KAMCO Research

Aramco IPO – Investor Brief

Sector – Integrated Oil & Gas **December-2019**

Near term focus on Aramco's index inclusions; dividend guidance to be key

Investors are likely to focus on the potential for increase in dividends, either as an increase in ordinary dividends or as special dividends. Moreover, Aramco's dividend sustainability is supported by the company's stable cashflows, low growth capex requirements, healthy ROE profile and lower royalties and taxes needed to be paid to the government. Even on the 2018 earnings of SAR 416.2 Bn (USD 111 Bn), the announced cash dividends for 2020-24 represent a dividend payout ratio of only over 67%. Moreover, the company will have the potential to payout significantly more of its earnings as long as the ROE does not witness a steep decline, according to our calculations. However, in the near term the focus will be on how quickly global index compilers such as MSCI and FTSE include Aramco into their indices. In terms of passive inflows, we believe that an additional USD 4.0 - 5.0 Bn would flow to Saudi Arabian equities post Aramco's inclusion into major global indices.

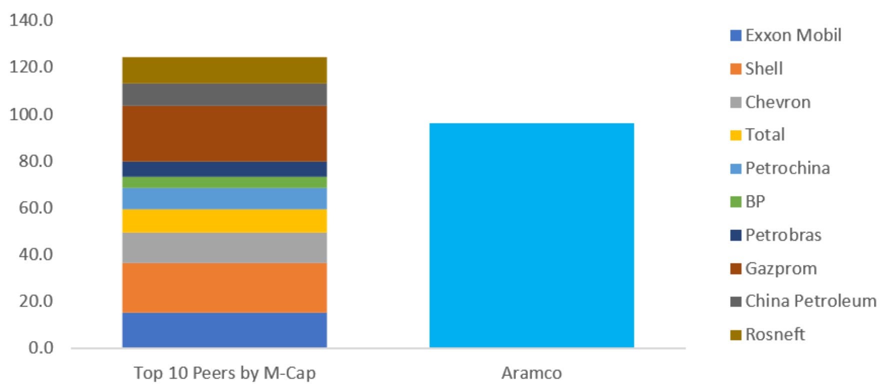
Aramco IPO demonstrates adequate avenues to meet Saudi 2030 vision

As of 9M-19, the total of income taxes, royalties and dividends paid to the government amounted to a total of SAR 475.8 Bn. Total budget revenues on the other hand over the same period amounted to SAR 713 Bn. The significant revenue side contribution of Aramco to Saudi Arabia's government revenues, fiscal consolidation, and non-oil diversification efforts should continue going forward. From an IPO context, the significance of Aramco's IPO would also set the precedent for how the privatization and IPO of state-owned enterprises would be viewed in the region. Further since the IPO is only restricted to Saudi nationals in its retail allocation, and regional participation via GCC institutional mandates, it will also set the precedent for how the region perceives the privatization of a state-owned enterprises raise going forward. In terms of IPO size, Saudi Aramco's potential proceeds are higher than the combined IPO proceeds of 2010 to 9M-19 in the GCC.

Fundamental and momentum indicators suggest crude at USD60-70/bbl range

Oil demand/supply fundamentals have become marginally favorable post the demand growth recorded in 2H-19. From a technical standpoint, the next resistance level for Brent crude is at USD 66.00/bbl, breaking which the upside chances and target is USD69.30/bbl, while above this will most likely call for a re-visit to this year high at USD75.70/bbl.

LTM-19 Aramco Net Income vs. Top 10 Global Peers - (USD Bn)



Sources: Reuters, Company Financials, KAMCO Research

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Report Highlights

This report highlights the significance and likely impact of the Aramco IPO and includes:

- Investor focus for Aramco's stock
- Index inclusions of Aramco
- Competitive landscape for Aramco
- Relative valuation vs. peers
- Saudi Arabia budget impact
- GCC IPO market significance
- Oil price dynamics

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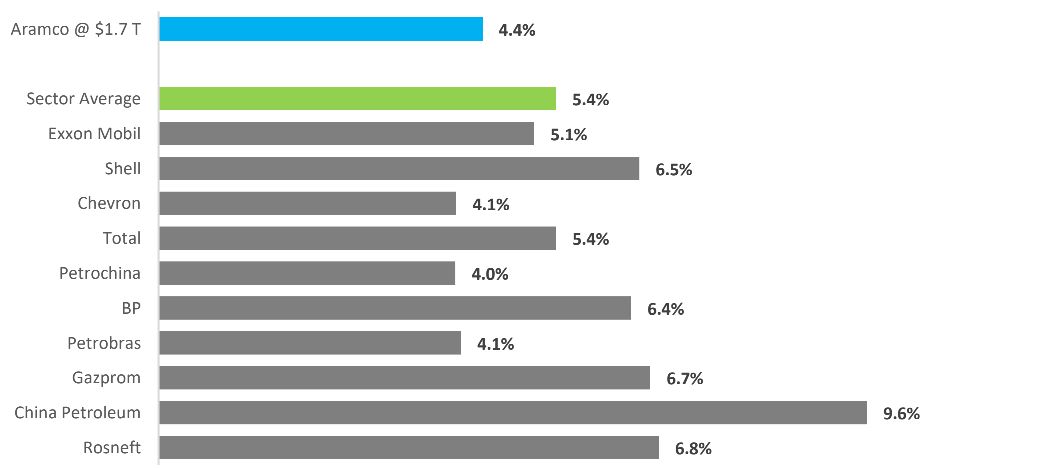
Dividend play with strong potential for upward revision in dividend guidance

Investors are expected to focus on the dividend potential of Aramco and the sustainability of dividends as compared to major integrated oil companies in the industry. Aramco mentioned that it intends to declare aggregate ordinary cash dividends of at least USD 75.0 Bn in 2020, in addition to any potential special dividends. Further the company mentioned a quarterly cash dividend guidance until 2024 of USD 0.09375/share and highlighted that the government will forgo its right to receive the portion of cash dividends on its shares equal to the amount necessary to enable the Company to first pay the minimum quarterly cash dividend amount to equity shareholders.

Expected Dividend Yield vs. Peers



Source: Bloomberg, Reuters, Company Financials, KAMCO Research

There is potential for increase in dividends in our view, either as an increase in ordinary dividends or as special dividends, supported by key factors like:

- Stable cashflows
- Low growth capex requirements
- Healthy return on equity profile
- Lower royalties and taxes needed to be paid to the government

Furthermore, the company has signed a gas subsidy compensation agreement with the government to be implemented in 2020 that will result in Aramco getting additional compensation for the government subsidies on LPG sold in the domestic market. This will further augment earnings and dividend potential for Aramco's shareholders. Meanwhile, the dividend information comes at a time when oil prices are subdued ranging from USD 60-70/b. The current prices of oil have seen intermittent volatility but has largely remained within a tight range.

Even on the 2018 earnings of SAR 416.2 Bn (USD 111 Bn) and 2018 ROACE (Return on Average Capital Employed) of almost 41% as per the company, the announced cash dividends for 2020-24 represent a payout of only over 67%. The ROACE of Aramco for 2017 was 33.8%. Moreover, the company will have the potential to payout significantly more of its earnings, as long as the ROE does not witness a steep decline, according to our calculations.

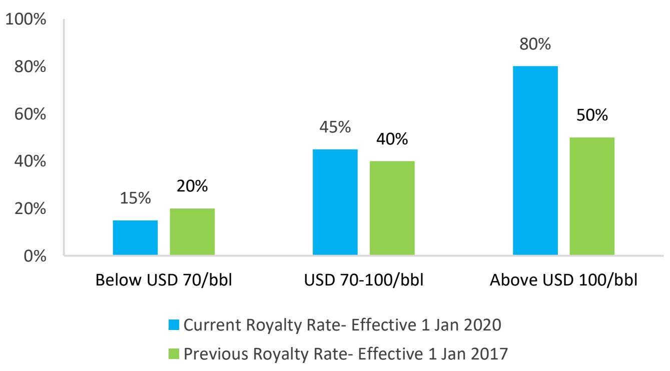
Higher profitability unless oil prices move significantly above USD 100/bbl

Aramco and the Government executed an amendment to the Concession effective as at 1 January 2020 applicable to crude oil and condensation production volumes such that:

1. The royalty rate on crude oil and condensate production is reduced to 15% (from 20%) on Brent prices up to USD 70/bbl;
2. The marginal royalty rate increases to 45% (from 40%) on Brent prices above USD70/bbl up to USD 100/bbl and
3. The marginal royalty rate increases to 80% (from 50%) on Brent prices above USD 100/bbl.

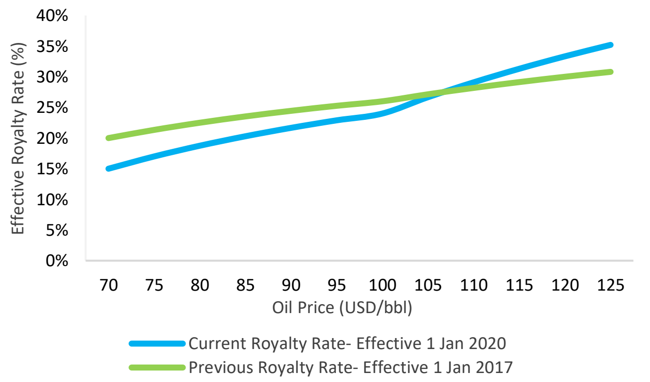
As per our calculations, the revisions to royalty rates (%) should translate into higher earnings and ROACE (%), as long as the price of Brent crude remains below USD 107/bbl.

Royalty rate (%) effective Jan 2020 comparison



Sources: Aramco IPO Prospectus

Effective royalty rate (%) based on achieved oil prices



Sources: KAMCO Research, Aramco IPO Prospectus

Other initiatives that should be earnings accretive for minority shareholders include the reduction of the tax rate applicable to Aramco’s downstream business from the 50%-85% multi-tiered structure of income tax applicable to domestic oil and hydrocarbon production companies to the general corporate tax rate of 20% applicable to similar domestic downstream companies under the Income Tax Law. This will be based on the condition that the Company consolidate its downstream business under the control of one or more separate, wholly owned subsidiaries before 31 Dec 2024 (effective as at 1 Jan 2020). Moreover the company mentioned that the period for which it will not be obligated to pay royalties on condensate production was extended for an additional ten years after the current five-year period ending on 1 Jan 2023, and may be further extended for subsequent 10-year periods, unless the Government determines the economics impacting gas field development do not warrant such an extension.

MSCI Inclusion

Shares of Aramco could see greater liquidity after listing as almost all major index providers have announced an accelerated inclusion of the stock in their respective Emerging Market indices. S&P Dow Jones (SPDJI) and FTSE Russell mentioned that they would include the stock in their emerging market universe soon after listing. SPDJI is even considering an exception to its minimum free float requirement in the case of Aramco. On the other hand, MSCI said that it would include the shares as soon as 17-December-19 if the listing happens before 12-Dec-19 and if it is listed post this date, then keeping in mind lower liquidity in the international market due to year-end holidays, it would include Aramco shares from the first week of January-2020.

Meanwhile, the weight of Aramco shares in the MSCI Emerging Market index is likely to be in the range of 0.4% to 1% depending on the free float of the company and the final valuation. With the inclusion, Aramco is expected to account for the biggest share of Saudi Arabian stocks in the MSCI EM index. The Kingdom's weight in the index was at 2.8% after the completion of the inclusion in August-19 which is expected to at least increase to more than 3% after Aramco's inclusion.

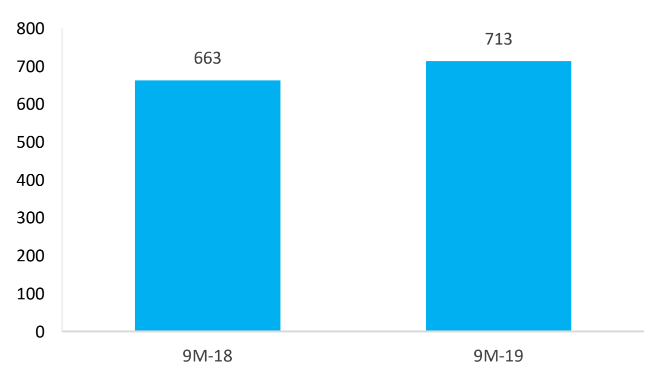
An earlier comment from MSCI highlighted that a USD 100 Bn IPO of Aramco could almost double the Kingdom's weight in the index to 5%. Based on this, we believe that an IPO of close to USD 26 Bn could increase the Kingdom's weight in the MSCI EM index to around 3.5%. In terms of passive inflows, we believe that an additional USD 4.0 - 5.0 Bn would flow to Saudi Arabian equities after the increase in the Kingdom's weight post the inclusion of Aramco in the aforementioned three indices.

Enough firing power for future budget deficits

The Aramco IPO is aimed at diversifying Saudi Arabia's significant reliance away from oil related revenues. As per Saudi Ministry of Finance Pre-Budget Statement-FY 2020 guidance, the budget deficit for FY 2019 is estimated to come in at SAR 131 Bn or USD 35.4 Bn. Given that the IPO has already been oversubscribed, this would mean that the IPO proceeds of the 1.5% stake sale would cover almost 72.4% of the 2019 budget deficits.

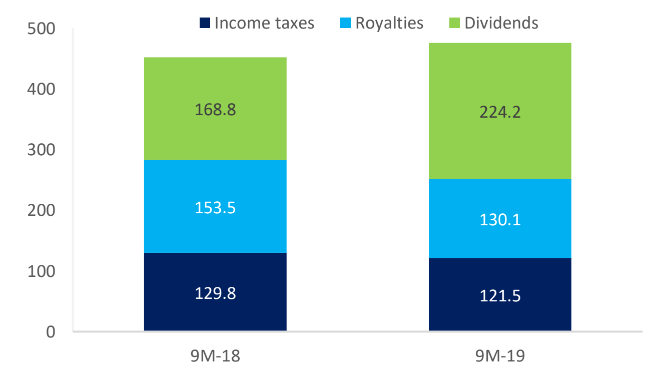
Moreover, to put things in perspective, at current valuation of Saudi Aramco, the total budget deficits for 2019-2022 can be covered by just 8.9% of stake, if the company and government wish to go down the equity capital markets route without utilizing other avenues to cover its budget deficits.

Saudi Arabia budget revenues (SAR Bn)



Sources: Saudi Ministry of Finance Pre-Budget Statement FY 2020

Payments to the Government by Saudi Aramco (SAR Bn)



Source: Aramco IPO Prospectus

Payments from Saudi Aramco to the government include income taxes, royalties and dividends. As of 9M-19, the total of income taxes (SAR 121.5 Bn), royalties (SAR 130.1 Bn) and dividends (SAR 224.2 Bn) amounted to a total of SAR 475.8 Bn. Total budget revenues on the other hand over the same period amounted to SAR 713 Bn. The significant revenue side contribution of Aramco to Saudi Arabia's government, the government's fiscal consolidation and non-oil diversification efforts should continue going forward.

Saudi 2030 plan

The IPO of Aramco comes as one of the strongest pillars of Saudi Arabia's 'Vision 2030' Strategy and the National Transformation Plan. Announced in 2016, the long-term plan was one of the most ambitious economic announcements by Saudi Arabia's Deputy Crown Prince in which he highlighted some of the key areas to strengthen the economy and drive the Kingdom away from oil that led to uneven growth and disruption in several sectors over the past few years. The plan highlighted an aim to turn the Kingdom into a 'global investment powerhouse' by diversifying revenues sources followed by a plan to transform the Kingdom into a global logistical hub exploiting its strategic location as the physical center of the world. The aim was to achieve the objectives of the plan even in a low oil price scenario as the projections were based on an oil price of USD 30/b.

The plan also envisaged the restructuring the Kingdom's Public Investment Fund (PIF) in order to promote Saudi Arabian investments internationally. Economic growth rates in the kingdom was expected to get a boost as it focused on all areas of development including generating employment opportunities, developing key sectors like housing and education and expanding the non-oil manufacturing capabilities.

The proceeds from the IPO of Aramco, expected to be around USD 26 Bn, would go to Saudi Arabia's Public Investment Fund (PIF). It would be deployed by the government in achieving its infrastructure investment plans for the Saudi economy and achieve long term economic growth. It is believed that further funds are expected to be raised from an international sale of stake in 2020 or 2021.

SABIC acquisition strengthens Aramco's competitive position as a global IOC

Earlier in 2019, Aramco announced the purchase of 70% stake in petrochemicals giant SABIC at a purchase price of USD 69.1 Bn. The acquisition boosts Aramco's refining and petrochemicals business, further strengthening its downstream business. SABIC, with a petrochemicals production capacity of 62 million tons a year would complement Aramco's 17 million tons capacity in the petrochemicals business. It also comes as Aramco plans to increase its refining capacity from 4.9 million barrels to around 8-10 million barrels by 2030. The acquisition is expected to be completed by 1H-20 and would further strengthen Aramco's business strategy as a full-fledged integrated oil and gas company and take advantage of natural gas production.

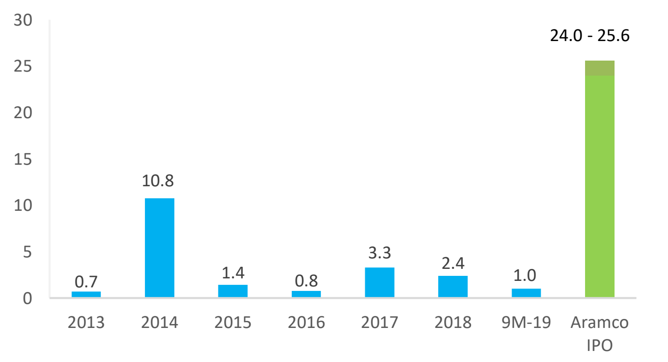
The acquisition of SABIC gives Aramco a strong foothold in the natural gas based chemical business globally, as SABIC's entire production is based on natural gas. In terms of competitive strengths, with the SABIC acquisition, Aramco will have the world's largest upstream operation and have one of the biggest downstream operation positioning it against global integrated oil and gas companies. This will also help the company to take advantage of the intrinsic value of the business and demand multiples comparable to that of the larger industry peers.

Multiple angles of significance for the GCC IPO market

The IPO proceeds of USD 24-25.6 Bn to be raised by Saudi Aramco is easily set to be higher than the combined IPO proceeds of the GCC region witnessed in the recent past. According to data from PWC, Saudi Aramco's potential proceeds are higher than the combined IPO proceeds of 2010 to 9M-19 in the GCC. Moreover, the significance of the IPO would also set the precedent for how the privatization and IPO of state-owned enterprises would be viewed in the region.

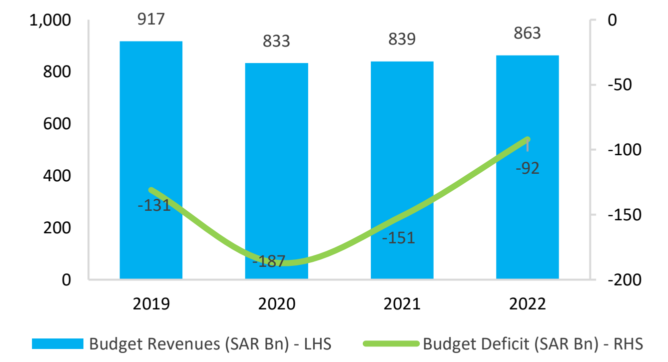
We believe that the Aramco IPO provides a significant opportunity for Saudi Arabia and the overall MENA region in attracting foreign capital in the form of both institutional money as well as FDI. The IPO will have far reaching implications for the economy in terms of overall improvement, as seen in the recently released ease of doing business scores, as well as induce reforms and regulatory changes to align the economy and market in line with advanced markets. The listing of the biggest state asset would also open doors for further privatization of other assets that would serve the dual purpose of funding state budgets as well as take advantage of the intrinsic value of the business. The allocation of 0.5% of the Aramco IPO to retail investors gives an opportunity to local investors to participate and take advantage of broader strategic plans.

Aramco IPO in historical GCC IPO context (USD Bn)



Sources: PWC, Aramco IPO Prospectus

Saudi Arabia medium term fiscal projections (SAR Bn)



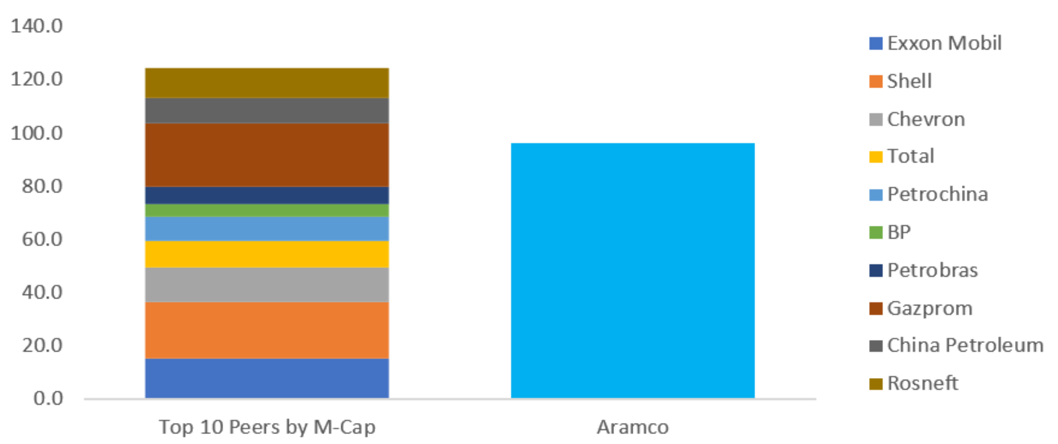
Sources: Saudi Ministry of Finance Pre-Budget Statement FY 2020

Furthermore, since the IPO is only restricted to Saudi nationals in its retail allocation, and regional participation via GCC institutional mandates, it will also provide a basis and a precedent for how much regional interest the privatization of a state-owned enterprise would raise going forward. As per Bloomberg, at the end of 29 Nov- 2019, Saudi Aramco's share sale attracted bids worth USD 44.3 Bn, representing 1.7x the amount the Kingdom plans to raise, and this is likely to increase, given that the institutional bids for allocation will continue until 4-Dec-19.

Market share behemoth in oil production and profitability

Aramco generates net income more than the sum of the next seven largest players in the industry by market cap. This gives the company a market leading position that also results in higher margins. The company pumps almost 13% of the world's crude oil generating a revenue of SAR 1.3 Trillion (USD 336.2 Bn) during LTM 9M-19 and a net income of SAR 360.3 Bn (USD 96.2 Bn). The company's financials depend heavily on the trend in oil prices and the volatility seen over the past few years can have an equivalent impact on the company's bottom-line.

LTM-19 Aramco Net Income vs. Top 10 Global Peers - (USD Bn)



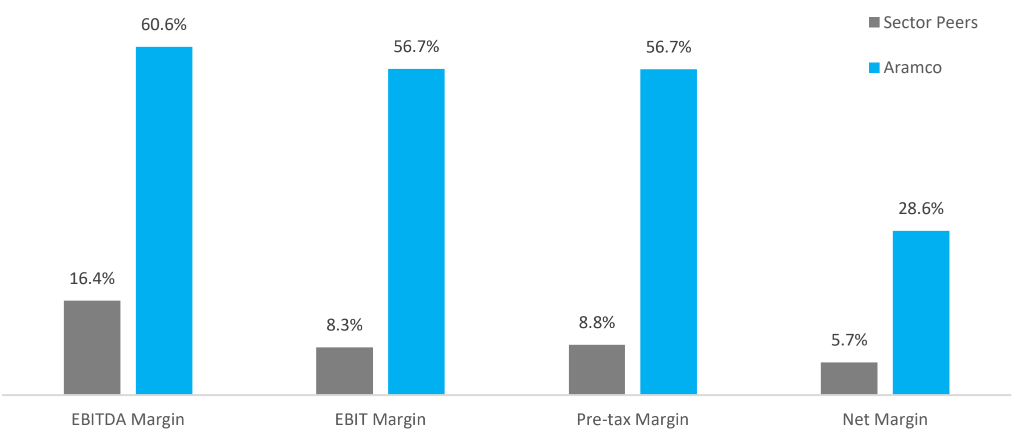
Source: Reuters, Company Financials, KAMCO Research

In addition, growing revenues in the future is all dependent on volumes, as prices are expected to remain at current levels over the near term owing to the oversupply-led glut in the oil market. On the other hand, increasing volumes would be difficult for the company due to Saudi Arabia's commitment to slash production volumes against the OPEC+ agreement. The meeting of OPEC countries during the first week of December-19 would indicate the future course of the agreement, however consensus estimates, and the current oil price scenarios shows that a significant change in the agreement is highly unlikely. This would imply that oil prices may not see a significant movement in the near term.

Sector leading margins

Aramco's margins beat peers on almost all fronts supported by its low cost of production. The company's lifting cost is the lowest in the industry, and with the current oil price environment, this gives a competitive advantage to Aramco against higher cost shale producers.

Aramco Margins vs. Peers (LTM-19)



Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Peer Analysis – Operating Metrics

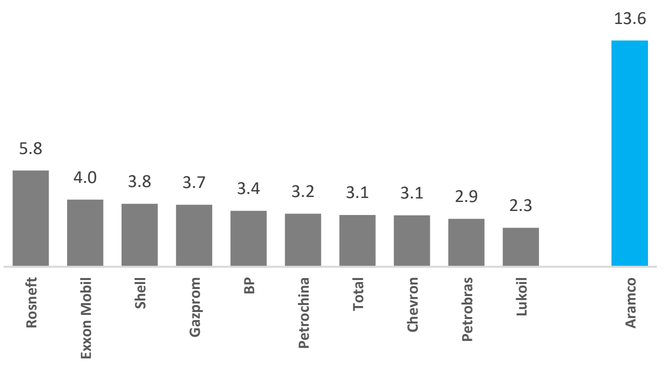
Aramco outperforms its global integrated oil & gas industry peers on almost all the operational parameters. In terms of production, total liquid production averaged at 13.6 mb/d for Aramco, the highest in the industry and almost equal to the top three producers in the industry. On the other hand, the company's lifting cost is significantly lower than its peers which reflects in the company's margins. At a lifting cost of USD 2.8/b, Aramco gets the highest netback in the industry per barrel giving it an inherent advantage against its peers, especially when oil prices are trending downwards.

According to OPEC, Saudi Arabia holds around 18% of the global proven oil reserves and has been the largest exporter of oil until recently. The Kingdom's reserves are around 297.7 billion barrels of oil equivalent, according to BP's latest estimates, which closely trails Venezuela's 303 billion barrels. Aramco estimates the Kingdom's reserves at 336.2 billion barrels of oil equivalent. According to Aramco's IPO prospectus, the company has proven reserves of 256.9 billion barrels, the highest in the industry and more than the combined reserves of the top seven players in the industry. At a production rate of 13.6 mb/d, the company's reserve life is around 52 years. Meanwhile, the company's exclusive rights to explore oil from the Kingdom's reserves was set at 40 years with an extension of 20 years and further extension of 40 years based on certain conditions. This effectively gives the company rights of around 100 years to explore oil in the Kingdom.

In terms of spending power, Aramco spent USD 33.2 Bn (SAR 124 Bn) as capex over TTM Jun-19. This was second only to Petrochina's USD 42.7 Bn.

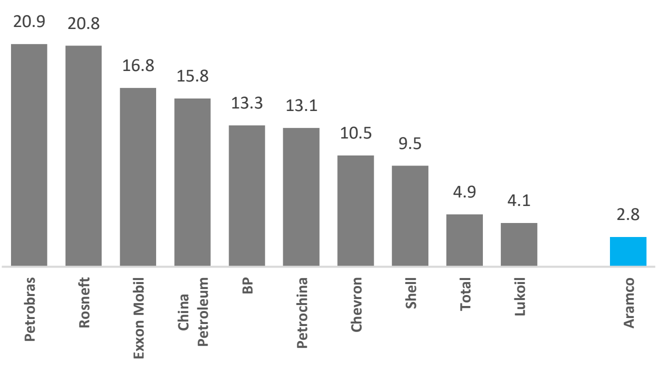
Operating Metrics

Production (mb/d)



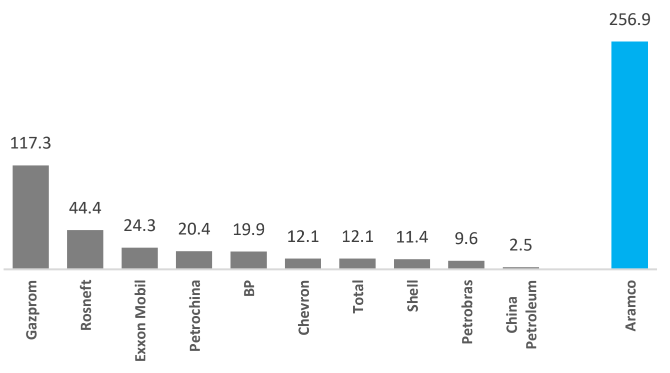
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Lifting Cost (USD/b)



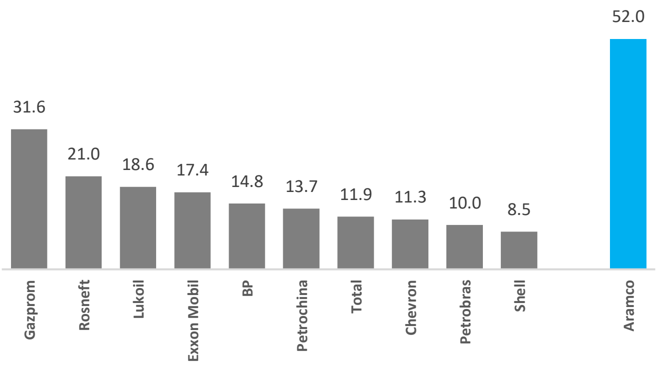
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Proven Reserves (Bn barrels)



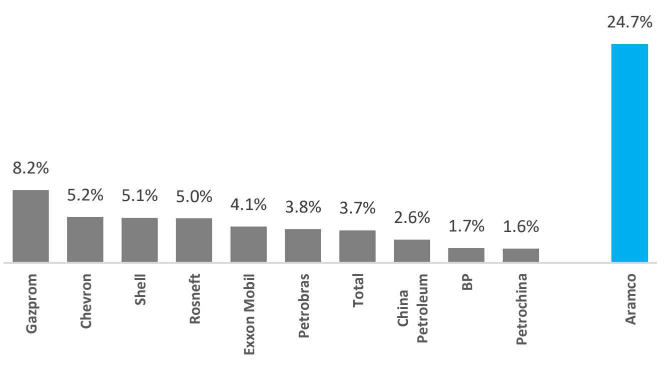
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Reserve Life (Years)



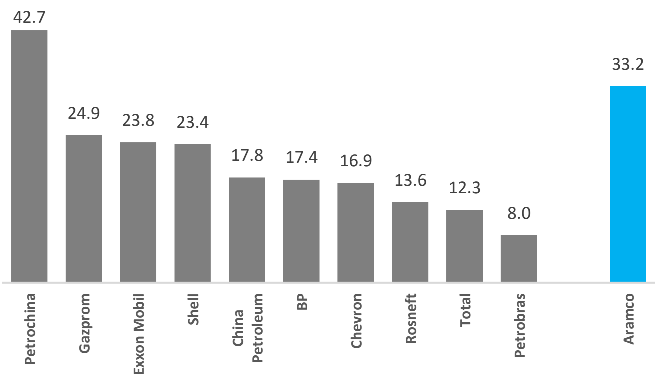
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Return on Assets (TTM-19)



Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Capex - LTM (USD Bn)

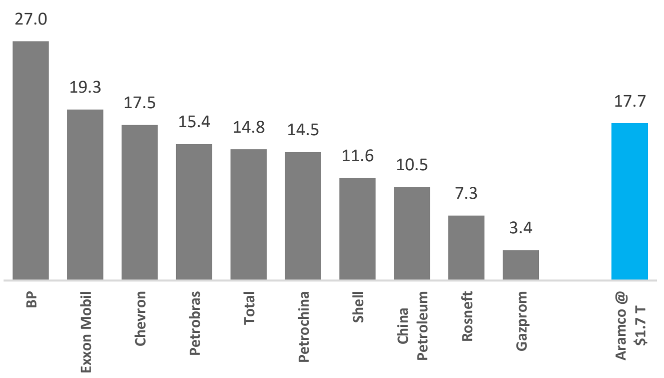


Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Aramco attractive on most relative valuation metrics

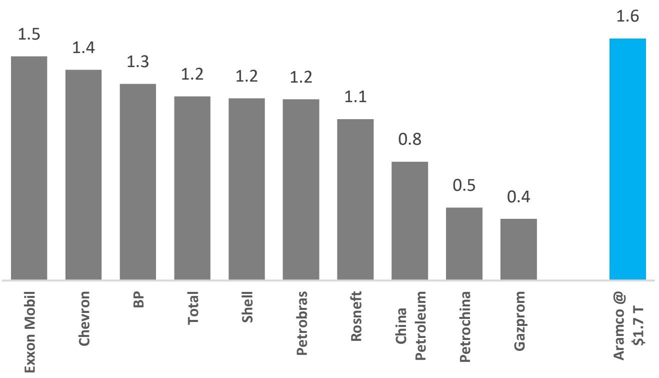
On most relative valuation metrics, Aramco's strong cost leadership and strong fundamentals reflect in the company's attractive valuations vs. peers. The EV/EBITDA for Aramco is the lowest amongst major peers and the company's FCF yield is the highest vs. competitors.

P/E Comparison (TTM-19)



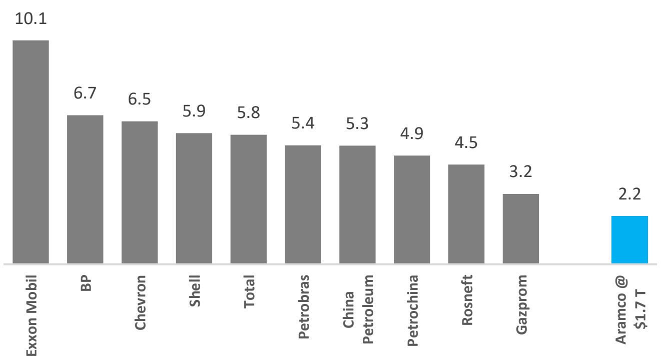
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

P/BV Comparison (Sep-19)



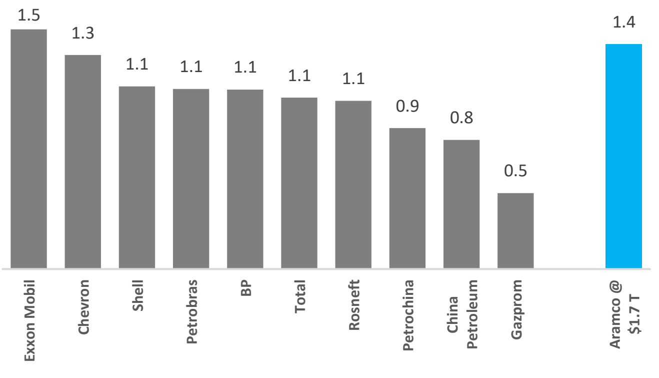
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

EV/EBITDA (TTM-19)



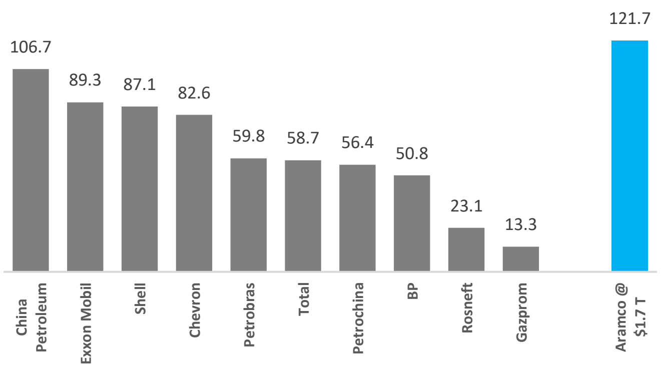
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

EV/Invested Capital (TTM-19)



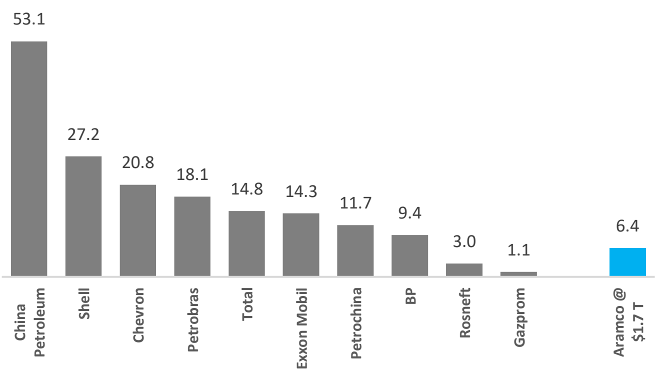
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

EV to Daily Production (Bn barrels)



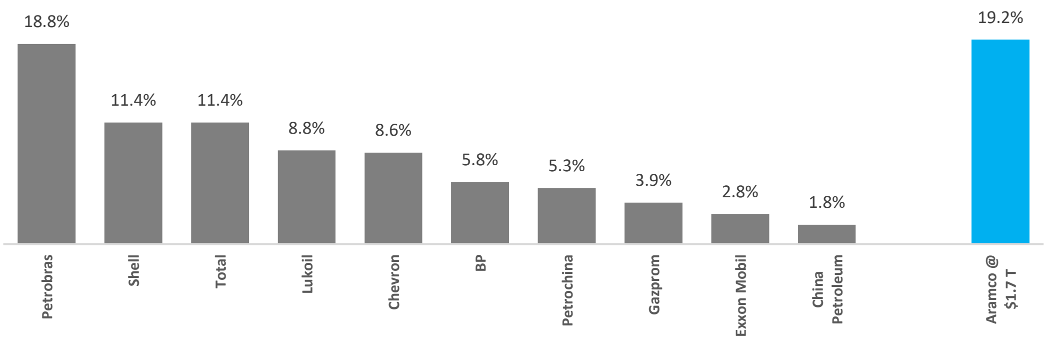
Source: Bloomberg, Reuters, Company Financials, KAMCO Research

EV to Proven Reserves



Source: Bloomberg, Reuters, Company Financials, KAMCO Research

FCF Yield (TTM-19)

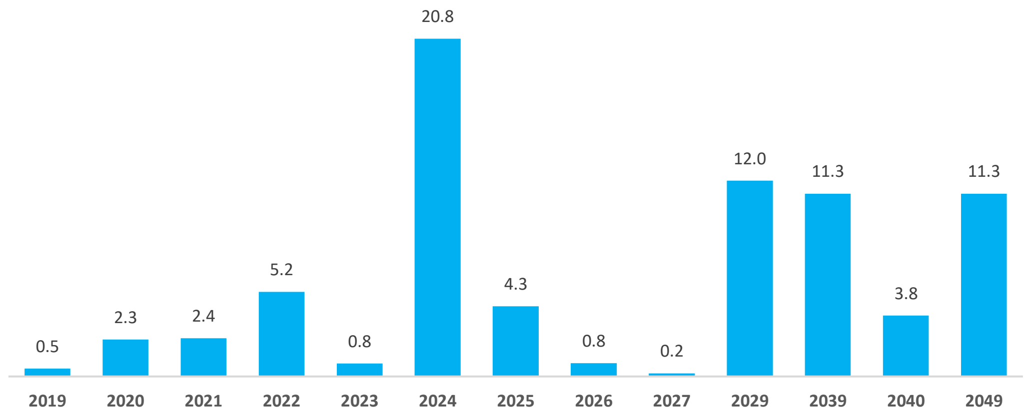


Source: Bloomberg, Reuters, Company Financials, KAMCO Research

Outstanding bond and sukuk payments

According to Reuters, Aramco and its subsidiaries have outstanding bonds and sukuk of around SAR 78 Bn that is spread until 2049. The biggest upcoming debt maturity would be in 2024 amounting to SAR 20.8 Bn. In April-19, Aramco issued bonds worth USD 12 Bn (SAR 45 Bn) in the international market that received interests of around USD 100 Bn. The company is expected to be in a comfortable position to repay or even refinance the upcoming maturities. Also, the repayment of debt should not put any burden on future dividend payments based on expected cash balance over the next five years.

Debt Maturity Profile - Aramco + Subsidiaries (SAR Bn)



Source: Reuters

Crude oil dynamics - Can the market break the current status-quo?

Catalysts that have affected the oil market have remained constant over the past three years especially after prices bottomed led by oversupply. These factors that explain a big part of the price movements are few and include the following:

- US oil production levels
- OPEC production
- Disruptions in supplies
- External factors with probable impact on demand

Oil Price Trend – Brent (USD/b)

Source: EIA, Bloomberg

Oil production in the US is at an all-time high and is the biggest factor that led to the crash in oil prices since 2014. Shale producers in the US have been producing at breakneck speed with productions now expected to have reached 13 mb/d. The pace at which the production capacity was added pushed OPEC to manage oil prices by lowering its oil output along with some non-OPEC producers.

OPEC currently produces at an eight-year low level of just below 30 mb/d. However, this is due to a voluntary limit self-imposed by the producers with Saudi Arabia sharing the biggest burden by curbing output more than what is required. These factors are more of fragile in nature and are set based on negotiations. As a result, a number of producers fail to comply with the limits imposed by the group due to economic compulsions and a number of other uncontrollable factors. The sustainability of such an agreement is a key concern for the industry due to the expected global economic slowdown. A slowdown affects all key determinants of the oil market starting from demand, which results in lower prices and in order to meet budgets, oil producers would be forced to produce more, further reducing the prices due to oversupply. As a result, the ongoing trade negotiations between the US and China would be crucial for oil demand and prices.

Meanwhile, temporary supply disruptions give a short-term boost to oil prices e.g. economic woes in Venezuela, disruptions in Libya and Nigeria and the sanctions on Iran. These are in a way forced limits on the producers and adds to oversupply risks, as sudden supplies could quickly lower prices. The increase in production by Iran that reached 3.8 mb/d during the second half of 2017 is one of the key examples. But following US sanctions, the country is currently producing at 2.1 mb/d. Similar factors have affected production in Venezuela. These factors have collectively resulted in a buildup of spare capacity that exceeds 4.5 mb/d currently.

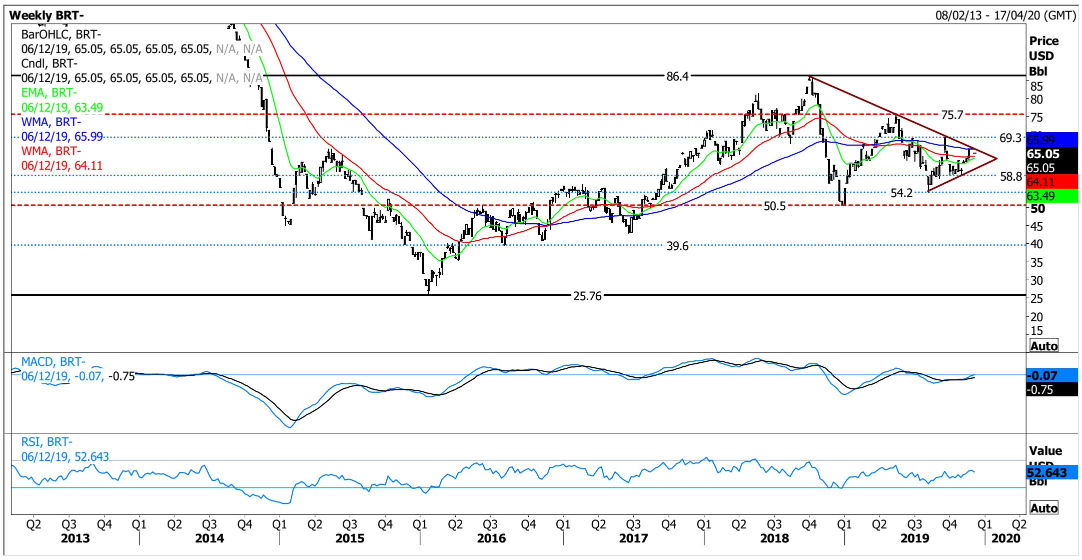
Lastly, trade wars and more inward-looking policies over the last few years has resulted in a slowdown in global economic growth rates. This has unexpectedly resulted in lower overall demand including for crude oil with recent trade wars adding to the woes. On the other hand, the increasing demand for electronic cars is further expected to dent oil demand in the future.

Nevertheless, there are positive factors that could affect oil fundamentals including:

- The implementation of new rules by the International Maritime Organization (IMO) starting in 2020 that would increase the demand for low-sulphur oil.
- Declining well productivity and a focus on margins and shareholder returns: this is especially true in the case of shale oil producers in the US. With oil prices remaining below US 70/b, margins are lower in the oil business and a number of oil explorers have announced a cut in capital expenditure in the coming years.
- Growing sale of SUVs: Despite improving fuel efficiencies, one factors that offsets the fuel consumption per vehicle metric are the SUVs. Industry data has shown that the sale of SUVs has continued to see growth in almost every market. The market share of SUVs has increased over the past seven years and they currently account for almost a third of the vehicle sales globally, according to data from JATO.
- Economic revival of high growth countries: Economies like India and China continue to be the key to oil demand. Although these countries have seen a consistent decline in a number of economic metrics, oil demand has remained robust. A revival in economic growth rates in these countries can provide the next cycle of growth for oil demand.

From a technical point of view, bulls need to break above the resistance level at USD66.00 to increase the upside chances and target USD69.30, while above this will most likely call for a re-visit to this year high at USD75.70; however, managing to print a foothold above this will open the road for the critical layer at USD86.40. On the counter side, a fall below the first support level at USD58.80 would allow a slippage to USD54.20 and maybe lower to the strong horizontal line at USD50.50, knowing that only below this will call for an aggressive bearish move. Therefore, the price is required to escape from the range of USD58.80-USD69.30 to indicate the next trend.

Oil Price Technicals – Brent (USD/b)



Source: EIA, Bloomberg

We see equal number of challenges on both sides of the oil market that affect demand and supply. As a result, markets continue to remain range bound and expectations for future oil demand growth and oil prices continues to be muted.

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