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PAKISTAN STRATEGY

REP-019
MARKET VISTA

Gas hike shows PTI Government can bite the bullet

- **ECC approved gas price hikes between 10-143% for all slabs of domestic consumers and 30-60% for industrial sector natural gas consumers, while cushioning export oriented textiles (amongst five zero rated industries) in a bid to augment cash flows at the state run gas utilities**
- **Lifting our expectations for CPI by 60/90bps for FY19/CY19F, we believe the knock on impact of rising price levels will translate to an additional 100bps hike in our benchmark rate expectations (+275bps cumulative rise during FY19)**
- **Industries consuming natural gas for feed stock (Fertilizers, Refiners, some chemicals), and mostly for fuel stock (Cements, Steel, Power) are expected to undergo varying degrees of pricing pressure, where their ability to pass-on escalations may be in doubt (particularly in the case of Fertilizers and Cements)**
- **Resultantly, the weight added to CPI expectations and persistent focus on sheltering export oriented sectors from input price hikes furthers an investment case based on export oriented industries and Banks where the themes of PkR devaluation and tightening monetary policy deliver upside.**

CPI inflation to shoot up: With increase in gas prices, we revise upward our CPI inflation by 60/90bps for FY19/CY19F to average out at 7.4%/8.04%YoY. Subsequently, SBP is likely to take a more proactive stance in setting benchmark interest rates, where we estimate cumulative 275bps hike (previously 175bps) with TR/DR ending at 10.25%/10.75% by Jun'19.

Textiles continue to benefit from export shelter: Continuing its support for the export sector, the GoP has kept gas prices unchanged for five zero-rated sectors (i.e. textile, carpets, leather, sports, and surgical goods) at PkR600/mmbtu. Also, contrary to the rate hike for other industries, the gov't announced to provide subsidized R-LNG to the textile industry to restore sector's competitiveness in the export market. Though the gov't has yet to work out subsidized LNG rate, the proposed scenario would only benefit Northern players (i.e. NML & NCL being the major beneficiary) due to their heavy reliance on R-LNG (gas mix for Northern players: 72% R-LNG vs. 28% N. Gas). South based textile manufacturers (i.e. GATM & GADT) – being on the domestic gas network – would remain immune to recent development.

Fertz - tariff hike could dampen profitability if GoP intervenes: ECC approved an increase of 50% and 30% on Feed and Fuel gas price from PkR123/600 per MMBTU to PkR185/780 per MMBTU. With this gas price hike, urea manufacturers need to increase their product price by at least PkR55-125/bag in order to maintain current margin profiles. In case of no price pass on, Fertilizer plants without concessionary gas pricing i.e. FFC and FFBL will be most impacted in this scenario, resulting in adverse earnings impact of ~29.1% and 31.8% in CY19 respectively. However, EFERT and FATIMA (running on concessionary gas and 2012 petroleum policy) are expected to have a relatively lower negative earnings impact of ~10.7% and 7.7% for CY19 respectively.

For Fertz, its a question of pricing power: In this regard, we feel that local manufacturers possess decent ability to pass on the higher cost impact given current ~30-35% discount to prevailing elevated cost of imported urea (US$300 per tons, landed cost: PkR2420/bag). However, for the sake of farm income, GoP can potentially restrict any further price hike in local urea prices, in our view, which could dampen sector's profitability. To recall, ECC in its previous meeting also showed serious concerns regarding urea export in the last season and windfall 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.

Cement – soft earning impact of PkR5-8/bag: For cement manufacturers using gas for captive power plant, ECC has approved gas tariff hike of 30% (from PkR600/mmbtu to PkR780/mmbtu**).** Financial impact of any gas price for cement industry seems to be insubstantial as most of the

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ECC finally decides to increase gas rates:

Sector	New	Old	Chg.(%)
Commercial	980	700	40%
CNG	980	700	40%
Industrial	780	600	30%
Cement Factories	975	750	30%
Fertilizer (Feed-Stock)	185	123	50%
Fertilizer (Fuel-Stock)	780	600	30%
Power	629	400	57%
Captive Power Plant	780	600	30%

Source: AKD Research

Earnings impact

Sector	Annualized EPS(PkR)	Impact
Fertilizer:		
FFC	2.88	
FFBL	0.81	Negative
EFERT	1.06	
FATIMA	0.43	
Cement		
LUCK	1.86	Negative
DGKC	0.64	
Chemical		
LOTCHEM	0.18	Negative
EPCL	0.38	
Steel		
ASTL	0.31	Neutral-Negative
ISL	0.49	

Source: AKD Research

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manufacturers using gas based captive power plants are located in Punjab (DGKC, MLCF, FCCL, GWLC & BWLC) where RLNG rates (mix of normal gas & RLNG) are in place for gas usage (much higher than this gas price). However, for KPK and South manufacturers (LUCK & DGKC) using gas at normalize rate (LUCK & DGKC), a 30% hike in gas price is expected to erode FY19F earnings by 4.2-5.5%. That said, we have already assumed a 15% rise in gas tariff from 2QFY19 in our models. With this gas price hike, cement manufacturers need to increase their product price by at least PkR5-8/bag in order to nullify the impact.

Steel – marginal impact due to limited use of domestic gas: Amongst steel sector, long steel players would see slight incremental cost impact due to revised gas rates (see table I). Interestingly, impact varies depending upon gas network and raw material a company is using to feed its operations. For instance, MUGHAL is primarily using furnace oil for reheating billets and R-LNG for electricity generation (Gas mix: 72% R-LNG vs. 28% N. Gas), thus very minimal earnings impact. On the other hand, ASTL uses gas for reheating billets (SITE plant only), thus approved rate hike would result in incremental cost of PkR249 per ton, which the company can comfortably pass on, in our view. In flat steel, ISL relies on captive power plant (19MW) resulting in higher generation cost of ~PkR213mn (EPS: PkR0.49).

Power – keep on adding to circular debt: Incremental gas rate to power plants from PkR400/mmbtu to PkR629/mmbtu will be a pass-on under the Energy Price Payment (EPP) of IPPs/fuel cost adjustment of GENCOs. To note, currently ~2,800MW is being generated on Gas where certain IPPs/power stations have field specific gas price arrangements (EPQL, Uch) and don't fall under the ambit of this increase. Other plants/turbines, although mentioned separately under OGRA's previous notifications, follow suit with the overall price movement. Moreover, taking cue from the minister's briefing, we believe GoP would not raise electricity tariff to compensate for the said increase leading to a further accumulation of circular debt stock. As per our back of the envelop calculations, this hike could raise overall revenue/receivables for power companies at PkR2.5bn per month (assuming an average 40% efficiency on gas) and would thus only shift the debt supply chain from gas to power.

Refineries are gas consumers too: Refineries are one of the highest energy consuming industries. Specifically, natural gas (along with other waste gases) is used for heating purposes of pre-flash and other units. While the portion of system gas is very less, even a minute impact can be burdensome for their already fragile bottom-lines.

Gas Utilities – Cash flows given much needed relief: Gas Discos (SSGC and SNGP) remain slight beneficiaries of such a rate hike as the companies are able to better manage their cash flow positions. Currently, SNGP has receivables of PkR103bn booked under the gas differential head while SSGC (in its latest FY16 account) had booked payables of PkR18.6bn (though we believe the situation might have reversed by now). In this regard, the petroleum minister in his press briefing highlighted that the deficit (receivables under GDS) of both utilities would go down by ~PkR94bn to PkR58bn from PkR152bn previously, while the impact of remaining PkR58bn would be adjusted later on. However, it should be noted here that the quantum of UfG losses would balloon as instances of leakage/theft remain high in retail (household consumer segment) which accounts for ~21% of total gas consumption. In this regard, absolute quantum of UfG loss would erode the bottom-line of both the utilities.

Chemicals – input costs climb: Primary earnings impacts are largely derived from either power generation demand for plants generating captive power (EPCL, LOTCHEM, amongst others) mostly in the South and natural gas users utilizing the resource in their primary production processes (DOL, SPL, ICI). Earnings impacts for EPCL amount to PkR0.38/sh and PkR0.18/sh for LOTCHEM in annualized terms.

Outlook: The much delayed gas price hike (first proposed by OGRA during caretaker regime) signals a willingness to make tough, belt-tightening moves by the nascent PTI-led set up. From a broader view, these hikes have been a point of contention in previous rounds of consultations with the IMF, delayed by the previous Government, where the recent hike could be a positive move in securing financing from the Fund. Resultantly, the heft added to CPI expectations and persistent focus on sheltering export oriented sectors from input price escalations furthers an investment case based on PkR devaluation and tightening monetary policy.

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