Aramco IPO

By Steve Clapham, Hardman & Co Analyst

Source: Creative Commons

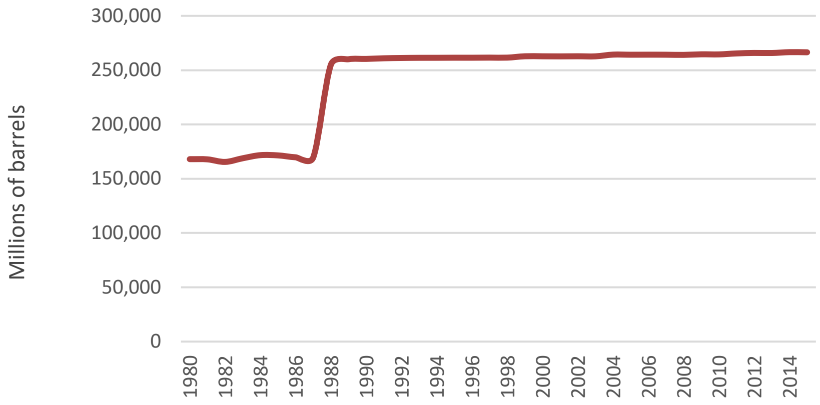
An IPO of Saudi Aramco in late 2018 at a valuation of $2 trillion (tn) has been widely trailed in the Press. Although the recent appointment of the man behind the flotation, Mohammed bin Salman, as Crown Prince has increased the impetus for a float, we believe the Aramco IPO may not happen in 2018, if at all, for three main reasons: timing, the oil price, and valuation.

Timing

An IPO in the second half of 2018 is a challenging deadline. It leaves scant time to restructure the conglomerate's myriad public interest and commercial holdings and to produce financial accounts to international standards. As a commercial arm of the Government, Saudi Aramco is responsible for many Saudi public projects, such as the construction of schools and hospitals, and it will be necessary to split the public service arm from the commercial operations prior to IPO.

Aramco does not publish financial information nor have its reserves until recently been subject to external audit. Construction of a full set of audited financial data to international accounting standards is likely to be difficult. A myriad of decisions will be required on the adoption of accounting policies and their implications which will absorb a lot of senior management and bankers' energies.

Saudi Crude Oil Reserves



Source: OPEC Annual Statistical Bulletins

The audit of the geological reserves is also a potentially contentious issue. Apparently both Gaffney, Cline and Associates (a subsidiary of oil services major Baker Hughes, which has a technology centre in Saudi Arabia) and Dallas-based DeGolyer and MacNaughton have completed audits which have confirmed the Saudi figure of c.265bn barrels. This estimate has been questioned over many years by a number of independent analysts – the chart shows that the reserves quoted by OPEC have flatlined in the last 25+ years, in spite of production which might have been expected to reduce reserves significantly; amazingly, new discoveries and technological advances have almost exactly matched production, a feat which no other oil major has achieved.

The timescale for an organisational restructuring, construction of audited financials, and resolution of reserves audit issues is extremely tight; senior management, unaccustomed to outsiders' interference in internal affairs, will be under pressure.

Listing Location

Clearly, Aramco will be listed on the local Saudi Exchange, but a sole listing is impractical given the size of the flotation and the issue of where else to list the shares is apparently a vexing question. New York may have to be ruled out because of its more onerous rules on reserves accounting, and the possibility of 9/11 related lawsuits.

London would be the obvious choice, but the proposed IPO would not meet the free float requirements for a premium listing. The FCA recently published proposals to create a special class of premium listing for companies owned by sovereign states, as a specific loophole to attract the Aramco IPO. Institutions are thought to be against such a relaxation and a Royal London spokesperson warned authorities against bending the rules to favour Aramco; clearly there has been pressure from the other direction.

Assuming New York is ruled out (too early to tell, and the new Crown Prince seems to have a close relationship with President Trump), we had suspected that a way to accommodate Aramco in London would be found, as the alternative, a listing in Singapore or Hong Kong, would not be satisfactory from the perspective of US and European capital. Another route - should the special premium listing be opposed by institutional investors (although it is not clear if they have the ability to do more than object) - would be to create a new investment trust or closed-end fund, with 100% free float on the London Exchange. It could own say 4% of Saudi Aramco, and it would flow through Aramco's dividend payments directly to its own shareholders.

By placing the majority of this fund with Chinese SOE investors, and by setting it up to meet index inclusion requirements, a real shortage could potentially be created. The FTSE 100 Index is currently capitalised at c. $3.1tn. A fund owning 4% of Aramco would therefore be 2.6% of the index if Aramco is valued at the desired upper-end $2tn valuation range. We believe this is way too high and discuss the valuation ranges below, but inclusion in indices is a key to success for this float.

Oil Prices and Production Volatility

Weakness in the oil price or Aramco volumes will reduce the valuation, potentially significantly. As the Hardman Monthly went to press, the oil price had just nudged back up above the $50 mark, after dipping below $45. It's possible that restraint from the Russians, Iranians and other OPEC members will be maintained; it is even possible that shale producers will not gear up production, but it seems an unlikely combination. Clearly the valuation of Aramco will be dependent on the market's assessment of long-term oil prices, but current year profitability will determine the starting dividend and this is crucial to the IPO valuation. Hence the market is convinced that the Aramco IPO means that the Saudis will have to support the oil price.

Catch 22: achieving higher prices may force the Saudis and OPEC to reduce production, but lower volumes mean lower revenues and profitability for Aramco. The crude oil market backdrop is therefore also a serious potential risk to the timing of the flotation.

Valuation

Valuation, however, is the real challenge. The Saudi ambition to sell 5% of a $2tn business is unlikely to be achieved. Assuming the oil price does not rocket up, admittedly a possibility given the collapse in oil capital expenditure in the last couple of years, we believe the valuation will be less than half this level, and that the proceeds will fall well short of $100bn. Such a figure is insufficient to make much difference to the Saudi budget, and potentially a very limited net gain when the reduction in the corporate tax rate paid by Aramco is factored in.

Background

On January 4th, the Kingdom of Saudi Arabia's then Deputy Crown Prince, Muhammad bin Salman, told The Economist that Saudi Arabia was considering the possibility of floating shares in Saudi Aramco, and subsequent press speculation has settled on a valuation of $2 trillion.

Financials

There is almost no financial data available for Aramco, but enough is known to make a rough calculation of likely revenues; given that crude production is by far the largest income source, we ignore the other business areas, including gas and downstream, for the moment. Our missing element is costs, and while we understand that its largest asset once had a lifting cost of c.$2/barrel, it is likely that it has risen to at least $5-8/bbl and more likely to $10/bbl or more in more recent times, given that the rig count has increased by a multiple in the last 20 years. As reported in the Financial Times, Saudi Aramco CEO Amin Nasser commented in New York in mid-April that the company was investing heavily in future crude production and it is clear that the company's cost of production will inevitably rise from here, as the easy oil has been extracted. In our calculations, we use a round figure of $10/barrel as the likely cost.

Baker Hughes Saudi Rig Count Trend – 000s (not all rigs)

Source: Baker Hughes - International Rotary Rig Count; it does not include all rigs

Deriving the Dividend and Valuation

We have done a very simple calculation of the likely profitability of the core Aramco crude oil production business, using the published number of 3.7bn barrels of production, a cost of $10 per barrel, and a flat crude price of $50/bbl. We use a 20% royalty and 50% corporate tax rate, and assume overheads of c.$5bn and a (perhaps overly conservative) 2x dividend cover.

Aramco Financial Model (US$ bn)	
Revenue	185
Direct Costs	-37
Royalties	-37
Gross profit	111
Overheads	-5
EBIT	106
Tax	-53
Profit after tax	53
Dividend	26.5

Source: Hardman & Co Research

If a $2tn market cap were used, this would equate to a P/E of 37.7x and a yield of 1.3%. Clearly with Shell and Exxon trading at a P/E of 16x and 23x and a yield of 6.9% and 3.8% respectively, such a valuation looks ambitious.

Our contention is that Exxon is overvalued because of its inclusion in multiple ETFs and that Shell is a better comparative to use; clearly this is arguable. Applying the Shell yield would give an Aramco valuation of $385bn and using its P/E would give $855bn. There is a plausible argument that Saudi Aramco should trade at a significant P/E discount and yield premium to Shell because of its geographical concentration, political risk and governance issues. Adding in say $50bn for its other businesses, it would be difficult to derive a valuation for Aramco of much over $500bn-600bn.

Alternatively, the $2tn valuation can be reverse engineered. On a generous 6% yield, it would require a $120bn dividend, which, based on a $10/bbl cost, would exceed the pre-tax profit. It is clearly an unrealistic aspiration, and would represent a valuation of over 10x sales; even the recently trailed lower internal valuation figure of $1.5tn equates to over 8x sales: such valuations have hitherto been the province of Silicon Valley technology start-ups.

A way round this has, we understand, been proposed by bankers, eager to push up sale proceeds. The suggestion is that Aramco should no longer be required to sell domestically at a discount to market prices. Clearly, forcing locals to pay full price for gasoline would cause upset, and some form of Government subsidy would be required. A rough calculation, based on Saudi oil and gas consumption, suggests that this could add up to between $25bn and $75bn of revenues or at the mid-point, say $25bn of earnings. This could therefore increase the valuation by up to $400bn, although our estimates already assume market prices.

The problem for the bankers is that the market will look at such income as a Government subsidy and it will not attract the same multiple as earnings from an oil major.

Valuation Constraints

The valuation of Aramco relative to its international oil company (IOC) peers is subject to some significant risk factors, including geographical, geological and earnings quality. In particular, country risk for this company is significant. Aramco's domicile will be perceived as risky, because:

- it has a concentration of assets in a volatile region, with restricted maritime access;
- the potential for a change of policy by the existing ruler, a voluntary change of ruler or an enforced change of system are clear political risks;

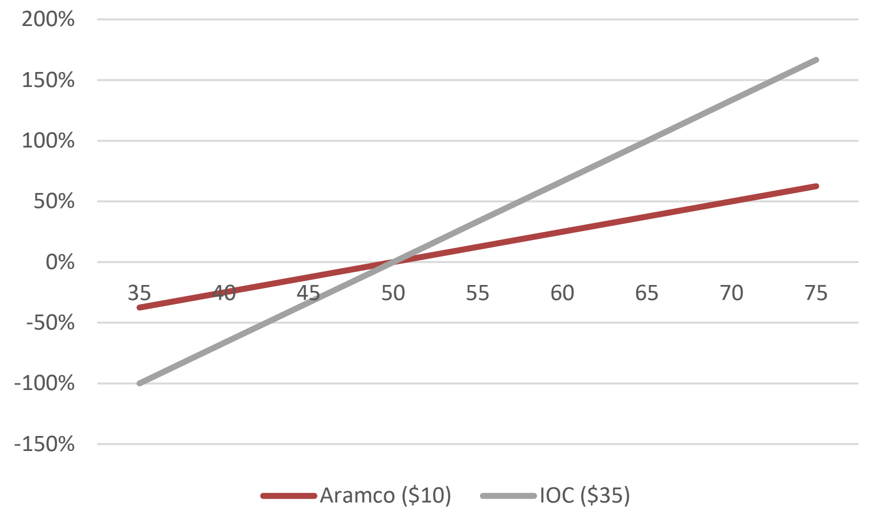
- if oil prices remain low, there could be a reversal of its recent corporate tax cut in order to maintain budget stability.

Reserves risk is perceived as high as the company/state has been secretive in the past and there has been suspicion that its reserves were over-stated. This risk could prove largely irrelevant as all the reserves are unlikely to be exploited (on flat volumes, they would last until 2090).

Governance is clearly a sensitive issue both for the seller and for potential international investors; and a significant governance discount will be required.

The IPO valuation will be capped by the company's limited growth prospects. Aramco's earnings from the production of crude oil will inevitably decline in a stable oil price environment as new production comes at a higher cost; hence the dividend growth potential will likely have to come from other sources; but replacing the core cash flow stream will be difficult and returns there will almost inevitably decline, unless oil prices rise.

Profit sensitivity to oil prices (cost of production)



Source: BehindtheBalanceSheet.com

Moreover, Aramco is less geared to higher oil prices than its peers, as its estimated cost of production is far lower; hence, incremental rises in oil prices have a much higher geared effect on its peers. The chart illustrates the sensitivity of Aramco's profitability at a $10 production cost vs a peer with a $35 production cost to changes in oil prices – Aramco derives much less benefit from higher oil prices. And although its downside is better protected than its peers, the downside risk for Aramco is greater than the upside because of likely lower output if oil prices are weaker.

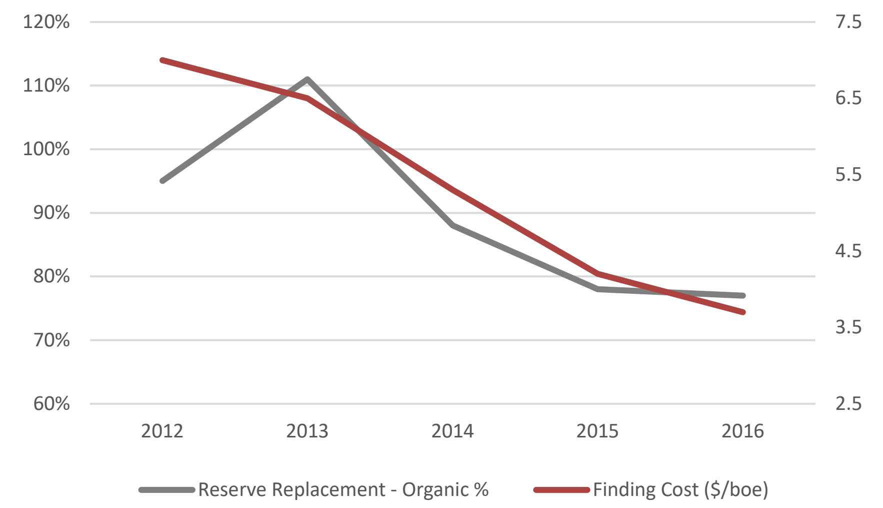
Hence, if Aramco's earnings growth depends on higher oil prices, an IOC would be a better investment, unless Aramco were priced at a significant discount. Equities in commodity sectors are generally considered higher quality if they have a lower cost of production. Aramco is unusual in being low cost and lower quality than its peers.

Upsides

There are upsides to the valuation, notably in that the downstream and other businesses could have a significant value. We assume a $50bn valuation, but clearly this could be significantly lower or possibly somewhat higher. Similarly, production costs could conceivably be lower than our $10/bbl estimate. Even if they were higher, that could reflect a significant investment already incurred, which could mean lower future investment and higher future free cash flow, thereby boosting the valuation. And as mentioned, allowing Aramco to sell locally at international market prices would significantly increase its profitability.

The most important upside to the valuation - relative to the IOCs - is reserves replacement. Oil majors' reserves' lives have been falling for several years, as reserves replacement has been below 100%, certainly organically (although Shell's mega-acquisition of BG has boosted the overall ratio). Finding costs for the majors have fallen significantly as reserve replacement has declined. Reserve life for the majors is now estimated at around 13 years.

IOCs - Finding Costs and Reserve Replacement



Source: BehindtheBalanceSheet.com, from various broker estimates

A comparison of Free Cash Flow should certainly favour Aramco, and it is conceivable that dividend policy will be set at a higher pay-out of earnings than the international players as less cash is required for investment, and notably for reserve replacement. This could boost the valuation significantly, but we contend that earnings multiples will be constrained by the peer group average and by the geographical and political risks.

Conclusion

It may be impossible for an outsider to value Aramco accurately, but a $1.5-2.0tn valuation is stretching credibility beyond comprehension. We believe the IPO timetable is ambitious, and the valuation aspirations are unrealistic.

Market consensus is that the Aramco IPO is a key support for the oil price over the next 12-18 months. A failure to float Aramco would hence undermine one bull argument for higher oil prices.

An IPO alternative would be a private placement of equity with one or more Chinese state-owned enterprises; they might have a more strategic objective and value security of supply over financial return on investment. Or they could be used to cornerstone an IPO and create a market shortage, especially if regulators could be persuaded to include Aramco in international indices.

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Steve Clapham is responsible for analytical coverage of a number of support services clients at Hardman & Co.

He is a founding partner of the Balance Sheet Surgery LLP, a financial analysis and research consultancy. Steve has been an investment analyst for the last 25 years working on the sell side for a number of investment banks covering the transport, utilities and conglomerates sectors. In 2005 he moved to the buy side where he was a partner at Toscafund Asset Management LLP, and then Head of Research at Altima Partners LLP.

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