DARSON SECURITIES (PVT) LTD
TREC HOLDER: PAKISTAN STOCK EXCHANGE

Fauji Cement Company Limited

darsonResearch

CALL

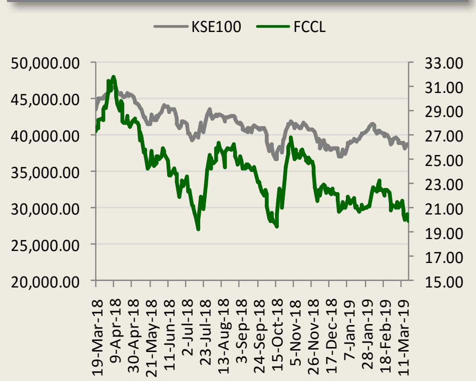
Buy	Hold	Sell

KEY STATISTICS

Symbol	FCCL
Current Price (Rs)	19.96
Target Price Dec'19 (Rs)	22.33
Market Cap (Rs.mn)	276,655
52 weeks high	32.52
52 weeks low	18.85
Shares outstanding (mn)	1,379,815
Free Float (mn)	758,898

Source: PSX / Darson Research

RELATIVE PERFORMANCE



Source: PSX, Darson Research

KEY STATISTICS

	FY19E	FY20E	FY21
EPS	2.54	2.45	2.96
DPS	1.75	1.50	2.00
P/E x	7.87	8.14	6.75
BVPS	15.63	16.59	17.54
P/B x	1.28	1.20	1.14
EV/EBITDA	4.45	4.29	3.42

Source: Darson Research

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FCCL- Growth May Restrict Ahead; Hold

We have initiate our coverage on Fauji Cement (FCCL), with a "Hold stance". We expect, declining market share on a medium term, less domestic demand and limited exports may confine earnings potential. Considering that, we have a "Hold" recommendation of the stock with Dec'19 target price of Rs22.33/share.

Market Share seems to decline ahead- FCCL's may find their market share to decline ahead once new capacities in North come online. We expect industry expansion cycle to reach at ~72.9mn TPA by FY23E. However, FCCL current market share stands at ~8.26% (with current industry operational capacity of 54.2mn TPA) and is expected to decline from ~8.26% FY19E to ~6.52% FY23E.

CAPEX doesn't look like achievable in current dynamics- To bring its markets share back at 9%-9.5%, company would need an expansion of at least 1.8mn TPA worth US$300mn (Investment cost of Greenfield US$120-150/ton). With rising interest rate and competition company may need to raise both debt and Equity and even need to cut off dividends.

Power Efficiencies- FCCL added WHR power plant of 9MW (for its Line 2) in February 2018. Subsequently, company is additionally intending to add Captive Solar Power Plant of 12.5MW which is expected to commissioned by mid 2019. We think, these additions will substantially save their power cost and give breather to gross margins.

Favorable opportunities in exports- Declining market share and slow down in domestic consumption, FCCL may search for more opportunities in Afghanistan and other neighbouring nations aside from Iran (US sanctions on Iran) and India (Recent imposition of 200% duty).

Upcoming Projects may trigger growth- Government housing scheme of 5m low cost housing units, constructions of dams and start of second phase of CPEC may demonstrate noteworthy development.

Valuation- We have valued FCCL by using FCFF method to arrive at target Price of Rs22.33/share. FCCL is currently trading at FY19E P/E of 7.87x. The script offers a total return of 20.71%, composed of dividend yield of 8.71% FY19E and a capital gain of 12% from the last price of Rs19.96/share.

Investment Risk

Upside triggers

- Increment in Local volumes
- Fall in Coal prices

Downside triggers

- Decline in local demand
- Price Competition

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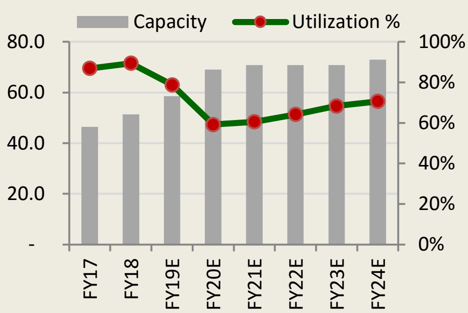
Industry Outlook

Pakistan's Cement industry is divided in to two regions North and South. Out of current operational cement industry capacity of 54.2mn TPA with utilization of 83% in 8MFY19 (Note, this ignores the addition of CHCC's line 3 of 2.1mn tpa in Jan'19), north region secures 76% of total capacity and rest lies in south region. In industry, Bestway cement has the highest market share of 18.2% and lowest of 0.9 % with Dandot Cement.

Industry Capacity vs Utilization %



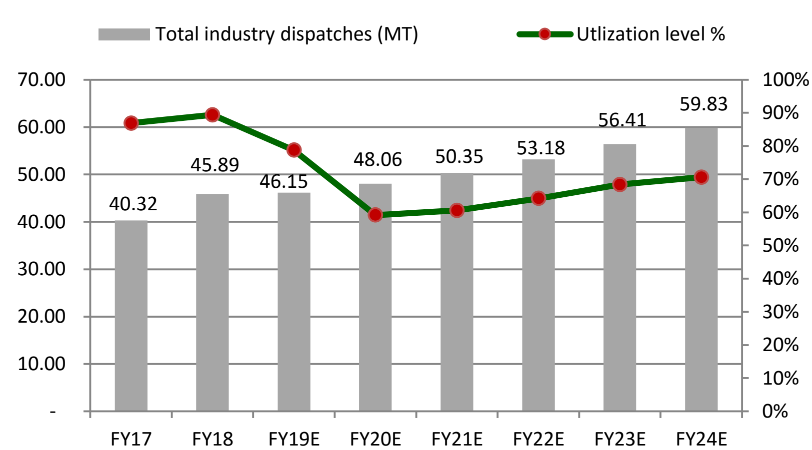
Source: APCMA, Darson Research

Capacities to expand

Having a post capacity of 46.39mn TPA in last two years, Pakistan Cement industry is going through substantial expansion due to robust demand ahead. We expect, whole industry expansion cycle may be completed by FY21-22 from 46.39mn TPA (in FY17) to 72.9mn TPA (in FY21).
However, upcoming major expansion in FY20 primarily by MLCF of 2.3mn TPA, PIOC 2.7mn TPA, LUCK 2.6mn TPA and KOHC 2.3mn TPA and dull activity in local consumption will keep utilization level to be near at 60% levels by FY20E. Hence, We believe, local demand to get back to its track by 3rd qtr of FY20E.

Domestic Consumption could be weak in FY19E

Weak Macroeconomic environment remained challenging during the first quarter of FY19. The foremost concerns are (i) the steep rise in global crude oil by ~17% during this fiscal year, (ii) inflationary pressures, (iii) fiscal deficit and (iv) rising of interest rate by 450bps (from Dec'17 till present). If we consider overall cement dispatches for the Feb'19 it has declined by 12%YoY to 3.3mt as compared to 3.6mt. This is on the back of (i) slow down in construction activities, (ii) lower PSDP disbursements and (iii) challenging macroeconomic environment. As a win-win situation, five million low-cost housing scheme, constructions of dams, higher disbursements of PSDP funds, second phase of CPEC, looking at these activities, we think it may prove a significant growth. Going Forward, we may estimate total industry dispatches to grow by ~5% by FY19E to FY24E.



Source: APCMA, Darson Research

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Housing scheme could accelerate utilization by 22%

Government housing scheme may push additional demand of 12mn TPA over a five year time frame (assuming 1mn low-cost housing units to be built every year). In case, if we accept just 1.5mn minimal effort of low cost housing units are to construct, at that point it could add only 3.6mn TPA additional cement demand to the total volumes and utilization to increment by 7%. Hence, we have excluded this in our valuations as government has not finalized the plan yet we emphatically consider it as the best advantage trigger.

Calculation for building 5mn low-cost housing

Size of housing unit	Square Yards	120
50kg bags required	Nos.	240
Total bags req for 5m	Tons	1,200,000,000
Total Cement	Tons	60,000,000
No of years	Tenure	5
Annual Cement Req	MT	12,000,000
FY19 total Industry dispatches	MT	47
FY19 effective capacity	MT	54
FY19 utilization	Percentage	86%
Increase in utilization	Percentage	22%

Source: Zameen.com, Darson Research

(Assuming only 1.5mn housing units to be built)

Total bags req for 1.5m	Tons	360,000,000
Total cement req	Tons	18,000,000
No of years	Tenure	5
Annual Cement Req	MT	3,600,000
FY19E total Industry dispatches	MT	47
FY19 effective capacity	MT	54
FY19 utilization	Percentage	86%
Increase in utilization	Percentage	7%

Source: Zameen.com, Darson Research

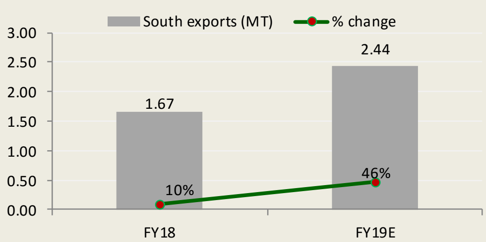
Construction of dams may give significant growth

The government has also planned to construct two major dams-Mohmand (800MW) and Diamer-Bhasha (4500MW) which is expected to begin in 2nd qtr of 2019, which could lift the additional demand by 20-30mt (during the construction time frame). We believe, this is an another real development which will trigger local demand ahead. Hence, we have excluded this also in our valuations as it looks too idealistic in current scenario.

PKR devaluation and US Sanctions on Iran may favor cement exports

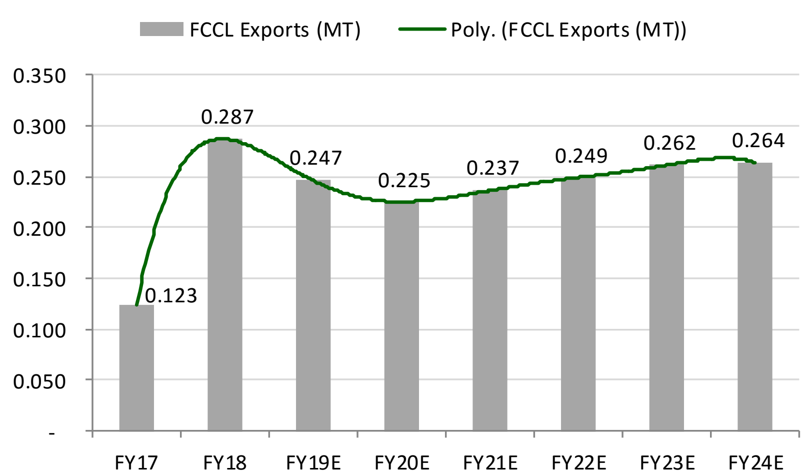
PKR has devalued against USD by ~31% since 2018, due to main concerns on Current Account Deficit (CAD). This helped cement exports to rose by 52% YoY in 8MFY19 to 4.6mn tons as compared to 3.05mn tons, this was mainly by southern region due to addition of new capacities by LUCK (1.2mn tons), DGKC (2.8mn tons) and ACPL (1.2mn tons). Over the past few years, exports have seen a continuous decline due to cheap Iranian cement (In Afghanistan market as sanctions were lifted in 2016) as compared to Pakistan export price. Ongoing Devaluation of PKRR against USD have given better export price of USD44/ton. However, recent restoration of Sanctions on Iran by US may favor Pakistan to take over the export share in Afghanistan market. We have determined industry exports may grow by 3% by FY19E to FY24E, primarily by southern region. In addition to this, south region may post incremental volume by 46% from 1.6mt to 2.4mt in FY19E as compared to FY18.

SOUTH EXPORTS (MT)



Source: APCMA, Darson Research

FCCL Total Exports

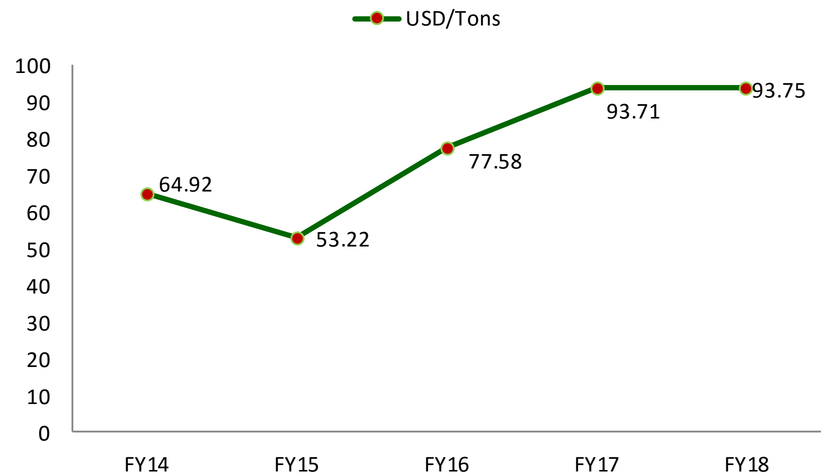


Source: APCMA, Darson Research

Coal-A major input

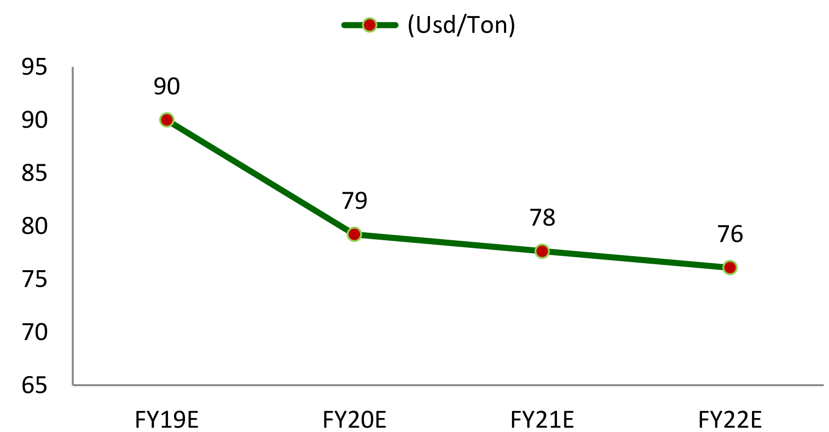
Coal is a major input use as an energy source for cement production which covers around ~30-40% of cost of production. Coal price has decreased by 20% settling at USD79.6/ton in past five months on account of new measures taken by the Chinese government to up production at domestic coal mines, suppressing the surge in import prices and developed nations are ditching coal in favour of cleaner –burning gas and renewable energy. This may lead over supply in the global market as China consumes ~40% of global coal imports). In any case, decline in coal price will give much support to their gross margins.

Avg Coal prices of last five years



Source: Quandl

Darson coal price (Estimates)



Source: Darson Research

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Investment Theme-FCCL

Company Profile

- Fauji Cement Company Limited (FCCL) was incorporated in 1992 with an initial capacity of 945,000 tons per annum and started operations in 1997.
- Fauji Cement is a prominent cement manufacturer in the industry in the North block of the sector as its two cement lines are located in Jhang Bahtar, Punjab.
- After a series of capacity expansions, the company raised capacity to 3.27 million annually.
- FCCL is engaged in manufacturing and sale of ordinary portland cement. The Company offers products, including ordinary portland cement, low alkali ordinary portland cement and sulfate resistant cement.
- Fauji Cement is an associated company of "FAUJI FOUNDATION" which is charitable trust foundation founded in 1954 for the welfare of the ex-servicemen and their dependents.

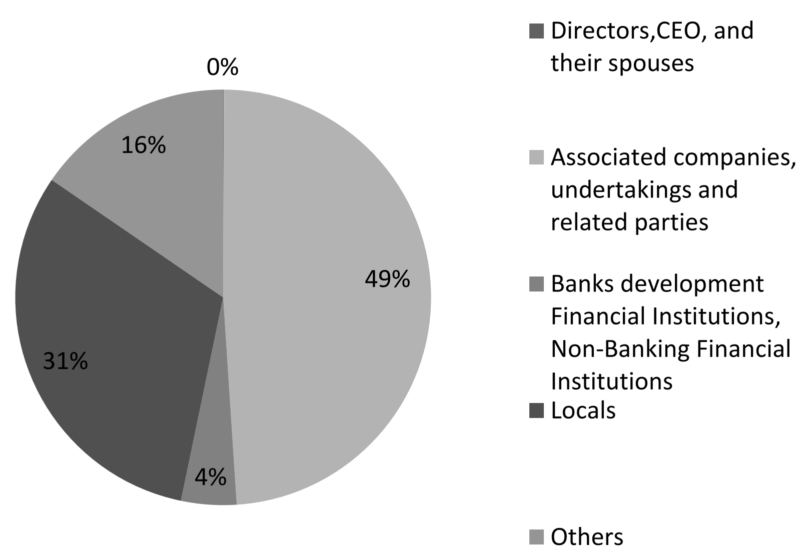
Vision

To be a role model cement manufacturing company, benefitting all stake holders and fulfilling corporate social responsibility while enjoying publics respect and good will.

Mission

FCCL while maintaining its leading position in quality of cement maximizes profitability through reduced cost of production and enhance share in domestic international markets

Shareholding pattern



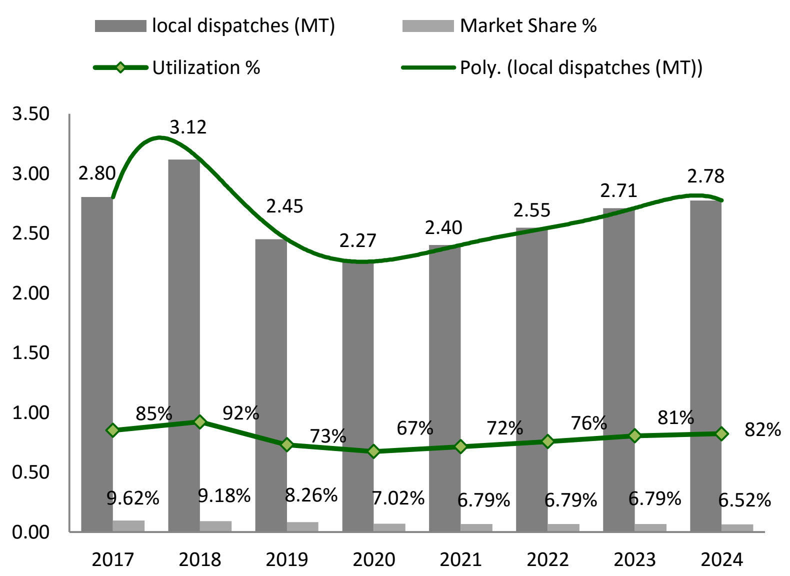
Source: Company Financials

Developments

- Fauji Cement is expanding its promising coverage of exports in the neighbouring regions /countries like Sri Lanka, India, Afghanistan, South Africa and Middle East & Africa.
- Company has also decided to setup a **12.5 MW** Captive Solar Power Plant which is expected to commissioned by mid of 2019.
- Fauji Cement has installed two WHR power plants (WHRPP) of **12 MW and 9 MW** respectively, with a concept to convert waste heat energy with a view to promote sustainable environment and reduce load on national grid.
- In order to cope up with demand in the industry, FCCL has also enhanced a new line to 7560 TPD in 2017.

Market share seems to decline ahead

FCCL might be in risk in terms of market share over the medium term, when new capacities in North come online. We expect industry expansion cycle to reach at ~72.9mn TPA by FY23. However, FCCL current market share stands at ~8.26% (with current industry operational capacity of 54.2mn TPA) and is expected to decline by ~21%. In order to maintain share, FCCL needs to go for an expansion phase of at least 1.8mn TPA to bring its market share back at 9% to 9.5%. Looking ahead, we estimated FCCL local dispatches to grow by ~2.5% from FY19E to FY24E.



Source: APCMA, Darson Research

FCCL faced tragic occurrence halts production

In May'16 FCCL "Raw Mill Silo" storing 25,000 tons of raw material having a capacity of 7,500TPD got collapsed, which additionally made harms to line-1 (having capacity of 3,700TPD). However, the company has claimed this loss against insurance by around Rs1,285mn. Around ~95% of claimed amount company has received.

Margins to recover as line-2 normalized

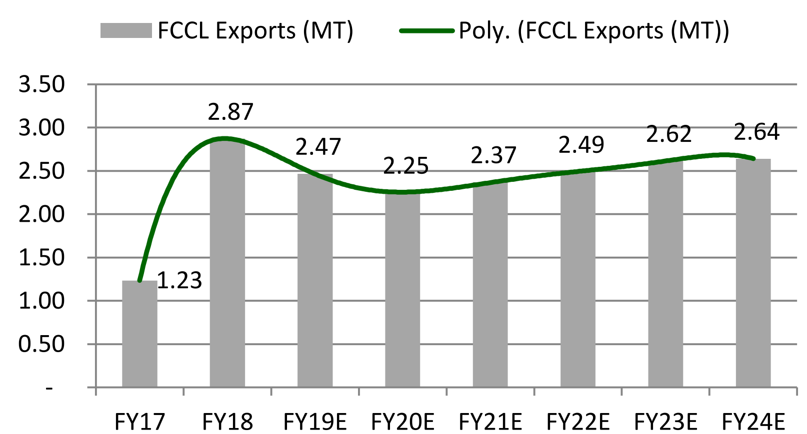
This unfortunate incident has hit their profitability margins by 51% in 2017 due to increased in COGS (as they need to purchase clinker from other manufactures in order to maintain market share). However, company got back to its track after Line-2 operations resumed and company recovered its previous lost margins.

EPS impact by WHR & Solar Power Plant

Company has installed two WHR power plants (WHRPP) of **9 MW** in Feb'18 taking to full capacity of 21 MW and upcoming Captive Solar Power Plant of **12.5 MW** by mid 2019 which will not only save their power cost, saves energy but also put fewer burdens on national grid. Nonetheless, we assessed that this will have positive impact on earnings by ~Rs0.43/share (after tax).

Export opportunities may fill local dispatches gap

Since moderate down in local dispatches and declining market share over the medium term, FCCL may look for more export opportunities to Afghanistan markets and other neighboring countries due to sanctions on Iran and imposition of 200% duty by India. We estimated, exports to grow by ~1.5% from FY19E to FY24E.



Source: APCMA, Darson Research

Earnings Sensitivity to coal price

FCCL's earnings is sensitive to coal price as it erodes there margins and profitability. Our presumptions demonstrate that 5% increase in coal price from average of FY19E USD90/ton to USD95/ton will diminish earnings by 6% from Rs2.54/share to Rs2.40/share as shown below:

	EARNINGS PER SHARE			GROSS MARGINS		
	FY19	FY20	FY21	FY19	FY20	FY21
5%	2.40	2.35	2.69	27.87%	27.44%	29.85%
BASE $90/Ton	2.54	2.45	2.82	29.22%	29.75%	31.06%
-5%	2.52	2.56	2.92	29.04%	30.90%	32.06%

Source: Darson Research

Valuations seems neutral

Assumptions

Method	FCFF
Risk free rate	13.00%
Market Risk Premium	6.00%
Beta	1.00
Cost of Equity	19.0%
Terminal Growth Rate	4.20%

Source: Darson Research

FCCL is currently trading at PE of 7.87x/8.14x for FY19E and FY20E. In addition to this, we believe dividend yield to be at ~8.77%/~7.52%/~10.02% for FY19E/FY20E/FY21E respectively.
As indicated by our valuations, the 3-yr average Ev/Ton of the stock will be at US$52.90/ton, which may be appear as a discount from industry average of US$105/ton. However, we have used FCFF as a valuation method to arrive at our Dec'19 target price of 22.33/share. We have estimated cost of equity of 19% by using CAPM, where we used 13% as a risk free rate, 6% of market risk premium and beta of 1.

Investment Risk

Upside triggers

- **Increment in Local volumes**- Looking at current scenario with dull volumes, we believe any upside trigger will significantly boost demand on the back of Naya Pakistan Housing Scheme, Constructions of dams, CPEC related activities and local constructions may prove for this upside.

- **Fall in Coal prices-** Since Coal is a major input for cement production which constitutes ~30-40%. So, declining in coal price will give some relief to their gross margins by ~3% .

Downside triggers

- **Decline in local demand-** Lower PSDP disbursements and slow down in economy may result for the downfall.

- **Price Competition-** To grab market share cement players may manipulate pricing which will result retention price to fall.

FINANCIAL STATEMENTS SUMMARY

Income Statement (Rs in Mn)	FY17	FY18	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E
Sales	20,423	21,161	19,996	18,676	20,436	22,149	23,650	24,272
Cost of sales	(15,986)	(16,046)	(14,153)	(13,120)	(13,822)	(15,322)	(16,727)	(17,670)
Gross Profit	4,438	5,115	5,843	5,556	6,615	6,826	6,923	6,602
Distribution cost	(166)	(276)	(267)	(303)	(326)	(345)	(366)	(387)
Admin Cost	(340)	(386)	(397)	(429)	(454)	(480)	(509)	(538)
Finance Cost	(153)	(148)	(117)	(88)	(58)	(37)	(27)	(22)
PAT	2,613	3,429	3,498	3,386	4,078	4,258	4,351	4,106
EPS	1.89	2.49	2.54	2.45	2.96	3.09	3.15	2.98
Eps growth	-51%	31%	2%	-3%	20%	4%	2%	-6%
DPS	0.90	2.00	1.75	1.50	2.00	2.00	2.00	2.00

Balance Sheet (Rs in Mn)	FY17	FY18	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E
Current assets	5,662	6,338	7,230	8,871	10,835	13,193	15,754	18,034
Cash	518	532	2,007	3,988	5,666	7,526	9,627	11,619
Non-current assets	22,091	22,711	21,963	21,200	20,423	19,630	18,822	17,998
Total Assets	27,752	29,049	29,193	30,071	31,258	32,823	34,576	36,032
Current liabilities	2,669	4,259	3,638	3,412	3,387	3,454	3,616	3,725
Short term debt	312	1,639	1,639	1,639	1,639	1,639	1,639	1,639
Non current liabilities	5,403	4,302	3,983	3,771	3,665	3,665	3,665	3,665
Long term debt	1,063	637	318	106	(0)	(0)	-	-
Shareholder equity	19,681	20,489	21,573	22,889	24,206	25,704	27,295	28,642

Key Ratios	FY17	FY18	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E
Gross Profit Margin (%)	21.73%	24.17%	29.22%	29.75%	32.37%	30.82%	29.27%	27.20%
EBITDA Margin	24.27%	26.27%	31.25%	31.83%	33.82%	32.04%	30.32%	28.23%
Net Profit Margins	12.80%	16.21%	17.50%	18.13%	19.95%	19.22%	18.40%	16.92%
ROE (%)	13.28%	16.74%	16.22%	14.79%	16.84%	16.56%	15.94%	14.34%
Divided Yield (%)	4.51%	10.02%	8.77%	7.52%	10.02%	10.02%	9.96%	9.96%
PE (x)	10.54	8.03	7.87	8.14	6.75	6.47	6.33	6.71
PBV (x)	1.40	1.34	1.28	1.20	1.14	1.07	1.01	0.96
EV/EBITDA (x)	5.82	5.34	4.45	4.29	3.42	3.05	2.73	2.56
BVPS	14.26	14.85	15.63	16.59	17.54	18.63	19.78	20.76
Debt/Equity (x)	0.09	0.13	0.11	0.09	0.07	0.06	0.06	0.06

Source: Company Financials, Darson Research

Important disclosures

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Rating System:

If;

- **Expected return >15%** - Buy Call
- **Expected Return is in between 0% to 15%** - Neutral/Hold Call
- **Expected Return <0%** - Sell Call

Valuation Methodology

To arrive at our period end target prices, DSL uses different valuation methodologies including:

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

SECP JamaPunji Portal link: www.JamaPunji.pk

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