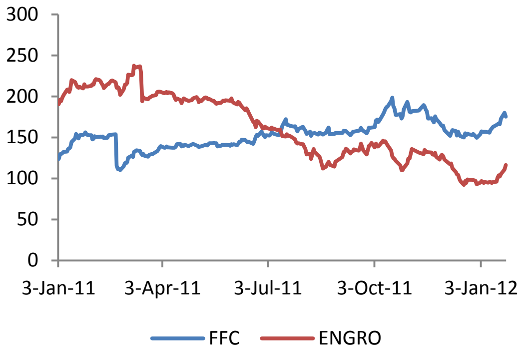
Pakistan

One's Gain, Another's Pain

27 January, 2012

Share Price Performance of FFC and ENGRO



Source: KSE, SFA Research

Plant's Energy Consumption Per Ton of Urea

Efficiency	ENVEN	FFC	DHC
MMBTU/Ton of Urea	20	24	27
Feed Gas Energy MMBTU	18	22	21
Fuel Gas Energy MMBTU	2	2	6

Analysis of ENGRO and FFC

Description	Unit	
EV/ Ton of FFC at Current Price	PKR 000/Ton	68
EV/ Ton of ENGRO at Current Price	PKR 000/Ton	59
ENGRO Value at EV/Ton of FFC	PKR/Share	162
FFC Value at EV/Ton of ENGRO	PKR /Share	150
Production Capacity of FFC	000 MT	2,048
Production Capacity of ENGRO	000 MT	2,300

Financial Highlights

Description	Unit	ENGRO	FFC
P/E		6.66	7.7
P/B		1.48	7.05
P/S		0.56	1.34
MKT Cap	MM	45,286.6	150,760.2
Dividend	PKR	4.92	9.87
EV/EBITDA		6.34	3.49
EV/Rev		1.44	1.30
Last Div	PKR	2	5.5
Average Volume (30 day)	MM	2.95	2.14

Source: Bloomberg

Has ENGRO Bounced Back to Claim its Throne From FFC?

Last weekend, a number of interesting developments were observed in local equity markets. Firstly, a CGT tax implication related to unexplained income and assets was deferred until June 2014 providing a sigh of relief for the depressed market. Secondly, GST on tractor manufacturers was also revoked back to 5% from the level of 16% ending the tug of war between the GoP and tractor assemblers. In addition to these events, a crucial hearing was also scheduled in the Sindh High Court for recommencement of gas supply to ENGRO's new plant, ENVEN. Although no decision was announced in the hearing, given the fragile situation surrounding the Gas Supply Agreement of ENGRO with GoP, it is expected that SNGPL will be required to resume the supply of gas to ENVEN at 75% for the winter season and 100% for the remaining year.

In the past year, particularly in the winter season, ENGRO spiked up its urea prices substantially. The increased prices were to cover up for losses in production stemming from the effects of gas curtailment and to meet towering finance costs incurred on the debt undertaken for setting up ENVEN. The GoP, unable to resume gas supply to ENVEN, could not force ENGRO to lower its prices. If the current scenario changes in ENGRO's favor and SNGPL resumes gas supply to ENVEN as per the Court's orders, ENGRO would have to lower its towered urea prices under the regulations of the GoP without further delay. If this arises, other players will have to follow suit as the GoP maintains a strong stance towards the issue of urea prices despite the fact that these players do not bear the benefit of improved gas supplies granted to fertilizer plants on SNGPL's network.

What Goes Around, Comes Around

After the market witnessed a justified price hike in ENGRO's urea prices, FFC decided to follow the trend and displayed a similar pattern in raising its urea prices. Investors, attracted by FFC's strong dividend yield, relatively lower risk of gas curtailment and upward revision in urea prices due to persistent gas curtailment, valued these factors indefinitely in FFC's stock price. This was incorporated into the long term view with a perception that this scenario would continue to remain.

Now the limelight has shifted from FFC to ENGRO. If there is an expected improvement in gas supply, there will be a simultaneous reduction in urea prices which will cause a downward price pattern to arise and this will also be evident in the stock price of FFC. With this factor in place, FFC's stock price will likely be affected as a falling trend in urea prices initiated by ENGRO will suppress the profit margins of FFC. Investor's preferences for ENGRO will be re-iterated due to expected renewed credibility of its newly installed efficient plant.

ENGRO's Brighter Outlook

ENGRO, caught in the midst of a gas supply shortage, was not able to continue production and had to hike its output prices to meet higher financing costs. If the court rules its judgment in favor of ENGRO and SNGPL resumes its gas supplies to ENVEN, a reversed pattern in prices will be imminent. A declining trend in urea prices will arise as ENGRO will be forced by the GoP to reduce urea prices after its gas supply is resumed. In addition to these factors, ENGRO is bound to make a solid come back with "ENVEN," a plant which has increased the urea production capacity by 1.3mm tons per annum to 2.3mm tons per annum. This makes it the largest urea designed production capacity holder in Pakistan surpassing FFC's designed production capacity of 2.048mm tons per annum. Incorporating these factors into ENGRO's pricing will ultimately result in huge positive price shift.

Pair Trade: Making Money from Rise & Fall…..& Both!

At this point in time, we propose a pair trade strategy: go long on ENGRO and short on FFC. We believe that given the expected circumstances, there will be a convergence in prices for both scrips. ENGRO will gain from positive sentiment from the court's ruling and FFC will incur a declining trend in its stock price. An investor can capitalize on the gain from both trends while at the same time, shielding itself from systematic risk factors. A long position in ENGRO and a short FFC position would leave the investor with a net exposure of zero to the fertilizer sector while exposing the investor solely to company specific risk factors. With such a position, the investor will not be exposed to regulatory or tax implications that currently negatively impact the industry. This is because a pair trade provides investors with a sector neutral strategy albeit enabling them to capitalize from key company specific developments. Given our expectations, a long position on ENGRO and a short exposure to FFC in the current scenario will translate into a net gain for investors.

Currently, the EV/Ton multiple of FFC stands 68,000 i.e. in order to obtain exposure on 1 MT of expected production capacity of FFC, the investor has to pay PKR 68,000. However, in the case of ENGRO the multiple stands at 59,000 translating into a PKR 59,000 investment in order to gain exposure to 1 MT expected production capacity of ENGRO. We can thus portray that based on the expected production capacity; ENGRO is selling at a discount while FFC is at a premium. In order to calculate the expected production capacity of ENGRO, we have assumed that the existing ENGRO plant will operate at 95%, while for ENVEN as per the decision expectation; we assumed that for 4 months it will operate at 75% and 100% for the remaining 8 months. For FFC, we assumed that expected production capacity stands at 2.45 Million MT. In our opinion, given such a large difference between the multiples of both firms, a convergence of multiples is inevitable. Therefore we are suggesting taking a long position on ENGRO and a short position on FFC, provided the court decides in favor of ENGRO.

Weighing the Worst

Given the inefficiency and unpredictability of markets, cross checking a strategy from every perspective is essential. Believing that markets have inflated the prices of FFC's stocks and placing the positive sentiments associated with ENGRO's stock aside, if the expected 'urea price decline trend' creates downward pressure on both stocks under discussion, (ENGRO and FFC), what proposed strategy would the investor be left with? A major decline in urea prices and margins will cause a significant decline in the EV/Ton multiple for both FFC and ENGRO. In the current situation, the multiple for ENGRO was already depressed as the plant was not operating at full capacity due to gas curtailment. The multiple of FFC was reflecting full production with the effects of increased prices and margins. A decline in margins will cause the multiples to fall for both ENGRO and FFC. However, the fall in ENGRO's multiple due to decreased margins will be offset by higher expected production from ENVEN. Furthermore, ENGRO's margins are expected to remain resilient to the declining trend due to higher expected utilization of the most efficient urea plant of the country, ENVEN and due to feed stock provided at a subsidized rate to ENVEN.

A net positive position

A fall in ENGRO's stock price and a much greater decline in FFC's stock price would leave the investor with a net positive position. This can arise as markets adjust to their justified prices in the medium to long run. The EV/Ton of FFC, which currently stands at PKR 68,000 will exhibit a downward trend by a greater adjustment factor than that of ENGRO, which stands at PKR 59,000. At the same time, the investor will remain shielded from systematic risks which play the largest role in driving returns in this sector. Thus, protect yourself in the event of a downturn!

If however, the market perceives pricing to be correct, incorporating the expected court decision in ENGRO's stock price would provide a gain to the long position. This will arise if we maintain that FFC is priced correctly and there are no further factors which will trigger a positive price shift.