



Rating NEUTRAL

Target price SAR97.00 (1.5% upside)

Current price SAR95.60

Key theme

While spreads are likely to soften in 2017, the stock may outperform spreads due to various factors such as use of its cash for acquisitions, divestment of non-strategic assets, additional cost cutting measures and improvement in metals segment. As a result there are chances of upside surprises. Though we have a Neutral rating, we are optimistic about the long term potential and recommend increased allocation on dips.

Share information

Market cap (SAR/US\$)	286.8bn / 76.46bn		
52-week range	63.72 - 96.93		
Daily avg volume (US\$)	131.4mn		
Shares outstanding	3,000mn		
Free float (est)	21%		

Performance	1M	3M	12M
Absolute	4.5%	12.8%	35.8%
Relative to index	6%	-5.3%	17.4%

Major Shareholder:

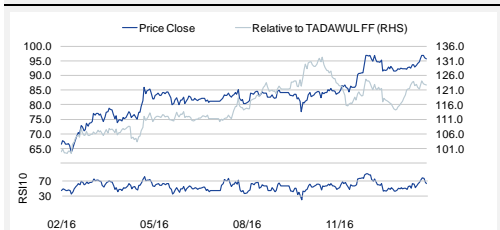
Public Investments Funds (PIF)	70.0%
GOSI	5.7%

Valuation

	12/'14A	12/'15A	12/'16A	12/'17E
P/E (x)	12.5	15.5	16.2	15.0
P/B (x)	1.4	1.4	1.4	1.3
EV/EBITDA (x)	6.5	7.7	7.6	7.3
Dividend Yield	5.7%	5.7%	4.1%	5.2%

Source: Company data, Al Rajhi Capital

Performance



Source: Bloomberg, Company data, Al Rajhi Capital

Please read important note on Page 8 for list of assumptions and considerations in this report.

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Saudi Basic Industries Corp (SABIC)

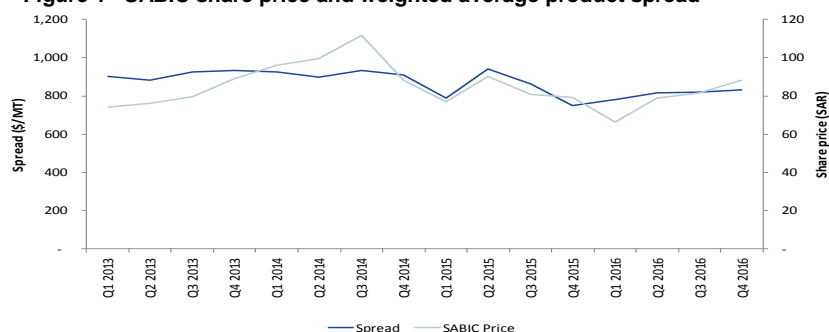
Spreads may soften but stock may see upside surprise

SABIC's petrochemical segment's performance (and its share price performance) in the past has broadly moved in line with products' spreads (Figure 1). As the discount between Naphtha and NGLs is closing in to historical averages, we expect increase in feedstock costs. We do not expect any major improvement in Petchem product prices, as marginal cost producer margins are above historical average and as incremental supply is likely to be more than demand. Therefore, as spreads soften by mid-year, overall petchem sector margins are likely to be lower in 2017. Beyond 2017/18, we expect spreads to soften further as new supply comes at the lower end of the cost curve. However, for SABIC, we expect other factors to work in its favour, helping share price to possibly trade higher despite softening in product spreads. These factors include a) acquisitions as the company looks to create incremental value with cash (21% of market cap) - e.g., SADAF deal, b) improvement in Metals segment, and c) any divestments of assets improving RoE. Any further significant cost cutting measures may also help its cause. The company also aims to diversify feedstock across gas and coal, and to have more value added products, which are more defensive. Though we do not factor these fully into our estimates yet, it builds our comfort and optimism in the stock for the long term and we recommend higher allocation on dips. In our view SABIC will be one of the more resilient plays in 2017 as the broader economy sees cost pressures. At the same time, there is no likely change in feedstock price mechanism for SABIC at-least till 2019 as we had highlighted in our note "Themes for 2017". After updating for Q4 results, we revise our TP to SAR97.0/share (7.3x 2017 EBITDA, 2017 DPS SAR5) and maintain Neutral rating, with possibility of upside surprises.

Why spreads may weaken: With 90% of profits coming from petrochemical segment and no significant increase in capacity, SABIC's stock price has closely moved with petrochemical products' spreads in the past (Figure 1). We believe that spreads are likely to weaken sequentially as petchem product prices are likely to remain more or less stable while feedstock costs rise based on our analysis of the cost structure and margins of the marginal cost producer.

As per various industry reports and based on our analysis of peer groups' margins (Figure 2), the Asian petrochemical firms are the marginal cost producers, with most of them using Naphtha as the key feedstock (Figure 5) which tend to move with oil prices (Figure 7). Post the recent OPEC deal, oil price increased to USD55 per barrel levels with Naphtha gradually catching

Figure 1 SABIC share price and weighted average product spread



Source: Company data, Al Rajhi Capital, Bloomberg



Figure 2 Median EBITDA margins of petchems by region

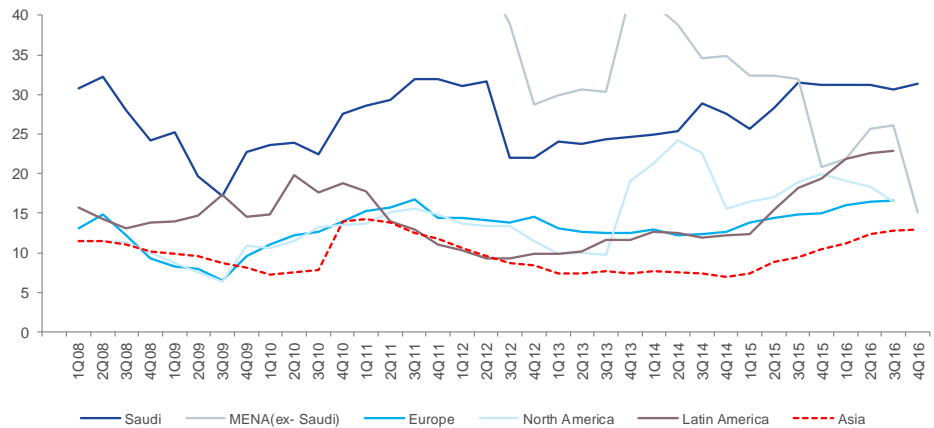


Figure 3 Feedstock Mix - Middle East

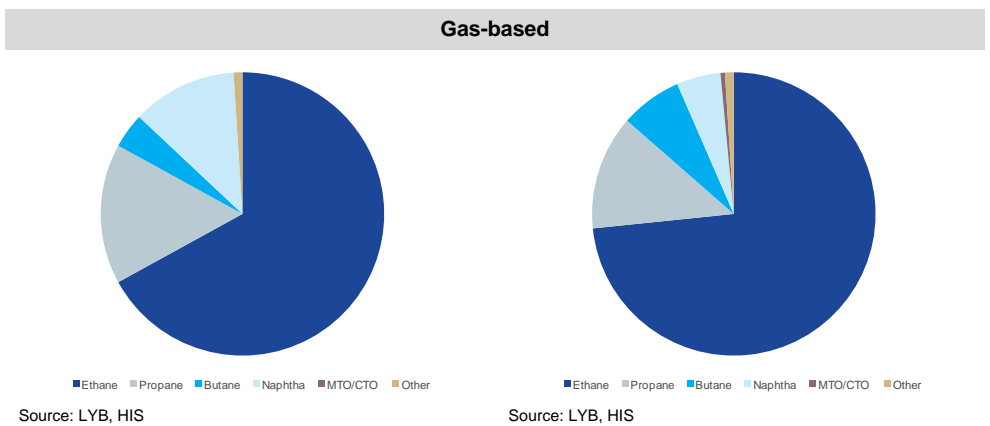


Figure 4 Feedstock Mix - North America

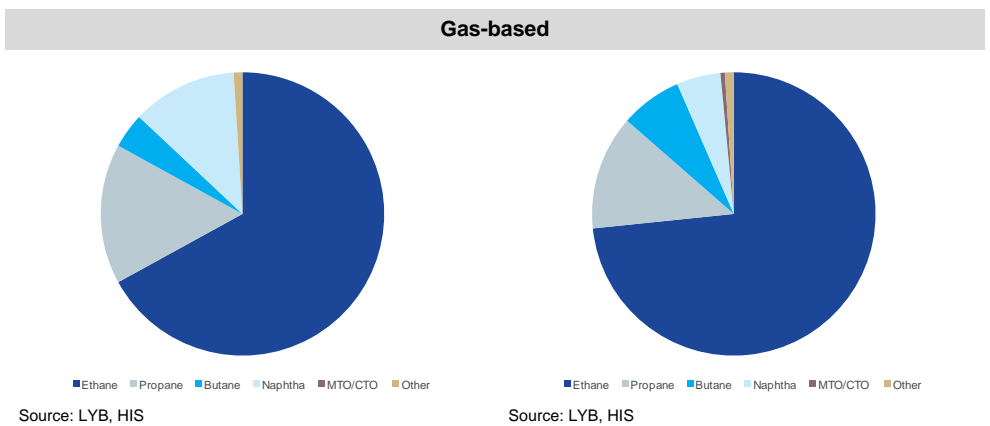


Figure 5 Feedstock Mix - Asia

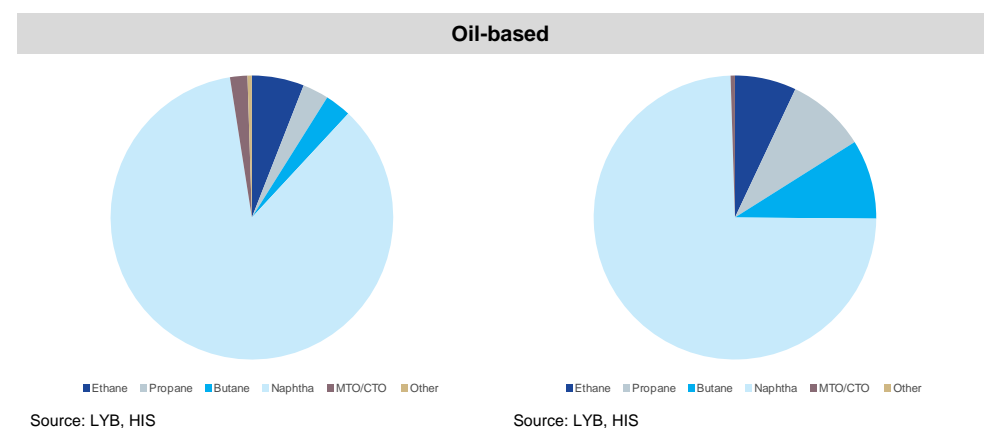
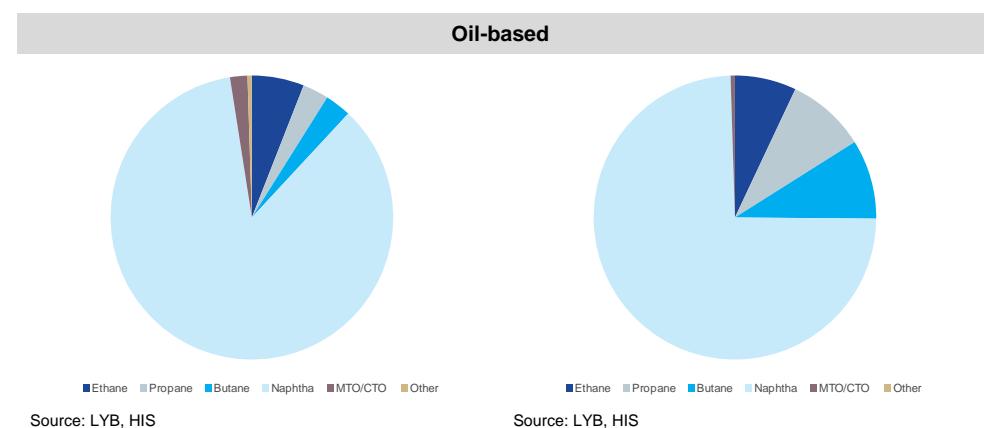


Figure 6 Feedstock Mix - Western Europe



up with the oil price. We believe the lag was partly due to some of the Asian Petchem companies' flexibility to shift part of their feedstock to NGLs (Propane, Butane), which have remained cheaper relative to Naphtha in 2016. NGLs which used to historically trade at a 9-10% average discount to Naphtha, were trading at ~20% discount in 2016, and are catching up with its historical averages (currently at 13-14%). As per Platts, up to 15-20% of the feedstock of Asian petchem manufacturers can be switched to NGL. Hence costs of Asian petchem players are likely to rise gradually till the NGL-naphtha discount catches up with historical averages and hence we expect spread to soften by mid-year. As a result, NGLs are likely to be capped by naphtha prices which in turn is likely to be capped by oil. With the relative stability seen in oil prices recently, we expect costs to increase only moderately in the current environment.

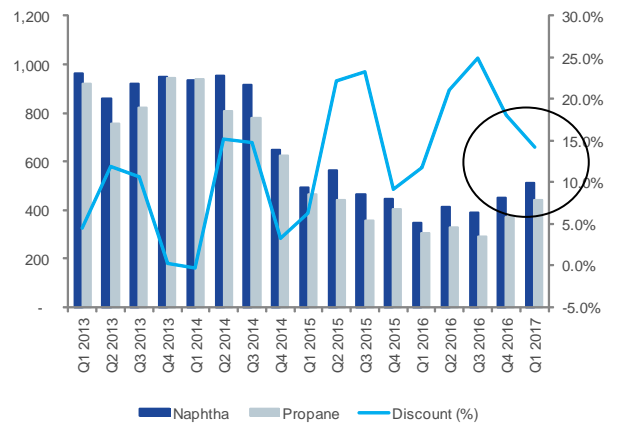


Figure 7 Brent and Naphtha prices trend



Source: Bloomberg, Al Rajhi Capital

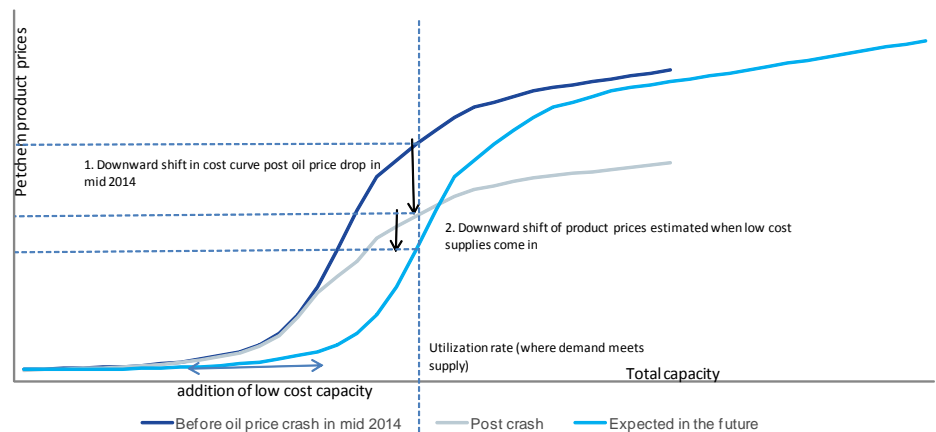
Figure 8 Expanding propane to naphtha discount



Source: Bloomberg, Al Rajhi Capital

Even if costs increase, we do not expect product prices to benefit materially for two reasons a) the marginal cost producers' margins are still at the higher end of the historical range (10-15%) (Figure 2) b) expected capacity additions using low cost feedstock are likely to put a cap on prices in the medium to long term. As most of the new capacity is likely to come in at the lower end of the cost curve, product prices are likely to come under pressure unless incremental demand offsets the incremental supply. We have shown the current and future likely changes in the cost curve (figure 9) given that the cracking of one tonne of ethane generates higher margins than cracking naphtha even after including transportation costs (see appendix for calculations).

Figure 9 Graphical representation of changes in cost curve (past and expected) – Not to scale



Source: Company data, Al Rajhi Capital

Therefore, we believe that the petchem product prices are likely to remain capped with pressure on gross margins continuing at-least till Q2 2017 in the absence of any significant increase in oil price.

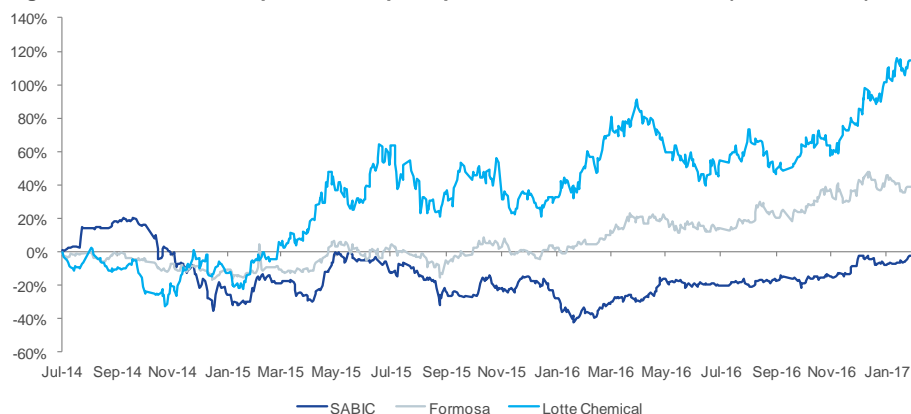
We note that naphtha costs constituted a significant chunk of the end products' weighted average revenue before the oil price decline in mid-2014. We believe this could have been one of the key reasons why a 50% decline in oil (Naphtha) price in 2014 led to only a 25-30% decline in Petchem product prices (on an average, across the board) with improvement in margins (Figure 17). This also explains why a strong historical correlation between the two dropped post mid-2014. Based on the same logic, we believe correlation may be weaker than seen in the past.

While the above analysis was for the marginal cost producer, SABIC being a price taker and with partly fixed cost base, saw its profits erode as revenue plummeted more than its costs.



This was evident in its share price trend vs. the other Asian producers' post 2Q14 after oil price crash (Figure 10).

Figure 10 SABIC and its peers share price performance since Q2 2014 (rebase at 0%)



To reduce dependence on its naphtha feedstock in the future, SABIC is aiming to grow using diversified feed stocks. SABIC has already upgraded its Wilton plant, enabling it to use US produced ethane as feedstock as compared to naphtha previously. SABIC and an affiliate of ExxonMobil are considering the potential development of a jointly owned petrochemical complex on the U.S. Gulf Coast in Texas or Louisiana using natural gas feedstock and would include a world-scale steam cracker and derivative units.

Why SABIC may better spreads: SABIC has not added any significant capacity in the recent past making its profits more a function of spreads. We identify a few key factors that can help it trade beyond its spread metrics.

- A) **Putting cash to use:** SABIC currently holds significant cash (including short-term investments, a total of 21% of total market cap) generating only marginal returns. Given the company's low leverage (currently 17.5% of total capital), the company has very deep pockets to grow inorganically. Combination of additional debt (increasing up to average industry debt to capital ratio of 30%) and existing cash provides the company with almost SAR 140bn war chest for potential acquisitions.

The company recently signed an agreement to acquire Shell's 50% stake in SADAF for ~USD800mn equity (based on our calculations, it also took on debt estimated at more than USD1bn). We believe this investment can generate up to incremental earnings of ~SAR1bn (annual, before servicing for debt). We believe that buying remaining stakes of successful investments would be positive for SABIC.

Previously, SABIC had announced that it will conduct a feasibility study for the development of fully integrated oil-to-chemicals (OTC) in Saudi Arabia, jointly with Saudi Aramco. The study is expected to be completed by early 2017. It is estimated that the project, if feasible, may involve an investment of up to US\$30bn (SAR112.5bn). SABIC currently has cash and short-term investments worth ~US\$16.3bn (SAR61bn) and with a free cash flow of more than SAR25bn annually, we believe that the company has the ability to fund its investment in the venture through internal accruals and debt given its low leverage without affecting its dividend pay-out. SABIC announced that the project will have a capacity to consume 10mn tons of crude oil per year (~200,000 bpd) and with this capacity, it could make around ~2.8mn tons of ethylene. Though the project is expected to be completed by 2020, we expect further delays given the complexity of the technology and current status. According to industry experts, converting crude oil directly to chemicals provides a cost advantage over naphtha feedstock, the industry's key feedstock in Asia and Europe apart from saving energy and reducing emissions by eliminating the refining steps. The project is also in line with the Kingdom's strategy to reduce dependence on crude oil exports and will also create more jobs, in line with the Government's Vision 2030.



- B) **Extent of cost cutting possible:** Though we believe that most of the cost cutting potential may have been realized (Figure 11), the media reports indicate company targeting further reductions, which may boost margins if materialized.

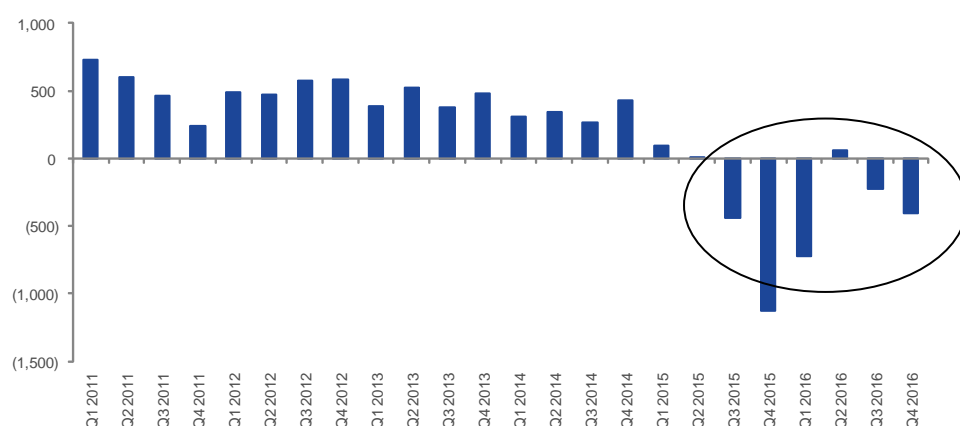
Figure 11 Improving operating performance



Source: Company data, Al Rajhi Capital

- C) **Improvement in Metals segment:** Metals have been volatile in terms of profitability (Figure 12) and any divestment or turnaround would be positive for the company.

Figure 12 Metal segment performance has improved on higher steel prices



Source: Company data, Al Rajhi Capital

DPS likely to increase in 2017: SABIC announced a DPS of SAR 2.0 per share for Q4 2016 taking the full year DPS to SAR4.0/share, slightly lower than our forecast. However, we expect SABIC to increase its DPS to SAR5.0/share in 2017 (implying a dividend yield of 5.2%) given the company's strong cash generation, balance sheet and potential to leverage further in case of new investments. Additionally, no revision in feedstock price mechanism at-least till 2019 and higher product prices, improved cost efficiencies would drive profitability and consequentially higher pay-out in 2017.



Q4 results

Figure 13 SABIC: Summary of Q4 2016 results

(SAR mn)	Q4 2015	Q3 2016	Q4 2016	% chg y-o-y	% chg q-o-q	ARC est
Revenue	34.2	33.3	34.0	-0.4%	2.2%	35.2
Gross profit	9.1	11.0	10.6	16.9%	-3.3%	10.6
Gross profit margin	26.6%	32.9%	31.1%			30.2%
Operating profit	4.4	7.6	7.3	67.2%	-4.6%	7.0
Net profit	3.1	5.2	4.6	47.7%	-12.8%	4.8

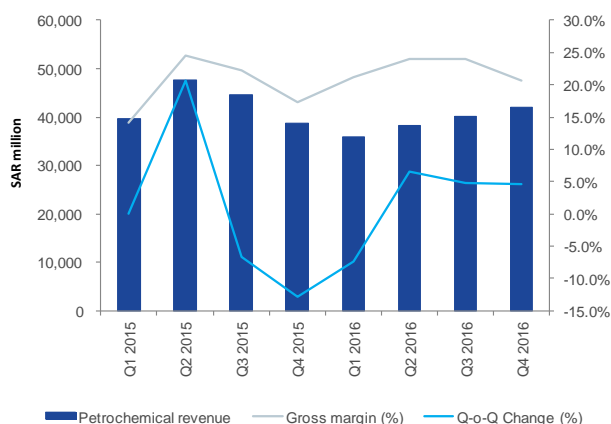
Source: Company data, Al Rajhi Capital

Key highlights: a) While top-line of SABIC's listed subsidiaries (Yansab, Kayan and SAFCO) was largely in line with our estimate (+1.6% above our combined estimate), we believe lower-than-expected sales volume at its non-listed petrochemical subsidiaries had contributed to majority of our miss (-3.2%) in Q4. b) Q4 gross profit (SAR10.6bn) came in line with our forecast as SAR1.1bn miss in revenue was offset by beat in COGS. c) Gross margin declined ~175bps q-o-q to 31.1% in Q4 owing to higher average feedstock prices. d) G&A expenses in Q4 were lower compared to historical trends (lowest in six years), which led to SAR320mn beat at the operating profit level despite an impairment of SAR706mn against its Ibn Rushd assets during the quarter. e) However, the beat was more than offset by lower equity income (-SAR142mn), other income (-SAR162mn) and higher financial charges (+SAR84mn). As a result, net profit came in 4.6% below our estimate of SAR4.77bn.

Petrochemical segment revenue improved; margin under pressure: The petrochemical segment revenue continued to improve sequentially, up by 4.6% q-o-q in Q4, mainly driven by higher product prices. However, petchem gross margin narrowed by 337bps q-o-q to 20.6% in Q4, weighed down by increased feedstock costs. We had mentioned in our Q4 [preview report](#) that the company's Petrochemical segment's margin could come under pressure due to lower product spread at its European plants on account of steep increase in naphtha prices (+15% q-o-q) and sharp increase in its NGLs prices at its Saudi-based petrochemical units.

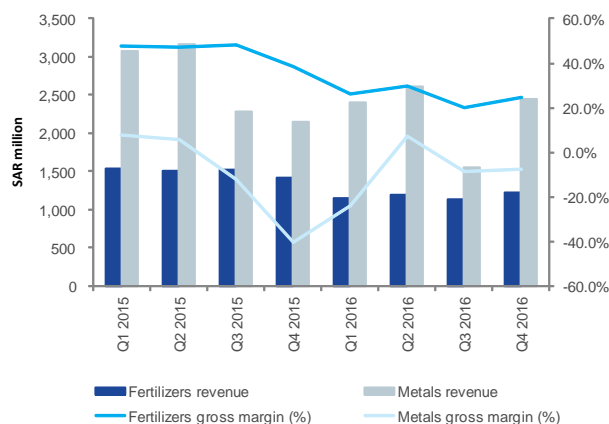
Higher fertilizer and metal prices helped the segments to improve performance: The improvement in urea prices (+16% q-o-q) and steel prices (+10% q-o-q) helped the fertilizer and metal segments to improve its top-line performance (7.1% q-o-q and 57.4%, respectively) in Q4. The higher revenue base in Q4 also resulted in improved gross margin sequentially in Q4.

Figure 14 Petrochemical segment performance



Source: Company data, Al Rajhi Capital

Figure 15 Fertilizer and Metal segments performance



Source: Company data, Al Rajhi Capital



Valuation and Risks

Upside surprise likely: Despite SABIC's Q4 results missing our top-line and bottom-line estimates, we remain positive on SABIC, given its improved operating performance, higher product prices (particularly urea and steel prices) and healthy petrochemical segment performance. Overall, we expect the petrochemical segment's performance to remain healthy, while increased fertilizers and metal prices could help the segments to improve its performance in 2017. Additionally, the recent SADAF acquisition deal should potentially improve the bottom-line further once the deal is completed. After taking into account the strong operating performance and revising the product prices forecast, we have revised our top-line and bottom-line estimates upward for 2017 to SAR144.5bn and SAR19.4bn from SAR141.1bn and SAR16.5bn, respectively. As we had expected and highlighted in our previous report, no change in feedstock costs is envisaged at least till 2019. For our long term estimates, we increase ethane and methane prices and lower discounts gradually to 10%. Consequently; we have revised our TP upwards to SAR97.0/share (7.3x 2017 EBITDA) and maintain our Neutral rating on the stock. We believe there may be upside surprises to this as we expect a) the company to make use of cash to grow faster b) metals division to improve performance and c) see some more benefits of cost cutting.

Risks: Sustained pressure on oil prices over the long-term will negatively impact petrochemical prices, which in turn, will affect SABIC's bottom-line. SABIC has forged various partnerships to expand downstream. In case of any delays, the company's earnings growth may be impacted. Other key downside risks are any further unexpected revision in the feedstock pricing prices and unplanned plant shutdowns. Upside triggers are associated to faster than expected commercial launch of its future expansion projects and sharp increase in product prices.



APPENDIX

Figure 13 Yield mix for ethane and naphtha

	Ethane	Naphtha
Hydrogen & methane	13%	26%
Ethylene	80%	30%
Propylene	2%	13%
Butadiene	1%	5%
Mixed butenes	2%	8%
C5+	2%	8%
Benzene	0%	5%
Toluene	0%	4%
Fuel oil	0%	2%

Source: United States Association for Energy Economics, Al Rajhi Capital

Figure 14 Margins for Ethane remain higher compared to Naphtha

	Before oil price crash (1Q12-2Q14)		After oil price crash (post Q414)	
	Ethane	Naphtha	Ethane	Naphtha
Revenue	1,164	1,190	959	833
Cost	242	934	140	452
Gross profit	922	256	818	381
Gross margin	79%	21%	85%	46%

Source: Al Rajhi Capital (based on figure 13)

Transportation costs for polyolefins may be marginal, at \$3.92/ton currently, assuming a) current tanker rate of USD8,500/day for a Panamax cargo ship with a capacity of 65000 tonnes and b) 25 days for the vessel to reach Asia from Middle East. Transportation costs for olefins may be higher as clean tanker rates are higher.

Important note: We have tried to simplify calculations for manufacturing ethylene based family of polyolefins by cracking Naphtha/ethane. Each polyolefin or polymer may have its own supply-demand considerations and can have too many variables (other input costs etc) which is beyond the scope of this report. We also do not account for shutdowns or seasonal demand patterns but focus on long term sustainable drivers. We also do not factor in any delays in additional supply of products coming into the market.



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"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.

Contact us

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