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Part of AXYS Group

September 2017

ARM Cement 1H17 Earnings Update
‘Bottoming Out’

Bloomberg Ticker	ARML KN
Reuters Ticker	ARM.NR

Share Statistics	
Price	16.60
Market Cap (KES B)	15.9
Market Cap (USD M)	154.3
Year end	Dec
Float (%)	9.7
Foreign ownership (%)	45.7
3-month Avg Trading Vol (USD)	33,849

We met with ARM Management recently after the company released 1H17 results last week, posting a 429.8% gallop in loss after tax to KES 1.4B. This was attributed to the double whammy of falling revenues (-19.8% y/y) and rising operating costs (decline in EBITDA to KES 261M). Below, we take a critical look at the numbers and provide insights into how we see the fortunes of this company playing out.

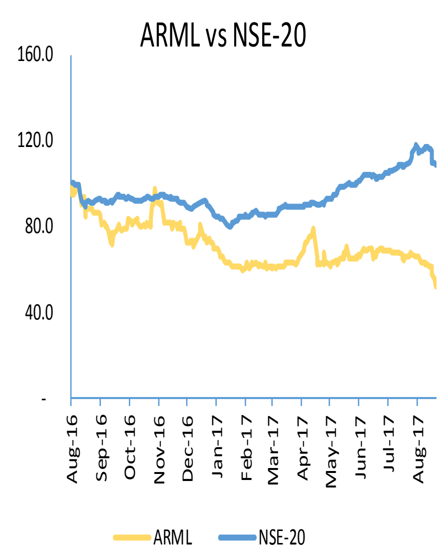
Tanzania headwinds drag top-line: ARM’s top-line came down 19.8% y/y to KES 5.3B attributable to headwinds faced in the Tanzanian market. The market saw 8 successive price declines from December last year to hit lows of USD 60 per tonne in 1H17. In addition, the cement maker toned down its production figures given the mounting competition in the country. Tanzania has an estimated annual cement consumption of 6.0M tonnes with cement production capacity outstripping demand. Cement players in the country cut production output aiming to control cement supply to raise prices.
According to management, the Kenyan segment remains profitable with ARM being able to sell-off all that it can produce. This implies that it is unable to meet the market demand for its product. As such, there remains headroom for the firm to grow its top-line in Kenya.

Ban on coal imports in Tanzania eats into profit margins: The Government of Tanzania banned the importation of coal mid last year aiming to increase appetite for locally mined coal. Since the ban came in when there was only one large coal mine (Ngaka mine managed by Tancoal Energy), there was insufficient supply of coal in the country which impacted clinker and cement production in 2H16 as well as 1H17. The dip in coal supply coupled with depressed cement prices in the country ate into the already low profit margins for ARM, leading to a negative EBITDA in Tanzania.
The insufficient supply of coal in Tanzania affected Kenyan operations as the Kenyan unit imports some clinker from Tanzania to meet its demand for cement production. As such, the volumes sold in Kenya declined. However, costs in Kenya remained manageable and with cement prices remaining stable, EBITDA from Kenya remained positive. 1H17 saw ARM’s EBITDA decline to KES 261M as the negative EBITDA from Tanzania ate into the positive EBITDA from Kenya.

CDC investment used to bring down debt levels bears fruit: CDC invested USD 140M which was used to bring down debt to current levels of USD 128M. As such, the net interest income paid by the group (cash) dropped 37.7% y/y to KES 741.3M. Informed by other measures being undertaken by the firm (discussed later), the finance costs for the firm are anticipated to come-off going forward.

Taxation charge amidst losses: Despite ARM having a loss before tax of KES 1.4B (+279.2% y/y) the cement maker incurred a taxation charge of KES 33.6M. Management attributes this as prudent provisioning though the firm may not necessarily incur a taxation charge for the full year. As such, ARM may reverse this in FY17 which may shield its bottom-line.

Price Trend



Source: (NSE)

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Non-current and current assets dip: Non-current assets for the group declined 1.8% y/y to KES 42.0B attributed to reduced investment (-34.4% y/y decline in cash used in investing activities) and depreciation expense incurred by the group. With the group set to dispose its non-cement segment, the non-current asset figure is set to fall even further.
Current assets fell 11.1% y/y to KES 7.4B which was attributed to more cash sales as demand outpaced supply enabling the firm to demand better terms on credit sales. In addition, the firm's inventory declined with the Kenyan unit being able to sell all volume produced. Current liabilities dropped 12.9% y/y, outpacing the fall in current assets to improve the current ratio to 0.60x (1H16 at 0.59x).

After the trough...

The expansion of ARM into Tanzania has seen the cement maker take hits on both its top-line and bottom-line with cement prices in the country plummeting while operating costs soared. However, management sees these tough times as a passing cloud with better fortunes awaiting the firm.

Top-line to grow while operating costs to be contained: Cement prices in Tanzania are expected to buck the falling trend and rise in 2H17. The prices are currently at USD 75 per tonne and the industry expects the prices to rebound to USD 85-90 levels going forward. This points to improved revenues to the cement maker in Tanzania. At current prices, ARM is selling above cost and may see the unit lower its negative EBITDA in FY17.
The ban on coal imports has raised the allure of coal mining in the country and has seen an entry of two new coal miners. As such, the issue of coal insufficiency stands resolved which may see ARM's 1.2M tonne Tanga clinker plant operate at (or close to) capacity. This will see the Kenyan unit receive sufficient clinker supply and may translate into additional sales for the Kenyan unit as well.
According to management, the Government of Tanzania has implemented a planned ban on the importation of clinker. Cement makers who rely on imported clinker will find it hard to operate in the country as clinker sufficient plants aim to meet their demand first before releasing it into the market. Seeing that ARM is clinker sufficient, the current developments give it a fighting chance in the Tanzanian market

Stable power supply in the country coupled with adequacy of coal supply may see the cement maker contain the operating costs and protect its bottom-line going forward.

Financing options: ARM plans to exit its non-cement business aiming at concentrating more on the cement business as it has higher margins (in Kenya). The disposal is expected to be completed by the end of the year and ARM could register gains on disposal which may support its bottom-line. The disposal proceeds are expected to bring down debt levels in the group which may translate into lower finance costs going forward.
The group is currently undertaking balance sheet restructuring which will see it convert some of the costly short-term debt into long-term debt. The assumption is that ARM will get better loan rates that may see it drive its finance costs lower. In addition, the conversion from short-term to long-term debt will lower its current liabilities, thereby raising its current ratio.
Negotiations are still ongoing with some of ARM's shareholders who are willing to lend on short-term basis which will enable it finance its operations. This will lead to a more leveraged balance sheet and will raise the firm's finance costs, albeit marginally since its assumed they'll attract lower than market rates.
After the above options, ARM plans to onboard a long-term strategic investor adding that, CDC has reached its limit as an institutional investor and has opted not to pump in more capital. Though the finer details of this plan are not yet public, this points to increased dilution for current shareholders and the news could see the counter take a beating at the bourse.

Hypothetical situation: In terms of a strategic investor, ARM would opt for a cement maker who would come in with technical and operational expertise. As such, we hypothesize on the possible interest of two cement makers: Heidelberg Cement Group and Dangote Cement.
Dangote cement would be more interested in acquiring a stake in ARM cement given that the former also plans an entry into Kenya. Dangote Cement intends to set up two new plants in Kenya by 2021 totaling 3.0M tonnes annual capacity. The cement maker would benefit from ARM's strong brand name eliminating the need to cut prices in the country to gain market share. In addition, the cement maker would merge its new plants with the current existing one resulting in a larger cement player in Kenya.

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Adding to the allure, ARM cement is fully clinker sufficient (with additional supplies from the Tanga clinker plant) which would aid in Dangote's strategy of being the lowest cost producer. In Tanzania, the acquisition of ARM would see Dangote solve a number of its issues. First, the Mtwara plant is the furthest cement plant in the country from the main market of Dar es Salaam (560km). The plant is also logistically challenged being 565km from the largest coal supplier (TanCoal). Dangote Cement in Tanzania currently does not produce its own clinker and as such, the acquisition of the Tanga clinker production capacity would be ideal. In addition, the power grid in Mtwara is not sufficient to keep the plant running.

Interest from Heidelberg would be purely for competitive reasons with the cement maker having bought ItalCementi (Belgium cement maker) amidst rumors of interest from Dangote cement (2015). ARM would be ideal for Heidelberg given the cement maker wants to cement its position in Tanzania in terms of clinker and cement production. The Kenyan unit would be an icing on the cake and could see the firm enter the Kenyan market which is more price and regulatory stable.

It's evident that ARM may not be willing to be a subsidiary of another cement maker and as such may decide to dispose the Tanzanian unit given that it's recording negative earnings. In either case, there exists interest for the full/ partial acquisition of the cement maker, subject to various conditions such as pricing.

Parting shot: With a huge KES 1.4B loss in 1H17 and an expected tough (though better) 2H17, ARM (to us) still has a long way to go before turning around. Management remains optimistic of the changes that are being implemented in the firm and changes in the cement market with the loss expected to be lower for FY17 and may breakeven in FY18. The negative sentiments surrounding the cement maker are expected to keep the price depressed, though, if the tides turn, we could see an astronomical upswing that could rally the price.

1H17 Financials

Income Statement	1H16 KES Million	1H17 KES Million	y/y % change
Revenue	**6,670**	**5,347**	**-19.8**
Loss Before Tax	(364)	(1,380)	279.2
Taxation Credit/ (Charge)	97	(34)	-
Loss After Tax	**(267)**	**(1,414)**	**429.8**
Loss Per Share	**(1.10)**	**(3.30)**	**200.0**

Balance Sheet	1H16	1H17	y/y
Assets			
Non-Current Assets	42,773	41,994	-1.8
Current Assets	8,286	7,370	-11.1
Total Assets	**51,059**	**49,364**	**-3.3**
Equity and Liabilities			
Share Capital	849	849	-
Share Premium	14,095	14,095	-
Capital and Other Reserves	12,845	11,432	-11.0
Equity Attributable to Parent	27,789	26,376	-5.1
Non-Controlling Interest	6	6	-
Total Equity	**27,795**	**26,382**	**-5.1**
Non-Current Liabilities	**9,104**	**10,647**	**17.0**
Current Liabilities	14,159	12,335	-12.9
Total Liabilities	23,264	22,982	-1.2
Total Equity and Liabilities	**51,059**	**49,364**	**-3.3**

Statement of Cash Flows	1H16	1H17	y/y
Cash Generated before WC Changes	**1,610**	**261**	**-83.8**
Working Capital Changes	(568)	947	-
Cash Generated From Operations	1,042	1,208	15.9
Net Interest	(1,190)	(741)	-37.7
Tax Paid	(82)	(0)	-99.6
Net Cash From Operating Activities	**(230)**	**466**	**-**
Net Cash Used in Investing Activities	(222)	(146)	-34.4
Net Cash Used in Financing Activities	172	(242)	-
Increase/(Decrease) in C&CE	**(280)**	**78**	**-**
Opening Cash and Cash Equivalents	206	157	-23.9
Exchange Adjustment	174	(122)	-
Closing Cash and Cash Equivalents	**100**	**113**	**13.1**

Ratios and Margins	1H16	1H17	y/y
Net Loss Margin (%)	-4.0	-26.4	-22.4
ROE (%)	-10.4	-15.0	-4.6
NAV/Share (KES)	28.95	27.48	-5.1%
Current Ratio (x)	0.59	0.60	
P/B (x)		0.6	

Source: ARM Cement & ApexAfrica Research

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