

Nigeria Strategy Report – H2 2017 Excerpts

Key Developments in Domestic Economic and Policy Environment

Economic Snapshot

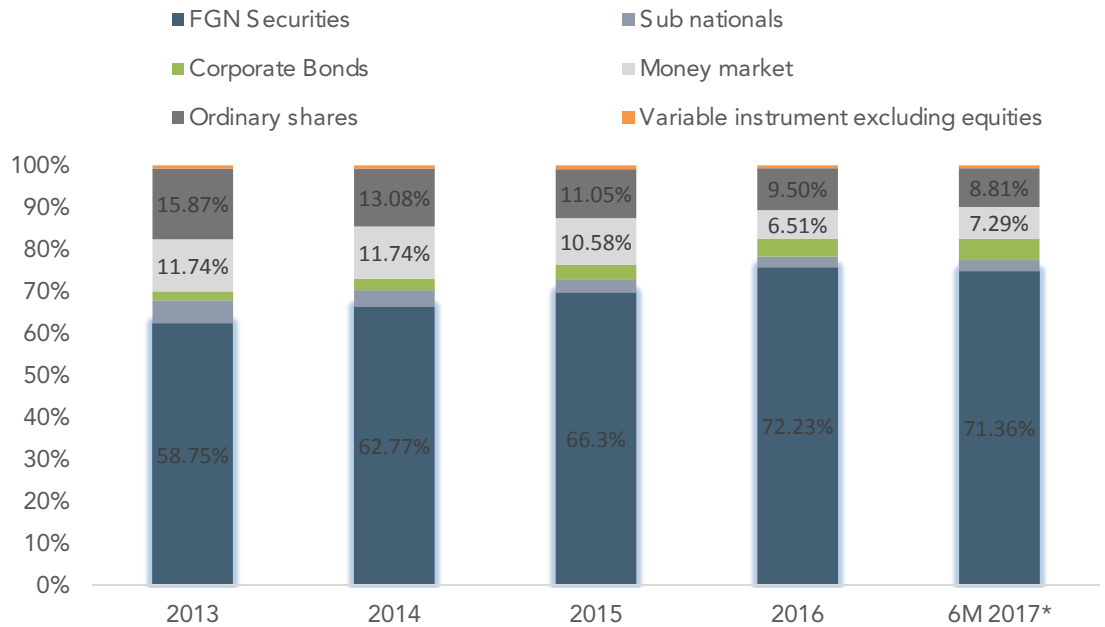
June 2017 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	1.6%	16.1%	16.25%
Food	2.0%	19.9%	19.3%
All Items Less Farm	1.3%	12.5%	13.0%
Imported food	1.6%	14.2%	14.9%
Energy	0.75%	14.2%	16.3%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	305.4	0.0%	0.0%
EURNGN	352.3	0.3%	9.6%
GBPNGN	398.1	-0.1%	6.2%
JPYNGN	2.72	0.0%	4.7%
Monetary Aggregates – April 2017			
	(₦bn)	MoM	YoY
M2	21,713	-1.4%	4.8%
CPS	21,943	-1.5%	13.2%
NCG	5,592	7.5%	42.2%
NFA	7,262	-4.1%	43.2%
NDC	27,535	0.2%	18.1%
External Position			
	Latest	QoQ	YoY
Trade Balance (\$'mn)	185.73	-21.5%	N/A
External Reserves (\$'mn)			
	30,323	0.95%	3.68%
Foreign Debt (\$'mn)	13,808	21.1%	23.3%
Growth Data – Q1 2017			
	(₦bn)	%of total	YoY
Real GDP	15,861	100%	-0.5%
Agriculture	3,385	21.3%	3.4%
Oil	1,411	8.9%	-11.6%
Services	5,975	37.7%	1.0%
Wholesale and Trade	2,819	17.8%	-3.1%
Manufacturing	1,543	9.7%	1.4%

New Regulations set sights on increasing gains for Pension Assets

Quest for elevated yields boost the Pension Assets

Pension fund assets continued its steady growth with AUM rising 5.4% to ₦6.4 trillion between year-end 2016 to April 2017. As in prior years, the increase in AUM was driven by increased return on pension funds as fixed income instruments gained +5.43pps, reflecting the prevailing general risk averseness exhibited by PFAs but also tactical shift in asset allocation to take advantage of the elevated yields at the short-end of the yield curve. Accordingly, T-bills holdings, rose 3.01pps to 15.66%, the quickest rate in 7 months while allocation to bonds fell for the fourth time over the review period. One surprise is the 24% (~₦60 billion) increase in CPFA's allocation to corporate bonds. Given that there were no sizeable corporate bond issues over the period, we suspect the development is likely a reclassification of some sort. Extending the decline of the last three years, variable income holdings fell marginally 0.81pps to 12.8% reflecting the dominance of equities within this asset group. Specifically, while equities holdings which is 69% of variable income fell (-4%) alongside private equity (-8.36%) and real estate properties (-6.41%), allocation to infrastructure funds doubled to 106.75%. The jump in PFA exposure to infrastructure asset class suggests government's thrust in channeling pension assets towards infrastructure might be yielding the desired outcomes. Nevertheless, at 0.07% of AUM, PFA investment in infrastructure is yet to scratch the surface.

Fig 1: PFA Asset Allocation



Source: PENCOM, ARM Research *Jan-April 2017

Variable instruments champion new guidelines

On the 18th of April 2017, the National Pension Commission (PENCOM) released amended Regulation on Investment of Pension Fund Assets. Central to the amendment is the introduction of the multi-fund structure which splits the RSA active and Retiree into potentially four funds with varying risk appetite as captured by varying asset allocation via minimum allocation to variable income instruments¹. Other notable changes include allowing Pension assets to be invested in companies evolving from a merger, acquisition or combination arrangement and would-be listed companies via IPO or private placement approved by SEC. Furthermore, the new guideline permits investment of the pension funds in non-interest compliant funds, particularly sukuk bonds issued by either state or corporate entities and the global depository notes. Consequently, the impact of the changes is already being felt in the capital market as the lifting of the investment ban on companies formed from reorganization, in part, led to strong gains of 120%, 13.6% and 90% in Stanbic,

¹ We discuss the multi-fund structure in later section.

FCMB and FBNH over H1 17. Similarly, with Sukuk now investable by PFA, the FGN recently unveiled plans to raise ₦100 billion Sukuk bond.

Elsewhere, the proposed amendments reviewed the number of ratings required for most qualifying investment to two, and in support of local content, mandates that at least one of the rating should be from a local rating agency. Also, in encouraging more Africa focused infrastructure funds to come to Nigeria, only 60% of the projects have to be in Nigeria vs 75% under the previous regulation.

Table I: Old guideline vs Amended PENCOT Guideline

S/N	PENCOT Guideline	Amended PENCOT Guideline
1	The PFAs are to maintain RSA active & RSA retiree fund structure	PFAs are to maintain the multi fund structure
2	PFAs could only invest in bonds issued by state/local and corporate debt instrument(s)	In addition to the bonds, PFAs can now invest in Sukuk and other non-interest compliant debt instruments issued by state and corporate entities.
3	Primary market investment in shares shall be through public offerings approved by SEC	Primary market investment in shares shall be through public offerings or private placement approved by SEC
4	Allowable instrument includes bonds, treasury bills and other securities (including bonds denominated in foreign currency)	Allowable instruments now include Sukuk, Global Depository Notes. in addition to the treasury bills and bonds in the previous guideline
5	PFAs could only invest in ordinary shares of listed company(s)	In addition to the shares of the listed company, PFAs can also invest in companies proposed to be listed through a IPO
6	Minimum credit rating of "A" by a SEC registered Agency for debts	Minimum credit rating of "A" or "BBB" by at least 2 SEC registered Agency for debt instruments in which only a maximum of 20% can be allocated to debt instruments with the later rating
7	Pension assets can only be invested commercial papers, and Bankers acceptances that fulfil the requirement of the " A" minimum credit rating issued by one rating agency	Pension assets can only be invested commercial papers, and Bankers acceptances that fulfil the requirement of the " BBB" minimum credit rating issued by at least two rating agencies
8	N/A	In the event of two rating agency(s) giving different rating on a particular investment, the lower rating grade shall apply, for the purpose of determining the relevant maximum investment limit
9	A minimum of 75% of the infrastructure fund shall be invested in projects within Nigeria	A minimum of 60% of the infrastructure fund shall be invested in projects within Nigeria
10	PFAs can invest in PE funds, supranational bond that have a minimum of 75% of its funds in Nigerian projects	PFAs can invest in PE funds, supranational bond that have a minimum of 60% of its funds in Nigerian projects
11	An active contributor could switch only once in three years	An active contributor may switch form one fund to another subject to prior approval form the regulators within a given year without paying fees, additional requests shall attract a fee

PENCOM swings into century-next with Multi fund structure

As earlier stated, the prime change to the investment regulation, the Multi-fund structure, is a framework designed to align the retirement savings of contributors to their risk appetite by maintaining four Funds (I, II, III and IV) with distinctly different tolerance for risk. It is based on the premise that investment in variable instruments (including equities) has a higher expected return, but also a higher risk compared to fixed income instrument. According to guideline, the default fund for RSA active contributors below 50 and above 50 will be Funds II and III, respectively, while RSA retiree fund metamorphoses into fund IV. However, Fund I will be optional for contributors given higher minimum allocation (20%) to variable income instruments. Intra fund movement is limited to contributors into fund II and III. Though the regulator is yet to provide a commencement date, PFAs will have 6 months from commencement to fully comply.

Table II: Multi Fund Structure

	Fund 1	Fund 2	Fund 3	Fund 4
Max. Exposure to variable Instruments	75%	50%	20%	5%
Min. Exposure to variable instruments	20%	10%	5%	0%
Default Zone (Age Bracket)	Below 50 Years	Below 50 Years	50 - 65 Years	Above 65 Years
Active Choices		Can move to Fund I	Can move to Fund II	N/A

Source: PENCOM, ARM Research

Pension Funds to sustain rally in the equities market

Using these estimated AUMs within the investment limits for each fund, we find that industry compliance pension fund allocation across all asset classes suggest minor disruptions to markets. For instance, blended allocation to variable income securities under the new structure should hover between 5% and 12% which is higher than current industry exposure of 9.45%. Similarly, combined allocation to FG securities of 75% is in line with current industry exposure. That said, of the minimum allocation to variable instruments in fund I and II (20% and 10% respectively), 2.5% each is required to be invested in 'other variable instrument' (infrastructure, private equity, mutual funds, and real estate). This leaves a 17.5% and 7.5% allocation to equities for fund I and II accordingly, as well as 5%

for fund III. Although, current industry exposure (6.9%) suggests no need for rebalancing, we note that industry exposure is largely skewed by the top five PFAs (9.45% of top five pension assets) with the other PFAs holding about 4.02% of their total pension assets in equities. Thus, assuming the other PFAs are to increase their holdings to the minimum requirement for each scenario, while assuming the top five maintains current equity exposure, approximately between ₦50.7 billion and ₦74.5 billion will have to flow into the equities markets based on scenarios shown below. For sake of context, considering average traded value of ₦2.9 billion in H1 2017, which is less than 5% of expected inflows suggest support to prices at current levels. To underscore our view, net portfolio flows of ₦6.6 billion and ₦51.1 billion in April and May respectively, where the market returned 14.5% and 12.3% MoM in that order, is less than our expected funds flows from pension fund assets into equities.

Table III: AUM distribution amongst Fund I, II and III

Scenario	Fund I (₦million)	Fund II (₦million)	Fund III (₦million)
1	0	3,271,141	1,127,222
2	327,114	3,056,749	1,014,500
3	490,671	2,949,553	958,139

Pension funds still expected to bridge the gap in Infrastructure investment

Still on the variable income securities, of the three asset classes competing for minimum 2.5% in alternative assets, we think infrastructure funds will experience the largest inflow in the near-term. Our reasons are not farfetched. PFAs have been investing in private equity (PE) funds and REITs for years and the return story has not been palatable. On the former, paucity of public information and corporate governance issues continues to hamper investment in PE funds even as FX challenges has affected seamless exit from the fund. Despite regulators move to allow for investment in PE funds with a minimum allocation of 60% to Nigeria projects (previously 75%), given that such funds currently account for circa. 10% of the West Africa total PE fund, still suggest limited prospect for increased allocation. Overall, based on the conservative nature of pension fund administrators, we do not see significant flow into PE funds. Similarly, existing REITs in the domestic market have not provided the liquidity such structures provide in other climes and hence have become

nearly a held-to, arguably infinite, maturity instrument. Indeed, PFA holdings of these assets have thus stagnated around ₦16 billion and ₦9 billion for PE and REITS respectively over the last 5 years. Thus, aided by moral suasion given the need to bridge the gap in domestic infrastructure investment, we think PFAs are likely to channel investments to the infrastructure funds. This premise is supported by regulators' move to reduce its previous caveat to say the pension assets can be invested in infrastructure funds with 60% of their investment in Nigeria as against 75% in the previous reform. Indeed, we suspect PFA subscription was a big part of the ₦4.5 billion ChapelHill infrastructure debt fund that closed in June².

In prior times, pension assets' investment in infrastructure funds has been low cause of the strict regulatory requirement, paucity of information and illiquidity of these funds. Though the infrastructure funds available in the country remains low, we still see returns in that space as we expect high yield to incentivize more investment. Also based on the modalities surrounding the sukuk whereby it's required for the issuers to invest the funds in return generating projects, we see prospects for more infrastructure development in the country.

² We await Industry data to ascertain.

Table IV: Global portfolio limit for Multi-Fund structure vs RSA Active Fund

Instruments	RSA active	Fund I	Fund II	Fund III	Fund IV
Govt. Securities	80%	60%	70%	80%	80%
Corporate Bonds	35%	35%	40%	45%	45%
Money Market	35%	30%	30%	35%	35%
Ordinary Shares	25%	30%	25%	10%	5%
Infrastructure Fund	5%	10%	5%	0%	0%
PE Funds	5%	10%	5%	0%	0%
Open/Closed funds, REITs & ETFs	20%	25%	20%	10%	5%

Source: PENCOM, ARM Research

More importantly, the wide range of possible investment allocation implied in the multi-fund structure gives room for PFAs to implement views more forcefully and perhaps deviate from the mentality that has seen PFA allocations find safety in similarity of strategy—regardless of whether it is optimum or not. On other fronts, the fixed income assets are still expected to expand considering the fact it remains an asylum for pension investments even if the return is not as high as the variable instruments. Also, going into the second half of 2017 we expect yields to remain at its current level or higher as the central bank still looks to hold on to its current monetary tightening stance with FX stability and inflation as justification to keep rates elevated. Increasing the range of funds to satisfy contributors’ risk-return preferences may, ultimately result in the optimum design, which is to offer as many funds as there are to contributors - alongside increasing returns in the system. Nevertheless, we perceive increased administration costs for the pension administrators thereby limiting the number of alternatives that can be offered efficiently in practice.

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