

# Day Break

Monday, 11 March 2019

## COMPANY UPDATE

### D.G. Khan Cement Company Limited

Cement

Recommendation	NEUTRAL		
Target Price:	31-Dec-19	93.7	
Last Closing:	8-Mar-19	89.7	
Upside:	4.5		
Valuation Methodology:	Discounted Cash Flow (DCF)		
Time Horizon:	9M		

### Market Data

Bloomberg Tkr.	DGKC PA		
Shares (mn)	438.1		
Free Float Shares (mn)	219.1		
Free Float Shares (%)	50.0%		
Market Cap (PKRbn   USDmn)	39.3	281.4	
Exchange	KSE ALL		
<b>Price Info.</b>	90D	06M	12M
Abs. Return	(0.1)	(12.3)	(40.6)
Lo	79.7	79.7	79.7
Hi	100.8	111.1	171.6

### Key Company Financials

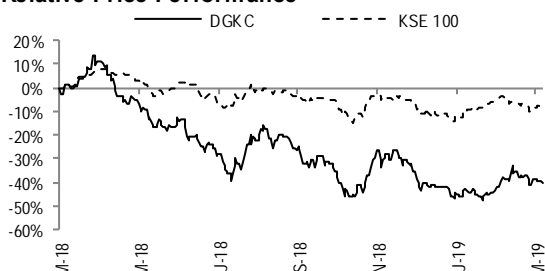
Period End: Jun

PKRbn	FY18A	FY19E	FY20F	FY21F
Total Revenue	30.7	41.1	43.2	43.2
Net Income	8.8	3.9	4.8	4.9
EPS (PKR)	20.2	8.9	11.0	11.1
DPS (PKR)	4.3	2.0	2.5	2.5
Total Assets	108	122	120	118
Total Equity	77	80	84	88

### Key Financial Ratios

ROE (%)	11.5	4.9	5.8	5.6
P/E (x)	4.4	10.1	8.1	8.1
P/B (x)	0.6	0.5	0.5	0.5
DY (%)	4.7	2.2	2.8	2.8

### Relative Price Performance



### About the Company

D. G. Khan Cement Company Limited is a public limited company incorporated in Pakistan. It is principally engaged in production and sale of Clinker, Ordinary Portland and Sulphate Resistant Cement.

Source: Bloomberg, PSX &amp; IGI Research

Analyst

**Muhammad Saad, ACCA**

Research Analyst

Tel: (+92-21) 111-234-234 Ext.: 816

muhammad.saad@igi.com.pk

## Cements

### DGKC: Earnings revised to reflect changes in accounting estimates; maintain 'Hold'

- We have revised our earnings estimates and target price for D.G Khan Cement Company Limited (DGKC) and reiterate our 'Hold' call.
- To recall the company reported 2QFY19 earnings of PKR 3.02/share (1HFY19 EPS: PKR 3.98), significantly higher to our and consensus expectations, which was totally uncalled for given weak cement sector fundamentals during the period and more so because of its poor 1QFY19 earnings display of PKR 0.95/share.
- As per the interim report, the management of the Company has extended the useful lives of majority of its fixed assets resulting in a lower depreciation charge of PKR 988mn during 1HFY19.
- The change in depreciation estimate has resulted in revised earnings forecasts. Our revised earnings forecasts for FY19E/20F/21F/22F have inched up by +30%/19%/16%/12% respectively to (PKR 8.91/11.03/11.13/12.73) /share. However, our Dec-19 based target price drops by 6% to PKR 94/share.
- We reiterate a "Hold" call on the scrip with a decline of 6% in our Dec-19 based target price of PKR 94/share. Though reduced depreciation will lift accounting earnings upwards, it will have a negative impact on valuation. However, this will allow the scrip to trade at an improved P/E.

### Reiterating 'Hold' stance on DGKC; Dec-19 TP: PKR 94/share

We have revised our earnings estimates and target price for D.G Khan Cement Company Limited (DGKC) and reiterate our 'Hold' call. To recall, the company reported 2QFY19 earnings of PKR 3.02/share (1HFY19 EPS: PKR 3.98), significantly higher to our and consensus expectations, which was totally uncalled for given weak cement sector fundamentals during the period and more so because of its poor 1QFY19 earnings display of PKR 0.95/share. However, recently available company's half yearly interim report reveals that the remarkable performance is reflective of management's change in accounting estimates pertaining to depreciation, while operational performance remains rather subpar.

### Depreciation estimates revised to boost accounting earnings; to reduce Dec-19 based target price by 6% to PKR 94/share

As per the interim report, the management of the Company has extended the useful lives of majority of its fixed assets resulting in a lower depreciation charge of PKR 988mn during 1HFY19. Though the change in depreciation estimate might be considered as management's concerted effort to expand earnings on the face of the Profit & Loss (P&L) Statement, given substantial depreciation cost from Hub Plant (South) is considerably eroding gross margins, it has a negative impact on the valuation of the scrip on a fundamental basis, reducing our Dec-19 based target price by 6% to PKR 94/share. However, it will allow the scrip to trade at an improved P/E, making it look better than previously.

### Earnings estimates revised; Change in depreciation expense to increase 4Yr avg. earnings by 19%

Accordingly, we update our earnings projection for the scrip based on the recent changes in depreciation estimates and our revised earnings forecasts for FY19E/20F/21F/22F have inched up by +30%/19%/16%/12% respectively to (PKR 8.91/11.03/11.13/12.73) /share. However, our Dec-19 based target price drops by 6% to PKR 94/share.

### Elevated production costs and expansion ancillary costs hamper 1HFY19 earnings performance; However QoQ earnings display appears quite impressive...

DGKC reported unconsolidated earnings of PKR 1.32bn (EPS: PKR 3.02) for 2QFY19 up by +48%YoY as against PKR 896mn (EPS: PKR 2.05) reported in the same period last year. This brings 1HFY18 earnings to PKR 3.98/share as against PKR 8.52/share, down by 53%YoY. However, the earnings surprise came from quarterly basis, wherein DGKC's EPS surged by a remarkable 3.2x, largely driven by improved gross margins - 19% as against 13% reported in the 1QFY19.

#### Exhibit: DGKC 1HFY19 result highlights - Unconsolidated

Period end (Jun) - PKRmn	1HFY19	2QFY19	1QFY19	FY18	4QFY18	3QFY18	2QFY18	1QFY18	FY17	FY176
Net Sales	19,767	11,581	8,186	30,668	7,293	7,612	8,236	7,527	30,136	29,704
<i>Net Sales Growth %</i>	<i>25%</i>	<i>-3%</i>	<i>-3%</i>	<i>2%</i>	<i>-3%</i>	<i>-4%</i>	<i>2%</i>	<i>14%</i>	<i>1%</i>	<i>14%</i>
Gross Profit	3,185	2,147	1,037	8,740	1,571	1,919	2,595	2,655	11,845	12,668
<i>Gross Profit Margins</i>	<i>16%</i>	<i>19%</i>	<i>13%</i>	<i>28%</i>	<i>22%</i>	<i>25%</i>	<i>32%</i>	<i>35%</i>	<i>39%</i>	<i>43%</i>
Sell. / Dist. & Admin	960	613	347	1,523	377	390	374	382	1,530	1,522
Other Op. Income	1,145	675	469	3027	1,388	446	708	485	2,118	2,379
EBIT	2,938	1,806	1,132	7,889	884	1,788	2,655	2,562	11,541	12,611
<i>EBIT Margins</i>	<i>15%</i>	<i>16%</i>	<i>14%</i>	<i>26%</i>	<i>12%</i>	<i>23%</i>	<i>32%</i>	<i>34%</i>	<i>38%</i>	<i>42%</i>
Finance Costs	1,348	736	612	519	201	125	104	89	383	130
Pre-tax Profits	1,590	1,070	520	7,370	682	1,663	2,551	2,473	11,158	12,481
Taxation	-152	-254	102	-1,468	-3,185	427	1,655	-364	3,183	3,691
<i>Effective Tax Rate (%)</i>	<i>n/m</i>	<i>n/m</i>	<i>20%</i>	<i>n/m</i>	<i>n/m</i>	<i>26%</i>	<i>65%</i>	<i>n/m</i>	<i>29%</i>	<i>30%</i>
Post-tax Profits	1,742	1,324	418	8,838	3,868	1,236	896	2,837	7,975	8,790
<i>Net Margin (%)</i>	<i>9%</i>	<i>11%</i>	<i>5%</i>	<i>29%</i>	<i>53%</i>	<i>16%</i>	<i>11%</i>	<i>38%</i>	<i>26%</i>	<i>30%</i>
EPS	3.98	3.02	0.95	20.17	8.83	2.82	2.05	6.48	18.20	20.06
DPS	-	-	-	4.25	4.25	-	-	-	7.50	6.00

Source: Company Accounts, IGI Research

No. of Shares: 438.1mn

### Earnings reflective of changes in depreciation estimates; not of operational performance...

Though earnings appear quite impressive on a quarterly basis, these are not reflective of actual performance of the Company but are rather subject to a material accounting adjustment made by management with respect to its depreciation estimates.

### Useful lives of major assets extended by two fold; annual depreciation expense to reduce materially

As per the foot note disclosures, the management of DGKC has extended the useful lives of its a) plant and machinery; b) factory buildings; and c) quarry equipment - during the period. With further probe with the management, it turns out that the Company has extended the useful lives of these assets by 2x (two folds). Provided that these assets represent almost 87% of the total operating assets of the Company (Book

value of operating assets as of Dec-18: 72.4bn, representing 60% of the total balance sheet), the management by doing so has curtailed its depreciation expense by almost 30%.

**Exhibit: Change in useful lives of material operating assets to reduce depreciation expense materially**

PKRbn	1Q'18	2Q'18	3Q'18	4Q'18	FY18	1Q'19	2Q'19	3Q'19E	4Q'19E	FY19E
Operating Fixed Assets (NBV)	30.8	30.3	30.1	47.1	34.6	72.9	72.4	72.0	71.7	72.2
Dep. based on Revised useful lives (A)	0.5	0.5	0.5	0.8	2.3	1.2	0.5	0.9	0.9	3.6
Dep. Charge Rate (annualized)	6.6%	6.7%	6.8%	6.6%	6.7%	6.4%	3.0%	5.3%	5.3%	5.0%
Dep. based on Prior useful lives (B)						1.2	1.2	1.2	1.2	5.0
Variance (B – A)						0.1	0.7	0.3	0.3	1.4

Source: Company accounts, IGI Research

**Valuation: Dec-19 based target price decreased by 6% to PKR 94/share; earnings based relative valuation metrics improved**

Since we have deployed a discounted free cash flow valuation methodology to value the scrip, changes in non-cash expenses, such as depreciation, do not directly alter our target prices. However, a reduced depreciation expense makes way for increased taxes and hence results in lower free cash flows, taking our Dec-19 based target prices down by 6% to PKR 94/share, as against our previous price target of PKR 100/share.

**Exhibit: Earnings estimates**

PKR/share	2016	2017	2018	2019	2020	2021	2022
EPS	20.1	18.2	20.2	6.9	9.3	9.6	11.4
EPS (revised)	20.1	18.2	20.2	8.9	11.0	11.1	12.7
Change %	0%	0%	0%	30%	19%	16%	12%
DPS	6.0	7.5	4.3	2.0	2.5	2.5	3.0
P/E (x)	4.5	4.9	4.4	13.1	9.7	9.4	7.9
P/E (x) (revised)	4.5	4.9	4.4	10.1	8.1	8.1	7.0
D/Yld. (%)	7%	8%	5%	2%	3%	3%	3%

Source: Company accounts, IGI Research

Albeit, the scrip's earnings based relative metrics, such as P/E, are to improve materially due to the management's change in depreciation estimates. Given, last day close price of PKR 89.67/share and a revised FY19E EPS of PKR 8.91, the revised P/E of DGKC now comes to 10x as against 13x had earlier EPS estimates of PKR 6.85 been used, improving the scrips metric by a substantial 30%.

**Recommendation**

We reiterate a **'Hold'** call on the scrip with a decline of 6% in our Dec-19 based target price of PKR 94/share. Though the acts of management will improve earnings performance of the Company on the face of the P&L, enhanced taxes due to reduced depreciation will reduce free cash flows on an overall basis. The scrip's revised P/E has now improved to 10x, however, it is still above the market P/E of 7.6x.

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**Time Horizon:** Dec – 2019

**Valuation Methodology:** The analyst(s) has used following valuation methodology to arrive at the target price of the said security (ies):  
(Discounted Cash Flow)

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IGI Finex Securities Limited

**Research Analyst(s)**

Research Identity Number: BRP009

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## Contact Details

### Research Team

Saad Khan	Head of Research	Tel: (+92-21) 111-234-234 Ext: 810	saad.khan@igi.com.pk
Abdullah Farhan	Senior Analyst	Tel: (+92-21) 111-234-234 Ext: 912	abdullah.farhan@igi.com.pk
Suleman Ashraf	Research Analyst	Tel: (+92-21) 111-234-234 Ext: 957	suleman.ashraf@igi.com.pk
Muhammad Saad	Research Analyst	Tel: (+92-21) 111-234-234 Ext: 816	muhammad.saad@igi.com.pk
Umesh Solanki	Database Manager	Tel: (+92-21) 111-234-234 Ext: 974	umesh.solanki@igi.com.pk

### Equity Sales

Faisal Jawed Khan	Head of Equities	Tel: (+92-21) 35301779	faisal.jawed@igi.com.pk
Zaeem Haider Khan	Regional Head (North)	Tel: (+92-42) 38303559-68	zaeem.haider@igi.com.pk
Muhammad Naveed	Regional Manager (Islamabad & Upper North)	Tel: (+92-51) 2604861-62	muhammad.naveed@igi.com.pk
Irfan Ali	Regional Manager (Faisalabad)	Tel: (+92-41) 2540843-45	irfan.ali@igi.com.pk
Asif Saleem	Branch Manager (RY Khan)	Tel: (+92-68) 5871652-56	asif.saleem@igi.com.pk
Mehtab Ali	Branch Manager (Multan)	Tel: (+92-61) 4512003	mahtab.ali@igi.com.pk
Zeeshan Kayani	Branch Manager (Abbottabad)	Tel: (+92-992) 408243-44	zeeshan.kayani@igi.com.pk
Ihsan Mohammad	Branch Manager (Peshawar)	Tel: (92-91) 5253035	ihsan.mohammad@igi.com.pk

### IGI Finex Securities Limited

Trading Rights Entitlement Certificate (TREC) Holder of  
Pakistan Stock Exchange Limited |  
Corporate member of Pakistan Mercantile Exchange Limited

### Head Office

Suite No 701-713, 7th Floor, The Forum, G-20,  
Khayaban-e-Jami Block-09, Clifton, Karachi-75600  
UAN: (+92-21) 111-444-001 | (+92-21) 111-234-234  
Fax: (+92-21) 35309169, 35301780  
Website: www.igisecurities.com.pk

### Stock Exchange Office

Room # 134, 3rd Floor, Stock Exchange Building,  
Stock Exchange Road, Karachi.  
Tel: (+92-21) 32429613-4, 32462651-2  
Fax: (+92-21) 32429607

### Lahore Office

Shop # G-009, Ground Floor,  
Packages Mall  
Tel: (+92-42) 38303560-69  
Fax: (+92-42) 38303559

### Faisalabad Office

Room #: 515-516, 5th Floor, State Life  
Building, 2- Liaqat Road  
Tel: (+92-41) 2540843-45  
Fax: (+92-41) 2540815

### Multan Office

Mezzanine Floor, Abdali Tower,  
Abdali Road  
Tel: (92-61) 4512003, 4571183

### Peshawar Office

2nd Floor, The Mall Tower,  
35 The Mall Saddar Cantt.  
Tel: (92-91) 5273035, 5223882

### Islamabad Office

Mezzanine Floor, Office 5, 6 & 7, Kashmir Plaza,  
Block- B, Jinnah Avenue, Blue Area  
Tel: (+92-51) 2604861-2, 2604864, 2273439  
Fax: (+92-51) 2273861

### Rahim Yar Khan Office

Plot # 12, Basement of Khalid Market,  
Model Town, Town Hall Road  
Tel: (+92-68) 5871652-3  
Fax: (+92-68) 5871651

### Abbottabad Office

Ground Floor, Al Fatah Shopping Center ,  
Opp. Radio Station, Mansehra Road  
Tel: (+92-99) 2408243 - 44

### Sialkot Office

Suite No. 10 & 11, 1st Floor, Soni Square,  
Mubarik Pura  
Tel: (+92-52) 3258028

IGI Finex Securities Limited

### Research Analyst(s)

Research Identity Number: BRP009

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