

IN FOCUS: THE SAUDI CEMENT SECTOR

JANUARY-SEPT 2008

Domestic cement market is well supplied by local

31 DEC 2008

Contents	Page
Market Demand Determinants	2
Saudi Market Supply-Demand Outlook	2
Cement Demand, historic perspective	4
Industry's Efficiency and Conclusion	5

Executive Summary

- Domestic cement market has been well supplied by 12 local producers during Jan-Sept 2008.
- Installed capacity was 30.4 million tons in 3Q08 and is set to reach 54 million tons by 2010.
- Total output was 25.8 million tons in Jan-Sept and grew 11% over the same period a year ago.
- Cement sales in the domestic market reached 23 million tons, accounting for 90% of the period's total output and growing by 10.6% on the same period a year ago
- For the final 4Q08 quarter, we estimate domestic sales of 7.5 million tons and to grow by 24.2% over the 4Q07.
- We project total output of 34 million tons and domestic sales of 30.5 million tons for entire 2008, and sales to grow by 13.7% over 2007.
- Cement exports orders of 2.6 million tons were met during Jan-Sept 2008 and grew 5.1% over the same period a year ago. Increased domestic demand and exports restrictions (except Bahrain) have slowed growth in cement exports
- In the medium-term to 2010, we project domestic sales to reach 37 million tons (69% share) along with exports orders of 7 million tons (13%) that would absorb 44 million tons (81%) out of total projected capacity of 54 million tons.
- Short-term domestic supply overhang of 10 million tons is seen before 2010.
- Overall demand growth is expected to accelerate after 2010 to absorb industry's capacity of 54 million tons, due to the overlapping of many mega projects.
- The eight listed companies reported 7.1% decline in their combined net profit to SR3.27 billion in Jan-Sept 2008 period over the same period of 2007. The 17.2% increase in the cost of sales depressed gross margin down to 57.2% in Jan-Sept 08, from 62.2% over the same period a year ago.
- Net-Profit per ton of total cement sold (local plus exports) declined from SR151.8 in Jan-Sept07 to SR143.5 in Jan-Sept08, on rising cost of sales and general administrations expenses.
- On profitability measure, traditional producers' efficiency deteriorated by 5.5% in one year to Sept 2008, however, the eight cement companies' breakeven selling price is 50% above the current selling price which strengthen their financial foundations.

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A. Market Demand Determinants

A vibrant Saudi economy measured in nominal GDP has doubled in the last seven years on continuing higher oil revenues receipts that strengthened domestic fiscal foundation while building current account surpluses on the external front. The twin surpluses lifted government's ability to retire public debt while allocating more funds for investments in infrastructure developments. These moves accelerated aggregate demand for construction materials and related goods and services thus raising private sector ability to boost corporate earnings which spread across the economy through dividend payouts and assets price gains.

The private sector also stepped up investments in new industrial projects, capacity enhancement of the existing ones, building of commercial centers, and residential units. The result has been a period of unprecedented economic growth with buoyancy in the construction sector. Along with whooping growth in bank lending activities, liquidity spiral evolved in the domestic economic system. As a result, inflation started peeping out on supply-side shocks inline with the spikes in international commodities and building materials prices including cement and steel.

1. Macro Economic Outlook for 2008-2009

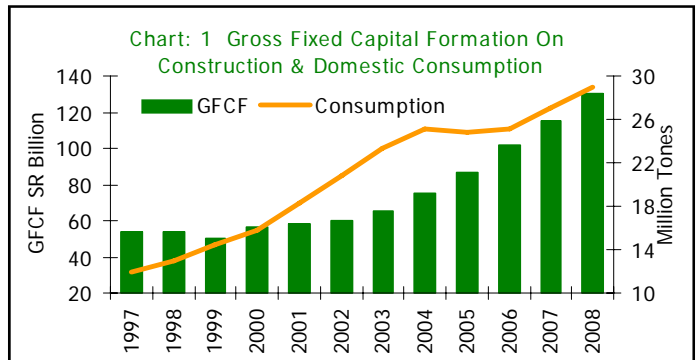
As measured in current size of GDP, the Saudi economy slightly more than doubled since 2000, from SR707 billion (\$189 billion) to SR1,430 billion (\$381 billion) in 2007 and has further increased by 22% to SR1,753 billion (\$467.5 billion) in 2008, with corresponding per capita GDP rising further to about SR70,500 (\$18,800). The government allocated SR 165 billion for projects in the 2008 state budget, consuming nearly 40% of the total planned expenditures worth SR410 billion. The construction spree is set to continue in 2009 as the Government has increased development outlays by another 36% to SR225 billion in the 2009 state budget. This move will tend to accelerate demand for cement and related materials.

We are strictly bullish on investment spending as a key driver for economic growth and in turn cement demand in 2009. Investment spending is primarily triggered by (1) capacity expansion by commodity exporters, (2) government investment in infrastructure and utilities, (3) establishment of economic cities, and (4) market liberalization and WTO accession.

2. Rising Cement Demand on Construction Boom

The Kingdom is on the verge of an unparalleled construction boom. Projects in excess of SR2.1 trillion (\$560 billion) are currently underway, all of which have significant element of civil work that consumes cement and steel. This value figure, however, is a moving target, as projects are announced, re-scoped or cancelled on a daily basis. Nonetheless, forward expectations are for more projects to enter the pipeline that in turn would induce cement demand. Thus, we expect growth in cement demand will remain strong even though short-term domestic supplies and high international prices have capped the growth in the recent period. Chart 1 explains long-term

growth trend in cement consumption and the gross fixed capital investments in construction goods in the Kingdom's economy.



3. Supportive Regulatory Environment

The Saudi cement industry will continue to enjoy supportive domestic regulations that provide protection to the local industry from the foreign competition by way of levying 15% (c.i.f.) custom duty on cement imports into the Kingdom. However, at times of widening demand-supply gaps in the domestic market, Saudi authorities could relax these regulations to facilitate continuance of local construction activities.

- Thus, to ease tight supply conditions persisting in the domestic market, the Saudi authorities for the time being have lowered the custom duty on cement imports to zero percent. Also exports have been banned except for destination to Bahrain.
- But, if the government is satisfied that the tight supply conditions are no more seen, the authorities could re-invoke 15% protective tariff on imported cement in order to protect domestic producers from the emergence of possible unfair foreign competition.
- In case foreign producers dump cheap cement into the Saudi market, the government holds preemptive rights under the WTO Charter to invoke 'anti-dumping' punitive tariffs under the 'Safeguard Measures' clause for a specific time frame. The levy in that situation could be far higher than the current 15% protective custom duty.

B. Saudi Cement Market Supply-Demand Outlook

On the supply-side, the Saudi market for cement has been well supplied by 12 domestic producers during Jan-Sept 2008, with nine months' total output reaching 25.76 million tons and growing 11% during the first 9-months of 2008 over the same period a year ago. Four new cement factories namely Riyadh, Najran, Madinah, and Northern Cement came on production stream during Jan-Sept08 period and added new local supply by 2.36 million tons, further easing tight supply conditions that were persisting since 2006. Our bullish stance is still intact for 34 million tons production target for the entire 2008 as one more factory, Al-Safwa, has planned to go on production

stream during 4Q08. For the full 2008, local output is set to grow 12.2%, from the 30.3 million tons realized production for the full 2007 (Table 1).

On the demand-side, total cement sales in the core Saudi domestic market increased by slower 10.6% to 23.0 million tons during Jan-Sept08 period, consuming about 90% of the total domestic production. In addition, 5.1% higher exports orders of 2.6 million tons were met during Jan-Sept 2008 period. Thus, combined total cement sales (local plus exports) rose slower by 10% to 25.6 million tons during the Jan-Sep08 period, over the same period a year ago. Domestic production surpassed total sales that resulted in 169% increase in clinker inventory to the level of 2.8 million tons and cement inventory of around 113,000 tons by end of Sept 2008. Despite whooping rise in clinker stocks, overall industry's inventory has not reached an alarming level, barely an equivalent to one month's of demand thus reducing pressure on prices on account of inventory management problems.

Table: 1 Saudi Cement Sector Basic Indicators: Jan-Sept 2008

Description	2007		2008	
	(Thousand Tones)			
	Jan-Sept	Jan-Sept	Growth (%)	2008 Forecast
No. of Factories	8	12	50.0%	13
Total Production	23,173	25,755	11.1%	34,000
of Which:				
Domestic Sales	20,774	22,979	10.6%	30,500
Exports	2,452	2,577	5.1%	3,400
Total Sales	23,226	25,556	10.0%	33,900

1. Local Demand Growth in Jan-Sept 2008

Pockets of feeble domestic demand has surfaced during Jan-Sept08 period on increased supply by new local producers along with mismatching availability of other construction materials causing delays in cement consumption. The sector's largest firm, Yanbu's cement sales in the domestic market declined by 9.6% in first 9-month in 2008. This was followed by medium sized Tabuk Cement's sales, down by 11.8% in the same period and Yamamah (-3%) in the same period. Elsewhere, meek growth in domestic sales has been reported by Saudi Cement (+1%), and Arabian Cement (0.3%). Emergence of construction activities in Eastern Province and Southern Region lifted domestic sales by 7.5% for Eastern Cement and robust 9.8% growth for Southern Cement, (Table 2).

Further developments on the supply-side, out of the pool of 37 new licensed factories, four new factories came on production stream during Jan-Sept08 while fifth one, Al-Safwa Cement with 1.4 million annual production capacity is lined up to start production during Oct-Dec quarter 2008. The Kingdom aggregate design capacity in 2008 will climb to 42.7 million tons of clinker, an equivalent of 45 million tons of end-use Portland cement while the number of local producers will increase to thirteen. We are optimistic on long-term domestic demand growth despite likely hiccup seen before 2010.

On 30th July 2008, Yanbu Cement Company announced yet another plan to set up additional 3 million tons clinker plant in the near-term. For that, the company has already signed an

EPC contract with Chinese Sinoma International Engineering Co Ltd. Yqnbu's announcement for a new factory vindicates our views of market viability in the long-term, but a looming supply overhang can't be ruled out in the short-to medium-term.

Table: 2 Cement Local Deliveries by Company: Jan-Sept 2008
(Thousand Tones)

Company Name	2007	2008	Growth (%)
	Jan-Sept	Jan-Sept	
1. Yamamah	3,373	3,273	-3.0%
2. Saudi	3,149	3,179	1.0%
3. Eastern	1,777	1,910	7.5%
4. Qassim	2,259	2,182	-3.4%
5. Yanbu	3,652	3,300	-9.6%
6. Arabian	2,190	2,196	0.3%
7. Southern	3,312	3,637	9.8%
8. Tabuk	1,062	937	-11.8%
Total Existing	20,774	20,614	-0.8%
9. Riyadh (New)	0	898	
10. Najran (New)	0	553	
11. Madinah	0	719	
12. Northern Cement	0	195	
Sub-Total, New Entrant	0	2,365	nc
Grand Total	20,774	22,979	10.6%

2. Expected Local Demand in Oct-Dec 2008

On the domestic market, despite weak demand growth seen during the first 9-month of 2008, we still maintain our firm view that the domestic cement sales is set to increase by 13.7% to 30.5 million tons for the entire 2008. For the subsequent fourth quarter of 2008, we project domestic sales will pick up and grow by 24.5% to 7.52 million tons, from 6.04 million tons in the same period a year ago.

Table: 3 Saudi Cement Sector: Installed Design Capacity
(Million Tones Annually)

	2006	2007	2008	2009	2010
	31-Dec	31-Dec	31-Dec	31-Dec	31-Dec
A: Existing 8 Projects	23.3	28.3	33.3	37.8	41.0
New Capacity Addition	1.9	5.0	5.0	4.5	3.2
B: New Projects*	0.0	5.0	9.4	10.4	10.4
New Capacity Addition	0.0	5.0	4.4	1.0	0.0
C: Total Design Capacity (A+B)	23.3	33.3	42.7	48.2	51.4
New Capacity Addition	1.9	10.0	9.4	5.5	3.2
D: Add back Net-Imported Clinker	0.297	0.2			
E: Clinker Drawdown Inventory	0.703	0.4			
Total Clinker Capacity (C+D+E)	24.3	33.9	42.7	48.2	51.4
Portland Cement Equivalent®	25.5	35.6	44.8	50.6	54.0
Domestic Demand	24.7	26.8	30.0	33.0	37.0
Growth (%)	1.4%	8.4%	11.9%	10.0%	12.1%
Surplus Over KSA Demand	0.774	8.8	14.8	17.6	17.0
Exports		3.5	4.5	6.0	7.0
Surplus After Exports		5.3	10.3	11.6	10.0

* Projects under implementations and EPC awarded.(R) add 5% on clinker for limestone for effective cement production

Source: Market Interviews and NCB Estimates

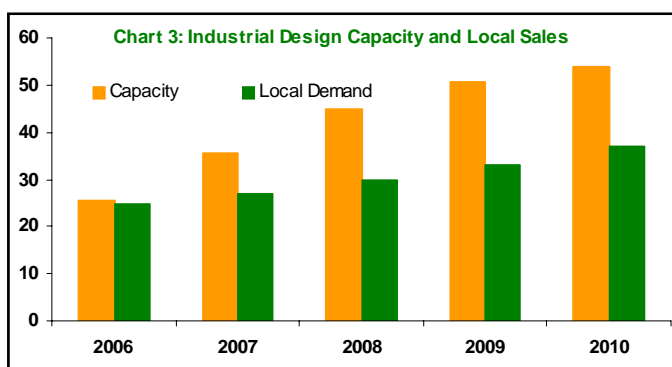
On the exports front, we expect the 3.4 million tons to be an achievable target for the entire 2008 given the robust demand in the importing countries and the competitiveness of Saudi cement prices. Thus, overall cement sales by the 13 Saudi manufacturers will reach 33.9 million tons in 2008, compared

with 30.34 million tons in the year before, an increase of 11.7% in year on year basis.

Table 3 exhibits our medium-term overall cement demand-supply outlook which demonstrates if all the projects presently under implementation were accomplished on time by 2010, domestic market demand for cement would have to grow by 80% to absorb the entire capacity being installed between 2008 and 2010. However, this demand growth scenario seems not possible to achieve within the stipulated time frame as many of the mega projects are at their early stages of preparatory developments. However, cement demand will pick up rapidly once building activities related to civil-work commence at a top gear after 2010 (Table 3).

3. Short-term Capacity Overhang

As per our projections, Kingdom domestic consumption of cement is forecast to reach 37 million tons by 2010 in relation to the available operative design capacity of 54 million tons, thus leaving a surplus capacity of around 17 million tons, and pointing towards a capacity overhang. The idle capacity if not fully utilized, the market value of surplus capacity at today's prices is estimated at SR4 billion, which will give a potential loss to current producers equivalent to net-profit of nearly SR2 billion.



On plausible assumptions, if the domestic consumption were to grow nearly 20% per annum between 2007 and 2010, the Kingdom's market demand will be around 46 million tons, which would still leave a sizable 8 million tons surplus capacity available for exports. This further supports our notion that the capacity overhang is in the making over the near-term which may trigger price competition mostly likely starting from the fourth quarter of 2009 (Chart 3).

While production capacity in the traditional Saudi exports market is also expanding, the main challenge ahead facing local cement industry is to find export markets ready to buy Kingdom's surplus cement equivalent to 17 million tons (base-case), which represents nearly 32% of total design capacity. Finding exports orders for such volume will pose a major challenge to the local cement producers as the European cartels will most likely compete with Saudi products by manipulating prices as we had observed five years ago when the Kingdom lost its market share in Spain.

4. Export Potentials

In the past, Saudi cement industry had exported about 5 million tons annually at a time when capacity expansion in most of the importing countries being under various development stages. Therefore, this time around, for Saudi producers export markets will become rather difficult to penetrate given that a significant new capacity addition is already in place.

5. More Projects Seeking Concessions

Four more projects, Al-Watan Cement, Al-Jazera, United and Al-Jouf, with combined capacity of 10 million tons are awaiting government approval for mining and quarrying concessions. However, market sources confirm that the Saudi authorities have so far not approved the concessions for them to start implementation. For the time being, capacity addition from these projects has not been considered in our current market demand-supply scenario.

C. Cement Market Demand, Historic Perspective

In absolute terms, domestic market demand for cement expanded by 12.7 million tons to reach 26.8 million tons in the last eight years through 2007 on increased construction spending induced by rising public sector capital expenditure and private investments. Accordingly, the annual average growth was equivalent to 8.4% in the last eight years.

In contrast, total investment in residential and non-residential construction activities grew by 9% annually, indicating a sort of a demand-supply mismatch during the period. As a result of this mismatch and with the wave of announcements of new construction initiatives, then existing eight cement companies put ambitious capacity expansion plans to meet growing domestic consumption (Table 4).

Table 4 Overall Cement Production and Sales Trends (Local plus Exports)
(Thousand Tones)

	TOTAL Production	Local Sales	Exports	TOTAL* Sales	Growth (%) Total Sales
1999	18,121	14,103	1,775	15,878	nc
2000	19,752	15,479	2,723	18,202	14.6%
2001	20,861	17,787	2,850	20,637	13.4%
2002	21,219	20,396	2,858	23,254	12.7%
2003	22,189	22,261	1,879	24,140	3.8%
2004	22,368	23,840	1,524	25,364	5.1%
2005	22,154	24,411	1,668	26,079	2.8%
2006	27,053	24,741	2,260	27,001	3.5%
2007*	30,309	26,815	3,522	30,337	12.4%
Jan-Sept 2007	23,173	20,774	2,452	23,226	
2008	25,755	22,979	2,577	25,556	10.0%

Source: Yamama Cement Company, Various Issues

*In years total sales more than total output due to clinker inventory drawdown

As a result of new capacity enhancement last year by Yamama, Qassim, Yanbu and Eastern cement companies, the capacity tightness that persisted had started fading during

2007. The government has also encouraged private initiatives by issuing 37 new industrial licenses, of which 5 new projects were given mining and quarrying concessions and four of them came on production stream during Jan-Sept period while the remaining one is lined up to start production during the 4th quarter of this year.

The year on year growth in the domestic cement consumption was following an erratic pattern. However, it has been decelerating every year since its peak in 2000 due to local capacity tightness and specifically higher product prices, both in the local and international markets. To ease supply tightness during the interim period, the Saudi government has allowed import of cement on a zero percent custom duty rate.

Prior to joining the WTO, the protective custom duty on cement imports into the Kingdom was 20% on the c.i.f. value basis. Local cement industry benefited from the supportive regulatory environment and increased profitability. Local cement producers sold a cumulative 211 million tons of cement between 1999 and 2007, of which domestic market bought nearly 190 million tons (90%) and the exports market accounted for the remaining 21 million tons (10%). Table 4 demonstrates the trend in local production, local cement deliveries and exports by domestic cement producers.

D. Cement Sector's Financial Fundamentals

Although overall average selling price of Portland cement has increased by 5.6% to SR267 per ton in the Jan-Sept 2008, combined net-profit declined by 7.1% for the eight listed companies on losing market share by 10% to the four new producers joining the market this year.

The sector's overall efficiency is measured by the rate of net-profit generated by each ton of cement sold, both in local and export markets by the existing eight listed companies (proxy for the sector). Accordingly, the eight existing companies sold cement a total of 22.81 million tons (local plus exports) in Jan-Sept08, compared with 23.23 million tons in Jan-Sept07. In the same period, the combined net-profit decreased by 6.1% to SR3.27 billion in Jan-Sept08. Thus, the combined average net-profit per ton of cement sold, declined from SR152.8 per ton in Jan-Sept07 to SR143.5 per ton in Jan-Sept08.

The average gross margin for the eight listed companies was also down from 62.2% in Jan-Sept07 to 57.2% in Jan-Sept08, on 17.2% increase in the costs of goods sold and loss in market share to the four newly established cement companies. Although margins are shrinking, yet they are still sizable for the traditional eight companies to sustain emerging competition. Chart 4 and summary table 5 (next page) demonstrate the same past trend; as the quantity of cement sales rises, net-profit per ton of cement sold rises faster than the sales, suggesting that economy of scale is adding to operating efficiency and lifting net margins.

E: CONCLUSION

The massive waves of ongoing construction activities have created sizable transient demand for cement recent years. In response to the emerging huge transient demand, the traditional eight cement companies enhanced their production capacity at a time when new players find cement manufacturing as a lucrative business opportunity to enter. As a result, 37 new industrial licenses were granted and seven of them got raw material mining concessions from the authorities of which five have come on production stream this year bringing the combined capacity to 44.8 million tons and by 2010 the design capacity is set to reach 54 million tons.

In the Kingdom's cement marketplace, nearly 65% of the aggregate cement sales arises out of core demand created by normal residential and non-residential construction activities. While cement exports absorbs nearly 10% of the total cement sales, the remaining 25% is met by the transient demand created by the waves of construction projects, both public and private sectors. Upon completion of these projects, a time we believe could be around 2015, excess capacity above the sustainable domestic demand and exports is widely feared amongst industry analysts. Thus, in the domestic market perspective, the capacity overhang looks as a real possibility that would tend to intensify competition among local cement producers and to push prices lower. This, however, would not only affect the profitability of cement producers, but also the creditors including banks.

Nevertheless, the cement producers in the Kingdom are enjoying healthy profit margins on the back of cheap energy, strong demand growth, and protection from foreign competition through higher custom duties on imports. The industry average (8 companies) gross margin was 57.2% in the Jan-Sept08 period while the average net-profit for each ton of cement sold (local plus exports) was SR143.5 in the same period. At the prevailing average selling price of SR267 per ton, the break-even selling price is nearly SR124 per ton, pointing that a considerable room exists for lower prices.

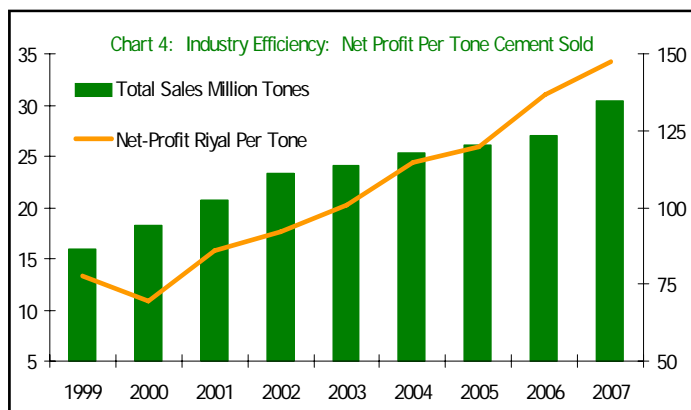


Table: 5 Traditional Eight Cement Companies Indicators: Jan-Sept 2008			
(Values in Thousand)			
	2007	2008	Growth (%)
			Jan-Sept08/07
Sales Revenues			
Q1	1,800.1	2,216.5	23.1%
Q2	2,064.9	2,192.8	6.2%
Q3	2,012.9	1,673.6	-16.9%
Total	5,877.8	6,083.0	3.5%
Cost of Sales			
Q1	727.7	913.7	25.6%
Q2	756.5	900.5	19.0%
Q3	735.9	786.9	6.9%
Total	2,220.1	2,601.2	17.2%
Gross Profit			
Q1	1,072.4	1,302.8	21.5%
Q2	1,308.4	1,292.3	-1.2%
Q3	1,277.0	886.7	-30.6%
Total	3,657.7	3,481.8	-4.8%
Net-Profit			
Q1	1,026.6	1,254.9	22.2%
Q2	1,280.3	1,204.3	-5.9%
Q3	1,218.2	815.0	-33.1%
Total	3,525.2	3,274.2	-7.1%
	Jan-Sept 07	Jan-Sept 08	
Domestic Sales	20,774	20,614	-0.8%
Exports	2,452	2,196	-10.4%
Total	23,226	22,810	-1.8%
Avg Selling Price	253	267	5.4%
Net-Profit Per Tone	157	153	-3.1%
Net-Margin (%)	60.0%	53.8%	-10.3%
Gross Margin (%)	62.2%	57.2%	-8.0%

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