Initiation of Coverage Report

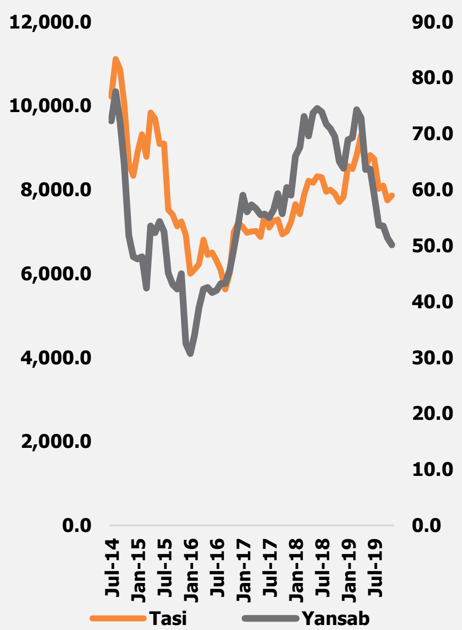
Yanbu National Petrochemicals Co.

The decline in petrochemical prices, especially Mono Ethylene Glycol (MEG), had a severe impact on Yansab's top line during 2019. However, the improvement in the company's financial position provides room for potential investment opportunities. We believe that Yansab's profitability will remain unstable due to the blurred vision of the trade dispute between China and the USA.

05 February 2020

Recommendation	Neutral
Current Price (04-02-2020)	SAR51.4
Target Price (52 Weeks)	SAR49.2
Upside/ (Downside)	(4.3%)
Shariah Compliance	Pass

Reuters Code	2290.SE
Bloomberg Code	YANSAB: AB
52 Weeks High	SAR75.0
52 Weeks Low	SAR48.5
Market Cap	SAR28.9bn
P/E	26.6
EPS	SAR1.9
Dividends	SAR3.5
AVG Value Traded	SAR0.9bn



Key Points

We initiate our coverage for Yansab with a NEUTRAL recommendation and 52 weeks target price at SAR49.2; this represents a downside potential of 4.3%.

- Since the US-China trade war in March 2018, the macroeconomy has been significantly impacted, which was reflected in many manufacturing industries globally. The trade tensions started when the USA imposed tariffs on Chinese products, after which China (the largest petrochemical importer) responded in kind.
- The trade war caused an accumulation of Chinese products in global ports due to their relatively high prices, which resulted in a drop in the demand for petrochemical products. Meanwhile, the US increased its petrochemical plants in an attempt to reduce its imports and invade both Asian and European markets.
- The imbalance in the supply and demand on petrochemicals/ products resulted in a significant decline in global petrochemical prices during 2019, unlike oil prices (historically known to be of high correlation with oil prices).
- Yansab net income decreased by 54.9% Y-o-Y during 2019 due to a decrease in global petrochemical prices (especially MEG), coupled with an accounting provision related to the costs of capital work in progress by SAR71mn.
- We expect that the demand from China (Yansab's primary importer) will provide short-term relief for Yansab. However, the increased competition with the US will continue to pressure petrochemical prices in the long-term, and hence, Yansab's profitability.

Key Growth Catalysts

- Government Support for Petrochemical Industry.
- Improvement in Liquidity.

Key Risk Factors

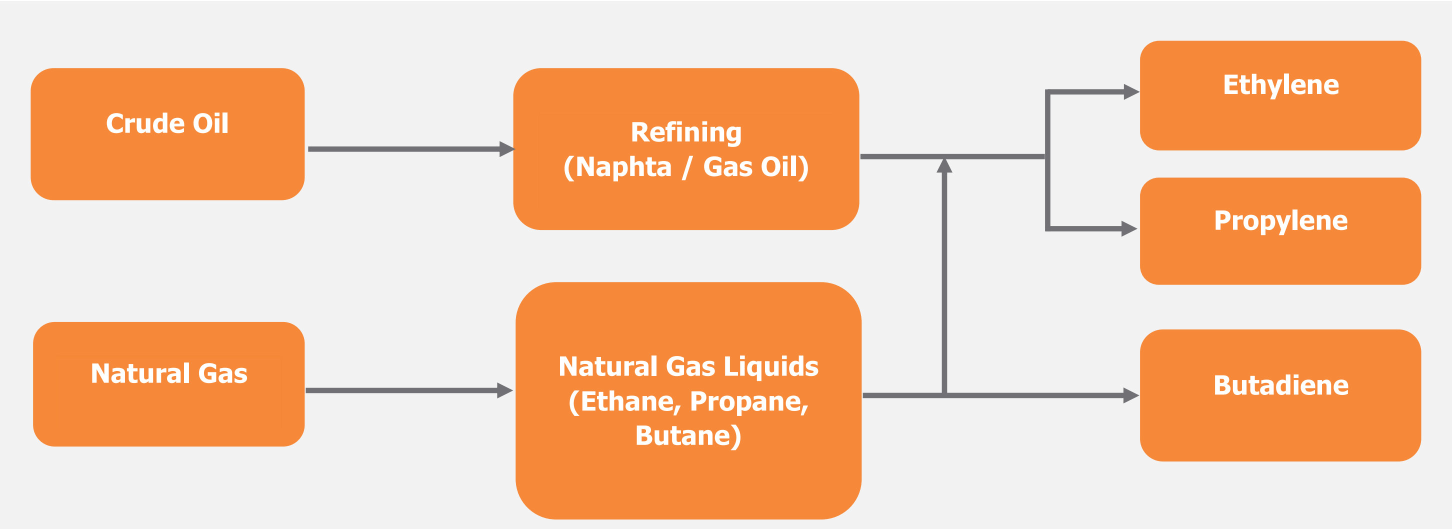
- Trade Dispute Between China Vs. The USA.
- Geopolitical Context Causes Uneven Capacity Utilization.
- Strait of Hormuz: Risks Rise Amid Tension

Company Analysis

Petrochemicals Overview

Petrochemicals are produced from crude oil or natural gas

- Petrochemical products are considered an integral part of our daily lives, as they are converted from crude oil and natural gas (primary feedstock) to more than 70,000 different products such as plastics, fertilizers, packing bags, medical equipment, tires, electronic devices, and solar panels. As a result, the petrochemical industry can be considered as one of the most critical industries in our time.



Petrochemical industry can be divided into three main phases

- Primary feedstock (Crude Oil – Natural Gas) is converted to basic petrochemicals (Ethylene – Propylene – Butadiene).
- Basic petrochemicals are converted to intermediates petrochemical.
- Intermediates petrochemicals are converted to final products (Application).

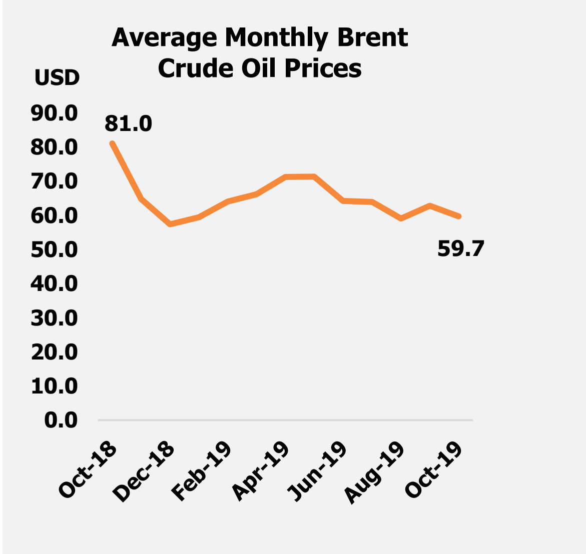
Basic Petrochemicals	Intermediates Petrochemical	Applications
Ethylene	Low-Density Poly - Ethylene (LDPE)	Bottles
	High-Density Poly - Ethylene (HDPE)	
	Ethylene Dichloride	Pipes
	Ethylene Oxide	Automotive
	Ethylene Glycol	
	Ethyl Benzene	Tires, Footwear
Propylene	Polypropylene	Pipes
	Propylene Oxide	Fibers, Foam
	Isopropyl Alcohol	Plastics, Paints
Butadiene	Polybutadiene Rubber	Tires, Golf Balls

Source: International Energy Agency (IEA).

Company Analysis

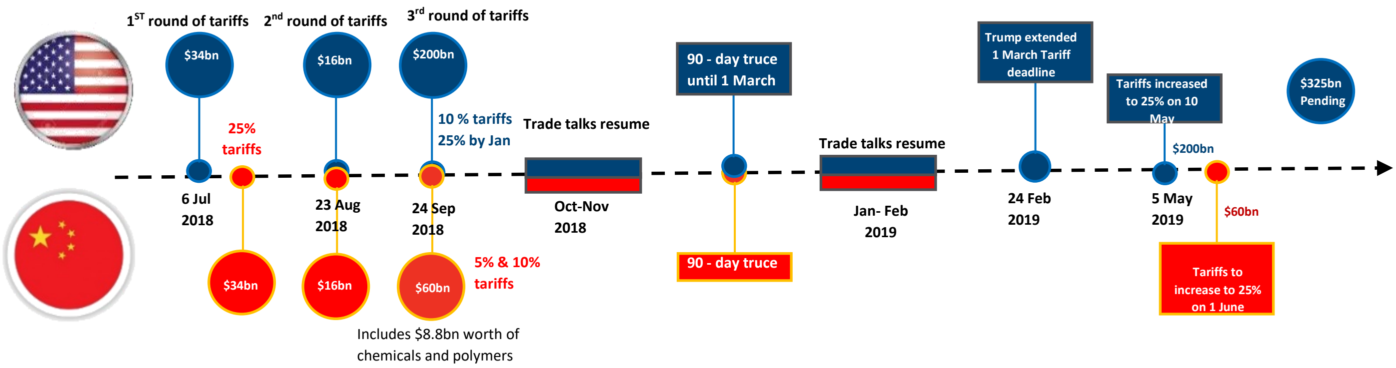
Pricing of petrochemicals exhibit a positive correlation with oil prices

- Pricing of petrochemicals shows a positive correlation with oil prices apart from petrochemicals produced through natural gas; naphtha cracking is the primary process used for the production of ethylene and propylene. As a result, prices of these basic petrochemicals follow those of naphtha, which in turn is obtained through the cracking of oil. This illustrates why petrochemical prices follow that of oil.
- A steadily increasing oil price marked the start of 2019, as production cuts from OPEC, in particular, Russia's participation and Venezuelan oil exports have collapsed amid US sanctions, coupled with continuing sanctions on Iran, reduced upstream supply just as demand was slowing, helping to achieve some measure of price stability.
- The petrochemical industry consumes nearly 13mn bpd (accounting for 14% of the world's oil production), and 300bn cubic meters (representing 8% of the world's natural gas production). The petrochemical industry is expected to become the biggest driver of global oil consumption, accounting for more than one-third of the growth in global oil demand in 2030. On the other hand, demand for oil is threatened by global efforts to shift towards clean energy and electric cars.



US-China Trade War

- Another major factor that caused a significant imbalance on a global macroeconomic level, especially in the worldwide petrochemical prices, is the US-China trade war. The trade war started in March 2018, when the US president announced the imposition of three round tariffs on more than 6,000 Chinese imports, to which China has responded in kind.
- China is the top export market for US Ethylene Dichloride (EDC), which has received more than 27% of 1.3 million mt shipped from the US in 2017, United States International Trade Commission (USITC) data showed.
- During 2019 global petrochemical prices significantly dropped, impacted by US-China trade war and increased supply. The back and forth trade war between the countries resulted in reduced demand for petrochemical products in the US. In addition, the increased supply of petrochemicals coupled with US efforts to increase the number of petrochemical plants put further pressure on global petrochemical prices.
- The US-China Trade war represents a double-edged weapon for the Middle East producers. While the Middle East producers are witnessing increased demands and bids emerging eastwards, they need to consider netbacks from Europe to judge their profitability from the European market. Moreover, the US is likely to look into penetrating the European market through key export markets (Germany and Spain), potentially eroding the Middle East producers' market share.
- On the other hand, it is plausible that the Chinese buyers will consider the Middle East as a short-term relief from the supply gap that has originated from the US due to the ongoing trade war.



Company Analysis

Yansab Establishment

- Yanbu National Petrochemical Company (Yansab) is a Saudi Joint Stock Company established in February 2006. The company's capital amounted to SAR5,625mn, divided into 562.5mn shares. Saudi Basic Industries Corporation (SABIC) owned 51% of Yansab, while the private sector and individuals owned the other 49%. Yansab provides its services through its industrial complex in Yanbu Industrial City, which started its operations in March 2010. Currently, Yansab production capacity reached more than 4mn tons of various petrochemical products such as; Ethylene, Ethylene Glycol, High-Density Polyethylene, Low Linear Density Polyethylene, Polypropylene, Butene 1, Butene 2, MTBE and BTX.
- Yansab's primary markets are focused on Asia and the Middle East, representing 71% out of Yansab's total revenue in 2018. Yansab has a competitive advantage compared to the other petrochemical producers in the region, thanks to its strong ties with SABIC and ARAMCO. Yansab can obtain low financing costs from SABIC, as one of its major shareholders. Additionally, the company receives ethane from ARAMCO (the official supplier and price setter to local and international market) with a fixed price of USD1.75, in addition to Propane at 20% discount. Therefore, Yansab enjoys a major competitive advantage on both a domestic and global scale.
- According to the company's strategy, Yansab successfully optimized its energy utilization; as a result, the company succeeded in increasing its total production by 1.9% Y-o-Y to reach 3,894,000 kilotonnes per annum (Ktpa) in 2018 compared to 3,822,000 Ktpa in 2017. Ethylene and Ethylene Glycol are considered the leading products for Yansab with a contribution of 33.0% and 19.0%, respectively.

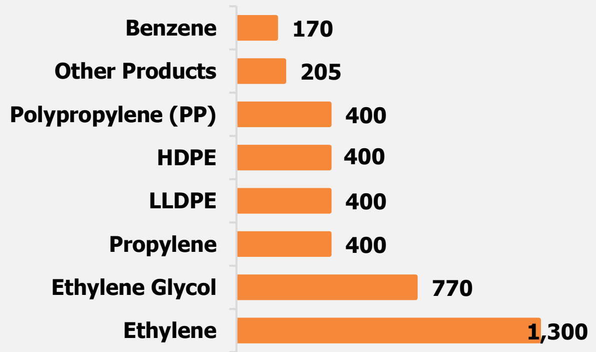
We used 2018 data (most recent data), due to elaborate disclosures.

Key Shareholders

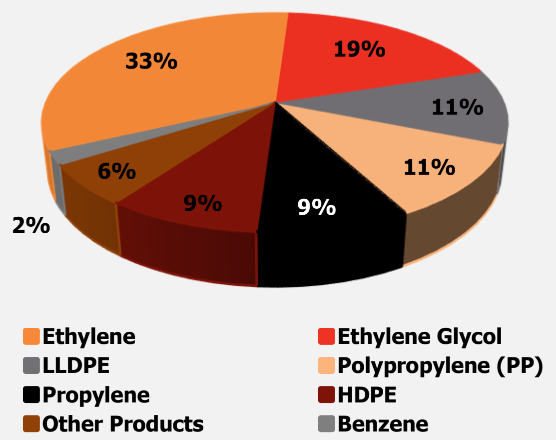
Name	Ownership (%)
Saudi Basic Industrial Co.	51.0%
General Organization for Social Insurance	7.6%
Free Float	41.4%

Source: Tadawul

Production Capacity (ktpa)



Yansab Total Production 2018

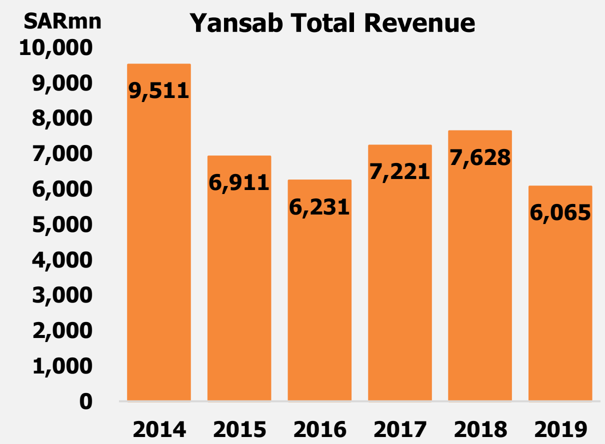


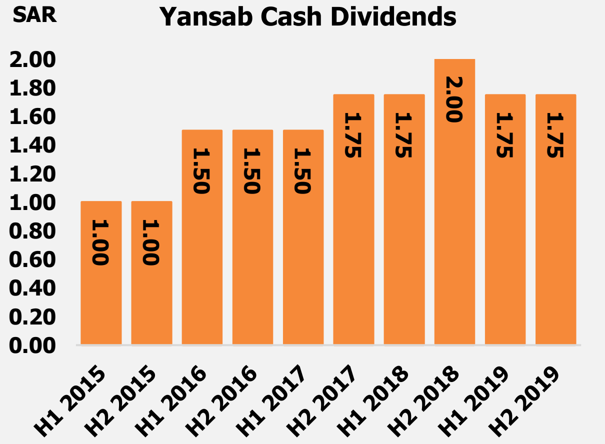
***Note:* During January 2019, Yansab announced the commencement of an expansion project to increase its production of Mono Ethylene Glycol (MEG). The project succeeded in increasing Yansab's production capacity of MEF by 10.4% to 850,000 ktpa from 770,000 ktpa**

Company Analysis

Yansab Revenue at Glimpse

- Yansab's sales volume decreased by 0.6% Y-o-Y in 2018 to reach 2,073,000 ktpa compared to 2,085,000 ktpa in 2017; however, Yansab successfully increased its total revenue by 5.6% Y-o-Y to reach SAR7,628mn in 2018 compared to SAR7,221mn in 2017. The increase was driven by improvement in crude oil prices during 2018. Yansab's total revenue was mainly generated from selling Mono Ethylene Glycol (MEG), High-Density Polyethylene (HDPE), and Polypropylene (PP).
- Despite the MEG expansion project, there was no improvement in the company's revenue during 2019, due to a decline in petrochemical prices, especially MEG prices which witnessed a rapid decrease. Yansab is highly dependent on MEG, which contributes 31.2% out of Yansab's total revenues, followed by HDPE, PP, and Low-Density Polyethylene (LDPE) with a contribution of 25.2%, 21.9%, and 17.8%, respectively.
- During 2019, petrochemical prices were impacted by various events, including US-China trade war and terrorist drone attacks on Aramco's stations. Consequently, these events have created challenges for the Saudi petrochemical sector, and like the rest of the sector, Yansab also affected negatively. While Yansab announced during September 2019, especially after the terrorist attacks on Aramco Plants that it suffered a shortage in supplies of some feedstock materials in varying proportions, estimated at 30.0%.
- Yansab's total revenue showed a dramatic decrease of 20.5% Y-o-Y, reaching SAR6,065mn in 2019 compared to SAR7,628mn in 2018. Similarly, Yansab's net income slumped by 54.9% Y-o-Y to reach SAR1,090mn in 2019 compared to SAR2,414mn in 2018. On a quarterly basis, Yansab's total revenue recorded a decrease by 8.5% Y-o-Y to reach SAR1,482mn in Q4 2019 compared to SAR1,619mn in Q3 2018.
- Despite Yansab's profitability slowdown during 2019, the company announced the distribution of cash dividends of H2 2019 equivalent to SAR1.75 per share. While Yansab distributed the same amount of cash dividends for H1 2019, its total distribution of cash dividends during 2019 represents SAR3.5 per share. Worth mention, that Yansab distributed SAR3.75 per share as cash dividends for 2018.





Company Analysis

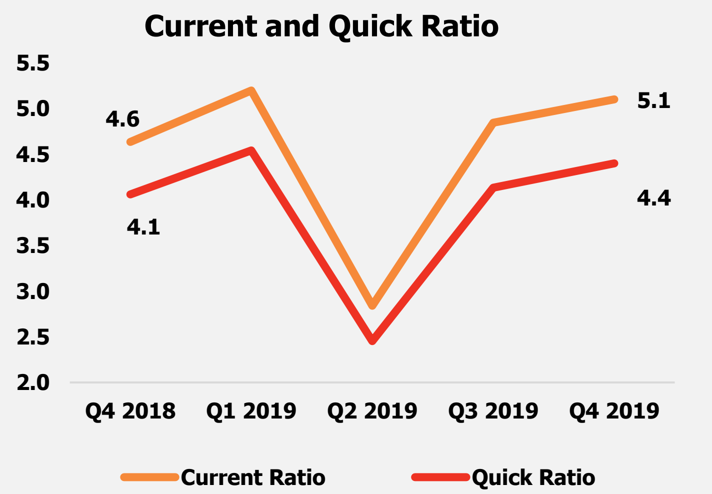
Key Growth Catalysts

Government Support for Petrochemical Industry

- As part of its 2030 Vision, the Saudi government aims to diversify away from oil revenues. Given that Saudi Arabia is the largest oil exporter in the world, with an abundance of gas associated with petroleum (feedstock), it is able to support the production of petrochemicals in large quantities in a cost-efficient model. The Saudi government aims to become the largest petrochemicals producer and exporter worldwide, and accordingly, relentlessly showed initiatives in increasing its investment and support for the Saudi petrochemical sector. It is worth mentioning that one barrel of oil can be converted into petrochemical products priced up to USD1,200.

Improvement in Liquidity

- Yansab's profitability ratios deteriorated during the year as a result of declining revenue and net profit. However, the company was able to improve its financial position by decreasing its liabilities, which in turn, supported its liquidity. Yansab's current ratio reached 5.1, while the quick ratio reached 4.4.
- We believe that Yansab's current financial position will support the company's ability to expand, as the company announced its intention to capitalize on its strong liquidity position to acquire or purchase shares in other petrochemical companies.

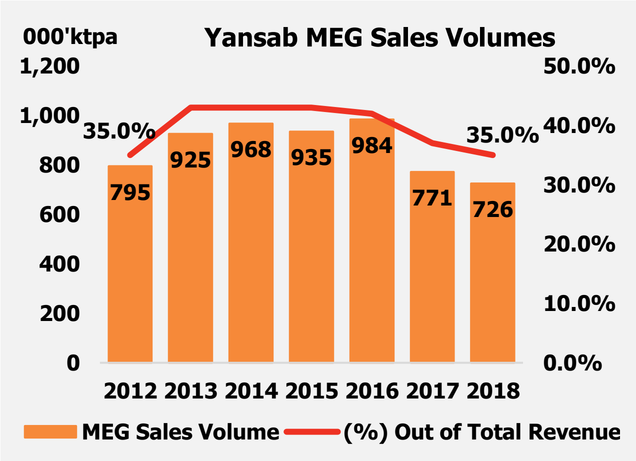


Company Analysis

Key Risk Factors

Trade Dispute Between (China Vs. the USA)

- In a series of economic actions known as the US-China trade war, which started in March 2018, there was an imposition of three rounds of tariffs by the US on more than 6,000 Chinese imports, which led China to respond in kind. Despite the trade war initially being considered as a lifeline for the Middle East petrochemical producers, as China (the world's largest petrochemical importer) sought an alternative to replace the US producers, the impact backfired on the long term. The trade war led to a drop in global petrochemical prices on the long-term and demand for Chinese products, especially auto sales. Consequently, producers in the Middle East, especially those focused on ethane production, witnessed lower profitability.



- During recent years, Yansab expanded its MEG capacity by 80 ktpa to reach 850 ktpa. However, due to the trade tensions, MEG prices also decreased to USD520 per ton, reaching its lowest point since 2009. Since MEG is considered a significant source for Yansab's revenue, the company's total revenue decreased by 20.5% Y-o-Y reaching SAR6,065mn in 2019 compared to SAR7,628mn in 2018.

Geopolitical Context Causes Uneven Capacity Utilization

- Capacity utilization is a crucial determinant of production margins in the petrochemicals value chain. Fixed-cost overheads mean that if production falls below a level of financially sustainable production, the company might start facing losses, potentially leading to bringing forward maintenance turnarounds, force majeure, or even mothballing in the worst-case scenarios. Variables include demand from buyers and the costs of feedstock.
- Demand is being influenced by a range of geopolitical factors with the US-China trade war leading to a shift in global petrochemicals trade flows and other disputes such as the Saudi-led blockade on Qatar and US sanctions on Iran. Such events led to an increase in the worldwide supply and put further pressure on imports, thus intensifying the competition for Yansab, which will impact the Yansab's revenue negatively.

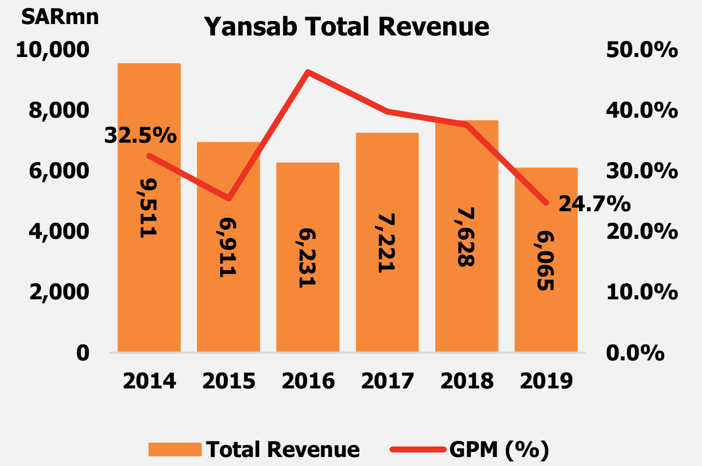
Strait of Hormuz: Risks Rise Amid Tension

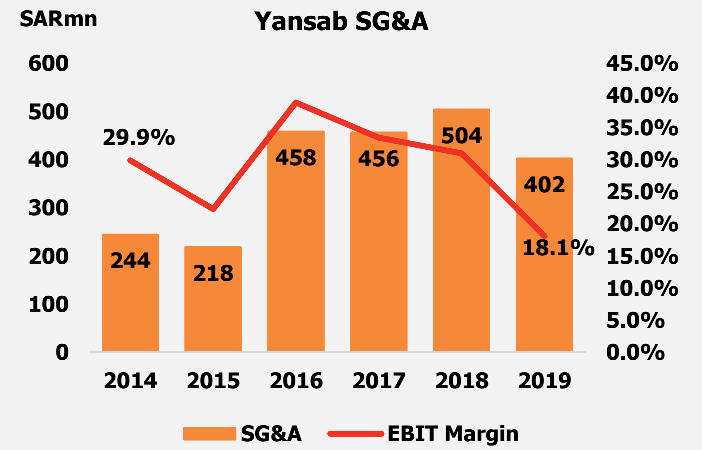
- During September 2019, two major Saudi ARAMCO plants (one of them ranked as the world's largest oil refinery) witnessed terrorist attacks by drones, which led the Kingdom's supply to be disrupted by 5.7mn barrel per day (50.0% of the Kingdom's total production); however, the Kingdom was able to offset this shortage through its inventories. It's worth mentioning that oil prices increased after this attack. Moreover, since ARAMCO is the primary feedstock supplier to Yansab, the company's supply decreased after the terrorist attacks. However, ARAMCO successfully returned its supply to its regular rates within two weeks.
- Despite the Kingdom's ability to successfully manage this crisis immediately, we believe that it is still at risk amid the political tensions in the region. Where Closure of the Strait of Hormuz between Iran and Saudi Arabia, which is one of the world's most important shipping lanes, would cut off most Middle East chemical exports, causing severe chemicals to supply shock, as well as a knock-on effect on demand from a significant spike in oil prices. It would severely impact chemicals produced in Iran, Kuwait, Qatar, and the UAE.

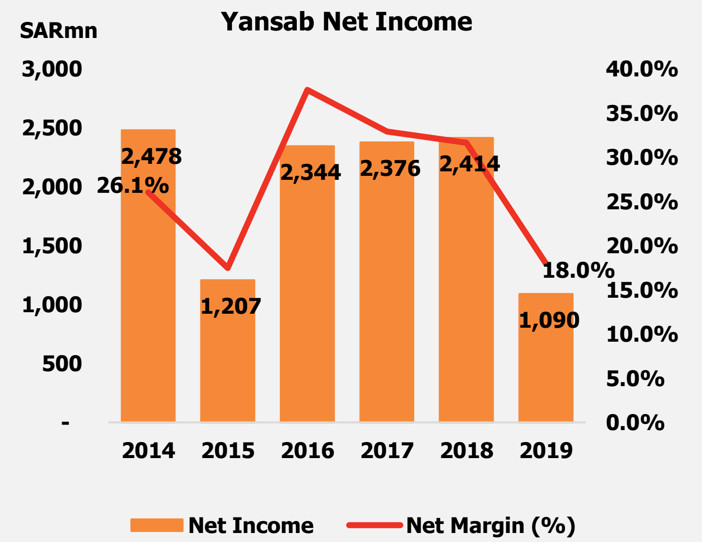
Company Analysis

Financial Results

- Yansab's top line was negatively impacted due to the dramatic decrease in petrochemical prices despite higher sales quantity. Yansab's total revenue decreased by 20.5% Y-o-Y to reach SAR6,065mn in 2019 compared to SAR7,628mn in 2018. On a quarterly basis, Yansab's revenue decreased by 8.5% Y-o-Y to reach SAR1,482mn in Q4 2019, compared to SAR1,619mn in Q4 2018.
- Yansab's gross profit margin decreased by 12.9% Y-o-Y to reach 24.7% in 2019 compared to 37.6% in 2019, due to higher production's inputs average cost.
- However, Yansab successfully decreased its selling, general & administrative expenses (SG&A) by 20.2% Y-o-Y to reach SAR402mn in 2019 compared to SAR504mn in 2018. Yansab's SG&A decreased by 22.3% Y-o-Y on a quarterly basis to reach SAR116mn in Q4 2019 compared to SAR149mn in Q4 2018.
- Yansab's finance income increased by 15.8% Y-o-Y to reach SAR91mn in 2019 compared to SAR78mn in 2018. On the other hand, the company's finance costs, and Other Income decreased by 15.3%, and 37.5 Y-o-Y, respectively. As a result, Yansab's net profit before zakat decreased by 51.2% Y-o-Y to reach SAR1,225mn in 2019 compared to SAR2,512mn in 2018.
- Yansab's zakat recorded an increase of 37.8% Y-o-Y to reach SAR135mn in 2019 compared to SAR98mn in 2018.
- Yansab's bottom line showed a significant decrease due to the impact of lower petrochemical prices. Besides, reported SAR71mn of impairment against capital work in progress, leading to declining in net profit by 54.9% Y-o-Y to reach SAR1,090mn in 2019 compared to SAR2,414mn in 2018. Moreover, it decreased on a quarterly basis by 26.8% Y-o-Y to reach SAR171mn in Q4 2019 compared to SAR233mn in Q4 2018.







Valuation Rational

DCF Valuation

	2020 F	2021 F	2022 F	2023 F	2024 F
EBITDA	2,483	2,558	2,634	2,657	2,682
Operating CF	2,403	2,498	2,573	2,646	2,670
Capex	(533)	(566)	(581)	(584)	(587)
FCFF	1,869	1,932	1,992	2,062	2,082
Stub Period (FCF to be discounted)	1,869	1,932	1,992	2,062	2,082
PV (FCFF)	1,704	1,606	1,510	1,425	1,312
WACC	9.7%				
Perpetuity Growth	3.0%				
PV-FCFF	7,557				
PV-TV	20,281				
Net Debt	(32)				
Less: End of services benefits	(621)				
Add: Investments	3,051				
Intrinsic Values	30,237				
Shares Outstanding	562.5				
Equity value per share	53.8				
CMP (04-02-2020)	51.4				
Upside / (Downside%)	4.6%				

We have valued Yansab using DCF and multiples approaches, considering a cost of equity is equal to 9.7% (based on a risk-free rate of 4.4%, market risk premium 6.0%, Beta of 0.89.

Based on the DCF valuation, the fair price of Yansab share price is SAR53.8, which is higher than the traded value by 4.6%.

Comparable Valuation – Local Peers

Name	Country	P/E
Yansab	KSA	26.5
SABIC	KSA	46.4
SAFCO	KSA	20.8
Advanced	KSA	13.2
Petrochem	KSA	17.4
SIIG	KSA	17.1
SIPCHEM	KSA	25.9
TASNEE	KSA	12.0
Median		**19.1**
Value Per Share		**42.4**

Note: We excluded Saudi Kayan, Nama Chemicals, and Chemanol as they have negative P/E

Weighted Valuation

Based on a weighted valuation approach, where the DCF is weighed 60%, and multiple valuation is weighed 40%, we value Yansab share price at SAR49.2.

Valuation Approach	Weight	Value
DCF	60%	53.8
P/E	40%	42.4
Valuation	**100%**	**49.2**

Financial Projection

Local Peers	Country	Code	Market Price (SR)	Market Cap (SRBN)	P/E	Revenue (SRMN)	Net Income (SRMN)
Yansab	**KSA**	**2290**	**51.4**	**28.9**	**26.5**	**6,065**	**1,090**
SABIC	KSA	2010	87.0	261.0	46.4	139,740	5,630
SAFCO	KSA	2020	73.4	30.6	20.8	3,288	1,468
Advanced	KSA	2330	46.2	10.0	13.2	2,595	759
Petrochem	KSA	2002	24.4	11.7	17.4	7,435	673
SIIG	KSA	2250	23.0	10.3	17.1	7,435	605
SIPCHEM	KSA	2310	16.8	12.3	25.9	4,986	477
TASNEE	KSA	2060	12.3	8.2	12.0	4,997	683
Saudi Kayan	KSA	2350	9.7	14.6	(22.9)	9,536	(637)
Nama Chemicals	KSA	2210	24.4	0.6	(21.4)	545	(27)
Chemanol	KSA	2001	8.6	1.0	(26.6)	581	(39)

Financial Ratios	2018 A	2019 A	2020 F	2021 F	2022 F	2023 F	2024 F
Return on Average Assets (%)	12.4%	5.9%	7.0%	7.7%	8.4%	8.8%	9.1%
Return on Average Equity (%)	14.2%	6.5%	7.9%	8.7%	9.5%	9.9%	10.4%
Earnings Before Zakat Margin (%)	32.9%	20.2%	22.0%	22.7%	23.5%	24.0%	24.5%
Net Income Margin (%)	31.6%	18.0%	19.8%	20.4%	21.1%	21.6%	22.1%
Revenue Growth (%)	5.6%	-20.5%	3.9%	2.7%	2.7%	0.5%	0.6%
EPS	4.3	1.9	2.2	2.3	2.5	2.6	2.6

Income Statement	2018 A	2019 A	2020 F	2021 F	2022 F	2023 F	2024 F
Revenue from Contracts with Customers	7,628	6,065	6,301	6,470	6,642	6,676	6,714
Cost of Revenue	(4,763)	(4,567)	(4,629)	(4,707)	(4,785)	(4,787)	(4,791)
Gross Profit	**2,865**	**1,498**	**1,672**	**1,763**	**1,857**	**1,890**	**1,923**
SG&A Expenses	(504)	(402)	(418)	(429)	(440)	(442)	(445)
Income from Main Operations	2,362	1,096	1,253	1,334	1,417	1,447	1,478
Net Income for The Period	**2,414**	**1,090**	**1,247**	**1,322**	**1,403**	**1,441**	**1,483**

Balance Sheet	2018 A	2019 A	2020 F	2021 F	2022 F	2023 F	2024 F
Total Current Assets	6,228	5,843	5,965	6,273	6,792	7,333	7,910
Total Non-Current Assets	12,845	12,228	11,393	10,589	9,797	9,010	8,229
Total Assets	**19,072**	**18,070**	**17,358**	**16,862**	**16,589**	**16,343**	**16,139**
Total Current Liabilities	1,344	1,153	1,162	1,172	1,183	1,184	1,184
Total Non-Current Liabilities	472	775	775	775	775	775	775
Total Liabilities	1,816	1,928	1,936	1,947	1,958	1,958	1,959
Total Liabilities and Equity	**19,072**	**18,070**	**17,358**	**16,862**	**16,589**	**16,343**	**16,139**

Guide to Ratings and Disclaimer

Guide to Ratings

Buy	An upside potential of more than 20% in 52-week period
Overweight	An upside Potential of more than 10% in 52-week period
Neutral	Will stay in the range of it value (up/down 10%) in a 52-week period
Underweight	A downside potential of more than 10% in 52-week period
Sell	A downside potential of more than 20% in 52-week period

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