

Market Commentary - Saudi Arabian Oil Company - IPO



Saudi Aramco in a Nutshell

- Saudi Aramco is the largest oil producer in the world with a production capacity of over 12 million barrels of oil per day (“bbl/d”). Aramco owns the largest proven reserve base in the world of c.257 billion barrels of oil with an average reserve life of 52 years. The company’s proven reserves are 3.2x greater than the top five International Oil Companies (“IOC”) combined.
- Aramco operates under a 60 years concession agreement with the Saudi government which allows it to have the exclusive rights to explore, drill, extract, and market Saudi hydrocarbons.
- Additionally, the company has a strategy in place to move higher in the hydrocarbon value chain through the expansion into downstream operation which typically extracts a higher value per barrel of oil than selling crude oil. The recent acquisition of 70% stake in Saudi Basic Industries Corporation (“SABIC”), as part of the company’s plan of Oil-to-Chemicals,

provides the platform to accelerate Aramco's chemical growth plans with SABIC's current chemical capacity dwarfs Aramco's current operations. Furthermore; we think there are significant synergies and integration of assets in place between the two companies.

IPO Background

On November 3, 2019, Saudi Aramco received the Saudi Capital Market Authority's approval to list on the Saudi Stock Exchange known as Tadawul with a reported initial floatation of 2%-3% of the company's outstanding shares. The table below lists basic facts about the IPO:

Issuer	Saudi Arabian Oil Company ("Saudi Aramco")
Industry	Oil and Gas
Selling Shareholder	Government of the Kingdom of Saudi Arabia
Transaction Type	Initial Public Offering ("IPO")
Indicative Offering Size	2-3% of The Total Outstanding Shares
Listing	Saudi Stock Exchange (Tadawul)
Price Range	TBD
Subscription Period	November 17, 2019 – December 4, 2019
First Day of Trading	TBD

Investment Thesis

- Aramco is the most profitable oil company driven by the lowest extraction costs, which in turn, is driven by favourable geological formation and economies of scale. The company's lifting cost of just US\$ 2.8 per barrel is well below international peers' average of c. US\$ 14 per barrel and hence drives a 41% return on invested capital compared to 11% for IOCs. The huge cost advantage makes Aramco one of a kind cash-generating engine with no real comparable. Using implied valuations of top IOCs results in sky-high valuations for Aramco given its sustainable earnings power.
- Furthermore, the recent reduction in the royalty structure offers strong visibility on earnings and cash flow generation during cyclical oil price downturns. It is estimated that Aramco will be able to generate US\$ 100 billion in net income in 2020 assuming an average oil price of US\$ 58 per barrel.
- The company has committed to pay US\$ 75 billion in annual dividend for the coming 5 years which translates to 3.75% - 5.0% dividend yield assuming a valuation range of US\$ 1.5 – US\$ 2.0 trillion. Aramco enjoys a net cash position, which reflects the company's ability to increase future dividend payout. Assuming a net gearing position of 10% - 15% would free up an additional US\$ 30 – US\$ 40 billion, that can be channelled to hiking future dividend, if needed.

- In terms of valuation, the company's earnings, cash generation ability and therefore its valuation is highly sensitive to oil price fluctuations. Having said that, it is estimated that the company would remain cash flow positive even at a US\$ 15 per barrel scenario.
- Aramco should be eligible for fast track inclusion by MSCI and FTSE Indices and could represent up to c.1% of the MSCI EM Index and thus attract significant passive flows.

Our Take

- **Valuation** – In an environment of low/negative yields, we believe Saudi Aramco shares screen extremely attractive from a yield perspective at a US\$ 1.5 trillion or lower valuation, which would translate to 5.0%+ dividend yield with an upside risk given Aramco's capability of hiking future dividend payout. One can think of Aramco share as an 'exotic' bond.
- **Sustainable Dividend** – Considering Aramco's earnings visibility, FCF generating capability and net cash position of c. US\$ 22 billion, we believe the annual cash dividend of US\$ 75 billion committed by the company is rather sustainable. Moreover, Aramco's shares act as a call option on higher oil price in the future.
- **Why Now?** The monetization Saudi Aramco is the cornerstone of all the reform plans drawn by the Saudi government as it provides the funding required to execute those reforms to diversify the economy away from oil. Furthermore, putting a price tag on Aramco would allow the Saudi government to collateralize Aramco shares and borrow against its market value. Moreover, the market value of Aramco will be used as a reference point for any future stake sales, whether through a secondary offering or a private placement.
- **Soft Dollar** – Aramco shares will turn into a currency that the Saudi government can use in acquiring strategic stakes in companies around the world by offering a share swap.
- **ESG** – Saudi Aramco's CO2 emission and environmental policies are in line with international best practices and we think that the company should be able to gain traction from a large and growing pool of environmentally and socially responsible investors. Having said that, given the important role Aramco plays not only in the Saudi economy but also in the global oil market, investors remain concerned over minority shareholder rights.
- **Order Book Size** – We understand that the Saudi authorities are pushing large local investors and government-related entities to heavily subscribe into the IPO and have also communicated with local banks to grant investors significant leverage towards IPO subscription. The aim is to get the issue well oversubscribed flashing to the world a super successful IPO. It has been also rumoured that Aramco plans to grant a stock dividend 6 months post listing to all shareholders subscribing into the IPO, to an effort to ease potential selling pressure post listing.
- **Future Listings** – Depending on the success of Aramco's IPO, other GCC countries might be encouraged to monetize their own national oil companies.
- **Stock Market Volatility** – Currently the Saudi Stock Exchange ("Tadawul") does not accurately reflect the Saudi economy where the upstream assets remain private. Therefore, the listing of Saudi Aramco ought to help Tadawul more closely track the economic activity on the ground. Moreover, floating Saudi Aramco would increase the overall market breadth,

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depth and boost liquidity while attracting additional capital into the Saudi equity market. However, given Aramco's expected market capitalization and weight (up to 15% of Tadawul All Share Index), it would naturally lead to an increased correlation between Saudi equities and the price of oil.

Risks

- Lower oil price adversely impacts company profitability.
- Disruption(s) to production and/or export facilities due to geopolitical events.
- Unfavourable changes to the current royalty and tax regime.