



US\$0.419bn Market cap
77% Free float
US\$1.841mn Avg. daily volume

Target price 30.00 26% over current
Current price 23.90 as at 31/10/2019

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Underweight **Neutral** **Overweight**

Key themes

We expect the company's top-line to grow in the near term due to increasing housing construction as a part of social housing program. Going forward net margins are expected to improve due to premium products offering as well as reduced capex requirements.

Earnings

(SAR mn)	2018	2019	2020E	2021E
Revenue	1,028	1,227	1,329	1,420
Revenue growth		19.3%	8.4%	6.9%
Gross profit	108	255	312	365
Gross margin	10.5%	20.8%	23.5%	25.7%
EBIT	(157)	5	62	115
EBIT margin	NA	0.4%	4.7%	8.1%
Net Income	(220)	(49)	14	67
Net margin	NA	NA	1.1%	4.7%
EPS	-4.40	-0.82	0.23	1.12

Saudi Ceramic Co. (SCERCO)

On the cusp of a turnaround

We re-initiate coverage on SCERCO with a target price of SAR30/share based on equal weights to DCF (SAR33/sh.) and relative valuation (SAR28/sh) methods. SCERCO is the market leader with ~22% market share in tiles segment, ~40% in both sanitary ware and water heater segments. Its economic moat is its leadership position in the local market, efficient capacity utilization and strong distribution channel. The company's fortunes changed over the last three quarters as it reduced its losses significantly mainly due to better demand for the company's tiles, change in strategy by enhancing its product portfolio and reaching to a wider audience through opening of company owned showrooms. In our view the worst is over for ceramic industry and there are ample opportunities in tiles, sanitary ware and water heater segments due to social housing projects as well as growth in hospitality and entertainment sectors. We believe there is strong visibility for high growth and improvement in margins as the company is deleveraging with no major capex plans. Further, introduction of new premium products and rising export avenues to African countries could aid margins. With an upside of 26% from the current price the stock looks attractive factoring in the current and long term development in the construction sector.

Huge potential from social housing projects: Demand for the company's products owing to the social housing projects is just beginning to show up in our view. As per our estimates, 1mn residential homes are expected to be constructed by 2022 from 2017. The pace of adoption is increasing with current run rate of 15000 contracts in Q2 as compared to 5000 new contracts in Q2 2018. As per our analysis social housing projects in itself is expected to create a demand for 143mn sq.m of tiles till 2023 (Fig 19).

Export opportunities provides a room for top-line expansion: Apart from rising domestic demand there is a significant opportunity to export to neighbouring GCC and African countries as these regions are net importer of tiles. In 2018 the company started exporting to Egypt and as per our calculations ~9% of the total tiles revenue and ~40% of the total water heater revenue was from exports. In the future, we expect this number to further increase as company is focusing to increase its export market.

Anti-dumping duty if implemented on Indian ceramic manufacturers will help in faster turnaround: Currently the ceramic manufacturers in GCC is facing competition from cheaper tiles import from India. However the local manufacturers in GCC have filed a case for implementing anti-dumping duty on Indian tiles. These duties can range from 15-25% and if implemented will be very positive for the company. However in our model we have not taken any impact of anti-dumping duty. (Fig 25)

Company to turn profitable due to change in product mix: The company has recently launched new products such as bathroom pods and changed the design of its existing products to match the requirement of the modern housing. As per our analysis there are enough opportunities for the companies to penetrate in sanitary ware segment which faces less competition from cheaper imports. As

per company there is demand in the market for the premium products and we feel that latest launches in the sanitary ware segments should help the company in fetching higher margins. SCERCO has opened six showrooms recently taking the total count to 36 showrooms; the company intends to take the total count to 50 by 2020e.

Operating leverage and Premiumization to push gross margins to old levels: In the last two years government as well as private spending was muted due to various structural reforms which took place in the kingdom. However we feel that the worst is over and we can see the overall gross margins to improve and reach 25% by 2020e. The main driver for gross margins will be improved capacity utilization across all the segments in particular the sanitary ware. The current capacity utilization as per our analysis stands at ~80% for the tiles, ~75% for sanitary ware and 78% for water heaters.

Deleveraging to support net margins going forward: The company increased its sanitary ware capacity from 40mn kgs to 67mn kgs in 2017; the new factory which was constructed in 2017 has a current capacity utilization rate of 40%. With the growing demand the company can easily increase its production without further capex requirement. Therefore the company's capex requirement is over and they have rescheduled the debt with the lenders in 2018, going forward we assume the most of the spending will be opex in nature and therefore the reduced interest cost will support the margins.

Q3 19 Results: In line with our expectations, the company reported a net profit of SAR35mn against a loss of SAR39mn in Q3 18, driven mainly by higher sales due to better demand and increase in product prices. The top-line increased 17%, y-o-y mainly due to increase in prices of the company's products and higher demand. This resulted in new level of gross margins at 37% compared to 14% in Q3 18.

Q3 2019: Results Summary

	3Q19	2Q19	q-o-q	3Q18	y-o-y
Revenue	292	274	7%	250	17%
COGS	183	213	-14%	213	-14%
Gross Profit	109	61	79%	37	197%
G. margin	37%	22%	NA	15%	NA
Op. costs	60	64	-6%	237	-75%
Op. profit	49	-3	NA	-24	NA
Op. margin	17%	-1%	NA	-10%	NA
Net profit	34	-16	NA	-39	NA
Net margin	12%	-6%		-15%	

Source: Company data, Al Rajhi Capital



Key Assumptions

- Going forward we have assumed that the prices of all the three segments increases only once (2019e) during our forecasted period. We have increased the capacity utilization and accordingly the sales volume given the strong demand from the residential housing projects, increasing hotel rooms, hospitals, malls, etc which creates a huge potential for the ceramic products.
- In figure 1 below the gross margins from sanitary ware segments is expected to reach ~50% and tiles segment ~11% by 2022e. In 2014-15 when the company was at its prime the ceramic segment margin used to be 37% and water heater segment margin used to be 27%.

Figure 1: Key Assumption and Facts

Capacity	2018	2019e	2020e	2021e	2022e
Tiles (mn sqm)	60.0	60.0	60.0	60.0	62.0
Sanitaryware (mn kgs)	67.0	67.0	67.0	67.0	67.0
Water Heater (mn)	2.0	2.0	2.0	2.0	2.0
Sales Volume					
Tiles (mn sqm)	46.31	48.55	51.30	54.15	57.14
Sanitaryware (mn kgs)	40.64	48.98	57.29	60.47	63.03
Water Heater (mn)	1.12	1.28	1.58	1.75	1.82
Average selling price per unit					
Tiles (sqm)	13	14	14	14	14
Sanitaryware (Per kgs)	3.8	4.1	4.1	4.1	4.1
Water Heater (ASP)	219.6	230.0	230.0	230.0	230.0
COGS segment wise					
Tiles	609	625	643	662	682
Fixed (49%)	299	299	299	299	299
Variable (51%)	311	326	344	363	383
Sanitaryware	107	118	129	133	137
Fixed (49%)	52	52	52	52	52
Variable (51%)	55	66	77	81	85
Water Heater	202	229	244	260	267
Fixed (49%)	99	99	99	99	99
Variable (51%)	103	130	145	161	168
Total COGS	918	971	1017	1055	1086
Total Revenue (SARmn)					
Tiles	1028	1227	1329	1420	1454
Sanitaryware	648	731	718	758	766
Water Heater	134	202	247	260	269
Water Heater	246	293	364	402	420
Gross Profit (SARmn)					
Tiles	110	255	312	365	369
Sanitaryware	39	106	75	96	84
Sanitaryware	27	85	118	127	132
Water Heater	44	65	120	142	153
GPM Segment wise					
Tiles	6%	15%	10%	13%	11%
Sanitaryware	20.00%	41.86%	47.75%	48.86%	49.15%
Water Heater	18.00%	22.04%	32.89%	35.44%	36.46%
GPM	10.69%	20.82%	23.51%	25.72%	25.35%

Source: Company Data, Al Rajhi Capital

- In our assumptions we have increased the margins for sanitary ware segment due to improving capacity utilization (in 2014 the capacity was 40mn kgs while currently it is 67mn kgs), the second reason is premiumization of new designer products in tiles and sanitary ware space will improve the overall margins.



- In water heater segments we expect the gross margins to improve as the overall demand picks up due to construction of modern houses, exports (~40% of the total EWH sales was from export in 2018) and awareness towards energy efficient products. SCERCO products are energy efficient and have a good reputation in the market. On the cost front the steel prices are expected to remain on the lower side due to softer demand globally, thus we expect the overall recovery in the company's margins from 2019e.

Valuations

We have used an equal mix of DCF based valuation and relative valuation to value SCERCO. Our DCF based target price stands at SAR32.4 based on an WACC of 9% and terminal growth of 2%. For relative valuation we have used average EV/EBIDTA multiple of global peers and consumer companies in Saudi Arabia as an exit multiple and valued SCERCO at 11.5x (15% premium reflecting the future earnings growth we are expecting for the company). Our relative valuation target price stands at SAR27.3 accordingly our equal weighted target price stands at SAR30/sh.

Figure 2: Summary of DCF Valuation

DCF Valuation Model	2019e	2020e	2021e	2022e	2023e	2024e
Years to forecast	0.19	1.19	2.19	3.19	4.19	5.19
(In SAR '000)						
Pre-tax operating profit	5,381	62,472	115,331	118,583	135,073	154,853
Tax rate	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Post-tax operating profit	5,139	59,661	110,141	113,246	128,995	147,885
Add: Depreciation & amortisation	163,821	134,504	111,424	102,292	94,239	87,556
Less: Change in working capital	- 5,350	2,606	64,637	- 6,646	- 82,132	37,402
Less: Capex	- 24,530	- 26,583	- 28,409	- 29,084	- 33,485	- 52,807
Free Cash Flow to Firm	139,079	154,839	207,633	135,695	126,099	228,621
Discount factor	0.50	0.90	0.83	0.76	0.70	0.64
PV of Free Cash Flows	69,539	154,010	214,274	137,275	75,464	141,721
Sum of present values of FCFs	792,284					
Terminal Value	3,265,491					
WACC	8.9%					
Terminal Growth rate	2.0%					
Enterprise Value	2,895,513					
Value of associates and non-core assets	16,922					
Less:						
Net debt	-903667					
Minorities	(39,000)					
Appraised value of the equity	1,945,165					
No of shares	60,000					
Share Price	32.70					

Source: Company data, Al Rajhi Capital



Figure 3: Sensitivity of DCF Price to terminal growth rate

WACC (%)	Terminal Growth Rate (%)						
	32.4	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
6.9%	39.5	43.3	47.9	53.3	60.0	68.4	
7.9%	31.7	34.5	37.6	41.3	45.6	50.9	
8.9%	25.8	27.8	30.1	32.7	35.8	39.3	
9.9%	21.2	22.7	24.5	26.4	28.6	31.1	
10.9%	17.5	18.7	20.0	21.5	23.1	25.0	

Source: Company data, Al Rajhi Capital

Figure 4: Sensitivity of relative based valuation to exit multiple

WACC (%)	Terminal EV/EBITDA Multiple (x)						
	27.3	8.5	9.5	10.5	11.5	12.5	13.5
6.9%	22.6	25.6	28.6	31.6	34.5	37.5	
7.9%	21.1	23.9	26.8	29.6	32.5	35.3	
8.9%	19.6	22.3	25.1	27.8	30.5	33.2	
9.9%	18.3	20.8	23.4	26.0	28.6	31.2	
10.9%	17.0	19.4	21.9	24.4	26.8	29.3	

Source: Company data, Al Rajhi Capital

Key Financials

Figure 5: Income Statement (SAR mn)

	2018	2019E	2020E
Revenue	1,028,050	1,226,519	1,329,132
Revenue growth%		19.3%	8.4%
COGS	(920,240)	(971,139)	(1,016,660)
Gross Income	107,810	255,381	312,472
Gross Income growth (%)		136.9%	22.4%
Gross margin (%)	10.5%	20.8%	23.5%
SGA	(265,173)	(250,000)	(250,000)
EBITDA	47,527	169,201	196,976
EBITDA Growth		256.0%	16.4%
EBITDA Margin	4.6%	13.8%	14.8%
Operating Income	(157,363)	5,381	62,472
EBIT Growth		-103.4%	1061.0%
EBIT margin	-15.3%	0.5%	6.1%
Financing Expenses	(47,540)	(50,190)	(40,844)
Investment Income	(3,036)	(3,622)	(3,925)
Net Income Before Zakat	-210,943	-51,436	14,699
Tax (Zakat)	(9,660)	2,315	(661)
Net Income	-219,801	-48,943	13,987
Growth (%)		-77.7%	-128.6%
Net margin (%)	-21.4%	-4.0%	1.1%
EPS (SAR)	-4.40	-0.82	0.23

Source: Company data, Al Rajhi Capital



Figure 6: Cashflow (SAR mn)

	2018	2019E	2020E
Cash flow from operations	151,460	109,349	151,148
CAPEX	(63,970)	(24,530)	(26,583)
Free Cashflow	139,079	170,189	257,793
Cashflow from financing	(53,240)	(70,000)	(80,000)
Change in cash	(31,290)	14,819	44,566

Source: Company data, Al Rajhi Capital

Figure 7: Balance Sheet (SAR mn)

	2018	2019E	2020E
Current Assets			
Cash & Cash Equivalents	48,008	62,827	107,392
Accounts Receivable	279,112	336,033	327,731
Inventory	706,211	665,164	643,420
Advance Payments to Suppliers	58,580	58,580	58,580
Total Current Assets	1,091,911	1,122,603	1,137,124
Non Current Assets			
Fixed Assets	1,811,386	1,672,096	1,564,174
Investment in associates	20,590	20,590	20,590
Licences	929	929	929
Total Non-Current Assets	1,832,905	1,693,615	1,585,693
Total Assets	2,924,816	2,816,218	2,722,817
Current Liabilities			
Short Term Debt	679,550	629,550	579,550
Accounts Payable	295,452	305,975	278,537
Others	8,697	38,697	58,697
Total Current Liabilities	983,699	974,222	916,784
Non-current liabilities			
Long Term Debt	352,966	302,966	252,966
Capital Lease	58,580	58,580	58,580
Provisions for Employee Termination Benefits	71,352	71,352	71,352
Total Non-current liabilities	482,898	432,898	382,898
Total Liabilities	1,466,597	1,407,120	1,299,682
Shareholders' Equity			
Paid-up Capital	600,000	600,000	600,000
Minority Interest	42,653	42,474	42,525
Legal & Statutory Reserve	218,336	218,336	218,336
Chg in Fair Val. Resv. & Translation Adj.	6,695	6,695	6,695
Retained Earnings/Accumulated losses	590,535	541,592	555,579
Total Shareholders' Equity	1,458,219	1,409,098	1,423,135
Total Liabilities & Shareholder Equity	2,924,816	2,816,218	2,722,817

Source: Company data, Al Rajhi Capital



Figure 8: Sensitivity of sanitary ware revenue to capacity utilization and price per unit (SARmn)

		Price per unit (Sanitary Ware)				
		133.64	3.0	3.4	3.8	4.2
Utilization	60%	93	105	116	130	
	69%	107	121	134	149	
	80%	123	140	155	173	
	90%	139	157	174	194	
	100%	154	175	193	216	

Source: Company data, Al Rajhi Capital

Figure 9: Sensitivity of Tiles revenue to capacity utilization and price per unit (SARmn)

		Price per unit (tile)				
		648.36	12	13	14	15
Utilization	70%	543	588	633	678	
	75%	582	630	678	727	
	77%	598	648	698	748	
	80%	620	672	724	775	
	85%	659	714	769	824	
	90%	698	756	814	872	
	95%	737	798	859	921	

Figure 10: Sensitivity of Water Heater revenue to capacity utilization and price per unit (SARmn)

		Price per unit (Water Heater)				
		246	200	220	240	260
Utilization	60%	192	211	230	250	
	70%	224	246	269	291	
	80%	256	281	307	333	
	90%	288	316	346	374	
	100%	320	351	384	416	



Overview of tiles market

Dominated by imports

The Saudi tiles market to reach SAR7.3bn

With a potential size of about SAR7.3bn, the Saudi tiles market is one of the biggest in the MENA region. The ceramic tiles market is dominated by imports which represent around 65% of the market. Saudi Ceramic has a ~22% market share, and the remaining is divided between small private Saudi companies such as Alfanaar, Future Ceramic in Dammam and Al-Jawdah Ceramic. Many of the local companies are suffering because of the lack of innovative designs that are an important feature of modern buildings. Imports, especially from Europe and US, are characterised by innovative designs, making them more attractive to people despite their high prices. However local players have off late have invested in R&D and have enhanced their product portfolio by introducing new designs, revamping their showrooms, redefining the distribution channels and investing in e-commerce which has brought them back in the game. We expect the market to grow further, driven by the Saudi government 2030 vision which leads to significant rise in infrastructure development project. The key growth driver will be the construction of multibillion dollar projects such as “Neom”, Red sea tourism project and Amaala to name a few, social housing projects, replacement demand for older houses, increasing capex in entertainment sector. The tiles include many kinds such as porcelain and ceramic tiles. Ceramics are made mainly of clay, which is extracted locally, and heated in gas kilns and mixed with other exported chemicals.

Figure 11: Flooring Products Segmentation, the GCC

Product	Segments
Tiles	Ceramic and Porcelain
Stones	Sand Stone, Lime Stone, Marble, Granite, Basalt, Slate, Quartzite etc.
Carpets	Carpets Rolls
Wood and Laminates	Engineered Wood and Solid Wood
Others	Linoleum, Vinyl, Luxury Vinyl Tiles (LVT), Rubber, Epoxy etc.

Source: Frost & Sullivan Analysis, Al Rajhi Capital

65% of the market sales are imports

Tiles are forecast to dominate the GCC market with a CAGR of 7.2% from 2016-2021 to reach 848mn sq.m and for Saudi Arabia it is expected to reach 254mn sq.m. Government’s push to increase the home ownership among Saudis, six mega projects announced by Saudi government and increasing disposable income is expected to boost the demand for tiles. The standard of living is high in Saudi Arabia and with female employment the overall income of the households have improved this has resulted in the demand for high-end residential development, thereby benefitting the tiles market in Saudi Arabia



Increasing Private spending creates a huge potential for ceramic products

Construction demand to pick up with strong visibility

Though the construction demand was subdued in 2016 and 2017 mainly due to lower oil prices which almost halted the government construction activities in Saudi Arabia, we see construction activities picking in the kingdom especially residential houses due to retail mortgages, increasing capex in the hospitality and entertainment sector. As per our calculations the total demand for tiles alone from residential projects will be ~144mn sqm in the coming three years. We believe government spending towards infra projects will also pick up and boost the demand for cements and construction materials in general. Tiles and ceramic product demand arises during the later stages of the construction cycle and thus we see a strong visibility for tiles demand in the near term due to residential houses and government projects in the longer term. As per the data available and our assumptions Neom project alone should create a demand of 75m sq.m tiles demand till the completion of phase 2 by 2025, apart from this there are 5 other mega projects which has a timeline of next 8-10 years. Along with this we are observing a increasing capex in hospitality sector where existing hotel chains are increasing their capacity to accommodate sudden spurt in tourist after Saudi Arabia started giving tourist visa to passport holders of over 49 countries. Entertainment sector is another avenue which has picked up a sudden pace in the kingdom; this sector is also experiencing a substantial capex over the last two years in terms of cinema halls, mall expansion, stadiums, restaurants, theme parks, etc. These positive developments have attracted foreign investors towards the kingdom which bodes well for the construction and ceramic sector overall. According to the ratings agency Fitch and the Saudi Contractors Authority, Saudi Arabia's construction sector is expected to see strong growth with investments of \$44 billion planned in 2019 alone. The total value of the country's infrastructure projects (buildings, industry, energy, water, oil and gas) is estimated at more than \$1.4 trillion.

Increasing government initiatives to support affordable housing, rising demand from the commercial and institutional sector such as hotels, offices, schools, colleges is also augmenting demand for sanitary ware products in a huge way.

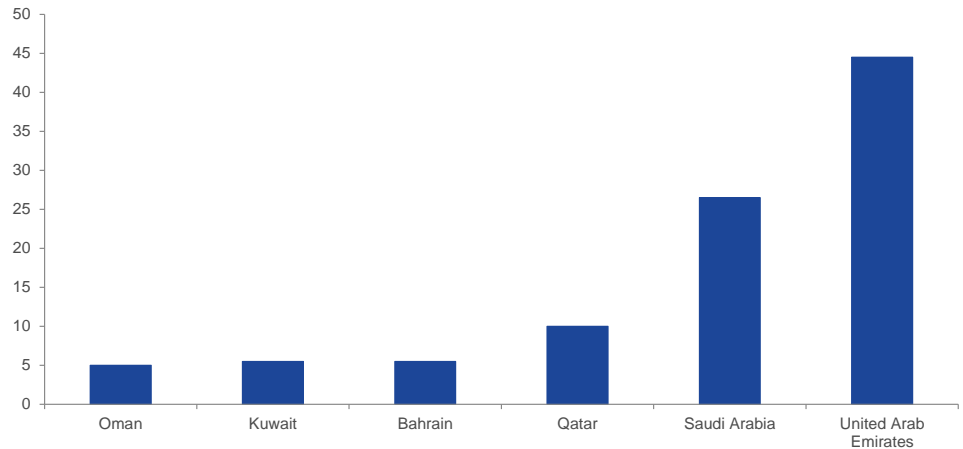
Figure 12: Potential from social housing projects in between 2018-2022e

	No of tiles (12*12 sqft) required	
Average Size of the house	165 sqm	2042
Average size of the villa	350 sqm	4332
Total number of housing*	1,000,000	
Houses	800,000	1634
Villas	200,000	1275
		2908
Total demand from social housing projects (mn sq.m)		242
SCERCO current capacity (mn sq.m)		60
SCERCO current Market Share		22%
Total potential from existing market share (mn sq.m)		53

Source: GASTAT, Company data, Al Rajhi Capital



Figure 13: Value of construction contract awards in the Gulf Cooperation Council in 2018, by country (in billion U.S. dollars)



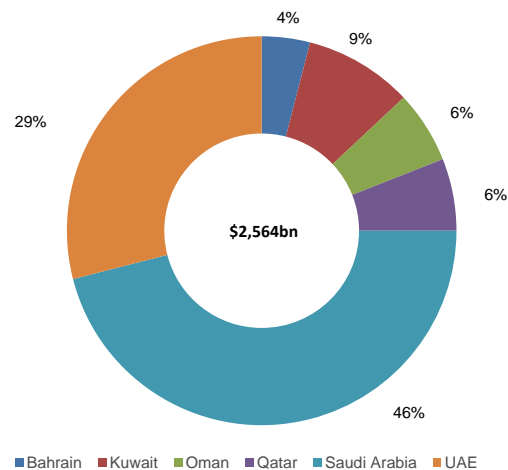
Source: Statista, Company data, Al Rajhi Capital

Total demand for ceramic tiles, porcelain and sanitary ware to reach \$257bn

Growing construction projects in GCC after a breather over the last couple of years

We believe that the oil prices in 2016 has bottomed and the current level of oil prices will sustain over the next few years which should support government spending compared to 2016 and 2017. Currently the GCC is in a position where the ceramics demand is in line with the total supply, if the regulator supports the domestic suppliers with the anti-dumping duties or any other tariffs on the imported tiles then the regional players are well placed to benefit from the existing demand as well as future demand. As on January 2019 the total pipeline for projects in entire GCC region was USD2,564bn, though the exact demand for ceramic tiles and sanitary ware is difficult to predict with this number but assuming that 10% of the total construction cost is allocated to ceramic, porcelain and bathroom fittings the total demand could be worth USD257bn in the coming years as these projects near to completion.

Figure 14: Project pipeline in the GCC, by country, as of January 2019 (\$bn)



Source: Deloitte GCC Powers of construction, Al Rajhi Capital



The demand to improve due to increasing construction as well as consumer spending

Saudi Ceramics

Opportunities foster amidst challenges with positive outlook

Saudi ceramics is the second largest ceramic producer in the entire GCC region. The company has a diversified manufacturing capacity with ~60mn.sqm of tiles, 67k tons of sanitary ware and ~2mn units of water heater. The company commissioned its red bricks factory in FY2016 which has a capacity of 264k tons.

The company has been facing a stiff competition from cheaper ceramic imports specially from India, China and Spain. In order to stay in the market it reduced its product prices in the past which in a muted demand environment of 2016 and 2017 (in 2017 the government projects were almost at halt due to falling oil prices) shrunk the company's top-line and bottom line significantly. Almost 64% of the total tiles demand was met from imports in 2018 and India accounted for ~45% of the total import demand of Saudi Arabia.

Figure 15: Top Importing Countries

Country	2014 (Sq.m, mn)	2015 (Sq.m, mn)	2016 (Sq.m, mn)	2017 (Sq.m, mn)	2018 (Sq.m, mn)	% on 2018 national consumption	% on 2018 world imports	% var. 18/17
USA	164	179	194	202	209	72.3%	7.6%	3.5%
Iraq	102	106	112	129	124	98.4%	4.5%	-3.9%
Saudi Arabia	156	188	167	131	113	64.2%	4.1%	-13.7%
France	99	99	104	112	108	87.8%	3.9%	-3.6%
Germany	95	100	115	109	106	87.6%	3.9%	-2.8%
Philippines	53	60	75	82	91	69.5%	3.3%	11.0%
Indonesia	46	45	57	64	77	17.1%	2.8%	20.3%
South Korea	76	72	75	78	77	66.4%	2.8%	-1.3%
Israel	44	52	57	58	61	93.8%	2.2%	5.2%
Thailand	49	56	54	55	57	31.1%	2.1%	3.6%
Total	884	957	1,010	1,020	1,023	64.2%	37.3%	0.3%
Total World	2,705	2,746	2,788	2,752	2,745	21.4%	100.0%	-0.3%

Source: CERSAIE 2019, Al Rajhi Capital

Figure 16: Top Exporting Countries

Country	2015 (Sq.m, mn)	2016 (Sq.m, mn)	2017 (Sq.m, mn)	2018 (Sq.m, mn)	% on 2018 national production	% on 2018 world exports	% var 18/17	Value 2018 (mn €)	Average export price (€/sq.m)
China	1,089	1,025	908	854	15.0%	31.1%	-5.9%	3,756	4.4
Spain	378	395	407	414	78.1%	15.1%	1.7%	2,729	6.6
Italy	316	332	338	328	78.8%	11.9%	-3.0%	4,547	13.9
India	134	186	228	274	23.9%	10.0%	20.2%	859	3.1
Iran	112	126	148	151	39.4%	5.5%	2.0%	361	2.4
Brazil	77	94	90	100	12.6%	3.6%	11.2%	398	4
Turkey	77	81	93	100	29.9%	3.6%	7.8%	506	5.1
Mexico	61	56	53	46	17.8%	1.7%	-13.2%	237	5.2
Poland	42	46	45	43	28.7%	1.6%	-4.4%	265	6.2
United Arab Emirates	54	48	46	42	60.9%	1.5%	-8.7%	171	4.1
Total	2,340	2,389	2,356	2,352	22.6%	85.6%	-0.2%		
Total World	2,746	2,788	2,752	2,749	21.0%	100.0%	-0.1%		

Source: CERSAIE 2019, Al Rajhi Capital

Drop in oil prices led to reduced government spending towards infrastructure or we can say most of the government projects were on hold. On the consumer front also the spending was weak and expat exodus led to the overall slump in the housing demand in the kingdom. However we believe that the worst is behind us and the announcement of mega government projects such as "Neom" and "red sea project" along with social housing program should benefit the overall construction sector.



Social housing projects to drive demand in near term

Social housing projects to drive demand from private sector

There is a significant increase in the mortgage contracts over the last one year with 5000 new contracts in Q2 2018 to over 15000 contracts in Q2 2019. Though there are concerns about the sustainability of mortgage contracts we believe there is still abundant potential to be tapped. As per the ministry 1mn residential homes are expected to be made by 2022 from 2017 which indicates the housing penetration rate might increase to 57% from 47% currently. With so much housing demand comes the need for tiles, porcelain, bathroom fittings and ceramics. As per our calculations the overall social housing program is expected to create a demand for 143mn sqm of tiles. Since the tiles are used in the mid to later stages of construction and as per our understanding that is the reason for increase in company's top-line growth for H1 2019. In tiles segment SCERCO has a market share of 22% and we feel there are no headwinds in terms of volume growth, the key concern regarding the pricing will be resolved as the company is focusing on product differentiation and reducing the cost. In this regard company has tested local materials to be used as a raw material for the finished products; this will help the company in reducing the COGS going forward.

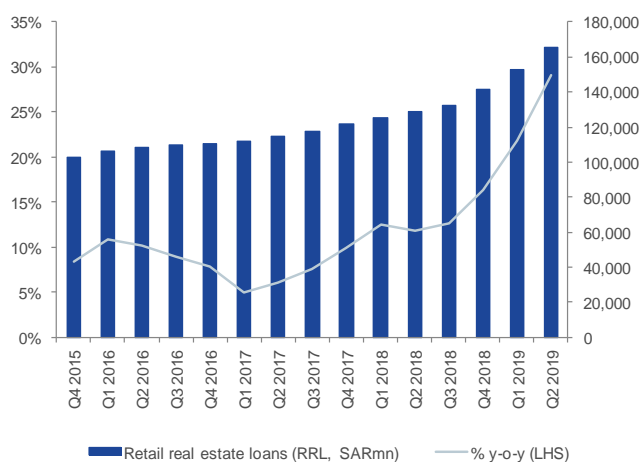
In Sanitary ware, the company has a market share of ~40% and as per our calculations ~ the revenue contribution from Sanitary ware segments was ~15% in 2018 and we believe that this segment will help in restoring the gross margins back to 20-22% over the coming three years.

Figure 17: Mortgage market

	2017	Q1 18	Q2 18	Q3 18	2018	Q1 19	Q2 19	Q3 19E	2019E	Q1 20E	Q2 20E	Q3 20E	2020E	2021E	2022E	2023E
Population																
Saudi Arabia population (mn)	32.6	32.7	32.9	33.0	33.2	33.4	33.5	33.7	33.9	34.0	34.2	34.4	34.5	35.2	35.9	36.7
Expats population (mn)	9.3	8.7	8.2	8.2	8.0	8.0	8.4	8.3	8.1	8.2	8.5	8.5	8.3	8.5	8.6	8.8
Saudi local population (mn)	23.3	24.1	24.7	24.9	25.2	25.3	25.2	25.4	25.7	25.8	25.7	25.9	26.3	26.8	27.3	27.9
Family size	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Mortgage market size (SARbn)	290	296	302	307	317	331	346	372	398	424	450	476	502	583	676	783
New retail housing loans (SARbn)		6.0	5.7	5.6	9.7	13.9	15.3	16.7	18.7	20.8	23.0	25.3	26.0	80.7	93.0	107.0

Source: IMF, Vision2030, Bupa Presentation, Al Rajhi Capital

Figure 18: Retail real estate loan



Source: SAMA, Al Rajhi Capital



Figure 19: Calculation of tiles requirement from social housing projects

	Apartments	Villas
Number of Units	800000	200000
Average Size (sq.m)	165	350
Demand for flooring material	132	70
Assuming 75% of the total flooring material is tiles (mn sq.m)	99	53

Source: Company data, Al Rajhi Capital

Market for energy efficient water heater is increasing

Increasing Opportunities in sanitary ware and water heater space

As per an article published by the chain magazine dated 15th January 2019 the sanitary ware market in Saudi Arabia is expected to reach SAR1.1bn by 2023 mainly due to increase in housing demand, home renovation due to rising household income amid female employment, increasing number of resorts and hotels. The company increased the manufacturing capacity of its sanitary wares from 40mn kgs to 67mn kgs and has introduced latest designs in its product portfolio to keep in pace with the modern housing requirements, earlier company was facing issues as its products lagged latest designs compared to imported products and this led to a fall in demand for company's product. As per our calculations we expect the revenue contribution from sanitary ware and water heater to reach 45% by 2021E which will enhance the company's margin.

The water heater (geyser and alike) market in Saudi Arabia is expected to be around SAR600mn in 2019 driven by rapid urbanization, very cold winters, rising population and increasing number of dwellings. On the commercial side the expanding tourism industry due to rising religious tourism as well as leisure tourism is expected to create a significant demand for the water heaters. Saudi ceramics is one of the key players in the water heater segment and based on our local research we found there is good demand for the company's product. Saudi ceramics currently has ~2mn capacity for water heaters and has a huge scope to increase its market penetration.

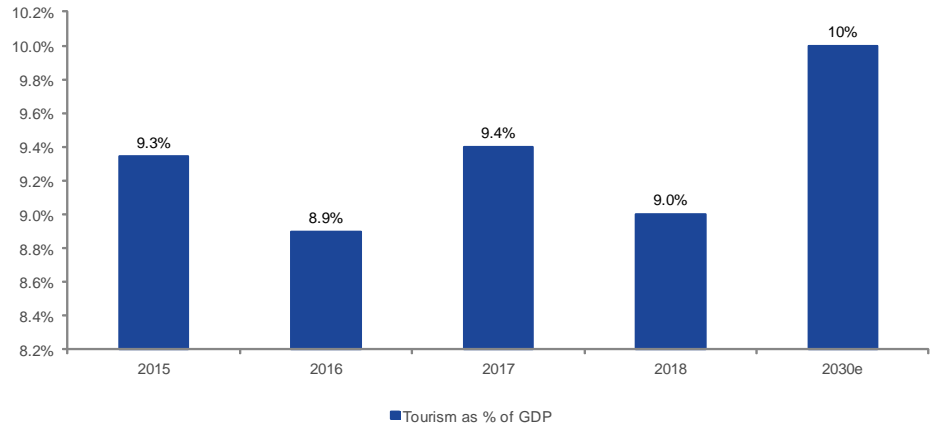
Rapid development in entertainment sector has resulted in increasing construction activities which will drive the demand for ceramic products

Increasing capex in tourism and entertainment sector

Over the last few years the entire Saudi Arabia has witnessed a lot of social reforms right from granting of female driving license, opening of cinemas to the granting of tourist visas. These changes have led to enormous expansion opportunities in the retail space, the entertainment industry is still in nascent stages and major players such as Majed Al Futtaim group, Arabian centres and Alhokair group have taken a giant leap to harness this potential by announcing mega capex plans covering the next 4-5 years. This is expected to create a strong demand for the ceramic products in the kingdom amidst increasing construction activities. Due to recent tourist visa and the expected increase in religious tourist as the government intends to increase the number of tourist to 30mn as one of the goals of vision 2030 there is a significant demand for hotels, recently some of the large hotel chains such as Radisson blue has announced that it will be adding 20 more hotels leading to an addition of 10,000 rooms by 2021e. Hilton hotels also announced its intention to add substantial hotel rooms over the next few years. This is one such example and it speaks volumes about the growth prospect in the tourism industry which international players are expecting in the kingdom over the next 10 years due to implementation of vision 2030.



Figure 20: Tourism as % of GDP



Source: Company data, Al Rajhi Capital

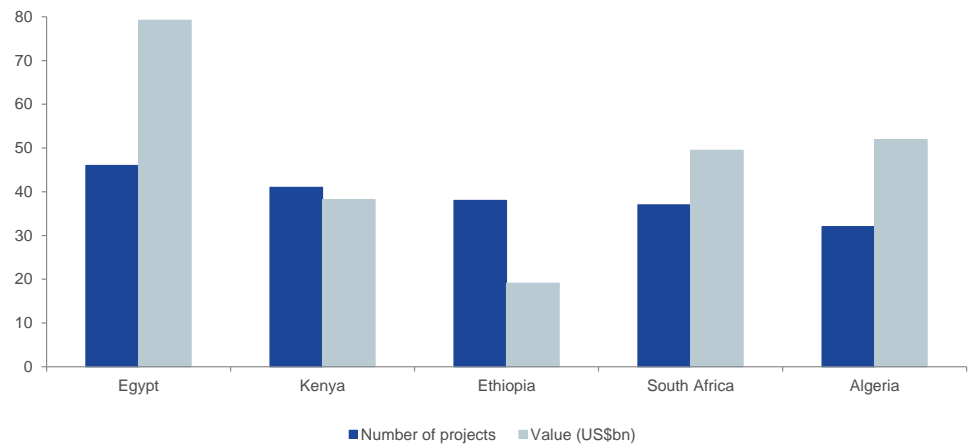
Real estate boom in African countries provides an opportunity to export

Export opportunities to neighbouring countries:

According to the Africa Construction Trends 2018 analysis by Deloitte in 2018, Africa saw a construction boom with the number of projects increasing 60% from 303 to 482 reaching a total value of USD471bn (+53% y-o-y). Since the tiles demand arises later during the construction cycle we believe that Africa provides a strong opportunity for ceramic producers worldwide. In 2017 the total tiles consumption in the region reached 920mn sqm registering a CAGR growth of 8.9% in between 2008-2017. The local production reached 700mn sqm in 2017, as per our calculations we estimate the total tiles demand to reach 1415mn sqm by 2022e and the local production to be 1101mn sqm by 2020e, thereby creating an export opportunity of deficit 314mn sqm. At present ~70% of the total import requirements in Africa are met by India, China and Spain but due to environmental concerns in India and China, a lot of ceramics factories are facing regulatory issues. In fact earlier this year National Green Tribunal of India ordered the shutdown of ceramics factories citing environmental reasons, we believe this will create serious challenges for the Indian tiles manufacturer as operating on cleaner sources of fuel will increase their cost significantly and make export expensive. Further, the real estate demand was subdued in India over the last few years which resulted in a surplus supply of tiles in India. However industry experts believe the real estate market to pick up in India partially due to increase in fund inflows to alternative investments as the equity markets are currently in a bad shape. We believe that the gap between supply and demand in India will reduce due to the reasons explained above which will reduce the import from India to the world. This in turn provides a significant opportunity for Saudi ceramics to increase their export revenue in Africa as the Indian players will channel their production towards the domestic demand. In 2018 the company's export revenue (export revenue consisted of ~14% of the total revenue) improved as the company added new market in 2018 and it started exporting to Egypt which has highest number of pipeline (including awarded) projects among the African countries in terms of value of the projects standing at USD79.2bn as on 2018.



Figure 21: Top 5 African countries by value of projects (Egypt has the highest number of projects by value and Saudi ceramics has started exporting to Egypt)



Source: Company data, Al Rajhi Capital

Over 500,000 houses are older than 30 years which requires renovation

Replacement demand for older houses

As per the data released by GASTAT below the number of houses which are older than 30 years is 550,520 and in between 20-30 years old are 794,169. As per figure 22 below, on an average the life cycle of carpets and laminates are below 10 years and tiles is little close to 20 years and marbles over 40 years. Most of the older houses in Saudi Arabia have tiles, carpets and wooden flooring. Assuming 70% of the houses older than 30 years and 40% of the houses aged in between 20-30 years are up for renovation there will be huge demand for flooring materials. Accordingly these older houses will also create a demand for sanitary ware and bathroom pods.

Figure 22: Number of Dwellings (Occupied with Saudi Households) by approximate age of dwelling

Administrative Region	Total	Older than 30 yrs	Older than 20-30 yrs	Older than 10-20 yrs
Riyadh	850419	124766	167158	295591
Makkah	896168	160455	251317	260927
Medina	248601	19579	44041	68435
Al-Qassim	166565	22961	26365	46774
Eastern Region	513886	98645	123814	163074
Asir	307016	31735	59757	98850
Tabuk	120843	12887	14274	36996
Hail	79785	13752	13681	24051
Northern Borders	37288	9888	9149	9613
Jazan	177131	32643	45132	53703
Najran	68122	7201	10335	18225
Al-Baha	67692	7696	15779	22337
Al-Jouf	57582	8312	13367	17987
Total	3591098	550520	794169	1116563

Source: GASTAT, Al Rajhi Capital

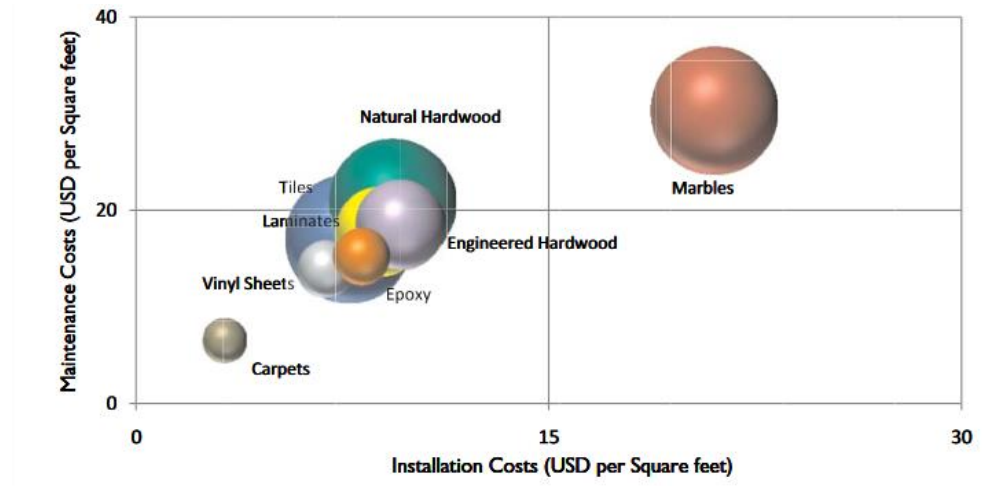


Figure 23: Replacement demand over the next 5-6 years

	Houses Older than 30 years	20-30 years	10-20 years
	550520	794169	1116563
Probability of replacement	70%	40%	15%
Houses up for renovation	385364	317668	167484
Average Size in sq m	350	300	280
Replacement demand (mn sq.m)	1349	953	469

Source: Company data, Al Rajhi Capital

Figure 24: Flooring products - Life cycle cost analysis, Global



Source: Tile Council of North America (the bubble represents the life cycle)

Anti-dumping duty if implemented on Indian ceramic manufacturers a big plus for the company:

Anti-dumping duty if implemented will improve the timeline of profitability

In November 2018 the local ceramic manufacturers filed a petition to the government to impose an anti-dumping duty on importers from India and china as they are dumping the cheaper tiles and disrupting the local markets. Till now the petition is under scrutiny and any update in this regard is expected to be out in another two months. On the other hand ceramic manufacturers in India are facing shutdown due to environmental reasons, we believe these two factors should be positive for local players such as Saudi ceramics. There was news in the Indian Ceramic market that GCC might impose an anti-dumping duty of 15% on Indian ceramic importers, if this happens then it is a big plus for the local manufacturers.

In 2018 Saudi Arabia imported 113mn sq.m which was ~64% of the total domestic demand this implies the total tiles demand of 174mn sq.m. Saudi Ceramics has a total operational capacity of ~66mn sq.m and is currently operating at a 80% capacity.

In fig 25 below we have estimated the impact of anti-dumping duty at various scenarios on the company's profitability. We have assumed that SCERCO's price is similar to Indian tiles importers and any increase in price of Indian tiles will make Saudi ceramic's tiles attractive



and thus company will operate at its full operational capacity of 50mn sq.m. Therefore any positive move by the government regarding the levy of anti-dumping duties shall support the bottom-line of the company and push it towards profitability. We are bullish on the near term demand from the home construction and renovation due to government housing projects in the kingdom. In the medium to long term the demand will due to various government projects such as Neom city, Red Sea project and the likes.

Figure 25: Impacts of Tariffs on Saudi Ceramics Profitability (SARmn)

	Duty @ 15%	Duty @ 20%	Duty @ 25%
Export Price of tiles from India post fuel price adjustment	14.29	14.29	14.29
Price post anti dumping duty	16.43	17.15	17.86
Incremental Profit per sq.m	3.20	3.92	4.63
SERCO operational Capacity (mn sq.m)	50.00	50.00	50.00
Total incremental revenue assuming 100% capacity utilization	160.08	195.80	231.53
TTM Profits	-164.00	-164.00	-164.00
New Profit	-3.92	31.80	67.53
New EPS	NA	0.53	1.13

Source: Company data, Al Rajhi Capital

Increasing regulatory issues faced by Indian and Chinese ceramic manufacturers will disrupt the import supply

Increasing cost and regulatory issues faced by Indian and Chinese ceramic manufacturers:

The biggest challenge which the local ceramic players were facing was from cheaper alternatives from India and china. In 2018, ~65% of the total tiles demand was imported and India alone accounted for 40% of the total demands of Saudi Arabia.

Why the ceramics from India and China are so cheaper?

There were few reasons which played in favour of Indian ceramic players

a) Indian government support in the form of export subsidy to the local manufacturers to improve export revenue.

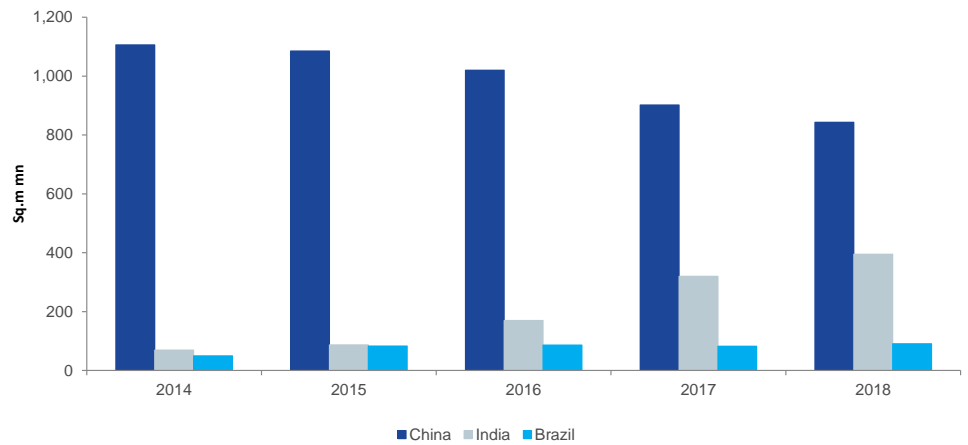
b) Post GST era the rates on ceramic products were reduced from 28% to 18%, this further reduced the export price of Indian tiles. This benefit was passed on to the consumers in terms of lowering the prices.

c) India has witnessed a slump in construction demand over the last few years which led to an excess production.

However as per the news article published by Times of India in March 2019 NGT (national green tribunal) ordered the shutdown of all the factories operating in ceramic cluster at Morbi and Wankaner which operates on coal gasifier. This is a big blow to small players operating in the clusters as they have two options either to shut down or switch over to CNG/LNG. As per the reports ~550 out of 1000 manufacturing units have been shut down and since using gas requires construction of appropriate infrastructure it will take time and cost for the smaller players to resume production. On the other hand switching to gas will increase their fuel cost (in India the cost of piped gas currently is USD 9.5/mmbtu), apart from this the excess supply will also reduce and there will be less exports to other countries. This auger well for local tiles manufacturers in Saudi Arabia. In 2017 end some of the Chinese ceramic producers had to shut down due to environmental reasons and this had an impact on the Chinese ceramics supplies. The export from China has reduced from 908mn sq.m in 2017 to 854mn sq.m in 2018.



Figure 26: Excess production of tiles in China, India and Brazil.



Source: Ceramic word review 2019, Al Rajhi Capital

Saudi Ceramics can go for future capex to supply to government demand

Government projects to help the case of future capex

All the key government projects are required to give a preference to local companies and pricing is also better for government projects, therefore we believe that the pricing issues which the company was facing in the past will ease in future with government projects taking a pace. For 2019 budget allocation, the capex is budgeted to be SAR246bn, the key sectors where these funds will be spent are:

Education- It is one of the most important pillar of Saudi vision 2030 and government's spending towards education has been of prime importance in the last few years. Over 2017-2019 government planned to complete the construction of 1069 schools, out of this 315 schools are still under construction and provides strong potential for the ceramics and sanitary ware market.

Healthcare- The government intends to build 35 new hospitals in 2019, the average size of an hospital in Saudi Arabia with 400 beds should be ~10,000-15000 sqm. With this assumption on an average 525000 sqm of additional space is to be constructed which should create the demand for construction materials in near term. Assuming that 1sqm of space requires 10 tiles and ~75% of the total flooring material are either ceramic or porcelain tiles the total demand comes to ~4mn tiles.

Infrastructure- Apart from mega projects like Neom, Red Sea, the Riyadh metro project, up gradation of King Abdulaziz international airport in Jeddah and construction of other airports in the kingdom are some of the projects where the construction is in final phases and will lead to an immediate demand for ceramics and sanitary ware.

New product launches to enhance the margins

Change in strategy and new product launches are margin accretive..

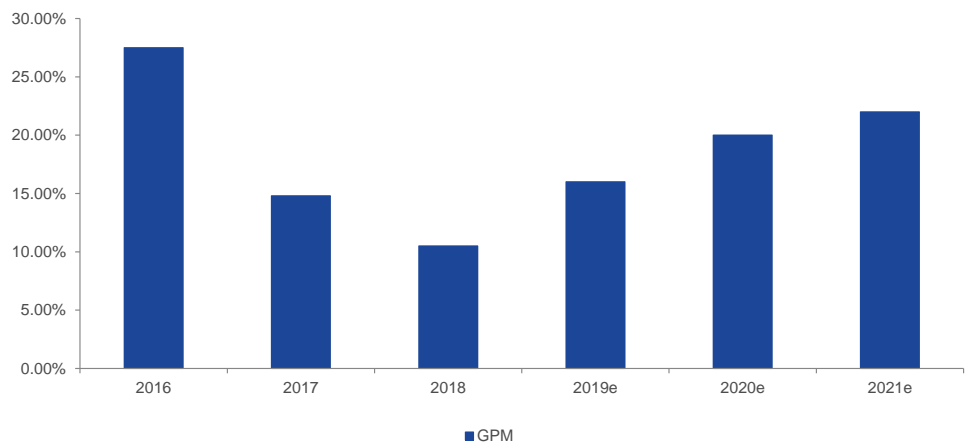
Earlier the company's products used to lag behind in designs and pricing compared to the tiles imported from international market, however we learned after speaking from the management that they are currently focusing on design, quality and pricing to compete with the international players. We could see that unfolding in the company's last two quarterly results where the top-line grew 17% y-o-y. In 2018 ~70% of the total revenue was derived from wholesale which is a low margin business. However currently the company is focusing to increase its retail presence through showrooms and e-commerce, it has invested heavily on



the online website. At present there are 36 showrooms operated by the company and we expect this number to reach 50 by the end of 2020e. We believe that this strategy will help the company in eliminating dealers and other middle men commissions and will support the gross margins. Saudi Ceramics has recently invested in changing the design for its products and launching new products named bathroom pods where it will be designing the bathrooms for the modern houses. These products currently don't face any competition and company can charge a higher margin in this segment. In entire Sanitary ware segment there is a change in the product design to match the current market demand regarding premium products. These new product offerings are in the nature of margin accretion from company's perspective.

We expect the company to deliver double digit growth in near to intermediate term and high single digit growth in the long term. As per our calculations we estimate the gross margins to improve to 23% by 2020e from 10.5% in 2018.

Figure 27: GPM to increase after bottoming out in 2018.



Source: Company data, Al Rajhi Capital

Company is currently not doing any capex which will reduce the debt levels

Deleveraging will reduce the debt levels and will support the net margins in future

The company increased its sanitary ware capacity from 40mn kgs to 67mn kgs in 2017; the new factory which was constructed in 2017 has a current capacity utilization rate of 40%. With the growing demand the company can easily increase its production without further capex requirement. The new stores will be on lease rentals and we believe that the less capex requirement will reduce the need for borrowing. Further we believe that the strategy to improve the revenue mix from directly selling to the customers will improve the cash flow for the company as they get immediate payment which reduces the need for working capital and releases the cash in the business. Therefore low debt levels in future will support the net margins positively and will push the valuations upwards.

Valuation: We use equal mix of DCF and relative valuation using EV/EBIDTA of 11.5x as the exit multiple to value SCERCO since the earnings are currently depressed. In near term the recovery in earnings might be tepid but we are very bullish on the medium term growth due to increasing residential housing and long term growth due to mega projects in the kingdom. Though we understand that the key risk for the company is cheaper imports especially from India but this risk is mitigated by the company to some extent by lowering the prices for standard tiles and product differentiation in case of designer tiles and sanitary wares. We believe that outlook for the tiles, sanitary ware and water heater market is very positive over the next decade. Therefore reflecting the future growth our DCF based target is



SAR32.4 and relative valuation target price based on 11.5x exit multiple stands at SAR28 and the equal weighted target price stands at SAR30 implying 26% upside from current market price of SAR23.90.

Downside Risk: There are few downside risks to our valuations and assumptions

a) Any delay in government spending towards residential and commercial projects will impact the company negatively. The gross margins will continue at the current levels and the timeline of overall profitability will increase.

b) Faster than expected revamping of small tiles manufacturers in Morbid region of Gujrat India will again increase the number of tiles imported from India. This will impact the Saudi Ceramics tiles sales specially the retail sales.

c) If the company is not able to reschedule its debt in favourable terms then it will impact the company negatively in terms of rising interest cost and net margins will be adversely impacted.

d) The fuel cost is currently 8% of the total revenue, if there is any increase in fuel cost then it will impact the bottom-line of the company and the time-line of the profitability will increase.



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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.

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