

Omani Cement Sector – Update Note

March 27th, 2018

	RCCI OM	OCOI OM
TP (OMR)	0.805	0.426
Current Market Price (OMR)	0.740	0.364
Upside/(Downside)	8.7%	17.2%
Recommendation	HOLD	HOLD

- Demand supply gap persists. Around 50% is covered by regional players
- Capacity utilization to improve in coming years.
- Cost control initiatives to support margins. Export front is key for business stability
- Multiples are attractive in the long run

We kept our earlier **HOLD** recommendation for both Oman Cement and Raysut Cement despite challenges and weak performance in 2017 with revised target prices at OMR 0.426 and OMR 0.805 Respectively. At those levels, Oman Cement offers an upside of 17.2% and Raysut Cement offers an upside of 8.7%

We believe the worse has happened and companies are forced to accelerate efforts towards finding solutions. Our major arguments are based on:

- 1- Strong macros and healthy sector status.
- 2- The implications of the current and coming cost saving initiatives
- 3- Higher capacity utilization without need for immediate large Capex
- 4- Attractive opportunities at the export front

We estimate total production to increase at CAGR of 4.9% during 2018 – 2022 at 6.9mn tons of cement assuming full utilization by end of the study horizon. We see sales of cement to be 5.7mn tons in 2018, an increase of 5.7% on yearly basis and to register a CAGR of 4.9% during the coverage period.

We expect cement dumping to continue in the short run. This will likely be eased due to hike in raw material and power costs. In addition to imposing of VAT which will result in higher production cost thus higher prices abroad and consequently lesser challenges to Omani cement players. We do not see threat from lifting ban on cement exports by Saudi Arabia due to logistic difficulties and higher transportation costs.

Total revenue to increase at a compounded annual growth rate (CAGR) of 5.3% during 2018 – 2022. We estimate diminishing role of power costs in the total operating costs during the forecasted period. We assume energy expenses as % of revenue to drop by about 512 BPS and 100 BPS for Oman Cement and Raysut Cement respectively in 2018 – 2022.

Key valuation metrics, 2018

	RCCI OM	OCOI OM
Operating Margin	10.6%	19.6%
Net Profit Margin	9.2%	19.5%
EV/EBITDA (x)*	9.84	6.11
EV/ton (OMR)	31.48	33.28
ROAE	4.6%	7.2%
ROAA	3.6%	5.9%
Dividend Yield	4.5%	8.3%
P/E Ratio (x)*	21.34	10.37
P/BV Ratio (x)*	0.97	0.74

Source: U Capital Research, Company Financials

*Market price for 2018 and subsequent years based on closing price of March 27, 2018

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Cement Industry Outlook

Adequate demand for cement but outsiders reduce the attractiveness of expansions

It is estimated that total demand for cement in Oman is around 9mn tons a year, of which 55 – 60% is covered by local players, mainly Raysut Cement and Oman Cement. Theoretically, this provides golden opportunities for expansions bearing in mind that current implied level of utilizations are set at good levels of 80 - 85%. However, the cheap landed cement from neighboring countries at OMR 20 – 22/ton compared with local realization average of OMR 25/ton, makes it unrealistic to expand unless providing great cost control initiatives. Moreover, the upcoming entrants to the market especially within free zone areas to add more pressures.

Nevertheless, in the medium to long run, we believe the demand for cement to absorb local player's total productions at existing and even at full utilization levels. Our positive view on cement demand is built on the following factors:

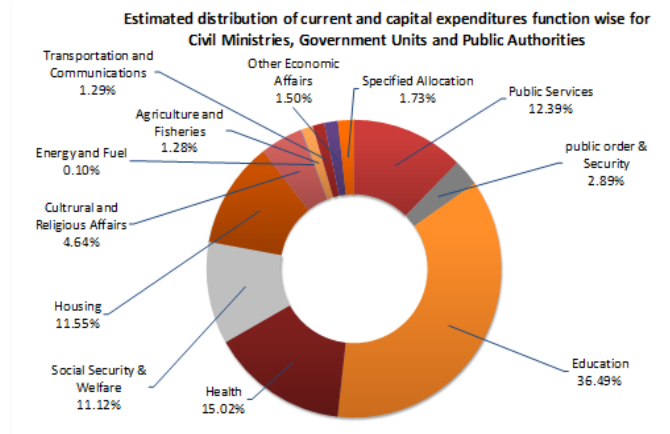
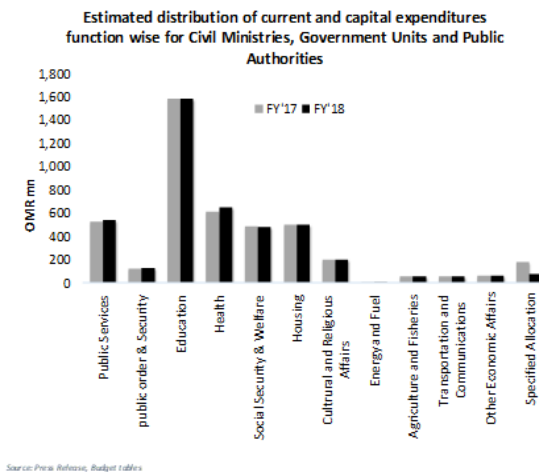
➤ Growing population and need for housing (traditionally forms more than 50% of the cement usage)

Oman population has increased at a compounded annual growth rate (CAGR) of 5.1% during 2014 to 2017, and currently stands at 4.6mn of which 55% are Omanis who prefer to own houses rather than to rent. This creates need for building houses bearing in mind that:

- 83% of the total building permits during 2016 were residential permits. (Source: NCSI)
- 87.8% of the granted lands in 2016 were for residential use. (Source: NCSI)
- Affordable housing programs are getting momentum supported by the government efforts along with the Ministry of Housing and other stakeholders to support and finance middle and low-income families through social housing programs.
- The government plans to develop houses at the Express Highways¹.

➤ Favorable general budget and government commitment

Oman government budgeted spending of OMR12.5bn in 2018 which is 6.8% higher than the budgeted spending of last year and 2% lower than the actual expenditure of OMR12.7bn in 2017. Social Security & Welfare and Housing Sector comprise 27.3% of the total budgeted spending. An amount of OMR80mn has been allocated to continue to implement the Social Housing Scheme and Housing Aid Program for eligible citizens, as well as housing loans provided by Oman Housing Bank. Moreover, the appropriations of housing and development loans amount to about OMR30mn.



¹ <http://www.omanobserver.om/affordable-housing-plan-take-off-soon/>

Moreover, the government efforts to tackle unemployment among Omani youth and notable increase in minimum salaries have helped the purchasing power and thus demand for houses. On the other hand, the budget statement has pointed out that key projects are still on the map or progressing. It named some projects such as **Liwa Housing project** (The housing project offering an estimated 2,500 – 3,000 housing units along with all infrastructure facilities of an urban development), Batinah Expressway, building new hospitals, roads, airports and projects within the industrial areas.

➤ The National Program for Enhancing Economic Diversification (TANFEEDH)

One of the program initiatives is to enhance the non-petroleum manufacturing industries including Cement. The focus towards non-oil industry will result in opening new windows for cement usage especially within the special economic zones and near the mega projects. The program also targets lowering landed cement from the other countries either through establishing new plant or enhancing current utilizations.

We forecast local listed cement players to improve their productivity and utilizations trying to benefit from the ample room for further production without the actual need for BIG CAPEX. At this moment, we do not expect Oman Cement and Raysut Cement to further increase their capacities, at least in the short run, but rather to indirectly support their top line either through setting up new cement company but at low cost or exploring new markets where they do not have to pressurize their realizations further.

Despite the intention of establishing a new joint cement company i.e. Al Wusta Cement Company LLC at Duqm Special Economic Zone, yet it is subject to further feasibility studies considering the huge costs involved which is estimated at around OMR 225mn. Al Wusta Cement Co. has received the right for 500,000 square metres of land within the industrial area in Duqm for 50 years to set up the project. The land lease agreement is renewable. Originally, it was planned that the construction work for the project to start in this year, while the actual production is expected to commence in 2020. According to a feasibility study conducted by Al Wusta Cement, there are two options for installed capacity: either 5,000 tonnes per day or 10,000 tonnes per day.² However, both Oman Cement and Raysut Cement are conducting further studies on the project and the final outcome is not yet finalized. For the time being, we have not implemented the assumption of setting up the new joint company in our model subject to further details including the cost of funding.

We estimate total production to increase at CAGR of 4.9% during 2018 – 2022 at 6.9mn tons of cement assuming full utilization by end of the study horizon. We see sales of cement to be 5.7mn tons of cement in 2018, an increase of 5.7% on yearly basis and to register a CAGR of 4.9% during the coverage period.

Realizations to remain under pressures

In 2017, both Oman Cement Co. and Raysut Cement Co. have attributed the decline in realizations to factors like competition, cheap landed cement, developments in export markets and offering discounts to key clients. However, in our view, the companies have done well in relatively maintaining selling prices near historical levels (OCOI OM: OMR 25.4/ton Vs. 3yrs avg. of OMR 26/ton and RCCI OM³: OMR 24/ton Vs. 3yrs avg. of 24.5/ton).

The main threat which is the landed cement being sold at low prices eats away 45% of the domestic demand is likely to remain due to the oversupply situation in the neighboring countries and slow recovery of the region economy. According to Reuters, the UAE has cement capacity of 41 metric tons while demand is around 21 metric tons, almost half⁴. This forces the UAE cement players to search for alternative markets, mostly nearby like Oman, Kuwait and Bahrain. During the Saudi Arabia cement export

² <http://timesofoman.com/article/119663>

³ Only local and include. Pioneer Cement

⁴ <https://www.khaleejtimes.com/gcc-building-materials-market-rides-regions-real-estate-boom>

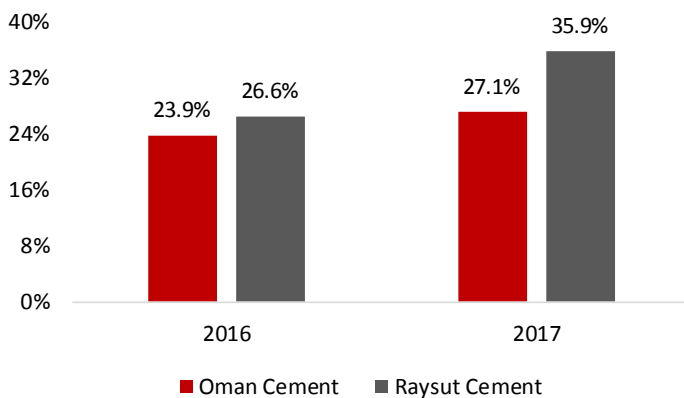
ban, the UAE players benefited from exporting more to Bahrian. However, after lifting the ban, pressures have returned, and Oman remains at top of the export list.

Although we expect their cement dumping to continue in the short run yet it is likely to be eased due to hike in raw material prices and power costs like coal in addition to imposing VAT which will result in higher production cost thus better realizations abroad and consequently lesser challenges to Omani cement players. We do not see threat from lifting ban on cement exports by Saudi Arabia due to logistic difficulties and higher transportation costs. We estimate realizations to soften slightly in 2018 by 0.5%

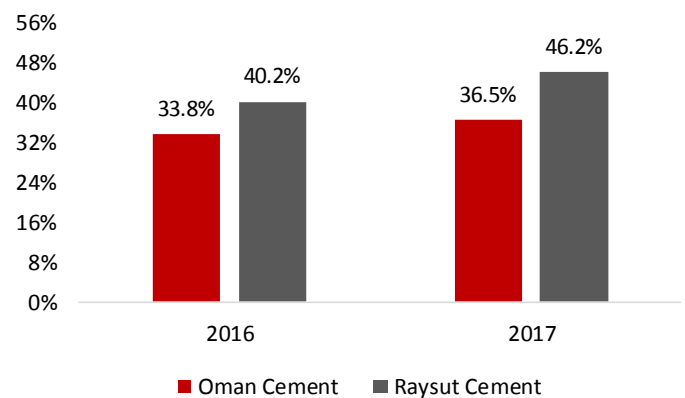
Cost restructure: how to optimize?

Like any other industrial company in the region, the GCC governments procedures to tackle the negative impact of low oil prices on their budgets, including imposing taxes, VAT and higher tariffs have squeezed operational and profit margins. Most of the impact was in shape of increasing power costs. The 2017 financials have revealed that energy expenses as percentage of revenue and percentage of cost of sales have gone up by 325 BPS and 276 BPS for Oman Cement and 929 BPS and 598 BPS for Raysut Cement in 2017 respectively.

Power Costs as % of Revenue



Power Costs as % of Cost of Sales



Source: Companies' Financials, U Capital

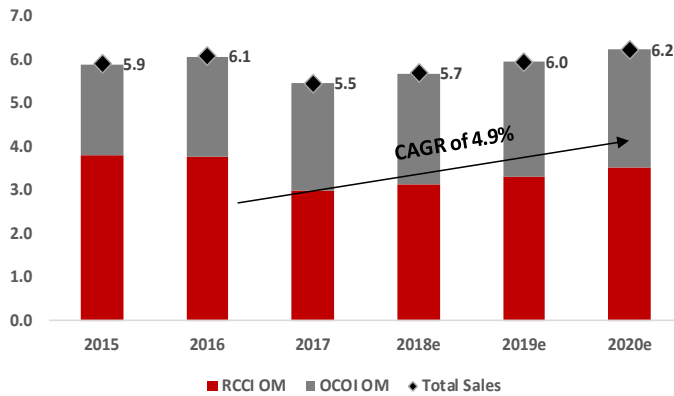
For instance, Raysut Cement Co. stated that higher energy costs due to increase in power tariff to OMR 0.027/KWH from OMR 0.016/KWH in 2016, a yearly increase of 69% and rise in gas price by 3% have resulted in total additional cost of OMR 1.97mn in 2017.

Due to the nature of business and cement glut, cement companies cannot pass higher operating costs to clients. Hence, to compete, companies must focus on cost control initiatives and product quality. Oman Cement Co. has a comparative advantage compared to its local peer as the company runs its own power plant which saves the company from importing the majority of its power needs unlike Raysut Cement which has to import most of its energy requirement. One of the upcoming expected cost control initiatives is Oman Cement intention to upgrade its power plant with the latest technology turbine aiming to better utilize the same amount of gas, which shall result in annual savings of OMR 2.5mn in operating expenses. Raysut Cement also said that it will focus on enhancing its cost control procedures.

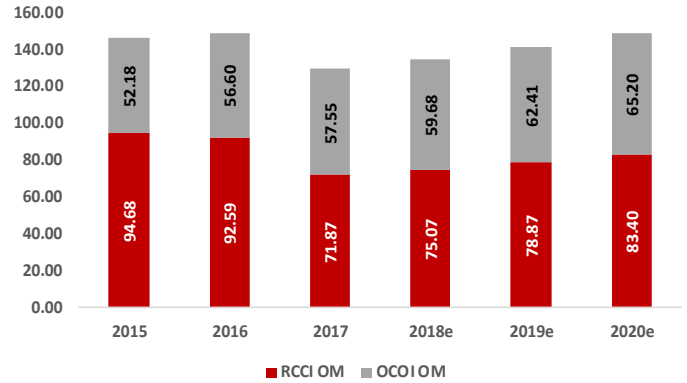
We believe this is one of the best ways to give greater flexibility to make competitive realizations, bigger market share and better margins. Having said that, we estimate diminishing role of power costs in the total operating costs during the forecasted period. We assume energy expenses as % of revenue to drop by about 512 BPS and 100 BPS for Oman Cement and Raysut Cement respectively in 2018 – 2022.

Cement Sector in Charts

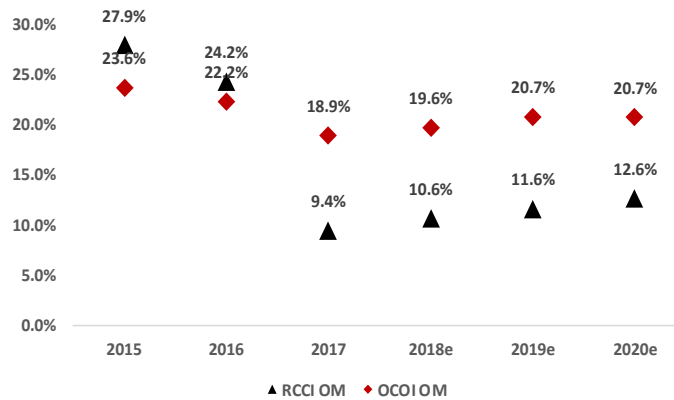
Combined Sales of Cement, Mn tons



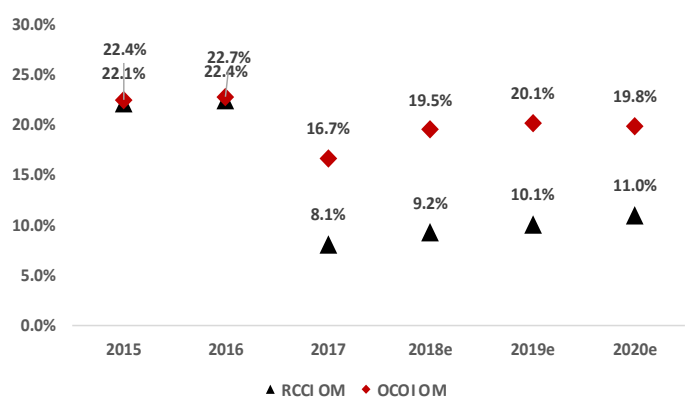
Total Revenue, OMR mn



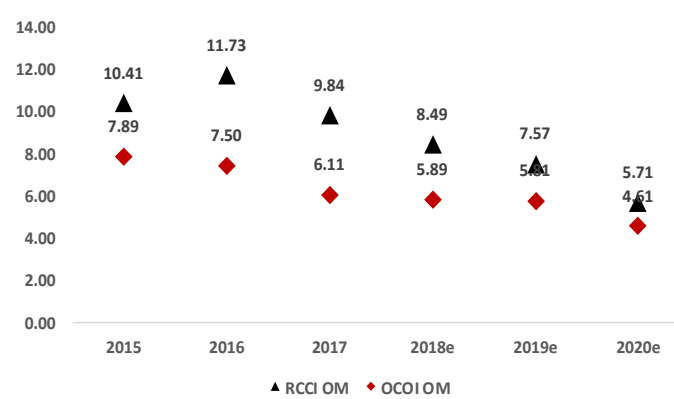
Operating Margins Performance



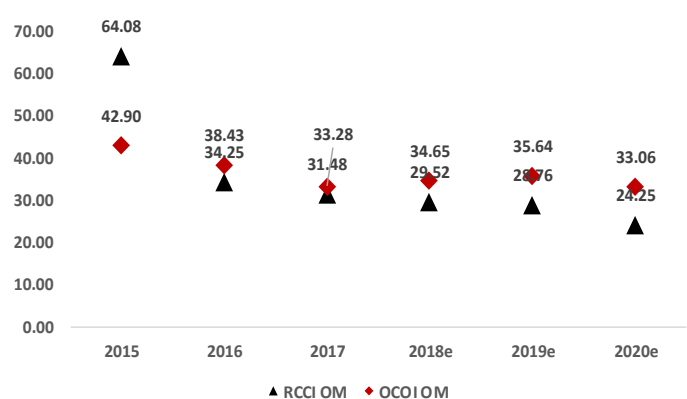
Net Margins Performance



EV/EBITDA (x)



EV/ton (OMR)



Source: Company's Financials, U Capital

*Market price for 2018 and subsequent years based on closing price of March 27, 2018

Oman Cement Co. – Outlook

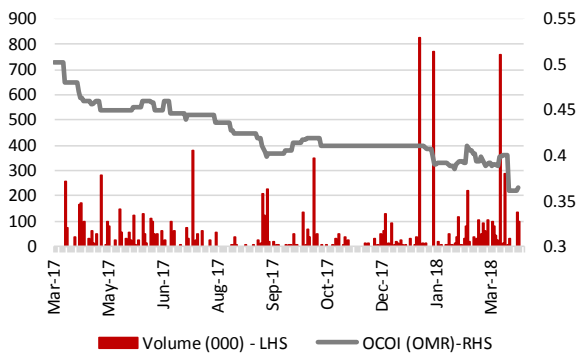
TP: OMR 0.426/ share

Recommendation	HOLD
Bloomberg Ticker	OCOI om equity
Current Market Price (OMR)	0.364
52wk High / Low (OMR)	0.48/0.36
12m Average Vol. (000)	39.30
Mkt. Cap. (USD/OMR mn)	313/120.4
Shares Outstanding (mn)	330.9
Free Float (%)	20%
3m Avg Daily Turnover (000)	27
6m Avg Daily Turnover (000)	18
PE 2018e (x)	10.3
PBv 2018e (x)	0.7
Dividend Yield '18e (%)	8.3%

Price Performance:

1 month (%)	-8.54
3 month (%)	-11.22
12 month (%)	-27.49

Price Volume Chart



Source: Bloomberg

We Keep our **HOLD** recommendation on Oman Cement with a target price of **OMR 0.426/share**, offers an upside of 17.2% compared to the current market price. TP implies PE'18e of 10.3x and PB'18e of 0.7x. The stock is down on YTD by -11.22%. Key triggers and assumptions include 1) Focus on export segment, 2) Stability in realizations, 3) production cost saving starting 2021 on upgrading the power plant and 4) better returns on investments.

We expect revenue of OMR 59.7mn in 2018, up by 3.7% on annual basis and a CAGR of 4.4% during 2018 – 2022 considering a sales discount of 9%. We see healthy operating margin over the forecasted years considering the ability to control cost taking into account the cheaper alternative raw materials and estimated annual savings of OMR 2.5mn in operating expenses due to upgrading of the power plant only. We expect cost of production to decline from the current level of OMR 14.36/ton to OMR 14/ton by 2022. Accordingly, operating profit margin is estimated at 19.6% in 2018 compared to 19% in 2017 and to reach 23% by 2022.

Further, the lack of tax adjustments and better return on investments to support the net earnings. We expect net profit to stand at OMR 11.6mn in 2018 up by 21% on yearly basis and net margin of 19.5%. We expect net earnings to register a CAGR of 7.9% during 2018 – 2022.

The company attempts to strengthen its export segment and implement cost saving initiatives are critical for the business stability. We believe 2017 challenges have been reflected on the stock price, thus at current levels, the stock is attractively placed. The company has solid balance sheet and sound returns and yields. We estimate the current dividend policy not to be distracted in the short to medium term. We have not implemented in our model the planned set up of Al Wusta Cement Co. which requires big CAPEX as we prefer to wait for further details in this regard. Currently the stock provides a dividend yield of 8.3% compared to the regional industry average of cement companies 6%.

Key upside risks include:

- Better than expected cost savings.
- Better than expected export sales and utilizations.
- Lower required CAPEX for expansions.
- Higher than estimated investment returns.
- Higher realizations for landed cement due to increase cost of production in the neighboring countries

2017 Review

Revenues went up by 1.67% YoY to OMR 57.5mn the highest since year 2009 in spite of tougher competition and higher discount sales (9.9% of revenue in 2017 Vs. 5.5% in 2016). This was due to higher level of sold volumes (+7.8% YoY) as Oman Cement sold 2.48mn tons of cement of which 98.8% being sold locally. Realizations on the other hand have declined to OMR 23.2/ton compared with OMR 24.61/ton a year ago, i.e. a decline of 5.7%.

Operating margin dropped on higher energy expenses. EBIT margin came down from 22.2% in 2016 to 18.8% in 2017 despite significant drop in imported clinker (the traditional cause of high cost of sales). The main reason is related to notably higher energy costs that include gas and electricity. Data shows that energy expenses to revenue ratio went up from 23.9% to 27.1% in 2017. Cost of sales to revenue ratio has gone up by 356 basis points. However, higher power costs impact is seen lower in the case of Oman Cement compared to its main rival as the company has its own power generator. The company used to buy electricity from the government before the hike in gas prices stating 2015. Later, the company has started utilizing its power generator fully.

Net earnings notably down further on higher taxes. Oman Cement Co. posted a net profit of OMR 9.6mn in 2017, down by 25.5% YoY. This was as consequence of higher tax rate and the adjustments which came at OMR 1.5mn. The tax portion out of profits before tax stood at 25% instead of historical average of 11% or current average of 15%. Accordingly, the net profit margin was 16.7% versus 22.8% in 2016.

2017 Year in charts



Source: Company's Financials, U Capital

*Built on the theoretical one

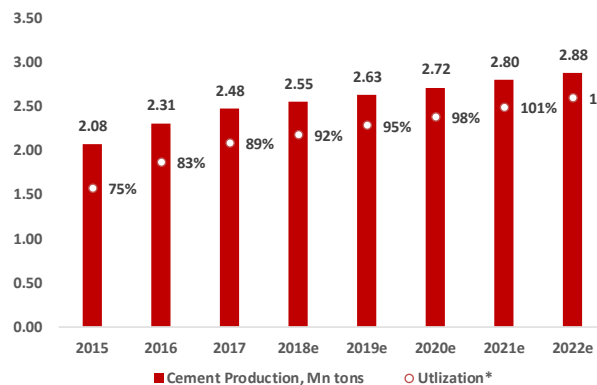
Forward Outlook

Eying export and retain key customers; expansions on hold for the time being

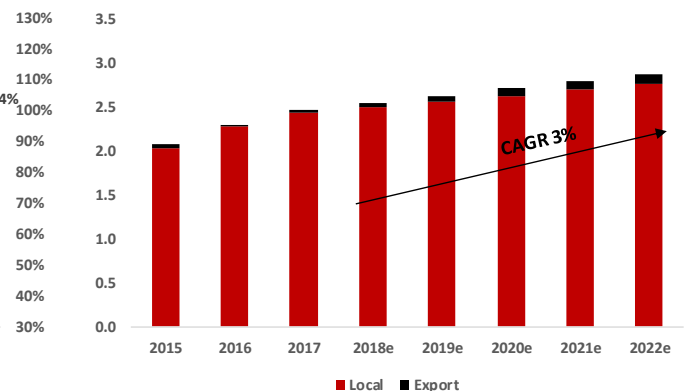
According to the management guidance, Oman Cement Co. is looking to strength its export segment which is currently represents around 2% of revenues before discounts. The company exports mainly oil well cement. Iraq and Qatar are promising markets and there are some exports to Venezuela. Considering the low profit margin from selling locally due to the stiff competition, we believe export segment to get momentum in the coming period. We forecast its share out of total sales to grow from 2% to 4% by 2022. In terms of production, there is an ample room for higher utilizations in the medium term without the need for extra expansions.

Currently, cement utilization rate stands at 69.7% based on theoretical capacity and 89.3% on the implied one. We forecast the rate to be fully utilized (based on the implied capacity) during 2018 – 2021. Going forward a need for either import of clinker or go for expansion will rise. We implement the first option in our model due to costs involved in the latter one and plans regarding setting up a new company in al Duqm. As a result, we expect cement sales to register a CAGR of 3% during 2018 – 2022. We expect sales of cement to touch 2.55mn tons in 2018.

Cement Production, Mn tons Vs. Utilizations*

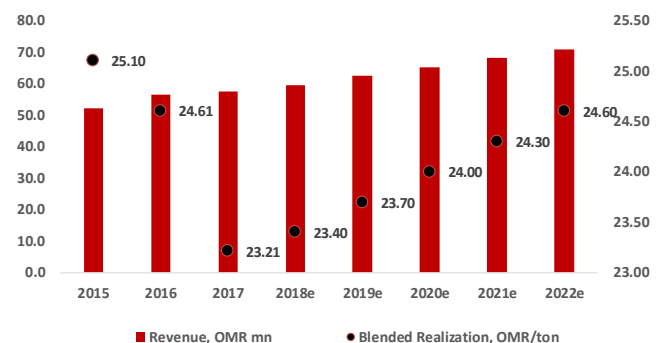


Cement Sales, Mn tons



* Built on the implied capacity

Realizations are expected to stand pressures due to better export segment as well as the already high level of given discounts to key clients. The company hints that it has no immediate intention to reduce prices thus avoiding price war. We forecast 2018 blended realization at OMR 23.4/ton, up by 0.8% YoY. Based on above, Oman Cement Co. is expected to post OMR 59.7mn of revenues in 2018, up by 3.7% on annual basis and a CAGR of 4.4% during 2018 – 2022 considering a sales discount of 9%.



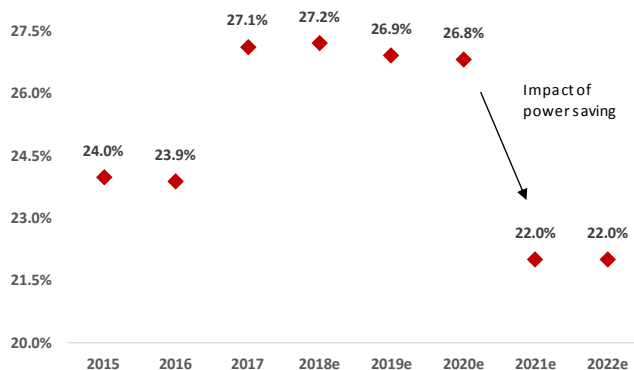
Cost of production to drop on key saving strategies

The government procedures to strength the financial position of the country and compensate lower oil revenues, have impacted the profitability of the Industrial companies due to higher energy expense which resulted in severe negative impact on cost of production. Energy expenses to revenue ratio went up from 24% in 2016 to 27% in 2017 for Oman Cement. The scenario was worse in case of Raysut Cement. Despite this, we expect Oman Cement to do well in this regard in the coming period in view of the following:

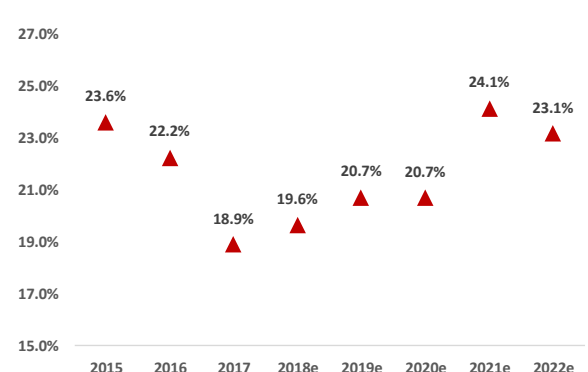
- The recent agreement regarding using alternative materials as raw materials. Current analysis show an increase of 86 basis points in raw materials expenses to revenue ratio from 2016 to 2017 as it stands now at 6.4%.
- Plans about upgrading the current power plant with the latest technology turbine. The goal is to better utilize the same amount of usage gas, which shall result in an estimated annual savings of OMR 2.5mn in operating expenses. The expected cost of this project is about USD 30mn and the duration for completion is about 18 months.

We believe such initiatives are critical to support margins on the long run. However, we do not expect the upgrading of the power plant to take place into 2018 considering the current market situation and investments involved. For the time being, in order to maximize the usage of the current power plant, the company has implemented better measures to increase the utilization of the power plant that stands currently at 98%. We assume the upgradation to take place between 2019 – 2020. In view of this, we expect cost of production to decline from the current level of OMR 14.36/ton to OMR 14/ton by 2022. Accordingly, operating profit margin is estimated at 19.6% in 2018 compared to 19% in 2017 and estimate to reach 23% by 2022.

Energy Expenses as % of Rev



Operating Margin

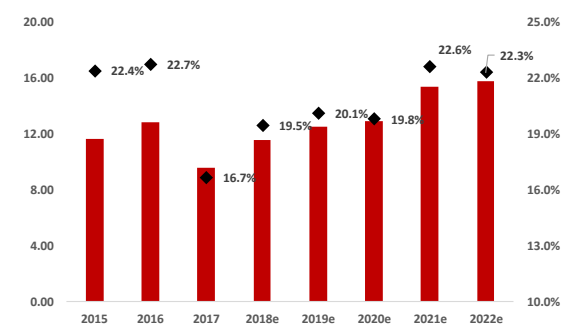


Source: Company's Financials, U Capital

Lack of tax adjustments and better investment income to support net margins despite higher cost of funding

Due to our assumptions of upgrading the power plant starting 2019. We assume the project to be funded through loans over 3 years. However, we expect also better return on investments and no further adjustments to deferred tax. This shall result in higher net earnings and margins during the forecasted period. We expect net profit to stand at OMR 11.6mn in 2018 up by 21% on yearly basis and net margin of 19.5%. We expect net earnings to register a CAGR of 8.1% during 2018 – 2022.

Net Profit, OMR mn Vs. Net Profit Margin %



Source: Company's Financials, U Capital

Financial Statements

OMR (000)	2016	2017	2018e	2019e	2020e	2021e
Income Statement						
Revenue	56,604	57,548	59,676	62,412	65,197	68,033
Cost of Sales	(40,030)	(42,745)	(43,808)	(45,182)	(47,204)	(46,933)
Gross Profit	16,574	14,804	15,867	17,230	17,993	21,100
G & A Exp.	(3,991)	(3,939)	(4,146)	(4,304)	(4,513)	(4,701)
Operating Profit	12,583	10,864	11,721	12,926	13,480	16,399
Finance Income - net	696	714	701	598	456	452
Net investment income	1,132	826	868	911	957	1,004
Other Income	71	416	374	337	303	273
Profit Before Tax	14,483	12,820	13,664	14,771	15,196	18,128
Tax	(1,607)	(3,228)	(2,050)	(2,216)	(2,279)	(2,719)
Net Profit	12,876	9,592	11,614	12,555	12,917	15,409
Balance Statement						
Net Property, plant and equipment	121,586	121,370	120,893	131,556	141,867	140,914
Investments in an associate	937	1,019	1,080	1,145	1,214	1,286
Available-for-sale investments	12,431	9,857	9,808	9,759	9,710	9,661
Held-to-maturity investments	10,273	11,291	11,291	11,291	11,291	11,291
Bank deposits	18,684	10,178	10,076	9,975	9,875	9,777
Non Current Assets	164,014	153,789	153,148	163,726	173,957	172,930
Held-to-maturity investments	1,000	0	0	0	0	0
Investments at fair value through pr	5,999	5,719	5,833	5,950	6,069	6,191
Inventories	20,418	20,021	20,861	18,826	16,859	16,468
Accounts and other receivables	5,484	6,243	6,141	6,108	5,981	5,315
Bank deposits	4,327	9,232	8,000	7,200	6,480	5,832
Cash and cash equivalents	3,530	3,707	3,939	4,373	3,166	10,165
Current Assets	40,758	44,922	44,774	42,457	38,555	43,971
Total Assets	204,772	198,711	197,922	206,183	212,512	216,901
Shareholder's equity	163,964	160,880	162,780	165,491	168,565	174,132
Term loans - non current portion	16,543	12,660	11,676	15,265	16,837	15,442
Net Deferred tax liability	5,623	7,426	7,501	7,576	7,651	7,728
End of services benefits	1,246	1,142	1,177	1,212	1,248	1,286
Non Current Liabilities	23,412	21,229	20,353	24,052	25,736	24,455
Term loans - current portion	6,499	7,650	5,838	7,632	8,418	7,721
Trade and other payables	9,642	7,526	7,451	7,432	8,139	8,855
Taxation	1,254	1,426	1,500	1,575	1,654	1,736
Current Liabilities	17,396	16,602	14,789	16,639	18,211	18,313
Total Liability	40,808	37,831	35,142	40,692	43,947	42,768
Total Liability and Equity	204,772	198,711	197,922	206,183	212,512	216,901
Cash Flow Statement						
Cash Flow from Operating Activities	13,906	8,985	10,984	14,790	15,908	17,379
Cash Flow from Investing Activities	(5,806)	6,600	1,759	(9,895)	(9,630)	1,554
Cash Flow from Financing Activities	(8,634)	(15,408)	(12,511)	(4,461)	(7,485)	(11,933)
Change in Cash	(534)	178	232	434	(1,207)	7,000
Net Cash at End	3,530	3,707	3,939	4,373	3,166	10,165

Source: U Capital Research, Company Financials

*Market price for 2018 and subsequent years based on closing price of March 27, 2018

	2016	2017	2018e	2019e	2020e	2021e	2022e
Key Ratios							
Gross Margin	29.3%	25.7%	26.6%	27.6%	27.6%	31.0%	30.1%
EBITDA Margin	34.2%	31.7%	32.4%	33.5%	33.5%	37.5%	36.5%
Operating Margin	22.2%	18.9%	19.6%	20.7%	20.7%	24.1%	23.1%
Net Profit Margin	22.7%	16.7%	19.5%	20.1%	19.8%	22.6%	22.2%
ROAA	6.4%	4.8%	5.9%	6.2%	6.2%	7.2%	7.3%
ROAE	7.9%	5.9%	7.2%	7.6%	7.7%	9.0%	9.0%
Current Ratio (x)	2.34	2.71	3.03	2.55	2.12	2.40	2.41
Price OMR	0.474	0.410	0.364	0.364	0.364	0.364	0.364
Debt / Equity (x)	0.14	0.13	0.11	0.14	0.15	0.13	0.13
EV/EBITDA (x)*	7.89	7.50	6.11	5.89	5.81	4.61	4.46
EV/ton (OMR)	42.90	38.43	33.28	34.65	35.64	33.06	32.51
Dividend Yield	6.3%	7.3%	8.2%	8.2%	8.2%	8.2%	8.2%
P/E Ratio (x)*	12.18	14.02	10.37	9.59	9.32	7.82	7.64
P/BV Ratio (x)*	0.96	0.84	0.74	0.73	0.71	0.69	0.69

Source: U Capital Research, Company Financials

*Market price for 2018 and subsequent years based on closing price of March 27, 2018

Raysut Cement Co. – Outlook

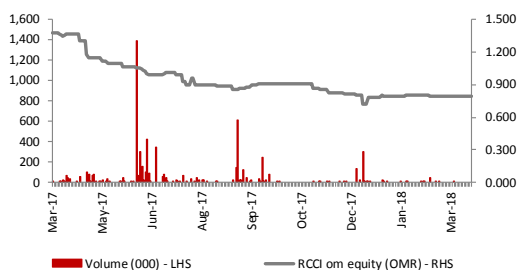
TP: OMR 0.805/ share

Recommendation	HOLD
Bloomberg Ticker	RCCI om equity
Current Market Price (OMR)	0.740
52wk High / Low (OMR)	1.45/0.72
12m Average Vol. (000)	26
Mkt. Cap. (USD/OMR mn)	384/148
Shares Outstanding (mn)	200.0
Free Float (%)	75%
3m Avg Daily Turnover (000)	1.79
6m Avg Daily Turnover (000)	7.17
PE 2018e (x)	21.3
PBv 2018e (x)	0.97
Dividend Yield '18e (%)	4.5%

Price Performance:

1 month (%)	-7.04
3 month (%)	2.78
12 month (%)	-46.38

Price Volume Chart



Source: Bloomberg

We Keep our **HOLD** recommendation on Raysut Cement with a target price of **OMR 0.805/share**, offers an upside of 8.7% compared to the current market price. TP implies PE'18e of 21.3x and PB'18e of 0.97x. The stock is down on YTD by 5.13%.

We believe that 2017 was an exceptional year and estimate gradual enhancement in the coming period mainly on better cost control and moderate recovery in export markets. In our view, the stock is fairly priced on lack of strong triggers in the near future.

We expect Raysut Group revenue to stand at OMR 75.1mn in 2018, an increase of 4.5% on annual basis and of which 30.7% is contributed by Pioneer Cement. We project a CAGR of 6% over 2018 – 2022. Higher cost of sales remains the biggest challenge. Over 2017 only, cost of sales to revenue ratio went up from 66% to 77.7% as major contribution came from higher energy expenses. We do not see significant improvement in energy expenses to revenue ratio in the coming period as the company secures most of its needs externally. However, we expect better control over other expenses and thus estimate total operating expenses out of total revenue to go down from 90.6% in 2017 to 85% by 2022 which will result in higher operating margins at 15% versus 9.35% currently. We expect net profit attributable to the parent company at OMR 6.9mn in 2018, up by 19%. We project net earnings to register a CAGR of 15.7% over the forecasted period (2018 -2022) and the average net profit margin is expected to be 11% compared with current of 8%.

Strengths of the group lay within their export business model, the entry to Al Duqm area and strong cash position. As stated earlier, we have not implemented in our model the planned set up of Al Wusta Cement Co. which requires big CAPEX as we wait for further details in this regard. Moreover, the company recently announced that it approved initial study to be carried out to explore the establishment of a 1 million tons per annum integrated cement plant in Georgia. The company said that through its subsidiary Pioneer Cement Industries Georgia Limited, it owns a mine with over 30 million tons of Limestone reserves some 60 kilometers from the capital city Tbilisi. No further details were given but that the final decision to be taken latest by June this year. We have not implemented this in our assumptions as we await for further details.

The company dividend payout stood at 100% for 2017. We expect the same level to be sustained in the future. Currently the stock provides a dividend yield of 4.5% compared to regional industry average of 6%

Key upside risks include:

- Better than expected recovery in Yemen.
- Better than expected cost control.
- Higher realizations for landed cement due to increase cost of production in the neighboring countries.
- Higher than estimated investment returns.

2017 Review

Revenues went down by 22.4% YoY to OMR 71.88mn as both “the Parent” and the main “Subsidiary” company saw drop in sales and realizations due to competition and export market developments. The Group sales of cement posted a decline of 21% to 2.94mn tons of cement and realizations went down by about 1% to OMR 27.4/ton and OMR 18.9/ton (blended prices) for Raysut Cement and Pioneer Cement respectively. The Yemen market, which traditionally constitutes 50% of Raysut Cement export sales, has severely harmed sales due to the ongoing unrest situation. Pioneer Cement Co. formed more than 30% of the total group revenues in 2017.

Despite lack of clinker import and favorable inventory adjustment, **the gross profit margin retreat** was a victim of higher energy costs. The board of directors’ report stated that higher energy costs (electricity, gas and coal) have resulted in additional expenses of about OMR 2.9mn. In 2017, gas price went up by 3% in addition to increase in power tariff to OMR 0.027/KWH from OMR 0.016/KWH in 2016, a yearly increase of 69%. Moreover, for the subsidiary, the international coal prices have gone to USD 82/MT from USD 70/MT, an increase of 17%. Accordingly, energy expense to revenue ratio went up from 26.6% in 2016 to 35.7% in 2017. Further, higher costs related to raw material, transportation, admin and general expenses have also pressurized the EBIT margin which stood at 9.35% versus 24.2%.

Net profit attributable to the parent company has declined massively by 72% to its lowest level since 2003 (as per Bloomberg) at OMR 5.8mn because of the above stated reasons in addition to the drop in the market value of the securities and higher tax rate which also affected deferred tax. This weak performance could even be worse if the company did not make the sales of an associate company during 2017 which resulted in a profit of OMR 1.112mn.

2017 Year in charts



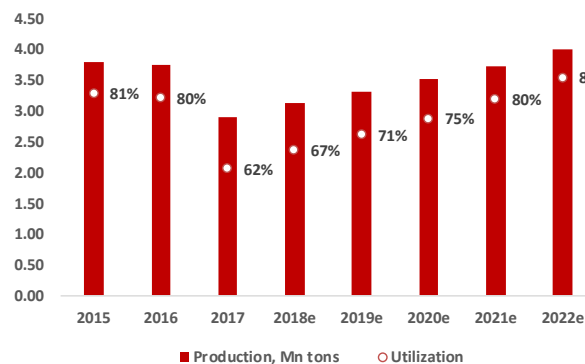
Source: Company's Financials, U Capital

Forward Outlook

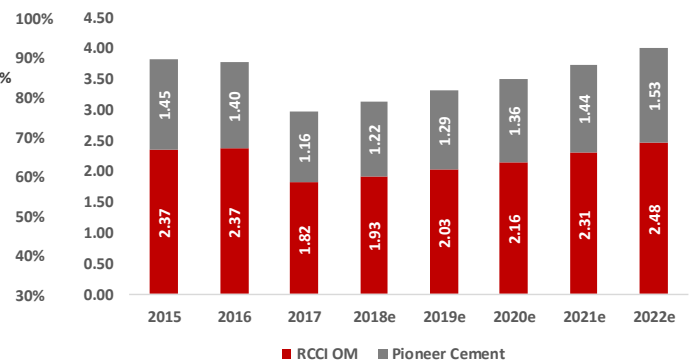
Tougher competition and export challenge to restrict top line growth in the short term

Despite the flexibility in the business model due to exports compared with its competitor, yet the unstable situation in major export markets like Yemen, which historically accounted for half of the parent company's external sales, has restricted the full utilization of this advantage. In 2017, export sales by the parent company went down by 28.7% YoY to 0.67mn tons of cement. This is compared with 4yrs historical average of 0.95mn tons. Similar situation was seen at local front as sales dropped by 19.6% in 2017. We expect moderate improvement at local front in 2018 with an annual growth of 5% on lack of major triggers. However, we expect better performance in the medium term with CAGR of 6.5% during 2018 – 2022 given the positive view on the economy diversification efforts. At Export front, we see a moderate improvement over the forecasted period with CAGR of 6%. A Strong trigger will be any favorable development in Yemen. This will directly translate in solid contribution and thus a revised CAGR of at least 12%. We expect an aggressive strategy to be implemented by Pioneer Cement Co. as the company seeks for better market share in the Northern part of the country. Accordingly, we expect the group utilization level to go up from (62%: theoretical capacity, 76%: implied capacity) in 2017 to (85%: theoretical capacity, 100%: implied capacity) by 2022.

Group Production, Mn tons Vs. Utilizations



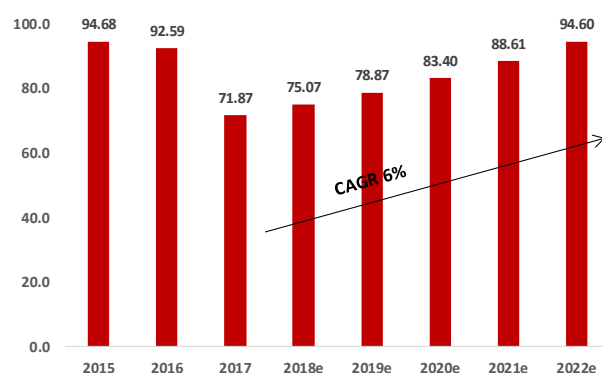
Sales, Mn tons



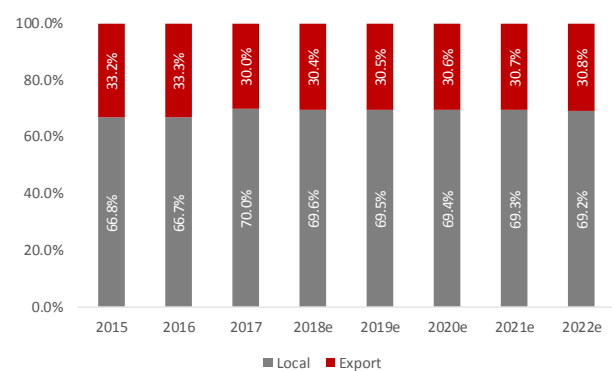
Source: Company's Financials, U Capital

We expect realizations to be slightly under pressures in order to sustain the market share. We expect selling price of OMR 27/ton for the parent company in 2018 down from OMR 27.4/ton. Overall, we expect the group blended realization to decline by 2% in 2018 to OMR 24/ton and remain relatively stable afterword. As a result, Raysut Cement group revenue is estimated at OMR 75mn in 2018, up by 4.5% YoY and project a CAGR of 6% over 2018 – 2022. Pioneer Cement contribution to total revenue is set at near its 4yrs historical average of 30%.

Group Revenue, OMR Mn



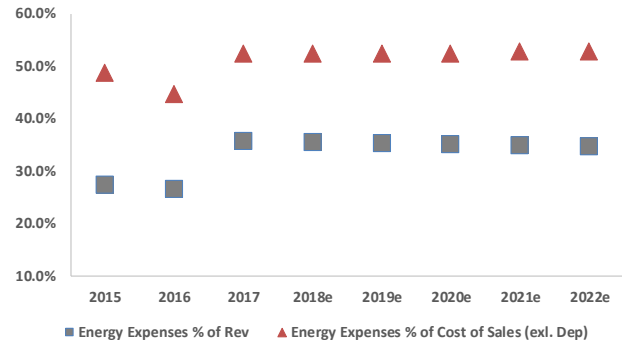
Revenue Segmentation



Source: Company's Financials, U Capital

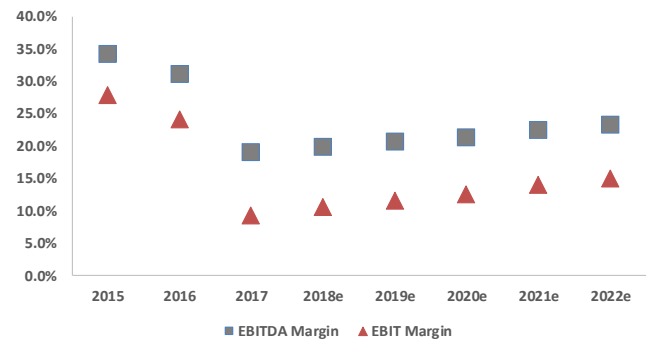
Operating margin to improve on better cost control yet way below historical levels

As stated earlier, the increase in energy expenses and other production elements coupled with limited ability to mimic this in end selling prices, have severely impacted operating margins which dropped from 24.2% in 2016 to 9.4% in 2017 bearing in mind that historical high level at 35%. Such levels are hardly to be seen again, a fact which dominates the entire industrial companies compared to their historical margins. Raysut Cement, unlike its peer, imports most of its energy needs making it more exposed to price changes and increases pressures. Such the case, we do not expect significant change in energy expenses to revenue ratio in the coming period and estimate it to stand at an average of 35.5%.



Source: Company's Financials, U Capital

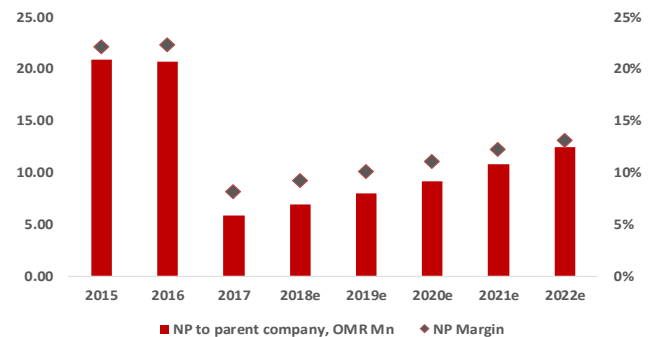
However, we expect better control over other expenses and estimate total operating expenses out of total revenue to go down from 90.6% in 2017 to 85% by 2022 which will result in higher operating margins at 15% versus 9.35% currently. The group total operating profit in 2018 is forecasted at OMR 7.9mn, up by 18.6% on annual basis. During 2018 – 2022, a CAGR of 15.7% is projected to be achieved. EBITDA margin is seen slightly better in 2018 at 20% up from 19.1% in 2016 and expected to reach 23.3% by 2022.



Source: Company's Financials, U Capital

Bottom line supported by the absence of tax adjustments

Due to hike in tax rate by 3% in 2017, amendments had to be done on the deferred tax. The lack of this one-off treatment will support net earnings onwards. We expect net profit attributable to the parent company at OMR 6.9mn in 2018, up by 19%. Excluding the one-off investment gain in 2017, the rise in net earnings would come above 50%. We project net earnings to register a CAGR of 15.7% over the forecasted period (2018 -2022) and the average net profit margin is expected to be 11% compared with current of 8%.



Source: Company's Financials, U Capital

Financial Statements

OMR (000)	2016	2017	2018e	2019e	2020e	2021e
Income Statement						
Group Revenue	92,587	71,875	75,071	78,874	83,403	88,614
Cost of sales	(61,222)	(55,842)	(57,751)	(60,124)	(62,993)	(65,954)
Gross Profit	31,365	16,033	17,320	18,749	20,410	22,660
Administration & general expenses	(5,903)	(7,019)	(7,181)	(7,387)	(7,644)	(7,944)
Selling and distribution expense	(3,190)	(2,362)	(2,392)	(2,434)	(2,490)	(2,557)
Other Income	135	70	225	237	250	266
Operating Profit	22,408	6,723	7,973	9,165	10,526	12,424
Finance Cost - Net	(324)	(381)	(317)	(288)	(259)	(229)
Investments and Others	812	1,686	467	463	489	506
Profit Before Tax	22,896	8,028	8,123	9,340	10,756	12,701
Tax	(2,186)	(2,213)	(1,188)	(1,373)	(1,582)	(1,872)
Net Profit	20,710	5,815	6,935	7,968	9,174	10,829
MI	(24)	0	0	0	0	0
NP to parent company	20,734	5,815	6,935	7,968	9,174	10,829
Balance Statement						
Goodwill	45,799	45,799	45,799	45,799	45,799	45,799
Net Property ,Plant and Equipment	96,208	93,826	90,193	86,501	82,709	78,789
Investment in an associate	4,678	225	230	230	230	230
Others	7,311	214	625	625	625	625
Total non-current assets	153,995	140,063	136,846	133,154	129,363	125,443
Inventories	20,226	27,289	27,501	15,031	15,748	15,703
Trade receivables	8,611	6,161	6,222	7,887	8,340	4,431
Financial asset at fair value through profit or loss	3,905	4,017	4,137	4,262	4,389	4,521
Prepayments & other receivables	2,411	4,135	1,877	1,972	2,085	2,215
Short term deposits	10,892	8,366	10,000	10,000	10,000	10,000
Cash and cash equivalents	8,412	5,131	7,346	15,841	18,718	39,154
Total current assets	54,458	55,099	57,082	54,993	59,281	76,025
TOTAL ASSETS	208,453	195,162	193,929	188,147	188,644	201,468
Trade payables and accruals	14,222	13,976	14,101	7,516	6,999	18,321
Taxation	2,208	1,314	1,000	1,000	1,000	1,000
Term loans – current portion	5,875	5,875	4,926	4,794	4,657	4,516
Total current liabilities	22,305	21,165	20,027	13,309	12,656	23,837
LT Loan less current maturity	22,438	16,563	16,422	15,979	15,524	15,053
Deferred tax liability	3,515	4,382	3,500	3,500	3,500	3,500
End of Service Benefits	1,371	1,413	1,200	1,200	1,200	1,200
Total long term liabilities	27,323	22,357	21,122	20,679	20,224	19,753
TOTAL LIABILITIES	49,628	43,522	41,149	33,988	32,880	43,590
TOTAL EQUITY	158,825	151,640	152,780	154,160	155,765	157,878
TOTAL EQUITY AND LIABILITY	208,453	195,162	193,929	188,147	188,644	201,468
Cash Flow Statement						
Cash Flow from Operating Activities	16,295	971	5,379	12,186	7,488	26,105
Cash Flow from Investing Activities	(23,838)	(11,778)	(7,295)	(7,164)	(8,161)	(9,327)
Cash Flow from Financing Activities	2,340	7,526	4,132	3,473	3,550	3,658
Change in Cash	(5,203)	(3,281)	2,215	8,495	2,877	20,436
Net Cash at End	8,412	5,131	7,346	15,841	18,718	39,154

Source: U Capital Research, Company Financials

*Market price for 2018 and subsequent years based on closing price of March 27, 2018

	2016	2017	2018e	2019e	2020e	2021e	2022e
Key Ratios							
Gross Margin	33.9%	22.3%	23.1%	23.8%	24.5%	25.6%	26.4%
EBITDA Margin	31.2%	19.1%	20.0%	20.7%	21.4%	22.5%	23.3%
Operating Margin	24.2%	9.4%	10.6%	11.6%	12.6%	14.0%	15.1%
Net Profit Margin	22.4%	8.1%	9.2%	10.1%	11.0%	12.2%	13.1%
ROAA	10.1%	2.9%	3.6%	4.2%	4.9%	5.6%	0.0%
ROAE	13.5%	3.7%	4.6%	5.2%	5.9%	6.9%	0.0%
Current Ratio (x)	2.44	2.60	2.85	4.13	4.68	3.19	3.78
Price OMR	1.480	0.780	0.740	0.740	0.740	0.740	0.740
Debt / Equity (x)	0.18	0.15	0.14	0.13	0.13	0.12	0.12
EV/EBITDA (x)*	10.41	11.73	9.84	8.49	7.57	5.71	5.08
EV/ton (OMR)	64.08	34.25	31.48	29.52	28.76	24.25	23.83
Dividend Yield	4.4%	3.7%	4.5%	5.1%	5.9%	7.0%	8.0%
P/E Ratio (x)*	14.29	26.83	21.34	18.57	16.13	13.67	11.92
P/BV Ratio (x)*	1.86	1.03	0.97	0.96	0.95	0.94	0.92

Source: U Capital Research, Company Financials

*Market price for 2018 and subsequent years based on closing price of March 27, 2018

Recommendation

BUY	Greater than 20%
ACCUMULATE	Between +10% and +20%
HOLD	Between +10% and -10%
REDUCE	Between -10% and -20%
SELL	Lower than -20%

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