

Lafarge Africa Plc. | Earnings Review
Surprise tax writeback swings earnings to positive territory (₦44.42 - NEUTRAL)

- Lafarge Africa Plc (Lafarge) released its FY 16 audited results with the company posting a shocking ₦16.9 billion profit (vs. loss of ₦37 billion as at 9M 16) that was well ahead of Bloomberg consensus estimate of a ₦30 billion loss following recognition of ₦40 billion tax credit related to prior year losses from UNICEM. Excluding the tax credit, Lafarge would have declared an after-tax loss of ₦23 billion. Despite the non-cash nature of the tax credit, management proposed a dividend of 105 kobo for the year (2015: ₦3.00) which implies a dividend yield of 2.7% using price as at last close.

Mammoth tax credit drives record quarterly earnings

- Management's presentation reveals that pass-through from gross level gains translated to ₦12 billion in core operating profit over Q4 16, representing a sharp rebound (over five-fold YoY) in organic growth. In addition, Lafarge recorded foreign currency translation gains (₦3 billion), write back on accrued charges no longer required, as well as a shock return from past tax over-provisioning (₦37 billion) linked with prior year losses in UNICEM which ultimately drove earnings to multi-year highs of ₦54 billion in Q4 16 with related margins printing at 93%. Excluding the tax credit and one-off gains, Lafarge would have posted profit of ₦7.6 billion in Q4 16 (vs. loss of over ₦5 billion in the corresponding period of 2015).

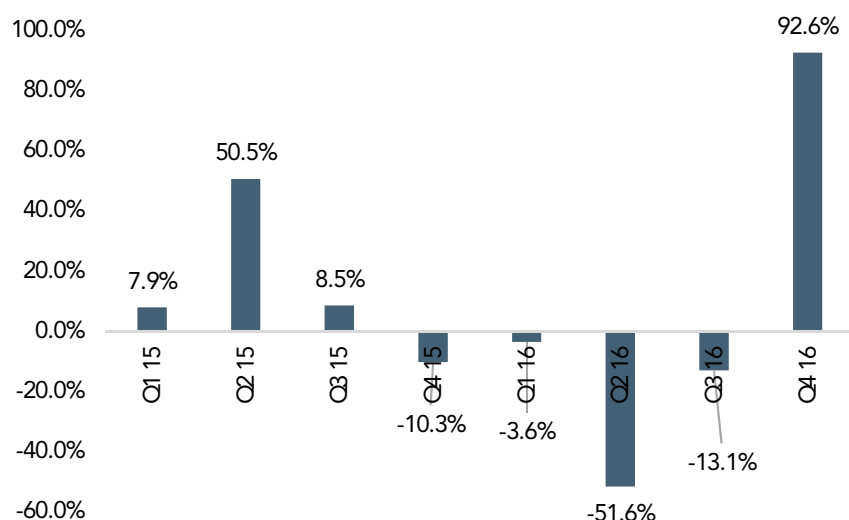
Income Statement Data			
	2016 – 12M'm	2015 – 12M'm	%chg
Revenue	219,714	267,234	20%
PBT	(22,819)	29,275	N/A
Tax	(39,717)	2,177	N/A
PAT	16,899	26,998	-37%
Balance Sheet Data			
	2016-Dec 'm	2015-Dec 'm	%chg
Inventory	44,531	33,027	35%
Receivables	25,801	23,474	9%
Cash	19,265	16,493	17%
Payables	100,808	76,847	31%
Net Assets	502,491	176,152	185%
Stock Data			
Price	₦41.00		
52 week range	₦36.28– ₦77.96		
Market Cap. (N'b)	198.26		
1-month Avg. Vol	201123		
Bloomberg Ticker	WAPCO:NL		
Lafarge Africa - Share Price Trend			



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Figure 1: Historical Net Income Margin



Source: Company financials, ARM Research

Price hike and improved gas supply drive margin recovery in Q4

- In response to price hike in late August 2016, volume contraction across Nigeria continued into Q4 16 (Q4: -17.8% YoY), with the impact dragging FY 16 cement volumes 15% lower YoY. Nonetheless, impact of price increase was net positive for sales in Nigeria in Q4 16 (+30% YoY to ₦45.9 billion). Consequently, top-line strength in Nigeria helped offset softer sales in South Africa (-21% YoY to ₦13.9 billion), where lower prices muted impact of volume growth (+6% YoY), to leave group top-line 12% higher YoY at ₦58.7 billion.
- Elsewhere, Lafarge reported its lowest input cost in over 9 quarters in Q4 16, as improved gas availability drove tamer COGS (-12.8% YoY to ₦36 billion). In addition, management noted greater resort to alternative energy across Ewekoro I and II as well as in Ashaka. Specifically, Lafarge achieved 50% and 100% alternative energy substitution availability across Ewekoro I and II respectively with the latter now fully equipped to run on cheaper petcoke (0.6x cost of gas vs 2.5x for LPFO). Largely reflecting higher pricing and better energy mix across Nigeria, gross margin printed at 38.4% in Q4 16 (Q4 15: 20.6%).

Management continues balance sheet restructuring

- On the balance sheet front, management reported that its syndicated dollar debt from Nigerian banks (\$88.4 million) was prepaid with fresh dollar borrowing from its parent (\$88million). At the close of the year, total debt in balance sheet had narrowed to ₦104 billion (vs. ₦133 billion as at 9M 16 end) with net debt now 26% lower at ₦85 billion. Importantly, the new loans were hedged with one year non-deliverable futures contract at ₦274.5/\$. Regarding its ₦181 billion (at current rate) quasi equity instrument which emerged following the conversion of \$591million shareholder loans, the item is now classified as non-controlling interest. In discussions with Lafarge, management remained non-committal regarding any future plans to convert the quasi equity instruments into equity in the coming period. In our view, continued reluctance to provide a definitive view, despite repeated questioning, on the likely conversion of these instruments raises concerns about potential for dilution under more favourable market conditions.

Organic recovery already in the wings

- Overall, despite the overbearing impact of the tax credit on earnings, Lafarge appears to have finally clawed its way back to organic growth from operations with price redemption the main fulcrum in Q4 16. Going forward, we see scope for relative stability in cement prices in Nigeria, given industry leader's guidance to a comfort zone of around \$130 per ton which largely approximates our 2017 price target of about ₦40,000 (+43% YoY). Whilst, as in Q4 16, price sensitive consumers are expected to cut back on consumption (2017E: -10% YoY), we forecast Nigerian revenues of ₦197 billion (+28% YoY) for FY 2017 as impact of price change nullifies likely retracement in volumes. At the South African end however, headwinds of stiff market condition and overall slow growth momentum which saw the cement sector shrink (-3% YoY) over 2016 should subsist in the current year despite a recent price increase. In line with our surmise, management has already guided to flat to negative growth (-2%) in South Africa for 2017. Against this backdrop and our more benign expectation for Nigeria, group revenues should print at ₦264 billion in the current year (+20% YoY).
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- In addition, the goings on in Lafarge's energy environment suggest that our prior 77% cost to sales assumption for 2017 (vs. 61.6% in Q4 16) now tilts more towards pessimism. This point is made firmer by progress in energy flexibility efforts across Ewekoro I and II as well as return to pre-2016 levels of coal utilization in Ashaka. On the strength of these, we have therefore reviewed our cost to sales assumptions across our forecast horizon closer to trend levels and more recent realities (mean: -4.8pps to 68%). This, as well as pass-through from firmer top-line expectation, now implies 13.5pps YoY rebound in gross margins to 31% (vs. average of 31% between 2014 and 2015).
 - Elsewhere, the complete hedging of the FX loan exposure and restructuring of shareholder loans to quasi equity instrument removes the transmission of currency volatility to Lafarge's earnings going forward. We have therefore rescinded our expectation for ~~₦~~12 billion FX loss from our previous surmise. Thus, with FX issues effectively addressed in the near term, gains from higher prices and energy savings should have more telling impact on earnings in 2017. We therefore forecast PAT at ~~₦~~35.6 billion (2016: ~~₦~~16.9 billion, 2014-2015 average: ~~₦~~37 billion). This should translate to EPS and DPS of ~~₦~~6.52 for 2017.
 - Following the release of the FY result, the company's share price rallied 13.8% to ~~₦~~41, leaving our post adjustment FVE of ~~₦~~41.42 (which also assumes dilution) at an 8% upside. The stock trades at 2016 EV/EBITDA of 12.1x (forward: 5.5x) relative to 8.2x (forward 7.8x) for Bloomberg peers. We retain a **NEUTRAL** recommendation on the stock.
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QUARTERLY					
Income Statement (₹'000,000)*	Q1 2017F	Q2 2017F	Q3 2017F	Q4 2017F	
Turnover	64,700	68,661	63,379	67,341	
COGS	44,384	47,102	43,478	46,196	
Gross Profit	20,316	21,560	19,901	21,145	
Operating Costs	8,087	8,583	7,922	8,418	
Operating Profit	12,228	12,977	11,979	12,727	
Net Finance costs	(2,192)	(2,326)	(2,147)	(2,281)	
Profit Before Taxation	10,036	10,651	9,832	10,446	
Taxation	1305	1385	1278	1358	
Profit After Taxation	8,732	9,266	8,553	9,088	
ANNUAL					
Income Statement (₹'000,000)*	FY 2015A	FY 2016A	FY 2017F	FY 2018F	FY 2019F
Revenue	267,234	219,714	264,081	275,513	316,771
COGS	184,703	179,052	181,160	189,002	217,305
Gross Profit	82,531	40,662	82,922	86,511	99,466
Operating Cost	30,885	30,735	33,010	28,929	33,261
Operating Profit	38,303	9,927	49,911	57,582	66,205
Interest income	2,183		2,762	765	1,180
Interest expense	11,211	3,675	11,708	14,859	15,007
PBT	29,275	(22,819)	40,965	43,489	52,378
Tax	2,277	(39,717)	5,325	5,654	6,809
PAT	26,998	16,899	35,639	37,835	45,569
Balance Sheet (₹ '000,000)*					
Assets					
Fixed Assets	364,397	389,841	397,537	403,251	409,237
Stocks	33,027	44,566	48,802	49,592	55,498
Trade debtors	23,474	36,494	44,894	46,837	53,851
Cash and other bank balances	16,493	(26,175)	(21,676)	(13,768)	(366)
Total Assets	453,012	448,463	473,294	489,649	521,957
Liabilities					
Trade Creditors	76,847	79,848	99,638	99,185	108,684
Non-current Liabilities	187,473	141,211	142,948	145,687	149,693
Total liabilities	276,861	276,861	276,861	276,861	276,861
Shareholders' fund	176,152	191,141	194,169	207,849	226,315
Key Ratios	FY 2015A	FY 2016A	FY 2017F	FY 2018F	FY 2019F
P/E	6.9	13.3	6.3	5.9	4.9
ROA	6.2%	3.7%	7.3%	7.1%	8.0%
ROE	15.4%	8.5%	15.2%	14.7%	16.2%
Gross Margins	30.9%	18.5%	31.4%	31.4%	31.4%
EBIT Margins	14.3%	4.5%	18.9%	20.9%	20.9%
PBT Margins	11%	-10%	16%	16%	17%
Net Margins	10.1%	7.7%	13.5%	13.7%	14.4%
EPS	5.93	3.09	6.52	6.92	8.34
Effective Tax Rate	8%	N/A	13%	13%	13%
Debt to Equity	84.2%	46.8%	72.6%	67.1%	61.7%
P/B	1.06	1.01	0.91	0.84	0.76

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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