VTB Capital

13 February 2013

SELL

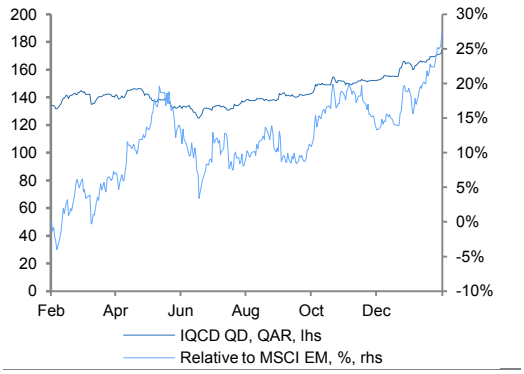
Primary ticker: IQCD QD

Currency: QAR

Stock Data

Last price	174.0
Last price date	11 Feb 2013
Target price	135.0
Target price established	12 Feb 2013
Upside/(downside), %	-22%
52 week price range	125.0 - 174.0
Market cap, USD / QAR mn	26,285 / 95,700
EV, USD / QAR mn	26,835 / 97,705
# shares outstanding, mn	550
Free float	25%
Benchmark Index (MXEF)	1,058.75

Share price performance, 12-mo



	1M	3M	12M	3Y
Price	5.4%	15%	30%	56%
Price relative	7.3%	8%	30%	36%
ADTV (USD mn)	7.07	7.72	6.58	8.69

Key financial highlights

Fiscal year end	12/11	12/12F	12/13F	12/14F
P/E, x	9.4x	8.3x	11.3x	11.4x
EV/EBITDA, x	8.9x	7.8x	10.3x	10.2x
P/B, x	2.8x	2.5x	2.7x	2.4x
FCF yield, %	8.7%	4.2%	5.7%	6.3%
DY (ords), %	4.0%	6.0%	4.4%	4.4%
Net sales, QAR mn	16,549	19,323	19,444	19,422
EBITDA, QAR mn	8,428	10,165	9,410	9,386
Net income, QAR mn	7,931	9,284	8,479	8,406
Net sales, chg	34%	17%	1%	0%
EBITDA, chg	45%	21%	-7%	0%
Net income, chg	42%	17%	-9%	-1%
EPS, QAR	14.42	16.88	15.42	15.28
DPS (ord.), QAR	5.50	8.44	7.71	7.64
BPS, QAR	48.42	56.87	64.60	72.25
EBITDA margin, %	50.9%	52.6%	48.4%	48.3%
ROE, %	30%	30%	24%	21%
Net Debt, QAR mn	(98)	1,960	1,448	366
ND/EBITDA, x	0.0x	0.2x	0.2x	0.0x
Net int. cover, x	49.6x	37.6x	29.4x	29.5x

Source: Bloomberg, Company data, VTB Capital Research

Change of Recommendation

Industries Qatar

Time to exit

Although Industries Qatar (IQ) is a great industrial asset, has very respectable cash flow yields and a robust earnings outlook, we believe that the recent price action is based on questionable earnings assumptions. We are therefore changing our recommendation on IQ from Hold to Sell, with a high degree of comfort given the lack of any impending catalysts and further earnings upside. We make no changes to our forecasts or underlying price assumptions and the change in recommendation is largely a function of optimistic earnings expectations built into Industries Qatar's valuation by the market. We believe the company's 4Q12 results (especially fertiliser unit performance) are likely to provide a potential negative surprise and advise investors to book profits in IQ at prevailing price levels.

Baseline earnings expectation ignores risks. The market is pricing in baseline quarterly earnings of QAR 2.6bn, while we believe that this is an optimistic scenario. There are a number of uncertainties in the 3Q12 results that we believe might potentially present an unrealistic longer-term picture of sustainable earnings and performance. The market is looking at the headline bottom-line numbers of 3Q12, wherein the company reported net income of QAR 2.6bn, as proof that this is likely to be the baseline for future earnings performance. Potential earnings uncertainty arising from depreciation adjustments, steel price deviations, annual year-end inventory reconciliation and stagnant COGS (even with higher volumes) represent some of the risks being ignored completely in the current assumptions of sustainable earnings capacity. This also contrasts sharply to value opportunities available in other large cap industrial names such as SABIC AB trading at similar consensus multiples but on very conservative assumptions.

Medium term fertiliser price risks need to be factored in. While our fertiliser forecasts might be deemed by some to be too conservative (USD 350/t, Middle East FOB granular) and might take longer to play out than our expected timeframe, the direction is nevertheless aligned with our view, considering the risks around surging Chinese exports, potential Indian subsidy rationalisation, potential lowering of the Ukrainian price floor and, most potently, shale gas-based risks. Our recommendation, however, is based largely on the pricing in of all the good news.

Sentiment has swung in extreme. Strategically considering stock specific factors, median international investor sentiment has turned from being too negative on capital allocation, volume growth and ROCE stability to keeping the risk horizon as a far-fetched unlikely outcome, in our view.

Valuations undemanding but price in all the good news. On valuations, Industries Qatar trades at a 2013F P/E of 11.2x on our forecast and 9.9x on the consensus earnings forecast. While the valuations are undemanding, they factor in strong fertiliser prices in the short to medium term, while our own view is less upbeat. Furthermore the stock is essentially trading in line with its regional peers at 10.0x but all good news is priced in.

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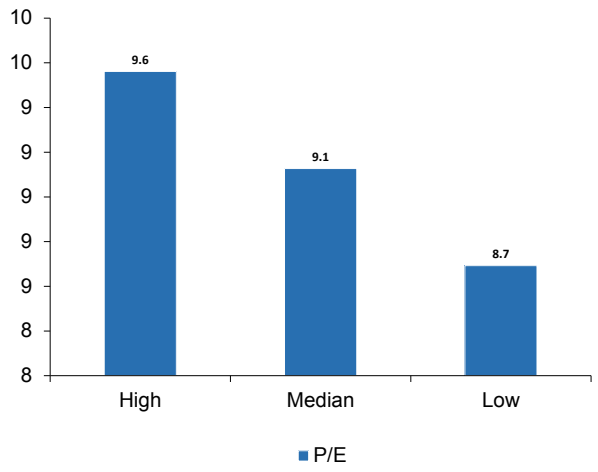
Equities

What's the market pricing in for sustainable earnings?

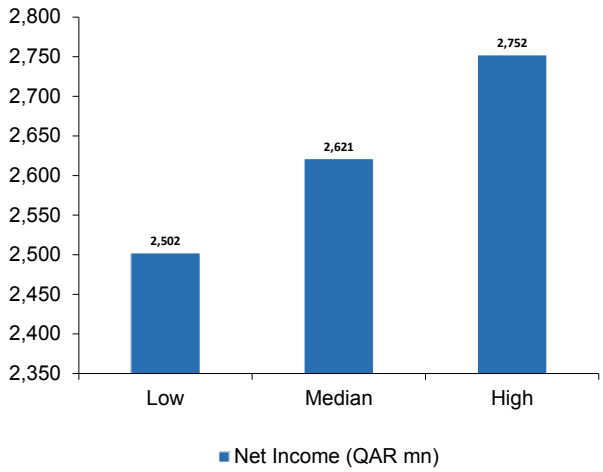
Industries Qatar has traded at a median 12 months forward P/E of 9.1x. The quarterly earnings assumption implicit in the multiple is QAR 2.6bn, at a share price of QAR 174. Even when a single standard deviation higher multiple of 9.6x is considered, the quarterly earnings assumption priced in is QAR 2.5bn.

Figure 1: Multiple range (2011-Present)



Source: Bloomberg, VTB Capital Research

Figure 2: Implied quarterly net income range

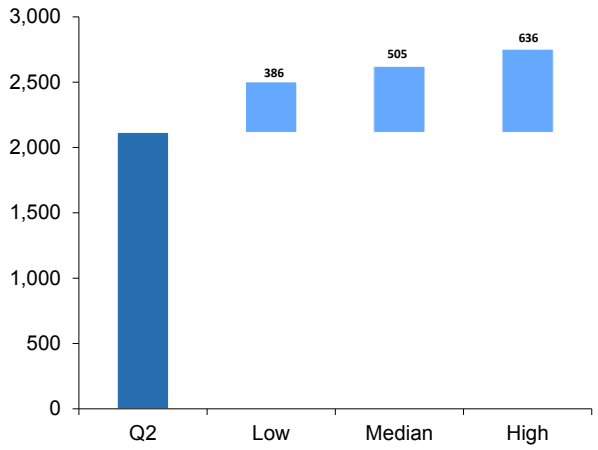


Source: Bloomberg, VTB Capital Research

Past performance provides (misplaced) conviction

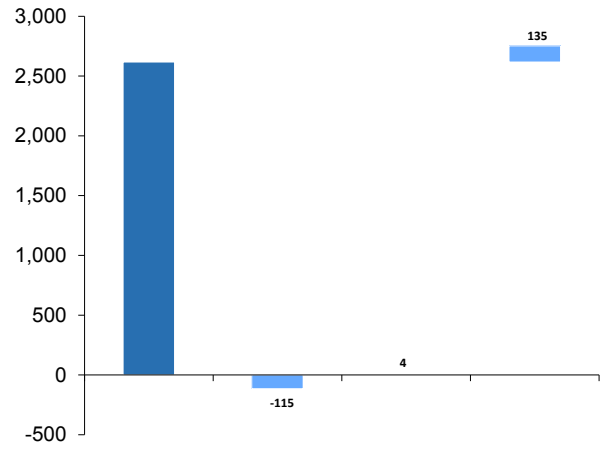
Despite the consensus estimate for 4Q12 earnings drifting downward from 28 December, the stock has registered a sharp appreciation of 12%, with international investors increasingly pricing in 3Q12 earnings performance as the baseline performance. Figures 3 and 4 show the difference in implicit earnings expectations against the baseline of 2Q12 and 3Q12 earnings. The 3Q12 baseline is largely in line with what the markets are currently pricing in for 4Q12, and as sustainable long-run, earnings.

Figure 3: Q2 actual vs expectation gap



Source: Company data, VTB Capital Research

Figure 4: Q3 actual vs expectation gap



Source: Company data, VTB Capital Research

We believe that 3Q12 profitability was a one off

3Q vs. 2Q revenues – where did the variance arise?

The 3Q12 revenue uptick was driven by primarily two factors (Figure 5): higher urea volumes, which was negated by the decline in prices, and higher ammonia prices and volumes. While volumes will sustain, price sustainability is an optimistic assumption to make, in our view.

Figure 5: Revenue variance: 2Q12 vs. 3Q12

Sales Volumes (MT '000)	2Q12		3Q12		Volume	2Q12	3Q12	Volume driven)	Price driven
	Production (kt)	Operating rate	Production (kt)	Operating rate	Variance	Price	Price	variance ('000 USD	variance ('000 USD)
Ethylene	304	111%	295	108%	-3%	945	881	(8,505)	(18,880.0)
LDPE	113	113%	102	102%	-10%	1,474	1,307	(16,214)	(17,034.0)
LLDPE	92	128%	74	103%	-20%	1,347	1,238	(24,246)	(8,066.0)
Methanol	208	83%	229	92%	10%	348	314	7,308	(7,786.0)
MTBE	173	113%	174	114%	1%	1,070	1,184	1,070	19,836.0
Ammonia	825	86%	906	94%	10%	457	612	37,017	140,430.0
Urea	1,117	101%	1,303	102%	17%	470	409	87,420	(79,483.0)
Melamine	13	87%	14	91%	8%	1,009	989	1,009	(280.0)
Rebar	499	111%	505	112%	1%	737	738	4,422	505.0
DRI/HBI	575	100%	644	112%	12%	391	407	26,979	10,304.0
Group		100%		102%					
Total								116,260	39,546
Elimination									(34,786)
Net variance									121,020

Source: Company data, VTB Capital Research

What about additional volumes for 4Q12?

Most brownfield facilities are operating at peak utilisation levels and volume uptick from these is neither going to be material nor provide a sustainable basis for revenue uplift. If we consider the greenfield plants of QAFCO V and QAFCO VI, IQ's 3Q12 urea production was 1.3mnt, which equates to an annualised capacity of 5.2mnt. Installed urea capacity post QAFCO VI is expected at 5.5mtpa. We therefore have a potential new urea volume of 75kt for 4Q12. The revenue uplift of QAR 115mn would represent 2.2% of additional revenues.

Why is QAFCO VI ramp up detrimental for earnings?

In the section above we examined the revenue impact to be immaterial. However on profitability measures, the current market pricing structure makes conversion of ammonia to urea an economically inferior decision (excluding transport costs). It takes on average 0.57 units of ammonia to produce 1 unit of urea (by weight) in IQ's plants, we estimate. Each new unit of urea volume that is produced by downstream conversion of existing ammonia to urea yields USD 72 in additional revenues. However when we factor in ammonia costs (on a cost basis) and process costs, the profitability falls incrementally by USD 19 per new unit of urea. Hence QAFCO VI, whose sole premise is to convert excess ammonia from upstream QAFCO V to urea, is immaterial if not downright detrimental for earnings uplift.

Figure 6: Urea vs ammonia trade off

	Urea	Ammonia	Difference
Price	423	615	
Unit	1	0.57	
Revenue	423	351	72
COGS per unit	138	47	
Gross Profit per unit	285	304	-19

Source: VTB Capital Research

Is there a case for operational leverage?

Across fertilisers and petrochemicals, the cost base of Industries Qatar is fixed (and low). Optimists might argue that petrochemicals are in third-to-bottom quartile margins and there is an earnings uplift opportunity, but the incremental revenue impact from a single quartile shift in petrochemical margins for marginal producers would not add more than QAR 130mn (best case) to IQ's quarterly EBITDA. In the steel segment, IQ is largely exposed to the steel cycle, being a non-vertically integrated producer. Furthermore in the case of any demand recovery in Asian steels, the midstream margin outlook is not materially brighter for the early stage in the cycle. We therefore see no case for operational leverage-driven growth in earnings spurned by broad based commodity demand recovery in Asia. On the contrary, it would be among the worst MENA plays on the theme (valuations adjusted) in such a scenario, in our view.

3Q12 vs. 2Q12 margins – Plenty to think about

To examine the cost base of Industries Qatar, we considered the inputs across each of the company's three main business lines. (IQ only discloses one significant digit after decimal for QAR, bn denomination, and the rounding up related differentials cannot therefore be considered for the purpose of analysis). Comparing 2Q12 vs 3Q12 COGS, the company managed to reduce COGS by QAR 0.1bn even while producing higher volumes of ammonia and urea with a relatively fixed price (volume weighed) input raw materials.

Fertilisers are one business segment in which margin uncertainty arises. Industries Qatar includes depreciation into COGS in segment reporting. Depreciation increased from QAR 207mn in 1Q12 to QAR 270mn in 2Q12 and QAR 287mn in 3Q12; and looking at EBITDA vs. operating profit figures, an additional QAR 0.1bn of D&A was imposed on the fertilisers segment (and included in COGS). However based on additional volumes of ammonia and urea alone, the COGS would have been an additional QAR 0.12bn higher.

Steel is another segment in which uncertainty arises. Depreciation was apparently reduced QoQ in 3Q12 by QAR 0.1bn. What is intriguing is that while historically the Qatari steel premium to international prices has not been large (< 5%) the rebar prices have remained relatively stagnant 1Q12-3Q12, and at high premia to globally prevailing prices.

Markets ignoring medium term risks and …

Fertiliser prices – we believe that it is time investors considered recent urea exports from China, which jumped from some 80 kt to 1.6mt between July and December 2012. The prices have remained stable as a function of inventory rebuild, in our view, but margin pressures might arise sooner rather than later. Chinese exports in 3Q12 matched the entire 2011 export volumes. Furthermore, if Russian Ukrainian gas negotiations settle to a price discount of 10%, the urea price floor underpinned by marginal producer Ukraine would move lower and impact both volumes and margins. The temporary shortfalls from Egyptian exports are supportive but pricing in current prices over a longer term scenario is fraught with risks, in our view. Our own estimates are at USD 350/t on a fundamental analysis, but we see limited upside from current prices. Potential subsidy cuts in India could impede demand growth in the medium term. Then there is shale gas. Dry shale gas has predominantly a C1 composition and the most profitable use of C1 in current environment across energy and chemical chains is for ammonia production. In the long run we see limited scope for being bullish on ammonia prices. The uplift from higher corn prices is largely in the price of nitrogen fertilisers and so is all the good news.

Capital allocation strategy – Less than 12 months ago an oft-repeated investor concern was around expanding in steel production and establishing overseas steel plants in countries with higher sovereign risk concerns. While steel projects got shelved, the lack of transparency in capital allocation strategy remains largely where it was 12 months ago.

Lack of growth opportunities – Irrespective of how the moratorium on North Pars shapes up, the entry of IQ's benefactor and majority owner Qatar Petroleum into development of new petrochemical projects directly, with minority participation for IQ, places a big question mark on growth opportunities for Industries Qatar in the attractive petrochemical segment where there is a significant option of scaling up in size with return on capital employed in excess of 14%.

…Short term inventory and earnings risk

Based on the uncertainties and anomalies detailed above, and coupled with operational concerns for a new plant, we believe there is a material risk of downside to market expectations. Since 28 December (*MENA Petrochemicals – 4Q earnings preview*, wherein we outlined our own forecast of QAR 2.34 bn for 4Q12), the consensus has moved lower, from QAR 2.74bn to QAR 2.38bn. The stock, however, has risen 12.1% and, as detailed earlier, the market is pricing in 3Q12 earnings as sustainable longer term earnings for IQ, discounting the margin anomalies in 3Q12 and pricing in bullish fertiliser price assumptions. Furthermore, inventory reconciliations that Industries Qatar typically concludes in **4Q** have the potential for unexpected negative surprises especially if rising iron ore costs in 4Q12 get factored in.

Disclosures

Important Disclosures

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Restricted	2	1%
Under Review	2	1%
	189	**100%**

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Buy	12	60%
Hold	7	35%
Sell	0	0%
Restricted	1	5%
Under Review	0	0%
	20	**100%**

Source: VTB Capital Research as at 31 January 2013

Price Targets

VTB Capital Research employs a Discounted Cash Flow (DCF) model as its principal valuation framework for estimating the fair and target prices of stocks. The central metric is fair current Enterprise Value (EV), which is obtained on the basis of Free Cash Flow to Firm (FCFF) discounted at a constant company-specific Weighted Average Cost of Capital (WACC).

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