



Nigerian Palm Oil Sector

Weaker CPO prices dim sector outlook

OKOMU

Rating	STRONG BUY
Price	₦73.20
FVE	₦92.45
52-week range	₦70.1 – ₦94.7
Market Cap. (₦mn)	66,869
1-month Avg. Vol	155,377
Curr. PE	8.29x

PRESCO

Rating	BUY
Price	₦53.35
FVE	₦67.47
52-week range	₦53.35 – ₦78
Market Cap. (₦mn)	56,550
1-month Avg. Vol	50,886
Curr. PE	9.2x

Analyst(s)

Damilola Olupona

damilola.olupona@arm.com.ng

- Following the H1 18 results and our recent discussion with Management, we update our assessment of the palm oil sector and outlook for Okomu and Presco. In the wake of weakening global crude palm oil (CPO) prices and relative stability in the naira at the parallel market, domestic CPO prices have trended lower with passthrough on margins and earnings of our coverage companies. We also look at the current market dynamic and the inherent opportunities that abound for sector players given Nigeria's position as a net importer of CPO.
- We believe the recent sell-off in the shares of Okomu and Presco provides upside opportunity for investors as valuations remain undervalued to the inherent sector opportunities and earnings outlook. Particularly, at 8.8x, the sector's mean P/E remains cheap relative to Bloomberg Africa peers (13.65x). Across our coverage, we prefer Okomu due to expectation of lower interest expense emanating from its slimmer debt profile compared to that of Presco. Also, the demand-supply gap for CPO coupled with Okomu's expansion plans guides to stronger earnings in the medium term. Hence, our FVE embodies 26% upside from current pricing for Okomu (₦92.45) and a 26% for Presco (₦67.47). Accordingly, we have a **STRONG BUY** rating on Okomu, been a top 20 stock and a **BUY** rating on Presco.

Company Name	Old FVE (₦)	New FVE (₦)	Upside	Rating
Okomu	102.33	92.45	26%	STRONG BUY
Presco	68.84	67.47	26%	BUY

Source: ARM Research

Earnings suffer setback on CPO price plunge

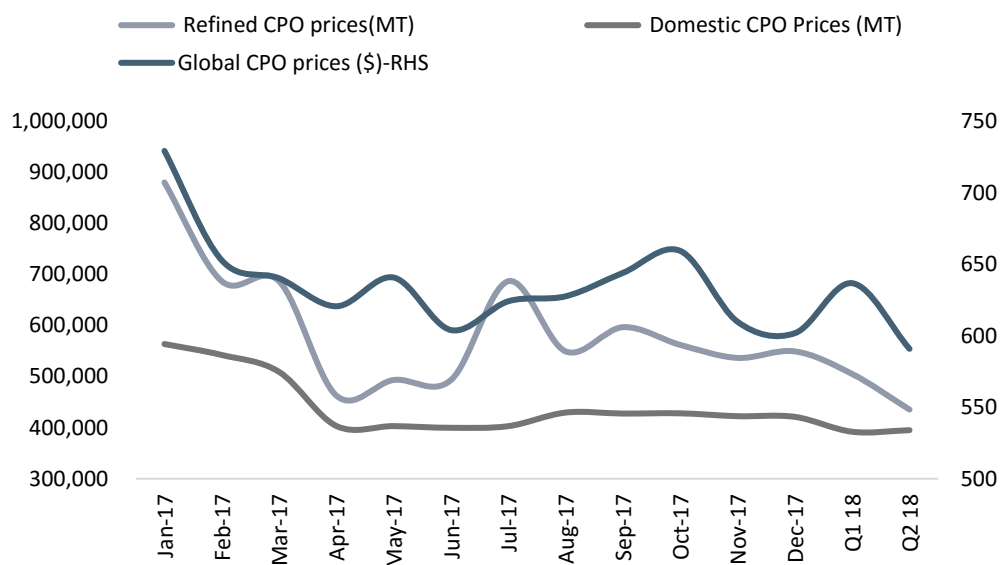
So far this year, the palm oil sector has struggled to replicate the spectacular feat in earnings achieved last year. The uninspiring performance over H1 2018 was mainly driven by lower CPO prices which declined 7.3% YoY on the back of widening glut in the global CPO market (4.5MMT in 2018 vs 3.2MMT¹ in 2017). The glut expansion stemmed from improved weather patterns, large oil extraction from high yield seedlings in Indonesia and Malaysia, and more importantly India's decision to raise crude and refined palm oil tariff² to their highest level in over a decade further dampened export prospects and prices – India is the largest consumer of CPO. Consequently, given that local prices are reflective of global CPO prices, Okomu had an average price of ₦395,032/MT over H1 18 which is 16% lower than last year's average price. In addition, the relative stability in the naira, particularly at the parallel market segment encouraged smuggling activities into Nigeria which further exerted downward pressure on domestic CPO prices. Specifically, the management of Okomu alluded to rising illegal CPO import flowing from Benin Republic as providing support to lower domestic CPO prices.

From our findings, over the last five years, importation of CPO into Benin Republic has been exceeding its domestic consumption. For context, Benin Republic imported 314,591MT of CPO from Malaysia in 2017 whereas its domestic consumption stood at 135,000 MT in the same period, and its import in H1 2018 of 110,826 MT is only 18% shy of touching last year's annual domestic consumption. In our view, it appears the excess CPO imports have been finding its way illegally into Nigeria thus, bypassing imports duties and providing further legroom for cheaper CPO in the Nigerian market. Furthermore, local refined CPO prices also buckled under falling global CPO prices with FEWSNET reporting an 18% YoY drop in prices to ₦505,023/MT. This largely accounted for the 9.1% YoY dip in Presco's top line over the first half of the year.

¹ MT means metric tons

² India raised import tax on crude palm oil to 44 percent from 30 percent and lifted the tax on refined palm oil to 54 percent from 40 percent

Figure 1: Trend in local refined, domestic (₹/MT) and global crude palm oil prices



Source: Company sources, FEWSNET, Bloomberg and ARM Research

Downtrodden Rubber Prices

Global rubber prices also towed similar path as CPO over H1 2018 with prices falling 15% YoY to \$1.52/kg due to glut following expiration of an agreement between Thailand, Indonesia and Malaysia to reduce exports (the 3 countries accounts for ~ 70% of global rubber supply). Thus, given that Okomu exports all its rubber, its rubber prices were largely reflective of external influences as management reported that prices plunged 12% to ₹419,340/MT over H1 2018. However, Okomu entered into a forward contract with off takers for its rubber before delivery (six months to one year) at a higher price which provided cover against sliding global rubber prices and translated into a 13% YoY expansion in export sales over H1 2018. However, going into subsequent quarters, the pass through of weaker rubber prices could filter into earnings as current contracts reflects weaker prices. Meanwhile, we did not see the impact of dwindling rubber prices on Presco's earnings as its rubber trees are yet to mature.

Figure 2: Trend in Global rubber prices (\$/kg)

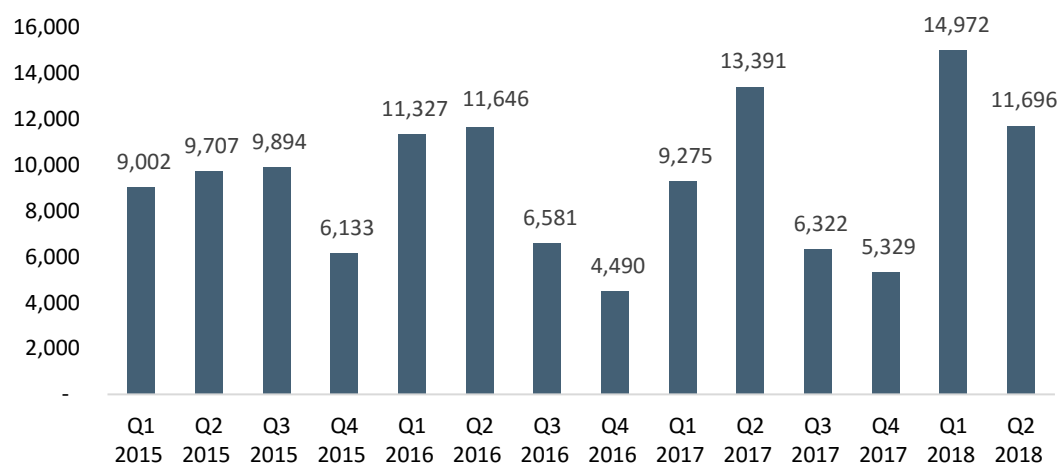


Sources: Bloomberg, ARM Research

CPO Volumes: Resilient half year

On volumes, Okomu witnessed a brilliant first quarter with volumes touching a thirteen-quarter high of 14,972 MT. According to management, this reflects the impact of favorable weather condition, expansion in matured area to 10,620 (+8% YoY) and higher Fresh Fruit Bunches (FFB) yield/ha (9% YoY) over the period. However, due to the onset of the lean season, yield on Okomu's plantation dipped resulting in a 13% YoY plunged in volumes to 11,696 MT in Q2 18. Also given that Presco's revenue dipped 9% YoY over H1 2018 on the back of falling refined CPO prices (-10% YoY to ₦435,320) we believe volumes were slightly higher over the period. This stemmed from supply to wholesalers and blue-chip consumer goods companies such as Nestle Nigeria and Dangote Group which saw improved top line growth.

Figure 3: Trend in Okomu's volumes (MT)

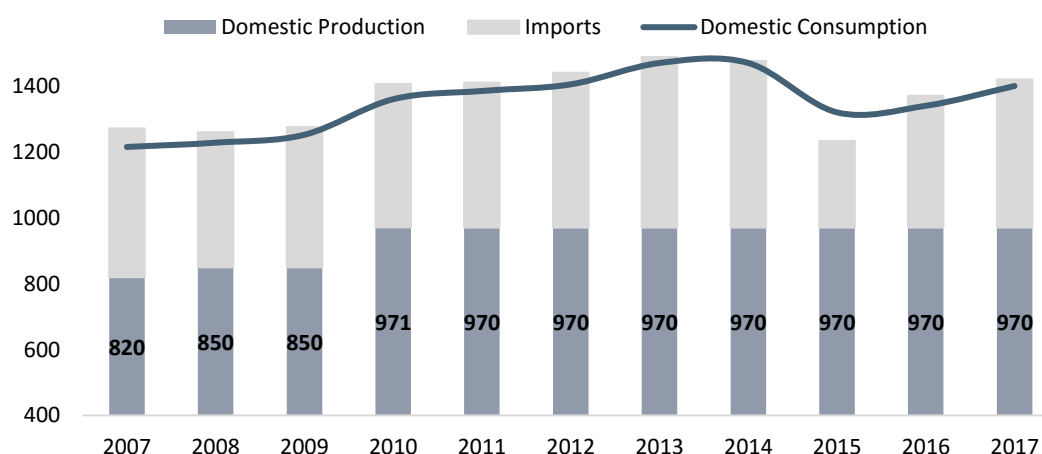


Source: Company sources, ARM Research

Market dynamics provides room for cheer

We highlight that a large percentage of Nigeria's CPO production is controlled by numerous small-scale farm holders with CPO output from key producers including Okomu and Presco accounting for ~8% of the total market although, individually holding sizeable market share due to their robust capacity (combined annual capacity at 78,000MT) compared to small farmers. However, despite recent government efforts to boost domestic production of CPO, local production still lags behind overall domestic consumption. In fact, according to available data from United States Department Agency (USDA), production has remained around 970 thousand MT, in the last 5-years, trailing domestic consumption of 1.4 million MT over the same period. We attribute the short fall to slowdown in investment from large corporates into the sector even despite sufficient arable land conducive for palm oil cultivation in Nigeria. That said, the demand-supply gap, which presently is around 430 thousand MT makes Nigeria a net importer of CPO with its imports largely sourced from Malaysia and Indonesia where production of CPO outweighs consumption. However, in recent times we have seen renewed interest in Nigeria's CPO market with PZ Wilmar investing more than \$650 million oil palm plantations and processing facilities. The company has planted almost 26,500 hectares of palm oil in Cross river state and installed about 65 tonne per hour palm oil mill which by our estimate translates to annual capacity of ~40,000 MT. No doubt, this is a drop in the ocean given Nigeria's current deficit picture (430,000 MT). In the light of this, we believe there is still scope for sector players—Okomu and Presco to expand capacity and grow volumes which guides to a possible leap in earnings in the medium to long term.

Figure 4: Trend in CPO demand and supply in Nigeria (KMT)



Source: USDA, ARM Research

Moving Forward with Expansion Plans

Over 2018, Management of Okomu hinted at ₦12 billion Capital expenditure plan majorly to meet expansion needs at its newly launched Extension 2 plant with likely funding sources from cheap CBN/BOI Agric lending facilities (~9%) and retained earnings. Accordingly, the company raised ₦1.95 billion in term loans from the Bank of Industry under the Agriculture Credit loan at an interest rate of 10% in April 2018 which led to a jump in terms loans from ₦1.1 billion in Q1 18 to ₦2.9 billion in Q2 18. In terms of specific project, management guided to building two new oil mills at its Extension 2 plant, both 30 ton/hour at peak which is expected to cost ₦5 billion. The First plant is scheduled to be commissioned in 2020, while the second will come on board between 2021 and 2022. Furthermore, according to management the first area to mature in Ext 2 will be what was planted in 2016 which is expected to add 1300 hectares to its existing matured area in 2018.

In a bid to diversify its revenue base, Presco plans to tap into the rubber markets which should be an additional source of foreign exchange (aside Palm Kernel export). In line with its plan, Presco has concluded the acquisition 17,600 ha of land in Edo state where it plans to plant palm oil and develop a bud wood garden nursery for the actualization of its investment in rubber. In terms of expertise to manage the rubber business, PRESCO can take advantage of the expertise of its parent company—Siat NV, which already produces rubber in Ivory Coast, Gabon, Cambodia, Belgium and Ghana. However, we are yet to reach management of Presco to get clarity on the timing for the maturity of its first set of planted rubber trees hence, we did not factor it into our valuation for the company.

OKOMU OIL PALM PLC: Lower CPO price submerge earnings

On the heels of lower than expected CPO prices over 2018 we cut our FVE by 10% to **₦92.45**. However, given current share price of ₦73.2 which implies a 26% upside on the stock we have a **STRONG BUY** rating on the stock. Okomu trades at a FY 18E P/E of 8.29x which is at a discount to Presco's 9.2x and Bloomberg MENA peers of 13.65x. At current price, our dividend expectation of ₦2.28 over FY 18E translates to a dividend yield of 3%.

- **Revenue plunge on price slip:** Going forward, the expectation of weaker global CPO prices provides scope for lower domestic CPO prices. Overlaying this with lower global rubber prices which could translate to weaker export sales, we project a 6% YoY drop in 2018E revenues to ₦19.02 billion.
- **Higher Cost fuels gross profit contraction:** Management stated that the abysmally low COGS (₦22 million) reported in Q2 17 was an error and stated that the FY 2017 COGS of ₦4.23 billion reflects adjustments made to make up for error. Thus, we normalize Q2 17 COGS to ₦591.7 billion to reflect 5-year historical COGS average for the company. Based on new adjustments, over Q2 2018, Okomu faced cost pressures with cost of sales significantly higher (+93% YoY to ₦1.14 billion in Q2 2018). Management linked the spike in cost of sales to the onset of lean season, higher cost of fertilizer purchased earlier in the year and Energy pressures due to bottleneck faced with achieving its planned Energy mix (40% Genset and 60% BEDC³) as Energy mix of 65% genset and 35% BEDC fell short of target. Going forward, while management guided to normalization of cost of fertilizer in Q3 2018, the onset of lean season which is usually the planting period for Okomu presents the possibility for higher cost going into rest of the year. More so, given the lingering bottlenecks faced by the BEDC we see scope for higher cost of sales over the rest of the year. Thus, we raise our cost of sales expectation for 2018 by 15% YoY to ₦4.85 billion.
- **Slimmer Finance costs to offset Higher OPEX:** Having fully paid down the FCY portion of its long-term borrowings (€10 million) owed to its parent company—SOCFINAF S.A in Q1 2018, we model a 43% YoY decline in interest expense over 2018. In our view, this should help mask impact of higher operating expenses (FY 18E: +5% YoY to ₦5.3 billion) over the rest of the year.
- **Catalysts:** Further depreciation in the naira at the parallel market and uptrend in global CPO prices would drive CPO prices higher which is positive for Okomu's revenue.
- **Valuation:** On balance, we now look for FY 18E PAT of ₦7.5 billion (-18.1% YoY). Base on the forgoing we cut our Fair value estimate (**FVE**) by 10.5% to **₦92.45** which implies a 26% upside from current pricing. Hence, we have a **STRONG BUY** rating on the stock. Okomu trades at a P/E of 8.29x relative to Presco's 9.2x and 13.65x for Bloomberg MENA peers.

³ BEDC: Benin Electricity Distribution Company

Summary of Results and Forecasts: OKOMU

ANNUAL					
Income Statement (N'000)	2016A	2017A	2018E	2019F	2020F
Revenue	14,364,736	20,261,918	19,024,457	20,429,060	21,395,001
Cost of Goods Sold	3,589,490	4,226,453	4,851,236	4,800,829	4,599,925
Gross Profit	10,775,246	16,035,465	14,173,220	15,628,231	16,795,076
Operating Cost	3,938,414	5,060,809	5,326,848	5,107,265	5,134,800
Other operating income (loss)	114,730	153,530	114,147	122,574	128,370
Operating Profit	6,951,562	11,128,186	8,960,519	10,643,540	11,788,646
Interest expense	1,340,588	484,382	275,331	194,039	196,342
Pre-tax Profit	5,906,453	11,140,142	9,141,361	10,973,719	12,088,241
Tax	996,180	1,992,292	1,645,445	1,975,269	2,417,648
PAT	4,910,273	9,147,850	7,495,916	8,998,449	9,670,592
Balance Sheet (N '000) *					
Fixed Assets	9,217,423	11,216,535	14,717,040	18,235,769	20,568,724
Inventory	1,719,080	2,687,196	2,231,569	2,208,381	2,115,966
Trade debtors	505,729	978,133	760,978	817,162	855,800
Cash & other bank balances	3,198,251	3,093,792	4,136,790	5,781,954	9,059,036
Total Assets	24,507,665	31,372,152	37,330,081	44,300,215	51,622,503
Liabilities					
Trade Creditors	641,148	487,695	873,223	864,149	827,987
Current Liabilities	3,007,934	3,768,398	4,251,135	4,288,722	4,302,953
Total liabilities	7,495,624	6,865,262	7,501,091	7,722,388	7,791,731
Shareholders' fund	24,507,664	31,372,152	37,330,081	44,300,215	51,622,503
Key Ratios	2016A	2017A	2018E	2019F	2020F
Gross Margin	75%	79%	75%	77%	79%
EBIT Margin	48%	55%	47%	52%	55%
PBT Margin	41%	55%	48%	54%	57%
Net Margin	34%	45%	39%	44%	45%
EPS	5.1	9.6	7.9	9.4	10.1
P/E	7.3	6.8	8.3	8.2	7.6
EV/EBITDA	6.1	3.9	4.5	3.5	2.9
ROA	20.0%	29.2%	20.1%	20.3%	18.7%
ROE	33.8%	44.1%	27.6%	27.1%	24.1%

PRESCO Plc: Bumpy road ahead

Following lower than expected CPO prices as well as expectation of higher interest expense tailing ramp up in Presco's debt stock over the period we cut our FVE by 2% to **₦67.47** which retains our **BUY** rating on the stock. Presco trades at a FY 18E P/E of 9.2x relative to Okomu's 8.29x and Bloomberg MENA peers of 13.65x. At current price, our dividend expectation of ₦1.13 over FY 18E translates to a dividend yield of 2%.

- ***Price plunge prompts revenue slip:*** We expect an 8.3% YoY drop in revenue to ₦20.5 billion over FY 18E. This is largely driven by tamer refined CPO prices (FEWSNET: -15% YTD to ₦466,700/MT) which is in consonance with falling global CPO prices. However, in line with recent trend where cost pressures have been dissipating, we model a faster drop in input cost (17% YoY) to ₦4.9 billion with gross margin expanding +260bps YoY to 76% over 2018.
- ***Higher borrowings propel interest expense higher:*** So far this year, Presco's borrowings is up 149% to ₦9.9 billion from December 2017 levels as it continues its expansion drive into FY 18E. Accordingly we expect that this would translate to higher finance expense over FY 18E thereby, informing our upward review of Interest expense to ₦1.55 billion (+58.9% YoY). Based on the foregoing, interest coverage ratio is expected to trail five-year average of 7.91x to 5.87x over 2018E while Debt to Equity ratio is expected to spike to 12.6% over 2018E from 7% in FY 17.
- ***Catalysts:*** Further depreciation in the naira at the parallel market and uptrend in global CPO prices would drive CPO prices higher which is positive for Presco's revenue.
- ***Valuation:*** Overall, on the heels of tamer CPO prices and higher interest expense we now look for a 17.5% YoY decline in 2018E PBT to ₦9.03 billion (excluding biological gains). However, based on the recent depreciation in the share price of Presco (-22% YTD) our **FVE** of **₦67.47** translate to a 26% upside on the stock and hence, we have a **BUY** rating on the stock. Presco trades at a P/E of 9.2x relative to 8.29x for Okomu and 13.65x for Bloomberg MENA peers.

Summary of Results and Forecasts: PRESCO

ANNUAL

Income Statement (N'000)	2016A	2017A	2018E	2019F	2020F
Revenue	15,716,198	22,365,372	20,516,053	22,953,939	25,095,708
Cost of Goods Sold	4,404,785	5,941,308	4,923,853	5,853,255	5,897,491
Gross Profit	11,311,413	16,424,064	15,592,201	17,100,685	19,198,216
Operating Cost	4,398,081	7,501,666	5,215,181	5,727,008	6,273,927
Other operating income (loss)	118,489	213,358	205,161	642,710	702,680
Operating Profit	7,031,821	9,135,756	10,582,180	12,016,387	13,626,969
Net Interest expense	684,655	973,479	1,547,263	1,761,849	1,625,941
Pre-tax Profit	31,226,453	10,951,581	9,034,917	10,254,538	12,001,028
Tax	9,490,987	-14,452,033	2,891,173	3,281,452	3,840,329
PAT	21,735,466	25,403,614	6,143,744	6,973,086	8,160,699
Balance Sheet (N '000) *					
Fixed Assets	22,444,657	28,122,101	30,510,313	33,201,459	36,114,373
Inventory	1,420,597	4,704,706	1,772,587	2,107,172	2,123,097
Trade debtors	1,095,901	3,607,661	3,118,440	3,488,999	3,814,548
Cash & other bank balances	2,585,128	3,307,211	6,663,184	9,735,243	13,394,054
Total Assets	83,161,838	98,324,096	101,381,683	108,702,993	116,571,979
Liabilities					
Trade Creditors	1,699,761	7,428,137	3,692,890	4,389,941	4,423,118
Current Liabilities	5,607,551	12,974,500	6,165,291	6,902,482	6,974,883
Total liabilities	31,042,834	22,343,924	20,388,032	21,664,374	22,315,221
Shareholders' fund	83,161,836	98,324,096	101,381,683	108,702,993	116,571,979
Key Ratios					
Gross Margin	72%	73%	76%	75%	77%
EBIT Margin	45%	41%	52%	52%	54%
PBT Margin	199%	49%	44%	45%	48%
Net Margin	138%	114%	30%	30%	33%
EPS	21.7	25.4	6.1	7.0	8.2
P/E	12.49	3.03	9.2	8.1	6.9
EV/EBITDA	7.13	5.73	4.77	4.04	3.38
ROA	31.4%	28.0%	6.2%	6.6%	7.2%
ROE	41.7%	33.4%	7.6%	8.0%	8.7%

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	Minimize exposure to security taking cognizance of its index weighting
SELL	Sell-off security completely from portfolio
RESTRICTED	In certain circumstances, Asset & Resource Management ("ARM") Group policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of ARM Securities' and/or ARM Group's engagement in an investment banking transaction and in certain other circumstances.

Copyright © 2018 ARM Securities Limited (“ARMS”).

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

This material has been issued by ARM Securities Limited, a member of the Asset and Resource Management (“ARM”) Group, and a Company regulated by the Nigerian Securities & 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 ARMS and its analysts believe to be reliable. Neither ARMS 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 ARMS, 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 ARMS. By accepting this document, you agree to be bound by the foregoing limitations.