Initiation of Coverage Report

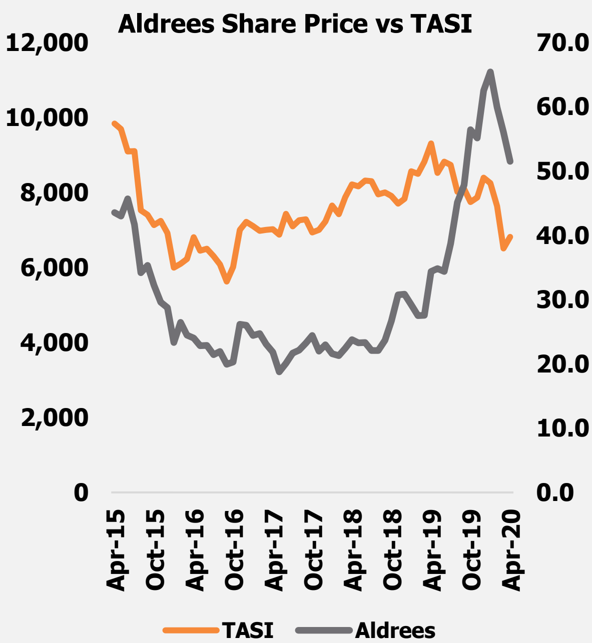
Aldrees Petroleum and Transport Services Co.

Aldrees reported a fourfold increase in net income during 2019 thanks to adjusted profit margins and strong revenue growth. However, we expect weaker performance going forward on the back of lower gasoline prices and intensifying competition.

28 April 2020

Recommendation	Neutral
Current Price (27-04-2020)	SAR55.4
Target Price (52 Weeks)	SAR58.0
Upside/ (Downside)	4.7%
Shariah Compliance	Pass

Reuters Code	4200.SE
Bloomberg Code	ALDREES: AB
52 Weeks High	SAR67.5
52 Weeks Low	SAR31.7
Market Cap	SAR3.3bn
P/E (TTM)	11.4
EPS (TTM)	4.9
Last Dividend	SAR1.5
AVG Value Traded	SAR394.7mn



Key Points

We start our coverage for Aldrees with a NEUTRAL recommendation and 52 weeks target price at SAR58.0; this represents an upside potential of 4.7%.

- Aldrees is the market leader in a highly fragmented fuel retail market in Saudi Arabia with 482 gas stations across the Kingdom. The company operates through two main divisions; petroleum, where it sells petrol 91, petrol 95, and diesel, and transport, which provides transportation and logistics services (mainly to the chemicals industry).

- During 2019, The Ministry of Energy approved the rise in petrol profit margins for gas stations; this represent a long-awaited lifeline for Aldrees which witnessed its profits reeling for the past three years.

- Aldrees reported strong revenue growth of 9.7% during 2019 thanks to higher gasoline prices during the year and rise in diesel sales quantities. The company applied the new profit margins impact on its financials retrospectively in 2019, which sent the net income soaring by 336.1% Y-o-Y. Aldrees partly regained its historical profit margins to record a 4-year high net margin of 5.1%.

- However, Aldrees' strong performance in 2019 is unlikely to be sustained during 2020 as the company is receiving a double hit from lower gasoline prices coupled with lower quantity amid social distancing measures and lower economic activity. The key growth catalysts for the company during 2019 (higher petrol prices and higher diesel demand) are now missing. On the longer term, Aldrees is facing intensifying competition from oil giants including Aramco, ADNOC, and ENOC, which jeopardizes its station yields. On the other hand, new profit margins and stations renovation should support the company's profitability going forward.

Key Growth Catalysts

- Approved rise in petrol profit margins
- Expansion and renovation of gas stations network

Key Risk Factors

- Drop in gasoline prices
- Slower economic activity to pressure diesel and transport sales
- Increased competition

Company Overview

Aldrees Establishment

- Aldrees Petroleum and Transport Services Co. is the largest petroleum retailer in Saudi Arabia, operating 482 gas stations in the Kingdom. The company also offers car wash and maintenance services within its gas stations network. Aldrees leads the gas stations sector in the Kingdom with 5% market share in terms of number of stations, followed by Sahel (3%), and Naft & SASCO (2% each). Aldrees' sales quantities account for around 10% of total quantities sold in the Saudi market.

- Aldrees purchases petroleum products from Aramco, being the sole distributor to Saudi Arabi's petrol stations, and resells them to retail customers within its stations as well as to government institutions and companies. The company sells petrol 91, petrol 95, and diesel.

- Aldrees was established in 1962 as a Saudi limited partnership company under the name Mohamed Saad Aldrees & Sons Co before it was officially renamed in 2004. The company was listed on Tadawul stock exchange in 2005 with a startup market cap of SAR200mn. The company later increased its capital three times over the years, through granting bonus shares, reaching SAR600mn in March 2019.

Aldrees's Revenue at Glimpse

Aldrees's revenue is derived from two main divisions: petroleum and transport.

- The petroleum segment accounts for the majority of Aldrees's revenue representing 94.2% of revenue during 2019. The segment includes petrol sales and miscellaneous car services. During 2019, Aldrees sold more than 4 billion liters of petroleum products. Revenue from the petroleum division recorded SAR5,350mn during 2019, reflecting 8.5% Y-o-Y growth. Aldrees's petrol sales revenue is significantly vulnerable to changes in domestic gasoline prices, which are impacted by two main factors: changes in oil prices and subsidy cuts. During 2016 and 2018, Aldrees's petroleum revenue soared by 59.1% and 53.0%, respectively, despite the fall in sales quantities, following energy price reforms in December 2015 and January 2018.

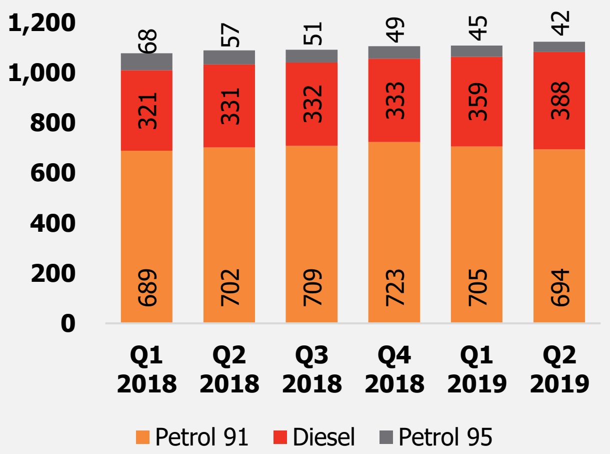
- The transport division accounts for around 6.0% of sales including a transport and logistics fleet encompassing more than 3,600 trucks and trailers, carrying around 189k tons per week. Aldrees mainly transports chemicals, oil & gas products, and foodstuff. Its key clients include Aramco, SABIC, Nadec, and Yamama Cement, to mention a few. Transport sales posted SAR331mn during 2019; 20.0% growth compared to 2018.

Key Shareholders

Name	Ownership (%)
Hamad Mohamed Saad Aldrees	3.76%
Free Float	96.24%

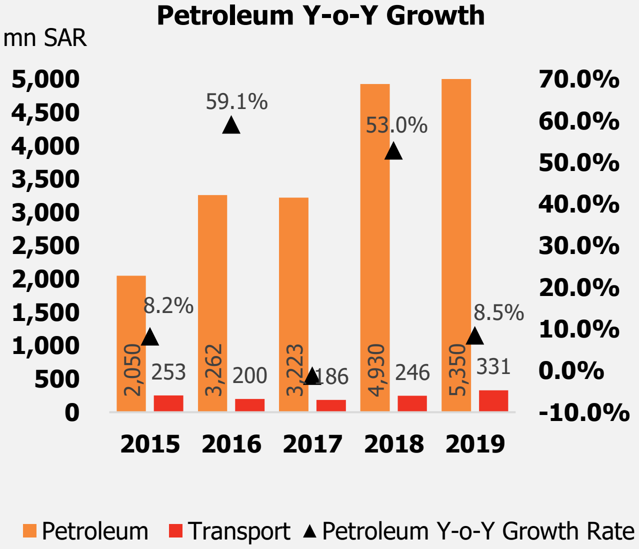
Source: Tadawul

Aldrees Petrol Sales Quantities (Million Liters)



Source: Aldrees investor presentation

Aldrees Revenue Segmentation & Petroleum Y-o-Y Growth



Source: Company Financials, Itqan Capital calculations

Company Analysis

Key Growth Catalysts

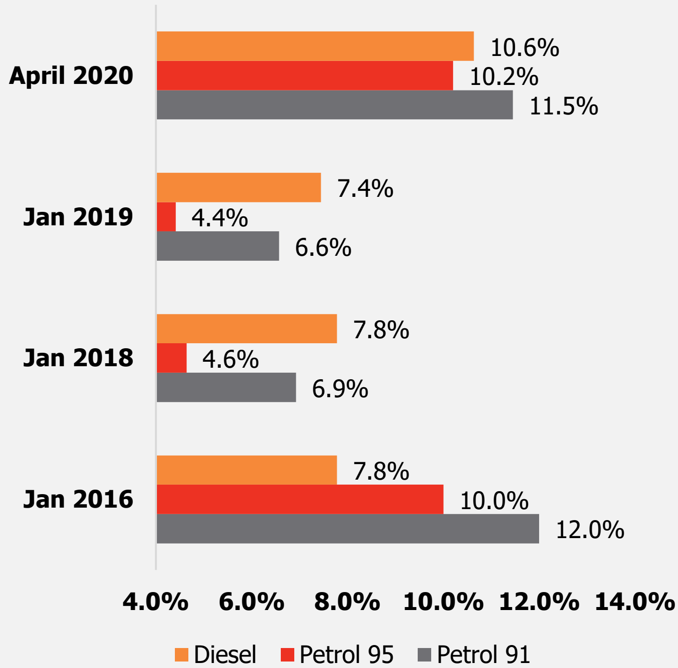
Approved Rise in Petrol Profit Margins

- In October 2019, the Ministry of Energy approved increasing profit margins of fuel stations, which are qualified by the Ministry of Municipal and Rural Affairs (MOMRA). Petrol profit margins were hiked to SAR0.15 from SAR0.09 per liter, and diesel margins to SAR0.05 from SAR0.035 per liter. During February 2020, Aldrees announced that it started reserving the required quantities from Saudi Aramco with the new profit margin.

- Since 2016, when the first wave of energy price reforms was introduced and petrol prices surged by 50% for petrol 95 and 67% for petrol 91, Aldrees's petroleum gross margins slumped to 4.3% in 2016 from 7.2% in 2015. In 2018, following the second price reform, gross margins dropped further to a historic low of 3.4%. The company has been struggling ever since in recovering to its historic profit margins. Approval of rise in profit margin represents a long-awaited lifeline for Aldrees' declining margins.

- As a result of the retrospective profit margins adjustment, Aldrees' net profit surged by more than 300% Y-o-Y as SAR200mn of costs are lifted from COGS during 2019. New margins are expected to support the company's profitability amid the challenging days ahead.

Profit Margin by Fuel Type



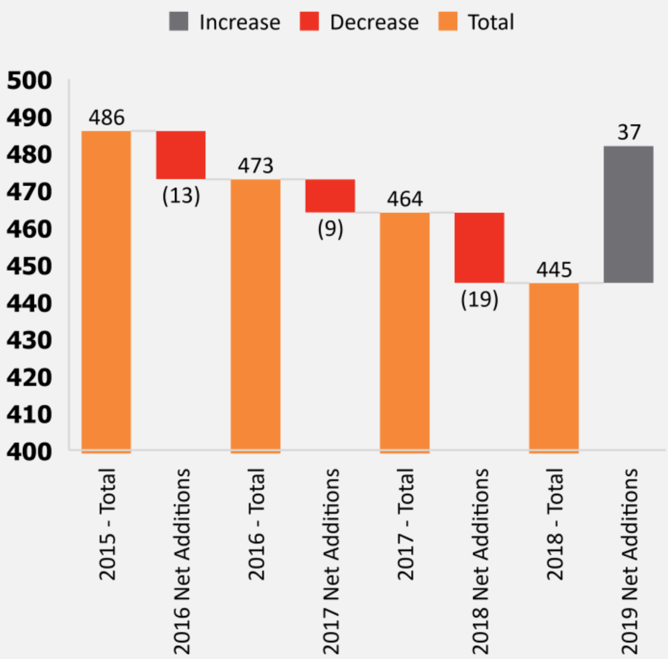
Source: Aldrees investor presentation, Itqan Capital calculations

Expansion and Renovation of Gas Stations Network

- For the past three years, Aldrees temporarily stopped the operations of some stations for renovation, which reduced the number of operating stations. Aldrees announced that it has completed the renovation of 270 stations and is expected to renovate addition 148 stations by 2020. In 2019, the company continued to renovate old stations along with opening new stations, bringing the number of operating stations back to its FY2015 levels.

- Over the past three years, total quantity sold witnessed a slowdown as a result of lower number of operating stations, while total revenue was mainly supported by the rise in gasoline prices. Currently, Aldrees' number of stations are back to FY2015 levels, which is set to support the rise in total sales quantities and total revenue on the long term. In such a highly regulated industry with preset gasoline prices, strong geographical presence and high service quality are some of the few tools available for differentiation. Aldrees successfully addressed both issues during 2019, enabling it to maintain its market share and profitability.

Aldrees Number of Gas Stations (year end)



Source: Aldrees annual report

Company Analysis

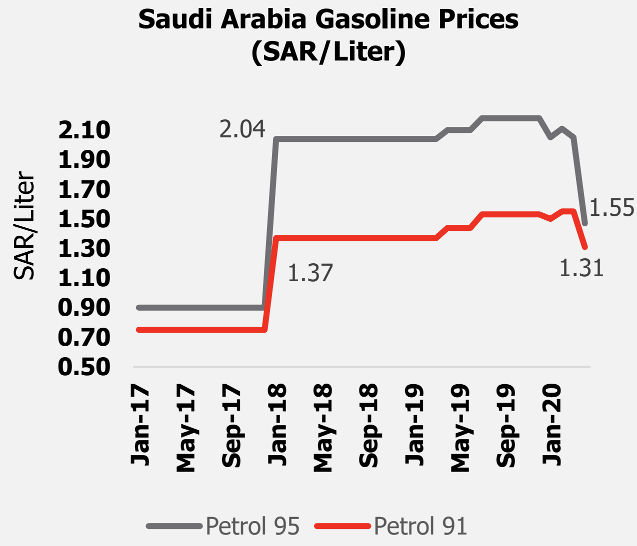
Key Risk Factors

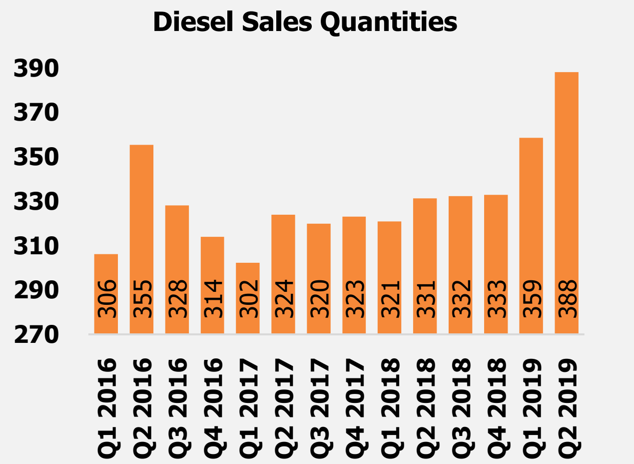
Drop in Gasoline Prices

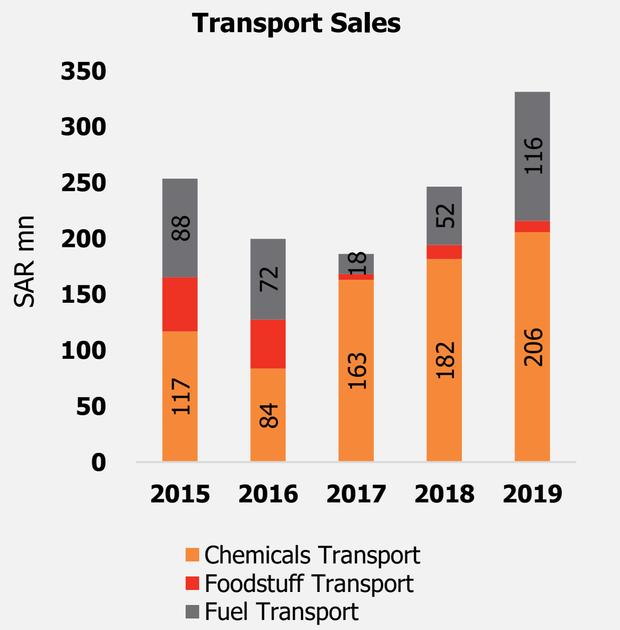
- Since February 2020, the Kingdom announced that petrol prices are updated on monthly basis instead of quarterly basis, making gas prices more volatile. Gas prices in the Kingdom decreased in tandem with the recent slump in oil prices (-60% YTD) with petrol 91 currently selling at a three-year low of SAR1.31/liter compared to SAR1.55/liter in March 2020.
- According to the latest update by the US Energy Information Administration (EIA), Brent oil prices are forecast to average $33/barrel during 2020 (2019 average: $64/barrel) and $45/barrel in 2021. Aldrees' petrol selling prices are expected to remain relatively low during the coming period. May petrol prices are expected to be even lower compared to April 2020 as export oil prices were further slashed during the previous month.
- It is worth mentioning that growth in Aldrees' petrol 91 and petrol 95 revenues during 2019 was mainly price-led rather than volume-led. Petrol 91 and petrol 95 prices increased by 12% and 7%, respectively in 2019 compared to 2018. In fact, petrol sales quantities slowed down by almost 2% in H12019. Aldrees will be experiencing a drop in Y-o-Y gasoline prices for the first time.
- During 2020, Aldrees' revenues are expected to lack the support of higher gas prices, with sales quantities remaining under pressure from increased competition and curfew measures. We anticipate a considerable drop in Aldrees' revenues during 2020, and particularly Q2 2020, on the back of lower gasoline prices and lower sales quantities during Q2 2020. The company already acknowledged a drop in petroleum segment revenues by more than 40% mid-March as a result of lower traffic.

Slower Economic Activity to Pressure Diesel and Transport Sales

- Aldrees' transport segment revenues reportedly declined by more than 16% in Mid-March due to the government's precautionary measures to curb the spread of COVID-19. Around 62% of Aldrees' transport revenues are from chemicals transport, while 35% from fuel transport. Demand for chemicals is likely to be hit by the outbreak of COVID-19 amid economic slowdown. Lower demand is expected to take a toll on Aldrees' transport division during 2020.
- Similarly, diesel sales (which were a key growth diver for Aldrees during 2019 thanks to higher demand during the year) are expected to slow down during H1 2019 on the back of lower trucks transportation as well as public transportation.
- COVID-19 is delivering a double hit for the Saudi economy, with the collapse of oil prices coupled with the economic repercussions of COVID-19 on demand. In the event of a prolonged recession, demand for transport and diesel will be significantly pressured on the longer term as well.







Company Analysis

Increased Competition

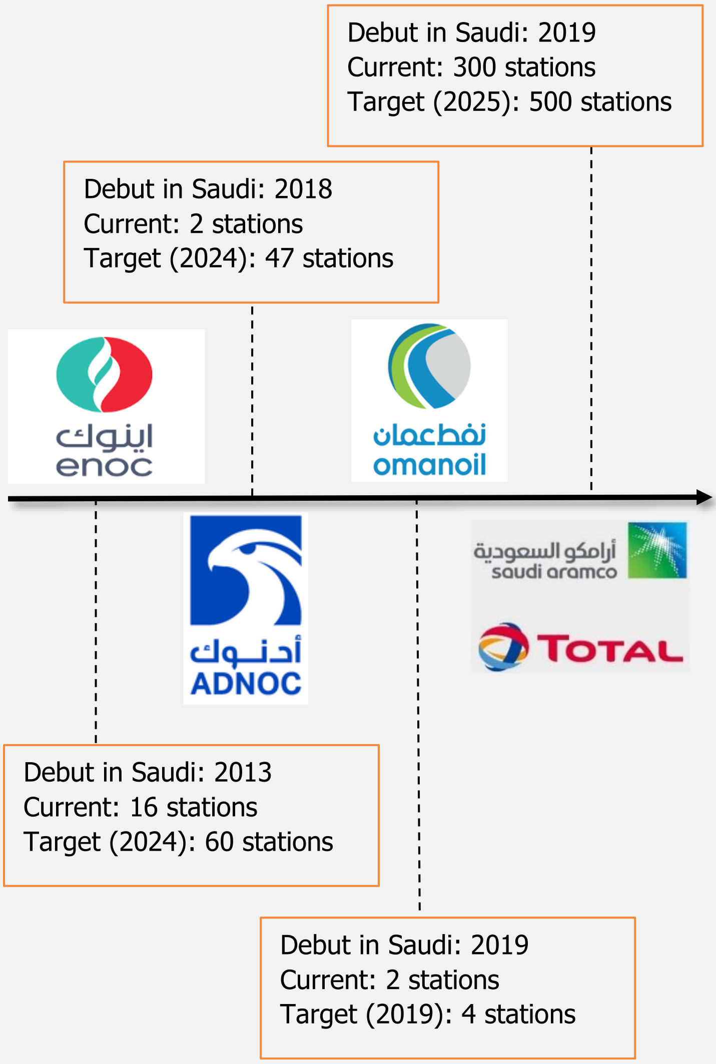
- The fuel stations market in the Kingdom is witnessing increased investment by both national firms and foreign players in light of the Kingdom's focus on the development of the oil & gas downstream sector. Such competition is expected to intensify over the next years given government support and as competitors are seeking expansion of their retail network in the Kingdom.

- In February 2019, Total and Aramco announced the formation of a 50/50 joint venture to invest around $1bn to develop a network of retail fuel service stations in Saudi Arabia. The two companies also signed an acquisition agreement with Tas'helat Marketing Company (TMC) including the acquisition of the company's existing 270 service stations in the Kingdom. It is worth mentioning that Tas'helat Marketing Company was only second to Aldrees in terms of market share. The combined experience of two oil giants, coupled with Aramco's cost advantages (being the source of crude oil production in the Kingdom) poses significant risk for Aldrees's competitiveness and market leadership on the long term.

- In addition, other foreign players recently entered the Saudi market including ADNOC and Oman Oil Marketing, in addition to ENOC's ambitious expansion plans in the Kingdom. Abu Dhabi National Oil Company (ADNOC), the state-owned oil company of the UAE, and Oman Oil Marketing expanded their footprint to Saudi Arabia in 2018 and 2019, respectively, by opening two stations each. In addition to market penetration by foreign competition, new local competitors are entering the market with two operators recently granted the license in Febrto operate gas stations in the Kingdom: Aljeri Transportation Co and Al-Nour United Est.

- Increased competition poses considerable risks to Aldrees's station yields, especially during a time when fuel demand is expected to remain weak. Although Aldrees took measures to maintain its competitiveness such as renovation of stations, its long-term market position remains jeopardized by the high quality service offered by new market entrants.

Competitors Key Highlights



Source: Total investor presentation, companies' annual reports, companies' press releases

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Company Analysis

Financial Results

- Aldrees reported strong top-line growth in 2019, and more evidently in H2 2019, supported by the Y-o-Y rise in petrol prices, strong growth in transport division, increase in diesel sales quantities, and increase in number of stations in Q4 2019. Aldrees' revenues grew by 9.7% Y-o-Y in 2019. Revenues recorded SAR5,681mn compared to SAR5,177 in 2018, with petroleum revenues accounting for 94.2% of sales.

- Aldrees applied new profits margins retrospectively in 2019 annual results, which was reflected in the significant rise in the company's gross margin from 4.9% in 2018 to 8.1% in 2019. Such gross margin represents a four-year high (the highest since 2015). Gross profit surged by 82.5%, mainly thanks to the retrospective application of new profit margins and to a lesser extent due to strong revenue growth in H2 2019.

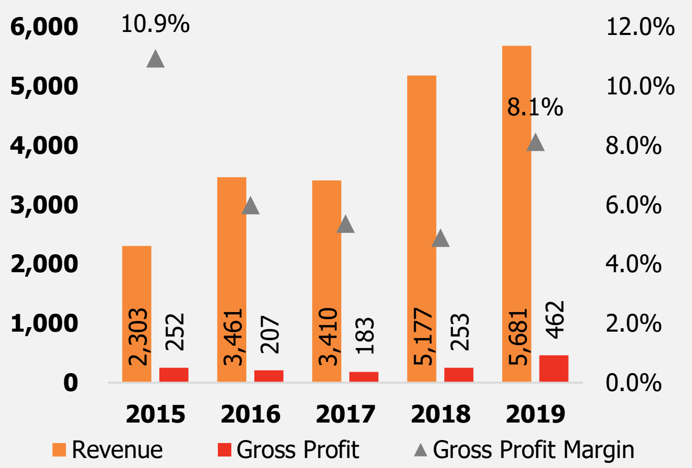
- Gross profit growth filtered to EBIT, which hiked by 113.0% Y-o-Y in 2019, recording SAR314mn compared to SAR147mn in 2018. EBIT margins expanded to 5.5% from 2.8% in 2018.

- Aldrees recorded one-off income of SAR83mn in Q4 2019, accounting for the impact of increasing profit margins for the period from August 2018 until December 2018. The one-off income accounts for almost 30% of Aldrees' net income in 2019. On the other hand, the company recognized one-off expense of SAR17mn as a provision for contingent liabilities[1].

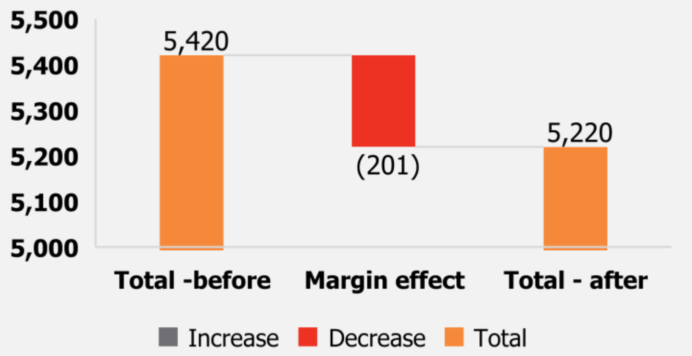
- As a result of the retrospective application of the impact of profit margins and recognition of other income, coupled with strong top-line growth, Aldrees' net income soared by 336.1%. The company posted net income of SAR292mn in 2019 compared to SAR67mn in 2018. Adjusting for the impact of one-off income and expenses, Aldrees' net income would have stood at SAR226mn.

- Aldrees posted net margin of 5.1% compared to only 1.3% in 2018. Adjusting for the impact of one-off income and expenses, Aldrees' net margin would have stood at 4.0%. EPS surged to SAR4.9/share compared to only SAR1.1/share in 2018. Adjusting for one-off income and expense, EPS would have stood at SAR3.8/share. As a result, Aldrees announced an all-time high dividend per share of SAR1.5, reflecting a dividend payout ratio of 30.8%. Aldrees announced the net financial impact of profit margins to be SAR215mn (accounting for 96% of net income growth during 2019.

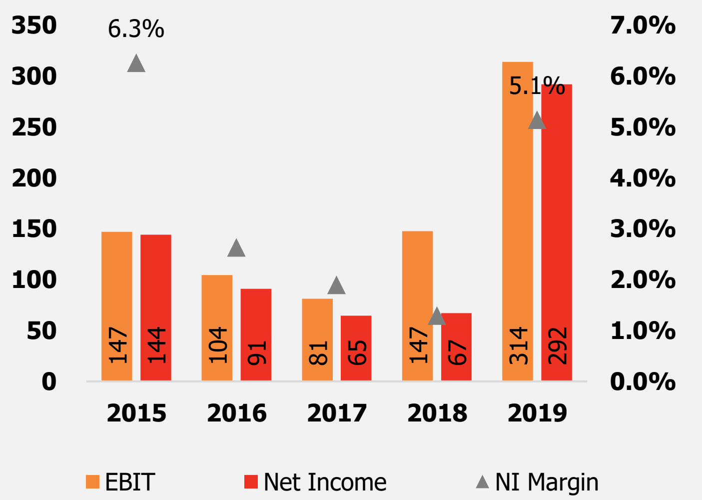
Revenue, GP, & GP Margin



Impact of New Margins on Cost of Sales



EBIT,Net Income, NI Margin



[1] Aldrees recorded a provision for potential liabilities against any liabilities that may arise on the company in line with the company's recognition of the impact of increasing profit margin from fuel.

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Valuation Rationale

DCF Valuation

	2020 F	2021 F	2022 F	2023 F	2024 F
EBITDA	401	578	614	646	678
Operating CF	100	366	365	385	404
Capex	(144)	(163)	(172)	(180)	(188)
FCFF	(45)	203	192	205	216
Stub Period (FCF to be discounted)	(45)	203	192	205	216
PV (FCFF)	(42)	179	158	155	150

WACC	6.1%
Perpetuity Growth	2.0%
PV-FCFF	600
PV-TV	3,289
Net Debt	(368)
Less: End of services benefits	(66)
Add: Investment	27
Intrinsic Value	3,482
Shares Outstanding (mn shares)	60
Equity value per share (SAR)	58.0
CMP (27/04/2020)	55.4
Upside / Downside (%)	4.7%

We valued Aldrees using DCF approach, considering a WACC is equal to 6.1% (based on a risk-free rate of 4.4%, market risk premium 7.3%, Beta of 0.62).

Based on the DCF valuation, the fair price of Aldrees share price is SAR58, which is higher than the traded value by 4.7%.

Regional Peers

Regional Peers	Country	Code	Market Price (SR)	Market Cap (SRMN)	P/E	Sales (SRMN)	Net Income (SRMN)
Aldrees Petroleum and Transport Services Co.	KSA	4200	55.4	3,324	11.4	5,681	292
Saudi Automotive Services Co. (SASCO)	KSA	4050	25.0	1,500	12.3	2,483	122
Aramco	KSA	2222	30.8	6,160,000	18.6	1,105,696	330,693
Abu Dhabi National Oil Company for Distribution (ADNOC	UAE	ADNOCDIST.AD	2.9	35,700	15.8	21,764	2,262
Abu Dhabi National Energy Co (TAQA)	UAE	TAQA.AD	0.6	3,898	3.2	17,940	1,228
Oman Oil Marketing Company (OOMCO)	Oman	OOMS.MSM	7.0	453	8.3	5,697	55
Qatar Fuel Company (WOQOOD)	Qatar	QFLS.QA	16.5	16,385	12.6	23,120	1,296
Al Maha Petroleum	Oman	MHAS.MSM	6.6	458	13.8	4,547	33

Valuation Rational

Financial Ratios

	2018 A	2019 A	2020 F	2021 F	2022 E	2023 F	2024 F
Return on Average Assets (%)	1.9%	8.3%	0.6%	6.3%	7.5%	8.8%	10.1%
Return on Average Equity (%)	10.5%	38.4%	2.6%	22.7%	22.1%	21.5%	21.2%
Income Before Zakat Margin (%)	1.3%	5.4%	0.6%	4.0%	4.4%	4.9%	5.3%
Net Income Margin (%)	1.3%	5.1%	0.5%	3.8%	4.3%	4.7%	5.1%
Revenue Growth (%)	51.8%	9.7%	-27.6%	32.0%	5.8%	4.6%	4.4%
DPS	0.83	1.5	0.0	0.8	1.5	2.0	2.0
Payout Ratio	74.7%	30.8%	0.0%	23.3%	36.7%	42.6%	37.7%

Income Statement

	2018A	2019 A	2020 F	2021 F	2022 E	2023 F	2024 F
Revenues	5,177	5,681	4,116	5,432	5,749	6,015	6,283
Cost of revenues	(4,924)	(5,220)	(3,875)	(5,013)	(5,289)	(5,521)	(5,752)
Gross Profit	253	462	241	419	460	495	531
SG&A	(106)	(148)	(144)	(142)	(150)	(157)	(164)
Zakat	(2)	(16)	(4)	(9)	(10)	(12)	(13)
Other income, net	3	68	3	3	3	3	3
Net Income	**67**	**292**	**22**	**206**	**245**	**281**	**319**

Balance Sheet

	2018A	2019 A	2020 F	2021 F	2022 E	2023 F	2024 F
Current Assets	679	735	570	697	727	776	832
Non-Current Assets	2,753	2,851	2,690	2,596	2,503	2,409	2,316
Total Assets	**3,431**	**3,585**	**3,260**	**3,293**	**3,230**	**3,186**	**3,148**
Current Liabilities	1,261	1,160	1,087	1,084	1,001	973	961
Non-Current Liabilities	1,527	1,550	1,367	1,197	1,019	811	587
Total Equity	**643**	**875**	**807**	**1,013**	**1,210**	**1,402**	**1,600**
Total Liabilities and Equity	**3,431**	**3,585**	**3,260**	**3,293**	**3,230**	**3,186**	**3,148**

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

Itqan Capital

The HQBP Tower, Corniche Road, Al Shatea District,
PO Box 8021, Jeddah 21482,
Kingdom of Saudi Arabia
Tel: 966 12 510 6030
Fax: 966 12 510 6033
info@itqancapital.com
www.itqancapital.com

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