Engro Polymer & Chemicals Ltd

CY18 to end on a strong note; reiterate BUY

Friday, December 28, 2018

EPCL - BUY

Target Price: PKR 53.50

Current Price: PKR 38.51

EPCL Performance

	3M	6M	12M
Absolute %	27%	33%	46%
Relative to KSE %	34%	41%	50%

Bloomberg	EPCL PA
Reuters	EPCL.KA
MCAP (USD mn)	250
12M ADT (USD mn)	1.8
Shares Outstanding (mn)	909

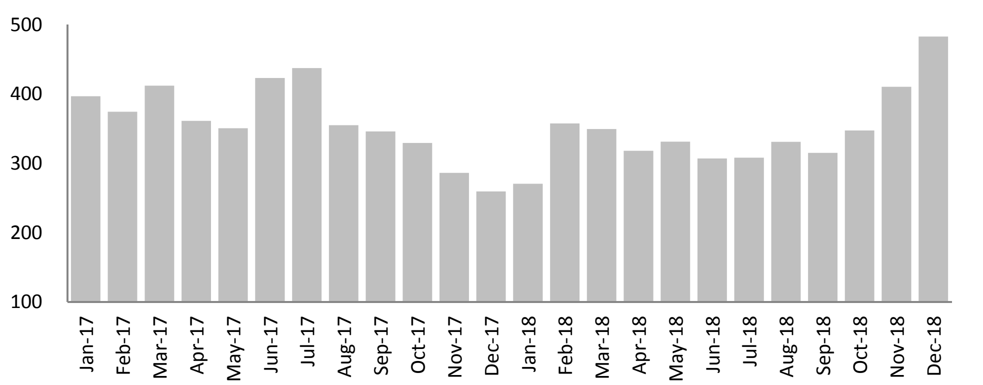
Source: PSX, BMA Research

- **We eye Engro Polymer & Chemicals Ltd (EPCL) to report CY18 earnings at PKR5.6/sh, up 2.5x YoY on the back of better volumes, favorable PKR parity, and higher realized delta.**
- **On sequential basis, uptick in average core delta to USD408/ton (up 28% QoQ) is expected to drive earnings for 4QCY18E to PKR1.38/sh despite increased gas prices.**
- **Despite upsurge in margins in near-term, we maintain our long-term margin assumption of USD350/ton for CY19. Current margin trajectory is triggered by timing mismatch in capacity additions in PVC and PE and ample ethylene supply. We see normalization of margin in 2H19.**
- **We reiterate our Buy rating on EPCL driven by; (i) healthy EBITDA generation, (ii) robust domestic demand growth for PVC (3-yr CAGR of 21%), (iii) company's expansion projects allowing it to capture demand growth, (iv) improved cash flow outlook, and (v) undemanding valuations.**
- **The stock trades at P/E of 7.9x on CY19E earnings and 4.6x on post expansion earnings in CY21E.**

Core delta remains the key driver for EPCL's bottom-line: We eye Engro Polymer & Chemicals Ltd (EPCL) to report CY18 earnings at PKR5.6/sh, up by 2.5x YoY on the back of better volumes, higher realized delta in PVC along with better caustic soda margins, favourable PKR parity, and certain one-offs (insurance claim, tax benefit on MTOT). Consequently, the company is expected to register revenues at PKR34bn for the year, up by 22% YoY. Gross margins are expected to settle at 28%, up 6ppt, compared to the same period last year. On sequential basis, uptick in average core delta to USD408/ton (up 28% QoQ) in 4QCY18 is expected to take the earnings for the quarter to PKR1.38/sh, up by 16% QoQ despite increase in gas prices during the quarter and a flattish topline.

Steep rise in int'l core delta to prevail in the short-term: Recent strength seen in PVC-Ethylene margin (USD 508/ton on week ending 14-Dec'18, +18% in 1M) is unlikely to sustain in the medium-term, in our view, though near-term outlook in margin remains positive. Recent upsurge in margin is triggered by timing mismatch in capacity additions of PVC and PE and ample ethylene supply. Around 9mn tons of ethylene capacity is estimated to have come online (5% of total supply) while only 6mn tons of PVC/PE capacity additions have materialized during CY18. We expect the disconnect in capacity additions to dilute from 2H19 as anticipated additions in PVC start materializing from 2020. Our long-term assumption of PVC-Ethylene delta is USD330/ton, slightly higher than average margin seen in the previous cycle.

Monthly PVC-Ethylene margins



Source: Bloomberg, BMA Research

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EPCL- Up-gradation projects on track: Supported by current margin environment and the positive demand dynamics from PVC, EPCL has undertaken multiple projects, which include 100k tons of expansion in PVC, debottlenecking of VCM, and up-gradation of caustic soda and power plant. While recent devaluation will likely result in cost-overrun, the projected timeline of project commissioning is little impacted. The company has successfully concluded membrane replacement of the existing caustic soda plant, up-gradation of gas turbine of the power plant and installation of a dryer for the new caustic flaker product line (capacity 20k tons) during 4QCY18.

Favorable sensitivity to currency devaluation: EPCL's profitability remains sensitive to PKR devaluation, as local prices are derived using a delta over the import parity. Hence, the devaluation (26% in 1-yr) is expected to keep profitability upbeat. As per our analysis, every 5% devaluation would likely add 6-8% to the bottom-line of EPCL. Additionally, company's performance is also highly susceptible to international margins where every USD5/ton shift in margins from our base case may move bottom-line by 2-3% in CY19-21E.

Valuations are attractive despite recent run-up: The stock trades at a forward P/E of 7.9x on CY19E earnings and a forward P/E of 4.6x in CY21E once the announced expansion comes online. On EV/EBITDA basis, EPCL trades at 4.8x on CY19E EBITDA or 13% discount to regional multiple. We highlight the current stock price implies PVC margin of only USD317/ton compared to average delta for the quarter at USD408/ton.

Risks to our thesis: (i) Above expected jump in gas cost, which is used in power generation, (ii) volatility in PVC-Ethylene margins, and (iii) adverse changes in duty structure.

CY18 Earnings Preview

(PKR mn)	3QCY18	4QCY18E	QoQ	YoY	CY17	CY18E	YoY
Sales	8,422	8,423	0%	15%	27,731	33,947	22%
GP	2,240	2,694	20%	2.4x	6,065	9,494	57%
SGA	506	519	3%	-16%	1,902	2,050	8%
Other Exp.	137	144	6%	-8%	365	685	88%
EBIT	1,717	2,043	19%	4.4x	3,930	7,461	90%
Fin. Cost	153	202	32%	-13%	821	654	-20%
PAT	1,082	1,252	16%	12.2x	2,049	5,116	2.5x
EPS	1.19	1.38	16%	12.2x	2.25	5.63	2.5x

Source: BMA Research

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Buy	>20% expected total return
Neutral	0%-20% expected total return
Underperform	<0% expected total return

*Total stock return = capital gain + dividend yield

Old rating system

Overweight	Total stock return > expected market return + 2%
Marketweight	Expected market return ± 2%
Underweight	Total stock return < expected market return - 2%

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)