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Sovereign Advisory Viewpoints

February 6th, 2023

The Nigeria Credit Rating Downgrade

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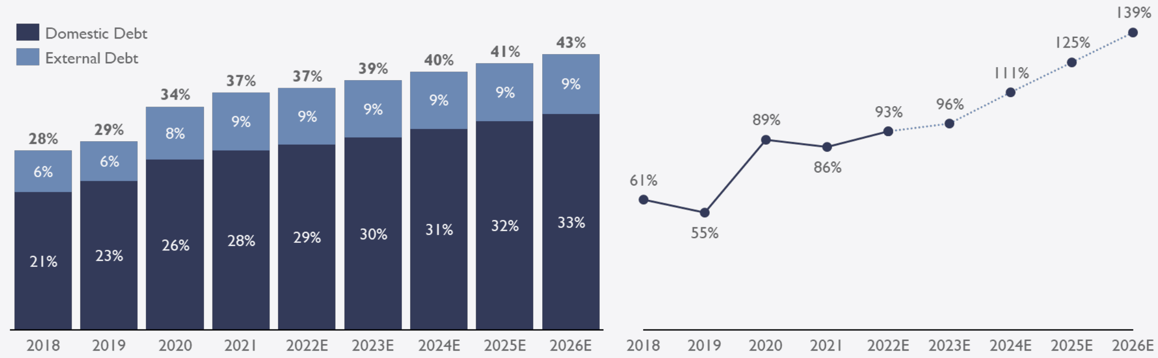
On the 27th of January 2023, Moody's downgraded Nigeria's credit rating to Caa1 (with a stable outlook) from B3, stating that it expected a continued deterioration in Nigeria's fiscal and debt position. This latest downgrade by Moody's puts Nigeria's credit rating on par with Gabon, Pakistan, and Iraq, and follows a downgrade to B3 from B2 in October 2022.

Moody's latest announcement came just a few weeks after Nigeria's finance minister Zainab Ahmed said the country's debt trajectory was sustainable and mentioned her plan to bring the debt service-to-revenue ratio down to 60% by year-end. Despite the relatively muted market response to this latest downgrade, we believe it has the potential to have a more significant impact on the economic and financial stability of the country than markets seem to currently indicate.

Nigeria's Gross Debt/GDP (left) and Interest Payments to Revenues (right) ratios

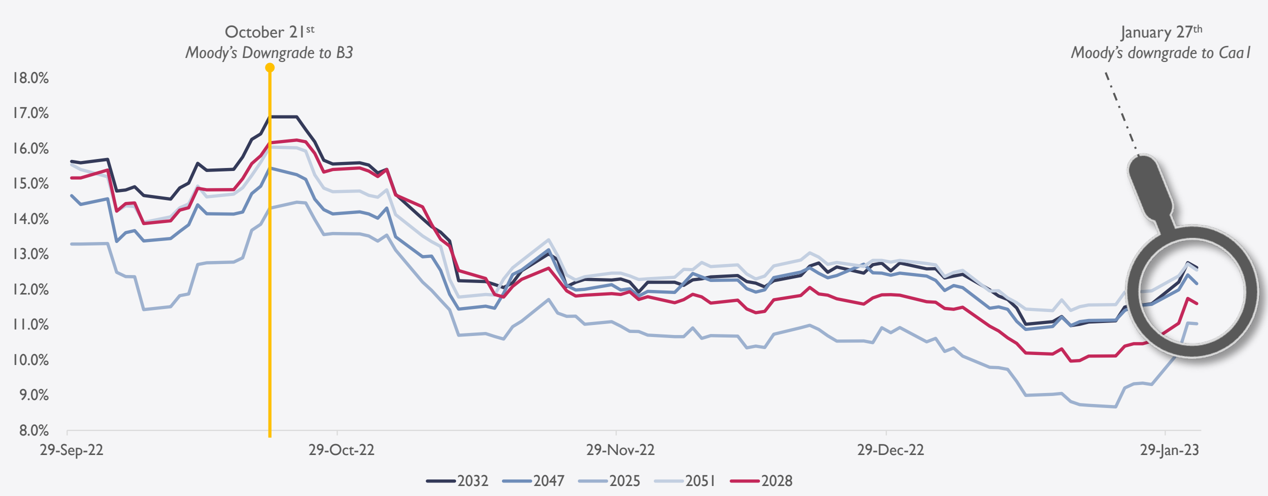


Source: IMF Article IV Feb 2022, World Economic Outlook Oct 2022

Normally, the immediate effect of a credit rating downgrade comes in the form of increased borrowing costs for the government driven by heightened investor caution and an increase in the risk premium demanded for new issuances. This is less of a concern with Nigeria for the following reasons:

- Firstly, Nigeria (alongside most of Sub-Saharan Africa) has been effectively locked out of capital markets since the dawn of the COVID-19 pandemic and has resorted to more expensive domestic markets where investors have an easier time with foreign currency rating downgrades and are more focused on Nigeria's local currency rating (which is higher).
- It helps that the overall amortization profile of the government's debt is favourable in the near to medium term. Nigeria has no significant public debt redemptions due this year, with the next one being a $500m bullet maturity in July 2023. An uptick in redemptions from 2025 is far enough in the future for a reasonable expectation of an improved fiscal picture.
- Finally, this downgrade was expected by the market and largely priced in. We believe that Nigeria's Eurobonds are currently trading at a level that does not fully account for the hard currency revenues from current commodity bull markets (despite Nigeria's reduced -and reducing - crude production capacity).

Selected Nigerian Eurobond yields from September 2022 to date



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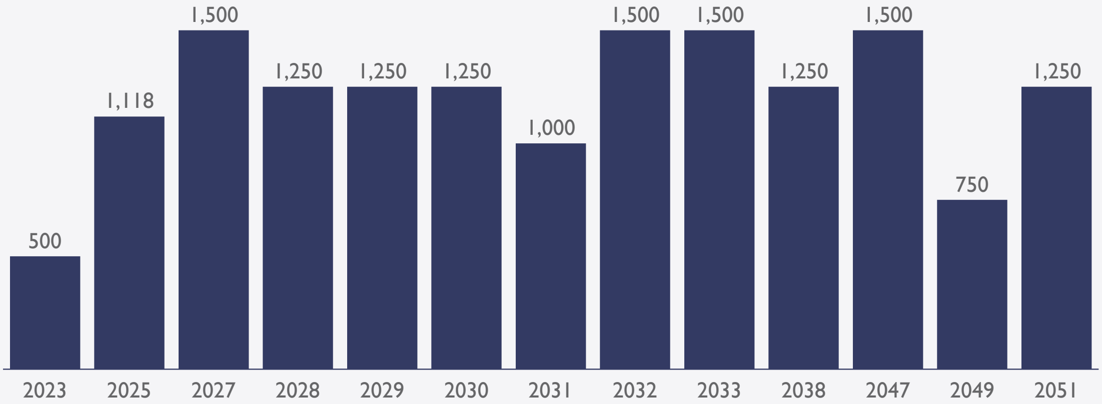
Selected Nigerian Eurobond yields and % change vs previous downgrades

Note	Outstanding Amount ($M)	COUPON (%)	YIELD			
			1-Feb-23	Δ 01/30/2023	Δ 01/27/2023	Δ 01/21/2022
NGN - 2025	1,118	7.63%	11.0%	+0.8	+1.7	(3.3)
NGN - 2028	1,250	6.13%	11.6%	+0.6	+1.1	(4.6)
NGN - 2038	1,250	7.70%	12.3%	+0.1	+0.6	(3.7)
NGN - 2047	1,500	7.63%	12.2%	+0.2	+0.6	(3.3)
NGN - 2051	1,250	8.25%	12.6%	+0.2	+0.6	(3.5)

Selected Nigerian Eurobond yields and % change vs previous downgrades



Source: Cbonds, as of February 1st, 2023

While immediate access to foreign capital markets might not be a pressing concern for the government, this rating downgrade brings with it other equally unpleasant side effects. From a reduction in foreign investment and an exacerbation of the existing economic challenges being faced by the country due to hard currency shortages to the potential political implications – especially with presidential elections coming up on the 25th of February. While more clarity is expected on the Central Bank of Nigeria's (CBN) currency management strategy after the elections, this downgrade is bound to bring more distress to an already fractured CBN.

In practical terms, this latest rating action also brings more stressors to the public and private sectors. We expect to see an uptick in non-performing assets across the banking sector which would lead to a further reduction in risk appetite and credit issuance volumes. Alongside traditional banks, start-ups, particularly fintech and service-based businesses will also experience a funding squeeze as investor capital takes flight. Meanwhile, more established local companies can expect an increase in their cost of capital which would in turn lead to an increase in the cost of goods & services produced – a cost that is often passed on to the consumer, and an unpalatable option with inflation already at a painful 21.3%.

More significantly impacted however are SMEs, as these enterprises often have more limited access to capital and are heavily reliant on local markets. As a direct consequence of this downgrade, SMEs may struggle to secure financing and face higher financing costs when they do get access to funds due to a shrinking pool of available local funding and the diminishing risk appetite of potential lenders (who would be more likely to direct capital to larger enterprises). Such a situation would impede their growth and job/value creation potential.

Despite these headwinds, pockets of opportunity remain for Nigeria. The agriculture sector remains a source of consistent growth, accounting for 23% of GDP. Low labour costs, a large and growing population, and relatively few actors across the agriculture value chain are just some of the reasons why this sector has continued to grow despite the challenges of COVID-19. It has also benefitted from commodity price inflation driving increased revenue from exported goods. Essential services e.g., healthcare and utilities, are also more resilient to the negative side effects of Nigeria's downgraded credit rating and are expected to better weather the coming challenges Nigeria would face on its road to fiscal and macroeconomic recovery.

Given the expectation of a continued deterioration in near-term fiscal metrics, DFIs, donors and other international stakeholders should play a part in ensuring that this decline is short-lived and that the human impact of the challenges highlighted above is minimised. Support can be most effectively rendered via interventions in the private sector using tools like credit guarantees, first-loss capital provision, equity injection, and results-based grant funding. Support for initiatives that scale climate and nature outcomes also benefit from the positive externality of providing support to local communities that directly contribute to economic output.

In conclusion, the most recent credit rating downgrade is expected to have a significant impact on Nigeria's economy and financial stability. Nigeria faces increased borrowing costs, a decline in foreign investment, reduced access to international financial markets, and increased pressure on the CBN to abandon currency controls and devalue the Naira. To restore its financial stability and improve its credit rating, the government must implement stringent fiscal reforms and address the underlying economic challenges, working with global partners and stakeholders on finding innovative solutions to some of the most pressing near-term challenges faced by the country.

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