Day Break

Thursday, 04 October 2018

COMPANY UPDATE

Cherat Cement Company Limited
Cement

Recommendation		**BUY**
Target Price:		95.4
Last Closing:	3-Oct-18	80.0
Upside:		19.2
Valuation Methodology:		Discounted Cash Flow (DCF)
Time Horizon:		Dec-18

Market Data

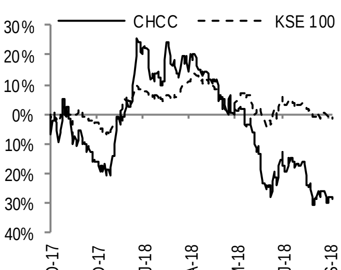
Bloomberg Tkr.	CHCC PA
Shares (mn)	176.6
Free Float Shares (mn)	106.0
Free Float Shares (%)	60.0%
Market Cap (PKRbn | USDmn)	14.1 | 114.6
Exchange	KSE ALL

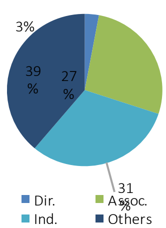
Price Info.	90D	06M	12M
Abs. Return	(11.9)	(40.7)	(28.6)
Lo	77.3	77.3	77.3
Hi	97.6	134.9	140.7

Key Company Financials
Period End: Jun

PKRbn	**FY18A**	**FY19E**	**FY20F**	**FY21F**
Total Revenue	14.4	20.8	23.8	23.0
Net Income	2.1	3.7	2.1	2.2
EPS (PKR)	12.1	21.0	11.7	12.6
DPS (PKR)	5.0	4.3	2.5	2.8
Total Assets	18.8	30.5	34.9	34.3
Total Equity	11.2	14.1	15.7	17.5
Key Financial Ratios				
ROE (%)	19.1	26.2	13.1	12.7
P/E (x)	6.6	3.8	6.9	6.4
P/B (x)	4.0	1.3	1.0	0.9
DY (%)	6.3	5.3	3.1	3.4

Relative Price Performance





About the Company

Cherat Cement Company Limited was incorporated in Pakistan as a public limited company by shares in the year 1981. Its main business activity is manufacturing, selling and marketing of cement. Company's current rated capacity is 1.1mn ton per annum, with a current market share of ~3%.

Source: Bloomberg, PSX & IGI Research

Muhammad Saad, ACCA
Research Analyst
Tel: (+92-21) 111-234-234 Ext.: 816
muhammad.saad@igi.com.pk

Cement

CHCC: Earnings revised; 'Buy' Intact

- We revisit our investment case on Cherat Cement Company Limited (CHCC) after incorporating FY18 accounts and changes in assumption post gas price hike, changes in sales price assumption and increase of monetary policy rate by 100bps.
- We had earlier anticipated CHCC's production line III to commence commercial operations post FY19, however, based on availability of updated information and changes of assumptions our earnings now stand at PKR 21/12/13 per share for FY19E,20F,21F respectively.
- Lower retention and increased cost structure led to decreased profit before taxation (PBT) of the Company, despite a +63%YoY rise in dispatches, however, a meagre tax charge, courtesy tax holiday on profits derived from production line II and positive deferred tax implications, led to an overall increase in earnings by 9%YoY.
- Based on our estimates, the recent hike in gas prices is expected to increase CHCC's cost of production by PKR 4/bag (PKR 80/ton).
- The State Bank of Pakistan (SBP) in its latest monetary policy statement raised the policy rate by 100bps to 8.5%. With a Debt; Equity ratio of 1.44, CHCC's interest expense is expected to rise significantly.
- We believe the scrip has been corrected significantly and given a Dec-18 based target price of PKR 95/share, offers a decent +19% upside from its last close.

We revisit our investment case on Cherat Cement Company Limited (CHCC) after incorporating FY18 accounts and changes in assumption post gas price hike, changes in sales price assumption and increase of monetary policy rate by 100bps.

We had earlier anticipated CHCC' production line III to commence commercial operations post FY19, however, based on availability of updated information and changes of assumptions post gas price hike and pricing scenario, our earnings estimates have been revised accordingly.

Exhibit:

CHCC's earnings highlight

	FY17A	FY18A	FY19E	FY20F	FY21F
EPS	11.1	12.1	21.0	11.7	12.6
DPS	4.5	5.0	4.3	2.5	2.8

Source: IGI Research, Company Accounts

Overall the scrip has underperformed the KSE100 index by 28% during CY18TD followed with a 21% underperformance in CY17. The subpar performance is linked to multiple factors such as a) lower sector retention prices following rising FED and limited pass over ability due to heightened competition, b) elevated coal and FO prices internationally, thus deteriorating margins, c) reversal of monetary easing in a situation when CHCC has already piled significant debt position to finance its back to back expansions d) apprehensions of a price war situation following expansions; and e) concerns of demand pullover in a fiscal tightening situation provided an IMF bailout package is sought.

We believe the scrip has been corrected significantly and given a Dec-18 based target price of PKR 95/share, offers a decent +19% upside from its last close. The scrip currently trades at FY19 P/E of 3.8x and offers a dividend yield of 5.3%.

FY18 earnings review: Dispatches from new plant and positive tax implications shield the Company from industry wide wrath of lower retentions and rising costs.

Cherat Cement Company Limited (CHCC) reported unconsolidated earnings of PKR 2.13bn (EPS: PKR 12.07) for FY18 up by +9%YoY as against PKR 1.96bn (EPS: PKR 11.08) reported in the same period last year. Despite achieving a substantial dispatches growth of +63%YoY, courtesy full year impact of its production line II inaugurated in the mid of last year (Jan-17), the Company could only enhance its net sales by +49%YoY, largely due to the industry's failure to pass over the impact of enhanced FED (up by +25%YoY) promulgated via Finance Act 2017-18 amid heightened competition among industry players. This forced the Company's average net retentions to decline by 9%YoY to PKR 286/bag during the period as against PKR 312/bag achieved in the similar period of the preceding year.

Though the significant dispatches growth considerably spread out fixed costs, surge in coal and FO prices (up by 20%YoY and 29%YoY) internationally coupled with PKR devaluation against the greenback (average annual +5%YoY rise) pushed the Company's cost structure up by +7%YoY, from PKR 208/bag in FY17 to PKR 223/bag in the period under review, thereby diminishing FY18 gross margins of the Company to 22% as against 33% reported in the comparative year.

Lower retention and increased cost structure led to decreased profit before taxation (PBT) of the Company by 14%YoY, however, a meagre tax charge of PKR 15mn (FY18 Effective Tax Rate: 1%), courtesy tax holiday on profits derived from production line II and positive deferred tax implications, led to an overall increase in earnings by 9%YoY.

Exhibit:

CHCC Result Highlights

Period end (JUN) - PKRmn	4QFY18	4QFY17	YoY	FY18	FY17	YoY
Net Sales	3,240	2,931	11%	14,388	9,645	49%
Gross Profit	570	698	-18%	3,139	3,213	-2%
Sell. / Dist. & Admin	152	130	17%	582	505	15%
Non-Operating Income	26	54	n/m	81	133	-39%
EBIT	416	594	-30%	2,504	2,698	-7%
Financial Charges	90	90	0%	357	188	2.74x
Pre-tax Profits	326	504	-35%	2,147	2,510	-14%
Taxation	(11)	114	-109%	15	553	-97%
Post-tax Profits	337	390	-14%	2,132	1,957	9%
EPS	1.91	2.21		12.07	11.08	
DPS	4.00	3.50		4.00	4.50	
Key Ratios						
Gross Margin (%)	17.6	23.8		21.8	33.3	
Net Margin (%)	10.4	13.3		14.8	20.3	
Effective Tax Rate (%)	(3.3)	22.7		0.7	22.0	

Source: Company Accounts, IGI Research *No. of Shares : 177mn*

ECC approves hike in gas prices… CHCC to be affected…

The Economic Coordination Committee (ECC) recently announced a hike in local gas prices for both domestic and industrial consumers. Ranging from +30% to +57% rise for industrial while +10% to +143% for the domestic lot, the revision is expected to have wider impacts on the economy as a whole.

While the increase in gas sales price for cement sector by 30% to PKR 975/MMBtu doesn't pose a significant risk to the industry, since it uses coal fired kilns for their manufacturing operations, increase in gas sales prices for captive power generation by 30% to PKR 780/MMBtu may affect companies relying on gas as their major source of power generation.

Based on our estimates, the above hike in gas prices is expected to increase CHCC's cost of production by PKR 4/bag (PKR 80/ton) which translates to a loss in earnings of PKR 173/239/257mn for FY19E/20F/21F respectively.

Industry hits back with an increase in sales price of PKR 20/bag

As per data published by Pakistan Bureau of Statistics (PBS) average cement prices in North region shot up by PKR 20/bag, with prices in certain areas rising as high as PKR 80/bag, post announcement of gas price hike by the ECC. Though, the move appears to attract investor attention, however, we believe this to be a short term phenomena and prices may soon fall back amid rising competition among players to dominate dispatches growth. Hence, we revise our FY19E average sales price assumption to PKR 575/bag (previously PKR 565/bag) for North and stick to PKR 563/bag for South.

Exhibit:

CHCC's FY19 earnings sensitivity to changes in North cements sales prices

Scenario	Bull	Base	Bear
Avg. cement sales price (PKR/bag)	590	575	560
EPS (FY19)	23.5	21.0	18.4

Source: IGI Research

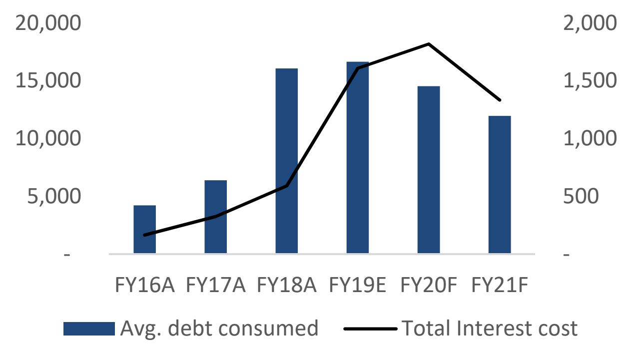
Interest rates rising; CHCC's debt burden to rise momentously post commencement of production line III

The State Bank of Pakistan (SBP) in its latest monetary policy statement raised the policy rate by 100bps to 8.5% and subsequently took discount rate to 9.0%. Rates have now been raised by 275bp since the start of the year 2018, and are now at their highest level since 2015.

With interest rates on the rise, CHCC's interest expense is also expected to rise simultaneously. To recall, CHCC is the most highly leveraged Company in our coverage, with a Debt; Equity ratio of 1.44, courtesy it is undergoing a back to back expansion. Though, a material interest amount is currently being capitalized under plant cost, this will soon form part of the Income Statement following commencement of its operations, decreasing profitability.

Exhibit:

Key Borrowing information



Source: IGI Research

Exhibit:

Key borrowing information of CHCC

	FY16A	FY17A	FY18A	FY19E	FY20F	FY21F
Total Debt - Closing	4,231	6,401	16,064	16,650	14,529	11,967
Avg. debt consumed	2,421	5,080	8,883	16,742	17,152	14,652
Interest expensed	44	188	357	1,054	1,818	1,333
Interest capitalized	122	138	234	554	-	-
Total Interest Cost	166	327	591	1,607	1,818	1,333
Avg. Kibor Rate (3M)	6.5%	6.1%	6.3%	9.3%	10.3%	8.8%

Source: IGI Research

Exhibit:

EPS and Target Price sensitivity to changes in SBP Policy Rate

	Avg. Annual Policy Rate Assumption			EPS (PKR)			Target Price (Dec-18)
Scenario	FY19E	FY20F	FY21F	FY19E	FY20F	FY21F	
Bull	7.5%	8.5%	7.0%	21.4	12.4	13.3	97.3
Base	8.5%	9.5%	8.0%	21.0	11.7	12.6	95.4
Bear	9.5%	10.5%	9.0%	20.5	10.9	11.8	88.2

Source: IGI Research

Production Line III expected to come online by Jan-19; CHCC to continue its volumetric growth spree in FY19

The management of the Company, in its annual report has disclosed that production from line III was initially expected to commence from May-19, however due to commendable work done from its workforce, the management now expects to commence production from the new line way ahead of its scheduled time. While the management has abstained from specifying the revised time frame, our industry sources confirm that this is due to occur in Jan-19, providing CHCC a complete half year of extended capacity.

This is expected to enhance CHCC's market share to around 7% in comparison to FY18's share of 5.32%. Accordingly, we expect CHCC's total dispatches to grow by +29%YoY to 3.25mn tons as against 2.52mn tons made during FY18.

Production line III to provide tax credit of PKR 1.2bn (PKR 7.0/share)…

In addition of the sizeable volumetric growth, the commencement of production line III is estimated to bring in a tax credit of PKR 1.2bn (PKR 7.00/share) for CHCC. This is expected to bring FY19 EPS to PKR 21, up by +74%YoY from its FY18 actual earnings.

To recall, 5Yr tax holiday would not be available to the plant as was the case for its production line II, since it had elapsed on 30-Jun-2018 and had not been extended further by the federal government via Finance Act 2018-19.

Recommendation

We maintain a 'BUY' call on the scrip with a Dec-18 based target price of PKR 95/share, offering a +19% upside from its last close. The scrip currently trades at FY19 P/E of 3.8x and offers a dividend yield of 5.3%.

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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)
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Time Horizon: Dec – 2018

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

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) 35777863-70	zaeem.haider@igi.com.pk
Muhammad Naveed	Regional Manager (Islamabad & Upper North)	Tel: (+92-51) 2604861-62	muhammad.naveed@igi.com.pk
Ejaz Rana	Regional Manager (Faisalabad)	Tel: (+92-41) 2540843-45	ejaz.rana@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, PSX 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) 35777863-70, 35876075-76 Fax: (+92-42) 35763542	**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
Faisalabad Office Room #: 515-516, 5th Floor, State Life Building, 2- Liaqat Road Tel: (+92-41) 2540843-45 Fax: (+92-41) 2540815	**Rahim Yar Khan Office** Plot # 12, Basement of Khalid Market, Model Town, Town Hall Road Tel: (+92-68) 5871653-6, 5871652 Fax: (+92-68) 5871651
Multan Office Mezzanine Floor, Abdali Tower, Abdali Road Tel: (92-992) 408243 - 44	**Abbottabad Office** Ground Floor, Al Fatah Shoppinig Center , Opp. Radio Station, Mansehra Road Tel: (+92-99) 2408243 - 44
Peshawar Office 2nd Floor, The Mall Tower, 35 The Mall Peshawar Cantt. Tel: (92-91) 5253035, 5278448	**Sialkot Office** Suite No. 10 & 11, 1st Floor, Soni Square, Mubarik Pura Tel: (+92-52) 3258437, 3258762

IGI Finex Securities Limited
Research Analyst(s)
Research Identity Number: BRP009