



EQUITY

The “Known Unknowns” Surrounding the Public Offering of Saudi’s Crown Jewel

May 19, 2017



Bassel Khatoun
Chief Investment Officer, MENA Equities
Franklin Local Asset Management – MENA

The proposed public listing of Saudi Arabia’s crown jewel Saudi Aramco could likely be the biggest the world has ever seen. Valuations of the state-owned oil company vary widely, but Saudi Arabia’s Deputy Crown Prince Mohammed bin Salman has touted a particularly lofty US\$2 trillion figure. Bassel Khatoun, chief investment officer of MENA Equities, Franklin Templeton Investments, suggests an accurate valuation is probably premature at this stage. He discusses what he sees as a set of “known unknowns” that could influence the valuation of this Saudi oil giant.

The valuation spectrum for oil players varies immensely, and Saudi Aramco is no exception. Given its historical preference for opacity, the reality is that there is a lot of guesswork that goes into sizing up a company which has never divulged financial statements and operates in a sector that naturally attracts huge valuation variations in any market, let alone in Saudi Arabia.

The potential mammoth public listing is certainly capturing the attention of capital markets around the world. The listing has been viewed as an important milestone in the Kingdom’s progress to diversify its economy and reduce its heavy reliance on oil. However, investors require a certain degree of transparency to make informed decisions about the value of a company.

Key to an accurate valuation, for example, is the defining of ownership boundaries of what parts of Saudi Aramco are to be listed. While some may value the company at up to US\$2 trillion, there is no clarity on exactly which parts of Aramco will be included in the initial public offering (IPO), and just as importantly, which will be excluded. Furthermore, questions remain. It’s unclear whether both the upstream and downstream businesses and non-core areas such as petrochemicals are within the ownership boundaries.

Until an independent audit has been completed, investors are basing valuation on the same oil reserves that have been reported by Riyadh for nearly three decades—261 billion barrels. That said, Saudi Aramco has committed to an independent audit while hinting that any audit will find its reserves to be similar to figures currently reported. However, we don’t know whether the audit will unearth the quality of the oil reserves or just the quantity. Either way, Saudi Arabia’s Deputy Crown Prince Mohammed bin Salman recently confirmed that the Saudi government would retain sole control over Aramco’s oil and gas reserves and would also decide on production levels.

Costs—a crucial part of financial modeling—are another key area to determine an accurate valuation. Disclosing production costs of oil wells and revealing operating and financial costs will enable investors to make more accurate value projections.

Ultimately, we are trying to understand how much it costs Aramco to extract oil from the ground. Aramco has said its costs are among the lowest in the world and, if the range it has publicly stated (US\$5 to US\$20 per barrel) is accurate, then this is most certainly the case. When the market price of oil is at US\$50, the cost of extraction is particularly significant in terms of potential profits. Also, production costs will vary from field to field, so providing average operating costs will only go so far to facilitate forecasting.

Another key cost to consider is staff. To accurately estimate staff costs, investors need to understand Saudi Aramco's long-term strategy with regard to "Saudization" given the cost implications of maintaining a very high percentage of Saudi Arabian nationals within the company, regardless of who invests in the IPO.

Gaining Clarity

Clarity on the Kingdom's tax policy is another key to an accurate valuation of Saudi Aramco. In March, the government announced it was reducing Aramco's tax rate on net income to 50% from 85%, bringing it more in line with global players, although there still exists a huge difference globally in tax rates. This recent change begs the question: In the face of continued fiscal pressures, what protection can investors expect against rolling back of the tax rate to 85% at any point? In addition, many investors are seeking clarity over whether the 20% royalty on revenue will remain in the event of an IPO.

Clarity on strategy and governance is also important. While these may be difficult to quantify, they do have a significant impact on valuation metrics. Generally speaking, investors demand a discount for state-controlled companies, given the requirement to balance the objectives of the government with those of investors.

In the case of Saudi Aramco, the government will be the majority shareholder, and outside investors will need to accept that. In terms of investor perceptions, how the company executes its strategy and the type of governance structure it puts in place are also important. Institutional investors in particular are likely to favor a structure with a board of directors and independent directors. A solid corporate governance framework should also help placate investor anxiety over how the sometimes-conflicting objectives of a state-controlled company and a listed company can be addressed.

Long-term investors also need to understand Saudi Aramco's business strategy in more detail to gain a better appreciation of what the company will look like in 10 to 20 years. Aramco has announced it is expanding its refining business with an aim to almost double capacity to 10 million barrels a day. We also know it is moving aggressively in the downstream area through its petrochemicals business. However, we don't know how much of their new funding will be dedicated to this part of their business.

A Segment of the Vision 2030

Saudi Arabia's National Transformation Program identifies renewable energy as a growth sector and aims to have 10% of the country's electricity from renewable sources by 2023. Saudi Aramco is now developing solar and wind projects in the northwest area of the Kingdom, begging the question of how much of management's time and funding will be directed towards these new energy sources. Investors will also want to understand whether environmental consciousness or future shareholder value is driving the company's diversification into renewables and whether these new businesses are within the realm of the IPO.

These "known unknowns" are serious considerations when valuing Saudi Aramco. While clarity would be most helpful, we cannot discount the impact of the market price of oil, given varying forecasts on future prices that could result in a massive range of valuations of the company. Whether one is of the opinion that the world is headed for an oil-supply shortage and therefore higher prices, or alternatively, if other forms of energy will take over powering the world in the next few decades, these factors will have an enormous impact on valuations of any oil company, including Saudi Aramco.

With what we currently know based on oil prices, the tax rate and reserves, there is a scenario under which Saudi Aramco could be worth around US\$1 trillion. However, as the company delivers on its commitment for further transparency and "unknowns" shift to "knowns", we are likely to see a tightening of the valuation discrepancy, which is currently challenging an already complex and colossal public listing.

The comments, opinions and analyses presented herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

Data from third-party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information, and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user. Products, services and information may not be available in all jurisdictions and are offered by FTI affiliates and/or their distributors as local laws and regulations permit. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

To get insights from Franklin Templeton delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_Global and on LinkedIn.

What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in developing markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with their relatively small size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. Investments in the energy sector involve special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector.