Saudi Aramco Base Oil Co

Materials
LUBEREF AB: Saudi Arabia
16 May 2023

US$5.724bn	29.99%	US$35.13mn
Market Cap	Free Float	Avg. Daily Volume

Target price	134.50	5.6% above current
Current price	127.20	as at 15/05/2023

Existing rating

Underweight | **Neutral** | Overweight

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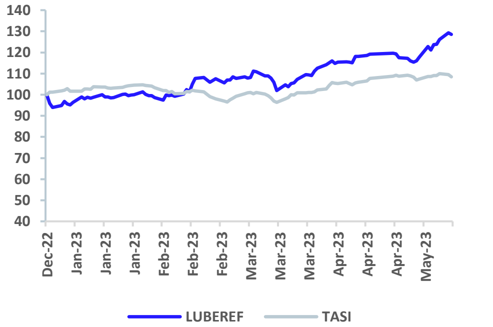
Performance(Rebased to 100)



Earnings

(SARmn)	2022A	2023E	2024E
Revenue	10,614	8,304	9,146
Y-o-Y	20.0%	-21.8%	10.1%
Gross profit	2,504	2,063	2,501
Gross margin	23.6%	24.8%	27.4%
Net profit	1,978	1,590	1,981
Y-o-Y	31.7%	-19.6%	24.6%
Net margin	18.6%	19.1%	21.7%
EPS(DAR)	11.7	9.4	11.7
DPS(SAR)	6.7	6.7	5.9
Payout ratio	56.9%	71.1%	50.0%
P/E (Current)	10.9x	13.5x	10.8x
P/E(Target)	11.5x	14.3x	11.4x

Source: Company data, Al Rajhi Capital.

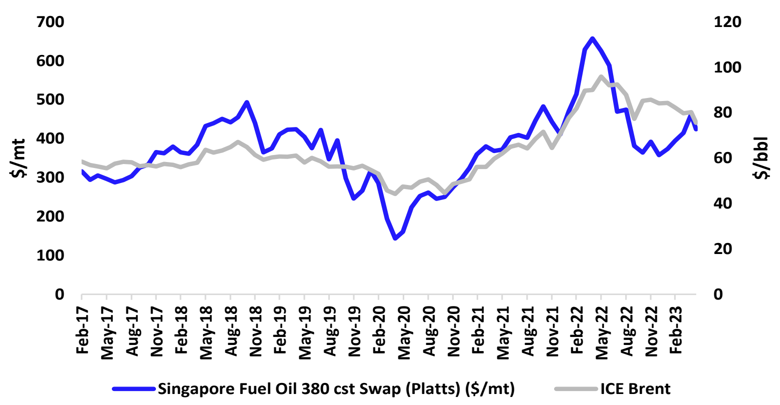
Saudi Aramco Base Oil Co.

TP increased to SAR134/sh, rating cut to Neutral

Luberef's Q1 earnings were mixed, with low sales volume being a primary driver for subdued revenues. The sales volume fell by 15% on a y-o-y basis but the decline in volumes were neutralised by an increase in base oil prices by 6% in Q1 2023 vis a vis Q1 2022 and a reduction in feedstock prices to some extent.

We expect 2023 earnings for Luberef may continue to be under pressure owing to squeeze in margins in H2 2023. This can be ascertained to the fact that even though crude oil prices declined in Q1 2023 versus Q1 2022, base oil crack margins improved considerably. The spreads in base oil improved from $420/mt in Q1 2022 to $680/mt in Q1 2023. We believe the current margins are not sustainable and will revert to average levels. We observe that the Singapore fuel oil which is a key feedstock for Luberef's products is generally correlated with Brent to a large extent (Figure 1). Accordingly, the current high margin scenario shall not flow through in the second half of 2023. However, as mentioned in our oil report, we expect the oil market to be balanced, driven by OPEC+ active role by way of announcing production cuts. As a result, we continue to remain positive on the company, mainly due to its i) leadership in downstream products, ii) strong operating cash flows, iii) competitive cost structure supported by its long term agreements on feedstocks, iv) proximity to key end market areas, v) strategic expansion via Growth II project which shall bring in production facilities for Group III base oils in its product portfolio and vi) ability to pay dividends. Overall, post Q1 2023 earnings, we revise our estimates, resulting in an improvement in TP to SAR134/sh from SAR114/sh earlier, implying a "Neutral rating" at the current market price. We believe despite the current rally in the stock due to MSCI inclusion, fundamental factors shall support the stock for more upside.

Figure 1 **Singapore Fuel Oil versus Brent**



Source: Bloomberg, Al Rajhi Capital

Figure 2 **Q1 2023 Earnings**

(SAR mn)	Q1 2023	Q4 2022	Q1 2022	ARC est.	Cons Est.	q-o-q	y-o-y	vs ARC	vs Cons
Revenue	1,797	1,809	2,741	2,088	1,947	-0.7%	-34.4%	-13.9%	-7.7%
Gross Profit	555	754	506	479	NA	-26.4%	9.5%	15.9%	NM
G. margin	*30.9%*	*41.7%*	*18.5%*	*22.9%*	*NA*				
Operating Profit	474	642	422	402	NA	-26.2%	12.1%	17.7%	NM
Op. Margin	*26.4%*	*35.5%*	*15.4%*	*19.3%*	*NA*				
Net Profit	**446**	**763**	**303**	**371**	**336**	**-41.6%**	**47.3%**	**20.3%**	**32.8%**
Net Margin	*24.8%*	*42.2%*	*11.0%*	*17.7%*	*17.2%*				

Source: Company data, Al Rajhi Capital

Q1 2023 results: Top-line decreased ~34.4% y-o-y to ~SAR1797mn, largely below our estimates of SAR2088mn owing to a drop in sales volume. However, gross profit and operating profit improved y-o-y, as a result of lower feedstock costs and improved margins. Accordingly, net income was reported at ~SAR446mn, substantially above our estimates of SAR371mn (consensus: SAR336mn).

Valuations: We expect Luberef to generate an annual cash flow in the range of SAR1.8bn-SAR2.1bn over 2023-2027e. Given its ability to generate decent cash flows, we believe that the company will be able to pay its minimum committed dividends of SAR6.7/sh for 2023. We value the company based on a mix of DCF (40% weightage) and dividend capitalization (60% weightage). The DCF valuation method (11.8% cost of equity; 10.9% WACC), implies a TP of SAR135/sh (SAR34.5/sh earlier). Dividend capitalization is based on a fair value yield of 5.0% and implies a target price of SAR134/sh. Our blended valuation gives a weighted average TP of SAR134/sh, implying a 5.6% upside from current levels. Based on the current TP we reduce our rating from “Overweight” to “Neutral”.

Risks: The key downside risk to our valuation is a steep surge in interest rates which looks unlikely at this point. Other downside risk factors to our estimates are lower-than-expected dividends, unplanned shutdowns, downside in oil prices and higher than expected freight costs.

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

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