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MEMBER OF THE DAR ES SALAAM STOCK EXCHANGE

EQUITY RESEARCH
TOL GASES LTD
LOCAL LISTED COMPANY

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Recommendation: A MEDIUM TERM BUY -TO - A SPECULATIVE BUY

We initiate our coverage on TOL Gases Limited with **a Medium Term BUY–to-a Speculative BUY recommendation** at a price range of between Tshs. 220 and Tshs. 355 per share. Our target price is Tshs. 275. Our stance on the company is a moderate medium term view supported by the company's aggressiveness in the implementation of its turnaround strategy ("Mission 6:3") since 2011.

We assume that TOL will ultimately implement its turnaround strategy. Our estimated chance of success to this is ~80%. We project that it will take considerance time for the market to digest the significance of the ongoing restructuring taking place at TOL even through the initial success has been seen in 2011 &1H, 2012.

Despite the loss making history on TOL, the company's turnaround strategy aims at making Tshs. 6 billion of cumulative profit within the first three (3) years of its implementation.

In the first year of the strategy implementation (2011), the company reversed its fortune from a loss making company for over 10 consecutive years to recording a decent profit of Tshs. 120 million, it has already made Tshs. 517 million of profit in 1H, 2012 with the projected profit of Tshs. 1.2 billion by year end (2012).

The company is currently trading at Trailing PER of 15.71x (on annualized earnings) and a Trailing P/Bs valuation of 3.19x relatively on the higher side when compared to its key regional competitors BOC Gases & CARBACID that are trading at trailing PERs of 14.40x and 13.60x respectively and P/BV of 1.4x and 3.5x respectively.

The company trades at EV/EBITDAs of 5.02x. We forecast a 3 year CAGR in Revenue and EPS, of 24% and 78% respectively on the back drop of product diversification, sales increase, production efficiencies and a capable human resources base.

Despite strengthening of the local competition and the tougher economic environment, we view TOL as a company well positioned to benefit from the growing gases demand, and, along with an improvement in its debt position, expect to post moderate operating growth.

Relative Statistics

Key Statistics	
Price (Tshs)	220
Issued Shares (mn)	37.22
Market cap (Tshs. mn)	8,919
Year end	12/31
Price (Tshs)	220
Trailing P/E (annualised)	7.92x
EV/EBITDA	8.36x
Annualised EPS (Tshs)	27.79
PER (x)	
2011A	62.06
2012E	6.72
2013E	3.17
2014E	2.32
EPS (Tshs.)	
2011A	3.22
2012E	32.71
2013E	86.81
2014E	153.88
P/NAV (x)	
2011A	4.35
2012E	3.19
2013E	3.22
2014E	3.37
EV/EBITDA (x)	
2011A	8.36
2012E	4.68
2013E	2.31
2014E	2.00
Price Range (Tshs.)	
2011A	220
2012E	220
2013E	275
2014E	355

Source: TOL Financials, DSE & Tanzania Securities (TSL) Estimates

Tshs (mn)	2012F	2013F	2014F
Revenue	10,258	13,605	17,638
Cost of sales	(6,271)	(6,584)	(6,913)
Gross Profit	3,987	7,031	10,724
Operating Cost	(2,248)	(2,405)	(2,573)
NPB Taxation	1,740	4,616	8,151
PAT	1,217	3,231	5,706

Source: TOL Strategic Plan & TSL Estimates

Period	Tshs. Per share	% change
Current price	220.00	0.00%
1 month ago	220.00	0.00%
3 month ago	220.00	0.00%
6 month ago	200.00	+10.00%
1 year ago	200.00	+10.00%

Source: DSE & TSL Computation

Net Assets	(Tshs.mn)
2011A	1,713
2012E	2,567
2013E	3,183
2014E	3,947
CAPEX	**(Tshs.mn)**
2011A	1,047
2012P	4,953
2013E	837
2014E	837

Source: TOL Financials, TOL Strategic Plan & TSL

Competition	TOL	BOC	CABACID
Mark. Cap (Tshs. mn)	8,189	35,496	75,016
No. of shares (mn)	37.2	19.5	34.0
Price per share (Tshs)	220	1,820	2,215
PER (x)	62.06	14.40	13.60
DY (%)	0%	6%	4%
P/BV (x)	4.35	1.4	3.5

Source: DSE, NSE & TSL Computation

Value creation

For the past 6 months TOL share price has remained flat. We foresee the price to pick up on the green as the company consolidates on its moderate profits into a significant profit growth as TOL strive to override the cumulative losses of past years.

Our price projection (Tsh.220 – Tshs.355) is backed by revenue growth and costs reduction in the medium term, hence profitability and dividend

Anticipated growth in the Carbon Dioxide (CO2) market within its key markets; Tanzania, Malawi and Zambia whose combined demand 18,756 tons per annum versus TOL's current production capacity of 5,040 tons per annum has seen the company making investment in a larger plant. This investment is expected to support growth in both revenue and margins. The new plant with 16,920 tons capacity (combined with the current 5,040 tons) is expected to be in 90% utilization capacity from 2013. Key markets for the product apart from beverage and food industries are: aviation, welding apparatuses, fire fighting, greenhouses, oil drilling, paint making, swimming pool cleaning, pharmaceuticals and tobacco industries.

We project increased sales revenue backed by the company's strategic actions that aims into:

- ✓ Increase carbon dioxide production capacity
- ✓ Diversification into welding & medical gas equipments
- ✓ Exporting bulk liquid oxygen
- ✓ Revitalization of TOL's existing market presence
- ✓ Entering into the LPG business

We cannot help but think that above actions will increase market share/presence and provide consistence growth resulting in increased revenue and earnings.

The Way into the Glory Days

Traditionally, TOL competitive advantage has been its quality products. We assume the company will continue to leverage and consolidate on this approach; however, it now seem likely that the company should be mindful of competition brought about by both foreign companies and domestic private gas merchants and still mills that have diversified by developing sideline gas businesses which sell their excess oxygen gas generated from their onsite oxygen plants.

Quality should continue to be the key value driver and a competitive leverage for TOL

The other key front for the company's direction towards profitability is reduction of its cost base; we also see restructuring the company's human resource base, palletisation of the cylinder handling process, investing in the new ERP system, targeting costing ASPEN related products and better management of the two Dissolved Acetylene in Dar es Salaam & Mwanza as key aspects of better cost management strategies which will eventually culminate into better margins and profitability.

Better management of the cost base, competent human resource base, palletisation of cylinders are key aspects for better margins and profitability

Downside Risks

We view downside risk emanating from TOL's failure to implement the turnaround strategic plan which if it happens will create uncertainty for TOL shares in the medium term. Increased competition and the reduced TOL's market share in the industrial and medical gases industry in Tanzania is another down ward side of this seemingly positive outlook.

Down side risks:
Failure to implement the Turnaround Plan & Unmanaged competition

Recommendation

We recommend **a Medium Term Speculative Buy** at a price of between Tshs. 220 and Tshs. 355. Our valuation approach is based on risked value related to strategy execution potential using the existing and new resources and an optimistic estimate for profitability of success in implementing the strategy. Our moderate stance excludes the company's plan positioning itself into diversifying to Liquefied Petroleum Gas (LPG) from 2013 particularly as BP and GAPCO exit this segment of their business. TOL can leverage on the existing infrastructures i.e. depots in major tows in Tanzania.

Recommendation:
Buy at Tshs. 220 to Tshs. 275; Speculative Buy at Tshs. 275 to Tshs. 355

Key statistics (Historical)

Key statistics (Historical)	FY2009A	FY2010A	FY2011A	CAGR
Number of shares	37,223,686	37,223,686	37,223,686	
Pre-tax profit (Tshs. Mn)	(1,035)	(1,493)	410	9%
Profit after Tax (Tshs. Mn)	(890)	(1,863)	120	-20%
Dividend (Tshs. Mn)	-	-	-	-
Market Capitalization (Tshs. Mn)	9,981	8,495	8,495	-12%
Net Assets value (Tshs. Mn)	3,456	1,593	1,713	-20%
Price per share (Tshs.)	235	200	200	-10%
Book value per share (Tshs.)	93	43	46	-20%
Earnings per share (Tshs.)	(24)	(50)	3	-20%
Dividends per share (Tshs.)	-	-	-	-
Price Earnings Ratio (x)	(10)	(4)	62	13%
Price book value (x)	2.53	4.67	4.35	13%

Source: TOL Financial Statements & TSL Analysis

Key statistics (Forecast)

Key statistics (Forecast)	FY2012E	FY2013E	FY2014E	CAGR
Number of shares	37,223,686	37,223,686	37,223,686	
Pre-tax profit (Tshs. Mn)	1,740	4,617	8,151	
Profit after Tax (Tshs. Mn)	1,218	3,232	5,706	
Dividend (Tshs. Mn)				
Market Capitalization (Tshs. Mn)	8,189	10,237	13,214	
Net Assets value (Tshs. Mn)	2,567	3,183	3,947	
Price per share (Tshs.)	220	275	355	
Book value per share (Tshs.)	69	86	106	
Earnings per share (Tshs.)	32.71	86.81	153.28	
Dividends per share (Tshs.)				
Price Earnings Ratio (x)	6.72	3.17	2.32	
Dividend Yield (%)				
Dividend Payout Ratio (%)				
Price book value (x)	3.19	3.22	3.35	

Source: TSL Estimates

Other Financial Statistics

(Tshs. 000)	2009A	2010A	2011A	CAGR
Total Assets	7,760,056	7,089,874	8,776,545	6%
Net Assets	3,455,935	1,592,954	1,712,921	-30%
Loans & O/D	644,240	975,575	2,782,966	108%
Cash	280,617	128,829	161,839	-24%
Depreciation	688,061	727,268	768,775	6%

Source: TOL Financials and TSL Analysis

(Tshs. 000)	2012F	2013F	2014F	CAGR
Total Assets	12,363,440	13,148,272	13,011,100	3%
Net Assets	2,566,685	3,183,080	3,947,019	24%
Loans & Overdrafts	5,661,338	5,498,690	5,336,043	-3%
Cash	676,714	291,633	484,174	-15%
Depreciation	733,420	927,087	974,525	15%
EV	12,868,159	11,073,866	14,051,761	5%
EBITDA	2,748,169	4,784,401	7,008,728	60%

Source: TOL Strategic Plan and TSL Estimates

Key Highlights

Our optimistic new is on the following basis; we believe that TOL is better positioned to compete advantageously in the medical gases and industrial gases. We foresee a downward risk from the competition posed by BOC Gases (for oxygen), CARBACID (for Carbon dioxide) and Domestic Private Gas Merchants and Steel Mills who have diversified by developing sideline gas businesses and sell their excess Oxygen gas generated from their onsite Oxygen plants. Despite the threat on competition we are impressed by the TOL operating business model, its strong management, and its ability to implement its turnaround plan, so far achievement made (since 2011)are impressive.

Managing competition from BOC Gases, CARBACID & Domestic Private Gas Merchants and Steel Mills is paramount for success.

TOL's management has already identified key strategies and action plans that will enable the company to leverage and consolidate on its existing potential, namely: the existing infrastructure, strategic locations, assets base, resource sites, brand loyalty quality of its products and human resources capabilities.

TOL to leverage in its existing infrastructure, its resources sites, brand loyalty and human resources capability into

We expect the company to return into the profitability zones and making TOL a uniquely recognizable brand name and this can only be achieved by management's zeal in moving the three prolonged strategies i.e. increase its sales volume and revenue while reducing production and operating costs; diversification into gas related products, running efficient operations; and restructuring the company's workforce into a lenient, competent and result-oriented team.

The way forward – Key Assumptions

We assume TOL sales volume and revenue will increase if the company implements the following key aspects of its business model:

Going big into the Carbon dioxide business – the cash cow and the clear future of the Company

✓ Increase the capacity of carbon dioxide production – the company's existing capacity for the two plants located in Kyejo (Mbeya) is 6,120 tons per annum; however, the annual average production output is only 5,040 tons per annum. On the other side, current market demand for CO2 for TOL customers within Tanzania, Malawi and Zambia is 18,756 tons per annum – 3x the current production capacity. The existing gap is filled by CARBACID from Kenya & local merchants and still mills upon full capacity utilization and better positioning, TOL should be able to be the key supplier to all blue chip companies in the beverage and alcohol industry. In this regard the company has invested about Tshs. 4 billion in a 16,920 tons-a-year plant that will bring the total TOL's CO2 production capacity to 21,969 tons a year. This would fulfill the existing demand of oc2 to TOl's key markets.

Diversification & Spin off to increase Sales volume and better margins

✓ Product diversification / increased sales – over the years, TOL has concentrated upon gases sales with minimal attempt to actively market other related products that compliments gases sales. However, we observe that since the beginning of 2011, the company embarked into the welding and medical gas equipments business. In this regard the company has forged a strategic partnership with ESAB where TOL is now ESAB's representative and distributor of welding and medical equipments, welding rods, welding machines, gas cutting machines and other accessories. TOL is leveraging into its infrastructure and wider retail network distribution centers in marketing and selling these products. The company has as well diversified and refocused into the special gases space – namely Argon and TOL shield. This move should assist TOL in terms of margins & profitability, for we note that the business case for special gases is that they are of good premium margins, and can easily be controlled with minimal operating costs.

Better utilization of the existing capacity & selling bulk liquid oxygen to change the fortune of this line of business

✓ TOL oxygen producing plant has a capacity to produce 31 tons a day, however, it only utilizes 26% of this capacity as the existing demand for oxygen in Tanzania is only 8 tons a day. Also, the emergence of other relatively cheaper and small oxygen producers has significantly lowered the barrier to entry that TOL enjoyed over the years. TOL is now increasingly facing competition from both these local producers and BOC Gases of Kenya. On the Oxygen segment to mitigate the competitiveness risk, TOL should embark into the production and selling of bulk liquid oxygen; this will be a key aspect for the company as it strategizes on how to make a better utilization of its ASPEN plant. The company has to also replace its high pressure cylinders system for distribution into a palletizing system designed for safe and efficient handling of gases.

Human resources restructuring – greatly increases chances of success

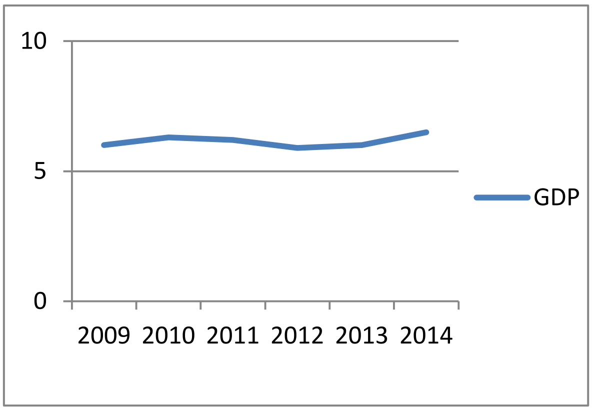
✓ In order to increase production and operating efficiencies – the company has to embark in human resources restructuring towards having a lenient and competent team capable to implement its turnaround strategy.

Macroeconomic Update

Economic Growth Outlook

Strong domestic demand should support growth through 2012 despite double-digit inflation and power outages. We are expecting domestic demand to remain the main driver of growth in 2012 in spite of higher than normal food prices.

GDP Movement (%)



In addition, gold production has increased substantially since the opening of the Buzwagi mine in June 2009, and, mining is likely to continue to underpin GDP growth despite the power rationing imposed by state-owned utility Tanesco in 2011.

We expect fiscal and monetary policy to remain on the stimulative side in 2012 although the authorities are likely to gradually move towards rebalancing economic policy in tandem with rising inflation.

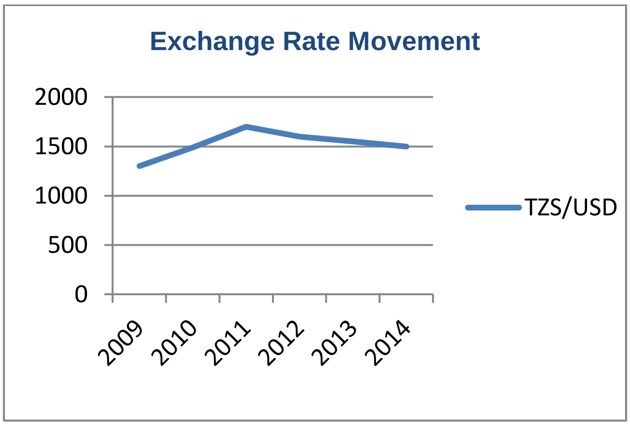
We are expecting economic growth that slowed to around 6% in 2011 to pick up somewhat in 2012. GDP data for the first half of 2011 indicate that economic activities slowed more radically than expected. This was particularly the case with agricultural growth, which slowed to 3.2% in the first half of 2011 after a strong 5.7% expansion in the second half of 2011.

The manufacturing sector has also slowed down in the first half of 2012 to 5.5%, from 11.9% in the second half of 2011. The National Bureau of Statistics partly attributes this slowdown to an unreliable power supply in the second quarter. Projections for the rest of the year will be the same as we continue to expect power cuts resulting from poor water levels in hydropower reservoir.

Even as most of users are switching to alternative sources of energy (thermal power and likes), the situation will continue to be affected by higher oil and gas prices in the country. This scenario was one of the factors considered in the reduction of the GDP growth forecast for 2012 from 6.3 to 5.9.

While the near-term growth picture remains robust, we caution that Tanzania faces challenges in maintaining its current growth rates (GDP growth averaged 6.5% over 2000–11). These are primarily found in removing the constraints on economic growth found in infrastructure, mainly power generation and distribution. Tanzania also needs to do more to raise its economic competitiveness through improving governance and the business environment.

If these issues are not sufficiently addressed, which is our base-case scenario; we then expect a slowing in economic growth in the coming years. We are currently forecasting GDP growth to average 6.1% in 2011 through 2015, roughly a percentage point lower than the expansion rate in 2001–10. However, limited integration with global financial markets and Tanzania's status as an oil importer and a gold exporter make it fairly well insulated to another downturn in global economic growth.

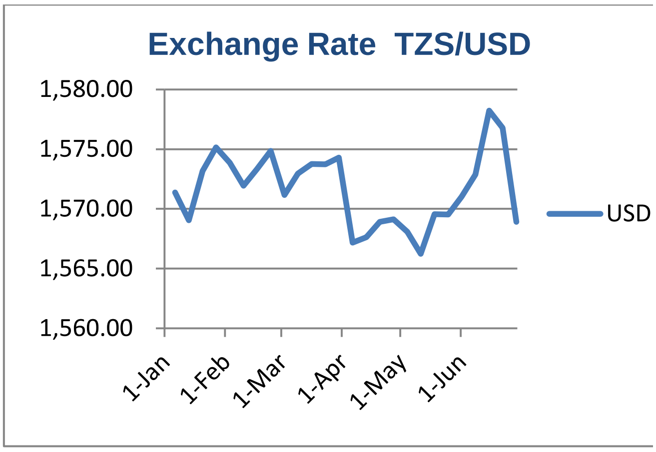


Exchange rates

The Tanzanian shilling, like its regional peers, came under pressure in the first half of 2011 due to political unrest in the Middle East and North Africa, raising risk aversion and the global oil prices.

The situation has recently started (especially in the second quarter of 2012) to improve as the shilling has been gaining against various foreign currencies (including the dollar).

While the shilling has historically held up well compared with some of its emerging market peers, it remains vulnerable to shifts in investor appetite due to Tanzanian's high current-account deficit, which is likely to increase in tandem with the higher oil price, and higher dependence on the unreliable/unpredictable farming based economy.



We expect the Tanzanian shilling to hold steady for the remainder of 2012. We believe that, the slight downtick movement in the prices and inflation in a whole in recent months will continue to hold for the rest of the year.

The current account deficit however, remains a weakness to the overall economic performance, leaving Tanzania reliant on foreign aid and investment inflows.

We are expecting Tanzania's current-account deficit to remain above 10% of GDP in both 2012 and 2013, which will mean that the Tanzanian shilling will remain vulnerable to interruptions in aid and investment inflows. Investment into the mining and energy sector should bolster the balance of payments in the medium term.

Monetary Policy

The Central Bank of Tanzania continued to pursue broad-based monetary measures trying to curb the higher than normal inflation rates, and easy out liquidity squeeze that affected the economy and financial/credit markets for most of the Q1 2012. Even though some might argue that these measures have done little to help out the situation, but, there seems to be improvements of the economy as a whole.

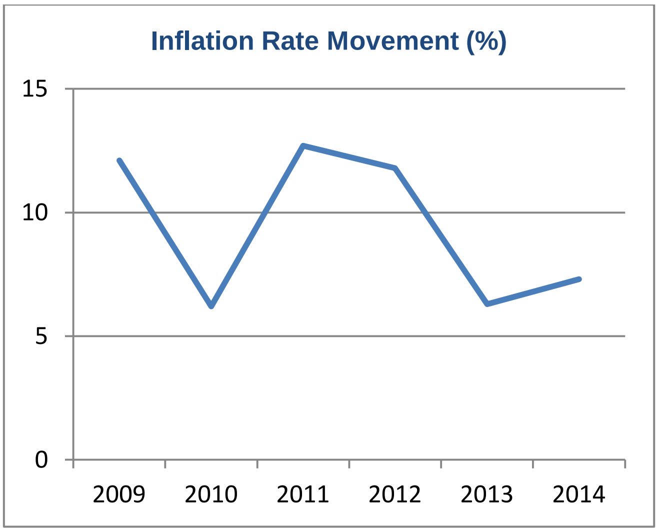
Even though, the International Monetary Fund has stated that it will support the external sector's stability, which should help ease some concerns about the shilling and economic outlook, the medium-term trend for Tanzanian shilling will be determined by the maintenance of a positive outlook for the external sector and the steady return of foreign direct investment and aid flows to emerging markets, as well as good performance in the tourism, mining, and agricultural sectors. In addition, Tanzania's stable political environment and reform program should bolster the long-term currency outlook.

Effectiveness of these measures is still limited and minimal, given the nature of the financial structures in the country, in addition to the underdeveloped structure of the banking sector. Monetary policy remains focused on managing liquidity conditions to decrease the volatility resulting from inflows and outflows of foreign exchange. However, the development of a commercial banking sector over the past two decades has considerably improved credit availability for the private sector and underpinned the strong economic growth rates experienced in recent years.

Inflation

We expect consumer price inflation to remain in double digits well into 2012. With projections from the Bureau of Statics showing stronger-than-expected impetus to food prices, expectations are higher that consumer price inflation would very likely fall in December.

While seasonal factors should see food-price inflation ease out over the coming months, we expect consumer price inflation to remain in the high teens on the back of the pricing-in of higher utility prices and sustained demand-side pressures.



The consumer price index (CPI) slightly fell to 18.2% in May 2012. This was slightly down from the yearly high of 19.2 in March 2012. The inflation rate for April 2012 was 18.9%. **The National Bureau of Statistics (NBS) switched its methodology from a simple-average to a geometric-means method as of October 2010,** which should see consumer price inflation come in at lower and less-volatile rates in the medium term. The collective change in consumer price index calculation is aimed at harmonizing and improving statistical methods across the East African Community as part of a wider move toward regional integration.

This also included changing the index's weights, base prices, and sub-index baskets to align them more with modern consumption preferences and patterns. The new method is likely to facilitate monetary policymaking for the Bank of Tanzania going forward.

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Neutral/Hold: The stock is correctly valued with little upside or downside pricing

Underperform/Sell: The stock is currently overpriced, its total return is expected to underperform; it has weak fundamentals and challenging operating environment

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