March 2023

Saudi Company for Hardware (SACO)

Investment Update

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Headwinds faced by SACO to soon reach its apex: a turning point for the firm can be found thereafter. Upgrade to "Overweight" with a revised TP of SAR 33.0/share

SACO was impacted by global supply chain constraints, and hence the long inventory cycle, and in certain cases even stock-outs of imported products. However, freight charges and global shipping costs are seen to be improving. We expect further easing in supply constraints to support revenue growth post H1-23, and the centralization of its distribution centers (DCs) to lower operating expenses. SACO may face near-term headwinds such as rising home acquisition costs, as we foresee inflation to further weigh on consumers' spending power. We do, however, look forward to the new management's turnaround plan to materialize into better growth prospects and improve its financial status. We revised our recommendation to "Overweight" on SACO with a TP of SAR 33.0/share indicating an upside of 19.3% from current levels.

Inventory provisions and impairments resulted in margin contraction imposing further pressure on bottom line for Q4-22: SACO reported a net loss of SAR 77.2mn in Q4-22 due to a decline in sales coupled with incurring expenses related to inventory provisions and impairment of non-financial assets. SACO's revenue fell 1.1% Y/Y (+22.7% Q/Q) to SAR 311.9mn in Q4-22 but was higher than our estimate of SAR 263.1mn. SACO incurred a gross loss of SAR 23.7mn in Q4-22 as the company recorded inventory provisions of c.SAR 31.9mn and impairment expenses of SAR 29.7mn in Q4-22. Adjusting for the one-off expenses, the gross profit stood at c.SAR 37.9mn, implying an adjusted GP margin of 12.1% as compared to our estimate of 6.2%. Adjusted EBIT denotes a loss of SAR 7.4mn and was lower than our estimate of loss of SAR 26.6mn. Adjusting for one-off expenses, SACO incurred a net loss of SAR 15.6mn versus our estimate of loss of SAR 37.9mn. Overall, in FY22, SACO was mainly impacted by supply chain disruptions, warehouse migration and stock unavailability. In addition to these challenges, inventory provision and impairment costs resulted in margin contraction and in turn a negative bottom line. In FY22, SACO's full year adjusted net loss increased to SAR 80.9mn from loss of SAR 28.5mn in FY21.

Recovery expected going forward; however, inflation concerns and low purchasing power to limit revenue growth in near term: SACO faced pressures due to the unprecedented challenges in its supply chain and high freight costs, lower appetence for home improvement products due to slowdown in housing sector, lower basket size due to inflation and reduced discretionary spending. The inability of the company to pass incremental costs to the customers weighed on the GP margins and ultimately on the bottom line. However, in the past few months, the supply chain pressure price indices have depicted improvement and freight costs are seen to be normalizing. However, we note a few factors that are likely to offset the revenue growth; 1) Lower purchasing power in the backdrop of rising inflation 2) Reducing home ownership due to rising mortgage rates, and 3) Alternative discretionary spending avenues like entertainment or tourism. We expect revenue to increase by 10.1% Y/Y and 13.0% Y/Y in FY23E and FY24E due to better availability of products, higher footfall and hence higher average revenue per store.

Strategies by SACO's new management points towards a positive trajectory: SACO's new management set a focus towards a turnaround strategy to improve its product mix and introduce new services. The management has hinted towards improving productivity and efficiency of operations by closing non-profitable stores. SACO has historically opened 1 store per year on average over the last seven years, and currently has a network of 34 stores spread across KSA. The management focuses on attracting footfall by studying market pricing to retain market share so as to be more competitive. Furthermore, SACO is progressing towards providing its products online as well as providing consumer financing services, however, these services are in a nascent stage. Customer footfall witnessed a slight improvement in Q3-22 to 3.3mn from 3.2mn in Q3-21. SACO is improving its store layout and rationalizing the assortment of its products and their range to boost the customer's shopping experience and loyalty program, while expanding its private label brands. This we believe will help to attract customer footfall and improve the conversion rate (33% as of Q3-22)

Recommendation	Overweight
Target Price (SAR)	33.0
Upside / (Downside)*	19.3%

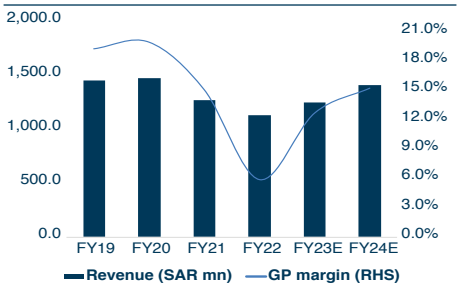
Source: Tadawul *prices as of 21st March 2023

Key Financials

SARmn (unless specified)	FY21	FY22	FY23E	FY24E
Revenue	1,273	1,137	1,251	1,413
Growth %	-14.1%	-10.7%	10.1%	13.0%
Gross Profit	193	68	160	216
Net Profit	-28	-143	-43	15
Growth %	NM	NM	NM	NM
EPS	-0.79	-3.96	-1.20	0.41

Source: Company reports, AlJazira Capital

Revenue (SAR mn) and GP Margin



Source: AlJazira Capital, Company reports

Key Ratios

	FY21	FY22	FY23E	FY24E
GP Margin	15.1%	5.9%	12.8%	15.3%
Net Margin	-2.2%	-12.5%	-3.5%	1.1%
P/E (x)	-65.1	-7.1	-23.3	67.0
P/B (x)	3.3	2.4	2.7	2.6
EV/EBITDA (x)	21.4	157.2	18.1	12.4
Div Yield (%)	0.0%	0.0%	0.0%	0.0%

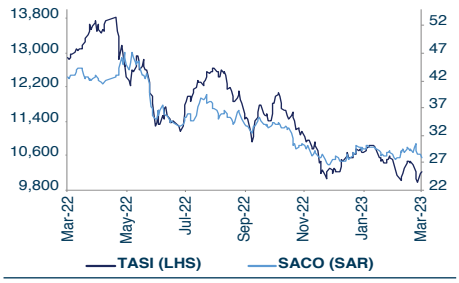
Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (SAR bn)	1.0
YTD %	2.9%
52 Week (High / Low)	47.3/26.6
Shares Outstanding (mn)	36.0

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

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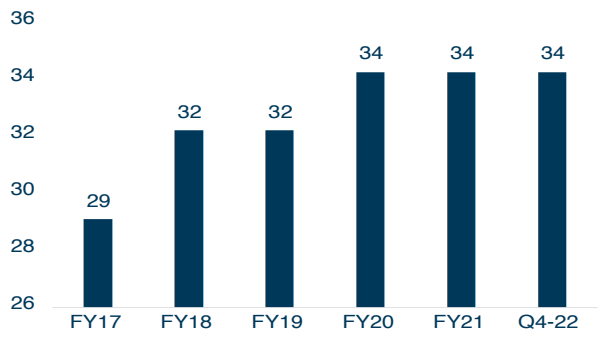
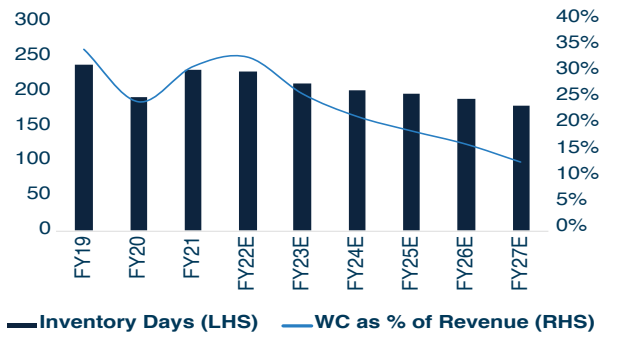
Historical evolution of stores



Source: Company filings, AJC analysis

SACO stores are spread out across KSA, however the roll-out has been gradual historically.

Inventory days vs. working capital as % of revenue



Source: Company filings, AJC analysis

Going forward, working capital position is expected to improve gradually with help of efficient logistical improvements.

Pressure on margins is expected to ease in the near term given the gradual pass through of increased costs to customers: Revenue is expected to increase by 10.1% Y/Y in FY23E. However, inflationary pressures are likely to keep margin expansion limited in the near term. Once the company's DC migration is completed and utilization rate improves, logistics costs will be under control, delivery time will be lower and will ensure quick availability of the products. In the short run, margin expansion will be limited due to the expenses incurred for relocation and development of the DCs. In FY23E, GP margin is expected to improve to 12.8% and post that increase gradually to reach 18.1% in FY25E.

Supply constraints added to longer inventory cycle further resulting in inventory provisioning: SACO's inventory days peaked in FY21 to 233 days due to slower inventory turnover given longer lead times, delayed shipping, and failure to convert the inventory into sales. This has resulted in a higher provisioning charge which weighed on the profit margins. In FY22, the company incurred a provisioning charge of SAR 38.5mn. However, in Q3-22, the inventory situation improved as the inventory balance reduced to SAR 595.6mn from SAR 690.8mn in FY21. Going forward, managing inventory efficiently would be of prime importance for the financial health of the company. This would be ensured by reducing lead times and improving product availability with the help of quick mobilization of inventory from scattered warehouses to centralized DCs. We believe that once both Riyadh and Dammam DC reach optimum utilization rate, it will help improve logistical efficiency in operations.

AJC view and valuation: Improving efficiency in logistics operations given the centralization of distribution centres will be essential in supporting sales and keeping operating expense in control. However, headwinds such as the slow-down in mortgages on account of higher interest rates and inflationary environment, and subdued purchasing power of consumers could limit the growth in the top line in the near term. We expect margins to improve gradually from FY23E on the assumption that the company will be successful in passing the increased cost to customers. Taking into considering the new positive developments in the supply chain situation, and new management's turnaround strategy for FY23, FY24 and FY25, we foresee a gradual recovery in the SACO's business. We forecast the company to report full year profits in FY24, albeit with low margins and expect the margins to improve from FY23 onwards. As of Q3-22, the company's net debt to equity was at 1.3x and cash balance was SAR 18.6mn.

Key upside risks include higher than expected footfall, higher than expected DC utilization rate and higher than expected conversion rate, whereas slower than expected store opening, inability to overcome supply challenges and lower than expected footfall are **key downside risks.**

We value SACO by assigning 50% weight to DCF (2.5% terminal growth and 6.8% average WACC), and 50% weight to EV/EBITDA (14.2x based on FY23E EBITDA). These yield a target price of SAR 33.0/share, implying an upside of 19.3% from the current levels. The current PE based on FY23E EPS is not meaningful given the prospects of negative bottom line. We estimate PE of 16.0x based on our FY25E EPS. We upgrade our recommendation to "**Overweight**" on SACO with a revised TP of **SAR 33.0/share.**

Blended valuation summary

All figures in SAR, unless specified	Fair value	Weights	Weighted average
DCF based value	35.9	50%	15.5
Relative Valuation - EV/EBITDA	30.1	50%	15.1
Weighted average 12-month price target			**33.0**
Current Price (SAR/share)			27.65
Expected Capital Gain			**19.3%**

Key Financial Table

Amount in SAR mn, unless otherwise specified	FY18	FY19	FY20	FY21	FY22E	FY23E	FY24E	FY25E	FY26E
Income statement									
Revenues	1,390	1,458	1,482	1,273	1,137	1,251	1,413	1,539	1,673
Y/Y	**-4.5%**	**4.8%**	**1.6%**	**-14.1%**	**-10.7%**	**10.1%**	**13.0%**	**8.9%**	**8.7%**
Cost of Sales	(1,141)	(1,176)	(1,185)	(1,080)	(1,069)	(1,091)	(1,197)	(1,260)	(1,357)
Gross profit	**250**	**282**	**296**	**193**	**68**	**160**	**216**	**279**	**315**
Selling, general and administrative expenses	(138)	(175)	(162)	(179)	(175)	(172)	(181)	(188)	(193)
Operating profit	**112**	**107**	**134**	**14**	**(108)**	**(13)**	**35**	**90**	**122**
Y/Y	**-25.1%**	**-4.7%**	**25.6%**	**-89.8%**	**-886.7%**	**-88.3%**	**-376.0%**	**159.7%**	**35.2%**
Financial charges	(6)	(38)	(42)	(37)	(34)	(37)	(33)	(33)	(35)
Profit before zakat	**109**	**73**	**97**	**(17)**	**(132)**	**(38)**	**17**	**73**	**101**
Zakat	(12)	(11)	(16)	(12)	(10)	(5)	(3)	(11)	(15)
Net income	**98**	**62**	**80**	**(28)**	**(143)**	**(43)**	**15**	**62**	**86**
Y/Y	**-27.4%**	**-37.0%**	**30.1%**	**-135.5%**	**400.3%**	**-69.7%**	**-134.4%**	**319.8%**	**37.5%**
Balance sheet									
Assets									
Cash & bank balance	16	17	33	15	27	45	83	99	105
Other current assets	776	848	696	762	733	699	731	748	780
Property & Equipment	255	268	301	394	415	430	441	452	461
Other non-current assets	51	630	610	735	808	869	932	980	1,015
Total assets	**1,097**	**1,763**	**1,639**	**1,905**	**1,983**	**2,042**	**2,188**	**2,279**	**2,362**
Liabilities & owners' equity									
Total current liabilities	362	554	402	546	650	662	705	696	672
Total non-current liabilities	100	668	627	803	920	1,010	1,097	1,166	1,230
Paid -up capital	360	360	360	360	360	360	360	360	360
Statutory reserves	10	16	25	25	10	6	7	9	10
Other reserve	1.4	1.4	1.6	2.1	2.1	2.1	2.1	2.1	2.1
Retained earnings	264	164	224	170	41	2	16	45	88
Total owners' equity	635	541	610	556	414	370	385	416	459
Total equity & liabilities	**1,097**	**1,763**	**1,639**	**1,905**	**1,983**	**2,042**	**2,188**	**2,279**	**2,362**
Cashflow statement									
Operating activities	117	133	342	67	11	143	184	233	273
Investing activities	(56)	(57)	(82)	(168)	(80)	(79)	(78)	(76)	(78)
Financing activities	(72)	(75)	(245)	84	80	(47)	(68)	(141)	(189)
Change in cash	(11)	1	15	(17)	12	17	39	16	6
Ending cash balance	**16**	**17**	**33**	**15**	**27**	**45**	**83**	**99**	**105**
Key fundamental ratios									
Liquidity ratios									
Current ratio (x)	2.2	1.6	1.8	1.4	1.2	1.1	1.2	1.2	1.3
Quick ratio (x)	0.3	0.2	0.3	0.2	0.1	0.2	0.2	0.2	0.3
Profitability ratios									
GP Margin	18.0%	19.3%	20.0%	15.1%	5.9%	12.8%	15.3%	18.1%	18.8%
Operating Margins	8.1%	7.3%	9.1%	1.1%	-9.5%	-1.0%	2.5%	5.9%	7.3%
EBITDA margin	11.2%	15.3%	17.3%	10.2%	1.2%	9.8%	12.7%	15.8%	17.2%
Net Margins	7.0%	4.2%	5.4%	-2.2%	-12.5%	-3.5%	1.1%	4.1%	5.1%
Return on assets	9.3%	4.3%	4.7%	-1.6%	-7.3%	-2.1%	0.7%	2.8%	3.7%
Return on equity	16.1%	14.1%	12.7%	-5.5%	-35.1%	-11.8%	4.0%	15.3%	19.0%
Market/valuation ratios									
EV/sales (x)	1.8	1.8	1.8	2.2	1.9	1.7	1.6	1.4	1.3
EV/EBITDA (x)	16.0	12.0	10.6	21.4	156.3	17.9	12.4	9.2	7.7
EPS (SAR)	2.7	1.7	2.2	(0.8)	(4.0)	(1.2)	0.4	1.7	2.4
BVPS (SAR)	248.5	180.7	199.9	171.7	66.5	74.3	71.4	66.1	59.9
Market price (SAR)*	66.2	52.1	58.2	51.5	27.7	27.7	27.7	27.7	27.7
Market-Cap (SAR mn)	2,383.2	1,875.6	2,095.2	1,854.0	995.4	995.4	995.4	995.4	995.4
Dividend yield	2.5%	1.9%	2.1%	0.0%	0.0%	0.0%	3.1%	3.6%	5.4%
P/E ratio (x)	24.3	30.4	26.1	(65.1)	(7.0)	(23.0)	67.0	16.0	11.6
P/BV ratio (x)	3.8	3.5	3.4	3.3	2.4	2.7	2.6	2.4	2.2

Source: Company filings, AlJazira Capital Research
Note: * Updated based on Interim Results

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RESEARCH DIVISION

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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