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PAKISTAN
CEMENT

REP-019
MARKET
VISTA

DGKC: Near-term headwinds standing strong

- **Revision of depreciation policy saved the day in 2QFY19 for DGKC as margins clocked in at 18.5% vs. 12.7% in 1QFY19 leading to an EPS of PkR3.02, up 47.7%YoY. Taking cue from company notes, without revision, it would have been a dismal 1HFY19 for DGKC with PBT of PkR0.60bn vs. actual amount of PkR1.59bn.**
- **Despite revision, misery will continue as utilization for 2HFY19 is expected to decrease resulting in a lower base to absorb fixed costs while if clinker exports are increased further to improve utilization, it will again hurt margins.**
- **Working capital needs of the company have increased resulting in further strain on income statement as company looks towards borrowing to fulfill its needs in the wake of negative net operating cash flow of PkR292mn for 1HFY19 vs. positive PkR4.4bn for 1HFY18.**
- **We have a Neutral stance on the stock (TP: PkR97/sh) since long term performance remains robust with 35.6% 3yr CAGR of earnings for FY19-22 (highest in AKD Cement universe). However, in the near term, sector overhangs will keep the stock price under pressure.**

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NEUTRAL

TARGET PRICE (PkR)	SHARE PRICE (PkR)
97.3	**83.1**
UPSIDE/DOWNSIDE	DIV. YIELD
17.1	**1.6%**

DGKC: Key ratios

	FY18	FY19F	FY20F
EPS (PkR)	20.2	6.8	7.8
EPS Growth	10.8%	-66.4%	14.5%
PER (x)	4.1	12.2	10.7
P/BVS(x)	0.47	0.47	0.45
DPS (PkR)	4.3	1.4	1.6
Dividend yield	5.1%	1.6%	1.9%
Gross Margin	28%	14%	17%
EBITDA Margin	33%	23%	25%

Source: Company Report & AKD Research

Change in depreciation policy uplifted margins in 2QFY19: DGKC revised its depreciation policy which resulted in company posting gross margins of 18.5% vs. 12.7% in the previous quarter – surpassing our expectations. As per company notes, had the depreciation policy not been revised, DGKC's PBT for 1HFY19 would have stood at PkR0.60bn against actual amount of PkR1.59bn. To note, PkR518mn were charged under the depreciation head as a part of cost of sales for 2QFY19 vs. PkR1.16bn in 1QFY19. Expected lives of plants at DG Khan and Kahirpur were revised upwards, however no changes were made to the policy of Hub. Though the change in depreciation policy provided respite to DGKC for second quarter, the same will not continue to support as utilization for 2HFY19 is expected to decline to ~85% vs. ~91% in 1HFY19, resulting in a lower base to absorb fixed costs.

Working capital needs increasing the burden on already debt-laden balance sheet: With a significant slowdown in dispatches in North (local dispatches for the region down by 6%YoY for 8MFY19) and DGKC opting for clinker exports to support utilization, working capital needs of the company have significantly increased as trade debts have reached to PkR1.4bn (as of Dec'18) vs. PkR0.2bn (as of Jun'18) taking days sales outstanding to 7.4 against an average of 2.4 for last three years. Moreover, a negative net operating cash flow of PkR292mn in 1HFY19 has led to company opting for short term borrowings to finance capital expenditures and repayment of long term loans (short term borrowings stand at PkR14.4bn as of Dec'18 vs. PkR12.2bn as of Jun'18). In an environment of increasing interest rates, the D/E of the company has reached 43% vs. 39% of our universe while interest cover has fallen to 2.5x in 2QFY19 vs. 15.2x for FY18.

Highest earnings CAGR though the near term metrics look weak: DGKC commands the highest 3yr (FY19-22) earnings CAGR among our universe (35.6% vs. 12.1% of our universe) as company's presence in both the regions will provide support in times of significant pricing pressure expected in North—expansion at Hub, Balochistan will lead to increase in overall market share to 10.2% by FY22 vs 9.2% in FY16. However, EBITDA margins of 23% for FY19F vs. 27% of our universe and consequently an EBITDA/ton of USD9.7 vs. USD11.4 of our universe offsets the positives. Moreover, in-line with the overall sector, DGKC's stock price is expected to remain under pressure in near term as pressure on local cement prices builds up in North on the back of capacity additions (7.1mn tons expected in rest of CY19) amid non-supportive demand outlook. We have a neutral stance on the stock with our TP of PkR97/sh offering an upside of 17%.

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Buy	**> 19% expected total return (Rf: 13% + Rp: 6%)**
Neutral	**> 13% to < 19% expected total return**
Sell	**< 13% expected total return (Rf: 13%)**

Old Rating Definitions (Discontinued)	
Buy	**> 20% upside potential**
Accumulate	**> 5% to < 20% upside potential**
Neutral	**< 5% to > -5% potential**
Reduce	**< -5% to > -20% downside potential**
Sell	**< -20% downside potential**
Not Rated	**No investment opinion or recommendation**

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- Equity & Asset return based methodologies (EVA, Residual Income etc.)

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