

Arabian Drilling Co.

TP increased to SAR 188/sh, Aramco contract to act as a medium-term catalyst

Neutral

Price Target (SAR): 188.0

Current: 187.60
Upside/Downside: 0.2% above current

Valuation Multiples	22	23E	24E
P/E (x)	27.4	29.2	22.0
P/B (x)	2.7	2.8	2.6
EV/EBITDA (x)	16.1	12.5	10.5

Major Shareholders % Ownership

Manufacturing & Energy Services Co.	35.70
Services Petroliers Schlumberger	34.30

Price Performance	YTD	1M	3M
Absolute	66.6%	4.8%	-1.3%
Relative to TASI	63.0%	2.2%	4.3%

Arabian Drilling reported Q3 2023 revenues at SAR920mn registering a significant increase of 31.1% y-o-y on the back 3 new offshore rigs deployment combined with an increase in average daily rates. The number of active rigs increased from 44 in Q2 2023 to 47 during the quarter pushing up the offshore revenues by 39% q-o-q. Besides, the Q3 fleet utilization rate inched up from 93.6% last quarter to 94% on account of the fresh rigs being deployed. Consequently, the revenues increased by 16.3% q-o-q with a robust order backlog of SAR12.7bn as compared to SAR7.6bn in Q2 2023.

Meanwhile, Arabian Drilling's order backlog construct explicitly changed on a sequential basis from a mix of 56:44 between offshore: land to 45:55 respectively. Given its sizable presence and strong positioning in the drilling market, the company bagged multiple contract awards for 10 new land rigs for Saudi Aramco's Unconventional Program in July 2023. The average contract tenor for these has been pegged at 5 years with an estimated backlog of SAR3bn supporting long-term revenue visibility. For 2024, we expect the double-digit revenue growth momentum to continue despite headwinds from rising costs. Arabian Drilling's onshore rig fleet size is expected to go up to 48 in FY24 underpinning robust revenue expansion post deployment of these rigs. Accordingly, we anticipate the company to witness margin improvement from 2024 onwards despite cost pressures stemming from multiple factors like- i). Startup costs for new rig mobilization, ii). High employee costs in line with crew hiring requirements for deployment of new rigs, and iii) higher depreciation expense with the rise in rig fleet size. This is because revenues from the new contract are expected to accrue from 2024 onwards. Hence, Net profit is expected to register a healthy increase in FY24.

Moreover, the company is well poised to deliver a significant margin expansion from 2025 onwards as the full operational effect of the new rigs will start flowing through to the bottom line. We also expect the company to keep adding 2 additional onshore rigs each in FY26 and FY27 as a result of the steam in the unconventional market. In other note, over the long-term, the company will significantly be able to reward its shareholders by way of increasing dividends gradually as a result of normalizing debt and depreciation levels. Overall, post-Q3 2023 earnings we revise our estimates upwards and increase our target price to SAR188/sh, from the earlier target price of SAR175/sh. As the current market price is closer to our target price, we turn "Neutral" from the Overweight rating before.

Q3 2023 Results: Arabian Drilling Q3 2023 revenues at SAR920mn were modestly higher than our expectations of SAR826mn and 5% above consensus estimates. In line with the rising revenues, gross profit grew by 23.6% y-o-y. In contrast, the Gross margins declined by 180 bps to 29% in Q3 2023. This was prompted by rising costs in respect of the new Aramco tender ahead of the commencement of revenue recognition for the same. Operating margins were also hit owing to a 12.6% rise in general and administrative expense q-o-q. Overall the bottom line came under pressure on a yearly basis due to a higher financing burden on the back of the new rigs startup.

Earnings

(SARmn)	2022A	2023E	2024E
Revenue	2,704	3,448	4,002
Revenue Growth	22.9%	27.5%	16.0%
Gross Profit	801	999	1,219
Gross Margin	29.6%	29.0%	30.5%
Net profit	558	571	758
Net Profit Growth	103.9%	2.5%	32.7%
Net margin	20.6%	16.6%	18.9%
EPS (SAR)	6.8	6.4	8.5
DPS (SAR)	-	2.5	4.3
Payout ratio	0.0%	39.4%	50.0%
P/E (Curr)	27.4x	29.2x	22.0x
P/E (Target)	27.4x	29.3x	22.1x

Source: Company data, Al Rajhi Capital

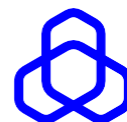
Figure 1 Earnings Summary Q3 2023 (*)

(SAR mn)	Q3 2023	Q2 2023	Q3 2022	ARC Est.	Cons Est.	q-o-q	y-o-y	vs ARC	vs Cons
Revenue	920.0	791.0	702.0	825.9	878.2	16.3%	31.1%	11.4%	4.8%
Gross Profit	267.0	229.0	216.0	229.5	NA	16.6%	23.6%	16.3%	NM
G. margin	29.0%	29.0%	30.8%	27.8%	NA				
Op. profit	206.0	180.0	178.0	193.5	NA	14.4%	15.7%	6.4%	NM
Op. margin	22.4%	22.8%	25.4%	23.4%	NA				
Net profit	140.0	140.0	213.0	156.7	159.3	0.0%	-34.3%	-10.7%	-12.1%
Net margin	15.2%	17.7%	30.3%	19.0%	18.1%				

Source: Company Data, Al Rajhi Capital; * Q32022 net profit includes the impact of a one-off tax credit adjustment of SAR64mn

Valuations: We value the company based on an equal mix of DCF and relative valuation. The DCF approach at a 1% terminal growth and WACC range of 8.03%-8.91% during the forecasted period implies a target price of SAR188/sh. The P/E based relative valuation methodology at a 22x multiple for 2024e EPS implies a target price of SAR187/sh. Thus, we revise our target price for the company to SAR188/sh from SAR175/sh earlier, implying an upside of 0.2%, and accordingly reduce our rating to 'Neutral'.

Risks: The key downside risks to our valuation assumptions are delay in deployment of upcoming rigs affecting the recognition of order backlog, adverse movements in day rates, higher crew hiring and retention costs, and deterioration in rig efficiency index.



Financials

Figure 2 Income Statement

(SAR mn)	2023E	2024E	2025E
Revenue	3,448	4,002	4,595
Cost of revenues	(2,449)	(2,782)	(3,052)
Gross profit	999	1,219	1,543
Provision for impairment on financial assets	(0)	0	0
General and administrative expenses	(197)	(204)	(188)
Other operating income	(15)	0	0
Operating profit	787	1,015	1,355
Finance costs	(165)	(196)	(149)
Finance income	47	47	7
Profit before zakat and income tax	669	867	1,212
Zakat and income tax	(98)	(108)	(152)
Profit for the period	571	758	1,061

Source: Company Data, Al Rajhi Capital

Figure 3 Cash Flow Statement

(SAR mn)	2023E	2024E	2025E
Operating activities	1,164	1,412	1,740
Investing activities	(1,639)	(2,248)	(1,012)
Financing activities	822	3	(645)
Change in cash	347	(832)	83
Cash and cash equivalents, start of the period	832	1,179	347
Cash and cash equivalents, end of the period	1,179	347	430

Source: Company Data, Al Rajhi Capital

Figure 4 Balance Sheet

(SAR mn)	2023E	2024E	2025E
Assets			
Cash and cash equivalents	1,179	347	430
Inventories	222	252	277
Trade and other receivables	1,052	1,221	1,402
Mobilization cost	7	7	7
Assets held for sale	1,012	1,012	1,012
Total current Assets	3,473	2,840	3,128
Property, plant and equipment	7,459	8,913	9,078
Right-of-use assets	184	243	305
Mobilization cost	15	15	15
Total non-current assets	7,658	9,171	9,398
Total assets	11,131	12,011	12,527
Liabilities			
Trade and other payables	753	855	938
Current portion of long-term borrowings	177	177	44
Current portion of lease liabilities	59	78	98
Mobilization of revenues	60	60	60
Provision for zakat and income tax	54	54	54
Total current liabilities	1,103	1,225	1,195
Long-term borrowings	3,413	3,736	3,692
Lease liabilities	126	166	208
Employee benefit obligations	289	305	322
Mobilization revenue	116	116	116
Deferred tax liabilities	149	149	149
Total non-current liabilities	4,092	4,472	4,487
Shareholders' equity			
Share capital	890	890	890
Additional paid-in capital	791	791	791
Statutory reserve	267	267	267
Retained earnings	3,988	4,367	4,898
Total equity	5,936	6,315	6,845
Total liabilities	11,131	12,011	12,527

Source: Company Data, Al Rajhi Capital

Figure 5 Key Ratios

KPIs	2023E	2024E	2025E
Gross margin (%)	29.0%	30.5%	33.6%
EBITDA margin (%)	42.7%	43.7%	46.6%
Operating margin (%)	22.8%	25.4%	29.5%
Net margin (%)	16.6%	18.9%	23.1%
ROA (%)	5.1%	6.3%	8.5%
ROE (%)	9.6%	12.0%	15.5%
D/E (x)	0.6x	0.7x	0.6x
Net debt/EBITDA (x)	1.8x	2.2x	1.7x

Source: Company Data, Al Rajhi Capital

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

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