1 November 2018

Equity Research

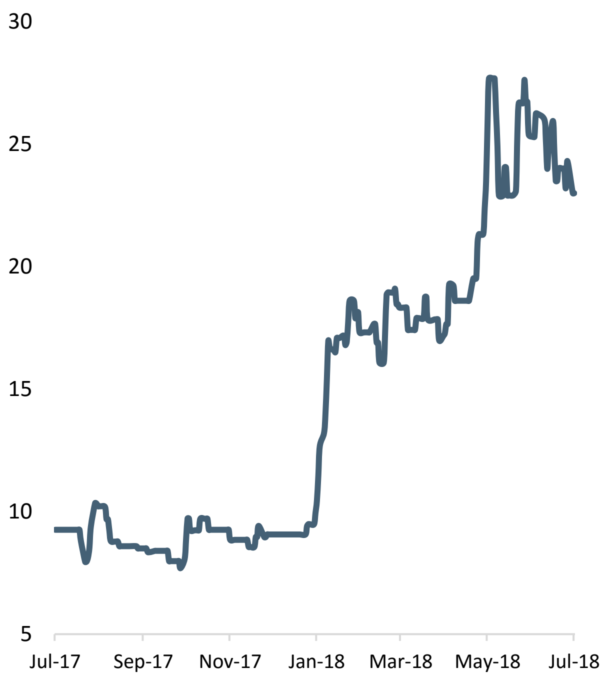
research@armsecurities.com.ng
+234 1 270 1652

ARM SECURITIES

CCNN Plc (Sokoto Cement)

Rating	**SELL**
Price	₦22.50
FVE	**₦17.01**
52-week range	₦8.97 – ₦32.00
Market Cap. (₦'bn)	31.354
1-month Avg. Vol	176,648
Current PE	5.9x

CCNN.NL - Share Price Trend



Analyst

Oluwasegun Akinwale
Oluwasegun.akinwale@arm.com.ng

Equity Commentary

Downgrade to SELL due to material dilution

- Late yesterday, we received the scheme of merger document which finally provided the much-needed clarity required on the expected dilution to shareholders of CCNN from the proposed merger of Cement Company of Northern Nigeria (CCNN) and Kalambaina Cement Company Limited (Kalambaina) – a wholly owned subsidiary of BUA wherein the new cement plant (1.5MT) in Sokoto sits. **The consideration now signals a substantial dilution for minority shareholders following an unexpected premium on the construction cost infused in intangibles of ₦207.3 billion. Management is proposing shareholders meeting to be held on the 29th of November 2018, wherein shareholders are expected to approve the terms of the merger.**

- In our earlier report on the proposed merger published in July 2018 following the press release by management on the share conversion ratio ***(See report: One game before the Finals),*** wherein we adopted a net asset valuation approach in valuing the $350 million construction cost using prevailing exchange rate of ₦360/$ (Scenario 1) and average exchange rate over the 3-year construction period of ₦251/$ (Scenario 2) which translates to asset value of ₦126 billion and ₦87.9 billion respectively. To our surprise, while the addition to property, plant and equipment (PPE) from the proposed scheme was not too far from our estimates, the management included an additional value of the sale in goodwill. For context, the enlarged CCNN post-merger

PPE is expected to increase by N107.5 billion – implying that management adopted an exchange rate of N307/1$ in treating the construction cost of $350 million – to N119.8 billion. However, the enlarge CCNN's intangible assets increased to N207.3 billion from just N499 million in FY 17.

- Accordingly, we estimate total cost of the conversion to shareholders of ₦308.9 billion, including increase in PPE and goodwill. While we find the value of the increase in PPE quite justified, as it is closely related to the construction cost of $350 million using an exchange rate of ₦301/1$, we believe the associated premium in terms of the goodwill requires more explanation on the part of management as we understand it is not associated with any right – in the form of mining of limestone – as the plant is situated in the same location as CCNN.

- **Any *'STEW'* for minority shareholders**. Recall, management of CCNN announced the consideration for the merger will be based on 100,000 shares of Kalambaina for 19,811,372 shares of CCNN (1:198) using the 30-day volume weighted average (VWAP) closing price of ₦25.99. Examining the impact of the proposed consideration on shareholders, using our estimated proposed conversion cost of ₦308.9 billion and overlaying that on the VWAP, we arrived at additional shares of 11.9 billion (in line with the scheme of merger document) which cascades total shares outstanding to 13.1 billion from current of 1.3 billion. Thus, we see a significant dilution to shareholders from the proposed consideration of the merger.

- We believe the significant deviation between our expected additional shares of 6.10 billion and proposed 11.9 billion shares results from the additional goodwill on the transfer of the asset to CCNN. Ex-goodwill, we estimate that additional shares created from the merger would have been 4.1 billion shares which is in line with our estimate.

- **Float to fall below NSE requirement.** After the conversion of the 60,000,000 shares outstanding of Kalambaina, BUA holdings in the enlarged CCNN is expected to increase to 92.27% with a float of 7.73%. To address the lower float relative to the NSE requirement, management intends to implement appropriate strategy to best address the issue. We estimate three possible scenarios:

  1. Rights issue, with the parent company exempted from taking its rights
  2. Tender offer by the parent company to minority shareholders at a price not lower than the conversion price of the plant to CCNN, assuming they intend to take the company private, and

3. Offer for sale of some of the shares of the parent company to the public at a negotiated price.

Table 1: Shareholding Structure pre and post-merger

Description	CCNN	Enlarged-CCNN
BUA	14.98%	87.42%
Damnaz Cement Company Limited	50.72%	4.85%
Others	34.30%	7.73%
Total	**100%**	**100%**

- **Volume consolidation ahead of merger**. In our recently published cement sector report **(See report: Still room for strategic selection),** we stated that the cement volumes reported by CCNN was inclusive of sales from Kalambaina. True to our words, the scheme of merger revealed that the reported revenue of ₦12.1 billion (+425 YoY) over H1 18 is that of the enlarged CCNN. For context, our suspicion was on the back of the estimated volume over H1 18 of 284,454 tons, which suggests that remaining expected production from the plant for H2 cannot exceed 215,546 tons to sum up to the expected annual capacity of the plant of 500K ton. However, using our H2 17 and H2 16 estimate of 264,496 and 263,808 tons respectively, we believe it is unusual for the plant alone to have produced so much in H1 18.

Table 2: Post merger proforma Income statement for full year 2018

Financial Highlight (N'mn)	FY 2017A	FY 18 Management Guidance	Our Estimate
Revenue	19,588	46,893	26,524
Cost of sales	11,983	22,542	14,566
Gross Profit	7,605	24,351	11,958
PAT	3,223	11,774	6,289

- While we maintain our volume and earnings expectation for the company over 2018 and beyond, the increase in shares outstanding informed a material adjustment to our FVE to ₦17.01 from previous estimates based on our expected 6.10 billion shares of ₦28.47, which translates to a **SELL** rating on the stock. CCNN trades at a current P/E and EV/EBITDA of 5.9x and 3.65x relative to Bloomberg Mena peer average of 9.31x and 17.32x.

- Management is proposing shareholders meeting to be held on the 29th of November 2018, wherein shareholders are expected to approve the terms of the merger.

ARM ratings and recommendations

ARM now employs a two-tier rating system which is based on systemic importance of the security under review and the deviation of our target price for the stock from current market price. We characterize systemic importance as a function of a stock's ranking among the group of top 20 stocks by NSE market capitalization over a trailing 6-month period (minimum) to the review date. We adopt a 5-point rating system for this category of stocks and a 3-point rating system for stocks outside this group. The choice of top 20 stocks arises from the consideration that this group of stocks constitutes >75% of overall market capitalization and stocks outside this group are generally less liquid and individually account for <<1% of market capitalization. For stocks in both categories, the basis for ratings subject to target price deviation is outlined below:

TOP 20		NON-TOP 20	
Rating	**Deviation**	**Rating**	**Deviation**
STRONG BUY	>20%	**BUY**	>20%
OVERWEIGHT	10% — 20 %	**NEUTRAL**	5% — 20 %
NEUTRAL	0% — 10 %	**SELL**	<5%
UNDERWEIGHT	-5% — 0%		
SELL	<-5%		

RECOMMENDATION KEY	
Rating	**Recommendation**
BUY	Accumulate security to a substantial extent constrained only by portfolio diversification considerations
OVERWEIGHT	Accumulate security to an extent moderated by cognizance of its benchmark weight
NEUTRAL	Maintain status quo for security with respect to current holding—i.e. keep if already holding and don't buy otherwise—subject to reasonable portfolio constraints
UNDERWEIGHT	Minimize exposure to security taking cognizance of its index weighting
SELL	Sell-off security completely from portfolio
RESTRICTED	In certain circumstances, Asset & Resource Management ("ARM") Group policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of ARM Securities' and/or ARM Group's engagement in an investment banking transaction and in certain other circumstances.

This material has been issued by ARM Securities Limited, a member of the Asset and Resource Management ("ARM") Group, and a Company regulated by the Nigerian Securities & Exchange Commission. The analyst(s) primarily responsible for preparing this research report, in whole or in part, certifies that with respect to each security or issuer covered; all the views expressed accurately reflect his/her personal views about the subject securities and issuers and no part of his/her compensation was, is, or will be, directly or indirectly, related to the inclusion of specific recommendations or views in the report.

This research report is based on information from sources that ARMS and its analysts believe to be reliable. Neither ARMS nor any of its research analysts, nor any member of the ARM Group, gives any representation or warranty, express or implied, or undertaking of any kind or assumes responsibility or liability of any kind with respect to the accuracy or completeness of the information set out in this report or any third party's use (or the results of such use) of such information. This report is provided solely for informational purposes and is not to be construed as providing advice, recommendations, or endorsements of any kind whatsoever. The investments and strategies discussed here may not be suitable for all investors; counsel of investment advisor should be obtained with regard to such investments and or strategies. This research report is not a replacement for advice from an accountant, lawyer, personal finance advisor or other category of investment advisor. The investments discussed in this report may oscillate in price or value. Opinions and information provided are made as of the date of the report issue and are subject to change without notice. This research report is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Reference herein to any specific security or financial instrument does not necessarily constitute or imply its endorsement or recommendation by ARMS, its directors, officers, employees, or designated agents. Members of ARM may act as broker, advisor, or lender, or make a market in any investments or issuers referenced in this report. Further information on any of the securities discussed herein may be obtained upon request to ARMS. By accepting this document, you agree to be bound by the foregoing limitations.