INITIATION

EQUITY RESEARCH

MAPLE LEAF CEMENT FACTORY LTD (MLCF)

Jan 07, 2016

HOLD

Price Target : PKR 79.68/share

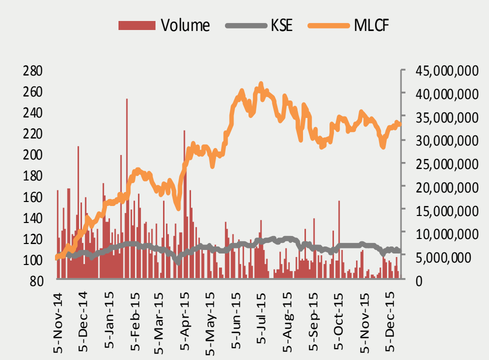
Closing Price : PKR 80.06/share

COMPANY DATA

52-week Price Range (PKR)	83.40-45.76
No. of Shares Outstanding (mn)	527.73
Market Cap (PKRmn)	42250.38
Market Cap (USDmn)	402.73
Free Float (mn shares)	237.48
Year End	Jun
KATS Code	MLCF

Source: KSE

CHART: STOCK PERFORMANCE



Source: KSE

- **We initiate our coverage on MLCF with 'Hold' rating:** Our Jun-16 DCF based price target of PKR 79.68/sh implies no upside potential from current price levels of PKR 80.06/sh.

- **Reaching potential capacity - within sight:** Uptick in local demand expected from CPEC projects will bode well for companies with room for potential capacity utilization. The current capacity utilization of MLCF stands at 84% (FY15), providing favorable position for taking advantage.

- **Improving operational efficiencies:** While other companies in cement sector are undergoing expansionary projects, MLCF is working on reducing its operational cost through

  I) Installation of 40MW coal fired power plant (to be operational by 4QFY17)

  II) Use of alternate fuel (pet coke)

  III) Contract with Pakistan Railway for transportation of ~30k tons/month of coal/pet coke

- **Depressed commodity prices to boost margins:** The diversified energy and power mix of MLCF provides advantage of benefitting from commodity downturn. Plunge in commodity prices has helped the company in improving its gross margins by reducing its fuel & power cost.

- **Manageable Financial leverage:** The recent trend of swift repayment to reduce leverage is unlikely to sustain as we expect the debt of MLCF to increase by another PKR 3.0 - 3.5bn for financing of coal fired power plant.

- **Investment Risk:** Key risks to our investments thesis are 1) Price volatility 2) Surge in commodity prices 3) Decline in local demand 4) Price war 5) Hike in interest rate.

MLCF FINANCIAL HIGHLIGHTS

	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
EPS	5.36	6.55	7.96	8.57	10.22	10.28	9.84
DPS	0.0	2.0	2.5	3.0	4.0	4.5	4.5
BVPS	28	33	36	42	49	55	61
PE (x)	5.6	12.0	10.1	9.3	7.8	7.8	8.1
Div Payout (%)	0	31%	31%	35%	39%	44%	46%
EBITDA Margin (%)	36%	36%	38%	38%	42%	41%	39%
ROA (%)	9%	11%	12%	13%	14%	13%	12%
ROE (%)	19%	20%	22%	21%	21%	19%	16%
Gross Margin (%)	34%	36%	39%	39%	42%	41%	39%
Net Profit Margin (%)	15%	17%	19%	19%	22%	21%	20%

Source: Company Accounts, NAEL Research

Jawad Ameer Ali AC

jawad@naelcapital.com

(+92-21) 32461812-13

Valuation

We initiate our coverage on MLCF with '**Hold'** recommendation using discounted free cash flow method. We have used Free Cash Flow to Firm methodology to derive the intrinsic value of MLCF at PKR 79.68/sh. The following assumptions have been incorporated to arrive at our target price

- Terminal growth rate of 4%
- Risk free rate of 9.09% (10yr PIB)
- Market Risk Premium of 6% & Adjusted Beta of 1.31 (using 7yrs)

Based on above assumptions, MLCF's Jun-16 PT is reckoned at PKR 79.68/share, offering no upside potential from its closing price of Jan 7, 2016.

	FY16E	FY17E	FY18E	FY19E	FY20E
PV of FCFF	3,231	2,832	4,602	4,228	3,664
WACC	14%	15%	15%	16%	16%
PV of FCFF	18,557				
Terminal Value	58,390				
PV of Terminal Value	32,594				
Ent Value	51,151				
PV of Debt	9,100				
Equity Value	42,050				
Target Price 6/30/2016	79.7				
Current Price	80.1				
Upside	-0.5%				

Performance Preview of 2QFY16

We anticipate MLCF to post PAT of PKR 1.03bn for 2QFY16 (+15%YoY/21%QoQ) against PKR 0.88bn recorded in same quarter last year. This implies an EPS of PKR 1.94 in 2QFY16 as compared to PKR 1.68 recorded in 2QFY15. Furthermore, we expect MLCF to announce an interim cash dividend of PKR 1/sh.

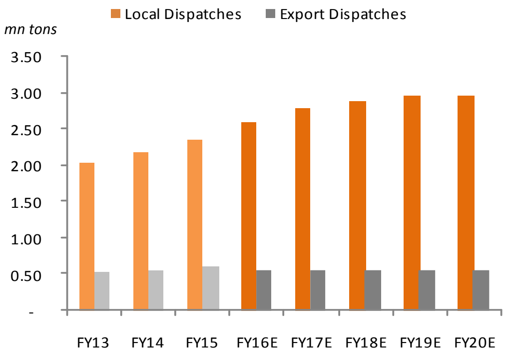
The top line of company is expected to surge by 6%YoY to PKR 5.53bn in 2QFY16 as against PKR 5.22bn in same period last year. The gross margins are likely to escalate by ~170bps.

This notable increase in EPS is mainly attributable to

- Surge in local demand resulting in volumetric growth of MLCF by 6.9%YoY/17.8% QoQ.
- Depressing oil (Avg $43/bbl in 2QFY16 vs $75/bbl in 2QFY15) and coal (Avg $50/ton in 2QFY16 vs $66/ton in 2QFY15) prices in international market.
- Lower financing cost owing to swift repayment and monetary easing. Although we expect the leverage of company to increase for financing of coal fired power plant but lower interest rate scenario will not hurt profitably.

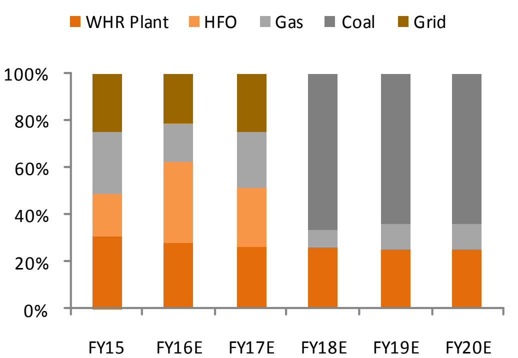
PKR 'mn'	2QFY16	2QFY15	YoY	1QFY16	QoQ
Sales	5,537	5221	6%	4966	11%
COGS	3,418	3313	3%	3140	9%
Gross Profit	2,118	1909	11%	1825	16%
Admin Exp	111	89	24%	113	-1%
Dist Exp	305	339	-10%	303	1%
Op Profit	1,703	1481	15%	1410	21%
Other op exp	102	76	35%	77	34%
Other op inc	5	9	-43%	5	5%
EBIT	1,605	1414	14%	1338	20%
Finance cost	142	270	-48%	186	-24%
PBT	1,464	1144	28%	1152	27%
Tax	439	256	72%	306	44%
PAT	1,025	888	15%	847	21%
Basic EPS	1.94	1.68	15%	1.60	21%

Fig: 1 **MLCF Cement Dispatches**



Source: APCMA, Nael Research

Fig: 2 **Electricity Generation Mix**



Source: Company Accounts, Nael Research

Average Fuel Mix	
Coal	78%
Pet coke	22%

Investment Argument

Our investment view on MLCF is based on improving cost efficiencies and growth in earnings for FY16E-FY19E based on following fundamentals:

Reaching potential capacity - within sight

MLCF currently operates at capacity utilization of 84% (FY15). This implies a room for uptick in capacity utilization owing to

- increase in demand of local cement
- the recent CPEC projects to be initiated in vicinity of MLCF

Based on current financials, we don't expect the company to plan any expansionary project soon.

Improving operational efficiencies

While other companies in cement sector are undergoing expansionary projects, MLCF is working on reducing its operational cost through

- **Installation of 40MW coal fired power plant:**

MLCF is planning to install a 40MW coal fired power plant that is expected to be operational by 4QFY17. However, we have incorporated its impact from 1QFY18. The capital outlay of project is estimated at PKR 5.0-5.5bn with debt financing of approx. 60%. (See Fig 2 for shift in power mix)

Although we firmly believe in the economic viability of using this plant for cheap power generation with high load factor, but it is important to remain well versed with its negative externalities to ecology. Assuming 38% plant efficiency and 88% boiler efficiency with 10% auxiliary energy consumption, we anticipate this plant to translate in electricity generation cost of PKR 5.5/kwh.

- **Use of alternate fuel (pet coke)**

With the decline in coal prices in international market, consumption/usage of alternate fuel in cement industry has reduced remarkably. The ratio of pet coke consumed by MLCF unlike in recent past has reduced but it is pertinent to mention the necessity of pet coke for production of white cement.

MLCF holds 90% of market share in white cement with capacity of 500tpd. Since heat requirement for white cement production is much higher as compared to ordinary grey cement therefore anode grade pet coke is used (< 1% S content) as its fuel. Based on our working, the current prices of coal from South Africa and pet coke from Saudi Arabia/India via sea with such characteristics, pet coke offers a marginal benefit.

Fuel Mix

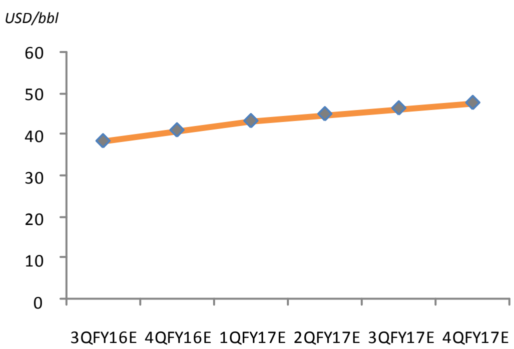
	White Cement	Grey Cement	
	(500tpd)	Line I (4000tpd)	Line II (6700tpd)
Coal	0%	100%	65%
Pet coke	100%	0%	35%

Diversified Power Mix

	Capacity	FY15
Required		47MW
WHR Plant	16MW	31%
Captive Power Plants		
HFO Based	4x6MW	18%
Gas Based	16MW	27%
Coal Based	40MW	NA
Grid	Remaining	24%

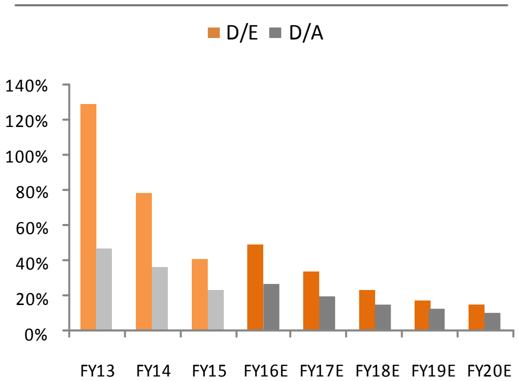
Source: Company's Account, Nael Research

Fig: 3 **Oil Prices Projection**



Source: IMF, Nael Research

Fig: 4 **MLCF Debt Ratio**



Source: Company Accounts, Nael Research

- **<u>Contract with Pakistan Railway for transportation of ~30k tons/month of coal/pet coke</u>**

MLCF has signed a 5yr agreement with Pakistan railways for transportation of coal/pet coke from port to proximity of their plant. This contract provides assurance for timely transportation of these inputs unlike continuous variation in prices of using truck/ wagon transportation. The contract entails capacity to transport ~30k tons/month which is equivalent to 360k tons/yr that is sufficient enough to cater the production of existing potential capacity of cement lines. However, keeping in view about their upcoming CPP (coal based), MLCF will have to revisit their contract for power generation or rely on other medium for its transportation.

Using this unique contract with current charges of PKR 1750/ton + PKR 1000/ton (assuming overhead charges of transportation from station to plant, etc) vs assuming PKR 2500/ton for using truck transport, this translate in an annual after tax saving of PKR 0.25/sh for FY16E (amount of cement production, ratio of pet coke and coal will vary the impact).

Depressed commodity prices to boost margins:

The diversified energy and power mix of MLCF provides advantage of benefitting from commodity downturn. Plunge in commodity prices has helped the company in improving its gross margins by reducing its fuel & power cost. The energy mix of MLCF currently utilizes WHR-31%, HFO-18% (usage dependent on oil prices), Gas-27% (based on its gas allocation and conservatively incorporating shortage in winters) & Grid-24% to fulfill its energy requirement.

- **<u>Oil price projections remains bearish</u>**

Current geo political situation seems to be benefitting oil importers around the world where 1) OPEC is not limiting its production 2) US has lifted ban on crude oil export after 40yrs 3) Iran to add surplus production post sanction 4) Low storage capacity (serious concern)

We remain bearish on oil prices heading FY16-FY17. However, we have incorporated recent near term estimates of IMF on commodity prices (see fig 3).

USD/bbl	3QFY16E	4QFY16E	1QFY17E	2QFY17E	3QFY17E	4QFY17E
Oil prices	38.5	41.1	43.3	45.0	46.4	47.7

Decline in international oil prices has turn out to be icing on cake for companies with FO based CPP to improve their margins.

With the commissioning of coal based CPP in 1QFY18, we don't expect MLCF to use FO anymore as WHR, Coal & gas based CPP would be sufficient enough to cater the required power.

Manageable financial leverage

The debt structure of MLCF during the recent past has improved notably especially during FY15 owing to swift repayment. However, we do not expect the trend to persist due to debt financing of PKR 3.0-3.5bn (~60% of capital outlay) for coal fired power plant. This will result in D/E to elevate from 42% in FY15 to 48% in FY16E, yet manageable (see fig 4).

PT Sensitivity

Figure: A

		Risk free rate				
		8.09%	8.59%	9.09%	9.59%	10.09%
Growth rate	3.00%	81	78	74	71	68
	3.50%	84	80	77	74	71
	4.00%	87	83	80	76	73
	4.50%	91	87	83	79	76
	5.00%	95	90	86	82	78

Source: Nael Research

Key Risks

Price volatility

MLCF price volatility remains a downside risk to our target price owing to past performance of management. Hence investors remain jittery and any unforeseen event will impact its share price negatively. (Beta of subject company is high)

Surge in commodity prices

The subject company is operationally not as efficient as other companies in cement sector yet. Gross margins that have escalated are likely to erode with increase in coal & oil prices. At macro level, current scenario supports the companies to boost its profitability where retail prices are kept constant and input prices are on bearish trend. The commodity super cycle poses a threat.

Decline in local demand

The only driver of cement volumes under current scenario is supported by local demand. The cheap influx of Iranian cement in Afghanistan and anti dumping duty in South Africa have kept the export volumes to remain subdued until new avenues are explored. If the local demand derived from CPEC is hampered then industry is expected to witness a hit.

Price war

The current expansions of LUCK, DGKC, ACPL, and CHCC supported by potential expansions of Chinese investment are likely to pose a threat of price war if the local demand didn’t surge as expected. There has been a meager decline in sale price of cement bag in last quarter.

Hike in Interest rate

Increase in interest rate will hurt companies with high financial leverage such as our subject company. The finance cost will elevate resulting in decline in profitability.

Financials

Income Statement (PKR mn)	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
Net Sales	18,969	20,720	22,258	23,902	24,675	25,519	25,877
Cost of sales	12,446	13,224	13,535	14,642	14,242	15,048	15,735
Gross Profit	6,523	7,496	8,723	9,260	10,433	10,471	10,142
Admin Expenses	297	381	445	476	492	508	515
Distribution Expenses	1,054	1,314	1,230	1,290	1,353	1,419	1,488
Operating Profit	5,172	5,801	7,048	7,494	8,589	8,544	8,138
Other operating expenses	197	263	412	452	539	543	519
Other operating income	81	46	21	74	172	190	209
EBIT	5,055	5,584	6,657	7,116	8,222	8,191	7,827
EBITDA	6,745	7,356	8,564	9,193	10,346	10,363	10,048
Financial Charges	1,465	1,083	712	656	520	440	407
Profit before taxation	3,590	4,501	5,945	6,460	7,702	7,751	7,420
Taxation	760	1,047	1,743	1,938	2,311	2,325	2,226
Profit after Tax	2,830	3,454	4,201	4,522	5,392	5,426	5,194
EPS	5.36	6.55	7.96	8.57	10.22	10.28	9.84

Source: Company Accounts, Nael Research

Balance Sheet (PKR mn)	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
Current Asset	7,145	7,439	9,571	9,440	12,340	16,329	20,271
Non Current Asset	24,766	23,782	24,843	26,503	25,343	24,147	22,936
Total Assets	31,911	31,221	34,414	35,943	37,682	40,476	43,207
Current portion Of LTF	1,034	2,179	1,885	1,528	723	350	350
Other Current Liability	6,099	5,965	6,228	6,394	5,814	5,989	6,220
Long term Financing	7,843	2,599	4,660	3,158	2,450	2,100	1,750
Other non current Liability	2,295	2,815	2,832	2,852	2,875	2,902	2,932
Total Liability	17,270	13,559	15,605	13,932	11,862	11,341	11,252
Paid up Capital	5,277	5,277	5,277	5,277	5,277	5,277	5,277
Retained Earning	4,472	7,634	8,780	11,983	15,792	19,107	21,926
Surplus Revaluation	4,892	4,751	4,751	4,751	4,751	4,751	4,751
Equity	14,641	17,663	18,809	22,011	25,820	29,135	31,954

Source: Company Accounts, Nael Research

Chief Executive Officer

Ashraf Bava, CFA	(92-21) 32461812-13	abava@naelcapital.com

Equity Sales

Muhammad Shakeel, Director Equity Sales	(92-21) 32461819-22	shakeel@naelcapital.com
Nasir Muqeet, Institutional Sales	(92-21) 32461819-22	nmuqeet@naelcapital.com
Irshad Ul Haq Khan, Institutional Sales	(92-21) 32461819-22	irshad@naelcapital.com

Research

Sarah Aslam, Research Analyst	(92-21) 32461812-13	sarah@naelcapital.com
Jawad Ameer Ali, Research Analyst	(92-21) 32461812-13	jawad@naelcapital.com
Nimerta Veerban, Research Associate	(92-21) 32461812-13	nimerta@naelcapital.com

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