

National Industrialization Company

Diversified Operations – Industrial

NIC AB: Saudi Arabia

الراجحي المالية
Al Rajhi Capital



US\$3.612bn

Market cap

87%

Free float

US\$16.88mn

Avg. daily volume

Target price

23.00

+12.7% over current

Current price

20.40

as at 22/5/2018

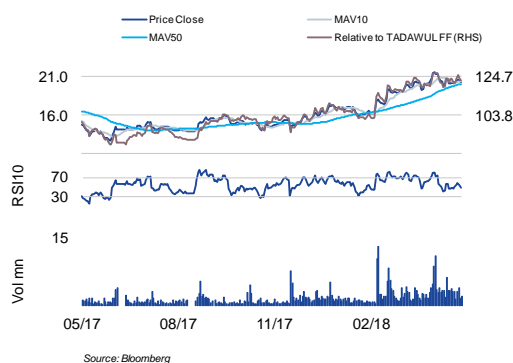
Existing rating

Underweight

Neutral

Overweight

Performance



Earnings

(SARmn)	2017	2018e	2019e
Revenue	10,796	11,451	11,423
Y-o-Y	25.3%	6.1%	-0.2%
Gross profit	2,104	3,260	3,190
Gross margin	19.5%	28.5%	27.9%
Net profit	716	1,257	1,193
Y-o-Y	NM	75.5%	-5.1%
Net margin	6.6%	11.0%	10.4%
EPS (SAR)	1.07	1.88	1.78
DPS (SAR)	-	-	-
Payout ratio	0.0%	0.0%	0.0%
P/E (Curr)	18.9x	10.8x	11.4x
P/E (Target)	21.5x	12.2x	12.9x

Source: Company data, Al Rajhi Capital

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NIC / Tasnee (NIC AB Equity)

Raise to OW: Surge in TiO2 prices not factored in

With continuous improvement in TiO₂ prices, NIC's EBITDA has almost doubled in the last six quarters, helped by operating leverage. However this improvement is not reflected in stock price. At recurring EBITDA of ~SAR500mn for the Chemical segment (which is largely dominated by Cristal), an 8x EV/EBITDA implies the value of Cristal (to be sold as part of deal with Tronox) at SAR11.5/share, while current market cap for Tronox implies value (to be received) of SAR2.4/share. If we are to incorporate Tronox's revised pro-forma EBITDA, then its value is ~SAR8/share for NIC. This implies that US investors are not expecting the deal to go through. With regulatory issues, possible FX and tax implications, we believe the deal not going through may be better for Tasnee. Even if it were to go through, the new addendum agreement - the option to buy 90% of Slagger is a positive for Tasnee as we were of the view that there is no visibility of profits for the Slagger. Tasnee can offload the debt associated with the Slagger to Tronox and can retain 10% stake. Tasnee can streamline its operations further, by disposing off other smaller loss making businesses and utilize the cash to pay off part of SAR15.6bn gross debt. Further upside could be when the company might also make the Titanium sponge plant cash flow positive. At this level of TiO₂ prices, without the deal (our base case) our TP would be SAR23/share, implying an Overweight rating.

Surging TiO₂ prices: Tasnee almost doubled its quarterly gross profits on a y-o-y basis to SAR818mn in Q1 2018 from SAR427mn in Q1 2017. This was mainly as a result of continuously improving TiO₂ prices (+25% y-o-y), reflecting in improving quarterly profits. Given bulk of costs being fixed in nature, the improved price directly translated to profits. In addition, the company was also able to reduce its production cost/tonne for the Chemical segment by 10% in the last two quarters, boosting bottom-line further. This improvement is not reflected in stock price in our view given the complexity of accounting changes. Leaving aside the accounting changes, simply multiplying TiO₂ production levels with increase in TiO₂ prices shows that increase in EBITDA is sustainable.

Scenario analysis: For various TiO₂ prices for 2018, we have a range of target prices for various multiples (target P/E), as seen below. As for the outlook of TiO₂ prices, in its analyst call, Tronox said that the pigment's price could marginally improve in the coming two quarters, which is positive for the stock.

Figure 1 TP under various scenarios

	TP	P/E multiples				
		11.0x	12.0x	13.0x	14.0x	15.0x
TiO ₂ prices (US\$/t)	2,600	14.8	15.6	16.4	17.2	17.9
	2,800	17.8	18.7	19.6	20.5	21.4
	3,000	20.7	21.8	23.0	23.8	24.8
	3,200	23.7	24.8	25.9	27.0	28.2
	3,400	26.5	27.8	29.0	30.3	31.5

Source: Company data, Al Rajhi Capital

Even if the company can see this level of TiO₂ prices (~US\$3000/t) for the next two years, it will be able to generate EBITDA of around SAR3.5bn and even conservatively assuming 500mn in capex, the cash flow to pay debt can be around SAR3bn. Thereby it can reduce debt substantially by 40%, which will further improve EPS. Beyond 2 years, unless the prices decline to below US\$2400, the company would still be able to manage quite comfortably. Given that the market is of oligopolistic nature, we expect only moderate capacity



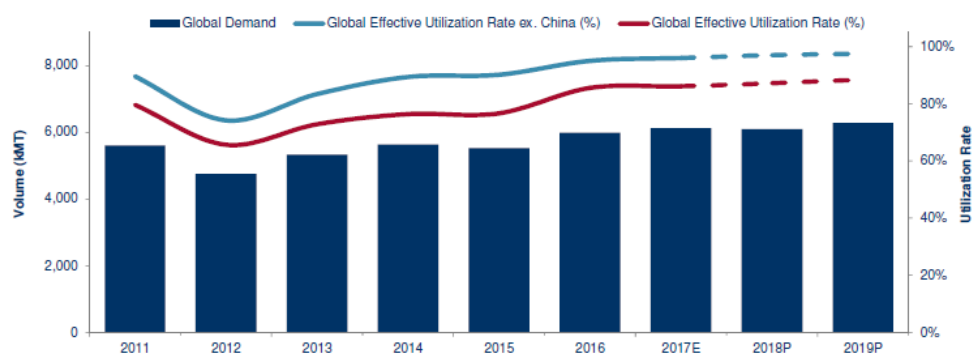
expansions post the fall in prices in the past few years due to over-supply and hence expect prices to sustain.

What we said post initial agreement: In our report where we analysed the initial deal between Tasnee and Tronox, we mentioned that without the deal the fair price of Tasnee was SAR16/share while post the deal the fair price could rise to SAR17-20/share ([Link to report](#)). This analysis was at a time when TiO₂ prices were around US\$2,460/tonne and Tronox pro-forma 2016 EBITDA was US\$0.7bn. Post increase in TiO₂ prices, at an annualized Q1 2018 pro-forma EBITDA of US\$1.2bn, the value of Tronox's shares to be received by Tasnee could improve to ~SAR8.0/share from SAR2.4/share, which is based on current market cap of Tronox. However, as TiO₂ prices have moved up, Cristal's value is already estimated to be at SAR11.5/share. Hence deal or no deal, we see upside in Tasnee if current level of TiO₂ price is maintained. Moreover even if the deal goes through, the realized value may be less than as calculated above because a) the company has to cut some of its supply as per the regulator and hence the pro-forma EBITDA could come down b) there would be Tax and FX implications the complexities of which would be known only post the deal. Hence it would be wise to apply a discount of 10-20% even after arriving at the proportional holdings. All in all, at these TiO₂ prices, we believe the deal not going through, may be better for Tasnee.

Titanium dioxide (TiO₂) market likely to remain tight: Rising demand for TiO₂, the world's most-used pigment, largely in paints & coatings and plastics markets, and relatively tight supply amid lower operating rates in China have improved the industry's fundamentals, thereby improving Tio2 prices notably over the past few quarters. The trend is likely to continue in 2018 as well, given a firm global Tio2 demand coupled with a lack of significant capacity expansion (mainly in China), which may help the global operating rates (ex-China) to sustain above 95% in the coming quarters. Moreover, environmental concerns in China, which lowered operating rates and also shut some of TiO₂ and ilmenite ore plants (idled ~250kmt-300kmt of annualized capacity in 3Q17; source: Venator) in 2017, continues to keep the global Tio2 market tight through 2018, supporting Tio2 prices further.

Also to note: a) 30% of the total global supply is from China of which 50% are smaller companies. We believe that these small companies may be unable to sustain operations due to environmental regulations and energy related policy changes such as reallocation of coal b) Lack of human capital is another factor which will make it not so easy to increase capacity c) Demand continues to be increasing steadily while supply has been consolidating in the recent past.

Figure 2 Global Tio2 demand and effective utilization rate outlook



Source: TZMI, Venator Presentation, Al Rajhi Capital

What is the current status of the deal?: Just to remind investors, Tronox had announced a “definitive agreement” to acquire titanium dioxide (TiO₂) business of Cristal for US\$1.673 billion of cash and class A ordinary shares representing 24% ownership in pro forma Tronox. The cash is not for Tasnee shareholders as it will be used to pay off the debt of Cristal and hence Tasnee shareholders will only get 19% shares in Tronox (24% x 79% stake in Cristal). The Federal Trade Commission (FTC) filed a lawsuit to block Tronox's proposed acquisition as it would make Tronox the world's largest producer with a total capacity of 1.3mn tons per year. In response, Tronox is fighting the FTC complaint, saying the regulatory body's lawsuit is based on an erroneous view of the global TiO₂ market and a flawed analysis of the



Tronox/Cristal transaction. The end date for the transaction has been extended to June 30 from May 21, with automatic three-month extensions until March 31, 2019, if necessary. Based on historical data, any deal blocked by FTC takes a long time to reverse, if it does at all. The deal was extended in the form of an option agreement/addendum. As per the addendum, Tronox and Advanced Metal Industries (AMI) have entered agreement with advanced metal industries cluster company to acquire 90% of AMIC's ownership in a titanium slag smelter facility (500kmt of TiO₂ slag and 220kmt of pig iron capacity). This is positive for Tasnee, in our view.

Why is the addendum (Option) positive for Tasnee? One of our key concerns for the company was the continued investment in the slagger project at Jizan without any visibility of profits. Based on our sources, this slagger plant was planned at a time when TiO₂ prices were at ~US\$4,000/tonne and with current price of TiO₂ at US\$3,100/tonne, the economic feasibility is in question. The plant is still shown as capital work in progress with SAR2.6bn as of Dec 2017 (SAR4.9bn before IFRS implementation). Based on our analysis, the equity investment in Jizan slagger could be now negative after the write offs. We derive the financial metrics for this subsidiary as shown in Figure 3, based on the below analysis.

Before IFRS implementation, the total assets on its balance sheet were SAR43.5bn at the end of 2016. SAR10bn was related to Cristal, and SAR21.4bn was related to petrochemical assets. Little details were provided about Advanced Metal Industries Ltd (AMI) which had assets of ~SAR5bn but a debt of SAR4bn. AMI is equally owned by Tasnee and Cristal, in-turn 79% owned by Tasnee, and thereby 89.5% owned by Tasnee. This is the subsidiary of Tasnee that is spear heading two major projects – 1) Downstream Titanium sponge factory (The sponge factory is a JV between Toho and Tasnee) whose trail run has been postponed and the commercial start-up is expected to take place by 2H18. 2) above mentioned Upstream Jizan slagger project.

Figure 3 AMI net worth calculations

(SARbn)						
AMIC and Toho				Ownership %		
Assets	4.5	2.8	Liabilities/Debt	Tasnee	58%	
		1.7	Equity	Toho	35%	
Subtotal	4.5	4.5		Others	7%	
Jizan Slagger				Ownership %		
Assets	0.5	1.2	Liabilities/Debt	Tasnee	89.5%	
		-0.7	Equity	Others	10.5%	
Subtotal	0.5	0.5				
Total	5.0	5.0				
Book value of Petchem	6.1			Major Petchem companies	Ownership	Revenue share
Book value of others	1.0			Saudi Polyolefin Company	75%	56%
Total Associates	7.0			SEPC	45%	29%
WIP	2.6			SAMCO	39%	9%
				SAPCO	39%	6%
				Weighted Average		61%

Source: Company data, Al Rajhi Capital

Based on our understanding, the AMI and Toho company has a book value of SAR1.7bn. Combined with this, based on publicly available information on the debt on AMI's books as well as debt for the Slagger part, we calculate the Slagger to be have negative net worth (Figure 3). Even in its annual report, we do not see the asset mentioned in its subsidiaries/JVs. The report only mentions titanium sponge factory (AMI and Toho company) as an associate. Jizan slagger is mentioned as only a project under progress, which corroborates our view that the equity part could be negative.

Post IFRS implementation, AMI has been included along with the petrochemical assets as an associate/JV (and not subsidiary) with a book value of SAR6.5bn. Out of this SAR6.5bn we calculate the value of Petchem segment to be around 6.1bn. This is based on previously estimated book value of Petchem segment at SAR9.9bn with ownership at 61%.



Option agreement: Based on our understanding, Jizan slagger was anyway going to be unprofitable. Thereby the Option Agreement to sell Jizan slagger is a positive for the company. As per the addendum, AMI will create a special purpose vehicle (SPV) and contribute its ownership interest along with US\$322mn of debt currently held by AMI. Tronox has agreed to lend AMI and the SPV up to US\$125mn for capital expenditures and operational expenses to facilitate the start-up of the Slagger. These funds may be drawn down on a quarterly basis as needed based. After completion of the acquisition of Cristal, but prior to exercise of the Option, Tronox and AMI have agreed to supply one another, on commercial terms, ilmenite as a feedstock for the Slagger and titanium slag produced by the Slagger, respectively.

Upon reaching the sustained operations of the Slagger as defined within the Option Agreement, Tronox will exercise the option to acquire a 90% ownership of the SPV. The total consideration payable by Tronox consists of the effective assumption of the AMI Debt through ownership in the SPV, the US\$125mn loan described above, a working capital adjustment and an adjustment to accurately compensate AMI for 10% of the outstanding liabilities of the SPV as of the closing. **This implies that Tasnee gets to offload the debt pertaining to the Slagger from its books and 10% of outstanding liabilities. Apart from this it gets 10% of future profits as part of its ownership.** Tronox and AMI also have agreed that they will enter into a shareholders agreement relating to their respective rights and obligations as shareholders of the SPV.

Valuation: In our base case, we believe the deal is unlikely to go through. We arrive at the valuation for the company using equal mix of FCF and relative valuation method. In our base case, we assume TiO₂ prices to remain flat at current levels into the future. Consequently, we revise our TP to SAR23/share based on equal mix of relative (SAR26.6/sh. based on 13.0x 12 month forward PE) and DCF valuation (SAR19.3/sh. based on FCF, cost of equity 11.7%). We also revise our rating to Overweight (earlier Neutral) on the stock.

If we are to employ EV/EBITDA of 8x for the Chemical segment, we get the value of the Cristal segment separately at 11.5/share based on recurring EBITDA of ~SAR500mn per quarter.

At the current level of EBITDA, the company can easily pay off the debt within 5 years and depending on the optimal debt/asset ratio, the company can even decide on dividends in 1-2 years. As of now, we do not expect any dividends.

Risks: The further upside triggers are higher TiO₂ prices, surge in Tronox share price, sale of Jizan slagger, disposal of other unprofitable segments, improvement in petchem prices. The company has presence in a wide range of small companies with no meaningful profits which drags the RoIC down. Disposal of these may help the net profit and cash position. We have not accounted for any upside from sale of Jizan slagger.

Downside risks are related to success of the deal when TiO₂ prices continue to remain at elevated levels. There is goodwill worth of SAR2.8bn on its balance sheet which was made when Tasnee purchased Cristal when TiO₂ prices were substantially higher. We expect this to be written off eventually and will act as a downside risk factor. The company does not show the debt on its subsidiaries (such as AMI) as it has started accounting it as equity investment. Hence the debt is higher than reported and thus Tasnee may have to step in-case of defaults.



Income Statement (SARmn)	12/16A	12/17A	12/18E	12/19E	12/20E
Revenue	8,620	10,796	11,451	11,423	11,485
Cost of Goods Sold	(7,712)	(8,692)	(8,191)	(8,234)	(8,370)
Gross Profit	907	2,104	3,260	3,190	3,115
Government Charges					
S.G. & A. Costs	(160)	(480)	(606)	(592)	(560)
Operating EBIT	748	1,624	2,653	2,597	2,556
Cash Operating Costs	(7,014)	(8,320)	(7,878)	(7,890)	(7,984)
EBITDA	1,606	2,477	3,573	3,534	3,502
Depreciation and Amortisation	(858)	(853)	(920)	(936)	(946)
Operating Profit	748	1,624	2,653	2,597	2,556
Net financing income/(costs)	(529)	(706)	(664)	(625)	(591)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	164	231	183	188	190
Other Expenses					
Net Profit Before Taxes	382	1,149	2,173	2,161	2,154
Taxes	(74)	9	(239)	(238)	(237)
Minority Interests	(207)	(442)	(677)	(731)	(728)
Net profit	101	716	1,257	1,193	1,188
Dividends	-	-	-	-	(594)
Transfer to Capital Reserve	-	-	-	-	-
	12/16A	12/17A	12/18E	12/19E	12/20E
Adjusted Shares Out (mn)	668.9	668.9	668.9	668.9	668.9
CFPS (SAR)	1.74	3.01	4.27	4.28	4.28
EPS (SAR)	0.15	1.07	1.88	1.78	1.78
DPS (SAR)	-	-	-	-	0.89
Growth	12/16A	12/17A	12/18E	12/19E	12/20E
Revenue Growth	-43.1%	25.3%	6.1%	-0.2%	0.5%
Gross Profit Growth	-59.0%	132.0%	54.9%	-2.2%	-2.3%
EBITDA Growth	25.6%	54.2%	44.3%	-1.1%	-0.9%
Operating Profit Growth		117.2%	63.4%	-2.1%	-1.6%
Net Profit Growth		606.1%	75.5%	-5.1%	-0.3%
EPS Growth		606.1%	75.5%	-5.1%	-0.3%
Margins	12/16A	12/17A	12/18E	12/19E	12/20E
Gross profit margin	10.5%	19.5%	28.5%	27.9%	27.1%
EBITDA margin	18.6%	22.9%	31.2%	30.9%	30.5%
Operating Margin	8.7%	15.0%	23.2%	22.7%	22.3%
Pretax profit margin	4.4%	10.6%	19.0%	18.9%	18.8%
Net profit margin	1.2%	6.6%	11.0%	10.4%	10.3%
Other Ratios	12/16A	12/17A	12/18E	12/19E	12/20E
ROCE	3.0%	5.9%	9.2%	8.6%	8.0%
ROIC	1.8%	9.5%	13.8%	13.7%	13.9%
ROE	1.3%	9.1%	14.0%	11.7%	10.7%
Effective Tax Rate	19.5%	-0.8%	11.0%	11.0%	11.0%
Capex/Sales	11.7%	6.5%	5.5%	3.0%	3.0%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	50.0%

Source: Company data, Al Rajhi Capital



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Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:

"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.

Contact us

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