

Brewery Sector Update

The forgotten stone now the stumbling block

NB: NL

| | |
|--------------------|------------------|
| Rating | SELL |
| Price | ₦79.4 |
| FVE | ₦76.58 |
| 52-week range | ₦75.00 - ₦155.00 |
| Market Cap. (₦'bn) | 679.73 |
| 1-month Avg. Vol | 2,016,867 |
| Curr. PE | 28.5x |

GUINNESS: NL

| | |
|--------------------|------------------|
| Rating | SELL |
| Price | ₦74.00 |
| FVE | ₦73.96 |
| 52-week range | ₦71.20 - ₦120.25 |
| Market Cap. (₦'bn) | 162.09 |
| 1-month Avg. Vol | 304,919 |
| Curr. PE | 19.9x |

Analyst(s)

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- The competition in the brewery sector took a new turn over 2018, with the impact now becoming noticeable on earnings of our coverage brewers. The financial results of Nigerian Breweries Plc (NB) and Guinness Nigeria Plc (Guinness) in the past quarter were disappointing, with NB reporting a loss after tax of ₦3.6 billion in its third fiscal quarter of 2018 (Q3 18) while Guinness reported a 37.3% YoY decline in earnings (excluding FX losses) in its first fiscal quarter of 2019¹ (FQ1 19). The weaker earnings for both companies reflects the stiff competition from International Breweries (IB) which not only impacted on beer volumes for NB and Guinness but limited their ability to raise prices considering higher excise duty rates. Following the poor earnings outturn by NB, we make downward revisions to our estimate for FY 18E and FY 19-23F. Specifically in 2018, we forecast FY 18E EPS at ₦2.87 (previous: ₦3.69) for NB, due to weaker margins from rising competition which has limited its ability for an upward adjustment in prices and higher operating costs.
- For both NB and Guinness, we see limited scope for margin expansion in FY 19F. Our view is based on IB's unrelenting push to increase national presence and drive up its market share, supported by the recent capacity expansion (added ~2.5 million hectoliters) at its Shagamu plant. Accordingly, we expect pressured volumes for other sector players in the medium term. Also, the next phase of excise duty increase (+17%) is expected to commence in early 2019. The 17% hike will see beer and spirit excise duty rates rise to ₦0.35 (previous: ₦0.30) and ₦1.75 (previous: ₦1.50) respectively per centiliter. While we expect some price hike to protect already weak margins, we think the increase will not be sufficient enough to fully offset the excise duty increase given the still pressured consumer wallets as well as intense competition for market share in the sector. On the back of this, we forecast FY 19F EBIT margin of 12.9% (FY 18E: 12.6%) and 8.6% (FY 18: 9.4%) for NB and Guinness respectively. On net, we forecast FY 19F EPS of ₦2.97 (FY 18E: ₦2.87) and ₦3.54 (FY 18: ₦3.07) for NB and Guinness respectively.

¹ Guinness Nigeria fiscal year ends June

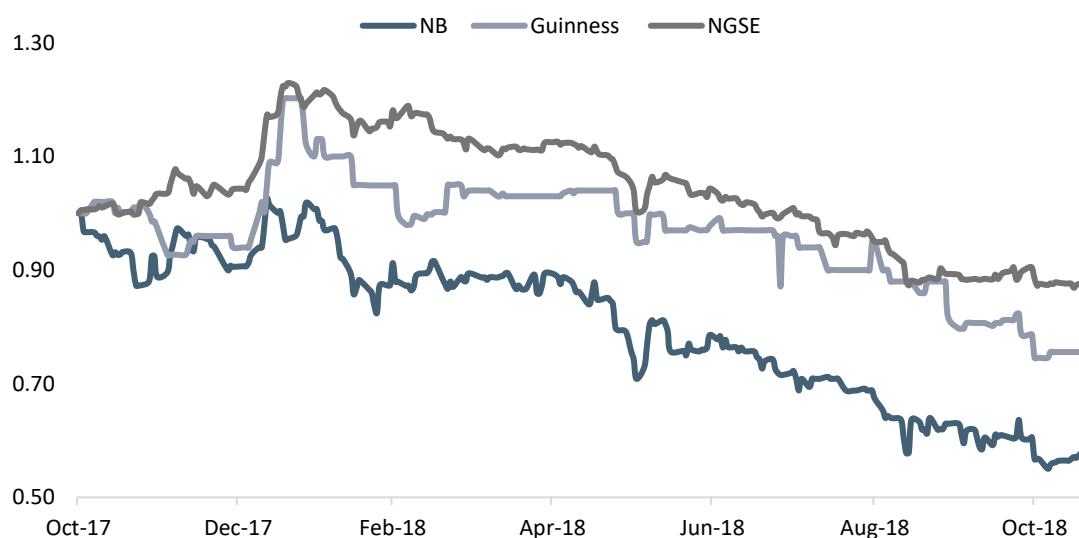
- Following adjustments to our forecasts, we cut our FVE on NB to ₦76.58 (previous: ₦121.30) and Guinness to ₦73.96 (previous: ₦88.21), translating to a SELL rating for both stocks.

Table 1: Financial Highlights

| N'Million | NB FY 18E | NB FY 19F | GUINNESS FY 18A | GUINNESS FY 19F |
|------------------|-----------|-----------|-----------------|-----------------|
| Revenue | 321,067 | 327,259 | 142,975 | 145,157 |
| Gross profit | 130,123 | 134,059 | 48,625 | 48,918 |
| Operating profit | 40,376 | 42,110 | 13,386 | 12,545 |
| Net profit | 22,976 | 23,725 | 6,717 | 7,756 |
| EPS | 2.87 | 2.97 | 3.07 | 3.54 |

Source: Company Financials, ARM Research

Figure 1: Share price trend (rebased) – NGSE, NB and GUINNESS



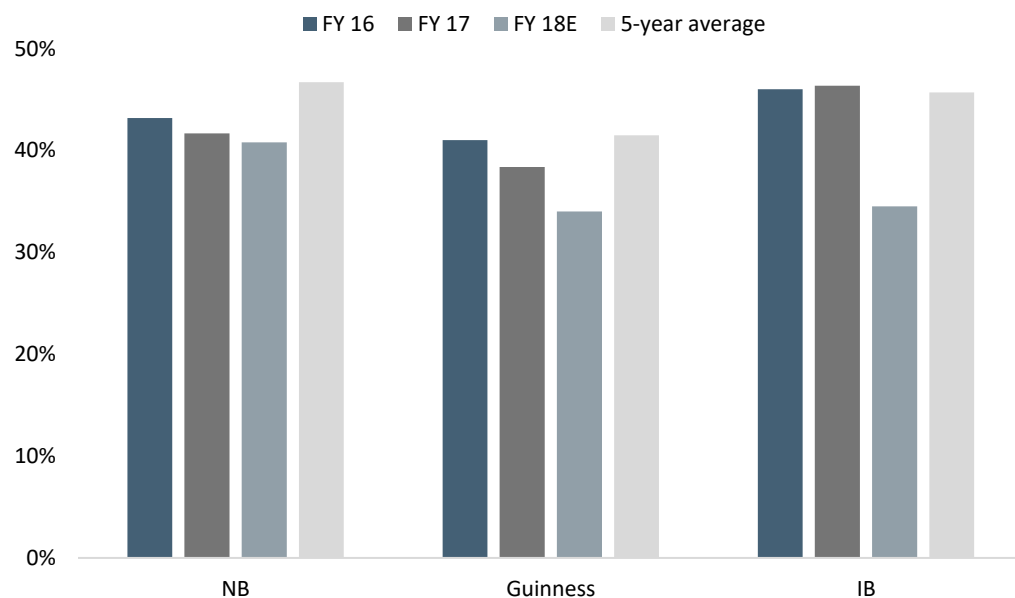
Source: Bloomberg, ARM Research

- **Competition bites sector heavy weights.** The intense competition in the brewery sector was majorly from an existing player – International breweries – whose cheap pricing strategy, strong mainstream products (Trophy and Hero) and new capacity of ~2.5 million hectoliters, enabled it to gain market presence in major regions in the country. With muted growth in the overall beer market over the period, this meant weaker volumes and loss of market share for NB and Guinness. Precisely, over the 9M 18 period, IB reported a double-digit growth in volumes, according to commentary from its parent company. On the other hand, NB's volume declined high single digit. We also estimate muted beer growth for Guinness over the same period. While we expect growth in the beer market to pick up in FY 20-23F hinged on our expectation for improved macroeconomic environment, we think

volume share gain for NB and Guinness will be limited due to IB's drive to gain substantial footprint in the country.

- Beer price increase on the cards but won't be enough:** The next phase of hike in excise duty rates on alcohol is set to commence in January with an expected increase of 17% over the last reviewed rate. The 17% hike will see beer & stout excise rate rise to ₦0.35 (previous: ₦0.30) while spirits rise to ₦1.75 (previous: ₦1.50) per centiliter. We recall that a 36% hike on excise duty rate for alcohol was implemented beginning June 2018 which led NB and Guinness to hike product prices by an average of 12%. However, the hikes were reversed due to weaker sales volume, after IB decided to leave prices unchanged on its mainstream products. As a result, gross margin over the nine-month period contracted for brewers – NB (-230bps YoY to 40%), Guinness² (226bps to 32.4%) and IB (-10ppts to 34.5%). Given currently weak margins and expectation of further pressure from the hike in excise duty rates in January, we believe all sector players will pass-through the increase to consumers through higher product prices in a bid to protect margins. However, we do not expect a full pass-through given still pressured consumer wallets. Basically, given that IB absorbed the initial increase in excise duty, we only expect a slight adjustment to the additional 17% increase in excise duty starting January. As a result, we estimate price hike in the low double-digit range over 2019. Already, current gross margin level for NB, Guinness and IB are below their respective 5-year historical average of 46.7%, 41.5% and 46%.

Figure 2: Brewery companies gross margin trend



Source: Company filings, ARM research

² Guinness' gross margin was based on FQ1 19

Nigerian Breweries Plc (₦76.58, SELL)

- **Earnings on track to touch an all-time low:** Nigerian Breweries earnings over 9M 18 came in below our expectation (EPS: ₦1.85 vs. ARM estimate of ₦2.52) due to higher cost of sales from rise in barley prices (+11.9%) and higher cost per unit with decreasing scale – a fallout of weaker volumes. Reflecting the heated competition and further declines in volumes into Q4 18, we forecast FY 18E revenue to decline by 6.8% YoY to ₦321 billion. As stated earlier, with IB's relentless drive to build presence in Nigeria as well as support from its new capacity, we expect volume pressure for NB in the medium term. Hence, we have cut our medium-term revenue forecast by 2% on average, representing a 5-year CAGR of 4%. Mainstream and affordable beer currently account for 80% of the total beer volume and also the segment that is contributing the most to IB's volume growth. We believe NB can regain market share, by increasing its product portfolio in the mainstream beer category although, we think it's a remote possibility given that it's a premium company in line with the strategy of its parent company – Heineken. Recent premium product innovations in 2018 – Stella and Tiger beer – attests to this.
 - We forecast FY 18E cost of sales to decline slower by 5.4% YoY to ₦190 billion due to rising barley price and loss of economies of scale. Accordingly, we forecast FY 18E gross margin at 40.8% (FY 17: 41.7%) and EBIT margin of 12.6% (FY 17: 17%). The steep decline in our EBIT margin forecast stems from higher operating expenses (OPEX to sales ratio of 28.4% vs. 26.3% in 9M 17), particularly marketing and distribution expenses which was elevated due to marketing campaigns during the world cup as well as its continued push to remain visible in the tough competitive environment. Over our forecast horizon, we project average EBIT margin of 15.7%, lower than 5-year historical EBIT average of 21%.
 - Overall, despite our tamer net finance cost expectation of ₦6.6 billion (-37% YoY) – on account of lower FX losses – our forecasts translate to FY 18E and FY 19F EPS of ₦2.87 (FY 17: ₦4.13) and ₦2.97 respectively. In line with historical trend of 100% dividend payout, we forecast dividend yield of 3.4% and 3.5% respectively.
 - Following adjustments to our forecasts and having rolled forward our model, we cut our FVE on NB to ₦76.58 (previous: ₦121.30), translating to a SELL rating on the stock based on current pricing. On our numbers, NB trades at a 2019 P/E of 28.6x (5-year historical average of 24.5x) relative to Guinness of 20.9x.
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Summary of Results and Forecasts - Naira (₦) – Nigerian Breweries

| ANNUAL | | | | | |
|----------------------------|---------|---------|---------|---------|---------|
| Income Statement (₦' m) | | | | | |
| | 2016A | 2017A | 2018E | 2019F | 2020F |
| Revenue | 313,743 | 344,563 | 321,067 | 327,259 | 340,655 |
| COGS | 178,219 | 201,013 | 190,124 | 193,200 | 197,207 |
| Gross Profit | 135,525 | 143,549 | 130,944 | 134,059 | 143,447 |
| Operating Cost | 83,237 | 88,647 | 91,605 | 93,738 | 97,487 |
| Operating Profit | 52,903 | 57,121 | 40,376 | 42,110 | 47,076 |
| Net finance Cost | 13,229 | 10,491 | 6,588 | 7,726 | 7,267 |
| PBT | 39,675 | 46,630 | 33,788 | 34,384 | 39,809 |
| Tax | 11,258 | 13,581 | 10,812 | 10,659 | 12,739 |
| PAT | 28,417 | 33,049 | 22,976 | 23,725 | 27,070 |
| Balance Sheet (₦ '000) | | | | | |
| | | | | | |
| Fixed Assets | 191,182 | 195,230 | 195,694 | 195,480 | 194,596 |
| Stocks | 31,245 | 42,729 | 34,222 | 34,776 | 35,497 |
| Trade debtors | 19,974 | 20,384 | 24,198 | 21,467 | 18,604 |
| Cash & other bank balances | 12,156 | 15,867 | 8,893 | 15,285 | 22,643 |
| Total Assets | 367,146 | 382,228 | 370,936 | 374,953 | 379,306 |
| Liabilities | | | | | |
| Trade Creditors | 111,184 | 127,947 | 85,556 | 86,940 | 88,743 |
| Non-current Liabilities | 56,978 | 47,877 | 67,952 | 70,010 | 71,957 |
| Total liabilities | 201,233 | 203,930 | 192,638 | 196,654 | 201,008 |
| Shareholders' fund | 165,914 | 178,298 | 178,298 | 178,298 | 178,298 |
| Key Ratios | | | | | |
| | 2016A | 2017A | 2018E | 2019F | 2020F |
| Gross Margin | 43% | 42% | 41% | 41% | 42% |
| EBIT Margin | 17% | 17% | 13% | 13% | 14% |
| PBT Margin | 13% | 14% | 11% | 11% | 12% |
| Net Margin | 9% | 10% | 7% | 7% | 8% |
| EPS | 3.6 | 4.13 | 2.9 | 3.0 | 3.4 |
| P/E | 41.3 | 32.6 | 47.0 | 45.5 | 39.9 |
| EV/EBITDA | 14.5 | 11.9 | 16.4 | 16.0 | 14.5 |
| ROA | 8% | 9% | 6% | 6% | 7% |
| ROE | 17% | 19% | 13% | 13% | 15% |

Guinness Nigeria Plc (₦73.96, SELL)

- ***Operating picture remains weak, but lower FX losses will support earnings:*** Guinness Nigeria started its 2019 fiscal year on a slow note with earnings (excluding FX losses) down 37.3% YoY due to a 6.8% decline in revenue and slower decline in cost of sales (-2.8%). The decline in revenue reflects weaker sales volume and higher excise duty rates, in our view. Irrespective, for the FY 19 period, we forecast a 1.5% YoY growth in revenue to ₦145 billion due largely to higher prices following the implementation of the new excise duty rates. We also expect some support from increased spirits contribution to revenue, particularly its resilient locally produced mainstream spirits products. Management guides to 20% spirits contribution to revenue by 2020 from 15% contribution in FY 18. Over FY 19-23F, we forecast revenue to rise by a 5-year CAGR of 3.9%.
 - In line with NB, cost to sales ratio rose (+226bps YoY to 67.6%) in FQ1 19 which we attribute to the rise in barley price (+11.9%) and higher cost per unit due to loss of diseconomies of scale following weaker volumes. Taking this into account, with our FY 19F cost to sales ratio forecast of 66.1%, we forecast cost of sales at ₦96 billion, representing a 1.7% YoY increase from FY 18. Accordingly, we forecast FY 19F gross margin at 33.7% and 35% on average over FY 20-23F, lower than 5-year historical gross margin average of 41.5%. Competition is expected to heat up further in the brewery sector, hence, we foresee higher operating costs majorly from higher marketing expenses. With our OPEX to sales ratio forecast of 25.7% (FY 18: 25.1%), we project FY 19F EBIT margin at 8.6% (FY 18: 9.4%). Over our forecast horizon, we forecast EBIT margin of 9.7%, relatively unchanged from 5-year historical EBIT margin average of 10%.
 - Guinness Nigeria successfully completed ₦40 billion rights issue in its 2018 fiscal year. The bulk of the proceeds was used to pay down its foreign currency denominated loans which previously inflicted pressure on finance costs via higher interest expense and FX losses. Precisely, the company's debt to equity as at FQ1 19 stands at 17% from 98% as at FY 17 respectively. With tamer debts, moderation in its FCY loans and stability in the currency, we forecast net finance cost to decline by 59.1% YoY to ₦2.3 billion in FY 19F.
 - Solely on account of lower net finance costs, which offsets pressures from revenue and higher input & operating costs, we forecast EPS of ₦3.54 and DPS of ₦2 in FY 19F. Following adjustments to our forecasts and having rolled forward our model, we cut our FVE on Guinness Nigeria to ₦73.96 (previous: ₦88.21), translating to a SELL rating on the stock based on current pricing. On our numbers, GUINNESS trades at a 2019 P/E of 20.9x (5-year historical P/E average of 25.5x) relative to NB of 28.6x.
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Summary of Results and Forecasts - Naira (₦) – Guinness Nigeria

| ANNUAL | | | | | |
|----------------------------|----------|----------|----------|----------|----------|
| Income Statement (₦' m) * | | | | | |
| | 2016A | 2017A | 2018A | 2019F | 2020F |
| Revenue | 101,973 | 125,920 | 142,976 | 145,157 | 150,126 |
| COGS | (60,163) | (77,605) | (94,350) | (96,239) | (99,083) |
| Gross Profit | 41,810 | 48,315 | 48,625 | 48,918 | 51,043 |
| Operating Cost | (37,895) | (38,976) | (35,908) | (37,305) | (38,582) |
| Operating Profit | 4,416 | 10,186 | 13,386 | 12,545 | 13,422 |
| Finance Cost | (7,948) | (9,778) | (5,645) | (2,308) | (2,951) |
| PBT | (2,347) | 2,662 | 9,943 | 11,080 | 10,903 |
| Tax | 331 | (738) | (3,226) | (3,324) | (3,271) |
| PAT | (2,016) | 1,924 | 6,718 | 7,756 | 7,632 |
| Balance Sheet (₦ '000) * | | | | | |
| Fixed Assets | 87,233 | 87,325 | 97,602 | 98,723 | 98,978 |
| Stocks | 13,021 | 23,094 | 19,032 | 24,060 | 24,771 |
| Trade debtors | 29,004 | 24,199 | 24,766 | 24,677 | 25,521 |
| Cash & other bank balances | 5,845 | 6,595 | 7,451 | 2,149 | 8,210 |
| Total Assets | 136,992 | 146,038 | 153,255 | 154,013 | 161,884 |
| Liabilities | | | | | |
| Trade Creditors | 37,530 | 43,053 | 31,176 | 28,872 | 29,725 |
| Non-current Liabilities | 28,222 | 39,376 | 22,820 | 23,631 | 24,524 |
| Total liabilities | 95,332 | 103,095 | 65,667 | 63,051 | 66,567 |
| Shareholders' fund | 41,661 | 42,943 | 87,588 | 90,962 | 95,317 |
| Key Ratios | | | | | |
| Gross Margin | 41% | 38% | 34% | 34% | 34% |
| EBIT Margin | 4% | 8% | 9% | 9% | 9% |
| PBT Margin | -2% | 2% | 7% | 8% | 7% |
| Net Margin | -2% | 2% | 5% | 5% | 5% |
| EPS | (1.34) | 1.28 | 3.07 | 3.54 | 3.48 |
| P/E | (82.17) | 86.11 | 35.87 | 31.07 | 31.57 |
| EV/EBITDA | 14.25 | 9.75 | 15.88 | 11.06 | 9.83 |
| ROA | -2% | 1% | 4% | 5% | 5% |
| ROE | -4% | 5% | 10% | 9% | 8% |

ARM ratings and recommendations

M now employs a two-tier rating system which is based on systemic importance of the security under review and the deviation of our target price for the stock from current market price. We characterize systemic importance as a function of a stock's ranking among the group of top 20 stocks by NSE market capitalization over a trailing 6-month period (minimum) to the review date. We adopt a 5-point rating system for this category of stocks and a 3-point rating system for stocks outside this group. The choice of top 20 stocks arises from the consideration that this group of stocks constitutes >75% of overall market capitalization and stocks outside this group are generally less liquid and individually account for <<1% of market capitalization. For stocks in both categories, the basis for ratings subject to target price deviation is outlined below:

| TOP 20 | | NON-TOP 20 | |
|--------------------|------------|----------------|-----------|
| Rating | Deviation | Rating | Deviation |
| STRONG BUY | >20% | BUY | >20% |
| OVERWEIGHT | 10% — 20 % | NEUTRAL | 5% — 20 % |
| NEUTRAL | 0% — 10 % | SELL | <5% |
| UNDERWEIGHT | -5% — 0% | | |
| SELL | <-5% | | |

| RECOMMENDATION KEY | |
|--------------------|--|
| Rating | Recommendation |
| BUY | Accumulate security to a substantial extent constrained only by portfolio diversification considerations |
| OVERWEIGHT | Accumulate security to an extent moderated by cognizance of its benchmark weight |
| NEUTRAL | Maintain status quo for security with respect to current holding—i.e. keep if already holding and don't buy otherwise—subject to reasonable portfolio constraints |
| UNDERWEIGHT | Minimize exposure to security taking cognizance of its index weighting |
| SELL | Sell-off security completely from portfolio |
| RESTRICTED | In certain circumstances, Asset & Resource Management ("ARM") Group policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of ARM Securities' and/or ARM Group's engagement in an investment banking transaction and in certain other circumstances. |

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