ARM Update:

August 2018

AIB Capital Ltd.

Your Vision… Our Mission

Recommendation:

WATCH

ARM Cement

When fright takes flight…

When Fundamentals clash with Headlines: *A short synopsis on ARM Cement:*

The tale of ARM Cement price volatility between 2012 and 2018 is a perfect showcase of the two extreme portions of investor overreactions. In a classic case of representative bias, the market price for the Arthi River based cement and clinker manufacturer in 2012 rallied from **KES 31.60** recorded on the 3rd of January 2012, to hit the all time high of **KES 97.50** on the 9th of January 2014. The price during this period were mainly driven by investor exucberance as investors assumed that the high growth during the period would continue to hit to newer hieghts, with expansion to Tanzania a key catalyst. Analyst sentiments during the period also helped fan the investors over-confidence with general analyst consensus remaining a buy even when the stock was trading at a premium to the P/E and P/B of the comparable cement companies in Sub-Saharan Africa due to high growth projections at the time.

With high expectations and an aggressive expansionary stance taken by management growing the EPS from **KES 0.42** in 2001 to **KES 3.01** by 2014. The **19.6%** Compounded Annual Growth Rate (CAGR) of earning per share during the 12 year period pushed up future earnings expectations pushing up the P/E ratio from **7.14x** on 3rd January of 2005 to hit a high of **32.39x** on the 9th of January 2014. The positive momentum changed after ARM's challenges in Tanzania resulted in negative EPS. The announcement of disappointing numbers in the Half Year of 2015 forced the market to readjust its future expectation starting on July 2015. Disappointing annual and Half results in 2015 and 2016 continued to push prices downwards to KES 20 by March of last year when Book Value Per Share was **KES 28**.

In our opinion, ARM at the KES 4.80 is trading below it's fair value. This our fair value opinion happens to be the current consensus opinion of most analysts. We believe the September 2017 annoucement of a **430%** drop of ARM's Half Year 2017 (**HY17**), Net Income to negative **KES 1.40Bn** from negative **KES 266.8 Mn** in HY16 when market risk aversion is high is the reason for the negative sentiments on the stock. The revision of analyst's consensus target prices from double digit prices to an average range of **KES 7** to **KES 14** also played a role in the deescalation of prices from KES 18.35 on 1st September 2017 to **KES 11.25** by the 28th of February of 2017. The profit warning released by management in March of this year was the final straw that broke the camel's back. The profit warning indicated to an already jitery investor confidence that the Net Income for Full Year 2017 (**FY17**) would be at least 25% worse than the Negative **KES 2.8Bn** Net Income recorded on FY16. Despite the information of **KES 28** book value then the investors reacted by devaluating the value of ARM Cement from **KES 11.25** at the beginning of March to **KES 7.00** by the 8th of May.

Another key observation we have made is that the price movement of ARM Cement in the current may be currently sensitive to the news media. The current predicament of the cement company's stock price that is current **KES 4.85**, way below the consensus fair value, lends to the fact that investors may have lost faith in the management and gravitate towards an independent voice i.e. the media.

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ARM's credibility and stock value we believe has fallen prey to the yellow brand of business journalism that currently afflicts our underdeveloped capital markets. With the majority of the retail investors more cormfortable with consuming bite sized enticing news articles of the Business Daily (a popular publication equivalent to the Kenya version of the New York Times) than consume long convuluted and intricate analysts report. The general mood of nationwide media publication has changed from a positive and exuberance confidence on ARM just after the acquisition of approximately **40.65%** of ARM Cement by CDC in 2016 to making ARM Cement the poster child for the cement industry's struggles in 2017.

ARM's Current Situation

A Historical Perspective:

To have a clear picture of of the current liquidity and working capital issues that plague the Arthi River based cement manufacturer we go back in time to put things into key perspective. The management attribute the current working capital to a decision to obtain a convertible notes from AFC, that enabled them get USD 50Mn in funding:-

A quick reminder:

The Full Year 2012 (FY 12)

Relevant Events:

i. Secured **50** convertible notes of **USD 1.00Mn** each for a total of **USD 50M** (**KES 4.3 Bn** at the then exchange rate) of convertible instument from Africa Finance Corporation at a premium in September of 2012.
ii. ARM in 2012 held **KES 2.3Bn** in short deposits and the rest about **KES 2.0Bn** disbursed immediately.
iii. Launch of Dar grinding Plant.
iv. Arm introduces the Rhino Cement.brand in Tanzania.

Positives:

i. ARM gets funding to continue building it's clinker plant in Tanga.
ii. Rhino cement captures **12%** market share in Tanzania in year 1.

Negatives:

i. Risk of dilution to Equity share holders if the **USD 50 million** plus the 10% (**USD 5.00Mn**) premium was to be converted into approximately **85.94 million** shares at **USD $0.64** per share in 6 years on the date of maturity.
ii. Increased Leverage (Net Debt Rose by **KES 2.5Bn**) and increase in fixed finance cost with the company paying 5% interest annually payable quarterly plus about 2.5% accrued interest payable upon maturity.

Balance sheet:

The debt outstanding increases by 41% to **KES 15.0Bn** in FY12 from the **KES 10.6Bn** debt in the FY11 balance sheet. The increase in Debt during the FY12 pushed an already leverages position of **KES 1.74** worth of debt for every **KES 1.00** of Equity to **KES 2.1** of debt for every **KES 1.00** of Equity. Debt in FY12 then constituted a significant **67.8%** (vs FY11's **63.5%**) of the capital structure with Equity **31.7%** (vs FY11's **35.9%**) of the capital structure. The additional **KES 4.3Bn** of Long Term borrowing also elongated the effective tenor of ARM's debt outstanding by increasing the Total Senior Bonds and Notes to **KES 6.8Bn.**

Balance Sheet Ratios:-

i. Long Term Solvency:	FY 11	FY12
Total Debt/Equity	174.1%	210.5%
Total Term Debt/Capital	63.5%	67.8%
Total liabilities/Total Assets	70.3%	73.6%

ii. Short Term Liquidity	FY 11	FY12
Current Ratio	0.8x	1.2x
Quick Ratio	0.5x	0.7x
CFO to Current Liabilities	0.5x	0.1x

Income Statement:

Key events like the exhaustion of accelerated investment deductions that ARM enjoyed from 2011 from prior investments drove the effective tax charge higher in 2012 which meant that Net income grew only by **8%** to **KES 1.25Bn** despite Profits Before Tax (PBT) growing by a massive **31.7%** to **KES 1.79 in 2012.** Pressure on Net Income in the face of a growing Common Equity forced ROE to drop to **18.8%** in FY12 from an FY11 ROE of **20.9%** but left ROA relatively untouched. The ROE and ROA is worth noting has never recovered to FY11 levels with tough operating conditions and low utilization levels suppressing the growth of Net Income.

Income Statement Ratios:-

Profitability:	FY 11	FY12
ROE	20.9%	18.8%
ROA	5.9%	5.8%
ROC	7.2%	7.1%

Margins	FY 11	FY12
Gross Margin	28.3%	24.3%
EBIT Margin	19.5%	16.3%
Net Income Margin	10.9%	9.6%

The Full Year 2017 (FY17)

Relevant Events:

i. The Group post disappointing results that includes a first time gross loss of **KES 1.2Bn**, caused by a dramatic **32%** reduction in ARM's topline mainly driven by tough operating conditions and working capital constraints that hampered production in 2017. In April as part of the restructuring efforts, ARM management reached out to IFC for help restructure the group to a tune of **USD 120Mn**.
ii. Imported clinker is banned in Tanzania
iii. Aliko Dangote delays his foray into the Kenyan market to 2021 and Dangote loses preferential treatment in Tanzania.

Positive:

i. IFC responds positively to the management's request for relief and considers offers **USD120Mn** in debt refinancing (**USD 90Mn** term loan and **USD 30Mn** in working capital lines) and also recommends that management seek a **USD 50Mn** equity injection to plug holes in the balance sheet.
ii. Imported clinker is ban in Tanzania opens up the market for ARM, with **1.2Mtpa** clinker capacity to full exploit opportunity.
iii. Aliko Dangote delays his foray into the Kenyan market to 2021 when the entire cement industry is in cyclical decline relieves the prospect for aggressive completion in the Kenyan market for at least in the medium term.
iv. The price of ARM cement drops below the current tangible book value of **KES 21.68** per share, allowing investors with the risk appetite to exploit mispricing and even price in the prospect of dilution.
v. The sale of the non-cement business is in the final stages.

Negative:

i. No announcement of any equity invest secured.
ii. Net reduction in cash drives working capital lower with current liability exceeding current assets by **KES 13.4Bn**.
iii. The Net Debt increased by **KES 1.2Bn.** Interest burden increase during 2017 due to delays in debt service.
iv. ARM Cement gets a shareholder loan of **USD 4Mn** from CDC in March 2018.

Balance sheet:

With debt outstanding above comfort levels of most financiers and ARM still in contravention of all their debt covenants, the group's debt levels increased marginally by 9% to **KES 14.4Bn** in FY17 from the **KES 13.2Bn** debt in the FY16 balance sheet mostly from accrued interest. With most long term debt such as Aureo capital's income note maturing in 2018, long term borrowing on the group's balance sheet declined by a **69.2%** to **KES 1.4Bn** from **KES 4.6B** registered in FY16. Maturing long term debt had the opposite effect of current liabilities as the short term borrowing doubled to **KES 13.03Bn** in FY17 from the **KES 8.7Bn** recorded in FY16.

Income Statement:

Tough operating conditions in both Tanzania and Kenya meant that the group's profitability was negative all the way from the Gross Profit line in the income statement.

Summary and Medium Term Outlook

ARM cement management decision to expand its operation into Tanzania through leverage we hold is a key reason for ARM's current precarious predicament. The observation we make, however, we note may be obvious with the benefit of hindsight but understandly hazy if veiwed in an unbiased manner. The decision was made during an intoxicating exuberant period when the regional production capacity was low, ARM cement considered itself a high growth stock, the regulatory situation in Tanzania was stable and competiton was still minimal. The key flashpoint for us happened in 2012 and 2016. The reason why we did a mini-refresher above is we believe that a robust entreprise wide risk management framework would have cautioned management against borrowing **USD 50 Mn** in what we consider unfavorable terms only two years after securing a cummulative **USD 70Mn** (**USD 45 Mn** from **DBSA** & **PTA** Bank, **USD 10Mn** from Aureos and privately placing Equity linked worth approximately **USD 15Mn**). The solvency ratios and short term liquidity ratios have yet to recover from FY16. The second point of no return was the decision to buy the conversion call option from AFC for **KES 1.4Bn** to convert the convertible note into debt of a value of USD 50. Ironically **USD 50Mn** in equity injection is what ARM Cement management currently needs.

The overall outlook for cement in the medium term in Kenya remains positive despite a slowdown in the homebuilders market due to the Kenyan government appetite for infrastructure and burdgeoning growth in the Real Estate. The market outlook for Tanzania is however still dim with imported cement putting downward pressure on prices currently. There is however hope given the Tanzanian government decision to strip Dangote cement of privileges it was awarded by the former Tanzanian president Jakaya Kikwete.

ARM managements plan to lengthen the duration of their loans to reduce the pressure of fixed finance costs on their cashflow is solid and with huge willingness from long term finance providers such as IFC has a very high probability of success. The recent revelations of a reduction in the number of staff will also help trim the fixed asset leverage albeit marginally. We encourage investors with the risk appetite to take on early position and benefit from the current mispricing caused by the current market loss aversion.

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Research Disclosure

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