

December 08, 2009
Pakistan Market

NML: Rising cotton prices – downgraded to ‘Hold’

KSE100 Index: Closing 8992.91 ↓ (-16.22)

MORNING BRIEFING



The rising trend in cotton prices continued in the month of December with cotton prices ascending to a new high of Rs4,600 per maund (as of December 6, 2009) compared to Rs3,200 per maund in the corresponding period last year, a colossal increase of 44%YoY. The price hike has been led by expected global shortage in cotton production by 5% in FY10 (source: ICAC), mainly due to lower crop estimates in China. This is bound to inflict negative effects on the gross profit margins of the textile companies. Nishat Mills Limited (NML), is likely to see its margins to squeeze by 40bps to 18.1% in FY10. Based on higher than expected average cotton prices in FY10 (a negative impact of 5% on FY10 earnings), we are downgrading our target price for NML to Rs65 per share. Trading at a FY10E and FY11F PE of 8.3x and 7.4x respectively, we have downgraded the scrip to ‘Hold’ at current levels.

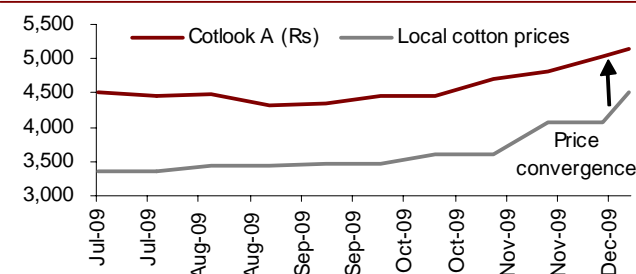
Rising cotton prices to squeeze margins

Based on the presumption of a better global economic state of affairs and depreciating rupee, we initially forecasted a net revenue of Rs27bn for NML with an average cotton prices to be Rs3,500 per maund for FY10. Based on these assumptions, NML’s gross margins for FY10 worked out to be around 18.5% (30bps higher on YoY basis). However, given the recent surge in the cotton prices, we have revised upward our average cotton price assumption to Rs3,900 per maund. Currently, the average cotton prices stand at Rs3700 per maund and is expected to rise further going forward, mainly owing to the global shortfall in the cotton production. Consequently, we expect NML’s full year margins to squeeze to around 18.1% from our initial estimate of 18.5%.

Cotton prices have been swelling for the past one month and have continued their momentum into the month of December soaring to a season high of Rs4600 per maund, converging towards the international cotton prices. Traditionally, cotton arrivals show a declining trend in the period of Jan-Mar, which is further, expected to put pressure on the cotton prices

allowing to them to continue hovering around their current levels.

Graph: Cotlook A versus local cotton price



Source: JS Research, Thomson Reuters

GSP plus status: a blessing in disguise?

Although input costs have been rising, the GSP (Generalised System of Preferences) plus status, if awarded to Pakistan, can be a potential trigger for the textile industry. The ongoing talks and the meeting to be held in Brussels next year show signs that an understanding is likely to be reached between the concerned parties. Additionally, according to news reports, the Belgian ambassador to Pakistan, Mr Hans-Christian Kent, also seconded the opinion of a GSP plus status being likely to be given to Pakistan. If successful, the status is likely to allow Pakistan to regain its competitiveness in the international market in form of relaxation in the duties currently imposed on the Pakistani products.

In context to NML, the status is likely to bode well for the company as it could allow more of its revenue to stem from exports. This along with depreciating currency is likely to augment the topline further.

NML: downgraded to ‘Hold’

Based on the revisited estimates of cotton prices and current pressure on the local equity market (affecting the portfolio value), we have revised our target price to Rs65 per share. The scrip is trading at a FY10E and FY11F PE of 8.3x and

7.4x respectively and we recommend a ‘Hold’ at current levels.

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Also in focus

Short selling to start w.e.f 4th Jan 2010

According to a notice issued yesterday, the BoD of the KSE has sanctioned short selling on the KSE 30 Index companies’ scrips in the Ready market, effective 4th Jan 2010. The SECP has already granted approval for this so in future trading will be subject to the regulations for short selling under ready market 2002. To recall, following the floor imposed on the index the Board had banned short selling on the 41 scrips being traded earlier on September 24, 2008.

Engro to issue Rs2.5bn TFCs at 6M KIBOR +2.4%

Engro Chemicals Pakistan Limited (ECPL) has published a prospectus regarding the issue of TFCs (December 16 & 17, 2009) worth Rs2.5bn with a tenor of 7 years and a profit rate of 6-month kibar plus 2.4%. This includes a green shoe option of Rs500mn. This facility will be used to meet the expansion costs which have increased to Rs1.05bn from the initial costs of Rs980mn. These incremental costs have already been accounted for in our models and will bear no significant impact on the earnings for ECPL. Major structured payments for the issue will start after the first 24 months.

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