

Nigeria Equity Strategy Note

Playing the defensive themes

The Precursor:

Our Investment Thesis: Defensive Themes

Premised on the consensus view of a tough outlook for the Nigeria capital market in Q1 and Q2:2009, which in our opinion sounds plausible in the face of **disturbing global and domestic economic dynamics**, we did initiate Meristem stock recommendation series, *Flight to Values*, based on **defensive investment strategies**. Since then we have engaged on selective recommendation of value stocks that meet selected **investment screens** framed around the overall defensive themes. To this end, we expressed our overweight on stocks of companies with: high dividend yield, low beta, low dependence on global factors and mild vulnerability to the general economic contraction, low financial leverage hence less susceptible to high interest rate environment, and businesses with **catalysts** on the horizon.

The quantitative selection screens include:

- **Track record of consistent annual dividend payment** (a minimum of 3 years). Our benchmark for current dividend yield is a minimum of: (91-day T-bill Yield) + 100 basis points.
- **Improved profitability:** Our benchmark is set at- improved current Net Profit Margin over the last FYE's Margin
- **Positive economic profit (Surplus ROaE):** Benchmarked as a higher Return on Average Equity (ROaE) than the estimated Cost of Equity (COE).
- **Appreciable expected earnings growth momentum:** Benchmarked as lower forward P/E ratio than the trailing P/E or higher expected EPS than the previous FYE EPS.
- **Attractive price multiples** compared to peers and significantly **oversold beyond fundamentally justified level.**

So far, are we vindicated?

Period to date (February 2009 to date), the broad market Index, The NSE-ASI has sunk under the weight of its correction mechanism racking up 16.39 percent in losses to investors. In the same investment horizon, the Meristem Portfolio, comprising 19 equities returned 8.93 percent, **outperforming the NSE-ASI by a stunning return of 25.32 percent**. Similarly, accounting for market transaction costs, it outperformed the benchmark index by **23.45 percent**.

Exhibit 1: Meristem Portfolio Performance Tracker

NSE Ticker	Rec* Date	Price (N)		N1m invested	Gain/Loss	HP** Total Return	Comment
		Rec	Current				
VITAFOAM	6-Feb-09	4.48	3.89	868,304	(64,732)	-6.47%	Adjusted for cash dividend of 30k on Feb 16
SKYEBANK	6-Feb-09	4.36	4.00	917,431	(82,569)	-8.26%	--
DANGSUGAR	6-Feb-09	12.83	15.00	1,169,135	169,135	16.91%	--
UBA	6-Feb-09	8.49	8.40	989,399	(10,601)	-1.06%	--
NESTLE	6-Feb-09	110.00	151.00	1,372,727	372,727	37.27%	Declared final cash div of N10.6. Not yet adjusted
NASCON	6-Feb-09	3.41	3.89	1,140,762	140,762	14.08%	--
NAHCO	6-Feb-09	7.58	7.02	926,121	(73,879)	-7.39%	Declared cash dividend of 55k. Not yet adjusted
CCNN	6-Feb-09	6.05	7.71	1,274,380	274,380	27.44%	Declared cash dividend of 45k. Not yet adjusted.
WAPCO	13-Feb-09	13.75	17.10	1,243,636	243,636	24.36%	Declared cash dividend of 60k. Not yet adjusted
OANDO	13-Feb-09	68.00	70.00	1,029,412	29,412	2.94%	--
GUARANTY	13-Feb-09	8.52	10.09	1,184,272	184,272	18.43%	--
TOTAL	13-Feb-09	121.99	143.51	1,176,408	176,408	17.64%	Declared final cash div of N9.13k. Not yet adjusted
UACN	13-Feb-09	24.28	29.60	1,219,110	219,110	21.91%	--
UPL	2-Mar-09	4.18	4.59	1,098,086	98,086	9.81%	--
UNILEVER	2-Mar-09	6.46	8.50	1,315,789	315,789	31.58%	Declared cash div of 68k. Not yet adjusted
PRESCO	2-Mar-09	6.00	5.00	833,333	(166,667)	-16.67%	--
GUINNESS	10-Mar-09	86.95	88.50	1,017,826	17,826	1.78%	--
REDSTAREX	10-Mar-09	2.50	1.99	796,000	(204,000)	-20.40%	--
NBC	10-Mar-09	21.75	23.00	1,057,471	57,471	5.75%	--
Meristem Portfolio				19,000,000	1,696,570	8.93%	

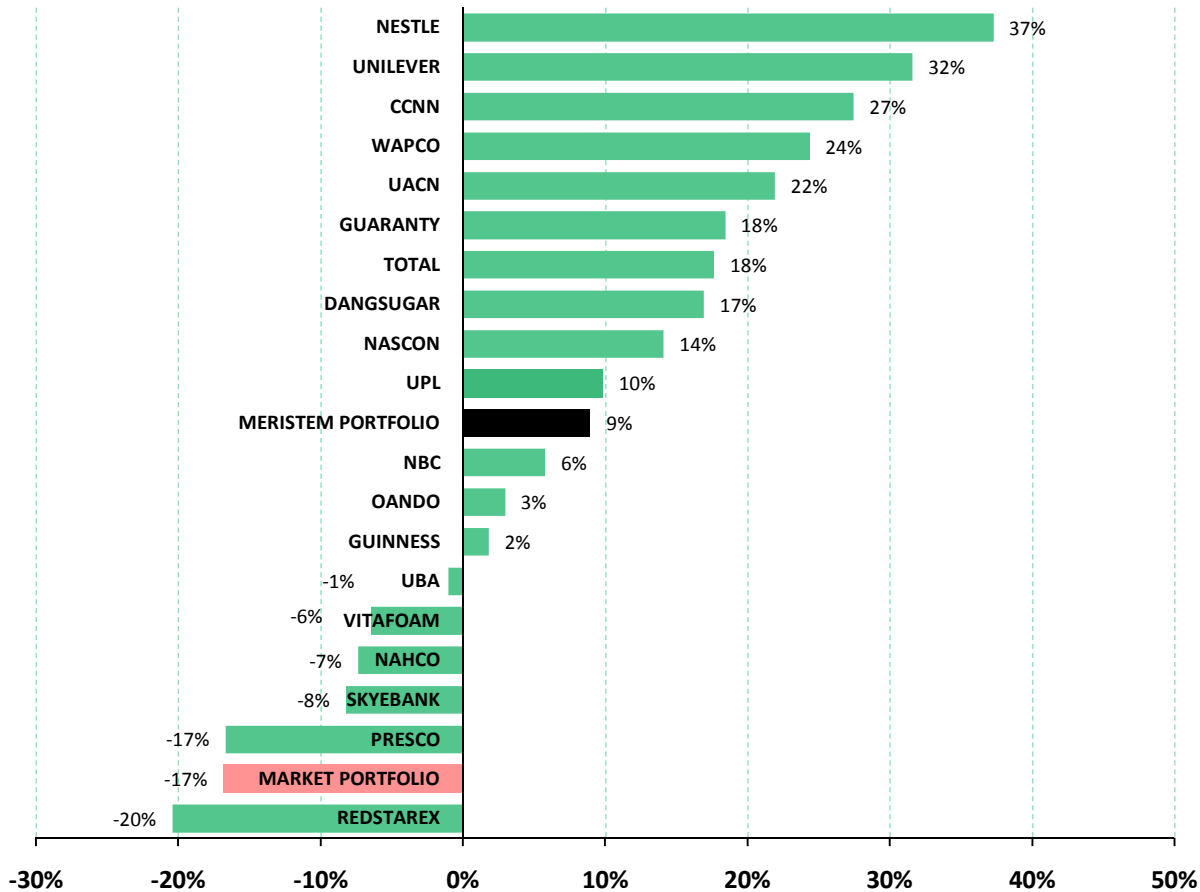
Note:

*Rec : Recommended

**HP : Holding period, referring to the date between our recommendation and the date of this report

Exhibit 2

Our portfolio performance vs. broader market (The NSE)



Source: Meristem Research

Needless to say is the seemingly unattractive investment scene in the economy spanning across virtually all sectors from real estate to the capital market with the latter amplifying swings in the real economy at levels consistent with fundamental macro economic outlook. Shifts in risk attitude of investors initiated by the market boom-burst and expressed by the current air of over-pessimism and eroding confidence, has further driven the market to levels below analysts' forecasts and expectations.

Our Investment Concerns: Despite outperforming the broader market within the period by 25 percent as group, we are compelled to express our investment concerns and cautious outlook on some few stocks whose current operating performance falls short or may fall short of our forecasts.

- **NBC:** We express concern on the Company's temporary operating logjam resulting 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. Nonetheless, top line growth remains healthy at 16 percent. **We are constrained by the quantum of information disclosure on the cause of the precarious performance.** We express skepticism on the ability of the Company to deliver superb value and subsequently meet (and probably beat) historical standard in rewarding investors for the financial year ended December 31, 2008. This is captured in our revised earning outlook for the company in Exhibit 6 below.
- **PRESCO:** 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.

Why we remain bullish on this portfolio: In our Q1:2009 Report titled *Nigeria Equity Marketplace: Savouring the Bitter Pills (dated April 8, 2009)*, we did express the "**expectation overhang**" surrounding the impact of global economic contraction and the transmission channels of this impact on the Nigerian economy and the capital market. At best, outlook still remains cloudy in the absence of clear cut short-term catalyst and potent market drivers. Nonetheless, the tail end of Q1:2009 witnessed some level of contraction in market volatility which has extended into Q2 but this has with it an appearance of unsustainable trend in the absence of **convincing catalysts** in the horizon to change the overall market direction. While the **potential of drastic dip in market value** (substantial downside potential) can be said to be abating with increasing degree of probability, **what appears probable at best on the positive side is narrow range trading or market stability.**

Hence, we see the adoption 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. We present the underlying factors why, in our opinion, the portfolio will remain above water in Q2 2009.

Interest rate exposure/gearing level: Our portfolio components exhibit a moderate exposure to the cash drain effect of high interest rate environment, typical of what currently operates in the Nigerian financial sector. This low level of exposure is captured in 2 key ratios that lay bare the routes of interest rate impact on the companies' operating performance. We have been cautious to absolutely rely on the potency of these ratios to adequately reflect the current financial positions as they have been computed based on the financial positions as at last financial year results, in our opinion, these ratios provide a **relatively high safety margin** to cushion the impact of **interest rate shocks** on the bottom lines in the meantime. Exhibit 3 gives a highlight of these figures for non-financial companies.

Exhibit 3: Interest coverage and leverage position of non-financials

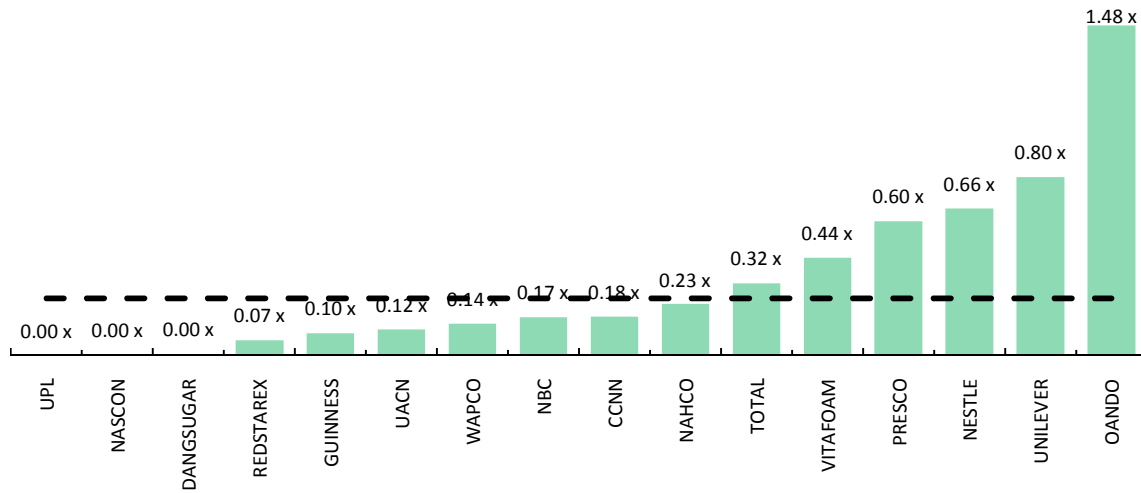
Stocks	Interest Coverage	Interest bearing debt/equity
VITAFOAM	19.72 : 1	0.44 x
DANGSUGAR	14,921.06 : 1	0.00 x
NESTLE	176.51 : 1	0.66 x
NASCON	272.09 : 1	0.00 x
NAHCO	33.88 : 1	0.23 x
CCNN	1.43 : 1	0.18 x
WAPCO	13.93 : 1	0.14 x
OANDO	6.25 : 1	1.48 x
TOTAL	60.20 : 1	0.32 x
UACN	10.68 : 1	0.12 x
UNILEVER	4.73 : 1	0.80 x
PRESCO	2.23 : 1	0.60 x
GUINNESS	36.18 : 1	0.10 x
REDSTAREX	101.18 : 1	0.07 x
NBC	10.52 : 1	0.17 x

Source: Meristem Research estimate

On the average, our portfolio has an interest coverage ratio of 1046:1 and interest bearing debt-to-equity ratio of 0.26x. While comparison among the components stocks could be misleading due to industry diversity and peculiarities, these averages on an absolute basis provide relatively gorgeous coverage to douse extreme shocks in interest rate movement.

Exhibit 4

Meristem portfolio: Interest bearing debt-to-equity ratio



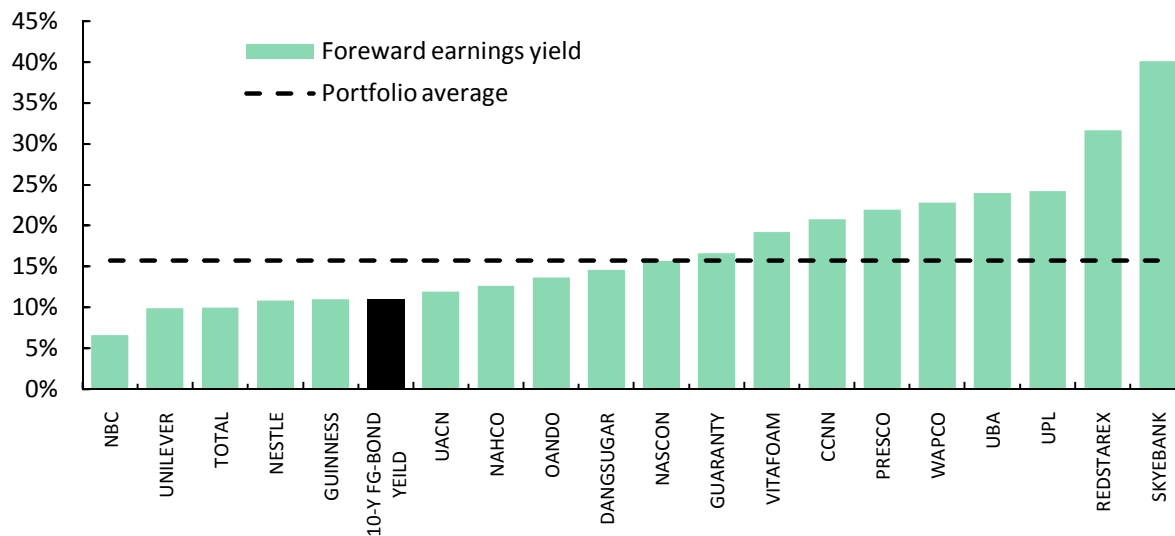
Source: Company Annual Reports, Meristem Research

Meristem Portfolio vs. 10-Year FG-Bond: Which is Cheaper?

Using an adaptation of the Fed Model, the portfolio currently appears **cheaper** than investment in the 10-Year FGN bond. **On a forward basis**, the average earnings yield of 13.34 percent of companies in our portfolio dwarfs the current average yield to maturity (YTM) of 10.93 percent on 10-Year FGN bond. This spread of 2.41 percent over the FGN bond signals a likely undervaluation of the Portfolio, hence an upside potential.

Exhibit 5

Meristem Portfolio vs. 10-Year FG Bond Yield



Source: Meristem Research

While this could be partly explained by the structural weakness of the Nigerian bond market to adequately price inflation expectation into bond yields, we see it as a market anomaly that should be exploited.

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, basic valuation indicators point to attractions that are most **likely under-appreciated by the market**. The portfolio currently trades at 6.69x 2009e EPS with a superb 2009 RoAE of 31 percent (vs. 17 percent for the overall market) translating to a 2009e P/BV of 1.96x. Also, beyond the current high dividend yields, the stocks present modest growth story once the economy recovers.

Exhibit 6: Valuation matrix

Ticker	LTP (N)	Est. Free Float (%)	Valuation					
			2009e RoAE	P/E-TTM*	P/E-09e	P/BV-09e	D/Y (Current)	Forward D/Y*
CCNN	7.71	14.2	44.9%	6.04 x	4.99 x	2.12 x	6.12%	7.0%
DANGSUGAR	15.00	11.4	84.6%	7.95 x	6.85 x	5.04 x	11.56%	9.5%
GUARANTY	10.09	25.7	14.8%	5.14 x	6.01 x	1.43 x	9.50%	8.3%
GUINNESS	88.50	20.8	37.9%	8.94 x	9.05 x	3.30 x	6.74%	8.8%
NAHCO	7.02	38.0	40.9%	8.57 x	7.79 x	2.91 x	7.88%	7.1%
NASCON	3.89	17.9	42.7%	7.32 x	6.68 x	2.68 x	10.03%	10.5%
NBC	23.00	24.0	8.3%	11.94 x	15.12 x	1.24 x	3.33%	2.2%
NESTLE	151.00	25.1	104.9%	11.89 x	9.91 x	9.88 x	8.37%	9.1%
OANDO	70.00	34.8	16.5%	9.11 x	7.69 x	1.24 x	8.82%	9.1%
PRESCO	5.00	9.0	58.0%	8.72 x	4.34 x	2.45 x	0.99%	20.7%
REDSTAREX	1.99	18.3	29.1%	4.72 x	3.03 x	0.82 x	13.16%	16.5%
SKYEBANK	4.00	32.6	18.8%	2.43 x	2.46 x	0.73 x	15.04%	18.3%
TOTAL	143.51	33.6	73.5%	10.93 x	10.05 x	7.13 x	9.02%	9.0%
UACN	29.60	48.8	24.9%	7.46 x	8.43 x	1.97 x	5.66%	5.9%
UBA	8.40	20.1	21.1%	4.31 x	4.22 x	1.39 x	11.76%	9.5%
UNILEVER	8.50	32.4	55.3%	12.94 x	10.85 x	5.83 x	8.29%	8.3%
UPL	4.59	24.5	29.2%	5.31 x	4.33 x	1.18 x	7.99%	11.6%
VITAFOAM	3.89	44.2	29.8%	4.43 x	4.94 x	1.36 x	8.09%	9.1%
WAPCO	17.10	18.0	31.3%	4.68 x	4.38 x	1.23 x	3.54%	5.7%
Portfolio average		24.5	31.3%	7.46 x	6.68 x	1.97 x	8.29%	9.08%

Note:

P/E-TTM: Trailing twelve month Price-earnings ratio

D/Y: Dividend yield

LTP: Last traded price (April 16, 2009 prices)

Strong cash generating potential and compelling dividend play. We admit that **“cash is king”** for businesses. More importantly, the royalty position of cash to companies in a contracting economy and business environment becomes more elevated than ever. It is on this basis that we pitch the tent of our recommended universe with stocks of companies with **robust and recurrent cash generative potential. On the average, the portfolio has CFO per share of N1.08k. More importantly, we see impressive cash generating potential as a source of value for investors through consistent and competitive dividend payments on the one hand; and a shield on dividend paying-ability on the other hand.**

Exhibit 7: Operating Cash flow and yield positions

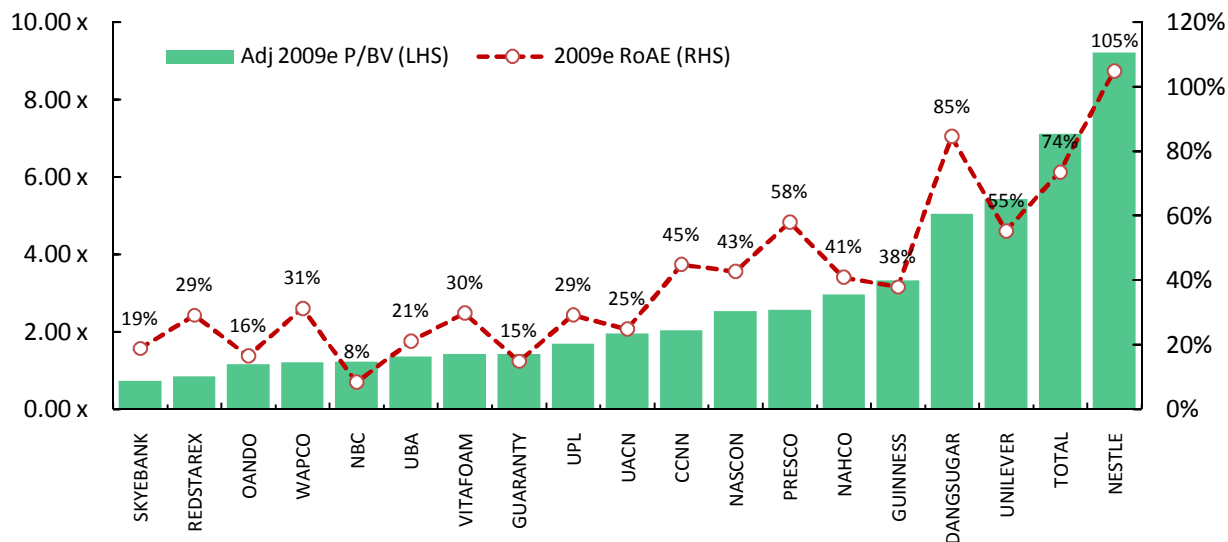
Stocks	CFO per share (N)*	Current D/Y	Current Earnings Yield	Expected D/Y
VITAFOAM	-0.01	8.09%	22.59%	9.10%
SKYEBANK	11.48	15.04%	41.14%	18.27%
DANGSUGAR	3.25	11.56%	12.57%	9.49%
UBA	16.13	11.76%	23.21%	9.48%
NESTLE	8.44	8.37%	8.41%	9.08%
NASCON	0.69	10.03%	13.65%	10.48%
NAHCO	1.08	7.88%	11.67%	7.06%
CCNN	-0.07	6.12%	16.56%	7.02%
WAPCO	2.35	3.54%	21.37%	5.71%
OANDO	5.35	8.82%	10.98%	9.11%
GUARANTY	-4.57	9.50%	19.46%	8.31%
TOTAL	24.72	9.02%	9.15%	8.95%
UACN	1.49	5.66%	13.40%	5.93%
UPL	0.96	7.99%	18.82%	11.56%
UNILEVER	1.08	8.29%	7.73%	8.30%
PRESCO	1.13	0.99%	11.47%	20.74%
GUINNESS	9.89	6.74%	11.18%	8.84%
REDSTAREX	0.58	13.16%	21.20%	16.52%
NBC	0.00	3.33%	8.38%	2.21%
Portfolio	1.13	8.29%	13.40%	9.08%

*From Companies' Annual Reports

As shown in Exhibit 7, the average dividend yield in our overweight universe is 8.90 percent which is expected to inch up to 8.95 percent based on relatively cautious earnings and payout estimates.

We see the confluence of ‘earnings resilience’ and excess return as a long-term source of value. While we admit the difficulty (**though not an impossibility**) inherent in delivering **high growth** in the face of overall global economic slowdown and the resultant domestic economic contraction, earnings resilience seems more likely on a base case scenario among our selected universe given the nature of the underlining businesses and to an appreciable extent, the brand esteem they command in their respective sectors. **Given somewhat stable growth outlook**, we see the **toughness of excess returns** as a source of value. These 2 fundamental attractions, in our opinion, are yet to be reflected in the current market pricing of the companies’ book value and the expected 2009 return on average equity (RoAE).

Exhibit 8 2009e P/BV (x) and 2009e Return on Average Equity (RoAE)



Source: Companies’ Annual Reports, Meristem Research

To what extent is downside risk? Prominent among the risk factors associated with our positive investment case on the above portfolio of stocks are **foreign exchange volatility** and **quality of earnings, ensuing from the quality and extent of disclosure** (a key regulatory concern in Nigeria capital market).

Coincidentally, a pocket of the selected stocks scaling our defensive themes are consumer goods companies with substantial exposure to foreign exchange risk stemming from the import-dependent nature of the underlining businesses for key raw material inputs. This poses a **concentration risk** in the wake of extreme and unfavorable swing in Forex rate, with the likely impact on bottom line. While the CBN has initiated a couple of direct and market induced policy responses to tame the vagaries in the forex market, the fundamental causal factors of the

depreciation of Naira still remain: **reduction of daily oil production, contraction in foreign exchange earnings, OPEC coordinated production cut, weakening global oil demand and expatriation of foreign investment within the domestic economy.**

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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.

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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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