



National Gas and Industrialization Co. (GASCO)

Exceptional earnings growth, yet earnings quality & sustainability is concerning

13 April 2021

GASCO's net income grew by 25.1% Y-o-Y during FY2020 as SG&A normalized from a high base in FY2019. While GASCO's net income during the year exceeded expectations, EBIT was below expectations and the majority of the net income was generated from non-operating investment income rather than operating income. GASCO's core operations are on a downtrend, which is expected to persist unless significant cost cutting initiatives are made. The rising cost environment, fixed selling prices, and GASCO's current high dependence on investment income for earnings generation are key downside risks for earnings.

We maintain our **Neutral recommendation for GASCO with a target price of SAR31.0/share.**

GASCO reported flat top-line growth during Q4 2020 compared to Q4 2019, dropping by 0.3% Y-o-Y, but rebounded by 10.4% Q-o-Q due to the seasonality of demand. Gas Sales (93% of total revenues) fell by 0.2% Y-o-Y, while new gas cylinders and tanks (6% of total revenues) sales grew by 5.4% during Q4 2020.

COGS dropped by 5.0% Y-o-Y during Q4 2020, likely due to improved margins from the sale of new cylinders and tanks. Gross profit surged by 71.0% Y-o-Y and 27.7% Q-o-Q during Q4 2020 to SAR58mn. Gross margin expanded to 11.7% vs 6.8% in Q4 2019 and 10.1% in Q3 2020. SG&A normalized from a high base in Q4 2019 to SAR51mn, representing a 40.2% Y-o-Y drop, but is 6.2% higher than Q3 2020. EBIT was reported at SAR7mn vs a loss of SAR51mn in Q4 2019. EBIT margin stood at 1.4% during Q4 2020.

Income from investments was the key contributor to GASCO's net income during the quarter, increasing to SAR66mn vs SAR16mn in Q4 2019 and SAR11mn in Q3 2020. Investment income mainly includes dividends income from National Industrial Gases Company, which amounted to SAR50mn during Q4 2020, while the remaining includes rental income from investment properties and other gains on investments. GASCO recently announced the receipt of SAR33.75mn in dividend income from National Industrial Gases Co., which will reflect on Q1 2021 earnings.

GASCO turned to profits of SAR82mn during Q4 2020, the highest since Q1 2019, vs a net loss of SAR21mn in Q4 2019. It is worth mentioning that non-operating investment income accounted for nearly 80% of GASCO's net income during the quarter.

During April 2021, GASCO announced the listing of one of its associate firms, Natural Gas Distribution Co., which will take place on Nomu.

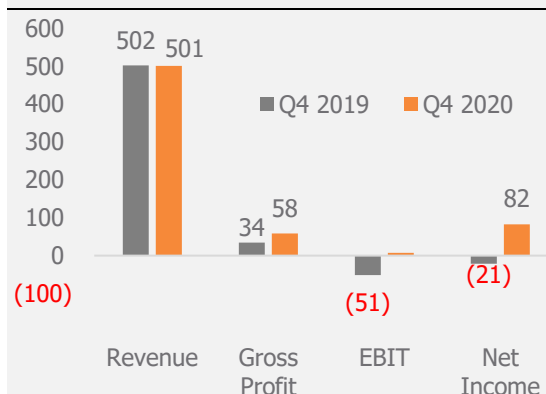
Concerning the embezzlement by a former employee of SAR34mn discovered by GASCO during July 2020, around 27.4mn were found to be routed by the employee through the accrued expenses account. Around 25.7mn of these transactions were reversed in the updated financial statements as of December 2020, while the remaining amount could not be traced. Accordingly, the auditor issued a "Qualified Opinion"¹ on GASCO's financial statements. The adjustments were reflected in higher accrued expenses account of 2018 and 2019.

Recommendation	Neutral
Previous Recommendation	Neutral
Current Price (12-04-2021)	SAR32.75
Target Price (52 Weeks)	SAR31.0
Upside/ (Downside)	-5.3%
Shariah Compliance	Pass

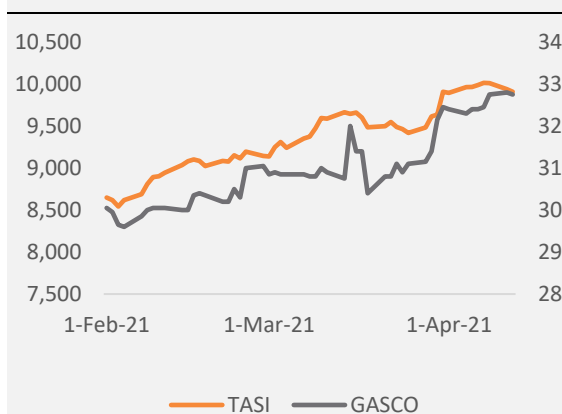
Key Financial Ratios

Ratio	Q4 2020	Q3 2020	Q4 2019
Revenue Growth	10.4%	-5.5%	-9.2%
Gross Margin	11.7%	10.1%	6.8%
EBIT Margin	1.4%	-0.5%	-10.3%
Net Margin	16.5%	1.7%	-4.2%

Key Financial Results (Q4 2020)



Share Price Performance



¹ Qualified opinion is the auditor's opinion that the financial statements are fairly presented with the exception of a specific area.

Financial Overview

2020A Overview & Outlook

GASCO's revenues were largely unaffected by COVID-19. The company's revenues grew by 2.1% Y-o-Y during FY2020 thanks to the defensive nature of the industry. Gas sales increased by 0.3% during the year, while gas cylinders and tanks sales surged by 39.2% accounting for the majority of the growth to contribute 6.9% of total revenues. Revenues trended lower, however, in H2 2020 dropping by 1.0% Y-o-Y in H2 2020 vs 5.2% Y-o-Y growth in H1 2020. We expect a sustained revenue growth rate of around 1.5% - 2.0% over the forecast period, but remain concerned about a declining expat population, which may pressure revenue growth.

Gross profit fell slightly during FY2020. Gross profit dropped by 1.7% Y-o-Y, mainly due to higher cost from early retirement plan of employees, which is expected to be a one-off expense. We expect gross profit to remain intact over the forecast period given GASCO's fixed profit margins on gas sales coupled with the company's efforts to increase operational efficiencies in the production process.

Lower SG&A supported GASCO's EBIT during FY2020. GASCO's EBIT rebounded by 45.6% as SG&A dropped by 9.4% mainly as a result of lower consultancy fees during FY2020. EBIT margins increased to 2.0% in FY2020 vs 1.4% in FY2019. EBIT and EBIT margins, however, remain significantly below historical average levels. Net income grew by 25.1% Y-o-Y on the back of higher EBIT and continued support from non-operating investment income.

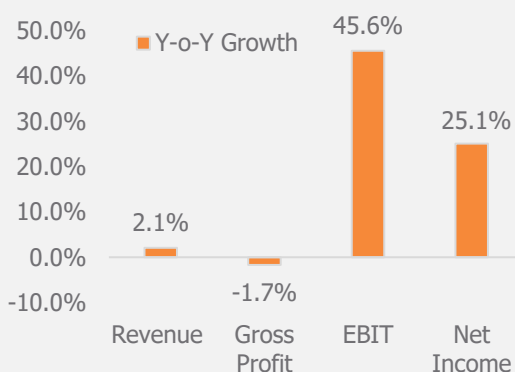
GASCO's increased dependance on investment income is threatening earnings sustainability. During FY2020, 67.3% of GASCO's earnings were driven by non-operating investment income, which mainly includes dividend income from National Industrial Gases company, rental income from investment properties, in addition to changes in fair value of other investments. Meanwhile, income from core operations (EBIT) contributed only 12.4% to the company's net income. GASCO's cash flows from operating activities fell by 39.3% during FY2020 to SAR127mn, reaching its lowest level since 2013. Net cash from operating activities fell below net income for the first time, indicating lower earnings sustainability and quality. We believe that GASCO's high dependence on dividend income from its financial assets to generate net income is risking high earnings volatility, especially given its lack of control on the investee (less than 10% ownership).

Sustainable top-line growth is expected, but earnings are at risk. Going forward, GASCO's top-line growth should continue during 2021 driven by population growth and recovery in the industrial segment (mainly restaurants) which are expected to increase their demand for LPG during 2021 thanks to improvement in business conditions compared to 2020. Rise in expatriates' exodus, however, might weigh down on top-line growth. Rising fixed costs and downtrend in operating cash flows and EBIT is the key downside risk, in our view. While investment income is currently compensating for the downfall in operating income, GASCO's increased dependence on investment income is unsustainable, thus risking high earnings volatility over the coming years.

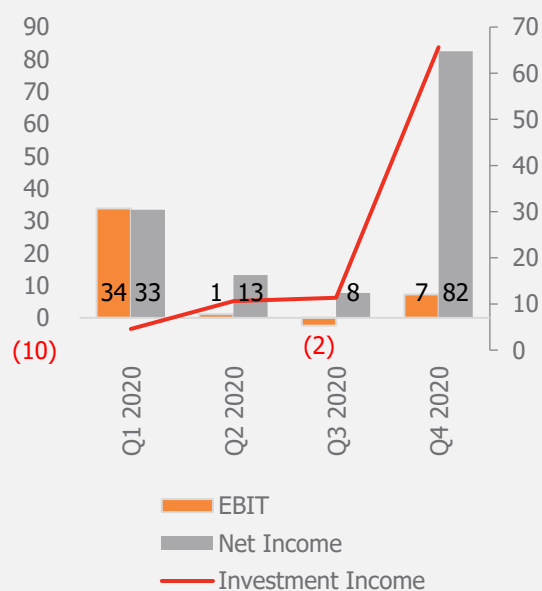
Key Financial Ratios

Ratio	FY2020	FY2019
Revenue Growth	2.1%	1.1%
Gross Margin	12.2%	12.6%
EBIT Margin	2.0%	1.4%
Net Margin	7.0%	5.7%

Key Financial Results (2020A)



Quarterly Performance



Financial Projection

DCF Valuation

	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F
EBITDA	134	160	162	164	165	164
Operating CF	117	133	144	147	148	148
Capex	(123)	(98)	(94)	(89)	(84)	(83)
FCFF	(5)	34	50	57	64	65
Stub Period (FCF to be discounted)	0	34	50	57	64	65
PV (FCFF)	0	32	45	48	50	48
WACC	6.0%					
Perpetuity Growth	1.5%					
PV-FCFF	224					
PV-TV	1,073					
Net Debt	97					
Less: End of services benefits	(156)					
Add: Investments	1,089					
Intrinsic Value	2,327					
Shares Outstanding	75					
Equity value per share	31.0					
CMP (12-04-2021)	32.75					
Upside / (Downside%)	-5.3%					

We have valued GASCO using DCF approach, considering a WACC is equal to 6.0% (based on a risk-free rate of 2.7%, market risk premium 7.0%, Beta of 0.49).

Based on the DCF valuation, the fair price GASCO's share price is SAR31.0, which is lower than the traded value by 5.3%

Financial Ratios

	2019 A	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F
Return on Average Assets (%)	5.2%	6.2%	6.6%	6.7%	6.9%	7.0%	7.1%
Return on Average Equity (%)	6.9%	8.7%	9.5%	9.6%	9.7%	9.7%	9.7%
Earnings Before Zakat Margin (%)	7.5%	7.6%	8.4%	8.4%	8.5%	8.4%	8.3%
Net Income Margin (%)	5.7%	7.0%	7.5%	7.5%	7.6%	7.6%	7.5%
Revenue Growth (%)	1.1%	2.1%	2.5%	1.5%	1.5%	1.5%	1.5%

Income Statement

	2019 A	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F
Revenues	1,923	1,963	2,012	2,044	2,075	2,106	2,138
Cost of Revenues	(1,680)	(1,724)	(1,742)	(1,767)	(1,792)	(1,817)	(1,845)
Gross Profit	243	239	270	276	283	289	293
SG&A	(216)	(199)	(208)	(215)	(222)	(229)	(236)
Zakat	(36)	(13)	(19)	(19)	(19)	(18)	(17)
Other income	118	110	107	110	114	118	121
Net Income	109	137	150	153	157	159	161

Balance Sheet

	2019 A	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F
Current Assets	573	809	807	806	813	827	845
Non-Current Assets	1,544	1,480	1,481	1,476	1,463	1,442	1,419
Total Assets	2,117	2,289	2,288	2,282	2,276	2,270	2,264
Current Liabilities	344	421	423	428	432	437	426
Non-Current Liabilities	208	302	273	243	214	185	173
Total Equity	1,565	1,565	1,592	1,610	1,629	1,647	1,665
Total Liabilities and Equity	2,117	2,289	2,288	2,282	2,276	2,270	2,264

Guide to Ratings and Disclaimer

Guide to Ratings

Buy	An upside potential of more than 20% in 52-week period
Overweight	An upside Potential of more than 10% in 52-week period
Neutral	Will stay in the range of it value (up/down 10%) in a 52-week period
Underweight	A downside potential of more than 10% in 52-week period
Sell	A downside potential of more than 20% in 52-week period

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