Day Break

Thursday, 28 April 2016

IGI Securities
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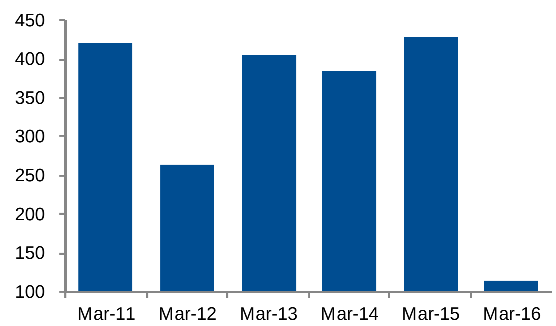
Sector Update

Industry Offtake (000'tons)

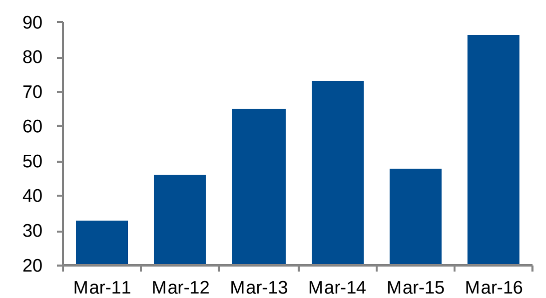
	Mar-16	YoY	1QCY16	YoY
Urea	114	-73%	770	-49%
Dap	86	80%	234	27%

Urea Industry Offtake (Ktons)



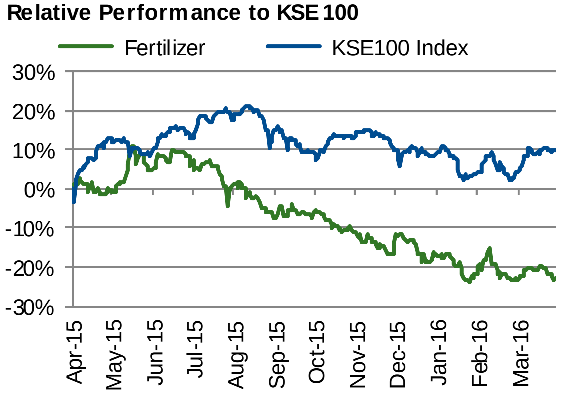
Source: NDFC & IGI Research

DAP Industry Offtake (Ktons)



Source: NDFC & IGI Research

Relative Performance to KSE 100



Source: Bloomberg, KSE 100 & IGI Research

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Fertilizer Review

Depressed Sales in 3QCY16

- For 1QCY16, Urea offtake declined by 49%YoY to 770k tons whereas production increased by 17%YoY to 1.4mn tons. For the month of Mar-16, Urea offtake arrived at 114k tons, depicting a massive decline of 73%YoY.
- DAP offtake surged by +27%YoY to 234k tons in 1QCY16, primarily on the back of PKR 500/bag DAP subsidy announced by government in Oct-15 and discounts offered by producers to reduce the inventory level. In Mar-16, DAP offtake improved by +80%YoY.
- As per media reports (Source), Fertilizer manufacturers have agreed to reducing urea price further by PKR 70/bag, despite absorbing the impact of gas price hike in Sept-15 to the tune of PKR 160/bag. This would effectively take MRP price for urea to PKR 1,790/bag (USD 280/ton ex-gst) from current PKR 1860/bag, leading to depletion in gross margins and earnings for fertilizer manufacturers in IGI Universe.

Urea Offtake declined by 49%YoY in 1QCY16

For 1QCY16, Urea offtake declined by 49%YoY to 770k tons whereas production increased by 17%YoYto 1.4mn tons.For the month of Mar-16, Urea offtake arrived at 114k tons, depicting a massive decline of 73%YoY. Production however has increased by +20%YoY to 517mn tons, as a result of better gas supply and import of LNG by fertilizer sector. We attribute this offtake decline largely to weak farm economies due to weakening in commodity prices.

Company-wise Urea Offtake

FFBL witnessed increase of +1.2xYoY in urea offtake, whereas sales declined by 50%YoY, 43%YoY and 41%YoY for Fatima, FFC and EFERT during 1QCY16, respectively. For Apr-16, offtake went down for all the manufacturers where EFERT has recorded largest fall of 88%YoY.

Subsidies and discounts pushed DAP offtake up by +27%YoY in 1QCY16

DAP offtake surged by +27%YoY to 234k tons in 1QCY16, primarily on the back of PKR 500/bag DAP subsidy announced by government in Oct-15 and discounts offered by producers to reduce the inventory level. In Mar-16, DAP offtake improved by +80%YoY. EFERT posted +64%YoY growth in sales whereas FFBL witnessed 17%YoY drop in

1QCY16. On monthly basis FFBL managed to show rise of +19%YoY in DAP offtake in Apr-16, whereas sales for EFERT remained flat.

Exhibit: Company wise Offtake

kTons	Mar-16	Mar-15	YoY	3MCY16	3MCY15	YoY
FFC						
Urea	59	209	-72%	357	625	-43%
FFBL						
Urea	8	13	-35%	35	15	127%
DAP	34	29	19%	71	85	-17%
EFERT						
Urea	20	166	-88%	286	481	-41%
NP & NPK	10	15	-33%	9	28	-66%
DAP	8	8	0%	58	36	64%
Fatima						
Urea	15	29	-47%	48.83	98	-50%
NP	40	37	9%	63.76	100	-36%
CAN	10	17	-38%	60	81	-27%
NFML						
Urea	1	12	-95%	14	292	-95%

Source: NFDC & IGI Research

Urea Prices-Still in Pressure

As per media reports (Source), Fertilizer manufacturers have agreed to reducing urea price further by PKR 70/bag, despite absorbing the impact of gas price hike in Sept-15 to the tune of PKR 160/bag. This would effectively take MRP price for urea to PKR 1,790/bag (USD 280/ton ex-gst) from current PKR 1860/bag, leading to depletion in gross margins and earnings for fertilizer manufacturers in IGI Universe. FFC is estimated to witness the largest hit of ~PKR 1.09/share to its original estimated earnings of PKR 9.85/share for CY16. Profitability for EFERT is expected to drop by PKR 0.46/share whereas FFBL would likely loose PKR 0.27/share in earnings (estimations are based on the assumption of new urea price effective from 2QCY16).

Exhibit:Impact of PKR 70/bag price reduction in Urea

PKR/share	CY15A	CY16E	CY16E -postprice cut	Per share impact
FFC	13.18	9.85	8.76	1.09
FFBL	4.35	1.97	1.70	0.27
EFERT	11.29	8.39	7.93	0.46

Source: IGI Research

Exports- Avenue to bring down inventory levels

As per our discussion with managements, urea export is also on cards, since demand is expected to drop by 7%YoY in CY16 to 5.2-5.4mn tons, whereas production is probable to rise on the back of better availability of gas and LNG, which can result in year-end inventoryof 1.0-1.2mn tons. We are of the view that manufacturersare in discussion with GoP to allow export of excess production to India and Afghanistan. It is pertinent to mention that currently India imports urea from China at USD 220/ton which translates into PKR 1,160/bag, a 33% discount from local prices post PKR 70/bag reduction.

While we understand the urea price gap between international and domestic is substantial, however, in our view companies will be able to limit the profitability hit through lower export tax charges.

Outlook

Considering the reduced gap between international and domestic fertilizer prices, along with PKR 70/bag cut on cards for urea, we see reduced margins as a permanent phenomenon in CY16. Another gas price hike in Jun-16 (highly unlikely, in our view) would further deteriorate margins for manufacturers. On contrary, as per management talks, fertiliser companies are debating to bring back gas price to pre Sep-15 level, which when materialized could provide some respite to companies' margins. On sales side, we expect better Urea sales in 2QCY16 owing to Kharif season.

Recommendation

Fertilizer Sector (IGI Universe) has negatively performed by -12% in CY16TD as compared to +2% return by KSE-100. Our favorite pick in the sector remains EFERT with Dec-16 target price of PKR 97/share, offering 38% upside from last close.

Analyst Certification

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

Valuation Methodology

The analyst^ has used following valuation methodology to arrive at the target price of the said security (ies):

- DCF (Discounted Cash Flow)

Time Horizon

- Dec - 2016

Risk

- Changes in State Bank of Pakistan Policy Rate
- Changes in country (Pakistan) macro-economic environment
- Changes in Company(ies) operating structure
- Change in Exchange Rate (USDPKR)

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