

Lafarge Africa Plc. | Earnings Update
Debt conversion reduces exposure to FX volatility
(STRONG BUY- ₦66.15)

- Lafarge Africa Plc. (Lafarge) released unaudited Q3 16 results, wherein it reported a pre-tax loss of ₦12billion (Q3 16E – ₦10billion) which extended the company's run of losses to the fourth consecutive quarter.

FX loss and net debt shrink on debt conversion...

- Following significant pressures from FX losses in prior quarters, Lafarge converted \$493 million of its shareholder dollar debt into equity instrument in Q3 16. Under the new arrangement, interest rate on the instrument remains at 6% while interest and principal payments are now to be made at the discretion of the borrower (Lafarge). The equity instrument would now reside directly in retained earnings along with associated FX volatility. During discussions, management insisted that the equity instrument is not dilutive to current shareholders in any form. In providing rationale for the decision, management explained that the conversion would reduce volatility from dollar denominated debt, which has now been narrowed to \$102 million (vs. \$595 million previously), with 83% of this amount owed to commercial non-shareholder sources (banks) and the balance 17% representing accrued interest on the reclassified shareholder debt.

Income Statement Data			
	2016 – 9M'm	2015 – 9M'm	%chg
Revenue	161,044	215,039	-25%
PBT	(40,368)	36,512	N/A
Tax	(2,965)	4,118	N/A
PAT	(37,402)	32,394	N/A

Balance Sheet Data			
	2016-Sep 'm	2015-Dec 'm	%chg
Inventory	44,930	33,027	36%
Receivables	37,113	23,474	58%
Cash	17,538	16,493	6%
Payables	107,577	76,847	40%
Net Assets	202,991	176,152	15%

Stock Data	
Price	₦47.50
52 week range	₦42.00 – ₦95.45
Market Cap. (N'b)	320.67
1-month Avg. Vol	237,994
Curr. PE	-6.1x

Bloomberg Ticker WAPCO:NL

Lafarge Africa - Share Price Trend

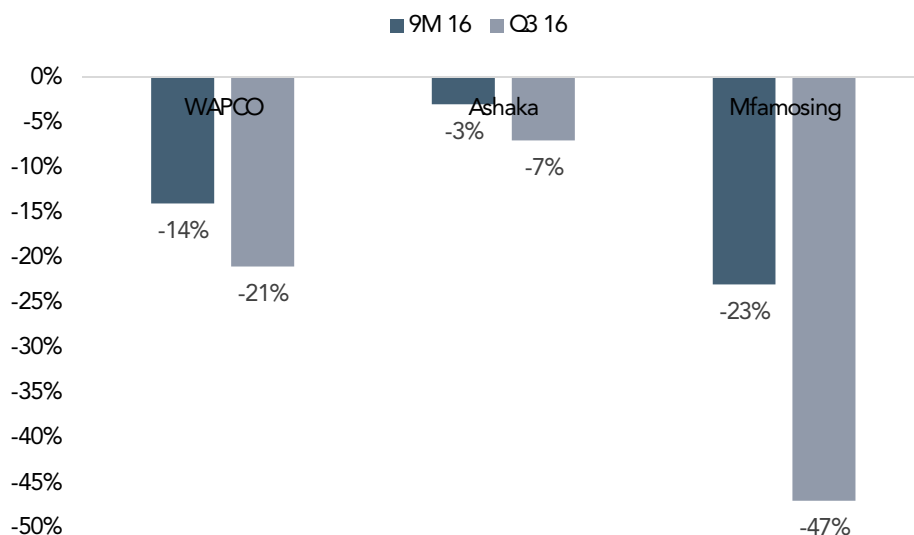
Analyst(s)
Philip Anegbe
philip.anegbe@arm.com.ng

- In view of this restructuring, the company's total debt declined 39% from Q2 16 levels to ₦133 billion with net debt closing the period 43% QoQ lower at ₦116 billion. Further aided by a relatively lower naira depreciation over Q3 16 (-11% QoQ), Lafarge reported an 86% QoQ moderation in FX losses to ₦3.4 billion while interest expense contracted 7% YoY.

...but weak operating performance underpins Q3 16 loss

- Away from debt issues, Lafarge recorded a third consecutive dip in group revenues in Q3 16 (-15% YoY to ₦54 billion) missing our estimates by 3.7%. Sales weakness stemmed from contraction in Nigeria (-29% YoY to ₦29.5 billion) which neutered the strong growth in South Africa (+19% YoY to ₦23 billion). On the Nigerian front, Lafarge was hit by a double whammy of volume contraction (-27% YoY to 1.028MT) and lower cement prices (-8% YoY to ₦27,164/ton). According to management, output compression was particularly significant at its WAPCO plant, following production outages due to gas shortages, and at Mfamosing, wherein volumes were pegged back by logistic challenges and plant maintenance. Away from Nigeria, revenue growth in South Africa reflects increases in ReadyMix (+9% YoY) and Aggregates (+9% YoY) volumes which offset declines in Cement (-16% YoY).

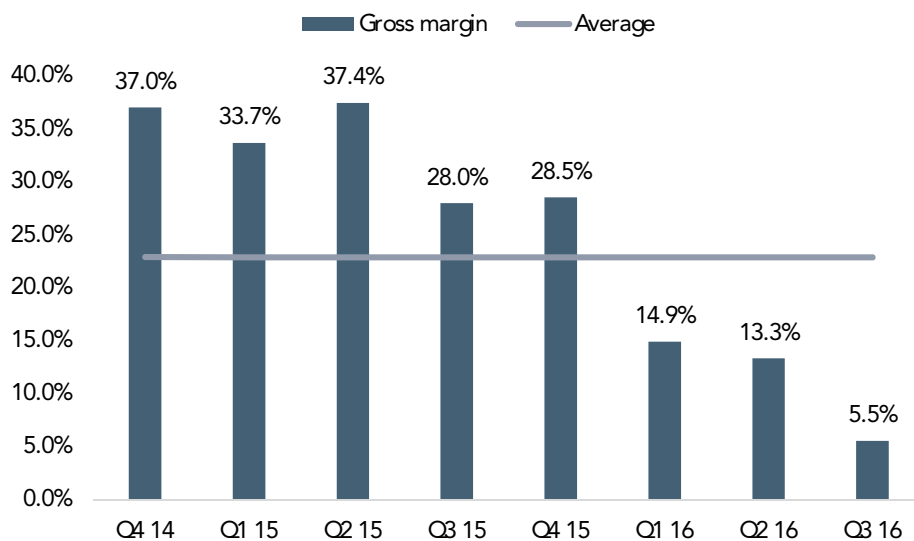
Figure 1: YoY Growth in Q3 16 Nigerian volumes



Source: Lafarge Africa Plc., ARM Research

- Worse still, sharp increases in input cost (+12% YoY to ₦51 billion) drove 22.4 pps YoY contraction in gross margin to 5.5% with gross profit declining 83% YoY to ₦2.97 billion—lowest level since consolidation. Akin to industry peers—Dangcem and CCNN—Lafarge increased usage of expensive alternative energy (LPFO) following extended gas shortages. In addition, Lafarge was unable to significantly reduce OPEX (-0.3% YoY to ₦8 billion) despite volume collapse across its cement subsidiaries. Consequently, Lafarge posted a first-time loss of ₦5 billion from core operations in Q3 16 (vs. operating profit of ₦10 billion in the corresponding period of 2015).

Figure 2: Historical gross margin movement



Source: Company presentation, ARM Research

- Overall, while NGN depreciation over the quarter and current restructuring of shareholder dollar debt drove significant QoQ contraction in FX loss, the loss—which was over six-fold higher on a year ago basis—remained a major drag on earnings over Q3 16. Thus, despite a reported tax credit of ₦3 billion (vs. tax charge of ₦607 million in Q3 15), Lafarge declared after tax loss of ₦8.6 billion vs. PAT of ₦5.4 billion in Q3 15.

Reduction in net debt drives FVE expansion

- Given the negative demand response across peers to the price increase, we expect Lafarge to experience a further pull-back in volume sales over Q4 16. Thus, in line with current run rate (-27% YoY in Nigeria), we now look for 26% YoY contraction in Nigerian cement volumes to 4.92MT (vs. -5% YoY to 6.3MT previously) with 2016 weighted prices now at ₦29,053 (vs. ₦23,500 in previous estimates). This implies a 22% YoY decline in cement revenues from Nigeria to ₦145 billion in 2016E (vs. -20% YoY to ₦147 billion in our previous forecast). Leaving expectations for South African operations unchanged, we now project that 2016E group revenues should contract 22.9% YoY to ₦206 billion (vs. ₦207 billion in prior projection). Similarly, given sustained energy pressures over 9M 16, we have also adjusted our target input cost higher by 9% to ₦178 billion (-3.6% YoY), implying 17.4pps YoY contraction in gross margin to 14% relative the 10pps drop in our prior forecast.
 - That said, Lafarge's 2016 outlook remains primarily hinged on its cumulative FX loss of ₦31 billion, which, in spite of an expected ₦5 billion tax credit over FY 16 (vs. tax charge of ₦2 billion in 2015), should drive Lafarge into after tax loss of ₦50 billion over FY. However, going into 2017, we expect the company to benefit from higher prices (+5% YoY) and significant moderation in earnings volatility following the successful restructuring of its shareholder dollar loan in line with IFRS' requirement. Furthermore, our model adjustment for the 43% contraction in net debt to ₦116 billion drives a 24% rise in our FVE to **₦66.15**.
 - Currently, largely reflecting pressures from significant FX losses and weak operating performance thus far in 2016, Lafarge trades at a 2016 EV/EBITDA of **53.9x** vs. 8.4x for its Bloomberg Middle East & Africa peers. Factor out however, a combination of higher prices and expected cutback in earnings volatility should see forward EV/EBITDA come in at **6.9x** for Lafarge in 2017 (Bloomberg average: 8.8x). Thus, in line with its significantly smaller net debt position, we have upgraded our recommendation on the company to a **STRONG BUY** (vs. SELL in previous communication).
-

Summary of Results and Forecasts

QUARTERLY

Income Statement (¥'000,000)*	Q1 2016A	Q2 2016F	Q3 2016A	Q4 2016F
Turnover	52,421	54,944	53,679	44,945
COGS	44,609	47,616	50,709	35,247
Gross Profit	7,812	7,328	2,970	9,698
Operating Costs	6,447	5,770	7,990	5,542
Operating Profit	351	1,558	-5,019	-6,173
Net Finance costs	(2,559)	(2,000)	(2,836)	(3,816)
FX revaluation loss	0	(27,527)	(3,740)	(3,740)
Profit Before Taxation	(2,208)	(27,969)	(11,591)	(13,728)
Taxation	343	405	(3027)	(2715)
Profit After Taxation	(2,551)	(28,373)	(8,563)	(11,013)

ANNUAL

Income Statement (¥'000,000)*	FY 2015A	FY 2016A	FY 2017F	FY 2018F	FY 2019F
Revenue	267,234	205,989	311,025	317,633	350,971
COGS	184,703	178,180	220,828	222,343	245,680
Gross Profit	82,531	27,809	90,197	95,290	105,291
Operating Cost	30,885	25,749	38,878	39,704	43,871
Operating Profit	38,303	(9,282)	45,272	49,538	55,373
Interest income	2,183	1,381	2,762	4,486	6,956
Interest expense	11,211	12,591	19,094	19,285	19,478
FX revaluation loss		(35,000)			
PBT	29,275	(55,493)	28,939	34,739	42,851
Tax	2,277	(4,994)	3,762	4,516	5,571
PAT	26,998	(50,498)	25,177	30,223	37,280
Balance Sheet (¥ '000,000)*					
Assets					
Fixed Assets	364,397	366,228	367,928	369,683	371,733
Stocks	33,027	27,425	33,124	37,798	34,395
Trade debtors	23,474	23,883	27,681	28,587	31,236
Cash and other bank balances	16,493	82,729	110,964	120,869	152,817
Total Assets	453,012	503,426	542,858	560,098	593,342
Liabilities					
Trade Creditors	76,847	84,234	108,206	106,725	115,470
Non-current Liabilities	187,473	239,027	242,558	246,184	251,177
Total liabilities	276,861	332,224	359,764	362,056	375,889
Shareholders' fund	176,152	233,579	245,471	260,420	279,830

Key Ratios	FY 2015A	FY 2016F	FY 2017F	FY 2018F	FY 2019F
P/E	8.01	(4.67)	9.37	7.81	6.33
EV/EBITDA	6.41	53.89	6.82	6.26	5.57
ROA	6%	-10%	5%	5%	6%
ROE	15%	-28%	13%	15%	16%
Gross margins	30.9%	14%	29%	30%	30%
EBIT margins	14%	-5%	15%	16%	16%
Net Margins	10%	-25%	8%	10%	11%
Debt to Equity	84.2%	146.0%	137.4%	128.3%	118.5%
EPS	5.93	(10.16)	5.07	6.08	8

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

Copyright © 2016 Asset & Resource Management Company Limited (“ARM”).

All rights reserved. Unauthorised use, reproduction, distribution or disclosure of this document is strictly prohibited.

This material has been issued by Asset & Resource Management Company Limited (“ARM”), a Company regulated by the Nigerian Securities and Exchange Commission. The analyst(s) primarily responsible for preparing this research report, in whole or in part, certifies that with respect to each security or issuer covered; all of the views expressed accurately reflect his/her personal views about the subject securities and issuers and no part of his/her compensation was, is, or will be, directly or indirectly, related to the inclusion of specific recommendations or views in the report.

This research report is based on information from sources that ARM and its analysts believe to be reliable. Neither ARM nor any of its research analysts, nor any member of the ARM Group, gives any representation or warranty, express or implied, or undertaking of any kind or assumes responsibility or liability of any kind with respect to the accuracy or completeness of the information set out in this report or any third party’s use (or the results of such use) of such information. This report is provided solely for informational purposes and is not to be construed as providing advice, recommendations, or endorsements of any kind whatsoever. The investments and strategies discussed here may not be suitable for all investors; counsel of investment advisor should be obtained with regard to such investments and or strategies. This research report is not a replacement for advice from an accountant, lawyer, personal finance advisor or other category of investment advisor. The investments discussed in this report may oscillate in price or value. Opinions and information provided are made as of the date of the report issue and are subject to change without notice. This research report is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Reference herein to any specific security or financial instrument does not necessarily constitute or imply its endorsement or recommendation by ARM, its directors, officers, employees or designated agents. Members of ARM may act as broker, advisor or lender, or make a market in any investments or issuers referenced in this report. Further information on any of the securities discussed herein may be obtained upon request to ARM. By accepting this document, you agree to be bound by the foregoing limitations.
