Arabian Cement

Initiating Coverage

Construction slowdown leads to muted outlook

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Investing with confidence

ARABIAN CEMENT

INITIATING COVERAGE

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We initiate on Arabian Cement Company (ACC), with a Neutral rating and a PT of SR41.7. The outlook for the sector is muted, with expectations of a 12-20% YoY decline in sales quantities in 2017E, and unfavorable cement export terms. Moreover, plans to reduce fuel support by 2020 will lead to a significant increase in costs. Potential positive catalysts include the Ministry of Housing initiatives and any increase in residential development activities resulting from the implementation of white land fees in Saudi.

- **Muted outlook, NTP 2020 and exports are potential demand drivers:** The Cement sector recorded its first decline in demand on record in 2016 (-9.5% YoY). Arabian Cement recorded the highest decline in sales quantities on record, at -17.2% YoY. Despite the muted outlook on projects, driven by the structural changes in the economy, we believe the National Transformation Plan 2020 (NTP 2020) initiatives may trigger demand growth. The Ministry of Housing's plans under NTP 2020 are promising, with plans to increase housing ownership from 47% to 52% by 2020. Despite export markets such as East Africa and Qatar being attractive, we believe the export tariff (SR83-SR133/ton) makes the exporting option largely unfeasible.

- **Competition, discounts and lower fuel support impact earnings:** The demand slowdown has led to high competition between players. We believe price discounts will continue, and forecast a decline in prices for Arabian Cement by -6% YoY in 2017E, following a -13.5% YoY decline in 2016. We believe this will impact gross margins. We forecast gross margins of Arabian Cement to decline from 43.9% in 2016 to 34.8% in 2021E. According to the Fiscal Balance Program, fuel support will be removed completely by 2020. This suggests potential further downside in profit margins.

- **Clinker capacity and operations in Jordan justify valuation discount:** ACC trades at a 2017E P/E of 10.6x vs covered peers average of 12.9x. We believe this discount is justified, due to the lower profit margins resulting from the low clinker capacity of ACC and Jordanian operations. Arabian Cement outsources part of its clinker needs, at higher rates. Demand in Jordan is weak and the ACC's operations have lower margins than Saudi due to the absence of fuel support. Operations are also indirectly impacted by the slowdown in Saudi, which leads to the clinker exchange program with Northern Cement to be placed on hold.

Summary Financials

SR mn	2016A	2017E	2018E	2019E	2020E	2021E	CAGR (%)
Revenues	1,257	1,075	1,036	1,035	1,033	1,031	(3.9)%
Gross Income	552	427	369	366	363	359	(8.2)%
Gross margin (%)	*43.9%*	*39.7%*	*35.7%*	*35.4%*	*35.1%*	*34.8%*	
Operating Income	487	360	304	301	298	295	(9.6)%
Operating margin (%)	*38.7%*	*33.5%*	*29.4%*	*29.1%*	*28.8%*	*28.6%*	
Net Income	491	356	308	307	306	304	(9.1)%
Net margin (%)	*39.1%*	*33.1%*	*29.7%*	*29.7%*	*29.7%*	*29.5%*	
EPS (SR)	4.9	3.6	3.1	3.1	3.1	3.0	(9.1)%

Source: Company, NCBC Research estimates

NEUTRAL

Target price (SR)	**41.7**
Current price (SR)	**37.8**
Upside/Downside (%)	**10.3%**

STOCK DETAILS

52-week range H/L (SR)	56.2/34.4
Market cap ($mn)	1,008
Shares outstanding (mn)	100
Listed on exchanges	TADAWUL

Price perform (%)	1M	3M	12M
Absolute	(2.6)	(13.8)	(18.6)
Rel. to market	(0.4)	(12.2)	(25.3)

Avg daily turnover (mn)	SR	US$
3M	15.1	4.0
12M	14.9	4.0

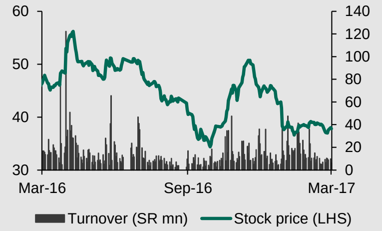
Reuters code	3010.SE
Bloomberg code	ARCCO AB
	www.arabiancement.com

VALUATION MULTIPLES

	16A	17E	18E
Reported P/E (x)	7.7	10.6	12.3
P/B (x)	1.2	1.1	1.1
EV/EBITDA (x)	5.7	6.7	7.4
Div Yield (%)	10.6	7.9	6.6

Source: NCBC Research estimates

SHARE PRICE PERFORMANCE



Source: Tadawul

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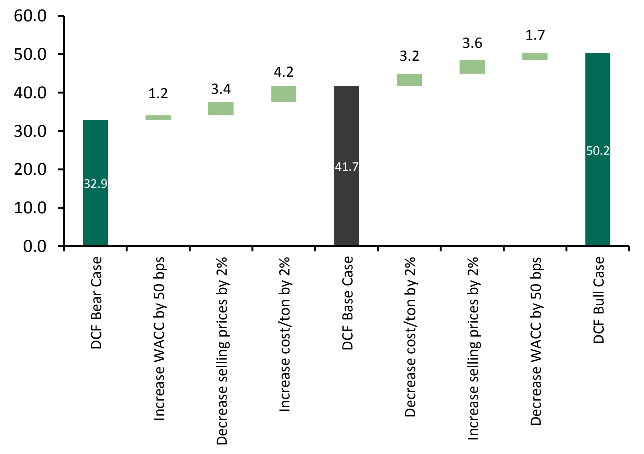
Investment Scenarios and View

Scenario analysis on DCF valuation



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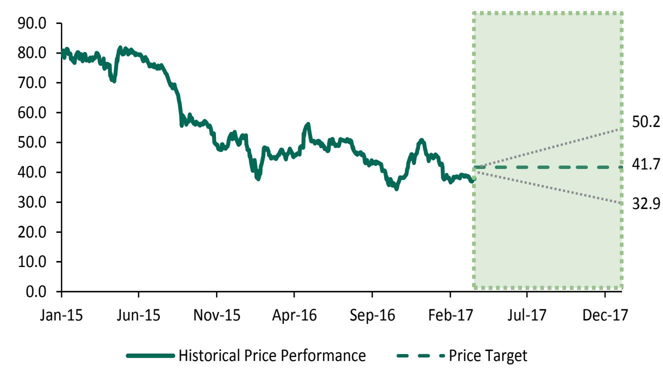
Historical and expected price performance



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Investment view

- **Favorable location:** Arabian Cement is located in the Western region, which is a key demand area in Saudi. Moreover if the company decides to export cement, it is ideally located near key markets such as East Africa.
- **Muted demand outlook:** The structural changes in the Saudi economy, amid weak oil prices and labour market changes, led to the first decline in demand on record in 2016. Capital expenditure by the government is expected to be limited going forward.
- **Increased competition:** The commercial operations began for Umm Al Qura and United Cement during 3Q16. This added c.6.3% to the total sector capacity, thereby placing further selling price pressures on established players such as ACC.
- **Unfavorable outlook on margins:** Muted demand outlook and lower fuel support, as highlighted in the FBP, is expected to have a negative impact on the margins of Arabian Cement.
- **Saudi slowdown impacts Jordan operations:** Due to the current low demand, ACC is producing less than 4.2mn tons of cement and will therefore not require outsourcing of clinker. This will impact the Jordanian Operations of the company, which benefits indirectly as a result of the swap agreement between ACC and Northern Cement

Investment scenarios

Price target: SR41.7	• Weighting of DCF base case is 70%, P/E is 15% and EV/EBITDA is 15%. P/E is calculated using 2017E EPS of SR3.54.
DCF bull case: SR50.2	• Limited price discounts due to an increase in demand levels in addition to a limited hike in fuel prices by the government would have a positive impact on ACC. This would translate to a limited decline in revenues at -3.4% CAGR between FY16-20E and net income at a -5.1% CAGR.
DCF base case: SR41.7	• Increased competition is expected to lead to further discounts. Moreover, lower fuel support will increase overall costs. We expected revenues to decrease -4.8% CAGR between FY16-20E, which net income will decrease by -11.3% CAGR.
DCF bear case: SR32.9	• Higher competition leading to larger price discounts in addition to a higher than expected hike in the price of fuel, would have a negative financial impact on ACC. This would translate to a steeper decline in revenues at -6.1% CAGR between FY16-20E and net income at a -20.2% CAGR.

Potential catalysts

- **Faster than anticipated economic recovery:** A V-shape economic recovery or faster than expected implementation of Vision 2030 will support infrastructure spending and overall demand for cement.
- **Increased demand in export markets:** Higher demand from key regional export markets such as East Africa will support the outlook for local players. Lifting the cement import ban in Iraq would also be a key positive catalyst.

Investment risks

- **Fuel allocation provided to all expansions:** There are currently six companies which added seven production lines with no fuel allocation. Gaining fuel allocation adds c. +20% to sector capacity and increase competition.
- **Any delay in Ministry of Housing projects:** The Ministry of Housing projects, under NTP 2020, are key future demand drivers. Any delay in project execution will have a negative impact on the sector's overall outlook.

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NCBC Investment Ratings

OVERWEIGHT:	Target price represents expected returns in excess of 15% in the next 12 months
NEUTRAL:	Target price represents expected returns between -10% and +15% in the next 12 months
UNDERWEIGHT:	Target price represents a fall in share price exceeding 10% in the next 12 months
PRICE TARGET:	Analysts set share price targets for individual companies based on a 12 month horizon. These share price targets are subject to a range of company specific and market risks. Target prices are based on a methodology chosen by the analyst as the best predictor of the share price over the 12 month horizon

Other Definitions

NR: Not Rated. The investment rating has been suspended temporarily. Such suspension is in compliance with applicable regulations and/or in circumstances when NCB Capital is acting in an advisory capacity in a merger or strategic transaction involving the company and in certain other situations

CS: Coverage Suspended. NCBC has suspended coverage of this company

NC: Not covered. NCBC does not cover this company