



US\$0.969bn Market cap
51% Free float
US\$0.737mn Avg. daily volume

Target price 68.00 +25% over current
Current price 54.20 as at 31/7/2019

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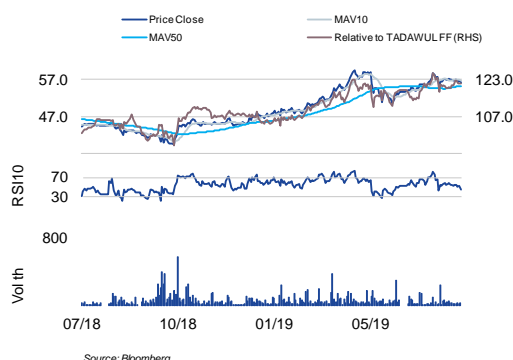
Existing rating

Underweight

Neutral

Overweight

Performance



Earnings

Period End (SAR)	12/17A	12/18A	12/19E	12/20E
Revenue (mn)	1,158	1,227	1,321	1,413
Revenue growth	0.1%	6.0%	7.6%	6.9%
EBITDA (mn)	274	288	300	333
EBITDA growth	-10.4%	5.1%	4.3%	10.8%
EPS	3.1	3.2	3.5	3.9
EPS growth	-8.0%	2.1%	9.8%	13.9%

Source: Company data, Al Rajhi Capital

Herfy Foods

Key beneficiary of shifting consumer behaviour; Reiterate buy

Herfy reported net income of SAR41mn (-11% y-o-y) for Q2 FY19, missing our estimate of SAR51mn and consensus estimate of SAR50mn. The miss in bottom-line was mainly due to higher selling and distribution expenditure (+46%, y-o-y), increase in general and administrative expenses (+15%, y-o-y) and increase in finance costs due to implementation of IFRS16 (Q2 FY18 financials are not reinstated for IFRS 16 and hence are not exactly comparable). More importantly, the top line came in at SAR309mn (+8% y-o-y) in-line with our estimate of SAR311mn. We believe the top line was driven primarily by store expansion and improving LFL growth.

Going forward we expect the company's top line to be driven by continued improvement in LFL growth as the consumer sentiments gradually pick up, improvement in efficiency of the current stores as well as store expansion in new geographies. We are bullish on the long term story of Herfy's even though currently average sales per store is subdued. This is because, normally in a QSR (Quick service restaurant) business model, the yield per store starts improving once the stores mature and capex decreases. There is a shift in the consumer behaviour due to increasing preference of youth (~70% of the total population in Saudi Arabia are below the age of 30) for eating out. Further there are new regulations proposed which would allow retailers to operate for 24 hrs. Both of these factors should have a positive impact on QSRs. Moreover, technology adoption in Saudi Arabia is high (88% smartphone penetration) and the growing number of online food delivery platforms provide an additional opportunity to reach out to a wider audience and increase top-line. We expect LFL growth for the old and new stores to improve going forward due to increasing consumer spending. We maintain "Overweight" rating on Herfy's with a target price of SAR68/sh.

Q2 19 Results: Revenue increased 8% y-o-y to SAR309mn (in line with our estimate of SAR311mn), the growth was likely driven by improving performance from restaurants segment, well supported by growth in meat and bakery business. Growth in Restaurants sales (+8.5%, y-o-y) would have been primarily driven on the back of increase in sales from new restaurants opened in 2018 (25 in 2018), complemented by LFL sales growth (our estimate of +2% y-o-y vs -1.8% y-o-y in Q2 FY 2018). Gross profit grew 12% y-o-y mainly due to increasing top-line and IFRS adjustment. Operating profit rose 2% y-o-y to SAR51mn. However, operating profit margins decreased 200bps due to higher SG&A resulting likely from new store expansion. Due to a subdued operating income and an increase in interest expense due to IFRS 16 the net profit was down 11%, y-o-y.



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Key Growth Drivers

Penetration of online food delivery apps/services gives room for further expansion:

As per Statista, the value of total food delivered online in Saudi Arabia is worth USD 1.1bn and according to the data released by Jahez, a food delivery app having a customer base of ~2mn people, hamburger meals were ordered the most (it consists of ~7.5% of the total food delivered online). The value of food delivered online was USD1.1bn and it is expected to increase by ~26%. Therefore we believe that the penetration of online food delivery will have a positive impact on the overall QSR industry. Herfy is one of the oldest player in hamburger meals and they roll out promotions strategically to capture these online sales. We believe this is expected to create an extra demand for Herfy's apart from store expansion.

Shift in consumer behavior towards value products:

Over the last few years we have seen a shift in consumer buying behavior towards value products mainly because of several structural reforms which took place in the kingdom. Herfy's is a value chain restaurant with strong brand image and geographical presence. The meals offered by the company are one among the cheapest compared to other players. The company is proactive in changing its product mix amidst dynamic market conditions. In future we believe the company has a room to increase product prices by 4-5% and even then it will continue to remain one of the most preferred value restaurants. The company is able to manage the cost because of its backward integration as it is self-sufficient in providing raw materials to its restaurants.

Increasing market share by store expansion:

Herfy's is the largest (in terms of number of restaurants) and one of the oldest hamburger chains in Saudi Arabia. The company has an ambitious plan to expand the number of restaurants by 8-10%. We believe this is a good strategy given that its brand is already well positioned in the market. The LFL growth has become flattish to marginally positive from negative in 2018, therefore with improving LFL and store expansion we project the revenue to grow 8% in 2019e to SAR1.3bn and 7% in 2020e to SAR1.4bn.

Rising preference towards fast food:

As per the market survey conducted by Cint in 2018, it was observed that the percentage of people eating out has increased considerably, this indicates the changing culture among youths to eat outside. Due to limited entertainment options, eating out is one of the mode of entertainment and networking. In our view the new regulations allowing the retailers to operate for 24 hrs. will have a positive impact on the restaurants sector as a whole.

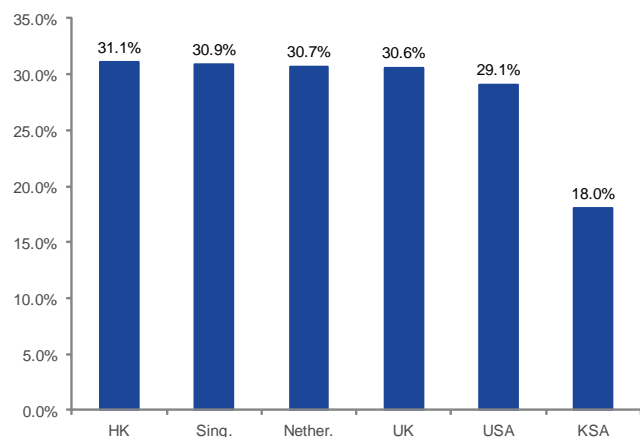
Herfy has the highest market share amongst the local QSR:

Herfy's strategy of store expansion augers well as it helps the company in capturing the market share. The company is planning to add 20 new restaurants in 2019 and 25 new restaurants was added in 2018, the total number of restaurants at the end of 2018 was 369. It is trying to increase its presence by entering into new areas and capturing new market. As on 2018 ~60% of its sales came from central region, 12% from eastern region, Generally it takes anywhere between 6-12 months for a new stores to normalize the operations. Though the increasing number of restaurants will have a negative impact on the SG&A initially but once these new stores matures and overall economy improves we feel that Herfy's margin will stabilize to 18% in 2020e.



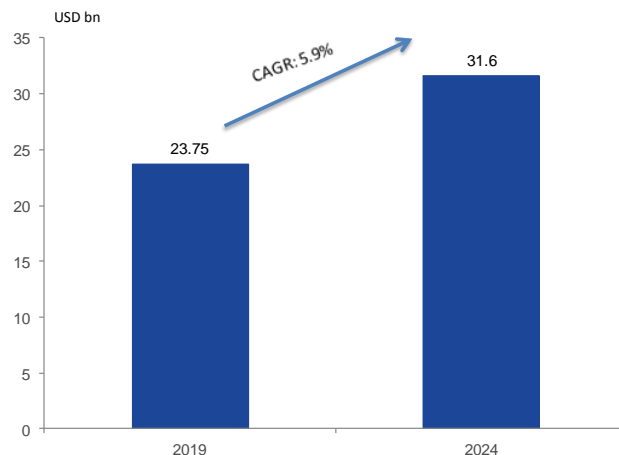
Key Performance Indicators of fast food sector

Figure 1 Global comparison of user penetration in the online food delivery segment



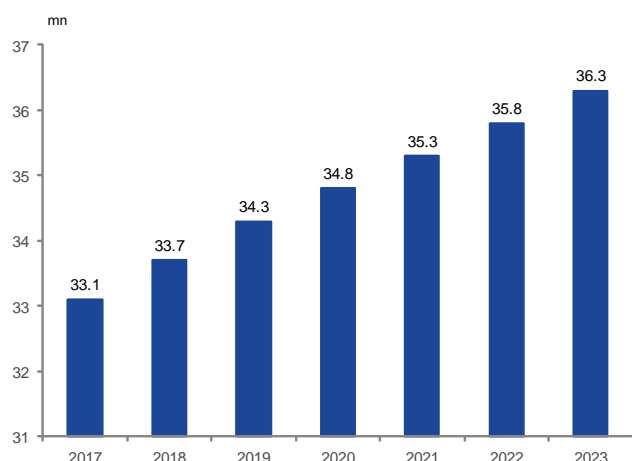
Source: Statista

Figure 2 KSA Food Service Market



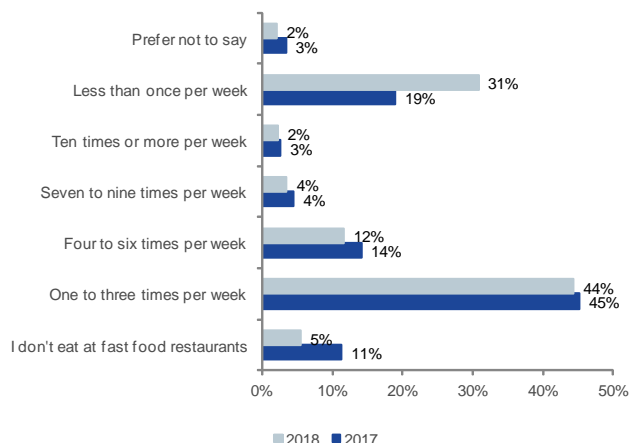
Source: Mordor Intelligence

Figure 3 Saudi Arabia: Population (mn)



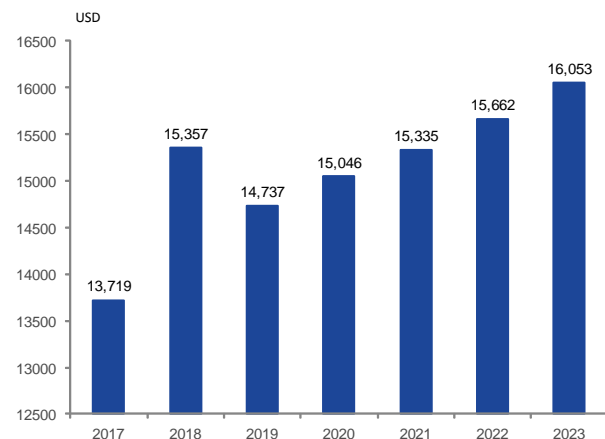
Source: Statista

Figure 4 Saudi Arabia: How often do you eat fast food (any quick service restaurant) in any given week (on average)?



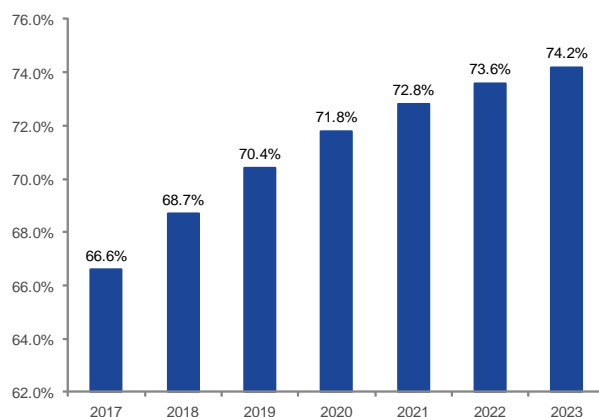
Source: Statista, cint

Figure 5 Saudi Arabia: Consumer Spending per capita (USD)



Source: Statista

Figure 6 Saudi Arabia: Internet Penetration



Source: Statista



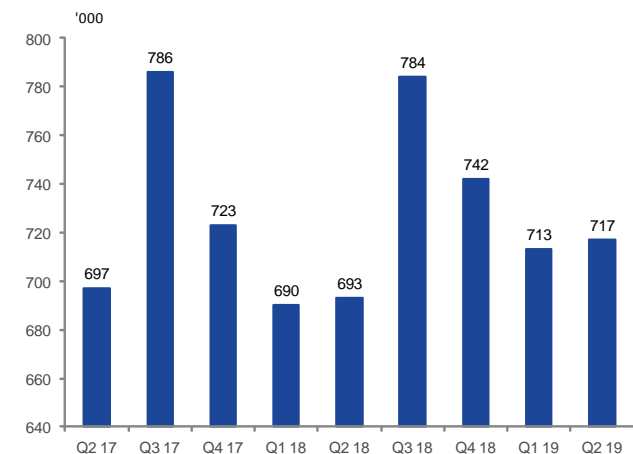
Outlook: Herfy's topline growth of 8% y-o-y looks sustainable given the company's strategy to increase its market share by store expansion and entering into new areas. We expect an improvement in LFL growth on the back of increasing consumer spending on food and beverages. We expect the bottom line growth to pick up due to higher sales and better margins once the impact of finance cost due to IFRS implementation is fully settled. Store expansion (increasing market share) along with LFL growth will remain the key growth driver for the topline. We also expect the bakery business (currently contributes ~10% of the total revenue) to pick up pace and add to the topline as well as bottom-line because bakery is generally a high margin business. Broad based economic recovery and economies of scale should further benefit the company going forward. With a dividend yield of 3.3% the stock looks attractive.

Key Risks:

- As per our calculations the average sales per store after declining in 2017 has again improved in 2018, but the trend is still erratic. So if the stores do not mature as per our expectations then it will have a negative impact on margins
- The company's fixed cost are increasing due to store expansion and hence if the like for like growth doesn't improve as per our expectations then the average revenue per store might further go down having a negative impact on the margins.
- Slower than expected consumer spending and any increase in government levies will have a negative impact on the growth.

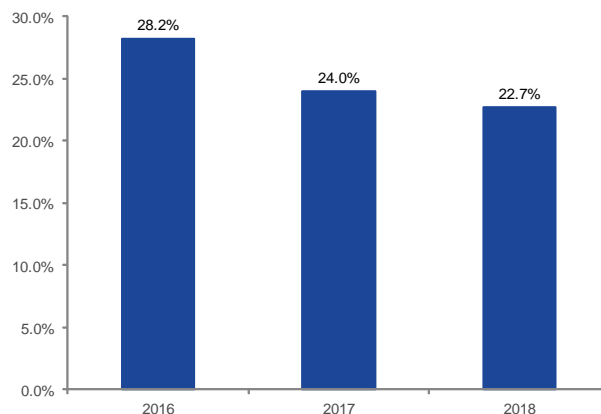


Figure 7 Average sales per store - Herfy (SAR'000)



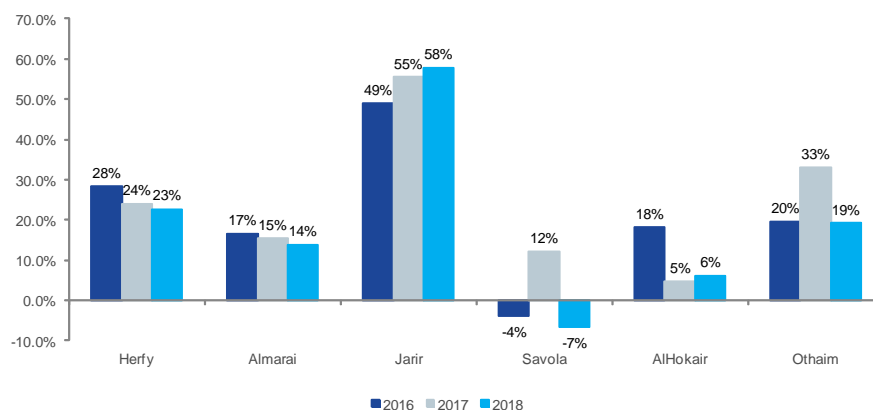
Source: Statista

Figure 8 Though declining, ROE is still healthy



Source: Company data, Al Rajhi Capital

Figure 9 ROE vis-à-vis regional peers (ROE is second best among listed retailers in KSA)



Source: Company data, Al Rajhi Capital

Figure 10 Herfy's Global Peers

Company	Country	Market Cap (USD mn)	PE	EV/EBITDA	EV/Sales	Div. Yield	ROE
Herfy	Saudi Arabia	931	17.5x	13.3	3.5	3.9	21.6
McDonald's	USA	162,134	27.6x	15.8	9.0	2.1	45.4
Wendy's	USA	4,264	29.1x	13.7	4.6	2.0	85.5
Yum! Brands	USA	34,649	36.4x	17.5	7.4	1.4	39.0
Jack in the Box	USA	1,870	16.3x	11.2	3.5	2.2	NA
Popeyes	USA	34,043	27.8x	12.4	5.4	2.6	31.5
McDonald's Japan	Japan	5,996	32.9x	19.0	2.4	0.6	14.1

Source: Bloomberg, Al Rajhi Capital



Valuation: Herfy has a solid payout history, a dividend payout of ~70% over the previous four years (except 2018), thereby implying a dividend yield of ~4% for FY19E. We continue to value Herfy based on equal weights for DCF and P/E based relative valuation. Our DCF based target price is SAR 62 per share, assuming 9% WACC (20% debt in capital structure) and 3% terminal growth. The P/E based relative valuation at 20x FY20 EPS yields a target price of SAR74 per share. The equal weighted target price stands at SAR68 per share, implying a 22% upside from current price. We remain “Overweight” on Herfy.

Figure 11 Summary of Q2 2019 results

SAR mn	Q2 2018	Q1 2019	Q2 2019	y-o-y	q-o-q	ARC est
Revenue	287	313	309	8%	-1%	311
Gross Profit	79	94	88	11%	-6%	86
Gross Margin	28%	30%	28%	3%	-5%	28%
Operating Profit	50	59	51	2%	-14%	55
Net Profit	46	48	41	-11%	-15%	51

Source: Company data, Al Rajhi Capital



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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

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