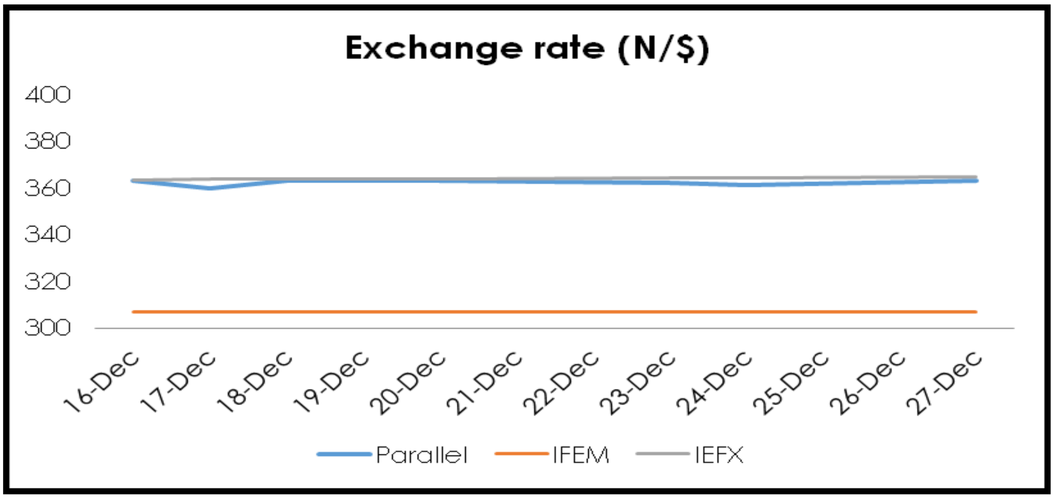
Forex Market

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

Exchange Rate

In the parallel market, the naira began the period trading at N363/$, the highest level since January 30, appreciating up to N361/$ on the 24th before reversing the gains to close the period at N363/$. At the interbank foreign exchange market, the naira traded flat at N306.95 from December 16 till December 23 before depreciating to close at N307/$ on December 27.

At the Investors & Exporters Foreign exchange window, the exchange rate rose to N364/$ for the first time since January 14, closing at N364.57/$ on December 27. During the review period, the naira lost 0.3% of its value and total forex turnover recorded in the investors and exporters window declined by 45.3% to $1.63billion compared to the first half of the month. During the review period, no CBN intervention was recorded in the IEFX market.



[5]

Outlook

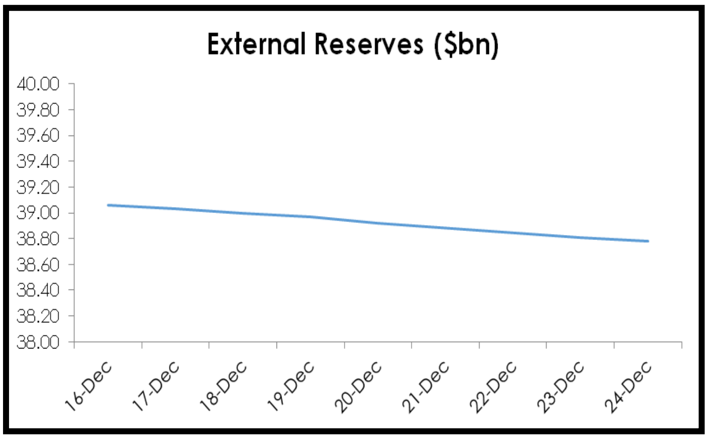
The continuous depreciation of the naira can be attributed to the absence of forex interventions by the CBN. Further depreciation of the naira is likely to occur in light of depleting external reserves, which could limit the CBN's ability to intervene in the forex market.

Impact

Further depreciation of the naira could translate to higher prices especially for goods without locally produced substitutes. This would result in increased spending by firms and individuals that depend highly on these products.

External Reserves

In the period under review, the external reserves level continued its steady depletion losing 0.72% (N28 million) to end the period at $38.78bn on December 24 from $39.06bn on December 16. The import cover has declined to 9.65 months from 9.91 months at the end of November. This is the first time external reserves have fallen below $39bn since December 28, 2018.



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Impact

The steady depletion of the external reserves has raised concerns on the value of the currency and the ability of the CBN to defend the exchange rate. Reduced intervention in the forex market can result in further depreciation of the naira.

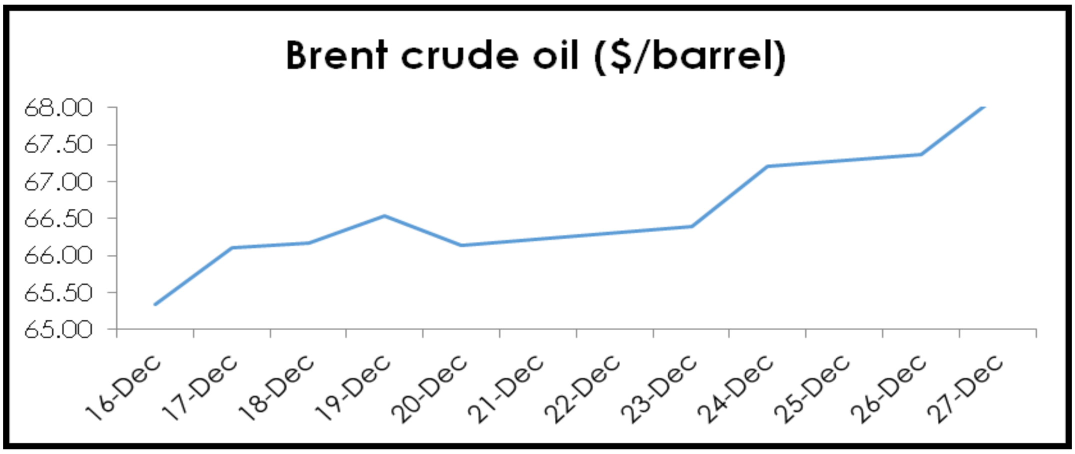
[5]FDC Think Tank
[6]CBN

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

On average, the price of Brent crude rose by 5.57% to $66.66pb in the second half of December from $63.14pb in the corresponding period in November. Oil futures increased by 4.32% to $68.16pb, a three month high on December 27 from $65.34pb on December 16th. This was partly due to declines in US crude inventories as well as easing US-China trade tensions which boosted the prospects for increased oil demand.



[7]

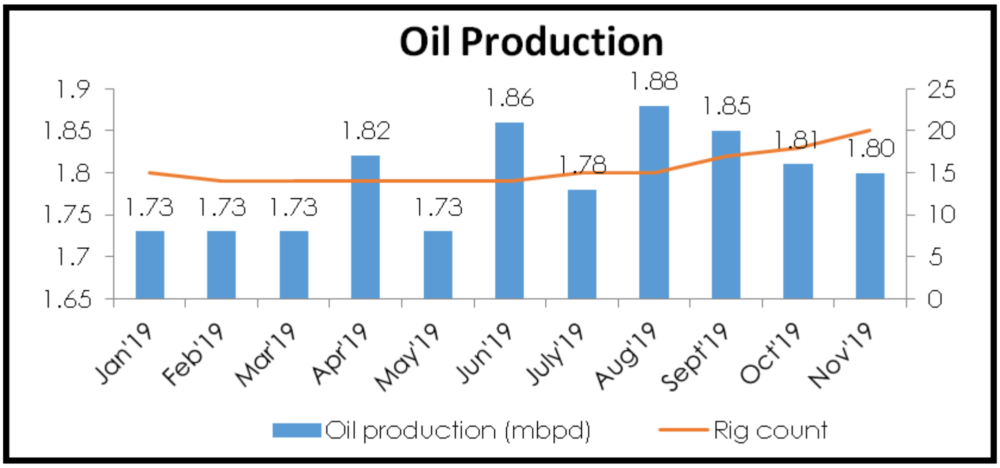
Outlook

We expect oil prices to remain above $60pb, owing to the decision during the OPEC meeting to cut the supply of oil further by 500,000 barrels/day which would take effect from January 2020.

Oil production

Oil production was 0.55% lower at 1.80mbpd in November. This was in spite of an increase in the country's rig count to 20 from 18 in October. Also, OPEC's crude oil production fell by 193bpd to an average of 29.6mbpd as oil output decreased in Saudi Arabia, Angola, Iraq, Iran, Gabon, Congo, Nigeria and UAE.

[7]Bloomberg, FDC Think Tank



[8]

Outlook

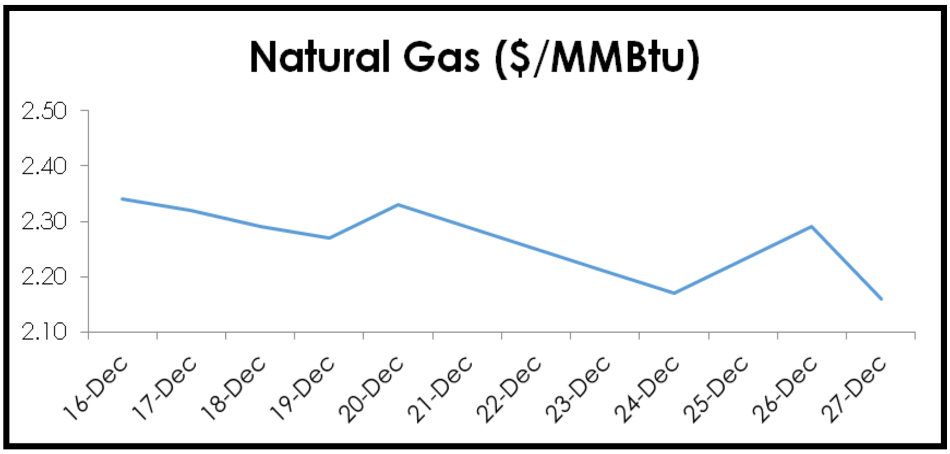
Oil production is expected to decline in coming months as the agreement on deeper production cuts kick in. Also, it is unclear whether Nigeria would be included in the deeper cuts. If this happens, and Nigeria is forced to comply, the country's oil output levels may fall towards 1.7mbpd.

Impact

Nigeria is more production sensitive than price. A lower oil output would affect the actualization of budgeted revenue projections as oil revenue accounts for 31.35% of the total revenue projected.

Natural Gas

On the average, the price of natural gas during the review period was $2.26/mmbtu which is 10.32% lower than the average price of $2.52/mmbtu in the second half of November. Natural gas prices dipped by 7.69% to close the review period at $2.16/mmbtu from $2.34/mmbtu on December 16. This can be attributed to the forecast of warmer temperatures in the US which caused a reduction in demand.



[9]

[8] OPEC, FDC Think Tank
[9] Bloomberg, FDC think Tank

Outlook

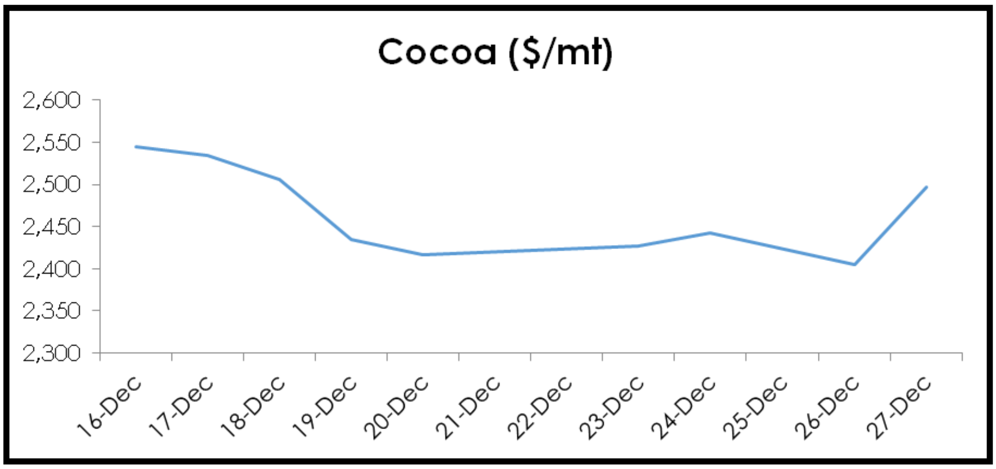
We expect natural gas prices to decline in coming weeks as forecasts show warmer than expected temperatures in the Northern Hemisphere despite the winter season.

Impact

Liquefied natural gas is Nigeria's second main export; lower prices will have a negative impact on the country's export earnings.

Cocoa

Average cocoa price fell by 5.87% to close the review period at $2,468/mt from $2,622/mt in the corresponding period in November. Prices fell to $2,497/mt on December 27, representing a decline of 1.89% from $2,545/mt on December 16. The decline in price was supported by Ivory Coast farmers' plan to increase production above the output cap.



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Outlook

We expect prices to increase in coming days driven by strong global demand for cocoa and reduced supply from Ivory Coast and Ghana due to climate conditions in the short term.

Impact

Cocoa is Nigeria's second main non-oil export commodity. An increase in cocoa prices means higher government revenue. It will also have a positive impact on the country's external reserves and foreign exchange earnings.

[10] Bloomberg, FDC Think Tank


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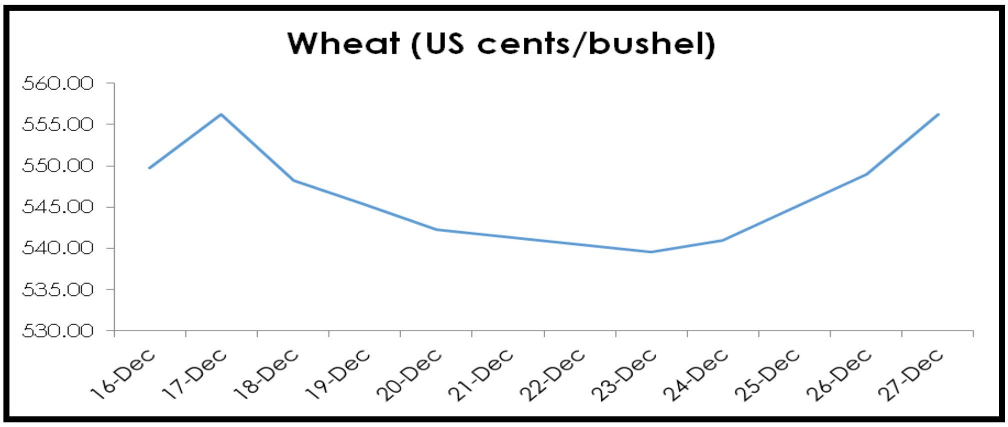
Commodities Market - Imports

Wheat

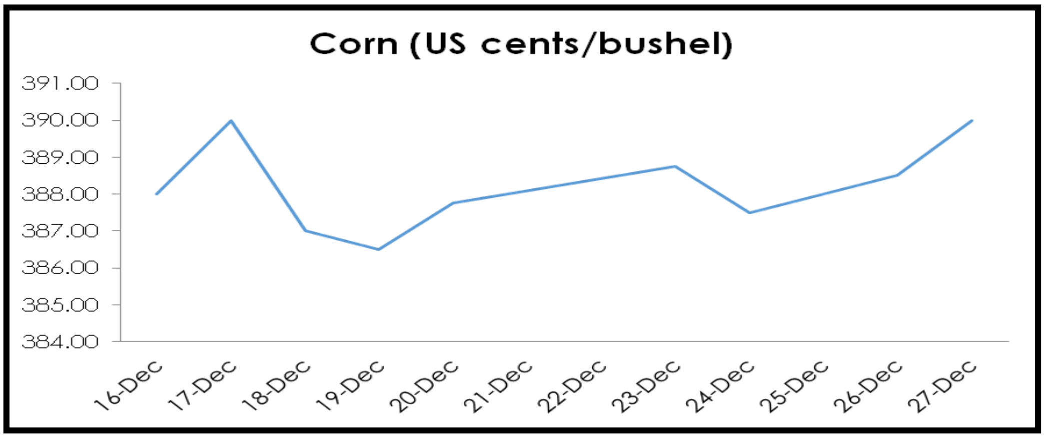
The price of wheat averaged $547.50/bushel between December 16 and 27. This represents a 4.59% increase when compared to the average of $523.48/bushel in the same period in November. Meanwhile, prices rose marginally by 1.18% to $556.25/bushel at the end of the review period from $549.75/bushel on December 16th. During the review period, wheat prices were supported by easing US-China trade tensions as well as ample global supplies.



[11]

Corn

The average price of corn from December 16 to December 27 stood at $388.22/bushel, an increase of 2.72% compared to $377.95/bushel in the corresponding period in November. Corn prices rose slightly by 0.52% to close the review period at $390/bushel from $388/bushel on December 16. The phase one trade agreement between US and China boosted corn prices during the period. However, the optimism was tempered by concerns over the lack of details on the trade deal.



[12]

[11]Bloomberg, FDC Think Tank
[12]Bloomberg, FDC Think Tank

Outlook - Grains

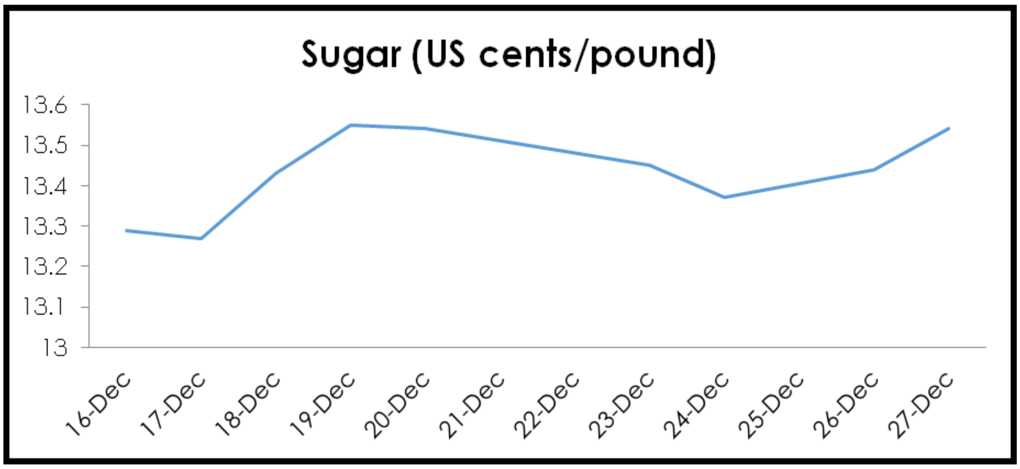
The US Department of Agriculture has revised downwards the US 2019 grain forecast. Possible reduction in output combined with increased export prospects as US-China trade tensions ease, could push up prices in the near term.

Impact

Higher grain prices will increase spending for wheat and corn dependent firms and push up production cost incurred on grain based goods.

Sugar

On average, sugar prices increased by 5.09% to $13.43/pound in the period under review from $12.78/pound in the relative period in November. Sugar prices also rose by 1.88% to close the period at $13.54/pound from $13.29/pound on December 16. This was partly due to lower exports from India and lower production as weather conditions affect produce in US and Australia



[13]

Outlook

Despite the reduction in supply, strong global demand is expected to boost sugar prices in the short term.

Impact

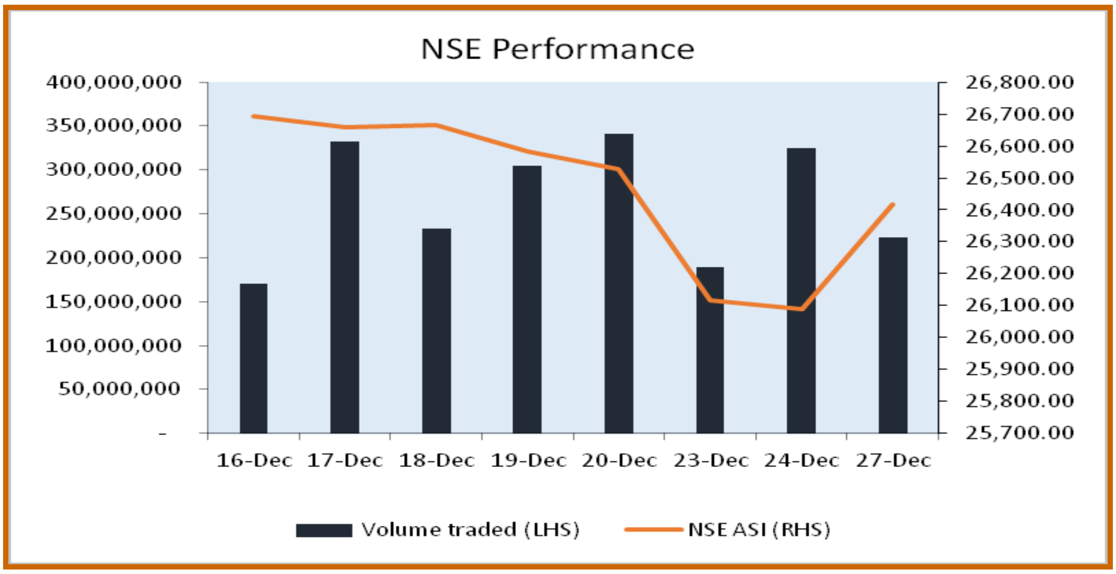
Nigeria is the largest importer of sugar in Sub-Saharan Africa. Rising sugar prices will increase the country's import bill which will in turn have a negative impact on the country's trade balance. The impact of this will be a reduction in government revenue and external reserves.

[13]Bloomberg, FDC Think Tank

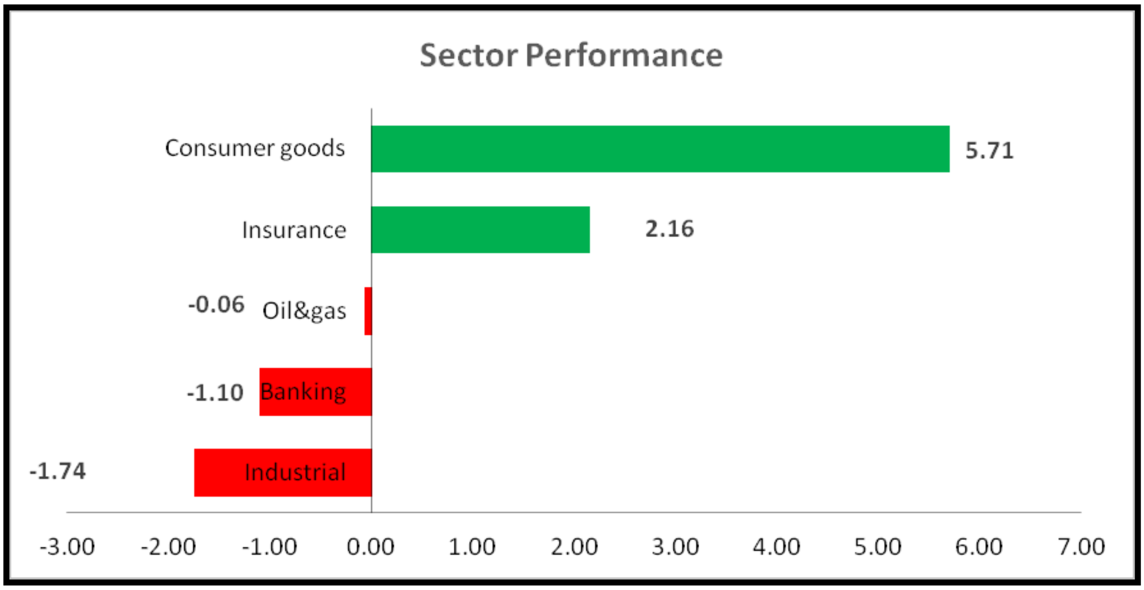
Stock Market Review

The Nigerian Stock Exchange All Shares Index lost 0.45% to close at 26,416.48 points on December 27 relative to its close of 26,536.21 points on December 13. In the same vein, market capitalization fell 0.47% (N60 billion) to N12.75 trillion. In the eight-trading day period, the market gained in three days and lost in five.

The Nigerian Stock Exchange traded at a price to earnings ratio of 6.91x as of December 27, 1.29% lower than the close of December 13 (7.00x). The market breadth was positive at 1.20x as 36 stocks gained, 30 lost while 99 stocks remained unchanged.



On the other hand, the market saw an increase in activity level. The average volume traded rose by 35.05% to 2.62 million units, while the average value of trades rose by 53.52% to N35.77 million.



The sector indices were mixed during the review period. The industrial sector lost the most with 1.74% followed by the banking sector (-1.10%) and then the oil and gas sector (0.06%). Conversely, the consumer goods sector gained 5.71%, while the insurance sector gained 2.16%.

AG Leventis & Co Plc topped the gainers' list with a 30.95% increase in its share price. This was followed by Chams Plc (23.33%), Unilever Nigeria Plc (19.24%), Royal Exchange Plc (12.00%) and NEM Insurance Plc (10.00%).

TOP 5 GAINERS (				
Company	Dec. 16'19	Dec. 27'19	Absolute Change	% Change
AG Leventis & Co PLC	0.42	0.55	0.13	30.95
Chams PLC	0.3	0.37	0.07	23.33
Unilever Nigeria PLC	18.45	22	3.55	19.24
Royal Exchange PLC	0.25	0.28	0.03	12.00
NEM Insurance PLC	2	2.2	0.20	10.00

The laggards were led by Cornerstone Insurance Plc (-36.67%), Dangote Sugar Refinery Plc (-16.62%), BOC Gases Plc (-9.84%), May & Baker Nigeria Plc (-9.81%) and Arbico Plc (-9.77%).

TOP 5 LOSERS (N)				
Company	Dec. 16'19	Dec. 27'19	Absolute Change	% Change
Cornerstone Insurance PLC	0.6	0.38	-0.22	-36.67
Dangote Sugar Refinery PLC	16.55	13.8	-2.75	-16.62
BOC Gases PLC	6.1	5.5	-0.60	-9.84
May & Baker Nigeria PLC	2.14	1.93	-0.21	-9.81
Arbico PLC	3.89	3.51	-0.38	-9.77

Outlook

We expect fund managers to continue to rebalance their portfolios as the year ends. Expectations of weak earnings results are however likely to weigh on market sentiments.

Corporate Focus: Flour Mills of Nigeria

Analyst Note

Analyst Recommendation: HOLD

Market Capitalization: N79.14bn

Recommendation Period: 365 days

Current Price: N19.5

Industry: Consumer Goods

Target Price: N20.45

Flour Mills of Nigeria (Flour Mills or FMN), a leading integrated and diversified food business and agro-allied group, recorded another sub optimal performance in its 2018/19 audited financial statement, year ended March 31, 2019, despite an impressive quarter. It recorded a 2.8% decline in revenue to N527.4bn from N542.67bn due to sales contraction, a slight increase in production costs. In spite of increasingly competitive prices in the animal feeds and edible oil markets, FMN was able to absorb the rising costs of doing business without passing the burden to its consumers.

The company's major revenue sources are from sales of goods and rendering of services. Their different revenue streams by segments are;

* Food: processing, production, and sales of flour, rice, pasta, snacks, sugar and noodles; with products like Golden Penny spaghetti, noodles, wheat, flour, Semovita, etc.

* Agro Allied: primarily farming of maize, cassava, soya, sugar cane and oil palm; also production and sales of fertilizer, edible oils and livestock feeds; with products like vegetable oil, soya oil, margarine, and NPK fertilizers.

* Sugar: harvested sugarcanes are processed, refined into sugar, and sold as granulated or cube sugar. Also includes sale of by-products from sugar refining.

* Support services: manufacturing and marketing of laminated woven polypropylene sacks and flexible packaging materials. Other services include port terminal operations, customs clearing and forwarding, shipping and haulage services, and leasing of investment property.

The sugar business was initially integrated in the food segment, but became a stand-alone segment following the acquisition and restructuring strategy. It is still striving to maximize its potential and is yet to gain a sizeable market share to complement the resources used and aid the undergoing business expansion.

Restructuring yields efficiency

Management has a strategic plan to manage the company's net debt -lowering its debt-to-capitalization ratio from 50.4% to 45.7%- as well as its borrowing cost. FMN has started to benefit from the decision to manage debt and borrowing cost, as this yielded notable efficiency in the last quarter of the period under review. Supporting FMN's plan to lower borrowing cost, the company recently completed its 11th series of its N100bn commercial papers worth N5bn at a discount rate of 8.8% and 9.5% yield. This is expected to float working capital requirements and yield more efficiency in its operations.

Flour Mills has shown its capability to consolidate investment with strong focus on innovative and efficient use of resources, by resizing and simplifying some farm operations that are integral parts of the company's backward integration strategy.

The group CFO attributed recent improvements to the fall-out of the balance sheet restructuring exercise and cost optimization, as it continues to reduce finance cost and deepen performance efficiency yield.

FMN

Food and Agro-Allied Group

Earnings boosted by lowered borrowing cost

Although pressurized consumer disposable income weighed on topline in this review period, FMN was able to strategically maximize the declining interest rate environment to its advantage. The company successfully reduced its finance cost by 30% to N22.89bn in the review period (2018/19 year-end). Furthermore, the recent quarter ended September 2019 (H1 2019/20) highlights a further decline in finance cost by 21% year on year (y-o-y) to N8.63bn.

However, PBT declined by 38% y-o-y in spite of reduced finance cost, due to a 32% increase in operating expenses, lower topline, and slight contraction on investment income. Ultimately, a positive performance was recorded because of the reduced finance cost, which is expected to continue into the future.

The growing Nigerian population and the quasi-necessity nature of its products present a good opportunity for the company to grow its revenue. Recent research has shown that pricing is a key factor for success as smaller brands have been able to increase their market share due to their lower prices. FMN is unlikely to further reduce the prices of its products, as it recently lowered the selling price of its flour and sugar to attain competitive edge in the market.

Based on the mixed signals in its performance, we recommend a **HOLD** on FMN stocks.

The Flour Milling Industry

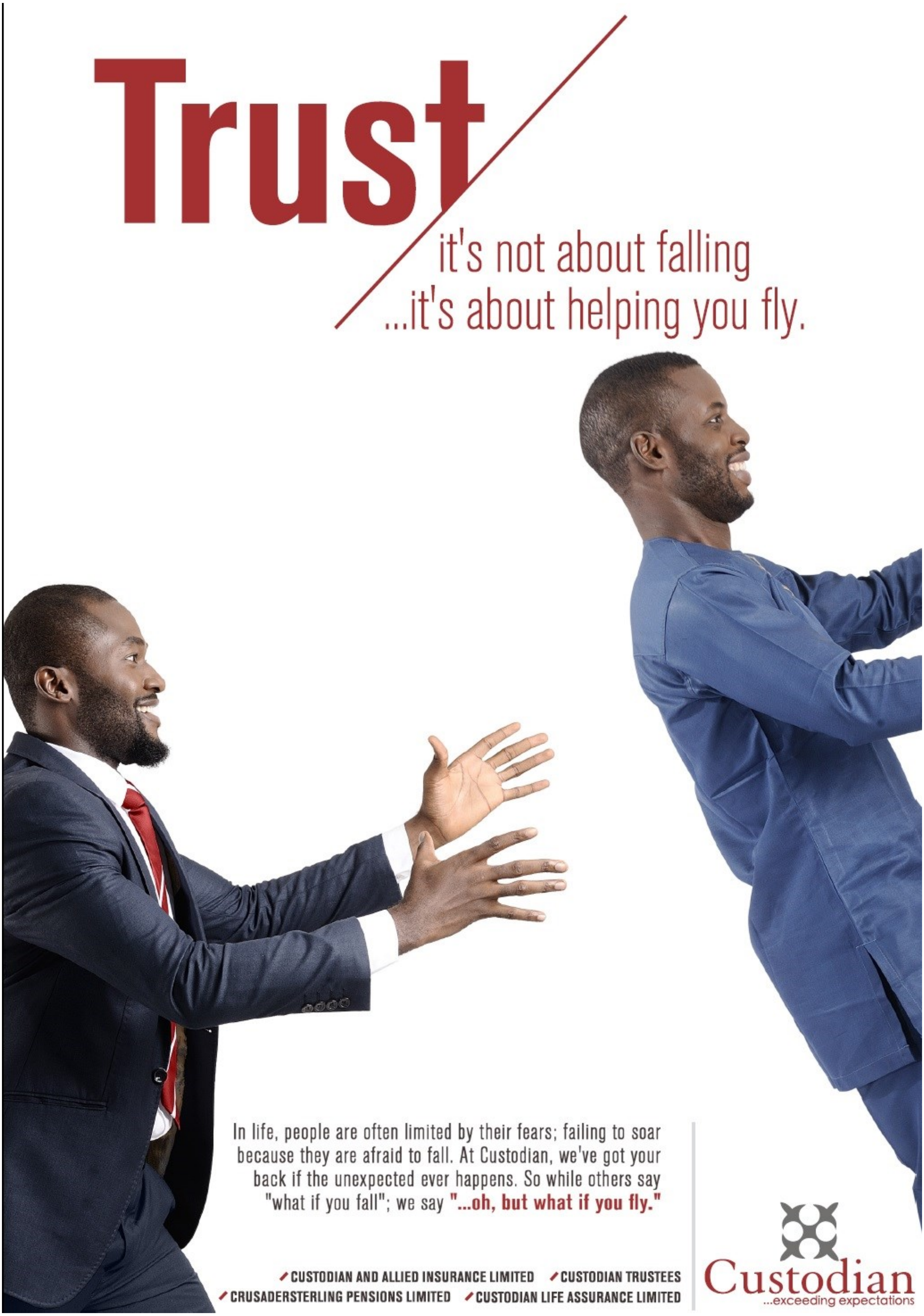
Nigeria, a country with 200 million people and a population growth rate of about 2.6% (according to the World Population Review), is the largest importer of wheat – the primary raw material of milling companies – in sub-Saharan Africa. This is expected to be the case going forward, with imports expected to increase by 200,000 MMT (about 4%) in marketing year ('MY') 2019/20 to 5.6 million metric tons compared to MY 2018/19 numbers based on food, seed, and industrial (FSI) usage. This growth in FSI wheat consumption is a consequence of increasing urbanization, population growth, and change in taste as consumption of wheat-based products in the country has increased.

The Nigerian government, however, is looking to 'incentivize' industry players to source their raw materials locally by requiring millers to purchase local wheat at a fixed price of $400 per metric ton, compared to the global market price of $500/MT. Having said that, this incentive isn't working because wheat farmers would rather sell to not-for-profit organizations or export at premium rates than sell to industry players. Moreover, unfavorable characteristics of locally-sourced wheat – higher protein content, lower moisture, and lower gluten – compared to its shipped-in equivalent, is another reason the industry is still largely import-oriented.

The flour milling industry is oligopolistic in nature with high barriers to entry and high concentration. The industry is dominated by very few players. The three largest players account for approximately 75% of the total revenue, with Flour Mills of Nigeria accounting for about 32% of the total market share. Key players within the industry operate at an average capacity utilization of about 50% or less but FMN is estimated to operate at about 70%, which has enabled the company to maintain its market dominance across the different regions in the country.

Operating profits within the industry seem to be contracting year-on-year, with major players like FMN – from N48.42bn in FY 2017/18 to N32.3bn in FY 2018/19 – and Honeywell Flour Mills – from N9.48bn in FY 2017/18 to N3.92bn in FY 2018/19 – realizing 33.3% and 58.68% reductions in their profit margins respectively. This is most likely a consequence of traffic bottlenecks at the Apapa port, making the distribution of finished products to consumer locations

[14]United States Department of Agriculture | Foreign Agricultural Service
[15]KPMG



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...exceeding expectations

more difficult. Interestingly, Olam's purchase of Dangote Flour Mills on November 1, 2019 at a premium of 124% suggests that investors are still willing to take bets on the industry despite current challenges.

FMN was incorporated in September 1960 as a private limited liability company. In 1978, FMN became a public limited liability company and its shares were subsequently listed on the NSE. The company's interest in becoming the nation's leading food business company is furthered by entities operating in agriculture, livestock feed and pasta manufacturing.

Income Statement for Flour Mills of Nigeria Plc FY March

N'000	2015	2016	2017	2018	2019
Revenue	308,756,526	342,586,459	524,464,448	542,670,409	527,404,567
Cost of Sales	(273,389,567)	(304,961,737)	(457,775,380)	(473,895,352)	(474,057,010)
Gross Profit	**35,366,959**	**37,624,722**	**66,689,068**	**68,775,057**	**53,347,557**
Other Gains and Losses (Other Income)	(685,050)	(7,720,517)	(1,488,216)	5,943,332	6,211,205
Selling and Distribution Expenses	(4,184,382)	(5,003,801)	(5,341,148)	(6,180,092)	(8,165,792)
Administration Expenses	(20,281,760)	(15,848,261)	(18,419,807)	(20,115,372)	(19,096,111)
Operating Profit	**10,215,767**	**9,052,143**	**41,439,897**	**48,422,925**	**32,296,859**
Investment Income	2,303,588	1,103,475	1,562,304	816,319	768,592
Finance Costs	(18,703,526)	(22,397,762)	(32,529,354)	(32,697,477)	(22,891,176)
Share of Loss in Associate Company	(381,012)	-	-	-	
Gain on Disposal of Investment in Associate	14,289,953	23,731,422	-	-	
Profit Before Tax	**7,724,770**	**11,489,278**	**10,472,847**	**16,541,767**	**10,174,275**
Income Tax Credit/(Expense)	738,292	2,931,006	(1,636,395)	(2,925,993)	(6,174,129)
Profit After Tax	**8,463,062**	**14,420,284**	**8,836,452**	**13,615,774**	**4,000,146**

Balance Sheet for Flour Mills of Nigeria Plc FY March						
N'000	**2015**	**2016**	**2017**	**2018**	**2019**	**H1'2020**
Property, plant and equipment	208,940,475	211,588,076	216,866,184	217,901,400	221,465,325	220,209,637
Intangible assets	496,248	735,330	208,370	1,095,317	1,316,670	1,123,191
Goodwill	4,148,022	4,148,022	4,148,022	4,148,022	4,148,022	4,148,022
Investment properties	-	2,023,379	1,929,196	1,841,977	1,737,559	1,685,350
Investment in subsidiaries	-	-	-	-	-	-
Investment in associates	-	-	-	-	-	-
Other financial assets/investments	114,716	45,696	24,140	62,900	41,140	34,680
Deferred charges/Deferred tax assets	411,431	66,022	1,846,674	6,459,761	3,963,819	4,100,079
Long-term loans receivable	3,904,188	-	989,022	944,472	1,402,210	663,737
Biological assets	58,509	352,020	29,131	37,710	111,784	861,225
Deposit for shares	-	-		-	-	-
Other long term assets	1,583,075	1,703,939	1,679,252	-	-	
Prepayments				1,610,730	2,365,692	1,533,722
Non-current assets	**219,656,664**	**220,662,484**	**227,719,991**	**234,102,289**	**236,552,221**	**234,359,643**
Inventories	68,426,003	58,698,768	117,296,162	111,373,409	118,867,186	92,788,161
Biological assets	399,081	182,613	558,480	179,653	18,498	17,807
Trade and other receivables	15,373,448	18,966,168	21,403,132	19,083,085	26,085,312	27,988,104
Prepayments	3,060,090	13,625,250	69,851,473	21,364,109	17,894,815	12,509,478
Non-current assets held for sale/Dervatives	3,514,035	-	755,516	-	198,026	198,026
Due from related companies	1,699,790	-	-	-		-
Cash and bank balances	31,131,719	33,213,043	45,018,503	22,245,372	17,205,546	20,681,327
Current assets	**123,604,166**	**124,685,842**	**254,883,266**	**174,245,628**	**180,269,383**	**154,182,903**
Total Assets	**343,260,830**	**345,348,326**	**482,603,257**	**408,347,917**	**416,821,604**	**388,542,546**
					2%	
Share capital	1,312,126	1,312,126	1,312,126	2,050,197	2,050,197	2,050,197
Share premium	36,812,540	36,812,540	36,812,540	75,377,444	75,377,444	75,377,444
Fixed assets revaluation exercise	-	(89,760)	(111,316)	(72,556)	(94,316)	(100,776)
Capital reserve	281,201	-	-	-		
Retained earnings	45,946,617	54,900,934	60,450,685	67,903,735	66,377,553	67,730,756
Equity attributable to owners of the compai	**84,352,484**	**92,935,840**	**98,464,035**	**145,258,820**	**143,710,878**	**145,057,621**
Non-controlling interest	3,057,910	2,829,934	4,080,309	5,357,888	7,261,317	6,890,965
Total Equity	**87,410,394**	**95,765,774**	**102,544,344**	**150,616,708**	**150,972,195**	**151,948,586**
Borrowings	55,260,645	48,009,715	50,879,043	29,376,221	46,231,074	59,952,261
Unsecured fixed rate bond	-	-	-	-		
Deferred revenue	7,182,184	7,093,966	8,618,213	9,117,232	16,370,523	15,919,465
Deferred tax liabilities	9,607,954	5,768,040	7,819,480	12,307,605	10,587,507	10,556,127
Retirement benefit obligation	3,245,308	4,077,811	3,676,418	5,193,788	5,848,372	6,411,485
Long service award	1,340,140	1,593,819	1,568,859	1,948,287	2,183,131	2,384,443
Non-current liabilites	**76,636,231**	**66,543,351**	**72,562,013**	**57,943,133**	**81,220,607**	**95,223,781**
Borrowings	113,940,442	100,830,460	141,702,267	103,922,863	71,053,087	62,566,383
Unsecured fixed rate bond	19,248,115	-	-	-		-
Deferred revenue	1,472,527	1,076,024	2,089,158	2,578,896	2,818,229	3,378,678
Trade and other payables	42,560,787	50,416,914	94,567,170	56,993,533	79,040,345	56,943,969
Due to related companies	22,290	-	-	-		-
Provisions	47,126	-	-	-		
Current tax liabilities	1,802,610	1,336,015	2,136,490	3,151,317	4,104,046	5,701,193
Customer Deposits	-	11,029,933	12,453,166	11,201,608	15,395,174	10,223,680
Dividend payable	120,307	1,936,869	2,032,098	2,005,814	2,566,783	2,545,415
Bank Overdraft		16,412,986	49,023,812	19,934,045	9,651,138	10,861
Derivative Liabiities	-	-	3,492,739	-	-	-
Current liabilites	**179,214,205**	**183,039,201**	**307,496,900**	**199,788,076**	**184,628,802**	**141,370,179**
Total liabilites	**255,850,436**	**249,582,552**	**380,058,913**	**257,731,209**	**265,849,409**	**236,593,960**
Total equity and liabilites	**343,260,830**	**345,348,326**	**482,603,257**	**408,347,917**	**416,821,604**	**388,542,546**

Management and Governance Overview

We find most of the qualities of the board to be in line with best practices. The board is made up of 14 members who have the necessary skills and vast experience across regions that make them more than capable to make sound decisions for the company. The role of the board is separated from the management's, as it is responsible for recognizing the risks the company faces and distinguishing these risks into different categories based on the magnitude and likelihood of such risks occurring.

John G. Coumantaros is the Chairman of the Board of Directors for Flour Mills of Nigeria Plc, a position he has held since 10th September, 2014. He is an experienced and successful entrepreneur who sits on the Board of several international companies, including ELBISCO, a fast-moving consumer food business in Athens, Greece. Mr. Coumantaros has over 30 years experience in international trade, logistics, manufacturing, and industry, and is passionately dedicated to continuing the evolution of FMN with its Golden Penny Food Brand as one of the leading fast-moving consumer food companies and largest agro-allied business in Nigeria and Africa.

Paul Gbededo, a Fellow of the Polymer Institute of Nigeria and Managing Director of FMN's Agro-Allied Business, has been the Group Managing Director/Chief Executive Officer of FMN since 1st April, 2013. He studied at the Polytechnic of North London UK where he became a graduate of the Plastic and Rubber Institute and Associateship of National College of Rubber Technology in 1980. He also holds an MSc. Degree in Polymer Technology (1981) of Loughborough University of Technology, UK. Paul's over 30 years' career with FMN Group started at Nigerian Bag Manufacturing Company Plc (1982 – 1998). He has also served as a pioneer General Manager/Director for Golden Pasta Company Limited, a former subsidiary (now a division) of Flour Mills – which has grown to become Africa's biggest pasta plant.

Bulls and Bears say

Bulls say:

* Large market size in Nigeria and market leadership

* Good regional presence in Nigeria

* Well experienced management

* Change in consumer tastes toward wheat-based products

Bears say:

* Weak consumer spending and decreasing disposable income

* Sustained gridlock along the Apapa wharf road

* Increasing competition from smaller brands

Risk and Outlook

The key risks that could prevent Flour Mills Nigeria from achieving its strategic goals and meeting shareholder expectations include Financial and non-financial risks.

Major risks include Foreign exchange, Credit, Liquidity (ability to meet short term obligations), Commodity price volatility in terms of price movement and unavailability of raw-material, importation ban on key raw materials, and interest rate risks among others.

Other risks include cyber security, reputational, loss of market share to competitors, regulatory compliance risks.

Although FMN has invested extensively in its backward integration of Agro-Allied product, the company is still relatively exposed to fluctuations in US dollars (USD) on purchases of raw materials and exporting of products to neighboring countries. This shows the importance of a stable foreign exchange market. However, a recent likelihood of volatile exchange rate will adversely affect importers of raw materials. In addition, management mitigates the currency risk partly by buying raw materials three months in advance.

Although the interest rate environment has been relatively friendly, the company is slightly exposed to interest rate risk and as a result, has put various strategies in place to mitigate these risks. It maintains a centralized treasury department, carrying out group borrowing to obtain lower interest rates.

Flour Mills addresses credit risk by setting credit limits and dealing primarily with credit worthy counterparts. The company transacts with corporate entities that are rated the equivalent of an investment grade or above. The company manages its liquidity risks by maintaining adequate reserves, banking facilities and reserve borrowing facilities.

Despite the severity of the risks facing FMN, the solid risk management in place alongside its backward integration with agricultural projects, growth and its productive use of debt to fund expansion, shows that the company has a viable investment plan. As such, it is a company with prospects to enhance shareholder value.

Valuation Summary

FMN valuation was derived from using Discounted Cash Flow (DCF) methodology. We estimated a stock price of N20.45, which is a 4.9% upside on the current stock price of N19.5 as at December 24, 2019. With a discount rate (Weighted Average Cost of Capital (WACC)) of 15.7% derived using a 14.55% risk free rate (FGN 10-year Bond as at December 2019), a Beta of 0.88, after-tax cost of debt of 10.5%, and a market risk premium of 6.3%. The long-term cash flow growth rate to perpetuity (4%) was derived by multiplying the return on equity of 8% by the retention rate of 45%.

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

DCF Valuation				
N'000	2020	2021	2022	2023
EBIT	36,227,421	38,410,153	39,338,122	42,258,882
Less: Taxes	(10,868,226)	(11,523,046)	(11,801,437)	(12,677,665)
EBIAT	25,359,195	26,887,107	27,536,685	29,581,217
Plus: Depreciation & Amortization Expense	18,496,886	19,562,109	20,236,863	20,905,686
Less: CAPEX	(26,872,373)	(27,486,200)	(28,099,620)	(28,733,008)
Change in working capital	2,004,674	(685,812)	(2,815,088)	950,066
Free Cash Flow (FCF)	18,988,382	18,277,204	16,858,840	22,703,962
WACC	15.7%	15.7%	15.7%	15.7%
Present Value (PV) of FCF	16,407,339	13,646,150	10,876,227	12,656,174
Terminal value @ perpetual growth rate (2020)	**2020**	**2021**	**2022**	**2023**
Terminal value as of 2020				201,279,232
Present value of terminal value	112,201,780			
DCF Calculation	**Valuation**			
PV of explicit period	53,585,890			
PV of terminal value	112,201,780			
Enterprise Value	165,787,670			
+ Cash	45,018,503			
- Borrowings	(126,935,299)			
Equity Value	83,870,874			
Share price	***20.45***			
Shares outstanding ('000)	4,100,396			