SIPCHEM
Petrochemicals – Industrial
SIPCHEM AB: Saudi Arabia
26 July 2018

الراجحي المالية
Al Rajhi Capital

US$2.249bn	90%	US$6.31mn
Market cap	Free float	Avg. daily volume

Target price	25.00	+8.7% over current
Current price	23.00	**as at 25/7/2018**

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Existing rating

Underweight	Neutral	Overweight

Performance

Earnings

(SARmn)	2017	2018e	2019e
Revenue	4,459	5,430	5,670
Y-o-Y	26.9%	21.8%	4.4%
Gross profit	1,426	1,922	1,985
Gross margin	32.0%	35.4%	35.0%
Net profit	437	673	699
Y-o-Y	NM	53.9%	3.8%
Net margin	9.8%	12.4%	12.3%
EPS (SAR)	1.19	1.84	1.91
DPS (SAR)	0.50	1.00	1.00
Payout ratio	41.9%	54.5%	52.5%
P/E (Curr)	19.3x	12.5x	12.1x
P/E (Target)	21.0x	13.6x	13.1x

Source: Company data, Al Rajhi Capital

Saudi International Petrochemical

Q2 beat; Raise TP to SAR25/sh.

Sipchem reported Q2 top-line and bottom-line above our estimates, largely due to higher-than-expected sales volume and improved operating leverage due to fixed input costs for Methane. While few intermediate products are likely to come under pressure in the near-term, Methanol prices are likely to remain firm or improve slightly. In the medium term, firm oil prices, robust demand for MTO plants and moderate increase in additional capacity in China on account of tight Chinese environment regulations may improve Methanol prices in the medium term. In addition, VAM prices continued to rise over the past six quarters and are firming up as well. IMC's efficiency enhancement project (Q4 2018) and the PBT plant (started in July) are likely to be earnings accretive. Given strength in products' price performance, we revise our estimates upwards. Consequently, we revise our TP to SAR25/share and rating to Neutral on the stock. The key upside trigger might be attributed to a sustained improvement in Methanol prices, while any unexpected disruption at the company's upstream operations may act as the key downside trigger.

Additional details: Sipchem reported record quarterly revenue at SAR1,475mn in Q2, higher than our estimate of SAR1,316mn (consensus: 1,291mn). While products prices were broadly known prior to earnings release, we believe that top-line beat was largely on account of higher-than-expected sales volume, most likely at its intermediate chemicals plants. Helped by operating leverage due to relatively fixed feedstock costs for Methane, gross profit outpaced the top-line growth, leading to the beat at the gross profit level. Further, lower than expected SG&A expenses (SAR135mn vs. SAR150mn anticipated) drove the operating profit above our estimate. Accordingly, net profit jumped to the highest level since Q2 2014 at SAR211mn, beating our (SAR173mn) and consensus (SAR171mn) estimates.

Figure 1 SIPCHEM Q2 results

(SAR mn)	Q2 2017	Q1 2018	Q2 2018	Y-o-Y	Q-o-Q	ARC est	Comments
Revenue	**918**	**1,171**	**1,475**	**60.6%**	**25.9%**	**1,316**	**Beat our and consensus estimates, largely due to higher than expected sales volume amid improved utilization rates.**
Gross profit	281	415	545	93.9%	31.4%	474	Improved production efficiencies further led to gross profit beat in Q1.
Gross margin	30.6%	35.4%	37.0%			36.0%	
Operating profit	176	284	410	133.7%	44.6%	340	Lower-than-expected SG&A expenses further pushed operating profit above our estimate.
Operating margin	19%	24%	28%			26%	
Net profit	**60**	**151**	**211**	**253.5%**	**39.6%**	**173**	**Consequently, beating our estimate of SAR173mn and consensus of SAR171mn.**
Net margin	7%	13%	14%			13%	

Source: Company data, Al Rajhi Capital

What to expect in the near term? Sales volume might come under pressure in H2 2018, largely due to possible maintenance shutdown at the IMC plant in Q4 2018, which is long due (last shutdown was in Q4 2015). Current prices of few intermediates products (such as Acetic Acid, EVA, etc., except VAM) indicate a likely decline in Q3, while Methanol and polymer prices are likely to remain stable in the near-term. Further, we expect the weighted average products spread is likely to remain firm on stable Methanol prices and rising VAM pries (+5% rise since Q2) amid improved operating leverage.

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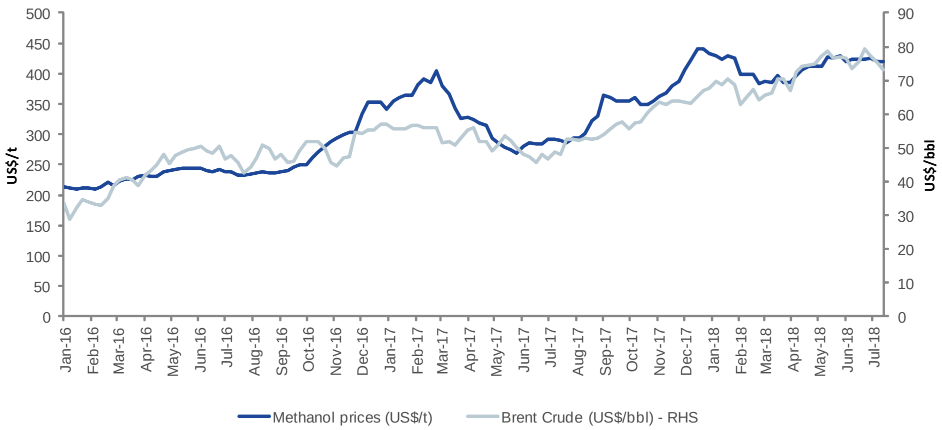
Medium term outlook for Methanol price: Global Methanol demand remained largely flat sequentially (~4% rise y-o-y) in Q2, on account of steady demand in energy-related applications (accounted~45% of total demand) despite lower MTO demand amid planned shutdowns (source: Methanex). On the supply side, the market remained tight in Q2, on the back of planned and unplanned maintenance shutdowns of few Methanol plants across several regions globally, which helped Methanol prices to increase moderately (+3% q-o-q) in Q2. Going forward, traditional Methanol demand (~55% of total), which is highly correlated with GDP and the industrial activities, continues to remain stable, while the demand for energy-related applications is likely to improve on strong operating rates for MTO plants in China post shutdowns. In addition, a couple of MTO facilities, which are currently under construction, are likely to be completed over the coming months, which will create an additional demand of ~3mn tonnes (at full capacity) of Methanol annually. On the other hand, the incremental capacity additions in China beyond 2018 are expected to be moderate due to tight Chinese environmental regulation. Consequently, healthy industry fundamentals may continue support Methanol prices, although the scope for significant rise in prices is limited from the current level, as evidenced by almost stable average Methanol price in July compared to Q2. Further, oil prices, which are highly correlated with Methanol (Figure 2), are likely to remain firm, on account of more balanced oil market, which may continue to support Methanol prices. Consequently, we update our price deck, which has resulted in upward revision to our forward looking estimates and thereby our TP.

Figure 2 Correlation between Brent and Methanol



Source: Bloomberg, Al Rajhi Capital

Sipchem signs an agreement to acquire 25% additional stake in IGC: Sipchem recently inked a deal with National Power Company (NPC) to acquire its 25% stake in the International Gases Company (IGC). Post deal, which is subject to approval of the concerned authorities, Sipchem's stake in IGC will increase to 97% from 72% currently. Given that Sipchem is already consolidating IGC in its operations, we don't see any material impact on the financial performance, except slight impact on distribution to minority shareholders, which would increase the bottom-line by just SAR3.5-4.0mn (+SAR0.01/share) based on our calculations. Also, we believe that the company is likely to finance this transaction (likely to be valued at SAR239mn) through internal accruals (Q1 cash balance: SAR2,193mn), while maintaining its capital structure.

New projects possible impact: Sipchem is currently upgrading its methanol plant and aiming to improve the efficiency of operations. It is expected that post completion of plant upgrade, likely in Q4 2018, methanol production capacity will increase to 1.3mtpa from 970ktpa currently. Being the high-margin product and the largest earning contributor, we consider this plant upgrade as earnings accretive as this will help the company to continue improve its bottom-line by expanding the external sales (currently 248ktpa used internally in Acetic Acid plant) in the coming years. In addition, the Polybutylene Terephthalate (PBT) plant, 100% owned by Sipchem, began the commercial operations on July 1, 2018 with a production capacity of ~63ktpa. We believe that the addition of the PBT plant will strengthen the company's product portfolio. As per our calculations (Figure 3), both the projects are likely to boost Sipchem' earnings (assuming full-year impact at 100% utilization).

Figure 3 Details of Sipchem's expansion Projects

Details of Sipchem's expansion Projects	Methanol plant Upgrade	PBT plant		Methanol plant Upgrade	PBT plant
Product capacity (kta)	330	67	**Ownership**		
Total capacity after expansion (kta)	1300	67	Sipchem	65.0%	100.0%
Location	Jubail	Jubail	Others	35.0%	0.0%
Construction phase	2Q16 - 4Q18	2Q13 - 2Q18			
In-service year	4Q18	3Q18			
Investment costs (SAR 'mn)	542.6	600	**Financing**		
Main feedstock	Methane	Butanediol	Debt	NA	Mixed
Feedstock supplier	Aramco	Internal - IDC	Equity		
Financial Impact on FY19E earnings					
Additional capacity (kta)	**330**	**67**			
Utilization	100%	100%			
Incremental sales volume (kta)	**330**	**67**			
Product prices price (US$/t)	350	1,150			
Implied incremental revenue (SAR 'mn)	**433**	**289**			
Average net margin	25%	15%			
Implied incremental net profit (SAR 'mn)	**108**	**43**			
Sipchem share (SAR 'mn)	**70**	**43**			

Source: Company data, Al Rajhi Capital

Valuation: We remain positive on Sipchem, given its strong fundamentals, improved production & operating efficiencies and cost saving measures along with a strong FCF generation capabilities. Further, IMC's Efficiency Enhancement Project is also on track and is likely to begin operation in Q4 2018, ensuring higher earnings growth in the coming years. Additionally, the commercialization of the PBT project enables the company to further realize the benefits from integrated operations. For 2018E, we expect the company to distribute a dividend of SAR1/share, on the back of sustainable cash flow and healthy financial position. Post updating our latest price deck as well as factoring in the PBT plant and IMC's Efficiency Enhancement project, we revise our forward looking estimates upwards. Accordingly, we revise our TP to SAR25/share based on equal mix of relative (SAR27/sh. based on 13.0x 12 month forward PE) and DCF valuation (SAR23/sh. based on FCF, cost of equity 13.6%). The stock is currently trading at a P/E of 12.5x and 12.1x on our 2018E and 2019E EPS, respectively, above its 3-year historical average of 11.8x.

Risks: Key upside risks include sustained improvement in Methanol price and higher than expected operating efficiencies. Major downside risks involve unexpected disruption at the company's upstream operations, which can further impact its downstream plants as well and persistent weakness in product prices, particularly Methanol prices. Methanol (IMC) is the most profitable segment and we believe any shutdown at Methanol plant could lead to steep decline in gross margin and may lead to revision in our estimates.

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