

UAC Nigeria Plc. (UACN.NL)

Rating	BUY
Price	₦6.50
FVE	₦8.96
52-week range	₦4.30- ₦12.00
Market Cap. (₦bn)	18,728
1-month Avg. Vol	1,694,485
Curr. PB	6.96x

UACN.NL – Share Price Trend



Analyst(s)

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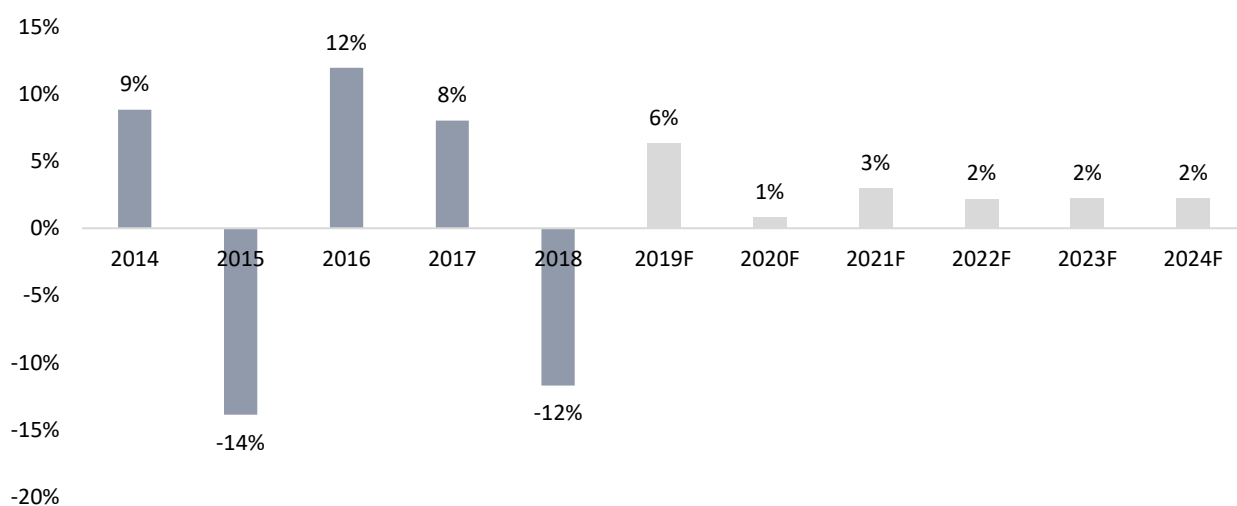
Stock Report

Old things have passed away...

- In this report, we resume coverage on UACN with a target price of ₦8.96 which translates to a BUY rating at current price. While UACN's history of reporting poor operating performance dulled investor's sentiment, we believe lower finance cost and little or no impairment charge in coming years, post exit from UPDC, supports a rerating. Coupled with recovery in the feeds business, we see improvement in earnings over our forecast period. Comparing 5-year historical average EV/EBITDA of 9.9x, to current level of 3.3x, UACN presents a good entry point on current valuation. At current price and based on our FY 19E dividend of ₦0.65, we view expected dividend yield of 10.6% as attractive and could be compelling to investors.***
- Restructuring exercise is positive for UACN.*** Ahead of the planned restructuring of UACN (which would involve UACN's outright dissolution of its interest in UPDC directly to its shareholders), UPDC was classified as a discontinued operation as at 9M 19 unaudited numbers. Accordingly, related finance cost and impairment charges (through the fair value difference between UPDC REIT and market value) were classified as discontinued operation, leaving UACN 9M 19 numbers at the strongest level we modelled post restructuring. With the exclusion of UPDC from 9M numbers and restatement of prior year, UACN delivered EBIT and PBT expansion of 175bps and 150bps YoY respectively, with EPS growing 30% YoY. Notably, without the exclusion of UPDC and restatement of the prior year, UACN would have reported a loss after tax of ₦12.8 billion (9M 18 loss of ₦994 million). With the exclusion of the volatility emanating from impairment charge on the real estate property and higher finance expense (UPDC account for 80% to 90% of total UACN borrowings) we expect stable growth in earnings over our forecast period, with EPS CAGR of 12.4% between 2020 and 2024.
- Recovery in feeds business to soften OPEX pressure.*** Our market survey revealed that OLAM and UACN's feed products now sell at similar price points, as OLAM steps down its aggressive pricing strategy. As a result, we see improvement in sales from feeds with contribution to group revenue gradually picking up to pre-2018 levels. In the short term, we believe the extended border closure creates some incentive for sales upside for local poultry products and by extension the feeds business.

- Value play or value trap?** With the recovery in sale of feeds already evident in the 9M 19 numbers, amidst flattened cost, we expect improvement in gross and operating margins by 117bps and 116bps YoY to 19% and 3.9% respectively in 2019. Though the management guided to an improvement in its operating expense, we are less optimistic of a significant change as the company has only been able to tame the cost and not reduce it as at 9M 19. On that note, we left opex to sales ratio unchanged at 15% till 2020 and gradual improvement from 2021 with mild improvement in operating margin to 4.1% in 2020 and average of 7% over FY21-24. Further down, with reduced finance cost and absence of impairment charge, following the reclassification of UPDC as discontinued operation, we expect earnings from continued operation to print at ₹1.35 in 2020 (₹1.32 in FY 19E from a loss per share of ₹2.08 recorded in the prior year) with 5-year earnings CAGR of 12.4% between 2020 and 2024. At current market price, UACN trades at 2019E and 2020E EV/EBITDA of 3.12x and 3.01x respectively, which is attractive when compared to 5-year historical average of 9.9x.
- We expect recovery in animal feeds business.** Following the entrance of OLAM into the feeds business in late 2017 with 720,000 metric tonnes annual capacity, which is equivalent to the combined capacity of the two top players (Livestock and Premier feeds), competition in the feeds landscape strengthened. From our engagement with stakeholders, we understand that OLAM flooded the market in 2018 with low-priced animal feeds, causing a market saturation and disruption to UACN's market share. Given that the feeds business accounts for 60% of the food and beverages (which is almost 80% of UACN's revenue), loss of market share in the feeds business amidst stable input cost left gross margin low at c.17%. Our market survey revealed that OLAM retracted from its low pricing strategy earlier in 2019, raising its price to the industry average price point. Accordingly, we saw a recovery in UACN's market share with revenue over 9M 19 expanding by 10.8% YoY with FY 19E of 10%. Farther out, while we see little or no change to pricing in the feeds segment, we believe the recovery in feeds business will support sales in the food and beverage segment with overall group revenue expanding modestly over 2020, with a CAGR of 2.5% (vs 2014 – 2018 CAGR: -2.1%) between FY 20 and 24. **On a short-term basis, we see some upside from the recent border closure and a lengthened period of the closure could further support revenue.**

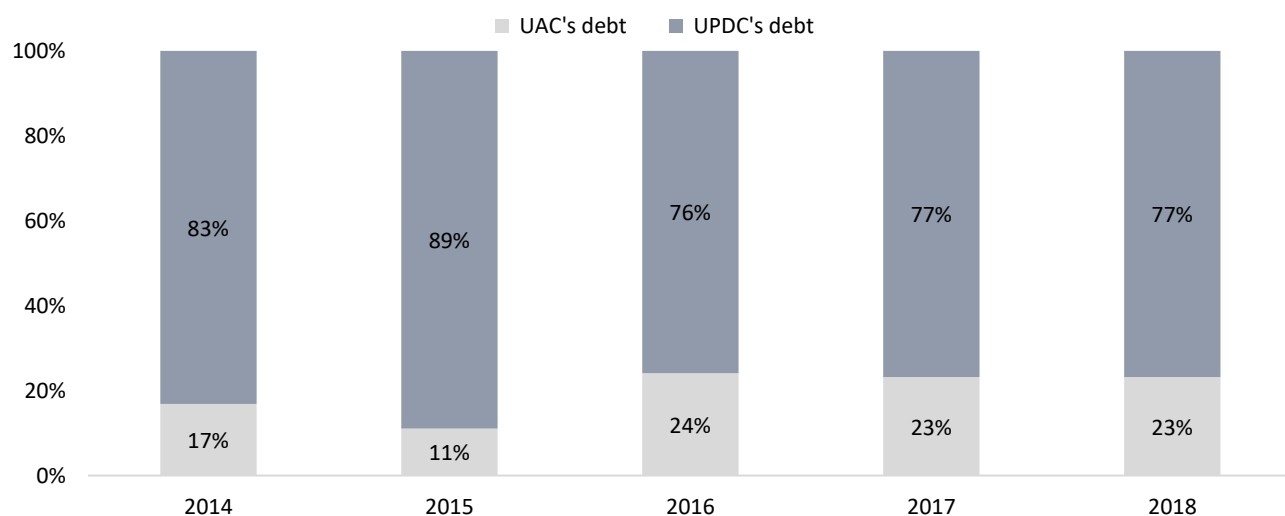
Figure 1: Historical and Forecast UACN YoY Revenue growth



Source: Company financials, ARM Research

- UPDC was a key drag on UACN's performance.** UACN and UPDC jointly announced a restructuring & recapitalization exercise recently (**See report: [Restructuring exercise: Are UACN or UPDC shareholders better-off?](#)**), with the endgame of unbundling UPDC from the parent company (UACN). To track back, apart from the poor operating performance of the holding company (UACN), elevated borrowing costs and impairment charge from its real estate business have also been a drag on UACN's financial performance. For context, 80% of the debt reported on UACN's balance sheets belongs to UPDC. Over the last 5 years (2014 -2018), UACN has paid out a total of ₦20 billion in finance cost, which translates to 63% of the sum of its total operating income (EBIT) over similar period. UACN also booked significant impairment charge, totalling ₦13 billion between 2014 and 2018, due to the declines in property value and unrecoverable receivables of UPDC. This duo fuelled consistent decline in earnings with the holding company reporting a loss in 2018.
- Ahead of the planned restructuring of UACN, UPDC was classified as a discontinued operation as at 9M 19 unaudited numbers. Accordingly, related finance cost and impairment charges (through the fair value difference between UPDC REIT and market value) were classified as discontinued operation, leaving UACN 9M 19 numbers at the strongest level we modelled post restructuring. With the exclusion of UPDC from 9M numbers and restatement of prior year, UACN delivered EBIT and PBT expansion of 175bps and 150bps YoY respectively, with EPS growing 30% YoY. Notably, without the exclusion of UPDC and restatement of the prior year, UACN would have reported a loss after tax of ₦12.8 billion (9M 18 loss of ₦994 million), largely reflecting loss from UPDC reported loss after tax of ₦17.6 billion, due to impairment charge of ₦12.6 billion (which accounts for difference between UPDC REIT's carrying value and market value), UPDC fair value adjustment loss of ₦3.1 billion and finance cost of ₦2.2 billion. With the exclusion of the volatility emanating from impairment charge on the real estate property and higher finance expense, we expect stable growth in earnings over our forecast period, with EPS CAGR of 12.4% between 2020 and 2024.

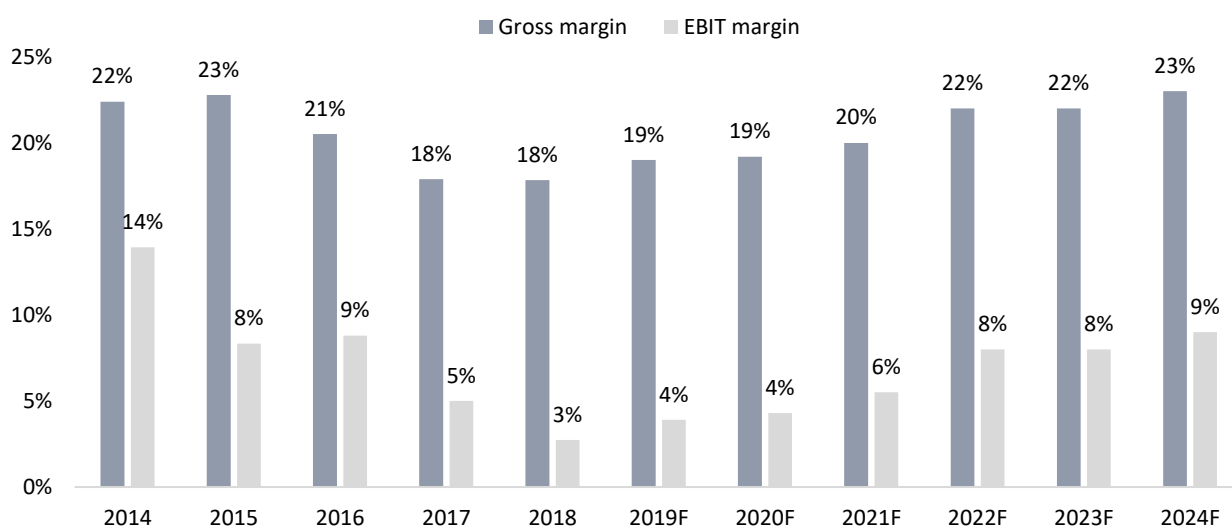
Figure 2: Breakdown of UAC's debt position



Source: Company financials, ARM Research

- Paints and Logistics business will continue to deliver strong margins.** Of all the subsidiaries within the UAC group, the paints segment (which comprises of CAP and Portland paints) is most profitable segment, delivering average net profit margin of 26% over the last five years. Contribution of paints business to group revenue has steadily increased over the last ten years, save for 2016 where sales of its marine & industrial paints dipped due to the challenges in the oil and gas sector. More importantly, its strong gross margins at an average of 48% for CAP and 38% for Portland paints as at FY 18 amidst negligible leverage have helped in supporting group earnings. Given that we see little risk in the oil and gas sector over the near to medium term, we expect the paints segment to continue to deliver strong margins for the group. On that backdrop we expect revenue to grow on average by 3.5% over our forecast horizon and contribution to group revenue remaining constant at 13%. We also expect the little or no leverage model to persist which would give further support to earnings.
- Despite the reduction of its stake in MDS logistics to 43%, we expect the business to continue to deliver strong contribution to PBT over our forecast period as the market for logistics business seems wide, coupled with the low leverage model. Beyond the contribution to earnings, following the reduction in stake in MDS logistics by 8%, UACN is expected to record gain on sale of ₦572 million in FY 19.
- A lid on OPEX would support margins.** Owing to unimpressive sales growth (5-year CAGR of -2.1%) amidst elevated cost, gross margin has remained on a consistent downtrend over the last five years. More disappointing is the elevated operating expense (precisely Admin.) with average growth rate of 13% YoY over the last five years. During our recent discussion with management, one of the strategies highlighted is improved operating efficiency. For us, we are less optimistic of a decline in operating cost, however, we believe the company might be successful in leaving it at current levels (OPEX to sales of 15%) till 2020 and gradual decline starting from 2021.

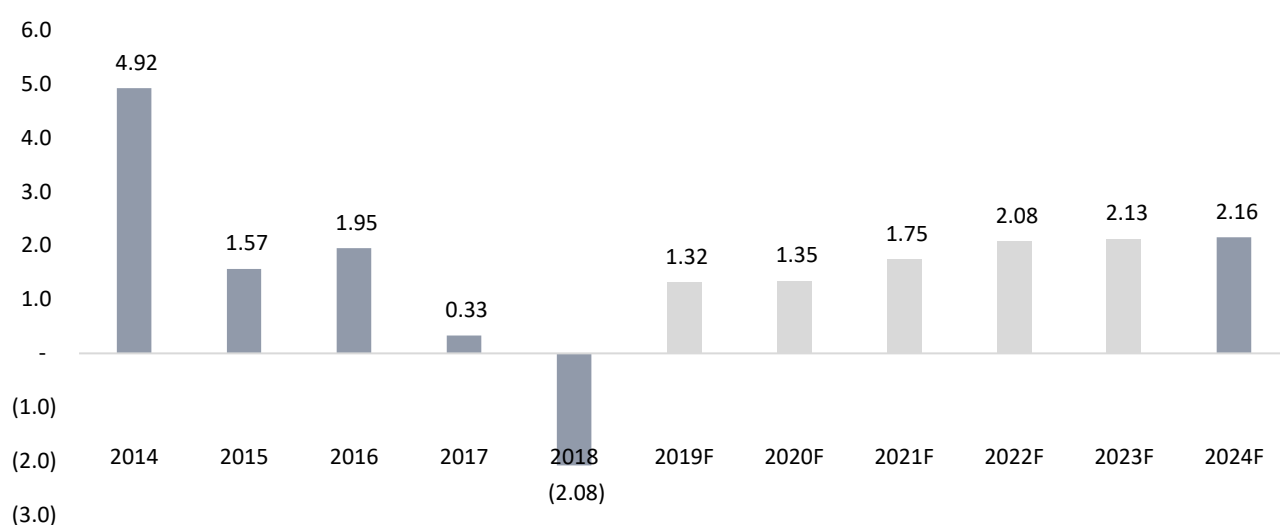
Figure 3: Historical and Forecast gross and EBIT margin



Source: Company financials, ARM Research

- **We believe old things have passed away with UPDC.** Overall, based on our expectation for each business, we expect improvement in earnings over our forecast horizon. First off, the recovery in feeds business amidst stable operating cost should drive an improvement in EBIT margin. We left cost stable over the next two years and a gradual decline beyond 2021 hinged on management guidance of efforts to improve its operating efficiency. Over our forecast horizon, we expect expansion in EBIT margin from a low of 2.7% in 2018 to average of 6.5% between FY19 and 2024E. Furthermore, the anticipated reduction in finance cost as well as little or no impairment on completion of the restructuring exercise would further support earnings. On the latter, we expect finance cost to dip significantly to less than a million from ₱5.0 billion as UACN reduced its overall borrowing by 80% over 9M 19 and swapped its short-term expensive borrowings for cheaper long-term borrowings. That said, we expect EPS to move from ₱1.32 in 2019E to ₱2.16 by 2024.

Figure 4: Trend in EPS (Historical and forecast)



Source: Company financials, ARM Research

- **Valuation:** We re-initiate coverage on UACN with FVE of ₱8.96, based on our five-year discounted cash flow (DCF) methodology. This presents 38% potential upside relative to current market price which translates to a **BUY** rating. On our estimates, UACN trades at a one year and two year forward P/E of 5.8x and 5.4x respectively and one-year and two-year forward EV/EBITDA multiples of 3.1x and 3.02x respectively. We believe the market has discounted the stock based on the historical poor operating performance, high leverage and impairment charges. However, we expect a re-rating, with earnings growth supported by deleveraging, little to no impairment charge, coupled with management's guidance to curb its operating expenses. Furthermore, the management guided to maintaining a stable dividend policy. Our FY 19 dividend per share of ₱0.65k, translates to a dividend yield of 10.6% culminating into total return of 48.6% based on the last closing market price.
- **Downsides:** OLAM remains a threat given its massive capacity as discussions with market stakeholders revealed OLAM's entry in 2018 gave a huge blow to the entire industry - driving a market imbalance. That said, entry of new players would only drive a further expansion in supply. Also, competition in the logistics and paints business (which happens to be the most profitable of all its business segment) could post downside to earnings.

Figure 5: UACN DCF Valuation Summary

₹' million	2020E	2021E	2022E	2023E	2024E
EBIT	3,627,979	4,779,652	7,104,843	7,260,928	8,348,126
EBIT (1-t)	2,467,026	3,250,163	4,831,293	4,937,431	5,676,725
Add: Depre. & NCC	1,767,140	1,822,826	1,880,182	1,938,796	1,978,732
Less: Capex	(1,265,574)	(1,303,541)	(1,332,158)	(907,616)	(927,570)
Less: change in net working capital	(198,627)	(746,851)	(309,424)	(671,939)	(501,680)
Free Cash Flow	2,769,965	3,022,597	5,069,893	5,296,672	6,226,207
WACC	17.6%				
Long Term Growth Rate	5.0%				
Terminal Value	58,072,975				
Discounted Terminal Value	24,835,498				
PV of 2020E - 2024E	32,356,416				
Less: Net Debt	(9,549,498)				
Less: NCI	16,078,903				
Equity value	25,827,011				
Shares outstanding	2,881,296				
Value per share	₹ 8.96				

Summary of Results and Forecasts - ₦'000

ANNUAL

Income Statement (₦' m) *	2018	2019F	2020F	2021F	2022F
Revenue	78,744	83,708	84,372	86,903	88,811
COGS	64,700	67,804	68,172	69,522	69,272
Gross Profit	14,044	15,905	16,199	17,381	19,538
Operating Cost	11,887	12,640	12,571	12,601	12,433
Operating Profit	2,157	3,265	3,628	4,780	7,105
Interest Income	2,981	2,839	2,616	3,849	3,506
Interest Expense	4988	185	186	226	228
PBT	-5,512	8,012	8,167	10,575	12,603
Tax	3,960	2,564	2,613	3,384	4,033
PAT	-9,472	5,448	5,554	7,191	8,570
Balance Sheet (₦ '000) *					
Fixed Assets	21,824	21,243	20,784	20,236	19,205
Stocks	30,526	20,688	21,098	21,022	21,483
Trade debtors	10,234	7,373	7,594	7,761	7,931
Liabilities					
Trade Creditors	15,438	8,201	8,364	8,334	8,517
Non-current Liabilities	10,170	6,697	6,708	6,718	6,728
Total liabilities	56,885	30,241	30,451	30,469	30,663
Shareholders' fund	74,208	82,306	83,162	84,121	84,734
Key Ratios					
	2017A	2018A	2019F	2020F	2021F
Gross Margin	18%	19%	19%	20%	22%
EBIT Margin	3%	4%	4%	5%	8%
PBT Margin	NA	10%	10%	12%	14%
Net Margin	NA	7%	7%	8%	10%
EPS	NA	1.32	1.35	1.75	2.08
P/E	NA	4.68	4.60	3.55	2.98
EV/EBITDA	8.61	-3.62	-3.18	-2.48	-1.67
ROA	NA	4.45%	4.91%	6.30%	7%
ROE	NA	6.86%	6.71%	8.60%	10%

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 reas portfolio constraints
UNDERWEIGHT	Minimize exposure to security taking cognizance of its index weighting
SELL	Sell-off security completely from portfolio

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