

# Flour Mills of Nigeria Plc.

## Earnings outlook still strong, even as new shares shrink TP

Following the conclusion of the NGN38 billion Rights Issue (RI) and our recent discussions with management, we revise our TP and earnings estimates for FLOURMILL. Feedback is that the RI was successful (oversubscribed). On net, we (1) increase the post-rights shares outstanding by 56% to 4.1 billion and WACC by 158 bps to 15.2% and consequently, (2) lower our TP for the stock by 21% to NGN30.76.

Although we revised our net earnings estimates slightly higher, however, overlaid on the post-rights shares, we now look for 2019E and 2020E EPS of NGN4.8 (NGN7.5 ex new shares) and NGN6.4 (NGN10 ex new shares) respectively. FLOURMILL's share price has accumulated 31% Ytd and we maintain a HOLD rating on our new TP. On our estimates, FLOURMILL is trading on forward (FY18E) P/E and EV/EBITDA multiples of 6.1x and 3.7x respectively, at material discounts to the (1) peer average forward P/E of 11.5x and EV/EBITDA of 7.8x and (2) its five-year historical average of 14x and 8.1x respectively.

Notwithstanding the impact of the RI on valuation and EPS, we have a fairly strong view of FLOURMILL over the medium term. From 1% average between 2014-2016 (2017 was an outlier, in our view) and 5% in 2018E, we forecast sales revenue growth to increase to 9% average over 2019-2020E. Management has continued to reiterate that its emphasis going forward is on driving returns from the investments of the recent years. And it is our view that the group's focus on food-based and agro-allied products, whilst favoured by Nigeria's demographic potential and spending patterns, also provides a good hedge against cyclical effects in the FMCG industry.

We also forecast EBITDA to grow steadily to NGN81 billion by 2020E, from NGN57 billion in 2017FY, and the margin to stabilize at 12% average, 300 bps above the rate achieved in the last five years. With a robust top-line, we view the sustenance of the opex margins of 4.5% achieved in 2017FY and 4% as at 9M-18, compared to 8% historical average, as positive for EBITDA formation going forward. Management said it does not expect opex-to-revenue ratio to change materially to the upside going forward, given its emphasis of growing revenue, while focusing strongly on containing costs.

Fig 1: FLOURMILL - Estimates

|                     | 2015  | 2016  | 2017  | 2018E | 2019E | 2020E |
|---------------------|-------|-------|-------|-------|-------|-------|
| Revenue (NGN'bn)    | 308.8 | 342.6 | 524.5 | 551.2 | 603.1 | 659.8 |
| Growth              | -5.2% | 11.0% | 53.1% | 5.1%  | 9.4%  | 9.4%  |
| EBITDA (NGN'bn)     | 22.5  | 23.7  | 57.2  | 71.8  | 73.8  | 81.0  |
| EBITDA margin       | 7.3%  | 6.9%  | 10.9% | 13.0% | 12.2% | 12.3% |
| EBIT (NGN'bn)       | 10.2  | 9.1   | 41.4  | 56.3  | 56.9  | 62.5  |
| EBIT margin         | 3.3%  | 2.6%  | 7.9%  | 10.2% | 9.4%  | 9.5%  |
| Net profit (NGN'bn) | 8.5   | 14.4  | 8.8   | 16.5  | 19.6  | 26.4  |
| Net profit margin   | 2.7%  | 4.2%  | 1.7%  | 3.0%  | 3.2%  | 4.0%  |
| EPS new (NGN)       | 3.0   | 5.6   | 3.0   | 6.3   | 4.8   | 6.4   |
| EPS (ex new shares) |       |       |       |       |       |       |
| NGN                 | 3.0   | 5.6   | 3.0   | 6.3   | 7.5   | 10.0  |

Source: Company account, Cordros Research estimates

On the highly leveraged balance sheet, we are not totally convinced that there will be a material reduction in the amount of FLOURMILL's borrowings (NGN201 billion as at 9M-18) over the near term. That said, we also do not expect borrowings will be higher. On net, it is our view that savings from the refinancing of expensive borrowings will be positive – in the short term especially – for cash and earnings. Over the medium term, it is our view that faster growth in EBITDA over fixed financing costs will be positive for earnings.

# HOLD

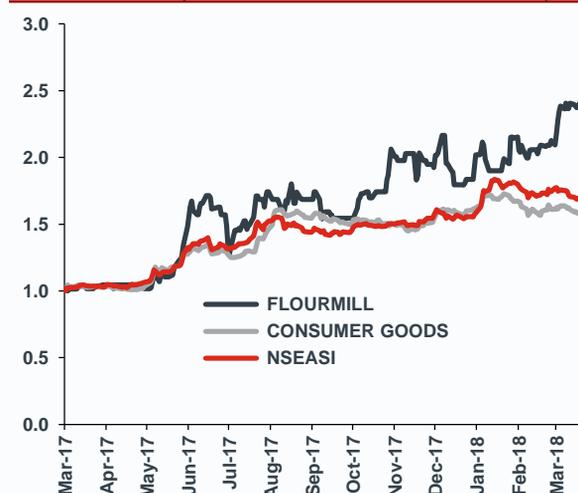
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|---------------------|--------|
| Target Price (NGN)  | 30.76  |
| Current Price (NGN) | 38.00  |
| Implied Return (%)  | -17.96 |

## Company Data

|                      |                |
|----------------------|----------------|
| NSE Code             | FLOURMILL      |
| Bloomberg Code       | FLOURMILL:NL   |
| Reuters Code         | FLOURMILL.LG   |
| Sector               | CONSUMER GOODS |
| Market Cap. (NGN'bn) | 153.76         |
| Free Float (%)       | 47.82          |

| Ratios       | Q3-18  | Q3-17  | 2017FY |
|--------------|--------|--------|--------|
| Gross margin | 15.90% | 12.68% | 12.72% |
| Opex margin  | 4.83%  | 3.96%  | 4.53%  |
| EBIT margin  | 11.41% | 5.99%  | 7.90%  |
| PAT margin   | 3.02%  | 0.69%  | 1.68%  |
| RoAE         | 10.25% | 20.43% | 7.83%  |
| EPS (NGN)    | 1.38   | 0.27   | 3.03   |

## Price movement (FLOURMILL vs. Benchmark Indices)



Source: NSE, Bloomberg, Cordros research

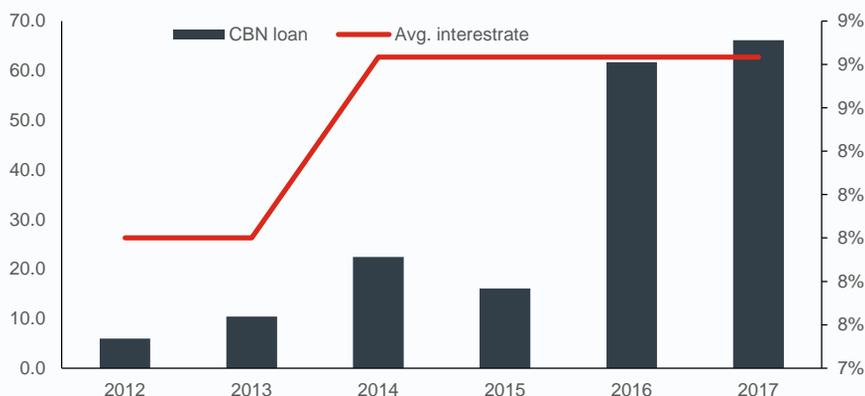
## Management discussion

We held discussions with management on the recently commissioned Sunti backward integration project in sugar, and also to understand the current market dynamics and outlook.

### Sunti and Golden Penny Sugar in general

We understand that the Sunti project, at commissioning, cost the group about NGN50 billion, funded with NGN30 billion of subsidized loans from the Central Bank of Nigeria (CBN) and the balance being own capital. The CBN loan is for twelve years, at 9% average interest rate. The land size is 15,000 hectares, to be utilized solely for planting and refining sugar. Thus far, 3,000 hectares have been developed, but not fully cultivated.

.Fig 2: Trend of CBN loans to FLOURMILL and the interest rates



Source: Company accounts, Cordros Research estimates

The refinery capacity is currently 100,000 tonnes of sugar per annum. Further expansion of capacity, according to management, is dependent on profitability. Management said it expects to achieve the first farm-to-factory output in the next 2-3 years. The refinery will be fed with own-grown sugarcane at the early stage but will subsequently be supported with supplies from outgrowers. We understand that sales will be largely to industrial consumers.

Management said the 750,000 tonnes per annum sugar refinery in Lagos will be retained and fed with imported raw sugar. It does not consider the movement of raw sugar from the North for refining in Lagos efficient. And it also does not consider the mandatory backward integration policy in the sector sufficient a threat – in the near term at least – to the continuity of the import-to-refinery model.

Capacity utilization on the 750,000 tonnes refinery is currently 45%. We were informed that the sugar business is profitable, accounting for about 15% of both group revenue and net profit. Although DANGSUGAR, the market leader, sets sugar prices, FLOURMILL management said it is able to derive about the same margin on its sugar, on average, as with DANGSUGAR (five-year average of 20% and 25.4% as at 9M-17). We were curious about the potential margin benefits derivable from Sunti, but management's response, however, did not convince us enough to conclude that there will be material improvement.

Currently, the group's sugar sales mix is 80% industrial and 20% retail (both cubes and refined 100g bags). Management said the margin on retail sugar sales is about 300 bps more, and that its mix is expected to improve only slightly above 20%.

Only small quantity of sugar is currently exported, and to neighbouring ECOWAS countries. Given the local excess sugar capacity, management sees good opportunity in exports, but – as with DANGSUGAR – we are not convinced that this aspiration will be pursued aggressively.

### On Debt

Gross debt as at 9M-18 was NGN201 billion, from NGN234 billion at the beginning of the year. As with previous guidance, management said it plans to reduce outstanding debt by 2019 (1) using the proceeds of the NGN38 billion Rights Issue and (2) via reduction of capex spending, by limiting them to only strategic investments (NGN20 billion capex guidance provided for 2019E, vs. NGN10 billion in 9M-18).

We are not convinced that FLOURMILL's outstanding debt in the next 2-3 years will be materially lower from what it is now. Management said its target is to achieve debt-to-EBITDA ratio of 1.5x, from c.6x average in the last five years. But this, in our view, can also be achieved by growing EBITDA (as we expect), and not necessarily by cutting down borrowings. Management said it is keen about being adequately capitalized/liquid.

Management confirmed that it has been quite busy in the debt market, refinancing its borrowings at lower interest rates. Gross outstanding debt, we understand, currently consists of about NGN25 billion of commercial papers (CPs), some of which were recently issued at 15% average interest rate (average rate on CPs was 21% as at 9M-18). Overall, target is to achieve 15-16% average interest rate on gross short term borrowings by 2019E (from 19.8% average as at 9M-18), should local inflationary condition continue to improve.

### Business Segments

*Food* – Feedback is that this segment remains resilient. Performance is driven by volume and mix, led by flour, semovita, and pasta. Target is to achieve 10% volume growth in 2019E.

*Agro-Allied* – As a result of losses associated with Sunti start-up costs as well as ROM Oil (edible oil), this segment is expected to close 2018 with negative PBT. However, remedial actions going into 2019 include (1) to reduce capex in Sunti and (2) for edible oil, to control costs and improve both pricing and RTM, with the target to achieve break-even, at minimum.

Also, on agro-allied, we were informed that (1) the export of garri commenced recently, (2) a second aqua feed will be commissioned in Q2-Q3 this year, and (3) the fertilizer business is performing well, notwithstanding the threat of government supplying the product at subsidized prices. Overall, for this segment, target is to achieve 7-10% volume growth in 2019E.

*Packaging* – Thus far, the performance of this segment is consistent with the trend seen over 9M-18 (150% PBT growth). Management said the revenue growth of 3% achieved in 9M-18 was strictly from third-party sales, guiding that inter-company sales cancel out at the group level. Emphasis remains on controlling costs.

### Prices

In the absence of the 2016-type of cost pressure, prices are expected to remain stable. There was a very marginal cut in the prices of sugar and flour late in 2017. On gross margin outlook, management said it is comfortable with the 13% it achieved in 9M-18.

### Other issues

*Withheld products* – Daily Delight (breakfast cereal) and Kool 2-Go (instant powdered drink) were recently withheld. Management said Daily Delight could not compete in the breakfast cereal market while Kool 2-Go was affected by the naira devaluation. We understand plan is ongoing to reposition and relaunch the breakfast cereal this year.

*Power* – Gas supply has improved significantly across the various plants (Ibadan, Iganmu, and Calabar), but excluding Apapa, wherein supply (we understand is currently in the 60-70s) is limited by high demand.

*Forex* – Less than 50% of FX requirement is met via the CBN's bi-monthly sales, at slightly above NGN325/USD. All demands can be met at the Investors and Exporters window. Management's view of the FX market is positive in the short term, suggesting losses linked to the outstanding USD borrowings (USD20 million) and trade payables are unlikely.

# Financial Statement (NGN'billion).

| Income Statement              | 2015a   | 2016a   | 2017a   | 2018e   | 2019e   | 2020e   | Profitability Ratios              | 2015a  | 2016a | 2017a | 2018e | 2019e | 2020e |
|-------------------------------|---------|---------|---------|---------|---------|---------|-----------------------------------|--------|-------|-------|-------|-------|-------|
| Revenue                       | 308.76  | 342.59  | 524.46  | 551.24  | 603.08  | 659.84  | Gross profit margin               | 11.5%  | 11.0% | 12.7% | 13.8% | 13.8% | 13.8% |
| Cost of sales                 | -273.39 | -304.96 | -457.78 | -475.33 | -519.95 | -568.81 | EBITDA margin                     | 7.3%   | 6.9%  | 10.9% | 13.0% | 12.2% | 12.3% |
| Gross profit                  | 35.37   | 37.62   | 66.69   | 75.92   | 83.13   | 91.03   | Operating profit margin           | 3.3%   | 2.6%  | 7.9%  | 10.2% | 9.4%  | 9.5%  |
| Operating expenses            | -24.47  | -20.85  | -23.76  | -26.01  | -28.15  | -30.46  | PBT margin                        | 2.5%   | 3.4%  | 2.0%  | 4.4%  | 4.8%  | 5.9%  |
| Other operating income        | -0.69   | -7.72   | -1.49   | 6.43    | 1.88    | 1.89    | Net profit margin                 | 2.7%   | 4.2%  | 1.7%  | 3.0%  | 3.2%  | 4.0%  |
| Operating profit              | 10.22   | 9.05    | 41.44   | 56.34   | 56.86   | 62.46   | RoAE                              | 9.9%   | 15.7% | 8.9%  | 15.1% | 13.7% | 14.7% |
| Investment income             | 2.30    | 1.10    | 1.56    | 0.57    | 0.66    | 0.73    | RoAA                              | 2.7%   | 4.2%  | 2.1%  | 3.6%  | 4.1%  | 5.0%  |
| Finance costs                 | -18.70  | -22.40  | -32.53  | -32.58  | -28.62  | -24.27  |                                   |        |       |       |       |       |       |
| Profit before tax             | 7.72    | 11.49   | 10.47   | 24.32   | 28.90   | 38.93   | Liquidity Ratios                  | 2015a  | 2016a | 2017a | 2018e | 2019e | 2020e |
| Taxation                      | 0.74    | 2.93    | -1.64   | -7.85   | -9.32   | -12.56  | Working capital (NGN'bn)          | -55.6  | -58.4 | -52.6 | -47.1 | -31.8 | -39.0 |
| Profit after tax              | 8.47    | 14.42   | 8.84    | 16.48   | 19.58   | 26.37   | Current ratio                     | 0.7x   | 0.7x  | 0.8x  | 0.8x  | 0.9x  | 0.9x  |
|                               |         |         |         |         |         |         | Quick ratio                       | 0.3x   | 0.4x  | 0.4x  | 0.4x  | 0.4x  | 0.4x  |
|                               |         |         |         |         |         |         | Cash ratio                        | 0.2x   | 0.2x  | 0.1x  | 0.2x  | 0.2x  | 0.2x  |
| Financial Position            | 2015a   | 2016a   | 2017a   | 2018e   | 2019e   | 2020e   | Solvency Ratios                   | 2015a  | 2016a | 2017a | 2018e | 2019e | 2020e |
| Property, plant, equipment    | 208.94  | 213.56  | 216.87  | 234.56  | 267.31  | 293.69  | Debt-to-capital ratio             | 0.7x   | 0.6x  | 0.7x  | 0.6x  | 0.5x  | 0.5x  |
| Investments                   | -       | 0.05    | 1.93    | 2.09    | 2.38    | 2.62    | Net debt/EBITDA                   | 7.0x   | 5.6x  | 3.4x  | 2.3x  | 1.7x  | 1.5x  |
| Deferred tax assets           | -       | 0.07    | 1.85    | 2.00    | 2.28    | 2.50    | Net debt-to-equity ratio          | 1.8x   | 1.4x  | 1.9x  | 1.4x  | 0.8x  | 0.7x  |
| Goodwill                      | 4.64    | 4.88    | 4.36    | 4.34    | 4.37    | 4.39    | Interest coverage                 | 1.8x   | 2.5x  | 0.8x  | 0.6x  | 0.5x  | 0.4x  |
| Biological assets             | 0.06    | 0.35    | 0.03    | 0.05    | 0.05    | 0.06    | Efficiency Ratios                 | 2015a  | 2016a | 2017a | 2018e | 2019e | 2020e |
| Other long term assets        | 1.70    | 1.75    | 1.70    | 2.83    | 3.22    | 3.54    | Fixed assets turnover             | 1.5x   | 1.6x  | 2.4x  | 2.4x  | 2.3x  | 2.2x  |
| Longterm receivables          | 3.90    | -       | 0.99    | -       | -       | -       | Current assets turnover           | 2.5x   | 2.7x  | 2.1x  | 2.8x  | 2.7x  | 2.7x  |
| Non-current assets            | 219.25  | 220.66  | 227.72  | 245.87  | 279.61  | 306.80  | Total assets turnover             | 0.9x   | 1.0x  | 1.1x  | 1.3x  | 1.2x  | 1.2x  |
| Inventories                   | 68.43   | 58.70   | 117.30  | 98.04   | 111.72  | 122.75  | Inventory turnover                | 4.1x   | 4.8x  | 5.2x  | 4.4x  | 5.0x  | 4.9x  |
| Biological assets             | 0.40    | 0.18    | 0.56    | 1.07    | 1.22    | 1.34    | Receivables turnover              | 20.0x  | 20.0x | 26.0x | 25.2x | 25.2x | 24.6x |
| Trade and other receivables   | 15.37   | 18.97   | 21.40   | 22.40   | 25.52   | 28.04   | Payables turnover                 | 7.5x   | 7.2x  | 6.3x  | 5.6x  | 6.8x  | 7.0x  |
| Amount from related companies | 1.70    | -       | -       | -       | -       | -       | Days inventory outstanding        | 88     | 76    | 70    | 83    | 74    | 75    |
| Non-current asset for sale    | 3.51    | -       | -       | -       | -       | -       | Days collection/sales outstanding | 18     | 18    | 14    | 15    | 15    | 15    |
| Other assets                  | 3.06    | -       | -       | -       | -       | -       | Days payable outstanding          | 21     | 23    | 17    | 17    | 18    | 18    |
| Deposit for FCY/imports       | -       | 13.63   | 69.85   | 35.93   | 40.95   | 44.99   | Cash conversion cycle             | 86     | 72    | 67    | 80    | 70    | 72    |
| Cash and bank balances        | 31.13   | 33.21   | 45.02   | 37.70   | 43.54   | 48.24   | Investment Ratios                 | 2015a  | 2016a | 2017a | 2018e | 2019e | 2020e |
| Current assets                | 123.60  | 124.69  | 254.88  | 195.13  | 222.95  | 245.36  | Earnings per share (NGN)          | 3.02   | 5.57  | 3.03  | 6.28  | 4.77  | 6.43  |
| Total Assets                  | 342.85  | 345.35  | 482.60  | 440.99  | 502.56  | 552.17  | Dividend per share (NGN)          | 2.10   | 1.00  | 1.00  | 2.10  | 2.10  | 2.10  |
| Trade and other payables      | 34.58   | 50.42   | 94.57   | 75.89   | 77.67   | 85.12   | Payout                            | 69.5%  | 17.9% | 33.0% | 33.4% | 44.0% | 32.7% |
| Customer deposits             | 8.05    | 11.03   | 15.95   | 13.48   | 47.15   | 68.17   | Dividend yield                    | 6.0%   | 5.2%  | 5.6%  | 5.5%  | 5.5%  | 5.5%  |
| Bank OD                       | 59.70   | 16.41   | 49.02   | 34.33   | 29.44   | 29.44   | Multiples                         | 2015a  | 2016a | 2017a | 2018e | 2019e | 2020e |
| Borrowings                    | 54.24   | 100.83  | 141.70  | 107.50  | 89.23   | 89.23   | P/E                               | 11.64x | 3.47x | 5.87x | 6.05x | 7.96x | 5.91x |
| Unsecured fixed rate bond     | 19.25   | -       | -       | -       | -       | -       | EV/EBITDA                         | 11.08x | 7.70x | 4.25x | 3.66x | 3.85x | 3.45x |
| Derivative liabilities        | -       | -       | -       | 1.52    | 1.56    | 1.71    |                                   |        |       |       |       |       |       |
| Deferred revenue              | 1.47    | 1.08    | 2.09    | 1.62    | 1.66    | 1.81    |                                   |        |       |       |       |       |       |
| Current tax liabilities       | 1.80    | 1.34    | 2.14    | 4.06    | 4.16    | 4.56    |                                   |        |       |       |       |       |       |
| Dividend payable              | 0.12    | 1.94    | 2.03    | 3.84    | 3.93    | 4.31    |                                   |        |       |       |       |       |       |
| Current liabilities           | 179.21  | 183.04  | 307.50  | 242.24  | 254.79  | 284.34  |                                   |        |       |       |       |       |       |
| Borrowings                    | 55.26   | 48.01   | 50.88   | 58.95   | 53.50   | 53.50   |                                   |        |       |       |       |       |       |
| Unsecured fixed rate bond     | -       | -       | -       | -       | -       | -       |                                   |        |       |       |       |       |       |
| Deferred revenue              | 7.18    | 7.09    | 8.62    | 8.94    | 9.15    | 10.03   |                                   |        |       |       |       |       |       |
| Deferred tax liabilities      | 9.20    | 5.77    | 7.82    | 8.52    | 8.72    | 9.55    |                                   |        |       |       |       |       |       |
| Retirement benefit obligation | 3.25    | 4.08    | 3.68    | 4.09    | 4.19    | 4.59    |                                   |        |       |       |       |       |       |
| Long service award            | 1.34    | 1.59    | 1.57    | 1.85    | 1.90    | 2.08    |                                   |        |       |       |       |       |       |
| Non-current liabilities       | 76.22   | 66.54   | 72.56   | 82.36   | 77.45   | 79.75   |                                   |        |       |       |       |       |       |
| Total Liabilities             | 255.44  | 249.58  | 380.06  | 324.60  | 332.24  | 364.09  |                                   |        |       |       |       |       |       |
| Equity (NGN'bn)               |         |         |         |         |         |         |                                   |        |       |       |       |       |       |
| Share capital                 | 1.31    | 1.31    | 1.31    | 1.31    | 2.05    | 2.05    |                                   |        |       |       |       |       |       |
| Share premium                 | 36.81   | 36.81   | 36.81   | 36.81   | 75.93   | 75.93   |                                   |        |       |       |       |       |       |
| Fixed assets revaluation      | -       | -0.09   | -0.11   | -       | -       | -       |                                   |        |       |       |       |       |       |
| Capital reserves              | 0.28    | -       | -       | -0.11   | -0.11   | -0.11   |                                   |        |       |       |       |       |       |
| Retained earnings             | 45.95   | 54.90   | 60.45   | 74.30   | 88.37   | 106.13  |                                   |        |       |       |       |       |       |
| Non-controlling interests     | 3.06    | 2.83    | 4.08    | 4.08    | 4.08    | 4.08    |                                   |        |       |       |       |       |       |
| Total Equity                  | 87.41   | 95.77   | 102.54  | 116.40  | 170.32  | 188.08  |                                   |        |       |       |       |       |       |

Source: Company Accounts, Cordros Research

# Disclosures

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