Thatta Cement Company Limited (THCCL)

Sharply Improving Fundamentals; BUY with a target of PkR 133.6/sh

Thursday, September 19, 2024

We initiate coverage on Thatta Cement Company Limited (THCCL) with a BUY rating. Our Jun25 target price for the stock stands at PkR 133.6/sh, offering a potential upside of 157% along with the dividend yield of 4%, taking the total return to 161%. Our investment case is based on the following premise:

Utilization levels on the rise: Thatta Cement's plant operating rates rose sharply over the past two years compared to industry peers. Historically, its capacity utilization stood around **20pps below** the southern region's cement industry. During FY23 and FY24, its utilization rates came on par with the region. Given the company's exit from the APCMA forum, we foresee its utilization rates remaining higher in the coming years.

Monetary easing cycle to support construction activities: The prevalent monetary easing cycle will likely benefit Thatta Cement through an increase in construction activity. Falling interest rates may also induce demand from large-scale public sector projects as a lower debt servicing burden may create fiscal space to fund these projects.

THCCL may benefit as southern region's prices convergence: South cement players, including THCCL, may benefit from windfall gains as southern region's cement prices converges towards the northern region's pricing. Historically, south pricing was 8-10% higher than its northern counterpart as the south region's utilization rate was significantly higher. Recent years, however, saw northern region's price hikes outpace the south because of higher demand and an increased royalty charge. The north pricing now stands 10% higher than its southern counterpart. As demand resumes, the pricing differential may potentially narrow, benefitting THCCL from higher margins.

Heightened focus on production efficiencies: Thatta Cement is enhancing efficiency through green technologies, installing 3.5MW solar panels and a 4.8MW windmill to reduce reliance on the national grid. The company's current solar capacity is 3.4MW, and its waste heat recovery (WHR) stands at 4.0MW, contributing PkR 3.3/share to its bottom line.

Efficient fuel and power mix to enhance margins: THCCL's gross margins may rise from 28.8% in FY24 to 32.0% in FY25-FY27. EBITDA margins may also increase to 32.6-34.5%, driven by greater reliance on local coal, declining coal prices, higher utilization rates and improved power efficiencies.

Healthy cash flows may expedite efficiency projects or improve cash yields: THCCL's improved cash flows may support the company's plan to enhance its efficiency dynamics. Increase cash generation may also raise the company's potential cash yields. Notably, the company concluded its stock buyback of 15 million shares, signalling perceived undervaluation for its company.

THCCL	FY22	FY23	FY24	FY25F	FY26F
EPS	1.4	2.9	17.7	22.2	27.0
EPS growth	-41%	109%	503%	26%	22%
DPS	-	-	1	2	4
DY	0%	0%	2%	4%	8%
P/E	36.9	17.7	2.9	2.3	1.9
EV/EBITDA	7.9	2.5	0.0	0.9	0.2
ROE	4.4%	8.3%	41.7%	35.5%	31.5%

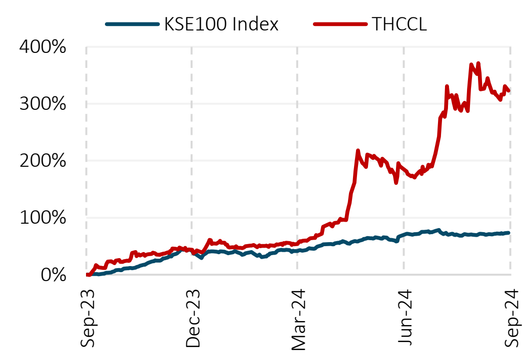
Source: PSX, Company Accounts, BMA Research

THCCL investment overview

KATS Code	THCCL
Bloomberg Code	THCCL PA
Market Price	PkR 52.0
Target Price	PkR 133.6
Upside	156.9%
1-Yr High/ Low	PkR 61.85/12.11
Estimated free float	30%
Share outstanding (mn)	99.7

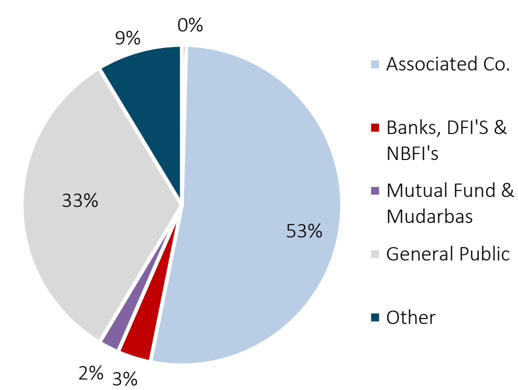
Source: PSX, BMA Research

KSE100 Index vs THCCL



Source: PSX, BMA Research

THCCL Shareholding



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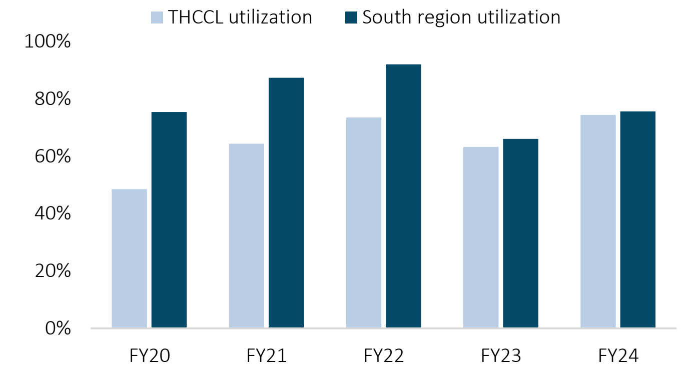
Higher utilization amidst exit from APCMA

Thatta Cement's capacity utilization averaged around 65% during the FY20-24 period, while the south region's utilization level averaged 79%. Thatta's low operating rates can be credited to the company's focus on the local market, operational issues and low demand in its vicinity.

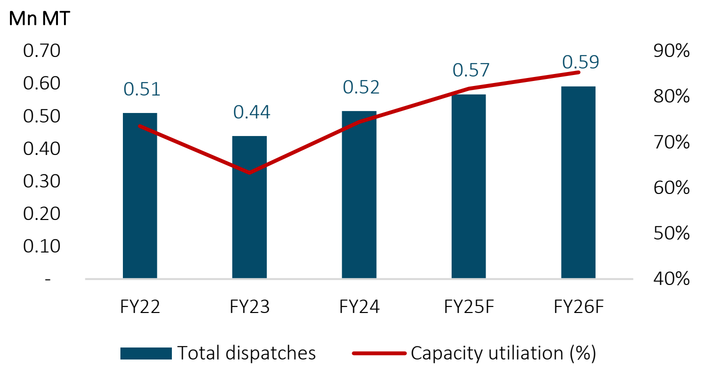
It is important to highlight that company has stepped out from the All Pakistan Cement Association (APCMA) forum recently. This move may be helpful in operating its plant at higher utilization levels. We have assumed utilization rates of 82%, 85% and 90% in FY25, FY26 and FY27 respectively.

Lower utilization compared to the region



Source: Company Accounts, APCMA, BMA Research

Utilization to pass 80% in FY25



Source: Company Accounts, BMA Research

We expect local cement demand to grow at just 2.8% in FY25 as Pakistan's economy emerges out of its stabilization phase. For Thatta, we have assumed local dispatches growth of 10% FY25, while other companies may see marginal growth. For the longer horizon, we foresee cement demand growth to accelerate because of improving fundamentals, including lower interest rates, a higher developmental budget and increased demand as the industry caters to its backlog. Moreover, the government has signed a USD 400mn loan for the Sindh Emergency Housing Reconstruction Project, part of the ADB's flood relief commitments. We believe this project will stimulate cement demand in the southern region.

Given these factors, we see **local cement demand growth of 4.3% in FY26**. Onwards, we have assumed average 6% growth in local sales amidst expectation of economic and political stability in the country.

Mn tons	FY22	FY23	FY24	FY25F	FY26F
North	40.35	33.85	33.00	33.90	35.32
Local	39.44	32.78	31.54	32.37	33.72
Export	0.91	1.07	1.46	1.52	1.60
South	12.55	10.73	12.29	12.84	13.48
Local	8.20	7.24	6.64	6.90	7.24
Export	4.35	3.50	5.65	5.94	6.24
Total Local	**47.64**	**40.02**	**38.19**	**39.27**	**40.96**
Total Export	**5.26**	**4.57**	**7.11**	**7.47**	**7.84**

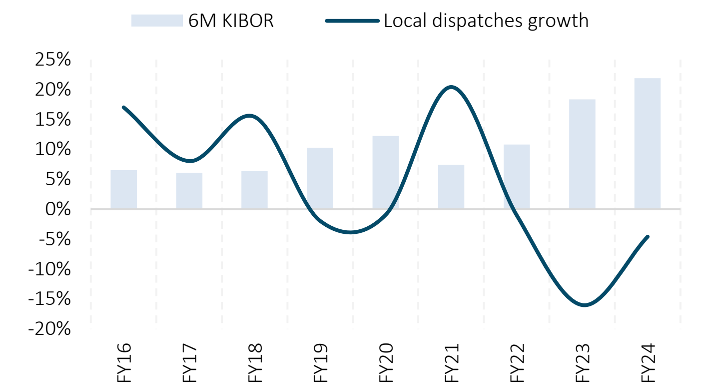
Source: APCMA, BMA Research

Monetary easing cycle to support construction activities

Easing inflationary pressures have allowed the State Bank of Pakistan (SBP) to begin its monetary easing cycle. Notably, inflation peaked at 38% in May 2023 before declining to a low of 9.6% by August 2024. In response, the SBP has reduced the policy rate by 450 basis points to 17.5% over the past few months. Furthermore, this monetary easing is likely to serve as a precursor to the recovery of Pakistan's economic cycle, which could benefit various industries, including construction.

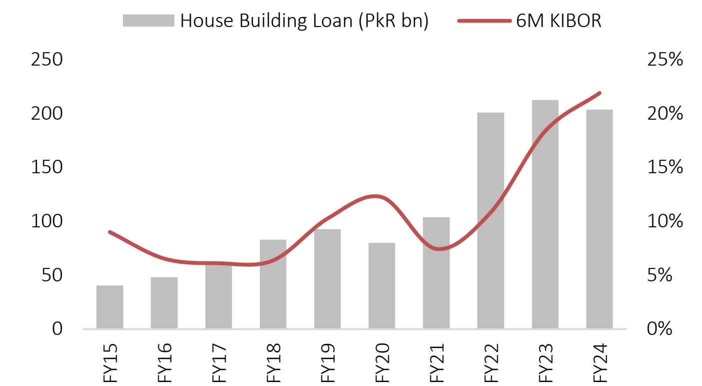
An analysis of borrowing trends for house construction in relation to the 6-month KIBOR indicates that borrowing increased during periods of low interest rates, supporting both house construction and purchases. However, in FY22 and FY23, borrowing surged significantly despite high interest rates. This unusual trend was driven by the government's decision to offer housing loans at rates between 3% and 9%, a policy aimed at stimulating the economy.

KIBOR vs local dispatches growth



Source: APCMA, SBP, BMA Research

KIBOR vs house building loan



Source: SBP, BMA Research

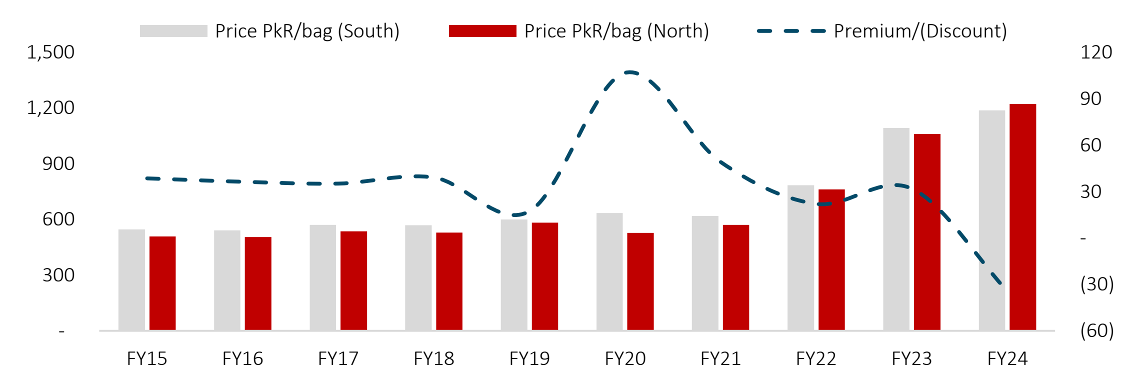
Price convergence would be good omen for THCCL

Over the past 10 years (FY14-23), cement prices in the south have averaged PkR 41 per bag higher than in the north. However, in FY24, the average prices in the north surpassed those in the south by PkR 34 per bag due to a sharper decline in local demand in the southern region. Notably, local cement demand in the south decreased by 8% in FY24, compared to a 4% decline in the north.

Currently the price difference between the two regions has further increased to PkR 120/bag because of a 6% royalty imposed on Punjab manufacturers for limestone and argillaceous clay.

The possibility that southern players might try to match the prices in the north cannot be ruled out, which could improve their margins. Our back of the envelope working suggests that for every PkR 10/bag increase in price, the annualized earnings impact on THCCL **would be PkR 0.80/share**,

Price convergence to favor south players



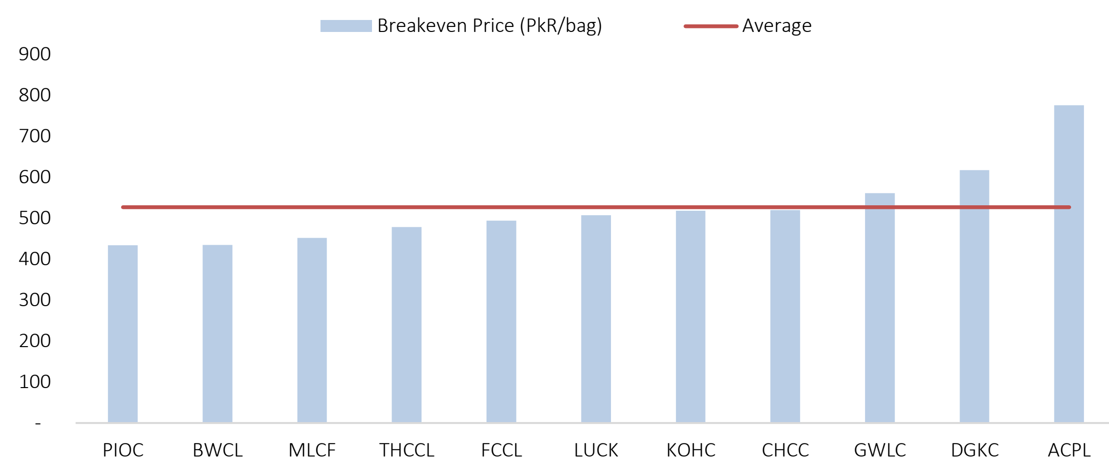
Source: PBS, BMA Research

Industry pricing discipline bodes well for the company

Despite low utilization rates, we believe that domestic cement prices will not come under pressure. The industry is expected to keep margins at sustainable levels to ensure its debt servicing capacity. We have assumed a 4% increase in retail cement prices for FY25 and FY26. We believe strong pricing power will enable the sector to sustain its profitability despite low operating rates.

It is important to highlight that Thatta Cement stands to benefit from this situation as the company will be able to sell at higher market prices while maintaining a high levels of utilization. Even in an unlikely case of a price war, Thatta cement would be in a better position as it has one of the lowest breakeven price of **PkR 479/bag in south region**. We, however, do not expect any price war among the players given that the industry exhibited heightened discipline despite a tough economic cycle.

Lowest breakeven price in south region



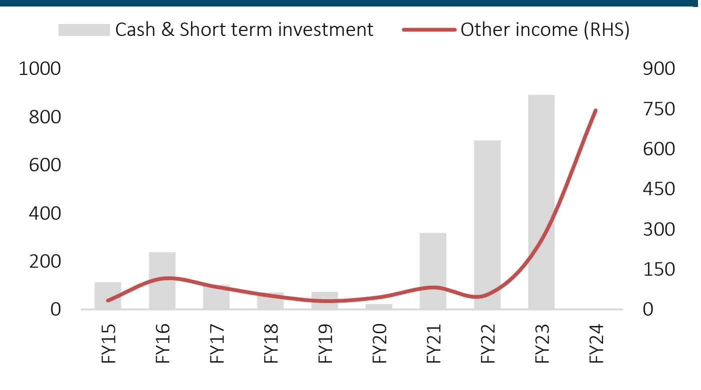
Source: Company Accounts, PSX, BMA Research

Strong cash flows to support on multiple avenues

With improving profitability, THCCL's operating cash flow has increased as well. Strong cash flows have the potential to support the company's capacity expansion projects, energy efficiency projects, and enhance cash yield potential.

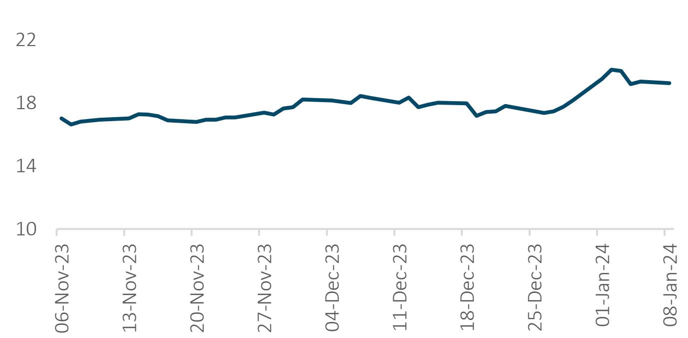
To recall, THCCL on September 26, 2023 announced a buyback of 15mn shares (15% of capital) with the intention to hold shares as treasury stock. The free float of the company reduced to 14.9mn shares from 29.9mn shares. The company concluded its buyback during November 04, 2023 to January 08, 2024, signalling perceived undervaluation for its company.

Cash & short investments vs Other income (PkRmn)



Source: Company Accounts, PSX, BMA Research

Price movement during buyback



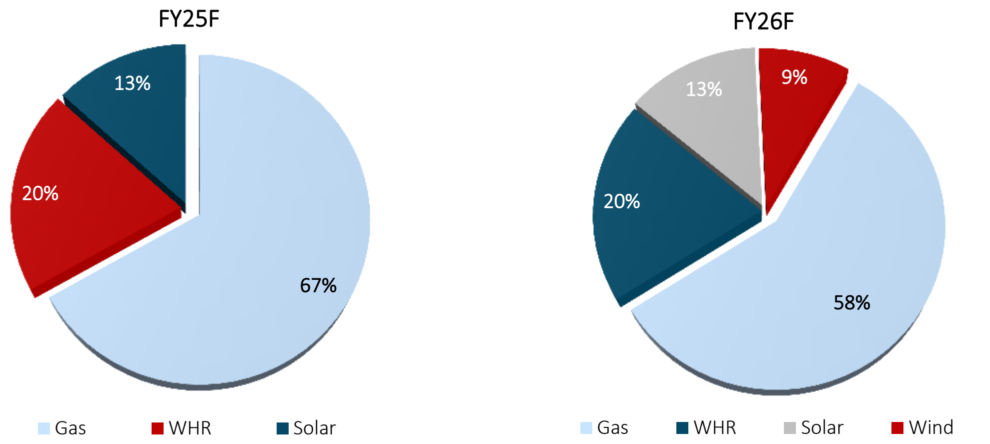
Source: PSX, BMA Research

Heightened focus on production efficiencies

Thatta Cement strives to become one of the most efficient cement players in the industry through the use of green technologies. As per the notice issued by the company, Thatta Cement Company is in process to install 3.5MW solar panels at plant premises. Additionally, company is also installing a windmill project of 4.8MW, reducing the company's dependence on national grid.

Presently, the company's solar generation capacity stands at 3.4MW and its WHR stands at 4.0MW. These efficiencies yield bottom line impact of PkR 3.3/sh for the company.

Power mix

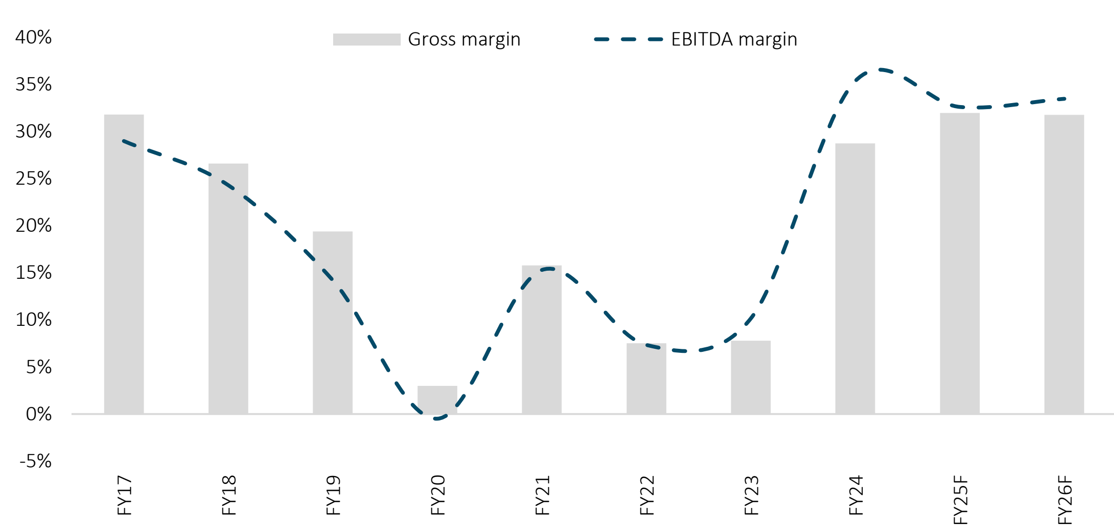


Source: Company Accounts, BMA Research

Efficient fuel and power mix to enhance margins:

We expect THCCL gross margins to improve from 28.8% in FY24 to 32.0% over FY25-FY27. Similarly, EBITDA margins are expected to improve from 31% in FY24 to 32.6-34.5% over the same period. The anticipated improvement in margins is on account of significant reliance on local coal, decline in coal prices and power efficiencies.

Margins approaching the levels last seen in FY17



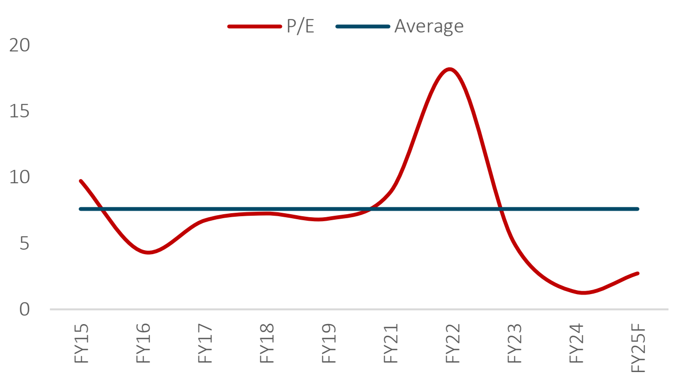
Source: Company Accounts, BMA Research

Valuation

THCCL offers a potential upside of xx% to our June 2025 TP of PkR 133.6/share. The stock is currently trading at FY25E PE of 2.3x and an FY26F PE of 1.9x, as compared to its 5-year average PE (Ex. FY20 Covid Year) of 8.3x, representing a discount of 69% and 75% respectively, and its 10-year average PE (Ex. FY20 Covid year) of 7.6x, representing a discount of 72% and 77% respectively.

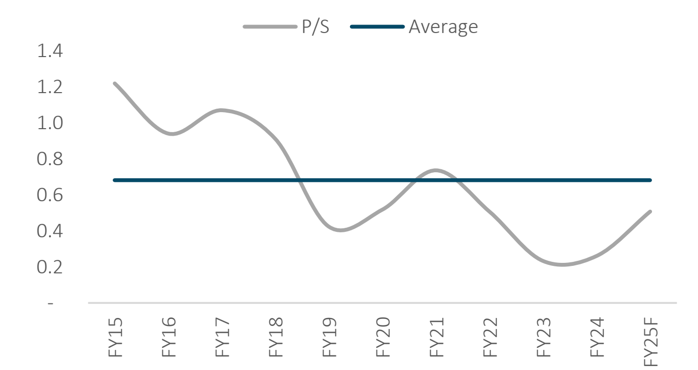
On EV/ton, THCCL is trading at USD 15.6/ton, compared to replacement cost of around USD 70/ton. THCCL is also cheaper than the sector average EV/ton of USD 27/ton.

Trading at FY24E P/E of 2.7x vs 10-Year average P/E of 7.6x



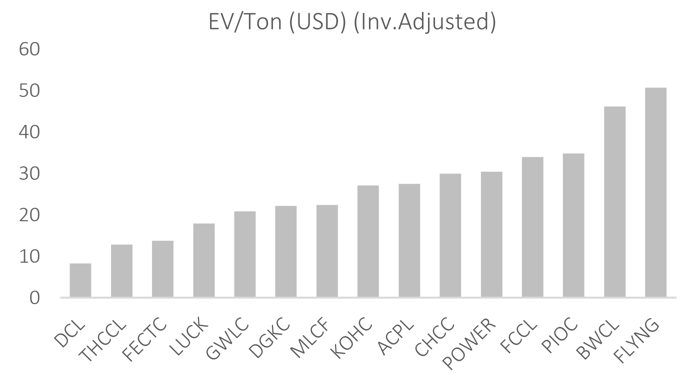
Source: Company Accounts, PSX, BMA Research

Trading at FY24E P/S of 0.5x vs 10-Year average P/S of 0.7x



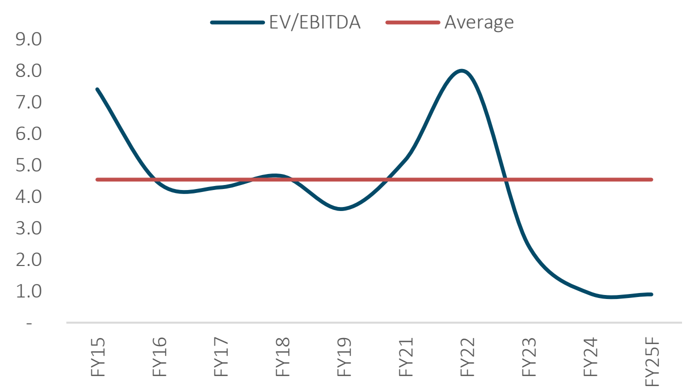
Source: Company Accounts, PSX, BMA Research

Trading at EV/Ton USD 15.6 vs 10-Year/Ind. average of 37.2/27.0



Source: Company Accounts, PSX, BMA Research

Trading at FY24E EV/EBITDA of 3.4x vs 10-Year average of 6.4x



Source: Company Accounts, PSX, BMA Research

Key Risks:

(i) Lower than estimated sales,

(ii) decline in cement prices due to lower capacity utilization, and

(iii) higher than expected increase in coal prices.

THCCL: Financial Projections

Income Statement	FY22A	FY23A	FY24A	FY25F	FY26F
Sales	4,264	5,410	7,522	10,316	11,284
Gross Profit	321	421	2,164	3,236	3,767
EBITDA	313	549	2,661	3,294	3,968
Finance cost	33	51	53	55	57
Profit after tax	119	249	1,501	1,884	2,291
EPS	1.4	2.9	17.7	22.2	27.0
DPS	-	-	1	2	4
Balance Sheet	**FY22A**	**FY23A**	**FY24A**	**FY25F**	**FY26F**
Non-Current Asset	2,270	2,147	2,311	2,199	2,131
Current Asset	2,363	2,596	3,815	5,803	8,008
Total Assets	**4,633**	**4,743**	**6,126**	**8,002**	**10,139**
Equity	2,740	2,985	3,596	5,311	7,263
Non-Current Liabilities	335	301	349	356	364
Current Liabilities	1,558	1,458	2,181	2,335	2,512
Total Equity & Liabilities	**4,633**	**4,743**	**6,126**	**8,002**	**10,139**
Ratios	**FY22A**	**FY23A**	**FY24A**	**FY25F**	**FY26F**
Gross Margin	7.5%	7.8%	28.8%	31.4%	33.4%
EBITDA Margin	7.3%	10.2%	35.4%	31.9%	35.2%
Net Margin	2.8%	4.6%	20.0%	18.3%	20.3%
ROE	4.4%	8.3%	41.7%	35.5%	31.5%
ROA	2.6%	5.3%	24.5%	23.5%	22.6%
P/E	**44.1**	**21.1**	**3.0**	**2.4**	**1.9**
P/S	1.2	1.0	0.7	0.5	0.5
EV/EBITDA	**7.9**	**2.5**	**0.0**	**0.9**	**0.2**

Source: BMA Research, Company Accounts

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Old rating system

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)