



# PAN AFRICAN CAPITAL GROUP, LLC

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**Research Note**  
**December 29, 2008**

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**The Forefront  
of Investment  
Banking  
Services in  
Africa**

## The Financial Outlook for Nigeria

Recent months have seen a rapid deterioration in Nigeria's financial sector as the combined effects of falling oil prices and the global credit crisis has reverberated across the Nigerian equity exchange and banking sector. Global oil prices have come crashing down with bonny light crude prices floating at almost a fourth of the peak just five months ago. Global and regional investors spurred speculation in the Nigerian Stock Exchange primarily focusing on the shares of Nigerian banks, fueling inflated balance sheets and headlong regional expansion. The aftermath is a financial sector in constant flux, making a highly specific research note virtually outdated upon publication. Instead, this note will focus on the main underlying factors that have created the current situation and what the Government of Nigeria, namely the Central Bank, can do in response to the prevailing market forces.

Global investors feeling the crunch of the credit crisis began withdrawing investments in the NSE in order to meet capital requirements elsewhere just as the price of oil fell, creating a negative spiral in NSE share prices and the value of the Naira. The NSE was undoubtedly *bubblesque*, indicated by extraordinarily high P/E ratios when compared to regional and historical levels, but few could have predicted that the fall would be so dramatic. Nigerian regulators are partially responsible for this predicament as the financial sector was allowed to speculate based upon extraordinarily high oil prices, but the fallout from the even greater economic slowdown in the US and European markets is limiting the possibility of a soft landing for the Nigerian financial sector.

## Regulatory Response

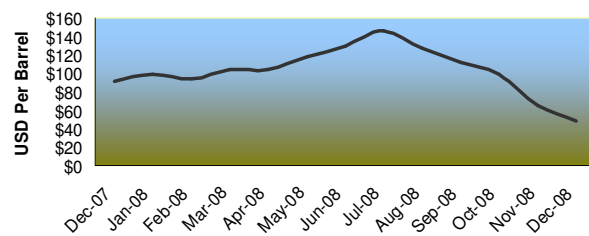
The Central Bank of Nigeria and the NSE has acted in the face of the crises, taking action when the threat of over-correction in the markets has loomed too large by either freezing the NSE, or propping up the Naira. The Exchange may have exacerbated the problem by implementing the stop-gap of halting share price declines earlier this year, creating pent-up selling pressure when the policy was lifted. The NSE is currently around 40% of 2008's highpoint, reached in March and April, while the Naira has suddenly depreciated 10% against the USD over the course of the past month, with the CBN shoring up the currency on two separate occasions and the official value is currently being defended at around 134 Naira to 1 USD.

## The Oil Effect

OPEC has cut production targets back 7.7% in an attempt to push oil back to US\$80 a barrel, but there is little chance that these price levels will be achieved. And even if they are, it will not have immediate knock-on effects for the Nigerian financial industry because the global slow-down will hinder the flows of capital back into commodity-driven equity markets. Nigeria has been focused on diversifying its economy in order to avoid just such a situation, and it may have avoided the current scenario if only the price of oil had dropped, but with the turmoil on the global financial markets, the steps taken are proving to be insufficient.

As China and India continue to slow down, and their demands for oil slacken, Nigeria must now evaluate how it will cope with the new financial realities when its national coffers depend so heavily on commodity prices and foreign capital investments. Neither of which will be leading national economic growth for the most heavily populated country on the African continent.

Price Since December 2007 of Nigerian Bonny Light

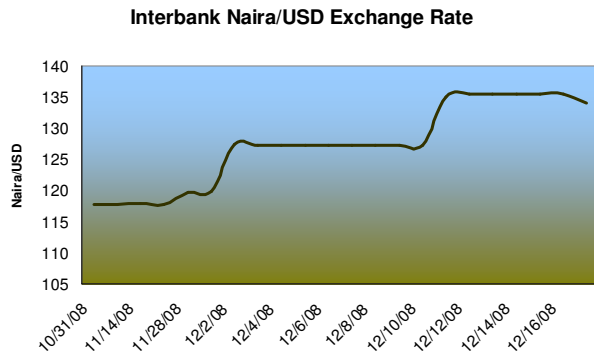


Even if prices return to a sustainable level for continued economic and financial development, oil production in the River States is under constant threat from rebels, piracy, and illegal bunkering. The major multi-nationals have for the time being shut down their facilities on Bonny Island, the center of their operations, because of the security situation.

## A Currency Sliding?

The Naira has faced a tough end of the year as it depreciated over 10% in just one month, and would have fallen more if not for the CBN freezing official exchange rates. Fighting the depreciation of the Naira may not be a worthy goal in the face of declining oil prices which will inevitably lower the reserves needed to maintain currency valuations. The CBN has found that the use of its Monetary Policy Rate has been insufficient in fighting inflation and depreciation, but

has committed to expanding its toolbox when necessary in 2009 to resist these monetary pressures. The strategy could prove dangerous, if the CBN continues to prop up the currency, it will decrease the attractiveness of its oil on global markets, which will in turn limit its ability to keep the Naira at an artificial level. The end of that frightful merry-go-round is an eventual currency crash coupled with a bare foreign reserve vault. That is unless the oil prices somehow manage to regain their formerly lofty levels, an unlikely scenario.



Each drop in the value of the Naira versus the USD has been attributed to a shortage of dollars available to banks that need to make inter-bank currency calls for the daily trades required to pay for imports, exports, and payments to foreign investors exiting the country. The CBN has halted the depreciation twice so far, but it is unreasonable to think that they will be able to pursue this policy if the situation persists. The Governor of the CBN, Chokwuma Soludo has both announced that it would be tragic to “fritter away” Nigeria’s US\$57 billion in reserves, while at the other times committing the CBN to taking a stand on the currency at artificial exchange valuations. There seems to be no guarantee that political pressure will not

overcome monetary rationality in the case of the Nigeria’s financial predicament.

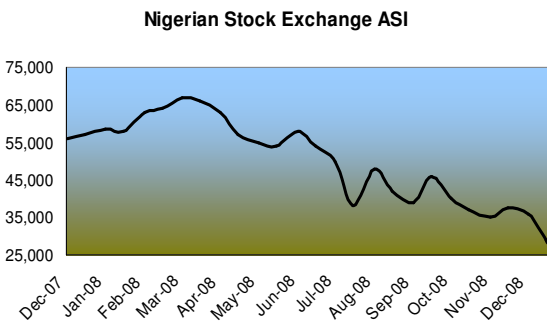
### Stock Market Continues Fall

Right when global investors started requiring more capital to shore up their domestic investments and liquidity requirements, the price of oil began to plunge in lock-step with the global slow-down. The logical response of many of these investors was to remove their capital from the markets most heavily dependant on the commodity markets. For many of them, Nigeria had only recently become an attractive equity market for their funds, with the downturn, it also became one of the first places they looked to leave.

The Nigerian Stock Exchange suffered from investors lacking confidence in the country’s diversification, seeing the linkage between oil prices and the growth in its financial sector as too closely intertwined. With the drop in oil prices slowing Nigeria’s economic growth and activity, investors began to exit. The results are that the All Shares Index of the NSE dropped from over 66,000 in March to under 29,000 in mid-December.

International flight of capital is only half of the story. Nigerian companies and high net worth individuals were also taking their money out of the market after making unbelievable returns for so long on the back of oil driven speculation. At the first hint that the party was about to end, or at least about to take a short break, these investors headed for the exits, leaving those who did not move quickly enough holding

severely depreciated share certificates which only weeks before had seemed like a sure bet. Nigerian banks may be one of the biggest losers from the fall in share values, many of them engaged in margin lending and are now left holding onto the stocks after they dropped below the margin price. The temporary freezing of share prices in order to stem the decline turned out to be counter-productive in the end, with immediate dives in the ASI as soon as the moratorium on prices were lifted.



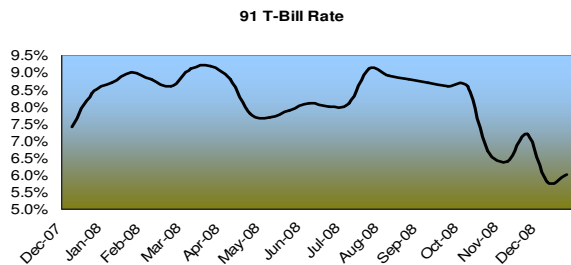
It would appear that the decline is an overcorrection in the market, and this would be comforting if it were true. The reality is that declining oil revenues coupled with a weakening currency may negatively reinforce the current trends in the NSE. It has been demonstrated that even large cash infusions into developed markets are not always sufficient to bring back investor confidence and normalize share prices. Nigeria is competing against numerous other equity markets that may appear to be more attractive solely for the fact that their economies are not as linked to commodities. As much as Nigeria has diversified, this is the overwhelming perception and defines its attractiveness for international investors. How much this perception is reality is debatable and many intelligent investors with in-depth research available to them

will be looking to place their capital in Nigerian stocks that have proven to be buoyant in the face of recent swings in the market.

Despite all of the negativity, the long term prospects for the NSE are good, even with a stunted commodities market and falling Naira, the Nigerian economy is diversifying and producing regional conglomerates that are competing across all economic sectors. As it is now, the NSE is too dependant on companies that either produce global commodities or are involved in the financial sector. As the exchange broadens its appeal to companies engaged in a variety of sectors, it will be more resistant to global fluctuations in these two markets.

### The Money Market

As the Naira depreciates and the stock market plunges along with international commodity indices, the CBN 91 T-Bill rate has fallen from a high of over 900 basis points in July to under 600 bps in December. Purchasers of these notes are more willing to accept lower returns in the face of uncertainty in the Nigerian stock market and abroad. This may make it easier for the Government of Nigeria to raise funds to counter the drop in commodity revenues, but over-selling will lead to inflationary pressure on the Naira, an issue on which the CBN has been wavering about so far.



## **Nigerian Banks, Regional Champions or Spread Too Thin?**

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Regional expansion has been the hallmark of the Nigerian banking industry over the past few years following the sector's consolidation after the revised capital requirements set by the Government. Spurred on by high oil prices and market capitalizations, their balance sheets were inflated by irrational share prices, which after falling precipitously in the second half of the year, are beginning to stabilize. Of further concern was that the bank's capital bases were directly exposed to the NSE through margin lending and direct participation in the market, demonstrating a culture of lax risk management which will not be acceptable going forward.

Nigerian banks may now have reached their limits as falling share prices and slowed economic growth erodes their capital bases and loan portfolios, a slight rebound in their share prices will only go so far in correcting the damage of the second half of 2008. The recent strategy has been to establish market share while sacrificing profitability and structural cost effectiveness. Economies of scale are difficult to establish on a regional level in West Africa due to the fragmented nature of the market and its varied regulatory regimes, preventing a regional financial group from establishing a uniform operating model. Instead, each additional entry into a national market increased marginal costs. With significantly fewer petrodollars sloshing around to support the model of "establish now and profit later," Nigeria's financial giants have become hamstrung

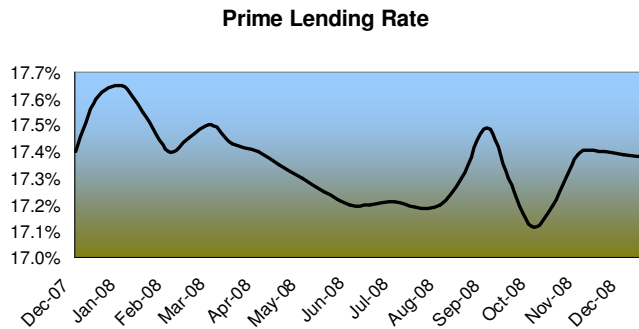
by their large networks. What appeared to be a significant asset may now prove to be a severe liability.

A basket of the leading banks in Nigeria show that their share prices have fallen, on average, 75% from their early year highs on the NSE. There are a variety of reasons for this, one being that the share prices were inordinately inflated due to creative lending schemes which allowed over purchasing of bank's IPO stocks. As these loans became due, investors sold their stock en masse, driving down the price, but still making large gains on their initial investments. This market distortion may not have been so important, but the global credit crunch amplified the rush to sell. The result is balance sheets that can no longer support the aggressive growth strategies of the past few years. An example of the recent plunge has been that the latest listing for Ecobank, a Togo based, but Nigerian owned regional bank, was vastly undersubscribed and essentially failed.

Banks which can adapt to this new reality will be led by strong management with nimble operating platforms. Those institutions which were growing only upon the backs of their share prices will prove to be sclerotic and may fall or, more likely, be bought out in a new wave of consolidation. It is too early to predict which Nigerian banks may seek out mergers to weather the present storm, but there is a very good possibility that this will occur in the near term.

The prime lending rate has remained relatively stable in the face of large fluctuations within the sector. Staying between 17.7% and 17.1%, the rate is

reflective of the risk involved in making loans in an emerging market and may still be low considering national economic fundamentals. The real issue may be the loan portfolios across the banking



institutions. The CBN recently announced it would allow banks to begin reclassifying their non-performing loans according to a less stringent qualification guide in order to maintain earnings and share prices in the face of tighter market conditions. This policy is more of a stop-gap than a sustainable measure, but it might allow the banks to continue lending when they otherwise might not have due to current balance sheet constrictions, but will undoubtedly hamper their ability to raise fresh capital on international markets, assuming that these credit markets will reopen for business in 2009.

## Conclusion

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The current policy choices of the CBN in the face of the most recent financial turmoil will define Nigeria's financial sector and overall economy for the next five years. Prudent policies that adapt to a deteriorated credit climate and commodity market will cushion the fall that Nigeria is currently experiencing. Propping up the Naira will only invite cash rich speculators to bet against the currency in search of a payday reminiscent of George Soros' crashing of the British Pound in 1992. Nigeria's current foreign reserves are substantial relative to historical and regional levels, but they should not be used in short-term battles that may cripple the economy over the long-term.

The country has ridden the wave of high commodity prices and should now look to invest the windfall in economic and financially diversifying measures. These steps will provide a stable environment for future investment inflows, even while Nigerian capital continues to be deployed in West African development projects. Nigeria will remain the predominant player in the sub-region as long as it recognizes that it must be more prudent in the existing global financial regime.

*Pan African Capital Group, LLC (PACG) is a US-based investment company focused exclusively on investment opportunities in Sub-Saharan Africa. PACG provides investment banking and advisory services, asset management, and private equity across the region. The firm is primarily focused on the financial services, telecommunications, manufacturing, and agribusiness sectors, and manages a diversified private equity portfolio.*

*Most recently, PACG, alongside partners Databank (Ghana) and Trust Bank Limited (The Gambia), acquired majority control of International Bank (Liberia) Limited, Liberia's oldest commercial bank and the preeminent business-focused financial institution.*

*PACG and its affiliates maintain a nexus of offices throughout West Africa and have strategic alliances in East Africa, North Africa and the United Kingdom.*

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