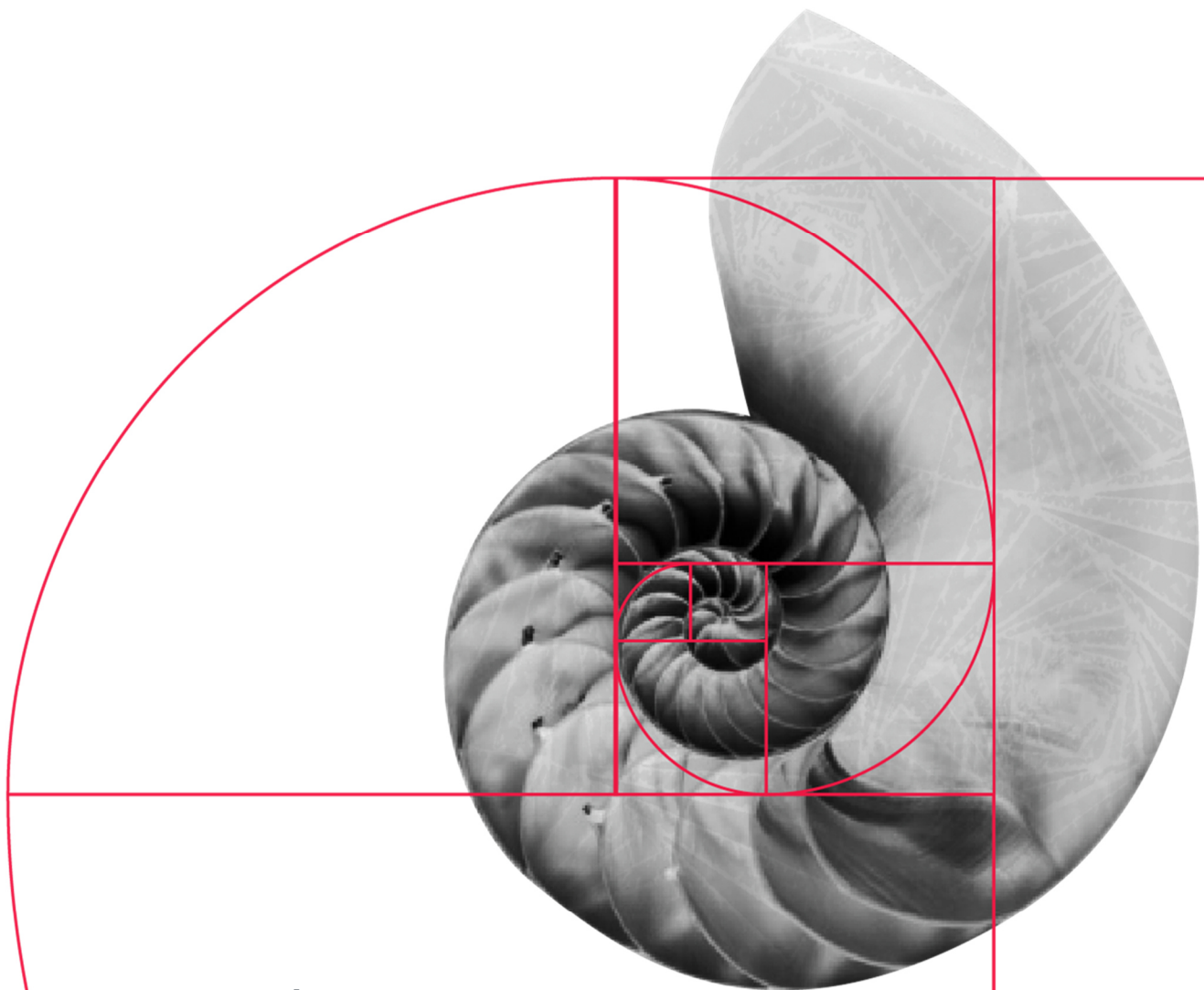


Nigeria

in 2023.

*Charting Through a
Pervasive Slowdown.*



Contents.

Global.....	2
Precis.	3
Domestic.	6
Precis.	7
Financial Markets.	10
Precis.	11
Disclosures.	14

Global.

Precis.

The Year 2022 – A period that started with the optimism of consolidation of the post-COVID recovery, albeit slowly, but eventually went southwards with the multifaceted impact of the Russia-Ukraine conflict and tighter monetary conditions. Not only did the Russia-Ukraine conflict disrupt the relatively smooth functioning of the global economy, but it also made global central banks hasten switches to monetary policy tightening as inflationary pressures rose to levels not seen in decades. To put it in a proper context, we acknowledge that global inflation rates were on the rise before Russia invaded Ukraine on 24 February, reflecting the (1) post-pandemic supply chain disruptions, (2) shortages of chips and semi-conductors, and (3) increased demand that accompanied the reopening of world economies. However, just before the world economies started feeling the impact of the war, global PMI surveys reflected that the supply chain delays had started easing in the US, UK, and Euro Area, implying that inflationary pressures may moderate by H2-22 amid the favourable base effects from the prior year.

However, the Russia-Ukraine conflict shattered the hopes of moderation as the conflict introduced new risks to the inflationary pressures, worsening the supply chain constraints. Moreover, food and energy prices also spiked, given the contribution of both countries to global supplies. Therefore, consumer prices spiralled across the developed and developing economies to the extent that some countries introduced export bans to limit price shocks in their respective domestic economies. Consequently, the preceding induced global central banks to aggressively tighten monetary policies faster than initially expected as inflationary pressures rose.

Given that the uncertainties concerning the global macroeconomic and financial environment are high striking a balance between avoiding a disorderly tightening of financial conditions and containing the potential threats will be critical as we head into 2023FY. With persistent and aggressive monetary policy tightening, the questions on the minds of investors have been centred around the probability of a ‘soft landing’. However, in our opinion, it will be difficult for major central banks globally to engineer this, especially given that inflation rates have significantly risen above the monetary authorities’ target, even as the impact of monetary policies lags behind inflation and output. Crucially, our call is for the US Fed to maintain its rate increases, albeit at a slower pace than implemented in 2022FY, until H1-23 and pause for the remainder of the year before cutting the key policy rate in 2024FY. Our prognosis is hinged on the Fed’s inflation-targeting strategy (adopted in August 2020), designed only to cut the Fed’s

funds rate when actual inflation converges to the 2.0% target. Thus, as the central banks in advanced economies keep raising key policy rates, we expect growth to falter and turn negative in H1-23. Indeed, the IMF forecasts that 31 out of selected 72 economies will experience a contraction in real GDP lasting for at least two consecutive quarters at some point during 2022 -2023, amounting to more than one-third of world GDP.

Away from that, the US dollar has appreciated significantly against other world currencies on account of the combined impact of (1) US Fed monetary policy tightening, (2) heightened global uncertainties, (3) the Russia-Ukraine conflict, and (4) country-specific conditions; for instance, fiscal risks in the United Kingdom. Moreover, the US dollar's strength against other world currencies could linger into H1-23, given that the US policy rate is expected to remain elevated, and many advanced economies could fall into economic recession. Consequently, (1) higher global interest rates and (2) a strengthened US dollar implies that it will become more difficult for many emerging and frontier economies to raise money and refinance their external debts, increasing financial markets' volatility. Notwithstanding, we believe the situation has created an opportunity for countries to embark on a conscious fiscal consolidation effort, as funding from alternative external sources (bilateral and multilateral) may not be enough to cover the outsized fiscal deficits, holding domestic debt issuances constant.

Overall, our outlook for the global economy is a slowdown compared with 2022E growth levels. On the one hand, we expect to see the impact of monetary policy tightening on global household demand and private investment conditions, weighing down the overall growth in 2023. Elsewhere, while inflationary pressures are likely to slow down compared to 2022E levels, given the favourable base effects, we expect prices to remain significantly above pre-pandemic levels, further pressuring consumer wallets and slowing household consumption. On the other hand, the slowdown in China primarily because of the lingering property sector woes and stifled domestic consumption will negatively impact other countries' external sector conditions, given the roles played by China in global trade. Equally, the lingering Russia-Ukraine conflict is also expected to contribute to the expected global economy's pervasive slowdown in 2023FY. On a balance of factors, the IMF expects global economic growth to slow to 2.7% y/y in 2023FY, down from an expected 3.2% y/y growth rate in 2022E.

Finally, the level of volatility in the crude oil market heightened in 2022 following an increased uncertainty about the interplay between supply and demand forces. Prices have generally fallen from the multi-year high reached in March, as global growth concerns and lockdowns in China influenced an underperformance in global demand. Amid the mire, supply recovered to pre-pandemic levels, underpinned by increased output from OPEC and its allies, and the US, coupled

with the substantial releases of crude oil from strategic reserves. As a result, we expect oil demand to reach pre-pandemic levels in 2023FY, driven majorly by increased consumption from China. On supply, while we still expect growth in oil production, we anticipate a slower increase with the drag stemming from a fall in output from the OPEC alliance following the newly instituted production cuts and the impact of EU sanctions on Russia's output. On a balance of factors, we forecast Brent crude oil price will average USD92.00/bbl. in 2023. We cite the slowdown in global growth and prolonged COVID-19 restrictions in China as potential risks to demand. On the flip side, we believe any disruption to current output poses key risks to supply.

Domestic.

Precis.

The domestic macroeconomic narrative did not change much in 2022, given the government's lack of will to institute the necessary reforms to propel the economy forward. While domestic economic activities appear more resilient than envisaged, inflationary pressures remain entrenched, pressuring consumer wallets. Similarly, FX pressures persisted, and foreign investments remained frail. In the words of the World Bank, "amid heightened risks, the government has kept a 'business-as-usual' policy stance that hinders prospects for economic growth and job creation". Amidst all these, the socio-economic conditions worsened, with 63.0% (or 113.00 million) of the population living in multidimensional poverty, according to the National Bureau of Statistics (NBS). At the same time, the unemployment rate remains high, exacerbated by an unfriendly business environment.

Although the Russia-Ukraine conflict compounded the domestic inflation woes, we highlight that price pressures were also self-inflicted in the form of policy distortions such as (1) trade restrictions, (2) lack of flexible FX framework, and (3) insincere monetary policy actions. On (3), the CBN continues to increase the key policy rate but maintains its monetary financing of the FGN's fiscal deficits and credit intervention programs.

The FGN's fiscal operations have been the same as in the last few years. On the one hand, the government continues to defer the decision on fuel subsidy removal and consistently increases its aggregate spending amidst a dwindling revenue profile. On the other hand, we like that the government continues to use the annual Finance Act to boost non-oil revenues. However, we think more efforts are needed to expand the current tax net so as not to 'over tax' the existing tax bracket, potentially reducing business flows and subsequent government revenues.

Going into the next year, we think a complete removal of the subsidy on PMS while consumer prices remain elevated could further aggressively stoke inflationary pressures, lead to massive protests, and ultimately compound economic woes. Indeed, Fitch ratings noted that the potential removal of fuel subsidies would reduce hard-currency demand but could fan inflation even higher, keeping the naira under pressure. Accordingly, we tilt towards a phased removal of PMS subsidies, similar to the phased increases of electricity tariffs. That said, the fiscal authorities need to come to terms with the fact that solving the lingering elevated price pressures rests more on them, given that supply constraints primarily drive the current consumer price increases.

Similarly, we do not see the current CBN management devaluing the currency, barring a new market-oriented fiscal administration. However, for credible policy framework and reform, we lean towards devaluing the currency at the official FX markets and improving flexibility and communication in the FX framework. Without flexibility, it is only a matter of time before the FX misalignments build back up, leading to more pressures to implement another outsized currency devaluation. Accordingly, we believe a currency devaluation followed by periodic communications allowing the local currency to depreciate in line with fundamentals will be tenable as power changes hands in 2023. On the fundamentals, the CBN can enable the currency to depreciate yearly based on the external balance assessment after considering inflation, net foreign assets, current account gap, and growth. Clear communication and commitment to this framework will be crucial to bringing back credibility and significantly reducing FX volatility.

For fiscal operations, we highlight that majority of the government spending is on personnel costs & overheads (29.7% of total expenditure) and debt servicing (30.8% of total spending), which are sticky, making it difficult to reduce the fiscal deficit amidst a low revenue profile. Also, rationalising the public workforce with no private sector absorption could compound the unemployment headaches in the country. Thus, while we believe most of the expense items are sticky, removing duplicated projects and cutting wasteful spending would go a long way in reducing the cost of governance and narrowing the fiscal deficit in the medium to long term. Moreover, freezing new employment in the public sector and creating an enabling business environment could help improve the country's employment situation while relieving the government of pressures to absorb unneeded labour into different parastatals.

Overall, we expect the growth momentum to be sustained in 2023FY, slightly higher than 2022E levels, primarily due to our expectation of the oil sector's performance turning positive after three consecutive years of negative performance. Our oil sector's positive outlook follows the low statistical base effects in 2022E and the government's efforts at tackling crude oil theft and pipeline vandalism. Elsewhere, we expect the non-oil sector to maintain its resilience, although growth is likely to come lower than 2022E levels given the trifecta impact of (1) tighter credit conditions, (2) flood-induced slower pace of Agriculture GDP growth in H1-23, and (3) higher inflationary pressures. On a balance of factors, we expect the oil and non-oil sector to grow by 12.40% y/y and 2.45% y/y, respectively, in 2023FY. Sequentially, we expect the Nigerian economy to grow by 3.02% y/y in 2023FY (2022E: +2.72% y/y).

Aside from looking at the GDP expectation using our estimates for performance across the different sectors of the economy, we think 2023FY growth will be

undermined by the impact of some monetary and fiscal decisions undertaken in 2022. For one, should the CBN not extend the deadline for making the old banknotes cease to become legal tender, we expect traders will be reluctant to accept old notes by the time the CBN starts rolling out the new banknotes on 15 December. As a result, the preceding could reduce trade flows, increase uncertainties, and negatively affect aggregate output. Elsewhere, high-interest rates in line with the CBN's tight monetary policy stance could suppress activities in interest rate-sensitive sectors, including the manufacturing, trade, construction, and agriculture sectors.

Financial Markets.

Precis.

The year 2022 was an auspicious year for investors in the financial market. As the global economy came under significant pressure, the domestic financial market's performance mostly tracked well with original expectations, with the variance stemming from the lower-than-expected yield rise.

The fixed income market was quite volatile in the year, with yields trending northwards and touching levels last seen in 2019. A switch to a hawkish stance by the Monetary Policy Committee of the CBN and the demand and supply imbalance drove the upward tilt of the naira curve. However, we believe the rise in yields should have been steeper, considering the government's inability to implement its external debt issuance program, which should ordinarily increase the FG's reliance on the domestic market. However, this eventuality was circumvented by the FG's continuous use of the CBN's Ways and Means.

On the other hand, the equities market's performance was mixed. A combination of significantly positive earnings with its associated dividend declarations, an accommodative monetary policy stance, and sustained FPI interest in fungible stocks underpinned the stellar H1-22 performance on the domestic bourse. However, the story turned sour in the year's second half, as investors rebalanced portfolios following the uptick in fixed income yields and a shortfall in liquidity, given the deliberate actions by the monetary authorities to hike interest rates. It is pertinent to note that the impact of electioneering activities on the equities market was less pronounced than in previous pre-election years.

In 2023, all signs indicate a sustained northward movement in fixed income yields, with intermittent periods of upward pressure in Q1-23. The factors supporting our thesis include (1) a sustained tightening in the global financing conditions, though at a much slower pace, (2) a sustained imbalance in the demand and supply dynamics, (3) monetary policy administration, and (4) the electioneering process outcome and fiscal policy management after that. Assessing all the factors, we estimate that the yields on Treasury bills and bonds will increase in the year and settle at c.12.8% and c.15.5% by the end of 2023FY.

For the equities market, we posit three scenarios for market performance next year - base, bear, and bull cases. In the base case, which is the scenario that we believe is most likely to play out, we expect a combination of (1) positive corporate earnings, (2) a muted uptick in fixed-income yields, and (3) investors' positive reactions to the election's outcome, will support market performance and lead to a 3.5% return for 2023FY. In the bear case scenario, we assume a blend of (1) significantly weaker corporate earnings and dividend pay-outs, (2) a higher-than-anticipated uptick in fixed income yields, and (3) a sudden violent

turn in 2023 election activities to drive apathy for stocks, to pressure the market performance. Finally, the bull case scenario expects the global economy to rebound within the year, and capital inflows strengthen as investors hunt for alpha. However, we still expect a disconnect between company fundamentals and valuation multiples.

We present our views on the different sectors we cover in the following sections:

Financial Services (Banking): For 2023FY, we believe Nigerian banks will maintain their growth trajectory supported by core income, owing to higher loans and investment securities yields. Although, we think banks will be cautious about growing loans domestically in 2023FY as the tight monetary conditions will likely limit risk asset creation. On the external front, Moody's downgraded nine Nigerian bank's long-term ratings based on the weakening in the Nigerian government's fiscal capacity to support the country's banks, and interlinkages between the sovereign's weakened creditworthiness and the banks' balance sheets, given the banks' significant holdings of sovereign debt securities. Although, we expect non-core income to support earnings in 2023FY, albeit marginal, as the price sharing and glitch on the e-banking platforms will continue to impact the performance. In addition, we believe this will negatively impact Nigerian banks looking to raise debt externally. Our top picks are (1) **GTCO (BUY, TP: NGN28.21/s)**, as the company maintains a leadership position in operational efficiency, and (2) **ZENITHBNK (BUY, TP: NGN26.91/s)**, given its dominance in the corporate and retail segments of the industry.

Industrial Goods (Cement): For 2023FY, we envisage solid growth in revenue for firms under our radar on the back of higher prices of cement and leverage of exportation strategy. On the flip side, we highlight that the higher inflationary environment will continue to pressure the operational activities of firms in the industry. Consequently, we believe companies that can maintain operational efficiency and optimise plants to enhance fixed cost absorption will be better placed to deliver decent earnings in 2023. Overall, our top pick for the industry is **WAPCO (BUY, TP: NGN32.31/s)**.

Agriculture: Despite the challenging operating landscape, factors such as CPO import restrictions amid current FX liquidity challenges and long-term sector growth prospects remain favourable for sector players. Thus, we remain optimistic about **OKOMUOIL (BUY, TP: NGN242.81/s)** and **PRESCO (BUY, TP: NGN213.37/s)**. For OKOMUOIL, though we do not expect a significant increase in its maturities, we believe the upgrade of the milling capacity at the Okomu II plantation will cause an improvement in its production efficiency and in turn, its volumes. For PRESCO, we expect the producer to deliver revenue expansion supported by improved volumes.

Consumer Staples: Across our coverage universe, we expect most **HPC** names to report single-digit volume growth over 2023 as we expect the high inflationary pressures to persist (Cordros estimate: 18.01% y/y), thus, keeping consumer spending in check. Nevertheless, we believe the agro-allied and the brewery subsectors will lead the next growth phase. Accordingly, we see scope for earnings growth for **Agro-allied** names – **FLOURMILL (BUY, TP: NGN63.12/s)**, **NASCON (BUY, TP: NGN27.84/s)**, and **DANGSUGAR (BUY, TP: NGN26.31/s)**, given the inelastic demand facing their products and the ability to implement more significant price increases than peers. In contrast, the HPC's growth will be more muted due to more exposure to foreign currency volatility and cost pressures. For **Brewery stocks**, **NB (BUY, TP: NGN60.71/s)** and **GUINNESS (BUY, TP: NGN93.25/s)**, we expect price increases and premiumisation to remain supportive of earnings growth amid cost pressures arising from higher excise duties and the high inflationary environment.

Oil & Gas (Downstream): We expect the price cap on PMS to remain in place, though we acknowledge the possibility of a hike in the product's price. We expect the NNPC to remain the sole supplier of the market, pending the potential commissioning of the Dangote Refinery in 2023. As structural issues persist, we highlight that individual product sourcing will remain a big challenge for downstream players. Our top pick remains **TOTAL (BUY, TP: NGN435.35/s)** as we expect the company to maintain its resilience in 2023, leveraging its ample storage and distribution network to sustain its control of sector volumes.

Disclosures.

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BUY (OVERWEIGHT) - Over the next twelve (12) months, we expect the stock to return at least 20% above the current market price.

HOLD (NEUTRAL/EQUAL WEIGHT) - Over the next twelve (12) months, we expect the stock to range between <-10% and <+20% from the current market price.

SELL (UNDERWEIGHT) - Over the next twelve (12) months, we expect the stock to be more than 10% below the current market price.

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