



MERISTEM EQUITY RESEARCH REPORT

UPDATES ON FIRST ALUMINIUM NIGERIA PLC

Report Date: May 23, 2008

Executive Summary & Investment Rationale

- First Aluminium Nigeria Plc is an indigenous company that deals in the manufacture of aluminium coils, sheets, circles, and tubes (laminated and seamless plastic). Incorporated in 1960 as **Alcan Aluminium of Nigeria Limited**, the company later changed its name to **First Aluminium Company (Nigeria) Plc** in 1991. Subsequently, it secured quotation on The Nigerian Stock Exchange (NSE) in 1992. Its activities are driven by operations in 3 key Strategic Business Units (SBUs), namely; **Rolling Mill, Aluminium City and Packaging with Aluminium City Limited existing as a full-fledged subsidiary**. The Group's annual sales averaged N7.12bn (US\$60.34mn) over the past 5 years with its market capitalisation currently standing at N7.45bn (US\$63.1mn).
- The company has been bedeviled by a cluster of internal operational challenges such as the dearth of skilled manpower, excessively high operating and financial leverages, as well as other major externalities ranging from bureaucratic bottlenecks, unfavourable government policies, social, environmental and economic factors which seem deadlier than internal hitches.
- Our analysis of the company's historical performance from 2002 to till date suggests imperative need for financial re-engineering and capital restructuring as the company's debt capital outweighs its equity funding by over 7 times, hence its excessively high annual

financial leverage. This we believe is very critical to mitigate some of the operational challenges being faced by the Company.

- Aside internal challenges, threats to the company's recovery and fortunes include harsh government regulations and bureaucratic bottlenecks as well as high dependency on gas supply. In addition, insecurity in the Niger-Delta due to youth restiveness and incessant violent crimes remains a strong environmental factor to contend with. Therefore, efforts of the Federal Government to douse tension in the region and contain activities of militants will definitely mean well for the Company and Nigeria as a nation.
- Also of prominence are foreign exchange risk and uncompetitive pricing regime that reigns in the industry due to cheap imports from China and loss of market as a result thereof. Similarly, the uncompetitive tariff rates on imported aluminium products (plain coil) and the unavailability of local raw material make local production unattractive and less profitable. However, it is hoped that the rejuvenation of hitherto moribund **Aluminium Smelters Company of Nigeria (ALSCON)** will provide succour for all local aluminium products Companies in Nigeria.
- Our valuation reveals that First Aluminium is currently trading at 70.3 percent discount to its fair value. We applied both relative multiples and discounted free cash flow valuation metrics with a volatility index of 0.32, risk-free rate of 10.75 percent and weighted average cost of capital of 18.3 percent. Our weighted price for First Aluminium is N10.75k. We therefore recommend the stock for a medium to long term investors.

The Nigerian Industrial Sector: A Diagnosis

The proposition espousing the transition from agrarian to service delivery in the developmental path of every economy remains a maxim to be justified in the context of the Nigerian experience. Industrial development, propped up by complex production lines, Research & Development and product innovations, is a notable phase that heralds the birth of sophisticated service sector. In the Nigerian case, a comparative analysis of these phases of development revealed a “jump” which explains the critical state of the country's industrial sector. At present

the sector contributes only 10percent to Gross Domestic Product (GDP) and operates only around 30percent capacity utilization. Despite the prevailing operational challenges, the sector remains very attractive for both foreign and local investors. This is premised on large domestic market (unarguably the largest in Africa), rich mineral and other resources as well as unutilized, cheap and abundant labour. These, coupled with the government renewed interest to reinvigorate the sector toward the achievement of vision 2020, are likely factors for the increase in the influx of foreign investments in the industrial sector. This sector raked 41.1percent of cumulative foreign private investment in Nigeria as at 2005.

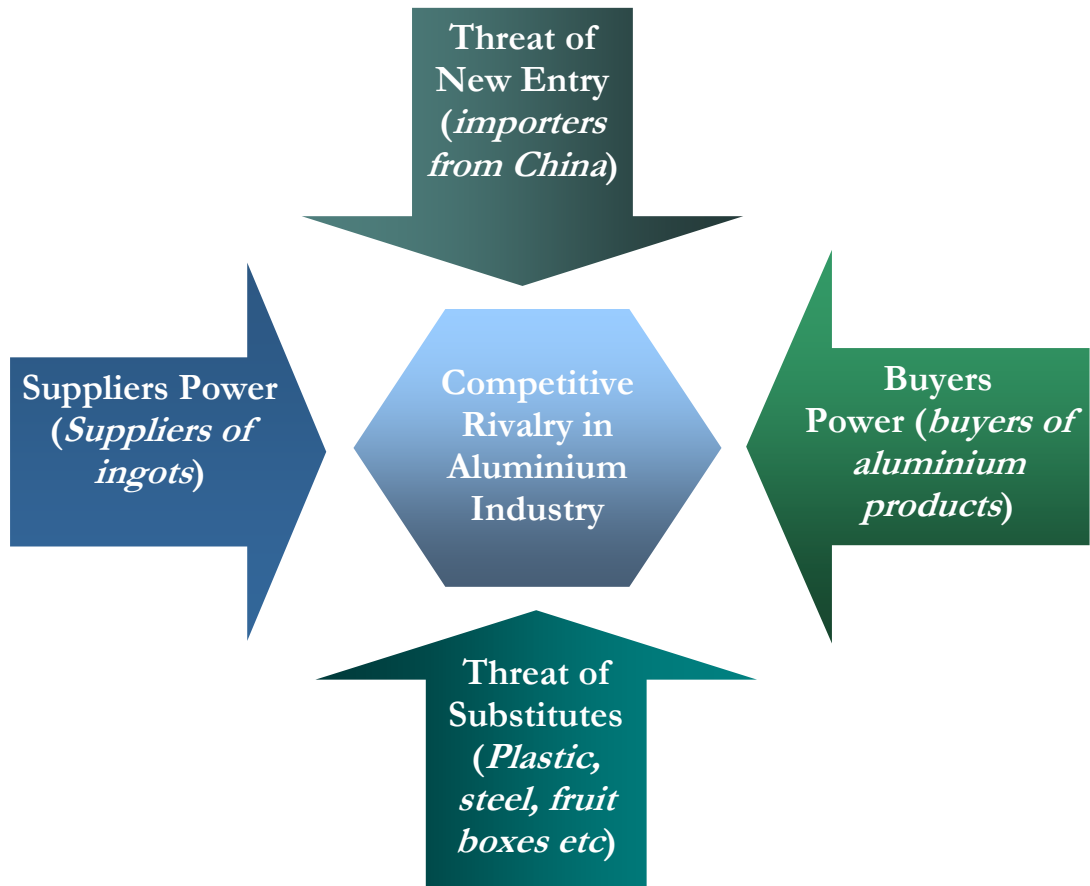
Analysis of Competitive Intensity and Attractiveness of the Nigerian Aluminium Industry:

- **Bargaining Power of Customers:** Nigerian aluminium companies fall in the category of industry producing intermediate products serving the input needs of related industries in downstream lines. Relatively, bargaining power leans more in favour of buying companies which include builders, architects, engineers and manufacturers of pharmaceuticals, cosmetics and food products, as they cut down cost from bulk purchases and contract supplies. However, sustainable and reliable demand for output is a positive factor for the aluminium producing companies.
- **Threat of New Entry:** Huge capital intensity, long gestation period of investment, and economies of scale enjoyed by existing companies in the aluminum industry raise entry barrier to prospective new entrants with inadequate technological and manpower savvy to compete profitably. Hence, competitive threats posed to aluminium manufacturers companies in Nigeria are basically those coming from foreign competitors. Huge initial capital outlay has made foreign firms embark on importation as a cost cutting strategy. Inferentially, the major threat to domestic aluminium-related companies in Nigeria is importation of cheaply produced aluminium products.
- **Threat of Substitute Products:** The nature of the output in the aluminium industry makes the threat of substitute product to viable. Though enormous resources go into Research &

Development (R&D) for the improvement of a viable substitute, at present, the most potent threat to aluminium products (especially in the area of packaging) are plastic and steel. The producers of these products continue to erode the huge market share once enjoyed by aluminium products.

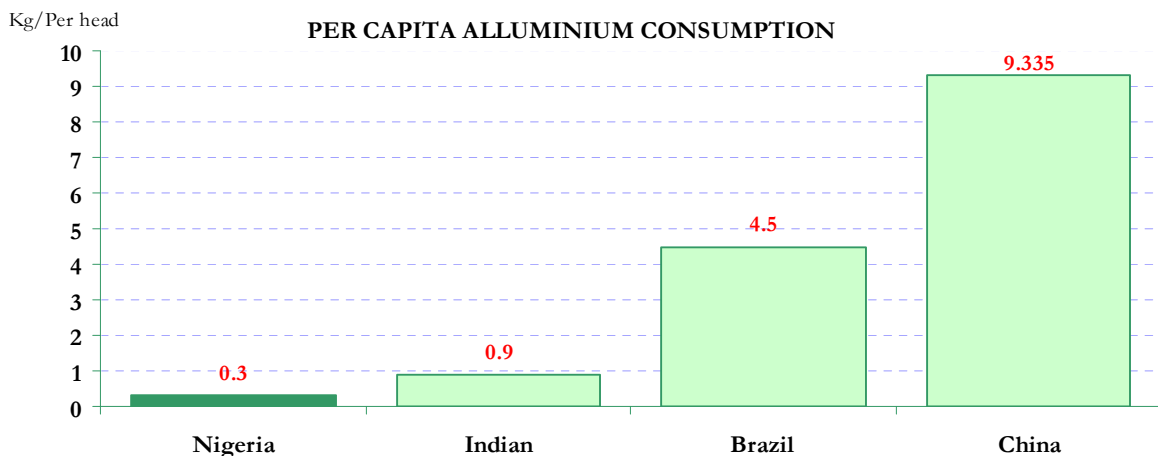
- **Bargaining Power of Suppliers:** Unreliable and shoddy nature of domestically sourced raw materials (specifically aluminium ingot) places domestic manufacturers of aluminium products at the mercy of foreign input suppliers. This singular factor of foreign-input dependence constitutes a strain on the bargaining power of Nigerian companies in sourcing for intermediate inputs such as *aluminium ingot*. The effect of this is much more pronounced in huge production costs and low margins. This phenomenon has its root in the inception (in the late 70's) of commodity trading in aluminum ingot on the London Metal Exchange (LME). It was the above scenarios that sparked the beginning of the breaking apart of the supply chain, triggering a shift from producer pricing to terminal-market pricing
- **Competitive Rivalry:** Though with few major players (including First Aluminium Plc, Aluminium Extrusion Industry Plc, Aluminium Manufacturer of Nigeria Plc, and Tower Aluminium Plc) and other fringe players, the aluminium industry is faced with more than industry-based competition. The major competitive forces emanate from companies producing substitute products such as plastic packages, steel and juice boxes.

Competitive Framework for Nigerian Aluminium Industry



Growth Prospects and Opportunities

Compared to other emerging economies, the per capita consumption of aluminium in Nigeria is ridiculously low which provides enormous upside potential for the industry as the economy grows. Indian, for instance, has a per capita consumption that is 300 percent of the consumption level in Nigeria while Brazil consumes as high as 1500 percent!



Furthermore, the upstream end of the sector is yet to reach its full potential. The moribund state of **ALSCON**, which was meant to produce 193,000 metric tonnes of aluminium ingots and billets, added to the challenges of the sector. However, recent development occasioned by injection of **₦18bn (approx. US\$150mn)** by **UC Rusal, a Russia-based aluminium producing giant, into ALSCON**, might well be the required impetus to set the sector free of its low developmental pace. **The odds are high in favour of a functional ALSCON as UC Rusal has 77.5 percent stake in the company.** At present, ALSCON has commenced the exportation of locally produced aluminium ingot while the local demand is expected to be filled. This development presents a bright prospect for aluminium ingot-dependent companies.

It is expected that the fresh funds from UC Rusal, and other stakeholders, Ferrostaal AG (7.5 percent) and the Federal Government (15 percent), will in the next three years facilitate the growth process in the industry.

With its first-rate technology and expertise, UC Rusal is charged with herculean tasks of ensuring that **ALSCON** products are highly competitive and transforming the smelter into a key driver behind the development of the Nigerian economy. Experts say the acquisition of **ALSCON** through the privatisation was part of the Federal Government's strategy to boost aluminum production in the country and sub-region as well as strengthen the Company's position in the industry.

First Aluminium Group: Background Information

First Aluminium Nigeria Plc was incorporated in Nigeria on August 20, 1960 as **Alcan Aluminium of Nigeria Limited**, a subsidiary of Alcan- **Aluminium Company of Canada**, one of the leading global Aluminium Companies. The Company changed its name to First Aluminium Company (Nigeria) Limited when it became a subsidiary of Alucon Holdings S.A., a wholly owned subsidiary of **Inlaks Group**, based in **Monte Carlo, Monaco** . The Company

later changed its name to First Aluminium Company (Nigeria) Plc in 1991. Its core investor/majority shareholder- Alucon Holdings S.A owns about 64 percent of the Company's issued share capital of N621.11mn (approx. US\$5.26mn) .

Business Model

First Aluminium Group is made up of three strategic divisions one of which was incorporated in 1995 as a wholly owned subsidiary- Aluminium City Limited. Over 70 percent of the Company's sales revenue is accounted for by its Rolling Mill division while the other strategic business units share the remaining 30 percent. The group maintains a technical assistance and know-how agreement with its core investor- **Alucon Holdings SA**, and commits 3 percent of its annual turnover after appropriate withholding tax to service the agreement. The **Rolling Mill** is a manufacturer of rolled aluminium products such as coils and circles. **The packaging division** with a total capacity of 120 million tubes per year manufactures collapsible aluminium, plastic laminate and seamless plastic tubes for the Nigerian and West African Markets. These materials are used for the packaging of toothpaste, cosmetic products, pharmaceutical products, industrial products and food products. On the other hand, **Aluminium City** specialises in supply of all types of aluminium products, manufacturing and installation of aluminium windows and doors, aluminium roofings and high quality office interiors. **It is a popular brand in the marketplace.**

Strategic Updates and Future Plans:

First Aluminium Group added another coil coating line in 2007 to its **Rolling Mill** business division with a view to growing sales revenue vis-à-vis market share in response to the boom in the construction industry. Later same year, the management reviewed its strategic business focus in favour of its core operations- fabrication and installation of sheeting and roofs- for which it has competitive edge and expertise. In addition, construction is already under way at the Port Harcourt factory for a second coil coating line which will enable **Rolling Mill** to further grow its renowned **Colortek** brand. The Company also established a new division named **First**

Engineering Procurement Service (FEPS) with the sole responsibility of proffering engineering solutions and procuring engineering equipment for Oil, Gas and Industrial companies in the country. Efforts are being made by Aluminium City to expand its sheet and roofing business in the Northern region of Nigeria as well as focus more on the existing markets in Lagos and Port Harcourt axes.

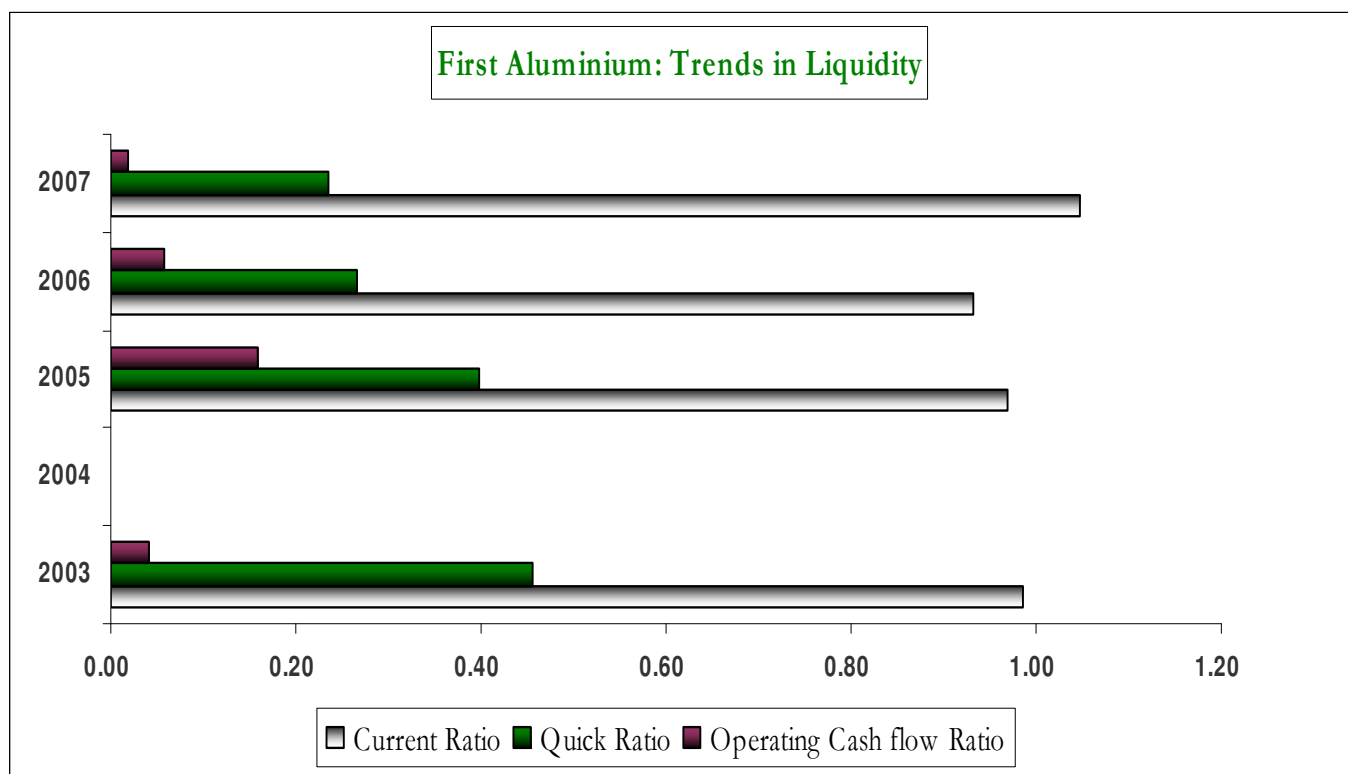
By and large, management has expressed strong desires to further consolidate on its **turn around maintenance (TAM)** efforts to return the Company back to the path of profitability in 2008 and beyond. Management hopes are hinged on the success of the rejuvenation of the ALSCON, as well as its own internal recovery strategies put in place to substantially jerk up its installed capacity especially at its Rolling Mills business unit. Apparently to pacify and excite its shareholders, the Company is making another key strategic move to buffer its working capital via fresh equity injection through rights issue of about N3bn (approx.US\$25mn).Supposedly, this will also reduce its huge financial leverage and subsequently impact on its profitability to equity holders.

Highlights of Management Performance:

Liquidity and Efficiency:

Historically, First Aluminium has not matched its current assets with increases in short term debt obligations. Over the past five years, current ratio, though relatively stable, has averaged 0.98 far below the theoretical benchmark of 2. A closer look at the balance sheet reveals that the Company has not been investing remarkably on assets and taking more short term financing from outside. Year-on-year (y-o-y), assets have gone mildly up just as the liabilities. However, in full year end 2007, current assets were proportionately higher, giving a marginal rise in the ratio. The operating cash flow ratio, which has been less than 1 over the past 5 years shows that the company's operations are not generating enough cash flow to cover its current commitments. This suggests that the firm needs to inject fresh funds to buffer its working capital in order to improve the current pace of operation.

In terms of efficiency, First Aluminium has done appreciably well. In the face of escalating production costs, it has maintained relatively constant operating expenses to sales ratio over the last 5 years. The y-o-y increases in Sales to Net Worth ratio also underscore management's effectiveness in utilizing firm's resources to achieve organic growth in top lines.

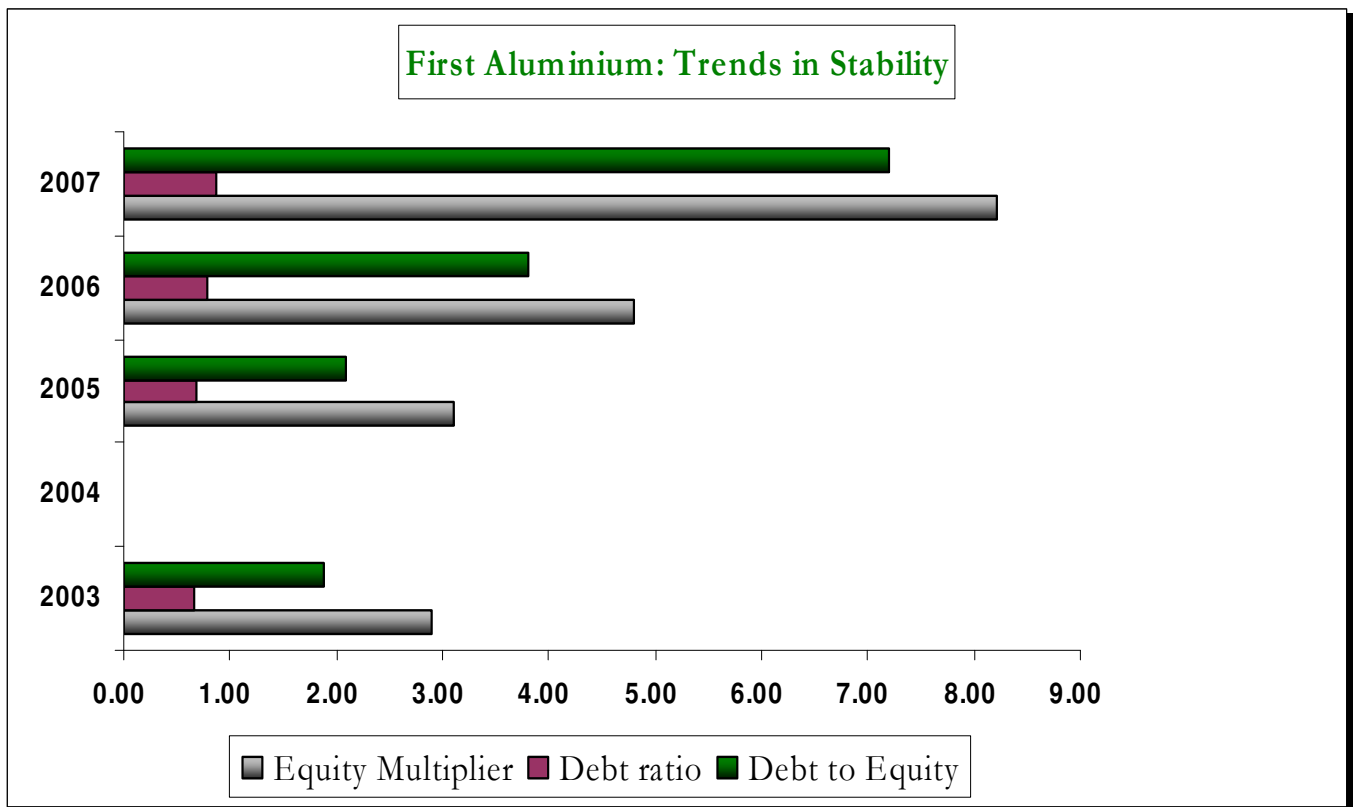


Source: Company's annual reports, Meristem Research

Growth and Profitability

First Aluminium's deteriorating profitability is visible in all ramifications. The Company's gross margin has fallen year-on year from 15.64 percent recorded in 2003 to 5.21 percent in its last financial year end December 31, 2007. Also, pre-tax and after-tax margins reveal a declining trend. Turnover has shown an irregular growth pattern with a compound annual growth rate (CAGR) of 15.9 percent between 2003 and 2007. The major reason for the company's dwindling profitability is huge operating leverage. For the past five years, cost of sales has averaged about

85 percent of turnover. The spiraling cost of energy, driven by high oil prices has had adverse effect on operational efficiency of the company.



Source: Company's annual reports, Meristem Research

Asset Utilization/Management

The Company's performance in terms of asset management has been impressive over the years. Despite a y-o-y increase in stock levels, inventory turnover continued to improve rising from 0.21 in 2005 to 0.41 in 2007. In the face of competitive pressures, the Company has been able to drive and grow demand for its product thereby protecting its market share. However, for its kind of business, a low rate may be appropriate, as it can take advantage of higher inventory levels in anticipation of rapidly rising prices as well as shortages of aluminium products and other building materials in the country.

Stability and Debt Management

A handful of First Aluminium's debt management indices have shown a deteriorating trend over the last five years. The company managed to cover its interest expenses 1.64 in 2003, 1.44 in 2005, and 1.06 in 2006. The Debt Ratio which measures the percentage of the company's assets financed by debt has been increasing year-on-year averaging 75 percent in the past 5 financial years. This is arguably attributable to the company's dependence on borrowed funds with attendant huge interest obligations without a good liquidity position. In the same vein, the debt to equity ratio shows a rising trend increasing from 1.89 in 2003 to 7.21 in 2007 representing **CAGR** of 40 percent. This unwholesome trend brings to fore the need for equity cushioning in the company's capital structure in addition to efficient strategic debt management policies.

Returns on Investment:

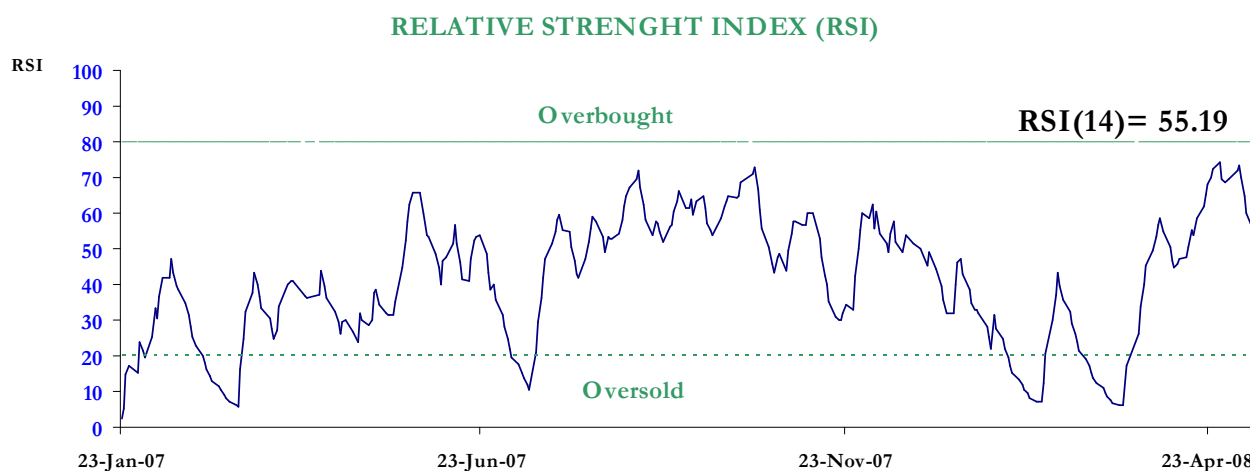
In terms of capital appreciation, First Aluminium has a 5-year **CAGR** of 32.5 percent in total market capitalization. However, both return on equity (ROE) and return on assets (ROA) have dwindled significantly from 14 percent and 5 percent in 2003 to 0.4 percent and 0.1 percent respectively in 2006. *The last dividend declared by the company was 5k in full year 2006 despite a meager EPS of 0.4k.*

Technical Analysis: Price Movement /Momentum

The share price performance of First Aluminium (Firstalum) presents a classic instance of a penny stock that returns 204 percent in 12 months from N 2.19 k in Jan 2007 to N6.67k in May 2008, despite a low volatility index of 0.32. Currently hovering around the threshold of its long

term trend line, the stock enjoyed enormous rally from investors during the first quarter of 2008. The rush for penny stocks as a veritable investment vehicle for superlative returns can be adduced for this impressive upward trend.

Analysis of Firstalum price momentum shows readings that are concentrated in oversold regions. The rallying strength of the stock as shown by the movements in relative strength index (RSI), a momentum oscillator, became immense from the last quarter of 2007 to the first quarter of 2008. During this period, the RSI inched consistently above the centerline of 50 towards the overbought region.



VALUATION

In valuing Firstalum, we employed relative as well as discounted cash flow valuation metrics. The valuation of the stock relative to its comparables was based on Price to projected earnings, Price to forecast book value per share as well as price to projected sales per share. We also discounted First Aluminium's Free Cash Flow using a risk free rate of 10.75 percent, risk premium of 8 percent and a weighted average cost of capital of 18.33. A weighted average of these valuation methodologies with a bias for free cash flow gives a fair price of N10.75k translating to a discount of 70.33 percent to current price. We therefore place a BUY recommendation on the stock for medium to long term investment horizons.

FIRST ALLUMINIUM PLC

KEY STATISTICS : 2007 FINANCIALS

FINANCIAL HIGHLIGHTS		VALUATION METRICS	
Income Statement		Trading Multiples	
Turnover (Nbn)	8.72	Market Cap(N'bn) as @ May 21	8.25
Turnover per share (Ngn)	7.02	Trailing EPS	NM
Operating profit(Nbn)	-0.14	Trailing P/E	NM
PAT(Nbn)	-0.67	Forward EPS (FYE 31-Dec-08) (Ngn)	0.43
Balance sheet		Trailing Price/Sales	0.95
Shareholders fund(Nbn)	0.90	Price/Book Value	9.20
Total Assets(Nbn)	4.74	TRADING INFORMATION	
Total debt/Equity	7.21	Stock price history	
Book Value Per Share (Ngn)	0.73	Volatility (β)	0.32
KEY FINANCIAL RATIOS		52-Week Chg % (Firsalum/NSE)	162.89/32.64
Profitability		52-Week High (Ngn)	10.05
Gross Margin	5.21%	52-Week low (Ngn)	1.76
Operating Margin	1.59%	Share statistics	
Management Effectiveness		Average volume (1 month)	1,980,448
Return on Average Asset	-9.18%	Average volume (1week)	2,146,267
Return on Average Equity	-55.69%	Shares Outstanding (billion)	1.24
Liquidity		Float	
Current Ratio	1.05	Earnings, Dividend and Bonus	
Quick Ratio	0.23	Last Paid Dividend Per Share(Ngn)	0.05
Operating Cash Flow Ratio	0.02	Dividend Yield	0.75%
DEBT MANAGEMENT		Trailing Earnings Yield	NM
Debt Ratio	0.88	Last Script Issue (03/06/2004)	na
Equity Multiplier	8.21	Payout ratio	
Debt to Inventory	1.68	Last Dividend date	03-Jul-06

NM= Not Meaningful; NA= Not Applicable/ (Available)

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