Cement Sector

Fauji Cement Company Ltd. (FCCL)

Attractive Valuation - BUY

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Stock Watch

September 28, 2018

Company Name:	Fauji Cement Company Limited
Symbol	FCCL
Target Price	**PKR 35.21**
Upside	**52%**

Key Statistics

Current Price*	PKR 23.19
Outstanding Shares	1272.24 mn
52 Week High	PKR 34.14
52 Week Low	PKR 19.24
Market Capitalization*	PKR 31,998.03 mn
1 year Avg. Daily Volume	4.05 mn
Valuation Methodology	DCF
Free Float	758.90mn

Source: PSX & WE Research
** Prices as of 24 Sep, 2018*

Key Numbers

	FY18A	FY19F	FY20F	FY21F
EPS	2.49	3.05	3.66	4.31
DPS	2.00	2.45	2.95	3.46
BVPS	14.85	15.44	16.16	17.00
P/E (x)*	9.33	7.61	6.33	5.39
P/BV (x)*	1.56	1.50	1.44	1.36
Dividend Yield*	8.62%	10.58%	12.71%	14.94%
ROE %	17%	20%	23%	25%

** Prices as of Sep 24, 2018*
Source: Company Accounts & WE Research

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- ***We initiate our coverage on Fauji Cement Company Limited (FCCL) with a 'BUY' recommendation based on our Jun'19 TP of PKR 35.21/ share, implying a potential upside of 52% along with a dividend yield of 10.58%.***
- ***We expect gross margin to improve to 32% in FY19 due to 7% increase in sales and reduction in cost of production by 4% primarily on the back of discontinuation of clinker purchasing from third party amid restoration of Line II operations.***
- ***We expect FY19 EPS to clock in at PKR 3.05 up by 23% mainly due to expected surge in gross margin & normalization of cost. Further, we expect the EPS to grow at CAGR 14% during FY19-23.***
- ***Company has maintained 7% market share in overall industry dispatches, while it has 8% market share in local dispatches and on average 5% share in total industry exports during FY18.***
- ***We expect demand would be slightly on the higher side during FY19 on the back of construction of houses for underprivileged families, private housing schemes, & infrastructure projects under CPEC.***
- ***DuPont Analysis suggests ROE is sensitive to Profit margins and Assets utility. We expect ROE to normalize as the profit margin increases.***
- ***Investment Risk to our valuations 1) higher than estimated prices of coal 2) Decline in estimated price per bag 3) Lower than forecasted capacity utilization of FCCL's cement plant 4) Change in Demand outlook***

Attractive Dividend Yield & Growth Prospects

We initiate our coverage on Fauji Cement Company Limited (FCCL) by incorporating FY18 financial results and current industry dynamics. Our Discounted Cash Flow (DCF) target price is PKR 35.21 for June 2019 which offers upside potential of 52% from current price with expected earning of PKR 3.05 per share and dividend yield of 10.58 % in FY2019F which is key attraction for investors. Hence, we initiate "BUY" rating on FCCL.

Fauji Cement is sustainably maintaining its market share of 7% since last 5 years (despite disruptions of Line II Ops in FY16-7). Currently, company is operating at 97% production capacity utilization to meet the on-going demand amid restoration of Line II operations. By keeping in mind growth prospects of industry backed by funds allocation under PSDP, progress regarding the low-cost housing scheme, private housing schemes & provincial infrastructure projects associated with Pak Economic Corridor (CPEC), we believe company would operate at 95% capacity utilization to produce 3.32 million Tones in FY19. Other factors are increasing prices of cement per bag in north region on account of higher local demand and inflationary pressures. We expect the prices to remain in the range of PKR 550 to 600 per bag in north region during FY19.

"FCCL has maintained 7% market share in total industry dispatches"

"FCCL has achieved 97% capacity utilization in FY18"

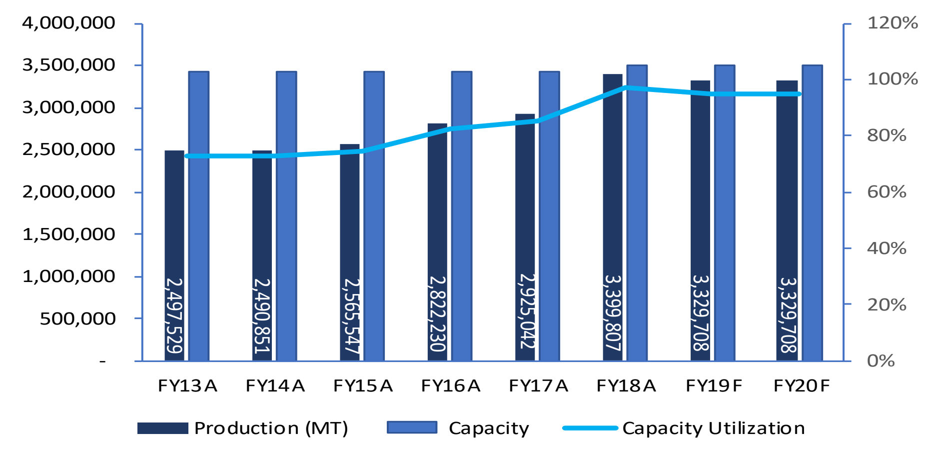
"Increasing trend in local dispatches"

Higher Local demand

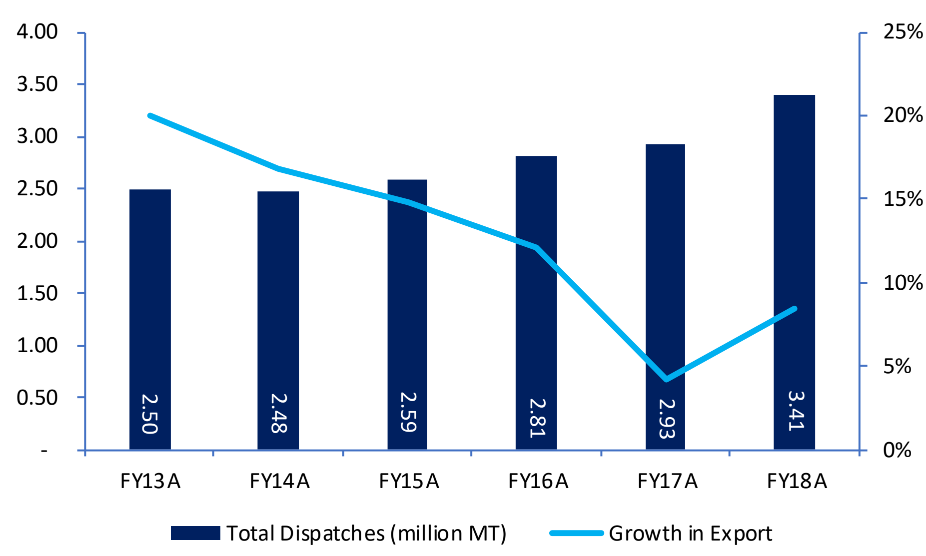
The Company achieved a higher capacity utilization over the years from 73% in FY13 to 97% in FY18 primarily driven by local sales wherein export share for FCCL fell from 20% in FY13 to 12% in FY16 and 8% in FY18.

Part of the reason of falling export share is declining demand in key markets; such as Afghanistan and South Africa, but another reason is an exchange of sales mix. At given limited capacity and higher local demand, the company may have diverted focus from exports to local markets offering relatively better margins, after all local sales give them a much better margin and savings in freight and transportation.

Product, Capacity & Utilization *Source: Company Accounts & WE Research*



Sales Mix *Source: Company Accounts & WE Research*



"Gross margin and net profit margin to grow at 32% and 19% in FY19F"

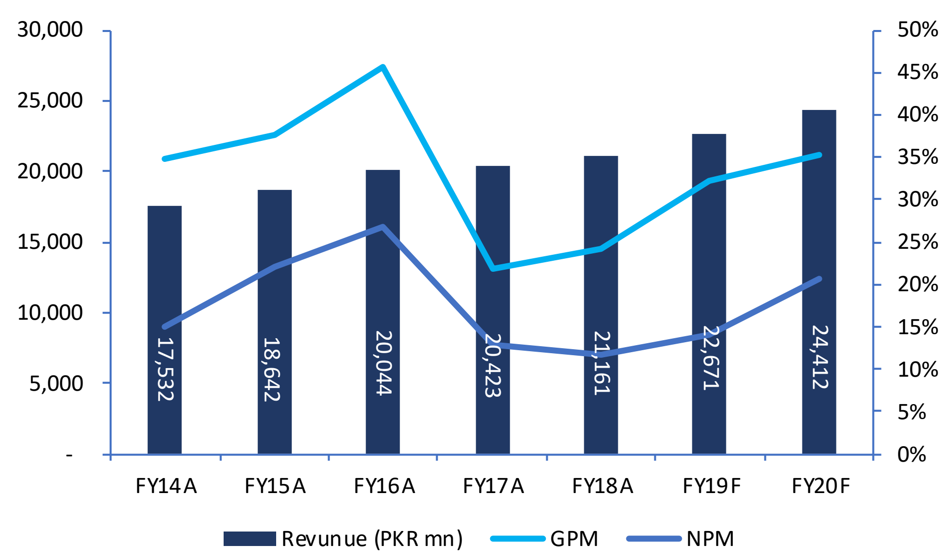
Line II Resumption to Normalize the Margins

The company's line II remained non-operational due to an accident involving Raw Meal Silo during 4QFY16. To maintain its market share, FCCL resorted to third party purchase of clinker, resultantly the COGS arose by 47% in FY17 and gross margin shrank to 22% during FY17.

The company resumed Line II operations on October 22, 2017, with enhanced cement production capacity to 3.50 million tons as compared to previously rated 3.43 million tons. Thus, we expect gross margins to stabilise and inch up to 32% in FY19 and 35% in FY20. Moreover, we expect net profit margins of 19%/21% during FY19/FY20 respectively.

On the other hand, sales have increased with 6 years CAGR of 4.8%. Going forward, we foresee sales to increase at a 5 years CAGR of 6.1% driven by host of factors including enhanced production, expected rise in local demand and price per bag.

Revenue, GPM & NPM *Source: Company Accounts & WE Research*



"12.5MW Captive Solar Plant to be Commissioned by mid 2019"

Energy Cost Efficiency

As per the management, the company is making all out efforts to undertake projects for cheap power generation. In addition to the existing 12 MW Waste Heat Recovery Plant FCCL commissioned 9MW Waste Heat Recovery Power Plant in February 2018 for its second line. This project will not only reduce the dependence on the National Grid but also enhances the power generation capability of the plant. In the same quest, the company has also decided to setup a 12.5 MW Captive Solar Plant which is scheduled to be commissioned by mid-2019. Till now we have not incorporated this in our model.

"Resumption of Line II operations and reversal of deferred tax had boosted the bottom line in FY18"

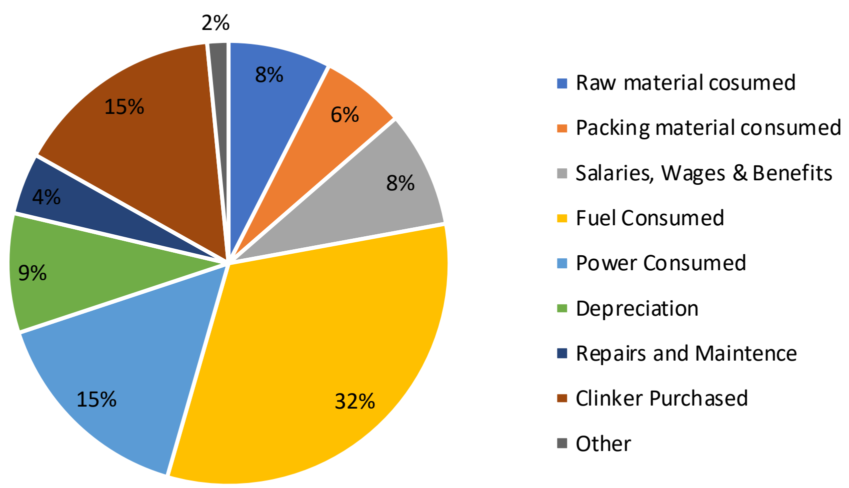
Financial Performance - FY18

PKR in Million	FY17	FY18	YoY%
Net Sales	20,423	21,161	3.61%
COGS	15,986	16,046	0.38%
Gross Profit	4,438	5,115	15.25%
Distr. Exp.	166	276	65.86%
Admin. Exp.	340	386	13.49%
Other Exp.	291	311	6.90%
Finance Cost	153	148	-3.36%
Other Income	137	104	-23.95%
Insur. Claim	306	-	NA
PBT	3,930	4,098	4.27%
Taxation	1,317	669	-49.23%
PAT	2,613	3,429	31.24%
EPS	1.89	2.49	31.24%

FY18 Performance at a Glance

- Reported EPS of PKR 2.49 up by 32%
- Announced PKR 2.00/ share dividend
- Resumption of Line II operations
- Company dispatched 3,405,837 MT up by 16% in FY18 including 3,118 671 MT local dispatches & 287,166 MT exports dispatches
- During the period, average retail prices of cement in north region recorded at PKR 535 per bag
- Achieved highest capacity utilization of 97% against 85% SPLY
- Clinker Production increased by 1.43 times to 2,729,020 MT as compared to 1,121,439 MT SPLY
- Clinker purchased during the FY18 reduced by 32% YoY to 549,192 MT
- Cement Production enhanced by 16% to 3,399,807 MT
- Gross margin increased to 22% mainly due to resumption of line 2 operations.
- The Net profit margins increased to 16% as lower tax recorded during FY18 in comparison to FY17 as reversal of deferred tax

COGS Structure – FY18 *Source: Company Accounts & WE Research*



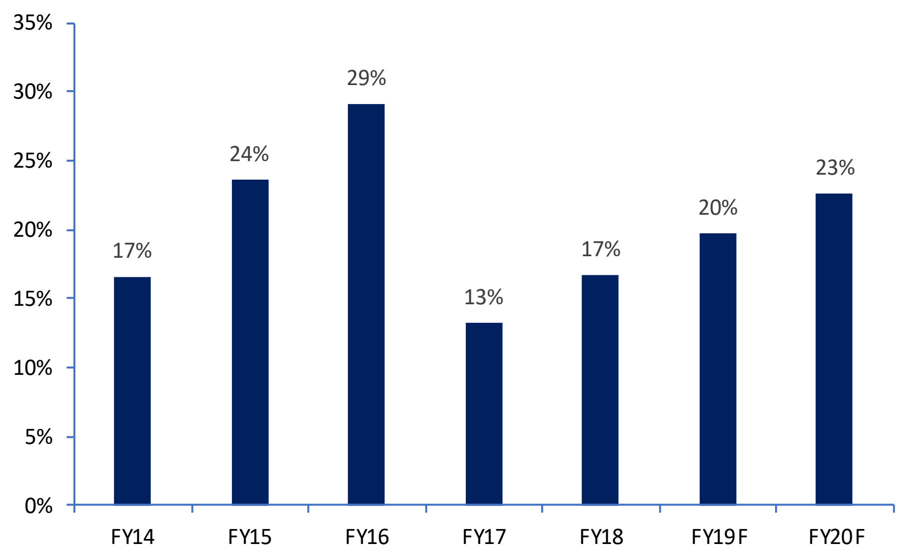
"ROE is more sensitive to Net Profit Margins"

DuPont Analysis

DuPont Analysis suggests that ROE is more sensitive to Net Profit Margin then Assets Turnover and Leverage. In past 6 years, sales and net income grew at CGAR 4.8% /12.3% respectively. This hefty surge in net profit margin was attributed to 90% decline (over 6 years) in finance cost due to scheduled maturities of long term debt. Similarly, leverage ratio indicates company has less reliance on debt to finance its assets. Forecasted reducing debt burden coupled with normal operations will result in sustained ROE growth.

	FY14	FY15	FY16	FY17	FY18	FY19F	FY20F
NPM	15%	22%	27%	13%	16%	19%	21%
Assets Turnover	0.60	0.61	0.68	0.74	0.73	0.76	0.79
Leverage	1.86	1.75	1.59	1.41	1.42	1.40	1.38
ROE	17%	24%	29%	13%	17%	20%	23%

Return on Equity Trend (ROE) *Source: Company Accounts & WE Research*



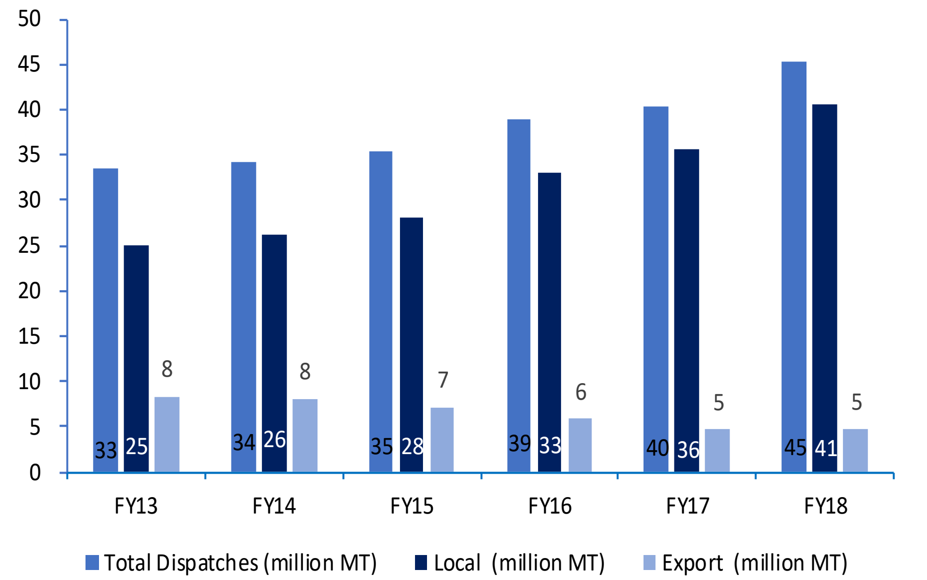
"FCCL's Expansion is on the card to match speed with competitors"

Future Outlook: Expansion Much Needed To Retain Market Share

Cement industry has witnessed a tremendous growth in recent past boosted by economic and infrastructure developments. During FY18, the industry registered a growth of 13% to record at 45.37 million tons versus 40.32 million tons SPLY. To meet this increasing demand, all the major players are expanding their capacities at a fast pace. Pakistan's existing capacity of cement production is between 46-49 million tons with expected expansion of 72 million tons by FY21. To keep pace with the cement industry and to gain more market share, the company has also planned to establish an additional plant and necessary preparation in this regard are underway. Going forward, industry growth will be fuelled by infrastructure projects under China Pak Economic Corridor (CPEC), DAMs, PSDP, Housing schemes by governments & Private sector housing projects.

Industry Dispatches	FY13	FY14	FY15	FY16	FY17	FY18
Total Dispatches (million MT)	33	34	35	39	40	45
Local (million MT)	25	26	28	33	36	41
Export (million MT)	8	8	7	6	5	5
%Local	75%	76%	80%	85%	88%	89%
%Export	25%	24%	20%	15%	12%	10%

Industry Dispatches *Source: APCMA & WE Research*



Sensitivity Analysis

PKR/Share

		EPS				
Coal Prices	TP	FY19	FY20	FY21	FY22	FY23
10%	24.80	2.80	3.14	3.45	3.75	4.11
5%	30.45	2.93	3.41	3.90	4.41	5.02
Base Case	**35.21**	**3.05**	**3.66**	**4.31**	**4.98**	**5.77**
-5%	39.2	3.17	3.91	4.67	5.47	6.38
-10%	42.82	3.30	4.14	5.00	5.88	6.88

Source: WE Research

PKR/Share

		EPS				
Price/Bag	TP	FY19	FY20	FY21	FY22	FY23
PKR 20+	51.77	3.54	4.67	5.86	7.11	8.52
PKR 10+	43.49	3.29	4.17	5.08	6.04	7.14
Base Case	**35.21**	**3.05**	**3.66**	**4.31**	**4.98**	**5.77**
PKR 10-	26.94	2.80	3.16	3.53	3.91	4.39
PKR 20-	18.66	2.56	2.66	2.75	2.84	3.02

Source: WE Research

PKR/Share

		EPS				
Exchange Rate	TP	FY19	FY20	FY21	FY22	FY23
20%	31.05	2.57	3.17	3.80	4.46	5.25
10%	33.13	2.81	3.42	4.05	4.72	5.51
Base Case	**35.21**	**3.05**	**3.66**	**4.31**	**4.98**	**5.77**
-10%	37.29	3.29	3.91	4.56	5.24	6.02
-20%	39.37	3.53	4.15	4.81	5.49	6.28

Source: WE Research

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Assumptions	
Risk Free Rate	9%
Market Risk Premium	6%
Adjusted Beta	1.24
Cost of Debt	7%
Cost of Debt (1-T)	5%
Weight of Equity*	92%
Weight of Debt	8%
WACC	15.55%
Target Price	PKR 35.21

Source: Company Accounts & WE Research

** Prices as of Sep 24, 2018*

Valuation

We have valued Fauji Cement Company Limited (FCCL) using Discounted Cash flow methodology to arrive at Jun'19 target price of PKR 35.21/share on the basis of projected free cash flow to the firm (FCFF), discounted at WACC 15.55%, with 5% sustainable growth rate, 16.45% cost of equity and 7% cost of debt.

We estimated cost of Equity of 16.45% by using Capital Assets Pricing Model (CAPM) approach using a risk free rate of 9%, equity risk premium of 6% and adjusted beta of 1.24 based on FCCL's last 3 year trading history.

Key Risks to Valuation:

Investment Risk to our valuations are:

1) higher than estimated Coal Prices
2) Decline in estimated price per bag
3) Lower than forecasted capacity utilization of FCCL's cement plant
4) Change in demand

TP Sensitivity *Source: WE Research*

Cost of Equity

Terminal Growth Rate	14%	15%	16%	17%	18%
1%	33.75	31.00	28.61	26.52	24.68
3%	38.73	35.11	30.82	29.43	27.16
5%	46.11	41.01	**35.21**	33.39	30.46
7%	58.18	50.18	41.66	39.09	35.1
9%	81.5	66.39	52.05	48.04	42.05

KEY FINANCIAL HIGHLIGHTS:

Figures in PKR million

PROFIT & LOSS ITEMS	FY14	FY15	FY16	FY17	FY18	FY19F	FY20F	FY21F	FY22F	FY23F
NET SALES	17,532	18,642	20,044	20,423	21,161	22,671	24,412	26,266	28,230	30,489
COST OF GOODS SOLD	11,448	11,615	10,879	15,986	16,046	15,372	15,813	16,318	16,843	17,420
GROSS PROFIT	6,084	7,027	9,165	4,438	5,115	7,300	8,599	9,948	11,386	13,069
OPERATING PROFIT	5,733	6,614	8,644	3,932	4,453	6,586	7,831	9,122	10,499	12,111
FINANCE COST	1,042	706	503	153	148	252	252	244	262	274
POST-TAX PROFITS	2,626	4,116	5,367	2,613	3,429	4,206	5,055	5,941	6,867	7,957

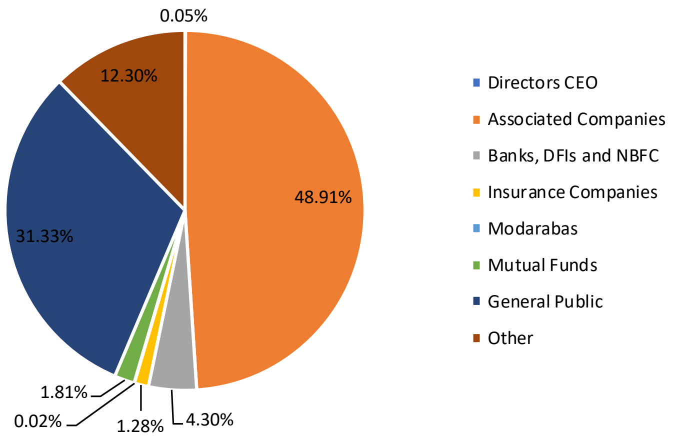
BALANCE SHEET ITEMS	FY14	FY15	FY16	FY17	FY18	FY19F	FY20F	FY21F	FY22F	FY23F
PROPERTY PLANT & EQUIP.	23,881	23,881	21,701	22,004	22,624	23,205	23,800	24,411	25,037	25,680
LONGTERM DEPOSITS & PREPAYMENTS	310	233	157	87	87	87	87	87	87	87
TOTAL NON CURRENT ASSETS	24,193	24,115	21,858	22,091	22,711	23,292	23,887	24,498	25,124	25,766
INVENTORY	1,409	889	541	1,072	1,245	1,240	1,276	1,316	1,359	1,405
TRADE DEBTS	580	566	569	1,149	1,168	1,252	1,348	1,450	1,559	1,683
TOTAL CURRENT ASSETS	5,188	6,414	7,500	5,662	6,338	6,527	6,980	7,599	8,485	9,626
TOTAL ASSETS	29,381	30,528	29,358	27,752	29,049	29,819	30,867	32,096	33,609	35,393
LONGTERM BORROWING	5,363	4,000	1,486	1,063	637	318	106	-	-	-
PAYABLES	1,726	2,056	1,968	1,558	2,158	2,106	2,166	2,235	2,307	2,386
SHORTTERM BORROWINGS	42	6	78	312	1,639	2,065	2,384	2,596	2,802	2,952
TOTAL LIABILITIES	13,593	13,109	10,930	7,743	8,561	8,508	8,569	8,638	8,810	9,039
SHARE CAPITAL	13,798	13,798	13,798	13,798	12,434	12,434	12,434	12,434	12,434	12,434
REVENUE RESERVE	1,990	3,621	4,630	5,883	8,055	8,877	9,864	11,024	12,366	13,920
TOTAL LIABILITIES & S H E	29,381	30,528	29,358	27,425	29,049	29,819	30,867	32,096	33,609	35,393

KEY RATIOS	FY14	FY15	FY16	FY17	FY18	FY19F	FY20F	FY21F	FY22F	FY23F
EPS (PKR)	1.80	2.91	3.98	1.89	2.49	3.05	3.66	4.31	4.98	5.77
DPS (PKR)	1.5	2.5	2.75	0.9	2	2.45	2.95	3.46	4.00	4.64
BVPS (PKR)	11.44	12.62	13.36	14.26	14.85	15.44	16.16	17.00	17.97	19.10
Current Ratio (x)	1.16	1.36	1.51	2.42	1.49	1.44	1.45	1.53	1.65	1.79
Quick Ratio (x)	0.32	0.61	0.45	0.71	0.40	0.41	0.42	0.46	0.56	0.67
Gross Margin	35%	38%	46%	22%	24%	32%	35%	38%	40%	43%
Operating Profit Margin	33%	35%	43%	19%	21%	29%	32%	35%	37%	40%
Net Margin	15%	22%	27%	13%	16%	19%	21%	23%	24%	26%
Time Interest Earned (x)	5.33	9.04	16.56	24.69	28.73	24.81	29.62	35.83	38.51	42.41
ROA	9%	13%	18%	9%	12%	14%	16%	19%	20%	22%
ROE	17%	24%	29%	13%	17%	20%	23%	25%	28%	30%
Debt/Equity	50%	37%	22%	9%	13%	13%	12%	12%	11%	11%
P/E (x)	12.88	7.97	5.83	12.24	9.33	7.61	6.33	5.39	4.66	4.02
P/B (x)	2.03	1.84	1.74	1.63	1.56	1.50	1.44	1.36	1.29	1.21
Dividend Yield	6.47%	10.78%	11.86%	3.88%	8.62%	10.58%	12.71%	14.94%	17.27%	20.01%
EV	39111	36232	34423	33282	34168	34106	34046	33842	33494	33006
EV/EBITDA (x)	8.69	6.12	4.87	8.70	6.87	5.84	5.06	4.43	3.88	3.38

Source: Company Accounts & WE Research

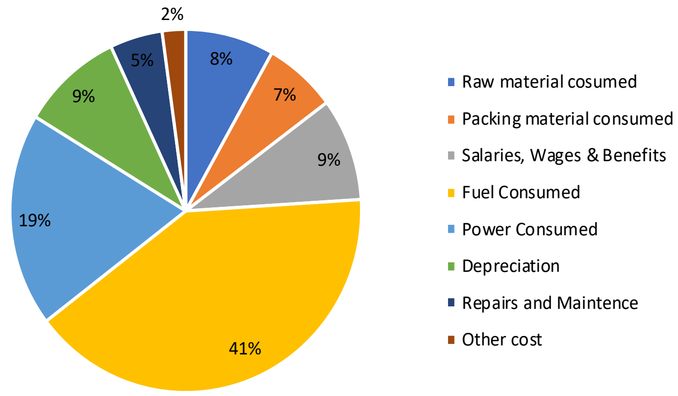
Shareholder Pattern

Source: Company Accounts & WE Research



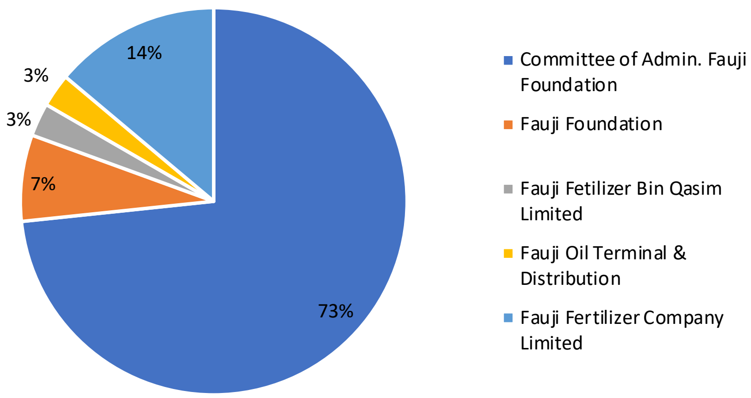
Cost of Goods Sold Structure - FY19F

Source: Company Accounts & WE Research



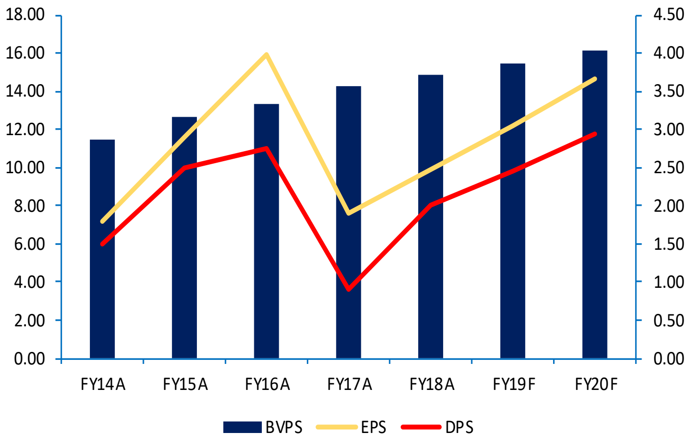
Associated Companies' Holding

Source: Company Accounts & WE Research



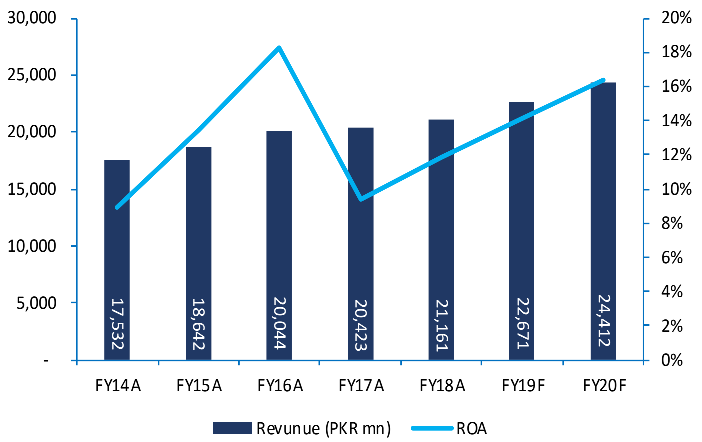
EPS DPS BVPS Trend

Source: Company Accounts & WE Research



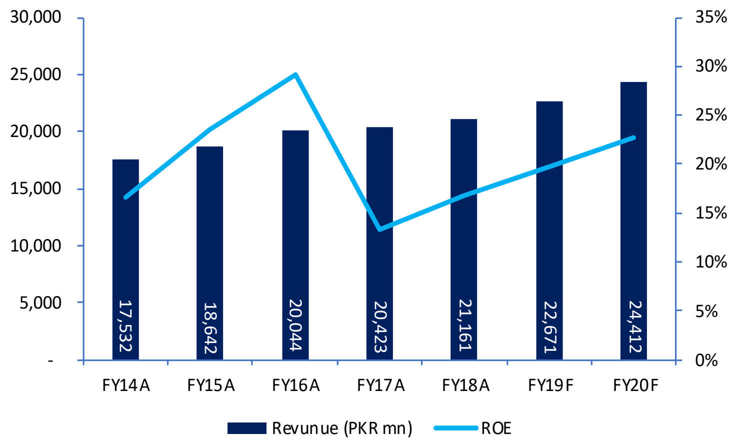
Net Income & ROA

Source: Company Accounts & WE Research



Net Income & ROE

Source: Company Accounts & WE Research



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Stock Ratings

WE Financial Services Ltd. uses three rating categories, depending upon return form current market price, with Target period as June 2019 for Target Price. In addition, return excludes all type of taxes. For more details kindly refer the following table;

Potential to target price	
Buy Upside	More than +10% from last closing price
HOLD	In between -10% and +10% from last closing price
SELL	Less than -10% from last closing price

Equity Valuation Methodology

WE Research uses the following valuation technique(s) to arrive at the period end target prices;

- Discounted Cash Flow (DCF)
- Dividend Discount Model (DDM)
- Relative valuation (P/E, P/B, P/S)
- Equity & Asset return based (EVA, Residual income)

Risks

The following risks may potentially impact our valuations of subject security(ies);

- Market Risk
- Interest Rate Risk
- Exchange rate risk

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