Saudi International Petrochemical Co

Petrochemicals – Industrial
SIPCHEM AB: Saudi Arabia

US$1.674bn	90%	US$4.414mn
Market cap	Free float	Avg. daily volume

Target price	16.60	2.9% over current
Current price	16.08	as at 21/5/2017

Existing rating

Underweight	Neutral	Overweight

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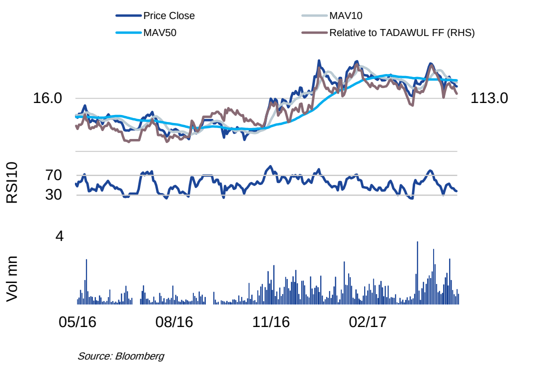
Performance



Earnings

Period End (SAR)	12/13A	12/14A	12/15A	12/16A
Revenue (mn)	4,072	4,124	3,515	3,367
Revenue Growth	3.8%	1.3%	-14.8%	-4.2%
EBITDA (mn)	1,630	1,655	1,264	1,165
EBITDA Growth	2.2%	1.5%	-23.6%	-7.9%
EPS	1.45	1.40	0.79	0.19
EPS Growth	-0.2%	-3.2%	-43.9%	-75.7%

Source: Company data, Al Rajhi Capital

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Product prices decline; Analysis of IFRS revision

Valuation impact of IFRS revision: *Migration to IFRS from SOCPA has resulted in lower net profits retrospectively despite higher gross and operating profits mainly on account of higher notional financing expenses. Though migration to IFRS will neither change overall business value of the company nor free cash flows, we believe IFRS based re-measurement of values especially liabilities such as defined benefit liabilities, decommissioning expenses etc., being based on international convention, is more accurate which is likely to revise valuation lower.*

Q1 snapshot: *Sipchem's Q1 net profit surged ~86% y-o-y and 187% q-o-q to SAR92mn but came much lower than consensus estimate (SAR108mn) and our estimate (SAR131mn) . The sharp increase in profit was mainly driven by the steep increases in Q1 average selling prices, especially Methanol which was up ~65% y-o-y, LDPE up ~15% y-o-y, partially offset by VAM which was down ~17% y-o-y. Towards the end of Q1, sentiments on Methanol turned bearish and price of Methanol has declined ~25% in the past two months which however is still above average of 2015 and 2016 price levels.*

Valuation changes: *We revise our product and feedstock price estimates (see table 6) post Q1 results, and thereby our new TP comes at SAR 16.6 per share (Neutral rating). We arrive at our target price based on a mix of DCF and PE methods. While DCF valuation (SAR 18.4/ share) is revised lower due to downward revision in forecasts, downward revision in relative valuation (SAR 14.7/share) also includes the effect of accounting changes related to IFRS.*

Key downside risks – further fall in product prices (esp. Methanol), increase in price of Butane and ethylene prices, unexpected prolonged shutdowns, higher than expected expenditures while key upside risk is related to improvement in demand-supply metrics of Methanol

Impact on net profit on migration to IFRS:

- **Revenue:** Revenue was previously reported on a net basis (revenue minus distribution expenses) while in IFRS revenue is reported on a gross basis, which is the reason for the ~4% deviation from SOCPA based revenues
- **Depreciation:** Depreciation was revised downward mainly because of lower PPE post impairment charges (See table for other reasons for the decline in depreciation), more than offsetting increase in depreciation which resulted from reclassification of spare parts of capital nature under PPE and re-measurement of decommissioning expenses. Across most companies in the sector, we note that depreciation is likely to have revised lower for the sector helping gross profit revise upwards.
- **Amortization:** Amortization too has been revised lower as some pre-operating expenses (related to branding etc.) were recognized from intangibles.

- **Cost of sales:** Cost of sales (excluding depreciation and amortization) have been revised lower mainly on account of lower expenses related to its defined benefit plans.
- **Operating expenses:** As mentioned above as revenue has been mentioned on a gross basis, the related distribution expenses are separately mentioned as administrative expenses and hence operating expenses have been revised upwards.
- **Financing expenses:** Financing expenses have seen an upward shift not because of higher debt or financing costs but because of notional interest expenses post migration to IFRS. Additional non-current liabilities in the form of employee benefits and decommissioning liabilities have been added to the balance sheet, which resulted in higher implied financing expenses. This is the reason why despite operating income coming higher in IFRS than in SOCPA, net profit has been revised lower.

Figure 1 IFRS impact

	Change (SARmn)	Reason
1 Revenue	147.56	Change in presentation of distribution costs
2 COGS	(25.80)	Impairment of IDC and PBT companies, leading to likely lower depreciation
	2.29	Decommissioning liability, likely leading to higher depreciation
	(0.51)	Derecognition of some pre-operating costs from PPE
	(2.89)	Derecognition of some branding costs from Intangibles
	(2.86)	Related to EOSB expenses
	2.04	Increase in dep due to inventories reclassifying to PPE
	2.47	Reclassification of certain software costs from PPE to intangibles
3 Operating exp	1.04	Increase in admin expenses - additional derecognition
	1.38	Share based payment - Sipchem incentive program
	147.56	Change in presentation of distribution costs
4 Finance charges	6.16	Decommisioning liability
	7.63	Increase in financing costs related to EOSB liability created
	29.15	Amortized costs of sukuk and borrowings' fees and discount/premium

Source: Company data, Al Rajhi Capital

How will this migration impact valuation?

DCF: Ideally, re- measurement and reclassification should not only impact DCF valuations as free cash flows are not impacted. However, purely from accounting perspective some additional liabilities have been recognized such as decommissioning expenses which will lower equity value for the company. The company also has an unfunded defined employee benefit plan whose liabilities have shown to be higher than previously estimated.

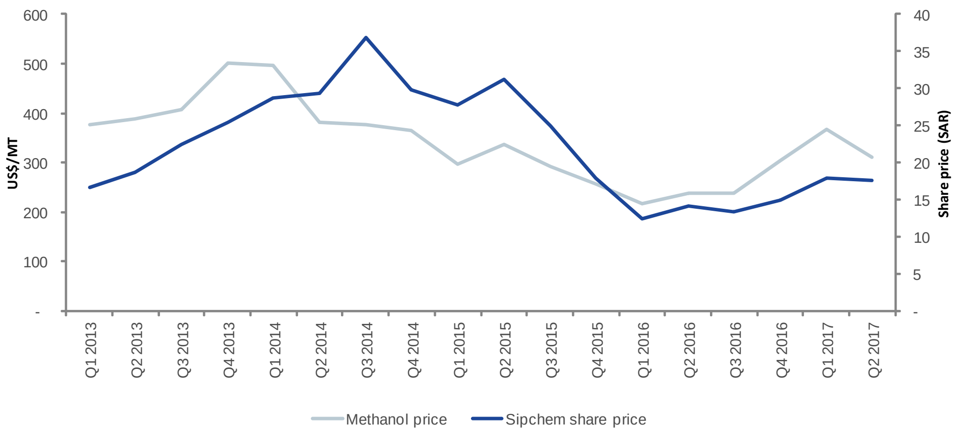
Relative: Purely on a forward P/E basis, valuation based on unadjusted forward multiples should be lower as IFRS has resulted in overall reduction in EPS numbers.

Sentiments reversed on Methanol: After peaking early in the year, price of Methanol has declined by 25% in the last two months. We note three key reasons why Methanol prices have weakened:

- As per Platts, Methanol demand has declined because of shrinking margins of MTO plants at China which is one of the largest global groups of methanol consumers.
- Moreover, supply is likely to have increased with increased production from Iran. This we believe is a key long term downside risk for Methanol prices as we mentioned in our previous report.
- The tightness caused over winter eased as methanol feedstock gases were curtailed for heating also was responsible for the sharp drop in the prior two months.

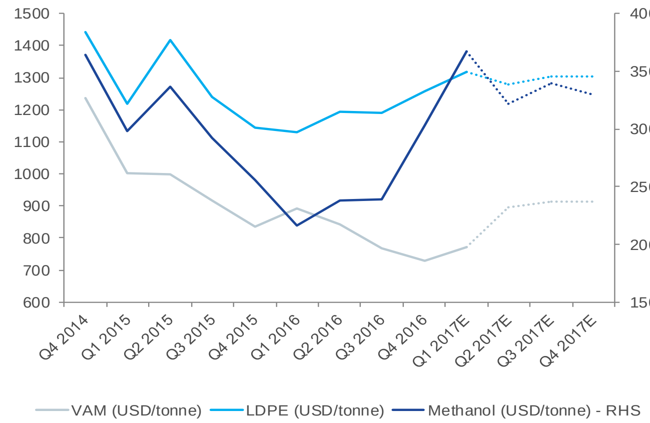
However going forward, we believe Methanol prices may stabilize at around these levels as Methanol demand may pick up at MTO plants at current levels. Prices are still above average price levels seen in 2015 and 2016. Methanol price is important for Sipchem given its close correlation in the past as seen below.

Figure 2 Sipchem price and Methanol price trend



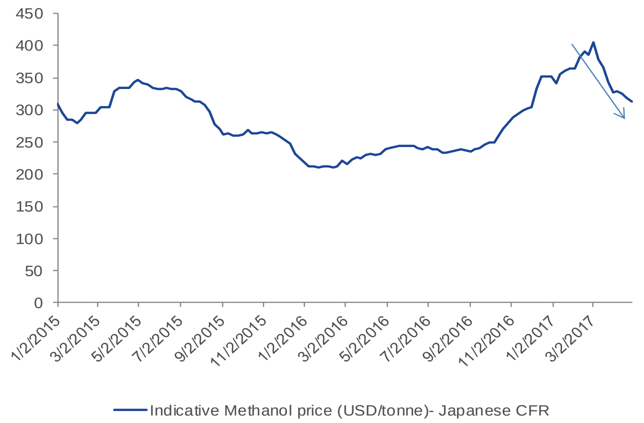
Source: Bloomberg, Al Rajhi Capital

Figure 3 Key products' price movement



Source: Bloomberg, Al Rajhi Capital

Figure 4 Indicative Methanol price (USD/mt) - Japan CFR (show average price) lines 2015 and 2016



Source: Bloomberg, Al Rajhi Capital

Q1 results snapshot:.

Revenue came slightly below estimates as we expected methanol prices to recover towards the end of Q1 and also due to revenue being reported gross of distribution expenses. As a result of this and also overall costs being revised upwards post migration to IFRS, the net profit came below our expectations. Comparison with our forecasts may be not ideal as some accounting items have been revised post migration to IFRS.

Figure 5 Sipchem Q1 results summary

	1Q16	4Q16	1Q17	ARCe	y/y	q/q
IFRS (SARmn)						
Revenue	920	NR	1,200	1,083	30%	NA
Gross Profit	269	249	352	356	31%	41%
Operating income	165	134	231	265	40%	72%
Net income	49	32	92	131	86%	187%
SOCPA (SARmn)						
Revenue	892	914				
Gross Profit	229	214				
Operating income	159	134				
Net income	51	52				
Difference						
Revenue	3.1%	NA				
Gross Profit	17.3%	16.7%				
Operating income	3.5%	0.0%				
Net income	-3.0%	-39.0%				

Source: Company data, Al Rajhi Capital

Valuation changes: Post updating our price deck , we revise Methanol price forecasts lower while other product prices are broadly unchanged.

Figure 6 Estimate change summary

	Old		New	
	2017	2018	2017	2018
Revenue (SARmn)	4,220	4,368	4,584	4,779
Gross profit (SARmn)	1,311	1,401	1,305	1,451
Operating profit (SARmn)	1,005	1,087	833	964
Net profit (SARmn)	461	536	323	408

Source: Company data, Al Rajhi Capital

We use an equal mix of DCF and relative valuation for arriving at our target price.

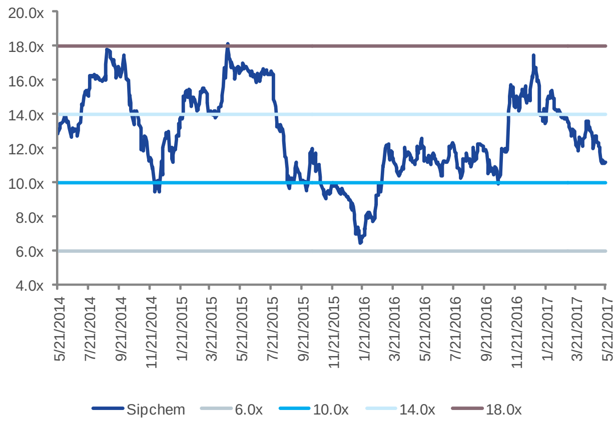
Based on **relative valuation** using a P/E of 13x on 12 month forward earnings (SAR 0.95 /share) we arrive at fair price of SAR14.7/share (adjusted for one year forward price).

Figure 7 Saudi petchem companies historical multiples (last three years period)

	EV/EBITDA			2016	Price/Earnings		
	Low	High	Avg	Debt/Assets	Low	High	Avg
APPC	6.4x	12.8x	9.8x	23.9%	7.8x	15.6x	12.0x
Yansab	4.9x	11.0x	8.6x	12.9%	7.6x	15.9x	12.8x
SABIC	5.0x	8.1x	7.0x	19.7%	7.0x	16.5x	12.8x
Tasnee	6.1x	11.7x	9.0x	55.7%	7.5x	20.7x	12.9x
Sipchem	6.7x	11.0x	8.7x	48.5%	7.5x	20.7x	12.9x
Kayan	8.8x	15.3x	11.7x	63.3%	14.3x	NA	14.3x
SIIG	7.4x	11.2x	9.0x	43.8%	4.7x	12.0x	8.8x
Sahara	8.8x	17.5x	12.8x	26.6%	7.2x	20.6x	13.5x
Petro Rabigh	5.9x	20.9x	14.7x	71.0%	5.8x	NA	5.8x
Petrochem	7.6x	12.0x	9.6x	53.3%	6.6x	15.1x	11.6x
Chemanol	5.5x	11.9x	8.8x	40.6%	NA	NA	NA
Alujain	6.0x	6.6x	6.2x	29.3%	9.5x	26.8x	14.6x
Average Saudi Peers	**6.8x**	**13.2x**	**10.0x**	**39.8%**	**8.0x**	**19.0x**	**12.3x**
Major methanol producers							
Methanex	5.9x	12.5x	8.8x	34.2%	8.4x	NA	21.6x
China Coal Energy	8.6x	24.3x	15.8x	40.5%	9.7x	NA	NA
Mitsubishi Gas Chemical	6.3x	10.0x	8.5x	16.0%	7.4x	15.5x	10.4x
Petronas Chemicals	5.7x	9.9x	8.4x	0.6%	11.3x	19.0x	16.2x
Average global peers	**6.6x**	**14.2x**	**10.4x**	**22.8%**	**9.2x**	**17.2x**	**16.1x**

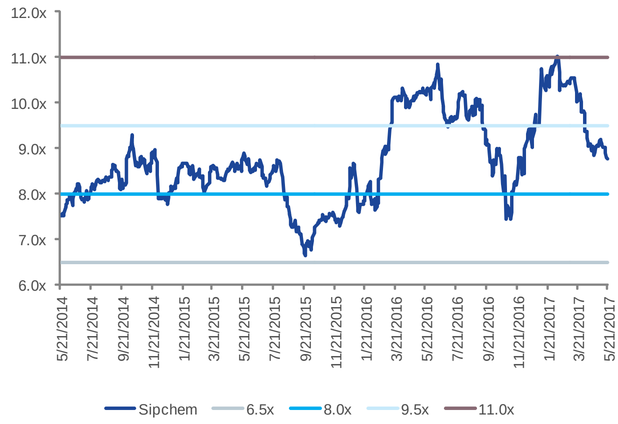
Source: Bloomberg, Al Rajhi Capital

Figure 8 Sipchem 1Y Fwd P/E multiple trend



Source: Bloomberg, Al Rajhi Capital

Figure 9 Sipchem 1Y Fwd EV/EBITDA multiple trend



Source: Bloomberg, Al Rajhi Capital

Based on **DCF valuation methodology**, we arrive at a fair price of SAR18.4/share.

- For our DCF methodology, we estimate 4% EBITDA CAGR (2017-2020) driven mainly by improvement in product prices and partly increase in volumes and cost optimisation.
- We forecast capex/sales at 5% from 2017 onwards (from average of 22% in the past four years, as we believe most of the expansion is done), a mild improvement in operating expenses post the company's efforts to optimize costs.
- We have maintained utilization rate of its production facilities at sub-optimal levels, similar to historical levels to account for shutdowns.
- We expect terminal growth rate at 2% and WACC to increase from 8.44% in 2017 to 10.75% as the company pays off its debt and equity base increases.

Based on the average of the above two values, we arrive at our **target price of SAR16.6/share**.

Upside risks:

- One of the key upside risks pertains to sustained increase in Methanol price as Methanol demand picks up and global supply remains constrained.
- Higher than expected reduction in operating expenses post the cost saving efforts – including selling at lower discounts in newer markets
- Reduction in frequency of shutdowns enabling higher production as well as lower maintenance expenditure

Downside risks:

- Frequent shutdowns, further fall in product price, especially that of Methanol, increased competition, regulatory changes that may be detrimental to the valuation such as increase in energy and feedstock price, higher than expected capex
- Purely from a technical point of view, the stock price movement is highly correlated with Methanol price in the past and the deviation between the two has widened – which could be a downside risk for the stock

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"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.

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