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Saudi Petrochemicals Sector: Kingdom continues to rule

Saudi Petrochemicals companies may face a rise in feedstock costs due to ethane shortages in the near term. However, even with likely increase in feedstock costs, the cost advantage of Saudi Petrochemicals companies remains intact. Further, strong demand from the Asian economies, coupled with slower capacity additions is expected to result in pricing power to the Petrochemicals players over the next few years.

Industry review

Favourable demand supply scenario augurs well for the product prices: Although the global Petrochemicals industry witnessed record capacity additions in 2010 (about 50mmt), it was matched by rebounding demand especially from the Asian giants. We expect a healthy growth in demand for Petrochemicals in the next few years driven by a rise in consumption levels especially in the BRIC economies as well as an economic recovery in the developed markets. On the other hand the capacity additions are expected to slow down because of 1) delays in project execution in the MENA region (about 30% of the overall global new capacity) due to political uncertainties, 2) delays in capacity additions in Iran (with large planned capacity additions) due to the sanctions and 3) lingering concerns of overcapacity due to record capacity additions over the last three years (global capacity addition of 115MMT versus a rise in demand of 58MMT). We believe that the growth in demand for Petrochemicals will surpass the growth in supply (figure 1), which can lead to a rise in product prices as well as higher utilizations for the Saudi Petrochemicals companies.

Tighter ethane supplies in Saudi Arabia may lead to a rise in feedstock costs: Saudi Petrochemicals companies are facing scarcity of ethane as a feedstock. Ethane supplies, which used to be significantly higher than the annual allocations till 2008, have been below the allocations since 2009 (figure 2). Dow's recent announcement to build ethylene production plant in the US, the first since 1995 to take advantage of increasing shale gas supplies also underscores the feedstock shortage concerns. Although, Saudi Aramco (the only ethane supplier in Saudi) is reportedly injecting huge investments in gas exploration in order to increase supplies (refer industry news section), we believe that the ethane supply will remain constrained in the near to medium term.

Apart from the scarcity of ethane, rising alternative use of natural gas especially in electricity generation and higher cost of production of non associated gas (where the economics are different from associated gas, a by-product of oil production) may lead to a reduced availability of ethane for the Saudi Petrochemicals sector.

Global cost advantage still remains intact: Although Saudi Aramco might raise ethane prices from $0.75/mmbtu currently from 2012 onwards as a response to anti-dumping concerns raised by the European countries, the global cost advantage of the Saudi Petrochemicals companies will remain largely intact as the average global market price of ethane is about $4.5/mmbtu (figure 3).

Key themes

This Market commentary analyses the short term and long term impact of record capacity additions over the last three years, ethane shortage and short term monetary tightening in China on the Petrochemicals industry in Saudi Arabia.

Implications

Although the industry has added record capacities in 2010, it was matched by rebounding demand. We believe that the long term fundamentals for the industry remain intact as future capacity additions are expected to lag the global demand post 2011. Further, as Aramco explores new gas fields, the pressure on the supply side of the value chain (ethane shortages) should also be eased.

Our coverage universe

Stock	Rating	Price Target
SABIC	Overweight	SAR 131.2
Sipchem	Overweight	SAR 25.5
Saudi Kayan	Underweight	SAR 15.7
Yansab	No rating	
PetroRabigh	No rating	

Share price performance – 11 June, 2011

Company	Current price	MoM (%)	YTD (%)
SABIC	SAR 102.5	-6.2%	-0.4%
Sipchem	SAR 21.35	0.7%	-14.6%
Saudi Kayan	SAR 18.55	3.3%	-3.9%
Yansab	SAR 46.6	-6.4%	-2.5%
PetroRabigh	SAR 27	-2.9%	20.0%

Source: Bloomberg, Tadawul, Al Rajhi Capital

Key benchmark overview

Name	11-Jun-11	1 M (%)	QTD (%)	YTD (%)
TASI	6509.5	-3.2%	-1.7%	-1.7%
TASI Petroleum	6745.0	-2.2%	3.5%	3.5%
Brent ($/brl)	119.0	4.7%	24.6%	24.6%
Natural Gas ($/MMBtu)	4.7	11.6%	11.6%	11.6%
Ethylene ($/MT)	1505.0	-2.6%	24.9%	24.9%

Source: Bloomberg, Tadawul, Al Rajhi Capital

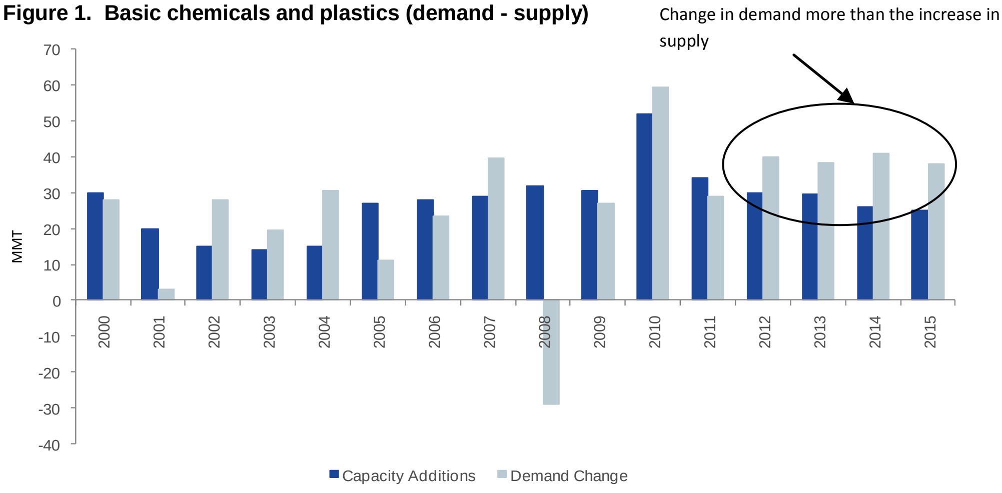
Key macroeconomic data

	2009	2010	2011F
GDP growth forecast	0.6%	3.8%	6.1%
Inflation	5.1%	5.3%	4.8%
Base interest rate	2.0%	2.0%	

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

Capacity additions lag demand growth post 2011

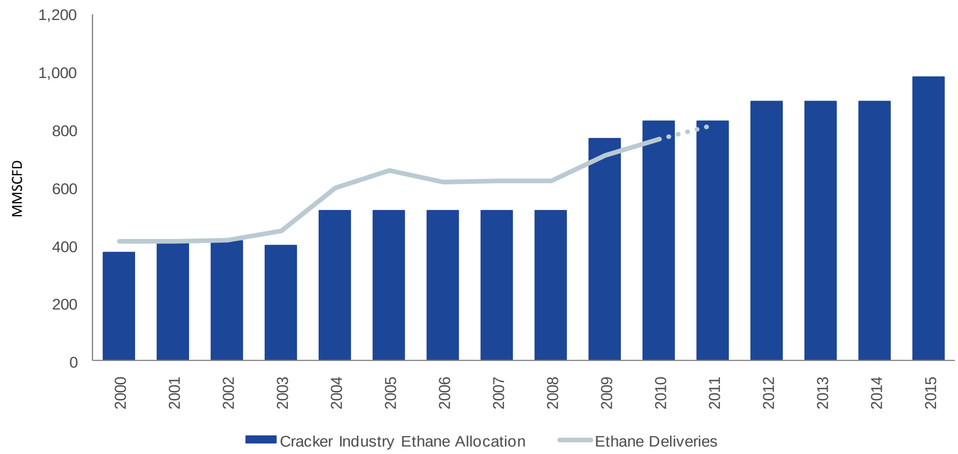
Figure 1. Basic chemicals and plastics (demand - supply)



Source: CMAI

Ethane supplies below allocations since 2009

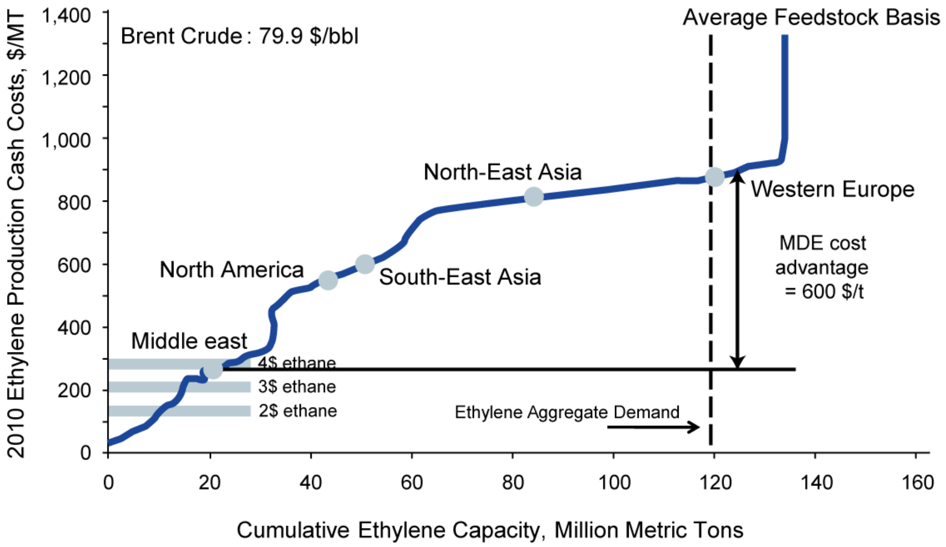
Figure 2. Ethane deliveries below allocations



Source: CMAI

Global cost advantage remains intact even with a probable increase in the feedstock cost

Figure 3. Cost competitive advantage for Middle East



Source: CMAI

Analysis: Impact of a rise in feedstock cost

Even though there is no clarity over rise in feedstock cost, which is heavily subsidized currently, we think that Saudi Aramco might raise ethane price (a major feedstock for Saudi Petrochemicals industry) from $0.75/mmbtu from Q1 2012 resulting in depressed gross margins for the Saudi Petrochemicals sector.

Below we calculate the impact of the increase in ethane prices on the 2012E gross margins of the companies under coverage. We have assumed that some of the increase in feedstock cost will be passed onto the customers. We don't expect any increase in propane prices as we believe that there is a little cost advantage to the Saudi companies using propane as a feedstock.

Company	Feedstock used	Ethane as a % of total feedstock	FY12E gross margin (at $0.75/mmbtu)	FY12E gross margins (at $1/mmbtu)	FY12E gross margins (at $1.25/mmbtu)
SABIC[1]	Ethane, Methane, Naphtha	65.0%	39.1%	37.2%	35.2%
Sipchem	Ethane, Methane	60.0%	57.1%	55.0%	52.9%
Yansab	Ethane, Propane	50.0%	55.0%	52.6%	50.3%
Kayan	Ethane, Butane	35.0%	50.1%	48.3%	46.4%
PetroRabigh[2,3]	Ethane, Butane	7.7%	11.2%	11.2%	11.2%
Saudi Petrochemicals sector		**70.0%**	**NA**	**NA**	**NA**

Source: Company data, Al Rajhi Capital

Notes- We have assumed a feedstock cost/total cost ratio of 35-45% for all the companies
1 - We have assumed the impact only on the Petrochemicals business and not on the other businesses
2 - The impact will be seen only on the Petrochemicals business (11% of the cost of sales).
3- As the company already buys ethane at $1.5/mmbtu. In addition, Saudi Aramco (ethane supplier) is a parent co. of PetroRabigh

We have no idea about the ratio of feedstock cost to total cost and have assumed a ratio of 35-45% for the companies under coverage. The impact on the margins of the companies will be different depending on the feedstock cost/cost of sales ratio. Our sensitivity analysis shows that the impact on the SABIC margins will be moderate as it has higher fixed cost (in cost of sales) as compared to other companies. The impact on the Yansab and Kayan margins is also not expected to be significant as these companies use higher percentage of heavier feedstock such as Propane and Butane. We expect the impact on Sipchem margin to be partially offset by benefits from higher output from phase II expansion. We don't expect any impact on PetroRabigh as the company already procures ethane at a higher price of $1.5/mmbtu. The charts below show the sensitivity of the feedstock cost ($/mmbtu) with the gross margin.

Figure 4.1 SABIC (gross margin - FY12E)

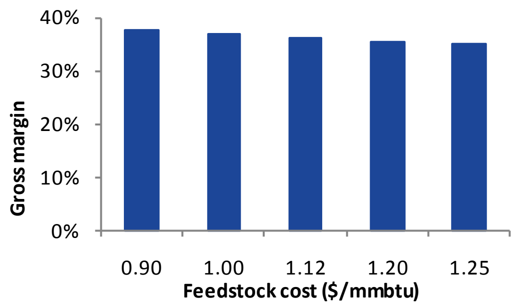


Figure 4.2 Sipchem (gross margin - FY12E)

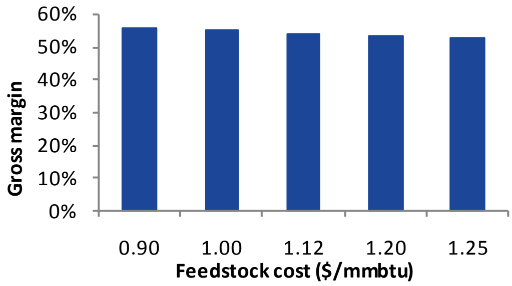


Figure 4.3 Yansab (gross margin - FY12E)

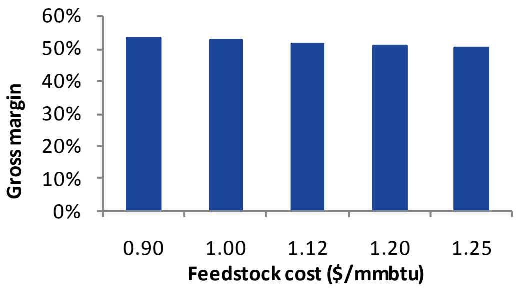
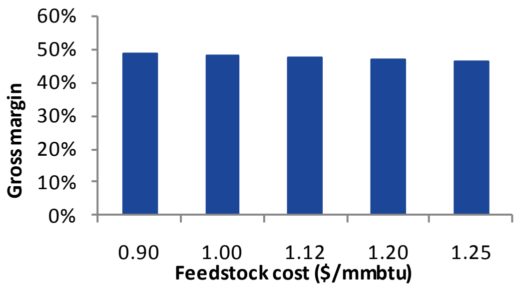
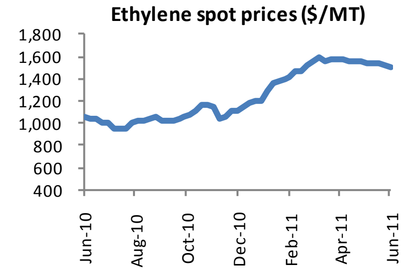
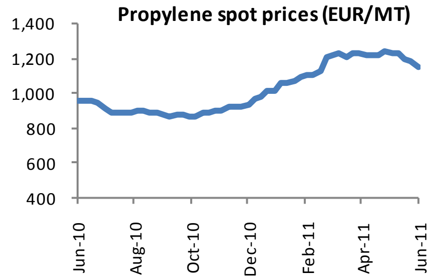


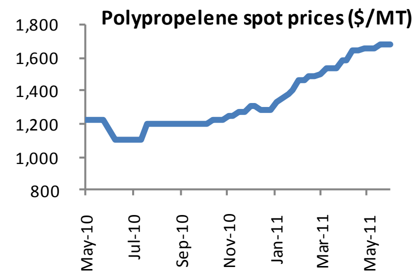
Figure 4.4 Kayan (gross margin - FY12E)

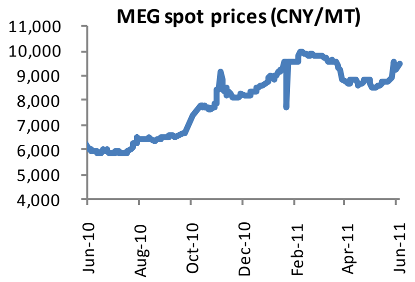


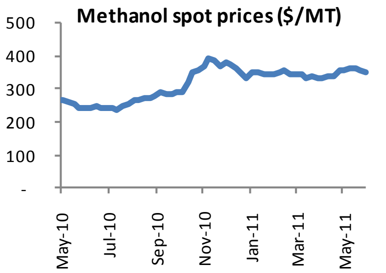
Analysis: key product prices











Source: Bloomberg

Ethylene

Ethylene prices have been moderately declining since the start of April 2011 due to easing supply concerns. The prices in the last two weeks of February and in March were at an elevated level due to cracker shutdowns in northeast Asia. However, as the crackers (Mitsubishi Chemical -0.45MTPA, Idemitsu Kosan- 0.37 MTPA, Korea Petrochemicals – 0.47 MTPA, and Shell – 0.8 MTPA) restart, the supply scenario should improve considerably easing the pressure on the prices. Nonetheless, Ethylene prices at $1505/MT (first week of June) are about 6% up as compared to the average price in the prior quarter directly benefiting most of our covered companies (SABIC : 7.2 MTPA capacity, PetroRabigh :1.25MTPA, Yansab :1.3MTPA)

Propylene

Recently, Propylene prices have also been dropping on account of slower derivative demand and rising supply levels. The crackers in Japan resuming the operations coupled with the return to normal operations in South Korea following a heavy cracker maintenance season boosted the Polypropylene supply. Nevertheless, Propylene prices at EUR1212/MT (first week of June) were up about 6% as compared to the average price in the prior quarter. We expect PetroRabigh (capacity: 0.9MTPA) and Yansab (capacity: 0.4MTPA) to benefit from the improved prices in Q2.

Polypropylene

Polypropylene prices are up about 13% sequentially so far in the quarter due to tight supply amidst a spate of maintenance shutdowns at plants in the Middle East and Asia and a force majeure situation at 'Enterprise Petrochemical' plant in Texas. However, the prices are not expected to increase further as there is no visible uptick in demand. We expect SABIC (capacity: 0.77MTPA), PetroRabigh (capacity: 0.7MTPA), and Yansab (capacity: 0.4MTPA) to benefit from the improved prices during the quarter.

Mono Ethylene Glycol (MEG)

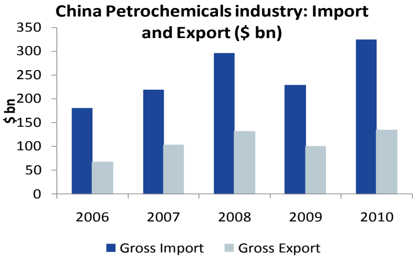
The MEG prices have sequentially declined about 7% so far in the current quarter. However, the prices have been on an uptrend from mid-May after Nan Ya Plastics was asked to shut two of its plants (capacity: 1.18 MTPA) by the Taiwanese government following a fire at two of its other plants (capacity: 0.72 MTPA) on May 12, 2011.The prices were further supported by a shutdown announced by Taiwan's FPCC of a couple of its crackers in Mailiao. We believe that the supply will remain constrained for at least a month helping boost the prices further. We expect SABIC (capacity: 3.5MTPA), PetroRabigh (capacity: 0.6MTPA) and Yansab (capacity: 0.7MTPA) to benefit directly from the improved prices in the quarter.

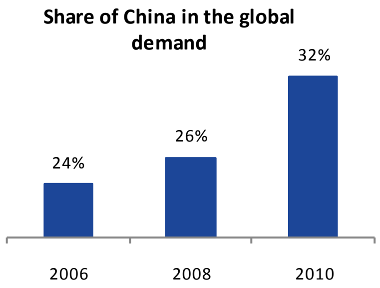
Methanol

Although declining moderately since mid May, Methanol price are up about 0.8% on an average compared to Q1. Methanol is a key product for SABIC (capacity: 4.13 MTPA) and Sipchem (capacity: 1MTPA). As the prices have remained stable in the quarter, we don't expect any material impact on SABIC and Sipchem's performance.

Vinyl Acetate Monomer (VAM)

From mid April to May end, the prices of VAM shot up due to a force majeure event on BP's acetic acid (a major feedstock for VAM) plant. The event affected VAM production in the US. Dow reportedly was the third major US VAM (after Celanese and LyondellBasell) producer to restrict production during April and May. The VAM prices in Q1 2011 and so far in Q2 were about 20% higher than Q4 2010. We believe that the demand for VAM remains bullish while the supply is expected to remain tight till June end. We further expect Sipchem to benefit in Q2 due to improved VAM (capacity: 0.3 MTPA) prices.





Source: CMAI

Region spotlight: China

China has been at the forefront of driving demand for Petrochemicals products. Chinese Petrochemicals industry has risen by 34% year-on-year during the first four months of 2011 to RMB 2.95trillion[1] ($453bn). China's Petrochemicals industry is expected to realize RMB15 trillion[2] (USD 2.31 trillion) of gross domestic output value by the end of 2015 from about RMB8.88 trillion in 2010, growing at a CAGR of 14%. China's Petrochemicals imports grew by 42.3% in 2010 to $324.5bn, after a dip in 2009.

Short term outlook

The demand for Petrochemicals is expected to be subdued in the next few months as a result of Chinese government's steps to curb inflation by withdrawing some of the economic stimulus measures such as tax breaks on smaller cars or subsidies to buy home appliances.

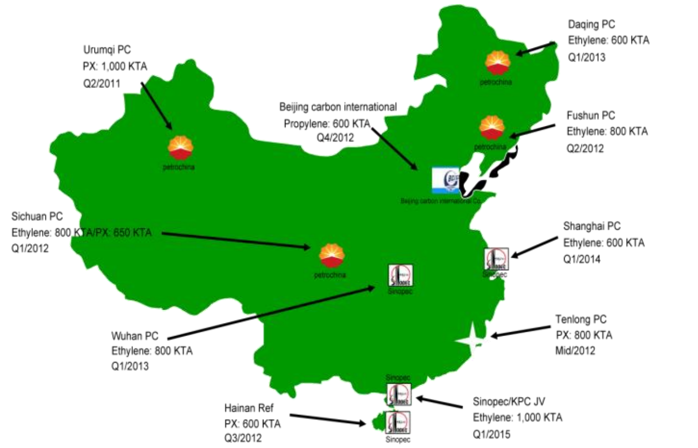
Long term outlook

In the medium to longer term, the Petrochemicals industry is set to indirectly benefit from 1) China's huge government spending on infrastructure (Chinese government has allocated $1.3 trillion for infrastructure development over the next five years in the 12th Five Year Plan announced in the early 2011), 2) increasing domestic consumption which is expected to grow by 2 to 3 percent over the next five years, and 3) continuing housing construction (Chinese government plans to build approximately 36 million affordable housing units by 2015). Although, China is adding substantial Petrochemicals capacities (refer figure 7.2), it will take a few more years for these capacities to come on-stream directly benefiting the Middle East Petrochemicals industry in general and Saudi in particular.

Figure 5.1 China supply – demand

Source: CMAI

Figure 5.2 Major Petrochemicals projects in China



Source: CMAI

[1] Source: National Development Commission of China
[2] Source: China Petroleum and Chemical Industry Federation

Major industry news

Saudi Arabia plans to raise Petrochemicals capacity by around 33% by 2016: Saudi Arabia plans to boost its Petrochemicals output to more than 80 MTPA from the current capacity of 60 MTPA. This would entail an investment of approximately $100bn over the next five years (Source: Bloomberg news dated June 07, 2011).

Impact/comment – The announcement is in-line with Saudi's ambition to be the global hub of Petrochemicals production.

Saudi Aramco to complete its first non-associated gas field project by 2012: Saudi Aramco, announced that it will complete its first offshore non-associated gas field project 'Karan' by 2012. Karan field has a capacity to process 1.8 billion standard cubic feet per day (scfd) of raw dry gas. The company also announced a discovery of additional Khuff offshore gas fields at Arabiyah (1.2 billion scfd) and Hasbah (1.3 billion scfd) and plans to commence drilling in June 2011. (Source: Saudi Aramco annual review released on June 06, 2011)

Impact/Comment - In order to meet the growing demand for gas from Petrochemicals and power industries Saudi Aramco has been focussing on raising gas output by concentrating its efforts on non-associated gas production. The development should help alleviate the concerns of ethane shortage currently faced by the Saudi Petrochemicals companies.

Oil falls as Saudi Arabia signals supply boost: Crude oil fell the most in four weeks after Saudi Arabia reportedly announced that it is increasing the oil production to 10 million barrels a day (an increase of 1.5 million barrels per day) next month. The oil prices had jumped on June 8 after OPEC failed to reach a deal to increase output, raising fears of supply shortages later this year. Brent crude for July delivery fell $1.18 to $118.39 on this news.

Impact/Comment – Our company forecasts assume a crude oil price of $93 per barrel, which is on a conservative end as compared to prevailing market price. PetroRabigh is a direct beneficiary of higher crude oil prices due to its refining exposure, while other companies are indirect beneficiaries (as Petrochemicals product prices move in tandem with oil prices).

Company news/result updates

The companies in our coverage universe reported robust Q1 2011 results in mid April. The companies in the current quarter benefited mostly due to increased Petrochemicals product prices on the back of improved crude oil prices.

SABIC (Overweight, Price Target: SAR131.2)

Strong product pricing helped deliver robust performance in Q1

Robust Q1 2011 performance: SABIC continued to deliver strong performance amidst improving product prices and capacity-driven volume growth. In Q1 2011, SABIC recorded a 31.5% year-on-year jump in revenues to SAR44.87bn powered by robust product prices (contributing about 60% to the top-line growth). The robust top-line growth was also supported by full production at Yansab and a launch of commercial production at Sharq (Saudi Arabia) and Tianjin complex (China) in Q2 2010.

JV for capacity addition in specialty chemicals, SABIC's focus area

SABIC to establish two new plants in collaboration with Mitsubishi Rayon: In late May, SABIC announced a 50:50 joint venture with Mitsubishi Rayon Company to build and operate two plants - one for methyl methacrylate (MMA), and the other for polymethylmethacrylate (PMMA) - at one of SABIC's manufacturing affiliates in Jubail. The MMA plant is expected to be the largest ever built, with an annual capacity of 250,000-metric tons while the PMMA plant will have an annual capacity of 40,000 metric tons. This project will help SABIC broaden its specialty portfolio enabling it to move further downstream.

Separately, in mid May, SABIC announced its plan to build a new polycarbonate plant at its joint venture Petrochemicals complex with Sinopec. The plant is designed to have an annual production capacity of 260,000 metric tons and is expected to be operational by 2015. Polycarbonate is a key plastic used for producing components for automotive parts and a variety of consumer products. The project is estimated to cost at least $1bn.

SABIC capital seeks $2bn revolving credit facility: According to industry news, SABIC Capital IBV, a financial unit of SABIC, is seeking a $2bn, five-year loan to refinance its debt. It may be noted that SABIC Capital was established in 2008 to look after the financing and tax operations of SABIC's investments in Europe and the U.S.

Sipchem (Overweight, Price Target: SAR25.5)

Maintenance shutdown results in sequential decline in revenues

Q1 revenues more than double on a year on year basis: Sipchem posted a robust revenue growth of about 127% in Q1 benefiting primarily from phase II expansion. However, the company recorded a 14% sequential fall in Q1 sales to SAR693mn as against our estimate of SAR800mn for the quarter (consensus was at SAR831mn). The sequential decline in revenues was principally due to a maintenance shutdown at 'International Acetyl Company' complex which was closed for about 20 days in January 2011.

Saudi Kayan (Underweight, Price Target: SAR15.7)

Increased inventory levels in Q1 signifies ramp up in trial operations

Net loss widens further: Saudi Kayan reported a net loss of SAR8mn in Q1 compared to a net loss of about SAR4mn in Q4 2010. During the quarter, the company started the trial operations at its polycarbonate plant (capacity: 26,000 tons a year). The company also witnessed a sharp jump in the inventory level to SAR947.1mn at the end of Q1 versus SAR498.3mn at the end of Q4 2010 reflecting an increased activity at the company's plants. However, high & rising debt (SAR26.4bn at the end of Q1 2011) and uncertainties related to timely start of operations remain major areas of concern.

Yansab (No rating, Price Target: NA)

Robust product pricing during the quarter helped deliver strong margins in the quarter

Strong overall performance in Q1: Yansab reported Q1 revenues of SAR2.1bn, up 10% quarter-on quarter. The sequential revenue growth was triggered by an increase in volumes as well as higher pricing for company's major products (Ethylene, Propylene, and Polypropylene). On a year-on-year basis, revenues increased by about three times as the company benefited from a low base in Q1 2010 (the commercial operations started by the end of Q1 2010). Riding on higher product prices, Yansab posted a robust net profit of SAR718m in Q1 2011, significantly higher than our estimate of SAR638m and the consensus estimate of SAR656m.

PetroRabigh (No rating, Price Target: NA)

Increased crude prices coupled with improved operating rates helped deliver strong results in Q1

Solid performance in Q1: PetroRabigh's revenues for Q1 2011 grew by 16.8% sequentially to SAR15.1bn (compared to our estimate of SAR12.9bn). The company benefited from improved crude oil and Petrochemicals product prices during the quarter (grew by about 13% sequentially on average) and increased operating rates.

PetroRabigh to restart crude unit this week: On June 5 2011, PetroRabigh announced that it will restart the crude oil distillation (capacity: 400,000 bpd) refinery on June 7. The refining and Petrochemicals complex was shut since April 21 for nearly two months on account of planned maintenance.

Annexure 1: Price performance charts

Figure 6.1 TASI & Petro Index Movement and Crude Prices

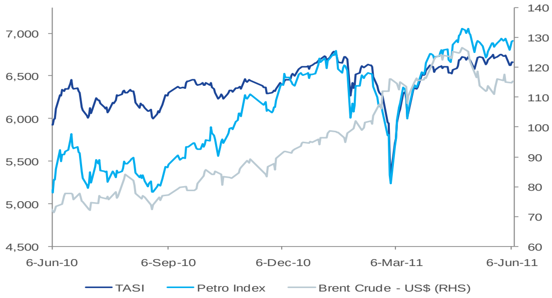


Figure 6.2 Stock Performance of PPC companies in Saudi (Rebased to 100)

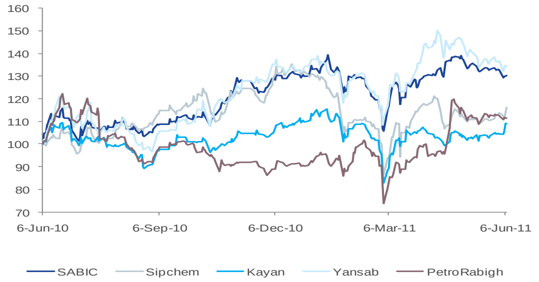


Figure 6.3 Relative movement of crude oil against dollar index

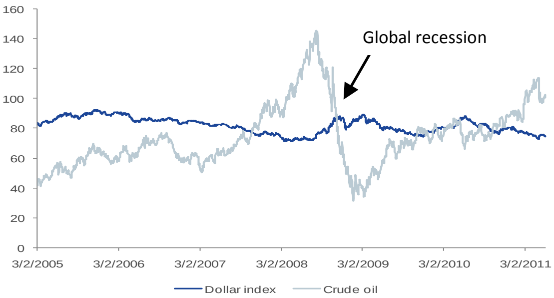


Figure 6.4 WTI Cushing Crude oil spot price

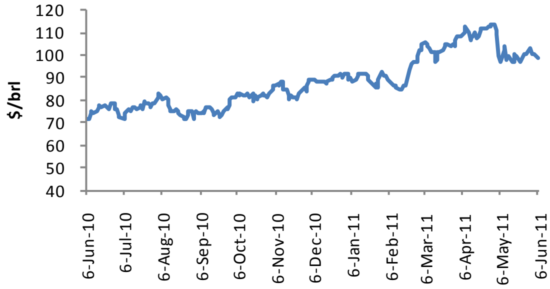


Figure 6.5 Henry Hub Index

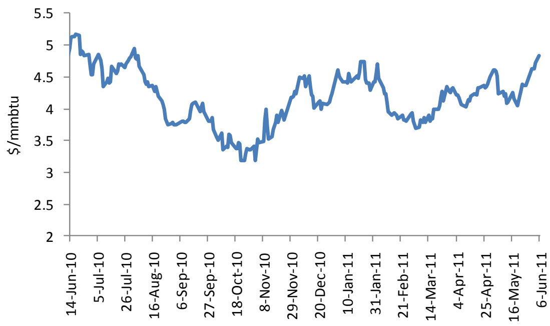


Figure 6.6 Naphtha Japan Spot Price

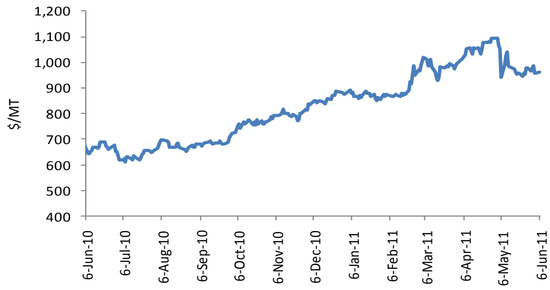
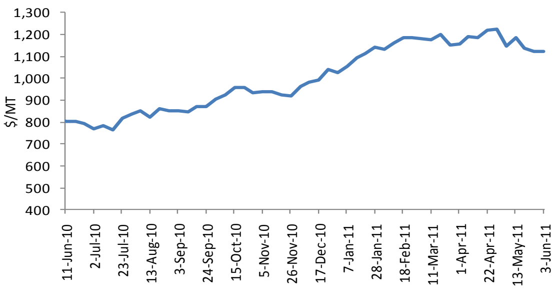


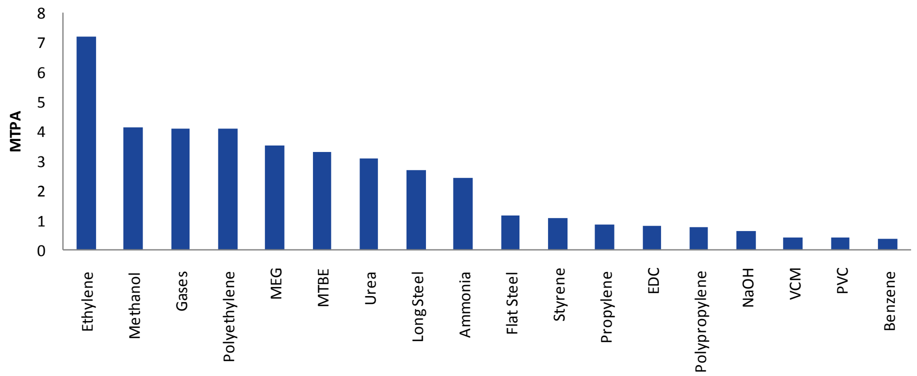
Figure 6.7 Benzene fob Korea Spot Price



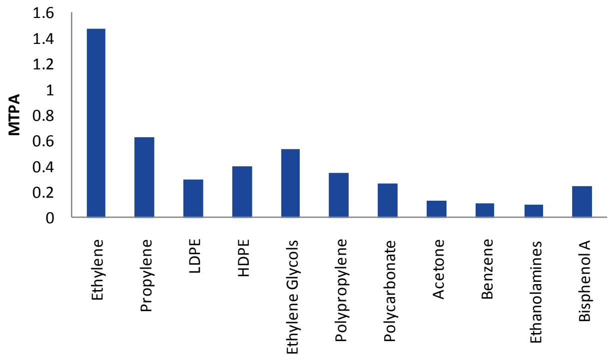
Source: Bloomberg, Al Rajhi Capital

Annexure 2: Coverage companies- Key products and capacities

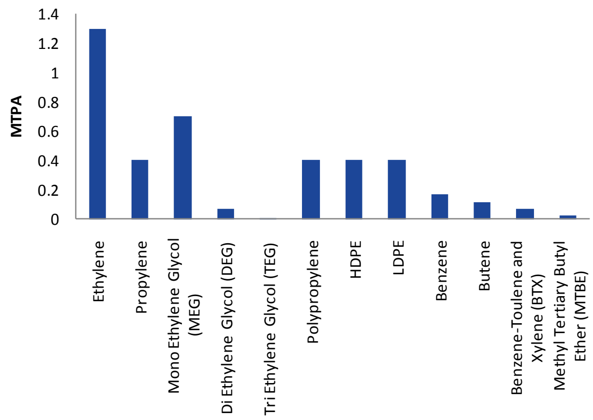
SABIC



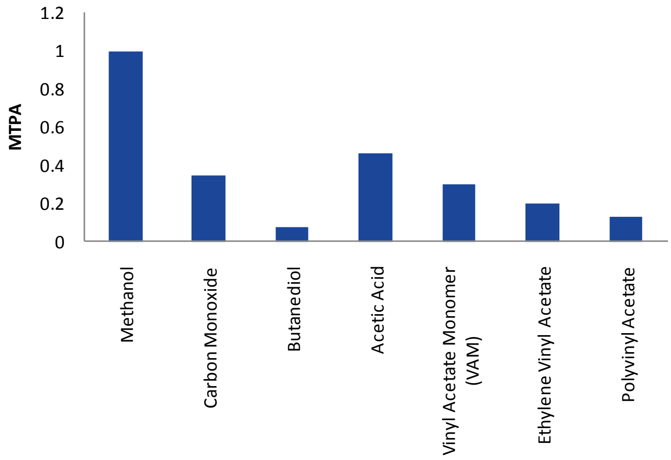
Kayan



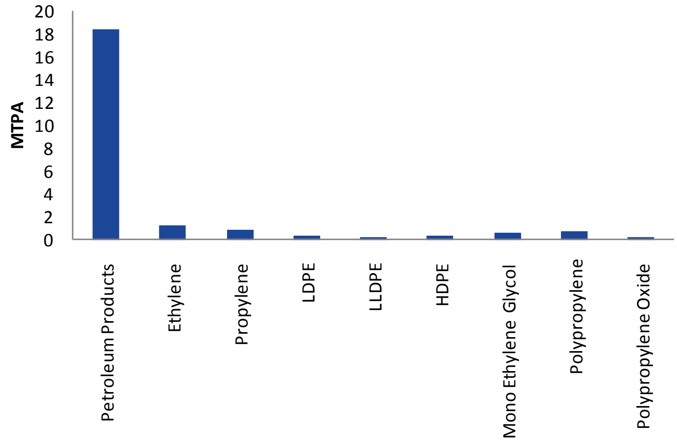
Yansab



Sipchem

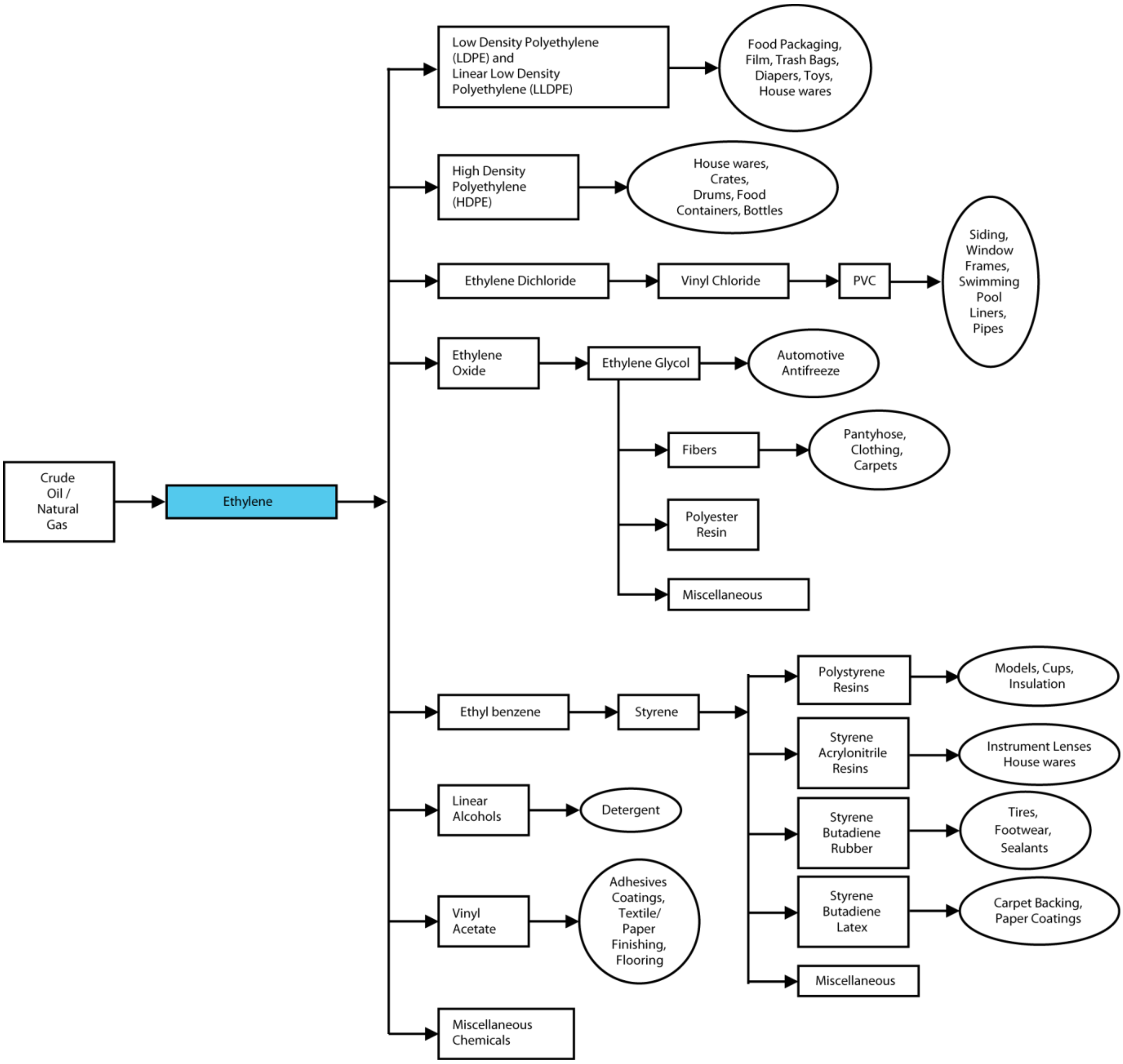


PetroRabigh



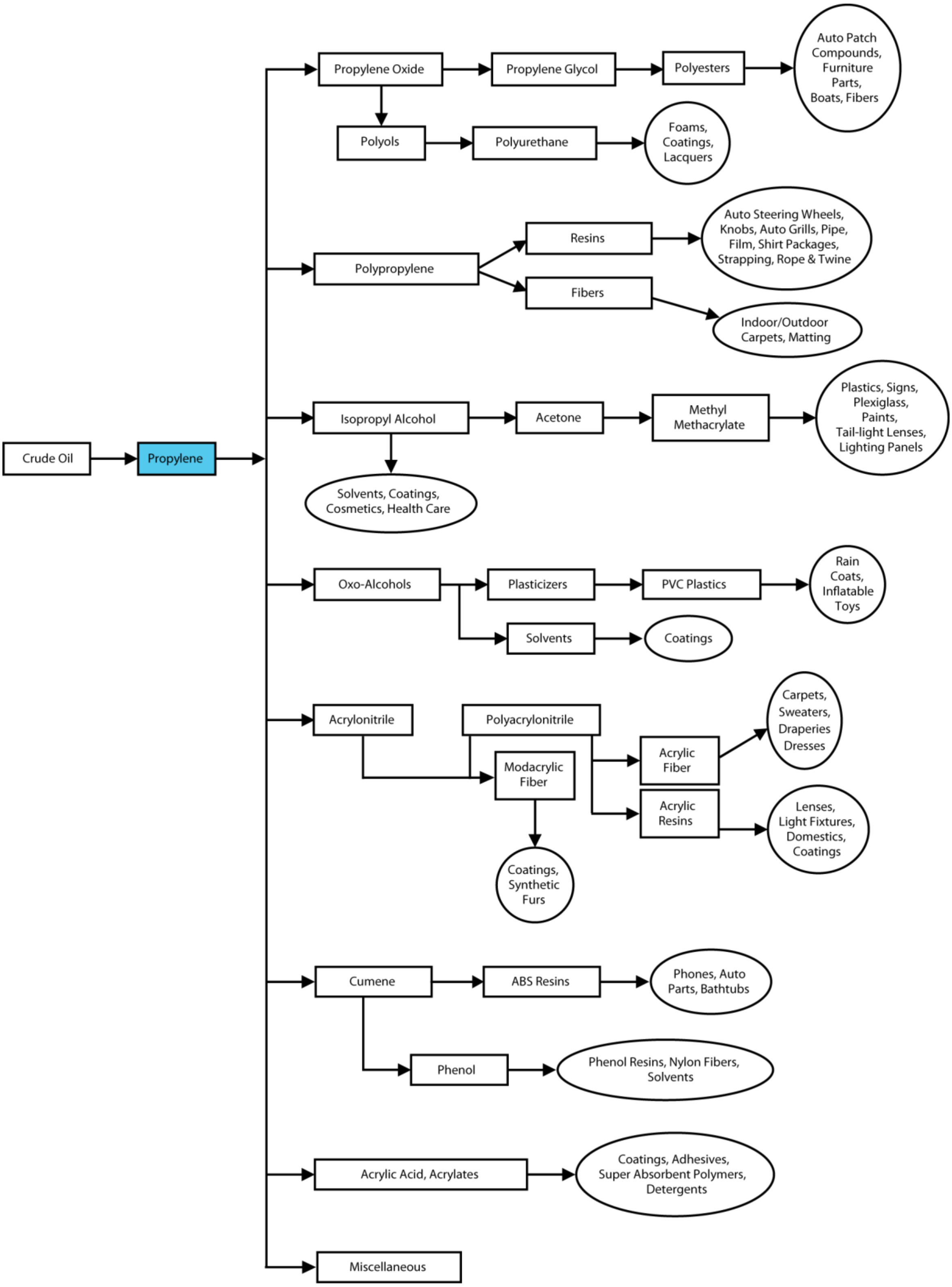
Source: Zawya, Company data

Annexure 3A: Production flow chart: Ethylene derivatives



Source: American Chemistry Council

Annexure 3B: Production flow chart: Propylene derivatives



Source: American Chemistry Council

Annexure 4: Glossary

Aromatics: An organic compound that has a hexagonal ring of carbon atoms, e.g. benzene.

Base chemical: Chemical building blocks from which many downstream products are made, e.g. ethylene.

Crackers: Production facilities for the manufacture of large volumes of Petrochemicals from either oil or gas feedstocks.

Cracking: The process of splitting long chains of organic molecules into smaller molecules, eg ethylene from ethane.

Derivative: Chemical compound derived or made from other chemicals. Polyethylene is an ethylene derivative.

Downstream: Processing of hydrocarbons such as crude oil and natural gas into compounds that form Petrochemicals feedstocks or other usable products.

Ethylene: A two carbon molecule with a reactive double bond, that is, C=C (C_2H_4).

Feedstock: Basic raw material that is converted into another product in a chemical process.

HDPE: high density poly ethylene: A thermoplastic resin made from ethylene. Commonly used for grocery bags.

Hydrocarbons: Compounds containing only hydrogen and carbon atoms. Hydrocarbons are the basic materials in the oil, gas and chemical industries.

LDPE: low density poly ethylene: A thermoplastic resin made from ethylene. Commonly used for packaging and plastic coatings for paper products.

Methanol: Simplest form of alcohol used in diverse applications, including formaldehyde.

Nameplate: As stated, usually referring to amount capacity as stated by company.

Naphtha: One of the main feedstocks for a Petrochemicals cracker. It is obtained by the fractional distribution of crude oil.

Natural gas: One of the main feedstocks for a Petrochemicals cracker.

Petrochemicals: Any chemical derived from crude oil, crude products or natural gas. Petrochemicals are used in the manufacture of numerous products such as synthetic rubber, synthetic fibres, plastics, etc.

Polyolefins: A polyolefin is a polymer produced from a simple olefin (also called an alkene) as a monomer.

Polypropylene: A polymer with properties making it extremely versatile and able to be used in substitution for wood, metal, glass and plastics.

Propylene: A three carbon molecule with a reactive double bond, that is C=C=C (C_3H_6).

Speciality chemicals: Chemicals produced in small tonnage, having higher unit and used for critical applications requiring stringent performance criteria.

Upstream: The searching for and the recovery and production of crude oil and natural gas. The upstream oil sector is also known as the exploration and production (E&P) sector.

mmbtu: “million metric British thermal units” – a traditional measure of energy

mtpa: “million tons per annum”

scf: "standard cubic feet"

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Additional disclosures

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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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