GCR GLOBAL CREDIT RATING CO.
Local Expertise • Global Presence

Lagos State Government of Nigeria

Nigeria Local Authority Analysis **May 2019**

Security class	Rating scale	Rating	Rating outlook	Expiry date
Issuer rating	National	A+$_{(NG)}$	Rating Watch	October 2019
Programme 2 - Series 1: N80bn Fixed Rate Bond	National	A+$_{(NG)}$		
Programme 2 - Series 2: N87.5bn Fixed Rate Bond	National	A+$_{(NG)}$		
Programme 3 - Series 1: N47bn Fixed Rate Bond	National	A+$_{(NG)}$	Rating Watch	
Programme 3 - Series 2 Tranche I and II: N85.1bn Fixed Rate Bond	National	A+$_{(NG)}$		
Programme 3 – Series 2 Tranche III and IV: N12.2bn Fixed Rate Bond	National	A+$_{(NG)}$		

Summary of bond programme:

Total programme value:
N167,500,000,000 (Programme 2- lapsed, 2014)
N500,000,000,000 (Programme 3)
Coupon rate: Series specific.
Maturity: Series specific.
Status of bonds: Bonds are direct, unsecured & general obligations of the State i.e. ranking *pari passu* with other senior unsecured obligations.

Key transaction counterparties:

Issuer: Lagos State Government of Nigeria
Joint Trustees: FBN Trustees Ltd, STL Trustees Ltd, United Capital Trustees Ltd, Union Trustees Ltd, CSL Trustees Ltd, Sterling Trustees Ltd, Radix Trustees Ltd, ARM Trustees Ltd, Coronation Trustees Ltd, and Stanbic Trustees Ltd.

Rating methodologies/research:

Global Master Criteria for rating Public Entities, February 2018

Lagos State Government ("Lagos State", "Lagos", or "the State") rating reports 2012-17

Glossary of Terms/Ratios (February 2018)

Rating history:

Rating class	Rating	Date	Outlook
Initial ratings			
Issuer	A$_{(NG)}$	Sep-11	Stable
Prog. 2 Series 1	A+$_{(NG)}$	Aug-12	Stable
Prog. 2 Series 2	AA-$_{(NG)}$	Aug-13	Stable
Prog. 3 Series 1	AA-$_{(NG)}$	Feb-17	Stable
Prog 3 Series 2,			
Tranche I & II	AA-$_{(NG)}$	Dec-17	Stable
Tranche III & IV	AA-$_{(NG)}$	Jan-18	Stable
Last ratings			
Issuer	A+$_{(NG)}$	Mar-19	Rating Watch
Prog. 2 Series 1	AA-$_{(NG)}$	Mar-19	Rating Watch
Prog. 2 Series 2	AA-$_{(NG)}$	Mar-19	Rating Watch
Prog. 3 Series 1	AA-$_{(NG)}$	Mar-19	Rating Watch
Prog 3 Series 2,			
Tranche I & II	AA-$_{(NG)}$	Mar-19	Rating Watch
Tranche III & IV	AA-$_{(NG)}$	Mar-19	Rating Watch

GCR contacts:

Primary Analyst:
Adekemi Adebambo
Senior Analyst
adekemi@globalratings.net

Committee Chairperson:
Dave King
king@globalratings.net

Analyst Location: Lagos, Nigeria
+23 41 904-9462-3

Website: http://www.globalratings.com.ng

Summary rating rationale

- The rating is supported by Lagos State's position as the financial, commercial and industrial centre of Nigeria, accounting for c.30% of Nigeria's Gross Domestic Product and over 50% of its industrial investments, foreign trade and commerce. Although Lagos has the most diversified revenue base in Nigeria, significant capital outlays are required to deliver required infrastructure, security and reduce unemployment.
- GCR takes a negative view of the incidents of non-compliance with the trust deeds in respect of timely transfer of funds in the Consolidated Debt Service Account to the respective sinking funds on Lagos' bonds, as well as failing to honour an irrevocable standing payment order ("ISPO") issued to a contractor. The potential for negative rating action should the non-compliance persist, is reflected in the Rating Watch.
- Although there has not been a default on the State's bonds on any coupon payments date, the persistent non-compliance with monthly IGR funding requirements could be reflective of potential liquidity issues. Due to the irregular IGR funding, the funds in the sinking fund account do not provide excess cash cover or a credit enhancement to the Bonds. Accordingly, GCR no longer considers that there are meaningful structural protections for bond holders and ratings for all the bonds issued by Lagos State have been equalised with the Issuer rating.
- Lagos has a resilient revenue generation capacity underpinned by a strong IGR base that has averaged 86% of income over the review period. On the back of a recovery in the nation's economy and ongoing reforms in revenue collection, total recurring income rose by N68.1bn to N481.4bn in FY17 and by 17% in FY18 (as per unaudited 12-months management accounts) but lagged budget by 33%.
- Overall, recurrent expenditure (excluding public debt charges) increased by 14% to N234.7bn in FY17 underlying an increase in government running costs. Staff costs as a portion of expenditure declined to 39% in FY17 (FY16: 42%) and was maintained at same level in FY18, albeit above GCR's 35% benchmark for prudent costs. IGR has been sufficient to cover recurrent expenditure over the review period. Operating surplus edged higher to N293.7bn in FY18 (FY17: N246.7bn), resulting in a higher total debt service coverage ratio of 1.9x (FY17: 1.3x) albeit below GCR's benchmark of 2.5x.
- Although gross and net debt to income have eased to 143% and 135% in FY18, from 191% and 182% at FY16, the metrics remain elevated. Of some concern is the potential for debt to climb towards N900bn by FY19, (given the budgeted deficit of over N70bn), which would place credit protection metrics under some pressure. However, to the extent that the debt translates into more robust economic growth and substantial increase in revenue, credit metrics are expected to improve in the medium to long term.

Factors that could trigger a rating action may include

Positive change: Consistent growth in revenue (especially IGR), combined with effective cost management and further diversification of the State's economic base could result in positive rating action over the medium term.

Negative change: Continued non-compliance with the terms of respective bonds and other obligations could lead to a negative rating action. GCR considers the debt level to be high. Thus, any revenue underperformance and/or further increases in the debt burden could place pressure on the State's ratings.

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Background on Lagos State

Lagos State is the smallest in the country in terms of geographical size, but it is the most densely populated, housing over 20 million people (c.10% of the estimated[1] Nigerian population). Lagos is the financial, commercial and industrial nerve centre of Nigeria, housing a significant number of commercial establishments and over 2,000 manufacturing companies. The two major sea ports; Tin-Can and Apapa ports account for over half of the nation's revenue from port services. Lagos State contributes c.30 of Nigeria's Gross Domestic Product ("GDP") and accounts for over 50% of the nation's industrial investments, foreign trade, commerce and tourism. It ranks as Africa's second fastest growing city, having witnessed significant infrastructural development in recent years, further expanding economic activities and diversifying revenue sources.

Recent developments

Outstanding bonds

Table 1: Lagos State Fixed Rate Bond Programmes					
Programme	**Note Series**	**Issue Date**	**Coupon Rate (%)**	**Tenor (yrs)**	**Maturity**
II - N167.5bn*	N80bn Series 1	Nov-2012	14.5	7	2019
	N87.5bn Series 2	Aug-2017	13.5	7	2020
III – N500bn	N47bn Series 1	Dec-2016	16.5	7	2023
	N97.4bn Series 2^				
	N46.4bn- TI	Aug-2017	16.75	7	2024
	N38.8bn- TII	Aug-2017	17.25	10	2027
	N6.9bn- TIII	Dec-2017	15.60	6.6	2024
	N5.3bn- TIV	Dec-2017	15.85	9.6	2027

*Lapsed

Lagos State's aggressive development programmes have been consistently funded through the Nigerian capital market. Since 2009, the State has successfully undertaken three bond programmes and issued nine fixed rate bonds. After fully settling the initial N50bn bond upon maturity in 2014 and the N57.5bn bond (in April 2017), the State registered a third Bond Programme in 2016, with N47bn issued as Series 1 Bonds and a combined N97.4bn issued in four tranches under Series II Bonds.

Previously, GCR has accorded the individual bond ratings a one notch uplift above the Issuer rating, based on some structural enhancements made under the respective Series Trust Deeds ("STD") to ensure sufficient funding for the repayment of principal and interest on the existing bonds. While the terms differ slightly for each bond, these include an Irrevocable Standing Payment Order approved by the Federal Government and monthly transfers from Lagos State's IGR via the Consolidated Debt Service Account ("CDSA"). Although Lagos has not defaulted on actual payments of coupon or principal payments on the respective bond issuances, GCR has identified a number of areas of non-compliance:

Programme 2, *Series 1 and 2 Bonds* - The state stopped making monthly IGR transfers to the respective sinking fund accounts after the last transfer done in May 2018, with the only regular funding being the monthly ISPO transfers from federally allocated revenue. Accordingly, the balance in the respecting sinking funds is currently much lower than indicated by the bond simulation schedule, with an anticipated shortfall of N6bn for the Series 1 Bonds and N23bn for the Series 2 Bonds, in the absence of regular monthly IGR transfers.

Programme 3, *Series 1* – Transfers from IGR have been irregularly made since inception of the bonds. A total of 26 monthly IGR transfers ought to have been made between January 2017 and February 2019, however, GCR notes that there have been 14[2] inflows. There were no deficits in the sinking fund account on coupon payment dates as shortfalls have been transferred by Lagos in lump sum via the CDSA just a week or few days to coupon payment, but this pattern remains in breach of the terms of the STD.

Programme 3, *Series 2* - Monthly IGR payment have not been made for the P3 S2 bonds (as contemplated by the respective STDs). Rather, exact funds for debt service are brought in a few days to the coupon payment date.

The mechanism with which the respective sinking fund accounts have been funded does not currently offer any credit enhancement to the bonds. As such, GCR has equalised the ratings for all the bonds issued by Lagos state with the Issuer rating. *A detailed discussion of all bonds issued by Lagos State is presented at the end of this report.*

In addition to non-compliance with some terms of the bond programmes, Lagos recently failed to honour an ISPO it had issued in favour of Municipality Waste Management Contractors Limited ("MWMCL")[3]. In brief, premised on an executive resolution issued by Lagos State Executive Council resolution in March 2017, an ISPO was issued by the State Treasury Office of the Ministry of Finance, Lagos State (dated April 20, 2017) and addressed to MWMCL, whereby Lagos committed to make monthly payments into a sinking fund account, from which the MWMCL bond servicing obligations would be met. However, Lagos suspended payment into the sinking fund accounts, as a result of which MWMCL defaulted on its coupon payment date of 5 March 2019. The State confirmed that the payment standstill is not as a result of its inability to pay, given the strength of LASG treasury, but rather the inability to secure requisite approval of the State House of Assembly to fund the sinking fund accounts. Subsequently, the necessary coupon and principal payments have been made. GCR understands from Lagos that Visionscape has suspended services in 3Q 2018 and the service contract is being reviewed.

GCR takes a negative view of the incidents of non-compliance with the trust deeds in respect to timely transfer of funds in the Consolidated Debt Service Account to the respective sinking fund accounts on Lagos' bonds, as well as reneging on an obligation. It is in this regard that that the current ratings have been placed on Rating Watch. Negative

[1] The last official population census was conducted in 2006. In 2016, the National Bureau of Statistics estimated Nigeria's population at c.193.4m.

[2] If respective components of lumped IGR inflows are counted separately, total inflows will be 14. There are instances when the inflows for 2 to 4 months are lumped together and transferred by Lagos (from the CDSA as one inflow), a week or few days to coupon payment date.

[3] a special purpose vehicle ("SPV") set up to serve as a funding structure to finance the acquisition and development of waste management infrastructure in Lagos State.

rating action may arise if remedial action to avoid similar scenarios is not put in place.

The impact of economics

The Federal Government of Nigeria ("FGN") implemented various intervention programmes as part of measures to cushion the effect of economic hardship on the States; including the disbursement of around N1.6tr to States and Local governments between 2015 and 2017. The interventions have taken the form of State Excess Crude Account Loans, Stabilisation Fund and Budget Support Facility. The FGN also approved the release of refunds to States, arising due to excess deductions (from their statutory allocations) in respect of repayment of external debts. Two tranches of N522bn (approved in December 2016) and N243.8bn (approved in May 2017) were released to the States to provide support, while a third and final tranche of c.N823.5bn has been approved, and disbursement commenced in September, 2018.

The nation's GDP grew by 1.9% in 2018 (2017: 0.8%) mainly underpinned by improvements in the non-oil sector (agriculture, information and communication technology, transport support services and manufacturing). This was broadly as a result of economic stimulating policies of the government and the relative stability in the foreign exchange market. In turn, State Governments have benefitted from the economic recovery, with increases in statutory allocations and various funding interventions in 2018. This notwithstanding, economic growth in 2018 was constrained by security challenges in certain parts of North-Eastern Nigeria as well as uncertain political environment. The first quarter of 2019 has being dominated by electioneering activities, as such progress on new legislation has stalled and the proposed 2019 budget has not been passed into law. Thus, economic growth may be sluggish during 1H 2019, as government expenditure (especially capital spending) is critical to economic growth and development.

Income and expenditure

Table 2: Financial performance (N'm)	FY16	FY17	% ∆
Total IGR*	365,205	419,823	15
Statutory allocation	48,097	61,548	28
Total recurrent income	**413,302**	**481,371**	**16**
Personnel costs	(87,072)	(91,983)	6
Overhead costs	(70,096)	(81,689)	17
Consol. rev. charges	(252)	(256)	1
Grants and Sub.	(47,721)	(60,742)	27
Total non-debt recurrent exp.	**(205,141)**	**(234,670)**	**14**
Operating surplus	**208,161**	**246,701**	**19**
Capital rec. and other income	36,307	29,626	(18)
Depreciation	(84,607)	(92,992)	10
Public debt charges	(55,573)	(65,613)	18
Capital expenditure	(215,228)	(278,171)	29
Net FX loss	(138,311)	(36,310)	(74)
Surplus/(Deficit)	**(249,252)**	**(196,759)**	-

*Includes VAT proceeds

A four-year historical financial synopsis is reflected at the end of this report and brief comment follows hereafter. While the financial statements for 2014 and 2015 were compiled using the modified cash accounting basis under the old GAAP, the 2016 and 2017 accounts represent the first and second transitional accrual IPSAS financial statements of the State. GCR positively considers the adoption of IPSAS accounting, as the new system is intended to improve disclosure and transparency, which will allow for a more in-depth analysis of underlying trends. The State Auditor-General issued an unqualified opinion on the 2017 financial statements and for preceding years, over the review period.

Following a recovery in the nation's economy (on the back of stronger oil output and improvement in the agricultural sector), Lagos' revenue increased by 16% to peak at N481.4bn in FY17, albeit below budget. The State's resilience is underpinned by a strong IGR base which averaged 86% of income over the review period. The sustained growth in IGR is largely supported by higher income tax receipts, attributed to the ongoing reforms in revenue collection and widening of the tax net. The impact of production cuts and the USA's sanctions on Iran supported higher global crude oil prices in 2017[4], and this served to strengthen the financial and budgetary capacity of the FGN. As such, the State's statutory allocation increased to N38.2bn (FY16: N27.3bn). Overall, the State reported growth across most revenue lines as reflected in Table 3.

Table 3: Revenue diversification N'm	Actual		Actual		% ∆
	FY16	%	FY17	%	
Income taxes	244,661	59	294,229	61	20
VAT	75,438	18	80,232	17	6
Other IGR	36,441	9	35,241	7	(3)
Inv. & Int. income	8,665	2	10,122	2	17
Statutory receipts	48,097	12	61,548	13	28
Total	**413,302**	**100**	**481,371**	**100**	

Overhead costs rose to N81.7bn (FY16: N70.1bn), underlying an increase in government running cost, with the bulk of the increase attributable to general expenses and social benefits. Although staff costs increased by 6% to N92bn, it was in line with budget and driven by State's ongoing revenue mobilisation drive. Staff costs as a portion of expenditure declined to 39% (FY16: 42%) given the larger increase in operating expenses, but remains above GCR's 35% benchmark for prudent costs. Given political dynamics, it is unlikely that Lagos will reduce staff or emoluments, especially during this period of economic recovery, and with a new governor expected to be sworn in before end-May 2019. Overall, recurrent expenditure (excluding public debt charges) increased by 14% to N234.7bn in FY17 and was within budget. Supported by the strong revenue growth, operating surplus[5] rose to a period high of N246.7bn (FY16: N208.2bn), translating to a 51% margin (FY16: 50%).

As a result of the net increase in domestic debt and impact of exchange rate movement on external debt, interest costs registered at a higher N65.6bn in FY17 (FY16: N55.6bn) and more than doubled the budget of N30.1bn. In line with

[4] Average crude oil price increased to USD52.5/barrel in 2017 (2016: USD40.7/barrel)

[5] before capital items, public debt charge and foreign exchange loss

ongoing industrialisation plans, capex spend has remained high, equating to 58% of income in FY17 (FY16: 52%). After accounting for depreciation and net exchange loss (incurred on year-end translation of foreign currency denominated loans and other monetary items), Lagos reported a net deficit of N196.8bn (FY16: N249.3bn). Infrastructure spend was largely funded by proceeds from bond issuances, internal loans and other capital receipts.

Table 4: Capex profile (N'bn)	Actual		Budget	%
	FY16	FY17	FY17	achieved
Gen. public services	43,683	54,599	95,283	57
Economic affairs	132,408	161,317	196,864	82
Environment	17,830	28,611	35,514	81
Housing & amenities	14,399	22,134	41,757	53
Education	12,499	10,414	23,582	44
Others	15,838	32,260	43,260	75
Total	**236,657**	**309,335**	**436,260**	**71**

Lagos State is less impacted (than other State Governments) by economic challenges, as it has a much lower dependence on statutory receipts. Lagos' revenue is well diversified and the majority is derived from internally generated sources, primarily from income taxes (61%) and VAT distribution (17%) and continue to support strong ratings.

Table 5: Operating cash flows (N'm)	Actual		Budget	%
	FY16	FY17	FY17	Achvd.
Recurrent receipts	413,330	478,503	593,684	81
Personnel costs	(98,566)	(101,554)	(104,712)	97
Overhead costs	(69,721)	(85,312)	(105,041)	81
Grants & subvention	(47,721)	(60,742)	(65,352)	93
Public debt charge payment	(54,271)	(61,638)	(30,078)	205
Recurrent payments	**(270,279)**	**(309,246)**	**(275,105)**	112
Net cash flows before capital items	**143,051**	**169,257**	**288,501**	59
Other capital receipts	36,307	29,626	49,164	60
Loans/bonds	106,147	151,228	170,151	89
Special funds	11	277	-	-
Capital expenditure	(236,657)	(309,335)	(436,260)	71
Utilisation of bond sinking fund	12,125	76,998	-	
Net movt. in receivables	(38)	(282)	-	
Net exc. gain/loss	(388)	374	-	
Repayment of borrowings	(49,821)	(128,593)	(71,556)	180
Net cash flow	**10,737**	**(10,450)**	**(0)**	-

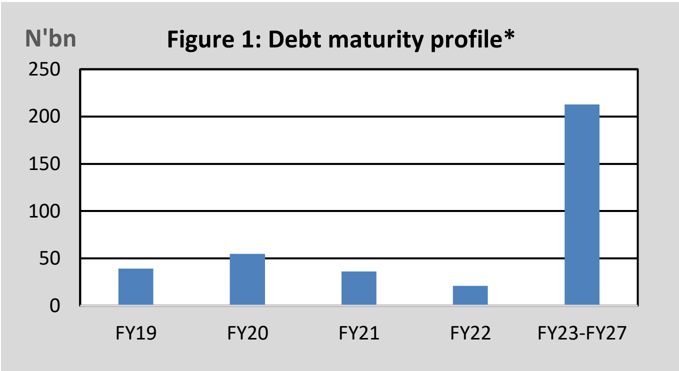
Funding profile

Table 6: Financing sources (N'm)	FY16	FY17	FY18*
External	410,926	454,415	438,810
Commercial	127,579	138,834	145,049
Bond Issues	241,362	251,334	214,279
Finance lease obligations	11,159	9,737	7,999
Total	**791,026**	**854,320**	**806,137**
Key ratios			
Gross gearing	*191.4*	*177.5*	*143.1*
Net gearing	*182.3*	*171.9*	*134.9*
*Debt Service Coverage ratio^*	*1.8*	*1.3*	*1.9*

*Total debt is moderated by funds in the Sinking Fund Account - N108.3bn at FY16 and N31.3bn and FY17 respectively.
^Operating surplus divided by actual principal and interest payments

Property, Plant and Equipment accounts for around 90% of the State's asset base. Lagos' huge capex spend mainly accounted for the N10.5bn net decline in cash holdings to N27bn in FY17. The State's cash is spread across 18 Nigerian banks, including sums allocated to various Ministries/agencies for capex, but which have not been expended. Days cash on hand increased to 63 days in FY18 (as per unaudited 2018 management accounts), which GCR considers to be sufficient. The strong cash generative capacity of Lagos partly serves as a support to the rating. The value of the State's investment portfolio was largely stable at N76.2bn at FY17, before falling to N75.1bn at FY18. Other financial assets[6] reduced substantially to N31.1bn in FY17 (FY16: N108.3bn) and N16.7bn at FY18, following the bullet redemption of the N57.5bn Bond (in April 2017) and repayment of other debt obligations.

In addition to the historical strong operating surpluses, there has been increased utilisation of debt to fund infrastructure programmes. Lagos raised additional internal loans of N45bn during FY18 but repaid N83.7bn in debt, with gross debt declining to N806.1bn as at end-December 2018. Of this 45% (FY17: 46%) is derived from commercial sources being banks and the capital market. Maturity dates on the bonds range from 2019-2027. The bonds are senior unsecured obligations of the Issuer and principal redemption basis is amortising following expiration of the moratorium period on the respective bonds.



* Excludes external loans
**The final maturity date of the N80bn Programme 2 Series 1 Bonds is November 2019. Outstanding balance on the bonds stood at N24.4bn at end-February 2019.

Internal loans as at FY18 comprised 20 credit facilities provided by eleven local banks with interest rates between 18% to 22% p.a. Maturities extend beyond three to five years in most instances. Around 60% of loans mature from FY23 onwards. The value of outstanding principal on the external/foreign loans reduced by USD50m to USD1,480m at end-December 2018. The loans have concessionary interest rates of around 1% - 2% per annum, with tenors ranging from 20 to 40 years, and moratorium on principal repayment ranging between five and thirteen years. The bulk of maturities fall within 2031-2051, while only one loan has final maturity of 2022[7]. Notwithstanding the foregoing, the loans expose the State to foreign exchange risk, especially when the Naira depreciates. The reduction in debt, coupled with revenue growth, saw a decline in both gross and net debt to total income to 143% and 135% respectively at FY18 (FY17: 178% and 172%). Gross debt and net debt accounted for 34% and 33% respectively of the State's asset base as at December 2018 (FY17: 39% and 37%).

[6] comprising bond sinking funds invested and managed by the Trustees for servicing the State's obligations on the respective bonds

[7] The loan was obtained in 2002 and has a 20-year tenor

2018 performance and future prospects

Lagos State's 2018 budget size was aggressive at around N1trn, with total revenue[8] expected to be N897.4bn and a funding deficit[9] of N148.7bn. Total recurring income increased substantially by around N82bn but lagged budget by 33%. The underperformance was attributed to general economic conditions. Underpinned by the revenue growth, efficiency metrics remained around FY17 levels despite a 21% rise in personnel and overhead costs. Operating surplus edged higher to N293.7bn (FY17: N246.7bn), with the margin reported at 52.2% (FY17: 51.2%). Gross debt had declined by N48bn as at end-2018 while public debt charges increased to N72.7bn (double the forecast level) due to impact of a full year interest on the bonds and loans obtained during 2H FY17. The State sustained its infrastructural development drive in FY18, with around 50% of capex spent on roads, drainages and bridges; N36.7bn on land and building and N34bn on the LAMATA[10] BRT[11] Project, while several smaller projects were also implemented.

Table 7: Financial performance (N'bn)	FY18^	FY18 Budget	% Achieved	% Δ
Total IGR*	481.6	783.8	61	17
Statutory allocation	81.6	57.5	142	33
Total recurrent income	**563.2**	**841.3**	**67**	**15**
Total non-debt recurrent exp.	(269.4)	(311.1)	87	15
Operating surplus	**293.8**	**530.2**	**55**	**19**
Other capital receipts	45.7	56.1	81	54
Depreciation	(101.2)	n.a	n.a	9
Public debt charges	(72.7)	(35.9)	202	11
Exchange gain	8.8	n.a	n.a	n.a
Capital expenditure	(375.6)	(600.8)	63	35
Surplus/deficit	**(201.2)**	**n.a**	**n.a**	**2**

^Unaudited management accounts to December 2018
*Includes VAT receipts

In February 2019, the governor submitted a N852.3bn budget proposal to the House of Assembly, but the approved budget is not yet available. Total revenue is budgeted to be N775.2bn, of which N606.3bn will be realised from IGR and N168.9bn from federal transfers, while the N77bn deficit will likely be sourced through debt financing. Global crude oil prices have been sustained above USD60/barrel since end-January 2019[12] and this suggests a strong potential for increased statutory allocations to the State. Lagos is positive that revenue will increase in FY19 based on established public financial management and technology–driven revenue reforms, through data integration and use of multi-payment channels. These reforms have helped to minimise loopholes in revenue generation activities and budgetary spending, thus enhancing transparency and accountability.

The budget proposal anticipates a total capex spend of N462.8bn (3-year average: N307bn) with focus on completing major ongoing projects including Oshodi-Murtala Mohammed International Airport Road; Agege Pen Cinema Flyover; Phase II of Aradagun-Iworo-Epeme Road, Oshodi Interchange Terminal; JK Randle Complex, Onikan Stadium, Imota Rice Mill as well as renovation/furnishing of Lagos Revenue House, *inter alia*.

Of some concern is the potential for debt to climb towards N900bn by FY19, given the budgeted deficit of over N70bn. While some increase in income may also be reported, debt metrics may likely climb further. However, to the extent that the debt translates into more robust economic growth in the medium to long term, credit metrics are expected to ease going forward.

Bond rating considerations

In performing the above analysis, GCR has considered those factors impacting the general creditworthiness of Lagos State i.e. its unsecured *Issuer* credit rating. However, structural and other enhancements have been (or are expected to be) utilised to improve the credit risk profile of a specific *Issue(s)* under the bond programme. In respect of the above, apart from the scenario of a full guarantee, GCR's approach to Issue Ratings is to utilise the unsecured Issuer rating as a base from which credit enhancement is considered. Credit enhancements are considered in terms of their impact on the likelihood of repayment of that particular Issue. The details of the issue date, coupon rate and tenor of the respective bonds are contained in Table 1

Table 8: Sinking fund account- P2S1 – Cumulative receipts and payments as at February 2019	N'm
Cumulative transfer from revenue (ISPO and IGR)	116,927.4
Cumulative investment income	12,910.8
Total before debt service	***129,838.2***
Total debt service as at February 2019	(117,761.6)
Professional fees/other charges	(1,783.1)
Cl. bal. sinking fund	**11,293.5**

Programme 2, Series 1 N80bn Fixed Rate Bond

Following the restructuring of the payment plans, principal repayment commenced in May 2016, and will be amortised semi-annually until full redemption in November 2019. Total debt service amount at each payment date is N13.53bn. In line with Clause 6.5 of the Series Trust Deed ("STD"), the security for the Bond are the ISPO (which specifies monthly deductions of N1bn from statutory allocations) and an additional monthly sum of N900m in form of monthly transfers from Lagos State's IGR (via the CDSA). This equates to ring fenced debt servicing receipts of N12bn annually and expected cumulative IGR transfers of N10.8bn yearly. Pursuant to Clause 6.2.1 of the STD, the Issuer committed to fund the SFA monthly in line with schedule 3 of the deed.

Although Lagos has not defaulted on actual payments of coupon or principal payments on the respective payment dates (since inception of the P2 S1 bonds), the State has not been funding the SFA in the manner specified in the Series Trust Deed and this constitutes a breach. The State stopped making IGR transfers to the sinking fund after the last transfer done in May 2018 (N623.9m), with the only regular funding being the N1bn monthly ISPO transfers from statutory allocations. This provides little leeway in the event of any liquidity constraints. The outstanding principal on the bond as at February 2019 is cN24.4bn.

[8] inclusive of capital receipts
[9] expected to be financed by debt
[10] Lagos Metropolitan Area Transport Authority
[11] Bus Rapid Transit
[12] Attributable to supply cuts by OPEC and the United States of America's ongoing sanctions to Iran and Venezuela

Table 9: Outstanding obligations and funding source – P2S1	N'm
Coupon payment (May, 2019)	1,767.1
Principal instalment payment (May 2019)	11,760.4
Professional fees (May 2019)	96.4
Coupon payment (November 2019)	914.4
Final principal instalment payment (November 2019)	12,613.1
Professional fees (November 2019)	94.4
Remaining obligations	**27,245.8**
Balance in sinking fund account (February 2019)	(11,293.5)
Expected monthly ISPO transfers in 2019	(10,000)
Anticipated shortfall*	**5,952.3**

*In the absence of monthly transfers from the CDSA
**excludes investment income as this will be dependent on actual investible funds in SFA

Due to irregular IGR transfers, the current funds in the sinking fund account does not provide excess cash cover/overcollaterisation and does not serve as a credit enhancement to the Bonds. The bond simulation schedule prepared in 2016 anticipates that the SFA will have a balance of N37.4bn[13] as at end-February 2019, meanwhile as per the Trustees report, the accrual in the sinking fund account stood at N11.3bn as at February 28 2019. In the absence of IGR transfers from the CDSA, the anticipated cumulative shortfall will be around N6bn in 2019, which the State will need to provide ahead of the repayment dates.

Programme 2, *Series 2 N87.5bn Fixed Rate Bond*

Table 10: Sinking fund account- P2S2 – Cumulative receipts and payments as at February 2019	N'm
Cumulative transfer from revenue (ISPO and IGR)	98,662.5
Cumulative investment income	6,793.8
Total before debt service	**105,456.3**
Total debt service	(98,386.8)
Professional fees/other charges	(1,350.3)
Cl. bal. sinking fund	**5,719.1**

Similar to Programme 2 Series 1 N80bn bond, repayment on the N87.5bn bond was restructured, thus, principal repayment commenced in May 2016, and will be fully amortised by final maturity in November 2020. Coupon payments and principal instalment payments are being made semi-annually (N12.3bn annually) in May and November. Pursuant to Clause 5.5 of the STD, the Bond obligations are secured by an ISPO, which specifies monthly deductions of N1bn[14] from statutory allocations, an additional monthly sum of N840m[17] in form of monthly transfers from Lagos State's IGR (via the CDSA). This equates to ring fenced debt servicing receipts of N12bn annually and expected cumulative IGR transfers of around N10.1bn yearly. As per Clause 5.2.2 of the STD, LASG committed to fund the SFA monthly in the manner specified in schedule 3 of the deed.

Table 11: Outstanding obligations and funding source – P2S2	N'm
Outstanding debt service (2019 to maturity date in 2020)	49,257.8
Professional fees for remaining tenor of bond	428.2
Remaining obligations	**49,686.0**
Balance in sinking fund account (February 2019)	(5,719.1)
Expected monthly ISPO transfers (21 months)	(21,000)
Anticipated cumulative shortfall 2019 to 2020*	**22,966.9**

*In the absence of monthly transfers from the CDSA
**excludes investment income as this will be dependent on actual investible funds in SFA

As with P2S1, the State has made all coupon and instalment payments on the respective due dates but stopped IGR transfers to the sinking fund since May 2018 and breached the terms of the STD. The outstanding principal on the bond as at February 2019 is cN41.9bn.

If IGR transfers had been made as specified in the Series Trust Deed, the SFA ought to have a balance of around N23bn as at end-February, however the accrued balance stood much lower at N5.7bn as noted in the Trustees report. In the absence of IGR transfers from the CDSA, the anticipated cumulative shortfall will be around N23bn in 2020, which Lagos has to provide ahead of the repayment dates.

Programme 3, *Series 1 N47bn Fixed Rate Bond*

The Bond is a senior unsecured obligation of Lagos and was issued on December 30, 2016, with maturity in 2023. Coupon is payable semi-annually while a three-year moratorium exists on the Bond, subsequent to which principal repayments would be amortised. Each semi-annual coupon payment is around N3.9bn (N7.8bn annually) until December 2019 (year three), thereafter decreasing in line with the amortisation of the principal from 2020 to maturity in 2023. In line with the STD, the coupon payments are secured by a transfer (from the CDSA) of N807.9m monthly (N9.7bn annually) to the Sinking Fund Account. Effective December 2019, this will be complemented by monthly ISPO deductions of N1bn from statutory allocations, equating to ring fenced debt servicing receipts of N12bn[15] annually (from 2020).

Table 12: Sinking fund account- P3S1 – Cumulative receipts and payments as at February 2019	N'm
Cumulative transfer from revenue (IGR)	15,614.8
Cumulative investment income	77.4
Total before debt service	**15,692.2**
Total debt service	(15,613.5)
Professional fees/other charges	(99.8)
Net shortfall as at 28 February, 2019	**(21.1)***

*represents net outstanding fees due to the Trustees

Pursuant to Clause 3.2.1 of the STD, the Issuer committed to fund the SFA with N807,885,350 monthly (from the CDSA) at least 15 business days prior to the end of every month. As per Clause 3.2.2 of the STD, Lagos also committed not to revoke or modify the terms under which sums from the CDSA are deposited in the Sinking Fund throughout the tenor of the Series I Bonds without the prior written consent of the Joint Trustees and the prior approval of SEC. In contrast, the State has not fully complied with the monthly funding commitments, with irregular transfers made since inception of the bond. A total of 26 monthly IGR transfers ought to have been made between January 2017 and February 2019, however, GCR notes that there have been 14[16] inflows. The trend noticed from review of the Trustees report and SFA is that any shortfall will be transferred by Lagos in lump sum via from the CDSA, just a week or few days to coupon payment. As such, no defaults have been recorded on coupon payment dates. This notwithstanding, the mechanism with which the accounts have been funded does not currently offer any credit enhancement to the Bonds.

[13] On the basis of regular funding of the SFA as per STD
[14] Effective three months from Issue date of 27 November 2013
[15] From 2020
[16] If respective components of lumped IGR inflows are counted separately, total inflows will be 14. There are instances when the inflows for 2 to 4 months are lumped together and transferred by Lagos (from the CDSA as one inflow), a week or few days to coupon payment date.

Programme 3, Series 2 Bonds

Lagos State issued a combined sum of N97.4bn in Series 2 bonds (in four tranches), under its N500bn Bond Issuance Programme ("Programme 3"). The coupon payments on each tranche are to be made semi-annually (in February and August), and are expected to be funded by monthly transfers (from the CDSA) to the Sinking Fund Account. As per the Trust Deed, commencing from December 2020 monthly ISPO[17] deductions from the statutory allocations would be paid into the sinking fund accounts, in order to augment contributions from the CDSA. This notwithstanding, the cumulative N1bn ISPO transfers for the P3S2 Tranche I to IV have commenced in September 2018, at the instance of the State, while monthly IGR transfers were not implemented for the P3 S2 Tranche I to IV bonds.

Table 13: Programme 3, Series 2 Bonds	**TI**	**TII**	**TIII**	**TIV**
Series amount (N'bn)	N46.4	N38.8	N6.9	N5.3bn
Issue date	Aug-2017	Aug-2017	Dec-2017	Dec-2017
Tenor (years)	7	10	6.6	9.6
Principal moratorium period	36	60	31	55
Optional early redemption	After 3 yrs	After 5 yrs	After 3 yrs	After 4.6 yrs
Interest rate	16.75	17.25	15.6	15.85

Lagos also committed not to revoke or modify the terms under which sums from the CDSA are deposited in the Sinking Fund throughout the tenor of the Series 2 Bonds without the prior written consent of the Joint Trustees and the prior approval of SEC. In contrast, the monthly IGR funding was not done for the P3 S2 bonds (as contemplated by the respective STDs), rather exact funds for debt service are brought in a few days to the coupon payment date. Lagos is in breach of applicable terms of the STDs, as regards monthly IGR transfers from CSDA on all the bonds, and this could be reflective of potential liquidity issues.

Table 14: Sinking fund account- P3S2 – Tranche I-IV Cumulative receipts and payments as at February 2019	**N'm**
Cumulative transfer from revenue (IGR and ISPO)	30,148.5
Cumulative investment income	124.0
Total before debt service	**30,272.5**
Total debt service	(24,148.5)
Professional fees/other charges	(121.5)
Cl. bal. sinking fund	**6,002.5**

P3S2 - Tranche I N46.4bn bond

Semi-annual coupon payments of around N3.9bn (N7.8bn yearly) will be made, up to year three. Following the expiration of the 36 months principal moratorium period, the sum of N16.4bn annual payment (including amortised principal) will be made on each coupon payment date. An optional early redemption at the instance of Lagos is applicable, after 3 years, albeit subject to approval of regulators and bondholders.

Pursuant to Clause 3.2.1 of the STD, the Issuer committed to fund the SFA with N1.15bn (from the CDSA) at least 15 business days prior to the end of every month. ISPO transfers of N1bn (of which N544.6m will be used to service the Series 2 Tranche I Bond) will be effected from December 2020, and consequently, the deductions from the CDSA is expected to reduce to N610.7m (from N1.2bn) such that the cumulative monthly funding from CSDA and ISPO equates N1.2bn. GCR notes that cumulative N1bn ISPO transfers for the P3S2 Tranche I to IV have commenced in September 2018, while Lagos did not comply with the STD's requirement to make monthly IGR transfers to the sinking fund account. Rather, any shortfall in funds is brought in a few days to coupon payment date.

P3S2 - Tranche II N38.8bn bond

Semi-annual coupon payments of N3.3bn (N6.7bn yearly) will be made, up to year five, thereafter it will decrease in line with the amortisation of the principal from year six to maturity in 2027. Following the expiration of the five-year principal moratorium period, the sum of N11.9bn will be paid annually, including amortised principal and interest on each coupon payment date. Pursuant to Clause 3.2.1 of the STD, the Issuer committed to fund the SFA with N965.9m monthly (from the CDSA) at least 15 business days prior to the end of every month. ISPO transfers of N1bn (of which N455.4m will be used to service the Series 2 Tranche II Bond) will be effected from December 2020, and consequently, the deductions from the CDSA is expected to reduce to N510.6m such that the cumulative monthly funding from CSDA and ISPO still equates N965.9m.

P3S2 - Tranche III N6.9bn bond

Pursuant to Clause 3.2.1 of the STD, the Issuer committed to fund the SFA with N146.6m monthly (from the CDSA) at least 15 business days prior to the end of every month. ISPO transfers of N1bn (of which N69.1m will be used to service the Series 2 Tranche III Bond) will be effected from December 2020, and consequently, the annual deduction from the CDSA is expected to reduce to N1.1bn (from N2.1bn). Semi-annual coupon payments of N539m (N1.1bn yearly) will be made during the moratorium period, up to the 31st month, thereafter, it will decrease in line with the amortisation of the principal up to maturity in 2024.

P3S2 - Tranche IV N5.3bn bond

Semi-annual coupon payments of N423m (N846m yearly) will be made during the moratorium period, up to the 55th month, thereafter, it will decrease in line with the amortisation of the principal up to maturity in 2027. Following the expiration of the principal moratorium period, around N793m (N1.6bn yearly) will be paid semi-annually, representing amortised principal and interest on each coupon payment date. Pursuant to Clause 3.2.1 of the STD, the Issuer committed to fund the SFA with N113.1m monthly (from the CDSA) at least 15 business days prior to the end of every month. ISPO transfers of N1bn (of which N53.4m will be used to service the Series 2 Tranche IV Bond) will be effected from December 2020, and consequently, the annual deductions from the CDSA is expected to reduce to a cumulative N1.1bn.

[17] Approved in June 2017

Lagos State Government of Nigeria

(Naira in Millions except as Noted)

Statement of Financial Performance Year end: 31 December	2014	2015	IPSAS 2016	IPSAS 2017	IPSAS 2018^
Income tax	213,686.9	212,203.3	244,660.6	294,228.5	315,132.2
VAT proceeds	72,619.1	73,060.8	75,437.6	80,231.7	99,055.2
Other internally generated revenue	62,383.9	55,088.9	36,441.2	35,240.8	63,130.8
Interest and investment income	1,049.6	289.7	8,665.4	10,122.0	4,269.1
Total internally generated revenue	**349,739.5**	**340,642.7**	**365,204.7**	**419,823.0**	**481,587.3**
Statutory allocation	51,576.5	37,834.2	27,308.6	38,230.9	57,055.3
Other income	6,806.7	5,934.1	20,788.3	23,317.4	24,512.3
Total recurring revenue	**408,122.7**	**384,411.0**	**413,301.6**	**481,371.2**	**563,154.9**
Recurrent expenditure*	(242,894.7)	(240,638.8)	(205,141.0)	(234,670.1)	(269,364.9)
Operating surplus (deficit)	**165,228.0**	**143,772.2**	**208,160.7**	**246,701.1**	**293,790.0**
Other revenue (capital receipt and grants)	0.0	0.0	36,306.9	29,626.4	45,662.7
Less capital items and related expenditure:					
Depreciation	0.0	0.0	(84,607.5)	(92,992.2)	(101,178.6)
Public debt charges	0.0	0.0	(55,572.7)	(65,613.2)	(72,704.8)
Exchange gain/(loss)	0.0	0.0	(138,311.0)	(36,310.2)	8,845.8
Capital expenditure	(213,139.9)	(173,987.1)	(215,228.2)	(278,171.0)	(375,588.5)
Surplus/(Deficit)	**(47,911.8)**	**(30,214.9)**	**(249,251.8)**	**(196,759.1)**	**(201,173.3)**
Capital expenditure funding:					
Opening balance	**7,950.3**	**3,981.6**	**n.a**	**n.a**	**n.a**
Capital receipts/grants and others	0.0	0.0	36,306.9	29,626.4	45,662.7
Internal loans	0.0	0.0	12,500.0	40,000.0	45,000.0
External loans	0.0	0.0	46,647.4	13,840.7	0.0
Bond issue	0.0	0.0	47,000.0	97,387.0	0.0
Total receipts	**298,222.4**	**339,865.5**	**142,454.3**	**180,854.1**	**90,662.7**
Capital expenditure	(213,139.9)	(173,987.1)	(236,657.4)	(309,334.9)	(375,588.5)
Facility repayments	(89,051.3)	(134,053.1)	(49,821.0)	(128,593.3)	(83,671.0)
Balance	**3,981.6**	**35,806.9**	**n.a**	**n.a**	**n.a**
Statement of financial position					
Consolidated revenue fund	124,288.0	108,060.1	0.0	0.0	0.0
Capital expenditure & development fund	3,981.6	35,806.9	0.0	0.0	0.0
Other funds	14,420.5	28,989.6	221.8	498.8	222.3
Reserves	0.0	0.0	1,458,199.2	1,256,172.7	1,214,068.6
Total reserves	**142,690.1**	**172,856.6**	**1,458,421.0**	**1,256,671.5**	**1,214,290.9**
Current debt	0.0	0.0	133,505.3	79,021.4	101,492.2
Non-current debt	0.0	0.0	657,520.9	775,299.0	704,644.6
Total debt	**0.0**	**0.0**	**791,026.3**	**854,320.4**	**806,136.9**
Other obligations	0.0	0.0	48,423.0	98,720.6	301,760.6
Total reserve and liabilities	**142,690.1**	**172,856.6**	**2,297,870.2**	**2,209,712.6**	**2,322,188.4**
Infrastructure (PPE)	0.0	0.0	2,071,169.7	2,064,995.6	2,123,973.3
Investments	96,577.8	149,248.8	185,078.4	107,541.4	91,786.8
Cash and cash equivalents	46,112.3	23,607.8	37,464.0	27,013.8	46,231.5
Other assets	0.0	0.0	4,158.0	10,161.8	60,196.9
Total assets	**142,690.1**	**172,856.6**	**2,297,870.2**	**2,209,712.6**	**2,322,188.4**
Total borrowings (up to 2015)	*581,077.5*	*619,278.4*			
Key ratios					
Efficiency					
Total revenue growth (%)	8.3	(5.8)	7.5	16.5	17.0
Internally generated revenue growth (%)	14.5	(2.6)	7.2	15.0	14.7
Total expenditure growth (%)	22.9	(0.9)	(14.8)	14.4	14.8
Personnel cost growth (%)	0.4	15.5	(4.3)	5.6	12.6
Increase in capex (%)	(22.4)	(18.4)	23.7	29.2	35.0
IGR: Total revenue (%)	85.7	88.6	88.4	87.2	85.5
Recurring expenditure: Total expenditure (%)	53.3	58.0	46.4	43.1	41.8
Recurring expenditure: Internally generated revenue (%)	69.5	70.6	56.2	55.9	55.9
Personnel cost: Total recurring expenditure (%)	32.4	37.8	42.4	39.2	38.5
Operating surplus/ (loss): Total income (%)	40.5	37.4	50.4	51.2	52.2
Capex: Total income (%)	52.2	45.3	57.3	64.3	66.7
Gearing & Liquidity					
Days cash on hand (days)	69.3	35.8	66.7	42.0	62.6
Gross interest bearing debt: Total income (%)	142.4	161.1	191.4	177.5	143.1
Net interest-bearing debt: Total income (%)	131.1	155.0	182.3	171.9	134.9
Gross interest-bearing debt: Total assets (%)	80.3	78.2	34.4	38.7	34.7
Net interest-bearing debt: Total assets (%)	73.9	75.2	32.8	37.4	32.7

**Includes interest payments on debt obligations in 2014 and 2015*
^unaudited management accounts to December 2018

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SALIENT POINTS OF ACCORDED RATINGS

GCR affirms that a.) no part of the rating was influenced by any other business activities of the credit rating agency; b.) the rating process was based solely on the merits of the rated entity, security or financial instrument being rated; c.) such ratings were an independent evaluation of the risks and merits of the rated entity, security or financial instrument; and d.) the ratings are valid until October 2019.

Lagos State participated in the rating process via face-to-face meeting, teleconferences and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The credit ratings have been disclosed to Lagos State

The information received from Lagos State Government of Nigeria and other reliable third parties to accord the credit rating included
-the audited accounts for the year ended 31 December 2017 (plus four years of comparative numbers);
-the unaudited accounts full year management account for the year ended 31 December 2018;
-the approved budget for 2018
-the Joint Trustees reports on the existing bonds for the period ended 31 December 2018, 28 February 2019 and April 30, 2019;
-a breakdown of facilities available and related counterparties, and
-information specific to Lagos State was also received.

The ratings above were solicited by, or on behalf of, the rated client, and therefore, GCR has been compensated for the provision of the ratings.