Saudi Petrochemicals Sector

Petrochemicals –Industrial
Saudi Arabia
10 October 2010

الراجحي المالية
Al Rajhi Capital

US$87.6bn	**27.7%**	**US$174.0mn**
Market cap	Free float	Avg. daily volume

Target mkt cap	**SAR378bn**	15.1% over current
Consensus mkt cap.	**SAR411bn**	25.8% over current
Current mkt cap.	**SAR329bn**	as at 06/10/2010

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Underweight	Neutral	**Overweight**

Key themes

We expect Saudi petrochemicals suppliers to outperform global rivals with margins driven by cheap feedstock costs and strong demand coming from Asia. We believe a shift towards heavier, more expensive feedstock in plants from now on will not constrain profits growth as improving prices and higher volumes should offset the higher costs.

Implications

We like SABIC's broad business mix, its low cost production and its strategy of high investment. Sipchem should see a strong recovery as new investment diversifies revenue streams and moves it further up the petrochemicals value chain. Conversely, Saudi Kayan has suffered severe delays in plant construction and we do not expect it to record sales of profits for nearly two years. We do not have ratings on Yansab and PetroRabigh.

What do we think?

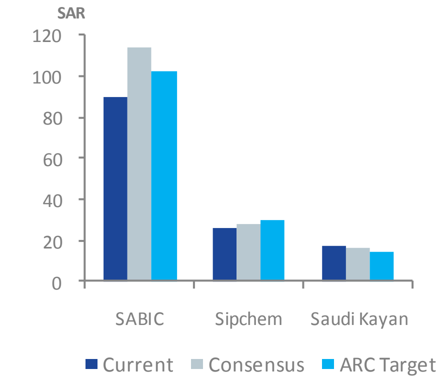
Stock	Rating	Price Target
SABIC	Overweight	SAR105.5
Sipchem	Overweight	SAR30.3
Saudi Kayan	Underweight	SAR14.4
Yansab	No rating	
Petro Rabigh	No rating	

Why do we think it?

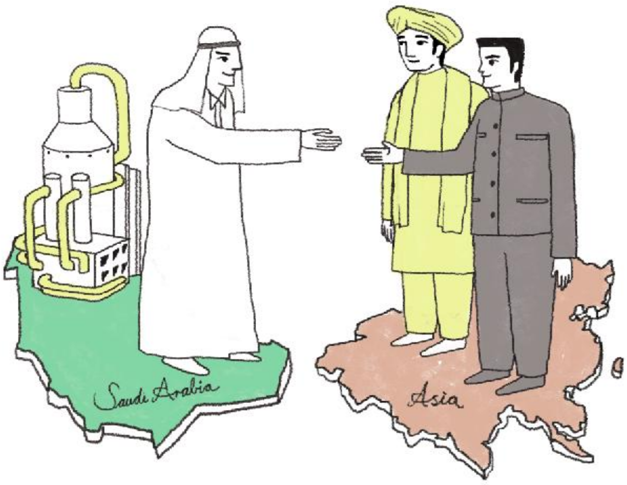
Stock	3 year EBITDA CAGR*	2010 EV/EBITDA
SABIC	10.3%	7.4x
Sipchem	18.0%	11.7x
Saudi Kayan	NA	NA
Yansab	12.5%	13.9x
Petro Rabigh	11.3%	15.4x

* 2010-2013, ie after strong cyclical recovery in 2009-10

Where are we versus consensus?



Source Bloomberg, Al Rajhi Capital



Saudi Petrochemicals Sector: Capex-led growth to drive Q3 2010

We expect the Saudi petrochemicals sector to report a strong Q3 2010, driven by growth in volumes and improving capacity utilisation. This in turn reflects continued high capex by the Saudi petrochemicals majors, which we believe is justified because it helps them to meet surging demand in China and Asia. While Q3 was marred by declines in petrochemicals prices on a quarter-on-quarter basis, this does not change our reasons for long-run optimism. We remain Overweight on SABIC and Sipchem, and Underweight on Saudi Kayan.

Capacity additions driving sector growth. We believe that volume growth from new capacity coming on stream so far in 2010 was the key factor driving Q3 performance. During the year, Yansab has commenced commercial production and the Phase 2 production facilities of Sipchem have come on stream. Furthermore, Sipchem recently announced expansion of its Phase 3 programme, while PetroRabigh has started construction of its Phase 2 expansion.

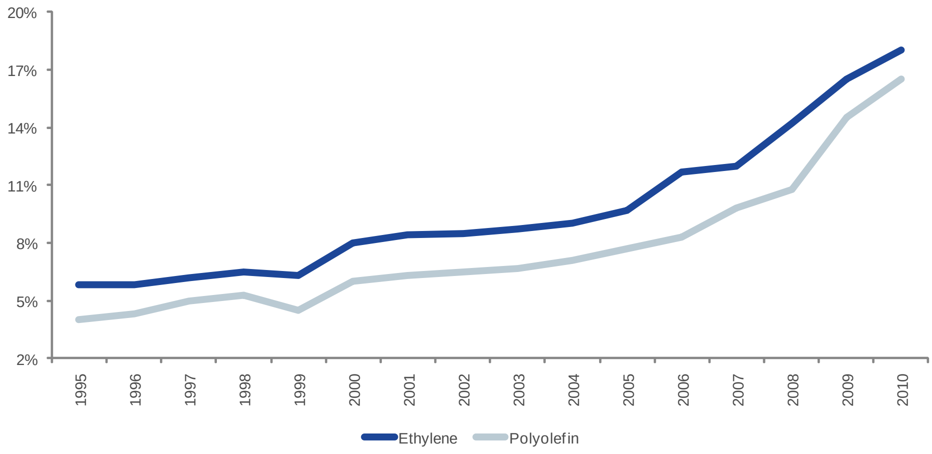
Growth momentum to continue in Q3. We expect the Saudi petrochemicals sector to record a 26% year-on-year aggregate increase in sales in Q3 2010 primarily due to a rebound in petrochemicals prices versus last year and the commissioning of new units in 2010. We estimate aggregate EBITDA of SAR15.77bn and expect the aggregate EBITDA margin to increase from 23.0% to 35.3%. This outcome should permit aggregate net profit in Q3 almost to double to SAR5.85bn during the period.

Pricing pressure. Notwithstanding the year-on-year recovery, petrochemicals prices started to weaken earlier in 2010. We believe that average prices of basic petrochemicals remained under pressure during Q3 2010 and fell by around 7% compared to Q2. This factor tempers our optimism about short-term prospects.

Conclusion. Low cost of production, aggressive capex plans and rising demand from Asian economies are the key drivers for the Saudi petrochemicals sector. As explained in our comprehensive report *Saudi Petrochemicals Sector: Advantage Saudi Arabia* (4th August, 2010), these factors underline our view that the sector will turn into a formidable global force over the coming decade. We remain Overweight on SABIC and Sipchem with marginally revised target prices of SAR105.5 and SAR30.3 respectively, implying 17-19% upside potential.

Middle East has seen rapid petrochemicals capacity growth since 2007

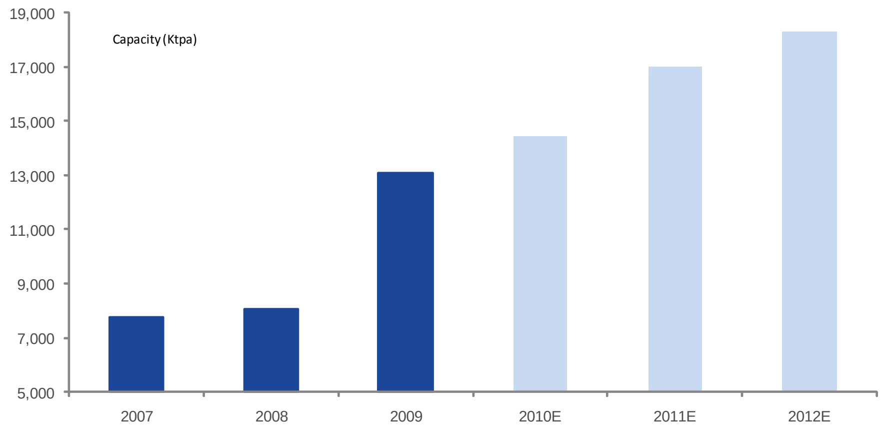
Figure 1. Share of Middle Eastern capacity in global petrochemicals production



Source: Industry data, Al Rajhi Capital

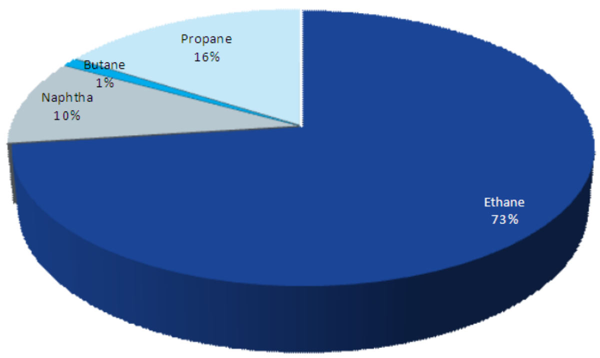
Saudi Arabia is leading capacity additions

Figure 2. Saudi Arabia ethylene capacity



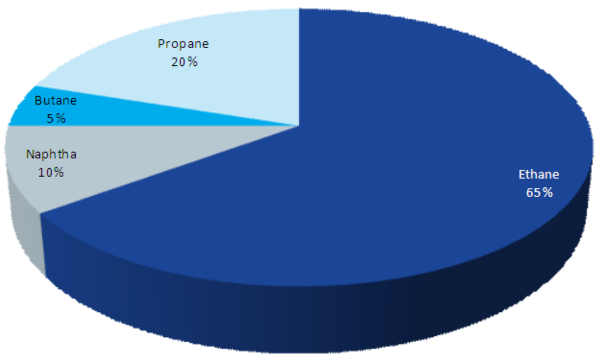
Source: Industry data, Al Rajhi Capital

Figure 3.1 Saudi Arabia: feedstock composition (2007)



Source: Industry data, Al Rajhi Capital

Figure 3.2 Saudi Arabia: feedstock composition (2014e)



Source: Industry data, Al Rajhi Capital

Sector outlook: capex-led growth but price pressures

Capacity additions driving sector growth

We expect the Saudi petrochemicals sector to record a 26% year-on-year aggregate increase in revenues in Q3 2010 primarily due to a year-on-year rebound in petrochemicals prices and the commissioning of new units in 2010. During the year, Yansab has commenced commercial production and the Phase 2 production facilities of Sipchem have come on stream. Furthermore, Sipchem recently announced expansion of its Phase 3 programme, while PetroRabigh has started construction of its Phase 2 expansion. We estimate aggregate EBITDA of SAR15.77bn and expect the aggregate EBITDA margin to increase from 23.0% to 35.3%. We expect operating profit to increase by 61% year-on-year to SAR9.08bn, and net profit almost to double to SAR5.85bn.

Average petrochemical prices fell in Q3 2010 from the level of Q2

Although average petrochemicals prices in Q3 2010 increased on a year-on-year basis, prices have seen a correction so far in 2010. Based on various sources, we believe that average prices of basic petrochemicals fell by approximately 7% in Q3 versus Q2. On a quarter-on-quarter basis, therefore, we expect aggregate net profit in the sector to increase only marginally, with the positive impact of higher volumes offset by lower prices. Note: the average oil price was US$77 per barrel during Q3, marginally higher than our assumption of US$75. The oil price does not directly affect our forecasts but certainly affects sentiment towards the sector.

Figure 4. Saudi PPC sector

(SAR mn)	Q3 2009	Q3 2010E	% Chg
SABIC			
Revenues	27,984	30,456	8.8%
EBITDA	8,692	13,706	57.7%
EBITDA margin (%)	31.1%	45.0%	
Operating Profit	6,360	7,648	20.3%
Net Profit	3,648	5,178	41.9%
Yansab			
Revenues		2,051	n.a.
EBITDA	(7)	627	n.a.
EBITDA margin (%)	n.a.	30.6%	
Operating Profit	(7)	428	n.a.
Net Profit	(7)	376	n.a.
Saudi Kayan			
Revenues			
EBITDA			
EBITDA margin (%)			
Operating Profit	(4)	(6)	50.0%
Net Profit	(4)	(5)	25.0%
PetroRabigh			
Revenues	7,301	11,533	58.0%
EBITDA	(569)	1,047	n.a.
EBITDA margin (%)	-7.8%	9.1%	
Operating Profit	(746)	765	n.a.
Net Profit	(845)	185	n.a.
Sipchem			
Revenues	197	689	249.7%
EBITDA	50	390	680.0%
EBITDA margin (%)	25.4%	56.6%	
Operating Profit	32	248	675.0%
Net Profit	55	115	109.1%
Aggregate			
Revenues	35,482	44,729	26.1%
EBITDA	8,166	15,770	93.1%
EBITDA margin (%)	23.0%	35.3%	
Operating Profit	5,635	9,083	61.2%
Net Profit	2,847	5,849	105.4%

Source: Company data, Al Rajhi Capital

SABIC (Overweight)

Higher year-on-year petrochemical prices to drive growth in Q3

We expect SABIC to report revenues of SAR30.46bn in Q3 2010 compared to SAR 27.98bn in Q3 2009 as a result of higher year-on-year petrochemicals prices and an increase in production volume. Our estimate for EBITDA is SAR13.71bn for Q3 2010 versus SAR8.69bn in the same quarter of 2009. We assume higher EBITDA due to growth in sales and cost optimisation. We estimate that net profit increased by 42% on a year-on-year basis to SAR5.18bn, but by only 3% versus net profit of SAR5.02bn in Q2. We do not expect any material impact on SABIC's Q3 earnings from the two week shutdown of Yansab's facility in September 2010.

We have raised our target price marginally, to SAR105.5

We have raised our estimate of long-run fair value per share on a discounted economic profit (DEP) basis for SABIC by 3%, from SAR102.7 to SAR105.5. This simply reflects an omission on our part: we had not included associates and other long-term investments on the balance sheet (SAR8.3bn at the end of 2009) in our valuation, but should have done so. We have made no other changes to our model. As in our comprehensive sector report of August, we take long-run fair value per share as our target price. Based on our new target price, SABIC offers 17% upside from the closing price of SAR90.0 on 9th October.

Yansab (No rating)

Higher plant operating rates to propel Yansab's earnings

Yansab only launched commercial production in Q1 2010. We estimate Yansab's Q3 2010 revenues at SAR2.05bn and EBITDA at SAR627mn. We estimate operating profit at SAR428mn and net profit at SAR376mn (implying a net margin of around 18%). On a quarter-on-quarter basis, we estimate revenue growth of 25% driven mainly by an increase in capacity utilisation. In September, Yansab's unit was non-operational for two weeks due to technical failure. Yansab has not specified the production unit's operating rates; however we are estimating a cracker utilisation rate of 80% for 2010 as a whole.

Saudi Kayan (Underweight)

Trial operations have started in Q3 2010

We expect Saudi Kayan to report a net loss of SAR5mn for Q3 2010 as its plants are in pre-operational stage. Saudi Kayan started trial operations at its olefins plant at the end of July and at its ethylene glycol and polypropylene plants in August. Currently we assume that the commercial production will not start until Q1 2012. In August 2010, the company received an SAR4.5bn loan from National Commercial Bank to part-finance the expected cost escalation of its Jubail petrochemicals plant. The cost over-run is estimated at around SAR9bn. We retain our Underweight rating on Saudi Kayan with an unchanged target price of SAR14.4.

PetroRabigh (No rating)

New unit to drive Q3 2010 performance

We expect PetroRabigh to report revenues of SAR11.53bn in Q3 2010, representing year-on-year growth of 58%. This reflects a year-on-year recovery in petrochemicals prices and growth in volumes. We estimate EBITDA at SAR1.05bn in Q3 2010 compared to an EBITDA loss of SAR569mn in Q3 2009. We predict net profit of SAR185mn for Q3 compared to a net loss of SAR845mn in Q3 2009. We attribute the increase in the net result to the commissioning of units which were not operational in Q3 2009. In August, PetroRabigh also faced technical difficulties which halted production for around two weeks. However we do not expect any material impact from this shutdown on Q3 2010 earnings.

Sipchem (Overweight)

Sipchem to build ethyl acetate plant by year 2013 as a part of Phase 3 expansion

We expect Sipchem to report revenue of SAR689mn in Q3 2010 compared to SAR197mn in Q3 2009 as a result of the completion of its Phase 2 expansion in Q1 2010. We expect EBITDA to surge from SAR50mn to SAR390mn as a result of increased revenue coupled with a higher gross margin. Wed forecast operating profit of SAR248mn compared to SAR32mn in the same period of 2009. On a year-on-year basis we expect net profit to increase by more than 100% to SAR115mn in Q3 2010. As part of its Phase 3 expansion, Sipchem recently signed an agreement with France's Rhodia Co. to build a new ethyl acetate plant. The ethyl acetate plant is expected to be commissioned in 2013 with a capacity of around 100,000-metric tons per annum.

We have raised our target price marginally, to SAR30.3

We have pushed up our estimate of long-run DEP fair value per share for Sipchem by 2%, from SAR29.7 to SAR30.3. This reflects slightly more positive assumptions in our model about long-run invested capital growth and asset turnover; we have made no changes to our near-term forecasts. As in our comprehensive sector report of August, we take long-run fair value per share as our target price. Based on our new target price, Sipchem offers 19% upside from the closing price of SAR25.5 on 9th October.

Disclaimer and additional disclosures for Equity Research

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Additional disclosures

1. Explanation of Al Rajhi Capital’s rating system

Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:
"Overweight": Our target price is more than 15% above the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.
"Neutral": We expect the share price to settle at a level between 5% below the current share price and 15% above the current share price on a 6-9 month time horizon.
"Underweight": Our target price is more than 5% below the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

2. Definitions

"Time horizon": Our analysts make recommendations on a 6-9 month time horizon. In other words, they expect a given stock to reach their target price within that time.
"Fair value": We estimate fair value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.
"Target price": This may be identical to estimated fair value per share, but is not necessarily the same. There may be very good reasons why a share price is unlikely to reach fair value within our time horizon. In such a case we set a target price which differs from estimated fair value per share, and explain our reasons for doing so.
Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company’s profits or operating performance exceed or fall short of our expectations.

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