Day Break

Monday, 25 July 2016

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Company Update

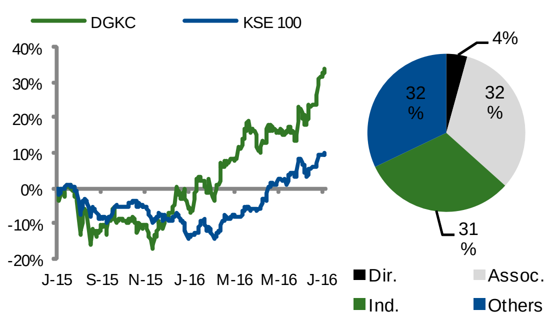
D. G. Khan Cement Co.			
Cement			
Recommendation			**BUY**
Target Price			242.0
Last Closing			206.8
Upside			17%
Market Data			
Bloomberg Tkr.			DGKC PA
Shares (mn)			438.1
Market Cap (PKRbn | USDmn)		90.6	864.4
Exchange			KSE 100
Price Info.	90D	180D	365D
Abs. Return	20.9	42.9	33.7
Low	170.3	144.7	127.8
High	206.8	206.8	206.8

Key Company Financials

Period End: Jun

PKRbn	FY15A	FY16E	FY17F	FY18F
Total Revenue	26.1	29.7	31.8	41.0
Net Income	7.6	9.2	10.6	11.7
EPS (PKR)	17.4	21.0	24.1	26.6
DPS (PKR)	5.0	6.7	7.7	8.5
Total Assets	74.4	82.2	96.7	113.0
Total Equity	62.3	68.6	75.7	83.7
Key Financial Ratios				
ROE (%)	12%	13%	14%	14%
P/E (x)	11.9	9.8	8.6	7.8
P/B (x)	1.5	1.3	1.2	1.1
DY (%)	2.4	3.2	3.7	4.1

Relative Price Performance & Shareholding



About the Company

D. G. Khan Cement Company Limited is a public limited company incorporated in Pakistan. It is principally engaged in production and sale of Clinker, Ordinary Portland and Sulphate Resistant Cement.

Source: Bloomberg, KSE 100 & IGI Research

Analyst

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DG Khan Cement

Expansion to Bring Core Growth; Buy

- DGKC is already running its northern plant at full capacity. In order to take advantage of springing local cement demand, company has broaden its domain to Southern region as well, with 2.8mn ton cement plant at estimated cost of USD 330mn (USD 106/ton).
- We have revised our investment case on DG Khan Cement Company (DGKC) based on a) 9000tons/day clinker capacity expansion in South, b) 5-yr tax holiday for revenues generated from Southern plant operations, c) local dispatches growth rate of +12% and, d) 30MW coal power plant in North operational from end of Jul-16.
- From its last closing of PKR 207/share the scrip is trading at a discount of +17% to our Dec-16 target price of PKR 242/share. DGKC is currently trading at FY17E P/E of 8.6x and offers dividend yield of 3.7%.We recommend 'BUY' call on the scrip.

Investment Case

We have revised our investment case on DG Khan Cement Company (DGKC) based on a) 9000tons/day clinker capacity expansion in South, b) 5-yr tax holiday for revenues generated from Southern plant operations, c)local dispatches growth rate of +12% and, d) 30MW coal power plant in North operational from end of Jul-16. As a result, our Dec-16 Sum of Parts (SOTP) based target price arrives at PKR 242/share, where core operations provide value of PKR 200/share and investment portfolio is worth PKR 42/share at 35% discount. At last close of PKR 206/share, stock provides +17% upside to our target price

Core Profitability to post Double Digit growth in 5 years

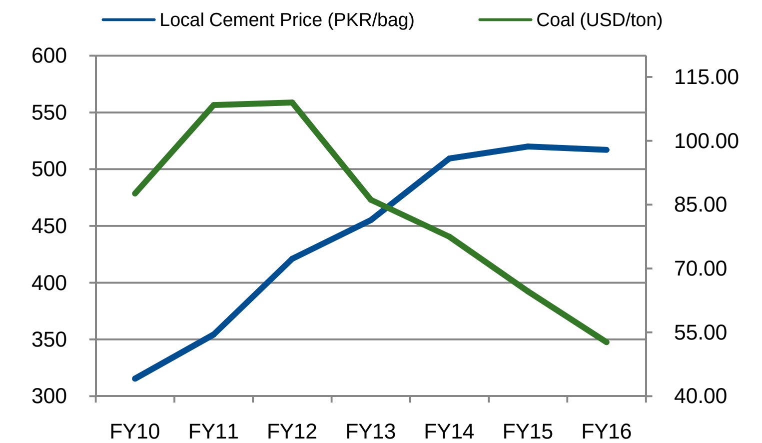
We project DGKC's profitability to post 5-yr CAGR of +12% from PKR 9.2bn (EPS PKR 21.0) expected in FY16 to PKR 14.7bn (EPS PKR 33.5) in FY21. Our earnings are based on the following assumptions; a) 2.8mn ton cement line expansion in Southern region to come online by Jan-18, taking total capacity to ~7mn tons, b) 5-yr tax holiday on green field plant, c) higher retention prices, as sales mix skewing towards local dispatches, d) estimated +12%YoY growth in local dispatches and, e) long term borrowing to the tune of PKR 17bn (50% of project cost) for new plant.

Expansion in South-Indispensible for Core Growth

Lower cost and Higher Prices-Supported Growth in Past

DGKC's core profitability has shown an impressive 3-yr CAGR of +10%, whereas gross margin expanded by 620bps from FY13-FY16E. We point out this growth largely on the back of a) rising cement prices with increasing local demand, b) decline in cost of power and fuel due to massive fall in FO and international coal prices, and c) shift in sales mix due to drying up exports Non-core income from strategic investments and utilization of group's tax losses also enhanced the overall profitability and resulted in impressive 3-yr CAGR of +19%.

Exhibit: Increasing Retail Prices despite decline in International Coal Prices



Source: IGI Research, Bloomberg, PBS

Expansion-Indispensible for Core Growth

However, company is already running its northern plant at full capacity. In order to take advantage of springing local cement demand, company has broaden its domain to Southern region as well, with 2.8mn ton cement plant at estimated cost of USD 330mn (USD 106/ton). As per management, equipment delivery would start taking place in next few months, as company has already made advance payment to one of its suppliers. The upsides of presence in South for DGKC are higher retention prices, exposure to exports via sea route and reduced transportation charges on coal. However, in our view, downside would be higher power cost as energy would be supplied by Karachi Electric (KEL) compared to company's own energy resources in North.

Gaining Diversified Foothold and Distribution network

With 90% capacity utilization achieved in South in FY16 and estimated +12% local dispatches growth going forward, we believe current capacity is insufficient to cater the mountainous local demand. However, expansion by DGKC and Attock Cement Company Limited (ACPL) would jack up total name plate capacity in the region to 12.89mn tons from current 8.59mn tons, providing companies in the region with sufficient capacity to cater demand.

Exhibit: Increase in capacity to 7.04mn tons in FY18 and expected capacity utilization

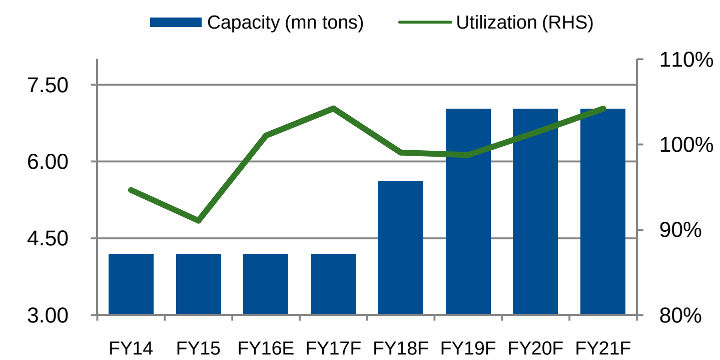
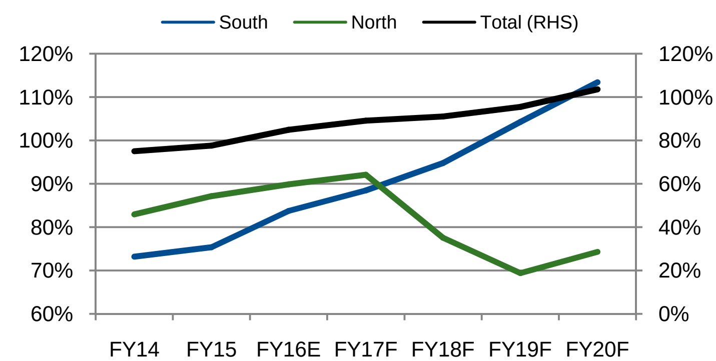


Exhibit: Industry's Capacity Utilization at 12% local dispatches growth



Source: IGI Research, Company's Financials

Leveraging

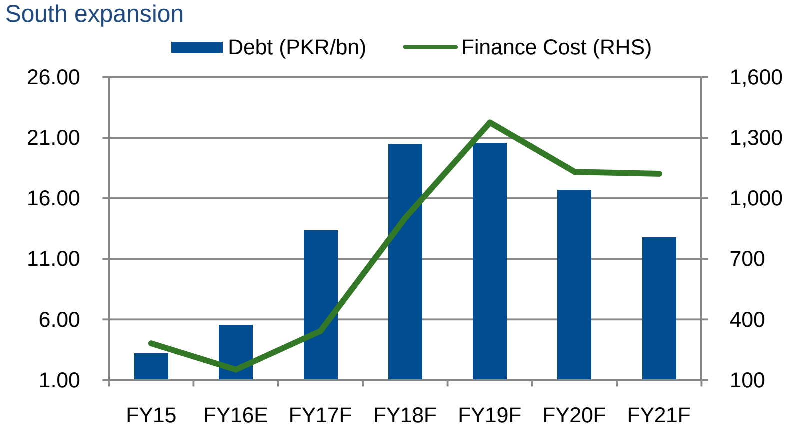
Project to be finance by Debt: Equity ratio of 50:50

Our discussion with the management suggests that company is likely to opt for debt to equity ratio of 50:50 for the South Expansion project. DGKC is expected to generate EBITDA of PKR 32bn in FY17-FY18, which in our view is more than sufficient to finance equity portion of the project.

Dividend to Continue

We have assumed company to obtain ~PKR 17bn debt at cost of 3M Kibor plus 0.5% payable in 5 years from FY19. According to financial account of 3QFY16, company has interest bearing debt of PKR 6bn, which is estimated to rise to PKR 20.5bn by the end of FY18, as a result of additional borrowing. Consequently, financial cost is also forecasted to go up from 3QFY18, whereas we expect company to keep up with its regular payouts on the back of healthy EBITDA generation of PKR 40.5/share in FY17, which is over and above working capital requirements. As a safety buffer, company also holds short term investment portfolio to the tune of PKR 17bn (PKR 38.77/share).

Exhibit: Debt and finance cost to increased due to additional borrowing for South expansion



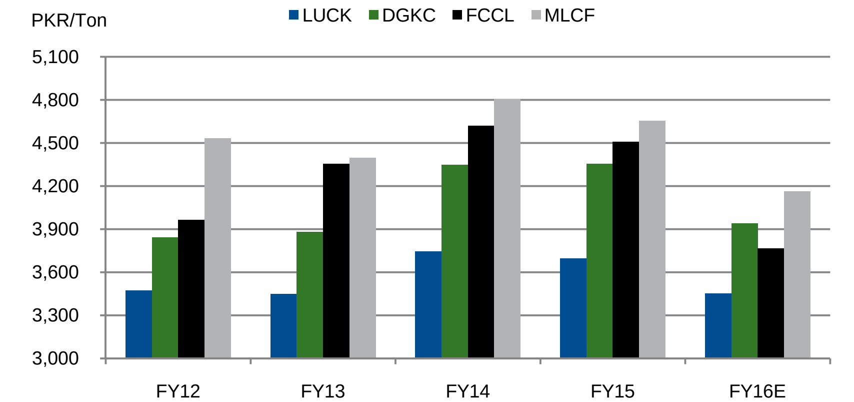
Source: IGI Research and Company Financials

Coal Power Plant and Tax Holiday

30MW coal plant to provide PKR 1.0-1.15/share cost saving

Company's 30MW Coal power plant is expected to come online in Aug-16, providing saving of PKR 1.0-1.15/share, annually. DGKC operates at second lowest cost/ton (PKR 3,452/ton or PKR 173/bag) among big 4 cement companies. Lower commodity prices, coal power plant and above 100MW other captive power plants make DGKC self-sufficient for its power needs in North side.

Exhibit: Discount to gradually decrease every six months



Source: IGI Research and Company Financials

5-yr Tax holiday-Budget 2017

Company will also be entitled to 5-year tax holiday on revenues earned by new plant in South. With plant expected to commence operations from Jan-18 onwards, we calculate company to save cumulative PKR 10.34/share in 4 years of plant's operations.

Exhibit: Estimated Financials For South Expansion

	FY18F	FY19F	FY20F	FY21F
		mn tons		
Local	0.96	2.16	2.37	2.61
Exports	0.11	0.20	0.14	0.10
Total Sales	1.06	2.35	2.51	2.71
		PKR mn		
Net Sales	7,607	17,074	18,609	20,589
Cost	5,058	11,343	12,479	13,840
Gross Profit	2,550	5,731	6,130	6,749
Finance Cost	582	1,020	806	564
Net Income	1,543	3,821	4,452	5,290
EPS	3.52	8.72	10.16	12.08
Saving/share	**1.06**	**2.62**	**3.05**	**3.62**
Gross Margin	34%	34%	33%	33%
Net Margin	20%	22%	24%	26%

Sources: IGI Research

Profitability

Better Retention amid higher Local/South Sales

Company's local dispatch to total sales ratio is forecasted to go up to 97% in FY21from 87% in FY16. This is primarily on the back of declining exports due to increased competition in Afghanistan, dumping duties by South Africa and international capacity expansion. We assume exports to continue to decline for the next 5 years. On the other hand, lower interest rates, private infrastructure spending and development projects under the ambit of CPEC, have led to healthy local dispatches and in our view local sales would keep driving the market. Going forward, higher local sales contribution towards total sales mix will likely lead to higher retention, as domestic sales are priced at 50% premium on export price.

Exhibit: Higher local/south dispatches leading to higher retention per ton, whereas margins are forecasted to decline to average rate of 35%

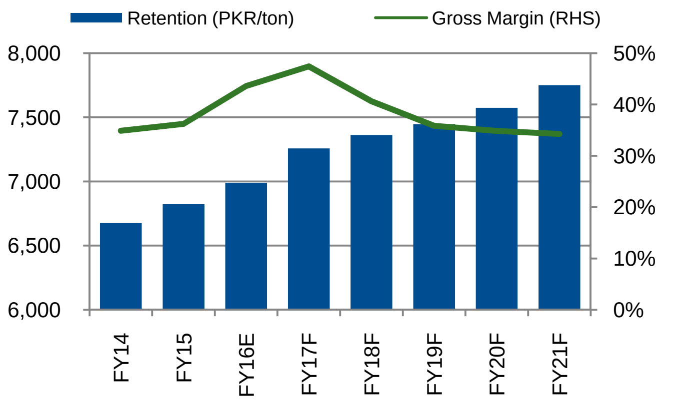
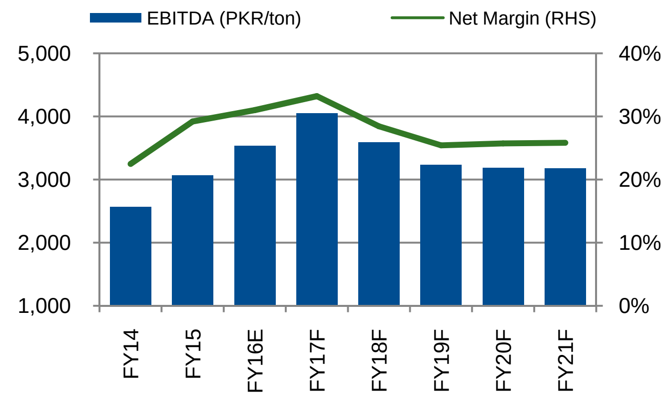


Exhibit: EBITDA per ton versus Net Margin



Source: IGI Research, Company's Financials

Profitability improved by impressive +52% in 3QFY16

Profitability posted double digit growth of +16%YoY to PKR 2.3bn (EPS: PKR 5.25) in 3QFY16, taking 9MFY16 earnings to PKR 6.4bn (EPS PKR 14.56), depicting a growth of +19%YoY. Revenue went up by +22%YoY to PKR 7.7bn in 3QFY16, on the back of +22%/+64%YoY increase in local sales/exports. Gross Margin improved massively by 801bpsYoY to 44% in 3QFY16 as compared to 36% in same period last year, as increased local sales resulted in higher retention, in tandem with low energy and fuel cost.

Exhibit: Financial Highlights

PKR'mn	3QFY16	3QFY15	YoY	9MFY16	9MFY15	YoY
Revenue	7,683	6,290	22%	21,318	18,945	13%
Gross Profit	3,408	2,286	49%	8,895	6,417	39%
Selling and Admin	354	246	44%	982	947	4%
Other Income	567	583	-3%	1,804	1,717	5%
PBT	3,349	2,388	40%	8,928	6,480	38%
Tax	1,050	407	158%	2,550	1,105	131%
Net profit	2,299	1,981	16%	6,378	5,375	19%
EPS	5.25	4.52	16%	14.56	12.26	19%
Key Ratios						
Gross Margin	44%	36%		42%	34%	
Net Margin	30%	31%		30%	28%	
Effective Tax Rate	31%	17%		29%	17%	

Source: IGI Research, Company Financials

Risks to Investment Case

Local Demand-The Driver

The recent wave of expansion is largely on the back of demand expected to arrive from CPEC projects. Local dispatches have grown by +7.8%YoY and +23.4%YoY in FY15 and FY16, respectively, whereas we estimate demand to rise by +12% for the next 4 years. We highlight that in absence of export avenues, any significant fall in local demand can cause commotion in the pricing arrangement, thus affecting profitability. Lucky cement has the largest market share of 40%, followed by Attock cement's 28% in South.

Coal Prices-Still the cheapest fuel option

International Coal prices started declining from FY11 from a high of USD 131/ton to an average of USD 61.26/ton in Jul-17, due to changed demand/supply dynamics and environmental issues. This has largely benefitted cement companies in Pakistan as declining coal reduced the cost of fuel whereas local quota arrangement kept the prices on upward trajectory.

However, prices have recently rebounded to USD 62.90/ton after touching a low of USD 47.75/ton in Dec-15. This uptick is likely on the back of bankruptcy of large coal companies in USA and imbalance in international demand/supply. We have assumed international coal prices to average at USD 58/ton and USD 63/ton in FY17 and FY18, respectively. Our profitability is highly sensitive to our coal price assumptions. For every USD 1/ton change from our base case coal price assumption of USD 58/ton, profitability for the company changes by 0.53% in FY17.

Local Cement Prices- Arrangement driven

Local prices are largely a function of pricing discipline set by local cement companies in Pakistan where supply is restricted to keep prices in check. This effectively provides edge to domestic players to pass on cost push pressures to end consumers. This is evident by recent cement price hike by PKR 35-40/bad in order to pass impact of PKR 25/bag increased FED in Budget-2017. We believe future demand growth to be of prime importance for profitability, in light of recent expansionary wave in the industry. With every 1% change in retail price assumption of PKR 546/bag, our earnings deviate by 2% in FY17.

Valuation

We have upgraded our price target for DG Khan Cement Company (DGKC) to PKR 242/share (previous PKR 228/share), incorporating expansion in our model from FY18. Our risk free rate and market premium are set at 6.5%, whereas 3-yr beta for the company is currently 0.95, which bring cost of equity at 12.7%.

Valuation Parameters	
Risk Free Rate	6.5%
Beta (3-yr)	1.26
Market Premium	6.5%
Cost of Equity	14.7%
Sustainable growth	2.0%

PKRmn	30-Jun-17	30-Jun-18	30-Jun-19	30-Jun-20	30-Jun-21
WACC	13.5%	13.2%	13.3%	13.6%	13.9%
EBIT	13,667	14,998	16,629	16,983	17,642
EBIT(1-t)	9,567	10,989	12,819	13,360	12,349
Depreciation	2,259	3,158	4,019	3,924	3,819
+ After Tax EBITDA	11,826	14,147	16,839	17,284	16,168
Chg. Current Assets	(1,099)	(1,386)	(2,886)	(526)	(641)
Chg. Current Liabilities	141	1,782	6,256	1,242	835
- Chg. Non-cash WC	(958)	396	3,370	716	195
- CAPEX	(17,866)	(20,919)	(2,411)	(2,354)	(1,782)
FCFF	**(6,998)**	**(6,377)**	**17,798**	**15,645**	**14,581**
Discounted FCFF	(6,544)	(5,236)	12,777	9,724	7,880

Sum of PV	18,601
Terminal Value	63,337
Sum of PV	**81,938**
Add: Cash	11,198
Less: Debt	5,547
Equity value	**87,589**
Investment Portfolio Value	**18,514**
Total Value	106,103
No. of Share (mn)	438.1
Target Price (Dec-16)	**242**

Recommendation

From its last closing of PKR 207/share the scrip is trading at a discount of +17% to our Dec-16 target price of PKR 242/share. DGKC is currently trading at FY17E P/E of 8.6x and offers dividend yield of 3.7%. We recommend a strong ‘**BUY** ‘call on the scrip.

Financials

DG Khan Cement (DGKC)

Current Price (PKR):	206.8		Target Price (PKR):		242.2
Jun-end	FY15A	FY16E	FY17F	FY18F	FY19F
Income Statement Items (PKRmn)					
Net Sales	26,105	29,661	31,769	40,967	51,741
Gross Profit	9,455	12,940	15,074	16,655	18,557
S&A exp	747	731	526	529	553
Oth. Income	472	492	505	651	776
Oth. Expense	2,320	2,388	2,421	2,421	2,421
EBITDA	11,728	15,008	17,741	19,971	22,462
Finance Cost	282	151	342	903	1,376
PBT	9,547	12,997	15,140	15,910	17,068
Tax	1,922	3,796	4,583	4,253	3,910
PAT	7,625	9,201	10,557	11,658	13,158
Balance Sheet Items (PKRmn)					
PPE	29,959	34,223	49,830	67,591	65,984
NC Assets	42,965	46,004	61,611	79,372	77,765
Inventory	1,188	1,499	1,605	1,660	2,097
Receivables	157	157	157	157	157
Cash	258	11,198	8,979	6,142	15,618
Total Assets	74,391	82,196	96,683	112,994	123,748
LT Debt	714	3,027	10,189	16,785	12,725
NC Liabilities	5,510	7,823	14,985	21,581	17,521
Payables	4,048	3,229	2,724	3,966	6,077
Total Liabilities	12,093	13,635	20,938	29,316	31,512
Share Capital	4,381	4,381	4,381	4,381	4,381
Total Equity	62,296	68,561	75,745	83,678	92,236

Upside	17%		Recommendation		BUY
Jun-end	FY15A	FY16E	FY17F	FY18F	FY19F
Valuation Ratios					
EPS (PKR)	17.4	21.0	24.1	26.6	30.0
DPS (PKR)	5.0	6.7	7.7	8.5	10.5
P/E (x)	11.9	9.8	8.6	7.8	6.9
D/Y (%)	2%	3%	4%	4%	5%
Prof. Growth (%)	28%	21%	15%	10%	13%
P/B (x)	1.5	1.3	1.2	1.1	1.0
ROE	12%	13%	14%	14%	14%
ROA	10%	11%	11%	10%	11%
Cash / Share	0.6	25.6	20.5	14.0	35.6
Financial Gearing					
Debt/Equity	5%	8%	18%	24%	22%
Interest Coverage	34.9	86.8	45.2	18.6	13.4
Macro- Assumption					
Coal	65.0	52.7	58.4	62.6	66.5
PKR / USD	102.8	104.8	106.9	109.1	111.2
Efficiency Ratio					
Current Ratio	4.8	6.2	5.9	4.3	3.3
Quick Ratio	4.0	5.1	4.6	3.2	2.4
Sales and Capacity Utilization					
Cap. Utilization	4.20	4.20	4.20	5.62	7.04
Local (mn'ton)	3.17	3.69	3.98	5.17	6.54
Export (mn'ton)	0.65	0.56	0.40	0.39	0.40
Total Sales (mn'ton)	3.82	4.24	4.38	5.56	6.95

Source: IGI Research, Company Financials

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Analyst Certification

The analyst^ hereby certify that the views about the company/companies and the security/securities discussed in this report are accurately expressed and that he/she has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report. The analyst is principally responsible for the preparation of this research report and that he/she or his/her close family/relative does not own 1% or more of a class of common equity securities of the following company/companies covered in this report.

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IGI Finex Securities employs three tier ratings system, depending upon expected total return (return is defined as capital gain exclusive of tax) of the security in stated time period, as follows:

Recommendation	Rating System
Buy	If return on aforementioned security(ies) is more than 10%, from its last closing price(s)
Hold	If return on aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
Sell	If return on aforementioned security(ies) is more than -10%, from its last closing price(s)

Valuation Methodology

The analyst^ has used following valuation methodology to arrive at the target price of the said security (ies):

- DCF (Discounted Cash Flow)

Time Horizon

- Dec - 2016

Risk

- Changes in State Bank of Pakistan Policy Rate
- Changes in country (Pakistan) macro-economic environment
- Changes in Company(ies) operating structure
- Change in Exchange Rate (USDPKR)

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