

Clinker Inventories: Clinker inventories touches historical high by end of 2016; raising market competition and putting downward pressure on price realization. Pressured fundamentals over 2017 outlook due to excess production capacity and lower demand. Clinker inventory to remain high in the near term, due to limited benefits from exports.

10MT Imported clinker in 2013 associated with excess production capacity and low demand led to the highest inventory level historically: Clinker inventories increased at CAGR of 17.55% during 2013-2016, the increase is attributed to: i) the government decree to import 10MT of additional clinker in 2013, which caused the inventories to increase by 130.0%YoY from 6.4MT in 2012 to 14.7MT in 2013, ii) cement companies raised their production capacity to exceed 70MT by the end of 2016, as compared to the local consumption of 56MT.

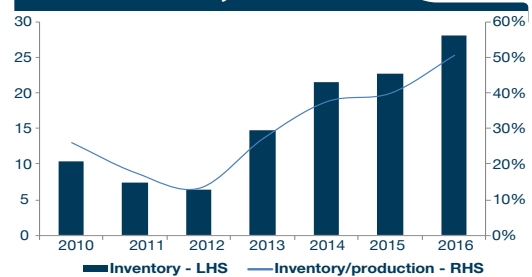
The government started to prioritize the projects to improve efficiency after the decline in oil prices, which caused a slowdown in construction activity. Furthermore, the government reduced its spending by 15.4%YoY in 2016 a decline from SAR 975bn to SAR 825bn, while capital expenditure on the strategic sectors declined by 56.1%YoY in addition to the cancelling of some projects. Therefore, a slowdown in construction activity was witnessed in cement dispatches recording a decline of 9.4%YoY and stood at 55.6MT, compared to 61.4MT in 2015. For 2017, despite the higher budgeted allocation on project (SAR 890bn from SAR 825bn in 2016), fundamentals for cement sector are still under pressure due to high production capacity, high inventory levels and limited benefits from exports. We expect cement dispatches to show signs of recovery by 2018 on back of improved economic outlook with high contribution from housing projects after the ambitious plan, that includes 280K residential products and funding allocation in all regions of the Kingdom. On the other hand, the government is planning to lift most subsidies on the provided fuel in FY2019, which could increase the production cost and impact profitability.

The key risks associated with high inventory level: The risks related with rise in clinker inventories is the high competition in the sector, which cause the companies to sell at high discount rate to keep their market share. This resulted in weak financial performance during end of 2015 and full year 2016. The average selling price for the sector in 4Q2016 stood at SAR 192.2 compared to SAR 217.0 in 4Q2015 as a result of higher inventories level. For instance, Yanbu Cement provided the highest discount on prices and sold at SAR 151.8/ton in 4Q2016, in order to maintain its market share. Furthermore, lower realized price per ton resulted in narrower gross margins for Saudi cement sector, which declined from 50.7% in 2015 to 46.6%. Total net income for the Saudi cement sector declined by 23.2% in FY2016 to stand at SAR 4.5bn compared to SAR 5.9bn in FY2015. This is mainly due to lower volumetric sales, weak selling price and higher production cost. This led to cut in dividend payment during 2016, as it declined from SAR 2.07bn in 1H2015 to 1.76bn in 1H2016 a decline of 15.0% (excluding City, Tabuk and Eastern Cement for comparison purposes).

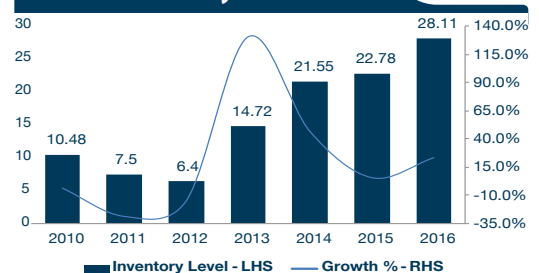
Central region contributed the most to the clinker build-up, and Saudi Cement has the highest clinker inventories: on regional basis, Central region has the highest clinker inventories level with a contribution of 29.7% to the total inventory level, followed by Southern region with contribution of 23.9%. We believe that the high inventory level in central and southern regions is ascribed mainly to the high production to sales ratio, along with a sudden sharp decline in the construction activity. On company basis, Saudi Cement has the highest inventory level of 4.7MT and a market share of 16.8%, followed by Yamama Cement with inventory of 4.3MT and market share of 15.4%. Aljouf Cement recorded the highest increase in inventories as it rose 94.5%YoY, followed by AlSafwa Cement which showed an increase of 78.8%YoY.

Decrease in production and lower requirement on exports in order to reduce the inventories level: For the near-term, construction activity is not expected to show signs of recovery; which could further increase the inventory levels and put more pressure on selling prices. We believe that the sector can have some benefit from ; i) halting some excess production lines .However, this will result in lower ROIC on production lines, which is unfavorable for the companies and stakeholders, and ii) the government needs to lessen regulation on exports, where the duties on exported ton is between SAR 85-133/ton. Based on our calculations, we believe that the cost per exported ton could increase to SAR 280-340 (including shipping cost and operating expenses). We believe that dropping some barriers on cement exports regulations might help local producers offload their excess inventory and relieve oversupply in the domestic market.

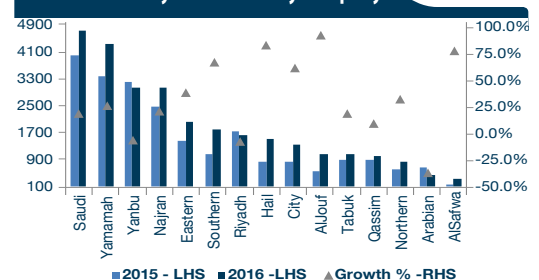
Clinker Inventory/ Production



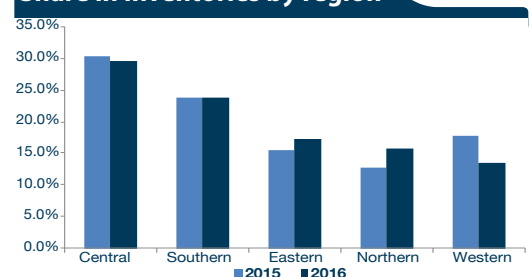
Clinker Inventory levels



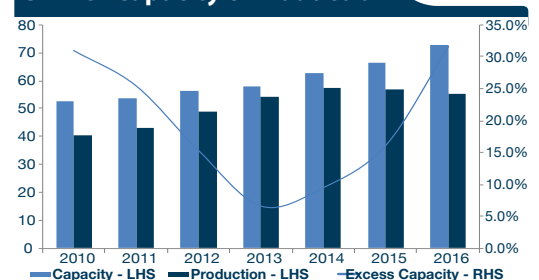
Clinker inventory distributed by company



Share in inventories by region



Clinker Capacity & Production



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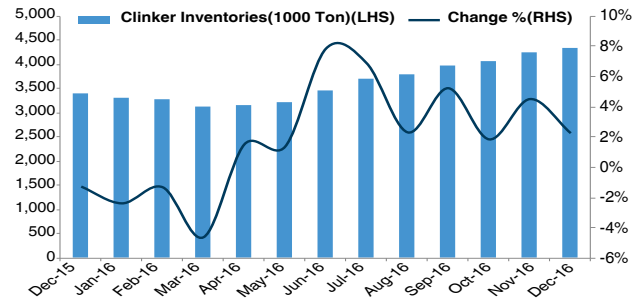
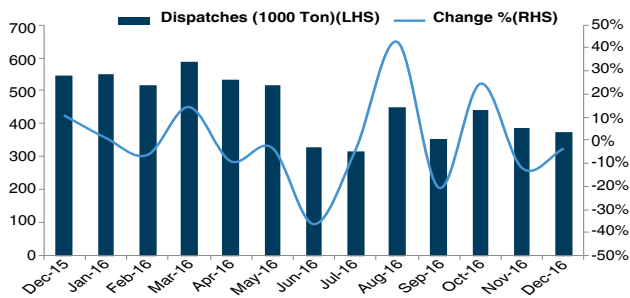
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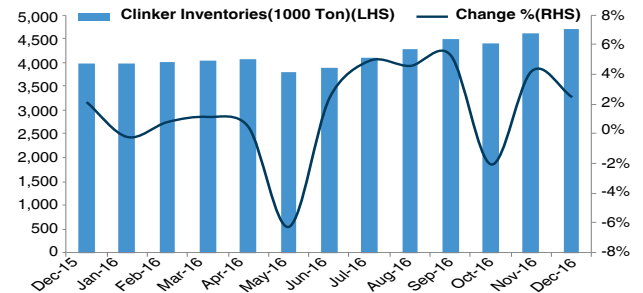
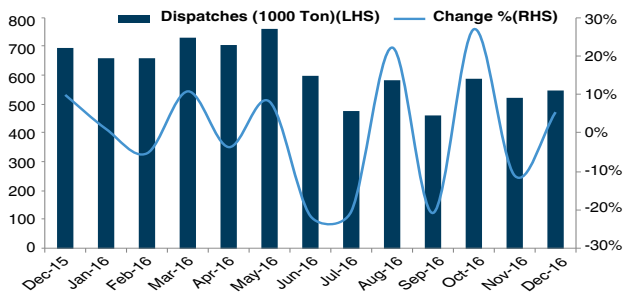
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Dispatches & Change

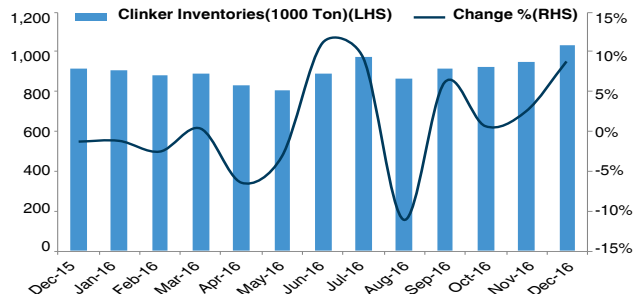
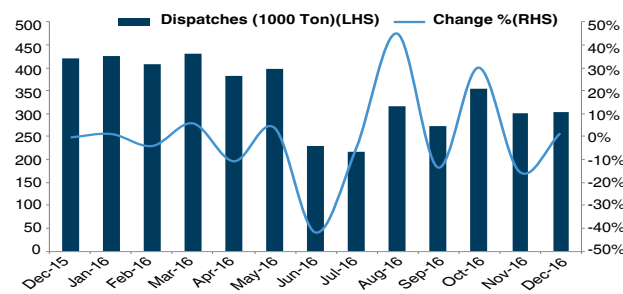
Yamaha Cement



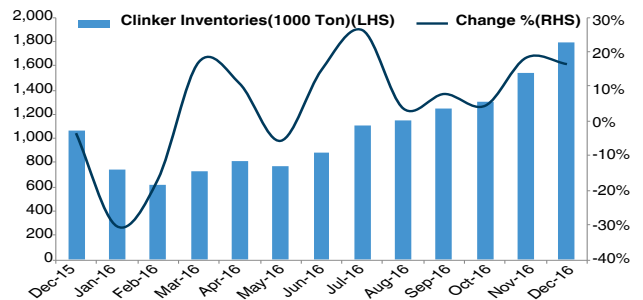
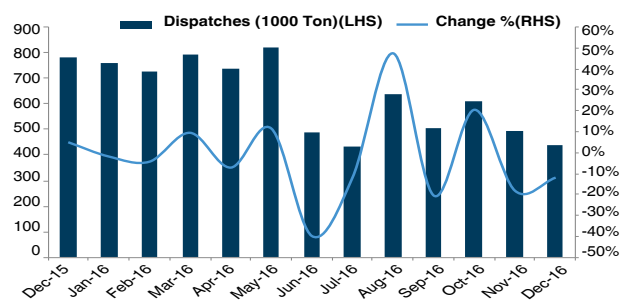
Saudi Cement Co



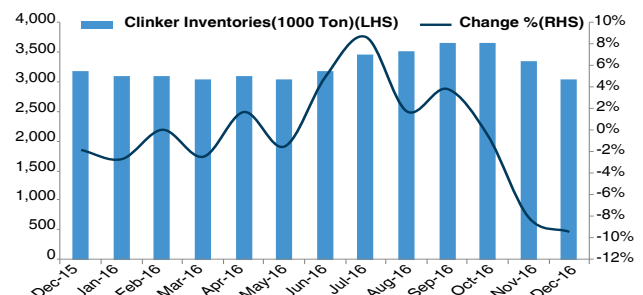
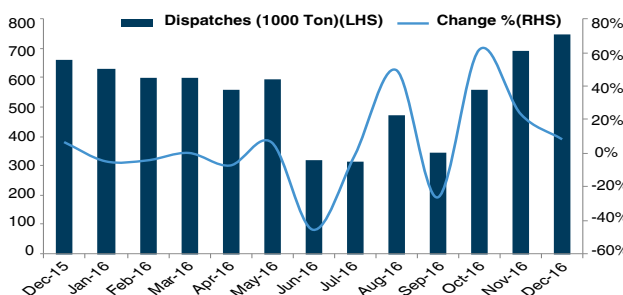
Qassim Cement



Southern Cement

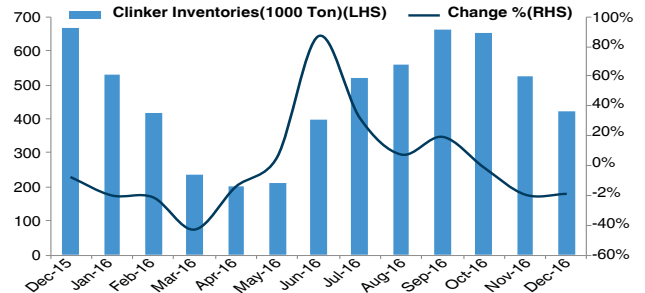
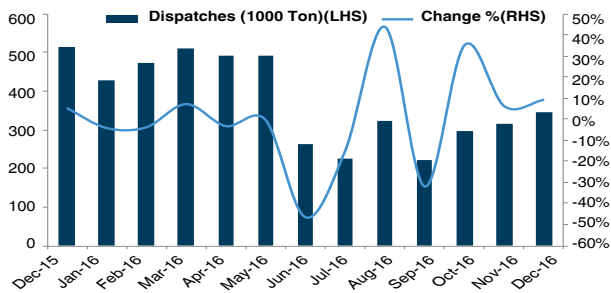


Yanbu Cement

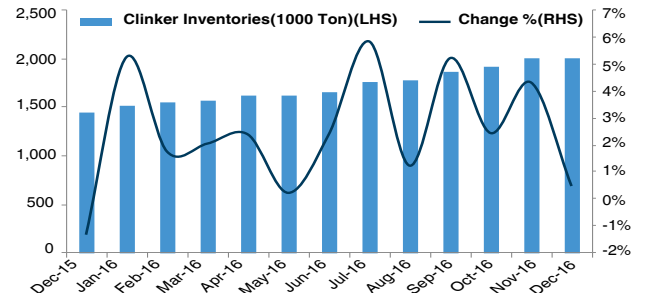
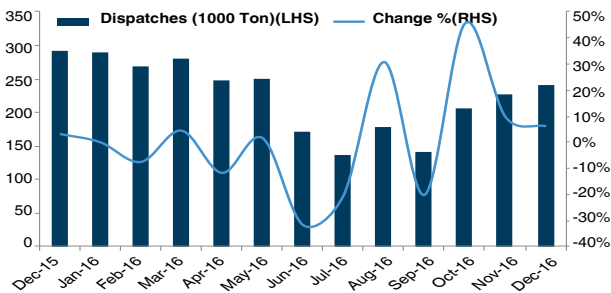


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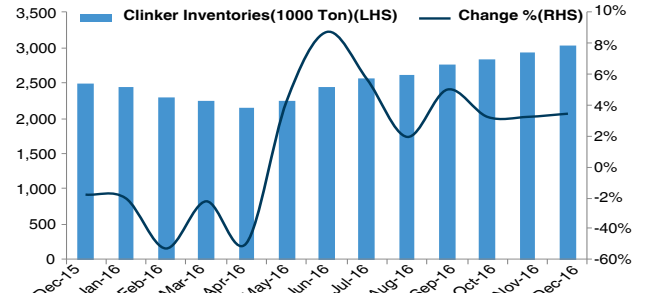
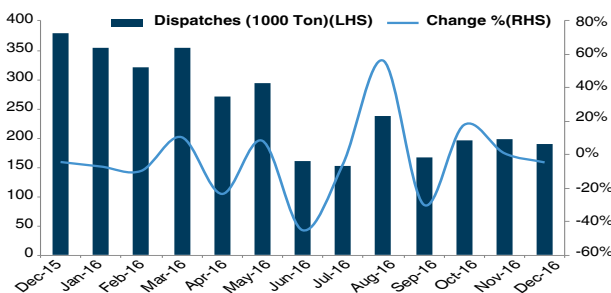
Arabian Cement



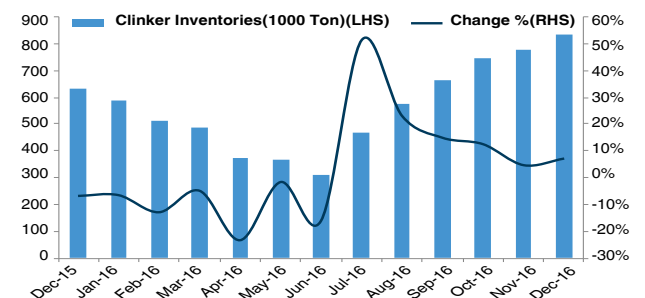
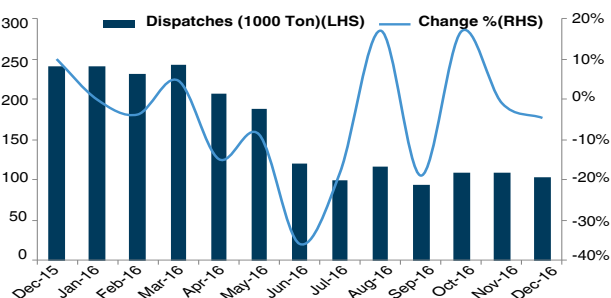
Eastern Cement Co



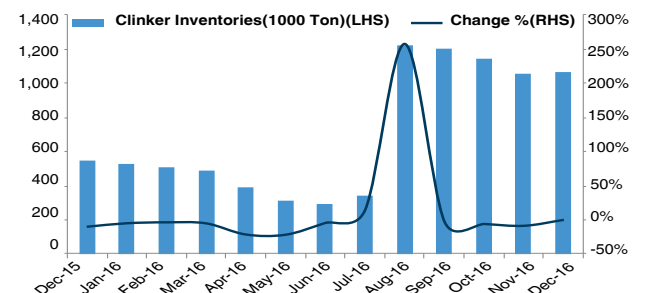
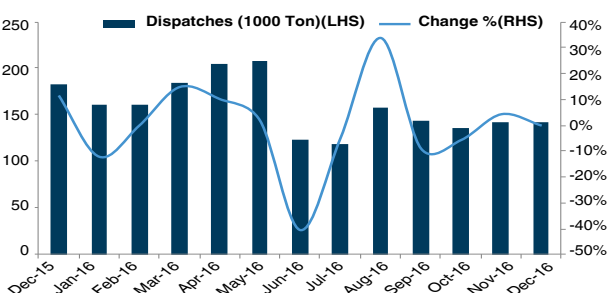
Najran Cement



Northern Cement

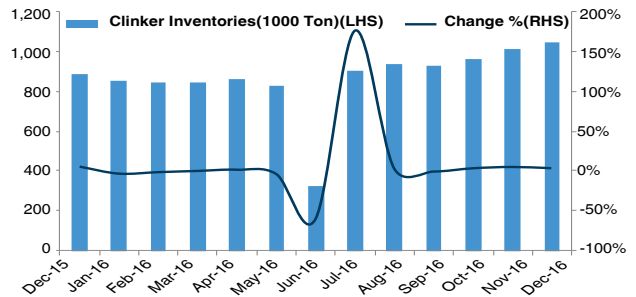
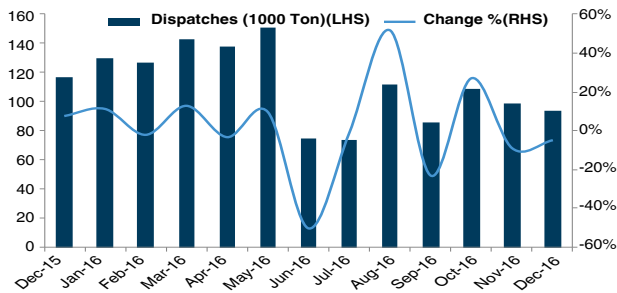


AlJouf Cement

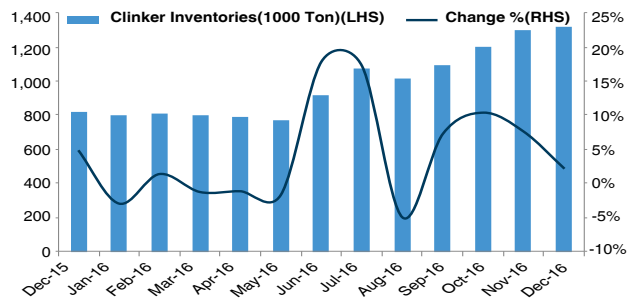
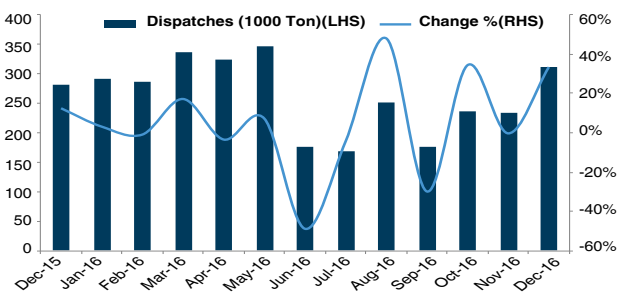


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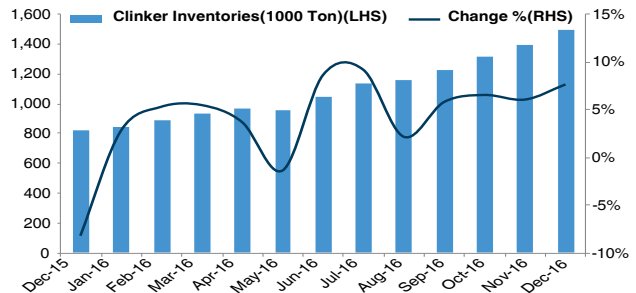
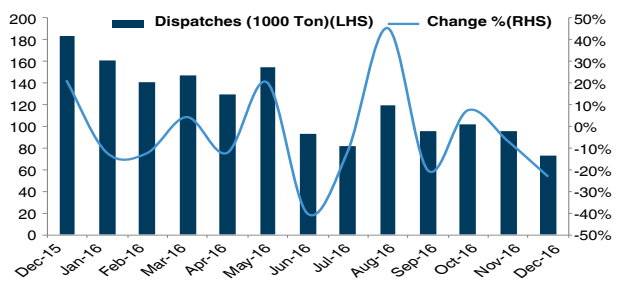
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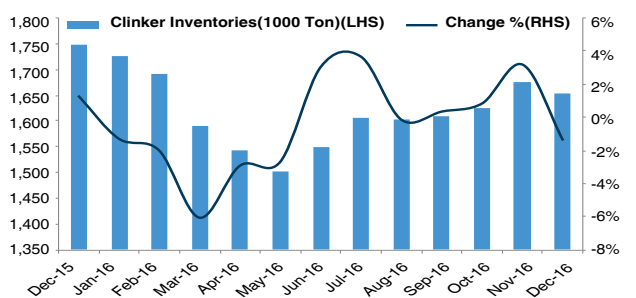
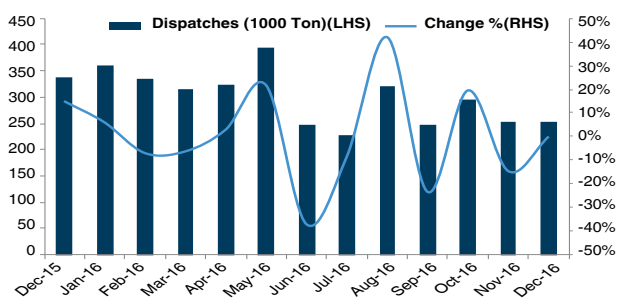
City Cement Co



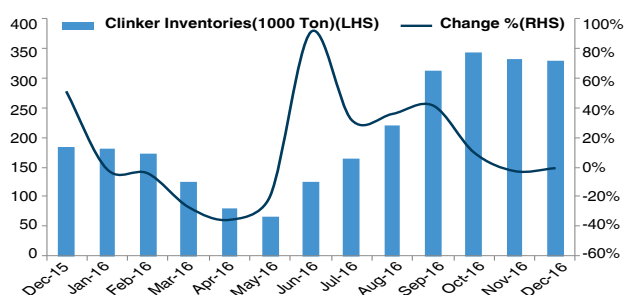
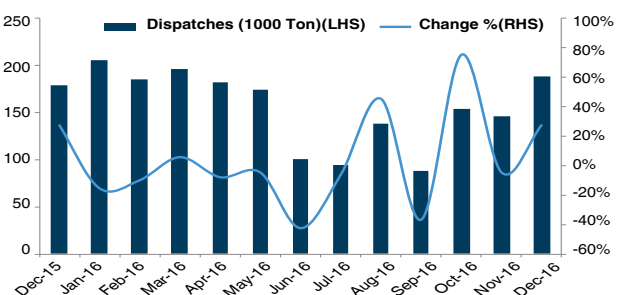
Hail Cement



Riyadh Cement



Safwa Cement



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