Market Commentary

Saudi Petrochemicals market
Industrial - Petrochemicals
23 February 2011

الراجحي المالية
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Key themes

We expect Saudi petrochemicals suppliers to outperform global rivals with margins driven by cheap feedstock costs and strong demand coming from Asia. We believe a shift towards heavier, more expensive feedstock in plants from now on will not constrain profits growth as improving prices and higher volumes should offset the higher costs. In addition, petrochemicals prices have maintained their upward momentum so far this year driven by growing demand from Asian countries and rising concern over supply from the Middle East.

Implications

The upward momentum of petrochemicals prices has been reflected in higher Q4 profits for the petrochemicals companies under our coverage. We expect price sto stay firm for the time being. The shift towards feedstock based on new technologies will generate new employment opportunities, but may also depress margins for petrochemicals producers since new feedstocks (naphtha, propane, butane, and other hydrocarbons) have a higher cost than the traditional heavily subsidised ethane.

Our coverage universe

Stock	Rating	Price Target
SABIC	Overweight	SAR 126.0
Sipchem	Overweight	SAR 29.9
Saudi Kayan	Underweight	SAR 15.5
Yansab	No rating	
PetroRabigh	No rating	

Note. We do not have investment ratings for Yansab and Petro Rabigh, as they are not Sharia-compliant by Al Rajhi Capital's definition. Saudi Kayan has appeared on our Sharia restricted list due to its high debt since the publication of our original Underweight rating.

– Feb 2011

No major events

Key benchmark overview

Name	21-Feb-11	1 M (%)	QTD (%)	YTD (%)
TASI	6298.9	-5.4%	-4.9%	-4.9%
TASI Petroleum	6139.2	-6.7%	-5.8%	-5.8%
Brent ($/brl)	107.7	10.6%	12.8%	12.8%
Natural Gas ($/MMBtu)	3.9	-18.6%	-9.0%	-9.0%
Ethylene ($/MT)	1465.0	6.5%	21.6%	21.6%

Source: Bloomberg, Tadawul, Al Rajhi Capital

Key macroeconomic data

	2009	2010E	2011F
GDP growth forecast	0.2%	3.8%	4.2%
Inflation	4.2%	5.4%	3.9%
Base interest rate	2.0%	2.0%	

Source: Al Rajhi Capital, Saudi Arabian Monetary Agency (SAMA)

Saudi Petrochemicals Monthly: Upward momentum continues

Prices of ethylene and other basic petrochemicals have continued their upward momentum, rising by 5% month-on-month and 22% year-on-year as of 21st February. The recent surge in the oil price, reflecting political unrest in the Middle East, should help ensure that the momentum persists. So too should firm demand from Asia and decreasing reserves of ethane, the major feedstock for Middle Eastern petrochemicals producers. Although we expect Saudi share prices to be very volatile in the near term, our long-term reasons for optimism about the sector are intact. SABIC is our preferred company in the sector and is one of our top five Overweight recommendations among Saudi stocks.

Petrochemicals prices still moving up: Petrochemicals prices have continued their upward move with an average increase of 5% month-on-month and of 22% year-on-year as of 21 February 2011. Note: our definition of the average change in petrochemicals prices is the simple average of price growth for ethylene, propylene, methanol and benzene. Besides rising crude oil prices (see below), we expect continued strong demand for ethylene from the Asia Pacific region, particularly China, to boost petrochemicals prices further in the near term.

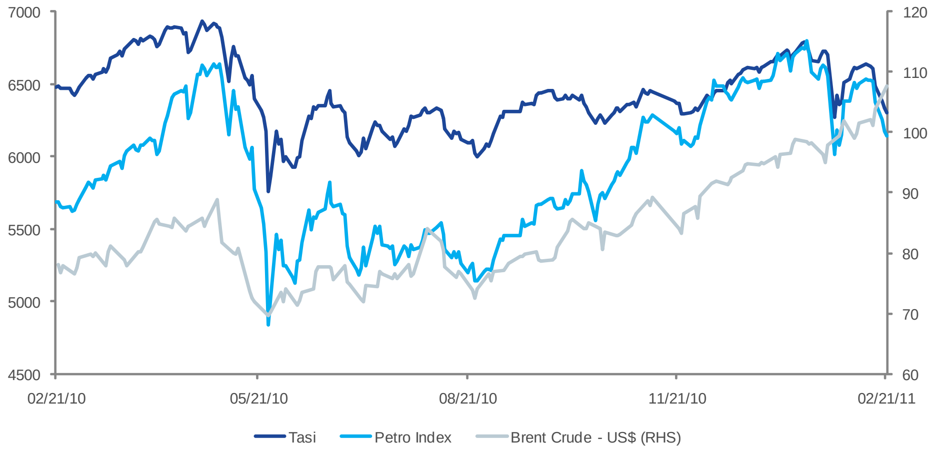
Oil prices rising fast: Political turmoil in the Arab world so far in 2011 has boosted oil prices. After revolutions in Tunisia and Egypt, unrest verging on civil war has now engulfed Libya, one of the region's leading oil suppliers. The price of Brent crude oil, which ended January at just over US$99, reached US$106 per barrel on 22nd February due to concern about the impact of the Libyan unrest on supply; meanwhile, the price of WTI crude oil, which had lagged that of Brent, surged by around 10% that day to over US$95. While the precise relationship between oil prices and petrochemicals prices is hard to analyse, there is little doubt that in practice they are closely correlated and so rising oil prices should help the upward momentum in petrochemicals prices to persist.

Focus on shift in feedstock: The GCC petrochemicals industry is experiencing a shortage of ethane, its prime feedstock, due to higher demand from other industries like power, steel, and aluminium. Industry sources suggest the region is developing policies that favour domestic gas use over exports and favour phasing out price subsidies. We expect these moves to encourage petrochemicals groups to start moving away from ethane-based, export-oriented petrochemicals production and to adopt plans to produce a wider slate of high-value speciality chemicals. For example, SABIC recently announced that it is exploring new technologies to replace gas-based crackers with LPG and other hydrocarbons.

Bright long-run prospects: In our key report *Saudi Petrochemicals Sector: Advantage Saudi Arabia* (4th August, 2010), we argued that the combination of the world's lowest feedstock costs and major capacity expansion was turning the Saudi petrochemicals sector into a formidable force capable of meeting surging demand in China and Asia. The upward move in petrochemicals prices since then supports our positive long-run view. Nevertheless, after this year's turmoil we expect equity markets in the region including Saudi Arabia to remain volatile and think investors may apply a higher risk premium to Saudi stocks. Against this background we highlight the attractions and relative safety of SABIC, which was one of the top five Overweight recommendations, included in our report *Saudi Equity Strategy: Top five stocks for harder times* (31st January, 2011).

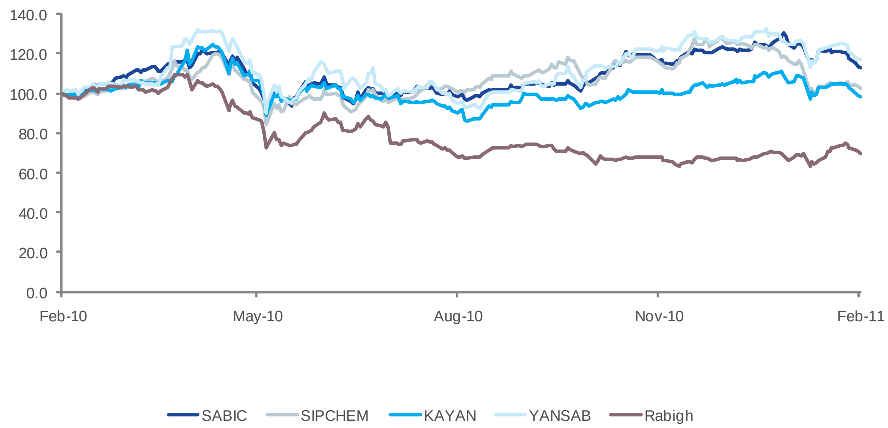
The TASI and crude oil prices moved in tandem historically. However, political unrest has led to a jump in the oil price while the TASI has fallen

Figure 1. TASI & Petro index movement and crude oil prices



Source: Bloomberg, Tadawul, Al Rajhi Capital

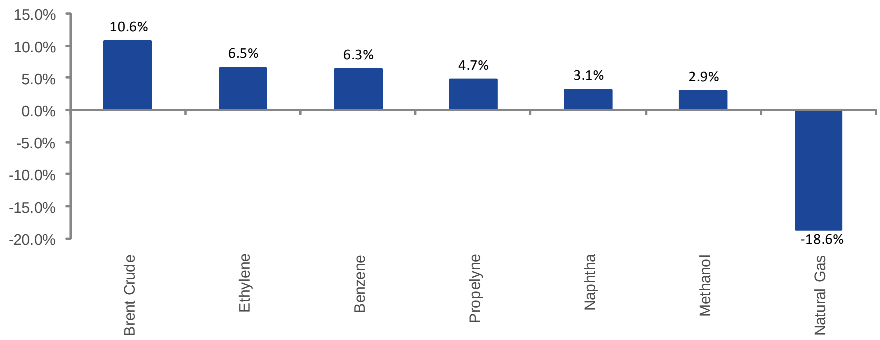
Figure 2. Stock performance of Saudi petrochemicals companies (rebased to 100)



Source: Bloomberg, Al Rajhi Capital

Except for natural gas, prices of hydrocarbons and basic petrochemicals have been rising

Figure 3. Price performance of hydrocarbons and basic petrochemicals (month-on-month, %)



Source: Bloomberg, Al Rajhi Capital. (Note: Prices as of 21 Feb 2011)

Industry developments
duties in India

Pressuring India for removal of anti-dumping duties

The Saudi government has been in talks with the Indian government about India's allegedly restrictive policies regarding petrochemicals imports. In 2010, India reimposed anti-dumping duties on polypropylene imports from Saudi Arabia. The Gulf Petrochemicals and Chemicals Association is willing to go to the WTO to protest (source: Zawya news, 23rd January 2011). We believe that Saudi companies will be only moderately impacted by Indian duties, as China is currently the key driver of demand.

Corporate developments
new technology the key

SABIC

Strong Q4 performance

In Q4 2010, SABIC reported revenues of SAR40.9bn, up by 30% from Q4 2009 and up by 8% from the Q3 2010 level. Revenues from the Petrochemicals, Fertilisers and Metals segments were up by 42%, 72% & 24% respectively. Revenues increased due to strong volume growth and higher product prices. In 2010, total production rose by 12% to 65mn tons. SABIC posted net profit of SAR5.8bn for Q4. For the full year 2010, the company reported net profit of SAR 21.6bn, an increase of 138% on a year-on-year basis.

Exploring new technologies and investment opportunities

According to Zawya (news dated 28th January 2011); SABIC is exploring new technologies for replacing gas-based crackers as it foresees a shortage of gas which is currently a major feedstock for the company. The company is carrying out research into the use of syngas, LPG and other hydrocarbons to replace gas. However the company will incur higher feedstock cost if it shifts to other sources to run its cracking plants as the company currently enjoys an advantage in the form of cheap feedstock, i.e. subsidised ethane. To capitalise on steady and modest growth in demand amidst an improved global economic environment, SABIC is also evaluating new investment opportunities especially in the faster-growing Latin American region. (Source: Zawya news dated 19 January 2011).

SABIC may face EU tariffs on PET exports

The European Union (EU) threatened to impose tariffs against import of polyethylene terephthalate (PET) from Saudi Arabia and Oman. The EU believes that EU producers of PET are suffering injury, as companies in Saudi Arabia and Oman benefit from government subsidies resulting in a price differential. SABIC, which is the sole producer from Saudi Arabia, is required to provide answers to the investigations by the EU by 25 March 2011. PET, with a US$4.1bn market in Europe, is used to make plastic bottles for carbonated drinks, juices, oils, cosmetics, and water. (Source: Zawya news dated 20th February 2011).

Sipchem

Q4 net profit more than doubles year-on-year

Net profit in Q4 2010 increased by 122% year-on-year and by 49% quarter-on-quarter to SAR125mn driven by strong revenue growth. The growth in revenues reflected higher production of two of the company's core products, methanol and butanediol, as well as better pricing for the majority of the company's petrochemicals products. The launch of Phase 2 production facilities in the middle of 2010 contributed to robust profits growth – albeit to a level below most analysts' forecasts. Net profit for the year 2010 increased to SAR378mn, a year-on-year increase of 168%.

Sipchem to start ethyl acetate, butyl acetate production by Q2 2013

As a part of the strategy to grow in downstream products, in full integration with current products portfolio, Sipchem plans to start production at its ethyl acetate/butyl acetate plant (with capacity of 0.1 mtpa) at its complex in Jubail during Q2 2013 (source: company press release dated 8th January, 2011). In mid-December 2010, Sipchem announced that it intends to raise US$400mn in Q1 2011 to finance its expansion project, of which around US$100mn is due to be spent on the ethyl acetate plant.

Saudi Kayan

Q4 net loss at SAR4mn

Saudi Kayan reported a net loss of SAR4mn in Q4 2010. The net loss for the year 2010 was SAR15mn compared to a loss of SAR17mn in the year 2009. The units of Kayan are in pre-operational stage. Saudi Kayan, coming on board at Jubail will be one of the largest petrochemical plants in the world with annual production capacity of around 6 million tons.

Kayan sends shipment of acetone and starts trial production at HDPE plant

Kayan has started producing acetone and sent its first shipment (1,600 tons) to India's markets. The output capacity of acetone plant is 140,000 tpa. The company also started trial operations at its high density polyethylene plant on 20th January, 2011 according to a company press release. The plant has production capacity of 0.4mtpa.

Kayan inks deal with Saudi firm and Dow-Aramco

According to a press release dated 31st January 2011, Kayan has signed an equal tripartite agreement with the Dow-Aramco joint venture entity and Saudi Acrylic Acid Co. to build and operate an SAR1.8bn N-butanol plant in Jubail Industrial City with a planned capacity of 0.3mtpa.

Yansab

Q4 net profit jumps

Net profit in Q4 2010 was SAR555mn, compared to a net loss of SAR7mn in Q3 2009 and representing a 55% increase from SAR356mn in Q2. Full commercial production and positive trends in product prices were reflected in higher net profit.

PetroRabigh

Improved Q4 net profit on a year-on-year basis

Q4 2010 net profit was SAR53mn compared to loss of SAR324mn in the corresponding quarter of 2009. Net profit after taxes for the year 2010 was SAR134mn, compared to a loss of SAR1.4bn for 2009. Higher volumes, higher product prices and lower financing costs were key contributors to the growth in net profit.

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Additional disclosures

1. Explanation of Al Rajhi Capital's rating system

Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:
"Overweight": Our target price is more than 15% above the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.
"Neutral": We expect the share price to settle at a level between 5% below the current share price and 15% above the current share price on a 6-9 month time horizon.
"Underweight": Our target price is more than 5% below the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

2. Definitions

"Time horizon": Our analysts make recommendations on a 6-9 month time horizon. In other words, they expect a given stock to reach their target price within that time.
"Fair value": We estimate fair value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.
"Target price": This may be identical to estimated fair value per share, but is not necessarily the same. There may be very good reasons why a share price is unlikely to reach fair value within our time horizon. In such a case we set a target price which differs from estimated fair value per share, and explain our reasons for doing so.
Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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