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Target Price Revision

Cementos Argos S.A.: expected recovery in profitability margins in 2010 provides room for further valuation

Prepared by:

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52-week Low	$ 5,030
52-week High	$ 10,000
Market Price (Sep-10-09)	$ 10,000
Year-to-date (%)	49.3%
Shares outstanding (bn)	1,151.67
Market Capitalization (COP$bn)	11,516,723
2010E Target Price	**$11,100**
Valuation Potential	11.0%

Table 2. 2010E Weighted Average Cost of Capital (WACC)

Exchange Rate Depreciation	3.0%
Kd	**10.1%**
Kd (1-t)	8.1%
Risk-free Rate	4.0%
Country Risk	2.5%
Market Premium	6.0%
Leveraged Beta	1.08
Ke COP	15.2%
WACC	**13.4%**

Source: Valores Bancolombia calculations.

Table 3. Valuation
(Figures are in COP$ million)

= Value of Operations	**8,518,415**
- Debt	3,609,176
- Minority Interest	219,895
+ Other Assets and Liabilities	8,144,103
= Enterprise Value	12,833,447
Shares Outstanding	1,151.7
= 2010E Target Price	**$ 11,100**

Source: Valores Bancolombia.

Base Case Senario

- The estimated target price for Cementos Argos S.A. by end-2010 is **COP$11,100** per share, based on a free cash flow valuation for the period 2010-2016. These flows were discounted at a weighted average cost of capital (WACC) of 13.4% (Table 2). The base case scenario considers a nominal growth rate to perpetuity of 6.0% and a country risk premium of 2.5%.

- We assume a recovery in volumes sold in Colombia and the U.S. in the year 2010 as a result of a favorable performance of the real estate sector in both those economies. The grounds for such recovery would be the latest data on sales of new and existing homes and also the development of mortgage applications[1] in the U.S. Also explaining the outlook for recovery is the recent performance of construction licenses, which have shown stability signals after a weak performance during 1Q09.

- Additionally, spending by the central government is expected to rise to COP$6.3 trillion in 2010, supported by recovery in sales volumes in the local market.

- On top of the foregoing, we are pricing in the positive impact that the stimulus plan may have on the U.S., where a 12% growth in demand for cement is estimated according to the PCA (Portland Cement Association), and some projects of large magnitude in the Caribbean.

- Results obtained during 1H09 have demonstrated the company's capacity to protect its operating margins. This is an outstanding ability, given that it posted increases in those margins in spite of the deterioration recorded in volumes sold in Colombia and the U.S.

- The base price estimated considers the valuation of the main assets making up the company's portfolio of non-operating investments, which represent nearly 43% of its shareholders' equity.

[1] In August, sales of new homes featured an annual variation of -13.4%, which stands as the best level since April 2006. Sales of existing homes on the other hand grew 5% annually for the same month. Finally, the Mortgage Bankers Association (MBA) announced that mortgage applications had increased 17% in the week ending on September 4.

- Operating revenue projections are based on our outlook of economic growth and inflation in Colombia, the U.S. and the Caribbean, and also on the historical EBITDA performance in each of those regions (see Figure 2).

- *Value of operations*:

  - We assume an increase in operating revenues in 2010 of 14.7% to COP$4 trillion. This result assumes a nominal growth rate of 30% for the operation in Colombia, of 2.7% in the United States, and of 9.3% in the Caribbean. During the period 2011-2016 we assume an annual average growth rate of 6.8% up to COP$6.2 trillion in 2016.

  - The valuation exercise considers the increase in participation of the Caribbean in total operating revenues, according with the firm's internationalization strategy. For 2010, we expect 16% of operating revenues to come from the Caribbean, 54% from Colombia, and the remaining 29% from the U.S. By 2016, 18% should be generated in the Caribbean, 50% in Colombia, and the remaining 32% in the U.S.

  - We assume that the EBITDA margin will rise to 19.6% in 2010, compared with 18.1% in 2009, reflecting the implementation of the Cartagena plant. For the period between 2011 and 2016, the EBITDA margin stands at 20%.

  - In 2010 we estimate that the CAPEX will rise to COP$200 billion (5% of sales), lower than that observed in 2009 of COP$350 billion, reflecting the completion of the Cartagena plant. For the remainder of the period of valuation we assume that the CAPEX remains stable as a proportion of sales at 5%. This value does not take into account acquisitions and/or enlargement projects.

  - Regarding debt we assume that the company does not take on any additional debt during the projection horizon, in line with the company's guidelines.

- *Investment Portfolio*: We value the investment portfolio by the end of 2010 according to the estimated target price for Grupo de Inversiones Suramericana (COP$28,000) and Grupo Nacional de Chocolates ($21,500), derived from our valuation exercises by Sum of the Parts and Discounted Free Cash Flow, respectively. Due to conflicts of interest, the stake in Bancolombia is valued at the estimated target price according to analyst consensus (COP$17,300).

The target price for Cementos Argos corresponding to this scenario is COP$11,100. We set the subjective probability of occurrence of this scenario at 70%.

Pessimistic scenario

- Even though most data on the real estate and construction activities in Colombia and the U.S.[2] suggest that the sector would be stabilizing, high housing inventory levels suggest that the sector's reactivation may take longer than initially anticipated. Likewise, delays in the execution of infrastructure spending in both markets may translate into lower-than-expected sales volumes in the base case scenario. The pessimistic scenario therefore assumes that the sector recovery would take place towards 2011. Bearing in mind the importance that those two markets have on the company's total revenues (80% projected for 2010), not even a favorable performance in the Caribbean would offset a slow recovery in Colombia and the U.S.

- The major assumptions of the pessimistic valuation scenario are:

  - We estimate an average growth in total operating revenues of 5.4% between 2010 and 2016. This rate results from average growth of 5.7% in Colombia, 1.8% in the U.S. and 7.6% in the Caribbean. This implies that operating revenues will reach levels of COP$5.4 trillion in 2016, that is to say 13.2% below the base case scenario.

[2] As at July, the stock of existing housing for sale was of 4.09 million units, 7.3% above that of June. As for new housing, the stock for sale reached 272 thousand units in July, standing 3.3% above the record for June.

- In line with the foregoing, the EBITDA margin would stand at levels of 18.9% on average, including the positive impact of the implementation of the Cartagena plant. The latter implies an EBITDA of COP$1 trillion in 2016, which means a reduction of 13.9% below the central scenario.

- In this way, the average annual investment in CAPEX would fall to 4% of total sales throughout the valuation period.

- Under this scenario, the target price is COP$9,200. To this scenario we assign a subjective probability of occurrence of 10%.

Optimistic Scenario

- The positive performance of sales in the Caribbean observed during 1H09, as well as the increase in the participation of the company in the region, offers a promising sales growth scenario. Hence, the optimistic scenario assumes that the operation in the Caribbean grows more than anticipated in the base case scenario. Additionally, we assume that recovery of the real estate and infrastructure sectors in Colombia and the U.S. is faster than expected as a result of the accelerated reactivation of demand for housing and an efficient execution of infrastructure spending. This presents a favorable scenario for the company's operating flows and margins.

- The major assumptions of the optimist scenario are:

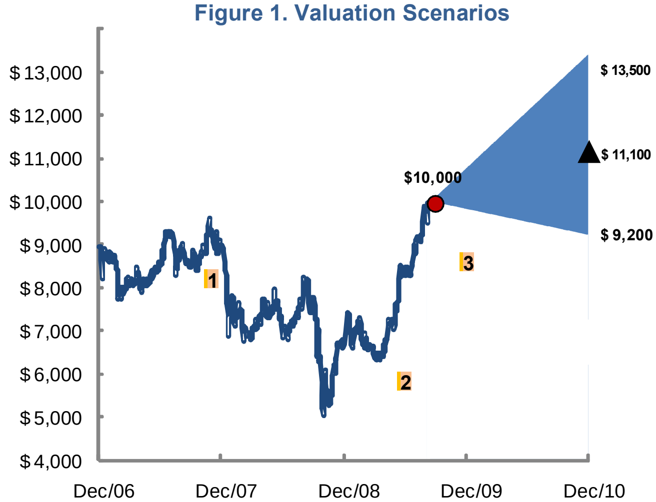
  - Operating revenues increase 10.7% between 2010 and 2015 to COP$7.4 trillion in 2016, 19.2% above the base case scenario.

  - We assume that the EBITDA margin stands at levels of 20.9% on average between 2010 y 2016. By the end of the valuation period an EBITDA of COP$1.5 trillion would be expected, which means an increase of 24.6% above the base case scenario.

  - Investment in CAPEX as a percentage of sales would remain at 5.5%, given that the greater production would be satisfied through greater installed capacity utilization.

- Under this scenario, the target price comes to COP$13,500. We assign a subjective probability of occurrence of 20% to this scenario.

Figure 1. Valuation Scenarios

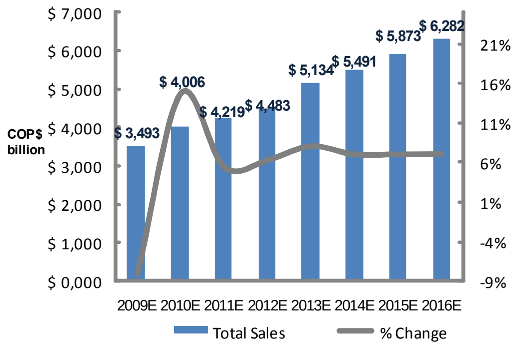


	Publication Date	Target Price	Closing Price
1	Aug-13-07	$10,470	$8,980
2	Mar-17-09	$7,100	$9,350
3	Sep-07-09	$11,100	$10,000

Source: Valores Bancolombia Calculations.

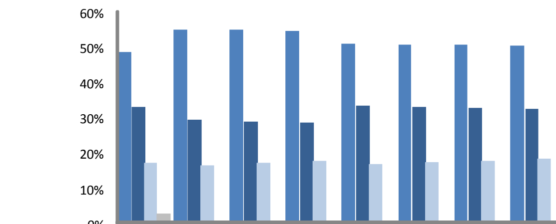
ANNEX I

Figure 1. Projected Total Operating Revenues



Source: Valores Bancolombia

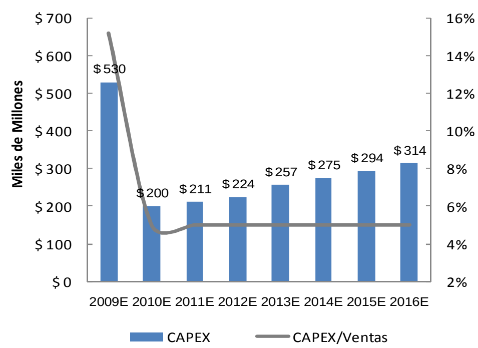
Figure 2. Evolution of the participation of operating revenues by destination



	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Colombia	48%	54%	54%	54%	50%	50%	50%	50%
U.S.A.	32%	29%	28%	28%	33%	32%	32%	32%
Central America	17%	16%	17%	17%	16%	17%	17%	18%
Other Businesses	3%	1%	1%	1%	0%	0%	0%	0%

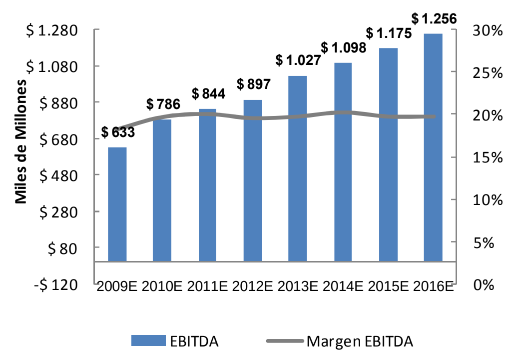
Source: Valores Bancolombia

Figure 3. Projected CAPEX



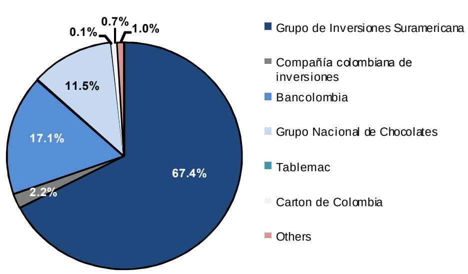
Source: Valores Bancolombia

Figure 4. Projected EBITDA



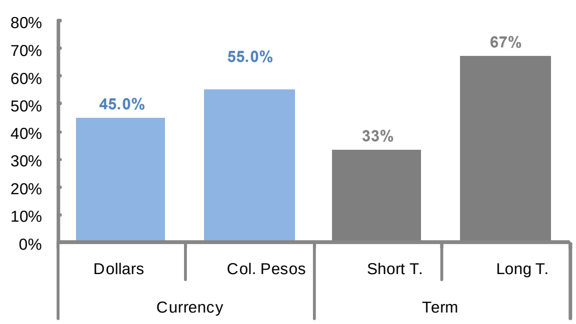
Source: Valores Bancolombia

Figure 5. Composition of Cementos Argos Portfolio (As at June, 2009)



Source: Cementos Argos S.A.

Figure 6. Debt Break-Up



Source: Cementos Argos S.A.

ANNEX II

Table 1. 2010E Target Price Sensitivity Analysis
(Continuity Value vs. WACC)

		WACC						
		10.4%	**11.4%**	**12.4%**	**13.4%**	**14.4%**	**15.4%**	**16.4%**
Continuity Value	**7.0%**	12,500	12,500	12,400	**12,300**	12,200	12,200	12,100
	6.5%	11,900	11,800	11,700	**11,700**	11,600	11,500	11,500
	6.0%	**11,300**	**11,300**	**11,200**	**11,100**	**11,100**	**11,000**	**11,000**
	5.5%	10,900	10,800	10,800	**10,700**	10,700	10,600	10,500
	5.0%	10,500	10,400	10,400	**10,300**	10,300	10,200	10,200

Source: Valores Bancolombia Calculations.

Table 2. 2010E Target Price Sensitivity Analysis
(Continuity Value Vs. Beta)

		Beta						
		0.55	**0.65**	**0.75**	**0.85**	**0.95**	**1.05**	**1.15**
Continuity Value	**7.0%**	12,700	12,600	12,400	**12,300**	12,200	12,000	11,900
	6.5%	12,000	11,900	11,800	**11,700**	11,500	11,400	11,300
	6.0%	**11,500**	**11,400**	**11,300**	**11,100**	**11,000**	**10,900**	**10,800**
	5.5%	11,000	10,900	10,800	**10,700**	10,600	10,500	10,400
	5.0%	10,700	10,600	10,400	**10,300**	10,200	10,100	10,000

Source: Valores Bancolombia Calculations.

ANNEX III

Table 1. Cementos Argos S.A. Consolidated Financial Statements
(COP$ billion)

Income Statement	2007	2008	2009E	2010E	2011E	2012E	2013E
Operating Revenues	3,787	3,805	3,493	4,006	4,219	4,483	5,134
Operating Costs and Expenses	3,459	3,626	3,283	3,686	3,861	4,079	4,672
Operating Income	329	179	210	321	359	403	462
Operating Margin	8,7%	4,7%	6.0%	8.0%	8.5%	9.0%	9.0%
Non-operating Revenues (Expenses)	-27	-65	75	15	16	17	18
EBITDA	683	592	633	786	844	897	1,027
EBITDA Margin	18%	16%	18%	20%	20%	20%	20%
Net Earnings	212	71	162	196	222	252	291
Net Margin	5,6%	1,9%	4.6%	4.9%	5.3%	5.6%	5.7%

Balance Sheet	2007	2008	2009E	2010E	2011E	2012E	2013E
Assets	11,268	12,092	12,731	13,622	14,576	15,596	16,688
Cash and temporary investments	288	1,034	1,045	1,118	1,196	1,280	1,369
Inventories	355	402	426	456	488	522	559
Liabilities	3,982	5,572	6,394	6,754	7,246	7,822	8,499
ST financial obligations	429	1,078	1,652	1,982	2,379	2,854	3,425
Other current liabilities	1,103	1,754	1,755	1,843	1,935	2,032	2,134
LT financial obligations	1,141	1,550	1,070	1,150	1,139	1,127	1,116
Bonds outstanding	584	600	1,300	1,150	1,152	1,155	1,157
Other non-current liabilities	725	590	616	629	641	654	667
Shareholders' Equity	7,080	6,297	6,083	6,596	7,038	7,462	7,855
Minority Interest	206	223	255	272	292	312	334

Source: Calculations by Valores Bancolombia with data from Cementos Argos S.A.

Table 2. Cementos Argos S.A. Estimated Multiples

Multiples	2007	2008	2009E	2010E	2011E	2012E	2013E
P/E	48,3	109,2	75,3	65,2	57,7	50,8	43,9
P/BV	1,4	1,2	2,3	2,1	2,0	1,9	1,8
EV/EBITDA	13,1	10,3	16,6	13,7	12,4	11,2	9,4
Earnings per share	184	61	141	170	192	219	253

Source: Calculations by Valores Bancolombia with data from Cementos Argos S.A.

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