PAKISTAN INVESTMENT RESEARCH

Fauji Cement Company (FCCL)

Improving fundamentals strengthening investment case

Tuesday, May 7, 2024

We reiterate our BUY stance on Fauji Cement (FCCL) with a revised June 2025 target of PkR 33/share, offering a potential upside of 46%.

We believe FCCL will reap the benefits of (i) an uptick in local cement demand by FY25, (ii) timely expansion strengthening market share, (iii) efficiency gains through new line and the incorporation of green technology, (iv) efficient fuel and power mix to enhance margins, (v) strong pricing power to support profitability in a low-demand environment, and (vi) anticipated reduction in interest rates to reduce debt servicing burden.

Local demand to pick up from FY25: We expect **local cement demand to grow at 5% in FY25 and FY26**, owing to improved economic conditions and higher agriculture income. Onwards, we have assumed a 7% growth in local sales amidst expectation of economic and political stability in the country.

Timely expansion to strengthen market share: Fauji Cement has become the **3rd largest cement player** in the country. Its amalgamation with Askari Cement along with additional capacities of 4.1mn MT has enhanced the company's cumulative capacity to 10.5mn MT. The expansion raised FCCL's **capacity-based market share** from 10.5% to **13.1% in Pakistan**. In the North region, its capacity-based market share increased by 3.2pps to 16.4%.

Heightened focus on production efficiencies: Fauji Cement also strives to become one of the most efficient cement players in the industry through the use of green technologies. Presently, the company's solar generation capacity stands at 40MW and its WHR stands at 55MW. **These efficiencies yield potential savings of PkR 100/bag for the company.**

Efficient fuel and power mix to enhance margins: We expect FCCL **gross margins to improve from 30% in FY23 to 30-32% over FY24-FY26**. Similarly, EBITDA margins are expected to improve from 29% in FY23 to 30-32% over the same period. The anticipated improvement in margins is on account of decline in coal prices, efficient fuel mix and power efficiencies.

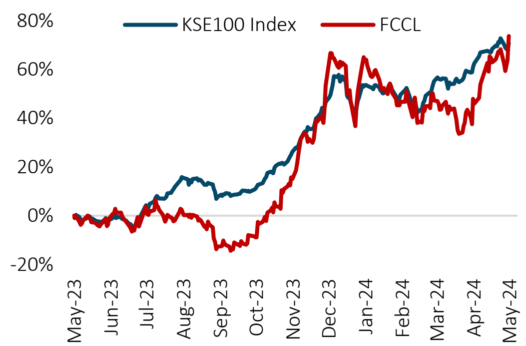
Strong pricing power to support bottom-line despite low utilization rates: Despite low utilization rates, we believe that domestic cement prices will not come under pressure. The industry is expected to keep margins at sustainable levels to ensure its debt servicing capacity. **We have assumed a 5% increase in retail cement prices for FY25** and 4% for FY26. We believe strong pricing power will enable the sector to sustain its profitability despite low operating rates.

FCCL investment overview

KATS Code	FCCL
Bloomberg Code	FCCL PA
Market Price	PkR 22.44
Target Price	PkR 33.12
Upside	46%
1-Yr Avg. Daily Avg. Vol. (mn)	6.2
1-Yr High/ Low	PkR 22.9/10.42
Estimated free float	35%
Share outstanding (mn)	2,453
Index weight	0.83%

Source: PSX, BMA Research

FCCL vs KSE100 Index



Source: PSX, BMA Research

FCCL Financial Overview

	FY22	FY23	FY24E	FY25F	FY26F
EPS (PkR/Sh)	2.9	3.0	3.7	5.3	6.6
Growth (%)	105%	5%	23%	42%	24%
DPS	-	-	1.0	2.0	3.0
DY	0%	0%	5%	10%	15%
P/E	7.5	7.2	6.1	4.3	3.4
P/BV	1.0	0.9	0.7	0.6	0.5
ROE	12%	11%	12%	15%	16%
ROA	6%	5%	6%	8%	10%

Source: Company Accounts, BMA Research

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Easing interest rates may further support profitability: FCCL has sizable debt on its balance sheet because of multiple expansions. In 3QFY24, FCCL's total debt stock stood at PkR 38.8bn as compared to PkR 40.1bn in FY23. We expect total interest bearing debt to decline to PkR 36bn by the end of FY24. Moreover, the anticipated reduction in the policy rate (275bps in FY25) will also support the company's profitability potential.

Trading at a significant discount to its replacement cost: On an EV/MT basis, FCCL is trading at USD 31.6 against the plant's replacement cost of USD 75/MT. Moreover, its last brownfield expansion of had a cost of USD 48/ton.

Valuation: FCCL offers a potential upside of 46% to our **June 2025 target of PkR 33/share**. The stock is currently trading at an FY24E PE of 6.1x and an FY25F PE of 4.3x, as compared to its 5-year average PE of 8.06x, representing a discount of 24.3% and 46.6% respectively.

Key Risks: (i) Geopolitical and macroeconomic instability continues affecting demand, (ii) risk of higher pricing competition if utilization rates remain lower for longer, and (iii) higher than expected increase in coal prices.

Local demand to pick up from FY25 onwards

Domestic demand to grow by 5% from FY25: We anticipate FY24's domestic dispatches to fall by 1% YoY, driven by a non-conducive macroeconomic environment. Moreover, record-high construction costs amidst high interest rates will limit construction activities during the period. We believe that the expected easing of inflationary pressures, economic stability, an expansionary monetary policy, and improved farmers' income will stimulate construction activities. Therefore, we have assumed a 5% growth in local sales for FY25 and FY26.

Export growth to normalize from FY25: On the exports front, dispatches are expected to increase by 46% YoY in FY24. This significant growth is attributed to the sharp devaluation of the rupee against the US dollar and favorable export margins resulting from reduced coal prices, making exports more viable. For FY25 and FY26, we anticipate export growth to be 5%.

Capacity utilization rates to inch past 60% from FY26: In the last two years, the industry added 14.0mn MT, bringing the total capacity to 83.0mn MT by FY24. With gradual improvement in industry sales, capacity utilization is projected to recover from 56% in FY24 to 58% in FY25 and 61% in FY26.

Timely expansions to strengthen market share: FCCL expanded its cumulative capacity by 4.0mn MT, with new lines installed at its Nizampur (2.0mn MT) and DG Khan (2.0mn MT) site. By November 2023, the company's cumulative capacity increased to 10.5mn MT, making FCCL the 3rd largest cement player in the industry. As a result, FCCL's capacity based market share increased from 10.5% to 13.1% in Pakistan. In the North, its capacity-based market share rose to 16.4% (+3.2pps), making it the 2nd largest player in the region.

Expansion cost

Symbol	Capacity (mn tons)	Cost (PkR mn)	PkR/ton
FCCL (B)	2.00	27,000	13,500
FCCL (G)	2.00	39,000	19,500
MLCF	2.10	22,000	10,476
LUCK	3.15	30,000	9,524
BWCL (B)	2.16	33,890	15,690
BWCL (G)	2.16	33,730	15,616

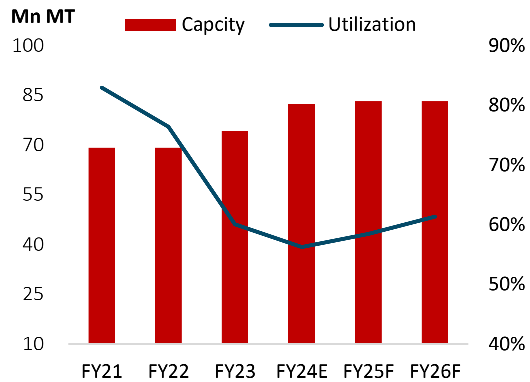
Source: Company Accounts, BMA Research

Cement Dispatches Outlook

Mn MT	FY21	FY22	FY23	FY24E	FY25F	FY26F
Local	48.1	47.6	40.0	39.5	41.5	43.5
YoY	20%	-1%	-16%	-1%	5%	5%
Export	9.3	5.3	4.6	6.8	7.1	7.5
YoY	19%	-44%	-13%	49%	5%	5%
Total	57.4	52.9	44.6	46.3	48.6	51.0
YoY	20%	-8%	-16%	4%	5%	5%

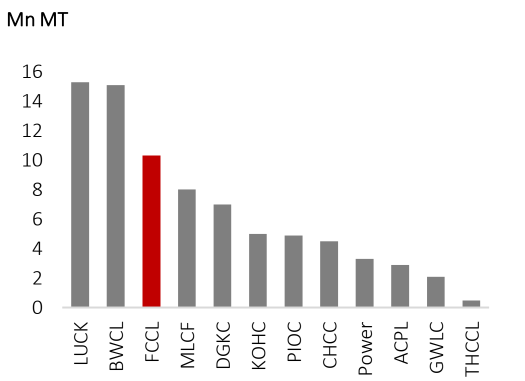
Source: APCMA, BMA Research

Cement Production and Utilization



Source: APCMA, BMA Research

FCCL Capacity Share



Source: Company Accounts, BMA Research

Improving efficiencies to bolster margins

Margins to consistently improve support by newer lines: FCCL's newer production lines benefit from the latest technology, raising FCCL's efficiency levels and enabling its margin growth to surpass industry peers. Peer analysis of listed cement companies revealed that FCCL's margin growth outpaced the industry's by 3pps over a 3-year period. Similarly, FCCL's EBITDA margins improved by 0.6pps to 29.2% in FY23 while the industry's reduced by 0.3pps to 25.1%. In addition to capacity enhancement, better efficiency is another key factor that will allow FCCL to record growth above the industry.

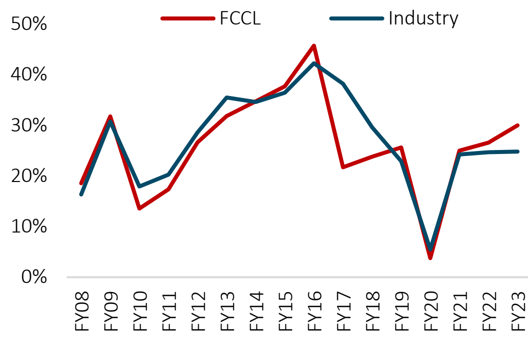
Improving energy mix to further bolster margins: We expect FCCL's gross margins to improve from 30% in FY23 to 32% by FY26. Similarly, EBITDA margins are expected to improve from 29% in FY23 to 32% till FY26. Further improvement in margins will likely be supported by declining coal prices, efficient fuel mix and the aforementioned efficient lines.

- **Richard bay coal prices on the decline:** Richards Bay coal prices have declined by nearly 50% to USD 107/ton by April 2024. Moreover, local and Afgan coal prices have followed suit and reduced at a similar pace. Onwards, we have incorporated international coal prices of USD 100/ton in our valuations, citing reduced global demand for the commodity. We have assumed average coal prices of PkR 39k per MT and PkR 43k per MT for FY25 and FY26 respectively.

- **Higher share of local coal supported by newer lines:** The two new lines enable increased utilization of local coal, which has a higher sulfur content. Given that local coal is priced at a 21-28% discount to its counterparts, FCCL could potentially save around PkR 8-10/bag by raising the mix of local coal by 10%.

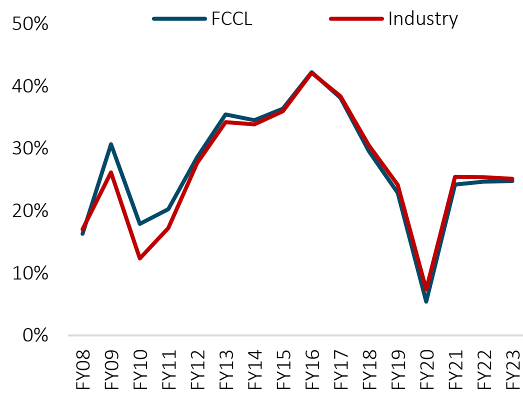
- **Green technologies to further support margins:** FCCL also benefits from a favorable power mix, including a 52.5MW Waste Heat Recovery (WHR) plant and 40MW solar plant capacities. In FY23, the solar capacities generated 40GWh units of electricity and the WHR facility generated 155GWh units of electricity. We estimate that the **green energy sources yield potential savings of PkR 100/bag.**

Gross Margin Trend



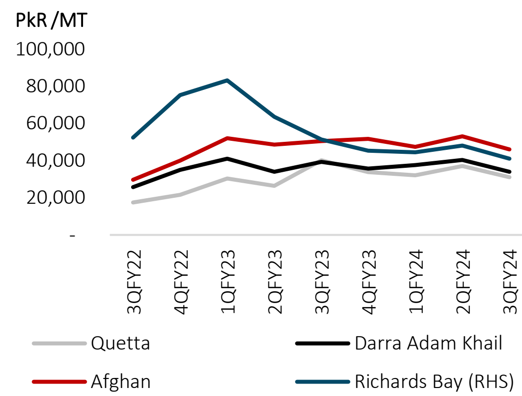
Source: Company Accounts, BMA Research

EBITDA Margin Trend



Source: Company Accounts, BMA Research

Coal prices on the decline



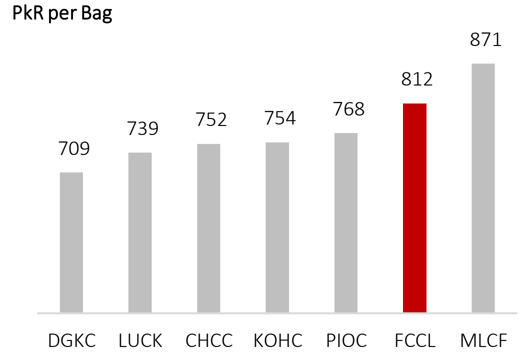
Source: Company Sources, BMA Research

Sustained retention to support bottom-line

Higher retention to support profitability: Despite low industry utilization rates, we downplay any immediate threat to a potential price war. We think the industry is focused on margin retention, given the high leverage levels of the industry. Moreover, the sector's capacity utilization is likely to improve by 2pps to 58% in FY25. Assuming 5% growth in sales, industry utilization is expected to reach 71% by FY29.

FCCL's retention stands higher compared to peers: FCCL enjoys a higher retention of PkR 812 per bag compared to the industry average of PkR 772 per bag because of consumer perception of a superior product. Higher retention prices allow FCCL to be better positioned to absorb price shocks and remain cash flow positive.

FCCL Retention vs. Peers



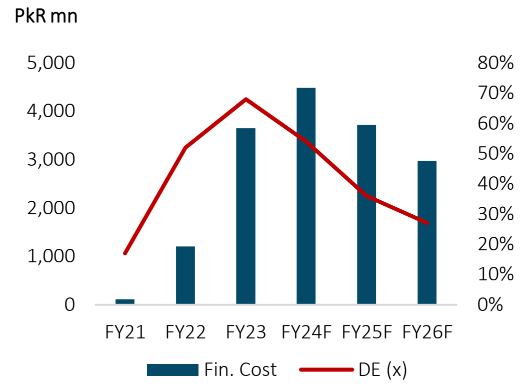
Source: Company Accounts, BMA Research

Monetary easing to enhance profits

Concessionary financing to limit growth in debt servicing: The two expansions ballooned FCCL's debt balance to PkR 38bn as of March 2024. Of the total debt, company's concessionary loan stands at PkR 14bn (36% of total debt). FCCL is anticipated to benefit from a sharp fall in interest rates in FY25. We expect financial charges to decline by 23% in FY25 and 22% in FY26 respectively.

Strong EBITDA generation to support deleveraging: The company generated EBITDA of PkR 5.1bn in 3QFY24. Supported by healthy cash flows, we expect total interest bearing debt to decline by 10% to PkR 36bn by FY24. Potential deleveraging amidst an easing interest rate environment may yield annual savings of PkR 0.4/share (10% of FY25F EPS).

FCCL Debt Servicing Burden

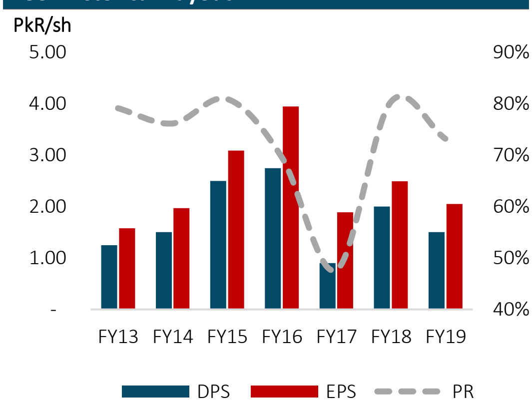


Source: Company Accounts, BMA Research

Cash earnings higher than accounting profits: FCCL is benefitting from deferred tax as accelerated depreciation for its expansions provide it with a tax shield (deferred tax advantage). Notably, the 9MFY24 results revealed that the company paid taxes of PkR 1.4bn in cash against the reported accounting tax of PkR 3.7bn. Coupled with the higher depreciation expenses, FCCL's accounting profits largely understate the company's cash-generating capacity.

Dividend stream likely to resume after debt reaches manageable levels: Given the anticipated reduction in debt and the company's strong cash generating capabilities, we think FCCL will resume its dividend stream from FY25 onwards. Historically, **FCCL's payout ratio hovered around 80%.**

FCCL Historical Payout



Source: Company Accounts, BMA Research

Valuation – BUY with a target of PkR 33/sh

FCCL offers a potential **upside of 46%** to our **June 2025 target of PkR 33/share**. The stock is currently trading at an FY24E PE of 6.1x and an FY25F PE of 4.3x, as compared to its 5-year average PE of 8.1x, representing a discount of 24% and 47% respectively. Moreover, FCCL offers a **dividend yield of 9%**, **taking the total return to 55%**.

FCCL's retention stands higher compared to peers: FCCL enjoys a higher retention of PkR 812 per bag compared to the industry average of PkR 772 per bag because of consumer perception of a superior product. Higher retention prices allow FCCL to be better positioned to absorb price shocks and remain cash flow positive.

Discounted Cash Flow Methodology

PkR mn	FY25	FY26	FY27	FY28	FY29
Discounted FCFE	7,481	8,611	8,607	8,127	7,893
Sum of FCFE	40,719				
Terminal Value	40,526				
Company Value	81,245				
Shares (mn)	2,453				
Present Value/sh	33.1				
Current Price (PkR/sh)	22.7				
Return (%)	46%				
Dividend Yield (%)	9%				
Total Return (%)	55%				

Valuation Assumption

Risk free rate	14.0%
Equity Risk Premium	6.0%
Beta	1.5
Cost of Equity	23.1%
Terminal Growth	3.0%

Source: BMA Research

Company Financials

Income Statement					
PkRmn	**FY22**	**FY23**	**FY24E**	**FY25F**	**FY26F**
Net sales	54,243	68,069	78,959	91,881	104,833
Gross profit	15,464	20,418	23,747	28,571	32,588
Dist. Exp	1,603	2,705	3,340	3,675	4,193
Admin. Exp	1,299	1,382	1,394	1,506	1,626
Other Income	977	964	740	1,415	2,097
Finance cost	1,202	3,646	4,917	3,781	2,934
Profit before tax	11,528	12,900	14,034	19,843	24,557
Profit after tax	7,113	7,440	9,179	12,990	16,152
EPS (PkR)	**2.90**	**3.03**	**3.74**	**5.30**	**6.58**
DPS (PkR)	**0.00**	**0.00**	**1.00**	**2.00**	**3.00**

Balance Sheet					
PkRmn	**FY22**	**FY23**	**FY24E**	**FY25F**	**FY26F**
Non-Current Assets	85,481	115,694	117,662	116,221	114,752
Current Assets	28,217	23,134	25,797	36,901	48,440
Total Assets	**113,698**	**138,828**	**143,460**	**153,123**	**163,192**
Equity	**57,736**	**65,176**	**74,354**	**87,345**	**101,044**
Non-Current Liabilities	29,241	45,166	43,770	40,436	36,217
Current Liabilities	26,721	28,487	25,335	25,341	25,931
Total Equity & Liabilities	**113,698**	**138,828**	**143,460**	**153,123**	**163,192**

Key Ratios					
PkR mn	**FY22**	**FY23**	**FY24E**	**FY25F**	**FY26F**
PAT	7,113	7,440	9,179	12,990	16,152
Growth (%)	*105%*	*5%*	*23%*	*42%*	*24%*
DPS (PkR)	0.0	0.0	1.0	2.0	3.0
DY (%)	0%	0%	4%	9%	13%
P/E (x)	7.4	7.1	6.0	4.2	3.4
P/BV (x)	1.0	0.8	0.7	0.6	0.5
ROE (%)	12%	11%	12%	15%	16%
ROA (%)	6%	5%	6%	8%	10%

Assumptions					
	FY22	**FY23**	**FY24E**	**FY25F**	**FY26F**
Local sales (mn MT)	5.4	4.4	4.7	5.4	5.7
Exports (mn MT)	0.2	0.4	0.5	0.5	0.5
Retail Price (PkR/bag)	778	1,067	1,187	1,247	1,297
Coal (USD/MT)	205	207	106	100	100
6-Month KIBOR	9.9%	18.0%	22.0%	19.3%	14.5%
PkR/USD	177.9	248.1	288.6	319.0	348.0

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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.)