KHADIM ALI SHAH BUKHARI SECURITIES (PVT) LTD.

28th March 2019

GIDC resolution to provide fresh legs to the Fertilizer Sector

Initiation on FFC (OP), ENGRO (Neutral), EFERT (Neutral) and FFBL (Neutral)

We initiate coverage on the Fertilizer sector with an 'Outperform' stance. Fauji Fertilizer Company (FFC: Target Price PkR 129) is our top pick. We are Neutral on Engro Corporation (ENGRO: Target Price PkR 384), Engro Fertilizer (EFERT: Target Price PkR 75), and Fauji Fertilizer Bin Qasim (FFBL: Target Price PkR 42). Among pure Urea based players, we recommend a shift from EFERT to FFC.

We believe resolution of pending GIDC issue remains a key trigger for the entire sector. The proposed mechanism (i) directs companies to pay 50% of the total GIDC accrued between 2012-2018 and (ii) reduces the prospective rates by 50% for some reduction in Urea prices. Consequently, we expect local Urea prices to decline by PkR150/bag. We think the matter could be resolved by Jun-19. FFC (PkR13/sh) and EFERT (PkR7/sh) are set to gain the most with possible reversals (cashflow impact). FFBL, on the other hand, would only benefit on recurring basis due to import parity pricing of DAP. ENGRO – not a core fertilizer play anymore – offers highest 5yr EPS CAGR of 21% p.a., led by recently commissioned projects at Thar and upcoming expansion in the polymer segment. ENGRO has ~40% of its market capitalization in cash. This is an unparalleled advantage, which can fund future growth beyond the forecasted EPS CAGR.

- **GIDC resolution remains a key trigger.** We think the proposed mechanism of 50% GIDC payment would go through – especially since the government has not been able to collect the tax for past 2.5 years. We think fertilizer sector remains a key beneficiary of GIDC resolution, especially if manufacturers get to keep a portion of cost impact (PkR190/bag on FFC). We have assumed a price decline of PkR150/bag of Urea from Jun-19.
- **Medium term demand trends to favour unconventional fertilizers.** We estimate demand for Nitrogen based fertilizers to remain flat, over the medium term. However, demand for phosphate fertilizers is more price sensitive. If adjusted for 17% GST, local DAP prices (~PkR3,500-3,600/bag) are trading close to the levels which were last seen in 2011-2012's commodity cycle boom. We think this may negatively affect demand for phosphate fertilizers (5yr forward CAGR of -2%pa). Also, Pak Arab Fertilizer (a key producer of CAN & NP) is likely to resume operations from Apr-2019. We think availability of CAN/NP would lead to some substitution effect for Urea/DAP as well. Resultantly, we are projecting demand for CAN/NP to grow at a 5yr CAGR of 8%/10% p.a. vs. 5yr demand CAGR of -1.0%/-0.4% for Urea & DAP, respectively.
- **Growth to come from diversified investments.** We think ENGRO sets a perfect example of diversification in various businesses. For FFC and FFBL, dividend income contributes 10% and 60%, respectively, to their profit before tax. However, their investments in food businesses have remained questionable (incurring substantial losses), we think investments in existing/upcoming power ventures (FFBL Power, Foundation Wind I & II and FFC Energy) should provide some relief.

Pakistan: Fertilizers

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Company	MkT Cap (US$ Mn)	Target Price (PkR)	Upside
FFC	959	129	23%
ENGRO	1,218	384	17%
EFERT	692	75	4%
FFBL	239	42	18%

Company	EPS CY19E	EPS CY19E*	EPS CY20E	DPS CY19
FFC	44.3	14.3	14.1	12.0
ENGRO	58.1	41.5	53.8	25.0
EFERT	22.7	11.1	11.0	10.0
FFBL	14.5	2.4	3.6	1.5

*Ex of GIDC reversal

Khadim Ali Shah Bukhari Securities is a TREC Holder of Pakistan Stock Exchange (#248).

GIDC Resolution - A matter of when, not if

We initiate coverage on Pakistan's Fertilizer sector with an Overweight stance. Fauji Fertilizer (FFC: Target Price PkR 129) is our top pick. We are Neutral on Engro Corporation (ENGRO; Target Price PkR 384), Engro Fertilizer (EFERT: Target Price PkR 75) and Fauji Fertilizer Bin Qasim (FFBL: Target Price PkR 42).

We believe government's proposition to resolve GIDC issue with (i) payment of 50% GIDC accrued between 2012-2018 and (ii) 50% prospective cut in GIDC tariff for a PkR100-200 per bag decline Urea prices would go through. We expect the matter to be resolved by Jun-19. Along with that, we are expecting a PkR150/bag decline in Urea prices.

Fertilizer sector has 7 companies in total. It constitutes 15% of the KSE100 index. The sector has cumulative market capitalization of ~US$4.1 Bn.

Proposed resolution of GIDC…

- The currently proposed mechanism directs companies to pay 50% of the total GIDC accrued between 2012-2018. Since government has not been able to collect GIDC for past 2.5 years, it is likely that this new plan would move forward. If this happens, fertilizer manufacturers including FFC, FFBL and EFERT may book one-time reversals. We believe FFC is likely to benefit the most with retrospective impact. FFBL, on the other hand stands to benefit the most with prospective reduction in GIDC rates by 50% due to import parity pricing of DAP.

- Since fertilizer manufacturers have already overpaid their due share of GIDC, these reversals could lead to net receivable position, in our view. We estimate FFC and EFERT to have a net receivable position of PkR16.74 Bn (PkR13.1/sh) and PkR PkR9.42 Bn (PkR7.0/sh). We believe a possible solution would be to adjust net receivables against future GIDC payables, which may take 2-3 years to recover the full amount.

…but there is a catch, it requires reduction in Urea prices.

- Reportedly, manufacturers would be required to reduce prices by PkR200/bag of urea against 50% reduction in GIDC. Based on our analysis, 50% cut in GIDC leads to cost savings of PkR190/bag for FFC – equivalent to the proposed cut in Urea prices.

Companies	Shares	Price	Mkt Cap (PkR Mn)	Mkt Cap (US$ Mn)	Free Float (Mn)	Free Float (%)	KSE100Weight
Engro Corporation Limited.	524	323	327	171,208	1,232	55%	5.1%
Fauji Fertilizer Co. Ltd	1,272	105	105	133,848	963	55%	4.1%
Engro Fertilizers Limited	1,335	72	72	96,328	693	45%	2.4%
Fatima Fertilizer Co. Ltd.	2,100	31	31	65,310	470	15%	0.5%
Dawood Hercules Corp. Ltd.	481	125	129	61,980	446	65%	2.2%
Fauji Fertilizer Bin Qasim Ltd	934	36	36	33,553	241	35%	0.7%
Arif Habib Corporation Ltd.	454	26	26	11,729	84	20%	0.0%

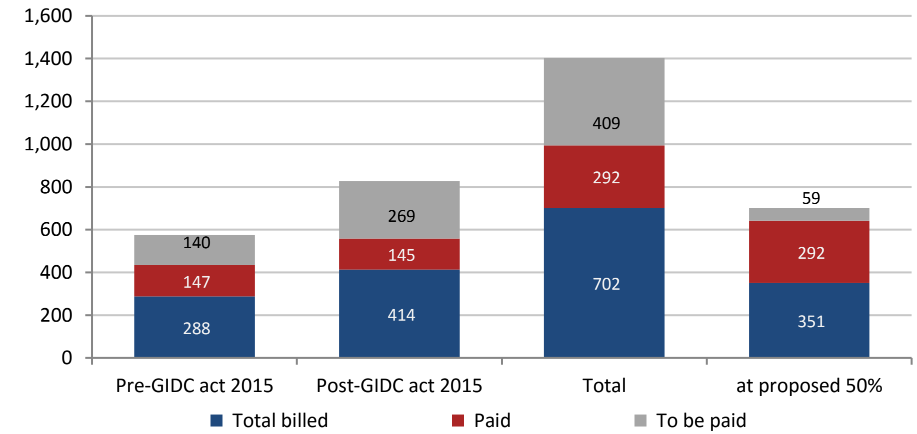
Source: Zakheera

GIDC position of fertilizer manufacturers

(Amount PkR Bn)	GIDC accrued	50% GIDC	After tax EPS reversal	Currently Unpaid	GIDC Paid	GIDC Receivables	Annual GIDC at 50%	Years to Receive full amt
FFC	117.64	58.82	32.36	42.08	75.55	16.74	9.31	1.80
FFBL	33.22	16.61	12.45	16.44	16.79	0.18	6.02	0.03
EFERT	44.00	22.00	11.53	12.58	31.42	9.42	2.97	3.18

Source: Company Accounts & KASB Estimates

Total GIDC situation



Source: News reports

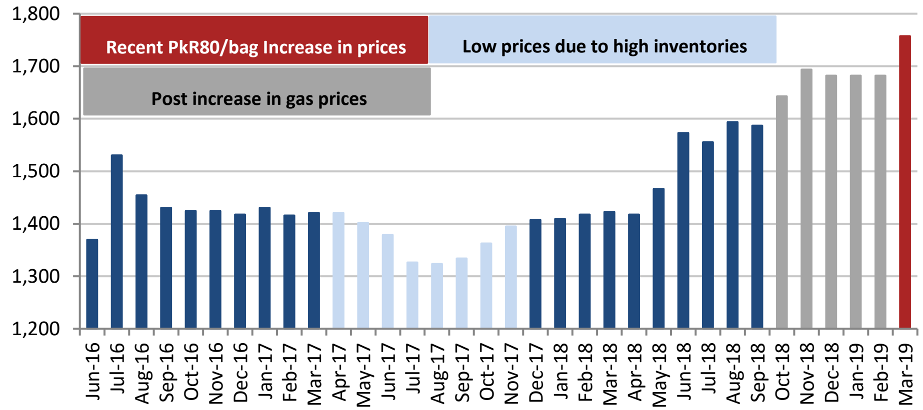
- We think manufacturers may easily agree to slash Urea prices by PkR100/bag instead of the cost impact of ~PkR190/bag. For FFC and FFBL – constituting 50-55% of Urea market – **it would be a win-win scenario to reduce prices by PkR150/bag as a middle ground.** Conversely, this scenario negatively affects concessionary gas-based players like EFERT and FATIMA.

- Recently, **FFC has increased Urea prices by another PkR80 per bag.** We attribute this increase to (i) prepare the market for a reduction in Urea prices against reduction in GIDC and (ii) offset potentially lower margins on DAP sales due to hefty discounts.

Comparison of Scenarios	Base Case: 50% GIDC Reduction				No reduction in GIDC*				Δ in TP
	2019E	2020E	2021E	TP	2019E	2020E	2021E	TP	%age
FFC	44.32	14.07	14.24	129	11.80	13.22	13.42	95	36%
EFERT	22.65	11.05	11.26	78	12.83	12.59	12.87	69	13%
FFBL	14.53	3.62	4.43	42	1.13	2.99	3.93	34	24%
ENGRO	58.10	53.84	59.38	384	41.78	55.98	61.62	374	3%

Source: KASB Estimates
*Accrued GIDC treated as debt

Trend of urea retention prices (PkR/bag – inclusive of subsidies)



Source: NFDC & KASB Research

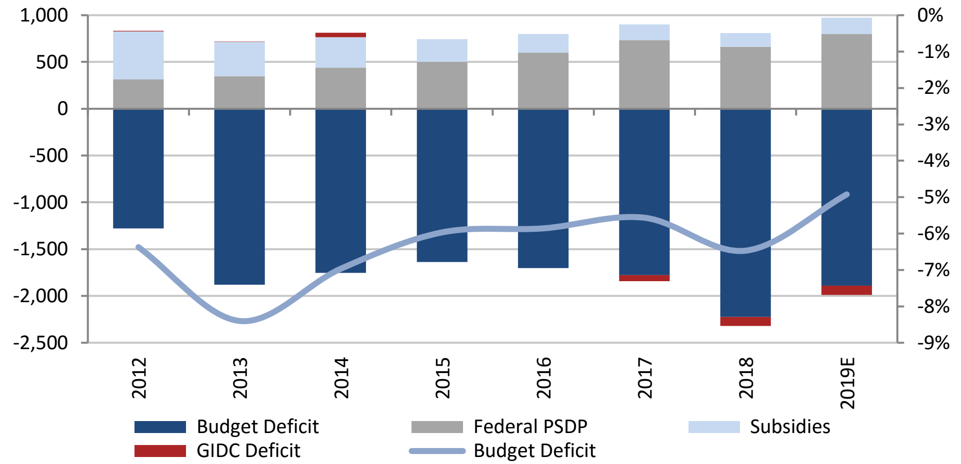
- So far other manufacturers - including EFERT and FATIMA - have not followed FFC in increasing Urea prices. We think it could be a short-lived phenomenon, where the case for price increase is weak, in our view. **Thus, we have not incorporated that scenario as our base case. If Urea prices sustain, the increase of PkR80 per bag would be an upside case to our estimates.**

What industry experts think?

- Our discussion with industry experts concludes that government is sincerely looking to resolve the GIDC matter. However, this matter may linger-on as collection from various sectors would require sometime. **The government is targeting to resolve the matter by Jun-19 to curb the ballooning fiscal deficit – reported revenue shortfall of PkR220 Bn (7MFY19) on top of targeted budget deficit of PkR1.89 Tn.**

Case for fertilizer manufacturers. Most of the companies are due to book reversals, which may result in accumulation of receivables. This can be offset by future GIDC proceeds at the 50% applicable rate. However, for subsidy receivables, government may look to issue promissory notes – just like they did for export-oriented sectors (click here).

Ballooning Fiscal deficit requires a quick fix for additional revenues



Case for other industries. We understand that a lot of companies, specifically from textile sector (for example Gadoon Textile) have not been accruing GIDC as an expense. A one-time adjustment of GIDC till Dec-2018 could require a huge one-off expense, however, it may not require cash outflow, due to sales tax and DLTL refunds. Reportedly, the government is also looking to adjust GIDC payables against GST claims and DLTL refunds. (click here)

How GIDC came into effect?

- GIDC was first introduced in 2011 to develop infrastructure for Turkmenistan-Afghanistan-Pakistan-India (TAPI) gas pipeline. It became a pain-point for most of the industries in Pakistan including Fertilizer, CNG, Textile and Industrial sectors. Unfortunately, the money raised from the cess was utilized for fiscal operations instead of TAPI pipeline. Resultantly, multiple high courts deemed GIDC as unconstitutional. Since Oct-16, Fertilizer sector has been accruing GIDC, but it has not paid a sizeable portion of this amount. We estimate fertilizer sector's (FFC, FFBL, EFERT and FATIMA) current GIDC payables of PkR74 Bn.

A counter argument for not reducing Urea price?

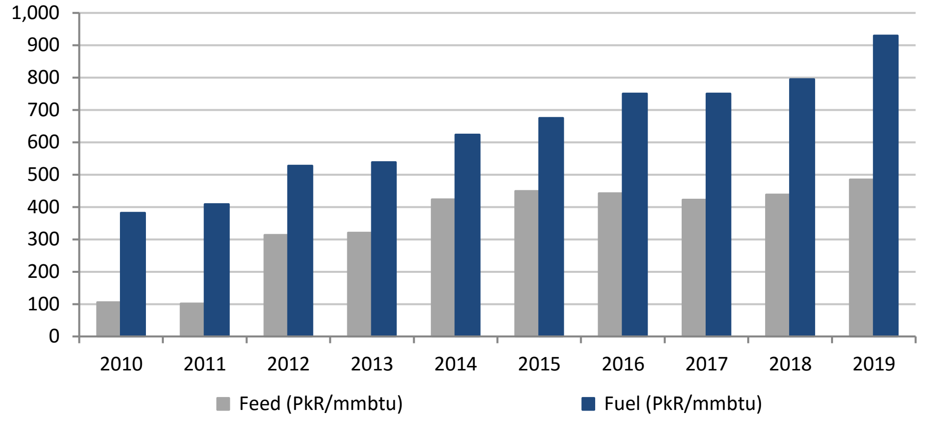
- Looking at the constrained fiscal space, government may decide to utilize several measures available to generate more revenue. Now that the incumbent government is close to signing an IMF program, it needs to take several measures towards fiscal consolidation.

Possible outcomes could be:

(a) Raising gas prices. In order to meet the previous and estimated revenue requirements of twin gas utilities, government still needs to increase gas prices by 41% (click here). Instead of reducing Urea prices, government can increase the burden of gas prices on the fertilizer sector – upto the tune of PkR200 per bag of Urea. That will not only hurt local farmers, and demand, but fertilizer manufacturers may even look to pass-on partial impact of further gas tariff hikes, in our view. **Due to concessionary gas pricing, EFERT and FATIMA would be likely winners of this scenario.**

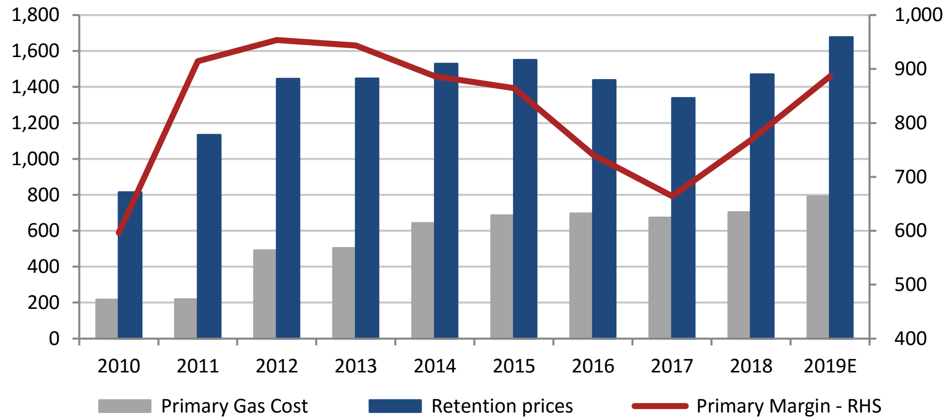
(b) Increase the GST back to 17% vs. 2% at present. Increase in GST back to 17% **on fertilizer produce may result in revenue collection of ~PkR60 Bn to the national exchequer.** We think government could come up with a solution to maintain urea prices at current levels while generating additional revenue by elevating GST rates.

Trend of gas price increases



Source: OGRA

Primary margin per bag of Urea is now close 2011-12 levels



Source: NFDC & KASB Estimates

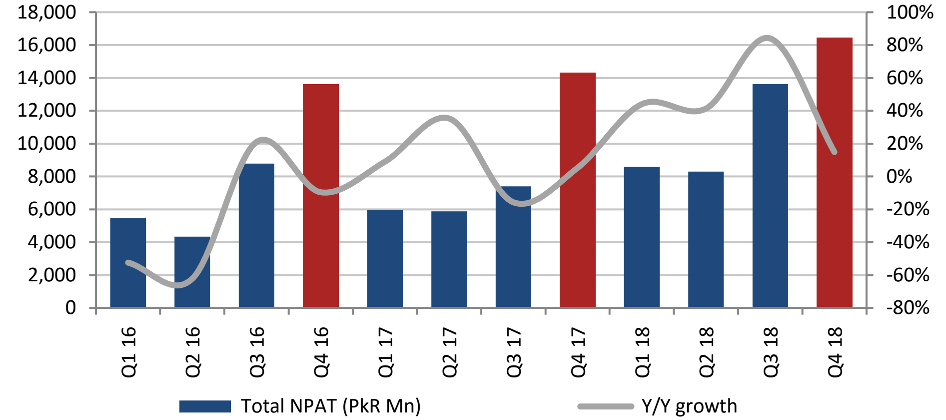
*Excluding recent increase of PkR80/bag by FFC

28th March 2019

Sectoral dynamics are in favour for now

- Pakistan exported 600KT+ of Urea in CY17. Since then, Urea inventory is down significantly to a more sustainable level of 100 KT from highs of 1.7MT (Apr-17). With that, local Urea retention prices have also increased, amid lower discounts to dealers. This led to 40% Y/Y growth in cumulative profits of four fertilizer companies (FFC, FFBL, EFERT and FATIMA*) in CY18.

Visible profit growth in last 1.5 year (4th quarter is generally the strongest)



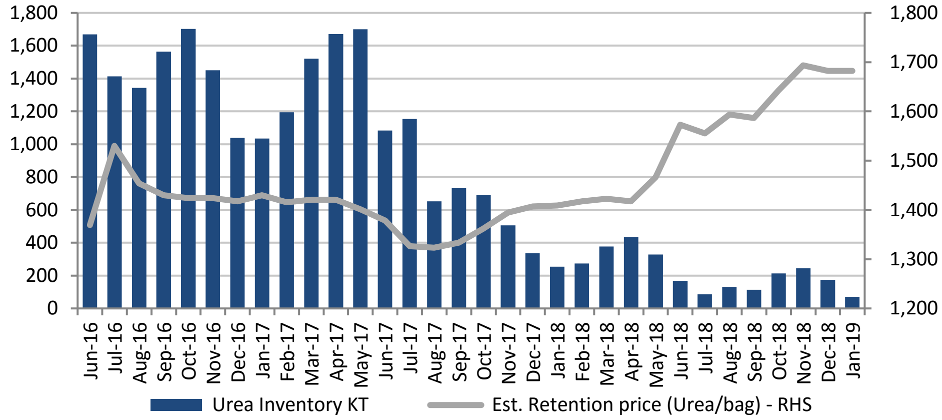
Source: KASB Estimates & Company Accounts
* FATIMA 4QCY18 is estimated

Supply side favouring local manufacturers

- Urea inventory stood at 69 KT at Feb-19. In an environment of falling gas production and FX reserves, GoP has been managing production via two closed fertilizer units in Punjab (Agritech & Fatima fert DH) through supply of RLNG (71 MMSCFD). We think this trend can continue for foreseeable future, where government may continue to divert RLNG at subsidized rates to meet the demand in peak season (Rabi).

- We think diversion of gas to closed fertilizer plants (DH and Agritech) is a realistic assumption for the medium term. Since the country is starving for FX reserves and LNG is already available, providing subsidy in PKR terms is better than importing Urea in foreign currency, in our view.

Substantial increase in Urea retention prices amid decline in inventories (PkR/bag)



Source: NFDC & KASB Estimates

Local production capacity is capable to meet country's demand.

- Pakistan's current Urea, CAN & NP capacity is enough to meet local demand. DAP (diammonium phosphate) is the only fertilizer where local production meets 1/3rd of the total demand. Due to shortage of indigenous gas and lower priority for gas supply, the country ends up importing all major products - except for CAN.

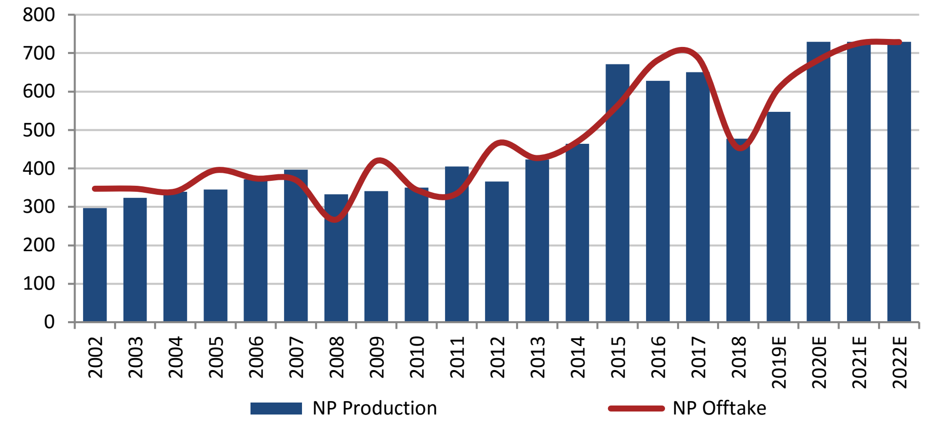
Current Fertilizer production capacity in Pakistan

Production Cap (KT)	Urea	CAN	NPK	NP	DAP
EFERT	2,225	-	100	-	-
FFC	2,048	-	-	-	-
FFBL	551	-	-	-	650
DH	456	-	-	-	-
Agritech	433	-	-	-	-
Pak Arab	100	450	-	305	-
FATIMA	500	420	-	360	-
Total	**6,313**	**870**	**100**	**665**	**650**

Source: NFDC & KASB Estimates

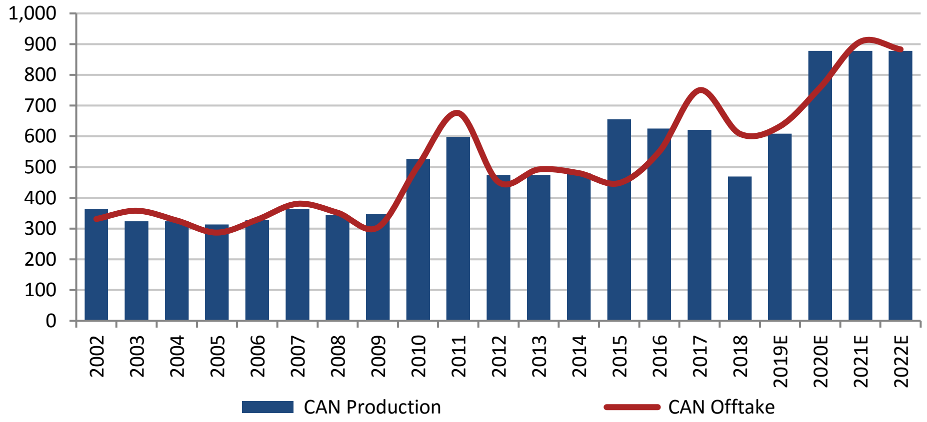
- **Pak Arab Fertilizers is about to resume formal operations by April-2019**. The Economic Coordination Committee (ECC) has already committed 75 MMCFD of Mari Network's gas for Pak Arab Fertilizers (click here). The company is now laying a pipeline which is expected to be completed by 2QCY19. Post that, Pak Arab should be able to operate at optimal utilization levels. We think this can create a surplus position in CAN & NP markets – which are considered substitutes to Urea and DAP.

Substitution effect to raise NP's offtake (KT)



Source: NFDC & KASB Estimates

Boost to CAN offtake from substitution effect (KT)



Source: NFDC & KASB Estimates

FATIMA Fertilizer's acquisition of Pak Arab Fertilizers. What does it mean for the sector?

- FATIMA fertilizer (FATIMA) has formally notified to acquire Pak Arab Fertilizer – an unlisted group entity – for a consideration of PkR9 Bn (click here). Pak Arab is a major producer of Calcium Ammonium Nitrate (CAN) and Nitro Phosphate (NP) fertilizers.

FATIMA & Pak Arab's existing portfolio of products

Capacity KT	Urea	CAN	NP
FATIMA standalone Capacity	**500**	**420**	**360**
-Production 2018	501	470	378
-Utilization 2018	100%	112%	105%
Pak Arab Capacity	**100**	**450**	**305**
-Production 2018	-	-	13
-Utilization 2018	0%	0%	4%

Source: Company Accounts & NFDC

- Post Pak Arab's acquisition, consolidation within the industry would increase – now three players including Fauji's, Dawood Group and Arif Habib group would control more than 90% of the fertilizer supply in Pakistan. For FATIMA, it would add more synergies. According to management, post consolidation, the company would be able to earn another PkR2 Bn p.a. (click here).

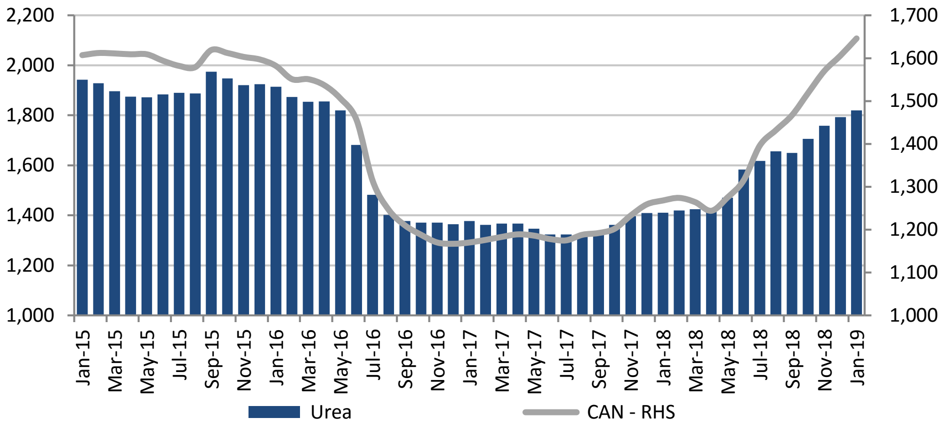
- We believe demand for CAN and NP is more dependent on product availability and their pricing gap to conventional fertilizers. Demand of 0.75MT and 0.68MT for CAN and NP, respectively, in 2017 corroborates this phenomenon. This was the time when Pak Arab was partially operational, and the industry had enough opening inventories of CAN & NP.

- We think FATIMA would now focus more on its Urea business and sell more profitable products like CAN and NP through its Pak Arab plant. **We suspect the new gas for Pak Arab could be priced on petroleum policy 2012 (click here).** Also, Pak Arab would be more profitable if it concentrates on CAN and NP businesses in future.

Pricing gap may rise b/w Urea-CAN and DAP-NP

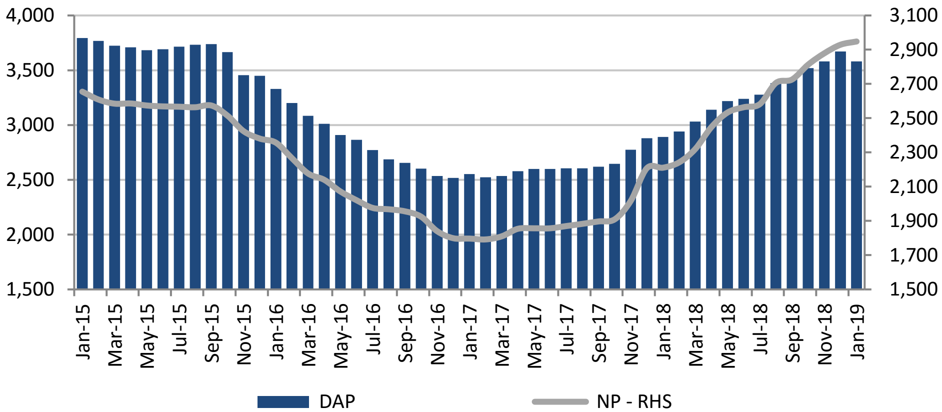
- Internationally and even locally, fertilizer prices are based on nutrient composition of the fertilizer products. For example, CAN & NP are locally priced at ~75% of the price of Urea & DAP, respectively.

CAN closely tracks Urea prices (PkR/bag)



Source: NFDC & KASB Estimates

NP tracks DAP prices (PkR/bag)



Source: NFDC & KASB Estimates

- That said, a surplus position in CAN market may restrict pricing power of Urea manufacturers, either through (i) volumetric push in CAN market or (ii) increase in gas prices for the fertilizer sector. Recall that increase in gas prices for the industry may not affect FATIMA due to concessionary gas pricing at the base plant and PP-12 based pricing on the Pak Arab plant.

- Furthermore, leveraging onto FATIMA's strong balance sheet, the consolidated group (FATIMA and Pak Arab) may look to strike another gas supply agreement for its DH Fertilizer based Urea plant. **This could be a win-win scenario for Pakistan & FATIMA group in balancing the supply situation in Urea market and maintaining a reasonable check on any price increases.** However, due to costlier gas pricing policies (petroleum policy 12) and Urea based product-mix, it would be difficult to add meaningful contribution at group level via DH Fertilizers (also known as Fatimafert now), in our view.

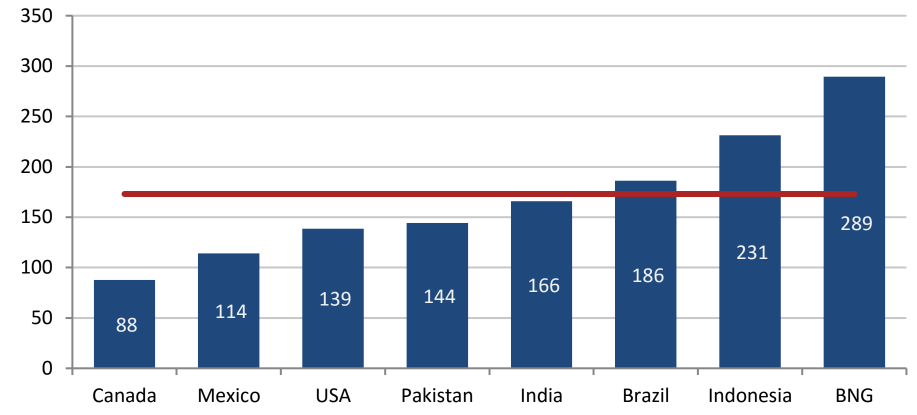
We think demand for conventional fertilizers may remain upward sticky

- **From 2018's base, we have assumed 5-yr demand CAGR of -1.0%/-0.4% for Urea & DAP, respectively. However, we are expecting demand for CAN/NP to grow at a 5yr CAGR of 7.6%/10.0%, respectively.** We think an unusually low number of CAN/NP offtakes in 2018 is justified by lack of supply from Pak Arab.

- Demand for Phosphate fertilizers is more price elastic. Recall that 34% PKR depreciation (since Dec-17) has led to 23% Y/Y rise in local DAP prices – despite lower GST of 2%. Local DAP prices would have been close to ~PkR4,200/bag, had it not been for lower GST (at 2% vs 17% in past). These levels were last witnessed in late 2011 during the commodity cycle peak. We think preference for NP over DAP would rise due to availability of the former – once Pak Arab's plant comes online in April-2019.

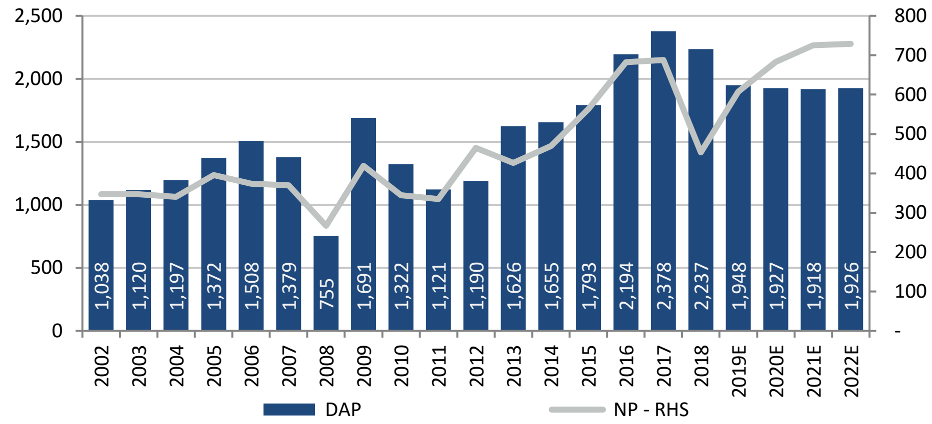
- While demand is more inelastic in the nitrogen market potential growth in Urea demand would be offset by more availability of CAN over the medium term.

Pakistan is close to comparable average in total fertilizer consumption/hectare (KGs)



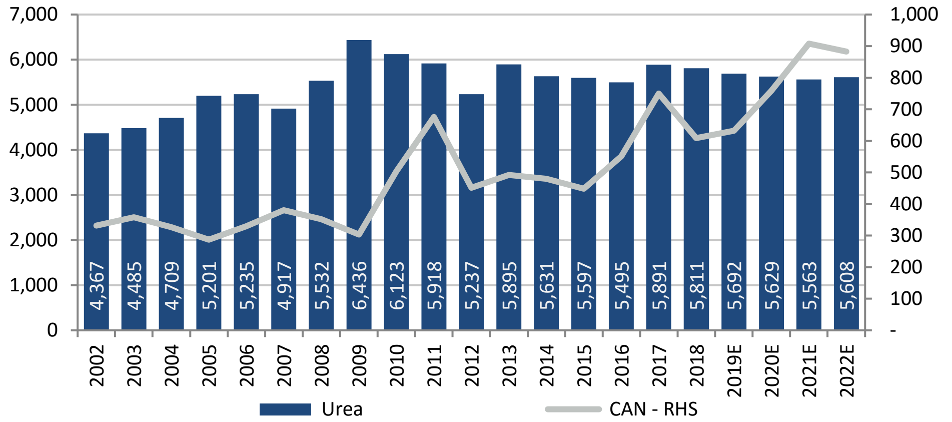
Source: World Bank

NP demand to supersede DAP demand over the medium-term



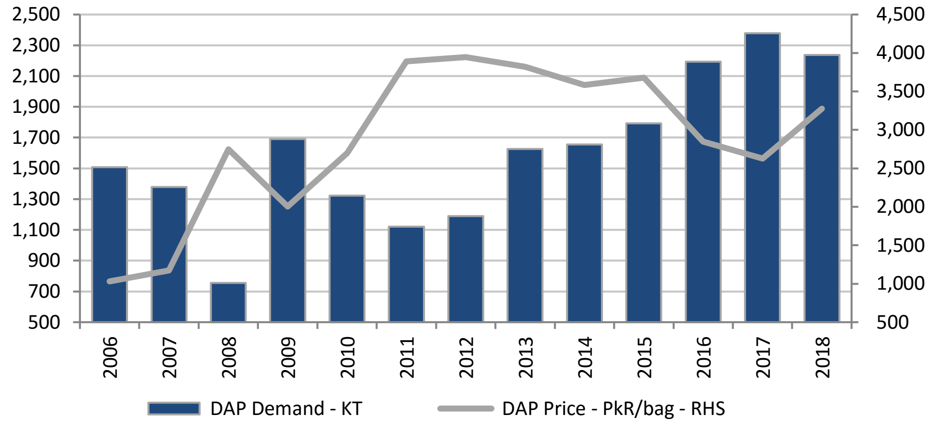
Source: NFDC & KASB Estimates

CAN to show more growth than Urea due to product availability



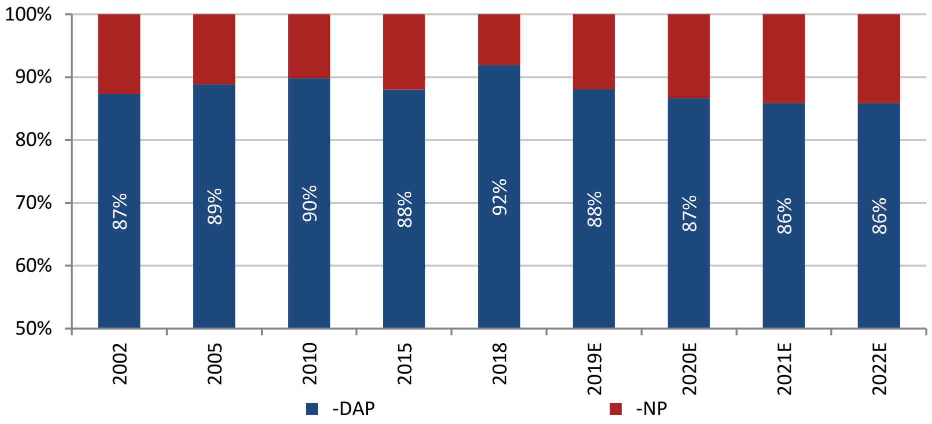
Source: NFDC & KASB Estimates

DAP's demand is more price sensitive



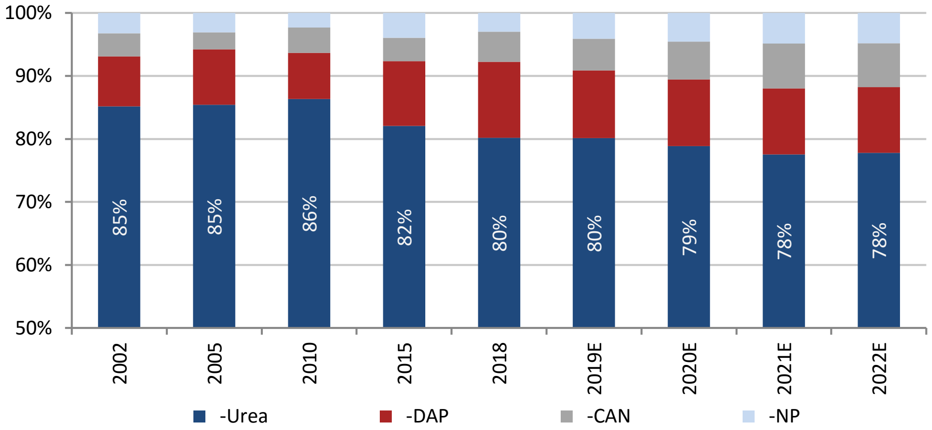
Source: NFDC & KASB Estimates

Contribution of NP to increase post 2018 in total phosphate nutrients



Source: NFDC & KASB Estimates

Nitrogen nutrient contribution to increase from unconventional fertilizers



Source: NFDC & KASB Estimates

Most common fertilizer products in Pakistan

- **Urea:** Most commonly used fertilizer having highest concentration of nitrogen (46%). Urea is mostly used on standing crops followed by irrigation to minimize losses. Urea is applied during the mid-stages of sowing and harvesting. It is most commonly available in prilled form.

- **CAN:** Calcium ammonium nitrate is a nitrogenous fertilizer, containing 26% of nitrogen and 10% of calcium. The composition of CAN is optimal for providing all crops with targeted nutrition. CAN is equally effective in water stressed areas where soil has low moisture.

- **DAP:** Di-ammonium Phosphate is produced from ammonia and phosphoric acid. DAP is the most concentrated phosphate-based fertilizer containing 46% of phosphate, and 18% of nitrogen nutrients. It is recommended for all crops at the sowing stage. Fauji Fertilizer Bin Qasim is the only company Pakistan that produces DAP.

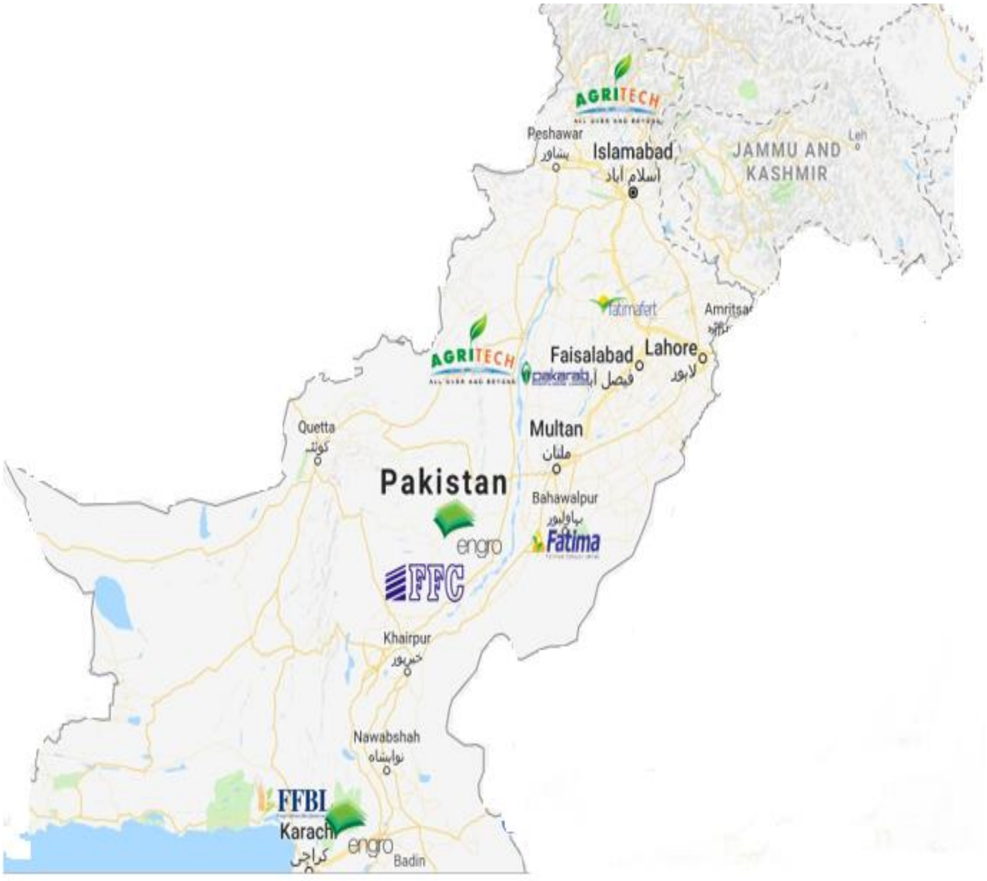
- **NP:** Also, commonly known as “Sarsabz” in Pakistan. It contains 20% of phosphate and 22% of nitrogen nutrients. It is most effective on soils having a higher pH value. The combination of both nutrients ensures both growth and development of plant. NP is produced in Pakistan by Fatima Fertilizer, Pak Arab Fertilizer and Engro Fertilizer.

Demand supply of major products

Products (KT)	2018	2019E	2020E	2021E	2022E
UREA					
Capacity	6,345	6,345	6,345	6,345	6,345
Production	5,602	5,708	5,715	5,682	5,643
Imports	105	75	88	100	113
Offtake	5,824	5,692	5,629	5,563	5,608
-FFC	2,527	2,476	2,461	2,422	2,432
-EFERT	1,994	1,941	1,933	1,924	1,916
-FFBL	562	597	597	597	586
-FATIMA	492	447	441	435	429
Closing	174	265	439	658	804
DAP					
Capacity	650	650	650	650	650
Production	728	787	787	787	773
Imports	1,818	961	980	1,098	1,153
Offtake	2,237	1,948	1,927	1,918	1,926
-FFC	480	418	414	412	414
-FFBL	687	787	787	787	773
-EFERT	602	525	519	517	519
Closing	493	293	134	101	101
CAN					
Capacity	870	870	870	870	870
Production	470	608	878	878	878
Imports	-	-	-	-	-
Offtake	609	633	759	908	883
-FATIMA	499	445	370	443	431
-Pak Arab	109	187	389	465	452
Closing	94	70	190	160	156
NP					
Capacity	665	665	665	665	665
Production	477	547	730	729	729
Imports	8	-	-	-	-
Offtake	529	620	742	789	792
-FATIMA	378	408	344	365	367
-Pak Arab	13	135	285	303	304
-EFERT	55	65	54	57	57
Closing	73	12	59	63	63

Source: NFDC & KASB Estimates

Location of fertilizer plants in Pakistan



Source: Google maps & KASB Research

Key Risks to our thesis would be:

Govt intervention in managing prices

- We believe any unexplainable price increases like the recent increase of PkR80/bag of Urea may raise few eyebrows. Though unlikely in current fiscal space, government's intervention would be a key risk.

- During PML-N's era, Urea prices were controlled through direct cash subsidy to manufacturers. This proved to be a popular move among masses, however, fertilizer companies have still not been able to recover their subsidy amounts. Besides that, due to an understanding with fertilizer manufacturers, government did manage to keep Urea prices capped at PkR1,400/bag, at a time when local inventories were on a rising trend.

Delay in resolution of GIDC matter

- We are expecting that GIDC would be resolved by Jun-2019. However, in case the plan does not go through, it would most negatively impact Fauji Fertilizer Company (FFC) – which is also our top pick. Sensitivity is given below:

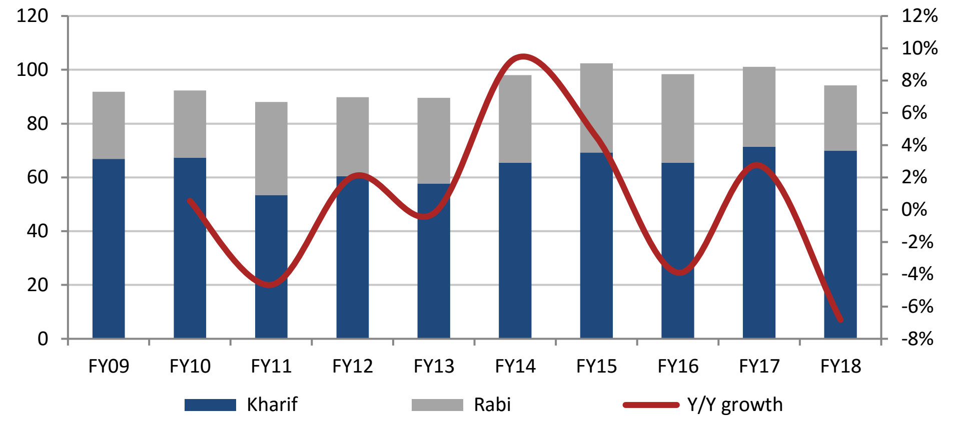
Comparison of Scenarios	Base Case: 50% GIDC Reduction				No reduction in GIDC*				Δ in TP
	2019E	2020E	2021E	TP	2019E	2020E	2021E	TP	%age
FFC	44.32	14.07	14.24	129	11.80	13.22	13.42	95	36%
EFERT	22.65	11.05	11.26	78	12.83	12.59	12.87	69	13%
FFBL	14.53	3.62	4.43	42	1.13	2.99	3.93	34	24%
ENGRO	58.10	53.84	59.38	384	41.78	55.98	61.62	374	3%

Source: KASB Estimates

Scarcity of water resources resulting in long-term change in agricultural patterns

- Recently, water scarcity has remained the most talked issue in Pakistan. Now that the country is planning to take long-term measures of building multiple dams, agricultural activity could be affected by it, in the meantime. We believe water scarcity could negatively impact demand for fertilizers, if the situation is not controlled.

Water availability was lower in the previous season (unit: MAF)



Source: NFDC & KASB Estimates

Rise in gas curtailment of operational fertilizer units

- Gas is the basic raw material for Nitrogen production. Despite a shortage of 2 BCFD, Fertilizer production over the years have not been impacted significantly, because most of the fertilizer manufacturers – except for FFBL – are based on Mari Network.

Company	Network	Est. Gas Supply in 2018 (mmcfd)	Plant Utilization	Exp. Gas supply in 2019 (mmcfd)	Gas Pricing
Fauji Fertilizer	Mari	263	123%	263	Industry
Engro Fertilizer	Mari &SNGPL	186	82%	196	Industry, concessionary & PP12
Fauji Fertilizer Bin Qasim	SSGC	58	107%	58	Industry
Fatima Fertilizer	Mari	104	104%	104	Industry & concessionary
Agritech	SNGPL	9	22%	9	Industry & LNG subsidized
DH Fertilizers	SNGPL	10	23%	10	Industry & LNG subsidized
Pak Arab	SNGPL & Mari	1	2%	56	Industry, LNG subsidized&PP12

Source: NFDC & KASB Estimates

- Gas curtailment has remained an issue for players which are connected to SSGC (FFBL) and SNGPL (Agritech, Pak Arab and DH Fertilizers) networks. Because of the importance of fertilizer sector in the agricultural landscape, we have assumed marginal gas decline of 0.70% for SSGC network (FFBL) and 0.45% for Mari network, respectively.

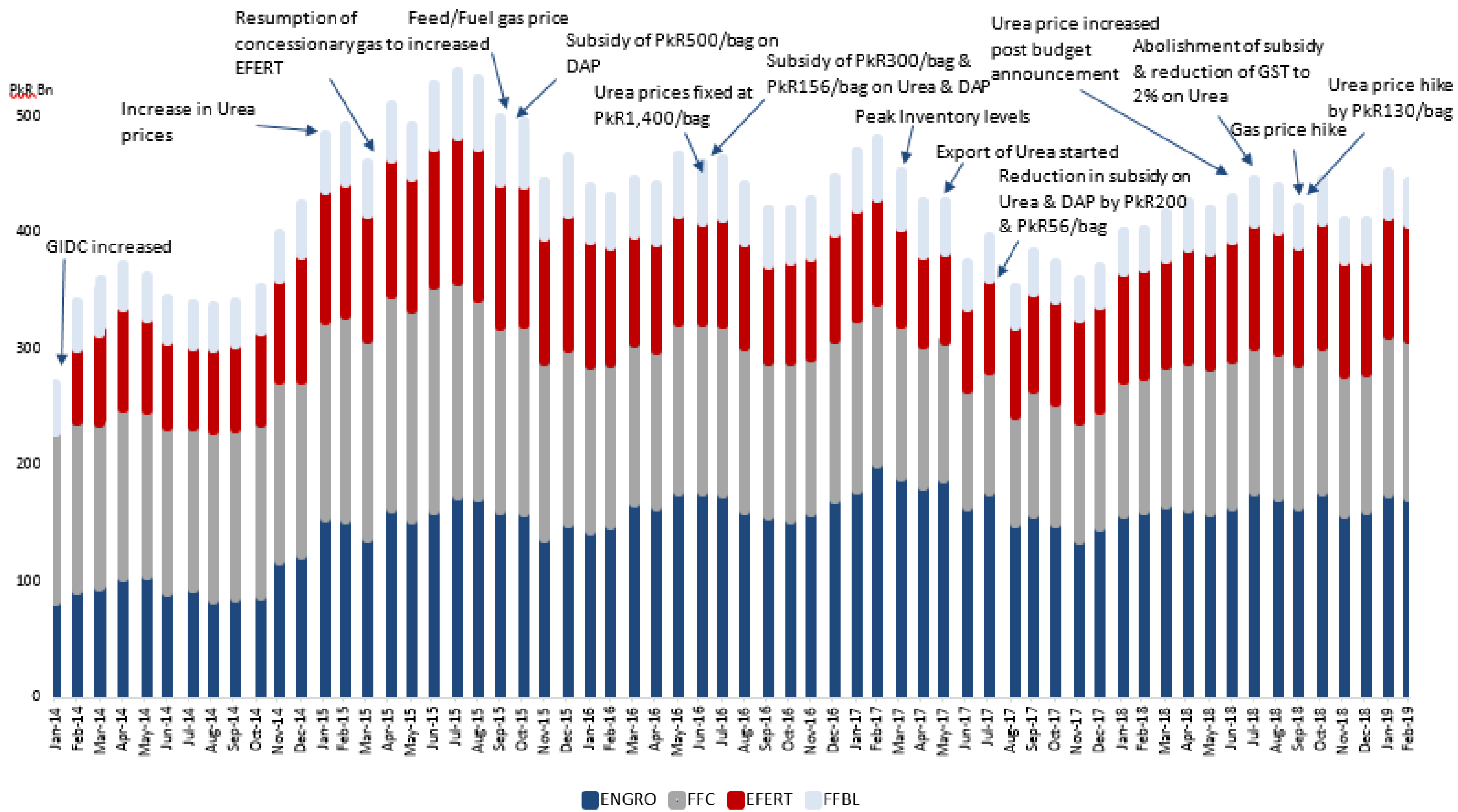
Consistent gas supply to closed fertilizer plants

- Though persistent operation of closed fertilizer plants is good for economy, it may create a threat of natural over-supply every now and then. We think demand for conventional fertilizers (Urea & DAP) would stagnate. In this regard, consistent operations of closed fertilizer plants like DH Fertilizers and Agritech would eventually create room for some price competition. Recall that, this episode took place during CY17 when Urea inventories peaked at 1.7 MT.

Delay in settlement of subsidy and sales tax refunds

- Due to constricted fiscal space, GoP has not been able to clear subsidy and sales tax refunds across the industrial sector. Now GoP has decided to issue promissory notes to export-oriented sectors. Due to recent increase in Urea prices, input-output adjustment of sales tax is marginal. However, delay in collection of existing receivables would continue to drag working capital, in our view.

Fertilizer Universe Timeline



Source: NFDC & KASB Estimates

28th March 2019

Fauji Fertilizer Company (FFC: OP)

Biggest beneficiary of GIDC reduction

Price Target: PkR 129 (23% upside), Current Price: PkR 105.2

Investment thesis

- We initiate coverage on Fauji Fertilizer Company (FFC) with an **Outperform** stance. The company accounts for ~55% of the total GIDC accrued by the fertilizers sector. Because of its mature business profile, we are expecting a 5yr EPS CAGR (excluding the impact of GIDC reversal) of 6% p.a., led by growth in dividend income from associates and Thar Energy Limited (30% stake).
- FFC controls ~55%/65% of Urea and DAP markets, including sales of FFBL – an associate concern with 49.8% stake. Unlike past, the company is now the price-setter within the industry due to highest cost impact of change in gas prices. This is corroborated by (i) PkR130/bag increase in Urea prices – post gas price hike in Sep-18 and (ii) PkR80 per bag pre-emptive rise in Urea prices in Mar-18. We attribute the recent price increase to (i) prepare the market for a reduction in Urea prices against half GIDC and (ii) offset potentially lower margins on DAP sales due to hefty seasonal discounts.
- FFC does not offer scalability in terms of volumes. Recall that FFC has been operating at 120%+ capacity utilization since last 4 years. However, the company has diversified its earnings potential through investment portfolio. The most recent example includes a 30% stake in Thar Energy Limited – a 330MW Coal based power plant at Thar. The project is expected to commence operations by 2HCY21E. We estimate recurring EPS contribution of PkR1.1/sh from TEL via dividends - ~8% of operating profits in CY22E.
- We believe a favourable resolution of GIDC may spike FFC's pay-out ratio beyond 100% to fund big-ticket investments by Fauji Foundation (example Fauji & Askari Cement's expansions).

Valuation

The stock is trading at normalized CY19E P/E of 7.4x, at a 6% discount to the KSE-100. We have valued FFC at PkR129/share using FCF methodology. We have assumed a conglomerate discount of 25% for its investments and a risk-free rate of 11%. The stock went up by 16% in the past 12-mnths, outperforming the benchmark index by 31%.

Key Risks

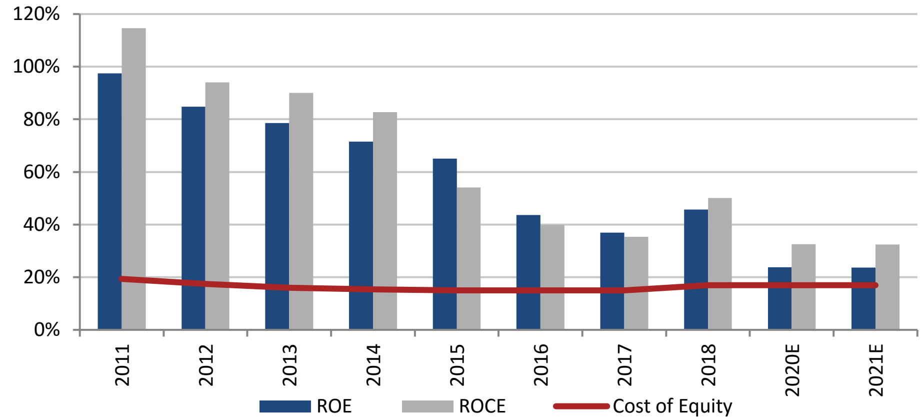
(i) Increase in gas prices, (ii) delay in resolution of GIDC, (iii) steep decline in Urea demand, and (iv) delay in collection of subsidy and sales tax refunds.

Year end Dec (PKR Mn)	2018	2019E	2020E	2021E	2022E
Income Statement					
Revenue (PkR Mn)	108,365	110,547	107,846	108,890	111,575
Growth (%)	12%	2%	-2%	1%	2%
Gross Margin	28.0%	88.0%	31.6%	30.4%	29.7%
EBITDA	21,614	81,606	24,225	23,015	22,689
Profit before tax	21,683	80,527	25,526	25,566	26,747
Tax	(7,244)	(24,146)	(7,627)	(7,451)	(7,553)
Net Profit	14,439	56,381	17,899	18,116	19,194
EPS (PkR)	11.35	44.32	14.07	14.24	15.09
EPS (Ex- of GIDC Reversal)	**11.35**	**14.28**	**14.07**	**14.24**	**15.09**
Balance Sheet					
Current Assets	95,355	88,233	74,556	68,205	65,426
Non-Current Assets	51,135	50,760	50,464	50,082	49,738
Total Assets	146,490	138,994	125,019	118,287	115,164
Total Liabilities	126,269	77,659	57,833	46,932	40,926
Total Equity	33,383	74,497	75,857	77,433	78,816
Cash Flow Statement					
Profit after tax	14,439	56,381	17,899	18,116	19,194
Depreciation	2,177	2,139	2,109	2,071	2,036
Change in Working Capital	9,880	(27,867)	648	3,512	(1,492)
CF from Operations	26,496	30,653	20,657	23,699	19,738
CF from Investing	(24,131)	52,821	(1,813)	(1,689)	(1,692)
CF from Financing	(2,317)	(36,768)	(22,457)	(20,415)	(20,467)
Net Cash Flow	48	46,706	(3,612)	1,594	(2,420)
Valuation					
EV/EBITDA (x)	5.54	1.30	4.29	4.28	4.33
P/E(x)	9.27	2.37	7.48	7.39	6.97
Dividend Yield (%)	9.5%	11.4%	12.4%	12.4%	13.3%

Source: Company Accounts, KASB estimates

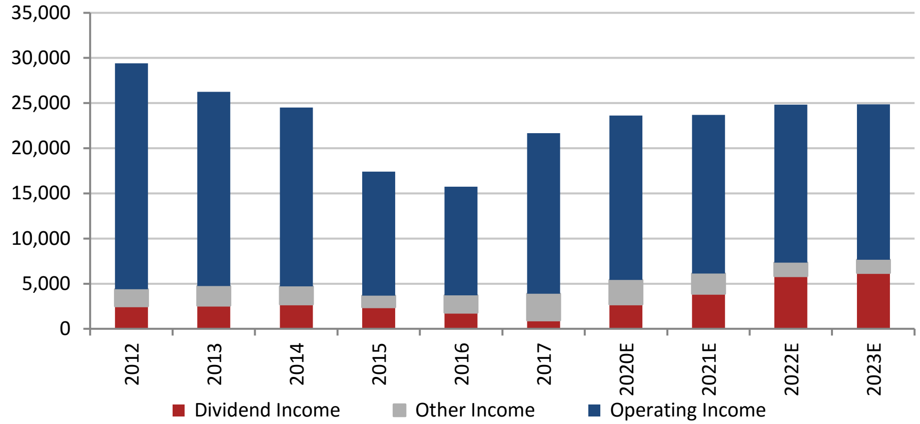
Investment thesis in charts

One of the best ROE generating business model



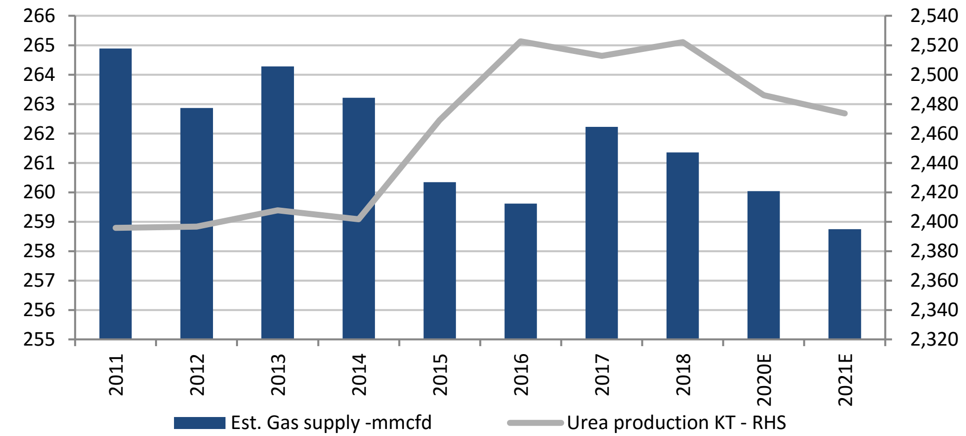
Source: Company data, KASB estimates

Contribution from other income to increase post 2020E



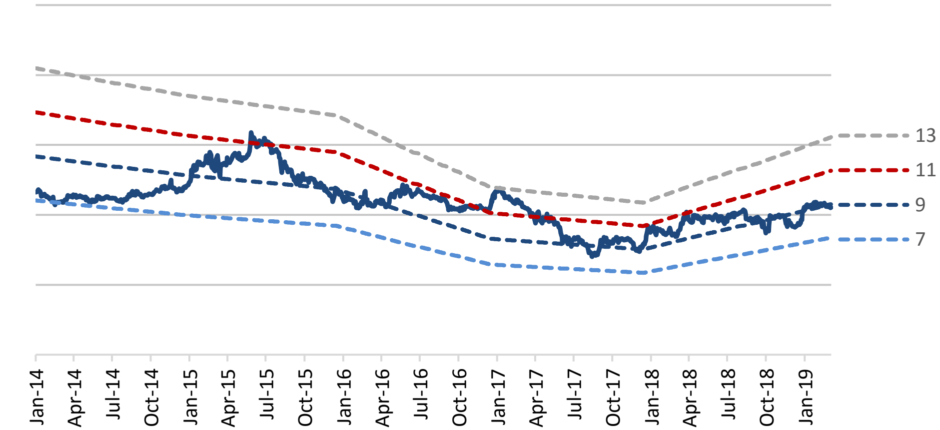
Source: Company data, KASB estimates

Consistent production above 2.4MT (120% utilization)



Source: Company data, KASB estimates

Stock's performance on price to earnings (x)



Source: Zakheera & KASB Estimates

Fauji Fertilizer Company history

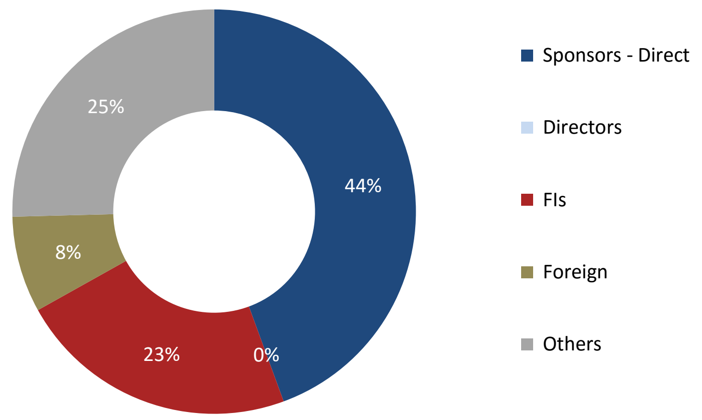
- Fauji Fertilizer Company Limited (FFC) is the second largest fertilizer manufacturer by capacity in Pakistan. However, it is the largest player in terms of market share accounting for 44% share.
- FFC was formed in 1978 as a joint venture between Fauji Foundation and Haldor Topsoe. First unit began production in 1982. FFC has expanded since then by setting up a second unit in 1993 and acquisition of Pak Saudi Fertilizer Ltd in 2002.
- Fauji Foundation is a major sponsor of FFC with 44.35% stake. The foundation has vested interest in fertilizer, cement, food, power generation, financial services and gas exploration.
- FFC's holds diversified stake in associated companies including Fauji fertilizer Bin Qasim (FFBL- 49.88% stake), Fauji Fresh & Freeze Limited (100% stake), FFC Energy (100% stake), Askari Bank (AKBL-43.15%), Thar Energy Ltd (TEL- 30% stake), Pakistan Maroc Phosphore S.A. Morocco (PMP- 12.50% stake) and Fauji Cement Company Ltd (FCCL – 6.79% stake).
- Diversified portfolio provides FFC with stable dividend stream and contributes 10% to its profit before tax.

Current management and their background

1. **Mr. Muhammad Munir Malik – Chief Financial Officer** has been associated with the company since 1990. He started his journey at FFC as Group general manager to finally be promoted as CFO. He played an active role in arrangement of syndicated loan to acquire Pak Saudi Fertilizer Ltd's plant in 2002. He is a charter Accountant by profession and holds various professional certifications from Kellogg School of Business, Harvard Business School, Foster School of Business, Chicago Booth School of Business, Ross School of Business and Center for Creative Leadership, USA and IMD, Switzerland. He is also a director on the Boards of Askari General Insurance Company Limited, Fauji Fresh n Freeze Limited and Thar Energy Limited. Apart from that, he is the CFO of FFC Energy Limited and Fauji Fresh n Freeze Limited.

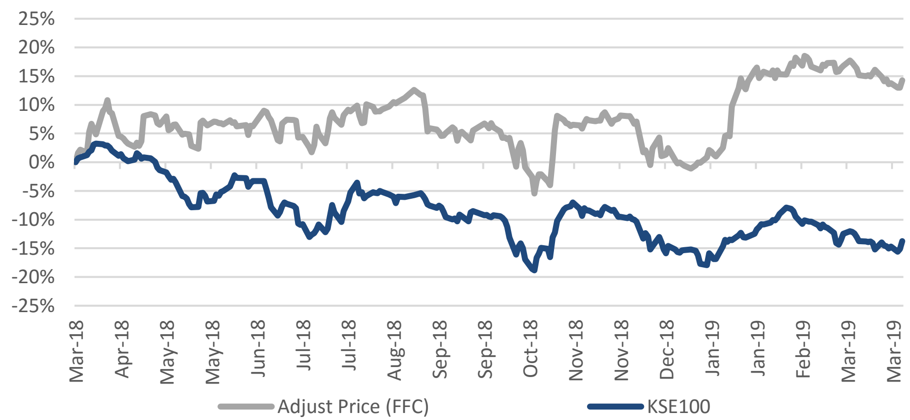
2. **Lt Gen Tariq Khan – Chief Executive Officer** is a war hero who was the Commander of I Strike Corps at Mangla. The General was commissioned in Pakistan Army in April 1977 with the coveted Sword of Honour. He is a graduate of Command and Staff College Quetta and National Defence University Islamabad. He holds master's degree in War Studies. He has served on the faculty of Command and Staff College Quetta and National Defence University Islamabad. Since his retirement, he is on the honorary faculty of renowned institutions including National Defence University as a senior mentor.

FFC's shareholding pattern



Source: Company Financials

FFC's price performance vs. the KSE100 index

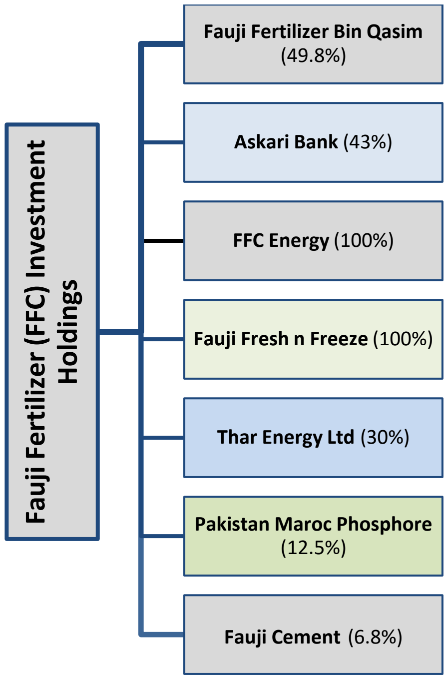


Source: Zakheera

Valuation Table

Valuation Table	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY27E
EBITDA	81,606	24,225	23,015	22,689	22,193	21,575	19,887
Less: Taxation	24,146	7,627	7,451	7,553	7,423	7,398	7,340
Working capital	(27,867)	648	3,512	(1,492)	1,007	744	371
Investing C/Fs	52,821	(1,813)	(1,689)	(1,692)	(1,409)	(1,423)	(1,175)
FCFF	82,413	15,433	17,388	11,953	14,367	13,498	11,743
Less: Interest after tax	(2,113)	(1,399)	(1,063)	(886)	(784)	(718)	(558)
Change in borrowings	(21,501)	(5,918)	(3,876)	(2,655)	(1,040)	(936)	(682)
FCFE	58,799	8,116	12,449	8,412	12,544	11,844	10,503

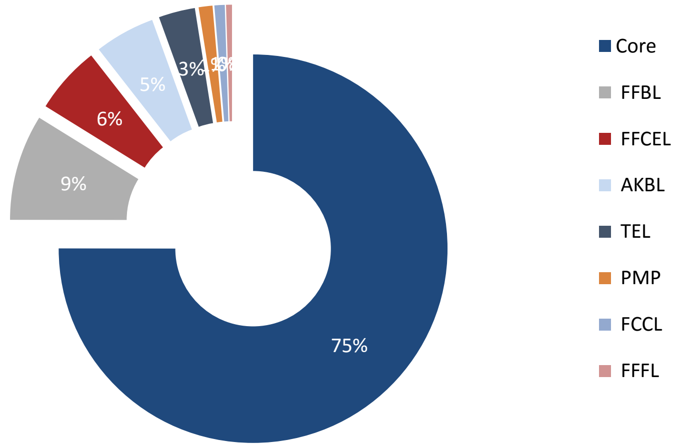
Source: KASB estimates



Business Segment	Equity Value	Per share of FFC	%age of value
FFC- Core Fertilizer Business	123,528	97.1	75%
Fauji Fertilizer Bin Qasim	19,349	15.2	12%
FFC Energy Limited	12,345	9.7	7%
Askari Bank	11,006	8.7	7%
Thar Energy	6,654	5.2	4%
Pakistan Maroc Phosphore	2,522	2.0	2%
Fauji Cement	1,882	1.5	1%
Fauji Fresh n Freeze	1,084	0.9	1%
Value of Equity	178,372	140.2	108%
Less: Conglomerate Disc. 25%	13,710	10.8	8%
Target Price-Dec-19		**129.0**	

Source: KASB estimates

Valuation contribution is still dominated by core fertilizer business*



Source: Company data, KASB estimates

Urea Volumes (KT)* CY20E	Urea Prices (PkR/bag) *CY20E					
		1,550	1,575	1,600	1,625	1,650
	2,361	11.68	12.20	12.70	13.22	13.73
	2,411	12.33	12.86	13.38	13.91	14.44
	2,461	13.00	13.53	**14.07**	14.59	15.14
	2,511	13.65	14.21	14.75	15.30	15.83
	2,561	14.32	14.87	16.11	15.98	16.55

Source: KASB estimates

Engro Corporation (ENGRO: Neutral)

Earnings mix to change in favour of power sector

Investment thesis

- We initiate coverage on Engro Corporation (ENGRO) with a **Neutral** stance. The company offers well-rounded business exposure and a 5yr forward earnings CAGR of 21% p.a. – despite expiry of concessionary gas arrangement of Engro Fertilizer in 2023E. ENGRO has ~40% of its market capitalization in cash. This is an unparalleled advantage, which can fund future growth beyond the forecasted EPS CAGR. We believe the market has captured some of these positives, however, we would recommend investors to wait for better entry points.
- We believe the company has skilfully leveraged its fertilizer business to support other investments. New power ventures (Engro Powergen Thar and SECMC), which have already commenced partial operations, are the next big thing for ENGRO. We are expecting annualized EPS contribution of PkR18-19 from these ventures – including the debt repayments. We believe ENGRO is now fully hedged against PKR devaluation through multiple power, polymer and chemical handling businesses.
- Fertilizer business remains the key earnings contributor (c. 60%) for ENGRO. We anticipate future earnings contribution to change more in favour of Power (Engro Powergen Thar and Sindh Engro Coal Mining) and existing Polymer (Engro Polymer) businesses. We believe the new power projects would more-than-offset the impact of decline in fertilizer's profits, post expiry of concessionary gas agreement in 2023E.
- ENGRO has the history of entering in strategic projects like (i) use of permeate gas (low BTU gas) for Engro Powergen Qadirpur, (ii) setting-up the largest single-line Fertilizer plant, (iii) setting-up the first LNG terminal in Pakistan, and (iv) exploring Thar's mammoth coal reserves. Taking cue from that, we believe ENGRO may end-up setting other priority projects in Pakistan, possibly in petrochemical and energy infrastructure space.

Valuation

Based on normalized earnings, ENGRO is trading at CY19E P/E of 7.8x. The stock outperformed the market by 14% in 2018. Based on sum of the parts value of its various businesses, we arrive at a Dec-19 target price of PkR384/sh. We have assumed a conglomerate discount of 25% and a risk-free rate of 11% respectively.

Key Risks

(i) Gas curtailment in the fertilizer business (ii) delay in announcement/execution of future/existing investments, and (iii) decline in PVC-Ethylene core delta.

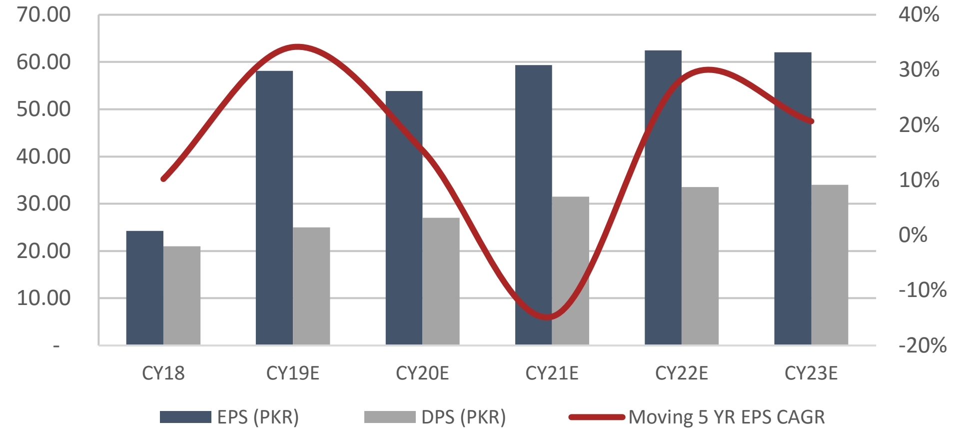
Price Target: PkR 384 (17% upside), Current Price: PkR 326.8

Year end Dec (PKR Mn)	2018	2019E	2020E	2021E	2022E
Income Statement					
Revenue (PkR Mn)	171,568	215,755	240,912	264,202	274,895
Growth (%)	28%	26%	12%	10%	4%
Gross Margin	29.8%	41.6%	33.5%	32.0%	31.6%
EBITDA	39,163	77,063	69,629	72,837	73,642
Profit before tax	36,427	69,349	58,547	62,578	65,399
Tax	(12,795)	(16,145)	(9,607)	(9,591)	(9,959)
Net Profit	12,708	30,431	28,202	31,100	32,711
EPS (PkR)	24.26	58.10	53.84	59.38	62.45
EPS (Ex- of GIDC Reversal)	**24.26**	**41.50**	**53.84**	**59.38**	**62.45**
Balance Sheet					
Current Assets	111,677	133,976	155,302	171,263	195,850
Non-Current Assets	246,953	272,711	273,006	273,773	276,401
Total Assets	358,630	406,687	428,308	445,037	472,251
Total Liabilities	174,912	182,861	169,685	149,926	139,246
Attr. Total Equity	133,174	150,511	164,571	179,172	194,336
Cash Flow Statement					
Profit after tax	12,708	30,431	28,202	31,100	32,711
Depreciation	6,559	8,395	10,242	10,093	9,954
Change in Working Capital	2,689	(7,388)	2,487	(6,959)	535
CF from Operations	21,955	31,438	40,931	34,235	43,200
CF from Investing	(5,005)	(29,269)	(8,547)	(9,927)	(9,028)
CF from Financing	17,092	33,238	(12,798)	(13,181)	(6,999)
Net Cash Flow	34,042	35,408	19,585	11,127	27,172
Valuation					
EV/EBITDA(x)	5.89	2.91	2.68	2.17	1.66
P/E(x)	13.48	5.63	6.07	5.51	5.24
Dividend Yield (%)	6.4%	7.6%	8.3%	9.6%	10.2%

Source: Company accounts, KASB estimates

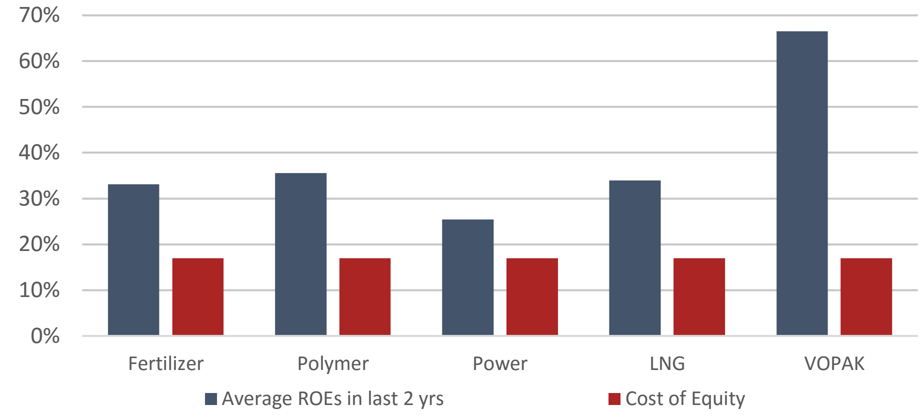
Investment thesis in charts

5yr forward EPS CAGR of 21% p.a.



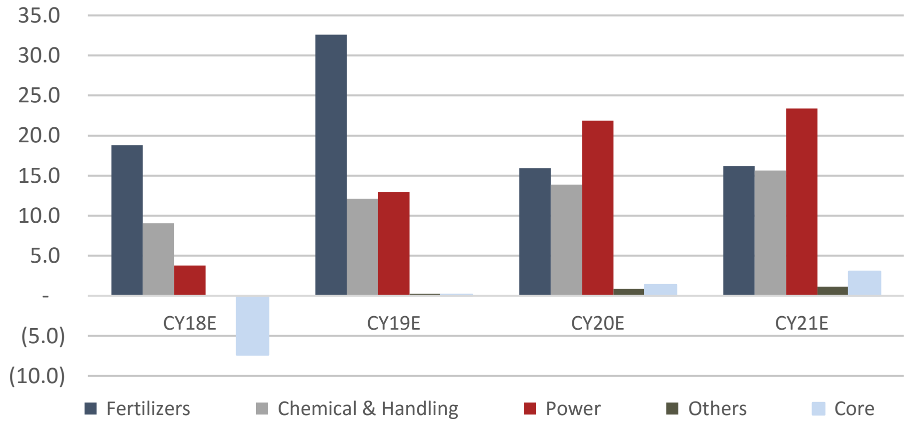
Source: Company data, KASB estimates

Estimated ROEs by business segment



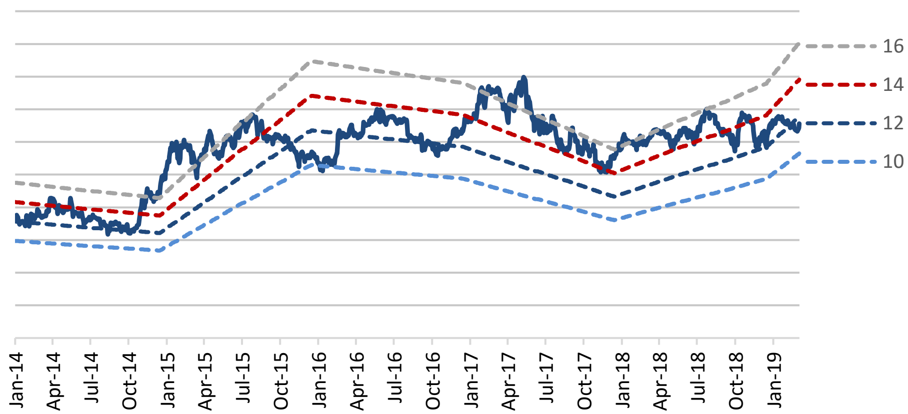
Source: Company data, KASB estimates

EPS contribution by business segments



Source: Company data, KASB estimates

Stock performance in price to earnings (x)*



Source: Zakheera
*Excluding one-off gains

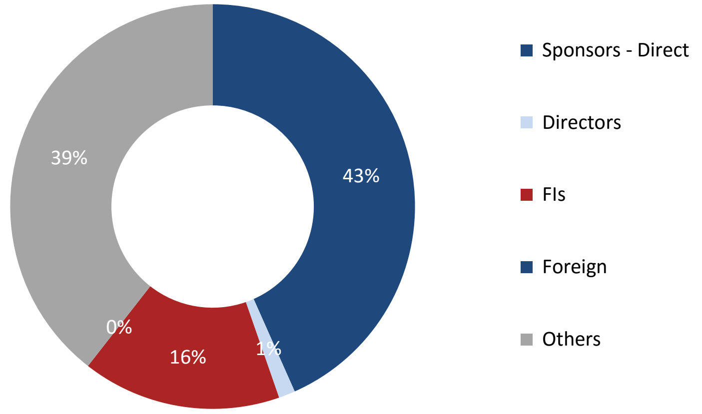
Engro Corporation Company History

- Engro Corporation is a prime example of diversification merit and a true growth story of Pakistan. Foundation of ENGRO was laid in 1966 as Esso Pakistan Fertilizer Co Ltd, incorporated by Esso.
- It was later renamed to Exxon Chemical Pakistan Limited. In 1991, Exxon decided to divest its stake, to be acquired by its employees as employee buy-out scheme in partnership with leading international and local financial institutions.
- Since then Engro has transformed into a conglomerate with vested interest in fertilizer, petrochemicals, foods and energy. Above all massive cash generation capability gives Engro the financial muscle to enter more diversified wings/uncharted territories.
- Dawood Hercules Corporation Limited (DHCL) is a major sponsor of Engro. DHCL is an investment company listed on Pakistan Stock Exchange.

Current management and their background

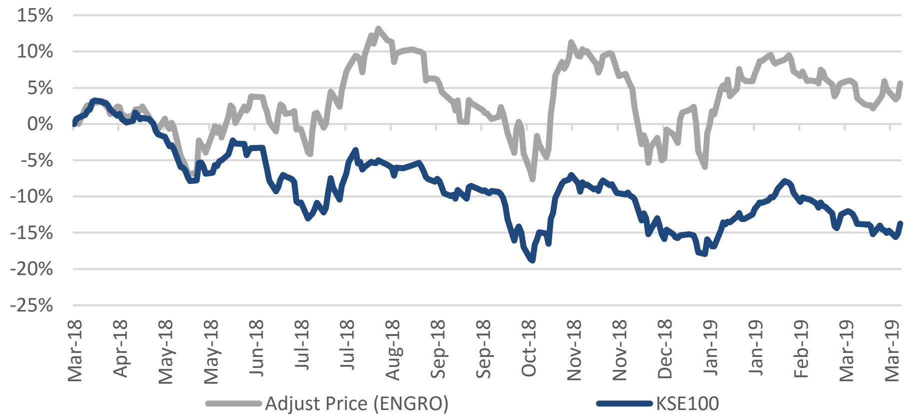
- **Mr. Hussain Dawood – Chairman** is a Pakistani Businessman, educationist and a philanthropist. He is the chairman of Engro, DHCL, Karachi Education Initiative, KSBL and the Dawood Foundation. Mr Dawood holds an MBA from Kellogg School of Management and is a graduate from Sheffield University, UK.
- **Mr. Husnain Moochhala – Chief Financial Officer** joined Engro as CFO in June-17. Prior to that he has had career in Commercial Finance, M&A, Corporate Governance, Treasury and Audit over 30 years across Europe and Asia. The last 20 years of his career has been with Royal Dutch Shell in various roles including Finance Director Shell Pakistan, Head of Finance for Shell Lubricants Asia Pac, Head of Downstream M&A East and Finance Manager Upstream Joint Ventures. Hasnain has also led, coached and mentored local teams in Singapore and Pakistan, as well as virtual teams across Asia Pacific and Europe.

Shareholding Pattern



Source: Company data

ENGRO's price performance vs. the KSE100 index



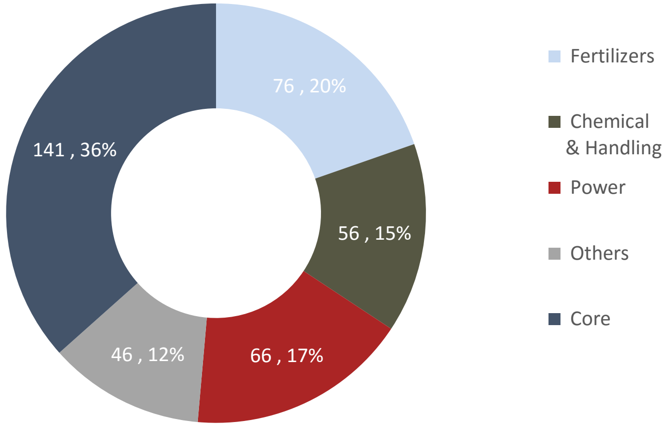
Source: Zakheera

Valuation Table

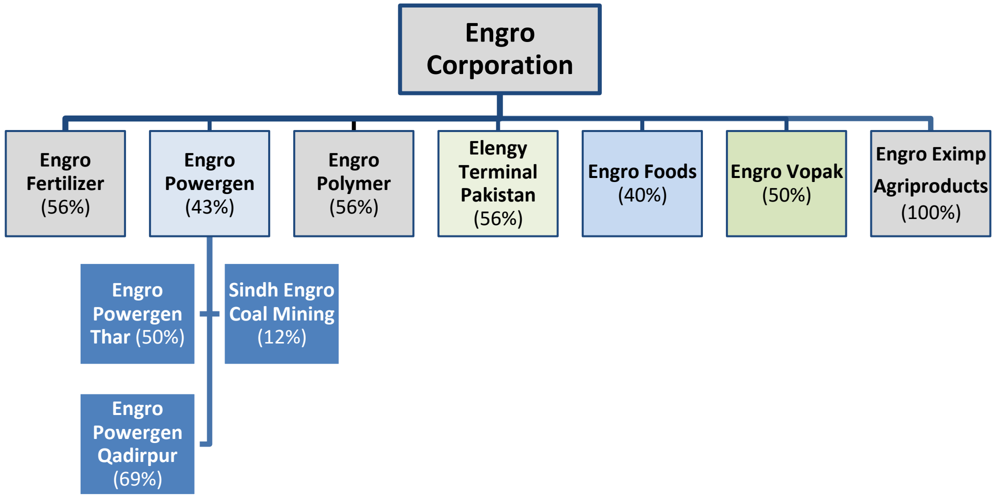
Engro Corporation Valuation	Method	Stake	Valuation on ENGRO	Value on ENGRO/sh
Engro Fertilizer	FV	56%	56,533	108
Engro Powergen Thar	FV	50%	38,513	74
Engro Polymer	FV	56%	27,579	53
Engro Foods	MV	40%	21,411	41
Engro Elengy	FV	56%	7,822	15
Engro Vopak	FV	50%	6,698	13
Engro Powergen Qadirpur	MV	69%	6,166	12
SECMC	FV	12%	3,479	7
Others			2,017	4
Total Equity Value			**170,220**	**325**
Less: Conglomerate Discount	25%		42,555	81
Equity Value- Ex discount			127,665	247
Net Cash			**65,013**	**124**
Net Value of Return on Cash and Royalty			8,658	17
Target Price (PkR/sh)			**201,336**	**384**

Source: KASB estimates

Valuation contribution by business



Source: Company data, KASB estimates



Engro Fertilizer (EFERT: N)

GIDC resolution may not be a good omen

Investment thesis

- We have a **Neutral** stance on Engro Fertilizer (EFERT). EFERT offers highest dividend yield (CY19E: 14%) in the fertilizer space. However, our Neutral stance is based on negative 5yr EPS CAGR of 9% p.a., due to expiry of concessionary gas arrangement in 2023E. We would be more positive on the stock if (i) terms of GIDC reduction are more favourable or (ii) gas flows improve to achieve even higher production levels.
- We believe most of the positive impact of GIDC reversal would be offset by the consequent decline in Urea prices. EFERT would have to give-up PkR75/bag of primary Urea margin, if industry cuts Urea prices by PkR150/bag - against 50% reduction in GIDC. This could have a negative EPS impact of ~PkR1.27/sh - 11% of normalized CY19E EPS.
- EFERT is the only company which is based on Mari network and still operates below 90% utilization, unlike peers (FFC & FATIMA). We have assumed average gas flows of 196 mmcfd (production levels of 5.6MT). However, additional production by Mari, if supplied, would be an upside case to our estimates. We have used industry's feed gas prices, post expiry of concessionary gas agreement. That said, application of gas prices based on petroleum policy 2012 after the expiry of concessionary gas arrangement would be a key risk to our estimates.
- EFERT's product portfolio is relatively more diverse compared to FFC. Within the speciality fertilizer business, EFERT posted 10%/19% Y/Y and 50% Y/Y growth NP/NPK and other specialized products, respectively. Though this business is relatively small when compared to Urea business; it can be an area of growth with more lasting imprints in future.

Valuation

The stock outperformed the KSE-100 by 10% in 12-mnths. We have used FCF valuation to arrive at a Dec-19 target price of PkR75/share. EFERT is trading at CY19E P/E of 6.5x but it is not a true reflection of earnings drop post expiry of concessionary gas supply contract.

Key Risks

(i) Gas curtailment in the fertilizer business (ii) higher than expected decline in Urea prices, and (iii) steep rise in oil prices.

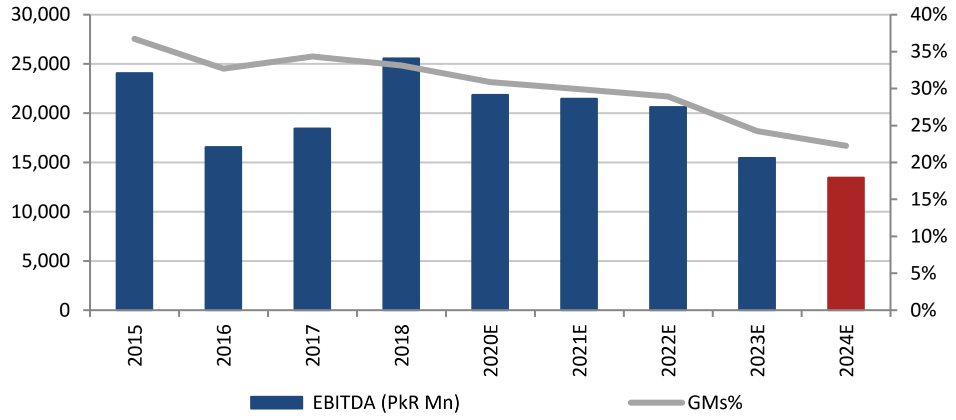
Price Target: PkR 75 (4% upside), Current Price: PkR 72.1

Year end Dec (PKR Mn)	2018	2019E	2020E	2021E	2022E
Income Statement					
Revenue (PkR Mn)	110,468	111,520	110,846	113,739	116,726
Growth (%)	35%	1%	-1%	3%	3%
Gross Margin	33.1%	52.3%	30.9%	29.9%	28.9%
EBITDA	30,729	50,518	26,708	26,164	25,201
Profit before tax	24,282	43,439	20,722	20,974	20,597
Tax	(6,869)	(13,194)	(5,967)	(5,944)	(5,715)
Net Profit	17,414	30,245	14,755	15,030	14,882
EPS (PkR)	13.04	22.65	11.05	11.26	11.14
EPS (Ex- of GIDC Reversal)	**13.04**	**11.12**	**11.05**	**11.26**	**11.14**
Balance Sheet					
Current Assets	44,887	48,210	43,667	35,969	35,012
Non-Current Assets	72,834	69,925	67,226	64,709	62,368
Total Assets	117,721	118,135	110,892	100,678	97,380
Total Liabilities	72,198	55,719	47,075	35,184	30,357
Total Equity	45,523	62,416	63,818	65,495	67,023
Cash Flow Statement					
Profit after tax	17,414	30,245	14,755	15,030	14,882
Depreciation	5,166	5,005	4,854	4,713	4,581
Change in Working Capital	1,372	(1,742)	1,298	2,046	(451)
CF from Operations	23,952	33,508	20,907	21,789	19,012
CF from Investing	(4,018)	5,643	(2,155)	(2,197)	(2,239)
CF from Financing	(21,000)	(18,944)	(22,305)	(23,479)	(17,679)
Net Cash Flow	(1,066)	20,207	(3,552)	(3,886)	(907)
Valuation					
EV/EBITDA	3.82	1.99	3.51	3.39	3.40
P/E	5.54	3.19	6.54	6.42	6.48
Dividend Yield (%)	15.2%	13.8%	13.8%	13.8%	13.8%

Source: Company accounts, KASB estimates

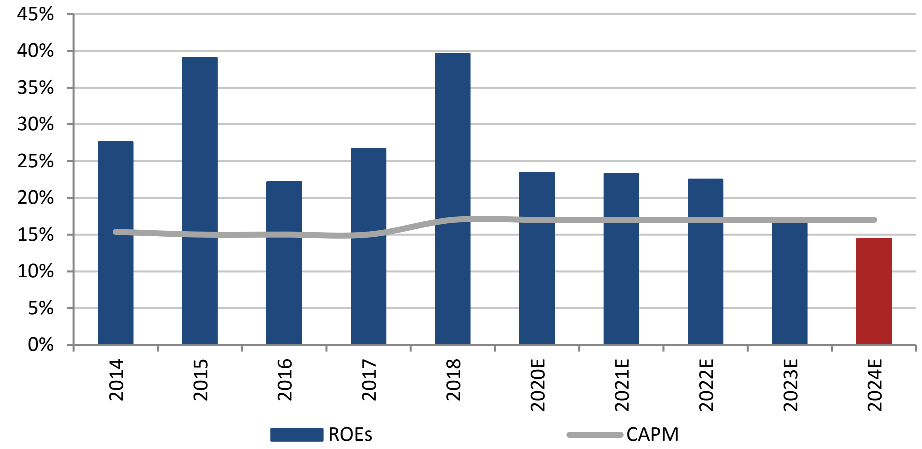
Investment thesis in charts

EBITDA to follow a declining trend



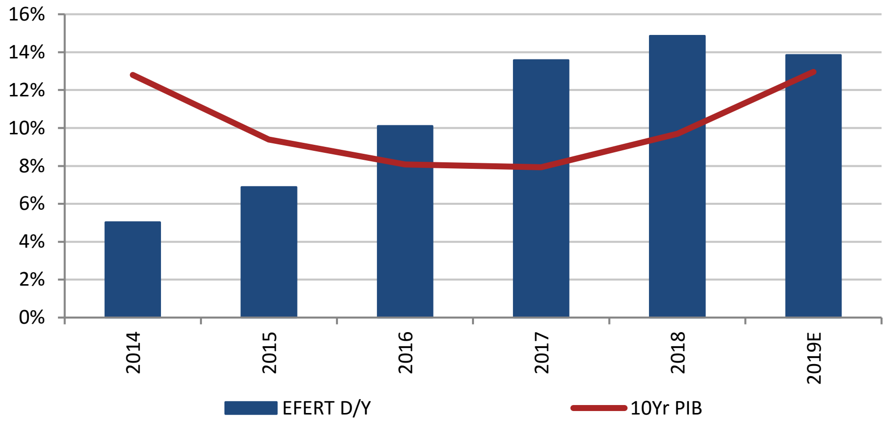
Source: Company data, & KASB estimates

ROEs to normalize by 2024E



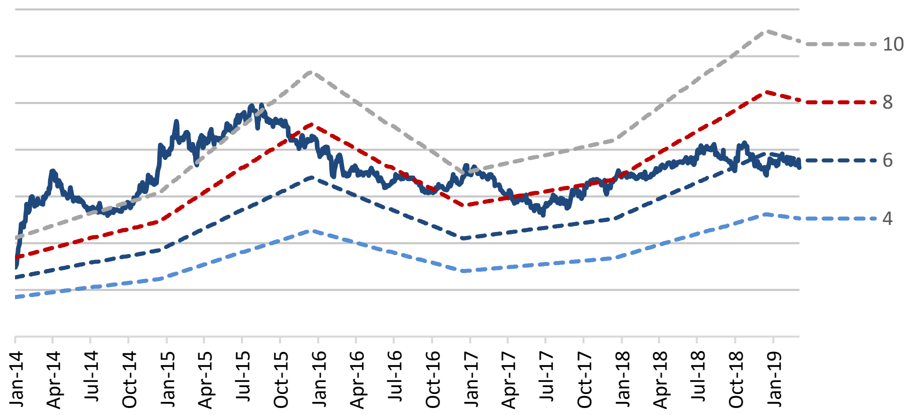
Source: Company data, & KASB estimates

Dividend yield is now close to 10yr PIB rate



Source: Company data, SBP, & KASB estimates

Stock performance in price to earnings (x)*



Source: Zakheera & KASB Estimates

Engro Fertilizer Company History

- Engro Fertilizer Limited (EFERT) was incorporated in June-09, following demerger from parent company Engro Chemical Pakistan Limited. EFERT is the largest player by capacity share.
- Engro Fertilizers Limited has earned itself a distinguished name by continually striving to uphold its tradition and trust of its loyal consumer base.
- EFERT made the largest investment in the history of Pakistan at USD1.1 Bn on the commitment of Government of Pakistan for guaranteed gas on an uninterrupted basis for Engro Fertilizer. The plant was established in 2010 which still is the world's largest single train urea plant with 1,300,000 metric ton capacity.
- EFERT's core competencies are its unique brand image, strategic location (near agricultural belt) which supplements vast distribution network underpinned by strong brand identity & resonance with farmers and remarkable dealer's network.

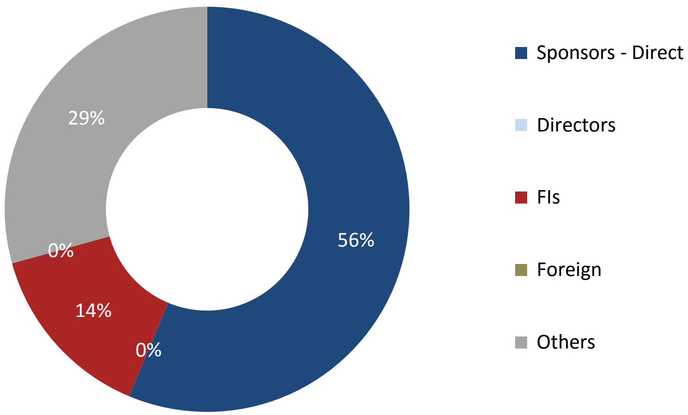
Current management and their background

- **Mr. Ghias Khan – Chairman** is the 4th President and CEO of ENGRO. Since he joined ENGRO in 2016, Mr Khan has stewarded company's commitment in the petrochemical sector and the management of all energy assets. Prior to joining ENGRO, Mr Khan was associated with Inbox Business Technologies, an enterprise technology company that he co-founded in 2001 and remained with till 2015.

  Ghias also serves as Chairman on the Boards of Engro Fertilizers Limited, Engro Polymer & Chemicals Limited, and Engro Energy Limited. He holds an MBA from the Institute of Business Administration, Karachi.

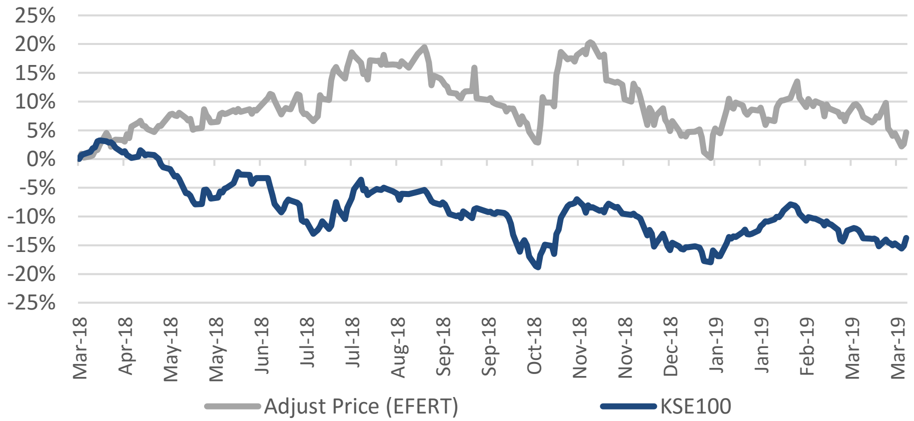
  Nadir Salar Qureshi – Chief Executive Officer did his MBA from Harvard Business School He was appointed as CEO on ENGRO in Dec-18, after joining the company in Mar-17 as Chief Strategy Officer. He brings with him expertise in multiple sectors across GCC, Turkey, Australia, India, ASEAN and EU. He is also experienced in consulting, private equity and finance. He is also a Director on the Boards of Engro Fertilizers Limited, Engro Powergen Limited, Engro Polymer Limited and Engro Vopak Terminal Limited.

Shareholding Pattern



Source: Company Accounts

EFERT's price performance vs. the KSE100 index



Source: Zakheera & KASB Estimates

Valuation Table

	2019E	2020E	2023E	2024E	2025E	2026E	2027E
EBITDA	50,518	26,708	19,907	17,797	16,792	15,627	14,949
Taxes	13,194	5,967	4,362	3,933	3,754	3,531	3,412
Working Capital Changes	(1,742)	1,298	861	690	478	419	293
Operating Cashflow	35,581	22,039	16,406	14,555	13,516	12,516	11,831
Less: Capex	(2,096)	(2,155)	(2,283)	(2,327)	(2,372)	(2,418)	(2,465)
Less: Investments	7,739	-	-	-	-	-	-
FCFF	41,224	19,885	14,124	12,228	11,144	10,097	9,366
PV - FCFF	41,224	17,381	7,754	5,706	4,464	3,473	22,252
Total PV	128,288						
Debt	32,298						
Cash	730						
Equity Value	99,835						
Target Price-Dec-19	**75**						

Source: KASB estimates

Gas Prices based on PP-12: Oil Price US$/bbl (Gas Prices in PkR) * Ex-GIDC						
USD/PKR	60	65	70	75	80	85
135	645	667	690	705	720	735
145	693	717	741	757	773	789
149	711	735	760	777	793	810
155	741	766	792	809	827	844
165	788	816	843	862	880	898

Source: KASB estimates

EPS estimates on above gas prices (PkR)						
USD/PKR	60	65	70	75	80	85
135	11.88	11.68	11.48	11.34	11.21	11.08
145	11.45	11.24	11.02	10.88	10.74	10.59
149	11.29	11.08	10.85	10.70	10.56	10.41
155	11.02	10.80	10.57	10.42	10.25	10.10
165	10.60	10.35	10.11	9.94	9.78	9.62

Source: KASB estimates

Urea Prices (PkR/bag)					
Urea Volumes (KT)	1,550	1,575	1,600	1,625	1,650
1,833	8.84	9.28	9.72	10.16	10.60
1,883	9.48	9.94	10.39	10.84	11.29
1,933	10.12	10.59	**11.05**	11.51	11.98
1,983	10.77	11.24	11.72	12.19	12.67
2,033	11.41	11.90	12.38	12.87	13.36

Source: KASB estimates

28th March 2019

Fauji Fertilizer Bin Qasim (FFBL: N)

A possible role reversal for DAP production

Investment thesis

- We have a **Neutral** stance on Fauji Fertilizer Bin Qasim Limited (FFBL). Due to import parity pricing of DAP, FFBL is expected to gain the most on recurring basis with 50% reduction in GIDC rates. However, due to leveraged balance sheet, potential decline in industry's DAP sales and volatile primary DAP margins, we are sceptical about the outlook of the company. We would be more convinced if partial sale of Fauji Foods – 51% owned subsidiary – yields additional cashflows.
- We believe phosphate fertilizers like DAP and NP are more price elastic. Due to 34% depreciation of PKR since Dec-17, local DAP prices are close to PkR3,600/bag. Excluding the sales tax, these levels were last visible in 2011-2012, when commodity prices were at its peak. We are expecting a 13% Y/Y in DAP volumes for 2019E. Though FFBL may continue to get preference in the branded category, it may not be able to sustain pricing premium over imported DAP, in our view.
- FFBL's efforts to diversify its business segments have remained questionable in the past. We highlight that 118MW coal-based power plant (FFBL Power) is the only profitable venture so far. It saves ~18mmcfd of gas, used for producing 200KT of Urea. Besides that, Fauji Meat – a 75% owned entity – and Fauji Foods – a 50% owned entity – incurred an attributable loss of PkR2.6 Bn in 2018. These food businesses are draining cash resources of the fertilizer business through loan support facilities (click here) from FFBL. We believe in a rising interest rate scenario, substantial leverage (debt to asset: 44%) may offset the impact of potential improvement in the fertilizer business.
- We believe (i) potential acquisition of Fauji Foods and (ii) decline in coal prices would help the cause. FFL's sale would not only stop the working capital drain but may even provide an opportunity to book one-off gains, if the strike price is above PkR17.6/sh.

Valuation

The stock went up by 5% in 2018, outperforming the benchmark index by 13%. Based on normalized earnings, FFBL is trading at CY19E P/E of 14.4x. We have assumed a risk-free rate of 11% and conglomerate discount of 25% for portfolio investments.

Key Risks

(i) Gas curtailment in the fertilizer business (ii) decline in DAP prices & demand, and (iii) unfavourable movement of primary DAP margins.

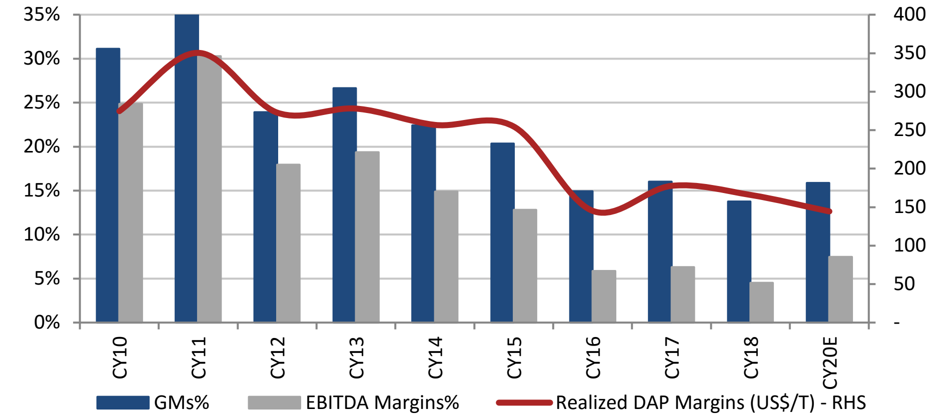
Price Target: PkR 42.3 (18% upside), Current Price: PkR 35.9

Year end Dec (PKR Mn)	2018	2019E	2020E	2021E	2022E
Income Statement					
Revenue (PkR Mn)	61,825	74,586	76,787	79,897	81,222
Growth (%)	11%	21%	3%	4%	2%
Gross Margin	13.7%	39.2%	15.9%	15.9%	15.7%
EBITDA	2,799	21,284	5,739	6,106	5,992
Profit before tax	2,124	19,597	5,193	6,141	6,567
Tax	(373)	(6,024)	(1,807)	(2,005)	(2,072)
Net Profit	1,751	13,572	3,386	4,137	4,494
EPS (PkR)	1.87	14.53	3.62	4.43	4.81
EPS (Ex- of GIDC Reversal)	1.87	2.39	3.62	4.43	4.81
Balance Sheet					
Current Assets	43,471	43,777	36,532	32,624	30,627
Non-Current Assets	36,893	35,377	34,816	34,313	33,866
Total Assets	80,364	79,154	71,348	66,937	64,493
Total Liabilities	66,467	53,085	43,761	37,550	33,179
Total Equity	13,897	26,069	27,587	29,388	31,314
Cash Flow Statement					
Profit after tax	1,751	13,572	3,386	4,137	4,494
Depreciation	1,634	1,601	1,570	1,542	1,516
Change in Working Capital	(8,933)	(2,133)	(4,336)	2,154	(2,903)
CF from Operations	(5,548)	13,040	620	7,833	3,108
CF from Investing	(1,698)	10,851	(1,009)	(1,039)	(1,069)
CF from Financing	5,923	(5,010)	(9,258)	(7,937)	(6,009)
Net Cash Flow	(1,323)	18,882	(9,648)	(1,144)	(3,971)
Valuation					
EV/EBITDA	24.77	3.32	10.59	8.84	8.22
P/E	19.20	2.48	9.93	8.13	7.48
Dividend Yield (%)	2.8%	4.2%	5.6%	6.9%	7.6%

Source: Company accounts, KASB estimates

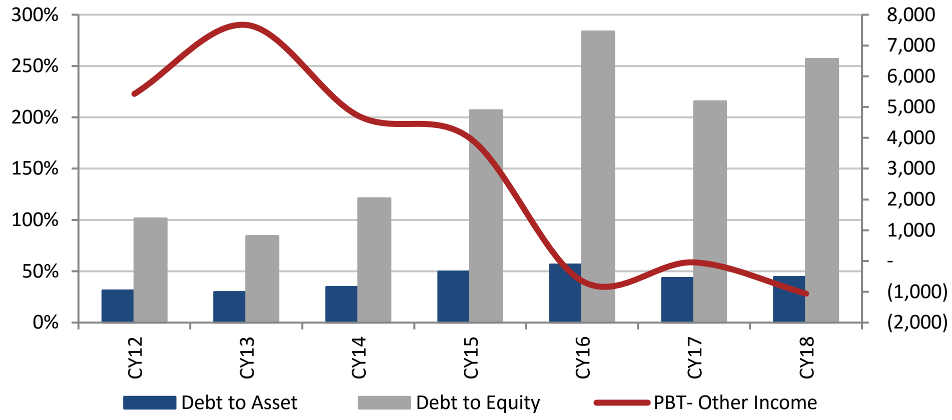
Investment thesis in charts

Volatile DAP margins



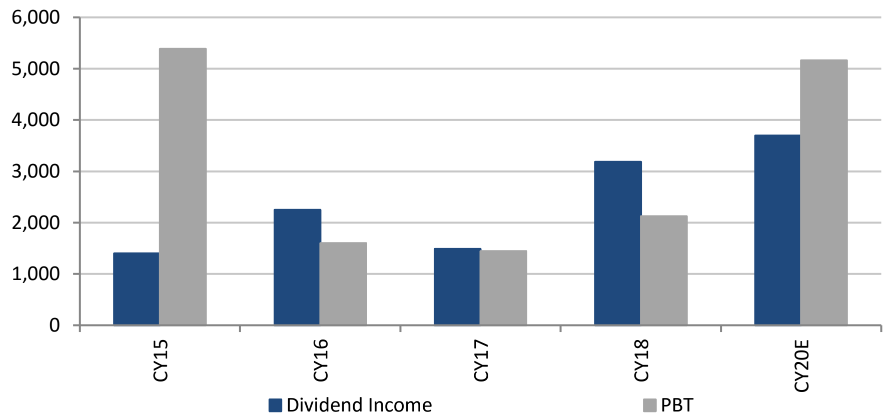
Source: Company data, KASB estimates

Core business profitability has gone down due to high leverage



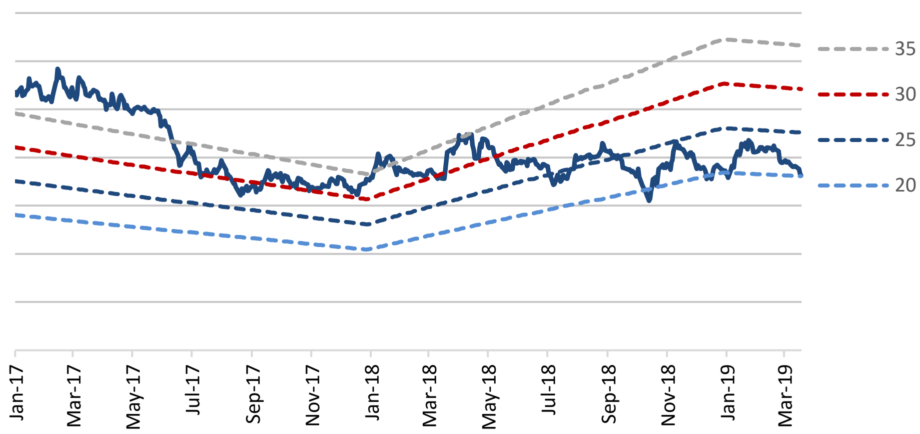
Source: Company data, KASB estimates

Dividend income contributes more than core fertilizer business



Source: Company data, KASB estimates

Stock performance in price to earnings (x)*



Source: Company data, KASB estimates

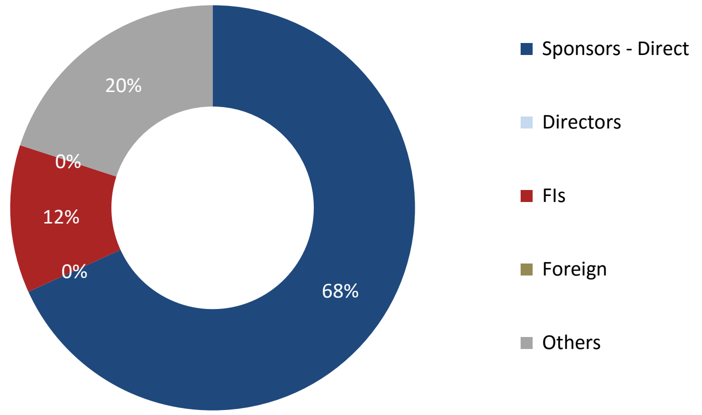
Fauji Fertilizer Bin Qasim Company History

- Fauji Fertilizer Bin Qasim Limited was initially incorporated as Fauji Jordan Fertilizer Company with a joint venture between Fauji Foundation and Jordan Phosphate Mines Company (JPMC).
- FFBL operates the only Di Ammonium Phosphate Fertilizer plant in Pakistan. It was built at a cost of US$468 Mn. Commercial production started in Jan-2001. FFBL is also the sole producer of Granular Urea in Pakistan.
- FFBL is owned 49.88% by Fauji Fertilizer (FFC) and 18.29% by Fauji Foundation.
- The company also did several BMRs in past. Now it has the rated capacity to produce 650KT of DAP and 551KT of Urea, however, due to efficiencies, the company operates its DAP plant at ~120% capacity utilization.
- In last couple of years, FFBL has expanded its business exposure into food, power, meat processing, wind energy. The company owns 75% stake in both Fauji Meat Limited and FFBL Power Company. It has a 50% stake in Fauji Foods, 21% stake in Askari Bank and 35% stake in both Foundation Wind Energy I and Foundation Wind Energy II. The company also owns 25% stake in Pakistan Maroc Phosphore which produces phosphoric acid for FFBL.

Current management and their background

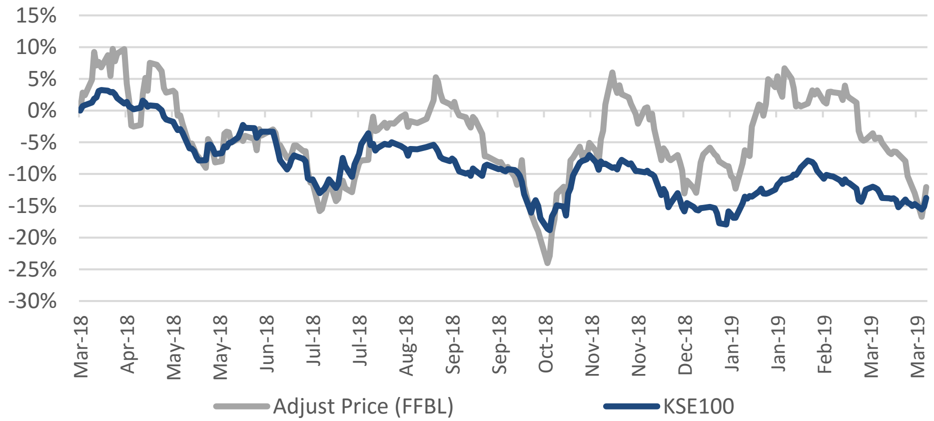
- **Lt Gen Syed Tariq Nadeem Gilani – Chairman** currently serves as Chairman of FFBL. Before getting his military training, in US, he also holds a Master's degree in war studies from Quaid-e-Azam University Islamabad.
- **Syed Aamir Ahsan – Chief Financial Officer** is the CFO of FFBL, FPCL, FML and FFBL Foods. He is a graduate from University of South Florida and Certified Public Accountant (CPA) from the university of Illinois, USA. Mr. Ahsan has over 32 years of experience, out of which he has served 26 years in the fertilizer industry. He worked at Engro Chemicals in various positions between 1993-2002. In 2002, he joined FFBL as the CFO, where he managed financial restructuring of FFBL with GoP and all financial feasibilities of Pakistan Maroc Phosphore – a JV between Fauji Foundation and PMP Maroc. He is also on the Board of Fauji Meat, FFBL Power Company, and Fauji Foods Limited as non-executive director.

Shareholding Pattern



Source: Company Accoun0ts

FFBL's price performance vs. the KSE100 index



Source: Zakheera

DCF Valuation

Fertilizer Business	2019E	2020E	2023E	2024E	2025E	2026E	2027E
EBITDA	21,284	5,739	5,993	5,798	5,755	5,689	6,017
Less: Taxes	6,024	1,807	2,102	2,131	2,202	2,271	2,421
Change in Working Capital	(2,133)	(4,336)	2,598	(1,498)	2,097	(1,373)	1,617
Operating C/Fs	13,126	(405)	6,489	2,168	5,650	2,045	5,213
CAPEX	(84)	(1,009)	(1,100)	(1,132)	(1,165)	(1,199)	(1,234)
Investments	10,936	-	2,400	-	-	-	-
Investment C/Fs	10,851	(1,009)	1,300	(1,132)	(1,165)	(1,199)	(1,234)
Others	-	-	-	-	-	-	-
FCFF	23,978	(1,414)	7,789	1,036	4,485	846	3,979

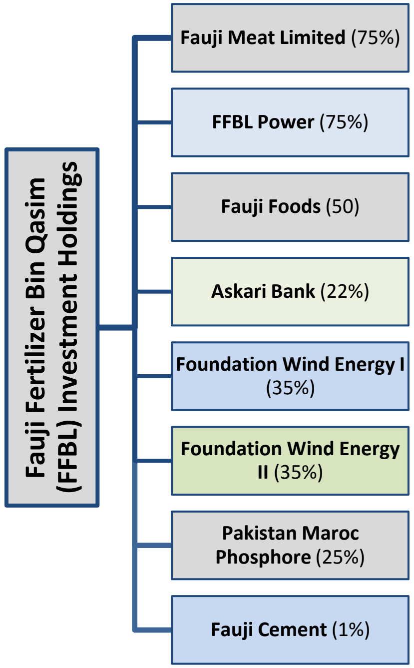
Source: KASB estimates

Business Segment	Equity Value	Per share of FFBL	%age of value
Fertilizer	18,542	19.85	47%
Fauji Meat	773	0.83	2%
FFBL Power	9,655	10.34	24%
Fauji Foods	3,592	3.85	9%
Askari Bank	5,535	5.93	14%
Pakistan Maroc Phosphore	2,522	2.70	6%
Foundation Wind I	2,997	3.21	8%
Foundation Wind II	2,661	2.85	7%
Fauji Cement	375	0.40	1%
Value of Equity 25%	46,651	49.94	118%
Portfolio Discount	7,027	7.52	18%
Target Value	**42**		

Source: KASB estimates

Urea Volumes (KT)	Urea Prices (PkR/bag) * CY20E				
	1,510	1,560	1,610	1,660	1,710
547	1.87	2.23	2.59	2.96	3.32
572	2.35	2.73	3.11	3.49	3.87
597	2.83	3.23	**3.62**	4.02	4.42
622	3.31	3.73	4.14	4.55	4.97
647	3.80	4.23	4.66	5.09	5.52

Source: KASB estimates



Abdul Samad is CFA level III candidate and has completed his BBA (H - Finance) from IoBM. Before joining KASB, Abdul was associated with InterMarket Securities (Research partner of Exotix Capital) and Fortune Securities Ltd.

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Rating Definitions

- Outperform >10% potential of outperformance against KSE100 Index
- Neutral: -10% to 10% potential relative to KSE100 Index
- Underperform <-10% downside potential of relative to KSE100 Index