NAMIBIA BREWERIES LIMITED
FY17 Results Review
November 2017

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Namibia Breweries Ltd

FY17 Results Review

Target Price (c)	***3230***
Current Price (c)	3753

Year End 30 June	2016	2017	F2018	F2019	F2020
Revenue (N$m)	2,426	2,708	2,468	2,656	2,927
Operating Profit	541	611	535	565	622
HEPS (c)	1.86	2.30	1.84	1.83	2.04
HEPU growth (%)	(0.7)	24	-20	0	11
PE	13.7	24.3	27.9	20.7	17.7
DPS (c)	80	84	92	100	110
DY	3.1	2.2	2.4	2.7	2.9
EV/EBITDA	10.8	13.8	9.7	8.4	7.1

Recommendation	SELL
NSX Code	NBS
Market Cap (N$m)	7751
Shares in Issue (m)	206.5
Free float (%)	51
P/B (x)	6.6
52 week high	3753
52 week low	2787
Expected Total Return (%)	-11.6

Source: NBS, IJG

FY17 Results

Namibia Breweries (NBS) released results for the year ended 30 June 2017. The results reflected robust operational performance with margins continuing to improve. Revenue for the year was up 11.7% y/y and operating profit increased by 13.0% y/y. Basic EPS **decreased** by 14.5% y/y to 154.2c, due to the losses in the associate, while HEPS **increased** by 23.6% from 185.7c to 229.6c. Final /Interim dividends increased by 5.0% to 84 / 42 cps.

Sales and Volumes

Revenue growth was primarily driven by an increase in volumes exported to South Africa. Namibian beer volumes declined by 3%, while beer volumes exported to South Africa increased by 46%. Robust overall volume growth of 8% was achieved for the period during tough economic conditions.

Heineken South Africa

Namibia Breweries' associate, Heineken South Africa continues to deliver operating losses. The loss from the associate was larger than we expected at N$159.7 million. Additionally, an audit adjustment and impairment of assets and liabilities resulted in a further loss of N$54.8 million. These losses were partially offset by the recognition of a deferred tax asset of N$58.8 million bringing the net equity loss from associate to N$155.7 million.

Exports to South Africa increased by 46% pointing to growth in volumes sold through Heineken SA. These volumes were produced by the Namibian plant which indicates that the Sedibeng Brewery struggled to meet demand. This seems to be as a result of plant capacity being allocated to other products due to the unexpected growth in demand for NBS products. As such we assume that the volumes exported to SA in FY17 will be produced at Sedibeng in FY18 in an effort to gain operational efficiency. NBS management have indicated that operational breakeven is expected in CY18 and a marginal net profit in CY19. This has had a tangible effect on our valuation.

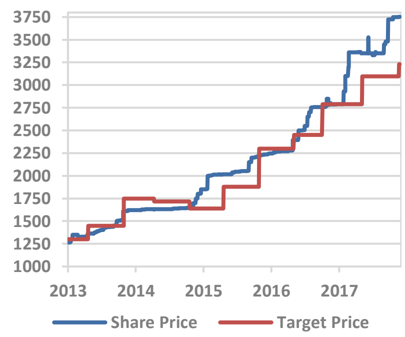
Export Markets

Total beer volumes sold to export markets grew by 2%. Volumes in Tanzania, NBS biggest export market, increased for the fourth straight year. Volumes in trading markets remained flat year on year.

Valuation

We value NBS using a combination of an EV/EBITDA multiple and discounted cash flow analysis on a 50/50 weighting. The first five years are explicitly modelled and thereafter a terminal value is used. We use an exit multiple of 9.5x based on the average EV/EBITDA multiple for smaller African breweries, a required rate of return on equity of 13.95%, based on a risk-free rate of 10.95% and an equity risk premium of 3.0%, and a long-term sustainable growth rate of free cash flows of 8.0%. Based on these assumptions and our forecasted cash flows for NBS, we have set a target price of N$32.30. As a result of the target price being substantially below the current price, **we maintain our SELL recommendation.**

NBS Share Price vs Target Price



Dividends

Notice is hereby given that an interim dividend of 42 cents per ordinary share was declared for the period ended 30 June 2017.

- Last day to trade: 6 October
- Ex-date: 9 October
- Payment date: 10 November

Global and Regional Trends

The global market for beer continues to post low growth figures on average, with mixed performance in the various regions. Anheuser-Busch Inbev (ABI) recorded total volume declines of 1.2% in 3Q17, while Heineken NV (HNV) reported consolidated beer volume growth of 2.6% in their 2017 half year results. ABI recorded its strongest volume growth in Latin America South (Argentina, Chile, etc), while Heineken's strongest regional volumes growth came from Asia Pacific.

Volume growth for many of the world's largest beer brands has been relatively slow for a number of years as the emergence of the craft beer industry coincided with health and wellness trends tending toward lower alcohol consumption. Craft beer has gained market share in markets like North America and Europe, effectively establishing a super-premium segment. The US Brewers Union estimates that craft beer had captured approximately 11% of the US market by 2014, leading to mainstream breweries such as Anheuser-Busch venturing into this space through acquisitions. Health and lifestyle trends continue to see strong support for beers and near beer beverages that are lower in alcohol and calories. As such brewers have needed to adapt and expand offerings into these segments of the market.

Rank	***Beer Brand***	***Current Owner***	***2015 (Hectolitres)***	***2016 (Hectolitres)***
1	Snow	China Resources Enterprises	105 100 000	105 600 000
2	Bud Light	ABI	48 500 000	46 900 000
3	Budweiser	ABI	44 600 000	46 700 000
4	Tsingtao	Tsingtao Brewery Company	50 100 000	45 900 000
5	Skol	Carlsberg/ABI/Unibra	38 400 000	36 400 000
6	Yanjing	Yanjing Brewery	33 900 000	32 300 000
7	Heineken	Heineken	30 900 000	31 900 000
8	Harbin	ABI	28 400 000	29 300 000
9	Brahma	ABI	28 000 000	27 100 000
10	Corona Extra	ABI	22 100 000	24 000 000
			430 000 000	426 100 000

Source: *thedrinksbusiness.com*

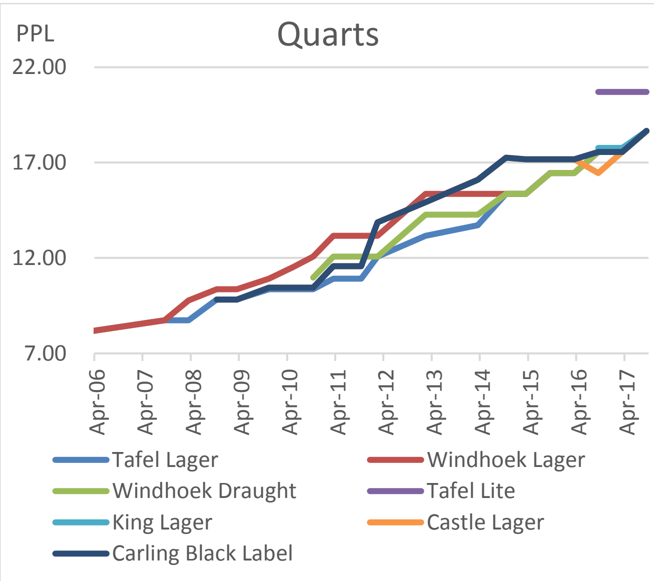
Craft beer has grown especially popular with younger consumers and this is evident in South Africa with over 160 craft breweries estimated to be in operation. These beers often compete in the same premium market segment of the South African market that Namibia Breweries (NBS) and Heineken compete in. While craft beers are sometimes viewed as only eating into the premium segment of the market, evidence suggests that craft beers also contribute to expanding the market. Younger consumers, millennials in particular, enjoy the choices and bold flavours that craft beers offer. Thus, along with expanding offerings into ciders and malted drinks, many mainstream brands have been acquiring or adding craft beers to their product offerings. Heineken South Africa (NSA) and NBS have ventured into Stellenbrau and Cammelthorn for this reason.

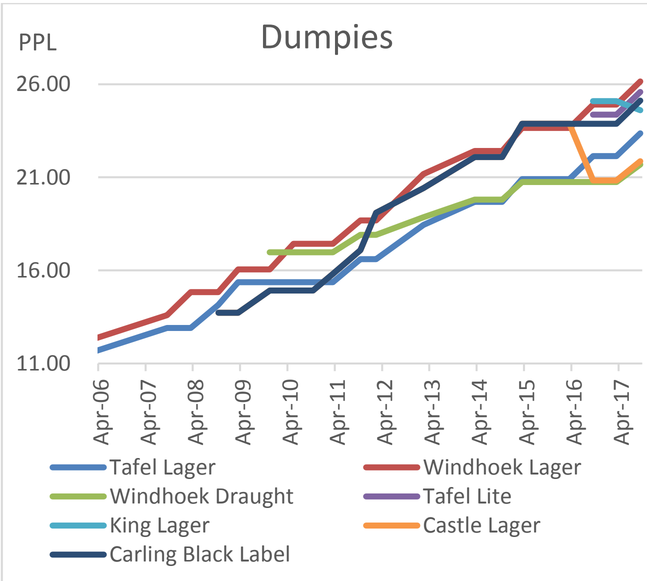
Pricing and Competition

	Windhoek Lager		Tafel Lager		Black Label		Castle Lager	
	N$/l	y/y % change	N$/l	y/y % change	N$/l	y/y % change	N$/l	y/y % change
Quarts	18.65	6.3%	18.65	6.3%	18.67	6.3%	18.67	6.3%
Euros	20.46	4.3%	20.46	4.4%	-	0.0%	-	0.0%
Dumpies	26.15	5.0%	23.36	5.6%	25.12	5.2%	21.88	5.0%

The latest wholesale prices display relatively consistent price increases for both NBS and Castle products. Prices for quarts, on a per litre basis, rose by 6.3% for the four large volume beers listed above. Quarts make up the majority of volumes sold in Namibia, with Tafel lager by far the largest volume contributor in the Namibian market. The wholesale prices of Windhoek Lager, Tafel Lager, Windhoek Draught, Castle Lager and Black Label quarts are, as near as makes no difference, now equal. Thus Castle Lager quarts are no longer priced to undercut the NBS products in the mainstream market. This suggests that the Castle Brewery at Okahandja is producing at, or near full capacity, and has achieved their targeted market share.

Castle Lager dumpies are however still priced below that of Tafel Lager. Castle is the beer picked to increase SAB/ABI's market-share in Namibia as it is priced significantly below Black Label. On a price per litre basis Windhoek Draught dumpies are slightly cheaper than Castle Lager making it the cheapest beer in this space. Windhoek Draught is sold in 440ml dumpies and thus the slight price per litre advantage may not be perceived as such by the customer. The same method of price discrimination is evident in the 660ml Tafel Lite quarts.





From a market share perspective it is reasonable to assume that the SAB/ABI products have achieved full capacity at the CBN brewery and with that a 15-20% market-share in Namibia. Thus market-share fluctuations in the future are likely to be marginal. As far as Namibia is concerned volume growth is not expected to be rapid due to the already high per capita consumption (Kirin company). BNS management expect volume growth of 4% to 6% over the next five-year period contingent on economic performance. The current duopoly should not result in excessive price competition if we correctly assume that the

CBN brewery has maxed out capacity for now. Our calculations estimate current production from the CBN brewery at around 240,000 hectolitres.

The Namibia breweries plant was developed to produce large amounts of a small number of different products. This is likely part of the success in Namibia. However, with consumer demands changing and variety becoming increasingly important a plant that is optimised to deliver large amounts of specific products (notably Tafel Lager) may reduce options for further product lines. A lack of market research does not allow us to conclude how much consumer preferences have changed in Namibia but the supply of South African craft beers has been increasing in various centres. NBS, with its dominant footprint, has distributed Stellenbrau and Cammelthorn to capture some of this high margin market.

"In South Africa, volume was up double digit with strong performance of Heineken as well as the successful launch of Strongbow. Amstel, Sol and Windhoek also saw good growth." – Heineken 1H17 results

The South African market seems to be going through and expansion of the premium segment. Heineken International reported double digit volume growth in 1H17 for Heineken, as well as Sol, Amstel, and Windhoek. Indeed, this is visible in the NBS numbers as exports to South Africa (up 46%) led revenue growth. ABI similarly posted decent figures in the premium segment with double digit Castle Lite volume growth while Stella and Corona delivered strong performance. Strong volume growth in the premium space by these large volume beers has taken place at the same time that craft beer volumes have been increasing. How sustainable this growth in volumes in the premium segment will be remains to be seen but it is evident that choice and competition will increase as well.

The number of different premium beer offerings available to consumers is growing in South Africa with Heineken and ABI launching global brands such as SOL, Corona, and Stella. Windhoek Lager seems to be holding its own and the strong growth in volumes for both NBS's Premium flagship beer and Heineken bode well for the future of the brands and the associate.

Heineken South Africa and Sedibeng

The joint venture between Diageo, Heineken and NBS was restructured during the previous financial year with Diageo exiting and leaving Heineken International and NBS with 75% and 25% of the restructured venture (Heineken South Africa). Heineken South Africa (HSA) includes the Sedibeng Brewery as well as the marketing, sales, and distribution operations in South Africa. The restructuring of the JV was a step in the right direction for Heineken and NBS as the Brandhouse distribution channel favoured Diageo and the distribution of spirits. Heineken South Africa is now free to focus on gaining efficiencies at the Sedibeng Brewery as well as growing the footprint of the products produced by the brewery. Thus, the sales and distribution operations should be more focussed on Heineken and NBS products than before.

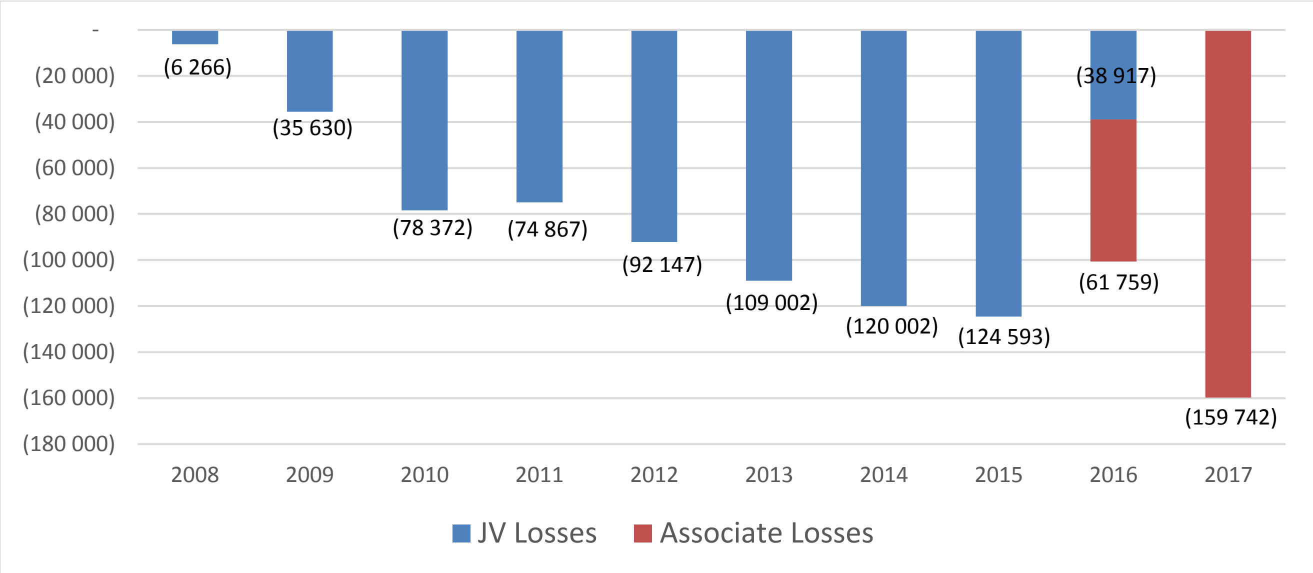
The Sedibeng Brewery has not reached operational breakeven yet. NBS management expects to achieve operational breakeven at some point next year (conservatively we expect this to be calendar year 2018). Breakeven on distributable profits is expected by calendar year 2019. Guidance on the performance of the Sedibeng Brewery and South African operations has been unreliable in the past but the restructuring of the joint venture has brought the necessary changes about that are likely to result in efficiency gains within marketing, sales, and distribution. We thus rely on this timeline in order to populate our valuation model.

That said, the restructured operations of Heineken South Africa do not ensure success in the highly competitive South African market. Heineken and NBS face many of the same challenges in the South African market as SAB/ABI face in the Namibian market with the Castle Brewery. ABI controls a very efficient distribution network that makes it very easy for the mainstream client to order stock. Building such a sales and distribution network is an expensive endeavour, as is maintaining it. ABI products are always available when the customer is in need of stock and this stock arrives at their doorstep, so to say (especially in the mainstream market). It is for this reason that Heineken South Africa (and previously DHN Drinks) is likely to struggle in the mainstream space. The scale efficiencies that ABI commands means that if necessary ABI could squeeze margins in order to keep out new entrants. This does not necessarily mean reducing prices. Just keeping prices where they are will put pressure on Heineken South Africa.

NBS and Heineken operate within the premium segment which offers higher margins and where it is easier to service the smaller number of distributors (wholesalers and retailers). Wholesalers and retailers have more floor space to be divided up between brands and service a wider variety of customer tastes than the mainstream and economy beer markets. Due to higher margins in the premium segment it is hotly contested though. Heineken has announced that it will be introducing SOL into this segment, while ABI will be introducing Corona and Stella Artois to complement a strong portfolio. In addition, and as noted earlier, craft beers have been gaining in popularity and effectively growing the size of the premium segment of the South African market.

NBS management previously estimated that between themselves and Heineken they hold 50% of the market-share within the premium segment of the South African market. This equates to roughly 8% of the approximately 30 million hectolitre market, or 2.4 million hectolitres. Management now point to HSA having 10% to 15% of the South African total market share (3.0 – 4.5 million hectolitres). While these are rough estimates it does point to capacity utilisation of under 50% of the Sedibeng Brewery if using the conservative 8% market-share figure (NBS management indicated that capacity has been upped to 5 million hectolitres at the Sedibeng Brewery from the previously reported 4.5 million).

The 10% to 15% market-share estimate would suggest that operating efficiencies should already have been gained and losses should have declined. It is also a big jump from last year's management estimate. This does not seem to be the case as losses from associate continue (previously JV losses - below). Thus, we revert back to the 8% (or 50% of premium segment) figures which explain some of the inefficiencies due to lack of scale.



As the premium segment is expanding through a range of different offerings it increases the complexity of the brewery operation. Management have also pointed to this complexity which stems from producing a wider range of products to service the diverse needs of the segment. We see challenges as HSA gains in footprint due to improved sales and distribution under the new company. Teething problems such as distributing the correct products in the correct packaging over this footprint have likely contributed to HSA's continued losses. The relatively new management and sales teams would also still have been learning the ropes. Should these complexities be ironed out, we believe that the operational and distributable breakeven timelines are realistic. As the teams in SA grow more accustomed to customer needs we are likely to see some progress with regards to efficiency gains. This does however not mean that market-share gains will be easy, with ABI's deep pockets likely to limit such gains through marketing, sales and distribution spend that HSA cannot match.

Revenue and Volumes

Namibia Breweries achieved revenue growth of 11.7% on total volume growth of 8.0%. Thus volume growth made up the bulk of revenue increases with price increases contributing modestly. Namibian beer volumes decreased by 3%, although NBS notes that this was offset by volumes exported to South Africa which increased by 46%. This 46% increase in exports to South Africa saw the SA beer volume contribution to total volumes increase from 20.7% in FY16 to 28.3%. Overall volumes grew more rapidly than beer volumes exported to markets other than SA (rest of world) which grew by 2% in FY17 and made up 4.7% of total volumes, down from 5% of total volumes in FY16.

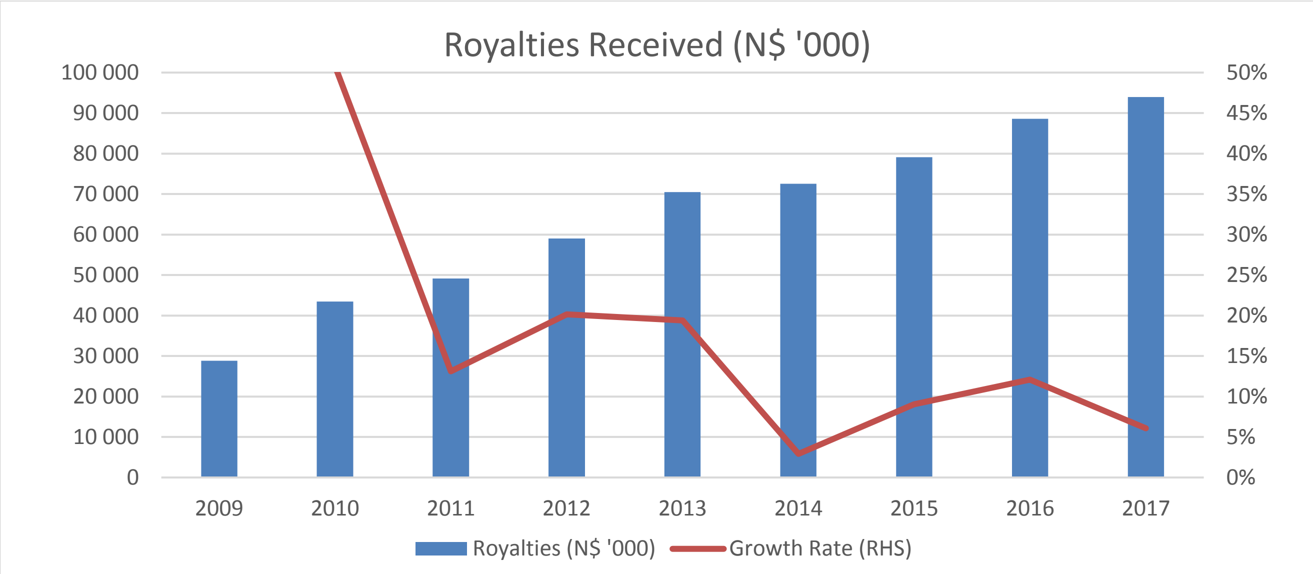
The decrease in Namibian beer volumes is largely due to the current economic climate. Unemployment has been increasing and the large layoffs in the construction sector in particular over the last 18 months have made an impact on sales of returnables (the mainstream market). The decline in volumes of 3% is reflective of good performance in light of these factors in our view. It is also due to the lacklustre recovery in the Namibian economy that we do not expect much growth in local beer volumes for FY18.

NBS's main competition in the local market is SAB/ABI with the Castle and Black Label brands. These brands are produced in Namibia at the 260,000 hectolitre Castle Brewery Namibia (CBN) at Okahandja. Assuming that the Namibian market is currently in the region of 1.7 million hectolitres (calculated via a mosaic of various estimates from different sources), the output of the CBN plant is 15% of the market size. NBS management previously indicated that their market share is estimated at 80% which suggests that the CBN plant is producing at, or near, maximum capacity, with imported beers contributing small volumes as well. This inference is supported by the increase in the price of Castle Lager (as seen above) which suggests that further market share gain through aggressive pricing is limited by production capacity at present. It should be noted that the CBN brewery is easily expandable by design.

The growth in volumes exported to South Africa is due to stronger than anticipated demand. This demand could not be serviced by the Sedibeng Brewery within the necessary timeframe. We assume that this is due to the plant setup which was not optimised for the growth in demand for NBS products. This volume growth is likely to be added to the Sedibeng volumes going forward and we are expecting to see a decline in export volumes to South Africa in the FY18 results. This will thus result in a decrease in revenue and operating expense in Namibia while contributing to smaller losses from the associate. As HSA is still loss making, the decrease in local volumes will be a drag on performance and should be reflected in earnings.

Volume growth in Namibia will be challenging in FY18, but management has indicated that they are expecting growth of between 4% and 6% in future years. By comparison South African volumes are expected to grow by 1.5% year-on-year (NBS FY16 report). Despite this lacklustre growth expectation for South Africa this is where volume growth lies for NBS according to management. NBS and Heineken believe that there is still room to improve market-share within the SA market. As mentioned above it does seem as though the premium segment is expanding as Heineken, NBS, and ABI are all reporting decent growth, not to mention the rise of craft beer.

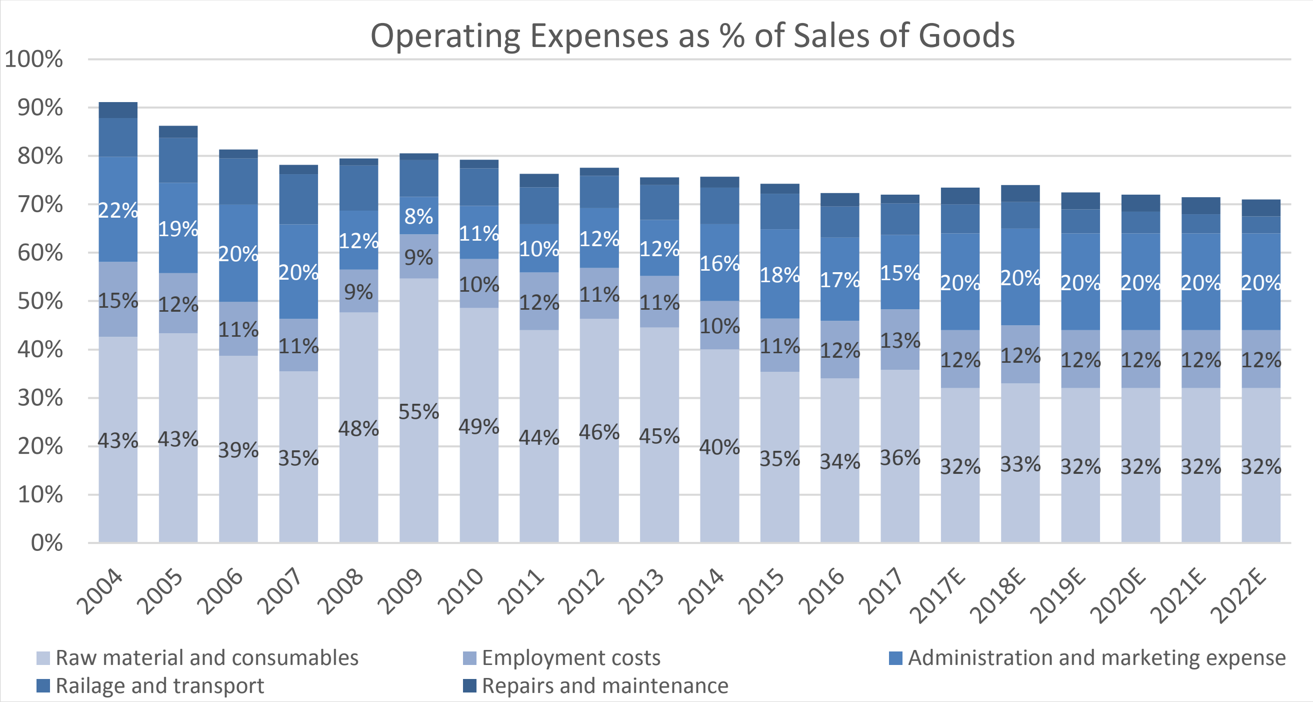
Our view is that NBS volume growth in South Africa will continue but will be relatively organic going forward if restricted to the premium segment. Establishing a foothold in the mainstream market will be very costly due to marketing, sales and distribution spend needed to gain market-share. That said, even a small foothold would be significant for NBS as currently Tafel is likely to be the only mainstream offering brewed at Sedibeng. The brewery is exploring the possibility of adding a returnable bottle line to the existing mix.



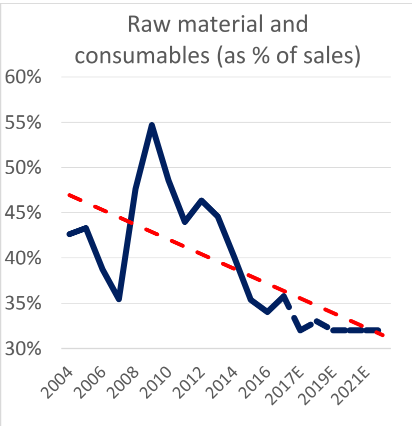
Royalties received from various export customers continues to grow steadily. The vast majority of these royalties come from HSA and are recorded under revenue on the income statement. NBS for a number of years (2013 to 2015) pointed to margins and royalty income from the JV (now associate) resulting in a positive return from South Africa overall despite losses from the JV and associate. The margin contribution referred to the margin on products produced in the Windhoek plant, which were then sold on in South Africa generating royalty income. The fact that the investment into South Africa has struggled so to produce positive returns serves as an indication of just how competitive the market is and how much MSD spend was needed to obtain the current footprint and market-share in SA. Whether the JV channel was the most effective method of growing to the current market-share is highly questionable though. The operating and net profit breakeven timelines highlighted elsewhere in this review should be monitored closely by shareholders.

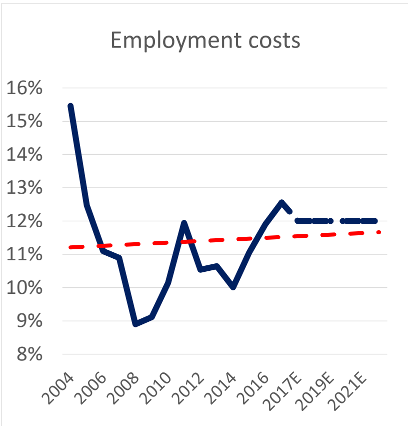
Operational Performance

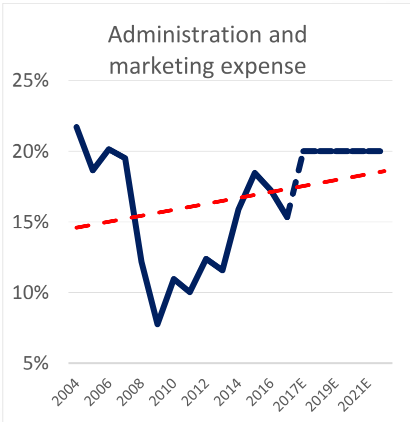
Operating performance has been improving for the most part since 2009. This is due to raw materials and consumables costs falling as a percentage of revenue. Administration and marketing expenses and employment costs have been increasing over the same period but these relative increases have been more than offset by the decreases in raw material and consumable costs relative to revenues.



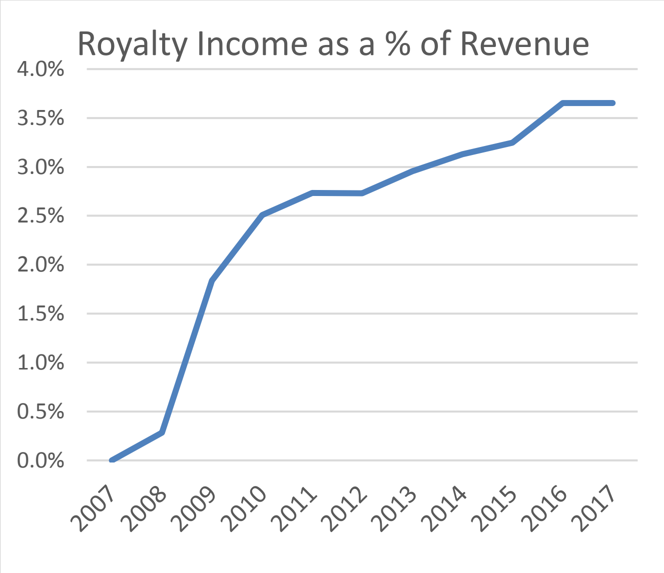
The reduction in costs of raw materials and consumables stems from efficiency gains in the production and packaging lines. NBS continues to work on gaining these efficiencies and the effort shows. The added export volumes during the period no doubt contributed to the further widening of the operating margin in FY17. The operating margin thus improved to 22.6% from 22.3% in FY16 and 20.8% in FY15.

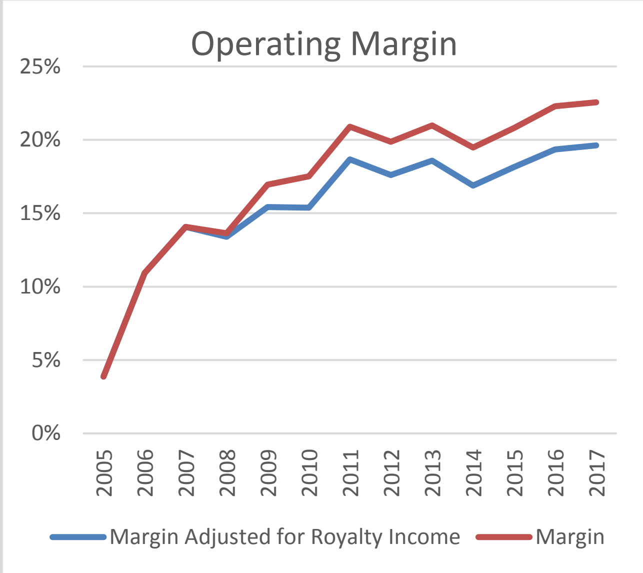






Royalty income is recorded under revenue and as such has contributed to the widening margin as there is no corresponding increase in raw material costs. The below figures indicate the royalty income growth when compared to revenue and the increase in the operating margin explained by royalty income. The growth in operating margin during the period between 2014 and 2016 was aided by growing royalty income but did not stem from this exclusively, pointing to the aforementioned efficiency gains.





Valuation

We continue to value NBS using a combination of an EV/EBITDA multiple and discounted cash flow analysis on a 50/50 weighting. The first five years are explicitly modelled and thereafter a terminal value is used. We use an exit multiple of 9.5x based on the average EV/EBITDA multiple for smaller breweries in Africa, a required rate of return on equity of 13.95%, based on a risk-free rate of 10.95% and an equity risk premium of 3.0% and a long-term sustainable growth rate of free cash flows of 8.0%. Based on these assumptions and our forecasted cash flows for NBS, **we have set a target price of N$32.30**.

The cash flow forecasts used in the target price calculation assume that operating breakeven at Sedibeng is achieved in CY18 and that a small net profit is achieved in FY19, as per management guidance. Furthermore, our forecasts assume that no further equity injections into Heineken South Africa will be necessary over the next five years. As a result, free cash flows are expected to improve. Our forecasts keep market-share relatively stable in South Africa and Namibia as per our view that growing market-share will remain challenging. We assume that South African total beer volumes will grow organically over the period.

Upside scenarios to our target include market-share gains in South Africa and with that efficiency gains at Sedibeng. Our forecasts remain quite modest in this respect and thus leave much upside should operating margins reach current NBS levels. However, we see this scenario as highly speculative and contingent on the breakevens mentioned above.

As our target price is 14.0% below the current share price we maintain our **SELL** recommendation on NBS.

Summary of Income Statement

N$'000	2015	2016	2017	2018E	2019E	2020E
Revenue	2 434 177	2 425 885	2 708 978	2 467 530	2 656 187	2 927 220
Operating expenses	(1 927 663)	(1 885 211)	(2 097 965)	(1 932 786)	(2 090 819)	(2 305 637)
Operating Profit	**506 514**	**540 674**	**611 013**	**534 744**	**565 367**	**621 584**
Finance Costs	(8 847)	(39 412)	(50 923)	(46 454)	(37 676)	(24 188)
Finance Income	22 000	18 315	18 304	22 931	26 797	29 682
Equity loss from JV-ongoing operations	(124 593)	(38 917)	-			
Equity loss from associate-ongoing operations		(61 759)	(159 742)	(103 370)	(4 369)	16 671
Equity loss from JV-deferred tax asset write back (/down)	-	89 212	4 025	-	-	-
Profit before income tax	**395 074**	**508 113**	**422 677**	**407 851**	**550 120**	643 749
Income Tax Expense	(136 092)	(135 643)	(104 249)	(130 512)	(176 038)	(206 000)
Profit attributable to ordinary shareholders	258 982	372 470	318 428	277 339	374 081	437 750
Shares in issue ('000)	206 529	206 529	206 529	206 529	206 529	206 529
Earnings per share (c)						
Basic EPS	125	180	154	134	181	212
HEPS	187	186	230	184	183	204
Dividend per share (c)						
Interim	37	40	42	46	50	55
Final	37	40	42	46	50	55
Total	74	80	84	92	100	110

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