PHAROS

Government Incentives

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New Incentives to Offer Respite but Will not Prevent Losses

The Government slashes natural gas and electricity prices

In an attempt to alleviate the current pressure, the government has reduced natural gas prices to USD4.5/mmbtu, down from USD5.5/mmbtu for steel, aluminum and tiles producers and down from USD6/mmbtu for cement. In our view, the key beneficiaries are ESRS, IRAX, ECAP, and LCSW. The government will also reduce the electricity tariff by EGP0.10/KWh, which will have a positive impact on EGAL and our cement coverage. We do not rule out that the government could launch a second round of incentives in the short term to support manufacturers further given that such incentives will not prevent producers from reporting losses.

Demand is highly contingent on protective measures but will be negatively affected

It is extremely difficult and nearly impossible to determine the exact magnitude on demand as we think this is highly contingent on 1) protective measures imposed locally and globally (i.e. partial or complete lock down), and 2) how long will the partial/complete lock down last besides import/export barriers. Nevertheless, we believe that demand for cyclical goods will be severely affected at least in the short term which should be felt in 1H20. In our view, highly leveraged, export oriented, and commodity driven firms will bear the brunt during this period.

Impact on steel producers

The recent reduction in natural gas price of USD1.0/mmbtu will result in savings of USD12/mmbtu (roughly EGP189/ton) and the electricity tariff cut will result in savings of roughly EGP100/ton. If we factor in the previous natural gas cut of USD1.5/mmbtu and the 300bps cut this should result in savings of EGP283/ton and EGP160/ton, respectively. If we combine together the total incentives, interest rate cut, and steel price cut of EGP1,470/ton ex-VAT since 3Q19, all else constant, this should result in gross loss/ton and net loss/ton of EGP898/ton and EGP738/ton respectively. Accordingly, we believe that losses will continue to widen in FY20 and exceed the EGP5.0bn mark given that the company reported gross loss margin of 3.0% and net loss of EGP1,852mn in 3Q19. Our estimates in table 1 are based on annual production of 4.5mn tons.

Impact on EGAL

As we previously mentioned that the tariff reduction solely will not stop EGAL from reporting losses since the company is also affected by global aluminum prices in addition to the FX rate. However, the recent reduction in electricity tariff will result in savings of EGP1,516/ton and EGP485mn if we assume that the company will run at 100%. It is worth noting that 1) EGAL's gross loss/ton recorded EGP8,807/ton in 2Q19/20, and 2) the company's utilization rate declined to 62.6% in an attempt to minimize losses. If we factor in the electricity tariff of EGP1.0'KWh in perpetuity along with our terminal estimates for Aluminum of USD2,200/ton vs USD1,640/ton currently, our FV would change to EGP16.53/ton. Nevertheless, we advise our clients to continue offloading positions in EGAL given depressed aluminum prices along with the expected demand weakness in both the local and export markets. It is worth noting that if we factor both electricity price of EGP1.0/KWh and aluminum price of USD1,640/ton in perpetuity, EGAL will report gross losses in perpetuity.

Impact on Cement

Cement companies will be affected only by the reduction in electricity tariff since the current energy cost is still lower than USD4.5/mmbtu and pet coke prices have declined to USD1.2-1.4/mmbtu (fig.1). The total savings from electricity are roughly between EGP9.0-14.0/ton. However, we do not rule out that this might be accompanied by selling price reduction given the market's huge supply/demand gap.

Impact on Tiles

Based on our estimates the recent reduction in natural gas prices and electricity should result in savings of 3.8%-4.5% in total COGS for ECAP and LCSW. However, we do not rule out that these savings might be passed onto consumers in the local market and could affect export margins positively. It is worth noting that demand will be affected negatively in both local and export markets at least in the short term.

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Table 1: Natural gas and electricity savings impact on ESRS profitability

Savings since 3Q19	Reduction	Savings/ton, EGP	Total change in profit (loss), EGP mn
Natural gas	USD2.5/mmbtu	472	2,124
Electricity	EGP0.10/KWh	100	450
Interest Rate	300 bps	160	720
Steel price cut	EGP1,470/ton	(1,470)	(6,616)
Impact on bottom line		(738)	(3,322)

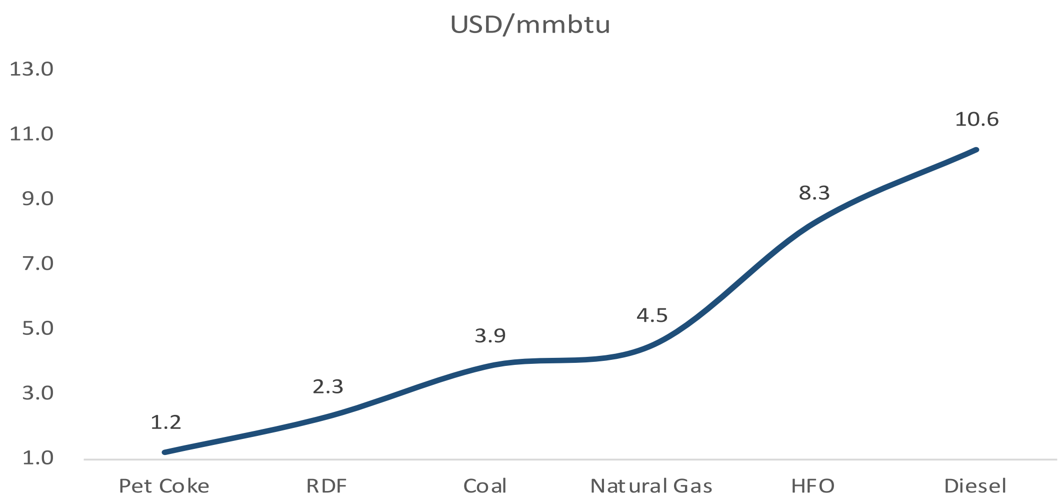
Source: Company Disclosure, Pharos Research

Table 2: EGAL Sensitivity to electricity tariff and aluminum prices in perpetuity

Electricity/Aluminum Price	Aluminum @ USD1,640/ton	Aluminum @ USD1,850/ton	Base Case Scenario	Aluminum @ USD2,300/ton	Aluminum @ USD2,400/ton
Electricity Tariff @ EGP 1.5	(23.11)	(13.22)	(0.35)	8.64	13.61
Electricity Tariff @ EGP 1.4	(19.80)	(9.88)	3.03	12.03	17.01
Base Case Scenario	(14.89)	(4.94)	8.00	17.02	22.02
Electricity Tariff @ EGP 1.0	(6.55)	3.47	16.53	25.60	30.63
Electricity Tariff @ EGP 0.9	(3.24)	6.81	19.91	28.99	34.03

Source: Company Disclosure, Pharos Research

Fig 1: Natural gas price remains higher than other energy sources



Source: Bloomberg, Company Disclosure, Pharos Research

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