PRIME

The Egyptian Cement Industry

Impact	**NEGATIVE**
Degree	**MODERATE**

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Gauging the Impact

A mixed bag: weaker EGP + high interest rates + high fuel prices

The Central Bank of Egypt hiked interest rates twice so far this year, 100bps on 21 March and 200bps on 19 May, while the EGP weakened by c.15%. Recently, Egypt's Prime Minister directed the Egyptian Competition Authority (ECA) to reach a fair price for cement after the latest price surges. This will all put pressure on cement producers' margins. From the surface, a weaker EGP may look promising for cement exporters, but not all exporters are created equal. In this note, we gauge the potential impact of a weaker EGP, a high interest rate environment, and higher fuel prices. In sum, we would prefer companies that are operationally efficient with strong balance sheets.

From boom to bust: The Egyptian cement industry has gone through a boom and bust cycle over the past two decades. Having embarked on an infrastructure boom, the Egyptian government had issued new cement licenses that eventually led to an oversupply status in the market. Today, with c.80mn tons in total cement capacity, the market sits on an excess capacity of c.30mn tons. This longstanding situation resulted in a couple of operating companies either exiting the market altogether (e.g. **National Cement**) or opting to turn off its production until further notice (e.g. **Tourah Cement**). Up until 2021, almost all operating cement companies have been suffering from low profitability levels, if at all. This led to an industry-wide solution that was approved by all 23 cement operating companies as well as the ECA around mid-2021. All cement producers agreed to a quota system, whereby they all cut their production capacity applicable to their local sales for one year starting 15 July 2021. These quotas were based on a preset formula applied by the ECA, indicating the amount of the production capacity cut for each company. See Page 7.

Back to profitability in 2021: Cement producers have suffered from low levels of profitability and sometimes bottom-line losses back in 2020. Having applied the new quota system mid-year, cement producers began to see their profitability shoring up, making 2021 a really good year for the cement industry as a whole. Some companies turned their losses into profits as prices began to rise as a result of the new quota system. On the other hand, local demand for cement has been growing, reaching 48.6mn tons (+6% y/y) in 2021, thanks to several government-led infrastructure projects, housing developments, and the building of new cities. That said, local demand is still not high enough for some companies to stage a full recovery, such as Sinai cement [**SCEM**] and South Valley Cement [**SVCE**] which continued to report losses in 2021.

Exports growth helping alleviate the supply glut partially: We have seen a significant growth in exports throughout 2021, jumping more than 5 times y/y to 8mn tons of cement and clinker. On one hand, the government's export incentive programs helped some producers utilize their idle capacities. Yet, exports are not prevalent across all cement producers, limiting growth to a selected group of companies. Also, export sustainability is not enough when neighboring Turkey (the second largest cement producer in the world) and Saudi Arabia (the tenth) enjoy lower costs and fuel prices compared to Egypt.

Summary of impact

Ticker	Weaker EGP	High Interest Rates	High Fuel Cost
ARCC	⇔	↘↘	↘↘
MBSC	↗	↗↗	↘↘↘
MCQE	↗	↘↘	↘↘
SCEM	↗	↘↘↘	n/a
SVCE	↘↘	↘↘↘	n/a

↗ Slightly Positive ↗↗ Moderately Positive ↗↗↗ Highly Positive
↗ Slightly Negative ↗↗ Moderately Negative ↗↗↗ Highly Negative

Source: Prime Research.

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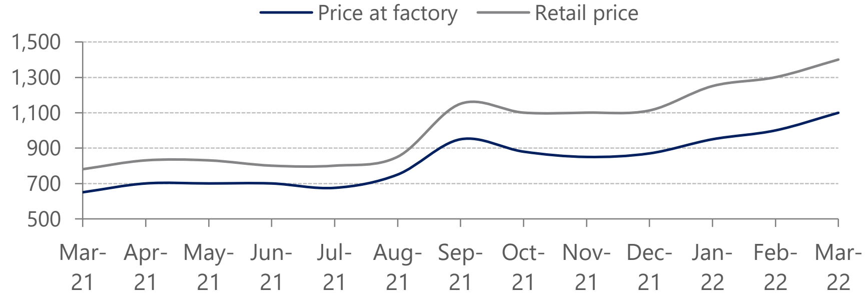
The Need to Survive

High prices, yet demand suffers: The price of packed Portland cement has doubled y/y reaching a peak of EGP1,400/ton by March 2022. Cement producers are pressured by soaring prices of fuels and packaging paper for cement, attempting to pass the higher cost to their customers. Consequently, the government is looking for ways to reduce the retail price of cement which will put more pressure on producers to cut costs.

Reinventing the kiln: Some producers are looking into the use of alternative fuels, such as Refuse-Derived Fuels (RDF), while others are looking into alternative production methods to fight lower demand expected in 2022. One way to do so is by increasing operational efficiency through the use of wasted heat from kilns and solar panels to generate electricity. Other cement producers are looking into "green cement" which uses alternative raw materials to lower the heat needed in the production from 1450°C to 600°C, thus lowering the amount of fuels needed in the process. For instance, **Amreyah Cement Group** is looking to adapt this method in producing cement.

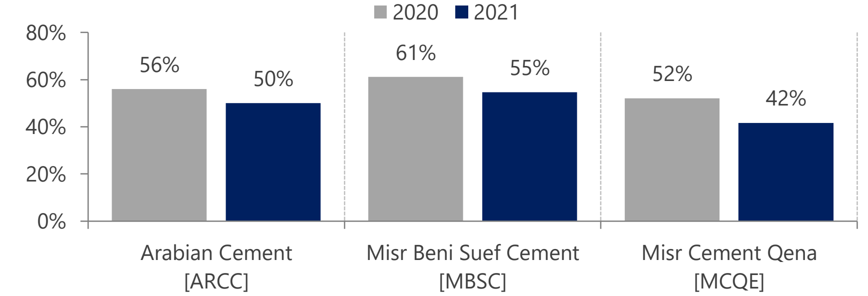
Dust to gold: The Ministry of Environment is looking to set a minimum of 15% of cement producers' fuel mix to be alternative fuels. This explains why many producers are looking to use RDF (i.e. fuel processed from solid household waste) instead of coal, diesel, or mazut. By doing so, cement producers will be lowering fuel cost, which currently constitutes 50% of their cost of goods sold (COGS), while lowering CO_2 emissions at the same time. Back in 2013, Arabian Cement Co. [**ARCC**] started using RDF which made up 9% its fuel mix in Q3 2021. ARCC is also establishing a company to source its RDF needs. Meanwhile, Suez Cement Group [**SUCE**] and **Amreyah Cement Group** have their own RDF processing plants.

Figure 1: Packed cement prices per ton (one year)



Source: Prime Research.

Figure 2: Energy cost as a percentage of COGS



Source: Company reports, Prime Research.

Detailing the Impact

Figure 3: Summary of impact

Ticker	Weaker EGP	High Interest Rates	High Fuel Cost
ARCC	⇔	↘↘	↘↘
MBSC	↗	↗↗	↘↘↘
MCQE	↗	↘↘	↘↘
SCEM	↗	↘↘↘	n/a
SVCE	↘↘	↘↘↘	n/a

↗ Slightly Positive ↗↗ Moderately Positive ↗↗↗ Highly Positive
↗ Slightly negative ↗↗ Moderately negative ↗↗↗ Highly negative

Source: Prime Research.

A weaker EGP: The overall impact of a weaker EGP on cement producers is mixed. On one hand, cement producers face higher prices of imported fuels (an essential component in producing cement) and even the packing materials that are imported from Russia and others. On the other hand, they will have a slightly positive impact which will naturally translate into a 16.5% growth in export revenues.

- With no foreign currency debt, Misr Cement Qena [**MCQE**], Misr Beni Suef Cement [**MBSC**], and Sinai Cement [**SCEM**] will be slightly positively impacted by the recent EGP depreciation which will boost export revenues.
- The impact on Arabian Cement Co. [**ARCC**] would be neutral as the positive impact from a 16.5% increase in export revenues (15% of total revenues) will be offset by the negative impact from its USD-denominated leverage (pushing higher its debt by 5% as well as interest expense).
- A weaker EGP will have a moderately negative effect on South Valley Cement [**SVCE**] due to its low level of USD-denominated debt. SVCE's total debt will increase by 0.4%, absent export gains.

A high interest rate environment: The impact of higher interest rates is twofold. First, EGP interest rates were hiked by 100bps in March then by another 200bps in May. Second, USD interest rates also rose with the Federal Reserve hiking 25bps in March then another 50bps in May.

- Among its peers, **MBSC** is the only positively impacted cement producer from higher CBE policy rates, having a debt-free balance sheet with a huge cash balance of EGP1.1bn. Thus, it should benefit off a higher interest income.
- **MCQE** will be moderately negatively impacted, facing a higher interest expense amounting to an increase of 22%. **ARCC** will also be moderately negatively impacted by a 23% increase in interest expense.
- **SVCE** and **SCEM** are the most negatively impacted among their peers by higher interest rates with their interest expense increasing by 28% and 37%, respectively.

Unexpected rising fuel costs: The price of fuels used in the production of cement (coal and pet-coke specifically) rose dramatically with the start of the Russia-Ukraine conflict, reaching new record highs. Producers tried to pass the cost through to customers, but this will not be sustainable as the Egyptian government is looking to put a cap on cement prices.

- **ARCC** is impacted negatively in a moderate manner, due to relying on pet-coke and RDF alongside coal, thus helping the company maintain good gross margins. Also, ARCC is looking to increase its RDF use in the upcoming years to its maximum capability of 18%.
- **MCQE** used 96% coal, 3% RDF, and 1% Mazut in its fuel mix in 2021, but the company is planning to lower its coal use to 80-85% with the remaining 15-20% in RDF and alternative fuels in the near future. The impact is slightly negative as their future expected fuel mix will lower the impact.
- **MBSC** uses coal mainly for production, thus rendering more susceptible to increases in its global market price.

What We Expect

Continued pressure on cement producers: We do not expect high fuel cost to decline anytime soon with the Russia-Ukraine conflict still ongoing. This year, we do not expect coal prices to fall back to their 2020 average of USD55/ton (using American Appalachia coal as a proxy). In Q1 2022, coal prices rose 15% q/q to USD117/ton. On the positive side, the weaker EGP effectively increased the cost of imports by 16.5%. On the other hand, we expect another 200bps hike in interest rates through the remainder of the year, which is not good news for most cement producers. As for cement prices, the Egyptian government and ECA are looking to find a fair price. From our perspective, we think any potential cap on the average cement price will be between EGP1,000-1,100/ton ex-factory.

Innovation is key: In order to improve their profitability, many cement producers will have to invest in newer and more efficient operations, such as solar power, alternative fuels, and green cement. Indeed, the Ministry of Environment wants cement producers to transition to a minimum of 15% RDF in their fuel use and to present plans for the transition within a year. We estimate that this should help decrease fuel costs by 11-17%. Meanwhile, some cement producers are looking into adding new equipment to capture wasted excess energy.

Figure 4: Summary of impact on selected EGX-listed cement stocks

	Impacted by*	**ARCC**	**MBSC**	**MCQE**	**SCEM**	**SVCE**
Increase in exports	Weaker EGP	16.5%	16.5%	16.5%	16.5%	0%
Increase in revenues	Weaker EGP	1.6%	0.2%	0.8%	0.4%	0%
Increase in debt	Weaker EGP	5%	0%	0%	0%	0.4%
Increase in interest exp.	Weaker EGP & higher interest rate	23%	0%	22%	28%	37%
Multiples & ratios**						
EV/EBITDA		5.7x	2.2x	4.3x	Neg.	Neg.
EV/ton (USD)		33.3	33.1	32.0	Neg.	Neg.
P/E		42.6x	19.5x	4.8x	Neg.	Neg.
Debt / Equity		64%	0%	56%	Neg.	77%
Cash / Market cap		8%	52%	10%	11%	18%
Net Cash / Market cap		Net debt	47%	Net debt	Net debt	Net debt

*Assuming same sales volume; based on an exchange rate of EGP18.3/USD, 300bps higher EGP interest rates, and 75bps higher USD interest rates.
** Prices as of 19 May 2022.
Note: Neg. = Negative.
Source: Company reports, Bloomberg, Prime Research.

Selected Companies

Arabian Cement Co. [ARCC]

Eye on efficiency: With 15% of its total sales coming from exports, ARCC is the fifth largest cement exporter. Thus, it will benefit from the EGP depreciation. On the other hand, the impact of higher COGS on ARCC's bottom lines is small due to its high efficiency, utilizing 70-80% of its coal needs from relatively lower-priced petcoke rather than imported coal. Nonetheless, ARCC has debt in both EGP and USD (49% of total debt in USD) which will have a double negative impact on its bottom line due to a higher FX rate and a higher interest rate (expected 23% increase in interest expense).

Misr Beni Suef Cement [MBSC]

Cash is king: Boasting a debt-free balance sheet, MBSC has a huge cash balance equivalent to 47% of its market cap. Thus, it should be the least affected by the latest monetary policy decisions in Egypt, even benefiting slightly from a weaker EGP and higher interest rates. Exports represent a small percentage of its sales (only 1%). On the other hand, MBSC should be negatively affected by the expected increase in coal prices as it uses only imported coal, not benefiting from locally-sourced alternative or cheaper fuels. We note that 56% of MBSC's bottom line in 2021 was due to a high interest income (EGP95.5mn) on its huge cash balance of EGP1.1bn. Thus, MBSC is the least impacted cement producer among its peers, benefiting off higher interest rates.

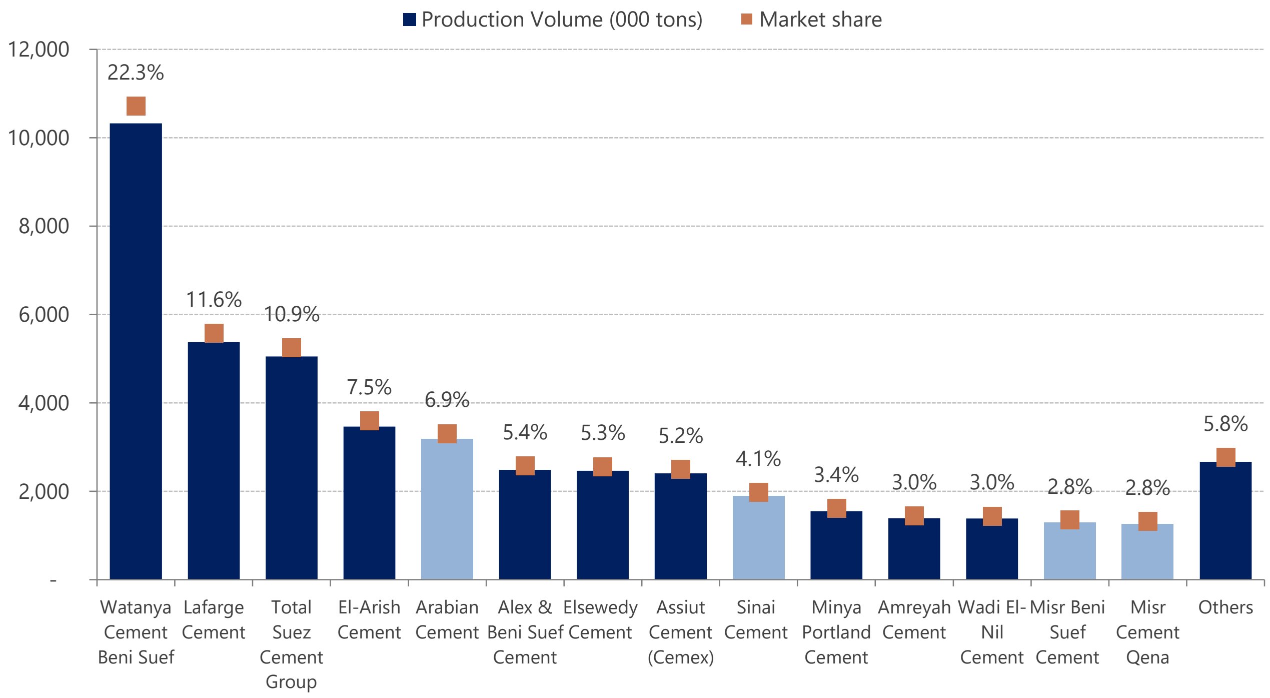
Misr Cement Qena [MCQE]

Strong earnings: MCQE managed to end 2021 with the highest bottom line among its competitors, reaching EGP174mn, more than double the second highest on the list, namely MSBC. Exports represented 6.5% of its sales in 2021. MCQE's debt/equity ratio stands at 56% with no foreign currency debt exposure. Thus, interest expense would increase by 21.6% on higher interest rates. MCQE will be impacted by the rising fuel prices less than its peers due to having better purchasing strategies and cost management.

South Valley Cement [SVCE]

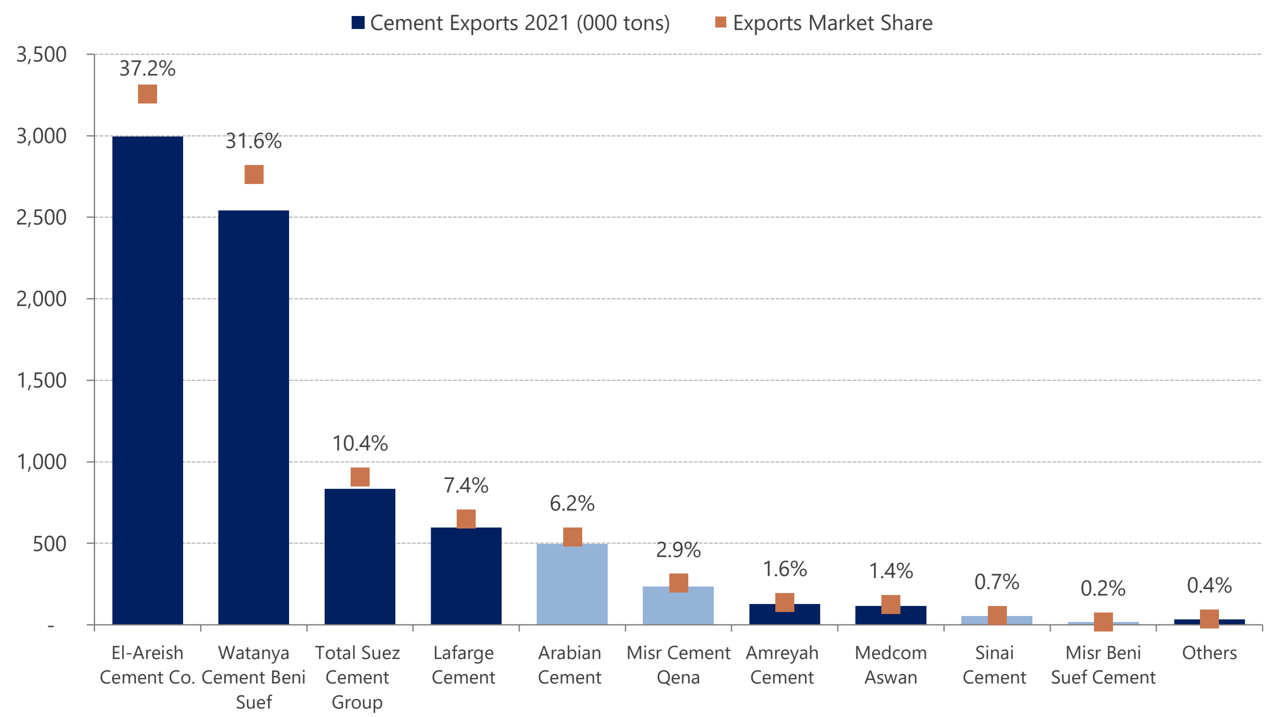
Expect a difficult year: SVCE is by far the most impacted of the four companies, with a debt-to-equity ratio of 63%, 5% of which is in USD. This means a double whammy on net margin, leading to a 37% increase in interest expense. Furthermore, with no exports, SVCE will not be able to benefit off a weaker EGP nor benefit from foreign currency cash to buy imported fuels.

Figure 5: Cement production in 2021 (000 tons) and market share



Source: Export Council for Building Materials, Refractories, and Metal Industries reports, Prime Research.

Figure 6: Cement exports in 2021 (000 tons) and market share



Source: Export Council for Building Materials, Refractories, and Metal Industries reports, Prime Research.

Figure 7: Cement quota explained (effective 15 July 2021)

The approval granted to 23 cement companies by the Egyptian Competition Authority (ECA) to cut their production capacity applied to local sales for one year starting 15 July 2021. The new quotas were set after taking into account the following formula applied by the ECA, indicating the amount of the production capacity cut for each company:

The amount of production capacity cut
= 10.69% * Company's production capacity
+ 2.81% * No. of production lines * Company's production capacity
+ 0.968% * Age bracket * Company's production capacity

We note that ECA grouped the companies into three age brackets:

- **Age Bracket I:** Factories founded before 2007 for which **15 years** are used,
- **Age Bracket II:** Factories founded between 2007 and 2016 for which **10 years** are used, and
- **Age Bracket III:** Factories founded after 2016 for which **5 years** are used.

We simplified the formula into the following:

$$y = x * (a + b\,\beta_1 + c\,\beta_2)$$

Where,

y = The amount of production capacity cut for the company.

x = The company's production capacity.

a (constant) set at 10.69%.

b (constant) set at 2.81%.

c (constant) set at 0.968%.

β_1 = The number of production lines.

β_2 = The age bracket (set as either 15, 10, or 5 years).

In other words, the formula reduces to:

$$y = x * (0.1069 + 0.0281\,\beta_1 + 0.00968\,\beta_2)$$

Source: Prime Research.

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