



**Report Date: August 17, 2007**

**Valuation Price: N10.52**

**Recommendation: HOLD/LONG TERM BUY**    **Discount to Valuation Price: 32.98 %**

### **EXECUTIVE SUMMARY AND INVESTMENT RATIONALE**

- Berger Paints Nigeria Plc is one of the leading paint makers in Nigeria. Its principal activities are manufacturing and marketing of paints and allied products. The company, through its one of its subsidiaries (Berger Construction Ltd and Berger Paints Cargo Services Ltd), also provides architectural services, renovation, reconstruction and decoration, landscaping, repairs and maintenance, painting and colour scheming recommendations, and cargo handling services. It was quoted on March 14, 1974 on the Nigerian Stock Exchange(NSE) and largely owned by Nigerians with only 11.26 per cent owned by CAB (Overseas Holdings) Limited, UK. It also has **Robbialac Nigeria Limited** as its other subsidiary with 95 per cent equity holding.
- Berger Paints' recent financial results reveal resurgence in performance. The company grew its turnover by 20.2 per cent from N1.94bn in 2005 to N2.3bn in the financial year ended December 31, 2006. It transited from a loss profile of N44.8m in 2005 to profitability with PAT of N81.7m in 2006. We project turnover and after-tax profit of N2.6bn and N103.8m respectively for the year ending December 31, 2007, premised on conservative growth rates of 12.8 per cent and 27.1 per cent in that order.
- Attached to our valuation is liquidity risk as Berger Paint's current ratio reveals that the company needs to strengthen its working capital management, most especially its days in payables by securing better credit terms with its suppliers. Thus, we expect a correction given the current strategic turnaround and performance success achieved in 2006 financial year and Q1-2007. There also exists policy risk with the current trade liberalization via **Common External Tariff (CET)** regime and reduction of tariffs on finished paints. Similarly, the sector's success and prospect is, without any doubt, hinged on implementation of local content policy. Importation of foreign brands of paints and weak controls on output from the Export Processing Zones

(EPZ) has worsened unfair competition against local manufacturers of paints. With the current pressure of inflation in Nigeria, the company faces the risk of rising cost of sales, mainly due to the possible depreciation in the value of naira relative to foreign currencies, as the company heavily depends on imported raw materials for its production.

- Based on our analysis, we recommend the stock for BUY especially for value investors with medium to long term investment horizons.

### **THE WORLD CHEMICAL INDUSTRY:**

The chemical industry includes large, medium, and small companies that engage in the production of industrial chemicals. This industry is central to modern world economy, converting raw materials (oil, natural gas, air, water, metals, and minerals) into more than 70,000 different products. Polymers and plastics, especially polyethylene, polypropylene, polyvinyl chloride, polyethylene terephthalate, polystyrene and polycarbonate comprise about 80 percent of the industry's output worldwide. Chemicals are used to make a wide variety of consumer goods, as well as thousands of inputs to agriculture, manufacturing, construction, and service industries, even the chemical industry itself consumes 26 percent of its own output as input. **Major industrial consumers of the industry's output include firms producing rubber and plastic products, textiles, apparel, petroleum refining, pulp and paper, and primary metals. Global chemical business is worth nearly a US\$2 trillion, and the EU and U.S. chemical companies are the world's largest producers.** The largest corporate producers worldwide, with plants in numerous countries, are BASF, Dow, Shell, Bayer, INEOS, Exxon Mobil, DuPont, and Mitsubishi, along with thousands of smaller firms.

The chemical industry has shown rapid growth for more than fifty years. The fastest growing areas have been in the manufacture of synthetic organic polymers used as plastics, fibres and elastomers. From time immemorial, the chemical industry has been concentrated in three areas of the world, Western Europe, North America and Japan (the Triad). The European Community remains the largest producer area followed by the USA and Japan. **The traditional dominance of chemical production by the Triad countries is being challenged by feedstock availability and price, labour cost, energy cost, differential rates of economic growth and environmental pressures.** Instrumental in the changing structure of the global chemical industry has been the growth in China, India, Korea, the Middle East, South East Asia, Nigeria, Trinidad, Thailand, Brazil, Venezuela, and Indonesia.

## **NIGERIAN INDUSTRIAL SECTOR:**

Nigerian industrial and manufacturing sector comprises multinational, national, regional and local operators. Save the multinationals, majority of the other players have been failing in the last two decades, due to unpredictable government policies and lack of basic raw materials (most of which are imported). Today, the Nigerian Industrial & Manufacturing sector accounts for less than 10 per cent of Nigeria's GDP, with manufacturing capacity utilisation remaining below 35 per cent for the most part for the last decade. The history of industrial development and manufacturing in Nigeria is a classic illustration of how a nation could neglect a vital sector through policy inconsistencies and distractions attributable to the discovery of oil. The near total neglect of agriculture has denied many manufacturers and industries their primary source of raw materials. The absence of locally sourced inputs has resulted in low level industrialization. Until recently, the industry has been plagued with myriad of challenges ranging from prohibitive lending rates, unpredictable government policies, lack of effective regulatory agencies, infrastructural inadequacies and decay, dumping of cheap products, uncompetitive tariff regimes, and low patronage.

## **RECENT DEVELOPMENTS:**

- Operational performances of Berger Paints Plc for the year ended December 31, 2006 and Q1-2007 beckon a more promising future and reveal that the company is on fast track to recovery, courtesy of the strategic recovery plan put in place over the past two years. The company's Q1-2007 results reveal that turnover grew by 10.5 per cent from N47.48m in Q1-2006 to N529.68m while PBT and PAT rose by 47.1 per cent and 61.5 per cent respectively. Berger reported a PBT of N30.31m in 2006 against N19.26m while PAT increased from N13.09m to N21.15m.
- The company recently commissioned a product centre 'Berger Colour World' in Abuja to carve a niche in the market. It also plans to commission more of this centre in 2007 and beyond with a view to expanding its market share. Plans are also in the pipeline to establish colour tinting program. All these are targeted at refocusing its business models to meet and surpass the expectations of its customers and improve performance.
- As part of its restructuring agenda, Berger Paints recently introduced a Point of Sale (POS) Colour Center, which enables it to produce paints instantly based on the colours specified by customers at the point of sale. This is expected to deliver greater value to customers and impact on the company's top and bottom-lines. Furthermore, in order to compete favourably in the automotive market, the company entered into a commercial and technical alliance with a top-class automotive company in the

world. Not only this, it is also working in collaboration with Sherwin-Williams Company, one of the leading paints conglomerates in the United States. Besides, Berger Paints is making moves in other related industries to secure housing, renovation and construction jobs given the avalanche of opportunities in the real estate sector.

## **ANALYSIS OF FINANCIALS:**

### **Growth:**

**Berger Paints** recorded a **Compounded Annual Growth Rate (CAGR)** of 12.17 per cent in turnover between 2002 and 2006. Turnover grew from N1.45bn to N2.3bn over this period. The company recently achieved an annual growth rate of 20 per cent as it improved its turnover from N1.91bn to N2.30bn between 2005 and 2006. The momentum of its growth appears moderate in the light of its most recent results for the first quarter ended March 31, 2007. This showed a turnover of N529.7m, thus translating to a growth rate of 10.5 per cent over N479.5m reported in corresponding period in prior year. Though commendable, the growth performance of **Berger** falls slightly below that of its peers- **DN Meyer Plc and CAP Plc**, which achieved **CAGR** of 15.2 per cent and 16.2 per cent respectively over the same 5-year period. Meanwhile, the results for the Q1-2007 revealed a quarter-on-quarter growth rate of 27.5 per cent for **CAP** and a decline in growth by 13.3 per cent for **DN Meyer**.

### **Profitability:**

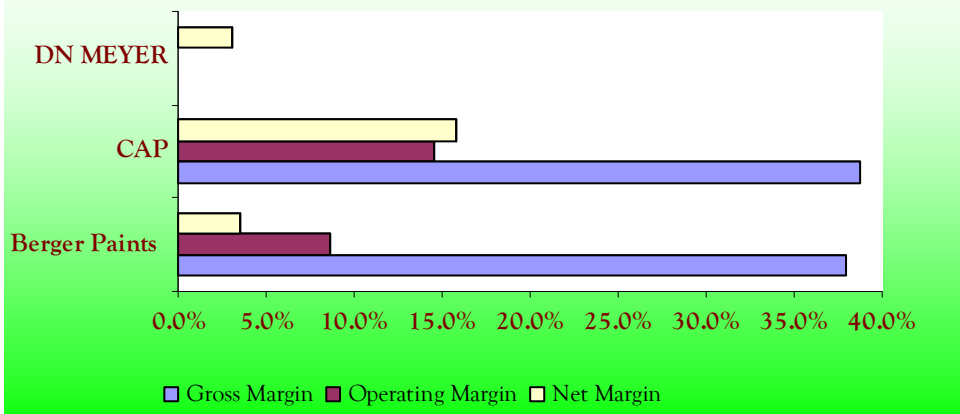
Berger Paints' gross profit margin, with a 5-year average of 40.3 per cent, dropped from 39.7 per cent in 2005 to 37.9 per cent in 2006. The observed downward movement in gross margin is attributable mainly to increased competition in the Chemical and Paints industry, which restricted local manufacturers of paints from raising their products' prices in response to increasing input costs. This was further reinforced by the liberalization and reduction of tariffs for finished paints from 40 per cent to 20 per cent, which made imported substitutes relatively less expensive. This problem was also

experienced by other local manufacturers of paints as CAP Plc also reported a decline in gross margin from 40.1 per cent to 38.8 per cent between 2005 and 2006. In addition, Berger's operating margin which rose consistently from 12.6 per cent in 2002 to 14.3 per cent in 2004 fell drastically to 4.0 per cent in 2005 and then rose again to 8.7 per cent in 2006. **Although the increase signals improvement in its operating performance in 2006, Berger's operating margin remains below the 14.5 per cent reported by its close rival, CAP in 2006.**

With an average annual growth rate of 9.5 per cent, Berger's after-tax profit rose from N85.9m to N101.2m between 2002 and 2004. However, due to loss of N466.2m resulting from financial shenanigans, operational failure and high interest burden, the company reported an abysmal performance in 2005, with an operational loss of N44.9m. Sequel to this, the company significantly revamped its corporate governance structures, upgraded its business processes and enhanced the reliability of its management information systems, and thus rebounded to profitability in 2006 financial year with an after-tax profit of N 81.7m.

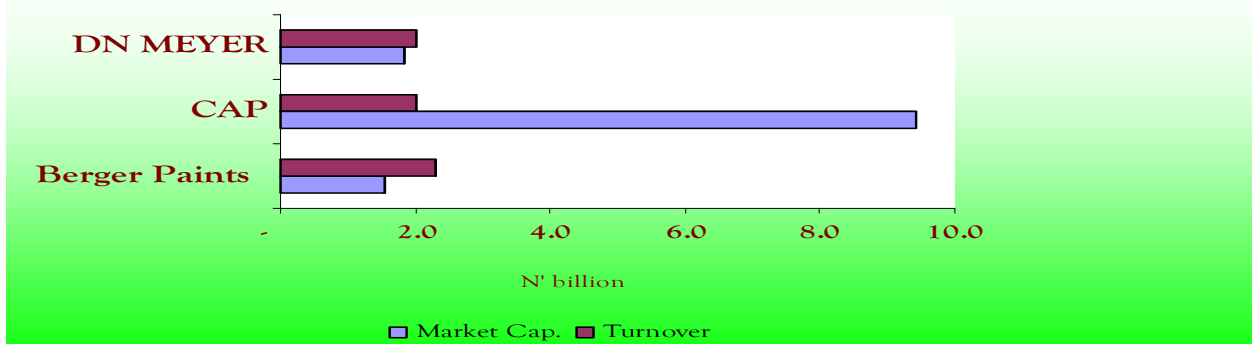
The company's profitability seems sustainable with its Q1-2007 results. It recorded an after-tax profit of N21.15m, which translates to an increase of 61.5 per cent over N13.10m reported over similar period in 2006. **This performance is highly commendable in the face of the performance of its peers. Over the same period, CAP Plc and DN Meyer reported quarter-on-quarter growth in after-tax profit of 44.7 per cent and 9.3 per cent respectively.**

GROSS, OPERATING AND NET MARGIN OF KEY CHEMICAL & PAINTS COMPANIES: 2006 FINANCIALS



Berger Paints' return on equity (ROE), which averaged 13.4 per cent over the last five financial years, rose continually from 19.6 per cent in 2002 to 20.4 per cent in 2004 and then dropped significantly to a negative level of 5.1 per cent in 2005. However, due to the recovery in performance in 2006, the company reported a positive ROE of 8.4 per cent for the year ended December 31, 2006. Similar trend is replicated in the company's return on asset (ROA) which initially rose from 14.6 per cent in 2002 to 17.7 per cent in 2003, then declined to 3.7 per cent in 2005 and finally upped to 10.0 per cent in 2006. Nevertheless, Berger Paints' most recent ROE and ROA (8.4 per cent and 10.0 per cent respectively) are pale in comparison with those of CAP Plc, which stand at 36.5 per cent and 29.5 per cent respectively.

TURNOVER AND MARKET CAP. OF KEY CHEMICAL & PAINTS COMPANIES: 2006 FINANCIALS



### **Liquidity, Efficiency and Solvency:**

Berger Paints' Current ratio for 2006 financial year stood at 0.88 times, up from 0.78 times recorded in 2005, suggesting slight improvement in liquidity position between 2005 and 2006. Similarly, change in the company's **Acid-Test ratio** between 2005 and 2006 portends improving liquidity position. The **Acid-Test ratio** which stood at 0.82 times in 2003 declined continually to 0.39 times in 2005, before slightly rising to 0.43 times in 2006, meaning that Berger Paints' readily realizable short-term assets now cover 43 per cent of its total short-term liabilities. Although there are indications of improvement in its liquidity position in recent year, the company's **Current and Acid-Test indices** remain below the rule of thumb benchmarks of 1.5 times and 1.0 times respectively for a manufacturing firm.

In addition, a review of Berger Paints' **Cash Flows** reveals improved liquidity between 2005 and 2006. The company's **Operating Cash Flow-to-Net Income ratio**, a measure of the extent to which net income generates cash for a business, rose from negative 1.13 times in 2005 to positive 5.99 times in 2006. Similarly, the company's operating **Cash Flow-to-Current Liabilities** ratio increased from 0.04 times in 2005 to 0.57 times in 2006, while its **Cash Operating Cycle (COC), which indicates the average number of days it takes a company to turn its acquired inputs into actual cash inflows through sale of its output**, declined from 114 days in 2005 to 74 days in 2006, thus implying that Berger Paints is tying up less capital in its processes. The improving trend in Berger Paints' liquidity is corroborated by trends in its average **Receivables' Days and Inventory Holding Period**. Berger Paints' average Receivables' Days declined from 30 days in 2005 to 26 days in 2006, meaning that it provides less finance to its customers. Also, the average inventory holding period declined from 144 days to 99 days between 2005 and 2006. **We expect the falling trend in inventory holding period to continue with the introduction of colour centres which allow paints of varying colours to be produced instantly on demand by customers.** Conversely, Berger Paints enjoyed less finance from its creditors as the average payable days declined from 59 days in 2003 to 51 days in 2006. **We expect**

**the company to experience a boost in liquidity if it can successfully obtain more finance from its trade creditors.** Furthermore, there are indications of improvement in the company's efficiency in the use of assets. The company's total asset turnover improved from 0.92 times in 2005 to 1.15 times in 2006, meaning that the extent of revenue generated from the use of its assets has increased over the two-year period. This improvement contributed to the rise in both ROE and ROA between 2005 and 2006.

In terms of long-term solvency, Berger Paints remains a very stable company. The company has no fixed-interest long-term debt in its capital structure. Its **Total Debt-to-Total Assets**, which averaged 62.7 per cent between 2002 and 2006, declined from 74 per cent in 2003 to 52 per cent in 2006, indicating reduced exposure to debt. Similarly, **Total Debt-to-Equity** declined from 281 per cent in 2003 to 107 per cent in 2006. **Berger Paint's debts, save its outstanding bank overdraft, are mainly made up of interest-free liabilities, thus it has low interest payments obligations.** Its **Earnings Before Interest and Tax (EBIT)** sufficiently covers its interest obligations. Interest cover rose from 0.5 times in 2005 to 2.2 times in 2006 with a five-year average of 1.68 times.

#### **Value to Investors:**

Berger Paints' Earnings Per share (EPS) declined from 39.5kobo to 37.43 kobo between 2002 and 2006. The company's trailing EPS however stands at 41 kobo, which is slightly above the 39.5 kobo reported in 2002. Berger Paints' trailing earnings yield of 5.8 per cent is slightly below the industry average of 6.2 per cent. The company has been consistently paying dividend in the past until 2005 financial year when it reported a loss. Consequently, the company did not pay dividend in the past two financial years. Before 2005, the company's dividend pay-out ratio averaged 76 per cent, with the highest of 83.5 per cent and the lowest of 64.5 per cent recorded in 2001 and 2004 respectively.

#### **Technical Analysis for Berger Paints Plc:**

Berger Paints qualifies as a penny stock with its trading price range of less than N10. The stock traded at an average of N4.14 and N3.39 in 2005 and 2006 respectively. In the year 2005, the stock recorded

a High/Low of N5.83/N3.00 on January 27 and June 3, 2005 respectively. Average daily volume traded was 100, 000 units same year. For the 1st half of the year, the stock exhibited a bearish trend with each successive heads, lower than the preceding head but the 2nd half showed a slightly bullish trend.

Average daily traded volume increased in 2006 but with generally lower trading prices relative to 2005. Bears dominated dealings in the stock for the earlier part of 2006, like it was in the preceding year. There was however, a brief and mild bullish run towards the last quarter of the year during which the year's High was recorded. The year's High/Low for the year was N4.16/N2.60 recorded on September 25, 2006 and May, 25 2006 respectively.

While the direction of the primary trend for Berger Paints from 2005 to 2006 was generally bearish, year 2007 has shown promises of a strong bullish trend. Though with sharp advances and declines, the bullish trend exhibited by the stock has been very sharp. This movement correlates with the general market trend. The High of Berger Paints from start of year till date is an all-time of N8.69 recorded on May 15, 2007 with the Low of N3.71 recorded earlier in the year on January 15, 2007. Except for the liquidity of the stock with respect to its low daily traded volume, its price fluctuation makes it a very good trading stock. Average daily traded volume, though, still low, has witnessed a surge from less than 150,000 units to over 240,00units from January 1, 2007 to date.

#### **VALUATION:**

In valuing Berger, a number of valuation metrics, such as Price-to-Book value method, Price-to-sales method, Price-to-Earnings method, and Discounted Free Cash Flow valuation method (with a discount rate of 12.82 per cent), were used. After applying appropriate weights with a bias for Free Cash Flow valuation method, we arrived at a fair value of N10.52.

*Meristem Securities Limited EQUITY RESEARCH REPORT and its attendant recommendations are prepared based on publicly available information and are meant for general informative purposes. Meristem Securities Limited can guarantee neither the accuracy nor completeness of the information as they are an expression of our analysts' views and opinions. Meristem Securities Limited cannot be held responsible for any loss suffered by relying on the said information as this information as earlier stated is based on estimates and opinions and is meant for general information purposes and not as solicitation to buy securities and financial instrument. © Meristem Securities Limited August 2007.*