Surrendering Market Leader Status?

From a five-year high of NGN34.85, GLAXOSMITH's share price has slumped by 81.35% to settle at NGN6.50 as of 4th November 2021. As a result, its market capitalization on the exchange has declined to NGN7.77bn, trailing behind FIDSON in the pharmaceutical industry.

The firm's business cuts across the pharmaceuticals (*67% of revenue on a 5-year average*) and consumer health segments. Its principal activities centers around the production, marketing, and distribution of healthcare and pharmaceutical products in Nigeria.

Although **GLAXOSMITH** still recorded the highest revenue in 2020FY (NGN21.30bn) relative to the other listed pharmaceutical firms, the revenue growth momentum is slowing. To a large extent, the pandemic ushered in an opportunity for revenue expansion in the pharmaceutical sector. Industry peers like **FIDSON** and **MAYBAKER** reported significant revenue growth during the heat of the pandemic driven by the surge in demand for drugs and related products. However, **GLAXOSMITH's** revenue only inched upwards by 2.58%– a low growth rate compared to its peers during the 2020 financial year.

An analysis of the firm's earnings also reveals a consistent decline in recent years. Despite undertaking strategies directed at streamlining their focus to select segments, performance has remained underwhelming.

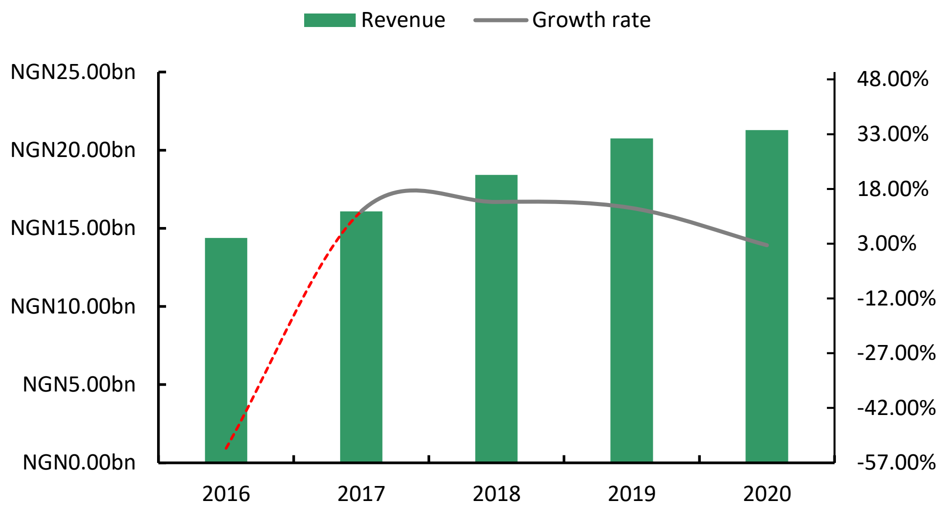
Post Divestment Gains

Following the divestment of its beverage business in 2016, **GLAXOSMITH**'s revenue sustained double-digit growth momentum, expanding by a 4-year compounded annual growth rate of 13.01% between 2016-2019. A revenue analysis of similar firms reveals that the firm compared fairly relative to **MAYBAKER**'s (at -1.55%) and **NEIMETH**'s (at 5.81%).

The firm was able to sustain market dominance as the divestment gave it room to focus operations on pharmaceuticals. In addition, its international alliance and premium pricing model were significant buffers against the intense competition in the market and helped maintain its market leadership status. An increase in its distribution networks in 2020 (*to nineteen distributors from nine*) also contributed to the impressive performance.

Contrary to the overriding theme for other pharmaceutical companies, 2020FY was a challenging year for **GLAXOSMITH.** The firm's topline expanded marginally by 2.58% YoY (*considerably low compared to* ***FIDSON:*** *29.97% and* ***MAYBAKER:*** *16.12%*).

Chart 1: Company Revenue (2015-2020)



Source: Company Fillings, Meristem Research

First Quarter Result Drags Performance

As part of the firm's plans to restructure its supply chain operating model, in 2019, **GLAXOSMITH** announced the selection of FIDSON Healthcare Plc. as its local manufacturing partner. **GLAXOSMITH** transferred the manufacturing of its wellness and respiratory products to **FIDSON**, a contract scheduled to commence in Q3:2021- the most recent financial period.

During the three months- Q3:2021- the firm recorded revenue growth of 9.55%YoY to NGN6.59bn from NGN6.02bn in Q3:2020. However, aggregate revenue for the 9M:2021 period increased only marginally by 0.03% YoY (*considerably lower than* ***FIDSON****: 59.39%,* ***MAYBAKER****: 25.26%*), weighed down by the top-line contraction in the first quarter *(-30.62%).* This underwhelming performance comes despite the increase in demand for products in the pharmaceutical market and an upward price review of some core products like Sensodyne.

While the consumer healthcare unit recovered from the downturn witnessed in 2020, expanding by 22.78% to NGN5.77bn in 9M:2021, the performance was different in the other business division.

The pharmaceutical division (c.65% of overall top-line) reported a decline in revenue- down by **9.06%** to NGN10.69bn from NGN11.75bn in 9M:2020.

In our view, the competitive landscape of the industry, as well as the firm's premium pricing model (*in the face of dwindling consumer wallets*), are the major factors responsible for the underwhelming performance of the business unit. Premised on these, we expect the slow growth to persist through the fourth quarter of 2021FY.

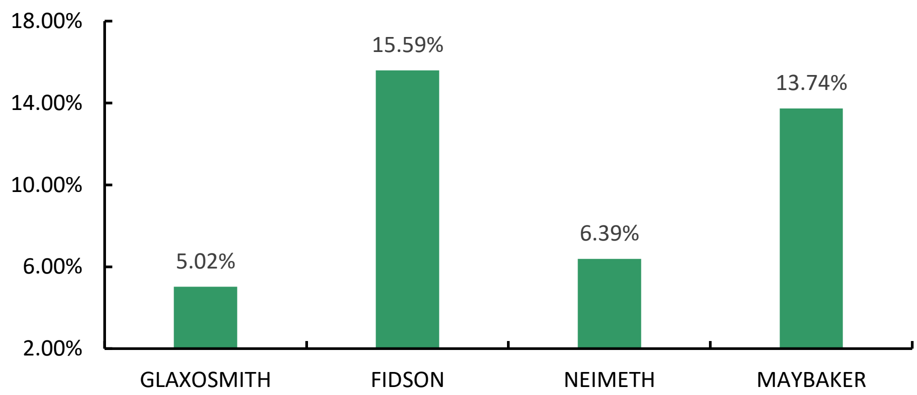
Costs- The Archilles Heel

In the most recent period, production cost settled at NGN12.08bn, representing a cost-to-sales ratio of 73.45% - *significantly higher than the industry average of 55.29%* (*data from listed firms*), *and its 5-year average of 63.24%.* We expect costs to remain elevated mainly due to the inflationary environment. Data published by the National Bureau of Statistics (NBS) reveal that increases in the prices of pharmaceutical products have been among the drivers of the core inflation sub-index *(core inflation rate currently at 13.74% vs. 11.37% in December 2020).*

Over the past four years, intercompany expenses have been at the heart of **GLAXOSMITH**'s costs. The intercompany expense, which represents its portion of the shared services expenses cross charged from GSK Pharmaceutical Nigeria Ltd (a related party), makes up c.35% of its operating expenses. We observed a 12.95% uptick in Intercompany expenses in the 9M:2021 period, coupled with the upsurge in freight costs (+55.48) and electricity expenses (+38.47%), drove total operating expense up by 10.42% to NGN4.31bn.

The firm's operating margin settled at 0.83%YoY in 9M:2021 (*a far cry from its 5-year average of 5.02%*) as margins buckled under the weight of extra cost pressure. This is also considerably lower than the operating margin for other firms in the industry (***NEIMETH**- 13.55%, **MAYBAKER**- 18.43%, **FIDSON**- 19.71%).*

Chart 2: 5- year Operating margin of industry players



***Source**: Company Financials, Meristem Research*

Profitability Metrics Remain Constrained

In Q1:2021, the firm recorded a significant loss of NGN238.07mn- masking the gains in subsequent quarters and resulting in a decline in Profit After Tax of 83.10% during the nine-month period.

However, a quarter-based analysis of Profit After Tax reveals a growth of 49.41% YoY to NGN62.79mn in Q3:2021- although much lower than the earnings growth reported by **FIDSON** *(+138.50%).*

Consequently, net margin slumped to 0.75%, ranking below the industry average of 8.35%. Furthermore, trailing Return on Equity (ROE) and Return on Asset (ROA) also declined significantly to 1.19% and 0.45% (from 6.81% and

2.93% in 9M:2021) and also significantly below the firm's cost of equity of 21.53%.

Earnings Quality Deteriorates During the Period

GLAXOSMITH obtains a substantial portion of its raw materials and manufactured products from related parties. During the nine-month period, trade payables increased by 6.96% to NGN14.53bn from NGN13.58bn in 2021FY.

Also, trade receivables expanded by 26.38% - higher than the marginal growth in revenue of 0.03% during the nine-month period- indicating favourable credit terms to distributors and (or) channel stuffing.

In 9M:2021, the firm's current ratio remained flat at 1.44x, while quick ratio- a more stringent measure of liquidity- declined to 1.1x from 1.51x in 9M:2020.

We also observed that earnings quality waned further in 9M:2021 as the firm recorded a negative cash flow from operations of NGN2.06bn- significantly lower than its net income of NGN122.70mn.

Outlook and Recommendation

Despite the essentiality of the firm's product and the opportunity presented by the pandemic, **GLAXOSMITH's** performance in recent times has been underwhelming.

We cite the intense competition in the industry, the increasing adoption of alternative medicines, and the proliferation of counterfeits products as inhibiting factors. With three months left to the end of the year, we opine that very little can be done to change the firm's fortune for the financial year.

Based on these factors, we project a revenue growth of 11.63% YoY in Q4, resulting in an overall top-line of NGN21.86bn in 2021FY. This also represents an annual revenue growth of 2.67%YoY in 2021FY.

While we expect some cost efficiency benefits to accrue to the firm due to the manufacturing contract with FIDSON, the impact in the fourth quarter might be marginal given the high costs recorded so far in the year. Hence, we expect cost-to-sales ratio to settle at 71.17% in 2021FY (*compared to 72.22% in 2020FY).*

Overall, we have modeled a bottom-line of NGN261.24mn, representing a decline of 58.02%YoY in 2021FY. This represents a net margin of 1.19%, compared to 2.92% in 2020FY. We also project a 2021FY EPS of NGN0.22 and a target P/E ratio of 27.36x. This yields a target price of NGN6.02, implying a downside potential of 7.40% based on the closing price of NGN6.50 on November 4th, 2021. Hence, we rate the ticker HOLD.

Sensitivity Analysis of Dec-2021 Target Price to key model inputs						
		EPS				
		0.20	0.21	0.22	0.23	0.24
Target PE	26.9x	5.47	5.68	5.91	6.13	6.37
	27.1x	5.52	5.74	5.96	6.19	6.43
	27.4x	5.57	5.79	6.02	6.25	6.49
	27.6x	5.62	5.84	6.07	6.31	6.54
	27.9x	5.67	5.90	6.13	6.36	6.60

Min	5.47
Max	6.60

Financial Highlights and Forecasts (NGN billion)

Profit & Loss Account	**H1:2020A**	**H1:2021**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**
Revenue	16.45	16.45	21.86	22.53	23.48	24.58	25.84
Cost of sales	12.03	12.08	15.56	15.19	16.08	16.14	17.09
Gross profit	4.42	4.37	6.30	7.34	7.41	8.44	8.75
Other gains and losses	0.06	0.08	0.17	0.18	0.18	0.19	0.20
Operating expense	3.91	4.31	5.72	6.23	6.43	6.36	5.84
Operating profit	0.58	0.14	0.29	0.61	1.10	1.01	0.76
Investment Income	0.06	0.05	0.11	0.12	0.14	0.16	0.18
PBT	0.64	0.12	0.38	0.87	0.63	1.68	2.47
PAT	0.64	0.12	0.26	0.59	0.43	1.14	1.68
Balance Sheet	**2020A**	**H1:2021**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**
Property, Plant and Equipment	1.83	1.73	1.58	1.47	1.26	1.13	1.06
Total Assets	23.74	23.49	23.45	23.95	24.90	25.78	27.74
Total Equity	9.12	8.76	8.90	9.01	8.90	9.45	10.47
Total Current Liabilities	14.59	14.70	14.52	14.90	15.96	16.30	17.24
Non-Current Liabilities	0.03	0.03	0.03	0.03	0.03	0.03	0.03
Total Liabilities	14.62	14.73	14.55	14.93	15.99	16.33	17.27
Financial Ratios	**2020A**	**H1:2021**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**
Gross Margin	26.86%	26.55%	28.83%	32.57%	31.55%	34.33%	33.85%
Operating Margin	3.50%	0.83%	1.31%	2.71%	4.68%	4.11%	2.94%
Net Margin	3.88%	0.75%	1.19%	2.62%	1.81%	4.65%	6.50%
Return on Asset	2.69%	0.52%	1.11%	2.49%	1.74%	4.51%	6.28%
Return on Equity	7.00%	1.40%	2.96%	6.60%	4.75%	12.46%	16.87%
Return on Invested Capital	7.65%	1.12%	2.32%	6.03%	4.06%	11.74%	15.85%
Asset Turnover	0.69	0.70	0.93	0.95	0.96	0.97	0.97
Financial Leverage	2.60	2.64	2.66	2.65	2.73	2.76	2.69
Current Ratio	1.45	1.44	1.46	1.47	1.44	1.47	1.51
Quick Ratio	1.23	1.11	1.12	1.15	1.13	1.17	1.20

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