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NIGERIA

MACROECONOMIC AND BANKING SECTOR THEMES FOR 2018

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This article presents our forecasts and opinions of the broad Nigerian macroeconomic and banking sector trends that we expect would shape the economic landscape in 2018.

KEY THEMES/TRENDS FOR 2018 INCLUDE:

- 2018 Budget of consolidation
- Exchange rate and interest rate policies
- Debt Profile
- Oil prices, production and Security
- Capital flows and Reserves

This report merely represents our views of the banking and macroeconomic landscape for 2018 and should not be relied upon for making investment decisions. Please consult qualified professionals for such investment decisions.

1

Overview of 2017

If 2016 was considered a year of unexpected political victories, 2017 took it up a notch. France elected its youngest president in history and a few months later, Robert Mugabe, who led Zimbabwe for 37 years, was forced to resign in a dramatic turn of events. The more things changed however, the more they stayed the same. Despite recent political happenings swinging in favour of populists, Angela Merkel was re-elected as the Chancellor of Germany for her fourth term making her the longest serving female leader in Europe. With President Xi-Jinping commencing his second 5-year tenure, China with improved political confidence might be in for increased reforms to further consolidate its ever-growing economy. Vladimir Putin's Russia focuses on averting more sanctions as he remains posed to run for a fourth term as President in the upcoming March 2018 elections.

Donald Trump exemplified his support for protectionism by pulling out of the Trans-Pacific Partnership (TPP) trade deal and the Paris Climate deal as tensions between him and the leader of North Korea, Kim Jong-un continued unabated. While Britain and the European Union (EU) were debating if Brexit is still Brexit, the Libyan slave market raised concerns about inhumane treatment of desperate Africans travelling into Europe through the embattled North African country. India is set to become the fastest growing big economy in the world.

The world economy rallied to its strongest pace since 2010 with global GDP estimated to have picked up from 2.4% reported in 2016 to 3% in 2017 on the back of firmer domestic demand, improved business & consumer confidence, rebound in global investment and higher-than-expected growth in the Euro area and China; two regions with strong trade ties with Sub-Saharan Africa (SSA). The SSA is estimated to have grown by 2.4% in 2017. However, it would have grown at over 4% if South Africa and Nigeria, where policy uncertainty continue to constrain growth, were excluded.

NIGERIA

The Nigerian economy recovered from the recession it slipped into in Q2 2016, after posting a 0.7%y/y growth in Q2 2017 and 1.4%y/y in Q3 2017. The early but weak recovery was largely aided by improved global oil prices and production volumes, with the oil sector growing by 25.9% y/y and the non-oil sector contracting by 0.8%y/y in Q3 2017. While the rebound of the oil sector to growth territory is laudable, the contraction of the non-oil sector reiterates the need to focus on diversifying the economy.

The Economic Recovery and Growth Plan (ERGP) was launched by the Presidency in April 2017 to promote industrialization through small and medium scale enterprises, address the country's huge infrastructural deficit and attain food security whilst also securing macro-economic stability. The effective implementation of the ERGP is expected to intensify economic diversification, accelerate growth and improve efficiency.

The rebound to growth territory was also buoyed by the actions of the Central Bank of Nigeria (CBN) who implemented policies that saw the exchange rate in one window and the parallel market converge. One of such policies was the introduction of the Investors' and Exporters' window (NAFEX rate) which enabled an increase in foreign portfolio investments and effectively improved FX liquidity in the system. The policy significantly addressed deficiencies which resulted in narrowing the difference between the parallel and official rates.

On the other hand, the apex bank continued the implementation of tight monetary policies which saw yields remain above 20% levels in the first three quarters with the benchmark policy rate left unchanged throughout the year. This action by the CBN paid off as foreign portfolio investors increased FX inflows into the economy to take advantage of the high yield environment thereby easing FX illiquidity challenges and curtailing attendant rise in inflation.

Meanwhile, headline inflation maintained a downward trend declining for the eleventh consecutive month to 15.4%y/y in December 2017 from a high of 18.7%y/y in January 2017 on the back of the base effect and improved FX liquidity. The moderation in inflation was dampened by high food prices which drove food index (y/y) to its

1

7-year high of 20.3% in November 2017. The surge in food prices was mainly due to high transportation cost, adverse weather conditions, displacement of farmers by attacks from suspected Fulani herdsmen and Boko haram sect etc.

There has been a recent resurgence of Boko haram attacks on army officers and suicide bombing attacks on soft targets which questions the veracity of the reported dismantling of the sect by the Nigerian Army in December 2016. The growing sense of insecurity in the country was aggravated by the continued sporadic attacks by suspected Fulani Herdsmen, the suspended quit-notice given to Igbo people in the north by some northern youths, the clampdown of rising Biafran agitators by the Nigerian Army, the resurfacing threats by the Niger Delta militants etc.

In spite of this, the positive macro-economic trends such as positive real GDP growth, moderation of inflation, improved Purchasing Managers' Index (PMI), 42.3% increase in Nigerian Stock Exchange (NSE) All Share Index (ASI) in 2017, significant accretion to reserves, improved capital flows, improved ease of doing business ranking by 24 places to 145th position etc. strongly suggest that the economy is on its way to posting decent numbers for 2018.

2017 at a glance

TIMELINE 2017

JANUARY

- CBN maintains status quo at January 2017 MPC meeting.
- CBN announces first Secondary Market Intervention Sales (SMIS) auction for the year
- World Bank projects 1% growth rate for Nigeria in 2017.
- Headline inflation increased slightly to 18.72% from 18.55% reported in December 2016.

FEBRUARY

- CBN sells US$660million in 3 and 5 months currency forwards to clear some backlog of dollar demands for manufacturing, airlines, agriculture, petroleum sector etc.
- Nigeria's 15-yr US$1 billion Eurobond notes priced at 7.875% oversubscribed by $7.8billion (800%).
- Deposit Money Banks (DMB) agree to contribute 5% of their PAT to fund projects meant to drive export.
- CBN directs banks to sell FX for invisible transactions (e.g. PTA, BTA, School and medical fees etc.) and pegs the rate at N375/$.
- CBN releases new guidelines for FX transactions for invisibles. PTA/BTA/School fees/Medicals.

MARCH

- CBN drops FOREX rate for Invisibles to N360 to $1; pumps $185m into FOREX Market.
- CBN maintains status quo at March 2017 MPC meeting.
- Inflation rate drops further to 17.26% from 17.78% reported in February 2017.

APRIL

- CBN directs all banks to pay cash over-the-counter to desiring foreign exchange customers.
- President Buhari launches Economic Recovery and Growth Plan (ERGP).
- CBN directs banks to remit 5% PAT into Agro/SME Investment scheme (AGSMEIS).
- CBN opens special FX window to sell a maximum of US$20,000 per quarter per SME.
- CBN introduces Form Q for SMEs barely a week after introducing special forex window for SMEs.
- CBN creates a special FX window for Investors, exporters and end users.
- CBN extends BVN registration exercise to microfinance banks.

MAY

- CBN's new guide to charges by banks and other financial institutions becomes effective.
- National Assembly passes 2017 Budget of N7.441trillion into law.
- Inflation drops to 16.25% from 17.24% reported in April 2017.
- Nigerian economy contracts by -0.52% in Q1 2017.
- CBN maintains status quo at May 2017 MPC meeting.
- Senate passes Petroleum Industry Governance Bill, first of four to replace the PIB.

JUNE

- CBN alters the guidelines for selection of FX primary dealers (FXPD) as new flexible exchange rate regime becomes effective.
- CBN introduces new FX circular to ease restrictions and further deepen the market.
- Unemployment rises to 14.2% in Q2-2017.

JULY

- Voluntary Assets and Income Declaration Scheme (VAIDS) launched to encourage voluntary disclosure of undisclosed assets and income.
- Inflation drops to 16.10% in June 2017 from 16.25% reported in May 2017
- FG releases details of fresh N244 bn Paris Club disbursement
- CBN's MPC leaves MPR unchanged at 14%

AUGUST

- Nigeria exits recession, records 0.55% y/y (revised to 0.72%) GDP growth in Q2 2017
- Federal Executive Council (FEC) approves US$3 bn borrowing plan to refinance domestic debt and capital projects.
- Buhari returns to Nigeria after medical leave in the UK
- IMF forecasts 0.8% growth for Nigeria, says threat to recovery still high

SEPTEMBER

- Federal government launches 7-year N100 billion debut sovereign Sukuk bond to fund road infrastructure.
- CBN reviews daily mobile money transaction and balance limit and also introduced BVN requirement for mobile money wallet holders.
- Headline inflation declines slightly to 16.01% in August 2017 from 16.05% in July 2017.
- CBN shifts parallel run of IAS 39 and IFRS 9 to Oct 1 to enable banks conclude the deployment of newly developed Expected Credit Loss (ECL) models.

OCTOBER

- President Buhari seeks Senate's approval for US$5.5 bn loan.
- President Buhari proposes N8.6tn budget for 2018 in the Medium Term Expenditure Framework (MTEF).
- Federal government obtains court order requesting 19 commercial banks to disclose details of accounts without BVN and freeze the said accounts.

NOVEMBER

- CBN reads riot act to exporters over non-repatriation of export proceeds, threatens to bar defaulters from accessing banking services
- President Buhari presents N8.6 tn 2018 appropriation bill to the joint session of the National Assembly.
- Senate approves President Buhari's request for US$5.5bn FCY loan.
- Headline inflation moderated further to 15.91% in Oct 2017 from 15.98% in October 2017.
- Nigerian economy grows by 1.40% in Q3-2017 as Q2 2017 is revised to 0.72%.

DECEMBER

- OPEC and non-OPEC extend oil output cut deal (1.8mbpd) by 1 year to Dec 2018 with Nigeria and Libya still excluded.
- Yuletide season was characterized by persistent fuel scarcity resulting in hike in transportation and food cost and general price increase.
- Headline inflation remained flat at 15.90% in Nov.2017 from 15.91% reported in Oct. 2017.
- CBN weakens the naira marginally by selling dollars for N307/US$1 as against N305/US$1 in the official spot market.

2

Outlook for 2018

The overall performance across most economic indicators such as inflation, GDP growth rate, Balance of trade, external reserves, etc. as well as consumer and business confidence improved in 2017. The National Bureau of Statistics (NBS) Q3 2017 GDP reports however revealed that all the various sectors of the economy with the exception of the oil sector contracted. This further speaks to the need for urgent and holistic structural reforms to encourage investment in the non-oil sector.

We expect the economy to grow by 2.3% – 2.8% in 2018 driven by sustained oil receipts, higher government spending on infrastructure and activities leading to 2019 elections.

Some prospects of macro-economic importance for 2018 include:

FISCAL POLICY AND 2018 NATIONAL BUDGET

The proposed 2018 budget of N8.4 trillion, dubbed "Budget of Consolidation", is predicated on a benchmark oil price of US$45[1] per barrel, oil production estimate of 2.3 million barrel per day (mbpd), exchange rate of US$1/N305, inflation rate of 12.4% and real GDP growth of 3.5%. This budget is 16% higher than the 2017 budget of N7.31 trillion and proposes a capital expenditure of N2.44 trillion (28% of total budget), recurrent expenditure of N3.49 trillion, debt servicing of N2.01 trillion, statutory transfers of N456 billion and sinking funds (to retire bonds to local contractors) of N220 billion. With a projected revenue of N6.61 trillion (Oil – N2.44 trillion and Non-Oil – N4.17 trillion), the projected deficit of N2.01 trillion would be financed partly by new borrowings (estimated at N1.70 trillion) - with 50% sourced externally and the balance sourced locally – and the outstanding N306 billion is to be financed by proceeds from privatization of some assets.

The proposed capital expenditure reiterates the government's commitment to addressing recurrent and capital spending imbalance which is in line with the goals of the ERGP. However, there are concerns of achieving the oil production estimate of 2.3 mbpd considering that at the November 2017 OPEC meeting, the group hinted that it might cap Nigeria's output at 1.8 mbpd at their next meeting scheduled for June 2018 having exempted Nigeria and Libya from the production cuts deal.

While some analysts have argued that the non-oil revenue projection of N4.17 trillion might be ambitious, the statement credited to Mr. Babatunde Fowler; Executive Chairman of Federal Inland Revenue Service (FIRS) that the commission had generated N3.23 trillion in taxes between January and October 2017 (78% of the 2018 projected non-oil revenue) gives a sense that the revenue projection may not be far-fetched. In recent times, the government has taken some steps to boost tax revenues such as the introduction of the Voluntary Assets and Income Declaration Scheme (VAIDS) to encourage disclosure of undisclosed assets and income.

In a related development, the Nigerian Customs Service (NCS) through its Public Relations Officer, Mr. Joseph Attah revealed that the NCS generated a total revenue of N1.01 trillion in 2017. This sterling performance was attributed to the implementation of some strategic measures for efficient service delivery. We applaud the government's feat in boosting non-oil revenue collection and in our view, this further underscores the possibility of the government meeting its projected non-oil funding requirement for the 2018 budget.

EXCHANGE RATE AND MARKET LIQUIDITY

The marginal weakening of the naira in December 2017, where the CBN sold dollars for US$1/N307 (from US$1/N305) lends credence to our expectation for a convergence of the rates in 2018. However, a N2 depreciation might be too insignificant to conclude that the CBN's thoughts are completely in line with ours. Considering that the rate convergence will result in some form of depreciation of the naira with its resultant impact on pump price of Premium Motor Spirit (PMS) and general pricing of goods and services, we expect that the monetary authorities would work towards allowing all other official rates converge, while retaining the N305-307/US$1 rate for oil imports. If the convergence is not achieved by the end of Q1 2018, it is unlikely to happen in 2018 considering that a devaluation won't be favourable when elections/

[1] The benchmark oil price was later revised by the National Assembly to US$47 per barrel

2

campaigning start.

Market liquidity would be further strengthened in the short to medium term given that oil prices and production volumes are at significantly higher levels compared to 2016. Activities in the I&E window and the sustained accretion to reserves should also support this.

INFLATION

We expect the government to pay more attention to curbing food inflation by implementing food import substitution policies, decisively ending the incessant attacks on farmers by suspected herdsmen and implementing a robust & stringent disbursement criteria for the beneficiaries of ecological fund.

While these measures coupled with the impact of base effect have been interpreted by many to mean a massive decline in year-on-year inflation, we project that the drop will be much less drastic. Our view is predicated on the spike in transportation cost, food prices and general living expenses resulting from the lingering fuel scarcity in most parts of the country, as well as the huge spending and doling out of cash that typifies electioneering in Nigeria. Hence, we project that inflation will come in at an average of 14% in 2018.

INTEREST RATE

In view of the proposed utilization of the proceeds of the US$3 billion dual-tranche Eurobond split between funding the 2017 budget capital projects and refinancing some short term domestic debt, we project that the yields on fixed income securities would decline marginally. However, we also expect that the monetary authorities would have to discover an equilibrium interest rate that will on the one hand, attract portfolio investors and on the other hand, encourage lending as a change might alter the inflow of FX, destabilize exchange rates and drive inflation northwards. We however, do not expect the Monetary Policy Rate (MPR) to drop by more than 200 bps in 2018.

DEBT AND DEBT SERVICING

In February 2017, the federal government successfully issued US$1 billion 2032 notes and tapped an additional US$500 million a month later. It raised another US$300 million through Diaspora Bond issuance in June 2017 and then issued US$3 billion dual-tranche notes comprising of 10 and 30-year Eurobonds of US$1.5 billion each. In December 2017, the Debt Management Office (DMO) offered for subscription a N10.69 billion Sovereign Green bond. This effectively brought total funds raised to over US$4.8 billion in a single financial year. Whilst debt to GDP is low at 16.2% (in June 2017) relative to Sub-Saharan African average of over 40%, debt to revenue stands at over 62% in the same period. The Debt Management Office (DMO) revealed that Nigeria spends 34% of its revenue on debt servicing while acknowledging concerns about the country's rising debt profile and the need to bring this ratio to much lower levels. A portion of these funds have been earmarked for refinancing existing domestic debt (which accounts for around 80% of total debt) to shift towards lower priced FX external debt. We expect the government to work towards reducing its borrowing cost and also utilize these borrowings (net of debt servicing) to fund infrastructural investments to stimulate and reposition the economy.

Despite the various interventions by this current administration - by way of bailouts, Paris club loan refunds and budget supports - to state governments, there are still valid complaints and agitations by workers over unpaid salaries and allowances in over 25 states. We expect these states to intensify efforts to increase their internally generated revenue (IGR) in order to achieve self-sustenance and reduce dependence on the monthly and one-off funds shared at the centre.

SECURITY AND OIL PRICE & OUTPUT

The government is presently faced with an enormous challenge of building a more effective counter terrorism strategy and directing more resources towards steering people away from militancy and other forms of violence by encouraging economic activities through job creation.

The recent increase in oil prices reflect the declining global oil inventory levels attributable to high compliance rate to the oil cut deal and Venezuela's decrease in oil exports. However, some industry experts have argued that the uncertainity regarding the duration of the oil cut deal coupled with the forecasted increased supply response by shale producers would increase global oil inventory and eventually, contribute to a decline in oil prices. Thus, we project that oil prices will average US$60 per barrel in 2018.

2

Considering that oil production which peaked at about 2.03 mbpd in Q3 2017, represents a 8.6% q/q and 27% y/y growth from 1.87 mbpd and I.6 mbpd reported in Q2 2017 and Q3 2016 respectively, was primarily driven by improved security in the Niger Delta region and not as a result of improved productivity, we expect the government to put appropriate measures in place to prevent another spate of pipeline attacks, crude oil theft and production shut-ins to ensure that oil production is at its optimum level in 2018 and beyond.

EXTERNAL RESERVES AND CAPITAL INFLOWS

According to Q3 2017 report released by the NBS, capital inflows increased to US$4.15 billion which represents a 127.5% y/y and 131.3% q/q increase from US$1.82 billion in Q3 2016 and US$1.79 billion in Q2 2017. This increase is due to improvement in FX policy vis-à-vis I&E window and the attractive yields in fixed income securities and equities. We expect that the sustenance or otherwise of these capital inflows will be largely dependent on the stability of the prevailing FX and interest rate policies. In addition, the upcoming 2019 elections might drive exit concerns of foreign portfolio investors premised on political uncertainty and might trigger repatriation of capital.

External reserves have increased by 48% y/y from US$25.8 billion in December 2016 to a 37-month high of US$38.2 billion in December 2017 on the back of increased foreign investments, successful US$3 billion Eurobond issuance as well as higher crude oil prices and production volumes. We expect that this commendable accretion would be sustained throughout 2018 with positive investor confidence and FX stability as key drivers.

3

The Banking Industry

2017 was a better year for the industry, compared to 2016 as there was improved FX liquidity - which aided the clearing up of pent up FX demand and increased activities on banks' trade books, attractive yields on fixed income securities, reduced asset deterioration owing to muted credit creation and a strong rally of banks' shares by over 70% in the year. The revised Bankers' Tariff however became effective in May 2017 posing huge challenges for non-interest revenue.

In 2018, the implementation of IFRS 9 and its impact on asset quality and capitalization will be on the front burner.

PROVISIONING UNDER IFRS 9

IAS 39 will be replaced by IFRS 9 effective January 2018 resulting in a change in provisioning from an incurred loss to expected credit loss model. Under IAS 39, the standard provides that there must be an objective evidence of impairment before provisions are taken. IFRS 9, on the other hand, is slightly more stringent because banks will have to recognise not only credit losses that have occurred but also losses that might occur in future. Put differently, banks would be required to make provisions for expected credit losses over the next 12 months and where credit risks are deemed to have increased significantly, banks would have to record the lifetime expected credit loss. The major implication of IFRS 9 is that more provisions will be taken by banks.

In view of the transitional entries to be taken in January 2018 in line with the provisions of IFRS 9, we except that most banks would have taken proactive steps of stressing their books to ascertain the potential effects of IFRS 9 and also identify measures to mitigate the potential shocks on their books.

ASSET QUALITY

2017 witnessed a crowding out of private sector lending following the attractive yields on treasury bills and the state of the economy. Consequently, credit growth was muted as some banks didn't see the need to aggressively grow their loanbook. The stronger-than-expected recovery in oil prices and production reduced the downside risks to oil and gas exposures (especially upstream loans) but there are still concerns about a potential deterioration of some power sector and telecoms exposures. We expect to see increased classification of more exposures on the back of stringent IFRS 9 provisioning requirements and a possible pick-up in NPLs.

CAPITALIZATION

The implementation of IFRS 9 should have a negative impact on Capital Adequacy Ratio (CAR) of all banks in the industry. Banks with strong regulatory risk reserves and a greater portion of its capital as Tier 1 are better positioned to withstand the shocks that would arise from the implementation of the new standard relative to its peers with limited regulatory risk reserves and Tier 2 as the major component of its capital base.

Secondly, the convergence of FX rates (if it happens) might provide an additional justification for all banks to value their books using an exchange rate closer to market (NAFEX rate) and not the CBN rates. This would also cause a decrease in CAR for most banks that currently value their books using the CBN rate (US$1/N305).

Banks that are at risk of having capital come under pressure are faced with the option of raising additional capital or retaining more of its profit at the expense of dividend payment to ramp up on their capital position.

LIQUIDITY

While the CBN's MPC left the official policy rates (such as CRR, liquidity ratio etc.) unchanged throughout the year, the CBN kept naira liquidity tight all year round using alternative tightening measures such as aggressive and regular OMO, Special OMO, non-refund of CRR as deposits drop and pre-funding for the bids at retail FX SMIS window. There are growing concerns on how difficult Asset and Liability Management has become as a result of these special OMOs. However, we project that the CBN will continue with its tightening stance going into 2018, even with the reduction in interest rates.

3

CONCLUSION

Below are some additional expectations and concerns for 2018:

- With preparations for the 2019 elections kicking off in earnest, we foresee increased agitations by several interest groups, including labour unions, civil society groups, civil workers etc., for the payment of salary arrears, allowances and other fringe benefits through industrial strikes and demonstrations.

- Following the economic realities that characterised the last two years, the cost cutting measures that have been adopted by households will continue. Household spending however, might witness some improvement in view of upcoming election campaign spending via campaign advertisement, payment of salaries owed to civil servants and contractors, cash and household material distribution, incentivised donations etc.

- The concerns around security of lives and properties will dominate the year. The government would be expected to increase its efforts in tackling the present state of insecurity in the country to guarantee the safety of lives and properties of its citizens and sustain investor and business confidence.

- Households would also be expected to create additional income streams to meet increasing demands and rising prices of goods and services.

- The true deregulation of the downstream oil and gas sector as well as the passage of the remaining sections of the Petroleum Industry Bill (PIB) should be on the front burner of the government's to-do list in 2018. The passage of the complete PIB is expected to attract significant investments in the oil and gas sector and make a better case for the true deregulation of the oil and gas sector.