



Revenue picks up amidst declining consumer spending and challenging business environment.

Investment Summary:

Flourmills of Nigeria Plc: we downgrade our forecast and price target to ₦25.69.

Three major issues which increased our uncertainty on the company's short term outlook includes weak FX supply, increasing cost and changing consumer taste & weak consumer spending on the back of dampened disposable income. In addition, we are of the view that the current competition in the industry and macroeconomic headwinds are likely to keep FMN's performance subdued in the near term and we do not expect this to abate any time soon. Though, FMN's strengths can be seen in multiple areas, such as prospects to grow revenue given its market share and products diversification, however, as a counterweight to these strengths, we find that the company's profits and margins have been weak overall after adjusting for the one-off cash flow from the sales of asset in a subsidiary. We had projected an 8% top line growth for year-end March 2016, however, we are inclined to review our target to 5%. Consequently, we arrived at a revised price target of ₦25.69 per share. Based on our new price target, the share is now trading on 7.89x 2017E EV/EBITDA (falling to 5.95x in 2019). **However, we think FMN offers the highest potential for shareholder returns among its peers in the sector given the limited need for expansion capex.**

From 2011 till date, FMN has achieved cumulative revenue of ₦1.70trillion buoyed by organic growth with increased products mix even as we note that some of its new products have lower margins than the existing ones. During this period, the growth plans achieved the following purposes; revenue grew between -5.23% and 16.91%, but at the cost of; a) increasing costs, b) reducing margins, c) reducing operating efficiency, d) decreasing working capital and increasing working capital requirement (WCR) / Sales, e) substantial increase in debt. The dividends paid were between ₦1.75 and ₦2.10 per share, (₦4.6bn – ₦5.5bn) implying a pay-out between ~31% and ~97%. Within this period, we note that the net income of a year and the sum of the net income of several years fluctuated so much even as we believe that many of the positive changes that we have seen in these periods are supposed to transfer net income from one year to another. The current FMN's financials position makes us think about the extent in which shareholders value is created or destroyed. The result released thus far after stripping off the one-off cash flow, is a pointer to one intriguing question which is "would FMN have ended 2015 financially stressed without cash flow from sales of assets even as net income remains positive?" This is a pointer to the fact that positive net income does not really translate into healthy financial position.

Fig. 1: Quarterly results highlights

	3Q'2015	2Q'2015	3Q'2014	Q/q Δ	Y/y Δ
Revenue (₦'mn)	86,097	95,302	78,739	-9.66%	9.34%
Operating profit (₦'mn)	0.257	5,230	1,816	-95.08%	-85.83%
Net profit (₦'mn)	(5,016)	23,047	(1,165)	-121.76%	330.49%

Source: Company report, Bloomberg, DLM Research

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Price:

- Current	₦17.22*
- Target	₦25.69
Recommendation:	HOLD

* As at Thursday March 03, 2016

Fig. 2: Stock data

FYE	March
Price Mov't: YtD / 52wk	-16.20%/-48.43%
52-week range	₦16.13- ₦37.00
Average daily vol./val.	2,641,819/₦52.84m
Shares Outstanding (₦'mn)	2,624
Market Cap. (₦'mn)	45,740.45 (\$232.24mn)
EPS, ₦- 12months trailing	3.23
DPS, ₦- FY2014	2.10
FCF, ₦- FY2014	0.00

Source: Bloomberg, Company's financials DLM Research

Fig. 3: Key ratios

	9M'15	9M'14
Gross profit margin	10.50%	10.21%
Net profit margin	7.21%	1.35%
Equity multiplier	3.26x	3.92x
Asset turnover	0.80x	0.71x

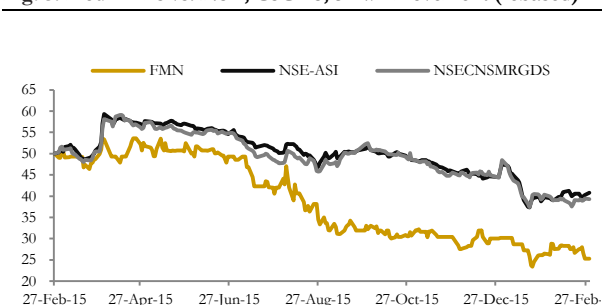
Source: NSE, Company financials, DLM Research

Fig. 4: Valuations

	FY2014	FY2015E	FY2016F	FY2017F
P/Sales	0.15x	0.14x	0.14x	0.14x
P/E	5.40x	3.35x	22.66x	14.32x
PEG	0.09x	0.05x	-0.27x	0.25x
EV/Sales	0.66x	0.67x	0.62x	0.64x
P/B	0.53x	0.44x	0.43x	0.44x
ROE	9.72%	13.22%	1.91%	3.10%
ROA	2.47%	3.76%	0.53%	0.88%
Div. Yield	12.05%	12.05%	0.00	0.00

Source: Company financials, DLM Research

Fig. 5: Flour Mills vs. NSE, CSGDS, 52-wk movement (rebased)



Source: NSE, DLM Research

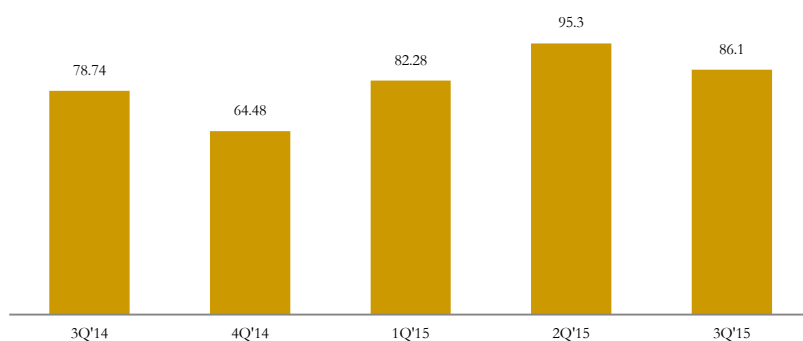
Result Highlights;

Flourmills of Nigeria Plc (“FMN”) recently released its nine months results for the period ended 31, December 2015, which saw revenue and profit after tax come in at ₦263.68billion and ₦19.00billion respectively, which was 7.94% and 476.74% higher than the comparable period. FMN’s 9M 15 revenue came in 0.05% below our estimates, while PBT and PAT surpassed by 3.22% and 9.02% respectively. On a quarterly basis, the company recorded revenue of ₦86.10billion for 3Q 15, which although represents an improvement of 9.34% y/y, but lags behind on a q/q basis (2Q’15, -9.70%). In our view, the 3Q revenue performance was relatively weak in relation to second quarter particularly given that 3Q, corresponds with the festive period which is usually a strong boost for sales. The period performance came as no surprise especially when one consider the impact of dampened disposable income which has significantly altered consumption pattern. Furthermore, the company was unable to significantly reduce its “costs” as we had expected to see a notable reduction in this line item to ease the pressure on operating profit and margins. Going forward, we expect the company to provide guidance on cost reduction strategy to improve its bottom-line.

Gross profit for the period increased by 11.05%y/y to ₦27.68billion even as paucity of FX was more palpable. We note that the slow growth in gross profit was a direct result of increases in cost of sales which rose by 7.59% to ₦235.99billion driven by increased cost of imported raw materials. Operating expenses also rose significantly by 43.27% y/y to ₦15.208billion (9M’14: ₦10.61bn) leading to a 12.82% y/y decline in operating profit to ₦12.48billion (9M’14: ₦14.32bn) with a corresponding contraction in operating margin. While we note a 13.40% y/y increase in financial charges to ₦17.40billion, however, a one-off cash flow of ₦23.73billion from the sales of investment in associate boosted pre-tax profit to ₦19.79billion, a growth of 435.24% from the ₦3.70billion recorded in the prior year. By stripping off this one off cash flow, we note that FMN would have recorded a pre-tax loss of ₦3.95million for the period. Consequently, post-tax profit accelerated by 476.749% to ₦19.00billion, (9M’14: ₦3.29bn).

“ On a quarterly basis, the company recorded revenue of ₦86.10billion for 3Q 15, which although represents an improvement of 9.34% y/y, but lags behind on a q/q basis (2Q’15, -9.70%). ”

Fig. Fig. 6: Quarterly sales revenue (₦billion)



Source: NSE, Company Financials, DLM Research

We are of the view that the company's earning capacity could further weaken if the current fiscal situation deteriorates. It is likely the company will adopt a new dividend payout policy in order to keep the current level of investments. FMN needs more capital to support its growth, as a result, it must strive to reduce its working capital cycle by collecting receivables quicker and stretching accounts payable. While the company announced in December that it had fully redeemed its bond which matured in December 2015, we reckon that it will lessen the pressure on net income as net debt for the 9 month period decreased by 237 basis points to ₦165.20billion even as the FMN was almost reaching its credit limit by every indication, which would have made it highly unlikely that banks would be willing to increase the company's credit level given the inherent default risk. Hence, the slight reduction in debt level has resulted in a debt to equity of 1.64x, 7.18x EBITDA, 13.23x EBIT, and 7.38x cash flow from operating activities.

Valuation. We employed several valuation metrics such as; the discounted cash flow model, residual income model, maintainable earnings (simple and weighted average), and a peer method based on trailing price to earnings ratio. We also carried out a sensitivity back test analysis using different discount rates. From this methodology we derived a target price of ₦25.69/share. The company appears to be burdened by the weight of financial charges and general economic pressures; hence, we see no positive catalysts for the stock in the near term despite valuations being cheap. Hence, we maintain our HOLD ratings on the stock

Fig.7: Valuation metrics

Capital structure (Equity)	31.56%
Capital structure (Debt)	68.44%
Forecast period	5years
Beta (2 year)	0.70
Long term growth rate	1.50%
Risk free rate	13%
Risk premium	8.00%
Tax rate	35.00%
WACC	10.76%
Outstanding shares (Million)	2,624

Fig.8: Betas and Leverage

Unlevered beta	
Calculated Company beta	0.70
Tax rate	35%
Debt/equity ratio	2.17
Unlevered Beta	0.29

Levered beta	
Unlevered beta	0.29
Tax rate	35%
Debt/equity ratio	2.17
Levered Beta	0.70

Fig.9: Sensitivity analysis of enterprise value to changes in EV/EBITDA multiple and WACC (₦billion)

	Discount	EV/EBITDA multiples				
		6x	7x	8x	9x	10x
Discount	9.00%	74,933	86,984	99,036	111,087	123,139
Discount	11.00%	67,288	78,292	89,296	100,301	111,305
Discount	12.00%	63,784	74,305	84,827	95,349	105,870
Discount	13.00%	60,474	70,538	80,603	90,667	100,731
WACC	10.76%	68,173	79,299	90,424	101,550	112,676

Fig.10: Sensitivity analysis of enterprise value to changes in growth rate and WACC (₦billion)

		Terminal perpetual growth rates				
		1.5%	2.0%	2.5%	3.0%	3.5%
Discount	9.00%	332,005	357,271	386,424	420,435	460,631
Discount	11.00%	238,703	253,129	269,252	287,390	307,947
Discount	12.00%	206,060	217,393	229,919	243,836	259,391
Discount	13.00%	179,481	188,559	198,501	209,438	221,526
WACC	10.76%	247,802	263,154	280,365	299,795	321,903

Fig.11: DCF Valuation

	FY'15E	FY'16F	FY'17F	FY'18F	FY'19F
EBIT (₦'mn)	14,265	16,696	19,307	18,921	18,543
Operating FCF	-748	-6,750	-40,826	22,837	37,448
Present Value of Op FCF	-711	-5,791	-31,624	15,972	23,647
EV	258,344				
Equity Value	69,534				
Price/Share	₦26.50				

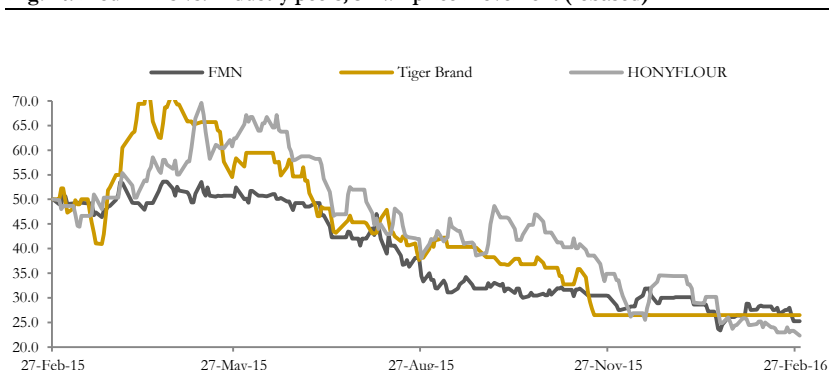
Fig.12: Sensitivity analysis of target price to changes in perpetual growth and WACC

		Terminal perpetual growth rates				
		1.5%	2.0%	2.5%	3.0%	3.5%
Discount	9.00%	54.57	64.20	75.31	88.27	103.59
Discount	11.00%	19.01	24.51	30.66	37.57	45.40
Discount	12.00%	6.57	10.89	15.67	20.97	26.90
Discount	13.00%	(3.56)	(0.10)	3.69	7.86	12.47
WACC	10.76%	22.48	28.33	34.89	42.30	50.72

Fig.13: Residual income model

	2015E	2016E	2017E	2018E	TV
	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000
Equity	39.39	40.28	39.34	48.17	46.32
Net income per share	5.21	0.77	1.22	1.02	0.99
Equity charge per share	7.32	7.48	7.31	8.95	8.61
Residual income	(2.11)	(6.71)	(6.09)	(7.93)	(7.62)
Terminal value	0	0	-	-	32.90
Total residual cash flow	(2.11)	(6.71)	(6.09)	(7.93)	25.28
Discounting factor	0.95	0.86	0.77	0.70	0.63
PV of total cash flow	(2.01)	(5.76)	(4.72)	(5.54)	15.96
PV of total cash flow	(2.06)				
Valuation per share (₦)	37.33				

Fig. 14: Flour mills vs. Industry peers, 52-wk price movement (rebased)



Source: NSE, DLM Research

Fig. 15: Statement of Profit or Loss, ₦'mn

	FY2014	FY2015E	FY2016F	FY2017F
Turnover	308,757	324,195	333,921	327,242
Change %		5.00%	3.00%	-2.00%
Cost of Sales	(273,390)	(288,533)	(297,189)	(287,973)
Change %		5.54%	3.00%	-3.10%
Gross Profit	35,367	35,661	36,731	39,269
Change %		0.83%	3.00%	6.91%
SG&A	(24,466)	(24,315)	(23,374)	(22,907)
Change %		-0.62%	-3.87%	-2.00%
EBITDA	23,416	28,853	32,390	35,015
Change %		23.22%	12.26%	8.10%
Operating Profit	10,901	11,347	13,357	16,362
Change %		4.09%	17.71%	22.50%
Other Income	(685)	2,918	3,335	2,945
EBIT	10,216	14,265	16,696	19,307
Change %		39.63%	17.05%	15.64%
Profit Before Tax	7,725	21,024	3,105	4,915
Change %		172.15%	-85.23%	58.31%
Taxation	738	(7,358)	(1,087)	(1,720)
Profit After Taxation	8,463	13,665	2,018	3,195
Change %		61.47%	-85.23%	58.31%

Source: Company's reports, DLM Research

Statement of Financial Position (₦'m)

	FY2014	FY2015E	FY2016F	FY2017F
Non-current assets:				
Fixed Assets	208,940	222,497	237,497	247,497
Other non-current assets	10,305	11,347	10,018	9,817
Total noncurrent assets	219,245	233,843	247,514	257,314
Current assets:				
Inventories	68,426	71,936	69,208	63,117
Trade Debtors	15,373	15,988	16,010	15,241
Prepayment	-	-	-	-
Bank and Cash Balances	31,132	16,210	23,374	19,635
Other current assets	8,673	25,936	23,374	6,545
Total current assets	123,604	130,069	131,967	104,538
Total Assets	342,849	363,912	379,481	361,852
Current Liabilities:				
Overdraft	-	-	-	-
Trade payable	42,561	47,430	48,853	39,448
Short term loan	133,189	133,189	133,189	133,189
Other current liabilities	3,465	3,242	8,348	9,817
	179,215	183,861	190,390	182,455
Non-current Liabilities				
Long term loans	55,621	55,621	50,000	50,000
Other noncurrent liabilities	20,964	21,073	33,392	26,179
	76,585	76,694	83,392	76,179
Total Liabilities	255,800	260,555	273,782	258,634
Shareholders' equity	87,049	103,357	105,699	103,218
Liabilities and Equity	342,849	363,912	379,481	361,852

Source: Company's annual reports, DLM Research

Fig. 16: Profitability & return

	FY2014	FY2015E	FY2016F	FY2017F
Gross profit margin	11.45%	11.00%	11.00%	12.00%
Operating profit margin	3.31%	4.40%	5.00%	5.90%
Net profit margin	2.74%	4.22%	0.60%	0.98%
ROCE	6.24%	7.92%	8.83%	10.76%
ROE	9.72%	13.22%	1.91%	3.10%
ROA	2.47%	3.76%	0.53%	0.88%

Source: Company's annual reports, DLM Research

Fig. 17: DuPont Analysis

	FY2014	FY2015E	FY2016F	FY2017F
Total assets turnover	0.90x	0.89x	0.88x	0.90x
Net income margin	2.74%	4.22%	0.60%	0.98%
Equity multiplier	3.94x	3.52x	3.59x	3.51x
ROE	9.72%	13.22%	1.90%	3.10%

Source: Company's annual reports, DLM Research

Fig. 18: Liquidity ratios

	FY2014	FY2015E	FY2016F	FY2017F
Working capital (₦'mn)	-55,611	-53,792	-58,423	-77,916
Current ratio	0.69	0.71	0.69	0.57
Quick ratio	0.31	0.32	0.33	0.23
Cash ratio	0.17	0.09	0.12	0.11

Source: Company's annual reports, DLM Research

Fig. 19: Efficiency ratios

	FY2014	FY2015E	FY2016F	FY2017F
Fixed assets turnover	1.48x	1.46x	1.41x	1.32x
Current assets turnover	2.50x	2.49x	2.53x	3.13x
Total assets turnover	0.90x	0.89x	0.88x	0.90x
Inventory turnover	2.07x	2.06x	4.29x	4.56x
Receivables turnover	20.08x	20.28x	20.86x	21.47x
Payables turnover	6.42x	6.08x	6.08x	7.30x
Days inventory outstanding	91	91	85	80
Days collection outstanding	18	18	17	17
Days payable outstanding	56	60	60	50
Operating cycle (days)	0.00	0.00	0.00	0.00

Source: Company's annual reports, DLM Research

Fig. 20: Long-term solvency & stability ratios

	FY2014	FY2015E	FY2016F	FY2017F
Gearing	0.00%	0.00%	0.00%	0.00%
Equity multiplier	3.94x	3.52x	3.59x	3.51x
Total debt-to-equity	2.17x	1.83	1.73x	1.77
Total debt-to-assets	55.07%	51.88%	48.27%	50.63%
Proprietary	25.39%	28.40%	27.85%	28.52%
Interest coverage	0.55	0.76	0.90	1.05
Cash coverage	0.00x	0.00x	0.00x	0.00x

Source: Company's annual reports, DLM Research

Fig. 21: Shareholders' investment ratios

	FY2014	FY2015E	FY2016F	FY2017F
EPS, ₦	3.23	5.21	0.77	1.22
DPS, ₦	2.10	2.10	0.00	0.00
Pay-out	0.00	0.00	0.00	0.00
FCFPS, ₦	0.00	0.00	0.00	0.00

Source: Company's annual reports, DLM 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. This equity research report qualifies as an initiation research report on the company whose stock has been analysed, hence the level and depth of details documented herein. Further updates on this company, or its stock, or both, will be communicated to investors via brief research notes or earnings-flash emails, as occasion demands.

Our recommendation is slightly biased 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 investment rank or grade given to a company is an alphabet which falls in the set {A+, A, B, C+, C, D, E, F}, where

- Grade A+ means the company has done excellently well on all fronts that form the basis of our consideration, and has a strongly positive performance outlook.
- Grade A means the company's performance is of high quality, but can be made better. Outlook for the company is positive.
- Grade B means the company performed marginally above average, at least relative to its peers, but faltered on some fronts. Outlook is weakly positive.
- Grade C+ means the company's performance is exactly average; outlook is neither positive nor negative.
- Grades C and D indicate that dwindling performance is the company's fate at the current time. Outlook for the company is mildly negative.
- Grades E and F mean the company is headed for towards jeopardy, which might impair its ability to continue as a going concern. Outlook for the company in this case is alarmingly negative.

The variables used to arrive at the company's investment rank cover a wide range of measures which characterize liquidity, operational efficiency, profitability, profitability margins, growth, economic profitability, 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

Source: DLM Research

In our analysis, we distinguish between fair value and price target. Fair value is our opinion of the actual fundamental worth of a stock, irrespective of what the market thinks of the stock or what investors are willing to pay for it. Value investors purchase stocks way below their fair values, while income investors might purchase stocks at their fair values at the very maximum.

Price target, on the other hand, is the estimated price we opine the stock will trade in the near to medium term. It is the price that, if realized, could result in the best investment returns, given prevailing market conditions. It gives an idea of the price other investors might be willing to pay for a stock regardless of its actual worth. We employ fair value, price target or both to determine a stock's upside or downside potential.

A BUY recommendation directly means what it says; purchase the stock according to your wallet and appetite for risk. A SELL recommendation prompts investors to exit their positions in the stock, as the analyst believes the stock is not worth investors' time and capital commitment. A HOLD recommendation generally tells investors to do nothing; if you have not bought the stock, do not buy it and if you have bought it, do not sell it.

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