Danareksa

CEMENT SECTOR/INITIATING COVERAGE

Semen Baturaja

Growing pains

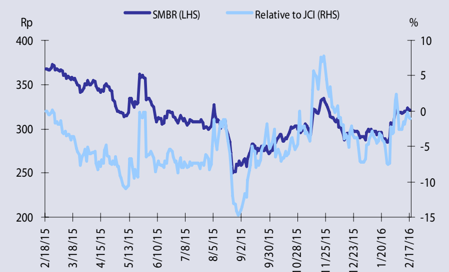
HOLD

Target Price, Rp	350
Upside	9.0%

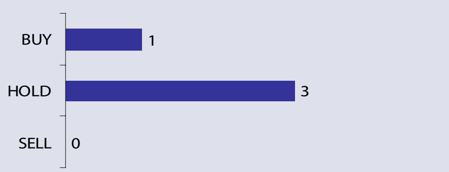
SMBRIJ/SMBR.JK

Last Price, Rp	321
No. of shares (mn)	5,931
Market Cap, Rp bn	**1,904**
(US$ mn)	143
3M T/O, US$mn	0.1

SMBR relative to JCI Index



Market Recommendation



Danareksa vs Consensus

	Our	Cons	% Diff
Target price, IDR	350	325	7.7
EPS 2016F, IDR	34.7	24.8	39.9
PER 2016F, x	9.3	13.0	-28.5

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Danareksa research reports are also available at Reuters Multex and First Call Direct and Bloomberg.

We initiate coverage on Semen Baturaja (SMBR) with a HOLD recommendation and TP of Rp350 (based on blended DCF and target PE valuation). Our target price implies 2016F PE of 9.8x - a 38% discount to the industry average. Although SMBR is finally delivering on its promise to build new plants, we believe that the current discount is appropriate given the inherent risks of illiquidity, capacity constraint, and considerable business risk due to niche market. Furthermore, we also expect SMBR's sales growth to slow down to around the industry's growth rate after 2018 (5–6% yoy). And despite its strengths in South Sumatera - a relatively isolated area which deters competitors - we expect the premium in bulk cement over bagged cement to decline as infrastructure access improves further.

Vulnerable to competition

With low production capacity, SMBR concentrates on penetrating niche markets in the southern part of Sumatera, including South Sumatera, Lampung, Jambi and Bengkulu. South Sumatera is SMBR's primary sales area. Despite SMBR's position as the market leader in this region, we expect SMBR to gradually lose market share in the southern part of Sumatera given: a) aggressive marketing/pricing by its competitors and b) SMBR's limited capacity which reduces its ability to defend its market share.

Normalized growth going forward

Despite booking impressive sales volume growth of 21.8% yoy in 2015 on the back of new infrastructure projects, we expect SMBR to report slower sales volume growth of only 13.8% yoy in 2016. While SMBR is still expected to outperform the industry in 2017 and 2018 thanks to multiple infrastructure projects and the development of Special Economic Zones and the supporting facilities in South Sumatera, the company's sales growth is expected to slow down and come in-line with the industry's growth rate (around 5–6% yoy). We believe this normalization of growth will be driven by infrastructure improvements in the southern part of Sumatra, reducing the premium on SMBR's bulk cement. Nonetheless, we still expect SMBR to retain its dominant position in South Sumatra since its brand recognition in the region remains strong.

Expansion to boost efficiency but weigh on profitability

Constrained by limited capacity and facing stiffer competition, SMBR has not been able to fully seize upon the opportunities in the southern part of Sumatera. Finally, SMBR has decided to expand its capacity by constructing the Baturaja II plant, with installed capacity of 1.85mn tons per year and operations expected to commence in the first half of 2017. While this plant should provide cost efficiencies in terms of electricity consumption and a reduction in clinker purchases, the expansion will need external funding in our opinion. This will increase SMBR's gearing and weigh on profitability.

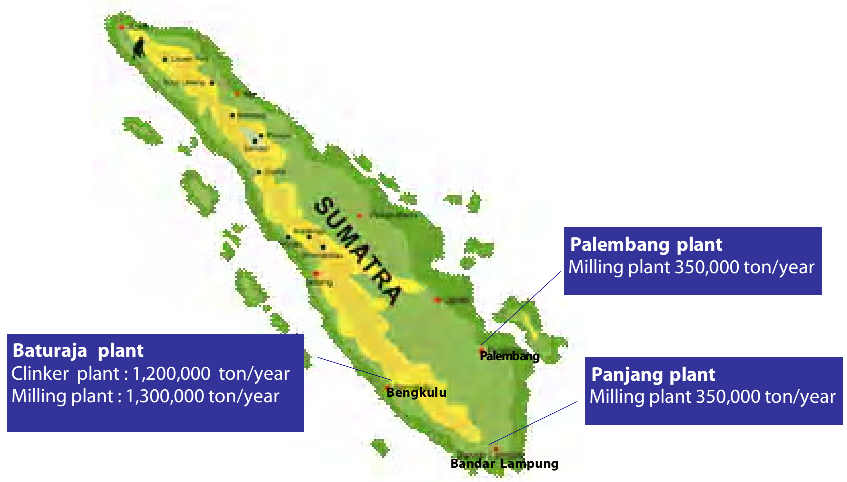
	2013	2014	2015F	2016F	2017F
Revenue, Rp bn	1,169	1,215	1,467	1,687	1,886
EBITDA, Rp bn	394	325	422	476	632
EBITDA growth, %	(5.3)	(17.5)	29.9	12.8	32.6
Net profit, Rp bn	312	328	354	341	222
Core profit, Rp bn	311	323	353	341	221
EPS , Rp	31.7	33.4	36.0	34.7	22.5
EPS growth, %	4.6	5.2	7.8	(3.6)	(35.0)
Core EPS , Rp	31.6	32.8	35.9	34.6	22.5
Core EPS growth, %	4.4	3.8	9.5	(3.6)	(35.1)
Net gearing, %	Net Cash	Net Cash	Net Cash	14.4	25.3
PER , x	10.1	9.6	8.9	9.3	14.2
PBV , x	1.3	1.2	1.1	1.0	0.9
EV/EBITDA, x	12.1	14.7	11.3	10.1	7.6
Yield, %	1.9	2.5	2.4	2.3	1.5

Baturaja: At a glance

SMBR was established in 1974 as a joint venture between Semen Gresik (45%) and Semen Padang (55%). In 1979, SMBR changed its status to Limited Liability Corporation with an 88% stake held by the Indonesian Government, 7% by Semen Padang, and 5% by Semen Gresik before being fully acquired by the government in 1991. Its operations began in 1981 underpinned by 500,000 tons of installed capacity, which has since increased threefold to 2,000,000 tons with production facilities spread across South Sumatera and Lampung.

SMBR's main production facilities are located in Baturaja, South Sumatera, where it has integrated cement production facilities with installed capacity of 1.3 million tons and clinker production facilities with capacity of 1.2 million tons. In addition, SMBR also has milling and packaging mills in Palembang, South Sumatera and Panjang, Lampung with capacity of 350,000 tons each. To fulfil the clinker requirements at the Palembang and Panjang production facilities, SMBR transports the internally produced clinkers at Baturaja by railway or alternatively makes purchases from external parties.

Exhibit 1. SMBR production facilities



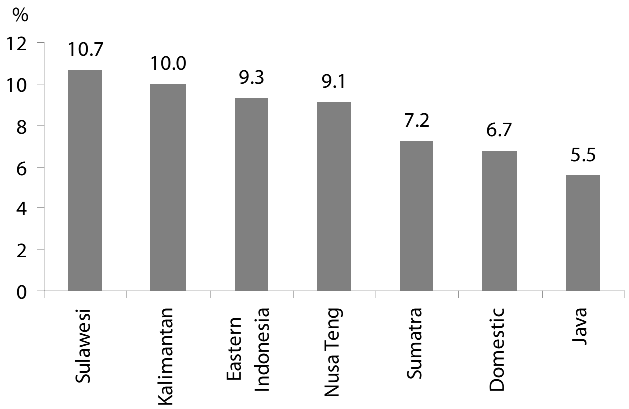
Source: Company

With a 40-year track record in the cement business, SMBR offers two types of cement product: Ordinary Portland Cement (OPC) with higher clinker content (90%) and Portland Composite Cement (PCC) Type I with lower clinker content (80%). With higher clinker content, OPC is often used in infrastructure projects. While SMBR has relatively small clinker production capacity, SMBR still seeks to promote the usage of PCC in infrastructure projects.

Advantage 1: Strong presence in Sumatera

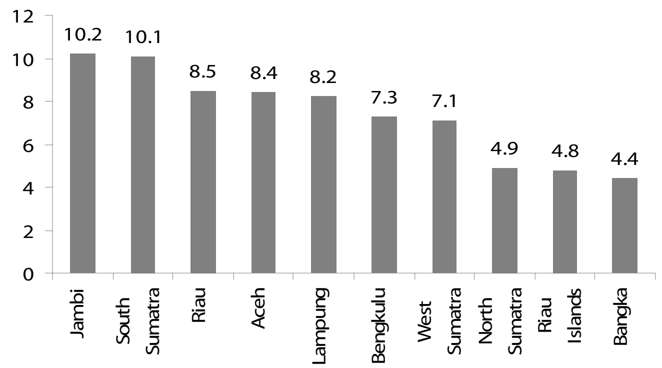
Over the past ten years, ex-Java posted higher cement CAGR growth than Java. Although total domestic demand grew by 10-year CAGR of 6.7%, ex-Java managed to report higher growth at CAGR of 8.5%. Sumatera, which posted higher growth at 10-year CAGR of 7.2%, is the second-largest contributor to total domestic cement demand after Java. South Sumatra province was the second-fastest growing region in Sumatra. Since SMBR is the only cement player with facilities in the region, the company benefits from its strategic location.

Exhibit 2. Out of Java to outperform Java growth



Source: ASI

Exhibit 3. South Sumatera as the second-fastest growing region in Sumatera



Source: ASI

Advantage 2: Strong brand equity in bagged cement

With its relatively small capacity, SMBR targets niche markets in the southern part of Sumatera which include the South Sumatera and Lampung provinces. In this niche market, SMBR has strong brand equity which helps it to sell its products at premium prices. Typically, the retail price of a 50kg cement bag of Baturaja cement is sold at Rp57,000-60,000/sack while Semen Padang, Holcim, and Semen Tiga Roda sell at a price which is Rp2,000-3,000/sack lower. Other smaller players, like Semen Bosowa, offer larger discounts to compete in the local market.

Advantage 3: Natural impediments to sales of bulk cement

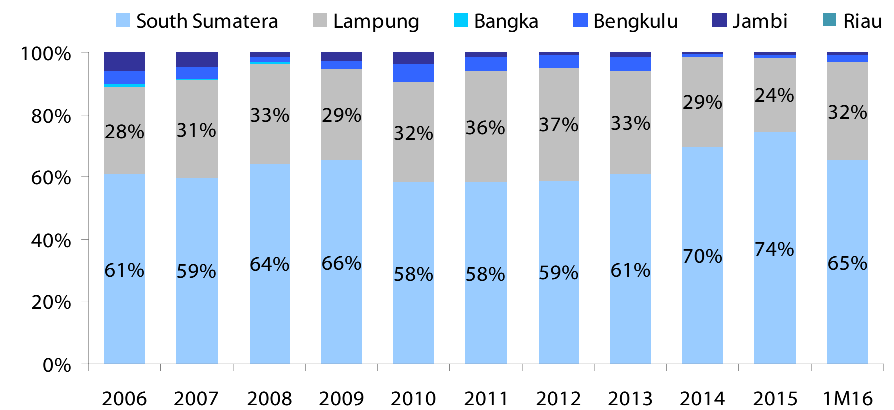
With limited infrastructure access to South Sumatera, SMBR's competitors face challenges in supplying bulk cement in the area. As such, SMBR enjoys an additional premium on the price of its bulk cement. Typically, SMBR's bulk cement is sold at Rp970,000/ton while its bagged cement is sold at Rp930,000/ton. With higher selling prices, margins on bulk cement are 4% higher than those on bagged cement.

Vulnerable to competition

Sales contribution by region

With relatively small production capacity, SMBR focuses on niche markets in the southern part of Sumatera, including South Sumatera, Lampung, Jambi and Bengkulu. South Sumatera is SMBR's primary sales area providing a 65% contribution in 1M16 (down from 74% in 2015 with limited development of multiple infrastructure projects in the beginning of the year). Lampung province is the second largest market for SMBR with a 32% contribution to total sales in 1M16. Going forward, we expect South Sumatra's contribution to increase even further as more infrastructure projects get underway.

Exhibit 4. SMBR sales contribution

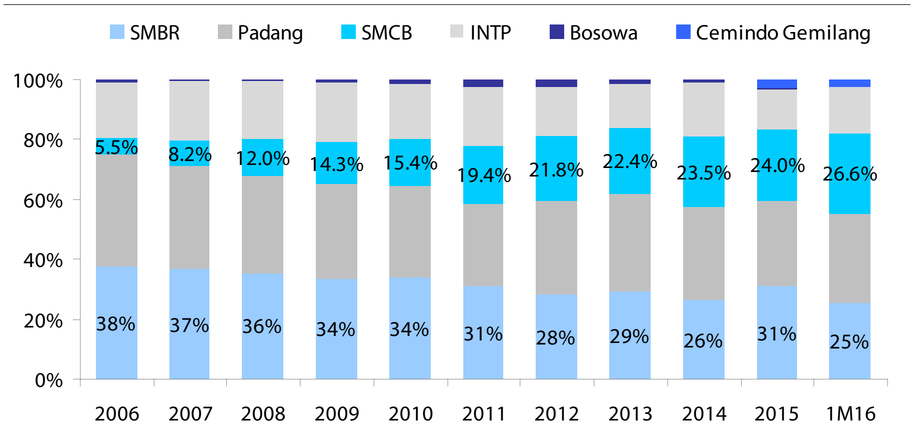


Source: ASI

Tighter competition in regional markets

Despite SMBR's leading position regionally, we foresee that SMBR has gradually loosen its market share in the southern part of Sumatera given: a) aggressive marketing/pricing by its competitors and b) SMBR's limited capacity which reduces its ability to defend its market share. Among its competitors, we note that Holcim Indonesia (SMCB) is the most determined to gain market share in the southern part of Sumatera. As a result, the market share of SMCB has surged over the past ten years to 26.6% in 1M16 from 5.5% in 2006.

Exhibit 5. SMBR's market share in the southern part of Sumatera



Source: ASI

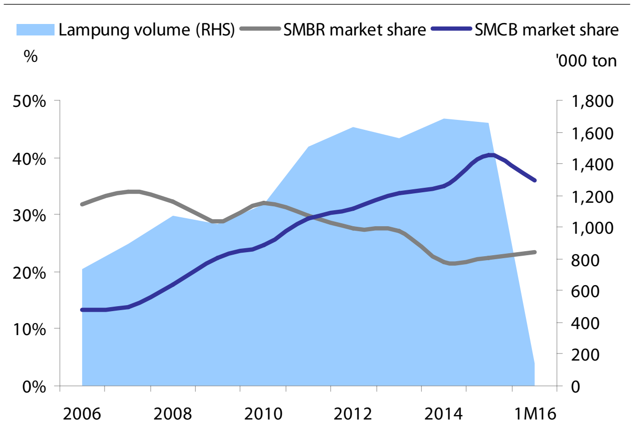
Vulnerable to competition in Lampung

We view Lampung province as the most vulnerable market. With a relatively accessible location, cement players can easily enter the market. This explains how SMCB has been able to establish its dominance in the area. With production facilities in Ciwandan (Banten province), SMCB has been able to easily penetrate Lampung with transportation costs lower than to other provinces such as Jambi and Bengkulu.

Indeed, over the past four years, SMCB managed to replace SMBR as the market leader in Lampung with more than a 40% market share in the province. Moreover, SMCB is also reportedly planning to inaugurate a packing plant with capacity of 1 mn tons in Lampung in May 2016 as well as establish a grinding plant in the next 1-2 years.

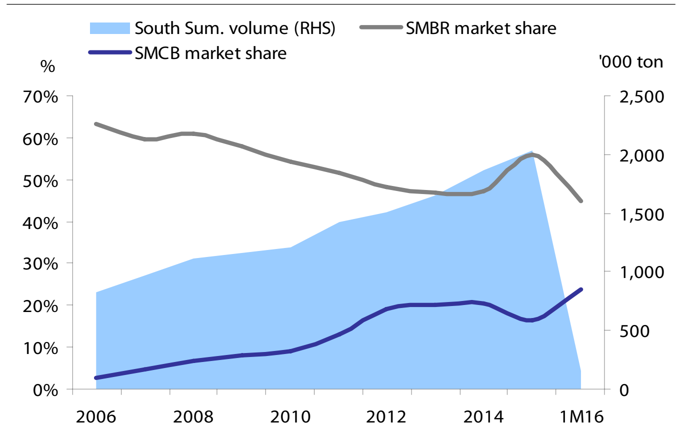
We also see that Cemindo Gemilang (CG) could easily penetrate the Lampung market as the company has production facilities in Ciwandan, Banten province. Last year, CG managed to sell about 64,000 tons of cement, gaining 3.9% market share. With CG and bigger players such as Indocement (INTP) expected to inaugurate their new plants in the **western part of Java** with total installed capacity of 8.4mn tons in 1H16, this will threaten SMBR's market share.

Exhibit 6. Competition in Lampung



Source: ASI

Exhibit 7. Competition in South Sumatera



Source: ASI

SMBR still enjoys premium pricing in South Sumatera

While Lampung is fairly accessible to SMBR's competitors which have production facilities in the western part of Java, South Sumatera is, by contrast, much more isolated. Hence, with underdeveloped infrastructure and limited capacity at the local ports, SMBR's competitors must rely on road transportation to penetrate South Sumatra. This makes it difficult to supply bulk cement to this area. As a consequence, SMBR enjoys premium pricing for its bulk cement in South Sumatra.

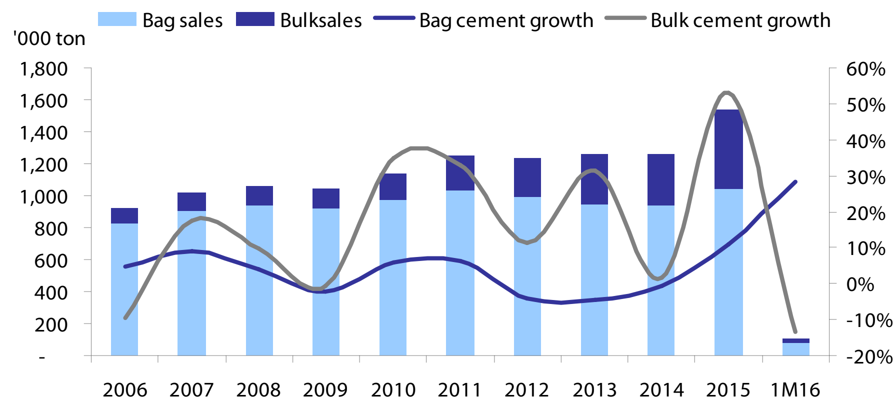
Nonetheless, going forward, we expect the premium pricing on SMBR's bulk cement to decline as infrastructure access improves with the completion of multiple toll-road sections, as part of the Trans-Sumatra project and the development of the Tanjung Api-Api port near Palembang.

Growth to normalize going forward

2015 was a strong year thanks to private projects

SMBR is the only cement player with production facilities in South Sumatra, and with considerable natural obstacles and limited infrastructure access, SMBR is benefitting from the infrastructure and private projects being undertaken in South Sumatera. As such, SMBR posted stellar sales growth amidst muted domestic cement demand. In 2015, SMBR's total cement sales volume jumped 21.8% yoy to 1.5mn tons, far surpassing domestic demand sales volume growth of only 0.9% yoy. SMBR's strong sales mainly owed to brisk bulk cement sales volume growth which reached 53.2% yoy (vs. only 11.1% yoy growth for bagged cement) from the construction projects of Oki Pulp and Paper factory, Bayung Lincir power plant (Sumsel 8), and the Pupuk Sriwijaya IIB plant.

Exhibit 8. Strong sales volume in 2015



Source: ASI

Still maintaining momentum on the first month of 2016

After recording brisk growth in 2015, SMBR continued to deliver strong performance in the first month of 2016. SMBR posted 15.2% growth yoy on the back of stellar sales volume in Lampung (+53.8% yoy), Bengkulu (+181.0% yoy), and Jambi, which compensated for the flat sales volume in South Sumatera. Sales were strong to the retail market as indicated by the higher bagged cement sales growth of 28.3% vs. negative growth on bulk cement of -13.4%. Thanks to government housing projects in the local areas that recently shifting its cement supplier from Semen Padang to SMBR following considerable discount offered. Negative growth on the bulk cement reflects infrastructure development in the area has not been commenced.

Expect growth to continue, but at a slower rate

Nevertheless, over the rest of 2016, we expect the cement sales of SMBR is triggered by upcoming mega infrastructure projects in the southern part of Sumatera - including the Trans Sumatera toll-road, the Palembang LRT and multiple public facilities to support the 2018 Asean Games as well as the Bangko Tengah coal fired power plant. These mega projects should enable SMBR to post sales growth of 13.8% yoy to 1.75mn tons in 2016. Although the growth is more than triple our assumption for the overall cement sales growth of only 4% yoy in 2016, we note that SMBR's growth is slowing.

Mega project 1: Trans Sumatera toll-road

The Trans Sumatera toll-road is part of the government's infrastructure drive. Spanning 2,700 km, this toll-road will cover the eastern part of Sumatra. For this project, the government has appointed Hutama Karya as the contractor and operator for 23 toll-road sections. Needing an investment of Rp368 tn funded by state capital injections (PMN), government loans, bilateral loans and bond issuances, this project started construction in April 2015. In the first phase, Hutama Karya will develop 8 toll-sections covering a total length of 650 km with completion expected around 2017 – 2019.

Exhibit 9. Progress of the first phase of the Trans Sumatera project

	Length Km	Investment Rp bn	Progress	Completion target
Medan-Binjai	17	2,295	Construction progress 2.0%Land acquisition progress to reach 69.7%	2018
Palembang-Simpang Indralaya	22	2,313	Construction progress 3.0%Land acqusition progress to reach 60.5%	2017
Pekanbaru-Dumai	126	15,000	Land acquisition progress reached 21.5km	2018
Bakauheni-Terbanggi Besar	140	17,389	Construction progress 0.5%Land acquisition progress to reach 16.4% and expected to be completed by May 2016	2019
Terbanggi Besar-Pematang Panggang	100	11,646	Construction is expected to be started in March 2016Started land acqusition progress, expected to be completed by December 2016	2019
Pematang Panggang-Kayu Agung	85	9,256	On feasibility study, expected to be completed by February 2016	2019
Palembang-Tanjung Api-Api	100		On feasibility study, expected to be completed by February 2016	2019
Kisaran-Tebing Tinggi	60	8,686	On feasibility study, expected to be completed by February 2016	2019

Source: Various publications

To accelerate the construction progress in the first phase of the Trans Sumatera toll-road project, Presidential Decree No. 3/2016 has been issued by President Joko Widodo. This regulation stipulates that the licensing process for national strategic projects, such as this toll road, should be shortened. First, the principal license needs to be issued within a one day period, vs. 6 working days for normal projects. Second, recommendation from the minister, governor or regional government is needed to be issued within 5 days vs. two weeks. For land acquisition - which is considered as the project's main obstacle - the government will provide support through (i) priority for land provision, and (ii) utilization of the central and regional government area. The issuance of this regulation demonstrates the government's full commitment to accelerate strategic infrastructure projects and reduce the risk of delays in project realization.

With 4 sections of the first phase of the Trans Sumatera toll-road development located in South Sumatera; SMBR will benefit the most from this project. With average cement consumption of 2,000 tons for the construction of each km of toll road, we estimate that those toll road sections will require about 694,000 tons of cement over the next 3 years.

Mega project 2: LRT Palembang and multiple public facilities to support the 2018 Asian Games

The Light Rail Transit (LRT) project in Palembang is one of several public facilities that will be constructed to prepare Palembang for the Asian Games that will be carried out in the third quarter of 2018. With total length of 22km, the LRT track will connect Sultan Mahmud Badaruddin II airport, Palembang city center and the Jakabaring sports complex. For this project, the government has appointed Waskita Karya (WKST) to undertake the construction. The physical construction started in December 2015 and it is expected to be completed by 1H18 at the latest.

At the moment, SMBR is on the tender process to supply cement for the LRT project in Palembang, South Sumatra. As the winner for the tender is expected to be announced in the near future, we believe that SMBR will likely to win this tender given SMBR is the only player with production plant in South Sumatra. The management estimates that the LRT will require for about 260,000 tons of cement in the next three years with this year requirement is estimated about 150,000 tons.

Other infrastructure projects to support the 2018 Asian Games will be: a) the Sultan Mahmud Badaruddin II flyover (total length of 455m), b) the Keramasan flyover (650m), c) the Musi IV bridge (635m), d) the Musi VI bridge and e) 16 towers at the athletes' village with capacity to accommodate 7,000 people.

Exhibit 10. LRT Palembang Track

Source: Presidential Decree no. 116/2015

Mega project 3: Bangko Tengah coal fired power plant

As part of its diversification strategy, Perusahaan Tambang Bukit Asam (PTBA) is conducting a joint venture with China Huadian Hong Kong Company Ltd to build and construct a coal-fired plant at Bangko Tengah. With capacity of 2x660MW and a total investment of USD1.6 bn, the groundbreaking of this power plant commenced in November 2015. Recently, SMBR mentioned that construction of the Bayung Lincir Power Plant with capacity of 2x150MW and an investment value of USD400mn required about 45,000 tons of cement. Hence, we assume that the Bangko Tengah coal-fired power plant with four times the capacity of Bayung Lincir will need 180,000 tons of cement.

The gross margin is expected to narrow in 2016

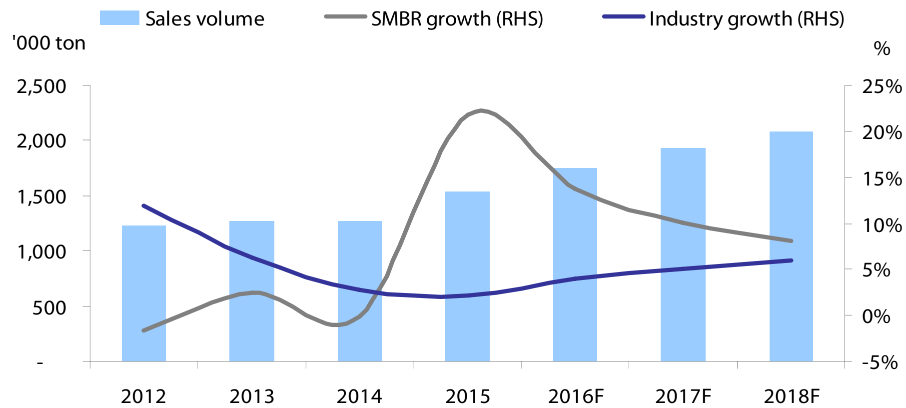
Although SMBR has annual installed cement mill capacity of 2mn tons, its clinker production capacity is only 1.2mn tons per year with average production of around 1.1mn tons per year. Given its limited clinker production capacity, SMBR has purchased clinkers from external parties since 2014. With SMBR expected to increase production by 13.8% to 1.75mn tons in 2016, we expect more purchases of clinkers from external parties in order to fulfill the shortfall in the company's own clinker production. With the cost differential between purchased clinkers and the company's own clinker production being approximately Rp100,000/ton higher and assuming only 1% increase in ASP, the gross margin will be narrowed to 33.2% in 2016 from 33.4% in 2015.

Normalized growth going forward

Although sales volume grew strongly by 21.8.% yoy in 2015 owing to the development of more infrastructure projects, we expect slower sales volume growth of only 13.8% yoy in 2016. While SMBR is still expected to outperform the industry in 2017 and 2018 thanks to multiple infrastructure projects and the development of Special Economic Zones and the supporting facilities in South Sumatera, the company's sales growth is expected to slow down and come in-line with the industry's growth rate (around 5–6% yoy).

With improved infrastructure, SMBR's competitors will have better access to South Sumatera. This will reduce SMBR's competitive advantage and its ability to charge premium prices on its bulk cement over its bagged cement. As such, we foresee further gross margins compression. Nonetheless, we believe that SMBR will remain dominant in the South Sumatra province as its brand recognition is still strong in the region.

Exhibit 11. Normalizing growth going forward



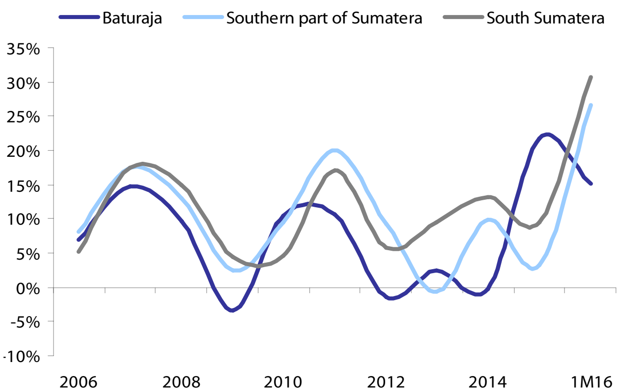
Source: ASI, Danareksa Sekuritas

Finally undertaking expansion

Expansion lagged behind in the past

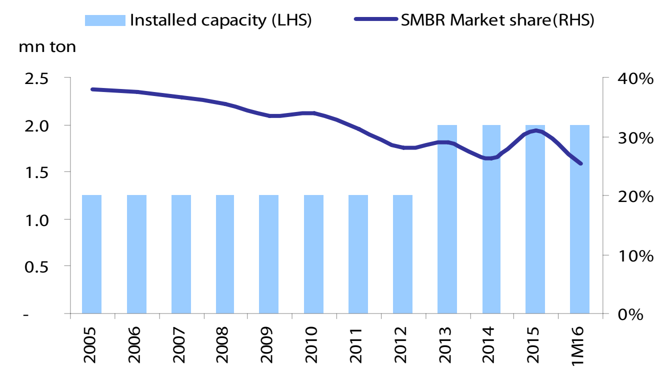
With limited production capacity and competitors aggressively boosting their capacity, SMBR was not able to fully seize upon the opportunities in the southern part of Sumatera. In the past 10 years, cement sales volume in the region grew by 10-year CAGR of 9.1%, while SMBR posted 10-year CAGR of 5.6%. Hence, SMBR's market share in southern Sumatera declined to 31.1% in 2015 from 38.0% in 2005. Earlier this year, SMBR further lossing itsmarket share by 6.6% with its weak-sales volume in South Sumatra.

Exhibit 12. Previously, SMBR could not fully seize growth opportunities in the area ...



Source: ASI

Exhibit 13. ...due to capacity constraints which reduced its market share



Source: ASI

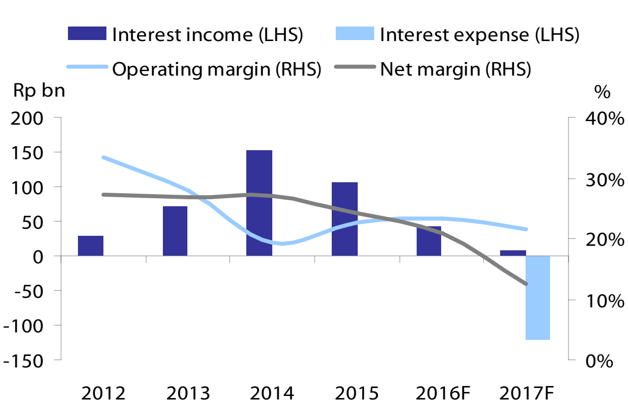
Now to boost capacity

SMBR is finally boosting its capacity by constructing the Baturaja II plant, with installed capacity of 1.85mn tons per year in a total investment reaching Rp3.3tn. The source of funds will come from the IPO proceeds and external funding. SMBR has signed an engineering and procurement contract (EPC) with Sinoma Group. With construction expected to take 30 – 32 months, this plant is expected to commence operation in 1H17.

Expansion will reduce interest income...

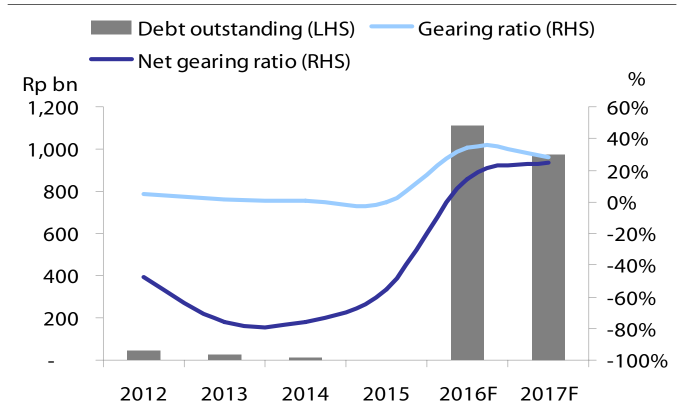
After SMBR listed on the IDX in June 2013 raising Rp1.26tn, SMBR managed to book interest income of Rp71bn in 2013 and Rp152bn in 2014. This is reflected in the company's net margin being higher than its operating margin. With construction of the Baturaja II plant, the company's interest income will decline, reducing net profits.

Exhibit 14. Expansion will reduce interest income ...



Source: Company, Danareksa Sekuritas

Exhibit 15. ... And increase gearing



Source: Company, Danareksa Sekuritas

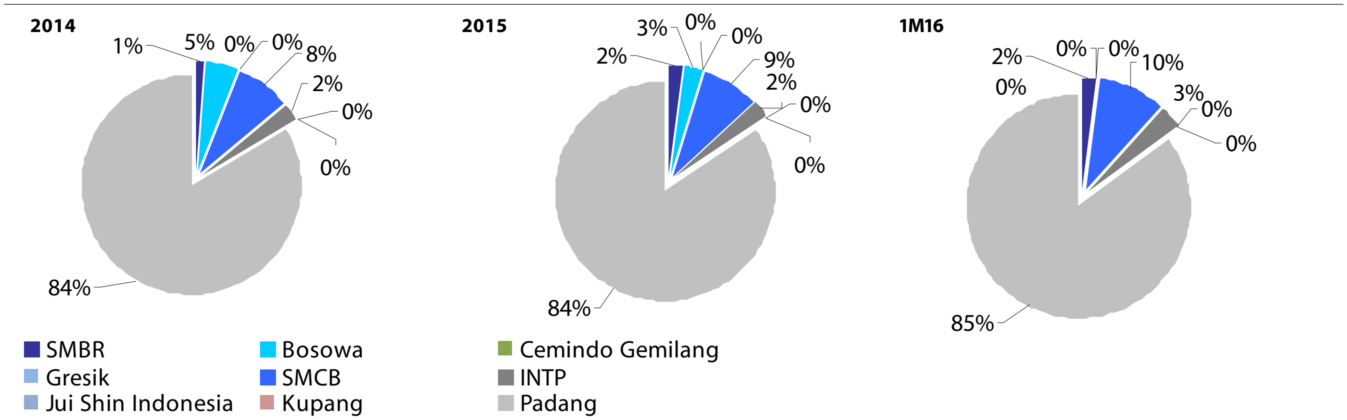
...and push up gearing

As the expansion will require external funding of Rp1 – 1.5tn, we estimate that SMBR's net gearing will increase to 14.0% and 24.6% in 2016 and 2017, respectively, from a net cash and debt free position. While the balance sheet is expected to remain strong, the use of loans will lower the earnings of SMBR in the future. Currently, the management is in the process of negotiating the loan-terms with several banks, and thus the term of financing has not yet been determined.

Penetrating the retail market in neighboring areas

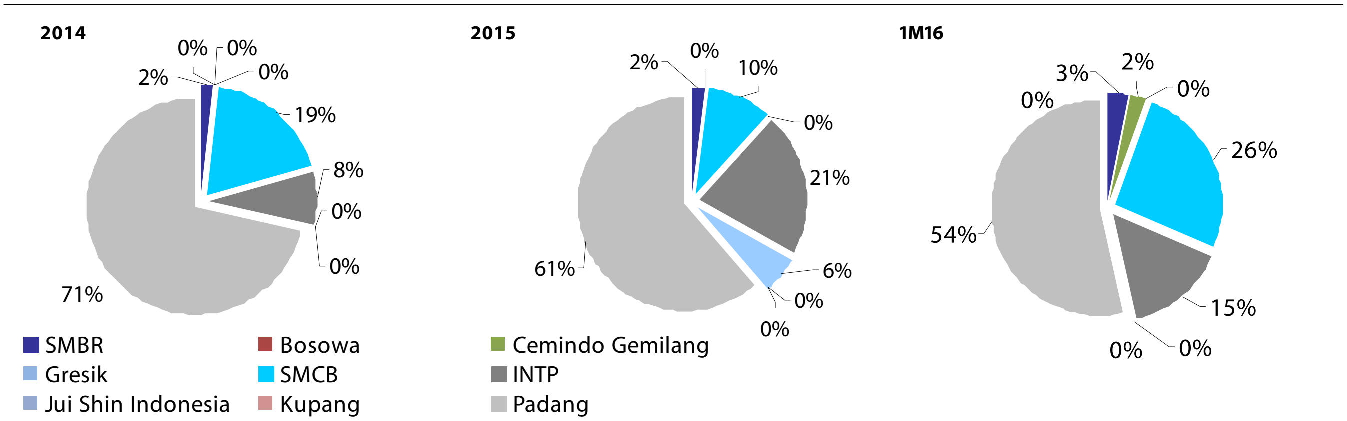
Besides relying on infrastructure projects, SMBR aims to strengthen its position in the retail market. To this end, SMBR plans to establish a distribution subsidiary in order to penetrate the markets in Jambi and Bengkulu. Both these markets are currently dominated by Semen Padang (SMGR group), whose market share exceeds 70%. To penetrate these markets and to compete with the existing players, SMBR will need to undertake extensive marketing and/ or lower its ASP. However, as land transportation such as trucks will be used to reach these areas, given the limited infrastructure in South Sumatera going into those areas, we don't expect these areas to make a significant contribution.

Exhibit 16. Market share in Jambi



Source: ASI

Exhibit 17. Market share in Bengkulu



Source: ASI

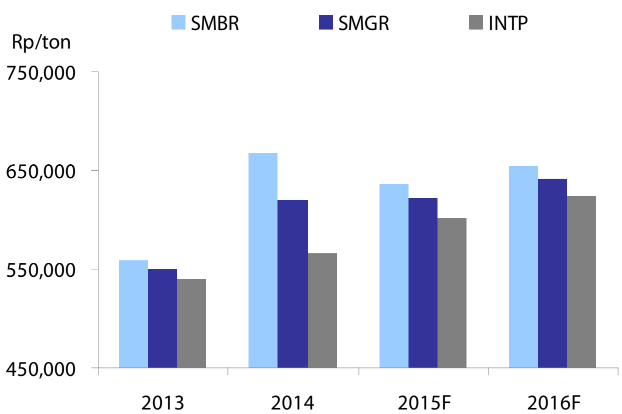
Further cost efficiencies

SMBR's cost structure

As a pure cement player, energy costs still dominate SMBR's cost structure. These energy costs consist of electricity and fuel costs and contribute about 30% of the total manufacturing cost. The second largest cost component is raw material costs, consisting of limestone, clay, gypsum and packaging. While limestone and clay comes from internal mines, raw material costs include the mining cost of these materials.

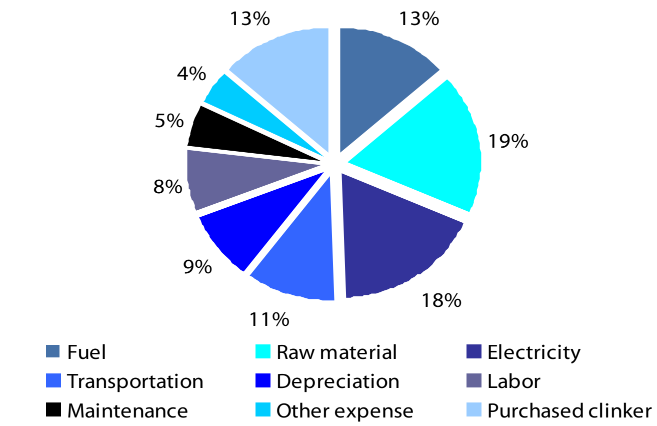
Compared to its larger competitors, SMBR has higher manufacturing costs, which we believe owe to: (i) different economies of scale as SMBR has much lower capacity, (ii) lower production efficiency as most of SMBR's plants are old, (iii) complete dependence on PLN to supply its electricity, and (iv) the need to purchase clinkers from external parties at a higher cost than its own clinker production.

Exhibit 18. COGS per ton comparison



Source: Company, Danareksa Sekuritas

Exhibit 19. SMBR cost breakdown

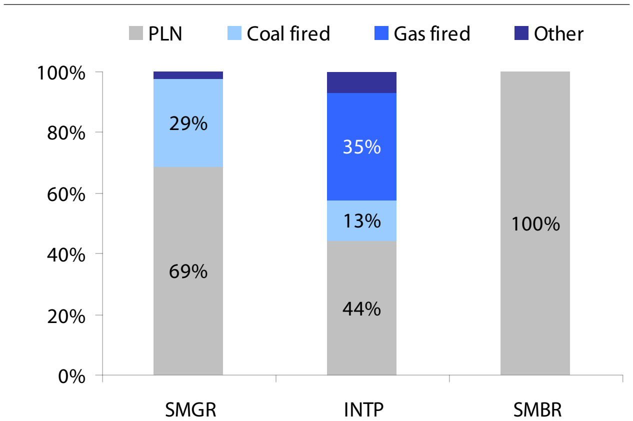


Source: Company, Danareksa Sekuritas

Low electricity prices benefit SMBR the most

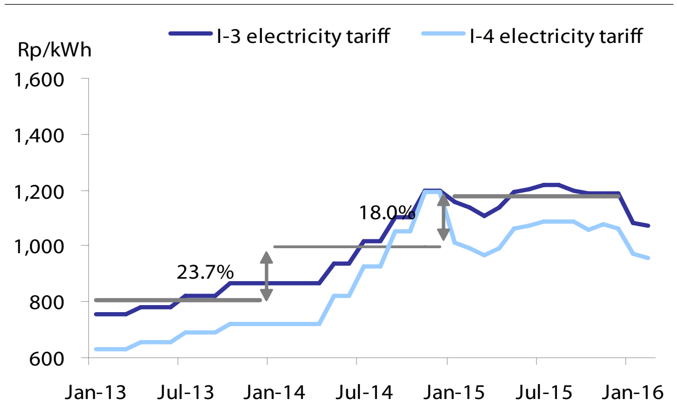
In producing clinkers and cement, SMBR relies on the electricity supply from PLN. To ensure the availability of supply, SMBR has signed an agreement with PLN to provide electricity to SMBR with power capacity of 18,500 KVA. Hence, SMBR is categorized into the I-3 tariff bracket. While in the past 3 years, the government has gradually cut the amount of electricity subsidies, this resulted in 23.7% yoy and 18.0% yoy increases in the 2014 and 2015 electricity tariffs, respectively.

Exhibit 20. Source of electricity comparison



Source: Company, Danareksa Sekuritas

Exhibit 21. Electricity industry tariffs



Source: PLN

On 1 May 2014, the government introduced a new formula to adjust monthly electricity tariffs to be effective in the beginning of 2015. This formula takes into account the foreign exchange rate, inflation and the Indonesia Crude Price (ICP). On the back of lower ICP, the I-3 tariff in February 2016 was reduced by 9.1% to Rp1,071/kWh from an average electricity tariff in 2015 of Rp1,177/kWh. With the currently beleaguered global oil prices, and therefore low electricity tariffs, we believe that SMBR stands to benefit the most given that it fully relies on PLN for its electricity.

Under the third economic package released in October 2015, PLN provides a 30% tariff reduction for usage between 11pm to 8am. This will benefit SMBR and other cement players that use electricity. To enjoy the incentive, however, cement players need to enter into further discussions with PLN so that an agreement report can be issued. SMBR and other cement players have obtained this incentive since the beginning of the year. As the electricity tariff represents 18% of SMBR's total manufacturing costs, the incentive is expected to result in a 1 – 2% reduction in SMBR's production cost per ton.

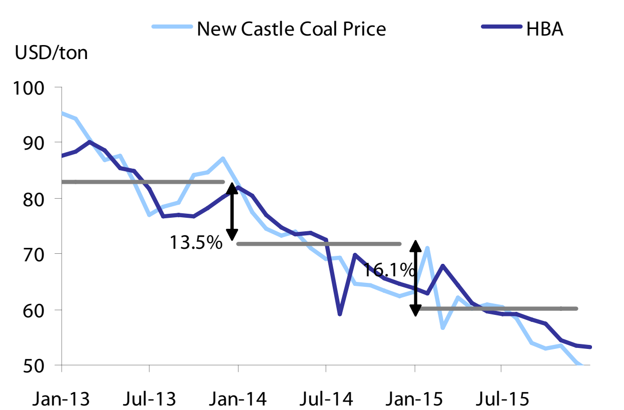
Lower coal price to benefit SMBR, but partially offset by the weak rupiah

In producing clinkers, coal is one of the main supporting raw materials used in the process. To procure the coal needed, SMBR relies on coal supplied by Tambang Batubara (PTBA) as well as smaller coal producers that can offer discounts to PTBA's price. On average, fuel costs, as represented by coal costs are around 13% of the total manufacturing cost.

The average Indonesia coal reference price (HBA) slumped to USD62.92ton in February 2016 from USD71.7/ton in 2014. This was mainly attributable to a) global coal oversupply in the seaborne market and b) weak demand from China which resulted from abundant coal production in that country. This was reflected in a 16% yoy decline in China's thermal coal imports in 2015. Over the short term we expect a dim outlook for coal prices since global oversupply shall persist and demand will remain weak.

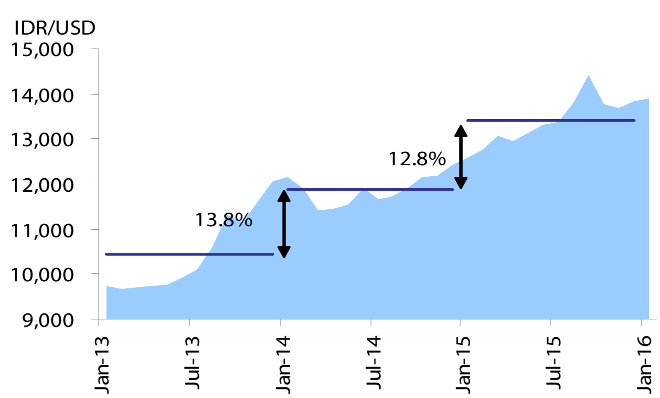
Given the weakening of the rupiah against the US dollar, the impact of muted coal prices was not fully translated into cost savings for SMBR since the coal sellers follow international coal prices and SMBR purchases coal in rupiah. Going forward, with the expectation that the rupiah appreciates slightly to Rp13,200-13,400/USD and given the dim outlook for coal prices, we believe that SMBR can reap the benefits of lower coal prices.

Exhibit 22. Coal price



Source: Company, Danareksa Sekuritas

Exhibit 23. Rupiah depreciation

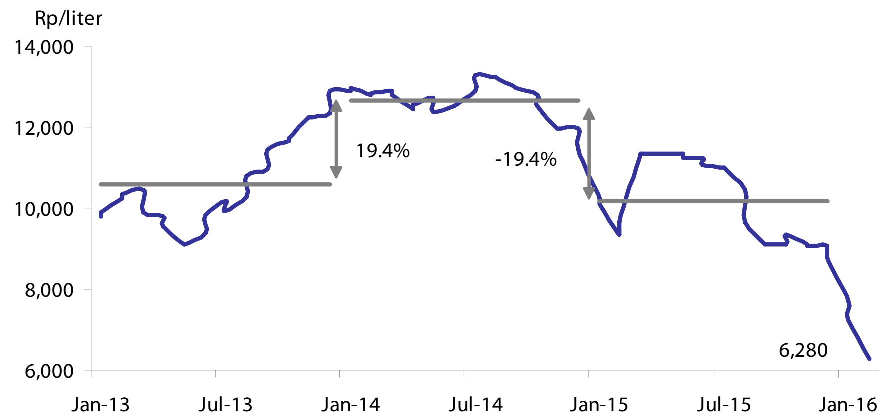


Source: PLN

Transportation: benefitting from the low diesel price

In transporting both clinkers and cement, SMBR relies on trucks (73.3%) and railway transportation (26.7%). For its truck transportation, SMBR is exposed to movements in non-subsidized diesel prices that are adjusted on a biweekly basis in accordance with the global oil price and movements in the exchange rate. On the back of low global oil prices, non-subsidized diesel prices dropped by 43.9% to Rp7,077/liter in the first two months of 2016 from Rp10,183/liter in 2015. Railway costs, by comparison, are not directly correlated to movements in the global oil price but rather to inflation. We believe that low crude oil prices may benefit SMBR by further reducing transportation costs as they are about 11% of the total manufacturing costs.

Exhibit 24. Price of diesel for industry



Source: Jalinan Group

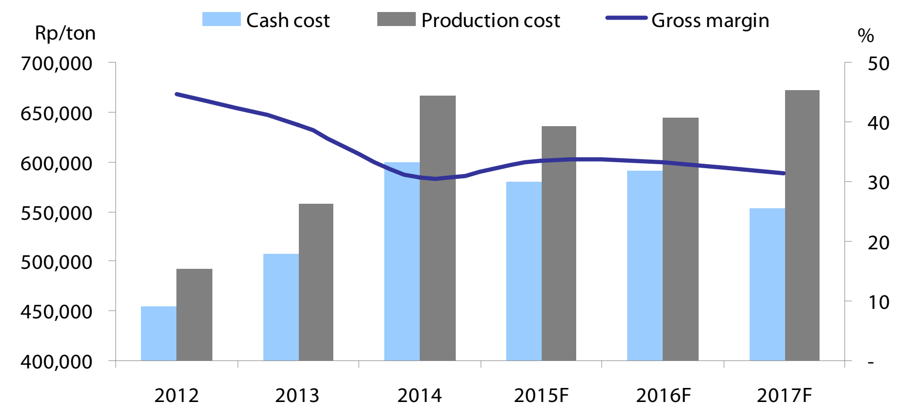
Greater efficiency upon commencement of Baturaja II …

Equipped with the latest technology, the new Baturaja II plant is expected to provide better efficiency in production activities. SMBR also claims that the new plant is as efficient as INTP's P14 plant, which consumes less electricity. Nonetheless, we estimate that the efficiency in SMBR's new Baturaja II plant will not be as much as INTP's P14 plant given the considerable difference in the economies of scale since the P14 plant has capacity of 4mn tons, or more than double the Baturaja II plant's 1.85mn tons.

To secure the supply of electricity for the Baturaja II plant, SMBR has signed a power purchase agreement (PPA) with PLN to supply electricity with power capacity of 45,000 KVA. Hence, with the commencement of Baturaja II, SMBR will enjoy lower electricity tariffs since with the higher capacity, it will be placed in the I-4 bracket which has lower tariffs than the I-3 bracket under which SMBR is currently placed. The lower electricity tariffs will reduce SMBR's manufacturing costs as electricity is about 18% of the total manufacturing costs.

With commencement of Baturaja II with cement production capacity of 1.85 million tons and clinker production capacity of 1.5 million tons, we are convinced that the company's internal capacity will be sufficient to meet its clinker needs, meaning that the company will no longer rely on externally purchased clinkers. Coupled with higher machine efficiency as well as migration to the I-4 electricity tariff bracket, we estimate that cement production's cash cost per ton will fall by 6.5% in 2017.

Exhibit 25. SMBR cash cost, production cost and gross profit margin



Source: Company, Danareksa Sekuritas

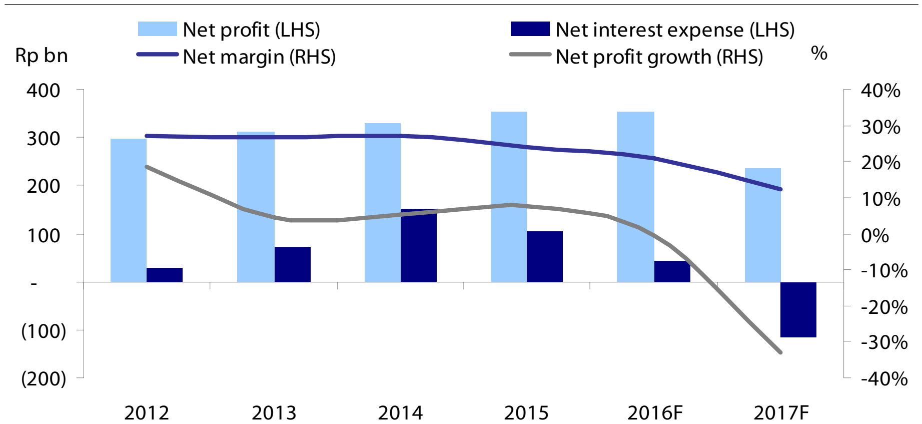
... offset by higher depreciation costs

Nevertheless, upon completion of the Baturaja II plant, depreciation costs will weigh on SMBR's total production costs. With a useful life of 20 years, we estimate the production cost per ton will increase by 4.4% in 2017. While we estimate ASP to increase modestly by 1.6% in 2017, this higher production cost will put downward pressures on the gross margin.

That ultimately negatively impact bottom line

While we expect the operational cost to be relatively manageable at 9.8% of total revenue in 2017F (vs. 10.7% in 2015 and 9.9% in 2016F), we expect bottom line profit to post a further negative growth by 33.1% yoy in 2017. This will be attributable to a) lower gross margin, and b) expansion plans to lower the interest income and increase interest expenses. As such, we expect net profit margin continue to post further decline to 12.5% in 2017F from 20.8% yoy in 2016F.

Exhibit 26. Higher production cost coupled with interest expense negatively impact profitability



Source: Company, Danareksa Sekuritas

Comparison to peers: the discount is justified

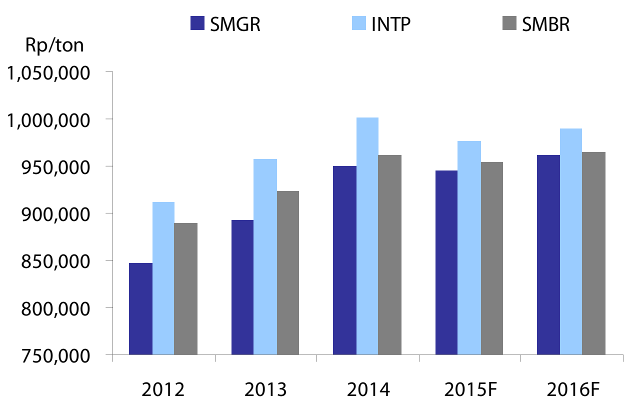
Operations wise

Compared to its peers, SMBR has the smallest installed capacity of 2 million tons vs. Semen Indonesia group (SMGR) with 30 million tons, Indocement (INTP) with 20 million tons and Holcim Indonesia with 13 million tons. With the relatively small installed capacity, SMBR is only exposed to the niche market in the southern part of Sumatera with no exposure to other markets. This means considerable specific company risk compared to its competitors which sell to more diversified markets.

Since cement producers typically have their strongest presence in the area in which their plant is located, SMBR benefits from strong pricing power in its home market, in which it generates 65% of its sales. This helps the company to have a comparable average selling price vis-à-vis its larger competitors.

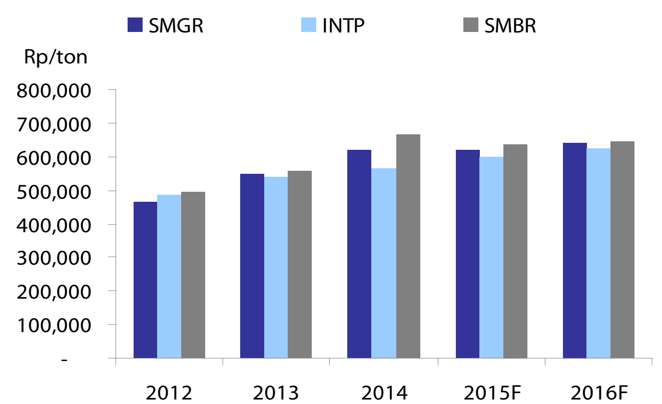
With relatively small capacity, SMBR does not have economies of scale that are enjoyed by its competitors - resulting in lower efficiency. This lower efficiency leads to higher COGS per ton which squeezes the profitability margin.

Exhibit 27. Comparable ASP to its peers



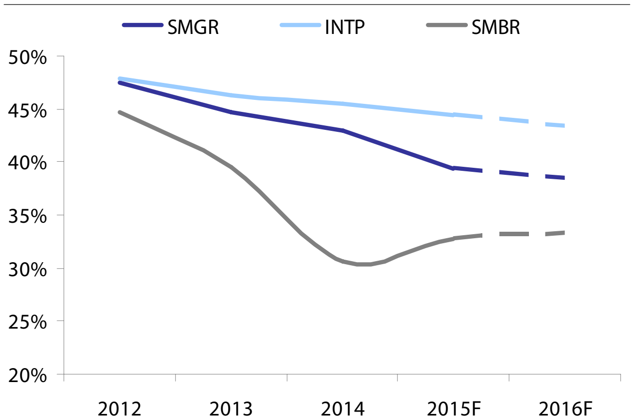
Source: Company, Danareksa Sekuritas

Exhibit 28. Lower efficiency leading to higher COGS ...



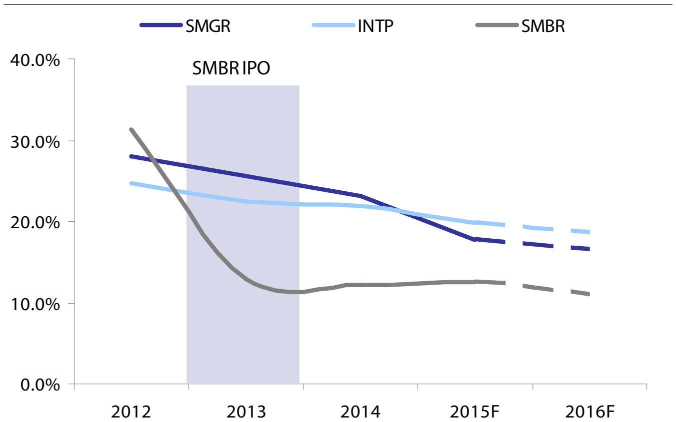
Source: Company, Danareksa Sekuritas

Exhibit 29. ... and lower gross margins



Source: Company, Danareksa Sekuritas

Exhibit 30. ROE comparison

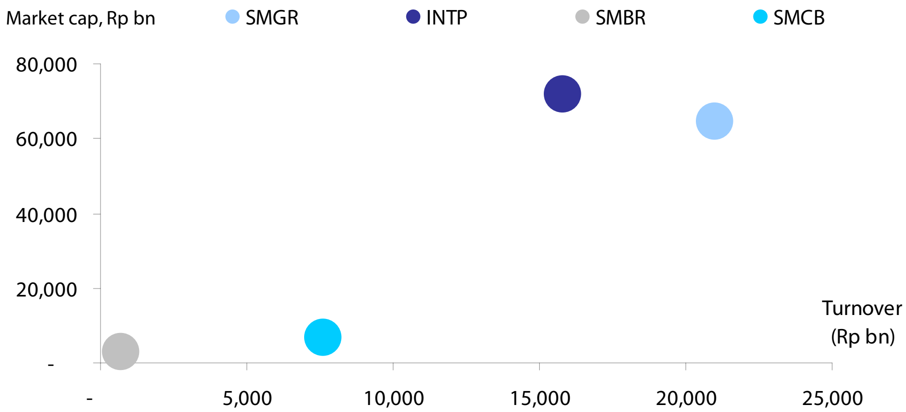


Source: Company, Danareksa Sekuritas

Liquidity wise

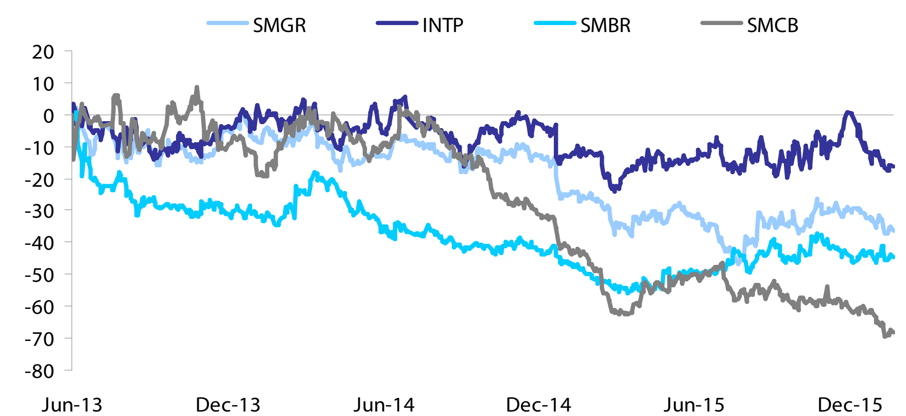
With relatively small market capitalization and trading value, SMBR is exposed to additional liquidity risk compared to its competitors (SMGR and INTP). As a result, investors apply an additional liquidity discount to SMBR shares.

Exhibit 31. Trading value and market capitalization comparison



Source: Bloomberg

Exhibit 32. Discount to JCI



Source: Bloomberg

Valuation

We use a blended valuation with DCF to capture SMBR's long-term outlook and target PE to capture the short-term prospects. Hence, we arrive at a target price of Rp350. This target price implies 9.8x 2016F PE, a 38% discount to average cement industry PE.

In our DCF valuation, we arrive at a fair value of Rp330, implying PE of 9.2x in FY16. This valuation is based on the following assumptions:

- First stage of our DCF analysis with forecast period from 2016 to 2021, which gives rise to EBITDA CAGR of 14.1%, assuming a slight increase in ASP by only 1-2.5% and sales volume growth of 5.2%-13.8%.
- Second stage of our DCF analysis with terminal value growth of 3.5%.
- WACC of 12.0%, with cost of equity of 14.0% (risk free rate 6.5%, risk premium 7.4% and beta of 1.0, and cost of debt of 10% and DER of 0.4x).

In our PE approach, we arrive at fair value of Rp375, based on target 2016F PE of 10.5x which equal to average historical PE of SMBR. This translates into a 34% discount of SMBR's PE to the average cement industry PE. We believe this discount reflects several factors. Firstly is the company's much smaller market capitalization compared to its peers. As this results in lower trading value, investors apply a "liquidity discount". Secondly is the decline in SMBR's market share in the domestic cement market due to previous capacity constraints. And thirdly is the risk associated with only serving a niche market in the southern part of Sumatera.

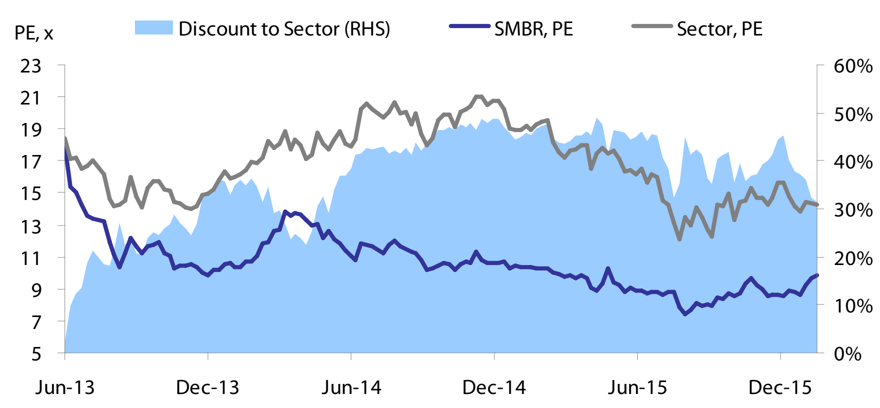
Currently the stock is trading at nears to its mean PE and implies a 34% discount to the average industry. Although SMBR is finally delivering on its promise to build new plants, we believe that the current discount is appropriate given the inherent risks.

Exhibit 33. Key assumptions

	2013	2014	2015F	2016F	2017F
ASP (Rp/ton)	923,646	962,150	954,087	964,026	979,257
Sales volume (mn ton)	1,265,212	1,262,708	1,538,049	1,750,400	1,925,900
Utilization rate (%)	63.3%	63.1%	76.9%	87.5%	50.7%
Coal price (USD/ton)	85	69	59	53	55
Electricity cost (Rp/kWh)	807	998	1,177	1,137	1,051

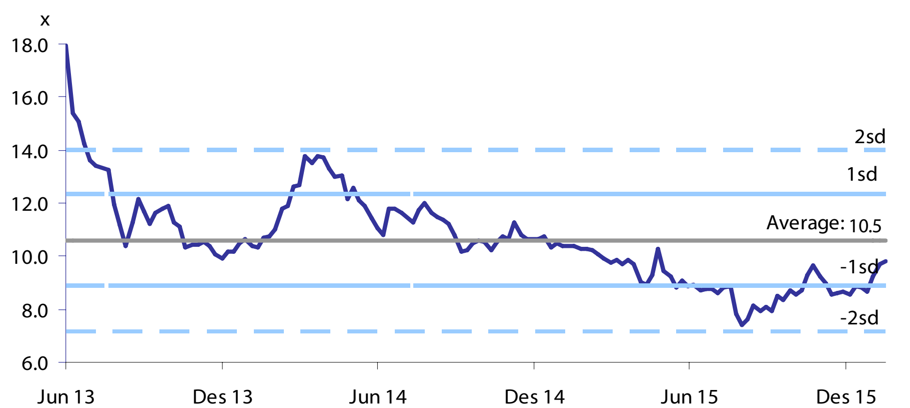
Source: Company, Danareksa Sekuritas

Exhibit 34. PE of SMBR compared to the Sector



Source: Bloomberg, Danareksa Sekuritas

Exhibit 35. Forward PE of SMBR



Source: Bloomberg, Danareksa Sekuritas

Exhibit 36. Peers comparison

Company	Country	Ticker	Price 17-Feb-16 (LC)	Mkt.cap US $ mn	PE, x 2015	PE, x 2016	PE, x 2017	EV/ton US$/ton	EV/EBITDA,x 2015	EV/EBITDA,x 2016	EV/EBITDA,x 2017	PB, x 2015	PB, x 2016	PB, x 2017
Regional Cement Manufacturing														
Siam Cement PCL/THE	Thailand	SCC TB	420	14,148	11.6	11.0	10.5	625.9	9.6	9.2	8.7	2.5	2.2	2.0
Lafarge Malaysia Bhd	Malaysia	LMC MK	9	1,807	26.7	23.7	22.2	134.6	13.9	12.4	11.9	2.4	2.4	2.4
Tasek Corp Bhd	Malaysia	TC MK	15	428	18.7	16.5	16.1	162.1	10.6	9.5	9.3	2.3	2.3	2.3
India Cements Ltd	India	ICEM IN	71	317	30.2	17.2	8.6	53.6	6.9	6.6	5.6	0.5	0.6	0.6
Ultratech Cement Ltd	India	UTCEM IN	2,777	11,112	28.8	32.1	23.1	183.7	16.7	17.0	13.2	3.6	3.6	3.2
Acc Ltd	India	ACC IN	1,212	3,317	29.4	22.9	15.9	103.8	14.6	11.6	8.8	2.7	2.6	2.5
Anhui Conch Cement Co	China	914 HK	15	11,160	10.0	9.2	8.0	48.6	5.6	5.5	4.9	1.0	0.9	0.8
Huaxin Cement Co Ltd	China	900933 CH	1	1,310	30.7	16.2	9.7	39.7	6.9	5.5	4.6	0.7	0.6	0.6
China National Building	China	3323 HK	3	2,350	8.9	9.1	8.8	96.1	12.0	12.1	11.4	0.3	0.3	0.3
Bbmg Corp-H	China	2009 HK	4	5,754	19.9	13.7	13.0	297.0	14.4	12.7	11.5	0.5	0.5	0.5
Asia Cement Corp	Taiwan	1102 TT	27	2,725	13.3	13.2	12.8	249.4	15.6	14.2	13.7	0.6	0.6	0.6
Taiwan Cement	Taiwan	1101 TT	28	3,121	16.3	13.7	11.4	82.1	12.1	11.0	10.6	0.9	0.9	0.9
Taiheiyo Cement Corp	Japan	5233 JP	229	2,489	7.5	7.6	6.8	246.2	6.8	6.5	6.1	1.1	0.8	0.8
Average Regional Cement Manufacturing				**60,852**	**14.2**	**13.1**	**11.4**	**111**	**12.2**	**11.7**	**10.6**			
Indonesian Cement Manufacturing														
Semen Indonesia Persero	Indonesia	SMGR IJ	10,575	4,646	13.5	13.4	13.0	160.9	8.7	8.4	8.1	2.4	2.2	2.0
Indocement Tunggal Prakarsa	Indonesia	INTP IJ	19,750	5,386	14.7	14.7	14.4	189.6	9.7	9.4	9.1	2.9	2.7	2.5
Holcim Indonesia	Indonesia	SMCB IJ	940	534	62.6	21.0	15.9	79.7	8.7	8.0	7.4	0.9	0.8	0.8
Semen Baturaja	Indonesia	SMBR IJ	321	143	8.4	8.8	9.1	54.8	4.0	3.5	3.1	1.1	1.0	0.9
Average Indonesian Cement Manufacturing				**10,798**	**14.5**	**14.1**	**13.6**	**153.5**	**9.0**	**8.7**	**8.3**			

Source: Bloomberg (as of Feb 17,2016)

Key business risk

Downside risks to our investment call

- **Delays in infrastructure projects**
  While short term cement demand is contingent upon infrastructure projects, there are multiple factors which can cause delays in infrastructure projects, including land acquisition and project financing schemes. Delays in infrastructure projects will negatively impact cement sales.

Exhibit 37. Sensitivity of sales volume to EPS 2016

	-5%	-2.50%	**Base case**	2.50%	5%
	1.66	1.71	1.75	1.79	1.84
	1.66	1.71	1.75	1.79	1.84
Utilization rate (%)	83.1%	85.3%	87.5%	89.7%	91.9%
Revenue (Rpbn)	1,603.1	1,645.2	1,687.4	1,729.6	1,771.8
EBITDA (Rpbn)	465.9	477.7	489.5	501.2	513.0
Net income (Rpbn)	332.8	342.2	351.7	361.2	370.7
EPS (Rp)	33.8	34.8	35.8	36.7	37.7
Impact to EPS	-5.4%	-2.7%		2.7%	5.4%

Source: Danareksa Sekuritas

Nevertheless, as we previously mentioned, due to the limited capacity of clinkers production, higher sales volume will also indicate a higher proportion of externally purchased clinkers which are more costly than internally produced clinkers. This would put downward pressures on the gross margin.

Exhibit 38. Sensitivity of sales volume to profitability margin 2016

	-5%	-2.50%	**Base case**	2.50%	5%
	1.66	1.71	1.75	1.79	1.84
Cash cost (Rp/ton)	586,631	589,219	591,678	594,016	596,243
Gross margin (%)	33.5%	33.4%	33.2%	33.1%	33.0%
Operating margin (%)	23.1%	23.2%	23.3%	23.4%	23.5%
Net margin (%)	20.8%	20.8%	20.8%	20.9%	20.9%

Source: Danareksa Sekuritas

- **Quicker-than-expected revival in commodity prices**
  SMBR currently benefits from low coal prices on the back of global oversupply. Should the recovery in the coal price happen earlier than our expectation in 2017, then the cost of production will be increased and earnings lowered.

Exhibit 39. Sensitivity of coal price to EPS 2016

	-5%	-2.50%	**Base case**	2.50%	5%
	50.4	51.7	53.0	54.3	55.7
Revenue (Rpbn)	1,687.4	1,687.4	1,687.4	1,687.4	1,687.4
EBITDA (Rpbn)	495.6	492.5	489.5	486.4	483.4
Net income (Rpbn)	356.6	354.2	351.7	349.3	346.8
EPS (Rp)	36.3	36.0	35.8	35.5	35.3
Impact to EPS	1.4%	0.7%		-0.7%	-1.4%

Source: Danareksa Sekuritas

- **Government intervention in cement pricing**
  Earlier this year, the government intervened in cement pricing for state owned cement producers (Semen Indonesia (SMGR) and SMBR), leading to a Rp3,000 reduction in the cement price per sack. This price reduction was followed by other cement producers as they tried to maintain their market shares. Should the government decide to intervene again in domestic cement pricing, this will further hit SMBR's profitability margins.

Exhibit 40. Sensitivity of ASP to EPS 2016

	-5%	-2.50%	**Base case**	2.50%	5%
	915,824	939,925	964,026	988,126	1,012,227
Revenue (Rpbn)	1,603.1	1,645.2	1,687.4	1,729.6	1,771.8
EBITDA (Rpbn)	405.7	447.6	489.5	531.3	573.2
Net income (Rpbn)	284.3	318.0	351.7	385.5	419.2
EPS (Rp)	28.9	32.3	35.8	39.2	42.6
Impact to EPS	-19.2%	-9.6%		9.6%	19.2%

Source: Danareksa Sekuritas

- **Longer-than-expected commencement of Baturaja II**

SMBR is currently constructing a new manufacturing plant with installed capacity of 1.85 mn tons. This will raise installed capacity to 3.85 mn tons. This plant is expected to commence its operational activities in the first half of 2017. Delays in the commencement of Baturaja II will mean that SMBR will be unable to capture more of the market due to capacity constraints in the future as well as delay cost efficiency gains.

Exhibit 41. Sensitivity of project delay to profitability margin 2017

	Base case No delay	1 year delay	Impact (%)
Cash cost (Rp/ton)	553,240	610,037	10.3%
COGS (Rp/ton)	671,907	679,321	1.1%
Gross margin (%)	31.4%	30.6%	-0.8%
EBITDA margin (%)	34.4%	28.6%	-5.8%
Operating margin (%)	21.5%	21.1%	-0.5%
Net margin (%)	12.5%	12.1%	-0.4%

Source: Danareksa Sekuritas

- **Disruption to electricity procurement**

  SMBR fully relies on the electricity supplied by PLN in its operating activities and the company does not have any alternative power generators. Therefore, disruption to its electricity supplies will also disrupt SMBR's operational activities and potentially increase manufacturing costs. This will negatively impact SMBR's profitability.

Upside potential to our investment call

- **Competitors still face difficulties in accessing SMBR's niche market**

  We estimate that by 2019, competitors will have better access to SMBR's niche market, thus reducing SMBR's competitive advantage. Nevertheless, if this takes longer than expected, it will result in upside potential for SMBR.

Exhibit 42. Profit and Loss, Rp bn

	2013	2014	2015F	2016F	2017F
Revenue	1,169	1,215	1,467	1,687	1,886
Cost of good sold	(706)	(842)	(977)	(1,126)	(1,294)
Gross profit	462	372	490	561	592
Operating expense	(135)	(136)	(158)	(168)	(186)
Operating profit	327	236	333	393	406
Depreciation	67	89	90	96	242
EBITDA	394	325	422	489	648
Other income (charges)	73	158	106	43	(115)
Profit before tax	400	395	439	436	292
Tax	(88)	(66)	(85)	(85)	(57)
Net profit	**312**	**328**	**354**	**352**	**235**

Source: Company, Danareksa Sekuritas

Exhibit 43. Balance Sheet, Rp bn

	2013	2014	2015F	2016F	2017F
Cash and equivalent	1,883	2,054	1,632	655	131
Restricted cash	20	0	0	0	0
Account receivable	36	81	77	89	99
Inventories	132	187	197	225	274
Other current asset	36	14	530	559	568
Total current asset	2,107	2,336	2,435	1,527	1,071
Fixed asset, net	590	558	703	3,016	3,541
Restricted cash	5	-	-	-	-
Others	11	35	71	73	72
Total asset	**2,711**	**2,928**	**3,210**	**4,616**	**4,684**
Trade payable	68	91	82	95	109
Short term bank loan	-	-	-	139	139
Others	126	88	102	110	118
Total current liabilities	194	180	184	344	365
Long term debt	-	-	-	971	833
Others	85	66	66	66	66
Total long term liabilities	85	66	66	1,037	898
Shareholder equity	2,433	2,683	2,960	3,236	3,420
Total liabilities and equity	**2,711**	**2,928**	**3,210**	**4,616**	**4,684**

Source: Company, Danareksa Sekuritas

Exhibit. 44. Cash Flow, Rp bn

	2013	2014	2015F	2016F	2017F
Net income	312	328	354	352	235
+ Depreciation & amortization	67	89	90	96	242
Changes in working capital	(218)	(105)	(541)	(49)	(45)
Operating cash flow	**161**	**312**	**(97)**	**399**	**432**
Fixed assets	(139)	(57)	(235)	(2,299)	(766)
Others	-	(3)	-	-	-
Investing cash flow	**(139)**	**(60)**	**(235)**	**(2,299)**	**(766)**
Bank loans	(17)	(14)	(14)	1,000	(139)
Proceed from IPO	1,378	-	-	-	-
Dividend	(60)	(78)	(77)	(76)	(51)
Others	41	(14)	-	-	-
Financing cash flow	**1,342**	**(106)**	**(90)**	**924**	**(190)**
Changes in cash	1,364	147	(422)	(976)	(524)
Beginning balance	**543**	**1,907**	**2,054**	**1,632**	**655**
Ending balance	**1,907**	**2,054**	**1,632**	**655**	**131**
Allocated to:					
Short term restricted cash	20	0	0	0	0
Long term restricted cash	5	-	-	-	-
Cash and cash equivalent	**1,883**	**2,054**	**1,632**	**655**	**131**

Source: Company, Danareksa Sekuritas

Exhibit 45. Ratios, %

	2013	2014	2015F	2016F	2017F
Gross margin	39.6	30.7	33.4	33.2	31.4
Operating margin	28.0	19.4	22.7	23.3	21.5
EBITDA margin	33.7	26.8	28.8	29.0	34.4
Net margin	26.7	27.0	24.1	20.8	12.5
ROA	11.5	11.2	11.0	7.6	5.0
ROE	12.8	12.2	12.0	10.9	6.9
Debt ratio	1.1	0.5	-	34.3	28.4
Net gearing ratio	Net Cash	Net Cash	Net Cash	14.0	24.6

Source: Company, Danareksa Sekuritas