Dangote Cement Investment Report

Introduction

Dangote Cement is cement producing company based in Nigeria listed on the Nigerian Stock Exchange. The company has the high market capitalization on the exchange and production facilities in 10 African Countries.

We initiate coverage of Dangote Cement with a Strong BUY rating, target price of ₦219.53 using the discounted cashflow method which means a potential upside of 7.14%.

The reasons for our recommendation of this stock is based on the following:

Nigeria's Infrastructure Stock Gap

The huge infrastructural gap in Nigeria creates a big opportunity for Dangote Cement because cement is a vital element in many infrastructural projects. Nigeria currently spends only 15% of GDP on infrastructure development and has the opportunity to the typical 70% in developing countries.

Government emphasis on Capital Expenditure

The Nigerian is currently focused on infrastructural development. As we come to an election year the government has become more willing to spend on development projects to show their commitment to their proposed budget.

Opportunities in Africa as a whole

Africa presents a lot of opportunities for cement producers. Morgan Stanley expects Africa to grow by 5.5% from 2016 – 2020. This growth gives Dangote Cement, which has 45% of the African Cement market, a lot of opportunities to grow.

Revenue Breakdown

The company's revenue grew by 30.97% to 805.6B in 2017. Growth in African Market in Nigeria and other market gives the company more opportunities for growth as the company expands operations.

Industry Leadership Performance

Dangote cement has shown clear leadership in its performance in the cement industry. With a gross profit of 56.39% it performs for above other industry participants.

An Overview of Dangote Cement

Dangote cement is Africa's leading cement producer with existing operations in 10 African countries. The company is currently headquartered in Lagos, Nigeria. Dangote cement started by importing cement into Nigeria before aligning with the Nigerian Federal Government initiative of Backward Integration in 2002 by engaging in the production of cement locally. The company's 13.25Mta Obajana Cement Plant in Kogi State, Nigeria is the largest in Africa and one of the largest and most profitable cement factories in the world, employing thousands of people directly and indirectly. The total combined production capacity of the firm is 45.6Mta of which 29.3Mta is from Nigeria. The company operates in the following countries; Nigeria, Cameroon, Congo, Ethiopia, Ghana, Senegal, Sierra Leone, South Africa, Tanzania and Zambia.

Dangote cement major focus is to develop enough capacity to fulfil the current and potential demand of countries in sub-Saharan Africa (SSA). The company believes that countries in SSA will have to implement two basic strategies to due to the rising cost of cement importation needed for infrastructural development. The strategies are that countries with limestone deposits will have to invest in production capacity and those without limestone deposits will have to import from neighboring African countries. Dangote cement is position to maximize the benefits from SSA countries applying these strategies.

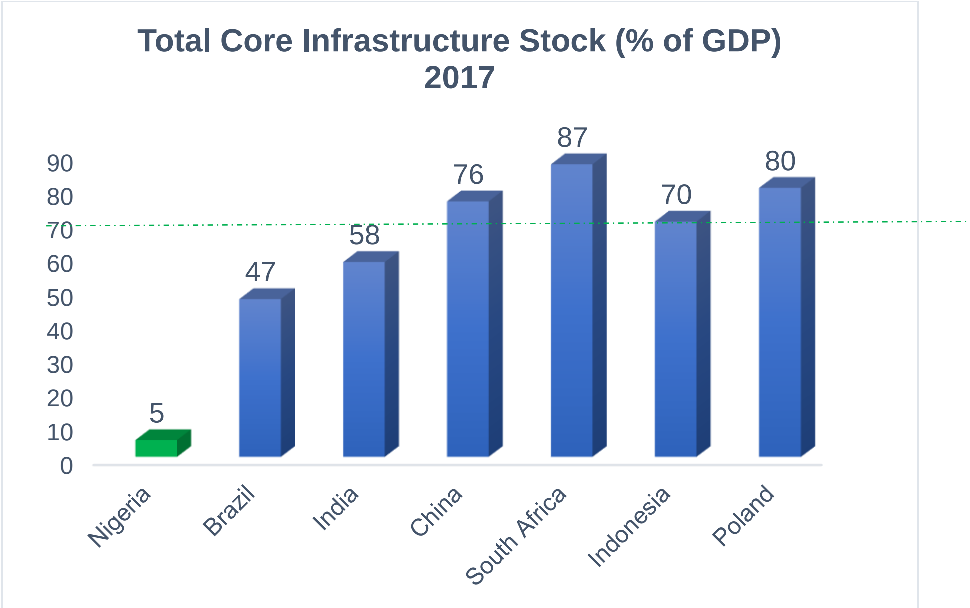
Dangote cement range of products include

1. 32.5R: A general purpose cement suitable for applications such as mortar and plastering, where loading strength is not a factor
2. 42.5R "3X": 3X is a quality assured blended cement manufactured to fully conform to the requirements of strength class 42.5R
3. 52.5R: 52.5 is a high-performance Portland cement manufactured to comply with the requirements of type CEM I cement strength class 52.5

Nigeria's Infrastructure Stock Gap

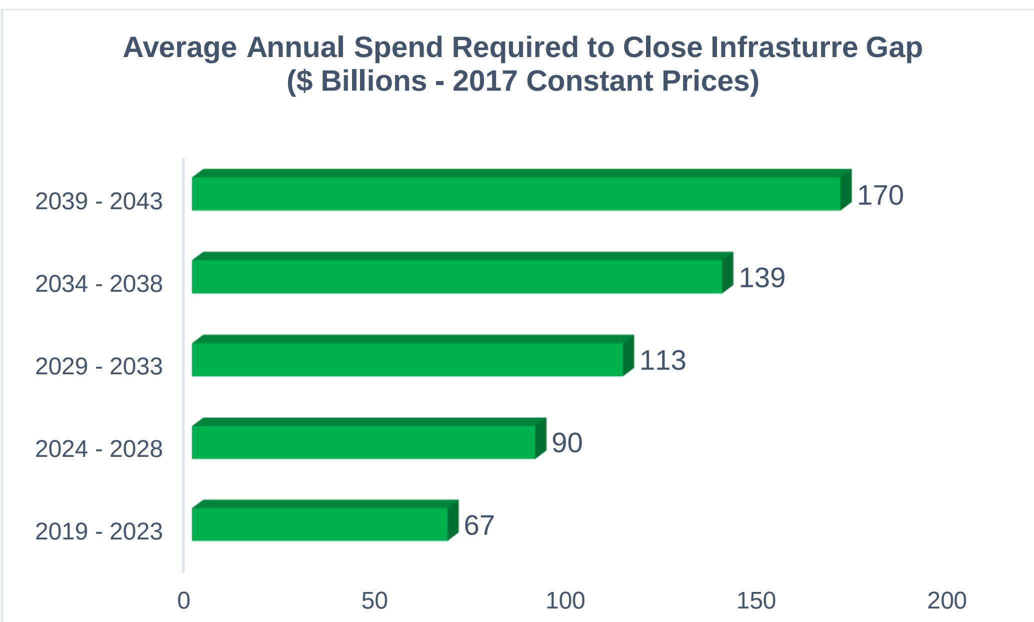
For an economy to be effectively functional, it requires working infrastructure as its backbone. This is because working infrastructure contribute significantly to the well-being of the population, the productivity of the workforce and facilitate broader access to education and health services. In making all these infrastructural aspirations a reality***, cement is a vital element*** as many key infrastructures require some form of construction or another.

According to several benchmarks, developed countries typically have about 70% of their "core infrastructure stock" (roads, rail, airports, ports, power, water and ICT), take up about 70% of their Gross Domestic Product (GDP). In contrast with other emerging markets, Nigeria infrastructure stock makes up less than 15% of its GDP. This presents an opportunity for cement companies, as a company requires better infrastructure to remain competitive in the market. See graph comparing Nigeria's infrastructure stock gap, to that of other emerging economies



Source: McKinsey Global Institute Analysis

To get to the desired benchmark of 70% of GDP for its core infrastructure stock, it is estimated that Nigeria would need about 3 trillion Dollars, which will be spent over the next three decades. This estimate was spelt out in the National Integrated Infrastructure Master Plan (NIIMP), as prepared by the national planning office of the Federal Government of Nigeria (FGN). The NIMMP arrived at this figure by benchmarking against best practices, including the estimated maintenance costs, and adding the cost for social infrastructure. Based on information provided by the NIMMP, the graph below shows the required expenditure on infrastructure, if the government is to attain its goal of 70% of GDP:

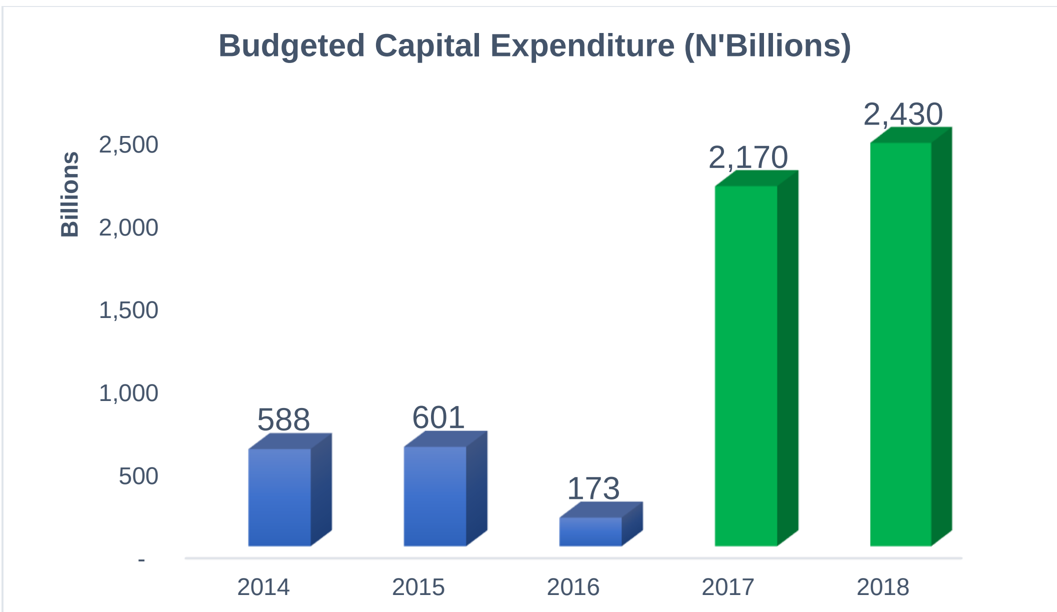


Source: National Integrated Infrastructure Master Plan (Nigeria 2017)

Given the planned expenditure above, it is clear that cement companies (especially a market dominant player like Dangote), is properly positioned to take advantage of the planned expenditure by government over the short and long term.

Government emphasis on Capital Expenditure

Following point one above, the current administration has indeed made good on its promise in spending heavily on infrastructure. This is reflected in the fiscal budgets for 2017 and 2018, in which allocation to capital expenditure, is significantly more compared to prior years, with the Ministry for Power, Works and Housing getting one of the largest allocation amongst all other ministries. We have extracted the budgetary allocation to capital expenditure (mostly consisting of infrastructure spend), over the past 5 years to show the astronomic hike:



Source: FGN Appropriation Budgets (2014 – 2018)

As can be seen from the chart above, the government has significantly stepped up spending on capital expenditure, and major cement players are positioned to benefit from this increased spending.

Apart from the two points outlined above, there are other specific interventions by the Nigerian government, which would favour a market leading cement producer like Dangote:

1. 2018 is a pre-election year and government tends to spend more generally. Some of the "hastened" spending will undoubtedly go to road constructions, as the incumbent government attempts to convince the people on why it deserves a second term in office.
2. The release of the NGN100 billion sukuk bond for the construction of 25 major roads, which cover all 6 geopolitical zones across Nigeria. Some of these roads are due to be delivered this

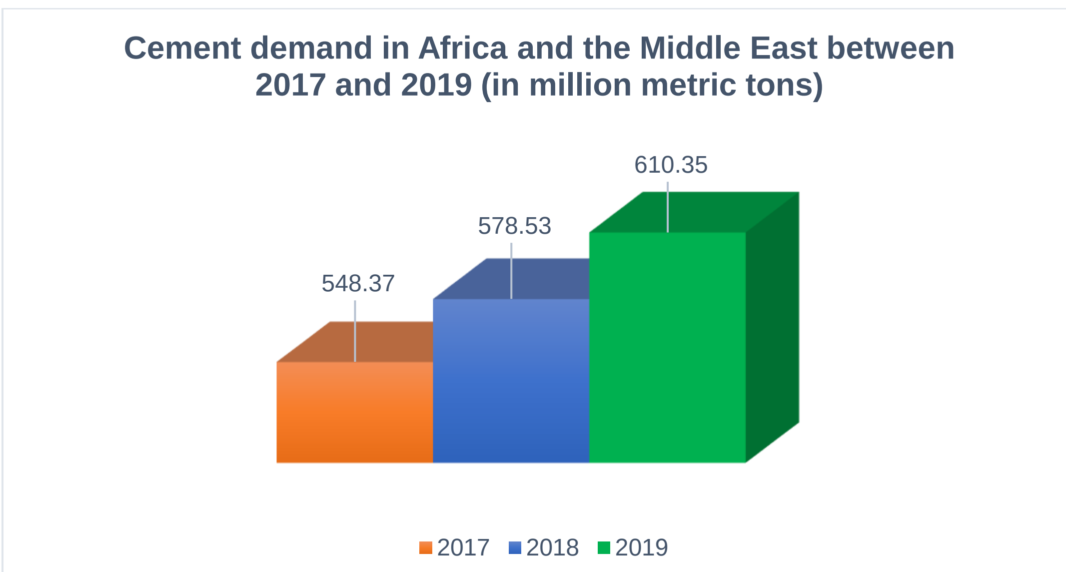
year, while others will are due early 2019 (coinciding with the timeframe for this contest and further strengthening the case for our leading stock)

3. The release of NGN2 billion towards the construction of the 44km second Niger bridge, which links two key cities and facilitates commercial activities in the South-Eastern region of Nigeria

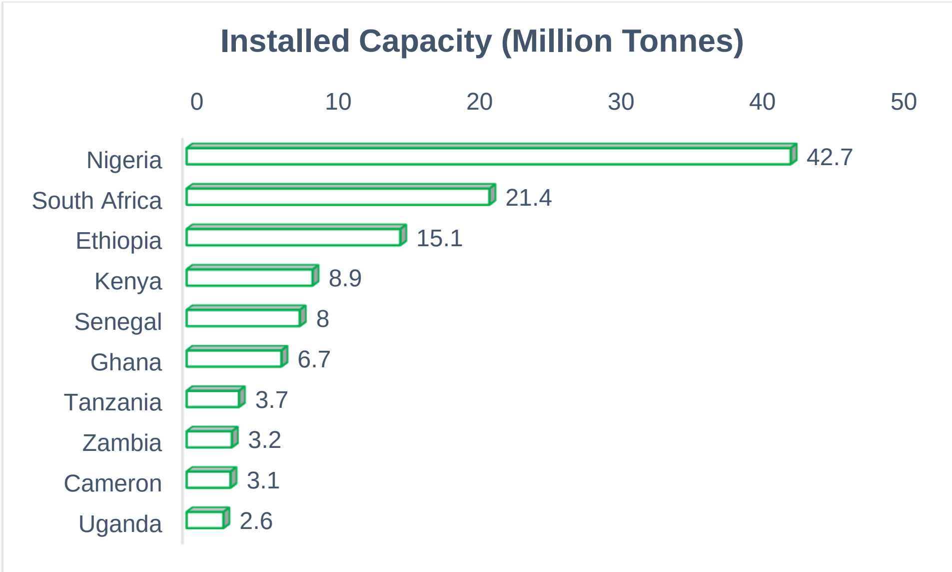
Opportunities in Africa as a whole

Africa as a whole, has many opportunities for cement producers like Dangote. This section will outline some of those opportunities, and why we think the outlook for our stock pick is positive both from a national and continental point of view.

1. According to Morgan Stanley, cement production in Africa is expected to grow at about 5.5% annually from 2016 to 2020. This is off the infrastructure gap across the continent. Given that Dangote has a 45% market share in Sub-Saharan Africa, with operations in about 9 African countries, the company is poised to take advantage of this expected growth in demand. See chart below for the expected cement consumption in Africa and Middle East between 2017 and 2019



Cement continues to play a vital role in African countries given the need for construction and infrastructure generally. The following are the top ten African countries in terms of production capacity of cement:



Some opportunities in specific African countries include:

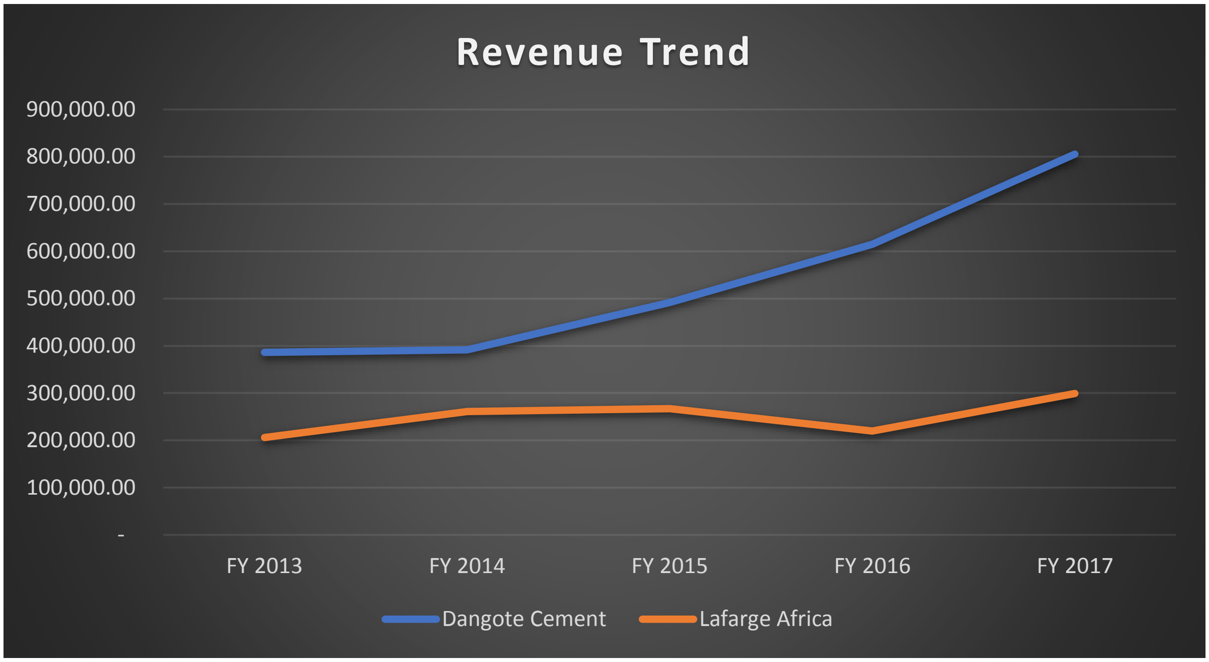
2. Ethiopia: Being the second most populous country in Africa, Ethiopia offers one of the largest opportunities for cement production in Africa. With a current cement consumption of about 61kg per person according to global cement, Dangote is targeting to take over about 25% to 30% of the market share in the country. With one of the lowest urbanisation rates in the world, the government has prioritised transportation and power projects as seen by its newly completed metro.

3. Tanzania: There is also ample opportunity for Dangote in Tanzania, as construction GDP has been growing at about 11.5% annually, and the economy as a whole has also been growing at about 7% per annum. So it comes as no surprise that Dangote plans to double its capacity in Tanzania by 2019. With a current urbanisation rate of 31%, annual per capita consumption of cement at about 65kg, the government is set to ramp up infrastructure spend significantly, as it hopes to attract 8 million annual visitors by 2025 (up from 1 million as at 2015). Also the recent gas discovery in Tanzania, also makes it an attractive destination for heavily industrialised businesses such as the manufacturing of cement.

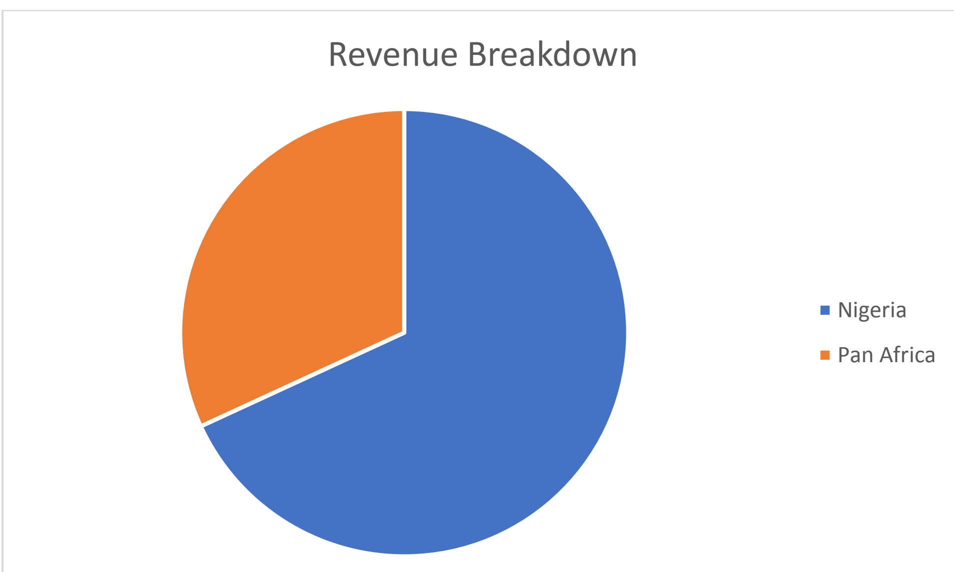
4. South Africa: Although cement demand in South Africa has slowed compared to smaller economies, there is still an opportunity given that the legacy plants are quite old, as they average about 32 years old and are in need of maintenance. Dangote is positioned to take advantage of this situation, as the company's partnership with Sephaku Holdings, as given the venture 64% ownership of the young plants in South Africa.

Revenue Breakdown

The company's revenue grew by 30.97% to 805.6B in 2017. Revenues from Nigeria contributes over 68% of the company's total revenue but revenues from the other countries (Pan-Africa) are growing strongly in 2017 they grew by 32.52% from 195B in 2016 to 258.4B in 2017. The companies net income increased by 32.8% in 2017 and the Q3 2018 also grew by 2.7% this shows consistent growth not only in the company's revenue but also in its net income. The operations in other countries also show promise because the losses reduced by 39.2% in 2017.



Source: Bloomberg Finance LP, Eagle Finance Research



Source: Bloomberg Finance LP, Eagle Finance Research

Dangote Cement also recorded increase in volume sales in both Nigerian operation (+6.16% y/y to 2.95mmt, Q3 2018) and Pan-African operation (+8.22% y/y to 2.46mmt, Q3 2018). Consequently, group sales volume was up by 8.14% y/y in Q3 2018 to 5.41mmt.

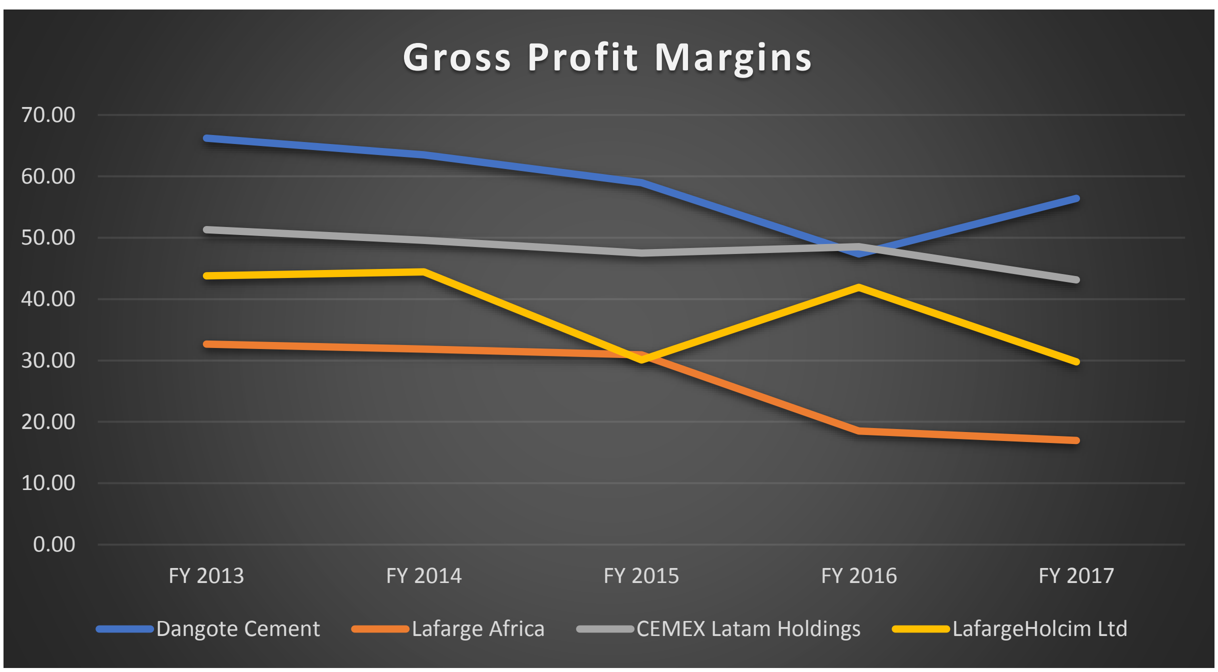
The Q3 report also shows that the company has made effort to reduce its operating expenses by improvements made to its fuel mix at two of its major production facilities in Nigeria i.e. Obajana and Ibese by eliminating the use of LPFO for a cheaper gas and self-mined coal

Nine months to 30th September 2018	Obajana		Ibese	
	2018	2017	2018	2017
Gas	53%	41%	69%	43%
Coal	47%	57%	31%	56%
LPFO	0%	2%	0%	1%

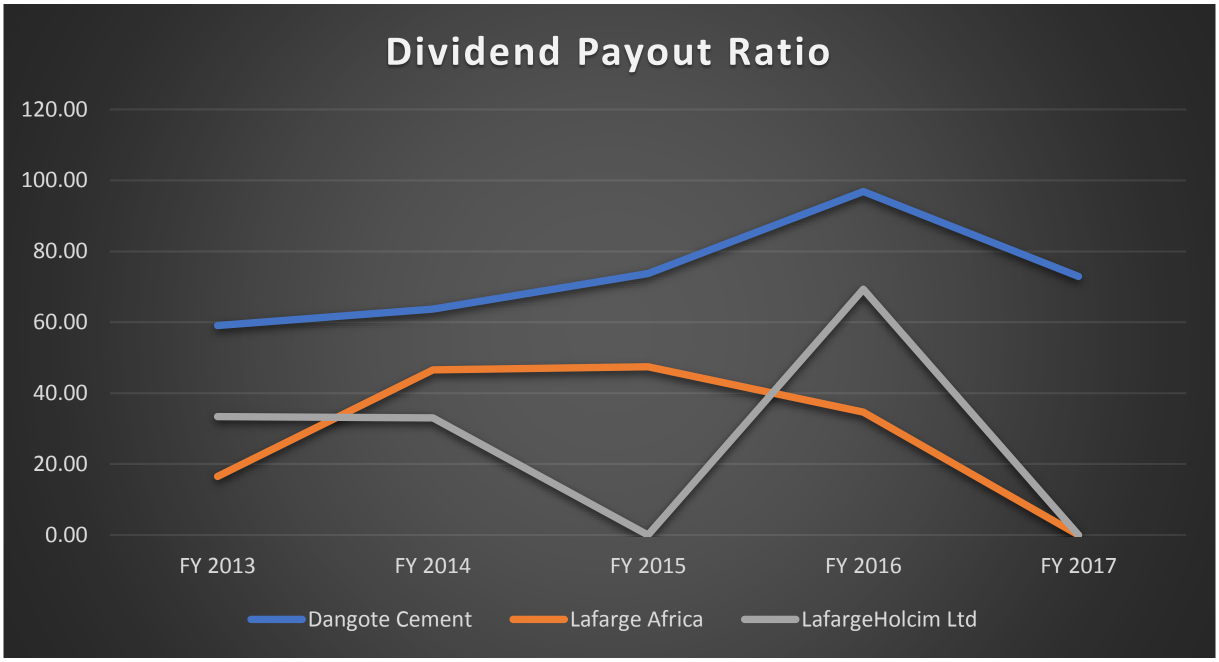
Source: Company Reports, Eagle Finance Research

Industry Leadership Performance

Dangote cement's gross margin last year was 56.39% which was far more than its major local competitor, Lafarge Cement, who had a margin of 16.97% and also international company's such as LafargeHolcim Ltd, 29.78% and CEMEX Latam Holdings, 43.13%. Dangote cement has also paid a large part of its earning as divided having a dividend payout ratio of 72.94% in 2017, 96.86% in 2016 and 73.69% in 2015.



Source: Bloomberg Finance LP, Eagle Finance Research



Source: Bloomberg Finance LP, Eagle Finance Research

Projection

We believe that the increase in volumes of product sold by the company will continue into Q4 2018 and will end with an overall increase this year. We project volumes of shipment to improve y/y by 10% (calculated 5yrs CAGR) at the end of 2018 given the growths experience in the past 3 quarters and that prices will remain stable. The growth in volumes of shipment will be driven by growth in Pan-African production which grew by 24% in 2017.

Due to the growth increase in volumes and relatively stable prices we project that the revenues of Dangote Cement will continue to grow at the rate of 16%. We project that as the company grows there would be a drop in gross margins by 3% as the effect of production cost pressures affect the company's current huge gross margins.

Business Valuation

In order to determine a target price for Dangote cement we valued the business using the discounted cashflow approach. The current interest on Dangote Cement bond, 13.96% was used as the cost of debt. We used an MRP of 11.42%, representing the Nigerian equities market from Damodaran and a Beta of 1.1497 gotten form the financial times. A perpetual growth rate of 7,13% was used because of the high inflationary pressures in Nigeria and the general ability for the economy to growth at a faster pace. The result was a target price of ₦219.53 a 7.14% increase in the price of the stock.

Discounted Cashflow Valuation

millions of Naira	**2018E**	**2019E**	**2020E**	**2021E**	**2022E**	**Terminal**
EBIT	331,586.72	497,380.08	746,070.12	1,119,105.18	1,678,657.77	
Tax	(106,107.75)	(159,161.63)	(238,742.44)	(358,113.66)	(537,170.49)	
NOPAT	225,479.0	338,218.5	507,327.7	760,991.5	1,141,487.3	
Depreciation and amortisation	82,801.05	90,253.14	98,375.93	107,229.76	116,880.44	
Change in working capital	(33,317.66)	(33,317.66)	(33,317.66)	(33,317.66)	(33,317.66)	
Capex	(136,735.68)	(149,041.89)	(162,455.66)	(177,076.67)	(193,013.57)	
FCF	138,226.7	246,112.0	409,930.3	657,827.0	1,032,036.5	
Terminal value						8,303,123.81
NPV FCF	1,238,719.41					
NPV Terminal Value	2,719,526.45					
EV	3,958,245.86					
Net Debt	217,362.32					
Equity value	3,740,883.54					
Share outstanding	17,040.51					
Target price	***219.53***					

PGR	7.13%
WACC	20.45%
Cost of Equity	26%
Cost of Debt	14%
Risk free rate	12.75%
MRP	11.42%
Beta	1.1497
Cost of Debt	13.96%
Debt ratio	33.16%
Equity ratio	66.84%
Tax rate	32%

Source: Eagle Finance Research Estimates

Risks which may impact Cement Industry

1. Increased competition from new players like BUA, which may lead to price cuts and consequently reduce healthy margins

2. Possible inflationary pressures as a result of high spending from campaigning, ahead of 2019 general elections. For instance, some of the residential constructions being executed to close the housing deficit, may be too high if inflation picks up because of the election

season. This may have the undesired effect of crowding out the middle class, who these buildings are targeted at in the first place

3. Another major risk is the availability of finance to the average African and Nigerian to purchase a home. Using Nigeria as an example, mortgage debt to GDP is at a paltry 0.5% and only about 14% of the houses available are currently being financed with mortgage debt.

4. Implementation of the government's budget, particularly with respect to capital expenditure spend is also a risk. This is because there is sometimes a long delay between when the budget is prepared, when it is approved and the money disbursed for project execution. Given the political and bureaucratic bottleneck, some of the planned infrastructure would most likely see significant delays prior to execution.

5. Climate risk: There has been incidence of flood in some parts of Nigeria, during which time construction activities either slow down, or hampered in one form or the other. Even though the Nigerian Meteorological Agency has predicted "normal" rainfall for the rest of 2018, it is still a risk worth noting note of as some predictions have been erroneous in the past.

6. Security: Some states in Nigeria continue to experience security challenges, especially in the middle belt region, due to the farmers-herdsmen conflict. Also, the Boko Haram threat in the North East still exists, albeit on a much lower scale compared to 2015. In any case, violent breakouts tend to disrupt construction activities and cement producers best take note of such.

Along with our lead stock pick, Dangote Cement we suggest the following names as well:

1. Nestle Nigeria Plc
2. First Bank of Nigeria Holding Company
3. Eterna Plc
4. Vitafoam Plc.

Nestlé Nigeria PLC

Nestlé Nigeria PLC is one of the largest food and beverage companies in Africa. For over 57 years, Nestlé has been delighting consumers in Nigeria with high quality nutritious food products. With a staff strength of over 2,300 direct employees, 3 manufacturing sites, 8 branch offices and a head office located in Lagos, the company produces and markets several iconic brands including Maggi, Milo, Golden Morn, Nescafé and Nestlé Pure Life.

Nestlé Nigeria Plc announced its financial results for first quarter of 2018. The company continued its momentum from 2017 delivering a revenue of N 67.5 billion for Q1 2018, a growth of 10.3% over Q1 2017. The Company also posted a net profit of N 8.6 billion compared to N 8.4 billion in the same period of the previous year.

Looking forward to the rest of 2018, Nestle is optimistic that the current business model will keep on delivering satisfactory results to shareholders and to society in line with the Creating Shared Value principle. Providing high-quality and affordable nutritious food and beverages which meet the needs and preferences of consumers will remain in focus as the company work alongside partners to build thriving and resilient communities through sustainable local sourcing and product innovation."

FBN Holdings Plc.

FBN Holdings Plc. is the non-operating financial holding company of First Bank, Nigeria's biggest bank by total deposit and gross earnings. FBNH offers commercial banking, asset management, merchant banking and insurance services to over 12.4 million customers across 12 countries. The business remains strong with 13.6% y-o-y growth in net earnings as at end of Q2 2018. The improvement in net income margin can be attributed to reduction in percentage of non-performing loans and increased operating efficiency of the company. The earnings per share also increased by 15.2% in the same time period. The Return on Sale at 11.42% is one of the best in the industry, an improvement from 10.2% ROS as at the end of Q2 2017.FBNH has a stable and diverse funding base and earns dividend from its non-commercial business subsidiaries. The y-o-y improvement in cost to income ratio and operating expenses despite inflationary environment is evidence of the company's performance. FBNH's business is impacted by currency devaluation, asset quality, capital management, operating efficiency and oil prices. As a result of FBNH's diverse portfolio, it is the least exposed of its peers to fluctuating oil prices. In the last quarter, FBNH recorded a loss and this caused the share price to drop by about 15% as some investors dumped the stock. It is recommended to buy this stock because this decline in share price promises to be temporary and quick returns will be achieved once share price picks up in soon as it is expected to.

Eterna Plc

Eterna Plc is a Nigeria-based company engaged in the manufacturing and marketing of lubricating oils and petrochemicals, importation and sale of fuels through its retail outlets, gas, power, upstream supply and technical services for companies in the oil industry. The Company's segments include Retail and Industrial, Lubricants and Chemicals, and Trading. The Retail and Industrial segment is engaged in the sale and distribution of petroleum products (white products and lubricants) in retail outlets and small units and to industrial customers across Nigeria. The Lubricants and Chemicals segment is involved in the manufacture and distribution of lubricants and chemicals to marine and energy customers across Nigeria. The Trading segment is involved in the bulk importation and sale of fuels (premium motor spirit (PMS), automotive gas oil (AGO), dual purpose kerosene (DPK)), base oils, bitumen and low pour fuel oil (LPFO), as well as involved in lifting and sales of crude oil. For the six months ended 30 June 2018, Eterna Plc revenues increased from NGN79.64B to NGN172.98B. Net income decreased 8% to NGN965.3M. Revenues reflect an increase in demand for the Company's products and services due to favorable market conditions. Net income was offset by General and Administrative Expenses - Ba increase of 25% to NGN1.09B (expense), Foreign exchange gains decrease of 28% to NGN289M (income). Forecast PE ratio 4x is cheaper than competitors 9x showing slow growth projection by investors. The company pays dividends with a yield of 6.6% and a historic EPS of 1.54. Its net debt is at levels of 0.9% of operating profit. Its valuation of price to sales is 0.1x, price to operating profit is 3.1x and return on equity 17.2%. Its 52 week price range is 3.70 to 6.05 Naira showing a relatively good stock performance and stable financial performance on the part of the company.

Vitafoam Nig. Plc

Vitafoam Nig. Plc is a consumer goods company that manufactures, markets and distributes flexible and rigid foam and fibre products, as well as textile linens. It has 4 subsidiaries in Nigeria, and in addition, operates 2 other subsidiaries in Ghana and Sierra Leone, all in West Africa. Its major products include: spring mattress, regular flexible foams, furniture and furnishings and more recently, rigid polyurethane insulation systems.

Our investment theory is founded on the belief that the company is expected to benefit from management’s sustained diversification from core rigid foam/mattress production, a strategy that give them an edge over competitors. Also, management has expressed plans to consider a spin-off of underperforming subsidiaries in Ghana and Nigeria, a move that will see the company return to profitability in the near future.

Recently released Q3 2018 results shows the company bouncing back to profitability, with profit after tax values increasing 287% from same period in 2017. The company has also sustained dividend payments, with Y-O-Y EPS increasing from NGN0.16 to NGN0.62. Vitafoam shares are valued at 10.09x -TTM P/E and 4.57x – Current EV/TTM EBITDA, a respective 58% and 64% discount to global emerging market comparables, suggesting a potential for increased growth in value.