Day Break

Monday, 18 February 2019

Sector Update

Exhibit: IGI Sector performance relative to Benchmark KSE 100 Index

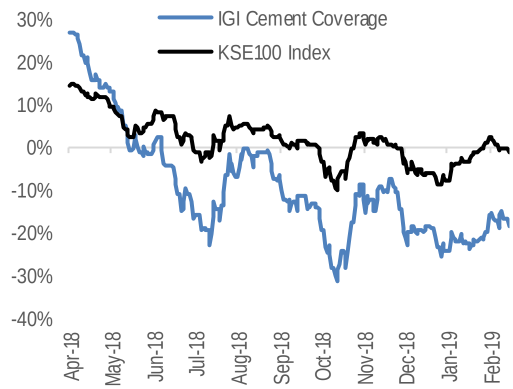


Exhibit: Landed cost of coal is falling despite sharp PKR depreciation.

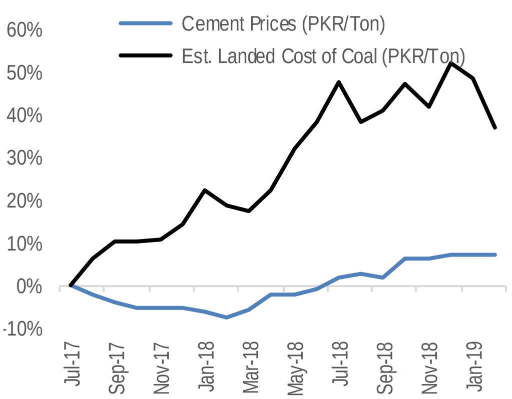
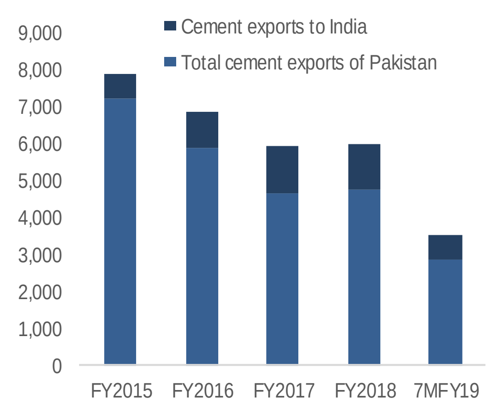


Exhibit: Cement exports to India, representing ~25% of total cement exports are expected to halt post Pulwama incident



Source: PSX, Bloomberg, PBS & IGI Research

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Cement

Volatile coal prices and the revocation of MFN status from India; MFN to have nominal impact

- Coal prices globally have remained on the high side for the last three years, having grown by an exorbitant 83% to FYTD average of USD 97/ton (average coal price FYTD)
- However, lately there have been some shifts in this norm, with prices being trimmed as high as 20% to USD 80/ton in the past five month alone.
- The sudden fall in prices have been largely drawn to a combination of built-up inventories of thermal coal by power producers in China and the arrival of lunar holidays therein coupled with reduced coal procurement from India due to lesser production of hot metals (steel) and volatility in commodity prices.
- Some experts take the recent price cut as a very temporary phenomena and believe coal prices are to rise again to levels above USD 90/ton once lunar holidays in China conclude, others expect them to remain in the current USD 80/ton range given China's sudden shift towards consumption driven policies in the recent period as against its historic investment driven style
- In the aftermath of the Pulwama attacks, Pakistan has lost its MFN status towards Indian exports. Though cement offtakes are largely dominated by local dispatches we do not expect a material damage.

Coal prices begin to melt over amid slowdown in Chinese investments; 20% decline in prices in the span of 5 months

Coal prices globally have remained on the high side for the last three years, having grown by an exorbitant 83% to FYTD average of USD 97/ton (average Richards Bay benchmark index coal price FYTD) as against average USD 53/ton back in FY16.

However, lately there have been some shifts in this norm, with prices having dropped as much as 20% to USD 80/ton in the past five month alone. The sudden fall in prices have been largely drawn to a combination of built-up inventories of thermal coal by power producers in China and the arrival of lunar holidays therein coupled with reduced coal procurement from India due to lesser production of hot metals (steel) and volatility in commodity prices.

Coal prices to hover between USD 75-95/ton in the medium term; market view lacking consensus

Although the picture appears quite rosy for the meanwhile, analysts have become more wary in determining where the prices will eventually settle in the medium term. While some experts take the recent price cut as a very temporary phenomena and believe coal prices are to rise again to levels above USD 90/ton once lunar holidays in China conclude, others expect them to remain in the current USD 80/ton range given China's sudden shift towards consumption driven policies in the recent period as against its historic investment driven style leading to lower hot metal production and lesser coking coal consumption. While proponents of the former corroborate their stance to stringent coal regulations being adopted worldwide driving coal consumers to a flight towards quality (high quality coal generates comparatively lesser pollution) and a decrease in coal mining licenses being issued by developed countries (example Australia) which in turn push prices of quality coal upwards, advocates of the latter place their bets on decreased hot metal production in China (World's largest coal consumer) and the arrival of fresh supplies of high quality coal from Russia and parts of Africa.

Coal assumptions intact; DGKC, MLCF and CHCC to perform better in declining coal scenario

Fuel costs, representing ~40% of the total cost of producing cement, comprise primarily of imported coal and as such are heavily affected by radical movements in the international arena. Since currently coal prices are very volatile and there exists a wide disparity among international coal analysts regarding where coal prices will eventually settle in the medium term, we maintain our coal assumption of USD (95/85/80)/ton for the time being. However we present an earnings sensitivity to variations in average annual coal prices as follows.

Exhibit:

Sensitivity of earnings to changes in coal prices

		FY19E	FY20F	FY21F
Coal Prices				
Current Assumption	USD/Ton	95	85	80
Revised Expectation	USD/Ton	90	80	75
Decline %		-5%	-6%	-6%

IGI Cement Coverage	Revised earnings trend				% change in earnings from current assumption			
	FY19E	FY20F	FY21F	TP	FY19E	FY20F	FY21F	TP
LUCK	37.26	39.72	43.37	607	4%	4%	5%	8%
MLCF	9.62	5.50	5.75	45	3%	8%	8%	-9%
KOHC	14.24	19.00	24.00	152	5%	5%	5%	35%
ACPL	17.97	26.05	27.88	243	9%	6%	6%	21%
CHCC	16.09	15.31	18.92	105	6%	10%	8%	14%
DGKC	7.66	10.22	9.80	101	12%	10%	3%	7%
FCCL	2.63	2.48	2.45	20	5%	6%	6%	8%
PIOC	6.79	15.92	12.80	70	5%	3%	8%	11%

Sources: IGI Research, PSX, Bloomberg & Company Accounts

Aftermath of Pulwama Attack; Pakistan's MFN status lost, Exports from Pakistan subject to outright duty of 200%.

In a recent turn of events, an unfortunate terrorist attack on Indian Occupied Kashmir killing more than 40 Indian armed forces has created a chaotic scene in the region. While banned terrorist outfits have already claimed responsibility for the attack, Indian Government has stressed Pakistan's role in the attack creating a rift among the foreign affairs of the two countries.

In a response, the Indian Government has revoked the 'Most Favored Nation' (MFN) status of Pakistan and has slapped an outright 200% duty on all exports from Pakistan. This is expected to materially hamper cement exports to India going forward making it totally commercially unviable given cement exports rank among top 5 exports to India and constitute around 25% of the total cement exports of Pakistan. Cement exports from Pakistan were subject to a modest 7.50% customs duty previously.

Exhibit:

Cement export to India

Period	Cement exports to India	Cement exports to rest of the world	Total cement exports of Pakistan	% of Exports to India
FY2015	696,337	6,498,732	7,195,069	10%
FY2016	992,631	4,879,973	5,872,604	17%
FY2017	1,253,208	3,410,361	4,663,569	27%
FY2018	1,212,771	3,533,256	4,746,027	26%
7MFY19	648,108	2,228,601	2,876,709	23%

Source: APCMA, IGI Research

Though cement exports currently represent a lower proportion of total cement offtakes since it is dominated by local dispatches, the impact won't be that much damaging enough. However, since BWCL, LUCK, DGKC and ACPL are major cement exporters to India, we expect nominal price correction in these stocks compared to other listed cement companies.

Recommendation

Since currently coal prices are very volatile and there exists a wide disparity among international coal analysts regarding where coal prices will eventually settle in the medium term, we maintain our coal assumption of USD (95/85/80)/ton for the time being.

Based on earnings sensitivity to changes in coal assumptions DGKC, CHCC and ACPL offer the highest upside potential, however, given current macro-fundamentals and the overall picture of the sector, we recommend LUCK as our preferred stock with PIOC, ACPL and KOHC as side plays.

Exhibit:

IGI cement coverage key investment highlights

		LUCK	MLCF	KOHC	ACPL	CHCC	DGKC	FCCL	PIOC
EPS	2018A	37.7	7.7	14.8	38.4	12.1	20.2	2.5	7.2
	2019E	37.8	10.3	14.9	16.9	17.4	8.8	2.8	6.7
	2020F	41.3	6.5	20.9	25.2	16.2	11.1	2.7	17.1
	2021F	42.7	6.3	25.1	23.7	16.1	10.5	2.3	12.5
	3Yr CAGR	4.3%	-6.6%	19.1%	-14.9%	10.1%	-19.6%	-2.3%	19.9%
EBITDA	2018A	18,094	8,542	4,599	3,917	3,588	10,194	5,785	2,819
	2019E	17,826	8,422	4,516	4,386	4,587	11,801	6,674	3,101
	2020F	18,598	10,553	4,828	5,491	6,886	11,690	5,949	4,137
	2021F	21,625	9,762	8,026	5,944	7,044	11,244	5,657	7,759
	3Yr CAGR	6.1%	4.6%	20.4%	14.9%	25.2%	3.3%	-0.7%	40.1%
	Target Price	602	44	150	239	101	100	20	69
	Upside	24%	-6%	71%	113%	31%	2%	-13%	53%

Source: Company Accounts, IGI Research

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Recommendation	Rating System
Buy	If target price on aforementioned security(ies) is more than 10%, from its last closing price(s)
Hold	If target price on aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
Sell	If target price on aforementioned security(ies) is less than -10%, from its last closing price(s)

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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