

Engro Corp (ENGRO PA)

Gas Curtailment: Price hike puts profitability concerns to rest

The fertilizer sector has come under the limelight for the past few days as the gas load management program has forced the government to curtail (7-20%) gas supply to the fertilizer sector for a period of 2-3 months. As a result, investor confidence has dwindled somewhat with all the major fertilizers hit hard, particularly Engro (Engro Corporation) the share price of which has fallen 4.4% since this news flow. The company has however reacted proactively on this matter and conducted an analyst briefing on Friday to share measures undertaken to deal with the situation. In response to the 7% gas supply cut, Engro has announced an immediate raise in urea prices by Rs75 per bag to Rs855 per bag with the possibility of increasing prices further, if the supply situation worsens. The management has also at the same time made a commitment to the government of restoring prices back to original levels once the gas supply is normalized.

This price hike by the management mitigates any major impact on Engro Fertilizer Limited's (EFL) earnings for the time being. However, if this load management is prolonged beyond when EFL's new urea plant comes online, the company would have to resort to major re-pricing, else earnings could take a significant hit. The huge price differential between domestic and international urea prices (US\$157 per ton) though remains a major comforting factor for manufacturers. Assuming a 2-3 months short gas supply, our valuations remain intact with a fair value of Rs235 per share. Trading at 2011F PE and EV/EBITDA of 8.7x and 4.3x, respectively, we recommend the investors 'Accumulate' Engro on exciting long term plays (Foods, Fertilizers, Power), with one caveat however, that a close watch be kept on any new developments on the said gas issue. Key risks to our thesis are; (1) timing and cost overruns on major expansions (2) prolonged gas supply disruptions (3) no major cut in interest rates in the 2H2010 & (4) lower urea margins post excess supply in 2011.

Price hike fine for now, but prolonged gas cut remains a risk

Under the load management program, the government has started to cut gas supply to the fertilizer industry, for a period of 2-3 months, in the vicinity of 7-20% depending on the field supply the gas. Fauji Fertilizer Bin Qasim (FFBL), Pak Arab & Dawood Hercules etc are receiving gas from the Sui networks, and face a curtailment of 20%, whereas Fauji Fertilizer Company (FFC) and Engro (both being supplied gas from the Mari Field) currently face a 7% supply cut. Engro's management believes, gas reduction from Mari field will remain on the lower side compared to the Sui networks as it supplies gas to only one power plant, Guddu. Nonetheless, even a 7% cut remains significant, as both production and plant efficiency are likely to suffer from this decision.

In order to avoid any losses and protect shareholder value, Engro's management has proactively reacted to this situation and raised product prices by Rs75 per bag to Rs855, with other fertilizer manufacturers likely to follow suit. This price revision is based on a 7% gas curtailment scenario and further revisions are likely if the quantum of gas reduction is increased. What offers solace to urea manufacturers

Company Update: **BUY**

Target Price: **Rs235**

Fertilizers

May 2010



JS Global Capital Limited

KATS Code:
ENGRO

Bloomberg Code:
ENGRO PA

Reuters Code:
EGCH.KA

Market Price:
Rs198.17

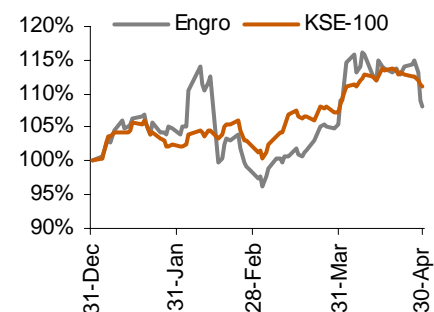
Market Cap:
Rs64.9bn
US\$773.2mn

1-yr Avg. Daily Volume:
2.8mn shares
Rs470.8mn
US\$5.6mn

1-yr High/Low:
Rs212.84/123.88

Estimated free float:
104.3mn shares (31.8%)

Engro vs KSE-100 index



Source: KSE & JS Research

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even after this price pass through is that (1) domestic urea prices (US\$203 per ton) still remain at a steep discount of 44% to the landed import cost of US\$360 per ton (2) incremental urea imports of 150k-200ktons would now be needed for the Kharif summer, implying a Rs1bn per month subsidy from the GoP & (3) since major players FFC and ENGRO are only facing a 7% gas supply cut, dealers may decide to stock up urea fearing a further price hike if the gas supply situation worsens.

While the price hike would resolve the situation in the short term, prolonged gas supply concerns especially once Engro's new plant is online does remain a potential challenge for the company. We believe, commissioning of the new RFO based IPPs by the Nishat Group and Hubco in 2H2010, together with possible sanctioning of some RPPs could eventually determine the fate of future gas flows to fertilizer companies. Moreover, it would be interesting to see how the government balances between gas supply to the fertilizer sector and the need to provide subsidy on urea imports.

We have carried out a sensitivity analysis on possible price hikes given various levels of gas reduction.

Engro's gas curtailment & price hike sensitivity

(Rs mn)	2010E
Original estimates	
Revenue	94,037
Cost of goods sold	72,022
EPS (Rs)	16.8
Base case: 7% curtailment & Rs75/bag increase	
Revenue	93,887
Cost of goods sold	71,880
EPS	16.8
12% curtailment & Rs128/bag increase	
Revenue	93,888
Cost of goods sold	71,878
EPS	16.8
14% curtailment & Rs150/bag increase	
Revenue	93,887
Cost of goods sold	71,880
EPS	16.8

Source: JS Research

Robust 1Q2010 performance

Engro reported strong 1Q2010 corporate results (a growth of 176%YoY to Rs5.76 per share), mainly led by higher profits in the fertilizer, trading, chemical storage and energy businesses. Although, Engro Foods Limited registered a loss of Rs11mn in 1Q2010, its revenues contributed substantially to the top-line with its tea whitener (Tarang) earning revenue of Rs2bn in the first quarter. Further, Engro's 217MW power plant commenced its operations during the period under review and even contributed Rs44mn to the bottom line of the company. In view of these impressive results, our 2010 full year earning estimates have been adjusted accordingly, and we expect the company to report a PAT of Rs5.5bn (EPS: Rs16.8) compared to estimated earnings of Rs4.6bn (EPS: Rs14.0) previously.

Engro's 1Q2010 result highlights

(Rs mn)	1Q2010	1Q2009	Δ%	Analytical Review
Engro Fertilizer PAT/(loss)	773	703	10%	Higher volumes and urea prices led growth
Share of Engro 100% (Rs/share)	2.36	2.15		
Engro Foods PAT/(loss)	(11)	13	NM	Higher marketing and administrative expenses due to its ice cream business
Share of Engro 100% (Rs/share)	(0.03)	0.04		
Engro Eximp PAT/(loss)	897	(73)	NM	Extreme turnaround in DAP volumes and higher DAP trading margin led to the turn to profitability
Share of Engro 100% (Rs/share)	2.74	(0.22)		
Engro Polymer PAT/(loss)	(154)	(69)	NM	Delays in VCM plant and shut down of Chlor-alkali plant suppressed PVC-VCM margins
Share of Engro 56% (Rs/share)	(0.26)	(0.12)		
Avanceon PAT/(loss)	(64)	(81)	NM	Achieved revenue growth of 22%YoY to Rs340mn which helped to reduce quantum of losses
Share of Engro 63% (Rs/share)	(0.12)	(0.16)		
Engro Vopak PAT/(loss)	264	182	45%	Strong results due to add on of Ethylene storage which was added in 1Q2009
Share of Engro 50% (Rs/share)	0.40	0.28		
Engro Energy PAT/(loss)	44	(10)	NM	Started supplying power to the grid since March 2010 resulting in a turn to profitability
Share of Engro 95% (Rs/share)	0.13	(0.03)		

Source: Company announcements & JS Research

Food & Fertilizer expansions remain long term growth triggers

Engro's long term investments in the food and energy sectors continue to remain major growth triggers for the company, going forward. During the past two years, Engro has undergone significant developments; from turning its dairy business towards profitability to launching its ice cream business, and from diversifying into the rice business to setting up its gas based power plant at Qadirpur. In the wake of these impressive 1Q2010 results, we foresee these investments to further contribute in the future.

Engro's Qadirpur power plant has already come online during 1Q2010 and in a short span of less than a month, added 2.4% to its consolidated profitability. Engro has also signed an MOU with PEPCO to supply coal from their JV with Sindh government at the Thar Coal field, for its 1200MW power plant.

The food business continues to progress well and after achieving profitability in the dairy business, Engro has made strong inroads with the ice cream segment (achieving 11% market share despite the launch being confined to limited towns in Punjab), while packaged juices are expected to be brought in to the market, in the current month. Expansion into the rice processing and trading business is also on track, with the rice plant likely to be operational by November 2010.

Valuation: 'Buy' on long term growth prospects

Our sum of the parts (SoTP) based fair value of Rs235 is based on separate valuation techniques for all major business ventures, and is skewed mainly towards the Fertilizer and Food businesses, which contribute around 70% to the total valuation. Our valuation uses a risk free rate of 11% and equity risk premium of 6.5% with varying terminal growth rates for different businesses. Engro currently trades at a post expansion consolidated 2011F PE and EV/EBITDA of 8.7x and 4.3x respectively, which is at a discount of 28% to the historical multiples. Hence, we reiterate our 'Buy' call on the scrip at current levels. The entity wise, fair value break-up is as follows:

Engro's SoTP valuation

Company	Valuation (Rs/share)	Contribution	Valuation Method
Engro Fertilizer & Exim	130	55.3%	FCF & DDM based valuations
Engro Foods	65	27.7%	Price to sales valuation
Engro Polymer	15	6.4%	DCF based valuation
Engro Energy	13	5.5%	DDM based valuation
Engro Vopak	11	4.7%	DDM based valuation
Engro Avanceon	1	0.4%	Valued at cost
Engro Corporation	235		

Source: JS Research

Key risks to realizing fair value

- **Prolonged gas supply disruptions** - could lead to a further fall in production; however at present, the company still has room to adjust prices if any more gas is curtailed, accordingly.
- **Timing and cost overruns** - in major expansionary projects in the fertilizer and foods businesses
- **No major cuts in interest rates in 2H2010** - we have assumed an average of 11% KIBOR for 2H2010, hence, absence of any downward revision by the government in the policy rate, would be a downside risk to our valuation.
- **Lower urea margins, post excess supply in 2011** – there is a general view that once Engro's new plant comes online, an excess supply situation will prevail in the domestic market. Though, there have been reports of exporting any surplus, any non materialization of such an event could dampen urea margins.

Engro Corporation – Financial Highlights

Year ended December (Rs mn)	2008A	2009A	2010E	2011F	2012F
Income Statement					
Net sales	40,973	58,152	93,886	112,257	120,086
COGS	30,111	44,658	71,891	83,199	89,293
Gross profit	10,862	13,494	21,996	29,057	30,793
Operating Profit	6,608	7,279	15,312	21,078	22,571
Other income	1,038	390	373	383	397
Financial charges	1,738	2,222	7,764	9,672	9,007
Share from JV	245	459	460	478	497
PBT	5,184	5,062	7,804	11,637	13,816
Tax	977	1,343	2,312	3,565	4,288
PAT	4,207	3,719	5,492	8,072	9,528
Less minority interest	80	88	(1)	630	848
Profit attributable to ordinary shareholders	4,126	3,631	5,493	7,443	8,680
Balance Sheet					
Issued, subscribed & paid-up capital	2,128	2,979	3,277	3,277	3,277
Reserves	18,306	23,140	26,368	29,899	33,826
Shareholder's Equity	20,434	26,119	29,646	33,177	37,103
Minority interest	3,114	3,225	3,224	3,854	4,701
Non current liabilities	44,974	86,791	91,361	79,734	71,563
Current Liabilities	12,280	15,970	19,788	27,093	28,484
Total Liabilities & Equity	80,802	132,105	144,019	143,857	141,851
Operating Fixed Assets	58,600	110,943	111,451	102,607	95,228
Other Assets	1,541	1,239	3,202	3,767	3,734
Total Current Assets	20,661	19,924	29,366	37,483	42,889
Total Assets	80,802	132,105	144,019	143,857	141,851
Ratio Analysis					
Valuation					
Eaming per share	12.6	11.1	16.8	22.7	26.5
Dividend per share	6.0	6.0	6.0	10.0	12.0
Book value per share	62.3	79.7	90.5	101.2	113.2
Price to earning ratio (x)	13.0	10.2	11.8	8.7	7.5
Dividend yield (%)	3.0%	3.0%	3.0%	5.1%	6.1%
Price to book value (x)	3.2	2.5	2.2	2.0	1.8
EV/EBITDA (x)	12.0	12.0	7.5	4.3	3.8
Profitability					
Gross margin	26.5%	23.2%	23.4%	25.9%	25.6%
Operating margin	16.1%	12.5%	16.3%	18.8%	18.8%
Pretax margin	12.7%	8.7%	8.3%	10.4%	11.5%
Net margin	10.3%	6.4%	5.8%	7.2%	7.9%
Return on assets	5.2%	2.8%	3.8%	5.6%	6.7%
Return on equity	20.6%	14.2%	18.5%	24.3%	25.7%
Momentum					
Sales growth	20.1%	41.9%	61.4%	19.6%	7.0%
Net profit growth	48.4%	-11.6%	47.7%	47.0%	18.0%

Source: JS Research & Company Accounts

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ANALYST CERTIFICATION

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