

## PAKISTAN FERTILIZER SECTOR

Pricing power remains intact amidst low inventory levels

Tuesday, July 27, 2021

As per the latest numbers released by NFDC, urea offtake declined by 41% YoY to 0.69Mn tons in Jun'21 due to high-base effect (1.2Mn tons in SPLY). To recall, sales crossed the 1.0Mn mark in Jun'20 amid clarification on the subsidy front and pre-buying by dealers in anticipation of hike in gas prices. DAP offtake also dropped by 61% YoY to 68K tons in Jun'21 owing to lower inventory levels driven by supply disruptions in the global market. On the other hand, we reiterate that the pricing power of fertilizer players is still strong (lower urea inventory levels of 0.43Mn tons in Jun'21), which is evident from the recent increase in urea prices by PKR 50/bag (effective from Aug'21). DAP prices are also on an uptrend with a recent price hike of PKR 200/bag in Jul'21. That said, our top picks in the sector are FFC and FFBL with Jun'22 TP of PKR 135 and PKR 35 (potential upside of 25% and 29%), respectively.

**High-base effect pulls down urea sales:** Urea production increased by 9% YoY to 0.51Mn tons in Jun'21, while it dropped by 14% MoM mainly due to curtailed gas supply resulting from the turnaround of KPD gas field and RLNG crisis in the country. On the other hand, the high-base effect dragged down urea sales by 41% YoY to 0.69Mn tons in Jun'21. Recall that urea offtake was higher in SPLY amid pre-buying by dealers in anticipation of hike in gas prices and clarification on the subsidy front. Sequentially, sales were up by 38% due to seasonal factors. Company-wise, FFBL, EFERT, and FFC witnessed a drop in sales in Jun'21 by 65%, 50%, and 45% YoY to 54K, 256K, and 247K tons, respectively. However, FATIMA's offtake surged by 2.4x to 105K ton owing to the production by LNG-based plants.

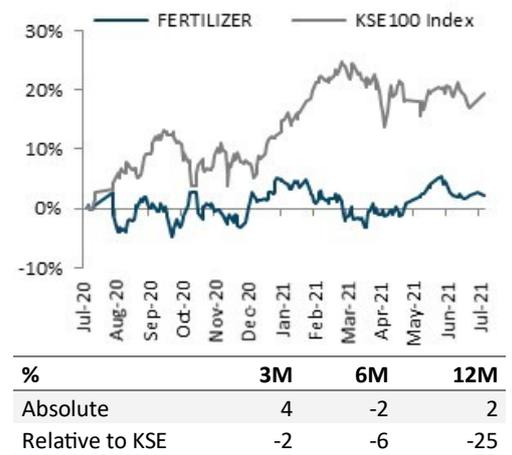
**DAP sales drop to 68K tons:** DAP offtake declined by 61% YoY (and MoM) to 68K tons in Jun'21 on account of lower inventory levels due to supply disruptions in the global market. Int'l DAP prices have been up by around 56% since CYTD (currently above USD 600/ton) owing to global commodity shortage and an uptick in energy prices. Since nearly 60% of DAP is imported in the country, local prices have also surged to new highs, hovering between PKR 5,700-5,800/bag to pass on the rising import costs (recently increased by PKR 200/bag in Jul'21). FFBL, being the only local producer of DAP, is expected to continue to capitalize on the strong pricing dynamics. Note that phosphoric acid prices have also recently risen to USD 1,160/ton (↑ 68% YoY), shrinking local DAP margins from USD 250/ton to USD 174/ton currently. However, we believe that the company is in a favourable position to pass on the impact of higher

Table 1: Fertilizer statistics for Jun'21

| Ktons                | June-21    | June-20      | YoY (%)     | May-21     | % MoM       | 1HCY21       | 1HCY20       | YoY (%)   |
|----------------------|------------|--------------|-------------|------------|-------------|--------------|--------------|-----------|
| <b>Urea Off-take</b> |            |              |             |            |             |              |              |           |
| FFC                  | 247        | 453          | -45%        | 183        | 35%         | 1131         | 1271         | -11%      |
| EFERT                | 256        | 511          | -50%        | 200        | 28%         | 1168         | 869          | 34%       |
| FATIMA               | 105        | 43           | 141%        | 48         | 119%        | 324          | 245          | 32%       |
| FFBL                 | 54         | 153          | -65%        | 58         | -8%         | 219          | 265          | -17%      |
| <b>Total</b>         | <b>690</b> | <b>1,160</b> | <b>-41%</b> | <b>501</b> | <b>38%</b>  | <b>2,899</b> | <b>2,666</b> | <b>9%</b> |
| <b>DAP Off-take</b>  |            |              |             |            |             |              |              |           |
| FFC                  | 1          | 11           | -92%        | 30         | -97%        | 65           | 42           | 55%       |
| EFERT                | 12         | 34           | -65%        | 27         | -55%        | 96           | 109          | -12%      |
| FFBL                 | 23         | 55           | -58%        | 69         | -66%        | 230          | 251          | -8%       |
| <b>Total</b>         | <b>68</b>  | <b>176</b>   | <b>-61%</b> | <b>173</b> | <b>-61%</b> | <b>601</b>   | <b>598</b>   | <b>1%</b> |

Source: NFDC, BMA Research

Fertilizer Performance vs. KSE-100 Index



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input costs as the supply-demand in the international DAP market is likely to continue in the near-term. As per our estimates, every USD 10/ton change in primary margins has an earnings impact of PKR 0.68/sh for FFBL.

**Urea inventory clocked-in at 0.43Mn tons:** Due to closure of RLNG-based plants during the end of Jun'21, urea inventory moderated to 0.43M tons, down 30% MoM. Our expectation for year-end inventory is between 0.35-0.40Mn tons. We reiterate that the pricing power of fertilizer players is still intact given the low levels of inventory (as suggested by historical trend; see chart 3) and widening disparity between local and international urea prices (domestic prices are trading at a discount of over 60%). As expected, EFERT and FFC have recently raised urea prices by PKR 50/bag (effective from Aug'21), taking current Dealer Transfer Prices to around PKR 1,720/bag. Other players are likely to follow suit soon. We expect this increase to have an earnings impact of PKR 1.3, PKR 1.1, PKR 0.3, and PKR 0.2 per share for FFC, EFERT, FFBL, and FATIMA, respectively.

Table 2: Urea inventory levels

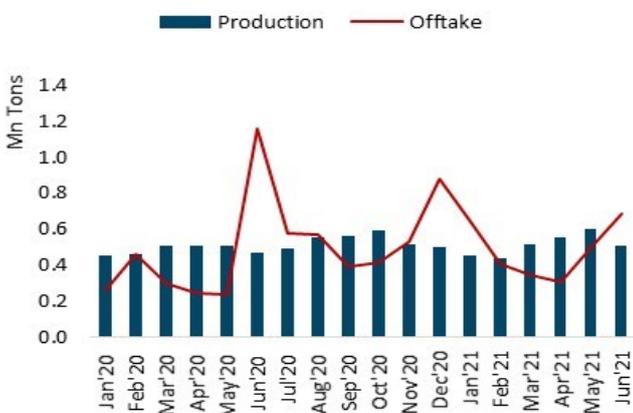
| Ktons        | June-21    | June-20    | YoY (%)   | May-21     | % MoM       | 1HCY21     | 1HCY21     | YoY (%)   |
|--------------|------------|------------|-----------|------------|-------------|------------|------------|-----------|
| FFC          | 93         | 16         | 497%      | 168        | -45%        | 93         | 16         | 497%      |
| EFERT        | 118        | 269        | -56%      | 190        | -38%        | 118        | 269        | -56%      |
| FATIMA       | 147        | 111        | 33%       | 166        | -11%        | 147        | 111        | 33%       |
| FFBL         | 11         | 1          | N/A       | 27         | -58%        | 11         | 1          | N/A       |
| <b>Total</b> | <b>432</b> | <b>414</b> | <b>4%</b> | <b>612</b> | <b>-30%</b> | <b>432</b> | <b>414</b> | <b>4%</b> |

Source: NFDC, BMA Research

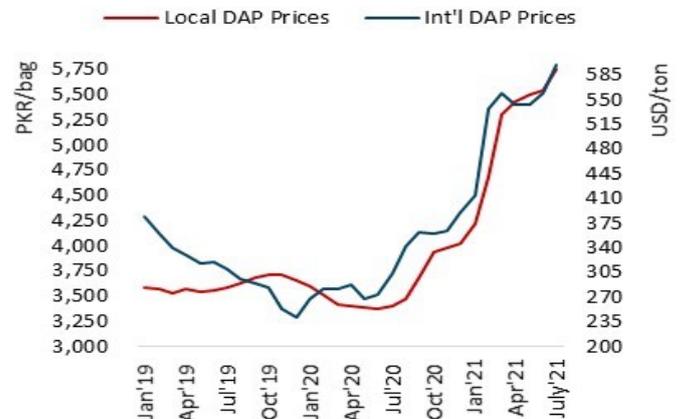
**Investment Outlook:** Given the strong pricing dynamics and improving farm economics, we have an overweight stance on the fertilizer sector, with FFC and FFBL as our top picks at Jun'22 TP of PKR 135 and PKR 35, respectively. Key **downside risks** include: 1) gas curtailment, 2) weak farm economics, and 3) higher than expected increase in gas prices and other input costs.

Chart 1: Urea offtake is up by 9% YoY in 1 HCY21 at 2.9Mn tons

Chart 2: DAP prices reach record highs



Source: NFDC, BMA Research



Source: NFDC, Bloomberg, BMA Research

Chart 3: Historical trend suggests that lower inventory levels increase the pricing power of fertz players



Source: NFDC, PBS, BMA Research

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|   |                               |
|---|-------------------------------|
| Buy   | >15% expected total return    |
| Hold  | 10%-15% expected total return |
| Underperform  | <10% expected total return    |
| *Total stock return = capital gain + dividend yield |                               |

### Old rating system

|              |  |
|--------------|--|
| Overweight   | Total sector return > expected market return |
| Marketweight | Expected market return                       |
| Underweight  | Total stock return < expected market return  |

## 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.)