



Chemicals
Collapsing oil, Corona – ain't bad for all



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Executive Summary

Most devastating pandemic ever seen by the mankind 'COVID-19' has curbed the economic activity and trade globally causing an overhang of oil inventories. This along with the recent Saudi-Russia oil tussle had brought the oil prices to their multi-decade low of c.USD19/bbl (Brent).

- Pakistan as a net-importer of oil , is slated to benefit from the lower oil prices giving it a breathing space from inflation as well as from the external current account
 - It is noteworthy that under our long term take-or-pay agreement with Qatar, our DES (delivered ex-ship) RLNG (Re-gasified Liquefied Natural Gas) price is largely linked to international oil prices (13.37% of last 3 month average Brent crude prices)
 - The OGRA notified RLNG DES price for April'20 shows c.17% decline MoM, where 3month avg. Brent stood at USD51/bbl. Brent price has further dropped 47% subsequently. We believe decrease in RLNG prices is yet to be seen
 - Industries in northern part of the country are huge consumers of RLNG where we highlight that three chemical companies (Ittehad Chemicals Ltd–ICL, Sitara Peroxide Ltd–SPL & Descon Oxychem Ltd–DOL) in our soft coverage universe, situated in Punjab are likely to hugely benefit from lower RLNG prices
 - We have estimated our base case earnings for the above mentioned companies on long term oil assumption of USD35/bbl(reasons for which are cited by our oil analyst in his report 'Gyrations from an oil price war')
 - Complimenting the lower RLNG rates, rising demand for disinfectants amid COVID-19 situation broadly benefits SPL and DOL, who recently launched SaniDOL and Sitara safe (H2O2 disinfectants)
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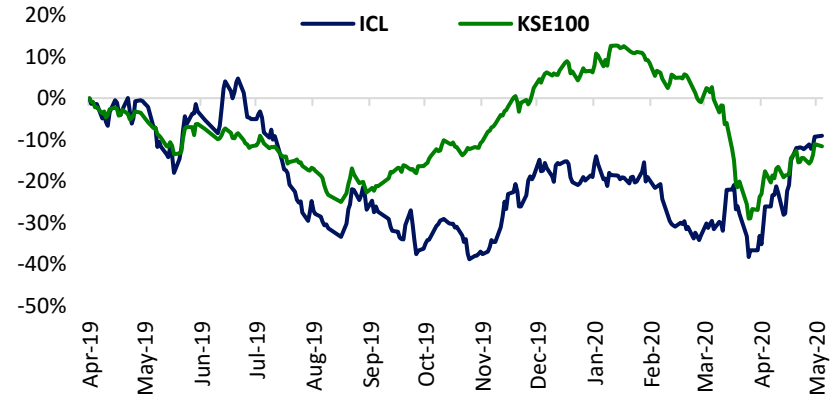
Snapshot of OGRA's RLNG calculation

USD/MMBTU	Transmission		Distribution	
	PSO	PLL	PSO	PLL
Snapshot of OGRA's RLNG calculation				
LNG Price (Delivered Ex Ship; DES @ 35 \$/bbl)	4.7845	4.1656	4.7845	4.1656
PSO/PLL other imports related actual costs	0.3708	0.3228	0.3708	0.3228
PSO/PLL margin (@ 2.5%)	0.1196	0.1041	0.1196	0.1041
Terminal Charges	0.6000	1.1250	0.6000	1.1250
RLNG Cost	5.8749	5.7175	5.8749	5.7175
Retainage volume adjustment	0.0650	0.0950	0.0650	0.0950
T&D Volume adjustment	0.0375	0.0335	1.1750	1.0500
LSA Mgmt fee (SSGC/PLTL)	0.0250	0.0250	0.0250	0.0250
Cost of Supply - SNGPL	0.0290	0.0290	0.0290	0.0290
Cost of Supply - SSGC	0.1440	0.1440	0.1440	0.1440
Total RLNG price without GST	6.1754	6.0440	7.3129	7.0605
Weighted Average Sale Price without GST		6.1426		7.2498

Source: OGRA, Fortune Research

Ittehad Chemicals Ltd (ICL) – Biggest Beneficiary of falling RLNG prices

- ICL is a renowned name for manufacturing of industrial chemicals (primarily Caustic Soda) in Pakistan. ICL is a public limited company listed at Pakistan Stock Exchange(PSX), with 84.7mn outstanding shares (Free Float : 29.65mn shares)
- ICL has recently added value to its diverse product portfolio by installing a LABSA (Linear Alkyl benzene Sulfonic Acid) plant having an annual capacity of 24k'tons. ICL also has an annual capacity of 170k'tons of Caustic Soda.
- Caustic Soda is a versatile alkali used mainly in bleaching processes by the textile manufacturers. It also used in manufacturing of soap, pulp & paper and for treatments of water and food
- Pakistan's demand for caustic stands at c.340k'tons per annum, where majority of the demand comes from the textile and soap manufacturers.
- Caustic installed capacity for the country currently clocks in at c.480k'tons, whereas the demand lies around 340k'tons leading to a excess capacity scenario. We believe this will likely keep the selling prices in check depending on the domestic demand, supply and competition dynamics. Imported landed prices have been and will continue to act as a price ceiling, as per our opinion (Local price for Caustic Liquid is currently PKR67000/ton, whereas the imported landed price is hovering around PKR68500-69000/ton)
- LABSA is a synthetic chemical surfactant used largely in the manufacturing of washing powder, detergent powder, oil soap and cleaning powder



Caustic Capacity (K'tons)	FY15	FY16	FY17	FY18	FY19
EPCL	106	106	106	106	106
ICL	151	151	120	157	170
Sitara	201	201	201	201	203
Total	458	458	427	464	479

Caustic Production (k'tons)	FY15	FY16	FY17	FY18	FY19
EPCL	111	102	98	107	106
ICL	57	74	82	87	95
Sitara	113	135	127	142	133
Imports	0	0	1	0	0
Total	281	312	308	336	334

Source: PBS, Company Accounts, Fortune Research

Low Base of outstanding shares magnifies EPS impact

- Manufacturing of Caustic Soda is an energy intensive process where ICL, as per our calculations, use 2500kwh to produce a ton of caustic soda. ICL uses RLNG as a fuel to produce caustic.
- ICL's fuel cost component is around 55-60% of the total cost of manufacturing
- Thus, we believe declining RLNG prices on the back of falling oil prices is likely to benefit ICL
- We estimate the fuel cost to decline 36% YoY for FY21 on our long term base case assumption of USD35/bbl Brent oil
- Low base of the outstanding number of shares is likely to magnify the earnings per share impact. (*Sensitivities on the right*)
- We are of the opinion that due to the COVID-19 situation, in case of any extension of the prevailing lockdown situation, ICL's offtakes might see a backlash from further closure of textile industries. Hence, we have kept utilization at 36% for FY21 as our base case

Sensitivities

RLNG (USD/MMBTU) Change per year	EPS(PKR)			
	FY18A	FY19A	FY20E	FY21E
5.25	4.91	4.78	1.74	13.37
6.25	4.91	4.78	1.74	10.77
Base case at 7.25	4.91	4.78	1.74	8.17
8.25	4.91	4.78	1.74	5.58
9.25	4.91	4.78	1.74	2.98

Caustic Utilization (%) Change per year	EPS(PKR)			
	FY18A	FY19A	FY20E	FY21E
16%	4.91	4.78	1.74	4.55
26%	4.91	4.78	1.74	6.57
Base case at 36%	4.91	4.78	1.74	8.17
46%	4.91	4.78	1.74	9.83
56%	4.91	4.78	1.74	11.66

Source: Fortune Research

Key Risks:

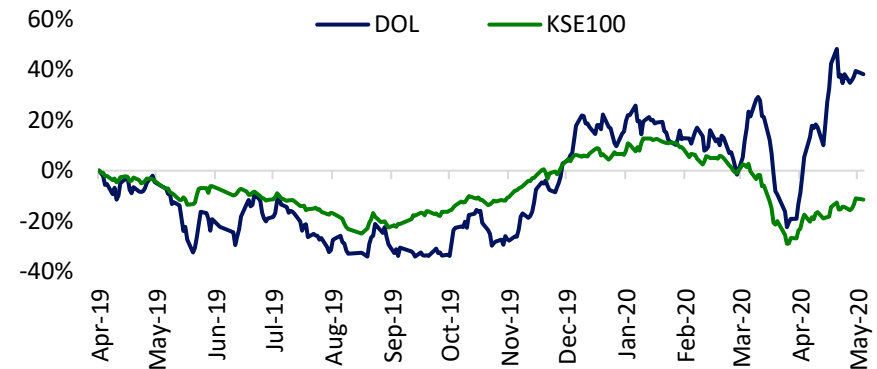
- ✓ Lower than expected offtakes
- ✓ Lower than expected prices
- ✓ Reduction/removal of custom duties by the government
- ✓ Higher than expected RLNG rates
- ✓ Higher than expected interest rates
- ✓ USD/PKR depreciation
- ✓ Any extension in lockdown, causing operations of industries to halt
- ✓ Global Economic Collapse

Base Case Assumptions:

- ✓ KIBOR: 4QFY20 (8.50%), FY21 (7.50%)
- ✓ Inflation: 4QFY20 (10.0%), FY21 (8.25%)
- ✓ USD/PKR avg. : 4QFY20(PKR162), FY21(PKR167)\
- ✓ RLNG:4QFY20(USD7.7/mmbtu),FY21(USD7.25/mmbtu)
- ✓ Caustic Utilization: 4QFY20(30%), FY21(36%)
- ✓ Caustic Soda Prices for FY21: Liquid(PKR67000/ton) & Flakes (PKR79000/ton)

Descon Oxychem Ltd (DOL) – Disinfectants to be the new norm

- DOL supplies hydrogen peroxide(H₂O₂) to textile, food and beverages , mining and other industrial and consumer markets
- Demand for hydrogen peroxide largely comes from textile sector (80%), where remaining 20% is a blend of demand from food & beverages, mining and others
- Currently, DOL's direct and only competitor in similar line of business is Sitara Peroxide Ltd. However, Engro Polymer & Chemicals Ltd has also announced to setup a H₂O₂ plant with an annual capacity of around c.30000MT by 2QCY21(though we could see delay in expansion because of the COVID-19 situation)
- DOL uses RLNG as a feedstock to produce H₂O₂ (as per our estimate, 10mmbtus are needed to make one ton of H₂O₂)
- Falling RLNG rates are likely to bode well for DOL, however as textile is the main consumer for H₂O₂ , we anticipate a drop in demand from the textile manufacturers (recent PBS data suggests 4.46% MoM decline in textile exports for the month of march)
- What comes as a savior on the offtake front, is the rising demand for disinfectants stemming from COVID-19 and DOL's proactive approach on launching 'SaniDOL' – a disinfectant made out of H₂O₂ - in late March
- SaniDOL is hydrogen peroxide disinfectant with 1% H₂O₂ concentration. It can be also used to make hand sanitizers
- As per our calculation, SaniDOL is a high margin product with only 1% concentrated H₂O₂ diluted in distilled water and sold in a 30kg jerry can



- ✓ **DOL had announced in 2018 to expand its capacity by 8000MT(stated to come online in mid-2020) taking total production capacity to 42000MT**
- ✓ **It is pertinent to note that SPL also announced to expand its capacity by 50% taking the total capacity to around 36000MT which was to be completed by 2019 (as per our channel checks, we believe SPL's expansion will at least take another year from now before it comes online)**
- ✓ **We are of the opinion that post these expansions the domestic market might witness oversupply of the commodity (demand numbers above)**
- ✓ **Contrary to which , DOL's management at its corporate briefing in Mar'20 said that they expect demand to kick in from other avenues/industries as well as they see multiple export opportunities, being confident that there would be no oversupply**

Descon Oxychem Ltd (DOL) –SaniDOL to drive profitability

- Currently, 30kg can of SaniDOL is sold for PKR3000(ex-factory), where as prices for 50% concentrated H2O2 stand at PKR105/kg in north and PKR102/kg in south
- We are of the view that post COVID-19 , World wouldn't be the same as it used to be. Regular disinfection of surfaces and places will become part of our lives causing increased demand for disinfectant like SaniDOL

H2O2 Demand - MT	FY15	FY16	FY17	FY18	FY19
DOL	31,785	33,841	34,295	34,066	30,957
SPL	24,305	24,622	21,087	21,006	25,324
Imports	7,181	4,174	8,772	6,100	6,545
Total	63,271	62,637	64,154	61,172	62,826

Source: PBS, Company Accounts, Fortune Research

Base Case Assumptions:

- ✓ KIBOR: 4QFY20 (8.50%), FY21 (7.50%)
- ✓ Inflation: 4QFY20 (10.0%), FY21 (8.25%)
- ✓ DOL use RLNG for feedstock and national grid's electricity for fuel and power
- ✓ USD/PKR avg. : 4QFY20(PKR162), FY21(PKR167)\
- ✓ RLNG:4QFY20(USD7.7/mmbtu),FY21(USD7.25/mmbtu)
- ✓ Utilization: 4QFY20(36%), FY21(57%) – including 466,667 SaniDOL cans for FY21
- ✓ New no. of shares at 151mn (previously 102mn) post conversion of loan to ordinary shares
- ✓ Expansion assumed to be delayed till 3QFY21

Sensitivities

RLNG (USD/MMBTU) Change per year	EPS(PKR)*			
	FY18A	FY19A	FY20E	FY21E
5.25	2.14	2.61	2.23	5.01
6.25	2.14	2.61	2.23	4.85
Base case at 7.25	2.14	2.61	2.23	4.70
8.25	2.14	2.61	2.23	4.54
9.25	2.14	2.61	2.23	4.38

Utilization (%) Change per year	EPS(PKR)*			
	FY18A	FY19A	FY20E	FY21E
37%	2.14	2.61	2.23	3.00
47%	2.14	2.61	2.23	3.83
Base case at 57%	2.14	2.61	2.23	4.70
67%	2.14	2.61	2.23	5.60
77%	2.14	2.61	2.23	6.54

*All EPS based on new no. of shares (151mn)

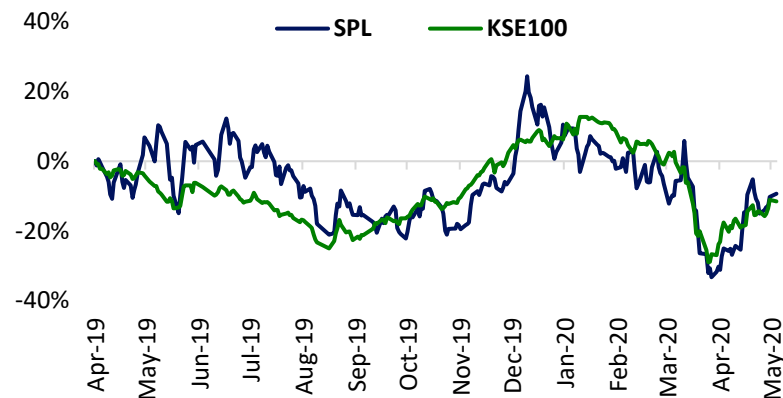
Source: Fortune Research

Key Risks:

- ✓ Lower than expected offtakes
- ✓ Lower than expected prices
- ✓ Reduction/removal of custom and regulatory duties by the government
- ✓ Higher than expected RLNG rates
- ✓ Higher than expected interest rates
- ✓ USD/PKR depreciation
- ✓ Any extension in lockdown, causing operations of industries to halt
- ✓ Global Economic Collapse

Sitara Peroxide Ltd (SPL) – Late to the race, could still catch-up

- SPL recently launched disinfectant by the name of ‘**Sitara Safe**’, a product almost identical to SaniDOL, however, SaniDOL had already captured a greater market share gaining a first mover’s competitive advantage over Sitara
- As per our channel checks, SPL was initially finding it difficult to penetrate the market with its product, leading it to offer a 2-3% H2O2 concentrated disinfectant at a 10% discount to SaniDOL. SPL is currently selling a 25kg Sitara Safe can at PKR2250(ex-factory)



Base Case Assumptions:

- ✓ **KIBOR: 4QFY20 (8.50%), FY21 (7.50%)**
- ✓ **Inflation: 4QFY20 (10.0%), FY21 (8.25%)**
- ✓ **SPL uses RLNG as feedstock and fuel both making it more sensitive to RLNG prices**
- ✓ **USD/PKR avg. : 4QFY20(PKR162), FY21(PKR167)**
- ✓ **RLNG:4QFY20(USD7.7/mmbtu),FY21(USD7.25/mmbtu)**
- ✓ **Utilization: 4QFY20(35%), FY21(60%) – including 320000 Sitara Safe cans for FY21**

Key Risks:

- ✓ **Lower than expected offtakes**
- ✓ **Lower than expected prices**
- ✓ **Reduction/removal of custom and regulatory duties by the government**
- ✓ **Higher than expected RLNG rates**
- ✓ **Higher than expected interest rates**
- ✓ **USD/PKR depreciation**
- ✓ **Any extension in lockdown, causing operations of industries to halt**
- ✓ **Global Economic Collapse**

Sensitivities

RLNG (USD/MMBTU)	EPS(PKR)			
	Change per year	FY18A	FY19A	FY20E
5.25	(1.19)	3.80	0.01	9.21
6.25	(1.19)	3.80	0.01	8.27
Base case at 7.25	(1.19)	3.80	0.01	7.32
8.25	(1.19)	3.80	0.01	6.38
9.25	(1.19)	3.80	0.01	5.44

Utilization (%)	EPS(PKR)			
	Change per year	FY18A	FY19A	FY20E
40%	(1.19)	3.80	0.01	3.64
50%	(1.19)	3.80	0.01	5.38
Base case at 60%	(1.19)	3.80	0.01	7.32
70%	(1.19)	3.80	0.01	9.12
80%	(1.19)	3.80	0.01	10.99

Source: Fortune Research

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To arrive at period-end Target Price(s), FSL uses different valuation methodologies:

- Discounted Cash Flow (DCF, DDM)
- Relative Valuation (PE, PB, PS, PCF)
- Equity and Asset return based methodologies (EVA, RI, etc.)

Acronyms

bps	basis points	LCY	Local Currency
BVPS	Book Value per share	MRP	Market risk premium
CAGR	Compounded Annual Growth Rate	NAV	Net Asset Value
CAPM	Capital Asset Pricing Model	NPV	Net Present Value
DCF	Discounted Cash Flow	PB	Price-to-Book Value
DDM	Discounted Dividend Model	PCF	Price-to-cash flow
DE	Debt-to-Equity	PE	Price-to-Earnings
DPS	Dividend per share	PKR	Pakistani Rupee
DY	Dividend yield	ppt	percentage point
EPS	Earnings per share	PS	Price-to-Sales
EUR	Euro	PV	Present Value
EV	Enterprise Value	RFR	Risk-free rate
EVA	Economic Value Added	RI	Residual Income
FCF	Free Cash Flow	ROA	Return on Assets
FCFE	Free Cash Flow to Equity	ROE	Return on Equity
FCFF	Free Cash Flow to Firm	SOTP	Sum of the Parts
FCY	Foreign Currency	TP	Target Price
g	Growth	TSR	Total Stock Return
IRR	Internal Rate of Return	USD	US Dollars
JPBV	Justified Price-to-Book Value	WACC	Weighted average cost of capital

Rating

BUY	TSR > 15%
HOLD	-10% > TSR > 15%
SELL	TSR < -10%
NR	Not Rated

TSR = Capital gain + DY

Old Rating

Overweight	TSR > 15%
Marketweight	0% > TSR > 15%
Underweight	TSR < 0%

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