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Pakistan Cement Industry- An Overview of Profitability Drivers From FY12 - FY17

REP-091

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Glossary

APCMA	All Pakistan Cement Manufacturer Association
CGAR	Compounded Annual Growth Rate
CPEC	China Pakistan Economic Corridor
FO	Furnace Oil
FYXX	Financial Year Ending 30 June XX
FYXXE	Financial Year Ending 30 June XX Estimate
HSD	High Speed Diesel
PKR	Pakistani Rupee
PSDP	Public Sector Development Program
WHR	Waste Heat Recovery
USD	US Dollar

- The objective of this report is to identify key drivers of profitability in the cement sector in the five year period from 2012 to 2017. The analysis presented is based on available data from 12 cement companies representing approximately 87% of the industry sales

- Cement dispatches (i.e. volumetric sales) grew by a 6.2% per annum in the five years from 2012 to 2017. Dispatches largely grew because of higher local sales which showed an annual increase of 8.3% whilst export sales declined during the same period

- In the last 5 years, cement manufacturers have benefited from higher gross profit margins driven by increase in retention prices, lower energy prices (including coal, HSD and FO) and reduced costs due to installation of efficient energy projects (WHR and Coal power plant)

- During the same period, capacity utilization also increased to 89% (FY12: 74%)

- Higher utilization, strong local demand and healthy gross margins have encouraged cement manufacturers to announce an increase in their capacities. As a result 27.50mn tons of capacity will be added between FY18 and FY20

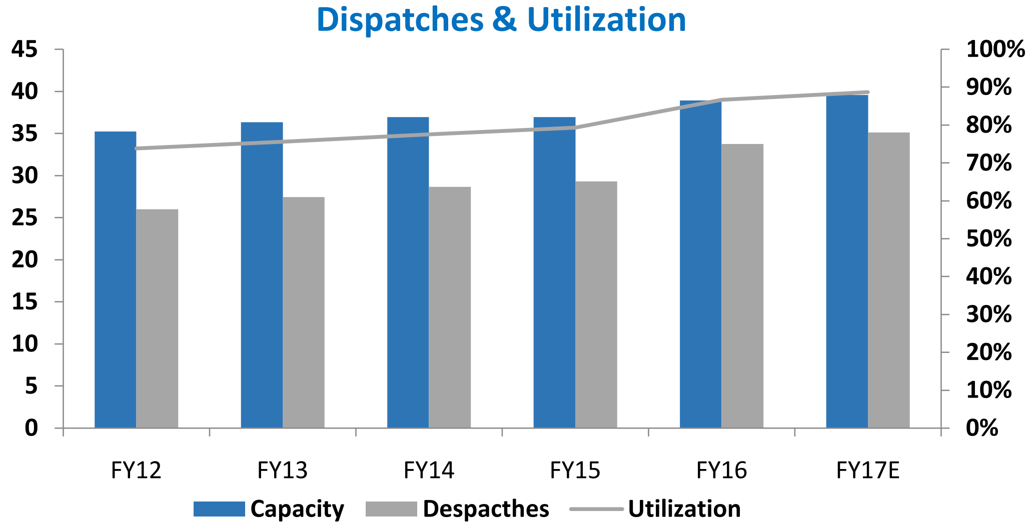
- We estimate that dispatches could grow at the rate of around 8% over the next 5 years taking expected utilization (post expansion) level to around 74% in FY21

6 Year Cement Industry Snapshot

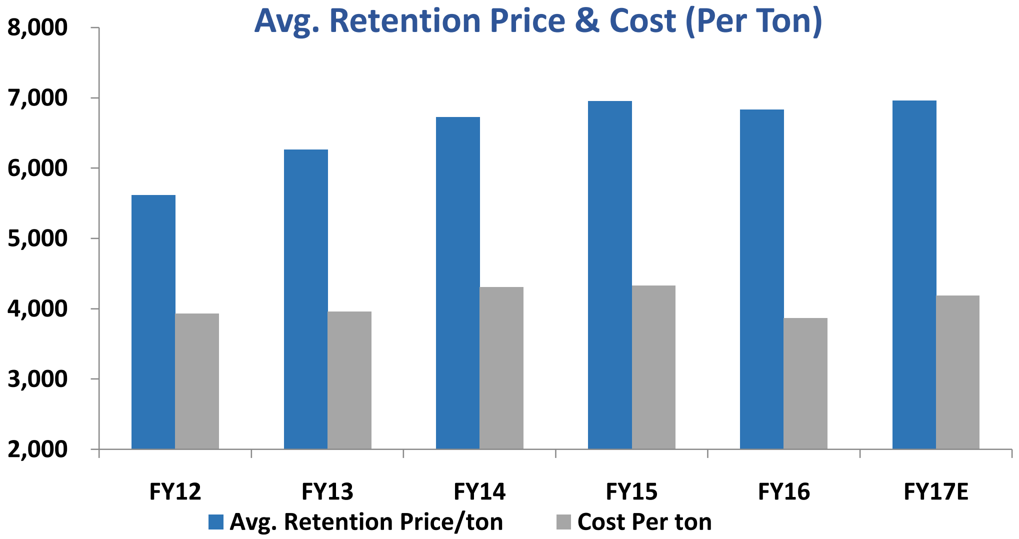
ABBASI SECURITIES

Particulars	FY12	FY13	FY14	FY15	FY16	FY17E
Qty Sold (Ton)	26,005,531	27,447,149	28,654,871	29,288,495	33,738,099	35,101,054
Avg. Retention Price/ton (Rs)	5,618	6,268	6,730	6,958	6,830	6,964
Cost Per ton (Rs)	3,930	3,958	4,308	4,331	3,865	4,192
Gross Profit/ton (Rs)	1,789	2,334	2,480	2,754	2,955	2,772
Net Profit Per Ton (Rs)	763	1,322	1,407	1,677	1,738	1,662
Total Profit (Rs 000)	19,838,785	36,272,412	40,319,861	49,125,423	58,632,165	58,337,259

Source: Reuters, Co Financials, AS Research



Source: APCMA



Source: Reuters, AS Research

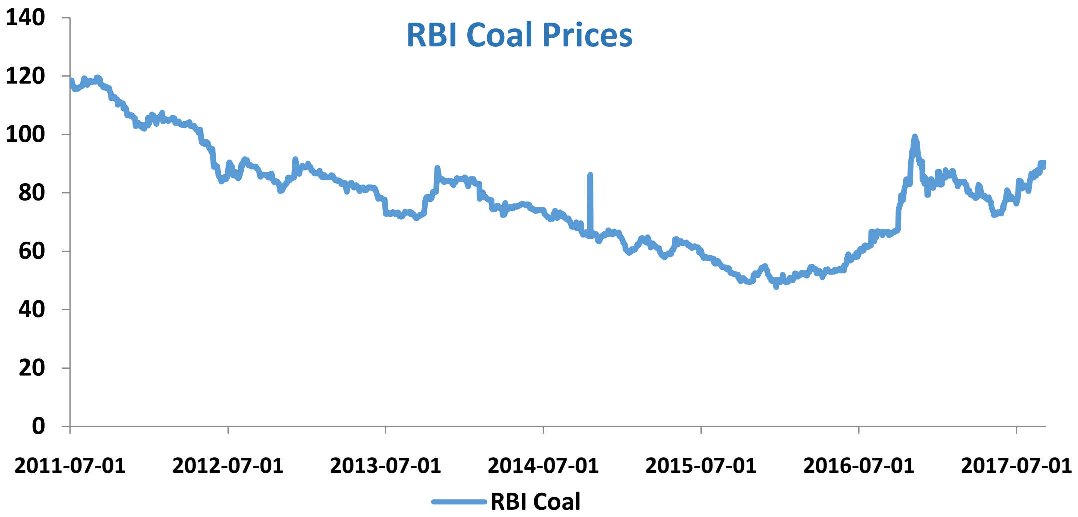
Higher Despatches and Retention prices lead to increase in profitability of Cement Sector

- Cement **dispatches** grew at a 5year CGAR of 6.2% mainly due to increase in local dispatches. Some of the drivers of higher sales include:
  - Increase in PSDP allocation from Rs478bn in FY12 to Rs1.05tr in FY17
  - Increased construction activities both form private and government entities (including CPEC related projects)
- On the other hand, export sales declined partly because of local manufacturers preference to sell in the more lucrative domestic market and partly due to lower demand from Afghanistan where Iranian cement is available at a cheaper price. Furthermore, imposition of anti-dumping duty in South Africa in FY16, increased global competition and economic slowdown in many countries also affected overall exports of Pakistan

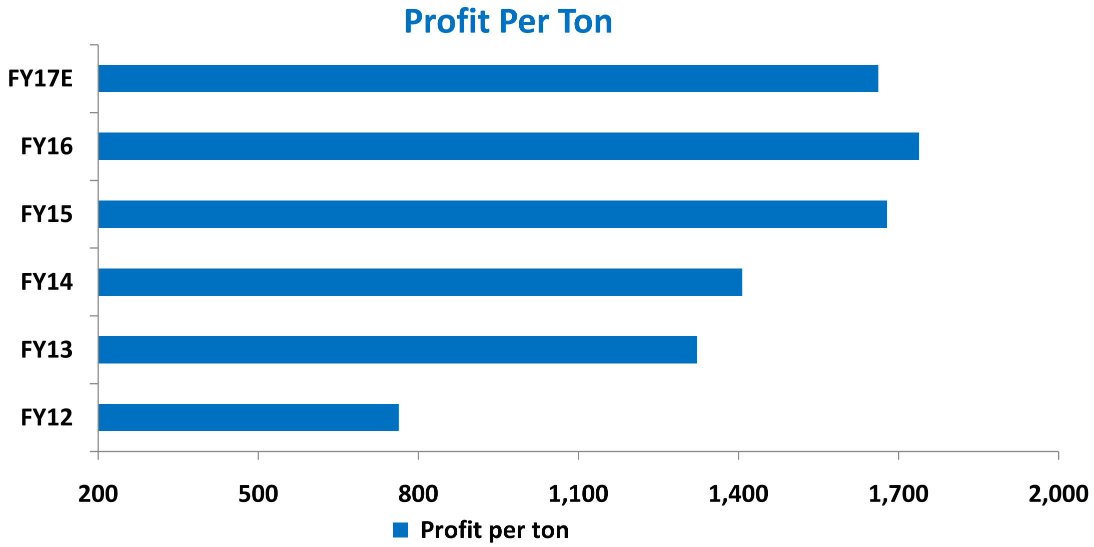
- Accompanied by higher demand, **retention price** of cement also increased from Rs8,420/ton in FY12 to Rs10,980/ton in FY17 (an increase of circa 30%). Increase in retention price indicates cement manufacturers' ability to pass on cost increases whether resulting from increase in manufacturing costs or higher taxes imposed by the Government

- From FY12 to FY15 **cost per ton** increased by 8.8% mainly due to devaluation of PKR against USD. Between FY15 and FY17 cost per ton declined by nearly 3.2%, possibly driven by lower energy costs and implementation of energy efficient projects such as WHR. So far ~195MW have been shifted to WHR since FY11

Key Drivers of Profitability (Contd.)



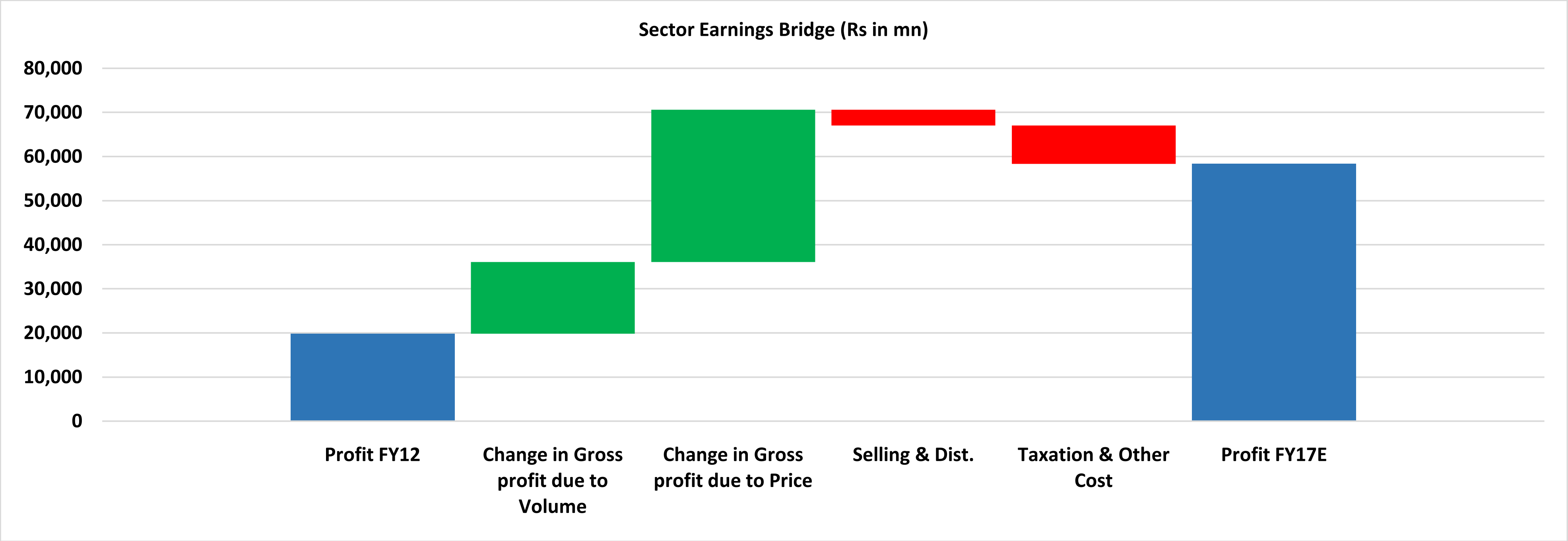
Source: Quandl



Source: AS Research

- Gross profit margins of cement manufacturers therefore increased from 30% in FY12 to 40% in FY17 due to higher retention prices and relatively flat costs per ton
- Due to the factors mentioned above, **profit per ton** increased to Rs1,738/ton in FY16 as compared to Rs763/ton in FY12 (an increase of nearly 2.8x)
- Furthermore, decline in finance cost due to repayments of loans and a low interest rate environment also support the bottom line

Sector Earning Bridge



Source: Co Financials, AS Research

- Increase in retention price of cement (net of additional production cost) has been the major driver of profitability between FY12 and FY17E

- Cement companies have been able to increase prices by significantly more than the increase in costs, thereby increasing their gross margins and profitability

- Any reduction in selling prices is seen as a key downside risk to future earnings of the sector

Capacities Expansion

(Mn tons)	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Prod. Capacity	44.64	45.62	45.62	46.92	49.37	63.77	73.12	73.12
Total Dispatches	34.28	35.41	38.87	40.31	43.30	46.53	50.04	53.84
Utilization	77.0%	78.0%	85.0%	86.0%	88.0%	73.0%	68.0%	74.0%
Surplus Capacity	10.36	10.21	6.75	6.61	6.07	17.24	23.08	19.28

Source: APCMA, AS Research

•In FY17 cement industry ran at a utilization level of 86% (highest since FY05 of 91%) to meet the robust demand in the local market. Encouraged by robust demand and rising profitability, the industry entered into the expansion phase with almost all major cement players announcing capacity expansions *(see table on next pg.)*. We estimate that ~26.25mn tons of cement capacity will be added between FY18 and FY20, which would increase the total capacity from current 46.92mn tons to 73.12mn tons (56% growth)

•We estimate the dispatches could grow at the rate of around 8% in the next 4 years taking the utilization level to around 74% by FY21E

•We note that historical capacity expansions have been accompanied by decline in cement prices to help increase off take. For example, in the period from FY09 to FY10, prices per bag decline from Rs368 to Rs273

Upcoming Expansion

SYMBOL	Capacity (Mn tons)	Online by	Location
ACPL	1.20	1HFY18	Hub, Balochistan
BWCL	1.80	1HFY20	Haripur, KPK
CHCC	2.13	1HFY20	Nowshera, KPK
DGKC	2.80	1HFY18	Hub, Balochistan
DGKC	2.20	2HFY19	Dera Ghazi, Punjab
FLYNG	0.60	1HFY20	Khoshab, Punjab
GWLC	2.40	FY19	Jhelum, Punjab
KOHC	2.30	FY19	Kohat, KPK
MLCF	2.20	FY19	Mianwali, Punjab
LUCK	1.30	1HFY18	Karachi, Sindh
LUCK	2.30	FY20	Punjab
PIOC	2.52	1HFY20	Khoshab, Punjab
POWER	2.50	4QFY19	Jamshooro, Sindh
Total	**26.25**		

Source: Co. Financials, PSX Announcement, AS Research

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- **Valuation Methodology**

To arrive at period end target price, Abbasi Securities uses different valuation methodologies:

· Comparable Method (P/E, P/B etc.)

· Discounted Cash flow Method

·Equity and Asset based valuation

- **Rating**
  - BUY Total return more than 20% from last closing of market price
  - HOLD Total return is in between 10% and 20% from last closing of market price
  - REDUCE Total return is less than 10% from last closing market price

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