Pakistan Cements

Risks overplayed; Fundamentals remain intact

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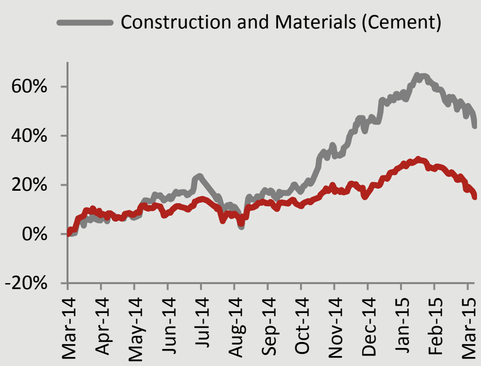
Construction & Mat. Sector Performance

	1M	3M	12M
Absolute %	-9%	-2%	44%
Relative to KSE %	1%	2%	29%

Relative Chart KSE100 vs Construction & Materials



Source: KSE, BMA Research

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The Cement sector has shed 10% Feb'15TD in tandem with the market decline of 10.9%. The recent bearish trend in the sector started off with a fundamental concern on anti dumping duty, with a potential to negatively impact cement manufacturers in the South. Moreover, the bearish sentiments were further compounded by indication of increase in gas tariffs from 1st Apr'15. However, given strong fundamentals (earnings growth: 16%), we believe the market has overreacted to the negative new-flows. Going forward, we believe sector dynamics will remain encouraging on account of i) notable reduction in fuel and power expenditure due to falling global crude oil, ii) lower finance cost following 200bps reduction in interest rates, iii) substantial dispatch growth and iv) lower sea and inland freight. We believe these factors will far outweigh the risks of potential decline in the earnings resulting from aforementioned risks. Within BMA Cement Universe, we reiterate our liking for MLCF with a target price of PKR73/sh, offering a total return of 46%.

Risks present; however not material: The sector is facing two prime risks 1) the anti dumping duty case in South Africa and 2) Increase in gas tariffs from 1st Apr'15. Both of these risks affect only selected payers in the industry with limited sector impacts.

1. **South African anti dumping duty:** The hearing for the case regarding the anti dumping duty was held on Mar19'15 where authorities presented their findings in relation to the case. However, even if the dumping is proved, the South African Authorities will need to consider other side effects from the imposition of the duty as Pakistani cement manufacturers have threatened to substitute South African coal with Indonesian coal in case duty is imposed. This substitution will leave South Africa in a net loss of ~USD230mn since our cement exports to South Africa stand at ~USD70mn while coal imported from South Africa by the cement industry stands at ~USD300mn. Companies like DGKC, ACPL and LUCK have exposures in South African market. Imposition of the duty might reduce their sales but will not wipe it off entirely. Below is an earnings sensitivity of the impact of complete and partial loss of export volumes to South Africa.

Earnings Sensitivity to Loss of South African Exports

Reduction in Sales	100%	50%
Company		
ACPL	14%	7%
DGKC	4%	2%
LUCK	10%	5%

Source: BMA Research

2. **Gas tariff hike 1st Apr'15:** As per news reports, the gas tariffs for captive power producers are expected to be raised by 30% from 1st Apr'15. LUCK and DGKC are expected the ones affected, given their high reliance on gas for power. The increase in cost of production will be to the tune of PKR9.1/bag and PKR6.6/bag for LUCK and DGKC, respectively, where in a no pass on scenario will translate into earnings impact of PKR1.9/sh and PKR0.7/sh. However, we believe the current demand scenario in the country will enable the companies to easily pass on the said impact. Any potential increase in prices are likely to benefit the companies which use alternative sources of power generation such as FCCL, FECTC, MLCF, PIOC, KOHC, ACPL etc.

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Monetary easing; levered plays to benefit: The recent 50bps cut in interest has brought the cumulative decline since Nov'14 to 200bps, with current DR at 8%. Companies such as MLCF and FCCL with Debt/Asset of 31% and 26%, respectively will likely be the prime beneficiaries of the on-going monetary easing.

High local dispatch growth; improving margins and profitability: The local dispatches in the country have been on a consistent rise with FY15 proving to be good year for the industry with 9.1%YoY growth during 8MFY14 in local dispatches. However, steep decline in Afghanistan exports due to the exit of US from the country and stiff competition from Iranian exports limited the growth in total dispatches to 5.5%YoY. Companies in the North region are primarily benefiting from the growth, especially those with below 85% utilization levels i.e. MLCF, FCCL and PIOC.

Reduced fuel and power to realize from 3QFY15: The cement industry has ample dependence on national grid and FO to meet its energy requirement. Following the decline in international oil prices, cost of power has decreased considerably by ~20%. Furthermore, the decline in petroleum product prices will also assist in reducing the transportation expenses (especially on exports). Thus, we expect the sector to likely realize the benefits of lower fuel cost from 3QFY15 onwards.

Investment perspective: Factoring in the above developments, we believe the sector fundamentals remain attractive despite a contradictory trend in market prices of the scrips. Thus, we maintain our "BUY' stance on the sector with MLCF being our top pick, offering a total return of 46%.

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