



H1:09: Update

Cement Company of Northern Nigeria Plc

12-M TP: N15.68

12-M Upside: 48.6%

Rating: BUY

Investment Thesis

Enterprise value expands on the back of improved capacity utilization; upgrade target price to N15.68

We upgrade our target price for CCNN by 65.5% from N9.47 to N15.68 based on emerging realities from CCNN H1: 2009 Results reflecting the company's drive to optimize its capacity utilization while benefiting substantially from improved cost structure. We see strong value proposition in the combined impacts of these 2 milestones as the company's enterprise value soars beyond our initial estimated level. We highlight below the salient changes in our underlining assumptions driving our overweight position on the stock.

- Increased capacity utilization at near 90% (vs. our initial anticipation of 70%), driving operational volume beyond our expectations:** We had based our production expectation for CCNN on an average of 70% utilization rate of its installed capacity of 500,000 tons of cement p.a. However, based on the H1:2009 interim operational results, our estimate suggests capacity utilization of +80% (substantially above our initial expectation of 70% for 2009 and 2010). This improved capacity utilization rate driving the company's top-line (sales revenue) is premised on the full-scale effect of higher run factor for the replaced damaged kiln shell segment of the company's plant in 2008. **See table below for key changes in production headlines.**

| Key production headlines | H1:2009 | | Surprise rate | FY 2009 estimates | | Surprise rate |
|--------------------------------|------------------|---------|---------------|-------------------|------------------|---------------|
| | Initial forecast | Actual | | Initial forecast | Revised forecast | |
| Installed capacity (tons p.a.) | 500,000 | 500,000 | 0% | 500,000 | 500,000 | 0% |
| Production [tons] | 170,000 | 217,500 | 32.4% | 340,000 | 435,000 | 32.4% |
| Capacity utilisation | 68.0% | 90.0% | 32.4% | 68.0% | 90.0% | 32.4% |
| Turnover (N'bn) | 4.83 | 6.59 | 36.5% | 9.66 | 13.73 | 42.2% |

Source: CCNN Interim Report, Meristem Research estimates

- Breaking the back of crippling energy challenge resulting in improved cost structure and the re-emergence of healthy margin:** CCNN completed Power Project of combined capacity of 12MW in addition to its 6.6KV substation which is connected to the national grid are playing out positively on the company's cost structure as the Company now runs its power plant on heavy fuel oil (LPFO) as against much more expensive diesel. We expect this to improve CCNN's cost-to-sales ratio to an average of 54% going forward (**vs. 72% in 2007**). We see this expectation much convincing knowing that energy cost alone constitutes c. 50% of CCNN's total production cost. **This submission is strongly supported by CCNN H1:2009 net profit margin of 17.78% (vs. 13.92% in 2008)**. In our forecast model, we have generated net profit margins of 16.2% and 18.7% for '09FY and '10FY respectively.
- Earnings experiencing new growth momentum on the back of improved capacity utilization and better cost structure:** Premised on the step-up in CCNN's production numbers and cost structure, we have revised our earnings models to capture these new drivers of the company's earnings. The current earnings momentum defies our initial estimates of a comeback to gentle earnings growth by 2010 following 2008 astronomical growth. **Re-emergence of healthy margins (2009e: 16.2%) and solid RoAE (2009e: 50.5%) are the chief drivers of CCNN enterprise value.** The table below gives extracts of our 2009 initial and revised earnings numbers.

| Headlines | 2009 | |
|-------------------|------------------|------------------|
| | Initial forecast | Revised forecast |
| Earnings (N'bn) | 1.25 | 2.15 |
| Headline EPS (N) | 1.00 | 1.71 |
| Growth | 15.80% | 40.2% |
| Net profit margin | 13.0% | 16.2% |
| RoAE | 31.32% | 50.54% |

Source: Meristem Research estimate

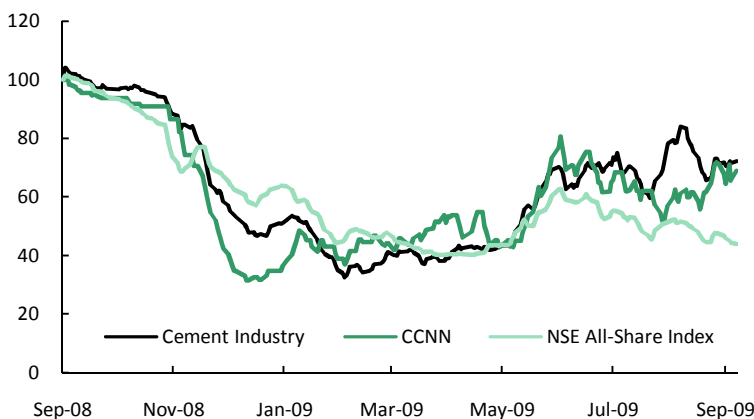
- Half-yearly and high cash dividend payout rate though not consistent with expansion plan going forward:** Following improved operational performance since 2007FY on the back of huge CAPEX program on plant refurbishment (estimated at N3.19bn between 2006 and 2008), **we perceive CAPEX slowdown in the interim** as evident in the stable asset base in H1:2009 compared to 2008FY. Hence, in addition to the interim dividend of 80k declared in H1:2009, we premised 2009e payout rate of 75% on **higher free cash flow position in 2009FY** and we forecast a modest final dividend of 48k at year end. This translates into a total dividend of N1.28 and at current price, **this gives a dividend yield of 11% (vs. Market: 6.72%, peer average: 2.24%)**.

| Headlines | 2007 | 2008 | H1:2009 | H2:2009 | FY2009e |
|--------------|------|------|---------|-------------|-------------|
| EPS (N) | 0.11 | 1.22 | 0.93 | 0.83 | 1.77 |
| Dividend (N) | 0.10 | 0.90 | 0.80 | 0.52 | 1.32 |
| Payout rate | 91% | 74% | 86% | 63% | 75% |

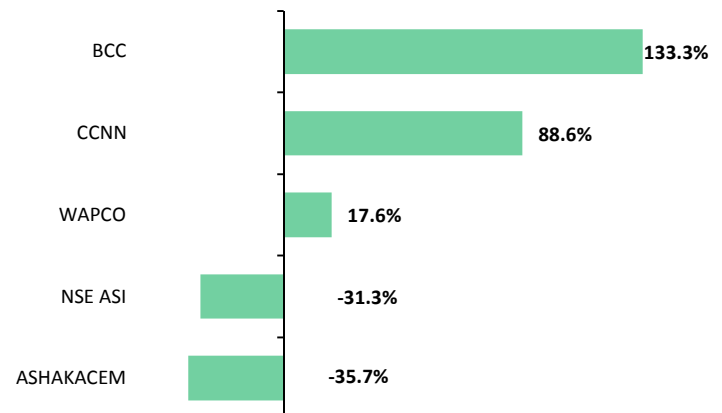
Source: CCNN Financial Report, Meristem Research estimates

- **Capital structure change is welcomed as we envisage better financial flexibility:** We observed a change in CCNN capital structure following the taking up of N760m long term loan in 2008 and drastic reduction in its short term debt obligations. Though this deteriorated the solvency ratio from 0.13x in 2007 to 0.30x in 2008, the current capital mix is very much within the company’s comfort zone as interest coverage hovers above 4x in addition to better financial flexibility as the company now has long term funds to play with. This implies that CCNN has even more debt absorptive capacity. Hence, we do not see this having negative impact on the company’s earnings.
- **New core investor, BUA International, on board; though capacity expansion plan of 750,000 tons p.a. was announced before the new acquisition, we have not included this in our forecast model.** We suspect that the current acquisition of 50.7% stake in CCNN by BUA International must have displaced Damnaz Cement Company Limited of its controlling interest. It is noteworthy that Damnaz was established in 2007 as a special purpose vehicle (SPV) to take up 50.7% of CCNN following the divestment of Scancem International in March 2008. So far, BUA has not made public any expansion plan for CCNN as it unfolded 2m tons capacity expansion plan to be delivered by 2011 in the case of Edo Cement Company Limited (ECC). Moreso, we still await concrete actions on the 750,000 tons expansion plan CCNN announced before the coming of BUA International. **We see this, as we expressed in our earlier report, as “must-do” strategy to ensure near to long term growth and position the Company competitively in the cement industry.**
- **Share price performance:** Cement stocks, as a basket, have outperformed the entire market by a broad variance of 71% having delivered 41% return YTD (vs. market:-30%) on the back of superb share price uptrend in BCC (YTD:133%) and CCNN (YTD:87%). In our opinion, this level of outperformance is fundamentally justified given the companies’ underlying earnings growth story, capacity expansions and superb profitability.

52-week share price performance trends



Year-to-date share price performance



Source: NSE, Meristem Research

Valuation

On a relative basis, we highlight the following valuation multiples to compare CCNN with its peers and give justification for market re-pricing.

- Trailing 12-month and 2009P/E Valuation:** Premised on our revised earnings forecast of 2009EPS growth of 45%, CCNN is currently priced at 2009P/E of 6.18x. Fundamentally, above industry-average earnings growth of 45% (**vs. peer median of 28% and market of -30%**) warrants higher P/E multiple. Though we expect growth momentum to slow down by 2011 (assuming no capacity expansion by then), the value of the current earnings momentum into 2010 is yet to be impounded into the share price. **Hence, compared to peers and the broad market, CCNN is underpriced.**

| Tickers | Price (N)* | P/E-TTM | 2009EPS forecast | 2009 EPS growth | 2009e P/E |
|---------------------|------------|----------------|------------------|-----------------|----------------|
| CCNN | 10.55 | 6.04 x | 1.77 | 45.2% | 6.18 |
| WAPCO | 30.99 | 7.70 x | 4.49 | 9.00% | 6.90 |
| ASHAKACEM | 10.42 | 10.51 x | 1.20 | 15.00% | 8.71 |
| BCC | 42.50 | 12.97 x | 5.46 | 313.6% | 7.78 |
| Peer median | | 10.51 x | 3.72 | 27.6% | 7.80 x |
| Broad market | | 8.39 x | | -30.0% | 11.99 x |

Source: Meristem Research estimates

- P/BV Valuation:** On book value basis, CCNN solid RoAE of 51% (**vs. peer median of 40%**), which is a chief driver of fundamental P/BV, presents a strong valuation case for higher P/BV multiple. Though this appears to be the case with current market pricing, further upside is not unwarranted given the spread of CCNN RoAE over peer average.

| Tickers | Price (N)* | BVPS (N) | P/BV | RoAE |
|---------------------|------------|----------|---------------|---------------|
| CCNN | 10.55 | 3.65 | 2.89 x | 50.90% |
| WAPCO | 30.99 | 13.48 | 2.30 x | 28.20% |
| ASHAKACEM | 10.42 | 6.43 | 1.62 x | 17.60% |
| BCC | 42.50 | 5.96 | 7.14 x | 73.74% |
| Peer median | | | 2.30 x | 39.85% |
| Broad market | | | 8.39 x | 15.80% |

Note: * Prices used here and thereafter are as of September 8, 2009

Source: Meristem Research estimates

- **Dividend yield:** CCNN's current annualized dividend yield of 15.2% dwarfs both industry average of 2.4% and broad market benchmark of 6.98%.

| Tickers | Price (Naira) | Dividend | Annualised yield |
|---------------------|---------------|----------|------------------|
| CCNN | 10.55 | 0.80* | 15.2% |
| WAPCO | 30.99 | 0.70 | 2.3% |
| ASHAKACEM | 10.42 | 0.30 | 2.9% |
| BCC | 42.50 | 1.00* | 2.4% |
| Peer median | | | 2.4% |
| Broad market | | | 7.0% |

* H1:2009 interim dividend. Annualised yield might not really reflect full year expectation

Source: Meristem Research estimates

Hence, CCNN's improved capacity utilization and current earning momentum fundamentally justify higher price multiples above what the market currently indicates.

On absolute basis, Dividend Discount Model (DDM) and Justified P/E Valuations give a strong support to our submissions of current market undervaluation of CCNN inherent value.

- **Fundamentally justified P/E Valuation:** Premised on our revised estimated parameters driven largely by CCNN business fundamentals, we derived a justified P/E multiple 11.16x. (**vs. current of 6.06x**). Applying our EPS forecast of N1.77 (based on 45% 2009 EPS growth); we derived an intrinsic value of N19.70 (97% higher than current market price). Hence, this supports our conviction of market undervaluation of the stock.

| Valuation 1: Justified P/E Model | |
|--------------------------------------|--------------|
| 2009e EPS (N) | 1.77 |
| Payout | 76.8% |
| RoAE | 53.80% |
| Sustainable growth rate | 12.47% |
| Required return | 19.36% |
| Justified P/E | 11.16 |
| Estimated intrinsic value (N) | 19.70 |

Source: Meristem Research estimates

- **Fundamentally justified P/BV Valuation:** Premised on a sustainable RoAE of 53.8% (average of our 5-year forecast), and estimated required rate of return of 19.36%, we derived a fundamentally justified P/BV multiple of 6x for CCNN. This is above industry average of 2.4x and is driven largely by the above-industry average RoAE of 53.8% (**vs. peer average of 40%**). Hence, this premium is justified. Applying this multiple on 2009e BVPS of N3.61 (derived from retention rate of 25% in 2009), we arrived at justified price of N21.64. **This also supports our undervaluation view.**

Valuation 2: Justified P/BV Model

| | |
|---|--------|
| Sustainable RoAE | 53.80% |
| Required return | 19.36% |
| Sustainable growth rate "g _t " | 12.47% |
| Justified P/BV (x) | 6.00 |
| 2009 BVPS (N) | 3.61 |

| | |
|--------------------------------------|--------------|
| Estimated intrinsic value (N) | 21.64 |
|--------------------------------------|--------------|

Source: Meristem Research estimates

- **Dividend Discount Model (DDM):** based on 5-year earnings projections, and terminal growth rate of 5%, we discounted our estimated future dividend flows of CCNN by 15.9% cost of equity to arrive at the equity value of N15.84bn (representing 119% of the current market capitalisation of N12.27bn). This fair value of total equity implies per share intrinsic value of N16.49.

DDM Valuation Output

| | |
|---------------------------------------|--------|
| Terminal growth rate | 5.00% |
| Estimated Cost of Equity | 19.36% |
| Terminal Value (Nbn) | 23.17 |
| PV of Terminal Value (Nbn) | 8.01 |
| PV of Dividend Flow (Nbn) | 7.83 |
| Fair Value of Equity (Nbn) | 15.84 |
| Current Shares Outstanding (bn units) | 1.26 |

| | |
|---|--------------|
| Fair value of equity per share (N) | 12.60 |
|---|--------------|

Source: Meristem Research estimates

- **12-month Target Price of N16 (49% upside):** We derived our 12-month target price of N15.68 for CCNN based on 60:40 weightage on DDM and justified multiples valuations. This clearly reflects our bias for DDM and represents a valuation level of 8.87x 2009EPS (still lower than peer average trailing P/E of 10.51x).

Blended valuation

| Valuation Model | Intrinsic Value (N) | Weightage | Weighted price |
|----------------------------------|---------------------|-----------|----------------|
| Justified P/E Valuation | 19.70 | 20% | 3.94 |
| Justified P/BV Valuation | 21.64 | 20% | 4.33 |
| Divided Discount Model | 12.60 | 60% | 7.56 |
| 12-month target price (N) | | | 15.68 |
| Current price (N) | | | 10.55 |
| 12-month upside potential | | | 50.1% |

Source: Meristem Research estimates

Investment Recommendation

Hence, CCNN's improved capacity utilization, improved cost structure, current earning momentum, margin rebound and solid and above-industry average RoAE fundamentally justify higher price multiples above what the market currently indicates. **Overall, we are OVERWEIGHT on CCNN with a target price of N15.68 (vs. our initial target of N9.47). We therefore reiterate our BUY rating for the stock.**

Appendix 1: Extract of CCNN Earnings Model

| Forecast Model Extract | 2007A | 2008A | 2009f | 2010f |
|-------------------------------------|----------------------|----------------------|----------------------|----------------------|
| Production Assumptions | | | | |
| Installed Capacity | 500,000 | 500,000 | 500,000 | 500,000 |
| Capacity Utilisation | 68.51% | 71.21% | 90.00% | 90.00% |
| Production | 342,548 | 356,056 | 450,000 | 450,000 |
| Price/tonne | 23,480 | 27,743 | 30,517 | 33,569 |
| Financials: Extracts (Naira) | | | | |
| Turnover | 8,042,945,852 | 9,878,093,386 | 13,732,829,179 | 15,106,112,097 |
| Cost of Sales | 5,759,222,736 | 5,708,705,932 | 7,553,056,048 | 8,157,300,532 |
| Gross Profit | 2,283,723,116 | 4,169,387,454 | 6,179,773,130 | 6,948,811,564 |
| Operating Expenses | 590,571,697 | 639,791,320 | 1,002,496,530 | 1,087,640,071 |
| Admin expenses | 1,875,164,511 | 2,262,761,638 | 3,158,550,711 | 3,459,299,670 |
| Other Income | 741,998,634 | 950,362,289 | 1,235,954,626 | 1,359,550,089 |
| Interest Expense | 387,137,218 | 536,672,434 | 480,649,021 | 453,183,363 |
| PBT | 172,848,324 | 1,680,524,351 | 2,774,031,494 | 3,308,238,549 |
| Tax | 34,184,478 | 150,000,000 | 554,806,299 | 661,647,710 |
| Profit after tax | 138,663,846 | 1,530,524,351 | 2,219,225,195 | 2,646,590,839 |
| Net Asset | 3,148,332,114 | 3,976,416,060 | 4,531,222,359 | 5,245,801,885 |
| Shares outstanding | 1,083,342,902 | 1,256,677,770 | 1,256,677,770 | 1,256,677,770 |
| Per share data (N) | | | | |
| Sales per share | 6.40 | 7.86 | 10.93 | 12.02 |
| EPS | 0.11 | 1.22 | 1.77 | 2.11 |
| NAPS | 2.91 | 3.16 | 3.61 | 4.17 |
| DPS | 0.10 | 0.90 | 1.32 | 1.54 |
| Growth and Profitability | | | | |
| Revenue Growth | 26.2% | 22.8% | 39.0% | 10.0% |
| Earning Growth | -496.7% | 1003.8% | 45.0% | 19.3% |
| Dividend growth | | 800.0% | 47.2% | 16.1% |
| Net Asset Growth | 103.9% | 8.9% | 14.0% | 15.8% |
| Gross Profit Margin | 28.4% | 42.2% | 45.0% | 46.0% |
| Net Margin | 1.7% | 15.5% | 16.2% | 17.5% |
| ROaE | 5.91% | 42.96% | 52.17% | 54.14% |

Appendix 2: CCNN Historical Financial Performance

| Historical Performance | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|--|----------|----------|----------|----------|----------|----------|
| Liquidity | | | | | | |
| Current Ratio | 0.59 | 0.84 | 0.83 | 0.64 | 0.84 | 1.14 |
| Quick ratio | 0.22 | 0.48 | 0.42 | 0.24 | 0.30 | 0.47 |
| Operating cycle (days) | 122.20 | 114.62 | 153.06 | 171.32 | 158.77 | 128.07 |
| Cash conversion cycle (days) | 64.83 | 50.68 | 73.02 | 22.55 | 1.23 | -19.36 |
| Financial leverage and solvency | | | | | | |
| Debt-Equity ratio | 1.85 | 0.79 | 0.70 | 0.60 | 0.18 | 0.43 |
| Long term debt/equity | 0.47 | 0.32 | 0.24 | 0.24 | 0.13 | 0.30 |
| Interest coverage | 0.76 : 1 | 3.46 : 1 | 2.15 : 1 | 0.97 : 1 | 1.45 : 1 | 4.13 : 1 |
| Efficiency and profitability | | | | | | |
| ROaE | -226.13% | 79.44% | 14.89% | -2.22% | 5.91% | 42.96% |
| ROaA | -3.15% | 18.35% | 3.84% | -0.49% | 1.61% | 17.09% |
| Net Margin | -3.28% | 14.95% | 3.79% | -0.55% | 1.72% | 15.49% |
| Gross Margin | 45.91% | 43.86% | 40.82% | 27.60% | 28.39% | 42.21% |
| Cost-to-sales | 54.09% | 56.14% | 59.18% | 72.40% | 71.61% | 57.79% |
| Expenses-to-sales | 37.36% | 35.29% | 35.81% | 31.06% | 30.66% | 29.38% |
| Working capital management | | | | | | |
| Inventory Turnover | 3.75 | 5.00 | 3.90 | 3.00 | 2.94 | 3.63 |
| DOH | 97.33 | 73.03 | 93.59 | 121.78 | 124.32 | 100.50 |
| Receivable Turnover | 14.68 | 8.78 | 6.14 | 7.37 | 10.59 | 13.24 |
| DSO | 24.87 | 41.58 | 59.47 | 49.55 | 34.45 | 27.57 |
| Purchases | 1.96 | 3.37 | 4.05 | 5.29 | 6.31 | 5.12 |
| Payable turnover | 6.36 | 5.71 | 4.56 | 2.45 | 2.32 | 2.48 |
| Day payable | 57.37 | 63.93 | 80.04 | 148.77 | 157.54 | 147.42 |

Appendix 3

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- HOLD:** Fair value of the stock ranges between **-20 percent and 20 percent** from the current market price.
- SELL:** Fair value of the stock is more than 20 percent below the current market price.

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