

Cement sector in pakistan

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INTRODUCTION

Major constituents of the cost are energy & power - over 60% of the cost of production of cement - and transportation costs. In addition to these elements efficiency of the production process is critical in keeping the overall cost structure competitive. In this regard, the size of the plant, its age, and origin - European or Chinese - are of importance. Until recent years, almost all the plants operating in the country were based on furnace oil, but the increasing furnace oil prices forced the cement industry to switch over to Coal-powered/dual-fuel plants. However, the price of coal has shown significant volatility over the recent periods therefore, some producers, having dual-fuel plants, use a mixture of coal and gas, alternating between the two as per changes in prices and availability.

Cement Sales during FY-10 Compared To FY-09 Source: All Pakistan Cement Manufacturers' Association As per All Pakistan Cement Manufacturer's Association (APCMA), the cement sales in FY-10 totaled 34. 20 million tons, registering a decent Year-on-Year (YoY) growth of 9. 30% compared to 31. 29 million tons in FY-09. The local dispatches remained at 23. 54 million tons, up YoY 14. 63% compared to 20. 53 million tons in FY-09 whereas export sales in FY-10 remained almost flat with a minor decline at 10. 66 million tons, down YoY 0. 89% compared to 10. 75 million tons in the previous year. As shown in the table, the local sales were the primary driver behind the growth. It is pertinent to note that the growth on the local front was mainly private-sector driven rather than the Government's infrastructure spending, showing signs of recovery in the construction sector.

INDUSTRY STRUCTURE

Industry Characteristics

The cement industry is highly cyclical in nature and its performance depends largely upon the economic growth of the country. There is a high degree of correlation between GDP growth and the growth in local cement consumption. Source: State Bank of Pakistan & All Pakistan Cement Manufacturers' Association Cement exports depend largely upon the demand/supply situation, price levels, and economic situation in the export regions. Cement, being a voluminous product, is a regional commodity.

Critical Factors

The cyclical nature of the sector along with the excess supply situation, whenever it persists, makes cement price a very critical factor. Some level of industry 'co-opetition', i. e. cooperative competition, is evident in cement industries globally such as consensual pricing. In the absence of such an arrangement, along with a supply glut, cement industries have witnessed intense price wars. Power & Energy costs constitute over 60% - 65% of the total cost of cement production. Therefore, smart inventory management of coal, along with hedging techniques, etc. lead to significant savings in energy costs. Plants closer to the port have cheaper access to exports and can maintain higher profit margins. Therefore, distance to port is an important consideration. Leverage, both financial and operating, is a major concern owing to the price-sensitivity of the sector. Pakistan's cement sector is highly leveraged. Cautious capital structure management and utilization of relaxations/incentives provided by the government, whenever possible, such

as the Export Refinance facility offered by the State Bank of Pakistan, create a significant difference.

Industry Concentration

Concentration refers to the number of major competitors in a given industry. This has important implications for the inherent profitability of a sector. We have applied the Eight-Firm concentration ratio to determine the concentration in the cement sector. Concentration ratios can generally be categorized into low, medium, and high concentration being 0% - 50%, 50% - 80% and 80% and above, respectively. An eight-firm concentration ratio over 90% is a good indication of oligopoly, i. e. an industry dominated by a small number of sellers. Based on FY10 market shares, the Eight-Firm concentration ratio in the cement sector is 80% which shows clear signs of high industry concentration. Therefore, the cement sector has an oligopolistic structure. However, given the excess capacity situation cement industry has been behaving like a ' low concentration industry' from time to time such as the intense price war in the recent past, pning nearly a year, with participants vying for higher volumes.

Market Share

The following pie-charts show the local, export, and total market shares of the top 8 players in the sector for FY-10. The charts show that D. G. Khan Cement is the leading player in the local market (17% market share) closely followed by Bestway (16. 7%) and Lucky Cement (13. 3%). In the export market, Lucky cement leads with its roaring 32. 8% share, followed by D. G. Khan and Bestway cement's 9. 3% share each. Overall, Lucky Cement

appears to hold the highest market share (19.4%), followed by D. G. Khan (14.6%) and Bestway (14.4%). Maple Leaf Cement ranks fourth in all three categories with 9%, 11.1%, and 9.7% market share in the local, export, and the overall market. Source: Fortune Securities .

SECTOR OVERVIEW

FY10 Cement Sector in FY-10 witnessed low prices, rising energy costs, the slowdown in construction activities locally and regionally, and a large amount of new supply availability in regional markets resulting in drying out of certain lucrative export avenues especially the Middle East. However, exports to African countries, Iraq, Sri Lanka, etc. mitigated the effect and exports remained flat at 10.66 million tones (YoY down 0.89%). As expected by market participants and analysts local sales picked up to close the year at 24.53 million tons (YoY up 14.63%). Overall, the sector closed the year at 34.20 million tones, registering a decent YoY increase of 9.30%. Cement prices and energy costs remained the key issues in FY-10. Since the dismantling of the alleged cement cartel, after the Competition. Commission of Pakistan imposed a fine in the colossal sum of Rs. 6.35 billion on 20 cement manufacturers (equivalent to 7.5pc of each company's FY08 net revenue), in August 2009, cement prices plunged and went down to Rs. 249/bag in North and Rs. 280/bag in the South zone, compared to Rs. 335/bag and Rs. 370/bag in FY09 in North and South, respectively.

CCP's decision has been challenged by the cement manufacturers on a number of grounds in the Lahore High Court, the Sindh High Court, and the Supreme Court of Pakistan. In all these cases stay orders have been granted

by the Courts and the matter awaits the court's verdict. Given the increased overall supply in the regional markets, the cement export price hovered around \$47-\$52 per tone, compared to the average export price of \$60-\$62 in FY09. On the other hand, energy costs remained on the rising trend and coal prices averaged around \$88 (FoB) per ton compared to the 2nd half FY-09 average of \$70. Australian (Newcastle) coal price made its 18-month high of \$108 (FOB) per ton on April 27, 2010, after making a low of around \$61 (FoB) per ton in Mar-09 last year. Thus, as a result of subdued prices and increasing energy costs, a sub-breakeven scenario prevailed in the industry for the most part of FY-10. In 9 months FY10, cement companies posted cumulative losses of Rs. 3.3 billion compared to profits of Rs. 3.7 billion in the corresponding period last year, YoY down 189%. Cement prices hiked by Rs. 40 per bag in North in June 2010. With no price moves in South – a region that was already enjoying higher prices due to lower intensity of price war largely for its geographical advantages – prices in the two regions finally came at par. FY-10 also saw the announcement of a 35% inland freight subsidy, during March 2010, on cement exports. It is likely to make Pakistan's cement exports more competitive in the regional market, as cement manufacturers will be able to reduce their export prices by almost 10% going forward, if needed, without hurting their margins. However, the government needs to make timely payments to the manufacturers for the subsidy to be of much use.

SECTOR OUTLOOK

Local market. Short Term Cement prices have risen by Rs. 24 per bag since the beginning of the ongoing financial year to Rs. 312 and Rs. 325 per bag in

North and South, respectively. This bodes substantially well for the sector after bleeding profusely in a price war and indicates a price consensus among the manufacturers. Also, we believe there is a limited appetite for price wars going forward especially as seasonal 1Q demand slowdown kicks in (Monsoons, floods, Ramadan, etc.). The recent floods have severely affected the roads and the distribution network which will inevitably hurt the local cement sales as well as export sales to some extent. We expect cement demand from the local market to remain subdued during the first half of FY11, due to monsoons, flood-related issues, the slowdown in construction during winters, etc. , and start picking up from 3Q FY-11, in the wake of reconstruction activities. Overall, we expect local dispatches to remain flat during FY-11 and believe that the real impact of the increased demand from reconstruction activities will materialize during FY-12. We believe the cement prices have hit the ceiling for now and do not expect further increase in them and expect the recent price hikes to sustain for a relatively longer time than the one-step ahead, two steps back situation that prevailed throughout FY-10. Going forward, Fauji Cement's capacity expansion, due in FY-11, of 2. 27 million tons, would create downward pressure on utilization levels. However, we expect capacity utilization levels to remain between 70% to 75% range.

Medium to Long Term

We have a positive outlook for the local market on a medium to long-term basis. The rehabilitation work along with the construction of dams will boost demand and possibly push prices upwards as cement manufacturers operate on higher and higher capacity utilization levels. Construction of dams seems inevitable given the power crisis and the recent flood. The Council of

Common Interests (CCI) unanimously approved the construction of Diamer Bhasha dam on July 18, 2010, leading the way for the release of funds from the Asian Development Bank (ADB). The projected timeline for completion is stated by the end of 2019. Manufacturers estimate a total requirement of 9.0 to 11. million tons of cement for the project with annual demand in between 1.0 to 1.5 mn tons. While all northern manufacturers would directly or indirectly benefit from the project, we believe the big players such as Askari and Bestway would be the key beneficiaries with proximity to the project.

5.9 Export Market We are pessimistic about the export dispatches during FY-11 owing to i) increased availability of cement in the regional markets, especially after lifting of the export ban in Saudi Arabia, ii) slowdown in construction in the Middle East and iii) local transportation problems ensuing from the flood. Therefore, we expect a decline of 10-15% in exports during FY-11. Our export price outlook remains flat around \$45, keeping in view the competitive environment in the export market. During FY-10 exports to Qatar, Oman, UAE, and Kuwait declined whereas exports to Afghanistan, Djibouti, Sudan, Sri Lanka, and other African Countries increased, as shown in the chart. We expect the trend to continue going forward as cement producers penetrate further into the African markets.

Source: TDAP 5

FINANCIAL ANALYSIS - CEMENT MAJORS

On the 9M-FY10 basis, the top-7 cement players face a tight liquidity situation with the Current ratio at 0.71x, Quick ratio at 0.63x, Cash Ratio at 0.05x and an Operating Cash Flow ratio at 0.16x. Among the Top-7, Attock Cement is the most liquid with a Current ratio at 2.67x, Quick ratio at 2.33x,

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Cash ratio at 0.66x, and Operating Cash Flow ratio at 1.02x. Overall, the Top-7 Average liquidity ratios show a low ability to settle short-term financial obligations as well as finance additional sales without incurring further debt.

6.11.2 Financial Leverage (average) among the top-7 cement players is at 0.1x, which seems moderate. Bestway, Maple Leaf, and Pioneer Cement have financial leverage at 2.32x, 3.56x, and 1.64x, respectively, which is high. Lucky and Attock Cement have financial leverage in control, at 0.35x and 0.25x, whereas D. G. Khan Cement's financial leverage stands at 0.67x. The average Interest Coverage ratio is at 1.04x, which means, on average, the cement players barely have enough earnings to meet their finance charges. Given the high financial leverage and low-Interest Cover, we believe cement companies' ability to take on further financing is highly subdued, with the exception of Lucky and Attock Cement.

Asset Utilization

We have adjusted the Asset Utilization ratios to reflect the full year (extrapolated) sales by a 4/3 adjustment factor. The resulting ratios, fixed asset turnover at 0.65x, and total assets turnover ratio at 0.45x, suggesting overall low asset utilization, point towards the capital intensive nature of the industry marred with low capacity utilization levels. Among the top-7 players, Lucky Cement seems to have the most efficient asset utilization with fixed assets turnover at 0.90x and total assets turnover at 0.75x levels. Lafarge Pakistan cement's asset utilization ratios rank lowest among the Top-7, being 0.3x and 0.11x on a fixed and total assets turnover basis, respectively. Lafarge's extremely low asset utilization levels call for further investigation into the causes.

6.11.4 Profitability We have adjusted the

Return on Assets (ROA) and Return on Equity (ROE) ratios to reflect the full year (extrapolated) sales by a 4/3 adjustment factor. The resulting ratios suggest moderate gross profitability and basic earnings power, at 21.26% and 9.68%, respectively. However, the final profitability is extremely low at 0.03% reflecting the sky-rocketing financial charges. Bestway, Maple Leaf, Lafarge, and Pioneer have negative net margins at -6.7%, -18.33%, -24.86% and -14.38%. Attock Cement appears most profitable during the period under review, with Net margins at 13.32% followed by Lucky Cement at 12.02%. Both these players have managed to post decent net profitability partially due to higher retention prices in the South, compared to North, and higher export contribution margins. During 9M-FY10, Maple Leaf, Lafarge, and Pioneer Cement posted negative Basic earnings power at -3.14%, -13.94% and -10.95%, respectively, which points towards the intense price war, especially in the North, throughout the period under review. D. G. Khan Cement has managed to post a decent EBIT margin, at 16.91%, however, the financial charges, which amount to Rs. 1.5 billion for 9M-FY10, have left only 3.79% in net margin.

DuPont Analysis is an expression that breaks Return on Equity (ROE) into three parts, profit margin, asset turnover, and equity multiplier representing, the operating efficiency, asset utilization efficiency, and financial leverage, respectively. Our DuPont analysis of the top-7 players suggests that the main reason behind the low industry ROE during the period under review has been low profitability. The price wars during the period under review, along with high financial charges have severely affected the ROE. Asset utilization is not too healthy either but is moderate.

financial analysis, we have a liking for Lucky and Attock Cement and feel that these are safe companies to lend to. D. G. Khan Cement seems to be understressat the moment due to its current maturity of long-term debts, worth Rs. 4 billion (approx.), and an O/S Forex loan of US\$ 40 million (FY-09 carrying value Rs. 3. 5 bn), payments commencing June 2011, therefore it is expected to go for re-financing arrangements with banks. However, strong sponsors' support, good reputation, largest local, and 2nd largest total market share, a large portfolio of liquid investments worth Rs. 17 billion (approx.), and Income from investments serve as strong mitigating factors. Bestway, Maple Leaf, and Pioneer Cement have financial leverage ratios at 2. 32x, 3. 56x, and 1. 64x levels which are certainly not sustainable. The DuPont suggests both profitability and leverage are a cause of concern for these companies. Lafarge Pakistan's low profitability and poor asset utilization have greatly affected its financial results. Overall, we recommend caution for the above three players.