ARCC -INITIATION

Arabian Cement Company - Stronger Ground!

We initiate coverage on Arabian Cement Company (ARCC) at a TP of EGP16.5/share and recommend an ACCUMULATE. With tentative approvals on coal usage coming to the rescue (on the backdrop of energy shortages significantly hampering YTD14 production), earnings should improve sequentially during 2014-2018. Overall, we expect plant utilisation rates and sales volumes to reach optimal levels by 2016. Post recent peaks, cement prices however should witness some consolidation in 2015 – mainly on the back of improved local supplies. ARCC is subject to real risks – ongoing court case, taxes on coal and threat from imports.

Thanks to coal, clinker production recovery anticipated starting 2H14 - Post having received tentative approvals from the government to import coal as an energy source (instead of natural gas and mazut), we expect ARCC to witness substantial earnings improvement starting 2H14 and in the years ahead. Coal-fired and alternative fuel (AF) supported, in-house clinker production rates (which dropped below 50% in 1H14), should improve, in our opinion reaching c. 78% in 2015 and the optimal levels of 90% in 2016. The anticipated rise, resulting from the company's installment of a coal mill for the two production lines – cushioning the company from local energy shortages (forcing clinker imports) and the anticipated energy cost inflation.

Steady earnings growth through 2014-2018 - With energy supply cuts forcing the import of expensive clinker, 1H14 profitability hit a low (2Q14 loss of EGP9m). However, with clinker production expected to take off as a result of coal and AF usage, we expect ARCC be at a stronger footing starting 2H14. Our view is based on the understanding that using coal (CIF USD130/ton) would be cost-beneficial to cement producers when compared to the current costs of natural gas (USD8/mmBtu) and mazut (EGP2,300/ton). Besides, ARCC currently uses c. 10-15% of its energy sourced, through renewable wastes (an even cheaper source than coal), and plans to increase this proportion to 30% by 2015.

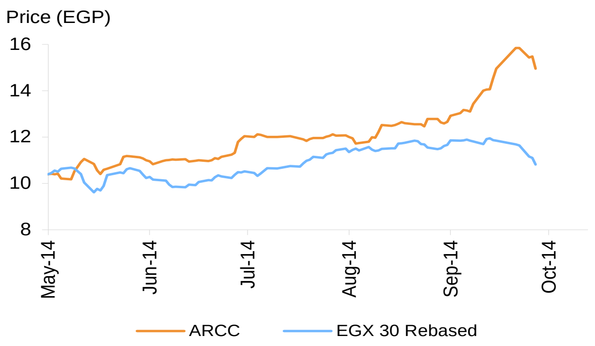
Prices to consolidate in 2015 and then gradually increase on the back of sustained demand- Given the local shortage of cement supplies and a high-cost infused industry pricing scenario, ex-factory cement prices rose above EGP650/ton in 2Q14 – compared to EGP500/ton in 2013. With local cement supplies and cash-cost structures headed towards normalcy (starting 2H14 as a result of coal availability), we expect average cement prices in 2015 to correct 7% YoY and then increase annually by 7%. With the Egyptian government directing substantial funds towards infrastructure projects, we anticipate a pickup in demand from the non-residential space (in addition to the robust real estate sector).

Court case and coal tax risks. Fallouts of an ongoing court case with the Industrial Development Authority (pending appeal at the Supreme Administrative Court) could expose the company to a higher than expected settlement. In addition, chances of the government charging exponentially higher taxes on coal could raise fundamental questions over the arguments in favor of coal.

Recommendation	ACCUMULATE
Market Price (EGP)	14.9
Fair Value (EGP)	16.5
Upside Potential (%)	11
Name of Index	EGX

Stock Data	
Reuters Code	ARCC CA
Bloomberg Code	ARCC EY
Shares Outstanding (m)	379
Market Cap (EGPm)	5,681
Market Cap (USDm)	789
Free Float (%)	23

ARCC vs. EGX30 (rebased)



Source: Bloomberg, NAEEM Research

Financial Indicators & Valuation Multiples

Year to 31 Dec.	2013a	2014e	2015f	2016f	2017f
Revenue (EGPm)	2,075	2,284	2,407	2,727	2,718
EBITDA (EGPm)	808	499	665	936	1,014
EBITDA Margin (%)	38.9	21.8	27.6	34.3	34.8
EPS (EGP)	1.11	0.45	0.79	1.36	1.53
P/E	13.5	33.6	18.9	11.1	9.8
Yield (%)	-	1.1	1.9	7.2	8.2
ROE (%)	36.7	14.8	23.2	35.6	37.4
Net debt/Equity (x)	0.7	0.5	0.3	0.1	0.0
Net debt/EBITDA (x)	0.9	1.2	0.5	0.2	0.0

Source: company data, NAEEM estimates
Closing price as of 14 October 2014

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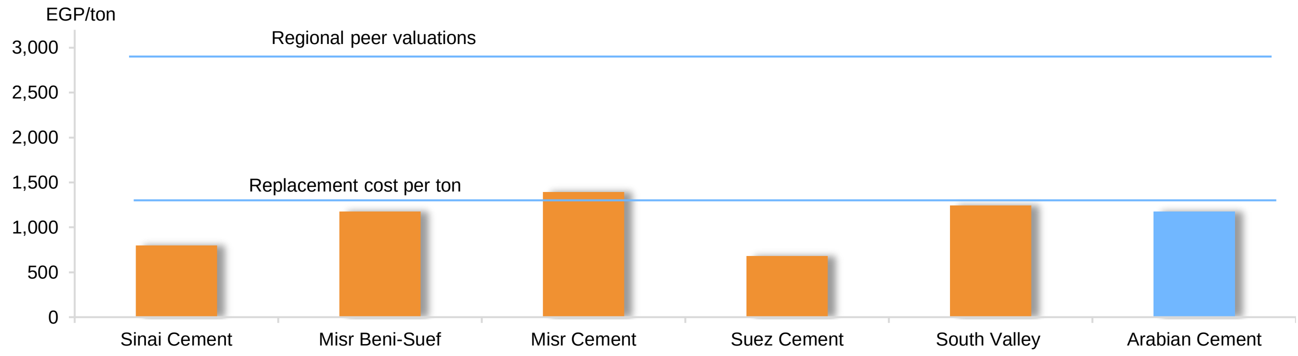
Valuation

ARCC trades at almost its current replacement cost

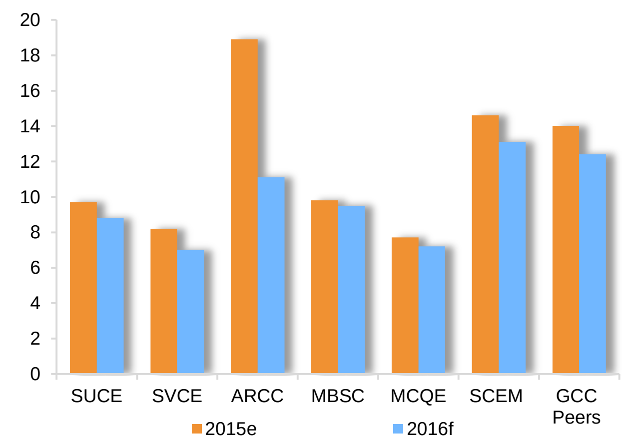
We value ARCC at a TP of EGP16.5/share and recommend ACCUMULATE. We base our valuation allotting 100% weight to the DCF model – assuming a WACC of 14.5%, Cost of Equity 17.5%, Cost of Debt 12% and terminal growth rate of 3.5%. At current market capitalisation, ARCC trades at almost its replacement cost of roughly EGP1,200/ton – in line with Egyptian peer averages, but a discount to GCC cement producers (pricing-in mainly the cost differential factors). While based on P/E comparables ARCC might currently seem relatively expensive (2015f of 18.9x), valuations should reflect opportunity when earnings eventually normalise and take off starting 2016 (P/E 11.1x). Important to note that like in the case of most cement producers, conventionally, valuations are highly sensitive to changing prices at the top-line – for 2015, our estimates assume 7% YoY correction in cement prices, expecting prices to cool off from the current peaks as a result of improved supplies (due to production kick-offs on account of the anticipated coal-switch across the industry).

ARCC valuations compared Price/ton



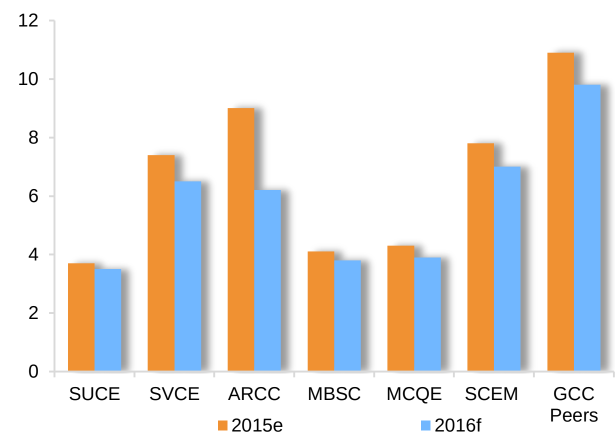
Source: NAEEM estimates

ARCC P/E vs. Egyptian & GCC Peers



Source: NAEEM Estimates

ARCC EV/EBITDA vs. Egyptian & GCC Peers



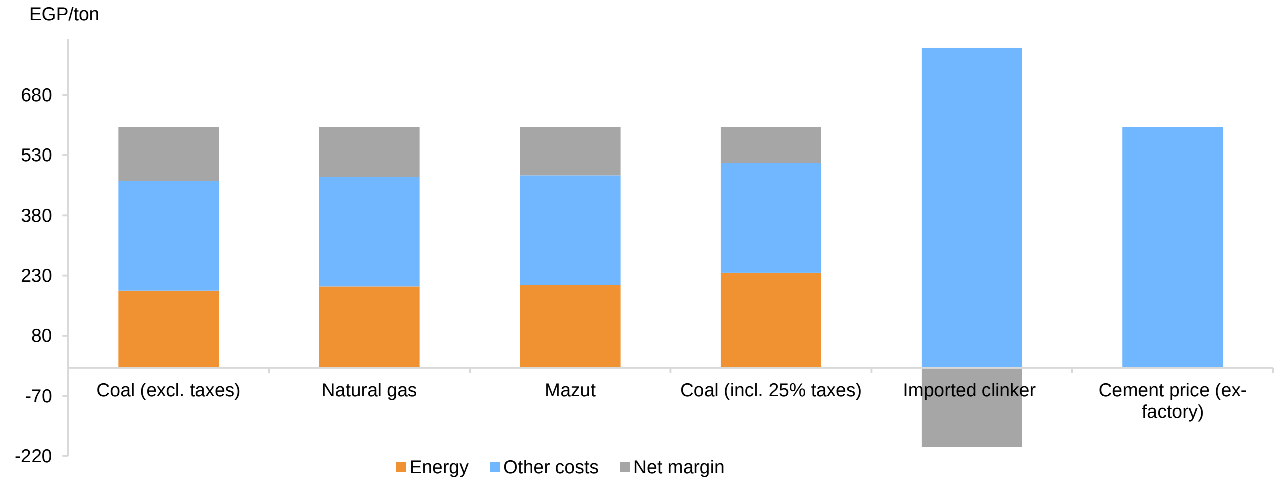
Source: NAEEM Estimates

What's going to change? Higher clinker production, coal and AF dynamics to kick in

ARCC should see profitability picking up on coal-switch and higher volumes

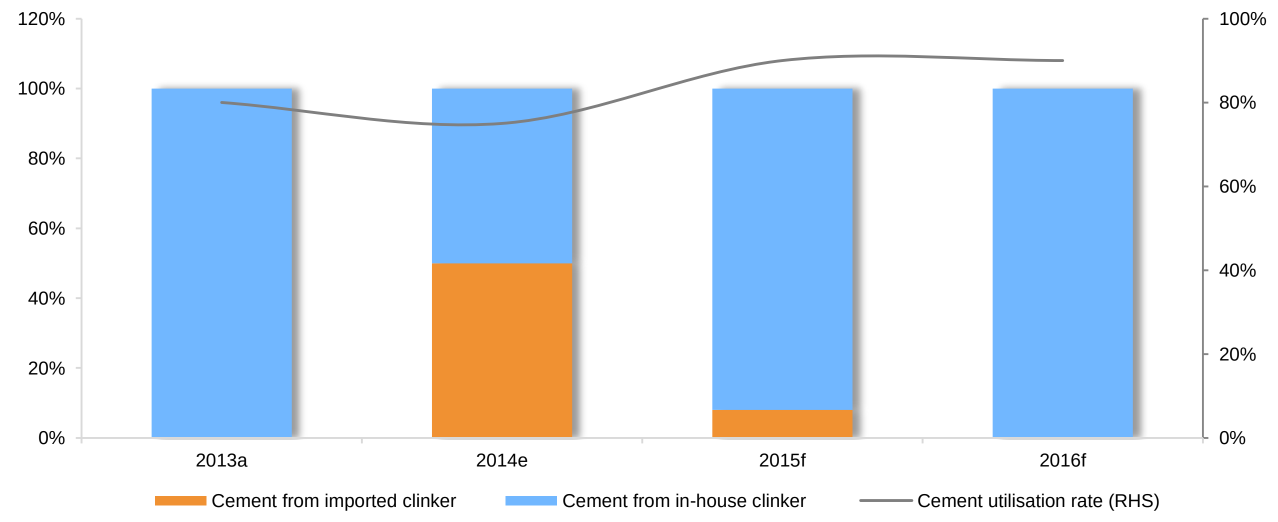
With the gradual switch to using coal as an alternative energy source to produce clinker, ARCC's profitability should pick-up sequentially during 2014-2018. Switching to coal and AF, should not only result in stronger plant utilisation rates (both cement and clinker), but at the same time preserve margins in the longer term - as per our assessment, at the current gas price of USD8/mmBtu in Egypt, it should be cheaper to use coal as an alternative energy source. Clinker production rates dropped to lows (below 50%) in 1H14, with gas supply shortages hampering plant production rates – forcing the company to import clinker (costing c. EGP450-500/ton of cement produced versus EGP200/ton using gas) and resulting in a 2Q14 loss. However, with the launch of ARCC's own coal mill (starting 3Q14), we forecast the company to rely more than 90% on internally produced clinker during 2015. YTD2014, one of the two production lines has already started operating with coal (c. 10%). With one line being almost self-sufficient using coal and with another 20% cement production exposed to alternative fuel (AF), clinker production rates should almost reach optimal levels in 2015 (we expect just 8% of cement production exposure towards imported clinker in 2015). Post 2015 however, we anticipate ARCC to be 100% self-sufficient in terms of energy required for clinker production.

Comparative cost dynamics



Source: Company Data, NAEEM estimates

Production mix and utilisation trends



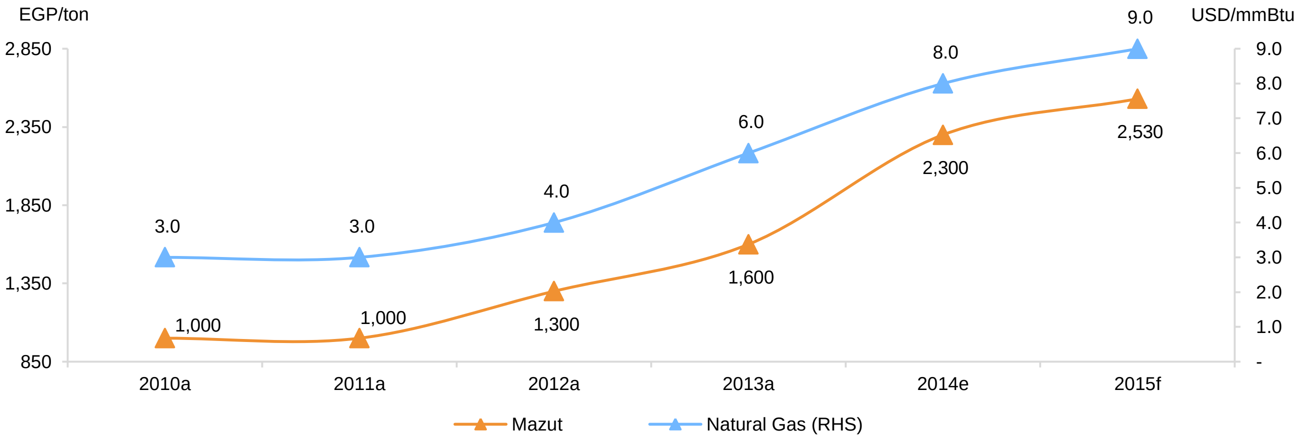
Source: Company Data, NAEEM estimates

Industry Outlook – Positive for ARCC

Post-2011 backdrop - Higher energy costs, production halts on energy and power supply disruptions

The cement industry in Egypt has a design capacity of around 67mtpa. New plant capex and licenses seem hard to materialise (with no new plants expected to be onstream anytime soon), given lack of visibility to secure energy and electricity. Post-2011, Egypt's cement sector was exposed to a string of challenges - energy supply cuts (starting 2013), power outages, labor strikes and rising energy costs - gas prices reached USD8/mmBtu (versus USD3/mmBtu in 2011) and Mazut increased to EGP2,300/ ton (cf. EGP1,000/ ton in 2011).

Energy input costs for cement producers in Egypt

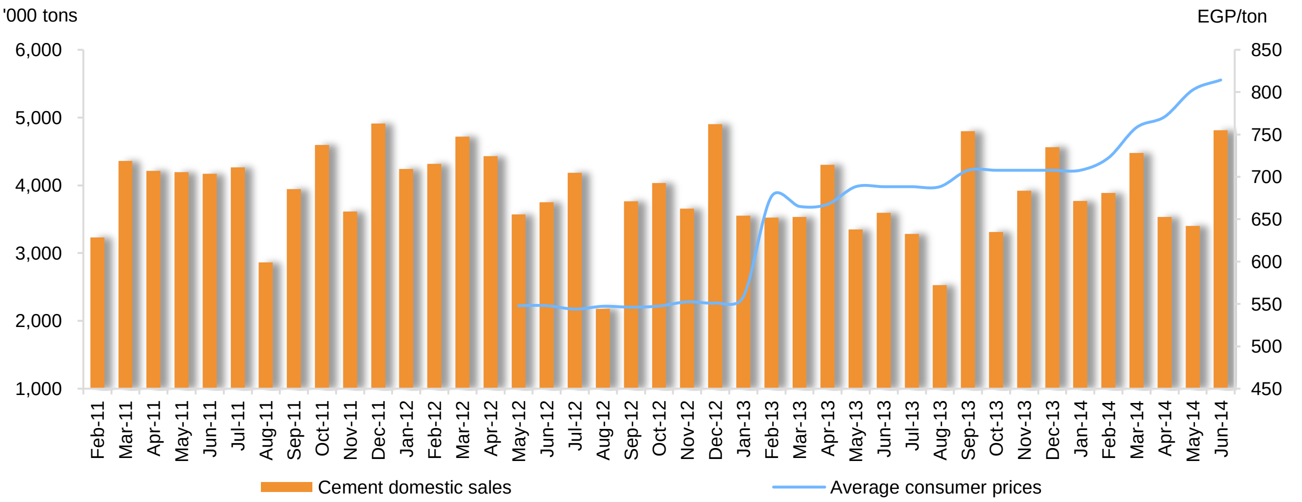


Source: NAEEM estimates

With demand being stubborn, rising prices reflect higher costs being passed on to the market

Contrary to conventional macro-economic indicators, industry demand for cement in Egypt has continued to be robust YTD, post the 2011 revolution. In our opinion, bulk of this sustained demand comes predominantly (more than 90%) from the booming real estate sector. With energy supply disruptions and power cuts starting 2013, resulting in higher production costs, ex-factory cement prices rose above EGP650/ton in 2Q14 with wholesalers quoting more than EGP800/ton. Major price fluctuations were seen when temporary recoveries in production resulted in cement prices being extremely volatile within a short span of time – indicating mainly, the underlying strength in demand (owing mainly to the real estate sector).

Egypt monthly cement sales versus prices

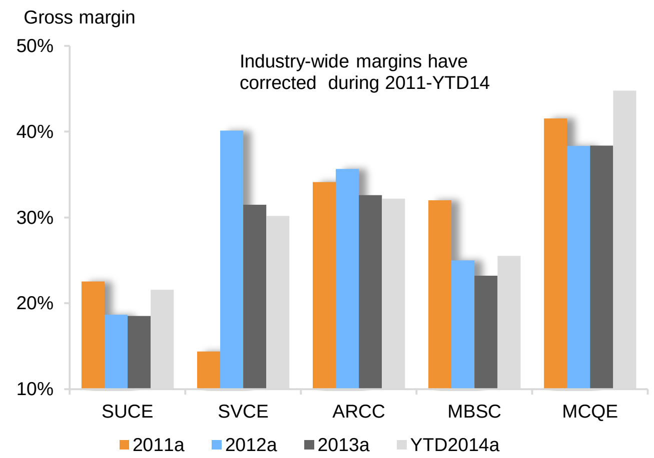


Source: CBE, NAEEM estimates Note: Monthly prices unavailable for the period before May 2012

While 2010 – YTD14 margins dropped, earnings in absolute terms remained mostly stable

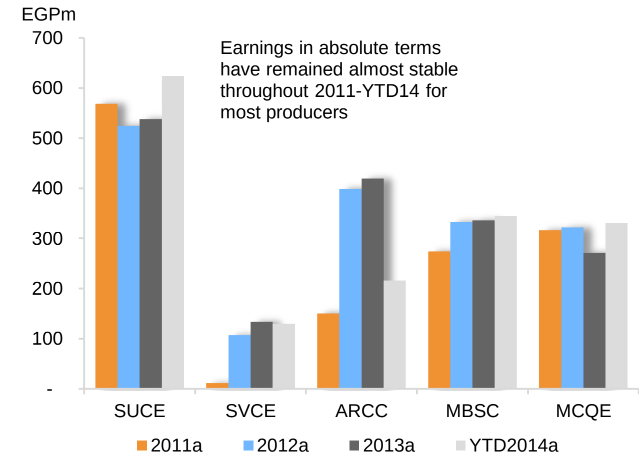
What comes as another clear indication of fundamental strength in the Egyptian cement sector, is the stubbornness in terms of industry earnings (in absolute terms) in spite of dropping margins since 2010. Roughly 90% of cement in Egypt is consumed by the residential sector (mostly private) wherein demand has continued to remain healthy even on the back of local unrest (starting 2011). Robust demand for real estate (both from the organised and unorganised sectors), to a large extent has resulted in strong price bargaining power having been restored for cement companies.

2011-YTD14 margin trends



Source: Company Data, NAEEM estimates

2011-YTD2014 earnings trend

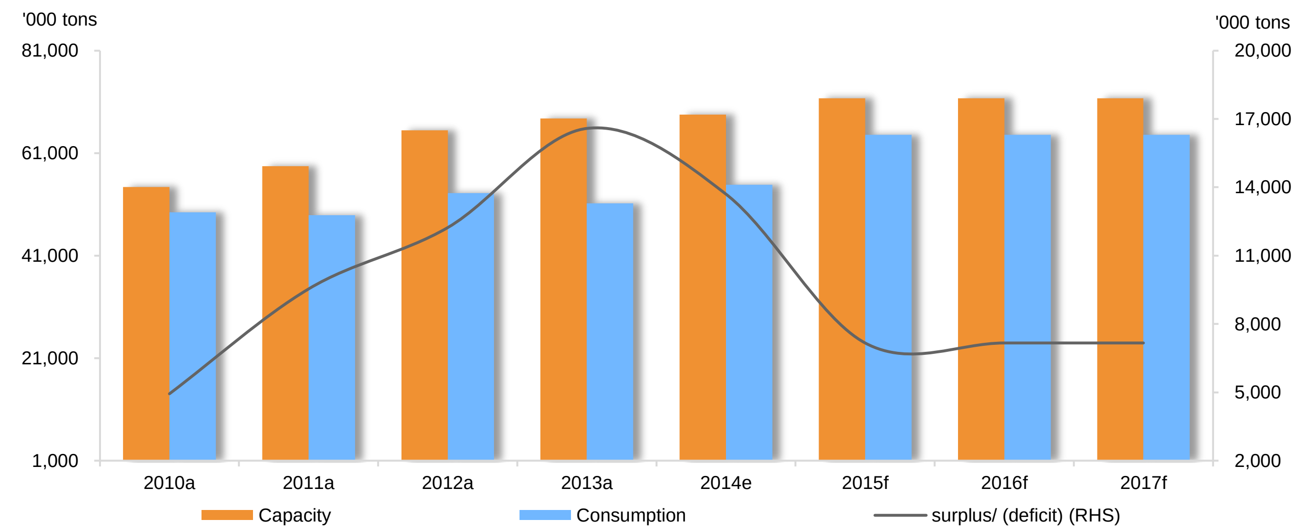


Source: Company Data, NAEEM estimates

Demand/supply fundamentals to be intact throughout our forecast period

Demand going forward from real estate and infrastructure projects is expected to flourish. Now with the Egyptian government directing substantial funds (more than EGP60bn) towards infrastructure projects, we anticipate a pickup in demand from the non-residential side as well (which has largely remained inactive post 2011). In addition, we expect no slowdown in real estate construction activity, given the government (in tandem with the Egyptian army)'s initiative to spur investments into the low-to-middle-income housing segments (ex-Arabtec's 1m unit housing project). Overall, we forecast cement consumption to grow at a CAGR of c. 7% during 2014-2018. With no new cement plants expected to be operational over the coming few years, the local demand/supply equation should remain tight in our opinion.

Egypt cement capacity, consumption, surplus/deficit



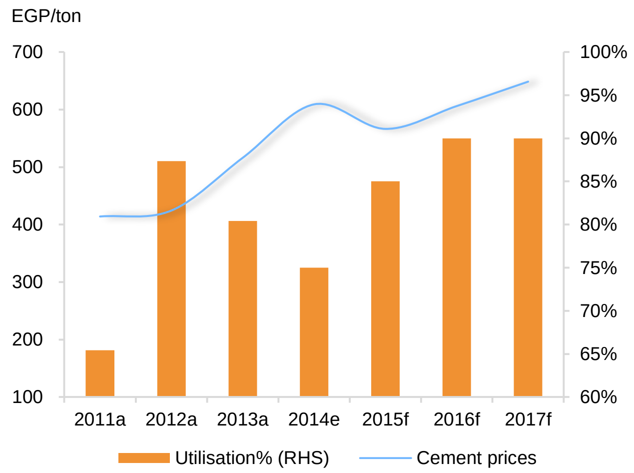
Source: CBE, NAEEM estimates

ARCC's earnings to grow steadily in 2014-18

Frequent energy shortage, lower utilization rates

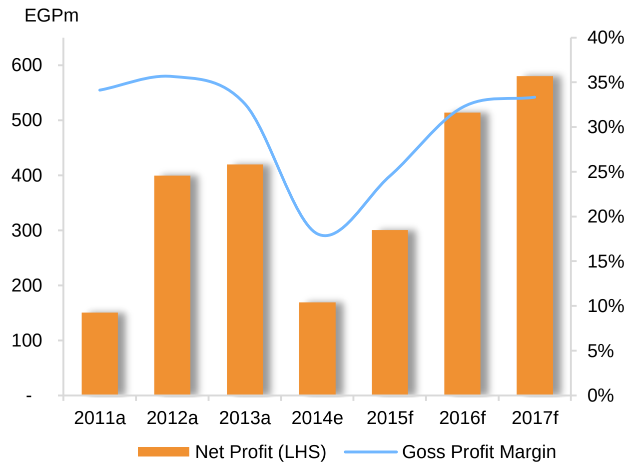
Impacted positively by higher production volumes and growing prices, ARCC's profitability (in real terms) should witness steady growth during 2014-2018. Given the tentative coal usage approvals that have come through, ARCC hopes to have both of its production lines to be operational using coal in 2015. As of 3Q14, ARCC has already commenced operating one of its clinker production lines using imported coal. With the company exposed 20% to alternative fuel (produced from agricultural and other wastes), we anticipate ARCC's cement plants to operate at 85% utilisation rates in 2015 – expecting less than 10% to be produced from imported clinker (reflecting mainly the exposure towards local energy supply cuts). Starting 2016 however, we expect the company to be 100% self-sufficient in terms of energy required for producing clinker and expect cement capacities to be utilised optimally at 90% from thereon.

ARCC cement volumes and price trends



Source: Company Data, NAEEM estimates

ARCC margin and profit expectations

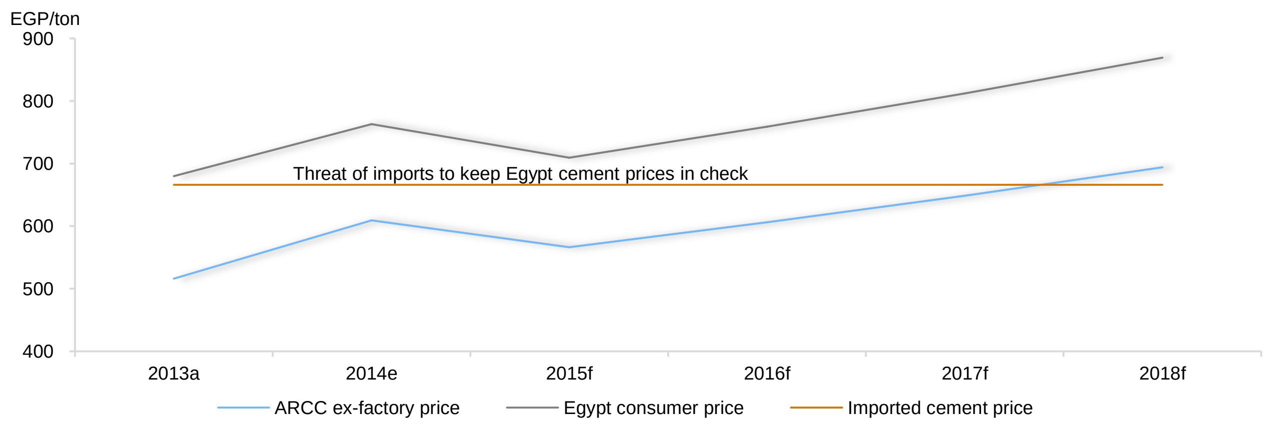


Source: Company Data, NAEEM estimates

We expect cement prices to correct 7% in 2015 followed by 7% annual growth starting 2016

Cement prices on the other hand, in our opinion should correct by 7% (to EGP566/ton) during 2015 from the peak 2014 levels (EGP610/ton) – assuming prices to cool off as a result of improved supplies and lower cash-costs (as reduced industry-wide clinker imports would result in lower price-support levels). Post 2016 however, we expect cement prices to increase by 7% annually. Our expectations on prices are more on the conservative side, given concerns over the threat from imports if prices surge steadily.

ARCC cement prices compared



Source: CBE, NAEEM estimates

Foreseeable risks

Possibility of high tax imposition on coal

Our estimates assume 25% tax (inclusive of all tariffs and carbon emission taxes) on imported coal, resulting in the total cost of coal to cement factories of USD160/ton of coal. However, our valuations could be subject to change, if the government decides on imposing exorbitantly higher tariffs on coal usage. According to an unconfirmed news source, an official at the Egyptian Ministry of Finance noted that Egypt is considering imposing high taxes - exceeding 60% of the coal purchase value. While we are yet to confirm the authenticity and accuracy of the news, we however are wary of what might actually unfold with regards to the government's tariff policy on imported coal (for which there are no precedents) – the government is yet to announce its decision on carbon taxes and/or duties on imported coal.

Ongoing court case with the IDA

The government (represented by the IDA) is demanding EGP563m (EGP280m per line) plus interest for the two licenses which were bought in an auction. ARCC has appealed against paying this amount alleging other competitors to have paid just a minimal amount in comparison. The initial ruling at a lower court went against the company and an appeal has been made at the Supreme Administrative Court. The dispute is also pending before the ICSID (International Centre for Settlement of Investment Disputes) with an arbitration case filed by CLU (ARCC's main shareholder) against the government. ARCC has agreed to pay EGP8m/month until settlement of the case. On this ongoing dispute, we estimate that roughly EGP380m has already been paid by the company as of 1H14. However, the ultimate outcome and payout is very difficult to assess in our opinion. Nevertheless, giving the below payout scenarios on TP -

Final Payout (EGPm)	TP (EGP/share)
587	Unchanged (already provisioned)
850	15.8
1,000	15.4

Energy cost increases with chances of much more to come

Our estimates assume natural gas and mazut costs to increase to USD9/mmBtu and EGP2,600/ton respectively by 2016. Post this our cost assumptions are capped at USD9/mmBtu for gas and EGP3,000/ton for mazut. Import parity price for gas is somewhere in the range of USD12-14/mmBtu. Hence, chances of the company failing to secure sufficient supplies of coal and AF as energy input, could result in drastic margin compression.

Stability in Egypt's political and economic landscape

With investor sentiment and confidence centered mainly on the changing variables in Egypt's political and macro-economic scene, it is paramount that stability is restored for assets to be fairly priced. Any escalation in the political and economic fronts could send risk premiums even higher.

Probability of price regulations

On the backdrop of the latest surge in local cement prices, the authorities could regulate prices to curb inflationary pressures. Any price controls implemented by the government would be bad news for ARCC, putting a cap on margins/returns.

Threat of imports – Turkey and KSA

With rising costs, break-even/price support levels for cement producers increase. Although not an option explored by local consumers in Egypt yet, the possibility of imports (Turkey and KSA) is something that needs to be borne in mind. While KSA currently has export restrictions in place, future imports from the kingdom cannot be ruled out (in case of construction activity slowing down in the kingdom).

Depreciating EGP

Our assumptions take into account an EGP/USD conversion rate of 7.4 throughout our forecast period, based on current black market rates. However, further depreciation of the EGP could result in Coal import costs rising higher and putting more pressure on margins

Upside potential

Ongoing court case swinging in favor of ARCC would be value accretive

With the ongoing license court case being subject to a decision by the SAC and ICSID, possibility of the final rulings being in favor of the company, could be value accretive to ARCC. With the company already having provisioned the liability to the extent of EGP587m in its books, chances of the final settlement amount being lower, could result in a valuation upgrade to the stock.

Final Payout (EGPm)	TP (EGP/share)
0	18.0
120	17.7
240	17.4

Cement prices could rise higher than anticipated

For cement prices, our estimates assume 7% correction in 2015, followed by 7% annual increase starting 2016. However, with demand expected to grow on the back of the government's economic stimulus packages and with supplies remaining stable (with no new plants expected anytime soon), local cement prices could end up being much higher than expected – triggering an upside to the valuation.

Generous dividend payouts

With most of the capex initiatives drawing to an end, the company could commence on a generous dividend payout policy earlier than expected. It is quite feasible that the company's payouts for the years 2014 and 2015 could be much higher than expected; our estimates currently assume 36% payouts for 2015 and 2016, followed by 80% starting 2017.

Growth potential

While there are currently no new expansion plans (organic or inorganic) announced by the company, possibilities of the same occurring in future cannot be ruled out. With the Egyptian cement industry being fragmented with 19 different players in the market, future M&A propositions are a realistic scenario for ARCC. Greenfield expansions could also be a future possibility; however, for this to occur, more visibility would be required in terms of auction mechanism, license fees, electricity grid connection & availability, coal taxes and energy supplies.

About Arabian Cement Company

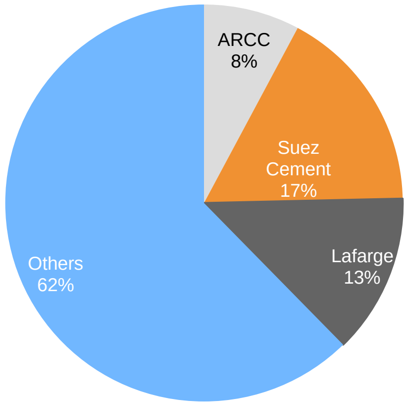
ARCC is Egypt's third largest cement producer

The company is one of the three largest producers of cement in Egypt and sells under the brand Al Mosalah. Production facilities are relatively new (commenced in 2008 and 2012). There are two cement production lines with a total production capacity of 5mt. The company also owns utilisation rights at a limestone quarry located approximately 2.8 km from its plant, from which it sources all of its limestone requirements. It sells its cement through distributors, wholesalers and retailers to most Egyptian governorates. Almost all of the production (more than 97%) is sold locally with minimal exposure to exports.

The company's main target is to switch to coal and AF as energy sources

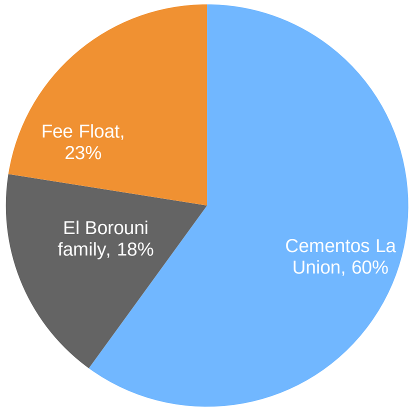
As of 2H14, the company relied mostly on natural gas for cement production, with 10% exposure to AF. The target is to increase the AF proportion to 30% by end-2015. Plans are also laid out to use coal as the primary energy source – both production lines to be equipped with coal during 2015. ARCC enjoyed a tax holiday until 2013 with a 25% tax rate applicable starting 2014. Spanish cement group Cementos La Union owns 60% of the company.

ARCC has an 8% market share in Egypt



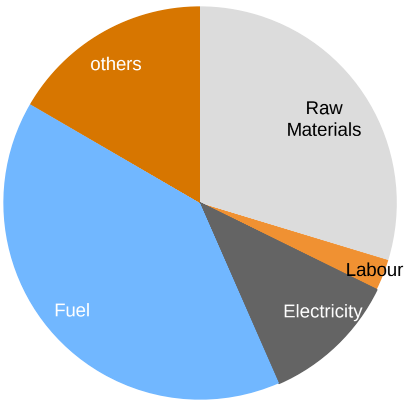
Source: NAEEM estimates

Main shareholders



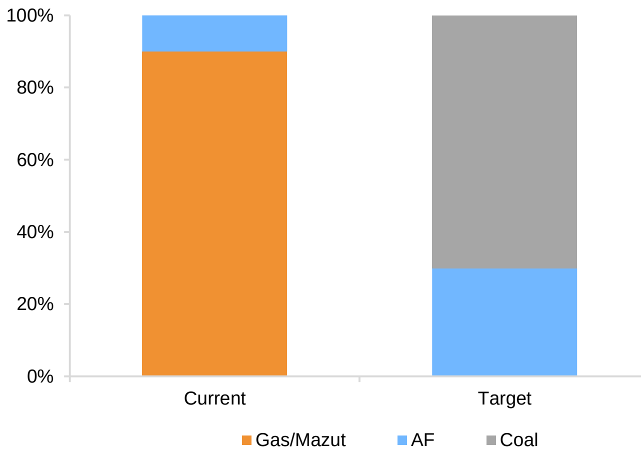
Source: Company Data

ARCC's COGS break-down



Source: NAEEM estimates

ARCC's energy exposure



Source: Company Data, NAEEM estimates

Disclosure Appendix

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Rating	Upside/Downside potential	Rating distribution as of 15 October 2014
BUY	>20%	46%
ACCUMULATE	>10% to 20%	11%
HOLD	+10% to -10%	35%
REDUCE	<-10% to -20%	4%
SELL	< -20%	4%

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