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## **The Nigerian Stock Market: Gauging the Fundamentals**

### **Synopsis**

The inherent dynamics and high volatility of emerging market like Nigeria have been mirrored profoundly in the gyrations of stock prices on the floor of The Nigerian Stock Exchange in recent times. The market has exhibited a vagary of movements that have culminated into returns diminutions and capital depreciations across all sectors. As activities continue to nosedive and selling pressures remain high, a section of market participants has attributed the trend to panic and herd trading while another camp of analysts opine that exogenous variables sparked off by government's loose monetary policies are a formidable cause of the current meltdown. Technical analysts however view the current trend as a mandatory cyclical trough in conventional capital market behaviour. Using simple price multiples analysis, we attempt to measure the fundamental strength of the Nigerian capital market as a whole, and the valuation levels of individual stocks quoted on the floor of the Exchange.

### **Market Fundamentals: The Potency of Price Multiples**

There is no gainsaying that the aggregation of individual stocks' fundamental characteristics points to the overall health of the stock market. This makes the analysis of stock market behaviour via price and earnings movements very key.

**Price multiples are a useful way to compare the valuation of a stock over time, against comparable companies or the market as a whole.** These

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multiples are generally ratios of stocks' current market capitalizations to some underlying accounting fundamentals such as book value (total owners' equity), revenues or net income (i.e Profit After Tax). Since investors are usually more familiar with share price rather than market capitalization (share price multiplied by shares outstanding), the accounting fundamentals are often converted to a per-share basis when using price multiples. The most common price multiples include **Price-to-Earnings (P/E)**, **Price-to-Book Value (PBV)**, and **Price-to-Sales (PS)**.

The value of a multiple speaks volume about market valuation of any equity. A high multiple indicates that the market is willing to pay a high price relative to a stock's underlying fundamental value such as earnings. A low multiple indicates that that the stock is undervalued - perhaps it has low growth prospects, high risk or is simply undervalued by the market. A company may trade at a high multiple because it has high growth prospects and future earnings are expected to be significantly higher than past and present earnings. Value investors however tend to search for companies trading at lower multiples than peer companies. Both P/E and PBV ratios have predictive power of future return, especially over longer time periods; hence can be used as tools in forming a market timing and asset allocation strategy in emerging equity markets.

### **Understanding and Using the PE Ratio**

The PE ratio is one of the oldest metrics used in conventional stock valuation. It is the ratio of the stock's price to the company's per share earnings. Most of the time, the P/E is calculated using EPS from the last four quarters earnings

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of the firm. This is known as the **trailing P/E**. Sometimes, we can also have what is called **Leading** or **Forward PE** which comes from estimated earnings expected over the next four quarters.

Theoretically, a stock's P/E tells us how much investors are willing to pay for each Naira the Company earns. It also takes into account market expectations for a company's growth. Stock prices reflect what investors think a company will be worth and future growth is already factored into the stock's price. As a result, a better way of interpreting the P/E ratio is as a reflection of the market's optimism concerning a company's growth prospects.

If a company has a P/E higher than the market or industry average, this means that the market is expecting impressive performance over the next few months or years. A company with a high P/E ratio will eventually have to live up to the high rating by substantially increasing its earnings, or the stock price will need to drop.

**Although the P/E ratio can help you determine a stock's value, it can sometimes be misleading, particularly for companies that have recently issued a warning about their future earnings.** Investors might have bid down the price of the stock based on those lowered expectations, resulting in an abnormally low P/E ratio for that Company. In such a case, a low P/E ratio does not reflect the true value of the Company based on its future growth.

On the other hand, Companies that grow very quickly often have extraordinarily high P/E ratios. However, if those Companies can continue to

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grow at the same pace, the rapid increase in earnings over time brings those P/E ratios back to more common values. Other valuation ratios can be used to confirm or challenge the value shown by the P/E ratio.

### **Do Fundamentals Drive the Nigerian Stock Market?**

A key consideration in the analysis of market behaviour is the extent to which stock market valuations reflect companies' financial fundamentals as well as the prevalence of investor disinclination to take decisions on the basis of fundamentals. Where a sentiment-based investment environment is encouraged, the result is often market-wide price deviations from intrinsic values.

In developed markets, a plethora of evidence has shown that share price levels have reflected financial fundamentals quite well. **When investors make good strategic decisions based on Discounted Cash Flow (DCF) analysis, the stock markets will reward them by setting stock prices according to companies' financial fundamentals.** Sometimes, however, market-wide price deviations from fundamentals can occur, but they are the exception, not the rule. Over the past decades, market has corrected itself to fundamentally consistent price levels. **Although many a time, fraud or the manipulation of accounting information may cause shares to rise above the real value of corporations, the market can only be fooled for a short while; sooner or later, earnings must justify share price.**

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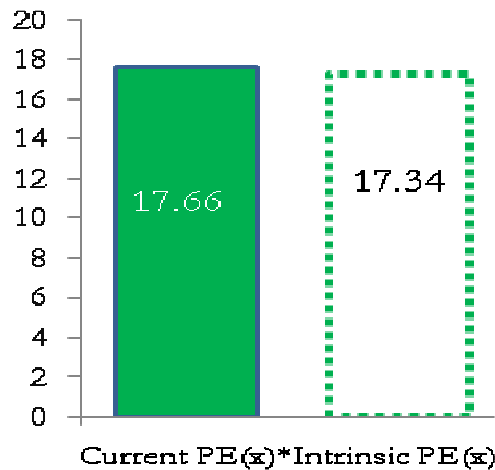
From experience, over the years, the Nigerian stock market has failed to reflect Companies' fundamentals for a number of reasons. In the past, investors have failed to process all available information correctly when forming future expectations about the behaviour of many stocks. Most investors overreact and attach too much importance to recent events and results, so they overpriced companies with strong short term performance. Worst still, large group of market participants often share similar patterns of behaviour and tend to move in the same direction causing persistent price deviations. Patterns of overconfidence, overreaction and overrepresentation are common to many of these investors. **This group usually possesses enough numerical strength to exert influences that tend to veil the fundamental values of a large number of stocks.**

## What is the Justified P/E Level of the Nigerian Stock Market?

To arrive at the valuation level for the Nigerian stock market as a whole, we have applied a simple fundamental valuation model to current price earnings level of the Stock market. From a weighted average of market metrics we derived a P/E ratio of 17.66x (trailing twelve months) for the entire market (see chart 1 below). Using the **Capital Asset Pricing Model (CAPM)**, we have modeled the fundamental return on the market as a linear function of theoretical market indices, where sensitivity to changes in each factor is represented by a factor-specific beta coefficient.

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Chart 1: Justified and Trailing P/E of the Nigerian Stock Market



Source: Meristem Research

\*Based on October 2, 2008 market prices

Our model rests on a risk free rate proxied by FG 10-year Treasury Bill Rate (TBR) of 12.75%, market risk coefficient of 1 and an assumed country risk premium of 5 percent (consistent with Nigeria's emerging market status). We arrived at a required rate of return of 18.60 percent which is reasonably close to a medium ROE of 18.65 and an average of 20.16 percent for the market (see chart 3 below). Assuming that companies' sustainable ROEs should be reasonably matched with investors' required return and removing the effect of inflation (currently 14 percent year -on- year), we obtained a real return of 5.98 percent. Further, we assumed a long run real economic growth rate of 3 percent for the country which yields an expected payout of about 50 percent. **Finally, we obtained a justifiable PE of 17.34x.**

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### Chart 2: Price Multiples of Selected Stock Markets

Countries/regions	PE (x)	PBV	
Asia	19.91	2.16	<b>Note: Indexes used</b> <i>Asia:</i> IFC Index <i>Latin America:</i> IFC Index <i>US:</i> Standard and Poor's Index <i>Japan:</i> Nikkei Index <i>UK:</i> FTSE 100
Latin America	16.17	1.11	
Japan	108.70	2.09	
UK	14.90	2.87	
US	19.30	3.50	
MSCI World	22.40	2.69	

Source: IFC and Meristem Research

### Chart 3: Nigeria's Stock Market Metrics (as at Oct 2, 2008)

Basic Market Metrics							
Per Share Data	Weighted	Mean	Median	Max	Min	Industry Count	
EPS	<b>0.83</b>	1.35	0.81	7.51	0.16	22	
BVPS	<b>3.96</b>	6.15	4.83	19.74	0.86	22	
Top line Per Share	<b>5.54</b>	21.75	6.51	209.81	0.86	22	
Price Multiples							
Market P/E (x)	<b>17.66</b>	31.64	24.70	89.46	12.03	22	
Market PBV (x)	<b>4.24</b>	6.03	5.05	21.13	1.35	22	
Price to Top Line (x)	<b>2.65</b>	4.03	2.89	13.57	1.19	22	
Basic Earning Power							
ROE		20.16%	18.65%	45.35%	1.9%	22	
ROA		8.18%	7.32%	27.04%	0.83%	22	
Margin		46.06%	12.17%	714.14%	3.23%	22	
Earnings Yield		5.15%	5.21%	7.66%	2.27%	22	

Source: Meristem Research

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*Having topped at a P/E of around 24x during the first quarter of this year (consistent with the behaviour of most markets across the globe), the proximity of the current Market trailing 12 months P/E (17.66x) to our derived justifiable P/E (17.34x) signals the fact that the market is very close to its intrinsic valuation levels (see chart 1 above). However, we are concerned that continued panic and loss of confidence might send the market to suboptimal levels.*

**We submit that even in the absence of general market deviations, it is important for investors to understand the true, intrinsic value of stocks.** This allows them to exploit any market mispricing. Investors and corporate managers can benefit from intrinsic value deviations by better timing (tactical considerations) in the implementation of strategic decisions. Apart from giving due diligence to overall corporate objective and financing needs, market overvaluation of a company's shares present an opportunity to issue new share capital and pay for acquisition with shares rather than cash. On the other hand market overvaluation of company's shares should be exploited not only for strategic investors to take position but also for corporate managers to repurchase a company's shares.

### **Sector Price Multiples Analysis and Rankings**

Our analysis of sector multiples shows that the Brewery sector remains the least expensive sector as it trades at a P/E of 12.03x trailing earnings. The most

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expensive sector on the Exchange is the Packaging sector with a trailing PE multiple of 56.34 earnings (See complete list in the Table 1).

While it might not be advisable to rely solely on P/E multiples alone in the determination of investment position taking, it throws a substantial light on the comparative performance of the sectors and the growth prospect expected by investors.

**Table 1: Sector Price Multiples as at October 2, 2008**

S/N	SECTORS	P/E ratio (x)	PBV ratio (x)	ROE	Ranking by PE
1	Breweries	12.03	6.64	40.7%	<b>Inexpensive</b>
2	Real Estate	13.06	1.35	5.0%	
3	Printing and Publishing	13.73	4.22	22.7%	
4	Other Financial Institutions	14.12	5.21	30.8%	
5	Hotel & Tourism	14.46	2.57	14.5%	
6	Automobile & Tyre	15.96	3.82	21.6%	
7	Chemical & Paints	17.49	2.38	10.4%	
8	Leasing	17.74	1.72	3.5%	<b>Expensive relative to market</b>
9	Commercial/Services	20.07	4.14	14.7%	
10	Conglomerates	20.61	6.13	14.1%	
11	Banking	21.34	4.89	15.7%	
12	Food/Beverages & Tobacco	24.55	8.87	34.5%	
13	Building Materials	24.68	7.39	24.9%	
14	Airline Services	24.84	8.48	24.7%	
15	Mortgages	27.45	3.35	11.7%	
16	Insurance	27.92	12.18	23.1%	
17	Agriculture	34.80	6.23	1.9%	
18	Industrial/Domestic Products	35.65	11.88	30.1%	
19	Healthcare	41.17	2.08	7.4%	
20	Petroleum Marketing	41.92	21.13	45.4%	
21	Construction	43.89	5.30	42.9%	
22	Packaging	56.34	2.75	3.2%	

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### **Stocks Price-Earnings (P/E) Analysis and Rankings**

Based on individual stock's trailing earnings, John Holt Plc ranks as the least expensive stock with a trailing PE of 7.81x. While this low P/E multiple is largely accounted for by the noise (exceptional item of N494m) observed in the Company's Q3 results, it suffices to opine that the low trailing P/E of stocks like Diamond Bank, GTBank, JBERGER and some others in table 2 below are pointers to viable investment opportunities.

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**Table 2: Relatively Cheap Stocks by PE Multiple as at October 2, 2008**

Stocks	P/E ratio (x)	PBV ratio (x)	ROE	Comment
JOHNHOLT	7.81	2.14	1.42%	<b>Inexpensive relative to the market</b>
NEM	8.59	na	na	
INTENEGINS	9.40	na	na	
DIAMONDBNK	10.67	1.41	11%	
GUARANTY	10.87	1.96	13%	
JBERGER	10.87	5.30	43%	
CUSTODYINS	11.29	2.25	16%	
DEAPCAP	11.40	na	na	
WAPCO	11.44	3.35	33%	
INTERCONT	11.63	2.20	17%	
DANGSUGAR	11.73	10.32	83%	
ACCESS	12.06	6.73	21%	
SKYEBANK	12.40	4.85	19%	
UPL	13.03	4.33	22%	
UAC-PROP	13.06	1.35	5%	
GUINNESS	13.19	5.43	37%	
MBENEFIT	13.49	1.43	8%	
PLATINUM	13.57	6.80	22%	
LONGMAN	13.97	7.35	50%	
UACN	14.04	3.56	22%	
CRUSADER	14.05	9.62	57%	
FLOURMILL	14.20	4.83	33%	
VITAFOAM	14.42	5.46	31%	
IKEJAHOTEL	14.46	2.57	15%	
UBA	14.76	2.56	13%	
ZENITHBANK	14.81	6.48	20%	
NB	14.84	7.84	44%	
ACADEMY	15.07	6.70	31%	
NASCON	15.86	6.33	36%	
IBTC	15.91	5.36	19%	

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Table 3: Relatively Expensive Stocks by trailing PE Multiple as at October 2, 2008

Stocks	P/E ratio (x)	PBV ratio (x)	ROE	Comment
THOMASWY	244.72	na	na	<b>Relatively expensive stocks</b>
BCC	162.45	14.41	13%	
UTC	134.04	4.00	4%	
COSTAIN	97.76	na	na	
MORISON	86.86	na	na	
CHEVRON	82.30	24.99	48%	
MOBIL	80.96	37.34	40%	
BAGCO	63.69	2.75	3%	
EQUITYASUR	57.95	8.38	8%	
WAPIC	56.32	na	na	
OKITIPUPA	52.38	na	na	
IAINSURE	49.34	6.64	10%	
UNITYBNK	47.76	na	na	
BOCGAS	46.72	23.86	29%	
JAPAUOIL	44.86	na	na	
WEMABANK	44.73	5.45	1%	
FIRSTINLND	41.18	4.93	-47%	
LASACO	40.14	17.96	11%	
UNILEVER	36.96	16.27	21%	
ASHAKACEM	31.93	4.41	29%	
AIRSERVICE	31.43	8.30	15%	
PRESCO	31.18	6.23	2%	
CONTINSURE	30.32	65.14	132%	
CORNERST	29.87	6.96	20%	
AP	29.48	29.72	77%	
AFRIBANK	29.02	9.46	17%	
UNHOMES	27.45	3.35	12%	
NIGERINS	26.94	2.75	9%	
UBN	26.21	4.86	13%	
GLAXOSMITH	26.07	na	na	

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### **Market Sentiments and Investors' Expectations.**

Hearts have not stopped beating excessively about the uncertainty in the direction of the stock market. In the face of the persistent lull and global financial market recession, there has been an injection of a number of expansionary monetary policy doses into the economy. The Monetary Policy Rate (MPR) was adjusted downward from 10.25 to 9.75. The Credit Reserve Ratio (CRR) was also brought to from 4 percent to 2 percent while the Liquidity ratio was reduced from 40 percent to 30 percent. However, the market has shown no immediate signs of recovery since with major market indices faltering further.

While these policy measures are meant to stabilize the economy in the face of looming global financial market crisis, a caucus of analysts maintains that the flexibility in monetary policies in recent times geared towards maintaining commodity price stability has instead led to distortions in the capital market. Usually, there is a trade-off between managing the level of inflation and keeping stock prices under control. Everywhere, an attempt to keep product price inflation down affect the real price earnings level of the stock market.

However, we are upbeat on the medium to long term returns prospects of the market as we expect government's other recent reactionary measures (a number of which are yet to be fully implemented) to redirect market trends. But as we await market resurgence, we recommend early positioning after a careful selection among stocks with price multiples below market and sector averages.

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