NAEL CAPITAL

INITIATION

EQUITY RESEARCH— REP099

D.G. KHAN CEMENT COMPANY LTD (DGKC)

Sep 20, 2016

BUY

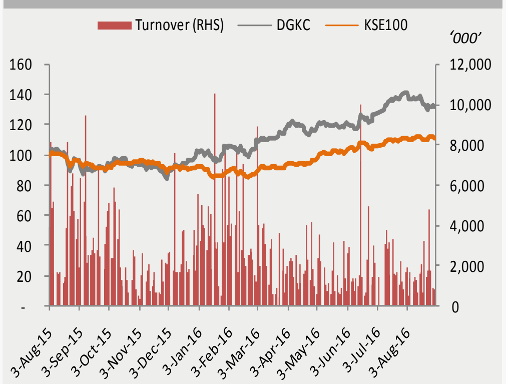
Price Target : PKR 275.68/share

Closing Price : PKR 187.09/share

COMPANY DATA	
52-week Price Range (PKR)	125.76 - 212.22
No. of Shares Outstanding (mn)	438.12
Market Cap (PKR mn)	81967.70
Market Cap (USD mn)	784.42
Free Float (mn shares)	240.97
Year End	Jun
KATS Code	DGKC

Source: PSX

CHART: STOCK PERFORMANCE



Source: PSX

- **We initiate our coverage on DGKC with 'Buy' rating:** Our Jun-17 DCF based price target of PKR 276/sh implies 47% upside from current price levels of PKR 187/sh.
- **South Expansion - Setting footprints across both regions:** The announced expansion will result in capturing 20% of the market share in south. The company will be subject to 5yr tax holiday if commercial operations initiate before FY19. Our valuation thesis incorporates this expansion in our price target.
- **Margins to remain Upbeat - Installation of Coal based CPP (30MW):** A key trigger in the near term for DGKC to boost its earning potential is its coal based captive power plant of 30MW commissioned in Dera Ghazi Khan site.
- **North Expansion - Sustaining its market share:** We believe this expansion to potentially accrue PKR 13.43bn value to DGKC. This implies a value addition of PKR 31/sh to our price target. Our valuation thesis doesn't incorporate this expansion in our price target.
- **Portfolio Investment - Steady dividend income:** Portfolio investment constitutes significant portion in earnings of DGKC. As of FY16, other income forms ~18% of the net earnings generated by company where major portion of earnings is contributed by its dividend income from MCB.
- **Loan book to surge significantly:** With heavy investments underway in Hub, Balochistan with capex of PKR ~30bn and anticipated brownfield expansion of PKR ~22bn (assuming USD 100/ton), we expect loan book to increase significantly.
- **Investment Risk:** The key risk to our investment thesis are 1) Breakdown of Price arrangement 2) Decline in local demand 3) Surge in international coal & oil prices 4) Delay in hub expansion 5) Increase in Interest rates 6) Concentrated portfolio investment.

DGKC FINANCIAL HIGHLIGHTS

	FY15	FY16	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	17.40	20.06	22.67	22.02	26.66	27.12	26.28
DPS	5.00	6.00	7.00	7.00	8.00	8.00	8.00
BVPS	142	157	174	189	209	228	246
PE (x)	10.75	9.33	8.25	8.50	7.02	6.90	7.12
Div Payout (%)	29%	30%	31%	32%	30%	29%	30%
EBITDA Margin (%)	45%	49%	52%	48%	46%	44%	42%
ROA (%)	10%	11%	10%	9%	10%	9%	9%
ROE (%)	12%	13%	13%	12%	13%	12%	11%
Gross Margin (%)	36%	43%	46%	41%	40%	38%	36%
Net Profit Margin (%)	29%	30%	31%	28%	29%	27%	26%

Source: Company Accounts, Nael Research

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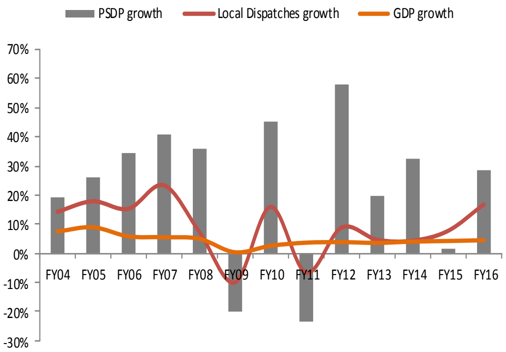
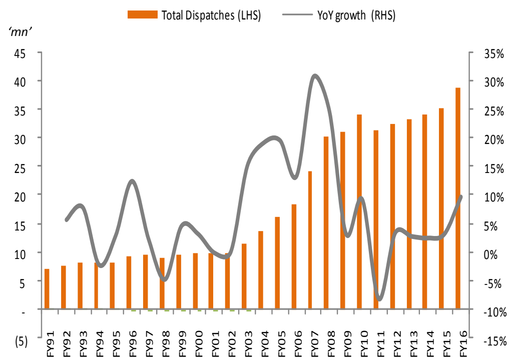
Fig: 1 **Relative Performance**



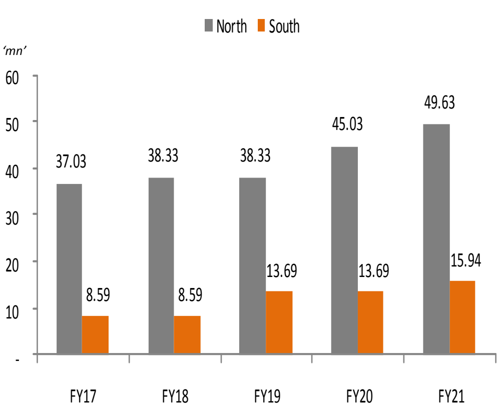
Source: MoF, SBP, APCMA, Nael Research

Fig: 2 **Growth in local Dispatches**



Source: APCMA, Nael Research

Fig: 3 **Regional Capacity Addition**



Source: Company accounts, Nael Research

Infrastructure projects to sustain upbeat domestic demand

Overcapacity concerns - Is Supply outpacing Demand?

The cement industry has entered into an expansionary phase whereby most of the local manufacturers have joined the expansion spree. It appears that all the players want to get their share of pie. Where CPEC led development has become the USP for construction sector, recent announced expansions (est ~20-22mn tons) have created concerns of supply outpacing demand. This has resulted in run down in stock prices of major cement companies from their highs.

Looking at the historical correlation between GDP and local cement demand, cement demand has 1.5x GDP multiplier. Assuming GDP growth rate of 4.5%, this implies cement demand to grow at ~6.75%/yr translating in utilization rate to achieve ~79% by FY21E (incorporating all expansions announced), albeit striking local demand witnessed in FY16 of 17%YoY.

Industry Utilization at 85% in FY16

The capacity utilization of cement industry stood at 85% during FY16. In view of similar growth prospects as mentioned above, utilization is expected to completely capitalize within 3yrs (incase of no expansion).

Our assumption is based on year end capacity. Incorporating estimated month of completion during the period will keep us in illusion as production numbers will not translate in a gradual pickup in utilization levels rather implying full utilization rates, being unrealistic. Based on these assumptions, our estimated utilization rates for FY19, FY20, and FY21 are reckoned at 87%, 82%, and 79% respectively with excess capacity estimated at ~7mn tpa, ~10.7mn tpa and ~14mn tpa respectively.

Is the demand/supply scenario equal across regions?

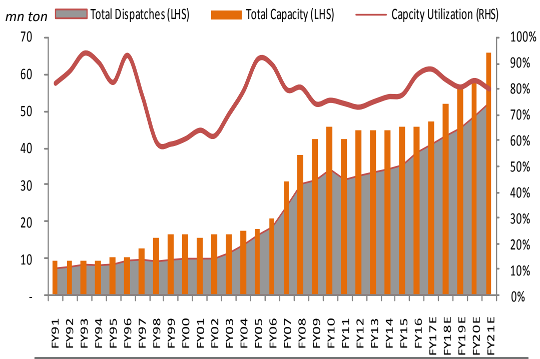
While we are looking at the total industry supply and demand, we are generalizing the sector. Neither demand nor capacity is created equally across regions. Expected capacity additions in north/south accumulates ~13/7 mn tons respectively.

The current utilization level of north stands at 84% whereas south utilization hovers around 95%. It is important in this regard to highlight the capacity addition in both regions. Expansion of 13mn tons in north results in 34% increase in capacity.

Highlighting the strategic location and major beneficiary of CPEC related demand growth, we believe north remains immune to breakdown of price arrangement. Even our overly cautious estimates of demand growth will keep utilization levels in check as new expansion comes online.

However, concerns are raised over capacity addition for southern players where 7mn tons of expansion constitute ~90% upsurge in capacity. Most of these expansions are anticipated to strike in FY18 with materialization in FY19. In view of current utilization level and strong uptick in local demand (~25% in FY16) erupting from housing schemes and infra projects, we remain affirm over gradual utilization of these additional capacities.

Fig: 4 **Industry - Demand/Supply**



Source: APCMA, Nael Research

Strong domestic demand - outlook intact

With new expansion plans underway and government's aggressive infrastructure push, we believe there is sufficient room for growth in domestic demand. The ongoing construction boom in the country has been driving the local demand. We believe, cement sector is expected to maintain its upbeat performance, mainly supported by strong government expenditure (PSDP up by 11%) and improving economic performance. As we approach elections, we anticipate strong PSDP growth to sustain in mid term.

The rising domestic demand driven by 1) uptick in private sector construction activity and 2) government's inclination towards infrastructural development (soaring PSDP), is likely to keep the sector in limelight. CPEC is likely to provide an additional impetus to domestic demand in the coming years with its earmarked USD 11bn infrastructural projects. Note, GoP under CPEC has plans to achieve the following infra projects in coming years:

- Road Projects - 832km length
- Rail sector Projects - 1736km length
- Gwador Port related projects

Recent affirmation by Assistant Minister of IDCPC claiming "China will not allow China-Pakistan Economic Corridor (CPEC) to be a failure", support our argument for materialization of said projects.

Valuation

We initiate coverage on D.G. khan cement with buy rating and a PT of PKR 276, implying 47% upside potential from its closing price of Sep 19, 2016. Our recommendation on this scrip is based on its strong positioning in local demand and long term growth outlook driven by rising private sector consumption and CPEC led infrastructure spending.

We have valued D.G. khan cement using sum of total parts (SOTP) given its investments in other companies of Mansha group. The core operations of business is valued using Free cash flow to Firm (FCFF) methodology with underlying assumptions:

- RFR of 7.72% (10yr PIB) , Beta of 1.26 (Adjusted 5yr) , Terminal growth rate of 4% & Market Risk premium of 6%

Based on these assumptions, we have derived the intrinsic value of DGKC to be PKR 228 from its core operation. The stock offers a dividend yield of ~3%.

	FY17E	FY18E	FY19E	FY20E	FY21E
PV of FCFF	(6,932)	3,937	9,686	8,796	7,497
WACC	14.0%	13.5%	13.8%	14.0%	14.2%
Sum of FCFF	22,985				
Terminal Value	149,893				
PV of Terminal Value	88,203				
Ent Value	111,188				
Debt	11,413				
Equity Value from Core Operations	99,774				
Equity Value of Portfolio @ 35% discount	21,008				
Total Equity Value	120,782				
Price Target 6/30/2017	275.68				
Current Price	187				
Upside	47%				

We have valued the investment holdings of DGKC at market value/fair value with portfolio discount of 35% on listed companies. The equity value derived from its portfolio investment is estimated to be PKR 48/sh.

Portfolio	Market Value/Fair Value	MV after Discount	% of Investment
NCL	281	183	1%
AICl	852	554	3%
Nishat paper	256	256	1%
Nishat diary	2,700	2,700	13%
NML	3,952	2,569	12%
MCB	21,797	14,168	67%
Nishat hotels & property	500	500	2%
Others	120	78	0%
	30,459	21,008	100%
Portfolio Value after discount	21,008		
No of shares	438		
Portfolio Value/sh	48		

Fig: 5 **Diverse Plant Locations**

Source: Google Maps

Investment Argument

Our investment argument on DGKC is based on upbeat domestic demand, lower coal & oil prices, cost rationalization initiatives and bottomed out interest rates. We believe DGKC is well positioned to benefit from the improving sector fundamentals.

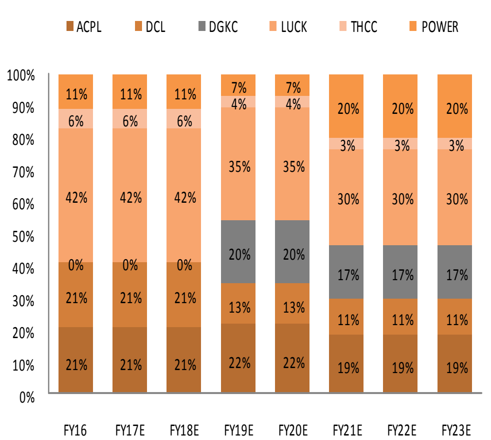
Diverse Plant Location - Setting footprints across both regions

DGKC has two cement plants (2 units in DGK and 1 unit in KHP) located in upper and lower Punjab with total capacity of ~14000tpd. Realizing the importance of making its presence across both regions and gaining competitive advantage , DGKC has initiated a greenfield expansion in Hub, Balochistan which is expected to commence operations from 4QFY18.

In view of other expansions announced resulting in compromising DGKC's market share in north, and its current capacity not sufficient to cater local demand, management of DGKC has announced another brownfield expansion of 2.2mn tons/yr at Dera Ghazi khan site to sustain its dominance in north region.

South Expansion - Gaining competitive advantage

Fig: 6 **South - Capacity based Market Share**



Source: Company Accounts, Nael Research

The company is in process of installing a cement plant in Hub, Balochistan with capital expenditure of USD 300mn. The greenfield expansion in south is aimed to expand its footprints across the southern region. The initial objective of this expansion is to cater the domestic demand but its expansion in south will open up new export avenues due to lower cost of transportation. The operations are likely to commence from 4QFY18.

The announced expansion will result in capturing 20% of market share in south. ACPL will be immunized from expansion by other players because its own expansion is sufficient to sustain its market share. However, LUCK's share is likely to be hurt because of entrance of DGKC.

Note, it is pertinent to mention here that unavailability of captive power plant or Waste heat recovery in Hub will keep the gross margins under pressure. However, lower cost of inland coal transportation and tax benefit availed for installation of new plant in Balochistan will compensate for its high cost of operations and positively impact bottomline.

- **Tax benefit from Greenfield expansion in Balochistan**

As per the budget of FY16, in order to encourage setting up new manufacturing units in the provinces of KPK and Balochistan, a five-year income tax holiday has been allowed to a taxpayer deriving profit and gains derived from new manufacturing units set up in the province between 1st July, 2015 to 30th June, 2018.

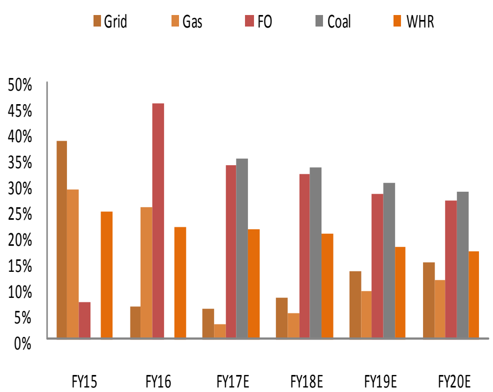
To avail the credit, commercial operations in Hub needs to start before FY19. As per our discussion with the management, company is well versed with the scenario and intends to complete installation process by 4QFY18.

Fig: 7

Inhouse Power Generation	
Dera Ghazi Khan	
WHR	10.4MW
Gas based	25.5MW
Oil based	23.8MW
Coal based	30MW
KHP	
WHR	8.6MW
Dual Fired (FO + Gas)	33MW

Source: Company Accounts, Nael Research

Fig: 8 **Diversified Energy Mix**



Source: Company Accounts, Nael Research

Margins to remain upbeat

A key trigger in near term for DGKC to boost its earning potential is its coal based captive power plant of 30MW commissioned in Dera Ghazi Khan site. The plant has started its operations in Jul'16. We anticipate partial utilization of plant during the first quarter of FY17 which is expected to increase gradually. Major impact is anticipated to be observed from 2QFY17.

- **Dera Ghazi Khan- Installation of Coal based CPP (30MW)**

Highlighting muted international coal prices, coal provides cheapest source of power generation. While we remain positive on installation of 30MW of coal based CPP, but we would like to highlight that there is limited upside potential in mid term until new brownfield expansion comes online.

The energy requirement at DGK (assuming 100% utilization) is fulfilled by gas based CPP and WHR while remaining is met through FO based inhouse generation (refer Fig 7). Commencement of this power plant will result in excess power generation capability than estimated energy requirement. Hence, once new cement plant commissions at this site (Exp FY19E), it will provide economies of scale and bode well for the company. However, we opine that this power plant will reap benefit once north expansion comes online.

- **Khairpur**

The gas curtailment in khairpur unit is a point of concern to the operational performance of company. However, dual fired CPP (FO & Gas 33MW) provides maneuverability for opting FO in present scenario where oil prices have plummeted heavily. As witnessed, the margins at khairpur site have high sensitivity to upsurge in oil prices.

Based on our assumptions with depressed oil prices, minimal reliance on grid is expected moving forward.

- **Hub**

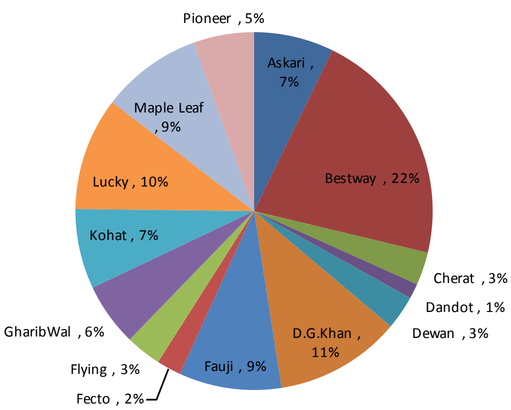
The greenfield expansion at Hub has no reliance on captive power plants or Waste Heat Recovery. Although management has intentions of installing a WHR plant six months after commencement of commercial operations but that is not incorporated in our model.

High reliance on national grid for production at Hub will hurt margins but bottomline is unlikely to hurt because of various reasons mentioned under south expansion (refer page 5).

North Expansion - Sustaining its Market Share

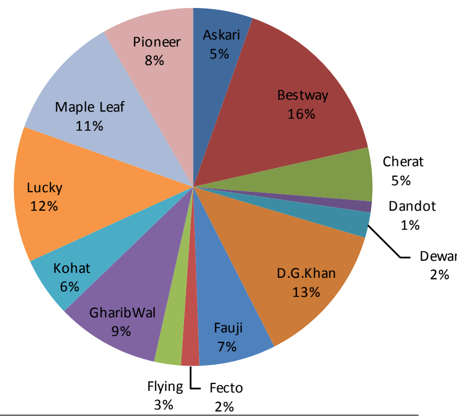
DGKC currently operates at capacity utilization of 105% (FY16) with strong uphold in north region. The capacity based market share of DGKC in north is ~11% (FY16). In order to maintain its dominance and cater soaring local demand with no idle capacity, DGKC has planned another brownfield expansion of ~7000tpd. As per recent expansion announcements, such initiative will make DGKC second largest cement manufacturer unless other major players jump in this expansion bandwagon.

North Capacity based Market Share - Pre Expansion



Source: APCMA, Nael Research

North Capacity based Market Share - Post Expansion



Source: APCMA, Nael Research

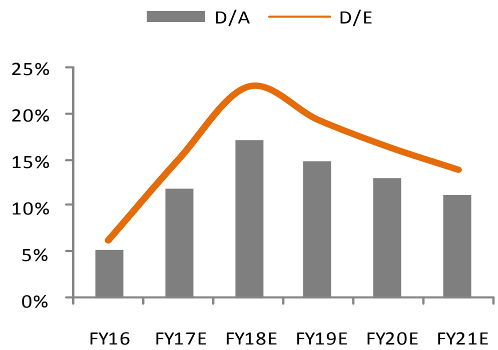
The announced expansion in DG khan site serves well for company because of its diversified in-house CPP that will keep the margins intact. The availability of gas, subdued oil prices, and cheap power generation from coal will require minimal reliance on grid at DGK.

As per the management, planning of this expansion is yet to be finalized by Dec'16. We believe this expansion to potentially accrue PKR 13.43bn value to DGKC. This implies a value addition of PKR 31/sh to our price target. Although management intends to commence its operations by the start of FY19 but our working incorporate its impact after 1HFY19.

Our valuation thesis doesn't incorporate this expansion in price target.

North Expansion	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E
EBITDA	-	-	2,328	3,673	3,640	4,422	4,643	4,875
Capex	(2,000)	(12,000)	(6,000)	-	-	-	-	-
Int(1-T)	-	-	352	730	607	484	361	238
Net Debt	2,000	8,500	3,000	(2,100)	(2,100)	(2,100)	(2,100)	(2,100)
FCFE	-	(3,500)	(320)	2,304	2,147	2,806	2,904	3,013
Ke	15%	15%	15%	15%	15%	15%	15%	15%
PV of FCFE	-	(3,036)	(241)	1,504	1,216	1,378	1,237	1,113
Sum of PV	3,171							
Terminal Value	27,777							
PV of Terminal Value	10,266							
Total Value	13,437							
No of shares	438							
Value/sh	31							

Fig: 9 **Financial leverage**



Source: Company Accounts, Nael Research

Portfolio Investments - Steady dividend income

Portfolio investment constitutes significant portion in earnings of DGKC. As of FY16, other income forms ~18% of the net earnings generated by company where major portion is contributed by its dividend income from MCB.

Most of the investment of DGKC is spread across companies within Mansha group. But the major investment stake (~67%) is in MCB; major source of its dividend income. Remaining investment is distributed within textile, food and insurance sector which includes NML, NCL, AICL, Nishat paper and Nishat Diary.

Portfolio	% of Investment Portfolio
NCL	1%
AICL	3%
Nishat paper	1%
Nishat diary	13%
NML	12%
MCB	67%
Nishat hotels and property ltd	2%
Other	0%
Total	**100%**

Fig: 10 **PT Sensitivity**

		Risk free rate				
		6.72%	7.22%	7.72%	8.22%	8.72%
Growth rate	3.00%	279	267	256	246	236
	3.50%	291	277	265	254	244
	4.00%	303	289	276	264	252
	4.50%	317	302	287	274	262
	5.00%	333	316	300	285	272

Source: Nael Research

Loan book to surge significantly

With heavy investments underway in Hub, Balochistan with capex of ~PKR 30bn and anticipated brownfield expansion of ~PKR 22bn (assuming USD 100/ton), we expect loan book to increase significantly.

Our model incorporates debt of 60% (PKR 18bn) for greenfield expansion while we expect strong cash flows to reverse the debt structure. The brownfield expansion is not incorporated in our valuation thesis but our separate working estimates debt financing of 60% (PKR 13bn).

Key Risks

Breakdown of Price arrangement

The profitability of cement sector is highly dependent on price arrangement between local players. Based on historical analysis, significant surge in profitability is witnessed during price arrangement (e.g. FY10 vs. FY16).

Decline in local demand

Domestic demand has a very high correlation with Public sector development fund and GDP. Lower than budgeted disbursement of PSDP will result in decline of local sales. Similarly, if demand anticipated from CPEC is hampered then the industry is expected to witness a hit.

Surge in International Coal & Oil prices

The gas curtailment in KHP unit with Dual fired CPP (33MW) implies high sensitivity of gross margins with oil prices. Gross margins are likely to erode with increase in coal & oil prices. The current depressed commodity outlook supports the companies to boost its profitability where retention prices are retained by local players. The commodity super cycle poses a threat.

Base Case	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	22.67	22.02	26.66	27.12	26.28
US$ Coal/ton	51.9	52.9	53.8	54.8	55.8

Sensitivity (with +10% in Base Coal Prices)	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	22.12	21.38	25.81	26.17	25.26
US$ Coal/ton	57.09	58.19	59.18	60.28	61.38

Sensitivity (with +20% in Base Coal Prices)	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	21.57	20.74	24.97	25.21	24.24
US$ Coal/ton	62.28	63.48	64.56	65.76	66.96

Delay in Hub expansion

Any delay in Hub expansion from 4QFY18 would imply non availability of 5yr income tax holiday. This would hurt the bottomline.

Increase in Interest rates

Due to heavy investments underway, financial leverage of DGKC is anticipated to increase significantly. Any reversal in interest rates is likely to elevate finance cost resulting in a decline in bottomline.

Concentrated Portfolio Investment

While we appraise significant earnings generated from its group investment, key risk to the company is its concentrated portfolio investments. A major stake is invested in a particular banking sector stock. In event of a downturn in banking sector, other income is expected to plunge heavily.

Financials

Income Statement (PKR mn)	FY15	FY16	FY17E	FY18E	FY19E	FY20E	FY21E
Net Sales	26,105	29,704	32,126	34,624	40,770	43,393	44,171
Cost of sales	16,649	17,036	17,244	20,316	24,376	26,939	28,310
Gross Profit	9,455	12,668	14,881	14,308	16,395	16,454	15,860
Admin Expenses	472	573	465	524	603	633	643
Distribution Expenses	747	950	876	887	912	922	925
Operating Profit	8,236	11,146	13,540	12,897	14,880	14,898	14,292
Other operating expenses	728	914	1,080	1,034	1,106	1,124	1,102
Other operating income	2,320	2,379	2,103	2,074	2,075	2,271	2,457
EBIT	9,829	12,611	14,564	13,937	15,849	16,045	15,648
EBITDA	11,709	14,442	16,724	16,730	18,861	19,079	18,704
Financial Charges	282	130	167	155	1,104	1,060	956
Profit before taxation	9,547	12,481	14,397	13,782	14,745	14,986	14,691
Taxation	1,922	3,691	4,463	4,135	3,064	3,103	3,178
Profit after Tax	7,625	8,790	9,934	9,647	11,681	11,882	11,514
EPS	17.40	20.06	22.67	22.02	26.66	27.12	26.28

Source: Company Accounts, Nael Research

Balance Sheet (PKR mn)	FY15	FY16	FY17E	FY18E	FY19E	FY20E	FY21E
Current Asset	31,426	33,230	32,651	43,745	54,240	64,104	73,397
Non Current Asset	42,965	48,181	63,471	66,775	64,192	61,603	59,007
Total Assets	74,391	81,412	96,123	110,520	118,432	125,707	132,404
Current Liabilities	6,583	6,308	5,965	7,541	8,239	8,537	8,626
Long Term Financing	714	1,411	9,160	15,400	14,000	12,600	11,200
Other non current Liabilities	4,798	4,798	4,798	4,798	4,798	4,798	4,798
Long term Liabilities	5,512	6,209	13,958	20,198	18,798	17,398	15,998
Total Liabilities	12,095	12,516	19,922	27,739	27,037	25,935	24,623
Reserves	37,388	37,388	37,388	37,388	37,388	37,388	37,388
Share Capital	4,381	4,381	4,381	4,381	4,381	4,381	4,381
Accumulated Profit	20,527	27,126	34,431	41,012	49,626	58,003	66,012
Total Equity	62,296	68,895	76,200	82,781	91,395	99,772	107,781

Source: Company Accounts, Nael Research

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