ANALYSIS REPORT

Company:

East African Breweries Limited

Recommendation

Closing Price (KES)	267.00
↓Price target	241.00

Ticker: BBG	Country	Sector
EABL KN	KENYA	MANUFACTURING

Signs of Product Cannibalization

HOLD recommendation maintained: We remain less optimistic on EABL due to; (i) revenue losses in the Tanzanian market driven by harsh regulations, increased taxation on beer products as well as increased competition, and (ii) waning revenues from key export markets (Burundi and S.Sudan) due to the ongoing political unrest. Moreover, the Group has taken a hit in the Tanzanian market for the last 2 years after the Tanzania's Fair Competition Commission (FCC) slapped them with a fine as reflected on contingent liabilities which rose by 165.6% to KES 793.7m in FY16. The woes began in July 2015, when the FCC threatened to revoke EABL's 51% stake in Serengeti Breweries Ltd (SBL), accusing EABL of breaching merger agreement rules. As part of the ultimatum, SBL is expected to enter into a capital restructuring exercise that will see EABL convert its loan into equity while maintaining 51% stake. In our opinion, we believe that the conversion disservices EABL with a potential one-off revaluation loss. As a result, we forecast 4.7% decline in FY18e PBT to KES 12.7b. However, the outlined plans to expand its production capacity to service the growing liquor market across the East African region, investments behind innovation, and brand re-ignition on mainstream beer and spirits predict well in cementing market share. We expect the emerging beer brands and the reserve, premium and mainstream spirits brands to maintain their growth momentum going forth.

Innovation gives EABL a cutting edge… EABL has over the years managed to safeguard its market share (C.80% - Formal liquor) aided by innovative brands. In Kenya, innovative brands such as Zinga, Tusker cider and Pilsner 7 recorded 13%y/y growth while in Uganda, Uganda Waragi, Bell and Ngule registered 33%y/y growth in FY17. Tanzania remained a weak consumer economy; this was however cushioned by innovative brands such as Kibo Gold, Pilsner and Serengeti, which grew by 5%y/y bringing the overall net sales growth to 13% y/y.

…But could this be a new threat to existing brands? The launch of new brands seems to excite the market on one hand but also it poses a significant risk to existing brands on the other hand. Weak bottled beer performance especially on the mainstream brands seems to be exacerbated by product cannibalization. More so on RTDs, Tusker Cider continues to phase out Snapp and other related products. As long as there exist a higher growth potential for the radler beer market, brand cannibalization can result to customers switching to other brands of which they could be from rival companies.

DCF Valuation: We believe the stock is slightly overvalued based on a fair value of KES 241/share, which represents 9.7% downside risk potential vis-à-vis the current market price of KES 267/share. Our investment case is informed by lower than expected earnings in FY17 (EPS - KES 9.71), as well as punitive tax regime which is slowing its low end brands category. The stock is trading on a forward P/E of 25.1x and an EV/EBITDA of 10.2x vs. our coverage universe average of 20.0x and 9.5x respectively.

Price Performance

Source: NSE, SCL Research

Company Data	
52-Week Range(KES)	200 - 290
Float (%)	31.4%
6MAvgT.O (KES m)	68.6
Market cap (KES Bn)	211.1b
Year End	June
Target Price End date	29.08.2018

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Year to 30th June	FY13A	FY14A	FY15A	FY16A	FY17A	FY18E
EV/EBITDA	11.9	12.2	10.0	10.8	10.5	10.2
EV/EBIT	12.0	14.9	12.0	13.0	13.1	12.9
EV/Sales	3.7	3.6	3.4	3.4	3.1	3.2
EV/Operating cash flow	13.0	14.4	9.9	7.8	10.2	10.3
EV/Free cash flow	97.2	-402.4	22.3	12.7	23.7	20.8
Opex/Av. Assets	16.3%	19.5%	15.9%	17.4%	17.5%	16.2%
Forward P/E (x)	20.6	32.5	23.6	20.6	24.8	25.1
Implied P/E (x)	18.6	29.3	21.3	18.6	22.4	22.7
Forward P/B (x)	8.2	7.7	6.6	18.7	22.2	11.8
Implied P/B (x)	7.5	7.0	6.0	16.9	20.0	10.6
Price to sales (x)	3.6	3.5	3.3	3.3	3.0	3.0
Dividend yield	2.1%	2.8%	2.8%	3.9%	2.8%	2.6%
Payout ratio	42.3%	91.3%	66.2%	80.8%	69.7%	65.8%
ROaE	40.7%	24.6%	30.2%	94.5%	71.0%	61.3%
ROaA	18.2%	10.7%	13.8%	13.0%	12.8%	12.3%

Source: Company filings, SCL Research

Bank borrowings to pressurize EABL's future balance sheet position: As far as Net Debt to EBITDA ratio slightly improved by 6bps to 1.20% from 1.26% in FY16, we are still concerned with the KES 15b debt for the construction of the new brewery. Net borrowings had improved by 5%y/y to KES 24.4b but this trend could change once EABL draws and loads this debt on their balance sheet. Despite the fact that the borrowing will improve the company's cash flow position in FY18f, the subsequent year might be characterized by deteriorating cash position which would imply a possibility of maintained short-term financing (overdraft) resulting in higher interest payments. The outlined Capex might be privy to liquidity constraint going forward.

Weak FY18f performance: We forecast a flat growth on the top line performance driven by improved distribution networks across the region as well as the positive outlook for consumer economies. Nonetheless, we expect the company's debt levels and operating expenses to remain high due to the ongoing infrastructure developments where we project a PBT margin of 17.7% in FY18e, down from 18.9% in FY17A. As a result, we forecast a lower dividend payout ratio of 65.2% to KES 5.0/share. We wait to see if the company will earn tax credit resulting from their Kisumu brewery which is under construction. Going forward, management plans to shift its gear to grow the spirits segments at a much faster rate than its beer segment in relation to consumer trends that are unfolding.

FY17 Financial Performance:

EABL announced its FY17 financial performance reporting a 2.3%y/y decline in PBT to KES 13.3b. The group's revenues advanced 9.2%y/y to KES 70.2b boosted by 5%y/y growth in volumes. Below are the main highlights;

Flat growth on mainstream beer, all eyes on spirits: Mainstay beer portfolio registered lackluster performance as compared to the spirits and value liquor markets. Mainstream beer brands (Tusker, Serengeti and Bell) recorded -7%y/y growth in NSV compared to mainstream spirits like Kenya Cane and Chrome Vodka that grew by 29%y/y. The spirits brand presents a significant growth potential owing to changes in consumption patterns. Value beer brands such as Balozi and Senator registered 13%y/y growth compared to -3%y/y growth in value spirits category. Both the reserve and premium spirits brands registered a growth of 11%y/y. RTDs registered 13%y/y growth driven by female consumption.

PAT down by 17.1%y/y to KES8.5b due to one-off gain recorded in FY16. In 2016, EABL sold one of its subsidiaries, Central Glass Industries Limited (CGI) realizing a profit of KES 2.2b. Excluding the one off gain EABL's PAT grew by 6.2%y/y. EPS stood at KES 9.71 compared to KES 12.20 in FY16. As a result, both ROE and ROA worsened to 71.0% and 12.8% from 94.5% and 13.0% in FY16 respectively.

Dividends: EABL declared a dividend per share (DPS) of KES 7.50, materially below our KES 8.00 DPS expectation in FY17. The DPS implies a dividend yield of 2.8% vs. our coverage universe average of 3.1%. The dividends will be paid on or about 31 October 2017 to shareholders in the company's books by 25 August 2017. In FY18e, we expect the payout ratio to remain above 65% but the dividend yield (2.6% vs. 2.8 in FY17) will be pressurized by the reduced profitability.

Income Statement KES m	**2,016**	**2,017**	**% Change**
Revenue	64,322	70,247	9.2%
Cost of sales	(32,110)	(39,117)	21.8%
Gross profit	**32,212**	**31,130**	-3.4%
Total Costs	(18,593)	(17,823)	-4.1%
Profit before income tax	**13,619**	**13,307**	-2.3%
Income tax expense	(5,598)	(4,793)	-14.4%
Profit for the year	**10,271**	**8,515**	-17.1%
Balance sheet KES m	**2,016**	**2,017**	**% Change**
Total equity	10,867	11,988	10.3%
Non-current liabilities	26,847	32,694	21.8%
Total equity and non-current liabilities	**37,714**	**44,682**	18.5%
Non-current assets	44,127	44,532	0.9%
Current assets	21,556	22,135	2.7%
Current liabilities	(27,969)	(21,984)	-21.4%
Net assets	**37,714**	**44,683**	18.5%
Cash flow statement KES m	**2,016**	**2,017**	**% Change**
Cash generated from operations	27,934	21,524	-22.9%
Net interest paid	(3,265)	(3,174)	-2.8%
Tax paid	(6,092)	(4,435)	-27.2%
Net cash from operating activities	18,577	13,914	-25.1%
Net cash used in investing activities	(1,330)	(4,668)	251.0%
Net cash generated from financing activities	(18,225)	(992)	-94.6%
Net increase/(decrease) in cash & cash equivalents	**(978)**	**8,255**	**-944.1%**
At start of year	(1,392)	(3,954)	184.1%
Fx impact of translation	(1,584)	(983)	-37.9%
Net increase/(decrease) in cash & cash equivalents	(978)	8,255	-944.1%
Cash and cash equivalents at end of the year	**(3,954)**	**3,318**	**-183.9%**

Source: Company filings

Valuation methodology

Our KES 241 price target is derived using a DCF model over the FY18f period. Our model is based on long-term growth rate of 5% and a discount rate (cost of equity) assumption of 17.1%. Our DCF model makes use of a WACC of 10.2%. Our WACC is driven by a beta of 0.9 and a risk free rate of 12.6% (10 –year bond). Other components driving our WACC include an equity risk premium of 5% and an after tax cost of debt of 12.0%.

KES m (12m to June)	**FY15**	**FY16**	**FY17**	**FY18F**	**Terminal value**
EBIT	18,226	16,884	16,780	17,047	
Add: Depreciation & Amortization	3,547	3,375	4,042	4,289	
EBITDA	21,827	20,334	20,876	21,391	
Less: Net Interest	(4,074)	(3,265)	(3,174)	(4,372)	
Less: Notional tax	(3,563)	(6,092)	(4,435)	(3,803)	
Less: CapEx	(4,944)	(5,018)	(4,668)	(4,942)	
Less: Net Working Cap change	1,022	8,498	(8,089)	(114)	
Free cash flow	10,267	14,457	509	8,160	
FCFF	13,119	16,939	3,137	11,221	226,485
Discount Period		-	-	0.83	0.83
Discount factor @ WACC		-	-	0.92	0.92
Present value of free cash flow		-	-	10,348	208,873

Value of operations	219,221
Add/(less) net debt	28,529
Market Capitalization	190,692
No of shares	791
Per share value	**241.00**
Current price	267.00
Upside/downside	(9.7%)

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Strong Buy: FV more than 30% above CSP

Buy: FV between 20% and 30% above CSP

Accumulate/Long-Term Buy: FV between 10% and 20% above CSP

Hold: FV between -10% and 10% around CSP

Lighten: FV between 10% and 20% below CSP

Sell: FV more than 20% below CSP

NB: The recommendation guide may change depending on the risk free rate.

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