Day Break

Friday, 15 December 2017

IGI Securities
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COMPANY UPDATE

CHERAT CEMENT COMPANY LIMITED
CEMENT

Recommendation	BUY
Target Price:	154.7
Last Closing: 14-Dec-17	88.7
Upside:	74.3
Valuation Methodology:	Discounted Cash Flow (DCF)
Time Horizon:	Dec-18

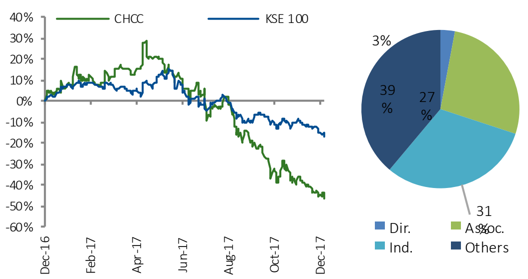
Market Data

Bloomberg Tkr.			CHCC PA
Shares (mn)			176.6
Free Float Shares (mn)			106.0
Free Float Shares (%)			60.0%
Market Cap (PKRbn | USDmn)		15.7	142.7
Exchange			KSE 100
Price Info.	90D	180D	365D
Abs. Return	(30.6)	(49.2)	(47.9)
Lo	88.7	88.7	88.7
Hi	131.1	178.8	212.0

Key Company Financials
Period End: Jun

PKRbn	FY17A	FY18E	FY19F	FY20F
Total Revenue	9.6	15.3	14.8	22.0
Net Income	2.0	2.2	1.6	2.5
EPS (PKR)	11.1	12.6	9.2	14.0
DPS (PKR)	4.5	5.3	3.8	5.8
Total Assets	18.8	23.2	31.2	32.0
Total Equity	10.5	11.8	12.7	14.2
Key Financial Ratios				
ROE (%)	18.7	18.9	12.8	17.4
P/E (x)	8.0	7.1	9.7	6.4
P/B (x)	1.5	1.3	1.2	1.1
DY (%)	5.1	5.9	4.2	6.5

Relative Price Performance & Shareholding



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

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Cements

CHCC: Paving way towards success

- Although we foresee a fragmented market share of 5.2% and 4.7% in FY18 & FY19 owing to arrival of other major capacities in this period, however, we believe CHCCs market share to eventually surface at ~7%
- Investment in power efficiencies to roughly provide ~40% earnings accretion in the years to come
- Effective tax rate of the Company to significantly reduce to 13%, 12% and ~3% for FY18, FY19 and FY20-22 as against otherwise applicable corporate tax rate of 30%
- Based on our Dec-18 target price of PKR 155/share, CHCC offers a ~74% capital upside from its existing price. This is in excess of expected PKR 5.25/share final dividend for FY18 accompanied with the scrip

We draw attention of our valued clients towards Cherat Cement Company Limited (CHCC), currently trading at its 52 week low price of PKR 89, despite offering a considerable +50%YoY earnings growth display in 1QFY18. This earnings growth was largely accredited to enhanced market share emanating from commencement of operations of production line II and incidental tax benefits. Inexpensive valuation multiples and substantial earnings growth potential stemming from production line III in the coming years offer a strong "Buy" opportunity at the existing price.

1QFY18 earnings up by +50%YoY

To recall, CHCC posted 1QFY18 earnings of PKR 606mn (EPS: PKR 3.43), up by +50%YoY (up +55%QoQ) as compared to PKR 404mn (EPS PKR 2.29) in the similar period last year. Taking full advantage of its recently commissioned production line II, CHCC registered a remarkable +156%YoY increase in volumetric sales. This not only enabled the Company to effortlessly outweigh the negative impact of industry wide lower retentions stemming from a) imposition of higher FED through Finance Act 2017-18; b) trimmed cement sales prices in the northern region and; c) elevated coal prices globally, but in the process also made it the only company in our coverage to surpass its own gross profits of 1QFY17. Further, income tax exemption on profits reaped from line II also lent additional support to earnings with effective tax rate of 1QFY18 restricted to 18% as against 27% in 1QFY17.

Dec-18 based target price of PKR 155/share, offers ~+74% upside

Based on our Dec-18 target price of PKR 155/share, CHCC offers a ~74% capital upside from its existing price. This is in excess of expected PKR 5.25/share final dividend for FY18 accompanied with the scrip, thereby marking an annualized dividend yield of +6%.

Line III to enhance market share

Having already doubled its market share to ~5.5% as against 2.8% prior to commencement of production line II, CHCC has almost instantaneously entered its 3rd expansionary phase by initiating construction of production line III on its existing site in an effort to uphold its market share post settlement of industry wide expansion cycle. With letters of credits (LC's) established and civil works already in progress, we expect the plant to come online by 4QFY19. Although we foresee a fragmented market share of 5.2% and 4.7% in FY18 & FY19 owing to arrival of other major capacities in this period, however, we believe CHCCs market share to eventually surface at ~7% once all the industry wide expansions have settled down.

Investment in power efficiencies to support margins

Apart from making investment in production line III, CHCC is also engaged in putting in place 3 Wartsila dual fuel engines (gas + furnace oil) having a combined capacity of 30MWs. These are expected to be commissioned by 4QFY18. This is in addition to 10MW Waste Heat Recovery (WHR) plant scheduled for line III. These measures are expected to materially reduce power costs of the company, roughly providing ~40% earnings accretion in the years to come.

No taxes on profits of new plants for the next 5 years.

Expanding its capacity base in its province of origin, the KPK, the Company becomes eligible to claim 5 years tax holiday on profits reaped from its new plants as per section 126L of the Income Tax Ordinance (ITO) which aims to boost economic activities in the underprivileged province. With the said provision already accounted for production line II and expected to be availed for production line III as well, we expect the effective tax rate of the Company to significantly reduce to 13%, 12% and ~3% for FY18, FY19 and FY20-22 respectively as against otherwise applicable corporate tax rate of 30%.

Contingent tax bonus on the way

It is pertinent to mention here that D.G. Khan Cement Company Limited's (DGKC) recent disclosure of intention, as communicated through its 1QFY18 report, to simultaneously claim section 126L and 65B of the ITO (which allows one time 10% tax credit on the cost of expansion) has created a difference of opinion among the industry players; who believe them to be mutually exclusive rather than available jointly. Although CHCC in its financial statements as of Jun-17 has prudently accounted for section 126L only, but thereinafter DGKC's disclosure, it intends to file its Income Tax Return claiming both these provisions. Since the matter is subject to acceptance of Federal Board of Revenue (FBR) and no such clarity has been issued by FBR as yet, we have not made this contingency a part of our valuation. However, does this contingency hold true, this will revise our earnings estimates for FY18 and FY19 by around +~35%.

Balance Sheet to remain leveraged in the wake of line III…

Making optimal use of investor friendly interest rate environment, CHCC's strategy to come up with back to back expansions provides an inexpensive financial solution for its capacity enhancement. Having already arranged financial close worth PKR 13bn (estimated cost of expansion) from a consortium of banks to finance line III, the existing 34% debt to asset ratio is all set to climb up to 46% by FY19.

…however, strong cash generation should allow for aggressive deleveraging strategy to follow suit

However, we strongly believe that CHCC will pursue an aggressive deleveraging strategy which involves premature retirement of long term debt during this period. Our belief is backed by a) strong operating cash flow generation by CHCC b) historic precedence of maintaining low debt profile, c) lack of short term investment avenues generating returns above borrowing costs, d) expected hike in interest rate structure post elections, and; e) no disclosure by the management of entering into any new business venture till now. Accordingly, we expect CHCC to retire almost all its expansion debt prior to Jun-24.

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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 – 2018

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

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