

ARM Brewery Sector Update

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Leveraged Acquisition Could Make NB a BUY

Positive impact of acquisitions: Following approval by its shareholders, Nigerian Breweries (NB) is in the process of acquiring 99.9% of the issued shares of Sona Systems and 99.14% of the issued shares of Life Breweries from its parent Heineken B.V, which acquired the companies January this year. From a top level perspective, in our view, the acquisitions make sense for NB as they:

1. Considerably shorten the lead time for adding on capacity compared to building green fields or expanding existing capacity
2. Provide NB with access to the fast growing low-end market; the brewer's previous absence in this segment put it at a disadvantage relative to rival, Guinness
3. Help checkmate – at least temporarily – an aggressive market incursion by SAB Miller given the mileage an acquisition of Sona Group (the third largest brewing entity in the Nigerian market) by SAB Miller would have provided .

By our estimates, the three acquisitions would provide NB with 2.9 mhl (currently 50% capacity utilisation) or 25% additional capacity. The big unknowns in the deal, however, are pricing and funding.

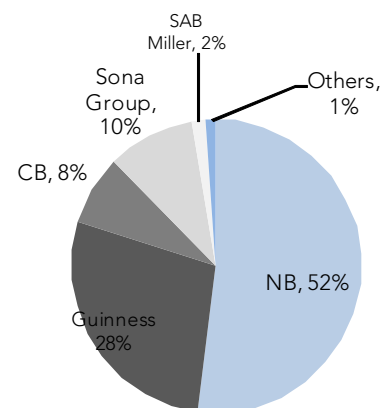
Table 1: NB's Acquisition Prospects and Estimated Capacity

Target	Estimated Capacity khl
Sona Breweries, Ogun	1945
Intl Beer and Beverages, Kaduna State	680
Life Breweries, Onitsha	275
Total Capacity	2900

Leverage appears the most probable alternative: With pricing uncertain, the effects of the acquisitions on NB's valuation are largely up in the air. To this end, we apply best judgement in coming up with a fair value estimate of the likely value accretion from the process. Our core assumptions are below:

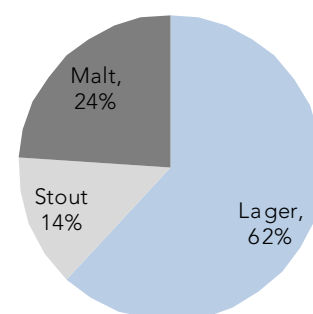
Acquisition is done in line with recent transaction valuation: We have looked at recent brewery acquisitions on the African continent and have estimated acquisition price of \$170 per hectolitre (using a weighted average of pricing from recent deals, see table 1 below). We suspect Heineken paid a significant premium for the Ethiopian assets given the competitive nature of their auction process and Heineken's prior absence in that market. These don't apply in the Nigerian case and we therefore believe that our price assumption, which puts the entire transaction cost at \$500 million or N77.5 billion, is conservative.

Market Share by Brewer



Source: Company Data; ARM Estimates

Beer Segment Share



Source: Company Data; ARM Estimates

Table 2: Recent Brewery Transactions on the African Continent

Acquirer	Target	Size of Target	Implied cost per hl	Transaction year
Heineken	Bedele Brewery (Ethopia)	300khl	\$284	2011
Heineken	Harar Brewery (Ethopia)	400khl	\$214	2011
Diageo	Serengeti Breweries (Tanzania)	1mhl	\$118	2010
Weighted Average Cost			\$170	

**Serengeti has an additional 500kHL brewery scheduled to come on stream later this year
Source: Heineken, East African Breweries; Ethiopian Privatisation Agency; ARM Research*

NB uses mostly debt to fund the transaction: As at 2010 year end, NB had cash and cash equivalents of N12.5 billion on its balance sheet, making an acquisition via internally generated resources unlikely. This leaves NB with two financing options: 1) Additional equity investment by Heineken, effectively increasing its stake in NB 2) Using leverage to part finance the transaction.

Given the purchase (by Heineken) and subsequent sale to NB (rather than keeping them as standalones), we believe financing through the equity route for NB seems like a rather inefficient use of balance sheet and hence also unlikely. We thus think the more probable course is a sale to NB via on-lending by Heineken (Nestle Nigeria used similar means to fund its Sagamu expansion). We have applied the following assumptions in this regard:

- NB borrows \$450 million (N70 billion) for 10 years with interest at 6 months USD Libor + ~300 bps (similar to the rate on Nestlé Nigeria's most expensive foreign loans)
- Principal moratorium of three years and amortization over the subsequent seven years. We consider this conservative compared to assuming a bullet payment at expiration.
- A gradual increase in USD Libor and 200bps add-on for currency risks
- Consolidation of new breweries is done in 2012.

Debt: earnings accretive; creates valuation upside: In the past five years, NB's Debt /Equity has been almost negligible, which is suboptimal in our view. The case for debt is strengthened by the low cost of long term foreign currency debt (<10% in the most conservative of estimates). In our cost of capital (COC) calculations, leverage reduces COC from 16.26% to 15.29%. This alone increases our derived valuation for NB by 16%.

Our assumptions lead to a **target price of N110.89** –26% above current market price—compared to N82.7 before considering the effects of the acquisitions and gains from leverage.

Outlook for NB

For 2011, we expect NB to record Sales and PAT of N218.8 billion (+17.7%) and N34.8 billion (+20.2%) respectively. Over the next five years, we expect NB's Sales and PAT to grow at CAGRs of 16.7% and 12.8% respectively.

Risks to our assumptions:

- The primary risk to our assumption is that pricing terms of the deal could be less favourable than we have assumed.
- Also, cost of debt could be higher than we have supposed especially if debt is sourced locally.

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