IGI Securities

Day Break

Thursday, 02 August 2018

Sector Update

Exhibit: IGI Cement Coverage performance relative to Benchmark KSE-100 index

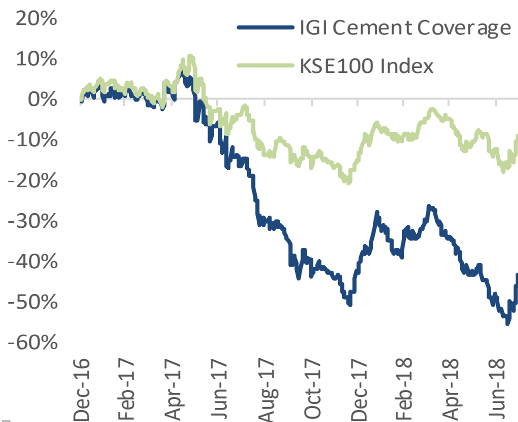


Exhibit: Rising imports and depleting SBP forex reserves, put pressure on PKR to fall in value against the greenback

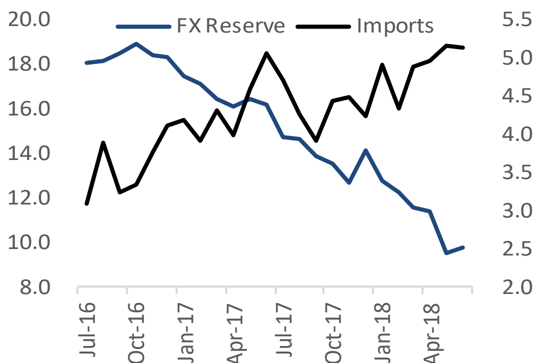
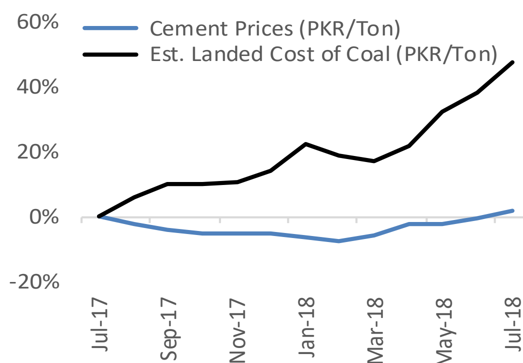


Exhibit: Peaked coal prices coupled with PKR devaluation have damaged the cost structure.



Source: PSX, Bloomberg, PBS & IGI Research

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Cements

Macro Headwinds Justifiable; Prefer LUCK, ACPL, FCCL and DGKC over others

- The burden of twin deficits coupled with depleting forex reserves of Pakistan pose significant economic challenges ahead raising concerns over sustainability of the already struggling PKR, interest rates and demand forecast of construction materials given a possible fiscal curtailment.
- With expectations of market participants building up for PKR to further depreciate to levels of around PKR 150/USD, the cost structure of the sector appears to increase substantially. Based on sensitivity analysis, ACPL and LUCK emerge as least susceptible to changes in PKR due to their better export mix and healthy margins.
- ACPL, KOHC and LUCK may have minimal impact in an interest rate volatile scenario since they carry nil or insignificant portions of debt in their respective balance sheets. However, CHCC and DGKC remain the most susceptible to any adverse changes in interest dynamics due to their substantial borrowings in lieu of expansions.
- Based on a simulation analysis, we observe that stock price of LUCK is the least susceptible to adverse changes in macro-economic factors given a low price dispersion factor, followed by ACPL, FCCL and DGKC.

Sector on a bumpy road into summer break

Months leading up to June this year were marked by various political irritations which of course also had a certain impact on macroeconomic indicators and market in general. After posting a robust performance over the past 3yrs, sector booming return trajectory finally halted, with sector return down by 5% CY18 to date. As of latest, IGI cement coverage companies forward P/E (Excluding LUCK) stands at 6.5x, which is at considerable 27% discount to market P/E. It is pertinent to mention that the sector had been trading at an average 13% premium over the market for the last 3yrs.

Macro headwinds pose significant challenges ahead… Sector to remain on watch

One of the major concerns influencing the market currently have been the deteriorating macro conditions of Pakistan's economy. Bulging imports, low exports, creeping remittances coupled with rising fiscal deficit and depleting forex reserves of the country have exerted much pressure over the domestic currency and interest rate alike. With move towards IMF's 14th debt programme seeming likely, cut down in fiscal development expenditures also looks imminent. All these measures are expected to have crucial impact on the cement sector at large and as such we present a sensitivity analysis over the sector's profitability to possible changes in some key macro indicators i.e.: PKR devaluation against greenback, interest rates and demand pullover due to fiscal curtailment.

PKR depreciation: Unwinding of the "Dar" Effect

The PKR has been struggling to find its feet ever since ex finance minister, Mr. Ishaq Dar left the office in Nov-17. Currently trading at PKR 122.92/USD, the PKR has lost almost 17% in value in the past 8 months alone. With expectations of market participants building up for PKR to further depreciate to levels of around PKR 150/USD, marking a further devaluation of ~17%, the picture doesn't seem rosy for the local manufacturing sector which largely imports critical raw materials for developing their final product.

Representing almost 40% of the total cost of producing cement, fuel costs comprise primarily of gas and imported coal. With international coal prices already at their peak

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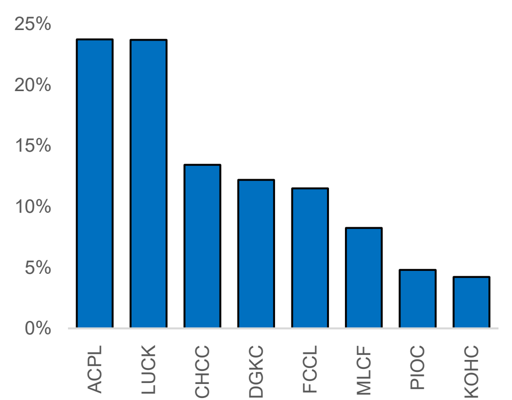
(currently trading at USD 106/ton, up by +28%YoY), devaluation of PKR further tightens the grip over the sector's compressing margins.

The situation is further exacerbated for the sector in the shape of higher capex and larger cash outflow given the industry is currently engaged in an expansion phase, requiring import of heavy plant and machinery of substantial dollar amount.

Exhibit:
ACPL and LUCK a sizeable export sales mix



Source: IGI Research

Exhibit:
Sensitivity of FY19E EPS over changes in PKR/USD

	Bull	Base	Bear	Earnings Dispersion
Exchange Rate	PKR 120/USD	PKR 129/USD	PKR 140/USD	
ACPL	14.26	14.27	14.28	0.1%
LUCK	38.40	37.49	36.41	3.8%
FCCL	4.26	4.09	3.90	6.3%
MLCF	8.75	8.40	7.98	6.5%
KOHC	27.10	25.91	24.50	7.1%
PIOC	12.46	11.87	11.18	7.6%
DGKC	15.12	14.19	13.10	10.1%
CHCC	21.35	19.58	17.50	13.9%

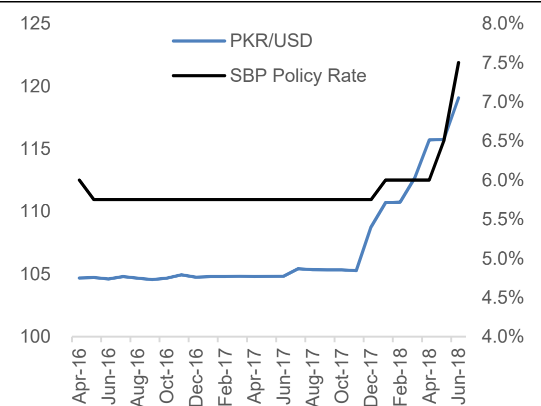
Source: IGI Research

We see ACPL to stand out in such a scenario having minimal earnings dispersion to changes in PKR/USD followed by LUCK given their substantial export volumes which act as a natural hedge against weakening PKR and their ability to generate better retention prices. Sizeable

Reversal of Monetary cycle: Caught in the wrong position at a wrong time

In order to curb the rising import bill, which has been one of the principal reasons behind the current financial mess; and in an effort to support the fragile PKR, the State Bank of Pakistan (SBP) has necessitated reversal of the monetary cycle. As such, the SBP Policy (Target) Rate has been cumulatively increased by 1.75% in three previous policy meetings to 7.50% in the last six months. With the market expecting the policy rate to further increase by 0.75% in the remaining portion of FY19, due to mounting inflationary and debt pressures, this will further exacerbate the woes of the sector in the shape of higher interest costs (resulting in lower profitability) given it has obtained substantial borrowings to finance its expansion requirements.

Exhibit:
Interest rates rise to curb PKR devaluation



Source: SBP, IGI Research

Exhibit:
Sensitivity of FY19E EPS over changes in SBP Policy Rate

	Bull	Base	Bear	Earnings Dispersion
SBP Policy Rate	7.75%	8.25%	8.75%	
ACPL	14.31	14.27	14.23	0.4%
KOHC	25.83	25.91	25.99	0.4%
LUCK	37.13	37.49	37.85	1.4%
CHCC	19.78	19.58	19.39	1.4%
DGKC	14.37	14.19	14.01	1.8%
MLCF	8.44	8.40	8.36	n/a *
PIOC	11.89	11.87	11.86	n/a *
FCCL	4.09	4.09	4.09	n/a *

Source: IGI Research

Based on the above table, we find ACPL, KOHC and LUCK to have minimal impact in an interest rate volatile scenario since they carry nil or insignificant portions of debt in their respective balance sheets. However, CHCC and DGKC remain the most susceptible to any adverse changes in interest dynamics due to their substantial borrowings in lieu of expansions.

MLCF and PIOC are also gravely affected, however, since their respective plants are expected to come online in later stages of FY19 or beyond that, the impact of borrowing costs to changes in SBP policy rates is not reflected in FY19E EPS due to capitalization of such costs. However, this only demonstrates accounting presentation and does not prevent excess borrowing cost cash outflow to occur and will be eventually offset via excess depreciation.

We have also kept FCCL in the not applicable criterion (n/a *), since its Board of Directors decision regarding a greenfield expansion (intention announced earlier by management) and investment in solar power plant remain pending and as such shall trigger substantial borrowings in case these projects are undertaken.

Bailout measures and rising inflation to keep cement demand on check

To recall, the industry players, projecting robust demand in the pretext of China Pakistan Economic Corridor (CPEC), higher infrastructural spending via PSDP to support continuous GDP growth, rapid private residential construction given benign interest rate environment lately and an investor friendly tax regime had entered its third expansionary phase.

Although CPEC projects, financed by Chinese administration, will continue to pump demand for construction materials, the widening gap between imports and exports and persistent fiscal deficits lately have raised serious question marks about the sustainability of the economy; and as such a bailout package from the IMF appears likely, indicating considerable fiscal curtailment. This is likely to be reflected through reduced PSDP allocations in the next couple of years.

Additionally, with interest rates on the rising, demand for private house financing is also expected to fall. This, coupled with rising cement prices due to a) enhanced FED, b) PKR devaluation and c) rising inflation index; will entice building contractors to widen the cement-sand mix from general 1:4 to 1:5 proportion in an effort to restrict housing costs within budgeted levels. All these arguments are likely to considerably reduce the expected growth in dispatches prospectively. Likewise, a sensitivity analysis depicting changes in growth assumptions is presented.

Exhibit:

Sensitivity of FY19E EPS over changes in Demand growth

* Base Case Assumptions FY19/FY20/FY21: PKR/USD – 129/136/142, SBP Policy Rate: 8%/7%/6%, Demand growth: 6%/6%/5%

Growth Rate	Worst -5%	Bear 0%	Base 6%	Bull 10%	Best 15%	Earnings Dispersion	3Yr EPS CAGR @ Base case *
LUCK	33.95	35.44	37.49	38.98	40.47	8.1%	4.46%
KOHC	23.60	24.75	25.91	27.06	28.21	8.1%	23.55%
PIOC	10.77	11.32	11.87	12.42	12.97	8.4%	38.23%
FCCL	3.67	3.88	4.09	4.31	4.52	9.5%	18.05%
CHCC	17.12	18.35	19.58	20.80	22.02	11.4%	21.35%
MLCF	7.30	7.84	8.40	8.98	9.57	12.3%	6.36%
DGKC	11.89	12.94	14.19	15.24	16.28	14.2%	1.57%
ACPL	9.77	11.28	14.27	15.76	17.24	24.9%	2.69%

Source: IGI Research

Simulation Analysis

Bearing in mind that the above analyses were in fact sensitivities of earnings to changes in a single economic metric, we extend our analysis further by scaling multiple macros in a concurrent manner in order to determine the price dispersion of respective scrips to probable economic situations. By doing so, we also ascertain the worst and best case asset prices which act as a floor and ceiling for them.

Exhibit:

Simulation Analysis - Probable scenarios for FY19

Scenario	Case	Demand Growth	PKR/USD	SBP Policy Rate
A	Worst	-5%	140	8.50%
B	Bear	0%	140	8.50%
C	Base	5%	129	8.00%
D	Bull	10%	120	7.50%
E	Best	15%	120	7.50%

Exhibit:

Simulation Analysis - Sensitivity of asset prices to changes in multiple macros

	Worst	Bear	Base	Bull	Best	Price Dispersion	Current Market Price	Upside from Worst Case
Scenario	A	B	C	D	E			
LUCK	645	658	687	716	726	5.9%	554	16%
ACPL	235	249	273	286	286	9.5%	149	58%
FCCL	30	31	34	37	38	12.1%	25	18%
DGKC	153	161	178	195	202	13.7%	120	28%
KOHC	198	210	241	271	284	17.9%	130	52%
MLCF	60	64	74	85	90	20.2%	56	6%
PIOC	92	99	119	139	148	23.4%	52	78%
CHCC	139	151	184	217	231	25.2%	92	51%

Source: IGI Research

Recommendation

Based on the above simulation, we observe that stock price of LUCK is the least susceptible to adverse changes in macro-economic factors given a low price dispersion factor, followed by ACPL, FCCL and DGKC due to their better export mix, healthy margins on local sales, less leveraged balance sheets (excluding DGKC) and diversified income portfolios. Not only are these scrips expected to fare well for longer term investment horizons, their low susceptibility to adverse macros provides them with an added guard against short term economic volatilities.

While the remaining scrips in discussion (KOHC, MLCF, PIOC and CHCC) are pretty much susceptible to short term macro headwinds due to their leveraged balance sheets, low exports and heavy cost structure, their large upcoming expansion sizes and existing low utilization levels offer an impressive earning growth, providing hefty upsides in the longer term horizon as against current price levels.

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Time Horizon: Dec – 2018

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