

15 November 2018

May & Baker Nigeria Plc.

“Rights” at the right time

We initiate investment note on MAYBAKER with a BUY rating at NGN4.43/s TP. The company is in the process of raising capital through Rights – its first foray into the equity capital market in 12 years – to fund expansion project and partly deleverage balance sheet. Issued shares will double to 1.96bn post the Rights in 2019, but beyond that, we have a medium-to-long term positive view of the company. Following the recent divestment from the loss-making Food business, going forward, we will see MAYBAKER commit resources to driving growth in its core business of drug manufacturing that has delivered solid growth over the years (we estimate 12% and 14% 5-year revenue and EBITDA CAGRs respectively). We believe the company will be able to sustain double digit EBITDA growth at 16% CAGR over the next five years, supported by its good market positioning, strong demand outlook for drugs in Nigeria, positive products price outlook, and more efficient processes following divestment from non-core operation.

Good market positioning, government support, healthy demand outlook

The Nigerian pharma market is forecast by McKinsey & Company to grow 9% per annum over the next ten years on growing manufacturing to meet burgeoning demand. MAYBAKER is well-positioned to tap into this growth outlook. The company is a major player in the local drug manufacturing market with 4% market share, supported by a large portfolio comprising 85 SKUs. Volume will be supported by the planned deployment of 22% of the proceed of the capital raise to expanding capacity of paracetamol, currently accounting for 25-30% of Pharmaceuticals revenues, with strong demand potential. Management is also set to increase MAYBAKER's contribution in the biovaccine production joint venture (JV) with the Nigerian government following the Rights. Management believes this J.V provides significant opportunity to boost revenues in the medium term, stemming from high demand for vaccination in Nigeria with the country's high birth rate. Management said it will cover for the divestment from Food business (accounting for about 23% average of total sales) by pushing pharmaceutical products strongly into the market, including supporting marketing/promotion activities with 20% of the capital raised from the ongoing Rights. We should mention that the flat 9M-18 revenue vs. 9M-17, despite the divestment, is instructive.

Divestment to spur gross margin and EBITDA

Following the recent divestment from non-core operation, MAYBAKER will from 2019e, focus on the core business of drug manufacturing which has delivered solid performance over the years (12% and 14% 5-year revenue and EBITDA CAGRs). Besides from delivering most of MAYBAKER's volume (85% as at 2017FY), Pharmaceuticals gross margin is higher at 43% average over the last ten years, 8ppt higher than the combined gross margin. From 34% in 2017FY, we forecast gross margin to recover to 39% in 2019e, and average 40% over 2019-2021e. Management also said it expects to achieve reduction of inefficiencies following the divestment from Food. Combined with healthy revenue outlook, we estimate MAYBAKER will achieve 16% EBITDA CAGR and 22% average EBITDA margin over 2019-2023e.

Both the Rights issue and current market prices are at significant discount to MAYBAKER's potential

At our TP of NGN4.43/s, the expected total return on MAYBAKER's stock is 100% on current market price, and 89% on the Rights price. We rate the stock a BUY. On our estimates, the stock is trading at 2019e EV/EBITDA and PE multiples of 2.4x and 5.2x respectively, which compares with 8.52x and 12.20x and 48.43x and 35.38x respectively for MEA and EM Asia peers.

BUY

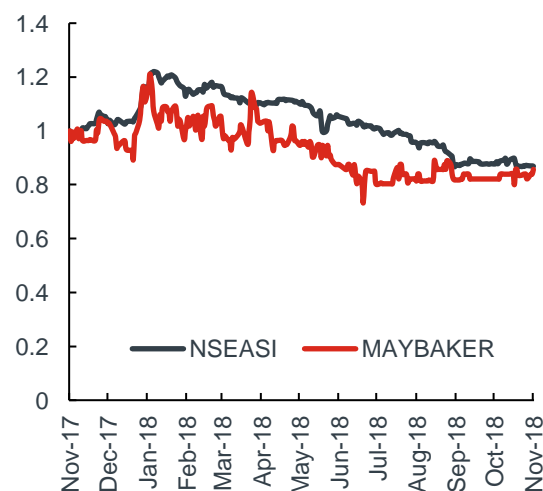
Target Price (NGN)	4.43
Current Price (NGN)	2.35
Rights Price (NGN)	2.50
Implied Return (Current price) (%)	88.32
Implied Return (Rights price) (%)	77.02
Expected Dividend Yield (%)	11.53
Total Return (Current price) (%)	99.85
Total Return (Rights price) (%)	88.55

Company Data

NSE Code	MAYBAKER
Bloomberg Code	MAYBAKER:NL
Reuters Code	MAYBAKE.LG
Sector	PHARMACEUTICALS
Market Cap. (NGN' bn)	4.61
Free Float (%)	72.48

Ratios	Q3-2018	Q3-2017	2017FY
Gross margin	36.5%	31.1%	35.0%
Opex margin	23.2%	20.2%	22.3%
EBITDA margin	18.7%	16.2%	18.1%
EBIT margin	13.6%	11.1%	13.2%
PAT margin	6.3%	3.2%	4.0%
EPS (NGN)	42.32	22.30	0.38

Price movement (MAYBAKER vs. Benchmark index)



Source: NSE, Bloomberg, Cordros Research

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An attractive pharmaceutical industry outlook ...

From USD600 million in 2009, the pharmaceutical industry in Nigeria is estimated will be worth USD1.9 billion by 2019 on about 12% annual growth. The industry is vibrant, with predominantly indigenous manufacturers. Yet there remains significant supply deficit, resulting in increasing reliance on imports. It is estimated that less than 15% in volume of Nigeria's demand for medicine was met by local drug manufacturers in 2016.

The industry dynamics are expected to change in the long-term with growing support from both the government and private local and international agencies. According to estimates by McKinsey & Company, the value of the Nigerian pharma market could rise by as much as 9% a year over the next ten years to reach USD3.6 billion by 2026.

Fig 1: Per capita spend on healthcare (USD)

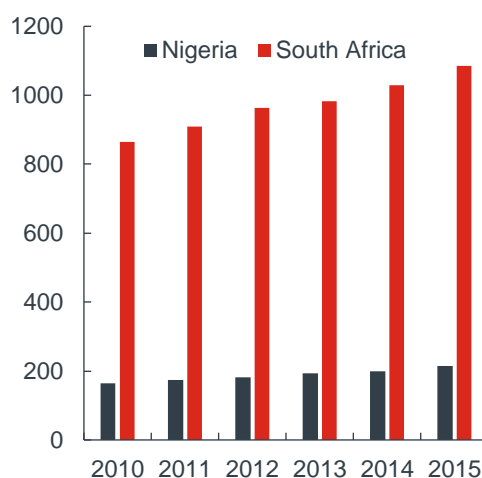
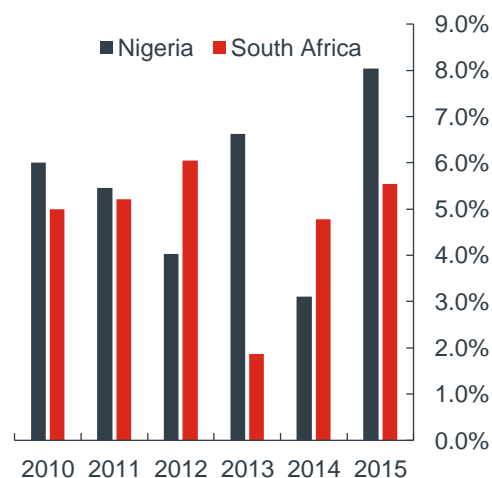


Fig 2: Growth rate of per capita spending on healthcare



Source: WHO, Cordros Research

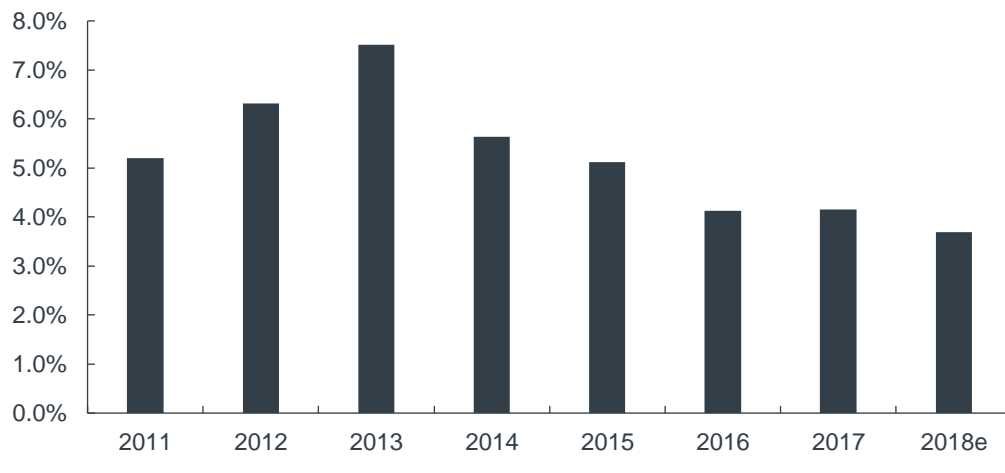
*Adjusted for the cost of living

The Federal government's National Drug Policy (NDP) set a target for 70% of the volume of the country's demand for medicines to be met by local drug manufacturers. The ban on the importation of some essential medicines – for which there is adequate local capacity and technical skills – and the recent increase in tariff (from 0% to 20%) on drugs imported via ECOWAS will be supportive in achieving this target.

The health status indicators for Nigeria are among the worst in the world¹. The Federal Executive Council recently approved USD17 billion under the 2018-2022 Strategic Health Development Plan II, representing USD3 billion annual spend to achieve universal health coverage in five years. The country has a huge growing population with one of the poorest environmental conditions in the world, suggesting that the demand outlook for health care is strong. These present opportunities for pharma companies to position themselves as long-term partners to the government by providing access to much-needed medicines.

¹ The country shoulders 10% of global disease burden, according to the World Health organization.

Fig 3: Share of healthcare budget vs. total FGN expenditure budget



Source: Budget Office of the Federation, Cordros Research estimates

There is a strong linkage between access to healthcare and GDP per capita. Looking at comparable frontier and emerging market economies, available data points show that countries with higher GDP per capita relative to Nigeria also have higher access to healthcare, as indicated by their better health status indicators. We believe sustained economic recovery in the years ahead will promote improvement in standard of living and consumer purchasing power, and thus, boost demand for drugs.

Fig 4: Health expenditure per capita (USD) in SSA (2015)

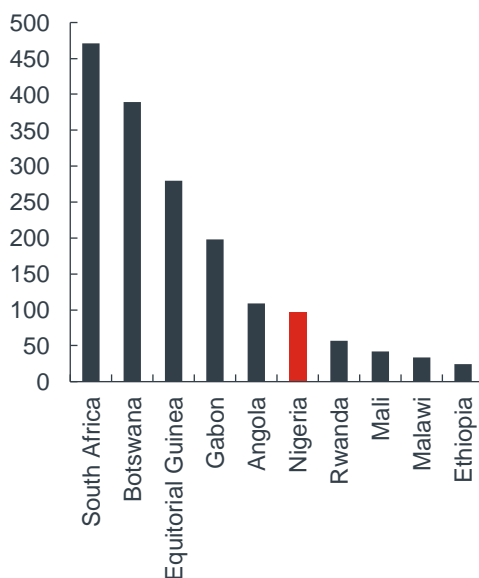
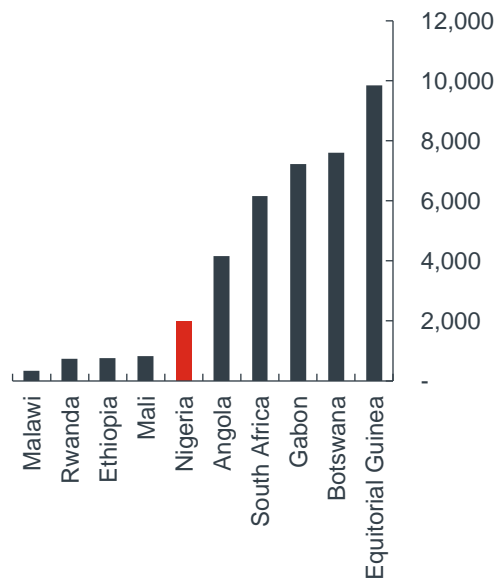


Fig 5: GDP per capita in SSA (2017)



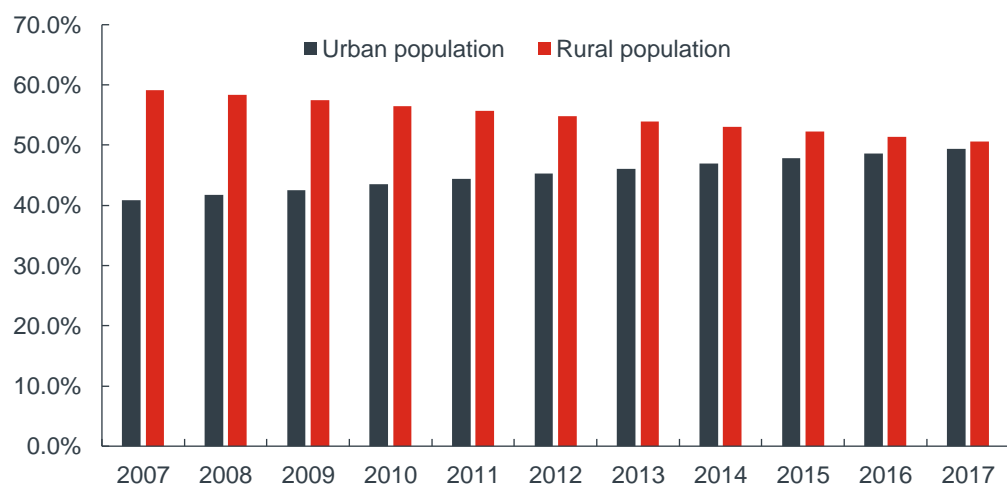
Source: WHO, Cordros Research

The health insurance industry has experienced a boom in the last decade. Since establishment of the NHIS scheme in 2007, the number of registered HMOs in the country have increased to 60 as at 2017. By improving affordability, these operators have increased access to healthcare among the middle-class and young Nigerian employees, with consequent boost in demand for medicine. It is estimated that Nigerians in the middle-class account for over 80% of the clients of health insurance companies. The middle-class growth prospect is strong, and with increasing health consciousness/awareness and affordability, should translate into higher healthcare spending.

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It was estimated by World Bank, in 2016, that 51% of Nigeria's population dwelled in poor rural areas. This is in spite of the rapid urbanization (at 3% rate) that the country has experienced over a decade. Health care is very poor in the rural parts of the country, owing to high poverty, low education rates, and logistical challenges. Nigeria is forecast to experience 3% urbanization rate over the next decade on increasing demand for better livelihood. We believe this would contribute to demand for health care, and growth for the pharmaceutical industry.

Fig 6: Urban and rural population vs. total population



Source: World Bank

...a positive case for investment in May & Baker

A leader in growth market

May & Baker was founded as the first pharmaceutical company in Nigeria and remains one of the leading manufacturers in the pharmaceutical space, with an average of NGN8 billion in annual sales over the last five years and c.4% market share as at 2017. The pharmaceutical market is expected to register robust sales growth over the next few years on account of increasing insurance coverage, rise of private-public partnerships in healthcare, investments in healthcare infrastructure and favourable government policies. As a result, we see material scope for medium-to-long term growth.

Strong earnings performance

MAYBAKER's pharmaceutical sales (85.5% of total sales in FY17) posted 11.7% CAGR in FY12-17 attributable to stronger pricing, following 3 price increases in FY16-17, as well as the implementation of the import adjustment tax (IAT) in Nigeria. The imposition of a 20% tariff on four categories of imported finished drugs, which could also be manufactured locally, have seen patients switch demand to domestically produced products. Supported by increased operational efficiency (OPEX margin has consistently declined, from 32.6% in 2012 to 22.3% in 2017), the firm has delivered a 15.7% EBITDA margin on average since 2012, with net profit posting 37.1% CAGR in FY12-17.

Evolving with change in market dynamics

MAYBAKER has one of the largest product portfolios in the market, with 85 SKUs as at June 2018. Over-the counter (OTC) drugs, which are high volume, high competition, and low margin products, account for most of this portfolio. Amidst the rise in noncommunicable diseases (such as diabetes and heart disease), the company plans to improve its product mix, by introducing the higher priced, higher margin (but low volume) ethicals. For example, the company has in the pipeline, sickle cell as well as some herbs-based drugs, in collaboration with the Federal Institute of Industrial Research, Oshodi (FIIRO) and the National Institute for Pharmaceutical Research and Development (NIPRD), respectively. These are expected to come on stream in 2019.

Additionally, pharmaceutical margins (gross) have averaged 40.5% over the last five years, higher than company level margins, and are expected to improve further as the proportion of ethicals increases in the portfolio.

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The company is looking to significantly increase its expenditure on marketing activities in order to promote and strengthen its brands. This could see the business witness substantial traction over the medium term on account of increasing exposure.

With the pharmaceutical market set to grow at a rapid pace over the next decade, MAYBAKER's local manufacturing and eventual pan-African presence, as well as favourable product basket, place it in a favourable spot to tap this lucrative opportunity.

Potent growth catalysts

According to estimates by McKinsey & Company, the value of the Nigerian pharma market could rise by as much as 9% a year over the next ten years to reach USD3.6 billion by 2026. In order to cater to the rising local demand for the paracetamol analgesic, the company plans to expand production capacity by building a NGN541 million dedicated production facility. Paracetamol accounts for c.25-30% of its pharmaceutical revenues.

Nigeria has the 7th largest birth cohort in the world with about 7 million births annually (UNICEF estimates). As vaccines are mainly used by babies, this provides a huge opportunity to boost revenue from the company's biovaccine production joint venture (JV) with the Nigerian government – Biovaccines Nigeria Limited. The company has signed an MoU with the government, with the government committing to being an off taker of the products produced by the business. NGN437 million of the planned capital raise will be invested in the JV as part of the Company's equity contribution funding.

Entry into export business, capturing new regional markets

According to estimates, the African pharmaceutical market will be worth between USD40 billion and USD60 billion by 2020. Market size apart, its rapid growth (c.9.8% annually) makes the continent very attractive. MAYBAKER plans to explore the West African sub-region in the near term, with the aim of expanding its footprint and increasing sales (exports) through targeted acquisitions and strategic alliances with smaller players with established market share in Francophone countries. MAYBAKER is one of only four manufacturers in Nigeria that have obtained the World Health Organization Good Manufacturing Practice (WHOGMP) certification on their facilities, giving it a significant competitive advantage. WHOGMP certification signifies that facilities meet global quality standards and can compete at an international level. The potential ratification of the African Continental Free Trade Area (AfCTA) by Nigeria, will open up regional markets, further supporting the firms plans.

Financial Statement (NGN'million).

Income Statement (million)	2016a	2017a	2018e	2019e	2020e
Revenue	8,469	9,353	9,353	10,288	11,337
Cost of sales	5,934	6,075	6,079	6,276	6,910
Gross profit	2,536	3,278	3,273	4,012	4,427
Other income	47	36	36	36	36
Operating expenses	1,819	2,082	2,136	2,331	2,566
EBIT	764	1,232	1,173	1,717	1,897
Finance income	2	30	2	6	7
Finance costs	519	635	394	342	211
Profit before tax	346	602	781	1,381	1,694
Tax expense/credit	387	235	250	442	542
Profit after tax	-41	371	531	939	1,152

Profitability Ratios	2016a	2017a	2018e	2019e	2020e
Gross profit margin	29.9%	35.0%	35.0%	39.0%	39.1%
EBITDA margin	15.1%	18.1%	17.8%	21.9%	22.1%
Operating profit/EBIT margin	9.0%	13.2%	12.5%	16.7%	16.7%
PBT margin	4.1%	6.4%	8.3%	13.4%	14.9%
PAT margin	-0.5%	4.0%	5.7%	9.1%	10.2%
ROAE	-1.3%	11.7%	15.2%	18.0%	16.2%
ROAA	-0.5%	4.6%	6.8%	10.3%	10.6%
ROCE	-0.7%	6.4%	9.7%	11.6%	13.5%

Liquidity Ratios	2016a	2017a	2018e	2019e	2020e
Working capital (NGN'm)	1,184	1,215	1,652	3,553	4,162
Current ratio	1.4x	1.5x	1.7x	3.2x	3.6x
Quick ratio	0.6x	0.5x	0.8x	1.5x	1.8x
Cash ratio	0.3x	0.2x	0.0x	0.0x	0.0x
Cash conversion cycle	58	39	89	139	158

Efficiency Ratios	2016a	2017a	2018e	2019e	2020e
Fixed assets turnover	1.2x	2.6x	2.5x	2.1x	2.1x
Current assets turnover	2.0x	2.5x	2.4x	2.0x	2.0x
Total assets turnover	1.0x	1.2x	1.2x	1.0x	1.0x
Inventory turnover	3.6x	3.7x	3.5x	2.9x	2.7x
Receivables turnover	7.4x	12.5x	7.9x	5.7x	5.5x
Payables turnover	3.9x	4.1x	6.0x	7.5x	8.5x
Days of inventory on hand (DOH)	102	100	103	124	134
Days of sales outstanding (DSO)	49	29	46	64	67
Number of days of payables	93	90	61	49	43

Solvency Ratios	2016a	2017a	2018e	2019e	2020e
Debt-to-capital	0.5x	0.4x	0.3x	0.2x	0.1x
Debt-to-equity	98.7%	74.1%	49.9%	19.2%	14.3%
Net debt-to-equity	0.7x	0.6x	0.4x	0.1x	0.1x
Net debt/EBITDA	1.6x	1.1x	1.0x	0.3x	0.2x
Interest coverage	1.5x	1.9x	3.0x	5.0x	9.0x

Investment Ratios	2016a	2017a	2018e	2019e	2020e
Earnings per share (NGN)	-0.04	0.38	0.54	0.48	0.59
Dividend per share (NGN)	0.06	0.20	0.27	0.24	0.29
Payout	-145%	53%	50%	50%	50%

Financial Position	2016a	2017a	2018e	2019e	2020e
Intangible assets	67	34	34	34	34
PPE	3,987	3,651	3,694	4,823	5,342
Deposit for investment	245	230	230	230	230
Non-current assets	4,300	3,915	3,958	5,087	5,606
Inventories	1,728	1,598	1,847	2,412	2,671
Trade and other receivables	782	719	1,663	1,966	2,177
Other assets	864	879	181	237	262
Due from related parties		6			
Cash and cash equivalents	947	546	230	587	678
Current assets	4,320	3,749	3,922	5,201	5,788
Total Assets	8,620	7,664	7,879	10,288	11,394
Trade and other payables	1,889	1,105	919	763	856
Current income tax liabilities	156	65	252	209	235
Borrowings	1,041	1,333	1,070	651	510
Other liabilities	50	32	29	24	27
Current liabilities	1,931	1,130	757	651	560
Borrowings	1,931	1,130	757	651	560
Employee benefits		79	478	612	1,076
Deferred tax liabilities	418	597	716	595	667
Total non-current liabilities	2,472	1,806	1,951	1,858	2,303
Total Liabilities	5,608	4,340	4,221	3,505	3,929
SHF	3,012	3,324	3,659	6,783	7,465

Source: Company Accounts, Cordros Research estimates

Disclosures.

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BUY (OVERWEIGHT) - Over the next twelve months, we expect the stock to return at least 20% above the current market price.

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