Lafarge Africa Plc

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Nigeria | Equities | Industrial Goods | July 9, 2019 — PAC RESEARCH

Shrinking Cement Demand in South Africa: A threat to Overall Group's Profitability

Oluwole Adeyeye
oluwole.adeyeye@panafricancapitalholdings.com

Price:	
- Current	**₦13.70**
- Target	**₦15.75**
Recommendation:	**BUY**

** As at Tuesday July 9 2019*

INVESTMENT SUMMARY

The 2018 full year audited report showed an improvement in the top-line as revenue increased by 3.10% to ₦308.43 billion (vs. ₦299.15 billion in 2017 full year audited report). However, the company recorded a decline in revenue in the first quarter of 2019 as it declined by 2.64% to ₦78.51 billion (vs. ₦80.64 billion in the first quarter of 2018). Due to lower impairment of property, plant and equipment in 2018, total manufacturing costs fell by 4.57% to ₦238.74 billion (vs. ₦250.18 billion in FY'17). The trend continued in the first quarter of 2019 as total manufacturing costs declined by 3.69% to ₦60.33 billion (vs. ₦62.64 billion in the first quarter of 2018). In the full year of 2018 and first quarter of 2019, administrative expenses declined by 3.30% and 18.60% respectively. Consequently, group EBITDA increased by 56.76% and 40.93% to ₦47.53 billion and ₦16.71 billion in FY'18 and Q1'19 respectively.

The non-operating activities of the company remains a burden as high net finance costs of ₦44.25 billion and ₦8.28 billion were recorded in FY'18 and Q1'19 respectively. Consequently, the company recorded a loss before tax of ₦19.51 billion in FY'18 (vs. a loss of ₦34.03 billion in FY'17). However, the company ended pre-tax losses of six consecutive quarters as profit before tax of ₦122.82 million was achieved in Q1'19 (vs. a loss before tax of ₦2.95 billion in Q1'18). With tax credits of ₦10.71 billion and ₦3.02 billion in FY'18 and Q1'19 respectively, Lafarge Africa recorded a reduced loss after tax of ₦8.80 billion in FY'18 (vs. a loss ₦34.60 billion in FY'17) while profit after tax increased to ₦3.15 billion in Q1'19 (vs. a loss of ₦2.02 billion in Q1'18). With the improved bottom-lines and proposed sale of 100% of the issued share capital in Lafarge South Africa Holdings Limited, we recommend a **BUY** on the stock as present forward estimate places the company's price per share at ₦15.75.

Fig. 1: Quarterly results highlights

	1Q2019	4Q2018	1Q2018	Q/q Δ	Y/y Δ
Revenue (₦'mn)	78,512	74,125	80,643	+5.92%	-2.64%
Op. Profit (₦'mn)	8,425	5,679	6,256	+48.35%	+34.67%
Net profit (₦'mn)	3,145	1,571	-2,002	+100.19%	-257.09%

Source: NSE, Bloomberg, PAC Research

Fig. 2: Stock data

FYE	December
Price Mov't: YtD / 52wk	+10.04%/-64.87%
52-week range	₦9.55- ₦38.00
30-day Average vol.	7,423,910
Shares Outstanding ('mn)	16,107.80
Market Cap. (₦bn)	220.68
EPS (₦) - 12months trailing	-0.60
DPS (₦) - FY2018	0.00

Source: NSE, Bloomberg, PAC Research

Fig. 3: Key ratios

	Q1'19	Q1'18
Gross profit margin	23.16%	22.32%
Net profit margin	4.01%	-2.48%
Equity multiplier	2.65x	3.60x
Asset turnover	0.13x	0.14x

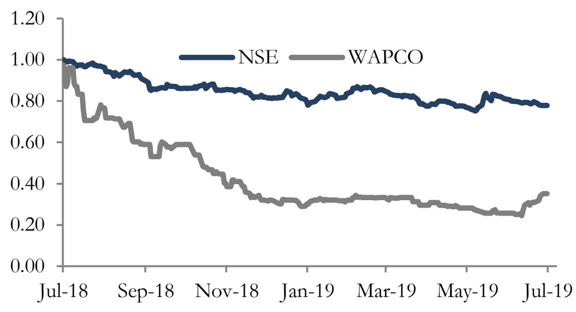
Source: NSE, PAC Research

Fig. 4: Valuations

	FY2017	FY2018	FY2019F	FY2020F
P/E	-6.38x	-25.07x	23.51x	12.60x
P/B	1.41x	1.64x	0.64x	0.61x
Div Yield (%)	10.95	0.00	3.65	7.30
Pay-out Ratio	-69.83%	0.00%	85.79%	91.94%
EV/EBITDA	14.08x	9.98x	4.84x	3.67x
Ev/Revenue	1.43	1.54	0.86	0.75
Sales Per Share	18.57	19.15	17.04	18.23
P/S Ratio	0.74	0.72	0.80	0.75

Source: NSE, PAC Research

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



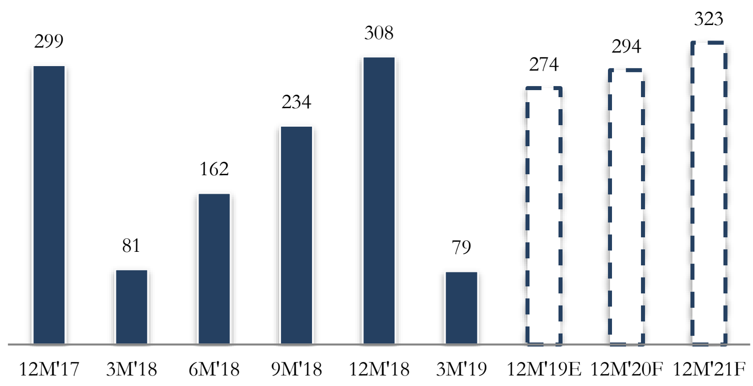
Source: Bloomberg, PAC Research

Cement sales in Nigeria continues to improve while South Africa continues to experience shrinking cement demand. In 2018, the group's revenue increased by 3.10% to ₦308.43 billion (vs. ₦299.15 billion in 2017), mainly as a result of higher sales in Nigeria. With higher cement volume, Nigerian revenue increased by 6.50% to ₦217.81 billion in FY'18 (vs. ₦204.49 billion in FY'17). However, South African revenue declined by 4.3% to ₦90.61 billion in FY'18 (vs. ₦94.67 billion in FY'17). In the first quarter of 2019, total revenue of the group fell by 2.64% to ₦78.51 billion (vs. ₦80.64 billion in the first quarter of 2018) due to the significant drop in South African sales. South African sales further declined by 10.80% to ₦20.50 billion in Q1'19 (vs. ₦22.97 billion in Q1'18). Despite the impact of the general election in Nigeria during the first quarter of 2019, sales improved marginally by 0.60% to ₦58.02 billion (vs. ₦57.67 billion in the first quarter of 2018).

Low growth indicators, growing budget deficits, declining infrastructure spend and reduced consumer discretionary income continue to constrain industry volumes which characterise the downward trend in South Africa's building materials sector.

Lafarge South African Holdings (LSAH) Limited's operations have been subjected to shrinking demand in South Africa - an aggressively competitive market. Low growth indicators, growing budget deficits, declining infrastructure spending and reduced consumer discretionary income continue to constrain industry volumes which characterise the downward trend in South Africa's building materials sector. The competitive environment, slow recovery and struggle to defend market share have heightened market pressure to reduce prices, significantly impacting LSAH's operating margins in recent years. As a result, Lafarge Africa Plc has announced the proposed sales of 100% of the issued share capital in LSAH to Caricement B.V.

Fig. 6: Revenue – 12M'17-12M'21F (Billion NGN)



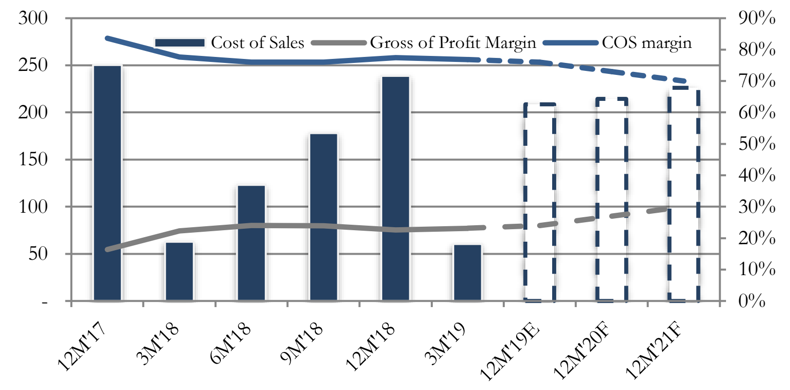
Source: NSE, Bloomberg, PAC Research

Compared to Dangote Cement's cost-to-sales ratio of 42.53% and 41.42% in FY'18 and Q1'19 respectively, cost-to-sales ratio of Lafarge Africa is too high and needs to be addressed.

Cost of sales drops in 2018 and first quarter of 2019, due to lower production costs, maintenance cost and lower impairment. The group's cost of sales fell by 4.57% to ₦238.74 billion in FY'18 (vs. ₦250.18 billion in FY'17), mainly as a result of lower production costs, reduced maintenance costs and significant drop in impairment of property, plant and equipment. Maintenance costs declined by 8.17% to ₦16.52 billion while provision for impairment on plant, property and equipment fell significantly by 95.18% to ₦0.93 billion in 2018. The first quarter of 2019 also witnessed a reduction in the group's cost of sales as it declined by 3.69% to ₦60.33 billion (vs. ₦62.64 billion in the first quarter of 2018), due to lower production costs, distribution costs and maintenance costs.

However, higher variable costs (such as distribution variable cost, cost on gas & power and raw materials & consumable costs) remain a major challenge in the overall cost of sales in 2018 and in the first quarter of 2019. Variable costs, which contributed 64.01% and 66.12% to total cost of sales in FY'18 and Q1'9 respectively, increased by 3.64% and 7.78% to ₦152.81 billion and ₦39.89 billion in FY'18 and Q1'19 respectively. This, in addition to other costs, translated to higher cost-to-sales ratio of 77.41% and 76.84% in FY'18 and Q1'19 respectively. Compared to Dangote Cement's cost-to-sales ratio of 42.53% and 41.42% in FY'18 and Q1'19 respectively, cost-to-sales ratio of Lafarge Africa is too high and needs to be addressed. In general, the company reported lower administrative expenses in 2018 and the first quarter of 2019, as it declined by 3.30% and 18.60% to ₦37.14 billion (FY'17: ₦38.41 billion) and ₦8.35 billion (Q1'18: ₦10.26 billion) respectively. However, selling and marketing expenses increased significantly by 64.14% to ₦7.73 billion in 2018 (vs. ₦4.71 billion in 2017), due to significant rise in the advertising expenses and marketing staff salaries during the period. Lafarge Africa continued with high advertising expenses in the first quarter of 2019, but with zero campaign and innovation expenses and lower marketing expenses. As a result, total selling and marketing expenses fell by 3.40% to ₦1.46 billion in Q1'19 (vs. ₦1.51 billion in Q1'18).

Fig. 7: Cost of Sales, GP Margin and COS Margin – 12M'17 - 12M'21F (Billion NGN)



Source: NSE, Bloomberg, PAC Research

Higher loan services and poor performance in South African operations continue to weigh on the profitability of the company. The company reported an unimpressive non-operating performance in 2018 and first quarter of 2019, mainly as a result of higher loan services. The interest on borrowings increased by 34.15% to ₦29.60 billion in FY'18 (vs. ₦22.07 billion in FY'17), and this trend continued in the first quarter of 2019 as interest on borrowings rose by 12.61% to ₦8.55 billion in Q1'19 (vs. ₦7.59 billion in Q1'18). The bulk of the company's loan came from Caricement BV, an indirect subsidiary of LafargeHolcim Limited. The higher interest on borrowings reflected on finance costs as it increased by 6.38% and 0.70% to ₦45.97 billion and ₦9.58 billion in FY'18 and Q1'19 respectively. However, finance income rose by 19.47% and 320.42% to ₦1.72 billion and ₦1.30 billion in FY'18 and Q1'19 respectively. Going forward, we expect finance costs to fall significantly as Lafarge Africa Plc reported that the proceeds from the proposed sale of 100% of the issued share capital in LSAH would be used to settle part of the debts owed by the group.

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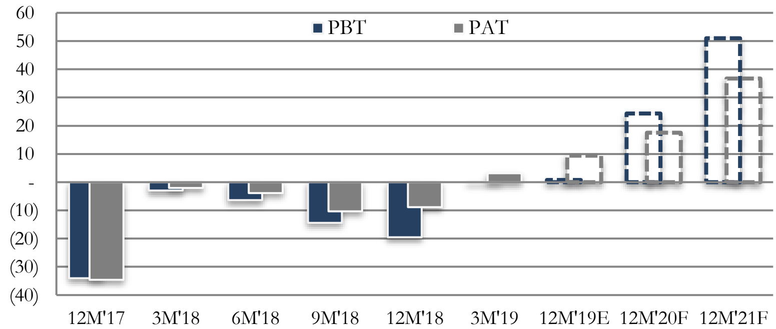
With the poor non-operating performance, the company reported a loss before tax of ₦19.51 billion in FY'18, though a reduced loss when compared with the loss of ₦34.03 billion recorded in FY'17. In the first quarter of 2019, the impressive operating performance overshadowed the poor non-operating performance of the company and as a result, Lafarge Africa reported a profit before tax of ₦122.82 million (vs. a loss before tax of ₦2.95 billion in the first quarter of 2018). The company enjoyed tax credit of ₦10.71 billion and ₦3.15 billion in FY'18 and Q1'19 respectively. Hence, the company reported a loss after tax of ₦8.80 billion in FY'18 (vs. a loss of ₦34.60 billion in FY'17) while a profit after tax of ₦3.15 billion was achieved in Q1'19 (vs. a loss after tax of 2.00 billion in Q1'18). Of the total loss after tax in 2018, Nigerian operations reported a profit after tax of ₦8.10 billion while South African operations reported a loss after tax of ₦16.90 billion. The trend continued in the first quarter of 2019 as Nigerian operations reported a profit after tax of ₦6.30 billion while South African operations reported a loss after tax of ₦3.16 billion.

Fig. 8: Profit before Tax and Profit after Tax – 12M'17-12M'21F (Billion NGN)



Source: NSE, Bloomberg, PAC Research

Improved Balance sheet due to lower short term loans and borrowings; expectation of insignificant dividend payment in FY'19. The balance sheet position of the company improved in the first quarter of 2019 as total assets increased by 6.16% to ₦597.20 billion (vs. ₦562.56 billion in the first quarter of 2018). The increase in total assets during the period can be mainly attributed to investment in property, plant, & equipment as it increased by 6.97% to ₦419.60 billion, from ₦392.27 billion reported in the corresponding quarter of the previous year. Impressively, total liabilities fell by 8.43% to ₦372.16 billion in Q1'19 (vs. ₦406.41 billion in Q1'18), due to lower trade & other payables and lower short term loans & borrowings. Consequently, the net assets of the company increased by 44.12% to ₦225.04 billion in the first quarter of 2019 (vs. ₦156.15 billion achieved in the first quarter of 2018) and this translated to a net asset per share of ₦13.37 (vs. ₦9.69 in Q1'18). With the expectation of improved income statement and balance sheet, we expect the company to pay at least a dividend of ₦0.50 per share in the full year of 2019.

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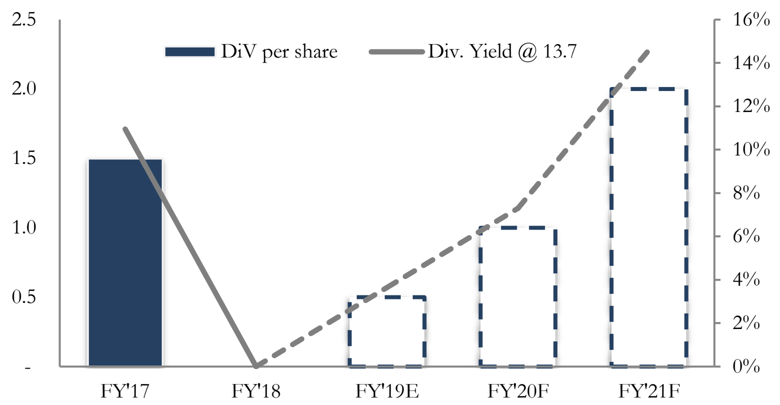
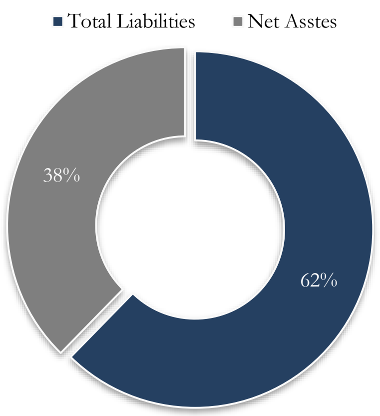
Fig. 9: Dividend Per Share and Dividend Yield (FY'17-FY'21F)



Source: NSE, PAC Research

Fig. 10: Total Liabilities Vs Net Asset in Q1'19



Source: NSE, Bloomberg, PAC Research

EXPLANATORY NOTE ON THE PROPOSED RELATED PARTY TRANSACTION WITH CARICEMENT B.V. (A SUBSIDIARY OF LAFARGEHOLCIM LIMITED)

Background: LSAH, a member of the LafargeHolcim Group, was established in 1998 and manufactures and supplies cement, aggregates, ready-mix concrete and fly ash in South Africa. LSAH became a wholly owned subsidiary of Lafarge Africa following the Company's acquisition of a 100% stake in LSAH in 2014. The consideration that Lafarge Africa paid for the acquisition of LSAH was settled by way of cash of US$200 million and the allotment of 724,758,803 ordinary shares in Lafarge Africa; to Financiere Lafarge SAS1.

Lafarge Africa's ownership of 100% of LSAH, represents an indirect average holding of 72.40% in the underlying principal operating companies in South Africa, including Lafarge Industries South Africa, Lafarge Mining South Africa and Ash Resources. LSAH's operations have been subjected to shrinking demand in South Africa - an aggressively competitive market. Between 2000 and 2007, demand was fueled by increasing infrastructure spend which tapered off and eventually declined quite sharply. Low growth indicators, growing budget deficits, declining infrastructure spend and reduced consumer discretionary income continue to constrain industry volumes; and characterize the downward trend in South Africa's building materials sector. The competitive environment, slow recovery and struggle to defend market share have heightened market pressure to reduce prices, significantly impacting LSAH's operating margins in recent years. The Board of Directors of Lafarge Africa ("the Board") have continued to deliberate on the impact of LSAH's performance on the Company and are now constrained to effect a sale of LSAH, in order to halt further erosion of shareholder value and restore profitability to your company.

Following the discussions and various negotiations on the Proposed Sale, LafargeHolcim agreed to purchase the Sale Shares for the Consideration being a set-off of all the outstanding amounts due by the Company to Caricement under the Inter-Group Loan Agreements at the Closing Date which is July 31, 2019. The value of the Consideration at the closing date is US$316,289,061.00 (three hundred and sixteen million, two hundred and eighty nine thousand and sixty one United State Dollars) being the sum total of the principal sum of US$293,000,000.00 plus all accrued interest of US$23,289,061 as at July 31, 2019.

Benefits of the Transaction: The Proposed Sale is expected to enhance the value of shareholders' investments in Lafarge Africa, which is of utmost importance to the Board.

In addition, following the conclusion of the Proposed Sale, Lafarge Africa's shareholder loan of US$293,000,000.00 as at July 31, 2019 ("Shareholder Loan"), which represents the only existing foreign currency loan in the books of the Company will be completely extinguished. This full repayment of the Shareholder Loan will protect and preserve Lafarge Africa's net income and cash flows considering the resulting decrease sums to be applied towards debt service as on the overall the Company's debt will be reduced by N115 billion and an additional N47 billion by the eventual deconsolidation of LSAH. The improvement in cashflow and net income, resulting from the reduction in debt service outflows, will enable Lafarge Africa to consider additional investments in cement production capacity to improve its market share in Nigeria. The Sale is expected to boost the Company's profitability, through positive cash flow generation.

In summary, the conclusion of the Sale is expected to:

a. Boost Lafarge Africa's cashflow and net income, given the reduction in debt service outflows;
b. Cut annual interest expense by N9.1 billion on account of the full repayment of the foreign currency inter-company loan;
c. Enable Lafarge Africa to reinvest in (and expand) operations in existing plants;
d. Enable the management of Lafarge Africa to devote attention to Lafarge Africa's operations with higher profitability and prospects;
e. Strengthen Lafarge Africa's Balance Sheet and position the Company to improve overall profitability; and
f. Enable the re-rating of the Company's share price.

Source: Lafarge Africa's explanatory note, NSE

TO READ THE FULL EXPLANATORY NOTE, KINDLY CLICK *HERE*

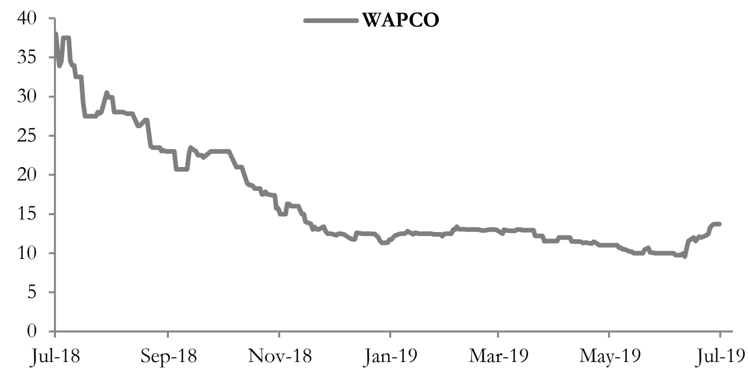
Valuation

Our valuation puts the target price of the stock at ₦15.75, representing an increase of 14.97%, from the current price of ₦13.70. In arriving at the target price, we employed Discounted Cash flow Valuation methodology. Consequently, we recommend a **BUY** 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, proposed sale of 100% of the issued share capital in LSAH and positive outlook of the management.

Our valuation puts the target price of the stock at N15.75 representing an increase of 14.97%, from the current price of N13.70.

Fig. 11: Share Price History (Naira)



Source: NSE, PAC Research

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

	2017	2018	2019E	2020F
Revenue	299,153	308,425	274,499	293,714
Change		*3.10%*	*-11.00%*	*7.00%*
Cost of Sales	(250,179)	(238,743)	(208,619)	(214,411)
Change		*-4.57%*	*-12.62%*	*2.78%*
Gross Profit	48,974	69,683	65,880	79,303
Change		*42.28%*	*-5.46%*	*20.38%*
Selling and marketing expenses	(4,711)	(7,733)	(6,725)	(7,196)
Change		*64.14%*	*-13.03%*	*7.00%*
Administrative expenses	(38,408)	(37,141)	(30,195)	(29,371)
Change		*-3.30%*	*-18.70%*	*-2.73%*
Operating profit	7,886	24,811	28,850	42,618
Change		*214.64%*	*16.28%*	*47.72%*
Finance Income	1,439	1,719	4,941	5,287
Change		*19.47%*	*187.40%*	*7.00%*
Finance Cost	(43,217)	(45,973)	(32,940)	(23,497)
Change		*6.38%*	*-28.35%*	*-28.67%*
Profit Before Taxation	(34,032)	(19,508)	782	24,334
Change		*-42.68%*	*-104.01%*	*3010.51%*
Taxation	(569)	10,707	8,606	(6,814)
Change		*-1981.20%*	*-19.62%*	*-179.18%*
Profit After Taxation	(34,601)	(8,802)	9,388	17,521
Change		*-74.56%*	*-206.66%*	*86.63%*

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

	2017	2018	2019E	2020F
Property, plant and equipment	393,652	394,489	356,848	378,890
Intangible assets	2,634	6,195	4,941	5,287
Deferred tax asset	17,514	28,720	24,705	22,029
Total noncurrent assets	436,186	447,376	401,262	422,008
Inventories	58,266	47,157	38,430	39,651
Trade and other receivables	25,110	21,164	18,035	19,297
Cash and Cash Balances	50,415	12,551	47,758	50,151
Total current assets	151,104	93,360	114,823	114,431
Trade and other payables	113,000	80,538	71,370	76,366
ST Loans and borrowings	187,832	93,834	8,235	8,811
Bank overdraft	31,082	35,281	19,215	20,560
LT Loans and borrowings	68,715	172,373	57,645	52,868
Deferred tax liabilities	11,026	10,200	9,607	10,280
Total Liabilities	430,304	406,196	169,201	172,234
Prepayments and other current assets	156,987	134,541	346,884	364,205

Fig. 14: Profitability Ratio

	2017	2018	2019E	2020F
Return on Equity	-22.04%	-6.54%	2.71%	4.81%
Return on Assets	-5.89%	-1.63%	1.82%	3.27%
Gross margin	16.37%	22.59%	24.00%	27.00%
EBITDA margin	10.13%	15.41%	17.81%	21.81%
PBT margin	-11.38%	-6.33%	0.28%	8.29%
Net Profit Margin	-11.57%	-2.85%	3.42%	5.97%

Fig. 15: Asset Utilization

	2017	2018	2019E	2020F
cash/sales	0.17	0.04	0.18	0.16
Sales to inventory (x)	5.13	6.54	7.14	7.41
Sales to total assets (x)	0.51	0.57	0.53	0.55
Sales to total fixed assets	0.76	0.78	0.77	0.78
Equity multiplier	3.74	4.02	1.49	1.47
fixed asset turnover	0.76	0.78	0.77	0.78

Fig. 16: Liquidity Ratios

	2016	2017	2018E	2019E
Quick ratio	0.27	0.22	0.74	0.68
Current ratio	0.44	0.44	1.11	1.04
Cash ratio	0.15	0.06	0.49	0.43
Interest Coverage	0.81	0.44	0.03	1.34
Debt/net income	-8.31	-34.25	9.06	4.69
Debt to asset	0.49	0.56	0.16	0.15
Debt to equity	1.83	2.24	0.25	0.23
Total liabilities/equities	2.74	3.02	0.49	0.47
Total liabilities/Asset	2.74	3.02	0.49	0.47
Inventory turnover	4.29	5.06	5.43	5.41
Inventory days	85.01	72.09	67.24	67.50
Account receivable days	30.64	25.05	23.98	23.98

Fig. 17: Shareholders' Investment Ratios

	2017	2018	2019E	2020F
EPS (₦)	-2.15	-0.55	0.58	1.09
DPS (₦)	1.50	0.00	0.50	1.00
NAVPS (₦)	9.75	8.35	21.54	22.61
Earnings yield (%)	-16%	-3.99%	4.25%	7.94%

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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PanAfrican Capital Holdings Ltd
8A, Elsie Femi Pearse Street
Victoria Island
Lagos, Nigeria
Tel: +234 (1) 2716899, 2718630
www.panafricancapitalholdings.com