Pakistan Fertilizer

REP-005

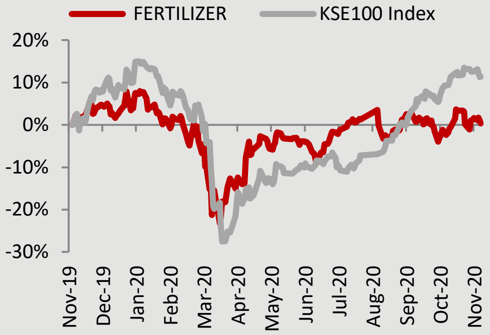
Earnings season's bullish spin is likely to extend

Monday, November 23, 2020

Fertilizers performance

	3M	6M	12M
Absolute %	3%	3%	-2%
Relative to KSE %	2%	-15%	-7%

KSE-100 vs Fertilizers performance



Source: PSX, BMA Research

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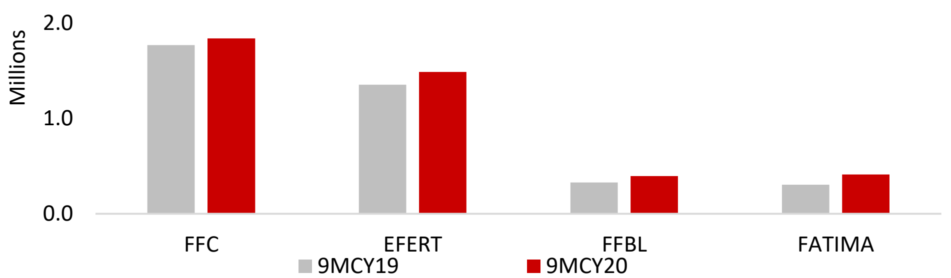
- **The BMA fertilizer universe showcased strong performance during 3QCY20 as the companies posted cumulative profitability of ~PKR 17.37Bn during 3QCY20, up 2.0x YoY. The improvement in industry profitability was mainly on the back of higher DAP (↑ 39% YoY) and Urea (↑ 3% YoY) offtake, and better urea and DAP margins.**
- **The fertilizer industry recorded urea production/offtake of 4.52/4.20Mn tons during 9MCY20, which took inventory levels to 0.47Mn tons (Sep'20 closing). We expect the year-end urea inventory to clock-in at around 0.31Mn tons.**
- **FFC/EFERT/FATIMA reported earnings of PKR 3.64/5.27/1.14 per share during 3QCY20, up by 1.30/2.11/1.11x, respectively. On the other hand, FFBL posted a turnaround in profitability with PKR 3.54 per share during 3QCY20 as opposed to LPS of PKR 0.50 in SPLY.**
- **On the GIDC front, the Supreme Court has allowed an extension of 3 years in the recovery of outstanding GIDC payables to 5 years (60 months). With this relaxation, the annual cash outflow impact per share now is PKR 9.85, PKR 4.75, PKR 2.84, and PKR 0.55 per share for FFC, FFBL, EFERT, and FATIMA respectively.**
- **We maintain our BUY call on FFC/EFERT/FFBL/FATIMA with Jun'21 TP of PKR 118.14/ 72.21/26.70/46.46 per share, offering upside potential of 13.83/7.82/23.44/69.99% respectively.**

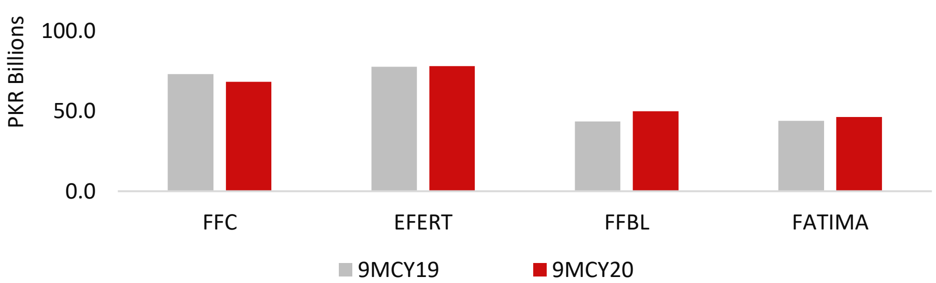
The BMA fertilizer universe showcased strong performance during 3QCY20 as the companies posted cumulative profitability of ~PKR 17.37Bn as opposed to ~PKR 8.58Bn in SPLY, up 2.0x YoY. The improvement in industry profitability was mainly on the back of higher DAP (↑ 39% YoY) and Urea (↑ 3% YoY) offtake during 3QCY20 due to improved farm economics. As a result, net revenue improved by 2% YoY to PKR 242.97Bn in 9MCY20 as against PKR 238.45Bn in SPLY. Additionally, better urea margins, and an uptick in DAP prices by 12% since Jan'20 also supported the bottom-line during the period.

Industry urea offtake stands at 4.20Mn during 9MCY20



Source: BMA Research

Cumulatively, sales revenue recorded a growth of 2% YoY



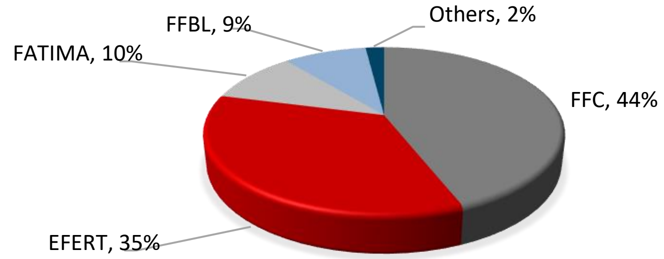
Source: BMA Research

Industry statistics-Urea			
Bn Tons	**2017**	**2018**	**2019**
Total production	5.65	5.60	6.17
Imports	0.00	0.11	0.10
Local Offtake	5.86	5.81	6.23
Exports	0.56	0.01	0.00
Closing Inventory	0.34	0.17	0.20

Source: BMA Research

Year-end urea inventory to clock in at 0.31Mn tons: The fertilizer industry recorded urea production/offtake of 4.52/4.20Mn tons during 9MCY20, which took inventory levels to 0.47Mn tons (Sep'20 closing). Company-wise, FFBL recorded the largest increase of 21.01% YoY in urea offtake to 0.40Mn tons due to low base effect (9MCY19 offtake: 0.33Mn tons). EFERT's offtake improved by 10.00% YoY, mainly on the back of higher production (↑16.62% YoY) during 9MCY20. Following them, FATIMA and FFC recorded sales volumes of 0.33Mn (↑ 9.67% YoY) and 1.84Mn (↑ 3.99% YoY) tons, respectively. Currently, the market share of FFC stands at 44%, followed by EFERT, FATIMA, and FFBL at 35%, 10%, and 9%, respectively.

FFC holds the largest urea market share at 44%



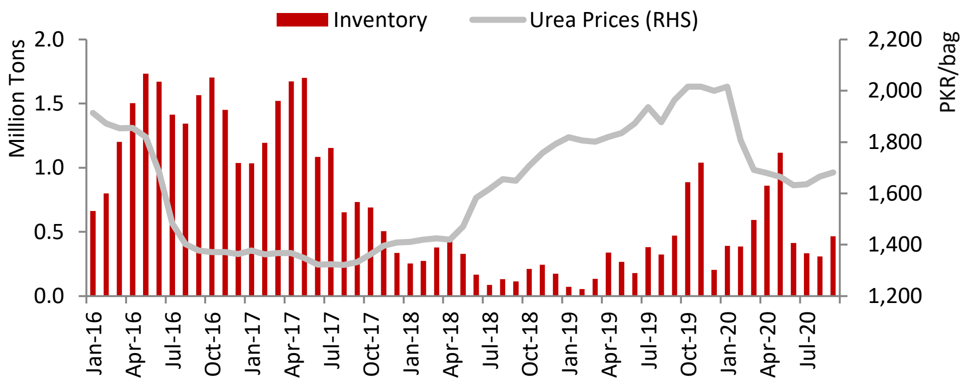
Source: BMA Research

We reiterate that the government is likely to extend the RLNG supply to fertilizer plants beyond Nov'20, given the expectations of lower inventory levels at the year-end otherwise. Considering this extension and the shutdown of Mirpur Mathelo plant by FFC during November for maintenance reasons, we expect the year-end urea inventory to clock-in at around 0.31Mn tons.

Expected inventory situation	Mn tons
Opening Inventory (as of Oct'20)	0.47
Production	1.66
Offtakes	1.81
Closing Inventory (as of Dec'20)	0.31

Source: BMA Research

Year-end urea inventory likely to clock-in at 0.31Mn tons



Source: BMA Research

Relaxation in GIDC instalment period provides relief to fertilizer players: The Supreme Court has allowed an extension of 3 years in the recovery of outstanding GIDC payables to 5 years (60 months). The earlier decision required payment of outstanding dues in 24 monthly instalments after which the fertilizer firms filed a review petition in the court. With this relaxation, the annual cash outflow impact per share is PKR 9.85, PKR 4.75, PKR 2.84, and

PKR 0.55 per share for FFC, FFBL, EFERT, and FATIMA, respectively. On the other hand, receivables from the government stood at PKR 13.27, PKR 12.72, PKR 6.25 and PKR 3.62 per share for FFC, FFBL, EFERT, and FATIMA, respectively.

	GIDC Outstanding (PKR Bn)	No. of Shares (Bn)	Annual Cash Outflow (PKR/sh)	Government Receivables (PKR/sh)
FFC	62.63	1.27	9.85	13.27
FFBL	22.20	0.93	4.75	12.72
EFERT	18.94	1.34	2.84	6.25
FATIMA	5.82	2.10	0.55	3.62

Source: BMA Research

Subsidy receivables and sales tax concerns: The fertilizer industry continues to face challenges due to the pending subsidy receivables from the government. The cumulative subsidy receivables of the industry currently stand at around ~PKR 20.0Bn. As per the companies, they have already passed the impact of subsidy on farmers in the form of lower urea prices. Additionally, the industry continues to take a hit on earnings by providing for the GST of the unregistered dealers. However, as per news flow, the government is expected to reverse the provision on sales tax; otherwise, the fertilizer players might pass the impact to consumers by raising urea prices by around PKR 35-50 per bag. On the other hand, the increase in DAP prices (PKR 3,962, ↑ 20% since Jan'20) is expected to be short-lived, and we believe that the prices will start to decline post-Rabi season.

Result Reviews

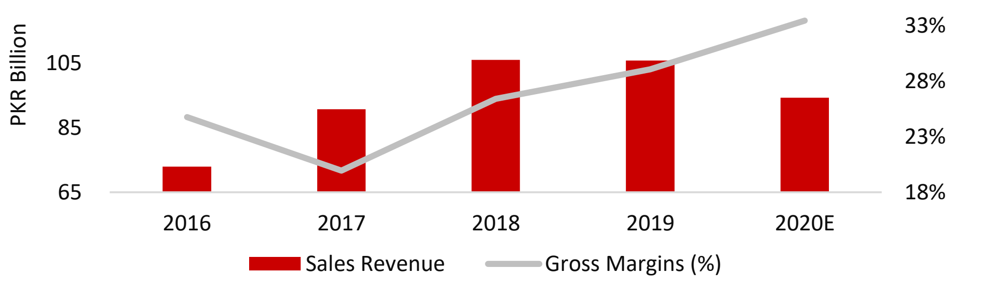
Higher DAP offtake kept FFC's 3QCY20 earnings upbeat: Fauji Fertilizer Company Limited (FFC) reported earnings of PKR 4.63Bn (EPS: 3.64) during 3QCY20 as opposed to PKR 3.56Bn (EPS: PKR 2.80) in SPLY, up 30% YoY. The 9MCY20 profitability was recorded at PKR 13.76Bn (EPS: PKR 10.82), up 10% YoY, while the 9MCY20 dividend pay-out stood at PKR 7.80/sh. The improvement in profitability is mainly due to higher DAP offtake (↑ 15% YoY) during 3QCY20; and better urea margins due to removal of GIDC levy during the year on feed and fuel gas. As a result, the gross margins improved by 8.00 ppts YoY to 34% in 3QCY20. The decline in finance costs by 51% YoY to PKR 0.27Bn also lifted the bottom line.

FFC: Valuation Snapshot

	2020E	2021E	2022E
EPS (PKR)	14.41	14.75	15.28
P/E (x)	7.20	7.03	6.79
D/Y (%)	10.65%	11.08%	11.32%

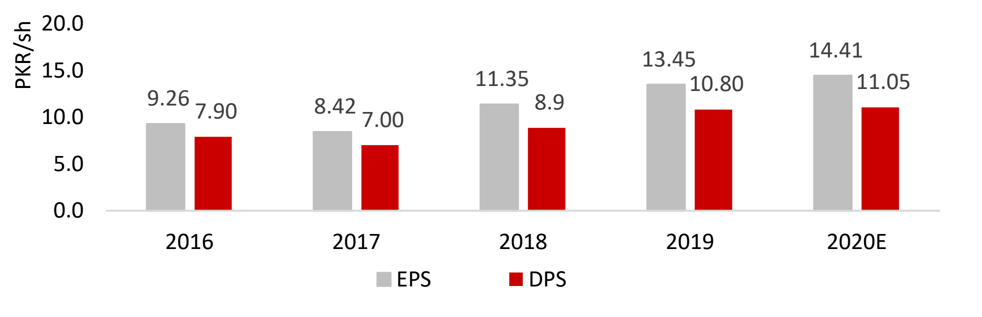
Source: BMA Research

FFC: Gross margins have improved by 8.70ppts over the years



Source: BMA Research

FFC: Earnings are expected to show a growth of 7.14% in CY20



Source: BMA Research

In addition to the above, Thar Energy Limited (TEL), which is an associated company of FFC (equity stake of 30%) and a part of CPEC, is a 330 MW coal-based power project which is expected to begin its commercial operations next year in CY21. The project is expected to add PKR 1.30/sh in CY21. Keeping everything in perspective, we reiterate our BUY call on the stock with Jun'21 TP of PKR 118.14/sh, offering an upside potential of 13.83% and a dividend yield of 10.65%.

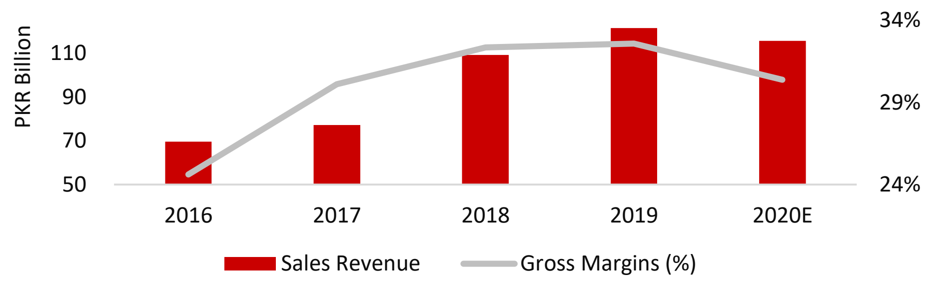
EFERT: Valuation Snapshot

	2020E	2021E	2022E
EPS (PKR)	11.55	11.58	11.81
P/E (x)	5.80	5.78	5.67
D/Y (%)	17.17%	17.17%	17.55%

Source: BMA Research

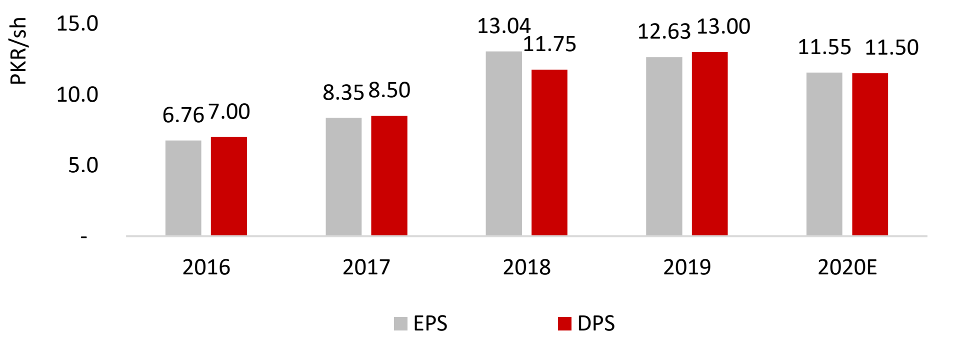
One-off tax benefit lifts EFERT's 3QCY20 earnings: Engro Fertilizers Limited (EFERT) reported earnings of PKR 7.03Bn (EPS: PKR 5.27) in 3QCY20 as against PKR 3.33Bn (EPS: PKR 2.49) in SPLY, up to 2.11x YoY. Higher one-off tax benefit booked by the company supported the bottom line during the period. Moreover, the company recorded an increase of 36% YoY in urea offtake during the period to 0.62Mn tons, and as a result, net revenue jumped by 38% to PKR 37.44Bn. Gross margins stood at 29% during the quarter, down by 4.00ppts YoY, mainly on account of sales mix changes with a greater focus on Special Fertilizer Business (SFB). The SFB business has achieved a steep growth of 2.00x in the top-line over the last three years with 9MCY20 SFB top-line clocking-in at PKR 7.71Bn, up 12% YoY. Cumulatively, the 9MCY20 earnings of the company stood at PKR 8.61/sh and dividend pay-out at PKR 9.00/sh. Overall, we maintain our BUY call on EFERT with Jun'21 TP of PKR 72.21/sh, offering an upside potential of 7.82% and a dividend yield of 17.17%.

EFERT: Sales revenue show a 5-year CAGR of 10.63%



Source: BMA Research

EFERT is likely to report earnings of PKR 11.55/sh during CY20.



Source: BMA Research

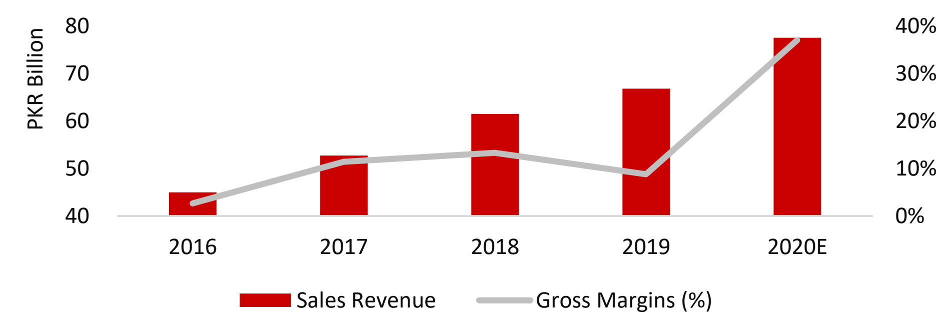
FFBL: Valuation Snapshot

	2020E	2021E	2022E
EPS (PKR)	0.41	2.25	2.97
P/E (x)	52.71	9.63	7.29
D/Y (%)	0.00%	4.62%	4.62%

Source: BMA Research

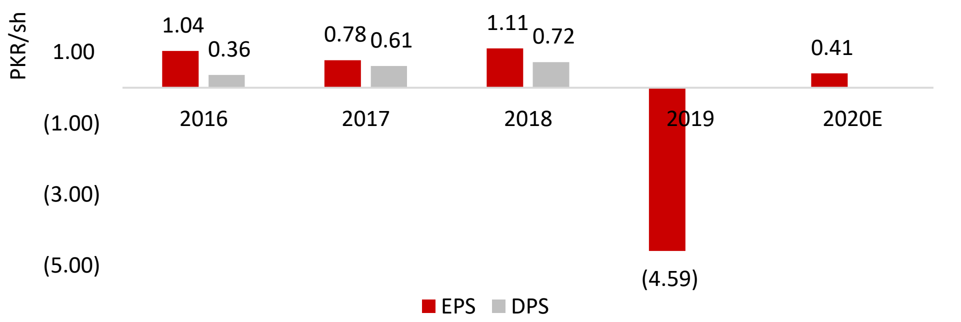
Higher dividend income support FFBL's 3QCY20 profitability: Fauji Fertilizer Bin Qasim Limited (FFBL) recorded earnings of PKR 3.31Bn (EPS: PKR 3.54) in 3QCY20 as opposed to a loss of PKR 0.47Bn (LPS: PKR 0.50) in SPLY, taking 9MCY20 loss to PKR 0.90Bn (LPS: PKR 0.96). During the period, net revenue improved by 14% YoY to clock-in at PKR 25.18Bn. The turnaround in profitability is mainly on account of higher dividend income received by the company from its subsidiaries and improved profitability posted by its associate companies, including AKBL (↑ 85% YoY) and FPCL (↑ 13% YoY) during 3QCY20. Additionally, gross margins improved by 6.00ppts to 16% during the quarter due to higher DAP international prices (USD 368/ton, ↑ 19% YoY) and better realized phosphoric acid prices.

FFBL: Sales revenue show a 5-year CAGR of 11.63%



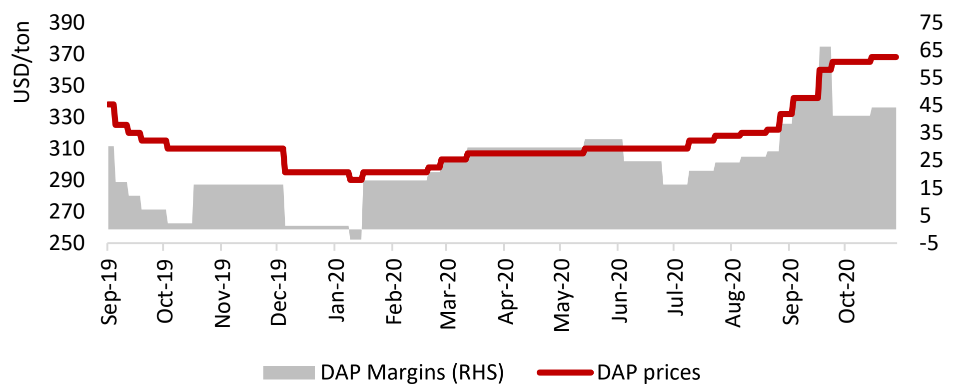
Source: BMA Research

FFBL expected to show a turnaround in profitability in CY20



Source: BMA Research

International DAP prices have increased by 25% since Jan'20



Source: BMA Research

FFBL's food ventures continue to be a cause of cash drain for the company. Although the company is planning to divest its meat business, FFL continues to weigh down the profitability of FFBL, with its 9MCY20 loss clocking-in at PKR 2.42Bn. The company is further planning to extend a loan of PKR 3.5Bn to FFL which it intends to convert into equity in the future. To manage its liquidity concerns, FFBL has recently announced a right issue at 38.23% (i.e., 357 shares) at PKR 14.00/sh, which is expected to raise around ~PKR 5.00Bn. The proceeds will be utilized to lower the company's debt levels and manage its working capital requirements. We estimate the EPS impact of the right issue to be around PKR 0.22/sh, assuming 100% of the proceeds are used to retire the debt.

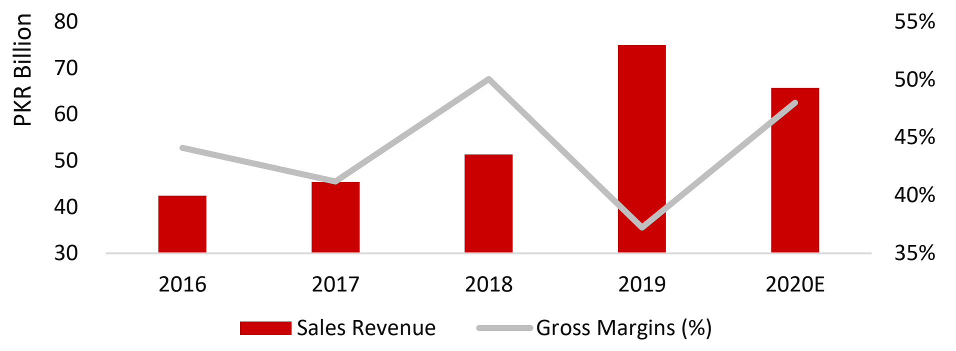
Overall, we change our stance on FFBL to BUY after incorporating the right issue. Our revised Jun'21 TP of 26.70/sh (adjusted for right shares) offers an upside potential of 23.44%.

FATIMA: Valuation Snapshot			
	2020E	2021E	2022E
EPS (PKR)	6.57	6.72	7.00
P/E (x)	4.16	4.06	3.91
D/Y (%)	7.32%	7.32%	7.32%

Source: BMA Research

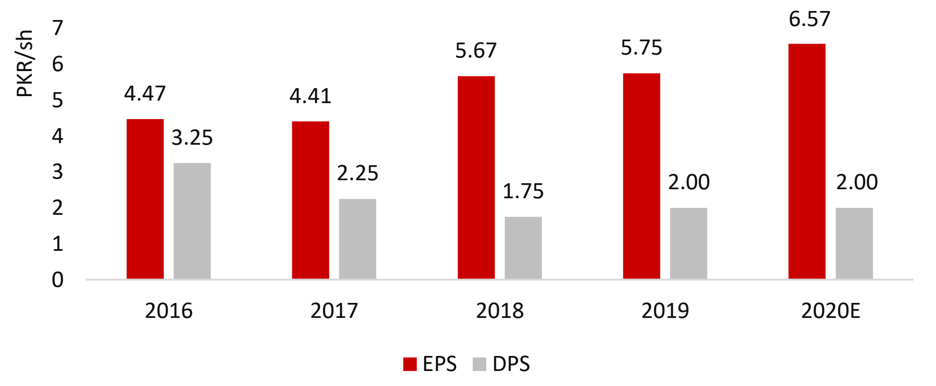
Increase in fertilizer offtake lifts FATIMA's earnings in 3QCY20: Fatima Fertilizer Company Limited (FATIMA) posted consolidated earnings of PKR 2.40Bn (EPS: PKR 1.14) during 3QCY20 as against PKR 2.16Bn (EPS: PKR 1.03), up 11% YoY. This takes 9MCY20 profitability to PKR 9.56Bn (EPS: PKR 4.55), up 3.74% YoY. The improvement in earnings is mainly on the back of higher fertilizer offtake during 3QCY20. Urea offtake improved by 2.01x YoY to 0.20Mn tons during the period while CAN/NP offtake increased by 1.97/1.75x YoY to 0.21/0.19Mn tons. As a result, the top-line witnessed a jump of 25% YoY to PKR 21.62Bn. Additionally, the decline in finance costs by 24% during the period to PKR 0.72Bn also supported profitability.

FATIMA: Gross margins have shown volatile trend over the years



Source: BMA Research

FATIMA is likely to report earnings of PKR 6.57/sh during CY20



Source: BMA Research

The company completed the transaction of acquiring Pak Arab Fertilizer Limited's operating plant in Sep'20. With all three plants operational at Sadiqabad, Multan, and Sheikhupura, the company's cumulative annual capacity now stands at 2.57Mn tons. Overall, we have a BUY call on FATIMA with Jun'21 TP of PKR 46.46/sh, offering an upside potential of 69.99% and a dividend yield of 7.32%.

Investment Perspective: Keeping the above mentioned in perspective, we maintain our BUY call on FFC/EFERT/FFBL/FATIMA with Jun'21 TP of PKR 118.14/ 72.21/26.70/46.46 per share, offering upside potential of 13.83/7.82/23.44/69.99%, respectively. With the ongoing Rabi season and the restoration of RLNG supply to fertilizer plants, we expect the fertilizer offtake to improve during the 4QCY20 and thus support the companies' bottom line. Key risks for the industry include the uncertainty around subsidy receivables, shortage of gas during winter, and the cost implications of input sales tax.

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Buy	>20% expected total return
Neutral	10%-20% expected total return
Underperform	<10% 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.)