EFERT: Armored against sector headwinds

- EFERT’s 2QCY20 result remained below market consensus, despite a significant 52% YoY uptick in urea offtake, due to one-offs including: (i) 83% YoY decline in other income, and (ii) 2.1xYoY higher other expenses.

- As per our back of the envelop calculation, assuming 100% of dealers are not registered in sales tax, disallowing 10% expense deduction could imply negative earnings impact of approximately Pkr2bn p.a. (EPS impact: Pkr1.50) for EFERT, which has provisioned for Pkr630mn impact in its 2Q earnings.

- The said measure is due to be effective from Oct 1, 2020 however, our correspondence with industry players suggest companies being in talks with the Government to exempt the sector from such measures. We await clarity on this regard before incorporating it in our model which would yield a negative earnings impact of 4% over CY21-25F, on average in case of no pass-on.

- As urea inventory has normalized from its peak of 1mn MT to approx. 300K MT levels, the fertz players would likely pass-on any negative hit from the aforementioned measure in terms of further urea price hike (Pkr20-25/bag to be a neutral event for EFERT, which has already increased Pkr25/bag in Aug’20).

- Despite comfort on impact of sector headwinds on EFERT, we maintain our Sell stance on the stock, as the end of concessionary gas agreement approaches (CY23), post which D/Y will narrow down from 13% at present to 8%.

One off contains 2Q EPS growth despite spectacular offtakes: EFERT’s 2QCY20 result remained below market consensus, despite a significant 52% YoY uptick in urea offtake, where volumes benefitted from decrease in urea price. To recall, GIDC was prospectively eliminated on the feed fertilizer sector w.e.f 20thJan’20, whereby FFC decreased its urea price by Pkr300/bag w.e.f Feb’20, while, EFERT brought its urea price at par with other players by Apr’20. This resulted in sequential volumetric uptick for EFERT in 2QCY20. While 2QCY20 EPS of Pkr2.91 was up 6.8x QoQ due to aforementioned factors, the YoY earnings growth was contained at 22% due to one-offs including: (i) 83% YoY decline in other income, and (ii) 2.1xYoY higher other expenses. The company booked Pkr630mn of tax provisioning with respect to expense disallowance to unregistered dealers.

Budgetary measures may result in price hike: To recall, tax regulations were implemented in sales tax and income tax laws in Budget FY21, seeking to increase cost of doing business of manufacturers in case of sales to unregistered persons. For sale to unregistered dealers, 10% expense deduction was disallowed w.e.f from Oct’20. The company has already provisioned Pkr630mn in this regard, where as per our back of the envelop calculation, assuming 100% of dealers are not registered in sales tax, it could imply negative earnings impact of approximately Pkr2bn p.a. (EPS impact: Pkr1.50) for EFERT. On normalization of urea inventory from 605K MT peak levels witnessed CYTD, EFERT also increased its urea price by Pkr25/bag w.e.f Aug’20 to 1,625/bag. The fertz players would likely pass-on any negative hit from the aforementioned measure in terms of further urea price hike, proving to be a neutral event for the scrip. We await further clarity on budgetary measures before incorporating them in our estimates, which may result in a negative earnings impact of 4% over CY21-25F on average in case of no pass-on.

Sufficient liquidity to meet GIDC payables: The fertilizer players have also requested to the government to increase the GIDC payment timeline from 24 months (as per Supreme Court’s directive) to 10 years. In case of refusal of request, the fertilizer players may potentially increase urea price by Pkr500/bag, reportedly. We believe both parties may find a middle ground in this regard. However, even in case of a fallout, EFERT’s cash and short term investment of Pkr15.6bn as per latest financials are sufficient to meet 80% of GIDC payables. To add, average CFO generation of Pkr10.8/sh over next two years indicate comfort on the scrip’s payout situation.

Investment Perspective: Despite comfort on impact of sector headwinds on EFERT, we maintain our Sell stance on the stock, as the end of concessionary gas agreement approaches (CY23), post which D/Y will narrow down from 13% at present to 8%.
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AKD Securities Limited
602, Continental Trade Centre, Clifton Block 8, Karachi, Pakistan.
research@akdsecurities.net