Day Break

Tuesday, 20 November 2018

Sector Update

Exhibit: IGI Sector performance relative to Benchmark KSE 100 Index

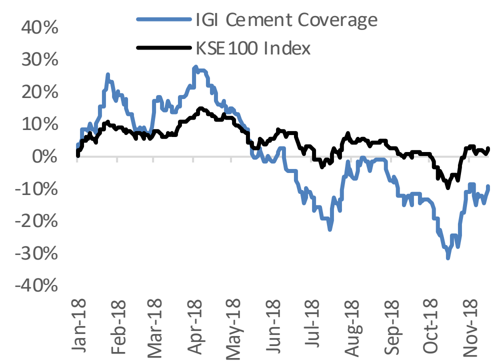


Exhibit: Interest rates have risen in order to curb PKR devaluation

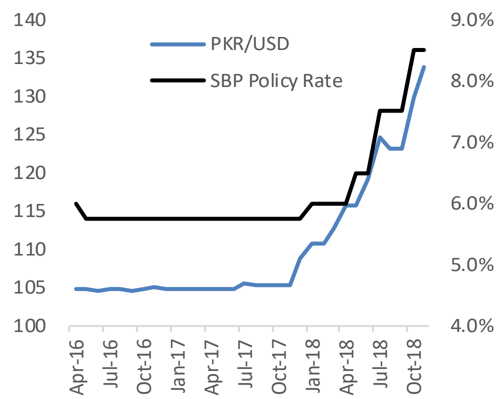
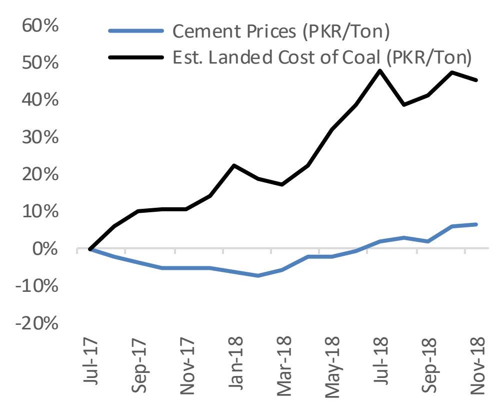


Exhibit: Landed cost of coal is falling despite sharp PKR depreciation.



Source: PSX, Bloomberg, PBS & IGI Research

Analyst

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Cement

Risks overplayed; LUCK, PIOC preferred

- Continued depreciation of the PKR along with reversing monetary cycle in addition to the government's decision to jack up energy prices (gas done and electricity likely) have all imprinted their mark on the sector's performance in the bourse recently.
- However, amid all the chaos and negatives the sector is facing currently, the news of coal prices going South comes as a breather and has been the driving force behind the stock rally in the last couple of weeks.
- We have revised our average annual coal price to USD 95/ton and have presented an earnings sensitivity to variations in average annual coal price at different levels.
- The sector has come across a rather precarious situation; wherein multiple risks have surfaced up in a simultaneous manner. Though most of the risks have been appropriately priced in by the market, there still remains room for generating alpha returns in selective stocks.
- Based on our analysis, we have a liking for PIOC, ACPL, KOHC, CHCC and LUCK offering a 3Yrs EBITDA Growth CAGR of (41%/12%/23%/23%/7%) respectively and an upside potential of (77%/71%/68%/30%/23%) respectively.

Ever since the incumbent government has assumed power, rapid changes have occurred that are expected to materially alter the sector's performance. Continued depreciation of the PKR along with reversing monetary cycle in addition to the government's decision to jack up energy prices (gas done and electricity likely) have all imprinted their mark on the sector's performance in the bourse.

As such after posting a robust performance over the past 3yrs, sector booming return trajectory has halted, with sector return down by -10% CY18 to date. As of latest, IGI cement coverage companies' forward P/E (Excluding LUCK and DGKC) stands at 7.7x, which is at 11% 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.

However, amid all the chaos and negatives the sector is facing currently, the news of coal prices going south comes as a breather and has been the driving force behind the stock rally in the last couple of weeks.

Accordingly, based on the changing dynamics, we revisit our investment case and tweak our earnings estimates and target prices.

Exhibit:

IGI cement coverage performance outlook and target prices

	Earnings performance				3Yr CAGR	3Yr CAGR	TP	Upside
	FY18A	FY19E	FY20F	FY21F	EPS	EBITDA	Dec-19	Potential
PIOC	7.2	6.7	17.1	12.5	19.9%	41.4%	92.8	77%
CHCC	12.1	17.4	16.2	16.1	10.1%	23.7%	112.7	30%
KOHC	14.8	14.9	20.9	25.1	19.1%	23.1%	170.8	68%
LUCK	37.7	37.8	41.3	42.7	4.3%	7.2%	613.9	23%
ACPL	38.4	16.9	25.2	23.7	-14.9%	12.0%	234.2	71%
MLCF	7.7	10.3	6.5	6.3	-6.6%	7.4%	56.7	13%
DGKC	20.2	8.8	11.1	10.5	-19.6%	5.0%	112.5	5%
FCCL	2.5	2.8	2.7	2.3	-2.3%	-0.5%	20.3	-19%

Source: Company Accounts, PSX & IGI Research

Based on our analysis, we having a liking for PIOC, ACPL, KOHC, CHCC and LUCK offering a 3Yrs EBITDA Growth CAGR of (41%/12%/23%/23%/7%) respectively and an upside potential of (77%/71%/68%/30%/23%) respectively.

Coal prices begin to melt over amid slowdown in Chinese investments

Coal prices globally have remained on the high side for the last two years, having grown by an exorbitant 77% to FYTD average USD 101/ton (average coal price FYTD) as against average USD 53/ton back in FY16.

Representing ~40% of the total cost of producing cement, fuel costs, comprise primarily of imported coal and as such are heavily affected by radical movements in the international arena.

However, lately there have been some shifts in this norm, with prices being trimmed as high as 12%MoM to USD 90/ton in the current month alone. This is largely due to investor's sensing a pullover in demand, from an anticipated slowdown in demand from China, the world's largest coal consumer, due to its sudden shift towards consumption driven policies in the recent period as against its historic investment driven style. This comes as a positive gesture for the sector and provides some breathing space to it.

As such we have revised our average annual coal price to USD 95/ton. In addition, we also present an earnings sensitivity to variations in average annual coal prices as follows.

Exhibit:

Sensitivity to FY19E earnings over changes in USD /ton coal prices

	Best	Bull	Base	Bear
	USD 80	USD 90	USD 95	USD100
LUCK	40.6	39.2	37.8	36.4
MLCF	10.9	10.6	10.3	10.0
KOHC	16.2	15.5	14.9	14.2
ACPL	19.9	18.4	16.9	15.5
CHCC	19.2	18.3	17.4	16.4
DGKC	10.4	9.6	8.8	8.0
FCCL	3.1	2.9	2.8	2.7
PIOC	7.4	7.1	6.7	6.3

Source: IGI Research

Fragile PKR causing trouble; LUCK and ACPL safe thanks to substantial exports

Another major factor impacting cement manufacturing costs has been the continued devaluation of PKR against the greenback (USD). Currently trading at PKR 134.50/USD, the PKR has lost an alarming 28% in value in the past 1Yr.

Given that the industry uses imported coal as its primary fuel object (which in turn represents 40% of the total cost structure), any volatilities in PKR materially alters the profitability of the sector. With international coal prices already high enough, 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 imports of heavy plant and machinery of substantial dollar amount.

An earnings sensitivity in this regard is also presented.

Exhibit:

Sensitivity of FY19E EPS over changes in PKR/USD

	Bull	Base	Bear	Earnings dispersion
	PKR 125/USD	PKR 131/USD	PKR 140/USD	
LUCK	38.5	37.8	36.5	3.7%
ACPL	16.5	16.9	17.6	4.6%
MLCF	10.7	10.3	9.8	6.0%
CHCC	18.0	17.4	16.3	6.9%
FCCL	2.9	2.8	2.6	7.2%
KOHC	15.6	14.9	13.7	8.8%
DGKC	9.4	8.8	7.8	13.2%
PIOC	7.2	6.7	5.8	14.5%

Source: IGI Research

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

Gas prices going hot, captivating the most captive

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 its manufacturing operations, increase in gas sales prices for captive power generation by 30% to PKR 780/MMBtu is to affect companies relying on gas as their major source of power generation such as LUCK.

Electricity prices; the sword has been sharpened and about to fall

Another important input factor that is to impede sector performance is the forthcoming hike in electricity prices. While the National Electric Power Regulatory Authority (NEPRA) has recommended an outright increase of PKR 3.75/Kwh (+29% from existing tariff structure), sources close to the cabinet disclose that the Economic Coordination Committee (ECC) of the Parliament has decided to increase it by only 2.58/Kwh (+20% from existing tariff structure) for industrial purposes, set aside special privileges for the five export oriented sectors and the agriculture division.

The said increase will mostly affect players that meet significant portion of their electricity requirements from the national grid such as PIOC (70%) and ACPL (60%).

Exhibit:

Sensitivity to FY19 earnings of changes in electricity tariff

	Bull Case I	Bull Case II	Base Case	Bear Case	Deviation of Base
	0%	10%	20%	30%	Case from Bull I
ACPL	18.75	17.84	16.92	16.01	-15%
PIOC	7.22	6.94	6.67	6.39	-11%
KOHC	15.80	15.35	14.90	14.45	-9%
MLCF	10.77	10.55	10.33	10.11	-6%
DGKC	9.13	8.97	8.81	8.65	-5%
FCCL	2.90	2.87	2.83	2.79	-4%
LUCK	37.80	37.80	37.80	37.80	0%
CHCC	17.36	17.36	17.36	17.36	0%

Source: IGI Research

Tax to remain sweet in the years to come

While the ongoing expansion phase of the industry is expected to alleviate the capacity constraint issue of the industry, it has never the less resulted in accumulation of massive debt in the respective balance sheets of the participants. Though, the fruits of expansion will come along gradually, one of the immediate benefits available to the players has been the tax credits ancillary to expansions.

Of the various tax credits put out by the previous government, two were of major importance to the industry initially; section 65B of the Income Tax Ordinance (ITO), providing one time 10% tax credit on the amount of plant and machinery invested therein; and clause 126L, offering 5Yr tax holiday over profits and gains derived on plants installed in the provinces of Khyber Pakhtunkhwa and Baluchistan.

While clause 126L is no longer available now, since it expired on Jun-18, with no extension granted thereof with the only successful applicant being CHCC (via its production line II inaugurated in Jan-17), the only tax benefit available now is the one time 10% tax credit as per section 65B which has an extended applicable date of Jun-21.

Exhibit:

IGI cement coverage taxability highlights

	FY17A	FY18A	FY19E	FY20F	FY21F
Sector PBT	57,194	43,383	39,518	39,501	42,698
Taxation	16,684	3,190	5,856	4,995	9,042
Sector PAT	40,510	40,193	33,662	34,506	33,656
Effective Tax Rate	29.2%	7.4%	14.8%	12.6%	21.2%

Source: Company Accounts, IGI Research

Less financial burden keeps LUCK, ACPL and KOHC's mast above the rest

Rising inflation amid PKR depreciation and administrative price hikes on gas tariff have prompted the State Bank of Pakistan (SBP) to jack up its monetary policy rates. As such, the SBP Policy (Target) Rate has been cumulatively increased by 275bps to 8.50% in the last nine months. With the market expecting the policy rate to further increase by 50bps 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).

This comes at a time when the sector (IGI cement coverage) is undergoing an expansion phase and has quadrupled its total debt financing to PKR 87bn (as of FY18) in comparison to PKR 21bn reported in FY16. Though we believe that the reversal of monetary cycle will encourage players to repay their debts earlier than schedule (a strategy currently being employed by CHCC), we see some players to be in more financial burden than the rest in the short term.

Exhibit:

Leverage information

	FY18A		FY19E	
	Debt	D/E %	Debt	D/E %
LUCK	-	-	-	-
MLCF	19,113	63.90	21,591	65.79
KOHC	426	2.37	1,093	5.35
ACPL	6,050	40.68	2,513	14.63
CHCC	16,064	143.77	16,845	123.66
DGKC	32,277	41.85	20,873	26.05
FCCL	2,702	13.19	637	2.99
PIOC	10,705	78.55	15,861	107.15

Source: Company Accounts, IGI Research

Exhibit:

Sensitivity of FY19E EPS over changes in SBP Policy Rate

	Bull	Base	Bear	Earnings Dispersion
SBP Policy Rate	8.00%	8.50%	9.00%	
LUCK	37.53	37.80	38.08	1.0%
MLCF	10.38	10.33	10.29	n/a*
KOHC	14.80	14.90	14.99	0.9%
ACPL	17.05	16.92	16.80	1.0%
CHCC	17.59	17.36	17.13	1.9%
DGKC	9.03	8.81	8.60	3.5%
FCCL	2.83	2.83	2.82	n/a*
PIOC	6.71	6.67	6.62	n/a*

Source: IGI Research

Based on the above table, we find KOHC, LUCK and ACPL 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) remains pending and as such shall trigger substantial borrowings in case these projects are undertaken.

Demand outlook: Export orientation back again.

As per 1QFY19 dispatches figures disseminated by APCMA, local offtakes for the quarter displayed a flattish growth. While North region, comprising almost 80% of the total demand pie, witnessed a setback of 5%YoY to 7.2mn tons, South region broke new records with a remarkable +22%YoY growth to 1.9mn tons. The fall in North region demand was largely ascribed to halt in development projects by the caretaker government during the period. However on a positive side, exports revived, particularly in the South region where excess capacities and weakened PKR played their part.

Post 1QFY19, local sales have also picked up pace and are expected to register a decent recovery by the financial year end. Our dispatches assumption for the year is as follows:

Exhibit:

Cements dispatches for FY19E

	1QFY18A	1QFY19A	Growth	FY18A	FY19E	Growth
Local	9.06	9.02	0%	41.15	42.44	3%
North	7.52	7.15	-5%	33.97	33.97	0%
South	1.54	1.87	22%	7.18	8.47	18%
Exports	1.29	1.79	39%	4.75	6.21	31%
North	0.93	0.73	-22%	3.03	2.43	-20%
South	0.35	1.06	201%	1.71	3.78	121%
Total Dispatches	10.35	10.81	4%	45.89	48.65	6%

Source: APCMA, IGI Research

Recommendation: EBITDA growth key; PIOC, ACPL, KOHC, CHCC and LUCK preferred

The cement sector has come across a rather precarious situation, wherein multiple risks in the shape of devaluing currency, administrative price hikes in gas tariff, rising interest rates and a possible demand pullover have surfaced up in a simultaneous manner. Though most of the risks have been priced in by the market, there still remains room for generating alpha returns in selective stocks.

Furthering our narrative, we present below some key performance indicators of IGI cement coverage in a tabular form. Based on the exhibit, it might appear that earnings for some particular scrips (such as MLCF, ACPL, DGKC and FCCL) are displaying a negative trend, however this is in fact not the case. Keeping in mind that the sector is currently undergoing an expansion phase wherein upcoming earnings will be subject to substantial non-cash expense of depreciation, it would be misleading to judge the sectors performance on earnings growth alone.

Consequently, we highlight EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization) as a more accurate measure in such a situation, since it is free from notional costs and unbiased with respect to financing arrangements of the Company (however finance cost cannot be ignored completely in our scenario). In contrast to earnings display, the EBITDA growth of all the Companies is quite healthy with PIOC, CHCC, KOHC and ACPL leading the charts, since their relatively large expansion sizes are expected to uplift their market share. The only exception remains FCCL, since it has not yet entered its expansion activities (though management have disclosed their interest to do so).

We also observe that though LUCK offers a decent upside of 21%, it forms part of the league that displays both EPS growth and EBITDA growth, thus making its way in our preferred picks – PIOC, ACPL, KOHC, CHCC and LUCK

Exhibit:

IGI cement coverage key investment highlights

		LUCK	MLCF	KOHC	ACPL	CHCC	DGKC	FCCL	PIOC
EPS	FY18A	37.7	7.7	14.8	38.4	12.1	20.2	2.5	7.2
	FY19E	37.8	10.3	14.9	16.9	17.4	8.8	2.8	6.7
	FY20F	41.3	6.5	20.9	25.2	16.2	11.1	2.7	17.1
	FY21F	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	FY18A	18,094	8,542	4,599	3,917	3,588	10,194	5,785	2,819
	FY19E	18,619	9,214	4,895	4,450	4,981	12,805	7,283	3,131
	FY20F	20,021	11,942	5,616	5,638	7,517	12,947	6,663	4,676
	FY21F	22,290	10,586	8,578	5,503	6,796	11,784	5,699	7,976
	3Yr CAGR	7.2%	7.4%	23.1%	12.0%	23.7%	5.0%	-0.5%	41.4%
	Target Price	614	57	171	234	113	112	20	93
	Upside	23%	13%	68%	71%	30%	5%	-19%	77%

Source: Company Accounts, IGI Research

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Time Horizon: Dec – 2019

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