

Pakistan Fertilizers

Aug'17 offtake rose sharply; emerging supply-demand rebalance

Thursday, September 07, 2017

Provisional Fertilizer offtake (000' tons)

| | Aug'17 | MoM | YoY |
|--------------|------------|-------------|-------------|
| Urea | | | |
| FFC | 377 | 175% | 64% |
| EFERT | 259 | 249% | 72% |
| FATIMA | 38 | 92% | -47% |
| FFBL | 78 | 84% | 41% |
| NFML | 64 | 38% | N/M |
| Total | 846 | 150% | 47% |
| DAP | | | |
| FFBL | 20 | -65% | -59% |
| FFC | 12 | -83% | 197% |
| Total | 90 | -68% | -33% |

Source: BMA Research

Urea Exports (000'tons)

| | Aug'17 | CYTD |
|--------------|------------|------------|
| EFERT | 50 | 187 |
| FFC | 29 | 62 |
| FATIMA | 30 | 39 |
| Total | 110 | 289 |

Source: BMA Research

- Major elements are coming together to support pricing power of urea players and likely stability/improvement in gross margins ahead.
- As per our channel checks, urea offtake for Aug'17 recorded a surge of 150/47% MoM/YoY to clock in at 846k tons. On the other hand DAP offtake recorded a decline of 68%/33% MoM/YoY to ~90ktons.
- The increase in urea offtake can be attributed to reduced prices by the dominant players and uptick in international urea prices (up 20% MoM). Urea inventory in Aug'17 stood at ~694k tons led by higher local offtake and 57% MoM growth in exports to 110k tons.
- High offtake and draw-down in inventory has allowed fertilizer players to restore prices back at May'17 levels whereby FFC has already increased its prices by ~PKR60/bag to PKR1,340-1360/bag (effective 4-Sep'17) while EFERT is expected to follow suit.
- Combination of improving pricing power and higher market confidence on earnings outlook bode well for fertilizer stocks which have received major battering in the past 3/6 month (down 19%/26%). We take this opportunity to reiterate our "Overweight" stance on both EFERT (DCF-based TP: PKR76) and FFC (SoTP-based TP: PKR94).

Urea offtake surged 47% YoY; DAP declined in Aug'17: As per our channel checks, urea offtake for Aug'17 recorded a surge of 150/47% MoM/YoY to clock in at 846k tons (excluding exports). On the other hand DAP offtake recorded a decline of 68%/33% MoM/YoY to ~90ktons. Engro Fertilizer (EFERT) remained the top performer with 72% YoY growth in offtake followed by Fauji Fertilizer Company (FFC, 64% YoY). The increase in urea offtake can be attributed to reduced prices by the dominant players and uptick in international urea prices (up 20% MoM). The higher local offtake along with 110ktons exports during the month led to reduced inventory burden. Urea inventory in Aug'17 stood at ~694k tons compared to 1.15mn tons in Jul'17.

Inventory pile transferred to dealers; urea price recovery imminent: To note, the significant growth in urea offtake came in a low demand period (August marks the end of Kharif sowing season, where DAP demand supersede urea demand), however Aug'17 offtake reflects a different case. That said, we believe the decline in manufacturer's inventory merely means piling up of inventory at dealers' end which might lead to lower than expected demand in the upcoming months (off season). Heavy rainfall during the month also lend credence to our thesis of pile up in dealers' inventory as it is not an ideal time to apply fertilizer to the crops. Higher dealer demand can be attributable to reduced prices to the tune of PKR50-80/bag by the dominant players bringing the price range down to PKR1,200-1,280/bag compared to price range of PKR1,200-1,330/bag up till May'17. High offtake and draw-down in inventory has allowed fertilizer players to recently restore prices back at May'17 levels whereby FFC has already increased its prices by ~PKR60/bag to PKR1,340-1,360/bag (effective 4-Sep'17) while EFERT is expected to follow suit.

Gas supply cut to ease supply concern: We believe, the recent decision by ECC to divert ~130mmcf gas from four fertilizer manufacturers (EFERT, Agritech, FatimaFert, Pak Arab) to household consumers will lead to reduced production and hence manageable inventory levels with improving pricing power of fertilizer manufacturers. We highlight that two of the four players were already relying on LNG to run their plants amid limited gas availability and in-line with our expectations (see our report dated 14-Jun'17, titled 'Limited impact from budget; Key factors to watch out in near-term'), have shut

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operations since Jun'17 as production on LNG becomes unviable under prevailing market situation.

Big growth in exports: As highlighted in our report dated 23-Aug'17, the recovery in international urea prices (up by 20% MoM to USD225/ton) has allowed manufacturers the room to export urea albeit at lower margins. Resultantly, Aug'17 witnessed 57% MoM growth in exports to 110k tons. EFERT once again managed to grab the highest share (45%) with better prices. FFC on the other hand, sold ~29k tons out of which 19k was exported to Srilanka while the rest was exported under its contract with Afghanistan (43% has been sold of the 100k tons negotiated quantity). Fatima Fertilizer (FATIMA) also managed to sell ~30k tons during the month, taking cumulative exports by the company to 39k tons. All in all, the industry exported 289k tons in six months as against the allocated quota of 600ktons with a deadline of Oct'17.

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Rating definitions

| | |
|---------------|--|
| Overweight | Total stock return > expected market return + 2% |
| Market-weight | Expected market return \pm 2% |
| Underweight | Total stock return < expected market return - 2% |

*Total stock return = capital gain + dividend yield

Old rating system (discarded effective Feb 29'16)

| | |
|------------|------------------------------------|
| Buy | >20% upside potential |
| Accumulate | >=5% to <=20% upside potential |
| Hold | <5% to >5% potential |
| Reduce | <=-5% to >=-20% downside potential |
| Sell | <-20% downside potential |

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.)