November 2017

West Africa – Abidjan, Accra and Abuja

Trip Notes

We visited the three West African nations of Côte d'Ivoire, Ghana and Nigeria during November. We met representatives from the government, the financial institutions of the countries, multinational institutions, embassies, domestic investors, think tanks and members of the media. All three countries have fairly recently experienced external and domestic imbalances and have new governments, with plans for structural reforms. Growth is generally strong, but increasing government tax revenue remains a challenge.

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- 25 meetings with a wide range of stakeholders, during five days and three countries.
- We remain very positive on the external debt of Côte d'Ivoire and Ghana. We tactically reduced our hard currency exposure to Nigeria, in order to benefit fully from attractive issuance in November.
- Correspondingly, we are very positive on Ghanaian and Nigerian domestic debt and remain invested in Ghana in all three local currency funds and in Nigeria in our Frontier fund.
- Local currency investments in Côte d'Ivoire offer an attractive risk-return profile and we expect to be invested there in the near future.

Côte d'Ivoire

Côte d'Ivoire experienced a brief civil war in 2011 that originated from the contested presidential election in 2010. The internationally recognised winner of the elections, president Alassane Ouattara emerged victorious from the crisis in the end and secured a second electoral win in the 2015 elections. The country rebounded quickly and has been among the fastest growing economies in Africa ever since.

Successful IMF-program execution

The country has been in a three year IMF-program since the end of 2016 (ECF and EFF) to support the government's development agenda and help with the resulting balance of payments issues. The government has shown a clear commitment to the objectives of the program and reached all their targets. It is widely accepted that the current authorities are very capable, with several senior figures having had international careers in the private sector and the president having served as the Deputy Managing Director of the IMF.

Growth is seen to average 7.25 % in the medium term. The country has huge growth potential by itself, but is also widely considered as a regional hub serving a market of over 100 million people in francophone West Africa. Currently 25 % of inhabitants are foreigners, who send large amounts of remittances to their home countries. Other important factors why Côte d'Ivoire is the local economic powerhouse include the reliable power supply, good access to ports and logistics, developed financial markets and strong agribusiness. Global businesses like Bayer, VISA, Oracle and Caterpillar have all opened offices in Abidjan. The size of the economy might also not be fully accounted for, as the current base for GDP-calculations is 2009 and there are plans for rebasing this.

Agriculture remains main driver in economy

Agriculture and related industries are still main drivers for the economy, as they form around 30 % of GDP, around 60 % of exports and employ around 60% of the active population. Cocoa forms the single most important crop, affecting around 7 million Ivorians and comprising 40 % of exports. The country is set to produce around 2 mio tonnes in 2017 (40 % of world output) and together with Ghana they form around 60 % of world supply. Cocoa prices have drastically depreciated since their highs in 2015, posing a large socio-economic challenge for the country. There are, however, plans to co-ordinate sales with Ghana and increase the amount of local processing and thus moving up in the value chain, mitigating the effects of the price volatility. The authorities have so far refrained from large scale subsidies of cocoa farmers. The country is also the largest producer of cashews in the world and an important producer of rubber. There is still ample room for agro-industries, as most of the production is unprocessed.

> **"The government has shown a clear commitment to the objectives of the program and reached all their targets"**

Sectors outside agriculture that are notable and growing are mining, telecom, construction and finance. The banking system is deemed healthy, with contained NPL's and credit growth at 16 %. There are also hopes that oil exploration will bear fruit, like it has in Ghana and Nigeria. Building and public works are the fastest growing sectors, on the back of the government's development plan.

The authorities realise that they cannot finance the development plan with current levels of tax collection, otherwise debt will grow too high (public debt to GDP still moderate at 42 %). Budget deficits are projected to be restrained at -3.75 % in 2018 and -3 % 2019. Public wages form a large part of expenditures and restrictions on hiring have been set in place, apart from education, as investments in social capital are prioritised. The challenge is to increase revenues, burdened by VAT-exceptions and the large informal sector, estimated at 40 % of GDP, e.g. most farmers are outside the formal economy. The government has plans to increase tax revenue by 3 %. by the end of the program, which would be very positive for debt investors.

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The power supply situation is very strong, with a household electricity coverage of around 80 %, one of the highest in the region, supporting the industrialisation process. The country even exports energy to neighbouring countries. Renewables form 45 % of supply after the completion of the Soubré dam and solar panels are seen as suitable small scale generation for rural villages.

WAEMU

The West African Economic and Monetary Union has been very successful in lowering inflation (estimate 1.5 % 2017) and decreasing the volatility of growth in the region. The eight member countries have pooled reserves (4.3 months import coverage, going to 5 next year) coupled with strict rules on deficits, the central bank does not lend to the governments and there is free movement of individuals across the region. The common currency the West African CFA franc has been pegged to the French currency since 1994. The IMF considers the REER in line with economic fundamentals for the union and even slightly undervalued for Côte d'Ivoire. The peg is very well protected at the moment. There is even a common securities exchange in Abidjan for the union. The central bank, BCEAO have their next meeting 6.12, but higher rates are improbable.

Political Risks

In our view, the largest risks in the country are political, as the 2020 presidential elections are approaching and the result is far from clear. Ouattara's coalition partners, the PDCI, claim that the next presidency was promised to them, and the president of the National Assembly, Guillaume Soro also has presidential ambitions. At the same time, Ouattara has several times stated that he will not seek re-election and has nominated his own apparent favourite successor, Amadou Coulibaly, as prime minister. The armed forces are also a factor, especially since dissatisfied units of the army staged a short-lived mutiny in the spring of 2017. The soldiers were paid the bonuses they were owed and returned to their barracks. There are, however, fears that Soro controls the army and that it could be leveraged during the elections. Preventive measures have been taken though, including reconciliation and demobilisation plans, with financial incentives coupled with further inclusive growth programs, especially targeted at the north, where the fruits of the economic growth have been scarcer. Additionally, elite forces are being trained abroad and the French have a base with several thousand soldiers in the country. There is also a feeling in the country that past mistakes will not be repeated.

Our View

We are very positive on the external debt of Côte d'Ivoire, especially the EUR-denominated bonds which offer attractive yields. The country is planning increasing the amount of domestic funding in the future and the rest to be done through concessional funding, e.g. the recent $525 mio approval from USA for educational projects (2015 law for compulsory education). There are no plans for external issuance in 2018. Local currency investments in Côte d'Ivoire offer an attractive risk-return profile (pegged currency) and we expect to be invested there in the near future.

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Ghana

Cocoa, gold and oil

Ghana is the second largest producer of cocoa in the world and agriculture remains an important part of the economy. Little is however still processed in Ghana, so the sector is vulnerable to commodity price volatility along with the Harmattan season, a local weather phenomenon that decreased the harvest a couple of years ago. 80 % of the cocoa production is, however, sold with forward contracts, decreasing budgetary uncertainty. The government purchases the cocoa from the small scale farmers and has not decreased the prices paid along with global market prices, amounting to a subsidy around 1bn cedi.

Gold mining is another important sector (98 % of mining activity), Ghana being the second largest producer of the metal in Africa. All but one of the producers will be able to increase their production in 2017, on the back of higher prices and improved power supply, after years of unstable power availability. Electricity is expensive, but now more reliable, which has been good for investments. There also are talks of privatisation on the generation side, perhaps further improving the situation. Illegal mining has been a problem in the country and there have been some skirmishes between soldiers and the illegal miners. The government also regulated the use of dangerous chemicals in the mining industry, which affected the standard of living and crops of nearby inhabitants.

There are plans to increase domestic production of the mining

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and other industrial sectors' inputs, e.g. an integrated aluminium industry on the back of bauxite excavation and the production of cement using local limestone. *One district, one factory* is an often mentioned initiative, where the government has pledged $1 mio per region to jumpstart the manufacturing sector and incentivise the private sector to set up factories. Private sector credit is currently growing at 8%.

Hydrocarbons will contribute an increasing amount to the economy and government revenues, as large offshore fields in the western part of the country have come online recently (Tweneboa Enyenra Ntomme in 2016 and Sankofa in 2017). GDP-growth in 2017-18 will be driven by the oil sector. Non-oil growth is projected to be 4.6% in 2017 and total growth a healthy 7.9 %. GDP-growth for 2018 is seen to stabilise at 6.8 %, where non-oil plays a larger role at 5.4 %. The base year for GDP-calculations is 2009 and there were talks of a re-basement.

It's all about fiscal

The IMF has had an Extended Credit Facility in place since the spring of 2015, recently extended to 2019. The aim of the program is to restore debt sustainability and macroeconomic stability after large fiscal and external imbalances.

The new administration found previously unreported public liabilities in the very beginning of their term, and the programme targets had to be revised. The fund is in the midst of a program review, where fiscal performance of 2017 and the 2018 budget and revenue mobilisation will be key. The government had very optimistic revenue expectations this year, and they are currently 5 %. behind the target. Expenditure has however been contained, and it is believed that the government is on track and passionate about meeting deficit targets. Growth is again key.

Wages are the biggest cost and there is a freeze on public sector recruitment, although education and health care are exempt. Wages are politically difficult expenses to cut. Interest rate costs are the second largest expense. There are several initiatives to contain costs, for example the *Ghana Integrated Financial Management Information System*, for improved centralized budgeting. The Treasury Single Account is another improvement, where all government accounts are consolidated into the central bank. A fiscal deficit act is currently in parliament for approval, which would cut deficits at 5%. The goal is to enforce fiscal stability with the law, entrench institutions strongly, so that fiscal discipline is assured, irrespective of who is at the helm of the country.

The problem so far hasn't been the existing laws and systems, but their implementation. In the past individual ministries spent more than their share of the budget, and even gave government guarantees, but now it is not possible to issue contracts without the verification of the Finance Ministry. Funding for so called statutory funds were also cut, so that their budget allocation cannot exceed 25% of government revenue, as these have traditionally been a reason for budget overruns.

The government is making a lot of effort to formalise the economy. There will be a stronger focus on personal income tax in the future, as only 1.2 mio people are paying this, out of a population of 28 mio. It is politically easier to broaden the base than increasing taxes for a centre-right government that came to power with the promise to cut taxes. There is already a massive national health insurance program, which will, in addition to the positive social contribution, be an effective way to register future tax payers

IMF performance targets are based on the primary balance and focus is on getting debt on a sustainable trajectory. Thanks to the strong growth in 2017, public debt declined to 68% of GDP by September from 73% in 2016. The 2018 budget envisages a lower deficit of 4.5% (6.3% in 2017). The country is believed to achieve targets, but there is not much room left to relax the fiscal targets. One complication is the large discrepancies in data, as some is estimated, some on a cash basis and some on a commitment basis. Expenditures are recorded at different times and there are varying definitions of government. Board approval will be in January 2018.

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Elections are always close

It has only been one year since the last presidential elections, but the speculations on the elections of 2020 have already started. The current administration is highly educated and viewed as very capable with good intentions. One big risk is that the authorities will run out of time for their budget consolidation, as the budget preceding elections will inevitably be strained. The current government is however still popular with the average Ghanaian. The free senior high school education was one of their main campaign promises that was delivered upon in the first year. The focus on developing human capital will support long-term growth potential. The weakest aspect of new government is how they communicate, partly because there are so many ministers with overlapping mandates, a good example being the communication around the extension of the IMF-programme.

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Reserves up, inflation down

Bank of Ghana has continued to accumulate reserves in 2017 and the target for 2018 is over 3.5 months of import cover and going forward no less than four. Dollar availability is apparently not an issue anymore and the IMF regards the currency to be close to an equilibrium valuation. The Bank of Ghana will not, however, reintroduce a currency auction system for now, even though it was a fair way to distribute dollars to local banks, as it created too much volatility for the authorities to be comfortable. The central bank gives balance of payments support to the market by selling around $60 mio monthly, smoothening out volatilities. The oil and gold sectors have boosted exports and a trade deficit is not expected currently.

The central bank has refrained from monetary financing throughout the year, reinforcing fiscal discipline. Inflation has been trending down and was 12.2% YoY in September. Administered prices have traditionally been the main driver for inflation, but going forward the largest risks to the inflation outlook are currency depreciation and an increase in oil prices. The food component is 42 % in the inflation basket, maize, rice and cassava being important crops. The central bank is very positive on inflation going forward, with a 6-10 % target in the medium term, expected to be reached already in June 2018.

The share of non-resident holdings in government debt is large, but the central banks is preparing for potential outflows if global central banks hike rates more than expected.

Our View

We are very positive on Ghanaian domestic debt, as funding needs (less issuance) and inflation are expected to come down allowing for monetary policy easing, coupled with attractive real yield levels. We remain strongly invested in the country in all three local currency funds. We are also positive on Ghanaian eurobonds, due to the fiscal consolidation, healthy growth, higher oil prices and moderate refinancing needs. There is still room for tightening if the government delivers on fiscal targets and our hard currency fund has investments in the country and we are ready to increase allocations in the new eurobond in 2018.

Nigeria

Nigeria is Africa's largest economy, beating Egypt, the second largest, by around a fourth in size. It also has the largest population by far, 186 mio and massive growth potential.

Significant potential in agribusiness, investments needed

Agriculture represents 32% of the economy and according to experts we spoke to, the country has the potential to be a top five producer in the world for up to 12 different agricultural products, including cashews, ginger, and coconuts. The amount of value added still remains low though, as efforts to increase the amount of processing and conservation have been hampered by an unreliable power supply. The government is working hard on power sector reform and there is an understanding that the private sector must be properly incentivised if they want investments into the grid and generation. The African Development Bank is involved in a $500 mio project, the Power Sector Reform Program.

There is large need for infrastructure investments and Lagos state has been a frontrunner in the field. As a result, the state has been growing significantly faster than the rest of the country. New railroads link Lagos to the north now though, a prerequisite for speeding up countrywide industrialisation. PMI's have been above 50 throughout 2017, but considering the weak non-oil growth, there is either a significant lag or then the correlation to the real economy is ambiguous. One reason for the slow growth in the non-oil sector might be expensive domestic financing, due to the central bank mopping up excess liquidity in order to decrease currency volatility. Large, global borrowers are paying 20 % and private sector credit growth is zero. Lower government benchmark yields are needed to improve the situation. Fundamentals for the economy remain good though and there is a feeling that the government is the best in a long time.

Oil fuels economic growth

The oil and gas sector is only about 10 % of GDP, but 90% of exports. Its importance for government revenues is also large at around half of fiscal revenues and 80% of FX-revenues. The 2014 oil price rout lead to severe fx-shortages and external imbalances. The situation stabilised with current oil prices, coupled with production again around 2 mio barrels per day. Nigeria is a member of OPEC and has received an exemption from the coordinated production cuts, as its production suffered from militant attacks in 2016. The exemption could be extended, were the attacks to return in the Niger Delta.

The Nigerian economy grew 1.4% YoY during Q3, a much better figure compared to 0.72% in Q2. It is noteworthy that nominal growth was even higher, due to higher oil prices. The growth was driven by production increases in the oil sector, whereas the non-oil economy declined with 0.76%. This was driven mostly by weak trade, finance and services, on the positive side, agriculture and manufacturing were strong. Q4 growth is projected to be around 2%, resulting in an average growth of 1.8% according to the authorities. The consensus expectation for 2018 growth is 2.6 %.

"Inflation approaching 12% would enable monetary policy easing if coupled with adequate reserves"

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The need for additional revenues

Debt to GDP is very low at around 23%, but due to the low government revenues (around 6% of GDP), debt to revenue ratios look weak. Furthermore, 70% of revenues go into interest payments, perpetuating further borrowing. Currently, the debt looks sustainable though, according to the IMF. The most efficient way of dealing with this situation is to sustainably increase domestic revenues. Tax compliance is a problem, both VAT-receipts (0,7% of GDP) and corporate tax income (1% of GDP) have come in below target. There are 2 mio registered corporates, but only around 5000 are paying taxes. VAT compliance is estimated to be around 25% and the interaction between VAT and the ordinary citizen is low. The government has initiated a tax amnesty program, which is projected to bring in $1bn of revenues. The authorities also target increasing independent revenues, i.e. dividends from state-owned enterprises, where there is substantial slack.

The rating agency Moody's recently downgraded the country, but most people we spoke to were very surprised at the timing, as the country is in better shape than during their last review nine months ago.

Sticky inflation is expected to moderate

Inflation has been sticky at around 16%, despite massive monetary policy tightening by the central bank (broad money growth negative). The CPI figure for October was 15.91%. The main driver this year has been food inflation at around 20%, when core inflation has been significantly lower at 12.3%. FX-pass through is a large contributor to the food inflation, coupled with higher energy prices and drought. The appreciation of the CFA-franc has also been a factor, increasing the purchasing power of neighbouring countries. Inflation will come down next year according to the authorities, due to strong harvests of e.g. rice and maize. They expect 2018 inflation to be between 10-12%. Inflation approaching these levels would enable monetary policy easing if coupled with adequate reserves ($40bn, currently $34bn), it definitely seems like the tightening phase is over. The MPC held rates constant in their November meeting, as they feel that it's counterproductive to ease at these inflation levels, even though the tight policy is dampening economic growth. The approaching general election in February 2019 will be a further incentive to ease monetary policy. Risks to the inflation outlook include fx-shocks and higher fuel prices. An appreciation of the naira would decrease inflationary pressures, but that does not seem to be in the cards currently.

Value of Naira anchored by the central bank

Even if reserves go up to $40bn (already $35bn is appropriate according to the IMF), the central bank will likely not let the naira appreciate and keep it at 360. The motivation seems mostly to be one of industrial policy: they don't want imports to be too cheap and stifle nascent domestic manufacturing and processing industries. The lack of dollars is also seen to stimulate the domestic agriculture sector. The authorities are for the same reason little worried about the slow credit growth, as the previous business model in the country was to lend to importers, which is not a favoured sector right now. The central bank has purchased at least $1.5bn lately and there is a strong motivation not to go through the same currency crisis again, but to be prepared with adequate reserves. The naira has been stable at around 360 (this is where 80% of the market trades, the rest is at 325, reserved for selected sectors) for the last three months, and would probably be stronger without the central bank intervention.

Interest rate costs will go down through external issuance

The Debt Management Office plans to switch from local borrowing towards external, currently 23% of total, the goal is 40% by the end of 2019. The motivation being very high yields in naira and interest cost being a drain on the government budget (over 60 % according to the IMF). More specifically, there are plans to issue an additional $3 bn in Eurobonds, where the proceeds will be used to pay back local currency debt. $500 mio of this was already done in November, and the rest will probably be done in 2018. $2.7 bn external bonds are expected on top of this for budgetary purposes. Non-resident ownership is around 10 % in the local market, but it is concentrated in T-bills, and the authorities, along with the IMF hope that this money would move into longer maturities.

As the naira should be stable in the near future, the largest risk to non-resident investors is the convertibility (a function of oil prices and hence not currently a base case). The situation could escalate again, were oil prices to depreciate to low 30's. The growing reserves also support future liquidity, as non-resident ownership of government and central bank liabilities is estimated to be $6-8bn, well below current reserves.

Our View

The return outlook on Nigerian local currency debt is very good, due to a stable currency outlook, moderating inflation enabling monetary policy easing, growing reserves, decreasing convertibility risks and a decreasing supply of T-bills. We are positive, but more selective when it comes to Nigerian external debt, as larger supply is expected going forward and the higher oil prices are partly priced in. We were involved in the issuances in November and expect to be involved tactically in new issuances in the future as well.

> **"The outlook on Nigerian LC debt is very good, due to a stable currency outlook, moderating inflation, growing reserves and a decreasing supply of T-bills"**

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Aktia Asset Management Ltd, Mannerheimintie 14 A, 00100 Helsinki

Aktia