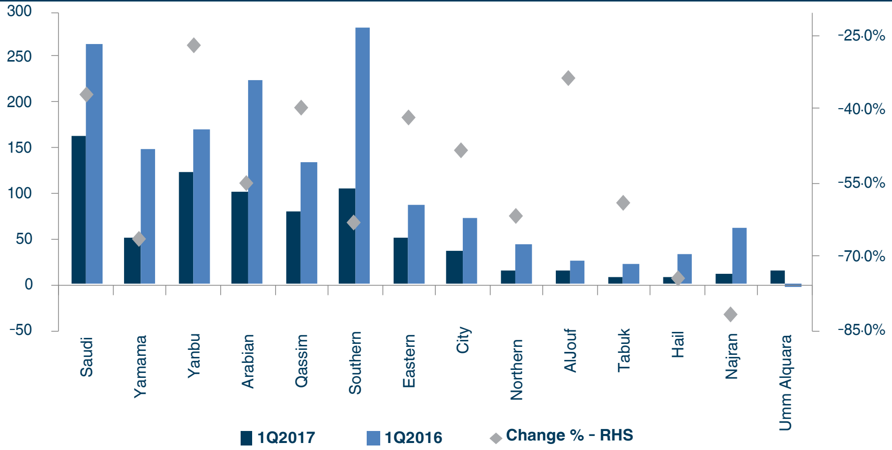
الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Saudi Cement Sector: Heavy discount in selling prices was the prime factor, impacting cement sector's earnings in 1Q2017. In addition to 19.9% decline in cement dispatches for 1Q2017. High clinker inventory level remains a concern after exceeding 28MT. Lower cement consumption with current excess capacity in the market (above 75MT) led to more pressure on the sector's fundamentals. Further expected cut on dividend payments for FY2017. We maintain our short-term negative outlook on the sector; however, the housing ministry initiatives are the key catalyst beyond FY2017 to boost demand.

Lower demand and high competition led to disappointing results: Cement sector's 1Q2017 net profit showed a significant decline of 49.4%YoY, to stand at SAR 791.6mn compared to SAR 1.6bn in 1Q2016. In order to gain market share and reduce inventory level, cement companies realized heavy discount on selling prices. Average selling price for the sector declined from SAR 224.9/ton in 1Q2016 to SAR 191.9/ton in 1Q2017. City cement provided the highest discount, selling at SAR 159.2/ton. Cost per ton for the sector increased from SAR 119.8/ton in 1Q2016 to SAR 127.0/ton in 1Q2017. Najran cement and Hail cement were hit the most, as their net income declined by 81.7%YoY and 74.3%YoY, respectively. Total revenue of the sector showed a decline of 31.6%YoY, Tabuk cement showed the lowest decline of 0.7%YoY.

1Q2017 Earnings



Source: AlJazira Capital, companies reports

Sector's gross margin declined from 50.2% in 1Q2016 to 39.6% in 1Q2017, contracted 21.1% YoY. Yamama cement showed the highest decline in margins (down 42.4%YoY), to stand at 28.6%. Margins are expected to show further decline in the coming months due to lower volumetric sales and discounted selling price. Furthermore, hike in fuel prices is another factor to weigh on production costs beyond FY2019. Sector's operating margin declined to 32.8% in 1Q2017 from 44.9% in 1Q2016. All Cement companies showed a decline in operating margin, except Northern cement that showed an increase of 5.6%YoY.

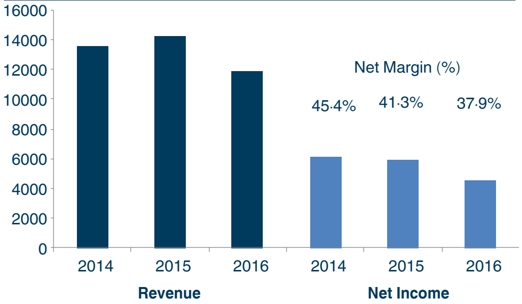
Key Market Data

Market Cap (bn)	44.4
P/E	13.82x
P/BV	1.60x
ROE	14.1%
ROA	11.1%
Dividend Yield	8.2%

Source: Bloomberg, Aljazira Capital. Prices as of 2nd July.

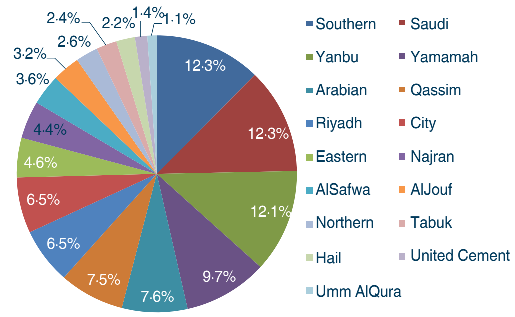
Data from Bloomberg for Construction Sector Include Gypsum Co.

Revenue / Net income



Source: AlJazira Capital, companies reports

Market Share in Dispatches (TTM)



Source: AlJazira Capital, Yamama Cement

Updated Financial Data & Investment Recommendation

Company	Recommendation	TP	Upside/ (Downside)	EPS FY2017	Forward P/E	DPS FY2017 (SAR)	Dividend Yield FY2017
Saudi Cement	Neutral	54.8	5.40%	3.84	13.54	3.75	7.69%
Yamama Cement	Neutral	18.1	2.30%	0.92	19.24	-	-
Yanbu Cement	Neutral	33.0	4.10%	2.69	11.78	2.50	8.83%
Arabian Cement	Overweight	40.8	13.30%	3.44	10.47	3.00	9.03%
Qassim Cement	Neutral	51.1	2.20%	2.98	16.78	2.75	6.40%
Southern Cement	Neutral	52.0	-4.60%	2.75	19.82	2.25	5.96%
Eastern Cement	Overweight	27.1	12.00%	2.29	10.57	1.50	6.20%
City Cement	Neutral	11.4	-1.70%	0.73	15.89	0.50	4.31%

Prices as of 2nd July 2017

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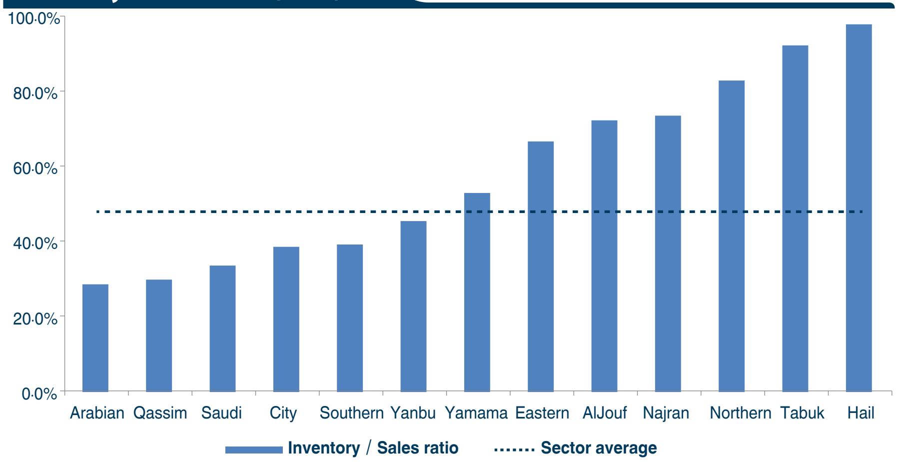
Negative outlook on short/mid-term, however a positive outlook on the long term: Cement dispatches declined 19.2%YTD, due to the continued slowdown in construction activity on the back of government austerity measures. For FY2017, we expect cement dispatches to record a decline of 12 - 15%YoY. However, recovery is expected in FY2018 driven by housing ministry initiatives and general improvement in construction activity on the back of expected recovery in oil prices (Source:IEA). The current capacity of cement sector exceeded 75MT, which is considered too high with current market demand of almost 55MT. Thus, Saudi cement, Eastern cement and Najran cement halted some of their production lines, in order to reduce the excess production in the market. We expect to see adjustment in cement capacity for the upcoming two years to reach equilibrium level.

Fuel subsidy will be lifted completely in 2019, which will increase production cost. However, we expect fuel cost hikes to enforce cement companies to increase selling prices in order to maintain margins. Small companies in low demand region (Najran cement, Hail cement, Tabuk cement, Northern cement, AlJouf cement) are expected to be impacted the most. Whereas companies with new production lines that have so far not been allocated fuel from ARAMCO (Southern cement, City cement) are expected to witness higher production cost than their peers. We remain negative on the sector for short/mid-term. However, on long run cement demand is expected to increase and construction activity to pick up on the back of expected oil price recovery, National Transformation Plans and the efforts of housing ministry.

Further cut in dividend payments: Dividend payment is expected to show further decline for FY2017. However, for the long run cement sector's dividend yield remains attractive compared to the companies' low market prices. Companies with strong balance sheets and low debt/equity ratio are expected to maintain their attractive dividend yield such as Saudi cement; Qassim Cement and Arabian cement (its worthy to note that Yamama cement singed a loan with SIDF of SAR 900.0mn and SAR 3.6bn facilities with NCB and SAMBA). On the other hand, the companies with high debt/ equity are expected to struggle for the upcoming quarters, and to show significant reduction on dividend payment such as Northern Cement and Najran Cement.

High clinker inventories with high competition in the market will increase the pressure on cement sector: Clinker inventories showed the first decline in April 2017 since June 2016. However, cement sector's Inventory/Sales ratio stand at 47.8% on TTM basis (excluding Umm AlQura). We expect inventory level to remain at high levels for the upcoming quarters with current downtrend in cement sales and high competition in the sector, specially that the total cement capacity exceed 75MT. Saudi cement company contributed 13.7% of total inventories. Hail cement registered the highest Inventory/Sales at 97.6%, significantly above the market, followed by Tabuk cement at 92.3%. While Arabian cement stands at 28.5%.

Inventory / Sales ratio (TTM)



Source: AlJazira Capital, companies reports

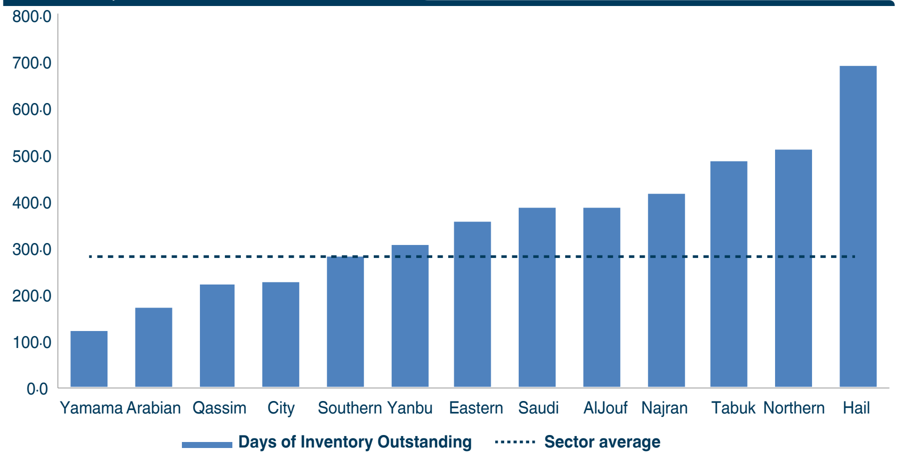
Highest D/E

Company	D/E Ratio
AlJouf Cement	50.2%
Northern Cement	50.1%
Tabuk Cement	41.0%

As on 31st March 2017

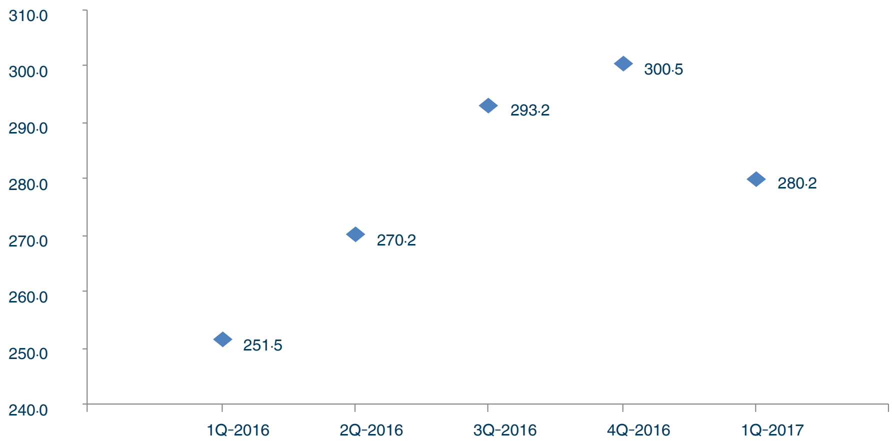
Cement sector's Days of Inventory Outstanding (DIO), stood at 280.2 days on TTM basis (excluding Umm AlQura), which is relatively high. Hail cement showed the highest DIO of 688.3 days, followed by Northern cement at 508.2 days. Yamama cement showed the least DIO at 118.6 days.

Inventory / Sales ratio (TTM)



Source: AlJazira Capital, companies reports

Sector' Days of Inventories Outstanding



Source: AlJazira Capital, companies reports

Key risks:

Low construction activity for long periods: The construction activity declined due to low government spending for last year. However, if the government decrease its spending on new projects and delayed payments to contractors, this could lead to more pressure on the sector.

High Inventory: Inventories are near historical high, but are not expected to show significant increase from current levels due to expected demand recovery in the mid-term. The more time it takes to reduce the inventories, a further discount in selling prices will impact margins.

Higher interest expenses: Federal Reserve recently increased the interest rate for the third time since Dec 2016 and is expected to push the interest rates higher till 2018. This will tend to increase the SAIBOR, and consequently increase interest expenses on the high leveraged companies. Furthermore, the government announced that it will borrow from local markets, which will reduce liquidity and increase interest rate. Companies with high leverage in the sector will have a noticeable increase in interest expenses.

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AlJazira Capital, the investment arm of Bank AlJazira, is a Shariaa Compliant Saudi Closed Joint Stock company and operating under the regulatory supervision of the Capital Market Authority. AlJazira Capital is licensed to conduct securities business in all securities business as authorized by CMA, including dealing, managing, arranging, advisory, and custody. AlJazira Capital is the continuation of a long success story in the Saudi Tadawul market, having occupied the market leadership position for several years. With an objective to maintain its market leadership position, AlJazira Capital is expanding its brokerage capabilities to offer further value-added services, brokerage across MENA and International markets, as well as offering a full suite of securities business.

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