Saudi Cement Sector
Cement –Industrial
Saudi Arabia
30 March 2017

Al Rajhi Capital

Key themes

The cement sector in Saudi Arabia witnessed sales decline of 10% y-o-y in 2016 and 20.4% y-o-y in the first two months of 2017 as a result of stiff competition coupled with falling demand due to the slowdown in construction activities. We expect increase in costs post energy reforms and weak demand to persist –leading to lower future profitability and dividends for most companies under our coverage.

What do we think?

Stock	Rating	Price Target
Yamama	N	SAR 17.8
Southern	N	SAR 57.0
Saudi	N	SAR 55.0
Qassim	UW	SAR 45.0
Yanbu	UW	SAR 32.0
Arabian	N	SAR 36.0

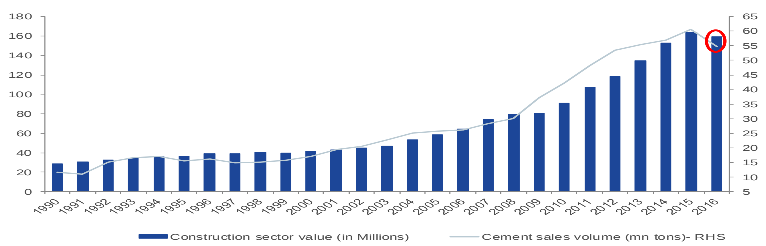
Saudi Cement Sector

Changing fundamentals; Reality seems tougher

Cement sales in the Kingdom continues to remain weak and recent data could indicate further downward revision to market estimates of demand and sector earnings for 2017. In the first two months of 2017, sales volume fell 20.4% on an annual basis, while in 2016, cement dispatches declined 10% y-o-y (54.8mn tons). In this context, we show the impact on companies based on our expectations of demand in 2017. With regard to prices, we have already seen prices decline sharply for Central and Western regions as they are most accessible to producers. If demand does not pick up, we believe there could be further downside to prices, after enjoying healthy margins in the past. Already higher fuel prices, intense competition and inventory pile up have triggered a price war among cement companies to maintain the market shares which has negatively impacted profitability in the sector. While dividends are likely to be cut, few companies with strong cash positions and limited future expansion might see lower impact on dividend payments. We see limited benefits from exports as well and do not expect a near term recovery in construction sector. We also highlight current upside and downside risks in the sector. Under current market conditions, we are Neutral on Saudi, Southern, Yamama and Arabian cement as we believe that most of the weaknesses are priced in, while we are underweight on Qassim and Yanbu cement.

C70% decline in value of awarded projects. Cement sector continues to be weighed down by weaker construction activities in the kingdom. According to the General Authority of Statistics' 2016 GDP preliminary figures, the construction sector output in the kingdom dropped 2% y-o-y in 2016, which was the first negative growth since 1999. The current weak conditions in the construction sector is attributed to lower government spending, as Govt. adjusts to lower oil prices through spending cuts and prioritization of projects. Moreover, in 2016, though Ministry of Finance approved 1,192 construction projects (-18% y-o-y) the total value of the awarded projects dropped 69% y-o-y to SAR 24 billion. Going forward, the construction sector has not shown any signs of recovery in the short term, which is likely to weigh on the cement sector. Construction sector is likely to depend on the private sector given government's plan of cancelling and delaying unnecessary projects.

Figure 1 First decline in at least a decade for cement sales volumes (1990-2016)



Source: GAS, Al Rajhi Capital

Demand and Supply: In 2016, cement dispatches declined to 54.8mn tons (10% y-o-y) as construction activities have been witnessing signs of spending cuts across various small and medium size projects as well as limited demand from mega projects that are nearing completion such as Riyadh metro, King Abdullah Financial District etc. In 2017, demand is unlikely to pick up steeply given that construction activities are bound to remain weak, thus we expect sales volume to remain modest with a decline of ~12-15% y-o-y (~47mn tons).

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In the first two months of 2017, sales volume declined 20.4% y-o-y

Yamama and Najran cement's announcements of cutting production represent 5% of 2016 clinker production in the sector.

On the supply side, clinker production in 2016 declined to 55.5mn tons (2.6% in yearly basis). Recently, Yamama and Najran Cement temporarily shut down part of existing production lines. The lines have a clinker production capacity of 5,600t and 3,000t/day, respectively. We believe that under the current weak market conditions, cutting production would be one of the realistic options for balancing the market. We anticipate cut in clinker production this year by more than 12% y-o-y.

Figure 2 Sales volume breakdown by regions 2016-2017E

All volumes in (000)	Feb-17	2016		2017E	
Regions	Inventory	Sales volume	Market share %	Sales volume	Market share %
Central & Eastern	**15,649**	**25,220**	**46.0%**	**22,090**	**47.0%**
Yamama	4,475	5,357	21.2%	4,771	21.6%
Qassim	1,052	4,041	16.0%	3,269	14.8%
City cement	1,191	3,136	12.4%	2,960	13.4%
Riyadh cement	1,717	3,415	13.5%	2,916	13.2%
Saudi	5,126	6,781	26.9%	6,185	28.0%
Eastern cement	2,088	2,490	9.9%	1,988	9.0%
Western & Southern	**9,577**	**23,095**	**42.1%**	**20,586.0**	**43.8%**
Yanbu	3,072	6,440	27.9%	5,630	27.4%
Arabian	357	4,453	19.3%	3,325	16.2%
Umm Al-Qura	333	-	0.0%	906	4.4%
United	459	-	0.0%	1,009	4.9%
Safwa cement	336	1,857	8.0%	1,441	7.0%
Southern	2,030	7,445	32.2%	6,299	30.6%
Najran	2,990	2,900	12.6%	1,976	9.6%
Northern	**4,655**	**6,481**	**11.8%**	**4,324.0**	**9.2%**
Northern cement	763	1,865	28.8%	1,232.34	28.50%
Hail	1,646	1,392	21.5%	968.58	22.40%
Jouf	1,087	1,884	29.1%	1,202.07	27.80%
Tabuk	1,159	1,340	20.7%	921.01	21.30%
TOTAL	**29,881**	**54,796**	**100%**	**47,000**	**100.0%**

Source: Yamama cement, Al Rajhi Capital.

Central region: Central region is considered as one of the highest demand regions in the kingdom. Given the increased competition coupled with the high production capacity in the region, we believe that selling prices in the central haven't seen the bottom yet. Looking to their inventories, production capacities and healthy operating margins, Yamama, City and Saudi cement will able to expand their market shares across central and eastern regions.

Western & Southern region: Amidst weakening demand, there is additional supply also coming into the market. Umm Al-Qura and United cement (unlisted company) commenced commercial production in 2016 with an annual production capacity of ~2mn tons each. Additionally, Southern cement started trial operations of the second production line at its Bisha plant with capacity of 1.6mn tons/year, increasing total production capacity in the kingdom to ~69mn tons. We expect these capacity additions to increase competition and to put further pressure on selling prices, already witnessed in Q4. Notably, Southern cement has increased its clinker inventory from May16-Feb17 by more than 150% to reach 2.2mn tons. Yemen reconstruction and construction projects in Mecca might give a temporary relief to the producers.

Eastern region: Although current inventories in the region represent 78% of 2016 sales volume of Saudi and Eastern cement, companies in the Eastern province enjoy high sale prices, mainly due to low competition. However, this is not sustainable especially after the sharp drop in selling prices in central and western regions which will result in a transportation cost for other producers that is lesser than cement price minus production costs.

Northern region: Current inventories represent 72% of producers' dispatches in 2016. Weak demand in the region have led companies to far away their products to other regions which have negatively impacted companies' average realized price/ton due to the high transportation costs. Therefore, northern region companies will face contractions in profit margins.

Pressure on selling prices amid inventory pile up : The weak market conditions, sluggish demand, excess supply and inventory pile up have led cement producers to compete on pricing. The Western region has witnessed the sharpest decline in selling prices in Q4 2016 (~25% q-o-q) due to the increase in production capacity after commencing commercial production of Umm AlQura and United cement last year. We believe that selling prices may not have seen the bottom yet and expect further decline from Q1 2017. Smaller producers continue to remain focussed on high demand areas especially Central and Western regions and this has led to oversupply and competitive pricing in these regions. Southern and Eastern regions which currently have much higher average selling prices (~SAR230/tonne) compared to ~SAR170 levels in Western and Central regions are likely to be eventually impacted, in the same order.

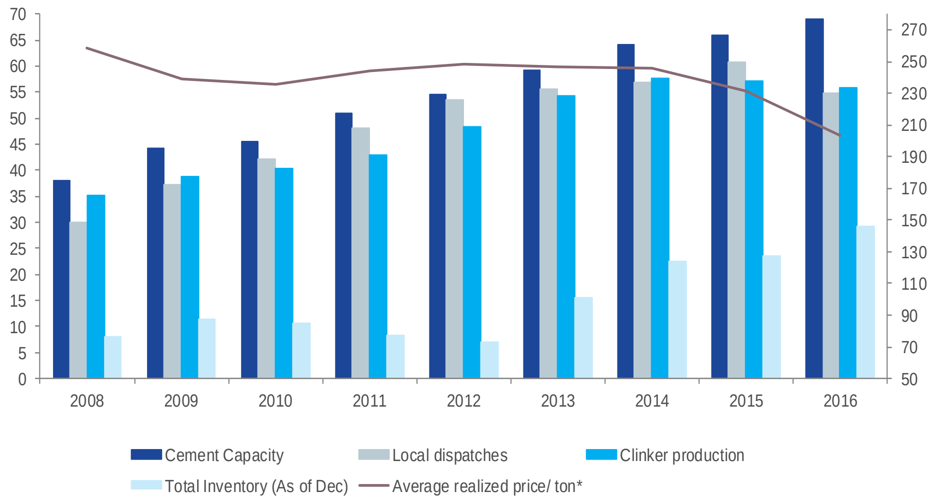
2008-2009: The Saudi government imposed a ban on cement exports in 2008 to force prices down and to insure enough supply for large government infrastructure projects. In 2009, the ban was partially lifted for some companies and under certain conditions.

2011-2012: High local demand led the government to impose the export ban again to ensure enough supplies for local demand. In March 2012, Ministry of commerce announced a price cap for cement at SR 280/ton for the end user

2013-2014: Total inventory reached 15.5mn tons after the royal decree of importing 10mn tons of clinker to ensure enough supplies for local demand. However, the market was impacted by reforms to promote local employment which created labor shortage.

2015-2016: Inventories continued raising after the government spending adjusts to low oil prices. In Dec 2016, Ministry of commerce lifted the ban on exports after determining the difference in energy costs between the local and international markets which was from SAR85-SAR133 per ton.

Figure 3 Cement sector: Total capacity, Production, Dispatches, Inventory and selling prices



Source: Company data, Al Rajhi Capital

In 2016, cost per ton increased 4-6% on average as a result of the increase in energy prices.

Cost pressure: Cost pressure is one of the concerns for the cement producers for the next couple of years due to Government's plan of energy prices reforms. After seeing an increase in energy prices in Dec 2015, cement producers have been facing pressures in profitability as the cost per ton increased by ~6%. However, we believe that the full impact hasn't yet been seen as some companies still consume from existing older inventory. Thus, some companies especially ones with lower inventory may tend to maintain current production levels prior to another round of energy price hikes in late 2017. In their ways to improve cost efficiency, some cement companies tend to use Tire Derived Fuel (TDF) as an alternative fuel in the operation of new production lines to reduce the use of conventional fuel. Also, Yanbu cement has constructed a waste heat recovery unit (WHR) to transform the plant's waste heat into electricity.

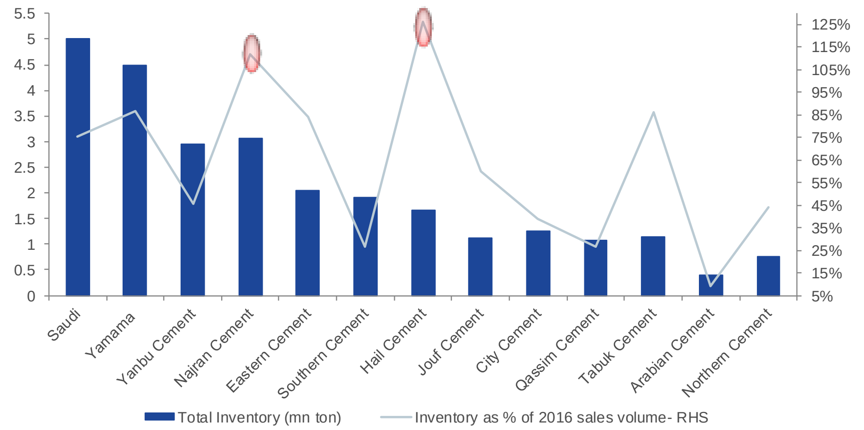
High Inventories strengthens the case for cutting production

The market value of total inventories in the sector is around SAR5.3bn.

In a sign of continuing woes for the sector, cement inventories in the Kingdom continued to rise driven by both decline in sales volumes and rise in production levels. By end of February 2017, total inventory in the Kingdom reached a new high level of 29.8mn tons (+29% y-o-y) , representing 57% of last 12-month sales. Four companies held 57% of the total inventory, namely Saudi, Yamama, Najran and Yanbu cement by 5.1mn, 4.5mn, 3.1 and 3.05mn tons respectively. Some companies such as Najran and Hail cement have more than 100% of 2016 sales as inventory. This could continue to result in more discounts being offered to customers. Arabian cement has the lowest level of 394k tons, representing only 9% of 2016 sales. The below figure shows current inventories of each company compared to 2016 dispatches.

Saudi and Yamama cement have the highest inventories of 5.1mn and 4.5mn tons ,respectively. While Northern and Arabian cement have the lowest levels of 763k and 357k tons, respectively.

Figure 4 Total inventories as compared to 2016 sales volume



Source: Company data, Al Rajhi Capital

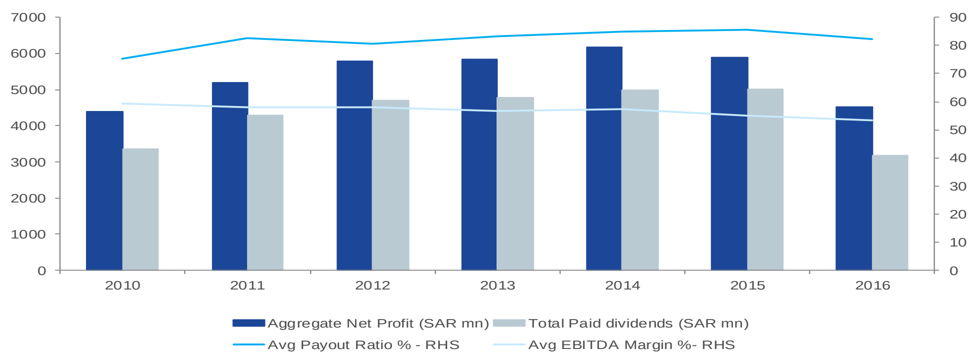
Lifting exports ban: In December 2016, Ministry of Commerce decided to allow Cement & Steel companies to export their products on the condition of paying the difference between fuel costs in local and international markets. The ministry estimated the export fees to be between SAR85-SAR133 per ton of cement. As we mentioned earlier, we see limited financial benefit for cement producers from lifting the ban on exports as we estimate the average operating profit of producers at about SAR 91 per ton during 2016. In our view, financial benefits from exports are limited due to transportation costs, geo-political issues, excess supply and competitive pricing in the region.

Dividends and key risks:

Although we anticipate a further reduction in dividend payments, the sector has an attractive dividend yield of ~5.8% (vs. 3.3% of TASI).

During 2016, dividend payments were cut across most of cement companies as a result of the decline in profitability, moving forward, we expect further reduction given the weak fundamentals for the sector in the short term. As we mentioned above, cost pressures, the supply and demand mismatch and high inventories are the key concerns for the sector. Upside risks to our view are enforcement of ministry of housing initiatives and government initiatives especially to boost religious tourism in Mecca and Madinah, clearing all dues to private sector etc.

Figure 5 Current level of dividend payments in the sector is not sustainable ..



Source: Company data, Al Rajhi Capital

Valuation and changes in target prices:

The cement sector witnessed a YTD decline by 12% (vs. -4.8% in TASI). Companies under our coverage are currently trading at an aggregate forward PE of 15.4x above 3 year average of 13.5x . We expect 2017 to be a challenging year for cement companies with profits falling by 33% on average for the companies under our coverage. Rising inventories, increased competition and price pressure, coupled with reforming fuel subsidy will all impact companies' net profit. We are Neutral on Saudi, Southern, Yamama and Arabian cement as we believe that most of the weaknesses are priced in, while we are underweight on Qassim and Yanbu cement.

Figure 6 valuation metrics for companies under our coverage

				2017E			
Company	Market Cap (SAR bn)	CMP	TP	P/E (x)	EV/EBITDA (x)	ROE (%)	DPS (SAR/share)
Yamama	3.81	18.3	17.8	13.5	6.3	6.80%	0.50
Qassim	5.09	51.0	45.0	13.6	10.4	17.1%	3.25
Southern	9.66	61.8	57.0	13.24	9.7	19.80%	4.00
Saudi	9.41	60.0	55.0	12.3	9.8	21.2%	4.25
Yanbu	5.83	36.9	32.0	14.2	8.3	12.3%	2.25
Arabian	3.85	38.1	36.0	12.9	7.5	10.20%	2.75

Source: Company data, Al Rajhi Capital

Company updates

Yanbu cement – Relatively higher pressure on selling prices amid stiff competition

In the first two months of 2017, Yanbu's sales volume fell 10% y-o-y, compared to 5% drop in clinker production.

In 2016, the company paid dividend of SAR 3/share (vs. SAR 5 in 2015).

In the past, Yanbu cement benefited from its strategic location in Western region, which is close major hot spots for high value construction projects. However, due to the sluggish demand in the Western region, decline in government infrastructure spending and inventory pile up, the company's profits declined by 34% in 2016. But despite the high competition, the company was able to reduce its inventory from 3.76mn tons by end of Q3 2016 to 3.05mn tons by end of February 2017 by offering huge discounts as seen in Q4 results. Thus, Yanbu's average realized price/ton dropped significantly by 13.2% y-o-y by the end of 2016. We expect the company to offer more discounts to maintain its market share in the Western region.

Recent developments: The company has signed a new contract - construction of a waste heat recovery unit (WHR) to transform the plant's waste heat into electricity, thereby conserving energy and cutting emissions. The company expects this system to improve efficiency of its grinding mills by 1mn ton/year. The WHR system is expected to be completed by early 2017.

Valuation and risks: Yanbu's stock is currently trading at a forward PE of 16.9x, while the expected dividend yield based on the current price is 5.5%. We value the company based on a mix of DCF and relative valuations. For now we are Underweight on the stock with a target price of SAR32 per share. The upside risks include benefiting from exports as the company located close to Yanbu commercial port. The downside risks include further drop in selling prices and difficulty to maintain market share amid oversupply situation in the region.

Qassim cement – Margin contraction

Qassim cement's sales volume and clinker production declined 14.2% and 11.5%y-o-y in the first two months of the year.

Qassim cement is one of the most operationally stable and cost effective companies in the cement sector, however, in 2016 the company was negatively impacted due to the increase in energy prices as well as the increased competition in the central region. The company's sales is concentrated in the central region (82.5% of 2016 sales). Western region contributes 8.8% and Northern 8.7% of sales. In 2017, we expect Qassim cement to be impacted by the high discounts that offered by competitors.

In 2016, the company distributed SAR4.75 dividend per share.

Recent development: In December 2016, Qassim Cement Co.'s shareholders, in their extraordinary general assembly meeting, approved transferring SAR 150.1 million from the company's statutory reserve to the retained earnings account.

Valuation and risks: Qassim's stock is currently trading at a forward PE of 15.7x, while the expected dividend yield based on the current price is 5.8%. We value the company based on a mix of DCF and relative valuations. Based on our revised estimates, we are underweight on Qassim cement with a target price of SAR45 a share. We expect the company to offer more discounts on its products as a result of increased competition from northern region's producers.

Saudi cement – Pricing advantage; may not sustain

In Feb& Jan 2017, the company's dispatches dropped 29% y-o-y (vs. market average of 20%).

Saudi cement is one of the largest cement producers in the kingdom, with a market share of 12.4%. Despite the weak market conditions in 2016, Saudi cement was able to maintain its steady performance compared to the sector mainly due to its locational advantage with low competition. Saudi Cement holds the highest level of inventory in the sector (5.1mn tons), which could give the company an advantage over its peers in the coming quarters after any potential removal of energy subsidies. However, this may lead the company to offer discounts especially if competition in the Eastern region increases.

The company paid SAR5.5 dividend per share in 2016.

Recent development: Saudi cement was the first cement company that cut production by its announcement in February 2016 of halting production at the 3500-ton capacity kiln due to market conditions in addition to put on hold its plans to replace three of the company's existing cement mills with two new higher-capacity mills.

Valuation: The company is currently trading at a forward PE of 13.7x. We value the company based on a mix of DCF and relative valuation. We are Neutral on Saudi cement with a target price of SAR55/share. We expect the company to distribute dividends of SAR4.25, which implies a dividend yield of 7% at current market price. We expect Saudi cement to continue expanding its market share in the central region.

Yamama cement – Challenging near term

Company's sales volume declined 32% y-o-y in first two months of 2017, and clinker production fell 17%y-o-y for the same period.

2016 was a tough year for Yamama as a result of limited demand from mega projects in the central region as well as higher depreciation expenses due to adjustment of useful life of plant. On the relocation issue, in November 2015 the company concluded the agreement to construct two production lines with total estimated cost of SAR 4.2bn.The new plant is located at Al-Kharj and it will have a capacity of 7.3mn tons compared to the existing 6.3mn tons plant(+16%) which will be closed when the new plant starts commercial production. The company has signed a SAR1.9bn loan with SIDF and commercial banks to partially finance the new plant. We expect the company to take advantage of its factory relocation by ramping up its capacity and replacing its old production lines with new technology.

The company distributed SAR 1 dividend per share in 2016 (vs. SAR3 in 2015).

Recent development: Recently, Yamama cement temporarily shut down five of its production lines due to the weak market conditions. The lines have a joint clinker production capacity of 5,600t/day. We anticipate further announcements from other producers in the coming months.

Valuation and risks: Yamama cement is currently trading at a forward PE of 15.2x. We value the company based on a mix of DCF and relative valuations. We are Neutral on the stock with a target price of SAR17.8/share. However, We believe that the uncertainty in future dividends will weigh on the stock as investors consider higher dividend yield as a key factor while investing in the sector. Given the relocation plans and challenging operating environment, we do not see any major triggers for the stock in the short-term.

Southern cement – Spare capacity

In the first two months of 2017, Southern's sales volume fell 34% y-o-y.

Southern cement continues to maintain the highest market share of 13.6% in 2016. The company was able to maintain stable average realized price/ton for many years, mainly due to relatively lower competition in the Southern region. However, it seems that the weak demand and company's spare capacity have led the company to offer discounts during 4Q 2016 as its selling price dropped 5% y-o-y to SAR230/ton. By end of February 2017, Southern's inventory grew 195% y-o-y to 2mn tons, representing 29% of 2016 sales volume compared to 55% market average. Despite the weak market conditions, we expect the company to maintain its current production level to ensure enough inventory to meet any significant demand from neighboring countries especially Yemen.

The company paid dividend of SAR 4.75 per share in 2016

Recent development: We expect the company to announce the commercial production of the second production line at its Bisha plant soon as the trial operations started on 25 Aug 2016. Looking to current market weak conditions, high inventories, and company's capacity addition of 3mn (1.5mn tons at both Bisha and Tuhama plants), we expect the company to operate these new production lines only partially and to offer more discounts on its sale prices.

Valuation: The stock is currently trading at a forward PE of 14.8x. We value the company based on a mix of DCF and relative valuation. We are Neutral on the company with a target price of SAR57/share. We expect southern cement to continue offering high dividend yield of 6.5% at current price level.

Arabian cement – Impacted by oversupply

In Jan & Feb 2017, the company sold 733k tons (-24% y-o-y)..

The current oversupply situation in the Western region has impacted Arabian cement's operating performance, which have led the company to sell at a deep discount in 4Q2016. In 2016, the company sales volume declined 17.2% as compared 2015 sales volume. The performance of the Jordanian subsidiary, Qatrana cement was below our estimate as the net profit fell 6.3% y-o-y in 2016. Unlike other companies in the sector, Arabian cement has a low level of inventory representing only 9% of 2016 sales. Thus, we don't expect the company to cut production in the short term.

Recent development: In November 2016, the company has said that construction works are still ongoing at its clinker grinder facility in Rabigh and that commercial operations are expected to start in Q4 2017. On the dividend side, Arabian cement distributed SAR4 per share in 2016, however, we believe that this level of dividends is not sustainable given the current market situation.

Valuation and risks: The stock is currently trading at a forward PE of 13.9x. We value the company based on a mix of DCF and relative valuations. After the sharp correction in the stock in January, we believe that most of the factors are priced in, thus we are Neutral on Arabian cement with a target price of SAR36.0/share. Arabian cement is likely to face difficulty in maintaining its market share as a result of the new producers in the region.

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"Overweight": Our target price is more than 10% above the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target 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.

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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