AKD Daily

Thursday, Sep 06, 2018

Today's Daily

Pakistan Fertilizers: New Government = New Rules

We downgrade our Fertilizer universe to 'Underweight' as we caution against potential sectoral headwinds including i) additional available inventory via either local production and/or imports, ii) gas price hike with the PM having reportedly approved a broad based gas tariff increase and iii) potential inability to pass on cost increase (with the key word being 'potential'). With regards to the latter, we believe any price increase may likely to be restricted by GoP action as evidenced by recent ECC discussions regarding windfall profits. At the same time, the decision to resume production on three closed urea plants (FatimaFert, Agritech and Pak Arab) on RLNG may not be viable in the context of annual costs (PkR8.4bn subsidy may not be economically feasible). If gas prescribed price hike is transposed on end consumer prices (as reported in news reports), our Fert Universe profitability for CY19 reduces by an average 14%, while adjusted TPs come at EFERT (PkR75.9/sh from current PkR87.7/sh), FFC (PkR86.8/sh; Current: PkR104.1/sh), FFBL (PkR40.1/sh; Current: PkR48.2/sh) and FATIMA (PkR38.7/sh; Current: PkR45.1/sh).

KSE100 - Index

Current	41,620.96
Previous	41,753.89
Chg.	-0.32%

Mkt Cap. (PkRbn/US$bn)

Current	8,662 / 69.72
Previous	8,688 / 69.93
Chg.	-0.30%

Daily Turnover (mn)

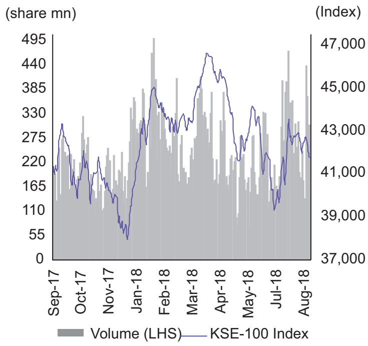
Current	126.93
Previous	126.57
Chg.	0.3%

Value Traded (PkRmn/US$mn)

Current	5,485 / 44.15
Previous	4,097 / 32.98
Chg.	33.9%

News and Views

- Pakistan and the United States have decided to give reset in ties another shot after the positive initial engagement on Wednesday resulted in an understanding between the Trump administration and the new Pakistani government on delivering on each other's expectations.
- The overall cement sales fell by two per cent to 7m tonnes in the first two months of 2018-19. Exports jumped by 21.5% to 1.076m tonnes, while local sales dropped by 5.31% to 5.930m tonnes during the period.
- The Economic Coordination Committee (ECC) of the Cabinet has directed K Electric to first settle liabilities of CPPA-G and SSGC and share sale purchase agreement with Privatisation Commission for review prior to bringing it before the CCoP.



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ECC decides in favor of restarting closed plants – Best possible decision or not? In order to address urea shortfall (urea inventory stands at a mere 86k tons), GoP has decided to resolve the issue through restarting of closed urea plants. The decision in this regard was taken in the latest ECC meeting with an outcome that RLNG would be supplied to the three closed urea plants (Fatimafert, Agritech and Pakarab) for a period of four months (Sep-Dec'18) at a subsidized rate of 50%. Having cumulative capacity of 81k tons (monthly), resumption of these units would result in an incremental production of ~324k tons, assuming 100% utilization. This would result in an inventory surplus of ~100k tons by the end of CY18 against the current scenario which implies a potential deficit of 225k tons in the rest of CY18 (supply/demand of 2.25/2.47mn tons).

Based on capacity additions / restarts, we do not expect any material impact of this decision on local manufacturers as it will only bridge the current supply-demand gap in the industry. However, we remain skeptical of the ECC decision, as the required subsidy of ~PkR8.4bn do not make for an economically feasible case for these plants to restart production. Our calculation suggests contribution margin of PkR114/bag (see table-I) that would be insufficient to cover associated distribution and administrative cost of these manufacturers. Against this backdrop, we believe urea import would be a better alternative for the government, where a subsidy of ~PkR4.4/bn is required (to compensate for pricing differential between local and int'l prices) as compared to a subsidy of ~PkR8.4bn in the former case.

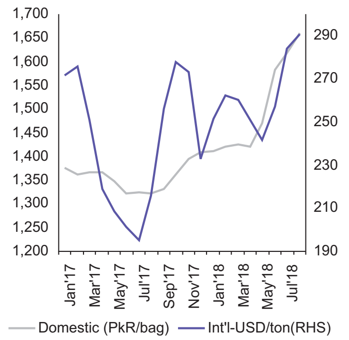
Restricted pricing power: The ECC in its latest meeting also showed serious concerns regarding urea export in the last season and windfall

Estimated inventory situation by end of Dec'18

Monthly Capacity (k tons)	K tons
Pak arab	7.7
Agritech	36.1
FatimaFert	37.1
Total (A)	80.9
Existing production (B)	450
Estimated Demand/Supply (Aug-Dec'18)	
Total new prodcution (A*4)	324
Total existing prodcution (B*5)	2,250
Total production	2,574
Estimated demand	2,475
Additional inventory	99
Existing inventory	86
Total inventory (Dec end)	185

Source: NFDC, AKD Research

Urea prices: Domestic vs. Int'l



Source: Bloomberg & AKD Research

gains reaped by fertilizer manufacturers through recent price hike. In this regard, the committee recommended adjustment of the said windfall gains against the outstanding subsidy claims, which we consider a major negative for the sector. While remaining skeptical on recovery of windfall profits by manufacturers (export made with the consent of previous government), we view this as a pressure tactic by the incumbent government to restrict pricing power of local manufacturers or to reverse recent price hikes.

Possible gas price hike could dampen profitability: PM has reportedly approved gas price hike in line with OGRA's Jun'18 recommendation (refer to SNGP & SSGC FY19 ERRs), which comes as a serious blow to the sector at a time when manufacturers hold limited pricing power. To recall, OGRA recommended an increase of ~29%/30% on Feed and Fuel gas from PkR123/600 per mmbtu to PkR159/780 per mmbtu in Jun'18. Assuming zero pass through, fertilizer plants without concessionary gas pricing such as FFC and FFBL will be most impacted, with respective CY19 earnings impact of ~19.1% and 22.2%. However, EFERT (partial concessionary feed) and FATIMA (concessionary feed) are expected to have relatively lower CY19 earnings impacts of ~8.7% and 6.1% respectively. With this gas price hike, urea manufacturers need to increase their product price by at least PkR70-80/bag in order to maintain current margin profiles.

Outlook & Investment Perspective: Fertilizer sector has gained 17%CYTD, outperforming the KSE-100 index by +14% during FY18. Going forward, we recommend a cautious stance on the sector, where risk of gas price hike looms large at a time when manufacturers appear to possess restricted pricing power.

***Possible Gas Price Hike** (PkR/mmbtu)*

	Current	Proposed	% increase
Feed Gas	123	156	26.8%
Fuel Gas	600	780	30.0%

Source: SNGP & SSGC ERR

Impact Of Gas Price Hike

	EPS impact	% of CY19 earnings	TP Revision
FFC	1.86	19.1%	-16.5%
FFBL	0.62	22.2%	-16.8%
EFERT	0.85	8.7%	-13.5%
FATIMA	0.34	6.1%	-14.2%

Source: Company Report & AKD Research

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