

Nigeria Market Update

April / June 2011



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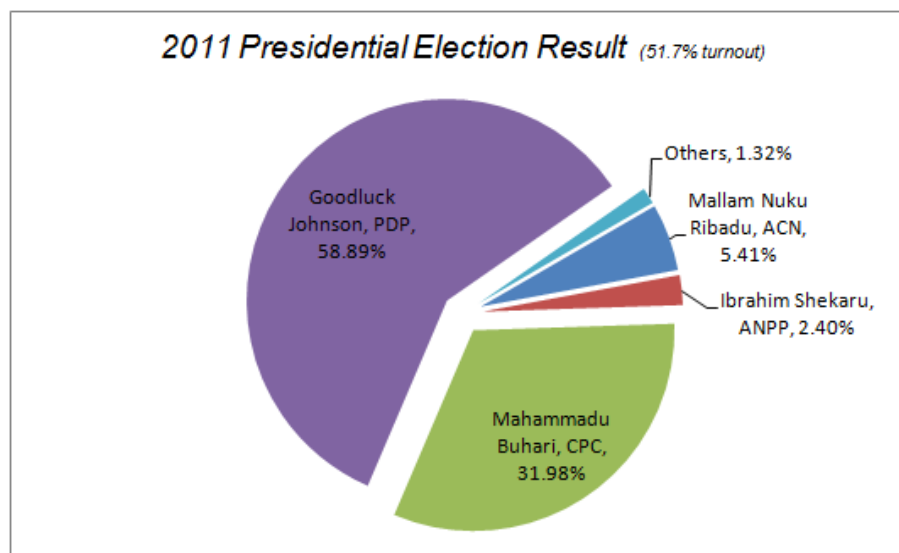
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Contents

Policy.....	3
Economic Trends.....	5
Inflation, Monetary and Foreign Exchange Rate Policy	8
Fiscal Policy	12
External Sector	14
Banks.....	15
Capital Markets Performance	17
Oil sector	18

Policy

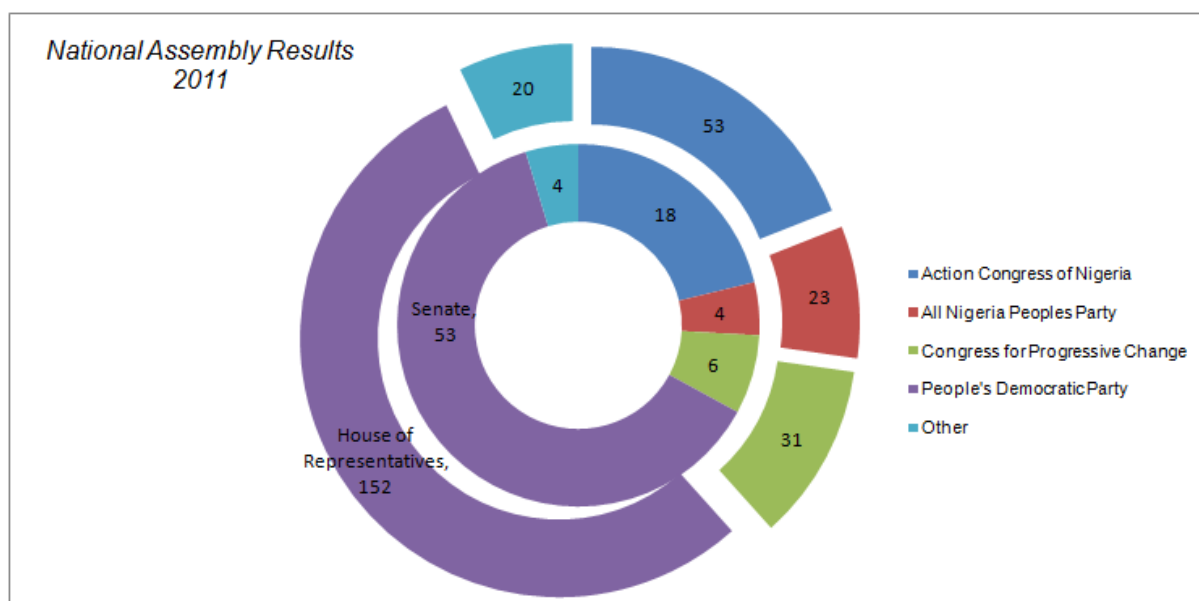
The successful election of the incumbent Goodluck Johnson as President in April's election, offers the potential of some stability in macro-economic strategy, in a period when commodity prices are particularly favourable. Furthermore banking sector reforms appear to be successfully establishing a financial system that facilitates growth in the real sector. The election campaign itself was marred by violence, and the post-election period has seen a serious deterioration especially in the northern states. These events must, however, be set in the context of much more serious instability regionally and throughout North Africa and the Middle East. This is not to diminish the challenges confronting President Johnson, who failed to win in any of the 12 Muslim northern states, while his principal Muslim opponent failed to secure significant support in the Christian southern states. The country is deeply divided, if not yet polarised, and serious efforts will have to be made to tackle the chronic infrastructure and power supply deficiencies, if the alienation of the northern states and of the oil-producing Delta region is not to deteriorate further.



Source: Independent Nigerian Election Commission

The Presidential, National Assembly and State elections, although far from trouble-free (delays in the arrival of ballot papers forced each of the elections to be deferred

by a week), are widely regarded as the freest and fairest to have taken place and in marked contrast to the accusations of widespread vote-rigging and intimidation that accompanied the 2007 polls. It is important to note that this is fourth consecutive election to be held according to schedule, despite the death of the previous incumbent President Yar'Adua in office, and that the openness of the election is reflected in the votes and seats awarded to opposition parties (although the not all results are in) in each of the elections.

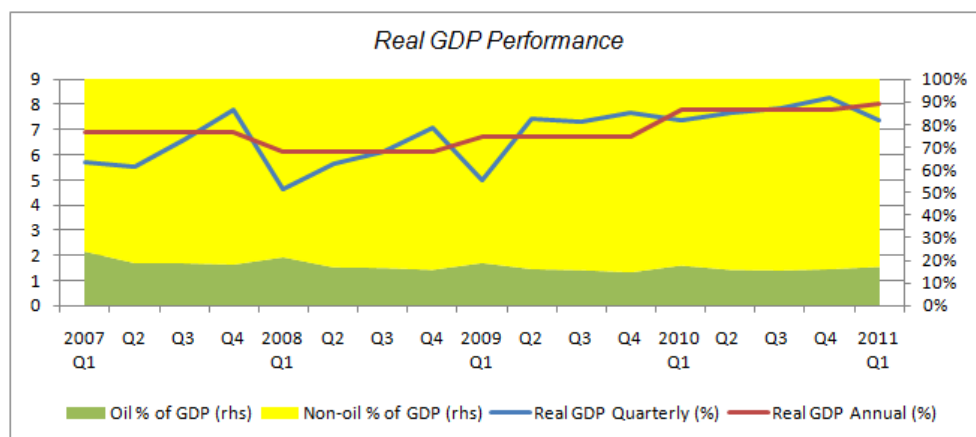


The markets have largely reacted favourably to the elections, although remaining unsettled by post-election violence, with equity prices and bonds firming. Attention will now focus on the capacity of the administration to sustain its economic reform programme. Crucial to the success of the strategy will be investment in the oil and gas sector to maintain, if not boost, productive capacity. Unfortunately, the electoral result is unlikely to assuage perceptions of injustice in the Niger Delta, with the Movement for the Emancipation of the Niger Delta adopting more strident rhetoric and renewed disruption to oil exports cannot be discounted. Passage of the

Petroleum Investment Bill, which advocates North American-style revenue distribution, will prove an early test of the competence of the administration.

Economic Trends

Already robust economic prospects have been further strengthened as a result of accelerating global oil prices. Real GDP growth this year is forecast to exceed 8% this year, from 7.8% recorded in 2010. Given the sensitivity to oil export revenue, coupled with policy stability, strengthening output in agriculture and other non-oil sectors, notably telecommunications, growth could be boosted further.

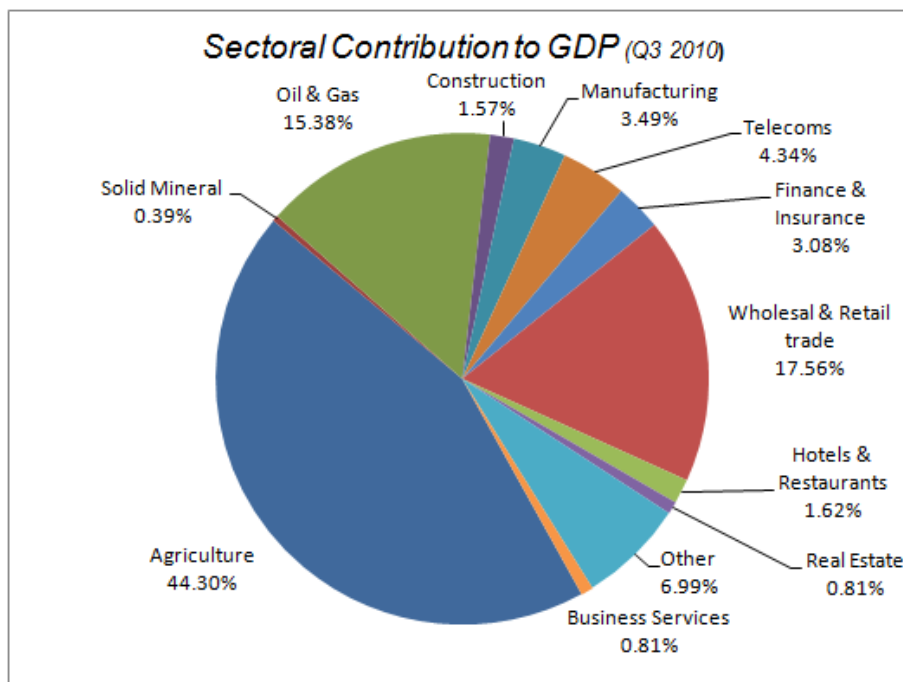


Source: Nigerian Bureau of Statistic & Nigerian National Petroleum Corporation

As oil revenues provide over three-quarters of fiscal revenue, government finances are particularly vulnerable to oil price volatility, and the price correction in 2009 undermined budget performance, contributing to a overall fiscal deficit of -5.3% for that year and -5.4% in 2010. In contrast during periods of inflated prices, Nigeria revenue tends to record large surpluses, which in the past, were divided between the states and the Excess Crude Account held at the Central Bank. The authorities have however announced their intention to manage excess revenues through the establishment of a dedicated sovereign wealth fund to enable funding of infrastructure. The sensitivity of the Naira to the price Bonny Light commands is highlighted by the fact that the currency fell by over a quarter against the US dollar

when global oil prices eased over the course of 2009. However, constrained oil export performance last year ensured that the appreciation of the oil price was not reflected in recovery of the Naira. The current account surplus last year was much weaker than forecast, although it was equivalent to 7% of GDP, and for 2011 is forecast to be close to 10% of GDP, providing support to the currency.

The strength of oil prices offers considerable scope to boost GDP, provided the depleted oil export infrastructure is able to respond to firming external demand as a result of supply concerns in more volatile regions of the globe. Some forecasts anticipate oil production increasing to 3 mbpd, from the 2010 close of 2.58 mbpd, although this would be a remarkable recovery from the nadir, in July 2009, of 1.69 mbpd that production fell to as a result of political instability in the Delta region. Indeed export capacity constraints during the last period of heightened fuel prices in 2008, ensured that Nigeria was unable to fully benefit from its comparative advantages. Provided peace prevails in the Delta, the economy will continue to reap benefits from positive trends in the oil market, and according to the CBN, first quarter growth was 7.4%, consistent with the forecast 8% growth for the year as a whole.

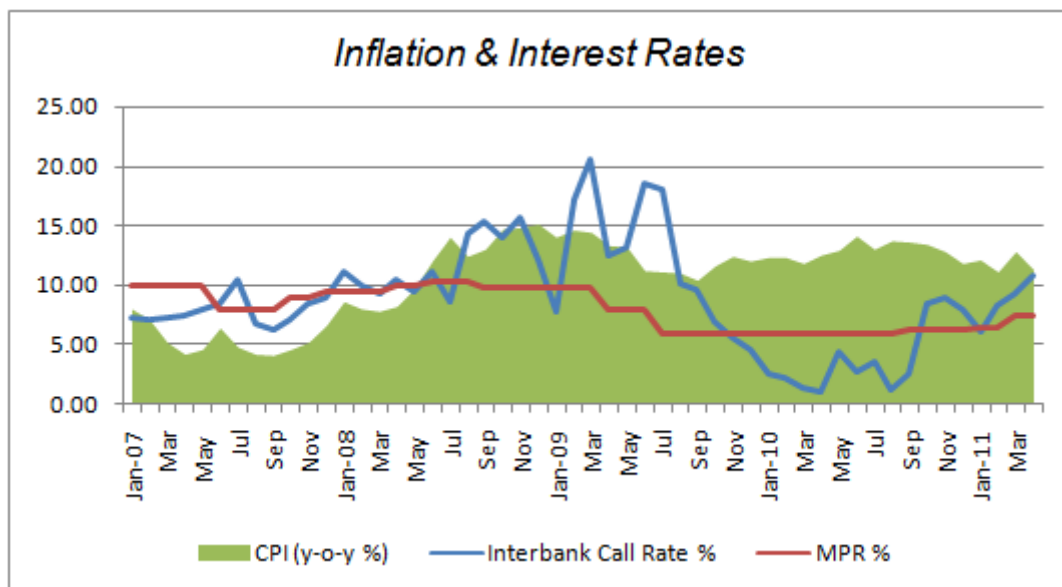


Source: National Bureau of Statistics

Growth prospects will be further supported by improving credit conditions, with a modest recovery in credit expansion in the final quarter of last year, following the deterioration in the first three quarters of last year. This revival is largely due to recovering sentiment as a result of the commencement of operations of the Asset Management Company of Nigeria (AMCON) which will permit restructuring of banks balance-sheets with the removal of impaired debt and greater transparency in calculating of that impaired debt. The authorities are at the same time attempting to stimulate recovery in the manufacturing and power sectors by providing subsidised targeted loans, with small and medium-sized enterprises also benefiting from similarly targeted credits. As a result credit expansion can be expected to return to more normal levels, in a range 20-30%.

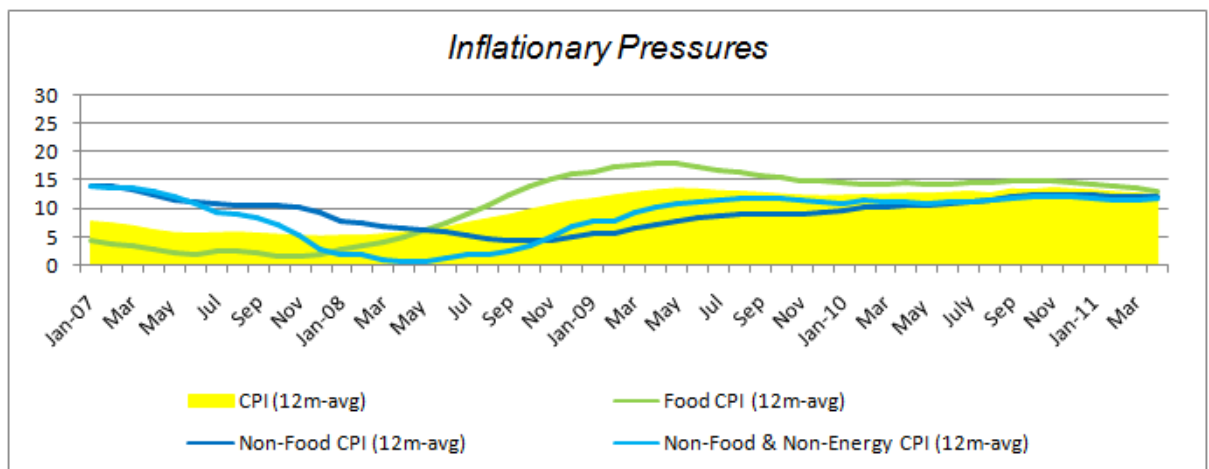
Inflation, Monetary and Foreign Exchange Rate Policy

Inflation moderated in April to 11.3%, have shifted upwards in March increasing to 12.8%, compared to an annual 11.1% in February. As a result of the continued strength of inflationary pressures, the CBN tightened its policy a further 100 bps to 7.5% in March. However this tentative shift in the policy environment, should not be seen as a move toward a fully fledged inflation targeting strategy. The authorities appear to be comfortable with pursuing a more pragmatic policy mix, despite pressure from the IMF to take a more hardline stance. A key factor in constraining price pressures is the stability of the Naira, given that the significance of imported inflation, especially food and refined petroleum product, which the CBN suggests account for close to 70% of the CPI. Furthermore, deficient transport and logistics infrastructure gives a structural component to inflation which is unlikely to ease in the short-term. Accordingly, with global commodity, food and non-food, prices increasing, inflationary pressures are likely to continue to be strong over the course of the year. Weakening fiscal discipline, as a result of the election campaigns will also stoke these pressures.



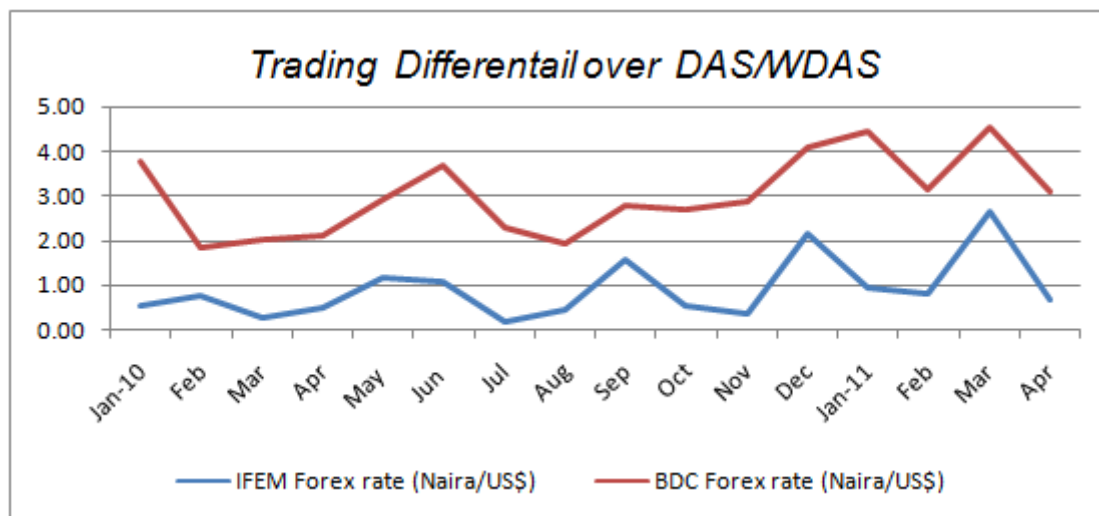
Source: CBN

The CBN has had to adjust its accommodative monetary policy, increasing policy rates thrice this year, both to stifle inflation and support the Naira. The monetary policy rate was increased to 7.5%, from 6.5% in March, with the inflation rate at 12.8% in March, above the CBN's target rate and at the May MPC tightened the MPR a further 50bps to 8% (effective June 8). The CBN has however questioned the extent to which a short-term movement in rates and monetary aggregates dampen inflation. Although it recognises that any sustained expansion in money supply and low interest rates for an extended period would contribute to upward inflationary pressures. Of particular concern for the authorities is the fact that all the components of inflation, food, energy and core inflation have strengthened over the past year.



Source: CBN

As part of its strategy to deepen Naira markets and bolster exchange rate stability, the CBN is commencing foreign exchange forwards auctions, with authorized dealers required to bid for a minimum of US\$500,000 for one, two or three month periods. Authorized dealers are only allowed to sell the forwards bought from the CBN to their customers. Foreign currency forwards bought from the central bank are not transferable in the inter-bank market. While the Naira has been subject to some volatility, over the course of the past year, it is expected to firm moderately. However, market concern regarding the depth and extent of electoral violence, saw the Naira weaken to an 19-month low in April against the US\$ 151.93 on the interbank market.



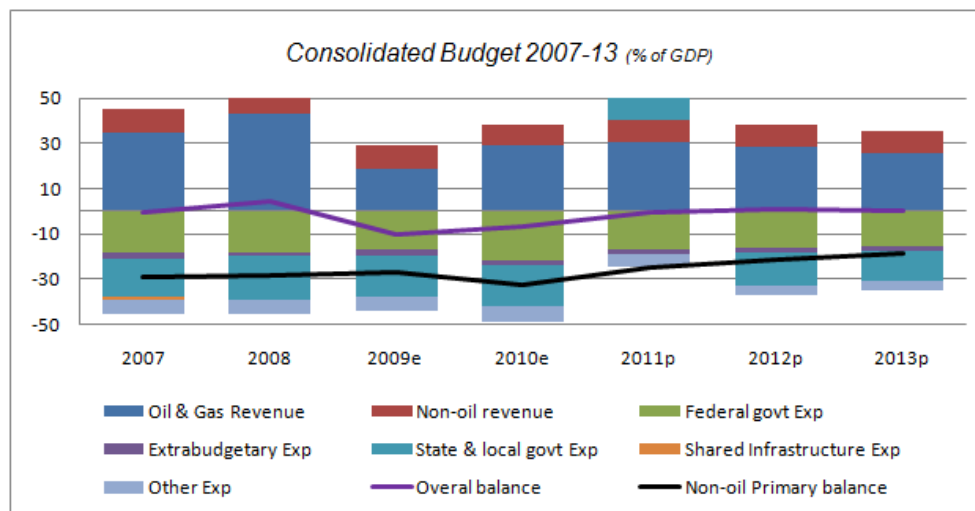
Source: CBN

Differentials between the benchmark Dutch-action system (DAS/WDAS) of foreign exchange trading and the Interbank and Bureau de Change rates have remained relatively constant over the past 12-months. This is as a result of the CBN strategy to bring greater transparency and predictability to foreign exchange markets. Over the course of 2010, the CBN defended the Naira, keeping it within a range of between 3% above or below 150 per US\$, as part of its anti-inflationary efforts. This contributed to a rapid erosion of foreign currency reserves, with the IMF voicing concern that the authorities need to adopt a more flexible exchange rate policy. However, the CBN has insisted that a more pragmatic policy mix is more appropriate to support the economy combining maintenance of a stable exchange, intervening to defend the currency as well as targeting inflation. As a result, MPC Policy will continue to be determined by the need to balance of the risks of inflation against the stability of the banking system.

Fiscal Policy

The government's attempts to maintain a prudential fiscal policy have been compromised, when during its legislative passage, the outgoing Senate increased the appropriation bill to NGN4.97 trillion (US\$31.8 billion), some 17% more than originally planned and increased the oil price assumption on which the budget is based. The revised budget is based on crude output of 2.3 mbpd, Bonny Light averaging US\$75 pb, an increase of US\$10 on the original projection and an exchange rate of NGN150:US\$1. The President must however approve the budget before it comes into effect, and market attention will focus how this issue is resolved in the post-election period.

The budget comprises recurrent expenditure of NGN2.47 trillion and capital investment projects totalling NGN1.56 trillion. Statutory transfers to government agencies will account for NGN496.6 billion and NGN445.1 billion will go toward debt servicing. The government's rhetoric is toward creating a macro-economic environment that enables private sector growth, increased labour absorption and boosts wealth creation. The fiscal deficit is forecast to fall to 3.6% of GDP, compared to last year's outturn of 6%, with oil revenues providing 80% of forecast income. The vulnerability of the fiscal sector to oil revenues is unlikely to evaporate in the medium-term, indeed current proven oil reserves are expected to remain commercially exploitable until 2065, however the authorities are making concerted efforts to sterilise the impact of global price volatility as much as practicably possible, and provide stability to the budget.



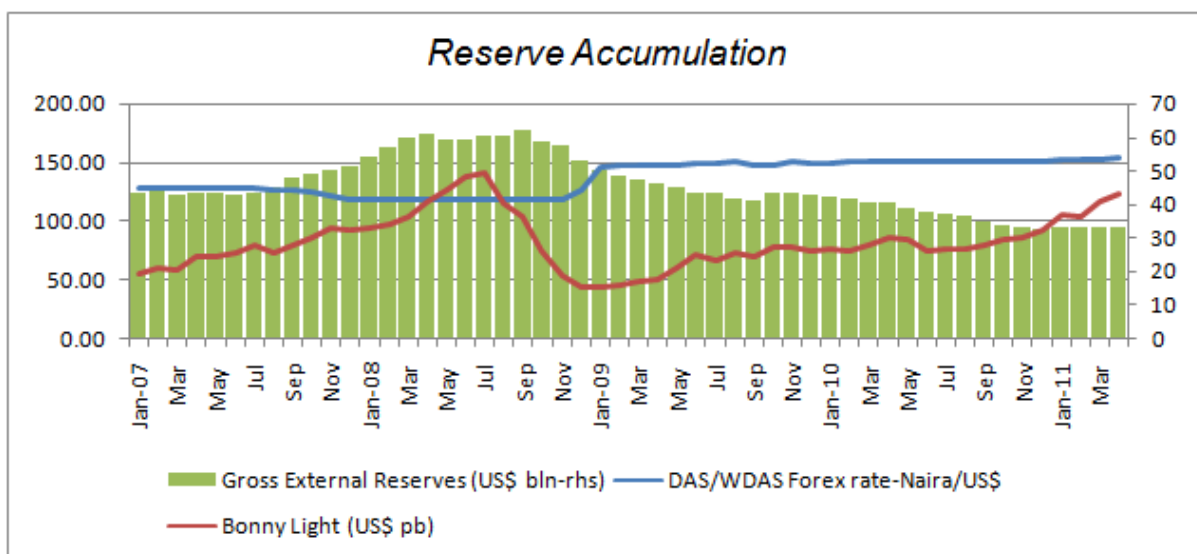
Source: Budget Office and IMF

As part of this process, the authorities are establishing a Nigerian Sovereign Investment Authority (NSIA), effectively a sovereign wealth fund, comprising three component parts: a stabilisation fund; a fund for future generations and a domestic infrastructure fund. While the legislative framework is still evolving, the government has said it intends to allocate 20% of all oil revenue in excess of annual budget base assumptions to each of the component funds, with the remainder allocated according to policy decisions of the NSIA board. While the NSIA represents an improvement on the Excess Crude Account (where decisions were made according to custom and evolving convention rather than within a specified legislative framework), if revenues fall below budget projections, the MoF can authorise drawdowns to support fiscal performance, as has occurred previously in 2009 and 2010. However, the creation of a separate infrastructure fund, if it does not complement the existing capital infrastructure investment projects and programmes, could compromise fiscal discipline. Indeed, the weakness of infrastructure is less a factor of expenditure allocations, than of chronic inability to realise expenditure and achieve project implementation. Furthermore, establishing the NSIA to provide stability within the budget process could prove elusive, given that the overall budget is currently in deficit and the persistent depth of the non-oil primary deficit. Securing the political legitimacy of the NSIA, in particular with the oil and gas producing regions in the

Delta, will be critical to the medium-term success of the sovereign wealth fund, and as a result the degree of transparency of its operations will prove critical.

External Sector

Pressure on external accounts, and in particular CBN interventions to support the Naira, has seen foreign exchange reserves fall from the recent peak equivalent to US\$62 bln in September 2008, to a low of equal to US\$32.35 bln last December. While there has been some limited improvement, foreign reserves accumulating to US\$36.47 bln in early March, volatility remains, easing back to US\$33.56 bln in April, before recovering to close US\$35 bln in May. Reserve re-accumulation over the course of this year will be heavily dependent not only on oil price movements, but also market perceptions of political stability and the sustainability of oil export capacity.



Source: CBN

The weaker external performance, was despite the improvement in the external environment, rising commodity prices, firming global demand and the subdued interest rate environment. Although oil and gas exports increased by close to a quarter, given the strengthening of price notably in the second half, import demand

surged by over a third, especially for non-oil related goods and services. As a result the current account surplus, halved from the 13% of GDP recorded in 2009 to close to 7% last year. Capital account performance has also eased, as the foreign direct investment sentiment suffered due to the protracted and extended passage of the Petroleum Industry Bill – which remains a legislative draft stage. While there are aspects of the proposed legislation that has unsettled some oil interests, the bill is intended to improve investment flows, enhance revenue yields and bring Nigeria closer to international market norms. Delay in the enactment of the legislation has however ensured that potential and current investors, domestic and foreign, are all postponing implementation.

Banks

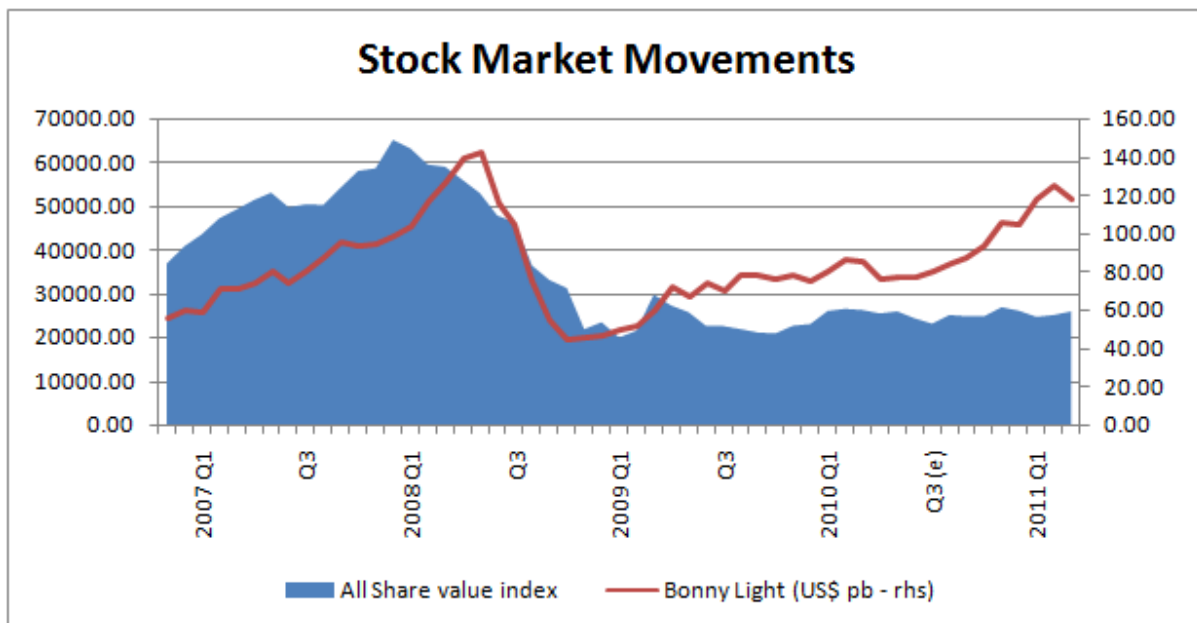
The end of the first quarter marked the deadline for banks submitting their results to the authorities. As part of the process of facilitating banking sector recovery, the Nigerian Accounting Standards Board (NASB) has agreed to waive the 1% general provisions for these results, following an agreement with the CBN. It can be anticipated that some financial institutions will have had to submit qualified accounts, as aspects of their financial statements do not meet revised accounting stipulations, such as, harder provisioning requirements. However, this is unlikely to alter the generally improving conditions in the banking sector. Last year saw a solid recovery in overall bank performance, from the 2009 crisis, and although the recovery has not been uniform. Despite the fact that asset growth has been slow, and yield return have weakened, reducing funding costs coupled with a combination of gains in operational efficiencies, improving credit quality and provisioning write-backs, have supported bank performance .

The CBN has introduced reserve averaging to the money market, in an attempt to dampen volatility in the overnight interbank market and strengthen the linkage between prevailing market rates and official policy rates. Under the new framework the CBN plans to remunerate banks' surpluses above the cash reserve requirement in their operational accounts in contrast to the previous practice, according to which the CRR account did not yield interest, could not be accessed and did not qualify for liquidity ratio computations. Under the modified framework, the daily average in banks' operational accounts with the CBN will be monitored over maintenance periods of four or five rolling weeks, and this would now serve as the banks' CRR, thus effectively terminating the existence of the CRR account. This will have the impact of boosting bank liquidity, given that previously this sum did not qualify for the computation of banks' liquidity ratio. It is also timely, considering that the upped 30% liquidity ratio requirement came into force at the beginning of March.

The restructuring of the banking sector can be expected to move up a gear, as M&A agreements are endorsed by the authorities. Intercontinental Bank and Oceanic Bank the largest of the banks involved in the conservatorship process, are finalising arrangements with Access Bank and First Bank, respectively. Confidence in the banks will be further bolstered, as AMCON purchases the bad debts and improves the balance-sheets of the banks. By the end of the first quarter, AMCON valued the assets bought in its first two tranches at NGN3 trn (US\$19.4 bln). AMCON to date has issued bonds equal to NGN1.7 trn, to fund these purchases, with a second series, equal to NGN1.3 trn will be sold to banks in conservatorship to bring their capital to neutral and facilitate their mergers. The CBN has stated that the bank recapitalisation process must be completed by September, or licences risk being revoked.

Capital Markets Performance

A combination of factors, including conclusive election results, accelerating oil prices and reviving confidence in the banking sector, have contributed to much stronger stock market performance. The All-Share Index peaked in the first and second quarter, closing May at 25,866 – thus reviving confidence had been attributed to AMCON purchases, but concerns over bank recapitalisation plans (due to be completed by September) to some extent deflated sentiment at the end of the second quarter.



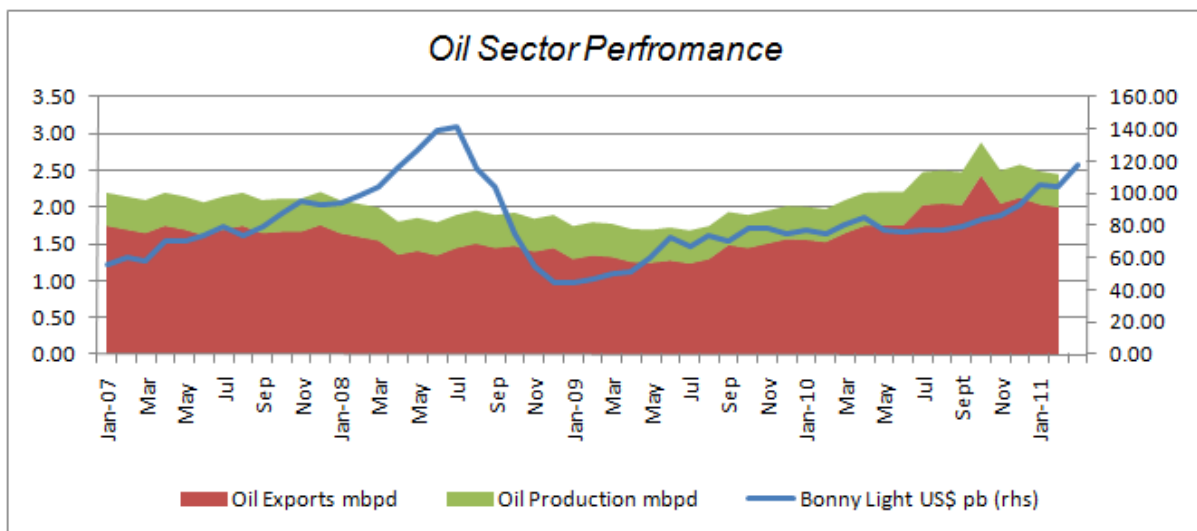
Source: NSE

In January, the MoF stated that it plans to borrow NGN865 billion to fund this year's budget deficit, 38% below that raised in 2010. In the second quarter, the Debt Management Office (DMO) has indicated that it will seek to tap domestic markets for NGN245 bln (US\$1.6 billion). The DMO issued NGN30 bln of seven-year and five-year debt in late April, with subsequent sales in mid-May and mid-June. Internationally, Nigeria's Eurobonds hit record levels following the elections results,

the dollar bonds due 2021 achieved the highest level since the bond was issued in January, with the yield falling 8 bps to 6.27%. The US\$500 million of bonds currently are Nigeria's only international notes.

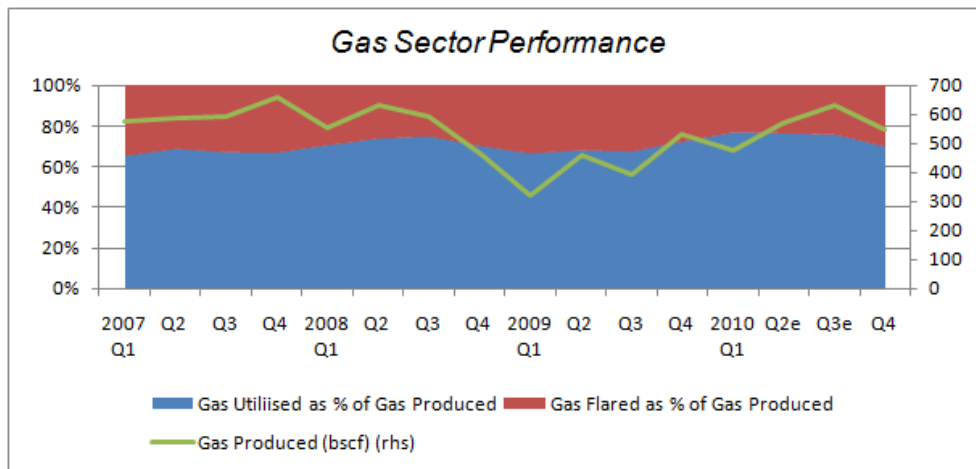
Oil sector

Delays in passing the PIB has delayed capital investment decisions, critical to sustaining and developing production capacity. The peace arrangements in the Delta enabled export production to recover from 1.71 mbpd in April 2009 to 2.58 mbpd at the end of last year, although the accord appears increasingly fragile. Given concerns over the reliability of oil supplies from other OPEC producers, Nigeria may again fail to fully exploit the opportunities available in the global market. Shell, Exxon Mobil, Chevron, Total and Eni all operate joint-ventures with the state-owned Nigerian National Petroleum Corporation (NNPC), which produce over 90% of current production. However NNPC future will remain is clouded until the PIB is enacted, and this has caused disquiet amongst its partners. Indeed, Shell, Total and Eni have agreed to sell assets in two fields to domestic producers, with NNPC retaining 55% interest in the fields. In total Shell plans to divest US\$5 billion in assets this year.



Source: CBN

The dearth of effective investment in the oil sector is reflected by the fact that Nigeria relies on fuel imports for 70% of its domestic needs, due to lack of refining capacity. Moreover, the government subsidises domestic fuel prices, boosting its spending as oil costs rise and increasing price pressures. Similarly, exploration of new fields has been delayed, and the development of marginal fields, which could incentivise local producers, has proved problematic. In 1996, the government initiated a programme for the development of marginal fields, although fields were not awarded until 2003. According to some estimates the 29 identified marginal fields contain approximately 200mn bbls of oil resources and approximately 400mn boe of gas and gas-condensate resources. Most of these fields were discovered a number of years before the marginal field programme was established, reflecting the lack of effective exploration to date.



Source: NNPC

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