Saudi Cement Sector: pressured fundamentals with attractive dividends. Ongoing infrastructure development, construction activity may provide incentive in medium term. In contrary, a high clinker inventory, coupled with high fuel cost, could affect cement sector margins in the near-to-medium term. Limited benefits on cement exports due to some barriers in the requirements.

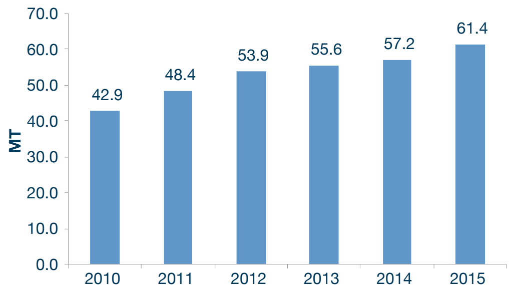
Cement sales to remain muted in 2016: Low crude oil prices over the past two years have led to low oil revenue in Saudi Arabia. This as a result was reflected in lower government spending and withdrawal of reserves to fund the budget deficit. Cement sales in Saudi Arabia rose 43.3% to 61.4mn ton from 42.9mn ton during 2010–15. In 2014, cement sales were affected by labor shortage. However, cement sales recovered in 2015 and in the first four months of 2016, with modest 7.4%YoY and 0.8%YoY growth rates, respectively. Simultaneously, clinker inventories reached an all-time high of 22.7mn ton in December 2015, gradually declining by 1.9mn ton to 20.9mn ton in April 2016.

Although Saudi Arabia has one of the largest reserves worldwide, which could fund the budget deficit over the next 3–4 years, pressure due to low oil revenue is affecting government expenditure. This can be observed from the Government's move to curb budgeted spending in infrastructure and transportation. In the 2015 budget, the government allocated SAR 63.0bn to the infrastructure and transportation sector, which was reduced to SAR 23.9bn in the 2016 budget. We expect more pressure on the sector due to reduced government spending. However, construction activity, which accounts for about 60% of cement consumption, could remain high, bolstered by a robust pipeline of projects under the housing ministry's public spending program. Although the budget for infrastructure and transportation has been reduced, cement sales could stabilize to show only a 3–4%YoY decline, led by ongoing spending on housing projects.

Sales increased 0.8%YoY to 22.5mn ton during the first four months ended April 2016. Cement sales for January–April 2016 suggest a healthy performance in FY2016 compared with FY2015. However, we expect cement sales to slow down in the next few months, registering a decline of 3–4%YoY in 2016. Furthermore, sales stability may not translate into the same level of profitability for cement companies in 2016 due to continued pressure on cement prices and higher fuel prices. Additionally, high inventory levels may hit the profitability of cement companies as a result of lower selling prices.

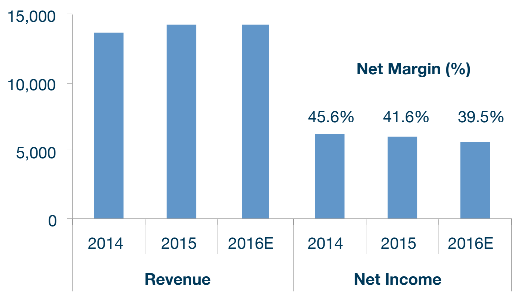
Decline in government spending to be reflected in cement sector: The Saudi government budget may face more pressure due to low oil prices. However, we continue to believe that spending on infrastructure would be reduced gradually over the long term, rather than any immediate cancellations of large-scale projects. This belief stems from the ongoing infrastructure development, particularly key projects such as the development of Saudi Arabia's various rail and metro projects, or the significant housing program. To support this ongoing spending, we expect the government to utilize its substantial reserves, as well as raise debt from the market. While data from the Saudi Arabian Monetary Agency (SAMA) shows Saudi Arabia used SAR 251bn (USD 67bn) of its general reserves in 2015, it still has USD 598bn in foreign assets (as of January 2016). Moreover, following a series of repayments over the past decade, public debt amounted to just USD 11.8bn (1.6% of GDP) at the end of 2014. With the current low level of public debt, Saudi bonds are considered highly attractive to institutional investors; the government will have no difficulties in financing its spending obligations over the next few years. The budgeted expenditure in 2016 is SAR 840bn with an estimated deficit of SAR 327bn, lower by 13.8% from 2015's actual expenditure. However, we believe the government will continue with its commitments to maintain high spending, despite challenges, which is a positive for the country's cement sector.

Cement sales – million ton



Source: Company reports, Aljazira Capital

Sector Performance (SAR mn)



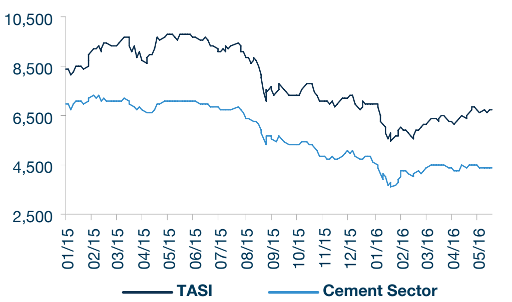
Source: Company reports, Aljazira Capital, Bloomberg

Key Market Data/Ratios

P/E (TTM):	9.80x
P/B	1.70x
Dividend Yield	8.75%
Market Cap(bn)	57.4
YTD %	-5.7%
ROA	13.4%
ROE	17.6%

Source: Company reports, Aljazira Capital

Sector Performance



Source: Bloomberg, Aljazira Capital

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Updated key financials & investment

	Company	Current Price	12month TP (SAR)	Recommendation	Profitability (SAR in mn)		EPS (SAR mn)		PE (x)*		PBV (x)*		Dividend yield*
					2015	2016E	2015	2016E	2015	2016E	2015	2016E	2016E
3020	Yamamah Cement	26.2	34.70	Overweight	641.9	586.2	3.17	2.89	9.9	9.1	1.69	1.46	7.6
3030	Saudi Cement	64.47	75.10	Overweight	940	920	6.14	6.01	10.6	10.7	3.07	2.99	8.5
3050	Southern Cement	74	86.50	Overweight	1038.6	1059	7.42	7.57	9.4	9.8	2.97	2.91	8.1
3040	Qassim Cement	62.7	69.70	Overweight	586.1	506.2	6.52	5.62	10.8	11.2	3.12	2.84	8.8
3010	Arabian Cement	47.86	65.10	Overweight	601.4	595.1	6.02	5.95	7.9	8	1.33	1.49	9.4
3060	Yanbu Cement	42.88	56.30	Overweight	806	750.3	5.12	4.76	8.6	9	1.80	1.81	10.5
3002	Najran Cement	13.43	17.40	Overweight	255.6	209.2	1.50	1.24	9.7	10.8	1.17	1.13	8.2
3001	Hail Cement	12.4	16.50	Overweight	113.5	144.19	1.16	1.47	12.4	8.4	1.33	1.14	10.1
3003	City Cement	14.52	17.20	Overweight	241.9	245.6	1.28	1.30	11.8	11.2	1.43	1.32	8.6
3080	Eastern Cement	29.8	38.80	Overweight	336.6	297.4	3.91	3.46	8.1	8.6	1.15	1.06	8.4
3004	Northern Cement	12.49	12.30	Neutral	206.9	159.2	1.15	0.88	13	14.2	1.27	1.15	6
3090	Tabuk Cement	14.36	13.20	Neutral	89.8	71.4	0.99	0.78	14.7	18.4	1.12	1.16	5.2
3091	AlJouf Cement	8.89	11.40	Overweight	76.3	88.7	0.59	0.68	18	13.1	0.91	0.77	-

Source: AlJazira Capital* we have taken respective December closing prices for 2015, while for years 2016 & onwards we used closing price of 30th May. 2016.

Housing construction to offset the impact of low government expenditure: Housing construction accounts for about 60% of cement consumption in Saudi Arabia. The kingdom is witnessing huge developments in housing construction due to growing domestic population, the expanding Saudi labor force, and a rapidly declining household size. The real estate off-plan sales program reached more than SAR 34bn since approval, including projects of more than SAR 13bn licensed during 2015. Recently, the Ministry of Housing signed agreements with 11 developers to construct about 56,099 housing units in Riyadh, Makkah, Hail, Tabuk, and the Eastern Province under a government housing program to support citizens. More than three-fourths of the new housing units will be constructed in Makkah. Among the total 42,183 housing units in Makkah, 41,998 will be built in the Jeddah governorate and 189 in Taif. These projects will be implemented by five real estate companies. Two real estate developers have been awarded contracts to build 8,518 housing units in Riyadh, while 1,394 housing units will be constructed in Hail by two developers. A total of 2,304 housing units will be built in the northern Tabuk region, while 1,700 units will be built in the Al-Khobar governorate in the Eastern Province.

The white land tax of 2.5% will be applied to undeveloped residential and residential/commercial properties in a bid to stop speculation and expedite the construction of housing units. The tax was introduced to tackle a housing shortage for the kingdom's young and growing population. Empty plots made up around 40% of the capital Riyadh in 2013. With this move, owners will be pushed to build on empty land or sell the plots, thus enabling the government to expedite construction. This will be the driving force for greater development and infrastructure activities.

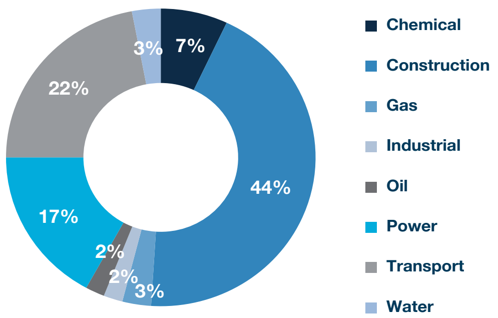
Ongoing, upcoming projects to support healthy consumption of cement: Based on statistics provided by MEED, Saudi Arabia plans to deliver USD 500bn worth of projects in the pre-execution phase spanning the power and water, transport, hydrocarbons, and construction sectors. Construction is the largest sector, accounting for over half of the total projects.

Ongoing, upcoming infrastructure and construction Projects to support cement sales

List of ongoing and upcoming projects	Total estimated investment (USD bn)
Riyadh Metro	22.0
King Abdulaziz International Airport	7.2
Saudi Landbridge	7.0
Makkah Grand Mosque Redevelopment	24.4
King Abdullah Port Expansion	2.0
Jubail II	80.0
King Abdullah Economic City (Rabigh)	27.0
The Kingdom Tower (Jeddah)	1.2
Jeddah Metro	8.5
Total	179.3

Source: Aljazira Capital, MEED

Projects Market by sector



High fuel cost to dent margins: In December 2015, the Saudi government raised the prices of electricity, water, and fuels, including natural gas and heavy fuel (main energy sources in the Saudi cement industry). The price of heavy fuel oil (HFO380) rose to USD 3.8 per barrel (4.90–8.96 hallah per liter). Based on our calculation for 1Q2016, the price revision resulted in a 5–12%, or SAR 5–10 per ton, increase in production cost for cement producers. However, Yanbu Cement, Aljouf Cement, Hail Cement, and Southern Cement could record a 3–7% decrease in production cost. Najran Cement's production cost raised the most at 17.1%YoY to SAR 135.7/ton, while that of Southern Cement declined the most at 6.6%YoY to SAR 108.2/ ton due to lower use of imported clinker. Gross margins at all companies declined, except at Southern Cement. The greatest decline in gross margin was observed at Tabuk Cement, sliding from 45.4% to 34.9%YoY in 1Q16, while the least decline was observed at Yanbu Cement, moving down from 51.3% to 50.1%YoY in 1Q16.

A ceiling on the cement price of SAR 240/ton and a high clinker inventory, coupled with high fuel cost, could negatively affect cement sector margins in the near-to-medium term as it would be difficult for manufacturers to pass on incremental costs to customers. However, the possibility of the export ban being lifted, improved production efficiencies, and higher utilization could bring respite to overall margin decline.

Analysis: Impact of high fuel cost

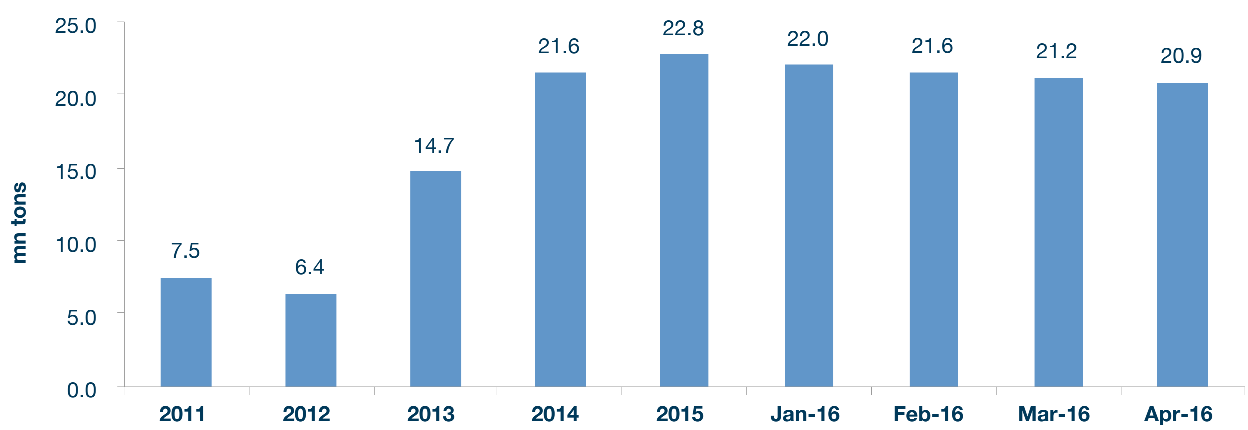
Companies	Production cost/ton (SAR)			Gross Margin (%)		
	1Q15	1Q16	Change (%)	1Q15	1Q16	FY2016E
Yamamah Cement	105.0	114.5	9.1	53.7	49.6	49.9
Saudi Cement	96.9	101.3	4.5	61.6	58.4	56.3
Qassim Cement	92.7	103.0	11.1	62.5	52.8	51.9
Yanbu Cement	111.7	108.8	-2.6	51.3	50.1	49.86
Southern Cement	115.8	108.2	-6.6	52.0	55.1	54.6
Tabuk Cement	117.0	122.8	5.0	45.4	34.9	35.3
Najran Cement	115.9	135.7	17.1	52.6	44.5	46.5
City Cement	103.8	105.8	1.9	52.1	46.5	44.6
AlJouf Cement	112.9	109.0	-3.5	42.1	39.1	38.9
Hail Cement	95.9	94.1	-1.9	56.5	52.8	52.4

Source: Bloomberg, companies' reports, Aljazira Capital

Lift of export ban to relieve excess inventory and oversupply, however financial benefit is limited: Cement production increased moderately at a CAGR of 5.4% over the past five years to 61.5mmt in 2015 from 48.3mmt in 2011. Simultaneously, cement and clinker inventories increased at a CAGR of 25.8% to an all-time high of 23.6mmt in 2015 from 8.2mmt in 2011. These inventories were driven by the Saudi government's ban on cement exports in February 2012 and a stockpile of 10.0mmt of imported clinker in 2013/2014. Nevertheless, according to industry sources and the local media, the government dropped the partial ban on cement exports to help exporters offload excess inventory and relieve the oversupply in the domestic market. Even a partial relief on the export ban could help cement producers regain normal sale prices. Cement exporters have to pay back the fuel subsidy for exported cement, in addition to carrying the transportation and shipping costs, which limits the attractiveness of cement exports. Only seven companies have satisfied the government's requirement with almost 50% inventories of their production capacity, which would allow them to export clinker. These companies are Saudi, Yamama, Eastern, Yanbu, Najran, Tabuk, and Hail Cement.

Thus, we believe cement firms located in the Northern, Eastern and Southern regions could reap the benefit of export demand from the kingdom's neighboring countries. The Qatar World cup 2022, the proposed reconstruction of Yemen, king Salman Bridge between Tabuk and Sharm el-Sheikh resort in Egypt, and the UAE EXPO 2020 are key catalysts of export potential. We believe the cement companies in Saudi Arabia are likely to focus on the potential markets in the Middle East.

Clinker inventory remains at multi-year-high



Source: Yamama Cement Company, Aljazira Capital

High inventory levels drive cement companies to halt production, expansion plans: The government's reduced spending on infrastructure, coupled with the export ban, has piled up clinker inventories in the kingdom. In April 2016, 20.9mn ton of clinker inventories were recorded, which remains a key concern for all cement producers. We estimate, the current clinker inventory is close to 35% of the cement sector's current production capacity. To relieve these all-time-high inventories, in the past couple of months, a few cement firms stopped producing new clinker and shelved expansion plans. Consequently, clinker inventory declined 8.3% to 20.9mn ton in April 2016 from 22.8mn ton in December 2015. We believe that other cement companies may follow suit to manage their inventory.

- **Saudi Cement halts kiln, pulls back on expansion plans:** Weighed by huge inventories, uncertain market conditions, and a continued export ban, Saudi Cement halted production at its kiln with 3,500 ton-per-day capacity in early February 2016 and postponed its mill expansion.
- **Eastern Cement announces shutdown of furnace until market conditions improve:** Eastern Cement plans to temporarily shut down a clinker furnace until market conditions improve and export bans in Saudi Arabia are lifted. According to the management, continued operations at the furnace with a capacity of 3,500 ton per day would bloat its clinker inventory, which already touched 1.5mn ton in 2015.
- **In the first 4M-2016, sector reduced clicker production by 1%YoY:** Cement sales stood at 22.2mmt during 4M-2016, compared with the 18.6mmt of clinker produced, to reduce the inventory level. Saudi Cement's clinker production declined 9.4%YoY, followed by Yamama's at 4.4%YoY, Najran's at 27.2%YoY, Northern's at 25.9%YoY and Alsafwa's at 13.4%YoY.

Peak inventory levels, highly competitive market continued to weigh on cement sale prices in 1Q2016: Weighed by peak inventory levels in 2015, cement producers adopted a volume-driven growth strategy and began to undercut prices, offering 7–10% discounts in certain strategic markets to maintain market share. By dividing revenues of all companies under our coverage by cement sales volume, we derived the cement sales price for each one. While this may not be an accurate estimate – as it would include revenue from other sources (for cement companies such as Arabian, Eastern, and Northern) – it can be used as a proxy to understand the YoY drop in cement sale prices from 2014 to 2015. Despite the cut-back in clinker production and halted expansion plans, we believe the current high level of inventory is likely to continue affecting cement sale prices in 2016. However, the expectation of lifting of the export ban and incremental government spending on housing construction could support prices in the medium term.

Charts: Excess inventories, competitive market to adversely affect margins in 2016

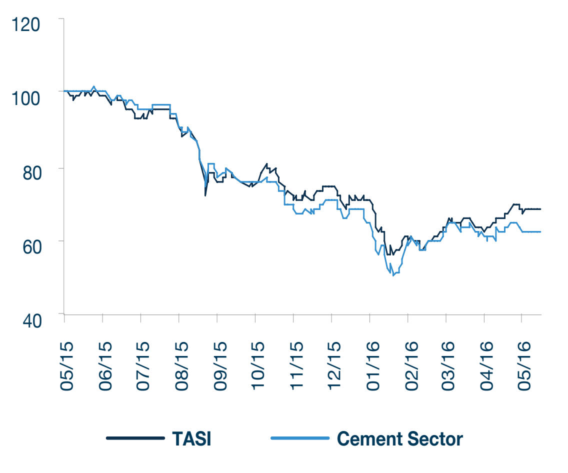
Companies	Gross margins (%)			Net margins (%)			Derived cement sales price in SAR per ton		Cement sale prices (% chg. YoY)	
	FY14	FY15	FY16E	FY14	FY15	FY16E	FY14	FY15	1Q16	Cement sale prices (%)
Al Jouf Cement	38.1	36.3	38.9	22.5	22.7	24.7	200.4	194.5	179.1	-7.9%
Arabian Cement	42.5	44.1	42.6	37.5	36.5	37.3	262.1	258.9	238.0	-8.1%
City Cement	55.9	49.6	44.6	48.8	43.2	38.4	227.1	210.3	198.1	-5.8%
Eastern Cement	41.7	41.6	38.0	44.2	35.4	32.2	241.1	236.4	229.1	-3.1%
Hail Cement	51.7	47.0	52.4	41.3	31.9	40.3	220.0	201.8	199.2	-1.3%
Najran Cement	48.2	48.0	46.5	29.4	23.5	20.0	242.9	243.7	244.4	0.3%
Northern Region	39.5	38.2	31.0	20.0	18.3	14.3	263.5	252.8	242.5	-4.1%
Qassim Cement	62.4	61.5	51.9	57.7	57.3	47.6	251.7	232.4	218.3	-6.1%
Saudi Cement	60.7	58.8	56.3	53.1	48.7	48.5	253.9	250.9	243.1	-3.1%
Southern Province	53.0	54.2	54.6	55.7	50.7	53.4	241.3	241.4	240.9	-0.2%
Tabuk Cement	57.3	41.8	35.3	42.7	33.0	25.3	224.8	209.4	188.7	-9.9%
Yamama Cement	53.6	57.7	49.9	50.5	49.0	42.6	244.0	225.9	227.2	0.6%
Yanbu Cement	54.7	54.0	49.86	51.4	50.0	46.1	247.8	230.2	217.9	-5.3%

Source: Bloomberg, companies' reports, Aljazira Capital

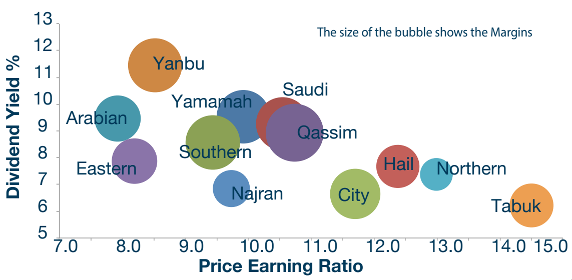
Attractive valuations: The Saudi cement sector currently trades at a 12-month (TTM) P/E of 9.80x, which is at a steep discount vis-à-vis an average P/E of 14.4x over the past three years. A continued decline in global oil prices and uncertainty in global markets due to weakness in the Chinese economy and economic tensions in Europe have weighed on the TASI over the past year, with a return of -34.4%. Conversely, the cement sector index declined 39.3% over the past year, more than the TASI. We remain bullish on the cement sector due to the positive impact of lifting the export ban, subsiding labor issues, continuing infrastructure development, and expanding residential building sector, which accounts for over 60% of the cement demand. The cement sector also recorded an average dividend yield of 8.75% in the last 12 months vis-à-vis average market's yield of 3.79%. We believe the current steep discount in trading multiples, coupled with potential price appreciation, would present the cement sector with an attractive buying opportunity to earn solid dividends over the next few months.

We have compared Saudi cement companies and few global leading cement companies based on their Price to Earning, Dividend yield and operating margins. Overall when comparing Saudi cement companies to its global peers, we believe Saudi cement companies on an average are trading at a much lower PE and higher dividend yields, coupled with robust margins making them very attractive in the global arena. We believe Yanbu cement and Arabian Cement looks the most attractive in terms of dividend yield and relatively low PE, while Southern cement, Saudi cement and Qassim cement have the strongest margins in the sector. Among other Saudi Cement Companies, Tabuk and Northern cement seems to be relatively expensive on valuations, coupled with low dividend yields.

Cement index underperforms broader index over past year



Source: Bloomberg, Aljazira Capital



Source: Bloomberg, Aljazira Capital

Undervalued sector with healthy dividend policy – A story to buy

	DPS (SAR)		EPS (SAR)		PE (X)	
Companies	FY15	FY16E	FY15	FY16E	FY15	FY16E
Al Jouf Cement	-	-	0.61	0.68	18.0	13.96
Arabian Cement	4.50	4.50	6.02	5.95	7.93	8.39
City Cement	1.25	1.25	1.28	1.30	11.8	11.32
Eastern Cement	2.50	2.50	3.91	3.46	8.1	8.88
Hail Cement	1.10	1.25	1.16	1.47	12.38	8.67
Najran Cement	1.00	1.10	1.50	1.24	9.71	11.32
Northern Region Cement	1.10	0.75	1.15	0.88	13.0	14.57
Qassim Cement	6.25	5.50	6.57	5.62	10.76	11.15
Saudi Cement	6.00	5.50	6.18	6.01	10.56	10.47
Southern Province Cement	6.00	6.00	7.40	7.57	9.44	10.03
Tabuk Cement	0.90	0.75	1.01	0.78	14.7	19.29
Yamama Cement	3.00	2.00	3.17	2.89	9.92	9.35
Yanbu Cement	5.00	4.50	5.12	4.76	8.56	9.18

Source: Bloomberg, Aljazira Capital

Key risks:

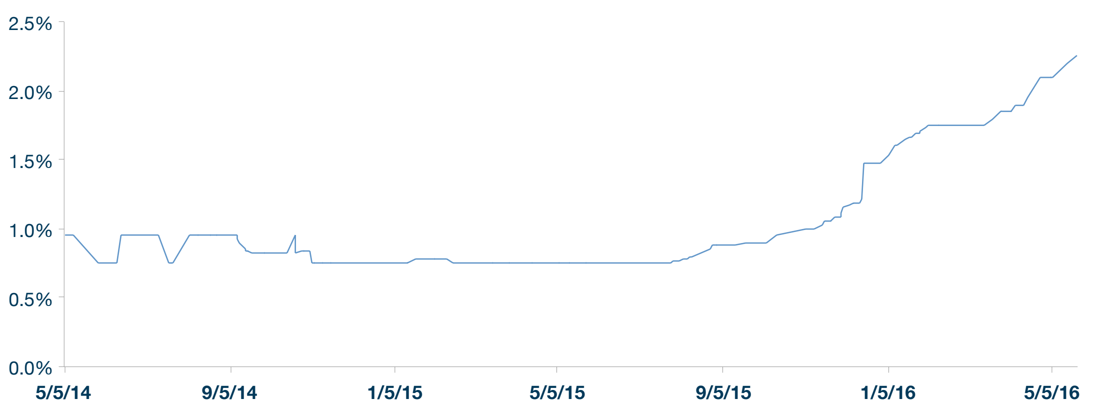
Possible fuel, electricity, water price hikes: In December 2015, the Saudi government increased the prices of electricity, water, and fuel. We believe sustained low global oil prices and continued government spending on infrastructure and social welfare could keep the government's balances in deficit in 2016. Consequently, as a measure to recover these losses, the government could once again push for a similar price hike in fuel, electricity, and water, which would impact cement companies' margins. However, such a move by the government seems unlikely before the end of 2016.

Declining global oil prices: The Saudi economy depends heavily on revenue from hydrocarbons. However, global oil prices falling to multi-year lows could hit government revenues and, consequently, government spending on construction and infrastructure. We believe low government spending on infrastructure, among the cement industry's biggest drivers, could force cement firms to continue with discounts to maintain market share and take an impact on margins.

High inventory: The high inventory of cement companies have weighed on margins in 2015. While cement manufacturers are trying all possible measures to lower stocks, it would take some time before the levels reach two months' forward inventory, as per government regulations. We believe the cost of these inventory balances and possible discounts offered by companies to reduce stocks and maintain market share could dent cement companies' margins in the near to medium term.

High interest expenses as SAIBOR between banks rose sharply in the last period: The Interbank Rate in Saudi Arabia (SAIBOR 3 Month) has been steadily increasing from the beginning of 2015. The SAIBOR 3 Month rate rose from 0.77% in May 2015 to 2.14% in May 2016. The Federal Reserve raised rates for the first time in nine years by 25 bps to 0.5% in December, which also led to the rise in the SAIBOR 3 Month rate. The rate is rising both because flows of new oil revenue into banks have shrunk and because the government is borrowing money from banks to cover a budget deficit created by lower oil price. Saudi Arabian money rates have entered a long-term uptrend that may end only when oil prices recover. The rise in SAIBOR would negatively impact bank credits for the building & construction sectors.

SAIBOR rate over the past two years



Source: Bloomberg

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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