Foundation Securities
A Fauji Foundation Group Company
REP-095

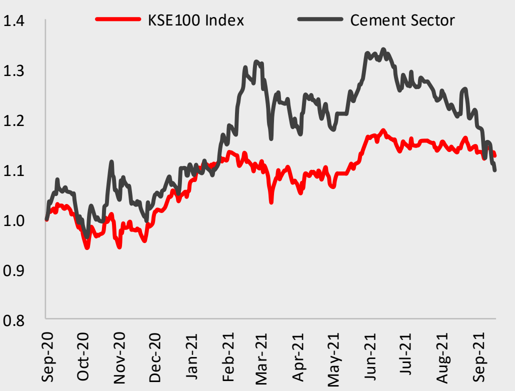
PAKISTAN

FSL cement universe valuation snapshot

	Reco	J-22 TP	Upside	EPS FY22E	EPS FY23E
LUCK	O-pr	912.6	23%	94.6	129.2
DGKC	O-pr	129.0	38%	4.7	15.7
CHCC	O-pr	186.6	18%	12.0	22.6
KOHC	O-pr	226.8	29%	14.1	24.0
FCCL	O-pr	23.9	34%	2.4	3.8
PIOC	O-pr	121.5	20%	9.0	17.3
ACPL	Neu	138.6	0%	3.7	12.9

Source: Foundation Research, September 2021

FSL Cement universe V/S KSE100 Index



Source: Bloomberg, Foundation Research, September 2021

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Construction and Material

Valuations unlocked by overplayed concerns

Event

- We believe market has overplayed the concerns of recent hike in energy prices and thus opened significant room for upside for cement stocks. We expect FSL cement universe would maintain its profitability despite a significant increase in energy and other overheads cost. Furthermore, cement players would witness moderate increase in pricing power from 2HFY22 due to (1) increased demand from public sector as infrastructure projects would gain momentum before election year, (2) ~93% utilization in FY23 given strong private sector demand due to construction package, (3) increasing inflows into RDA, (4) disbursement of subsidy under NPHP and (5) normalization of coal prices after winter season.

Impact

- **Higher domestic demand to improve pricing power:** Early PSDP disbursement and strong private sector demand would allow domestic demand to increase by 7.7/10.0/6.1% YoY in FY22/FY23/FY24. On regional basis, we expect domestic demand growth in south to outpace industry in FY22. However, strong demand would allow a moderate increase in cement prices in 3QFY22 to pass on the impact of higher energy cost as coal prices are expected to remain at elevated during winter season. Normalization of coal prices and higher demand on account of general elections in FY23 would provide significant boost to profitability in FY23.

- However, on exports front we expect exports from north/south region to decline by 15/20% YoY in FY22. Exports from north region would take a hit on account of economic slowdown in Afghanistan while exports from South would take negative impact of higher freight cost and decline in realized price.

- **Supply side issues to remain least concerning till FY24:** Cost of announced expansions currently faces an upside risk from Rupee devaluation which would put margins under pressure due to increase in project cost/depreciation charge. However, unlike last expansionary cycle, finance cost would not witness any substantial increase due to use of concessionary borrowing (TERF). Cement companies have so far announced expansion of 19.4mn tons (18.1/1.3mn ton on north/south region) which would take total industry capacity to 88.6mn tons by FY25, translating into an increase of 28%.

- We are not overly concerned on disruption in pricing discipline. However, cement prices may observe softness during FY24 (post-election year) as economic consolidation would keep demand in check.

- **Resolution of supply chain issues and normalized demand after winter season to bring down coal prices:** Recent surge in coal prices (↑35% from 4QFY21) is likely to sustain in the short run due to increased demand in the upcoming winter season. We expect coal prices to remain at elevated levels till 4QFY22 due to (1) lower inventory in China/India, (2) decision to freeze export license of 34 coal exporters falling to meet local demand by Indonesia, (3) higher operating cost for miners given increased environmental regulatory compliance, (4) decline in expected capacity addition due to ESG focus and (5) supply chain issues post COVID outbreak and bad weather conditions.

Outlook

- We have positive stance on the sector with LUCK, DGKC, CHCC, KOHC, FCCL and PIOC as our top pick.

Private sector demand and early PSDP disbursement to overshadow the impact of higher energy cost

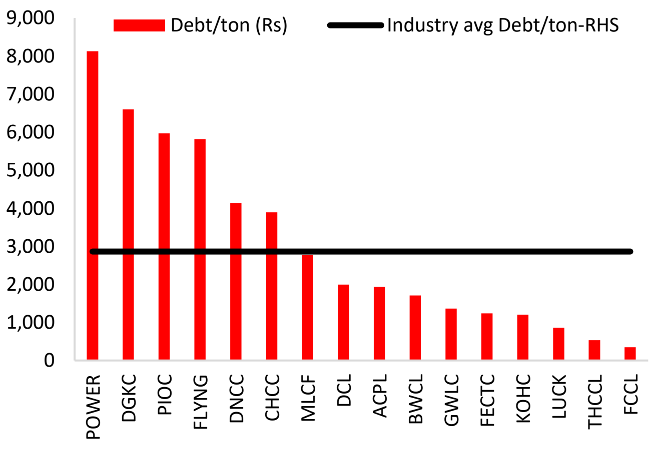
We expect profitability of FSL cement universe to stay in the green zone in FY22 despite the significant increase in energy cost due to surge in coal and FO prices. Cement companies have already passed on the ~60% impact of surge in energy and other overhead cost by multiple hike in prices (↑~Rs158/68/bag in north/south region) since Jun'20. However, we expect increased demand would allow increase in cement prices in 3QFY22 as low cost coal inventories is substituted by pricey coal shipments. To highlight, coal prices are currently hovering over USD160/ton for Oct'21 supplies. On demand front, we expect domestic demand would gain momentum from 2HFY22 given boost from execution of public sector infrastructure projects on account of FY23 general elections. Furthermore, we have taken a risk free rate of 11.5% for FSL cement universe valuation and we expect another 175bps increase in policy rate by the end of FY22.

Fig01: FSL Cement Universe valuations snapshot

	CMP	Jun-22TP	Rating	FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
				EPS (Rs)			**DPS (Rs)**			**BVPS**		
LUCK	741.7	912.6	O-pr	70.7	94.6	129.4	-	3.0	11.0	485.6	589.8	722.2
DGKC	93.6	129.0	O-pr	8.5	4.7	15.7	1.0	-	1.5	166.4	176.0	196.2
CHCC	157.5	186.6	O-pr	16.5	12.0	22.6	2.2	1.0	2.2	68.6	78.3	99.9
KOHC	175.7	226.8	O-pr	17.4	14.1	24.0	-	-	-	110.6	124.7	148.7
FCCL	17.9	23.9	O-pr	2.5	2.4	3.8	-	-	-	16.9	19.3	23.0
PIOC	101.1	121.5	O-pr	8.0	9.0	17.3	-	0.5	1.5	65.8	74.8	91.7
ACPL	139.1	138.6	Neu	8.0	3.7	12.9	4.0	0.7	2.6	152.5	157.3	174.7
				P/E(x)			**DY (%)**			**PB (x)**		
LUCK				10.5	7.8	5.7	-	0.4	1.5	1.5	1.3	1.0
DGKC				11.0	19.8	6.0	1.1	-	1.6	0.6	0.5	0.5
CHCC				9.5	13.2	7.0	1.4	0.6	1.4	2.3	2.0	1.6
KOHC				10.1	12.5	7.3	-	-	-	1.6	1.4	1.2
FCCL				7.1	7.5	4.7	-	-	-	1.1	0.9	0.8
PIOC				12.6	11.3	5.8	-	0.5	1.5	1.5	1.4	1.1
ACPL				17.4	37.8	10.8	2.9	0.5	1.8	0.9	0.9	0.8
				Earning Growth (%)			**EV/EBITDA (x)**			**ROE (x)**		
LUCK				272.8	33.8	36.9	8.4	6.5	4.7	15.8	17.6	19.7
DGKC				N/A	(44.4)	231.5	7.3	7.5	5.4	5.3	2.8	8.4
CHCC				N/A	(27.5)	88.7	6.2	7.7	5.5	27.4	16.3	25.3
KOHC				N/A	(19.2)	70.5	5.9	7.1	5.5	17.1	12.0	17.6
FCCL				N/A	(5.0)	58.2	3.3	4.6	4.0	16.1	13.2	17.9
PIOC				N/A	11.5	93.8	10.1	6.9	4.4	13.0	12.7	20.8
ACPL				N/A	(54.1)	249.2	8.7	15.6	10.1	5.4	2.4	7.7

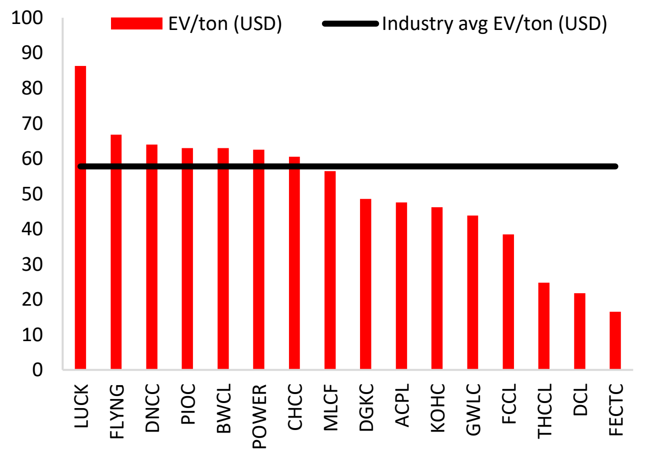
Source: Company Accounts, Foundation Research, September 2021

Fig 02: In FSL cement universe DGKC, PIOC and CHCC are more sensitive to interest rate hike (Rs/ton)



Source: Company Accounts, FSL Research, Sept 2021

Fig 03: FCCL, KOHC, ACPL and DGKC are trading at discount to industry avg EV/ton



Source: Company Accounts, FSL Research, Sept 2021

New expansion cycle to bring capacity closer to 100mn tons

Incentives to construction sector announced by the Gov't coupled with a strong private sector demand given excess liquidity and increasing RDA flows into real-estate sector has allowed cement companies to opt for another expansion cycle. After fourth expansionary cycle, cement manufacturing capacity in Pakistan is expected to increase by 22.9mn tons (19.4mn tons Ex DGKC) to 92.7mn tons by FY25. Cost of the upcoming expansionary cycle is estimated to be much higher than the previous cycle (addition of 24mn tons) due to sharp rupee deprecation by 19.2/6.3% from FY19/20 avg. In addition to this, higher commodity prices are expected to further elevate the cost of expansion. To highlight, we have assumed six months delay in expected COD of expansion projects from the announced dates due to constraints of cross border travel and supply chain since COVID outbreak.

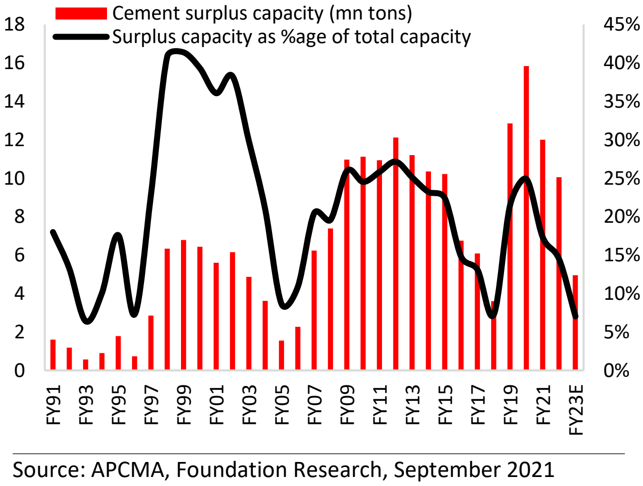
Furthermore, current debt of cement companies (APCMA members Ex Askari) stands at ~Rs199bn that is expected to further increase due to higher debt mix (~60-70%) in the expansion cost as current sector cash position stands at ~Rs40bn. However, companies would further benefit from concessionary borrowing under TERF/LTFF facility as the maximum financing cost for TERF/LTFF is ~5% with a payback period of 10 years.

Fig 04: Upcoming expansions to come with significant cost escalation

	Capacity (Mn tons)	Additions (Mn tons)				Capacity (Mn tons)	Additions (Mn tons)				Capacity (Mn tons)
	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	FY25
Northern plants											
Bestway Cement	8.5	0.2	0.1	2.0	-	10.7	-	2.3	-	-	12.9
Lucky Cement	4.2	-	-	-	2.8	7.0	-	1.6	1.6	-	10.2
Cherat Cement	1.1	1.3	-	2.1	-	4.5	-	-	3.5	-	8.0
D.G Khan Cement*	4.2	-	-	-	-	4.2	-	-	-	3.5	7.7
Fauji Cement	3.4	-	0.1	-	-	3.6	-	-	2.1	-	5.6
Kohat Cement	2.7	-	-	-	2.3	5.0	-	-	2.5	-	7.5
Maple Leaf Cement	3.4	-	-	2.3	-	5.8	-	2.2	-	-	8.0
Pioneer Cement	2.2	-	-	-	3.0	5.2	-	-	-	-	5.2
Others	7.3	-	0.1	-	-	7.4	-	2.4	-	-	9.8
Sub-total	**37.0**	**1.5**	**0.3**	**6.4**	**8.1**	**53.4**	**-**	**8.5**	**9.6**	**3.5**	**74.9**
Southern Plants											
Attock Cement	1.8	-	1.2	-	-	3.0	-	-	1.3	-	4.4
Power Cement	0.6	-	-	-	2.4	3.0	-	-	-	-	3.0
Lucky Cement	3.6	-	1.6	-	-	5.2	-	-	-	-	5.2
D.G Khan Cement	-	-	2.8	-	-	2.8	-	-	-	-	2.8
Others	2.4	-	-	-	-	2.4	-	-	-	-	2.4
Sub-total	**8.4**	**-**	**5.6**	**-**	**2.4**	**16.5**	**-**	**-**	**1.3**	**-**	**17.8**
Total	**45.4**	**1.5**	**5.9**	**6.4**	**10.6**	**69.9**	**-**	**8.5**	**10.9**	**3.5**	**92.7**

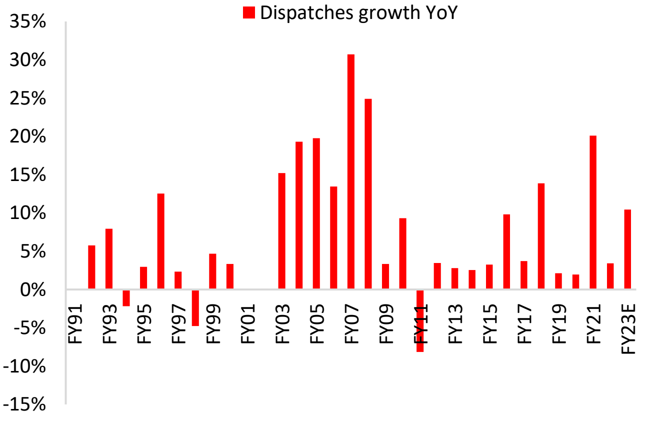
Source: PSX, APCMA, Foundation Research, September 2021
*not yet formally announced by the company

Fig 05: Decline in surplus capacity to 7% In FY23 to support pricing power amid strong demand



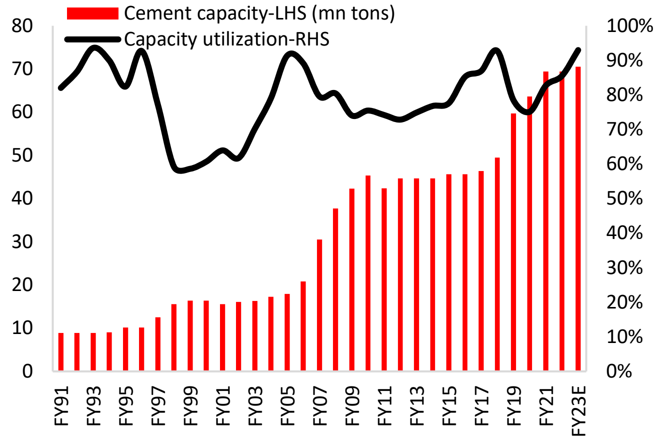
Source: APCMA, Foundation Research, September 2021

Fig 06: Growth in dispatches to remain intact due to strong domestic demand



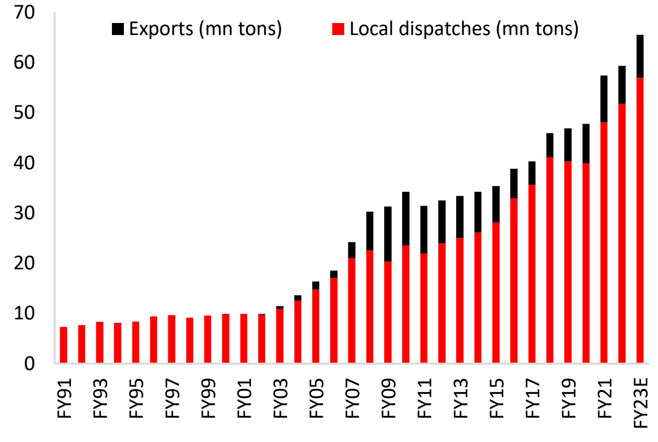
Source: APCMA, Foundation Research, September 2021

Fig 07: industry capacity utilization to touch ~93% ahead of new expansions coming online



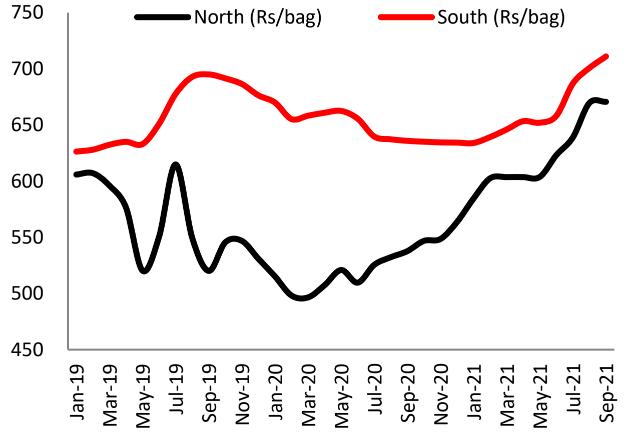
Source: APCMA, Foundation Research, September 2021

Fig 08: Exports to remain restricted in FY22 in both north/south region



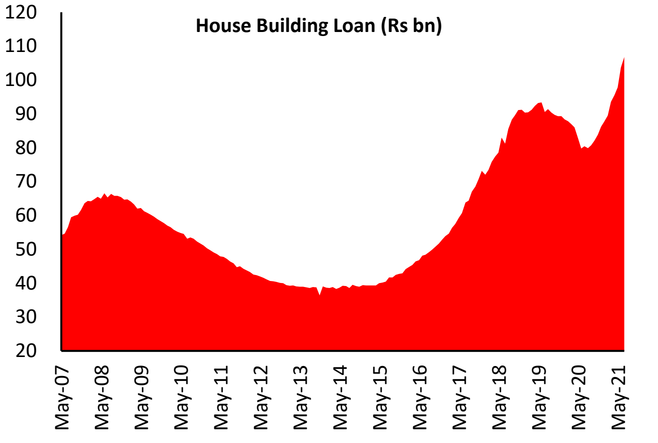
Source: APCMA, Foundation Research, September 2021

Fig 09: Prices to witness moderate increase to further pass on the impact (Rs/bag)



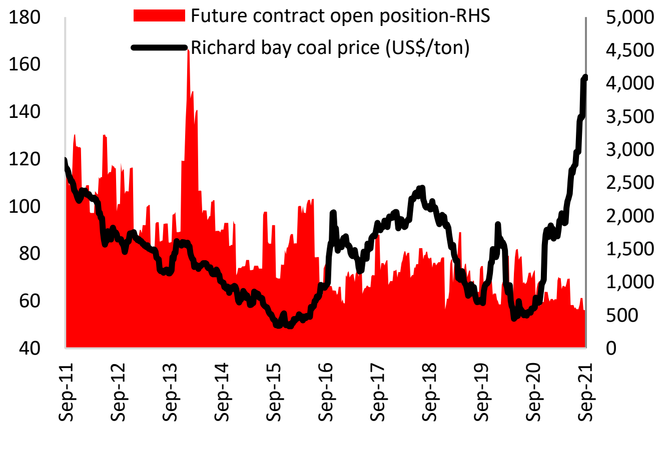
Source: PBS, Foundation Research, September 2021

Fig 10: Housing finance at highest level in Pakistan history due to lower borrowing cost (Rs bn)



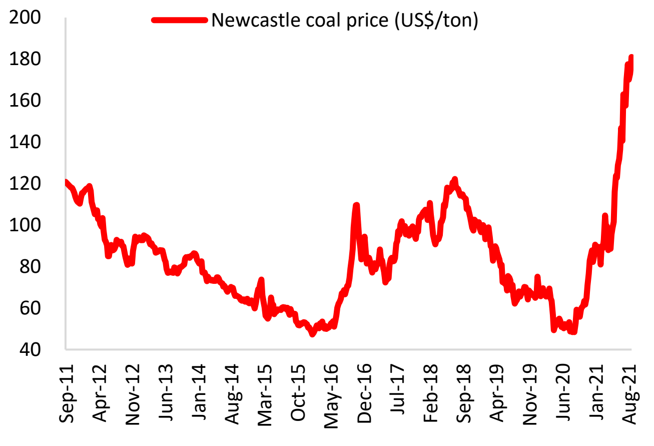
Source: SBP, Foundation Research, September 2021

Fig 11: Coal prices increased ahead of winter season demand due to lower inventory in China/India….



Source: Bloomberg, Foundation Research, Sep 2021

Fig 12: ….amid supply chain constraints and freezing of coal export licenses in Indonesia



Source: Bloomberg, Foundation Research, Sep 2021

Abbreviations

YoY	Year on Year
MoM	Month on Month
FY	Fiscal Year
FO	Furnace Oil
Mn	Million
FOB	Free On Board
MRP	Market Retail Price
NAB	National Accountability Bureau
SBP	State Bank of Pakistan
NPHP	Naya Pakistan Housing Program
TERF	Temporary Economic Refinance Facility
LTFF	Long Term Financing Facility

Recommendations definitions

If

Expected return >+10%	Outperform.
Expected return from -10% to +10%	Neutral.
Expected return <-10%	Underperform.