

## PIONEER CEMENT LIMITED (PIOC)

Sept 9, 2016

### BUY

Price Target : PKR 132/share

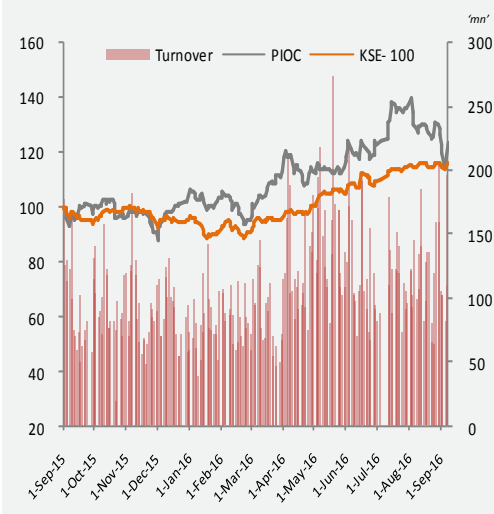
Closing Price : PKR 108/share

#### COMPANY DATA

52-week Price Range (PKR)	77.03 - 122.36
No. of Shares Outstanding (mn)	227.15
Market Cap (PKR mn)	24534.34
Market Cap (USD mn)	235.19
Free Float (%)	55
Year End	Jun
KATS Code	PIOC

Source: PSX

#### RELATIVE TO KSE-100



Source: PSX

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- **We initiate our coverage on PIOC with 'Buy' rating:** Our Jun-17 DCF based price target of PKR 132/sh implies 22% upside from the current price of PKR 108/sh.
- **Idle capacity– Well positioned to capture soaring local demand:** Robust local demand presents a sweet spot for PIOC to capitalize its idle capacity to serve domestic offtake. The company is in process of debottlenecking and upgrading its plant to increase efficiency and stand competitive to its peer.
- **All Set to pull margins via WHRP—12MW:** PIOC has been a laggard in curtailing its operational cost through WHR power plant unlike it's peers. The plant is likely to commence its operations by 3QFY17. Based on our estimates, WHRPP will reduce the reliance on national grid by 16% in FY17E and 30% in FY18E respectively.
- **Joining the expansion bandwagon:** The company has announced its intention of brown-field expansion of 2.1mn tons/yr. Since the details of the procurement of plant and financing structure of expansion is yet to be announced therefore our valuation doesn't incorporate its impact.
- **Debt Obligation at its historic low:** The Debt structure of PIOC has noticeably twirled since 2011. Few foreign loans were booked by company in FY06. However, swift repayment of these loans in FY12 led to major shift in capital structure where D/E plunged from 0.5 in FY12 to 0.03 in FY16.
- **Investment Risk:** Key risks to our investments thesis are 1) Price war 2) Decline in PSDP 3) Hindrance in CPEC's continuation 4) Volatility in coal prices.

#### PIOC Financial Highlights

	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	7.79	10.99	11.04	12.51	14.17	13.66	14.30	14.49
BV/sh	30	37	41	47	53	59	65	72
P/Ex	13.87	9.83	9.78	8.63	7.62	7.91	7.56	7.45
DPS	4.25	6.25	6.25	7.00	8.00	8.00	8.00	8.25
EBITDA/sh	12.99	17.03	17.98	19.88	22.03	21.24	22.17	22.47
EBITDA Margin (%)	37%	46%	43%	44%	45%	46%	46%	46%
ROA	15%	21%	20%	21%	21%	19%	18%	17%
ROE	34%	37%	32%	31%	31%	26%	25%	22%
Gross Margin (%)	32%	38%	41%	43%	44%	43%	42%	41%
Net Profit Margin (%)	22%	30%	26%	28%	29%	29%	30%	30%

Source: Company Accounts, Nael Research

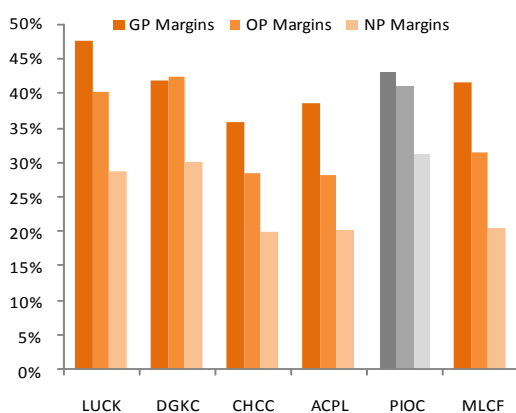
## Valuation

We initiate coverage on Pioneer Cement Ltd (PIOC), with 'BUY' rating and a TP of PKR 132/sh, implying 22% upside potential from its closing price of Sep 08, 2016. We have used discounted cash flow (Free Cash Flow to Equity) methodology to derive the intrinsic value of PIOC at PKR 132/sh. The stock offers a dividend yield of ~5.8%. Following assumptions have been used to arrive at our price target:

- Terminal growth rate of 4%
- Risk free rate of 7.72% (PIB 10yr)
- Adjusted Beta of 1.3 (using 5yr)
- Market Risk Premium of 6%

Valuation	June '17	FY18E	FY19E	FY20E	FY21E
PV of FCFE	898	3,036	2,638	2,476	2,085
Cost Of Equity	15.5%	15.5%	15.5%	15.5%	15.5%
PV of FCFE	11,132				
Terminal Value	33,513				
PV of Terminal Value	18,819				
Equity Value	29,951				
Target Price 12/31/2017	131.86				
Current Price	108.01				
Upside	22%				
# of shares (Mn)	227				

Fig: 1 Key Players Comparison - GM,OM & NM



Source: Company Accounts (9MFY16), Nael Research

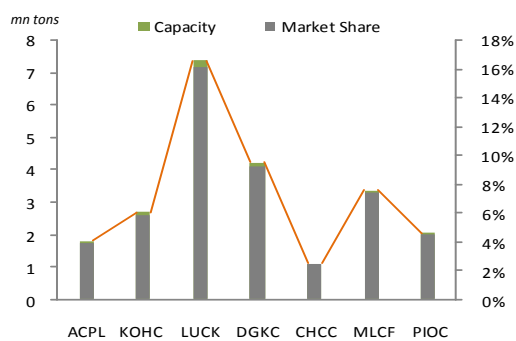
## Operational Performance

Pakistan's cement industry has been greatly influenced by various key demand factors that has brought the sector in the limelight. Owing to stagnant retention prices, cheap coal and oil prices, historically low discount rates, strong infrastructure development and better economic conditions, cement industry is reaping hefty margins. This has resulted in significant hike in gross margins of various players including PIOC.

PIOC enjoys gross margins of 41% (during FY16E) despite 100% reliance on national grid owing to sole dependence on domestic demand. In comparison to the industry average we have found PIOC as a tough competitor as the firm depicts to have growth prospects. PIOC is mainly relying on domestic sales and has a minute share in exports in the region of Afghanistan.

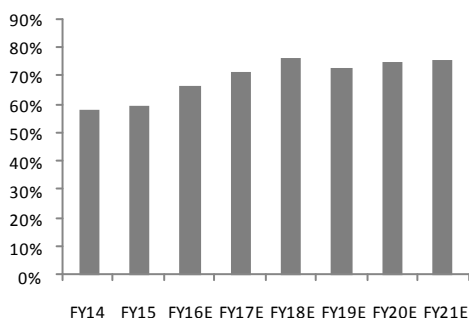
As per company officials, once the WHRPP gets operational, PIOC would be able to contribute in exports once again owing to reduction in cost of exports.

Fig: 2 **PIOC's Market share**



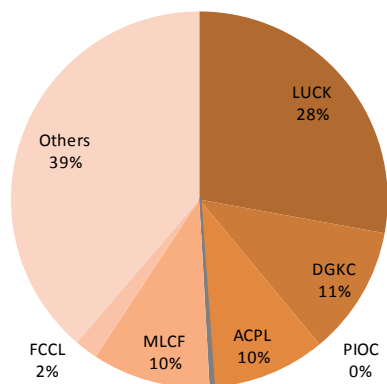
Source: APCMA, Nael Research (FY16)

Fig: 2.1 **Capacity Utilization of PIOC**



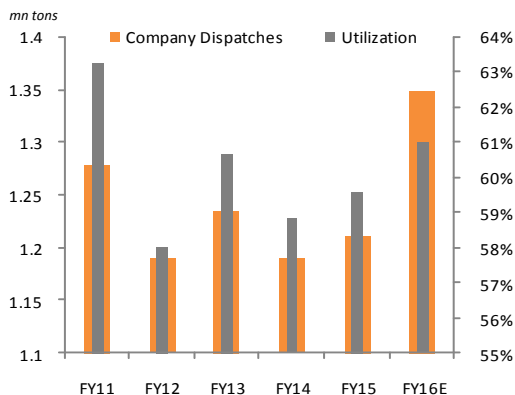
Source: Company's Account, Nael Research

Fig: 2.2 **Industry's Export Share (9MFY16)**



Source: Company accounts, Nael Research

Fig: 3 **PIOC's Volumetric Sales**



Source: Company accounts, Nael Research

## Investment Argument

Our investment view on PIOC is based on potential uptick in earnings estimate resulting from robust local demand, debottlenecking & up-gradation in plant equipments, production efficiencies from 12MW WHR power plant and other factors as mentioned hereinafter:

### Idle capacity– Well positioned to capture soaring local demand

With the lowest utilization level (63% in FY16) amongst its peers, robust local demand presents a sweet spot for PIOC to capitalize its idle capacity to serve domestic offtake. The company has been operating at utilization levels in range of 58% -65% during FY11-FY16E while average utilization level of industry stood at 85% during FY16E. This has raised various doubts amongst investors regarding efficiencies of cement mill. Based on our analysis and as per our discussion with the management of company, cement plants at PIOC dates back to 1994 which requires enhancement to optimize its overall capacity. Taking this issue in consideration, company is in process of debottlenecking and upgrading plant equipments i.e. installation of grate cooler at line II, enhancement of grinding mill, replacement of burner etc which is expected to pull utilization of PIOC to industry level.

### Hindered Exports—volumes remain negligible

Depressed demand from neighboring countries, high freight charges and low margin export avenues has hindered export volumes of PIOC like its competitors in industry. The primary focus of the company is to meet high margin local demand. The trend in export volumes of PIOC depicts a bearish outlook.

### All Set to pull margins via WHRP

We anticipate a noteworthy surge in the earnings of PIOC post 12 MW—Waste Heat Recovery Plant from PKR 11.04/sh in FY16E to PKR 14.17/sh in FY18E (an upsurge of ~28%).

### New WHR plant at line II (12MW)

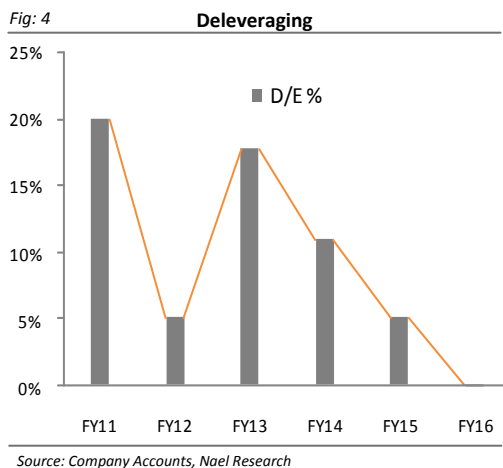
The key trigger for the company in near term is its commissioning of 12MW WHR power plant at line II with operational capacity of 4200tpd. The project is completely equity financed. It is expected to commence operations by 3QFY17. This will translate in annualized savings of PKR 0.98/sh and PKR 1.90/sh in FY17E and FY18E respectively.

With no Captive power plants and power interruptions issues, PIOC currently relies completely on the national grid. However, with the initiation of WHR power plant, reliance on grid is likely to reduce to ~84% in FY17 and ~70% in FY18.

### Joining the expansion bandwagon

The company has announced its intention of brownfield expansion of 7000tpd equivalent to 2.1mn tons/yr. Once the expansion materializes, inclusion of this new line would double the capacity of PIOC which currently stands at 2.03mn tons. Since the details of the procurement of plant and financing structure of expansion is yet to be announced therefore our valuation doesn't incorporate its impact.

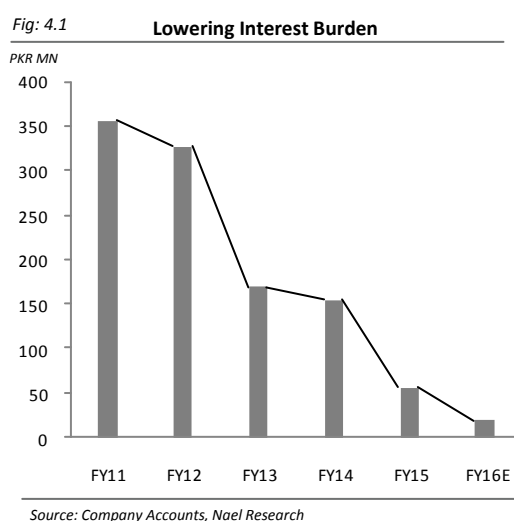
Expansion of such magnitude will cost approximately PKR 20bn. We anticipate significant borrowing as free cash flow of firm is not sufficient enough to bear this investment.



### Debt obligation at its historic low

The Debt structure of PIOC has noticeably twirled since FY11. Few foreign loans including loans from ADB were booked by company in FY06. However, swift repayment of these loans in FY12 led to major shift in capital structure where D/E has plunged to 5:95 from 52:48 in FY06. Financing of long Term Musharika of PKR 900mn from Meezan Bank Limited in FY13 against which the foreign loan of ADB was settled by 1HFY16. The tenure of this debt was 5 yrs but owing to its strong capital structure and reserves PIOC retired almost all of its Musharika by 3QFY16E. Hence, PIOC currently has no long term loans on its book.

Pioneer Cement is currently operating at its historically low D/E. We expect that if the company implements its expansion plan in due time by FY19E, the firm will need to finance a long term debt.



### Stock Performance—Trading at an attractive multiple

Due to various demand drivers i.e. 1) Materialization of CPEC, 2) Significant PSDP Allocation and 3) Economic Stability, cement sector has shown immense results. Various stocks that were trading under par a few years ago have now surpassed their own threshold levels and the industry has come under limelight. Pioneer Cement seems to be an attractive buy as it is trading at a multiple of 9.7x which is well below its industry average.

During FY'12, it is witnessed that the stock has shown a remarkable performance. Moving with a low pace until 4QFY14 where the stock propelled receiving a price boost in 1QFY15. Trading under the bands of 8x and 9x during that period PIOC once again propelled in 1QFY16 translating in the band of 11x.

However, we propose our view that currently at this lower P/E, PIOC has growth potential and strong trading fundamentals that could be clearly observed in Fig: 5 which explains the trend of Pioneer's historical P/E.

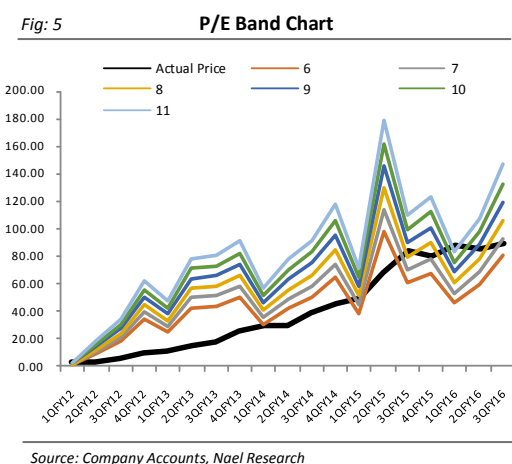
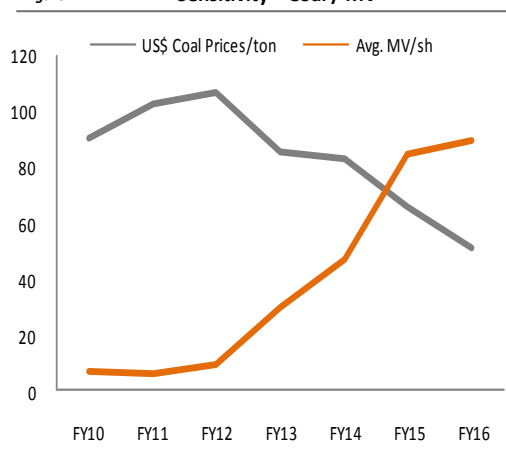


Figure: A PT Sensitivity

Growth %	Risk Free Rate				
	6.72%	7.22%	7.72%	8.22%	8.72%
3.00%	134.9	129.48	124.51	119.91	115.65
3.50%	139.18	133.36	128.03	123.12	118.58
4.00%	143.87	137.59	131.86	126.59	121.75
4.50%	149.04	142.23	136.03	130.37	125.18
5.00%	154.74	147.32	140.6	134.49	128.92

Source: Nael Research

Figure: B Sensitivity—Coal / MV



Source: Nael Research

## Key Risk Measures

### Price War

The expansion plans of major players in the industry i.e. LUCK, DGKC, ACPL, CHCC, MLCF and few others equivalent to ~22mn tons is likely to pose a threat of price war if the local demand didn't surge as expected.

### Decline in PSDP Allocation

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 utilization will pose a threat for the domestic manufacturers.

### Hindrance in CPEC's Continuation

The China Pakistan Economic Corridor (CPEC) is one of the key demand driver of the industry. Any proposed threat which would in anyway affect the continuation or materialization of CPEC will directly affect the cement off take. Although, we underweight this scenario keeping in view the positive outlook of economic and political conditions.

### Volatility in International coal prices

The gross margins are likely to erode owing to surge in coal prices. The company is highly sensitive to changes in coal prices which is its primary fuel.

Base Case	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	12.51	14.17	13.66	14.30	14.49
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	12.18	13.78	13.25	13.83	13.98
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	11.86	13.40	12.84	13.37	13.47
US\$ Coal/ton	62.28	63.48	64.56	65.76	66.96

Source: Company Accounts/World Bank, Nael Research

We have used the World Bank's projections of the coal prices as our assumptions. As 60%-65% of the COGS is constituted through fuel and power, a slight uptick or decline in the fuel prices would result in a significant impact on the earnings of company.

Therefore, we have performed a sensitivity analysis by inflating the projected coal prices by 10% and 20% respectively to analyze the change in bottom-line.

## Financials

Income Statement (PKR mn)	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E
Net Sales	8,025	8,426	9,532	10,324	11,038	10,602	10,993	11,108
Cost Of Sales	5,436	5,260	5,662	5,847	6,150	6,054	6,382	6,591
Gross Profit	2,589	3,166	3,869	4,477	4,888	4,547	4,611	4,517
Distribution Expenses	53	57	57	69	74	71	74	75
Admin. Expenses	64	71	80	86	92	88	91	92
Other Income	272	809	258	115	228	365	528	692
Other Expenses	190	326	260	288	322	310	325	329
Operating Profit	2,553	3,520	3,730	4,148	4,628	4,443	4,649	4,713
Finance Cost	155	56	19	29	29	11	10	10
Exchange loss/gain	(32)	(37)	-	-	-	-	-	-
PBT	2,430	3,501	3,711	4,119	4,599	4,432	4,639	4,703
Taxation	661	1,005	1,202	1,277	1,380	1,330	1,392	1,411
Net Income	1,769	2,496	2,509	2,842	3,219	3,102	3,247	3,292
<b>EPS</b>	<b>7.79</b>	<b>10.99</b>	<b>11.04</b>	<b>12.51</b>	<b>14.17</b>	<b>13.66</b>	<b>14.30</b>	<b>14.49</b>

Source: Company Accounts, Nael Research

Balance Sheet (PKR mn)	FY14	FY15	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E
Current Assets	4,262	4,674	4,211	5,575	7,164	8,688	10,383	12,093
Non Current Assets	7,615	7,440	8,059	8,117	7,970	7,756	7,520	7,265
Total Assets	11,877	12,114	12,270	13,692	15,134	16,444	17,903	19,358
Total Current Liabilities	2,982	1,680	1,094	1,267	1,313	1,278	1,324	1,350
Total Non - Current Liabilities	2,093	2,101	1,761	1,762	1,761	1,759	1,757	1,755
Total Liability	5,075	3,781	2,855	3,029	3,075	3,037	3,081	3,105
Authorized Share Capital	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500
Issued & Paid up Capital	2,271	2,271	2,271	2,271	2,271	2,271	2,271	2,271
Reserves	4,531	6,062	7,144	8,391	9,788	11,136	12,551	13,982
<b>Total Liabilities &amp; Equities</b>	<b>11,877</b>	<b>12,114</b>	<b>12,270</b>	<b>13,692</b>	<b>15,134</b>	<b>16,444</b>	<b>17,903</b>	<b>19,358</b>

Source: Company Accounts, Nael Research

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