MEPCO

CONFERENCE CALL TO DISCUSS MEPCO FINANCIAL AND OPERATIONAL RESULTS FOR THE THIRD QUARTER OF 2020.

Company: MEPCO

Presenter: Sami Al Safran, Chief Executive Officer

Date: 02.11.2020

Participants:

- Sami Al Safran, Chief Executive Officer
- Mohamed Darweesh, Group Chief Financial Officer
- Bassem El Shawy, Head of Strategy and Business Development

Operator
Ladies and gentlemen, thank you for standing by, and I would like to welcome you to MEPCO 3Q results call. At this time all participant lines are in listen-only mode. The format of the call will be a presentation by MEPCO management and IR team followed by question-and-answer session. After the call, if you would like to ask a question, please press star-two on your telephone keypad and wait for your name to be called. So, without further ado, I would now like to pass the line to Mr. Bassem. Please go ahead, sir. Your line is open.

Bassem El Shawy, Head of Strategy and Business Development
Thank you very much. Thank you everyone for joining us today. We will start today's call by citing a forward-looking disclaimer as usual. Today's presentation may contain forward-looking statements. While management has made every effort to present a fair view of MEPCO's operational and financial performance, it is important to note actual future results may change in the future due to changes in prevailing operational, financial and market conditions. Management does not give forward-looking statements for investment decision making

purposes. Accordingly, it does not take the responsibility to explain differences between future and actual results stated in the course of this presentation. I will hand over the presentation now to Engineer Sami Al Safran to present an overview about the business performance in the nine months of 2020. Engineer Sami.

Sami Al Safran, Chief Executive Officer

Good morning, good afternoon, ladies and gentlemen. Another interesting year, the performance of the first nine months of this year exceeded expectations. These nine months have been exceptionally challenging at the multiple dimensions, with a high level of uncertainty, swap shift in consumer behavior, pricing as well as logistic challenges. The (?) second wave of demand witnessed in the March to May 2020 period resulted in different things between overstocking of most of our clients in addition to major escalations of e-commerce transactions, in addition to the finally the logistic challenges which was mentioned earlier, which enhances the localization demand and supply for our industries. However, going forward, life is going back now to normal and supply and demand is normalizing. The situation, however, is corrective in nature. And it has reached it since. We're noticing international uptrend in pricing. Some international players announce price increases. This should give us an uplift of the overall price level, which should be reflected partially in Q4 2020 and Q1 in 2021.

We continue our focus on local sales while making sure international key customer demands are fully met on time. This strategic shift sales have helped us greatly in creating a sales and logistical side. More than SAR 4 million appeared in our financial numbers. It is important to note that lagging of the prices changes every quarter, with the affected by contracts committed during the previous quarter at price prevailing then. According this quarter reflects the drop of selling prices discussed and negotiated during Q2 2020. Year-to-date, although sales revenue looks relatively flat, however, in terms of volume, we have achieved 10% sales increase compared with our last year similar period. It tells us actually to offset part of the low prices in addition to drop our logistic costs and our manufacturing costs.

From the side of the raw material, it's a bit interesting to happen that during the lockdown the generated quantities of the raw materials as the base of the raw materials are wastepaper, has dropped locally and internationally due to the closure of schools, businesses and other areas, which makes it very challenging for us to grab the required quantities of raw material needed. However, the situation had been met through our crisis management plan that we have prepared ourselves in terms of the raw materials demand. We cover up the shortage or the potential shortage through the imports, in addition to a proper utilization of our owned company WASCO. That tells us successfully to pass it through the crisis with the stable performance and makes us a great achieved milestone in terms of our production volume, our sales volume, and the drop in our operating costs. We are hoping that the coming future will be brighter for us in a better position. And now I will hand over the speak to Doctor Darweesh to give us about the financial performance.

Mohamed Darweesh, Group Chief Financial Officer

Good afternoon and good morning, ladies and gentlemen. MEPCO management is proud to report important achievements in cost efficiency for Q3 and the nine months 2020. Compared to same period of last year the presented figures are based on consolidated financial statements. MEPCO has reported the 2% and 10% higher production volume in quarter three and year-to-date September 2020, respectively as compared to quarter three and year-to-date September 2019. Due to improvements in machine efficiencies on the lower machine downtime. Waste material collection by our fully owned subsidiary WASCO improved by 15% in Q3 2020 as compared to Quarter 3 2019, due to resuming of business after COVID-19 lockdown. However, it dropped by 60% in year-to-date September 2020, as compared to the same period last year 2019.

MEPCO consolidated sales volume dropped by 2% in Q3 2020 as compared to Q3 2019. However, it is increased by 7% year-to-date September 2020, as compared to year-to-date of last year, mainly due to higher production volume. MEPCO consolidated average gross sales prices dropped by 5% and 7% in Q3 year-to-date respectively, as compared to Q3 and year-to-date, September 2019, respectively due to steep market conditions. Average cost of sales (?) sold increased by 3% in Q3 as compared to cost of sales in Q3 2019 revenue comparatively in fiber prices. However, it's decreased by 5.6% year-to-date due to drop in average fiber (?) prices and saving in almost all material consumption, manpower costs and our fixed costs.

Gross margin dropped by 7% in quarter-to-quarter basis, and 1% year-to-date basis, mainly due to drop in (?) price. The (?) expenses dropped by about 29% and 16% in Q3 and year-to-date basis September 2020 respectively, mainly due decrease in sales expenses (?) allowance of impairment of accounts receivable and other fixed expenses. Finance charges dropped by 76% and 25% in Q3 and year-to-date, respectively as compared to Q3 and year-to-date of last year. Financial charges representing 47% of operating profit for year-to-date September 2020, as compared to 83% of year-to-date operating profit of the same period last year due to drop in volume driven by 8.1%, as well as decrease in average LIBOR and SAIBOR as compared to the same period last year.

Net profit margin dropped by 0.3% in Q3 compared to the same period of last year. However, it is improved by 2.5% in year-to-date, this is due to drop in cost of goods sold and as well as finance cost. Total volume driven has been decreased by 10% from 656 million at the end of December 2019 to 590 million at September 2020, which represents 67% of total assets of growth. Finally, debt-to-equity ratio on year-to-date basis dropped from 0.90 to 0.79.

Thank you. And now I will hand over the mic to Mr.Bassem.

Bassem El Shawy, Head of Strategy and Business Development
Thank you, Doctor Darweesh. Back to you, operator, for Q&A.

Operator
Thank you very much for the presentation. We will now be moving to the Q&A part of the session. If you have any questions, please press star-two on your telephone. If you are dialed in via the web, you may also ask a voice or a text question. We will now give it a minute or so.
Our first question comes from Mr. Riyas Abdul Kader from Integra Asset Management. Your line is open, please go ahead.

Riyas Abdul Kader, Integra Asset Management
Yeah. As-salamu alaykum, guys. Thank you for the call. I just want to understand the pricing dynamics. So, you mentioned that the Q3 numbers are reflection of Q2 prices. So, the Q2 prices go down in line with how commodity prices and how overall prices went down, if that happened in Q2, and that got reflected in Q3 revenues? And if so, if things rebound in Q3, which would reflect in Q4? The other question was on the raw material pricing, if you can shed some light on August [inaudible]. In 2019 also, you had the issue where the raw material prices went up? And I just wanted to understand, how are you looking to manage this and what sort of strategy you have in place to mitigate this? Because the margins are really decreased compared to 2018 into 2019. And you're facing the same issue it seems this year also. Just if you can understand what you can do from your end, I mean, understand it is the commodity, but is there something that can be done to mitigate this, to make things better? Thank you.

Bassem El Shawy, Head of Strategy and Business Development
Okay, hi Riyas. It is Bassem. Allow me to tap the first point you mentioned, and noting that your voice was a bit distant, so we couldn't hear very well. But regarding your first question about the (?) price from one quarter to another, we produce the orders. So, sometimes prices change during one quarter. And that change can be significant. So let's say for example, an order that we have contracted in the last month of a given quarter, that will be carried out and produced during the following quarter, and it will not hit the P&L until it has been delivered to the client in the following quarter. So, it would reflect prices that have been contracted one quarter ago at a different level of prices. This is why there is a lag in the effects of prices that will hit our P&L later on maybe a month or two later. And in Q2, late Q2, we started to see a slight downtrend in price levels, and it impacted the third quarter.

Riyas Abdul Kader, Integra Asset Management
Okay.

Bassem El Shawy, Head of Strategy and Business Development
Does that answer your question?

Riyas Abdul Kader, Integra Asset Management
Oh, yes, yes. Okay.

Bassem El Shawy, Head of Strategy and Business Development
About the second part of your question, I think was related to raw materials.

Riyas Abdul Kader, Integra Asset Management
Yes.

Bassem El Shawy, Head of Strategy and Business Development
Okay, I will hand over to Engineer Sami.

Sami Al Safran, Chief Executive Officer
Yes, it's known internationally, the raw material is going through the major regulation, regulatory happened by China where, by the early 2021, there will be a complete ban of RCPs imports to China, which we will see a 25 million ton, which at the peak of imported Chinese RCPs will (?) damage. We have seen a drop up to 8 million tons this year, and by the next year, it will be zero. Logically, it should impact positively to the favor of the buyer when the prices should go down. However, due to the lockdown situations happened through the world, it's created actually a scarcity of supply, and that we have seen it after the first wave of pandemic, the lack of the materials drives the prices up and it was actually reported in our financial statements. We believe by the normalizing the situations; we should see a favorable performance of the raw material prices that should help us. But it is really difficult to quantify it as long as the pandemic is there. I believe in the second quarter of the next year the picture should be very clear for us regarding the direction of the raw materials.

Bassem El Shawy, Head of Strategy and Business Development
And regarding the third question related to strategies management do to mitigate the price swings, when it comes to pricing, we are a price taker due to our size relative to the national industry size. So, there is little that we can do to actually dictate prices. What we can do actually is to manage costs, and this is has been doing very well in MEPCO. And we've been achieving significant milestones in cost reduction so far. The other thing we can also monitor, and tweak is the product mix, because we have multiple products of paperboard and containerboard, and adjusting that mix can help us a little bit in improving our margins. So, this is as much as we can do with regards to the overall financial performance of the company, with very much little impact on the price itself.

Riyas Abdul Kader, Integra Asset Management
Okay. On your unit production costs, how can you bring that down? Is it to paper waste collection, just to understand that dynamic?

Sami Al Safran, Chief Executive Officer
Well, Riyas, if you benchmark the business of MEPCO comparing with the globe, you will find we are actually in the one of the efficient mills in the world that we are operating our business. And the (?) you want the main driver for us is having a backward integration of WASCO. However, if you compare the raw material, the local prices of the raw material in Saudi Arabia comparing with Europe, you will find major differences are there. And the only reason for that, Europe is regulated in terms of waste generation, and accordingly, you will find most of the time, the price of the raw material in Europe is 50% lower than our local market. It's been announced two years ago about the national strategy of waste management for Saudi Arabia, which is under execution. We have seen the government have launched the National Waste Center they have launched with PIF a recycling company which they are developing the policies and procedures and regulating the industry, which we are hoping when this comes into full force, it should favorably reflect the cost of raw materials and being competitive with the rest of the world.

Riyas Abdul Kader, Integra Asset Management
Okay. Thank you.

Operator
Thank you very much. Our next -- yes. Please, go ahead.

Riyas Abdul Kader, Integra Asset Management
A follow-up, just on the Chinese import ban you mentioned. So, this is kicking early next year, right?

Sami Al Safran, Chief Executive Officer
It was actually a middle of last year, where it was applied in two countries, Spain and Poland. And we have seen a deterioration in supply from both countries. And the market share for those ones went to the favor of MEPCO. We have reported the numbers in the previous quarter that MEPCO had increased local sales by 50% compared with last year.

Riyas Abdul Kader, Integra Asset Management
Okay. All right. Thank you.

Operator
Thank you very much. Our next question comes from Mr. Anas Al-Sadafi, NCB Capital. Please, go ahead. Your line is open, Anas.

Anas Al-Sadafi, NCB Capital
Salam alejkum. This is Anas Al-Sadafi from NCB Capital. Thank you, Mr. Bassem, Dr. Darweesh and Engineer Sami for the call. Engineer Sami, I have a couple of questions, if you don't mind me asking. My first question is regarding the China situation. So, if I understand correctly, of course this has been -- this is not a new initiative, this is an old initiative, where China wants to ban OCC imports. I've been reading in the IP, the National Paper disclosure, they are very bullish on the container segment but the OCC very negative. And I understand that the pricing of these products is related to each other. So, let's say -- and correct me if I'm mistaken in my thinking, let's say that this Chinese ban will go through, OCC prices will collapse. At the same time container prices will also mimic OCC prices. So, if you can give me color on the margins on these products, given the OCC ban.

Sami Al Safran, Chief Executive Officer
Anas, thank you very much, you're really on top of the subject exactly, and what has been said is correct. The Chinese approach by banning OCC will create a pressure in the OCC prices and then in reality, before the pandemic situation we in MEPCO had imported the raw material from outside, even at negative prices there, which makes it very competitive. The situation went

through a disturbance due to the pandemic. And this is why my previous answer to Riyas that I see that after the situation normalized, the raw material prices should go to before the pandemic, which is at the low level.

Now, we're coming to the second statement regarding the containerboard. Your comment is correct, the containerboard prices are to a certain level linked to the raw material prices. However, since the inventory is the game changer of the supply and demand, and through our experiences, we have seen the average inventory of four weeks where the purchasing managers are maintaining through their companies. And usually, if the inventory drops below those rates, we will find the prices reflected above difference and the other way around is happening, if the inventory goes higher.

So, coming to conclusion, number one, yes containerboard industries are positively growing, supported by the consumer behavior, change in requirements, and one of the major drivers is the e-commerce. The second thing is that while Chinese are taking measures to ban the OCC import, still they need to produce goods and still they need to export it. So, they need a packaging paper at the end of the day. And that we have seen it, that Chinese started to import finished products directly to their consumptions because they are not able to produce the required volume internally. And we in MEPCO have sold a recognizable volume this year to China. In fact, China is becoming for this year, the largest export market to us. So, which means the demand will continue, the growth will continue. And here it remains really the challenge between stocking of the inventory and dropping the inventory.

Anas Al-Sadafi, NCB Capital
Fair enough. So, you are witnessing stocking up in the finished product ahead of this ban?

Sami Al Safran, Chief Executive Officer
In the first wave, yes, it has happened because there is uncertainty. The same measures we have taken in MEPCO where we have actually prepared ourselves for the wave, we filled our inventories, our clients did the same thing. But still, the local clients, we have talking about them, that was not enough for them to mitigate the wave and accordingly MEPCO has greatly supported the local market with the shortage of supply because the logistic disturbance, and I believe everyone in that industry is aware that there was no enough goods to be shipped through sailing during the period, and that's why most of local customers have relied on MEPCO to fulfill their needs. Now what has happened is that by the relief of the pandemic, June onward, everyone started business to be normalized, it leads to everyone started the business with the third quarter with a high inventory. And that created the pressure on the prices. Now we think that by the second month of the third quarter inventories went normalized. And accordingly, the prices start

to pick up and move upward the trend. IP is one of the companies who announced the price increases of the containerboard. We believe this healthy situation should continue for Q4 and Q1.

Anas Al-Sadafi, NCB Capital
Fair, fair enough. I have a couple of more questions, expanding on the situation in Turkey. So, there is one of the regional competitors, one of the biggest competitors in the region, Modern Karton Company. What is the situation in the market given the latest developments with Turkey and Saudi?

Sami Al Safran, Chief Executive Officer
Of course, Modern Karton is one of the players in the region, and the boycott which is happening by the citizens in Saudi Arabia is we believe that it will reduce the competition from Turkey. However, generally Turkey is not a large supplier to the local market, still the large suppliers to the local markets are mainly Germany, Spain, and I believe, Italy and India.

Anas Al-Sadafi, NCB Capital
Okay. A couple of more questions. So, on the sales mix, of course, as you mentioned in your release, the local to export mix has drastically changed during 2020. Now we are -- our experts are around 40%, while our local market around 60%. Just for me to understand, generally, is the local revenue or the local segment higher margin than the export?

Sami Al Safran, Chief Executive Officer
It's really -- classically, the answer is yes. However, when it comes to our sales strategy, and as usually we chose the market and the product that has a better margin for us, and we focus at. So, for example, if the conventional products are having a better margin, we would focus on them, if the local market is having a better margin is focus; and the other way around. Noting that some of the products cannot be sold locally, it's always international. Like for example, the semi-chemical, which is only used for vegetable and fruit applications that's going to French, we typically export it to agricultural countries like Egypt.

Anas Al-Sadafi, NCB Capital
Okay, so despite the fact that we saw an increase in local contribution, our margins for Q3 were weaker than last year. And this is due to what exactly is happening?

Sami Al Safran, Chief Executive Officer

It's mainly due to the international prices drop of the finished goods. And whether you are selling local or international Anas, still you are actually subject to the international prices, commodity prices, and you have to respond accordingly, keeping in mind that Saudi Arabia is an open country, and still there is a recognizable volume of imports is going on. We are taking our measures by rationalizing the market, like for example, we have filed an anti-dumping case, we have actually -- we have improved our relation in terms of raising the standards of the quality of the product, because MEPCO is having a distinguished specification of paper. And now thankfully, the guys from (?) used our product specification as a benchmark of imports. So, we are actually uplifting the quality of the standards of the market, which we believe for the long term it is to our favour.

Anas Al-Sadafi, NCB Capital

Great. The final two questions from my end, and sorry for taking more time. WASCO and the National Waste Center, can we see like a collaboration between these two entities? And to what extent can we see the collaboration?

Sami Al Safran, Chief Executive Officer

Absolutely. Look Anas, WASCO is the largest waste management company in the Middle East. WASCO is controlling half million tons, and this was the number one at least in Saudi Arabia, the second one is at the size of 160 thousand tons. So, you could understand, you could rationalize the difference between us. WASCO is controlling almost 50% of the Saudi market. And yes, since the foundation of the National Waste Center, and we are in close contact with them, because we believe the regulations which should be addressed, and regulations of the market will always end up to the favor of WASCO. Keeping in mind WASCO is well-organized company, we have --actually well-positioned, we have most of the market information available with us, the business model is aware of for us. So, yes, I think we are in a good communication with them. Even with the SIRC, by the way, the Saudi recycling company, we have open channel with them, we talk to them a lot.

Anas Al-Sadafi, NCB Capital

And my final question is on benchmarking the efficiencies of the company. So, you mentioned a very interesting thing in terms of how efficient we are compared to European and international players. Does this consider the HFO subsidy that we are receiving?

Sami Al Safran, Chief Executive Officer

Well, Anas, definitively, you cannot ignore the energy part as a contributor of efficiencies, but it's not actually only this one. Number one Anas, when I address the benchmarking, it is not really, we call it a media comments rather than it's a business comment. Because we have subscription with different institutes in the industry and we receive from them an operational benchmark and we measure our performance with it. Taking, for example, water consumption, globally, water consumption is an average of 5 to 10 cubic meter of water per ton. We in MEPCO at 6, although we are talking about a desert area, we are talking about technology that is there for quite some years, but we are aware of the water consumption. Not only this, the cost of water per ton on in the case of MEPCO is almost like $ 5, which is on-par with the performance efficiencies in water consumption. The same applies with the maintenance, it applies with the operational costs. And definitely, you cannot ignore the energy costs.

Anas Al-Sadafi, NCB Capital

So, more on the energy costs. So, if there is no subsidy, we will be in the red. Is this true or my thinking is wrong, if we quantify the subsidy amount?

Sami Al Safran, Chief Executive Officer

Well, to answer the comments, number one, there is nothing called subsidies because what prices MEPCO is taking is the announced prices by Aramco. Number two, we have run our business model, and we assumed that if energy prices have been doubled by Saudi Arabia, the impact of the cost of the goods sold is only 3%.

Anas Al-Sadafi, NCB Capital

Thank you very much, Engineer Sami. Thank you. This was very helpful.

Sami Al Safran, Chief Executive Officer

Thank you, you really did a good job in terms of asking detailed questions.

Anas Al-Sadafi, NCB Capital

Thank you.

Operator

Thank you very much. Okay, in that case, Bassem, we will perhaps go to the text questions. Please go ahead, Bassem with the text questions.

Bassem El Shawy, Head of Strategy and Business Development
All right, we have a question from Mishadnra. The question is as follows, due to the OCC ban in China production expected will drop, production through means other than OCC is the cost much higher, which would mean China producers will be less competitive?

Sami Al Safran, Chief Executive Officer
It's a true, actually, it's similar to the answer that I have given earlier. Reality, the cost of production of China classically is the highest in the world, because majority of their raw material demand is being imported from outside. Chinese, our producer -- our consumer of almost 50 million tons of OCC materials, half of it has been imported from outside. Now, with the further ban of what we have seen, yes, rationally, the prices will come up. And that's how we have seen Chinese are number one investing in the new mills in different places in the world, including Europe and the United States. In addition to they are actually buying a direct finished product to cater the requirements of their need. So, the comment is correct.

Bassem El Shawy, Head of Strategy and Business Development
The second part of the question is what are your expectations for containerboard prices for 2021 and beyond, given that China production of containerboard could drop due to the ban of OCC.

Sami Al Safran, Chief Executive Officer
Look, it's really difficult to anticipate the year performance. I mean, in our press release we have anticipated what we have seen closely to us. Definitely, like others, if the COVID-19 situations come in a control and economy open up, then we anticipate the growth, the demand which really support the prices. But again, all of them are if the situation of the COVID-19 has been changed. So, at least now we are able to forecast this quarter. If I had the magic wand, definitely, I would give you that clear answer.

Operator
Thank you very much. So just once again, reminder for any additional questions, star-two if you're dialed in via the phone. You may also ask a voice or text question, if you are dialed in via the web. I'm recording no further questions at this point. I'll pass the line back to the management team to conclude the call.

Sami Al Safran, Chief Executive Officer
Thank you very much gentlemen, for your time given to address our performance in the nine months. I was really proud during that period, how we, MEPCO managed the crisis properly, it is still reflected in our numbers, it is reflected in our operational results. With the challenging situation of pandemic, our team here have made great achievements in terms of production volumes, sales, costs of manufacturing. I think that gives the key advantage of MEPCO, having a 20 years legacy of work experience, a good knowledge in the business, motivated team to meet and exceed the expected results.

We are biased by the second two quarters and we are challenging ourselves to meet our expectations and exceed them. And we would like to thank you for trust in MEPCO.

And I wish this for all, please stay safe, like we have taken care of our employees here. Thank you.

Operator
Thank you.