PAKISTAN FERTILIZER SECTOR REVIEW

Industry Update

Aisha Kirmani
aisha.kirmani@igi.com.pk
111-234-234 Ext. 808

Research Department
igi.research@igi.com.pk

Data as of May 22'09

IGI Securities

Table of Contents

Investment Consideration

Fundamentals support fertilizer consumption

Fertilizer demand and profitability is expected to remain strong in CY09 and beyond. The need to increase food production to meet the requirements of a large and fast growing population; limited land, water and power resources; and rising per capita incomes provide incentives for higher yields and increasing crop production. Given the emphasis of policymakers on long term food security, we are overweight on the fertilizer sector with FFC and ENGRO being our top picks.

FFC: Main beneficiary of strong urea demand

Being a pure urea play, FFC is well positioned to be the main beneficiary of strong urea demand through CY09 and beyond. Given the current market volatility we believe the scrip presents a perfect investment avenue offering a CY09 dividend yield of 13%. FFC enjoyed a ROE of 53.1% in CY08 well above the industry average of 33.1% placing the company more comfortably than peers for internal cash generation. Most industries have been hit hard by the current high interest rate environment and in the current tight liquidity environment a firm's internal ability to generate cash should be an important criterion in stock selection. The company also enjoys a comfortable debt to equity ratio of 1.60 versus the sector average of 2.22, putting FFC at a lower credit risk in a slow economy or intensified competition. We have a target price of PKR 108 for FFC.

ENGRO: Bottomline pressure in CY09 but growth story intact

ENGRO has long been regarded a growth stock and we believe the long-term growth prospect is intact. The company's presence in agri-linked fertilizer business and strong management capabilities should help it sail smoothly through difficult times. While the scrip is trading at a CY09 P/E of 18x, at par to its average trailing CY04-08 P/E of 18x, at our target price the scrip would be trading on a CY09 P/E of 26x. We remain positive on ENGRO and believe that further downside from the current levels will offer an attractive entry to lock in diversification-led-growth at a relatively cheap valuation.

FFBL: Volatility to continue through CY09

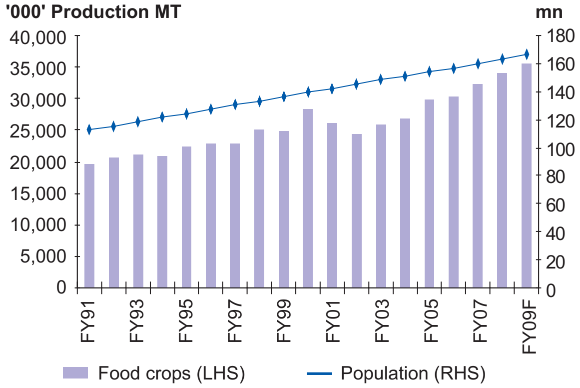
We believe FFBL's gross margin is likely to take a hit during FY09 as primary margins come under pressure. In CY10 we expect margins to stabilize and earnings growth to be driven by an improvement in volumes as the N:P ratio reverts back towards historical norms. While we note our fair value of PKR 23 allows for some healthy upside in FFBL, we have a Neutral rating, reflecting our view that FFC and ENGRO currently offer a more attractive risk/reward balance.

Sector Overview

Population demographics secure demand dynamics

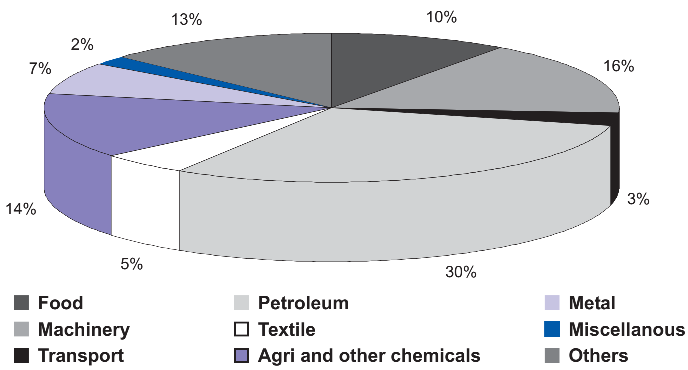
Pakistan has a young population that is expected to grow at 2% per annum (10 year CAGR) faster than the world population growth rate of 1.19%. The country remains a net food importer with the food group having on average accounted for 10% of the total import bill over FY04-08. Given the rapid population growth and limited reserves of good agricultural land, we can expect continued focus on agriculture as the population grows and the nation strives towards its aim of food self sufficiency.

Chart 1: Population growth compared to growth in production of food crops



Source: Agricultural Statistics of Pakistan, Federal Bureau of Statistics

Chart 2: Weight of categories in FY08 import bill



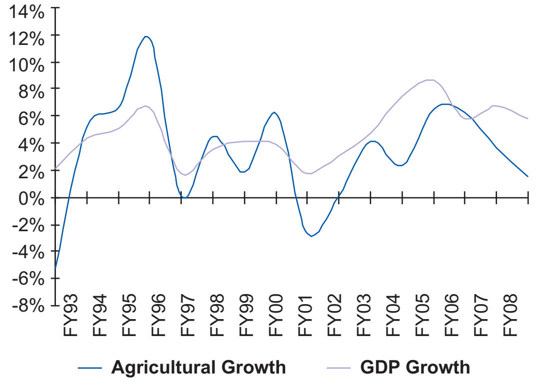
Source: State Bank of Pakistan

Fiscal policy makers increasing focus on agriculture

While the agriculture sector accounted for 21% of GDP in FY08, down from almost 40% in the 1970s, its growth is critical from an employment perspective. The decline in percentage contribution of the agro sector to GDP has been inversely proportional to the increase in the manufacturing and services base which is nevertheless heavily dependent on agricultural commodities such as cotton. Over the last three years the GoP has made a concerted effort to focus on agricultural growth by increasing the subsidy on DAP, increasing the support prices on crops and disbursement of agricultural credit.

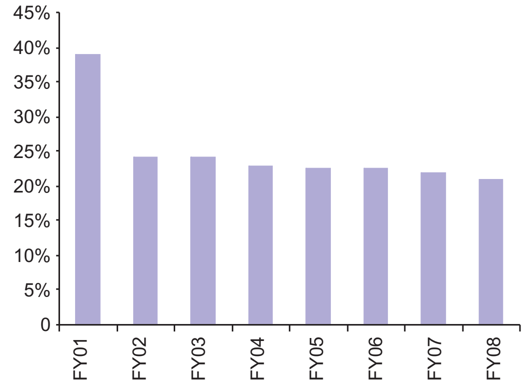
After the GoP increased Minimum Support Price (MSP) on wheat to PKR 950 from PKR 725, a bumper wheat crop of 25.7mn MT is expected versus the initial government target of 23.3mn MT. The overall agricultural sector expected to post a robust 4% growth YoY during FY09. However agricultural growth is heavily dependent on weather patterns, water and power supply.

Chart 3: Agricultural growth versus GDP growth



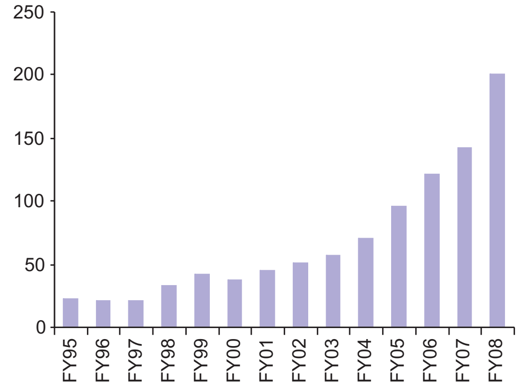
Source: Economic Survey of Pakistan

Chart 4: Agriculture as a % of GDP



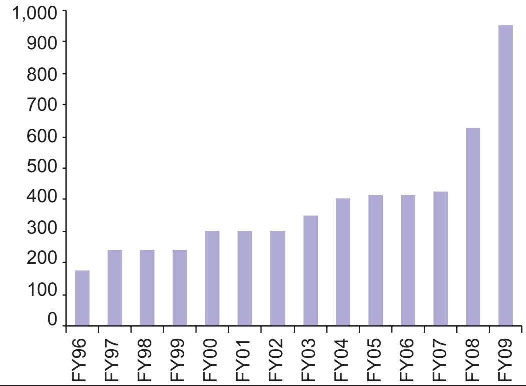
Source: Economic Survey of Pakistan

Chart 5: Agricultural credit offtake (PKR bn)



Source: Agricultural Statistics of Pakistan

Chart 6: Wheat support price (PKR 40kg/bag)



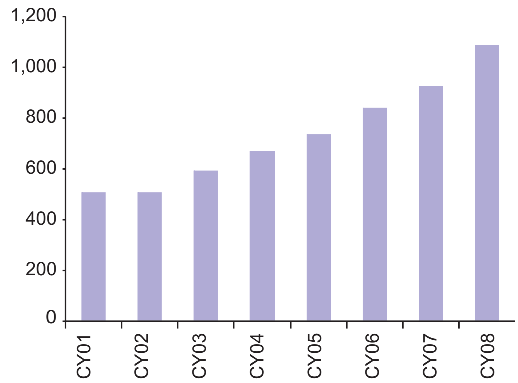
Source: MINFAL

Going forward as the government creates more avenues for revenue generation and with agricultural tax on the cards, we expect there to be a shift towards farmer education so to increase per hectare yield. Maximizing per hectare yield will allow for greater revenue generation for the government. According to recent news reports the government is expected to allocate some land to the UAE for agricultural purposes. This should lead to investment in upgradation of skills and farming techniques which in our opinion will lead to opportunities for the local farming community and boost fertilizer use.

Changing dietary pattern to support fertilizer use

Rising incomes in developing countries enable the poor to consume more food and to improve the quality of their diet. Importantly, as income levels grow the transition to a meat based diet boosts fertilizer use. Increased meat production will require more feed such as coarse grains and oilseed meals. It takes 2kg of feed grain to produce 1kg of poultry meat which rises to 7kg for beef. This means that even as population growth slows down there is significant scope for further increases in the demand for food.

Chart 7: CY01-08 per capita income (USD)

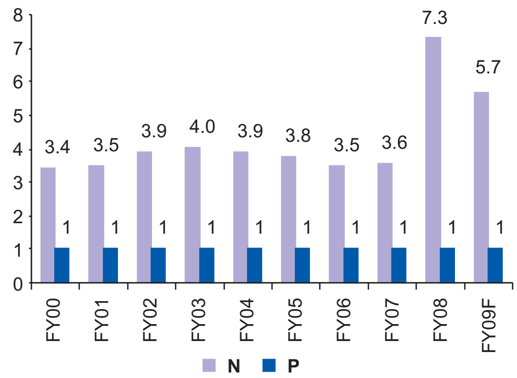


Source: Economic Survey of Pakistan

Fertilizers in Pakistan

The two most commonly used fertilizers in Pakistan are the nitrogen (N) based urea and phosphate (P) based DAP. On average Urea has accounted for 71% of total fertilizer offtake during CY03-08 while DAP for 17% of total fertilizer consumption. The recommended N:P ratio for Pakistan soil conditions is 2:1. However in Pakistan the ratio tends to be skewed towards the N content with the N:P ratio averaging 3.7:1 over CY00-07. In CY08 with DAP demand declining by 45% YoY the ratio stood at 7.2:1. In CY09 as DAP prices stabilize we expect the N:P ratio to gradually begin reverting to historical average to sit at 5.7:1.

Chart 8: NP Ratio



Source: NFDC, IGI Research

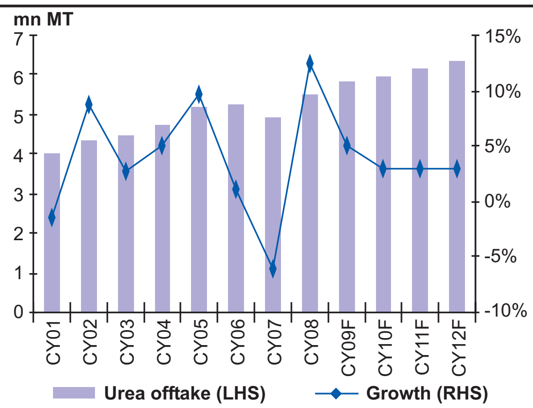
Demand dynamics intact

We expect urea demand to register strong growth during CY09 growing by 5% YoY and 3% (in line with 10 year CAGR of 3.6%) per annum post CY09. The characteristics of the fertilizer are such that farmers really can't do without it. It dissipates quickly in the soil and is removed in large quantities by the crops that need it.

Rising MSP provides added boost

The demand for urea is also very susceptible to wheat support price, leaving the argument for urea offtake not about lower application rates, but rather, about how many acres will or won't get planted. In FY09, the economics of growing wheat have improved significantly, as the government had hiked the wheat support price by 52% YoY to PKR 950/40kgs. As a result a record harvest is expected in the wheat crop this year. Given the continued focus on agriculture to achieving the crucial national goal of food sufficiency we can expect urea demand to continue to grow steadily.

Chart 9: Urea offtake trend

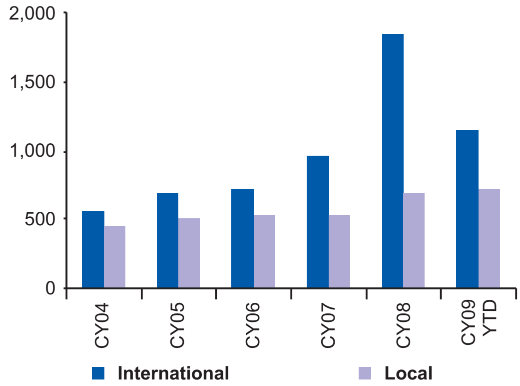


Source: NFDC, IGI Research

Affordability will sustain demand push

Urea has long been perceived as the more affordable fertilizer and urea prices tend not to be as volatile as DAP prices. Unlike DAP pricing, local urea price is not determined by international pricing and is generally at a considerable discount to international urea prices. The reason being that feedstock gas is available 72% cheaper to local urea manufacturers. With gas being a major component in urea production and feedstock gas accounting for 80% of the total gas consumed in manufacturing urea, an increase in gas prices is followed by an increase in urea prices.

Chart 10: CY04-09YTD Avg global urea prices versus local urea prices (PKR/bag)

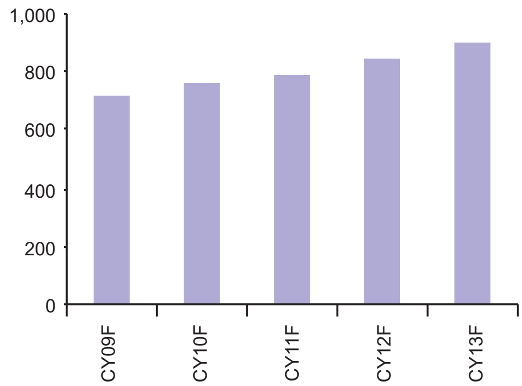


Source: Bloomberg, NFDC, IGI Research

Feedstock subsidy likely to remain

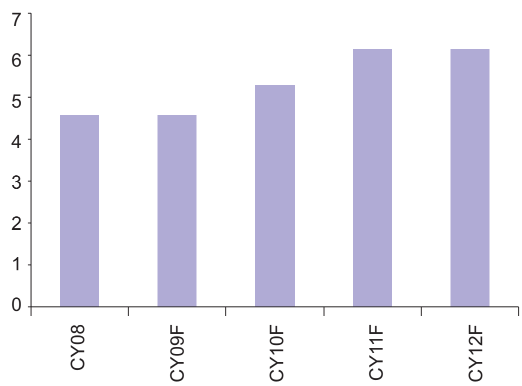
We estimate that PKR235/bag would be added to the price if the GoP were to discontinue the subsidy in feedstock, narrowing the discount between international and local urea from 37% currently to 16%. However given the agrarian focus we believe the feedstock prices are likely to remain subsidized. In CY09 we expect ex factory urea prices to average PKR 720/bag as manufacturers continue to exercise pricing power resulting from the booming demand. Going forward in CY10 with Engro's capacity expansion of 1.3mn MT and Fatima Fertilizers 0.5mn MT expected to come online we expect some erosion in pricing power till the demand rises to meet supply by CY14.

Chart 11: CY09-13 Urea price assumption (PKR bag)



Source: IGI Research

Chart 12: CY08-12 Urea capacity addition schedule (mn MT)

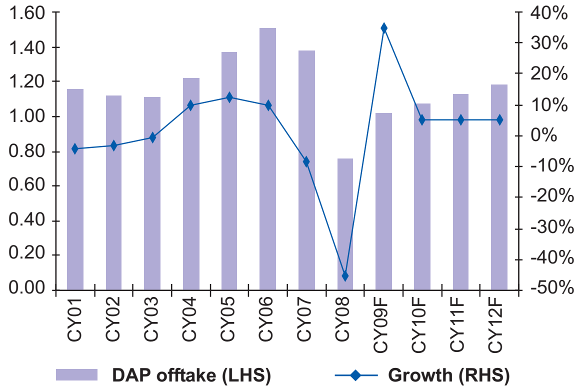


Source: NFDC, IGI Research

Local DAP demand is likely to pick up

With DAP demand having declined by 45% YoY in CY08 to 0.756mn MT as a result of soaring international DAP prices and uncertainty over the implementation of subsidy, we can expect a recovery in DAP demand over CY09. During 3mo CY09 a sharp 153% YoY recovery has been witnessed in DAP demand to 0.189mn MT from 0.075mn MT in the same period last year. It would be prudent to highlight here that the first few months of any calendar year are not generally representative of the demand trend for the whole year. However CY08 was a year of exceptionally low DAP demand and in CY09 with DAP prices having stabilized in the local market, we expect demand to pick up to grow at 35% YoY and cross 1mn MT. Going forward we expect DAP demand to grow in line with CY97-07 10 year CAGR of 5%.

Chart 13:DAP offtake trend (mn MT)



Source: NFDC, IGI Research

Demand to respond to easing prices in CY10

Unlike urea, DAP prices are linked directly to international commodity prices. Over CY04-08 Pakistan imported 66% of DAP requirements. As commodity prices skyrocketed internationally in CY08, local DAP prices soared by 145% YoY to average at over PKR 2,825/bag resulting in a sharp decline in DAP demand. The year ended with over 0.340mn MTs of unsold DAP inventory. The characteristics of DAP are different from urea in the sense that the fertilizer tends to stay in the soil. DAP demand is generally more price elastic than urea as farmers tend to use lesser quantities of DAP in times of sharp price acceleration.

DAP prices likely to sink as global capacities increase

Given the importance of international DAP prices in determining local prices we note international DAP trends. Internationally has been little activity in the DAP market with prices holding at USD 330 MT, down from a high of over USD 1,200 MT in CY08. For their part, retail fertilizer distributors, who hold significant amounts of high cost fertilizer, have been reluctant to sell inventory at today's significantly lower prices. As a result, the inventory pipeline for fertilizers is full, causing fertilizer producers to cut their near-term production.

With fertilizer manufacturers already operating well below nameplate capacity, China's export tax of 120% expected to expire by end 1H CY09 and a number of capacity expansion projects expected to come online over the course of the next few years, international DAP prices are likely to remain under pressure. Currently local DAP prices are hovering between PKR 1,700-1,900/bag versus international DAP prices of USD 335 MT translating into a landed price of PKR 1500/bag. This suggests that there may be further room for downside in DAP prices during CY09.

Table 1: Phosphoric Acid (100% P2O5): Summary of Announced and Projected Changes in Global Capacity

Company	Location	Planned Start-up	DAP/MAP (000 MT)	P205 (000 MT)
Al Jalamid Phosphate Project (Ma'aden Mining Company/ SABIC)	Ras ax Sawr, Saudi Arabia	2012	3000	1500
Jordan Phosphate Mines Company (JPMC)-IFFCO Joint venture	El-Eshidiya Mine Jordon	Late 2011 or beyond		475
Indo Egyptian Fertilizer	Edfu, Sebaeya, Egypt	End 2010		500
Groupe Chimique Groupe Chimique*	Shkira, Tunisia	2010 or later		360
Vietnam Chemical Corp*	Ha Bac, Vietnam	2010 or later		120
Fosfertil*	Minas Gerias, Brazil	2010 or later		260
China	various	2009-2010	1000-1200	500
*proposed				

Source: Bloomberg, IGI Research

FY10 Budget to be neutral for Fertilizers

With international DAP prices having shown a steep decline in 4Q CY08, the GoP discontinued subsidy of PKR 2,200/bag on production and imports during CY09. Going forward with prices expected to remain low, resumption of the subsidy remains unlikely. Gas prices are expected to be increased with effect from 1 Jul '09 but the cost is to be passed through to the end consumer. With the GoP having shown a renewed focus on agriculture in FY09, we do not expect the budget to be negative for the fertilizer sector.

Key risks

- Production supply disruptions can have a dramatic effect on fertilizer pricing
- Demand is significantly influenced by crop prices and the weather, which can dramatically impact fertilizer consumption volumes on a seasonal basis
- Higher or lower than expected changes in urea pricing will lead to a revision in our earning estimates and fair value
- We would also have to revisit our financial model based on any policy changes in gas pricing, subsidy or pricing mechanism.

Stock Summaries

Recommendation **BUY**

Fair Value **PKR 108**

Fauji Fertilizer Company

Company Update

Aisha Kirmani
aisha.kirmani@igi.com.pk
111-234-234 Ext. 808

Research Department
igi.research@igi.com.pk

IGI Securities

FFC: Rock steady

Guaranteed demand

FFC is largest urea manufacturer and enjoys leadership position in the urea market with a 56% market share during CY08. Owing to strong urea demand, the company has historically had to operate well above its nameplate capacity. With urea demand outpacing supply, Pakistan generally had to import 8% of annual urea requirement per during CY05-08.

Strong dividend play

FFC has long been regarded a dividend yielding stock, and offers a CY09 dividend yield of 13%. The scrip's dividend yield remains amongst the highest in the KSE-100 and going forward we expect this to be a key selling point as interest rates begin to show a declining trend. FFC is 44% owned by the Fauji Foundation and historically its payout ratio has been in excess of 100%. Going forward we can expect this trend to continue as the foundation relies on FFC for dividend income.

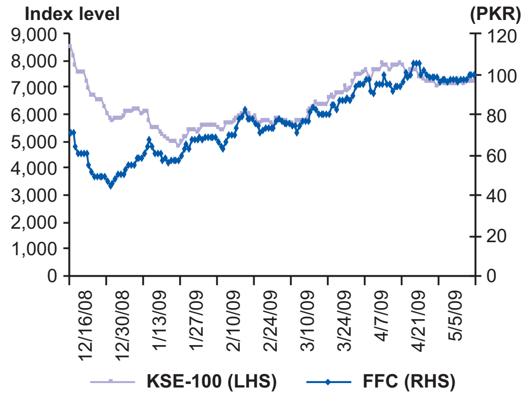
Resilient balance sheet

FFC enjoyed a ROE of 53.1% in CY08 well above the industry average of 33.1% placing the company more comfortably than peers for internal cash generation. Most industries have been hit hard by the current high interest rate environment and in the current tight liquidity environment a firm's internal ability to generate cash should be an important criterion in stock selection. The company also enjoys a comfortable debt to equity ratio of 1.60 versus the sector average of 2.22, putting FFC at a lower credit risk in a slow economy or intensified competition.

Leading the defensives

Subsequent to the removal of the price floor, the scrip touched a low of PKR42.06 but quickly recovered to touch a high of PKR 105.45 as investors accumulated owing to the defensive nature of the scrip, gaining over a 100% in absolute terms. The scrip has outperformed the KSE-100 index which has gained 47% from its low of 4,815 points. Offering a strong dividend yield CY09 dividend yield of 13%, we continue to like FFC on account of its stable cashflows, solid balance sheet, market leadership position and strong bottomline growth.

Chart 1: FFC Price Performance vs KSE100 Index

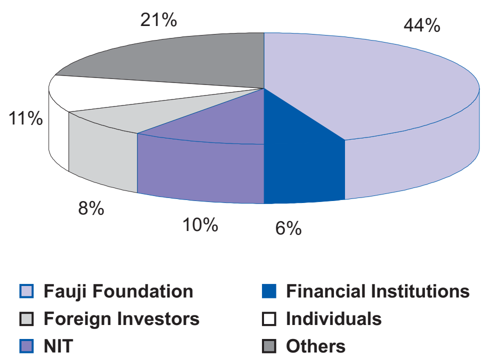


Source: Bloomberg, IGI Research

Play it safe with FFC

FFC remains the ideal defensive scrip offering investors a CY09 dividend yield of 13%. The Fauji Foundation holds 44% of FFC and the sponsors ensure that the payout ratio remains high, as they rely on the dividends from their investments. Upon removal of the price ceiling at the KSE, FFC was amongst the first scrips to rebound and has gained over a 100% in absolute terms owing to the high dividend yield and defensive nature of the scrip. Due to the steady nature of urea demand and its high dividend yield FFC remains our top pick in the current volatile investment climate.

Chart 2: CY08 Shareholding Pattern



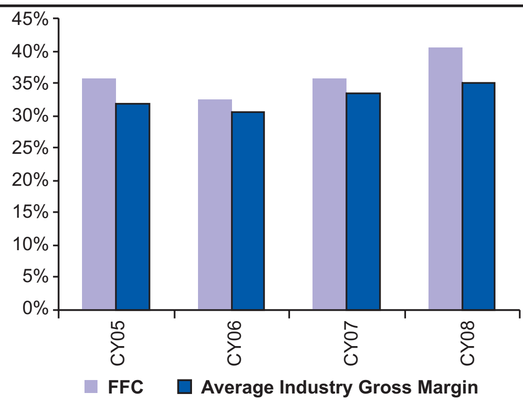
Source: Company annual reports

Going forward with Engro's capacity expansion expected to lead to a supply surplus situation over CY11-CY13, we expect some weakness in urea manufacturer pricing power. Our discussion with numerous industry participants leads us to believe that GoP is likely to permit urea exports during the surplus period with export volumes being allocated to each company as per manufacturer production capacity. Subject to no further urea capacity expansion projects being announced, we believe pricing power will return to urea manufacturers as demand outpaces supply by CY14.

Expanding margins

Over the last few years the company has enjoyed steadily expanding gross margins on account of strong pricing power and production efficiencies arising from economies of scale. FFC is the largest urea manufacturer accounting for 45% of urea manufacturing capacity. As shown in the below chart FFC's gross margin has consistently remained above the industry average. Furthermore with the government expected to use its own distribution channel to market low margin imported urea we expect FFC's gross margin to further expand to 40% during CY09 versus 36% in CY08.

Chart 3: FFC gross margin versus industry



Source: Company annual reports

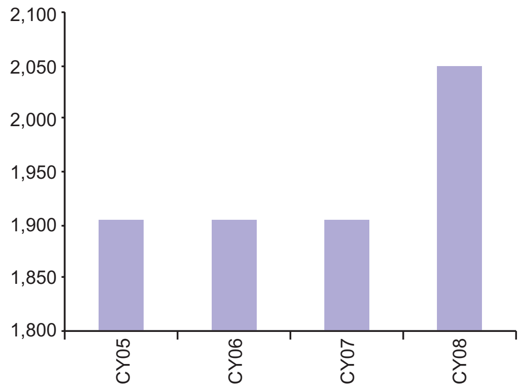
Provides exposure to FFBL

FFC provides investors with exposure to FFBL by virtue of its 50.9% stake in FFBL. FFBL is the third largest urea manufacturer and sole DAP manufacturer. Similar to FFC, FFBL also has a high payout ratio and dividend income from FFBL helps cushion FFC's bottomline. Our SOTP based valuation values FFC's stake in FFBL at PKR 12/share. In our model we have assumed a PKR 2.25/share dividend from FFBL for CY09. This has already been received in 1Q CY09. Any further dividend payouts from FFBL would present an upside to our earning estimate for FFC. FFC investments include a 12.5% stake in Pak Maroc Phosphore (PMP), a phosphoric acid manufacturer expected to deliver 5% ROE in CY09 and 15% in CY10 and a power project to come online by end 2010 delivering a fixed 15% ROE.

Growth to come via continuous debottlenecking activities

Over the years bottomline growth for the company has been driven by pricing power and debottlenecking activities. Currently the company is assessing whether to proceed with capacity increases via further debottlenecking activities but we hold off incorporating any capacity increases in our valuations till further details are disclosed by management.

Chart 4: Capacity additions through debottlenecking ('000' MT)



Source: Company annual reports

Healthy ratios and attractive valuations

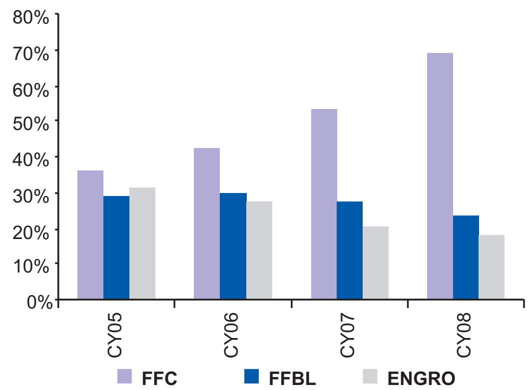
Due to its high payout ratio, FFC's ROE is the highest amongst the IGI Universe fertilizer sector. In line with margins FFC's, ROE has been on an upward trend averaging 44% over the last three years. We highlight FFC's debt to equity ratio of 1.60 versus the sector average of 2.22, putting FFC at a lower credit risk in a slow economy or intensified competition.

Table 1: FFC ROE Analysis

	CY06	CY07	CY08	CY09
Profit margin (PAT / sales)	15%	19%	21%	25%
Asset management (sales / total assets)	109%	97%	96%	116%
Financial Leverage (assets / shareholders equity)	212%	230%	260%	242%
ROE = Profit margin*asset management*financial leverage	36%	42%	53%	69%

Source: Company annual reports, IGI Research

Chart 5: FFC ROE versus fertilizer sector average



Source: Company annual reports, IGI Research

The global fertilizer sector is trading on a CY09 PER of 9.6x. FFC is trading on a 21% discount to global fertilizer sector PER valuations. With FFC being a bluechip stock we believe there is room for re-rating which would result in the discount narrowing. At a PER of 9.6x FFC's stock price would be PKR 121.

Table 2: Global Fertilizer Sector PER Valuation (x)

	CY09	CY10
Yara International	10.1	8.8
Mosiac Co	7.9	na
Agrium Inc	7.3	7.1
Potash Corp Sask Inc	9.9	8.7
K&S Ag	9.9	8.2
Terra Industries	8.0	8.6
CF Industries Holding Inc	9.9	9.8
Israel Corp	13.9	4.8
Average	9.6	8.0
FFC	7.6	6.9

Source: Bloomberg, IGI Research

Stake in FFBL not fully priced in

We use a SOTP based valuation to derive our target price for FFC. Our standalone DCF valuation for FFC excluding dividend income from FFBL provides us with a fair value of PKR 95. This is based on 679mn outstanding shares, a terminal growth rate of 3% and a WACC of 15.5%. After adjusting for a 25% discount from our fair value for FFBL we add another PKR 12 per share to account for FFC's 51% stake in FFBL taking our total target price for FFC to PKR 108.

Financials: FFC

Income Statement (PKR mn)	CY07	CY08	CY09	CY10
Net sales	28,429	30,593	35,307	37,145
Cost of sales	18,312	18,235	19,277	20,644
Gross profit	10,117	12,358	16,030	16,501
Operating profit	7,699	9,690	13,096	13,529
EBITDA	8,397	10,522	13,957	14,419
Financial charges	696	695	855	612
Other income	1,658	1,943	2,150	2,737
Profit before tax	7,815	10,041	13,180	14,531
Taxation	2,454	3,516	4,613	5,086
Net Profit	5,361	6,525	8,567	9,445
Shares outstanding (mn)	679	679	679	679
EPS (PKR)	7.90	9.62	12.63	13.92

Cashflow Statement (PKR mn)	CY07	CY08	CY09	CY10
Cashflow from Operating Activites	9,817	13,067	15,281	16,324
Cashflow from Investing Activities	(480)	(3,243)	518	(1,000)
Cashflow from Financing Activites	(5,800)	(7,529)	(10,450)	(9,323)
Net change in cash	(22)	(2,607)	(119)	303
Beginning cash balance	3,885	3,344	932	813
Ending cash balance	3,344	932	813	1,116

Balance Sheet (PKR mn)	CY07	CY08	CY09	CY10
Current assets	10,811	9,710	9,614	10,046
Operating assets	18,430	22,209	20,809	20,908
Total assets	29,241	31,919	30,423	30,954
Current liabilities	11,476	11,824	10,214	11,929
Long term liabilities	5,035	7,810	7,746	6,277
Shareholders equity	12,730	12,285	12,463	12,749
Total equity and liabilities	29,241	31,919	30,423	30,954

Key Ratios	CY07	CY08	CY09	CY10
Gross Margin	36%	40%	45%	44%
Operating Margin	27%	32%	37%	36%
Net Margin	19%	21%	24%	25%
EBITDA Margin	30%	34%	40%	39%
Sales Growth	16%	22%	31%	10%
EPS Growth	16%	22%	31%	10%
ROE	42%	53%	69%	74%
ROA	18%	20%	28%	31%

Valuation	CY07	CY08	CY09	CY10
PER (x)	12.45	10.23	7.79	7.06
P/BV (x)	5.24	5.43	5.35	5.23
Dividend Yield	9%	11%	13%	14%
EV/EBITDA (x)	10.17	8.12	6.12	5.92

Source: Company Reports & IGI Research

May 2009

FERTILIZER
PAKISTAN

Recommendation **NEUTRAL**

Fair Value **PKR 23**

Fauji Fertilizer Bin Qasim Ltd.

Company Update

Aisha Kirmani
aisha.kirmani@igi.com.pk
111-234-234 Ext. 808

Research Department
igi.research@igi.com.pk

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FFBL: Volatility expected to ease by CY10

Decline in local DAP prices to remain a key risk in CY09

FFBL is currently pricing its DAP at PKR 1,900/bag, a premium of PKR 200 over importers selling at PKR 1,700/bag. With international DAP prices having declined to USD 335 MT currently, translating into a landed price of PKR 1,500/bag pressure is likely on FFBL's DAP prices. DAP prices could potentially correct to PKR 1,500-1,600/bag during 2Q CY09 as offtake is expected to remain slow but prices are expected to pick up during 3Q CY09 as DAP offtake recovers and average PKR 1,700/bag during the year.

Sharp rise in volumetric sales on account of low base

FFBL closed CY08 with 0.173mn MT of unsold DAP inventory. With the company having sold 0.105mn MT during 1Q CY09, we expect the company to be left with just under 75,000 MT of DAP written off at PKR 1,600/bag. During 2Q CY08 DAP offtake is expected to remain low but pick up once again in 3Q CY09. A trend observed over the last 7 years has been that second half of the CY has accounted for 75% of DAP offtake while 4Q alone has accounted for as much as 50% of DAP offtake.

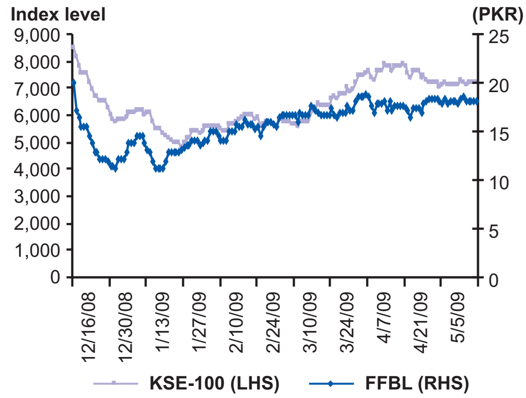
Margins to stabilize in CY10

After DAP and input prices skyrocketing in CY08, we expect CY09 to be marked with sharp YoY declines in margins and earnings. In addition to taking a hit on prices, FFBL's gross margin and bottomline is not going to be cushioned by subsidies and compensation payments received over the last few years. Gross margin which stood at 31% during CY08 is expected to narrow to 23% during CY09. Resultantly earnings are likely to decline by 33% YoY to a PAT of PKR 1,946mn. Going forward in CY10 with P205 prices tracking DAP prices, we expect margins to stabilize and earning growth to be driven by sales volume.

Cautious on FFBL

We have a fair value of PKR23 for FFBL. Our fair value is derived using a WACC 15%, a terminal growth rate of 3%, a cost of equity of 18%, and a beta of 0.927. Even though FFBL currently offers an upside of 35% to our fair value of PKR23, the scrip lacks near term triggers. Given that earnings volatility is expected to remain through CY09 we would advise investors to adopt a cautious approach with the scrip.

Chart 1: FFBL Price Performance vs KSE100 Index



Source: Bloomberg, IGI Research

Global price trends curtailing margins

FFBL is currently pricing it's DAP at a premium of PKR 200/bag at PKR 1900/bag. The company believes the premium from importer price is justified given its wide distribution network and strong brand name. International DAP prices have stabilized at USD 335 MT currently from highs of over USD 1,200 MT in CY08. USD 335 MT translates into a landed price of PKR 1,500 bag lending support to our belief that pressure is likely on FFBL's DAP prices. DAP prices are likely to correct to PKR 1,500-1,600/bag in the current quarter as offtake remains slow but recover during 3Q CY09 as DAP offtake picks up.

DAP Price to average PKR 1,700/bag through CY09

We expect FFBL's DAP price to average PKR 1,700/bag during full year CY09. The key risk to our DAP price assumption is lower than expected international DAP prices. With DAP raw material prices being a function of DAP prices, we believe that there may not be significant margin expansion on the cards for non-integrated DAP manufacturers. We expect FFBL's gross margin to come under pressure during CY09 due to 1)a decline in DAP prices 2)discontinuation of GoP feedstock gas 3)discontinuation of DAP price subsidy, and 4)No annual compensation payments from the government. Going forward in CY10 we expect the strong earnings growth of 48% YoY to be driven by stronger DAP volumes and a YoY decline in financial charges.

Table 1: Domestic Prices: Prices generally pick in 2H

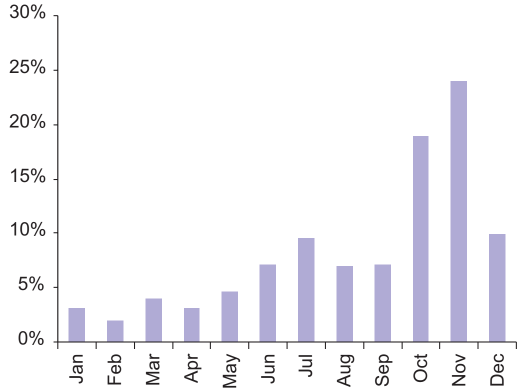
	1H Average	2H Average	Change
1998	584	635	8.7%
1999	697	664	-4.7%
2000	600	655	9.2%
2001	684	703	2.9%
2002	716	748	4.4%
2003	782	847	8.3%
2004	982	980	-0.2%
2005	1,024	1,090	6.5%
2006	1,071	980	-8.5%
2007	1,000	1,309	30.9%
2008	2,580	3,069	18.9%
Average			7.0%

Source: NFDC, IGI Research

FFBL sales volume to rise by 71% YoY during CY09

During CY08 DAP offtake registered a substantial YoY decline of 45% on the back of soaring prices. During 1Q CY09 FFBL has sold 0.106mn MT of DAP inventory. With 2Q CY09 expected to remain slow, in line with historical trends we expect most of the DAP sales to be during 2H CY09. During CY09 we expect FFBL to sell 0.524mn MT of DAP, a growth of 71% YoY.

Chart 2: DAP Seasonality Index CY01-08



Source: NFDC

Table 2: CY08 Industry and FFBL DAP inventory position (MT)

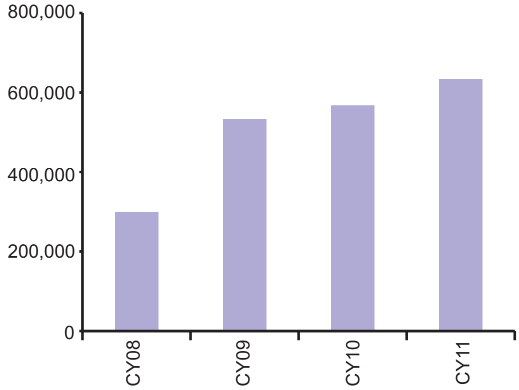
	Industry	FFBL	FFBL as a % of Industry
Sales	756,582	306,280	40%
Closing Stock	340,234	173,401	51%

Source: NFDC

Input prices easing

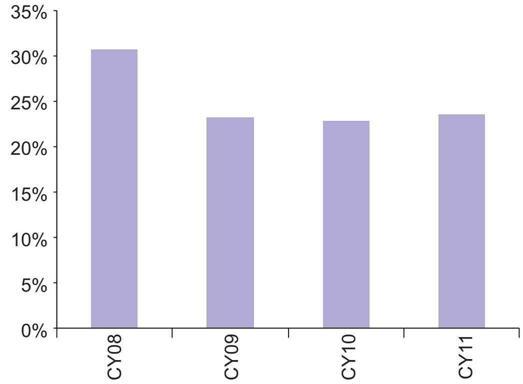
Whilst we believe raw material prices are a function of DAP price and not the other way around, markets like to focus on key raw materials so we have outlined some thoughts below on the major inputs. To produce 1 MT of DAP approximately 0.47 MT of Phosphoric acid (P205) is required. FFBL's P205 supply is guaranteed by virtue of its 25% stake in PMP of Morocco. Prices for P205 are set via quarterly contrasts. After peaking at USD 2,400 MT in CY08 P205 prices have declined to USD 632 MT in 2Q CY09.

Chart 3: FFBL's DAP sales volume (MT)



Source: NFDC, IGI Research

Chart 4: FFBL Gross Margin

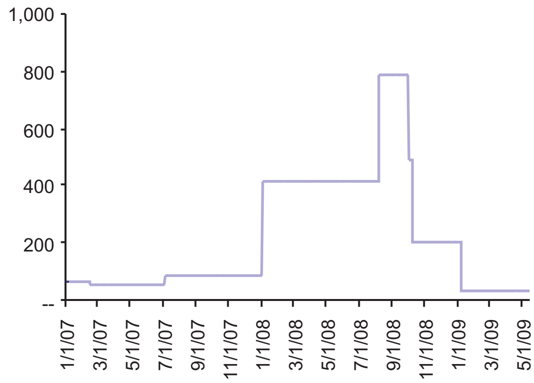


Source: Company Reports, IGI Research

P205 inputs: Phosphate rock and sulfur key

Morocco accounts for around 45% of the global phosphate rock exports. Whilst prices for rock tripled in 2008 peaking at around US$350/t, we are now seeing thin volumes currently being sold at around USD 110-120 MT down from USD 250-290 MT earlier in the quarter. International sulfur costs skyrocketed in CY07 and CY08 due to surging demand for phosphate fertilizer (which accounts for more than 50% of global sulfur demand in all forms). However in CY09 subdued demand and an expected rise in global sulfur supplies within 18-24 months have resulted in a decline in spot sulfur rates. Given the reduction in DAP:P205 margins and declining raw material costs we can expect new P205 contracts to be set at lower than the current USD 632 MT.

Chart 5: CY07-CY09YTD Sulphur spot price trend (USD MT)



Source: Bloomberg, IGI Research

Table 3: FFBL CY09-11 primary margin assumption

	CY09	CY10	CY11	CY12
Cost of P205 (USD/tonne)	637	650	663	676
Cost of P205 /tonne of DAP (USD)	303	309	315	321
Cost of DAP (PKR/bag)	1,700	1,853	1,964	2,082
Cost of DAP (USD/tonne)	425	433	445	458
DAP/P205 Margin (USD)	122	124	130	137

Source: Company annual reports, IGI Research

Valuations and dividend yield potential price triggers

DCF yields us a fair value of PKR 23 for FFBL. Our WACC of 15% is derived using a Cost of Equity of 18%. We use a terminal growth rate of 3%. The scrip is expensive on CY09 PER of 8.3x. However it does offer a CY09 dividend yield of 11%.

Financials: FFBL

Income Statement (PKR mn)	CY07	CY08	CY09	CY10
Net sales	12,243	26,821	27,157	30,917
Cost of sales	7,420	18,595	20,871	23,803
Gross profit	4,823	8,226	6,286	7,114
Operating profit	3,279	6,242	3,831	4,326
EBITDA	3,279	6,242	3,831	4,326
Financial charges	631	2,792	1,703	1,074
Other income	1,252	1,520	865	784
Profit before tax	3,900	4,405	2,993	4,036
Taxation	1,360	1,505	1,048	1,413
Net Profit	2,540	2,900	1,946	2,624
Shares outstanding (mn)	934	934	934	934
EPS (PKR)	2.72	3.10	2.08	2.81

Cashflow Statement (PKR mn)	CY07	CY08	CY09	CY10
Cashflow from Operating Activites	3,998	(6,117)	15,417	4,146
Cashflow from Investing Activities	(5,908)	2,494	53	(215)
Cashflow from Financing Activites	(1,514)	7,191	(18,348)	(6,005)
Net change in cash	(3,424)	3,569	(2,877)	(2,074)
Beginning cash balance	7,236	3,801	7,369	4,492
Ending cash balance	3,801	7,369	4,492	2,418

Balance Sheet (PKR mn)	CY07	CY08	CY09	CY10
Current assets	11,161	28,493	13,209	12,298
Operating assets	17,885	18,279	17,218	16,448
Total assets	29,046	46,772	30,428	28,747
Current liabilities	9,570	26,219	14,892	15,293
Long term liabilities	10,967	10,066	7,400	6,524
Shareholders equity	8,509	10,486	8,136	6,930
Total equity and liabilities	29,046	46,772	30,428	28,747

Key Ratios	CY07	CY08	CY09	CY10
Gross Margin	39%	31%	23%	23%
Operating Margin	27%	23%	14%	14%
Net Margin	21%	11%	7%	8%
EBITDA Margin	35%	27%	18%	17%
Sales Growth	-17%	119%	1%	14%
EPS Growth	4%	14%	-33%	35%
ROE	30%	28%	24%	38%
ROA	9%	6%	6%	9%

Valuation	CY07	CY08	CY09	CY10
PER (x)	6.34	5.56	8.28	6.14
P/BV (x)	1.89	1.54	1.98	2.32
Dividend Yield	14%	16%	11%	15%
EV/EBITDA (x)	10.55	6.21	9.31	8.48

Source: Company Reports & IGI Research

Recommendation **BUY**

Fair Value **PKR 197**

Engro Chemicals Pakistan Ltd.

Company Update

Aisha Kirmani
aisha.kirmani@igi.com.pk
111-234-234 Ext. 808

Research Department
igi.research@igi.com.pk

IGI Securities

ENGRO: The growth story

Capacity expansion to pay off

ENGRO is currently the second largest fertilizer manufacturer after FFC. A planned expansion of 1.3mn tons per annum or 130% of existing capacity costing over USD1bn will take the company's urea production capacity to 2.3mn tpa making it the largest urea manufacturer.

Volumes to drive bottomline growth

The increase in volumetric growth resulting from the urea expansion is expected to drive CY09-13 top and bottom line CAGRs of 27% and 29%, respectively. The company will also benefit from the GoP's fertilizer policy which allows the company to receive feedstock gas at a fixed rate of USD 0.7/mmbtu for ten years – a 47% discount to current feedstock prices. Combined, these factors should help improve EBITDA margins to 35% in CY11 from 22% in CY08.

Diverse income stream bolstering bottomline

In CY08 other income made a 53% contribution to Engro's PBT. After paying out steady dividends through CY08 on account of inventory gains, Engro Eximp alone accounted for 82% of ENGRO's total other income. Going forward we believe that investments from core business and other key investments should start flowing in post CY10. We expect a 38% CY09-13 CAGR in dividend income.

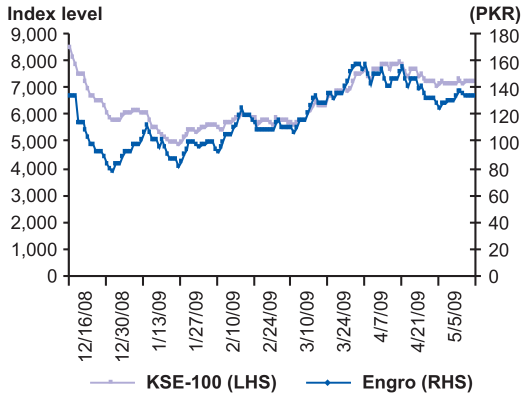
Demerging of fertilizer business to help achieve synergies

Along with 1Q CY09 results, ENGRO announced its decision to demerge the fertilizer business from ECPL. ECPL is to be renamed as Engro Corporation and the fertilizer business will become a wholly owned subsidiary of Engro Corporation. The company has applied for the necessary legal approvals and expects the new structure to be in place by Jan'10. Upon successful completion of the organizational restructuring process, ENGRO's management expects the company to benefit from enhance organizational efficiencies and be better positioned to exploit growth opportunities without disturbing existing shareholders.

Subsidiaries not priced in

Our SOTP based value for ENGRO is PKR 197. The fertilizer business is valued separately using DCF at PKR 127 and accounts for 64% of the total value. Engro Foods is valued at PKR 41, Engro Energy at PKR 10 and Engro Polymer at PKR 13. The other businesses are included as a dividend stream in the fertilizer business. Engro is trading at a premium on a CY09 PER of 18x at par to its average CY04-08 PER of 18x. While we believe that the growth in the fertilizer business is mainly factored in the share price, the upside from other businesses does not reflect in the share place justifying the premium.

Chart 1: Engro Price Performance vs KSE100 Index



Source: Bloomberg, IGI Research

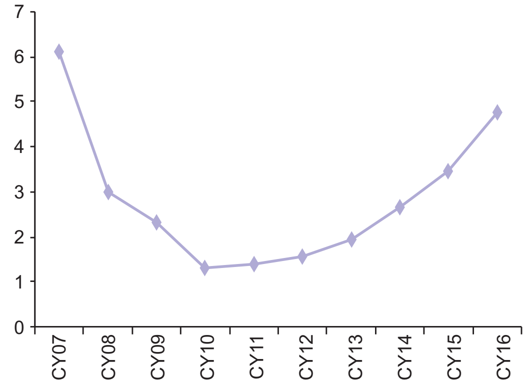
Expansion project on track

We expect ENGRO's Debt:Equity for the entire project to stand at 80:20. However with 30% of the borrowing being USD denominated and 70% hedged, ENGRO was exposed to the weakness in the PKR and rise in interest rates resulting in a USD70mn overrun from the initially targeted amount of USD980mn. An overrun of approximately 7% is understandable given the testing economic environment. We have assumed a currency forecast for the entire project to average PKR70/USD. The company does not expect any significant delays in the project and expects the new urea plant to come online in early 2H CY09. Any major project delays would require us to revisit our valuations.

Interest coverage in safe territory

There has been much talk in the market regarding the overrun and heavy financial charges to be incurred by Engro on completion. However as per our calculation despite the heavy financial charges and depreciation charges that are expected to come online with the commencement of the urea project in CY10, strong management and planning will allow the company's interest coverage to comfortably average 1.5x during CY10-13 and begin expanding by CY14.

Chart 2: CY07-16 Interest coverage ratio (x)

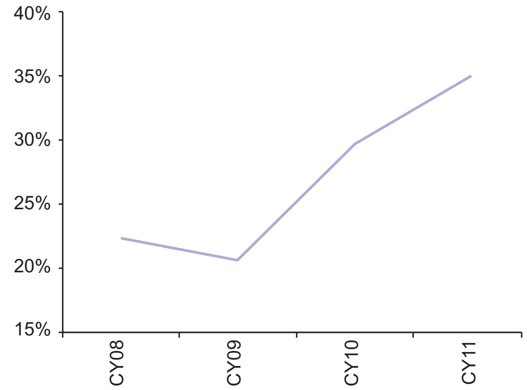


Source: Company annual reports, IGI Research

CY11 EBITDA to see a 3.3x increase from CY09 level

The urea expansion project should allow ENGRO to improve it urea capacity to 2.2 million tons up from 975,000 at present, while fixed feedstock rate on expansion capacity is likely to push the company's core (fertilizer business) EBITDA margin up to 35% in CY12 from 21% in CY09.

Chart 3: CY08-11 EBITDA margins



Source: Company annual reports, IGI Research

Robust other income growth

In CY08 ENGRO's Other Income constituted 53% of PBT with dividend from Engro Eximp accounting for almost 81% of Other Income. The surge in dividend income from Eximp was on the back of inventory gains while DAP prices continued their sharp upward trend during CY07 and CY08. Given the decline in international DAP prices, we assume dividend income from Eximp to decline by 75% YoY during CY09 to PKR 550mn and revert back to historical levels. In CY10 we expect Dividend Income to increase to PKR 2,141mn as dividend begins to pour in from Polymer and Energy.

Table 1: Other Income analysis (PKR mn)

	CY07	CY08	CY09	CY10
Dividend Income (includes Energy from CY10)	1619	2605	994	2141
Dividend from Eximp	1165	2200	550	605
% of total dividend income	72%	84%	55%	28%
Dividend from Polymer	229	159	189	663
% of total dividend income	14%	6%	19%	31%
Dividend from Vopak	225	248	255	263
% of total dividend income	14%	10%	26%	12%
Others (including Energy from CY10)	212	149	156	164
Total Other Income	1831	2754	1151	2305

Source: Company annual reports, IGI Research

Restructuring to improve efficiencies

Engro's decision to separate and transfer the fertilizer business into a separate company will not lead to a dilution in shareholding. In our view shareholders of the newly formed Engro Corporation will continue to enjoy the same ownership stake in each of the subsidiaries. Each of the companies will be in a position to raise funds for further growth without disturbing existing shareholding pattern. Upon successful completion of the organizational restructuring process by Jan10, ENGRO could likely benefit from organizational efficiencies as management is able to direct focused attention to each of the businesses allowing. Going forward a trigger for the scrip will be the potential listing of the fertilizer and/or foods business.

Foods: A winning proposition

Engro Foods is a 100% owned subsidiary. The company started production in 2006 with a milk production capacity of 200k/liters per day (lpd). The current milk production has been expanded to 900k/lpd. The company has also recently launched its ice cream brand "Omore". In just the first month of launch Mar09 sales were at PKR10mn and volume stood at 76,000 liters. In 1Q CY09 Foods turned profitably declaring a PAT of PKR 104mn, earlier than the planned timeline of CY10.

The packaged milk business is a low margin and high volume business. We are optimistic on the growth prospects presented by Engro Foods for the following reasons: 1) Milk consumption is expected to remain strong as more than 50% of Pakistan's population is under 19 and the demographic is likely to remain young 2) The rise in per capita income to USD 1085 should lead to an increased spend on quality nutrition. Currently only 4% of total milk production in Pakistan reaches consumers after UHT treatment 3) Engro Foods has invested heavily on promotion activities which have resulted in an impressive market share of 14% in a short time span of under 3 years and 4) the company has taken bold measures to ensure supply of milk by aggressively expanding milk collection centers and investing in a corporate farm. Engro has set up a corporate farm with a headcount of 1,682 animals to ensure it has its own supply network.

Engro Foods is still evolving with a rapidly expanding product base. Going forward, management has not ruled out the possibility of a separate listing or joining hands with a foreign company to pursue an even more aggressive growth strategy. This, is our opinion may help to crystallize the company's true value. We have incorporated earnings and valuation estimates for Engro Foods based on information made available regarding the company's performance in its third year of operations (14% market share and revenues of PKR 8,162mn) and future investment plans. Engro Foods is expected to start paying dividends from 2012. By 2015 we expect Engro Foods to make a 25% contribution to total dividend income. We assign a DCF based value of PKR47 to Engro Foods.

Overweight for good business, strong management and impressive long-term growth

Our DCF for ECPL extends to CY21, till the gas subsidy available for the expansion in urea capacity runs out. Our DCF value per share for Engro Chemical's core fertilizer business is PKR 127 and total outstanding shares are 298mn. We use a terminal growth rate of 3% and a WACC of 14%. Detailed earnings and cost details for each of Engro's investments are not separately mentioned through individual profit and loss statements. Engro Chemical's standalone financial statements record only dividends from its joint venture partners and subsidiaries. Dividend flows from Engro Energy, Engro Foods and Engro Polymers have been deducted from our free cashflows as we have valued these companies separately. Engro Foods has been valued at PKR 47. Engro Polymer has been valued at a 30% discount to market price at PKR 13 and Engro Energy has been valued in a separate DCF at PKR 10. With regard the other investments we have included the dividend income stream within the core business valuation.

Financials: Engro

Income Statement (PKR mn)	CY07	CY08	CY09	CY10
Net sales	23,183	23,317	20,465	28,205
Cost of sales	18,263	17,121	15,061	19,995
Gross profit	4,920	6,197	5,405	8,210
Operating profit	3,279	4,539	3,556	5,800
EBITDA	3,913	5,192	4,233	8,368
Financial charges	535	1,509	1,530	4,449
Other income	1,339	1,831	2,754	1,151
Profit before tax	4,236	5,205	2,800	3,399
Taxation	1,081	964	504	612
Net Profit	3,155	4,240	2,296	2,787
Shares outstanding (mn)	298	298	298	298
EPS (PKR)	10.59	14.23	7.71	9.36

Cashflow Statement (PKR mn)	CY07	CY08	CY09	CY10
Cashflow from Operating Activites	1,815	(117)	6,968	8,308
Cashflow from Investing Activities	(10,641)	(20,797)	(33,592)	(7,811)
Cashflow from Financing Activites	15,863	13,187	39,160	1,375
Net change in cash	7,038	(7,728)	12,536	1,872
Beginning cash balance	734	7,771	44	12,580
Ending cash balance	7,771	44	12,580	14,452

Balance Sheet (PKR mn)	CY07	CY08	CY09	CY10
Current assets	15,685	15,323	23,548	22,232
Operating assets	22,559	44,869	78,778	86,162
Total assets	38,244	60,192	102,327	108,394
Current liabilities	5,265	5,999	5,053	6,882
Long term liabilities	17,410	31,205	71,542	74,521
Shareholders equity	15,741	23,084	25,828	27,086
Total equity and liabilities	38,415	60,289	102,423	108,490

Key Ratios	CY07	CY08	CY09	CY10
Gross Margin	21%	27%	26%	29%
Operating Margin	14%	19%	17%	21%
Net Margin	14%	18%	11%	10%
EBITDA Margin	17%	22%	21%	30%
Sales Growth	32%	1%	-12%	38%
EPS Growth	24%	34%	-46%	21%
ROE	20%	18%	9%	10%
ROA	8%	7%	2%	3%

Valuation	CY07	CY08	CY09	CY10
PER (x)	12.94	9.63	17.78	14.64
P/BV (x)	2.59	1.77	1.58	1.51
Dividend Yield	5%	7%	4%	4%
EV/EBITDA (x)	7.99	5.86	8.63	4.15

Source: Company Reports & IGI Research

Research Team

Zainab Jabbar	Investment Strategy, Economy	Tel: (92-21) 111-234-234 Ext.:810	zainab.jabbar@igi.com.pk
Aisha Kirmani	Research Analyst	Tel: (92-21) 111-234-234 Ext.:808	aisha.kirmani@igi.com.pk
Abdul Sajid	Database	Tel: (92-21) 111-234-234 Ext.:813	abdul.sajid@igi.com.pk
Mansoor Ahmed	Design, Layout	Tel: (92-21) 111-234-234 Ext.:812	mansoor.ahmed@igi.com.pk

Equity Sales

Maheen Rahman (Karachi)	Tel: (92-21) 536-8823	maheen.rahman@igi.com.pk
Nazia Enam (Karachi)	Tel: (92-21) 530-1711	nazia.enam@igi.com.pk
Samira Omer (Karachi)	Tel: (92-21) 536-8845	samira.omer@igi.com.pk
Ovais Ahsan (Karachi)	Tel: (92-21) 536-8811	ovais.ahsan@igi.com.pk
Abrar Raza (LHR)	Tel: (92-42) 570-7415	abrar.raza@igi.com.pk
Shafqat Ali Shah (ISL)	Tel: (92-51) 280-2243	shafqat.ali@igi.com.pk
Chaudhry Usman Javed (SKT)	Tel: (92-52) 3242689	usman.javed@igi.com.pk
Muhammad Ejaz Rana (FSD)	Tel: (92-41) 254-0854	ejaz.rana@igi.com.pk
Riaz Naseeb Khan (Multan)	Tel: (92-61) 450-0183	riaz.naseeb@igi.com.pk
Asim Irfan (Peshawar)	Tel: (92-91) 525-3980	asim.irfan@igi.com.pk

Analyst Certification

I, Aisha Kirmani hereby certify that the views expressed in this research report accurately reflect our personal views about the subject, securities and issuers. I also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Head Office

7th floor, The Forum, Suite 701-703, G-20, Block 9, Khayaban-e-Jami, Clifton, Karachi
Phone: (92-21) 111-234-234 Fax: (92-21) 111-567-567, 5301780

Branch Offices

Karachi (Clifton)
F-5, Block 9, Clifton, Karachi.
Phone: (+92-21) 5309260-65 Fax: (+92-21) 5309168

Karachi - KSE
Room # 70, 1st Floor, KSE Bldg. Karachi Stock Exchange Road, Karachi
Phone: (92-21) 2429601-06 Fax: (92-21) 2429607

Lahore
5-F.C.C. Ground Floor, Syed Maratib Ali Road, Gulberg, Lahore
Phone: (92-42) 5756701, 5777861-70 Fax: (92-42) 5762790

Lahore - DHA
75-T, Phase 2, DHA (near Lalak chowk), Lahore
Phone: (92-42) 5707411-33 Fax: (92-42) 5748935

Islamabad
Mezzanine Floor, Razia Sharif Plaza, 90 – Blue Area, G-7, Islamabad
Phone: (92-51) 111-234-234, 2802241-43 Fax: (92-51) 2802244

Faisalabad
9th Floor, State Life Building, 2 – Liaqat Road, Faisalabad
Phone: (92-41) 2540843-45 Fax: (92-41) 2540815

Sialkot Office
Room No: 206, Sialkot Trading floor, Cantt Plaza, Sialkot Cantt.
Phone: 052 -4566032-36 Dir.: 052 – 4566034-36 Fax: 052- 4566035

Multan Office
C-2, 1st floor, Hassan Arcade, Multan Cantt.
Phone: (92-61) 4784401-02 Fax: (92-61) 4784403

Gujranwala Office
Nasir Plaza, Main GT Road, (Adjacent to New Railway Station), Gujranwala
Phone: (92-55) 3841346-48 Fax: (92-55) 3257453

Peshawar Office
Mall Tower, 2nd floor, 35. The Mall Peshawar
Phone: (92-91) 5253980-88 Fax: (92-91) 5253989

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Securities