INITIATION
EQUITY RESEARCH - REK 200

CHERAT CEMENT COMPANY LTD (CHCC)

Feb 23, 2016

BUY

Price Target : PKR 112.94/share

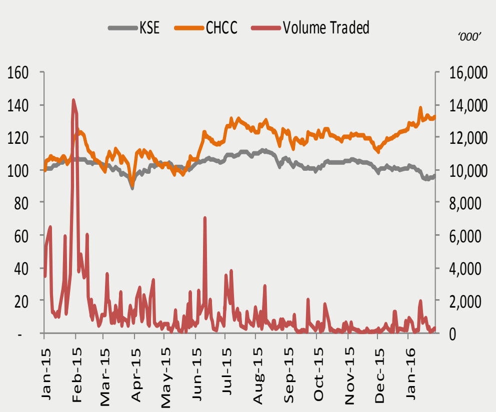
Closing Price : PKR 91.45/share

COMPANY DATA

52-week Price Range (PKR)	99.6 - 65.36
No. of Shares Outstanding (mn)	176.63
Market Cap (PKR mn)	16152.99
Market Cap (USD mn)	154.13
Free Float (mn shares)	114.81
Year End	Jun
KATS Code	CHCC

Source: PSX

CHART: STOCK PERFORMANCE



Source: PSX

- **We initiate our coverage on CHCC with 'Buy' rating:** Our Jun-16 DCF based price target of PKR 112.94/sh implies 24% upside from current price levels of PKR 91.45/sh.
- **Expansion cycle - Cherat leading the Industry:** The stalled cement industry capacity since FY12 is likely to increase from 3QFY17 where CHCC leads the expansion cycle.
- **Expansion to increase market share:** The market share (installed capacity based) of CHCC is expected to increase from 2.2% in FY16 to 4.9% post expansion. Further change in Cherat's market share is expected once other plants get online.
- **Robust earning growth post expansion:** Earnings of CHCC is anticipated to surge massively post expansion from mere PKR 7.95/sh in FY16 to PKR 16.36/sh in FY18. This upsurge primarily stems from

  1) New cement line II(1.3mn tons)—room for capitalizing domestic growth

  2) 6MW WHR plant

  3) Tax exemption of 5yrs
- **Shift in capital structure:** CHCC has recently approved a loan of PKR 10.5bn for its cement plant line II & WHR plant but we anticipate the total drawdown amount to be lower with estimated debt financing of PKR ~7-8bn.
- **Investment Risk:** Key risks to our investments thesis are 1) Price war 2) Decline in PSDP 3) Volatility in international oil prices 4) Increase in discount rate.

CHCC FINANCIAL HIGHLIGHTS

	FY14*	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
EPS	7.45	7.29	7.95	11.68	16.36	15.07	13.68
DPS	3.00	3.00	3.00	4.50	6.00	6.00	6.00
BVPS	27.54	45.44	52.66	61.34	73.20	82.27	89.95
PE (x)	12.27	12.54	11.50	7.83	5.59	6.07	6.68
Div Payout (%)	40%	41%	38%	39%	37%	40%	44%
EBITDA Margin (%)	31%	30%	33%	32%	33%	30%	27%
ROA (%)	20%	14%	8%	10%	13%	11%	10%
ROE (%)	27%	16%	15%	19%	22%	18%	15%
Gross Margin (%)	33%	30%	35%	34%	34%	32%	29%
Net Profit Margin (%)	20%	20%	20%	20%	21%	19%	17%

Source: Company Accounts, Nael Research

**Based on current no of shares*

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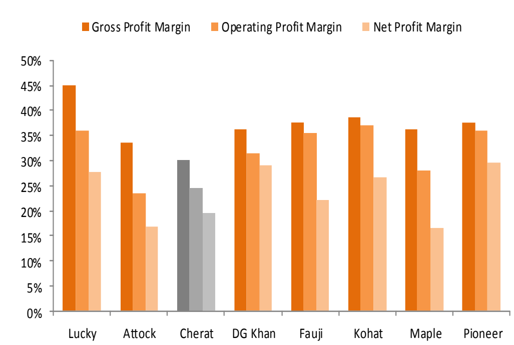
Valuation

We initiate coverage on Cherat Cement (CHCC), with '**Buy'** rating and a TP of PKR 112.94/sh, implying 24% upside potential from its closing price of Feb 22, 2016. We have used discounted cash flow (Free Cash Flow to Firm) methodology to derive the intrinsic value of CHCC at PKR 112.94/sh. The stock offers a dividend yield of 3.3%. Following assumptions have been used to arrive at the our target price:

- Terminal growth rate of 4%
- Risk free rate of 8.85% (PIB 10yr)
- Adjusted Beta of 1.04 (using 7yr)
- Market Risk Premium of 6%

	FY16E	FY17E	FY18E	FY19E	FY20E
PV of FCFF	(5,256)	1,616	2,809	2,423	1,958
WACC	11.3%	11.3%	11.7%	12.0%	12.5%
PV of FCFF	3,550				
Terminal Value	38,389				
PV of Terminal Value	23,972				
Ent Value	27,521				
Debt	7,572				
Equity Value	19,949				
Target Price 6/30/2016	113				
Current Price	91				
Upside	24%				

Fig: 1 **Peer Comparison - GM,OM & NM**



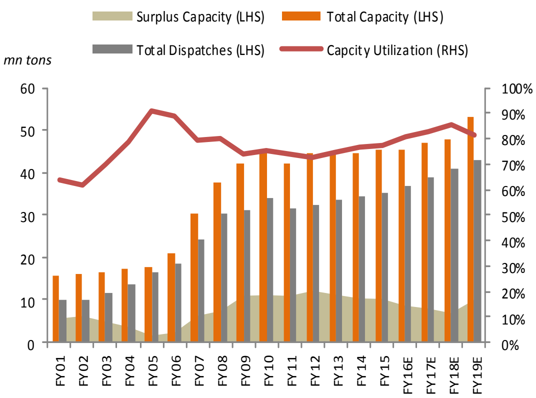
Source: Company Accounts (FY15), Nael Research

Operational Performance

CHCC has been a laggard in improving its gross margins primarily due to 1) inefficiencies in fuel and power consumption and 2) higher proportionate of export sales (29% as of FY15). The company currently has one of the highest fuel and power cost per bag amongst its peer despite using WHRPP (7MW) & CPP (~25MW FO & HSD based) to curtail its power cost.

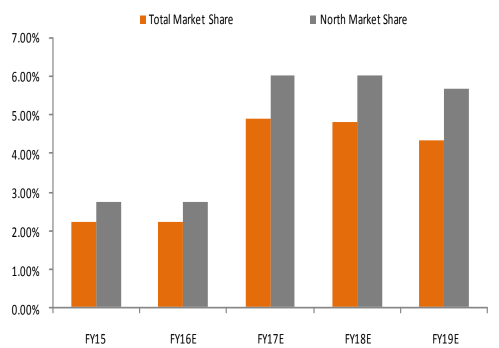
When compared to its peers, we can see its operational performance based on gross margins, operating margins & net margins (refer fig 1) to be below its peer competitors.

Fig: 2 **Industry Demand vs Supply**



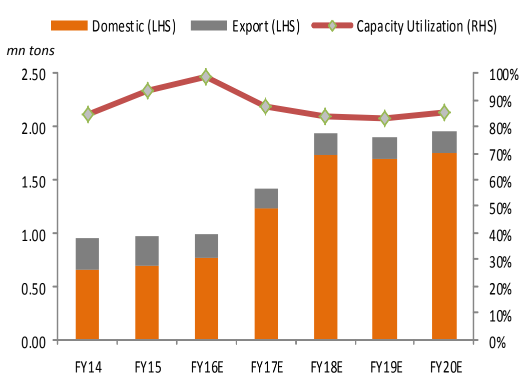
Source: APCMA, Nael Research

Fig: 3 **Cherat's Market share**



Source: APCMA, Nael Research

Fig: 4 **Cherat's sales volume**



Source: Company accounts, Nael Research

Investment Argument

Our investment view on CHCC is based on robust earnings growth post expansion supported by other factors hereinafter:

Expansion Cycle—Cherat leading the industry

Cherat cement has been operating at its potential capacity for the past few years (+90% capacity utilization). Its existing capacity served as a deterrent in exploiting growing demand where domestic industry dispatches grew at a 4yr CAGR of 6.37%. Based on sharp uptick in private sector consumption, rising domestic demand, higher PSDP consumption, boost in demand expected from CPEC, CHCC is well placed to benefit and attain competitive advantage of initiating expansion cycle in cement industry. The stalled industry capacity since FY12 is likely to increase from 3QFY17 onwards.

Expansion to increase market share

CHCC currently has a market share (based on installed capacity) of 2.2%. With this expansion expected to come online by 3QFY17, the market share is expected to increase to 4.9% in FY17. We don't expect CHCC's market share to sustain because of other expansions anticipated in FY18 and FY19 (ACPL, DGKC and LUCK with estimated capacity of ~6mn tons). Hence, market share is likely to deteriorate moving forward (see fig 3).

Robust earnings growth to propel from...

We anticipate earnings of CHCC to surge massively post expansion from mere PKR 7.95/ sh in FY16E to PKR 16.36/sh in FY18E (~200%). However, a decline is expected (refer P&L) once other cement manufacturers get their expansion online. The major upsurge in bottom line stems from

1. New plant Line II – room for capitalizing domestic growth

CHCC has planned a brown field expansion of 4200tpd equivalent to ~1.3mn tons/yr. As per the management, this expansion is expected to come online in 3QFY17. Commissioning of new cement line would significantly improve its market share. As per our assumption, volumes are derived on capacity basis. Hence, we have used market share (capacity based) to determine the forecasted volume (see fig 4) with estimated domestic offtake of 8% till FY19E.

Although both the cement plant are Chinese but we expect the operational efficiency of new plant to be better than the existing plant.

2. New WHR plant at line II (6MW)

Cherat currently has a WHRPP with net operational output of ~5MW (gross 7MW) at line I. As mentioned, company plans to install another WHRPP with gross potential output of 6MW at line II which is expected to commission after 1HFY17E. This is likely to translate in annual after tax savings of 2.29/sh for FY18E.

The existing WHRPP covers 31% of the required power (FY16E) while new WHRPP (6MW) at line II, assuming boiler efficiency of 80%, is expected to save 15% of required energy in FY18E (refer table below).

The table below shows the impact of WHR plants (at line I & II) on EPS.

EPS Impact	FY16E	FY17E	FY18E	FY19E	FY20E
WHR Line I	1.88	1.84	2.34	2.57	2.81
WHR Line II	0	0.59	2.29	2.18	2.41
Power Gen with WHR	31%	29%	31%	30%	29%

Source: Nael Research

Fig: 5 **In house Power Generation**

Power Generation	
	Nominal Output
WHR Line I	7MW
WHR Line II (4QFY17)	6MW
Captive Power Plant	
FO based	5.1MW x 4
Diesel based	1.3MW x 4

Source: Company Accounts

- **RDF - hedge against recovery in coal prices**

The rising coal prices in the past, compelled CHCC to install refuse derived fuel to catch up their rising fuel cost. Since the primary fossil fuel consumed in CHCC's kiln is coal, therefore CHCC launched its RDF operation to limit its fuel cost. However, RDF is no longer viable amid depressed coal prices but it covers company's downside risk of recovery in commodity prices.

3. Tax exemption for 5yrs

In order to boost construction activities in KPK, GoP announced a 5yr tax holiday in federal budget FY16 for companies establishing a new manufacturing unit during Jul'15-Jun'18. The major beneficiary of this relief package in cement universe is CHCC whose operations are likely to commence from 3QFY17.

Keeping in view about the tax exemption, the current expansion of 1.3mn tons as compared to its existing capacity of 1mn ton (> 2x its current capacity), it provides an added advantage by diverting its production to new plant in order to avail tax savings from this provision. Also, efficiency of new plant is assumed to be higher as compared to the existing plant.

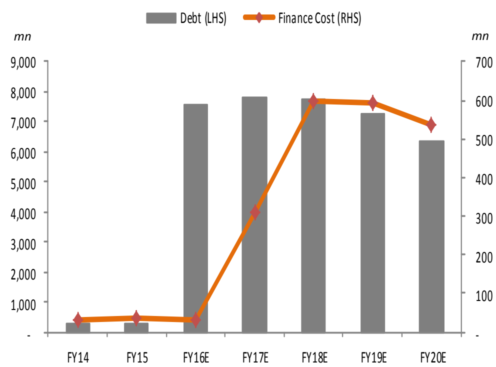
Hence in our base case, we have utilized production from new plant initially while remaining demand is to be met by old plant.

The table below indicates the tax savings impact of utilizing new plant on EPS.

Tax exemption impact on EPS		Cap Utilization	FY18E	FY19E	FY20E
Scenario A	Line I	Remaining	3.97/sh	3.68/sh	3.27/sh
	Line II	100%			
Base case	Line I	Remaining	3.57/sh	3.31/sh	2.94/sh
	Line II	90%			
Scenario B	Line I	Remaining	3.16/sh	2.94/sh	2.61/sh
	Line II	80%			

Source: Nael Research

Fig: 6 **CHCC Debt and Finance cost**



Source: Company Accounts, Nael Research

Shift in capital structure

A notable shift in capital structure of CHCC is likely to be observed due to its expansionary plans of installing WHRPP and commissioning of new cement line with estimated investment of PKR 12bn.

Company has approved a loan of PKR 9.5bn for its cement plant line II and PKR 1bn for WHR plant but we anticipate the total drawdown amount to be lower with estimated financing of PKR ~7-8bn while remaining amount is to be utilized from internal cash flows. The syndicated loan has a grace period of 3yrs.

The first draw down of borrowing took place in 1QFY16 but its impact on finance cost would be observed once the plant gets operational in 3QFY17 (expected) as company is currently capitalizing its interest cost.

PT Sensitivity

Figure: A

		Risk free rate				
		7.85%	8.35%	8.85%	9.35%	9.85%
Growth rate	3.00%	112	104	97	91	85
	3.50%	121	112	105	98	91
	4.00%	131	121	113	105	98
	4.50%	142	132	122	114	106
	5.00%	155	143	133	123	114

Source: Nael Research

Key Risks

Price War

The current expansions of LUCK, DGKC, ACPL, and CHCC are likely to pose a threat of price war if the local demand didn't surge as expected.

Decline in PSDP

Lower than expected allocation of budgeted Public sector development fund will hurt domestic cement off take. With declining demand eminent from export avenues, lower PSDP will pose a threat for manufacturers.

Volatility in International oil prices

The gross margins are likely to erode owing to surge in oil prices. The current macro supports the companies to boost its profitability where company has the advantage of using its FO and HSD based CPP to curtail its energy cost.

Increase in discount rate

Our subject company tends to be highly sensitive to increase in interest rate because of its recent hefty financing for its expansionary business. The finance cost will elevate resulting in decline in profitability.

Financials

Income Statement (PKR mn)	FY14*	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
Net Sales	6,451	6,565	6,947	10,117	13,983	14,131	14,605
Cost of sales	4,349	4,582	4,499	6,640	9,219	9,583	10,312
Gross Profit	2,103	1,984	2,447	3,477	4,764	4,548	4,292
Admin Expenses	141	164	187	275	382	387	400
Distribution Expenses	188	206	231	331	459	464	480
Operating Profit	1,773	1,613	2,029	2,871	3,923	3,697	3,413
Other operating expenses	133	105	142	185	246	226	206
Other operating income	77	201	43	92	197	135	79
EBIT	1,716	1,709	1,930	2,777	3,874	3,606	3,286
EBITDA	1,975	1,983	2,295	3,243	4,551	4,304	4,007
Financial Charges	29	38	32	310	596	596	537
Profit before taxation	1,688	1,672	1,898	2,467	3,278	3,011	2,749
Taxation	372	383	493	404	388	349	332
Profit after Tax	1,316	1,288	1,405	2,063	2,890	2,662	2,417
EPS	7.45	7.29	7.95	11.68	16.36	15.07	13.68

Source: Company Accounts, Nael Research

**Based on current no of shares*

Balance Sheet (PKR mn)	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
Current Asset	2,905	2,267	3,876	5,440	8,172	9,698	10,558
Non Current Asset	3,526	7,197	14,205	14,718	14,405	14,089	13,772
Total Assets	6,431	9,464	18,081	20,158	22,577	23,786	24,329
Current portion Of LTF	41	41	41	141	653	1,025	1,025
Other Current Liability	840	786	831	1,164	1,626	1,885	2,093
Long term Financing	163	122	7,432	7,541	6,888	5,863	4,838
Other non current Liability	522	489	476	478	481	483	486
Total Liability	1,567	1,438	8,780	9,324	9,648	9,255	8,441
Paid up Capital	1,051	1,766	1,766	1,766	1,766	1,766	1,766
Retained Earning	3,813	6,260	7,535	9,068	11,163	12,765	14,122
Equity	4,864	8,026	9,301	10,834	12,929	14,531	15,888

Source: Company Accounts, Nael Research

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Stock Recommendation	Return
BUY	> 15%
HOLD	> -15% to < 15%
SELL	< -15%