GTBank

Guaranty Trust Bank plc
RC 152321

NIGERIA

MACRO-ECONOMIC AND BANKING SECTOR THEMES FOR 2019

2018 OVERVIEW

'Winter is Coming' is not a weather forecast, it is the motto of House Stark, one of the Great Houses of Westeros in HBO's medieval fantasy TV series, Game of Thrones. This phrase, which conveys a sense of inevitability and constant vigilance, typically excites lovers of the TV series eliciting anticipation and suspense. 'Sanctions are Coming', President Trump's satirical warning in the wake of the breakdown of the Iranian Nuclear deal failed to elicit much enthusiasm. 2018 was a busy year for the Trump Administration, as the global power wielded its big stick against various other countries including China. The Trump Administration slammed China with export tariffs running into billions of US dollars and China responded likewise. This impasse between the U.S.A and China, which decelerated after they signed a 90-day truce that ended an intense 12-months trade war, became a major source of global economic nightmare.

Speaking of nightmares, French President Emmanuel Macron seems to be living through one, with the *Yellow Vest Protests* which started as a demonstration against rising fuel prices (which were subsequently shelved) and redistribution of wealth has ballooned into a full-scale movement that is now demanding his resignation. On the other side of the English Channel, Theresa May staggers on, surviving a Vote of No Confidence and 2 defeats in Parliament over her draft Brexit deal. The Saudis were also put to question in the wake of the death of Jamil Khashoggi, bringing to fore the age-old question on the value of true press freedom.

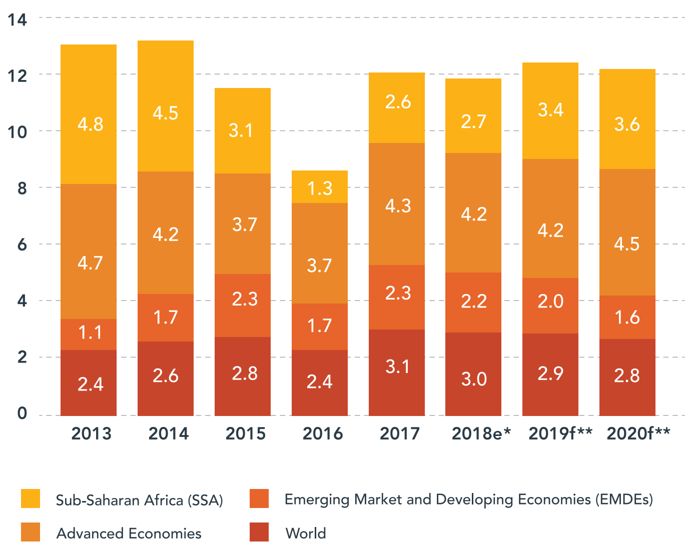
In Asia, tension eased on the Korean Peninsula as leaders of the North and South agreed steps towards achieving peace and economic cooperation between the erstwhile adversaries. On the Horn of Africa as well, a new era of peace and prosperity seems afoot with Ethiopia and Eritrea signing a peace deal to end 20 years of enmity and opening their borders to trade.

On the global economy, the World Bank projected that the global economy will expand by 2.9% in 2019, down 0.1% from 3.0% reported in 2018 predicated on softer-than-expected global trade, elevated financial market pressures on some Emerging Markets and Developing Economies (EMDEs) and heightened financial market pressures on some economies. Following an estimated 4.2% growth for 2018, EMDEs' expansion for 2019 is expected to remain unchanged at 4.2% on the back of weaker-than-expected acceleration in commodity exporting countries, lingering effect of financial crisis in the large economies (including Turkey, Argentina, South Africa etc.) and tighter external financing conditions. Sub-Saharan Africa (SSA) region is expected to have grown by 2.7% in 2018 and trend upwards to 3.4% in 2019 driven primarily by improved investment in large economies including Nigeria, South Africa and Angola, implementation of investment friendly policies and growth in non-resource intensive economies.

Nigeria

Back home, the atmosphere is charging up as the incumbent, President Muhammadu Buhari of the All Progressive Congress (APC) squares against ex-Vice President Atiku Abubakar of the People's Democratic Party (PDP), alongside presidential candidates from other political parties for electoral votes at the February 2019 elections. The upcoming elections to decide who steers Nigeria's government for the next four (4)

Global Real GDP Growth %



Source: World Bank

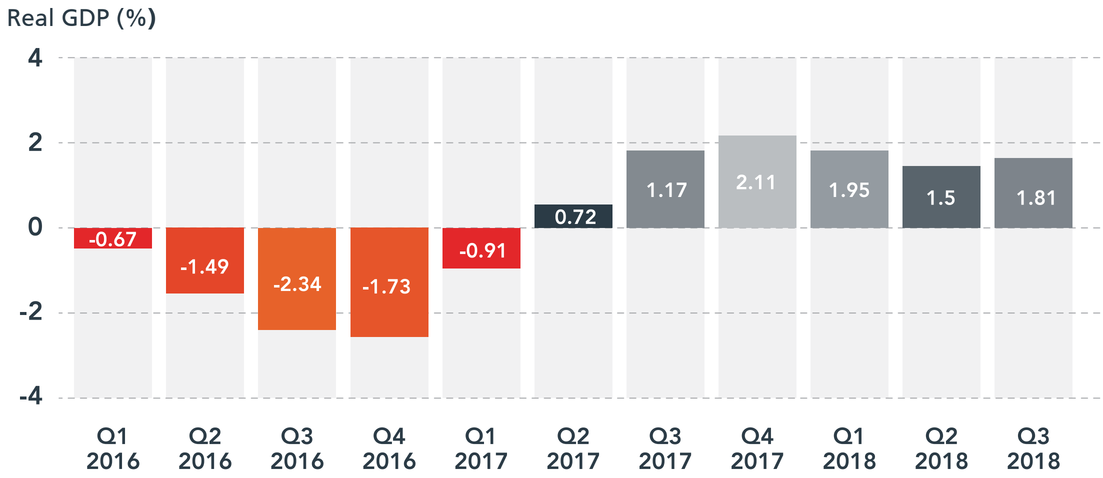
**e- expected   **f- forcasted*

years promises to be an interesting contest, with all eyes on the Independent National Electoral Commission (INEC) to conduct free, fair, credible and peaceful elections.

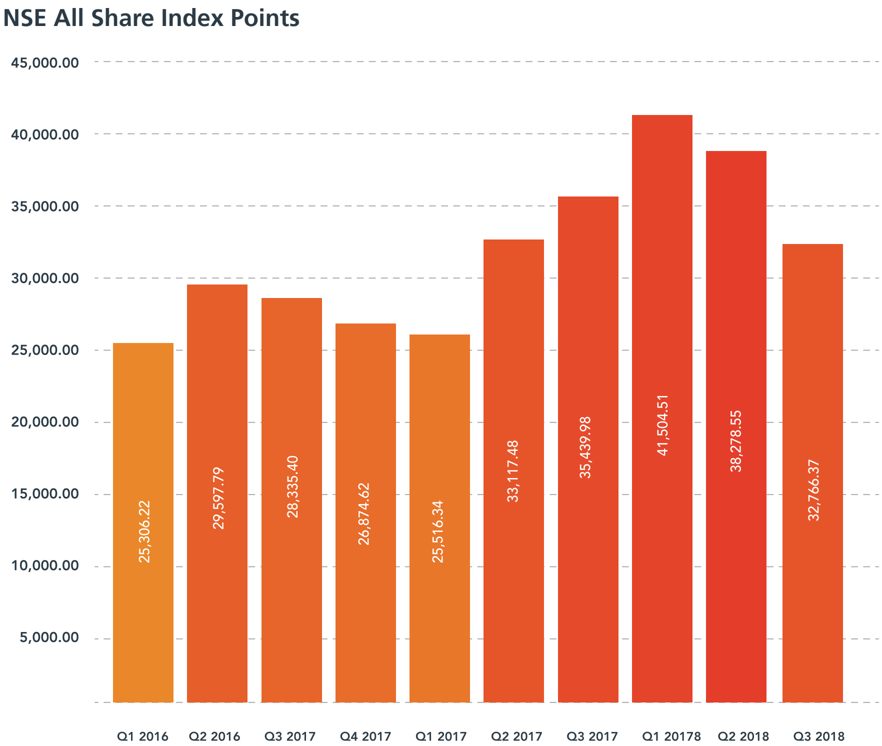
The economy was however weighed by ongoing domestic concerns including the resurgence of Boko Haram attacks in the North East and the escalation of clashes between cattle herders and farmers which negatively impacted agricultural output in the worst hit areas. Consequently, GDP from the Agricultural sector grew by 1.91% in Q3 2018, down 1.16% from 3.07% in the same period in 2017.

On the whole, the economy expanded 1.81% in Q3 2018 relative to 1.17% reported in the same period in 2017 driven by a 2.3% growth in non-oil sector activities, including Information and Communications, Agriculture, Services and Trade sectors. The oil sector expanded 19.6% quarter-on-quarter but contracted 2.9% on a year-on-year basis primarily driven by lower oil production levels.

Economic growth was also dampened by heightened capital outflows on the back of rising yields in developed countries such as the US & UK and uncertain domestic political environment. This resulted in the Nigerian Stock Exchange (NSE) All Share Index (ASI), which was the 3rd best performing stock market in 2017, contracting by 17.81% as investors exited the market and repatriated capital.



Source: National Bureau of Statistics



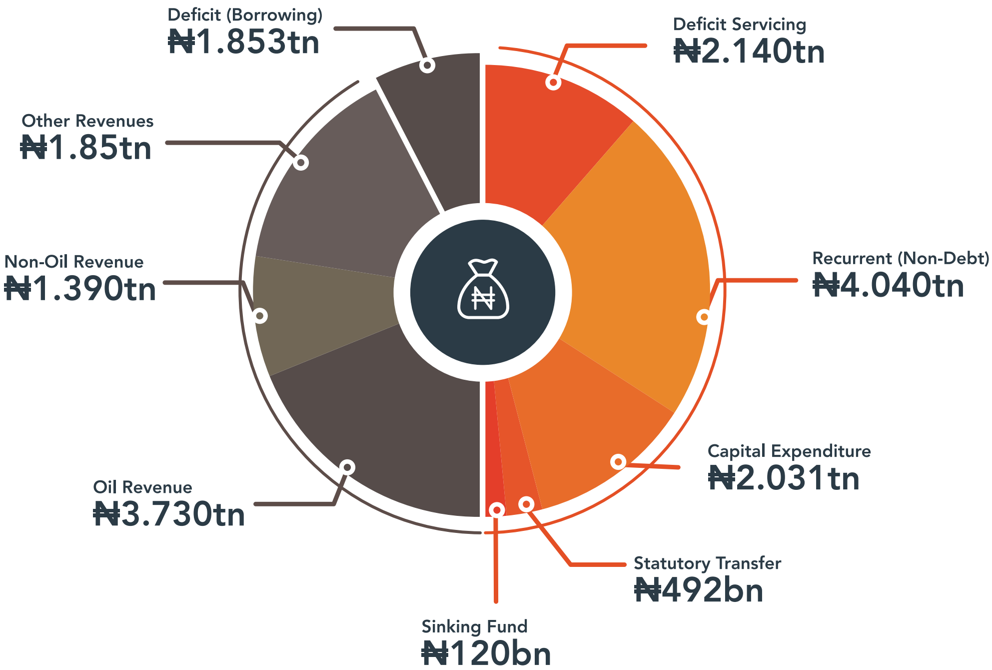
Source: Nigerian Stock Exchange

OUTLOOK FOR 2019

As the political environment braces up for the 2019 general elections with campaigning and electioneering activities gaining momentum, concerns abound on the state of the economy and what needs be done to stimulate the growth most desired by the populace. Given the latest performance of the macroeconomic indicators, it is safe to assume that irrespective of who emerges as President, the task ahead remains employment creation, security, economic growth, amongst others.

Contrary to projections about the expected rate of economic growth in 2019, which include predictions of 2.0% and 2.2% by the IMF and World Bank respectively, we believe growth will be slower, nearing 1.75% in 2019. We expect that electioneering will dominate fiscal activities in the first half of the year, with significant policy activities resuming in the second half. Therefore, the true measure of economic growth will be dependent on the intensity of economic activities in the second half of the year. This would be predicated on a peaceful post-election environment, improved performance in the non-oil sectors and positive oil sector contribution.

2019 Proposed Budget



₦6.97tn TOTAL REVENUE

₦8.83tn TOTAL EXPENDITURE

Budget Assumption

- Oil price US$60pb
- Oil production 2.3 mbpd (including condensates)
- Exchange rate US$1/₦305
- Real GDP growth rate of 3.01%
- Inflation rate of 9.98%

Other prospects of macro-economic importance for 2019 include:

Business and Regulatory Environment

We believe the business environment in 2019 will remain challenging – following on from 2018. As highlighted earlier, we expect a slowdown in economic activities in H1 2019 due to election related uncertainties to also weigh on the industry with banks exercising significant restraint and due diligence on all cash transactions. We expect the regulatory environment to be firm, but supportive and more conciliatory in 2019 – in view of the need to manage investor perceptions to supposedly harsh regulatory decisions and foster confidence in the economy.

Fiscal Environment and the 2019 Proposed Budget

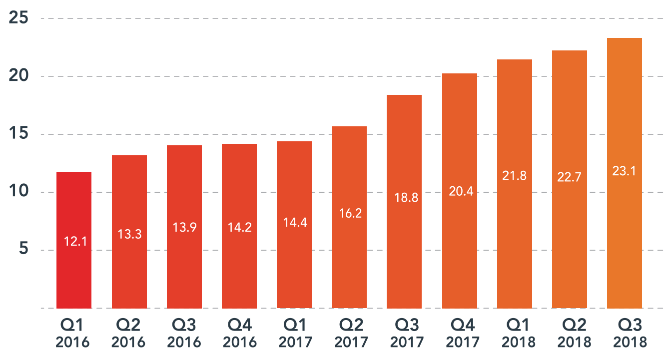
With a targeted revenue of ₦6.97tn, the proposed budget for 2019, aptly dubbed 'Budget of Continuity', projects to spend ₦8.83tn during the year, resulting in a budget deficit of ₦1.85tn. Specifically, the budget proposes to generate ₦3.73tn in Oil Revenue, ₦1.39tn from non-oil sources and the balance ₦1.23tr from Other Revenue sources. Of the ₦8.83tn planned expenditure, ₦4.04tn was earmarked for Recurrent Expenditure, ₦2.03tn for Capital Expenditure and ₦2.14tn for Debt Servicing.

Given the recent fall in crude oil prices, and the noted challenges around the effectiveness of the government revenue machinery, we are concerned about the downside risks to a higher deficit. With the recent commitment to Nigerian Labour Congress (NLC) to implement the new minimum wage structure in 2019, there is a higher chance that government expenditure could rise above the projected level, thus widening the deficit.

The real GDP growth estimate of 3.01% appears aggressive considering the marginal growth recorded in 2018. Given that the official unemployment figures released by the NBS for Q3 2018 puts unemployment rate at 23.1% (Q3 2017; 18.8%) which represents about 21 million unemployed Nigerians and that the job creation statistics of the country does not suggest the likelihood of accelerated job creation within the next 12 months, achieving a GDP growth of 3.01% in 2019 may be an uphill task for the government.

It is likely that the National Assembly will pass a budget that incorporates the new minimum wage structure and adjust for lower oil price & production level estimates. It will however be interesting to see how these will be balanced with recent calls to reign in fiscal borrowing.

Unemployment Rate %



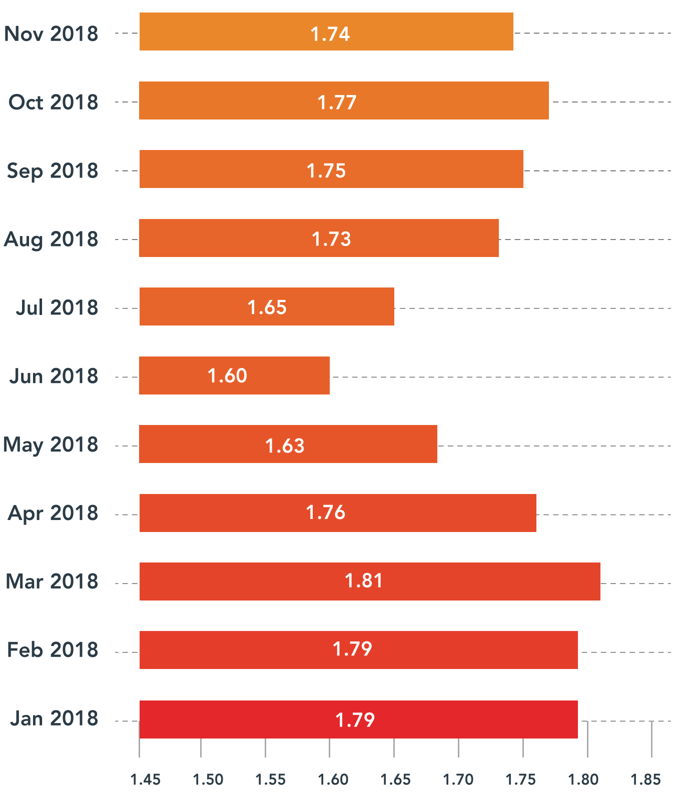
Source: National Bureau of Statistics

Oil Price & Production

With crude oil prices declining in the wake of concerns around excess crude oil supply and a slowdown in global economic growth, the Organization of Petroleum Exporting Countries (OPEC) and its allies agreed to cut global oil production by 1.2 mbpd in the first half of the year effective January 2019 in a bid to support crude oil prices in the near term. The new OPEC deal will see Nigeria cut its production by 3.15% to a cap of 1.685 mbpd (excluding Condensates), which puts total allowable production at between 1.885 mbpd and 2.035 mbpd after adjusting for estimated condensate production of between 200 kbpd and 350 kbpd. Overall we see a risk to the budget, which was projected on assumptions of US$60 pb oil price and 2.3 mpbd (including condensates) production level.

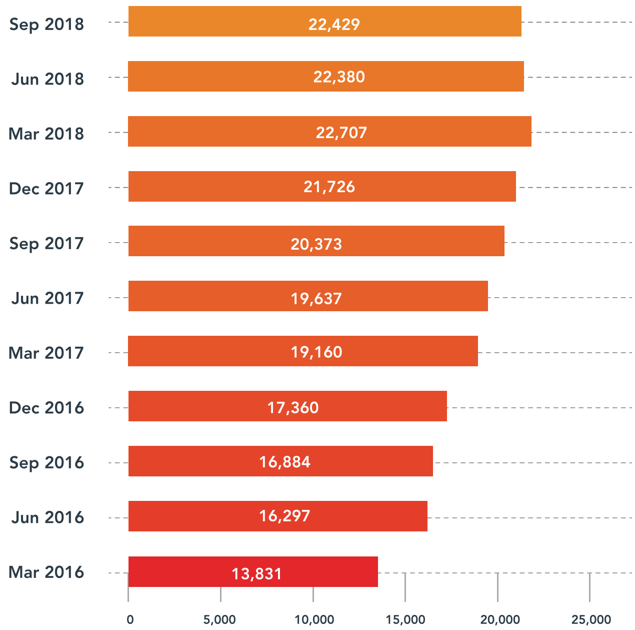
To forestall future vandalization of oil installations, we expect the NNPC to replicate its recent surveillance contract with Ocean Marine Solutions (OMS) for the protection of the Trans Forcados Pipeline (TFP) to other installations. The contract requires the security provider, OMS, to be responsible for repairs in the event of any damage to assigned installations. We believe this will go a long way in motivating effective surveillance and curbing pipeline vandalism in the Niger Delta.

Nigeria's Oil Production Output (mbpd)



Source: OPEC

Nigeria's Total Public Debt Stock (in ₦'billions)



Source: Debt Management Office

Debt Profile

Recent releases from the Debt Management Office (DMO) puts total public debt stock as at Sep, 30 2018 at ₦22.43 tn (US$73.2bn), consisting of ₦15.8tn Domestic Debt (Federal and State governments) and ₦6.6tn External Debt (Federal and state governments). The data brings to the fore ongoing discussions about the sustainability of the government's debt profile in the face of declining revenues. The potential capacity to repay as highlighted by the debt-to-GDP ratio of 19% has been questioned in many quarters as less important than debt-to-revenue of 65% which measures ability to repay. Thus, while government debt is currently about 19% of national GDP, the cost of servicing the debt is projected to be 24% of the 2019 budget and 30.7% of the planned revenue.

With the IMF and the lower legislative house expressing concerns about the level of debt and the challenge of significantly increasing its revenue streams, it becomes imperative for some moderation to be introduced to the rate of debt accumulation. It is our opinion that irrespective of which measure you hold, the ability to accelerate revenue generation is an important barometer for debt servicing.

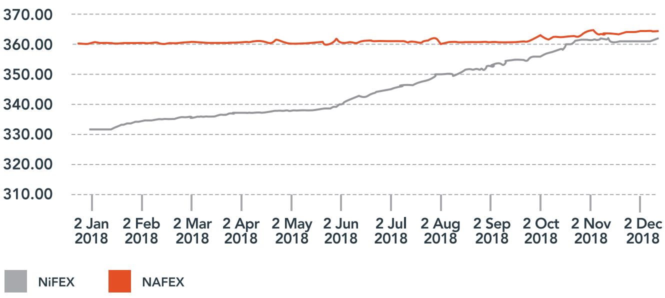
We are concerned that any planned deficit financing in 2019 will only balloon the debt profile, contributing to a further crowding out of the private sector, with attendant impact on economic growth.

Exchange Rate, External Reserves and Capital Inflow

In 2018, we had projected the possible convergence of some of the exchange rate benchmarks in existence at the time. In line with our expectations, the underlying rates for the NiFEX and NAFEX benchmarks did converge and remained within a marginal spread of each other. Thus, only the official CBN rate - which is used for FX transactions by the NNPC and the oil companies - remains below market at ₦305 - ₦307/US$1. Consequently, what used to be a multiple exchange rate regime is now more or less a two-rate regime. The CBN was able to sustain the currency in 2018 through its market intervention activities with available data suggesting that about US$48bn has been provided to the market through the CBN interventions.

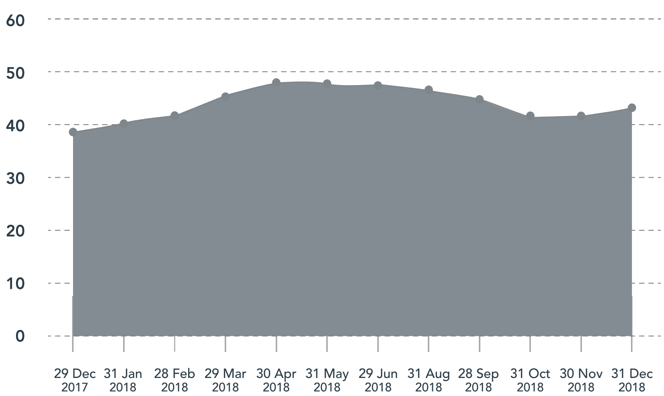
On the corollary, external reserves grew 13.3% in 2018, from US$38.1 billion in Dec. 2017 to US$43.1 billion in

FX Rates (US$/₦)



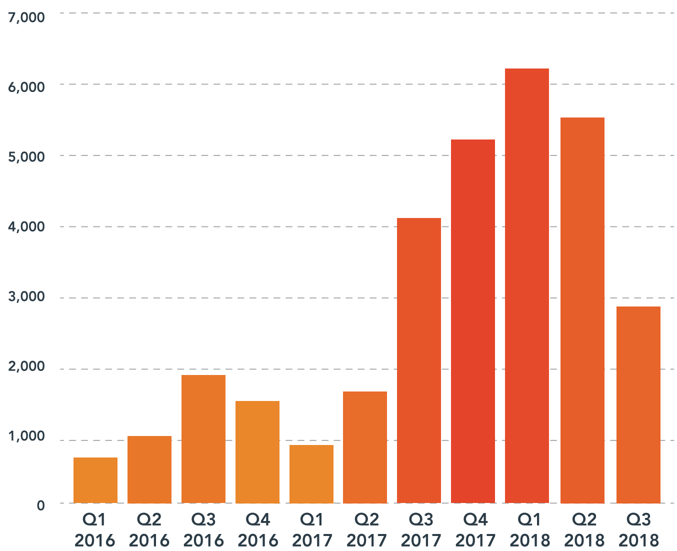
Dec. 2018, though it rose as high as US$47.6 billion in June 2018. Accretion to reserves was supported by proceeds from the Eurobond issuances in 2018, strong crude oil receipts occasioned by the higher oil prices recorded in most of 2018 and positive capital flows recorded in the first half of 2018. According to the NBS, capital flows contracted 31.1% y/y and 48.5% q/q in Q3 2018, with outflows by portfolio investments, which accounted for 60% of capital flows, shrinking 38% y/y and 58% q/q. The reversal of capital flows was triggered by the effect of the U.S. FED monetary policy normalization actions and the strengthening of the U.S. markets.

Reserves (US$' billions)



In 2019, we expect that the CBN will sustain its interventions in the FX market in a bid to ensure that rates remain relatively stable into the elections and sustain its price stability objectives. While the OPEC production cap rules and lower oil price levels pose a downside risk to reserve accretion, we are optimistic of an improvement in capital flows on the back of a non-violent elections, stable exchange rate and attractive fixed income yields.

Capital Importation (US$'million)



Source: National Bureau of Statistics

Monetary Policy – Interest Rate and Inflation

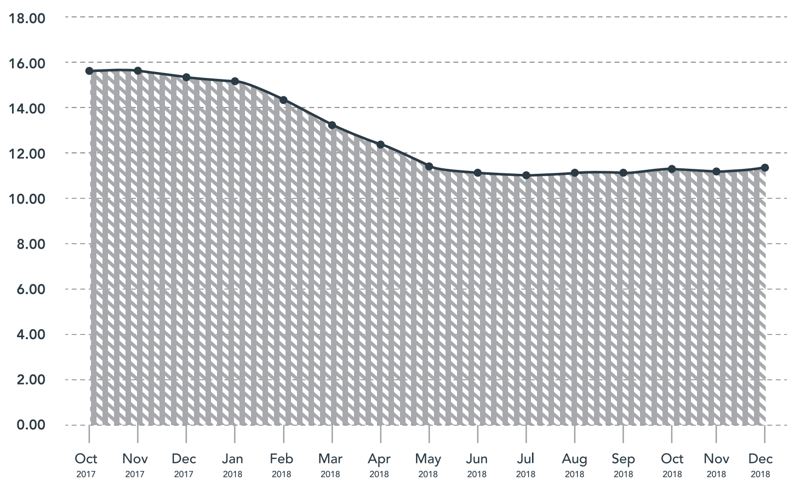
As a predominantly import dependent economy, any decline in the relative value of our currency will have a direct impact on the price level of goods and services. It therefore became imperative for the Monetary Policy Committee, and the Central Bank, to take necessary steps to maintain the value of the currency by sustaining a tight monetary policy environment. While this has been largely achieved, the impact of flooding on communities and farm lands, and escalation of farmers-herders crisis had a negative impact on foods production and therefore food inflation.

In spite of ongoing activities to manage price stability, we expect inflation to rise during the year. The recent convergence in exchange rates, the rise in food prices, new minimum wage and increased government and election related spending are expected to weigh on the general price levels over the near term. We expect headline inflation to come in at an average of 13.5% in 2019.

Going into 2019, we expect monetary policy to remain contractionary, given the overarching concerns of maintaining exchange rate stability. We expect that the current monetary policy variables will be maintained in 2019, while Open Market Operations (OMO) by the CBN will be sustained. Presently, the CBN mops up all excess liquidity from the banking system using issuances of short-term securities to banks. It is our expectations that this situation will not change, rather might escalate if money supply within the banking system expands over the year. We expect that short-term interest rates will rise to reflect the increased tightness in market liquidity, with implications for lending activities in the year and a slight rise in fixed income yields during the year to encourage the return of foreign portfolio investors and capital formation.

in Taraba & Benue states, and the accusations against top army commanders of arming Nigerian soldiers with obsolete weapons while enriching themselves with the funds meant for acquiring sophisticated weapons to fight insurgency. These allegations are weighty and echoes the need to reform the security infrastructure of the country. These reforms must be holistic and strategically flawless as the desired economic growth may not be attained if the security fabric of the country is perceived as largely inefficient.

Headline Inflation (y-o-y)



Source: National Bureau of Statistics

The 5-year term of the current CBN Governor, Godwin Emefiele ends in June 2019. Given that he's eligible to serve a second term, we expect that his re-appointment or successor will be announced before the end of March 2019. A change in leadership at the Apex bank may have implications for the monetary policy direction of the country.

Security

The frequency and stealth nature of the resurgent Boko Haram attacks may appear to have overshadowed the successes recorded by the army against the sect in the last three or so years. In a related development, the herders – farmers crisis has also caused immeasurable destruction of lives and properties in the last 12 months.

Of grave concern however, is the allegation of collusion with the militia levelled against the Nigerian Army in the killings

THE NIGERIAN BANKING INDUSTRY

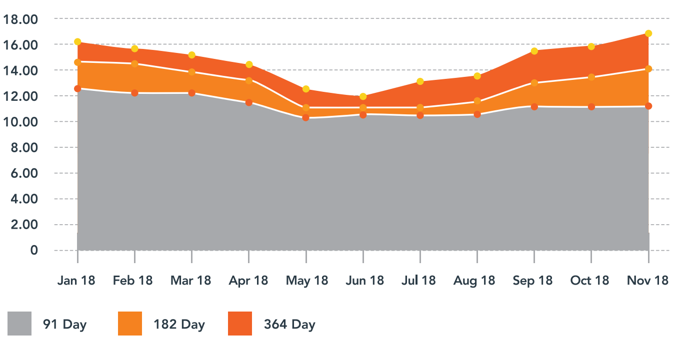
Overview of 2018

The industry had its fair share of events in 2018 – from the implementation of IFRS 9 standards, the establishment of a bridge bank, Polaris Bank to assume the assets and liabilities of the defunct Skye Bank, the resolution of the 9Mobile facility to the proposed merger between Access and Diamond banks. During the year, Banks had to contend with tight system liquidity, declining loan book and a rise in NPLs. Unlike 2017, banks' stocks closed the year in negative territory as the NSE Banking Index declined by 16.1%.

Outlook for 2019

Short term interest rates will remain elevated, and market liquidity tight due to the expected contractionary monetary policy. All existing policy measures deployed towards achieving the monetary objectives of the CBN should remain in force – at least up through to half year 2019. In light of the expected increase in federal government borrowings, the high interest rate regime could exacerbate any crowding out effect which may negatively impact bank lending rates and cost of funds, with attendant implications for growth and profitability.

Average T.Bill yield (PMA) (%)



The highly regulated foreign exchange environment is expected to remain unchanged. With foreign exchange reserves closing 2018 at US$43.1 billion, an estimated 15 months of import, we see room for the CBN to maintain a policy of defending the currency. While this, in our opinion, may provide some level of stability and positive view for the currency in the short term, a continued decline in crude oil prices will create downside risks to further accretion to the reserves, and capacity to continue to support the currency. It is not unlikely therefore that we will witness a divergence in the rates offered at the CBN interventions and rates available on the Investors & Exporters (I&E) Window. We expect the CBN to continue to monitor activities within the market that could adversely affect foreign exchange stability.

Asset Quality

A close scan of the industry reveals that there's a positive relationship between performing loan book and elevated global oil prices, and the reason is not far-fetched as over 30% of the total industry exposure are to the oil and gas sector. With oil prices relatively elevated, the industry had to contend with the combined effect of IFRS 9 resulting in increased loan loss charges against shareholders' fund which decreased capital, declining loan book due to the relatively low demand for credit and reduced capacity of banks to lend. We expect banks to intensify efforts to grow their loan books albeit to quality risk rating names, and also expect NPLs to decline from present levels.

Capitalization

The impact assessment of IFRS 9 on the industry revealed that the transition to the new standard resulted in lower capital position in view of the shift from Incurred Loss to Expected Credit Loss (ECL) model. In effect, most banks saw between 150-500 basis points (bps) shaved off their capital, resulting in significant decline in the regulatory Capital Adequacy Ratio (CAR) of some banks below the minimum of 15% (and 16% for D-SIBs) bringing to fore the need for these banks to raise fresh capital. In a move to cushion the effect of the ECL provisions on tier 1 capital, the CBN introduced a 4-year transitional arrangement which will require banks to hold static the Adjusted Day One impact of IFRS 9 impairment figures and spread it over a 4-year period. Consequently, capital position of banks will improve relative to the figures that were published for the 2018 reporting periods.

We expect to see more steps by banks to cover any shortfalls in their capital ratios including raising qualifying debt capital to shore up their capital base.

Evolving Competitive Landscape

Increasing Competition for Retail

The industry continues to face increasing competition from Financial Technology (FinTechs) and other non-bank companies offering a wide range of financial services to the retail and MSME segments leveraging technology. FinTechs have been able to achieve a fair disruption of the retail banking landscape through the deployment of simplified banking services which has revolutionized the service offerings of commercial banks. It is however believed that their capacity to effectively gain significant market share is limited without collaboration. The relative ease with which Fintechs approached and gained market share in the retail lending space, a hitherto unserved market, has prompted commercial banks to give this more focus. We expect to see an increase in competition amongst banks to capture market share in the retail and micro/small business space over the course of 2019.

A more compelling threat however relates to the recent decision by the CBN to license Payment Service Banks (PSBs) to facilitate transactions in remittance services, micro-savings and withdrawal services in rural areas. The primary idea is to drive financial inclusion by leveraging the capacity of other entities, like the telcos with existing infrastructure in the areas not easily reached by bank networks. While the PSBs are to be prohibited from providing lending services and participating in the FX market, they will be able to offer other services, thus competing with commercial banks for the pool of earnings and also ensure that the battle for retail is won using digital and mobile strategy. While this is net negative for the industry, we view this as positive for customers as it has the capacity to improve customer service, increase product and service offerings, enhance financial inclusion and drive the adoption of digitization of banking services.

Consolidation in the Industry

Like George W. Bush's decision to give Michelle Obama what appeared to be a candy rather than the handshakes he offered to other former U.S first ladies at his father's funeral service, the proposed merger between Access Bank and Diamond Bank came as a surprise to many after both banks debunked reports of the planned merger a few weeks before the formal announcement was made. The proposed merger, which still requires the approval of shareholders and regulators, is expected to make the new entity the largest commercial bank as well as the biggest retail franchise in the country. Barring any unforeseen issues, the proposed merger will increase the competitive landscape in the industry. The post-integration challenges and downside risks cannot entirely be dismissed on the back of historical experience of one of the banks but we expect that the process will be well-executed by the banks and properly monitored by the relevant regulators. The success of the merger could trigger other such mergers, with the potential to strengthen the industry.

Conclusion

In the wake of normalizing interest rates, uncertainty in the oil market, slowing global economy and capital flight from emerging markets, Nigeria's economic performance will be largely dependent on the interplay of these external factors especially the global oil market in a year that will be split into two halves. The first half will see politics and electioneering dominate much to the detriment of economic activities which may translate into muted capital inflow, increased pressure on the naira, accelerated FX intervention and declining external reserves.

We expect some level of normalcy to return in the 2nd half of the year translating to strengthened investor confidence, increased capital flows, softened pressure on the naira and decreasing yields on government securities as well as the likelihood of increased inflationary pressure. That said, the continued normalization of interest rates by the U.S. FED, lower oil prices, weaker-than-expected oil output and a tense post-election environment pose downside risks to our expectations.