



Nigeria's Flour Milling Industry

(An Analyst's Perspective)

Prepared by



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Macro-Economic Overview

Over the last few years, the Nigerian economy has experienced a series of reforms and restructuring of its key sectors. Such reforms include the financial, petroleum, power sector, among others. The financial sector reform has been the most noticeable as the banks and insurance companies have been mandated to recapitalise in line with government regulatory requirements. The telecommunications industry also experienced a major transformation when the general system for mobile telecommunications (GSM) was introduced in 2001. The deregulation of the downstream petroleum sector and privatization of many previously government-owned parastatals also represent some of the many structural changes that have been made in recent years.

The size of the Nigerian economy as measured by the country's GDP has increased by a compound annual growth rate (CAGR) of 20.68% (in nominal terms) between 2001 and 2006. A noticeable trend in the economy's growth pattern is the increasing contribution of the non-oil sector, particularly the agricultural and manufacturing sectors to the nation's GDP. It is expected that in the years ahead, other key sectors such as construction, consumer goods and tourism may begin to play more important roles in overall economic growth and development. As the on-going economic reforms continue to trickle down into other segments, and barring any unforeseen circumstances, we expect a much more balanced and self-sustaining economy in years to come.

Furthermore, consumer prices (year on year) declined sharply in 2005 due to the application of strict monetary and fiscal policy measures. With single digit inflation already being experienced, the economy is gradually moving towards a more stable and investor friendly position. This decline in inflation figures is further aided by the boost in agricultural production which has led to the general rise in the food supply resulting in reduced price level. Government's favorable monetary and fiscal policies have also contributed to the favourable consumer price index position.

The capital market has experienced a phenomenal growth over the past couple of years. The deluge of public offerings and rights issues have increased the overall level of activity in the market with volumes and values attaining unprecedented levels. The CBN enforced recapitalization drive (for banks) in 2005 is largely responsible for the bullish trend that has been experienced in recent times. With the Pension reforms having had its desired effect through the injection of fresh capital into the market by the PFAs and increase in private equity investments, the level of capital market activities have increase tremendously.

The country has experienced 8 years democratic rule for the first time in its recent history and for the first time in the post-independence period, political power has been successfully transferred from one civilian government to another. Furthermore, the country has retained its BB- credit rating by S&P and Fitch and has continued to receive rave reviews both as a result of its ongoing reforms and agendas. Sustainability of these initiatives will however remain a major challenge for the new administration in the years to come.

Nigeria's Flour Milling Industry

The Nigerian Flour Milling industry ('the industry') comprises a large number of players that can be segmented on the basis of their installed capacity. The top two players have an installed capacity of approximately 11,000 MT per day and control over 65% of the market. Given the industry's high fixed cost regime, profitability is largely dependent on the company's ability to increase volumes.

Shortages of cassava flour coupled with surging wheat prices at the world market are adversely affecting the operations of flour milling companies in the country. In the flour mills industry, almost 90% of the raw materials are imported because Nigeria's climate is not viable for production of wheat. Rising prices of wheat is therefore a major challenge being faced in the industry as a ton of wheat is currently priced at between \$180 and \$240.

Another major challenge is the problem of low capacity utilization and erratic power supply by the state owned Power Holding Company of Nigeria (PHCN). Rising prices of refined products has also led to an increase in general overheads as many manufacturing concerns are compelled to source alternative forms of power generation. These financial pressures invariably make the unit cost of doing business in Nigeria relatively expensive.

Wheat consumption in Nigeria at 69g per capita is currently among the lowest in the developing economies. With a population of 140 million as well as a projected population growth rate of 3%, there is still a lot of room for growth in flour consumption in the immediate future. This

to a large extent will however depend on certain exogenous factors such as inflation rate and availability of substitutes among others. Tariff policies and other government regulatory requirements may however hinder the supply capacities required to meet up to the expected increase in demand.

There are currently 21 flour milling companies in Nigeria. Unfortunately, about 80% of market share is dominated by only 6 of the 21 firms and as such there's a lot of disparity between the 'big players', the 'mid size firms' and the 'smaller companies'. The 6 major players by market share include:

- Flour Mills of Nigeria Plc
- Dangote Flour Mills Plc
- Ideal Flour Mills Ltd
- Honeywell Flour Mills Ltd
- Standard Flour Mills Ltd
- Crown Flour Mills Ltd

As a result of the strong hold of the total market by the 'big 6', there are 'invisible entry barriers' for prospective and aspiring flour millers. Keen competition exists only within the various tiers of the market with occasional movements between the small and mid tiers. There however exists a wide gap between the top tier category and the other companies in the sector.

The Flour Milling industry in Nigeria has a total installed capacity of over 22,000 metric tones with Flour Mills of Nigeria controlling about 38%. Other top producers by installed capacity include Dangote Flour Mills (18%), Honeywell, Ideal Group and Crown Flour with 7%, 14% and 8% respectively.

Industry Characteristics

The Nigerian Flour Milling Industry is characterized by many key features which distinguish it from other sectors of the economy. With turnover and earnings driven primarily by market share and capacity utilisation, the major determinant of success among its players is organic growth. A summary of the said features include:

Stiff Competition

The level of competition that exists within the industry is extremely keen. With the success of each individual company hinged on its ability to gain market share, industry players go through various lengths to increase capacity. Also, being an oligopoly the pricing is determined by the Flour Millers Association who would determine a 'fixed' price which the producers are not allowed to exceed. This 'sticky' price is however often violated especially by the companies which control reasonable share of the market.

High Volumes

The flour Milling Industry is volume driven with most of the producers scrambling to get increased capacity in order to boost production and sales. Due to high overheads as a result of heavy cost burdens, margins within the sector are relatively thin and as such earnings are determined by ability to increase sales. Therefore, the more profitable firms are those that are capable of out-producing the competition while keeping costs relatively stable.

Heavy Cost Outlay

The Flour Milling Industry is largely dependent on imported inputs. The basic raw material for flour processing is wheat

and it is estimated that about 97% of the wheat that is used by flour milling companies is imported. With high tariffs being imposed on imports, the cost of producing flour in Nigeria is very high. Many prospective companies are either forced out of business or have to grapple with very thin margins and therefore cannot compete effectively.

Seasonal

The existence of seasonal variation is prevalent in the industry. Demand for wheat based foods is usually higher in the dry season (between March and September) while the wet season is characterised by demand for other substitute foods such as maize, groundnuts etc. These foods are cheaper and are more readily accessible and therefore in higher demand when available. The strategy therefore is to take advantage of the 'peak periods' by aggressively growing volumes while reducing their outputs during the 'off-peak' periods in line with forces of Demand and Supply.

Price Sensitive Demand

Being a staple food with many substitutes within the consumer goods industry, the products are characterised by high elasticity of demand. Any slight increase in price could lead to a higher decrease in quantity demanded as consumers will instantly shift their preference to other cheaper substitutes. Also, quality control standards are a key feature of the flour milling industry with producers constantly improving on the quality of their products in order to retain customers. The demand for flour is therefore dependent on several factors such as quality, price of substitutes, seasons as well as other exogenous factors.

Critical Success Factors

Capacity

One major critical factor for the success of flour millers is capacity. Being a volume driven market, the ability to constantly increase its production capabilities clearly distinguishes the more successful players from the less successful. The ability to increase capacity is also directly related market share, ultimately leading to greater output and profitability.

Marketing Strategy

Aggressive marketing is a significant factor for the success of flour millers. Being a manufacturing related industry with keen competition among its players, large resources should be deployed towards promotions, advertisements and general publicity. Various media for marketing are usually deployed such as print (newspapers and magazines), electronic (TV, radios and internet) as well as billboards and sponsorships of events /programmes. All these efforts create awareness in the minds of consumers, invariably leading to greater patronage.

Adequate Distribution

An effective and efficient distribution network is a key requirement for the success of flour millers in Nigeria. Since flour is consumed in virtually all areas of the country, it is pertinent that the end product gets to the final consumer as at when needed. Also, the demand for flour is heavy in certain areas and as such producers should ensure a higher preference in such areas. Adequate distribution network therefore compliments the productive and marketing strategies of the companies.

Good Management

Just like in any other industry, an essential ingredient for success lies in the quality of its management team. The track record, experience and competence of top management determines to a large extent the ability to grow volumes and margins. Most of the flour milling companies are owner managed and so it bestows on the owners to clearly distinguish family from business. Also, competent staff should be employed in strategic units to ensure a positive impact on the company's bottom line.

Adequate Storage Facilities

Wheat is essentially a perishable commodity, therefore adequate storage remains a key success factor. With proper storage in place, losses and wastages due to spoilage and deterioration will be reduced to the bearest minimum. With companies incurring high cost outlays due to overheads from distributing, marketing and other miscellaneous costs, reduction of wastages will greatly help reduce overall cost burden and help improve profitability. Storage Facilities should therefore be situated close to distributors in order to reduce turnaround time and to save costs. In addition to the quality of the facilities, they should also be kept safe to prevent losses from theft and pilferation.

Pricing

Pricing within the flour milling market is regulated primarily by the Flour Millers Association. However, the big players prefer to set prices which are higher than the fixed price in order to increase their margins and grow profits. Since costs are very high, most producers usually make the 'extra cash' through optimal pricing of their products.

Challenges & Risk Factors

Regulatory and Operating Environment

Due to the strict and highly regulated operating environment in which flour millers operate, import duties, levies, taxation and other encumbrances impose heavy burdens on manufacturers thereby increasing overall cost of production. Such heavy overheads reduce producers' overall margins.

Lack of Sufficient Infrastructure

The problem of infrastructure continues to be the bane within the real sector of the economy. With erratic power supply from the Power Holding Company of Nigeria (PHCN) as well as lack of adequate amenities such as water supply and good roads, distribution and marketing costs are continually on the increase. Since flour millers require constant electricity to run their heavy duty machinery, its inadequacy and/or ineffectiveness imposes heavy financial burdens.

Low Demand for Wheat

Comparatively, demand for wheat in Nigeria is very low. Official statistics suggest that at 69g per capita, wheat consumption in Nigeria (relative to its 2006 population figure of 140 million) is below that of other developing economies such as Syria (490g), Turkey (484g), Chile (370g), Egypt (397g), Argentina (344g) and South Africa (318g) with much less population headcount. This demand inadequacy creates supply gaps especially in certain areas where demand is extremely low.

Continuity

Most flour milling concerns have issues of continuity since a large portion of their

equity contribution is dependent on single individuals. Only 3 of the 21 flour milling companies are quoted while the 18 private companies are characterised by sole ownerships by key men. As such, the instance of death or incapacity of the individual owners renders the companies concerned vulnerable to possible financial crises and/or liquidation.

High Cost of Operations

Even though the industry is highly competitive with free entry and exit, the existence of high initial set-up costs means that only high networth individuals and/or institutions have access to the financial capital required to run the business. Also, the high cost structure and capital intensive nature of flour milling imposes huge economic difficulties for prospective and existing manufacturers.

Foreign Exchange Fluctuation

Due to poor climatic conditions, majority of the wheat used by local manufacturers is imported especially from countries like the US and Brazil. Such practices create foreign exchange risks as currency volatility sometimes works against the producers. However, the recent appreciation of the naira against the dollar seems like a good omen which would help hedge against such risks.

Inflationary Pressures

In the past, inflationary pressures have been a major impediment to the growth of producers. Official figures from the Federal Office of Statistics (FOS) suggest that the consumer price index has been on the rise for the few years. However, due to Nigeria's economic recovery programme, inflation is now on a steady and consistent decline having attained single digit figures in recent times.

Key Players

The flour milling industry is a highly competitive one. However, the competition is prevalent among the top echelon with the 6 largest companies controlling over 80% of market share. Being a volume driven market, with earnings dependent on the ability to produce in large quantities, the strategy for its major players is to continually increase capacity to meet the ever growing demand. As a result of these, entrance into the highly capital intensive industry is dependent on the ability of prospects to build the required capacity needed to survive and compete. Also, the requirements of efficient distribution networks, marketing strategy and competitive pricing makes it more difficult for the smaller concerns to break into the 'league of the big players' with many of them forced out of business due to various inadequacies.

A close look at the top players within the industry reveals that many of them are still privately owned and characterised by 'one man' ownership structures. Such tight holdings create 'key man risks' and as such increase their perceived risk profiles. Alhaji Aliko Dangote (Dangote Flour Mills), Oba Otudeko (Honeywell Group) and George Coumantarous (Flour Mills) are some of the personalities behind the top flour mill producers. Others include Alhaji Arisekola Alao of Lister Flour Mills and Chief Bode Akindele of Standard Flour Mills. Also, majority of the companies have large foreign interests especially among the Lebanese, Greek-Americans and Americans. Most of the top companies are parts of business groups with other activities that include telecommunications, oil and gas and cement manufacturing.

Currently, the largest milling company in Nigeria is Flour Mills of Nigeria Plc with an installed daily capacity of over 4,500 tonnes. The company is however highly diversified with income streams along the lines of flour milling, bag manufacturing (through its subsidiary - Bagco), port operations, cement manufacturing and trade, fertilizer blending and agricultural business. The company also fully owns a publicly quoted flour milling company – Northern Nigerian Flour Mills (NNFM). With its 48 years of experience, the group can leverage on its experience, reputation as well as position as the industry leader in terms of turnover and capacity.

Followed closely behind is Dangote Flour Mills (DFM) with an estimated daily capacity of 4,000 tonnes. The company, a subsidiary of Dangote Industries Limited recently listed by introduction 5 billion shares on the floor of the Nigerian Stock Exchange after a highly successful public offer for sale. Dangote Flour is structured around its fully owned subsidiary companies – Dangote Agro Sacks and Dangote Pasta. DFM's business philosophy, in line with that of its parent company, is to occupy dominant presence in any sector in which it operates. It has therefore committed huge resources towards increasing capacity. Some of its efforts have already started yielding benefits as the company has recorded huge growth in recent times.

Crown Flour Mills, owned by Chief Maan Labadidi is a highly diversified company with interests in telecommunications, fisheries, shipping, banking and industrial bulk haulage. The company has an installed capacity of about 1,100 tonnes per day and is one of the major players in the flour milling industry.

Flour Mills of Nigeria Plc

Current Price (N) ¹	105.51
Shares Outstanding (bn)	1.55
Market Capitalisation (N'bn)	163.86
Trailing PAT (N'bn)	7.39
Trailing P/E ratio (x)	22.17
Trailing EPS (N)	4.76
Expected PAT (N'bn)	1.2
Forecast P/E ratio (x)	18.62
Forecast Earnings Yield (%)	5.4
Forecast Dividend Yield (%)	2.7
6 Month Target Price (N)	130
12 Month Target Price (N)	150

Recommendation

Short Term

BUY

Long Term

BUY

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Company Profile

Flour Mills of Nigeria Plc ('Flour Mills' or 'the company') was incorporated in 1960 and listed on the floor of the Nigeria Stock Exchange in 1978. The company has a diversified income base with its major activities spanning flour milling, pasta production, cement manufacturing, port operations, bags manufacturing and agricultural business amongst others. The largest contribution to its bottom line however comes from its cement manufacturing business as it contributes an estimated 49% while that of Flour Milling is estimated at 30%.

Flour Mills currently has an ownership base in excess of 60,000 shareholders while its market capitalisation of N163.86² makes it the fourth largest company in the consumer goods sector by market cap. The company is however the largest in its sector by turnover with an excess of N105.6 billion as at FYE 2007. Profit after Tax of N7.4 billion also ranks it as the industry leader in terms of earnings capacity.

The Flour Mills group is made up of 7 subsidiary companies which include Nigerian Bag Manufacturing Company (BAGCO), Northern Nigeria Flour Mills Plc (NNFM), Niger Mills Company Limited, Golden Pasta Company Limited, Golden Shipping Company Nigeria Limited, Southern Star Shipping Company Limited, Niger Mills Company Limited and Apapa Bulk Terminal Limited. One of its subsidiaries, BAGCO recently approached the capital market to raise N7 billion through an IPO for subscription while NNFM is an existing quoted company.

¹ All prices are as at 5th March 2008

² Based on prices as at 5th March 2008.

The company also has interests in other companies including Maiduguri Flour Mills Limited, United Cement Company Limited and Kaboji Farms Limited. Flour Mills can therefore leverage on the strengths of its subsidiaries and affiliate companies to diversify and grow income and asset base.

The company's product portfolio can be broadly categorised into 5 divisions, namely:

- Foods (Wheat & Pasta Products)
- Packaging
- Fertilizer
- Cement Manufacturing
- Shipping and Port Operations

The wheat category of the foods division consists of household names such as 'Golden Penny Flour' and 'Golden Penny Semovita' while that of packaging is handled by industry leader BAGCO. The bag manufacturing concern currently controls an estimated 35% of total market share and is expected to grow phenomenally once the proceeds of its recent IPO are utilised. The Cement Manufacturing arm of the company is known for its production of Burham Cement. With emerging opportunities in the cement industry and the increasing contribution of cement production to the company's revenues, we expect the company to continue to strengthen its competitive advantage in this core business area.

Flour Mills is made up of 12 directors and 16 members of its executive management team. The company has its branches, subsidiaries and associated companies strategically located in all the geographical regions of the country.

Investment Strategy

Flour Mills is currently priced at N100.80. Year to Date, the company's share price has appreciated by 31.2% as compared with the NSE all share index of 11.09%. Its 52 week price history reveals that the stock has gained in capital appreciation by 44.24% while its price history from year 2007 to date shows an upward movement of 68.84%. This analysis reveals that although the stock might not be one of the fastest moving stocks by capital appreciation, it has a history of slow and steady growth in value.

Given its full year 2007 PAT of N7.4 billion, its trailing Earnings per Share (EPS) is N4.76. The company is therefore trading at multiples of 22.17x which compares favourably with the industry average (for the consumer goods industry³) of 35x. Based on its full year 2007 dividend payment of 90 kobo, and assuming they maintain a 50% dividend pay-out, we project that the company will declare a cash dividend of N2.13. This will in turn lead to a YE forecast dividend yield of 2.7% - above the industry average of 2.1%. Its Net Asset per Share of N9.80 is the highest in the industry.

Our Forecast statistics reveals a projected year end after tax earnings of N8.8 billion. Assuming the shares outstanding remains at 1.55 billion shares, its YE PE valuation stands at 18.62x, making it the cheapest stock amongst its peers. Utilising various methods of valuation such as earnings (P/E multiples) and Net Asset per share, we arrive at a fair value of N160. Based on the above analysis, we recommend the shares of Flour Mills as a **BUY** for investors with short and long term horizons.

³ Constituents include Dangote Flour Mills, Nestle, PZ, Cadbury and Dangote Sugar. NNFM was excluded due to is negative full year earnings.

Dangote Flour Mills Plc

Current Price (N)	45.89
Shares Outstanding (bn)	5
Market Capitalisation (N'bn)	229.45
Trailing PAT (N'bn)	2.1
Trailing P/E ratio (x)	109.29
Trailing EPS (N)	0.42
Expected PAT (N'bn)	4.6
Forecast P/E ratio (x)	49.7
Forecast Earnings Yield (%)	2.0
Forecast Dividend Yield (%)	1.1
6 Month Target Price (N)	30
12 Month Target Price (N)	35

Recommendation

Short Term

Long Term

SELL

HOLD

Analyst

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Company Profile

Dangote Flour Mills Plc ('DFM' or 'the company') commenced operations in 1999 as a division of Dangote Industries Limited (DIL). DFM was incorporated in 2004 after which it restructured in January 2006. The assets, liabilities and undertakings of the erstwhile flour division of the DIL were therefore transferred to Dangote Flour Mills Plc

The company has grown to become an industry leader with a market share in excess of 30% within a six year period. The company has two wholly owned subsidiaries which are:

- Dangote Agro Sacks Limited
- Dangote Pasta Limited

In line with DIL's business philosophy of establishing a dominant presence in any sector it operates in, these subsidiaries occupy leadership positions in their respective industries.

The company is in the business of flour milling, processing and marketing of branded flour. Its product portfolio comprises of Bread flour, Pasta Semolina and Wheat Offals. The company imports its principal raw material – wheat, from United States of America in shiploads of about 35,000 Metric Tonnes each.

To remain a market leader, the company will continue to implement its aggressive strategies to produce and sell significant volumes thereby ensuring sustainable profitability, as it is able to significantly reduce the fixed cost per unit of its products. DFM will focus on maximizing returns in products where it has some comparative advantage. DFM will also

continue to invest in high margin segments that are capable of delivering above average growth. The company also intends to explore identified new markets.

The company is planning an aggressive expansion strategy by investing in additional production plants and a mill. This expansion would afford the company the capacity to aggressively penetrate the lucrative export market, with encouraging government incentives.

As part of its competitive advantages, DFM uses state of the art equipments and a fully automated production process thereby optimizing and minimizing down time. The company also has a wide branch and distribution network with over 2000 distributors in various parts of the country. With an established brand name as well as a leverage on the expertise and experience of its parent company – DIL, DFM has in place a highly knowledgeable and experienced board and management staff with proven track record.

The major risk facing the company is its high debt financed capital structure. DFM's gearing ratio is above industry norms – leading to huge annual interest payments. The equity injection from its September 2007 IPO should however help correct this imbalance.

The Dangote group, founded by Alhaji Aliko Dangote, is a highly diversified business concern with interests in sugar refinery, pasta production, property, transportation, polythene bags, salt manufacturing, cement production, insurance brokerage, salt manufacturing, oil & gas, textile, shipping as well as haulage. The group has been in existence since 1976.

Investment Strategy

DFM was officially listed by introduction on the 4th of February 2007 at N15.00 and has gained 151% since then. The company approached the capital market in September 2007 with a public offer for sale of 1.25 billion ordinary shares (25% of its paid up share capital of 5 billion ordinary shares). The offer was over 600% subscribed making it one of the most successful public offers in 2007.

Based on its audited consolidated financials for the five year period ended December 31st 2006, the company grew its sales and asset base by Compound Annual Growth Rates (CAGR) of 34% and 30% respectively. During the same period, it however recorded declines in its Return on Assets (RoA), Profit margins as well as Return on Capital Employed (RoCE) while its Cost to Sales ratio increased from 71.27% in 2002, to 86.89% in 2006.

Based on a historical growth of 185% in its PAT and assuming the company maintains this trend, we consider the company's forecast earnings per share of N0.92 as achievable. The reporting accountants' report in their offer prospectus indicates that the company will start to pay dividends of 50 kobo from 2007 which will, in our estimation, lead to a dividend yield of 1.3% (at current market price). The forecast P/E valuation based on its forecast EPS would be 49.7x - making the stock fundamentally overvalued when compared to its YEF peer average P/E valuation of 35x. Its implied price will therefore be N32 which means that the stock is trading at a premium of 42% above its fair value. We therefore recommend a **SELL/HOLD** on DFM's shares for short and long term oriented investors respectively.

Northern Nigeria Flour Mills Plc

Current Price (N)	47.89
Shares Outstanding (million)	148.5
Market Capitalisation (N'bn)	7.1
Trailing PAT (N'm)	(104.4)
Trailing P/E ratio (x)	N/A
Trailing EPS (N)	N/A
Expected PAT (N'm)	114.1
Forecast P/E ratio (x)	62.3
Forecast Earnings Yield (%)	1.6
Forecast Dividend Yield (%)	0.96
6 Month Target Price (N)	45
12 Month Target Price (N)	65

Recommendation

Short Term	HOLD
Long Term	BUY

Analyst

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Company Profile

Northern Nigeria Flour Mills Plc ('NNFM' or 'the company') was incorporated on the 29th October 1972 and began milling and commercial operations in November 1975. The company was subsequently listed on the floor of the Nigerian Stock Exchange (NSE) in 1978. NNFM was the first flour milling outfit in Kano and has continued to maintain its competitive advantage as one of the fore runners in the northern region of Nigeria.

NNFM is a subsidiary of Flour Milling conglomerate Flour Mills of Nigeria Plc. The latter owns a majority stake in NNFM and has continued to nurture the growth and development of its subsidiary by providing financial backing and know-how transfer.

NNFM currently has a milling capacity of 1,750 tonnes per day which makes it one of the top northern millers by installed capacity. The company is reputed for producing household brands such as 'Golden Penny Flour' and 'Golden Penny Semolina'.

Investment Strategy

NNFM has gained over 73% in capital appreciation from January 2nd 2008 to date. The stock which recorded an FYE 2007 loss of N104.4 million is expected to declare a profit of N114m based on its Q3 interim PAT of N86 million. Our expected FYE 2008 P/E valuation therefore stands at 62.3x. NNFM is currently trading at its year high and is not expected to experience any major rallies until the release of its full year results. Based on the seeming turnaround in profitability of the company, we recommend its shares as a **HOLD/BUY** for short and long term investors.

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