

PANAMA PETROCHEM

INR 133

At inflection point

BUY

* Growth led by buoyant user industries

Panama Petrochem (Panama) manufactures specialty petroleum products that serve as raw materials for various industries like inks and resins, textiles, rubber, pharmaceuticals, cosmetics, transformers and power cables. These industries are growing significantly on the back of strong demand growth for their manufactured goods, which in turn, is propelling Panama's growth. Panama also has a well-diversified customer profile, eliminating risks of revenue concentration.

* Petronas' gateway to India

Panama has tied-up with Petronas, the Malaysian oil and gas (O&G) giant, to distribute Petronas' high end auto lubricant 'Syntium' in India. Petronas is keen on entering the Indian markets in a big way and plans to launch more of its products here. Panama, the most likely medium for Petronas' Indian foray, stands to benefit greatly, as the alliance will give Panama a foothold in the ~INR 5 bn high end auto lubes market in India. Depending on Syntium's success, Panama will also start blending and packaging Petronas' products at its Baddi plant in future. We expect this division to generate ~INR 12 mn of revenues in FY07E with gross margins of ~12%.

* FY09- Doubling capacities, tripling revenues

Panama is doubling its existing capacities at a cost of ~INR 400 mn funded through a mix of debt and equity. An expansion of 15,000tpa at the existing plants and a 30,000tpa greenfield plant at Baddi will take the company's total capacities to 88,100mtpa by FY08E. Panama plans to manufacture mining oils in its Baddi facility along with other high value speciality chemicals. We believe that with higher volumes on the back of additional capacities will more than triple Panama's revenues from INR 1bn in FY06 to INR 3.6bn in FY09E.

* Valuations

We estimate Panama's revenues and profits to grow at a 25% and 26% CAGR, respectively, between FY07E and FY09E. At the current market price of INR133, the stock trades at 5.7x FY07E EPS of INR 23.2 and 4x FY08E EPS of INR 33. Given its expansion plans, improving product mix, strategic alliances, excellent return ratios, and extremely attractive valuations, we initiate coverage on the stock with a 'BUY' recommendation.

Financials

Year to March	FY06	FY07E	FY08E	FY09E
Revenues (INR mn)	1,093	1,894	2,777	3,699
EBITDA (INR mn)	100	145	218	300
Net profit (INR mn)	65	100	142	198
EPS (INR)	15.4	23.2	33.0	46.1
EPS growth (%)	84.7	51.2	42.2	39.7
PE (x)	8.7	5.7	4.0	2.9
P/CEPS (x)	8.2	5.3	3.4	2.4
EV/EBITDA	5.9	5.8	5.8	4.4
Dividend yield (%)	2.3	3.8	3.8	3.8
ROE (%)	30.5	34.4	34.8	34.1



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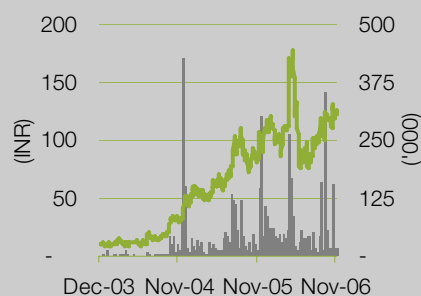
Reuters : PAPT.BO
Bloomberg : PNPC IN

Market Data

52-week range (INR) : 185 / 71
Share in issue (mn) : 4.3
M cap (INR bn/USD mn) : 0.5 / 12.0
Avg. Daily Vol. BSE ('000) : 32.4

Share Holding Pattern (%)

Promoters : 40.8
MFs, Fls & Banks : 0.3
Fls : 4.7
Others : 54.2



Risks and Concerns

- Volatility in prices of base oil, the key raw material
- Project execution ability

Company Profile

Panama is a leading manufacturer and exporter of petroleum specialty products and solvents. Its wide range of products like ink oils, cable jelly, anti static coning oil, and transformer oil find applications in varied industries like textiles, cosmetics, pharmaceuticals, telecom cables, and transformers.

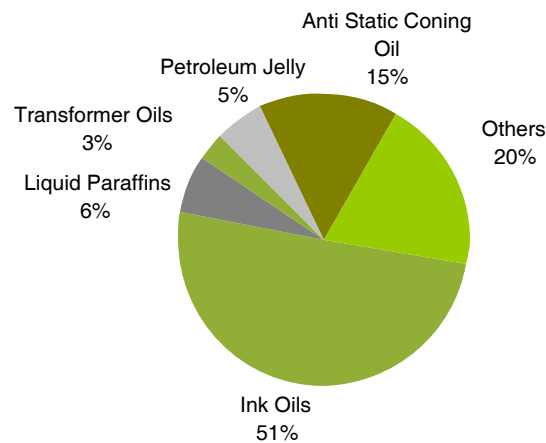
Panama has two plants - one at Ankleshwar and the other at Daman with capacities of 23,000mtpa and 20,000mtpa respectively. Both these plants have flexible manufacturing facilities, wherein, capacities can be swung easily between products as per customer specification and demand. The Daman plant was put up in 2003, especially to cater to the large client base in the surrounding region; this facility will continue to enjoy income tax benefits till 2008.

Panama sells 85% of its production in the domestic market to a diverse clientele, including companies like Mico Inks, Alok Textiles, JBF Industries, Garden Silk, Cipla, and Usha Martin. The remaining is exported to the US, UK, Middle East, and Australia.

Panama also has a ten-year marketing tie-up with Lubcon, a German MNC, for marketing its oil and grease products in India. In FY06, this alliance contributed INR 92mn to Panama's total revenues; the alliance's contribution to the company's revenues is expected to grow at 10% annually.

* Product mix

Chart 1: FY06 Revenue mix



Source: Company

Ink oils contributed INR 550mn (51%) to Panama's total FY06 revenues. **Ink oils**, as the name suggests, are used in the manufacture of printing inks. Micro Inks is one of Panama's major customers for this product.

Panama is the only organised large scale producer of **anti-static coning oil** used in the texturising of synthetic yarn such as viscose, rayons, and polyesters. The company plans to focus on this product, as it yields relatively higher margins and has been seeing an increase in demand for the past few months, especially from the textile belt in Gujarat. It is a regular supplier to texturisers like Alok Industries and JBF Industries. Anti-static coning oil generated revenues of INR168 mn in FY06, contributing 15% to the topline, which we expect would go up in the future.

Panama also manufactures **liquid paraffin and petroleum jelly**, which are widely used in the cosmetics and the pharmaceutical industries. Liquid paraffin (popularly known as white oil) is used as a blending base in cosmetics. The oil is skin friendly and adds softness and smoothness to the final product. Petroleum jelly is used as a base in ointments and creams.

Transformer oil is another Panama product with a turnover of INR 35mn in FY06. Currently, the company supplies transformer oil to most of the state electricity boards (SEBs) in India. The Indian transformer oil industry is estimated at ~INR 5.5bn and is expected to grow at a rapid pace, owing to the huge investments being made in power transmission and distribution (T&D) sector. This augurs well for Panama's **transformer oil** division.

Panama sells **rubber processing oil** under its own brand *PANOIL*. The oil is used in the manufacture of automotive tyres and tubes, bi-cycle tyres, and tyre rethreading material. Its other brand *PANGEL* is the filling compound used in jelly filled telecom cables and co-axial cables.

* **Syntium—entry into the auto lubricants industry**

Petronas Syntium is a synthetic multigrade engine oil, specially designed for high performance engines, especially those fitted with emission control devices. It is formulated with premium quality base oils that provide excellent thermal and oxidation stability and ensure minimum oil thickening. This product is targeted at the premium segment including special utility vehicles (SUVs) and high performance and luxury cars. Currently Petronas sells Syntium in Malaysia and Indonesia, while Motorex distributes it in Switzerland. Globally there are only 3-4 players in the segment like Exxon, Chevron and others.

* **Raw material price increase can be passed on**

Base oil is the major raw material for Panama forming 82% of sales. In FY05, many base oil manufacturers shifted their production from base oil to other petroleum products; consequently, there was a shortage in supply of base oil. This coupled with increasing crude oil prices saw base oil prices move up by more than 50% in less than a year. However, fresh base oil capacities are now being added, especially in Korea which plans to double its existing capacities. With supplies being restored, base oil prices have now started cooling off and are expected to remain stable going forward. Panama usually has long term contracts with built in escalation clauses and can easily pass on the increase in raw material prices to its clients. This is evident from the fact that inspite of increasing base oil prices, the company's EBITDA per tonne has increased from INR 1440 per tonne in FY04 to INR 3006 per tonne in FY06 and we believe it will continue to do so going ahead.

Chart 2: Rising EBITDA per tonne



Source: Company, Edelweiss research

* **Competitive scenario**

Savita Chemicals and Apar Industries are among other players in the petroleum specialty products industry in India. Though these companies have similar products, their revenue mix differs to some extent.

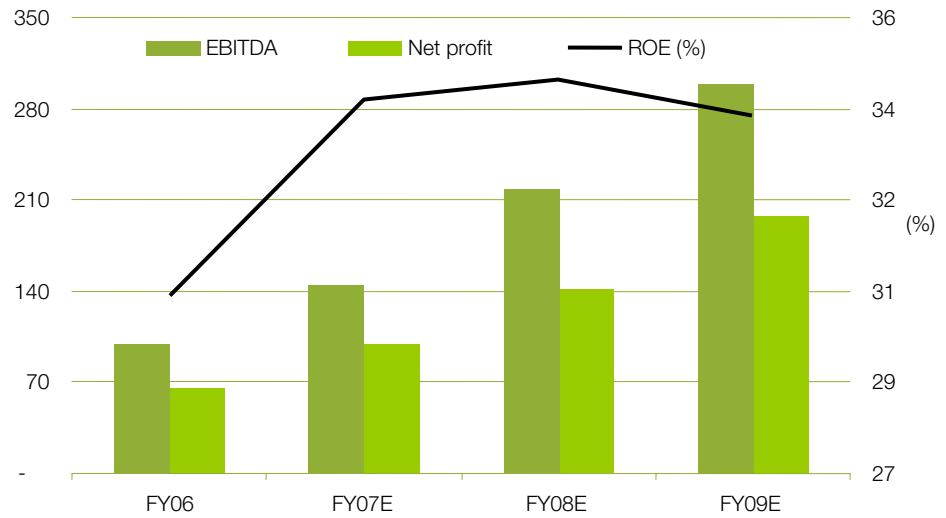
Table1: Peer comparison

FY07E	Panama	Savita	Apar
Revenues (INR mn)	1,894	7,793	14,870
EBIDTA (INR mn)	145	605	1,058
margins %	7.6	7.8	7.1
Net Profit (INR mn)	100	440	585
margins %	5.3	5.6	3.9
EPS (INR)	23.2	50.2	28.1
PE (x)	5.7	10.0	8.7
Dividend yield (%)	3.8	2.5	1.6
ROE (%)	34.4	22.9	27.7

Source: Edelweiss research

Outlook

Chart 3: Improving profitability



Source: Company, Edelweiss research

As Panama has not yet decided its funding mix, we have assumed that it will raise debt to meet its capex requirements and have capitalized a part of the interest expenses in our projections.

Panama has recorded revenue and profit CAGR of 29% and 68%, respectively between 2004 and 2006. It has been a consistent dividend paying company with healthy return ratios. Panama intends to achieve a revenue target of INR 10bn within the next five years. Along with capacity expansions the company is also looking for inorganic growth opportunities to attain its revenue objective. Any positive developments on the Petronas alliance front could act as a growth trigger for the stock.

We estimate Panama's revenues and profits to grow at a 25% and 26% CAGR respectively, between FY07E and FY09E. At the current market price of INR133, the stock trades at 5.7x FY07E EPS of INR 23.2 and 4x FY08E EPS of INR 33. Given its expansion plans, improving product mix, strategic alliances, excellent return ratios, and extremely attractive valuations, we initiate coverage on the stock with a **BUY** recommendation.

Panama Petro (CMP 133)



- The stock has underperformed the mid-cap index with a wide margin. The mid-cap index is hardly 5% below its all time high but Panama is still 25% below its all time high of INR 185.
- The stock has crossed the intermediate resistance at INR 120 and has been sustaining around that level for the last one month. This indicates a strong sign of price up-move in the short term (one month).
- The stock has formed strong support around INR 110 levels and any weakness around this price level should be taken as buying opportunity with stop of INR 90.

Financial Statements

Income statement					(INR Mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net Sales	725	1,093	1,894	2,777	3,699
Raw material cost	628	924	1,644	2,416	3,209
Employee cost	4	5	8	10	15
Power & fuel cost	2	2	4	6	7
Other mfg exp	16	19	33	46	59
Selling & administration expenses	25	36	57	76	102
Miscellaneous expenses	1	7	4	6	7
Total operating expenses	677	993	1,749	2,559	3,400
EBITDA	48	100	145	218	300
Other income	7	2	4	2	2
Interest expense	11	21	23	33	36
Depreciation	3	4	9	25	40
Profit before tax	42	77	117	161	225
Provision for tax	7	11	18	19	27
Profit after tax	35	65	100	142	198
Net profit	35	65	100	142	198
Earnings per share	8.3	15.4	23.2	33.0	46.1
Shares outstanding	4.3	4.3	4.3	4.3	4.3
Dividend (INR/share)	2.5	3.0	5.0	5.0	5.0

Common size metrics as % on revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Operating expenses	93.3	90.8	92.4	92.2	91.9
Depreciation	0.4	0.4	0.5	0.9	1.1
EBITDA margins	6.7	9.2	7.6	7.8	8.1
Net profit margins	4.9	6.0	5.3	5.1	5.4

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	43.3	50.8	73.3	46.6	33.2
EBITDA	78.9	107.7	44.5	50.5	37.5
PBT	87.1	83.1	53.1	37.4	39.7
Net profit	154.7	84.7	52.6	42.2	39.7
EPS	124.8	84.7	51.2	42.2	39.7

Cash flow statement

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Cash flow from operations	38	70	108	167	238
Cash for working capital	(53)	(28)	(203)	(208)	(218)
Net operating cash flow- A	(14)	41	(94)	(41)	20
Net purchase of fixed assets	(7)	(4)	(121)	(353)	(62)
Net purchase of investments	(0)	-	0	-	-
Net cash flow from investing- B	(7)	(4)	(121)	(353)	(62)
Proceeds from equity	5	-	0	-	-
Pro./repayments from borrowings	(15)	20	201	425	60
Net cash flow from financing- C	2	6	177	401	36
Net cash flow (A+B+C)	(19)	44	(38)	7	(7)

Balance sheet					(INR mn)
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	43	43	43	43	43
Reserves & surplus	121	172	247	365	539
Shareholders funds	164	214	290	408	582
Secured loans	49	73	273	698	758
Unsecured loans	14	11	11	11	11
Deferred tax liability	1	1	1	1	1
Total debt	63	84	284	709	769
Source of funds	228	299	575	1,118	1,352
Gross block	60	63	184	538	600
Depreciation	22	27	35	60	100
Net block	37	37	149	477	500
Net fixed assets	37	37	149	477	500
Investments	0	0	-	-	-
Cash, bank bal & deposits	15	58	20	26	20
Inventory	191	286	467	685	912
Sundry debtors	158	258	446	654	872
Loans & advances	30	40	40	40	41
Total current assets	394	641	973	1,406	1,844
Sundry creditors	146	300	467	685	912
Others	40	39	40	40	40
Provisions	18	40	40	40	40
Total current liabilities	204	380	547	765	992
Net current assets	190	262	426	641	852
Application of funds	228	299	575	1,118	1,352
Book value (BV) per share	38	50	68	95	135

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROE (%)	21.6	30.5	34.4	34.8	34.1
ROCE (%)	20.3	28.9	21.3	15.7	17.4
Inventory days	96	95	90	90	90
Debtor days	80	86	86	86	86
Fixed assets t/o	11.5	15.9	10.3	5.2	6.2
Debt /Equity	0.4	0.4	1.0	1.7	1.3

Valuation parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS (INR)	8.3	15.4	23.2	33.0	46.1
YoY growth (%)	124.8	84.7	51.2	42.2	39.7
CEPS (INR)	9.0	16.3	25.2	38.9	55.4
PE (x)	16.0	8.7	5.7	4.0	2.9
P/CEPS (x)	14.8	8.2	5.3	3.4	2.4
Price/BV (x)	3.5	2.6	2.0	1.4	1.0
EV/Sales (x)	0.8	0.5	0.4	0.5	0.4
EV/EBITDA (x)	12.7	5.9	5.8	5.8	4.4

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