

MEPCO

CONFERENCE CALL TO DISCUSS MEPCO FINANCIAL AND OPERATIONAL RESULTS FOR THE FULL YEAR OF 2020.

Company: MEPCO

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Participants:

- Sami Al Safran, Chief Executive Officer
- Mohamed Darweesh, Group Chief Financial Officer
- Bassem El Shawy, Head of Strategy and Business Development

Operator

Ladies and gentlemen, thank you for standing by. I would like to welcome you to MEPCO Full Year 2020 Results Call. At this time all the participant lines are in listen-only mode. The format of the meeting today will be a presentation by the management team followed by a question-and-answer session. So, without further ado, I would now like to pass the line to Bassem. Bassem, the floor is yours.

Bassem El Shawy, Head of Strategy and Business Development

Thank you very much for joining us today. We will start as usual by disclaimers for forward-looking statements. Our management has made every effort to present a fair view of MEPCO's operational and financial performance, it is important to acknowledge the expectations about future results, the common line of prevailing operational, financial, and market conditions may change in the future. Management does not give forward-looking statements for financial investment decision purposes, does not take responsibility to explain differences between the future and actual results stated in the course of this presentation. Thank you very much.

I will start by giving you our quick overview about the results of the financial year 2020. It has been quite an interesting year for us. And it is not simply a set of results that we report today comparing 2020 to 2019. It's actually a lot more than that, it's something we take great pride on. It's definitely a landmark in this company's history. And I'll explain to you why. We are all at this stage the pandemic and its effects on the world and economies and different sectors. And when it comes to paper making in general, the sector was hit from two sides. First of all, you all know that we're very closely tied to the overall economic activity of nations and the consumption levels of consumers. And both things got really impacted. While we faced partial or even complete lockdown in many countries, the basic goods, the demand for basic goods climbed significantly in the first quarter of 2020, as people stocked up to get ready for an unknown lockdown.

So, we faced two contradicting things at the beginning of this year. First of all, a lot of decisions handicapped how we work reducing the number of workers to shift, and a lot of restrictions on mobility. And from the other side we are required to face and satisfy an excessive amount of demand that happened abruptly. So, the company's agility really was paramount in that situation. And as you see from the results, we did increase our production. And this was the immediate action that we put in place to face that excessive demand, even with lower number of workers and with less resources, especially on the fiber core. As fiber becomes scarce, because schools are shut down, offices are shut down. So, the availability of fiber locally and even across the world was a challenge. Add to this the challenge of actually delivering these collected amounts, no matter how small they are, to the factory. But we are blessed with having WASCO. And WASCO really was the building block of the success in this year, due to the far-reaching hands that extend across the whole of Saudi Arabia, Jordan and Sudan. WASCO was able to provide MEPCO with a continuous steady of fiber during this lockdown, that enabled us to actually push our utilization rate above 92%, while statistically the official rate dropped from 86% to below 82% worldwide.

This, of course, was a great vantage point. But price was not yet reflective of that situation. And we saw price starting to improve in Q4. This was the reason why we made our first increase for prices, back in December which was followed by another increase in prices this quarter. Prices now are still increasing rapidly, so are the prices for fiber worldwide, they're taking a really steep turn upwards. With raw material prices increase it pushes the end prices upwards as well. So, the bottom line of all that is that we are seeing a very good quarter in Q1 that's also been quite impressive. The results of 2020 that we achieved recording a 10% plus increase on both the production and sales levels. Also, we were paired by more efficiency in production; our cost per ton has been reduced. So, we achieved the best of both worlds in 2020.

Besides all that, we managed to lower our debt to equity ratio significantly from 0.9x in the end of 2019, to 0.77x in the end of 2020 and increased the cash at hand level that brought down the net debt to equity to 0.71x. This ratio is extremely low, it's really low. And it cannot be compared across the industrial sector, it has to be compared across the paper manufacturing sector. And the reason for us to bring this level down to that threshold is that gives us more ability to fuel the expansion strategic plan of the company during the next three years, which you saw, one of them was the tissue mill project. There are other projects only coming in the pipeline, this is only the tip of the iceberg. So, we are positioning the company in the situation that can leverage more going forward, to fuel more growth across different things.

This is a very quick overview about what we did in 2020. I would like to give you the chance to ask your questions. I'm sure there are a lot of them. So, please go ahead and queue up your questions. Thank you.

Operator

Thank you very much. We will be now moving to the question-and-answer session of the call. [Operator Instructions]. We have a question from Anas Al Sadafi from NCB Capital. Please go ahead. Your line is open.

Anas Al-Sadafi, NCB Capital

Thank you for the call. I have a couple of questions. Firstly, on the paper prices trajectory. If you can give us color and compare this cycle with the previous cycle? What are the factors that are causing paper prices to grow in a rapid pace? That's my first question, if you can just summarize what are the factors that are playing out especially the China factor, if you can also give us color on this front. And I leave my second and third questions later.

Sami Al Safran, Chief Executive Officer

Good afternoon gentlemen. This is Sami, the CEO of MEPCO. Thank you for the question. Paper prices used to be prices that are really like any other commodities, cyclical moving up and down based on supply and the demand and inventory level. Long ago we used to monitor this happening on the year, where the year started in upward, the trend peaked in the summer, then start the downward trend by the end of the year. However, in the last decade, we have monitored that this cycle has been stretched for an average of 4-5 years. And classically now

we are monitoring an upward trend for two years stabilization and downward trend for another two years. And thus, we have seen that by the peak of 2014 the prices start to soften '15, '16, then it started to pick up '17, '18. And now '19, '20 is becoming a downward trend and it's a normal evolution to see the prices of paper to go back and start to increase again, classically it should continue for two more years.

Now, the main driver reason behind the excessive spikes of prices of commodities is that the pandemic situation actually accelerated the demand of the packaging materials among all levels. And especially if you are well prepared, you can maybe materialize the opportunity very well, which we have done here at MEPCO that we have sold record quantities of production in the market. Now the economy is opening up and the things are normalizing, and most of the inventories are in a very low level.

Coming to the final comment about China's impact. China is one of the drivers of the demand of paper industries; due to the regulation, the restriction of receiving raw materials to the country creates the deficit between the local supply and the demand. And that increases the import from China from the rest of the world. We were lucky in MEPCO here to sell a significant increase of the volume year-to-year to Chinese market.

Anas Al-Sadafi, NCB Capital

Thank you, Engineer Sami. Can you give us color on the current spread between final paper and OCC? Because I have been reading that the final paper products have been increasing to the amount of \$120 per ton, they increase, of course, and OCC is that \$50 increase. What is the current today?

Sami Al Safran, Chief Executive Officer

Honestly, it's a bit difficult really to link them heavily. However, the curve is moving in parallel, we have seen classically. However, the developing and environmental regulation is affecting the movement of the curb for the raw materials. So, the raw material has been affected not only by the supply and demand, by the environmental legislations and regulations, which happen from one country to another. That we have seen in China, when the Chinese market dropped their import, China used to import an average of 25 million tons annually, from the total amount of almost 130 million tons in the market, assuming honestly, I'm not having an accurate figure for that. It drops from 25 to 12, and now almost touching zero. So, we have seen in 2019, an extensive drop in raw material prices due to the disappearance of the Chinese competition here.

Now, the same evolution should happen for 2021. But in reality, the demand was a big driver for the OCC and that kept the OCC prices as high. So, probably percentage wise it could rally but an absolute figure is a bit difficult.

Anas Al-Sadafi, NCB Capital

Okay, if you can give us color now on -- so you operate on a [inaudible] basis. If I want to just imagine your backlog, beginning of Q1 2021 and compare it to the same backlog in the past cycle, the mid of 2017-2018; profitability wise, is it the same in terms of spread or 2017-2018 was a better spread for you?

Bassem El Shawy, Head of Strategy and Business Development

Anas, this is Bassem. We might not be able to give you all these analytical details at that level. But I can tell you now that our current backlog extends beyond eight weeks, which is quite a healthy zone. Because if backlog becomes too much this is not a good sign. So, right now we are in a perfectly favorable zone when it comes to the backlog. Back to the previous years, of course 2019 we did not have such a thing, it was much lower than that. And 2018 had its own different set of circumstances. But what I can confirm to you right now is that the backlog we have is [inaudible].

Anas Al-Sadafi, NCB Capital

Maybe on the cost efficiencies, you mentioned that you were able to reduce your cost per ton. Can you give us more color on this? And my final question is on the new expansion and to the jumbo rolls, if you can give us a rationale regarding this expansion. Thank you.

Mohamed Darweesh, Chief Financial Officer

This is Mohamed Darweesh, CFO. We have a cost reduction in all directions starting from cost of goods sold up to the financial costs. If you look at the cost of goods sold, it dropped by 4%, we have several reasons for such reduction. As Bassem mentioned now, production increased by about 20% and consolidated shares increased by about 10%. This led to a decrease in cost over ton of fixed expenses. Also, fiber expenses or fiber cost dropped significantly in 2020 compared to 2019. We have also efficiency and maintenance expenses, CAPEX expenses, and so on.

If you go to operating expenses, we have a significant drop in operating expenses; operating expenses dropped by about 11%, compared to 2019. From another angle following the level that Bassem mentioned dropped by about 87 million and this made the net debt to EBITDA 0.71x. This issue dropped in finance costs; finance costs dropped by about 20% compared to 2019. For three reasons, less or lower banking rates, lower fiber and paper rates and lower volume.

Bassem El Shawy, Head of Strategy and Business Development

Anas, the second part of your question was related to tissue. And tissue was a natural evolution for us. It's something that we did because it's a low hanging fruit. Not to spend too much time into answering this because there are so many details related. But the proposition we saw in the tissue market in Saudi Arabia is very attractive; the market consumes circa 250,000 tons per annum, with a decent consumption of 7 kilograms per capita in Saudi Arabia that has the potential to grow. While the vast majority of this 250,000 which is around 160,000 to 180,000 tons is being imported from neighboring countries. You will have distinct advantage of being a local manufacturer of jumbo rolls and selling them to converting companies within Saudi Arabia. So, we have a logistical advantage, we have an energy advantage. We have many advantages, actually, compared to UAE and Egypt, and primarily Jordan which are the main exporting countries to Saudi Arabia, taking into consideration that Saudi Arabia is one of the top importing countries of tissue worldwide. So, these are the basic pillars that the whole plan is built on.

Anas Al-Sadafi, NCB Capital

The reason I asked is I'm just wondering, in terms of margin, across the [inaudible] more niche paper products have a higher margin than the test liners and also the tissue rolls. So, at the same time, we saw other players, we saw the returns on invested capital for other players in the market in the tissue space, and it is not that lucrative. So, if you can give us guidance on the margins for your expansion, and if you can comment on the strategic decision of expanding to the tissue, given the fact that you could have expanded into more niche paper products that have higher multiples?

Bassem El Shawy, Head of Strategy and Business Development

Great question actually, it taps on the very core of the decision. The strategic importance of this decision will answer your question about the margin. The tissue itself is as you said, is a finished product. But why did we integrate it into the operation model? It's not to make excessively high

margin. It is to streamline the revenue stream of MEPCO and the profitability of MEPCO in general. We could avoid the cyclical in containerboard and in also key prices because, of course tissue uses a different kind of fiber, it uses virgin pulp. And virgin pulp though can be cyclical, its cyclical is much lower than OCC and much lower than containerboard in general. So, it's going to flatten the cyclical of the top line and bottom line to a great extent. And it will offer you a few additional profitability [technical issue]. So, we look at it from a broader perspective. [technical issue]. Finally, I would like to emphasize that the difference in containerboard and tissue is that [technical issue] in all competitive markets, whether you are in the Middle East or Europe, or United States, we have the same [technical issue].

Anas Al-Sadafi, NCB Capital

Thank you.

Bassem El Shawy, Head of Strategy and Business Development

We have also another question. Did you receive any support from the government in 2020? If yes, how much was it?

Sami Al Safran, Chief Executive Officer

Actually, the support was very minimal. That has not been even addressed, because thankfully in 2020, we kept our operations to the maximum, our operating grade is exceeding 90% against the rest of the mills, which is below 90% or some of them went to the full shutdown. Because we are blessed with a backward integrated network that secures the raw material to us. As I said the containerboard was in a healthy demand in the region due to the disturbance of logistics; that helped us to divert a significant amount of our sales to the local market. We have actually increased our sales in the local market by more than 50,000 tons. So, accordingly, we would not need really for government to support except the regular ones, like rescheduling some of the minor loans and other.

Operator

Thank you very much. [Operator Instructions]. It looks like we are seeing no further questions. I'll pass the line to the MEPCO management team for the concluding remarks. Excuse me for that. There is a follow-up question from Mr. Anas. I will open the line once again. Anas from NCB Capital, your line is open.

Anas Al-Sadafi, NCB Capital

Just a follow-up, gentlemen on, again, the outlook of the market. So, we've been reading a lot of news that for the next 6 months, analysts are expecting further upside for all paper prices. Will this be reflected in your P&L going forward given that you are on a backlog basis? And my second point is, if you can give us more of a strategic view on the market prices? Do you think that this cycle could last more than a year, year and a half compared to the previous cycle?

Sami Al Safran, Chief Executive Officer

Thank you for the question. Regarding the paper analyst, it's true, the prices of paper are expected to continue healthy, like what we have mentioned earlier, look into that we are coming from the end of the two years downward cycle. Technically we should anticipate another two years of upward trend cycle. However, this time the cycle speed was so fast to see such high growth. This is why MEPCO consistently announced two price increases in one quarter, which is not a normal practice we do. Of course, speaking about the backlog, the backlog was taken in consideration, the escalation of the prices. And classically, most of the developments are doing so. And because we are running by order, usually we have a stock on our hands. I can read what is in my hand, which is a Q2 performance, like what my colleague was mentioning about the healthy demand, the healthy prices that should reflect positively and the P&L. But definitely it's difficult to commit anything for the time being until the right time is coming.

Anas Al-Sadafi, NCB Capital

Thank you, Engineer Sami. Also, I have been reading that there are lots of paper mills in Europe that are going through downturns, they are closing for maintenance. How do you see this affecting the pricing? And why would they go to maintenance now with very strong prices, if you can give us some color?

Sami Al Safran, Chief Executive Officer

In reality, it is classically like any other commodity in the world. Let's take the oil prices for example, you will find the oil prices is being adjusted by reducing the inventory and reducing the production which increase the demand and accordingly increase the prices. So, the same evolution is happening here with the paper industry. When the market gets saturated inventory goes high classically, most of the end user inventory is an average of four weeks. Once it drops

below the four weeks it increases the demand. And if there is not enough capacity in the market, it escalates the prices. And being in the pandemic in the last year that is leading to certain number of paper mills whether inside Saudi Arabia or in Europe, whether they are in a forced shutdown due to lack of material or they are in rescheduling and extended maintenance to maintain the healthy supply since the prices have been eroded heavily during 2020.

Now, the advantage is that if you are immune during the difficult time and such turning point is happening, you will be the first one to get an advantage upfront. So, we anticipate through the escalation of the demand that those developments in Europe will resume and operation to cater the market demand. However, it will take them some time before they reposition themselves and maintain a market share as needed.

Anas Al-Sadafi, NCB Capital

Thank you, Engineer Sami. Thank you, gentlemen.

Bassem El Shawy, Head of Strategy and Business Development

Thank you. We have a question about the current local export sales. It's always in our earnings release, you would always find them in our earnings release. And in 2020, we were standing at 57.7% for local sales and 42.3% on export sales. Which is lower for export sales than what we did in the previous year because we redirected a lot of our sales energy to cater for the local market needs during the pandemic. What we expect, we expect to still have focus on the local market. But that does not mean that we ignore or leave out export opportunities because we have presence in more than 35 or 40 countries worldwide.

I don't think we have any further questions.

Sami Al Safran, Chief Executive Officer

Thank you very much, gentlemen for giving us the time to present our results for 2020. I would like to thank our team in MEPCO. We have proven resilience at the critical timing where a lot of industries and businesses including paper industries were facing a lot of challenges. Whereas it is the year where MEPCO had recorded production numbers, and we have recorded sales volume numbers, which reflects the preparation and agility of our business model here. We are proud thankfully that we have catered the local market of Saudi Arabia for the containerboard was needed to subsidize at pandemic timing. And thankfully, we were at the right time, we achieved

a great satisfaction of our customers during the pandemic. We are delightful for this year that we are actually enjoying the fruits of the improving of the paper market prices, while the company is in a good shape and will prepare to harvest the effort which has been done. We will continue monitoring our expenses, of course, except for the raw material, which is based on commodity prices, but the healthy situation of the selling prices is able to accommodate such differences.

And needless to finalize, also or speak about our own company WASCO, and how WASCO have worked in a great support to cater the requirements of MEPCO during the demand of raw materials. In addition to WASCO now is exploiting the great opportunity into the waste management since Saudi Arabia has clearly announced the part of their vision of 2030 is to improve the waste management industries in Saudi Arabia. And hopefully we are in a good position to collaborate with the government, and a better result for the company. Thank you very much gentlemen.