Saudi Arabia Fertilizers Company - SAFCO

Result Flash Note 4Q-2016 January 2017

ALJAZIRA CAPITAL الجزيرة للأسواق المالية

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SAFCO: 4Q-2016 earnings were in-line with our forecast; but 4.7% better than expected revenue; Gross margin is at the highest level during FY2016 due to lower production cost. Losses from Ibn-Al-Baytar impacted the bottom line. 50% acquisition of Ibn-Al-Baytar by debt financing to raise SAFCO's valuation toward SAR 76.0/share. "Underweight" recommendation on the stock with higher PT.

Amount in SAR mn; unless specified	Forecasts 4Q-16	Actual 4Q-16	Deviation (%)
Sales revenues	730.3	765	**4.7%**
Net profit	286.9	284.5	**-0.8%**
EPS (SAR)	0.69	0.68	**(0.09)**

Higher than expected operating rate with better production efficiency led to gross margin of 40.6% in 4Q2016: 4Q2016 net profit was in-line with our estimates and showed a deviation of 0.8% from AJC estimates and 6.9% from the market consensus of SAR 266.6mn. SAFCO posted net income of SAR 284.5mn; indicating a fall of 24.8%YoY and an increase of 56.8%QoQ. We believe that the YoY weak profitability is mainly attributed to i) A drop in product prices ii) higher production cost after increase in feedstock costs and utilities iii) losses recognized from IBN-ALBAYTAR due to scheduled shutdown, where the net losses from Ibn-Byatar stood at SAR 18.1mn, as compared to net profit of SAR 36.6mn in 4Q2015. On the other hand, the strong performance on QoQ basis is mainly ascribed to higher Urea prices and a reduction on the production cost due to adoption of cost optimization program.

The company reported a 10.9%QoQ increase in revenue for 4Q2016 to SAR 765mn, which is 4.7% above our estimate of 730.3mn due to higher than expected operating rates. Based on our estimates, SAFCO operated at 96.3% that is higher than 95.1% in 3Q2016. We believe the company's sales in FY2017 will witness some recovery, due to improvement in operating rate of SAFCO-5 and higher product prices.

Gross profit stood at SAR 310.9mn depicting a decline of 13.7%YoY and an increase of 53.6%QoQ. This is slightly above our estimates due to higher than expected operating rate. Gross margin expanded to 40.6% in 4Q2016 from 29.4% in 3Q2016, which is the highest during FY2016. Operating Profit stood at SAR 290.9mn depicting a decline of 15.1%YoY and an increase of 56.8%QoQ; as the company witnessed slightly higher OPEX at SAR 20mn, as compared to SAR 17.9mn in 4Q2015.

In 4Q2016 Urea prices fell 11.3%YoY, but increased 16.8%QoQ. Ammonia price declined 58.4%YoY and 29.8%QoQ and a short-term fundamental for ammonia is expected to remain weak due to Ammonia overcapacity and inventories in the industry. We expect the urea prices to keep increasing for the next month due to better demand is expected from Europe and the US and lower urea export from China as it concentrates on domestic demand. However, the Start-up of new nitrogen plants in the US and increase in operating rates in China over the coming months could put a halt to price increases according to ICIS.

50% acquisition of Ibn-Al-Baytar by debt financing to raise SAFCO's valuation toward SAR 76.0/share: The company announced it has signed an agreement on Oct 10th, 2016 to study the economic feasibility of SAFCO's acquisition full share of Saudi basic Industries Corporation (SABIC) in the national company of chemical fertilizers (Ibn Al-Baytar - is a 50-50 joint venture between SAFCO and SABIC. SABIC, meanwhile, owns 42.99% of SAFCO). We expect the company has more flexibility to go with two different scenarios for payment methods to pay the minimum value of Ibn Al-Baytar at SAR 662mn (based on the book value in SAFCO's Balance sheet, please note that Ibn Baytar is recognized under equity method).

Recommendation	'Underweight'
Current Price* (SAR)	73.00
Target Price (SAR)	62.50
Upside / (Downside)	-14.4%

*prices as of 17th of January 2017

Key Financials

SARmn (unless specified)	FY14	FY15	FY16	FY17E
Revenues	4,456	3,547	2,856	3,006
Growth %	5.1%	-20.4%	-19.5%	5.2%
Net Income	3,174	2,130	1,051	1,351
Growth %	0.4%	-32.9%	-50.7%	28.5%
EPS	7.62	5.11	2.52	3.24

Source: Company reports, Aljazira Capital

Key Ratios

SARmn (unless specified)	FY14	FY15	FY16	FY17E
Gross Margin	68.5%	58.8%	36.8%	42.1%
EBITDA Margin	74.6%	68.1%	50.0%	54.0%
Net Margin	71.2%	60.1%	36.8%	44.9%
P/E	14.8x	16.07x	29.59x	22.52x
P/B	5.97x	4.51x	5.06x	4.87x
EV/EBITDA (x)	13.63x	13.57x	21.50x	18.32x
ROE	39.4%	27.6%	15.3%	21.8%
ROA	34.6%	23.8%	12.6%	17.4%
Dividend Yield	5.5%*	7.3%	3.3%	4.1%

Source: Company reports, Aljazira Capital *Adjusted price

Key Market Data

Market Cap (bn)	30.52
YTD %	-1.9%
52 Week (High)	82.0
52 Week (Low)	58.0
Shares Outstanding (mn)	416.67

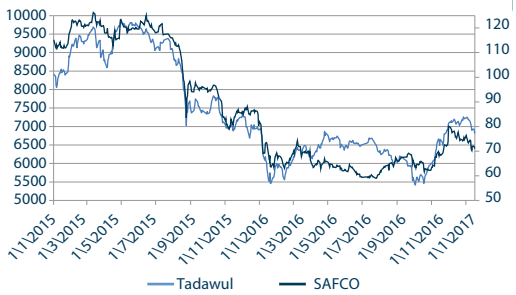
Source: Company reports, Aljazira Capital

Shareholders Pattern

Shareholders Pattern	Holding
Saudi Basic Industries Corp.	42.99%
General Organization for Social Insurance - GOSI	12.20%
Public	44.81%

Source: Company reports, Aljazira Capital

Price Performance



Source: Bloomberg, Aljazira Capital

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Scenario 1: Acquisitions can be made with a mixture of current cash of SAR 316mn and the selling of the company's investments available for sales (SAR 512mn), which means that the company no longer have to worry about the future performance of their company impacting by the amount paid for financing. However, based on our calculation that the implementation of the 1st scenario would slightly increase the company's valuation by the size of the increase in FCF, so the TP of the company is expected to be at around **SAR 66.0/share** from the current TP of SAR 62.5/share. In addition, we cannot rule the possibility of further cuts in dividends in 2017, as the company has to exhaust its entire cash balance

Scenario 2: SAFCO may include debt of SAR 662mn in the structure of its deal to acquire Ibn Al-Baytar. This can be beneficial to the company, since they would not run out of cash. In addition, the debt financing will reflect positively on valuation, as WACC will be adjusted lower. For the current case, the annual interest on debt would be around 25mn compared to the average annual net income from Ibn Al-Baytar at SAR 140mn/year (please note that Safco is still recognizing 50% of the Ibn-Baytar net income); the benefits exceed the costs, there will be a gain in value to equity investors from the use of debt.

In our view, the optimal choice for valuation is to apply the second scenario with financing the acquisition through debt (with a assumed Debt to Capital Ratio 15%), which reduces the WACC and maximizes the overall value of the firm. Therefore, as the cash flows to the firm are improved, and the cost of capital is minimized, the value of the firm will be maximized. Consequently, the implementation of the 2nd scenario would raise the TP of the company to **SAR 76.0/share**. Therefore, we believe that the market assumed the debt scenario and already priced in the positive effect on the stock price.

We update our recommendation to "Underweight" on SAFCO with a higher PT of SAR 62.5/share indicating a potential downside of 14.4%: SAFCO is expected to post SAR 1,351mn in net income (3.24 EPS) for FY2017, recording an increase of 28.5%YoY for the year supported by higher levels in product price and better margins. However, we update our recommendation to 'Underweight' on the stock due to high price in the market relative to our target price of SAR 62.50/share. The company is trading at forward PE and P/B of 23.3x and 4.4x respectively based on our 2017 earnings forecast.

The company in 2015 proposed a DPS of SAR 6 with payout ratio of 117.4% and a yield of 7.3%. We expect the company to reduce its dividend payment to SAR 2.5 DPS (3.4% D/Y) in 2016 owing to a decline in operating cash flow. The company ended FY2016 with cash & equivalent of SAR 316mn, along with zero debt in the balance sheet makes the company flexible to maintain a payout ratio above 95%.

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RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

Disclaimer