فاروس
PHAROS

CEMENT SECTOR

The Oversupply Apocalypse

September 5, 2016

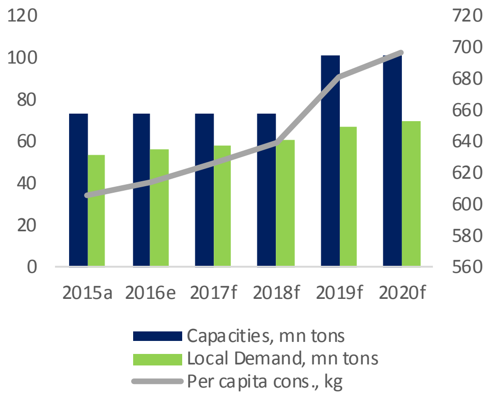
New Capacities, Inability to Export, and FX Challenges Weigh on Price Outlook and Margins

Our outlook for the cement industry is underpinned by the new capacities that are expected to come on stream by 2019/2020. Furthermore, current players are unable to access regional markets with exports, due to the buildup of excess supply in the region, in addition to low commodity prices, sluggish economic conditions, and political instability in key export markets. With the current buildup of FX scarcity and overshooting of the EGP/USD exchange rate, operating costs are on the rise, and financing cost is also mounting for players who have foreign currency denominated debt.

Oversupply Is the Name of the Game

The government signed a EUR 1.05 billion deal with China-based Sinoma to build 6 new production lines, 6,000 tpd each, adding 12 mtpa to existing supply, which would bring total production under government control to 19 mtpa, together with the 7 mtpa at El Arish plant. The added capacities represent c.18.7% of Egypt's expected production capacity, taking into consideration the potential issuance of 8 new licenses (16 mtpa) that the IDA has previously tendered. The result of the tender is yet to be released. South Valley Cement, Misr Beni Suef Cement, Royal Minya, and Egyptian Steel Group are bidding for one license each, whilst El-Sewedy Cement and Jushi of China are bidding for two licencses each. It should be noted that a new plant takes 2-3 years to become fully operational. However, we still expect oversupply to dominate the outlook, since the industry is operating at a capacity utilization rate north of 75%, with potential increase in demand insufficient to absorb the capacities that might come on stream.

Figure 1 | Despite estimated pickup in demand, the expected additional capacities dampen the price outlook



Source: UNICEF, Suez Cement Investors' Presentation, Pharos Research

Oversupply Concerns Offset Gains from Higher Infrastructure Spending

Even if demand picked up on higher infrastructure spending, we realize that the new capacities expected to come on stream would create pressure on prices and utilization rates amongst existing players. Demand has to grow at a CAGR of 11.3% over the coming 3 years to maintain the same utilization rate by 2019, which in our view, is highly unlikely. We estimate that demand will grow at a CAGR of 5.4% between 2015 and 2020 on the back of higher infrastructure spending, to hit 70 million tons by 2020, which is roughly equivalent to the industry's current nameplate capacity. Furthermore, the new capacities should come on stream to take market supply to north of 100 million tons per annum (assuming that existing players as well as new market entrants will execute their capacity expansion plans).

Oversupply to dominate the outlook, since the industry is operating at a capacity utilization rate north of 75%

Regional Markets Are Difficult to Access

We rule out the alternative that companies would resort to exports to mitigate oversupply issues and/or source foreign currency, given low commodity prices and political instability in neighboring countries, in addition to the buildup of excess supply in the region, creating potential competition on the exports front. Based on market intelligence, clinker inventories in Saudi Arabia and Turkey hover around 23.9 and 4.9 million tons, respectively. Turkish and Saudi cement exports stood at 3.4 and 0.5 million tons, respectively.

Potential increase in demand insufficient to absorb the capacities that might come on stream

Additional Capacities Curb Potential Aggressive Price Inflation

We expect ex-factory prices to grow at a CAGR of 4.1% between 2015 and 2020, mainly on the back of a weaker EGP against the USD. In USD terms, our conservative estimates imply a selling price of c USD 53/ton by 2020 versus c USD 66/ton in 2015. In EGP terms, prices would range between EGP 587 and 631/ton in 2017 and 2020, respectively, reflecting the difference in exchange rates.

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Egypt Cement Sector At A Glance

Listed Players	ARCC	SVCE	MCQE	MBSC	SUCE	SCEM	TORA	ALEX
Last Price, EGP/Share	6.70	4.30	81.95	20.50	10.96	23.79	10.14	6.00
Market Cap, EGP mn	2,538	1,263	2,449	1,538	1,993	1,665	725	1,542
Capacity Utilization Rate, %	85.1%	112.5%	112.3%	111.6%	66.9%	75.2%	59%	77.0%
Sales, mn tons	4.0	2.7	4.5	3.3	8.0	2.4	1.9	3.9
Cement Revenue, EGP mn	2,212	1,019	2,646	1,781	4,247	1261	991	2,287
Ex-factory Price/Ton, EGP	553	578	589	532	529	524	522	594
COGS/Ton, EGP	386	465	423	491	460	399	492	484
GPM, %	29.7%	19.7%	28.2%	7.7%	13.1%	23.9%	5.7%	18.5%
Net Income, EGP mn	251.3	91.57	275.1	189.1	99.7	30.7	(63.7)	(181.5)
EPS, EGP	0.66	0.19	9.21	2.52	0.55	0.44	(0.89)	(0.71)
Price/Sales, x	1.2	2.0	0.9	0.9	0.3	1.3	0.7	0.7
P/E, x	10.2	13.8	8.9	8.1	20.0	54.2	n/m	n/m
EBITDA Margin, %	34.9%	15.8%	28.6%	16.0%	12.1%	13.3%	4.4%	18.2%
EV/EBITDA, x	4.3	10.3	6.1	3.2	2.8	10.8	20.0	7.9
BVPS, EGP	3.8	5.1	46.0	20.4	39.1	18.9	6.2	0.9
P/B, x	1.8	0.52	1.8	1.0	0.3	1.3	1.7	6.8
ROE, %	19.2%	3.8%	20.0%	12.4%	1.4%	2.3%	n/m	n/m
EV/Ton, USD	67	64	104	27	16	52	25	60
FY2015 DPS Declared, EGP	0.53	0.00	3.00	1.50	1.00	0.00	0.00	0.00
Dividend Yield, %	7.9%	0.0%	3.7%	7.3%	9.1%	0.0%	0.0%	0.0%
CFO, EGP mn	537	391	586	498	509	511	(79)	562
Net Debt, EGP mn	898	396	1,667	(634)	(560)	142	135	1,761
Net Debt/Equity, x	0.43	0.12	1.21	(0.42)	(0.08)	0.11	0.31	7.77

Source: Company Financial Statements, Pharos Research

Notes:

1 With the exception of ARCC, where we present our FY2016 estimates, figures included are based on 1H16 annualized figures, and SVCE figures are based on 1Q16 annualized figures.

2 ARCC figures are based on our estimates for FY2016. Revenues reported exclude non-cement revenues. Accordingly margins and related ratios show slight variations from the financial tables at the end of the report.

3 SVCE figures, specifically market cap, EV, CFO, BVPS and ROE exclude 75% of the book value of its investment portfolio, whereas net income excludes the income from the investment portfolio. Additionally, SVCE cement capacity is adjusted for its 47.6% stake in BMIC.

4 SUCE revenues represent cement segment sales only. COGS were pro-rated to reflect cement costs solely.

5 TORA sales volume and capacity utilization are based on our estimates.

Data as of September 1, 2016

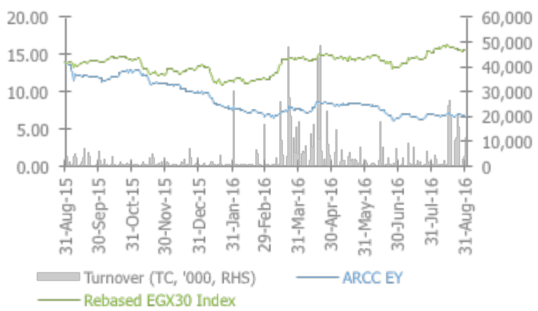
Arabian Cement Company (ACC)

Right Company; Wrong Time

ARABIAN CEMENT COMPANY

RECOMMENDATION	HOLD
Fair Value	8.58
Implied EV/Ton , USD	80.59
EV/Ton, USD	66.75
Reuters/Bloomberg	ARRC.CA/ARCC EY
Last Price, EGP/Share	6.70
Valuation Gap	28.1%
Shares Outstanding, mn	378.7
Market Cap, EGP mn	2,538
52W H-L, EGP/Share	13.98-6.00
52W ADTV, EGP mn	4.2

ARCC versus EGX30 (Rebased)



Shareholder Structure	
Aridos Jativa	60.0%
El Bourini Family	17.5%
Free Float	22.5%

Upcoming Dividend Date	30-Nov-16
Coupon, EGP/Share	0.33

Right Company; Wrong Time

While we realize that ACC is one of the most efficient listed cement producers and is trading below FV and regional emerging market peers, we expect the company to face strong headwinds, namely, 1) the new capacity expansion plans, 2) weaker EGP against the USD, which would result in higher debt repayments and higher energy costs, and 3) inability to offload excess supply due to inability to access regional markets.

Downgrade ACC FV to EGP 8.58/Share; Reiterate Hold Recommendation

We cut our DCF FV for ACC to EGP 8.58/share. Despite the presence of a 28.1% valuation gap, we believe the aforementioned risks will be a large drag on the outlook for cement prices and margins. Accordingly, we cautiously assign a “Hold” recommendation. In our view, the new capacities expected to come on stream by 2019/2020 are unlikely to be absorbed by the expected increase in demand due to higher spending on infrastructure.

Our assumptions discount ex-factory cement prices of EGP 587/ton for 2017, recording a CAGR of 2.8% over the next 3 years, mainly due to a weaker EGP against the USD. We project market dynamics to enforce a stable utilization rate of around 85% over our forecast horizon and estimate that EBITDA margins will level off from 34.9% in 2016 to 26.3% in 2020.

ACC is Trading at Par with Less Efficient Players

Despite its higher efficiency, ACC is trading almost at par with less efficient listed players on an EV/ton basis, at USD 67/ton. We believe that ACC’s higher efficiency is attributed to being one of the first cement players to shift to coal, whereas other players operate towards the high end of the cost curve. It is notable that on an EV/ton basis, the sector is trading significantly below replacement cost, which in our view could be explained by the unattractive sector developments that will continue to overshadow sector performance.

Ratio Analysis	2015a	2016e	2017f	2018f	2019f	2020f
EPS, EGP	0.72	0.66	0.95	0.90	0.74	0.93
P/E, x	9.3	10.2	7.1	7.5	9.1	7.2
BVPS, EGP	3.62	3.75	4.17	4.30	4.28	4.54
P/B, x	1.8	1.8	1.6	1.6	1.6	1.5
EV/EBITDA, x	5.2	4.3	4.5	4.6	5.3	5.0
DPS, EGP	0.53	0.53	0.53	0.76	0.76	0.66
Dividend Yield, %	7.9%	7.9%	7.9%	11.4%	11.3%	9.9%

Soft Recovery in Prices on a Weaker EGP Against the USD

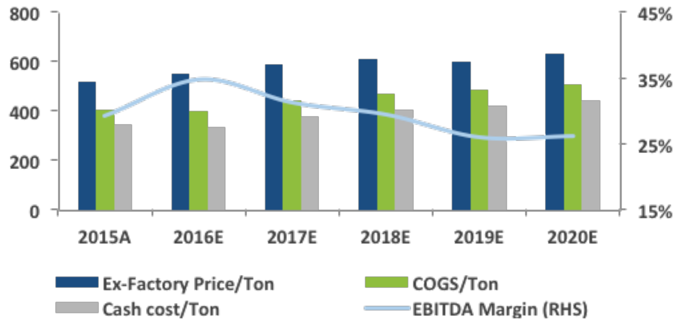
Based on the aforementioned dynamics, we expect ex-factory prices to grow at a CAGR of 4.1% over our forecast horizon, and utilization rates to hover around 85%. We expect the cash cost/ton (including transportation and other costs) to hover around EGP 337 in 2016. Starting 2017, we expect the cash cost to increase to EGP 379 on the back of 1) a weaker EGP against the USD and 2) the increase in electricity prices. Looking ahead, we expect the GPM to hover around 29.7% in 2016 versus 31.8% attained by the company in 1H16, and to decline to 21.1% when the new capacities come on stream. Additionally, we expect EBITDA margin to hover around 26.1% by 2019.

Energy Costs and Electricity Bills Will Rise Due to a Weaker EGP and the Government's Plan to Lift Subsidies

The energy mix stood at 78/11/11 for coal/diesel/RDF in 2015. We estimate the blended energy cost to hover around USD4.00/mmbtu over our forecast horizon, down from USD4.90/mmbtu in 2015. Energy cost is mostly stable in USD terms due to weaker local currency, despite our estimates that the blended energy cost will grow at a CAGR of 4.9% in EGP terms over the next five years. Additionally, we expect the company to gradually substitute reliance on diesel with RDF. However, we expect diesel to constitute a minimum of 3% of the energy mix, due to technical requirements.

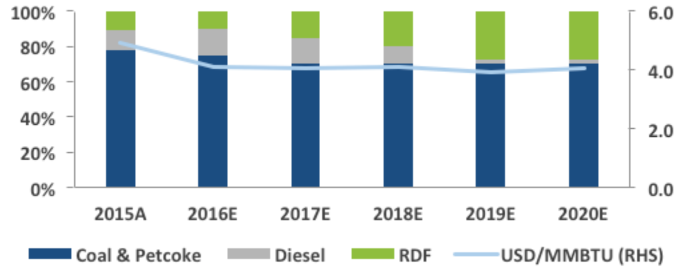
We expect rising energy costs and electricity bills in EGP terms to be a large drag on margins, assuming that the increase in COGS will not be fully passed on through prices, due to oversupply concerns. In addition, we conservatively expect electricity prices to increase by 20% in 2017 and again in 2018, followed by a moderate increase thereafter.

Figure 2 | EBITDA margin to soften over our forecast horizon, given oversupply concerns (EGP per ton)



Source: Company Financial Statements, Pharos Research

Figure 3 | Coal and pet coke to level off to 70% of energy mix; RDF to gradually replace diesel; USD4.00 energy cost/mmbtu

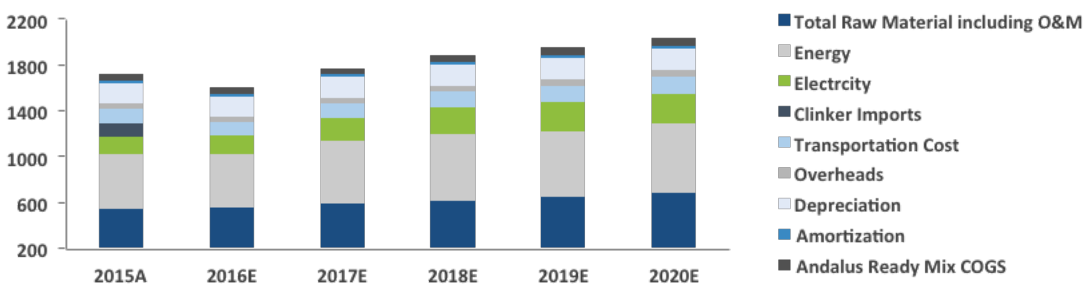


Source: Company Financial Statements, Pharos Research

Figure 4 | Coal prices are highly volatile; We expect a gradual pickup over 2017-2020 (USD/ton)

Source: Bloomberg, Pharos Research

Figure 5 | Raw material, energy and electricity determine the outlook for costs (EGP Mn)



Source: Company Financial Statements, Pharos Research

FX Challenges Weigh on Margins and Debt Repayments

ACC is negatively exposed to a weaker EGP, given that the company has an outstanding foreign currency denominated debt of c.USD 60 million and incurs coal cost in USD. While we realize that a weaker EGP against the USD would shield the industry from regional competition through imports, we point out that rising energy bills and debt repayments coupled with oversupply will weigh on margins, as noted above. We project ACC to book another sizable FX loss north of EGP 100 million in 2H16, assuming the official exchange rate moves to EGP10.95/USD, or the company continues to source FX from the parallel market at a significant premium.

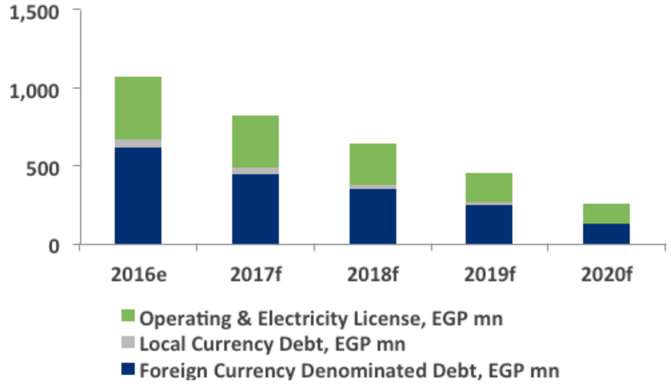
New Pet Coke Mill to Add EGP 80 Million to CAPEX; Results in Favorable Working Capital Dynamics

As per management guidance, the firm will spend EGP 60 million per annum in capex in addition to the one-off EGP 80 million to install another pet coke mill in 2017. Additionally, the new petcoke mill will allow the company to alternatively switch between the 2 mills during scheduled shutdowns, which will lead to less reliance on diesel, and thus result in favorable payment terms, which should reflect positively on working capital management, as per management guidance.

2017 Dividend Distribution in the Neighborhood of EGP 200 Million, Yielding 7.9%

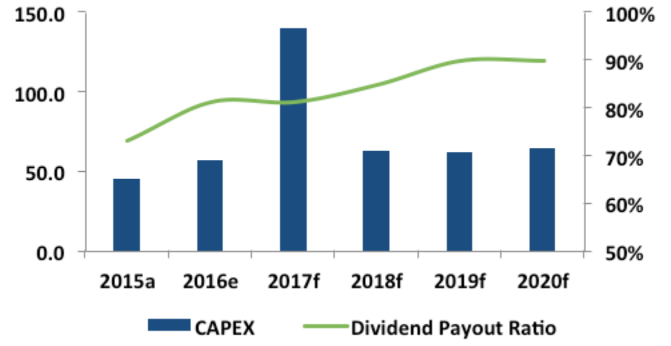
The company declared a cash dividend of EGP 200.7 million (EGP 0.53/share) in 2016 out of 2015 net income. As per management guidance, the company will pay another EGP 200.7 million in 2017 out of 2016 net income, implying a 81% dividend payout ratio. In the absence of guidance on expansion plans, we assume the dividend payout ratio will gradually increase to 90%. We will adjust our payout ratio in case the company announces further expansion plans.

Figure 6 | Foreign currency denominated debt rises on a weaker local currency, negatively impacting profitability



Source: Company Financial Statements, Pharos Research

Figure 7 | Dividend payout ratio gradually increases until the announcement of new expansion plans, if any



Source: Company Financial Statements, Pharos Research

Valuation

Our DCF yields a fair value of EGP 8.58/share, taking into account 1) soft recovery in ex-factory prices, mainly driven by a weaker EGP versus the USD, 2) pressured margins due to oversupply coupled with inability to fully pass on the increase in costs through prices, and 3) higher debt repayments, due to a weaker EGP against the USD.

Cost of Capital Assumptions	
Explicit Forecast Horizon	2H16 to FY20
Risk Free Rate	12%
Beta	1.0
Equity Risk Premium	7%
Cost of Equity	19%

Terminal Cost of Capital	
Risk Free Rate	6%
Beta	1.0
Perpetual Cost of Equity	13%
Perpetual Growth Rate	3%

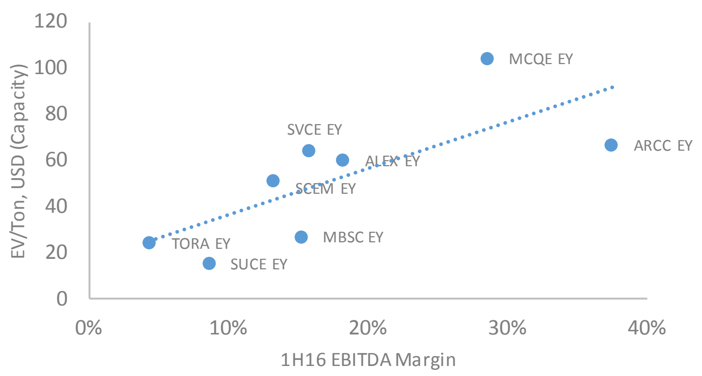
EGP mn, Unless Otherwise Stated	2H16e	FY17f	FY18f	FY19f	FY20f	Terminal
EBIT	271	552	532	432	469	
Taxes	(61)	(124)	(120)	(97)	(106)	
Labor Bonuses	0	(4)	(5)	(5)	(4)	
Reinvestment	173	119	142	180	141	
CAPEX	(25)	(140)	(63)	(62)	(65)	
Depreciation	89	182	187	190	193	
Amortization	11	23	23	23	19	
Change in Working Capital	98	55	(5)	29	(7)	
FCFF	383	543	548	509	500	515
PV of FCFF	357	434	373	293	238	
∑ PV of FCFF	1,695					
TV of FCFF						5,147
PV of TV	2,452					
Enterprise Value	4,148					
Debt*	1,152					
Cash*	254					
Equity Value	3,250					
Shares Outstanding, mn	378.7					
FV/Share, EGP	8.58					
EV/Ton, USD	66.75					
Implied EV/Ton, USD	80.59					

* Foreign denominated debt and cash are calculated based on EGP 10.95/USD

EV/Ton of ACC Paradoxically Below Less Efficient Rivals

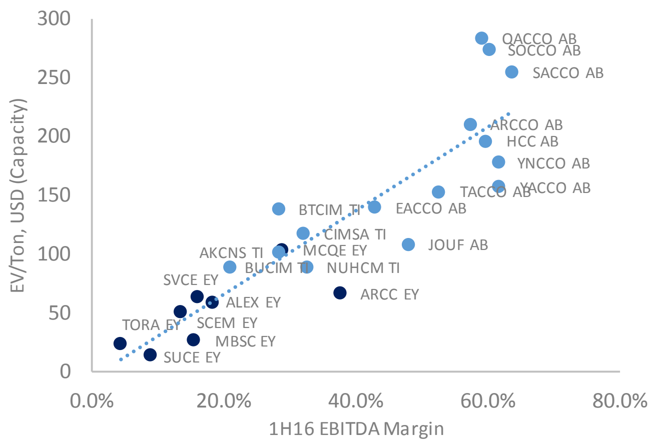
Despite being more efficient than other listed players, ACC is trading at an EV/ton of USD 67, which is below other less efficient players. Additionally, the sector is trading significantly below replacement cost, which is explained by 1) the government's EUR 1.05 billion deal with China-based Sinoma, 2) the current FX challenges, and 3) the oversupply concerns in the home market as well as neighboring markets.

Figure 8 | ACC is trading below peers whilst offering higher profitability



Source: Bloomberg, Pharos Research

Figure 9 | Compared to regional peers, ACC is trading at a lower EV/ton



Source: Bloomberg, Yamama Cement, Pharos Research

Upside Triggers

- Delays/cancellation of new capacity expansion plans, which would mitigate oversupply concerns
- Stronger-than-expected recovery in prices, due to stronger-than-expected increase in demand from infrastructure spending and the informal sector
- Lower-than-expected energy prices, which would yield higher margins

Downside Risks

- Lower-than-expected infrastructure spending coupled with a slowdown in the informal sector
- Weaker-than-expected EGP against the USD coupled with inability to fully pass on price increases, which would result in slimmer margins, booking higher-than-expected FX loss, and higher energy prices

Financial Statements

Income Statement, EGP mn	2015a	2016e	2017f	2018f	2019f	2020f
Revenues	2,273	2,276	2,413	2,509	2,470	2,593
COGS	(1,718)	(1,600)	(1,774)	(1,887)	(1,950)	(2,031)
Gross Profit	555	676	639	622	521	562
SG&A	(81)	(82)	(87)	(90)	(89)	(93)
EBIT	458	594	552	532	432	469
Net Interest Expense	(131)	(270)	(84)	(87)	(65)	(10)
EBT	327	324	468	444	367	459
Net Income	277	251	363	344	284	356

Balance Sheet, EGP mn	2015a	2016e	2017f	2018f	2019f	2020f
Cash and Equivalents	379	468	491	506	488	533
Working Capital	(265)	(213)	(268)	(263)	(292)	(285)
Other ST Assets/Liabilities, Net	(139)	(68)	(68)	(68)	(68)	(68)
Investment in Cash, WC and Other	(25)	187	156	176	129	181
Investment in LT Assets	2,780	2,638	2,573	2,427	2,276	2,129
Total Investment	2,755	2,825	2,729	2,603	2,405	2,309
Financed By	2,755	2,825	2,729	2,603	2,405	2,309
Shareholders' Equity	1,372	1,420	1,579	1,628	1,619	1,720
Interest Bearing Debt and LT Liabilities	1,383	1,404	1,151	975	786	590
LT Debt	358	488	372	256	127	-
ST Debt and Liabilities	294	255	186	196	200	181
Other LT Liabilities	731	662	592	523	459	408

Cash Flow Statement, EGP mn	2015a	2016e	2017f	2018f	2019f	2020f
EBT	327	324	468	444	367	459
Depreciation and Amortization	206	199	204	209	213	212
Change in Working Capital	167	(52)	55	(5)	29	(7)
CFO	712	537	624	559	533	565
CFI	(67)	(57)	(140)	(63)	(62)	(65)
CFF	(425)	(392)	(460)	(481)	(489)	(456)

Ratio Analysis	2015a	2016e	2017f	2018f	2019f	2020f
GPM, %	24.4%	29.7%	26.5%	24.8%	21.1%	21.7%
EBIT Margin, %	20.1%	26.1%	22.9%	21.2%	17.5%	18.1%
EBITDA Margin, %	29.2%	34.9%	31.4%	29.5%	26.1%	26.3%
NPM, %	12.2%	11.0%	15.0%	13.7%	11.5%	13.7%
ROAA, %	8.2%	7.5%	10.9%	10.5%	9.1%	11.8%
ROAE, %	20.8%	18.0%	24.2%	21.5%	17.5%	21.3%
Net Debt/Equity, x	0.5	0.4	0.2	0.1	0.0	-0.2
CCC, days	-40	-58	-53	-54	-54	-54
EPS, EGP	0.72	0.66	0.95	0.90	0.74	0.93
P/E, x	9.3	10.2	7.1	7.5	9.1	7.2
BVPS, EGP	3.62	3.75	4.17	4.30	4.28	4.54
P/B, x	1.8	1.8	1.6	1.6	1.6	1.5
EV/EBITDA, x	5.2	4.3	4.5	4.6	5.3	5.0
DPS, EGP	0.53	0.53	0.53	0.76	0.76	0.66
Dividend Yield, %	7.9%	7.9%	7.9%	11.4%	11.3%	9.9%

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