Recommendation:
HOLD
Target Price: KES 218.00

East African Breweries Limited (EABL)

The right ingredients are brewing…

Price on 7th August 2018:
KES 223.00

52-week Trading Range:
KES 272.30 to KES 200.00

EPS:
KES 7.19

P/E
31.15X

Dividend Yield:
3.3%

Market cap:
KES 176.3Bn

Estimated free float:
50.0%

Shares Outstanding:
790.8 Million

Latest Full Year Results:
The full Year 2018

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EABL still rules the East African Savanna: *Dominance still a key value driver:*

East African Breweries Limited still dominates the East African Alcoholic beverage landscape despite aggressive emerging competition and tradition competition in the industry. The group reported a **7% (YoY)** increase in volume to **12.5 mEU** in Full Year 2018(**FY18**) from a recorded the Full Year 2017 (**FY17**) volume of **11.7 mEU** mostly driven by a **10%** resurgence of volumes sold in the Second Half Year of 2018 (**2HY18**). The group, however, failed to convert their **7%** advancement in volumes and the consequent **9%** flourish in Gross Sales (from **KES 124.1Bn** in **FY17** to **KES 135Bn** in **FY18**) into an equal growth in Net Sales but managed a suppressed **5%** growth due to a higher effective excise duties that hit **45.63%** or **KES 61.6Bn** excise duty charge on **KES 135Bn** Gross Sales in FY18.

The **2.28ppt** increase in effective excise tax from **43.35%** or **KES 53.8Bn** in FY17 to **45.63%** in FY18 was mainly occasioned by poor weak Senator Keg sales in the first half of 2018 (**1HY18**) that led to increased gearing and effect of excise duty on EABLs exports to Uganda in **1HY18.** The effective excise duty for the group going forward will most likely be a lot more suppressed in FY19 and in the medium term with the sales of less excise taxed or geared senator keg and the relocation of production of EABL products bound for the Ugandan market moved into Uganda to escape excise duty on imports. In fact, we suspect that Net Sales impressive growth in **2HY18, 10%** growth which is the highest recorded in the second Half year **(2HY)** in about six years, benefited from a potent combination of a better business environment that boosted demand in **2HY18** and also crucially from the relocation of production to Uganda in **2HY18.**

Gross profit in **FY18** also grew by **4%**(YoY) slower than the **5%**(YoY) growth of Net Sales. Gross profit in **FY18** firmed up at a slightly subdued rate during the Full Year 2018 (**FY18**) due to the dilutive effects of the sales of lower margin Senator Keg (EABL's flagship value brand) that resulted in a weaker mix. The productivity savings driven by procurement optimization by management, however, ameliorated the Gross profitability from a weaker performance by driving Cost of Goods Sold per unit down by about 200 basis points **(2%).** The combined effect of lower COGs per unit, economics of scale from higher volumes and a weaker profit mix due to increase in sales of Senator Keg during the the **H2FY18** meant that COGS as a percentage of Net Sales remained relatively muted in FY18 at **56%** to hit **KES 32.4Bn** over the FY18, a **4%** strengthening over the **KES 31.1Bn** registered in **FY17.**

Profit After Tax (**PAT**) in the **FY18** period declined by **15%** to **KES 7.3Bn** from the PAT of **KES 8.5Bn** achieved in FY17. The **15%** weakening of the **FY18** Net Income was the group's worst bottom line performance since a **16%** decline in Net Income in **FY16.** The weaker performance in **FY18** has been mostly driven by an increase in selling & distribution (**S&D**) expenses during the period and a one-off **KES 2Bn** tax provision during the **FY18** period. The bottom line failed to benefit from a **4%** increase in Gross profit during the period due to a **19%** (YoY) acceleration of Selling & Distribution costs to **KES 6.4Bn** in FY18 from **KES 5.4Bn** used in **FY17** to promote brand and product selling activities. The increase in **S&D** we believe was driven by subdued demand for EABL's products forcing management to spend

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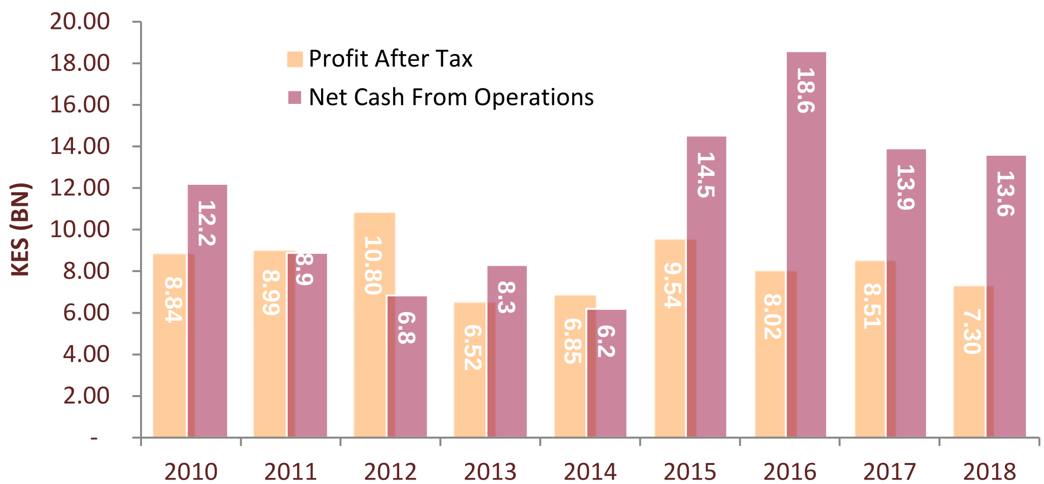
more to shore up visibility during a tough business environment with decreased discretionary spending by households in Kenya and by extension, the region.

EABL's Cash-Flow: *Cash-Flow performance still roars strong:*

EABL in the **FY18** results reported an operating cash conversion of **117%,** showing more than ample quality earnings well supported by cash earnings. EABL's good operating cash flow conversion rate in **FY18** demonstrate that EABL's earnings are not only solid but sustainable growth. We expect with the strong nature of EABL's business, the strength of EABL's inventory management and the firming up of demand inspired by the recovery of economies in the region that the company will maintain their cash conversion within the range of **90%** to **110%** in the medium term. In summary, we advise investors to expect the strong Cash Flow From Operations (CFO) performance in the past to get only better as the economy recovers.



Source: EABL Fillings, AIB Capital

EABL's Outlook: *Expect a stronger performance in both the short and medium term:*

EABL is one of the manufacturing companies we see most likely to benefit from the cyclical recovery of the Kenyan economy. The recovery of consumer confidence in the region, lower inflation inspired by the end of the drought in the region and recovery of incomes over the medium term will continue to amplify the group's volume especially in the value segment/Brands (i.e. Senator Keg). We also see the growth of incomes and the middle class in the region providing support for the resilient spirits business and the ever dependable bottled beer segments. The growth in the volume of goods sold may be further augmented by the increased ability of EABL to pass more of their costs to the consumer through higher pricing.

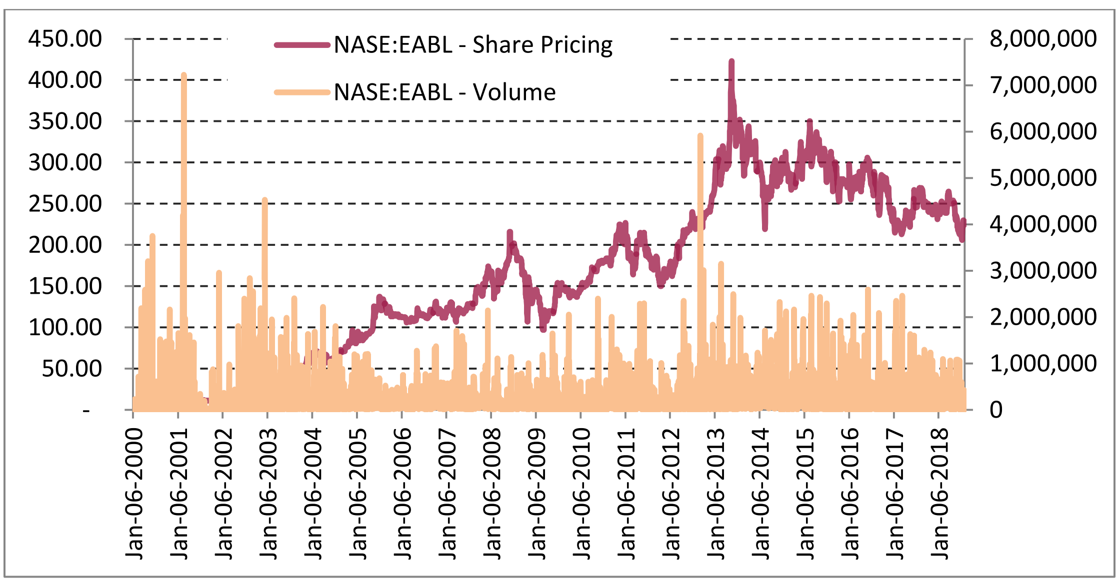
We, however, do not expect the profit margins of the group to recover in the medium term due to the dilutive effects of an increase in the proportion of lower value Senator Keg in the group's overall sales. We also caution investors to expect the possibility of an an increase in expenses on the group's income statement because of a high profitability of an increase in marketing expenses as the management engages in a higher sustained level of marketing efforts and spend more in innovation to maintain SBL's profitability momentum and sharpen its competitive edge on its crown jewel, Kenya.

Management's new modular approach to decentralizing its production units to Uganda, Tanzania and Kenya with an emphasis on sourcing at least 80% of raw materials locally is a great strategy to continue to drive the sustainable growth of shareholder value in an ever-volatile multi-country regulatory environment. The decentralization can also build the group's vulnerability towards any harsh protectionist excise regime and therefore maintain an attractive in the full glare of budding competition in the countries they operate. Management's long-term strategy of driving innovation through the introduction of new and reinvigorating products to keep its brand fresh and forward-looking will also be key in growing EABL's current competitive edge, offering the widest choice to consumers in the region.

EABL's Valuation: *Hold EABL if fairly valued:*

We update our recommendation on EABL to a hold from a **buy** to a **hold**. The current price of East African Breweries Limited is **KES 224,** only a **3%** downside to our current Target Price of **KES 225,** which falls within our fair valuation opinion range of below **KES 240** but above **KES 196.2**. We believe the counter is currently valued by the market even though their FY18 net earning of **KES 7.3Bn** were **36%** below our expectations of **KES 11.2Bn** in Net Income. We believe that the slump is cyclical and doesn't represent any downshift in their long-term profitability.

EABL, on a relative value basis, is only marginally overvalued compared to its Sub Saharan Africa (**SSA**) peers. The group is currently trading at a **P/E** of **31.15x** and EV/EBITDA of **11.49x** which are slightly richer than the market multiples of its peers of an **SSA median P/E** of **25.95x** and the **SSA median EV/EBITDA** if **10.41x**. We advise value investors who seek to unlock returns by buying undervalued stocks and selling them at a higher valuation to pass on the counter at the current price but still keep an eye out for the stock if it falls below **KES 198**. The likelihood for the stock trading below fair value we will point out that is highly unlikely because the stock is well covered, well followed and the stock has historically achieved a Return on average Equity (ROaE) that is above peers. Investors should, however, note that the impressive ROaE is inflated by the Equity Multiplier or the high leverage on the balance sheet which may be unsustainable in the long run.



Source: Capital IQ, AIB Capital

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