EABL- Tough Operating environment brews

DATE:	**15 July,2020**
Recommendation	**BUY**
Target price	**KES 263.36**
Current price	**KES 156.50**
Upside	**68.3%**
52 Week Low	**KES 135.25**
52 Week High	**KES 224.25**
EPS:	**KES 11.23**
DPS (interim):	**KES 3.00**

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We recommend a **BUY** on EABL with a **target price** of **KES 263.36,** offering a potential **upside of 68.3%** on the current market price. Our view is informed by the huge price dip that has been driven by a bear run at the NSE and the brewer's profit warning announcement. In our view, despite the tough prevailing environment, we remain confident of the brewers' recovery in the medium to long term once the full effect of the pandemic has been integrated in the economy.

Graph 1: Price trend

Source: AIB-AXYS Research, Company Fillings

According to the IMF, global economic growth is projected to contract by 4.9% as the COVID-19 pandemic has negatively impacted activity in the first half of 2020 and the recovery is projected to be more gradual than previously forecasted. The alcoholic beverages industry has also been affected as alcohol consumption is heavily dependent on the economic wealth of people within an economy and a slowdown in the global economy spells a downturn for players in the industry. With the outbreak of this virus, consumer demand will be negatively affected, incomes will decline and a shift of sentiments towards fear of the contagion will greatly alter consumption of alcohol.

Key issues that have stood out for us include:

The glum

- A profit warning which is likely to be the result of a 79% decline in bottom line in 2H20
- Decline in tax remissions on Senator Keg is likely to depress FY21 revenues
- Collapse of Senator Keg value chain as the Kisumu Plant remains shut
- Lower demand as disposable income decreases

The positive

- Reduced corporate tax
- Roll out of a recovery fund for bars

» Outlook within East Africa

The outbreak of the coronavirus is changing the dynamics for most firms with EABL having to bear some of the negative economic effects of the virus. Some of its major revenue drivers have been affected, causing a necessary revaluation of the company's revenues and revision of the company's outlook.

Diageo Plc, the parent company of EABL had initially announced that it anticipates at least a 3% decline in sales on the back of the coronavirus pandemic as restaurants, bars and social gatherings in many countries have been closed and restricted. Diageo has since abandoned their forecast due to weaknesses in key markets in Africa and the Asia pacific region.

EABL's revenue contribution per country has Kenya, Uganda and Tanzania contributing 71%, 16% and 13% respectively. As at 1H20, net sales had grown 8%, 10% and 19% in the respective subsidiaries.

Kenya, Uganda and Tanzania governments effected the closing of restaurants, bars and nightclubs and banned public gatherings while encouraging a work from home policy. Nationwide curfews and lockdowns were imposed in both Kenya and Uganda.

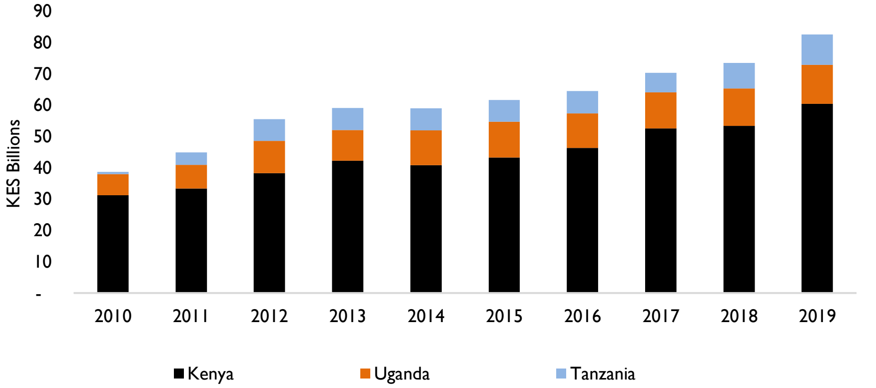
Uganda

Reserve spirits, mainstream and premium beers have been growth drivers for revenue in the region aiding Uganda Breweries limited weather the headwinds of a sachet ban on spirits that has reduced sales. Given that business operations are bound to be hit by the current pandemic, we anticipate continued recovery in the premium and mainstream beer categories as the economy slowly opens up. We however anticipate some gloom in the mainstream spirits category which before the pandemic was yet to recover from declined sales due to ban on sachets (grew a minute 1% y/y in 1H20).

Tanzania

The brewer has plans to acquire an additional 30% stake in Serengeti Breweries further tightening its grip in the Tanzanian market. In July 2019, EABL spent KES 313M to acquire an additional 4% stake in Serengeti raising its ownership to 55%. Tanzania has stood out as the brewer's fastest growing market with back-to-back double-digit growth in net sales and growing contribution to the company's top-line growth. We anticipate that the subsidiary will continue to stand out despite the detrimental effects of the prevailing pandemic with the gradual opening of the Tanzanian economy expected to see continued recovery in the mainstream beer and mainstream spirits categories.

Graph 2: Revenue Distribution by Subsidiary

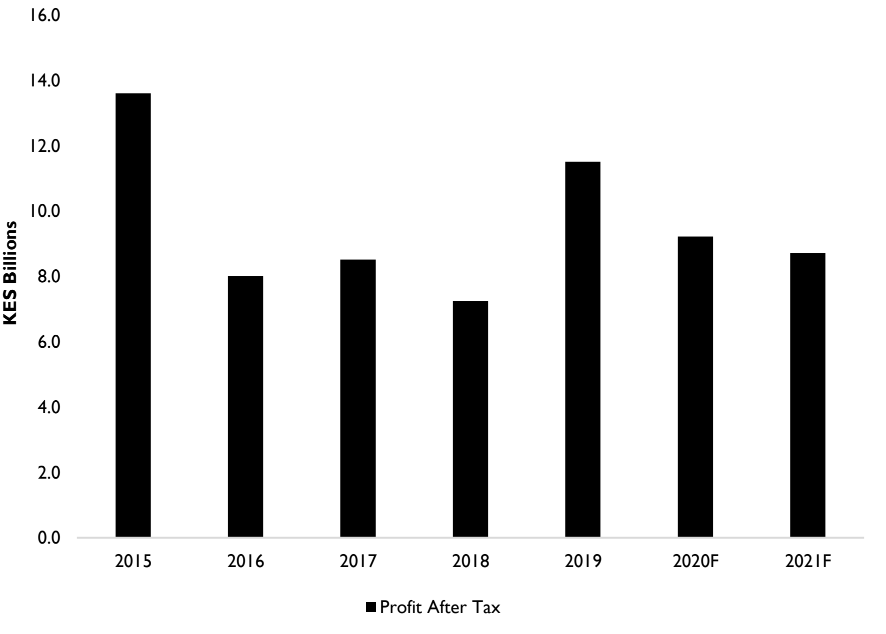


Source: AIB-AXYS Research, Company Fillings

» Bottom-line declines 78.6% in 2H20

The brewer announced an expectation of a 25% decline in PAT for its FY20 earnings implying that the bottom line would reverse from Kes 11.86Bn in 2019 to approximately Kes 8.94Bn for FY 2020.

Graph 3: Net Profit

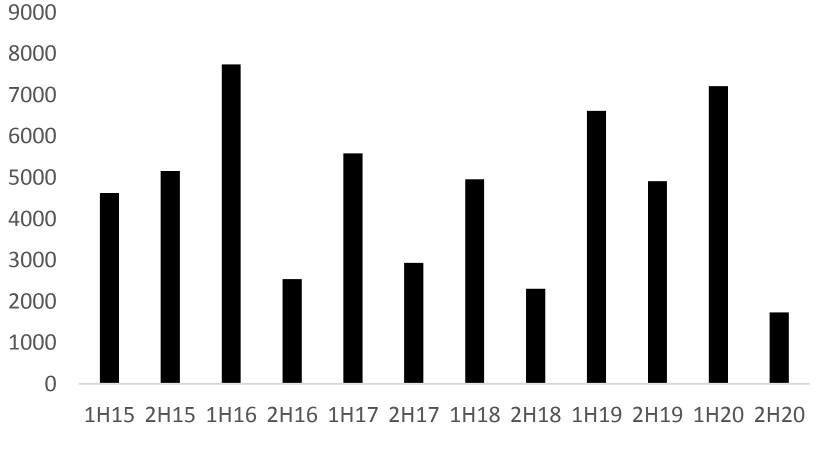


Source: AIB-AXYS Research, Company Fillings

Given that the brewer made a net profit of KES 7.21Bn in 1H20, this would mean that in the last 4 months of FY20, the brewer anticipates to make KES1.73B only in 2H20 (-78.6% y/y).This signifies that 1H21 is also likely to be difficult as the full effects of the pandemic are yet to be felt.

According to the Bars, Hotel and Liquor traders Association of Kenya, the outbreak of the pandemic has severely affected bar owners who estimate that the measures taken to control the virus has led to losses estimated at KES 1Bn in the three months to June.

Graph 4: Half year revenue (KES M)



Source: AIB-AXYS Research, Company Fillings

»Operational headwinds likely in the foreseeable future with changes to the tax regime

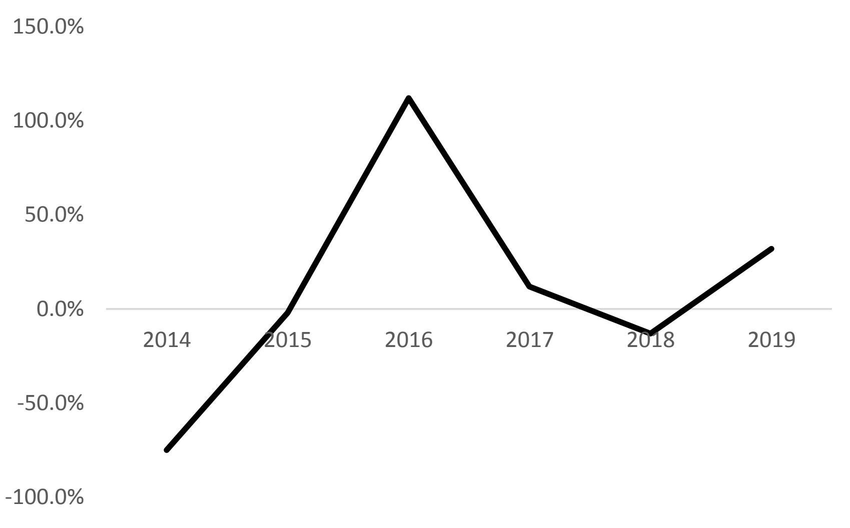
EABL is likely to experience further operational headwinds that may further depress revenues. The government, having adjusted the income tax and VAT for certain goods downwards, is proposing a downward revision of the remission of excise duty on beers manufactured from sorghum, millet or cassava to 60% from 95%. This would speak to the sales risk faced by the firm as the tax effect would be translated to pricing of EABL's value segment, Senator Keg.

If the proposal to reduce the remission was to go through, it would come into effect in FY21 pushing up the pricing of a 300 ml serving by Kes 10 from to Kes 38 forcing consumers to dig deeper into their pockets for the same unit of sale.

Senator target market is very price sensitive, thus price increases have historically negatively affected volumes. In recent times, the segment has held ground as a revenue driver for EABL, as increased volumes drive growth. Historically an adjustment to the excise remission has led to revenue and cost implications for EABL. The last decrease in remissions led to:

- Lower revenue for both EABL and the government. At the beginning of FY14, the government reduced the excise duty remission from 100% to 65% in a bid to raise revenue driving down Senator Keg volume growth by 65% between 2013 and 2015.
- According to a report by UNCTAD on the illicit trade forum, the number of outlets selling senator keg reduced from 12,900 to 6,500 translating to lower sales volumes by the brewer. Similarly, about 13 000 farmers lost their livelihood.

Graph 5: Senator Keg Volume Growth (%)



Source: AIB-AXYS Research, Company Fillings

»Kisumu Brewery wasting away

A dark cloud looms over the KES 14B Kisumu plant that has remained closed since March 23 when the government ordered the closure of bars with the Senator Keg value chain collapsing by 100%. The Kisumu Plant coming on stream in January this year had improved volume growth by 30% before the onset of COVID 19 restrictions in March. Barely one and a half years into operations, operations at the plant are at a standstill, given that Senator Keg does not have a takeaway option. This has also seen an increase in the rise of illicit brew consumption hence a loss of market share that may take time to recover once bars are open. In addition, with the aforementioned decrease in tax remissions expected to see an increase in prices, it is anticipated that the plant will operate at 20% capacity making the KES 14B investment untenable. Under normal circumstances, the plant is expected to produce 100M liters per annum translating to KES 8.3B in revenue per annum. If the plant was operating at 20% capacity as aforementioned, the plant would be expected to bring forth KES 1.7B in revenue per annum.

It remains unfortunate that the instability in tax laws and continued lip service by the government has rendered operations at the plant untenable at the current state.

»Subdued economic growth likely to erode consumer purchasing power

We anticipate a decline in alcohol consumption on the back of reduced consumer demand as household disposable income decreases. This is expected to hit topline growth in the short to medium term as households focus on meeting basic needs as opposed to leisure activities. The government has been trying to offer some reprieve with a KES 54B economic stimulus package. We however feel that this may be felt little in an economy that has experienced an almost complete shutdown. While the government has been effecting a gradual opening of the economy, it is anticipated that the economy will take time to recuperate in the face of the pandemic.

Positive Outlook

However, despite the tough outlook, not all has been glum for the brewer:

»Corporate tax environment may offer some respite in unprecedented times

The lowering of corporate tax rates from 30% to 25% is expected to see the brewer forego a huge tax burden with this cushioning the bottom line in the short-term with this being a positive thing for EABL in the current harsh economic environment.

» "Raising the bar" to boost recovery of bars and eateries

EABL launched a USD 5M (KES 536M) recovery fund dubbed "Raising the bar" to aid the revival of bars and eateries following the lifting of COVID-19 restrictions with the initiative being part of the USD 100M global Diageo program to help bars and outlets recover. The funds will assist in the purchase and installation of physical equipment to implement social distancing rules and the implementation of technology in operations. This is anticipated to aid in long term recovery of the hospitality sector that has been most hit by the pandemic.

Valuation Summary

We used the Discounted Cashflow (DCF) and Relative valuation methods to value EABL. We made the following assumptions-:

- Risk free rate 10-year government bond: 11.10%
- Equity risk premium: 5%
- Beta: 0.64

We recommend a **BUY** on EABL with a target price of **KES 263.36**, offering a **potential upside of 68.3%** on the current market price of KES 156.50.

Table 1:Valuation

Assumptions	
Rfr (10-yr T-bond)	11.10%
Equity Risk Premium	5.0%
Regulatory Risk Premium	0.5%
Leverage Risk Premium	0.5%
Adjusted Beta	0.64
Cost of Equity (Based on CAPM)	15.3%
Cost of Debt	11.6%
Equity/Debt Ratio	44.5%
Terminal Growth	6.0%
Tax Rate	30.0%
WACC	11.7%

Methodology	Fair Value Estimates	Weighting	Weighted Average
Discounted Cash Flows (DCF)	144.12	50%	72.06
Relative Valuation	270.71	50%	135.36
Fair Value			207.42
Current Price			156.50
Upside			32.5%

Source: AIB-AXYS Research, Company Fillings

Table 2: Financial Statements

Income Statement (KES 000)	2017	2018	2019	2020F	2021F	2022F
Revenue	**70,247,065**	**73,456,832**	**82,543,241**	**70,161,755**	**71,564,990**	**78,005,839**
Y/y Change		4.57%	12.37%	-15.00%	2.00%	9.00%
Cost of sales	**(36,074,661)**	**(37,891,637)**	**(44,426,104)**	**(33,057,423)**	**(34,954,732)**	**(37,535,483)**
Y/y Change		5.04%	17.25%	-25.59%	5.74%	7.38%
Gross profit	**34,172,404**	**35,565,195**	**38,117,137**	**37,104,332**	**36,610,258**	**40,470,356**
Y/y Change		4.08%	7.18%	-2.66%	-1.33%	10.54%
Total Costs	**(20,865,071)**	**(23,823,385)**	**(19,958,602)**	**(25,189,573)**	**(23,668,908)**	**(25,247,347)**
Y/y Change		14.18%	-16.22%	26.21%	-6.04%	6.67%
Profit for the year	**8,514,568**	**7,255,555**	**11,859,015**	**8,936,070**	**9,058,945**	**10,656,107**
Y/y Change		-14.79%	63.45%	-24.65%	1.38%	17.63%

Balance Sheet (KES 000)	2017	2018	2019	2020F	2021F	2022F
Total equity	**11,988,170**	**11,652,036**	**16,154,751**	**18,369,240**	**20,706,604**	**24,641,129**
y/y Change		-2.80%	38.64%	13.71%	12.72%	19.00%
Non- current liabilities	**32,694,428**	**33,811,022**	**37,251,495**	**28,331,084**	**24,076,188**	**13,613,349**
y/y Change		3.42%	10.18%	-23.95%	-15.02%	-43.46%
Total Equity and noncurrent liabilities	**44,682,598**	**45,463,058**	**53,406,246**	**46,700,324**	**44,782,792**	**38,254,478**
y/y Change		1.75%	17.47%	-12.56%	-4.11%	-14.58%
Current assets	**22,134,600**	**21,525,962**	**29,602,381**	**14,952,530**	**12,558,478**	**4,726,157**
y/y Change		-2.75%	37.52%	-49.49%	-16.01%	-62.37%
Current liabilities	**21,983,714**	**25,783,768**	**33,659,381**	**28,882,016**	**31,350,701**	**33,299,168**
y/y Change		17.29%	30.54%	-14.19%	8.55%	6.22%
Net assets	**44,682,598**	**45,463,058**	**53,406,246**	**46,700,324**	**44,782,792**	**38,254,478**
y/y Change		1.75%	17.47%	-12.56%	-4.11%	-14.58%

Ratios	2017	2018	2019	2020F	2021F	2022F
Ebitda growth	-3.8%	0.4%	3.9%	-14.4%	2.1%	11.4%
Ebit growth	-3.4%	-0.3%	25.3%	-20.8%	0.5%	12.3%
Gross profit margin	48.6%	48.4%	46.2%	52.9%	51.2%	51.9%
Ebitda margins	29.8%	28.6%	26.5%	30.7%	30.8%	31.5%
Ebit margins	24.9%	23.7%	26.5%	24.3%	23.9%	24.7%
Net profit margins	11.0%	8.7%	14.4%	12.7%	12.7%	13.7%
ROE	11.6%	9.0%	13.6%	52.7%	50.7%	52.9%
Tax rate	36.0%	38.2%	34.7%	25.0%	30.0%	30.0%

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Investment ratings

- **BUY:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.

- **HOLD:** Issued on counters with an upside of between 1% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.

- **SELL:** The counter currently has weak fundamentals coupled with potential downside.

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