

**Sinai Cement (SCEM.CA)** announced that its BOD has approved increasing the company's licensed capital from EGP 1bn to EGP 2bn in addition to increasing the company's issued and paid in capital from EGP 680.5mn (distributed over 68.058mn shares with a par value of EGP 10/share) to EGP 1.361bn distributed over 136.116mn shares with a par value of EGP 10/share, through issuing new 68.058mn shares at a par value of EGP 10/share plus issuing fees. The mentioned new shares will be issued through right issues mechanism in accordance with the EGX relevant rules. The company added in an official release to the EGX that it will hold an EGM on November 18, 2017 to consider the mentioned capital increase as well as authorizing the company's BOD to amend articles # 6&7 of the company's bylaws.

According to the company's financial position for 1H2017, the company's general reserves (other than the legal reserve) and its retained earnings (net of 1H2017 losses) enable it to distribute about 25.52mn free shares to increase its issued capital, however, the company has decided to finance the above mentioned capital increase through issuing new shares through the right issues mechanism. Practically, increasing issued capital of any company through issuing new shares should have a negative impact on the company's fair value due to the share dilution impact as any reported earnings will be divided by higher number of outstanding shares. But in the long run the impact will be positive if the capital increase were to finance expansion projects in a growing industry or to improve the company's production efficiency or to settle a high-interest bearing debts.

Sinai Cement SCEM.CA has already announced recently that the pending capital increase aims at settling banking loans and credit facilities worth EGP 546mn and securing cash liquidity of EGP 17mn. The company added that it is planning to invest EGP 100mn to develop the company's current main two production lines as well as developing plants' equipment.

### **Sinai Cement SCEM.CA's Financial Results for 1H2017**

Sinai Cement SCEM.CA posted a consolidated net loss after minority interest of EGP 153.22mn for 1H2017 compared to a consolidated net profit after minority interest of EGP 15.37mn in 1H2016. The company's net loss was due to a 40% increase in the cogs in 1H2017 which despite a 3.7% increase in the consolidated sales revenues has led to a gross loss of EGP 19.19mn for 1H2017 compared to a gross profit of EGP 150.44mn in 1H2016. The company posted consolidated sales revenues of EGP 653.60mn for 1H2017 compared to EGP 630.27mn in 1H2016. The company's net loss was also due to a 5.4% increase in the SG&A, a 194% increase in the net interest expense and a 40% increase in the provisions. The company posted SG&A of EGP 100.91mn for 1H2017 compared to EGP 95.71mn in 1H2016. The company posted a net interest expense of EGP 29.42mn for 1H2017 compared to EGP 10mn in 1H2016. The company posted provisions of EGP 12.32mn for 1H2017 versus EGP 8.80mn in 1H2016.

The following table demonstrates the most important cement producers in Egypt along with their current designed production capacities in million tons per year:

Cement Producer	Production Capacity in Million Ton/Year	Share of Total Capacity
Suez Cement SUCE.CA	12	18%
ASIC Cement Co	6.5	10%
Al Arish Cement	3.5	5%
National Cement NCEM.CA	3	5%
Al Nahda Cement Co	1.9	3%
Al Amreya Cement	3.5	5%
Alexandria Portland Cement Co	1.6	2%
Arabian Cement ARCC.CA	5	8%
Lafarge Egypt Cement Co	10	15%
Misr Beni Suef Cement MBSC.CA	1.5	2%
South Valley Cement SVCE.CA	1.5	2%
<b>Egypt's total Production Capacity including other producers</b>	<b>66</b>	<b>76%</b>

Source: Al Mal Newspaper and AOLB Research.

According to official industrial sources, Egypt's local demand for cement increased to 57.3mn tons in FY2016 hence marking a 6.5% increase compared to local demand of 53.8mn tons in FY2015.

### **Egypt's current Cement production capacity and the new production capacities that will be brought into stream in the coming period**

Egypt's Industrial Development Authority (IDA) has recently sold three licenses to three companies to implement new cement production plants in Egypt. The three companies are Al Sewedy Cement Co, South Valley Cement SVCE.CA and El Masryeen Group. Every license authorizes the buyer to implement a plant to produce up to 2mn tons of cement per year. The three companies have already started the construction works. SVCE.CA was reported to have scheduled the trial operations for its new plant by the end of 2017 or so. According to the terms and conditions stipulated in the licenses given to the three companies, every company will have to produce and secure the energy required to operate the new plant. Also every company will adhere to the rule which states that it will produce cement through using raw materials obtained from quarries and not just through using clinker obtained from a third party.

It is worth noting that Al Arish Cement Company, which is an affiliate of the Egyptian Armed Forces, was reported to have been conducting an expansion plan to increase its production capacity from 3.2-3.5mn tons/year of cement to 6.4mn tons of cement per year, with the mentioned expansions to come into stream by the end of 2017. According to China-based Sinoma International Engineering Company,

The Egyptian Armed Forces have signed an agreement with Sinoma by which the latter will implement six new cement production lines in Egypt to produce about 12mn tons of cement per year with the mentioned production lines to come into stream by the end of 2019.

### **The Factors that will Boost Local Demand on Cement**

Despite the fact that Egypt's current total production capacity is more than 66mn tons of cement per year which seems to be higher than the local demand which reached 57mn tons per year in 2016, but the country's local demand for cement has increased by 6.5% in 2016 compared to 2015 and is expected to reach 80mn tons per year by 2020 according to GAFI's estimates. The local demand for cement in Egypt has increased for several reasons such as, implementing large and several infrastructure projects, implementing mega national housing projects such as the social housing project, middle-class housing project (Dar Masr), Sakan Masr housing project, Beit Al Watan housing project which targets Egyptian expatriates and several large housing and real estate investment projects that are currently implemented by the private sector. Also implementing the New Administrative Capital Project, the Suez Canal Axis project in addition to the increasing marriage rate which along with other factors has increased the local demand for new residential units to 600k units per year, all these factors combined have boosted the local demand for cement. The economic development breakthrough in general is expected to boost local demand for cement. Also it is worth noting that the local merchants and distributors of building materials in Egypt have also contributed to the increase in the local demand for cement in the recent periods due to their increased appetite to rebuild their own inventories in anticipation for price increase.

### **Floation of Egyptian Pound and Its Impact on Egypt's Annual Exports of Cement**

The Head of the Cement Industry Division at the Federation of the Egyptian Industries was recently reported to have said that the adoption of the floating exchange rate regime in addition to the slow growth in the local demand for cement in 1Q2017 have enabled the local cement manufacturing plants to export about 1mn tons of cement in 1Q2017 for the first time in eight years record. The same source added that the local cement manufacturing companies were unable to export cement in the past few years due to losing competitive advantages because of the fixed exchange rate regime that was in effect in Egypt which have made the local prices of cement higher than the international prices of cement. Now after the adoption of the floating exchange rate regime which caused a depreciation of about 50% in the value of the Egyptian Pound, the local cement producers have restored their competitive advantages as the local prices of cement have increased by less than the depreciation in the Egyptian Pound. It is worth noting that Egypt had exported 12.3mn tons of cement in 2004 which is considered the highest record in the country's annual exports of cement in the past years. Egypt's

Annual exports of cement then deteriorated to 6mn tons in 2007 and then to 300k tons in 2014. The head of the cement division at the Federation of the Egyptian Industries said also that the local cement producers target increasing the total production capacities to 84mn tons of cement by 2020 and they can boost it further to 100k tons per year in the way that could enable Egypt to export 10mn to 30mn tons of cement per year to increase the country's annual proceeds of foreign currency. It is worth noting that despite the fact that the current designed production capacities for cement producers in Egypt are estimated at more than 66mn tons of cement per year but the majority are not operating at high capacities.

According to the head of the cement division at the Federation of the Egyptian Industries, the current supply of cement in the Egyptian market exceeds the current demand by 10mn tons in the way that could enable the local cement producers to export 10mn tons of cement per year with the surplus to increase to 30mn tons of cement per year by the time the new plants (that have been granted licenses recently) are being put into stream. The mentioned surplus can be directed to exports, according to the same source.

In fact, Saudi Arabia was reported to have a surplus of 20mn tons of cement per year that can be directed for exports if the Saudi Government lifts the ban on cement exports. Therefore, Saudi Arabia's cement exports could represent real threat for Egypt's cement exports to the neighboring states particularly that the Saudi cement firms enjoy more fuel subsidies than their Egyptian counterparts.

### **Trend of Local Prices of Cement in Egypt in the Past Years**

In fact the average ex-factory local prices of cement in the Egyptian market have increased from EGP 300/ton in 2007, EGP 404/ton in 2008, EGP 460/ton in 2009, EGP 537/ton in 2010, EGP 439 ton/2011, EGP 541/ton in 2012, EGP 775/ton in 2013, EGP 791/ton in 2014, EGP 650/ton in 2015 to EGP 730-810/ton in 2017.

### **Current Fuel Blend Allowed for Cement Manufacturing Firms in Egypt**

In fact, the cement manufacturing plants operating in Egypt used to rely on natural gas and fuel oil as main sources for the energy required for production processes for this industry in Egypt in the past years. Starting May 2014 and amid the country's severe energy crisis, the government has decided to allow the local cement manufacturing firms to use the European fuel blend as a main source for energy instead of the fuel oil and natural gas. The European fuel blend consists of 85% of coal while the remaining 15% consist of natural gas, fuel oil, RDF and biomass and other alternative fuel sources.

The most important raw materials for cement industry are limestone that is obtained from the local quarries in addition to energy sources which are coal, RDF, fuel oil, natural gas and electricity. The cement industry's production costs are also affected by the cost of the land shipping for sales and raw materials, labor costs, packaging costs, interest costs and other operating costs.

### **Reasons for Pending Development Breakthrough in Sinai Peninsula**

We expect a breakthrough in the development projects and the construction and building activities in Sinai Peninsula in particular and Egypt in general in the coming period. For Sinai Peninsula, The Egyptian President in April 2016 has ratified the agreement signed with Saudi Arabia by which the Saudi Development Fund will secure USD 1.5bn in loans to finance development projects in Sinai. Also the Egyptian government is currently implementing in partnerships with local and foreign investors several mega projects at Suez Canal Axis project. Also the tunnels that are currently being implemented beneath the Suez Canal in Ismailia and Port Said are expected to be ready by the mid of 2018 and the end of 2018, respectively and at the latest. The two tunnels are expected to increase the Egyptian population residing in Sinai Peninsula in the way that will boost development and housing sector in Sinai.

The Egyptian Minister of Housing was reported to have said that the country's 2030 vision strategy aims at increasing the urban area in Egypt from 7.8% at the time being to 11% in the way that will increase the urban area in the country from 78.99k km<sup>2</sup> now to about 110k km<sup>2</sup> as the total area of Egypt is estimated at 1mn km<sup>2</sup>.

All these reasons will argue in favor of a brilliant future for Sinai Cement SCEM.CA provided that the current military confrontation between the Egyptian Armed Forces and the terrorists groups in Sinai will come to an end very soon, perhaps by the time the new tunnels are brought into stream as the change of the demographics of Sinai shall end the terrorism in the peninsula, according to our own viewpoint.

### **Valuation Assumptions for Sinai Cement SCEM.CA**

- The company will increase its total outstanding number of shares to 136.116mn shares through issuing new shares with the proceeds of the capital increase to be used in settling the current outstanding banking facilities.
- The company's main production lines which have total annual production capacities of 3.5mn tons of cement (grey cement) will operate at 70% utilization rate within 2018 compared to a utilization rate that is much lower than 50% in 1H2017. Therefore, the company will produce 2.45mn tons of cement within 2018 with the total production to be directed for immediate sales.
- The fuel blend that will be used by the company in 2018 consists of coal (85%) and fuel oil (15%). As 2.082mn tons of cement will be produced by coal and 367.5k tons of cement will be produced by fuel oil in 2018.
- For producing one ton of cement the company will consume 200kg of coal.
- For producing one ton of cement the company will consume 56kg of fuel oil.
- The company has already converted its plants into using coal since Aug 2016.
- For producing one ton of cement the company will consume 105 kw of electricity at a price of EGP 0.55/kw.
- The prices of the other raw materials such as limestone will be in line with the most recent data.
- The ex-factory selling price for cement by the company will be EGP 750/ton.
- The price of fuel oil will be EGP 3.5k/ton.
- The price of coal will be EGP 2k/ton as an average for using pet-coke in addition to imported coal.
- Other operating expenses such as SG&A, depreciation, land shipping costs etc. have been used in line with its recent levels and the average of its shares as percentage to sales revenues.
- The company's investment stake which is 25.4% in its subsidiary "Sinai White Cement Portland" has not been taken into account in the estimated fair value. It is worth noting that the mentioned subsidiary has an annual designed production capacity of 800k tons per year of white cement and this company has reported a net profit after tax of EGP 995k in 1Q2017.

### **Estimated Fair Value for SCEM.CA by Relative Valuation Techniques**

In accordance with the above mentioned assumptions, we have estimated the company's net profit after tax to reach EGP 264mn in 2018. Since the company's current market price is EGP 21.60/share, the company's share will then be trading at a P/E of 11.13x for FY2018 versus current P/E of 13.74x and 16.4x for building and construction sector and the whole EGX market, respectively (the P/E of the sector and the market according to EGX estimates in the report date). Therefore, we do believe that the stock will be relatively undervalued at the current market price and that its fair value is close to EGP 29.24/share which refers to a P/E of 15.07x.

### **Important Note**

Our set assumptions and the estimated fair value for SCEM.CA will not be applicable unless the current military operations in Sinai Peninsula come to an end completely before the beginning of 2018. We assume that the Army will be able to achieve this target at the latest by the mid of 2018 after the opening of the first tunnel beneath the Suez Canal in Ismailia Governorate. The security conditions in the Sinai Peninsula will be much better by the time the Egyptian citizens flow in millions to Sinai, in the way that change the demographic structure of the Peninsula's majority of population in favor of the Egyptians against the Bedouin of Sinai, which is expected by the opening of the two tunnels beneath the Suez Canal at Ismailia and Port Said (which are currently under construction) within 2018.

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