Saudi Aramco Base Oil Co.

Materials
LUBEREFAB: Saudi Arabia
16 February 2023

alrajhi capital الراجحي المالية

US$4.68bn	30%	US$42.4mn
Market cap	Free float	Avg. daily volume

Target price	114.00	~10% over current
Current price	104.00	as at 15/2/2022

Research Department
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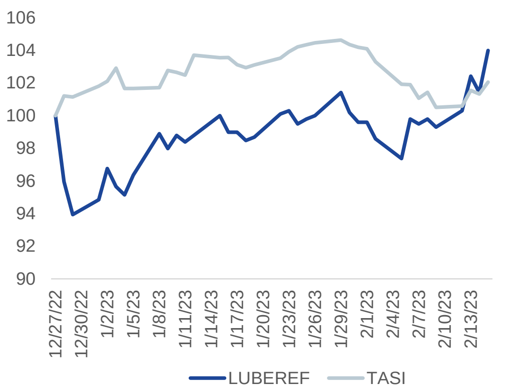
Existing rating

Underweight	Neutral	Overweight

Performance



Earnings

(SARmn)	2022E	2023E	2024E
Revenue	11,530	9,822	10,002
Y-o-Y	30.3%	-14.8%	1.8%
Gross profit	2,504	2,062	2,092
Gross margin	21.7%	21.0%	20.9%
Net profit	1,750	1,421	1,447
Y-o-Y	16.5%	-18.8%	1.9%
Net margin	15.2%	14.5%	14.5%
EPS (SAR)	10.4	8.4	8.6
DPS (SAR)	10.0	6.7	6.9
Payout ratio	96.4%	80.0%	80.0%
P/E (Curr)	10.0x	12.4x	12.1x
P/E (Target)	11.0x	13.5x	13.3x

Source: Company data, Al Rajhi Capital

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Saudi Aramco Base Oil Co.

Initiate with a TP of SAR114/sh.

We initiate coverage on Saudi Aramco Base Oil Company (LUBEREF) with an "Overweight" rating and TP of SAR114/sh., implying an upside of ~10%. LUBEREF is one of the leading base oil producers globally with a total base oil production capacity of 1.3mtpa. We are positive on the company, due to i) its global scale assets, ii)) its proximity to key end-markets, iii) premium base oil pricing, iv) competitive cost structure, and v) global marketing network through the Aramco Base Oil Alliance. In addition, the company's Yanbu Growth II expansion project is likely to provide more flexibility in shifting the product mix (from Group II to III and vice-versa) based on the market dynamics, offering stability to sales volume going forward. Moreover, backed by healthy cash flows and a robust liquidity position, the company commits to distribute a minimum SAR6.7 DPS for 2023e (SAR3.3/sh. for H2 2022), offering a yield of 6.4%.

Base oils demand continues to gradually improve: Global real GDP is estimated to grow by 2.9-3.1% over 2023-24e (Figure 1), which is likely to drive the demand for refined (Figure 2) and lubricant products (Figures 5 & 7), thereby ensuring a healthy demand for base oils products (+0.7% CAGR over 2022-30e; Figure 9 & 10). Further, the oil market is likely to remain balanced with OECD inventory as a % of global demand still remaining below 8% (Figure 18), supporting oil prices in the range of US$80-85/bbl. Hence, base oils prices, which track oil prices closely, (Figure 17) would remain steady (mostly above 2021 levels; although a slight decline is expected) going forward.

Pure-play base oil producer with a competitive advantage: LUBEREF, the only virgin base oil producer based in Saudi Arabia with a significant regional market position, is the standalone base oil producer compared to its peers (produces just ~1% of base oil to total production), providing a unique and competitive advantage. The company's strategically located facilities (Jeddah and Yanbu), long-term feedstock agreement with Aramco, and involvement in the Aramco Base Oil Alliance enable it to market high-value base oil products to key markets quicker than its global peers. Accordingly, we expect LUBEREF's base oil sales volume to grow faster at a CAGR of 1.8% over 2021-27e, aided by robust operating rates and plant efficiencies (Figures 23 & 24).

Industry-leading crack margins: Backed by its low-cost structure (ex-feedstock costs; ~60% lower than its peers; Figure 27), long-term feedstock agreements, and proximity to key demand markets, the company enjoys the industry-leading crack margin (~US$120/mt premium over peers; Figure 28). Going forward, we expect the company to continue generating premium crack margins on optimum product mix, thereby expecting mostly stable margins going forward (Figure 29).

Healthy dividend payout: Healthy and stable cash flows amid low capex needs are expected to turn the company into net debt positive by 2024-25 (Figure 31). This along with a robust liquidity position ensures steady growing payouts in the future. The company plans to distribute a minimum DPS of SAR6.7 for 2023, implying a solid dividend yield of 6.7%.

Valuation and risk: We value LUBEREF based on DCF (SAR116.6/sh; cost of equity: 10.8%; WACC: 8.6-9.7% during the forecasted period; 40% weightage) and dividend yield methods (SAR112.2/sh.; 6% yield on 2023E DPS; 60% weightage). Our weighted avg. TP stands at SAR114/sh. implying an Overweight rating. The key upside risks include above-expected economic growth, higher-than-expected utilization rates/crack margins, and above-expected dividends. The key downside risks include below-expected economic growth rates, lower margins, and unplanned shutdowns.

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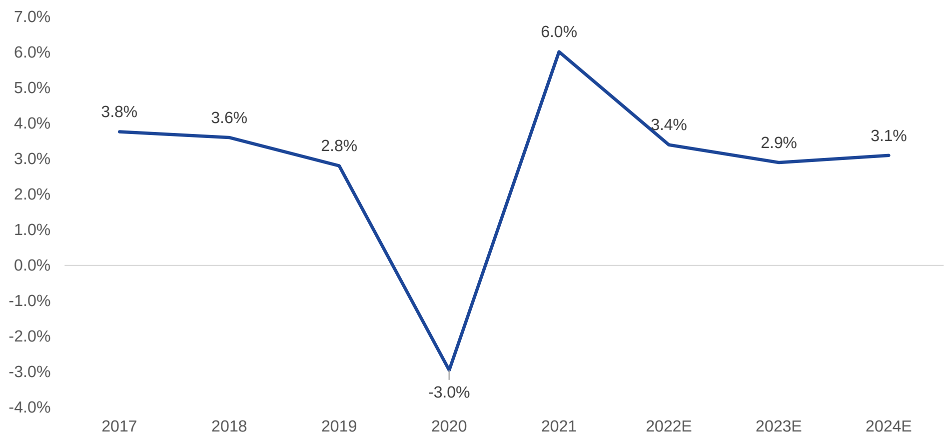
Sector outlook

Healthy global economic growth to ensure a steady growth in oil products demand

Global real GDP is estimated to grow by 2.9% in 2023e and 3.1% in 2024e, driven by growth in non-OECD countries. Accordingly, we believe that healthy economic growth will continue to support the demand for oil and lubricant products, thereby ensuring a stable demand for base oil products.

Figure 1 Global real GDP growth forecasts

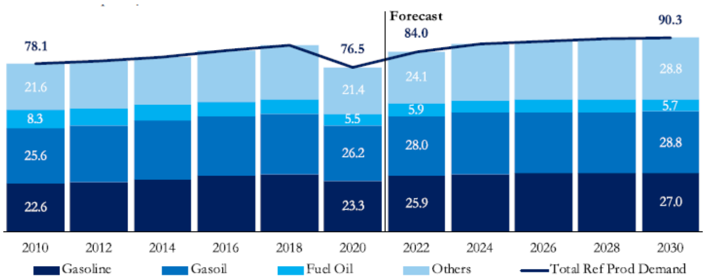


Source: IMF, Al Rajhi Capital

Global refined products demand to grow at a CAGR of 0.9%

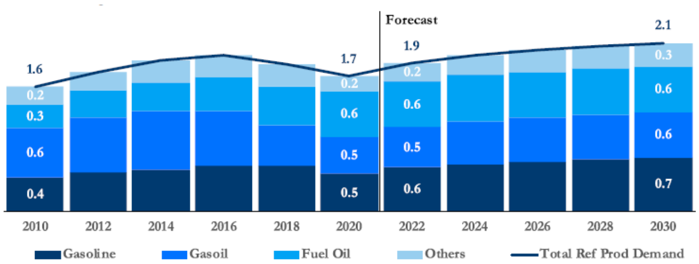
The demand for refined products is estimated to grow at a CAGR of 0.9% to reach 90.3mmb/d over 2022-30e, aided by higher demand from Africa, the Middle East, and Asia Pacific regions. Meanwhile, Saudi Arabia, which is the largest consumer of refined products in the Middle East, is expected to witness a faster demand growth compared to the global as well as the regional markets, increasing at a CAGR of 1.6% over 2022-30e.

Figure 2   Global refined product demand



Source: IPO Prospectus, Al Rajhi Capital. Others include NAPHTHA, Jet / Kerosene

Figure 3   Saudi refined product demand

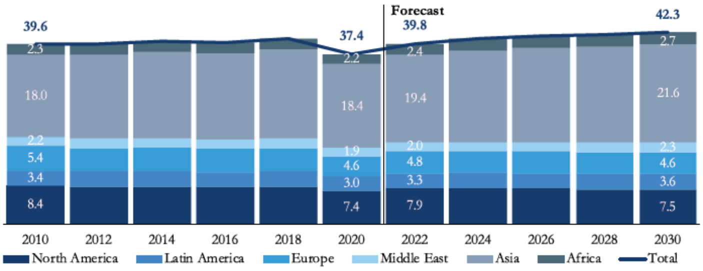


Source: IPO Prospectus, Al Rajhi Capital. Others include NAPHTHA, Jet / Kerosene

Lubricants demand to continue to improve on vehicles and industrial growth

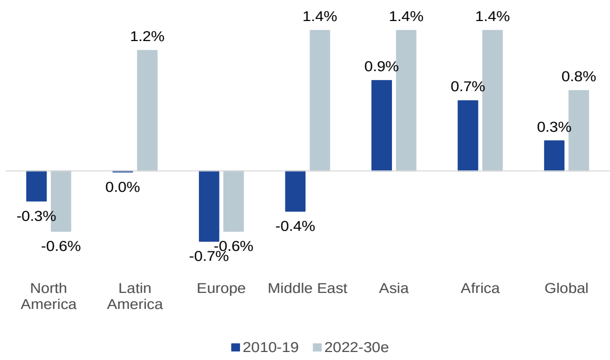
The demand for lubricants globally came under pressure in 2020 (-7.8% Y-o-Y decline), owing to COVID-19, however, it recovered notably to reach 39.1mtpa (+4.5% Y-o-Y) in 2021 and 39.8mtpa (+1.8% Y-o-Y) in 2022, post easing COVID restrictions. Going forward, the global demand for lubricants is likely to continue to grow at a steady rate (+0.8% CAGR) over 2022-30e. The expansion of population, economic growth, and growth in the global vehicle fleet are likely to remain key driving forces, offsetting improvements in lubricant efficiency. Geographically, Asia (+1.4% CAGR)), the Middle East (+1.4% CAGR), Africa (+1.4% CAGR), and Latin America (+1.2% CAGR)) are expected to witness stronger growth, while North America (-0.6% CAGR) and Europe (-0.6% CAGR)) may experience a decline during the same period.

Figure 4 Global lubricants demand by region (mtpa)



Source: IPO Prospectus, Al Rajhi Capital. Others include NAPHTHA, Jet / Kerosene

Figure 5 Global lubricants demand CAGR by region



Source: IPO Prospectus, Al Rajhi Capital. Others include NAPHTHA, Jet / Kerosene

The automotive sector continues to account for a lion's share of demand growth. The Automotive sector continues to account for a lion's share of the total lubricants demand (56% share in 2022e; likely to reach 57% by 2030e), with the demand for transportation lubricants estimated to grow at a CAGR of 0.8% over 2022-30e. The growth would be mainly driven by the high demand for heavy-duty engine oil (HDEO) which is projected to grow at a faster pace of 1.3% annually, driven by the growth in economic activity.

On the other hand, the demand for passenger car motor oil (PCMO) is predicted to grow at a slower rate of 0.2% per year over the same period, as the increase in the number of vehicles would be offset by the effects of longer drain intervals, improving vehicle efficiency, the growing adoption of hybrid and electric light-duty vehicles (LDVs), and shifts in consumer behaviour. Meanwhile, the demand for the non-transportation segment of lubricants also suggests a gradual improvement, driven by rising economic activity.

Figure 6 Global lubricants demand by sector (mtpa)

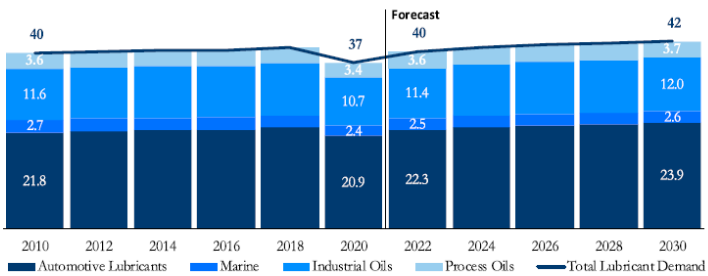
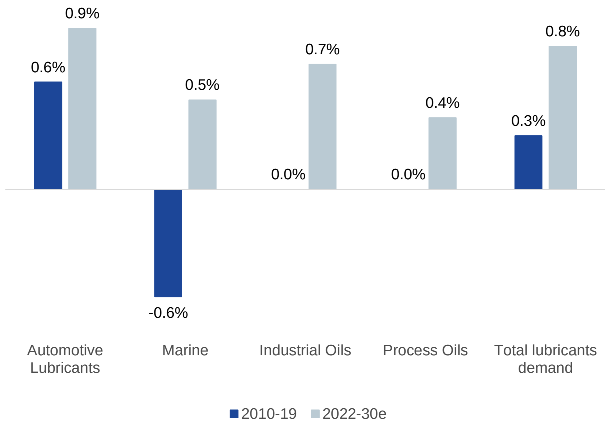


Figure 7 Global lubricants demand CAGR by sector



Source: IPO Prospectus, Al Rajhi Capital. Automotive lubricants and Marine oil are all in the "Transport" sector. Process Oils and Industrial Oils re "Non-Transport" sector.

Source: IPO Prospectus, Al Rajhi Capital. Automotive lubricants and Marine oil are all in the "Transport" sector. Process Oils and Industrial Oils re "Non-Transport" sector.

Base Oil market dynamics. Base oils are mainly classified into five different groups based on their properties, as shown below.

Figure 8 Base Oil Groups classification

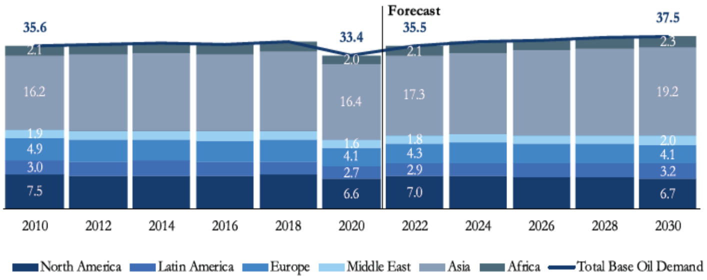
Paraffinic Base Oils				
	Saturates (% wt.)	Sulfur (% wt.)	Viscosity Index	Production Technology
Group I	< 90	> 0.03	80 - 120	Solvent Extraction and Dewaxing. Needs a Paraffinic Crude Oil feedstock
Group II	> 90	< 0.03	80 - 120	Hydrocracking and Hydroisomerisation
Group III	> 90	< 0.03	> 120	Severe Hydrocracking and Hydroisomerisation

Non-Paraffinic Base Oils		
Group IV	Poly Alpha Olefins (PAOs), Traditional Synthetic Lubes	Specific Molecular Manufacture - built up from ethylene
Group V	All other base oils, but primarily Naphthenic Base Oils.	Naphthenic Base Oils produced by Solvent Extraction, Dewaxing and Hydro processing. Needs a Naphthenic Crude Oil feedstock

Source: Company data, Al Rajhi Capital

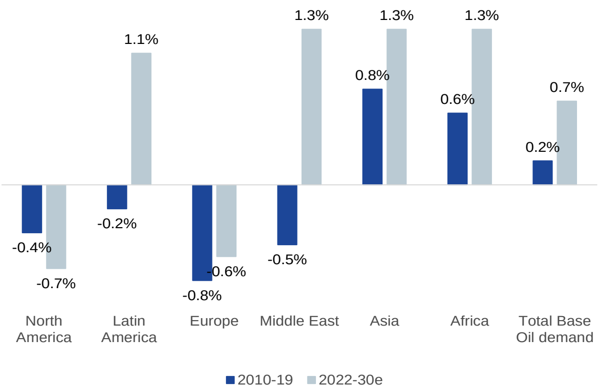
Base oils demand. The demand for base oils generally follows the trend of lubricant demand, as lubricants are comprised of base oils and additives. Similar to lubricants demand, between 2022 and 2030e, it is projected that the global demand for base oils will increase at a CAGR of 0.7%, with significant growth in regions such as Asia, the Middle East (+1.3% CAGR), Africa, and Latin America, compensating for the expected decline in North America and Europe. The growth of global demand for base oils will be propelled by a rise in demand for Group II and Group III base oils, with projected CAGRs of 3.5% and 4.8% respectively over 2022-30e.

Figure 9 Global base oil demand by region (mtpa)



Source: IPO Prospectus, Al Rajhi Capital. Aisa Includes CIS and APAC.

Figure 10 Global base oil demand CAGR % by region



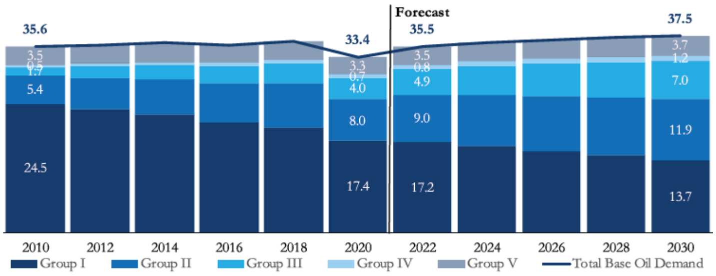
Source: IPO Prospectus, Al Rajhi Capital. Aisa Includes CIS and APAC.

Despite the overall stagnant demand for base oils with only a modest increase forecasted, there have been and will continue to be, significant shifts in demand for the different Groups. The need for higher-performance lubricants, particularly in the automotive industry, will remain the driving force behind the continued growth of technical demand for Group II and Group III base oils, resulting in a decrease in demand for Group I base oils. Accordingly, Group I base oils demand is expected to decline at a CAGR of 2.9% over 2022-30e.

On the other hand, it is estimated that the demand for Group II and III Base Oils worldwide will rise by ~5mtpa between 2022 and 2030e, with a projected CAGR of 3.5% and 4.8% respectively for the same period.

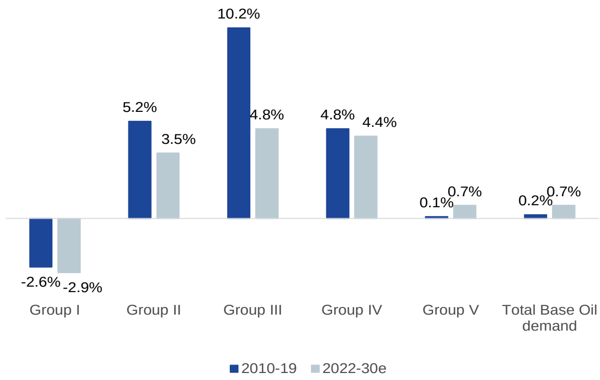
In terms of demand contribution, Group I (~48% of total demand in 2022e) and Group II (25%) base oils account for almost two third of the total demand.

Figure 11 Global base oils demand by groups (mtpa)



Source: IPO Prospectus, Al Rajhi Capital

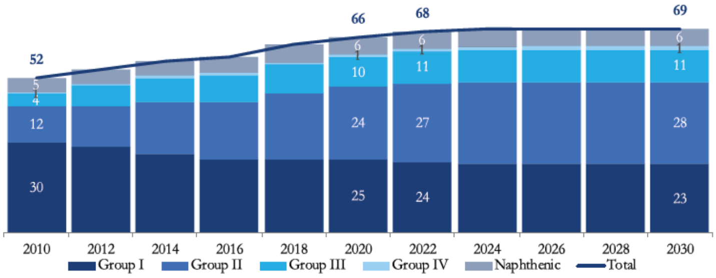
Figure 12 Global base oils demand CAGR (%) by groups



Source: IPO Prospectus, Al Rajhi Capital

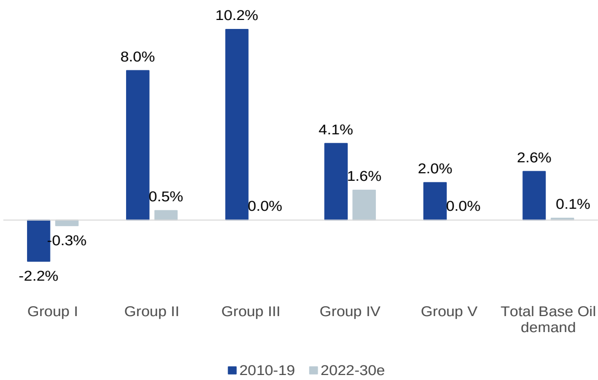
<u>Base oils capacity and utilization:</u> Throughout the past decade, the global production capacity for base oils has steadily increased, causing a significant transformation in the market structure. Despite the demand for base oils, the global production capacity has surpassed it, leading to a gradual decline in utilization rates. At the beginning of 2021, the total production capacity reached ~67mtpa and is expected to have reached 68mtpa. Going forward, the total global production capacity is likely to remain broadly steady till 2030e.

Figure 13 Global base oils production capacity (mtpa)



Source: IPO Prospectus, Al Rajhi Capital

Figure 14 Global base oils production capacity CAGR (%)

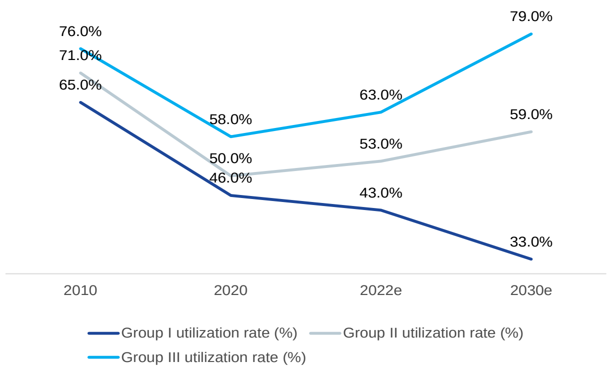


Source: IPO Prospectus, Al Rajhi Capital

It is expected that the global average base oil capacity utilization rates will remain low through 2030e due to surplus capacity in all base oil segments. The Group III segment is likely to have the most stable utilization rates (79% expected by 2030e from 58% in 2020) as the forecasted increase in demand will reduce the spare production capacity. It is worth noting that LUBEREF plans to expand its Yanbu facility, which will provide high-value Group III base oil production capacity by 2025. Further, Group II utilization rates are anticipated to gradually increase to 59% by 2030e, from 50% in 2020, mainly aided by stable organic demand growth. On the other hand, Group I capacity utilization rates are expected to decline continuously in tandem with the declining global demand for Group I base oils.

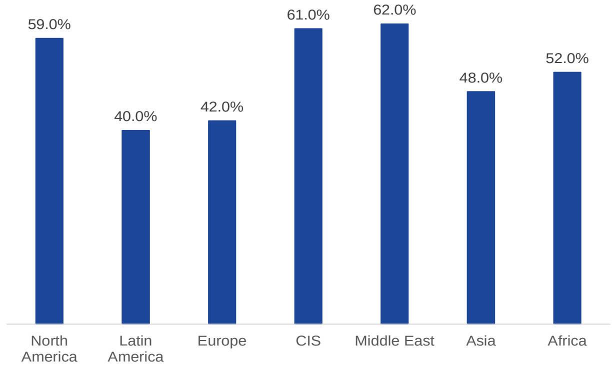
Regionally, the Middle East region is expected to have the highest utilization rate among other regions, mainly on account of the low cost of fuel for electricity generation (which provides a structural advantage to the regional base oil plants), and rising demand for Group II and III base oils globally.

Figure 15 Global paraffinic base oil plant utilization



Source: IPO Prospectus, Al Rajhi Capital

Figure 16 Regional paraffinic base oil plant utilization in 2021



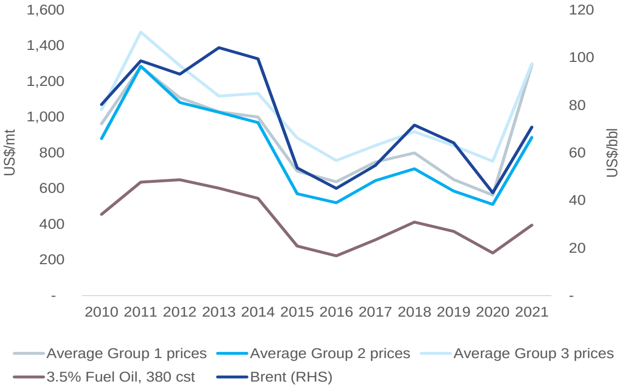
Source: IPO Prospectus, Al Rajhi Capital

Base Oil prices closely follow the oil and feedstock prices

Base oil prices are generally aligned with crude oil and feedstock prices, with a lag time (ranging from 1-3 months). In addition, base oil prices are also affected by market dynamics (supply and demand). Group I prices tend to follow crude oil more closely, while the bright stock grade, which has a higher viscosity, has historically been more stable and often trades at a higher price compared to the lower viscosity grades.

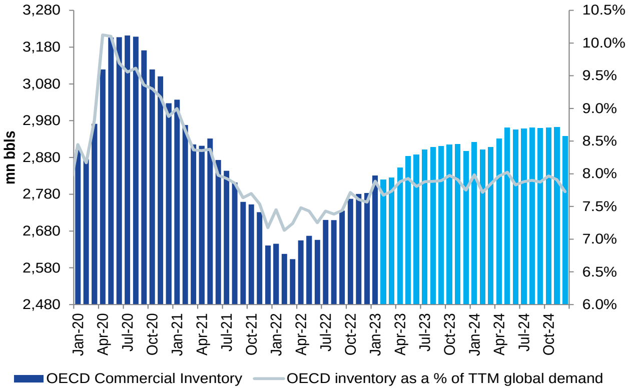
Post-pandemic, base oil prices benefited notably, due to i) recovery in crude oil prices, ii) tight base oil supply market, iii) shortage of feedstock amid lower refinery throughputs. Overall, base oil prices remained strong in 2022. Going forward, we expect oil prices to remain healthy, in the range of US$80-85/bbl, due to likely balanced oil markets with OECD inventory as a % of global demand still remaining below 8%. This will continue to support base oil prices (mostly above 2021 levels).

Figure 17 Base oil prices vs. Brent crude vs. feedstock prices



Source: Company data, Al Rajhi Capital

Figure 18 Monthly OECD inventory with a % of global demand



Source: IPO Prospectus, Al Rajhi Capital

Benchmark base oil and fuel prices, tracked by LUBEREF, are listed below.

Figure 19 Benchmark base oil prices by API Group and grades and fuel oil prices (US$/t)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Avg. (2010-21)
Group I													
150 N (EU)	897	1,213	1,084	959	914	565	485	701	734	593	521	997	**805**
500 N (EU)	927	1,231	1,103	1,009	979	662	577	746	765	624	550	1,270	**870**
Bright Stock (EU)	1,065	1,406	1,138	1,122	1,110	866	853	798	901	733	620	1,611	**1,019**
Group II													
60-80 N (Asia)	839	1,258	1,073	984	963	504	433	547	645	557	447	719	**747**
150 N (Asia)	852	1,251	1,047	1,001	964	546	483	608	715	593	509	799	**781**
500 N (Asia)	948	1,349	1,127	1,097	983	662	645	779	771	609	578	1,143	**891**
Group III													
2 cSt (Asia)	1,030	1,455	1,260	976	1,048	793	703	800	872	788	710	1,231	**972**
3 cSt (Asia)	1,048	1,462	1,271	1,099	1,120	884	788	862	941	860	774	1,348	**1,038**
4 cSt (Asia)	1,085	1,490	1,307	1,177	1,182	944	798	846	941	860	774	1,348	**1,063**
6 cSt (Asia)	1,035	1,492	1,318	1,177	1,184	940	793	841	936	855	769	1,343	**1,057**
8 cSt (Asia)	1,017	1,484	1,292	1,160	1,132	858	703	857	905	836	740	1,223	**1,017**
Fuel Oil													
3.5% Fuel Oil, 180 cst	463	639	661	609	552	286	228	318	419	366	246	403	**433**
3.5% Fuel Oil, 380 cst	455	636	649	602	545	278	223	313	412	360	239	395	**426**

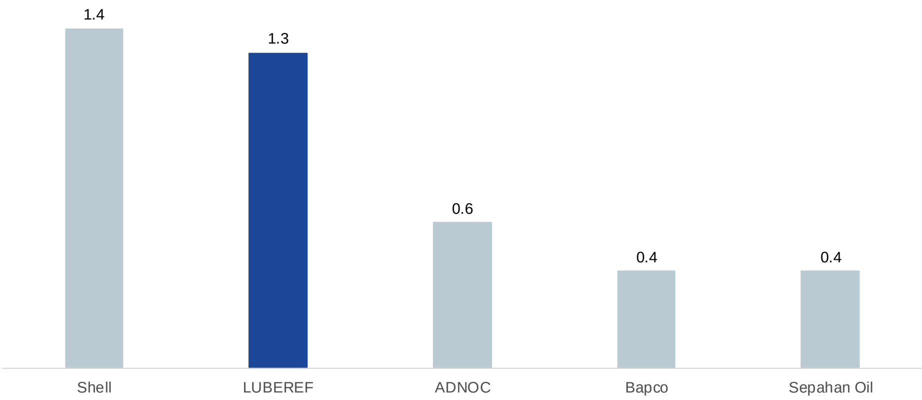
Source: Company data, Al Rajhi Capital

Key investment rationale and catalysts

One of the leading and standalone base oil producers with a robust market position

LUBEREF is the second largest high-quality base oil producer in the Middle East region and a market leader in the Kingdom with a total production capacity of 1.3mtpa of base oil across the two facilities. As a pure-play base oil producer, the company operates two facilities (Yanbu: 1.07mtpa; Jeddah: 0.28mtpa) that are specifically designed for base oil production. According to market data from a consultant, sother base oil producers are usually part of larger refineries, where base oil production accounts for roughly 1% of the total refined product output. Hence, the company's optimized operations, coupled with its unique position in the region, provide a competitive advantage to the company on a global scale.

Figure 20 Top 5 base oil Middle East producers by capacity in 2021 (mtpa)



Source: Company data, Al Rajhi Capital

Well-placed to benefit from the healthy demand growth in key markets

LUBEREF's both facilities (Jeddah and Yanbu) are strategically located on the west coast of Saudi Arabia, providing proximity to its significant target markets such as KSA (~30% sales contribution as of 2021), MENA (~38%), and India (~20%). Given that the demand for base oils products (mainly Group II and III) in its key markets is likely to improve gradually, we believe that LUBEREF is well-placed to cater to this demand. Additionally, the company's involvement in the Aramco Base Oil Alliance enables it to supply base oils to crucial markets in Asia and the Americas via other alliance partners (S-Oil and Motiva), leveraging demand from alternate markets.

Figure 21 Strategically located facilities

Source: Company data, Al Rajhi Capital.

Figure 22 Located in proximity to key-end markets

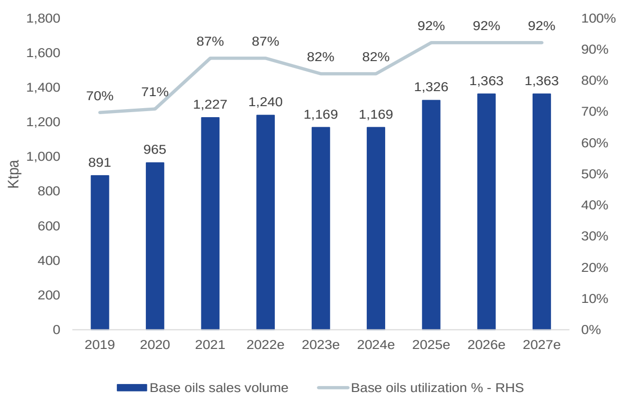
Source: Company data, Al Rajhi Capital

Yanbu Expansion II project to provide more flexibility and drive base oils revenues

The company's Yanbu Growth II expansion project (175ktpa of Group 3 base oils capacity) is expected to complete by 2025-26, taking the Yanbu base oil capacity to 1.3mtpa (~0.3mtpa of Group I, ~0.8mtpa of Group II and ~0.2mtpa of Group 3). On the other hand, we note that the Jeddah facility (Group I base oil) is likely to shut down by mid-2026 due to the expiry of the license. Nonetheless, the Yanbu expansion project will provide the company more flexibility that allows it to produce additional Group II and Group III base oil depending on the market dynamics, and also offset a possible decline in sale volume resulting from a likely reduction in production capacity by 2027e. Upon completion of the Yanbu expansion project, the company would be mostly marketing Group II and III base oils, which will put the company in a better position, given the likely healthy demand for these groups. This will also ensure steady production and sales volume in the coming years.

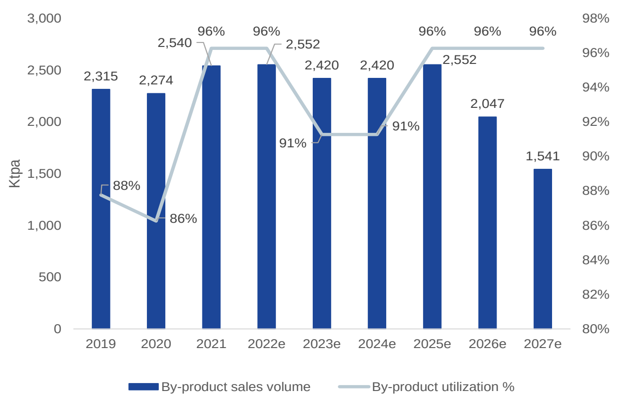
Overall, we expect the company's base oil plant utilization to increase to ~92% by 2027e from ~87% in 2021, likely due to improvement in plant efficiencies. Accordingly, despite a 1-month planned shutdown in 2023-24, we expect base oil sales volume to grow at a CAGR of 1.8% over 2021-27e, outperforming the global demand growth rate.

Figure 23 Base oils utilization rate and sales volume



Source: Company data, Al Rajhi Capital. * 1-month planned shutdown at the Jeddah facility. ** * 1-month planned shutdown at the Yanbu facility.

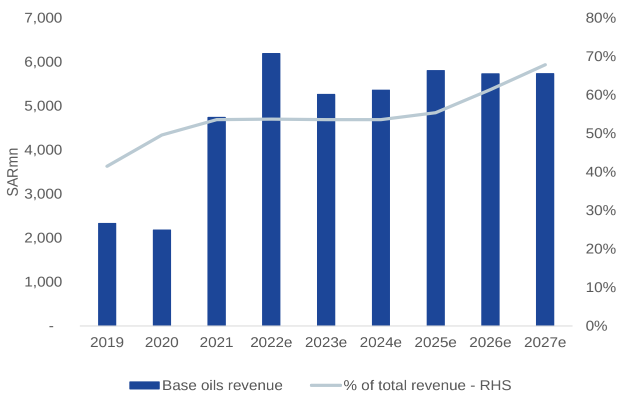
Figure 24 By-product utilization rate and sales volume



Source: Company data, Al Rajhi Capital. * 1-month planned shutdown at the Jeddah facility. ** * 1-month planned shutdown at the Yanbu facility.

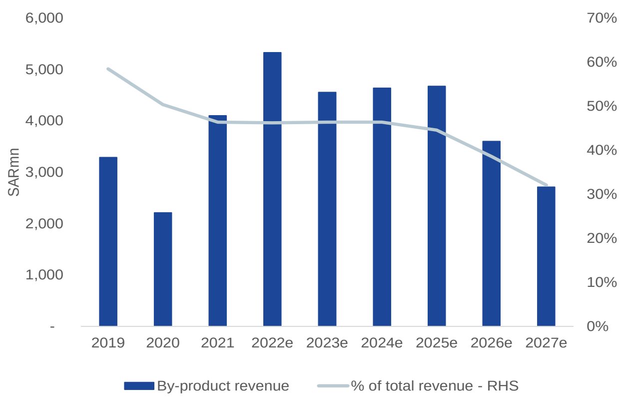
In addition, the company also produces by-products. As of 2021, it has 2,551ktpa of by-product capacity (Jeddah: 1,050ktpa; Yanbu: 1,600ktpa), which is expected to remain the same in the coming years. However, post-closure of the Jeddah facility, the by-product capacity is expected to decline to 1,600mtpa. Accordingly, we expect by-product sales volume to decline at a CAGR of ~8% over 2021-27e, mainly due to the closure of the Jeddah facility. However, we don't expect much impact on earnings as it is a low-margin business.

Figure 25 Base oil revenues and contribution



Source: Company data, Al Rajhi Capital

Figure 26 By-product revenues and contribution

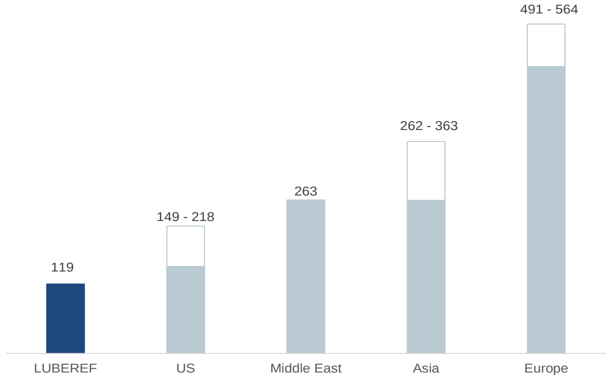


Source: Company data, Al Rajhi Capital

Low base oil production cost to generate higher crack margins

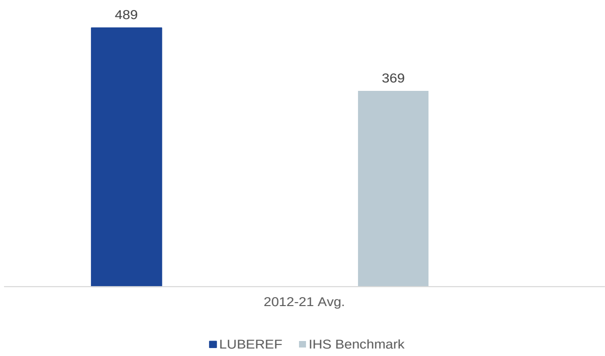
LUBEREF has long-term agreements with Saudi Aramco for the supply of Reduced Crude Oil (RCO; a key feedstock for base oils) to both of its facilities. RCO is generally priced similar to high sulfur fuel oil, with lower average market prices than Brent, and also generates the maximum base oil value due to its composition. The company's secure optimal composition of feedstock ensures high base oil plant utilization rates, leading to cost efficiency as well as a competitive edge over other global base oil producers that depend on their own refinery operations for feedstock. Further, the company enjoyed the lowest production cost (ex-feedstock) at US$119/mt as of 2021, almost 60% lower than the average cost of its base oil competitors globally (~US$310/mt). This could be due to its lower shipping and transportation costs to key base oil markets given its strategic location. Hence, the company usually generates premium crack margins, almost US$120/mt higher than its global peers.

Figure 27 Base oil production cost (ex-feedstock)* - US$/mt



Source: Company data, Al Rajhi Capital.

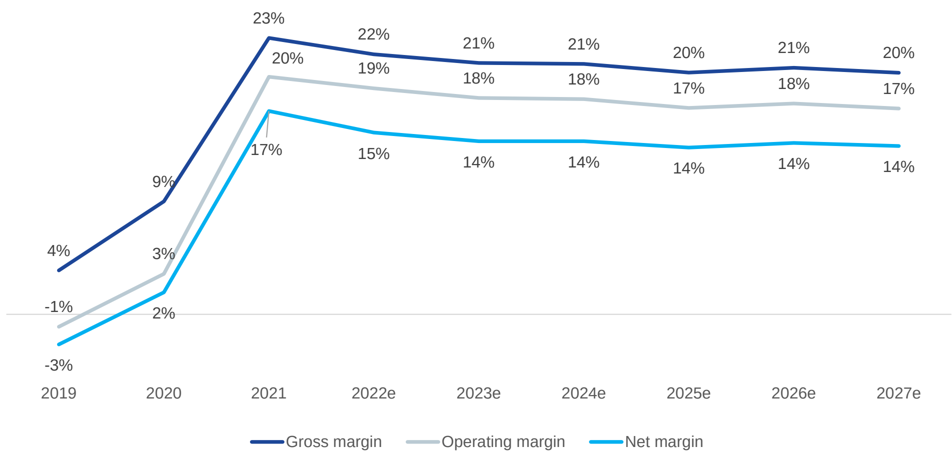
Figure 28 Premium base oil crack margins (US$/mt)



Source: Company data, Al Rajhi Capital. Crack margins are calculated based on average realized prices minus freight costs and feedstock costs.

Going forward, the company is likely to continue to generate premium crack margins on optimum product mix and hence, we expect the margins will broadly remain stable, mostly in line with the current levels.

Figure 29 Margins likely to remain stable

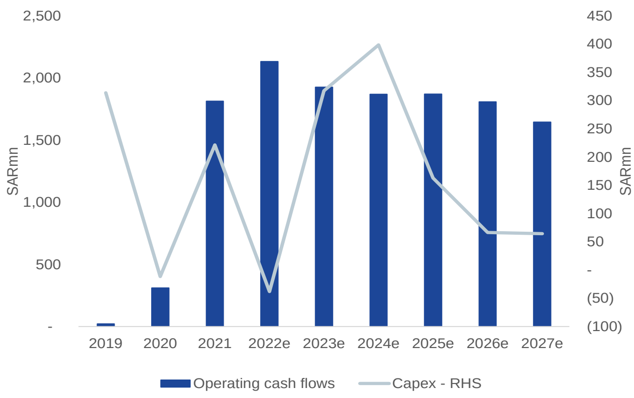


Source: Company data, Al Rajhi Capital

Healthy cash flows to maintain robust liquidity position amid low capex needs …

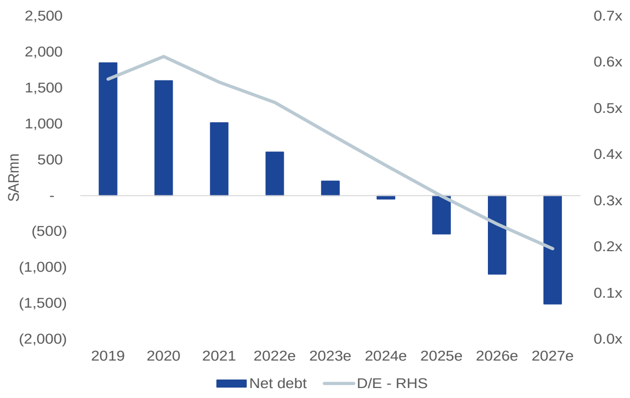
LUBEREF has shown prudent fiscal management with a robust liquidity position and maintained a strong balance sheet with a gearing ratio of 15% (25-35% targeted) as of 2021. Going forward, the company plans to spend around US$150-200mn over 2022-24 with the largest portion in 2023-24 for the construction of the Yanbu Growth II expansion project. Upon completion of the expansion project, the company is expected to spend only the maintenance capex of roughly US$10-15mn annually. We believe that the company would be comfortably able to fund its growth capex through internal accruals, given its strong cash flows generations amid premium crack margins. Further, the company is expected to improve its leverage position by repaying its debt and may turn net-debt positive by 2024-25.

Figure 30 Capex to decline amid healthy cash flows



Source: Company data, Al Rajhi Capital.

Figure 31 Improving leverage position

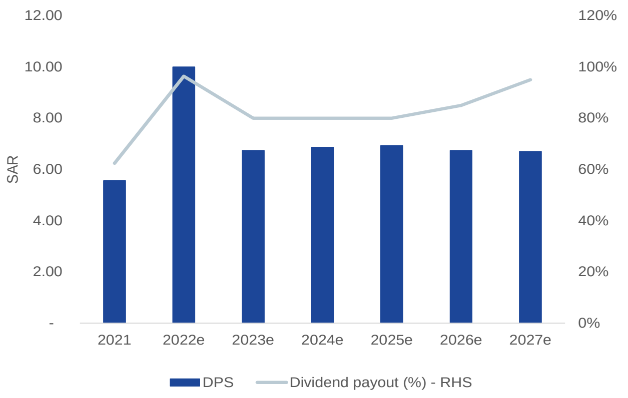


Source: Company data, Al Rajhi Capital.

… and help in improving dividend payouts going forward

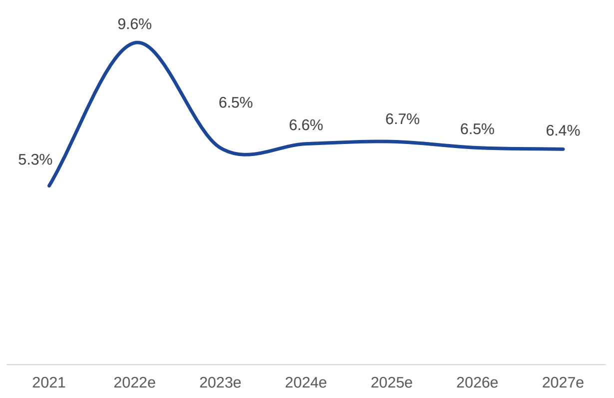
The company distributed SAR5.6/sh (~62% payout) for 2021 and SAR6.7/sh. (152% payout) for H1 2022. Going forward, backed by its robust liquidity position amid healthy cash flows, LUBEREF plans to distribute minimum dividends of SAR563mn (US$150mn) for H2 2022 and SAR1,125mn (US$300mn) for 2023, implying SAR3.3 DPS and SAR6.7 DPS, respectively. At the current price, 2023e DPS implies a yield of 6.7%, which looks appealing to fixed-income seeking investors, in our view.

Figure 32 Steadily growing dividend payout



Source: Company data, Al Rajhi Capital.

Figure 33 Attractive dividend yield (%)



Source: Company data, Al Rajhi Capital.

Figure 34 Financial summary and KPIs

	2021A	2022E	2023E	2024E
Income statement (SARmn)				
Gross revenue	8,847	11,530	9,822	10,002
Gross profit	2,042	2,504	2,062	2,092
EBITDA	2,096	2,521	2,132	2,170
Operating profit	1,756	2,177	1,776	1,799
Net income	1,503	1,750	1,421	1,447
Revenues breakdown (%)				
Base oil revenues	4,743	6,198	5,266	5,362
% of total	54%	54%	54%	54%
By-product revenues	4,104	5,332	4,556	4,640
% of total	46%	46%	46%	46%
Balance sheet (SARmn)				
Cash	1,349	1,604	1,837	1,884
Other current assets	1,759	2,119	1,812	1,846
Fixed tangible assets	5,224	4,991	4,952	4,980
Intangible assets	17	19	20	21
Other non-current assets	14	9	9	9
Total assets	**8,364**	**8,743**	**8,631**	**8,740**
Trade payables	1,087	1,441	1,239	1,263
Total debt	2,363	2,209	2,039	1,836
Other liabilities	670	785	761	760
Shareholders' equity	4,245	4,307	4,591	4,881
Liabilities & Equity	**8,364**	**8,743**	**8,631**	**8,740**
Cash flow (SARmn)				
Operating activities	1,815	2,134	1,927	1,870
Investing activities	(222)	38	(318)	(399)
Financing activities	(916)	(1,917)	(1,377)	(1,424)
Change in cash	**677**	**255**	**233**	**47**

	2021A	2022E	2023E	2024E
Per share data (SAR)				
EPS	8.90	10.37	8.42	8.58
BVPS	25.15	25.52	27.21	28.92
DPS	5.56	10.00	6.73	6.86
FCF	9.24	11.93	9.51	8.68
Operational data				
Base oil capacity (mtpa)	1.3	1.3	1.3	1.3
By-product capacity (mtpa)	2.7	2.7	2.7	2.7
Base oil utilization %	87%	87%	82%	82%
By-product utilization %	96%	96%	91%	91%
Base case sales volume (mtpa)	1.2	1.2	1.1	1.1
Alliance trade/direct import sales volume (mtpa)	0.1	0.1	0.1	0.1
By-product sales volume (mtpa)	2.5	2.6	2.4	2.4
Total sales volume (mtpa)	3.8	3.8	3.6	3.6
KPIs				
Gross margin (%)	23.1%	21.7%	21.0%	20.9%
EBITDA margin (%)	23.7%	21.9%	21.7%	21.7%
Operating margin (%)	19.8%	18.9%	18.1%	18.0%
Net margin (%)	17.0%	15.2%	14.5%	14.5%
ROA (%)	18.0%	20.0%	16.5%	16.6%
ROE (%)	35.4%	40.6%	30.9%	29.7%
D/E (x)	0.6x	0.5x	0.4x	0.4x
Net debt/EBITDA (x)	0.5x	0.2x	0.1x	0.0x
Valuation metrics*				
P/E (x)	11.7x	10.0x	12.4x	12.1x
P/BV (x)	4.1x	4.1x	3.8x	3.6x
EV/EBITDA (x)	9.8x	8.2x	9.7x	9.5x
EV/sales (x)	2.3x	1.8x	2.1x	2.1x

Source: Company data, Al Rajhi Capital. * As of 15 Feb 2023.

Valuation

We expect LUBEREF to benefit from the healthy demand outlook for base oils products (mainly Group II and III), on the back of its global scale, low-cost high-margin products, unique value chain positions, and Yanbu Growth II expansion project. Further, its competitive location & cost advantage, and secure and stable & high-quality feedstock availability are expected to drive the efficiencies and support margins. Accordingly, we expect LUBEREF to generate SAR1.5-1.6bn FCF annually (on an average) over 2023-27e amid low sustaining capex needs. This, along with a prudent balance sheet (likely to turn net debt positive by 2024-25) ensures strong distribution going forward (as high as 85-95% upon the completion of the Yanbu Growth II expansion project), offering attractive dividend yields.

The key upside risks include higher-than-expected economic growth, higher-than-expected utilization rates, stronger-than-expected crack margins, and above-expected dividend. **The key downside risks** include weaker-than-expected global economic growth rates, lower margins than expected, unplanned shutdowns, and higher-than-expected shipping costs.

DCF-based valuation (40% weightage). Based on 2% terminal growth and a WACC range of 8.6% to 9.6% during the forecasted period, we arrive at a TP of SAR116.6/sh.

Dividend yield method (60% weightage). The key peers of the company offer dividend yield of about 4.5%, compared to LUBEREF's 2023e dividend yield of 6.4%. Moreover, the high dividend yield companies in the KSA (such as Aramco, STC) offer dividend yield of ~4.0%. The company has committed to pay minimum dividends of SAR 6.7/share for 2023, that translates to an yield of 6.4%.

Given its ability to generate consistent cash flows, we see this dividends to be sustainable. In terms of risks, the stock is not purely defensive in nature, thus applying a spread of 200 bps over 4.0% dividend yield offered by high quality companies in the KSA, we believe at dividends of SAR 6.7/share (committed dividends), the fair value derived through relative dividend yield method is SAR 112.2/share.

Figure 35 2023E dividend yield

	2023E Dividend Yield
Global O&G and Lubricants peers	
TotalEnergies Marketing	4.8%
Galp Energia	4.6%
Shell	3.9%
Average	**4.5%**
-	
Local companies	
SABIC	3.6%
STC	4.4%
Aramco	3.9%
Average	**3.9%**
KSA	**4.0%**
SAIBOR	**5.5%**

Source: Bloomberg, Al Rajhi Capital

Blended valuation. Our blended valuation, based on a DCF valuation and Dividend Yield method, gives a weighted average TP of SAR114.0 per, implying a ~10% upside potential. Hence, we initiate our coverage on LUBEREF with an Overweight rating.

Figure 36 Valuation Summary

Valuation Methodology	Fair value (SAR)	Weightage	Weighted value per share (SAR)
DCF	116.6	40%	46.6
Dividend yield	112.2	60%	67.3
Weighted value per share (SAR)			**114.0**
Current price (As of 15 Feb 2023)			104.0
Upside (%)			**10%**

Source: Al Rajhi Capital

Company Overview

Incorporated in 1976, Saudi Aramco Base Oil Company (LUBEREF; 70% owned by Saudi Aramco) is the exclusive producer of virgin base oils in Saudi Arabia and is also one of the largest base oil producers globally. The company sells its products both domestically as well as in various countries across the MENA region, the Americas, and Europe. In addition to Group I and Group II Base Oils products, LUBEREF also produces a range of byproducts such as asphalt, marine heavy fuel oil (MHFO), slack wax, bright stock extract, and sulfur, as well as white products like ultra-low sulfur diesel (ULSD), naphtha, and drilling fluid. The company markets its main products under trademarks licensed by Saudi Aramco, including "aramcoDURA" for Group I Base Oils, "aramcoPRIMA" for Group II Base Oils, and "aramcoULTRA" for Group III Base Oils.

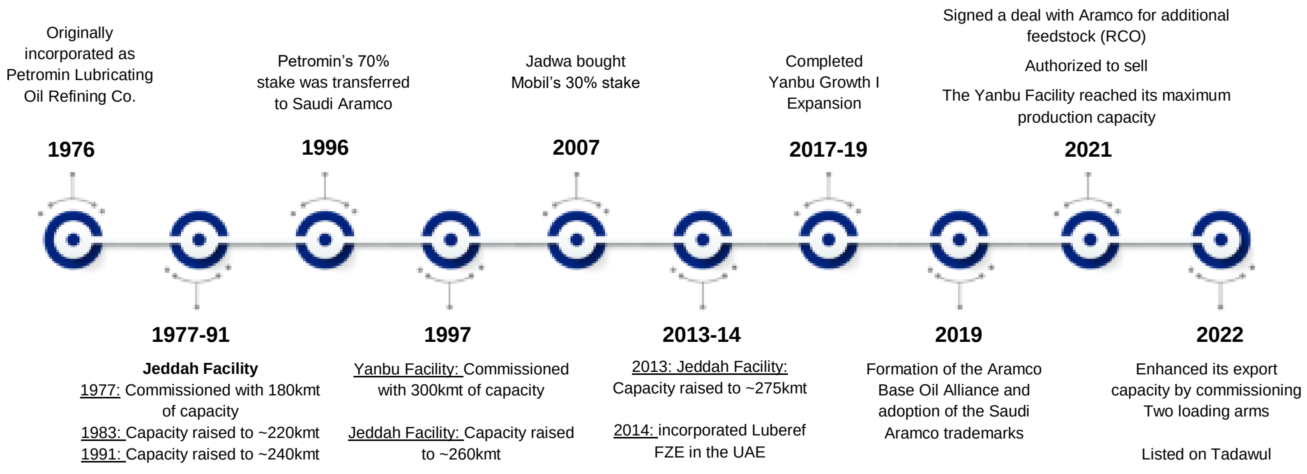
Figure 37 LUBEREF's products details

Group	Trademark	Key Properties	Products
Group I	aramcoDURA™	Good viscosity index	aramcoDURA 150
			aramcoDURA 500
			aramcoDURA BS 150
Group II	aramcoPRIMA™	Good viscosity index, low sulfur	aramcoPRIMA 70
			aramcoPRIMA 110
			aramcoPRIMA 230
			aramcoPRIMA 500
Group III	aramcoULTRA™	High viscosity index, low sulfur	aramcoULTRA 2*
			aramcoULTRA 4*
			aramcoULTRA 6*
			aramcoULTRA 8*

Source: Company data, Al Rajhi Capital. * Not currently produced by the Company

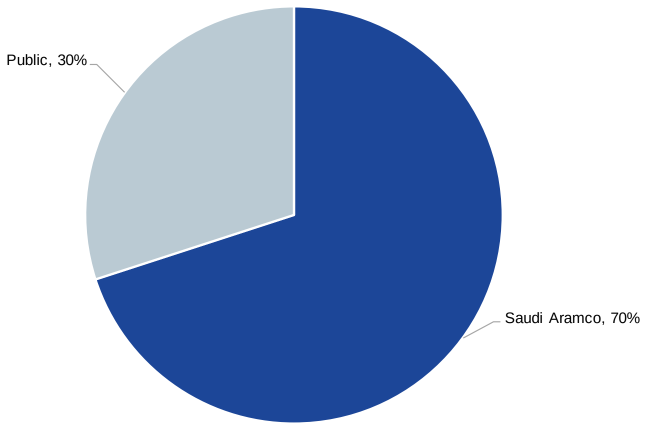
LUBEREF currently operates two facilities, located in Jeddah and Yanbu. The Jeddah facility, which was established in 1977, has a yearly production capacity of around 275kmt of Group I Base Oils. The Yanbu facility, which was commissioned in 1997, has a production capacity of approximately 270kmt of Group I Base Oils and ~800kmt of Group II Base Oils. Accordingly, the company has a combined production capacity of 1.3mmmt of Base Oils. Further, through the Aramco Base Oil Alliance (including S-Oil and Motiva), LUBEREF procures Group III Base Oils from other members of the Alliance and resells them in the markets. The company also plans to expand its production in Yanbu to include Group III Base Oils by 2025-26.

Figure 38 LUBEREF's products details



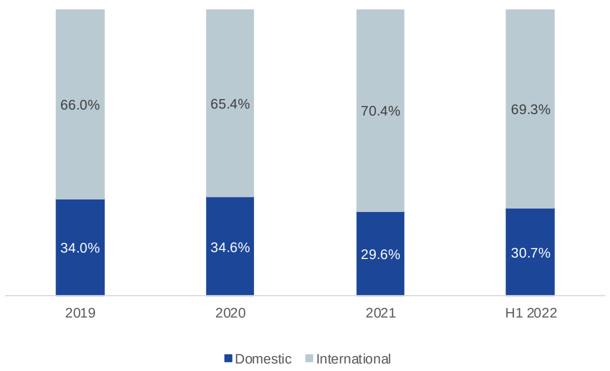
Source: Company data, Al Rajhi Capital

Figure 39 Shareholding Structure (%)



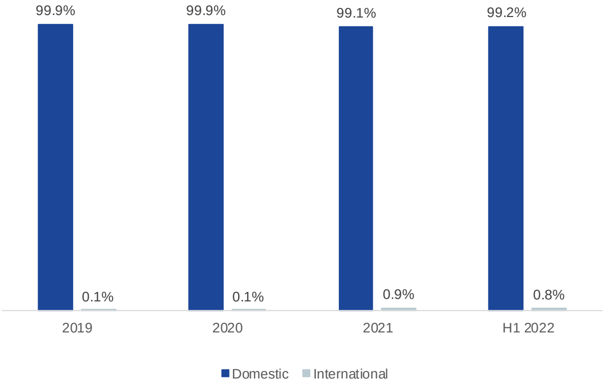
Source: Company data, Al Rajhi Capital

Figure 40 Base oils sales volume mix (%)



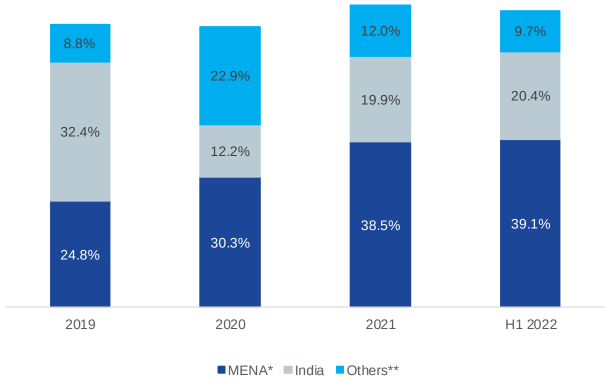
Source: Company data, Al Rajhi Capital

Figure 41 By-products sales volume mix (%)



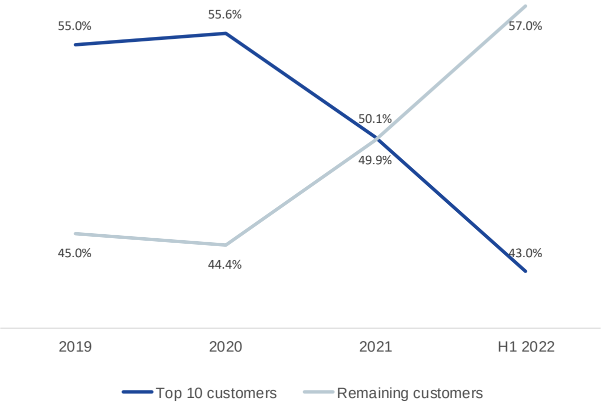
Source: Company data, Al Rajhi Capital

Figure 42 Base oils international sales volume mix (%)



Source: Company data, Al Rajhi Capital

Figure 43 Customer concentration



Source: Company data, Al Rajhi Capital

Detailed Financials

Figure 44 Income Statement

(SAR mn)	2021	2022E	2023E	2024E	2025E	2026E	2027E
Revenue	**8,847**	**11,530**	**9,822**	**10,002**	**10,485**	**9,341**	**8,453**
Cost of revenues	(6,805)	(9,026)	(7,760)	(7,910)	(8,368)	(7,417)	(6,747)
Gross profit	**2,042**	**2,504**	**2,062**	**2,092**	**2,117**	**1,923**	**1,706**
Selling and distribution expenses	(117)	(115)	(100)	(104)	(111)	(101)	(93)
General and administrative expenses	(177)	(208)	(177)	(180)	(189)	(168)	(152)
Other (expenses) / income - net	(6)	(11)	(9)	(9)	(10)	(9)	(8)
Fair value (loss) gain on derivative instruments	13	6	0	0	0	0	0
Operating profit	**1,756**	**2,177**	**1,776**	**1,799**	**1,808**	**1,646**	**1,453**
Finance income	6	20	16	18	19	21	24
Finance costs	(70)	(76)	(70)	(63)	(55)	(45)	(36)
Profit before zakat and income tax	**1,691**	**2,122**	**1,722**	**1,754**	**1,772**	**1,622**	**1,441**
Zakat and income tax	(189)	(371)	(301)	(307)	(310)	(284)	(252)
Profit for the period	**1,503**	**1,750**	**1,421**	**1,447**	**1,462**	**1,338**	**1,189**
EPS	8.90	10.37	8.42	8.58	8.66	7.93	7.05
Weighted average number of shares	169	169	169	169	169	169	169
DPS	5.56	10.00	6.73	6.86	6.93	6.74	6.69
Payout (%)	62%	96%	80%	80%	80%	85%	95%

Source: Company data, Al Rajhi Capital

Figure 45 Balance Sheet

(SAR mn)	2021	2022E	2023E	2024E	2025E	2026E	2027E
Assets							
Cash and cash equivalents	1,349	1,604	1,837	1,884	2,137	2,434	2,574
Inventories	710	942	810	825	873	774	704
Trade receivables	863	1,124	958	975	1,022	911	824
Prepayments and other assets	40	53	45	46	48	43	39
Short-term deposit	146	0	0	0	0	0	0
Total current Assets	**3,108**	**3,723**	**3,649**	**3,730**	**4,081**	**4,161**	**4,141**
Property, plant and equipment	5,122	4,897	4,864	4,897	4,688	4,381	4,069
Right-of-use assets	102	95	89	83	77	72	67
Intangible assets	17	19	20	21	21	22	22
Employees' home ownership receivables	0	1	1	1	1	1	1
Loans to employees	14	8	8	8	8	8	8
Total non-current assets	**5,256**	**5,020**	**4,982**	**5,010**	**4,796**	**4,484**	**4,167**
Total assets	**8,364**	**8,743**	**8,631**	**8,740**	**8,877**	**8,645**	**8,308**
Liabilities							
Trade payables	1,087	1,441	1,239	1,263	1,336	1,184	1,077
Accrued expenses and other liabilities	105	137	117	119	125	111	100
Current portion of long-term borrowings	146	163	197	225	259	270	315
Lease liabilities	5	5	5	4	4	4	3
Zakat and income tax payable	151	93	93	93	93	93	93
Total current liabilities	**1,494**	**1,839**	**1,651**	**1,704**	**1,817**	**1,662**	**1,589**
Long-term borrowings	2,104	1,941	1,744	1,519	1,260	990	675
Lease liabilities	108	100	94	87	82	76	71
Employee benefit obligations	322	318	315	312	309	306	303
Deferred tax liabilities	55	192	192	192	192	192	192
Other non-current liabilities	38	45	45	45	45	45	45
Total non-current liabilities	**2,626**	**2,596**	**2,389**	**2,155**	**1,887**	**1,608**	**1,285**
Shareholders' equity							
Share capital	441	1,688	1,688	1,688	1,688	1,688	1,688
Statutory reserve	221	322	506	506	506	506	506
Retained earnings	3,583	2,298	2,398	2,687	2,980	3,180	3,240
Total equity	**4,245**	**4,307**	**4,591**	**4,881**	**5,173**	**5,374**	**5,433**
Total liabilities	**8,364**	**8,743**	**8,631**	**8,740**	**8,877**	**8,645**	**8,308**

Source: Company data, Al Rajhi Capital

Figure 46 Cash Flow Statement

(SAR mn)	2021	2022E	2023E	2024E	2025E	2026E	2027E
Operating activities	1,815	2,134	1,927	1,870	1,872	1,810	1,646
Investing activities	(222)	38	(318)	(399)	(163)	(67)	(64)
Financing activities	(916)	(1,917)	(1,377)	(1,424)	(1,455)	(1,447)	(1,441)
Change in cash	**677**	**255**	**233**	**47**	**253**	**296**	**141**

Source: Company data, Al Rajhi Capital

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"Overweight": Our target price is more than 10% above the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"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.

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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