FAUJI CEMENT COMPANY LIMITED (FCCL)

Nov 10, 2015

BUY

Price Target : PKR 43.02/share

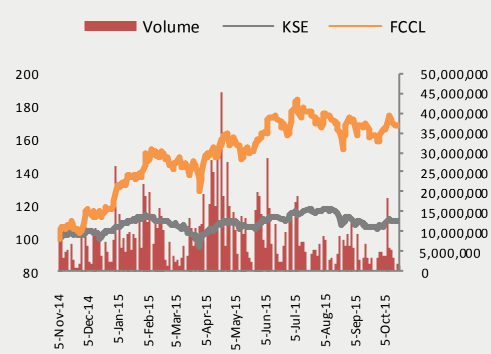
Closing Price : PKR 35.63/share

COMPANY DATA

52-week Price Range (PKR)	38.61-21.78
No. of Shares Outstanding (mn)	1331.12
Market Cap (PKRmn)	47427.66
Market Cap (USDmn)	449.68
Free Float (mn shares)	732.11
Year End	Jun
KATS Code	FCCL

Source: KSE

CHART: STOCK PERFORMANCE



Source: KSE

- **We initiate our coverage on FCCL with 'Buy' rating:** Our Jun-16 DCF based price target of PKR 43.02/sh implies 21% upside from current price levels of PKR 35.63/sh.
- **Improvement in margins:** The gross margin of FCCL is expected to surge by massive 655bps to ~44% for FY16 as against ~38% observed in FY15. This is mainly attributable to

  1) operation of 10MW WHR power plant

  2) decline in international oil & coal prices
- **Volumetric growth:** The recent CPEC projects and FCCL's strategic location in north along with proximity to cement driving project allows local volumetric growth in near future.
- **Financial Deleverage:** The reduction in finance cost owing to 1) monetary easing 2) swift repayments of long term loans.
- **Investment Risk:** Key risks to our investments thesis are 1) Price war 2) upsurge in international coal & oil prices 3) decline in local demand 4) Reversal of interest rate.

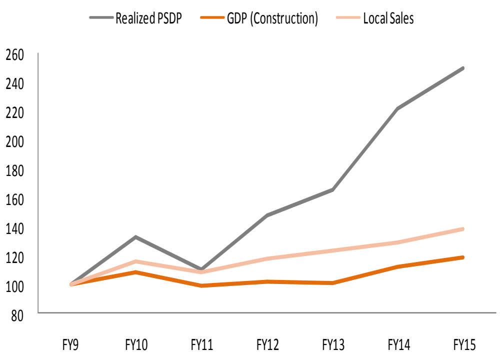
FCCL FINANCIAL HIGHLIGHTS

	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
EPS	1.80	2.91	3.50	3.78	4.02	4.08	3.96
DPS	1.50	2.50	3.00	3.00	3.50	3.50	3.50
BVPS	11.86	13.09	14.27	15.24	16.43	17.20	17.84
PE (x)	11.10	11.32	10.17	9.41	8.87	8.73	9.00
Div Payout (%)	76	81	81	76	83	82	85
EBITDA Margin (%)	41	43	50	48	46	45	42
ROA (%)	9	13	16	18	18	18	17
ROE (%)	17	24	26	26	26	25	23
Gross Margin (%)	35	38	44	43	41	40	37
Net Profit Margin (%)	15	22	25	25	25	24	23

Source: Company Accounts, NAEL Research

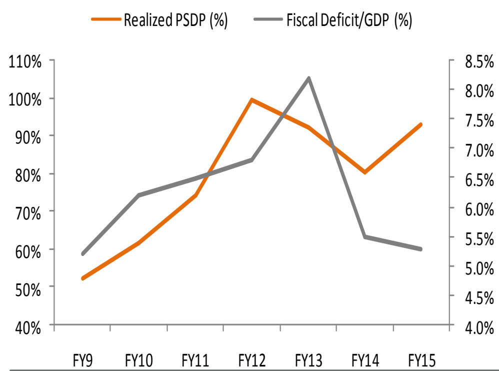
Jawad Ameer Ali AC
jawad@naelcapital.com
(+92-21) 32461812-13

Fig: 1 **Relative Performance**



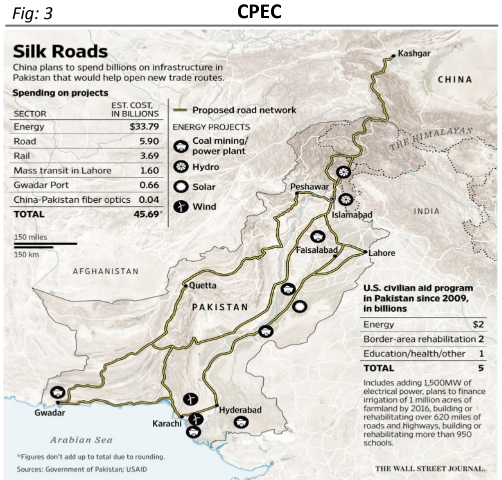
Source: PBS, SBP

Fig: 2 **Fiscal Deficit vs Realized PSDP**



Source: Economic Survey, Fiscal Operations

Fig: 3 **CPEC**



Source: Wall Street journal

Cement industry to cash on upcoming infrastructural projects

Domestic demand to remain upbeat

Keeping in view about the current government manifesto and its primary focus on deriving growth from infrastructural development, we remain affirm over hike in cement demand for the next 3 years.

Historical analysis depicts PSDP spending to be the major demand driver of local cement in Pakistan. We have observed a strong positive correlation (96%) of local cement sales with utilized PSDP and GDP construction. Our regression analysis implies 89% of variation in local sales which is explained by these two variables.

The increase in budgeted PSDP allocation by 33% for FY16 is likely to translate in robust cement growth. With respect to growth of domestic volumes at 4 year CAGR of 6.37% (7.7%YoY in FY15), we anticipate an annual increment of 8% in local sales during FY16-FY18, albeit boost in infrastructural opportunities expected from CPEC.

China Pakistan Economic Corridor (CPEC) - Infrastructure Opportunities

The initiation of CPEC projects which is supported by trio of ruling government, military force and external agents, keep us positive about deliverance of these projects. Under the CPEC, China and Pakistan plans to build infrastructure to connect Gwadar Port in Pakistan with Kashgar in Xinjiang (China) supported by ancillary projects. The plan also envisage adding 10,400MW of electricity (including hydropower projects). The cement demand from these infrastructural projects will bode well for the sector even with dismal exports. If these projects are delivered on time, plugging the electricity deficit, existing government would be able to go into election year saying they have lived up to their pledge.

Housing Backlog

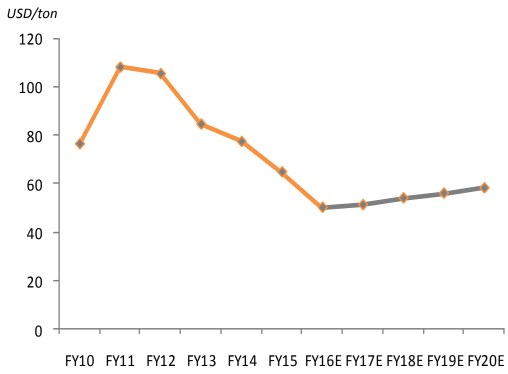
As per the estimates of World Bank in 2009, the housing backlog in Pakistan was estimated at 7.57mn units in 2009 of which 2.5mn of them are in urban areas. As per the unofficial estimates, housing backlog currently stands at 9mn units. As against the current incremental demand for housing estimated at 570k units annually, only about 300k units are being built annually, mostly in urban areas.

Upcoming private housing schemes notably Bahria town, DHA Oasis, LDA city has positively impacted private sector cement demand growth. Even though, there is a huge demand in housing sector we don't think that these projects are sufficient enough to cater the existing backlog until special attention is paid by government to fill in the gap.

Dismal exports outlook to continue in the near term

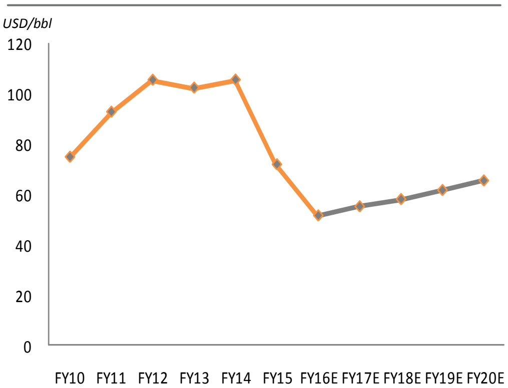
The export volume plunged by 11%YoY in FY15 leading to decline in 4 year CAGR of 6.4%. In the light of depressing export volumes owing to depleting share in Afghanistan market (major export avenue) and anti dumping duty in South Africa, sustenance of existing share pose a challenge. Until new export avenues are explored, we remain concerned for further deterioration of export volumes in near term. Furthermore, Iranian cement export in the region and removal of sanctions will pose added threat for Pakistan's cement export .

Fig: 4 **Coal Prices**



Source: World Bank, Nael Research

Fig: 5 **Oil Prices**



Source: World Bank, Nael Research

Slump in international oil and coal prices

Weak coal prices to bode well for cement sector

We expect coal prices to remain subdued in future owing to clean energy projects to cap coal usage, changes in fuel mix structure , and downturn in economic cycle of China (largest coal consumer).

These dwindling prospects reflect several main factors:

1) increasing weight of other environmental regulations (New standards limiting mercury emission & toxic pollutant

2) increasing energy efficiency

3) surging installation of renewable energy plants especially wind and solar

As coal is the major cost component for cements, weak international prices will bode well for cement manufacturers. We expect average coal prices for FY16E to be around USD 50/ton (WB estimates), compared to FY15's average price of USD 67/ton , 25% down.

Oil market to face uncertainties

We anticipate oil market to face uncertainties heading FY16-FY17, including the pace and volume at which Iranian oil reenters the market, the strength of oil consumption growth, and the responsiveness of non-OPEC production to low oil prices.

We foresee positive impact of low international oil prices on

1. cement manufacturers who have oil based CPPs

2. Inland transportation cost

We have taken oil prices at USD 51.4/bbl for FY16E based on the estimates of World Bank commodity outlook. These estimates reflect a gradual increase in oil prices in years ahead.

Industry Analysis

Threat of New Entrant

1. Highly capital intensive
2. Gestation period of 2-3 yrs
3. Location - Proximity to raw material sources and proximity to markets

Impact: LOW

Bargaining power of Supplier

1. Cartel
2. Price Setter
3. Price elasticity to input cost is high

Impact: HIGH

Rivalry among Existing Competitors

1. Oligopolistic market structure
2. Industry is dominated by few major players
3. Large companies enjoy economies of scale
4. Four-firm and eight-Firm concentration ratio comes out to be 50% and 75% respectively

Impact: MODERATE - LOW

Bargaining power of Buyer

1. Consumer market is highly fragmented
2. Lack of substitutes
3. Price taker

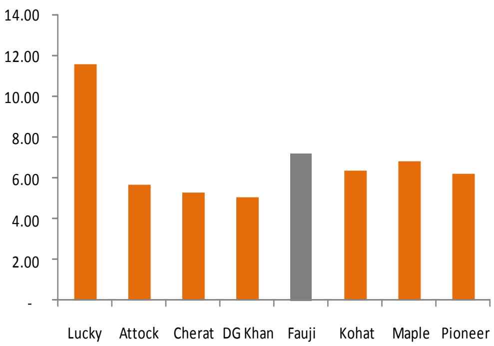
Impact: LOW

Threat of Substitute

1. Use of asphalt in road construction

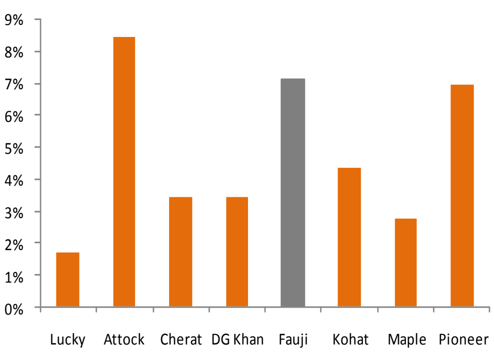
Impact: MODERATE - LOW

Fig: 6 **Peer Comparison - EV/EBITDA**



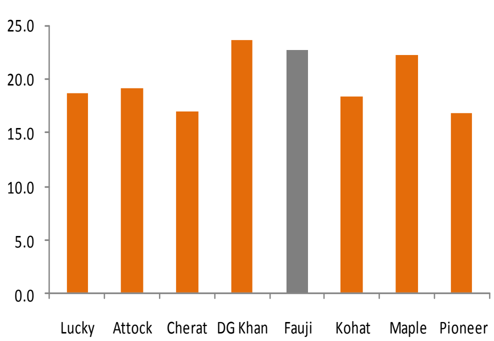
Source: Company Accounts (FY15), Nael Research

Fig: 7 **Peer Comparison - Dividend Yield**



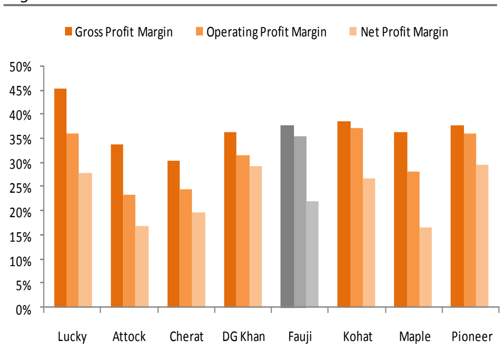
Source: Company Accounts (FY15), Nael Research

Fig: 8 **Peer Comparison - EBITDA/Ton**



Source: Company Accounts (FY15), Nael Research

Fig: 9 **Peer Comparison - GM,OM & NM**



Source: Company Accounts (FY15), Nael Research

Valuation

We initiate our coverage on FCCL with '**Buy**' recommendation using discounted free cash flow method. We have used discounted cash flow (Free Cash Flow) method to derive the intrinsic value of FCCL at PKR 43.02/sh. We have made the following assumptions to arrive at the our target price

- Terminal growth rate of 4%
- Risk free rate of 9.75%, Beta of 1.2 & Market Risk Premium of 6%

Based on above assumptions, FCCL's Jun-16 PT comes out to be PKR 43.02/share, offering an upside potential of 21% from its closing price of Nov 9, 2015 with a dividend yield of 8% for FY16E.

	FY16E	FY17E	FY18E	FY19E	FY20E
PV of FCFF	7,795	5676	5011	4310	3591
WACC	15%	16%	16%	17%	17%
PV of FCFF	26,383				
Terminal Value	64,899				
PV of Terminal Value	34,951				
Ent Value	61,334				
PV of Debt	4,064				
Equity Value	57,270				
Target Price 6/30/2016	43.0				
Current Price	35.6				
Upside	21%				

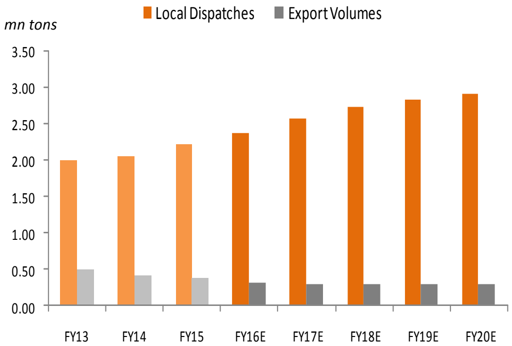
Peer Comparison

The company has dividend yield (refer fig 7) of 7% for FY15. This yield tends to be one of the highest amongst its peers followed by ACPL.

The gross margins (refer fig 9) of the company has improved to 38% in FY15 as against 35% in FY14 and are likely to improve further in line with big players whose margins hover around 40%. This is likely the result of using WHR plant and CPP.

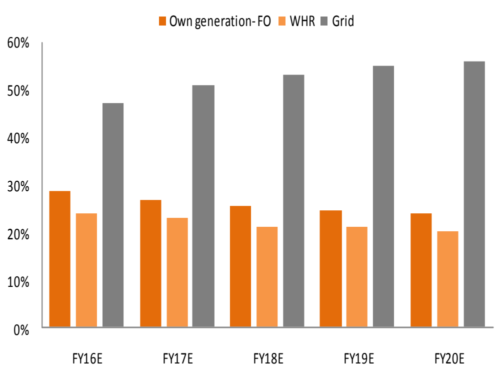
When compared to its peers in the cement industry, we can see its operational performance based on EV/EBITDA (refer fig 6) and EBITDA/ton (refer fig 8) to be either at par or near its peer competitors.

Fig: 10 **FCCL Cement Dispatches**



Source: APCMA, Nael Research

Fig: 11 **Electricity Generation**



Source: Company Accounts, Nael Research

Investment Argument

Our investment view on FCCL is based on strong earnings growth for FY16E-FY18E based on following fundamentals:

Volumetric Growth

FCCL currently operates at capacity utilization of 76% (FY15). This implies a room for uptick in capacity utilization owing to

- increase in demand of local cement
- the recent CPEC projects and FCCL's strategic location in north and
- proximity to cement driving project allows local volumetric growth in near future.

Based on 7.8% market share of Fauji cement as of FY15 in local sales, we expect the capacity utilization to reach 89% by FY18.

Improvement in gross margins

The gross margin of FCCL is expected to surge by 655bps to ~44% for FY16E as against ~38% observed in FY15. This remarkable elevation in margins are supported by factors mentioned below:

1. **10MW WHR plant**

Installed in last quarter of FY15, WHR plant has started reducing power cost for FCCL and will enhance its profitability. We expect this power plant to constitute around ~24% of total power for FY16E. This will translate in to an annual saving of PKR 0.40/sh in EPS for FY16E, implying an annual cost savings of 7.65% for the given period.

2. **Plunge in international oil and coal prices**

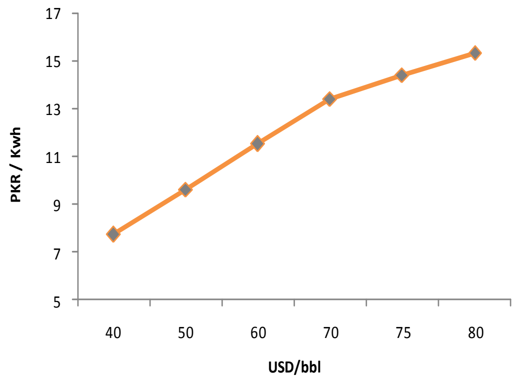
Downfall in international commodity prices have served a benefit for FCCL to elevate its gross margins remarkably. The acute shortage of gas availability in northern areas along with higher FO prices in past has kept CPP underutilized.

However, due to decline in international oil prices, we anticipate a change in energy generation component for FCCL. Consumption of FO is expected to increase supported by WHR plant which is expected to reduce reliance on grid.

- **Change in energy components for electricity generation**

FCCL has two Captive Power Plants (CPP) with a gross potential generation capacity of 22.3MW. A 6MW CPP installed in 2007, operates purely on gas with thermal efficiency of 38.3%.

Fig: 12 **Feasibility of oil in CPP**



Source: Company Accounts, Nael Research

The second power plant installed in 2009, is dual fired (Gas & FO) 16.3MW CPP obtained from Wartsilla, Finland with max. thermal efficiency of 47.3% for gas and 44% for liquid fuel. This implies a heat rate of 201gms/kwh for FO. Being conservative, we have also incorporated auxiliary energy consumption of 10% in our model.

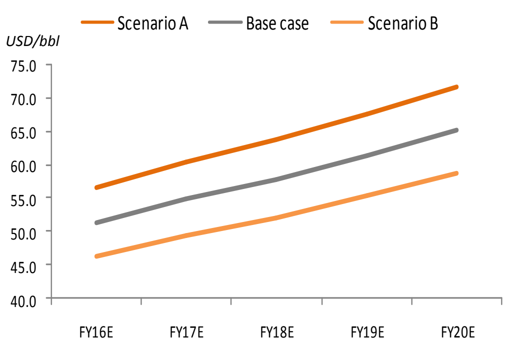
The benefits of installation of dual fired CPP 16.3MW is expected to reap now when oil prices have plunged near USD 45/bbl. Moving forward, we have based our assumption on the use of FO in dual fired 16.3MW CPP.

Oil and coal price sensitivity to gross margins

Given the depressed outlook of oil and coal prices in international market we have taken conservative approach with gradual uptick in prices from FY16-FY20. Our base scenario is based on world commodity price outlook of World Bank Oct 2015 review. In order to understand the sensitivity of these variables on EPS, GM and TP, we have presented two scenarios.

Scenario 'A' presents 10% inflated commodity prices with respect to our base case while Scenario 'B' unveils impact of 10% deflated commodity prices. We have assumed constant cement prices under these scenario's.

Fig: 13 **Oil Prices Projection**

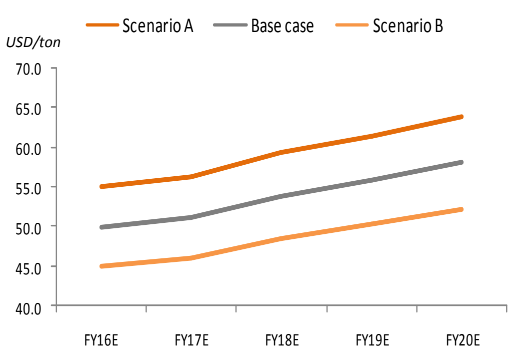


Source: World Bank, Nael Research

Scenario A					
	FY16E	**FY17E**	**FY18E**	**FY19E**	**FY20E**
Oil price	56.5	60.5	63.7	67.7	71.8
Coal Prices	55.0	56.2	59.3	61.5	63.9
EPS	3.40	3.61	3.81	3.85	3.71
GM	43%	41%	40%	38%	35%
TP (Jun'16)	PKR 41.08/sh				

Base Case					
	FY16E	**FY17E**	**FY18E**	**FY19E**	**FY20E**
Oil price	51.4	55	57.9	61.5	65.3
Coal Prices	50	51.1	53.9	55.9	58.1
EPS	3.5	3.78	4.02	4.08	3.96
GM	44%	43%	41%	40%	37%
TP (Jun'16)	PKR 43.02/sh				

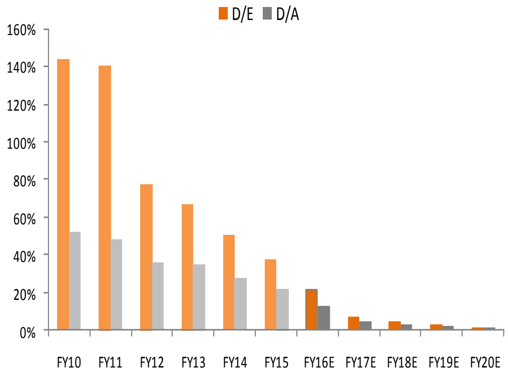
Fig: 14 **Coal Price Projection**



Source: World Bank, Nael Research

Scenario B					
	FY16E	**FY17E**	**FY18E**	**FY19E**	**FY20E**
Oil price	46.3	49.5	52.1	55.4	58.8
Coal Prices	45.0	46.0	48.5	50.3	52.3
EPS	3.62	3.96	4.22	4.31	4.21
GM	46%	45%	43%	42%	39%
TP (Jun'16)	PKR 44.96/sh				

Fig: 15 **FCCL Debt Ratio**



Source: Company Accounts, Nael Research

Financial Deleverage

FCCL has been a highly leveraged company in past due to hefty loan borrowing for its expansion in 2011. However, the swift repayment of loan has decreased its D/E to 37% in FY15 from 144% in FY10. This has enabled FCCL to decline its finance cost over the years. A major plunge in finance cost in FY15 is also attributable to monetary easing by SBP resulting in cheaper loans.

Since FCCL has recently borrowed PKR 1bn from MCB therefore we don't expect the company to retire all its debt before FY21. However, lower interest rate environment and lower financing volumes are expected to support company's profitability.

PT Sensitivity

Figure: A

		Risk free rate				
		8.75%	9.25%	9.75%	10.25%	10.75%
Growth rate	3.00%	43	42	41	39	38
	3.50%	45	43	42	40	39
	4.00%	46	45	43	42	40
	4.50%	48	46	44	43	41
	5.00%	50	48	46	44	43

Source: Nael Research

Key Risks

Price War

The current expansions of DGKC (2.5mn ton), ACPL (1.1mn tons), and CHCC (1.3mn tons) supported by potential expansions of LUCK and Chinese investment (estimated 5mn tons) are likely to pose a threat of price war if the local demand didn't surge as expected.

Decline in 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. The only driver of cement volumes under current scenario is supported by local demand. If the local demand derived from CPEC is hampered then industry is expected to witness a hit.

Surge in International Coal & Oil prices

The gross margins are likely to erode with increase in coal & oil prices. The current macro 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.

Reversal of Interest rate

Increase in interest rate will hurt companies with high financial leverage. The finance cost will elevate resulting in decline in profitability.

Financials

Income Statement (PKR mn)	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
Net Sales	17,532	18,642	19,284	20,877	22,385	23,368	24,135
Cost of sales	11,448	11,615	10,752	11,935	13,123	14,122	15,172
Gross Profit	6,084	7,027	8,532	8,942	9,262	9,246	8,963
Admin Expenses	226	272	313	333	357	373	386
Distribution Expenses	125	141	163	171	182	191	198
Operating Profit	5,733	6,614	8,057	8,438	8,723	8,683	8,380
Other operating expenses	334	420	512	551	584	593	576
Other operating income	152	191	290	270	358	462	485
EBIT	5,885	6,806	8,346	8,708	9,081	9,145	8,865
EBITDA	7,154	8,052	9,612	9,986	10,373	10,449	10,184
Financial Charges	1,042	706	513	278	160	84	62
Profit before taxation	4,510	5,680	7,321	7,878	8,338	8,468	8,227
Taxation	1,884	1,564	2,416	2,600	2,751	2,794	2,715
Profit after Tax	2,626	4,116	4,905	5,279	5,586	5,673	5,512
EPS	1.80	2.91	3.50	3.78	4.02	4.08	3.96

Source: Company Accounts, Nael Research

Balance Sheet (PKR mn)	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
Current Asset	5,188	6,414	8,002	7,927	10,316	12,062	13,890
Non Current Asset	24,193	24,115	22,021	21,090	20,157	19,222	18,287
Total Assets	29,381	30,528	30,022	29,017	30,472	31,284	32,177
Current portion Of LTF	2,551	2,525	2,622	443	443	212	212
Other Current Liability	1,768	2,061	2,663	2,942	3,247	3,486	3,738
Long term Financing	5,363	4,000	1,362	972	530	318	106
Other non current Liability	3,911	4,523	4,379	4,379	4,379	4,379	4,379
Total Liability	13,593	13,109	11,026	8,735	8,598	8,395	8,435
Paid up Capital	13,798	13,798	13,798	13,798	13,798	13,798	13,798
Retained Earning	1,990	3,621	5,198	6,483	8,076	9,091	9,944
Equity	15,788	17,419	18,996	20,282	21,874	22,889	23,742

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

Disclosure Related to Author
The analyst mentioned on the cover of this report, primarily involved in the preparation of this report, certifies that (1) the views expressed in this report accurately reflect his/her personal views about all of the subject companies/securities and (2) no part of his/her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Disclaimer
The report has been prepared by Nael Capital (Pvt.) Ltd and is for information purpose only. The information and opinions contained herein have been compiled or arrived at, based upon information obtained from sources, believed to be reliable and in good faith. Such information has not been independently verified and no guaranty, representation or warranty, expressed or implied is made as to its accuracy, completeness or correctness. All such information and opinions are subject to change without notice. Descriptions of any company or companies or their securities mentioned herein are not intended to be complete and this document is not, and should not be consulted as, an offer, or solicitation of an offer, to buy or sell any securities or other financial instruments.

Research Dissemination Policy
Nael Capital (Pvt.) Ltd. endeavors to make all reasonable efforts to disseminate research to all eligible clients in a timely manner through either physical or electronic distribution such as mail, fax and/or email. Nevertheless, not all clients may receive the material at the same time.

Company Specific Disclosures
Nael Capital (Pvt.) Ltd. as per the applicable law or regulation, prohibits its respective directors, officers, representatives, employees and/or related persons to make a purchase and/or sale, or offer to make a purchase and/or sale of any such securities or other financial instruments during the restricted period specified in the company policy.

Other Important Disclosures
Foreign currency denominated securities is subject to exchange rate fluctuations which could have an adverse effect on their value or price, or the income derived from them. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies effectively assume currency risk.

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