

Fatima Fertilizer (FATIMA PA)

Maneuvering itself to new highs

Company Update: **BUY**

Target Price: **Rs29**

Chemical

December 2011



JS Global Capital Limited

Fatima Fertilizer (FATIMA) has been in the thick of investor interest since commencement of its commercial production in July, 2011 – evident from its average daily turnover of 4.2mn shares in December, 2011 compared to 1.6mn shares since its listing till June 2011. FATIMA seems to be the least effected of the fertilizer manufacturers as it is connected to the Mari network – facing lesser gas curtailment. In addition, the subsidized fixed feedstock gas tariff for ten years gives it an edge over its peers. It is for these reasons and higher fertilizer prices, the company has started of its commercial production with exorbitant gross margins of 64% in 3Q2011.

The free ride seems to continue, as Gas Infrastructure Development Cess (GIDC) is unlikely to be imposed on FATIMA and consequent increase in urea prices by the impacted fertilizer producers may result in additional margins for the company. The Certified Emission Reduction (CER) credit benefits under the Kyoto Protocol is likely to boost the topline of the company. A product portfolio that is a bit different than other conventional fertilizer manufacturers producing only urea also helps the company in reaping benefits of a diversified portfolio. Moreover, the debt burden that tends to worry investors is less of a concern at these exorbitant fertilizer margins. However, imposition of an equalization tax, reduced fertilizer margins and the ammonium nitrate issue with the US remain as key risk to our investment thesis. On a relative basis, FATIMA is trading at 2012E PE of 5.4x compared to the JS Universe fertilizer sector PE of 5.3x. We recommend our Buy call on it with a DCF based target price of Rs29 (potential upside of 25%).

Exorbitant gross margins

The company has started its commercial production with the exorbitant gross margins of 64% in 3Q2011. This is attributed to higher fertilizer margins together with feedstock gas supply at subsidized rates. Urea and CAN margins are linked with gas related woes. CAN price is linked with the local urea price and it normally sells at ~20% discount to urea price in the local market. However, as it is directly linked with the local urea prices, the volatility in urea prices are likely to impact the revenues from the CAN segment as well. Whereas NP margins follow DAP margins. NP generally sells at ~35% discount to DAP prices that are somewhat internationally linked. Therefore, the increased DAP prices have also boded well towards the profitability of the company.

Key statistics

	2011E	2012F	2013F	2014F
Revenue (Rs mn)	14,621	31,109	32,660	34,089
Profit after Tax (Rs mn)	3,642	8,543	9,782	11,830
Earnings per share (Rs)	1.8	4.3	4.9	5.9
Book value per share	11.7	15.9	20.8	26.7
Price to earnings (x)	12.7	5.4	4.7	3.9
Price to book value (x)	2.0	1.5	1.1	0.9

Source: JS Research

KATS Code:

FATIMA

Bloomberg Code:

FATIMA PA

Reuters Code:

FATIMA.KA

Market Price:

Rs23.16

Market Cap:

Rs46.3bn
US\$519.7mn

1-yr Avg. Daily Volume:

3.4mn shares
Rs61.2mn
US\$0.7mn

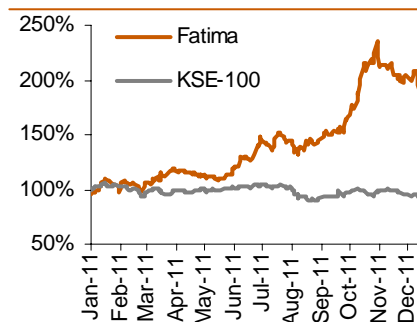
1-yr High/Low:

Rs26.52/9.98

Estimated free float:

300mn shares (15%)

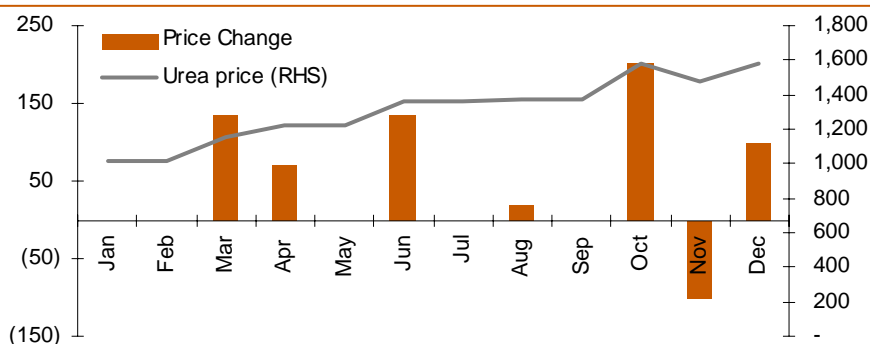
Fatima vs KSE-100



Source: KSE

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Urea prices in 2011 (Rs/bag)

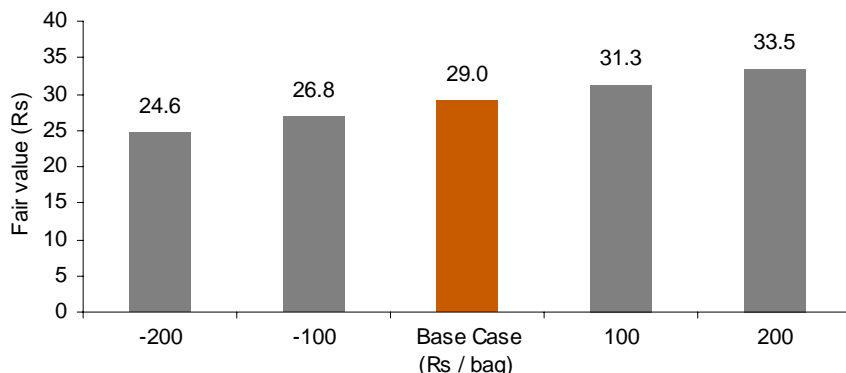


Source: JS Research

Unlikely to be impacted from GIDC

The Gas Infrastructure Development Cess (GIDC) is unlikely to impact FATIMA as it is expected to get feedstock gas supplies at their previous subsidized rate because of their agreement with GoP. Therefore, FATIMA will benefit if the fertilizer companies decide to pass through the incremental cost of GIDC.

Impact of urea price change on fair value



Source: JS Research

Certified Emission Reduction (CER) credit benefits

Revenues from the sale of Certified Emission Reduction (CER) as part of the Clean Development Mechanism (CDM) project at nitric acid plants will also contribute towards earnings. CDM is an arrangement under the United Nations Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol which aims to combat global warming. The arrangement was to expire in 2012, now has been renewed till 2017. We expect FATIMA to generate additional Rs0.6bn to top line in 2012 through CER. However, the carbon credit is directly linked with the production of nitric acid therefore it is highly sensitive to production levels of NP and CAN.

A diverse product portfolio

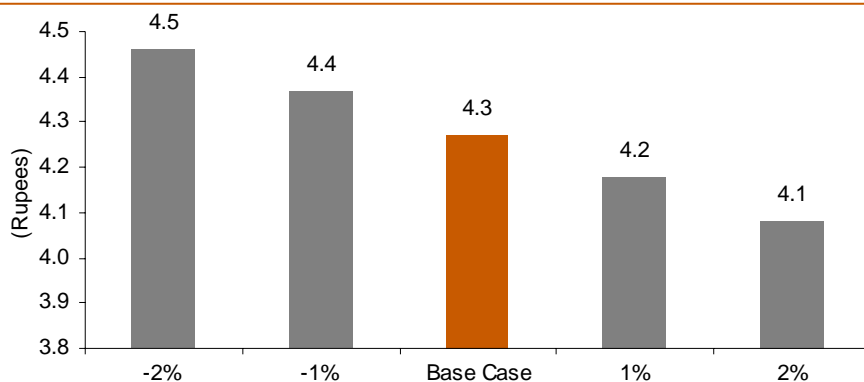
Apart from urea, in which it is enjoying towering margins due to gas curtailment woes faced by SNGP based plants, the other products of the company namely Calcium Ammonium Nitrate (CAN) and Nitrogen Phosphate (NP) are also not behind in terms of profitability margin. With approximately, 80% of Ammonium

nitrate, CAN is considered to be a close alternative for urea. Whereas, NP can be termed as a partial substitute to DAP due to its nutrient component.

Debt burden and sensitivity to discount rate

FATIMA currently has a 70% debt ratio that seems alarming. However, 1ppt increase in the interest rates from our base case results in 2% decline in EPS for 2012. Moreover, considering the EBITDA of more than Rs20,000/ton and interest coverage ratio of 3.7 in 2012, the concern fades away.

Discount rate impact on 2012 EPS



Source: JS Research

Key Risks

The major threat: Equalization tax

So far, the company has remained immune to the gas issues faced by fertilizer sector. However, this free ride is not expected to last forever. GoP is considering different proposals to tackle the high urea price issue. Amongst them, is a proposal of equalization tax which plans to tax those fertilizer producers facing lesser gas curtailment to compensate for those facing excessive gas shortages. Consequently, margins may come under check.

Fertilizer Margins

The fertilizer margins are at their historic peak level. However, we believe these exorbitant gross margins can not continue forever and reduction in fertilizer prices and shrinkage in margins remains a key risk to our investment thesis.

US: Ammonium Nitrate issue

FATIMA is amongst the two fertilizer companies which produce CAN in Pakistan. CAN producers have come under scrutiny from the US that the product is being used in Improvised Explosive Devices (IEDs) for roadside bombings in Afghanistan. However, according to company sources the discussions are there to restrict CAN supplies across border rather than halt production altogether. To rectify, the company has already stopped supply of CAN to dealers in KP province and coloring them differently from the imported CAN so as to differentiate. In the worst case, though a distant probability if the company has to stop production of CAN, it can divert some gas to produce urea. However, it will severely damage the earnings of the company even assuming 120% capacity utilization of urea plant.

	Fair Value (Rs)	Urea Capacity Utilization							
		85%	90%	95%	100%	105%	110%	115%	120%
CAN Capacity Utilization	80%	29.0	31.0	33.0	34.9	36.9	38.9	41.1	43.2
	70%	26.6	28.5	30.5	32.5	34.4	36.4	38.4	40.5
	60%	24.1	26.0	28.0	30.0	32.0	33.9	35.9	37.8
	50%	21.6	23.5	25.5	27.5	29.5	31.4	33.4	35.4
	40%	18.8	21.0	23.0	25.0	27.0	29.0	30.9	32.9
	30%	16.3	18.3	20.3	22.5	24.5	26.5	28.4	30.4
	20%	13.7	15.8	17.8	19.8	22.0	24.0	26.0	27.9
	10%	11.2	13.2	15.2	17.3	19.3	21.5	23.5	25.4
	0%	8.6	10.6	12.7	14.7	16.7	18.8	20.9	22.9

Valuation

On a relative basis, FATIMA is trading at 2012E PE of 5.4x compared to the JS Universe fertilizer sector PE of 5.3x. We recommend a 'Buy' call on it with a DCF based target price of Rs29 (potential upside of 25%).

Fatima Fertilizer – Financial Highlights

(Rs m n)	2011E	2012F	2013F	2014F
Income Statement				
Revenue	14,621	31,109	32,660	34,089
Cost of goods sold	5,129	11,151	12,028	12,712
Gross profit	9,492	19,957	20,632	21,377
EBIT	8,576	18,023	18,590	19,236
PBT	5,430	12,838	15,050	17,555
Taxation	1,788	4,295	5,267	5,725
PAT	3,642	8,543	9,782	11,830
Ratio Analysis				
Valuation				
Earning / (Loss) per share	1.8	4.3	4.9	5.9
Book value per share	11.7	15.9	20.8	26.7
Price to earning ratio (x)	12.7	5.4	4.7	3.9
Price to book value (x)	2.0	1.5	1.1	0.9
Profitability				
Gross margin	65%	64%	63%	63%
Operating margin	59%	58%	57%	56%
Net margin	25%	27%	30%	35%
Return on assets	5%	11%	11%	12%
Return on equity	12%	22%	20%	20%
Momentum				
Sales grow th	NA	113%	5%	4%
Net profit grow th	NA	135%	15%	21%

Source: JS Research & Company Accounts

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