Cement Sector

We maintain our cautious outlook on the sector. Sector to remain under pressure for FY19, on expectation of even weaker cement dispatches. Cement demand is yet to see a reversal, as the announced projects (Red Sea and NEOM) are expected to commence by end of next year. In addition, buildup in inventories and lower demand raises ST provision concerns. The lack of visibility on the current economic reforms, along with fuel subsidy cut are the downside risk. Fuel prices hikes would also increase shipping cost of the companies. Small players in low demand region will have difficulty in reducing their inventories. We revised our TP for the companies under coverage, while maintaining our "Neutral" recommendation on the sector. We place Arabian Cement "Under Review" until we have more clarity on the company.

Earnings were a negative surprise as demand declined. Cement companies started to sell at loss in order to gain market share, a sign of continuation of weak fundamentals.

Cement sector recorded a net loss, in Q2-18, of SAR 47.9mn compared to net profit of SAR 444.7mn a year earlier. Out of 14 listed companies, 7 companies announced a net loss for the quarter. The rest of the companies showed a decline in the range of 20.0% - 97.6%.

Total revenue showed a decline of 24.1%Y/Y, while cement dispatches declined by 0.5%Y/Y in Q2-18 (including exports). Average realization price per tonne declined significantly in Q2-18 as result of intense competition. Average selling price for the sector stood at SAR 140.4/tonne in Q2-18, a decline from SAR 180.8/tonne in Q2-17. While cost per tonne showed a modest decline to SAR131/tonne, hence GP margin for the sector has declined to 6.9% in Q2-18 from 27.1% in Q2-17. Selling prices are expected to remain under pressure as long as the competition remains intense.

Table 1: Combined revenue and dispatches

	Central Region			Eastern Region			Southern Region			Western Region			Northern Region		
	Q2-17	Q2-18	Change %	Q2-17	Q2-18	Change %	Q2-17	Q2-18	Change %	Q2-17	Q2-18	Change %	Q2-17	Q2-18	Change %
Revenu (SAR mn)	447.1	270.1	-39.6%	365.2	346.6	-5.1%	320.8	233.1	-27.3%	475.6	336.3	-29.3%	178.1	169.9	-4.6%
Dispatches ('000)	2883	2232	-22.6%	1720	1935	12.5%	1696	1639	-3.4%	2286	2413	5.6%	1030	1442	40.0%
Price (SAR)	155.1	121.0	-22.0%	212.3	179.1	-15.6%	189.1	142.3	-24.8%	208.0	139.4	-33.0%	172.9	117.8	-31.8%

Source: Company Reports, Aljazira Capital

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Cement Sector

Government's capital spending has been, and will remain, the key driver for the sector. The government reduced its capital spending for the last couple of years, resulting in weak demand. Housing, a key driver for the sector, is facing a downtrend and is yet to see a reversal.

The government announced an increase in capital spending by 13.9%Y/Y in FY18; allocating almost SAR 205bn, from SAR 180bn in FY17. It is worth to mention that there is a lag between government spending and the impact on cement demand. Based on the current scenario, we can't clearly estimate the time period for the impact to materialize. However, historically it usually has taken 12-18 months. The government budget usually is back loaded, as most of the major capital spending is expected during the fourth quarter. Therefore, the positive impact is expected to materialize in FY20. In addition, Public Investment Fund (PIF) will provide the needed funding for Red Sea and NEOM projects. According to PIF the cornerstone of Red Sea and NEOM projects will be laid in Q3-19 and Q4-19 respectively.

Capital spending and progression of mega projects should be monitored as key drivers. Housing construction is another key driver for the sector which is also facing a downtrend. Even with Ministry of Housing objectives, the visibility remains low.

Most of the Ongoing mega projects have reached completion phase, hence reducing cement demand. New mega projects are expected to replace these old projects in the mid-term.

Table 2: Growth in Capital Spending and Cement Dispatches (%)

	2011	2012	2013	2014	2015	2016	2017	2018E
Capital Spending	38.9	-5.3	0.5	21.5	-34.2	-36.2	34.2	13.9
Cement Dispatches	13.5	14.5	3.3	2.8	7.4	-9.4	-15.1	-12.0

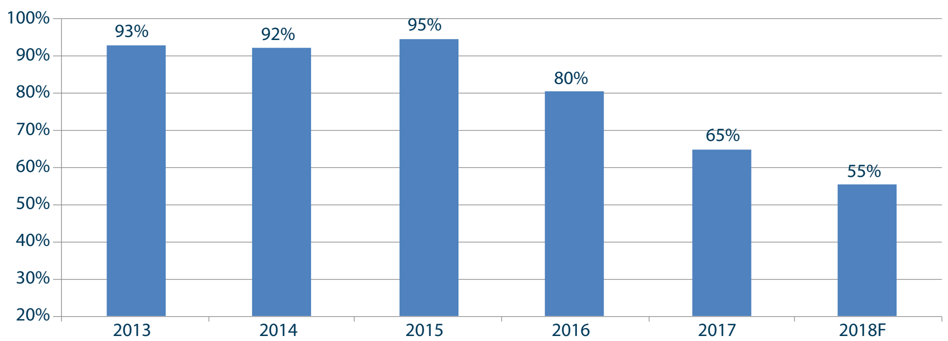
Source: Yamama Cement, Aljazira Capital

Based on that, we expect cement sector to remain under pressure in FY19, continuing its decline dispatches. Growth in dispatches is expected to pick up in FY20, on the back of higher capital spending and mega projects.

Clinker inventory increased by 14.9% this year through September, reaching historical high of 40.94MT. It is expected to continue its buildup, as sales to production remains low.

Based on our calculation, clinker inventories as percentage of the total designed capacity stood at 54.2% by end of September. Despite the increase in clinker exports, inventories continued to build up due to low sales/production ratio at 0.93 (including exports) through this year. We expect local sales of cement to decline by 12%-15% this year, depicting a utilization rate of 53.5%-55.3%. Utilization rate has declined significantly in last few months, as result of slowdown in construction activity, currently standing at 59.8% based on TTM dispatches.

Figure 1: Utilization Rate*



Source: Yamama Cement, Aljazira Capital
*Based on average capacity.

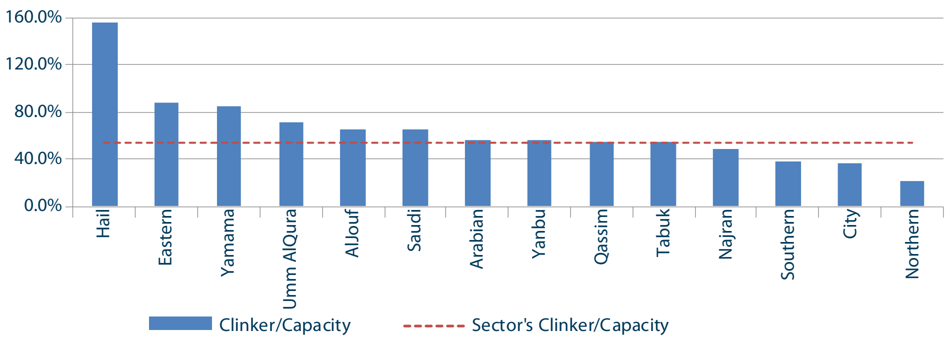
Utilization rate declined significantly in the light of lower demand, while production capacity has increased.

In 2015 dispatches stood at 61.4MT, its historical high. This peak is 18.7% lower than current capacity, which indicates that a reduction in capacity is needed.

Inventories will continue to build up in the short/midterm. Hail Cement recorded the highest inventories as percentage of designed capacity, while Northern Cement recorded low inventories level. At current rate, inventories will exceed current year's dispatches. Oversupply and high level of inventories will keep the sector under pressure.

Even if demand starts to pick up, inventories and high competition will keep selling prices under pressure. The sector is oversupplied in term of capacity and participants; a consolidation is needed in the sector, to reduce current competition. If cement dispatches continue to decline next year, which we expect, it should see consolidation by then.

Figure 2: Clinker Inventory as % of cement capacity



Source: Yamama Cement, Aljazira Capital

Clinker inventories remain a short term concern with a high concern of provisions. Clinker inventory of Hail Cement has exceeded its cement capacity by 56%. Northern Cement recorded the lowest clinker inventory to total cement capacity at 22%. The company benefits from exports and has managed to decrease its inventories by 31% this year.

Expected decline in dispatches, low utilization rate and weak price realization are priced in. The sector is trading at EV/EBITDA of 11.48x compared to 11.22x for the market. Yamama Cement EV/EBITDA is the highest amongst our coverage, partially due to its high level of debt.

The sector's multiples are in line compared to the market, but above 3-years average of 9.69x, that been said the companies under coverage are in line with historical average (except for Yamama Cement). Saudi Cement, Qassim Cement and Southern Cement are top three companies in terms of ROE, while the rest of our coverage recorded ROE of 4.8% or lower. We upgrade our recommendation on Yanbu Cement and Eastern Cement to "Neutral" and "Overweight" due to recent decline in the market. We place Arabian Cement "Under Review" until we have more clarity on the company. We maintain our "Neutral" recommendation for the rest of the coverage.

Yamama Cement FCF for FY17 stood at SAR -1.1bn on the back of high CAPEX for construction of company's new plant. The company announced it will finance its CAPEX through debt. By building new plant the company will lose its competitive advantage of its current location, which potentially will result in higher shipping costs. The current market conditions of rising interest rate at a higher debt burden, the company might face some difficulties in fulfilling its debt obligations. We should note that we did not incorporate the proceeds from land sales in our valuation

	Recommendation	PT	EPS		Fwd. PE	EV/EBITDA	FCF Yield (%)	ROE	Div Yld (%)
			FY18E	FY19E					
Saudi Cement	Neutral	40.2	2.13	1.58	17.9	10.2	7.1	15.01	5.9
Yanbu Cement	Neutral	19.2	0.33	0.42	61.8	9.3	9.6	4.84	3.7
Yamama Cement	Neutral	12.6	-0.29	-0.09	NM**	15.2	-52.6	0.99	-
Southern Cement	Neutral	31.9	1.35	1.02	24.4	9.7	9.5	9.67	4.5
Arabian Cement	Under Review	NA*	-1.34	-0.81	NM**	9.7	1.2	2.36	-
Qassim Cement	Neutral	31.2	1.29	1.15	27.0	9.2	9.8	11.32	4.3
City Cement	Neutral	9.3	0.27	0.18	33.6	7.6	5.7	3.77	2.2
Eastern Cement	Overweight	21.4	0.73	0.68	25.0	8.6	3.4	2.60	5.5

Source: Bloomberg, Aljazira Capital, Prices as of 18th of October
*Not Applicable ** Not meaningful

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RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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