Fauji Fertilizer Bin Qasim (FFBL)

Upgraded to BUY

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Earnings Revised upward – Upgraded to 'BUY'

- **Investment thesis:** We upgrade our stance on Fauji Fertilizer Bin Qasim (FFBL) to "BUY" from "HOLD" primarily on the back of 1) improved GP margins in DAP segment underpinned by removal of cap on DAP prices, 2) depletion of urea inventory and improved urea prices to further augment GP margins, and 3) higher expected profit from associates and subsidiaries FFBL Power Company (FPCL), Foundation Wind Power (FWEL) and Askari Bank (AKBL). FFBL is currently trading at attractive discount of 41% to its sum of the parts value (SOTP).
- **Turnaround in DAP segment:** Post removal of pricing cap on DAP by the Govt. amid increase in international DAP prices provided some respite to FFBL, the only producer of DAP in Pakistan. Currently company is securing contribution margin of ~US$160 per ton vs. average of ~US$140 in 2017. We expect these margins to further improve to ~US$170-180 in 3Q and 4Q 2018 on back of peak demand in the start of winter crop (rabi season). Thereafter, implied contribution margins are estimated at ~US$170.
- **Urea inventory depletion, augmenting GP margins:** Urea inventory in Pakistan as per Mar 2018 is hovering around ~0.3mn tons, down by ~80% YoY owing to 1) allowance of exports upto 600k tons by Govt. 2) higher local dispatches, and 3) lower production by SNGPL based fertilizer manufactures (Agritech and FatimaFert) amid disrupted natural gas supply and higher LNG prices. As a result, local urea prices touched maximum cap of Rs1400 per bag during Nov-Dec 2017 vs. average Rs1,357 per bag in 2017, leading to higher GP margins.
- **Portfolio companies, breaking the ice:** Energy sector portfolio of the company (FPCL and FWEL) is expected to start paying dividends to FFBL from 2018, resulting in improved unconsolidated earnings. Similarly, their profitability is likely to gain momentum owing to recent devaluation of PKR/USD (USD indexed ROE), resulting in higher profit from associates in consolidated earnings. Moreover, Fauji Meats Limited (FML, 75% owned by FFBL) is looking to expand its foot prints in China and Saudi Arabia, both of these markets are among world's largest import markets. Fauji Foods Limited (FFL, ~51% owned by FFBL) is expected to turn into a profit post 2020 mainly on back of the rationalization of various fixed costs due to the gradual increase in volumetric sales.

Earnings Revised upward – Upgraded to 'BUY'

- **Earnings to grow at 3-years CAGR 36% (2018-2020) :** From its core operations (Urea and DAP) we expect earnings contribution of ~Rs1.3-1.6 per share during 2018-2020 (~30% of total) vs. ~Rs0.2 per share in 2017 primarily due to improved margins in both segments. While, FPCL is expected to add Rs1.3 per share to the bottomline of the FFBL (indexed to USD ROE) during 2018 (30% YoY higher than last year), as company started its commercial operations in May 2017. Moreover, profit from associate companies is expected to post 3-years CAGR (2018-2020) of 8%, as we expect higher earnings from AKBL and FWEL. Post 2020, we expect FML and FFL to contribute ~Rs0.5-1.0 and Rs1.5-2.5 per share to the bottomline of the FFBL, respectively.
- **Attractive valuation:** FFBL is currently offering attractive discount of 36% to its SOTP with decent dividend yield of 7-10% in 2018-2020.
- **Risks:** Key risks to our valuation/earnings includes, 1) poor crop season, 2) regulatory changes in packaged milk products, 3) barrier to entry in exports markets for meat segment, and 4) increase in coal prices beyond our expectations.

FFBL: Key Numbers

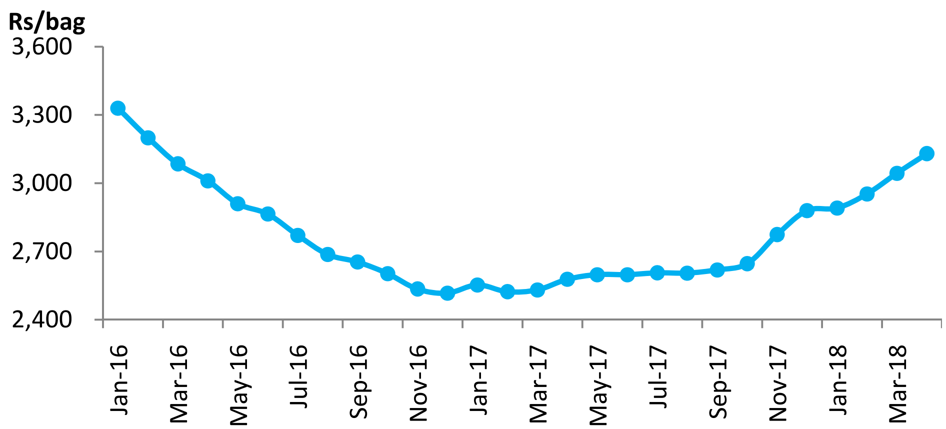
	2016A	2017A	2018E	2019F	2020F
EPS	1.0	2.0	3.7	4.5	5.1
Earnings Growth	-82%	104%	80%	22%	14%
PE at Rs42	42.2	20.7	11.5	9.4	8.3
Dividend Yield	6%	7%	7%	8%	10%
ROE	1%	5%	15%	21%	30%
PBV	2.2	2.0	2.1	2.2	2.1

Source: Company Accounts, Topline Research

DAP segment’s prospects improving

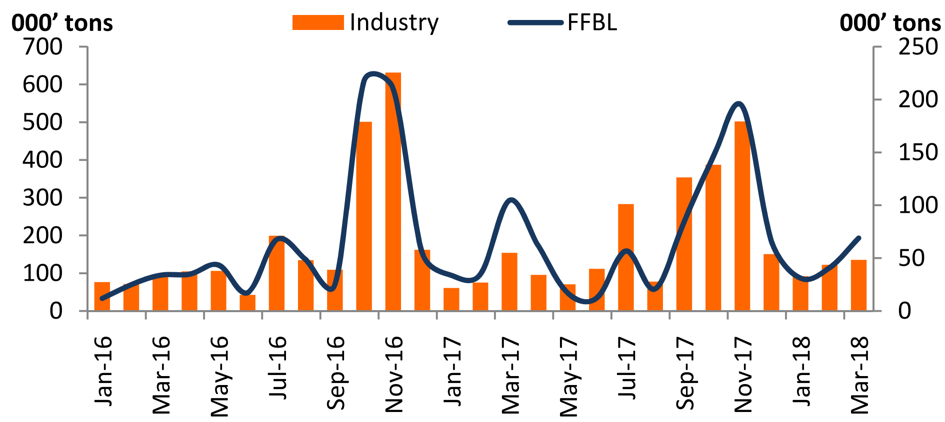
- To recall, DAP price cap of Rs2500/bag was removed during 2Q2017, since then domestic DAP prices are up by ~24% due to, 1) increase in phosphoric acid price by ~15% to US$678 per ton, and 2) currency devaluation of ~9% in two rounds (Dec 2017 and Mar 2018).
- The contribution margin of the company on DAP has improved to US$128/ton vs. US$93-100 per ton in April 2017 due to successful passing of the prices to the consumers. Going forward, we believe margins to further improve in the start of Rabi season to US$140-150 per ton.
- We expect DAP sales volume of the company to fall slightly by 2% YoY to 813k tons amid its negative price elasticity to demand.

DAP Prices Jan 2016 - Mar 2018



Source: Topline Research, PBS

FFBL DAP vs. Industry sales

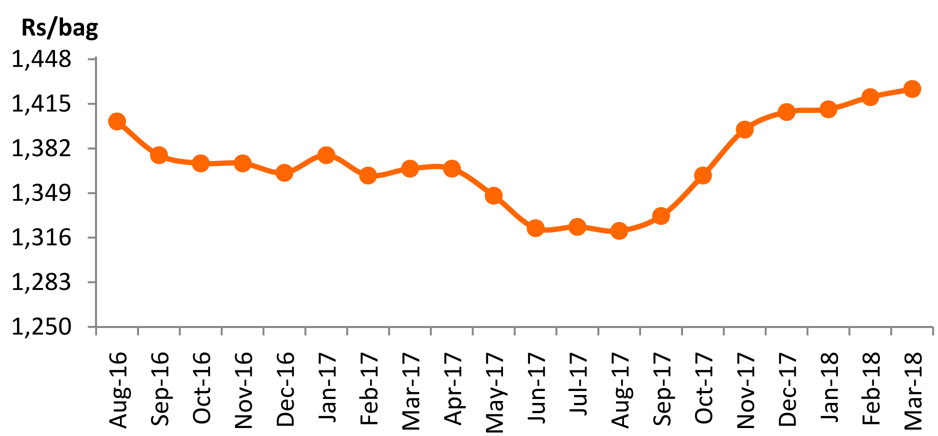


Source: Topline Research, NFDC

Urea inventory depletion; further augmenting GP margins

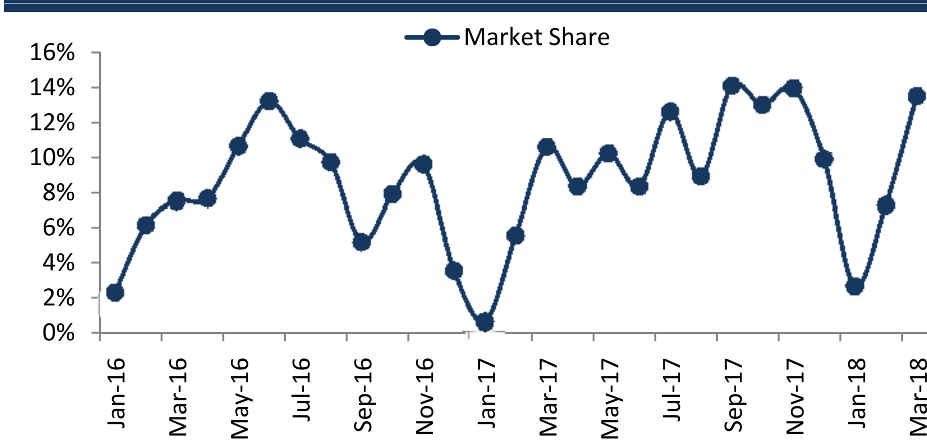
- Urea price after fall in inventory level is hovering around Rs1420-1430 per bag. Previously, prices touched low of Rs1300-1320 per bag during 3Q2017, when National Fertilizer Marketing Limited (NFML) started offloading its imported stock into the market. Later prices recovered in the end of 4Q2017, as industry players exported surplus stock of around ~550k tons of urea (out of allocated quota of 600k tons).
- Further, we expect the company to post volumetric growth of ~5% in urea during 2018 to 573k tons on the back of higher production resulting from availability of power supply from FPCL, this coupled with higher appetite of urea sales in domestic market amid absence/disruption of supply from SNGPL based players (like Agritech and FatimaFert).

Urea Prices Aug 2016- March 2018



Source: PBS, Topline Research

FFBL Urea Market Share



Source: NFDC, Topline Research

Portfolio companies- All set to Break the ice

- As per our talks with management, FPCL and FWEL are expected to pay maiden dividend payment from 2018 (expected payout 70-80%), that is likely to support unconsolidated bottomline of the company. As a result we expect company to post unconsolidated earnings of Rs3.3/3.4/3.8 during 2018, 2019 and 2020 respectively.
- Further, in consolidated earnings, we expect profit from associated companies to increase mainly from AKBL, and FWEL. AKBL is likely to post profitability growth of 10% YoY in its 2018 earnings due to increase in interest rate, while FWEL is set to grow on the back of recent devaluation of PKR-USD (as company has USD index ROE).
- FML is expanding its foot prints to world's largest market China (Annual imports around ~US10bn) and Middle East's largest market Saudi Arabia (US$2-3bn). Quality inspection team of Saudi Arabia has visited site facility of FML, while Chinese inspection team is expected to visit during 2Q2018.
- We expect, FFL to turn into profit by 2021, mainly on the back of rationalization of various fixed costs accounts coupled with gradual improvement in Tea whitener and UHT sales. Right now Tea whitener is contributing around 84% to total liquid milk sales of the company. Going forward, this ratio is likely to come down with progress of UHT milk sales. We expect Tea whitener-UHT ratio of 70:30 post 2019-20.

Fauji Foods and Fauji Meats Key Statistics

	Fauji Foods Limited (FFL, mn litres)		Fauji Meats Limited (FML, tons)	
	2016	2017	2016	2017
Production Capacity	117	228	22,500	30,000
Actual Production	37	87	2,057	4,854
Utilization	32%	38%	9%	16%

Source: Topline Research, Company Accounts

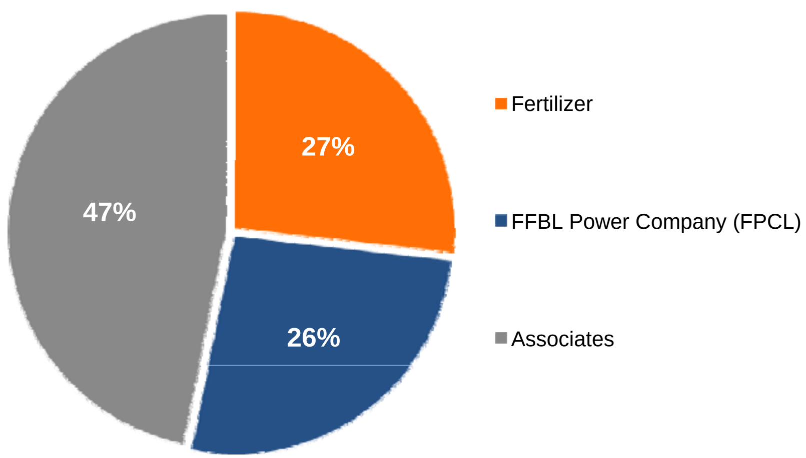
Portfolio Companies – Why FML will bear fruits

- FML is expected to receive exports approval for its meat products from Saudi Arabia, as inspection team of Saudi Arabia has visited company's site facility. Notably, Saudi Arabia is the largest market in middle east with total imports of US$2.5-3bn. Brazil, France and India are the top exporter to Saudi Arabia, while Pakistan is on 5th number.
- Chinese market is also under active consideration of FML, where quality inspection of China is expected to visit company's facility in 2Q2018. To note, currently FML is indirectly selling meat to China via Vietnam (started in late 2017). China is the world's largest meat market for the imports where annual imports are valued ~US$10bn. Brazil, U.S.A. and Australia are the largest importer of meat to china.
- Currently, company is exporting its products in Malaysia, Iraq, UAE, Iran, Kuwait, Qatar, Bahrain, and Oman. While approvals are in process from Saudi Arabia, China, Russia, Indonesia and Sri Lanka .
- Fauji Meats has recently launched retail chain store under brand name of "Zabeeha" in Badar Commercial, Phase 5 DHA Karachi. The company is planning to expand its retail chain stores reach to 19 outlets.
- Based on above prospects, we expect company to attain utilization level of 45%, 70%, and 90% during 2018, 2019, and 2020 respectively from current level of 16% in 2017.

Earnings to grow at CAGR of 36% during 2018-2020

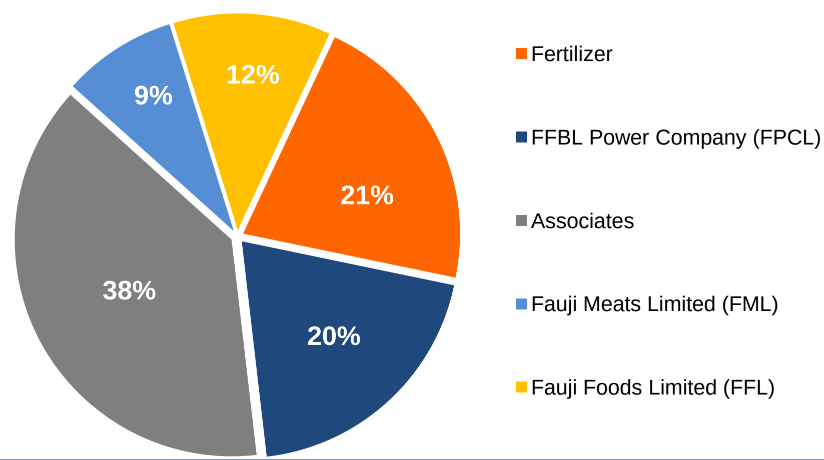
- The core operation (fertilizer) of the company is estimated to post contribute Rs1.3-1.6 during 2018-2020 vs. Rs0.2 in 2017, due to improved contribution margins on DAP and higher retention prices in Urea segment amid depletion of surplus stock.
- FPCL is estimated to add Rs1.3-1.5 per share to the consolidated earnings of the company, 25% higher than last year, as last year company operated for only 227 days (plant commenced operations in May 2017).
- Profit from associates is estimated to post 3-year (2018-2020)CAGR of 8%, where AKBL's contribution will rise from ~47% in 2017 to 52% in 2020 due to expected rise in policy rate by 275bps to 8.75% till 2020. While FWEL's profitability is expected to grow in line with PKR depreciation (USD indexed ROE). We expect cumulative PKR depreciation of 19% to Rs138 till 2020.
- FML is expected turn into profit by 2020 as company is expanding its foot prints in China and Saudi Arabia. We believe, FML will add Rs0.5-1.0 per share to the company's earnings post 2020.
- FFL is expected to turn into profit during 2021 mainly on the back of rationalization of fixed costs and higher volumetric sales. We estimated FFL to add Rs1.5-2.5 per share to the bottomline of the company.

Earnings contribution CY18



Source: Topline Research

Earnings Contribution CY21



Source: Topline Research

Valuation Sum-Of-The-Part (SOTP) and key risks

- We have used Sum Of The Parts (SOTP) methodology to value FFBL. The core operations of the company makes around 34% of the total valuation.
- **Key risks:** Key risks to our valuation/earnings includes, 1) poor crop season, 2) regulatory changes in packaged milk products, 3) barrier to entry in exports markets for meat segment, and 4) increase in coal prices beyond our expectations.

Fauji Fertilizer Bin Qasim (FFBL): SOTP Valuation

Businesses	Rs/Share	Basis of valuation
Fertilizer Business	23	DCF
Fauji Power Company Limited (FPCL)	15	DCF
Fauji Foods Limited (FFL)	11	Market price
Askari Bank Limited (AKBL)	7	Market price
Fauji Meat Limited (FML)	6	DCF
Foundation Wind Power (FWEL)	3	DCF
Pakistan Maroc Phosphore S.A., Morocco (PMP)	2	At Cost
Fauji Cement (FCCL)	1	DCF
Total	**66**	
FFBL Market Price	**42**	
Market Price Discount	**-36%**	

Source: Company Accounts, Topline Research

Fauji Fertilizer Bin Qasim (FFBL): Financial Snapshot

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Income Statement

Rsmn	2016A	2017A	2018E	2019F	2020F
Net sales	49,222	64,389	87,593	98,687	109,469
Gross profit	1,047	9,578	14,673	16,949	19,484
Selling and Dist. expense	5,842	7,519	7,989	8,600	8,620
Administrative Expenses	1,995	2,320	2,537	2,775	3,048
Other Income	7,057	3,615	1,842	1,866	1,892
Finance cost	2,567	3,880	4,247	4,654	4,613
Profit before tax	184	1,184	3,183	4,383	6,802
Profit after tax	229	925	2,681	3,754	5,702
EPS (Rs)	**1.0**	**2.0**	**3.7**	**4.5**	**5.1**

Source: Company Accounts, Topline Research

Balance Sheet

Rsmn	2016A	2017A	2018E	2019F	2020F
Non-Current Assets	62,452	68,201	68,035	68,216	68,208
Current Assets	40,731	42,139	46,874	47,827	46,690
Total Assets	**103,183**	**110,340**	**114,909**	**116,043**	**114,898**
Equity	17,924	19,975	18,661	17,960	18,849
Non-Current Liabilities	42,755	41,704	34,609	32,996	30,798
Current Liabilities	42,503	48,661	60,743	63,392	63,180
Total Equity & Liabilities	**103,183**	**110,340**	**114,014**	**114,348**	**112,828**

Source: Company Accounts, Topline Research

Assumptions

	2016A	2017A	2018E	2019F	2020F
Urea Sales (tons)	442,624	546,000	573,144	578,655	578,655
DAP Sales (tons)	790,622	831,173	812,500	812,500	812,500
Meat Sales (tons)	2,057	4,854	13,500	21,000	27,000
Liquid (mn liters)	37	87	137	171	205

Key Ratios

	2016A	2017A	2018E	2019F	2020F
DuPont Analysis:					
Tax Burden	1.2	0.8	0.8	0.9	0.8
Interest Burden	(0.1)	(1.0)	3.2	2.2	1.6
EBIT Margin	-5%	-2%	1%	2%	4%
Total Asset Turnover	0.5	0.6	0.8	0.9	0.9
Financial Leverage	5.8	5.5	6.2	6.5	6.1
ROE	1%	5%	15%	21%	30%
Others:					
Gross Margin	2%	15%	17%	17%	18%
EPS Growth	-82%	104%	80%	22%	14%
Net Margin	0%	1%	3%	4%	5%
Return on Assets	0%	1%	2%	3%	5%
Interest Coverage	(1.0)	(0.3)	0.2	0.4	0.9
Current Ratio	1.0	0.9	0.8	0.8	0.7

Source: Company Accounts, Topline Research

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Market Weight	= Weight in KSE-100 Index
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