

NAIRA DEVALUATION JUNE 2016



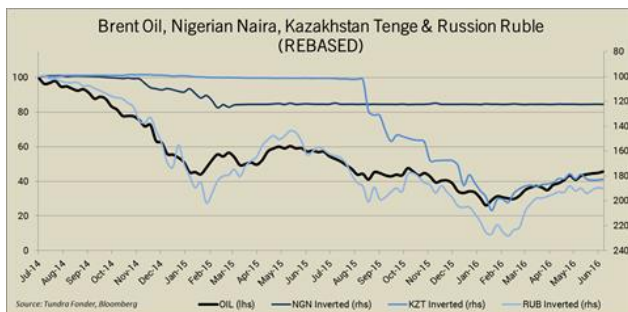
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Nigeria devaluation - Summary

Nigeria has expressed its intentions to let the market determine the value of the Naira starting Monday June 20th after 15 months of a central bank kept rate at 197 Naira per USD. As a result of the Central Bank of Nigeria (CBN) controlling the rate, the access to USD has gotten worse leading to large parts of the economy struggling. The economy has deteriorated fast in 2016 and Nigeria recorded negative GDP growth in the first quarter. The devaluation is long overdue, and a key factor in restoring investor confidence in the Nigerian economy. We are now more positive on the long term outlook for Nigeria and still believe it offers the biggest opportunity in Sub-Sahara Africa, but near term will be volatile, especially in the first week with the new currency structure. The value (in USD) of our Nigerian holdings will take a hit on Monday, but market reaction should continue to be positive and it is possible the devaluation effect is neutralized by higher share prices within a couple of weeks.

Background

Even though oil is less than 15% of GDP in Nigeria, 90% of Nigeria's FX revenue and more than 60% of Government revenue come from the sale of oil related products. The fall in oil price has led to enormous pressure on the foreign exchange reserve and government spending capabilities. But the government has, unlike most other large oil exporting economies like Russia and Kazakhstan, resisted devaluing the currency. And even though oil has come back from its lows it's still a long way back to USD 100/bbl.



To preserve the FX reserve, which has declined from USD 40 bln in 2014 to USD 26 bln today, CBN introduced several administrative measures to decrease the demand, without any significant success. Since Nigeria imports a lot of basic necessities for day-to-day life, such as rice and petrol (yes they export oil but import the refined petrol) the measures instead led to increased demand in the "parallel market" (basically black market) where the Naira now trades

around 350 per USD (compared to the official rate of 197 per USD). One of the reasons CBN as well as president Buhari have raised against devaluing the currency is the lack of benefits for the country and that it would hurt the lowest income groups since it would soon transfer into price inflation. The current policies however led to inflation anyway since importers had to go to the parallel market for their foreign currency. It also led to petrol shortages since the fuel importers stopped importing when they couldn't access USD through the Central Bank any longer, which hurt their margins and eventually led to a loss making business (since pump prices are regulated).

Wake Up Call

The fuel shortage together with the negative GDP growth in Q1 2016 served as a brutal wake up call that the current situation was not working and a first step was to partly deregulate the fuel prices and come up with a new formula that based the price on an FX rate of around 285 per USD. For the consumers that meant paying almost 50% more than before, but on the other hand supply was no longer an issue. And with inflation rising rapidly (+15.6% in May YoY), GDP growth stalling, the resurgence of attacks on crucial oil pipelines, trying to finance a huge budget deficit (caused by a very expansionary budget to restore growth) the president as well as CBN now have come to their senses and adjusted the FX policy. From June 20th the price of the Naira will be set by the market, although CBN will selectively intervene in the market.

Where do we go from here?

The market was looking for a devaluation to at least NGN 280 per USD and with as little involvement from CBN as possible, so in that respect the new structure is good. It doesn't take much to improve from the current situation, but restoring full confidence from the investment community will be a longer process. A year ago it would have been much smoother, but later is better than never. President Buhari's commitment to crack down on corruption and deal with Boko Haram as well as the Niger Delta Avengers (the group behind most of the attacks on oil pipelines), should find it easier to finance his expansionary budget which should restore growth. And longer term this was a band aid that needed to be ripped off even though the short term effects will be painful before we see things improve.

Where do we go from here – cont.

On Monday June 20th, when the new guidelines are implemented, we will see a significant devaluation of the Naira. We can't be sure on how much, since it will be set by the market. Our "guesstimate" is that it will be very volatile first couple of days when pent up demand is released and (supposedly) met by new inflows attracted by the much improved investment case. It is more likely that the market overshoots on Monday than the opposite, with new investors taking a wait-and-see approach. We could see the currency fall to where the black market rate has been of late, around 350 per USD, but judging by most analysts' views on fair value the Naira should stabilize below 300 per USD, a 30% devaluation. There is possibility, but less likely, that CBN intervenes already on Monday to make the initial fall less dramatic and tries to stabilize the Naira around 250 per USD.

Effects on companies

The effects on the bottom line for the companies is difficult to estimate, it obviously depends on their pricing strategy, but it is likely that consumer companies will take a bigger hit than the banks, with consumer income already under pressure it will be hard to raise prices. Banks on the other hand have assets in USD that will be worth more in Naira after the devaluation, and better access to foreign exchange should lead to more business opportunities. At the same time banks will see part of their loan book deteriorate when customers find it harder to service their loans due to worse profitability. Oil companies should benefit since they have a lot of their costs in Naira but revenues in USD. Net net for the market it should be a positive, since the overvalued Naira has been one of the main reason for lack of foreign interest and also led to MSCI now reviewing the potential exclusion from the Frontier Markets Index (to be decided in November 2016). That should now be less likely

Effect on our funds - Expect volatility

The Nigerian holdings in our funds will most likely lose around 30% initially (in USD terms), so for the Nigeria & SSA Fund (where Nigeria has to be at least 51% of assets) will see an initial hit on the NAVs of around 15%. The interest in the Nigerian stock markets has already increased since details were released on Wednesday (with market approx. +7%) and we will most likely see the continued increase in interest over the coming months. We should see the effects of the devaluation neutralized within a couple of weeks, if not days. The Nigerian banks are very attractively valued, with several of them trading below 0.5x book value and yielding around 10% so even a scenario with a sharp rise in NPLs seems to be priced in.

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