Middle East Paper Company

CONFERENCE CALL DEDICATED TO MEPCO FINANCIAL RESULTS Q1 2023

Date: 21.08.2023

Participants:

- Sami Al Safran, Group President
- Ahmed Fazary, Group Chief Commercial Officer
- Amr Masry, Group Chief Financial Officer
- Sarah Moussa, Investor Relations Manager

Nour Eldin Sherif Good morning and good afternoon, ladies and gentlemen, and thank you for joining us today. This is Nour Eldin Sherif and, on behalf of Arqaam Capital, I'm delighted to welcome you to MEPCO's second quarter results conference call. I have with me here, today, Mr Sami Al-Safran, Group President, Mr Amir Masry, Group CFO, Mr Ahmed El Fazary, Group CEO, and Ms Sarah Moussa, IR Manager. With no further delay, I will now turn over the call to Ms Sarah.

Sarah Moussa Thank you, Nour. Good morning and good afternoon, ladies and gentlemen. First of all, I would like to start with a disclaimer. Nour, do you hear me?

Nour Eldin Sherif Yes. All is clear.

Sarah Moussa Okay. I will repeat again. Good morning and good afternoon, ladies and gentlemen. I'm Sarah Moussa. I'm the IR Manager and we are welcoming you today to actually discuss with you the previous results for the first half of the fiscal year of 2023. But, first of all, I would like to start the presentation with a disclaimer. This presentation is prepared by MEPCO and contains basic information about company activity as of the latest published results. The information is presented in summary rather than detailed form. This information, including any forward-looking statements, should not be taken as a basis for investment recommendation/solicitation for any of the company's tradable securities. While management has made every effort to present a fair view of MEPCO's operational and financial performance in this presentation, it is important to note that expectations about the future results that come in light of prevailing operational, financial and market conditions may change in the future.

Management does not recommend using such forward-looking statements in financial modelling or investment decision-making. It thus takes no liability to explain differences between future actual results and what was stated in the course of this presentation.

Now, of course, as Nour has mentioned, we are joined with our Group President, Eng. Sami Al-Safran, and Mr Ahmed El Fazary, the Group Chief Commercial Officer, and we would like to actually welcome Mr Amr Masry, our newly joined Group Chief Financial Officer. Mr Amr, he has over 17 years of experience in finance, specifically in strategic finance and mobilising funds and guiding corporate mergers. Now, going to our key financial indicators for the first half, it's undeniable that in this first half we have witnessed decreases in our profitability margins versus the first half of the year 2022, yet we witnessed still very positive milestones. The first milestone we witnessed was the commercial launch of JUTHOR. It specifically started in the last week of quarter two, year 2023, and from the first week we were able to actually achieve sales amounting to SAR 800,000 and, as you all know, on 1st August, in the beginning of this month we had an announcement over Tadawul for the PIF subscription shares agreement, which also proves that MEPCO is still abiding to its growth strategy despite what we are currently witnessing.

First, like we always do, we would like to discuss with you what were the economic factors that impacted our results as well as a market overview. First of all, on a global perspective, we are witnessing slowness in economic growth and, as per the World Bank estimates, the world economy is only projected to grow by 2.1% and, as a result of this, we have seen in Q2 2023 Saudi GDP only grew by 1.1%, yet still this growth was backed up non-oil activities increase by 5.5%, while the oil activities actually decreased by 4.2%. As a result of this global recession and inflation in prices, which is impacting the consumer behaviour worldwide and their standing, we have communicated previously in the first quarter that, as per RISI, the world containerboard demand growth was forecast to have growth of only 1.7% in 2023 but this forecast got adjusted to have the growth for 2023 to reach only 0.5% as a result of the slowness of the recovery of the global economy, which has of course impacted our international prices that we benchmark against. We will see from Q1 to Q2 the average test liner 2 has dropped by around 18%, from USD 509 to USD 419, while the OCC prices on average have decreased 2%. What we currently are expecting is that we will see the price movement will be between flatish to a relative decrease throughout the year of 2023.

Now, this is in regard to the containerboard market but for the tissue market we are seeing that despite the global inflation and the global recession and what is happening on an economic perspective, we still see that the tissue is a very attractive market and industry, specifically for the local producers. The growth forecast for 2023 on a global perspective by 2.8% still remains the same and we are still growing, working on increasing our market share in Saudi Arabia. No undeniable fact that of course that international prices of the pulp, which we benchmark against, have decreased and we are still also forecasting or seeing that the movement for the pulp will be between being flattish or a relative decrease but it's not going to be decreasing as the containerboard prices.

Now, that's the overview for the market dynamics. When we come to talking about the exports and the local sales review we will see that, even though we have witness a decreased on a Q-to-Q, total sales volume decreased by 10%, yet will see that the demand was actually impacted locally by two seasonal national holidays in Saudi Arabia and the total sale volume for year-on-year decreased by 2%. Yes, there is a decrease in the sales volume in Q-to-Q and year-on-year but we would like to hand out your notice that despite the declining demand in our containerboard demand globally, we managed to actually increase our sales volume in exports year-on-year by 17%, which still proves resiliency and the strong position in the international market for MEPCO. We're still remain in the balance between the sales distribution in value between the export sales, having a balance of 40% against the local sales of 60%.

Now, coming to the financial overview, you will see that there has been a major decrease when we compare a year-on-year basis first half of 2022 to first half of 2023. This is basically attributed to that in the first half of the previous year we were witnessing higher international prices and better global containerboard market dynamics. Yet, if you look at the decrease from Q-to-Q in the sales revenue and in the gross profit and profit margin, you will find that it is a relatively less steep decrease. You'll see that the average selling prices pertaining to both the local the export only decreased by 7%, while the average cost of sales per ton decreased by 3%. On a year-on-year basis, the average selling prices, local and export, have decreased by 35%, while the average cost of sales increased by 5%.

Now, we will take you through a detailed cost of sales breakdown because previously, in the previous quarter, we have communicated with you that we are working on cost management throughout the whole factors for costing, whether they are related to the cost of sales or the other cost factors. And we are seeing here that we have actually fulfilled our promise, since you can see that in the first quarter of 2023 there has been a decrease in the cost of sales by 12%. Going to the second quarter of 2023, we achieved in the total fiber cost, in the variable cost and in the fixed cost, we communicated that we are anticipating lower raw material cost, which actually was the case. The total fiber cost consumed per ton decreased by 16% Q-to-Q, while the local OCC per ton consumed actually also decreased by 16%.

If we look at year-on-year for the cost of sales, it has only increased by 2%, yet you will see that the total fiber cost actually also decreased. Based on that, the total fiber cost consumed per ton decreased by 10% and the local OCC per ton consumed during the first half also versus the first half of 2022 decreased by 29%, even though there has been a slight increased in the fixed cost, which actually was incurred for business needs. I would like to hand out that that the total fiber cost, it includes the OCC and other virgin pulp that is needed for certain product grades.

Now, going to the other profitability margins, you will find that we were able to have EBITDA positively from Q1 into Q2. It has decreased by 57% but, of course, year-on-year it decreased by a larger percent, by 85%, yet we incurred a net loss. The total net loss in the first half reached SAR 27 million, with a net loss margin of -6%, and in the second quarter we incurred solely SAR 20 million. Now, this is now highlighting the fact that it is the impact of the international prices of paper and the slow recovery of demand, yet we want to communicate with you what has been done on a favourable perspective on a Q-to-Q basis that has impacted our bottom line and also on a year-on-year basis that impacted our bottom line.

See here, as we have communicated previously, we are seeing that the international prices are in the lower ranges. We don't see that they will be dropping so much than what we are currently perceiving. We did a small interpretation for you, that we will find that the impact of the lower sales volume on sales revenue Q-to-Q is around 10%, while the impact of lower selling prices is only 6% on the sales revenue. Now, going to the favourable part. As we mentioned, there has been a decrease in the cost of sales by 12% and we have also managed to decrease our selling and distribution cost by 6%. Due to our good working capital management and also working on developing and having increased collection from customers, the impairment losses on financial assets actually decreased and it was reversed by SAR 6.0 million. And despite having a decrease by 34% Q-to-Q, other operating income realised is backed up by an insurance claim recovery of SAR 2.0 million, but we also witness a decrease in the financial charges payment by 11%. Now, the unfavourable part has undeniably contributed to the sales volume Q-to-Q and also, of course, that we witnessed an increase in the G&A cost, having a provision for a WASCO penalty of SAR 5.0 million and some equity shares which we have also announced about it on the Tadawul announcement.

On a year-on-year basis, on a half-and-half basis, we will find that the impact of lower sales volume on the sale revenue is only 2% since the sales volume didn't decrease that much half-to-half and the impact of lower selling prices actually amounted to 35%. The favourable, of course an increase in the export sales volume year-on-year by 17% and a decrease in the selling and distribution, the reversal impact of the impairment losses of financial assets. And we witnessed in this first half a foreign exchange gain, specifically SAR versus euro and the insurance claim. The unfavourable, of course, is the decrease in the total sales volume, it is the increase of the cost of sales, and the increase in the general and administration cost. And, of course, if we compare on a year-on-year basis, we'll find that we witnessed an increase in financial charges by 41%.

Now, going to a very positive financial indicator in MEPCO. MEPCO has been always pioneering in managing its working capital. Despite all the global impact that currently we are witnessing, our working capital decreased only by 38%. We are diligently working on developing better account receivable turnover, AP turnover, which we are seeing right now that they are in the normal ranges for MEPCO performance, and the inventory turnover we are working on enhancing it to attain lower OCC costing. All of these have actually impacted the cash flow operation to only decrease by 4% year-on-year. Despite what we have witnessed in the decrease in the sales revenue and the international prices, we are still maintaining very healthy ranges for our cash flow from operations.

Our net debt-to-equity has increased slightly from 0.46 to 0.51. We still remain in the industry averages of 1.1. Actually, in the first half we witnessed a decrease by 33% in the short-term, but we also witnessed an increase in the mid-term by 18% and we are still being in the normal ranges of our total debt that MEPCO usually portrays in its financial statements. Of course, the net debt-to-EBITDA it has increased by 9.6 and this is something that we are seeing as temporary due to the incurred losses, which are expected to be recovered once there are better international market prices and we see that the industry dynamics are getting better.

Now, for the management outlook. MEPCO is still abiding to its growth strategy and we are still proving, despite all the kinds of challenges that we may witness, that we are still developing in the paper sector and we are also developing in the waste management sector. And we are seeing that the market, local demand is poised to catch up, especially after the end of the national holidays, and this will be seen in Q3 of fiscal year 2023. For JUTHOR, which is a very promising market here, in Saudi Arabia, we are working diligently on expanding and growing our market share and we are continuously working on implementing cost control initiatives but yet management is still taking a conservative outlook for the second half of 2023. Now, we have come to the end of the earnings release presentation. Thank you, Nour. Now, we are ready to receive your questions.

Nour Eldin Sherif Thank you very much, Sarah, for the presentation and your valuable insights. Can we please open the floor for questions?

Passant Mohamed Please, everyone, if you have a question, use the Raise Hand button or submit it in the Q&A box.

Nour Eldin Sherif We have a question from Sean. Thank you for the increased disclosure and around the cost structure and the movement in operating profit drivers. This is useful. From a volume perspective, impressive that volumes were down only 2%. On that, are able to give any colour on tissue volumes and the ramp up? And another question. Are you able to share any updates around the potential PM5 expansion?

Ahmed El Fazary Hello, ladies and gentlemen. This Ahmed El Fazary, Chief Commercial Officer. I'll be answering the first part regarding our sales volumes for containerboard having dropped only by 2% in the first half and around also the tissue volumes. First of all, just reconfirming what Sarah just mentioned, that Q2 we had two national holidays that affected our shipments and we confirm that in Q3 we should see a good ramp up of shipments to offset any drop that we face in Q2, where we're targeting to hopefully beat the sales volumes of last year overall when we look at the forecast. Commenting on the tissue ramp up in volumes, the stock up started by the end of the first half, which meant that there was nothing significant to report, but by Q3 we should see a good impact. Volumes are ramping up. I don't want to overpromise but things are going as planned, if not slightly better. I'll give the mic to our Group President, Mr Sami.

Sami Al-Safran Thank you very much for asking. Regarding PM5, for those who don't know about it, it's our aspiration into doubling the capacity of the containerboard inside Saudi Arabia for the reason that Saudis are still importing more than 40% of our need from abroad. And the idea is to invest in a new technology to start, I think, the low GSM production to serve primarily the e-commerce industries, the new evolution of container corrugated boxes demand and also in addition some of the recyclable shopping bags that will be in need for them. Now, regarding the status, what we have done we have actually physically finalized the land location and now we are in the contracting phase. Principally, it will be adjacent to our JUTHOR land, which is located in King Abdullah Economic City. The expected area will be an additional 120,000, so we will be owning 250,000 footprint at King Abdullah Economic City to beef our broad, whether in the containerboard or the tissue industries.

Regarding the technology, we have shortlisted two technology suppliers. We have finalized the technical discussion with them. Early next month, we will do some reference visits as finalization, in addition to the commercial discussion. And hopefully, once we nail the most critical one, which is the technology provider, we will proceed to announce the zero date for the project, targeting hopefully to do it before the end of this year.

Passant Mohamed Nour, we have one of these. They are raising their hands. Abdulaziz Al-Alshaikh, please you can go ahead with unmuting your mic.

Abdulaziz Al-Alshaikh Hello, everyone. Thank you for the presentation. This is Abdulaziz Al-Alshaikh, from Jadwa Investment. I have one question, if I may. Is there any regulatory update on the anti-dumping or on the tariffs?

Ahmed El Fazary The latest update, which we shared earlier, is that the final report was concluded by the technical office for anti-dumping practices, recommending and confirming dumping from the said countries that were ranging from 7% to over 70% were, as a procedure, it gets raised to the higher ministerial committee responsible in the GCC for them to approve to implement it or not. And the first decision was not to implement it. Then, we filed a reappeal and we are in the process of that case. So, that's the latest update.

Abdulaziz Al-Alshaikh Thank you so much.

Nour Eldin Sherif As a reminder, if you have a question, please raise your hand or submit in the Q&A box.

Ahmed El Fazary Until we receive further questions, I would like to share with the participants on the call a milestone that happened in the past few months, where we have been working with one of the most recognized entities in benchmarking and indexing in the paper industry, where there have been indexes for containerboard for most major economic regions, while the Middle East and GCC didn't have any coverage for the price index. Currently, now, it's available publicly, which I believe could be very helpful for the investors who are invested in the industry here, in the region. I just wanted to share this information, thinking that it could be helpful, until we see a further question.

Nour Eldin Sherif Thank you, Ahmed.

Passant Mohamed We have a question from Adnan Farooq. He's asking what sort of protection is available to the local tissue manufacturers in terms of import tariffs?

Sami Al-Safran The tissue industry in Saudi Arabia has a demand ranging between 250,000-280,000. We don't have the board figures yet. And still Saudis are importing a recognizable volume of their needs from the nearby markets. The largest suppliers to the Saudi market are from UAE. No doubt, in addition to MEPCO, other companies have announced expansion programs but, even with the aggregates of that growth, still the country will be bit more than importing countries.

Now, interestingly, on the tissue side, customs and duties applied on the imports are 15%, which I think, if I'm not mistaken, this is one of the highest duties in the paper sector and this duty is applied everywhere excluding those who are having import agreements with them. But those that did not meet the criteria, they still apply on them the import duties, which actually creates a very favorable situation for the local industries to grow. Needless to mention that the tissue industry has a unique advantage than others, is that, number one, all the players in the industry are having a similar response of raw material. So, whether you build your operation in the region or outside the region, classically the cost of fibers reaching you is almost the same unless you are actually building in places like, for example, Brazil or Indonesia, where they are actually producing pulp and converting it directly into paper.

The other factor is that this industry is energy intensive, which is probably one of the competitive edges we have in the region here, in addition to the logistics position of our company and the capability of MEPCO for quick wrapping-up in the business, and that's really what creates the difference here. Finally, also due to the nature of the tissue, that is lightweight, it is very unlikely to see competition coming from remote areas like Europe or United States or Asia. Most of the competition will be from nearby markets and the competition will remain between the efficiencies and the cost manufacturing that you are doing.

Passant Mohamed Another one from Adnan. He's saying one of the local manufacturers of tissue is expanding its production capacity at the same time as the launch of JUTHOR, asking do you see any pressure on prices because of this?

Ahmed El Fazary Of course competition will remain always competition, whether we're facing competition from the domestic market or from imports, but considering all the factors Mr Sami just mentioned, we leverage on certain advantages that give us a competitive advantage. I would like to highlight a piece of information which we shared in previous calls, that before JUTHOR starts the local production in Saudi Arabia barely fulfils 50% of the local demand. So, even after JUTHOR and announced local expansion by competition, there would be still a gap between demand and supply. I hope this answers your question clearly.

Passant Mohamed We have another question from Amal. She's thanking your for your presentation and asking when is JUTHOR expected to be profitable and what is the funding source for PM5?

Amr Masry Hi. This is Amr Masry, the Group CFO. We believe that the ramp up is very promising for JUTHOR and although we have previously announced about our expected date for the profitability, looking at the current status that we have, we do expect for JUTHOR to be profitable earlier than what was previously announced. In terms of funding for PM5, part of the funding for PM5 will be through a debt and equity structure that we have already developed in the group and committed to for all our projects and plus the partnerships that we have with a lot of the local funds and the funding institutions within the Kingdom of Saudi Arabia, similar to SIDF and other structures that exist.

Passant Mohamed Everyone, if you have another question, please use the Raise Hand button or type it in the Q&A box. We have a question from Abdulaziz. He mentioned that we saw Chinese manufacturers entering multiple industries locally, like steel and ceramics. He's asking do you see the same risk for containerboard?

Ahmed El Fazary We have not heard or seen any indications showing that and, as we've mentioned, we are in talks with machine suppliers. We have access to all the industry information and we don't see this and we don't see Chinese manufacturers venturing into investing outside China when it comes to paper mills, except a few years back when they had the new regulations to ban waste where they invested in recycled mills, pulp mills not paper mills. So, we don't see this as a potential threat.

Sami Al-Safran I would like to add to my colleague. The containerboard industry in China is by its nature higher than the other regions due to the fact that the scarcity of fiber in China makes the cost of importing or generating fibers in China very high, which makes them less competitive to export than containerboard outside. It could be shipped as a finished product for goods but definitely not as a raw material. And it has been years. We have not really seen or felt the Chinese stake in any evolution in terms of changing technology that is creating a potential risk for now or for the future. The classical picture remains the same and we are taking really great support from the Ministry of Industry how to regulate the market and create a competitive work environment within the market itself, and definitely welcoming any investment to come into the region.

Now, moving the second question here, there is a question from Khalid asking about them expanding, whether it's in tissue or carton. It is a very interesting question. Thank you, Khalid, for it. Very soon, I think we will be announcing more detail about the subject but, in general, MEPCO strategy and investment and growth, it passes through multiple layers of governance and one of them is the market attractiveness, demand, our value-added and capabilities in the business lines that were are targeting and the tech, accordingly with our plants.

As in today's situation, like what I mentioned earlier, if you speak about the tissue industry, Saudi Arabia is a net importing region and actually, if I see the statistics two years ago, we are one of the top ten in the world, mostly importing our needs from outside, and this is why we will see why MEPCO Group or other groups will continue their investments in that field until we create at least a balance between supply and demand. And the same thing applies for the containerboard, looking to Saudi Arabia importing 40% of our needs from abroad. That gives, really, a great opportunity to move forward with that subject.

So, that's my view, not to forget of course when we are talking about expansion, we cannot ignore the fact that we are talking about also a waste management sector that is very much a growing sector in Saudi Arabia. Like what has been announced earlier, there is 200 billion of an investment opportunity in that sector and our subsidy, WASCO, that has two decades of experience in different business lines in waste management, will be in a better position to capture it. Accordingly, two years ago we have established a strategy for one of the reputable offices and this is a strategy in execution. You might have heard last year that we have announced our partnership with Jeddah Municipality and established a company for waste management. And we will continue to expand in the waste management to beef our and to meet our demand for the growth, PM5 regarding fiber supplies, in addition to expanding into different business segments through expansion.

Nour Eldin Sherif Thank you, Eng. Sami. This is very helpful. Another question from Khalid. At the last presentation you said there is talk of other opportunities with British companies. Can you tell us what's new?

Ahmed El Fazary I believe maybe it was mis-received. We did not announce anything about opportunities with any British companies. I don't believe this. Maybe it was not received correctly.

Sami Al-Safran In general, gentlemen, we in MEPCO here, we are almost on a regular basis analysing and studying different opportunities, whether inside Saudi Arabia or in the nearby region, focusing mainly on our expertise in the field, which is the paper sector, waste management sector, and when we're talking about paper, we're talking about the whole value chain between fiber sourcing, all the way through that. And hopefully, I'm sure everyone is aware of our step towards calling an anchor investor and raising the capital of the company. That is a clear indication of the appetite of the company to grow and position ourselves as a champion leader in the region where, until now, no one is available for that level of operational excellence. And we intend, with our existing capabilities and the support we are getting, to grow and position ourselves in that.

Nour Eldin Sherif That's very helpful. Just as a final reminder, if you have a question please raise your hand or submit it in the Q&A box. I think we can now turn the call to Mr Sami, if you have any final remarks before we conclude. Thank you.

Sami Al-Safran Thank you, gentlemen, and thank you for your attendance and showing an interest in MEPCO. No doubt, what we are facing nowadays, the economic challenges, the quick turning point in terms of economic slowdown and competitive impact has impacted us in our business, which you might see in our financial results. We are trying quickly to recover. Hopefully, we are entering the second half of the year with a more conservative approach. Anyone who is looking into our financial results here will be recognizing that we are seriously taking the operational optimization in a very serious manner to meeting the change in itself and that's why, on a continuous basis, you will find we are reducing the cost of our sales and trying to capitalize on the new operation of JUTHOR, which is the new dimension of tissue.

And what we have announced regarding the private subscriptions of the anchor investor is an indication that the company is very serious in our growth. And, as you can see, every time we meet with you guys or we talk to you, we have a new story and a new development. We have a committed board to drive our strategy and to achieve the result and creating shareholders value, and hopefully that's the commitment we can deliver to our shareholders and to you guys.

Nour Eldin Sherif Thank you very much. Thank you. This concludes our call for today.