Engro Fertilizers Limited

Fundamentals contradicting perception

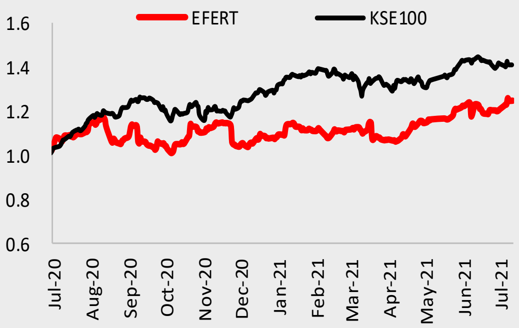
Pakistan

EFERT PA		**Underperform**
Price (LDCP)	Rs	73.4
Jun-22 Target Price	Rs	59.4
Upside/Downside	%	(19.1)
12M Target Price	Rs	59.7
- Discounted Cashflows		
Sector		Fertilizer
Market cap	Rs bn	98.0
30-day avg turnover	$ m	0.6
Market cap	$ m	628.1
Freet float	%	600.9
Shares issued	m	1,335.3

Investment fundamentals

Year end Dec		2020A	2021E	2022E	2023E
Net Revenues	mn	105,846	120,966	117,222	122,148
EBITDA	mn	29,126	39,736	30,239	28,251
EBITDA growth	%	-17%	36%	-24%	-7%
PBT	mn	21,298	29,906	23,778	21,325
Recurring prof.	mn	21,298	29,906	23,778	21,325
Net Profit	mn	18,133	20,066	16,403	14,595
EPS reported	Rs	13.6	15.0	12.3	10.9
Revenue Growth	%	(12.8)	14.3	(3.1)	4.2
EPS growth	%	7.5	10.7	(18.3)	(11.0)
PE	x	5.4	4.9	6.0	6.7
DPS	Rs	13.0	11.5	5.0	5.0
Div. Yield	%	17.7	15.6	6.8	6.8
ROA	%	14.0	15.9	14.8	14.5
ROE	%	40.3	42.6	34.5	31.2
EV/EBITDA	x	5.3	5.3	5.0	4.8
Net D/E	x	(0.3)	(0.0)	(0.2)	(0.2)
Price to Book	x	2.1	2.1	2.1	2.1
Price to Sales	x	0.9	0.8	0.8	0.8

EFERT KSE 100 Relative Performance



Source: Bloomberg, Foundation Research, July 2021

(all figures are in Rs unless noted)

Analysts

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Foundation Securities (Pvt) Ltd

Tuesday, July 13, 2021

Event

- End of concessionary gas flows along with the payment of GIDC on concessionary flows as per Supreme Court directives would restrict company's profitability and dividend payouts, in our view. However, Urea dynamics are expected to remain favorable for the company given restricted urea supply and better farmer agronomics. We have an "Underperform" stance on the scrip with Jun-22 TP of Rs59.4.

Impact

- **GIDC payment to restrict dividend payout capacity:** Execution of gas infrastructure projects by Gov't and mounting pressure on fiscal management given increasing cost of debt servicing and lower revenue collection would bring GIDC collection under limelight in FY22, in our view. Total liability of the company mounts to ~Rs57.8bn including those on concessionary flows too. To highlight, company hasn't booked GIDC charge on concessionary flows in its financials. The company would have cash outflow of Rs6.0/14.5/14.5/14.5/8.4bn in CY21/22/23/24/25 in our base case scenario assuming full payment of GIDC in 48 monthly installments starting from Aug'21. Adjustment of receivables from Gov't of ~Rs9.2bn would reduce cash outflow of the company and enhance our valuation by ~5.9%. Our valuation would enhance by ~21.1% in case of exemption on payment of GIDC on concessionary gas.

- **End of concessionary gas to dampen profitability:** EFERT profitability would decline by ~Rs4.9bn or EPS impact of Rs2.4/sh after ending of concessionary gas flows. We expect these flows to continue till Mar'22 based on our calculation of concessionary flows to the company since COD. To highlight, concessionary gas flows are available to EFERT for 10 years after COD of its plant which is ended in Jun'21 as per SNGPL. However, the company is in discussion with gov't and SNGPL to extend the concessionary flows for the number of days for which minimum Contract Quantity of gas under the GSA was not supplied to the company.

- **DAP trading to remain on lower side as prices reached multiple year high:** DAP demand is expected to decline by ~12% YoY in CY21 to 1.9mn tons as its usage in cash crops (rice & cotton) would remain restricted due to 69% YoY increase in DAP prices in Jul'21. Thus, we have assumed company's DAP sales to shrink by 23% YoY in CY21.

- **Higher Urea production amid pricing power to support profitability:** We expect pricing power in Urea market to remain with base players given (1) better farmer agronomics, (2) restricted Urea supply and (3) higher breakeven of RLNG players without subsidy. Based on the same we expect EFERT to clear inventory backlog of previous year.

Earnings Revision

- We have revised our earnings upward by 32/54/18% for CY21/22/23 as we tweak our assumption of Urea production, DAP margins and extension of concessionary flows.

Price Catalyst

- June 22 TP: Rs59.4/sh based on discounted cash flow methodology.
- Catalyst: (1) end of concessionary gas, and (2) overdue payment of GIDC.
- Risk: (1) relaxation in GIDC payment, and (2) extension in concessionary flows.

Outlook

- We have "Underperform" stance with Jun-22 TP of Rs59.4/sh.

GIDC payment to hurt dividend payout capacity

EFERT dividend payout capacity is expected to erode substantially as Government is committed to collect Gas Infrastrucutre and Development Cess (GIDC) in multiple installments as per Supreme Court guidance. This includes GIDC on conceesionary flows that the company hasn't booked amounting to ~Rs38bn in its financials. In GIDC Act 2015, it is stated that both new fertilizer companies established under fertilizer policy 2001 and old fertilizer plants would pay GIDC on feed stock and fuel gas supplies. To highlight, EFERT along with other fertilizer companies have already passed on the impact of GIDC to the farmers by increasing their prices.

Our coviction for GIDC on concessionary gas is further strengthened by company's agreed clause, in principle that MARI shall charge invoice at OGRA notified gas prices plus applicable duty/taxes in its novation agreement signed with Sui Northern Gas Pipelines Limited and Mari Petroleum Company Limited. Furthermore, in Supreme Court detailed judgment on GIDC issue government has also shown details of GIDC receivables from fertilizer companies using concessionary gas flows.

EFERT's current GIDC payable on non-concessionary gas stands at Rs19.6bn while company's overdue GIDC on concessionary flows are ~Rs38bn, as per our calculation. We have assumed payment of GIDC in 48 monthly installments starting from Aug'21 for our fertilizer universe. This is based on expectation of signing of commercial agreement between Government and Russian firms for construction of North-South project in near future that would be followed by project execution in later half of 2HCY21. Furthermore, Gov't would finance its equity portion in the project through GIDC collection proceeds as per Supreme Court directives and GIDC Act 2015. To highlight, in FY22 budget Gov't has also set GIDC collection target of Rs130bn.

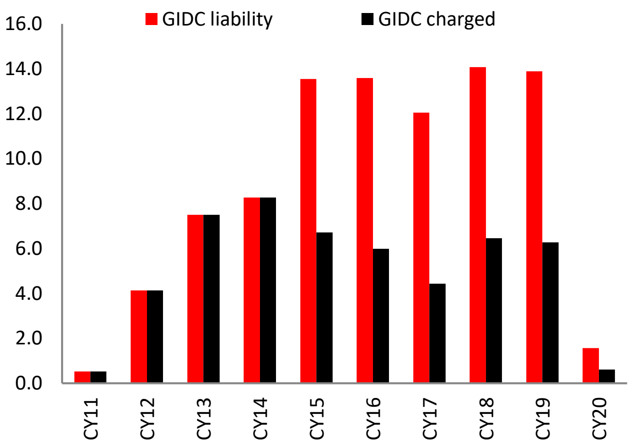
Moreover, assuming 48 monthly installments and no adjustment of refunds from Gov't in our base case scenario EFERT GIDC payment would be ~Rs6.0/14.5/14.5/14.5/8.4bn for CY21/22/23/24/25. However, if company gets exemption on GIDC payable on concessary gas our valuation would enhance by Rs12.5/sh.

Table 1: Total collection and overdue payment of GIDC as at Jun'19 as per Supreme GIDC decision annexure (Rs bn)

Sector	GIDC Accrued	GIDC Collected	GIDC Outstanding
Fertilizer – Fuel	31.8	15.2	16.6
Fertilizer Feed (old)	192.2	111.8	80.4
Fertilizer Feed (New)	***68.3***	***1.1***	***67.1***
General Industry	70.7	24.4	46.3
Captive Power	119.2	17.5	101.7
IPPs	60.8	51.7	9.1
KESC	40.4	3.9	36.5
GENCO/WAPDA	67.3	44.8	22.6
CNG Region-I	53.4	11.8	41.7
CNG Region-II	48.1	13.2	34.9
Total	**752.3**	**295.4**	**456.9**

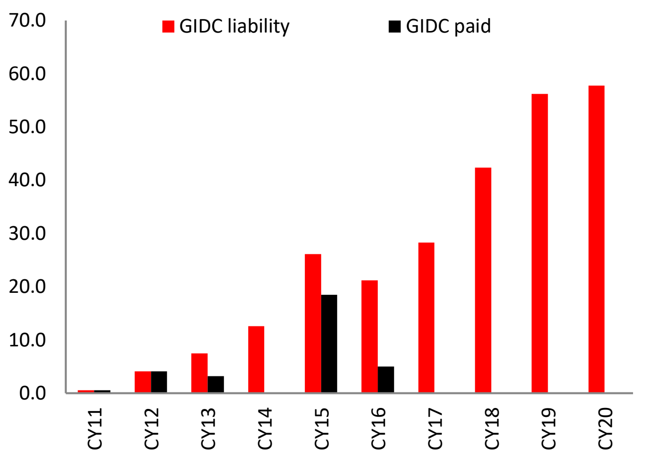
Source: Supreme Court, Foundation Research, July 2021

Fig 1: EFERT didn't booked GIDC on concessionary gas due to stay order from High Court (Rs bn)



Source: Company Accounts, Foundation Research, July 2021

Fig 2: EFERT overdue GIDC liability increased to ~Rs58bn as per Gov't records and FSL working (Rs bn)



Source: Company Accounts, Foundation Research, July 2021

GIDC brief history and key developments

Federal Government in Dec'11 promulgated the Gas Infrastructure Development Cess Act, 2011 to generate funds for development of gas infrastructure projects to overcome the emerging gas supply crisis given (1) depleting domestic natural gas reserves and (2) continuous decline in gas reserves replacement ratio. In this regard Federal Gov't has initiated multiple projects in collaboration with foreign partners that include (1) TAPI pipeline project, (2) IP gas pipeline project, (3) North South gas pipeline project to transport imported RLNG up country and (4) construction of underground gas storage facilities as a part of initiatives taken to strengthen national security.

2011
- GIDC was promulgated to generate funds for building gas infrastructure projects
- Soon after its promulgation it was challenged in various Courts of Law

2012
- Through Finance Act, 2012 Gov't increased GIDC to Rs300/mmbtu for feed gas and to Rs100/mmbtu for industry/CPP/KESC/GENCO/WAPDA. However, for fertilizer Gov't subsequently reduced GIDC on feed gas to Rs197/mmbtu
- Fertilizer companies increased their prices for UREA by Rs215/bag to pass on the impact and power sector charged it as a part of tariff adjustement, while others took a hit on their profitability

2014
- GIDC rate on fertilizer feed/fuel and CPP gas increased by Rs103/50/100mmbtu to Rs300/100/200mmbtu, but remained constant for power sector
- Fertilizer manufacturers continued to withhold GIDC due to Court decision which declared GIDC Act 2011 unconstitutional

2015
- Gov't introduced GIDC Act 2015 in which rates for all sectors remained the same except for reduced rates for CNG sector and Gov't also imposed GIDC on new fertilizer plants operating on concessionary gas
- During 2015 fertilizer sector paid majority of outstanding GIDC related to previous years

2016
- In Oct-16 Sindh High Court declares GIDC as unconstitutional and fertilizer sector along with other industries stopped paying GIDC after obtaining stay order from courts

2019
- In Aug-19 Government introduced GIDC amendment ordinance 2019 and reduced GIDC applicable on fertilizer by 50% contingent upon price reduction and half payment of outstanding/accrued GIDC.
- Amid public pressure Government withdrew GIDC ordinance and referred the matter to the Supreme Court

2020
- Government reduced GIDC applicable on fertilizer to Rs5/mmbtu on feed/fuel stock with condition of reduction in Urea prices by Rs400/bag
- On Aug'20 Supreme Court of Pakistan dismissed all petitions challenging applicability of GIDC Act and directed Gov't to collect outstanding dues in 24 monthly installments and Court also barred Gov't from charging any cess till the time accrued amount will be spent on gas infrastrucutre projects
- In Nov'20 Supreme Court dismissed all review petitions seeking review of its earlier decision

End of concessionary gas flows to dampen profitability

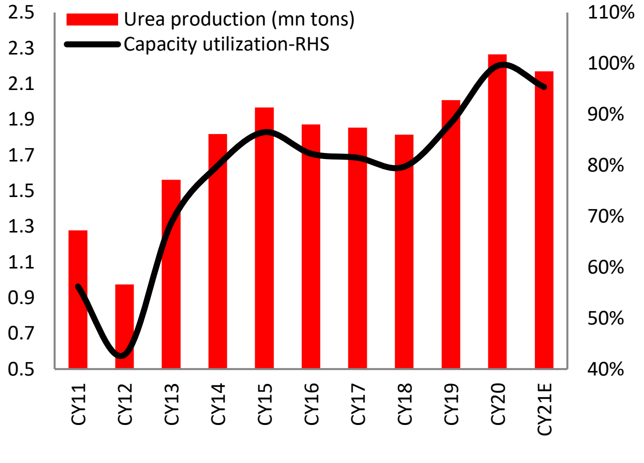
We have assumed ending of concessionary flows by the end of 1QCY22. Our working is based on calculation of concessionary flows delieverd to the EnVen Plant by SNGPL since its COD as per the earlier argument of EFERT's management. Subsequently, EFERT's profitability is expected to decline by ~Rs4.9bn translating into annualized EPS impact of ~Rs2.4/sh.

This is despite the fact that EFERT's concessionary gas flows are expected to end by Jun'21 as per SNGPL based on fertilizer policy 2001. However, company is of the opinion that they should get gas flows at concessionary rates till the end of 2023. Under fertilizer policy it is stated that "Plant setup under the fertilizer policy 2001 would receive gas at the Middle Eastern price prevailing on the date of signing of the GSA or US$0.77/mmbtu (with 10 percent discount) whichever is higher and shall remain fixed at such price till the expiry of 10 years from the date of commissioning". To highlight, EFERT's new plant achieved COD in June 2011 and has been getting 103mmbtu concessionary gas under fertilizer policy 2001 from MARI HRL.

Furthermore, EFERT signed initial gas supply agreement with Sui Northern Gas Pipelines Limited (SNGPL) for a period of 20 years and then post COD of its plant EFERT failed to get required gas allocation for optimal production. Thereafter, ECC directed Sui Northern Gas Pipelines Limited, Mari Petroleum Company Limited and Engro Fertilizers Limited to enter into a novation agreement for the supply of feed gas to the EFERT new plant. Currently, EFERT is in negogiation with the gov't and SNGPL for extension of concessionary flows for the number of days for which Minium Contract Quantity of gas under the GSA was not supplied to the company.

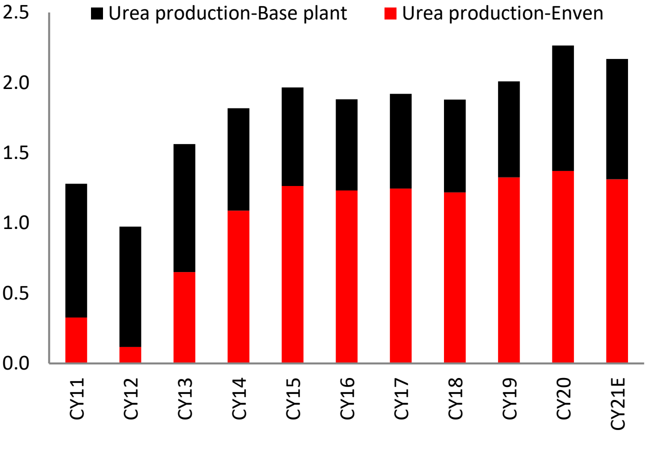
Furthermore, we expect EFERT production to decline by ~4% YoY in CY21 foreseeing current supply and demand situation. We expect availability of gas flows to EFERT remain strong given (1) enhanced probability of continuation of current flows from MARI till 2025 on the back of significant development expenditure, (2) priority of gas allocation to Fertilizer from MARI reserves, and (3) strong cash flows of fertilizer business. Subsequently, we have assumed Urea production of 2.1/2.2mn tons For CY22/23.

Fig 3: Better gas flows and capex on base plant allowed EFERT to enhance capacity utilization



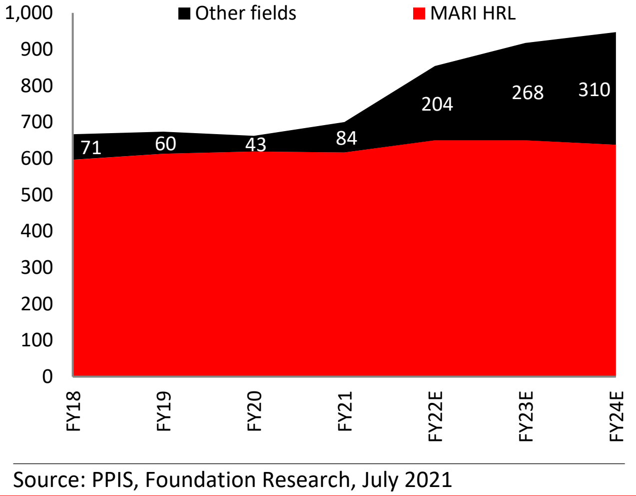
Source: NFDC, Foundation Research, July 2021

Fig 4: EFERT production to remain higher than 2mn tons mark due to better gas flows (mn tons)



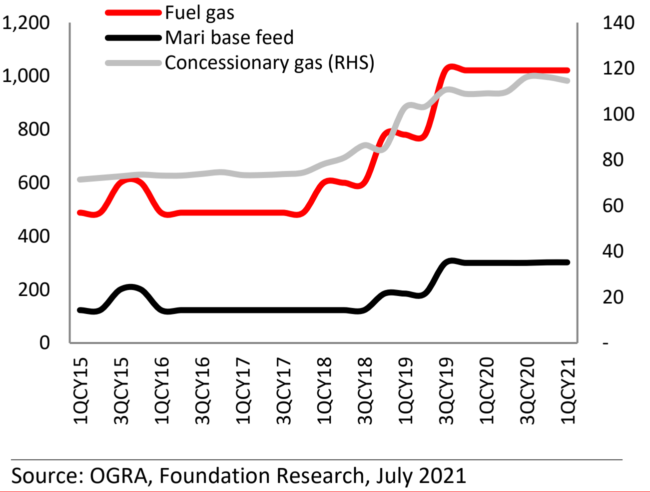
Source: NFDC, Foundation Research, July 2021

Fig 5: Development of Mari gas fields to provide sustainable flows to the fertilizer sector (mmmbtu)



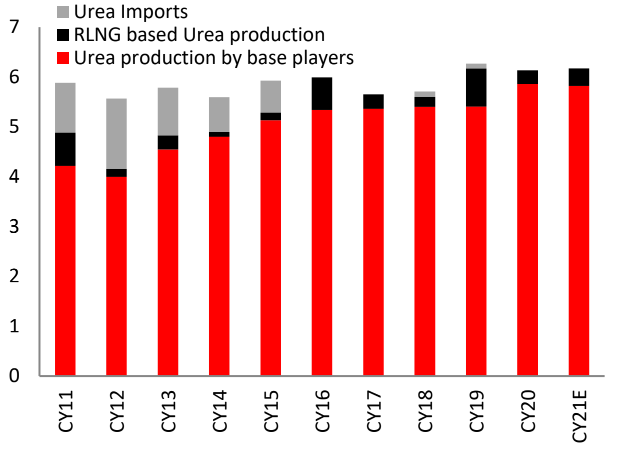
Source: PPIS, Foundation Research, July 2021

Fig 6: Gas prices remained stable for fertilizer sector as Gov't provides relief to the farmer (Rs/mmbtu)



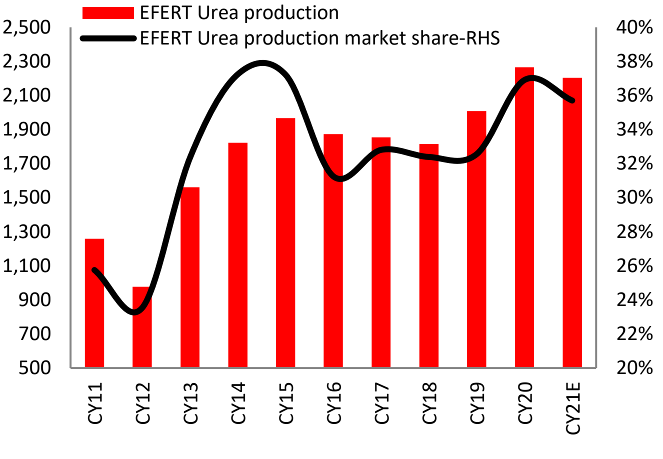
Source: OGRA, Foundation Research, July 2021

Fig 7: Majority demand to be met by local production given higher landed cost for imported Urea (mn tons)



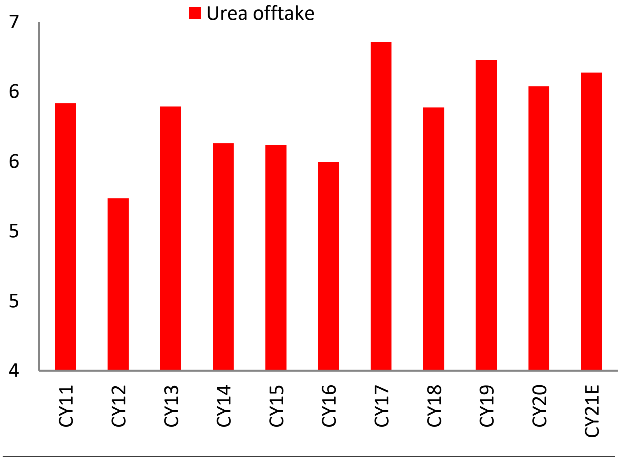
Source: NFDC, Foundation Research, July 2021

Fig 8: Better gas flows allowed EFERT to increase market share in production (K tons)



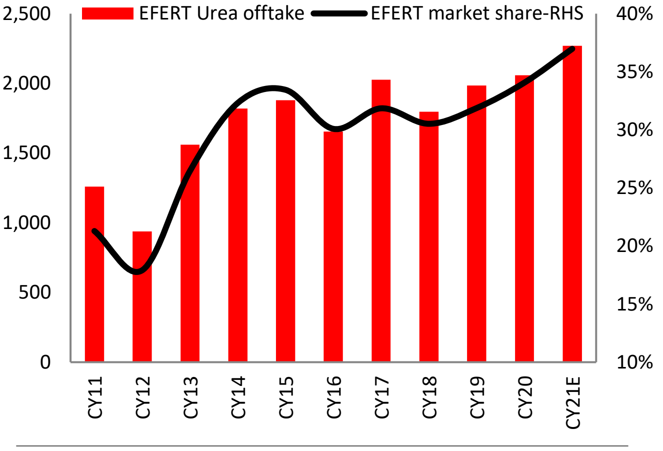
Source: NFDC, Foundation Research, July 2021

Fig 9: Urea demand remained range bound (mn tons)



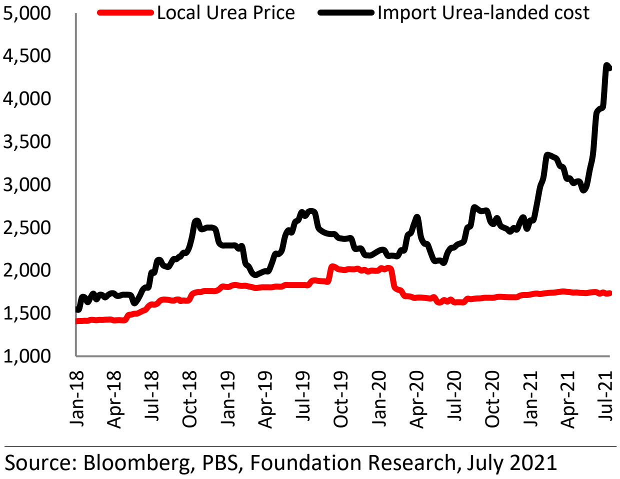
Source: NFDC, Foundation Research, July 2021

Fig 10: EFERT to sold highest ever Urea in CY21 (K tons)



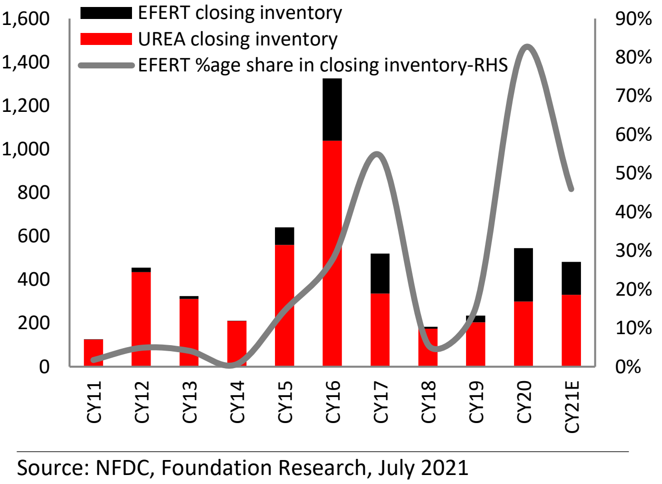
Source: NFDC, Foundation Research, July 2021

Fig 11: Landed cost for imported Urea to remain higher given ↑ in int'l feedstock prices (Rs/bag)



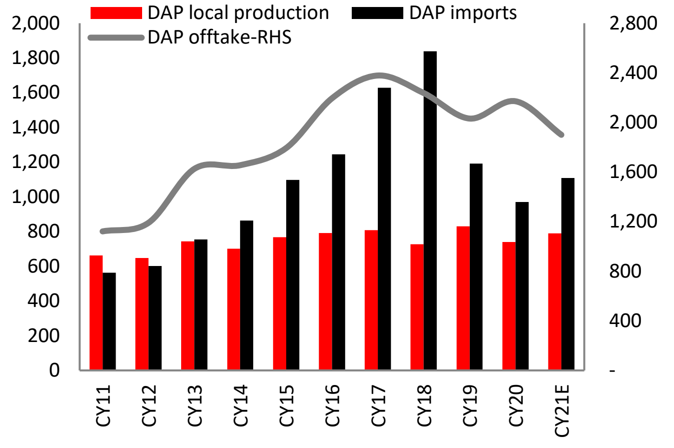
Source: Bloomberg, PBS, Foundation Research, July 2021

Fig 12: Majority of times EFERT ends up carrying higher inventory at year end (mn tons)



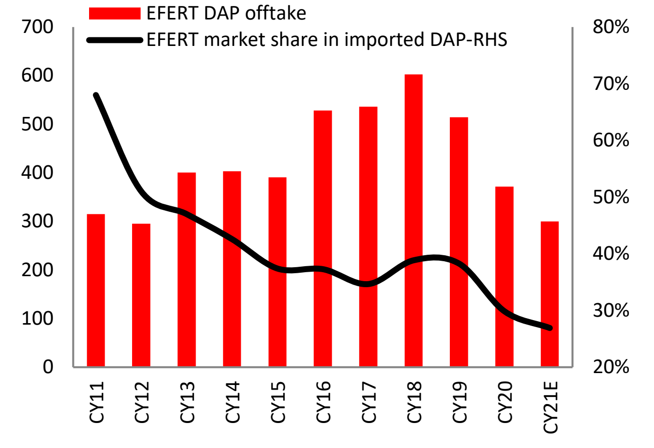
Source: NFDC, Foundation Research, July 2021

Fig 13: DAP market to shrink in CY21 as local prices make historical high (K tons)



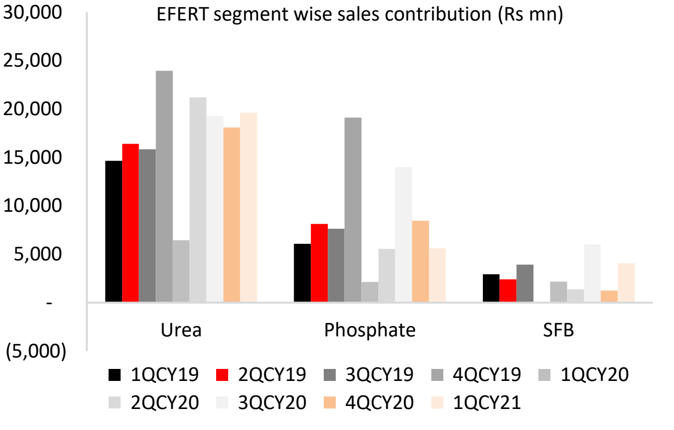
Source: NFDC, Foundation Research, July 2021

Fig 14: EFERT market share in imported DAP on declining trend (K tons)



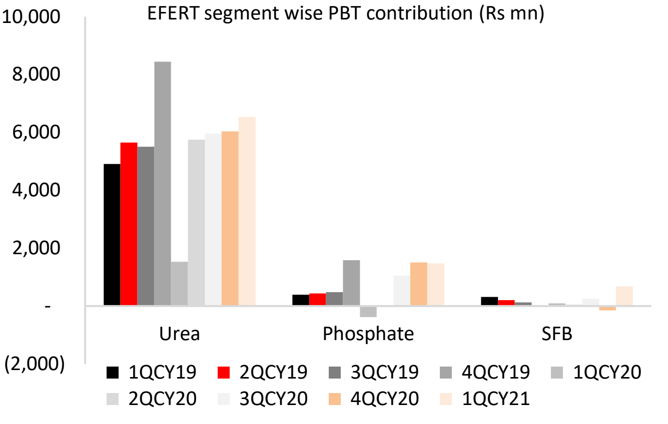
Source: NFDC, Foundation Research, July 2021

Fig 15: Phosphate business sustainability remains at risk in the longer run due to possibilities…



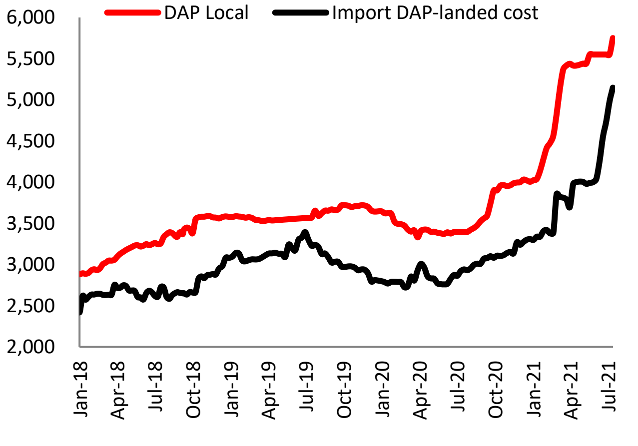
Source: NFDC, Foundation Research, July 2021

Fig 16: ….of establishing new local DAP plant in order to reduce burden on Fx reserves (Rs bn)



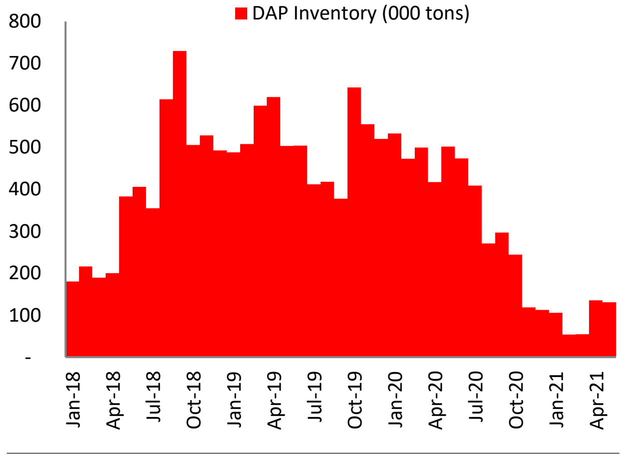
Source: NFDC, Foundation Research, July 2021

Fig 17: DAP local prices to increase further (Rs/bag)



Source: Bloomberg, PBS, Foundation Research, July 2021

Fig 18: DAP inventory falls below buffer level (K tons)



Source: NFDC, Foundation Research, July 2021

Table 02: Engro Fertilizer Limited (PA, 'Underperform', Target price: 59.4sh)

Balance sheet		**CY20A**	**CY21E**	**CY22E**	**CY23E**
PP&E	m	65,646	63,779	62,230	60,908
Cash & ST invest	m	30,374	18,036	104	988
Other receive	m	8,461	8,461	8,461	8,461
Inventory	m	7,533	9,588	9,378	9,772
Other Assets	m	19,699	21,323	20,821	21,243
Total Assets	**m**	**131,713**	**121,187**	**100,994**	**101,373**
LT+ST debt	m	25,001	15,921	12,109	18,787
Acct. payable	m	47,656	45,619	28,884	24,213
Deferred liab	m	11,678	11,678	11,878	11,878
Others	m	648	513	502	516
Total Liabilities	**m**	**84,983**	**73,730**	**53,372**	**55,394**
Paid-up capital	m	13,353	13,353	13,353	13,353
Others	m	33,378	34,103	34,268	32,625
SH' Equity	**m**	46,731	47,456	47,621	45,978
L+E	**m**	**131,713**	**121,187**	**100,994**	**101,373**

Profit & Loss		**CY20A**	**CY21E**	**CY22E**	**CY23E**
Net sales	m	105,846	120,966	117,222	122,148
Cost of sales	m	71,592	76,902	81,056	87,308
Gross profit	**m**	**34,255**	**44,064**	**36,166**	**34,840**
S&A	m	10,365	10,548	11,060	11,597
Other income	**m**	1,667	1,416	1,649	645
Other exp	m	1,022	3,451	2,158	2,079
EBIT	**m**	**23,890**	**33,516**	**25,106**	**23,243**
Finance cost	m	3,236	1,575	1,445	1,617
PBT	**m**	**21,298**	**29,906**	**23,153**	**20,191**
Taxation	m	3,165	9,841	6,750	5,596
PAT	**m**	**18,133**	**20,066**	**16,403**	**14,595**
EPS	x	13.6	15.0	12.3	10.9
EPS growth YoY	%	7.5%	10.7%	-18.3%	-11.0%
DPS	x	13.0	11.5	5.0	5.0

Q performance		**1Q'21A**	**2Q'21E**	**3Q'21E**	**4Q'21E**
Net sales	m	29,444	23,927	28,109	39,486
Cost of sales	m	17,886	14,808	17,400	26,809
Gross profit	**m**	**11,558**	**9,120**	**10,709**	**12,677**
S&A	m	2,239	2,542	2,709	3,058
Other income	m	479	537	200	200
Other exp	m	869	532	960	1,090
EBIT	m	**8,929**	**6,582**	**7,239**	**8,730**
Finance cost	**m**	269	368	460	477
PBT	m	**8,660**	**6,214**	**6,779**	**8,252**
Taxation	**m**	2,919	1,901	2,238	2,783
PAT	m	**5,741**	**4,313**	**4,541**	**5,470**
EPS		4.3	3.2	3.4	4.1
EPS growth QoQ		35%	-25%	5%	20%
DPS		5.0	3.0	1.5	2.0

Key ratios		**CY20A**	**CY21E**	**CY22E**	**CY23E**
BVPS	x	35.0	35.5	35.7	34.4
EPS	x	13.6	15.0	12.3	10.9
PE	x	5.4	4.9	6.0	6.7
PBv	x	2.1	2.1	2.1	2.1
GP margins	%	32%	36%	31%	29%
EBITDA margin	%	28%	32%	26%	23%
NP	%	17%	17%	14%	12%
ROE	%	40%	43%	35%	31%
ROA	%	14%	16%	15%	14%
EY	%	19%	20%	17%	15%
Payout ratio	%	80%	49%	102%	90%
DY	%	18%	16%	7%	7%
EV/EBITDA	x	5.3	5.3	5.0	4.8
Operating cycle	x	(182)	(167)	(80)	(52)
Debt/Equity	x	0.5	0.3	0.3	0.4

Source: Company data, Foundation Research, July 2021
All figures in Rs unless noted

About the company

Engro Fertilizers Limited ('the Holding Company') is a public company incorporated on June 29, 2009 in Pakistan under the repealed Companies Ordinance, 1984 (the Ordinance), [now the Companies Act, 2017] as a wholly owned subsidiary of Engro Corporation Limited (the Parent Company), which is a subsidiary of Dawood Hercules Corporation Limited (the Ultimate Parent Company). The Holding Company is listed on Pakistan Stock Exchange Limited (PSX).

The principal activity of the Holding Company is manufacturing, purchasing and marketing of fertilizers. It is located in Daharki, District Ghotki. The site hosts two plants, Base and Enven namely. Base plant has an installed capacity of 975k tons per annum, while Enven has a production capacity of 1267k tons per annum.

Subsidiaries

- EFert Agritrade (Private) Limited (EAPL)

Plant Location

- **Urea Plant:** Daharki, District Ghotki, Sindh
- **Zarkhez Plant:** EZ-1 P-I-II Eastern Industrial Zone Port Qasim, Karachi

Auditors: A.F. FERGUSON & CO.

Table 03: Engro Fertilizer key personnel

Key Personnel	Name	Designation
Board of Directors	Mr. Ghias Khan	Chairman
	Mr. Nadir Salar Qureshi	Chief Executive Officer
	Mr. Abdul Samad Dawood	Director
	Mr. Asad Said Jafar	Director
	Mr. Asim Murtaza Khan	Director
	Mr. Javed Akbar	Director
	Mr. Mazhar Hasnani	Director
Management	Mr. Nadir Salar Qureshi	Chief Executive Officer
	Mr. Imran Ahmed	Chief Financial Officer
	Ms. Sunaib Barkat	Company Secretary

Source; Company Accounts, Foundation research, July 2021

Table 04: EFERT Pattern of shareholding and free float as at Dec 2021 (mn sh)

Pattern of shareholders	Holding (mn)	Shares
Associated companies	751	56.27%
Modarbas and Mutual Funds	79	5.91%
Banks, DFIs and NBFC	59	4.43%
Insurance companies	17	1.30%
Individuals	203	15.23%
Others	225	16.86%
Free Float	601	45.00%

Source; Company Accounts, Foundation research, July 2021

Abbreviations

ATDO	Avg. Daily Turnover
LT	Long term
avg	Average
bn	billion
Mcap	Market Capitalization
CAGR	Compounded Annual Growth Rate
mmcfd	million cubic feet per day
CMP	Current Market Price
mn	Million
COD	Commercial Operations Date
CY	Calendar Year
PBS	Pakistan Bureau of Statistics
DAP	Di-Ammonium Phosphate
TP	Target Price
DR	Discount Rate
YoY	Year on Year
DY	Dividend Yield
GP	Gross Profit
EPS	Earnings Per Share
Mn	Million
Bn	Billions
BS	Balance Sheet
Sh	Share
FF	Free Float
WCC	Working capital charges
Rs	Rupee
EPS	Earning Per Share
DPS	Dividend per Share
DCF	Discounted Cash Flow
PE	Price/Earning
FY	Fiscal Year
ROE	Return on Equity
GDP	Gross Domestic Product
DY	Dividend Yield
PBV	Price to Book Value
BVPS	Book value Per Share
EBIT	Earnings before Interest Tax
EBITDA	Earnings before Interest Tax Depreciation Amortization
PBT	Profit before Tax
LNG	Liquefied Natural Gas
EV	Enterprise Value
SFB	Speciality fertilizers business

Important disclosures:

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Recommendations definitions

If

Expected return >+10%	Outperform.
Expected return from -10% to +10%	Neutral.
Expected return <-10%	Underperform.