Saudi Basic Industries Corp

Petrochemicals – Industrial

SABIC AB: Saudi Arabia

29 July 2018

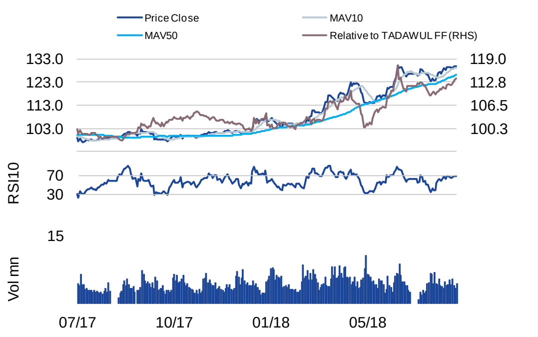
US$103.8bn	21%	US$139.3mn
Market cap	Free float	Avg. daily volume

Target price	**135.00**	**4% upside**
Current price	129.80	as at 26/7/2018

Existing rating

Underweight	Neutral	Overweight

Performance



Source: Bloomberg

Earnings

(SARbn)	2017	2018e	2019e
Rev	151.6	171.9	163.0
Rev growth	6.0%	13.4%	-5.2%
Gross Profit	51.0	60.0	55.3
Gross margin	33.7%	34.9%	33.9%
EBITDA	43.8	54.2	50.4
EBITDA margin	28.9%	31.5%	30.9%
Net Profit	18.4	24.2	22.8
Net margin	12.1%	14.1%	14.0%
EPS	6.1	8.1	7.6
DPS	4.2	5.2	5.3
Payout ratio	68%	64%	70%
EV/EBITDA	10.0x	8.1x	8.7x
P/E	21.2x	16.1x	15.5x

Source: Company data, Al Rajhi Capital

الراجحي المالية
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SABIC (SABIC AB Equity)

Strong earnings beat; Raise TP to SAR135/sh.

SABIC reported exceptional results in Q2 with net profit coming at SAR6.7bn much above consensus (5.5bn) and our estimate (5.03bn). While top-line came 2.2% above our estimate, the improvement in costs notwithstanding the increase in naphtha prices and shutdown at Netherland plant, led to the beat in gross profit (even after adjusting for the strategic restructuring one off expenses, SAR1.1bn in last quarter). SG&A costs were also below our expectation by~SAR0.3bn. The strong set of results comes at a time when Aramco is looking to take a stake in SABIC and the company is expected to be included in emerging market indices. The company's historical discount to EV/EBITDA of global chemical peers has diminished to 10% from 25% historically. Based on equal mix of DCF and EV/EBITDA valuation methods, we arrive at a TP of SAR135/share.

Figure 1 Q2 2018 results summary

(SAR bn)	Q2 2017	Q1 2018	Q2 2018	Y-o-Y	Q-o-Q	ARC est	Comments
Revenue	**34.4**	**41.9**	**43.3**	**25.7%**	**3.4%**	**42.3**	**Slightly above our estimate of SAR42.3bn (consensus: SAR42.5bn), likely due to higher-than expected sales volume.**
Gross profit	10.4	14.2	15.9	53.2%	11.6%	13.7	Further, improved production efficiencies led to gross profit beat in Q2.
Gross margin	30.1%	33.9%	36.6%			32.3%	
Operating profit	5.6	8.9	10.8	94.1%	21.1%	8.4	Lower-than-expected SG&A expenses further contributed to a beat at the operating level.
Operating margin	16.2%	21.4%	25.0%			19.9%	
Net profit	**3.7**	**5.5**	**6.7**	**80.6%**	**21.6%**	**5.0**	**Consequently, beating our (SAR5.0bn) and consensus estimate (SAR5.5bn).**
Net margin	10.8%	13.2%	15.5%			11.9%	

Source: Company data, Al Rajhi Capital

Factors leading to the beat:

- In Q2, we may not have seen the usual volatility in the metal segment's gross profits, which historically has seen a see-saw pattern in profits. The swings usually are significant – with SAR0.5bn profit in 1Q18 vs loss of SAR0.4bn in 4Q17, implying a turnaround in gross profit level of around SAR1bn sequentially. Hence in Q2 we expected losses of SAR0.2bn for the metal segment's gross profit, while it may have come much better.
- We only partially accounted for the one off strategic initiatives & restructuring costs of SAR1.1bn, as mentioned by the company last quarter, due to lack of enough details. Similar to other companies reporting restructuring initiatives, we expected the process to be stretched over multiple quarters. However despite adjusting for this the costs have lower than our expectation by SAR0.3bn as naphtha price increased by 10% q-o-q in Q2.
- SG&A costs came SAR0.3bn below our estimates, likely at SAR5bn. We forecasted SAR5.3bn vs quarterly average of SAR5.5bn last year.
- As product prices are generally known by the end of the quarter, based on the slight beat in top-line, the production may have come slightly (~1.5%) above our expectations.
- Altogether, Q2 results were stellar if one were to combine the best rates of production, prices, cost savings and efficiencies seen in this quarter.

Outlook and valuation: Currently most product prices on an average have declined by 1-4% q-o-q. We conservatively take an average decline of 2% so far across key products (we may revise this by the end of the quarter). With regard to costs, at an absolute level, we expect costs to remain firm for the petchem segment due to slightly increase in naphtha price while we expect losses for metal segment in 2H18(gross profit level). For 2019, we expect a 5% decline across most product lines, on an average in-line with our outlook for oil price. Based on this outlook, we arrive at an EPS of SAR8.1 for 2018 and SAR7.6 for 2019.

For valuation, we take an average of DCF based valuation (SAR138/share, WACC of 9.8%) and EV/EBITDA based valuation of SAR132 (8x multiple, 15% discount to global peers as compared to 25% discount seen previously given the inclusion into global indices and stake sale) and arrive at a target price of SAR135/share. DPS could increase to SAR5.2/share in 2018 and SAR5.3/share in 2019 based on dividend payout ratios of 64% and 70%. At current price, the forward 12 month P/E is 16.6x, above local peers of 12-14x. Overall based on our ratings methodology, we remain Neutral on SABIC.

Risks: Key upside triggers are associated with acquisitions, faster than expected successful commercial launch of its future expansion projects and increase in product spreads. SABIC is most likely to be included in MSCI EM , FTSE, S&P emerging market indices, generating additional global interest in the stock once Saudi Arabia upgrades to Emerging market list, which could eliminate a bit of the discount compared to global peers provided disclosures improve. Downside risks include weak oil & thereby decline in petchem product prices, unplanned plant shutdowns and any further unexpected revision in the subsidized feedstock prices. The newer projects such as the OTC project are quite large and are unconventional, which could be a negative risk factor.

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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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