Renaissance Capital Africa

Thoughts from Renaissance Capital Africa

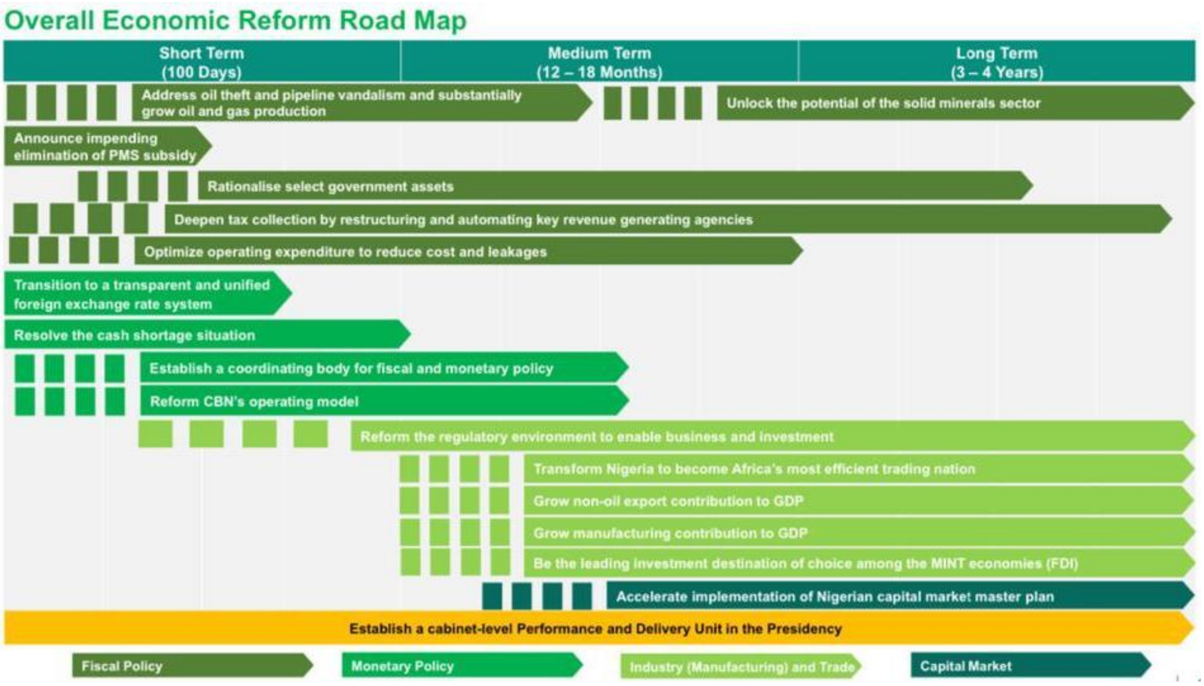
A New Nigeria Re-emerges

The swearing-in of President Bola Ahmed Tinubu has seen a seismic shift in economic policy when compared to his predecessor. Over the past two weeks, we have seen a move to a more market-based system as evidenced by policies on FX and subsidies. These policies have been positive for the Federal Government of Nigeria's fiscal position with fewer short term positive effects, and possible adverse effects in some cases, on household and individual balance sheets. The impact of the subsidy removal on inflation remains to be pronounced (although already felt by the population) and we are watching for the June inflation announcement. We are also cognizant that rates remain below inflation across all domestic sovereign instruments and are keen to see how this plays out in the coming months. The President has clearly stated a desire for lower interest rates to fuel economic growth and how this relates with renewed inflationary pressures from the subsidy removal and new money supply (from higher civil service salaries, the printing of Naira to settle to CBN OTC Futures, a national census and a possible change in the CRR regime) will also be key to a sustainable macroeconomic framework.

We recall that the policies being implemented are in line with 'Solution 1' of the 4 hypothetical solutions we proffered in our earlier note titled "Nigeria: Debt problem is mainly domestic", though we note that IFIs appear to think CPI will remain below 30% on average in 2023. We highlight this below.

"Inflate away domestic debt. Push inflation up to 60-100%, devalue the naira by 50% to our REER estimate of NGN670-680/$ or more, and end the fuel subsidy. If nominal expenditure rose 0% in 2024, and oil revenues rose 50%, Nigeria could run a primary surplus in 2024. Over half of Nigeria's domestic debt with interest rates of 10-20% would mature with principal payments becoming very cheap to pay off relative to the amount that was raised originally, and under half would need to be rolled over at high interest rates (to reflect the high inflation). Yes, the external debt ratio would then look worse – and repayment of external principal would be more expensive in NGN terms, but that's relatively hedged by Nigeria's oil revenues."

The overall economic reform road map as released by the National Economy Sub-Committee shows a refreshed set of plans with the short term monetary related items mostly addressed. We expect announcements around security to be made in coming weeks which will aim to address oil production. The 2023 Finance Act signed in May 2023 also comes into effect and further tax reform measures are expected to deepen the tax net.



Source: Policy Advisory Council Report – May 2023, Renaissance Capital Africa

The Three Big Moves – The Government means Business

There have been three big moves by the current administration to revitalize Nigeria's economy. We highlight these below, in order of occurrence, and see a concerted effort to change both the macroeconomic story and the narrators of this tale.

Subsidy removal

- The President during his inauguration speech on 29 May 2023 declared a stop to the country's fuel subsidies. The subsidies, a mix of actual subsidies and other variables, cost US$10billion in 2022 acting as a fiscal drag whilst forcing the government to borrow to support it. The policy change led to a rise in the quoted PMS price from NGN185 per liter to a range of NGN488 to NGN551 per liter (transportation costs differ by state thus the different prices). The expected implication of this change is positive for all arms of the government as deductions were made from federally allocated revenues which may now be allocated towards these arms. It is however expected that the move is inflationary for households and will see an increase in the cost of living and depleted purchasing power. We wait to see if the following Naira devaluation (as addressed below) leads to a further increase in the pump price to reflect this change.

Removal of CBN governor

- The President suspended the Central Bank of Nigeria (CBN) governor, Godwin Emefiele, whilst undertaking an investigation related to national security. The former CBN Governor is seen as a major architect of the cashless policy in 2023, a move that might have been seen as partly political, as well as the unorthodox FX and interventionist policies of the previous administration. The move to change this former narrator, whilst not totally unexpected, has seen a renewed focus on Nigeria by domestic and international market participants with the earlier actively expressing their views via the Nigerian stock market – which reached a 15-year high on June 14, 2023.

Naira rate setting mechanism

- The CBN returned the rate setting mechanism in the Investors and Exporters (I&E) window to one of willing buyer / willing seller – as initially laid out in 2017 - whilst discontinuing existing rebate schemes. This action has led to the official devaluation of the Naira from NGN470/$ to around NGN702/$ (using I&E rate of 15 Jun 2023) albeit on very low volumes. This policy decision focuses on clearing up the country's FX backlog, providing pricing clarity and attracting foreign investments into the country. Volumes remain very low and we expect that these will improve as the CBN, the single largest FX provider in Nigeria, will remain a primary liquidity provider in this market. This inevitably links Nigeria's FX to oil production and price which in turn is linked to the country's security infrastructure. A freer market remains a net positive for the economy, and one could easily argue that goods and services had already been priced at parallel market rates (NGN750 – 760/$ range in June) for most imported items. A removal of restrictions on domiciliary accounts also supports the formalization of FX flows jn Nigeria and might improve onshore USD balances if sustained.

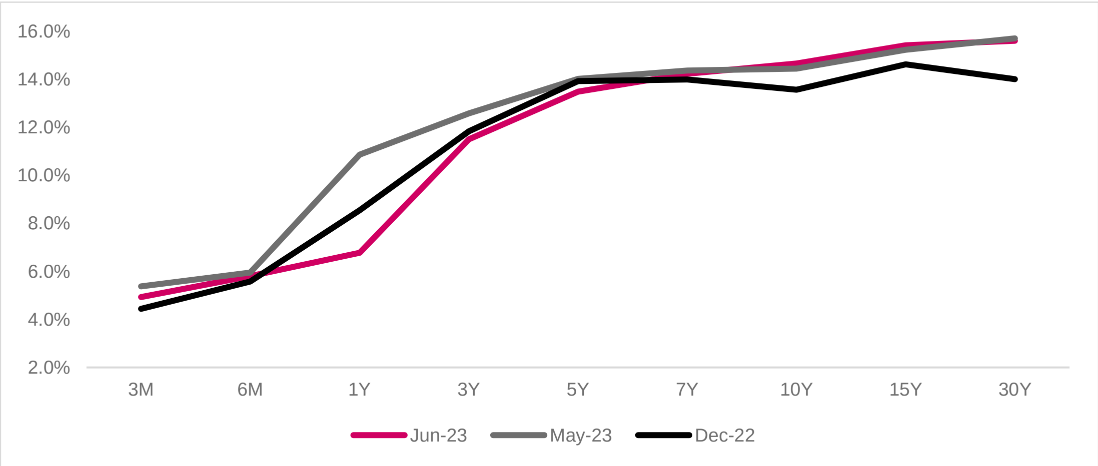
Fixed Income Markets – Pleased but what about domestic inflation?

The fixed income market has seen significant investor interest on the back of the recent policy developments spearheaded by the new administration. Nigeria sovereign and bank Eurobond yields have compressed by 62bps (on average) Week-to-Date and 100bps (on average) since the inauguration of President Tinubu – driven by renewed optimism on the sovereign's fiscal stance.

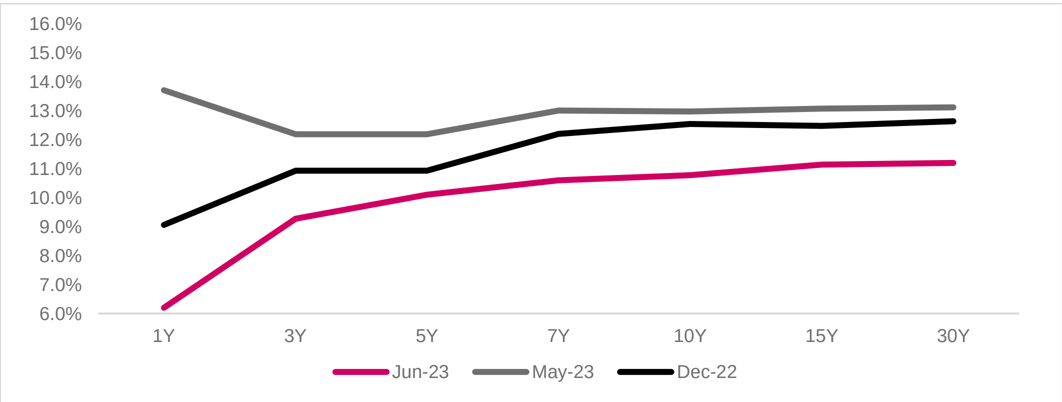
Domestic yields have compressed by 20bps (on average) since the inauguration. These continue to deliver negative real returns and as inflation continues to climb, we expect this fact to remain unchanged. We note that the new administration will likely implement a supplementary budget, and this will be a major factor, amongst others, in determining short-term rate expectations.

The recent moves, however, provide a message of return to normalcy backed by strong political will and these have firmly been acknowledged by the market.

LCY Yield evolution



FCY Yield evolution



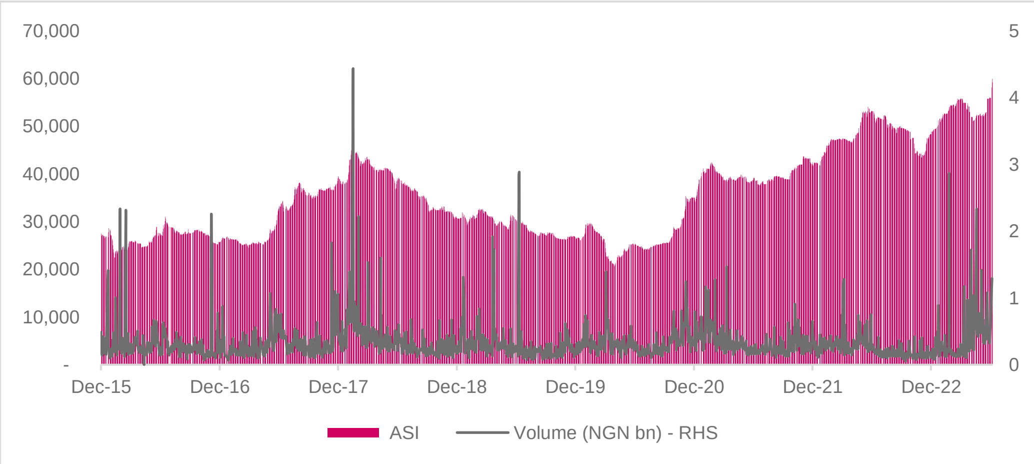
Source: Bloomberg, Renaissance Capital Africa

Notes: May-23 refers to last trading day before inauguration

Equity Markets – picking up steam

The domestic equity market has rallied to a 15-year high following the recent policy decisions. The excitement is premised on optimism that these policies, if sustained, alongside other difficult political decisions would give Nigeria a much-needed revamp. Also, equities provide some protection against inflation arising from the policy changes. Additionally, the recent devaluation exercise opens an avenue for foreign investors to take investment positions in Nigeria. Feedback from our equity trading desk suggests foreign investors are only channeling small portions of their cash from the repatriation. We believe a fresh influx of cash is yet to come in as foreign investors assess the FX policy developments in Nigeria. Fixed income investments generally lead the foreign investment inflows. The attractiveness of carry trade opportunities, avenues for real return investments and the extent of the devaluation are key considerations would dictate the pace of flows into Nigeria. With that said, the repatriation queue remains top of mind for FPIs as the net demand for dollars lingers. While they find Nigeria attractive, they are taking a wait and see approach to assess the recent developments with renewed optimism towards Nigeria.

NGX ASI Performance



Source: Bloomberg, Renaissance Capital Africa

Macro – The FX impact on short term "everything". Is this stable ground for medium term growth?

GDP

A mechanical analysis of the impact of FX on Nigeria's GDP naturally translates to a lower current GDP level in USD terms. On that same note, GDP per capita now reflects the move from US$2,088 to US$1,326 in clearer terms – an impact that has since been and part of underlying cause of the 'japa' wave. GDP will likely remain under pressure in the short term and the expected economic growth from new monetary policies and expected fiscal policies, if sustained, allow for a recovery and growth in the medium term. With the NGN officially moving from roughly 50% overvalued to the naira's long-term average (NGN690/$ since 1997, as of May 2023), Nigerian domestic producers may now recommence using more formal finance networks thus reducing costs and friction of trade.

Public debt to GDP

Federal Government public debt is estimated to rise by c.N12trillion to c.N80trillion (including ways and means). As a result, debt to GDP will increase by 5% to 40% using FY22 numbers. This has implications for the country's credit risk as Nigeria reaches Fitch's 2024 forecast for debt/GDP. A concerted effort to reign in public debt, by improving/diversifying revenue streams and reducing costs, whilst improving GDP is key. Overall, we see the policy changes as helpful for Nigeria's ratings and believe the cuts in Nigeria's ratings over recent years may now be over.

Debt service to revenue

We expect a rise in debt service cost with respect to the FCY component of public debt on a naira basis. This should be partially offset by Nigeria's oil revenues. Government revenue is expected to trend upwards in naira terms resulting in higher tax/revenue to GDP. The removal of the fuel subsidy is a welcome development as this frees up more cash for other productive uses. Government policy and action on allocation will determine the trajectory.

Inflation / consumer wallet

The fuel subsidy removal constitutes the largest contributor to inflation expectations. Following the decision and abrupt decisions to reflect this across prices of goods, we expect inflation to accelerate further. Generally, prices of goods and services have inched higher to reflect the N750/USD rate quoted at the parallel market. However, goods imported via the CBN's 'valid for export' list are likely to be partly impacted. Furthermore, businesses are likely to pass-through costs in the near terms given the rise in cost of doing business. Altogether, this is negative for the consumer wallet which has already been largely subdued for years.

Balance of payments

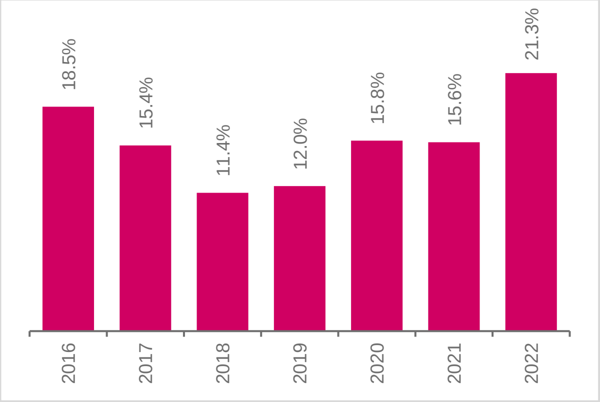
The devaluation exercise and the decision to float the naira should support the country's current account position. While the depreciation could incentivize foreign investors to look at Nigeria for investment opportunities, more clarity on the clearing of the FX backlog (estimated at US$12bn by Goldman Sachs), current FX restrictions and the political will to sustain a floating Naira would dictate the trajectory of foreign investments.

Eurobond performance

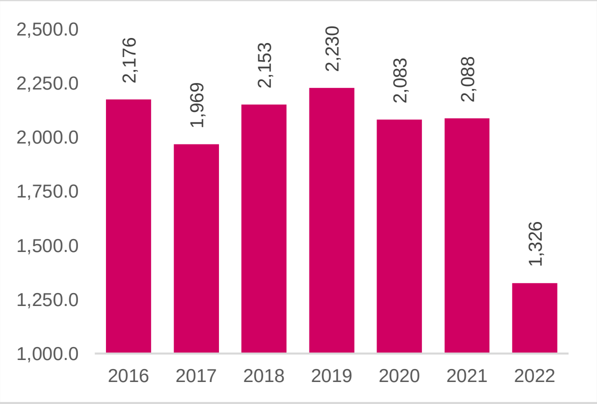
Our expectation is for Nigerian Eurobond yields to stabilize after a strong rally in recent weeks.. The removal of fuel subsidy and unification of interest rates has been viewed as credit positive events for bond investors and rating agencies alike. Also, US rates are expected to plateau after 1-2 more hikes in coming months.

GDP Growth Trajectory

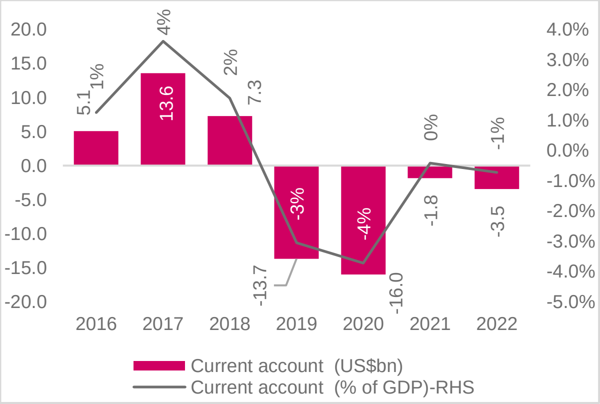
Inflation Rate Trajectory



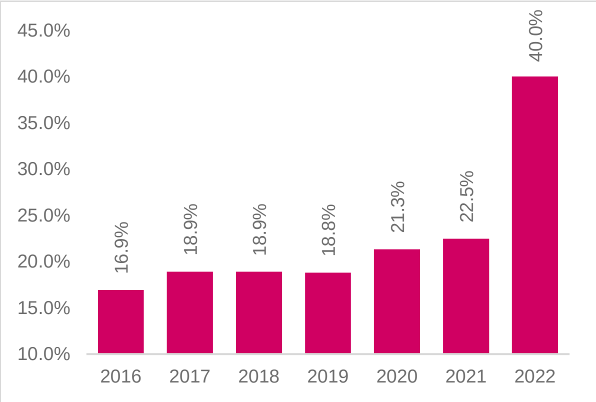
GDP per Capita (US$)



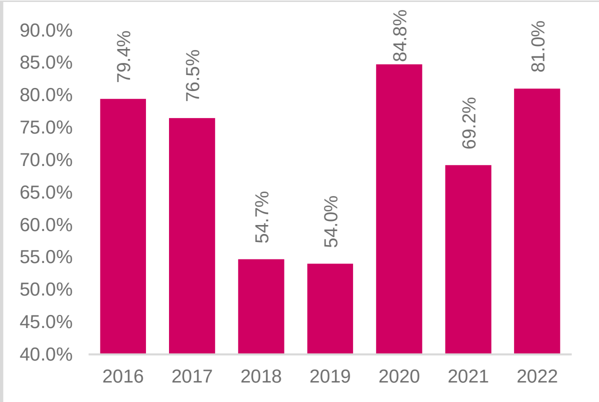
Balance of Payments



Public Debt to GDP



Debt Service to Revenue



Source: Bloomberg, IMF, Budget Office, Renaissance Capital Africa

Note 1: Total public debt applies the adjusted FX rate of N702/NGN on 2022 to estimate debt/GDP.

Note 2: GDP per capital applies the adjusted FX rate of N702/NGN in 2022 to estimate the impact of the devaluation.

Key variables to watch

Nigeria's oil production and security

Oil production has been on a downward trend falling as low as 1.1 mbpd in 4Q22 owing to security challenges, underinvestment and a trend of IOCs exiting the country. This has since improved to 1.4 mbpd in May 2023, a signal of improvement which if sustained bodes well. The new administration has highlighted in its economic plan a focus on curbing vandalism, incentivizing stability in oil producing states and reinstate the oil producing sector as a viable investment opportunity. The CBN remains the biggest seller of FX and the new currency regime would benefit greatly from revitalized oil production and high crude prices.

FPI – Waiting to Exhale

Foreign portfolio investment has been decelerating in recent years owing to stringent capital controls, a large FX backlog that was unattended to and a weakened GDP outlook. Foreign investors are generally waiting to receive clarity on plans to clear the FX backlog, the sustainability of the flexible currency regime, and updates on the existing FX/capital controls put in place. The removal of the CBN governor paves the way for a new and market-friendly monetary leadership, which could incite investor interest towards Nigeria. We note increased engagement with foreign investors here who are waiting to see but have started to look more intently as the situation evolves.

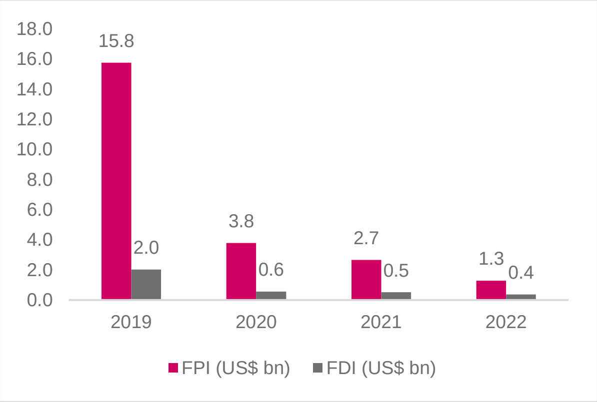
FMDQ OTC Futures

The CBN's outstanding FX OTC futures as of April 2023 stood at US$5.2 billion. The devaluation of the naira to N702/USD levels suggests a differential of c. NGN230 (estimated) which investors will need to be made whole by. On a gross basis settlement would cost an additional c. N1trillion on outstanding contracts indicating further inflationary pressure on the economy. The futures, a hedge for investors over the past few years, are now being repriced.

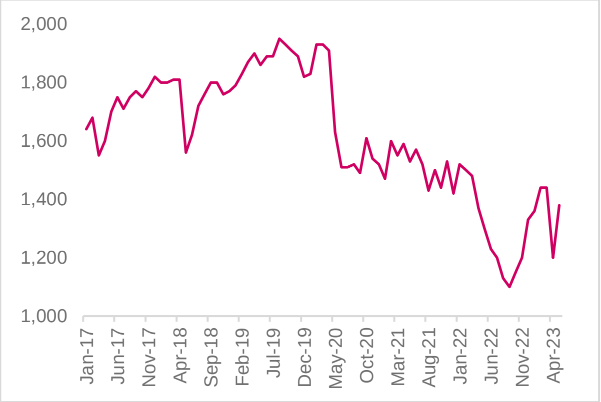
Cash Reserve Requirements

Following the removal of the CBN governor, we could see an end to the unorthodox policies rolled out in recent years, including some of the excess CRR debits. Additionally, with the fuel subsidy removal, the budget deficit could narrow, leading to lower central bank financing vs previous years. With the possibility of excess CRR debits on the table, this could be net positive for Nigerian banks, who can channel their reclaimed liquidity towards growth-enhancing projects. That said, the reversal is partly inflationary and its impact on the CBN balance sheet might be a stumbling factor.

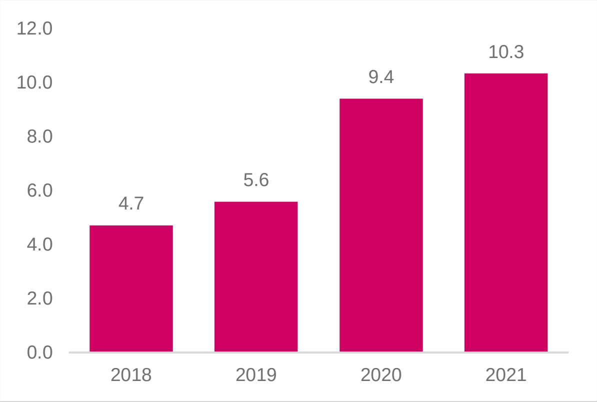
Foreign Inflows (US$ bn)



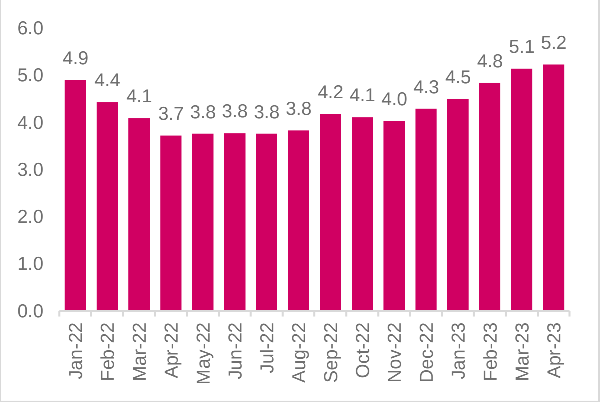
Nigeria Oil Production (000 bpd)



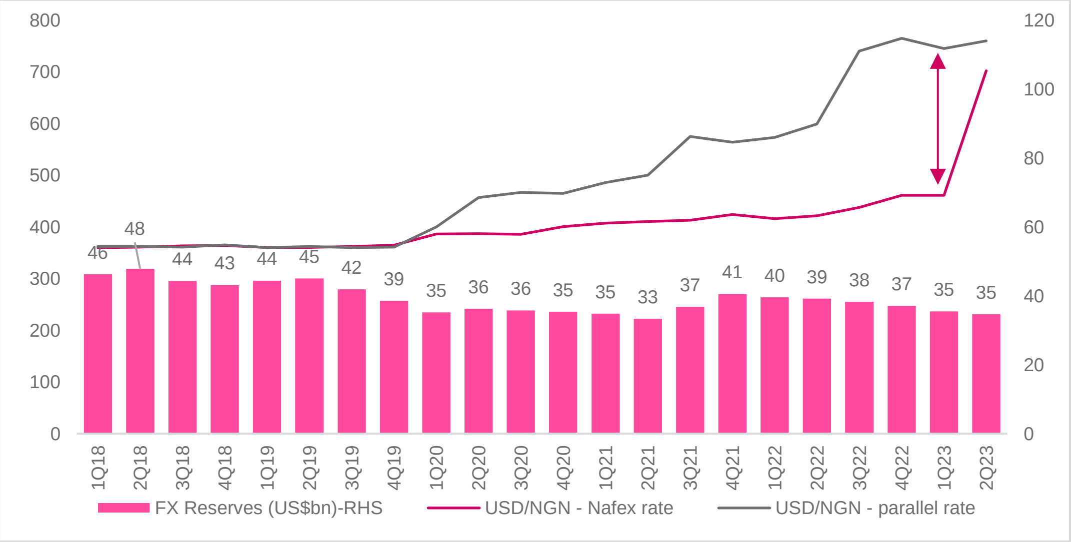
Cash Reserve Requirements (NGN trillion)



OTC FX Futures (US$ bn)



The Great Convergence



Impact on domestic banks

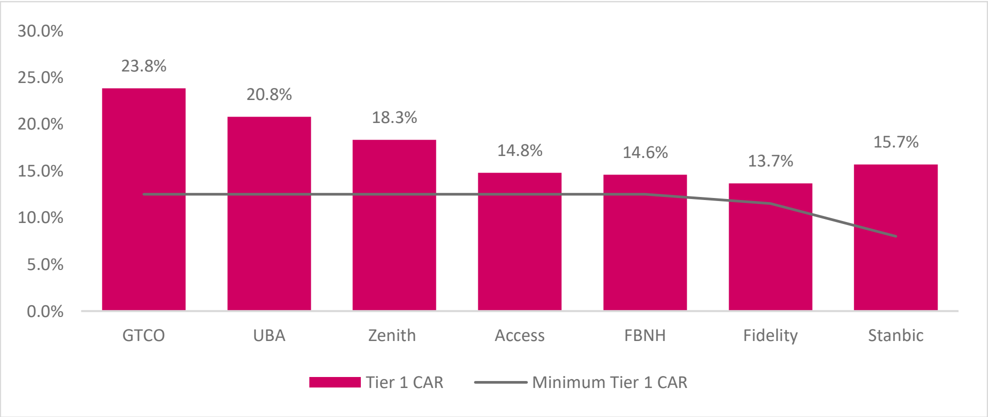
Net long USD players

Banks with net long dollar positions would greatly benefit from the recent devaluation exercise, on track to print healthy revaluation gains. We will highlight these in a further report.

Capital Adequacy

Nigerian banks' capitalization has been largely resilient, particularly with the commencement of the transition to Basel III on the horizon. However, the weaker naira implies weakening capital ratios as it inflates FCY risk weighted assets. For banks with strong net dollar positions this can be partially offset by revaluation gains which should support capital growth. This is also true for banks with profitable and robust foreign subsidiaries. Notwithstanding, this could create difficulties for some banks, with Basel III adoption in focus. To shore up capital, banks may resort to AT1 raises, asset sales, rights issues and disposals of foreign subsidiaries.

Basel III Minimum Regulatory Requirements



Eurobond

The devaluation of the naira should lead to improved dollar liquidity which should support meeting foreign currency debt obligations, albeit at higher naira refinancing costs.

Impact on FinTechs

Valuations and financial metrics

Valuations are expected to shrink for Nigerian FinTechs, further compounding the reductions witnessed following the global tech deflation that began in 2022. These have shrunk by c.50% following the recent FX devaluation – most FinTechs showed their number at official rates. Financial metrics important for assessing the value of these businesses such as revenue and EBITDA are predominantly denominated in naira and this portends less attractive valuations.

We also note many FinTech entities were arbitrage plays on the FX and here margins will compress and competition from traditional banks increase. Size will matter - FinTechs that thrive off offering low-cost products and services and have limited financial capacity will need to pivot across verticals, merge and/or pray.

The current government policies are however supportive of medium-term value creation.

Disclaimer

This Communication is for information purposes only. The Communication does not form a fiduciary relationship or constitute advice and is not and should not be construed as a recommendation or an offer or a solicitation of an offer of securities or related financial instruments, or an invitation or inducement to engage in investment activity, and cannot be relied upon as a representation that any particular transaction necessarily could have been or can be effected at the stated price. The Communication is not an advertisement of securities nor independent investment research, and has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Opinions expressed therein may differ or be contrary to opinions expressed by other business areas or groups of Renaissance Capital Africa as a result of using different assumptions and criteria. All such information is subject to change without notice, and neither Renaissance Capital Africa nor any of its subsidiaries or affiliates is under any obligation to update or keep current the information contained in the Communication or in any other medium.

Descriptions of any company or issuer or their securities or the markets or developments mentioned in the Communication are not intended to be complete. The Communication should not be regarded by recipients as a substitute for the exercise of their own judgment as the Communication has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The material (whether or not it states any opinions) is for general information purposes only and does not take into account your personal circumstances or objectives and nothing in this material is or should be considered to be financial, investment or other advice on which reliance should be placed. Any reliance you place on such information is therefore strictly at your own risk. The application of taxation laws depends on an investor's individual circumstances and, accordingly, each investor should seek independent professional advice on taxation implications before making any investment decision. The Communication has been compiled or arrived at based on information obtained from sources believed to be reliable and in good faith. Such information has not been independently verified, is provided on an 'as is' basis and no representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness, reliability, merchantability or fitness for a particular purpose of such information, except with respect to information concerning Renaissance Capital Africa, its subsidiaries and affiliates. All statements of opinion and all projections, forecasts, or statements relating to expectations regarding future events or the possible future performance of investments represent Renaissance Capital Africa's own assessment and interpretation of information available to them currently. Any information relating to past performance of an investment does not necessarily guarantee future performance.

The Communication is not intended for distribution to the public and may be confidential. It may not be reproduced, redistributed or published, in whole or in part, for any purpose without the written permission of Renaissance Capital Africa, and neither Renaissance Capital Africa nor any of its affiliates accepts any liability whatsoever for the actions of third parties in this respect. The information may not be used to create any financial instruments or products or any indices. Neither Renaissance Capital Africa and its affiliates, nor their directors, representatives, or employees accept any liability for any direct or consequential loss or damage arising out of the use of all or any part of the Communication.