

Saudi Aramco IPO

A Reality Of Mythical Proportions?



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“The devil’s excrement”.

That’s what Juan Pablo Pérez Alfonzo, former Venezuelan Oil Minister and OPEC co-founder, had referred to oil back in 1975. “Ten years from now, twenty years from now, you will see: oil will bring us ruin,” he had famously exclaimed. In fact, a decade ago, Venezuela went from a country with highest per-capita income in its continent, to be riddled with near civil-war state and per-capita income lower than its 1960s level. This is what economists refer to as ‘natural resources curse.’ Much similar to a 16-century Spain that was once rich on gold from the Americas, and eventually went bankrupt when the ships stopped sailing.

Ever since its inception, the OPEC has had oil prices literally under its control, with the Saudi Arabian oil company (Saudi Aramco) as its driving force. It is only natural that when the ruling family of Saudi Arabia that owns the oil giant, lets out feelers of a likely Aramco IPO to perhaps reduce its economic dependency on oil, the world’s political, economic and investor classes pay rapt attention.

In this article, we look at the sheer scale of the company and its impact on the industry, size up possibly one of the largest IPOs the financial world could ever see, and what political and economic ramifications such an event can have.

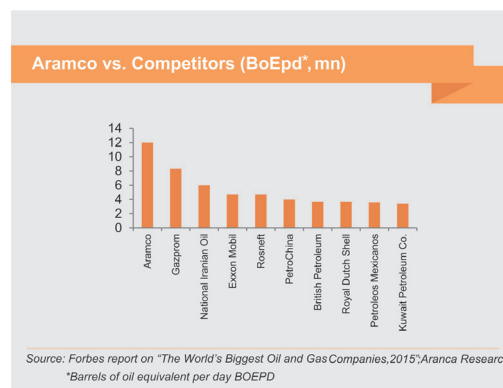
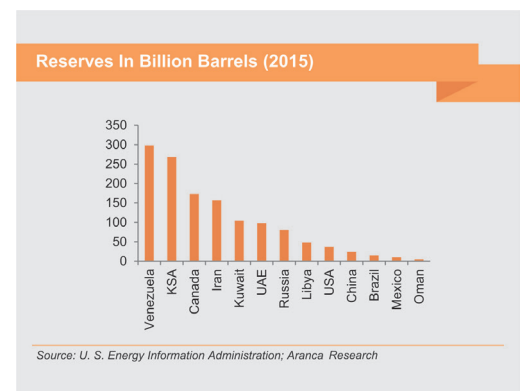
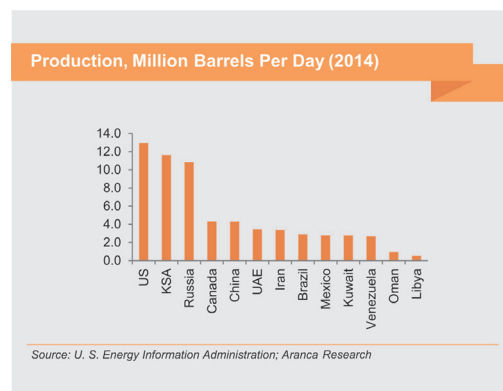


Sizing Up Aramco: A Giant Under Wraps?

Saudi Aramco is one of the largest oil exploring and producing companies in the world. It's nearly as big as Venezuela's oil reserves as a whole, bigger than Canada's oil reserves, and several times larger than its other global corporate competitors such as Rosneft, Exxon Mobil, PetroChina and BP.

Aramco boasts of crude oil and condensate reserves of nearly 260 bn barrels and nearly 294 trillion standard cubic feet (scf) of natural gas reserves. Reports suggest that Saudi Arabia was the world's second largest producer of crude oil and natural gas liquids (NGL) in 2014 with a production of 11.6 million barrels per day. The state-owned oil producer alone contributes to 45% of Saudi Arabia's GDP, 90% of the country's export revenues, and almost 80% of budget revenues. Aramco also has significant influence on how the official selling price (OSP) of crude oil is determined – calculated by adding a differential to a specific crude oil benchmark price depending on the location of a customer and quality of crude oil being considered.

Saudi Aramco is the world's largest exporter of petroleum, and is responsible for supplying nearly one-tenth of global oil. The company's oil reserves are over ten times more than that of Exxon Mobil, the world's largest publicly listed oil company with a market capitalization of US\$362 bn.



Company Facts And Figures

| Aramco key metrics | 2013 | 2014 |
|------------------------------------|-------|-------|
| Crude Oil Exports (mn Barrels) | 2,677 | 2,544 |
| Refined Products Pdn (mn Barrels) | 494 | 561 |
| Refined Products Exp. (mn Barrels) | 121 | 168 |
| Crude Oil & Cond. Res (bn Barrels) | 260 | 261 |
| Natural Gas Reserves (tn scf*) | 288 | 294 |
| Crude Oil Production (bn Barrels) | 3 | 4 |

Source: Company websites; Aranca Research
*Standard Cubic Feet

The company exports nearly 2.5 billion barrels of crude oil each year, although these levels have fallen in the recent months due to weaker demand and a sharp decline in oil prices. However, its record low production costs and high cash reserves (over US\$500 billion) have cushioned the impact from the downward spiral of oil prices.

According to industry sources, cost of production is around US\$25 to US\$80 per barrel in the US compared to around US\$10/barrel at Saudi Arabia's Ghawar oilfield, giving the latter significant competitive advantage. Further, Saudi Arabia recently signed an agreement with Russia to freeze productions at last recorded levels which is likely to further impact competitors despite taking a hit itself.

The Announcement: Cashing in or Cashing Out?

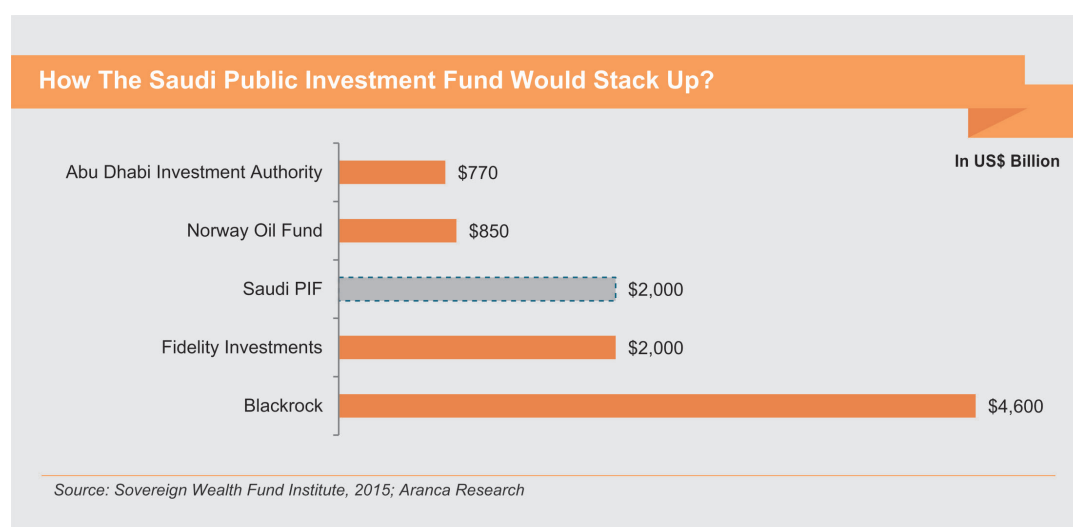
Earlier this year, the Deputy Crown Prince of Saudi Arabia, Muhammad Bin Salman suggested that the company was evaluating possibilities of selling a percentage of shares for public ownership. The Deputy Crown Prince expressed his enthusiasm about the prospects of Aramco going public mainly as a measure to “increase transparency” and “curb corruption”. He reportedly believed it would also be beneficial to the emerging Saudi Arabia Stock Exchange (Tadawul), especially since it opened up to foreign investors just last year.

Saudi Aramco has since come out with an official announcement stating that it was considering options to allow public participation in its equity through an IPO that could include its downstream businesses or the lucrative upstream business of exploration and production or a combination of assets from both segments.

We believe a lot of the inspiration to go public is driven by the direction in which the oil industry is heading.

The uncertain demand, low (read volatile) oil prices and the increasing self sufficiency of major economies, such as the US, is forcing the desert kingdom to explore ways to reduce its economic dependency on oil.

Some may suggest that it surely looks like Saudi Arabia finally took a cue from Alfonzo’s prophetic rant against oil dependency to unlock the value of its prized assets, making use of its dominant position and cashing out, while the world frantically searches for sustainable alternative energy. In fact, the Deputy Crown Prince has floated the idea of forming a US\$2 trillion mega fund (Public Investment Fund), likely to be funded by the Aramco IPO proceeds. The aim of the fund is to achieve a level of nearly 50% of its total investments in foreign assets and create a global conglomerate over a period of time, thereby aiming to shift the economy’s dependency away from oil.



Here, only time will tell whether the oil giant will be able to cope with the scrutiny subjected to a publicly listed company. Considering Aramco is known to be extremely discreet about its operational revenue and reserves, a decision to go public certainly invites scepticism from prospective investors as much as it raises interest among global financial markets.

The Numbers: The Aramco IPO Could Dwarf the Biggest Ones we Know Yet

In a recent interview with Bloomberg, the Deputy Crown Prince announced that less than 5% of the equity could be offered in the IPO, which could happen as early as 2017. Naturally, the announcement has led analysts working the math to gauge the size of the IPO.

- » Conservatively, using an industry standard of US\$10/barrel would itself imply a valuation of US\$2.6 trillion for Aramco.
- » However, oil and gas companies rarely get valued purely on the basis of their reserves alone. The closest rivals of Aramco (Exxon Mobil, Petrobras, PetroChina and BP) trade at an average EV/reserve ratio of 23x. Applying this to Aramco's reserves of around 260 billion barrels implies an enterprise value of a little over US\$6 trillion.
- » In fact, media reports have quoted Mohammad al-Sabban, a former senior adviser to the Saudi oil ministry putting Aramco's valuation as high as US\$10 trillion.

Going by these unfathomable figures, listing a mere 5% Aramco could raise anywhere between US\$130 billion to US\$500 billion. This would make some of the largest IPOs such as those of Alibaba (raised US\$25 billion in 2014) and Facebook (raised US\$16 bn in 2012) look insignificant.

The one thing we do know for sure is the amount of interest these numbers would generate among the largest investment banks, looking to grab a share of what could be sizeable commissions.

| Top-10 Largest IPOs (In US\$ Bn) | | |
|----------------------------------|------|---------------|
| Company | Year | Amount raised |
| Petrobras | 2010 | 70.9 |
| Alibaba Holdings Group | 2014 | 25.0 |
| Agricultural Bank of China | 2010 | 19.2 |
| ICBC Bank | 2006 | 19.1 |
| NTT DoCoMo | 1998 | 18.1 |
| Visa Inc. | 2008 | 17.9 |
| AIA | 2010 | 17.8 |
| Enel S.p.A. | 1999 | 16.5 |
| Facebook | 2012 | 16.0 |
| General Motors | 2010 | 15.8 |

Source: Capital IQ; Aranca Research

| Top-10 Oil & Gas IPOs (In US\$ Bn) | | |
|------------------------------------|------|---------------|
| Company | Year | Amount raised |
| Petrobras | 2010 | 70.9 |
| Rosneft | 2006 | 10.4 |
| PetroChina | 2007 | 9.0 |
| China Shenhua | 2007 | 8.9 |
| Inpex Corp. | 2010 | 5.6 |
| Óleo e Gás | 2008 | 3.6 |
| China Coal | 2007 | 3.6 |
| Coal India | 2010 | 3.5 |
| TransCanada Corp. | 2016 | 3.2 |
| China Petroleum | 2013 | 3.1 |

Source: Bloomberg; Aranca Research

Significant Value Attached To Aramco IPO – Both Political And Financial

Saudi Arabia is currently undergoing a socio-political reform under King Salman's regime.

The Deputy Crown Prince, who is also the country's defence minister, assumed office in April 2015. The country that has heavily relied on revenue from oil has not been immune to the impact from falling oil prices.

Saudi Arabia reported a deficit of \$98 billion in 2015, 15% of its GDP. The country has, since then, adopted stiff measures to curb the deficit, including reduction in subsidies for water, electrical power and fuel, something the country has comfortably enjoyed over the years.

However, the falling oil prices aren't the only reason for the economic impact. The kingdom has also been spending heavily on military activity in the Middle East. It spent nearly 25% of its annual budget on military personnel and purchase of sophisticated vehicles and armament in 2015. There is, therefore, an emerging air of economic and policy-level reform in the kingdom and the Aramco IPO could well be the start of it.

Mohammad Bin Salman, in an interview with The Economist, stated that he plans to reduce the heavy reliance on oil revenue by levying value added taxes and privatizing certain sectors such as healthcare and education.

Other areas that are open for change include religious tourism and exploring mining opportunities in uranium (Saudi Arabia claims to have 6% of the world's uranium reserves). Selling shares of Aramco clearly appears to be part of the Deputy Crown Prince's bigger plan to reform the country socio-politically by increasing transparency and curbing corruption.

The desert kingdom may not want to wait too long before both Iran and Russia shrug off the effects of global sanctions.

Additionally, Saudi Arabia is entering a phase of stiff competition from Iran and Russia, both from social and market standpoint. A successful attempt at letting the global investor community get a glimpse of its assets and their valuation could help the country use the finances to maintain its dominance in the region and also plan for long-term economic growth. The desert kingdom may not want to wait too long before both Iran and Russia shrug off the effects of global sanctions., many of which have already been lifted off the former via the recent agreements with the US.

Why Would Aramco Opt To Go Public, Now Of All Times?

Currently, Aramco holds enough influence to be able to sway OPEC's decisions, keeping competitors at bay and yet sustain operations supported by its high cash reserves. So why would an industry dominating country such as Saudi Arabia want to let the world in on its most critical national asset?

Scenario #1: The Threat from Shale?

The so called 'Shale revolution' has had more effect psychologically, in our view, than on the ground. Yet the oil producing and exporting countries have started to weigh its impact on their longer-term sustainable competitiveness. We believe the Aramco IPO could be a major step for Saudi Arabia to ensure it stays relevant even as the influence of OPEC starts to wane.

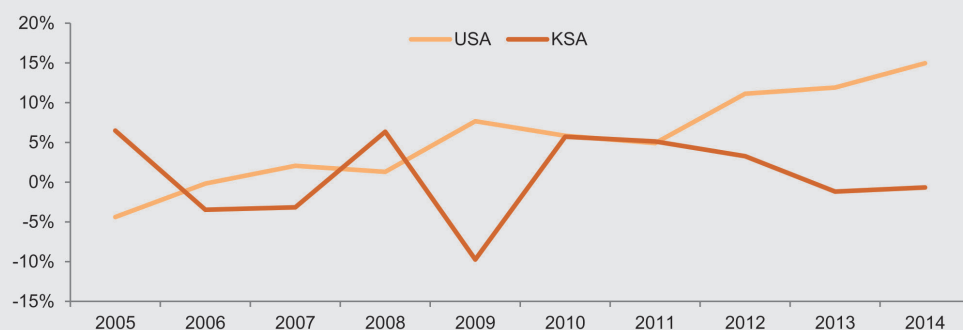
Despite higher production costs, growth in the US output has outshone Saudi Arabia, especially after export prohibition on US producers was lifted. We also view the recent Saudi Arabia-Russia pact to freeze production at last recorded levels as an attempt to curtail the shale upsurge.

However, Aramco's vulnerability to the growth of shale could be far-fetched as there is still time for shale producers to ramp up to meaningful production level. Iran and the US are expected to become leading producers among OPEC and non-OPEC nations, respectively by 2021. The US has gained significant competitive advantage with its ability to adjust production as per market fluctuations.

For example, at current market prices, there are several shale oil wells with idled production that are waiting for oil prices to rise to be able to initiate production again. Industry experts call this period as the "fracklog". It is the ability of shale oil producers to be able to start and stop production and have a "quick reaction time" to fluctuations that will decide whether US producers will be price takers or price makers in the future.

That being said, Saudi Arabia is not intending to fall too far behind in the race to get a hold in the shale market. So far, through Aramco, the country has spent upwards of US\$10 bn towards shale-related investments. The most recent being Aramco's campaign to explore the unconventional gas in the kingdom's Jafurah gas basin.

Production Growth: United States vs. Saudi Arabia



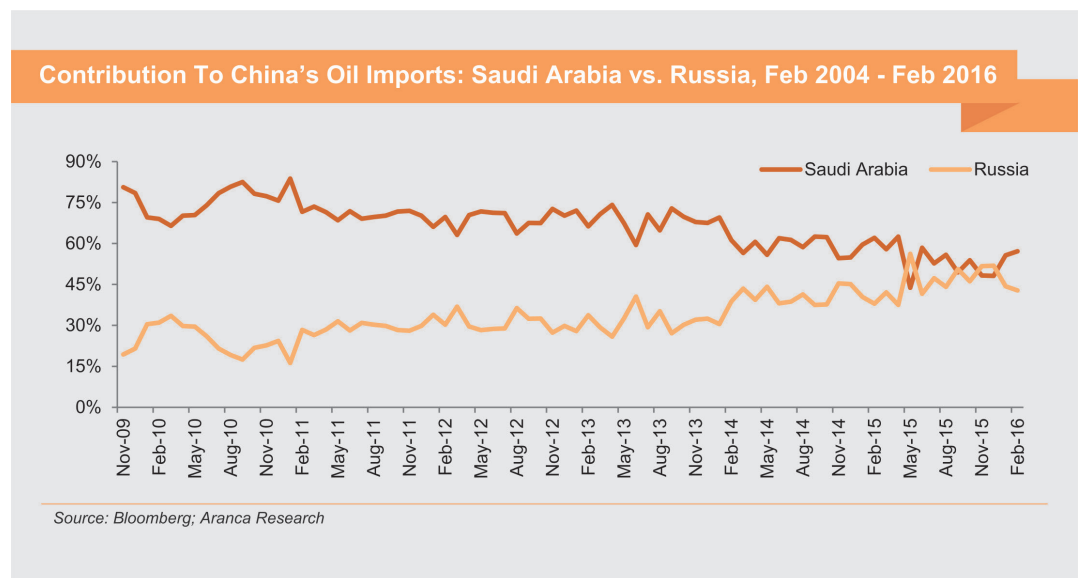
Source: U. S. Energy Information Administration; Aranca Research

Scenario #2: The Threat from a Weakening Chinese Economy?

With nearly 20% of its imports coming from Saudi Arabia, China has been one of Saudi's largest crude oil importers. It is no surprise that Chinese officials are also pitching in for a dual-listing of Aramco on the Hong Kong stock exchange.

However, imports have also begun to fall over the recent years as China has increasingly been importing crude oil from Rosneft, Russia's largest oil producer. The close proximity and the ease of transport due to the East Siberia Pacific Ocean Pipeline only strengthen ties between Russia and China. In fact, Rosneft and CNPC have a 25-year agreement worth \$270 billion under which the Russian company is expected to supply nearly 360 million tons of crude to China.

Even though China's monthly oil imports from Saudi Arabia hit their second highest level on record in February, Russia has proved to be a tough competitor. With Iran back in play after its UN sanctions were lifted, Saudi Aramco could have more than a few issues to deal with.



Scenario #3: Or, a Longer Term Strategic Economic Overhaul?

With weak oil prices and higher military expenditure (led by the ongoing regional crisis) pushing Saudi Arabia into a deficit, exploring a public listing of one of its most prized assets is indicative of a changing political and economic stance. The royal family has clearly become more vocal in expressing their views in changing Saudi Arabia's current economic and socio-political structure and their way forward. As part of that, the Deputy Crown Prince's long-term growth blueprint will require investments of nearly \$4 trillion (as per a McKinsey report, Dec 2015) over the next 15 years.

A significant portion of that would need to be funded from private and foreign capital and partly by selling stake in existing assets. For this, Saudi Arabia would need to present itself as a corruption-free destination for international investors with avenues of high return potential. The announcement of the \$2 trillion Public Investment Fund ties up well with this strategy but would need careful execution.

A bigger flow of foreign capital into Saudi Arabia can play a crucial role in diversifying the country's revenue sources outside of oil and into other industries and sectors. Also, we believe, these measures can have valuable long-term impact on [the country's employable population](#) (below the age of 30 and 70% of Saudi Arabia's population).

Would The World (Oil) Be Different If The IPO Were To Go Through?

Well, that depends on what business, part or whole, does the company decide to make available for public listing. Clearly, the upstream business is where all eyes would be focussed. But, it would also mean putting the most prized and highly valued asset up for scrutiny.

Global oil economics is, to a very large degree, dependent on the OPEC's assets and their ability to control demand and supply. So far, the OPEC's asset values have been determined internally by respective countries. A public listing of Aramco's upstream assets would warrant a certain amount of external audit. Any level of negative assessment of Aramco's oil reserves can have a significant impact on global oil prices, not to mention the pressure it can bring other OPEC nations under.

Selling or diluting stake in the downstream business may not necessarily be as eventful. Aramco's downstream business is a cluster of joint ventures and it would not be too difficult to offload stake in one or a group of such entities. Aramco's downstream business currently ranks fourth in the world after Exxon, Shell and China Petroleum. The company processes over 5.3 million barrels per day through the JVs. Current plans call for that number to increase to 10 million barrels per day and the a downstream IPO could aid in achieving that target.

Is There A Precedent In History? Not In Scale, But Maybe In Rationale

The only IPO in the oil & gas industry that possibly generated similar buzz and bore reasonable similarities was that of Petrobras' in 2010. Brazil's state-owned oil producer raised US\$70 billion by selling 36 per cent of the government's stake. Brazil's oil sector, back then, contributed nearly 10 per cent of the country's GDP. Brazil's government received \$43 billion in shares in exchange for allowing Petrobras to drill for 5 billion barrels in reserves. The offer was also part of Petrobras' development targets in 2010, with capital worth \$224 billion needed over five years for oil extraction from the "pre-salt layer" under approximately 4,000 m of salt which was further 2,500 m below the Atlantic Ocean.

However, five years after ambitious production targets and raising a significant amount of money, the company's performances have fallen a bit short of expectations. Not to mention, the political and corporate irregularities that started to surface. Reports of funds from construction companies being diverted for political purposes and large amounts of unaccounted expenses also impacted investor confidence.

We take away the following from the Petrobras example:

- » A big government stake meant there was always a mix of politics and business which impacted performance and ultimately Petrobras' market valuation.
- » Given the size of the IPO and a subsequent weak performance meant the Brazilian Stock Exchange bore the brunt of it. At one point Petrobras accounted for nearly 10% of the country's total market capitalization. A sell-off in a counter as big as this can easily trigger a 'risk-off' trade and exacerbate the impact

No 'Leap Of Faith'

All Factors Need To Be Carefully Strategized

The one thing we know for sure is that an Aramco IPO, upstream, downstream or a combination of both, would involve numbers the global financial markets have rarely seen. Absorbing an IPO of this size itself would be demanding and could even have an impact on smaller, emerging markets as funds find their way to the offer. But, that's just one of the elements. A company as big as Aramco and an industry as critical as oil can ill-afford an event such as this to miss its mark.

Given the impact of oil price volatility on economies, significant reserves at stake and the severe geo-political complexities, the repercussions can be significant. Therefore, all factors including timing the IPO, assets to include in the offer, size and listing exchanges would have to be carefully weighed in before Saudi Arabia goes ahead.

That said, we believe the desert kingdom would eventually have to open up sooner than later to achieve a more lasting and political, economic and financially stable economy. A successful Aramco IPO can kick-start just that.



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