

Decelerating growth in consumer spending. Gradually lifting energy subsidies and inflationary pressures to alter consumer spending patterns. VAT and a growing Saudization program are estimated to pressure margins, leading to revised earnings growth for the sector. Outlook remains comparatively positive for non-discretionary retailers

Decelerating growth ahead, decline in retail equities reflect outlook:

The retail sector currently trades at a PE of 19.0x and a PB of 3.6x. Excluding Healthcare companies would place the sector at a T12 PE of around 15.3x, in line with broader market T12 PE of around 15.7x. The sector traded at a 3-year historical average T12 PE of around 21.2x. Revision of forward earnings and growth potential for most companies negates previous high multiples; reversion to mean would be highly unlikely under different economic circumstances and regulatory settings. Retail sector index fell 18.9% on an YTD basis and 42.1% on a 52-week time horizon, significantly underperforming the market (-3.4% YTD). The decline was justified under an estimated deceleration in consumer spending growth as well as a potential shift in consumer spending patterns, ultimately pressuring valuation.

Retail companies posted a disappointing set of Q1-2016 results, discretionary retailers underperformed the sector:

With the exception of a few healthcare companies, sector companies posted earnings below estimates. Total Q1-2016 earnings stood at SAR 532.3mn compared to SAR 972.7mn posted last year, a 45% decline. Excluding healthcare would further dent retail earnings. We should note that part of the decline in earnings is owed to the two month salary bonus made on Q1-2015; the mandate set a higher base for growth figures in Q1-2016. We believe the mandate had a spill over effect on Q2-2015 earnings thus setting a higher base for next quarter's earnings as well. Revenues for the sector have been relatively flat since Q4-2015, signalling a trend in estimated sales going forward. A declining sector price/sales ratio QoQ signal a larger drop in price against sales growth, reflecting a negative sentiment towards forward sales growth. Sales for the quarter showed a YoY decline of around 2.55%, taking the high base into account would set growth at the low positive levels. It is worth noting that 44% of sales growth for FY2015 was from Q1-2015.

POS (Point of Sales) data gave early signals on how consumer spending will take shape going forward. Inflationary pressure to gradually

change consumer spending patterns in the kingdom: POS data have shown signals of forward declines in consumer spending, setting the scene for a prospective change in spending patterns. A 9% decline YoY along with an 8% decline MoM in POS transactions took place on February of this year, part of the decline is due to the two month salary bonus taking place on Q1-2015. ATM withdrawals have shown a similar trend, declining 13% YoY on February 2016 after posting an 8% growth YoY on January. POS data and ATM withdrawals are estimated to show decelerating growth going forward. Recent inflation figures have shown a significant rise, standing at 4.3%, up from 2.3% on December 2015. The recent rise was mainly due to the increase in fuel prices from partially lifting energy subsidies. The aforementioned inflationary pressure will weigh on Saudi consumer spending, effectively changing current and long-standing spending patterns.

Key Market Data

YTD %	-18.9%
52 Week (High) / (Low)	18258 / 8781
Market Cap (SAR mn)	51.8
Dividend Yield	3.58%
Number of Listed Companies	15

Source: Bloomberg, Aljazira Capital
Based on 8th of May prices

Sector Earnings

SARmn (unless specified)	FY15	1Q2016
Net Income	3,055.1	532.3
Growth YoY %	2.1%	-45%

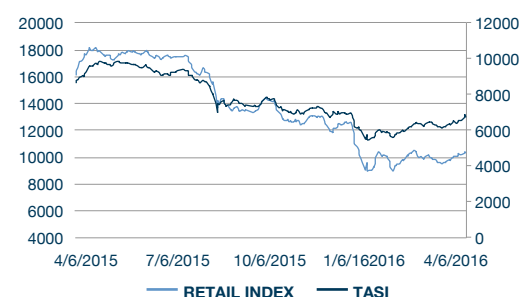
Source: Bloomberg, Aljazira Capital

Key Ratios

	FY15	Current
P/E	20.2x	19.0x
P/B	4.5x	3.6x
P/Sales	1.75x	1.5x
ROE	25.1	21.6
ROA	12.8	11.0
Dividend Yield	2.94%	3.58%

Source: Bloomberg, Aljazira Capital
Based on 8th of May prices

Price Performance



Source: Bloomberg, Aljazira Capital

Company	12-month PT (SAR)	Recommendation	Upside Potential	EPS FY2015	EPS FY2016E	Growth %	T12 PE	Forward PE
Jarir	131.0	Overweight	11.90%	9.21	8.4	-8.8%	13.9x	13.8x
Fawaz Al Hokair	56.7	Overweight	49.90%	2.93	3.2	9.2%	13.2x	11.9x
Al Othaim	102.3	Neutral	3.33%	5.13	5.45	6.2%	19.4x	18.1x
SACO	99.7	Neutral	3.50%	5.25	5.47	4.2%	19.1x	17.6x
Al Khaleej Training	34.2	Overweight	25.50%	1.72	1.35	-21.5%	17.3x	20.2x

Source: Bloomberg, Aljazira Capital *Based on 12th of May prices

pressures on VAT (Value Added Tax) along with Saudization programs and tighter labour regulation limits forward earnings potential and add valuation pressures on retail companies through tighter margins:

VAT on retail companies' places pressure on forward earnings potential, forward margins and top line figures are estimated to weaken in case VAT takes place post FY2018. Valuations will have to be revised to take into effect the likely outcomes of VAT on retail companies. Our assumptions include a 5% VAT on non-essentials by FY2018. Essentials under consumer staples are broadly expected to be VAT exempt, with up to 100 items under the essentials category projected to be tax exempt, placing non-discretionary retail at a relatively favourable state. The continued push for Saudization accompanied with relatively low labour participation will weigh on retail margins going forward. Growth in female labour participation rates will partially offset the overall negative drag on the sector (in the form of consumer spending). Retailers can offset margin compression by increasing labour productivity through training and a higher level of efficiency and automation. Touching average OECD labour productivity levels for retailers is enough to maintain and possibly improve margins in the medium to long term. It is vital for forward labour productivity in retail to grow at a higher rate than average salaries for retailers to be able to maintain a level of growth in earnings.

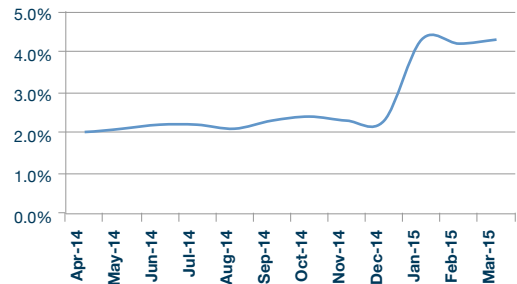
Cautious outlook on discretionary retail. Investment in E-commerce is critical for mitigating downside risk:

We revised our outlook on Jarir and Fawaz Al-Hokair based on estimated sector growth for discretionary retail in the Kingdom. FY2016 earnings for Jarir were revised down 9% while Fawaz Al Hokair was revised down 23%. The revision was based on decelerating sector sales growth. We are "Overweight" on Jarir with a PT downgrade to SAR131.0 per share. We update our recommendation on SACO to "Neutral" based on revised earnings forecast (-6.5% to stand at SAR 5.47 EPS) with a PT of SAR 99.7 per share. We update our recommendation on Fawaz Al Hokair to "Overweight" with a downgraded PT of SAR 56.7 per share. The downgraded PT is based on revised forward earnings. However, upside potential from current price points while trading at a discount to the sector demands an "Overweight" recommendation. Growth in E-commerce in the kingdom is expected to bypass Fawaz Al Hokair given the high growth in fashion e-commerce and the apparent hesitance of the company on entering the space. SACO and Jarir have initiated online efforts, albeit with minimal investments.

Favourable outlook on Non-discretionary (consumer staples) retailers and Education sub-sectors supported by earnings visibility:

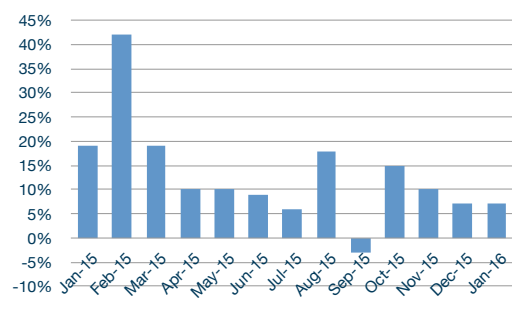
The markets seems to favour non-discretionary retailers, evident in an YTD performance of 3.08% against discretionary YTD of -28.9% YTD. We update our recommendation on Al-Othaim to "Neutral" based on valuation realization (up 10.4% YTD), supported by positive Q1-2016 earnings, with an updated PT of SAR 102.3 per share. We remain "Overweight" on Al Khaleej Training with an updated PT of SAR 34.2 per share. We should note that the company's core business is estimated to continue its declining trajectory. However, the movement towards the education segment demands a positive outlook on the company, taking into account a level of execution risk associated with schooling projects.

Rise in Inflation figures witnessed on Jan-2016



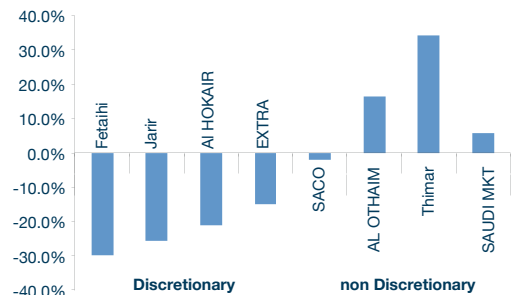
Source: SAMA, Aljazira Capital

Monthly POS Growth% YoY



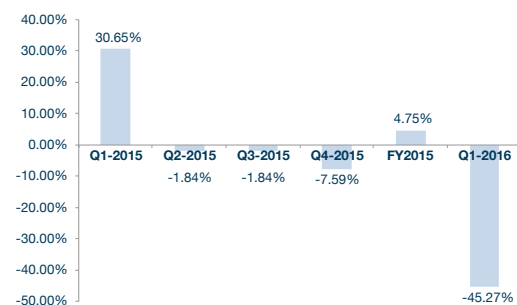
Source: SAMA, Aljazira Capital

Q1-2016 Sales Growth YoY



Source: Bloomberg, Company reports, Aljazira Capital

Retail Sector Earnings Growth YoY



Source: Bloomberg, Company reports, Aljazira Capital

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We remain "Overweight" on Al Khaleej Training based mostly on a favorable view regarding the company's direction in the "schools" segment. Q1-2016 results confirm our negative outlook on the company's current core segments.

Maturity of core business confirmed in Q1-2016 results. The company posted earnings below AJC and consensus estimates: Al Khaleej reported a disappointing set of results, net income for the period stood at SAR 8.24mn recording a 47% decline YoY, 31.4% and 38.3% below AJC and consensus estimates respectively. The decline is mainly due to: i) Top line weakness, sales dropped 11.3% YoY. ii) Slight increase in OPEX and finance charges. Revenues from language and computer training have declined 26.1% and 27.4% YoY respectively, confirming our negative view on the segment. Education projects segment have shown the most dramatic decline, posting a 40.9% drop YoY. The segment is vulnerable to government spending cuts, evident on Q1-2016 results; our estimates include a continuation of the negative trajectory for the segment. Language and computer training segments along with education projects have dropped a combined SAR 31.1mn in revenues for the quarter. On the other hand, call centres, schools, and financial training posted revenue growth for the reported period, recording 7.1%, 34.6%, and 13.2% growth YoY respectively.

Margins still under pressure, estimated shift in margins due to changes in revenue mix: Gross margins declined 140bps YoY on Q1-2016. Pressure was mainly from call centres and computer training segments, while schools margins expanded significantly despite having a small yet growing contribution to gross profits; from 6.2% on Q1-2015 of gross profits to 11.1%. Part of the schools segment contribution growth is attributed to the declining base of gross profits on Q1-2016. We expect margins to be under pressure as the company expands in schools, and call centres.

We remain negative on the training segment, with a positive overall outlook supported by expansion in the schools segment: Our broad positive outlook is based on the current growth trajectory the company is leaning towards. This view is supported by the company's prospects in the education sector. We expect FY2016 top line to benefit from on-going school expansions. The main growth driver for FY2016 is the addition of a new school in Riyadh with a capacity of 2800 students on Q4-2016. AJC estimates the capacity of operating schools to reach 10,800 students by the end of FY2016 compared to 1100 students in FY2014. Two more schools with a total capacity of around 5500 students are expected to start operations by Q4-2017 and Q4-2018

We maintain our "Overweight" recommendation on Al Khaleej Training and Education with an updated PT of SAR 34.2 per share: Al Khaleej currently trades at T12 PE of 16.5x, against current retail sector PE of 15.3x (excluding healthcare companies). The downgraded PT is based on revised forward EPS and disappointing Q1-2016 results. We revised our FY2016E EPS to 1.35, a 22.4% decline YoY. The company demands a higher valuation based solely on estimated expansion in the schools segment, albeit during a transition year. The downside risk to valuation remains the level of execution risk associated with expansion projects along with a larger drop in revenues from training segments compared to estimates.

Recommendation	'Overweight'
Current Price* (SAR)	27.2
Target Price (SAR)	34.2
Upside / (Downside)	25.5%

*prices as of 12th of May
** The company announced bonus shares on April 2015.

Key Financials

SARmn (unless specified)	FY14	FY15	FY16E
Revenues	724.0	725.9	692.1
Growth %	8.9%	0.2%	-4.7%
Net Income	86.0	68.9	53.8
Growth %	9.8%	-20.0%	-22.4%
EPS	2.15*	1.72	1.35

Source: Company reports, Aljazira Capital

Key Ratios

SARmn (unless specified)	FY14	FY15	FY16E
Gross Margin	26.8%	24.8%	24.2%
Operating Margin	13.3%	11.2%	9.5%
Net Margin	11.9%	9.4%	7.8%
P/E	24.7x	17.7x	19.3x
P/B	4.2x	2.7x	1.8x
ROE	18.2%	13.6%	9.7%
ROA	9.8%	6.6%	4.7%
Dividend Yield	1.40%	1.50%	1.55%

Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (mn)	1,040.00
Shares Outstanding (mn)	40
YTD %	-24.04%
52 Week (High)/ (Low)	(62.5/18.5)
Sector	Retail

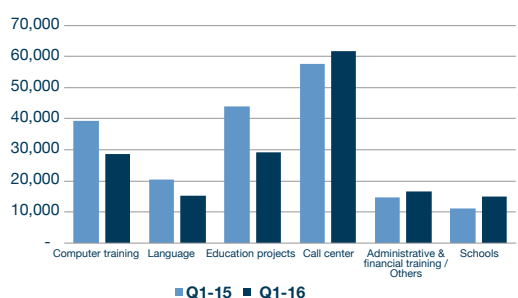
Source: Company reports, Aljazira Capital

Shareholders Pattern

Shareholders Pattern	Holding
Waleed Al Dreian	10.7%
Abdulaaziz Al Belaihid	7.0%
Ahmad Al Shadwi	10.9%

Source: Company reports, Aljazira Capital

Sales per Segment



Source: Bloomberg, Aljazira Capital

Q1 – 2016 earnings in line with estimates (excluding non-recurring items). Growth is supported by new stores and is expected to continue at current levels. Healthy sales growth and improved margins for the quarter sets the tone for non-discretionary retail in FY2016.

Positive outlook supported by notable revenue growth on Q1-2016:

Q1-2016 earnings stood at SAR 47mn, a 3.8% YoY decline. Operating profits grew 19.3% YoY. The decline in net income was mainly due to a non-recurring provision by a subsidiary (recovery of provision expected during FY2016). Growth in same store sales was reflected on revenues which witnessed an impressive 16.5% YoY growth. Q2-2016 sales are estimated to exhibit solid growth on a YoY basis given the larger portion of Ramadan falling within quarter and the reflection of new outlets on earnings.

Growth in store network in a highly fragmented industry support positive outlook. Saudization initiatives and VAT could prove a net positive for MGRs (Mass Grocery Retail) going forward in the form of improved productivity and market share gains:

Growth is supported by an expanding store network, new store openings will add sales growth momentum for Al Othaim to capture further market share. A total of 15 new stores were added in FY2015. As of March 2016, Al Othaim's store network has reached a total of 146 stores (including two new stores in Egypt); the last 4 stores were all added during Q1-2016. We expect Al-Othaim to add 12 -14 new outlets by the end of FY2016 compared to an announced target of 15 stores for FY2016. Saudization initiatives were long expected to cause margin compression for retailers, from a longer term perspective, Saudization efforts can prove as a net positive. In a margin sensitive industry, smaller retailers will have a harder time adapting in a tighter labour regulatory environment along with VAT, leaving larger room for growth for MGR's. We should note that improving labour productivity is imperative for maintaining margins on the medium to long term. We should also note that most MGR's have a reached a relatively higher level of Saudization compared to discretionary retailers, leading to lesser room for margin compression in MGRs.

We update our recommendation for Al-Othaim Markets to "Neutral" with a PT of SAR 102.3 per share:

Al Othaim trades at T12 PE of 19.3x and an estimated forward PE of 18.07x, at a premium compared to TASI which trades at around 15.7x earnings, and close to sector multiples of around 19.0x. Current multiples are justified by forward earnings potential in an earnings outlook where most retail companies are estimated to incur forward declines on a YoY basis. We revised our FY2016 earnings to stand at (EPS 5.45) a 6.0% growth YoY. Sales are estimated to post consistent growth figures, 7.8% CAGR to 2018, driven by an expanding store network and market share growth. Continued growth in outlets, positive sector outlook, and a higher level of earnings visibility albeit a form of regulatory risk place Al Othaim as our favourite for non-discretionary retail in the market. Projected changes in Saudi consumer spending patterns will ultimately favour non-discretionary retailers. We downgrade our recommendation for the company to "Neutral" based on valuation realization with limited upside potential. The stock is up 10.40% YTD compared to the sector and market drop of 18.9% YTD and 3.4% YTD respectively. A key downside risk to valuation would be the level of execution risk associated with Al-Othaim's store expansion plan and steeper competition driving down margins.

Recommendation	'Neutral'
Current Price* (SAR)	99.0
Target Price (SAR)	102.3
Upside / (Downside)	3.3%

*prices as of 12th of May

Key Financials

SARmn (unless specified)	FY14	FY15	FY16E
Revenues	5251.9	6035.8	6649.8
Growth %	14.7%	14.9%	10.1%
Net Income	214.7	230.8	244.8
Growth %	11.6%	7.4%	6.0%
EPS	4.77	5.13	5.45

Source: Company reports, Aljazira Capital

Key Ratios

SARmn (unless specified)	FY14	FY15	FY16E
Gross Margin	16.6%	16.5%	16.6%
Operating Margin	3.9%	3.4%	3.5%
Net Margin	4.1%	3.8%	3.8%
P/E	23.3x	17.5x	18.1x
P/B	5.2x	3.6x	3.4x
EV/EBITDA	16.6x	12.5x	11.5x
ROE	24.4%	22.4%	20.1%
ROA	9.9%	8.4%	8.9%
Dividend Yield	1.6%	2.2%	2.2%

Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (mn)	4,432
Shares Outstanding (mn)	45
YTD %	10.4%
52 Week (High) / (Low)	(116 / 62.25)
Sector	Retail

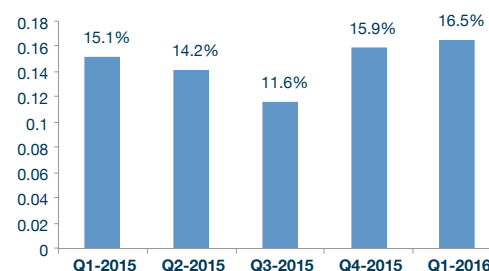
Source: Company reports, Aljazira Capital

Shareholders Pattern

Shareholders Pattern	Holding
GOSI	6.36%
Abdullah Al-Othaim	6.00%
Al-Othaim Holding	27.66%

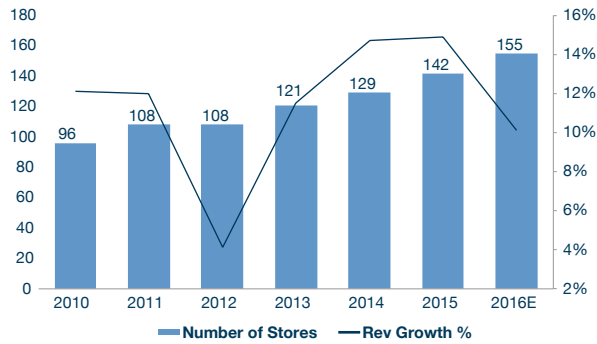
Source: Company reports, Aljazira Capital

Sales Growth % YoY



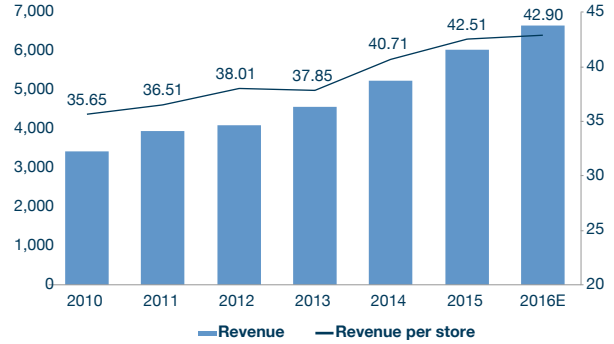
Source: Bloomberg, Aljazira Capital

Expansion in Outlets and Revenue Growth



Source: Bloomberg, Aljazira Capital

Consistent Growth in revenues per store highlights Same store growth.



Source: Bloomberg, Aljazira Capital

Fawaz Al-Hokair: Lower than expected sales and net income for the 3-months ending 31st of March. Results highlight losses from international subsidiaries. We update our recommendation on Fawaz Al-Hokair to "Overweight" with a PT of SAR 56.7 per share

Fawaz Al-Hokair reported lower than expected sales and net income, disappointment originated from international operations: Net income for the three months ending 31st of March stood at SAR 3.16mn, posting a 98.5% decline YoY and 96.5% decline QoQ, significantly below our estimates and market consensus. The deviation was mainly due to weakness from international operations and lower than expected top line growth. Total sales posted a 3.2% decline YoY, while local sales posted a 7% decline YoY (broadly in line with expectations), albeit from a higher base. Lower than expected growth in revenues was exacerbated by lower gross margins. Lower margins were attributed to discounts offered to accommodate lower demand levels (inventory turnover have declined post Q1-2015 registering a 10% decline YoY), as a result gross profit declined 12.2% YoY. This in turn reflected negatively on operating results, posting the first operating loss for Fawaz Al Hokair (annually, the company recorded its first decline in EBITDA on a YoY basis since FY2009). Other income increased by SAR 18.1mn for the three months period.

Our cautious outlook on discretionary retail is backed by decelerating growth in consumer spending, likely shift in spending patterns, VAT on non-essentials, and a forthcoming tighter credit environment: Reported revenues posted a 5.5% growth for the 12-months period ending 31st of March 2016. Previous double digit growth figures for the company were mainly supported by acquired and new stores in the Saudi market. Decelerating growth in consumer spending would hamper growth from same store sales in the short to medium term. While a tighter credit environment, given the company's current debt position (Debt / Equity stands at 1.39x), will potentially impede growth from acquisitions and new stores. The company did not disclose updates on the status of Blanco stores, which is a decisive factor regarding the company's direction. The company ought to consider divesting international loss making units in the event where a turnaround is unlikely. The approaching application of VAT on non-essentials supports our neutral view on discretionary retail on the medium to long term.

We update our recommendation to "Overweight" on Fawaz Al-Hokair a PT of SAR 56.7 per share. Trades at a discount to peers, a positive set of results in the upcoming quarter could act a short term catalyst in realizing upside potential: The company currently trades at a relative discount, TTM PE of 13.1x and a forward PE multiple of around 11.9x compared to a historical average PE of around 19.5x and a sector T12 PE of 15.4x. We expect earnings to grow 9.0% by the end of this fiscal year*. The main downside risk to consider in Fawaz Al-Hokair is continued operating losses from international operations, along with the company's ability to maintain the pace of growth going forward given that a significant part of recent growth figures are derived from acquired brands and stores. On the other hand, divestment of loss making units (assuming a turnaround is unlikely from the company's perspective) and a positive set of results for the upcoming quarter could act as a short term catalyst in realizing upside potential.

Recommendation	'Overweight'
Current Price* (SAR)	37.6
Target Price (SAR)	56.7
Upside / (Downside)	49.9%

*prices as of 12th of May

Key Financials

SARmn (unless specified)	FY14	FY15*	FY16E
Revenues	6,898.7	7,276.9	7042.8
Growth %	25.8%	5.4%	-3.2%
Net Income	803	615.8	671.4
Growth %	4.1%	-23.3%	9.0%
EPS	3.8	2.9	3.2

Source: Company reports, Aljazira Capital
*Year ends on March 2016

Key Ratios

SARmn (unless specified)	FY14	FY15*	FY16E
Gross Margin	25.9%	23.8%	25.7%
Operating Margin	12.1%	9.3%	10.2%
Net Margin	11.6%	8.4%	9.5%
P/E	25.3x	24.1x	11.9x
P/B	8.4x	5.7x	2.5x
Dividend Yield	1.6%	-	3.3%
ROA	13.6%	8.6%	9.6%
ROE	38.2%	24.6%	23.5%

Source: Company reports, Aljazira Capital
*Year ends on March 2016

Key Market Data

Market Cap (mn)	7,959.0
YTD %	-45.9%
52 Week (High)	108.7
52 Week (Low)	37.0
Shares Outstanding (mn)	210

Source: Company reports, Aljazira Capital

Shareholders Pattern

Shareholders Pattern	Holding
Abdulmajeed Al Hokair	7.0%
Salman Al Hokair	7.0%
Fawaz Al Hokair	6.19%
FAS Holding Co.	49.0%

Source: Company reports, Aljazira Capital

Price Performance



Source: Company reports, Aljazira Capital

*Year ends on March-2017

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RATING TERMINOLOGY

1. **Overweight:** This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. **Underweight:** This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. **Neutral:** The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. **Suspension of rating or rating on hold (SR/RH):** This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

Disclaimer

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