Day Break

Thursday, 21 February 2019

COMPANY UPDATE

Engro Polymer & Chemicals Limited

Chemical

Recommendation		**BUY**
Target Price:	31-Dec-19	48.3
Last Closing:	20-Feb-19	37.0
Upside:		30.5
Valuation Methodology:		Discounted Cash Flow (DCF)
Time Horizon:		10M

Market Data

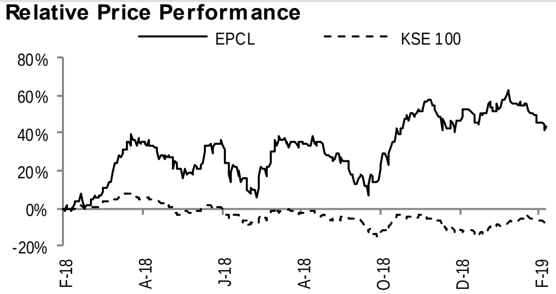
Bloomberg Tkr.			EPCL PA
Shares (mn)			908.9
Free Float Shares (mn)			454.5
Free Float Shares (%)			50.0%
Market Cap (PKRbn | USDmn)		33.7	241.6
Exchange			KSE100
Price Info.	90D	06M	12M
Abs. Return	(8.2)	7.5	43.9
Lo	36.2	27.6	25.6
Hi	41.8	41.8	41.8

Key Company Financials

Period End: Dec

PKRbn	**CY17A**	**CY18A**	**CY19E**	**CY20F**
Total Revenue	27.7	35.3	40.0	44.4
Net Income	2.1	4.9	4.3	4.3
EPS (PKR)	2.3	5.4	4.8	4.7
DPS (PKR)	1.3	1.1	1.0	1.0
Total Assets	24	24	40	46
Total Equity	8	17	20	24
Key Financial Ratios				
ROE (%)	26.6	28.9	21.1	17.9
P/E (x)	16.4	6.8	7.8	7.9
P/B (x)	3.3	4.4	2.0	1.6
DY (%)	3.4	3.0	2.7	2.7

Relative Price Performance



About the Company

Engro Polymer & Chemicals manufactures, markets and sells Poly Vinyl Chloride (PVC), Vinyl Chloride Monomer (VCM), caustic soda and other related chemicals. The Company is also engaged in the supply of surplus power generated from its power plants to Engro Fertilizers Limited (a related party).

Source: Bloomberg, PSX & IGI Research

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Chemicals

EPCL: Potential upgrade story in longterm

- We have revised our forward earnings estimates after incorporating CY18 full year results. Company reported earnings of PKR 4.93bn (or PKR 5.42/share) for CY18 up by +2.5x
- With respect to price performance, the stock outperformed by +54%YoY against the benchmark index KSE-100, as rise in core delta and new expansions in plans kept investor confidence strengthened
- We think near-term earnings outlook (PKR 4.76 & 4.68/share in 2019/20 will keep stock under-pressure. Nevertheless, growth in earnings will come from CY20 onwards on the back of capacity expansion and new product additions
- We have a **"BUY"** call on the scrip based on our Dec-19 target price of PKR 48/share offering +31% upside from its last closing. The stock is currently trading at P/E of 7.8x and offers dividend yield of 2.7%

Medium-term earnings outlook should be overlooked; value unlocks from CY20 onwards

We have revised our forward earnings estimates after incorporating CY18 full year results. We maintain a 'buy' call on Engro Polymer Company Limited (EPCL) with CY19 target price of PKR 48/share offering a +30% upside from its last day close price of PKR 37/share. We think near-term earnings outlook (PKR 4.8 & 4.7/share) in 2019/20 will keep stock under-pressure. Nevertheless, growth in earnings will come from CY20 onwards on the back of capacity expansions and new product additions.

To recall, the stock has outperformed market index (KSE100) by +54% posting a return of 46% during CY18. The company reported earnings of PKR 4.93bn (or PKR 5.42/share) for CY18 up by +2.5x, thanks to; a) better PVC-ethylene margins amid weak PKR USD exchange rate, b) continuation of Anti-dumping and Regulatory Duty, c) volumetric growth in PVC sales and d) steady caustic soda market.

On international pricing dynamics, ethylene prices have so far shown strong recovery after witnessing downfall in the last quarter of CY18. While PVC prices also picking up pace slowly, core delta has shrunken to 390 USD/ton. Although this will be short-lived we view new ethylene capacity additions and demand from downstream products will create demand-supply imbalance, keeping prices range-bound. Hence, we have assumed core-delta to hover in the range 320-330 USD/ton going forward.

Strong pricing dynamics and sustained PVC demand drove earnings to PKR 4.92bn (EPS: PKR 5.42) in CY18

For 2018, the company reported earnings more than double to PKR 4.92bn (EPS: PKR 5.42) as against PKR 2.05bn (EPS: PKR 2.26) during CY17. Accretion to earnings stemmed from strong demand of PVC in downstream sectors, premium pricing strategy and healthier core delta. In PVC segment, the company achieved highest ever sales at a growth of +9%YoY. Similarly, demand for caustic soda remained stable with sales witnessing a minor growth of +2%YoY during CY18.

Exhibit: **EPCL volumetric sales improved significantly during CY18**

(kTons)	**2014**	**2015**	**2016**	1Q'17	2Q'17	3Q'17	4Q'17	**2017**	1Q'18	2Q'18	3Q'18	4Q'18	**2018**
PVC	**147**	**169**	**172**	44	45	49	49	**187**	54	49	46	54	**203**
Caustic Soda	**91**	**85**	**83**	21	20	20	24	**84**	23	21	21	21	**86**

Source: Company Accounts, IGI Research

However, during its 4QCY18, profitability inched down a bit on sequential basis with company recording multiple one-offs. As per se, company received insurance claim (last tranche) post tax of around PKR 294mn. In addition, one-time non-recurring write offs of PKR 143mn (post tax) was also recorded during the quarter. Furthermore, company also incurred foreign exchange loss of around PKR 150-200mn.

Exhibit: **EPCL 2018 result highlights**

Period end (Dec) - PKRmn	**2018**	4Q18	3Q18	2Q18	1Q18	**2017**	4Q17	3Q17	2Q17	1Q17	**2016**	**2015**
Net Sales	35,272	9,748	8,422	8,414	8,687	27,731	7,341	7,344	6,233	6,812	22,854	22,264
Net Sales Growth %	***27%***	*33%*	*15%*	*35%*	*28%*	*21%*	*18%*	*35%*	*15%*	*19%*	*3%*	***-7%***
Gross Profit	8,736	1,936	2,240	2,060	2,500	6,065	1,105	2,013	1,012	1,936	3,935	2,773
Gross Profit Margins	*25%*	*20%*	*27%*	*24%*	*29%*	*22%*	*15%*	*27%*	*16%*	*28%*	*17%*	*12%*
Sell. / Dist. & Admin	2,044	513	506	494	530	1,912	617	388	454	444	1,699	1,727
Other Op. Income/Expense	377	237	(17)	(64)	221	(219)	(23)	(146)	(11)	(53)	(129)	(268)
EBIT	7,069	1,660	1,717	1,501	2,191	3,935	465	1,479	548	1,439	2,107	778
EBIT Margins	*20%*	*17%*	*20%*	*18%*	*25%*	*14%*	*6%*	*20%*	*9%*	*21%*	*9%*	*3%*
Financial Charges	*606*	155	153	141	158	820	233	193	163	233	927	1,144
Pre-tax Profits	6,463	1,506	1,564	1,360	2,033	3,115	232	1,286	385	1,206	1,180	(366)
Taxation	1,533	431	483	34	585	1,062	130	385	185	360	525	(283)
Effective Tax Rate (%)	*24%*	*29%*	*31%*	*3%*	*29%*	*34%*	*56%*	*30%*	*48%*	*30%*	*45%*	*0%*
Post-tax Profits	4,930	1,074	1,082	1,326	1,448	2,053	102	901	200	846	655	(83)
Net Margin (%)	*14%*	*11%*	*13%*	*16%*	*17%*	***7%***	*1%*	*12%*	*3%*	*12%*	*3%*	*0%*
EPS	**5.42**	**1.18**	**1.19**	**1.46**	**1.59**	**2.26**	**0.11**	**0.99**	**0.22**	**0.93**	**0.72**	**(0.09)**
DPS	**1.10**	**0.30**	**-**	**0.80**	**-**	**1.25**	**0.80**	**-**	**0.45**	**-**	**-**	**-**

Source: Company Accounts, IGI Research *No. of Shares: 908.9mn*

Ethylene prices remained high during year, while PVC prices witnessed sluggish growth; core delta dropped by 7%YoY to 340 USD/ton

During 2018, international PVC prices witnessed a slight increase of +3%YoY, averaging at USD 920/ton. On the flip side, ethylene prices climbed aggressively (+9%YoY) to 1,165 USD/ton on the back of high feed costs and tight supply amid cracker turnarounds. Hence, PVC core delta decreased by 7%YoY to 340 USD/ton for CY18.

Ethylene prices remained volatile touching a high of USD ~1,200/ton by mid-year and dropping down to USD 845/ton by year end. As a result, core margins of PVC-ethylene increased from an average of USD 362/ton during the 9MCY18 to 426 USD/ton by 4QCY18. However, the benefit has rather been not reflective in EPCL gross margins, which saw sequential decline, from 29% in 1QCY18 to 20% in 4QCY18. Key reasons behind tepid margins include, upward gas price revision effective from Oct-18 with limited price pass-over and high cost inventory on-hand.

Exhibit: **After touching a low in Dec-18, Ethylene prices finally started to cross USD 1,000/ton mark by Feb-19**

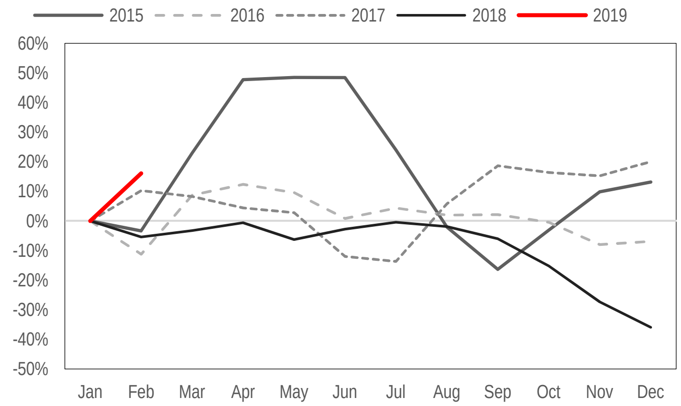
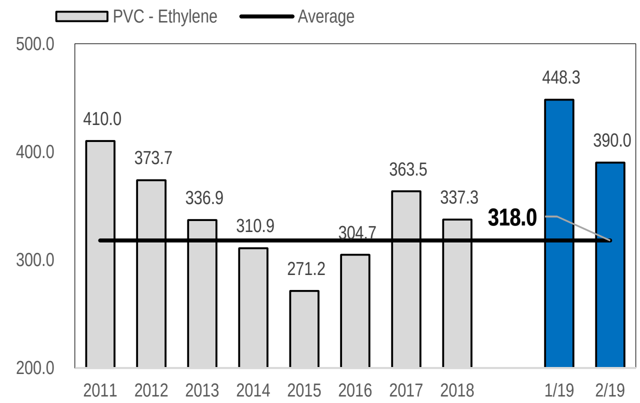


Exhibit: **Low ethylene prices have helped push EPCL core margins to historic high level**



Source: IGI Research, Company Accounts

Ethylene prices have rebounded strongly beginning CY19

Nevertheless, ethylene prices have yet again recovered crossing USD 1,000/ton mark during Feb-19, up by nearly +25% since Dec-18, but remained below its 5-year historic average of USD 1,190/ton. However, prices may follow a softer tone for the remaining year with ethylene capacities coming online amid downstream cuts, leading to declining demand and increasing supply, thereby changing demand-supply dynamics.

Global new ethylene capacities are set in motion: From a long term perspective, global ethylene capacity additions are in process for the next nine years (totaling 280mtpa). Major additions are coming up in China and USA, where ample feed supply and high demand in downstream products have necessitated new expansions. Some of these capacities are expected to come online in CY19 with supplies in Asia already increased to 3.5% in 2019 (S&P Global Analytics)

Exhibit: **Global Ethylene Capacity Additions (MTons)**

Year	2017	2026	Estimated plant add.
China		22	36
USA		16	17
Iran		11	17
Russia		7	11
Indonesia		-	7
South Korea		-	7
India		-	12
Qatar		-	2
Egypt		2	2
Brunei		-	1
Total Capacity	**184**	**242**	**112**
Supply Growth		3.07%	

Source: IGI Research, Hydrocarbons-Technology

Asian PVC supply concerns awaits; demand to remain strong

Demand for PVC in Asia is expected to remain strong given growing private consumption and infrastructure developments. However, supply side might be a concern given China is cutting back on its production (due to environmental regulations). Hence, prices are likely to stay firm, backed up by seasonal demand from India during the 1H2019.

Earnings to grow significantly from CY20 onwards; however, medium-term attrition may persist

The company witnessed highest profitability of PKR 4.93bn (EPS: 5.42) during CY18, increasing gradually from CY16. Profitability entered in the positive territory in CY16 after witnessing losses in the preceding years, mainly on account of a) improved PVC-ethylene margins, b) steady growth in PVC market, c) imposition of anti-dumping duties (ADD) and d) steady growth in high margin caustic soda have aided well to company's bottom-line growth.

In-line with the trend seen, the company is expanding its business (PVC expansions) while adding up its product portfolio (caustic flakes and hydrogen peroxide). We see EPCL forward earnings of PKR 4.76/share and PKR 4.42/share for CY19/20.

In spite of this we believe, earnings may start to build up from CY20 onwards (PKR 5.59/share for CY21) as impact of subsequent capacity expansions will be materialized fully. Growth in earnings will also be supported by stable core delta (320 USD/ton) with international pricing dynamics of ethylene turning favorable (softer ethylene prices).

Exhibit: **Earnings and Multiple**

	CY16A	CY17A	CY18A	CY19E	CY20F	CY21F
EPS	0.72	2.26	5.42	4.76	4.68	5.53
DPS	-	1.25	1.10	1.00	1.00	2.25
P/E(x)	51.41	16.40	6.83	7.78	7.91	6.74
EV/EBITDA (x)	14.18	8.55	3.94	4.45	3.93	3.06
Div. Yield (%)	-	-	2.97%	2.70%	2.70%	6.07%

Source: IGI Research, Company Accounts

Exhibit: **EPCL Capital Expenditure (PKRbn) and efficiency projects**

Projects	Add.(ktpa)	Project Type	Commencement Date	Estimated Capital Expenditure	Cumulative CAPEX
Sodium Hypochlorite/chloride	-	Debottlenecking	Sep-18	0.2	0.2
Caustic Soda Membrane for Efficiency	-	Efficiency	Sep-18	0.6	0.8
Gas Turbines	-	Efficiency	Sep-18	0.2	1.0
Other	-	Efficiency	Dec-18	1.4	2.4
Caustic Flakes	20	Greenfield	Mar-19	0.3	2.7
Polyvinyl Chloride (PVC)	100	Brownfield	Sep-20	7.6	10.3
Vinyl Chloride Monomer (VCM)	50	Debottlenecking	Sep-20		
Hydrogen Peroxide (HP)	25-30	Greenfield	Sep-20	3.1	13.4
VCM / Ethylene Di Chloride (chloride to Oxygen) HCL		Efficiency	Dec-20	1.2	**14.6**

Source: Company Accounts, IGI Research

PVC plant expansion in motion

The company is in the process of expanding its capacity in PVC by 100k tons, which is expected to come online by the end of 2020. To fund its capex requirement, the company raised PKR 5.4bn through right share issue and recently availed Ijarah based financing facility of US 35mn (PKR 5.0bn) with IFC to partial fund the expansion project.

Operational efficiencies- shifting to oxygen based VCM technology

Furthermore, as part of process improvement, EPCL will make use of oxygen based VCM technology (capex of USD 9mn), thereby reducing its raw material consumption by 2%, and providing cushion to the input costs (positive EPS impact PKR ~0.5/share). The project will be funded through internal cash generation.

Caustic Flake to sweeten the pot

EPCL also has plans to introduce a variant of caustic soda, namely, caustic flake in its chlor-alkali segment. The production capacity will be 20k tons and is expected to come online in Mar-April 2019. With this new product addition, the company can also tap in to export markets, in addition to the local industry, enhancing its market share. The new variant is expected to be offered at a price of 10-15% above that of caustic soda.

Exhibit: **Segment margins**

	2011	2012	2013	2014	2015	2016	2017
PVC	11%	15%	17%	2%	12%	18%	22%
Caustic Soda	49%	50%	50%	45%	45%	32%	42%

Source: Company accounts, IGI Research

New product in the offing-entry into Hydrogen Peroxide underway

The company has also planned to enter into hydrogen peroxide (HP) business (20-25k tons of expected capacity) with a capex of USD23mn where DOL and SPL have dominated the market, catering mostly to Northern region. The company produces hydrogen as a waste product from its electrolysis process which will be utilized for the production of hydrogen peroxide. As per our estimates, the business will contribute PKR 1.69/share to the company's value.

Key Catalysts

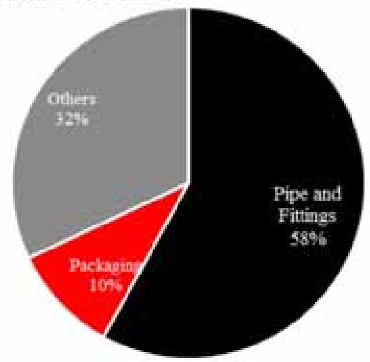
- *Sole producer of PVC-advantage of premium pricing:* EPCL enjoys the monopoly of being the sole producer of PVC in Pakistan, having a competitive advantage to charge at premium pricing. Demand for the product has remained robust (4Yr-CAGR of 9%) spurred by strong activities in the downstream sectors (pipe and fittings, construction activities). The company is operating at full capacity and has maintained its market share of 70%.

Exhibit: **PVC market**

kTons	2013	2014	2015	2016	2017	2018	5Yr CAGR
PVC Market	170	160	182	218	242	254	8%
EPCL	139	124	149	168	187	203	8%
Import	31	36	33	50	55	51	10%

Source: Company accounts, IGI Research

Exhibit: **PVC Demand**



- *Anti-dumping duty-a plus point but now a concern:* The imposition of anti-dumping duty (3%-21%) by NTC in the year 2017 has given favorable advantage to the company, safeguarding against threat from local importers. However, recently the government has withdrawn regulatory duty (2%) on imported resin, the impact of which translates negatively to PKR 0.30/share for EPCL.

- *PKR depreciation – reaping more margins:* Currency devaluation impacts favorably to EPCL's bottom-line owing to imported parity principle. With local PVC prices determined by international prices, the company in this regard can easily pass on the impact of devaluation, thereby reaping additional margins. As per our calculation, for every 3% PKR depreciation, the impact is a positive PKR 0.30/share.

Exhibit: **PVC-Ethylene Margins and PKR exchange rate sensitivity to (2019EPS)**

		PKR/USD					
		137	**141**	**145**	**150**	**154**	**159**
PVC-ethylene Margins (USD/ton)	**300**	3.2	3.4	3.6	3.9	4.1	4.3
	320	3.8	4.0	4.3	4.5	4.8	5.0
	335	4.3	4.5	4.8	5.0	5.3	5.5
	350	4.7	5.0	5.2	5.5	5.8	6.1
	365	5.2	5.4	5.7	6.0	6.3	6.6

Recommendation

We have a **"BUY"** call on the scrip based on our Dec-19 target price of PKR 48/share offering +30%upside from its last closing. The stock is currently trading at P/E of 7.8x and offers a dividend yield of 2.7%. Although on P/E basis, the stock is trading relatively higher (7.80x), assuming forward market P/E of 7.6x, potential value unlocks in CY20/21 onwards when impact of expansions and new business translates.

Exhibit: **Stock price hovering at mid-range P/E of 6.0x and 8.0x**

Exhibit: **P/E performance during CY18**

Source: IGI Research, Company Accounts

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Recommendation	Rating System
Buy	If target price on aforementioned security(ies) is more than 10%, from its last closing price(s)
Hold	If target price on aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
Sell	If target price on aforementioned security(ies) is less than -10%, from its last closing price(s)

Time Horizon: Dec – 2019

Valuation Methodology: The analyst(s) has used following valuation methodology to arrive at the target price of the said security (ies):
(Discounted Cash Flow)

Risk: Investment in securities are subject to economic risk, market risk, interest rate risks, currency risks, and credit risks, political and geopolitical risks. The performance of company (ies) covered herein might unfavorably be affected by multiple factors including, business, economic, and political conditions. Hence, there is no assurance or guarantee that estimates, recommendation, opinion, etc. given about the security (ies)/company (ies) in the report will be achieved.

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