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CEMENTS

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Is the worst over?

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- **Surrounded by negatives, cement industry of Pakistan has been under severe pressure lately, where the sector has corrected 22% CYTD (underperforming KSE-100 by 17%).**
- **Already suffering from supply side glut and higher input cost pressures, cement industry is fighting 'war of fundamentals' on multiple fronts, where repercussions of the upcoming IMF program (aggressive monetary tightening and currency devaluation) could further dampen sector's profitability going forward.**
- **In this regard, stress-testing our base case impression, we have intensified our currency depreciation, interest rate and coal price assumptions to a worst possible case scenario (PkR/US$ parity: 145; Discount rate: 12.5%; Coal: US$106/100 per ton for FY19/20F). Consequently, our AKD cement universe (ex-luck) valuations shrink by an average 44% while earnings drop by 23/45% for FY19/20F.**
- **On the flip-side, tailwinds of currency depreciation include improved competitiveness of Pakistani cement in the export market, countering potential slowdown in local demand.**
- **In light of the worst case scenario outcome under prevailing market situation, further correction in the sector cannot be ruled out, where our cement universe is currently trading at a relatively expensive FY19/20F P/E(x) of 9.0/11.5x (31%-67% premium over current KSE-100 PE of 6.9x). Therefore, we have a cautious stance on the sector in the medium term, where volatile cement prices in the prevailing high cost environment can further deteriorate already pressurized primary margins, in our view.**

Continuous pressure on input cost - suppressing margins: Declining consistently every quarter, gross margin for AKD cement space came down to as low as 25.4% in 4QFY18 (lowest in last 7 years) owing to persistent upward pressure from input costs and volatile cement prices.

Analyzing worst possible case scenario – IMF program repercussions: Already suffering from supply side glut and higher input cost pressures, the cement industry is fighting 'war of fundamentals' on multiple fronts, where fallout of the upcoming IMF program could further temper sector's outlook going forward. In this regard, while analyzing the potential for aggressive monetary tightening, we have stressed our currency depreciation and interest rate assumptions to a worst possible case scenario as follows:

I. **Currency depreciation:** While coal constitutes 45-50% of cost of production, further currency depreciation is a major drag on primary margins that are already struggling on account of persistent rise in input costs (higher int'l coal prices). In this regard, we have intensified our PkR/US$ parity to 145 from 2QFY19 (base case 133 by the end of FY19). In this worst case, GM estimates for AKD cement universe shrink by an average 1.7/2.5ppts to 23.4/23.3% for FY19/20F. Consequently, our earnings estimate (ex-luck) go down by an average 7.7/16.0% for FY19/20F bringing down our Jun'19 TPs for the universe by an average 10.3%. In this scenario, LUCK will be least impacted owing to its efficient cost structure and higher export mix in total sales.

II. **Aggressive policy rate:** With the anticipation of more rapid interest rate reversal than earlier expected, cement sector remains exposed to sizeable debt financing costs, considering current financial leverage of the sector (D/E: 51% in Jun'18) owing to the ongoing expansion cycle. In this regard, our stress-test analysis suggests an average bottom-line impact of 4-11% (FY19-20F) on AKD cement universe for a further 250bps further hike in interest rate from our base case, dragging our Jun'19 valuations by 20% (risk-free rate: 12.5%). In this regard, CHCC and PIOC being highly leveraged (D/E reaching 140% and 79% by Jun'18) stand more exposed to interest rate hikes than the rest. However, owing to its debt free balance sheet, LUCK emerges out as a clear winner in this scenario.

III. **Coal Price:** We currently have a base assumption of US$100/90/ton for FY19/20F, while the current int'l coal price is hovering around US$100/ton. For our worst case modeling, we have increased our average coal price assumption for FY19 & FY20 to US$106/ton &

Stress-testing: Worst possible scenario

	EPS(PkR)	FY19F	FY20F	Price	TP
	Worst case	30.95	30.74		538.2
LUCK	Base case	33.12	35.09	460.4	666.0
	Change	-7%	-12%		-19%
	Worst case	8.92	7.57		69.0
DGKC	Base case	12.26	13.92	81.9	122.0
	Change	-27%	-46%		-43%
	Worst case	4.51	4.14		35.0
MLCF	Base case	5.88	6.42	38.4	65.0
	Change	-23%	-35%		-46%
	Worst case	1.99	2.07		17.0
FCCL	Base case	2.36	2.74	20.0	26.0
	Change	-16%	-24%		-35%
	Worst case	7.41	3.83		49.0
CHCC	Base case	9.46	8.49	63.7	96.0
	Change	-22%	-55%		-49%
	Worst case	5.88	2.85		39.9
PIOC	Base case	7.06	5.57	38.6	69.0
	Change	-17%	-49%		-42%
	Worst case	2.43	3.13		19.0
GWLC	Base case	3.48	4.49	17.4	36.0
	Change	-30%	-30%		-47%

Assumptions

	Base Case	Worst Case
PkR/US$ parity	133.0	145.0
Discount rate	9.50%	12.50%
Coal Price (US$/ton)	100/90	110/100

AKD Cement Universe: Financial Leverage

Jun'18	D/E Ratio	D/A Ratio
LUCK	-	-
DGKC	42%	26%
MLCF	64%	33%
FCCL	13%	9%
CHCC	140%	51%
PIOC	79%	37%
GWLC	33%	18%
Average	51%	29%

Source: Company Reports & AKD Research

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US$100/tons, resulting in the earnings of our Universe shrinking by an average 9/15% for FY19/20F while valuations come down by 8%.

That said, tailwinds still exist: With a recent average price hike of PkR50/bag, cement prices in the North have posted a decent recovery from Feb'18 (cumulative increase of PkR110/bag), now up by almost 8.7% since its peak in Jun'17. In the southern region, cement prices have risen by 4.4% since then, where the prices have so far remained stable. Beside this, tailwinds of currency deprecation include improved export margins that will increase competitiveness of Pakistani cement in the export market, hence boosting sales (countering potential slowdown in the local demand).

Investment Perspective: In the light of worst case scenario outcome under prevailing market situation, further correction in the sector cannot be ruled out, where our cement universe is currently trading at an expensive FY19/20F PE(x) of 9.0/11.5x (31%-67% premium over current KSE-100 PE of 6.9x).Therefore, we have a cautious stance on the sector in the medium term, where volatile cement prices (potential slowdown in demand amidst higher supply triggering another pricing indiscipline) in the prevailing high cost environment can further deteriorate already pressurized primary margins, in our view.

Cement Universe: P/E Testing

	Base Case		Worst Case	
	FY19F	FY20F	FY19F	FY20F
LUCK	13.9	13.1	14.9	15.0
DGKC	6.7	5.9	9.2	10.8
MLCF	6.5	6.0	8.5	9.3
FCCL	8.5	7.3	10.0	9.7
CHCC	6.7	7.5	8.8	20.3
PIOC	5.5	6.9	6.6	14.5
GWLC	5.0	3.9	7.2	5.6
Average (ex-luck)	7.0	6.5	9.0	11.5
KSE-100	6.9	6.9	6.9	6.9
Pre/(Dis)	2%	-5%	31%	67%

Source: AKD Research

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Neutral	> 10% to < 16% expected total return
Sell	< 10% expected total return (Rf: 10%)

Old Rating Definitions (Discontinued)	
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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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