

Nigerian Palm Oil Sector - Waxing stronger under policy cover

Summary

- In contrast to the macro-induced sell-offs across the broad equities market in 2016, palm oil producers had a stellar year as the policy changes in response to the FX pressures handed the sector a lifeline. Specifically, CBN's proscription of FX access for palm oil imports changed sector dynamics as it provided a competitive edge in pricing for local producers over CPO importers. Accordingly, the sector reported stronger revenues and higher margins in the period which fueled the positive price performance over 2016 (vs NSEASI: -6%). In this report, we outline our views regarding the drivers of 2016 performance and set out our views ahead of FY 16E earnings releases.
- CPO Prices ascend as importers exit the supply picture:** In the aftermath of CBN policy pronouncement regarding CPO imports, domestic prices surged 144% over 2016 to ₦661.4/kg as importers who account for 29% of local supply cutback on imports.
- Upward price movement inflates sector margins:** Whilst the upsurge in CPO prices drove sector revenue to a record high of ₦22.8 billion, its impact was more pronounced on operating margin (+12pps YoY to 53%) as the largely domestic sourcing of raw materials and labour kept cost (COGS and OPEX) in check.

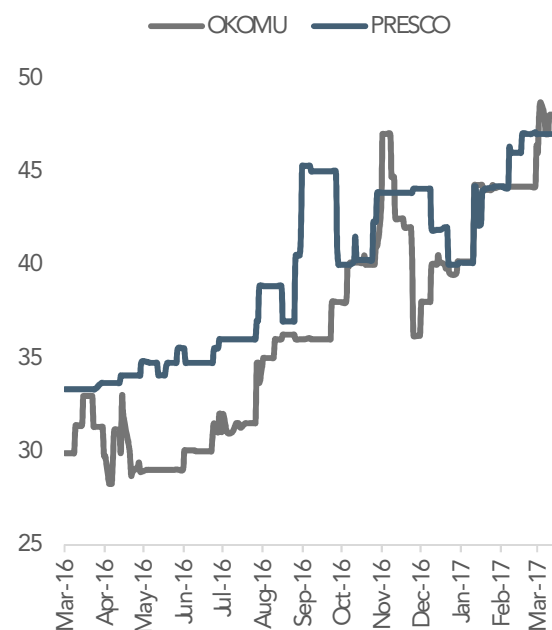
Income Statement Data

	2016-9M	2015-9M	%chg
Revenue	22,849	15,795	45%
PBT	10,415	5,060	106%
PAT	6,567	3,408	93%

Sector Margins

	2016-9M	2015-9M	chg
Gross	82%	74%	7pps
EBIT	53%	41%	12pps
PBT	46%	32%	14pps
PAT	29%	22%	7pps

Sector price performance



Analyst(s)

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- **Low cost financing help moderate FX losses:** Another positive policy handout for the sector was CBN's renewed supply of concessionary loans, which given already weak naira outlook drove coverage companies to change the currency character of their debt. FCY borrowings as a share of total debt shrank 5pps YoY to 13.8% while total borrowing cost contracted 7% YoY over the review period.
- **Conservative on dividend payout despite record high earnings:** Overall, reflecting robust top-line gains and financial efficiency, we estimate that core earnings¹ should climb 108% YoY to a record high of ₦8.1 billion in FY 16. That said, despite our strong view on earnings, we expect dividend payout ratio to come below trend levels as management of coverage companies guides to capacity expansion plans from retained earnings. We project Presco's 2016E DPS of ₦2.02 to be higher than that of its domestic peer, Okomu (₦1.77).
- **Sector players remain cheap:** Notwithstanding strong YTD price performance, we believe current pricing is yet to fully reflect the stellar earnings performance reported so far, but more importantly, the robust earnings outlook. Particularly, at 9.1x, the sector's mean P/E remains cheap relative to trend (3 year: 11.4x, 5 year: 11.3x) and Bloomberg Africa peers (10.1x). Across our coverage, we prefer Presco due to its larger oil palm plantation (2015 mature area hectares of 10,949 vs. 8,671 for Okomu) and homogenous product mix, which makes it a greater beneficiary of improved conditions in the domestic CPO market. Accordingly, our FVE embodies a 46% upside from current pricing for Presco (₦68.84) relative to 40% for Okomu (₦67.43) and we have a **BUY** rating for both companies.

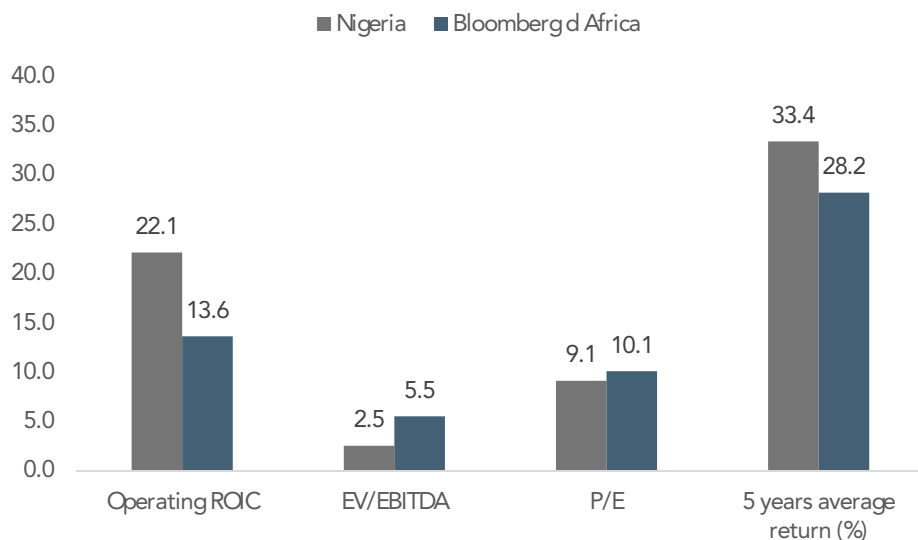
Table 1: Valuation Changes

Company name	Current price (₦)	Old FVE (₦)	New FVE (₦)	Upside	Rating
Okomu	48.00	49.78	67.43	40%	BUY
Presco	47.00	48.70	68.84	46%	BUY

Source: ARM Research

¹ PAT less gains from biological asset

Figure 1: Nigeria vs Bloomberg African peer ratios



Source: Company financials, ARM Research

Table 2: Relative valuations with EM peers

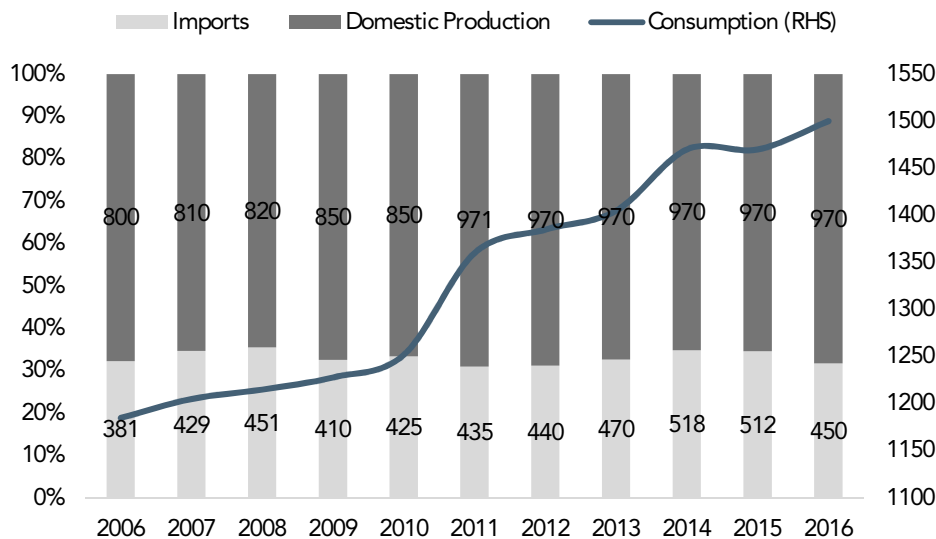
	Country	Mkt Cap (\$ million)	2017 P/E	Debt to Equity (%)	EV/mature hectares
KUALA LUMPUR KEPONG BHD	MALAYSIA	5,942.21	20.93	41.48	36,171
GOLDEN AGRI-RESOURCES LTD	SINGAPORE	3,499.81	16.73	74.86	13,407
FIRST RESOURCES LTD	SINGAPORE	2,210.62	13.73	48.35	16,366
ASTRA AGRO LESTARI TBK PT	INDONESIA	2,200.92	15.22	23.31	N/A
UNITED PLANTATIONS BHD	MALAYSIA	1,325.19	N/A	0	30,738
SAWIT SUMBERMAS SARANA	INDONESIA	1,039.21	17.56	98.58	24,556
BUMITAMA AGRI LTD	INDONESIA	1,001.48	10.91	64.72	15,493
IJM PLANTATIONS BHD	MALAYSIA	629.06	19.41	53.25	15,622
BOUSTEAD PLANTATIONS BHD	MALAYSIA	594.93	31.96	40.69	N/A
HAP SENG PLANTATIONS HLDGS	MALAYSIA	472.16	15.14	-	13,445
SARAWAK OIL PALMS BERHAD	MALAYSIA	464.21	13.65	60.23	9,615
SAMPOERNA AGRO TBK PT	INDONESIA	282.73	13.1	106.13	N/A
EM Average		1,638.54	17.12	50.97	19,490
PRESCO	NIGERIA	148.03	5.09	18.81	14,559
OKOMU	NIGERIA	144.21	4.87	5.82	16,192
Nigerian Average		146.12	4.98	12.32	15,375

Source: Bloomberg; ARM Research

Local CPO Prices ascend as importers exit the supply picture

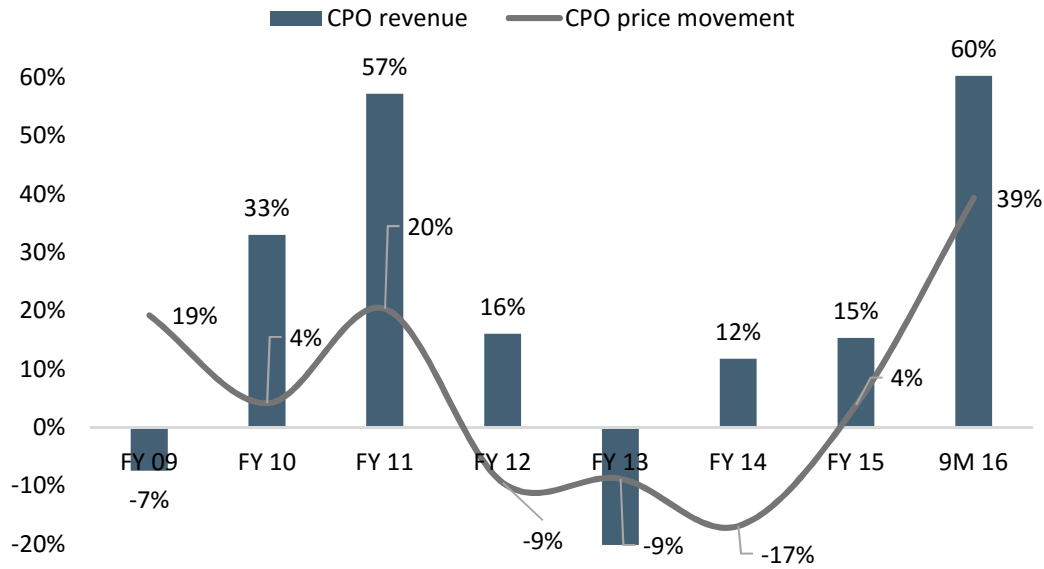
- In response to the decline in FX reserves, following the collapse in crude oil prices, the CBN resorted to demand management by directly targeting selected imports with a list of 41 items exempted from the interbank FX market. Given the inclusion of Crude Palm Oil (CPO) in the list of banned items, the wider NGN depreciation at the parallel market and, to a lesser extent, recovery in global CPO prices deterred importers as cost of imports surged 73% YoY by our estimates. Given the mismatch between domestic CPO production (2016: 970KMT) and consumption (2016: 1470KMT), the pullback in CPO imports as importation costs tracked higher underpinned a steep rise in domestic CPO prices over 2016 (9M: +39% YoY, FY 16: +69% YoY). Unsurprisingly, reflecting the favourable pricing regime and modest volume growth (+8% YoY by our estimate), which stemmed from improved yields on matured plantation, CPO sales of publicly listed palm oil companies surged 50% YoY. The robust CPO turnover more than offset weakness in Rubber sales (-7% YoY) to drive overall top-line to a record high of ₦22.8 billion. Management of Okomu linked the lower rubber sales to decline in global prices as well as weaker production.

Figure 2: Trends in CPO demand and supply in Nigeria (KMT)



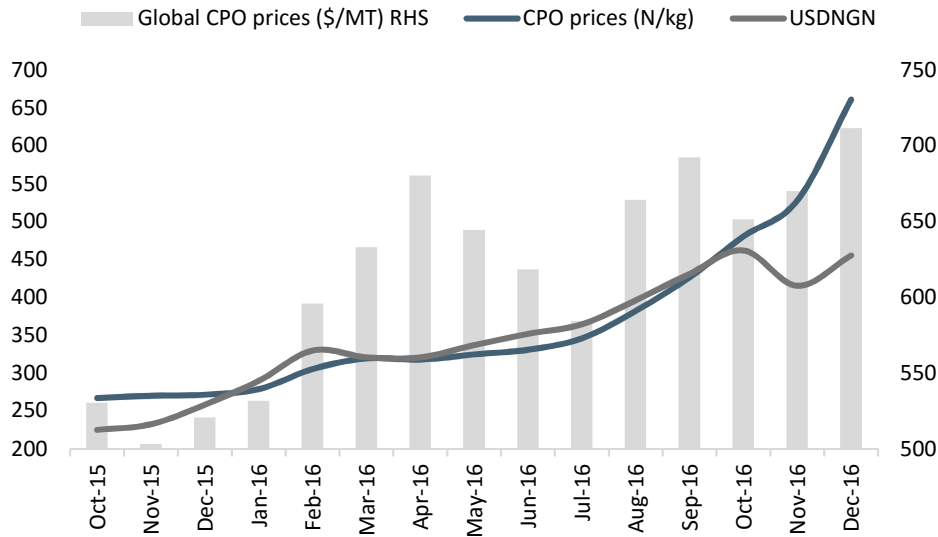
Source: USDA, ARM Research

Figure 3: Palm oil sector revenue growth (YoY)



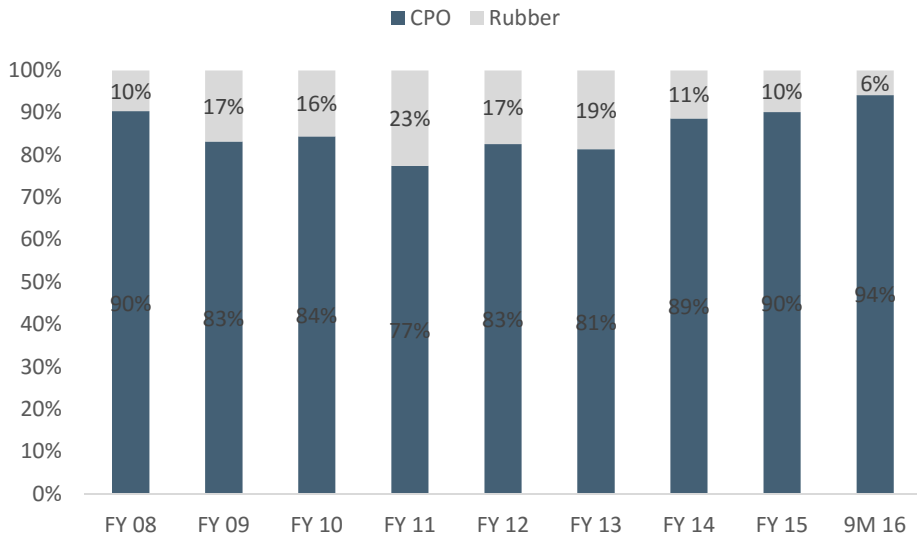
Source: Companies financials, ARM Research

Figure 4: Trend in parallel market exchange rate and domestic CPO prices



Source: FEWSNET, ARM Research

Figure 5: Revenue breakdown

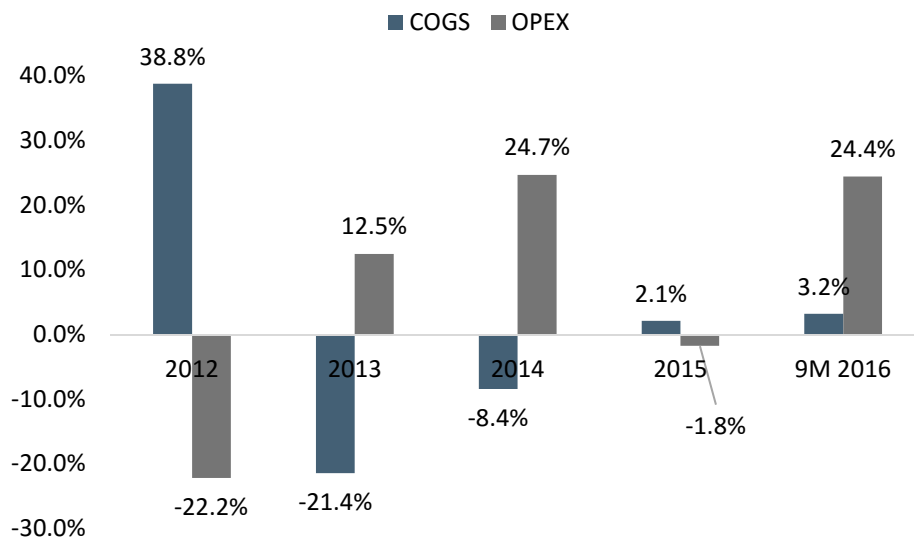


Source: Companies financials, ARM Research

Positive for sector margins

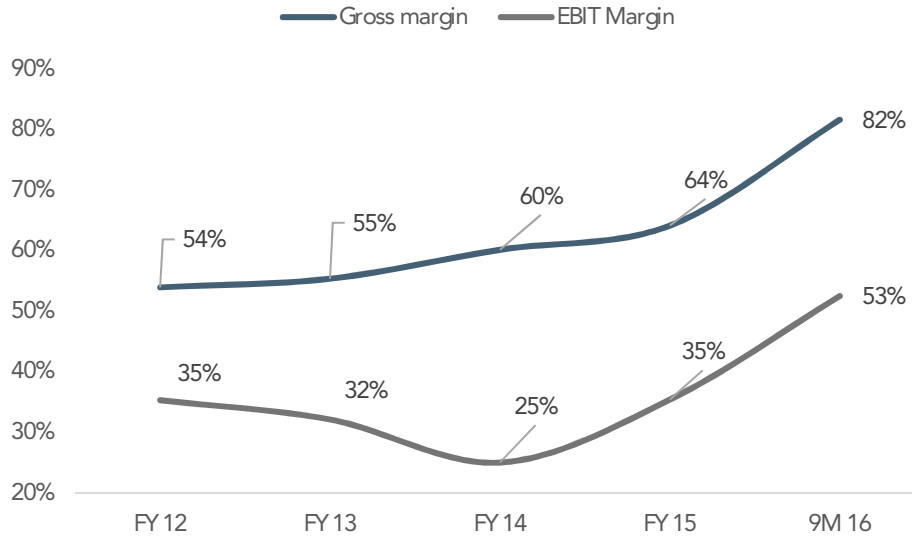
- Interestingly, impact of higher CPO prices was more pronounced on operating margin of the sub-sector (+12pps YoY) as the largely domestic sourcing of raw materials and labour underpinned subdued movement in both COGS and operating cost.

Figure 6: YoY growth in COGS and OPEX



Source: Companies financials, ARM Research

Figure 7: Trend in Gross and EBIT margins

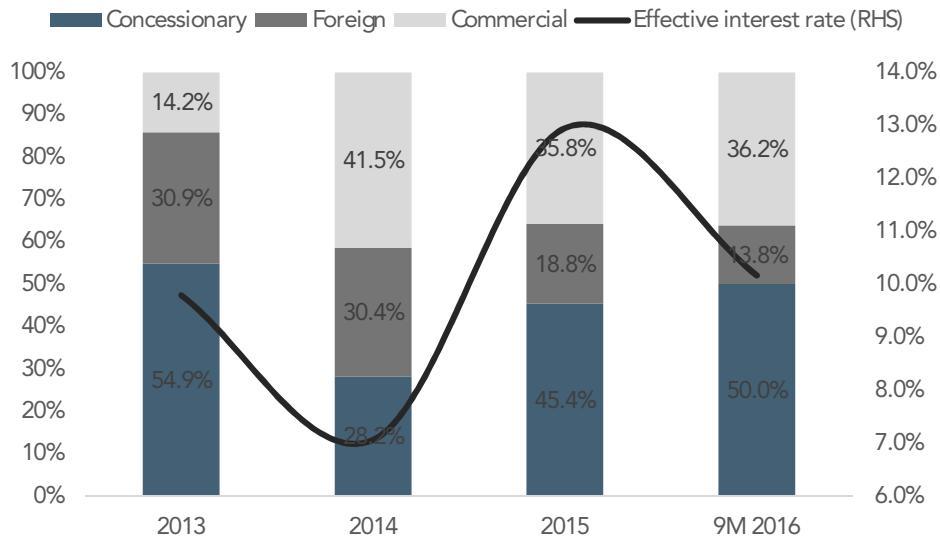


Source: Companies financials, ARM Research

Low cost financing helps moderate FX losses

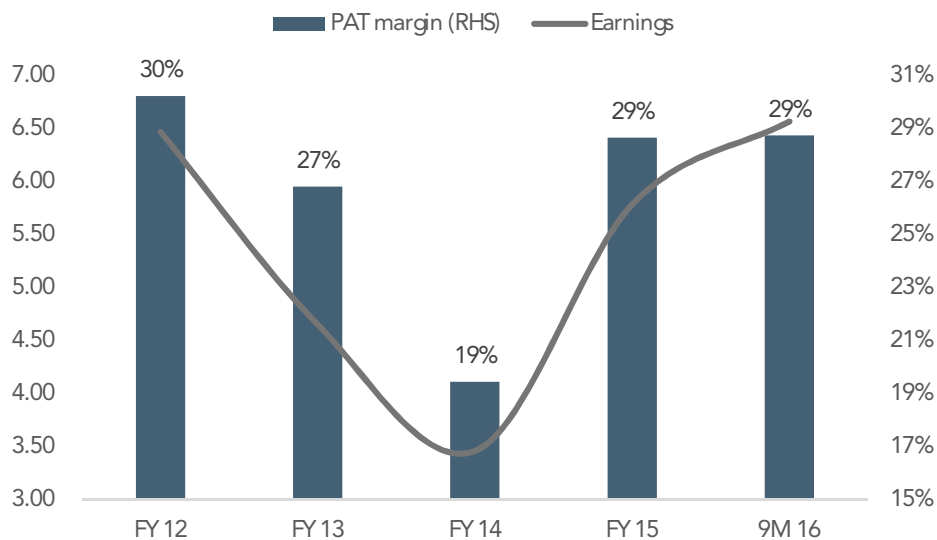
- Given the elevated interest rate in the domestic environment as well as the long lead time required for CPO seedlings to develop into matured products (3-5 years), coverage companies had resorted to foreign borrowings from their parent companies to finance their expansion plans. However, owing to the weak naira outlook and more importantly availability of increased concessionary loans from the CBN, palm oil producers intensified the refinancing of their external debt, with foreign debt now constituting only 14% of total borrowings from 30% in 2014. Hence, despite a 55% NGN depreciation over the year, effective interest rate fell 94bps YoY to 10.2% translating to a 7% YoY decline in the borrowing costs. The foregoing combined with robust top-line gains underpinned sector's core earnings increase by 93% YoY to ₦6.6 billion with earnings margin expanding 7.2pps YoY to a record high of 28.7%

Figure 8: Breakdown of debt profile



Source: Companies financials, ARM Research

Figure 9: Trend in earnings and earnings margin



Source: Companies financials, ARM Research

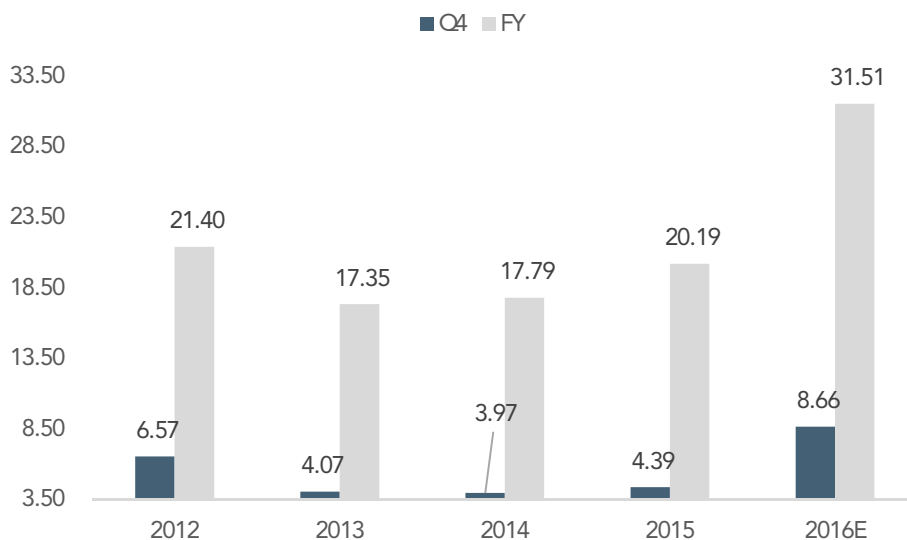
- Overall, despite the generally dour macro environment, systematic changes which inhibited competition as well as access to cheap financing bolstered the sector's operating performance. Particularly, gains from higher product pricing, domestic sourcing of inputs, which limited losses from currency weakness, as well as cost containment impelled earnings. Accordingly, over 9M 16, our coverage CPO companies delivered 93% earnings growth with PAT margin up 7pps YoY to 29%. The

improved earnings underpinned the strong performance of the share price of coverage companies.

Higher CPO prices to propel strong finish to 2016

- Over the final quarter of 2016, domestic CPO prices surged a further 45% QoQ bringing average CPO price for the review period to ₦557/kg (+106% YoY). Furthermore, global rubber prices rebounded over Q4 16 (+53% YoY) following cartel like cuts by leading rubber exporters. Inputting the Q4 prices in our models, we project 97% YoY rise in sector revenues to N8.7 billion which brings FY 16 sales to ₦31.5billion (+56% YoY).

Figure 10: Palm Oil sector’s revenue growth (N’ billions)



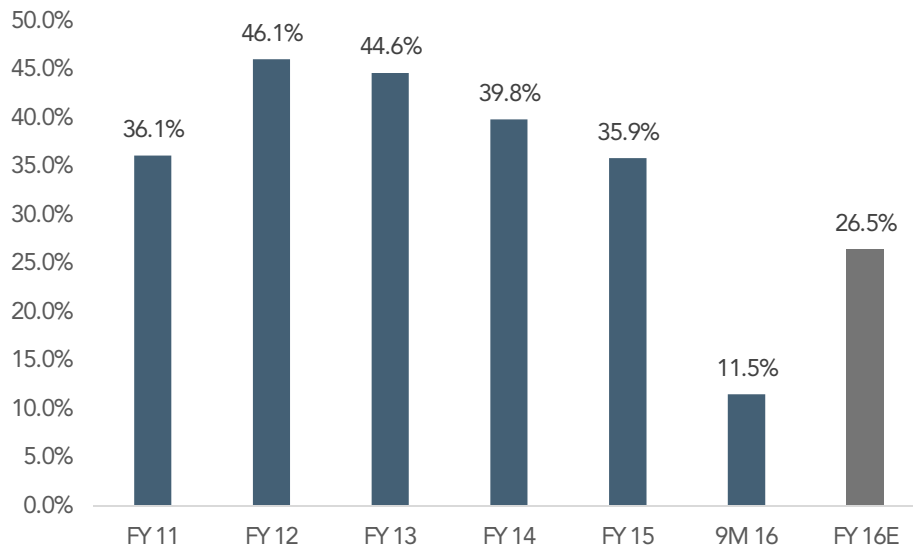
Source: Companies financials, ARM Research

- Having tracked below trend levels over the first nine months of 2016 as management across Presco and Okomu deferred clearing activities to Q4 16 on greater than expected rainfall (9M 16: +20% YoY), we believe the dry season of Q4 would underpin elevated input cost in the period, which we forecast at ₦4.3 billion (+30.7% YoY). Similar sentiments surround our higher OPEX estimate for Q4 16² which we estimate at ₦2.0

² Presco’s OPEX is projected to rise only 16% YoY.

billion (+110% YoY). The weighty YoY growth largely reflects sizable jump in Okomu where over accruals of OPEX over 9M 15 resulted in the company reporting an operating income of ₦436 million in the final quarter of 2015.

Figure 11: COGS to Sales ratio

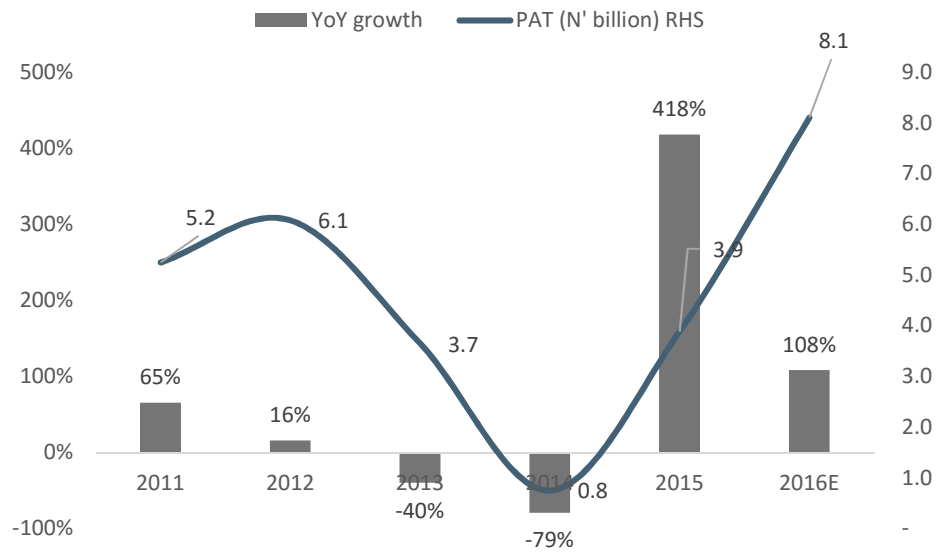


Source: Companies financials, ARM Research

- Largely reflecting the sturdy revenue gains, Q4 16 core earnings should rise over three-fold YoY to ₦1.7 billion. Overall, 2016 bottom-line is projected to come in at a record high of ₦8.1 billion³ (+108% YoY).

³ This Excludes Presco's projected biological asset gains of ₦4.9 billion (9M 16: ₦4.4 billion). Including the biological asset gains, FY 16 sector's earnings should rise 171% YoY to ₦13.4 billion.

Figure 12: Trend in Palm-oil sector's earnings



Source: Companies' financials, ARM Research

OKOMU OIL PALM PLC: Price action pumps up earnings

- **CPO price increase to drive strong 2016 sales close:** 2016 has been a spectacular year for Okomu, with 9M 16 EPS already surpassing that of FY 15. The improved operating performance largely stemmed from higher CPO prices which drove overall revenue growth (+41% YoY), despite a 7% YoY cutback in rubber sales reflecting softer global prices and lower production. Over the last quarter of 2016, management noted a recovery in rubber prices and subsisting momentum in CPO prices. Consequently, we look for topline growth of 112% YoY as guiding to a strong Q4 16 and by extension FY 16E revenues of ₦15.1billion (+55% YoY).
 - **Lower finance costs to mask higher OPEX over Q4 16:** Following the scale down in foreign debt and increased drawdown of CBN single digit financing, Okomu reported 27% YoY cutback in net finance charges over 9M 16 to ₦228million. In our view, this pattern should continue over Q4 16 and should help mask impact of higher cultivation activities on cost lines (COGS and OPEX) over the last quarter. Particularly, management noted that labour constitutes the biggest chunk of cost, with the wage bill over 2016 negotiated only 5% higher despite inflationary pressures.
 - **Mounting capex outlay to keep a lid on dividend pay-out:** On balance, we think the higher pricing and benign finance costs should drive Q4 earnings 51% higher YoY, raising 2016E EPS to ₦5.05 (+83% YoY). That said, while Okomu's record profit raises prospects of a return to bumper pay-out as in 2011-12, management guides towards using retained earnings to finance expansion plans which hints at a likely cut in pay-out ratio from trend mean levels (six-year average: 42%). Consequently, assuming a pay-out ratio of 35% (FY 15: 4%), we project FY 16E DPS at ₦1.77 which implies dividend yield of 3.7% on current pricing.
 - **Catalysts:** The subsisting FX ban on imported CPO at the interbank market leaves importers subjected to the vagaries at the parallel market. Hence in a situation where naira weaken further or global CPO prices resume a bullish trend, importers could be further deterred with cutback in domestic supply driving CPO prices higher. In addition to a potential currency weakness, bullish trend in global prices could see rubber turnover significantly higher than 2016 irrespective of the continued decline in production.
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- **Valuation:** Largely reflecting upswing in CPO prices, we revise our FVE for Okomu to **₦67.37** (vs. ~~₦49.78~~ previously), which implies a 40% upside from current pricing. Okomu trades at a current P/E of 9.95x (2016E: 9.50x) relative to 10.1x for Bloomberg African peers. We upgrade our rating on the stock to **BUY** (vs. NEUTRAL in previous communication).
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Summary of Results and Forecasts – Okomu Oil Palm Plc

QUARTERLY

Income Statement (N' million)*	Q1 2016A	Q2 2016A	Q3 2016A	Q4 2016E
Turnover	3,310	4,235	3,367	4,211
COGS	140	510	608	2,577
Gross Profit	3,170	3,725	2,759	1,635
Operating Costs	1,499	1,361	1,458	849
Operating Profit	1,672	2,363	1,301	869
Net Finance costs	53	73	102	76
Profit Before Taxation	1,619	2,290	1,200	793
Taxation	39	275	619	151
Profit After Taxation	1,580	2,015	581	642

ANNUAL

Income Statement (N' million)*	FY 2015A	FY 2016E	FY 2017F	FY 2018F	FY 2019F
Revenue	9,738	15,123	28,249	30,104	33,327
COGS	3,425	3,834	7,910	8,730	9,998
Gross Profit	6,313	11,289	20,339	21,374	23,329
Operating Cost	3,221	5,167	9,040	9,332	11,331
Operating Profit	3,278	6,205	11,864	12,794	12,831
Interest income	429	563	406	274	64
Interest expense	43	259	160	165	311
PBT	2,899	5,902	11,618	12,685	13,078
Tax	268	1,084	2,207	2,537	2,746
PAT	2,631	4,818	9,411	10,148	10,332

Balance Sheet (N' million)*					
Assets					
Fixed Assets	9,849	12,493	15,856	19,261	26,911
Biological Assets	7,396	7,544	7,695	7,849	8,006
Stocks	1,491	1,687	3,085	3,317	3,699
Trade debtors	359	667	1,977	2,408	2,666
Cash and other bank balances	958	2,243	4,376	8,077	7,692
Total Assets	20,053	24,634	32,989	40,912	48,975
Liabilities					
Trade Creditors	889	997	1,898	2,008	2,200
Non-current Liabilities	5,473	4,627	3,611	3,306	3,428
Total liabilities	7,989	6,911	6,796	6,601	6,915
Shareholders' fund	12,064	17,723	26,193	34,311	42,060

Key Ratios	FY 2015A	FY 2016E	FY 2017F	FY 2018F	FY 2019F
EPS	2.76	5.05	9.87	10.64	10.83
P/E	9.95	9.50	4.87	4.51	4.43
P/B	2.40	1.63	1.10	0.84	0.69
EV/EBITDA	7.16	3.30	2.02	1.57	1.57
ROA	13.1%	19.6%	28.5%	24.8%	21.1%
ROE	21.8%	27.2%	35.9%	29.6%	24.6%
Debt/Equity	30.9%	14.3%	5.8%	3.6%	3.2%
Gross Margin	64.8%	74.6%	72.0%	71.0%	70.0%
EBIT Margin	33.7%	41.0%	42.0%	42.5%	38.5%
PBT Margin	29.8%	39.0%	41.1%	42.1%	39.2%
PAT Margin	27.0%	31.9%	33.3%	33.7%	31.0%
Interest coverage	7.64	11.02	29.20	46.65	200.49

Source: ARM Research

PRESCO PLC: Producing palm-oil with glamour

- **CPO price boon drives top-line to record high:** Presco, as the only integrated oil palm production company in Nigeria⁴ benefitted immensely from favourable pricing environment which underpinned a strong rise in both top-line and earnings. Importantly, Presco's 9M 16 sales of ₦11.9 billion (+48.4% YoY) eclipsed previous sales peak of ₦11.3 billion in FY 12, buoyed by higher CPO prices and to a lesser extent modest volume growth, which we estimate rose 7% YoY. Given upward local price movement in Q4 16 (+106% YoY), we estimate Q4 revenue at ₦4.5 billion (+85.1% YoY) which brings FY 16E sales to ₦16.4 billion (+57% higher than historical average).
- **Subdued cost movement buoys operating profit:** In addition to the robust turnover, costs rose tamely over the period (9M 16: COGS: +3.4% YoY, OPEX: +37.8% YoY) reflecting economies of scale and deferral of cultivation activities to Q4 16. Consequently, operating profit blossomed, rising nearly two-fold (+86.5% YoY) with related margin expanding 11.4pps YoY to 55.8%. Ahead of the Q4 16 results, whilst operating margin should remain robust relative to trend level (31%), we expect upsurge in input cost (+62% YoY) to apply downward pressure, against the backdrop of increased clearing activities related to the dry season. Overall, we project an EBIT margin of 39.8% over Q4 16, bringing full year operating margin to 52% (+14.5pps YoY).
- **Higher Biological asset gains propels earnings:** Another catalyst to Presco's result is the upsurge in biological asset gains (+98% YoY to ₦4.4 billion) reflecting impact of higher CPO prices as well as improved yields on the company's biological asset. This together with lesser finance charges (-27% YoY to N423 million) helped offset losses on foreign exchange translation (+92% YoY to ₦967 million). Having repaid all its outstanding external debt, the FX loss stemmed from dollar financing for the purchase of chemicals and fertilizers, equipment, and spare parts, all which according to management contributes 20% of its entire cost. Consequently, earnings surged 98% YoY to a record high of ₦6.8 billion. Excluding the biological asset gains, PAT would have been 99% higher at ₦2.4 billion. Given flat movement in FX rate over Q4 16, which portends lower FX loss, as well as higher CPO prices which bodes well for biological asset gains, we project the final quarter's bottom-line to print at ₦1.1 billion (Q4 15 loss after tax of ₦1.1 billion) bringing full year earnings

⁴ have operations across the entire value chain

at ₦7.9 billion (+239% YoY, 2016E core earnings: +161% YoY to ₦3.3). We forecast DPS to rise 102% YoY to ₦2.02 using a four-year average dividend payout of 25%.

- **Catalysts:** Bullish trend in global crude palm oil prices as well as further naira weakness could see local crude palm oil prices resume its upswing. This together with increased access to concessionary borrowings from the CBN, which would result in the abandonment of expensive commercial loans could bolster earnings.
 - **Valuation:** Presco is trading at a current P/E of 8.27x (19.21x excluding gains from biological asset) vs. 10.1 for its Bloomberg Africa peers. Net impact of adjustments to our model result in upward adjustment in our FVE to **₦68.84** for the stock from N48.70 previously. Consequently, we upgrade our rating on the stock to **BUY** (vs. NEUTRAL in previous communication).
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Summary of Results and Forecasts – Presco Plc

QUARTERLY

Income Statement (£'million)*	Q1 2016A	Q2 2016A	Q3 2016A	Q4 2016E
Turnover	3,181	4,337	4,419	4,450
COGS	1,178	1,580	188	1,560
Gross Profit	2,004	2,757	4,231	2,890
Operating Costs	477	404	1,527	1,165
Operating Profit	1,763	2,742	2,157	1,770
Net Finance costs	202	101	119	125
Profit Before Taxation	1,544	2,582	5,588	1,789
Taxation	398	716	1800	715
Profit After Taxation	3,181	4,337	4,419	4,450

ANNUAL

Income Statement (£'million)*	FY 2015A	FY 2016E	FY 2017F	FY 2018F	FY 2019F
Revenue	10,448	16,388	28,737	31,825	35,357
COGS	3,813	4,506	7,759	9,548	11,314
Gross Profit	6,635	11,882	20,978	22,278	24,043
Operating Cost	3,140	3,572	6,063	7,320	8,274
Operating Profit	3,860	8,433	15,202	15,276	16,123
Interest income	708	548	724	802	883
PBT	4,215	11,503	14,886	15,536	16,302
Tax	1,894	3,630	5,657	5,593	5,543
PAT	2,321	7,873	9,229	9,943	10,759
Balance Sheet (£'million)*					
Assets					
Fixed Assets	12,962	15,499	19,360	23,537	28,093
Biological Assets	36,319	40,084	43,532	46,923	50,402
Stocks	1,106	1,307	2,716	3,914	5,205
Trade debtors	2,986	4,682	7,472	7,638	7,779
cash	669	(1,710)	(4,168)	(5,228)	(5,969)
Total Asset	55,478	61,299	70,347	78,220	86,946
Liabilities					
Trade Creditors	3,357	3,967	6,905	8,593	10,296
ST borrowings	2,042	2,227	2,355	2,439	2,486
Long Term Liabilities	18,656	19,367	19,993	20,411	21,236
Total liabilities	25,083	26,698	30,495	32,710	35,314
Shareholders' fund	30,395	34,601	39,852	45,510	51,632
Key Ratios					
EPS	2.32	7.87	9.23	9.94	10.76
P/E	20.25	5.97	5.09	4.73	4.37
P/B	1.55	1.36	1.18	1.03	0.91
EV/EBITDA	10.68	5.44	3.39	3.37	3.20
ROE	8%	23%	23%	22%	21%
ROA	4%	13%	14%	13%	13%
Debt/Equity	15%	20%	19%	17%	17%
Gross Margin	64%	73%	73%	70%	68%
EBIT Margin	37%	51%	53%	48%	46%
PBT Margin	40%	70%	52%	49%	46%
PAT Margin	22%	48%	32%	31%	30%
Interest Coverage	5.45	15.38	21.01	19.05	18.26

Source: Company financials, ARM Research

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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