Al Jouf Cement Co.

Initiation | KSA | Cement — November 2015

ALJAZIRA CAPITAL الجزيرة للأسواق المالية

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Al Jouf cement: High volumes to fuel growth in FY2016; however, debt repayment and higher depreciation charge do not tell a dividend story in 2015/16. 'Overweight' recommendation with TP of SAR13.60/share.

Diversifying regional contribution could be a potential opportunity; long-term drivers such exports, growth in cement consumption could help: Al Jouf generates 62% of its revenue from the northern region, which accounted for 11.1% (6.3mn tons) and 11.7% (5.8mn tons) of cement sales in 2014 and during January–October 2015, respectively. As the northern region is a structurally weak market, the company could look to benefit from growing cement consumption (as projected by Holtec) in the neighboring regions such as Al Madina. Moreover, Al Madina City, the western region, and the eastern region currently contribute 14.0%, 5.6%, and 5.3% to the company's revenues, respectively. Given its presence in other regions, we believe there is huge potential for the company to increase cement dispatches outside its core area. However, as cement is a commoditized business with pricing advantages that favor regional players, we remain skeptical of the margin impact from any volume expansion by Al Jouf in the western and eastern regions.

Strong near-term visibility; capacity expansion to prove beneficial: Al Jouf recently signed an agreement to sell 200,000 tons of clinker to Arabia Cement Co. in 2015. We expect near-term volumes to remain strong. Furthermore, the company has launched its incremental capacity of 5,000tpd for the 2nd production line in 2Q2015. Our model assumes that the bulk of the incremental production from this capacity addition would be realized in 4Q2015. We expect volumes to increase at a CAGR of 15.6% during 2014–17. At the same time, we remain cautiously optimistic that the market would absorb this volume, supported by large infrastructure projects.

Cash flows do not tell a dividend story: We expect the company to generate steady cash flows. The company started paying off debt in 2014 and plans to repay a significant portion of the loans secured from SIDF (SAR 438.5mn), SAAB (SAR 350.0mn), and Al Rajhi Bank (SAR 300.0mn) in order to comply with its debt repayment schedule by end-2019. The company repaid SAR 70mn of its SIDF debt in 2014, with the final repayment scheduled for 2017. It intends to pay outstanding dues to SAAB by 2019 and to Al Rajhi Bank by 2021, starting 2015.

The company's debt level is expected to drop by more than 50% by 2019 (from SAR 915mn in 2014 to about SAR 400mn by 2019). We expect the depreciation charge to increase from 2015 due to the commissioning of the new production line. The company did not pay dividends in 2014 due to expansion-related investments. Furthermore, we believe the company would be unable to pay dividends in 2015/2016 due to the debt repayment schedule and high depreciation charges.

Cost to rise; margins to remain neutral: Subsidized fuel provided by Saudi Aramco and easy availability of raw materials (such as limestone) give Saudi Arabia's cement companies edge in the global market. Al Jouf has failed to secure approval from the Ministry of Petroleum for subsidized fuel for its new production line. Therefore, we expect Al Jouf to rely on alternative fuels and the Waste Heat Recovery system (WHR) to increase capacity utilization gradually. While we believe that cost drivers would exert pressure on margins due to the use of unsubsidized fuel for the new production line, our model assumes the margin scenario to remain largely neutral (32–33% EBIT margin over 2015–16, which would eventually stabilize at 34–35%). This would be primarily due to volume expansion (improvement in operating leverage) and use of unsubsidized fuel (rise in cost per unit).

Analyst
Jassim Al-Jubran
+966 11 2256248
j.aljubran@aljaziracapital.com.sa

Recommendation	Overweight
Current Price* (SAR)	11.60
Target Price (SAR)	13.60
Upside / (Downside)	17.3%

*prices as of 26th of November 2015

Key Financials

SARmn (unless specified)	FY14	FY15E	FY16E	FY17E
Revenues	269.2	341.2	410.9	474.9
Growth %	-8.3%	26.7%	20.4%	15.6%
Net Income	60.5	97.8	120.1	145.6
Growth %	11.9%	61.5%	22.8%	21.2%
EPS	0.47	0.75	0.92	1.12

Source: Company reports, Aljazira Capital

Key Ratios

SARmn (unless specified)	FY14	FY15E	FY16E	FY17E
Gross Margin	38.1%	41.9%	42.2%	41.6%
EBITDA Margin	43.4%	55.2%	59.2%	55.3%
Net Margin	22.5%	28.6%	29.2%	30.6%
P/E	30.0x	15.4x	12.6x	10.4x
P/B	1.27x	0.98x	0.91x	0.87x
EV/EBITDA (x)	23.1x	11.8x	8.3x	7.1x
ROE	4.3%	6.3%	7.3%	8.3%
ROA	2.5%	4.0%	4.9%	6.0%
D/Y	-	-	-	4.3%

Source: Company reports, Aljazira Capital

Headquartered in Jeddah, Saudi Arabia, Al Jouf Cement Co. (TCC) started commercial production in May 2010. It produces ordinary Portland cement (85%) and Sulphate-resistant cement (15%). The company operated at an annual production capacity of 1.8mn tons (mt) in 2014 and has increased to 3.4mt (to be updated). The company controls 2.9% of domestic sales.

Shareholders Pattern

	Holding
KSB Capital Group	5.00%
Public	95.0%

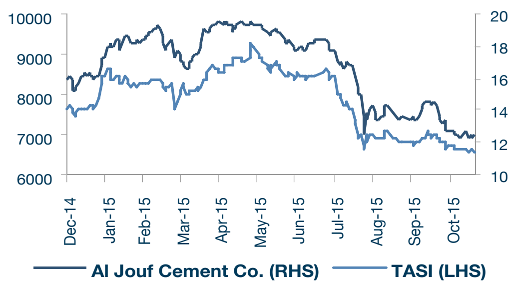
Source: Company reports, Aljazira Capital

Key Data

Market Cap(mn)	1,508.0
YTD %	-17.8%
52 Week (High)	21.50
52 Week (Low)	11.35
Shares Outstanding (mn)	130.0

Source: Company reports, Aljazira Capital

Price performance



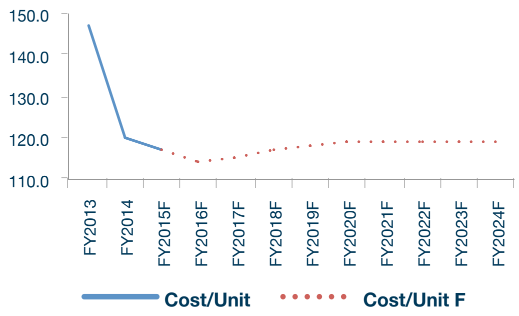
Source: Bloomberg, Aljazira Capital

High growth driven by increase in sales and government initiatives: Al Jouf's net profit in 3Q2015 jumped 116.6% YoY, primarily due to a 29.8% YoY rise in sales. Net profit for 9M2015 increased 79.4% YoY. However, operating costs are expected to rise in the near future due to the start of the new production line. At the end of October 2015, the inventory of clinker is about 23.1mn tons (~48.9% of the total production of clinker YTD). Such high inventory levels may exert downward pressure on cement prices. However, the government could lift its cement export ban, which was imposed to ensure adequate resources for local development plans. The country may lift the ban in the wake of reduced government spending on infrastructure projects and threat of overcapacity in the domestic cement industry. If the ban is revoked, the company would be able to increase export revenues and utilize its additional capacity. Furthermore, the government is considering a new tax on undeveloped land in a bid to compel citizens to develop their land. Such a move would help address the current shortage in the housing sector and also benefit cement companies. Considering these factors, we expect Al Jouf Cement to post double-digit growth in sales and net income in FY2016.

Sluggish economy, high financing rates, and oversupply concerns threaten cement industry: Robust oil revenue and economic reforms have spurred cement consumption in Saudi Arabia in recent years. However, we believe that the ongoing economic slowdown would hinder some infrastructure projects in the country. In response to this slowdown, the government was forced to issue sovereign debt bonds for the first time since 2007 to maintain the country's net foreign assets, which have hit a three-year low of USD 646.9bn. Weak oil prices are weighing on government revenues, inhibiting investments. Furthermore, with the US Federal Reserve ready to increase interest rates (first revision expected in December 2015) and the Saudi Riyal (SAR) pegged to the dollar (USD), the cost of borrowing for Saudi companies would increase, impacting their profits. In addition, the combined inventory of clinker stood at 23.1mn tons at the end of October 2015; this can lead to oversupply in the market and could weaken the company's margins.

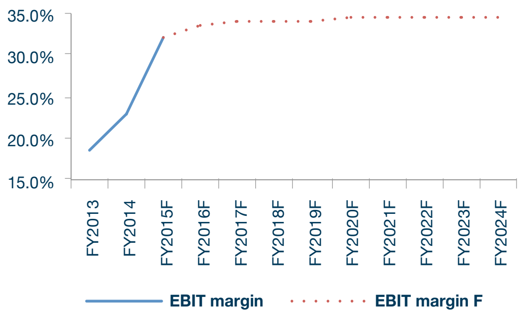
Investment consideration: We have used the DCF methodology for the valuation of Al Jouf Cement, considering the explicit forecast for 2015–24, cost of equity at 14.1%, and cost of debt at 3.2%. Our DCF valuation methodology suggests a 12-month target price of **SAR 13.6/share**, which provides an upside of 17.2% from the current market price of SAR11.6/share (as on November 25, 2015). The stock is trading at higher P/E multiples of 15.4x and 12.4x than the sector average (Bloomberg sector average) of 13.7x and 11.7x for 2015 and 2016, respectively. The company is expected to witness near-term headwinds due to price/ton of less than SAR 200 (price/ton was more than SAR 200 in the past four years, peaking at SAR 233 in 2012), absence of dividends due to debt repayment, and higher costs due to the use of non-subsidized fuel for the new Production line. On the contrary, we expect volume growth to emanate with geographical expansion to neighbouring regions of Al Madina and Western from new capacity addition, which would boost profitability over 2015–17. Furthermore, price/ton and revenues may improve if the Saudi government allows cement exports.

Figure 1: Cost/ton to rise



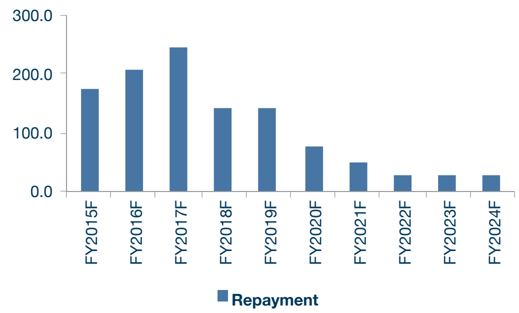
Source: Company reports, Aljazira Capital

Figure 2: EBIT margin to normalize at 34–35% in the long term



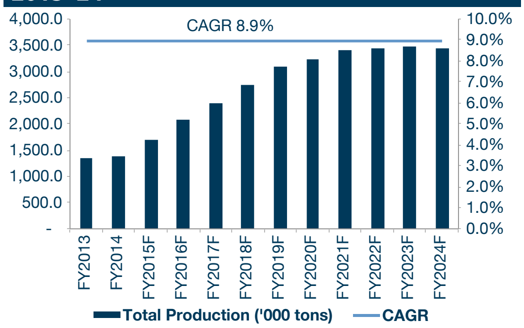
Source: Company reports, Aljazira Capital

Figure 3: Strong debt repayment over 2016–21



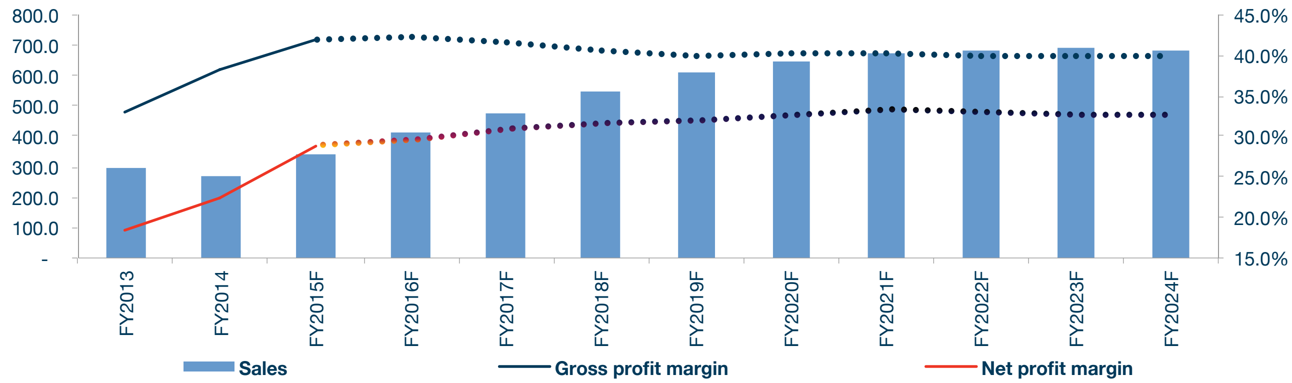
Source: Company reports, Aljazira Capital

Figure 4: Volume growth at 8.9% CAGR over 2013–24



Source: Company reports, Aljazira Capital

Figure 5: Increasing sales volume and high net profit margin



Source: Company reports, Aljazira Capital

The key risks to margins in the Saudi cement sector are:

Increasing inventory level: The clinker inventory level of Saudi cement companies increased 9.1%YoY to 23.1mn tons in October 2015, after reaching a low of 4.2mn tons in June 2013. The rise in inventory was primarily due to high level of imported clinker and the fall in cement demand in 2014. The rise in clinker inventory level has led to an increase in market competition and resulting selling price decline per ton early 1Q15. Higher future inventory level would cause more oversupply in the market and force cement companies to more reduce prices, thereby impacting margins.

Declining global oil prices: Saudi Arabia depends heavily on the revenues generated from the petroleum sector. However, the global oil prices are on the decline, touching six-year lows. This would adversely impact the Saudis Arabia revenues, thereby could impacting government spending on infrastructure. Lower government spending on infrastructure (biggest driver of cement) would impact demand, thereby affecting prices due to high inventory level in the sector. Consequently, margins are likely to decline.

Valuation Metrics: Our DCF based valuation methodology is based on 10-year explicit cash flows to reduce the sensitivity of our valuation to terminal value with the following key assumptions;

- Terminal growth rate is taken at 2.8%.
- 5-years monthly raw beta of 1.021 (Bloomberg).
- Risk free rate is taken at 3.3%.
- KSA total market risk premium is taken at 13.8% from Bloomberg. Hence, the equity risk premium is calculated at 10.5%.
- Capital Assets Pricing Model (CAPM) is used to calculate cost of equity at 14.1%.
- Cost of debt is taken at 3.2%.
- Weighted average cost of capital (WACC) is calculated at 9.8%.

Based on our DCF valuation, our 12month price target for AlJouf cement stands at **SAR13.60/share**, against current market price of SAR 11.60 per share, we initiate our coverage on the company with "**Overweight** " recommendation.

DISCOUNTED FREE CASH FLOW TO FIRM											
Year to Dec (SAR mn)	**FY15E**	**FY16E**	**FY17E**	**FY18E**	**FY19E**	**FY20E**	**FY21E**	**FY22E**	**FY23E**	**FY24E**	**Terminal Value**
Operating profit	109.1	137.7	161.7	185.6	207.7	220.4	233.9	235.1	236.3	233.9	
Add: Depreciation and amortisation	79.1	105.6	101.0	96.8	92.8	89.1	85.7	82.5	79.4	76.6	
Less: Change in working capital	(6.3)	(5.1)	(0.9)	1.9	5.4	(2.2)	(6.0)	(4.6)	(4.7)	(4.5)	
Less: Capex	(21.1)	(22.4)	(23.5)	(24.8)	(26.0)	(26.6)	(27.2)	(27.3)	(27.4)	(27.3)	
Less: Zakat	(3.0)	(3.8)	(4.5)	(5.3)	(6.0)	(6.4)	(6.9)	(6.9)	(6.9)	(6.8)	
Free cash flow	157.8	212.1	233.8	254.2	273.9	274.4	279.5	278.8	276.7	271.9	3,092.3
Beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Debt/ (Debt + equity)	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Weighted average cost of capital	9.8%	10.5%	11.1%	11.7%	11.9%	12.1%	12.1%	12.0%	11.9%	11.8%	11.8%
Discount period	0.08	1.08	2.08	3.08	4.08	5.08	6.08	7.08	8.08	9.08	9.08
Discount factor @ WACC	1.0	0.9	0.8	0.7	0.6	0.6	0.5	0.4	0.4	0.4	0.4
Present value of free cash flow	156.6	190.3	187.9	180.8	173.1	153.5	139.2	125.2	111.5	98.4	1,119.3
TOTAL RETURN											
Enterprise value											2,635.8
Less: Net debt											(870.6)
Equity value											1,765.2
No of shares outstanding (mn)											130.0
Fair value (SAR/share)											$\boxed{13.6}$
Current price (SAR/share)											11.6
Expected capital gain											17.1%

Source: Company Reports, Aljaizra Research

Summary Table									
Income Statement (in SAR mn unless specified)	FY 2013	FY 2014	FY 2015F	FY 2016F	FY 2017F	FY 2018F	FY 2019F	FY 2020F	FY 2021F
sales	293.7	269.2	341.2	410.9	474.9	545.6	610.5	642.3	675.8
EBITDA	109.3	116.8	188.2	243.4	262.7	282.4	300.5	309.6	319.6
Depreciation & Amortization	55.1	55.7	79.1	105.6	101.0	96.8	92.8	89.1	85.7
Operating income	62.6	71.5	109.1	137.7	161.7	185.6	207.7	220.4	233.9
Net income before zakat	54.2	61.1	100.7	123.8	150.1	176.9	200.0	213.6	229.1
Net profit	54.1	60.5	97.8	120.1	145.6	171.6	193.9	207.2	222.3
Number of shares (in mn)	130.0	130.0	130.0	130.0	130.0	130.0	130.0	130.0	130.0
EPS (SAR per share)	0.4	0.47	0.75	0.92	1.12	1.31	1.48	1.58	1.70
DPS (SAR per share)	-	-	-	-	0.5	1.0	1.3	1.3	1.5
Balance Sheet (in SAR mn)									
Net intangible assets									
Net Plant, Property & Equipment	1,907.8	1,978.1	1,920.2	1,836.9	1,759.5	1,687.5	1,620.7	1,558.1	1,499.6
Cash & Cash Equivalents	143.9	45.0	21.0	111.0	121.3	193.5	253.9	359.1	489.0
Accounts Receivable	15.5	34.8	41.7	44.6	45.1	44.3	41.2	43.3	45.6
Total Assets	2,355.7	2,480.0	2,413.9	2,437.8	2,384.6	2,398.7	2,402.5	2,454.8	2,537.8
Long Term Debt	791.7	691.1	556.6	475.3	365.1	332.6	300.0	280.0	315.0
Accounts Payable	12.6	21.2	26.3	32.8	39.8	48.3	56.6	59.5	62.5
Total Liabilities	976.2	1,037.2	873.3	777.1	643.4	615.9	588.2	595.8	651.6
Total Stockholder's Equity and Non-controlling Interests	1,379.5	1,442.8	1,540.6	1,660.6	1,741.2	1,782.8	1,814.3	1,859.0	1,886.2
Cash Flow Statement (in SAR mn)									
Net Income	54.1	60.5	97.8	120.1	145.6	171.6	193.9	207.2	222.3
Change in WC	(41.7)	(98.4)	(6.3)	(5.1)	(0.9)	1.9	5.4	(2.2)	(6.0)
Cash Flow from Operating Activities	74.9	35.6	170.6	220.7	245.8	270.4	292.3	294.3	302.0
Capex	(253.3)	(126.2)	(21.1)	(22.4)	(23.5)	(24.8)	(26.0)	(26.6)	(27.2)
Cash Flow from Investing Activities	(261.6)	(188.3)	(21.1)	(22.4)	(23.5)	(24.8)	(26.0)	(26.6)	(27.2)
Dividends	354.9	123.8	(173.4)	(108.4)	(146.9)	(43.4)	(43.4)	-	50.0
Cash Flow from Financing Activiites	229.9	53.8	(173.4)	(108.4)	(211.9)	(173.4)	(205.9)	(162.5)	(145.0)
Ratio Analysis									
Growth									
sales growth	-20.4%	-8.3%	26.7%	20.4%	15.6%	14.9%	11.9%	5.2%	5.2%
Operating profit growth	-49.3%	14.3%	52.6%	26.2%	17.4%	14.8%	11.9%	6.1%	6.1%
EBITDA growth	-35.4%	6.9%	61.1%	29.3%	7.9%	7.5%	6.4%	3.0%	3.2%
NP growth	-49.5%	11.9%	61.5%	22.8%	21.2%	17.9%	13.0%	6.8%	7.3%
Total Assets growth	15.7%	5.3%	-2.7%	1.0%	-2.2%	0.6%	0.2%	2.2%	3.4%
Profitability									
Gross profit margin	33.0%	38.1%	41.9%	42.2%	41.6%	40.7%	40.0%	40.1%	40.2%
EBITDA margin	37.2%	43.4%	55.2%	59.2%	55.3%	51.8%	49.2%	48.2%	47.3%
EBIT margin	18.5%	22.7%	32.0%	33.5%	34.0%	34.0%	34.0%	34.3%	34.6%
Tax rate (%)	-0.2%	-0.9%	-3.0%	-3.0%	-3.0%	-3.0%	-3.0%	-3.0%	-3.0%
NP margin	18.4%	22.5%	28.6%	29.2%	30.6%	31.5%	31.8%	32.3%	32.9%
RoCE	2.5%	2.8%	4.7%	5.6%	6.9%	8.1%	9.2%	9.7%	10.1%
RoA	2.5%	2.5%	4.0%	4.9%	6.0%	7.2%	8.1%	8.5%	8.9%
DuPont Analysis									
Profit margin (%)	18.4%	22.5%	28.6%	29.2%	30.6%	31.5%	31.8%	32.3%	32.9%
Asset turnover (x)	0.1	0.1	0.1	0.2	0.2	0.2	0.3	0.3	0.3
Equity multiplier (x)	1.7	1.7	1.6	1.5	1.4	1.3	1.3	1.3	1.3
RoE	4.2%	4.3%	6.3%	7.3%	8.3%	9.7%	10.7%	11.3%	12.0%
Efficiency									
Fixed asset turnover (x)	0.2	0.1	0.2	0.2	0.3	0.3	0.4	0.4	0.4
Inventroy turnover (x)	2.5	1.4	1.7	2.0	2.3	2.6	2.9	2.9	3.0
Receivables turnover (x)	18.6	10.7	8.9	9.5	10.6	12.2	14.3	15.2	15.2
Payables turnover (x)	16.1	15.9	14.4	13.9	13.1	12.4	11.6	11.1	11.1
Gearing & Liquidity									
Debt to equity (%)	38.4%	38.8%	32.5%	27.6%	21.8%	19.9%	18.1%	17.7%	19.3%
Debt to total assets (%)	36.6%	36.9%	30.7%	26.0%	20.4%	18.5%	16.6%	16.3%	17.7%
Net Gearing (%)	62.5%	63.5%	48.2%	38.2%	28.0%	24.9%	22.0%	21.5%	23.9%
Current ratio (x)	1.8	1.0	1.0	1.4	1.6	1.9	2.1	2.3	2.6
Quick ratio (x)	1.1	0.4	0.4	0.7	0.9	1.2	1.4	1.6	1.9
Valuation Multiples									
EV/CE (x)	1.4	1.3	1.1	0.9	0.9	0.8	0.8	0.7	0.7
EV/EBITDA (x)	27.5	23.1	11.8	8.3	7.1	6.2	5.5	5.0	4.6
EV/Sales (x)	10.2	10.0	6.5	4.9	3.9	3.2	2.7	2.4	2.2
P/E (x)	41.9	30.0	15.4	12.6	10.4	8.8	7.8	7.3	6.8
P/BV (x)	1.7	1.27	0.98	0.91	0.87	0.8	0.8	0.8	0.8
Enterprise Value									
Year end price	17.6	14.1	11.6	11.6	11.6	11.6	11.6	11.6	11.6
Number of shares	130.0	130.0	130.0	130.0	130.0	130.0	130.0	130.0	130.0
Market value	2,288.0	1,833.0	1,508.0	1,508.0	1,508.0	1,508.0	1,508.0	1,508.0	1,508.0
Net debt	(717.8)	(870.6)	(721.1)	(522.7)	(365.5)	(249.9)	(146.1)	(40.9)	39.0
Non-controlling interests	-	-	-	-	-	-	-	-	-
Enterprise value	**3,005.8**	**2,703.6**	**2,229.1**	**2,030.7**	**1,873.5**	**1,757.9**	**1,654.1**	**1,548.9**	**1,469.0**

Source: Company Reports, Aljaizra Research

الجزيرة كابيتال
الجزيرة للأسواق المالية ALJAZIRA CAPITAL

RESEARCH DIVISION

AGM - Head of Research
Abdullah Alawi
+966 11 2256250
a.alawi@aljaziracapital.com.sa

Senior Analyst
Talha Nazar
+966 11 2256115
t.nazar@aljaziracapital.com.sa

Analyst
Sultan Al Kadi
+966 11 2256374
s.alkadi@aljaziracapital.com.sa

Analyst
Jassim Al-Jubran
+966 11 2256248
j.aljabran@aljaziracapital.com.sa

BROKERAGE AND INVESTMENT CENTERS DIVISION

General Manager – Brokerage Services & sales
Alaa Al-Yousef
+966 11 2256060
a.yousef@aljaziracapital.com.sa

AGM-Head of international and institutional brokerage
Luay Jawad Al-Motawa
+966 11 2256277
lalmutawa@aljaziracapital.com.sa

AGM- Head of Western and Southern Region Investment Centers & ADC Brokerage
Abdullah Q. Al-Misbani
+966 12 6618400
a.almisbahi@aljaziracapital.com.sa

AGM-Head of Sales And Investment Centers Central Region
Sultan Ibrahim AL-Mutawa
+966 11 2256364
s.almutawa@aljaziracapital.com.sa

AGM-Head of Qassim & Eastern Province
Abdullah Al-Rahit
+966 16 3617547
aalrahit@aljaziracapital.com.sa

RESEARCH DIVISION

AlJazira Capital, the investment arm of Bank AlJazira, is a Shariaa Compliant Saudi Closed Joint Stock company and operating under the regulatory supervision of the Capital Market Authority. AlJazira Capital is licensed to conduct securities business in all securities business as authorized by CMA, including dealing, managing, arranging, advisory, and custody. AlJazira Capital is the continuation of a long success story in the Saudi Tadawul market, having occupied the market leadership position for several years. With an objective to maintain its market leadership position, AlJazira Capital is expanding its brokerage capabilities to offer further value-added services, brokerage across MENA and International markets, as well as offering a full suite of securities business.

RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

Disclaimer