

July 24, 2009

Pakistan Market

DGKC: Checking cost inefficiencies

MORNING BRIEFING



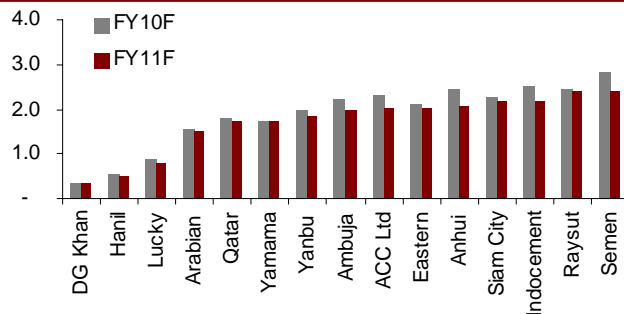
KSE100 Index: Closing 7863.86 ↑ (+61.05)

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.

Graph: Regional PBV (x)



Source: Reuters, JS Research

Positive triggers

Budgetary measures 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.

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.

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 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.

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).

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. 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%.

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.

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.

For more details please refer to our short report titled "DGKC: Checking cost inefficiencies" released earlier today.

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