The South African cement market has, over the last three years, been experiencing what could be described as a perfect storm, with the following characteristics:

- a sluggish demand backdrop on the back of weak economic growth
- an increase in industry supply capacity
- a higher level of imports from Pakistan and China
- more intense competition for market share amongst both cement producers and retailers
- the bargaining power of retailers has increased due to surplus cement production capacity
- a structural change leading to the retail channel now making up almost 70% of cement sales, which is an increase from below 40% in 2011.

The above has led to predictably lower prices and historically low cement industry profitability.

The price disruption by the new SA entrants (Sephaku and Mamba Cement) caused significant uncertainty, but supply/demand fundamentals and hence the outlook for the cement industry is slowly improving due to:

- all new cement capacity is in the system with no more additions on the horizon, limiting the risk of further disruption
- cement prices are beginning to stabilise, with the producers who were initially responsible for cutting prices, now leading the price increases
- given the historically low profitability and high debt levels, the overall cement industry has limited financial flexibility to endure sustainably lower prices.

At Electus we believe that in fundamental valuation related research, the biggest payoffs are found in valuing companies where there is uncertainty about the future, where micro and macro uncertainty cause investors to abandon valuation first principles. For these reasons we think the cement industry may offer some interesting investment opportunities which could turn out to be bargains for the long-term investor.
The new entrants were successful in gaining market share (the pricing disruption had the desired effect), but the market has now settled from a capacity perspective and recent evidence suggests a shift in focus from increasing volumes to improving prices and profitability (see Chart 4 below); fundamentally current pricing is not sustainable for the industry as returns on capital are below the industry cost of capital.

But there is no new capacity on the horizon. New capacity development lead times in the cement industry are long; it normally takes as much as 6-9 years to get from the point when the initial decision is made to expand capacity, to the point of reaching steady state production, broken down as follows:

- 2-3 years for environmental approvals and proving reserves
- 2-3 years for plant build
- 2-3 years to ramp-up to full production.

Additionally, domestic production will benefit from reduced import substitution as imports, which have averaged about 1mtpa over the last four years, are expected to drop by half following import duties imposed on cheap imports from Pakistan and China (as well as rising freight costs and lower coal exports from SA to India leading to less ships available to collect cement on the return journey to South Africa).

The stabilising (or improving) price environment is a positive development for the industry because the high operating leverage of cement producers implies that price increases are more important than volume growth. A recovery in prices signals an upswing for the industry, and as capacity utilisation increases margins will benefit. Industry utilisation is currently between 60%-70%, mainly due to the higher cost idled production; whereas optimal levels are between 85%-90%. During 2015 industry demand totalled 14.6mt, equivalent to 67% capacity utilisation.
Costs
Capital costs (80% exposed to US dollar) - The cement industry is highly capital intensive as the cost of building a new cement plant in SA today is about two billion rand per million tonnes of cement production capacity. At current cement prices of R1,150/t that equates to a cost of around two years’ turnover.

Operating costs - Cement is an energy intensive, low value-high volume product, therefore logistics and energy efficiency are key considerations from an operational cost perspective, together with access to and cost of raw materials. Of these, logistics makes up the largest portion of total costs (25%-30%), making plant location and logistics efficiency a key differentiator across the market.

Market Structure - paints a bullish longer-term picture
In South Africa, access to raw materials and large capital requirements provide significant barriers to entry. The only available unused raw materials are in the Northern Cape region, an area geographically far from the cement end-user, which implies higher logistics costs and higher total production costs for any new industry capacity. Given the significant capital costs (which is 80% exposed to the US dollar), producers need increasingly higher cement prices to incentivise new production. Existing plants were all developed in a more favourable exchange rate environment, yet are currently earning low returns on invested capital (ROIC). In the current exchange rate and cement pricing environment the industry is unlikely to see new capacity being developed. Whilst current industry capacity exceeds demand, based on our expectations for demand growth, demand could outstrip supply within the next 5 years. The threat of substitute products is low, but given the structural change in the industry towards a higher proportion of retail/bags vs bulk, the bargaining power has shifted towards the small number of retailers such as Cashbuild and Build-It. However, all the main retailers now stock most brands, so none hold relatively higher exposure to a particular producer.

On balance, beyond a five year horizon we believe the market will be in need of additional capacity, but prices need to be noticeably higher to incentivise new production. Having said that, even though we think the cement market has favourable long-term fundamentals from a supply/demand perspective, it is a commodity-based business and is cyclical by nature, products are largely undifferentiated in terms of customer usage, being:
• 32.5 grade for general construction like plastering and finishing works where high strength is not required
• 42.5 grade for structural works where higher strength is required
• 52.5 grade heavy duty construction.

Prices are set by the laws of supply and demand. Therefore, when investing client funds in cyclical businesses, we prefer to own the high quality companies with sustainable competitive advantages that can withstand the vagaries of economic cycles.

Sources of competitive advantage in the cement industry
Given the dynamics mentioned above, in our view the key to augmenting a sustainable competitive advantage and building an economic moat in the cement industry is an ability to produce at a lower cost than competitors. Scale, favourable access to raw materials, energy efficient production methods and/or favourable plant location make this achievable. Due to cement’s low value/weight ratio, producers located closest to potential customers are able to sustain a cost advantage.

PPC
After several years of challenges, we believe that local cement industry fundamentals are improving due to the lack of new supply for the foreseeable future (raw material and capital barriers) and resilient demand, leading to higher industry profitability as utilisation rates and prices rise. Within the sector, we believe PPC is relatively well positioned to benefit from a recovering market.

PPC is South Africa’s leading cement manufacturer with about 35% (2016) of market installed capacity. It has a wide geographic footprint locally with operations in five provinces and operations in Botswana and Zimbabwe. It is evolving into a Pan-African business, with an aggressive expansion strategy adding operating exposure in Zimbabwe, Rwanda, DRC and Ethiopia.

What makes PPC attractive?
1. Dominant player, with leading industry margins and sustainable competitive advantages in an industry with improving fundamentals and profitability
PPC’s scale and mix of different production facilities/processes has given it a relative cost advantage (as fixed costs are spread over a higher number of production units) as well as an ability to produce across the range of...
different quality cement, which has enabled it to build a strong brand, evidenced by its ability to command a price premium relative to competitors. This is an important strategic benefit in the growing exposure to the retail market (see Chart 7).

**Chart 7: PPC’s price premium versus competitors**

During 2015 PPC achieved higher EBITDA margins at lower utilisation rates than competitors (largely due to a better cost profile). As an example, relative to Sepaaku (the other low cost producer in the industry) PPC’s EBITDA margin was 26% (vs 22.5% for Sepaaku) and utilisation rate was 62% (vs Sepaaku’s 80%), which implies that margins are likely to improve when PPC increases utilisation rates as demand picks up.

The pricing premium and perceived product differentiation gives PPC flexibility in managing price moves and market share gains/losses against profitability. During the recent period of price disruption, PPC’s strategy to maintain profitability (vs maintaining market share) paid off, the market has stabilised and it is now in a position with the flexibility to either keep prices lower and gain market share or increase prices and earn higher margins.

But cement is essentially a homogenous, commoditised product, which implies that product differentiation, whilst clearly possible, is not necessarily sustainable. In our view, the location of PPC’s plants (in relation to raw materials and end-users) is of far more importance to the quality of its investment case. This is a structural benefit that cannot be easily duplicated, thereby making it sustainable over the long-term (see Chart 8).

2. **Further restructuring benefits will improve cost profile**

Since Daryll Castle’s appointment as CEO in January 2015, there’s been a sharp focus on cost reductions, with the level of cost efficiencies achieved exceeding expectations. Whilst further gains will be harder to achieve, management has targeted inefficient legacy logistics contracts and PPC’s high payroll as a percentage of sales (13% vs 7% average for sub-Saharan peers) as further areas to reduce costs.

3. **Reaching end of capex cycle, debt levels peaking, reducing pressure on cash flow**

PPC has historically been a highly cash generative business, but over the last two years free cash flow turned negative, largely due to its aggressive expansion strategy into Africa. The large capex burden to develop four projects (Zimbabwe, DRC, Rwanda and Ethiopia) came at a time when profitability in SA hit cyclical lows, compromising the balance sheet. During May 2016 PPC announced a rights issue, because a combination of EBITDA pressure and high debt levels (debt/EBITDA 3.8x) led to an S&P ratings downgrade, which triggered accelerated bond redemption clauses, leading to an urgent need for liquidity. The rights issue was successful and funds raised were used to reduce debt, bringing the balance sheet back to relative health (at the cost of diluting existing shareholders at the time). Capex and debt will peak over the next 18 months as project developments come to an end, and as the capex cycle comes to an end pressure on cash flow will reduce. Post this current capex cycle PPC will not need to spend similar quantum’s of cash for a considerable time as its capacity will be in place and be sufficient for several years.

4. **Latent capacity**

PPC has mothballed, inefficient latent capacity (about 2mt) which can be brought back on-line in a higher price environment, at a significantly lower relative cost and in a shorter time than developing new capacity (1 year versus 6-9 years to build new capacity).

5. **African projects (the elephant in the room)**

PPC’s African exposure spans Zimbabwe, Botswana, DRC, Rwanda and Ethiopia. On paper the Africa growth strategy makes sense; high forecast urbanisation and infrastructure growth rates into the next decade coupled with low consumption per capita across the region pointing to strong structural tailwinds for cement demand. On average, these regions are supplied by old, inefficient, costly cement plants which rely on imported clinker, with import-parity pricing mechanisms that inherently are higher than cost-of-production type pricing due to the high logistics cost component. Clearly, more efficient local production that PPC is developing (close to end-user) would be competitive, displacing more expensive imports. Assuming successful development of all projects, PPC’s share in ex-SA production capacity will be 2.3mtpa (Rwanda 350kt, DRC 670kt, Zimbabwe 770kt, Ethiopia 490kt), taking the PPC’s total capacity to over 10mt.
It all makes sense in theory, but from a practical perspective operating in Africa is easier said than done. The African landscape is vast, each region comes with its own unique challenges – political and social instability, power shortages, imports, price volatility, formidable competition (Dangote Cement), corruption and unpredictable tax regimes to name a few. Whilst each of PPC’s African projects arguably makes sense on an individual basis, the business has been too ambitious in trying to do all these projects simultaneously. Unfortunately for PPC, capex related debt increased at a time when profits were under pressure, hence, it suffered the consequences through its rapidly falling share price and market capitalisation (resulting in the rights issue).

The mistakes have been made, and the scars are raw, but the African projects have now largely been de-risked from a construction perspective (all nearing completion thereby reducing execution risk) with all plants ramping-up over the next two years. In our view the DRC poses the largest risk (it’s the only country where debt is not ring-fenced), with almost R1 billion rand of capex remaining in the next 12 months, with the additional risk of potential cost overruns and intense political risk with elections on the horizon. These will eventually settle, but the true challenge comes once all these projects are operational - price discovery will be key to setting the tone regarding PPC’s ability to generate cash flow and pay off the significant levels of debt. If actual prices are materially below management expectations, we expect high impairment risk because budgeted selling price expectations were noticeably above spot cement prices.

All these uncertainties create risk, yet we see this risk as a good opportunity to invest in PPC. Why? Because we view the Africa projects as blue sky, essentially free optionality on the growth assets.

6. Valuation
The operational and financial challenges that PPC has endured over the recent past, namely the weak market conditions and poor financial risk management that led to the rights offer (R4 billion at a ratio of 160 for 100 shares), has understandably weighed on the share price, resulting in significant underperformance over the last 5 years (see Chart 9).

Chart 9: PPC Share price relative performance

Following the uncertain strategic direction and CEO management departure, we sold our clients’ PPC holdings to zero at 3000 cents per share in Sep/Oct 2014. Electus clients’ funds were not invested in PPC for the past two years specifically due to the financial risks and concerns articulated above.

Recalling an old Warren Buffett saying, “any investment is a good investment at the right price”, we believe this sharply lower PPC share price now presents us with an opportunity to invest at the right price, in a business with good quality assets that over the long term should earn a return on invested capital (ROIC) that exceeds its cost of capital.

Based on Electus’ sum-of-the-parts (SoTP) valuation methodology, we consider PPC’s fundamental valuation to be around 843cps, implying significant upside off the current price of 600cps. In our view the current share price represents a good entry point, with a sufficient margin of safety, for the long-term investor. This valuation views the Africa projects (excluding the DRC) as blue sky, which we value at 99cps, while we value the DRC at -4cps. Management guidance regarding profitability in the DRC has been volatile, with current projections of 25%-30% earnings before interest, tax, depreciation and amortization (EBITDA) margins significantly below the original (budgeted) expectations of between 35%-40%. We have been more conservative than management in our assumptions for the DRC, based on evidence in the market currently, and expect margins towards the lower end of the range. This may be too punitive and there is a risk that the DRC performs better than our expectations, but given the volatility and uncertainty in the DRC, we will assign value once it is demonstrated - reaching a steady state of production with commensurate margins. Therefore at these levels Electus clients are paying a discount for PPC’s assets in place (SA assets, which we value at 748cps), whilst essentially receiving the growth assets (Africa assets) for free.

As a valuation cross-check we analyse PPC on a Price/Earnings (P/E) multiple basis as well on a Replacement Cost basis. We believe that PPC will earn (a normalised) 127cps in its financial year to March 2020, implying a forward Price/Earnings multiple (P/E) of 4.7x to March 2020. Assuming a 10x exit P/E multiple, when this is discounted, it values PPC at 815cps today. We show our broad replacement cost calculation for PPC below (see Table 1), which also makes for interesting reading. In our view replacement cost should be representative of value as cement plants are capital intensive, tangible, manufacturing assets.
Table 1: PPC Replacement Value - Excluding African Projects

<table>
<thead>
<tr>
<th>Projects</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capacity</td>
<td>mt 7.6</td>
</tr>
<tr>
<td>Average replacement cost</td>
<td>Rm 2,000</td>
</tr>
<tr>
<td>Replacement value - EV</td>
<td>Rm 15,200</td>
</tr>
<tr>
<td>Less net debt</td>
<td>Rm 2,000</td>
</tr>
<tr>
<td>Replacement value - Equity</td>
<td>Rm 13,200</td>
</tr>
<tr>
<td>Shares in issue</td>
<td>'000m 1,625</td>
</tr>
<tr>
<td>Replacement value - Equity per share</td>
<td>R 8.12</td>
</tr>
</tbody>
</table>

Source: Electus, Company info

Risks to the investment case

Sustaining a leadership position in a commodity based industry like the cement sector is not easily achievable and comes with several risks - raw materials eventually deplete, production processes require upgrades consistently which allow competitors to catch-up, and in high operating leverage industries (like the cement industry) some players can produce even when selling prices fall below the marginal cost of production. Good management is required to maintain or enhance a company’s economic moat.

PPC management have made a few mistakes in the past, most notably the poor financial risk management which led to the rights offer. PPC should be able to maintain its leadership position, but further management mistakes are a key concern for us. It will cut short any chance of the PPC share price ever closing the valuation gap. Daryll Castle, the new CEO, is driving a renewed focus in the business to reduce this risk.

Successful delivery and ramp-up of PPC’s African projects is another key risk. To date capital costs have been reasonably well managed, but the risk of material cost overruns and timing delays cannot be ignored, especially given the volatile environment. Project funding is ring-fenced (except for the DRC), but this comes at a high interest cost and places high risk on operating cash flows once projects are at steady state.

IN CONCLUSION

The drawback of PPC’s expansive Africa growth strategy was that, despite its dominant market position and strong brand in SA, it fell into the trap of losing focus in its core domestic market. A combination of lack of investment, slow reaction to shifting competitive dynamics and a level of complacency led to a 6% compounded annual growth rate (CAGR) decline in earnings over the last five years. Over the period return on invested capital (ROIC) declined from 33% to 16%. This was clearly negative and largely the reason for the value destruction.

However, for investors that were not invested in PPC, which includes Electus clients, the current price presents a good opportunity to invest in a business with good quality assets that is the dominant cement market player, with sustainable competitive advantages and an ability to earn excess returns. For these reasons we have recently acquired a holding in PPC for Electus clients. Whilst we believe there is a significant valuation gap to be closed, the timing for that to happen is made uncertain by the complex risks inherent in PPC at the moment (especially relating to its African operations). We manage this risk by taking a risk adjusted weighting in the portfolio, thereby not exposing too large a portion of clients’ funds to PPC.

SA EQUITY MARKET VIEW AND FUND MANAGEMENT by Neil Brown and Richard Hasson

Pleasingly, as we also mentioned earlier this year, we believe that in 2016 the SA equity market has been paying much greater attention to the “Valuation” (not “value”) of companies, and not to the macro or sectoral “Momentum” related criteria. A focus on “Valuation” suits how we analyse companies and invest our Client funds and is totally aligned with our “bottom-up” focused methodology of investing. This is also positive for our Client funds as we build funds that are well diversified across key sectors, enabling us to seek to obtain excess returns for Clients from share selection and not from sector selection. As a four person SA equity research team since August 2015, we were initially very focused on building a strong research base for Electus. The research work, which involved undertaking industry, sector and company work, as well as building robust financial models, was completed in January 2016 and pleasingly, the 2016 relative performance of Client funds has been very strong (See Chart 10 and 11).

Over the past 6 months the SA equity market has been broadly flat, with the Resource sector continuing its better performance, which started in early 2016. We still believe that most of the key equity market sectors are now “fairly valued”, with the Financials being a bit undervalued. As our financial markets are currently faced with SA’s political and economic uncertainty, the volatility increases in the Financial sector, especially as the decision re the possible December 2016 downgrade to SA’s investment credit rating draws nearer.

Based on the above, we believe that good share selection will be critical for success in Client funds for the balance of 2016 and into 2017 and we therefore remain focused on primarily investing in best-in-class businesses with zero tolerance for poor businesses that have high financial risk. Based on our Electus fundamental valuations, we have been able to identify several mid-sized investment opportunities in the SA equity market, mainly in the Financial and SA Industrial sectors. This means that, in aggregate, the Client funds are extremely undervalued with current upside of >30%, which suggests a well above average expectation of excess returns. Therefore, we remain confident that the Client funds are well positioned.
Chart 10:
Long-Term Performance History
Nedgroup Investments Growth Unit Trust to 30.09.16
Excess Return pa vs General Equity Peer Group Unit Trust of 1.5% (Net vs Net)

Source: Morningstar and Electus

Since managed by Neil Brown and Richard Hasson

Chart 11:
Long-Term Performance History
Nedgroup Investments Growth Unit Trust to 30.09.16
Excess Return pa vs FTSE/JSE All Share Index (ALSI) of 1.9% (Gross vs Gross)

Source: Morningstar and Electus

Since managed by Neil Brown and Richard Hasson

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