

DG Khan Cement

Company Update

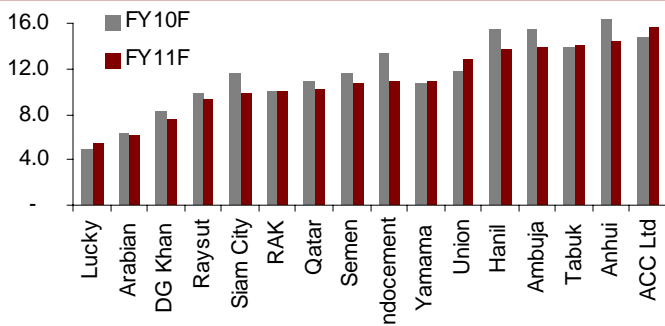
Checking cost inefficiencies

We reiterate our liking for DG Khan Cement (DGKC) given its anticipated earnings turnaround at the back of expected rise in local demand and easing cost pressures. Record allocation of PSDP and cut in excise duty will help re-ignite local demand whereas declining interest rates, falling coal prices and cost efficient operations will help ease off cost pressures. Hence, we have revised upward our earning estimates for DGKC to Rs4.6 per share for FY10F from Rs3.2 per share earlier. Resultantly, DGKC is expected to post a 3 year (FY10-13) profit CAGR of 17%.

The scrip has already posted a more than decent return year-to-date (adjusted 94%), however we believe there still remains a decent upside potential of 19% to our SOTP based target price of Rs45. The scrip currently is trading at a massive discount to the region on FY10F P/E and P/BV of 32% and 81% respectively. Moreover compared to local peers, DGKC is available on cheap multiples trading at FY10F PE and PBV of 8.2x and 0.3x. The key risks to our thesis are: (1) major slowdown in export sales and (2) price war between local cement manufacturers.

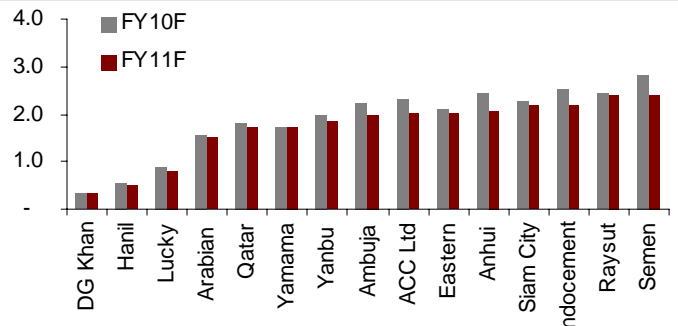
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Graph 1(a): Regional PE (x)



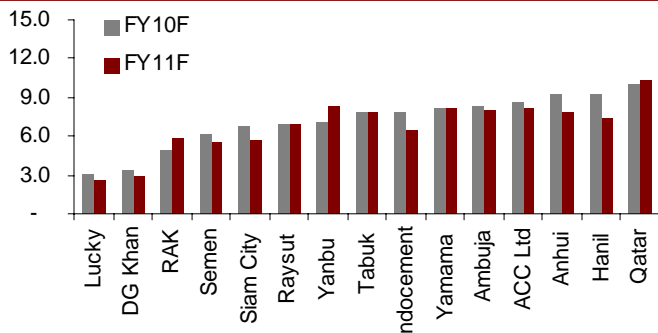
Source: Reuters, JS Research

Graph 1(b): Regional PBV (x)



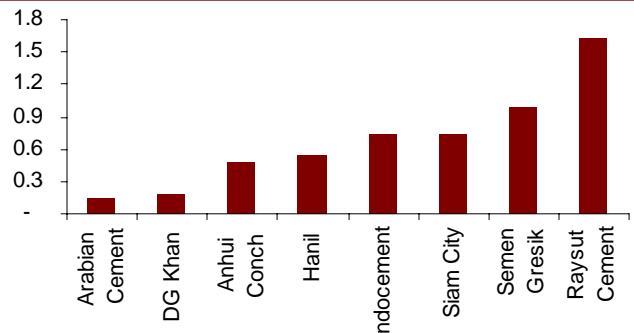
Source: Reuters, JS Research

Graph 1(c): Regional EV/EBITDA (x)



Source: Reuters, JS Research

Graph 1(d): Regional PEG FY10F (x)



Source: Reuters, JS Research

Valuation: Huge discount to the region

Though DGKC has posted a handsome return year to date (adjusted 94%) outperforming the market by 60%, we believe the scrip still has more to offer with expected earnings turnaround amid 1) rise in local demand due to record PSDP allocation, 2) increased share in export sales due to identification of new export markets and 3) cost-efficient measures.

The stock is currently trading at a FY10 P/E and P/BV of 8.2x and 0.3x respectively translating into a significant discount of 32% and 81% respectively to the region. The region is currently trading at a P/E of 12.1x and P/BV of 1.9x. Moreover, DGKC on current multiples looks cheap when compared to local peers while historical premium on PE to local competition further validates our stance. The scrip is currently trading at a discount of 22% to local peers on one year forward multiples with a 45% huge discount on P/BV. Hence, we believe it still offers a decent upside of 19% at our target price of Rs45.

Positive triggers

Budgetary & post-operation rehabilitation to boost local demand

Budget FY10 left a positive impression on the cement sector. Amongst the measures announced, record allocation on PSDP of Rs621bn and decrease in federal excise duty (FED) by Rs200 per ton (Rs10 per bag) were reasons to cheer for cement manufacturers.

PSDP allocation of Rs621bn (up 60% from last year) is a major boost for cement manufacturers. Not only does it bode well for FY10, it also shows governments inclination towards infrastructure development in the coming years. This is also evident from the fact that 52% of the fund has been allocated towards infrastructure development with several dam building projects including 4,500 MW Diamer Bhasa Dam (worth Rs1.1trn) to meet country's energy crisis. Construction of Bhasa Dam is likely to generate an average of 1.5-2mn tons per annum of demand over the next 5 years while 5 small dams will help shore up demand by 12-15mn tons over the course of 5-6 years.

Table 1: PSDP allocation for on-going and new dam projects (Rs mn)

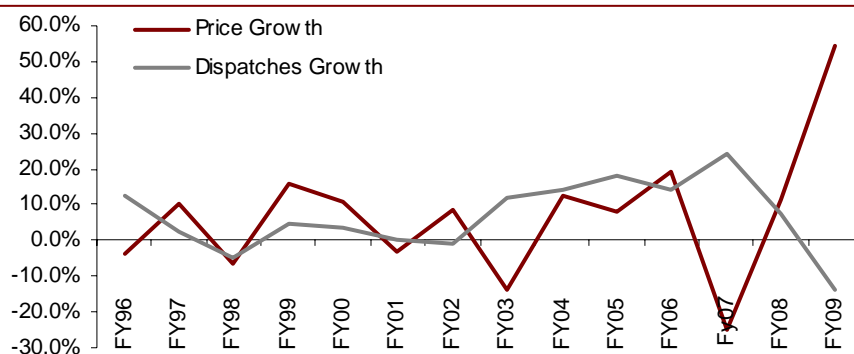
Ongoing Schemes		New Schemes	
Raising of Mangla Dam	12,000	Diamer Basha Dam	14,500
Gomal Zam Dam	2,000	8 small-medium dams in Balochistan	800
Delay Action Dams, Balochistan	600	8 small-medium dams in NWFP	700
Naigaj Dam, Dadu Sindh	400	8 small-medium dams in Sindh	500
Mirani Dam	314	8 small-medium dams in Punjab	500
Saakzai Dam	280	Tank Zam Dam	500
20 small Dams in NWFP	200	Bara Dam (FATA)	200
Porali Dam, Balochistan	200	100 small dams in Balochistan	200
Restoration of Bolan Dam	100	Small Dam at Torawaria	80
Others	300	Small water storage dam in Dureji	10
Sub-total	16,394	Sub-total	17,990
Grand Total			34,384

Source: Planning Commission of Pakistan

Reduction in FED by Rs200 per ton (Rs10 per bag) is another positive as Rs10 per bag have been passed on to the consumer. Local cement demand had been lackluster in the outgoing year FY09 (down 14%) with record high cement retail prices being one of the major reasons.

Local retail prices have averaged Rs340 per ton in FY09 compared to Rs220 in FY08, up 55%.

Graph 2: Local dispatches versus local prices



Source: APCMA, JS Research

Moreover, success in the SWAT operation will provide further boost to local demand as not only will it lead to reconstruction in war-torn areas, it will also help re-ignite earthquake rehabilitation activities within the region.

Exports sales, another ace in the pack

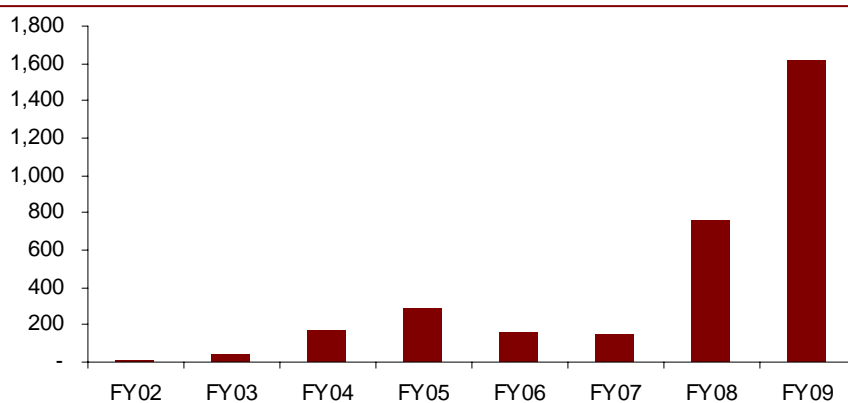
DGKC posted astounding growth of 113% in export sales in the outgoing fiscal year – improving its market share in the export market to 14% from 10% earlier. Since major chunk of DGKC’s exports have been to Afghanistan and India, its exports sales are less vulnerable to capacity overhang in the Middle East. However, with Middle East also part of its exports market, DGKC have been proactive to seek new markets like Sri Lanka, Lebanon and Sudan to cover for future expected loss in sales in the Middle East.

Table 2: Pakistan export markets (share)

Countries	8MFY09	8MFY08
Afghanistan	28.0%	36.7%
Qatar	12.0%	16.4%
Oman	10.4%	6.1%
U.A.E.	10.0%	9.0%
Djibouti	8.1%	9.8%
Other	7.0%	1.3%
India	6.9%	10.4%
Iraq	6.4%	1.1%
Kuwait	4.7%	2.2%
Bahrain	2.3%	0.0%
Sri Lanka	1.5%	0.6%
UR of tanzania	1.4%	0.7%
Mozambique	1.1%	0.0%
Yemen	0.1%	5.4%
Iran	0.1%	0.0%

Source: TDAP

Graph 3: DG Khan's export sales (000 tons)



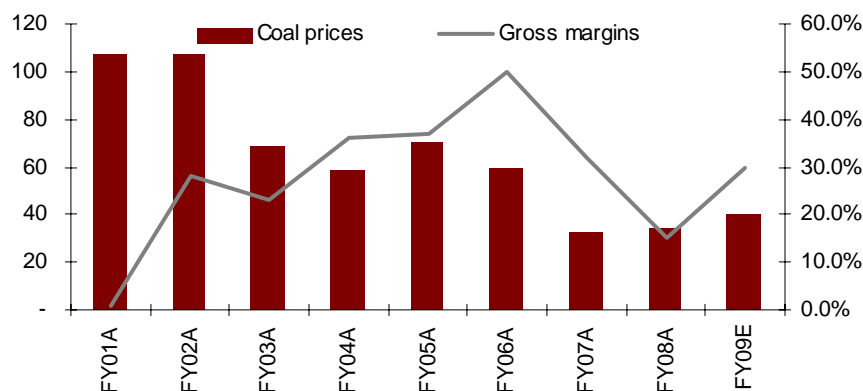
Source: APCMA, JS Research

Declining coal prices to ease off cost pressures

Coal prices, a major cost driver for cement manufacturers, have seen a sharp fall due to global economic slowdown. For our analysis, we have used MCIS (McCloskey Coal Information Services) NEW Steam coal (C&F) market price index which reveal that coal prices are down 69% from its peak. In second half FY09 coal prices averaged US\$68 per ton compared to US\$146 per ton in the first half. Hence full year average came down to US\$107 per ton compared to US\$110 per ton in FY08, down 3%.

With coal currently trading at US\$70 per ton, we are expecting coal prices to average at US\$85 per ton. Since cement sector profits are highly sensitive to coal prices we have run a sensitivity analysis to show impact of variances in coal prices.

Graph 4: Coal prices versus gross margin



Source: Company Accounts, JS Research, Reuters

Table 3: Sensitivity (EPS)

Δ in coal price	FY10F	FY11F
up 15%	3.7	3.9
up 10%	4.0	4.3
up 5%	4.3	4.6
Base case *	4.6	5.0
down 5%	4.9	5.4
down 10%	5.2	5.8
down 15%	5.5	6.1

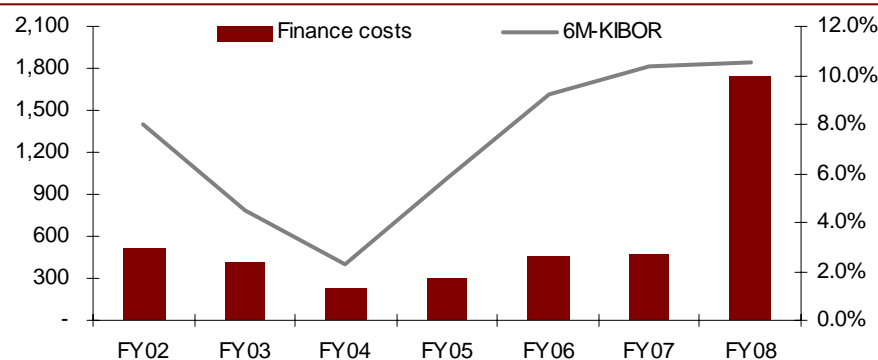
Source: JS Research

* FY10-US\$85/ton

Declining interest rates to rejuvenate bottom-line

We have seen a sharp decline in 6-month KIBOR which is currently trading at 11.91% down 379bps since the start of the year amid improving liquidity in the interbank market. This decline is expected to improve DGKC's profitability as it bodes a high debt to equity ratio of 98% (Mar 31,2009).

Graph 5: 6-month KIBOR versus finance cost



Source: Company Accounts, JS Research, SBP

Our average full year (FY10) 6-month KIBOR expectation is 11% down 314bps from FY09 average. According to our analysis, reduction in interest rates by 100bps will result in improvement of profits in the band of 2-5%.

Cost efficient projects to enhance efficiency

DGKC have been looking out for operational upgrades to reduce its energy and maintenance costs. In this regard, two significant projects were initiated. Out of which cement grinding mill has already started commercial production. The facility is said to be the world's largest vertical cement grinding mill with a capacity of 5,000 tons per day. It is expected to reduce energy consumption which constitutes 45% of the total cost of production in the range of 32-35%. Moreover, it will help reduce maintenance costs compared to its conventional ball grinding cement facility.

Table 4: Sensitivity (EPS)

Δ in KIBOR	FY10F	FY11F
up 150bps	4.26	4.86
up 100bps	4.38	4.91
up 50bps	4.49	4.96
Base case *	4.61	5.01
down 50bps	4.72	5.06
down 100bps	4.84	5.10
down 150bps	4.95	5.15

Source: JS Research

* FY10-6-month KIBOR of 11%

Work on Waste Heat Recovery Project with a capacity of 10MW is also under way. It is expected to come online in Oct-Nov 2009 and is expected to help reduce power costs in the range of 25-30%.

Impairment: Not a cause of concern anymore

In the 3QFY09, DGKC recognized an impairment loss of Rs155mn while deferring Rs527mn over the next 3 quarters in accordance with the SECP relief. However, thanks to significant rise in its portfolio value during 4QFY09, no impairment loss needs to be recognized, thus boosting DGKC's future profits.

Equity portfolio boosting valuation

Another factor augmenting our target price is the increase in the portfolio value. DGKC has equity investment stakes in MCB Bank (9%), Nishat Mills (13%) and Adamjee Insurance (3%). All of these have seen a significant price increase since the start of the year, up 53%, 84% and 5% respectively. Currently, market value of DGKC equity portfolio comes to Rs38 per share. Hence equity portfolio alone provides tremendous value to the investor.

Risks

Slowdown in exports

Local cement manufacturers benefited from early capacity expansion when compared to its regional peers. This is evident from rise in export's share in total dispatches to 37% this year from 26% in FY08. However, major capacity expansions are expected to come online in the Middle Eastern region which will hurt exports going forward. Though success has been achieved to a certain degree in exploring new markets like Sudan, Lebanon and Sri Lanka, it still remains a major risk to our earning estimates.

Table 5: GCC cement capacity expansions by FY10 (mn tons/annum)

Country	Capacity in 2007	Proposed capacity expansions	% change
Bahrain	0.6	0.4	66.7
Kuwait	2.9	-	-
Oman	3.6	1.8	50.8
Qatar	1.5	1.1	76.9
Saudi Arabia	26.6	33.2	124.9
UAE	14.7	22.7	154.6
Total GCC	49.8	59.2	118.9

Source: MEED

Price war

Currently a cartel like price arrangement exists in the local market with 50kg cement bag being sold in the region of Rs330-350. Demand & supply dynamics do not justify such high price levels. Hence any break in the price cartel will lead to substantial decline in prices which will in turn hurt margins of the company.

Table 6: Earnings sensitivity to change in retention prices

	FY10F	FY11F
up 15%	8.8	9.6
up 10%	7.4	8.1
up 5%	6.0	6.6
Base case *	4.6	5.0
down 5%	3.2	3.5
down 10%	1.8	1.9
down 15%	0.4	0.4

Source: JS Research, * FY10-Retention price Rs205

DG Khan Cement

Year ended June (Rs mn)	FY07A	FY08A	FY09E	FY10F	FY11F
Income Statement					
Net sales	6,420	12,446	18,076	16,191	17,541
CGS	4,388	10,532	12,713	11,071	12,971
Gross profit	2,032	1,914	5,363	5,120	4,570
EBITDA	2,658	2,844	5,464	4,938	4,549
Other income	465	839	749	763	844
EBIT	2,189	1,497	4,384	3,842	3,490
Financial charges	468	1,750	3,028	1,843	1,323
PAT	1,622	(55)	971	1,402	1,524
Balance Sheet					
Paid up capital	2,535	2,535	3,042	3,042	3,042
Unappropriated profit	31,388	27,543	28,514	29,916	31,439
Shareholder's Equity	33,923	30,079	31,557	32,958	34,482
Long term liabilities and others	10,431	9,858	9,530	5,333	4,078
Current liabilities	7,390	12,055	14,050	16,002	18,309
Total Liabilities & Equity	51,744	51,991	55,137	54,293	56,869
Total Fixed Assets	24,158	25,471	25,533	25,166	24,849
Other assets	8,371	7,319	6,523	4,523	4,523
Total current assets	19,215	19,201	23,081	24,604	27,498
Total Assets	51,744	51,991	55,137	54,293	56,869
Ratio Analysis					
Valuation					
Eaming per share	5.3	(0.2)	3.2	4.6	5.0
Dividend per share	1.5	-	-	0.5	1.5
Book value per share	133.8	118.6	103.7	108.3	113.3
Price to earning ratio (x)	14.8	NM	11.8	8.2	7.5
Price to book value (x)	0.3	0.3	0.4	0.3	0.3
Profitability					
Gross margin	31.7%	15.4%	29.7%	31.6%	26.1%
Operating margin	29.0%	10.0%	20.5%	19.6%	15.8%
EBITDA margin	41.4%	22.8%	30.2%	30.5%	25.9%
Net margin	25.3%	-0.4%	5.4%	8.7%	8.7%
Return on assets	3.1%	-0.1%	1.8%	2.6%	2.7%
Return on equity	4.8%	-0.2%	3.1%	4.3%	4.4%
Momentum					
Sales growth	-19.3%	93.9%	45.2%	-10.4%	8.3%
EBITDA growth	-37.3%	7.0%	92.2%	-9.6%	-7.9%
Net profit growth	-32.9%	-103.4%	-1873.7%	44.4%	8.7%

Source: JS Research

KATS Code: DGKC

Bloomberg Code: DGKC PA

Reuters Code: DGKH.KA

Market Price:
Rs37.73

Market Cap:
Rs11.5bn
US\$139.9mn

1-yr Avg. Daily Volume:
6.2mn shares
Rs179.4mn
US\$2.2mn

1-yr High/Low:
Rs60.25/13.01

Estimated free float:
139.5mn shares (45.2%)

Company background

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. In 1992, DGKC was acquired by Nishat Group under the privatization program.

DGKC is a producer and seller of ordinary portland and sulphate-resistant cement. It has a countrywide distribution network and its products are preferred on projects of national repute both locally and internationally due to the unparalleled and consistent quality.

Table 7: Key Events

1978	DGKC established under the management control of State Cement Corporation of Pakistan Limited (SCCP)
1986	Commercial production started with 2000 tons per day (TPD) clinker based on dry process technology
1992	DGKC acquired by Nishat Group under the privatisation programme
2007	Inaugural ceremony of Khaipur cement plant was held, in the presence on Mr Shaukat Aziz
2008	Work on the project of Power Generation from waste heat at DGKC, capable of producing 10.4MW, is under way with civil work and fabrication work already started
2009	The World's largest Vertical Cement Grinding Mill at D.G. Khan Site started its commercial operations

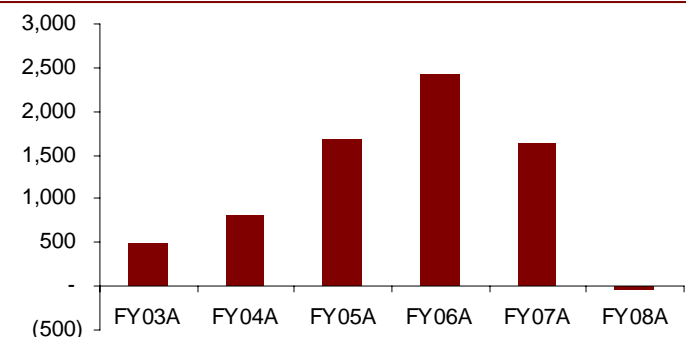
Source: Company accounts

Key Management Personnel

Mr. Mian Raza Mansha – Chief Executive

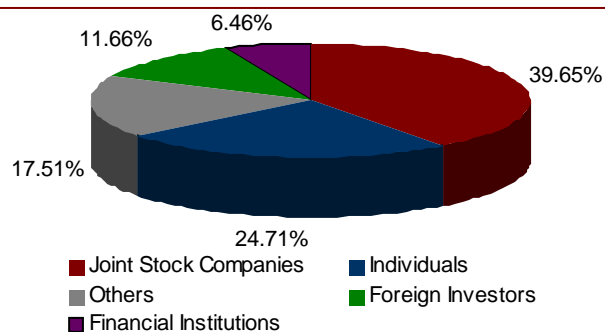
Mr. Mansha, a graduate from the University of Pennsylvania currently serves as Managing Director and Chief Executive of DG Khan Cement Co. Ltd. Mr. Mansha also serves as the Director of MCB Bank Limited, Nishat Hotels and Properties Limited and Nishat Power. In addition to that, Mr. Mansha serves as Non Executive Director of Sui Northern Gas Pipelines Ltd and as a Director of JS Value Fund Limited. His past experience includes serving as a Director of BSJS Balanced Fund.

Graph 6: Historical PAT (Rs mn)



Source: Company accounts

Graph 7: Share holding pattern



Source: Company accounts

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