

Profit & Loss statement
(In mn)

Years	CY10	CY11	CY12	CY13E	CY14E
Revenue	42,402	57,577	52,823	58,159	61,843
Cost of Sales	35,370	50,915	52,617	55,785	57,801
Gross Profit/(loss)	7,032	6,663	206	2,374	4,042
Distr. and selling exp.	110	197	133	144	154
Admin. expenses	268	330	305	317	324
Other oper. expenses	606	502	47	30	19
other oper. Income	11	23	71	40	39
Operat. Profit/(loss)	7,032	5,655	(207)	1,922	3,583
Finance Income	882	786	291	379	568
Finance costs	229	232	146	71	53
Profit before tax	7,032	6,209	(62)	2,230	4,098
Taxation	2,184	2,031	62	669	1,230
Profit after tax	4,527	4,178	1	1,561	2,869
EPS	2.99	2.76	0.0005	1.03	1.89
DPS	0.50	0.50	-	0.50	0.60

Source: company accounts

LOTCEM Statistics

Last trade	26 June, 2013
Avg. 52 week (vol.)	4,858,591
52 weeks high	9.13
52 weeks low	6.20
Market capitalization (\$ mn)	114
Total no. of shares(mn)	1,514

Source: www.scstrade.com

Company briefs

- ❖ KP Chemical & associates owned 75% stakes i.e. 1.13bn shares; the individual holding is to the extent of 15.9% shares i.e. 240.6 mn shares
- ❖ ICI BV Omicron are also one of the former owners
- ❖ South Korean group instrumental in turning around fortune especially in 2010

Analyst:

Saud Khan

Tel: 111-111-721 ext 116

www.scstrade.com

Lotte Chemical Pakistan..... Earnings to flourish **Buy@7.60**
|Target price Rs 14.0/sh|

Investment case – financial turnaround

LOTCEM (formerly LOTPTA) is a sole supplier of purified terephthalic acid (PTA) in Pakistan, owned by South Korean origin KP Chemical. PTA is an essential raw material used in polyester industry. A very significant use of PTA is in the manufacturing of polyester staple fibre (PSF) which is used as a substitute for cotton. So at times of higher cotton prices the demand of PTA increases in the wake of PSF demand.

- ❖ Planned expansion in the Px capacity in Asia during 2014-2017 is a great event which would end supply shortage. This will be favourable for the PTA manufacturers as it will increase the PTA-Px margin.
- ❖ PTA-Px margin increased recently; reached \$100/ton and we expect it to hover around 120-140/ton;
- ❖ These margins are still higher than the expected conservative margin of \$10-15/ton of the polyester chain.
- ❖ **Financial turnaround** is apparent making LOTCEM an attractive investment case:
 - **Better finance income;**
 - **an upward adjustment in the PTA-Px primary margin has compelled to forecast an EPS of Rs 1.03 for CY13 and of Rs 1.89 for CY14;**
 - **Going forward reduction in financial charges due to repayment of loan;**
 - **expected reduction in the storage cost;**
 - **also low cost in house power generation will contribute to earnings growth.**
- ❖ **Very low gearing: company has repaid the loan to the parent company thereby bringing the gearing of the company to very low level.**
- ❖ The expected decline in the oil prices in near future will keep Px prices down and thereby will reduce the PTA production cost thereby assisting in achieving improved PTA-Px margin.

- ❖ The PTA demand is affected by the global cotton prices, since the expected rise in the cotton prices will increase the PTA demand in local market.

We have based our assumptions based on some global forecast over future cotton prices:

Cotton price forecast	
Commerzbank cotton price forecasts	
Q1 2013	75 cents a pound
Q2 2013	75 cents a pound
Q3 2013	77 cents a pound
Q4 2013	80 cents a pound
Average Cotton Price	77 cents a pound
Morgan Stanley cotton price forecasts	
2012-2013 : 80 cents a pound	
Source: Agrimoney.com	

Valuation Matrix

	CY09	CY10	CY11	CY12	CY13E	CY14E
EPS (Rs)	2.34	2.99	2.76	0.0005	1.03	1.89
EPS growth %	292.2%	27.8%	7.7%	100.0%	100%	83%
P/E (x)	3.25	2.54	2.75	N/m	7.38	4.02
BV/S (Rs)	4.9	6.4	8.6	8	8.3	8.8
P/BV (x)	0.8	1.6	1.6	1	0.9	0.9
Dividend yield	13.2%	5.0%	3.7%	-	6.0%	7.2%
Return on Equity	45.4%	46.7%	31.9%	-1.5%	5.1%	6.2%
Return on Capital employed	39.4%	40.8%	39.6%	-2.9%	4.7%	5.7%
Gearing Ratio	41.7%	34.7%	8.4%	6.2%	6.2%	6.2%

Source: www.scstrade.com & company accounts



Contents of the report...

- PTA Import and import duty....
- PTA-Px margin....
- Industry dynamics....
- Financial turnaround....
- Financial statement analysis
- Investment in power generation & lower gearing....
- Future outlook.....
- DCF valuation....
- Valuation....
- LOTCHEM financial statement....
- LOTCHEM snapshot of ratios.....

Abbreviations

PTA	Purified terephthalic acid
Px	Paraxylene
PSF	Polyester staple fibre
PET	Poly ethylene terephthalate
KESC	Karachi Electric Supply Corp.
PSM	Pakistan Steel Mills
DCF	Discounted Cash Flow

PTA import and import duty...

LOTCEM is a sole PTA producer in Pakistan but it faces competition from imported PTA. The demand of PTA hovers around 600,000 tons and PTA production is around 480,000 tons. The shortfall in supply is met through import of PTA at which only 3% import tariff is levied however LOTCEM has been pressing to increase this tariff since it is very low compared to that of regional players viz. China and India. The main raw material of PTA is paraxylene (Px) which is being imported and there is no excise duty Px import however 2% sales tax is needed to be paid on Px. Prices of imported PTA have a significant impact on local PTA prices, as the local PTA prices follows international prices. **Current PTA international prices are around \$1220/ton thereby spelling price of hovers around Rs120,800/ton as per company scribe.**

PTA-Px margins posted strong recovery in May 2013...

During previous months PTA-Px margins remained below USD50/ton; however in the month of May, a significant improvement in margins is observed as PTA primary margins have rebounded above USD100/ton to hover in the range of USD125-135/ton. The prevailing margins are still higher by USD15-20/ton than conservative long term PTA-Px margin expectation. The outgoing CY12 was marked by a sharp decline of 13% YoY in average PTA prices on account of massive PTA capacity additions. Planned expansions of PX capacities in China, South Korea and Middle East in 2014-2017 are expected to outpace PTA capacity additions. This may again shift the scenario in favour of PTA manufacturers amid weak PX prices. The notable surge in PX capacity till 2017 (up by 14 mn tons) will be led by increasing number of refineries being built to cater the additional energy demand in Asian region. On the other hand, PTA capacity in Asia is expected to augment by 21mn tons to 67mn tons by 2017. The table below shows position at different PTA capacity utilization rates on resulting surplus of PX supply:

Published Sensitivity analysis of Px over supply based on our inference

Expected Global PTA & Px Capacity in 2017 (mn tons)

PTA Capacity 67

Px Capacity 41

Situation	PTA utilization level	PTA Production	Px Demand	Px Supply	Over Supply
A	90%	60	39	40	1
B	85%	57	37	40	3
C	80%	54	35	40	5
D	75%	50	33	40	7

Source: Platts.com, www.scstrade.com

Based on the above, we see PX surplus at all the capacity utilization level this will exert pressure on PX prices resulting notable uptick in PTA primary margins.



Industry dynamics...

LOTCHEM is suggesting that import duty over PTA should be raised from 3% to 5%, but the major PTA consumer has stated that the duty should be lowered from its existing level of 3%; however the PET customers, another user of PTA, has stated that the 3% import duty should not be changed from its existing level. We consider Px oversupply dynamics would be a major event rather than duty structures since increase in cotton prices to spur PTA usage among PSF and PET players.

CY12 has been a rough year not just for LOTCHEM but also for the whole PTA industry in general. The recent downturn in PTA-Px margin could be held accountable. Capacity expansions of additional 7.5 mn tons of PTA from china and shortage of Px, major raw material of PTA, put the strain on PTA prices.

The PTA market was also brought down because of low downstream demand which badly affected the PTA price. The effect was increased by the economic downturn in Eurozone and US. The lacklustre demand for PTA could also be explained by lower international cotton prices which warrant lesser need to substitute PSF for cotton.

Financial performance of LOTCHEM...

The sales revenue declined by around 8% during the year which is formed by the combination of decrease in sales volume and also the decline in PTA prices. The rise in paraxylene prices resulted in that the gross profit margin declined from 11.6% to 0.4%.The distribution cost declined by 33% YoY basis and administration cost has reduced by 8% YoY basis. Finance cost has also declined by 37% YoY basis and the finance income also went down by 63% compared to last year. The decline in finance income was due to decline in cash surplus of the company which fell because the company made repayment of its outstanding parent company loan and capital expenditure on acquisition of co-generation power plant.

Profit & Loss statement

In Rs. Mn

Year	Q1CY12	Q1CY13	Change
Revenue	13,405	13,032	-2.78%
Cost of Sales	13,134	13,187	0.40%
Gross Profit/(loss)	270	(155)	-57.30%
Distr. & sell exp.	45	19	-57.96%
Admin. Exp	76	78	1.73%
Other oper. Exp	24	12	-49.27%
other oper. Inc	9	51	475.98%
Oper. Profit/ (loss)	133	(213)	-159.70%
Finance Income	130	19	-85.55%
Finance costs	25	34	35.40%
cost of Sales	238	(229)	-96.12%
Taxation	87	64	-25.93%
Profit after tax	151	(164)	-108.78%
EPS	0.1	-0.11	-110.00%
DPS		-	-

Source: Company accounts

The company has deposit of Rs14.42mn with KESC and Rs 24.27 mn with PSM on which it is getting 5% markup / return.

**Financial turnaround evident in the wake better margins amid low gearing...**

	CY09	CY10	CY11	CY12	CY13E	CY14E
<u>Liquidity Ratio</u>						
Current Ratio	1.7	1.7	1.5	1.3	1.3	1.3
Quick ratio	1.4	1.3	0.9	0.6	0.7	0.7
<u>Profitability Ratio</u>						
Gross Profit margin	15.6%	16.6%	11.6%	-0.4%	4.1%	6.5%
Net Profit margin	9.4%	10.7%	7.3%	-3.5%	2.7%	4.6%
ROE	60.6%	46.8%	31.9%	-1.5%	13.8%	21.4%
ROCE	30.9%	34.0%	31.8%	-1.5%	12.9%	20.0%
<u>Activity ratio</u>						
Total Asset turnover	2.2	2.0	2.5	2.4	2.6	2.7
<u>Valuation ratios</u>						
EPS	2.34	2.99	2.76	0.0005	1.03	1.89
PE	3.25	2.54	2.75	N/m	7.38	4.02
DPS	0	0.5	0.5	0	0.50	0.60

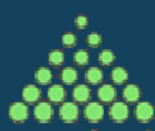
Source: Company accounts

Investment in power generation and lower gearing...

The company has made a long term investment of Rs 4.5 bn in Lotte Powergen (Pvt) limited, a wholly owned subsidiary of the company. The co-generation plant started commercial production in July 2012 and has operated smoothly since then. During the year the company paid off the loan borrowed from its parent company bringing down the net liabilities of the company resulting in reduced debt to equity ratio.

Future outlook...

Previously stretched PTA-Px prices created uncertainty about the LOTCHEM prospect but recent conditions have elicited some optimism about the company. These include an improvement in PTA-Px margin due to steeper decline Px prices led by reduced demand from the profit strapped PTA manufactures and also strong global cotton prices will drive up PTA prices because PSF will be substituted for cotton if the cotton prices goes up. **Our thrust for the investment case in LOTCHEM is to lay focus on supply side dynamics of Px and not duty structures, since we believe CY14 to be very eventful in the context of LOTCHEM.**

**DCF Valuation...**

Year	Rs mn	CY09	CY10	CY11	CY12	CY13E	CY14E	CY15E
Net Income		3,537	4,527	4,178	1	1,561	2,869	2,972
Add:Depr. & Amorti.		1,206	1,244	1,317	1,504	1,570	1,503	1,378
Add/(Less) changes in WC		1,239	50	(2,644)	(53)	(1,342)	(1,552)	(1,784)
Capital expenditure		(542)	(572)	(277)	(4,354)	(2,178)	(1,090)	(545)
Free Cash Flow		5,440	5,249	2,574	(2,902)	(389)	1,730	2,021
Plus: Net borrowings		-	(3,438)	-	-	-	-	-
FCFE		5,440	1,811	2,574	(2,902)	(390)	1,730	2,021
FCFE/sh		4	1	2	(2)	(0.3)	1.14	1.33
Terminal value		23.0	7.7	10.9	(12.3)	(1.7)	7.4	8.7
PV of FCFE		2,767	1,447	1,869	(4,163)	(409)	1,395	1,572
Fair value								14
Risk free rate								11%
Risk premium								7%
BETA								1.16
Terminal growth								3.70%
Cost of Equity								19.70%

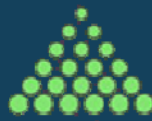
Source: Standard Capital Research

Valuation...BUY

We see clear earnings growth owing to financial turnaround viz. **reduced financial charges because of repayment of loan, reduction in storage cost of Px and low cost in-house power generation will all contribute to earnings growth**, going forward. Any delay or abandonment in Px capacity expansion amid increasing PTA capacity would exert pressure on PTA primary margin due to shortage in Px supplies.

Based on our CY13 earnings forecast of Rs 1.03/sh; we see PE of 7.4x wherein we also estimate PBV of 0.9x.

We have come up with a DCF target of Rs 14, wherein we have a BUY stance given upside potential of around 30% from current market price.

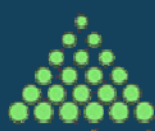


LOTCHEM Financial statement...

Profit & Loss statement**(In mn)**

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Source: company accounts



Important aspects of Statement of Financial Position & Cash flow Statement

Statement of Financial Position

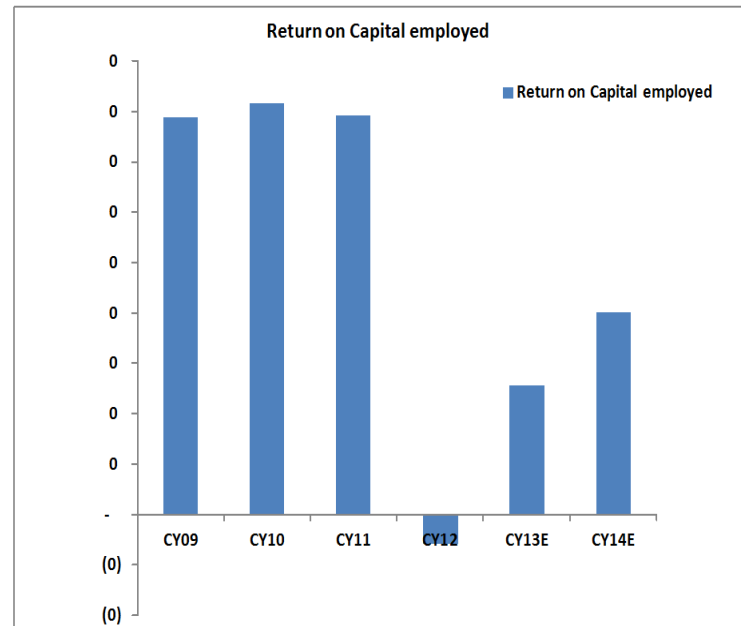
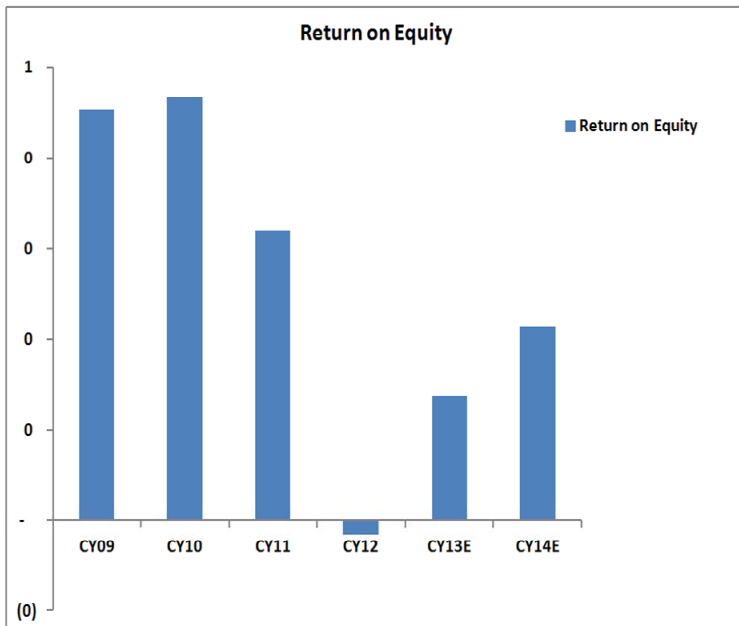
Rs in mn.

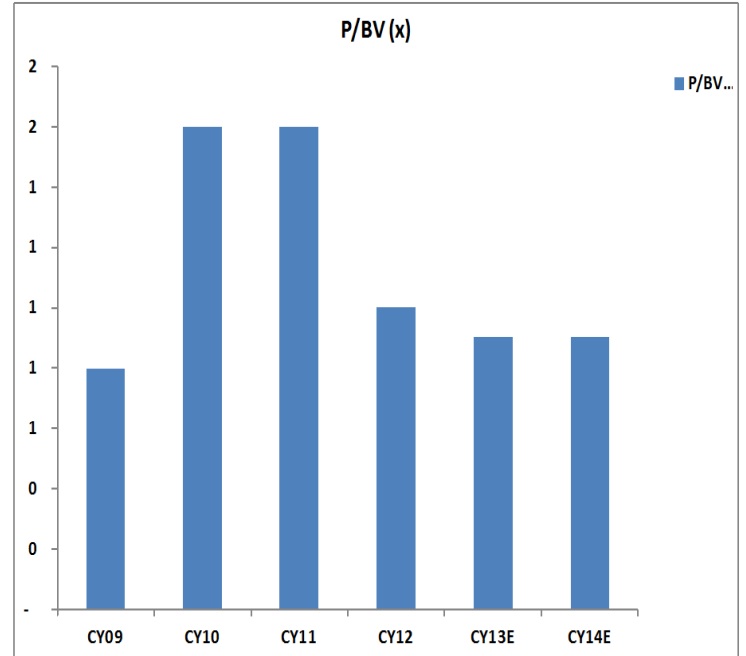
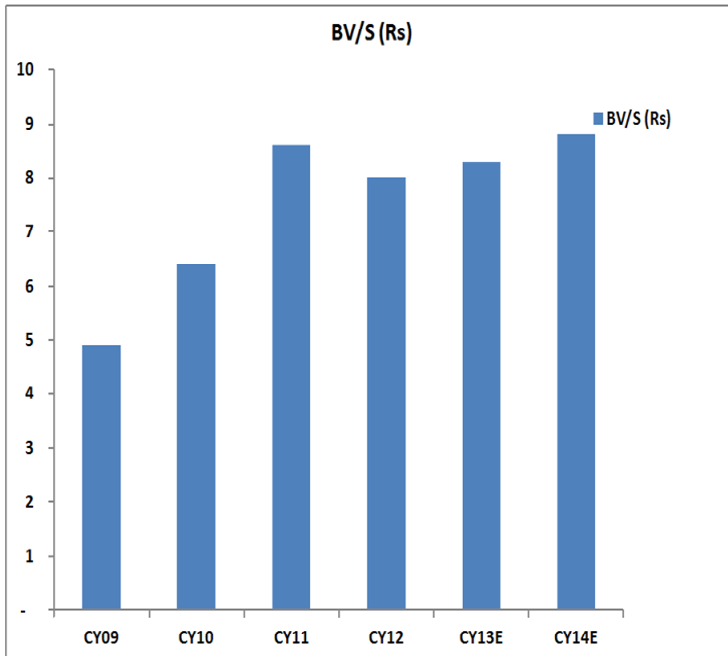
Year	CY09	CY10	CY11	CY12	CY13E	CY14E
<u>Non Current assets</u>						
Fixed assets	9,336	8,890	9,853	10,066	10,670	10,252
<u>Current Asset</u>						
	9,544	13,897	13,901	10,883	11,434	12,217
<u>share Capital and reserves</u>						
share Capital	15,142	15,142	15,142	15,142	15,142	15,142
Capital reserve	2.35	2.35	2.35	2.35	2.35	2.35
Accumulated losses	(9,313)	(5,542)	(2,062)	(2,818)	(1,750)	(383)
	5,832	9,602	13,083	12,326	13,394	14,761
<u>Liabilities</u>						
Long term liabilities	5,322	3,438	-	-	-	-
Current Liabilities	5,751	8,055	9,616	7,947	8,511	9,148

Year	CY09	CY10	CY11	CY12	CY13E	CY14E
Cash Flow Statement						
Rs in mn.						
Cash Flow from Operating Activities	7,051	5,631	2,209	946	3,382	5,676
Cash Flow from Investing Activities	(277)	(1,305)	(1,956)	(1,721)	(2,178)	(1,090)
Cash Flow from Financing Activities	(98)	(2,853)	(2,658)	(2,851)	164	616

source: Company accounts

LOTCHEM snapshot...





Source: Company accounts and our model

This report can also be retrieved from *Capital IQ* & www.scstrade.com