

Flour Mills of Nigeria Plc | Company note
Flour Mills of Nigeria: Core momentum inspires fresh upside
(BUY: ₦35.07)
The stone the builders rejected...

- Prior to the FX-induced equity rally in Nigeria, the food sub-sector bore the brunt of a challenging macro-economic environment as investors priced in effects of constrained consumer income, naira depreciation and high interest rate on the performance of food producers. The scale of aversion was however not equal across sector names with the shares of Flour Mills of Nigeria (FMN), Honey Well Flour Mills and Cadbury taking a greater beating. Investors' aversion to FMN's stock was underpinned by the negative core earnings¹ declared in the two financial years ending March 2016. Precisely, the combination of higher input cost, sizable FX losses as well as upsurge in finance charges deprived the otherwise low margin business of profitability. The latter drag was consequent on a surge in debt levels which pushed the company's net gearing ratio² to a then record high of 164% at the end FY 15 (Bloomberg EMEA average: 56%) despite receiving ₦18.2 billion in cash from sale of UNICEM.

Income Statement Data			
	2018 – 3M'm	2017 – 3M'm	%chg
Revenue	148,975	119,207	25.0%
PBT	6,194	5,873	5.5%
Tax	1,663	1,459	14.0%
PAT	4,532	4,414	2.7%

Balance Sheet Data			
	2017-Jun 'm	2017 - Mar 'm	%chg
Inventory	109,724	117,296	-6.5%
Receivables	24,365	21,403	13.8%
Cash	46,435	45,019	3.1%
Payables	105,405	94,567	11.5%
Net Assets	102,530	108,116	-5.2%

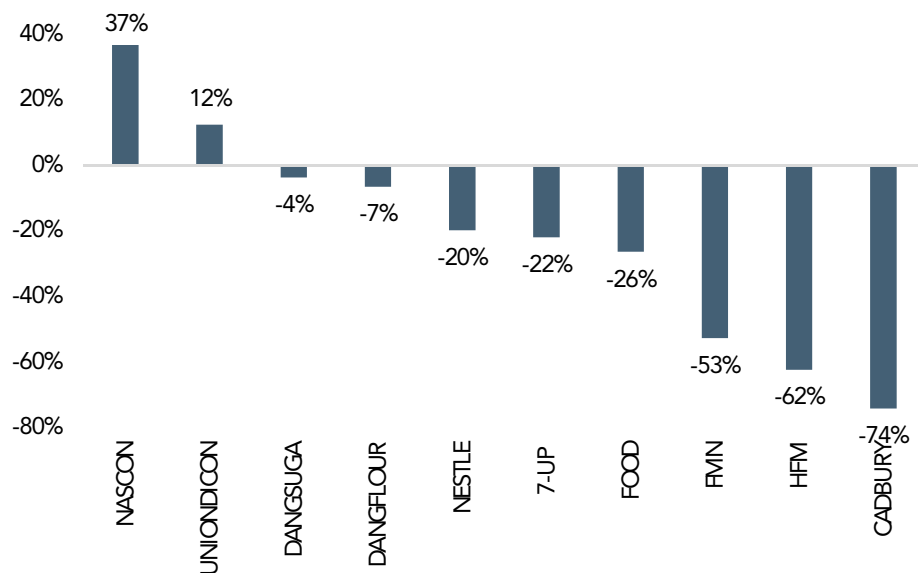
Stock Data			
Price			₦29.10
52 week range		₦16.20 –	₦31.00
Market Cap. (N'm)			76,365
1-month Avg. Vol			1,400,573
Curr. PE			8.5
Bloomberg Ticker			FLOURMIL:NL

Flour Mills of Nigeria Plc- Share Price Trend

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¹ PAT less profit from discontinued operations

² Net debt less cash

Figure 1: Equity returns over the two-year ended December 31st, 2016



Source: Bloomberg, ARM Research

...has become the pillar stone

- However, FMN's operating performance turned the corner in the financial year ending March 2017 with the company posting its highest operating profit³ on record (+156% YoY to ₦42.9 billion) while profit from core operations (PAT less profit from sale of associate) printed at a six year high of ₦8.8 billion (FY 16: ₦9.3 billion loss). The improved performance largely stemmed from its robust turnover⁴, which printed at a historical high of ₦524.5 billion (+53.1% YoY) following price hikes (YoY: Flour: +40%, Noodles: +31%, Spaghetti: +29%) in the food segment (81% of overall revenue) and pick-up in volumes⁵.
- Supporting the robust top-line was an 81% YoY cutback in other loss to ₦1.5 billion largely reflecting absence of a ₦4 billion impairment charge⁶ recorded in the preceding year and, to a lesser extent, an 11% YoY contraction in FX losses to ₦5.7 billion⁷. However, FX pressures still lingered. Particularly, given the company's high dependence on imports (FY 17 import-COGS ratio: 88%), sustained naira weakness underpinned an

³ We placed the line item "other operating income" below the line due to the volatility of the nature of the components (FX loss, impairment, insurance claims etc.)

⁴ Prices were also raised by between 30% and 40% across other operating segments of the business

⁵ Consumers switched from more expensive cereals and tubers to wheat related food items

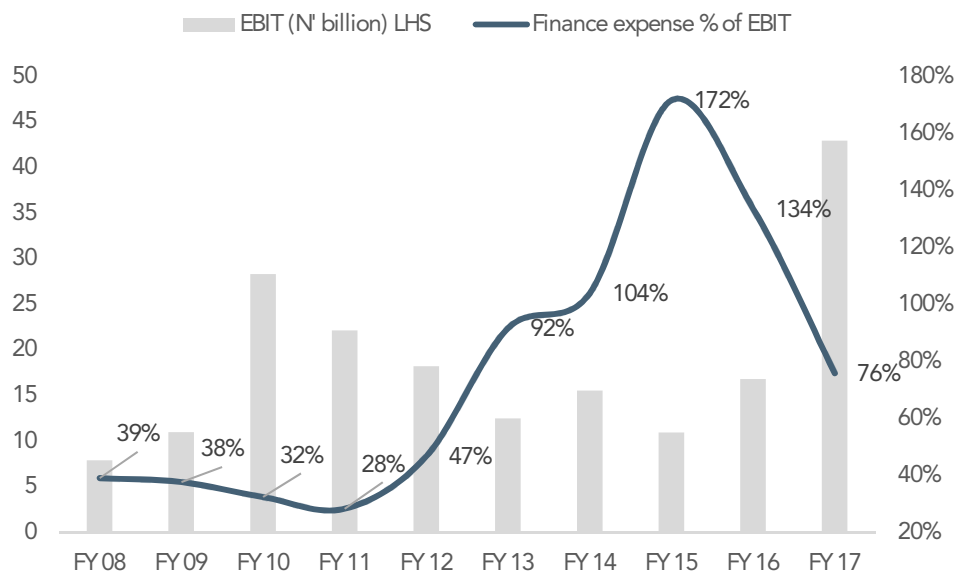
⁶ Management attributed to challenges at its snacks production line in the northern part of the country

⁷ Reflecting impact of a slower depreciation of the naira (Average FX rate: FY 17: ₦400/\$, FY 16: ₦295.75\$)

upsurge in the company's raw materials cost (+53.1% YoY) which in turn drove COGS (+50.1% YoY) higher. The effect of naira depreciation also bloated the company's working capital needs, as it inflated both inventories (twofold higher YoY to ₦117.3 billion) and prepayments (fivefold higher YoY to ₦71.5 billion). Consequently, FMN raised its short-term borrowings (+63% YoY to ₦191 billion) which, together with a higher interest rate environment, drove finance charges to a record high of ₦32.5 billion (76% of EBIT). Management attributed the upsurge in prepayment to the severe illiquidity at the interbank FX market, which resulted in a nearly three-fold YoY jump in the company's deposit for imports (letters of credit) to ₦26.4 billion over the period. The tight dollar supply also compelled the company to queue at CBN's forward market (of five months tenor), with the knock-on effect underpinning a ₦31 billion deposit for FX relating to forward and futures contracts (vs. nil in FY 2016).

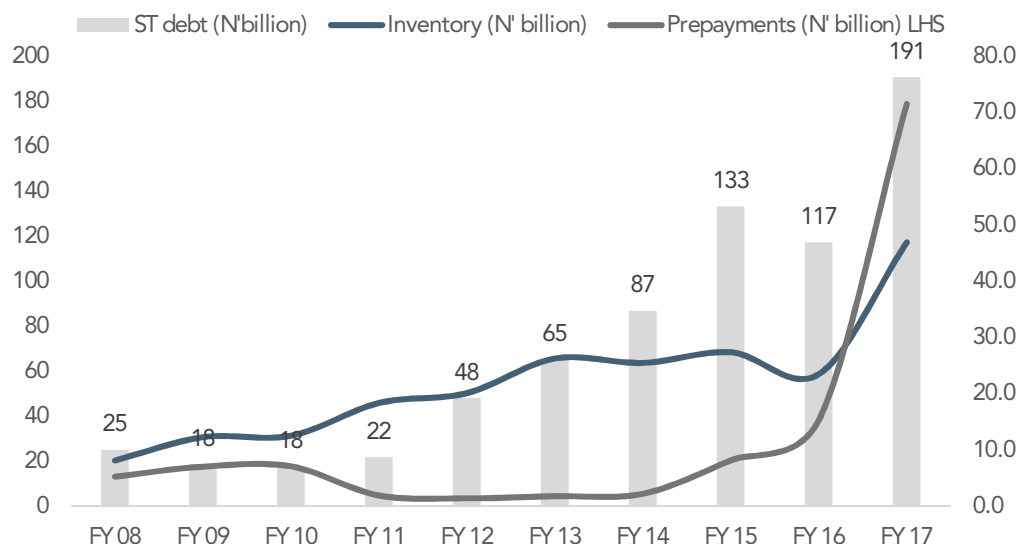
- Overall, despite lingering currency woes and elevated interest rate environment, the turnaround in FMN's performance stemmed from significant improvement in the company's core operations.

Figure 2: Trend in EBIT (₦ billion)



Source: Company's financials, ARM Research

Figure 3: Trend in Short term debt, inventory and prepayments (₦' billion)



Source: Company's financials, ARM Research

Earnings surge as FX pressures subside

- In more recent releases, some of these FX pressures however dissipated following CBN's liberalization of the FX market which helped underpin strong naira gains at the non-interbank FX windows. Particularly, over FQ1 18, FMN reported FX-induced other income of ₦3.2 billion on revaluation of outstanding FX liability at cheaper FX rate even as inventories (-6% QoQ to ₦109.7 billion) and prepayments (-48% QoQ to ₦36.6 billion) declined. FMN's management attributed contraction in the latter to improved liquidity in the currency market and reduction in the tenor of CBN's forward contract to 2 months (five months previously) which enabled the company to meet its outstanding letter of credit obligation (₦26.2 billion) and lower its deposit for FX relating to forward and futures contracts (-58% QoQ to ₦13.0 billion) respectively. Against this backdrop, FMN cutback its borrowings (-21.4% QoQ to ₦190 billion) which in turn applied downward pressure on interest charges (-39.8%QoQ to ₦8.9 billion). Thus, aided by a double-digit revenue growth (+25% YoY to ₦148.9 billion, QoQ: +10.7%) which was sustained for the sixth consecutive quarter in FQ1 18, FMN reported its highest core earnings in 21 quarters (₦4.5 billion) in the period.

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- Largely reflecting expected improvements in the company's performance and an overall investor excitement trailing the introduction of the IEW window in April, the company's share price has outperformed the broader food index (FMN: +62% YTD; Food Index: +47% YTD; NSEASI: +36% YTD). However, since the release of its FQ1 18 result on the 1st of August 2017, the company's share price has been largely flat—a development we attribute to investors' concern about the sustainability of the company's debt contraction. For us, we believe this concern is slightly exaggerated with our view reflecting an expectation for a largely unchanged debt level.

Naira gains and cutback in debt underpin bullish outlook

- In projecting our outlook for the company over the rest of the financial year, we begin by estimating the company's debt levels. On long term debt, management's guidance of limited capital outlay over the near term underpins our view for sustained stability of the company's largely concessionary borrowings from the CBN. However, on short term borrowings, we project a modest rise (+7%) from current levels to ₦169 billion. Our prognosis for higher leverage largely stems from expected rise in prepayments. In our view, whilst sustained FX liquidity and unchanged 2 months tenor on CBN's forward contract should keep deposits for forward contract largely in check, we believe the nil reading of "letters of credit" is unsustainable given the company's huge dependence on imports. Against this backdrop, aided by comparison with the relatively stable FY 16 reading, we estimate a ₦13.2 billion deposits for imports over the year. Overlaying the increase in debt with the company's current effective interest rate of 16.5%, we forecast a tepid rise (+3.4% YoY) in finance charges to ₦34 billion over FY 18. Nonetheless, the impact of high borrowing cost should be tempered by other income of ₦4.2 billion (FY 17 other loss: ₦1.5 billion) largely driven by FX-induced gains reported in FQ1 18.
 - On core operating fronts, we expect higher YoY prices and resilient volume increases to sustain top-line growth. Based on the foregoing, we project a 16% YoY growth in FY 18 revenue to ₦608.3 billion. Elsewhere, we expect the stronger naira to keep growth in COGS (FY 18E: +18% YoY to ₦540 billion) relatively contained compared to the prior two years. Consequently, we forecast an 11% YoY expansion in gross profit to 74.3 billion while EBIT is estimated to increase to ₦47.2 billion (+10.0% YoY) as management continues to keep OPEX (FY 18E: +14.1% YoY to ₦27.1 billion) in check.
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- Post these adjustments, PAT now comes in 48% higher YoY at ~~₹~~13.1 billion. FMN trades at discount to peers, both on a current (P/E: FMN: 8.5x, Bloomberg EMEA: 11.8x) and forward basis (P/E: FMN: 5.7x, Bloomberg EMEA: 10.2x). The company's attractive P/E, robust core performance and cutback in debt levels underpin our **BUY** rating on the stock with a **FVE of ₹35.07**.
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QUARTERLY

Income Statement (₹'mln)*	FQ1 2018A	FQ2 2018F	FQ3 2018F	FQ4 2018F
Turnover	148,975	153,603	155,270	156,505
COGS	131,736	136,189	135,517	136,595
Gross Profit	17,239	17,415	19,753	19,910
Operating Costs	5,309	5,380	5,968	10,451
Operating Profit	11,930	12,035	13,784	9,458
Other operating income (loss)	3,153	363	363	363
Interest income	38	130	130	130
Interest expense	8,928	8,355	8,355	8,355
Pre-tax Profit	6,194	4,173	5,923	1,597
Taxation	1663	1127	1599	431
Post-tax Profit	4,532	3,046	4,324	1,166

ANNUAL

Income Statement (₹'mln)	FY 2016A	FY 2017A	FY 2018F	FY 2019F	FY 2020F
Revenue	342,586	524,464	614,353	627,332	668,917
Cost of Goods Sold	304,962	457,775	540,037	545,778	583,964
Gross Profit	37,625	66,689	74,316	81,553	84,952
Operating Cost	20,852	23,761	27,109	28,857	30,770
Other operating income (loss)	(0)	0	-	-	-
Operating Profit	16,773	42,928	47,208	52,696	54,182
Net Interest expense	21,294	30,967	33,562	31,167	32,100
Pre-tax Profit	(4,522)	10,473	17,887	23,411	24,758
Tax	(2,931)	1,636	4,820	7,491	7,923
Post-tax Profit (continued operations)	(1,591)	8,836	13,068	15,919	16,835
profit from discontinued operations	23,731	(1)	-	-	-
PAT	22,141	8,835	13,068	15,919	16,835
Balance Sheet (₹'mln)	FY 2016A	FY 2017A	FY 2018F	FY 2019F	FY 2020F
Assets					
Fixed Assets	213,562	216,866	222,191	229,670	238,779
Cash	33,213	45,019	18,288	28,789	42,256
Inventory	58,699	117,296	119,476	130,987	140,151
Trade Debtors	18,966	21,403	28,200	30,739	32,777
Total Assets	124,686	254,883	236,339	260,836	283,390
Liabilities					
Trade Creditors	50,417	94,567	82,140	90,053	96,354
ST Borrowings	117,243	190,726	169,365	177,833	186,725
Long Term Liabilities	66,543	72,562	76,892	79,750	82,753
Total liabilities	249,583	380,059	350,600	369,840	388,035
Shareholders' fund	95,766	102,544	118,571	131,306	144,775
Key Ratios	FY 2016A	FY 2017A	FY 2018F	FY 2019F	FY 2020F
Valuation multiples					
P/E	3.45	8.64	5.84	4.80	4.54
EV/EBITDA	9.59	6.72	4.73	3.91	3.73
ROA	18%	3%	6%	6%	6%
ROE	23%	9%	11%	12%	12%
EPS	8.44	3.37	4.98	6.07	6.42
Debt/Equity	1.73	2.36	1.88	1.78	1.70
Gross margin	11%	13%	12%	13%	13%
EBIT Margin	5%	8%	8%	8%	8%
PBT Margin	N/A	2%	3%	4%	4%
PAT Margin	6%	2%	2%	3%	3%

ARM ratings and recommendations

ARM 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	Minimise exposure to security taking cognizance of its index weighting
SELL	Sell-off security completely from portfolio

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