PRIME

Natural Gas Price Hike

Impact	NEGATIVE
Degree	STRONG

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"Hike" or Treat?

What new higher NG prices mean for EGX stocks and sectors

On Friday, the Egyptian government said it will raise natural gas prices for certain industries effective 1 November 2021 (tomorrow), as follows:

- **Fertilizer and petrochemical industries** will be supplied with natural gas at USD5.75/MMBTu or according to the pricing formula stated in their respective contracts.
- **Cement and iron & steel industries** will also be supplied with natural gas at USD5.75/MMBTu.
- **All other industries (including ceramics, for example)** will be supplied with natural gas at USD4.75/MMBTu.

The new natural gas prices represent a 28% hike vs. the USD4.5/MMBTu charged previously. In this note, we look at the companies and sectors in the EGX universe that we believe will be most impacted by the surprise decision. We note that Sidi Kerir Petrochemicals [**SKPC**] should not be impacted because it pays for natural gas using a pricing formula.

Why hike? Why now?

In March 2020, the Egyptian government had cut prices of both natural gas and electricity supplied to certain industries in the wake of COVID-19. Since then, with the exception of fertilizers, all other sectors reaped the fruits of such lower natural gas prices. Today, the Egyptian government decides to reverse gear, despite recent calls by certain industry players to cut prices even further. We think the new decision is mainly driven by the price rally seen recently across almost all global commodities, be it energy (e.g. oil, coal, and natural gas) or others (e.g. urea, food, etc.). We note that liquefied natural gas (LNG) prices have been up notably in the last couple of months, thanks in part to the fallout of the European energy crisis with the winter season still underway. Weak storage levels of natural gas since last winter, coupled with a tight Russian supply, spurred a significant upward price movement.

How bad is the hike?

Hiking natural gas prices for industries, especially those that are considered energy-intensive, will surely pressure operating margins. However, the big question is whether natural gas prices will be revised in the future when the current global energy crisis is behind and if so, when?

Initially, we think the effect will be felt in the form of:

- **Margin contraction** as a natural result of higher cash costs. The "trick" here for some names is to what extent the current rally in global commodity prices would compensate for higher natural gas prices.
- **Trimmed valuations** in view of lower future cash flows, pushing valuation levels lower. The "trick" here is that certain names might continue to look attractive, albeit with a capped upside.
- **Market reaction**, the trickiest of all. We believe the initial reaction would be negative at market open regardless of the impacted sector. This could pave the way for tactical opportunities later on.

Figure 1: Summary

Abu Qir Fertilizers	**ABUK**
FV / 12M PT (EGP)	21.9 / 25.4
Closing price (EGP)	21.50
Up/(downside) potential	18%

MOPCO	**MFPC**
FV (EGP)	75.0
Closing price (EGP)	101.90
Up/(downside) potential	(26%)

Egypt Kuwait Holding Co.	**EKHO/ EKHOA**
Impact per share (USD / EGP)	(0.08) / (1.3)
Closing price (USD / EGP)	1.379 / 21.40
Up/(downside) potential	(6%) / (6%)

Ezz Steel	**ESRS**
Impact per share (EGP)	(7.93)
Closing price (EGP)	15.86
Up/(downside) potential	(50%)

Lecico Egypt	**LCSW**
Impact per share (EGP)	(0.89)
Closing price (EGP)	3.26
Up/(downside) potential	(27%)

Al-Ezz for Ceramics & Porcelain (Gemma)	**ECAP**
Impact per share (EGP)	(0.65)
Closing price (EGP)	9.63
Up/(downside) potential	(7%)

Arab Ceramic Co. (Ceramica Remas)	**CERA**
Impact per share (EGP)	(0.19)
Closing price (EGP)	3.24
Up/(downside) potential	(6%)

* As of 28 October 2021.

Source: Prime Research.

Abu Qir Fertilizers [ABUK]

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Our fair value (FV) for Abu Qir Fertilizers [**ABUK**] was previously set at EGP22.6/share with a 12-month price target (12M PT) of EGP26.0/share. However, our valuation and hence price target did not reflect the recent rally in global urea prices. Had we left natural gas prices unchanged at USD4.5/MMBTu, our FV would have risen to EGP27/share with a 12M PT of EGP31/share. However, applying the now-higher natural gas prices, our FV would be trimmed to EGP21.9/share with a 12M PT of EGP25.4/share. Nonetheless, this still offers an 18% upside off Thursday's market close.

While a subsequent hike in local fertilizer prices is a possibility, we did not include it in our base case. We note that ABUK fulfills most of its local monthly quota (i.e. 77,000 tons) through ammonium nitrate as opposed to prilled or granulated urea. With the eventuality of raising local subsidized prices, we assume that local urea prices will represent 70% of export prices on average. Furthermore, we assume ammonium nitrate prices to range between USD190-314/ton. Raising local fertilizer prices at that exact pace (i.e. to be 70% of export prices) would result in an FV of EGP24.0/share with a 12M PT of EGP27.9/share, offering a more decent 30% upside off Thursday's market close.

Figure 2: ABUK's DCF valuation

EGPmn (ended 30 Jun.)	2022e	2023e	2024e	2025e	2026e	Terminal
EBIT (1 - t)	5,814	3,376	3,364	2,956	2,524	3,355
Non-Cash Items (D&A)	104	123	134	146	328	
Gross Cash Flow	**5,918**	**3,499**	**3,498**	**3,102**	**2,852**	
Change in Operating Working Capital	(347)	206	(41)	18	23	
Capital Expenditures	(281)	(885)	(1,087)	(236)	(232)	
Gross Investment	**(628)**	**(678)**	**(1,128)**	**(218)**	**(209)**	
Free Cash Flow to the Firm (FCFF)	**5,290**	**2,820**	**2,370**	**2,885**	**2,643**	**16,492**
Discount factor	0.91	0.78	0.67	0.58	0.50	
Present Value of FCFF	**4,789**	**2,202**	**1,598**	**1,679**	**1,326**	**8,271**
DCF Enterprise Value	**19,864**					
Net (Debt)/ Cash	5,585					
Other investments	2,162					
DCF Equity Value	**27,611**		**Reinvestment rate**			**16%**
NOS	1,262					
FV (EGP/share)	**21.9**		**ROIC**			**19%**
12M PT (EGP/share)	**25.4**		**TGR**			**3%**

Source: Prime Research.

Figure 3: ABUK's operational and financial KPIS

	2021/22	2022/23	2023/24	2024/25	2025/26
Total Revenues					
Prilled Urea	4,778	3,631	3,504	3,393	3,266
Granulated Urea	6,236	4,673	5,429	5,246	5,038
Ammonium Nitrate	2,278	2,317	2,430	2,578	2,745
Others	762	564	589	568	544
Total Revenues (EGPmn)	**14,055**	**11,185**	**11,952**	**11,784**	**11,594**
Volumes (ktpa)					
Prilled Urea	616	616	616	616	616
Granulated Urea	690	690	832	832	832
Ammonium Nitrate	758	758	758	758	758
Total volumes (ktpa)	**2,064**	**2,064**	**2,206**	**2,206**	**2,206**
Blended Average Prices (USD/t)					
Prilled Urea	488	364	335	306	277
Granulated Urea	568	419	385	350	316
Ammonium Nitrate	189	189	189	189	189
	428	**335**	**319**	**297**	**274**
EBITDA by Factory (EGPmn)					
Abu Qir I	2,462	1,303	1,106	900	668
Abu Qir II	690	616	654	707	768
Abu Qir III	3,973	2,337	2,511	2,197	1,844
Others	480	223	203	157	305
EBITDA	**7,606**	**4,479**	**4,475**	**3,961**	**3,585**
EBITDA margin					
Abu Qir I	51.5%	35.9%	31.6%	26.5%	20.5%
Abu Qir II	30.3%	26.6%	26.9%	27.4%	28.0%
Abu Qir III	63.7%	50.0%	46.3%	41.9%	36.6%
ABUK EBITDA margin	**54.1%**	**40.0%**	**37.4%**	**33.6%**	**30.9%**

Figure 4: ABUK's DCF sensitivity analysis

		Gas price (USD/MMBTu)				
		3.50	**4.50**	**5.75**	**6.75**	**7.75**
LT urea price	**305**	35.5	31.2	25.8	21.5	17.2
	295	34.7	30.4	25.0	20.7	16.4
	300	35.1	30.8	**25.4**	21.1	16.8
	275	33.2	28.9	23.5	19.2	14.9
	265	32.4	28.1	22.7	18.4	14.1

Source: Prime Research.

MOPCO [MFPC]

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MOPCO [**MFPC**] has long been unfazed by any changes in natural gas prices charged by the Egyptian government because it enjoys a long-term agreement whereby it is subject to a pricing formula linked to global urea prices. Indeed, this pricing formula has helped MFPC outperform its local and regional peers with regards to profitability; natural gas was supplied mostly at a price below USD4.0/MMBTu. However, MFPC's current agreement is set to expire after 2023, leaving the fate of natural gas pricing post 2023 completely unknown.

Initially, we valued MFPC at EGP100/share, considering that MFPC receives natural gas at USD4.5/MMBTu. Come the renewal of the agreement with the Egyptian government, MFPC's natural gas prices will likely be revisited, leaving MFPC's stock market price very unattractive. If we factor in natural gas prices of USD5.75/MMBTu for MFPC while altering its exports mix to be 82% of total urea production (instead of 75%), we would arrive at a lower FV of EGP75/share, 26% off Thursday's market close.

Figure 5: MFPC's DCF valuation

EGPmn (ended 31 Dec.)	2022e	2023e	2024e	2025e	2026e	Terminal
EBIT (1 - t)	4,620	3,603	2,015	1,397	698	719
Non-Cash Items (D&A)	1,160	1,160	1,160	1,160	1,160	
Gross Cash Flow	**5,780**	**4,763**	**3,175**	**2,557**	**1,858**	
Change in Operating Working Capital	(311)	139	1	25	28	
Capital Expenditures	(132)	(112)	(112)	(108)	(104)	
Gross Investment	**(442)**	**27**	**(110)**	**(83)**	**(76)**	
Free Cash Flow to the Firm (FCFF)	**5,337**	**4,790**	**3,065**	**2,474**	**1,783**	**14,125**
Discount factor	0.84	0.73	0.63	0.54	0.47	
Present Value of FCFF	**4,506**	**3,495**	**1,928**	**1,342**	**834**	**6,604**
DCF Enterprise Value	**18,709**					
Net (Debt)/ Cash	(1,192)					
Deferred taxes	(2,780)					
DCF Equity Value	**14,737**		**Reinvestment rate**			**19%**
NOS	229					
Fair value	**64**		**ROIC**			**16%**
12M PT (EGP/share)	**75**		**TGR**			**3%**

Figure 6: MFPC's DCF sensitivity analysis

TGR \ Terminal WACC	14%	15%	16%	17%	18%
5%	90.4	85.5	81.5	78.1	75.3
4%	85.1	81.1	77.8	74.9	72.5
3%	80.7	77.4	74.6	72.2	70.2
2%	77.0	74.3	71.9	69.9	68.1
1%	74.0	71.6	69.6	67.8	66.3

NG Price Post 2023 \ Export as % of sales volumes	70%	75%	82%	90%	100%
7.75	22.7	27.3	33.7	41.0	50.1
6.75	43.2	47.7	54.1	61.4	70.6
5.75	63.7	68.2	74.6	81.9	91.1
4.50	89.2	93.8	100.2	107.5	116.6
3.50	109.7	114.3	120.7	128.0	137.1

Source: Prime Research.

Egypt Kuwait Holding [EKHO/EKHOA]

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Alexfert (55.4% owned by Egypt Kuwait Holding Co. [**EKHO**/**EKHOA**]) sells urea in addition to ammonium sulphate. On average, Alexfert's annual consumption of natural gas is 20.8mn MMBTu at a price of USD4.5/MMBTu. Raising natural gas prices will cause Alexfert to incur an additional natural gas cost of c.USD26mn. In return, this will dent Alexfert's bottom line by USD20.2mn, implying USD11.2mn attributable to EKHO. Thus, the per-share negative impact on EKHO would be c.USD0.08/share. This, in turn, means that the per-share negative impact on EKHOA would be c.EGP1.3/share.

Ezz Steel [ESRS]

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Ezz Steel [**ESRS**] had a wonderful make-believe turnaround story during H1 2021, where finally selling prices improved to capitalize on lower natural gas and electricity costs. Indeed, ESRS was successful in achieving an EBITDA of EGP5.3bn, implying an EBITDA margin of 17.3%, during H1 2021. Given successive price hikes that took place since late H1 2021 until recently, we believe H2 2021 is bound to be even stronger than H1 2021, thus writing a successful end to an exceptional year.

Since the now higher natural gas prices will only cover a short window of 2021, the effect is set to fully materialize in 2022. ESRS uses natural gas as part of producing its direct-reduced iron (DRI) process, with each ton of DRI requiring some 11 MMBTu of natural gas, on average. Elsewhere, the other steel making process has each ton of steel requiring between 0.75-1.2 MMBTu, on average.

We simulated the effect of raising natural gas prices on our 2022 projections, which resulted in (1) an additional annual cost of EGP1.02bn, (2) a decrease of 155bps in GPM to 20.65%, and (3) an 8.3% lower EBITDA.

Our 2022e EBITDA assumption at a natural gas price of USD4.5/MMBTu was initially set at EGP12.3bn. At Thursday's market close (i.e. prior to raising natural gas prices), ESRS was trading at a 2022e EV/EBITDA of 4.12x. Feeling the pain of mounting costs, our updated estimate for 2022e EBITDA would be EGP11.3bn (i.e. 8% lower). If we were to apply the same 2022e EV/EBITDA of 4.12x, the per-share negative impact would be EGP7.93/share. That said, several factors should help alleviate the negative impact of higher natural gas prices, include but not limited to (1) maintaining selling prices at elevated levels, (2) lower iron ore prices, and (3) lower scrap prices which in turn supports lower DRI weight within ESRS's raw materials mix.

Figure 7: Impact on ESRS

NOS, mn	533
Market price, EGP	15.86
Market cap, EGPmn	8,452
Net debt, EGPmn	39,346
MI, EGPmn	3,099
EV (EGPmn)	**50,897**
2022e EV/EBITDA (pre NG price hike)	4.12x
2022e EBITDA, EGPmn (pre NG price hike)	12,340
2022e EBITDA, EGPmn (post NG price hike)	11,316
Annual impact on EBITDA, EGPmn	1,024
Per-share negative impact, EGP	7.93

Source: Prime Research.

Figure 8: Impact on ESRS's income statement in 2022

EGPmn	2022 prior to NG price hike	2022 post NG price hike
Total Steel volume (000 tons)	5,061	5,061
Revenues	**66,000**	**66,000**
Average price per ton (blended)	13,041	13,041
COGS	(51,345)	(52,369)
Gross Profit	**14,654**	**13,630**
GPM	*22.20%*	*20.65%*
EBITDA	12,340	11,316
EBITDA margin	*18.70%*	*17.15%*

Figure 9: ESRS's DCF sensitivity

		Blended average selling prices EGP/ton				
		11,828	12,420	13,041	13,693	14,377
DRI % in raw materials mix	60%	14.12	9.65	7.25	5.74	4.71
	65%	14.50	10.04	7.59	6.05	4.98
	70%	14.84	10.41	7.93	6.34	5.24
	75%	15.16	10.76	8.25	6.62	5.49
	80%	15.46	11.09	8.55	6.90	5.73

Egypt Cement

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Generally speaking, we see the higher natural gas prices having a neutral impact on Egyptian cement manufacturers. This is mainly because Egyptian cement manufacturers already depend on coal as their main source of energy. That said, we now believe that the potential shift back from coal to natural gas be put on the backburner for now since it would be more cost effective for them to use coals as opposed to the now-higher natural gas prices.

Egypt Ceramics

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We see a minimal negative impact on certain Egyptian ceramics manufacturers as a result of now-higher natural gas prices. We note that the year 2021 has so far witnessed a strong recovery for the industry. With only two months left in 2021, we do not see the companies badly hurt. That said, we think the recent hike in natural gas prices will impact the cost of goods sold (COGS) by only 1%, which we think can be easily absorbed this year.

We calculated the per-share negative impact for three names by capitalizing the after-tax increase in cost using each company's cost of equity, resulting in the following:

- Lecico Egypt [**LCSW**]: A per-share negative impact of EGP0.89/share (-27%).
- Al-Ezz for Ceramics & Porcelain (Gemma) [**ECAP**]: A per-share negative impact of EGP0.65/share (-7%).
- Arab Ceramic Co. (Ceramica Remas) [**CERA**]: A per-share negative impact of EGP0.19/share (-6%).

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