Day Break

Wednesday, 29 March 2017

Sector Update

Recommendation

	TP	P/Ex (2017)	DY% (2017)	RECOM.
FFC	114	11.04	8%	9%
EFERT	86	7.31	10%	32%
FFBL	59	15.76	5%	9%
FATIMA	43	7.76	8%	12%

TP= Target price based on Dec-17 (PKR)
CP= Last day closing price (PKR)
RECOM. = Recommendation

Exhibit: Urea/DAP Offtake (KTons)

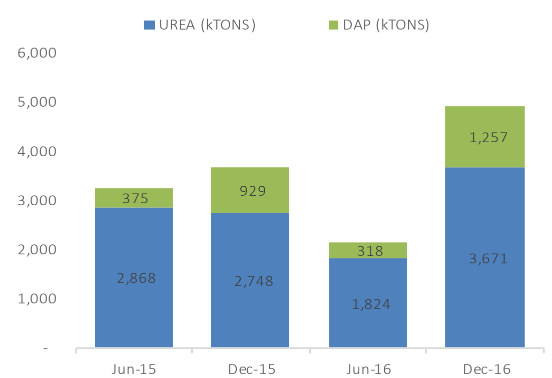
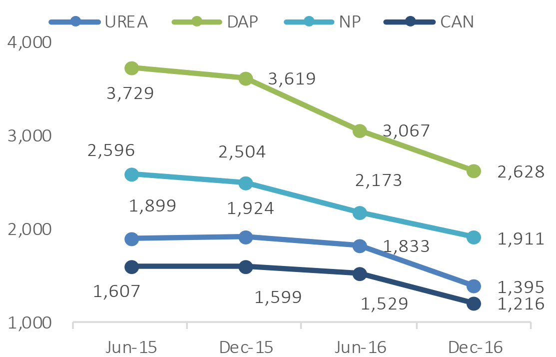
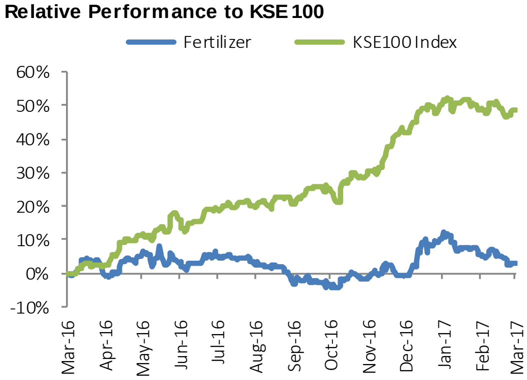


Exhibit: Fertilizer Product Prices (Local)



Relative Performance to KSE 100



Source: Bloomberg, KSE 100 & IGI Research

Analyst

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Fertilizer

Urea volumes to increase; leading to relatively better earnings prospects for Sector in CY17

- Fertilizer secotr's profitability was down by 29%YoY in CY16 as compared to last year. FFBL posted highest decline of 69%YoY to PKR 1.3bn followed by EFERT and FFC down by 43%YoY and 30%YoY to 9.02bn and 11.7bn. Whereas, FATIMA posted a growth of +6%YoY to PKR 9.8bn.
- In terms of earnings, we estimate CY17 would churn out better than last year owing to +8%YoY (including export of 0.3mn) growth in urea offtake in CY17 on the account of, a) lower urea prices as we expect government subsidy to continue, and b) approval of export. However, this would also mean overall gross margins to stay depressed in CY17
- Fertilizer Sector (IGI Universe) has underperformed by 46% in FY17TD. EFERT and FATIMA are our preferred picks in the sector based on inexpensive valuation compared to peers with target price of PKR 86/share and PKR 42/share, offering upside potential of +32% and +12%, trading at CY17 P/E of 7.3x and 7.76x respectively.

CY16 was challenging year for fertilizer sector mainly owing to slow offtake during 1HCY16 and lower retention prices during the year. As a result, IGI fertilizer sector's profitability dropped by 29%YoY to PKR 31.9bn. Going forward, we believe that urea offtake is expected to pick up by +8%YoY (including export of 0.3mn) in CY17 on the account of, a) lower urea prices as we expect government subsidy to continue, and b) approval of export. On DAP, we suspect rising international DAP prices could ward-off further imports, which could create tighter supply conditions in 2QCY17 and eventually leading government authorities to re-consider DAP prices/subsidy on DAP.

Amongst our coverage companies we recommend EFERT purely on the basis of attractive valuation multiples, trading at CY17 forward P/E of 7.31x with a +31.3%YoY earnings growth expected in CY17, followed by FATIMA.

Lower retention prices of Urea and DAP, batter earnings in CY16

Fertilizer sector's profitability was down by 29%YoY in CY16 as compared to last year attributed to drop in retention prices of urea/DAP and flattish volumetric growth. Among the fertilizers manufacturers, FFBL posted highest decline of 69%YoY to PKR 1.3bn followed by EFERT and FFC down by 43%YoY and 30%YoY to 9.02bn and 11.7bn (EPS PKR 1.43, 6.78 and 9.26) respectively. Whereas, FATIMA posted a growth of +6%YoY to PKR 9.8bn (EPS PKR 4.66) on the back of increase in offtake by +12%YoY primarily owing to hefty discounts offered by company.

Exhibit: Gross Profit Margins (including Subsidy)

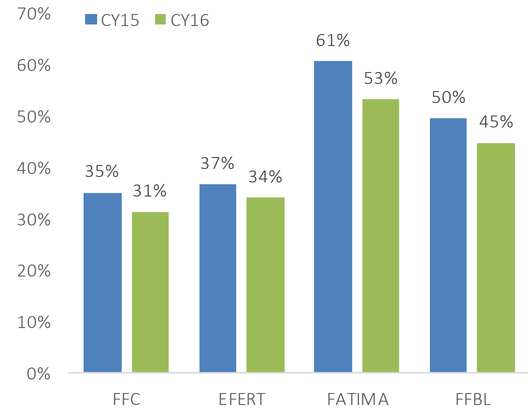


Exhibit: Urea ending inventories in kTons

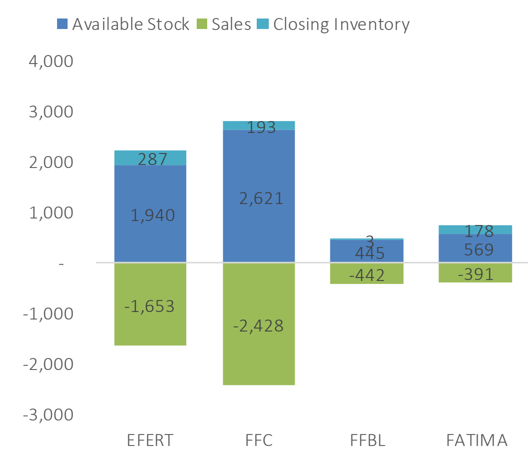
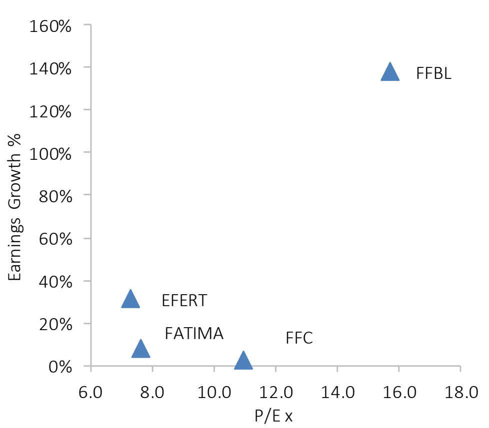


Exhibit: IGI Fertiliser Sector - P/E to Earnings Growth %



Source: NFDC, Bloomberg, Company Acc.

Supply dominated demand

Industry demand remained depressed during 1HCY16 on the back of weak farm economics and expectation of price reduction through government subsidy. Whereas, availability of gas/LNG during the year kept production numbers high throughout the year. As result 1HCY16 ended with higher inventory levels (May-16 recorded highest ever urea inventory of 1.7mnTon). However, inventory levels did subsided eventually in 2HCY16 following announcement of subsidy on both Urea and DAP prices by government, leading to urea/DAP offtake increased by +2.0x/+3.9x to 3.7/1.26mn tons.

Gross margins decline to 39%

Gross margins (including subsidy) of fertilizer sector recorded drop by 382bps to 39% during the year CY16. This decline is due to lower retention prices of fertilizer products. To recall that government of Pakistan (GoP) in budget FY17 reduced urea price to PKR 1,400/bag from PKR 1,790. This was achieved through a combination of price reduction mechanism, price cut by manufacturers (PKR 50/bag), cash subsidy (156/bag) and GST reduction from 17% to 5%. For DAP cash subsidy of PKR 300/bag was announced to reduce prices to PKR 2,500/bag. Moreover high inventory level forced urea manufacturers to offer discounts of PKR 100-150/bag.

Outlook: +8%YoY growth in Urea offtake, leading to better earnings prospects in CY17, but margins likely to stay depress…

In terms of earnings, we estimate CY17 would churn out better than last year owing to +8%YoY (including export of 0.3mn) growth in urea offtake in CY17 on the account of, a) lower urea prices as we expect government subsidy to continue, and b) approval of export. However, this would also mean overall gross margins to stay depressed in CY17.

…while for DAP, lower margins could potentially impede DAP imports

Recently Phosphoric acid prices have surged to USD 590/ton after experiencing a temporarily drop to USD 550/ton. We suspect Phosphoric acid prices are likely to settle in the region of USD 590/ton at least till 2QCY17 owing to established prices in India, which has historically dictated prices for Pakistan as well. This increase in phosphoric acid along with supply tightening of DAP in international market has led to increase in International prices of DAP, to USD 375/ton, up by +17% from a low of USD 320/ton recorded in Dec-16. Henceforth, given higher international DAP prices combined with capped local DAP prices (as per our talks with the company management, price negotiations with government authorities are still underway). We view local DAP importers margins could come under pressure, restriciting further import of DAP. With DAP demand in 2QCY17 projected at 198kTons and given limited imports, we suspect DAP could face a shortfall, leading government authorities to re-consider DAP prices/subsidy on DAP.

Recommendation

Fertilizer Sector (IGI Universe) has underperformed by 46% in FY17TD. EFERT and FATIMA are our preferred picks in the sector based on inexpensive valuation compared to peers with target price of PKR 86/share and PKR 42/share, offering upside potential of +32% and +12%, trading at CY17 P/E of 7.3x and 7.76x respectively.

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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 priceon aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
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Time Horizon: Dec - 2017

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

Risk: Investment in securities are subject to economic risk, market risk, interest rate risks, currency risks, credit risks, political and geopolitical risks. The performance of company(ies) covered herein mightunfavorably 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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