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MEMBER OF THE DAR ES SALAAM STOCK EXCHANGE

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Tanzania Breweries Ltd

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# Tanzania Breweries Limited: MEDIUM-TERM BUY

- We initiate coverage of Tanzania Breweries Limited (TBL) with a **medium-term BUY** recommendation. Our stance on the company is a bullish medium term view on one of the highest potential growth markets in terms of alcohol beverage demand in East Africa.
- Our conviction is backed by:
    - Moderate growth in per capita GDP driving the growth potential of the local alcohol beverage industry
    - Undervaluation of the shares – TBL is trading at an FY11 PER of 4.7x compared to EABL's PER of 20.1x – implying that it TBL is grossly undervalued, relative to other players in the industry, at its current trading price of Tshs. 1,820
- TBL's strong operating performance are not reflected in the current price. Over the last five years, TBL has more than doubled sales and net income from Tshs. 315 bn and Tshs. 64bn respecteively in FY07 to c.Tshs. 636bn and Tshs.122bn in FY11. However in the same period, shares rose only by 18% from Tshs. 1,540 in FY07 to Tshs. 1,820 FY11 pushing the year-end PER down to 4.7x in FY11 vs. 7.6x in FY07, i.e. a 38% drop. In our view, the current low valuation fails to capture the company's operating fundamentals and potential.

- Despite the stengtherning of the local competition and the tougher economic environment, we view TBL as well positioned to benefit from the growing demand, and, along with an improvement in its debt position, expect to continue to post robust operating growth.

## Catalyst for the share price

- We expect the main catalyst to be the sale by EABL of its 20% shareholding that we see occurring in H2, 2011. The local market constraints will likely continue to weigh negatively on TBL's share price, but we anticipate a rerating once EABL completes the disposal of its stake, as it should highlight the significant mismatch between the group's current share price and its impressive operating performance.

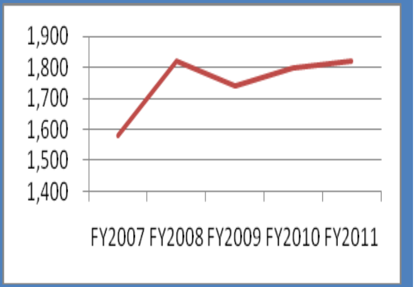
- We view downside risk emanating from EABL's corporate action which creates uncertain for TBL in the medium term. EABL's also purchased 51% in Serengeti Breweries Ltd (SBL) which creates an increased competition and this reduces TBL's market share in the alcohol beverage industry in Tanzania.

## Share Statistics

| | |
|---|---|
| Price as at 31 July (Tshs) | 1,820 |
| Target price (Tshs.) | 2,100 |
| Issued shares (mn) | 295 |
| Free float (%) | 28 |
| Market cap (Tshs bn) | 537 |
| Market cap (US$ mn) | 358 |
| Financial year end | 31March |
| Avg daily trdg volume, Tshs. | 11 Mn |

(Sources : TBL website, Dar es Salaam Stock Exchange)

Share Price Performance (Tshs.)



### Risks to our scenario

- The main risks to our scenario are the price at which the transaction is finalised, and the type of buyers involved in the sale, as in our view the fewer foreigners the transaction is opened to, the less interest there will be in the stock. The competitive power of EABL (via its subsidiary Serengeti Breweries Ltd) in the local market, higher than expected demand (impact on capex increasing funding needs) and a tougher economic environment could also substantially affect our stance on the stock.

| Tshs. mn | FY12f | FY11 |
|---|---|---|
| Sales | 712,491 | 635,863 |
| PBT | 182,609 | 173,183 |
| PAT | 122,780 | 121,695 |
| EPS (Tshs) | 416 | 387 |

### Investment Case

- TBL has delivered an impressive performance over the last five years. From FY07 to FY11, net sales and net profit grew at CAGRs of c.19% and c.17% respectively, while the share price moved from a low of Tshs. 1,540 in 2007 to Tshs. 1,820 as of 31 July 2011.
- We believe that TBL is currently trading at a deep discount compared to its competitor EABL at 57%. TBL is currently trading at PER 4.7x compared to EABL's 20.1x. Discounting the current price by country and market risks should place TBL at a price range of between Tshs. 2,700 and Tshs. 3,750.

### FY11 Financial Performance

- Sales revenue grew by c.20% in 2011 -- mainly attributed to growth in the market share, strong performance of TBL's wine and spirit business as well as annual price increases. Also the increased brand and market focus, with Castle Lager, Castle Lite and Ndovu Special Malt significantly outperforming its premium segments: Kilimanjaro Premium Lager and Safari Lager contributed to the growth in sales performance.

- TBL has been exposed to some risks associated with tougher economic environment in Tanzania, which has put pressure on its operating costs (c.21% over the past five years and c.17%, 2011). These difficulties dampened the company's performance in FY11. The Shilling depreciated against major currencies resulting into increased cost pressure on imported materials, while the significant rise in oil prices and unreliable power supply also adversely affected fuel and energy costs. However, improved production and distribution efficiences allowed operating profit to end 26% ahead of FY11.

### TSL's view on TBL's FY12 earnings

With the economic challenges and the increased competition, overall, we expect the company to not maintain its historical double-digit growth in net profits in FY12, we anticipate the company to post about y-o-y c.5% increase on net profit to c.Tshs. 128bn vs. c.Tshs. 122bn in FY11. However, given the IMF's positive forecasts for per capita GDP and the low per capita alcohol beverage consumption in Tanzania, we expect beverage volume growth to keep pushing up TBL's sales, despite: (1) the potential inflationary pressure in the short term and (2) the growing competition in the medium to long term. Taking into account these two parameters, we estimate TBL's total volume to increase by 10%.

TBL should be able to achieve this growth despite economic odds that are anticipate to put pressure on production and operating costs and also the results brought by the divesture of the EABL shares in TBL and its acquistion of 51% in SBL. Postive achievement are expected, thanks to: (1) the recent investment related to the commissioning the Mbeya brewery plant; (2) quality products; (3) customer retention and (4) the increased market share. The increase in sales is expected to emanate from increased demand, market focus as well as aggressive penetration into the far south region following the commissioning of the Mbeya brewery which is anticipated to significantly reduce distribution costs in the region.

### TBL: Undervalued by the market

TBL's valuation has decreased continuously since end of FY02, falling by 68% in the period, from a 14.5x PER to 4.7x PER at end-FY11. Breaking down those numbers, its EPS increased by 252% from Tshs. 110 to Tshs. 387 in FY11 while in contrast the share price increased just by 14%, from Tshs. 1,600 to Tshs. 1,820.

**Impressive Performance**. Neither the company's past performance nor the business outlook provide room for doubt in our view over the stock's mispricing. Our analysis of the last five years confirms that TBL has consistently achieved a good operating performance underpinned by strong financial fundementals. The main P&L lines recorded double digit CAGRs over the past five years (FY07-11): (1) Total revenue: 19% (2) reported EBIT: 17% (3) PBT: 16%.

The company has more than doubled its sales and net earnings in five years, which is comparable to the performance achieved by the best known stocks in the Sub-Saharan Africa (SSA) brewers industry, i.e. Nigerian Breweries (NB), Guiness Nigeria (GN) and EABL Kenya.

| Tshs. bn | FY07 | FY08 | FY09 | FY10 | FY11 | CAGR |
|---|---|---|---|---|---|---|
| Revenue | 314.9 | 383.2 | 464.2 | 527.8 | 635.9 | 19% |
| Costs | 219.3 | 274.0 | 349.0 | 394.0 | 462.7 | 21% |
| PBT | 95.6 | 109.2 | 115.2 | 133.8 | 173.2 | 16% |
| Net income | 63.9 | 74.2 | 80.8 | 92.3 | 121.7 | 17% |
| Net Assets | 109.4 | 123.3 | 156.9 | 201.2 | 317.3 | 30% |
| EPS (Tshs.) | 209 | 242 | 262 | 297 | 387 | 17% |

Source: TSL estimates, Dar es Salaam stock exchange

As can be seen the table below, TBL's operating earnings growth stood in the high teens over the past five years, close to Guiness Nigeria, as well as EABL.

| | NB | GN | EABL | TBL |
|---|---|---|---|---|
| Total revenue | 18.3% | 18.4% | 13.3% | **18.1%** |
| EBITDA | 19.4% | 14.8% | na | **14.6%** |
| EBIT | 22.0% | 14.5% | 8.5% | **15.5%** |
| Net Earnings | 29.7% | 23.1% | 8.5% | **14.7%** |

Source: Company annual reports, TSL estimates

Despite challenges brought by 2008/09, TBL has continued to grow its net profits, unlike EABL, which struggled to maintain its EPS growth in recent years. This strong performance could be explained by the resilience of TBL's business model and its dominant position within the high growth potential alcohol beverage market.

**Debt position**: TBL has been relying on debt to run and most of its expansion activities over the years, this being amplified in the high investment period which started in FY09. From FY10, TBL benefited from the support from its parent company (SaMiller), but also short-term borrowings granted by local banks and the medium-term note that the company issued last year. However, thanks to the decrease in capex needs since FY11, the debt situation has broadly imroved.

### How much is TBL shares worth?

To answer this question, we build our scenario using two methods : (1) based on TBL's current share price ; (2) the acquisition of SBL by EABL as a reference

- First approach : TBL's enterprise value

We summarise in the table below the calculation of TBL's enterprise value.

| | Tshs. mn | US$ mn |
|---|---|---|
| Market cap as of 31 July | 536,770 | 335 |
| Net Debt of FY11 | 79,600 | 50 |
| Tax obligations | 35,504 | 22 |
| LT provisions | 274 | 0.2 |
| **Total EV** | **421,392** | **263** |

Source: TSL estimates, Dar es Salaam stock exchange

We view this estimate as the lowest value which TBL is worth.

- Second approach: SBL's acquisition by EABL as a reference point

In October 2010, Diageo disclosed that EABL (its subsidiary), had acquired a 51% stake in SBL for a total amount of US$ 60.4mn, implying an enterprise value of SBL of around US$ 118 mn. Given that this value corresponds to an entity representing 15% of the Tanzanian alcohol beverage market (before the addition of EABL's volumes in the Tanzania market), we estimate TBL's market value at c. Tshs. 1,155bn (US$ 718mn) as shown in the table below:

| | Tshs. mn | US$ mn |
|---|---|---|
| SBL EV (15%* market share) | 188,800 | 118 |
| Estimated EV of entity owning 100% market share | 1,258,667 | 790 |
| TBL's implied EV (with 70% market share) | 881,067 | 551 |
| Implied price per share | 2,985 | 1.79 |
| Implied PER | 10.1x | |

Source: TSL estimates, Dar es Salaam stock exchange

The second approach calculation puts TBL's PE at 10.1x which is almost twice the PE derived from our floor valuation. Both lack of liquidity and the limitation placed on foreign investors' participation on the Dar es Salaam Stock Exchange (DSE) could explain the difference.

**TSL's view on the two valuations** The second approch derives a value for TBL of more than twice that given by the first approach. Before choosing our central scenario, the main question is: which of these three aproaches reflects the value an investor would be actually be willing to pay to acquire TBL's stake?. To respond to this question, we have examined the existing and potential competitor and compare to TBL.

In the anticipated public offering of the TBL's shares, Tanzanian will be given priority, followed by East Africans and then other investors. As EABL is the most traded stock in the brewing industry, it looks the best regional peer for our comparison exercise. All other peers are either not listed or publish very little information on their operations to enable a proper analysis.

| Market data | Tanzania | Kenya |
|---|---|---|
| Local market share | c.70% | c.95% |
| Estimated population | 42mn | 41mn |
| Beer per capita consumption | 5 | 8 |
| FY11f per capita GDP (Tshs) | 883,200 | 1,400,000 |
| 2011f GDP growth | 6% | 4% |
| 2012f-2015f GDP growth | 7.2% | 6.7% |

## TBL vs. EABL

| Operating data (in Tshs. mn) | TBL (2011) | EABL (2011f) |
|---|---|---|
| Sales | 635,863 | 724,800 |
| EBIT | 186,432 | 213,731 |
| EBIT margin | 35.6% | 29.3% |
| Net income | 121,695 | 133,381 |
| EPS (Tshs) | 387 | 177 |
| PER | 4.7x | 20.1x |

Source: TSL estimates, Dar es Salaam stock exchange

Assuming that EABL generates the bulk of its revenue and earnings from Kenya and TBL generates over 98% of its profits from Tanzania, our comparison leaves no room for doubt that TBL is deeply undervalued. As mentioned previously, the lack of liquidity and the foreign investors limitation on the DSE could explain the discount in TBL's valuation, but, in our view, a difference of four times (TBL's 2011 PER is 4.7x vs EABL's at 20.1x) is not justified. The Kenyan and Tanzanian markets are quite similar in terms of population, but the potential growth in beer demand is higher in Tanzania given its lower per capita consumption, i.e. c.3 litres below Kenya.

In our view, any investor prepared to buy EABL at its current valuation would find TBL more than attractive at a 4.7x PER, and would still be interested in the stock at about 10x PER. We summarise below three key points that strengthen our view:

• We expect EABL and TBL to have similar ROEs in FY11 at c.34%
• TBL's operating margin is well above EABL's, at 36% vs 29%
• In FY10, TBL's dividend yield was almost twice EABL's, at c.8% vs 4.1%

| | |
|---|---|
| EABL current PER | 20.2x |
| Discounting for country risk | 0.2% |
| EABL PER after discounting for country risk | 19.8x |
| Market illiquidity discount | 60% |

| | |
|---|---|
| EABL PER after country and illiquidity risks discount | 8.9x |
| Normalized earnings based on 3 years (Tshs. Mn) | 112,308 |
| TBL's Estimated EV (Tshs. Mn) | 999,541 |
| Implied price per share (Tshs.) | 3,750 |

The only limitation to our call would be the restriction of the public offering to the Tanzanian market, but as long as it is open to East African investors (and potentially foreigners), we are confident that the company can reach a 10x PE valuation, which is still 50% below EABL's trading multiple.

TSL central scenario is that TBL value is currently at Tshs. 797 bn equivalent to Tshs. 2,700 per share.

The central scenario we choose is the combination of the two approaches described above, weighted according to two ratios that sum to 100%. Given that we judge the second scenario as being closer to reality, we decided to give a 65% weight to the second scenario and 35% to the first scenario.

**TSL scenario vs other approaches**

| In Tshs. mn) | 1st Approach | TSL's central scenario | 2nd approach |
|---|---|---|---|
| TBL's EV | 421,392 | 797,181 | 999,541 |

Source: TSL estimates, Dar es Salaam stock exchange

We assess the enterprise value of TBL's share at c.Tshs. 797bn. The implied PE is 7.0x, which is 48% above the current PE on the DSE, but 85% below relative multiple valuation approach.

**FY11f and FY12f dividends at risk**

The company has had a c.69% dividend payout ratio on average over the last four years (except FY11 where the company did not declare divivends), which corresponds to a c.10% dividend yield over the same period. Despite the low visibility on the company's investment programme, we anticipate the return of dividends from this year. At this stage, the company hasn't disclosed any dividend policy, but, having SabMiller as main shareholder should, in our view, incentivise TBL to allocate efficiently its cash at bank between its funding needs and shareholders remuneration. Our dividend estimates set a payout ratio of at least a 60% on average for the FY12-16f period, which is below the 69% ratio we highlighted earlier (FY07-10).

**TBL dividend payout to shareholders**

| | FY07 | FY08 | FY09 | FY10 | FY11 | FY12f |
|---|---|---|---|---|---|---|
| EPS (Tshs.) | 209 | 242 | 262 | 297 | 387 | 416 |
| DPS (Tshs.) | 200 | 200 | 150 | 150 | NIL | 208 |
| PE Ratio | 7.56 | 7.52 | 6.64 | 6.06 | 4.70 | 4.81 |
| Dividend Yield | 13.0% | 11.0% | 9.0% | 8.3% | NIL | 10.4% |
| Payout Ratio | 92% | 80% | 55% | 48% | NIL | 50% |

We expect the group's net cash position to stand at c.Tshs. 53.8bn at the end of FY12, i.e. c.1.6bn higher than the previous year. Starting from a lower level of cash available, the TBL is expected not to face higher financial needs than usual given the investments actions that were made from FY09.

Even if the TBL's overall financing needs are manageable, we do think that the temptation to lower the dividend payout ratio or not to declare dividends like last year is a risk investors have to factor in.

**Analyst' stock ratings are defined as follows:**

**Outperform/Buy:** The stock is of good value, is currently underpriced and have strong fundamentals

**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

**Important Disclosures**

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