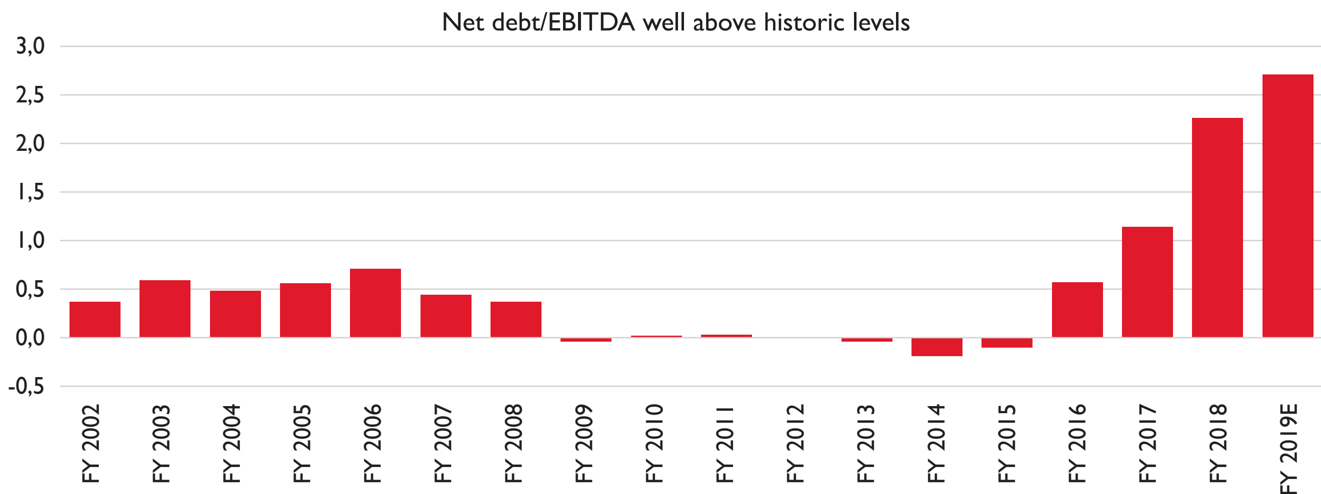
Sasol Limited – Is it time to kiss the dividend goodbye?

POOR CAPITAL ALLOCATION AND PROJECT EXECUTION

We have seen Sasol's share price decline as management has failed to deliver on the Lake Charles Chemical Project (LCCP), which is over budget and behind schedule. Sasol's management team have also delayed the release of their financial results as they investigate the weak control environment that led to the problems at LCCP. The project was initially budgeted to cost $8.9bn and be completed by the end of 2018. Management now expect the cost to be between $12.6-12.9bn with the majority of units operating by Q4 2019. Management have repeatedly over-promised and under-delivered. Capital allocation and project execution has been poor and the initial projected return of around 12% for LCCP has been severely impaired.

FINANCIAL RISK HAS INCREASED SIGNIFICANTLY

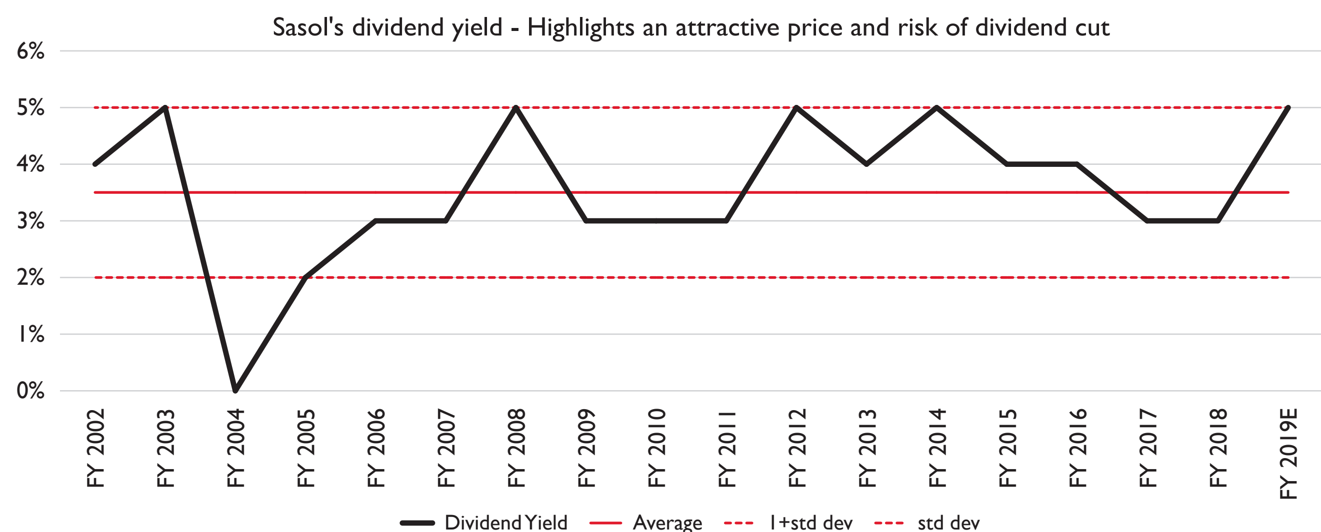
Management have significantly increased the financial risk of the business due to the investment into LCCP. Before the LCCP project, net debt was negative (positive cash balance of R10bn) and Sasol's ability to pay dividends was good. Presently, net debt has increased significantly with Net debt/EBITDA likely to hit 2.7x (see chart below).



Source: Bloomberg, Cadiz Asset Management

In order to avoid breaching various debt covenants, Sasol was able to increase its Net Debt/EBITDA covenant level to 3x from 2.5x. This increase in the covenant should provide sufficient breathing room for Sasol to narrowly avoid a rights issue, but the dividend will in all likelihood be cut. As production at LCCP ramps up over the next few years, free cash flow should improve allowing Sasol to reduce the debt load. However, the longer the project is delayed the longer it will take to lower the financial risk of the business.

HIGH LIKELIHOOD OF A DIVIDEND CUT



Source: Bloomberg, Cadiz Asset Management

Sasol's current dividend yield (chart above) is high at 5.2% compared to its long run average of 3.5%. In early 2016 when the dividend yield was at similar levels, Cadiz held an overweight investment position, as the financial risk was low, with the high dividend yield indicative of an attractive purchase price. We correctly assessed that an oil price of less than $40 per barrel, which was below the average cost of production, was unsustainable and a higher long-term oil price would be required to ensure continued oil production.

The current situation is quite different. The share price is low due to elevated financial risk and a lack of confidence in management. Repairing the balance sheet is a top priority which is likely to be achieved by cutting the dividend. In a worst-case scenario, a rights issue may be required.

Sasol has been a good contributor to Cadiz investment performance over the last 3 years. Cadiz have retained a small position in Sasol. We believe the current valuation is attractive, however, we are more cautious due to the high financial risk, likely dividend cut and further negative disclosures regarding LCCP. For now, patience is warranted until we have clarity on whether a rights issue can be avoided.

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