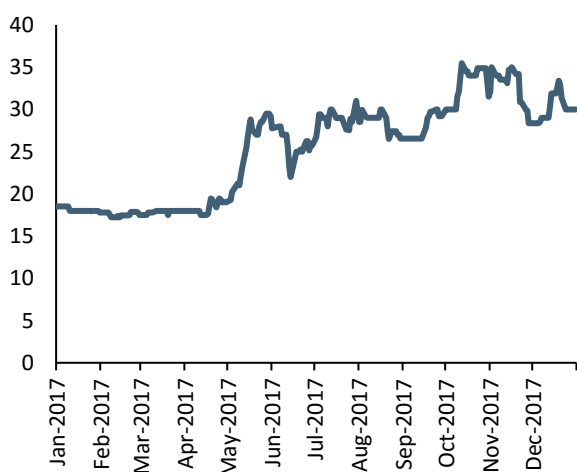


Rating	BUY
Price	₦30.80
FVE	₦38.33
52-week range	₦15.22-35.07
Market Cap. (₦'bn)	80.8
1-month Avg. Vol	5,573,016
Curr. PE	8.3x

Quarterly EPS	Q1	Q2	Q3	Q4
2016 A	0.36	0.26	1.91	1.75
2017 A	1.68	0.78	0.36	0.55
2018A(E*)	1.73	1.84	1.36*	1.29*

Rights price	27
Ratio	9 for 16
Current Issued Shares (bn)	2.6
Post Rights Issued Shares (bn)	4.0
Rights Value (₦ bn)	39
Rights discount	11%

FLOURMILL:NL - Share Price Trend



Analyst(s)

Feyisike Ilemore
oluwafeyisike.ilemore@arm.com.ng

Flour Mills of Nigeria Plc. (Flourmill.NL)

Company Note

Rights Issue: Grist to the Mill

- We issue a BUY recommendation on Flourmill based on a FVE of ₦38.33, representing 24% and 42% upside from market and Rights Issue price of ₦30.80 and ₦27.00 respectively. Our positive sentiment is supported by the recovery in earnings (FY18: +44.6% YoY) with FY18 PAT estimated at ₦16.3 billion (+84.7% YoY). Considering the impact of capital raising on Flourmills' finance expense, we remain optimistic on the stock going into FY19 with a projected PAT of ₦23.9 billion. However, owing to the dilution from the Rights Issue, FY19 EPS of ₦5.83 represents a 6% decline when compared to FY18 estimate of ₦6.22.
- Flourmill is seeking to raise ₦39 billion (\$127 million) by way of Rights Issue. The company is offering 1.47 billion ordinary shares of 50 kobo each at a rights price of ₦27.00/share to existing shareholders based on 9 new ordinary shares for every 16 ordinary shares held as at 8th December 2017. The Rights issue opened on the 15th of January 2018 and closes on the 21st of February 2018.
- Proceeds from the Rights Issue will be used to pay down some of its overdrafts and short-term borrowings with the intent of deleveraging the balance sheet and strengthening the capital base of the company. Precisely, 45% of the proceeds will be used for the repayment of short term loans (₦17.5 billion), 30% will be used for the repayment of overdraft facilities (₦11.9 billion) while the balance (25%) will be applied towards working capital for strengthening and achieving efficiency in the company's operations.

- Earnings expansion underpinned by deleveraging.*** In estimating the impact of the rights issue on earnings, Flourmill's debt position remains the reoccurring recital. As at FQ2 18, Flourmill's borrowings totaled ₦188.2 billion, split into overdrafts (₦41 billion), short-term (₦93.5 billion) and long-term borrowing (₦53.9 billion) - short-term borrowings and overdrafts constitute ~50% and 22% of total debts respectively. Consequently, following the repayment of ₦29.4 billion¹, we expect its debt position to dip by 15.4% YoY to ₦143 billion over FY 19. This view is supported by a sustained recovery in operating cash flow from improving EBIT² margin (FY 19E: +95bps YoY; FQ2 18: +33bps QoQ) and lesser need to prefund Letters of Credits³, reflecting improved dollar liquidity. Pertinently, our discussions with management revealed that Flourmills moved to unconfirmed from confirmed LCs which eliminated the need to prefund payments for its imported inputs.
- Accordingly, we estimate a decline in debt-equity⁴ ratio to 0.94x (FH1 18: 1.74x; 3-year average of 2.01x). In terms of interest rate, we use an average rate of 16% over FY 19 in line with our view of a downtrend in yields over the year which would have a direct impact on its borrowing costs particularly its commercial papers. Overlaying the lower debt position with our interest rate expectations, we estimate a 26% YoY decline in interest expense to ₦23 billion (FY 18E: ₦30.9 billion; FY 17: ₦32.5 billion). In addition, we view funds allocated to working capital (₦9.7 billion) as positive for finance costs as the liquidity would reduce the burden on the company to borrow expensive short-term borrowings in a bid to finance its operations. Tying the above-mentioned with our expectation of a recovery in gross margin⁵ to 13% (FH1 18: 11.9%; FY'17: 12.7%), we estimate earnings to print at ₦23 billion in FY 19 which translates to an EPS of ₦5.83 post dilution (FY'18E: ₦6.22). Underlying our view of a recovery in earnings is a successful rights issue where the intended amount is fully raised.

Given our expectation of earnings recovery going forward, we recommend that qualified investors take up their rights.

¹ Repayment of overdraft facilities and short-term loans amounting to ₦11.9 billion to ₦17.5 billion

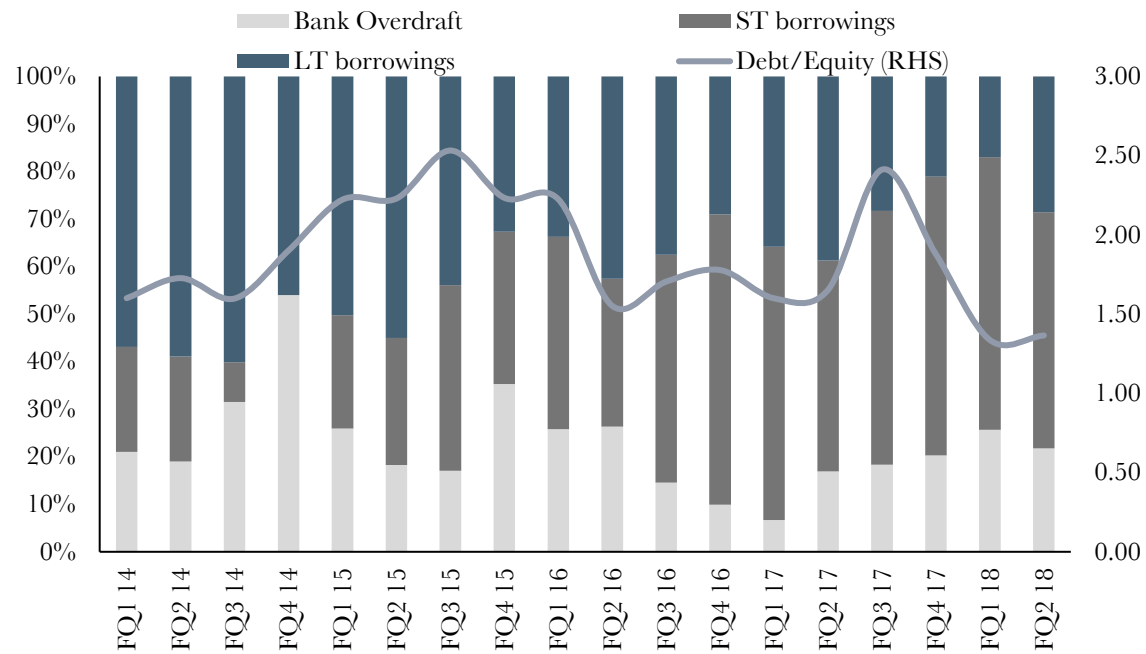
² In computing EBIT margin, we excluded "other operating income" which includes volatile FX gains and biological asset revaluation gains

³ In FH1 18, deposits for LCs declined to ₦1.1 billion from ₦14.4 billion in FH1 17 and ₦26.2 billion in FY 17

⁴ Full proceeds from the ongoing capital raise was captured in our equity computation

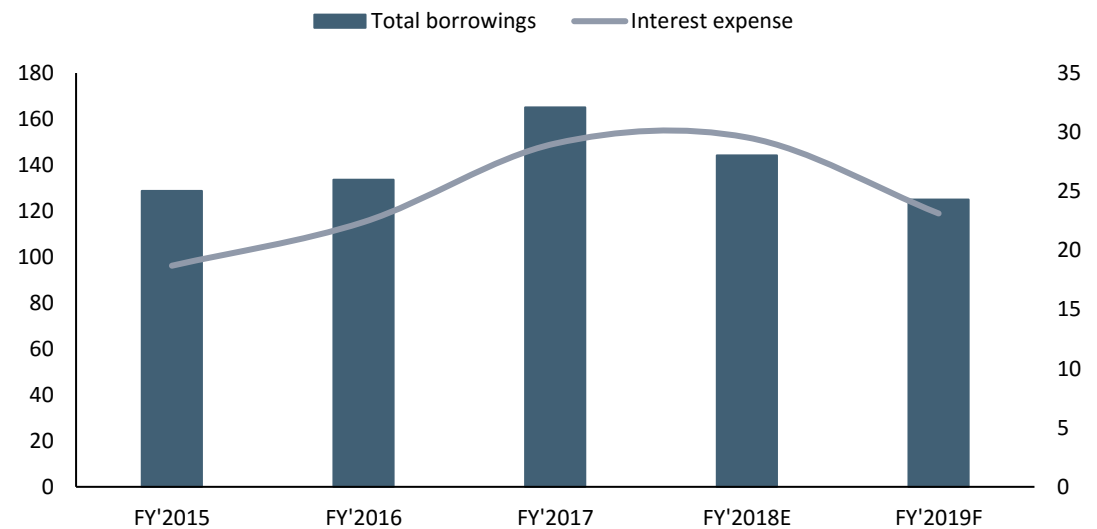
⁵ USDA estimates respective surplus of 10.8MMT and 11.9MMT for raw sugar and wheat in the 2017/2018 season which suggests a bearish price outlook for these commodities

Figure 1: Historical trend in borrowings and leverage ratio



Source: Company's Financials ARM Research

Figure 2: Lower finance cost anticipated over FY 19



Source: Company's Financials ARM Research

- Net impact of these assumptions results in a FVE of ₦38.33. Our FVE factors in the additional shares from the rights. Against this backdrop, we place a **BUY** rating on the stock. Flour Mills trades at a current P/E of 8.3x versus 13.7x for Bloomberg Middle-East & African peers.
- In terms of other plans to reduce its interest expense burden, FMN is looking to debt restructuring as it intends to raise ₦70 billion in Medium Term Notes to refinance its expensive debts at a lower interest rate. Also, the company plans to generate ₦35 billion through the sale of some of its real estate properties for the repayment of its short-term debts. Management guides to the commencement of the bond programme when interest rates are favorable and hopes to complete the sale of non-core assets this year. Our FVE does not consider the impact of these strategies thus, we view the adoption of these plans as a positive catalyst to earnings and FVE.
- ***Earnings growth underpinned by non-core operations.*** Flourmills most recent FH1 18 results revealed a 45% YoY increase in earnings to ₦9.4 billion, 1.1x ahead of FY'17 earnings (₦8.8 billion). However, the sizable jump in earnings reflected gains from non-core operations particularly “other operating income” which printed at ₦5.1 billion from a loss of ₦8.1 billion in FH1 17. Specifically, the company reported gains on its non-deliverable forwards amounting to ₦2.1 billion which reflected the Naira appreciation (+3.7% QoQ) at the IEW⁶ during the quarter. Added to this, FMN reported gains of ₦733 million from the revaluation of its sugar plantations.
- In terms of core performance, despite a 16.9% YoY increase in revenue, gross margin contracted by 237bps YoY owing to a faster increase in cost of sales (+20% YoY) amidst the hike in the price of Maize (+33% YoY) and negative product mix. According to management, despite higher input cost on its edible oil business, the company was unable to raise prices due to lower domestic prices for edible oil on which flourmills pricing is anchored. Further, operating expenses rose by 21.6% YoY to ₦11 billion, largely driven by a 36.7% YoY increase in administrative expenses. Management stated that, the sharp increase in administrative expenses was due to the employment of workers for its newly commissioned sugar crushing plant in Sunti, Niger State. Consequently, EBIT declined by 10.6% YoY to ₦24.4 billion.
- Interest expense remained elevated as it surged 48.9% YoY to ₦16.3 billion on account of the twin impact of high interest rates (FH1 18 effective interest rate at 20% vs 15% in FH1 17) and expanded borrowings (+11.5% YoY to ₦147 billion). The expansion in borrowings

⁶ Investor and Exporter Window (IEW)

followed the depreciation in the currency which drove an increase in the cost of imported inputs and, by extension, liquidity to meet working capital requirements.

- Looking ahead to FH2 18, we envisage a faster rise in earnings (+194.3% YoY) mainly due to the low base of FH2 17. However, in line with seasonality, we expect a slowdown in wheat flour demand as consumption switches to yam from bread following the just concluded harvest season. This guides to a slowdown in the pace of revenue growth over FH2 18 (+8.1% YoY). However, we expect cost of sales to rise at a slower pace (+6.6% YoY) than revenue, owing to global oversupply of its key inputs including wheat and raw sugar coupled with an improvement in the domestic supply of Maize which suggests bearish prices for these commodities and softer pressures on COGS. We expect finance costs to remain elevated in FH2'18 (₦14.7 billion) which, however, translates to a 32.1% YoY decline from FH1'17 due to the high base of FQ4 18.

Summary of Results and Forecasts - Naira (₦)

ANNUAL					
Income Statement (₦' m) *					
	2016A	2017A	2018E	2019F	2020F
Revenue	342,586	524,464	589,474	635,501	677,652
Cost of Goods Sold	304,962	457,775	517,558	552,886	591,590
Gross Profit	37,625	66,689	71,916	82,615	86,062
Operating Cost	20,852	23,761	27,116	28,280	31,172
Other operating income (loss)	(0)	0	-	-	-
Operating Profit	16,773	42,928	44,800	54,335	54,890
Net Interest expense	21,294	30,967	29,512	21,141	15,738
Pre-tax Profit	(12,242)	10,473	22,362	35,101	41,862
Tax	(2,931)	1,636	6,038	11,232	13,396
Post-tax Profit (continued operations)	(9,311)	8,836	16,324	23,869	28,466
profit from discontinued operations	23,731	(1)	-	-	-
PAT	14,420	8,835	16,324	23,869	28,466
Balance Sheet (₦ '000) *					
Fixed Assets	213,562	216,866	213,304	221,145	229,280
Stocks	58,699	117,296	124,214	132,693	141,982
Trade debtors	18,966	21,403	28,884	31,140	33,205
Cash & other bank balances	33,213	45,019	30,676	12,164	23,315
Total Assets	124,686	254,883	255,825	247,216	267,581
Liabilities					
Trade Creditors	50,417	94,567	85,397	91,226	97,612
Current Liabilities	117,243	190,726	116,343	89,584	87,792
Total liabilities	249,583	380,059	299,780	279,917	285,644
Shareholders' fund	95,766	102,544	180,203	199,298	222,071
Key Ratios					
Gross Margin	11%	13%	12.2%	13%	13%
EBIT Margin	5%	8%	8%	9%	8%
PBT Margin	-4%	2%	3.8%	6%	6%
Net Margin	4%	2%	3%	4%	4%
EPS	5.50	3.37	6.22	9.10	10.85
P/E	6.37	10.40	5.63	3.85	3.23
EV/EBITDA	10.26	7.21	4.99	3.46	3.29
ROA	12%	3%	6%	10%	11%
ROE	15%	9%	9.1%	12%	13%

Source: ARM Research *unless otherwise stated

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