Advanced Petrochemicals Co

Petrochemicals – Industrial
APPC AB: Saudi Arabia
08 July 2018

الراجحي المالية
Al Rajhi Capital

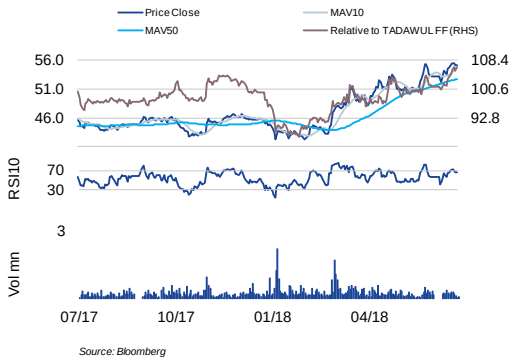
US$2.891bn	9%	US$2.792mn
Market cap	Free float	Avg. daily volume

Target price	**61.00**	10.7% over current
Current price	**55.10**	**as at 5/7/2018**

Research Department
Pritish K. Devassy, CFA
Tel +966 11 2119370, devassyp@alrajhi-capital.com

Existing rating		
Underweight	**Neutral**	**Overweight**

Performance



Earnings

(SARmn)	2017	2018e	2019e
Revenue	2,385	2,615	2,745
Y-o-Y	11.5%	9.7%	4.9%
Gross profit	738	819	923
Gross margin	31.0%	31.3%	33.6%
Net profit	631	724	811
Y-o-Y	-13.8%	14.7%	12.0%
Net margin	26.5%	27.7%	29.6%
EPS (SAR)	3.2	3.7	4.1
DPS (SAR)	2.8	3.0	3.4
Payout ratio	87.3%	80.2%	82.5%
P/E (Curr)	17.4x	15.1x	13.5x
P/E (Target)	19.0x	16.6x	14.8x

Source: Company data, Al Rajhi Capital

Advanced Petrochemicals Co

Upgrade to OW. Raise TP to SAR61/share

APPC reported a remarkable second quarter with beat across all line items. In Q2, the company increased sales quantity by ~5% y-o-y. Its net price realization (+18% y-o-y) was higher than our expectation by 3%. Both combined, the company managed to increase revenue by ~24% y-o-y to SAR750mn (vs. our exp. of SAR678mn). Helped by lower propane costs as well, the margins improved and the company recorded its best ever quarterly net profit since inception at SAR253mn (+30% y-o-y) vs our expectation of SAR184mn and consensus of SAR200mn. The increase in income from its Korean associate also helped (~SAR24mn vs our expectation of ~SAR14mn). The higher than expected sales volume is likely to have come from better efficiency/output post the replacement of production catalyst done in the last quarter. Based on our conservative estimates, we arrive at next 12 months EPS of ~SAR4.0. Based on equal mix of DCF and relative valuation, we revise our target price upwards to SAR61/sh with key downside risk of decline in Polypropylene price.

What to expect in the near term? If we were to annualize this quarter's EPS, we would see EPS of SAR5.14 for the next 12 months. However to arrive at what would be a conservative estimate, we take a few assumptions: a) Lower this quarter's production by ~5% b) Increase propane costs by 5%, as generally propane catches up with naphtha price, which is already up +8% YTD, following oil price rally. This is because many petrochemical companies in Asia and Europe have the option of switching between their feedstocks (Naphtha/Propane) based on the economic benefit and hence, propane prices have traditionally caught up with Naphtha (barring one-offs/seasonality effects). Though there are reports of a 25% tariff on US propane exports to China, which could further lower propane prices, we assume a 5% increase conservatively. c) For its associate SK Advanced, we assume SAR17mn net contribution on a sustainable basis. SK Advanced had its last shutdown in Q4 17 and hence is unlikely to see one in the near future. d) As per industry reports, there is a strong demand situation for Polypropylene – however we forecast a 5% drop in PP prices conservatively. Overall we arrive at an annual EPS of SAR4.0 for the next 12 months. The stock has not reacted to the strong results and presents investors to take position for potential upside.

Figure 1 APCC Q1 results

(SAR mn)	Q2 2017	Q1 2018	Q2 2018	Y-o-Y	Q-o-Q	ARC est	Comments
Revenue	**604**	**504**	**750**	**24.1%**	**48.9%**	**678**	**Beat our and consensus estimates, largely due to higher than expected sales volume amid improved utilization rates.**
Gross profit	220	119	276	25.4%	131.7%	208	Lower other COGS further led to gross profit beat in Q1.
Gross margin	36.4%	23.6%	36.8%			30.7%	
Operating profit	192	95	247	28.6%	160.8%	182	Jumped significantly, owing to higher top-line and lower costs.
Operating margin	32%	19%	33%			27%	
Net profit	**195**	**98**	**253**	**30.1%**	**159.4%**	**184**	**Higher than expected equity investment income (SAR23.6mn vs SAR14.2mn expected) pushed net profit above our estimate of SAR184mn (consensus: SAR200mn)**
Net margin	32%	19%	34%			27%	

Source: Company data, Al Rajhi Capital

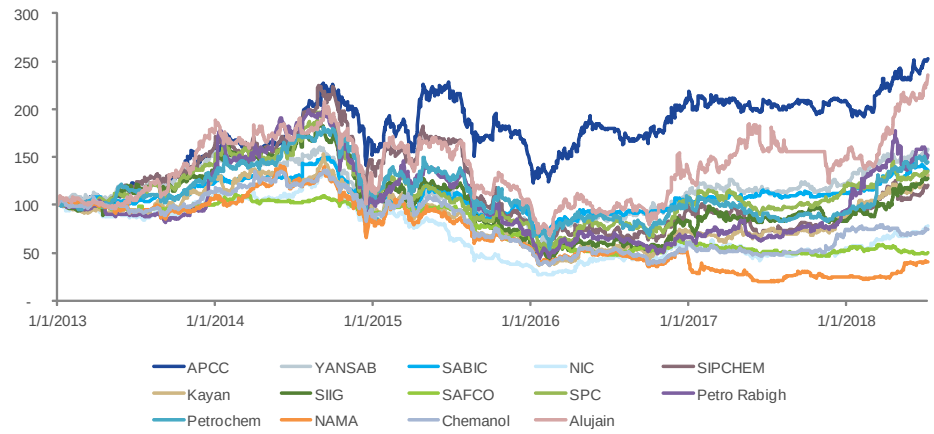
Possible downside factors: The key downside risk is decline in polypropylene (PP) price – the spot price which is slightly declined from the peak seen in end of June despite the strong demand for PP. The risk of a shutdown is limited in the next 12 months as seen from the company's track record.

Hence the momentum could sustain at least for the next one year. Another possible factor is that the production could decline further as the efficiency could have been at its best – however this is the reason we incorporate a 5% decline as generally the production strength only wanes towards the end of the lifetime of the catalyst, which is around 3 years.

New Projects possible impact:

In terms of stock performance, APPC has beaten the Saudi petrochemical sector comprehensively over the years (Figure 2). The company reached a stable state and just when it was being viewed as a stable dividend company, the company has shown its intent to grow (though growth is likely to be only moderate and will come to fruition by 2020/21). We do a rough estimation of what could be the impact of the new projects announced the company.

Figure 2 APCC stock price performance vs its peers (Rebased at 100)



Source: Bloomberg, Al Rajhi Capital

1. **APCC's Korean JV plans to set up a US$420mn PP plant:** SK Advanced Company, a 30% subsidiary of APCC, has recently signed a deal with PolyMirae Company to establish a new PP plant in South Korea with an estimated investment cost of US$420mn. The plant will have a total production capacity of 400kmt and is likely to begin construction in January next year (subject to final investment decision) with an anticipated in-service date in 2021. We consider this strategic investment to be positive as this will enable its Korean partner to go down further in propylene chain. Moreover, SK Advanced, which will supply Propylene (a main feedstock for the plant), is well-positioned to secure local Propylene off-take on a long-term basis through this new plant. The management indicated that around 60% (400kta) of SK Advanced's output (600kta) will be consumed in the new plant. As per our calculations (Figure 3 and 4), once the project starts commercial production in 2021, it would improve APCC's bottom-line by ~SAR24mn (or 3.3% incremental earnings on 2018E bottom-line at 100% utilization rate) annually.

Figure 3 New Polypropylene Plant - South Korea

New Polypropylene Plant - South Korea			
New PP plant capacity (kta)	400	**Ownership**	
Location	South Korea	SK Advanced Company	49.99%
Construction phase	2019-2021	PolyMirae	50.01%
In-service year	2021	APCC's indirect stake in SK Advanced	30.00%
Estimated investment costs (SAR 'mn)	1575	APCC's indirect stake in new PP plant	15.00%
Main feedstock	Propylene	**Financing**	
Feedstock supplier	SK Advanced	Debt	60%
SK Advanced Propylene capacity (kta)	600	Equity	40%

Source: Company data, Al Rajhi Capital

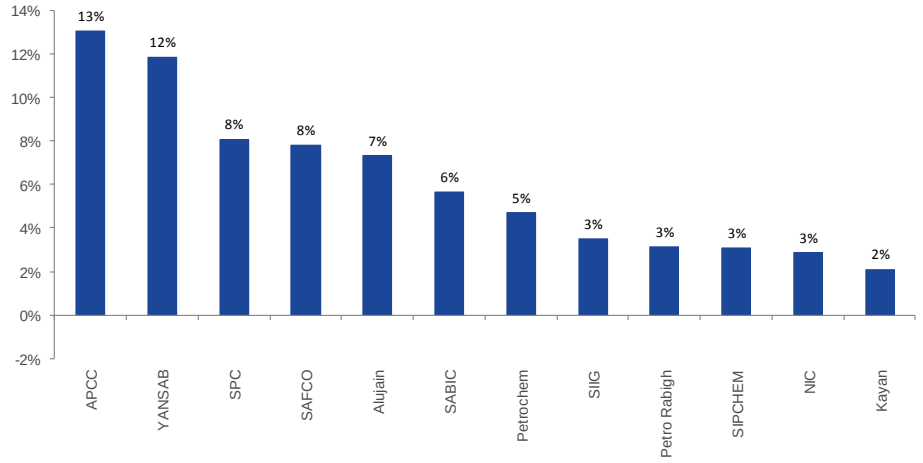
Figure 4 Annual financial Impact - New PP plant

Annual financial Impact - New PP plant	
PP production capacity (kta)	**400**
Utilization	100%
Sales volume (kta)	**400**
PP price (US$/t)	1200
Implied revenue @100% utilization (SAR 'mn)	**1800**
Average net margin	9%
Implied net profit (SAR 'mn)	**160**
APCC's share in profit from new PP plant (SAR 'mn)	**24**
Impact on 2018E earnings	3.3%

Source: Company data, Al Rajhi Capital

2. **The Pyoil and Pygas downstream project:** The downstream project was announced by the company for a total investment of SAR2.17bn. Assuming the project returns 10% RoA in mature phase (lower than 13% by parent company APPC), this could imply 10%* SAR2,170mn = SAR217mn annual returns from the project and specifically for APPC , with 30% stake, ~SAR65mn contribution to current annual net profit (additional EPS of SAR0.3, 7.5% of annual EPS).

Figure 5 Saudi Petchem companies' ROA (%) - As of Q1 2018



Source: Bloomberg, Al Rajhi Capital

Dividend could improve to SAR0.85/sh from SAR0.70/sh per quarter: APCC's cash flows remain stellar and it has a healthy debt/equity ratio of ~10%. We think it makes sense for the company to maintain its existing debt given that the cost of debt is only 3.6% as compared to cost of equity of 10.6%. Thereby the company could improve its value by extending this debt than paying it off. For Q2, as announced previously the company will pay only 0.7/share but the company could improve its DPS to 0.85. We expect an increase in DPS by the end of the year as has been seen in the past. At our 12 month forward DPS of SAR3.25/share, the stock offers a healthy dividend yield of 5.8% and also some moderate growth.

When we look at cash flows, annual EBITDA based on our 12 month forecast is ~SAR950mn while normal capex has ranged around SAR150mn, which implies ~SAR800mn left for dividends. Even if we take into SAR200mn investment required for Pygas (no change in debt), then also, it implies ~SAR600mn left for distribution. Please note that there won't be cash required from APPC for the JV between PolyMirae and SK because it will be funded by SK and its partners unless they are unable to raise cash at which point it could be a loan or further equity investment.

Valuation and risks: The stock is currently trading at a P/E of 13.5x on our 2019E EPS, above its 3-year historical average of 12.7x (range 12-14x). We raise our TP to SAR61/share (prior 47/sh) based on equal mix of relative (SAR61.3/sh. based on 15.0x 12 month forward PE) and DCF valuation (SAR59.8/sh. based on FCF, long term WACC/ cost of equity at 10.6%). We factor in a higher than historical target multiple to account for the moderate long term growth and management quality. The key upside trigger might be attributed to an increase in dividends while weakness in spreads may act as the key downside trigger.

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"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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Contact us

Mazen AlSudairi
Head of Research
Tel : +966 1 211 9449
Email: alsudairim@alrajhi-capital.com

Al Rajhi Capital
Research Department
Head Office, King Fahad Road
P.O. Box 5561, Riyadh 11432
Kingdom of Saudi Arabia
Email: research@alrajhi-capital.com

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