Day Break

Wednesday, 23 May 2018

COMPANY UPDATE

Engro Fertilizers Limited
Fertilizer

Recommendation			**BUY**
Target Price:			84.3
Last Closing:	22-May-18		74.9
Upside:			12.6
Valuation Methodology:	Discounted Cash Flow (DCF)		
Time Horizon:			Dec-18

Market Data

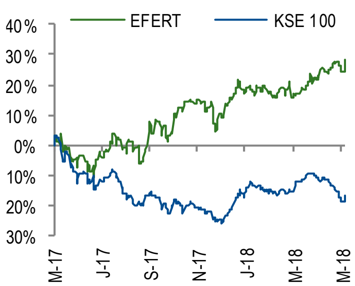
Bloomberg Tkr.		EFERT PA
Shares (mn)		1,335.3
Free Float Shares (mn)		600.9
Free Float Shares (%)		45.0%
Market Cap (PKRbn | USDmn)	100.0	865.6
Exchange		KSE 100

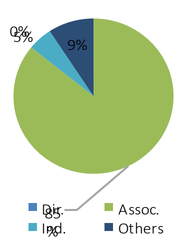
Price Info.	90D	06M	12M
Abs. Return	10.0	12.3	28.3
Lo	67.4	61.0	51.9
Hi	74.9	74.9	74.9

Key Company Financials
Period End: Dec

PKRbn	**CY17A**	**CY18E**	**CY19F**	**CY20F**
Total Revenue	77.1	84.2	86.6	87.8
Net Income	11.2	11.0	11.7	12.1
EPS (PKR)	8.4	8.3	8.8	9.1
DPS (PKR)	8.5	7.0	8.0	8.0
Total Assets	111.8	93.2	101.3	91.3
Total Equity	42.5	44.2	45.2	46.7
Key Financial Ratios				
ROE (%)	26.3	25.0	25.9	26.0
P/E (x)	9.0	9.1	8.5	8.2
P/B (x)	1.0	2.4	2.3	2.2
DY (%)	11.3	9.3	10.7	10.7

Relative Price Performance





About the Company

The Company is a public limited company incorporated on June 29, 2009 in Pakistan as a wholly owned subsidiary of Engro Corporation Limited. The principal activity of the Company is manufacturing, purchasing and marketing of fertilizers.

Source: Bloomberg, PSX & IGI Research

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Fertilizer

EFERT: Earnings revised post-budget; "BUY" call intact

- We revisit our investment case on the scrip, wherein we have revised our earnings estimates upwards after incorporating budgetary measures, 1QCY18 financial accounts and changes in our pricing assumption.
- For the 1QCY18 the company recorded impressive growth in its earnings attained at PKR 3.89bn (EPS: PKR 2.91) led by healthy offtake in urea and DAP along with improved retention prices.
- With respect to budgetary measures decrease in tax rates and corresponding removal of subsidy will serve to bode well in easing down receivables while giving manufacturers advantage over pricing power (as can be signaled from the recent price increase of PKR~100/bag in urea)
- Taking all the aforementioned measures in to account will result in our revised earnings estimates of PKR (8.28/8.79/9.10)/share for CY18E/CY19F/CY20F.
- We prefer EFERT as our top pick in IGI Fertilizer universe with our revised Dec-18 target price of PKR 84.3/share offering +13% upside from its last closing. The company is currently trading at CY18E P/E of 9.1x and offers an attractive dividend yield of 9.3%.

We revisit our investment case on EFERT, wherein we have revised our earnings estimates upwards after incorporating budgetary measures, 1QCY18 financial accounts and changes in our pricing assumption. For the 1QCY18 the company recorded impressive growth in its earnings attained at PKR 3.89bn (EPS: PKR 2.91) led by healthy offtake in urea and DAP along with improved retention prices. With respect to budgetary measures decrease in tax rates and corresponding removal of subsidy will bode well in easing down receivables while giving manufacturers advantage over pricing power (as can be signaled from the recent price hike of PKR~100/bag in urea) amid low inventory levels. In addition, the input-output tax disparity that existed will be further widened leading to piling up of sales tax refundable (although the quantum is relatively less when compared to outstanding subsidy amount). Furthermore, continuation of super tax charge will dent earnings in the short-term (for CY18 and CY19) but its impact will ward off with gradual reduction in corporate tax rate by 1% each year. Integrating all these changes in our assumptions will result in revised earnings estimates of PKR (8.28/8.79/9.10)/share for CY18E/CY19F/CY20F. Consequently, our target price will be revised upwards by ~5% to PKR 84.3/share from our previous target price of PKR 80.5/share.

Healthy offtake in urea along with improved retention prices lifted 1QCY18 earnings by +2xYoY to PKR 3.9bn (EPS: PKR 2.91)

The company witnessed massive surge in its profitability during 1QCY18, achieving +137%YoY growth to PKR 3.9bn (EPS: PKR 2.91) v/s PKR 1.6bn (EPS: PKR 1.24) in the same period last year. This was largely driven by a) high urea offtake tuning at 497k tons and b) high domestic prices of urea and DAP (leading to improved DAP margins in the range of PKR 200-250/bag). For DAP in particular, multiple factors such as pre-buying (anticipation of international price increase) and demand from farmers (driven by coupon based subsidy) spurred healthy sales during the period. This resulted in net sales of PKR 18.2bn attaining growth of +81%YoY. In addition, enhancement to the topline also came from improved sales of blended fertilizer which increased by +42%YoY to 44k tons. Moreover, further accretion to earnings stemmed from reduced finance cost (PKR 0.52bn vs PKR 0.67bn) owing to subsequent debt repayments.

Budgetary measures (FY18-19)

To recall the government in its budget (FY18-19) announced various measures for the fertilizer sector. As such these pertained to a) reduction in sales tax to 2% across all fertilizer products b) 5% reduction in sales tax for feed gas, previously charged at 10% c) removal of subsidy on urea (PKR 100/bag) and d) imposition of super tax charge (3%) and corporate tax (30%) with 1% decline thereof each year. We have incorporated these measures in our assumptions to evaluate individual impact to our earnings estimates.

Reduction in tax rate on feed gas to 5% to cushion up earnings

The reduction in tax rate on feed gas by 5% (previously charged at 10%) will have minimal impact on our earing estimates on average by PKR ~0.12/share since most of the gas being utilized for production is charged at concessionary feed rate gas. However, we expect that with this measure the input and output tax disparity may worsen off leading to build up of sales tax refundable (currently at PKR 1.1bn), thereby impacting cash flows.

Removal of subsidy on urea with tax rate reduced to 2%; impact countered by price hike

Previously, the sales tax rate on urea was charged at PKR~70/bag or 5% of the price cap (PKR 1,400/bag). With the reduction in tax rate to 2% and removal of subsidy (PKR 100/bag) as highlighted in the budget, the manufacturer will have to undergo net impact of PKR ~60/bag. However, the recent pricing dynamics suggests the industry players have increased their prices by PKR ~100/bag (rationalizing subsidy removal) surpassing the price cap. Under this scenario, we have revised our pricing assumption (given the pricing momentum continues), increasing our prices for urea to PKR ~1,490/bag for CY18 and onwards. Hence, our earnings will have a positive impact of PKR~ 0.50/share or 5% on average for CY18-CY23F.

Continuation of supertax will dent earnings in the short-term

As per the tax measures enacted in the budget, imposition of super tax will chip away earnings by PKR~ (0.6-0.1)/share for CY18E/CY19F with the impact being significant for CY18 owing to 5% super tax charge. Hence, our earnings (inclusive of the impact from the above measures) will decline by 7% to PKR~ 8.28/share for CY18E. For CY19F the super tax effect will be partially nullified with the reduction in corporate tax rate to 29% which will be reduced henceforth by 1% each year to 25% by CY23. Accordingly, we see earnings to gain some traction by PKR~ (0.3-0.5)/share from CY20F onwards.

Taking all the aforementioned budgetary measures in to account will result in our earnings estimates to be revised upwards by +6% on average to PKR (8.79/9.10/9.23)/share for CY19F/CY20F/CY21F. For CY18E the net impact will result in downward revision in our estimates by 1% to PKR 8.28/share.

Exhibit:

Net impact on earnings estimates

	CY18E	CY19F	CY20F	CY21F
Pre-budget (EPS)	8.32	8.40	8.47	8.49
Net impact (PKR/share)	(0.04)	0.39	0.64	0.75
Post-Budget (EPS)	8.28	8.79	9.10	9.23
% change	-1%	5%	8%	9%

SOURCE: IGI Research

Recommendation

We prefer EFERT as our top pick in IGI Fertilizer universe with our revised Dec-18 target price of PKR 84.3/share offering +13% upside from its last closing. The company is currently trading at CY18E P/E of 9.1x and offers an attractive dividend yield of 9.3%.

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Time Horizon: Dec – 2018

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

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