OUT OF AFRICA

NIGERIA | MARCH 2020

NIGERIA – A KEY INVESTMENT MARKET

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No more okadas

I arrived in Lagos one week after a ban on okadas (motorcycles) came into effect, which has put an end to the burgeoning motorcycle ehailing industry in the city. Okadas as well as kekes (tricycles) provided a much-needed "last mile" service in Lagos's heavily congested traffic but had developed such a bad reputation for reckless driving that authorities decided to ban them in certain areas. The response by the government does seem to be a bit heavy-handed, as the alternatives provided (extra buses and new ferry routes) do not really address the "last mile" requirement of commuters, whilst the growth of ehailing companies such as Gokada, Max.ng and ORide seemed to be a positive, tech-driven solution to traffic congestion while providing much-needed work opportunities. On a side note, Uber has been in Lagos since 2014. The immediate impact of the ban was even worse traffic than before, a situation not

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helped by Valentine's Day (that was on a Friday this year), which has a reputation for terrible traffic in Lagos, leading to a routine trip that would ordinarily take about 45 minute from Lagos Island to Ikeja turning into a 3-hour trek the evening before Valentine's Day.

My visit to Lagos was facilitated by a local stockbroking firm organising an annual investor trip to Abuja and Lagos around this time of year for the past four years. It's a great way to get a head start on the year in one of our most important markets. One of the objectives of this trip was also to meet with local PFAs (pension fund administrators). It's important when investing in foreign stock markets to understand the structure of the domestic investor base, and in particular the dynamics of its pension system. Nigeria's current pension system is relatively young, having been implemented in 2006 following the promulgation of the Pension Reform Act of 2004. It is regulated by Pencom (National Pension Commission of Nigeria). As at the end of June 2019, there were 8.8 million people registered to the scheme memberships (this is less than 5% of Nigerian's 200 million people). As the pension system has grown, so have the contributions by members, currently averaging around NGN59bn (USD164m) per month, and because it is a new system, only 8% of members are in retirement. This means that Nigeria's pension system is in a growth phase, with lots of younger members who are still far away from retirement. Total pension fund assets at the end of 2019 are estimated at around USD28.3bn (about 10% of the size of South Africa's industry of approximately USD270bn). Of this, around USD20.4bn is invested in so-called FGN securities – basically, long- and short-term loans to the Nigerian government. Pension funds like to invest their money in government securities because they are risk-free and the yields have been high (historically between 10% and 20%). In contrast, only 5.4% of pension fund assets are invested in domestic shares, a fact that is much lamented by local stockbrokers, who would like to see local pension funds be much more active on the Nigerian Stock Exchange (NSE).

Traditional investment theory also recommends shares (or equities) as the best asset class for long-term savings. Unfortunately, the Nigerian stock market performance has been quite volatile in recent years, and this, amongst other reasons, has meant that local pension funds have shunned this asset class. The pension funds that I met bemoaned the fact that the regulator (Pencom) is somewhat overbearing in requiring funds to submit daily transaction reports. In the event that a pension fund realised a loss on sale of a share, the manager typically gets a letter from Pencom asking to explain the rationale behind the transaction. This oversight is not without merit and it's in the best interest of investors, to avoid overtrading. The unintended consequence is that pension funds then rather allocate to government securities to avoid the hassle of potential losses associated with equity investments.

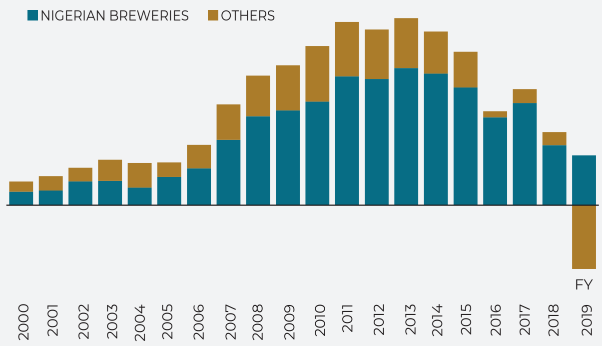
Talking about strict regulators, much of the discussions with the listed banks I met centred on recent regulations by the Central Bank of Nigeria (CBN). Most banks are of the opinion that 2020 will be a "technical" and "difficult" year. One change introduced by the CBN in 2019 was to set a minimum loan-to-deposit ratio of 65%. This forced banks to extend new loans even though they might have preferred to keep their funds in safer or more liquid assets. The CBN also published new fee guidelines just before Christmas last year, slashing allowable charges on various electronic products by an average of 45%.

PENSION FUND CONTRIBUTIONS HAVE BEEN GROWING

Average monthly contribution (NGNbn)

Source: National Pension Commission of Nigeria

BEER SECTOR PROFITABILITY UNDER PRESSURE



Nigerian beer market profit pool (NGNbn)

Source: Nigerian Breweries FY19 results presentation

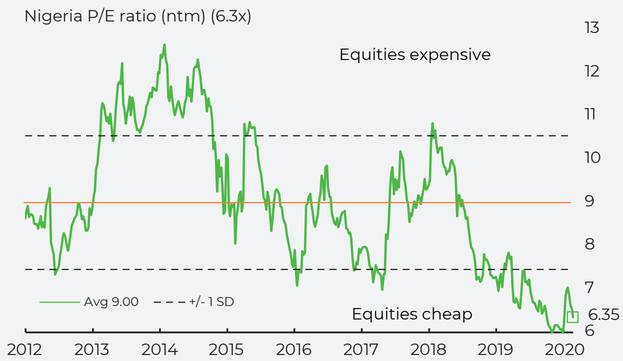
Then, at its last monetary policy committee meeting, the CBN hiked the cash reserve ratio (CRR) from an already high 22.5% to 27.5%. This means that 27.5% of a bank's deposits must be kept at the CBN.

By contrast, the CRR is 14% in Egypt, 5.25% in Kenya, 2% in Morocco and 2.5% in South Africa. It was not all bad news with the banks though, with a number of banks now starting to make good progress with retail and consumer lending. In the past, banks in Nigeria mostly took deposits from individuals and then lent this money to corporates. This has started to change with the implementation and development of important enabling mechanisms such as the Nigerian Bank Verification Number (BVN – which enables banks to uniquely identify clients) as well as credit bureaus (which allows banks to check/report the creditworthiness of clients). In addition, the CBN now allows banks to add a clause to loan agreements that will allow them to access funds held in other bank accounts in the event of a default.

We also met with a number of consumer and cement companies. Consumer companies have been struggling in recent years, as a result of a slowdown in economic activity as well as increased competition in some industries. It does seem as though there might be light at the end of the tunnel for some companies, as modest revenue growth, combined with a leaner cost base as well as lower finance costs, could provide support to earnings growth. Much of the discussions focused on collapsing interest rates, which provide a unique opportunity for companies to re-finance expensive existing borrowings or borrow cheaply for new projects. Interest rates in Nigeria have reduced sharply after the CBN decided to stop pension funds from investing in OMOs (effectively, short-term loans to the CBN). Flour Mills of Nigeria (a diversified food producer), for example, was able to issue commercial paper at 9.5% in December 2019, from 14.75% at the start of the year.

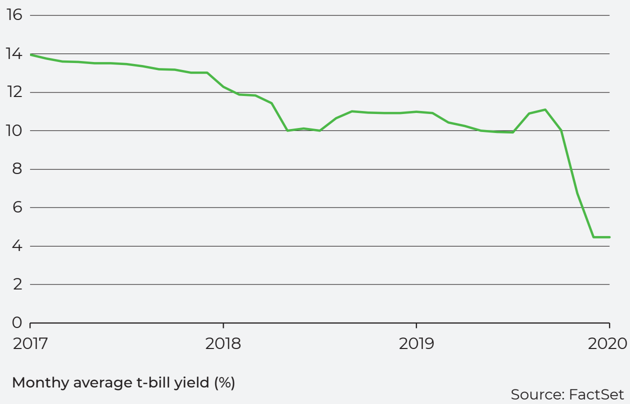
Nigerian share prices reflect the difficult economic environment, with valuation multiples at multi-year lows (market price to earnings ~ 6.3x, price to book ~ 3.6x, dividend yield ~ 8%). The outlook is also mixed with mounting fears about the ability of the CBN to maintain the currency at its current level of around NGN360. Nevertheless, we are confident that our portfolio companies will be able to navigate the challenging environment and provide us with good returns in the medium term.

NIGERIA'S STOCK MARKET PRICE/EARNINGS RATIO IS AT MULTI-YEAR LOWS



Source: FactSet

NIGERIAN T-BILL RATES HAVE DROPPED SHARPLY



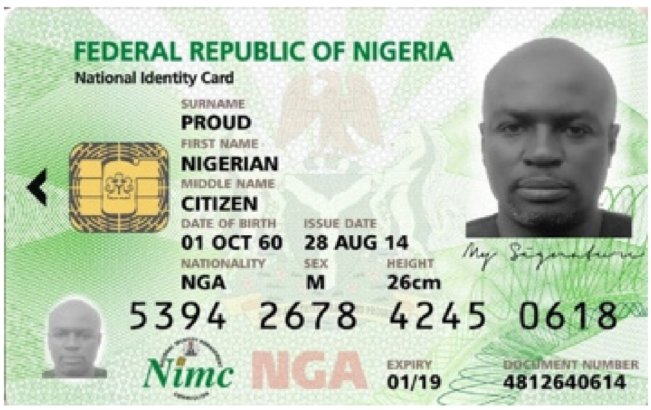
Source: FactSet

FAST FACTS

KNOW YOUR ACRONYMS

BVN – Bank Verification Number: biometric identification system used by banks. At the end of 2019, over 40m active bank accounts were linked to a BVN.

NIN – National Identification Number: used to tie together all records – demographic data, fingerprints, head-to-shoulder facial picture, other biometric data and digital signature in the National Identity Database (NID).



TRAVEL TIPS

We always stay in the Federal Palace Hotel when we travel to Lagos. It's not the newest and certainly not the most fashionable but we find it dependable and good value. And the breakfast buffet is very good!

HARMATTAN

The Harmattan is a season on the West African subcontinent, which occurs between the end of November and the middle of March. It is characterised by the dry and dusty north-easterly trade wind, of the same name, which blows from the Sahara Desert over West Africa. In some countries in West Africa, the heavy amount of dust in the air can severely limit visibility and block the sun for several days, comparable to a heavy fog. This effect is known as the Harmattan haze. It costs airlines millions of dollars in cancelled and diverted flights each year.

THE NEW SET-OFF CLAUSE IN NIGERIAN LOAN AGREEMENTS

"In the event that I fail to repay the loan as agreed, and the loan becomes delinquent, the bank shall have the right to report the delinquent loan to the CBN through the Credit Risk Management System (CRMS) or by any other means and request the CBN to exercise its regulatory power to direct all banks and other financial institutions under its regulatory purview to set off my indebtedness from any money standing to my credit in any bank account and from any other financial assets they may be holding for my benefit."

OMO – NOT THE WASHING POWDER

In this case OMO stands for Open Market Operations and it refers to the activities by a central bank to manage liquidity. Historically, this entailed the central bank buying or selling government bonds in the open market. In recent years in Nigeria, the central bank started selling so-called OMO Bills – the main difference being that these are not government securities but rather central bank securities, so the "borrower" effectively assumes the role of the central bank.

Keeping it simple – Seplat office in Lagos

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