Look Beyond 2015

Our core premise for the petrochemical sector is that investors should look beyond 2015. Next year will be bad as the full impact of lower oil prices is realized in terms of a drop in petrochemical prices and more importantly margins. Margins are likely to hold-up in the final quarter of 2014 due to a lag effect as feed prices fall more than output prices. On the face of it, the market seems to have discounted 2015 pain in stock prices as the broader TASI is down ~12.5% just in December to date.

Sector Themes

We would argue that the petrochemical producers are not a domestic play. Almost all output is exported to countries and regions as diverse as China, Asia, Europe and the United States. Thus, demand for petchem products depends on (1) global economic growth and (2) the increasing use of petrochemical derivatives in everyday life from cell phones to automobiles to the building materials in sport stadiums. While output prices have traditionally closely followed oil, demand has been driven by a more modern lifestyle in the West and rising population and changing demographics in Asia.

Exhibit 1: Petrochemical Product Flow

Given the Saudization drive by the government, it is unlikely that a reduction in headcount will be possible even when corporate earnings suffer. However, discretionary spending by some of the bigger players such as SABIC on research projects may have to be re-evaluated. In recent years, SABIC has put a lot of emphasis on innovation; establishment of 19 dedicated Technology & Innovation (T&I) facilities in KSA, USA, Netherlands, Spain, Japan, China, India and South Korea employing hundreds of researchers being a case in point.

There is risk of oversupply in 2016/2017 as new ethylene plants come on line. In the US, 11.3 million tons of new ethylene capacity has been announced representing around 20% of incremental capacity through 2017, driven by the shale boom. A 6 million tons plant is expected to begin operations in China also in 2016/2017 in addition to commercial operations of the 2.8 million tons Sadara plant in 2016. While it may take a few quarters for them to attain peak capacity, supply is definitely on the horizon.

In these turbulent times, it is wise to stay invested in more diversified and blue chip names rather than companies who have concentrated risk. We believe long term investors should consider exposure to SABIC, which is now trading at 2015/2016 PE of 12.1x and 11.3x respectively. While we forecast 2015 EPS at SAR 6.30 (-24% Y/Y), even a worse case EPS of SAR 5.50 (-33% Y/Y) means SABIC is currently trading at 13.8x 2015 earnings. A dividend yield of 6.6% compares favorably to global peers such as Dow or BASF and complements the investment case. In addition, urea prices are coming off their lows experienced in 2014. While this means stable earnings for SAFCO, it is also a cushion for SABIC earnings.
Exhibit 2 below compares pre-tax margins at SABIC versus its global peers such as DOW and BASF. SABIC’s superior margins will likely taking a greater beating in this lower oil environment. Nevertheless, we still expect margins to remain ahead of peers.

Exhibit 2: SABIC & Peers Margins

For the Saudi Petrochemical sector, predominantly ethane based producers will feel a greater pinch as the feed price remains the same (USD 0.75/mmbtu) while product prices decline. Producers with a greater proportion of heavier feed such as naphtha should be affected to a lesser extent as feed prices also fall. Although we expect margins to contract across the board, the drop in margins will be softer for heavier feed versus ethane based producers. The exhibit below illustrates how Polyethylene/Naphtha margins have widened in 4Q, particularly in December.

Exhibit 3: Petchem Margins Expand in 4Q

Source: Bloomberg
WTI likely to average under USD 70 in 2015

With the steep decline in oil prices and corresponding slump in the Tadawul, the question is where will oil (and consequently the market) go from here? The focus right now is on maintaining market share, which has led to a buyers’ market as producers cut their Official Selling Prices (OSP) to attract consumers. Exports to the US from Saudi Arabia have declined by 200,000 bpd now as compared to the beginning of the year. We believe the KSA’s October crude production of 9.7 million bpd can be maintained over the next year.

Exhibit 4: Market Tracking Oil

WTI is down –48% since July 1st, Tadawul has come off –19.7% while the petrochemical index (TPCHEM) has slumped –31.5%. As winter dawns in the West, it was expected to boost oil consumption and prices, which has not happened. It appears that the impact of all negative developments in the oil market is being incorporated as we speak.

Although it is not wise to predict oil prices, we do not believe that the current WTI level of around USD 55 is sustainable over the medium term. While it is possible that WTI may drop even below USD 50, this will not be a longer term phenomenon assuming no major negative developments in the region and stable global geo-political situation. We now view US based shale as the swing players for international oil prices as OPEC seems to have given up that role for the time being.

According to the US EIA, oil production from key shale basins currently stand at close to 5 million bpd. The PIRA energy group forecasts that at Brent prices of USD 70/bbl, long term shale output should be between 4.5-5.0 million bpd. Further, at prices between USD 60-70/bbl, the marginal shale producers (such as Bakken region Tier 3) make a 10% return on investment although the bigger shale regions make money at USD 50 or below.

Based on this, we have assumed WTI at an average of USD 67/bbl and USD 70/bbl for 2015 and 2016 respectively. Brent prices are generally at a USD 3-4/bbl premium to WTI. Our projected petrochemical prices are based on the above.
Resultantly, target prices of all stocks under coverage have changed and recommendations have been revised, where needed. We have also rolled over our forecast one year forward as it is year-end. Consequently, our target prices are for 2015-end. The following table highlights the changes.

Table 1: Petchems Target Price and Ratings

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Source: Riyad Capital

Target prices for all companies have decreased ranging from -12% for SAFCO to -26% for SABIC. Given the massive correction in stock prices, five stock have been upgraded to a Buy. We note 2015E PE now in single digits for SIIG, Sahara and Petrochem.

Some company-specific factors need to be considered as well. Sipchem and Sahara have undergone expansions and enhanced capacity is expected to be fully online in 2015 increasing volumetric sales despite softer prices. Advanced has been active in stock investments booking a profit of SAR 35 million in 3Q as the TASI touched record highs. With a slump in the market, it remains to be seen whether the Company will book losses in its Income Statement or keep unrealized losses in the Balance Sheet in 4Q. Saudi Kayan is expected to be one of the worst affected as 2015 bottom line plunges into a loss on greater exposure to market based feed pricing.

**Petrochemicals underperform TASI**

Petchem has become a volatile sector of late, outperforming the TASI in a bull market and underperforming in a bear market. The sector has led the market down as investors view declining oil prices impacting petchem producers the most although impact on banks is also being felt on the back of an expected slowdown in the economy.

Opening the market to foreign investors has been anticipated by 1H 2015. With the downturn in the market, this may be delayed although there are concrete developments on the regulatory framework.

The following chart illustrates petchem stock performance versus the TASI. Only Advanced and SAFCO have outperformed the TASI in 2H2014.
Exhibit 4: 2H2014 Petrochemical Sector vs. TASI Performance

Source: Tadawul
Stock Rating

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<th>Strong Buy</th>
<th>Buy</th>
<th>Hold</th>
<th>Sell</th>
<th>Not Rated</th>
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<td>Expected Total Return ≥ 15%</td>
<td>Expected Total Return &lt; 15%</td>
<td>Overvalued</td>
<td>Under Review/Restricted</td>
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