PETROVIETNAM FERTILIZER & CHEMICAL CORP (DPM)

Market Price	Target Price	Dividend Yield	Rating	Sector
VND21,600	VND24,500	9.3%	HOLD	BASIC MATERIALS

Outlook – Short term	Outlook – Long term	Valuation
Negative Neutral Positive	Negative Neutral Positive	Negative Neutral Positive

4 December 2017
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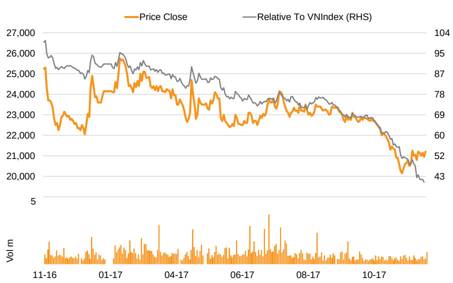
Key changes in the report

- Reduced our target price by 4%
- Revised our 2017 and 2018 forecast

Price Performance



Source: VNDIRECT

Key Statistics

52w high (VND)	25,750
52w low (VND)	20,150
3m Avg daily volume (shares)	483,229
3m Avg daily value (VNDmn)	10,579
Market cap (VNDbn)	8,453
Outstanding shares (m)	391.4
Free float (%)	20

Ownership

PetroVietnam	59.6%
Deutsche Bank AG London	3.1%
Market Vector Vietnam ETF	1.8%
Others	35.5%

Source: VNDIRECT

We maintain our HOLD recommendation for DPM, as we expect that its urea production segment will underperform amid rising oil prices. We reduced our target price to VND24,500/share in order to reflect DPM's lower-than-expected 9M 2017 ASP. A possible change in the VAT policy could be an additional catalyst for the company if it materializes, and there is also potential for further upside for DPM if its NPK sales exceed our projections.

The company's gross margin continued to decline in 9M 2017 due to the increase in oil prices. The company slightly increased its ASP by 2.5% YoY, yet this was not enough to offset the 35% YoY surge in gas input prices. This increase led to a 6.4% contraction in its gross margin. This resulted from the 50% surge in fuel oil prices in Singapore, which is used as the benchmark to calculate DPM's gas input price. As a result, the company's 9M 2017 net profit only reached VND592bn, declining by 40.2% YoY.

The company's NPK-NH_3 expansion project could be a long-term growth driver. DPM plans to do a trial run for its NPK chemical technology plant at the end of November, and for this plant to begin operating in the beginning of 2018. Given the limited room for growth in the urea segment, its 18% revenue growth in 2018 will mainly come from the contribution of its NPK segment (estimated at VND2.2trl). However, its earnings growth will not likely be as impressive due to the high fixed costs and interest expenses. We forecast that the company's net revenue and net profit for 2018 will reach VND10,092bn (+18% YoY) and VND593bn (-21% YoY), respectively, assuming that its NPK plant will operate at 70% of capacity.

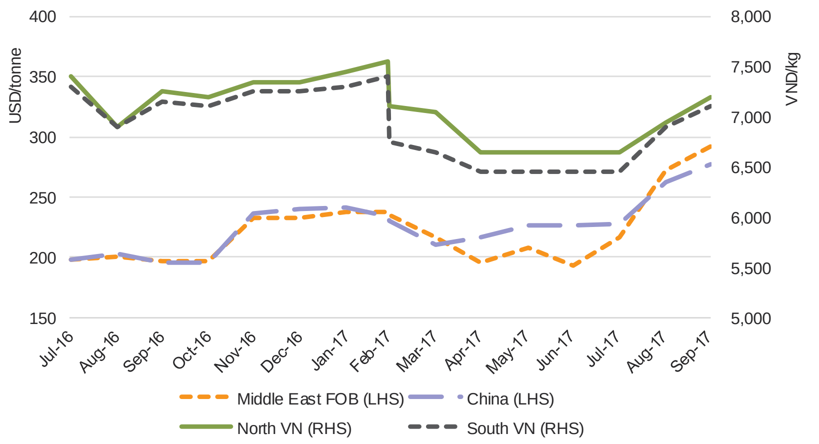
We reduced our target price by 4% to VND24,500/share, as our forecast for its urea ASP this year is now 4% lower. We now forecast that the company's 2017 EPS will reach VND1,914/share, resulting in a 2017 forward P/E of 11.3x. This is considerably higher than the company's historical 4-year average trailing P/E of 8.0x. We maintain a HOLD recommendation for DPM, given the poor prospects of the urea segment due to the likely increase in the price of oil, and the fact that growth from its new business lines will not fully kick in until later years. However, we believe that the potential news regarding the VAT policy change, and PVN's divestment from DPM, could be positive price catalysts in the future.

Financial summary (VND)	12-15A	12-16A	12-17E	12-18E
Net revenue (bn)	9,765	7,925	8,562	10,092
Revenue growth	2.3%	(18.8%)	8.0%	17.9%
Gross margin	32.3%	30.2%	24.9%	21.4%
EBITDA margin	22.0%	20.7%	14.0%	14.4%
Net profit (bn)	1,488	1,141	749	593
Net profit growth	35.8%	(23.3%)	(34.3%)	(20.9%)
Recurring profit growth	31.1%	(23.3%)	(34.3%)	(20.9%)
Basic EPS	3,917	2,929	1,914	1,514
Adjusted EPS	3,329	2,490	1,627	1,287
BVPS	21,988	20,581	20,495	20,009
ROAE	17.4%	13.9%	9.3%	7.5%

3Q 2017 Results Update

The company's 3Q 2017 net revenue rose by 16% YoY after two sluggish quarters, which mainly resulted from the 14% YoY surge in sales volume following favorable weather conditions and its aggressive sales efforts. The company's ASP also recovered mildly in September 2017, which was in line with the recovery in global urea prices. This recovery was driven by new tenders from India and consistent low exports from China.

Figure 1: International and Domestic Urea Prices



Source: VNDIRECT, Ministry of Industry and Trade (MoIT)

However, the company's gross margin continued to decline in Q3, reaching 22.5% in 3Q 2017 compared to 26.8% in 3Q 2016 and 25.8% in 2Q 2017. The decline of DPM's gross margin resulted from the sharp increase in gas input prices, which is linked to the fuel oil (FO) price traded in Singapore's market. The average FO price rose 27.9% YoY in 3Q17, leading to a 21.2% rise in its gas input price. DPM's 3Q17 net profit consequently declined by 40% YoY to VND138bn, despite its strong top line recovery.

DPM's net revenue reached VND6,463bn (+3.5% YoY) during 9M 2017, attributable to strong growth in 3Q**. However, its net profit fell to VND592bn (-40.2% YoY)** following the continuous increase in gas input prices (+35.4% YoY) and higher operating expenses (+9.9% YoY).

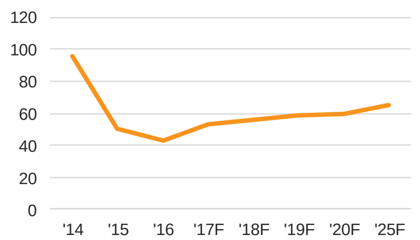
2017-2018 Prospects

We expect for 4Q17 sales to be low, as DPM will carry on a 1-month periodic maintenance during this quarter and prepare for the operation of its NPK-NH_3 expansion facilities in 1Q 2018. This could prevent the company from fully benefiting from the fourth quarter peak season demand from the start of the winter-spring crops. Based on this, we maintain our forecast of flat volume growth for this quarter and 2017, equivalent to 180,000 tonnes of sales volumes in 4Q and a total of 825,000 tonnes this year.

The recovery in the price of urea might not be enough to offset rising production costs. We expect that local urea prices will rise moderately in 2018 (+1% YoY) due to recovering demand caused by improved weather conditions and higher input costs (coal and natural gas prices). However, the price of oil is forecasted to increase by 5.6% in 2018 according to the World Bank, which would result in a further tightening of DPM's gross margin next year.

The NPK-NH_3 expansion project will become the new revenue driver in 2018. Given that the urea market is still recovering from a

Figure 2: Average Crude Oil Forecast (US$/bbl)



Source: World Bank Commodity Markets Outlook Oct 2017 recent supply overhang, DPM's diversification into high-quality NPK products will be critical to sustain growth. The company currently trades around 90-100,000 tonnes of imported NPK annually under the brand Phu My. This will allow DPM to benefit from its well established brand name and widespread distribution network, and to have an advantage over competitors in the market. In addition, the company will enjoy a 0% income tax rate for its NPK sales in 2018-2019, followed by a 10% tax rate for the next four years.

However, we are concerned that DPM might not be able to utilize the plant's full capacity of 250,000 tonnes p.a. in the first few years of operation. The NPK market is currently saturated with low-to-medium quality products and it will take time for farmer's purchasing preferences to shift towards higher quality and complex products.

We project a 70% utilization rate for the NPK plant and a 40% utilization rate for its NH_3 expansion facility in 2018. We also project that the average NPK price in 2018 will be 535 USD/tonne. This pricing is similar to the pricing for the high end products of BFC, the leading NPK producer in Vietnam. Because DPM has positioned its NPK fertilizer in the premium segment, with products manufactured using the most advanced technology in Vietnam, we believe that the high pricing for its NPK fertilizer products is justifiable. From 2019 onwards, we assume a fixed 3% growth rate in the price of NPK following a recovery in the fertilizer sector and a 5% growth rate in the price of NH_3, resulting from rising oil prices.

These above assumptions for 2018 would result in losses in the first year of operation due to high fixed costs combined with high interest expenses. As the NPK plant approaches full capacity and consumption of NH_3 picks up in later years, the project could become profitable and improve its margins. On another note, we do not discount the possibility that the ramp-up of this product line and higher ASP could result in these operations exceeding our forecast.

Figure 3: NH3-NPK complex projections

	2018	2019	2020	2021
Utilization rate (%)				
NPK	70%	80%	90%	100%
NH3	40%	70%	100%	100%
Volumes ('000 tonnes)				
NPK	175	200	225	250
NH3*	36	63	90	90
Financial projections (VNDbn)				
Revenue	2,193	2,773	3,395	3,800
Gross profit	141	298	468	530
EBIT	(61)	78	230	279
Net income**	(129)	(2)	159	219

*Volumes including the amount used for producing NPK
**Assuming SG&A equal to 3% of estimated revenue
Source: VNDIRECT

The Approval of a VAT policy change is a potential price catalyst for DPM. In August 2017, the Ministry of Finance announced the Draft law on the amendment of five tax laws, including the VAT law. Under this draft law, fertilizers would be reclassified from tax-exempt goods to goods taxed at a 5% or 10% VAT rate. The amendment will be presented at the National Assembly meetings for approval in 2018 and if it is successful, it will be effective from 2019.

The change in policy will allow fertilizer companies to have lower COGS, higher gross margins and potentially to even have a stronger cash flow from operations. Under the current VAT-exempt policy, companies do not pay output taxes, but are not returned the tax amount they paid for their inputs. If fertilizers are moved to taxed-goods bracket, companies will then receive input tax deductions, which will lower COGS and boost margins.

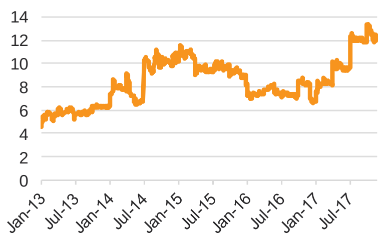
Although companies will receive tax deductions, fertilizer producers will need to pay the government output tax, and often choose to pass this cost on to customers, either wholly or partially. The net benefit depends on companies' ability to adjust selling prices, and large producers like DPM and DCM that receive larger amounts of input tax deductions will have more room to adjust selling prices to increase their competitiveness in the market.

We estimate that DPM will be the biggest beneficiary of the VAT change in the sector, saving VND290-300bn in its production costs/year. Despite the high possibility of the VAT change being approved, we have not yet factored this into our valuation, as there is no visibility on when this will actually happen.

PVN's divestment is scheduled for 2018. According to the company's representative, DPM is currently preparing two divestment scenarios to present to PVN for approval: one scenario is the sale of an 8.6% stake to reduce the state holding to 51%. The second scenario calls for further state stake sell-downs to reduce PVN's ownership to below 51%, possibly to 20-25%. We will keep an eye out for any progress or news on this front.

Valuation

Figure 4: DPM's TTM P/E during 2013-2017



Source: VNDIRECT, Bloomberg

Because of the lower than expected ASP in 9M17, we have lowered our full-year ASP forecast by 4%. However, we now expect that its revenue from trading activities will be higher than our initial projections, offsetting this decline. Hence, we forecast that its 2017 net revenue will remain rather unaffected at VND8,562bn (+8% YoY, vs. our previous forecast of VND8,524bn) but forecast that its net profit will decline to VND749bn (-34% YoY, vs. our previous forecast of VND1,043bn) as a result of the higher contribution of low-margin trading activities and higher SG&A expenses. Based on these projections, the company's 2017 EPS will be VND1,914/share, implying a 2017 forward P/E of 11.3x, much higher than the trailing 4-year average P/E of 8.0x.

For 2018, we expect that the company's net profit will decline further primarily due to an adjustment in the length of the depreciation period of its NPK-NH_3 project. According to DPM, the majority of expenses will be depreciated over 10-12 years, leading to considerably higher depreciation expenses than our previous forecast, which was based on 20 years of depreciation. Therefore, its net profit in 2018 will be largely affected by the increase in expenses.

In the upcoming period, the company's gross margin for its urea segment will likely be depressed further due to the higher gas input prices, which will not be offset by an equal rise in ASPs. Therefore, **we maintain our HOLD recommendation for DPM**, with investment highlights including the company's attractive dividend yield (which should be sustainable given DPM's large cash balance) and the pending change in the VAT policy. Downside risks include oil prices increasing higher than expected, bad weather in 2018 and harsher market competition leading to weaker fertilizer demand and prices.

Recent news on December the 1st revealed the exclusion of DPM from FTSE Vietnam Index, as the company no longer meets the index's liquidity requirements. The new index will be in effect from December

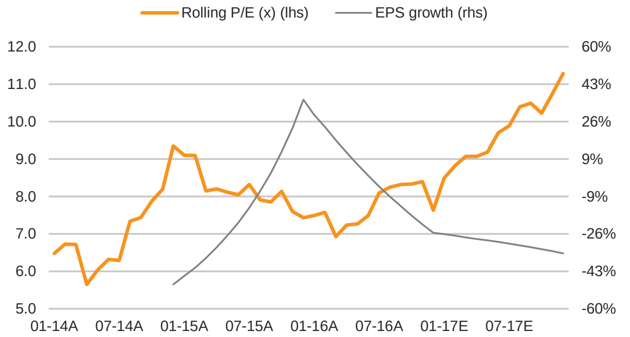
15, which could trigger a temporary sell off that is unrelated to the company's fundamentals.

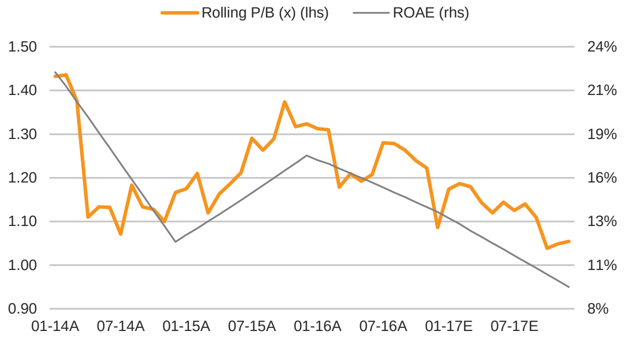
Figure 5: Forecast Revision

	2017F			2018F			
VNDbn	**Old**	**New**	**%∆**	**Old**	**New**	**%∆**	**Note**
Urea volume ('000 tonnes)	825	825	0%	833	833	0%	
Urea ASP (VND/kg)	6,797	6,552	-4%	7,035	6,618	-6%	Urea price increase at the beginning of the year could not sustain for long and 9M17 ASP was lower than our expectation.
NH3 volumes ('000 tonnes)	35	20	-43%	37	41	13%	We cut 2017 NH3 volumes as the company will reserve part of the extra NH3 produced for trial run of NPK plant.
Trading fertilizer volumes ('000 tonnes)	301	360	20%	201	240	19%	10M volumes was already reported at 330 thousand tonnes, better than our forecast, thanks to higher demand from the agriculture sector. 2018 volumes is lower than 2017 volumes to account for the decrease in imported NPK, which will be replaced by in-house NPK.
GPM of trading activities	4.8%	6.0%	+120 bps	4.8%	6.0%	+120 bps	Trading activities yielded 6.5% gross margin in 6M17 (vs. 4.5% in 6M16 and 4.8% in our forecast) thanks to higher ASPs and lower cost of sales. Thus we expect a higher gross margin for 2017 and 2018 onwards.
Net revenue	8,524	8,562	0%	9,215	9,078	-1%	
Gross profit	2,233	2,135	-4%	2,398	2,266	-6%	Total gross profit falls as the effect of lower urea and NH3 gross profit overshadows the increase in trading gross profit, noted that urea and NH3 account for over 90% of total gross profit. Higher contribution of NPK products in 2018 would further depress GPM.
Selling expenses	748	813	9%	809	851	5%	Adjusted to better reflect DPM's high expenses from sales activities and market preparation for its new NPK products.
G&A expenses	511	557	9%	553	614	11%	
EBIT	1,099	765	-30%	1,168	694	-41%	
EBT	1,273	915	-28%	1,313	749	-43%	
Net profit	1,043	749	-28%	1,100	593	-46%	
Basic EPS (VND/share)	2,665	1,914	-28%	2,810	1,514	-46%	
Adjusted EPS (VND/share)	2,265	1,627	-28%	2,388	1,287	-46%	

Source: VNDIRECT

Valuation





Income statement

(VNDbn)	12-16A	12-17E	12-18E
Net revenue	7,925	8,562	10,092
Cost of sales	(5,529)	(6,427)	(7,933)
Gen & admin expenses	(735)	(813)	(851)
Selling expenses	(499)	(557)	(614)
Operating profit	**1,161**	**765**	**694**
Operating EBITDA	1,403	1,030	1,329
Depreciation and amortisation	**(242)**	**(265)**	**(635)**
Operating EBIT	**1,161**	**765**	**694**
Interest income	234	163	115
Financial expense	(14)	(28)	(77)
Net other income	8	11	14
Income from associates & JVs	4	4	4
Pre-tax profit	**1,393**	**915**	**749**
Taxation	(228)	(150)	(144)
Minority interests	(24)	(16)	(12)
Net profit	**1,141**	**749**	**593**
Adj. net profit to ordinary	1,141	749	593
Ordinary dividends	(2,312)	(783)	(783)
Retained earnings	**(1,171)**	**(34)**	**(190)**

Balance sheet

(VNDbn)	12-16A	12-17E	12-18E
Cash and equivalents	4,099	2,877	2,049
Short term investments	55	55	55
Accounts receivables	513	547	653
Inventories	923	1,073	1,325
Other current assets	227	245	289
Total current assets	**5,816**	**4,797**	**4,370**
Fixed assets	3,261	5,315	6,393
Total investments	45	45	45
Other long-term assets	447	450	472
Total assets	**9,569**	**10,607**	**11,280**
Short-term debt	0	0	0
Accounts payable	475	553	648
Other current liabilities	684	739	871
Total current liabilities	**1,159**	**1,292**	**1,519**
Total long-term debt	0	924	1,548
Other liabilities	180	180	180
Share capital	3,914	3,914	3,914
Retained earnings reserve	625	592	402
Shareholders' equity	**8,055**	**8,022**	**7,832**
Minority interests	174	189	202
Total liabilities & equity	**9,569**	**10,607**	**11,280**

Cash flow statement

(VNDbn)	12-16A	12-17E	12-18E
Pretax profit	**1,393**	**915**	**749**
Depreciation & amortisation	242	265	635
Tax paid	(318)	(150)	(144)
Other adjustments	613	(3)	(8)
Change in working capital	**(94)**	**(67)**	**(166)**
Cash flow from operations	**1,836**	**960**	**1,066**
Capex	(1,289)	(2,309)	(1,704)
Proceeds from assets sales	0	0	0
Others	30	(13)	(31)
Other non-current assets changes	256	0	0
Cash flow from investing activities	**(1,002)**	**(2,323)**	**(1,735)**
New share issuance	114	0	0
Shares buyback	0	0	0
Net borrowings	(227)	924	624
Other financing cash flow	0	0	0
Dividends paid	(2,312)	(783)	(783)
Cash flow from financing activities	**(2,425)**	**141**	**(159)**
Cash and equivalents at beginning of period	5,690	4,099	2,877
Total cash generated	**(1,591)**	**(1,221)**	**(828)**
Cash and equivalents at the end of period	4,099	2,877	2,049

Key ratios

	12-16A	12-17E	12-18E
Dupont			
Net profit margin	14.4%	8.8%	5.9%
Asset turnover	0.77	0.85	0.92
ROAA	11.1%	7.4%	5.4%
Avg assets/avg equity	1.25	1.25	1.38
ROAE	13.9%	9.3%	7.5%
Efficiency			
Days account receivable	5.25	4.94	5.25
Days inventory	61.1	60.9	60.9
Days creditor	31.5	31.4	29.8
Fixed asset turnover	2.77	2.00	1.72
ROIC	13.9%	8.2%	6.2%
Liquidity			
Current ratio	5.02	3.71	2.88
Quick ratio	4.22	2.88	2.01
Cash ratio	3.58	2.27	1.39
Cash cycle	34.9	34.5	36.4
Growth rate (yoy)			
Revenue growth	(18.8%)	8.0%	17.9%
Operating profit growth	(35.7%)	(34.1%)	(9.3%)
Net profit growth	(23.3%)	(34.3%)	(20.9%)
EPS growth	(25.2%)	(34.6%)	(20.9%)
Share value			
Basic EPS (VND)	2,929	1,914	1,514
BVPS (VND)	20,581	20,495	20,009

Source: VNDIRECT

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Hold	The stock's total return is expected to be between negative 10% and positive 15% over the next 12 months.
Reduce	The stock's total return is expected to fall below negative 10% over the next 12 months.

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Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings	Definition:
Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.

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