Flour Mills of Nig. Plc

PAC Holdings
| A PROPRIETARY INVESTMENT COMPANY |

Nigeria | Equities | Consumer Goods | February 13, 2019 — PAC RESEARCH

Challenging Operating Environment Impacts Revenue

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Price:	
- Current	**₦21.20**
- Target	**₦23.94**
Recommendation:	**BUY**

** As at Wednesday February 13, 2019*

INVESTMENT SUMMARY

In line with our projection, the recently released nine-month to December 2018/19 unaudited report by Flour Mills of Nigeria Plc showed unimpressive figures in its top-line as revenue declined by 6.28% to ₦400.64 billion (vs. ₦427.51 billion reported in nine-month to December 2017/18). The decline in revenue came as a result of poor performance in the three operational segments of the group as the company continues to cope with the logistic problems posed by the traffic challenges in Apapa. Although, the company reduced cost of sales by 4.69% to ₦354.05 billion in 9M'19 (vs. ₦371.47 billion in 9M'18), cost of sales to revenue ratio remains a major concern during the period. Cost of sales to revenue ratio rose to 88.37% in 9M'19, from 86.89% achieved in 9M'18. The decline in cost of sales is mainly attributed to the decline in material costs. The company reported an impressive figure in non-operating activities as finance costs dropped by 34.21% to ₦16.55 billion, compared to ₦25.16 billion incurred in the same period last year. The reduction is due to the repayment of overdraft facilities and replacement of high interest yielding loans with more favourable loans.

With unimpressive performance from core operating activity of the company, profit before tax fell by 42.17% to ₦11.28 billion in 9M'19 (vs. ₦19.50 billion in 9M'18). However, the company made a provision of ₦3.38 billion for tax in 9M'19 (vs. ₦6.26 billion in 9M'18). Consequently, profit after tax reduced by 40.40% to ₦7.90 billion (vs. ₦13.25 billion in 9M'18). The disappointing results reflected on 12-month trailing EPS as it decreased by 43.71% to ₦2.02, from ₦3.58 recorded in the previous period. Based on the recent figures released by the company, we upgrade our target price to ₦23.94 (from ₦21.91 previously recommended). However, we maintain a **BUY** recommendation as the current market price is below the intrinsic value.

Fig. 1: Quarterly results highlights

	3Q2019	2Q2019	3Q2018	Q/q Δ	Y/y Δ
Revenue (₦'mn)	130,905	136,708	129,066	-4.25%	+1.42%
Operating profit (₦'mn)	8,050	8,035	14,724	+0.19%	-45.33%
Net profit (₦'mn)	2,826	1,420	3,653	+99.03%	-22.62%

Source: Bloomberg, PAC Research

Fig. 2: Stock data

FYE	March
Price Mov't: YtD / 52wk	-8.23%/-32.70%
52-week range	₦39.50- ₦15.25
30-day Average vol.	781,506
Shares Outstanding ('mn)	4,100.38
Market Cap. (₦bn)	86.93
EPS, ₦- 12months trailing	2.02
DPS, ₦- FY2017	1.00

Source: NSE, Company's Annual Reports, PAC Research

Fig. 3: Key ratios

	9M'19	9M'18
Gross profit margin	11.63%	13.11%
COS/Revenue	88.37%	86.89%
Net Profit Margin	1.97%	3.10%
Asset turnover	0.93	1.01

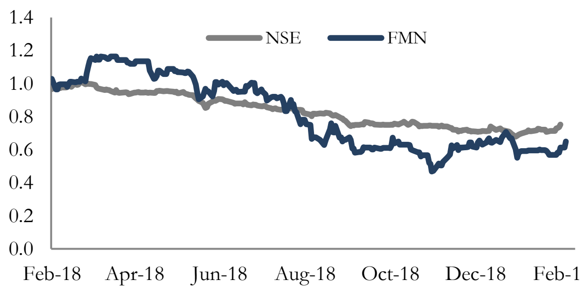
Source: NSE, PAC Research

Fig. 4: Valuations

	FY2016	FY2017	FY2018F	FY2019F
P/E(x)	9.03	5.86	7.70	4.98
P/B(x)	0.78	0.53	0.49	0.49
Div. Yield	5.14%	5.14%	5.14%	6.68%
Payout Ratio	46.40%	30.11%	39.58%	33.30%
Ev/Revenue	-2.85	-2.77	-6.00	-5.99
Rev Per Shr	127.91	132.35	127.98	137.71
ROE	8.62%	9.04%	6.37%	9.88%
ROA	1.83%	3.33%	2.35%	3.47%

Source: NSE, PAC Research

Fig. 5: FMN vs NSE, 52-wk Movement (Rebased)



Source: Bloomberg, PAC Research

Drop in revenue YoY due to logistics upheavals posed by the traffic challenges in Apapa

The group recorded positive growth in volume in the third quarter of 2019 which impacted overall revenue for the quarter. However, the group revenue declined by 6.28% year-on-year to ₦400.64 billion in 9M'19 (vs. ₦427.51 billion in recorded in 9M'18). The drop in revenue is related to the logistics upheavals posed by the traffic challenges in Apapa as all the business segments of the group suffered major setbacks, with the exception of Support Services segment. Food revenue, which contributed 63.54% to total revenue, fell by 4.59% to ₦254.57 billion in 9M'19 (vs. ₦266.82 billion in 9M'18). Revenue from Agro-allied segment declined by 10.12% to ₦67.97 billion (9M'18: ₦75.62 billion) while revenue from Sugar Value Chain segment dropped by 13.60% to ₦59.57 billion in 9M'19 (9M'18: ₦68.94 billion). However, revenue from Support Services segment of the company improved by 14.90% to ₦18.54 billion in 9M'19 (vs. ₦16.14 billion in 9M'18). The strong growth in Support Services segment of the company is attributed to the bagging business, benefited from a strong season and innovative products.

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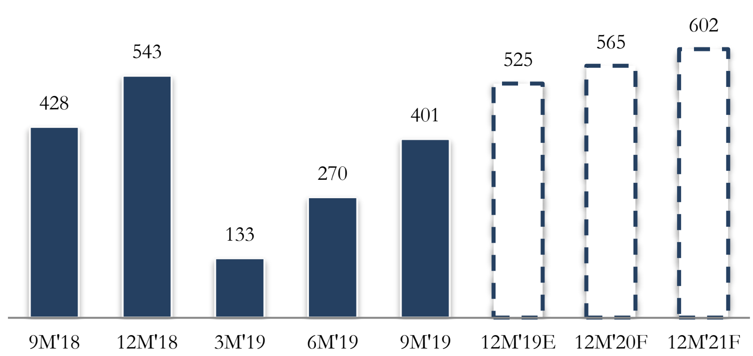
Going forward, we expect improved revenue from the firm's fertilizer business as we expect the company to benefit from the ban on importation of fertilizer by the Federal Government of Nigeria. FMN is focusing more on the fertilizer business and as a result, the group announced its intent to carve out its fertilizer business from FMN Plc and register it as an independent company to hold its Agro-Allied businesses. This, according to the company, is expected to position the business segment for further growth and ensure optimal financial structures for the related businesses. The fertilizer business holding company will be fully owned by FMN Plc. This arrangement is however subject to the approval of the Securities and Exchange Commission.

Fig. 6: Revenue – 9M'18-12M'21F (Billion NGN)



Source: NSE, PAC Research

Inefficient cost management reflects on high cost of sales to revenue ratio

Although FMN Plc recorded a lower cost of sales during the period under review, high cost of sales to revenue ratio remains a major concern. Cost of sales declined by 4.69% to ₦354.05 billion in 9M'19 (vs. ₦371.47 billion in 9M'18). The decline is attributed to a significant drop of 7.48% in material costs, which accounted for 86.50% of total cost of sales. Other components of cost of sales increased during the period. However, we are not impressed with the company's performance in the management of cost of sales as cost of sales to revenue ratio increased to 88.37% in 9M'19, from 86.89% recorded in 9M'18. Going forward, we expect cost of sales to revenue margin to reduce as we expect the assistance of ₦70.00 million from Flour Milling Association of Nigeria (FMAN) to Wheat Farmers Association of Nigeria in April 2018 to boost the country self-sufficiency in wheat production in coming years.

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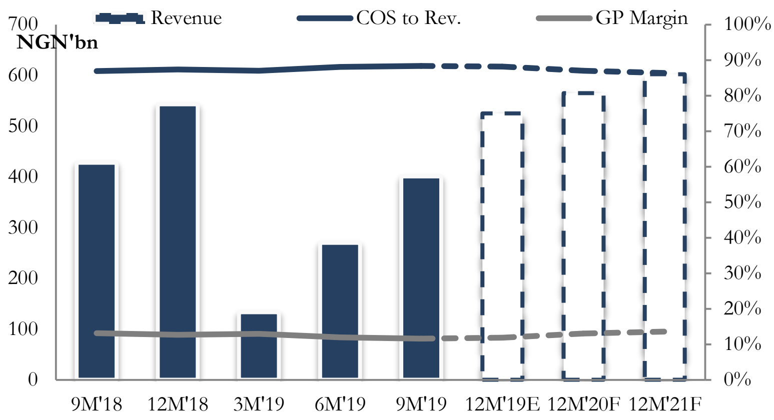
However, the impact of drop in company's revenue outweighed the impact of reduction in total cost of sales and this showed on gross profit as it declined by 16.85% to ₦46.60 billion in 9M'19, from ₦56.04 reported in 9M'18. Company's effort in driving sales and promote brand through advertisement reflected on selling and distribution expenses as it increased by 46.95% to ₦5.93 billion in 9M'19 (₦4.04 billion reported in 9M'18). Administrative expenses recoded an increased of 12.21% to ₦14.94 billion in 9M'19 (vs. ₦13.31 billion in 9M'18).

Fig. 7: Revenue, COS to Rev. and GP Margin – 9M'18-12M'21F



Source: NSE, PAC Research

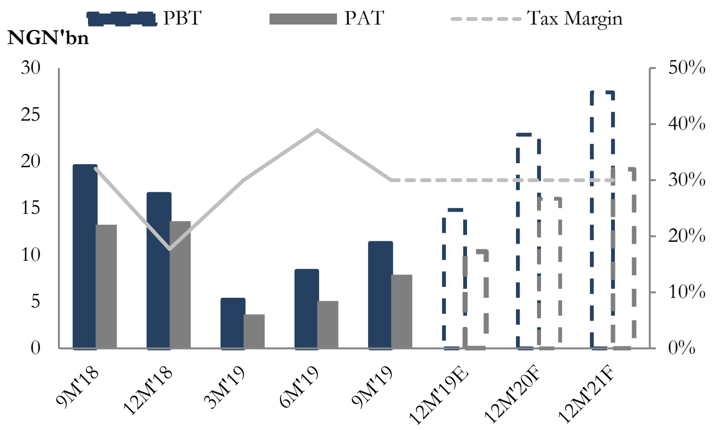
Unimpressive operating performance outweighs improved non-operating performance as profit declines

During nine-month to December 2018/19, FMN Plc reported a significant improvement in non-operating activities of the company, witnessed in finance costs as it fell by 34.21% to ₦16.55 billion in 9M'19 (₦25.16 billion reported in 9M'18). The reduction in finance costs is due to repayment of overdraft facilities and re-financing of high interest yielding loans with more favourable loans.

However, the unimpressive performance from the core operating activities of the company threatened the profitability of the company during the period under review. With significant reduction of 34.21% in finance costs, the company was able to record a profit before tax of ₦11.28 billion in 9M'19 (vs. ₦19.50 billion in 9M'18), representing a reduction of 42.17%. During the period, a provision of ₦3.38 billion was made for tax expenses (vs. ₦6.26 billion recorded in corresponding previous period). Consequently, profit after tax declined by 40.40% to ₦7.90 billion, from ₦13.25 billion reported in 9M'18. The disappointing results however reflected on 12-month trailing EPS as it decreased by 43.71% to ₦2.02, from ₦3.58 recorded in the previous period

The reduction in finance costs is due to repayment of overdraft facilities and re-financing of high interest yielding loans with more favourable loans.

Fig. 8: PBT, PAT and Tax Margin – 9M'18-12M4'21F



Source: NSE, PAC Research

Balance sheet remains strong; Expectation of at least ₦1.00 final dividend Per Share in FY'19

In the third quarter of 2018/19, FMN Plc recorded an improvement in its total assets as it increased by 2.03% to ₦432.22 billion (vs. ₦405.57 recorded in the third quarter of 2017/18). Total liabilities of the company fell by 10.41% to ₦279.42 billion in Q3'19 (vs. ₦311.90 billion in Q3'18). The reduction in total liabilities is partly attributed to the impact of bond and restructuring of loan portfolio.

Long term borrowing increased by 10.83% to ₦69.12 billion in Q3’19 (vs. ₦62.37 billion in Q3’18) while short term borrowing fell significantly by 43.99% to ₦58.30 billion in Q3’19 (vs. ₦104.09 billion in Q3’18). Consequently, net assets improved by 36.76% to ₦152.80 billion in Q3’19 (vs. ₦117.73 billion reported in Q3’18), with net assets per shares rising by 36.76% to ₦37.26 in Q3’19 (vs. ₦27.25 in Q3’18).

Looking at the strong position of balance sheet, we estimate that the company will pay at least ₦1.00 per share as final dividend in full year of 2019 as 12-month trailing EPS remains solid at ₦2.02 (vs. ₦3.58 recorded in previous period).

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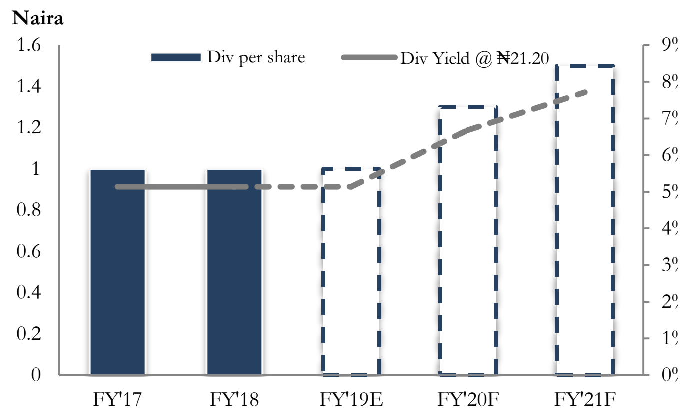
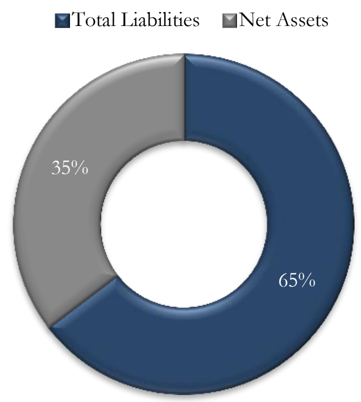
Fig. 9: Dividend Per Share and Dividend Yield – FY’17-FY’21F



Source: NSE, PAC Research

Fig. 10: Total Liabilities Vs Net Asset in Q3’19



Source: NSE, PAC Research

Valuation

Our valuation puts the target price of the stock at ₦23.94 and this shows that the stock is undervalued by 12.93% at the current market price of ₦21.20. In arriving at the target price, we employed discounted cashflow valuation and dividend discount methodology. Consequently, we maintained **BUY** recommendation on the stock of the company.

Our valuation and forecasts considered several factors (both quantitative and qualitative) among which are; the previous financial reports of the company, the current figures released by the company, the challenging operating environment in Nigeria, increased competition within the industry and outlook from the management.

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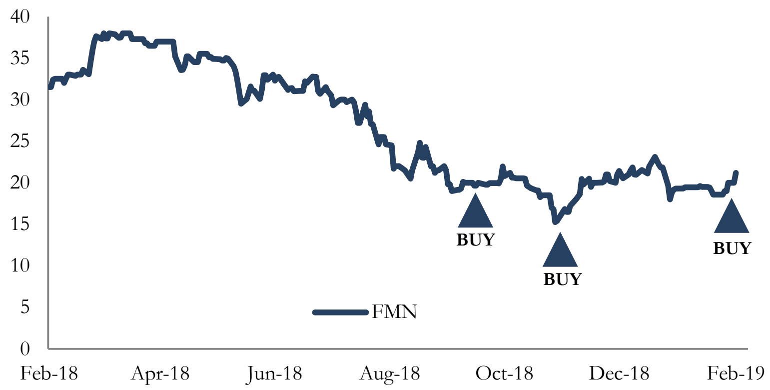
Fig. 11: Share Price History



Source: NSE, PAC Research

Fig. 12: Statement of Profit or Loss, N'mn

	2017	2018	2019E	2020F
Revenue	524,464	542,670	524,762	564,644
Change		*3.47%*	*-3.30%*	*7.60%*
Cost of sales	-457,775	-473,895	-462,578	-491,240
Change		*3.52%*	*-2.39%*	*6.20%*
Gross profit	66,689	68,775	62,184	73,404
Change		*3.13%*	*-9.58%*	*18.04%*
Selling and distr exp.	-5,341	-6,180	-8,134	-9,034
Change		*15.71%*	*31.61%*	*11.07%*
Administrative exp.	-18,420	-20,115	-20,203	-22,586
Change		*9.21%*	*0.44%*	*11.79%*
Net Op. gains (losses)	-1,488	5,943	2,047	3,106
Change		*-499.36%*	*-65.57%*	*51.74%*
Operating profit	41,440	48,423	35,894	44,889
Change		*16.85%*	*-25.87%*	*25.06%*
investment income	1,562	816	945	1,129
Change		*-47.75%*	*15.71%*	*19.56%*
Profit Before Tax	10,473	16,542	14,798	22,868
Change		*57.95%*	*-10.54%*	*54.53%*
Taxation	-1,636	-2,926	-4,439	-6,860
Change		*78.81%*	*51.73%*	*54.53%*
Profit After Tax	8,836	13,616	10,359	16,008
Change		*54.09%*	*-23.92%*	*54.53%*

Fig. 13: Statement of Financial Position, N'mn

	2017	2018	2018E	2019F
Property plant and equip.	216,866	217,901	220,400	226,422
Investment property	1,929	1,842	1,930	2,077
Goodwill	4,148	4,148	4,150	4,466
Defferred tax	1,846	6,460	11,545	11,293
Long term recievables	989	944	990	1,065
Inventories	117,296	111,373	128,567	138,338
Biological assets	558	180	262	282
Trade and other rec.	21,403	19,083	21,415	23,043
Total Assets	482,599	408,348	441,114	461,652
Bank overdraft	49,023	19,934	18,367	19,763
Trade & other payables	94,567	56,994	83,962	90,343
Borrowings	141,702	103,923	52,476	56,464
Retirement benefit oblig.	3,676	5,194	5,248	5,646
Long service award	1,568	1,948	1,889	2,033
deferred tax	7,819	12,308	15,743	16,939
Total liabilities	380,054	257,731	278,508	299,562
Net Assets	102,545	150,617	162,606	162,090

Fig. 14: Profitability Ratio

	2017	2018	2019E	2020F
Gross profit margin	12.72%	12.67%	14.00%	14.00%
Net Profit Margin	1.68%	2.51%	1.97%	2.84%
operating profit margin	7.90%	8.92%	8.80%	8.80%
Return on Equity	8.62%	9.04%	6.37%	9.88%
Return on Assets	1.83%	3.33%	2.35%	3.47%
ROCE	24.52%	20.37%	0.35%	0.41%

Fig. 15: Asset Utilisation

	2017	2018	2019E	2020F
cash/.sales	0.09	0.04	0.04	0.04
Sales to inventory (x)	4.47	4.87	4.08	4.08
Sales to total assets (x)	1.09	1.33	1.19	1.22
sales/EBITDA	8.97	9.03	-23.81	-24.39
Sales to total fixed assets	2.42	2.49	2.38	2.49
Equity multiplier	4.71	2.71	2.71	2.85

Fig. 16: Liquidity Ratios

	2017	2018	2019E	2020F
Quick ratio	*0.45*	*0.31*	*0.41*	*0.40*
Current ratio	*0.83*	*0.87*	*1.15*	*1.14*
Cash ratio	*0.15*	*0.11*	*0.13*	*0.12*
Interest Coverage	*0.32*	*0.51*	*0.67*	*0.99*
Operating Cash Flow Ratio	*0.00*	*0.00*	*0.00*	*0.00*
Debt/net income	*27.74*	*11.25*	*8.87*	*6.17*
Debt/operating profit	*5.91*	*3.16*	*97.22*	*87.50*
Debt to asset	*0.51*	*0.38*	*0.21*	*0.21*
Debt to equity	*2.39*	*1.02*	*0.89*	*0.61*
Total liabilities/equity	*3.71*	*1.71*	*1.71*	*1.85*
Inventory turnover days	*93.52*	*85.78*	*101.45*	*102.79*
Account receivable days	*14.90*	*12.84*	*0.18*	*0.18*
Account payable days	*75.40*	*43.90*	*66.25*	*67.13*

Fig. 17: Shareholders' Investment Ratios

	2017	2018	2019E	2020F
Earnings per share	2.16	3.32	2.53	3.90
DiV per share	1.00	1.00	1.00	1.30
NAVPS	25.01	36.73	39.66	39.53
Earnings yield	11.08%	17.07%	12.99%	20.07%
P/S ratio	0.12	0.12	0.12	0.11

Source: Company's Annual Reports, PAC Research

Equity research methodology employed in this report

Views documented in this equity research report stem from conclusions reached through the use of multiple valuation methodologies, industry-wide knowledge, company specific information and our near to medium term expectations of industry and company performance, as well as market outlook. Our forecasts are based on a combination of top down and bottom up analysis, alongside historical trends in industry and company financials. Where appropriate, we factored in available forecasts and business direction provided by company management.

Our recommendation tends towards value investing. Therefore, our investment rank gauge—a customized scale we use to judge how well a firm under coverage has performed—is determined using major value parameters as well as relevant ratios and multiples computed with figures from the company's most recent financials.

The variables used to arrive at the company's investment rank cover a wide range of measures which characterize liquidity, operational efficiency, profitability, profit margins, growth, economic viability, gearing, relative valuation ratios, capital structure and management performance. Our investment recommendation is underpinned by the upside or downside potential of a stock under coverage. This potential is estimated by comparing the stock's current market price to its price target and fair value, on a percentage increase or decrease basis as summarized below:

Deviation from current price	Recommendation
>30%	STRONG BUY
10% to < 30%	BUY
-10% to < 10%	HOLD
<-10%	SELL

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