Saudi Kayan Petrochemical Co.

Investment Update

Saudi KAYAN posted a disappointing set of result for Q2-19, with net loss of SAR -273.1mn; broadly in-line with our estimate of SAR SAR 291.1mn but above market consensus estimates of SAR 220mn. The result was mainly affected by high feedstock cost and an increase in finance cost by SAR 91mn due to debt restructuring. Sales revenue came in-line with our estimates, recording a strong operating rate of 97.5%. We expect that the substantial decline in feedstock price could shift the bottom line to profitability in Q3-19. We revised our recommendation to "Overweight" on the stock with a revised TP at SAR 14.50/share.

Weak margins and product prices hit bottom-line: Saudi KAYAN posted net losses of SAR 273.1mn in Q2-19 (EPS; SAR -0.18). Weak result is ascribed to shrinking product spread on high feedstock prices, weak product prices and high finance expenses; despite a 17%Y/Y decline in SG & A expenses. Deviation of Q2-19 net income from our estimates is mainly attributed to i) lower than expected production cost ii) higher finance cost. Finance expenses increased by SAR 91mn to SAR 378.4mn from SAR 287.3mn in Q1-19, which could be due to additional expenses for debt restructuring.

Continued high operating rates, indicates operational efficiency: Kayan's sales in Q2-19 stood at SAR 2,429.2mn depicting a decline of 4.5%Q/Q, in-line with our estimates of SAR 2,460mn. Based on our calculation, operating rate improved to 97.5%, higher than the average of 93.5% in FY18. During the quarter, Asian average prices of Kayan key products MEG-Asia declined by -10.3%Q/Q and -41.4%Y/Y, in addition to the decline in HDPE and LDPE by -1.9%Q/Q and -1.1%Q/Q, respectively.

Gross margin shrinks on high feedstock cost: Gross profit stood at SAR 192.5mn, indicating a fall of 85.2%Y/Y and 26.5%Q/Q. Gross margin further declined to 7.93% in Q2-19 vs. 10.28% in Q1-19, but above our estimate of 5.95%. During Q2-19, Butane (feedstock) average prices increased by 5%Q/Q to USD 493/tonne. MEG-Butane spreads declined to USD 361/Mt in Q2-19 from USD 437/Mt in the previous quarter. Operating profit stood at SAR 39.6mn, depicting a decline of 96.5% Y/Y. The company witnessed a decline of 17%Y/Y in OPEX (SG & A) to record SAR 152.9mn as compared to our estimate of SAR 160mn and SAR 184.2mn in Q2-18.

SARmn	Q2-FY18	Q1-FY19	Q2-FY19	Change YoY	Change QoQ	Deviation from AJC Estimates
Revenue	**3,524.2**	**2,544.3**	**2,429.2**	-31.1%	-4.5%	-1.2%
Gross Profit	1,300.7	261.8	192.53	-85.2%	-26.5%	26.4%
Gross Margin	36.91%	10.28%	7.93%	-	-	-
EBIT	1,116.5	98.5	39.58	-96.5%	-59.8%	-
Net Profit	878.65	(197.5)	(273.1)	NM*	-38.3%	6.2%
EPS	0.59	(0.13)	(0.18)	-	-	-

Source: : Company Reports, AlJazira Capital *NM: Not meaningful

Debt restructuring, lower financing cost to mitigate the impact on net income by SAR 230mn in FY20: Kayan has a relatively high leveraged balanced sheet, with long-term obligation of SAR 22.7bn and financing expenses of SAR 1.04bn in FY18. Kayan announced that the refinancing of its debt would cut financing cost by SAR 71mn in H2-19 and SAR 230mn in FY20. This we believe will mitigate the impact on the bottom line, improving the company's capability to maintain a strong cash flow and reducing debt level to SAR 19.5bn by end of FY19. We expect finance cost to decline to SAR 245mn in Q3-19 vs. SAR 378.4mn in Q2-19 and SAR 287.3mn in Q1-19. However, net Debt/EBITDA would stay high at 5.4x in FY19 against only 4.1x in FY18, limiting the company's ability to pay dividend in the next three years.

Overweight

Target Price (SAR)	**14.50**
Upside / (Downside)*	**28.8%**

Source: Tadawul *prices as of 22th of July 2019

Key Financials (in SAR mn, unless specified)

SARmn (unless specified)	FY17	FY18	FY19E	FY20E
Revenues	9,984	12,263	9,928	10,289
Growth %	16.0%	22.8%	-19.0%	3.6%
Net Income	668.2	1,702.2	(100)	956
Growth %	418.5%	154.8%	NM	NM
EPS	0.45	1.13	(0.07)	0.65

Source: Company reports, Aljazira Capital

Key Ratios

SARmn (unless specified)	FY17	FY18E	FY19E	FY20E
Gross Margin	23.5%	27.4%	16.0%	23.6%
Net Margin	6.7%	13.9%	-1.0%	9.3%
P/E	23.9x	11.9x	High	17.7x
P/B	1.2x	1.3x	1.1x	1.02X
EV/EBITDA(x)	8.3x	7.0x	8.7x	7.0x

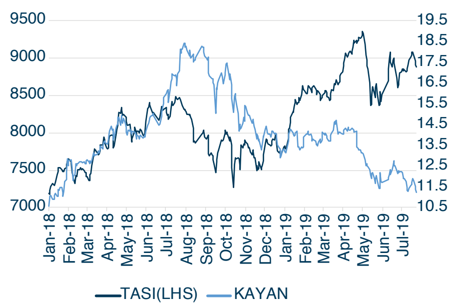
Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (mn)	17.04
YTD %	-12.6%
52 Week (High / Low)	18.52/11.18
Shares Outstanding (mn)	1500

Source: Company reports, Aljazira Capital

Stock Performance



Source: Company reports, Aljazira Capital

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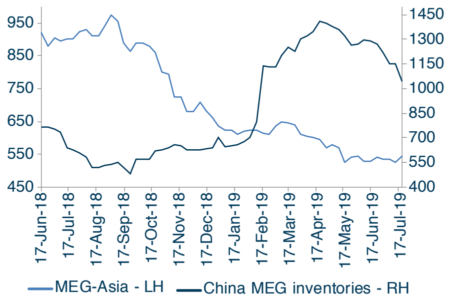
Lower feedstock prices could turn Kayan Co. to profitability during Q3-19 with a net income of SAR 170 – 200mn: We expect MEG and PC prices (50% of total product portfolio) to remain around current levels for Q3-19, while we expect a slight improvement for polyethylene prices (PE) in the short-term due to a tighter supply in southeast Asia amid a concentration of plant turnarounds (Source: ICIS news). We forecast feedstock price to decline by around 20-23%; Aramco further reduced butane prices for July-19 to USD 355/Mt from an average of USD 493/Mt during Q2-19. This should deliver improved gross margins at 23.1% during Q3-19 from only 7.93% in Q2-19, with a net income of SAR 170 – 200mn.

Our estimates and valuation: We believe, the continued high operating rate, in Q2-19, was offset by weak product prices and an increase in overall COGS and finance cost. The sensitivity of Kayan's gross margin is very high as compared to other players, due to its high dependency on Butane (80% of feedstock), especially with the current oil price volatility. Repaying and debt restructuring to reduce finance cost by an estimated SAR 175mn in H2-19 to SAR 490mn from actual SAR 666mn in H1-19. Decline in SG & A expenses during Q2-19, has become a key support going forward, where the company seems to have more control on operating expenses. Bearish S-T outlook on main product MEG and Polycarbonate prices (50% of the total product portfolio) has been eased, which is expected to mitigate the impact on top line and gross margin during H2-19. Furthermore, our mid-term outlook remains optimistic on the company due to improved operating rate; and expected noticeable recovery in product spreads after Q2-19. Saudi Kayan Co. is expected to post SAR 956mn in net income (0.64 EPS) for FY20, as compared to expected losses of SAR 100mn in FY19. "**Overweight**" recommendation on KAYAN with a revised TP at **SAR 14.50/share**.

Risks to rating and price target: We value Kayan on 50% weight for DCF (2.0% terminal growth and 9.4% average WACC), and 25% weight each for P/E (15.0x FY20 EPS) and EV/EBITDA (9x FY20 EBITDA) based relative valuation. These yield a target price of **SAR 14.50/share**, implying a 28.8% upside from the current levels. We revised our recommendation to "**Overweight**" for Kayan, aided by strong FCF, improved margins going forward, and stable S-T outlook on MEG and Polycarbonate as we believe short-term risk from weaker petrochemical prices are fully reflected on stock price and the company's performance. Lower than expected GP margin and lower-than-expected operational performance are considered as the downside risk to the valuation, while higher-than-expected product prices recovery and products' healthy global demand could drive the top line in FY19.

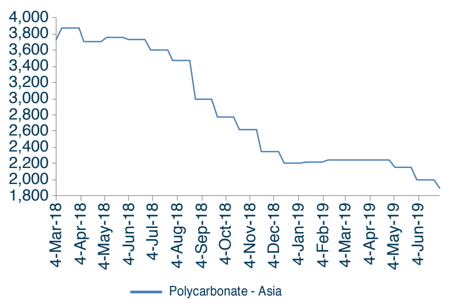
Figure2: MEG-Prices Vs. China MEG inventories



Source: Aljazira Capital, Argaam, ICIS news

Monoethylene glycol (MEG) and Polycarbonate (PC) represented 50% of total topline for KAYAN, price of MEG reached its lowest level since FY09 to USD 525/Mt due to the high inventory level in east China and weak demand for downstream product. We expect MEG price to remain around current levels for H2-19 after consecutive weeks of declines, as MEG inventories in east China start to decline.(source: ICIS)

Figure3: Polycarbonate-Price



Source: Aljazira Capital, Argaam

Polycarbonate (PC) is widely used in the auto industry and housing industry for the manufacturing of products such as appliances, home electronics and some building materials. Asia (PC) prices reached its lowest at USD 1900/Mt from USD 3800/Mt in Mar-18 as (PC) markets are well-supplied. However, on the S-T Asia polycarbonate (PC) markets are expected to stabilize with limited fluctuations, due to demand improvement.

Key Financial Data

Amount in SAR mn, unless otherwise specified	2016	2017	2018	2019E	2020E
Income statement					
Revenues	8,609	9,984	12,263	9,928	10,289
Revenue Growth	***7.9%***	***16.0%***	***22.8%***	***-19.0%***	***3.6%***
Cost of sales	(6,803)	(7,635)	(8,898)	(8,340)	(7,858)
Gross profit	**1,805**	**2,349**	**3,365**	**1,588**	**2,430**
Selling & general expenses	(746)	(719)	(705)	(633)	(636)
Operating profit	**1,059**	**1,629**	**2,661**	**955**	**1,794**
Operating profit growth	***-278.5%***	***53.8%***	***63.3%***	***-64.1%***	***87.8%***
		84.1	88.5	129.1	129.1
Financial charges	(868.4)	(910.3)	(1,004.2)	(1,155.8)	(941.7)
Other income	(22.3)	(60.0)	87.7	24.1	15.2
Income/(loss) from SaBuCo	36.0	49.5	48.5	60.6	98.9
Income before zakat	**204.5**	**792.3**	**1,881.1**	**13.2**	**1,095.3**
Zakat	(96.7)	(124.1)	(178.8)	(113.2)	(139.4)
Net income	**107.8**	**668.2**	**1,702.2**	**(100.0)**	**956.0**
Net income growth	***NM***	***519.9%***	***154.8%***	***-105.9%***	***-1055.9%***
Balance sheet					
Assets					
Cash & equivalent	1,387	2,514	2,377	2,315	1,122
Other current assets	4,675	4,246	6,797	6,610	7,111
Property, plant & equipment	34,141	32,754	30,723	29,331	27,987
Other non-current assets	827	798	798	853	947
Total assets	**41,031**	**40,311**	**40,695**	**39,109**	**37,166**
Liabilities & owners' equity					
Total current liabilities	3,493	3,350	3,296	4,722	3,212
Long-term debt	21,184	19,813	18,461	15,416	13,898
Total other non-current liabilities	3,102	3,240	3,239	3,327	3,411
Share capital	15,000	15,000	15,000	15,000	15,000
Statutory reserves	49	49	49	39	135
Retained earnings	(2,419)	(1,762)	28	(17)	890
Total equity	12,630	13,287	15,078	15,022	16,025
Total equity & liabilities	**40,410**	**39,690**	**40,074**	**38,488**	**36,545**
Key fundamental ratios					
Liquidity ratios					
Current ratio (x)	1.7	2.0	2.8	1.9	2.6
Cash ratio (x)	0.40	0.75	0.72	0.49	0.35
Profitability ratios					
Gross profit margin	21.0%	23.5%	27.4%	16.0%	23.6%
Operating margin	12.3%	16.3%	21.7%	9.6%	17.4%
EBITDA margin	40.5%	40.1%	41.9%	34.6%	0.0%
Net profit margin	1.3%	6.7%	13.9%	-1.0%	9.3%
Return on assets	0.4%	1.6%	4.2%	-0.3%	2.5%
Return on equity	1.2%	4.9%	11.5%	-0.6%	5.9%
Leverage ratio					
Interest coverage (x)	1.2	1.8	2.6	0.8	1.9
Debt / equity (x)	1.7	1.5	1.3	1.2	0.9
Market/valuation ratios					
EV/sales (x)	3.8	3.3	3.0	3.0	2.9
EV/EBITDA (x)	9.5	8.3	7.1	8.7	7.0
EPS (SAR)	0.10	0.45	1.13	(0.07)	0.64
BVPS (SAR)	8.8	9.3	10.5	10.4	11.1
Market price (SAR)*	8.85	10.68	13.50	11.30	11.30
Market-Cap (SAR mn)	1,328	1,602	2,025	1,695	1,695
P/E ratio (x)	87.30	23.98	11.90	(169.48)	17.73
P/BV ratio (x)	1.00	1.15	1.29	1.08	1.02

Source: The company report, AlJazira Capital, Tadawul

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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.

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