

Lotte Pakistan PTA (LOTPTA)

Positives Overplayed - Sell

We initiate coverage on Lotte Pakistan PTA (LOTPTA) with a 'Sell' stance and a target price of Rs8 per share. The company is a sole producer of Purified Terephthalic Acid (PTA) in the country and has a market share of 80-85% in the local PTA market. PTA is a chief raw material used in the production of Polyester Staple Fibre (PSF), Polyester Filament Yarn (PFY) and Polyethylene Terephthalate (PET) resin. Since its takeover by the Lotte Group, the company's profitability has shown a remarkable turnaround with EPS jumping from a negative Rs1.16 in 2008 to Rs2.24 in 2009. Despite improvement in the company's fundamentals, we believe, the stock is overvalued at the current level of Rs9.51 (a premium of 16%) as it has already priced in most of the positives. The scrip is currently trading at a PBV of 1.6x compared to the market's 1.5x, a premium of 9%.

2009: Best year since inception

In 2009, the profitability turnaround came with exceptional primary margins which benefited mainly on account of lower Paraxylene (Px) prices and higher PTA prices amid robust demand from the downstream sector. The former is linked with international crude oil prices, while the latter is driven by the global cotton crop outlook. Escalating cotton prices amid global cotton shortage alongside falling crude oil prices created favorable demand supply dynamics for the company. The dual effect caused gross profit margin to stand at an astounding 15.6 % compared to an average of 5.1% in the last three years and a meager 2.6% in 2008.

Are margins sustainable, going forward?

Our answer is no, on account of a rebound in international crude oil prices and better cotton crop outlook in 2010. However, we believe the company is likely to remain in control to accommodate financial costs and mitigate exchange losses on the \$63mn loan, while its potential to generate income through its cash balance is likely to remain intact in 2010. Overall, we expect company's EPS to decline from Rs2.24 in 2009 to Rs1.81 and Rs1.74 in 2010 and 2011, respectively.

Key points to watch out for

We believe, apart from primary margins, the company's fundamentals are further dependent upon continuation of duty protection and its initiatives in new projects (power plant in our case).

- **Duty protection critical for survival:** At present, the company is subject to 7.5% duty protection (previously 15%) and may see a further downward revision. Since the revenue stream is contingent upon the level of tariff protection, a further cut would not bode well for the company.
- **New power plant to improve earnings:** On a positive note, the company is flexing its muscles to involve itself in new projects and is already in the process of setting up a 40MW cogeneration power plant. We have not incorporated the details of the project in our valuation as the project is in its initial stages and the details are awaited.

Initiating Coverage: **SELL**

Target Price: **Rs8**

Chemical

March 2010



JS Global Capital Limited

KATS Code:
LOTPTA

Bloomberg Code:
PPTA PA

Reuters Code:
LOTT.KA

Market Price:
Rs9.49

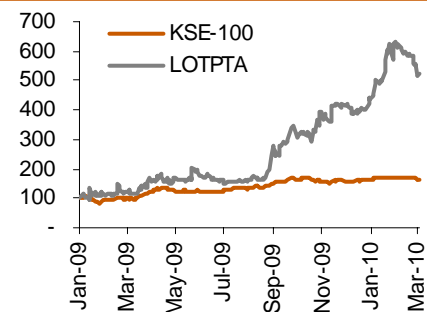
Market Cap:
Rs14.4bn
US\$169mn

1-yr Avg. Daily Volume:
8.9mn shares
Rs59.1mn
US\$0.7mn

1-yr High/Low:
Rs11.45/2.05

Estimated free float:
378.6mn shares (25%)

Graph: LOTPTA vs KSE-100



Source: JS Research

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Profitability spike: A temporary phenomenon

Following Lotte Group’s interest in acquiring Pakistan PTA, the company’s profitability has shown a remarkable turnaround with EPS jumping from a negative Rs1.16 in 2008 to Rs2.24 in 2009. Despite improvement in the company’s fundamentals, we believe, the stock is over valued at the current level of Rs9.51 per share as it has already priced in most of the positives. The scrip is currently trading at a 2010 PBV of 1.6x compared to market’s 1.5x (a premium of 9%), hence we recommend a ‘Sell’ stance on the scrip. Based on the FCFE methodology and using a required return on equity of 18.8%, our target price arrives at Rs8 per share, indicating 16% downside to the current market price.

2009: Best year since inception

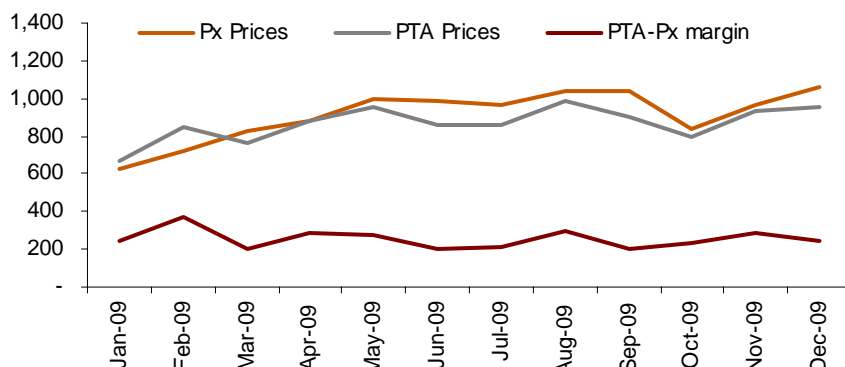
In 2009, the company’s primary margins benefited mainly on account of lower Paraxylene (Px) prices and higher PTA prices amid demand for PTA. The former is linked with international crude oil prices, which hit a trough of US\$39 per barrel in Jan 09. As a result, Px prices also touched a low of US\$630 per ton and the full year average came in at US\$912 per ton compared to US\$ 1,164 per ton last year. At the same time, PTA demand from the downstream sector remained robust due to spike in international cotton prices amid a cotton shortage worldwide. The dual effect caused gross profit margin to stand at an astounding 15.6 % compared to an average of 5.1% in the last three years and a meager 2.6% in 2008.

Table: Key Valuation Ratios

	2010E	2011F	2012F
EPS (Rs)	1.81	1.74	1.68
PE (x)	5.25	5.47	5.64
PBV (x)	1.63	1.34	1.15
EV/ton (US\$)	373	160	228

Source: JS Research

Graph: Price trend



Source: JS Research

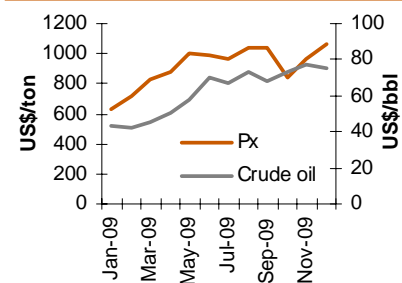
Are margins sustainable, going forward?

Our answer is no, on account of a rebound in international crude oil prices and better cotton crop outlook in 2010. However, we believe the company is likely to remain in control to accommodate financial costs and mitigate exchange losses on the \$63mn loan, while its potential to generate income through its cash balance is likely to remain intact in 2010. Overall, we expect company’s earnings per share to decline from Rs2.24 in 2009 to Rs1.81 and Rs1.74 in 2010 and 2011 respectively.

Paraxylene prices susceptible to oil price volatility

Paraxylene is the main raw material for PTA production and is used at a conversion ratio of 0.67. Given the product’s high sensitivity to oil prices, we believe, a 2.5% rise in the Px prices could lead to a Rs0.3 erosion in the

Graph: Crude oil vs Px price



company's earnings per share, assuming all else constant. Our oil analyst expects average oil prices to be at US\$73 per barrel compared to 2009 average of US\$62 per barrel. Hence, we expect Px prices to be around US\$1,100 per ton and \$1,144 per ton in 2010 and 2011 respectively.

Table: Sensitivity analysis of Px prices on EPS

	2010E	2011F	2012F
Base Case			
Px Price	1,100	1,144	1,155
EPS	1.81	1.74	1.69
Px price up 2.5%			
Px price	1,127	1,173	1,184
EPS	1.50	1.39	1.33
Px price up 5%			
Px price	1,155	1,201	1,213
EPS	1.18	1.04	0.96

Source: JS Research

We believe, tight supply of Naphtha (a raw material for Px and a bi-product of crude oil) along with a strong demand for petrochemicals in the Asia Pacific region would also keep Px prices high. However, this may be slightly offset by new Px capacity start ups in the Middle East and China which were supposed to become fully operational by the 4QFY09, but have been facing delays due to production hiccups. We believe, a hike in crude oil prices, Naphtha supply constraints and high Px demand would override the impact of new capacity startups.

Table: Paraxylene Capacity Additions

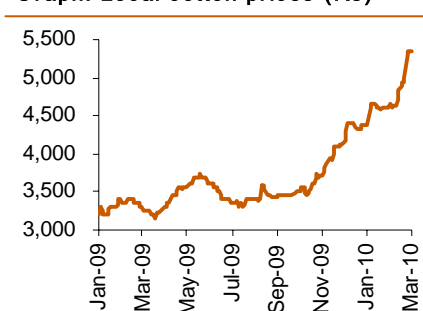
(000 tons)	2010E	2011F	2012F
China	1,820	1,100	1,050
NE Asia (excluding China)	-	-	600
India and Pakistan	-	417	833
Middle East	1,161	-	100
SE Asia	-	40	150
Others	305	347	258
Total	3,286	1,904	2,991

Source: PCI, Deutsche Bank & JS Research

Fall in cotton prices to slowdown PTA demand

In the wake of a robust PTA demand from the downstream sector (i.e. polyester and PET manufacturers), the company operated above 100% capacity in 2009 with both sales and production exceeding its name plate capacity of 500,000 tons. PTA is a chief raw material used in the production of Polyester Staple Fibre (PSF) and its demand is driven by PSF demand. PSF consumption is highly correlated with cotton prices as cotton is used as a substitute for polyester in fabric production. Depending upon the prevailing cotton prices and availability, the downstream sector manufacturers adjust cotton polyester ratio which is typically 80:20. Global cotton production fell by 10% in FY09 and is expected to fall by 5% in FY10 which exerted an upward pressure on both local and international cotton prices in 2009. Hence, in the backdrop of escalating prices, the local textile spinning sector increased its consumption of polyester which eventually led to an increased demand for PSF and correspondingly PTA. With LOTPTA being a sole producer of PTA in the country and having a lion's share of 80-85%, it remained a direct beneficiary of rise in PTA demand from the downstream sector.

Graph: Local cotton prices (Rs)



Source: PCGA

As per the global cotton outlook, cotton production is likely to go up by 10% in FY11, which will help cotton prices to come down from the current peak level of Rs5,700. Alongside, we anticipate PSF sales to decline and consequently PTA demand to slowdown as well. We estimate PTA prices to come in at US\$992 per ton and US\$1,020 per ton in 2010 and 2011 respectively compared to last year's average of \$954 per ton (after accounting for duty protection).

Key turnarounds since LOTTE's takeover

- **Reduced financial costs:** Apart from exceptional PTA-Px margins, one significant development with regards to the company's profitability is reduction in its finance costs which fell by a massive 70% owing to decline in short term and long term borrowings. Improved operating cash flows in 2009 helped the company to eliminate its reliance on short term borrowings to meet working capital requirements. In addition, retirement of US\$11.2mn at the end of 2008 reduced financial charges related to long term borrowings. We believe finance costs would stay close to the current levels in 2010-2012, and would reduce considerably thereon due to retirement of US\$63mn loan from an associate company.
- **Exchange losses to remain in check:** Rupee depreciation remains a source of concern for the company as higher than anticipated change in rupee dollar parity could lead to substantial exchange losses on its dollar denominated loan of US\$63mn. In 2008, the company booked exchange losses of around Rs1.37bn which had an EPS impact of Rs0.91. With exchange losses declining by Rs928mn (67%) in 2009, we expect it remain in check on the back of a relatively stably rupee-dollar outlook.
- **Other income to stay intact:** The company recorded other income amounting to Rs261mn in 2009 versus Rs154mn in 2008. This was primarily on the back of receipt of Rs178mn on insurance claim pertaining to a fire incident at a supplier's plant and Rs261mn interest earned on excess cash deposits, which stood above Rs3bn compared to Rs16.4mn in the same period last year. While the company has fully received the insurance claim amount, it is expected to to accrue higher interest income amid rising cash balance.

Key points to watch out for

Duty protection critical for survival

It is important to note that the LOTPTA's profitability is highly contingent upon the PTA tariff structure. At its inception in 1998, the Government of Pakistan agreed to grant a 15% duty protection to the company. The ten year protection ended on June 30, 2008 and subsequently in the Federal Budget 2008-2009, the government slashed the tariff rate to 7.5%. Any further rate cut poses a big threat to the company's future revenue stream as local downstream manufacturers can then buy PTA from the international market where prices are favorable. Given the high sensitivity of profitability to the level of duty protection, we have resorted to sensitivity analysis to determine the impact of slash in rates on the company's gross profit margins and EPS.

Table: Duty sensitivity analysis

2010E					
Duty	7.5%	6.5%	5.5%	4.5%	0.0%
Gross Profit Margin	12%	11%	11%	10%	5%
EPS	1.65	1.55	1.37	1.19	0.39
2011F					
Duty	7.50%	6.50%	5.50%	4.50%	0.00%
Gross Profit Margin	11%	10%	9%	8%	4%
EPS	1.62	1.46	1.27	1.08	0.23
2012F					
Duty	7.50%	6.50%	5.50%	4.50%	0.00%
Gross Profit Margin	11%	10%	9%	8%	4%
EPS	1.58	1.39	1.20	1.00	0.12

Source: JS Research

Power plant to improve earnings

In order to ensure uninterrupted supply of power, the company is setting up a 40MW cogeneration power plant for which it has already signed a Gas Supply Agreement (GSA) with Sui Southern Gas Company Ltd. We have not incorporated the impact of this US\$40mn Capex in our valuation as the project in its initial stages and the details are awaited. However, we have conducted a scenario analysis at different levels of debt financing to determine the incremental finance costs and valuation impact. Although, the company expects the payback period to be around 3 years, we have assumed it to be 4 years in order to be more conservative. Based on these estimates, we have calculated the cumulative impact of higher finance costs and lower fuel costs on the company's earnings and valuation. The plant is expected to commission operations by end 2011.

Table: Project financing

Debt Contribution	100%	80%	60%	40%	20%	0%
Valuation Impact (Rs)	1.40	1.20	1.10	0.90	0.80	0.60
EPS impact 2012	0.03	0.07	0.12	0.16	0.20	0.24
EPS impact 2013	0.07	0.11	0.14	0.18	0.21	0.24

Source: JS Research

Additionally, the company is installing a Catalyst Recovery Unit (CRU) at a cost of US\$5mn for the purpose of enhancing production efficiency, which is also expected to be positive for the company's profitability.

Assumptions

Project Cost (\$ mn)	40
Exchnage Rate	85
Project Cost (Rs mn)	3,400
Cost of debt	13%
Cost of equity	18.8%
Project life (years)	20

Source: JS Research & Company

New PTA plant setups by regional competitors

At present, the PTA supply demand balance is just sufficient in the Asia Pacific region. However, China and India being PTA deficit countries are adding capacities in order to cater the local demand. Commissioning of these capacities is expected to bring down PTA prices regionally which would pose the risk of dumping of PTA in Pakistan. Hence, from the company's standpoint, persistence of duty protection is critical for survival while the local PSF manufacturers are pressuring government for a further cut in tariff protection.

Table: PTA Capacity Additions

(000 tons)	2010E	2011F	2012F
China	1,800	213	2,050
NE Asia (excluding China)	-	-	-
India and Pakistan	325	-	1,000
Middle East	-	-	400
Others	225	2,463	657
Total	2,350	2,676	4,107

Source: PCI, Deutsche Bank & JS Research

Valuation

We used FCFE methodology for valuing the company and based on a required return on equity of 18.8% and a terminal growth rate of 2%, our target price arrives at Rs8, indicating 16% downside to the current market price. Hence, we recommend a 'Sell' on the scrip. On a PBV basis, the company appears to be trading at a 2010E PBV of 1.6x versus market's 2010E PBV of 1.5x, a premium of 9% which further reiterates our sell stance. On EV/ton basis, the company trades at a US\$373 in 2010, a premium of 10% to the historical average seconding our view. Since the company had been incurring losses previously, PE was not amongst our preferred valuation indicators.

Assumptions

Risk free rate	11%
Beta	1.2
Market Premium	6.5%
Terminal Growth	2%
Cost of Equity	18.8%

Source: JS Research & Bloomberg

Table: FCFE projections

(Rs mn)	2010E	2011F	2012F	2013F	2014F
Net Income	2,742	2,630	2,551	2,443	2,332
Depreciation	1,235	1,251	1,269	1,287	1,311
Working Capital	(2,489)	137	(103)	145	(57)
Capex	(330)	(350)	(370)	(400)	(500)
Net Borrowings	(125)	(125)	(5,981)	(25)	-
Free Cashflow to equity	1,033	3,543	(2,635)	3,450	3,086
Discounted Cashflow	869	2,510	(1,572)	1,732	1,304

Valuation

PV of cash flows	4,844
Terminal value	7,917
Total present value	12,761
No of shares (mn)	1,514
Target price (Rs)	8.0

Source: JS Research

Table: Key Valuation Ratios

	2008A	2009A	2010E	2011F	2012F
Earnings per share (Rs)	(1.16)	2.24	1.81	1.74	1.68
Price to earnings (x)	NM	1.48	5.25	5.47	5.64
Price to book value (x)	1.64	0.75	1.63	1.34	1.15
EV/ton (US\$)	360	166	373	160	228

Source: JS Research

About the company

Lotte PPTA is a member company of a South Korean conglomerate LOTTE Group. The company started commercial production in 1998 under the membership of ICI group. In 2000, it de-merged from ICI and operated under the name of Pakistan PTA. Subsequent to Akzo Nobel's acquisition of ICI in 2008, PPTA became Akzo's group company. In September 2009, KP Chemical (a subsidiary of a South Korean conglomerate, LOTTE) completed acquisition of 75% holding in the company for \$490mn at a purchase price Rs0.86 per share, making it a single largest foreign direct investment in the petrochemical industry of Pakistan.

Lotte PPTA is a sole producer of Purified Terephthalic Acid (PTA), an essential raw material for Polyester Staple Fiber (PSF), Polyester Filament Yarn (PFY), and Polyethylene Terephthalate (PET) resin. The company previously operated above 400,000 capacity, however a minor de-bottlenecking project in 2005 ramped up its name plate capacity to 500,000 tons. Later, the company installed a Supplementary Process Air Compressor for US\$2mn which enhanced its hourly production from 50 tons to 60 tons.

Lotte Group

Lotte Group commenced operation in 1948 and established a food business in 1967 in Korea with the name of Lotte Confectionary Co. Ltd. Initially, the company was engaged in the manufacturing and distribution of confectionaries, but overtime it expanded its reach into different industries such as restaurants, hotels, tourism, construction, electronic products, chemicals, professional baseball, finance and service. The company is headquartered in Seoul, South Korea and has consumer base in over 70 countries. The Group aspires to become one of the top 10 companies in Asia by 2018 and as such is in the process of developing a global network of integrated subsidiaries. Recently, the group expressed a keen interest to invest in food, construction, insurance, trade and other industries of Pakistan.

KP Chemical

KP Chemical is one of the Korea's leading petrochemical company involved in the production of PTA, PET, Px, Purified Isophthalic Acid (PIA) and Meta-xylene (MEX) with annual production of 955,000 tons, 446,000 tons, 740,000 tons, 200,000 tons and 160,000 tons respectively. The company is a market leader in PIA and PET, while it holds commendable market shares in Px and PTA in Korea. Like Lotte, KP Chemical also has a strong presence in the international markets such as China, Russia and Europe where it exports majority of its products. On September 17, 2009, the company acquired 75% holding of PPTA and on December 28, 2009, it merged with Honam Petrochemicals, another leading petrochemical company of Korea.

Appendix I: Income statement & Balance sheet

(Rs mn)	2008A	2009A	2010E	2011F	2012F
Income Statement					
Net Sales	32,936	37,774	38,542	40,770	42,287
COGS	32,068	31,898	33,611	36,034	37,587
Gross Profit	868	5,875	4,931	4,736	4,700
EBITDA	543	6,245	5,359	5,229	5,139
EBIT	(651)	5,026	4,124	3,978	3,871
Financial charges	1,027	308	316	325	328
PBT	(1,679)	4,718	3,809	3,653	3,543
PAT	(1,760)	3,397	2,742	2,630	2,551
Balance Sheet					
Paid up capital	15,142	15,142	15,142	15,142	15,142
Accumulated Loss	(11,075)	(8,435)	(6,450)	(4,577)	(2,783)
Shareholder's Equity	4,067	6,707	8,692	10,565	12,359
Current Liabilities	5,667	7,048	6,373	12,770	7,221
Long term liabilities	5,397	5,583	5,670	25	-
Total Liabilities and Equity	15,223	19,430	20,827	23,451	19,671
Total Fixed Assets	9,953	9,014	8,068	7,167	6,268
Total Current Assets	5,149	10,243	12,573	16,085	13,186
Total Assets	15,223	19,430	20,827	23,451	19,671

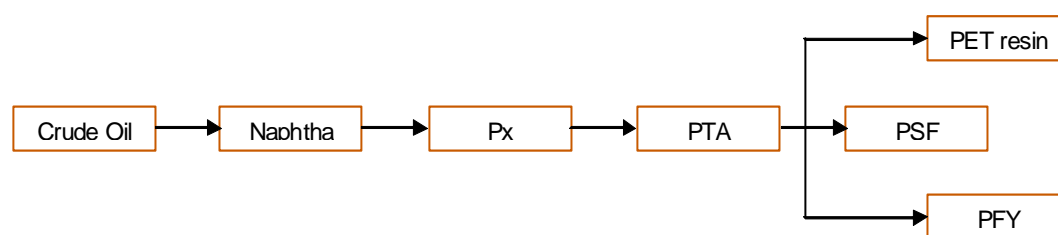
Source: JS Research & Company accounts

Appendix II: Ratio Analysis

	2008A	2009A	2010E	2011F	2012F
Valuation					
Earnings per share (Rs)	(1.16)	2.24	1.81	1.74	1.68
Dividend per share (Rs)	-	0.50	0.50	0.50	0.50
Price to earnings (x)	NM	1.48	5.25	5.47	5.64
Book value per share (Rs)	2.69	4.43	5.74	6.98	8.16
Price to book value (x)	1.64	0.75	1.63	1.34	1.15
EV/ton (US\$)	360	166	373	160	228
Dividend Yield	-	0.15	0.05	0.05	0.05
Profitability					
Gross Margin	3%	16%	13%	12%	11%
Operating Margin	-2%	13%	11%	10%	9%
EBITDA margin	2%	17%	14%	13%	12%
Pretax margin	-5%	12%	10%	9%	8%
Net margin	-5%	9%	7%	6%	6%
Return on assets	-12%	17%	13%	11%	13%
Return on equity	-43%	51%	32%	25%	21%
Momentum					
Sales growth	16%	15%	2%	6%	4%
EBITDA growth	-77%	1051%	-14%	-2%	-2%
Net profit growth	NM	NM	-19%	-4%	-3%

Source: JS Research & Company accounts

Appendix III: PTA Production process



Source: JS Research

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ANALYST CERTIFICATION

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