

Improved Urea fundamentals, higher utilization rate and margins are likely to drive the overall performance

Urea prices have recovered considerably during last few weeks to reach USD 305/ton from an average price of USD 230/ton in 2017 and USD 205/ton in 2016. The nitrogen fertilizer market is seeing Improved fundamentals, due to capacities closure after the enforcement of environmental regulations in China and higher feedstock cost that has limited urea exports.

Urea fundamentals are the key driver for SAFCO, given advantages of access to low-fixed cost Methane (feedstock) at USD 1.25/mmbtu. Utilization rate rose to 95% during 2Q18, as compared to an average of 82% in 2017, suggests that the new ammonia capacity is operating well after the scheduled maintenance at SAFCO 3 and SAFCO 4 during FY17. The effect of higher urea price drives our revenue estimates by 8.0% and 12.0% in FY18 and FY19 respectively from previous assumptions, while we revised our estimates for Urea average prices to USD 269/ton and USD 286.5/ton in FY18/19 from previous USD 247/ton and 252/ton.

Sales growth on higher Urea prices is expected to expand gross margins to 50.1% during FY18 from 43% last year. SAFCO's net margin in FY18 could recover at a faster pace (39.4% vs. 31.8% in 2017) by further support from its associate (Ibn Al-Baytar) due to recovery in urea prices.

Short-term optimistic outlook, albeit conservative view on Urea prices post FY19

Although we expect near-term Urea market to show tighter supply, global Urea overcapacity could get worse beyond 2019, due to i) the expected large capacity to come on-stream in Africa, South Asia and Eastern Europe & Central Asia, ii) sign of improving price spreads between global urea vs. Chinese coal feedstock and easy access to cheap US natural gas (feedstock) which could drive output high in the nitrogen fertilizer market.

Our estimates and valuation

While our long term outlook on fertilizer sector remains uncertain, however in short-term we expect Urea prices to stabilize between USD 270-300/ton over the next year. Demand is expected to pick up from South Asia, Latin America and Southeast Asia, whereas Chinese exports are expected to be limited due to domestic concentration, supporting our price assumption.

The company announced scheduled maintenance of Ibn Al-Baytar for 30 days in 4Q18 that will slightly weigh on bottom line, however overall improvement is expected in FY18/19 due to higher Urea prices and improved operating rate. Revenues were revised to SAR 3,675mn in FY18 compared with earlier estimate of SAR 3,404mn and actual SAR 2,759 mn in FY17. SAFCO is expected to post SAR 1,449mn in net income (3.48 EPS) for FY18, recording an increase of 64.8%Y/Y for the year, supported by higher sales volume and margins. Thus, we upgraded our TP to **SAR 70.0/share** while reiterating our **"Neutral"** recommendation on SAFCO due to the increase in stock price (up 29% in 3Q18). The company is trading at forward PE and P/B of 22.0x and 4.2x respectively based on our FY18 earnings forecasts. The company in FY17 proposed a DPS of SAR 1.75 with payout ratio of 83% and a yield of 2.9%. We expect the company to pay a dividend of SAR 2.75 DPS (3.5% D/Y) in 2018 owing to a strong operating cash flow and no major capital expenditure in the medium term.

	A2017	E2018 (old)	E2018 (New)	change	E2019 (old)	E2019 (New)	change
Revenues	2,759	3,404	3,675	7.90%	3,464	3,875	11.90%
Gross Margin	43.00%	48.40%	50.10%	170bps	48.70%	52.30%	360bps
Net Income	879	1,253	1,449	15.60%	1,356	1,705	25.70%
EPS	2.11	3.01	3.48	0.47	3.26	4.1	0.84
DPS	1.75	2.5	2.75	0.25	2.75	3	0.25
PE	28.3x	25.4x	22.0x	-	23.5x	18.8x	-

Source: Company reports, Aljazira Capital

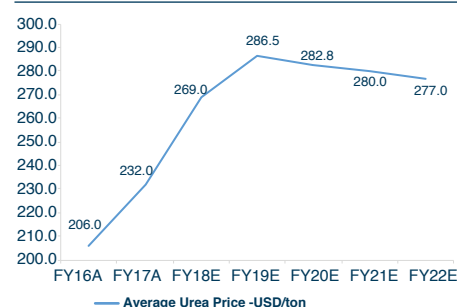
Neutral

Target Price (SAR) **70.00**

Upside / (Downside)* **-9.2%**

Source: Tadawul *prices as of 18th of September 2018

Figure1: Average Urea prices – USD/tonne



Source: Bloomberg, Aljazira Capital

Key Ratios

SARmn (unless specified)	FY16	FY17	FY18E
Gross Margin	47.9%	43.0%	50.1%
Net Margin	36.3%	31.8%	39.4%
P/E	30.7x	28.3x	22.0x
P/B	4.8x	3.6x	4.2x
EV/EBITDA (x)	21.9x	19.0x	16.1x
Dividend Yield	3.3%	2.9%	3.5%

Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (bn)	32.1
YTD %	19.05%
52 Week High/ Low	79.70/57.00
Shares Outstanding (mn)	416.67

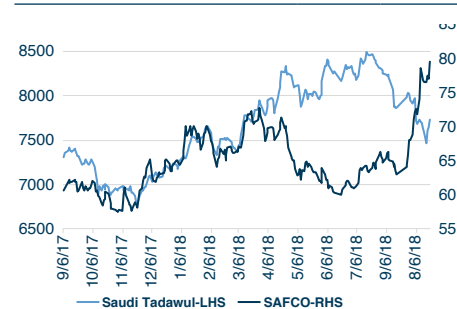
Source: Company reports, Aljazira Capital

Major Shareholders Holding

Saudi Basic Industries Corp.	43.0%
General Organization for Social Insurance	10.5%
Public	46.5%

Source: Tadawul

Price Performance chart



Source: Bloomberg, Aljazira Capital

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Strong Cash flow to support SAFCO's acquisition of Ibn Al-Baytar, improving bottom

line and valuation: Book Value of SAFCO's of Ibn Al-baytar is SAR 616.0mn(50%); however, the rest of the 50% will demand a premium over the current book value. We expect that the acquisitions can be made with a mixture of current cash of SAR 500.4mn and the strong cash flow during this year. The company is expected to consolidate revenue from Ibn Al-Baytar, hence resulting in higher Free Cash flow, which can potentially improve the company valuation. Based on our calculation, the acquisition would surge the company's intrinsic value to **SAR 74.5/share** from the current TP of **SAR 70.0/share**. In addition, we cannot rule out the possibility of dividends cuts in FY18 or FY19, as the company has to exhaust its entire cash balance.

Urea prices reached the highest in three years amid tight Chinese supply; however, new capacity would keep market oversupplied:

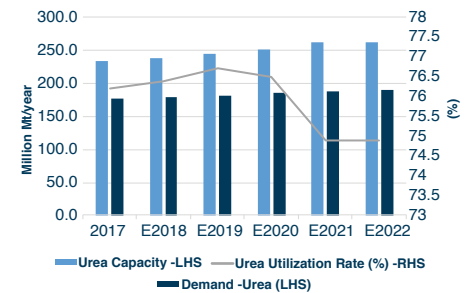
The Urea-Gulf price reached USD 305/MT mid of SEP-18, near three-year highs after gaining almost 27%YTD. This is due to limited Chinese supply after a significant number of urea capacities closing to abide by the environmental regulations, while coal-based production costs have also increased. The urea market is not balanced yet, however it seems to be in a better shape in terms of supply/demand.

According to data from GTIS/China Custom, Chinese exports were the lowest in several years in the H1-18, at 700 KT, down over 75%Y/Y compared to 2.8 MT in 1H17 (Figure3). Thus, China is expected to export 1.5-2.0m tonnes in FY18 compared to 4.7m tonnes in FY17.

Although imbalance between urea supply and demand would fall in the short-term, Urea excess capacity will take years to be absorbed, according to Yara international (the world's largest nitrogen producer). Based on statistics derived from Bloomberg (Figure:2), global Urea capacity is projected to expand by 3% (a net 6.3M metric tons), from 238 Mt in FY18 to 244.9 Mt in FY19. Whereas Urea demand is forecasted to show a slower growth rate at 1.5%, which would end with excess supply of 5.5 million MT during FY19 (assumed 76.7% utilization rate).

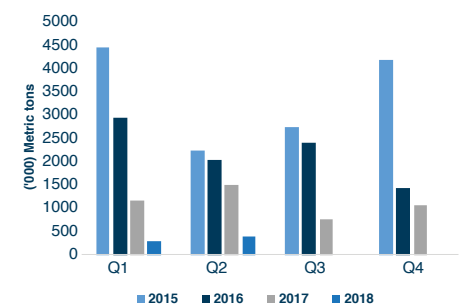
Near-term Urea market to show tighter supply, while global Urea overcapacity will get worse beyond 2019, given the expected large capacity to come on stream in Africa, South Asia and Eastern Europe & Central Asia. According to CF industries, Urea additional capacity is expected to reach 4.3M metric tons in 2018, compared to more than 7.1M metric tons capacity closure during 2018 in China and Brazil. However, the new Urea capacity is expected to reach 6 million MT in 2019, compared to 4.5 million metric tons of capacities shutdown.

Figure2: Global Urea Demand/supply Vs. Utilization rate



Source: Bloomberg, AlJazira Capital

Figure3: Exports of Chinese urea ('000)



Source: Profercy via GTIS/China Customs, ICIS news, AlJazira Capital

Cheaper Chinese coal cost and easy access to cheap US-shale gas could drive the oversupply again: While Urea International prices remain high; we expect that some concerns should be taken into consideration. The recent surge in urea prices improved margins to open the appetite of producers to push more output.

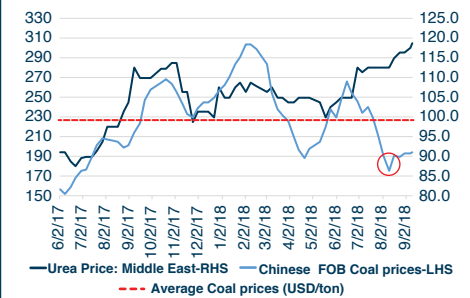
Cheaper coal prices (Figure 4) could also revive some output, as China is the largest producer of coal-based nitrogen fertilizer in the world, especially urea. We believe that the increases in coal prices at the beginning of FY18 to reach USD 120/ton was one of the reasons for the closure of some Urea production plants in China. Price spreads between global urea prices vs. Chinese coal cost plunged during 2017 and 1H-2018. However, the current decline in Chinese coal prices to around USD 90/ton might returns back some outputs to the global market.

Even though future prices for oil and European gas are expected to increase, cheap US natural gas (Henry Hub prices: Figure 5) is expected to drives new US Urea capacity, rising uncertainty over Urea supply/demand balance. Due to shale gas boom in US, it became the fourth largest ammonia producer after being a net importer few years back. Furthermore, USA is the world's third largest fertilizer consuming country, accounting for nearly 12% of world consumption (IFA). Thus, we expect that the price margins expansion for US Urea producer is a key catalyst to boost global fertilizers capacities. North America urea capacity alone expanded by more than 30% in 2015/18, led by expansions at CF Industries and OCI Chemical due to low-cost US plants (Green Markets forecasts).

Key risk to valuation:

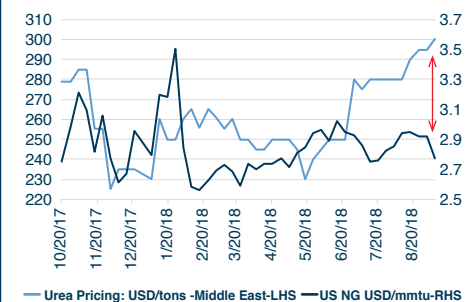
Stronger than expected capacity utilization or healthier than expected Urea global demand are the main upside risk to the valuation, while lower than expected GP margin due to any unexpected hikes in feedstock prices (Before 2020) or any sudden increase in global urea outputs are the main downside risk to the valuation.

Figure4: Urea Prices Vs. Chinese Coal Prices



Source: Bloomberg, AlJazira Capital

Figure5: Urea Prices Vs. US natural Gas



Source: Bloomberg, AlJazira Capital

Key financial data

Amount in SARmn, unless otherwise specified	2015	2016	2017	2018E	2019E
Sales revenue	3,547	2,856	2,759	3,675	3,875
<i>Sales revenue growth</i>	-20.4%	-19.5%	-3.4%	33.2%	5.4%
Cost of sales	(1,462)	(1,489)	(1,572)	(1,832)	(1,848)
Gross profit	2,085.1	1,366.8	1,187.6	1,842.4	2,027.3
General & administrative expenses	(71.22)	(270.15)	(197.19)	(211.99)	(169.46)
Operating profit	2,014	987	808	1,429	1,670
<i>Operating profit growth</i>	-32%	-51%	-18%	77%	17%
Interest income & financial charges	64.4	(30.3)	27.5	7.1	9.9
Other income (expenses) - net	-	45	(23)	(24)	(23)
Profit before zakat & minority interest	2,078	1,002	812	1,412	1,657
Income from Ibn-Baytar	118	57	94	76	88
Zakat	(66)	(23)	(27)	(40)	(40)
Net profit	2,130	1,036	879	1,449	1,705
<i>Net profit growth</i>	-32.9%	-51.4%	-15.2%	64.9%	17.7%
Assets					
Cash & equivalent	1,460	285	245	986	2,064
Property plant & equipment	5,173	5,442	5,683	5,652	5,631
Intangible assets	-	35	53	54	54
Other non-current assets	1,024	1,311	1,418	1,375	1,336
Total Assets	9,012	8,228	8,347	9,154	10,167
Liabilities & owners' equity					
Other current liabilities	820	878	785	841	847
Other non-current liabilities	596	671	690	697	704
Paid -up capital	4,167	4,167	4,167	4,167	4,167
Statutory reserves	1,880	1,985	1,250	1,250	1,250
Retained earnings	42	52	980	1,720	2,706
Total owners' equity	7,596	6,667	6,861	7,605	8,606
Total equity & liabilities	9,012	8,228	8,347	9,154	10,167
Key fundamental ratios					
Liquidity ratios					
Current ratio (x)	3.4	1.6	1.5	2.5	3.7
Cash ratio (x)	1.8	0.3	0.3	1.2	2.4
Profitability ratios					
Gross profit margin	58.8%	47.9%	43.0%	50.1%	52.3%
Operating margin	56.8%	34.5%	29.3%	38.9%	43.1%
EBITDA margin	68.1%	50.4%	46.8%	52.2%	55.7%
Net profit margin	60.1%	36.3%	31.8%	39.4%	44.0%
Return on assets	23.8%	12.0%	10.6%	16.6%	17.7%
Return on equity	27.6%	14.5%	13.0%	20.0%	21.0%
Market & valuation ratios					
EV/sales (x)	9.2	11.0	8.9	8.4	7.7
EV/EBITDA (x)	13.6	21.9	19.0	16.1	13.8
EPS (SAR)	5.1	2.5	2.1	3.5	4.1
BVPS (SAR)	18.2	16.0	16.5	18.3	20.7
Market price (SAR) *	82.2	76.3	59.6	76.5	76.5
Market-Cap (SAR mn)	34,229.2	31,791.7	24,833.3	31,875.0	31,875.0
Dividend yield	7.3%	3.3%	2.9%	3.5%	3.9%
P/E ratio (x)	16.1	30.7	28.3	22.0	18.8
P/BV ratio (x)	4.5	4.8	3.6	4.2	3.7

Source: Company reports, Aljazira Capital

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