WE Detailed Report

May 2014

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D.G. Khan Cement Company Limited

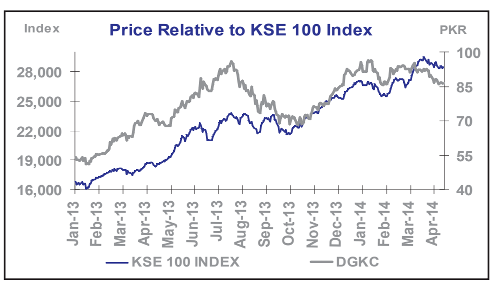
DGKC: Expanding to Dominate

We continue the coverage of D.G. Khan Cement Ltd. (DGKC) with a Dec'14 Target Price of Rs 109.40/share, offers an upside of +29% (including 3% Dividend Yield)-BUY! Our bullish stance is based on; 1) Stable earnings growth expected from DGKC at a 9% CAGR (FY14-FY16), 2) DGKC have cost efficient plant with WHR, RDF technology and running at full capacity, 3) Investment Income supports bottom-line. Furthermore, Company announced expansion in Hub of new green field plant of 2-2.5mn MT capacity with total estimated cost of the project would be $250 million. The share is trading at FY15 and FY16 prospective P/E multiple of 5.9x and 5.2x respectively. The key risks to our valuations are; 1) Cut in cement prices would squeeze margins 2) Coal prices volatility, 3) Debt/Right shares issue.

KEY DATA

KATS Code	DGKC
Reuters Code	DGKH.KA
Current Price (Rs)	84.25
Year High, Low (Rs)	97.75, 83.26
Market Cap (Rs' bn)	37
Market Cap (US$ mn)	373
Shares Outstanding (mn)	438.12
Free Float (%)	55.00%

Source: KSE, Reuters & WE Research



Source: KSE & WE Research

DGKC Financial Snapshot

	FY12A	FY13A	FY14F	FY15F
Net Sales (Rs mn)	22,950	24,916	27,041	29,421
Profit after Taxation (Rs mn)	4,108	5,502	5,796	6,517
EPS (Rs)	9.38	12.56	13.23	14.87
Book Value (Rs/share)	75.17	109.56	119.00	129.11
DPS (Rs)	1.50	3.00	3.50	4.00
P/E x	9.38	7.01	6.65	5.92
P/ BV (x)	1.17	0.80	0.74	0.68
EBITDA (%)	28%	29%	33%	33%
ROE (%)	12%	11%	11%	12%
ROA (%)	8%	10%	9%	10%

Source: Company Reports & WE Research

Valuation: BUY with a Target Price of Rs 109.40

We have used Sum of Parts Valuation Technique (SOTP) to calculate the Target Price of DGKC in which we separate valuation method for the core cement business and portfolio investment. For computing cement business, we have used Discounted Cash Flow Technique with assumption of 17.9% cost of equity (13% Risk free rate and 5% market premium) and 3% growth rate, thus our SOTP Base Dec'14 Target Price for DGKC is Rs 109.40/share offers upside of +29% (including 3% FY14 Dividend Yield) - Buy!

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DGKC Valuations

Rs in million	**FY14E**	**FY15E**	**FY16E**	**FY17E**
EBIT(ex associates)	6,849	7,639	7,409	7,036
EBIT(1-t)	5,480	5,959	5,779	5,488
CAPEX	2,883	2,865	2,934	2,992
Depreciation	1,639	1,571	1,493	1,409
Changes in Working Ca.	79	(160)	(182)	(207)
Free Cash Flow	4,315	4,505	4,157	3,698
Present Value of FCF	4,315	3,883	3,087	2,367
Pv of Terminal Cash Flow	18,728			
Firm Value	32,379			
(Less) Debt	9,885			
(Add) Cash	469			
Value of Equity	22,963			
No of shares in million	438			
DCF Valuation (Rs/share)	52.41			
Investment Value (Rs/share)	56.98			
Target Price Dec'14 (Rs)	**109.40**			

Source: WE Estimates

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Core Earnings to grow at 9% CAGR

DGKC's core earnings have grown by 13x in last 4 years, however earnings growth is expected to slow down going forward to 9% (FY14-16). On the flip side, other investment income would hover around Rs 1,500 million (EPS: ~3.08).

DGKC's earnings divides in two phases 1) core earnings and 2) hefty dividend income from investments. Historically in rough patch when company's core earnings remained depressed due to lower margins on cement sales along with high finance cost, the investment income has been the saviour. DGKC's core earnings have grown by 13x in last 4 years, however earnings growth is expected to slow down going forward to 9% (FY14-16). On the flip side, other investment income would hover around Rs 1,500 million (EPS: ~3.08).

DGKC's Operational activities

DGKC has a name plate capacity of 4,020k tons (4 mn MT) per annum and the plant runs at full capacity due to high demand of DG Khan Brand. The company's domestic sales network is spread throughout the country while its major exports markets are Afghanistan, African countries, SriLanka and India.

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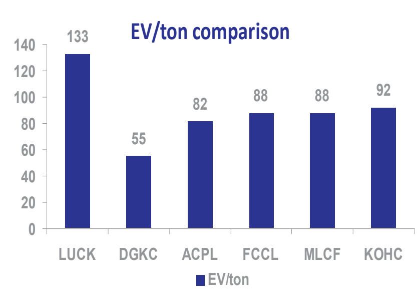
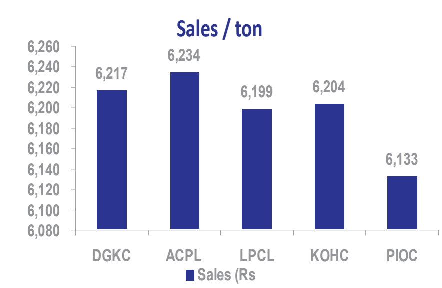


Source: Company Reports & WE Research



Source: Company Reports & WE Research

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Efficiency measures to keep margins intact

DGKC's plant is one of the efficient in the industry with WHR and RDF technologies. The company commissioned 8.4MW WHR plant at Khairpur site. As per our estimates company would have annual savings of Rs ~285 million. However company's RDF plant is a long term hedge against surge in coal prices above USD 100/ton. DGKC is poised to exploit full advantage of high margins and cost efficiency during turbulent times of energy crisis, usually industry pass on any hike in cost and major beneficiaries are cost efficient players.

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Trading at attractive multiples

In comparison to peers in the sector, DGKC is trading at FY14 P/E of 6.65x as against the major players (LUCK, ACPL, FCCL and LPCL). Moreover re-rating of Pakistan capital markets would make DGKC further cheaper in the cement sector if we assume P/E of 8.5x and above going forward. On the flipside, DGKC among big players is the only player receives hefty income from investments in blue chip stocks which gives a hedge against sector headwinds as compared to other players.

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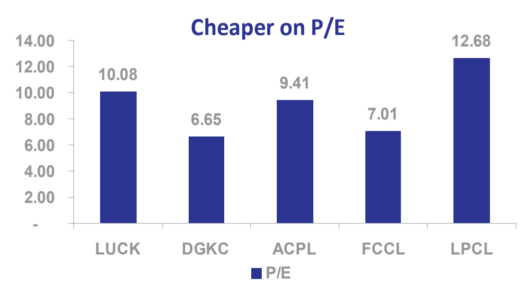
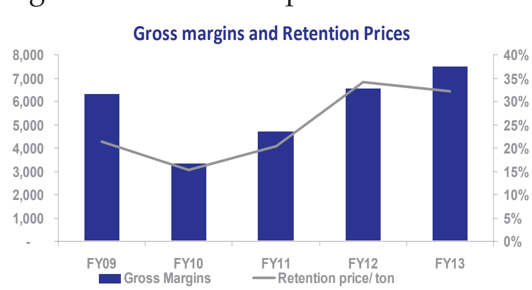


Source: Company Reports & WE Research

Sensitivity to retention prices

DGKC's gross margins trend is highly correlated with movement in retention prices. Cement prices continued its upward trend since FY10 and similarly gross margins of the company continued in same direction. However, there has been slight decline in retention prices in FY13 but gross margins continued its upward trend which is due to cost efficiency achieved by the company through WHR technology. Going forward with full implementation of in-house power generation on all sties would make the company less sensitive to retention prices movement.



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DGKC is actively looking for expansion for 2-2.5mn MT annually either through acquisition of running plant or installing new setup. For this purpose DG Khan announced expansion in Hub of new green field plant with total estimated cost of the project would be $250 million

Poised to capture rising local demand

DGKC is actively looking for expansion for 2-2.5mn MT annually either through acquisition of running plant or installing new setup. For this purpose DG Khan announced expansion in Hub of new green field plant with total estimated cost of the project would be $250 million. The project would be financed with mix of Debt and Equity, where we believe equity can be raised through right shares as well considering historic capex plans executed by DGKC in past through issuing rights and debt. There is lot of scope for local construction activity in all segments but inefficient use of PSDP by govt. is the major bottleneck. The new govt. has shown some resilience and economy is gradually picking up. The cement demand going forward is under pinned on construction/infrastructure activity from govt.

DGKC - debt and equity financing possible scenario

As it is evident from DGKC's official announcements that company is looking for expansion either through acquisition/new plant erection, the probable financing required would be in the range of PKR 13-15 billion. We have done some calculations on LPCL acquisition by DGKC and financial arrangements by the company for the deal. We believe that DGKC will not divest its strategic investments; however company's balance sheet is strong enough to go for debt/equity mixture of financing. Our calculation is based on LPCL possible acquisition price of Rs 13/share, however a change in Rs 1/share deal price would increase the acquisition amount by Rs 1,051 million.

LPCL- acquisition cost	
No of shares (mn)	1313
Stake	80%
Acquisition Price	13
Deal Price PKR mn	13,655
DGKC assets	
Cash	469
Investments	19,550
Total	20,019
Debt	60%
Equity	40%
Debt PKR mn	9,454
Equity PKR mn	6,302
Finance Cost PKR mn	768
EPS impact	1.75

Source: Company Reports & WE Research

Key Risk

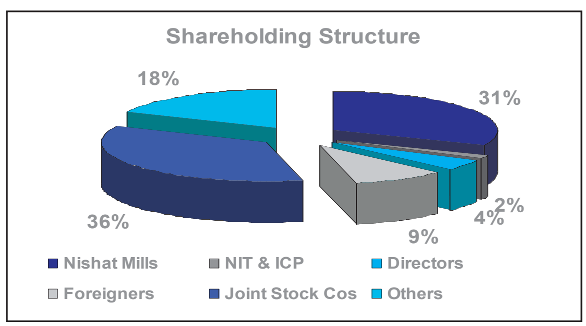
Reduction in Cement Prices
DGKC earnings are highly sensitive to cement prices due to higher reliance on national grid for power supply. Earnings of DGKC would decline by 6.40% if cement prices are cut by Rs10/bag.

Coal Prices Volatility or uptick
Coal is the major component of cement making, and if there is hike in coal price by USD 5/ton DGKC's earning would reduce by 3.10%. Extremely volatility in coal prices can also result in buying the commodity at higher price.

Debt/Right shares for expansion
DGKC is looking for both acquisition/expansion of its existing capacity and increase in debt financing would affect the earnings estimates and valuations. Similarly, right share issue would affect our valuations negatively.

Company Introduction

DGKC was established in 1978 under the management control of State Cement Corporation of Pakistan Limited (SCCP). The company started its commercial production in April 1986 with 2000 tons per day (TPD) clinker-based on dry process technology. DGKC was acquired by Nishat Group in 1992 under the privatization initiative of the GoP. It is principally engaged in production and sale of Clinker, Ordinary Portland and Sulphate Resistant Cement. The company is currently operating with a total annual capacity of 4.2 million tons. DGKC is a public limited company incorporated in Pakistan and is listed on Karachi, Lahore and Islamabad Stock Exchanges.



Source: Company Report

DGKC - Financial Highlights

Valuation

	FY12A	FY13A	FY14F	FY15F
EPS (Rs)	9.38	12.56	13.23	14.87
Book Value (Rs/share)	75.17	109.56	119.00	129.11
DPS (Rs)	1.50	3.00	3.50	4.00
P/E x	9.38	7.01	6.65	5.92
P/ BV (x)	1.17	0.80	0.74	0.68

Source: Company Reports & WE Research

Key Ratio Analysis

	FY12A	FY13A	FY14F	FY15F
Current Ratio (x)	1.65	2.79	2.93	3.79
ROE (%)	12%	11%	11%	12%
ROA (%)	8%	10%	9%	10%
Gross Margin (%)	33%	37%	35%	36%
Net Margin (%)	18%	22%	21%	22%
Sales Growth (%)	24%	9%	9%	9%
PAT Growth (%)	2303%	34%	5%	12%

Source: Company Reports & WE Research

Income Statement

Rs in million	FY12A	FY13A	FY14F	FY15F
Sales	22,950	24,916	27,041	29,421
Cost of Sales	15,443	15,590	17,510	18,933
Gross Profit	7,507	9,326	9,531	10,488
Distribution Expenses	2,203	1,751	1,846	1,910
Admin. Expenses	268	406	354	395
Operating Profit	5,036	7,169	7,332	8,183
Other income	1,188	1,466	1,402	1,430
Finance Cost	1,671	995	915	620
Profit before Taxation	4,052	7,096	7,246	8,355
Taxation	(56)	1,594	1,449	1,838
Profit after Taxation	4,108	5,502	5,796	6,517

Source: WE Research & Company Reports

Balance Sheet

Rs in million	FY12A	FY13A	FY14F	FY15F
Share Capital	4,381	4,381	4,381	4,381
Shareholder Equity	32,931	47,998	52,134	56,563
Non Current Liabilities	6,549	6,221	2,169	1,702
Current Liabilities	11,206	9,308	8,719	6,908
Total Liabilities	17,755	15,529	10,888	8,610
Non Current Assets	32,245	37,543	37,488	38,958
Current Assets	18,440	25,984	25,534	26,215
Total Assets	50,685	63,527	63,022	65,173

Source: WE Research & Company Reports

Cash Flow Statement

Rs in million	FY12A	FY13A	FY14F	FY15F
Cash from Operations	4,997	7,477	7,515	7,928
Cash from Investing activities	(2,648)	(5,070)	(1,467)	(2,865)
Cash from financing	(2,044)	(2,366)	(4,974)	(2,399)
Net change in cash	304	41	1,074	2,664
Beginning Cash balance	124	428	469	1,543
Ending Cash balance	428	469	1,543	4,207

Source: WE Research & Company Reports

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