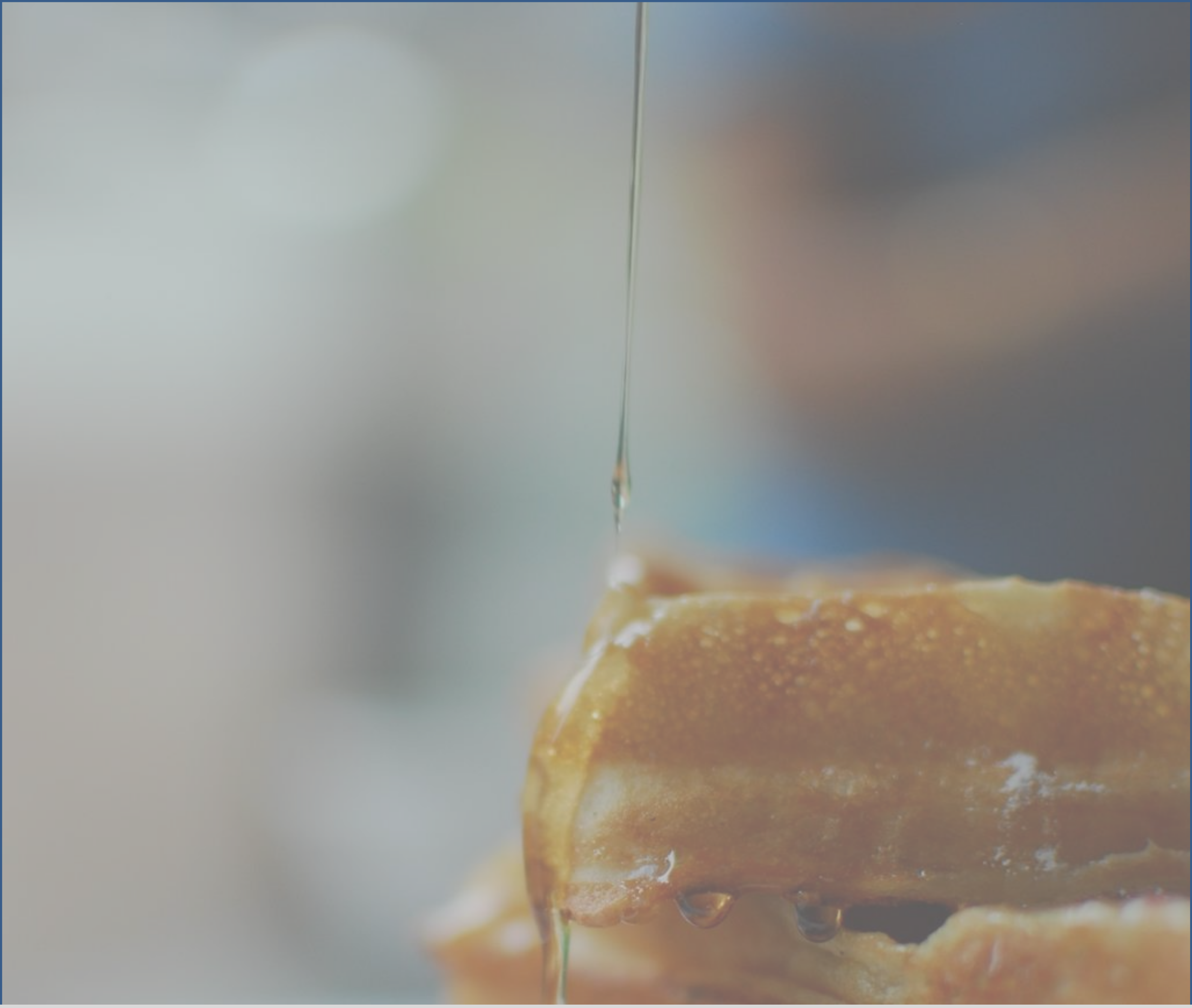


Optimizing Expansion Strategies For Growth

…….. Analyzing Dairy and Quick Service Restaurant Industries

MERISTEM

Consumer Goods Update

….Analyzing Dairy and Quick Service Restaurant Industries

Overview of Global Dairy Industry

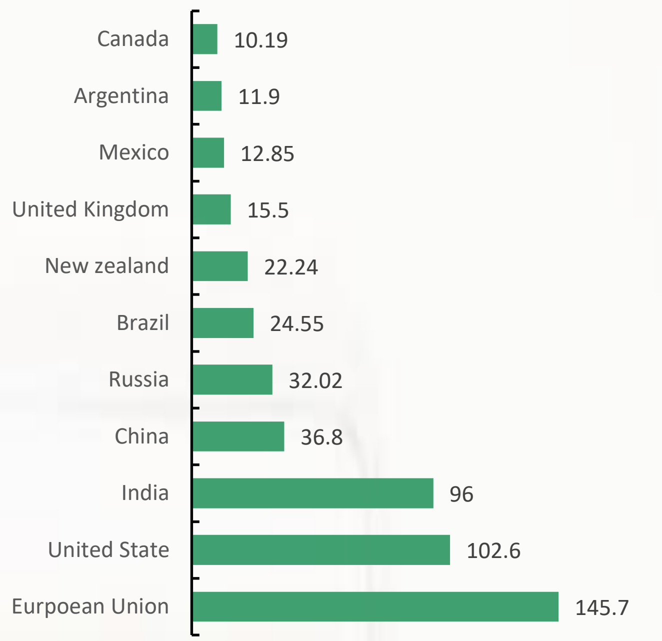
While players in the dairy industry have leveraged growing demographics, Quick service restaurant operators have also employed technological advancements to sustain growth. However, the sectors are faced with challenges which cut across importation, high input costs, and high inflation affecting the cost of production. Although backward integration strategies appear to be the secret weapon shielding firms from global disruptions and FX volatility, challenges in the domestic environment remain a significant issue. Nonetheless, we expect the backward integration drive to persist and deepen in the near term.

According to the Food and Agriculture Organization (FAO), raw materials used in the dairy industry, such as milk, corn and other grains for major consumer goods products, have recorded a significant uptick in their prices. Given that price volatility has a significant bearing on the industry, the rise in inflation rate across major milk-producing economies has also added an extra layer of pressure on the cost of the commodity globally.

The FAO reports that global milk production stood at 887.13 MMT in 2021, higher than 887.48 in 2020, with the European Union being the major contributor (16.42%).

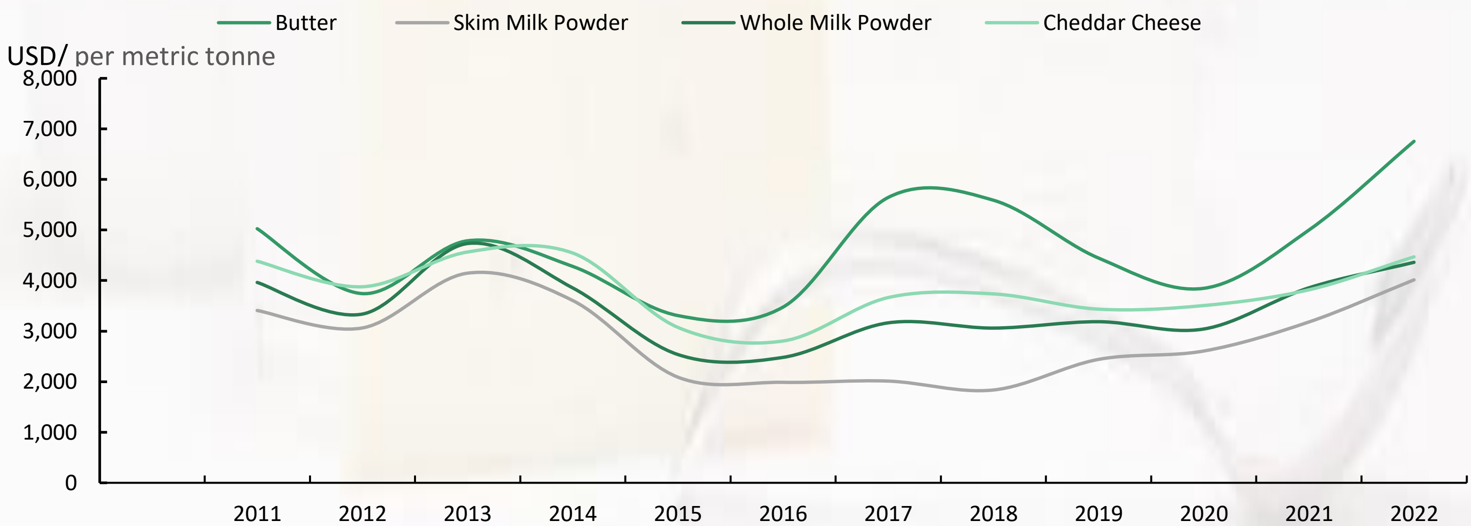
Coming into 2022, the optimism about expansion in production remained. However, it has remained flat on the back of adverse weather conditions (warm and dry weather) and high input costs, which are significant limiting factors for production.

Chart 1: Milk Production amongst the Top 11 producers in 2021 (Million Metric Tonnes)



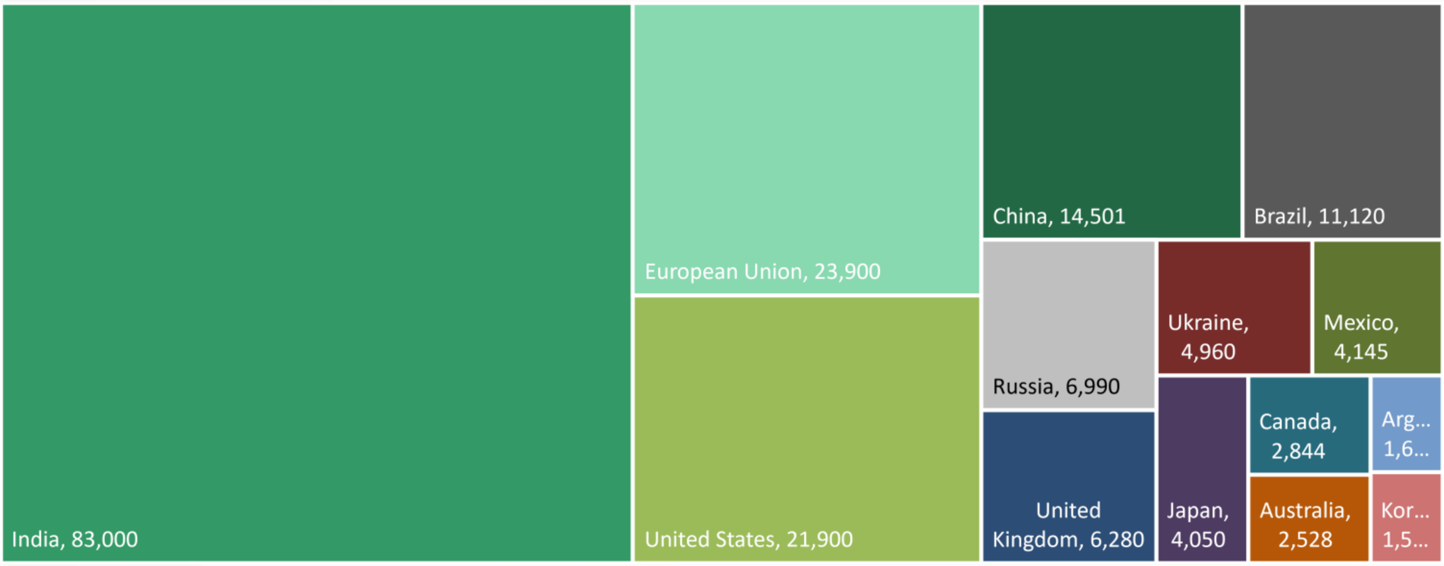
Source: United States Department of Agriculture, Meristem Research

Chart 2: Dairy Product Prices



Source: FAO, Meristem Research

Chart 3: Fluid Milk Consumption by Country in "000 Metric tonnes (2021)



Source: *United States Department of Agriculture, Meristem Research*

Production in 2022 is set to come in lower than 2021 levels owing to the prevalent challenges with adverse weather conditions and higher transportation and production cost. The E.U., U.S. and Argentina have experienced increased cow discomfort, lower output per cow and depleting producer profitability. For 2023, we expect production to remain pressured, given the rise in input prices and changes in climate conditions.

On the other hand, demand is expected to remain high going into 2023 especially in Asian regions.

However, the past few months has seen rather low demands from China due to the resurgence of COVID-19 in its major cities and the implementation of Zero Covid policy lockdowns. Thus, prices of dairy products have trended lower in recent months. Also, given the EU's position as the largest producer of dairy raw material, the recent strengthening of the USD against the EUR has pulled prices downwards as both are major currencies used in the global milk trade. Thus, the EU is likely to take more heat if this persists. Therefore, on a balance of factors, we expect prices of dairy products to increase in 2023.

Dairy Based Products

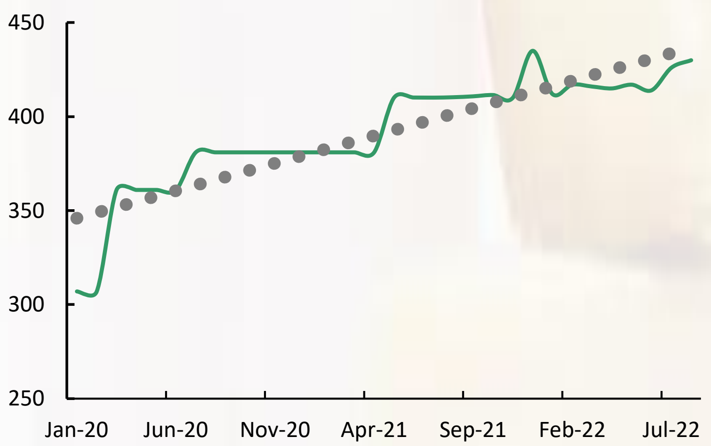
Nigeria Dairy Industry

Growing Demographics: An Attractive Destination For Industry Players

In its Nigeria Multidimensional Poverty Index report for 2022, the National Bureau of Statistics (NBS) estimated the country's population to be about 211 million. As such, the market for the consumption of dairy products in Nigeria is robust, given that it is a crucial ingredient in the production of many household items like milk, butter etc. Producers rely on the dense population to rapidly turn over inventory and minimize spoilage of the products. Dairy products are classified under the Food and beverage sector, which made up 50.84% of manufacturing real output as of Q2:2022. Given the active consumption needs, the industry is largely dependent on importation to meet demand.

Owing to the industry's exposure to importation from the global economy, it's not immune to challenges affecting the global scene. According to the Food and Agriculture Organization (FAO), locally-produced milk in Nigeria accounts for 40% of consumer demand, while the remainder (60%) is largely imported. The CBN Governor, Godwin Emefiele, has also hinted that Nigeria spends between USD1.2bn and USD1.5bn on milk importation annually.

Chart 4 : Official exchange Rate (Jan 2020- Sep 2022)



Source: Central Bank of Nigeria, Meristem Research

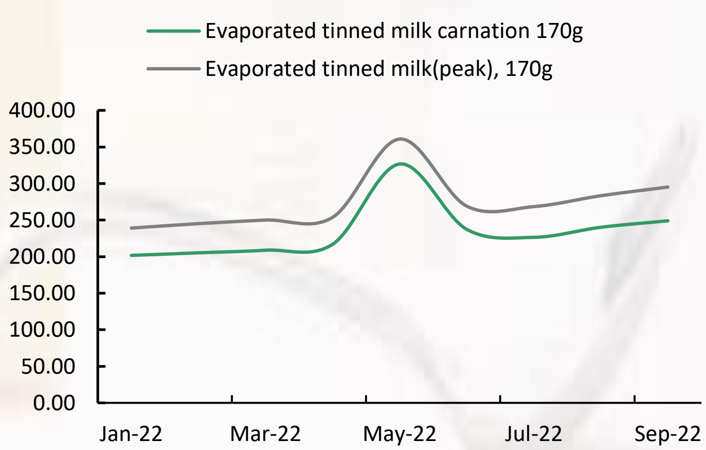
In an attempt to limit the amount spent on importation of dairy products, the CBN in 2020 restricted the sale of FOREX for the importation of milk and other dairy products to only six companies: NESTLE, TG Arla, Friesland Campina, Integrated Diaries Limited, Promasidor and Chi as they had keyed into the backward integration strategies of the Government. As a result of the policy, some players in the dairy space decided to exit the industry as they were rather less uncompetitive. Others have to source for FX at the parallel market, where the rate remains significantly above the official exchange rate.

Challenges surrounding the exchange rate illiquidity have remained significant. For manufacturers who have access to the official FX window, Importation of raw materials is restricted to FX unavailability and or scarcity in the country. Thus, we do not rule out the possibility of the approved manufacturers also having to resort to the parallel market rates, which translate to higher production costs for the firms in the industry.

The NBS report on Selected food prices also revealed an uptick in the price of evaporated milk - a major dairy product - so far this year (+25.76%YtD). The product's price hit its zenith in May 2022, before declining marginally in June and July. This buttresses the point that the impact of exchange rate volatility and a spiraling inflationary environment has negatively affected consumers of dairy products. High insecurity in food-producing areas and incidences of kidnappings and banditry also poses a challenge for firms seeking to expand their backward integration policies and distribution networks in the affected areas. While firms would also face an uptick in production cost, the ability to pass down its cost to consumers to preserve margins makes the effect less severe for players in the space.

We expect the challenges related to the industry's operational environment (exchange rate, higher prices of dairy products and inflation, as well as its associated costs) to translate into significant headwinds in 2023. Demand should however remain robust, given the essential nature of dairy products and the unavailability of well-accepted alternatives

Chart 5 : Evaporated Milk Price Watch (Jan- Sep 2022)



Source: National Bureau of Statistics, Meristem Research

Company Analysis

Friesland Campina WAMCO Nigeria Plc - Nourishing at its Peak

With 150 years of active operations, FrieslandCampina WAMCO Nigeria Plc (**SDFCWAMCO**) has reinforced its position as a leader in Nigeria's dairy industry. The firm is primarily involved in the manufacturing and marketing of evaporated milk,- ready-to-drink beverages, instant milk powder, and other dairy-based products.

The firm's rich product portfolio spans across iconic brands like Peak, Three Crowns, Coast, NuNu, Olympic, Peak 4-5-6, Peak Yoghurt, Peak Chocolate and Peak Milky Pap. The company explores both organic and inorganic growth strategies and has remained focused on investment in backward integration, capacity expansion, product innovation and Route to market infrastructure strategies. To further establish its market dominance, it completed the acquisition process for Nutricima's dairy business from PZ Cussons in 2020 as an avenue to strengthen its regional market penetration.

Strong backing from its parent company (Royal Friesland International Beheer B.V- which holds a 67.81% stake), also allows **SDFCWAMCO** access to easier foreign currency financing and raw material sourcing. The company is currently listed on the NASD OTC exchange (**SDFCWAMCO**).

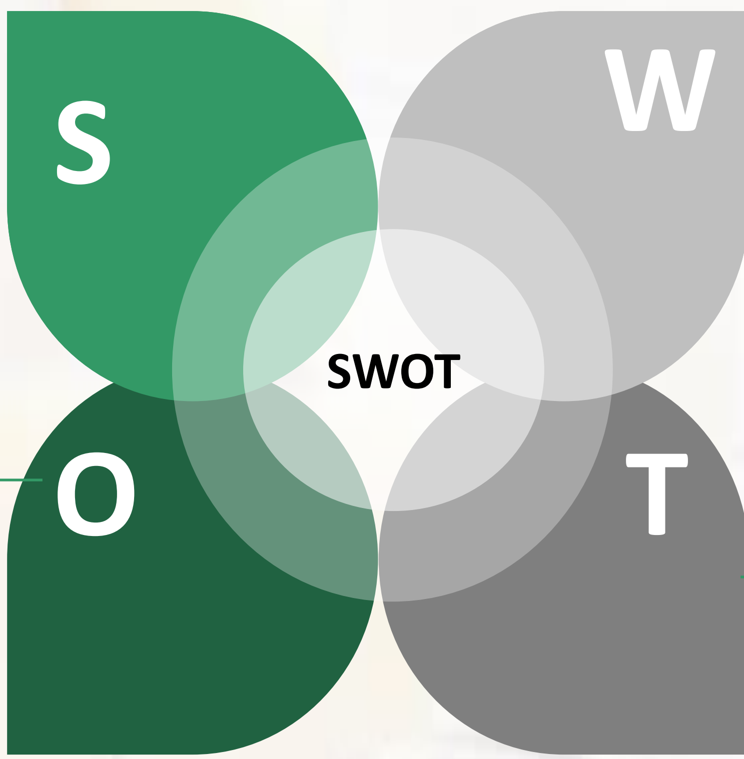
WAMCO SWOT Analysis

STRENGTHS

- Industry leadership in the dairy industry with most of its products being household names.
- Strong brand presence and goodwill.
- Research and Development to improve its business.
- Wide portfolio of products, which makes it competitive in every market segment.

WEAKNESSES

- The company is highly dependent on foreign sourced raw materials, making it exposed to foreign exchange volatility (imported materials and services represented c. 84% of total materials and services consumed in H2:2022).



OPPORTUNITIES

- High demand for dairy products exists in the country which local production is currently unable to meet.
- The government provides support for dairy manufacturers in the country with a view to enhancing production.

THREATS

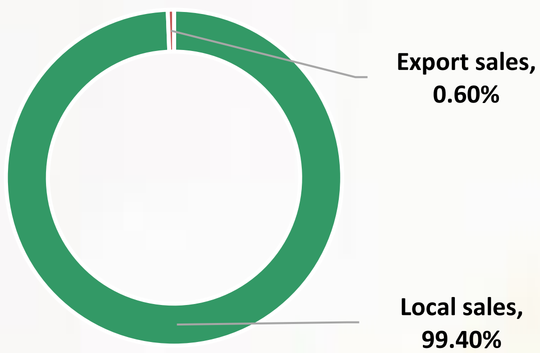
- Inadequacy of raw materials locally.
- Herdsmen crises

Company Analysis

Financial analysis – Backward Integration and Capacity Expansion Boost Performance

Revenue- WAMCO has grown at a CAGR of 16.75% in the past 5 years, despite the difficult operating environment and strong competition it has faced over the years. In its most recent financials H1:2022, topline expanded by 35.73% to NGN170.71bn

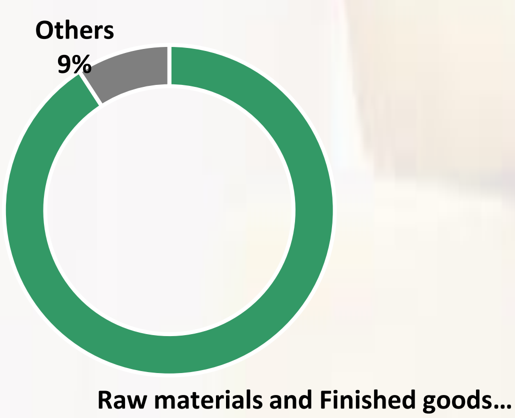
Chart 6: Share of Revenue by Geography



Source: Company Filings, Meristem Research

Production costs has also climbed significantly, from NGN111.94bn in 2017FY, to NGN224.78bn in 2021FY (an implied 5-year CAGR of 19.92%) on the back of weakening Naira, higher cost of dairy raw materials and disruptions to global supply chain. It expanded by 38.95% in H1:2022, outpacing revenue growth rate and leading cost to sales upwards to 84.38% (vs 82.43% In H1:2021).

Chart 7: Share of Production costs

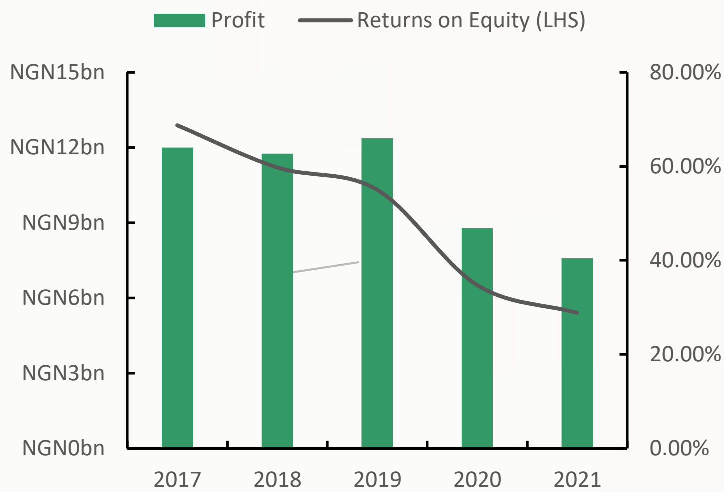


Source: Company Filings, Meristem Research

Operating expenses also expanded by 31.36% during the period as energy costs, personal expense and maintenance cost ticked up during the H1:2022 period. Thus, operating margins declined to 7.44% from 1.92%.

In 2020FY, WAMCO obtained intercompany loan from its parent company of NGN103.81bn and term loan from the CBN of NGN2.3bn to fund working capital requirements and dairy development. Similarly, the company obtained NGN3.5bn from the CBN in 2021, leading finance cost upwards by 104.62% to NGN12.17bn.

Chart 8: Annual Net profit (2017-2021)



Source: Company Filings, Meristem Research

While **WAMCO** has stayed on the path of profitability, the momentum has been weakening (5-year CAGR of -8.76%). This has significantly impacted its Returns on Equity which has consistently declined since 2016. An assessment of the firm's earnings quality also revealed a decline in 2021FY and H1:2022 as it recorded a positive net operating accrual (NGN3.01bn and NGN11.11bn) and lower cashflow from operations to Net income ratio (0.60x, -0.60x), respectively) in both periods compared to negative net operating accrual (NGN41.53bn and NGN405mn) and higher cashflow from operations to net income ratio (5.73x and 1.10x), respectively in 2020FY and H1:2022.

Outlook

- ***Increased production volumes, due to the recent completion of new factories***
- ***Demand would remain robust on the back of its significant investment in route to market, acquisition of Nutricima's dairy business, and expected increase in production volumes. We expect 2022 and 2023FY earnings to grow by 30% AND XX%, respectively.***
- ***Production operating and financing costs are expected to increase given the projected uptick in cost of dairy raw materials, rising energy cost and the finance costs on additional loans obtained.***
- ***We however expect benefits related to economies of scale owing to the size of its business.***
- ***Based on the aforementioned factors, we anticipate a 30.26% expansion in profit after tax for 2022FY and 2023FY***

MERISTEM

Stock Recommendation

Friesland Campina WAMCO Nigeria Plc (SDFCWAMCO)

Valuation and Recommendation	
Trailing EPS	5.31
BVPS	14.93
P/E	12.66x
P/BV	6.71x
Target PE	15.77xx
Dec-2023 Exp. EPS	NGN7.01
Dec 2023 Target price	**NGN110.58**
Current Price	NGN67.20
Up/Downside Potential	64.55%
Ratings	**BUY**

Sensitivity Analysis of Dec-2023 Target Price to key model inputs						
		EPS				
		6.49	**6.75**	**7.01**	**7.28**	**7.55**
Target PE	**15.3x**	99.07	102.99	107.05	111.12	115.34
	15.5x	100.69	104.67	108.81	112.94	117.23
	15.8x	102.32	106.36	**110.56**	114.76	119.12
	16.0x	103.94	108.04	112.31	116.58	121.01
	16.3x	105.56	109.73	114.07	118.40	122.90

Min	**99.07**
Max	**122.90**

Nigeria Quick Service Restaurant Industry Analysis

Leveraging on Growing Demographics and Advancing Technology

With the growing population and increased preference for fast food, it is no surprise that the Nigeran food service sector has continued to thrive amidst the challenging operating environment. Over the years, the sector has become more structured, transitioning from being dominated by one major player and a small number of family-owned businesses in the 1990s to establishing numerous local and foreign franchisees operating in major cities across the country.

In 2021, the Association of Fast-Food Confectioners of Nigeria (AFFCON) valued Nigeria's organized fast-food industry at c. NGN250bn, expanding at an annual rate of 10% in recent years. The growing population, accelerated urbanization and eCommerce penetration are the major factors contributing to the growth of fast and ready-to-eat food. However, the numerous macroeconomic headwinds in the operating environment (notably the infrastructure gap, insecurity in the food-producing region and spiralling inflationary pressures) limit the sector's potential to grow. Notwithstanding, some key players in the sector have adjusted to the changing market conditions within the fast-food industry, while unfavourable industry restrictions and fierce rivalry still constrain others.

Recent trends in the Nigeria fast food industry

As consumers' tastes and preferences evolve, quick service restaurants are also becoming more creative by presenting new cuisine concepts such as vegetarian fast food, and low-calorie fast food options, among others. Also, the quest for convenience and a fast-paced lifestyle by the working-class and other consumers has positively contributed to the rise in the consumption of fast food and ready-to-eat food package.

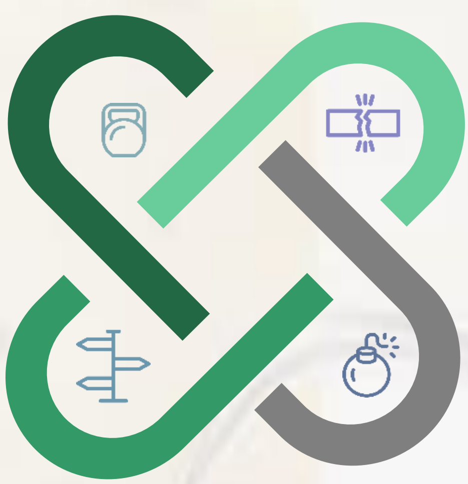
We also observe that consumers are increasingly inclined to dine out rather than prepare their meals, contributing more to the profitability of quick-service restaurants.

To attract more customers in response to the growing appetite for fast food, QSR players have begun investing massively in doorstep delivery services to drive sales upward. As a result, the demand for motorbike food delivery services is rising sharply, and Nigerian fast-food businesses are also leveraging the use of mobile applications and websites to expand their e-commerce and food delivery operations. Furthermore, the millennial generation's growing preference for hanging out in cafés and upscale outdoor restaurants has contributed to the expansion of the QSR market.

Nigeria Fast Food Market SWOT Analysis

S

STRENGTHS
- Growing population
- Technology advancement



WEAKNESSES
- Dwindling consumer purchasing power
- Iinfrastructural deficiencies

W

O

OPPORTUNITIES
- Growing taste and preference of consumers
- Increasing urbanization
- Growing you population with rapid change in lifestyle

THREATS
- Rising insecurity at the food producing region
- Rising inflationary pressures

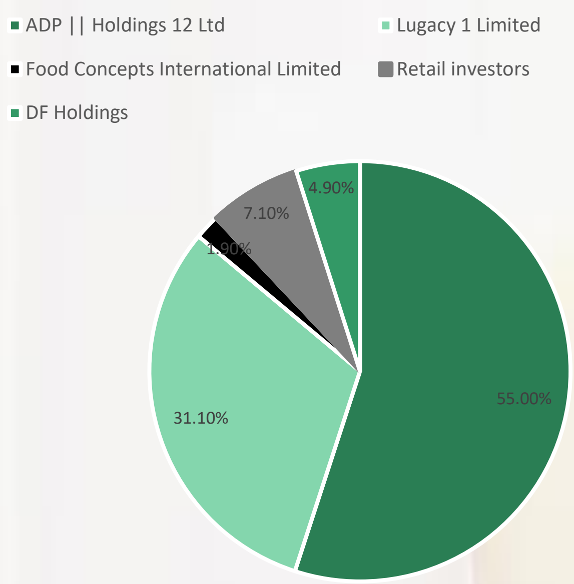
T

Company Analysis

Food Concepts Plc (SDFOODCPT) – Strategic Focus on Expanding Footprint

Food Concepts Plc was incorporated on December 6, 1999, as Food Concepts & Entertainment Limited and started operation in 2000. By a special resolution on May 10, 2009, the company was converted from a Private Limited Liability Company into a Public Limited Liability Company, and the name was changed to Food Concepts Plc. The company is currently listed on the NASD OTC exchange.

Chart 9: Food Concept Shareholding Structure



Source: Company Filings, Meristem Research

Following the company's incorporation, it obtained franchises from South African Quick Service Restaurant owners to establish their brands in Nigeria. Subsequently, the company acquired and developed other brands, including Chicken Republic, PieXpress, Butterfield, Yum Yum and The Chop Box. After several corporate restructuring and divestment, the company now operates and owns three food brands - Chicken Republic, PieXpress and The Chop Box.

To further solidify its footprint and implement its growth strategy, the company has launched several stores over the years, notably 41 new Chicken Republic stores and 44 PieXpress stores in 2021. This brings the total company owned stores to over 250 in 2021. In 2022, the company also intends to further solidify its long-term growth initiative by launching 74 new Chicken Republic stores in Nigeria and 2 in Ghana whilst continuing an aggressive rollout of 57 PieXpress stores, pushing the company's total number of stores to over 300 by the end of 2022.

Growth Strategy

Food Concept's continuous product innovation and capacity expansion have significantly contributed to its sales growth trajectory. Some notable initiatives implemented include the aggressive rollout of online delivery service, product launch and highly competitive pricing. Also, one of its major strengths is anchored on backward integration strategy as it sources the bulk of its raw materials locally, hedging against the volatile FX market.

Product analysis

Food concepts operate a chain of restaurants and bakeries offering chicken products, sausage rolls, pies, bread, and others.

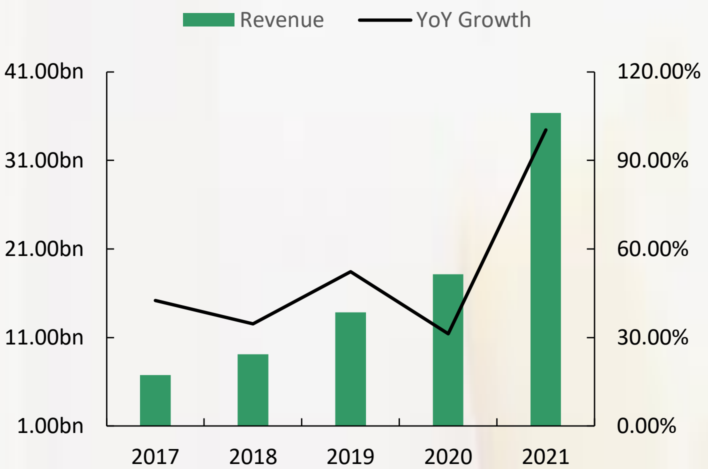
- **Chicken Republic** is one of Food Concept's fastest growing brands, with over 150 company-owned and franchise stores across Nigeria, Ghana and Tamale. Over the years, the food brand has remained one of the most preferred chicken-focused quick-service restaurant chains due to the affordability and sustained quality of the meals. The brand has retained its growth trajectory over time due to continuous capacity development, improved route to market, aggressive marketing, promotions, and online marketing.
- **PieXpress:** Food Concept launched PieXpress in 2019 to provide quality pies and pastries for mobile, transient consumers who desire convenient, quality food on-the-go, at affordable prices. Since its introduction into the market, PieXpresss currently operate over 70 stores in Nigeria.
- **The Chop Box** is a recent fast food brand created by Food Concept to cater for consumers' demand for traditional Nigerian meals. The company currently has only one Chop Box store thus far, used as a prototype to define and find the menu mix and value proposition.

Financial Analysis

Food Concepts Plc (SDFOODCPT) – Aggressive Expansion Strategy Underscore Performance

Over the years, Food Concept has consistently delivered revenue growth, expanding by a 5-year CAGR of 50.35% (between 2017FY and 2021FY. In 2021FY, the company's top-line improved exponentially by 100.35% YoY to NGN36.37bn from NGN18.16bn 2020FY. We credit the remarkable growth to the broad increase in demand and the numerous expansion initiatives (including expansion of footprint across different states and development of existing facilities across regions) implemented by the management during the period.

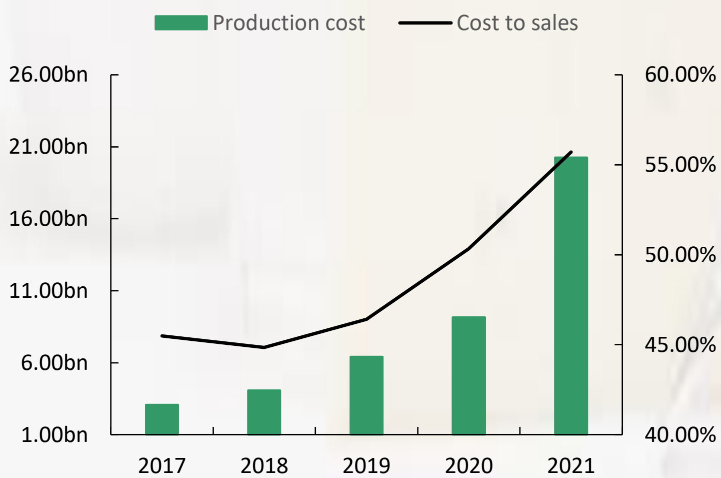
Chart 10: Annual Revenue and Growth Rate



Source: Company Filings, Meristem Research

Due to rising inflationary pressure in the domestic economy, the cost of raw materials and consumables cost increased exponentially by 121.72% YoY in 2021FY. As a result, the cost to sales ratio spiked to 55.71% in 2021FY from 50.34% in 2020FY. Similarly, operating expenses expanded by 47.93% YoY due to increased employee benefits and other company expenses. Notwithstanding, the operating margin advanced to 14.87% in 2021FY from 9.81% in 2020FY.

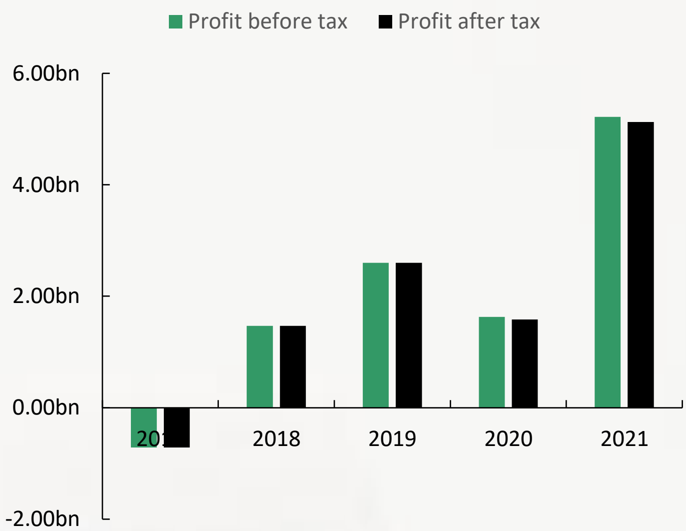
Chart 11: Annual Production Cost and Cost to Sales Ratio



Source: Company Filings, Meristem Research

Despite maintaining a modest leverage position over the years, the company's net financing cost climbed from NGN151.00mn in 2020FY to NGN189.00mn in 2021FY. This can be attributable to the increased interest paid on lease liabilities. Nevertheless, profit before and after tax improved substantially by 220.18% YoY and 238.04% YoY in 2021FY.

Chart 12: Profit Before and After Tax



Source: Company Filings, Meristem Research

The company has retained a healthy balance sheet over the years with a total asset size of NGN23.65bn and asset turnover improving to 1.19x in 2021FY (vs. a 5-year average of 0.89x). However, liquidity metrics, including current, quick and cash ratios, settled lower to 1.18x, 0.81x and 0.16x (from 2.29x, 2.01x and 0.48x in 2020FY), indicating less cover for the company's short-term obligations

Outlook

- **Roll out of new company-owned Chicken Republic and PieXpress branches.**
- **Expand footprints across other African countries.**
- **Increase franchise agreement**
- **Sustained demand growth owing to consumers' growing preference for fast food, doorstep deliveries, intensive utilization of e-commerce channels, and continuous implementation of expansion initiatives.**
- **Increase production cost due to the rising inflationary pressures.**

Stock Recommendation

Food Concepts Plc (SDFOODCPT)

Valuation and Recommendation	
Trailing EPS	0.15
BVPS	0.79
P/E	6.11x
P/BV	0.15x
Target PE	5.36
Dec-2023 Exp. EPS	0.21
Dec 2023 Target price	**1.11**
Current Price	0.90
Up/Downside Potential	+ 23.46%
Ratings	**HOLD**

Sensitivity Analysis of Dec-2023 Target Price to key model inputs						
		EPS				
	1.11	**0.20**	**0.20**	**0.21**	**0.21**	**0.21**
Target PE	**5.20x**	1.05	1.06	1.08	1.09	1.11
	5.28x	1.06	1.08	1.09	1.11	1.13
	5.36x	1.08	1.09	**1.11**	1.13	1.14
	5.44x	1.09	1.11	1.13	1.14	1.16
	5.52x	1.11	1.13	1.14	1.16	1.18

Min	1.05
Max	**1.18**

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