

Equity Strategy Note (II)

- **At the global level, recovery “green shoots” appear tentative as optimism remains mild.** Recent happenings have indeed shown that there is a small light at the end of the tunnel, though faint now but getting brighter as equity markets are gradually pricing-in the anticipated recovery and demonstrating symptoms of provisional stability
- **Underlying fundamentals still remain weak!** At global economic level, potential downside risk remains as oil market fundamentals are far from balanced due to the persistent contraction in demand and growing supply overhang. The quest remains whether this sentiment will lead to a sustainable recovery, despite the prevailing weakness in economic fundamentals.
- **The Nigerian Equity Story.** Rationale for recent spikes is not quite dissimilar from what obtained in other developed markets. This feat was engendered by a mix of ease of liquidity owing to **foreign portfolio investment from emerging market funds**; juicy corporate results cum outstanding benefit declarations, beating analysts’ forecasts and investors’ expectations. Other secondary factor is largely attributed to **“buy-the-available-phenomenon”**.
- **Our Opinion: Taking a breath for sustainability?** An ostensibly fair and balanced view is to opine that it would be healthy for the market to take a breath and allow some of the fundamentals to catch up to avoid a repeat of the recent past.
- **Our Equity Strategy: Still Defensive, Not Yet Offensive.** We believe our defensive themes still hold much steams as the bear market psyche is yet to disappear. Not only do the themes and the resultant stocks contain substantial downside protection against loss as well as substantial return opportunity, but the expected returns will increase rapidly as valuations move up materially when the economy recovers

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Overview of Global Marketplaces: Recovery ‘green shoots’ and Wishy-washy Optimism

Recent happenings have indeed shown that there is a small light at the end of the tunnel, though faint now but getting brighter as equity market is gradually pricing-in the anticipated recovery. Equity markets across the globe have demonstrated further evidence of symptoms of provisional stability after the most severe economic recession since the World War II. Performance statistics have traced the most promising signs to China and the US sequel to aggressive policy measures (most importantly; colossal stimulus packages) which have, at least marginally, induced economic activity and subsequently engendered some level of confidence in the global marketplace.

In the US, S&P 500 rose 9% in April and 34% since the low seen on 9 March. This increase was mainly driven by improvements in the banking sector, and by better-than-expected 1Q09 corporate earnings results as well as by a general perception that the global economy might bottom out somewhere in the second half of 2009. Similarly, French and Italian equity markets returned double-digits gains while other markets posted singular gains. In the same vein, significant rallies were recorded in emerging markets with **BRIC** countries maintaining strong lead as **Brazil, Russian and India** posted above 15% during April.

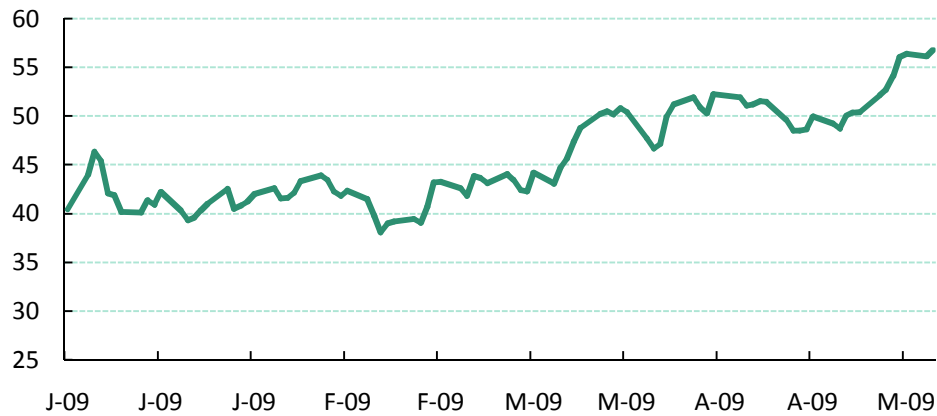
Disappointingly, US equities (as well as few other regional equity markets) on Friday (May 15) ended their first week of significant losses since the start of the rally in March as investors worried that economic green shoots could turn out to be little more than weeds.

Underlying fundamentals still remain weak!

Contrary to the market-wide ‘green shoots’ of recovery, underlying indicators of global economy present a *somewhat dissimilar* picture with *mild* motivation for optimism. The baseline projection for global economy has been revised to 1.3% GDP decline in 2009 by **World Economic Outlook** of the IMF, in April. Advanced economies are projected to contract by 3.8% with the US economy expected to further trim down by 2.8%. Euro-zone is set to further shed weight by 4.2% while Japan is estimated to record the most hurting GDP contraction of 6.2%. Largely, these forecasts are in tandem with projections of a number of other international and national organisations.

At global economic level, potential downside risk remains as oil market fundamentals are far from balanced due to the persistent contraction in demand and growing supply overhang. The quest remains whether this sentiment will lead to a sustainable recovery, despite the prevailing weakness in economic fundamentals.

Exhibit 1 International oil price movement, US\$pb [YtD]



Source: OPEC

Yet, on the whole, there is increasing **convergent view that the worst may be over** as the pace of decline has also abated significantly towards the end of 2008 in most regions or Q1-2009 in a few others. However, most coherent opinions hold that the equity markets recovery is still fragile and mild. As of April till date, in the oil market, prices have remained above \$US50pb due more to **positive market sentiment** than fundamentals.

The Nigerian equity story:

In the same spirit, the Nigeria equities market, in a dramatic fashion, has posted a double-digit growth of c.15.4 percent month-to-date (MtD), consolidating on 8.3 percent gain booked in the month of April. Rationale for recent spikes is not quite dissimilar from what obtained in other developed markets. This feat was engendered by a mix of ease of liquidity owing to **foreign portfolio investment from emerging market funds**; juicy corporate results cum outstanding benefit declarations, beating analysts' forecasts and investors' expectations. Other secondary factor is largely attributed to "**buy-the-available-phenomenon**".

Major Activity Propellants:

- Liquidity creep:** The influx of fresh portfolio investments via emerging market funds and other sources into the Nigerian equities market has been the chief propellant of activity on the floors of the Exchange. Market was rife with return of foreign money managers which has induced demand for a few banking stocks and subsequently sparked activity in the market in April and early May. The top 5 banks that benefited most from the rally are **ACCESS, DIAMOND, UBA, GUARANTY, and ZENITHBANK** posting 13 percent, 34 percent, 29 percent and 22 percent respectively in April.
- Banking stocks' earnings extravaganza:** Aside ease of liquidity which has remained the singular boost for investor confidence, recent upbeat in the market was also buoyed by superb corporate earnings broadcast by the financial and non-financial companies spiced with superlative benefits by a few banks; **GTBank and Zenith Bank**.
- Performance expectations:** All of the above have increased appetite of all investors across classes with renewed high expectations in respect of performance results of a few other banks whose financial year-ends have just passed or close-by while earnings broadcast are around the corner. Since the release of the **GTBank and Zenith Banks'** results with the accompanied benefits, investors' expectations have changed to the upside.
- Buy-the-available phenomenon:** This is yet another major driver of market activity in the last couple of weeks as not all advancing stocks fundamentally deserve uptrend. As for the *reactive* investors who *often fall victims of greater-fool theory*, their attention has been shifted to other available stocks since they cannot partake in the initial rally. However, investment decision here is rather based on sentiments rather than companies' fundamentals.

Our Opinion: Taking a breath for sustainability?

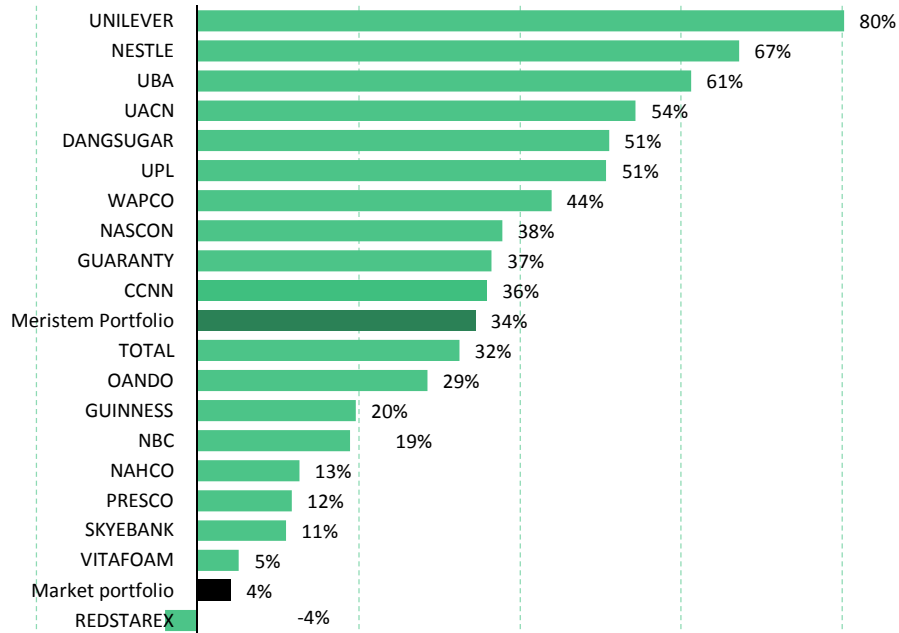
No doubt, there have been some significant precursors that things are getting better owing to the assertion that the performance of equity market is generally seen as a leading indicator for the real economy. However, globally there is a convergence of opinion that it will be unrealistic and, at best interim, to expect this trend to continue onward and upward. **An ostensibly fair and balanced view is to opine that it would be healthy for the market to take a breath and allow some of the fundamentals to catch up to avoid a repeat of the recent past.**

Meristem Portfolio performance:

Holding period return (HPR) of 35% dwarfs our expectations. The reiteration of our overweight position on all the constituent stocks of our portfolio proved quite rewarding as the portfolio rode strongly on the current up-market to deliver a return stronger than our expectation. Average portfolio return puff up to 36 percent vs. 9 percent recorded last month since the initiation of our *Flight to Value series* in February 6, 2009. (See *Equity Strategy Note dated April 17, 2009*). This shows that the portfolio outperformed the broader market by 40 percent. While outperformance was expected based on the underlining defensive strategy in the selection of the constituent stocks, the magnitude surpassed our expectation.

Exhibit 2

Our portfolio performance vs. broader market (The NSE)



This strong performance has been driven largely by UNILEVER (return: 80%), NESTLE (return: 67%), UBA (return: 61%), UACN (return: 54%), and DANGSUGAR (return: 51%).

Portfolio laggard: Returns have been deferred but not lost. Despite recouping 26 percent appreciation in the last one month REDSTAREX remains the worse performer in the portfolio. While 18 out of 19 (95 percent) of the portfolio constituents outperformed the broader market (just as was recorded last month), REDSTAREX remains the laggard in our portfolio with a disappointing and wider level of underperformance of -8 percent this month

(vs. -3 percent last month). This is below our expectation. Nonetheless, the stock remains fundamentally strong as our basis about the Company remains. Hence, we believe, the market is yet to appreciate this just as it did on its comparables (on fundamental basis).

Equity Strategy: Still Defensive, Not Yet Offensive

So far, our staunch support for defensive strategy has paid off substantially as the expectation about the broader market played out on the heel of mild “green shoots” for global economic recovery. However, as more signs of potential recovery emanate across the globe and the equities markets stage a comeback, this strategy *might* underperform a “sector based strategy” or even the broader market substantially when market goes bullish.

So much as we might want to be tempted to thoroughly rebalance the portfolio to gain more exposure to more volatile stocks in the light of the current U-turn in the Nigeria equities market and across the globe; we are yet to be convinced that the current up-trend will not play out to be tentative after all. **To this end**, we are on the prowl to adjust our portfolio composition “**to play the next market**” by going offensive but not until we discern **potential sustainability in the fundamental macro drivers of the market**.

We believe our defensive themes still hold much steams as the bear market psyche is yet to disappear. Not only do the themes and the resultant stocks contain substantial downside protection against loss as well as substantial return opportunity, but the expected returns will increase rapidly as valuations move up materially when the economy recovers.

Potential exclusions ...when further upside is speculative

- **NBC (Delivered 20% holding period return):** In our last **Equity Strategy Note (dated April 17)**, we did express concern on the Company’s disappointing Q3 performance which emanated from the devastating fire outbreak in one of its plants in Edo State. This has resulted in shrinking profit margin, which stands at 1.72 percent in Q3 2008 vs. 3.45 percent in Q3 2007, 55 percent sequential de-growth in earnings and 42 percent drop on quarter-on-quarter basis. Subsequent upon this revelation, we see substantial drag in the Company’s ability to meet customers’ orders. This is likely to reduce turnover (as current inventory might get stocked-out) and hurt bottom line in the near term. Factoring this into our forecast for the Company, we are constrained to step it down from our portfolio as further appreciation in the near term, in our opinion, is highly speculative.

- **PRESCO (Delivered 12% holding period return):** Although PRESCO still remains the cheapest in its industry (agro-allied), we believe other stocks could offer better value in the long term. While we adequately capture the Company's astonishing growth in the 2008 FY, we see such level of growth as a bounce to normalcy and hence expect growth to be modest in 2009FY and 2010FY. Our key area of strong concern as regard potential drag on earnings growth lies in the current **liberalization stance** of the Federal Government on palm oil importation. In our opinion, this will likely **strip off industry players of their protective garments, stifle industry competition and encumber the Company's ability** to reap substantial return on its huge investment in palm plantation. Premised on this, we step it down from our portfolio.
- **UNILEVER (Delivered 81% holding period return):** Our bullish expectation on UNILEVER broadly played out as we did express a potential target price of N11.33k premised on 6 percent target dividend yield (the highest target price of our 4 scenarios). To this end, we believe the stock has delivered based on our expectations and hence, expect further appreciation to be highly speculative.

Potential inclusion

- **FLOURMILLS:** In our equity report titled "*Flour Mills of Nigeria Plc: How Long More in the Penalty Box?*" we expressed our overweight position on the stock with a target price of N33 after factoring in the Company's current operational challenges. Even at our double conservative stance, the Company' valuation shows significant resilience confirming our view that the market over-reacted and thus over-discounted the Company's current earning weakness in its share price.

Our target price of N33.45k, which is a 70:30 percent blend of DCF and justified price multiple suggests a 59 percent upside potential. This implied a valuation level of 1.7x 2010e BV and 13x 2010e EPS.

Why overweight on this portfolio?

While the potency of this style strategy to sustainably outperform the broad market stands the chance of being dispelled over a full market cycle, it has proved exceedingly rewarding in coping with the bear market. To this end, we look much more excitingly forward to see these stocks deliver the second round of returns as we thrust more into a *likely* end of the bears reign. Hence, we see the preservation of our defensive themes on value stocks as having **strong countercyclical potential, inherent resilience and the formidability** to further deliver value for investors in the face of the possible scenarios.

In our update, we have ensured high safety margin by retaining the building of double conservatism into our analysis by applying the validated high discount rates against depressed 2009 earnings streams.

We present the underlying factors why, in our opinion, the portfolio will sustain its above market return in Q2 2009.

Valuation Matrix: Quite compelling

Looking at key fundamental performance metrics vis-a-viz current pricing multiples suggests compelling valuation levels. Beside the relative macroeconomic shield that the companies in the portfolio enjoy in terms of low gearing level and cash generative potentials, basic valuation indicators point to attractions that are most **likely under-appreciated by the market**. The portfolio currently trades at 7.44x 2009e EPS with a superb 2009 RoAE of 31 percent (vs. 17 percent for the overall market) translating to a 2009e P/BV of 1.70x. Also, beyond the current high dividend yields, the stocks present modest growth story once the economy recovers.

Stock Tickers	P/E (X)	P/B (X)	Current D/Y	Forward P/E (X)	2009 P/BV (X)	Expected D/Y	Dividend Growth
VITAFOAM	5.26x	1.91x	6.80%	4.70x	1.51x	7.44%	9%
SKYEBANK	2.97x	0.59x	12.40%	2.92x	0.53x	13.72%	11%
DANGSUGAR	10.49x	8.96x	8.77%	9.40x	7.53x	8.51%	-3%
UBA	6.94x	1.53x	7.30%	6.57x	1.40x	9.13%	25%
NESTLE	13.74x	12.67x	7.24%	11.45x	11.37x	7.86%	9%
NASCON	8.63x	3.59x	8.51%	8.66x	3.23x	8.43%	-1%
NAHCO	9.81x	4.01x	6.88%	8.92x	3.47x	7.29%	6%
CCNN	6.38x	3.10x	5.79%	5.80x	2.35x	6.89%	19%
WAPCO	5.08x	1.47x	3.03%	6.20x	1.25x	4.03%	33%
OANDO	11.71x	1.67x	6.86%	11.23x	1.62x	7.12%	4%
GUARANTY	5.02x	0.88x	9.41%	4.24x	0.80x	11.80%	25%
TOTAL	11.64x	8.17x	8.48%	10.03x	7.85x	9.47%	12%
UACN	9.32x	2.79x	4.54%	10.31x	2.46x	4.85%	7%
UPL	7.64x	1.96x	5.56%	7.07x	1.70x	6.36%	15%
GUINNESS	10.00x	4.16x	5.77%	10.43x	3.72x	6.71%	16%
REDSTAREX	5.96x	1.20x	10.42%	4.59x	1.06x	10.90%	5%
FLOURMILL	12.07x	1.31x	4.08%	20.42x	0.92x	2.65%	-35%
PORTFOLIO	8.63x	1.96x	6.88%	8.66x	1.70x	7.44%	9.42%

Appendix

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Fair Value Estimate

We estimate stock's fair value by computing a weighted average of projected prices derived from intrinsic and relative valuation methodologies. The choice of relative valuation methodology (ies) usually depends on the firm's peculiar business model and what in the opinion of our analyst is considered as a key driver of the stock's value from a firm specific as well as an industry perspective. However, we attach the most weight to discounted cash flow valuation methodology.

Ratings Specification

BUY: Fair value of the stock is above the current market price by at least **20 percent**

HOLD: Fair value of the stock ranges between **-20 percent and 20 percent** from the current market price.

SELL: Fair value of the stock is more than 20 percent below the current market price.

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