Tokyo Cement Lanka Plc

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ASIA WEALTH MANAGEMENT CO. (PVT) LTD.

TOKYO CEMENT

INTERIM UPDATE 1QFY12

Highlights

Despite the post war construction boom being held back in 2010 due to depressed global economic activity, the cement sector in Sri Lanka is worth approx. LKR51 bn in 2011 and is projected to grow by a healthy 10% p.a.

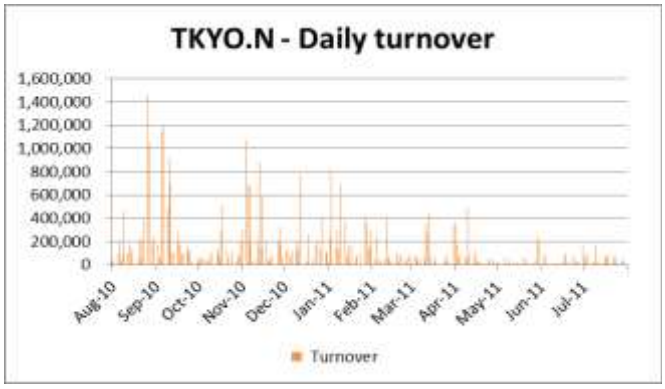
TKYO cement recorded a healthy increase in revenue of 11.92% in FY11 compared to the contraction of -16.51% in FY10 while maintain its market leader status.

A sharp decline in its finance cost in FY11 led a staggering 135% increase in earnings. Earnings are expected to remain at an elevated level as the firm de-levers by retiring some its long term debt preferring instead to fund investments with retained earnings.

The future ahead appears promising for TKYO which is strategically positioned to benefit from the post war reconstruction boom. The depressed global economic condition is expected to keep oil and clinker prices at a low level in the medium to long term, enabling the firm to maintain its gross profit margins. The expected increase in household's disposable income would also raise cement demand for households which is the most lucrative sector of the cement market.

Based on our analysis the firm has strong growth opportunities both in the construction sector as well as the renewable energy sector. Thus we expect the forward P/E multiples for the firm to be 12.5X and 8.0X respectively.

Recommendation - Buy



As at 26.08.2011	LKR
Average Daily Turnover (LKR mn)	0.2
Market Capitalisation (LKR mn)	165,942.4
12 month High/Low	69.40/37.60
Price Movement-25 August 2011	LKR54.00
1M-LKR50.00	8.60%
3M-LKR65.00	-16.46%
12M-LKR37.6	44.41%

Major Shareholders(%) - Voting	
Nippon Coke & Engineering Co	27.5%
St. Anthony's Consolidated Ltd	27.5%
South Asian Investment	16.2%
Capital City Holdings	3.0%

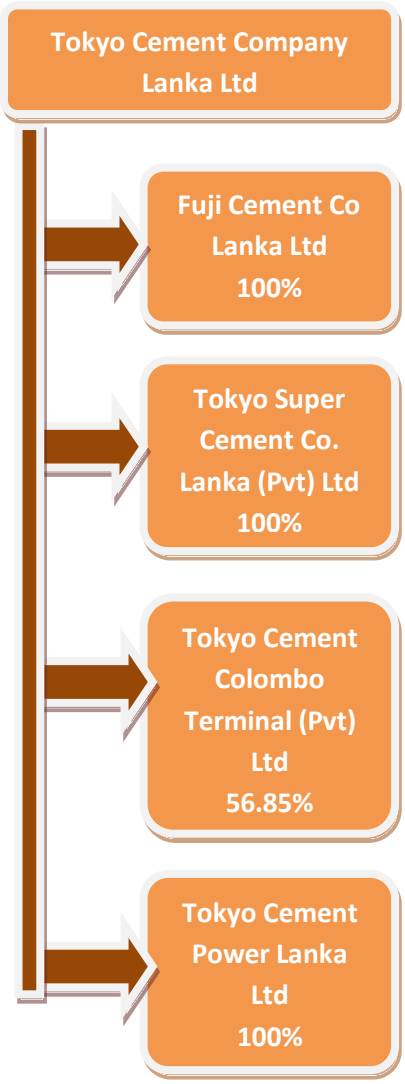
YE 31 Mar	FY06	FY07	FY09	FY10	FY11	FY12E	FY13E
LKR mn							
Earnings to Equity holders	653.08	834.21	553.66	346.63	369.30	874.01	1,369.73
YoY %		27.7%	-33.6%	-37.4%	6.5%	136.7%	56.7%
EPS- voting (LKR)	3.23	4.12	2.73	1.71	1.82	4.32	6.76
YoY %		27.7%	-33.6%	-37.4%	6.5%	136.7%	56.7%
EPS- Non voting (LKR)	6.45	8.24	5.47	3.42	3.65	8.63	13.53
YoY %		27.7%	-33.6%	-37.4%	6.5%	136.7%	56.7%
P/E - voting	16.1	12.6	19.0	30.4	28.5	12.0	7.7
P/E - Non voting	6.19	4.84	7.30	11.65	10.94	4.62	2.95

Company overview

Tokyo cement a joint venture between Nippon, coke and engineering (Formerly Mitsui Mining Company) and St. Anthony's Consolidated, has been the leading cement producer in Sri Lanka for almost three decades. Together with the Swiss Cement manufacturer Holcim, they make up almost 60% of the domestic cement market and have been the market leader since 2006. Tokyo cement has the singular honor of being the only listed company in the Colombo Stock exchange. After the country saw the end of a three decade long civil war, the expected post-war reconstruction boom is yet to achieve its full potential. At the end of June 2011 the company's revenue increased by 12% to LKR 16.5 Billion. Compared to the recorded values of Sales of the industry of about LKR 51.56 Billion this gives them a market share of about 31%.

The company has a reputation for being innovators and risk takers; steered by its visionary founder Mr. A.S.G Gnanam, it aggressively increased its production capacity in the North-East of the island despite the ongoing conflict that prevailed at the time. It was also the pioneer of "green Cement" with an investment in a 10MW Bio mass plant which grants the firm a cost advantage and is an additional source of revenue. Furthermore, the firm identified the future potential of blended hydraulic cement (BHC) and enjoys a first mover advantage in this segment.

The firm uses a closed circuit cement production process for its three grinding mills in China Bay Trincomalee, producing 200 tons of cement per hour. The mill employs some of the latest production techniques including the cost effective vertical roller mill (VRM). Installed in 2008, it is the only VRM exclusively dedicated to the production of cement in the South Asian region. The plant also enjoys a significant competitive advantage by being self-sufficient in its energy requirements, supplied from its 10MW bio mass power plant. The firms employment of green technology entitles it to carbon credits which could be worth as much as LKR 40-45mn per annum at current market prices.

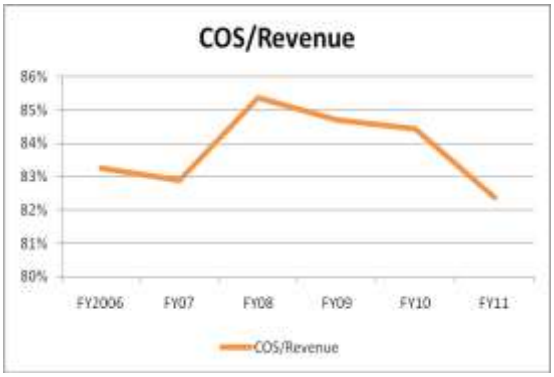


An overview of TKYO's 1QFY12 Performance

Short run clinker price hike erodes gross margins

	1QFY12 Rs'000	1QFY11 Rs'000	% Change	CumFY11 Rs'000	CumFY10 Rs'000	% Change
Revenue	1,903,661	1,497,811	27%	16,494,867	14,737,746	12%
Cost of sales	(1,396,374)	(1,020,477)	37%	(13,588,371)	(12,442,271)	9%
Gross operating profit	**507,287**	**477,334**	6%	**2,906,496**	**2,295,475**	27%
Other operating income & expenses	(189,194)	(117,883)	60%	(606,351)	(206,209)	194%
profit from operating activities	318,093	359,451	-12%	2,300,145	2,089,267	10%
Depreciation	(127,129)	(124,564)	2%	(972,667)	(904,647)	8%
Finance Cost	(39,446)	(54,641)	-28%	(485,583)	(837,128)	-42%
PBT	**151,518**	**180,246**	-16%	**841,895**	**347,491**	142%
Taxation	(2,250)	(2,250)	0%	(12,688)	3,868	-428%
PAT	**149,268**	**177,996**	-16%	**829,207**	**351,360**	136%
Minority Interest				(44,802)	(17,944)	150%
Profit to equity holders				**874,009**	**369,304**	137%

Despite Tokyo cement's favorable disposition to benefit immensely from the post war construction boom, oil supply disruptions in the Middle East coupled with the weakening of the dollar, led to a rise in the freight cost in the first quarter of 2011. Clinker and Gypsum; which are the building blocks of cement, are what is termed "dirty Cargo" and hence freight cost is a factor that weighs heavily on the firms cost of production. Contemporaneously, Thailand and Indonesia; the firms two main suppliers of raw materials are currently experiencing a development boom and hence the pressure created by local demand has made importation of clinker less attractive.



As a result cost of sales has risen at a faster rate than revenue resulting in a modest 6% rise in gross profit compared to 1QFY10. However the firm is self-sufficient in terms of its energy requirement at the production stage, which is currently supplied by a 10MW bio mass power plant which is part of a fully-owned subsidiary of the firm; Tokyo Cement power Lanka (Pvt) Ltd. Commissioned in 2009, the power plant gives Tokyo cement a considerable cost advantage over its rivals. This grants the firm considerable flexibility as some industry estimates suggest that 60-87% of a cement grinding mills cost of production can be attributed to energy consumption. This has led to an overall decline in the firms cost of production despite fluctuations in clinker prices.

Extraordinary items & declining handling charges

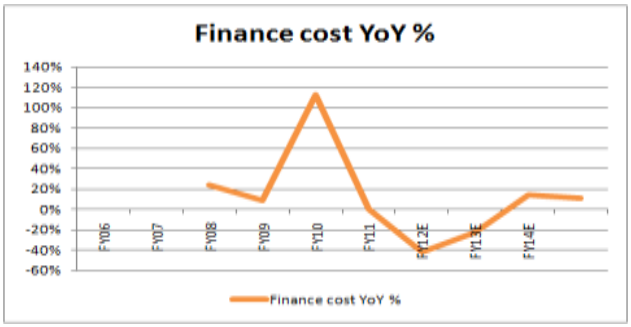
Net other operating expenses rose by 60% for the 1Q of FY11 compared with the same quarter of the previous year. Whilst operating expenses such as distribution and administration costs remained fairly stable, other operating income seemingly fell considerably leading to an overall decline in profit from operations.

On closer inspection this drop in operating income can be almost entirely attributed to a one-off rise in freight income that occurred in 2010. This came about due to the fact that one of the firm's 4 vessels which was being utilized for an income generating activity and not for clinker transportation due to the surprisingly low level of construction activity during that year.

This accounted for almost 40% of the entire "other operating income" in that year. At the same time given the current government policy with regard to imports of duty free concessions granted to industrial materials, handling charges which previously accounted for around 20% of other income, is expected to remain at a more modest level in the future(Almost 60% YoY decline in handling charges from FY10 to FY11). However the completion of the Dendro power Plant by mid-2013 is expected to make a noteworthy contribution to the firms operating income.

Deleveraging leading to a surge in PAT

The 42% YoY decline in the firms finance cost in FY11 led to a staggering jump in earnings before tax (142% rise YoY). This trend is expected to continue as the firm preference for funding shifts towards retained earnings and equity. In fact, a significant proportion of the funding for the 6MW Dendro power plant project valued at LKR 1.2 bn which represents a considerable capital infusion will come from retained earnings.



Quick performance review*

	FY06	FY07	FY08	FY09	FY10	FY11	FY12E	FY13E
Profitability ratios								
Revenue growth	0.00%	26.27%	24.06%	25.83%	-16.51%	11.92%	19.66%	10.00%
Gross Profit margin	16.75%	17.12%	14.62%	15.30%	15.58%	17.62%	16.60%	16.60%
PBIT margin	10.28%	10.66%	6.65%	8.39%	8.04%	8.05%	9.01%	9.01%
PBT margin	7.02%	7.46%	3.85%	3.66%	2.36%	5.10%	7.10%	7.02%
Net profit margin	7.29%	7.38%	3.95%	1.96%	2.51%	5.30%	6.94%	6.91%
Liquidity ratios								
Current ratios	0.85	0.76	0.59	0.53	0.63	0.65	0.57	0.24
Quick ratio	0.49	0.53	0.34	0.30	0.44	0.30	0.09	(0.37)
Efficiency ratios								
Interest cover	3.16	3.33	2.38	1.78	1.42	2.73	4.71	4.54
Inventory Cycle	29.43	23.38	36.95	33.89	20.18	30.15	21.90	21.90
Receivable Cycle	25.12	30.60	38.08	35.72	32.52	24.26	24.26	20.00
Payables Cycle	29.78	35.99	68.61	92.14	65.12	44.18	44.18	30.60
Gearing ratios								
Debt to equity ratio	75.50%	71.62%	65.59%	65.56%	67.68%	57.72%	54.81%	51.26%
Debt to capital ratio	43.02%	41.73%	39.61%	39.60%	40.36%	36.60%	35.40%	33.89%
Investor ratios								
ROE(%)	17.11%	18.60%	11.06%	6.61%	6.68%	15.55%	20.32%	18.84%
ROA(%)	8.6%	9.1%	4.9%	2.6%	3.0%	7.6%	10.7%	10.9%
Asset turnover(X)	0.09	0.09	0.05	0.03	0.03	0.08	0.08	0.12
Equity Multiplier(X)	0.47	0.44	0.57	0.70	0.57	0.49	0.24	0.07
DPS	0.3	0.5	0.1	0.4	0.3	1.7	0.8	0.9
Dividend Yield	0.7%	1.0%	0.2%	0.8%	0.6%	3.6%	1.8%	2.0%

*The above ratios are based on the analysis of Asia Wealth management Co. (Pvt) Ltd and may defer from Company estimates

DuPont Analysis

	FY06	FY07	FY08	FY09	FY10	FY11	FY12E	FY13E
ROE	17.11%	18.60%	11.06%	6.61%	6.68%	15.55%	20.32%	18.84%
Tax Burden	103.81%	98.84%	102.40%	53.58%	106.28%	103.81%	97.76%	98.42%
Interest Burden	68.33%	70.01%	57.96%	43.67%	29.33%	63.42%	78.75%	77.98%
EBIT margin	10.28%	10.66%	6.65%	8.39%	8.04%	8.05%	9.01%	9.01%
Asset turnover	0.09	0.09	0.05	0.03	0.03	0.08	0.08	0.12
Equity Multiplier	0.47	0.44	0.57	0.70	0.57	0.49	0.24	0.07

Return on Equity (ROE)

Return on Equity for the FY11 more than doubled to 15.55% in contrast to 6.68% for the previous year. This was primarily due to an increase in return on assets from 2.98% to 7.63% for the same period as the post-war construction boom finally took off. However, despite the rising gross profit margins, the return on equity is expected to remain depressed and will probably remain below the FY07 level as high capital expenditure in the future may take time to translate into higher earnings

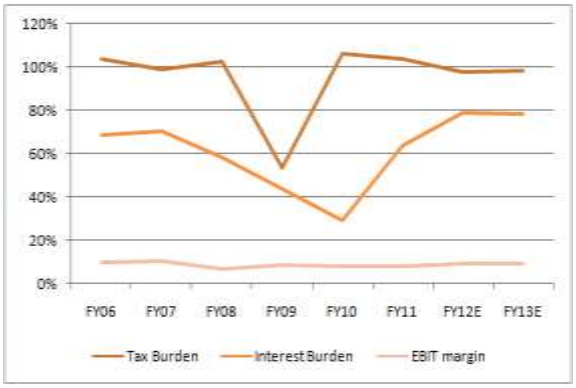
Equity multiplier

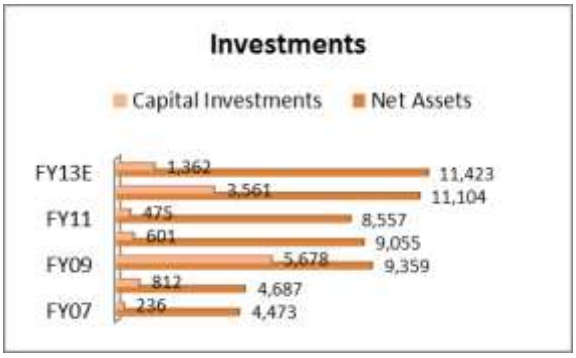
As with all debt management ratios, the equity multiplier is an indicator of the proportion of debt in the capital structure. Based on an evaluation of the optimal capital structure using the cost of capital methodology, the company was slightly over-leveraged relative to its peers (39% vs. 41%). The firms main source of debt is its joint venture partner; Nippon, coke and engineering Plc. However overdrafts and outstanding value of debt is on a downward trend since 2010 as the firm tends to favor financing capital expenditure with retained earnings and new share issues. Hence the equity multiplier is expected to fall over time.

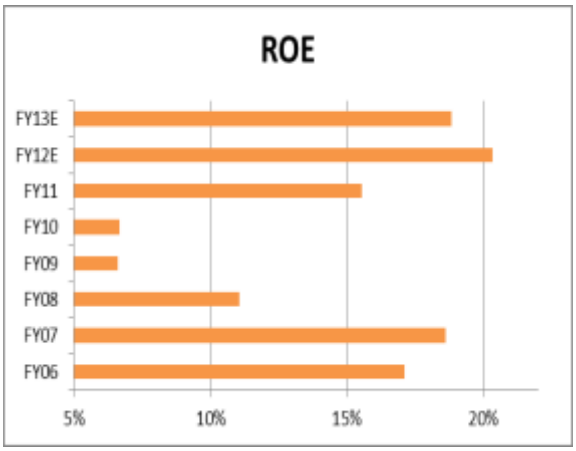
Tax Burden

Tokyo cement benefits greatly from a number of tax breaks it enjoys from the Sri Lanka Board of investment (BOI) due to its involvement in sustainable power generation. The firm's tax burden is expected to decrease as the tax break enjoyed by its subsidiary Tokyo super cement plc will expire in 2013. However the Dendro power plant which is expected to be commissioned by mid-2013 would benefit from a tax holiday which would partially offset its impact.

Net Profit Analysis







Investment Risk

- **Competition risk**

  The cement industry in Sri Lanka is projected to grow by around 10% for the forthcoming years. In this context and given the resource endowment and geographical constrains of domestic cement production, importation of bagged cement would remain an integral part of the local cement scene. Due to the various indo-Sri Lanka and Indo-Pakistan free trade agreements, bagged cement from these sources experience a cost advantage. The average bag of imported cement is LKR 684.00 which is almost 5% lower than domestically produced cement. Furthermore large Indian manufacturers such as Bharathi cement and Madras Cement have shown interest in entering the local market.

- **Rising clinker prices**

  Clinker is a composite comprising around 2/3rd limestone and 1/3rd silicate and other aggregates which are the direct material that goes into the production of cement. Tokyo cement imports clinker chiefly from Indonesia & Malaysia and occasionally from India. The two key factors that drive Tokyo's cost of clinker is oil price's which directly impacts the freight cost, and the level of construction activity in source countries which affects the total demand for clinker. As mentioned earlier, the recent rise in clinker price was chiefly due to the latter as both Indonesia and Thailand are experiencing a property boom.

- **Limited opportunities for organic growth**

  A prerequisite for setting up a cement finishing plant in Sri Lanka is its close proximity to a port. All of TKYO cements production takes place at its Tokyo super cement plant in China bay Trincomalee which is supplemented by 7 bagging plants in various parts of the island. Considering the location of TOKYO's rivals and the limited space available at the ports, the firm maybe unable to take advantage of the growing demand for cement and increase its production capacity.

- **Inability to pass on higher cost of production to consumers due to price controls**

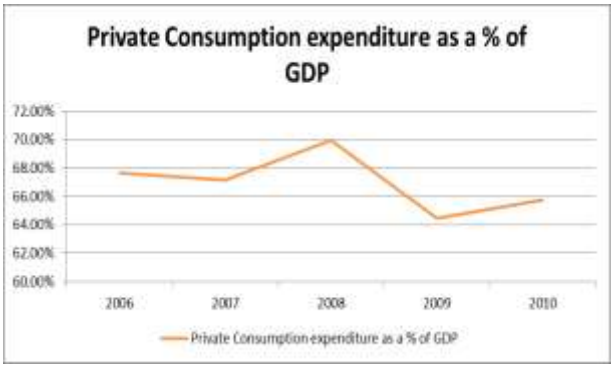
- **Currency risk** -Weakening of the dollar could push up oil prices.

- **Heightened domestic competition** - Lanka Cements KKS plant in Jaffna becoming operational

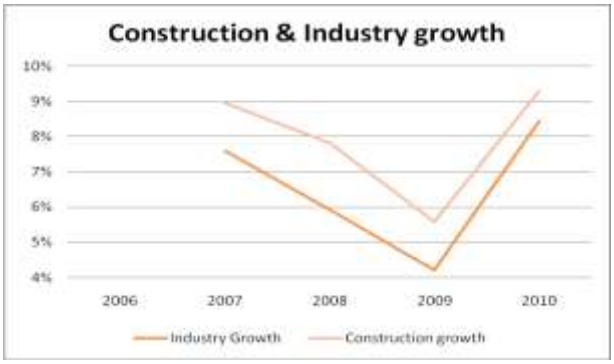
- **Regulatory risk -** Stricter regulation due to environmental concerns with respect to cement production.

Future Outlook

Despite the expected increase in competition from abroad due to the inability of domestic cement manufacturers to meet local cement demand which is projected to grow at 10% p.a, we are confident that Tokyo cement will continue to maintain its market leader status with its superior product portfolio and fragmented distribution network. The increase in household disposable income is expected to increase the demand for the firm's specialized products such as pre-mix, ready mix and tile bonding cement and thus drive the firm's revenue due to high gross margins for said products.

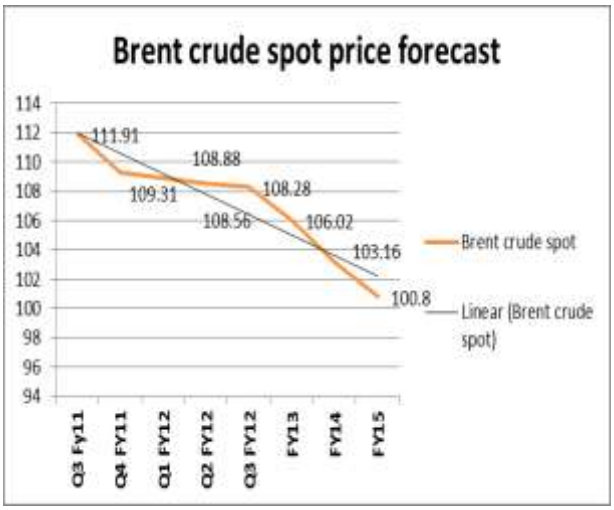


We do not expect the consumer affairs authority to raise the maximum retail price of a 50kg bag of cement. However, the depressed state of the world economy would rein in the price of oil which would curtail freight costs. Hence despite the CAA's decision we do not expect the firm's margins to be affected significantly.



Source: CBSL

The bold decision taken by the firm in 2006 to enter the renewable energy sector with the construction of a 10MW bio mass power plant in Trincomalee was a resounding success. Not only was it an uninterrupted and cost effective source of power, but also a profitable and stable source of additional revenue. Building on this success, the firm through its dedicated subsidiary Tokyo Cement power (Pvt) Ltd is planning to construct a 6MW Dendro power plant at a cost of LKR 1.5 bn to add to the national grid. The new plant will be commissioned by end- 2013 and would be a guaranteed source of revenue till the year 2020. The firm is also in a position to take advantage of carbon credits in the future which could be worth as much as LKR 40-45 mn p.a.



Source: Economist Intelligence Unit

In the past Tokyo Cements premium product Nippon(Formerly known as Mitsui cement) has been the preferred choice by contractors when it comes to mega development projects such as the Southern highway, Hambanthota phase I, Upper Kotmale, kinniya bridge. Going forward, the company is confident that it would continue to be a key player in the country's development activities.

Valuation

Taking into consideration the monumental growth expected for the construction sector and the fact that Tokyo Cement is the only listed local clinker grinder in the Colombo Stock Exchange, we forecast a strong upside potential for the firm. We project the firm to achieve a net profit figure of LKR 874.01 mn in FY12E which represents a 136% YoY growth and a figure of LKR 1.37 bn in FY13E(YoY 56.7% growth).

The voting and non-voting shares are currently priced at 28.5X and 10.9X trailing P/E respectively. The voting stock has the potential to reach a maximum of LKR 69.40 with a price volatility of 12.6% around a mean of LKR 55.79 based on a 52-week price movement. The forward P/E of TKYO.N for FY12E and FY13E is expected to be 12.0X and 7.7X respectively.

The non-voting shares have also met with investor approval in the past and have the potential to reach a maximum of LKR 49.10 with a price volatility of 5.14% around a mean of LKR 39.55 based on a 52- week price movement. The forward P/E of TKYO.X for FY12E and FY13E is expected to be 4.6X and 3.0X respectively.

The Sharpe ratio for the firm stands at 0.63 with a standard deviation of 41% while the Sharpe ratio for the manufacturing sector was 0.77 with a standard deviation of 16%. Hence Tokyo cements implied risk premium per unit of risk is 0.09

In light of our analysis, Tokyo cement's stock is a potential growth stock and is a definite ***buy***

Valuation Dashboard

TKYO:N	FY11	FY12E	FY13E
Price(LKR)	52.00	52.00	52.00
EPS	1.82	4.23	6.76
P/E	28.5	12.0	7.7
BVPS	27.3	27.8	33.3
P/BV	1.9	1.9	1.56
TKYO:X			
Price(LKR)	39.90	41.00	41.00
EPS	3.6	8.6	13.5
P/E	10.9	4.6	3.0
BVPS	54.6	55.5	66.6
P/BV	0.7	0.7	0.6
Sharpe Ratio-TKYO	0.63		
Sharpe Ratio-Manufacturing	0.77		
Sector P/E	17.48		
Sector P/BV	3.28		
Market P/E	19.03		
Market PBV	3.03		

Voting	FY11		FY12E		FY13E	
LKR	61.1	69.40	61.1	69.40	61.1	69.40
P/E	33.50	38.05	14.16	16.08	9.03	10.26
P/BV	2.24	2.54	2.20	2.50	1.84	2.09
Non-voting			FY12E		FY13E	
LKR	41.58	49.1	41.58	49.1	41.58	49.1
P/E	11.40	13.46	4.82	5.69	3.07	3.63
P/BV	0.76	0.90	0.75	0.88	0.62	0.74

*The above price range is based on the following criteria;
The lower bound is based on an upward growth of 9.5% for voting shares and 5.14% for non voting based on a 12-month standard deviation of the stock.
The upper bound is the maximum closing price of the stock recorded over the same 12-month period

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Gagani Jayawardhana	(011)- 5320236	0714-084953	gagani@asiacapital.lk
Priyantha Hingurage	(011)- 5320217	0773-502015	priyantha@asiacapital.lk
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CSE Floor	CSE,01-04, World Trade Centre, Colombo – 1.	Thushara Adhikari	(011)-5735122	0773-688202	adhikari@asiacapital.lk
		M G Suranjana	(011)-5763539	0773-954994	
Kiribathgoda	Level 2-6,Udeshi City Shopping complex, No 94,Makola Rd,Kiribathgoda	Danushka Boteju	(011)-5634803	0716-270527	boteju@asiacapital.lk
		Suranga Harshana	(011)-5734773	0783-452500	harshana@asiacapital.lk
Kurunegala	Union Assurance Building, No.6,1st Floor, Rajapilla Rd, Kurunagala.	Asanka Samarakoon	(037)-5628844	0773-690749	asanka@asiacapital.lk
		Gayan Nishsanka	(037)-5642717	0777-105356	nishshanka@asiacapital.lk
		Bandula Lansakkara	(037)-5643580	0773-925852	
Matara	E.H.Cooray Building, Mezzanine Floor, No:24, Anagarika Darmapala Mw, Matara	Sumeda Jayawardena	(041)-5677525	0773-687027	sumeda@asiacapital.lk
		Lalinda Liyanapathirana	(041)-5677526	0778-628798	rishan@asiacapital.lk
Galle	Peoples Leasing Building, 2nd Floor, No.118,Matara Road, Galle	Ruchira Hasantha	(091)-5629998	0773-687027	ruchira@asiacapital.lk
		Ushan Sachith	(091)-5676767	0778-628798	ushan@asiacapital.lk
Negombo	Asia Asset Finance, 171/1, Station Road, Negombo.	Uthpala Karunatilake	(031)-5676881	0773-691685	uthpala@asiacapital.lk

Service Centers

Kandy	k3-L1,Level 01,kcc, No 5 ,Dalda Veediya, Kandy.	Nilupul Hettiarachchi	(081)-5628500	0773-691816	nilupul@asiacapital.lk
		Radhika Hettiarachchi	(081)-5625577	0777-810694	radhika@asiacapital.lk
Hambantota	Hambanthota Chamber of Commerce, Thangalle Road, Hambantota.	Gayan Sanjeewa	(047)-5679240	0715-536309	sanjeewa@asiacapital.lk
		Anusha Muthumali	(047)-5679241	0772-351716	muthu@asiacapital.lk
		Shermin Ranasinghe		0772-378352	shermin@asiacapital.lk
Ampara	2nd Floor, T.K.S. Building, D.S. Senanayake Street, Ampara.	Ravi De Mel	(063)-5679071	0772-681995	ravide@asiacapital.lk
		Madushanka Rathnayaka	(063)-5679070	0779-036577	shanka@asiacapital.lk
Jaffna	11-8, First Floor, Stanley Road, Jaffna	Gratian Nirmalan	(021)-5671800	0777-567933	nirmal@asiacapital.lk
		S.Puviraj	(021)-5671801	0775-096969	puviraj@asiacapital.lk
Wennappuwa	Asia Asset Finance, No.176, Negombo Road, Katuneriya.	Sajith Iroshan	(032)- 5673881	0773-740208	sajith@asiacapital.lk
		Sandun Athulathmudali	(032)- 5673882	0772-533331	sranga@asiacapital.lk
Moratuwa	Asia Asset Finance, No.18, New De Zoysa Rd, Moratuwa.	Hashan Lalantha	(011)-5238662		lalantha@asiacapital.lk
		Charith Perera	(011)-5238663		charithn@asiacapital.lk
Panadura	Asian Alliance Building, 293, Galle Road, Panadura	Ranganath Wijetunga	(038)-5670400	0715-120723	ranganath@asiacapital.lk
		Asanka Chaminda	(038)-5670407	0713-559552	chaminda@asiacapital.lk