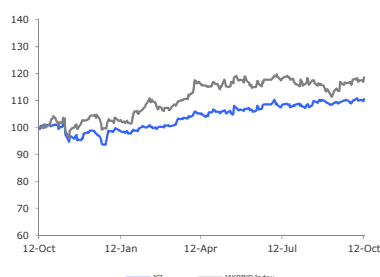


Cement

Underweight (Unchanged)

Sector Index Performance (JAKBIND)

	3M	6M	12M
Absolute (%)	0.5	2.3	18.7
Relative to JCI (%)	-1.3	-2.7	8.3
52whigh/low (Rp)	632/503		



Source: Bloomberg

Consolidation needed

- **Oversupply might force consolidation**
- **Anhui Conch a serious contender**
- **Big boys will survive a new environment**
- **Remained underweight on the sector**

Total cement capacity hits 109.5mn tons. According to Assosiasi Semen Indonesia (ASI), total cement production capacity reached 109.5mn tons as of FY16, which already includes couple cement plant that will run in FY17. However, clinker capacity was 71.3mn tons, which translates to integrated cement production of 89.2mn tons (based on the assumption of 80% clinker content). This means that some cement plants will need to import clinker to maximize its production capacity. Total production is estimated to hit 68mn in FY17, leaving a gap of oversupply of 41.5mn, based on cement capacity and 21.2mn if based on integrated capacity. A growth of 6% p.a in cement demand will enclosed the oversupply gap in 10 years for cement capacity and 5 years for integrated capacity.

Disruptive strategies, Anhui Conch. Anhui Conch has been very aggressive in entering the Indonesian domestic cement market. Disruptive strategies have been implemented to win markets from pricing, distribution and manufacturing. ASP of Indocement (INTP IJ; Rp19,275; Hold) and Semen Indonesia (SMGR IJ; Rp10,450; Hold) are relatively similar with Anhui Conch being 15% below them. Distribution fess are normally about 1-2%, while Anhui Conch is willing to provide 4-8% depending on areas. We estimate that Anhui Conch could have 20% lower COGS compared to incumbents such as Semen Indonesia and Indocement. We think that Anhui Conch has lower overhead in general administrative. These higher efficiencies have led to disruptive pricing and distribution.

New players might be suffering. Stiff competition has led to erosion of EBITDA margin. Before the price war, incumbent operators were able to booked EBITDA margin of 35-40%, compared to current EBITDA margins of 19-20% in 1H17. With such squeezed margin we think that Semen Bosowa and Cemindo Gemilang (Semen Merah Putih) are in financial distress to service bank loans. We believe that Semen Indonesia, Indocement, Holcim Indonesia and Semen Baturaja are in healthy cash flow. No financial information is stated about Anhui Conch, but we know that Anhui Conch overseas operation, which includes Indonesia, is in pretax profit of US\$4.4mn in 1H17 and US\$15.4mn in FY16. We suspect that other smaller new players having difficulties to service bank loans.

Waiting for consolidation. Before we see any improvement in the sector, consolidation is a necessary condition to fulfill. Nevertheless, we also think that post consolidation, EBITDA margin will normalized around 20-25%, similar to margins across the globe. New player such as Anhui Conch will continue to disrupt the margin pushing the industry into new equilibriums. Nevertheless, with Anhui Conch operation to spread out in Indonesia, cost advantages might slim down especially on logistics. We maintain our underweight view on the sector with Hold calls on both Semen Indonesia and Indocement.

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Stock	Ticker	Rating	Price (Rp)	TP (Rp)	17F P/E (x)	18F P/E (x)	17FEV/EBITDA (x)	18FEV/EBITDA (x)
Indocement	INTP	Hold	19,275	19,800	32.2	28.9	17.1	15.3
Semen Baturaja	SMBR	Sell	2,850	375	214.8	311.9	85.6	73.8
Semen Indonesia	SMGR	Hold	10,750	11,450	24.8	17.8	12.4	9.7

Source: IndoPremier

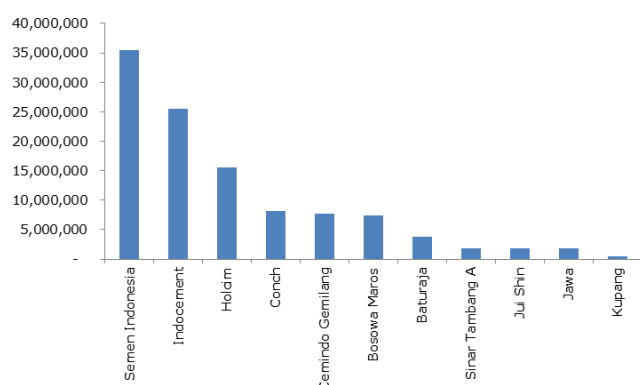
Note: Share prices as of closing 12 October 2017

Cement capacity hit 109.5mn tons p.a with clinker capacity of 74.6mn tons

According to the ASI cement report, total national installed capacity of cement was 109.5mn tons per annum, meanwhile clinker capacity was only 74.6mn tons. This means that cement production capacity consist of integrated cement capacity of 88mn tons, assuming clinker content of 85%, with the remaining balance of 21.mn tons is milling facility only. Imported clinker will be needed to run the full capacity of cement production of 109.5mn tons.

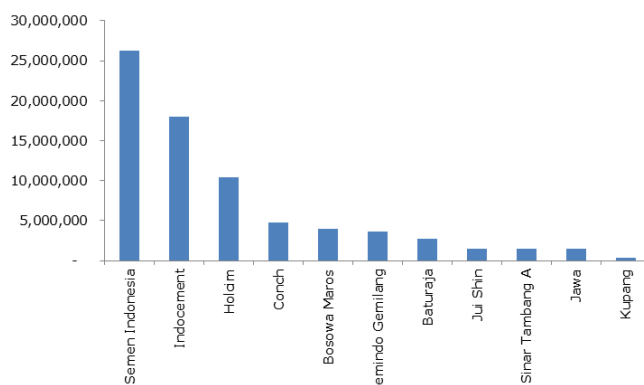
Based on the latest ASI report of Sep17, no cement manufacturer has imported clinker to be fed into these extra milling capacities. This means that some milling capacity remained idle. The opportunity cost of shut down milling facility is relatively low since it does not involve significant starting and depreciation cost. Investment cost for a milling capacity is US\$35-50mn per ton compared to an integrated facility of US\$150-200mn per ton. Additional, an integrated capacity will need significant amount of energy for preheating. The clinker heat consumption is required to run 247 to ensure highest efficiency. Any shut down will increase overall production cost.

Fig. 1: Cement production capacity (tons)



Source : ASI

Fig. 2: Clinker production capacity (Tons)



Source : ASI

A 20mn oversupply gap

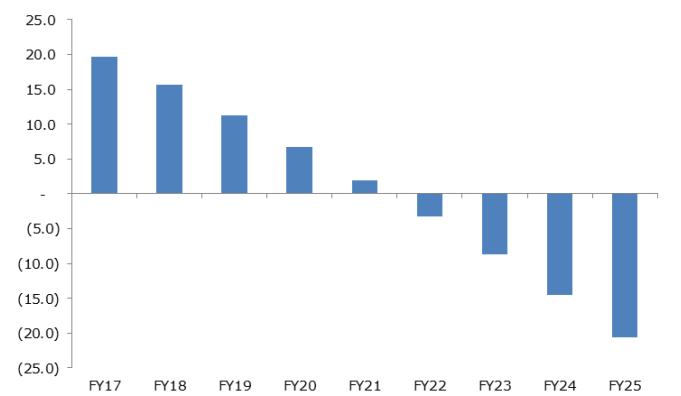
We expect cement production to reach 68mn tons in FY17, consist of 97% supplied to the domestic market and the remaining to export. This will leave a 20mn oversupply gap to be filled. We based our calculation on integrated capacity, assuming extra milling capacity to be left idle since it is less economical to operate. This will translate into a utilization rate of 77%, which means that cement manufacturers still should generate positive cash flows. If assume a growth of 6% each year, the oversupply will ended within 5 years. However cement companies will need to invest in new capacity 3 years prior the gap encloses. This means that the industry will need to build a new capacity in FY21. Nevertheless, the new investment could be stretch further since there is idle milling capacity.

The oversupply gap will be 40.5mn tons if based on the total cement production capacity. Assuming a 6% growth rate, the oversupply gap should disappear within 8 years. This signifies that the industry should not be in any rush to add new capacity. A sudden bump in additional production was costly to the industry.

This year, the industry added another 12.0mn tons coming from Semen Indonesia 6.0mn tons, Holcim Indonesia 1.97mn tons, Baturaja 1.85mn tons and Anhui Conch of 2.2mn cement milling. Major players such as Semen Indonesia, Indocement and Holcim Indonesia, do not have any major expansion for FY18. Nevertheless, Anhui Conch is building another cement plant in North Sulawesi with a capacity of 1.5mn tons, which is expected to be completed in FY18. The development of this factory has not been smooth as problems with local authority and people.

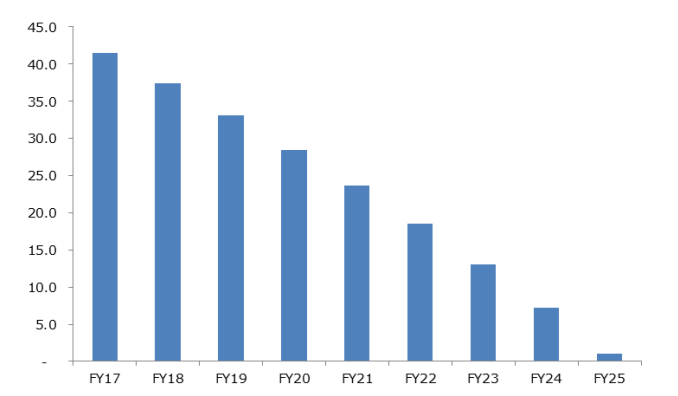
Cement Update

Fig. 3: Oversupply based on clinker capacity with 6% growth



Source : ASI

Fig. 4: Oversupply based on cement capacity with 6% growth



Source : ASI

Disruptive pricing from Anhui Conch

Anhui Conch adapted two simple strategies to penetrate the domestic market, 1) introduce competitive pricing and 2) provide strong incentive for distributors. Currently, Anhui Conch is 15% averagely cheaper than price of Semen Indonesia and Indocement. Meanwhile, distribution incentive is usually 2-3% of the product's price. However, Anhui Conch is willing to provide distribution fees double of the incumbents offer. Existing distributors would simply establish new companies to serve Anhui Conch distribution. Therefore, Anhui Conch distributors are not necessarily new players and know the market well.

To justify such aggressive pricing and distribution incentive, Anhui Conch manufacturing cost need to be very efficient. The South Kalimantan manufacturing plant has an integrated capacity of 2x1.5mn tons per annum (clinker capacity of 1.2mn tons). The plant has its own power plant. Being close to coal resources, reduces the cost logistics cost for cement production and electricity generation, the two largest cost component in cement manufacturing. Another area, that we think Anhui Conch is very efficient is labor cost due to abundant labor from mainland.

Electricity cost: Own generation vs PLN

Semen Indonesia and Indocement mostly uses electricity from PLN to run their manufacturing. Semen Tonasa, a subsidiary of Semen Indonesia, uses its own coal power generator of 2x25MW and 2x35MW, while other manufacturing facility is dependent on supply from PLN. Meanwhile, Indocement has developed a aero derivative gas turbine of 73MW in Citeureup with remaining electricity supplied by PLN. On average, cement manufacturing will need about 110-120kWh/tons. Semen Indonesia and Indocement are subject to I4 electricity tariff of Rp990/kWh as of Oct17. This means that electricity cost should be around Rp109k per ton. Semen Indonesia's cost of electricity was Rp99k per tons in 1H17.

Anhui Conch is using its own coal fired power plant that is really close to coal resources. Therefore there is nearly zero logistics cost for power generation. Assuming that coal price for power is US\$50/tons with 33% efficiency rate, fuel cost of generating power is about US\$1.9 cents. Assuming that depreciation and maintenance cost is another US\$1.5cents, then total power generation cost could be US\$3.4 cents. Based on PLN's annual report, power generation for coal power plant was US\$3.9cents in FY16.

Comparing electricity cost of Semen Indonesia of Rp99k/ tons vs our estimate on own power generation of Anhui Conch of Rp46k /tons, Anhui Conch will be more efficient by Rp54k/ton or about 10% of total Semen Indonesia's COGS.

Coal logistics another cost to save

Being located in South Kalimantan, is simply saving logistics cost for coal. However, the down side is that Anhui Conch will be expose to higher logistics cost for finished products, especially when shipped to Java or other areas within Kalimantan. We will only concentrate on logistics cost of coal to determine cost saving in COGS. Transportation and logistics cost for finished goods is usually booked in operating expenses. Logistics cost for coal from Kalimantan to Java could cost US\$3-5 per ton. This would be the cost that Anhui Conch saved by having a manufacturing facility close to coal resources. we estimated that Anhui Conch could save logistics cost of Rp13.5k /ton or about 2.6% of total COGS.

More savings from Labor cost

Anhui Conch is a private company in Indonesia, making it impossible to get disclosure on the financials. Nevertheless, Anhui Conch parent company is a listed company. Based on its annual report in FY16, labor cost for the consolidated group was reported RMB18.55 per ton cement, which translate into Rp38k per ton. Semen Indonesia has disclosed that its labor cost was Rp43.4k per ton. Assuming that Anhui Conch mirrors the cost structure of its parent company, Anhui Conch should save Rp5.5k per ton cement or 1% of total COGS of Semen Indonesia.

Total Cost savings is 14% of COGS

Adding up the cost saving from own power generation, lower logistics cost from coal and labor cost, we estimated that Anhui Conch could save about 14% of COGS of the incumbents or about Rp72.5k per ton. This saving could be used to lower selling price as well as to cover extra distribution cost. It is interesting to know, that Anhui Conch overseas cement operation which includes Indonesia is already making profit. Based on the annual report of Anhui Conch, the overseas cement operation generated pre-tax profit of RMB29.15mn in 1H17, RMB 102.0mn in FY16 and net loss of RMB(212)mn in FY15. We do not know for sure whether Anhui Conch Indonesia is profitable or not. But we can conclude that overseas cement operation of Anhui Conch should be sustainable since it is making profit.

Risk towards Anhui's business model in Indonesia

Up to 1H17, Anhui Conch has completed two production lines in South Kalimantan with a total capacity of 2x1.5mn tons combined with a cement grinding facility in West Java. We think that this efficient business model will be unlikely to be replicated in other location. We know that Anhui Conch has developed a facility in West Papua and North Sulawesi, of which these two location lacking coal resources. So coal would be procured from Kalimantan with consequences of higher logistics cost. Nevertheless, all of these new plants are equipped with own coal-fired power generators, where saving still could take place plus the saving on labor.

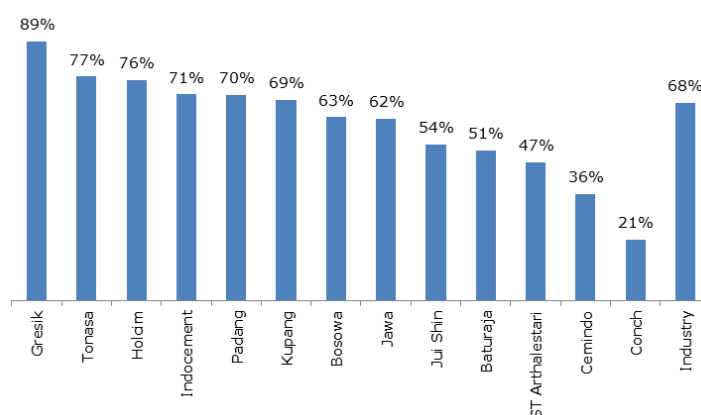
Incumbents are on the safe side

Main cement players such as Semen Indonesia and Indocement remained to maintain sound fundamentals despite fierce competition in the domestic market. These incumbents are debt free with no pressure on cash flows. Despite that EBITDA margins are running around 21% (vs 30% prior to price war), incumbents continue to generate sufficient cash flow. We expect Semen Indonesia to generate EBITDA of Rp5.5tn in FY17, which is sufficient to build a new manufacturing facility with a production capacity of 2.5mn tons.

From the operation perspective, Semen Indonesia and Indocement have the advantage of economies of scale for raw materials procurement, distribution and operating leverage. Additionally, with several plants, incumbents are able to optimize production cost by firing up only the most efficient plants. For instance, Indocement has five production lines that were built prior 1981, with a total capacity of 3.9mn tons. Despite that these manufacturing facilities are able to operate, but the efficiency is lower than newer production facility. Since these plants are built back in 1981, they are practically fully depreciated. To choose to shut down these plants will have no significant impact on fixed cost since they already fully depreciated. Semen Indonesia has 2.5mn tons capacity that is also considered old and less efficient.

Incumbents have relatively a higher utilization rate compared to the new players. Higher utilization translates to higher production efficiency, lowering cost per unit production. Semen Indonesia's subsidiary Gresik, Padang and Tonasa were running on 89%, 77% and 70%, utilization rate in FY16, while Indocement was running 71% utilization rate. Unlike the incumbents, new players were running utilization between 30-60%, which is less efficient. Anhui Conch had very low utilization rate due to new capacity of 2x1.5mn tons were completed in FY16 and have yet to contribute to sales. By excluding this new capacity to normalized utilization rate should be at 83%, also a strong number to reach healthy utilization rate.

Fig. 5: Clinker utilization rate



Source : ASI

New player facing financial difficulties

We think that new players are facing financial difficulties, with an exception for Anhui Conch. Even more established players such as Cemindo Gemilang (Semen Merah Putih) and Semen Bosowa are indicated to have difficulties to fulfill financial obligation. CemindoGemilang was provided a bank syndication loan of Rp5.3tn in FY13 by BNI (BBNI IJ; Rp7,500; Buy), BRI (BBRI IJ; Rp15,375; Hold), Bangkok Bank and Lembaga Pembiayaan Ekspor Indonesia. Moreover, BRI also provided loan facility of approximately Rp2.1tn to finance expansion project of Semen Bosowa in FY14. During analyst meeting of the two listed banks, BNI and BRI, it has been mentioned that some cement debtors are facing difficulties to fulfill its obligation and has been categorized as special mentioned loans. We suspect that Cemindo Gemilang and Semen Bosowa are among these names.

Assuming that new players built their facility with an investment cost of US\$150mn by using cheaper Chinese equipment and 30% equity, EBITDA margin at 16% and ASP of US\$60.2 per ton, new player will not able to book profit while serving interest. Therefore, new players should not be able to fulfill debt installment unless the major shareholder will inject fresh capital. The manufacturing plant will not generate sufficient cash flow to cover up interest cost and debt installment. If cash injection is not possible then debt re-structuring is a second option. In order to achieve sustainable cash flows, EBITDA margin will need to be above 21%,

which could only be achieved by raising selling price. But this would be an unlikely scenario under the oversupply condition. A third option, then, would be to sell the company to other third parties. Incumbents such as Semen Indonesia and Indocement have opened the possibility to acquire these newly developed plants.

Fig. 6: Estimated cash flow of incumbents vs new players

	Incumbents	New comers	Note
ASP, US\$ per tons	60.2	60.2	similar price
EBITDA margin	21%	16%	5% (lower of difference economies of scale)
EBITDA, US\$ per tons	12.6	9.6	
Interest cost, US\$ per tons investment	-	(16.8)	
Cash flow	12.6	(7.2)	

Source : IndoPremier, SMGR, INTP

Maintain underweight on the sector with Hold calls on both Semen Indonesia and Indocement

Up to Sep17, total domestic cement demand grew +6.0% yoy to 47.4mn tons, with export flat at 1.1mn tons. Thanks to the infrastructure development, cement demand in 2H17 has picked up. Nevertheless, we have not seen any demand recovery from the property sector. Up to Sep17, the overall property market remains shy with relative disappointing marketing sales. Despite growing momentum in demand, we feel that profitability will not improve with EBITDA margin around 21-22% for the incumbents. In the past two years, ASP of Semen Indonesia has dropped from its peak of Rp901k per ton to Rp730.3k per ton in Sep17 (-18.9%). Furthermore, cement manufacturers will feel cost pressure from rising coal price, with limited ability to pass on cost to buyers.

We remained skeptic for any recovery in profitability due to weak ASP. Unless consolidation happened in the market it will be difficult to see any increase in EBITDA margins. We remained Underweight to the sector due to continuous pressure on pricing and profitability. We have Hold call on Semen Indonesia and Indocement with new target price of Rp11,450 and Rp19,800 based on DCF target price for FY18.

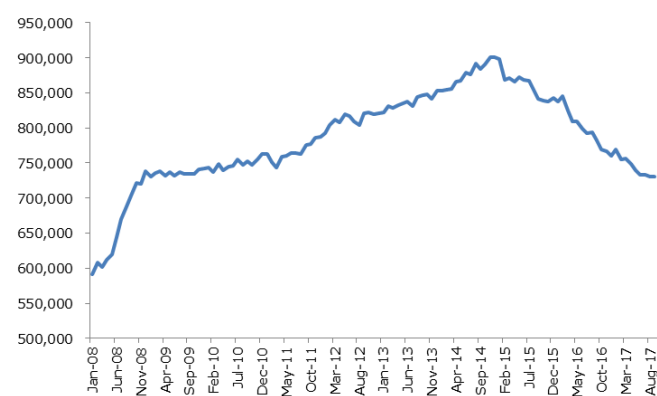
Fig. 7: Domestic cement demand (tons)

	Aug-17	Sep-17	+/- %	Sep-16	+/- %	9M16	9M17	+/- %
Semen Indonesia	2,668,771	2,513,297	-5.8	2,422,709	3.7	18,644,701	19,392,704	4.0
Indocement	1,608,318	1,609,088	0.0	1,434,032	12.2	11,699,318	12,083,069	3.3
Java	3,718,230	3,553,119	-4.4	3,101,997	14.5	24,396,922	26,914,814	10.3
Sumatera	1,407,516	1,346,477	-4.3	1,217,542	10.6	9,617,159	10,009,157	4.1
Kalimantan	377,274	381,734	1.2	390,570	-2.3	3,082,130	2,903,124	-5.8
Sulawesi	518,958	532,464	2.6	488,075	9.1	3,874,500	3,841,412	-0.9
Nusa Tenggara	343,299	346,401	0.9	308,923	12.1	2,631,060	2,687,150	2.1
East Ind	130,555	143,082	9.6	126,372	13.2	1,102,499	1,051,627	-4.6
Indonesia	6,495,831	6,303,276	-3.0	5,633,478	11.9	44,704,269	47,407,283	6.0

Source : ASI

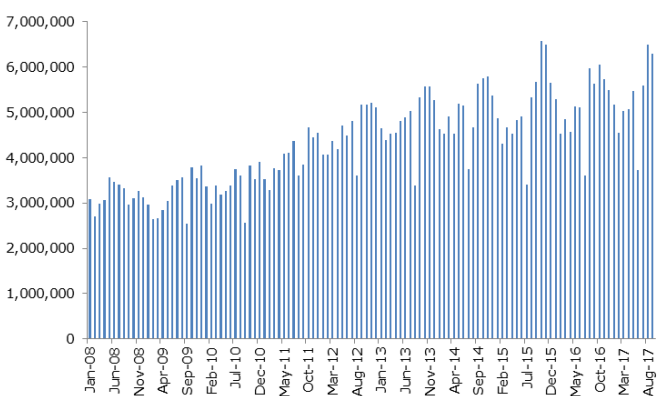
Cement Update

Fig. 8: SMGR’s domestic cement price Rp/ton



Source : ASI

Fig. 9: Monthly domestic cement demand (tons)



Source : ASI

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INVESTMENT RATINGS

BUY : Expected total return of 10% or more within a 12-month period
HOLD : Expected total return between -10% and 10% within a 12-month period
SELL : Expected total return of -10% or worse within a 12-month period

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