INDUSTRY RISK ANALYSIS

Cement Sector

October, 2021

Assessment of industry risk is an essential part of credit rating process. The industry risk assessment sets the ceiling for ratings of individual entities within a given industry. It focuses on the degree of cyclicality and the strength of competitive forces along with the extent of capital intensity, vulnerability to technological change, level of regulatory interference and energy sensitivity. All these factors are assessed on a scale ranging from High to Low to assign an overall risk level to each industry. Industry risk categorization for different industries is available on our website under Sector Updates "Industry Risk Analysis" (https://docs.vis.com.pk/docs/Industryrisk062021.pdf).

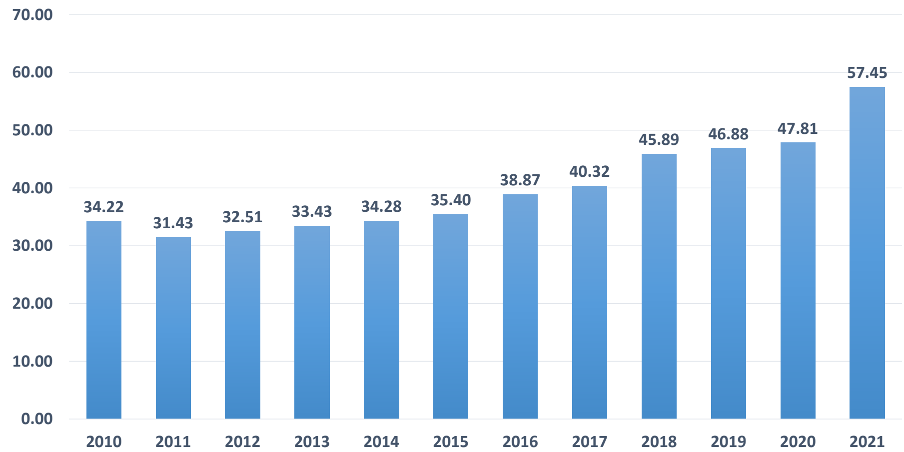
This document explains VIS approach to assess industry risk of Cement sector of Pakistan.

Cement Sector in Pakistan

OVERALL INDUSTRY RISK
High
High to Medium
Medium
Medium to Low
Low

Cement industry of Pakistan comprises of 25 cement manufacturing plants owned by 17 companies as per All Pakistan Cement Manufacturing Association (APCMA). The cumulative total production capacity of the country is 69 Million Tons which is expected to grow to ~88-91 Million Tons in the next 3-4 years. Overall dispatches in FY21 clocked in at 57.4 Million Tons with a utilization level of 82.7%. The sector is divided into two regions namely North & South. North consist of around 76% of the capacity while the dispatches share of North region in FY21 stands at 75%. Both regions have their own demand and supply dynamics. Players of the Southern region, benefit from greater export market availability given their geographical proximity to the sea; providing room for revenue diversification. Local demand growth in Northern region remained higher due to China-Pakistan Economic Corridor (CPEC) and other government related infrastructure projects. The major raw material of cement production is Limestone and Gypsum and these are available in abundance in Pakistan. Major portion of the industry's cost is fuel and power, comprising of 50-60% of total production costs.

Pakistan's Cement Dispatches (Million Tons)



Source: APCMA, VIS Database

In Pakistan, cement demand is closely linked to the overall economic growth, particular the infrastructure and housing sector. Pakistan's Public Sector Development Projects (PSDP) allocation plays an important role in driving the demand of cement. Government of Pakistan annual allocation of PSDP and utilization of the same plays a critical role on demand for cement. Historical data related to the financial performance of the sector depicts a strong correlation with changes in economic environment. Slowdown in economic activity in the country affects cement demand on the back of slowdown in construction and development activities. Consequently, the industry remains exposed to high cyclicality risk.

Competitive risk in the cement industry is considered medium. High capital requirements for establishment of a new cement facility provides an effective entry barrier. Secondly, over time existing players have achieved significant economies whereby it has become a challenge for a new entrant to compete on cost structure and therefore acts as a deterrent. However, at the same time there are no restrictive government regulations, licensing requirements, tariffs, or taxation regime that may hamper entry of new players. Therefore, risk of effectiveness of barriers to entry is considered medium for existing cement players.

Substitution risk in the cement industry is low. Locally there is no other material available currently which may be substituted as a building material in place of cement. However, internationally, sustainable and eco-friendly alternatives are gaining popularity wherein Fly Ash (by product of combustion of coal), Blast furnace slag (taken from molten iron) and Micro silica (by product of ferrosilicon alloy, silicon production) are being used for similar purposes.

Growth trends in the cement sector are correlated with the economy and are expected to remain positive with a projected GDP growth rate of 3.5-4% in FY22 on the back of strong development activity anticipated in the country. In addition, Government focused initiatives on housing and infrastructure development and incentives announced under the construction package will lend support to the construction sector and expected to provide boost to the cement sector. Therefore, risk in growth trends is assessed medium to low in the long run for the cement sector. On account of medium risk of new entrants, low substitution risk and medium risk of growth trend, competitiveness of the industry is termed medium.

Another factor for assessing industry risk is capital intensity. Capital intensity in terms of initial capital outlay as well as maintenance or expansionary capex can increase industry risk especially for those with a long-term return horizon. Financial strength and access to funds becomes an important determinant for supporting long-term growth in such industries. In terms of cement sector, capital intensity is rated as high risk. Cement manufacturers not only require high initial capital outlay, they also need sizeable investment for expansionary capital expenditure in order to sustain market shares amid growing demand. The need to invest in capacity enhancements from time to time becomes imperative to maintain competitiveness.

Cement industry vulnerability to technological change remains low given limited product line without much room for research and innovation. Product obsolescence is also low in this sector. While there is a push for adopting technologies for energy conservation and improvement in environment, the pace of change in the domestic industry is slow and therefore technology risk for cement sector remains limited.

Regulatory environment related to cement sector in terms of licensing, approvals, tariffs, taxation, environmental regulations and price controls is not restrictive. Most of the companies in the cement sector are owned by private business groups and government has no direct intervention in supply and demand dynamics and even pricing. Taxation regime is also in line with the large scale manufacturing sector. However, given the importance of the industry in the economy, it may attract regulatory interest in pursuit of achievement of economic objects set forth by the Government and therefore regulatory risk is assessed as medium to low.

Cement sector is considered one of the more energy intensive sectors of the economy. Energy costs account for 50-60% of total production cost for cement manufacturers. Energy efficiency consequently has become a competitive factor among players. Several players in Pakistan have their own captive power plants mostly based on coal which exposes them to volatility in international coal prices along with currency risk. Consequently, the sector remains high risk in terms of energy sensitivity. In view of all the risk parameters discussed above, overall industry risk for Cement sector is Medium.

Table 1: Summary of Industry Risk Factors

CEMENT								
Cyclicality	**Competition**				**Capital Intensity**	**Technology Risk**	**Regulatory Framework**	**Energy Sensitivity**
	Risk of Effectiveness of barrier to entry	**Risk of Substitution of Products, Services & Technology**	**Risk in Growth Trends**	**Overall**				
High	Medium	Low	Medium to Low	Medium to Low	High	Low	Medium to Low	High

Analyst Contact

Muhammad Amin
Assistant Manager
amin.hamdani@vis.com.pk