Equity Research | Materials

TOKYO CEMENT COMPANY (LANKA) PLC (TKYO.N)

Construction industry turnaround expected to gather pace in the coming year

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TKYO reported positive revenue growth of +4% Y/Y and EPS growth of +68% Y/Y to LKR 2.43 in 2Q FY25 (+52% Q/Q) (see here and Exhibits 2 through 6). Revenue on a TTM basis in seen to be stabilising after a period of contraction following the economic crisis and is expected to pickup going forward. **Rating upgraded** to **"Buy"** with a **12M price target** of **LKR 88.00** on expected turnaround in the construction industry, favorable long-term outlook, market multiple expansion and potential further upside to our valuation if volume growth is higher than our expectations driven by a faster recovery in construction activity.

Trailing revenue has bottomed out after 6 quarters. Early signs of revenue growth expected to gather momentum. TKYO is Sri Lanka's largest locally owned cement manufacturer operating in both the ready-mix concrete and dry mortar product segments, with a market share >25% of national cement consumption. TKYO's TTM revenue is expected to turn positive on a Y/Y basis in 3Q FY25 (see Exhibit 4) with the gradual pickup in the construction sector. Volumes are currently well below pre-crisis levels indicating significant potential upside in the medium term. Regulatory interventions on cement pricing remains a concern. Historically TKYO has maintained average gross margins >25% despite periodic ad hoc price controls imposed on the cement industry in Sri Lanka. We expect that utilization of spare capacity as the industry volumes pick up from a low base following the economic crisis coupled with potentially stable exchange rates (a key determinant of pricing) will translate into higher profitability through operating leverage given the capital-intensive nature of the business.

Upgraded to Buy	
12M Target Price	**LKR 88.00**
Previous Price	-
CMP	**LKR 69.70**
Dividend	LKR 2.00
Upside/ Downside	**29%**

Market Cap (LKR Bn)	20.58
No. of Shares (Mn)	441.05
52w High | Low (LKR)	73.00 | 42.00
Beta | Sharpe Ratio	1.13 | 0.04
TTM P/E (X)	11.41
TTM Dividend Yield	3%

Exhibit 4: TKYO Trailing Revenue

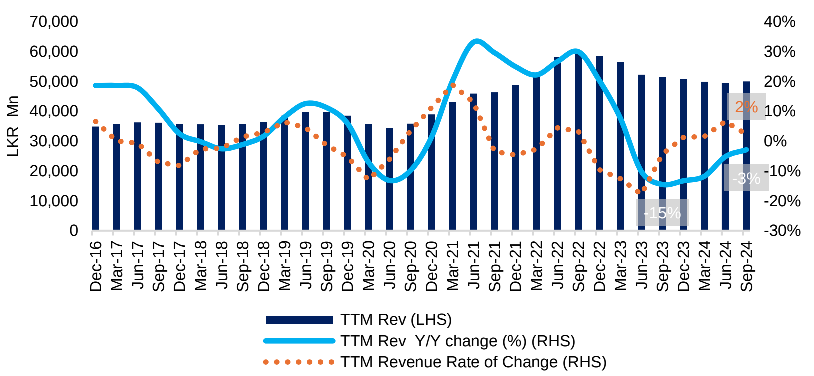


Exhibit 5: TKYO 2Q FY25 Income Statement

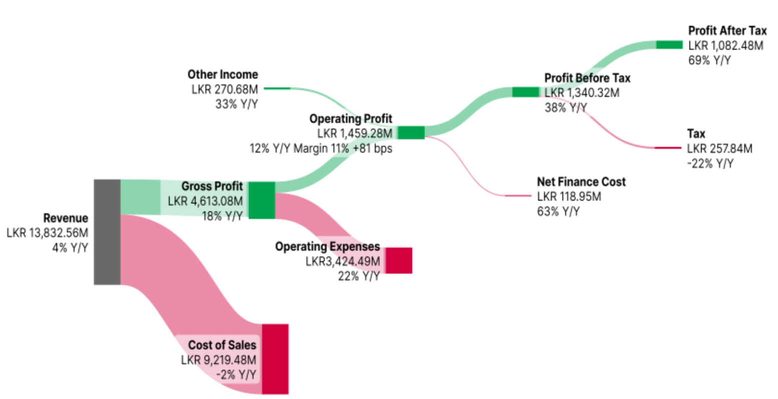


Exhibit 1: Share Price of TKYO vs ASPI

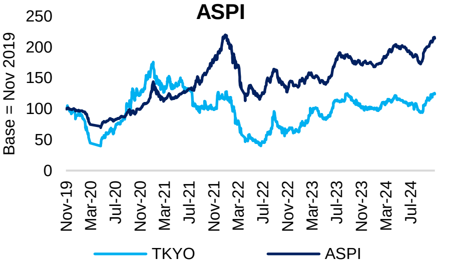


Exhibit 2: TKYO Quarterly Revenue

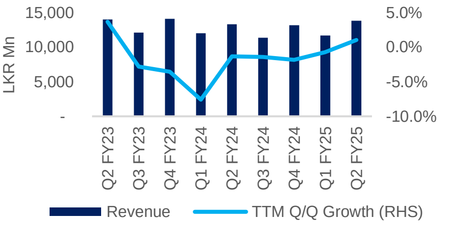
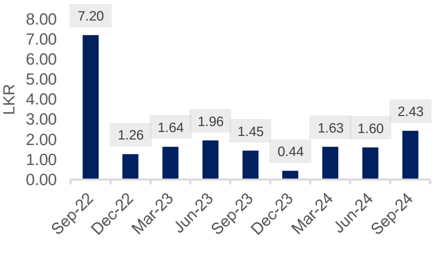


Exhibit 3: TKYO Quarterly EPS



For analyst certification and other important disclosures, refer to the Disclosure Section, located at the end of this report.

Exhibit 6: TKYO Quarterly Financial Summary

(in LKR 000s)	2Q FY24	3Q FY24	4Q FY24	1Q FY25	2Q FY25	Y/Y %	TTM 2Q FY24	TTM 2Q FY25	Y/Y %
Revenue	**13,311**	**11,348**	**13,145**	**11,665**	**13,833**	**4%**	**51,495**	**49,990**	**-3%**
Gross Profit	3,905	3,595	4,129	4,062	4,613	18%	16,642	16,399	-1%
Gross Profit Margin (%)	**29%**	**32%**	**31%**	**35%**	**33%**	**401 bps**	**32%**	**33%**	**49 bps**
EBIT / Operating Profit	1,298	541	1,336	1,287	1,459	12%	6,420	4,623	-28%
Operating Profit Margin (%)	**10%**	**5%**	**10%**	**11%**	**11%**	**80 bps**	**12%**	**9%**	**-322 bps**
Finance Cost	327	233	361	117	119	-64%	1,852	831	-55%
Profit attributable to Shareholders	**640**	**196**	**720**	**706**	**1,073**	**68%**	**2,778**	**2,695**	**-3%**
Net Profit Margin (%)	5%	2%	5%	6%	8%	295 bps	5%	5%	0 bps
Quarterly EPS (LKR)	**1.45**	**0.44**	**1.63**	**1.60**	**2.43**	**68%**	**-**	**-**	**-**
TTM EPS (LKR)	**6.30**	**5.48**	**5.48**	**5.13**	**6.11**	**-3%**	**6.30**	**6.11**	**-3%**
DPS (LKR)	1.50	-	-	-	2.00	33%	1.50	2.00	33%

Construction activity is back in expansionary territory since early 2024 with momentum expected to be sustained as the economic recovery takes hold. The Purchasing Managers Index for Construction which tracks construction sector activity returned to expansionary levels in January 2024, whilst available housing approvals data shows a bottoming out in the negative trend since the start of the economic crisis in early 2022 (see Exhibits 7 and 8). We expect that construction activity will gain momentum with the economic recovery taking hold and with credit growth picking up, usually a leading indicator of investment levels in the economy. Typically, we expect a lag of 6-12 months for favorable economic data to translate into revenue growth for construction materials given the timeframe for obtaining building approvals and securing financing arrangements.

Exhibit 7: PMI Construction

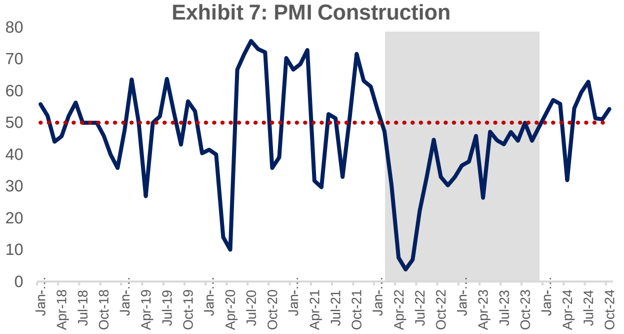
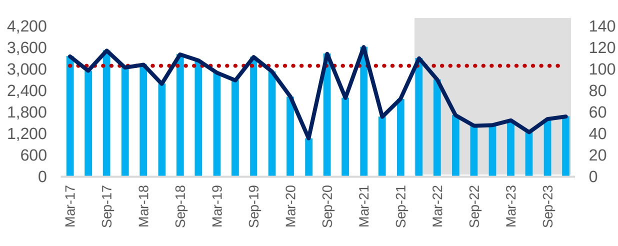


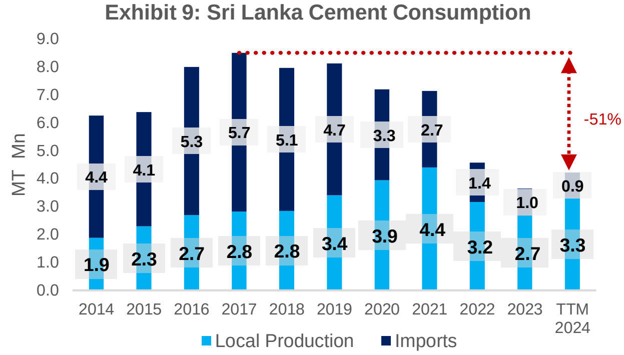
Exhibit 8: Greater Colombo Housing Approvals



Construction materials sector in Sri Lanka still has substantial upside given the gap between current volumes and pre-crisis levels. We believe that construction materials businesses in general and the cement industry in Sri Lanka in particular still has a long runway ahead given that the recovery in construction activity is still at a nascent stage. This is reflected in a gap of c. 51% between current cement industry volumes of c. 4.2 Mn MT and the previous high of 8.5 Mn MT set in 2017 (see Exhibit 9).

The recent conclusion of the external debt restructuring and upgrading of Sri Lanka's credit rating, which moved out of default category after a lapse of over 2 years will be a further boon for construction in medium term. We expect that with the country coming out of debt default, many bi-lateral/ multilateral funded infrastructure projects as well as FDI investments which were put on hold, may now be in position to commence construction in the near to medium term.

Exhibit 9: Sri Lanka Cement Consumption



TKYO is currently operating at c. 30% of capacity and is well positioned to benefit from a normalisation in industry volumes. TKYO's installed capacity is estimated at c. 3.1 Mn MT per annum compared to the current estimated TTM volume of c. 1.07 Mn MT as at September 2024 (see Exhibit 10). Whilst a steep increase in cement prices in response to the collapse in the value of the LKR at the beginning of the economic crisis in 2022 served to shore up TKYO's revenues, sales volumes collapsed in-line with the industry. TKYO's current volumes are c. 50% below estimated annual volumes of >2.0 Mn MT achieved in FY20 through FY21 period. Availability of ample capacity with current and ongoing capacity expansion projects implies that TKYO is well positioned to benefit from a recovery in industry volumes with moderate capex requirements for capacity expansion in the medium term, hence potentially higher free cash flow generation.

Exhibit 10: TKYO Quarterly Revenue and Est. Production Volume

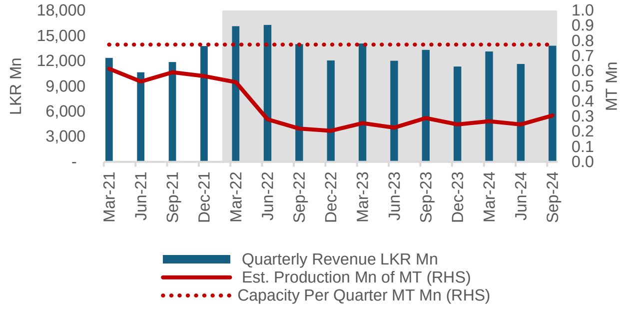
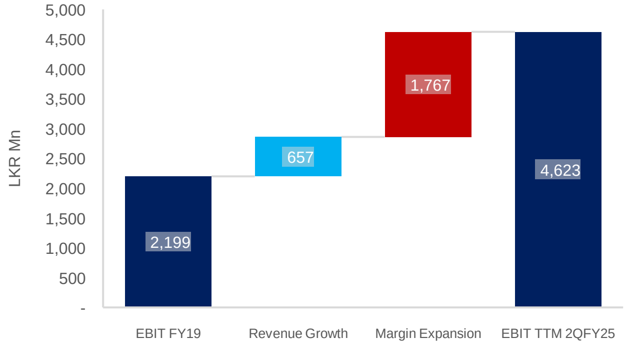
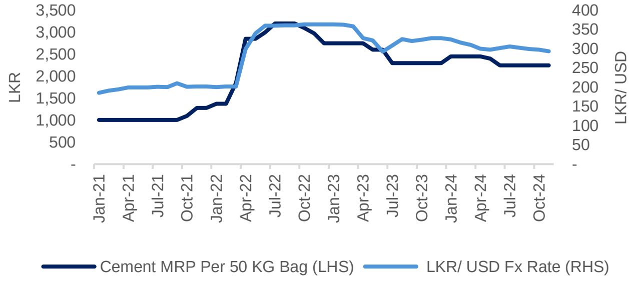


Exhibit 12: TKYO EBIT Bridge



Exchange rate is the key determinant of pricing in Sri Lanka's cement industry. Sri Lanka's cement manufacturing industry is oligopolistic, consisting of one integrated manufacturing unit and two large grinding units (including TKYO) with a total installed capacity of >9 Mn MT per annum, in addition to several bulk cement bagging plants for imported cement. Given the high reliance on imports of clinker and other raw materials for manufacturing, coupled with the dollarized nature energy/ fuel prices, the LKR/ USD foreign exchange rate is the key determinant of pricing in Sri Lanka's cement industry (see Exhibit 11). Retail prices of cement have increased by c. 60% from LKR 1,375/- per 50 kg bag in February 2022 to LKR 2,250/- at present as the LKR has depreciated by c. 50% over the same period. Cement industry players have generally eschewed price-based competition at the retail level, whilst competing on pricing at the project level.

Exhibit 11: Cement Price MRP and Exchange Rate



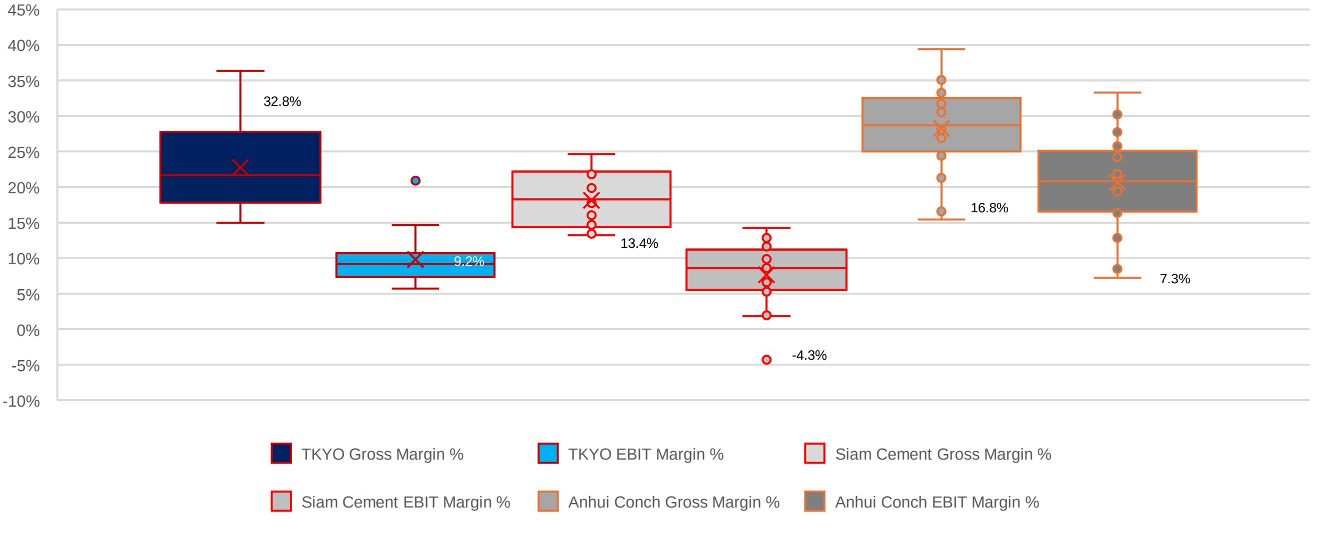
Given the location of its manufacturing plant in Trincomalee which affords closer access to the country's hinterland and better margins in the retail segment, TKYO is likely to benefit more from a pickup in the retail/ housing construction activities.

Notwithstanding periodic government interventions on pricing, which remains a concern, TKYO has maintained gross margins at reasonable levels cf. regional peers. TKYO reported gross margins of 32.8% for TTM 2Q FY25 and EBIT margins of 9.2%. TKYO's current operating margins and historical margin dispersion compares favourably with regional peers (see Exhibit 13). TKYO's current operating margins and overall profitability is commendable in the context of Sri Lanka's recent economic crisis and resultant collapse in demand for cement.

Whilst TKYO's revenue levels have sustained cf. pre-crisis FY19 on account of the steep increase in the retail price of cement, higher margins have shored up profitability (see Exhibit 12). Given that TKYO is currently operating at a low capacity utilisation rate of c. 30%, we expect that EBIT margins could expand as volumes pickup.

TKYO's production volumes can conceivably double to pre-crisis levels; which coupled with margin expansion through operating leverage could significantly grow earnings in the coming years. However, the timing is highly dependent on economic growth and the recovery in overall construction activity. Therefore, macroeconomic risks continue to weigh heavily on the counter/ sector.

Exhibit 13: TKYO Margin Profile



Box & Whisker Chart Interpretation. Box: The box represents the interquartile range (IQR), which contains the middle 50% of the data. The edges of the box are the first quartile (Q1) and the third quartile (Q3). **Median**: The line inside the box marks the median (Q2), which is the middle value of the dataset. **Whiskers**: The lines extending from the box (whiskers) show the range of the data, excluding outliers. The whiskers typically extend to the smallest and largest values within 1.5 times the IQR from the quartiles. **Values:** The numerical values are the values for the most recent period.

Exhibit 14a: Historical & Forecast Revenue

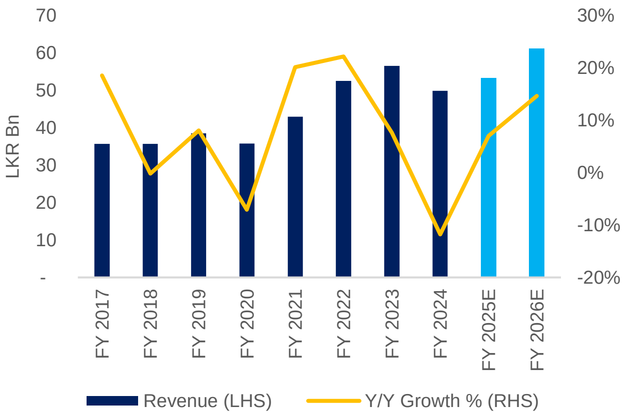


Exhibit 14b: Historical & Forecast EBIT

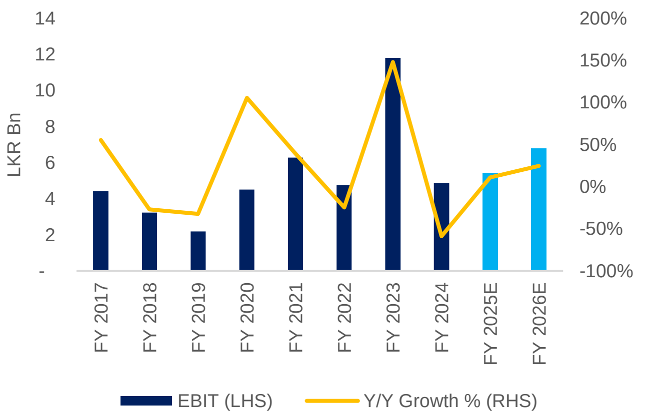


Exhibit 14c: Historical & Forecast Capex

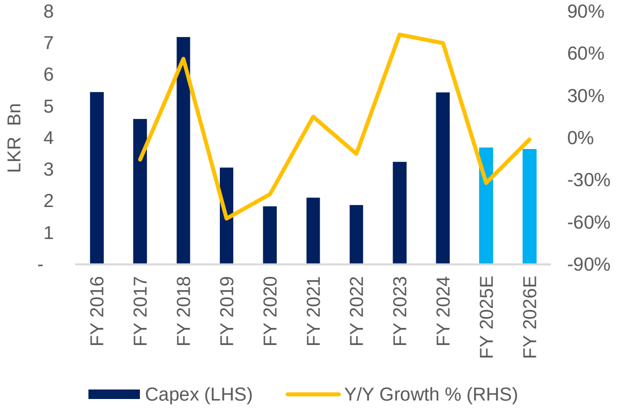
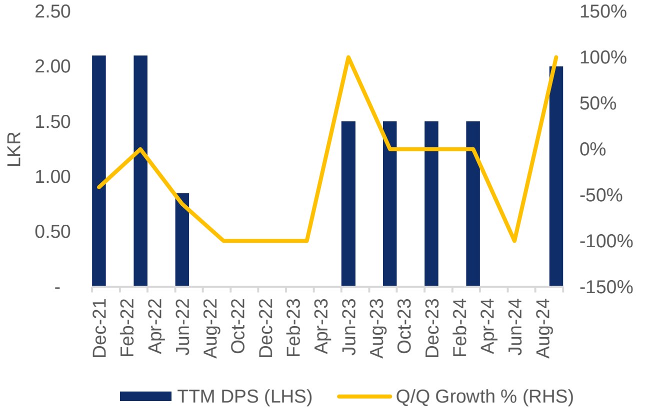


Exhibit 14d: TTM DPS



We forecast TKYO's revenue to post a growth of c. 7% Y/Y in FY25E to c. LKR 53.3 Bn, and 14.6% Y/Y to c. LKR 61.1 Bn in FY26E. Our topline forecast is underpinned by an expectation that annual volumes will grow by 24% on a cumulative basis by end FY26E from FY24 levels. The c. 50% decline in volumes since the economic crisis implies that volumes could double to pre-crisis levels. However, given the uncertainty in relation to the timeframe over which construction activities will recover, we have adopted a more conservative forecast assumption and will review the same based on actual outcomes over the next year.

Given the potential operating leverage from volume growth, we expect that margins will expand from current levels to c. 11.5% in the medium term. We expect EPS to come in at c. LKR 7.37 in FY25E (+34% Y/Y cf. LKR 5.48 in FY24) supported by the volume led recovery in revenue in the current year.

Exhibit 15: Salient Forecast Assumptions

For the year ended 31-March	Actual						Forecast	
	FY20	FY21	FY22	FY23	FY24	TTM	FY25E	FY26E
Est. Volume Growth Y/Y (%)			3%	-57%	7%	9%	11%*	12%**
Revenue Growth Y/Y (%)	**-7%**	**20%**	**22%**	**8%**	**-12%**	**-3%**	**7%**	**15%**
EBIT (LKR Mn)	4,494	6,250	4,760	11,808	4,887	4,623	5,427	6,778
EBIT Margin (%)	**13%**	**15%**	**9%**	**21%**	**10%**	**9%**	**10%**	**11%**
Effective Tax Rate (%)	12%	-4%	-24%	26%	30%	29%	32%	31%
Capital Expenditure (LKR Mn)	1,835	2,110	1,872	3,246	5,433	3,180	4,477*	2,811**
WACC (%)							**14%**	**14%**

* 2Q FY25E + 12 month
** 2Q FY26E + 12 months

Exhibit 16: Summarized DCF Valuation					
LKR Mn	Year 1	Year 2	Year 3	Year 4	Year 5
EBIT	6,231.24	7,325.61	8,012.77	8,763.91	9,584.93
FCFF	1,096.84	3,126.19	3,676.35	4,345.32	4,177.44
Discounted FCFF (WACC @ 13.7%)	964.67	2,418.15	2,501.03	2,599.90	2,198.26
PV of 10 Year FCFF					21,589.29
PV of Terminal Value					29,152.28
Enterprise Value/ Sum of PV					50,741.57
Net Debt					10,900.09
Equity Value (net of NCI)					39,734.58
# of shares (Mn)					441.05
DCF based Intrinsic Value (LKR) per share					**90.09**
12M Target Price at PER of 10.5x on estimated TTM EPS of LKR 8.40 in Sept 2025					**88.00**
CMP as of 3 January 2025 (LKR)					69.70
Potential Upside / (downside) to 12M Target Price					26%

We value TKYO at LKR 90.09 per share based on a DCF valuation and upgrade the stock to a "Buy". We assign a **12M price target** of **LKR 88.00 per share** for TKYO which is a 26% upside to CMP (LKR 69.70), while we estimate a DPS of LKR 2.00 per share for FY25E resulting in a total return of c. 29%. The share is currently trading at 11.4x of TTM EPS as at 2Q FY25 and 9.5x of FY25E forward EPS. Our 12M forward price target is based on the share trading at c. 10.5x of estimated EPS (TTM) of LKR 8.40 in 2Q FY26E. This is slightly higher than TKYO's current trailing PE and at a premium to the current market PE.

However, we believe a higher multiple is warranted by overall market rerating and better growth prospects for TKYO compared with the overall market. We estimate TKYO's PEG ratio at c. 0.5 at the target price based on average EBIT growth of c. 20% p.a. over the next three years.

Exhibit 17: TKYO Share Price & 12M Target Price

Exhibit 18: Summarised P&L Forecast							
Years ended 31 March	Actual					Forecast	
(In LKR Mn)	FY20	FY21	FY22	FY23	FY24	FY25E	FY26E
Revenue	**35,768**	**42,962**	**52,478**	**56,482**	**49,824**	**53,319**	**61,125**
COGS	(25,542)	(30,505)	(41,065)	(35,964)	(34,261)	(35,724)	(41,259)
Gross Profit	**10,226**	**12,457**	**11,412**	**20,517**	**15,563**	**17,595**	**19,866**
EBIT	**4,494**	**6,250**	**4,760**	**11,808**	**4,887**	**5,427**	**6,778**
Net Interest Cost	(1,864)	(1,041)	(5,521)	(5,036)	(1,439)	(626)	(674)
PBT	**2,629**	**5,209**	**(290)**	**6,772**	**3,448**	**4,801**	**6,105**
Tax	(312)	202	(68)	(1,774)	(1,026)	(1,520)	(1,898)
Recurring Net Profit	**2,318**	**5,411**	**(358)**	**4,999**	**2,423**	**3,281**	**4,207**
Earnings per share (LKR)	**5.26**	**12.33**	**(0.86)**	**11.31**	**5.48**	**7.37**	**9.44**
Dividend per share (LKR)	1.50	2.10	0.00	1.5	2.00	2.00	2.25
Dividend Yield (%)	7%	3%	0%	3%	4%	3%	3%
Price/ Earnings Ratio (X)	**3.89**	**4.92**	**-35.99**	**4.02**	**9.39**	**9.46**	**7.38**
ROE (%)	**14%**	**25%**	**-2%**	**19%**	**9%**	**11%**	**13%**

Disclaimer: