ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Another offshore suspension a setback, unconventional land rigs to support topline but revenue mix change to pressurize margins; switch to "Overweight" with a lower TP on attractive valuation

Arabian Drilling Company (ADC) faces another suspension of an offshore rig contract by Aramco. This in addition to earlier announced three makes the total number of suspended rigs four. These suspensions will impact the company's topline and will also weigh on the margins, as offshore margins are higher compared to onshore. Nevertheless, intensified gas exploration at Jafurah field will be a key growth driver for the company. Anticipated deployment of 13 unconventional onshore gas rigs is likely to partially compensate for revenue lost due to suspensions. We see the company's limited exposure to the offshore market and lack of presence outside KSA as a challenge towards securing new contracts for suspended rigs. However, potential wins in anticipated contracts from Aramco for Jafurah phase 2 will be positive for the company. Moreover, ADC is able to strengthen its position should it expand to markets outside of KSA, such as Kuwait. We project the company's active rigs to reach 63 by FY28E from the current 48. The rise in the number of active rigs is anticipated to result in a revenue CAGR of 4.6% for the FY23-28E period. EBITDA margin is expected to contract from 42.7% in FY23 to 38.3% in FY24E and recover to 42.5% by FY28E, while the bottom line is forecasted to grow at a CAGR of 4.9%, rising from SAR 605mn in FY23 to SAR 769mn in FY28E. We revise our TP on ADC lower to SAR 142.50/share. However, after a ~49% decline in the stock price during 2024, we believe all negatives are factored in, with an upside potential present. Thus, we upgrade our recommendation to "Overweight".

Higher depreciation, rig startup cost, and increased finance cost drag adjusted net income in Q2-24: ADC's adjusted net income declined 10.8% Y/Y to SAR 125mn in Q2-24, in line with AJC's estimate of SAR 126mn. The net income was impacted by higher depreciation related to new offshore rigs, unconventional rig startup cost, and increased finance cost. The reported net income stood at SAR 20mn due to impairment of assets worth SAR 105mn related to suspended rigs. Revenue rose 18.8% to SAR 939mn, in line with our estimated SAR 927mn. The Y/Y topline growth was driven by contribution from three offshore rigs that began operations in Q3-23 , and the earlier-than-scheduled startup of 4 unconventional rigs. The gross margin decreased to 13.8% in Q2-24 from 29.0% in Q2-23, as cost of sales included a SAR 105mn impairment charge, excluding it gross margin came in at 24.9%; below our expectation of 26.0%. Normalized operating profit was flat at SAR 180mn, slightly below our estimate of SAR 191mn. Normalized operating margin contracted ~360bps Y/Y to 19.2% (below AJC's estimate of 20.6%).

Unconventional land rigs at Jafurah field to drive revenue growth in near-to-medium term amid impact of offshore rig suspensions: Saudi Aramco's plan to increase gas production by 60% by 2030 bodes well for ADC due to its presence in onshore drilling in the Kingdom. ADC has already won contracts for a total of 13 rigs with Aramco for its unconventional gas program at Jafurah field. By the end Q2-24, 4 unconventional rigs were operational. We expect at least 3-4 more rigs to be operational in Q3-24, as the company expects all the 13 rigs to start operations by the end of FY24, ahead of the scheduled Q1-25 target. Thus, the new unconventional rigs being added to the company's active onshore fleet would drive revenue for the company amid pressure on the topline due to suspension of offshore rigs. One more suspension in addition to earlier announced three is a setback for the company, taking the total number of suspended offshore rigs to four. We forecast ADC's total active rigs to reach 63 by FY28E. Accordingly, revenue is estimated to register a CAGR of 4.6% during FY23-28E to SAR 4.3bn.

EBITDA margins to be hit by revenue shift due to offshore suspensions and higher OPEX owing to several rig startups, depreciation to weigh on GP margin: ADC's EBITDA margins are expected to contract to 38.3% this year from 42.7% in FY23. The suspension of four offshore rigs and startup of new unconventional land rigs is expected to shift revenue mix to lower margin; as generally, offshore rigs possess the ability to generate 2x margins than onshore rigs. Additionally, the OPEX related to start-up of unconventional rigs will increase the costs. Accordingly, we forecast EBITDA margins to contract from 42.7% in FY23 to 38.3% in FY24E and then recover gradually to 42.5% in FY28E. Moreover, GP margin will be hit by higher depreciation, while rise in finance cost will impact net margin. We expect the net income margin to be at 10.2% in FY24E (FY23: 17.4%) before improving to 17.7% in FY28E, supported by EBITDA margin recovery, decrease in finance cost with anticipated debt repayments as operating cash flows improve and lower interest rates in future.

Recommendation	Overweight
Target Price (SAR)	142.50
Upside / (Downside)*	31.0%

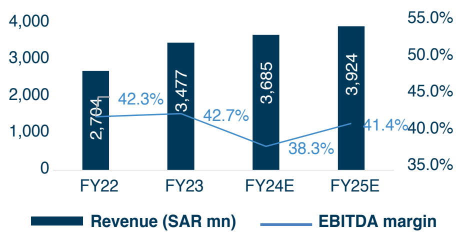
Source: Tadawul *prices as of 22nd of October 2024

Key Financials

in SAR mn, (unless specified)	FY22	FY23	FY24E	FY25E
Revenue	2,704	3,477	3,685	3,924
Growth %	22.9%	28.6%	6.0%	6.5%
Gross Profit	801	976	834	946
EBITDA	1,144	1,485	1,409	1,625
Net Income	558	605	377	515
Growth %	99.0%	8.4%	-37.7%	36.8%
EPS	6.27	6.79	4.23	5.79
DPS	0.24	5.06	2.70	4.00

Source: Company reports, Aljazira Capital Research

Revenue and EBITDA margin



Source: Company reports, Aljazira Capital Research

Key Ratios

	FY22	FY23	FY24E	FY25E
Gross Margin	29.6%	28.1%	22.6%	24.1%
EBITDA Margin	42.3%	42.7%	38.3%	41.4%
Net Margin	20.6%	17.4%	10.2%	13.1%
ROE	11.4%	10.5%	6.2%	8.3%
ROA	6.9%	6.0%	3.5%	4.6%
P/E	NM	28.1	26.7	19.5
P/B	NM	2.9	1.6	1.6
EV/EBITDA (x)	NM	12.5	9.3	7.9
Dividend Yield	NM	2.6%	2.4%	3.5%

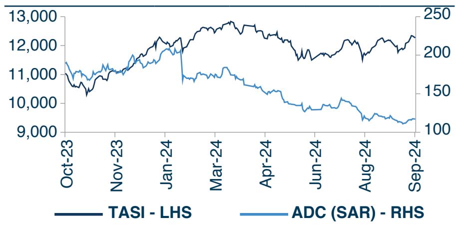
Source: Company reports, Aljazira Capital Research

Key Market Data

Market Cap (SAR bn)	10.0
YTD%	-40.9%
52 weeks (High)/(Low)	214.2/103.6
Share Outstanding (mn)	89.0

Source: Company reports, Aljazira Capital Research

Price Performance



Source: Tadawul, Aljazira Capital Research

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Room for higher dividend payout as CAPEX peaks: ADC's CAPEX intensity increased in FY22 (65% of revenue; SAR 1.7bn) and FY23 (53% of revenue; SAR 1.8bn) due to an increase in offshore rig capacity. The contracts for 13 onshore rigs are expected to keep CAPEX intensity high in FY24E as well (64% of revenue; SAR 2.4bn). Thus, we expect payout ratio to be lower at 65-70% in the near term. However, CAPEX is expected peak out in FY24E. Thus, we expect dividend payout to improve to 75% by FY28E, with the capex intensity expected to normalize to 16% of revenue by FY28E. At current market price FY25E dividend yield is estimated at 3.4%.

Uncertainty over suspended rigs a concern; while additional unconventional rig contracts from Aramco and expansion outside KSA are potential upside risks: Unlike its peers, ADC has not been able to secure new contracts for any of its suspended offshore rigs till date. The company's limited exposure in the offshore market and lack of presence outside the Kingdom raises concerns over its ability to win new contracts in the offshore market. Thus, there is a possibility that ADC may return some or all of the suspended rigs which are on lease. However, we assume the company to be able to secure contracts for two of the suspended offshore rigs until the end of FY25. On the other hand, Aramco is expected to come up with 1 or 2 more rounds of tenders for its unconventional gas expansion project. We see the company could be able to expand further If ADC's win rate continues in its upcoming tenders (won 13 out of 23 in in earlier tenders, and expected to deploy these rigs ahead of schedule). Moreover, if the company is able to expand its presence outside KSA, particularly in Kuwait which is closer to where some of the company's rigs are operating, this will help the company diversify its business.

Investment thesis and valuation: ADC's near to medium term performance will be driven by two key factors 1) negative impact from suspension of four offshore rigs and 2) startup of 13 unconventional onshore rigs before schedule at Jafurah field. The shift in revenue mix towards onshore segment is likely to pressurize the company's margins. However, the current valuation seems enticing despite all the negatives factors which are already priced in the market value. We forecast ADC's active rigs to reach 63 by FY28E from the current 48, mainly driven by increase in onshore rigs. Thus, revenue is estimated to post a CAGR of 4.6% for the FY23-28E period. EBITDA margin will contract from 42.7% in FY23 to 38.3% in FY24E and recover to 42.5% by FY28E, while the bottom line is forecasted to grow at a CAGR of 4.9%, rising from SAR 605mn in FY23 to SAR 769mn in FY28E.

We valued ADC with 50% weightage to DCF (WACC=8.3%, terminal growth rate=2.0%) and 50% weight to FY25E EV/EBITDA (9.0x) to arrive at a TP of **SAR 142.50/share**. We upgrade to "**Overweight**" rating on the stock. The stock is currently trading at a P/E of 19.5x and EV/EBITDA of 7.9x, while the dividend yield is expected at 3.5%, based on our FY25E estimates. Downside risks to our valuations are 1) Unable to secure contracts for the suspended rigs 2) additional suspensions by Aramco including land rigs 3) subdued activity in oil and gas industry impacting rig demand 4) lower than expected day rates. Major upside risks to our valuation are 1) Wining new contracts for unconventional rigs in Jafura phase II 2) expansion outside KSA 3) growth through aggressive acquisition of rigs 4) securing new contracts for suspended rigs at significantly higher rates.

Blended valuation summary

	TP (SAR)	Weight	Weighted TP
DCF	138.9	50%	69.5
EV/EBITDA	146.1	50%	73.0
Blended TP			**142.5**
Up/Downside (%)			**31.0%**

Source: AlJazira Capital research

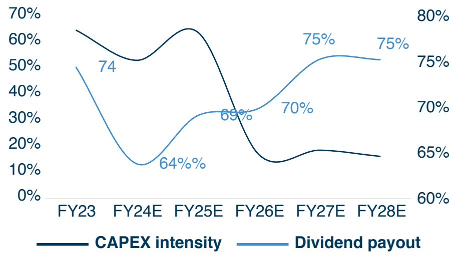
Active rigs: Onshore and Offshore

Operating metrics

	FY23	FY24E	FY25E	FY26E	FY27E	FY28E
Active rigs	47	53	58	59	61	63
Onshore	35	45	48	50	51	53
Offshore	12	8	10	10	10	10

Source: Company reports, AlJazira Capital research

CAPEX intensity and dividend payout



Source: Company reports, AlJazira Capital research

Key Financial Data

Amount in SAR mn, unless otherwise specified	FY20	FY21	FY22	FY23	FY24E	FY25E	FY26E	FY27E	FY28E
Income statement									
Revenues	2,533	2,199	2,704	3,477	3,685	3,924	4,128	4,253	4,344
Y/Y	**-10.0%**	**-13.2%**	**22.9%**	**28.6%**	**6.0%**	**6.5%**	**5.2%**	**3.0%**	**2.1%**
Cost of revenue	(2,009)	(1,723)	(1,902)	(2,501)	(2,851)	(2,979)	(3,119)	(3,202)	(3,258)
Gross profit	**523**	**476**	**801**	**976**	**834**	**946**	**1,009**	**1,051**	**1,086**
General & administration expense	(124)	(105)	(180)	(181)	(195)	(184)	(186)	(189)	(191)
Operating profit	**400**	**370**	**619**	**801**	**634**	**766**	**827**	**866**	**900**
Y/Y	**5.2%**	**-7.4%**	**67.3%**	**29.4%**	**-20.9%**	**20.9%**	**8.0%**	**4.7%**	**3.9%**
Financial charges	(63)	(38)	(94)	(161)	(238)	(225)	(141)	(89)	(55)
EBITDA	**1,132**	**910**	**1,144**	**1,485**	**1,409**	**1,625**	**1,722**	**1,797**	**1,845**
Y/Y	**12.7%**	**-19.6%**	**25.7%**	**29.8%**	**-5.1%**	**15.3%**	**6.0%**	**4.3%**	**2.7%**
Income before zakat	**338**	**333**	**552**	**688**	**424**	**572**	**707**	**788**	**854**
Zakat	(44)	(53)	5	(83)	(47)	(57)	(71)	(79)	(85)
Net income	**294**	**280**	**558**	**605**	**377**	**515**	**637**	**710**	**769**
Y/Y	**27.6%**	**-4.7%**	**99.0%**	**8.4%**	**-37.7%**	**36.8%**	**23.6%**	**11.4%**	**8.4%**
EPS (SAR)	3.30	3.15	6.27	6.79	4.23	5.79	7.15	7.97	8.64
DPS (SAR)	0.22	-	0.24	5.06	2.70	4.00	5.00	6.00	6.50
Balance sheet									
Assets									
Cash & equivalent	640	412	832	1,435	410	581	375	275	257
Other current assets	719	864	2,017	1,365	1,218	1,363	1,397	1,425	1,452
Total current assets	**1,359**	**1,275**	**2,849**	**2,801**	**1,628**	**1,944**	**1,771**	**1,699**	**1,709**
Property plant & equipment	5,562	5,259	6,491	7,738	9,326	9,141	9,023	8,791	8,485
Right of use assets	5	2	199	132	124	115	107	99	91
Total assets	**6,942**	**6,544**	**9,554**	**10,686**	**11,093**	**11,217**	**10,918**	**10,605**	**10,301**
Liabilities & owners' equity									
Trade payables	463	457	585	729	608	681	698	718	733
Other current liabilities	689	576	225	362	358	354	350	346	342
Total current liabilities	1,152	1,033	809	1,091	966	1,035	1,048	1,064	1,074
Lease liabilities – non-current	2	-	136	68	64	60	56	51	47
Long term loans	1,377	836	2,481	2,886	3,286	3,186	2,686	2,186	1,686
Total non-current liabilities	**1,878**	**1,320**	**3,155**	**3,634**	**4,029**	**3,925**	**3,421**	**2,917**	**2,413**
Share capital	23	23	890	890	890	890	890	890	890
Reserves	3,890	4,169	4,700	5,071	5,208	5,367	5,558	5,734	5,924
Total owners' equity	**3,912**	**4,192**	**5,590**	**5,961**	**6,098**	**6,257**	**6,448**	**6,624**	**6,814**
Total equity & liabilities	**6,942**	**6,544**	**9,554**	**10,686**	**11,093**	**11,217**	**10,918**	**10,605**	**10,301**
Cashflow statement									
Operating activities	1,436	676	1,242	1,360	1,388	1,496	1,635	1,710	1,746
Investing activities	(486)	(227)	(2,724)	(789)	(2,327)	(635)	(748)	(679)	(569)
Financing activities	(531)	(677)	1,903	33	(87)	(689)	(1,094)	(1,131)	(1,141)
Change in cash	418	(228)	420	603	(1,025)	171	(207)	(100)	35
Ending cash balance	**640**	**412**	**832**	**1,435**	**410**	**581**	**375**	**275**	**257**
Liquidity ratios									
Current ratio (x)	1.2	1.2	3.5	2.6	1.7	1.9	1.7	1.6	1.6
Quick ratio (x)	0.6	0.8	2.5	1.3	1.3	1.3	1.3	1.3	1.4
Profitability ratios									
Gross profit margin	20.7%	21.6%	29.6%	28.1%	22.6%	24.1%	24.5%	24.7%	25.0%
Operating margin	15.8%	16.8%	22.9%	23.0%	17.2%	19.5%	20.0%	20.4%	20.7%
EBITDA margin	44.7%	41.4%	42.3%	42.7%	38.3%	41.4%	41.7%	42.2%	42.5%
Net profit margin	11.6%	12.7%	20.6%	17.4%	10.2%	13.1%	15.4%	16.7%	17.7%
Return on assets	4.1%	4.2%	6.9%	6.0%	3.5%	4.6%	5.8%	6.6%	7.4%
Return on equity	7.8%	6.9%	11.4%	10.5%	6.2%	8.3%	10.0%	10.9%	11.4%
Leverage ratio									
Net Debt / equity (x)	0.35	0.23	0.30	0.27	0.50	0.44	0.38	0.31	0.23
Market/valuation ratios									
EV/sales (x)	NM	NM	NM	5.4	3.6	3.3	3.0	2.9	2.7
EV/EBITDA (x)	NM	NM	NM	12.5	9.3	7.9	7.3	6.7	6.3
Market-Cap	NM	NM	NM	16,999	10,042	10,042	10,042	10,042	10,042
P/E ratio (x)	NM	NM	NM	28.1	26.7	19.5	15.8	14.2	13.1
P/BV ratio (x)	NM	NM	NM	2.9	1.6	1.6	1.6	1.5	1.5
DY (%)	NM	NM	NM	2.6%	2.4%	3.5%	4.4%	5.3%	5.8%

Source: Company reports, Aljazira Capital Research, * market price as of October 20, 2024

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RESEARCH DIVISION

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3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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