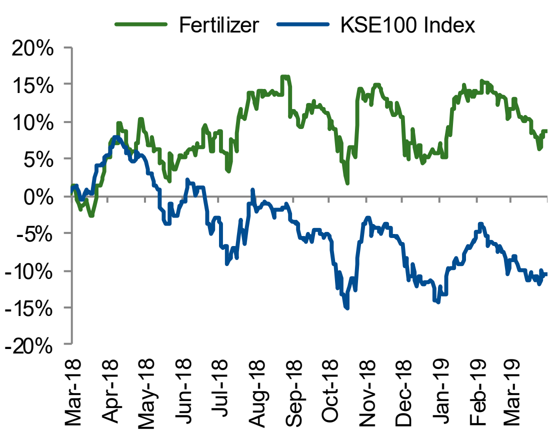
Day Break

Monday, 08 April 2019

Sector Update

Sym	Target price	P/E 2019	D/Y2019	Recomm.
EFERT	82.4	5.9	15.5%	BUY
FFC	109.9	8.6	9.2%	HOLD
FFBL	42.2	30.6	2.4%	BUY
FATIMA	U/R	-	-	-

Relative Performance to KSE100



Source: Bloomberg, PSX & IGI Research

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Fertilizers

Refining sector's profitability; EFERT stays our preffered pick

- We revisit our investment case on the sector after incorporating full year results for the companies under our coverage. We have revised our earnings estimates upwards for the companies, resulting in upgradation in valuations. Stable demand and improved retention prices (recently FFC increased urea prices by PKR 80/bag) are the key factors in upward revision.
- From demand perspective we see urea sales of ~5.7mn tons for CY19, while for DAP with sales number depicting unhealthy outlook we have narrowed down our assumption to ~1.9mn tons. Increase in prices following PKR depreciation may keep demand for DAP subdued
- We have a **"BUY"** call on EFERT, based on our revised Dec-19 target price of PKR 82.4/share, offering +16% upside from its last closing. The company is currently trading at CY19E P/E of 5.91x and offers a dividend yield of 15.5%.

We revisit our investment case on the sector after incorporating full year results for the companies under our coverage. We have revised our earnings estimates upwards for the companies, resulting in changes in our valuation. Stable demand and improved retention prices (recently FFC increased urea prices by PKR 80/bag) are the key factors in upward revision. For CY18 total profitability of the sector increased by +39%YoY to PKR 46.6bn on the back of high urea prices and sustained urea offtake. With respect to performance, the sector outperformed by 20%YoY against the benchmark index as strong demand and pricing power kept investors' confidence strengthened. The rally continued starting 2019 as GIDC issue came up. On this regard, nothing concrete as yet has been finalized given unwillingness on part by the manufactures to reduce urea prices by PKR 200/bag. Our stance on the sector remains neutral with strong liking for EFERT based on our Dec-19 target price of PKR 82.35/share, offering high dividend yield of 15.5% with inexpensive P/E of 5.91x.

Sector's profitability jumps up by +40%YoY to PKR 46.6bn in CY18; EFERT led the growth chart

The sector recorded highest profitability of PKR 46.6bn during CY18 at a growth of 3% (5YR-CAGR). Growth in earning was seen during the 2HCY18 primarily driven by increase in retention prices of urea and continued demand. In addition to this, low finance cost (20%YoY) and income from other businesses (FFC and FFBL) also amplified the profitability. Company wise, EFERT led the growth chart with earnings reported at PKR 13.05/share (+56%YoY) followed by FFC with a profitability of PKR 11.35/share (+35%YoY). Similarly, FATIMA witnessed increase in its profitability by +25%YoY to PKR 6.32/share. FFBL maintained its lowest share within the sector's profitability, contributing PKR 1.44bn (+43%YoY) after witnessing cumulative losses of PKR 0.76bn during the 1HCY18.

Exhibit:

Sector: Highest profitability recorded in CY18

(in PKR mn)	2014	2015	2016	2017	2018
FFC	18,171	16,766	11,782	10,711	14,439
EFERT	8,208	15,027	9,283	11,156	17,414
FFBL	4,016	4,062	1,338	1,180	1,437
FATIMA	9,258	9,254	9,782	10,576	13,272
SECTOR	**39,653**	**45,109**	**32,186**	**33,623**	**46,561**

Source: IGI Research, Company Financials, PSX

Industry offtake for urea stood at 5.7mntons while DAP sales inched down to 2.2mn tons in CY18

Total industry offtake for urea during CY18 stood at 5.7mn tons, achieving a growth of 4% (4yr CAGR) with sales reaching at stable levels during the last three years. Company-wise FFC led the growth chart, maintaining its share of 44% with EFERT trailing behind at a market share of 35%. For DAP, industry sales receded by 5%YoY to 2.2mn tons as high prices, following PKR depreciation kept demand subdued for the fertilizer. Likewise, FFBL offtake decreased by 17%YoY to 687k tons, witnessing decline in its market share to 31%.

Exhibit: **Urea offtake (ktons) company wise during the years**

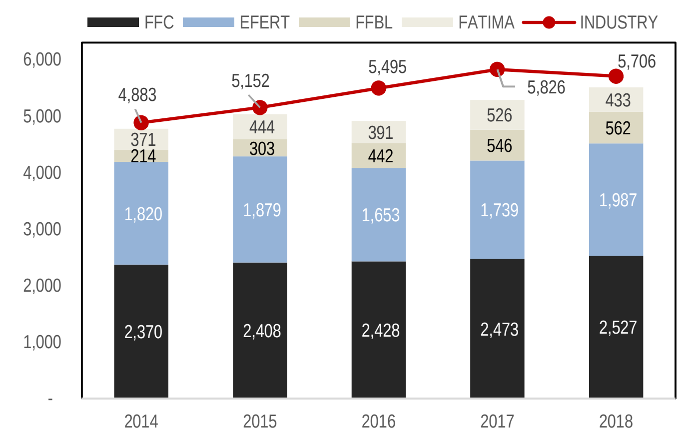
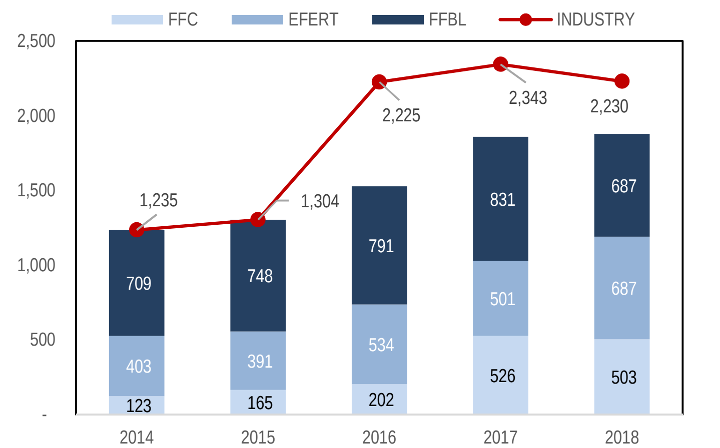


Exhibit: **DAP offtake (ktons) company wise during the years**



Source: IGI Research, Company Accounts

Local fertilizer prices were on rising trajectory in CY18

Local urea prices picked up pace during the 2HCY18 following removal of price cap and subsidy (PKR 100/bag). Prices thereof increased by PKR 340/bag, factoring in gas price hike (50% and 30% on feed and fuel) in addition to the aforementioned factors. As such, urea by the year end was selling at a discount of PKR 700/bag, when compared to international price of 290 USD/ton. For DAP, local prices have increased substantially by +24%YoY following PKR depreciation and rise in international prices by +19%YoY to 421 USD/ton.

Exhibit: **Local urea prices (Pkr/bag) selling at a discount**

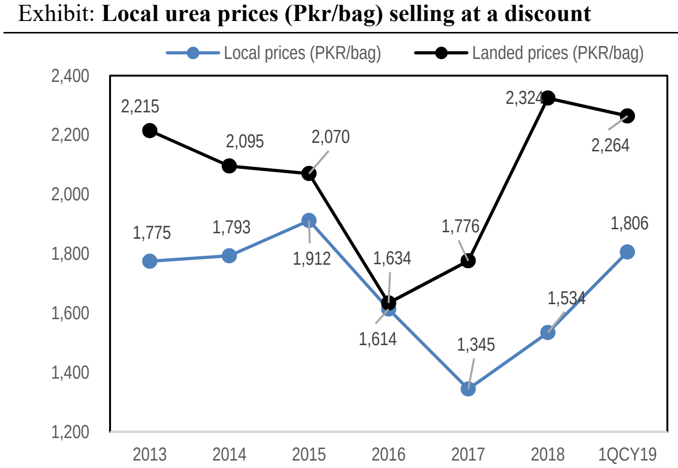
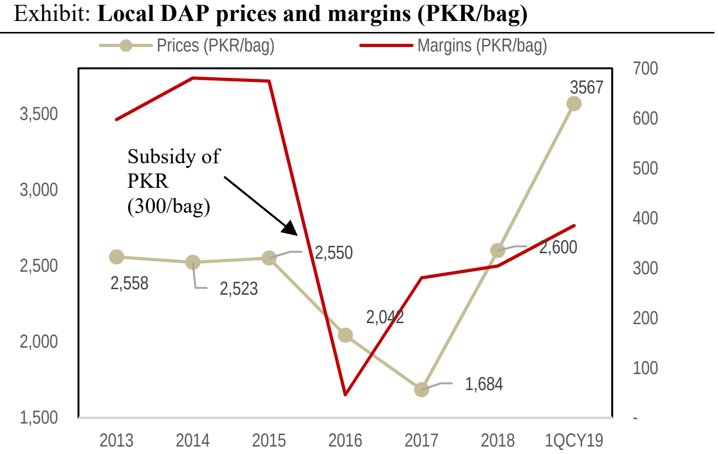


Exhibit: **Local DAP prices and margins (PKR/bag)**



Source: IGI Research, Company Accounts

Year 2019 starts off with major events...

The year 2019 started off on GIDC front, wherein a proposal was put forward in "Economic Reform Package 2019" of allowing 50% reduction in Gas Infrastructure Development Cess (GIDC) rate with a condition of paying half of accrued amount of GIDC for the period 2012-18. In addition, the government further proposed for fertilizer sector to reduce urea bag price by PKR 200/bag. So far, nothing concrete as yet has been finalized on this front given manufactures unwillingness to decrease prices of urea as they have already absorbed 90% of the cost since its inaction. Moreover if the proposal materializes FFC stands major beneficiary, witnessing a positive impact (one-off) in its earnings. (Refer *"GIDC resolution; not exactly a win-win game"*)

However, in a major upswing FFC increased prices of urea by PKR80/bag in March-19 while other players in the industry hitherto are cautious. We think the increase in price was reflective of strong demand with low inventory level (0.56k tons) in the system as RLNG plants were shutdown. We are of the view that with increase in Sona urea prices this may spur up demand for less expensive urea (EFERT/FATIMA and FFBL) selling in the market.

Furthermore to curb urea supply shortfall on account of gas shortages (in case supply to be diverted to power producers) in the summer season, recently government has again permitted urea import of 100k tons. Currently, international urea prices are on declining trajectory, hovering close to 280 USD/ton as against 346 USD/ton recorded in Oct-18, during which 0.1mn tons of urea was imported. Nevertheless, PKR depreciation (8% since Oct-18) may push up imported cost (PKR ~200/bag) of the fertilizer if the import materializes.

Earnings momentum to continue amid sustained demand and high prices

We have revised our earnings estimates upwards for the companies (FFC/EFERT and FFBL) taking into account respective financial year accounts of CY18. For FATIMA we await detailed accounts before revising our investment case. From demand perspective we see urea sales of ~5.7mn tons for CY19, while for DAP with sales number depicting unhealthy outlook we have narrowed down our assumption to ~1.9mn tons. Increase in prices following PKR depreciation may keep demand for DAP subdued; we opine this may spur up demand for NP (a substitute), which is sold at a discount of PKR 600-650/bag.

On pricing front, current dynamics suggest strong pricing power and as such, if other manufacturers (EFERT/FFBL and FATIMA) also increase prices by PKR 80/bag this would add up further to their bottom-line by PKR (1.40/0.50/0.20)/share. From operational perspective, margins may improve supported by increase in retention prices of urea by PKR (1680-1700)/bag. However, increase in finance costs on the back of high interest rates may act as a damper to the earnings.

Exhibit:

Summary of Financials

Period end Dec-PKRbn	FFC			EFERT			FFBL		
	CY18	**CY19E**	**CY20F**	**CY18**	**CY19E**	**CY20F**	**CY18**	**CY19E**	**CY20F**
Net Sales	105.96	108.32	114.79	109.20	103.79	108.98	61.51	63.65	70.58
Gross Profit	27.98	31.50	31.36	35.32	35.36	35.73	8.18	8.54	8.39
Selling / Dist.	8.83	8.27	8.61	8.01	7.30	7.57	4.53	4.70	5.21
Other Op. Income	6.28	4.33	5.44	2.06	1.07	1.50	3.18	2.78	2.96
EBIT	23.32	25.27	25.85	26.35	26.20	26.63	5.18	4.72	4.09
Finance Cost	1.64	4.33	3.56	2.07	3.58	2.35	2.22	3.48	2.63
Post-Tax Profits	21.68	20.94	22.30	24.28	22.61	24.28	2.96	1.23	1.46
EPS	11.35	11.92	13.07	13.05	12.03	13.28	1.54	1.07	1.27
DPS	8.85	9.50	10.50	11.00	11.00	12.00	1.00	0.80	0.90

Source: IGI Research, Company Financials, PSX

EFERT: Refining profitability-highest in the sector; stays our preferred pick
For CY18 the company reported earnings of PKR 17.4bn (EPS: PKR 13.05) led by increase in urea and DAP sales and high prices. In addition, one-off tax impact (PKR 2bn) and reduced (22%YoY) finance cost also corroborated growth in earnings. Moreover, the company also declared cash dividend of PKR 11.00/share compared to PKR 8.5/share in CY17.

Earnings forecast revised: We have revised our earnings estimates upwards by +7%/16% to PKR (12.0/13.3)/share for CY19/20**.** Our base assumption for urea and DAP sales stays intact at 1.8mn tons and 0.5mn tons respectively. Increased urea prices coupled with benefit of concessionary feed gas may keep margins inflated. On the flip side, increase in financial leverage and the ensuing high finance cost may act as a drag to the earning in CY19.

Valuation: We have a **"BUY"** call on the scrip based with our revised target price of PKR 82.35/share offering +16% upside from its last closing. High dividend yield of 15.9% and relatively inexpensive P/E of 5.9x makes its top pick amongst our coverage companies.

Exhibit:
Earnings estimates

	CY17	CY18	CY19E	CY20F	CY21F
EPS	8.4	13.0	12.0	13.3	13.6
DPS	8.5	11.0	11.0	12.0	12.0
Div.Yield (%)	12.0%	15.5%	15.5%	16.9%	16.9%
P/E (x)	8.5	5.4	5.9	5.3	5.2

Source: IGI Research, Company Financials, PSX

FFBL: DAP sales a key concern; Earnings to stay afloat
For CY18, the company witnessed growth of +43%YoY in its earnings (unconsolidated) to PKR 1.44bn (EPS: PKR 1.54) led by improved margins and contribution from other businesses (PKR 1.79bn as against PKR 0.32bn in CY17). Total offtake was down by 9%YoY to 1.25mn tons as DAP sales weakened to 687k tons (17%YoY) in CY18, while urea sales inched up by +3%YoY to 562k tons. Although, margins in urea businesses improved (high retention prices), however, DAP margins weakened owing to high input costs (high phosphoric acid prices and PKR devaluation). As such, exchange loss further drag profitability down by PKR 1.15bn during CY18.

Earnings revised: We have revised our earning assumptions downwards by 14%/7% to PKR (1.07/1.27)/share for CY19/CY20. We expect FFBL to face slowdown in DAP sales as high prices may restrain demand (in contrast heavy discounts may spur up demand compromising margins). On the positive side, FFBL has low dependency on system gas for its fuel requirement (Fauji Power providing steam). Hence, any increase in gas price hike may pose a minor setback to the costs. Nevertheless, with Fauji Power running on coal we believe any rise in coal prices may increase input costs.

Highly leveraged-acquisition to ease down burden: Moreover, company's balance sheet is highly leveraged (2.53x D/E), leading to high finance costs in CY19/CY20. We expect this could partially offset by continuous dividend income from its businesses by PKR (2.03/2.32)/share in CY19/CY20. Moreover, acquisition (51%) of foods business (FFL) by Inner Mongolio Yili group has not materialized yet, we believe the cash inflows from this transaction will aid in improving working capital requirements for FFBL, lessening the financial burden.

Valuation: We have a **"BUY"** call on the scrip using SOTP method with DEC-19 target price of PKR 42.2/share, offering +39% upside from its last closing. The company is currently trading at P/E of 30.6x and offers a dividend yield of 2.4%.

Exhibit:
Earnings estimates (unconsolidated)

	CY17	CY18	CY19E	CY20F	CY21F
EPS	1.3	1.5	1.1	1.3	1.9
DPS	0.9	1.0	0.8	0.9	1.4
Div.Yield (%)	2.6%	3.1%	2.4%	2.7%	4.3%
P/E (x)	25.9	21.3	30.6	25.7	17.1

Source: IGI Research, Company Financials, PSX

FFC: Recent price increase to fuel the bottom-line; Target price raised to PKR 109/share

The company witnessed +35%YoY growth in its earnings to PKR 14.4bn (EPS: PKR 11.35) in CY18 on the back of high urea offtake and sustained DAP sales. In addition, decrease in finance cost by 34%YoY also kept profitably during the year floated. Moreover, support to the earnings also came from dividend contribution from its associates and subsidiaries to the tune of PKR 1.25bn down by 45%YoY, owing to nil dividend from AKBL. The company also declared cash dividend of PKR 8.85/share as against PKR 7.00/share dividend announced last year.

Earnings forecast revised: We have revised our earnings estimated upwards by +8%/17% to PKR (11.9/13.1)/share for CY19/CY20. Major accretion to our estimates stems from recent increase in urea prices by PKR (80/bag) while keeping our total offtake assumption intact at 2.8mn tons. Moreover, we expect dividend contribution from diversified business to cushion up profitability by PKR ~2.0bn, arresting the impact of high finance cost during the year, CY18.

Valuation: We have raised our target price by +9% to PKR 109/share implying an upside of +7% from its last closing with a **"HOLD"** call. The company is currently trading at P/E of 8.9x and offers a dividend yield of 9.0%.

Exhibit:
Earnings estimates

	CY17	CY18	CY19E	CY20F	CY21F
EPS	8.4	11.3	11.9	13.1	13.6
DPS	7.0	8.9	9.5	10.5	10.9
Div.Yield (%)	6.6%	8.3%	9.0%	9.9%	10.3%
P/E (x)	12.6	9.3	8.9	8.1	7.8

Source: IGI Research, Company Financials, PSX

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Time Horizon: Dec – 2019

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