06 November 2019

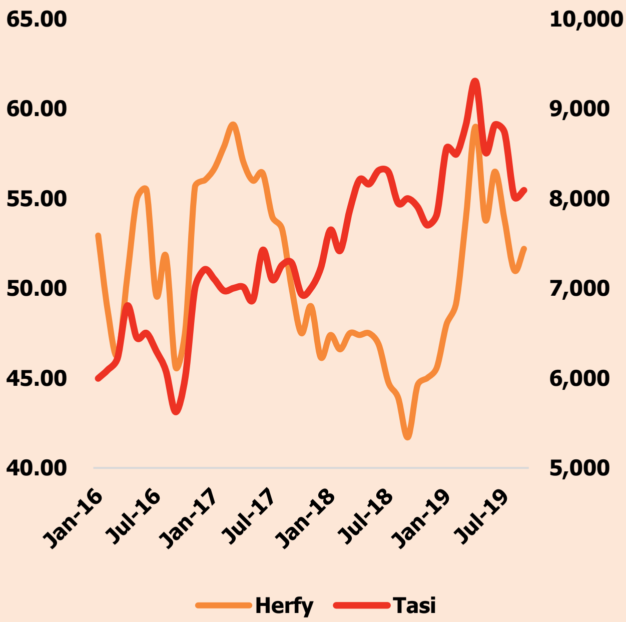
Herfy Food Services Co.

Initiation of Coverage Report

Since inception, Herfy grew to be the largest Saudi fast food brand, surpassing McDonald's in terms of geographical presence in the Kingdom. We are bullish on Herfy on the grounds of expected rise in tourism in the Kingdom, its strong online ordering platform, and cost advantages.

Recommendation:	**NEUTRAL**
Current Price (05-11-2019):	**SAR 50.7**
Target Price (52 Weeks):	**SAR 54.7**
Upside/ (Downside):	**7.9%**
Sharia Compliance:	**Pass**

Reuters Code	6002.SE
Bloomberg Code	HERFY: AB
52 Weeks High	SAR59.7
52 Weeks Low	SAR38.0
Market Cap	SAR3.3bn
P/E	16.5
EPS	SAR3.1
Last Dividends	SAR1.0
AVG Value Traded	SAR3.40mn



Key Points

We initiate our coverage for Herfy with a NEUTRAL recommendation and 52 weeks target price at 54.7; which represents an upside potential of 7.9%.

- Herfy Food Services Co. (Herfy) is the strongest local rival to McDonald's in Saudi Arabia. With the geographical presence of 375 restaurants, Herfy grew to be the largest and most successful Saudi fast-food brand in the Kingdom. The company offers fully integrated food services with the operation of its fast-food restaurants, as well as the sale of bakery and meat products.

- Herfy reported decent Y-o-Y revenue growth of 6.6% during the nine months ending September 2019, which is higher than its 3-year historical average of 4.5%. However, on Quarterly basis, Herfy reported sluggish revenue growth of 3.0% in Q3 2019, likely impacted by slower than average restaurants expansion. On the other hand, gross margin and EBIT margin reached a 3-year high of 32.7% and 20.5%, respectively caused by the IFRS adjustments and lower COGS.

- We project a positive outlook for Herfy supported by the company's increased penetration of online food delivery, cost advantages compared to its competitors and the expected rise in tourism in the Kingdom. The company is also set to benefit from its impressive geographical expansion and strong brand image in the Saudi market.

Key Growth Catalysts

- Expected boost in tourism in Saudi Arabia
- Cost advantages compared to competitors
- Introduction of Herfy app

Key Risk Factors

- Rise in marketing and selling expenses
- Shift in consumer behavior towards healthier food

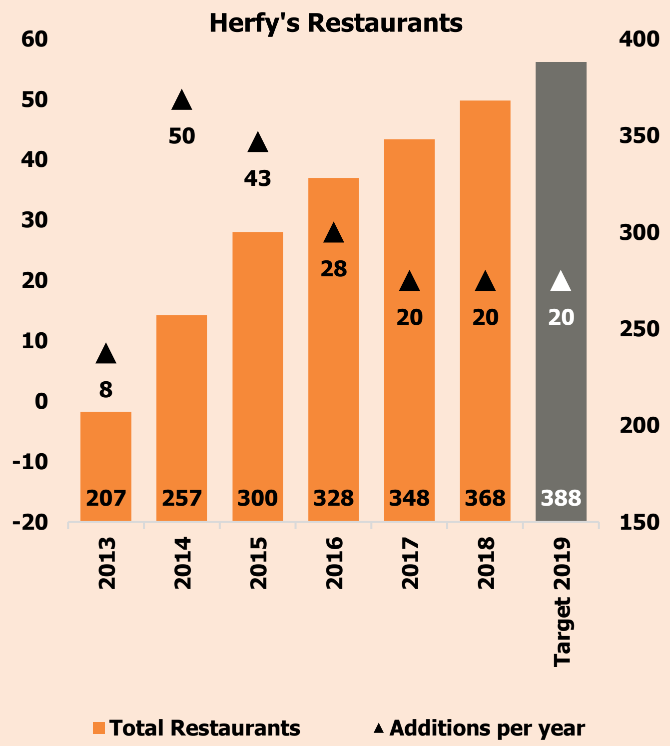
Company Profile

- Established in 1981, Herfy is one of the oldest companies in the Saudi fast food sector. Herfy was co-founded by Ahmed Alsaeed in 1981 through a partnership with Panda United. In 1994, Kingdom Holding Company took control of Panda United's stake in Herfy. Kingdom's stake in Herfy was later transferred to Savola Group. The company later launched its IPO in 2010.
- Herfy grew to be the Kingdom's largest and most successful Saudi fast food brand selling around 33mn burgers in 2018 (source: company data). Herfy markets itself as a 100% Saudi brand, thus differentiating itself from international franchises and building high loyalty with its Saudi customers.
- The company generates its revenue from two main sources; operation of fast food restaurants and food processing (including sale of bakery and processed meat products). The company's restaurants are either franchises or full ownership restaurants. As of September 2019, Herfy has 375 restaurants mainly in KSA, Kuwait, and Bangladesh. Herfy announced in 2018 that it aims to add 20 restaurants in 2019.
- In addition to its restaurant chains, Herfy operates bakery and meat processing factories which supplies to its own restaurants, as well as to external customers in the local Saudi market and abroad.
- The company operates its bakery segment through two factories in Riyadh producing bread, cake, and pastry. Bakery products are sold in the company's bakery shops reaching 16 stores in 2018.
- Its meat factory is considered a leading meat processing plant in the Middle East selling burgers and chicken products. Herfy has annual contracts with restaurants and grocery stores to which it supplies its meat products.
- Herfy distributes dividends on semi-annual basis with an average per share dividend of SAR1.0 for the past two years. The company distributed SAR64.7mn dividends for H1 2019 accounting to SAR1.0 per share.

Key Shareholders

Name	Ownership (%)
Savola Group	49.0%
Ahmed Alsaeed	20.3%
Public	30.1%

Source: Tadawul



Herfy's Key Milestones:

1981 — Opening of Herfy's first restaurant in the Kingdom

1982 — Opening of Herfy's first bakery to supply Herfy's restaurants needs of bread

2005 — Establishment of a meat processing factory to supply Herfy's restaurants

2007 — Supplying Herfy's food products to external customers in the Saudi market

2011 — Establishment of cake & pastry factory

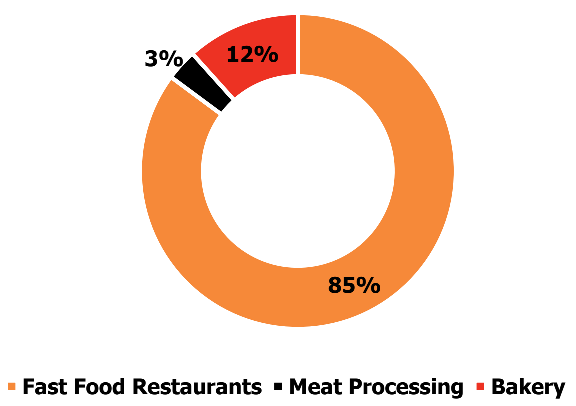
Herfy's Revenues at Glimpse

- Herfy aims to diversify its revenue sources and offer fully integrated food services to its customers. The restaurants segment is the largest contributor to Herfy's revenue representing 85.1% of revenue in Q3 2019. The average revenue per restaurant reached around SAR2.9mn in 2018. On the other hand, the bakery segment is the second largest revenue source with 11.6% contribution in Q3 2019. Meat processing segment is the smallest contributor to revenue with only 3.2%.

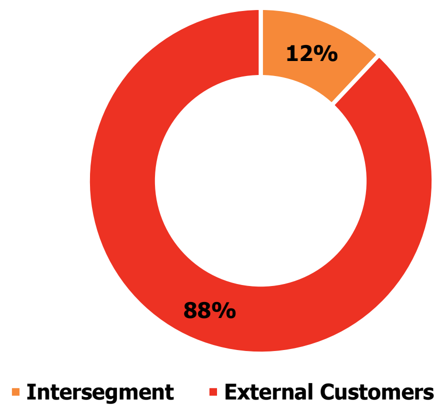
- Supported by recovering consumer purchasing power and Herfy's continuous geographical expansion, Herfy reported a 6.6% revenue growth for the nine months ended September 2019. The company's 3-year historical average (2016-2018) of revenue growth recorded only 4.5% impacted by the economic slowdown and reduced demand. On the other hand, Herfy's revenues increased by only 3.0% in Q3 2019, which is likely due to the slowdown in the geographical expansion (only 6 restaurants were added during 2019 to the company's chain).

- The meat processing business was the fastest-growing segment in 2019 recording double-digit Y-o-Y revenue growth of 40.0%[1]. Meanwhile, the restaurants' segment and bakery segment both reported a 5.8% growth in 2019. On a Quarterly basis, the restaurants' segment recorded stagnant growth in Q3 2019 of only 1.3% (the lowest Y-o-Y growth in two years). The majority (70.0%) of the meat processing segment is provided to the company's restaurants, meanwhile, 30% is sold to external customers. However, bakery segment revenue is mainly driven by external customers, with only 12% of its total revenues generated from Herfy's restaurants.

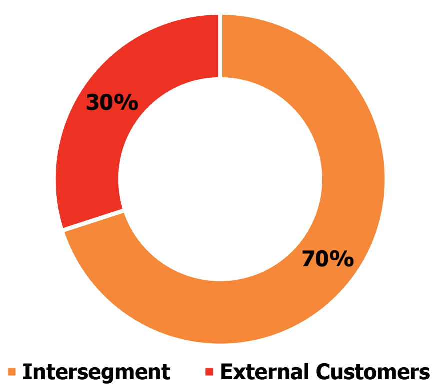
Revenue Segmentation (Q3 2019)[1]



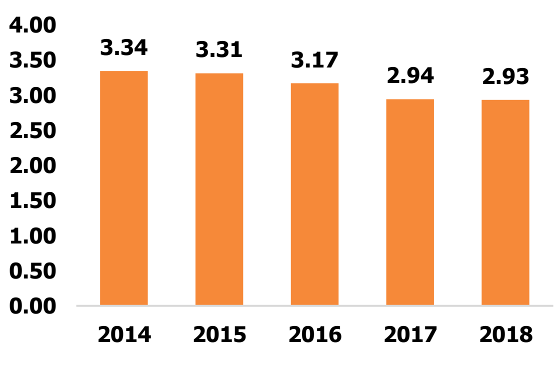
Bakery Sales Distribution (Q3 2019)



Meat Factory Sales Distribution (Q3 2019)



Average Revenue Per Restaurant



[1] includes revenue from external customers only.

Key Growth Catalysts

Expected Boost in Tourism in Saudi Arabia

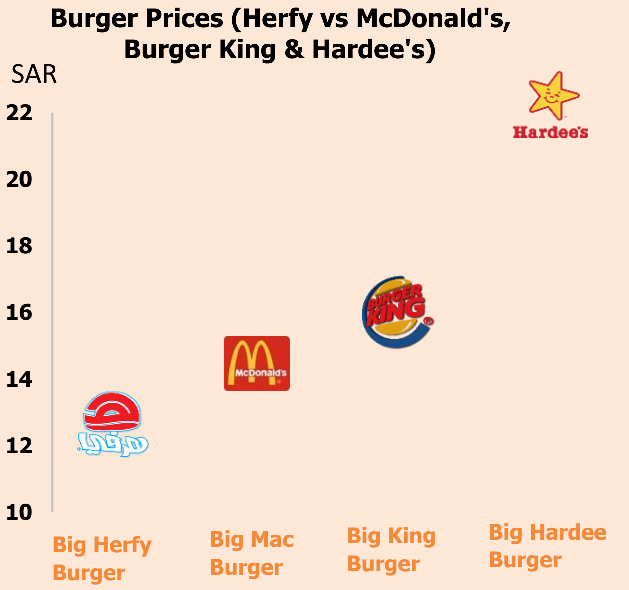
- Saudi Arabia decided in September 2019 to open its doors for the first time to international tourists from 49 countries. Previously, entrance to the Kingdom was only admitted for religious purposes, business trips or family gatherings. The government announced targeting 64mn visits by 2022 and 100mn by 2030, compared to 40mn tourists today.[2]
- Since restaurants are an everyday destination for any tourist, the rise in incoming tourists to the Kingdom is expected to increase the demand for Herfy's restaurants and increase their like-for-like sales. Herfy is expected to specifically benefit from such a decision given its strong geographical presence in the Kingdom surpassing McDonald's Saudi in terms of the number of restaurants that operates 285 restaurants in the Kingdom.[3]

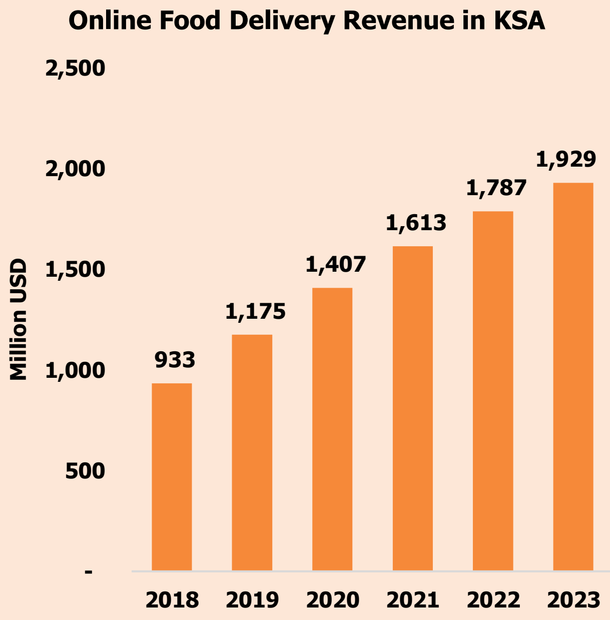
Cost Advantages Compared to Competitors

- Herfy benefits from cost advantages compared to other QSR[4] restaurants in the Kingdom. As part of its strategy, Herfy supplies the majority of its raw materials from its bakery and meat processing businesses since 2005. Today, 100% of the bread, chicken and meat products used in Herfy's sandwiches are supplied by the company's factories. Such vertical integration enables Herfy to better manage its costs and mitigate its risks, compared to its competition.
- Being a Saudi company, Herfy is also relieved from royalty fees paid by international brands in Saudi Arabia such as McDonald's and Hardee's. This enables Herfy to reduce its costs and accordingly its offered prices, giving it the opportunity to offer lower prices than competitors. In fact, Herfy's prices are considered one of the lowest in the Saudi QSR sector compared to its closest competitors.

Introduction of Herfy App

- Herfy recently introduced its own online food ordering app in 2019, where customers can order online whether for home delivery or pick up from one of Herfy's restaurants in the Kingdom. Herfy also utilizes its app platform to market its latest promotional offers. In less than a year, Herfy app was able to establish its position among the most downloaded apps in Saudi Arabia ranking 20th, closely following Talabat (a leading food ordering platform in the Middle East)[5] which ranked 19th.
- Saudi Arabia's online food delivery is estimated to grow at CAGR of 13.2% in the next four years[6]. This app is expected to help Herfy in growing its customer base and increase the loyalty of its customers, especially given the increasing popularity of online food ordering in the Kingdom.





Source: Statista

[2] Source: Bloomberg
[3] Source: McDonald's Corp
[4] Quick Service Restaurants
[5] Source: SimilarWeb
[6] Source: Statista

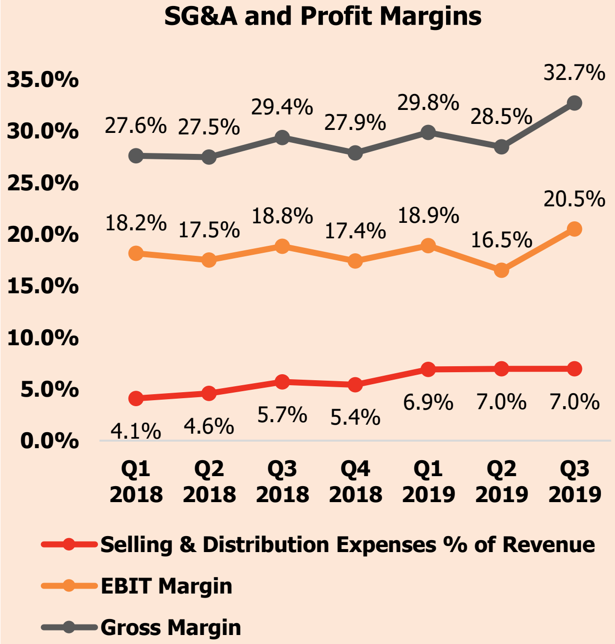
Key Risks

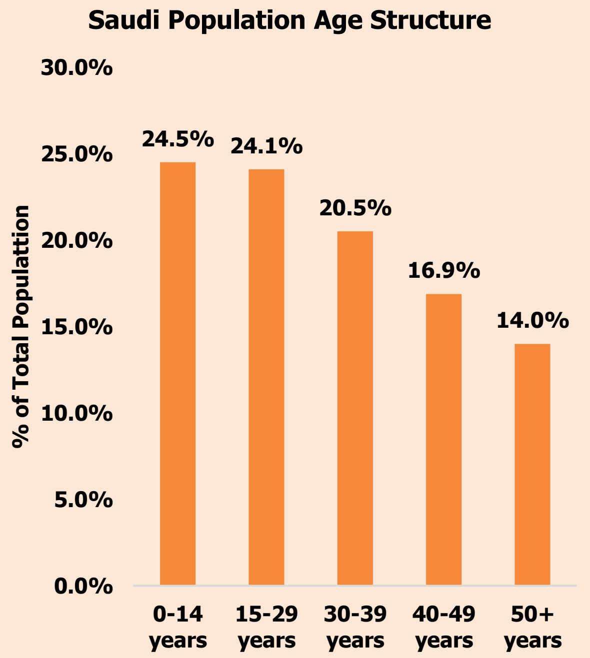
Rise in Marketing and Selling Expenses

- Herfy's sales and marketing expenses witnessed a surge of 48.7% in 2019 reaching an all-time high of SAR65mn in 2019 compared to 9 months 2018 of SAR43mn. Meanwhile rise in sales and marketing expenses may not represent a risk on its own given its positive impact on revenue growth, Herfy does not seem to benefit yet from rising marketing expenses. It is worth mentioning that in the restaurants sector, promotion and marketing expenses should typically reflect almost immediately on revenue growth.
- In Q2 2019, EBIT margin slumped to 16.5% despite the rise in gross margin as a result of rising selling and marketing expenses. In Q3 2019, Herfy reported only 3.0% Y-o-Y revenue growth despite the continuous rise in marketing and selling expenses. On the other hand, EBIT rebounded in Q3 2019, only as a result of significant improvement in gross margins reaching 32.7%; its highest level since Q4 2016.
- Despite the rise in EBIT margins, which is mainly a result of lower COGS, sales and marketing expenses still pose a risk on Herfy's profitability.

Shift in Consumer Behavior Towards Healthier Food

- Shift towards healthier food options is becoming a general trend worldwide, particularly among youth and teenagers. According to Euromonitor research published in 2019, Saudi consumers are becoming more conscious than ever of their eating habits as a result of higher education and rise of internet usage.
- On the other hand, according to General Authority for Statistics, 48.6% of the population in the Kingdom is under the age 30. Given such young population, the fast food industry might encounter growth challenges on the long term.
- Hence, Herfy might encounter lower than expected growth on the long term, hit by rising consciousness among the country's young population.





Source: Saudi Authority for Statistics

Financial Results

Historical Annual Overview (2016-2018): Challenging Economic Conditions Driving Down Profit Margins

- Although Herfy's top line numbers in the recent years were in an upward trend, revenue growth rates fluctuated (with positive growth was maintained). Despite the recent economic slowdown in Saudi Arabia, Herfy didn't report any negative growth rates on annual basis. The average revenue growth rate was 4.5% per year in the last three years, which reflects the company's expansion plan.

- Revenue grew by 6.0% Y-o-Y to SAR1,227mn in 2018 compared to SAR1,158mn in 2017. Revenue growth was mainly driven by the company's continuous stores expansion with an average increase of 20 restaurants per years in the past three years. However, revenue was stagnant in 2016 growing with only 0.1% Y-o-Y.

- Gross profit growth had the same pace as the revenue trend over the past years. However, Gross margins recorded 30.1% in 2016, 29.5% in 2017 and 28.1% in 2018; showing a downtrend over the past three years impacted by the general slowdown in the sector and economy. Gross profit recorded SAR345mn in 2018 representing 1.0% increase compared to SAR342mn in 2017.

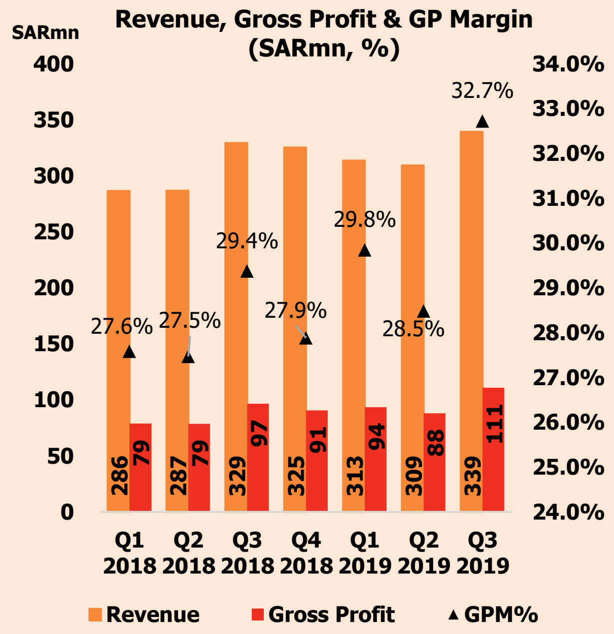
- EBIT margins recorded 19.8%, 18.6% and 18.0% in 2016, 2017, and 2018, respectively. EBIT reached SAR221mn in 2018 with 2.5% growth compared to SAR215mn in 2017, mainly driven by revenue growth.

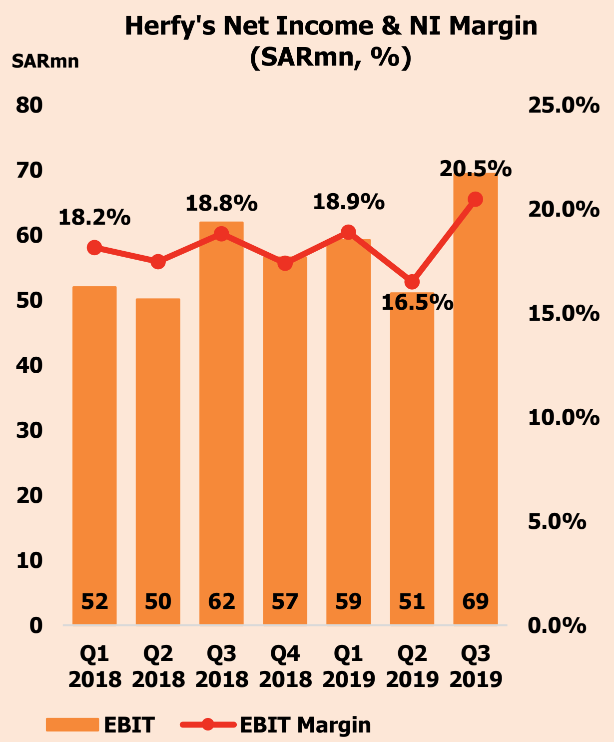
- Impacted by declining operating margins, net income margins were also declining where the margins recorded 18.8%, 17.3% and 16.6% for 2016, 2017 and, 2018, respectively, impacted by the challenging market conditions. Herfy reported net income of SAR204mn in 2018 compared to SAR 200mn in 2017 with 2.1% growth rate.

2019 Quarterly Overview: Strong Revenue Growth in H1 2019 and Impressive Profit Margins in Q3 2019.

- Herfy's revenue rebounded strongly starting Q4 2018 with Y-o-Y revenue growth of 8.8%. Such growth continued through Q1 2019 and Q2 2019 with Y-o-Y revenue growth of 9.5% and 7.9%, respectively. However, Herfy's latest results in Q3 2019 show slowing Y-o-Y revenue growth of only 3.0% reaching SAR339mn compared to SAR329mn in Q3 2018. Below average growth rate is likely a result of slowdown in the company's restaurants expansion, where only 6 restaurants were open in 2019 so far compared to an announced target of 20 restaurants in 2019. However, Q-o-Q growth was 9.6% compared to SAR309mn achieved in Q2 2019, which is a result of seasonality factors due to high rate of vacations and outings during the summer period.

- Gross margins also witnessed significant and consistent Y-o-Y improvement in 2019 for each of the three quarters supported by revenue growth and IFRS adjustments. Gross margin reached its highest level in almost three years recording 32.7% (highest margin

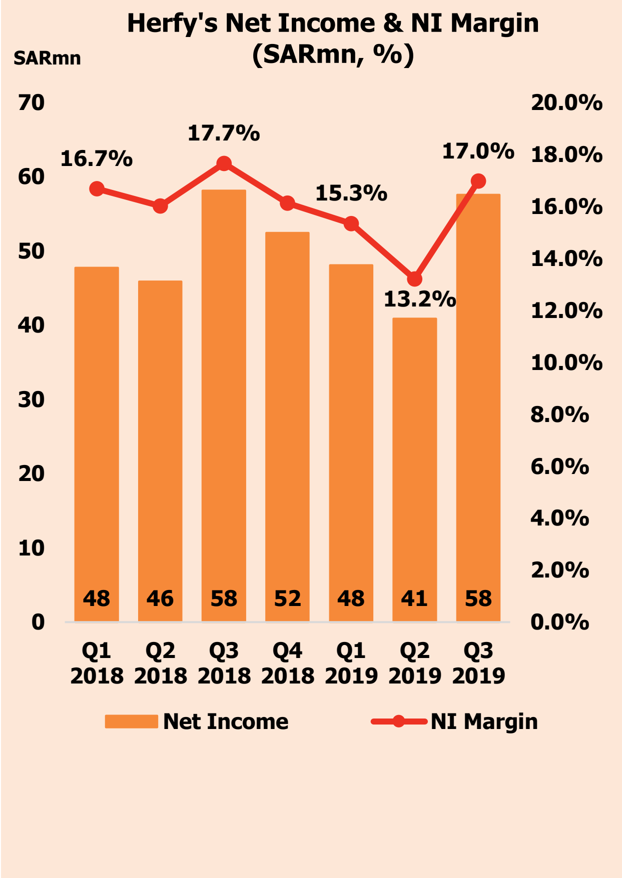




since Q4 2016) in Q3 2019 compared to 29.4% in Q3 2018. Y-o-Y gross margin growth is mainly supported by IFRS16 adjustments[7] starting Q1 2019 (rent represented around 12% of COGS in 2018) and cost cuts in Q3 2019.

- In line with gross margin improvement in 2019, EBIT margin also increased reaching its highest level of 20.5% in Q3 2019; highest margin in three years. EBIT recorded SAR69mn in Q3 2019 with 12.1% Y-o-Y increase compared to SAR62mn in Q3 2018, and the Q-o-Q recorded 36.0% growth compared to SAR51mn in Q2 2019. EBIT margin reached its highest level since Q1 2017 as a result of lower COGS. In contrast, Q2 2019 EBIT margin declined to 16.5%, mainly as a result of rising selling and marketing expenses.

- Despite the significant improvement in EBIT margins in 2019, net margins declined Y-o-Y for all three quarters impacted by the surge in finance costs as a result of IFRS 16 adjustments. Rise in selling and marketing expenses also impacted net margins in 2019. Herfy's net margin slumped to an 8-year low of 13.2% in Q2 2019, despite improvement in gross margin, impacted by EBIT decline and further pressures from finance cost.



[7]IFRS16 obligates companies to remove rent costs (short term leases are still kept) recorded in the income statement and report finance cost, depreciation, lease liabilities and right of use assets instead. Herfy's rent costs were all recorded in cost of sales.

DCF Valuation

	2019 E	2020 F	2021 F	2022 F	2023 F	2024 F
EBITDA	378	393	409	422	433	444
Operating CF	359	297	307	338	345	352
Capex	(83)	(85)	(77)	(72)	(67)	(68)
FCFF	276	212	230	266	279	284
Stub Period (FCF to be discounted)	69	212	230	266	279	284
PV (FCFF)	68	191	190	200	190	176

WACC	8.4%
Perpetuity Growth	3.0%
PV-FCFF	1,014
PV-TV	2,729
Net Debt	(164)
Less: End of services benefits	(71)
Add: Investments	85
Intrinsic Value	3,592
Shares Outstanding	64.68
Equity value per share	55.5
CMP (05-11-2019)	50.7
Upside / (Downside%)	9.7%

We have valued Herfy using DCF and multiples approaches, considering a WACC is equal to 8.4% (based on a risk-free rate of 4.4%, market risk premium 6.9%, Beta of 0.87)

Based on the DCF valuation, the fair price of Herfy share price is SAR55.5, which is higher than the traded value by 9.7%.

All Values are SARmn

Comparable Valuation – Local Peers

Name	Country	P/E
Herfy	KSA	16.5
Sadacfo	KSA	18.0
Almarai	KSA	26.7
Median		**18.0**
Forecasted EPS		**3.0**
Value Per Share		**53.5**

Weighted Valuation

Based on a weighted valuation approach, where the DCF is weighed 60% and multiple valuation is weighed 40%; we value Herfy share price at SAR54.7

Valuation Approach	Weight	Value
DCF	60%	55.5
P/E	40%	53.5
Valuation	**100%**	**54.7**

Financial Projection

Local Peers

	Country	Code	Market Price (SAR)	Market Cap (SARmn)	P/E	Revenue (SARmn)	Net Income (SARmn)
Herfy	**KSA**	**6002**	**50.70**	**3,279**	**16.5**	**1,287**	**199**
Sadafco	KSA	2270	125.20	4,069	18.0	1,888	226
Almarai	KSA	2280	50.00	50,000	26.7	14,036	1,869

Financial Ratios

	2018 A	2019 E	2020 F	2021 F	2022 F	2023 F	2024 F
Return on Average Assets (%)	14.4%	11.1%	10.6%	11.9%	13.2%	14.3%	15.3%
Return on Average Equity (%)	22.7%	20.0%	20.8%	21.3%	21.7%	22.2%	22.6%
Income Before Tax Margin (%)	16.9%	15.2%	16.2%	17.2%	18.2%	19.0%	19.7%
Net Income Margin (%)	16.6%	14.8%	15.8%	16.8%	17.7%	18.5%	19.2%
Revenue Growth (%)	6.0%	5.6%	3.7%	3.2%	2.5%	2.1%	1.8%
DPS	2.1	2.1	2.1	2.2	2.5	3.0	3.5
Payout Ratio	66.5%	70.6%	64.7%	61.1%	64.2%	72.3%	79.7%
EPS	3.2	3.0	3.3	3.6	3.9	4.2	4.4

Income Statement

	2018 A	2019 E	2020 F	2021 F	2022 F	2023 F	2024 F
Revenues	1,227	1,296	1,343	1,386	1,421	1,451	1,477
Cost of revenues	(882)	(905)	(932)	(955)	(974)	(989)	(1,002)
Gross Profit	**345**	**391**	**412**	**431**	**447**	**461**	**475**
SG&A	(136)	(169)	(175)	(178)	(181)	(182)	(184)
Zakat	(4)	(5)	(5)	(6)	(6)	(7)	(7)
Net Income	**204**	**192**	**213**	**233**	**252**	**269**	**284**

Balance Sheet

	2018 A	2019 E	2020 F	2021 F	2022 F	2023 F	2024 F
Current Assets	**339**	**368**	**404**	**424**	**463**	**528**	**601**
Non-Current Assets	1,103	1,655	1,586	1,508	1,426	1,339	1,254
Total Assets	**1,442**	**2,023**	**1,990**	**1,932**	**1,889**	**1,866**	**1,855**
Current Liabilities	299	374	351	318	310	319	327
Non-Current Liabilities	211	661	581	485	392	318	241
Total Equity	**933**	**988**	**1,058**	**1,129**	**1,187**	**1,229**	**1,287**
Total Liabilities and Equity	**1,442**	**2,023**	**1,990**	**1,932**	**1,889**	**1,866**	**1,855**

Guide to Ratings and Disclaimer

Guide to Ratings

Buy	An upside potential of more than 20% in 52-week period
Overweight	An upside Potential of more than 10% in 52-week period
Neutral	Will stay in the range of it value (up/down 10%) in a 52-week period
Underweight	A downside potential of more than 10% in 52-week period
Sell	A downside potential of more than 20% in 52-week period

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