Travel Journal Nigeria 2015

TUNDRA FONDER

Introduction

So it was time to again visit Nigeria, Africa's largest economy and one of the most important markets in frontier markets. Before the price of oil fell below USD 100/barrel Nigeria was an economy in an enviable situation, something which dramatically changed during the autumn and winter of 2014 when the oil price in a period of only a few months halved. A new situation for a country that suddenly lost one of their few clear comparative advantages. When these words are written (November 2015), the stock market in local currency, from the peak in early July 2014 to date, has fallen 35% in local currency, 47% in USD and 33% in Swedish kronor. Valuations have come down significantly, for many companies to levels where we again find value. With that said, it's also important to make an assessment of the negative dynamics of a country that, provided that oil prices do not change dramatically, in the coming years will go through a very painful transition period. Conditions change. Old rules potentially no longer apply.

From Amsterdam to Lagos

We went there early in the summer to see first hand the impact on listed companies and receive input regarding our current and future allocations to the stock market. What seems to be a grim introduction must not overshadow the fact that Nigeria, with its 160 million young population (median age in 2014 was 18 years), large reserves of oil and gas, as well as its strategic location between Central and West Africa, has the potential to become one of the more important equity markets outside the developed world. Timing of an investment is however of utmost importance and prerequisite for timing is knowledge. What is a better time to visit a country than when it is dismissed by most of the world's investors?

Happy reading!

Mattias Martinsson

Chief Investment Officer, Tundra Fonder AB

Towards Lagos

Getting to Nigeria is a relatively smooth flight, just below 11 hours with a stop over in Amsterdam. With necessary travel documents, including a certificate of vaccination for yellow fever, we arrived on time, at 19.15 local time. We noted that the recent gains from oil had not been allocated to the international airport.

Outside the Murtala Muhammed Airport Saturday evening

A one-hour wait for the baggage gains was followed by an hour's drive to the hotel. We noted that in terms of pricing hotel prices in Lagos are 2-2.5x the levels in Karachi and slightly above the levels in Kenya, i.e., 2 500-3 000 SEK/night.

Sunday morning in Lagos

On Sunday we decided to take a stroll with visits to some local shopping centers as a natural starting point. The hotel we stayed at was in a relatively quiet area which allowed a few kilometers walk through both residential neighborhoods and commercial centers.

Mattias outside a reseller of MTN (Nigeria's largest cellular operator)

Shamoon on the streets of Lagos

As usual, we took the opportunity to examine the range of products. The dominance of foreign brands was striking in the organized trade and the huge price differential was observed between foreign and domestic brands.

Mattias compares pricing of Flour Mills' (one of our past portfolio holdings) different pastas

The usual big contrasts in the street environment - new luxury buildings side by side with neglected roads

Our first meeting on Monday was with Flour Mills, one of Nigeria's largest food producers. As can be implied from the name, the company's business initially was wheat flour production. Wheat is imported to Nigeria given poor climate conditions to grow wheat in Nigeria. With the years the company has refined its products and is now one of the largest producers of pasta, noodles and biscuits. The company has also expanded into sugar processing. The company's primary strength is its distribution capacity. Moving into sugar production was for example motivated primarily by opportunities to sell related products through the same sales force, thus achieving economies of scale.

Outside the factory, we see hundreds of Flour Mills own transport vehicles

As for most of the companies in the consumer industry Flour Mills imports large parts of the raw materials used in production. In combination with a weaker economic activity their ability to pass on higher costs are currently limited. In the face of this their high leverage is a bit worrisome. Despite the fact that the shares have fallen nearly 80% from their peak in mid-June 2013 we see risks of further downside in the short term.

After Flour Mills we went on to **Oando**, one of Nigeria's oil and gas producers. The company has reserves of about 420m barrels of oil equivalent (boe) out of which 60% consists of gas and produces about 20m boe per day. For the company to report a profit, the company needs an oil price of around USD 50-55 / barrel and for a positive cash flow (before investments and interest payments) oil price should stay at USD30/barrel. We got a good roundup of Nigeria's relatively complex energy policy, in which conclusions for us were that it continues to make sense to avoid this sector at present – and not only because of the low energy prices. There are long-term tremendous opportunities for Nigeria to better exploit the country's gas reserves, not least to facilitate increased electricity output. We do not see that there is a clear cut strategy to achieve this at present however.

Tundra meets Oando

After Oando it was time for meetings in the banking sector. First meeting was with **Zenith Bank**, which is one of our larger holdings. Zenith Bank is one of Nigeria's three largest banks, which means that we get a good insight into the economy and the banking sector's current status. In accordance with the consensus Zenith Bank also expects further devaluation of the Naira in line with futures contracts on the Nigerian Naira indicating 10-15% by the end of 2016. On the positive side, we note that the crisis of 2008-09 (last time oil prices collapsed) means that the majority of banks, including Zenith Bank, have been relatively conservative in its lending to the energy sector in recent years. Zenith Bank today has 20% of its lending to the energy sector (including 8% to oil and gas producers). A long-term oil price below USD 50/barrel may create problems for oil producers but bank loans to the energy sector is stress-tested down to levels just below USD 40/barrel. Private credit as a percentage of GDP in Nigeria is currently at around 25%, which is about ¼ of the OECD average. Growth prospects for the banking sector in Nigeria thus look good for the long-term. As shareholders in Nigerian financials, our primary focus is to be comfortable with the level of risk the banks take.

We left the meeting with Zenith Bank as happy shareholders.

Shamoon and Mattias with Zenith Bank

Lunch time traffic in Lagos

After Zenith Bank we were off to **Transcorp**. The company is a fairly sprawling conglomerate, whose assets currently consist primarily of hotel properties and power but where future investments will increasingly be allocated to the energy sector, specifically gas and gas-fired power plants. It tells the story of an ambitious project that aims to develop vertically integrated gas-fired power plants that include both the development of a recently obtained gas license, pipeline construction and the expansion of its power generation capacity by 2,000 MW. A quick rough estimate suggests that it involves an investment of USD 2.5-3bn, which in the current financial climate in Nigeria may seem ambitious and entails some execution risk. It is however always interesting to meet visionary managements. The idea of making better use of Nigerian gas to generate cheap electricity is good.

Mattias and Shamoon with Transcorp's CEO

On our way to the next meeting, we were reminded of one of Nigeria's more serious problems - the terrorist organization Boko Haram. In several places in the cities, we found posters with the names of the more than 200 girls who still are missing after Boko Haram's attack on a girls' secondary school in April 2014 with a call to the government to resolve the issue.

Posters calling for the government to rescue Boko Haram abducted girls.

We then took off for **Dangote Cement**, Nigeria and Africa's largest cement producer. Here we had the privilege to meet the company's relatively new (February 2015) CEO, Onne van der Weijde and CFO Brian Egan.

Dangote Cement is an exciting company and an example where aggressive expansion has paid off, both in terms of market share and in margins. The company is currently the most profitable cement producer (to our knowledge) in the world. The best located limestone reserves found in close proximity to the manufacturing facility and access to cheap gas partly explain the advantageous position. Explanations can however also be found in their bold expansion, thereby curbing competition, and availing tax breaks. The company has kept capacity utilization well below 80% for a long time. It is very rare that a company which is expanding its capacity as quickly as Dangote Cement has done during the last ten years, manages to do this while maintaining profitability. The company impresses with a well thought out expansion strategy and has executed almost flawlessly despite its aggressive rollout. Looking ahead, however, the expansion outside Nigeria will increasingly be more important and in that expansion the company will lose some of the benefits it has today (superior limestone deposits and low gas prices, and sometimes tax holidays). In addition, we are somewhat concerned about the fact that the company is now also adding coal as a fuel source for clinker production in Nigeria. The company does not want to go into the reasons for this but the conspiratorial mind can imagine a political desire for more market based prices for gas (to stimulate the production) in Nigeria in the coming years. Assuming sharply lower oil prices is hampering economic activity in Nigeria in the coming years demand is also likely to slow, while the tax holidays the company is currently enjoying fade (at present the company pays no tax), which will trickle straight down to the bottom line. The company's net margins of 40% are of course not sustainable. Despite the decline of nearly 40% from the highs the valuation P/E of 13x is not very low considering the risks ahead.

Mattias and Shamoon with Dangote Cement's CEO and CFO

We then went on to meet **Stanbic IBTC Holdings**, a Nigerian bank operating in the premium client segment. Stanbic is one of the most prestigious banks in Nigeria known for its conservative accounting policy. The business was built initially on the basis of lending to international corporates and asset management. Only in 2007 the company began to also target retail clients in order to improve access to cheap deposits. The traditional banking operations currently represent around 60-65% of the company's profit before tax, while asset management constitute 35-40%. The most interesting part of the company's business in our eyes is its pension wealth management. The background is the Nigerian pension system that was formed in 2004. The companies set aside 10% of the gross salary and the employee allocates slightly less. A total of 6-7 million Nigerians (i.e., those that are "officially employed" - primarily government employees) are now covered by the pension system, but that number increases by around 10% annually. Stanbic's pension wealth management holds above 20% market share and is thereby the market leader. The total pension system amounts to about USD 35bn and Stanbic's pension management arm manages approximately USD 7 billion. The average gross income is currently at about 1%, but should drop as the pension system grows. Profitability in wealth management is understandably high (45% return on equity) and the future growth potential seems high given Stanbic's strong local brand.

Tundra with Stanbic's executive leadership

On our way to the next meeting, we saw an interesting example of the recovery of bad debts in the banking sector - an oil rig was towed to the center of Lagos as the borrower was not able to follow the payment plan.

"Well anchored security"

As the rain poured down we arrived at the meeting with **FBN Holdings**, Nigeria's largest bank in terms of assets. We had another interesting discussion about the condition of the Nigerian economy and in which sectors problems can be discerned. FBN Management also expects a 10-15% devaluation. FBN is the bank that has the highest exposure to the energy sector (40% of the loan book). A slightly lower status than the other major banks means the customer clientele quality is also slightly below the average level, which in itself translates into somewhat higher credit risk. We have thus adopted a slightly more cautious view given greater historical problems with risk management. After obtaining a review of the loan book distribution, we noted that the risks over the next 12-18 months, in light of valuation (P/E 3x, P/BV 0.3x), seem fairly conservatively priced in.

Tundra with parts of FBN Holdings' management

Our last meeting, during this relatively short trip was with **United Bank of Africa** which is one of our major Nigerian holdings in both our frontier funds. Like its competitors, the bank anticipates further weakening of the Naira in the next twelve months, albeit at a more modest rate of about 8-10%. We got a very thorough review of the loan book, whose diversity supports our thesis that the disaster that the market is now pricing in will be very difficult to achieve (although not impossible). The valuation of just above a P/E of 2 discounts for possibly overestimated profits for years to come. It is required however also that such a bottom is reached without a subsequent recovery in the years that follow thereafter. We believe there is value to be attained in the shares.

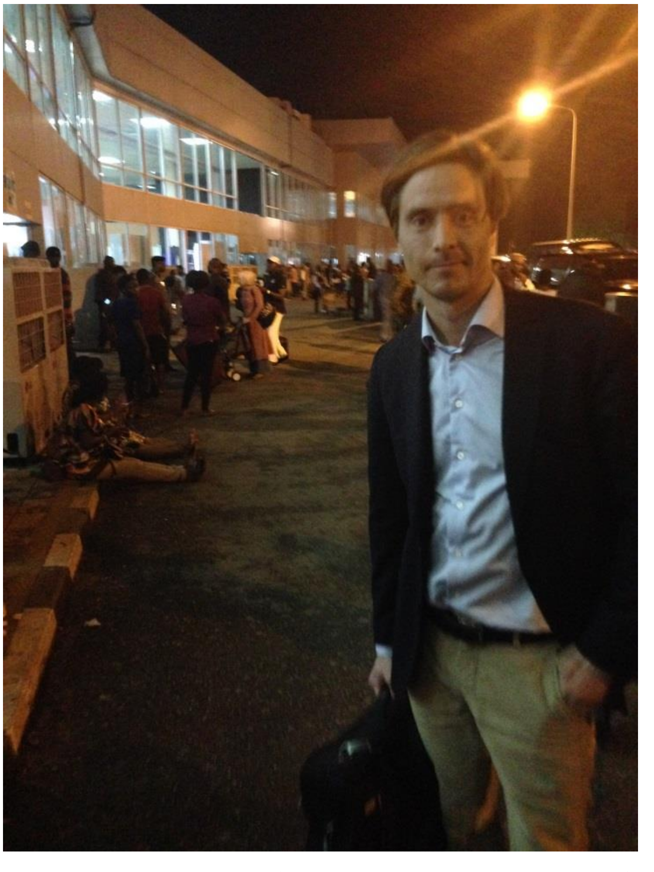
Mattias and Shamoon meet UBA's management

Our flight was scheduled for 22:00 and the meeting with UBA ended at 15:30. We were thus somewhat surprised when we were told by our hosts that that we would have to head for the airport immediately. It turns out, however, that we barely managed to get to the airport (almost 30 kilometers) in 5 hours, despite police escort.

In good company

During the undersigned's nearly 20 years of travel in emerging and frontier markets it is actually the first time I nearly miss a flight.

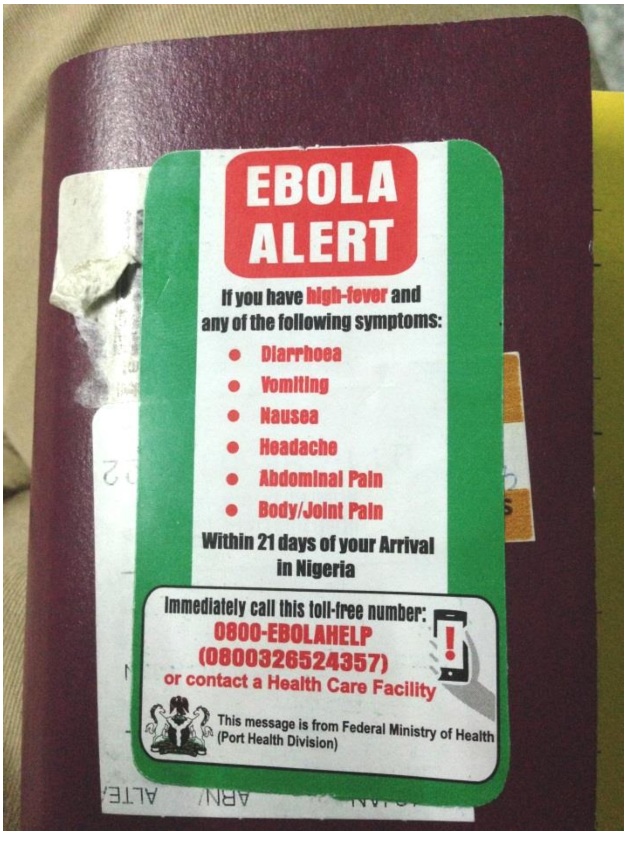
Sports entertainment during a less amusing car trip



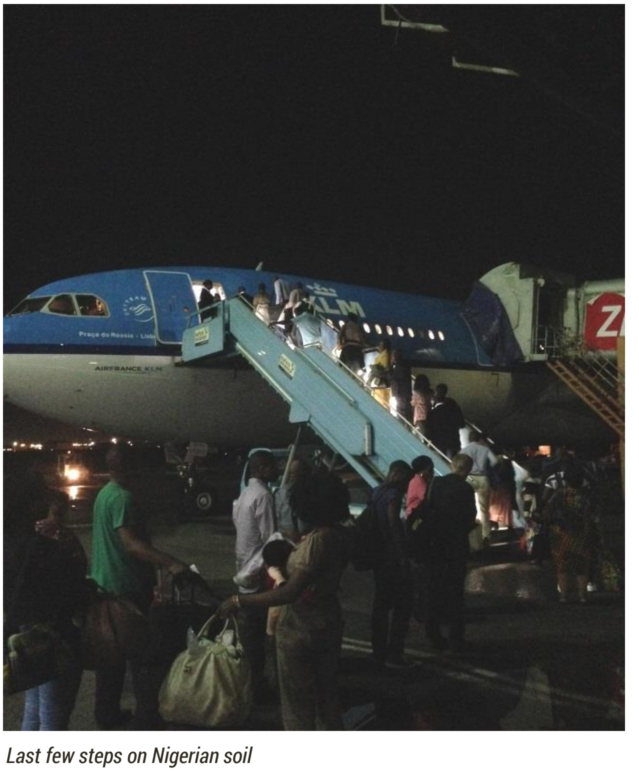
A final picture outside the airport (which nearly cost us our seats on the plane)

There are several conclusions to be drawn from the journey. We do not believe in a sudden collapse of the Nigerian economy. The banks appear to be well-prepared, most likely due to the fact that the crisis of 2008-09 and 2011 is so close in time. If oil prices remain below USD 50/barrel for several years, the country will be facing a major restructuring that even with the strongest political commitment will take time to implement. From an investment perspective, we see that the banking sector tends to be early to discount new conditions. Prices have been pushed to what are likely to be excessively low levels on risks we believe are relatively obvious. Current levels offer strong future returns which can not be completely ignored even though the through in prices will be hard to call. We are much more cautious towards the consumer sector. Here too prices have fallen sharply, but valuations are still high in the wake of international investors' sometimes overly naive search of "safe and structural growth" in recent years. Too much has been paid for too little growth historically. The correction has thus been initiated from already inflated levels. There is likely more downside ahead. Most of the companies in the consumer sector import a large part of the goods used in the manufacturing process because of lack of local options. Most likely, we will see a further significant weakening of the Naira which increases production costs for those manufacturers. Given weaker domestic demand, such costs will be difficult to pass on to the final consumer, which could squeeze margins. After the presidential shift and with the new government in place we expect a harder (necessary we think) attitude regarding tax collection. The clearest example is the requirement of Africa's biggest mobile operator MTN to pay a specified tax liability of above USD 3 billion, taxes that were allegedly hidden from the tax authorities of Nigeria. In the absence of oil money, the new regime will need more alternative incomes. One of the world's lowest alcohol taxes (6% of the factory price) with a newly appointed Muslim president is a specific risk to the largest Nigerian company, Nigerian Breweries (we don't own the shares).

Our summary may appear pessimistic. We would say it rather reflects our generally cynical view of the markets we monitor and what is required for us to include companies in our portfolios. Africa in general and Nigeria in particular, will provide great investment opportunities in the coming years. It is necessary however that investors keep a safety margin towards the risks such investments entail. Ultimately our job is about finding companies which offer strong value at somewhat the right time. To invest in Nigeria at this point of time requires a signficant safety margins in valuations.



Travel memory – Unfortunately had to take it off for a new trip a few weeks later



Last few steps on Nigerian soil