



Set for a new round of double-dip?

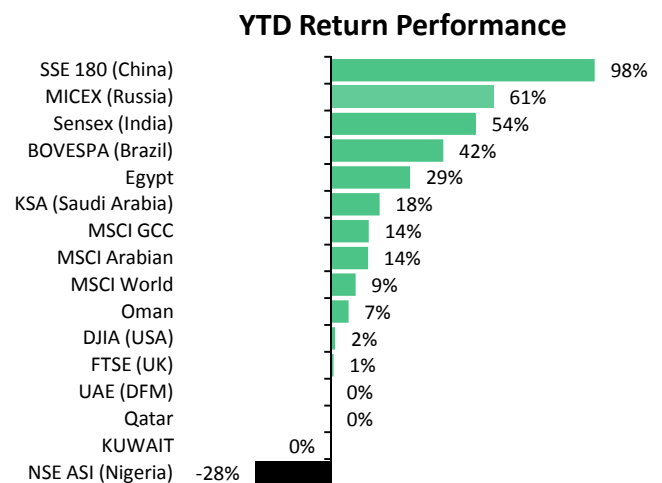
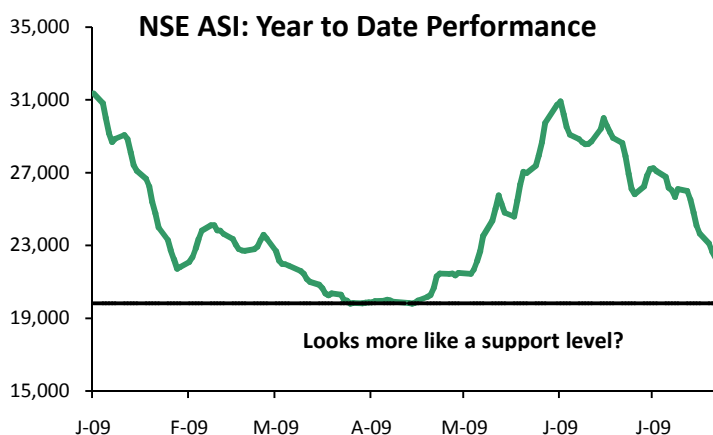
...discerning winning strategy amidst transient hiccups

The prelude

- What investment decision should investors (across board) take in response to the short-term emerging trend in Nigeria equities market? Outright exit for capital preservation, strategic buy and hold in anticipation of recovery or a 'siddon-look' (stay-away) approach?
- We believe the recent trend in marketplace warrants a more-than-the-usual paraphrasing and conventional/casual sentiments. **Rather, it is imperative to critically diagnose the cause and effect with a view to taking appropriate and informed decision for superb value.**

A diagnosis of the situation: A closer look at macro fundamentals

- Equities at global level have trended more in line with the direction of global macro economic conditions. Regions with solid macroeconomic outlook are delivering better equities returns. This explains the sound returns recorded in China, India and other GCC countries (**Gulf Cooperative Countries**). This underscores the strong correlation between economic growth and equity market performance.



Source: Bloomberg, Local Exchanges, Meristem Research

- Nigerian equities continue to trade rather choppily, sometimes quickly reversing short term trends as risk appetite waxes and wanes. On a year to date basis, Nigerian equities still underperforms global and emerging markets peers significantly. Despite the resurgence of stability in oil price, supply disruption still remains a concern putting the economic outlook in less predictable path, though the momentum in non-oil sector is expected to continue.
- In Q2-09, available data suggests Nigerian economy experienced a real GDP growth rate of 5.13%. This is broadly in line with consensus estimate of >4% 2009 growth.
- Much more important explanatory variable in the short term “up-and-down behaviour” of the equities market is the regulatory pressure surrounding the purging of commercial banks’ toxic assets inherited from margin loans exposure. **Though we are deep in the tunnel, the current downward pressure of equity prices presents a light.**
- **2009 budget vs. fluctuation in oil revenue** – Though oil price is pitching far ahead of budgeted price of US\$45 pb (about 50% above benchmark), daily oil production has been hampered significantly with **May 2009** figure standing at 1.7 mb/d, some 25% below budgeted production level of 2.29 mb/d. On the good side, if the current tempo is sustained, oil price outperformance of budgeted figure of US\$45pb will be more than enough to offset the shortfall in production caused by the severe and incessant unrest in the Niger Delta.
- The oil price is increasingly averaging higher than budgeted and by Q2-09 has outperformed the benchmark price by 57.78%. Nigeria’s contribution to total OPEC production fell marginally from 6.26% as of March 2009 to 6.16% as of May 2009. **Amidst all, outlook for oil revenue looks pretty more stable in 2010 which expectedly will also mean well for the economic well-being and specifically, the financial system including capital market.**
- **Socio-political unrests**-Nigeria’s economic fortunes have been considerably impaired not only by external shock, but also by domestic unrests especially in the Niger Delta region owing to its overly oil export-dependence and weak industrial capacity. Similarly, recent myriad of industrial actions by various labour groups and workers unions pushing for pay rises and arrears is also worrisome. Meanwhile, we expect the scale and speed of violence to trim down and abate going forward as federal government is showing more genuine concern at resolving the Niger Delta lingering crisis. **The creation of Niger Delta ministry, recent grant of amnesty and subsequent release of the MEND leader-Henry Okah as well as President Yar Adua’s visit to the oil-rich region are widely considered as good gestures and assurances toward dousing and resolving tension in the region.**

Capital market and the banks' cleansing exercise: Up-and-coming trend

- **Pre-regulatory shift impetus:** In tandem with recovery in global equities markets, Nigeria equities market recorded 55.8% appreciation between March 31 and June 2, 2009 when the NSE All-Share Index hit 30,924.97pts from the base of 19,800pts.
- **Regulatory shift and equities capsize:** However, the above trend was rather short-lived, buckled largely by the paradigm shift in regulatory ambience in the financial system (largely dominated by banks) with the appointment of new Central Bank of Nigeria (CBN) governor-Sanusi L. Sanusi.
- Owing to the significant influence of the Nigerian banks on equities market, it is not unexpected that equities market will be badly hit by any adverse upshot of policy shifts in the operations of the banks (more precisely as they affect key performance drivers of growth and earnings) since these banks drive near 60% of Nigerian equities market activities.
- **Banks remain major sellers of shares as supply is largely localised, rather than market-wide:** June 2 till date, market direction has been upturned and marred by massive sell-off of banks' equity margin portfolio. Impliedly, banks constitute the only and major supply source to the market mechanism. Put differently, the supply of shares in equities market is largely localised with banks singled out as the main sellers.
- However, a critical analysis and environmental scanning shows the evolving paradigm shift in regulatory and operating environment as the prime cause.

Highlights of recent CBN policy shift:

- 10% of shareholders' fund cap on banks exposures to public sector lending and the subsequent provisioning.
- Directive on banks' disclosure of credit exposure to oil and gas sector
- Directive on banks' disclosure of exposure to margin lending and share-loans to institutions and individuals.
- New policy position on proposed **Asset Management Company of Nigeria (AMCON)** and the accounting treatment (marking-to-market) of banks' toxic assets (especially equities portfolios) and the subsequent disposition/reaction of banks to the 'olive-branch'.
- Unification of banks' year-end by December 31, 2009.
- Compulsory adoption of IFRS reporting standard by December 31, 2009.

Banks' response to policy shift impulse:

- Growing and intense race for cover as liquidity squeeze heightened, thereby crowding out the equities market.
- Overheating of NIBOR (interbank rates) as yields from equities market become uncompetitive; leading to anomaly in yield curve.
- Quantum leap in short term cost of funds (deposit rates) as competition amongst banks becomes wild and cut-throat.
- Colossal and mounting sell-off of banks' (and subsidiaries) proprietary equities portfolios.
- Aggressive loans recovery strategy by banks, forcing borrowers (corporate entities and individuals) to sell-off assets including equities.

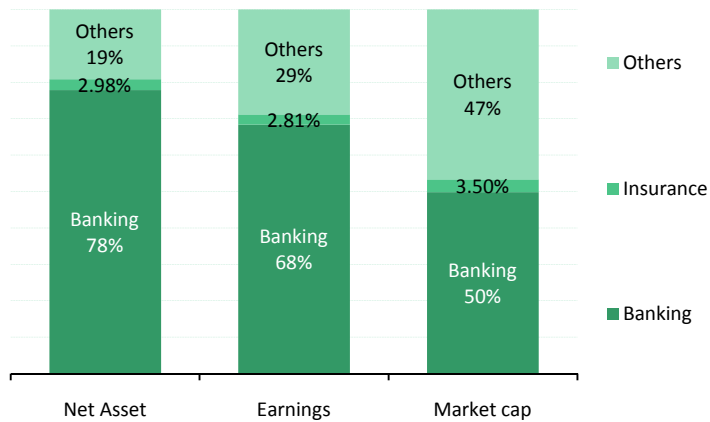
Banking reforms, equities deform?

- Given the strong dependence of the real sector on the fortunes of the financial system particularly the banking industry and its strong link with the Nigerian economy and entire financial system, we are very positive and upwardly biased about the aftermath, on the economy and equities market, of the nascent reforms in the Nigeria financial system, precisely banks, based on the tripod policy stand of **risks management, disclosures and market-induced consolidation**.
- However, without mincing words, these policy thrusts and industry reforms of the CBN governor have sent some panic to the system with its consequent ripple effect on the equities market.

Current valuation level looks justified, compelling but....

- Considering the risky outlook that surrounds the earnings and the balance sheet positions of financials (banks and insurance) which as a group commands about **53% of the entire market capitalisation, 81% of the entire market book value, and 72% of the entire market earnings**, it is no surprise that the market is swift at factoring in this risky outlook into equity prices.

Financials dominate key market metrics



Is the market right by current pricing?

The impact of weak expected earnings emanating from margin loan exposure of financials has played out significantly in low equity prices. This is largely reflected in the falling trend in the proportion of the market capitalization of financials as against the current standings of their earnings and net assets relative to the market. **In our opinion, we think market seems to be right in pricing their book value and earnings at low levels.**

Source: Companies' Annual Reports-(2007, 2008, MRQs), Meristem Research

- We believe, from the perspective of current market pricing, the level of valuation of Nigerian equities **appears** fairly discounted at our estimated market wide **P/E multiple of 8.08x** and dividend yield of 5.84%. This valuation level represents some **70% discount** to the level attained at the peak of the burble in March 2008 when the market traded at a P/E range of 26x –28x. **On a book value basis**, the conclusion **appears** similar as the market currently prices companies' book value at 1.39x. Similarly, this valuation also represents some 71% discount to the level attained in March 2008 when the market traded at 4.8x.

Sector and market valuations (as of July 22, 2009)

Company	# of Companies	Market Cap (bn)			Sector metrics and statistics		
		Naira	US\$	%of Market	P/E -TTM	P/B*	D/Y
Banking	21	2,500.11	16.77	48.77%	6.44 x	1.10 x	8.39%
Breweries	3	581.63	3.90	11.34%	12.63 x	7.05 x	4.66%
Food/Beverages & Tobacco	25	163.10	1.09	3.18%	9.68 x	3.40 x	6.35%
Petroleum Marketing	7	177.63	1.19	3.46%	11.60 x	8.87 x	7.34%
Building Materials	13	425.78	2.86	8.31%	8.46 x	4.22 x	3.44%
Conglomerates	7	289.90	1.95	5.65%	10.26 x	3.20 x	3.12%
Insurance	6	21.78	0.15	0.42%	11.26 x	1.83 x	6.86%
Construction	4	243.55	1.63	4.75%	13.20 x	2.78 x	7.17%
Healthcare	7	42.44	0.28	0.83%	20.02 x	2.00 x	4.72%
Chemical & Paints	7	27.77	0.19	0.54%	16.79 x	3.90 x	6.13%
Weighted average of key sectors	100	4,473.70	30.02	87.26%	8.59 x	2.82 x	6.24%
Overall market		5,126.78	34.40	100.00%	7.83 x	1.32 x	6.12%

Source: Meristem Research Computations

...how does Nigerian equities valuation look from forward perspective?

- On a 2009e earnings basis, the valuation of Nigerian equities appears less attractive compared to the current level. This is particularly so for financials (Banks and Insurance), hence the overall market giving their overbearing dominance on market valuation and trend.
- **In the face of the emerging realities and the policy direction of the apex bank in addressing the margin loan overhang of banks (margin loans exposure, according to the CBN in Nov. 2008, was estimated at about N900bn), 2009e earnings will face significant downward pressure.**
- This trend is getting established as banks now boldly dance to the rhythm of the new policy directives. This is deducible from the provisionings made so far by **Ecobank** (N12.5bn provisioning as at FY-Dec. '08), **FirstBank** (N26bn provisioning as at FY- Mar '08), **Oceanic Bank** (N41.9bn provisioning as at FY-Dec. '08) and **Access Bank** (N4bn provisioning as at Jun. Q1-09).
- Apparently, Nigerian financials (banks and Insurance) are set for significant headwinds in 2009e earnings after 3 years of superb earnings and credit growths (the first ever contraction in their earnings trajectory since 2005 consolidation).
- Conversely, the story appears quite different for non-financials. Provided the current operating environment is sustained, a good number of non-financial companies with exciting revenue and earnings growth in previous quarters are expected to sustain this feat till Q3-09 and FY-09. These stocks are expected to enjoy favourable sentiments and spur good rally (especially from domestic and foreign portfolio managers as well as long term value investors) as their quarterly results trickle to the marketplace with sumptuous earnings report and complementary interim/final benefits.

Growth and valuation scenarios: Financials vs. *market ex-financials*

- **On a 2009e earnings basis, valuation attractiveness tilts more in favour of non-financials on the back of base-case 2009e earnings growth of 15%.** On a scenario basis, we anticipate a significant industry-wide earnings contraction of the range of 30-60% in financials, premised on emerging trend in provisioning for toxic loans and subsequent earnings report, other anticipated provisionings and stiffening industry competitive landscape, an offshoot of the year-end harmonisation 'rat race'. Overall, our model scenarios suggest that the market expected earnings growth tilts more towards a negative territory of 31% on a base case.

Scenarios	Bull Case	Base Case	Bear Case
Earnings growth projections			
Financials	-30%	-50%	-60%
Non-Financials	20%	15%	10%
Market	-16%	-31%	-40%
Projected P/E			
Financials	9.85 x	13.79 x	17.24 x
Non-Financials	12.78 x	13.33 x	13.94 x
Market	11.05 x	13.57 x	15.50 x

Source: Meristem Research Computations

Our submission

- Giving this earning growth scenario, valuations of non-financials appear more attractive at 2009e P/E of 13.33x (base case: 15% earnings growth) vs. 13.79x for financials. The investment case for non-financials seems more compelling giving the strong tendency for their prices to trend along financials despite their different earnings growth story.
- While we admit that equities market will be more volatile and prices may remain subdued, **it is cheering to note that this will present another rare investment vista with upside potential as valuation becomes even more attractive and compelling.** Besides, we do not expect the semblance of the free-fall in 2008 and Q1-09.

Stocks Recommendation: The following table summarizes our new portfolio of Nigerian equities

- Premised on the above growth scenarios, we advance on our belief that growth at moderate aggression will further deliver superb value going forward. Sequel to that, we present our portfolio of Nigerian equities.

Valuation matrix								
Stocks	Price (N)	EPS (N)		P/E		2009e P/BV	Target price (N)	Upside %
		2009e	2010e	2009e	2010e			
Non-financials								
NASCON	2.98	0.55	0.63	5.41x	4.70x	1.98x	9.60	222%
FLOURMILL	18.99	1.18	2.52	16.15x	7.55x	0.99x	33.00	74%
REDSTAREX	2.82	0.52	0.65	5.39x	4.31x	1.29x	6.22	121%
OANDO	85.70	8.44	10.13	10.16x	8.46x	1.65x	165.00	93%
WAPCO	26.00	4.09	4.49	6.36x	5.79x	1.57x	35.00	35%
TOTAL	150.09	16.17	17.79	9.28x	8.44x	7.71x	221.00	47%
UPL	7.59	0.94	1.17	8.09x	6.48x	2.03x	10.65	40%
Average				8.09x	6.48x	1.65x		73.8%
Financials								
UBA	10.50	1.11	1.44	9.48x	7.29x	1.12x	17.25	64%
SKYEBANK	4.88	1.66	1.99	2.94x	2.45x	0.53x	11.48	135%
GUARANTY	13.97	2.01	2.61	6.96x	5.35x	1.31x	19.99	43%
FCMB	6.01	1.13	1.46	5.34x	4.11x	0.69x	13.00	116%
DIAMONDBNK	6.01	1.46	1.90	4.12x	3.17x	0.67x	14.38	139%
Average				5.34x	4.11x	0.69x		116.3%

Source: Meristem Research estimates

Our concerns on the financials in our recommendations

- In the light of the cloudy earnings atmosphere surrounding the performance of financials, we felt compelled to stress test the financials on our recommendation list against the likely impact of the expected provisionings for toxic loans (margin loans).
- **This uncertainty regarding the actual figure of exposure remains the overriding downside risks to our target price estimates.** Nonetheless, we have adopted a conservative earnings outlook by dipping into annualised earnings positions by outright 60% write-down rate to provide for estimates of expected provisionings.

A base case scenario analysis of expected write-off valuation impacts

Companies	2008 PAT (N'bn)	MRQ	PAT (N'bn)	Annualised PAT (N'bn)	Implied YE PAT (N'bn)	Implied Growth	Expected write-off*	SHO (bn)	Implied EPS	Implied P/E
UBA	40.83	2009Q2	19.90	39.80	15.92	-61%	23.88	21.56	0.74	14x
SKYEBANK	16.00	2008Q2	9.61	19.23	7.69	-52%	11.54	11.58	0.66	7x
GUARANTY	28.32	2009Q1	9.48	37.91	15.16	-46%	22.74	18.89	0.80	17x
FCMB	15.11	2008Q3	12.35	16.46	6.58	-56%	9.88	16.38	0.40	15x
DIAMONDBNK	12.75	2008Q3	15.83	21.11	8.44	-34%	12.67	14.48	0.58	10x

Source: Meristem Research estimates

- At that rate of write-down, the average expected earnings contraction stands at 50%, much more in line with our base case forecast for the industry in 2009 financial year end. **Frankly, it is worth noting that the expected write down presents a significant downside to our recommendation.**

Appendix :

Abbreviations and definitions

Key terms and definitions	
OBB:	Open Buy Back
bn:	billion
TTM:	Trailing twelve months
P/E-TTM	Price-Earnings-Ratio on Trailing twelve month basis
y-o-y: MRQs	Year on year change; Most recent quarters
WtD:	week to date
YtD:	Year to date
Market Cap:	Market capitalisation
The NSE ASI:	The Nigerian Stock Exchange All-Share Index
LTP:	Last traded price
P/B:	Price to book ratio
D/Y:	Dividend yield
na:	not available
NIBOR:	Nigerian Inter Bank Offer Rate
NITTY:	Nigerian Interbank Treasury Bill True Yield Fixing
Chg:	Change
NIFEX:	Nigerian Interbank Foreign Exchange
ROE:	Return on Equity
Vs.	Versus

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