Pakistan Cement Sector

The worst isn't over but...key question is—is it all in the price? Accumulate!

Friday, February 24, 2023

It has been a challenging year for the construction industry so far having been marred by extensive PKR devaluation, sluggish demand and import constraints. However, the same seems to have been adjusted in current valuations. Pakistan Cements trade at FY23/24F P/E multiples of only 4.2/3.0x respectively, down ~53/67% from average 10-year sector multiple of ~9x. Using historical multiples as a matrix to incorporate the worst, we opine valuations could take a maximum hit of ~10% however, the room for re-rating if things improve economically is much bigger.

To second our earlier thought, we have done a scenario analysis to see how major players fare if everything goes south. Taking cue from the analysis below, we advise taking positions in relatively 'safer' companies that are more resilient to rate hikes, adverse currency movement and coal price increases to name a few. In the light of the above, top picks for the sector are LUCK, KOHC & FCCL. Our liking for LUCK is based on its diversified income stream, cash rich balance sheet and in-house power generation. KOHC is preferred on the back of low debt levels and cheap valuations with an EV/Ton of only USD 18.5/ton (discount of 27% to industry). Moreover, FCCL's market share accretion (from 5% to over 12%) due to amalgamation with Askari and 2 expansions are expected to give the company a competitive edge and greater access to new markets.

Table of the day

Tenor	Mid rate as at close of 23-Feb	Change (bps) since last MPC
3M	19.62	223
6M	19.80	206
9M	19.87	208
1Y	19.88	204
3Y	18.38	204
5Y	15.90	69
10Y	15.46	127
20Y	15.36	112

Source: MUFAP, BMA Research

	EPS			EPS growth		P/E		Avg. 10-Yr P/E	Discount to	EV/EBITDA		Div. Yield		
	FY22	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY12-FY22	10-Yr P/E	FY23E	FY24E	FY22	FY23E	FY24E
MLCF	3.3	7.2	9.1	119%	27%	3.1	2.4	8.5	-64%	3.6	2.5	0%	0%	9%
KOHC	23.5	32.1	41.1	36%	28%	4.1	3.2	7.1	-42%	2.4	1.8	0%	0%	2%
CHCC	22.9	24.9	30.1	9%	21%	4.1	3.4	8.0	-49%	3.5	2.9	3%	3%	3%
LUCK	91.2	105.1	117.8	15%	12%	3.9	3.5	10.0	-61%	4.1	3.5	0%	2%	2%
DGKC	6.8	7.0	13.9	4%	98%	5.8	2.9	9.7	-40%	5.7	3.9	0%	0%	7%
PIOC	4.6	11.2	17.6	142%	57%	4.9	3.1	8.8	-44%	6.2	5.0	0%	0%	5%
FCCL	3.3	3.5	5.5	7%	57%	3.3	2.1	10.5	-68%	4.0	2.5	0%	0%	9%
Average						**4.2**	**3.0**	**8.9**	**-53%**	**4.2**	**3.2**			

Source: Bloomberg, Company Accounts, BMA Research

Assumptions	Base Case	Worst Case
Dispatches growth	-15%	-30%
PKR/USD	256	300
Coal (USD per ton)	200	250
Policy rate (%)	18%	20%
Price per 50kg bag	1,050	900
FY23E EPS		
KOHC	32.09	(4.49)
PIOC	11.19	(5.90)
DGKC (UCS)	7.03	(25.72)
LUCK (UCS)	43.9	(2.30)
MLCF (UCS)	7.22	(6.18)
CHCC	24.88	(16.27)
FCCL	3.49	(0.17)

Source: BMA Research

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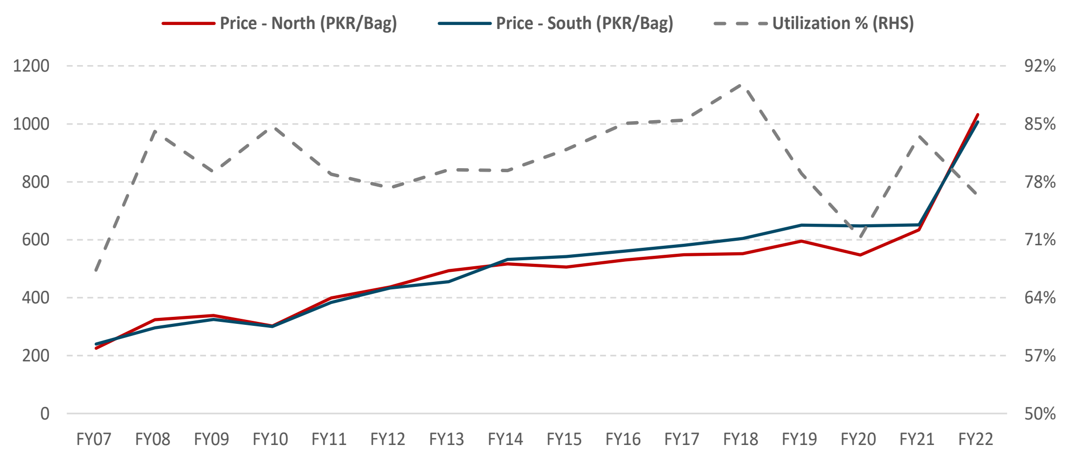
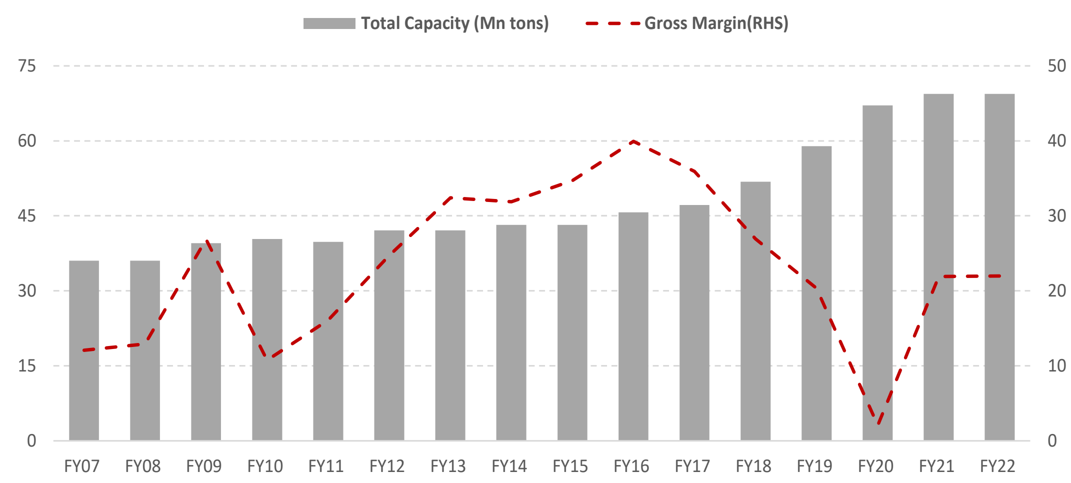
Gross margins maintained despite weak demand: It has been a challenging year for the construction industry so far having been marred by extensive PKR devaluation, sluggish demand and import constraints. In a bid to counter the impact, retail cement prices have increased by 11% FYTD but given the sector dynamics where over 11Mn of new capacities have been added to the system amid dampened demand, it seems evident that cement players are not ready to compromise on gross margins. To highlight, in the past expansionary cycles, cement players have undergone margin attrition on the back of retail price cuts in order to maximize utilization. However, this cycle stands different. In this expansionary cycle almost all major players have added new capacities or are in the process of doing so unlike the previous expansionary cycles which causes us to believe that there are little chances of price disruption.

Chart 1: How is pricing linked to sector utilization levels?



Source: Zakheera, BMA Research

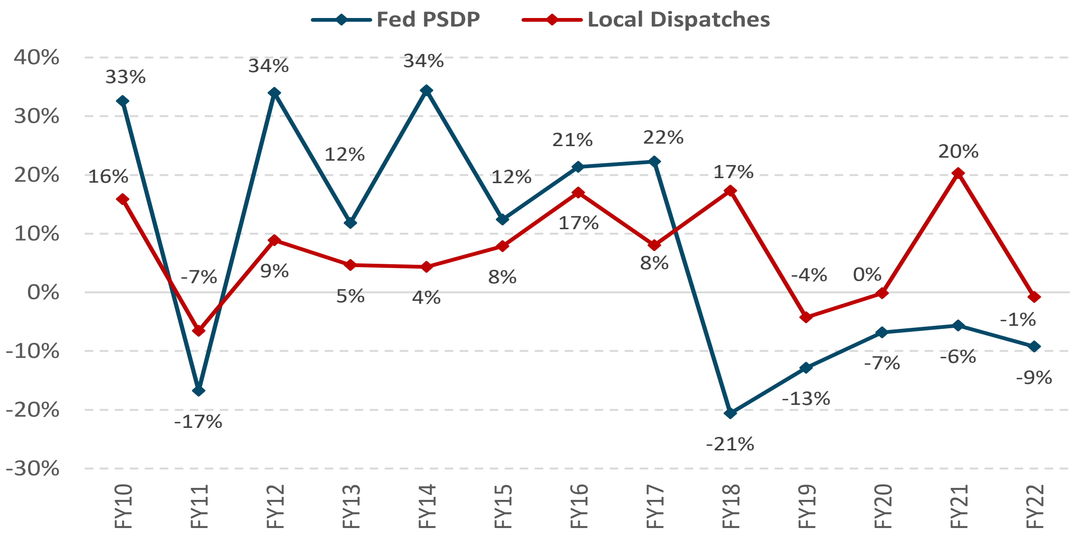
Chart 2: How margins have fared as new capacities are added?



Source: Zakheera, BMA Research

Limited govt. spending is taking its toll: Deteriorating economic landscape with tight fiscal position has kept government spending on infrastructure limited. PSDP spending has only been reported at PKR 203Bn in 7MFY23 against a full-year target of PKR 727Bn. Though demand from public sector is only ~30% of the total domestic demand, it sets the tone for construction based spending in the private sector. As the govt. focuses on austerity, we opine PSDP stands to be the perfect low hanging fruit and releases going forward will continue to remain unappealing. It is pertinent to mention that during 7MFY23 local dispatches (92% of total sales) have declined by 14% YoY while exports has plunged 45%. Resultantly, sector utilization has slipped to 60% and we do not see the remaining months of the fiscal to fare any better and expect to close the year with a 15% decline in domestic sales. Furthermore, with the artificial curb on imports, rebar manufacturers are facing severe problems in the procurement of scrap that may lead to lower production in the coming months which can have a knock-on impact on cement sales and domestic construction at large, in our view. However, with increased likelihood of revival of the long stalled IMF program, this situation will likely improve going forward.

Chart 3: Federal PSDP Vs. Local dispatches



Source: Zakheera, BMA Research

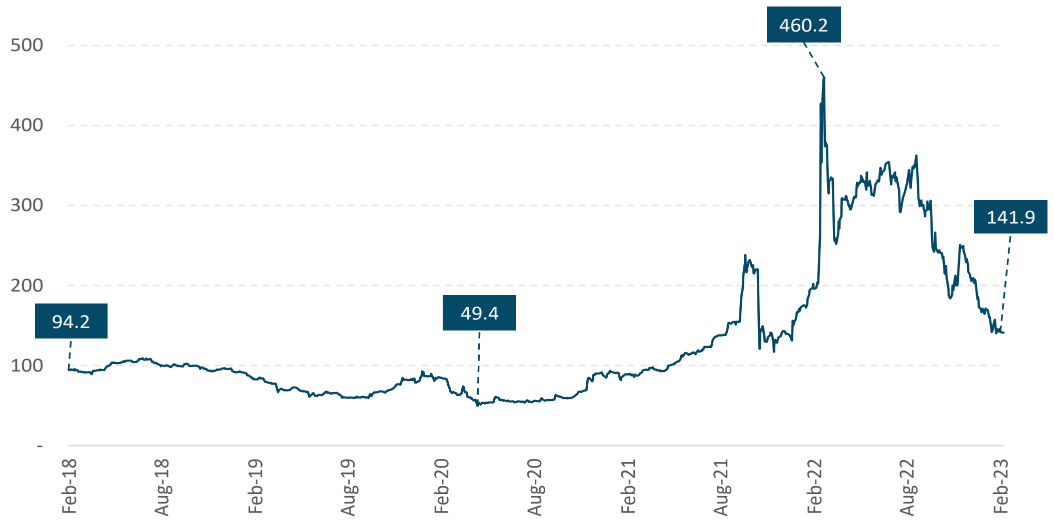
Strong case for a rate hike but major adjustment has already been done: News flow suggests that IMF have proposed an upwards adjustments of 200-300bps in policy rate to ~20%. To supplement the action, yields on government papers are up by close to 200 bps already. Though we have incorporated a hike of 100bps from current levels in our base assumptions, a greater hike can further dent domestic demand outlook and increase financing cost of sector players. However, we opine major adjustment has already been done and downside from current levels is limited. Our workings below incorporate a 200/300bps hike and suggests that earnings can be dented by a maximum of 7/11% respectively with PIOC standing to be the worst affected due to high leverage.

Impact as a % of FY24E EPS	200bps hike	300bps hike
FCCL	-2%	-3%
DGKC	-5%	-8%
MLCF	-3%	-5%
LUCK	0%	-1%
CHCC	-3%	-4%
KOHC	1%	2%
PIOC	-7%	-11%

Source: BMA Research

Easing coal prices to compensate for hike in policy rate: Declining trend of international coal prices is still intact and it is coming at just the right time for cement players amidst a weak demand outlook. International coal prices currently hover at around USD 150/ton however, FYTD average has been USD 249/ton (↑59% YoY). We have assumed an average fiscal year price of USD 200/ton and highlight that anything below the same could support earnings going forward. Furthermore, it could tame risks of price disruption without compromising gross margins in case the race for market share intensifies. Every PKR 5k/ton change in coal prices results in an impact of PKR 30-33/bag.

Chart 4: Richards Bay Coal (USD per ton)



Source: Bloomberg, BMA Research

Downside triggers:

1) Increase in international coal prices
2) Retail price cuts
3) Higher than expected interest rate hike
4) Weaker govt. spending
5) PKR depreciation

Upside triggers:

1) Improved macroeconomic environment
2) Interest rate reversals
3) PKR appreciation
4) Decline in international coal prices

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Buy	>15% expected total return
Hold	10%-15% expected total return
Underperform	<10% expected total return
*Total stock return = capital gain + dividend yield	

Old rating system

Overweight	Total sector return > expected market return
Marketweight	Expected market return
Underweight	Total stock return < expected market return

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)