Almarai Company

Food-Diversified – Industrial
ALMARAI AB: Saudi Arabia
29 January 2018

الراجحي المالية
Al Rajhi Capital

Rating	**NEUTRAL**
Target price	**SAR48.2 (-9.2% upside)**
Current price	**SAR53.1**

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Key themes & implications

We believe Almarai will settle into a lower revenue growth trajectory over the next couple of years due to consumer spending headwinds in KSA. However, the company has many levers for operating margin to sustain at the current levels despite cost pressures. Increasing FCF on the back of lower capex should aid material deleveraging over FY17-20e in our view.

Share information

Market cap (SAR/US$)	53.17bn / 14.18bn
52-week range	52.12 - 77.16
Shares outstanding	1,000.0mn
Free float (est)	36%

Performance	1M	3M	12M
Absolute	-1.9%	-5.5%	-4.2%
Relative to index	-6%	-14.1%	-9.7%

Major Shareholder:

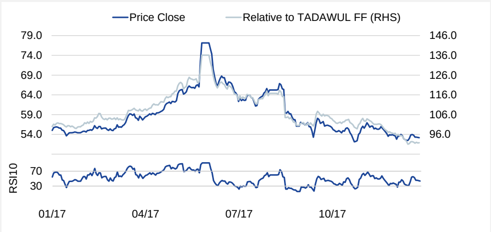
Savola Al-Azizia United Co	34.52%
Al-Saud Sultan Mohamed	23.69%
Public Investment Fund	16.32%

Valuation

Period End (SAR)	12/15A	12/16A	12/17E	12/18E
P/E (x)	27.8	24.8	24.4	23.6
P/B (x)	4.4	4.1	3.7	3.4
EV/EBITDA (x)	16.7	14.5	13.8	13.5
RoE (%)	15.9%	16.5%	15.1%	14.2%

Source: Company data, Al Rajhi Capital

Performance



Source: Bloomberg, Company data, Al Rajhi Capital

Almarai

Revenue/ earnings growth to remain modest

Almarai's Q4 2017 earnings were broadly in-line with estimates except for marginally lower gross margin. Going forward, we expect Almarai to clock modest revenue growth (3.3% CAGR over FY17-20e) due to sustained pressure on consumer spending in KSA, led by factors such as VAT and hike in residential electricity/ gasoline prices. This will partially be mitigated by citizen account program/ cost of living allowance (for 2018) in KSA, continued growth in other GCC countries (excl. Qatar), and Egypt's lower base already baked into 2017 financials. Operating margin is expected to remain flattish – tailwinds from benign agro commodity prices, which remain at historical lows unlike other commodities, and further savings from cost optimization and efficiency program (SAR500mn annualized savings targeted) will be negated by expat levy burden and the need to import 100% of Alfalfa going forward. Start of new central processing plant (efficiency and productivity gains will accrue over the long run), and improved performance in Poultry and Others segment (infant nutrition and international Alfalfa operations) are also margin and earnings drivers. As majority capex is behind, the capex run rate is likely to trend down to SAR2.2-2.3bn going forward, which results in high FCF generation (SAR1.9bn+ each in 2018 and 2019). Apart from deleveraging (expect net debt/ equity to fall to 0.42x by 2020 vs. 0.73x in 2017), we believe increased dividend pay-out (~35% currently) may also be on the cards.

Triggers: (a) Price hikes in milk segment – however near term implementation is unlikely due to high competitive intensity, (b) new revenue streams – HORECA (hotels, restaurants and catering) and frozen poultry brand gaining traction, and (c) pick-up in economic growth improving disposable incomes.

Risks: (a) Increase in diesel and commercial electricity prices going forward, (b) increase in commodity prices and Alfalfa costs starting 2019, and (c) lifting ban on Brazil poultry imports or lowering custom duties on frozen poultry imports.

Valuation: After our underweight call post Q3 2017 results, the stock corrected ~10%. Based on our revised estimates, our Dec-2018 target price stands at SAR48.2/ share (earlier SAR50.1), which is an equal weight of relative valuation (based on 20x FY19 earnings) and DCF (3% terminal growth, 35% debt in capital structure and 7.9% WACC). Due to recent stock price correction, our revised target price represents 9% downside, hence we upgrade the stock to Neutral. Investors should note that Almarai could witness some price action when FTSE and MSCI announce inclusion of Saudi Arabia in their indices.

Period End (SAR)	12/15A	12/16A	12/17A	12/18E	12/19E
Revenue (mn)	13,795	14,339	13,936	14,114	14,690
Revenue Growth	9.4%	3.9%	-2.8%	1.3%	4.1%
Gross profit margin	38.3%	38.5%	40.1%	40.1%	39.9%
EBITDA margin	27.9%	30.9%	33.5%	33.5%	33.2%
Net profit margin	13.9%	15.0%	15.7%	15.9%	16.1%
EPS	1.92	2.15	2.18	2.24	2.37
EPS Growth	14.4%	12.1%	1.6%	2.5%	6.0%
ROE	16.7%	17.1%	15.9%	14.7%	14.3%
ROCE	10.3%	11.1%	11.0%	11.0%	11.1%
Capex/Sales	29.5%	34.2%	23.6%	18.0%	17.0%

Source: Company data, Al Rajhi Capital; **Note:** EPS based on current 1,000 mn shares for all years

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Revenue growth to be tempered

We expect Almarai to clock 3.3% revenue CAGR over FY17-20e. This is mainly to do headwinds to consumer spending in Saudi Arabia. The key headwinds are:

- Sustained pressure on consumer spending over the next few years, led by factors such as VAT and hike in residential electricity/ gasoline prices,
- Decline in population growth due to exit of some expats on the back of nitaqat requirements and higher cost of living (includes dependent levy), and
- Almarai's market share in KSA already reaching 65-70% in the key categories of Milk, Laban and Bread

Apart from citizen account program, the slower consumer spending in KSA is partially mitigated by the cost of living allowance (announced only for 2018). Further, Almarai's revenue growth in other GCC countries (excluding Qatar) is expected to remain healthy and the lower base of Egypt (due to devaluation in Nov 2016) is already baked into 2017 financials, both of which will support Almarai's consolidated revenue growth in 2018.

The other revenue driver in KSA is industry consolidation (e.g. NADEC and Al Safi exploring merger), which will improve pricing discipline and hence drive better revenue and margins.

Figure 1 Summary of revenue assumptions

SAR mn	2015	2016	2017	2018e	2019e
Dairy	7,173	7,403	7,160	7,202	7,428
Fruit Juice	1,931	1,877	1,601	1,573	1,628
Cheese & Butter	1,655	1,681	1,749	1,802	1,838
Bakery	1,655	1,881	1,807	1,789	1,864
Poultry	1,242	1,332	1,464	1,601	1,792
Others	138	165	154	147	139
Total	**13,795**	**14,338**	**13,935**	**14,114**	**14,690**
% y-o-y	*9.4%*	*3.9%*	*-2.8%*	*1.3%*	*4.1%*

Source: Al Rajhi Capital

Margins likely to be maintained despite cost pressures

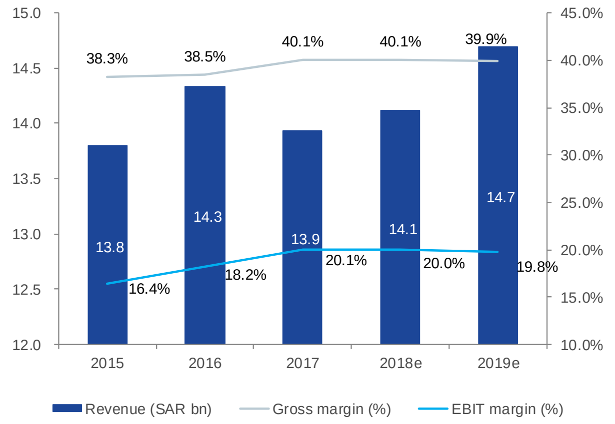
With slower revenue growth and increasing cost pressures (expat levy, likely increase in electricity and diesel prices in the next few years, higher alfalfa costs and possible uptrend in commodity prices), operating margin will be under pressure in a normal scenario.

However, we believe Almarai's operating profitability is unlikely to be materially impacted (expect just 50bps EBIT margin decline over FY17-20e) due to:

- Commodity prices esp. agro commodities continuing to remain at historical lows, while Alfalfa costs increased only marginally,
- Poultry profitability expected to improve further, and losses from infant nutrition and international Alfalfa ops are expected to decline,
- Start of new central processing plant (CPP3), the benefits of which will start to reflect as the production ramps up, and
- Further gains from cost optimization program (Almarai reported SAR300mn savings in 2017 from the cost optimization and efficiency program)

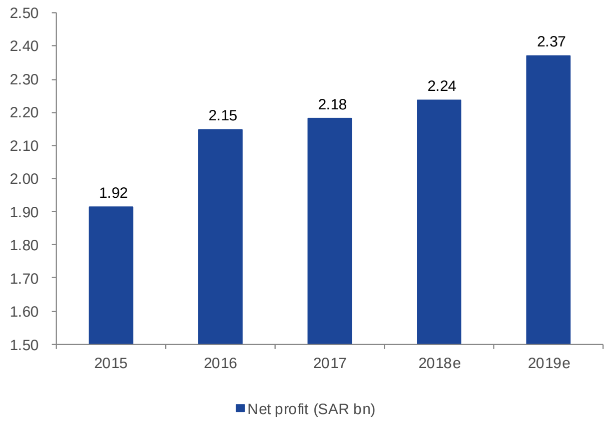
The key risk to our assumption is a quick rebound in agro commodity and Alfalfa prices.

Figure 2 Margins expected to be broadly maintained



Source: Al Rajhi Capital

Figure 3 Earnings track modest revenue growth



Source: Al Rajhi Capital

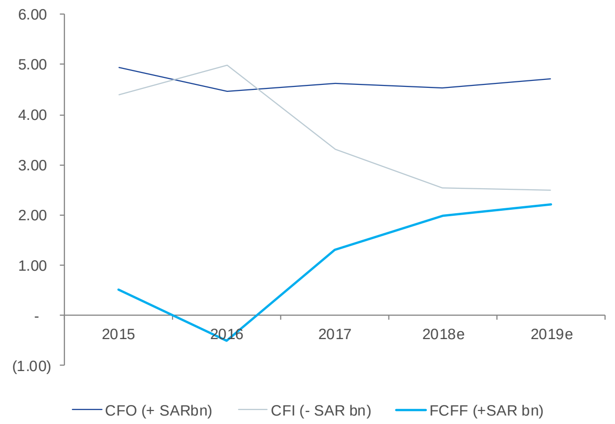
Lower capex and higher FCFs to aid deleveraging

Almarai's capex stood at SAR18bn over the last 5 years (FY13-17), implying average capex run rate of SAR3.6 p.a. However, as majority of expansion plans are behind, the capex run rate is expected to fall to SAR2.2-2.3bn p.a. over the next few years. This includes maintenance capex for existing infrastructure and some growth capex for international footprint expansion.

Higher FCFs will help Almarai deleverage, we expect net debt/ equity to trend down to 0.42x by 2020 from 0.73x at the end of 2017. Lower growth capex requirement also presents the possibility of dividend pay-out being increased.

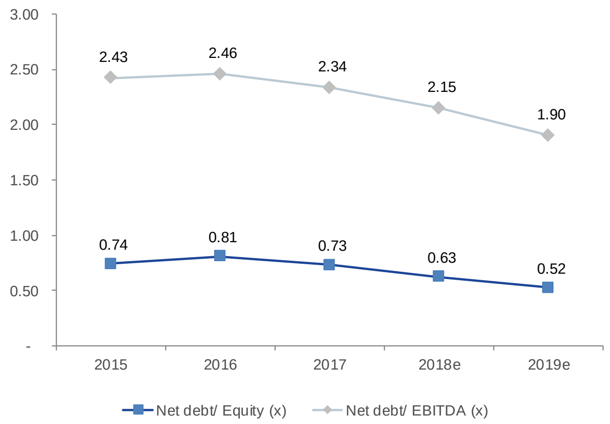
Deleveraging will be another earnings driven over the next few years as interest cost will decrease from SAR401mn in FY17 to SAR351mn in FY20 by our estimates.

Figure 4 FCFF set to improve…



Source: Al Rajhi Capital

Figure 5 … aiding deleveraging



Source: Al Rajhi Capital

Valuation and outlook

We continue to value Almarai assuming equal weights for relative valuation and DCF. Our P/E based target price stands at SAR47.4/ share, valued at 20x FY19e earnings. We maintain our target multiple, though aggressive in light of 14-15% RoE and just ~5% earnings CAGR over FY17-20e, due to high revenue visibility/ defensive nature of business, and growth opportunities over the long term.

Our DCF based target price stands at SAR49.0/ share, based on 7.9% WACC (we assume 35% debt in capital structure) and 3% terminal growth rate.

Figure 6 Sensitivity of equal weighted TP to DCF (WACC %) and P/E (multiple)

		Target P/E Multiple (x)					
		17.0	18.0	19.0	**20.0**	21.0	22.0
WACC (%)	5.9%	66.0	67.2	68.4	69.6	70.8	71.9
	6.9%	52.6	53.8	55.0	56.2	57.3	58.5
	7.9%	44.7	45.9	47.0	**48.2**	49.4	50.6
	8.9%	39.4	40.6	41.8	43.0	44.2	45.4
	9.9%	35.7	36.9	38.1	39.3	40.5	41.7

Source: Al Rajhi Capital

The equal weighted target price stands at SAR48.2/ share, which implies 9% downside from the current price.

Figure 7 Equal weighted TP (SAR/ sh)

Method	Valuation	Weight	ARC Target
FCFF plus terminal growth	49.0	50%	24.5
Relative	47.4	50%	23.7
ARC PT			**48.2**
CMP			53.1
% upside			**-9.2%**

Source: Al Rajhi Capital

Due to ~10% stock price correction post Q3 2017 results, we upgrade the stock to Neutral from Underweight earlier. Due to muted growth prospects, we believe the stock will undergo time correction over the next few quarters. However, the stock price may see some action when FTSE and MSCI announce their decisions to include Saudi Arabia in their indexes. As such, any deep corrections (10%+ from current price) will be buying opportunities for long term investors in our view.

Income Statement (SARmn)	12/15A	12/16A	12/17A	12/18E	12/19E
Revenue	**13,795**	**14,339**	**13,936**	**14,114**	**14,690**
Cost of Goods Sold	(8,511)	(8,816)	(8,352)	(8,456)	(8,831)
Gross Profit	**5,283**	**5,522**	**5,584**	**5,658**	**5,858**
Government Charges					
S.G. & A. Costs	(3,021)	(2,913)	(2,789)	(2,834)	(2,947)
Operating EBIT	**2,262**	**2,609**	**2,794**	**2,824**	**2,911**
Cash Operating Costs	(9,945)	(9,913)	(9,272)	(9,391)	(9,817)
EBITDA	3,850	4,426	4,664	4,722	4,873
Depreciation and Amortisation	(1,588)	(1,817)	(1,870)	(1,898)	(1,961)
Operating Profit	**2,262**	**2,609**	**2,794**	**2,824**	**2,911**
Net financing income/(costs)	(313)	(338)	(388)	(402)	(367)
Forex and Related Gains	46	45	7	5	5
Provisions	-	-	-	-	-
Other Income	-	-	-	-	-
Other Expenses	(131)	(91)	(211)	(130)	(110)
Net Profit Before Taxes	**1,864**	**2,224**	**2,202**	**2,297**	**2,440**
Taxes	(66)	(74)	(42)	(69)	(73)
Minority Interests	117	(2)	22	10	5
Net profit	**1,916**	**2,148**	**2,182**	**2,238**	**2,371**
Dividends	(690)	(720)	(750)	(850)	(950)
Transfer to Capital Reserve	-	-	-	-	-

	12/15A	12/16A	12/17A	12/18E	12/19E
Adjusted Shares Out (mn)	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0
CFPS (SAR)	3.39	3.97	4.03	4.13	4.33
EPS (SAR)	1.92	2.15	2.18	2.24	2.37
DPS (SAR)	0.69	0.72	0.75	0.85	0.95

Growth	12/15A	12/16A	12/17A	12/18E	12/19E
Revenue Growth	9.4%	3.9%	-2.8%	1.3%	4.1%
Gross Profit Growth	15.0%	4.5%	1.1%	1.3%	3.5%
EBITDA Growth	11.5%	15.0%	5.4%	1.3%	3.2%
Operating Profit Growth	13.2%	15.3%	7.1%	1.1%	3.1%
Net Profit Growth	14.4%	12.1%	1.6%	2.5%	6.0%
EPS Growth	14.4%	12.1%	1.6%	2.5%	6.0%

Margins	12/15A	12/16A	12/17A	12/18E	12/19E
Gross profit margin	38.3%	38.5%	40.1%	40.1%	39.9%
EBITDA margin	27.9%	30.9%	33.5%	33.5%	33.2%
Operating Margin	16.4%	18.2%	20.1%	20.0%	19.8%
Pretax profit margin	13.5%	15.5%	15.8%	16.3%	16.6%
Net profit margin	13.9%	15.0%	15.7%	15.9%	16.1%

Other Ratios	12/15A	12/16A	12/17A	12/18E	12/19E
ROCE	10.3%	11.1%	11.0%	11.0%	11.1%
ROIC	10.9%	11.6%	11.4%	10.7%	10.8%
ROE	16.7%	17.1%	15.9%	14.7%	14.3%
Effective Tax Rate	3.5%	3.3%	1.9%	3.0%	3.0%
Capex/Sales	29.5%	34.2%	23.6%	18.0%	17.0%
Dividend Payout Ratio	36.0%	33.5%	34.4%	38.0%	40.1%

Valuation Measures	12/15A	12/16A	12/17A	12/18E	12/19E
P/E (x)	27.8	24.8	24.4	23.8	22.4
P/CF (x)	15.7	13.4	13.2	12.9	12.3
P/B (x)	4.4	4.1	3.7	3.3	3.1
EV/Sales (x)	4.7	4.6	4.7	4.6	4.3
EV/EBITDA (x)	16.9	14.9	14.0	13.7	13.1
EV/EBIT (x)	28.7	25.2	23.4	22.9	21.9
EV/IC (x)	3.0	2.7	2.6	2.5	2.4
Dividend Yield	1.3%	1.4%	1.4%	1.6%	1.8%

Source: Company data, Al Rajhi Capital

Balance Sheet (SARmn)	12/15A	12/16A	12/17A	12/18E	12/19E
Cash and Cash Equivalents	2,039	730	1,892	1,568	1,508
Current Receivables	1,281	1,406	1,712	1,738	1,772
Inventories	2,836	3,169	3,122	3,129	3,223
Other current assets	3	5	97	101	106
Total Current Assets	**6,155**	**5,305**	**6,813**	**6,527**	**6,600**
Fixed Assets	19,924	22,431	23,685	24,327	24,863
Investments	198	199	220	220	220
Goodwill	1,009	931	1,047	1,047	1,047
Other Intangible Assets	11	10	17	17	17
Total Other Assets	74	147	114	146	150
Total Non-current Assets	**21,216**	**23,718**	**25,083**	**25,757**	**26,297**
Total Assets	**27,371**	**29,023**	**31,896**	**32,283**	**32,897**
Short Term Debt	2,039	1,484	2,259	2,259	2,259
Trade Payables	2,730	3,207	3,227	3,246	3,342
Dividends Payable	-	-	-	-	-
Other Current Liabilities	37	102	285	299	314
Total Current Liabilities	**4,807**	**4,793**	**5,771**	**5,804**	**5,915**
Long-Term Debt	9,343	10,135	10,543	9,489	8,540
Other LT Payables	-	-	-	-	-
Provisions	603	638	700	721	752
Total Non-current Liabilities	**9,946**	**10,773**	**11,244**	**10,210**	**9,292**
Minority interests	560	421	397	387	382
Paid-up share capital	6,000	8,000	10,000	10,000	10,000
Total Reserves	6,058	5,036	4,484	5,882	7,309
Total Shareholders' Equity	**12,058**	**13,036**	**14,484**	**15,882**	**17,309**
Total Equity	**12,618**	**13,457**	**14,881**	**16,269**	**17,690**
Total Liabilities & Shareholders' Equity	**27,371**	**29,023**	**31,896**	**32,283**	**32,897**

Ratios	12/15A	12/16A	12/17A	12/18E	12/19E
Net Debt (SARmn)	9,340	10,885	10,901	10,170	9,281
Net Debt/EBITDA (x)	2.43	2.46	2.34	2.15	1.90
Net Debt to Equity	74.0%	80.9%	73.3%	62.5%	52.5%
EBITDA Interest Cover (x)	12.3	13.1	12.0	11.7	13.3
BVPS (SAR)	12.06	13.04	14.48	15.88	17.31

Cashflow Statement (SARmn)	12/15A	12/16A	12/17A	12/18E	12/19E
Net Income before Tax & Minority Interest	**1,864**	**2,224**	**2,202**	**2,297**	**2,440**
Depreciation & Amortisation	1,588	1,817	1,870	1,898	1,961
Decrease in Working Capital	1,016	(28)	(185)	(5)	(23)
Other Operating Cashflow	227	407	817	347	340
Cashflow from Operations	**4,694**	**4,420**	**4,704**	**4,537**	**4,718**
Capital Expenditure	(4,073)	(4,910)	(3,287)	(2,540)	(2,497)
New Investments	(18)	-	(25)	-	-
Others	(318)	(71)	1	-	-
Cashflow from investing activities	**(4,409)**	**(4,981)**	**(3,310)**	**(2,540)**	**(2,497)**
Net Operating Cashflow	**285**	**(561)**	**1,393**	**1,997**	**2,221**
Dividends paid to ordinary shareholders	(599)	(688)	(718)	(850)	(950)
Proceeds from issue of shares	-	-	-	-	-
Increase in Loans	1,837	352	1,105	(1,054)	(949)
Effects of Exchange Rates on Cash	(13)	(31)	9	-	-
Other Financing Cashflow	(507)	(381)	(628)	(416)	(382)
Cashflow from financing activities	**719**	**(748)**	**(232)**	**(2,320)**	**(2,281)**
Total cash generated	1,004	(1,309)	1,162	(324)	(60)
Cash at beginning of period	797	2,039	730	1,892	1,568
Implied cash at end of year	**1,801**	**730**	**1,891**	**1,568**	**1,508**

Ratios	12/15A	12/16A	12/17A	12/18E	12/19E
Capex/Sales	29.5%	34.2%	23.6%	18.0%	17.0%

Source: Company data, Al Rajhi Capital

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

"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.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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