الراجحي المالية
Al Rajhi Capital

Themes and implications

Revenue and profitability of consumer sector companies are under pressure due to weak consumer spending and down-trading. While the companies are trying to partly mitigate these challenges by lowering SG&A costs and focusing on cash flows (lower inventory, capex being pared), we believe the full impact of cost pressures going forward (cut in allowances, levies such as GCC wide VAT, possibly increased custom duties on few products and expat levy) will likely require further cost saving and revenue enhancing measures from these companies, which we will discuss in a subsequent report.

Rating and target prices

Stock	Rating	Price Target
Jarir	N	SAR127.8
Fawaz Al Hokair	OW	SAR36.1
Extra	N	SAR35.7
Al Othaim	N	SAR111.0
Almarai	N	SAR62.8
Savola	N	SAR39.4
Herfy	N	SAR83.1

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Saudi consumer sector
Adjusting to a new normal

We assessed evolving consumer spending patterns through an analysis of aggregate revenue/ margins of consumer sector companies#, for both the past 5 years for a macro view and the last 12 quarters for more emphasis on the current period. Q4 2016 was the first quarter in which the cut in some allowances of public sector employees has been partially effective (two months of salaries on new base, but deferred loan instalment for one month – effectively consumer spending impact was only for a month in Q4). Hence, the analysis assumes importance as it could hold out signals on how lower consumer spending is impacting companies and that are likely to recur over the next few quarters. This report details the key trends spotted during Q4 results. In a subsequent report we will analyse how the consumer companies may adjust to the new normal. Following are the ***key trends:***

(a) Consumer spending remains weak: Revenue growth of consumer sector companies continues to be tepid clocking just 2% y-o-y average growth in the last 6 quarters vs. average 10% y-o-y growth in the preceding 6 quarters, impacted by lower disposable incomes.

(b) Pockets of strength, helped by regulation: Electronic retailers (Jarir and Extra) witnessed solid growth, due to mandatory Saudization of shops in telecom business by September 2016.

(c) Consumers' down-trading visible: Gross margin of consumer sector companies, which is a reliable indicator for assessing pricing power, contracted by average 115 bps y-o-y in each of the last 2 quarters and contracted 34 bps in 2016 (after continuous expansion of 46 bps per annum over the last 4 years).

(d) SG&A cost savings being tapped: While gross margins are market determined, the companies are moving to cut SG&A costs (as % of revenue) – especially retailers, while they remained flattish for food companies.

(e) Inventory levels normalizing: Q4 2016 witnessed a faster momentum towards normalizing inventory levels, as companies are likely recalibrating their business projections for the new realities of slowing consumer spends.

(f) Capex being pared: Some companies indicated that the capex will be cut going forward, while a few others are maintaining existing roll-out plans.

Going forward, earnings trajectory of consumer sector stocks hinges on their ability to protect operating margin by driving revenue growth (will result in operating leverage) and finding SG&A savings, as gross margins will mostly be market determined due to (a) low pricing power of companies in the current environment, and (b) preserving market share being priority.

In the subsequent report, we will analyse how the consumer sector companies may respond and adjust to the evolving 'new normal'.

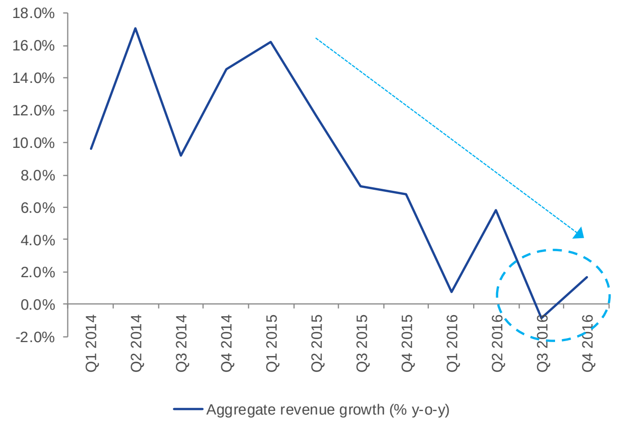
Note#: Refer to Appendix section on page 6 for the list of companies for which we have considered the aggregates.

Key takeaways

Consumer spending remains weak

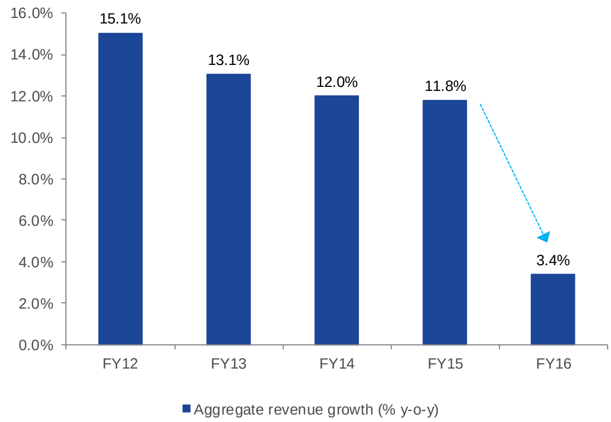
- Consumer sector revenue growth continues to be tepid in the last 6 quarters clocking average of just 2% y-o-y vs. average 10% y-o-y growth in the preceding 6 quarters. In FY16, revenue growth dropped to 3.4% y-o-y vs. average of 13% in the previous 4 years.
- Lower disposal income – increase in fuel and utilities prices, cut in some allowances of public sector employees and slowdown in government spending – is the key factor weighing on revenue growth of consumer sector companies.
- **Our view:** We believe that consumer spending will continue to remain weak given that the full impact of allowance cut, likely hikes in in energy/ utility prices and impact of expat levy (both likely to start in 2H FY17) will weigh down consumer disposable incomes further. The trend of weak spending is already reflected in the POS transactions. As per SAMA data, annual value of POS transactions fell by 4.7% in 2016, the first drop since the publication of the data in 1993. Similarly, aggregate annual ATM withdrawals fell by 3% in 2016, first time since 2013 indicating the on-going weakness in consumer spending.

Figure 1 Lowest qtly revenue growth in the last two quarters



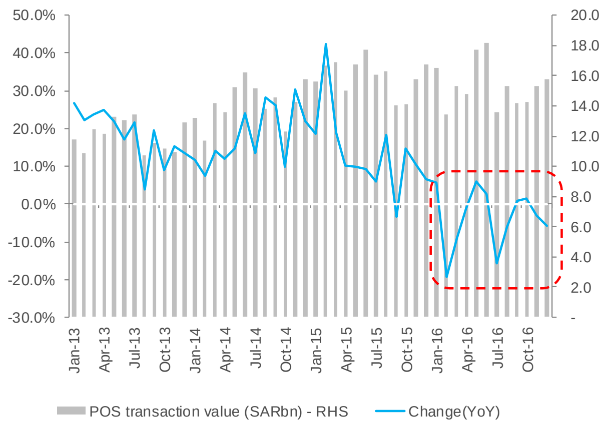
Source: Company data, Bloomberg, Al Rajhi Capital

Figure 2 FY16 revenue growth signals weak demand environment



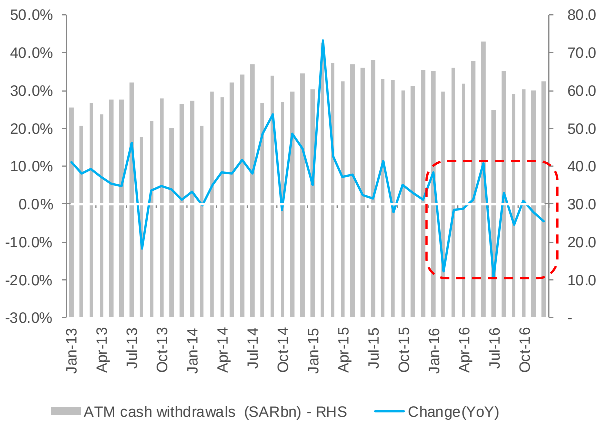
Source: Company data, Al Rajhi Capital

Figure 3 POS transaction value declined y-o-y in 2016…



Source: SAMA

Figure 4 … weakness is reflected in ATM cash withdrawals also

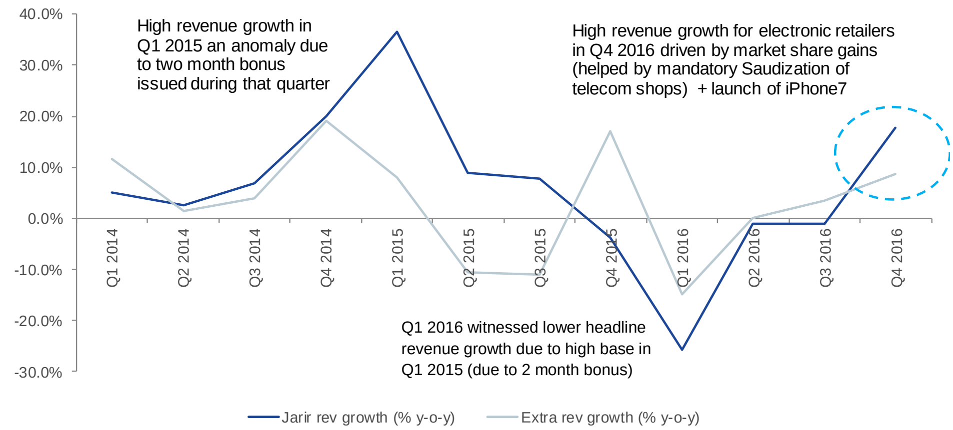


Source: SAMA

Pockets of strength, but not driven by consumer spending

- Smartphones and associated peripherals witnessed solid growth, due to which revenue growth of Jarir and Extra was above estimates.
- However, this is mainly due to mandatory Saudization of shops in telecom business by September 2016, which led to approx. 50% of small shops in this segment to shut down. Consequently, this benefited the large organized retailers in this segment.
- One other reason for strong performance of smartphone segment in Q4 2016 was launch of iPhone7, which has high adoption rates worldwide among Apple customers.
- **Our view:** The market share gains for electronics retailers are likely to continue in the next few quarters as Saudization of telecom shops was completed only in September 2016 and the benefits of the same have started to kick in from Q4 2016. Extra mentioned that its market share improved to 11.1% in 2016 from 8.9% in 2015, and we assume the same would hold true for Jarir also.

Figure 5 Strong revenue growth for electronic retailers in Q4 2016

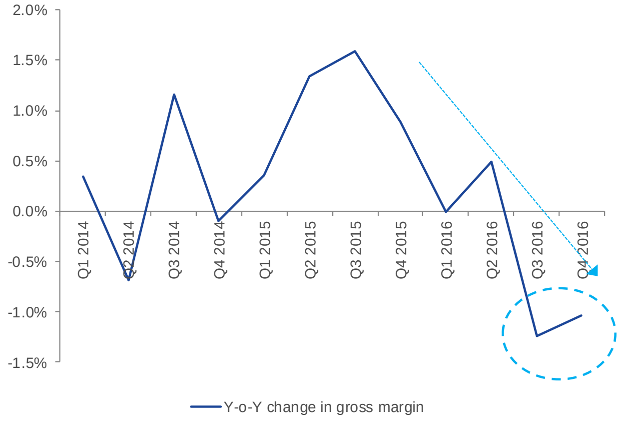


Source: Company data, Al Rajhi Capital

Consumers’ down-trading visible

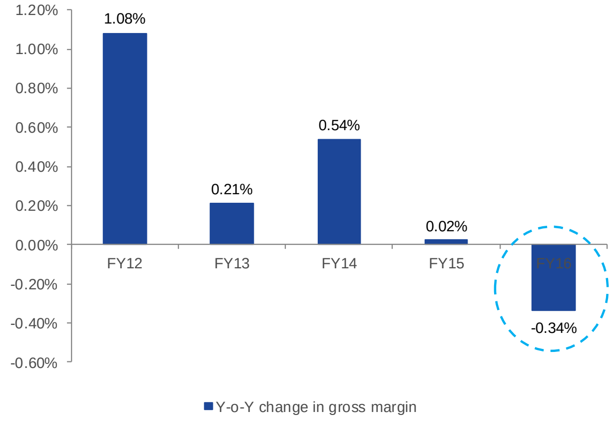
- Gross margins are a reliable indicator for assessing the pricing power of retailers, as they capture premiums/ discounts, promotional sales and inventory provisions/ write-downs.
- Aggregate gross margins of consumer sector companies contracted by an average of 115 bps y-o-y in each of the last 2 quarters and contracted 34 bps in 2016 (after continuous expansion of 46 bps per annum over the last 4 years).
- Management commentary in Q4 2016 confirmed high discounts prevailing in the market and also longer than usual periods of discount sales.
- **Our view:** This is in-line with our views outlined in our November 2016 report “What happens to consumer spending now”, where-in we mentioned that since the average Saudi household did not witness increase in volume of purchases over the past decade (2/3rd of increase in household spending was eaten up by inflation), their preferred approach to deal with lower disposable incomes will be to trade down rather than cut volume. Hence, we believe consumers’ down-trading is here to stay over the next few quarters.

Figure 6 Gross margins declined by average 115bps y-o-y each in last 2 quarters



Source: Company data, Al Rajhi Capital

Figure 7 First decline in gross margins in last 5 years

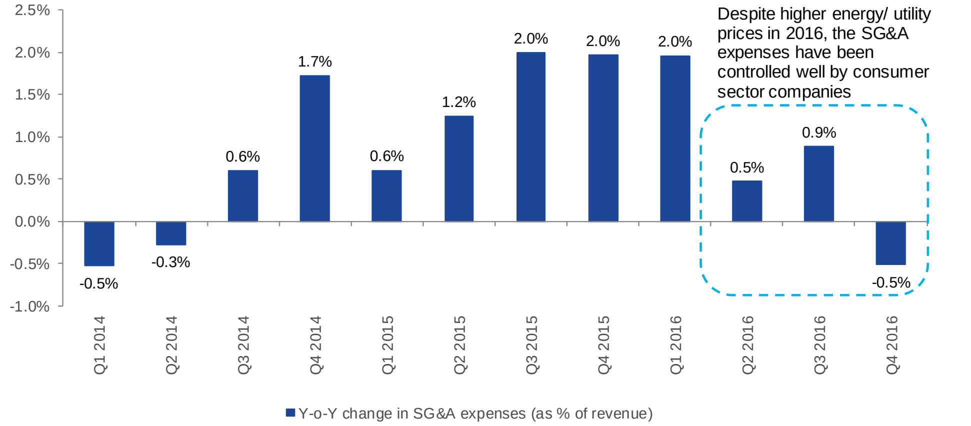


Source: Company data, Al Rajhi Capital

SG&A cost savings being tapped

- For the most part, gross margins are market determined, especially in the current environment of higher discounts in which the companies have little pricing power and preserving market share is priority.
- However, the companies are moving to cut SG&A costs (as % of revenue), something which the companies have control on. After consistently rising over the previous few quarters, SG&A expenses declined for the first time in Q4 2016.
- The decline was primarily driven by retail companies while SG&A costs remained mostly flattish for food companies.
- **Our view:** We believe that the SG&A costs will continue to be looked at closely by companies as the companies have a handle on these costs. Not just employee costs, we believe the companies will closely look at all aspects of the supply chain to assess opportunities to become leaner and save costs.

Figure 8 SG&A expenses (as % of revenue) decline in Q4 2016 after sustained rise over previous 2 years

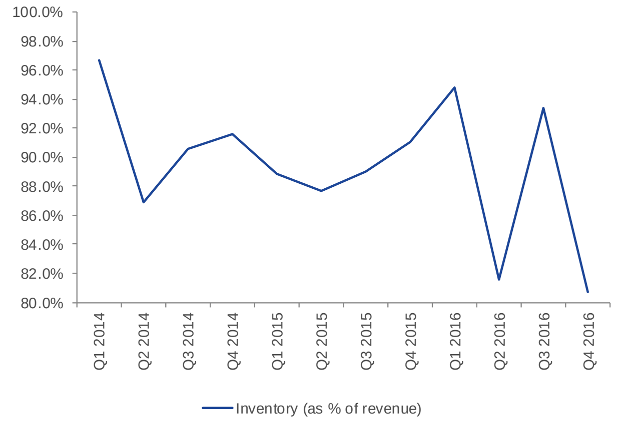


Source: Company data, Al Rajhi Capital

Inventory levels normalizing

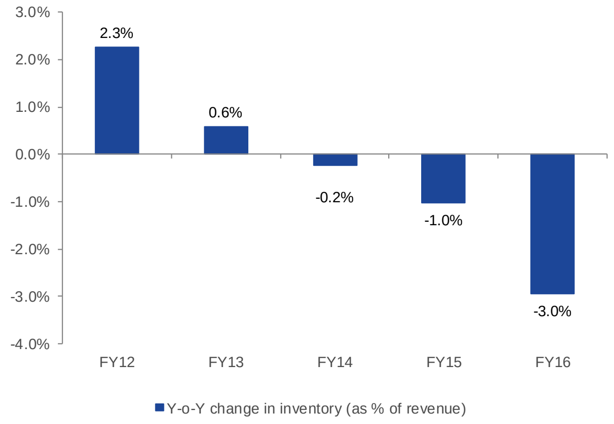
- The inventory levels (as % of revenue) have been slowly normalizing from the start of 2015, however 2016 (especially Q4 2016) witnessed a faster momentum towards normalizing inventory levels.
- This is a positive development, as we believe the businesses have recalibrated their business projections for the new realities of lower demand driven by slowing consumer spending. Further, normalizing inventory levels will release the much needed cash back to the business and will result in lower working capital investments and shortening the cash cycle.
- Retail companies witnessed the largest change in inventory levels as these were the companies to have witnessed the most impact of slower consumer spending. Panda, Savola's retail business, stands out among the consumer pack due to the significant inventory reduction (mainly due to write-downs in Q4 2016), followed by Extra. Food companies, since they are mostly defensive, witnessed little change in inventory levels.
- **Our view:** We believe the low hanging fruit has already been tapped by the retailers in terms of adjusting inventory levels to the current demand environment. Hence we don't see major reductions going forward.

Figure 9 Consumer spending slowdown leading companies to pare back on inventories



Source: Company data, Al Rajhi Capital

Figure 10 Significant decline in FY16 inventory levels mainly driven by retailers, augurs well for the long term



Source: Company data, Al Rajhi Capital

Capex being pared

- Some companies have indicated that the capex will be cut going forward, mostly as the companies re-assess their business plans in the current environment.
- While major capex for Almarai is behind, the company indicated that it would focus on lowering projected capex going forward. Jarir will continue with its investments – management guided for opening 5 new stores in 2017. However, Extra and Fawaz Al Hokair have indicated that the new store roll-outs will be lower. Extra plans to open 1 new store in 2017 while investing in two distribution centres. Fawaz Al Hokair, while continuing to invest in international expansion, will moderate the pace of store roll-outs in the Kingdom next year as focus shifts to cost savings and cash flows.
- **Our view:** We believe that the companies will continue to focus on cost savings and cash flows until there is a significant improvement in revenue visibility.

Appendix

For the purpose of this analysis, we have considered an aggregate analysis of revenue and other items for a set of leading consumer companies. The companies are as follows:

- Jarir
- Fawaz Al Hokair
- Extra
- Al Othaim
- Farm superstores
- Almarai
- Savola Retail*
- Herfy
- Sadafco
- Nadec
- Halwani Brothers

Note*: For Savola, we just consider the Retail operations, as food operations have significant international component and has also undergone restructuring. Also for Q4 2016, we have adjusted the financials for SAR377mn inventory write-downs for Savola, for a like-to-like comparison of underlying margins and profitability.

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