Sector Update

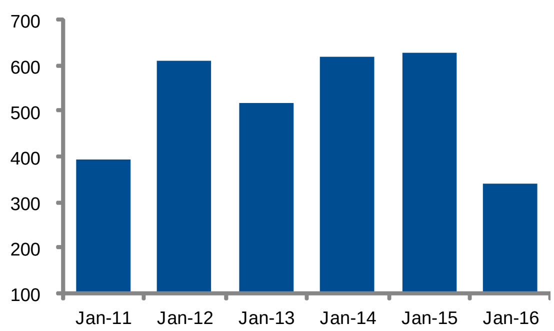
Thursday, 10 March 2016

Sector Update

Industry Offtake (000'tons)

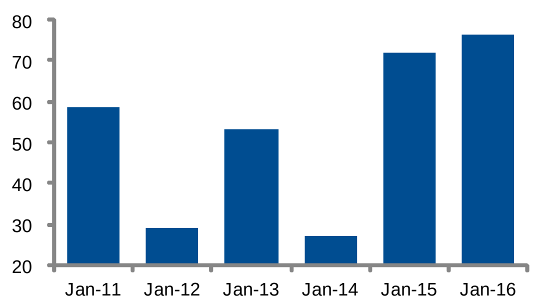
	16-Jan	YoY	CY15	YoY
Urea	341	-46%	5,616	0%
Dap	77	6%	1,797	7%

Urea Industry Offtake (Ktons)



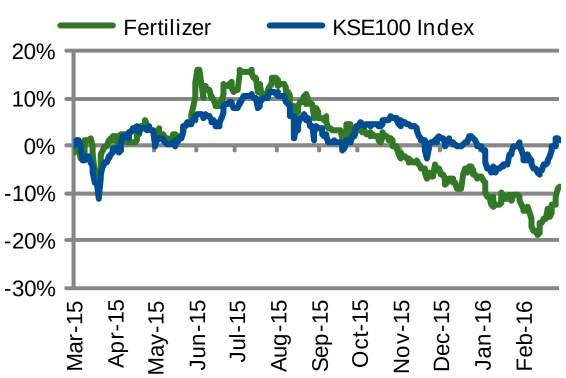
Source: NDFC & IGI Research

DAP Industry Offtake (Ktons)



Source: NDFC & IGI Research

Relative Performance to KSE 100



Source: Bloomberg, KSE 100 & IGI Research

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Fertiliser

2016: A Depressed Year For Fertilisers

Urea Price halved since 2014…

International Urea prices (Middle East) have nearly halved to USD 220/ton in Mar-16 from a high of USD 410/ton in Mar-14 (down by 46%), whereas prices have fallen by 26%YoY from ~USD 297/ton in Mar-15. This plunge in prices is primarily due to supply driven dynamics; as declining crop price failed to attract significance demand rise for fertilizers. In addition to aforementioned, a) drop in cost of global fertiliser production on the back of low input prices, b) new urea capacities coming online, and d) fall in major commodities prices following oil price dive, pushed prices further towards downfall.

Fertiliser Outlook: Prices to remain Under Pressure

Going forward, we foresee international urea prices to remain range bound at current levels owing to a) International urea market is expected to remain supply driven, since demand is expected to be more than offset by excess supply as a result of additional capacities coming online, b) dampened oil prices (we have assumed average level of USD 35-40/bbl and coal at USD 50/ton in 2016), will provide limited room for fertiliser cost escalation) lower production levels estimated for Wheat (723mnT, down by 1.4%) and Rice (total production/consumption is estimated at 498mn tons/493mn tons is estimated, having inventory level of 170mn tons) in 2016, according to Food and Agriculture Organization of United Nations, will keep crop prices unattractive.

Implication on Local Industry

The decline in International Urea prices has eroded the discount that was available with local manufacturers, thus restricted the room to raise domestic prices. Looking ahead, for local manufacturers, weak pricing power along with tumbled crop prices and inflated gas tariff, margins are likely to remain under pressure in CY16.

A looming risk of urea import allowed by government in Feb-16, seems to have dried up with recent recovery in international urea prices which is likely due to demand from USA. However, import of urea by private investors in the wake of fall in commodity prices can exert pressure on domestic manufacturers to reduce the prices, further stressing margins, in our view.

On the production front, permanent allocation of 60mmcfd gas to fertiliser sector would bode well for FFC and FATIMA while negative for EFERT.

Exhibit: International Urea Prices vs Oil

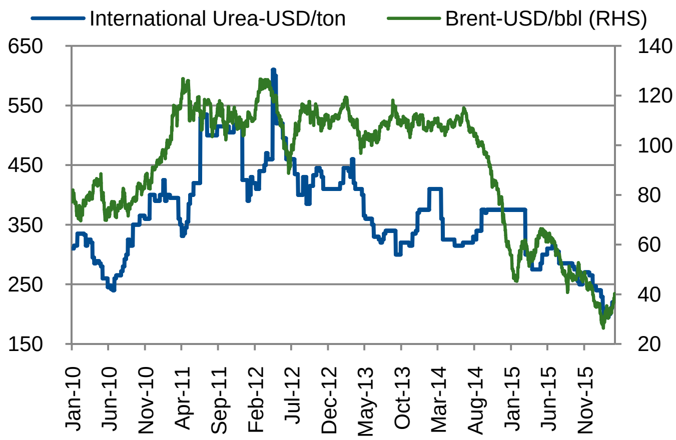
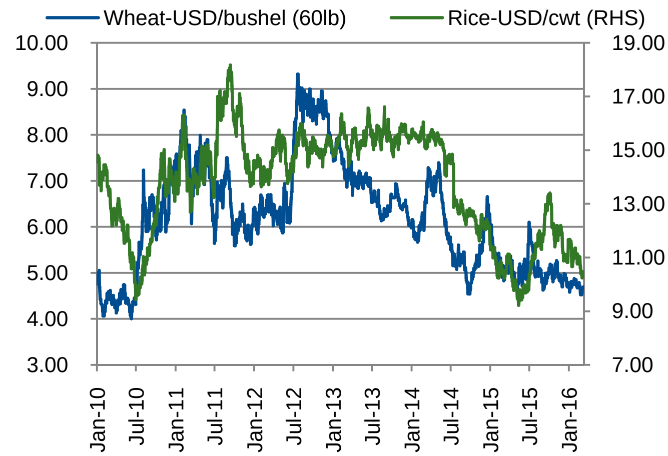


Exhibit: Declining Major Crop Prices



Source: IGI Research, Bloomberg

Fertiliser off-take – Tepid January Sales

Urea offtake in Jan-16 declined by a substantial 46%YoY to 341k tons, which in our view is primarily on the back of higher off-take in Dec-15. FFC reported highest drop of 34%MoM to the tune of 152k tons.

Production on the other hand improved by +6%YoY in Jan-16. DAP offtake inched up by +6%YoY to 77k tons, whereas imports and production went up by +57%YoY and +11%YoY, respectively in Jan-16.

Exhibit: Company wise Off take

kTons	Jan-16	Jan-15	YoY	CY15	CY14	YoY
Industry						
Urea	341	629	-46%	5,616	5,628	0%
DAP	77	72	6%	1,797	1,683	7%
FFC						
Urea	152	232	-34%	2,408	2,370	2%
FFBL						
Urea	8	2	211%	303	214	42%
DAP	12	28	-57%	748	709	6%
EFERT						
Urea	138	167	-17%	1,879	1,820	3%
NP & NPK	2	5	-58%	137	119	16%
DAP	39	10	278%	391	403	-3%
Fatima						
Urea	30	39	-22%	444	371	20%
NP	7	36	-80%	282	343	-18%
CAN	21	20	4%	351	426	-18%
NFML						
Urea	12	187	-94%	520	761	-32%

Source: NFDC & IGI Research

Fauji Fertiliser Company Limited (FFC)

Profitability declined by 8%YoY to PKR 13.18/share

Fauji Fertiliser Company (FFC) posted profitability of PKR 17bn (EPS PKR 13.18) in CY15, depicting a decline of 8%YoY, primarily due to a) gas tariff hike in Sept-15 tearing down margin by 12%QoQ to 27% in 4QCY15, b) lower crop prices and weak farm economies resulting in subdued pricing power, and c) 74%YoY higher financial cost in CY15 since company had to borrow post GIDC expense 2QCY15.

To be an Under-Dog

Going forward, we expect company to remain under the grip of lower urea prices, resulting in depressed earnings and margins. Company's borrowings to the tune of PKR 38bn in CY15 versus PKR 16bn last year, would likely result in higher financial cost leading to inclined profitability. Other income from FFBL is anticipated to witness curtailment on back of further investments expected in Noon Pak, however higher dividends from AKBL and FCCL might provide some respite to earnings. Future dividends from Fauji Fresh and Freeze (FFF), which started operation from Jan-16 and FFC Energy Limited (payout dependent upon financial covenants) will provide boost to earnings in the years ahead. Although allocation of 34mmcfd gas can be positive for the company if the production can be increased from current 121% utilization level.

Exhibit: Financial Highlights-FFC

PKR mn	CY15	CY14	YoY	4QCY15	4QCY14	YoY
Net Sales	84,831	81,240	4%	30,537	26,201	17%
Cost	55,949	50,137	12%	22,290	16,878	32%
Gross Profit	28,882	31,103	-7%	8,248	9,323	-12%
Dist. Expense	6,814	6,432	6%	1,835	1,821	1%
Opt. income	6,194	4,721	31%	1,826	1,232	48%
Other Expenses	2,285	2,303	-1%	643	672	-4%
EBIT	25,978	27,090	-4%	7,595	8,062	-6%
Interest Expense	1,475	849	74%	512	243	111%
PBT	24,503	26,241	-7%	7,083	7,819	-9%
Tax	7,737	8,070	-4%	2,263	2,610	-13%
PAT	16,766	18,171	-8%	4,820	5,209	-7%
EPS	13.18	14.28		3.79	4.09	
DPS	11.86	13.65		3.42	3.50	
Key Ratios						
Gross Margin	34%	38%		27%	36%	
Net Margin	20%	22%		16%	20%	
Effective Tax Rate	32%	31%		32%	33%	

Source: IGI Research, Company Financials

Fauji Fertiliser Bin Qasim Limited (FFBL)

Earnings clocked in at PKR 4.35/share, up by 1%YoY

Fauji Fertiliser Bin Qasim's (FFBL) profitability inched up by +1%YoY to PKR 4.1bn (EPS PKR 4.35) in CY15, whereas earning jumped by +54%YoY in 4QCY15to PKR 3.3bn (EPS PKR 3.55)largely on the back of a) +44%YoY growth in DAP offtake to 442ktons and b) PKR 500/bag subsidy announced by government in Oct-15.

Diversification still on the Map

Company is planning to invest further PKR 2.55bn in Noon Pakistan and PKR 5.5bn in 118MW coal power plant. With an IRR of 18.38%, coal project is expected to commence by 1QCY17, whereas Nepra has already awarded Tariff in Dec-15. We believe this would provide core value to the business in terms of additional production, as company would be using coal power plant for fuel generation instead of gas. Further value would be added from Fauji Meat Limited which has started its testing activities and dividends from 99MW Fauji Wind Power Plants.

Exhibit: Financial Highlights-FFBL

PKR mn	CY15	CY14	YoY	4QCY15	4QCY14	YoY
Net Sales	52,182	49,445	6%	27,131	20,788	31%
Cost	44,968	38,353	17%	24,405	15,837	54%
Gross Profit	7,214	11,092	-35%	2,726	4,951	-45%
Dist. Expense	3,820	3,314	15%	1,467	1,022	44%
Admin. Expense	1,427	1,318	8%	511	331	54%
Oth. Income	5,683	1,063	435%	4,563	275	1558%
Oth. Op. Exp.	399	430	-7%	334	248	35%
EBIT	7,252	7,093	2%	4,976	3,625	37%
Finance Cost	1,868	1,313	42%	447	282	59%
EBT	5,384	5,780	-7%	4,529	3,343	35%
Tax	1,322	1,764	-25%	1,215	1,195	2%
Net Profit	4,062	4,016	1%	3,314	2,148	54%
EPS	4.35	4.30		3.55	2.30	
DPS	3.80	3.70		3.05	2.25	
Key Ratios						
Gross Margin	14%	22%		10%	24%	
Net Margin	8%	8%		12%	10%	
Effective Tax Rate	25%	31%		27%	36%	

Source: IGI Research, Company Financials

Engro Fertiliser (EFERT)

Earnings posted remarkable Growth of 83%YoY to PKR 11.29/share

Engro Fertilisers (EFERT) posted remarkable +83%YoY growth in its profitability to PKR 15.03bn (EPS PKR 11.29) in CY15 compared to PKR 8.21bn (EPS PKR 6.17) in same period last year. The extraordinary financial performance of the company is attributed to a) +3%YoY increase in urea offtake, b) 70 cents gas provision for Enven Plant from 2QCY15, c) continued flow of 60mmcfd gas to new urea plant, d) PKR 300/bag subsidy announced in Oct-15, and e) 31%YoY plunge in finance cost due to lower interest rates and debt prepayments.

70 cents and DAP business to Rescue

Amid availability of 70cents gas, company has an edge over other domestic producers due to stretched margins. DAP importing business also provides diversification benefit to the company. However diversification of gas from EFERT to other producers can curtail the earnings for CY16 to the tune of PKR2.0-2.5/share, while we believe company would be able to secure additional gas reserves from Mari field for its operation.

Exhibit: Financial Highlights-EFERT

PKR mn	CY15	CY14	YoY	4QY15	4QCY14	YoY
Revenue	87,615	61,425	43%	35,687	17,733	101%
Gross Profit	32,180	22,603	42%	11,477	6,687	72%
Selling and Distribution	5,453	4,441	23%	2,265	1,378	64%
Other Income	1,707	2,449	-30%	268	-162	-265%
Finance Cost	4,588	6,625	-31%	1,028	1,664	-38%
Profit before Tax	21,169	11,895	78%	7,557	3,722	103%
Tax	6,141	3,687	67%	2,434	1,025	137%
Profit after tax	15,027	8,208	83%	5,123	2,697	90%
EPS	11.29	6.17		3.85	2.03	
DPS	6.00	3.00		3.00	3.00	
Key Ratios						
Gross Margin	37%	37%		32%	38%	
Net Margin	17%	13%		14%	15%	
Effective Tax Rate	29%	31%		32%	28%	

Source: IGI Research, Company Financials

Recommendation

Fertiliser Sector (IGI Universe) has negatively performed by -3% in CYTD as compared to 0.43% return by KSE-100 in same period. However with recent increase in international urea prices and permanent supply of 60mmcfd gas diverted from power sector, fertilizer industry has gained +5% in month of Mar-16 so far. Our favorite pick in the sector remains EFERT with Dec-16 target price of PKR 97/share, offering 25% upside from last close.

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Valuation Methodology

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

- Free Cash Flow (FCF)

Time Horizon

- Dec-16

Risk

- Changes in State Bank of Pakistan Policy Rate
- Changes in country (Pakistan) macro-economic environment
- Changes in Company(ies) operating structure
- Gas shortage
- Gas Price Hike
- Decline in International Urea Prices

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