Day Break

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Cements

Will rising environmental concerns spill the milk for industry wide expansions? Expansions in Punjab at halt; MLCF & PIOC affected…

- MLCF recently issued a notice to the Pakistan Stock Exchange (PSX) citing suspension of its expansionary work following receipt of similar order from the Environmental Protection Agency (EPA) Punjab.
- Following media attention over the drying up of pond water of the Katas Raj Temple, the Supreme Court of Pakistan took a Suo Moto action on Nov-17 with the apex court even passing remarks of closing down these plants if the need may arise.
- The Chief Minister (CM) Punjab and his team are considering to impose a ban on the expansion of existing cement plants. Simultaneously, the EPA has disseminated notices to cement factories in the province to put on hold their expansion activities, thereby making MLCF and PIOC the major affectees.
- With possible change in favorable tax legislation given a change in government coupled with rising interest rate outlook post elections, the players might lose out an inexpensive financial solution for their capacity enhancement needs.

MLCF recently issued a notice to the Pakistan Stock Exchange (PSX) citing suspension of its expansionary work following receipt of similar order from the Environmental Protection Agency (EPA) Punjab over concerns of negative foot prints of cement manufacturing to the environment at large. The issue, instigated by the already heightened Katas Raj issue whereby BWCL, DGKC, GWLC & ASKARI Cement have been accused of disturbing the water table of the entire district, has resulted in dissemination of similar notices halting expansions all over Punjab. Accordingly, we brief our investors about the recent events and possible outcome of these events on the respective stocks. However, we firmly establish that this briefing is to apprise the investors regarding the prevailing situation only and does not change our long term view on the sector till conclusive reporting is made by the regulatory and judicial authorities.

The Katas Raj Syndrome: BWCL, DGKC, GWLC & ASKARI Cement in red zone…
Following media attention over the drying up of pond water of one of the prominent national heritage sites of the country, the Katas Raj Temple, the Supreme Court of Pakistan took a Suo Moto action on Nov-17. Situated in Chakwal district, the temple holds proximity to four cement companies (BWCL, DGKC, GWLC & ASKARI Cement) which have been heavily blamed for evacuating temple water for commercial purposes. With the district already facing low water supply situation coupled with rising concerns of the Hindu community, the issue has gained both judicial and political importance. As per news summary, the apex court has taken a strong stance in the said case, with the Chief Justice even passing remarks of closing down these plants if the need may arise [(News Link)](). Although, currently BWCL

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and the Government of Punjab have been ordered to refill the pond on an immediate basis, a possible situation of plant closure still looms over them as a hanging sword.

Government of Punjab playing low ball to avoid another judicial controversy… Expansion in Punjab halted…

The provincial government of Punjab has also been swift in taking the matter into its hands. As per news tabloid, the Chief Minister (CM) Punjab and his team are considering to impose a ban on the expansion of existing cement plants (News Link). An inquiry is being conducted into the expansionary cement plants in the province by the CM Inspection Team and further action will be taken in light of the inquiry's findings. Simultaneously, the EPA has disseminated notices to cement factories in the province to put on hold their expansion activities, thereby making MLCF and PIOC the major affectees.

Khyber Pakhtunkhwa contemplating environmental concerns as well

With the Peshawar High Court seeking response from the Government of Khyber Pakhtunkhwa (KPK) by 11-Jan, over where they are going to set up cement factories and what efforts would be made to protect the environment, a rising environmental concern is also surfacing from there as well. However, these are on a very nascent stage given that KOHC has recently been provided an NOC (No objection certificate) from the environmental agencies for setting up of expansion plant at their existing site.

Management View

As per our discussion with the management of cement companies, they view this latest development as a temporary phenomenon. According to them the current political instability has played a major role in the dilemma; however they believe this to phase out once political clarity surfaces. Albeit, they agree that this situation might result in delays in expansions coming online and may even escalate the cost of expansion to a certain degree. Since no concrete decisions have been announced yet, either by the provincial government or from the apex court, we abstain from drawing conclusive opinions on this matter.

What's at risk?

Given our belief that the benign interest rate environment and generous tax measures have been the trigger points of expansions for the existing cement players, rather than imminent demand outlook, any delay in such activity might deprive them from these lucrative benefits. With possible change in favorable tax legislation given a change in government coupled with rising interest rate outlook post elections, the players might lose out an inexpensive financial solution for their capacity enhancement needs. Moreover, since industry players claim to have obtained necessary regulatory approvals prior to commencement of expansionary plans, we believe the affected expansion players to indulge in litigation over the subject matter (as the case is for MLCF). This will make way for additional legal expenses undermining their profitability.

South players remain unaffected… To be in added advantage…

However, all these environmental concerns have no detrimental impact over players residing or expanding in South. With Lucky Cement Limited's expansionary plant already operational and provided ACPL and DGKC's south expansions to come online during the current fiscal year, we believe them to surface out as winners. This is in addition to the following advantages: a) close proximity towards port to reduce inward freight & transit insurance cost of coal, thereby providing excess cushion to extend their supply to far-fetched areas, b) ensuring higher market share in South market where all season sales are made as against North where poor weather in winter hinders sales for approximately two months, c) comparatively better retentions in South than North region, d) advantage of 5yrs tax holiday available through section 126L of the Income Tax Ordinance (ITO) for establishment of industrial undertaking in Baluchistan (Khyber Pakhtunkhwa as well) , e) geographically and economically better suited to cater demand in Southern Punjab and Baluchistan where highest demand is expected, and; f) providing additional option of exports via sea given political strained relations with Afghanistan & India.

Earnings assessment of MLCF & PIOC

Since, expansions are to make considerable impact on future earnings we have carved out the impact of expansions on earnings on both MLCF and PIOC for the next 5 years, presented as follows:

Exhibit:
Bifurcation of MLCF's Earnings Per Share

EPS Contribution	FY17A	FY18F	FY19F	FY20F	FY21F	FY22F
Existing operations	9.05	8.32	7.47	6.95	7.08	7.38
Impact of Expansion	-	(0.13)	3.04	1.91	0.96	0.99
Total	9.05	8.20	10.52	8.86	8.03	8.37

Source: Company Financials & IGI Research

Exhibit:
Bifurcation of PIOC's Earnings Per Share

EPS Contribution	FY17A	FY18F	FY19F	FY20F	FY21F	FY22F
Existing operations	12.84	8.68	11.98	9.56	8.27	9.66
Impact of Expansion	-	(0.01)	(0.31)	9.39	8.36	7.40
Total	12.84	8.67	11.66	18.95	16.63	17.07

Source: Company Financials & IGI Research

On an alternative hypothesis, assuming that there is a delay of one year in expansions coming online, the resulting earnings structure has also been presented. However, since we have already incorporated a similar delay for PIOC based on its consistent failure to meet its stated timelines, we do not consider incorporating further delays necessary for PIOC. Accordingly, we have incorporated a delay of one year for MLCF only.

Exhibit:
Earnings estimates given one year delay in expansions

EPS	FY17A	FY18F	FY19F	FY20F	FY21F	FY22F
MLCF	9.05	8.24	7.39	8.39	6.92	7.49
PIOC	12.84	8.67	11.66	18.95	16.63	17.07

Source: Company Financials & IGI Research

We wish to state that for simplicity concerns we have performed our one year delay calculations on a standalone basis (i.e.: all else remains same whereby possible impact of profitability of other coverage companies due to enhanced dispatches made by them in the delayed period is ignored). Further, although the timing of expansions will temporarily trigger earnings dispersion in MLCF's earnings, however this does not change our long term view on it. Accordingly, we are intact on our Dec-18 based target prices of PKR 78/share and PKR 134/share for MLCF and PIOC respectively.

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Time Horizon: Dec – 2018

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