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PAKISTAN
CHEMICAL

REP-019
MARKET
VISTA

EPCL: Continuing to push above its weight

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BUY

TARGET PRICE (PkR)	SHARE PRICE (PkR)
71.7	54.4
UPSIDE/DOWNSIDE	DIV. YIELD
32.0%	4.3%

We initiate coverage on Engro Polymer & Chemicals Ltd (EPCL) with a Buy call and a TP of PkR72/sh (upside: 32.0% at LDCP), citing significant near term catalysts including (i) uptrend in PVC Ethylene margins and (ii) 100K MT PVC expansion (50% of existing capacity; CoD: 1QCY21). The PVC ethylene margins have recently surpassed ~US$1,000/MT in Mar'21 on the back of force majeure declared by PVC capacities in the US and, soft ethylene prices amid recent wave of global capacity expansion resulting in excess ethylene supply. We expect PVC Ethylene margins to hover at US$850/MT in 1HCY21, normalizing to some extent in 2H, to average at US$690/MT in CY21. Our long term assumption stands at US$400/MT on average, where every US$50/MT higher than expected margins would result in ~20% EPS impact. To add, EPCL's investment in high temperature direct chlorination (HTDC) technology will reduce gas requirement for PVC manufacturing process by 10% from CY22F onwards (incorporated in our estimates), somewhat negating the impact of upcoming gas rate hikes (incorporated 15% hike in Jul'21). Upside triggers include EPCL's entry into hydrogen peroxide and LABSA business (c. 15% impact on bottomline post CoD; not incorporated yet). EPCL is trading at undemanding CY21/22F P/E of 4.68/6.50x vs. market P/E of 6.70x—Buy!

(Detailed Report to be released soon)

PVC Ethylene margins surpass US$1,000/MT: PVC ethylene margins have surpassed all-time high of ~US$1,000/MT in Mar'21. A cold rush during Feb'21 in US resulted in further delay in production from US PVC capacities which had just recently come back online after declaring force majeure during Aug'20 to Jan'21. We expect PVC Ethylene margins to average at US$850/MT in 1HCY21 (1QCY21 average: US$840/MT), normalizing further through CY21, averaging at US$690/MT for CY21F. Strong PVC demand recovery on roll-out of COVID-19 vaccines (pent-up demand), coupled with excess ethylene availability on global scale would keep margins above long term average in CY22F as well. Our long term assumption for margins is at US$400/MT. Every US$50/MT higher margins than our assumption would result in ~20% impact on bottom-line.

Expansions come at an opportune time: The bull cycle in PVC ethylene margins comes at an opportune time for EPCL, which has expanded PVC capacity by 100K tons (50% of existing capacity) and is carrying out VCM debottlenecking exercise to unlock 50K tons capacity in 2QCY21. This can potentially enable EPCL to cater to 100% local PVC demand post commissioning, with a volumetric offtake CAGR of 17% over CY20-23F (low base in CY20 due to COVID'19 disruptions). Other projects in pipeline include 24K MT capacity of Linear Alkyl Benzene Sulphonic Acid (LABSA – used to produce household detergents) and 27K MT capacity of Hydrogen peroxide (used in bleaching processes in textile, pulp, and paper industries) - not incorporated in estimates. EPCL also has plans to invest in high temperature direct chlorination (HTDC) technology which will reduce gas consumption in PVC manufacturing by 10% from CY22F onwards. To recall, PVC and chlor alkali manufacturing processes, both are energy intensive processes, with power and fuel currently accounting for ~20% of cost. We have incorporated (i) 15% gas price hike w.e.f Jul'21, and (ii) lower gas consumption CY22F onwards emanating from HTDC usage in PVC manufacturing process.

EPS growth to be modest over medium run; upside triggers abound: While near term triggers are abound, normalization of PVC ethylene margins as PVC supply shock ends may contain EPS growth over CY20-25F. Going forward, materialization of HPO and LABSA projects are potential upsides (cumulative impact of these two projects to PkR0.98/sh or 15% of CY23F EPS). Furthermore, our estimates do not incorporate the tax credits on PVC III expansion due to ongoing discussion on definition of 'green field investment' (EPS impact of PkR1.22;~15% of earnings on average over CY21-25F). That said, our conviction on the scrip stems from healthy EBITDA generation (PkR13bn on average over our investment horizon), where CAPEX for the aforementioned projects has mostly been met through internal cash generation or raising fresh equity to avail tax benefits. Debt to asset for EPCL is projected to stay below 0.40x vs. an average of 0.93x over last 10 years, indicating room to tap into more opportunities in chemical sector. Our TP of PkR72/sh implies an upside of 32% at last close, with 20% payout ratio translating in total return of 36%.

EPCL- Valuations Glance

Key Matrics	CY19	CY20	CY21F	CY22F
EPS (PKR)	4.1	6.3	11.6	8.4
EPS Growth	-25.0%	54.5%	84.7%	-27.9%
DPS (PkR)	0.8	1.2	2.3	1.7
Dividend Yield	1.5%	2.3%	4.3%	3.1%
PER (x)	13.4	8.6	4.68	6.50
BVS (PkR)	19.5	28.7	37.6	43.9
P/BVS (x)	2.8	1.9	1.4	1.2
ROE	21.4%	26.1%	35.0%	20.5%
ROA	12.2%	13.3%	23.6%	17.1%

Source: Company Report & AKD Research

Macro Assumptions

Macro Assumptions	CY20	CY21F	CY22F	CY23F
PVC Sales (K MT)	153.0	230.0	258.6	268.9
Core Delta (US$/MT)	540.0	690.0	480.0	400.0
Exchange Rate	163.0	156.0	162.2	168.7
PkR Depreciation	7.9%	-4.3%	4.0%	4.0%
Gas Price (PkR/mmbtu)	1,021.0	1,098.0	1,174.0	1,232.7
Gas Price incr.	13.8%	7.5%	6.9%	5.0%

Source: Company Report & AKD Research

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To arrive at our period end target prices, AKDS uses different valuation techniques including:

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

New Rating Definitions	
Buy	**＞ 14.5% expected total return （Rf: 8.5% ＋ Rp: 6%)**
Neutral	**＞ 8.5% to ＜ 14.5% expected total return**
Sell	**＜ 8.5% expected total return （Rf: 8.5%）**

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