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Dangote Sugar Refinery Plc. (DANGSUGAR.NL)

Stock Report

Rating	**OVERWEIGHT**
Price	₦12.70
FVE	₦14.44
52-week range	₦12.70-₦23.95
Market Cap. (₦'bn)	153
1-month Avg. Vol	534,044
Curr. PE	5.1x

Quarterly EPS	Q1	Q2	Q3	Q4
2016 A	0.28	0.34	0.23	0.36
2017 A	0.40	1.03	0.78	1.10
2018 A (E*)	0.45	0.62	0.34	0.55*

DANGSUGAR:NL - Share Price Trend

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Tough operating environment dim outlook

- Dangote Sugar Refinery (DSR) released its 9M 18 result for the period ended September 2018. Revenue for the period was down 29.2% YoY to ₦116.7 billion owing to lower refined sugar prices (-19% YoY) and lower volumes (-13.5% YoY). On volumes, pressure stemmed from increased competition from smuggled sugar and unrelenting gridlock in Apapa owing to the bad road condition. As a result, EPS for the period declined 37% YoY to ₦1.41, below our expectation of ₦1.55 for the period – 9M 18 EPS is about 61% of our FY 18 estimate.

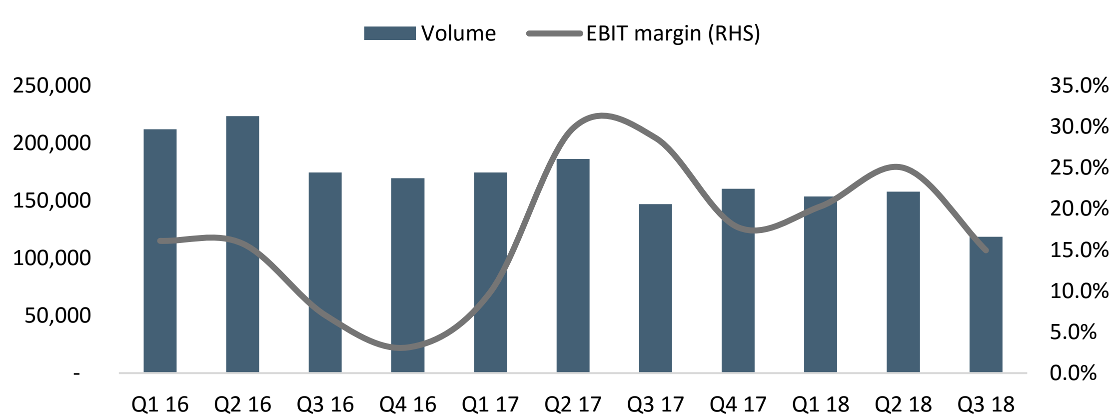
- For the rest of 2018, we cut our FY 18 revenue estimate by 8.1% to ₦154 billion to reflect the sustained decline in volumes. We forecast EBIT margin of 19.6% (previous estimate: 21.7%) due to higher operating expense to sales ratio from weaker volumes. Overall, we forecast FY 18E EPS to decline 41.3% YoY to ₦1.95. Based on historical 50% payout ratio, we forecast DPS of ₦1.00 for FY 18E which translates to a dividend yield of 7.9% based on current pricing. In 2019, we do not see pressures from smuggling activities abating due to slow action from the authorities to curb the illegal activity. Regarding the Apapa road, repairs are underway, but its completion is taking longer than anticipated. We therefore see gridlock from the bad road persisting into 2019. Consequently, we cut our FY 19E EPS by 13% to ₦1.75. We also cut our FY 20-22E EPS by 3% on average. Following adjustments to our forecasts, and having rolled forward our model to 2019, we cut our FVE to ₦14.44 (previous: ₦17.01) which translates to an **OVERWEIGHT** rating.

- **Bad roads, increased smuggling impact revenue:** Over Q3 18, the company's performance was dull, as EPS declined 57.6% YoY to ₦0.34 (Q3 17: ₦0.79). The disappointing earnings was due to lower revenue (-26.3% YoY) following loss of volume from the smuggling of cheap low-quality sugar into the country and constant gridlock in Apapa[1]. On smuggling, management noted that smuggled sugar has taken up to 40% of the market despite efforts being deployed by regulators to stem the tide. We estimate that this took out 15% of DSR's market share[2] and thus explains the loss in volumes since Q3 17. Volumes in the review quarter was down 19.3% YoY to 118KMT. Also, as stated earlier, the unrelenting gridlock in Apapa impacted on revenue as the bad roads in the region constrained the number of trucks required to distribute finished goods from the plant to its consumers thus impacting on volumes in the period.

- To add, due to the free fall in raw sugar price (-26.5% YoY) in international markets as well as effort to regain market share, DSR rolled back prices with its refined sugar price down 19% YoY to ₦256,680/MT. However, the cut to selling prices hasn't supported volumes due to the fact that smuggled sugar remains cheaper than its refined sugar. In our last update on DSR, we noted that the price of the low-quality sugar is at a 10% discount to refined sugar price.

- **Lower sales volume pressure EBIT margin:** Although EBIT margin in Q3 18 contracted by 13.7ppts to 14.9%, it remains higher than 5-year historical average of 13.6%. The sharp contraction in EBIT margin stemmed from (1) decline in gross margin (-12.1ppts YoY) owing to higher per unit fixed costs (direct overheads & depreciation) because of lower volumes and (2) higher OPEX to sales ratio (+156bps YoY), owing to weaker revenue.

Figure 1: Trend in DSR Quarterly Volume and EBIT margin



Source: Company's financials and presentation

[1] Where Dangote Sugar's plant is situated
[2] Previously controlled about 53% of the market

Sales volume on track to touch its lowest level in five years

- We cut our FY 18 revenue estimate by 8.1% to ₦154 billion to capture the sustained decline in volumes worsened by the incessant bad roads in Apapa which limited distribution of products. Precisely, while we maintained our per ton price forecast of ₦256,000 (-14% YoY), we cut our FY 18 volume forecast by 8.5% and estimate volume to touch a 5-year low of 562KMT (FY 17: 667KMT). This combined with our per ton price forecast translates to a FY 18E revenue of ₦154 billion (-24.9% YoY).

- We forecast EBIT margin of 19.6% (previous estimate: 21.7%) to capture the increase in per unit fixed cost as well as higher operating expense to sales ratio due to weaker volumes. Overall, with the reduction in our revenue estimate and lower EBIT margin forecast, we forecast EPS to decline 41.3% YoY to ₦1.95. Based on historical 50% payout ratio, we forecast DPS of ₦1.00 for FY 18E which translates to a dividend yield of 7.9% based on current pricing.

- In 2019, we do not see pressures from smuggling activities abating due to slow action from the authorities to curb the illegal activity. Management explained in its H1 18 conference call that the company is in partnership with regulatory authorities and others in the sugar industry to stem the influx of poor-quality unlicensed sugar into country, but we are pessimistic due to the elections which will distract the authorities for much of H1 19.

- Regarding the Apapa road, repairs are underway, but its completion is taking longer than anticipated. We therefore see gridlock from the bad road condition persisting into 2019. Hence, we forecast a muted volume growth of 0.5% YoY to 565KMT over FY 19. With our price forecast of ₦225,000/MT (-12% YoY), we forecast FY 19E revenue of ₦138 billion.

- EBIT margin should remain flat at 19.4% (FY 18E: 19.6%; 5-year historical EBIT margin average: 13.6%). Our EBIT margin forecast is based on further moderation in raw sugar prices which should offset pressures from expected higher operating expenses (+10.2% YoY). Management plans to establish new markets to improve sales. This entails investment in its route-to-market thus, prompting our expectation of higher operating expenses over the period.

- Net impact of the above translates to a FY 19E EPS of ₦1.75 (FY 18E: ₦1.95; FY 17: ₦3.32), with a dividend expectation of ₦1.00. We also cut our FY 20-22E earnings by 3% on average.

- Following adjustments to our forecasts, and having rolled forward our model to 2019, we cut our FVE to ₦14.44 (previous: ₦17.01) which translates to an **OVERWEIGHT** rating. A sooner than expected successful curtailment of smuggled sugar and repairs of the Apapa road will be an upside potential to earnings and FVE. On our numbers, Dangote Sugar trades at a 2019 forward P/E of 6.5x, a discount to 5-year historical average of 7.6x.

Summary of Results and Forecasts - Naira (₦)

ANNUAL Income Statement (₦'m) *	2016A	2017A	2018E	2019F	2020F
Revenue	169,725	204,422	153,611	138,132	141,873
COGS	146,736	153,434	115,208	102,908	104,986
Gross Profit	**22,989**	**50,988**	**38,403**	**35,224**	**36,887**
Operating Cost	6,929	7,482	8,249	8,412	8,654
Operating Profit	**10,307**	**14,266**	**16,059**	**43,506**	**30,154**
Interest Income	**601**	**7,501**	**2,979**	**3,015**	**3,543**
Interest Expense	299	278	236	248	261
PBT	**19,614**	**53,599**	**33,357**	**29,992**	**31,940**
Tax	5,218	13,815	10,007	8,998	9,582
PAT	**14,396**	**39,784**	**23,350**	**20,994**	**22,358**
Balance Sheet (₦ '000) *					
Fixed Assets	54,803	59,414	60,375	62,743	64,017
Stocks	47,409	47,656	34,562	25,727	26,246
Trade debtors	17,734	20,907	27,650	17,957	21,281
Cash & other bank balances	35,020	41,368	33,999	54,572	55,733
Total Assets	**178,382**	**195,080**	**182,323**	**186,736**	**193,015**
Liabilities					
Trade Creditors	88,278	75,653	51,844	46,309	41,994
Non-current Liabilities	11,475	6,680	5,213	5,213	5,213
Total liabilities	**112,230**	**102,345**	**78,612**	**73,158**	**68,929**
Shareholders' fund	**66,152**	**92,736**	**103,710**	**113,578**	**124,086**
Key Ratios	2016A	2017A	2018E	2019F	2020F
Gross Margin	13.5%	24.9%	25.0%	25.5%	26.0%
EBIT Margin	6.1%	7.0%	10.5%	31.5%	21.3%
PBT Margin	11.6%	26.2%	21.7%	21.7%	22.5%
Net Margin	8.5%	19.5%	15.2%	15.2%	15.8%
EPS	1.20	3.32	1.95	1.75	1.86
P/E	14.75	5.34	9.10	10.12	9.50
EV/EBITDA	1.51	4.12	5.75	5.60	5.25
ROA	8.1%	20.4%	12.8%	11.2%	11.6%
ROE	21.8%	42.9%	22.5%	18.5%	18.0%

Source: ARM Research *unless otherwise stated

ARM ratings and recommendations

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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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