LUCK: Ventures cushion in time of crunch

- We update our investment case for LUCK, incorporating the FY20 detailed accounts where we adjust our working capital assumption as working capital cycle moves towards normalcy after worsening in FY20 due to company providing discounts, while also adjusting gas tariff assumption and streamlining difference between PBS price and realized price.

- Real surprise lies in company’s other ventures where Kia Lucky Motors (KLM) stands out, as company posted positive operating margins while cement operations in Congo also posted impressive net margin of 13% for FY20. We also incorporate upcoming clinker plant in Iraq into our valuations, increasing the ventures contribution to PkR47/sh from PkR22/sh previously.

- We continue to like the scrip based on company’s efficient local cement operations where gross margins of 14.3% for FY20 against 1.9% of peers (MLCF, CHCC, FCCI, DGKC) stand as a testament, while company’s strong market network will aid in capitalizing on the status of largest cement producer.

- Company is currently at EV/EBITDA of 6.3x (against 7.7x of AKD Cement Universe) and after having a dull FY20, we expect earnings to grow at a CAGR of 19% for FY21-24 as prices improve in North while dispatches expected to grow at 12% for FY20-23. We have a Buy stance on the stock with our Jun’21 TP of PkR761.3/sh providing upside of 15%.

Path towards normalcy begins: Difference between PBS reported price and LUCK’s realized price for FY20 stood at 20% against 15/18% for FY18/19 as industry witnessed severe price competition with prices in North declining by 24% from a high of PkR655/bag to make a low of PkR496/bag during the year. Historically, this difference has correlated with utilization as whenever industry goes through an expansion cycle, players engage in price competition, resulting in higher difference. However, once utilization increases post completion of an expansion cycle, difference starts decreasing where lowest difference since FY08 was witnessed in FY17 of 11% when utilization reached 93%. Moving forward, we expect the same to continue with difference for FY21/22 expected at 16/15% against utilization levels of 78/83%. We highlight a 5.1% impact on EPS of 1ppt change in difference. While going through a down cycle, company’s working capital cycle worsened as discounting resulted in increased receivable days (30 for FY20 against 16 for FY19) while payable days declined to 197 for FY20 against 206 for FY19. However, with sector dynamics improving, historically working capital cycle has also reverted back and we expect the same with working capital cycle to return to normalcy by FY23. We also adjust our gas tariff assumption, postponing the 10% increase in gas tariff to Mar’21 against previously assumed Jul’20.

Other ventures support in times of local cement downturn: In times when local cement operations were going through a downturn, LUCK’s other ventures delivered, with phenomenal results posted by KLM and cement operations in Congo. KLM in its first full years of operation has posted a positive operating profit as Sportage and Picanto witnessed overwhelming response with company announcing plans to move towards double shift from Jan’21. Though 4Q operating margins of KLM dropped to 3.4% against 4.4% in 3QFY20, they still outperformed industry peers like PSMC/INDU which witnessed operating margins of -13.6/-6.2% in 4QFY20 against ~1.8/-2.7% in 3QFY20. At the same time, operation in Congo turned profitable with a net margin of 13% for FY20 where margins are currently better than local cement operations, according to our estimates. We believe healthy foreign operations at this crucial time provide much needed support to the company particularly when cash flow is required to fund ongoing investments in Lucky Electric Power Limited (LEPL) and a clinker plant in Iraq. We also incorporate upcoming clinker plant in Iraq into our valuations which is consequently expected to increase topline as well as margins on the back of in-house clinker production. Venture’s contribution to our TP has increased to PkR47/sh from PkR22/sh previously.
Outlook: We continue to like the scrip as efficient cement operation (denoted by 14.3% gross margins during FY20 against 1.9% of peers (MLCF, CHCC, FCCL, DGKC)) which acted as a shield in times of downturn, is going to aid company in retaining above average margins, moving forward. Company is currently trading at EV/EBITDA of 6.3x and after having a dull FY20, we expect earnings to grow at a CAGR of 19% for FY21-24 as prices improve in North while dispatches are expected to grow at 12% for FY20-23. We have a Buy stance on the stock with our Jun’21 TP of PkR761.3/sh providing upside of 15%.
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