

Quarterly Earnings

Saudi Arabia Market

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الراجحي المالية
Al Rajhi Capital



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Key themes

Results in Q3 were mixed, with strong earnings from the petrochemicals giant SABIC and other well-known companies such as Mobily (telecoms) and Almarai (food), but a weaker performance from other stocks in those same sectors. Results in the large banking sector were also generally dull.

Implications

Evidence of improvement in petrochemicals prices and continuing strong demand in emerging economies augur well for the market's largest sector. The robust domestic economy provides a strong backdrop for further strong results from the higher-quality telecoms and food stocks. We do not now expect significant recovery in banking earnings until 2011.

What do we think?

Major Sectors	Rating
Petrochemicals	Overweight
Agriculture & Food	Overweight
Telecoms	Neutral

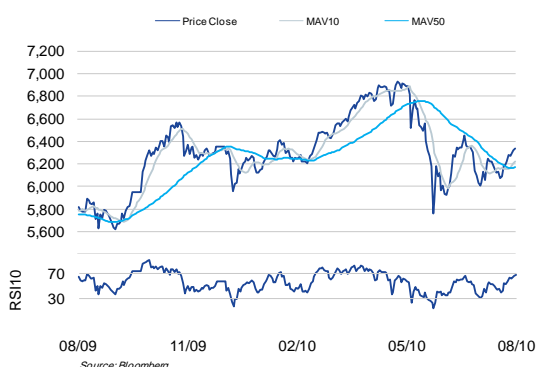
* not yet covered on a bottom-up basis

Why do we think it?

Sector	EPS LTGR*	2010E EV/EBITDA
Telecoms	11.6%	6.6x
Agriculture & Food	18.2%	12.1x
Petrochemicals	41.4%	9.7x

* 2009-2012. Source: Al Rajhi Capital

Saudi Arabia market index



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FY2010 Q3 results: Another mixed performance

Results in Q3 were mixed, with strong earnings from the petrochemicals giant SABIC and other well-known stocks such as Mobily (telecoms) and Almarai (food), but a weaker performance from other companies in those same sectors. The mining group Ma'aden also produced weak results, although we expect a transformation of the company next year. The sectors that we rate as Overweight are Petrochemicals and Agriculture & Food; we are Neutral on Telecoms. Please note that we offer detailed comment only on those sectors and stocks on which we have launched bottom-up coverage.

Telecoms. The results for the three large telecoms operators were not dissimilar to our expectations. STC's operating performance improved modestly, especially versus the very poor results of H1. Mobily's results featured weak sales growth but surging profits and margins; it remains one of our favourite stocks in the Saudi market. Zain KSA's results again showed strong growth in sales and gross profit but high depreciation and interest costs. High interest reflects high debt and shows the urgency of financial restructuring.

Agriculture and Food. Driven by the largest company, Almarai, the sector's net profit rose by 11% from SAR670mn in Q3 2009 to SAR774mn. Savola's weak net profit slightly hindered the sector as it is the second largest company. In general, the outlook for the Saudi food sector is promising given the Kingdom's attractive demographic profile. We expect Almarai to maintain its strong H1 performance.

Petrochemicals. In aggregate, the Saudi petrochemicals sector recorded a 44% year-on-year increase in sales in Q3 2010, driven by volume growth from new capacity and rebounding petrochemicals prices. However, the average price of basic petrochemicals products fell by about 7% versus Q2. This affected results for many companies although results for the sector giant SABIC were above forecasts. We expect prices to stabilise in Q4 with upside surprises possible.

Other sectors. The gold mining group Ma'aden released weak Q3 results. However, investors should focus on prospects for 2011: we expect the launch of phosphate operations to push up sales fivefold. Results in the banking sector were again dull and suggest that it is lagging overall growth in the economy.



Telecoms sector Mobily remains ahead

The results for the three large telecoms operators for Q3 2010 were not dissimilar to our expectations. STC's operating performance improved modestly, especially in relation to the very poor results of H1 2010. Mobily reported strong results featuring slightly weak revenue growth but remarkable expansion in profits and margins. Zain KSA's results again featured strong growth in sales and gross profit but high depreciation and interest costs. High interest reflects high debt and shows the urgency of financial restructuring.

Figure 1. Saudi telecoms sector: Q3 2010 aggregate results

(SAR mn)	Q3 2009	Q2 2010	Q3 2010	% chg y-o-y	Q3 2010 est
STC					
Revenues	12,934	12,591	13,232	2.3%	13,010
EBITDA	5,092	4,504	5,417	6.4%	5,009
EBITDA margin (%)	39.4%	35.8%	40.9%	1.5pp	38.5%
Operating profit	3,112	2,345	3,255	4.6%	2,952
Net profit	2,403	2,062	3,265	35.9%	2,355
Mobily					
Revenues	3,511	3,972	3,989	13.6%	4,057
EBITDA	1,278	1,388	1,648	29.0%	1,420
EBITDA margin (%)	36.4%	34.9%	41.3%	4.9pp	35.0%
Operating profit	862	940	1,187	37.7%	960
Net profit	807	901	1,138	41.0%	907
Zain KSA					
Revenues	825	1,450	1,662	101.3%	1,662
EBITDA	-299	57	135	-145.1%	135
EBITDA margin (%)	-36.3%	3.9%	8.1%	n/m	8.1%
Operating profit	-668	-314	-235	-64.8%	-235
Net profit	-820	-632	-544	-33.6%	-544
Aggregate					
Revenues	17,271	18,014	18,883	9.3%	18,729
EBITDA	6,071	5,949	7,201	18.6%	6,564
EBITDA margin (%)	35.1%	33.0%	38.1%	3.0pp	35.0%
Operating profit	3,305	2,971	4,207	27.3%	3,677
Net profit	2,390	2,331	3,858	61.5%	2,718

Note. Zain KSA released its Q3 results just before the publication of the original English version of this report on 13th October. This is why our estimates for Q3 for Zain KSA are shown as equal to the actual results.

Source: Company data, Al Rajhi Capital

STC: prospects still mixed

Summary

STC's Q3 results support our view that earnings bottomed in H1 2010. While the operating performance was encouraging, we are slightly concerned by a doubling of financial costs and high capex in the period. Near-term prospects remain dull and we do not expect a material acceleration in growth till 2012. While STC's 7.5% yield is attractive, our target price implies only 10% upside and so we remain Neutral.

Sales growth encouraging

STC reported year-on-year sales growth of 2.3% for Q3; compared to Q2 growth was 5.1%. The growth was above our estimate and is a sign that STC's results bottomed in H1 2010, as we argued in our recent report Saudi Telecoms Sector: Mobily still our favourite. However, STC has given few precise indications of what factors lay behind the stronger growth.

EBITDA and operating profit recover

EBITDA in Q3 rose by 6% year-on-year and was 8% above our estimate. Employee costs in particular were lower than we had expected. Depreciation and amortisation charges were

about 5% above our estimate, reflecting the impact of further expansion overseas. However, the rise in EBITDA was enough to outweigh the high depreciation. Operating profit consequently grew by 5% year-on-year and was 10% above our estimate. Operating profit was 38-39% higher than the very depressed levels of Q1 and Q2.

Net profit affected by capital gains and adoption of IAS 39

Historically STC's net profit has been affected by large exceptional items, so operating profit is a better guide to underlying trends. As reported, net profit rose by 38% year-on-year and by 61% quarter-on-quarter. However, net profit was again affected by special factors. These included a capital gain of SAR728mn on the sale of mobile towers in India, excluding which growth would have been 8% year-on-year and 26% quarter-on-quarter. Of greater note was the doubling of financial costs to SAR731m that arose from STC's adoption of IAS 39. Looking ahead, we assume financial costs fall back from this level, although this cannot be assured.

Capex surprisingly high

Combined expenditure on tangible and intangible fixed assets was SAR6.10bn in Q3, or 46% of sales. Investment in 3G mobile licences in India was one of the factors behind this high spending, but certainly not the only one. Since high investment was partly offset by high proceeds from asset disposals, STC ended Q3 with net debt little changed at SAR24.3bn. STC remains very strong financially with a net debt/EBITDA ratio of 1.1x. However, Mobily is arguably stronger still with a net debt/EBITDA ratio of 1.0x.

We have modestly revised our forecasts

While we think H1 was the trough for STC's results, the near-term outlook for sales and profits growth is still dull. We have therefore only modestly raised our forecasts for 2010 and 2011. We expect faster growth between 2012 and 2014, followed by a gradual slowdown.

Valuation and conclusion

We have raised our estimate of long-run fair value per share for STC by 5% to SAR44.4. Our estimate of fair value based on peer comparisons remains SAR43.8. Our new target price of SAR44.1 is an average of the two methods and is only 2% above our previous target. While STC's strong balance sheet and dividend yield of 7.5% remain attractive, on this basis STC's share price only offers around 10% appreciation potential. We remain Neutral.

Mobily

Summary

We remain Overweight in Mobily as the leader in the surging Saudi mobile broadband market. Mobily's results for Q3 2010 were again excellent, but differed from our expectations: sales growth was weak, but expansion in profits and margins was remarkable. We regard the weakness in sales growth as temporary, but conversely expect profits growth to moderate from now on. We have modestly raised our overall forecasts, and have a set a new target price of SAR75.4, implying 38% upside.

Weakness in sales growth probably temporary

After rising by 27% year-on-year in Q1 and by 24% in Q2, sales rose by 14% in Q3. We think the main reason for the slowdown was weak handset sales. Sales of smartphones should pick up from now on since 1) Blackberry service has not been banned, and 2) Mobily has just started to sell i-phone 4. More importantly, we expect a strong Hajj season in Q4 after a relatively weak Hajj season in Q4 2009. On this basis we predict a recovery in sales growth to 16% in Q4 2010, with similar growth in 2011.

Gross profit and EBITDA remarkably strong in Q3

Mobily staged a major promotion on international calls in Q1 and a similar but less aggressive promotion in Q3. In Q1, the promotion boosted call volumes and thus revenues, but weighed heavily on gross profit. In Q3, by contrast, cost of sales was well below our estimate, so that Mobily achieved a gross margin of 57.9%, compared to our estimate of 54.5%. We think that the key factor behind strong gross profitability was further expansion in high-margin mobile broadband service: data revenues seem to have reached 18-19% of the total for Mobily in Q3.

Not only was cost of sales below our estimate, but also SG&A costs fell by 6% year-on-year. In consequence, EBITDA surged by 29% to SAR1,648bn, while the EBITDA margin expanded from 36.4% to 41.3%. This was far above our estimate of a margin of 35.0% and was a truly

impressive outcome. The strong growth in EBITDA fed directly through to a 41% increase in net profit.

Margins may slip, but profits growth should stay robust

We do not view the very high profit margins of Q3 as sustainable. Mobily makes almost no profit on handset sales, so as handset sales pick up margins should slip. We also expect promotional activity in mobile voice service to continue. Then again, the rising importance of data to Mobily is positive for margins. We also expect a strong Hajj season in Q4 to support profit growth in what is traditionally Mobily's best quarter. For 2010 as a whole we thus predict an EBITDA margin of 38.0% (versus 37.0% in 2009), but we expect a drop to 37.3% in 2011. In absolute terms we predict an increase in EBITDA of 23% in 2010, followed by 14% in 2011.

Balance sheet strengthens further

Net debt was SAR6.53bn at the end of Q3, down from SAR7.13bn at the end of Q2. Higher EBITDA and lower debt pushed the net debt/EBITDA ratio down to 1.0x at the end of Q3, versus 1.8x one year ago. This is the lowest level of gearing in Mobily's history and below the level for STC. With its finances very healthy, Mobily can continue to invest for growth.

Valuation and conclusion

Mobily dominates the surging mobile broadband market in Saudi Arabia. While in the near term trends in mobile will drive the company, Mobily's GED ("Growth, Efficiency and Differentiation") strategy should prepare it for a future of likely greater fixed and mobile integration. Following the results, we have raised our target price by 6% to SAR75.4, implying 38% upside.

Zain KSA

Summary

While Zain KSA again achieved strong sales growth in Q3, its results also featured rising SGA costs and high depreciation and interest charges. We have raised our sales forecasts but left our profit forecasts little changed, and our target price remains SAR8.0. We expect Zain's share price to be driven not by its results, but by Etisalat's bid for Zain Kuwait – whose implications in our view are negative for its affiliate – and the timing of financial restructuring. We remain Neutral.

Sales growth very strong:

As in Q2, Zain KSA reported impressive revenue growth. Sales of SAR1,662mn were up by 95% year-on-year and by 15% versus Q2; sales were 7% above our estimate of SAR1,554mn. We believe that this strong performance reflected continuing robust subscriptions growth and high call volumes. However, we do not see evidence that mobile broadband accounts growth accelerated significantly during Q3.

Gross profit strong, but SG&A rising

Gross profit of SAR712mn was up by 193% year-on-year and was 9% above our estimate of SAR653mn. We believe that one of the key reasons for this strong performance was further roll-out of Zain KSA's network; this should have reduced roaming payments to Mobily. While gross profit was well above our forecast, sales, general and administrative costs were also above our estimate. Consequently, by our calculation Q3 EBITDA stood at SAR135mn, or 3% below our estimate of SAR139mn.

Depreciation and financial charges still weigh on net profit

Combined depreciation and amortisation charges remained high at SAR370mn. Zain KSA's operating loss thus came in SAR235mn, or 4% below our estimate of a loss of SAR246mn. Net financial costs, which jumped in Q2, remained high in Q3 at SAR309mn. Consequently, Zain KSA reported a net loss of SAR544mn. This was 2% above our estimated net loss despite the strong sales and gross profit.

Financial costs surge

High financial costs reflect the ongoing impact of the jump in gross debt from SAR11.97bn at the end of Q1 to SAR14.07bn by the end of Q3. On the basis of our new sales forecast for 2010 of SAR5,925mn, Zain KSA's net debt/sales ratio remains very high at 2.4x (1.7x for 2011). Zain's high gearing explains why we regard financial restructuring as essential.

Our new forecasts

Zain KSA has published financial targets for 2011 which we see as broadly achievable. We have raised our estimates of sales for the company but have not pushed up our estimates of EBITDA or net profit correspondingly. A significant increase in net profit is contingent on completion of Zain's financial restructuring, which would reduce the company's huge interest costs. With higher sales but profit forecasts little changed, our estimate of fair value per share on a long-run DEP basis is essentially unaltered at around SAR8.0.

Valuation and conclusion

We believe that issues largely beyond Zain KSA's control will determine the direction of its share price: namely, Etisalat's bid for Zain Kuwait and the timing of financial restructuring. Even though Zain KSA's recent results have shown strong operating progress, we have not changed our view that it is too risky to invest in the company as a potential recovery stock until after the financial restructuring is completed – something which the offer for Zain's parent puts in question. We retain our target price of SAR8.0, which is equivalent to the long-run fair value, and retain our Neutral rating.



Agriculture & food sector: Robust results led by Almarai

Almarai recorded impressive growth of 16.8% in net profits in Q3

Almarai, the largest company in the food sector, achieved impressive top line growth of 18.5% in Q3, from SAR1.54bn in Q3 2009 to SAR1.83bn in Q3 2010. As we had expected, sales growth was mainly driven by strong growth in the bakery and cheese segments; other categories showed good sales growth as well. Net income grew by 16.8% from SAR363mn in Q3 2010 to SAR424mn in Q3 2010. Looking forward, we expect Almarai to achieve sales growth of 15.6% in Q4, from SAR1.54bn in Q4 2009 to SAR1.78bn in Q4 2010. We expect net income to show stronger growth of 26.6% from SAR248mn in Q4 2009 to SAR315mn in Q4 2010. We retain our overweight rating on Almarai with a target price of SAR237.4.

Savola, the second largest company in the food sector, announced a disappointing net profit growth of 1.8% from SAR278mn in Q3 2009 to SAR283mn in Q3 2010. This decline is surprising considering that Savola's revenues grew by 10% from SAR5.1bn in Q3 2009 to SAR5.6bn in Q4 2010. We believe that this inconsistency can be attributed to increasing raw material costs and the rapidly growing retail segment, which contributes lower margins than Savola's food operations. Looking ahead, we expect Savola's sales and net income in Q4 to grow by roughly 13% and 9% respectively from last year same period.

We are positive on the large-cap companies in the sector with diversified operations

Herfy, another promising company that was listed earlier this year, announced good top line growth but relatively weak profits. Herfy reported sales growth of 9.5% from SAR133mn in Q3 2009 to SAR145mn in Q3 2010. Herfy achieved lower net profit of SAR30.8mn higher than that in Q3 2009 by 2%. Regarding Q4 results, we expect Herfy to achieve strong revenues growth of 14% reaching SAR148mn, while net income reaching SAR32.5mn, 10% growth from last year similar period. We remain overweight with a target price of SAR90.2.

Figure 2. Net profit performance (figures in mn's except per share data)

Agriculture & Food Industries	Net Income (Q3)			Net Income (9M)			EPS (9M)	
	2009	2010	YoY	2009	2010	YoY	2009	2010
SAVOLA Group	277.9	283.0	1.8%	682.9	884.7	29.6%	1.37	1.77
Food	1.6	2.2	41.0%	6.2	17.4	180.3%	0.31	0.87
Almarai	363.4	424.5	16.8%	847.9	1001.7	18.1%	7.78	8.71
Anaam Holding	0.9	2.2	140.7%	-1.2	7.3		-0.11	0.67
Halwani Bros	9.9	20.3	105.1%	34.3	62.9	83.4%	1.2	2.2
Herfy Food	29.9	30.4	1.7%	85.0	91.2	7.2%	3.15	3.38
NADEC	11.3	0.7	-93.8%	-9.9	24.4		0.16	0.41
Qassim Agriculture	-1.8	-2.5	38.9%	-4.7	-11.5	144.7%	-0.1	-0.23
Tabuk Agriculture	-1.6	1.2		-8.3	4.1		-0.42	0.21
Saudi Fisheries	-7.4	-7.8	4.3%	-16.4	-19.7	20.4%	-0.82	-0.99
Sharqiyah Agriculture	-1.9	0.3		-2.9	-3.0	4.5%	-0.38	-0.4
Jouff Agriculture	16.8	23.5	39.6%	42.0	42.7	1.6%	2.1	2.14
Jazan Development	0.7	-3.7		-2.0	-7.8	299.5%	-0.04	-0.16
Total	699.7	774.4	10.7%	1653.1	2094.3	26.7%		

Source: Companies data, Al Rajhi Capital



Petrochemicals sector: Capex drives growth but prices fall

As elaborated in our major sector report *Saudi Petrochemicals Sector: Advantage Saudi Arabia* (4th August, 2010), we believe that strong demand from Asian markets, low input costs, aggressive expansion plans and supportive government policies are driving growth in the Saudi petrochemicals industry.

In aggregate, the Saudi petrochemicals sector recorded a robust 44% year-on-year increase in revenues during Q3 2010, primarily driven by a year-on-year rebound in petrochemicals prices and volume growth from new capacity coming onstream. Aggregate EBITDA increased by 58% year-on-year to SAR12.92bn while the aggregate EBITDA margin increased 2.2 percentage points to 25.2%. Operating profit increased by 67% while net profit jumped by 94% during the period.

However, on a quarter-on-quarter basis, aggregate net profit fell by 3.5%, reflecting an average drop of about 7% in the prices of basic petrochemicals products in Q3 versus Q2. The decline in product prices pulled down the performance of all operating petrochemicals companies and hence the results of many of the Saudi petrochemicals suppliers were lower than consensus estimates. The key exception was SABIC, whose results were above forecasts.

Strong year-on-year performance in Q3 2010

Petrochemicals prices fell in Q3 2010 compared to Q2

Figure 3. Saudi PPC sector: Q3 2010 aggregate results

(SAR mn)	Q3 2009	Q3 2010	% Chg
SABIC			
Revenues	27,984	37,877	35.4%
EBITDA	8,692	11,616	33.6%
EBITDA margin (%)	31.1%	30.7%	
Operating Profit	6,360	8,982	41.2%
Net Profit	3,648	5,326	46.0%
Yansab			
Revenues		1,603	n.a.
EBITDA	(7)	721	n.a.
EBITDA margin (%)	n.a.	45.0%	
Operating Profit	(7)	469	n.a.
Net Profit	(7)	356	n.a.
Saudi Kayan			
Revenues			
EBITDA			
EBITDA margin (%)			
Operating Profit	(4)	(5)	26.2%
Net Profit	(4)	(5)	26.7%
PetroRabigh			
Revenues	7,301	11,275	54.4%
EBITDA	(569)	296	n.a.
EBITDA margin (%)	-7.8%	2.6%	
Operating Profit	(746)	(213)	-71.4%
Net Profit	(845)	(237)	-71.9%
Sipchem			
Revenues	197	509	158.2%
EBITDA	50	283	467.0%
EBITDA margin (%)	25.4%	55.7%	
Operating Profit	32	176	449.4%
Net Profit	55	84	52.9%
Aggregate			
Revenues	35,482	51,264	44.5%
EBITDA	8,166	12,916	58.2%
EBITDA margin (%)	23.0%	25.2%	
Operating Profit	5,635	9,408	67.0%
Net Profit	2,847	5,524	94.0%

Source: Company data, Al Rajhi Capital



Q3 results round-up

Improvement in product prices and higher capacity utilisation driving growth

SABIC

SABIC's Q3 2010 results were better than both consensus estimates and our own. SABIC reported revenues of SAR 37.88bn, up by 35% from Q3 2009, but down by 2.5% from Q2 2010. On a year-on-year basis, SABIC's top line benefited from improved demand, higher capacity utilisation and higher product prices. The quarter-on-quarter decline in sales reflected an average drop of about 7% in the prices of basic petrochemicals products in Q3. The year-on-year improvement in sales was sufficient to permit operating profit of SAR8.98bn, which exceeded consensus estimates. The operating profit margin improved to 23.7% compared to 22.7% in Q3 2009 and 23.5% in Q2 2010.

We expect prospects for SABIC to improve further owing to new capacity-driven volume growth and margin expansion led by cost efficiencies and a mild improvement in petrochemicals prices. Reflecting these assumptions, we have raised our sales estimates by around 9% for the years 2010-2012. Consequently we recently raised our target price to SAR120.2, implying 15% upside, and remain Overweight.

Shutdown marred Q3 performance

Yansab

Yansab's Q3 2010 net profit of SAR356mn was slightly below our estimate of SAR376mn. Net profit was 29% lower compared to Q2 on account of an increased production cost owing to a two week shutdown of the olefin cracker. On a quarter-on-quarter basis, revenues declined by 2% to SAR1.6bn and EBITDA declined by 15% to SAR721mn. Note that the commercial production by Yansab was launched only in Q1 2010; hence year-on-year results are not comparable.

Trial operations started in Q3

Saudi Kayan

Saudi Kayan reported a loss of SAR5mn for Q3 2010, in line with our estimates, as its plants are in a pre-operational stage. The company started trial operations at its olefins, ethylene glycol and polypropylene plants in Q3 2010. Currently we assume that the commercial production will not start until Q1 2012. In the quarter under review, the company received SAR4.5bn loan from National Commercial Bank to part-finance the expected cost escalation of its Jubail petrochemicals plant.

Shutdown of units and weak petrochemical prices has affected Q3 performance

Petro Rabigh

Petro Rabigh reported a net loss of SAR 237mn for Q3 2010 versus a consensus estimate for net profit of SAR125mn. Increased production cost coupled with declining petrochemicals prices impacted net earnings in Q3. Petro Rabigh faced technical difficulties which halted production at its polymers and MEG units for around two weeks in August 2010. However, the net loss declined compared to the net loss of SAR 845mn for Q3 2009 on account of the year-on-year recovery in petrochemicals prices and the commissioning of new units.

Weak Q3 results however, expansion plans to drive growth

Sipchem

On a year-on-year basis, Sipchem reported high growth in sales, EBITDA, operating profit and net profit reflecting the contribution from the company's Phase 2 expansion which came on-stream in Q1 2010 and improving petrochemical prices. On a quarter-on-quarter basis, however, net profit fell approximately 4% in Q3 due to the decline in basic petrochemicals prices versus Q2. In consequence, Sipchem's results were below consensus forecasts: net profit of SAR84mn in Q3 may be compared with our estimate of SAR115mn and the consensus estimate of SAR125mn. Recently Sipchem has signed an agreement to build ethyl acetate plant with a capacity of around 100,000-metric ton per annum as a part of its Phase 3 expansion programme.

We expect petrochemicals prices to stabilise in Q3M, with upside surprises possible

Near-term prospects for the sector

As noted, prices of basic petrochemical products declined over the last two quarters. We expect prices in Q4 to stabilise at around Q3 levels, although there may be positive surprises if the crude oil price rises further due to winter season demand and depreciation of the US dollar. On a year-on-year basis, we expect the petrochemicals sector to report better results, driven mainly by volume growth from new capacity. However, we do not expect any major increase in capacity utilisation levels in Q4 compared to Q3.

The main reasons for our view are as follows. During Q3 2010, the average price of crude oil remained under pressure while the average price of gas remained close to Q2 level. Reflecting this, average prices of basic chemicals and fertiliser products registered quarter-on-quarter declines. Winter season demand and currency fluctuation looks set to lead the average price

of crude oil to remain strong in Q4 2010 compared to Q3. If so, this should be reflected in stabilisation of the prices of basic chemicals and fertiliser products. The demand outlook for petrochemicals products remains positive, being driven by rising consumption rates in the emerging economies of Asia, primarily China and India. Renewed downturn in developed economies is the key risk for the sector.

Other sectors

Ma'aden – look ahead to 2011

Ma'aden

Summary

Ma'aden Q3 results were disappointing, and as a result we have become cautious about its gold business. We remain bullish about the new businesses, phosphate and aluminium, due to be launched from next year onwards. We expect Ma'aden's structure to be transformed through these operations, with gold accounting for only 9.1% of revenues by 2014. While we have cut our forecasts for the gold business, we have lowered our target price only fractionally, to SAR28.2. This target implies 25% upside and we remain Overweight.

Gold business likely to be flat in 2011

Ma'aden's gold production has been declining after touching an all-time high in 2009. This is because two of the existing five mines are either closed or nearing exhaustion. These two are Sukhaybarat (already exhausted) and the Al Hajjar mine (expected to cease operations in 2011). We therefore expect essentially flat production in 2011. However, flat production should be offset by the strong rally in the gold price which has resulted in the company maintaining decent revenue growth in 2010.

Margins have fallen; we expect a boost after phosphate launch

The gross margin fell to 52.7% in Q3 2010 compared to 57.2% in Q3 2009 which is mainly due to the fall in gold content with two mines ceasing operation and drilling and processing costs increasing. So far this year the cost of production has increased by 27% to US\$600 per ton from an average of US\$471 per ton in 2009. This increase is hurting the gross margin. However, after the start of phosphate, we expect gross profitability to be boosted significantly. We expect a gross margin of 56% and an operating margin of 37% in 2011.

North-south railway nearing completion

According to Meed, the 1,486 kilometre north-south mineral railway intended to carry phosphate rock from the Al Jalamid mine to the plant at Ras Az Zawr is nearing completion. About 1,200km of track is complete and the line is on schedule for opening in early 2011. Due to its importance for Ma'aden, the PIF which is funding construction and which is also a 50% owner in Ma'aden, is giving priority to this project. We regard the railway line as the most crucial reason for the likely success of the phosphate business as it will reduce transport costs and boost margins.

Debt levels set to rise

As noted in our initiation of coverage report dated 2nd August 2010 (*Ma'aden: Revenue surge set to drive price*), Ma'aden's debt level is set to rise in order to facilitate the aluminium project due for launch by 2014. Gross debt in Q3 2010 stood at SAR12.14bn versus SAR12.12bn in Q2 2009. We expect gross debt of SAR12.8bn by the end of 2010 and of SAR16.3bn by the end of 2011. However, Ma'aden has a big cushion in its short term investments and cash equivalents which stood at SAR11.3bn as at Q3 2010. We thus predict net debt of SAR1.7bn at the end of 2010, followed by SAR1.1bn at the end of 2011.

We remain Overweight

We like Ma'aden's investments in phosphate and aluminium. These are due to start in 2011 and 2013 respectively, and should create the world's cheapest producer of DAP fertiliser and aluminium. Ma'aden trades on an enterprise value/invested capital ratio of 0.8x, suggesting that the market lacks faith in the company's ability to create value from its new projects. We disagree, and think Ma'aden still offers over 25% upside. In our full results comment reported 1st November, we lowered our target price fractionally, to SAR28.2, but retained our Overweight rating.



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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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