

October 5, 2016

## SAUDI BUILDING MATERIALS

3Q2016 Preview

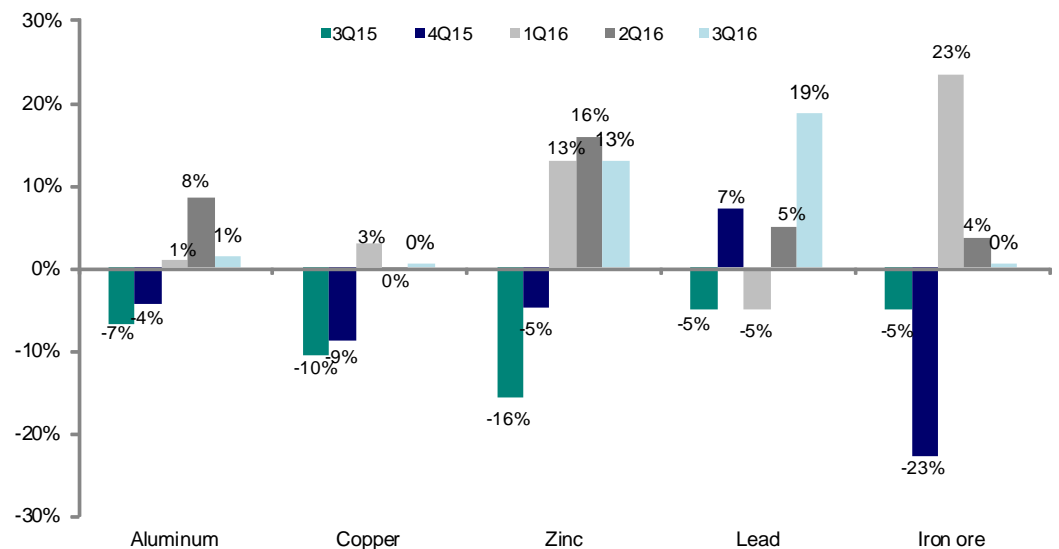
### Another Quarter of Weakness

We look forward for another weak quarter in building materials sector as data from construction sector points to a trough. We believe the key reasons are firstly, the impact of capital spending cuts, as project awards declined by -66% Y/Y to SAR 48 billion in 1H2016 versus SAR 140 billion in 1H2015. Secondly, a -12% decline in cement dispatches over the last three months has taken a toll on building material sector due to weak construction spending. Cement dispatches over last 3 months averaged 3.6 MT versus 4.1 MT during the same period in 2015. Thirdly, prices of steel and cables fell Y/Y by -12% and -15% respectively, reversing any hope for a topline growth. We believe this entire scenario is driven by the spending cuts as project awards dried up since start of 2016, which has affected the producer's operating in the sector. Sector earnings could drop further especially with Saudi Ceramics, Amiantit and Zoujaj, while we expect growth from Bawan and Aslak for 3Q2016. An earnings surprise from Saudi Ceramics and Aslak during 2Q2016 did add some sanguinity but this is likely short-lived, as the same is driven by low cost inventory and unlikely to push beyond 4Q. The recent meltdown has beaten the sector stocks, leaving large valuation gaps, however we remain Neutral on the sector as TASI has further re-rated to 11.5x 2016E P/E.

Barring any seasonal adjustment, depressed earnings outlook continues to largely affect the sector. Local steel prices increased Q/Q since start of 2Q but weak demand has led to inventory destocking from contractors side, burdened further due to lesser flow of new projects. Production cuts from steel producers at times of weak demand is a strategy to curtail excess supply, but low operating rates and competition could impact margins which remains thin. Additionally, the impact of subsidies could hurt margins as the inventory impact has started flowing between 2Q and 3Q due to weighted inventory mechanism, which most producers adopt.

We believe commodities globally have underperformed in 3Q versus a positive ride during 1Q16 as China continues to show signs of slowdown. Global base metals indices grew by +2% Q/Q in 3Q2016. Iron ore prices remained flat Q/Q at USD 56/ton after a sharp rally in 1Q2016. Aluminum moderately increased by +1% Q/Q to USD 1,673/ton while zinc and lead increased by +13% and +19% respectively.

#### Exhibit 1: Global Base Metals Performance



Source: Bloomberg

### Earnings trend to be weaker on seasonality

We forecast 3Q2016 estimates with revised earnings as we expect a delayed recovery and seen extending till 2018. We expect revenues to register a decline of -8% Y/Y and earnings to decline -20% Y/Y for the companies under our coverage.

**Table 1: 3Q2016 Estimates (SAR mln, except per share data)**

Company	Revenue			EBITDA			Net Income			EPS		
	3Q2015	3Q2016E	Y/Y Chg	3Q2015	3Q2016E	Y/Y Chg	3Q2015	3Q2016E	Y/Y Chg	3Q2015	3Q2016E	Y/Y Chg
Ceramics	355	285	-20%	109	65	-41%	63	1	-98%	1.25	0.02	-98%
Bawan	546	570	4%	43	65	51%	20	43	114%	0.34	0.72	114%
Aslak	183	170	-7%	28	40	45%	21	32	51%	0.48	0.73	51%
Zoujaj	20	28	38%	6	10	74%	6	9	43%	0.21	0.30	43%
Amiantit	677	580	-14%	100	55	-45%	27	25	-8%	0.23	0.22	-8%
<b>Group Total</b>	<b>1,781</b>	<b>1,633</b>	<b>-8%</b>	<b>286</b>	<b>235</b>	<b>-18%</b>	<b>137</b>	<b>110</b>	<b>-20%</b>	<b>3</b>	<b>2</b>	<b>-21%</b>

Source: Riyad Capital, Company Reports

- ✓ Saudi Ceramics have announced the impact of impairment provision to the tune of SAR 25 million, a negative over medium term, when topline decline is imminent.
- ✓ Bawan is expected to see continued impact of inventory costs in metal segment, which could propel 3Q earnings, while new contracts from SEC also could lift profitability in electric segment.
- ✓ Aslak is likely to report decent earnings growth because of inventory markup at low prices leading to a rise in margins, though steel and iron prices have increased during the quarter.
- ✓ Zoujaj's earnings are set to decline, as slowdown in UAE hurt float glass segment and continued utilization issues in glass container segment is likely to affect margins.
- ✓ Amiantit is likely to record lower earnings as new projects have dried up, while it may continue to report legal provisions this quarter.

### Valuation and Conclusion

Though 3Q2016 was less volatile for oil markets, TASI retreated largely on domestic concerns with 3Q decline of -13% while the sector index was down by -25% underperforming by -12%. For the quarter, stocks that got impacted were Saudi Ceramics, which went down by -33% and Zoujaj which fell by -29%. Sector continues to trade at high trailing P/E of 14.1x versus TASI P/E of 13.1x as earnings decline tends to be large. Additionally, most companies face the brunt of construction downturn as ancillary sectors were constrained with tightened cash flows and delayed payments. In such a scenario of anticipated downturn, we have adjusted our estimates and cut our target prices accordingly. However, valuation upside is high as stocks were beaten down due to TASI's recent retreat. We upgrade few ratings due to large upside despite cuts in target price except Amiantit, which continues to be a sell. We are likely to see some positive stride starting 2018, until then maintain our neutral view on the sector but selective stocks continue to offer good return.

**Table 2: Ratings and Valuations (SAR mln)**

Company	TASI Code	Current Price	Market Cap	Target Price (Old)	Target Price (New)	Rating	Dividend Yield	P / E		P/B	
								2015	2016E	2015	2016E
Ceramics	2040	24.57	1,229	42.00	↓ 32.00	↑ Buy	NA	4.3x	12.3x	0.6x	0.6x
Bawan	1302	16.23	974	28.00	↓ 24.00	Buy	7.4%	11.0x	5.9x	1.1x	1.0x
Aslak	1301	20.18	885	17.00	↑ 23.50	↑ Buy	9.9%	12.3x	7.8x	2.1x	2.0x
Zoujaj	2150	15.25	458	23.00	↓ 21.00	↑ Buy	8.2%	10.2x	9.0x	1.2x	1.1x
Amiantit	2160	5.70	658	7.30	↓ 6.50	Sell	NA	6.6x	30.0x	0.4x	0.4x
<b>Group Average</b>								<b>8.9x</b>	<b>13.0x</b>	<b>1.1x</b>	<b>1.0x</b>

Source: Riyad Capital

## Stock Rating

Buy	Neutral	Sell	Not Rated
Expected Total Return Greater than 15%	Expected Total Return between -15% and +15%	Expected Total Return less than -15%	Under Review/ Restricted

*\* The expected percentage returns are indicative, stock recommendations also incorporate relevant qualitative factors*

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