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PAKISTAN
CEMENT

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MARKET
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Price of being in the limelight

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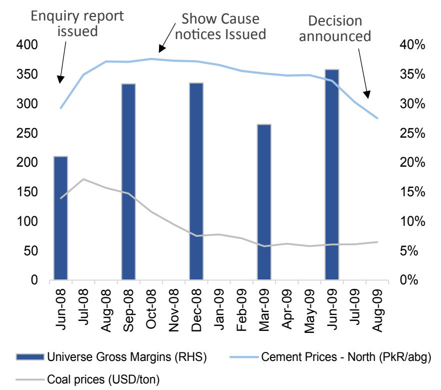
- **Number of risk are looming on the horizon for local cement manufacturers in the form of i) Competition Commission of Pakistan (CCP) initiating inquiry over cement price increase, and ii) sharp spike in coal prices (up 50% since Oct'20), with implications for pricing moving forward.**
- **CCP has recently issued an enquiry report regarding alleged cartelization by cement manufacturers during Apr'20-May'20, increasing prices by PkR50/bag. The enquiry committee has recommended initiating proceedings against the APCMA and its member undertakings.**
- **With the sector on strict watch of CCP, we believe the spot light may force players to self regulate, possibly staggered price hikes at best, with complete absorption of cost by the sector at worst (unlikely) and in case of the latter, margin suppression in 3QFY21 cannot be ruled out.**
- **We continue to prefer LUCK (TP: PkR868.5/sh, 28.6% upside) and MLCF (TP: PkR57.6/sh, 37.3% upside) with LUCK's low cost based shielding against potential headwinds while a diversified portfolio further reduces the risk. MLCF having the option of petcoke can switch its fuel to petcoke in case coal prices continue increasing.**

Potential headwinds in sight: Not all seems to be well for local cement manufacturers as after margins improving on the back of improved demand and pricing, number of headwinds seem to be present ahead in form of i) CCP initiating inquiry over cement price increase, and ii) sharp spike in coal prices (up 50% since Oct'20). CCP has recently issued an enquiry report regarding alleged cartelization by cement manufacturers during Apr'20-May'20, increasing prices by PkR50/bag. The enquiry committee has recommended initiating proceedings against the APCMA and its member undertakings. To recall, the last time CCP proceeded against local cement manufacturers, it took 4-5 months from issuance of report till show cause notices being served and further 9-10 months from issuance of show cause notices to imposition of penalties. Though cement prices in North increased by 41% from May'08 to Oct'08 majorly to pass-on increase in coal prices, from Oct'08 to Jun'09, prices in North declined by PkR37/bag. During this time period of declining prices, margins of our universe declined from 34% in 2QFY09 to 26% in 3QFY09, though recovered to 36% in 4QFY09 as coal prices declined.

Cost pass-on to be staggered at best: Current scenario is different from what was witnessed earlier as the proceedings have coincided with a sharp spike in coal prices (up 50% since Oct'20) and to wade off the impact of increase in fuel cost, manufacturers will need to increase prices. To note, assuming coal prices to average at USD90/ton against USD60-65/ton for 1QFY21, manufacturers will need to increase prices by PkR30-45/bag to maintain margins. Though we do not rule out a cost pass-on by local manufacturers, with the sector on strict watch of CCP, we believe the increase in prices is going to be staggered at best while in worst case, local manufactures will need to absorb costs and in case of the latter, margin suppression in 3QFY21 cannot be ruled out. We have incorporated an increase in prices of PkR20/bag during subsequent quarters with assumed coal prices of USD70/65/ton for 3QFY21/4QFY21. However if local players will have to absorb the increased cost, assuming cement prices/coal at PkR550/USD90, gross margins of our universe will decline to 13% from 20% in our base case (with cement price/coal assumed at PkR565/USD70).

Outlook: In light of aforesaid cost absorption, we continue to like our preferred plays where we believe LUCK's low cost base will continue to cushion against commodity spikes and company will continue to outperform peers in terms of margins. Though MLCF is comparatively more sensitive to change in coal prices than LUCK and DGKC (see table on RHS), option of switching towards petcoke gives the company an option in case coal prices continue to increase. MLCF currently is not using petcoke due to the fuel being expensive on cost per kcal basis (PkR3.9/kcal vs. PkR3.5/kcal of coal) however with refinery run rates increasing globally, short term scenario for petcoke looks better than coal. Overall, we expect the sector to tread sideways in near term as negative news flow and muted demand is expected to keep price performance in check however in medium term as coal prices cool down and demand picks up, sector is expected to outperform.

Prices decline after issuance of show cause notices



Source: APCMA, PBS & AKD Research

Sensitivity to a USD5/ton increase in average coal prices

	Change in EBITDA
PIOC	-6.63%
CHCC	-6.40%
MLCF*	-6.16%
FCCL	-5.76%
DGKC	-5.46%
LUCK	-5.08%

*Assuming no petcoke usage

Source: AKD Research

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