

Rating	BUY
Price	₦27.05
FVE	₦32.83*
52-week range	₦4.60 – ₦27.05
Market Cap. (N'bn)	30.91
1-month Avg. Vol	16,304
Current PE	10.5x

* Most possible scenario

CCNN.NL - Share Price Trend



Analyst(s)

Oluwasegun Akinwale

Oluwasegun.akinwale@arm.com.ng

Cement Analyst

CCNN Plc (Sokoto Cement)

Stock Report

A case for optimism...stay tactical!

Summary

- Limited Upside for CCNN without expansion.** Over 2017, CCNN achieved a capacity utilization of 94%, suggesting little upside for volumes growth over the medium term. Besides volumes upside, the relatively low production capacity, has masked gains from economies of scale with CCNN consistently reporting the highest energy cost per tonne among peers due to its heavy reliance on LPFO – sourced from the epileptic Kaduna refinery. Noting the expected capacity max out in 2018 amidst still elevated energy costs (60% of total cash cost), the company's operation in the medium to long term signals high sensitivity to price movements.
- Some Cause for Cheer as BUA comes to the rescue.** Playing to the increasing cement consumption in the Northern region and to address the impending loss of market share as production capacity at the 500KT plant reaches its zenith, BUA Group (CCNN's parent company) announced plans to increase production capacity by 1.5MT in 2015.
- Over most part of 2016 and 2017, update on the plant was not made available by BUA, however, our engagement with the management of BUA revealed that the plant would be commissioned in May 2018. The commissioning process of the plant has started, and the cement production is expected to start soonest.

- **How will this play out?** Given a total capex spend of ₦5.8 billion by CCNN between 2015 and 2017, compared to the estimated plant cost of \$350 million (₦126 billion), we believe the expenditure is being undertaken BUA. In accessing the possible structure on how the plant would be integrated into CCNN, we assumed three possible scenarios: (1) a debt related structure (finance lease); (2) contract manufacturing services (operating lease); and (3) consolidation of BUA cement plants into a single entity. In all, we believe the value accretion would vary depending on the structure and therefore analysed the impact of the possible arrangements on earnings.

Table 1: Summary of scenario EPS, FVE and Forward PE

Structure	FVE (₦)	2018 EPS (₦)	2018 PE (x)
Current Capacity	25.31	3.10	5.7
Expansion (Finance lease)	32.83	1.78	13.9
Expansion (Operating lease)	34.74	1.96	9.6
Expansion (Merger)	42.96	2.85	6.7

- **CCNN vs. DANGCEM...who has competitive advantage in the north?** From the look of things, CCNN and DANGCEM have a strategic roadmap of increasing their market share in the northern region as well as expanding their export base through Niger Republic. On this basis, we look at the factory location of both players to the major northern Market (Kano State) and to Niger Republic, based on distance and cost of transportation, we think CCNN will play better in terms of competition.

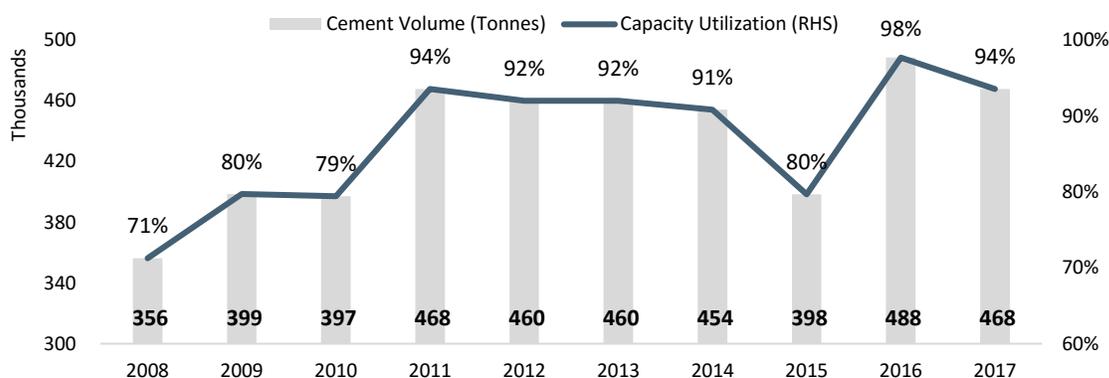


A case for optimism... stay tactical!

- Despite our positive outlook for the cement sector on the back of increase in volumes and moderating cost pressure, CCNN (Sokoto Cement), at current capacity, is unlikely to benefit from the positive outlook, as low installed capacity (relative to peers) and full reliance on

expensive LPFO continues to limit growth. As at FY 17, the company capacity utilization was 94%, with accompanying cement production of 468KT (-4.3% YoY), suggesting a possible capacity max out over 2018. Consequently, despite strong demand for cement in CCNN's region of dominance, with supply tracking below demand, an investment case for the company remains quiet without possible expansion in capacity and room for energy efficiency.

Figure 1: CCNN volume (KT) vs. Capacity Utilization



Source: Company Financials, ARM Research

- BUA Group, the largest shareholder (~51%) in CCNN¹ has announced plans to commission the 1.5MT Kalambaina Cement Plant in Sokoto, Nigeria. The plant, which was to be commissioned on Thursday May 10th but now postponed, is fully owned by BUA, but expected to be added to the current installed capacity (500KT) of CCNN, to bring combined installed capacity to 2.0MT (4x YoY) and improve operational efficiency. For context, the current 500KT cement plant of CCNN is 33-years (installed 1985), operates at ~94% capacity utilisation, and solely runs on expensive LPFO with associated haulage costs from Kaduna refinery; whereas, the newly installed 1.5MT cement plant is expected to run on a ~32MW coal power plant. Although, update has not been provided by BUA group on how the new plant would be merged into CCNN's operation, we believe that the capacity expansion will be a major game changer for CCNN.

Table 2: Key details of the existing and new plant

Description	Old Plant	New Plant
Cement Plant Name	CCNN	Kalambaina plant
Capacity (Tonnes)	500,000	1,500,000
Location	Sokoto	Sokoto
Energy use	LFPO	Coal

¹ Damnaz Cement Co. Limited, a wholly-owned subsidiary of BUA Group, owns 50.72% of CCNN's shareholdings.

Is the low hanging fruit ripe?

- In accessing the value accretion from the expansion in capacity, we analyse the possible arrangements between BUA and CCNN, given that the new cement plant is fully owned by BUA but will be operated by CCNN. In our view, we expect the plant to come in form of a debenture (finance lease) or operating lease. Thus, we looked at the impact of two kinds of lease arrangement – finance and operating –, while noting the scope of consolidation of the cement subsidiaries into a single entity in the medium term by BUA. In all, we believe the impact on EPS, ROA and ROE would vary under both scenarios, and therefore analysed the impact of these arrangements on earnings.

Scenario 1: Finance Lease. In line with the guidance by BUA of a \$350 million construction cost, we estimated the naira value at ₦126 billion. On our first scenario, we assumed a finance lease, with a term of 20 years and interest expense of 8% (*Dangote Industries Limited's interest rate on loans to subsidiaries*) over the period of the lease. Also, we used a straight-line depreciation expense over life of the asset with a zero-residual value. Over H2 18, we estimate a lease interest expense of ₦5.0 billion and capital lease obligation of ₦1.4 billion, with corresponding depreciation expense of ₦2.1 billion – contributing 9% increase to FY 18F cost to sales. While we adjusted for higher distribution spend over H2 18, we left other cost assumptions largely unchanged. Therefore, we project 2018F PAT at ₦1.3 billion with EPS expected to sit at ₦1.78 (compared to ₦2.57 in FY 17). In addition, we believe the company would be looking to pay out 24% of its earnings (DPS: 43 kobo) in the current year.

- Father out, having adjusted for plant size running on full course alongside the 500k improved energy plant and the annual average lease interest expense of ₦9.6 billion – with accompanying average depreciation expense of ₦4.2 billion – for the coming years (2019-2022), we expect an average annual EPS of ₦3.49 over our forecast horizon and DPS of ₦0.82. The net impact of the adjustments drove our FVE to **₦32.83**, a 21% upside to current price of ₦27.05 which implies a **BUY** recommendation by our rating system.

Table 3: Finance lease assumption and impact

Finance Lease	2018	2019	2020	2021	2022
Current Capacity (MT)	2.00	2.00	2.00	2.00	2.00
Capacity Utilization	30.3%	52.0%	55.0%	59.0%	64.0%
Cement Production (MT)	0.61	1.04	1.10	1.18	1.28
Financial Highlights (₦mn)					

Revenue	25,273	42,952	45,210	48,498	52,288
Cost of sales	11,878	20,617	21,701	23,764	24,052
Finance Lease Expense	5,040	9,970	9,741	9,493	9,226
Depreciation	2,100	4,200	4,200	4,200	4,200
PAT	2,232	2,288	3,304	4,417	7,525
FCFF	8,281	18,767	18,034	18,923	20,455

Scenario 2: Operating Lease. On our second scenario, we adopted an operating lease assuming the consolidation of the cement subsidiaries of BUA in the nearest term (we estimate 5 years) which would limit the term of use of the asset under CCNN. Accordingly, Over H2 18, we estimate an operating lease expense of ₦6.6 billion. With other cost assumptions unchanged, we project 2018F PAT at ₦2.5 billion with EPS expected to sit at ₦1.96 and a 24% pay out of its earnings (DPS: 48 kobo) in the current year. Over the lease period, with a full installed capacity of 2.0MT, we estimate annual operating lease expense of ₦12.8 billion over 2019-2022 and expect an average annual EPS of ₦3.28 over our forecast horizon and DPS of ₦0.92. The conclusion of these changes translates to a FVE of ₦34.74 which represents a 27% upside from current price of ₦27.05. We retain a **BUY** rating on the stock.

Table 4: Operating lease assumption and impact

Operating Lease	2018	2019	2020	2021	2022
Current Capacity (MT)	2.00	2.00	2.00	2.00	2.00
Capacity Utilization	30.3%	52.0%	55.0%	59.0%	64.0%
Cement Production (MT)	0.61	1.04	1.10	1.18	1.28
Financial Highlights (₦mn)					
Revenue	25,273	42,952	45,210	48,498	52,288
Cost of sales	11,878	20,617	21,701	23,764	24,052
Operating Lease Expense	6,417	12,833	12,833	12,833	12,833
Depreciation	789	817	871	913	928
PAT	2,463	2,614	3,239	4,143	6,470
FCFF	2,812	6,316	958	5,379	6,451

A merger is looking likely. In the medium term, acknowledging the possible loss in value through a finance or operating lease (especially in the short term) and the impact it could have on the parent company if any of the lease method is employed, we foresee a possible combination of all BUA cement plants, with the 1.5MT operated as an operating lease by CCNN in H2 18. Going by available data, BUA currently owns 5MT plant (including the soon to be commissioned Kalambaina plant) with estimated total assets value of ₦354 billion.

Table 5: Business combination share conversion ratio

Description	Current Business	Consolidate Business
Plant Size (MMT)	0.50	5.00
Shares Outstanding (Billion)	1.30	12.6
Conversion Ratio	10	1

Table 6: Key details of BUA Cement Plants

Description	Plant Size (MT)	Assets Value (N'000)
Obu Cement Plant (Edo)	3,000,000	216,000,000
Kalambaina Plant (Sokoto)	1,500,000	126,000,000
CCNN Plant (Sokoto)	500,000	12,324,586
Total	5,000,000	354,324,586

- In our view, the consolidation of the plants would significantly reduce operational cost and improve synergies across the business. Also, with the strategic location of the plants, we believe BUA Cement would be well positioned to compete effectively. **Given the small size of CCNN in the pie, we assumed a share conversion ratio of 10.1 with estimated group shares outstanding of 12.6 billion (Current:1.6 billion).** However, in the absence of information on the funding of the plants by BUA, we assumed a debt structure and transferred the total value of the construction of the new plants to the consolidated venture as long term financial liabilities. Also, we used a straight-line depreciation expense over the life of the asset, estimated at 40 years.
- With the merger of the plants and capacity increasing to 5MT in 2018, we assumed a capacity utilization of 46% (cement production of 2.3MT) alongside average cement price of ₦41,700/tonne, implying revenue growth of 55% YoY to ₦95.9 billion. Over 2020-2023, we expect a cautious expansion in capacity utilization given the excess capacity in the domestic market, however, we do not rule out the possibility of higher exports over the period. As such, we adopted average capacity utilization of 63% and average cement price of ₦41,180/ton, which informed our revenue CAGR estimate of 36.3% over the period.

Table 7: BUA cement plant merger assumption and impact

Operating Lease	2018	2019	2020	2021	2022
Current Capacity (KT)	2.0	5.0	5.0	5.0	5.0
Capacity Utilization	36.3%	46.0%	60.0%	59.0%	64.0%
Cement Production (MMT)	0.7	2.3	3.0	3.0	3.2
Financial Highlights (N'M)					
Revenue	30,402	95,910	124,500	122,425	130,720
Cost of sales	12,161	40,282	49,800	49,786	53,450
Interest Expense	5,500	27,061	26,439	25,768	25,042

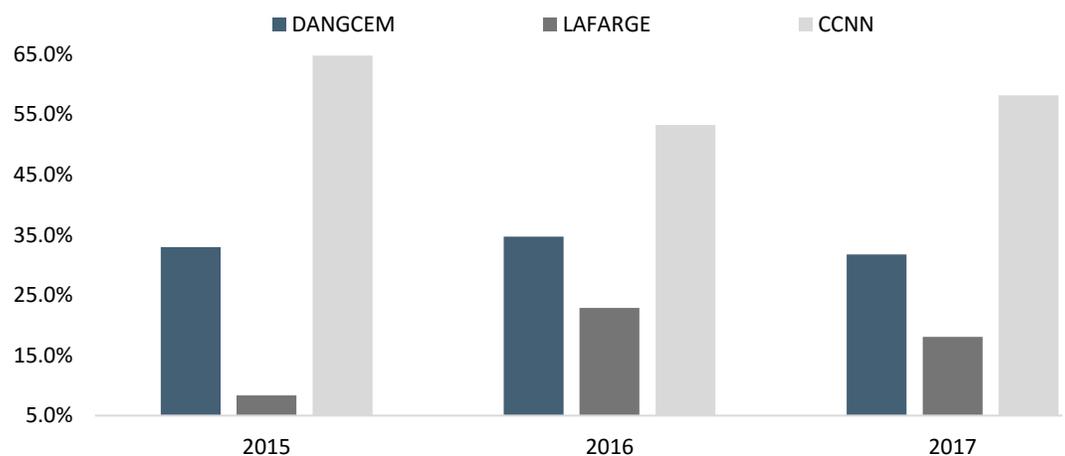
Depreciation	4,275	8,550	8,550	8,550	8,550
PAT	3,576	7,030	21,690	20,710	25,172
FCFF	12,114	48,856	60,643	52,556	57,458

- On balance, we expect an average annual EPS of ₦14.50 over our forecast horizon and DPS of ₦1.36. The net impact of the aforementioned drove our FVE to **₦42.96**, a 58% upside to current price of ₦24.60 which implies a **BUY** recommendation by our rating system.

Coal conversion... game changer for earnings

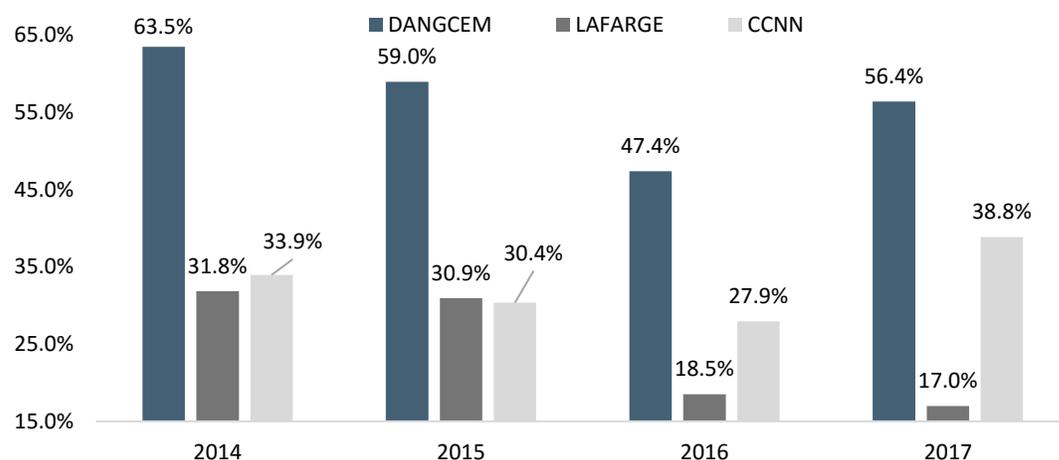
- Driving our outlook for the company are two crucial factors. The first is the outlook on demand while the other two are closely related to production costs projections. On demand, we believe that CCNN will be the major beneficiary of the ongoing rehabilitation/reconstruction in the North East region of the country. Also, its proximity to Niger Republic signals a potential export revenue for the company, given underperformance in prior years (FY 17: ₦154 million). On production cost, CCNN currently grapples with one of the highest production cost among peers, with energy cost to total cash cost in excess of 38% in FY 17 (43% in FY'16) given its reliance on LPFO and associated haulage cost from the epileptic Kaduna refinery. However, in line with the ongoing expansion, management of BUA guided that the plant would run on a 40MW coal power plant. Accordingly, adjusting the plant installation running on coal and by extension the 500k plant (which is expected to be shut down for 3 months for the power conversion), we have adopted a modest 55% (61% in FY 17 and 72% in FY 16) average cost to sales ratio over the forecast period.

Figure 2: Energy to total input cost (Lafarge, Dangcem and CCNN)



Source: Company Financials, ARM Research

Figure 3: Gross margin (Lafarge, Dangcem and CCNN)



Source: Company Financials, ARM Research

Long term outlook remains juicy

- We expect the price level over 2017 to persist in H1 18 – as any price correction occasioned by the dissipating cost pressures will be gradual. Our H1 18E revenue of ₱10.3 billion is 20.6% higher YoY (vs. ₱8.5 billion in H1 17). Over H2 18, we adjust for the increase in installed capacity to 2.0MT per annum, with a cautious capacity utilization of 42% alongside cement price of ₱41,490/tonne. This implies cement production of 315k (reflecting the shutdown of operation at the 500k plant for kiln conversion to run on coal) and accompanying revenue rising 18.0% YoY to ₱13.1 billion. Farther out over 2019-2022, we expect a gradual expansion in capacity utilization over the period (average: 54.5%) and average cement price of ₱41,090/ton, which informed our revenue CAGR estimate of 22.3% over the period.

Summary of Results and Forecast (Finance Lease Scenario)

ANNUAL					
Income Statement (₹'m) *	2016A	2017A	2018F	2019F	2020F
Revenue	14,088	19,588	25,273	42,952	45,210
COGS	10,151	11,983	13,978	24,817	25,901
Gross Profit	3,936	7,605	11,294	18,135	19,309
Operating Cost	2,268	3,482	3,766	5,947	6,260
Operating Profit	1,807	4,227	7,782	12,618	13,502
Finance Income	133	108	120	114	117
Finance expense	199	132	140	220	248
Finance Lease	-	-	5,040	9,970	9,741
PBT	1,741	4,203	2,722	2,542	3,631
Tax	487	979	490	254	327
PAT	1,254	3,224	2,232	2,288	3,304
Balance Sheet (₹'m) *					
Fixed Assets	10,530	12,325	134,938	130,608	126,143
Stocks	5,246	6,516	6,295	11,339	12,369
Trade debtors	1,790	2,674	1,769	3,135	2,452
Cash & other bank balances	2,463	3,134	6,777	5,705	9,273
Total Assets	20,030	24,649	150,285	152,077	151,136
Trade Creditors	4,901	6,101	4,395	7,319	5,857
Non-current Liabilities	3,035	3,071	101,720	99,035	95,942
Total liabilities	8,537	10,237	108,173	108,891	104,934
Shareholders' fund	11,493	14,412	42,112	43,186	46,201
Key Ratios					
P/E	24.7	9.6	13.9	13.5	9.4
ROA	6.7%	14.4%	2.6%	1.5%	2.2%
ROE	11.6%	24.9%	14.5%	13.2%	16.7%
Gross Margins	27.9%	38.8%	44.7%	42.2%	42.7%
EBIT Margins	12.8%	21.6%	30.8%	29.4%	29.9%
PBT Margins	12.4%	21.5%	10.8%	5.9%	8.0%
Net Margins	8.9%	16.5%	8.8%	5.3%	7.3%
EPS	1.0	2.6	1.8	1.8	2.6
Effective Tax Rate	28.0%	23.3%	18.0%	10.0%	9.0%
Debt to Equity	9.7%	5.3%	8.5%	10.2%	11.6%
P/B	2.7	2.1	1.9	1.7	1.4

Summary of Results and Forecast (Operating Lease Scenario)

ANNUAL					
Income Statement (₹'m) *	2016A	2017A	2018F	2019F	2020F
Revenue	14,088	19,588	25,273	42,952	45,210
COGS	10,151	11,983	11,878	20,617	21,701
Operating Lease	-	-	6,417	12,833	12,833
Gross Profit	3,936	7,605	13,394	22,335	23,509
Operating Cost	2,268	3,482	3,766	5,947	6,260
Operating Profit	1,807	4,227	3,465	3,984	4,868
Finance Income	133	108	120	114	117
Finance expense	199	132	335	630	657
PBT	1,741	4,203	3,250	3,468	4,329
Tax	487	979	787	854	1,090
PAT	1,254	3,224	2,463	2,614	3,239
Balance Sheet (₹ 'm) *					
Fixed Assets	10,530	12,325	11,038	11,767	12,343
Stocks	5,246	6,516	6,295	11,339	8,817
Trade debtors	1,790	2,674	1,769	3,135	2,452
Cash & other bank balances	2,463	3,134	8,790	10,634	20,134
Total Assets	20,030	24,649	28,398	38,165	44,645
Trade Creditors	4,901	6,101	4,395	7,319	5,857
Non-current Liabilities	3,035	3,071	6,134	6,467	3,377
Total liabilities	8,537	10,237	12,587	16,323	12,369
Shareholders' fund	11,493	14,412	15,811	21,842	32,275
Key Ratios					
P/E	24.7	9.6	12.6	11.8	9.5
ROA	6.7%	14.4%	9.3%	7.9%	7.8%
ROE	11.6%	24.9%	16.3%	15.4%	16.7%
Gross Margins	27.9%	38.8%	27.6%	22.1%	23.6%
EBIT Margins	12.8%	21.6%	13.7%	9.3%	10.8%
PBT Margins	12.4%	21.5%	12.9%	8.1%	9.6%
Net Margins	8.9%	16.5%	9.7%	6.1%	7.2%
EPS	1.0	2.6	2.0	2.1	2.6
Effective Tax Rate	28.0%	23.3%	24.2%	24.6%	25.2%
Debt to Equity	9.7%	5.3%	27.7%	27.5%	11.9%
P/B	2.7	2.1	2.0	1.7	1.5

Summary of Results and Forecast (Consolidated Business Scenario)

ANNUAL					
Income Statement (₩ 'm) *	2016A	2017A	2018F	2019F	2020F
Revenue	14,088	19,588	30,402	95,910	124,500
COGS	10,151	11,983	16,436	48,832	58,350
Gross Profit	3,936	7,605	13,966	47,078	66,150
Operating Cost	2,268	3,482	4,530	13,280	17,238
Operating Profit	1,807	4,227	9,740	34,757	50,157
Finance Income	133	108	120	114	117
Finance expense	199	132	5,500	27,061	26,439
PBT	1,741	4,203	4,361	7,811	23,835
Tax	487	979	785	781	2,145
PAT	1,254	3,224	3,576	7,030	21,690
Balance Sheet (₩ 'm) *					
Fixed Assets	10,530	12,325	348,999	341,149	333,207
Stocks	5,246	6,516	6,445	22,155	28,386
Trade debtors	1,790	2,674	2,128	7,001	4,565
Cash & other bank balances	2,463	3,134	14,685	25,367	68,483
Total Assets	20,030	24,649	372,865	398,551	436,384
Trade Creditors	4,901	6,101	4,499	14,300	9,400
Non-current Liabilities	3,035	3,071	341,475	334,249	325,855
Total liabilities	8,537	10,237	348,032	351,086	338,390
Shareholders' fund	11,493	14,412	24,833	47,464	97,994
Key Ratios					
P/E	24.7	9.6	8.6	4.4	1.4
ROA	6.7%	14.4%	1.8%	1.8%	5.2%
ROE	11.6%	24.9%	19.1%	26.8%	55.4%
Gross Margins	27.9%	38.8%	45.9%	49.1%	53.1%
EBIT Margins	12.8%	21.6%	32.0%	36.2%	40.3%
PBT Margins	12.4%	21.5%	14.3%	8.1%	19.1%
Net Margins	8.9%	16.5%	11.8%	7.3%	17.4%
EPS	1.0	2.6	2.8	5.6	17.3
Effective Tax Rate	28.0%	23.3%	18.0%	10.0%	9.0%
Debt to Equity	9.7%	5.3%	1471.0%	1129.9%	663.2%
P/B	2.7	2.1	1.3	1.1	0.6

Summary of Results and Forecasts (Without Expansion)

ANNUAL					
Income Statement (₹' m) *	2016A	2017A	2018F	2019F	2020F
Revenue	14,088	19,588	20,370	20,541	20,335
COGS	10,151	11,983	12,018	12,324	12,404
Gross Profit	3,936	7,605	8,352	8,216	7,931
Operating Cost	2,268	3,482	3,450	3,565	3,487
Operating Profit	1,807	4,227	5,105	4,857	4,647
Finance Income	133	108	219	434	622
Finance expense	199	132	150	191	207
PBT	1,741	4,203	5,175	5,100	5,062
Tax	487	979	1,285	1,242	1,220
PAT	1,254	3,224	3,890	3,858	3,842
Balance Sheet (₹' m) *					
Fixed Assets	10,530	12,325	12,435	12,460	12,473
Stocks	5,246	6,516	6,129	6,655	6,392
Trade debtors	1,790	2,674	1,222	1,294	1,258
Cash & other bank balances	2,463	3,134	7,671	10,503	14,311
Total Assets	20,030	24,649	27,866	31,529	34,947
Trade Creditors	4,901	6,101	4,447	4,375	4,411
Non-current Liabilities	3,035	3,071	3,271	3,628	3,628
Total liabilities	8,537	10,237	9,617	10,078	10,306
Shareholders' fund	11,493	14,412	15,892	19,094	22,283
Key Ratios					
P/E	24.7	9.6	7.9	8.0	8.0
ROA	6.7%	14.4%	14.8%	13.0%	11.6%
ROE	11.6%	24.9%	25.7%	22.1%	18.6%
Gross Margins	27.9%	38.8%	41.0%	40.0%	39.0%
EBIT Margins	12.8%	21.6%	25.1%	23.6%	22.9%
PBT Margins	12.4%	21.5%	25.4%	24.8%	24.9%
Net Margins	8.9%	16.5%	19.1%	18.8%	18.9%
EPS	1.0	2.6	3.1	3.1	3.1
Effective Tax Rate	28.0%	23.3%	24.8%	24.4%	24.1%
Debt to Equity	9.7%	5.3%	7.7%	7.4%	7.2%
P/B	2.7	2.1	1.9	1.6	1.4

Source: ARM Research *unless otherwise stated

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