Advanced Petrochemicals Co

Petrochemicals – Industrial
APPC AB: Saudi Arabia
20 April 2021

الراجحي المالية
Al Rajhi Capital

US$4.65bn	9%	US$6.00mn
Market cap	Free float	Avg. daily volume

Target price	90.00	+11.7% over current
Current price	80.60	as at 19/4/2021

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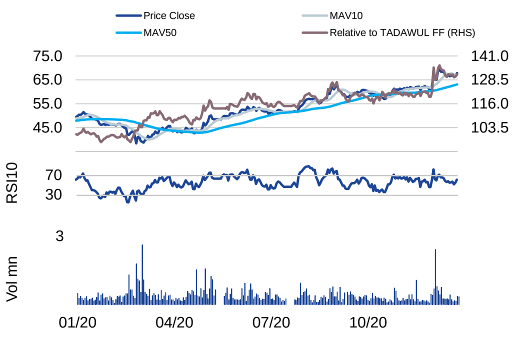
Existing rating

Underweight	Neutral	Overweight

Performance



Earnings

(SARmn)	2019	2020	2021E
Revenue	2,595	2,231	3,068
Y-o-Y	-5.6%	-14.0%	37.5%
Gross profit	899	729	1,082
Gross margin	34.7%	32.7%	35.3%
Net profit	759	596	940
Y-o-Y	5.9%	-21.6%	57.8%
Net margin	29.3%	26.7%	30.6%
EPS (SAR)	3.5	2.8	4.3
DPS (SAR)	2.6	2.6	2.6
Payout ratio	73.3%	94.5%	59.9%
P/E (Curr)	23.0x	29.3x	18.6x
P/E (Target)	25.7x	32.7x	20.7x

Source: Company data, Al Rajhi Capital

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1Q 21 earnings / Management commentary; Raise target price to SAR90/share

We hosted a couple of calls for investors/clients with APPC to discuss Q1 earnings and details about the recently announced gas allocation/Jubail project. Post our calls, we reiterate our OW rating on Advanced Petrochemicals. Q1 results was also a testament to management quality where the company managed to outperform expectations despite the planned shutdowns, with net income beating our estimate by 20%. PP prices continue to remain elevated, mainly due to tight supply (on account of planned/unplanned maintenance shutdowns) and higher oil prices (winter storm in Texas in Feb). Some plants are likely to come on stream in April/May, so prices may come down due to the seasonality factor. On the other hand, there is a healthy demand in the market, which may support PP prices going forward. Overall, we expect a good spread for PP products in the coming quarters, given that Propane prices are generally lower in Q2 (already declined by 10% m-o-m in April) and Q3. Accordingly, we expect healthy earnings growth in 2021. Given the management quality, the pipeline of projects, healthy demand, and prices, we revise our target price upwards to SAR90/share based on SAR65/share for existing plants (4% dividend yield on DPS2.6/share), SAR15/share for the PDH-PP Jubail plant (NPV basis) and SAR10/share for the latest project. Despite the 2 projects, the stock is currently trading at a P/E of 18.6x on our 2021E EPS. We believe there is high visibility for SAR2.6/share dividends in 2021 given the est. profits and company's preference to maintain dividends.

Figure 1 APPC Q1 2021 results

(SAR mn)	Q1 2021	Q1 2020	Y-o-Y	Q4 2020	Q-o-Q	ARC est	vs ARC
Revenue	**632**	**535**	**18.1%**	**633**	**-0.2%**	**608**	**3.9%**
Gross profit	207	154	34.4%	217	-4.6%	160	29.0%
Gross margin	32.8%	28.8%		34.3%		26.4%	
Operating profit	164	125	31.2%	175	-6.3%	124	32.3%
Operating margin	25.9%	23.4%		27.6%		20.4%	
Net profit	**171**	**104**	64.4%	**180**	-5.0%	**142**	20.2%
Net margin	27.1%	19.4%		28.4%		23.4%	

Source: Company data, Al Rajhi Capital.

Q1 results: APPC reported Q1 revenues at SAR632mn, almost flat sequentially and mostly in line with our expectation of SAR608mn. PP sales volume declined 24% q-o-q, mainly on account of 16 days and 25 days shutdowns (starting 11 March) at the PP and Propylene plants, respectively. However, this was offset by the improvement in PP prices (+32% q-o-q) during the quarter. The impact from the shutdowns was lower than our expectation, leading to a beat at the gross profit level. This further flowed down to the operating level as well. Consequently, gross and operating margins came in 6.4pps and 5.6pps above our estimates, respectively. Nonetheless, lower-than-expected equity income from SK Advanced (~SAR16mn vs. SAR26.7mn estimated) capped the beat at the net profit level. Accordingly, net profit reported at SAR171, missing our estimate of SAR142mn.

SAR0.65 DPS for Q1 2021. Advanced Petrochemical Co.'s (APPC) board of directors recommended a 6.5% cash dividend (SAR0.65/sh) for Q1 2021, amounting to SAR140.7mn, in line with the recent historical quarterly trend. We believe that the company may prioritize expansion plan ahead of dividends and accordingly, we now expect the company to maintain its annual dividend at SAR2.6 for 2021E.

Q1 earnings call summary (14 April 2021)

Q1 2021 highlights

- Net profit for Q1 2021 increased by 64% y-o-y, driven by higher prices; however, declined 5% q-o-q.
- Polypropylene sales prices rose 36% y-o-y and 32% q-o-q in Q1
- Sales volumes declined 13% y-o-y and 24% q-o-q resulting from periodic scheduled maintenance in Q1 2021
- Propane and outsourced Propylene prices increased by 22% y-o-y (40% q-o-q) and 11% y-o-y (11% q-o-q), respectively
- Consumption of outsourced Propylene jumped 126% y-o-y; however declined 30% q-o-q in Q1, due to a planned shutdown at SATORP.
- SK Advanced: Higher spreads and relatively lower base last year (mainly due to shutdowns) contributed a sharp jump in equity income on an annual basis. Expecting better product spreads going forward.

Sales breakdown: Shifted to high netback markets in Q1.

- Turkey: Sold 36% of total sales volume vs. the average of 21% in Q4 2019 and 40% in Q1 2020.
- Latin America: 14%
- China: 3%

Turnaround: The PDH and PP plants were closed for 31 and 17 days in Q1, resulting in lower sales volume. The company said that post catalyst replacement, the plants usually take around two weeks to ramp up the production at full capacity. Further, the company indicated that there would not be any further plant shutdowns this year and the next planned shutdown would be in March 2024.

PP Price is improving, mainly due to tight supply (7% drop in propylene and 8% cut in PP supply) on account of a few plant turnarounds and snowstorms in the US in Feb, resulting in higher earnings for the company in Q1 2021. A few of the plants are likely to come on stream in April/May, so prices are expected to come down gradually; however, APPC doesn't expect a sharp reduction in PP prices going forward. There is a healthy demand (4-4.5% annually) in the market, post improving economy amid the roll-out of vaccination programs across the globe. This, along with lower Propane prices (mainly in Q2 and Q3) in the coming quarters due to seasonality factors, is like ensure a very good spread for the company this year (mainly in H2 2021).

EPC contracts: Advanced subsidiaries signed a total of US$1.7bn worth of contracts to construct propylene and polypropylene plants in Jubail. Both these contracts have a term of 37 months with the likely commencement of commercial operations by H2 2024.

- First contract: AGIC inked EPC contracts worth US$1.2bn with Samsung Engineering Co. Ltd. and Samsung Saudi Arabia Co. Ltd. for the construction of the PDH plant (843k tons of propylene) in Jubail Industrial City II.
- Second contract: AGIC also signed EPC contracts worth US$485mn with Tecnimont S.p.A and Tecnimont Arabia Ltd. for the construction of two polypropylene plants (800k tons of PP) in Jubail Industrial City II.

Payment terms: The company has not yet paid to the vendors; however, the company is expected to make the regular payment as per the agreed payment terms in the future.

March 2021 – Management call summary (17 March 2021)

- **Products:** 1.15mtpa of ethylene, 850ktpa of propylene, and 400ktpa of aromatics and fuels, and their derivatives.
- **Technology:** Will be the first of its kind in the Kingdom
- **Feedstock mix:** Mixed feedstock depending on the prices but will share the details in due course.
- **Grace period:** 7 years and 3 months of grace period from the commencement
- Ownership: The majority of the plant will be owned by the company through AGIC
- **D/E:** 70-75% debt and 25-30% equity
- **IRR:** Aiming for a double-digit IRR (above 10%)
- APPC aims to create an incremental value for its shareholders through this project.
- APPC plans to differentiate its products using new technology to sustain itself in the market, which is likely to see an incremental supply globally, mainly in China.

Possibility of an additional allocation of producers: APPC is not sure about others if they can get the additional allocation from the ministry of energy. If the producers request then they might get depending on the type of plant and projects.

DPS: Plans to maintain the dividend going forward despite the announcement of the new project.

PDH-PP project: The project is progressing well despite the pandemic. The company signed almost 15 agreements in 2020, starting from licensing the JV agreement, SAR3bn project financing, to the signing of offtake agreements.

More details on the project

APPC's subsidiary secured feedstock allocation to set up a petchem complex in Jubail. Advanced Petrochemical Co., through its subsidiary Advanced Global Investment Co. (AGIC), obtained approval from the Ministry of Energy for allocating the required feedstock to develop a petrochemical complex project in Jubail. APPC plans to produce 1.15mtpa of ethylene, 0.85mtpa of propylene, and 0.4mtpa of aromatics and fuels and their derivatives. Based in Jubail Industrial City, the project is expected to start commercial production in Q4 2025.

Currently, the company has a PP production capacity of ~0.6mtpa, and another 0.8mtpa PDH-PP plant is under construction (likely to start the production in H2 2024; 85% owned). Now, this project is even bigger with a total capacity of ~2mtpa, ensuring continuous organic growth in the coming years. While it is difficult to estimate the potential impact on the stock currently, due to limited data availability, we believe that the stock is likely to trade a premium to others due to its this and other proposed projects (new PDH-PP plant, new PDH plant in Korea, among others).

New PDH-PP project provides an additional upside: APPC and SK Gas recently have started constructing a SAR6.75bn complex of PDH and PP plants. The capacity to manufacture is 800kpta of Polypropylene and the complex will be set up in Jubail Industrial City, Kingdom of Saudi Arabia. This new capacity is even larger than the current production levels of around 600ktpa. In Oct 2020, APPC also announced the addition of the Isopropanol (IPA) plant with a production capacity of 70ktpa and an estimated cost of SAR300mn. Post the IPA plant addition, the project cost is now estimated at SAR7.05bn (SAR6.75bn expected earlier), which is likely to be financed by equity (25%) and borrowing (75%). Advanced JV will own an 85% equity stake while the remaining 15% will be owned by SK Gas. The project is estimated to begin commercial production in H2 2024. APPC has also signed 5.5 years of Murabaha facility worth SAR1.5bn with banks, which will be utilized to fund most of its growth capex including this project.

Based on our NPV analysis, using a 9% cost of equity, 4% cost of debt, and expected EBITDA of SAR1.2bn annually from 2025 and SAR7bn capex spread throughout the initial years till 2024, we expect the value accretion to APPC of around SAR15/share. Although there were concerns that dividends may get cut, however, we believe that the company won't cut any dividends for this project given that a new Murabaha facility has been signed for SAR1.5bn (this is the same as 25%*85%* SAR6.75bn, the project cost ex-IPA plant).

Figure 2 New PDH-PP KSA plant

	Capacity	EBITDA (SARmn)	Fair value calculation	
Now (ktpa)	600	886	WACC	5.2%
New PP project (ktpa)	800	1,181	NPV (SARmn)	9,103
New IPA project (ktpa)	70	83	Debt (SARmn)	(5,288)
Ke (%)		9%	**Equity value (SARmn)**	**3,816**
Kd		4%	No. of shares (mn)	216
Tax rate (%)		3%	**Per share value (SAR)**	**18**
Maintenance capex (of EBITDA)		6%	APPC stake	85%
			APPC's value (SAR)	**15**
Initial investment (SARmn)		7,050		
Debt finance (%)		75%		
Equity finance (%)		25%		

Source: Company data, Al Rajhi Capital

Figure 3 Approx. expected cash flows of new PDH –PP plant

Year	2021	2022	2023	2024	2025	2026	2027
% project completion	20%	20%	40%	20%			
Investment (SARmn)	(1,410)	(1,410)	(2,820)	(1,410)			
EBITDA (SARmn)					1,264	1,264	1,264
Tax (SARmn)					(32)	(32)	(32)
Post Tax EBITDA (SARmn)					**1,232**	**1,232**	**1,232**
Maintenance capex (SARmn)					(76)	(76)	(76)
Change in working capital (SARmn)					-	-	-
Expected cash flow (SARmn)	**(1,410)**	**(1,410)**	**(2,820)**	**(1,410)**	**1,157**	**1,157**	**1,157**

Source: Company data, Al Rajhi Capital

Valuation and risks: We continue to remain positive on the company's medium to long-term growth prospects, due to i) strong utilization rates, ii) consistent operating performance, iii) FCF generation ability, iv) healthy balance sheet, and v) excellent management quality. The stock is currently trading at a P/E of 18.6x on our 2021E EPS despite the massive expansion (3-year historical average of 15.6x).

We value the existing plants using a 4% historical dividend yield on DPS of SAR2.6 for 2021. The management has reiterated its preference to maintain dividends giving us confidence especially as PP prices stay elevated. To this, we add our estimated value of the new PDH-PP KSA plant (SAR15/sh based on our NPV analysis) and the recently announced project (SAR10/sh) to arrive with a TP of SAR90/sh. We believe that the dividend yield-based valuation approach is ideal to value the fundamentally strong dividend-paying companies like APPC amid the current market dynamics. The key upside trigger might be attributed to sustained improvement in spreads while further weakness in product spreads, a dividend cut, and/or any unplanned shutdown may act as the downside triggers.

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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.

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