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EABL- Tough Operating environment brews

DATE:	4 August,2020
Recommendation	BUY
Target price	KES 188.20
Current price	KES 156.00
Upside	20.6%
52 Week Low	KES 135.25
52 Week High	KES 224.25
EPS:	KES 8.88
DPS (Total):	KES 3.00

Analyst:
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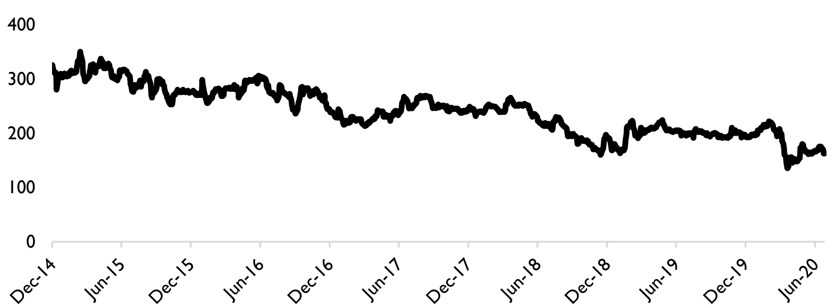
We recommend a **BUY** on EABL with a **target price** of **KES 188.20,** offering a potential **upside of 20.6%** on the current market price. Our downward valuation was informed by the brewer's dismal FY20 performance as the top line was weighed down by effects of COVID 19. EABL announced a 39.0% y/y decline in net earnings higher than our projection of a 25% y/y drop on the back of dismal performance in 2H20.

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 that saw a 39% decline in net earnings in FY20
- 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

FY20 Financial Performance

The brewer's gross profit declined 13.4% y/y higher than our forecast of a 2.7% y/y decrease. Total costs grew 10.2% y/y to KES 22.4B lower than our forecast of a 26.2% y/y growth. In effect, net earnings plummeted 39.0% y/y higher than our projection of a 24.7% drop.

Income Statement	FY19 KES M	1H20 KES M	2H20 KES M	FY20 KES M	Chng y/y %	Chng h/h %
Revenue	82,543	45,856	29,060	74,916	(9.2)	-36.6
Cost of Sales	(44,426)	(24,013)	(17,883)	(41,896)	(5.7)	-25.5
Gross Profit	38,117	21,843	11,177	33,020	(13.4)	-48.8
Total Costs	(20,302)	(11,241)	(11,124)	(22,365)	10.2	-1.0
Profit before tax	17,815	10,602	53	10,655	(40.2)	-99.5
Income Expenses	(6,300)	(3,393)	(241)	(3,634)	(42.3)	-92.9
Profit after tax for the year	11,515	7,209	(188)	7,021	(39.0)	-102.6
EPS (KES)	14.56	7.00	1.88	8.88	(39.0)	-73.2
DPS (KES)	8.50	3.00	-	3.00	(64.7)	-100.0
Statement of Financial Position						
Total equity	16,155	17,924	13,993	13,993	(13.4)	-21.9
Non-current liabilities	37,251	38,527	43,621	43,621	17.1	13.2
Total equity and non-current liabilities	53,406	56,451	57,614	57,614	7.9	2.1
Non-current assets	57,463	60,756	62,690	62,690	9.1	3.2
Current assets	29,602	32,612	25,986	25,986	(12.2)	-20.3
Current liabilities	(33,659)	(36,917)	(31,044)	(31,044)	(7.8)	-15.9
Net assets	53,406	56,451	57,614	57,614	7.9	2.1
Statement of Financial Cashflows						
Cash generated from operations	28,491	15,158	(1,522)	13,636	(3.7)	80.6
Net interest paid	(3,604)	(1,841)	(1,964)	(3,805)	10.6	19.5
Tax paid	(2,321)	(4,390)	(2,095)	(6,485)	198.4	55.3
Net cash from operating activities	22,566	8,927	(5,581)	3,346	(29.1)	97.7
Net cash used in investing activities	(11,546)	(4,652)	(3,678)	(8,330)	(0.6)	-14.7
Net cash generated from/(used) in financing activities	(1,724)	(4,714)	(644)	(5,358)	89.9	13.8
Net increase / (decrease) in cash & cash equivalents	9,296	(439)	(9,903)	(10,342)	(108.1)	-518.3
At start of year	3,187	12,469	-	12,469	291.2	-52.0
Cash and cash equivalents at end of period	12,469	12,092	(10,363)	1,729	38.1	-726.8
Ratios						
Operating profit margin (%)	21.58	23.12	0.18	14.22		
Net margin (%)	13.95	15.72	(0.65)	9.37		
Payout ratio (%)	58.37	42.86	-	33.79		
Return on assets (%)	21.56	13.12	(0.33)	12.19		
Return on Equity (%)	71.28	42.31	(1.18)	50.18		
Current ratio	0.88	0.88	0.84	0.84		
P/E (x)				18.1		
P/B (x)				9.1		

Source: AIB-AXYS Research, Company Fillings

» 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 69%, 16% and 15% 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.

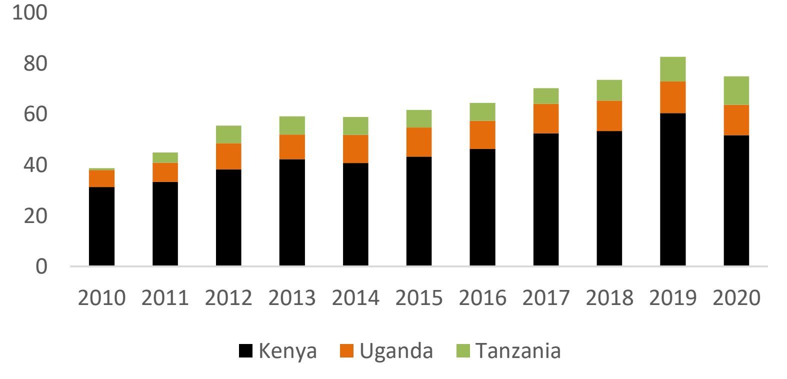
Uganda

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. We anticipate continued recovery in the premium beer (+5% in FY20), premium spirits (+15% in FY20) and mainstream beer categories (+24% in FY20) 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 (declined 20% in FY20).

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. The subsidiary saw a 14% growth in FY20 despite a 10% slowdown in net sales in 2H20 from 19% in 1H20 given the Tanzanian government lax restrictions on containment measures. We anticipate that the subsidiary will continue to stand out despite the detrimental effects of the prevailing pandemic supported by continued lax regulations on containment measures.

Graph 2: Revenue Distribution by Subsidiary (KES B)



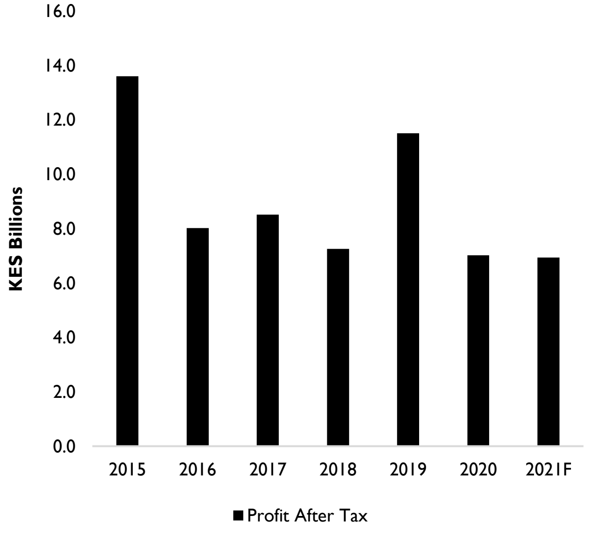
Source: AIB-AXYS Research, Company Fillings

» Bottom-line to remain compressed in FY21

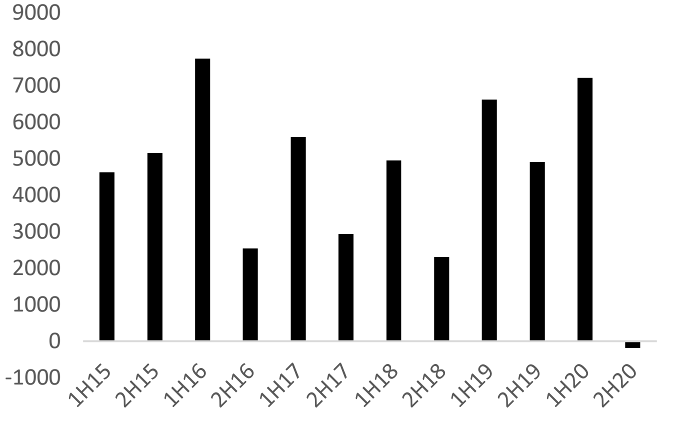
The brewer announced a 39.0% y/y decline in net earnings on the back of dismal performance in 2H20 due to the impact of the prevailing COVID-19 pandemic that saw containment measures implemented see a fall in sales by the brewer. EABL's topline declined 9.2% y/y to KES 74.9B premised on a 36.6% h/h drop in revenues in 2H20 despite strong 1H20 performance.

Supported by the aforementioned resilience in Tanzania, strong growth in premium beer and spirits categories in Uganda and stability of the mainstream spirits category in Kenya, we project a 15% drop in the topline in FY21 to KES 145.4B despite the effects of the pandemic. While containment measures remain in Uganda and Kenya, we anticipate the gradual opening of bars and restaurants as the respective governments effect sustainability measures for the economy. While the time frame of the pandemic remains uncertain, we anticipate a stronger 2H21 premised on expectations that by then containment measures will have been relaxed as communities work to adjust and "live with" the virus.
The brewer has also effected cost saving measures to shield the bottom-line with a slow down in inventory movement. We anticipate a 15% y/y decline in costs in FY21 resulting in a 9.6% drop in PBT to KES 9.6B.

Graph 3: Net Profit



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

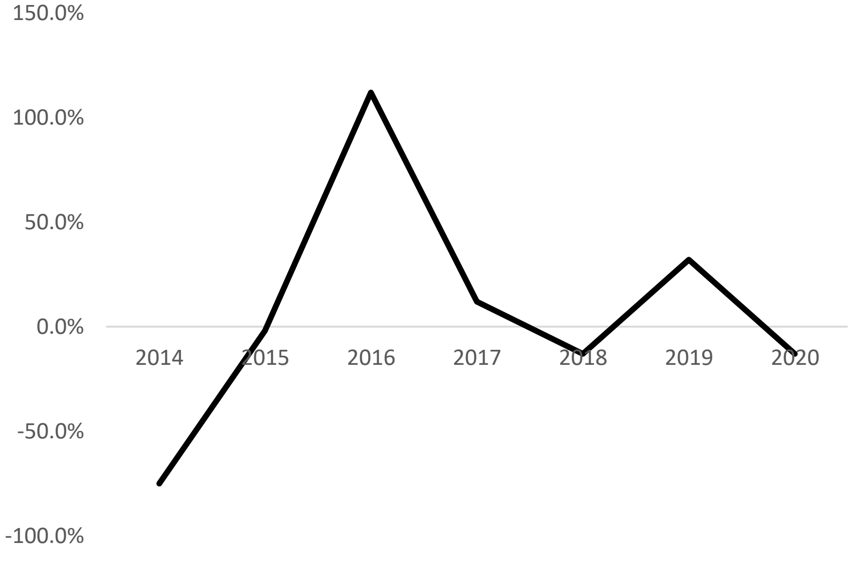
EABL is likely to experience further operational headwinds that may further depress revenues. The government, having adjusted the income tax and VAT for certain goods downwards, is proposing a downward revision of the remission of excise duty on beers manufactured from sorghum, millet or cassava to 60% 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: 12.5%
- Equity risk premium: 5%
- Beta: 0.9

We recommend a **BUY** on EABL with a fair value price of **KES 178.43**, offering a **potential upside of 14.4%** on the current market price of KES 156.00.

Table 1:Valuation

Assumptions	
Risk Free Rate- 10 yr bond	12.5%
Beta	0.9
Risk Premium	5.0%
Cost of Equity	16.9%
Cost of Debt (1-T)	13.8%
Target Weighting of Debt	75.0%
Weighting of Equity	25.0%
WACC	14.6%
Long term growth rate	6.0%

Methodology	Fair Value Estimates	Weighting	Weighted Average
Discounted Cash Flows (DCF)	188.20	50%	94.10
Relative Valuation	168.67	50%	84.33
Fair Value			178.43
Current Price			156.00
Upside			14.4%

Source: AIB-AXYS Research, Company Fillings

Table 3: Financial Statements

Income Statement (KES M)		2018	2019	2020	2021F	2022F	2023F
Revenue		**73,457**	**82,543**	**74,916**	**63,679**	**66,863**	**72,880**
	% growth		*12.4*	*-9.2*	*-15.0*	*5.0*	*9.0*
Cost of Sales		**41,052**	**44,426**	**41,896**	**35,158**	**36,765**	**40,356**
	% growth		*8.2*	*-5.7*	*-16.1*	*4.6*	*9.8*
Gross Profit		**32,404**	**38,117**	**33,020**	**28,521**	**30,098**	**32,524**
	% growth		*17.6*	*-13.4*	*-13.6*	*5.5*	*8.1*
Total Costs		**20,663**	**20,302**	**22,365**	**18,886**	**19,571**	**21,252**
	% growth		*-1.7*	*10.2*	*-15.6*	*3.6*	*8.6*
Profit before tax		**11,742**	**17,815**	**10,655**	**9,635**	**10,527**	**11,272**
	% growth		*51.7*	*-40.2*	*-9.6*	*9.3*	*7.1*
Income Tax Expenses		**4,486**	**6,300**	**3,634**	**2,698**	**3,158**	**3,381**
	% growth		*40.4*	*-42.3*	*-25.8*	*17.1*	*7.1*
Profit after tax for the year		**7,256**	**11,515**	**7,021**	**6,937**	**7,369**	**7,890**
	% growth		*58.7*	*-39.0*	*-1.2*	*6.2*	*7.1*
EPS (KES)		**9.18**	**14.56**	**8.88**	**8.77**	**9.32**	**9.98**
	% growth		*58.7*	*-39.0*	*-1.2*	*6.2*	*7.1*
DPS (KES)		**7.50**	**8.50**	**3.00**	**0.00**	**5.50**	**5.50**

Statement of Financial Position (KES M)		2018	2019	2020	2021F	2022F	2023F
Total equity		**16,001**	**18,728**	**14,877**	**20,837**	**22,505**	**25,424**
	% growth		*17.0*	*-20.6*	*40.1*	*8.0*	*13.0*
Non-current liabilities		**33,811**	**34,379**	**40,164**	**37,170**	**34,550**	**32,325**
	% growth		*1.7*	*16.8*	*-7.5*	*-7.0*	*-6.4*
Total equity and non-current liabilities		**49,812**	**53,107**	**55,041**	**58,007**	**57,054**	**57,749**
	% growth		*6.6*	*3.6*	*5.4*	*-1.6*	*1.2*
Non-current assets		**49,721**	**56,352**	**57,391**	**58,378**	**58,314**	**58,585**
	% growth		*13.3*	*1.8*	*1.7*	*-0.1*	*0.5*
Current assets		**21,526**	**28,239**	**22,259**	**22,675**	**23,294**	**22,986**
	% growth		*31.2*	*-21.2*	*1.9*	*2.7*	*-1.3*
Current liabilities		**25,784**	**22,030**	**21,012**	**28,609**	**27,557**	**27,264**
	% growth		*-14.6*	*-4.6*	*36.2*	*-3.7*	*-1.1*

Ratios	2018	2019	2020	2021F	2022F	2023F
EBIT Margin(%)	20.6	25.7	19.3	20.4	20.3	19.8
EBITDA Margin(%)	25.4	30.3	24.2	26.2	26.2	25.7
Net debt/EBITDA	1.6	1.2	2.0	2.0	1.8	1.6
Gross profit margin(%)	44.1	46.2	44.1	44.8	45.0	44.6
Net profit margin (%)	9.9	14.0	9.4	10.9	11.0	10.8
Payout ratio (%)	81.7	58.4	33.8	0.0	59.0	55.1
ROaA (%)	16.1	21.3	11.6	12.5	13.8	14.6
ROaE (%)	51.8	66.3	41.8	38.8	34.0	32.9
P/E (x)			**20.1**	**20.3**		
P/B (x)			**9.5**	**6.8**		
Dividend yield (%)			**1.7**			

Source: AIB-AXYS Research, Company Fillings

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Investment ratings

- **BUY:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%.
- **HOLD:** Issued on counters with an upside of between 1% and 10.0%
- **SELL:** The counter currently has weak fundamentals coupled with potential downside.