

July 14, 2019

## SAUDI PETROCHEMICALS

Event Update

### US-China Trade War and Saudi Petrochemicals

The U.S and China recently agreed to restart negotiations and hold off any new tariffs after negotiations between the two parties broke down in May. Petchem stocks have exhibited heightened volatility as trade uncertainties remain at the forefront and we expect the sector's bottom-line to weaken as the trade spat lingers. However, if we tune out the noise, we see the medium-term prospects remain attractive despite the short-term headwinds. China's economic evolution and shifting demand trends will provide lucrative opportunities for the specialty segment in specific. We recommend a buy for Sipchem with a target price of 24.00 and Saudi Kayan with a target price of SAR 16.00 (SAR 18.00 earlier).

#### The Chinese miracle and its relation to the trade war

China's rapid economic expansion since the early 2000's was a key revenue driver for many of Saudi Arabia's Petchem Companies. China's ultra-fast growth was driven by their shift from a consumption dependent economy to an investment/export led economy. This is in contrast to advanced economies where consumption constitutes around 70% of GDP.

Exhibit 1: China GDP Composition

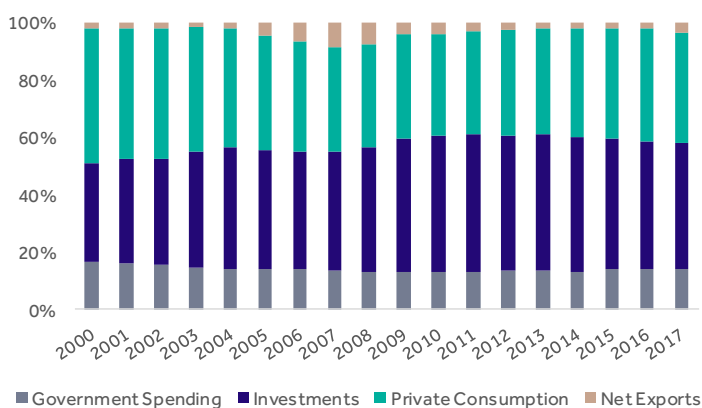
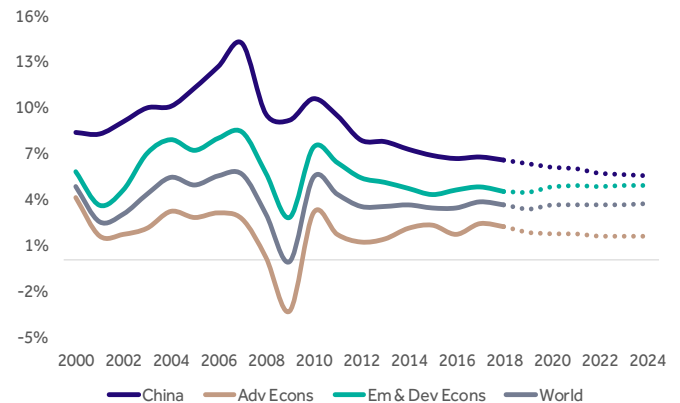


Exhibit 2: Real GDP Growth (%)



Exports/GDP moderated after the global financial crisis (GFC) as advanced economies (the main market for China's exports) struggled to recover. This made the economy more reliant on investments to maintain its strong growth, which in turn caused China's debt levels to rise. Moreover, rising labour costs, shrinking rural labour supply and an appreciating Yuan began to erode China's competitiveness in low-skilled, labor-intensive manufactured goods (its main export). The rise of alternative suppliers, such as Bangladesh and Vietnam, also encouraged manufacturers to shift production from China.

Exhibit 3: Chinese Exports (% of GDP)

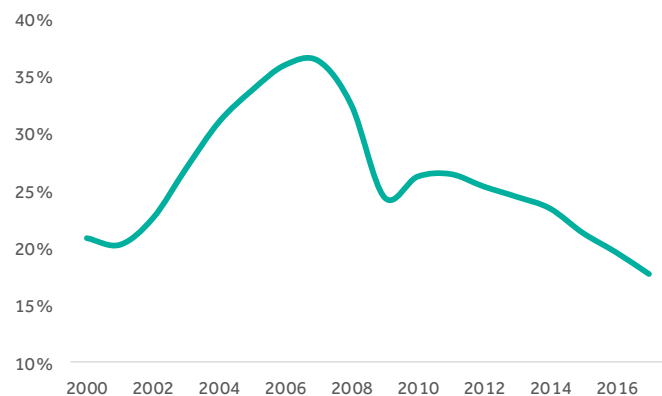
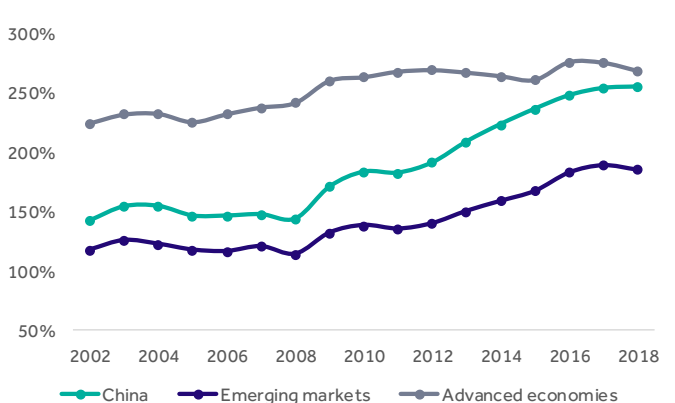
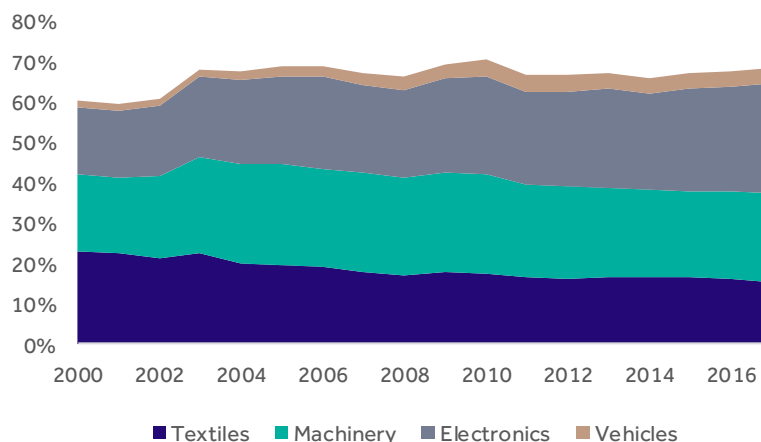


Exhibit 4: Debt/GDP (%)



A diminishing competitive advantage in low-end manufacturing is a natural consequence of China's economic development. Higher wages, better workforce skills and improvements in infrastructure prompted Chinese manufacturers to switch to high value-added production in order to compete in the export market. Consequently, high-end manufacturers in the US gradually shifted their production to China (much to the dismay of American workers) and this helped widen America's trade deficit. In addition, China made it an official mandate to upgrade its manufacturing industry to produce high value-added products through their "Made In China 2025" initiative. The initiative of the goal is to make China a leader among the world's manufacturing powers and possess competitive advantages in major manufacturing areas by 2049.

**Exhibit 5: Chinese Exports by Product (% of total exports)**



Source: atlas.cis.harvard

It is worthy to note that the trade imbalance is not the sole cause for the trade war. American companies had long complained about China's mercantilist policies such as 1) Forced technology transfer 2) Forced joint ventures 3) State subsidization for Chinese companies 4) Intellectual property theft...etc. Policies that have been integral in China's move up the value chain. This began to raise security concerns in recent years in the American government given the vital role of technology in economic and military dominance. Therefore, confrontation was bound to occur eventually.

#### **Petchem companies should focus on specialties**

As noted earlier, China's economy had a profound effect on Saudi petchem's profits in the past and we expect it to continue to be so. However, unlike before, we believe growth opportunities will be skewed towards specialty chemicals rather than commodity chemicals due to the following:

1. **Economic rebalancing:** China's investment/export growth model was widely acknowledged as unsustainable in the long-run. Therefore, the Government focused its efforts in recent years in transitioning the economy into a domestic demand-driven economy. Several incentives and policies have been introduced to support the transition, and this helped make consumption the primary driver for China's economic growth in the last 5 years.
2. **Large middle class emerging:** China's economic development was accompanied by a rapid rate of urbanization and considerable rise in disposable income. This has elevated the majority of the population into middle class status and with it rising demand for home care products, personal care products and cosmetics, to name a few, all of which depend on specialty chemicals.

3. **High-tech production expansion:** Speciality chemicals are crucial for a wide range of electronics and we expect the aforementioned two points to boost local demand for consumer electronics. More importantly, China's move towards higher value-added production and their "Made in China 2025" initiative will strengthen specialty chemicals demand in the medium to long term.
4. **Credit reduction:** The credit boom post-GFC bolstered local Petchem demand and provided ample funding for local petchem companies to expand and increase capacity. We don't expect that to be the case going forward given the government's determination in rebalancing the economy as well as their deleveraging campaign that began in 2017 in an attempt to rein in the country's debt. This will have a positive effect on both speciality and non-specialty chemicals.

In light of the above, we expect to see demand for specialty chemicals to outpace Chinese GDP growth in the medium term. To be sure, Chinese demand for non-specialties will continue to generate strong revenues for Saudi Petchem companies, but its growth will be more in line with GDP growth. Even so, GDP growth will still be large in absolute terms.

## SIPCHEM

### Investment thesis:

We forecast Sipchem's topline to be much more resilient after the successful merger with Sahara Petrochemical. Aside from the expected synergies (SAR 175 mil – SAR 225 mil EBITDA annually), the new entity will provide several growth opportunities through many of Sahara's subsidiaries. Much to our pleasure, management have reiterated their intent in entering the U.S market. We view international expansion as a necessity for the company to maintain its competitiveness. In regards to specialties, Sipchem has steadily added specialty chemicals to its product portfolio and we expect this trend to continue. We reaffirm our buy recommendation with a target price of SAR 24.00

### Risks:

Weak product prices, higher financing costs, currency fluctuations, exiting of strategic partners.

### Financials and Forecasts

	2018	2019 E	2020 E	2021 E
<b>Income Statement (SAR mln)</b>				
Revenue	5,036	6,043	6,345	6,662
Gross Profit	1,635	1,994	2,094	2,199
Operating Profit	1,096	1,450	1,523	1,599
Net Income before Zakat	867	1,597	1,757	1,909
Net Income	583	1,070	1,177	1,298
EPS	1.59	1.46	1.61	1.77
DPS	1.15	0.90	1.00	1.20
EBITDA	1,921	2,630	2,836	3,039
<b>Balance Sheet (SAR mln)</b>				
<b>Assets</b>				
Cash & equivalents	1,014	2,615	2,641	2,773
Inventories	807	1,049	951	999
Accounts Receivable	889	1,591	1,413	1,484
Property Plant & Equipment	11,956	18,024	18,773	19,298
<b>Total Assets</b>	<b>15,380</b>	<b>24,049</b>	<b>24,560</b>	<b>25,347</b>
<b>Liabilities &amp; Equity</b>				
Current Portion of LT Debt	1,197	1,413	1,484	1,558
Long term Debt	4,803	5,822	5,966	6,124
<b>Total Liabilities</b>	<b>8,255</b>	<b>10,612</b>	<b>10,771</b>	<b>11,141</b>
Total Equity	7,125	13,437	13,789	14,207
<b>Total Liab &amp; Equity</b>	<b>15,380</b>	<b>24,049</b>	<b>24,560</b>	<b>25,347</b>
<b>Key ratios</b>				
P/E	13.1x	14.3x	13.0x	11.8x
P/B	2.6x	1.5x	1.4x	1.4x
ROA	3.8%	4.4%	4.8%	5.1%
ROE	9.8%	10.4%	11.1%	11.9%
EV/EBITDA	11.1x	8.0x	7.5x	7.0x

Source: Company reports, Riyad Capital

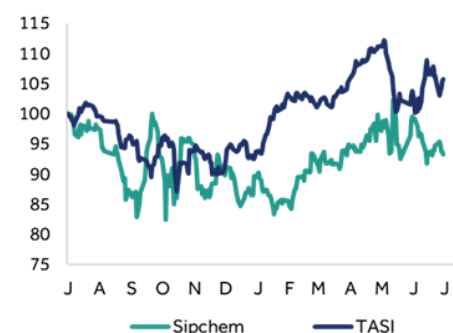
Rating	Buy
12- Month Target Price	SAR 24.00

Price as on Jul-11, 2019	SAR 20.88
Upside to Target Price	14.9%
Expected Dividend Yield	4.3%
Expected Total Return	19.2%

### Market Data

52 Week H/L	SAR 23.50/18.48
Market Capitalization	SAR 15,312 mln
Shares Outstanding	733.3 mln
Free Float	95%
12-Month ADTV	974,091
Bloomberg Code	SIPCHEM AB

### 1-Year Price Performance



Source: Bloomberg

### Specialty Chemicals by Sipchem

**Polybutylene Terephthalate (PBT):** insulator in the electrical and electronics industries and automotive industry (electrical system, mirror housings, handles fuel system)

**Tetrahydrofuran:** general solvent (pharmaceuticals, adhesives)

**Gamma Butyrolactone:** pharmaceuticals, agri-chemicals, epoxy coatings and as a solvent in industrial cleaning products, paint strippers and adhesive removers.

**Ethyl Acetate:** has numerous applications as a solvent, in inks, adhesives, pharmaceuticals and as a carrier solvent for herbicides. High purity Ethyl Acetate is used in the electronics industry.

**Butyl Acetate:** used in the production of lacquers. Also used as a synthetic fruit flavoring in foods such as candy, ice cream, cheeses, and baked goods.

## SAUDI KAYAN

### Investment thesis:

Kayan produces multiple specialty chemicals and has recently entered into an MoU with leading specialty company Clariant to evaluate a JV to manufacture Alkoxylates (Capacity: 120 KTA). Producing new and specialized competitive products is part of the company's strategic objectives. Our bullish outlook for Kayan comes down to its ability to generate healthy OCF despite unfavorable conditions and its progress in deleveraging its balance sheet. Kayan's large depreciation expense puts heavy pressure on earnings (especially in weak markets) which distorts their performance. Additionally, the company receives strong support (both financial and non-financial) from its parent company Sabic and this is a key factor in its rating. We reaffirm our buy recommendation but reduce our target price to SAR 16.00, from SAR 18.00 earlier.

### Risks:

Weak product prices, substantial rise in feedstock costs, higher financing cost, currency fluctuations.

### Financials and Forecasts

	2018	2019 E	2020 E	2021 E
<b>Income Statement (SAR mln)</b>				
Revenue	12,263	10,301	10,507	11,558
Gross Profit	3,365	2,060	2,522	2,889
Operating Profit	2,661	1,303	1,722	2,046
Net Income before Zakat	1,881	583	985	1,311
Net Income	1,702	400	801	1,122
EPS	1.13	0.27	0.53	0.75
DPS	-	-	-	-
EBITDA	4,917	3,447	3,759	3,981
<b>Balance Sheet (SAR mln)</b>				
<b>Assets</b>				
Cash & equivalents	2,377	2,527	2,781	1,500
Inventories	1,659	1,648	1,936	1,994
Accounts Receivable	2,822	2,369	2,522	2,774
Property Plant & Equipment	30,723	28,579	26,542	24,607
<b>Total Assets</b>	<b>40,695</b>	<b>39,136</b>	<b>37,675</b>	<b>34,287</b>
<b>Liabilities &amp; Equity</b>				
Short Term debt	1,522	1,373	1,236	1,022
Long term Debt	18,461	16,454	14,811	11,750
<b>Total Liabilities</b>	<b>24,997</b>	<b>23,065</b>	<b>21,204</b>	<b>17,495</b>
Total Equity	15,698	16,071	16,471	16,792
<b>Total Liab &amp; Equity</b>	<b>40,695</b>	<b>39,136</b>	<b>37,675</b>	<b>34,287</b>
<b>Key ratios</b>				
P/E	10.1x	42.9x	21.4x	15.3x
P/B	1.1x	1.1x	1.0x	1.0x
ROA	10.8%	1.0%	2.1%	3.3%
ROE	4.2%	2.5%	4.9%	6.7%
EV/EBITDA	6.9x	9.3x	8.0x	7.1x

Source: Company reports, Riyad Capital

Rating  
12- Month Target Price

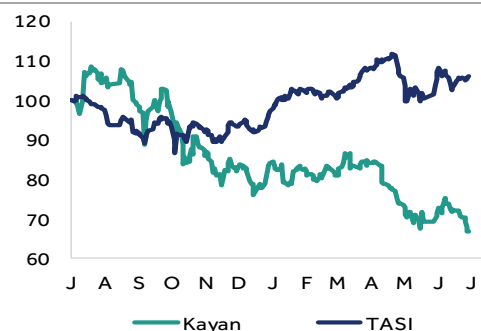
Buy  
SAR 16.00

Price as on Jul-11, 2019	SAR 11.42
Upside to Target Price	40.1%
Expected Dividend Yield	0.0%
Expected Total Return	40.1%

### Market Data

52 Week H/L	SAR 18.52/11.18
Market Capitalization	SAR 17,130 mln
Shares Outstanding	1,500 mln
Free Float	65%
12-Month ADTV (mln)	8.5
Bloomberg Code	KAYAN AB

### 1-Year Price Performance



Source: Bloomberg

### Specialty Chemicals by Kayan

**Monoethanolamine, Diethanolamine and Triethanolamine:** Gas sweetening, detergent and specialty cleaning formulations, concrete mixtures, flexible urethane foam catalysts, pharmaceuticals, personal care products, herbicides.

**Ethoxylates:** Detergent, paint, leather industry.

**Natural Detergent Alcohol:** Detergent.

## ■ Stock Rating

Buy	Neutral	Sell	Not Rated
Expected Total Return Greater than +15%	Expected Total Return between -15% and +15%	Expected Total Return less than -15%	Under Review/ Restricted

The expected percentage returns are indicative, stock recommendations also incorporate relevant qualitative factors  
For any feedback on our reports, please contact [research@riyadcapital.com](mailto:research@riyadcapital.com)

## Disclaimer

Riyad Capital is a Saudi Closed Joint Stock Company with Paid up capital of SR 200 million, licensed by the Saudi Arabian Capital Market Authority NO.07070-37. Commercial Registration No: 1010239234. Head Office: Granada Business Park 2414 Al - Shohda Dist. – Unit No 69, Riyadh 13241 - 7279 Saudi Arabia. Ph: 920012299. The information in this report was compiled in good faith from various public sources believed to be reliable. Whilst all reasonable care has been taken to ensure that the facts stated in this report are accurate and that the forecasts, opinions and expectations contained herein are fair and reasonable. Riyad Capital makes no representations or warranties whatsoever as to the accuracy of the data and information provided and, in particular, Riyad Capital does not represent that the information in this report is complete or free from any error. This report is not, and is not to be construed as, an offer to sell or solicitation of an offer to buy any financial securities. Accordingly, no reliance should be placed on the accuracy, fairness or completeness of the information contained in this report. Riyad Capital accepts no liability whatsoever for any loss arising from any use of this report or its contents, and neither Riyad Capital nor any of its respective directors, officers or employees, shall be in any way responsible for the contents hereof. Riyad Capital or its employees or any of its affiliates or clients may have a financial interest in securities or other assets referred to in this report. Opinions, forecasts or projections contained in this report represent Riyad Capital's current opinions or judgment as at the date of this report only and are therefore subject to change without notice. There can be no assurance that future results or events will be consistent with any such opinions, forecasts or projections which represent only one possible outcome. Further, such opinions, forecasts or projections are subject to certain risks, uncertainties and assumptions that have not been verified and future actual results or events could differ materially. The value of, or income from, any investments referred to in this report may fluctuate and/or be affected by changes. Past performance is not necessarily an indicative of future performance. Accordingly, investors may receive back less than originally invested amount. This report provides information of a general nature and does not address the circumstances, objectives, and risk tolerance of any particular investor. Therefore, it is not intended to provide personal investment advice and does not take into account the reader's financial situation or any specific investment objectives or particular needs which the reader may have. Before making an investment decision the reader should seek advice from an independent financial, legal, tax and/or other required advisers due to the investment in such kind of securities may not be suitable for all recipients. This research report might not be reproduced, nor distributed in whole or in part, and all information, opinions, forecasts and projections contained in it are protected by the copyright rules and regulations.