AlDrees Petroleum
Oil and Gas – Industrial
ALDREES AB: Saudi Arabia
20 August 2020

الراجحي المالية
Al Rajhi Capital

US$0.971bn	100%	US$4.911mn
Market cap	Free float	Avg. daily volume

Target price	79.00	+23% over current
Current price	64.00	as at 19/8/2020

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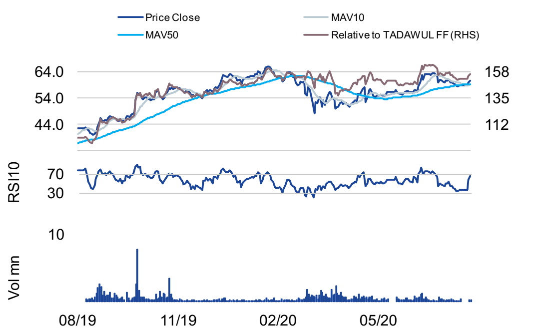
Rating

Underweight	Neutral	Overweight

Performance



Earnings

(SARmn)	2019	2020E	2021E
Revenue	5,681	4,594	6,433
Y-o-Y	9.7%	-19.1%	40.0%
Gross profit	462	331	443
Gross margin	8.1%	7.2%	6.9%
EBITDA	619	502	580
EBITDA margin	10.9%	10.9%	9.0%
Net profit	292	101	153
Y-o-Y	336.0%	-65.2%	50.8%
Net margin	5.1%	2.2%	2.4%
EPS (SAR)	4.86	1.69	2.55
P/E (Curr)	13.0x	37.3x	24.7x
P/E (Target)	16.0x	46.1x	30.6x

Source: Company data, Al Rajhi Capital

Aldrees Petroleum

Market share gains from Industry Consolidation; Initiate with TP of SAR79/sh

We initiate coverage on Aldrees with a target price of SAR79/sh based on equal weights given to DCF (SAR86/sh), EV/EBITDA (SAR92/sh), and PE (SAR59/sh) based relative valuation. Aldrees is the market leader in a fragmented fuel stations market with ~5% market share in terms of the number of fuel stations operated (491 stations as on Q2 2020). Aldrees is set to gain market share after the increase in fuel margins to licensed players in 2019 (retrospectively implemented from August 2018). The margin hike was the much-needed relief for the fuel industry which was struggling for many years. Since only 20 licensed players are qualified for the new margins we are expecting a strong consolidation in the sector driven by organic as well as inorganic growth of the organized players. Aldrees intends to capitalize on this by aggressively opening 250 additional stations over the next five years. Significant growth of non-fuel revenue and modest growth of the high margin transportation sector could further boost the profitability of the company. Post the implementation of new margins, the ROCE of Aldrees has improved from 10% in 2018 to 38% in 2019. With an upside of ~23% from CMP, the stock is trading at an attractive valuation factoring in the future growth potential of the overall fuel sector.

Aggressive expansion plan to drive fuel segment revenue: Aldrees intends to expand 250 stations over the next 5 years to its existing network of stations. The company has recently modernized its existing stations and renovated many old stations over 2016-2020e. This has improved the footfall in its stations recently. We expect that with improving throughput per existing station and contribution from new stations the overall revenue of the company will grow at a CAGR of 15% from 2020e to 2025e to reach SAR~9.2bn.

Fuel demand to rebound strongly next year: We expect the fuel volumes to pick-up gradually towards the end of the year. In Q2 2020 the volumes were impacted due to lockdown implemented in the kingdom. However, once the economic activities, schools, and offices are back to normalcy we expect the demand to pick up. Further, in the absence of international tourism options, we expect local traveling to nearby cities in private vehicles to increase thereby driving the fuel demand.

Robust business model with strong return metrics: Address cash conversion cycle is very low driven by a very higher inventory turnover ratio and a month's credit period it receives from Saudi Aramco. This means that the working capital isn't tied up for a longer period of time and requires minimal financial leverage. As a result, the company generates sufficient cash flows to fund its future capex plan with minimal debt requirements. We expect the EBITDA to grow at a CAGR of 17% from SAR435mn in 2020e to SAR975mn in 2025e. The company's ROCE and ROIC have improved significantly from 10% and 12% respectively in 2018 to 38% and 22% in 2019. We expect the company to reinvest future cash flows and maintain a similar range of return on capital.

Increasing non-fuel revenue to improve the FCF and overall margins: Aldrees leases the space in its stations to leading F&B outlets and retail, the company plans to maximize returns by improving the occupancy rates to leading players which will improve the cash flow of the company and overall net margins. This will also help the company in improving the footfall thereby supporting the fuel business. In the transportation segment, the company transports chemicals, grains, and other stuffs and has long term contracts. Being a higher margin business the growth in transport segment revenue will improve the profitability of the company.

Dividend payout ratio can increase amid solid cash flow generation: We expect Aldrees to increase the payout ratio in the future as the company's business model generates sufficient FCF to fund the capex plans. We expect the payout ratio to be 30% in 2021e, 50% in 2020e and increase to 60% by 2024e. The company provides a solid growth prospect as a well stable dividend for the coming few years and looks extremely attractive at current levels.

Attractive Valuation at current levels: We value Aldrees with equal weight given to DCF, EV/EBITDA and PE based relative valuation. Our DCF target price based on 1% terminal growth and 8.5% WACC is SAR85, EV/EBITDA based on 13.3x (average EV/EBITDA of regional peers) FY 2022E EBITDA is SAR92 and PE based on relative valuation based on 18x FY 2022E EPS is SAR59 thus equal-weighted target price stands at SAR79/sh which implies 23% upside from CMP of SAR64/sh. The stock looks extremely attractive at current levels considering the future growth and dividend potential. We initiate on Aldrees with a "Buy" recommendation.

Valuations

Figure 1 Summary of DCF Valuation

DCF Valuation Model	2020e	2021e	2022e	2023e	2024e	2025e
Years to forecast	**0.36**	**1.36**	**2.36**	**3.36**	**4.37**	**5.37**
(In SAR 'mn)						
Pre-tax operating profit	187	259	352	446	546	626
Tax rate	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Post-tax operating profit	**169**	**233**	**317**	**401**	**491**	**564**
Add: Depreciation & amortisation	315	321	327	334	341	349
Less: Change in working capital	146	(116)	71	(17)	(18)	(13)
Less: Capex	(195)	(81)	(84)	(88)	(91)	(118)
Less: Lease payment	(246)	(242)	(238)	(234)	(232)	(197)
Free Cash Flow to Firm	**189**	**115**	**394**	**395**	**490**	**584**
Discount factor	0.97	0.90	0.83	0.77	0.71	0.66
PV of Free Cash Flows	183	104	328	305	349	385
Sum of present values of FCFs	**1,654**					
Terminal value	8,349					
WACC	8.1%					
Terminal Growth rate	1.0%					
Enterprise Value	**7,160**					
Value of associates and non-core assets	7					
Less:						
Net debt	(2,029)					
Minorities	-					
Appraised value of the equity	**5,137**					
No of shares (mn)	60					
Fair value per share (SAR)	**85.6**					

Source:Al Rajhi Capital

Figure 2 Sensitivity of DCF Price to terminal growth rate and WACC

		Terminal Growth Rate					
		0.50%	**0.75%**	**1.00%**	**1.25%**	**1.50%**	**1.75%**
WACC	7.6%	87.9	91.6	95.5	99.8	104.4	109.4
	7.8%	83.4	86.8	90.4	94.3	98.5	103.1
	8.1%	79.1	82.3	**85.6**	89.2	93.1	97.3
	8.3%	75.2	78.1	81.2	84.5	88.1	91.9
	8.6%	71.5	74.2	77.0	80.1	83.4	86.9

Source: Al Rajhi Capital

Key Assumptions

Figure 3 Fuel Segment

(SAR '000)	2018	2019	2020e	2021e	2022e
No. of Stations	445	482	522	562	602
Throughput per station (L)	9,611	10,206	9,696	12,604	13,078
Total fuel volume (L)	4,363,466	4,730,461	4,867,221	6,831,561	7,611,261
Diesel (L)	1,318,509	1,613,729	1,660,383	2,330,489	2,627,605
Petrol91 (L)	2,820,274	2,942,517	3,027,587	4,249,477	4,699,984
Petrol 95 (L)	224,683	174,215	179,252	251,595	283,671
Average capex per new station	NM	40,863	500	500	500
Average rent per new station	574	586	650	650	650

Source: Company data, Al Rajhi Capital

Figure 4 Transport Segment

(SAR '000)	2018	2019	2020e	2021e	2022e
No of trucks	1,283	1,283	1,283	1,283	1,283
No of trailers	2,437	2,437	2,437	2,437	2,437
Average revenue per fleet	58	75	50	80	85

Source: Company data, Al Rajhi Capital

Figure 5 Capex

(SAR '000)	2018	2019	2020e	2021e	2022e
Fuel segment	113,804	122,590	94,942	50,677	54,075
Transport segment	10,878	0	100,000	30,000	30,000

Source: Company data, Al Rajhi Capital

-Total fuel revenue is a function of throughput per station and average number of stations during the year. We have increased the throughput per station by 30% in 2021e as we expect a sharp rebound after a dip of 5% in 2020e. Post 2021e we have assumed a modest increase of 5% in the throughput per station.

-We have assumed selling prices of diesel as follows: SAR0.47/litre, petrol 91 SAR1.32/litres, petrol 95 SAR1.06/litres for our forecast. (Please note fuel prices are revised now every month but gross margins are fixed)

-The gross margins for fuel segment is calculated based on volumes as the margins remains fixed at SAR0.15/litre for petrol 91 and 95 and SAR0.05/litres for diesel.

-Average capex for building a new station is assumed to be SAR500,000 and rental per new station is SAR650,000.

-Company has guided for 50 stations each year till 2024e but for our calcualtions we have assumed net addition to be 40 stations per year as we expect company to close a few.

-In transportation segment company is doing a heavy capex in 2020e as they intend to replace 100 old trucks with new ones we expect going forward the capex in transport segment will be more of maintenance.

-The overall capex in 2020e is expected to be around SAR200mn as per the company's guidance and we have taken SAR195mn capex in 2020e for our calculations.

-For valuation we have taken an equal mix of DCF, EV/EBITDA and PE to value the company, the EV/EBITDA multiple of 13.3 is taken based on average of regional peers.

Key Financials

Figure 6 Income Statement (SAR mn)

	2019	2020E	2021E
Revenue	**5,681**	**4,594**	**6,433**
Revenue growth%		-19.1%	40.0%
COGS	(5,220)	(4,263)	(5,990)
Gross Income	**462**	**331**	**443**
Gross Income growth (%)		-28.2%	33.6%
Gross margin (%)	8.1%	7.2%	6.9%
SGA	(148)	(144)	(184)
EBITDA	**619**	**502**	**580**
EBITDA Growth		-18.9%	15.5%
EBITDA Margin	10.9%	10.9%	9.0%
Operating Income	**314**	**187**	**259**
EBIT Growth		-40.3%	38.1%
EBIT margin	5.5%	4.1%	4.0%
Financing Expenses	(74)	(78)	(93)
Income from Affiliate	1	1	1
Investment Income and others	68	2	3
Net Income Before Zakat	**308**	**113**	**170**
Tax (Zakat)	(16)	(11)	(17)
Net Income	**292**	**101**	**153**
Growth (%)		-65.2%	50.8%
Net margin (%)	5.1%	2.2%	2.4%
EPS (SAR)	4.86	1.69	2.55

Source: Company data, Al Rajhi Capital

Figure 7 Cash flow (SAR mn)

	2019	2020E	2021E
Cash flow from operations	526	561	357
Cash flow from investing	(149)	(205)	(91)
Cashflow from financing	(324)	(314)	(287)
Change in cash	52	42	(21)

Source: Company data, Al Rajhi Capital

Figure 8 Balance Sheet (SAR mn)

	2019	2020E	2021E
Cash & Cash Equivalents	98	141	119
Accounts Receivable	390	441	617
Inventory	72	58	82
Other	174	174	174
Total Current Assets	**735**	**813**	**992**
Non Current Assets			
Fixed Assets	2,833	2,937	2,922
Investment	6	7	8
Other	12	15	16
Total Non-Current Assets	**2,851**	**2,958**	**2,945**
Total Assets	**3,585**	**3,772**	**3,937**
Current Liabilities			
Short Term Debt	625	625	625
Accounts Payable	226	409	492
Others	309	309	309
Total Current Liabilities	**1,160**	**1,343**	**1,427**
Non-current liabilities			
Long Term Debt	1,484	1,554	1,529
Other	66	66	66
Total Non-current liabilities	**1,550**	**1,620**	**1,595**
Total Liabilities	**2,710**	**2,963**	**3,022**
Shareholders' Equity			
Paid-up Capital	600	600	600
Statutory Reserve	66	66	66
Retained Earnings	209	143	250
Total Shareholders' Equity	**875**	**808**	**915**
Total Liabilities & Shareholder Equity	**3,585**	**3,772**	**3,937**

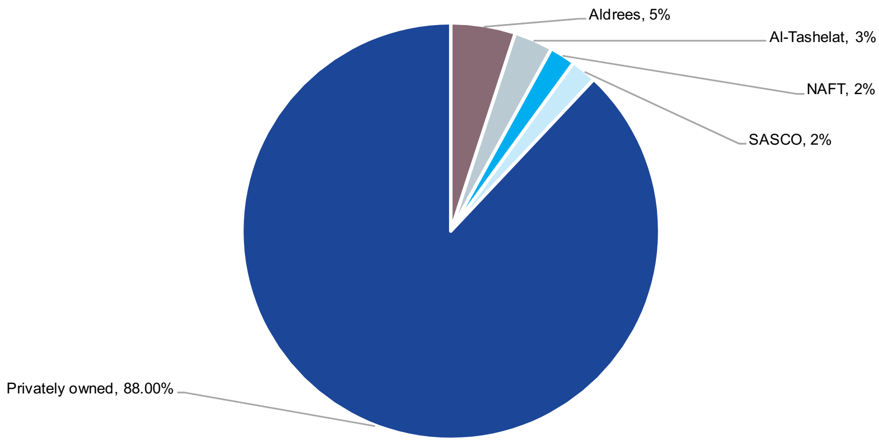
Source: Company data, Al Rajhi Capital

Overview of KSA Fuel Market

Fragmented market with strong consolidation opportunities

The fuel market in Saudi Arabia is highly fragmented with over 10,000 fuel stations. The top four players are having a combined market share of ~12% while the unorganized players hold the remaining. Aldrees is a market leader with ~5% market share and 491 stations (at the end of Q2 2020) other top players are Al-Tashelat 3%, NAFT 3% and SASCO 3%. Normally a fuel station consists of convenience stores, F&B outlets, car service stations and car accessories shops. These value-added services contribute directly to the bottom-line of the fuel stations and enhance the return metrics.

Figure 9 Gas station market share (Q2 2020)



Source: Company data, Al Rajhi Capital

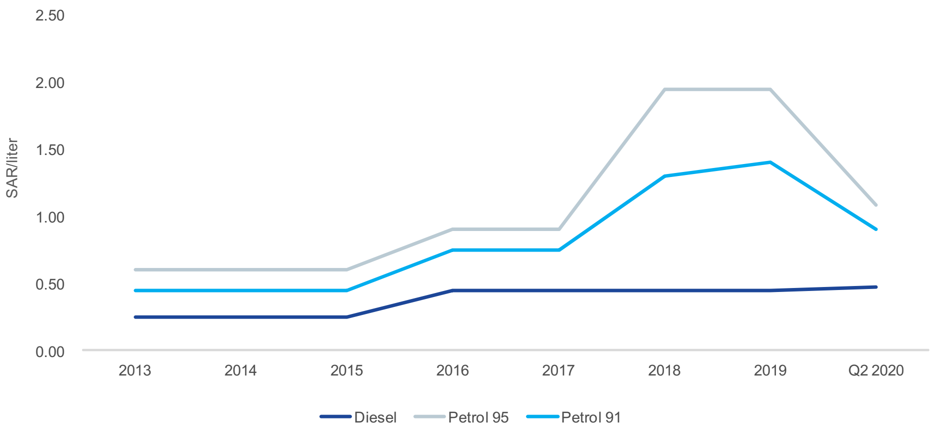
Regulatory requirements under Masar program to consolidate the industry

Starting 2016, the Saudi Ministry of Municipal and Rural Affairs (MOMRA) has set standard regulations for the fuel players under the Masar program to modernize the gas stations thus enhancing the end-user experience in-line with global standards. Accordingly, the government has recognized 20 organized players and qualified them to operate the petrol stations. The cost of compliance is huge for small players and therefore they are either forced to shut down or get merged with larger players thus leading to industry consolidation. In fact, from December 2019 a significant number of gas stations have shut down for failing to comply with the new standards. With COVID 19 disruptions in H1 2020, we expect this consolidation to pick further pace as smaller players face the liquidity crunch and other operational issues. The gas stations business is heavily dependent on expats and with international flights being stopped this creates an additional burden for petrol station operators to expand. We expect market leaders to benefit from economies of scale as they can rationalize their workforce among different stations as well as incur capex on automating a part of the workflow.

Margin upliftment of fuel companies enhances the industry-wide return metrics

The government has lifted the gross margins of 20 qualified gasoline retailers starting August 23rd 2018. The new gross margins for octane (both 91 and 95) are fixed at SAR0.15/litres and SAR0.05/litres for diesel. This is significantly higher compared to the historical margins of SAR0.09/litres for both the variants of octane. The announcement regarding raising gross margins was done in October 2019 while it was retrospectively implemented from August 23rd, 2018. As a result, Aldrees received 287mn and SASCO received SAR112mn margin refund from Aramco in May 2020. Another key change in the sector is that starting from March 2020 Saudi Aramco announced that fuel prices will be reviewed on a monthly basis. Historically the fuel prices remained constant at SAR0.6/litres for 95-octane and SAR0.45/litres for 91-octane for a long time till 2018. In 2018 there was a price hike in gasoline and following that the government announced quarterly price revision for fuel in the kingdom.

Figure 10 Historical gasoline prices



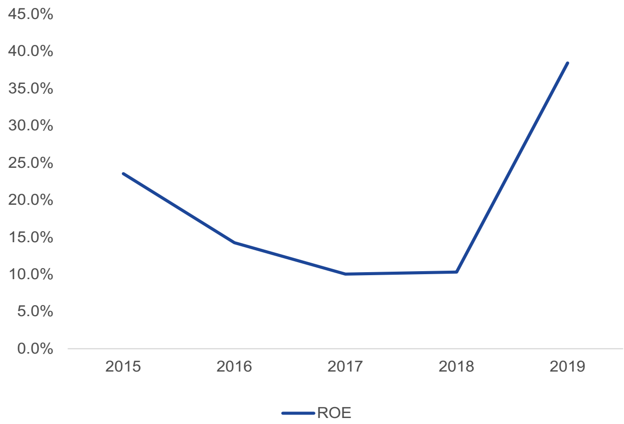
Source: Company data, Al Rajhi Capital

The new level of margins has increased the return on equities and return on capital employed significantly thus making this business extremely attractive. With the largely unorganized nature of the sector, there are enormous opportunities for organized gasoline retailers to expand and capture the market share. As a result, this sector has lured several foreign players to enter the market. In Feb 2019 Total and Saudi Aramco signed a 50:50 joint venture agreement to develop a network of fuel stations in the kingdom. They plan to invest ~SAR1bn from 2019-2025e to expand their scale of operations. The two companies also signed an agreement with Tas'helat marketing co and Sahel transport company to acquire their 270 stations in the kingdom. Dubai based ENOC has also announced its expansion plan in KSA, the company aims to open ~124 stations by 2030e.

As per our discussions with the industry experts, we are expecting further M&A related activities in this industry which aims to organize and make the gasoline sector more efficient.

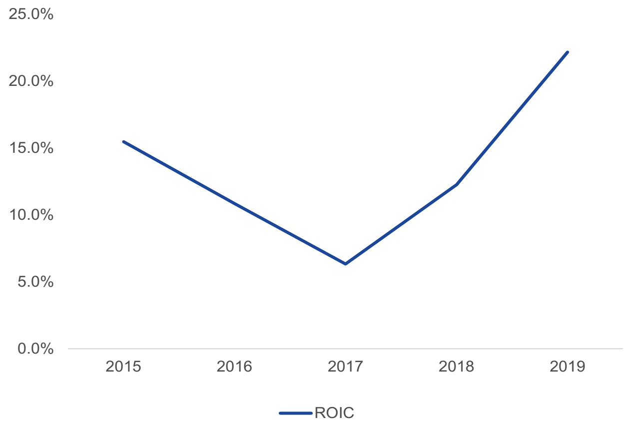
Since the implementation of the new margins, the ROE of both Aldrees has improved from 11.5% in Q3 2019 to 39% at the end of Q2 2020. For SASCO the ROE improved from 4.45% to 16% during the same period.

Figure 11 ROE trend (Aldrees)



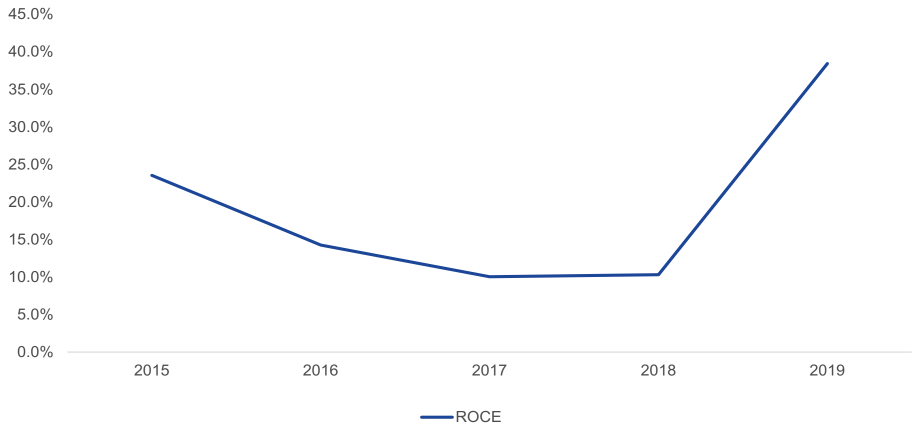
Source: Company data, Al Rajhi Capital

Figure 12 ROIC trend (Aldrees)



Source: Company data, Al Rajhi Capital

Figure 13 ROCE trend (Aldrees)



Source: Company data, Al Rajhi Capital

Company Overview

Business Model

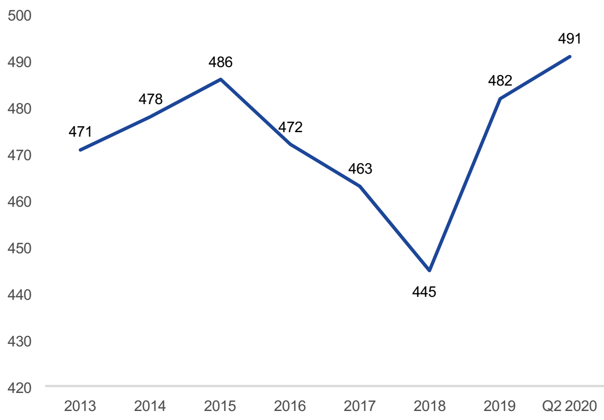
Aldrees has two main segments the major one is fuel and the second one is the transportation segment. In the fuel segment the company operates as a trading company, it receives fuel from Saudi Aramco and sells it to the retail and wholesale customers. The fuel prices are revised on a monthly basis but the gross margins are fixed at SAR0.15/litres for Petrol 91 and 95 while SAR0.05/litre for diesel. The company receives the fuel on the credit of an average 30 days from Aramco and sells it in cash to retail customers while providing credit to wholesale customers. Generally, the day's inventory outstanding is 5 days therefore cash conversion cycle for the fuel business is very low. Apart from fuel company also have service centers, vehicle accessories shops, food and beverage outlets in their stations. These additional retail stores are leased to the leading F&B players and the company gets a fixed rental from them. These non-fuel revenues help in improving the returns per station. Recently renovated its old stations and did a huge capex over the last three-four years to meet the requirements of the Saudi Ministry of Municipal and Rural Affairs (MOMRA). Aldrees is the first company in the kingdom to automate its fuel stations thereby attracting higher footfall leading to a higher throughput per station. Currently, the overall fuel sector is fragmented and we expect Aldrees to gain market share by rapid expansion across the kingdom.

The transport segment comprises just 5% of the overall top-line of the company however this segment is growing fast. The company has several long term contracts with leading companies in Saudi Arabia such as Maaden, Nadec, etc to transport chemicals, oils, grains, sugar and other foodstuffs. These contracts provide revenue visibility in the future and being a higher-margin segment contributes significantly to the overall operating and net profits of the company The company owns 1205 trucks of leading international brands such as Volvo and Mercedez currently and plans to increase its fleet size in anticipation increased demand for its transport business. Company's trucks have wider specifications and have a competitive advantage. Maintaining such a large fleet size is not easy and therefore it is not easy for the new players to enter into this business as it involves regular capex, technical knowhow and strong relations with the corporates. Building such a strong network takes time and therefore we think Aldrees being one of the oldest players in the region has a strategic advantage over other players.

Key highlights of Fuel Business (~95% of the revenue)

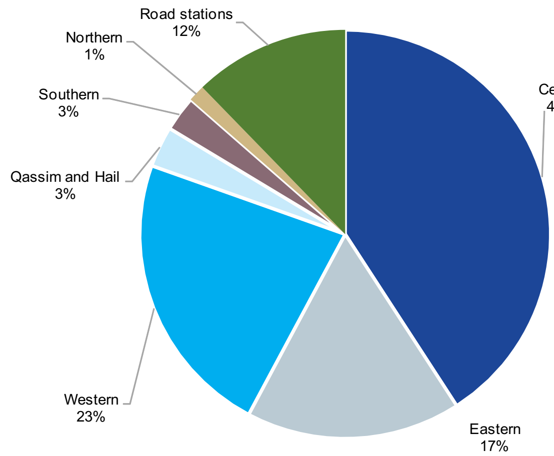
Aldrees is currently the market leader among the gasoline retailers in Saudi Arabia with a market share of 5% in terms of stations and ~10% in terms of sales volume. Aldrees operates 491 stations as of Q2 2020 with 475 rented stations and 16 owned stations. The company has aggressive expansion plans to add 50 stations each year from 2020-2024e leading to an additional 250 stations over the next 5 years. The majority of the new stations will be rented as per our analysis and the average tenor will be 10 years in-line with current rental agreements. In 2019 the total throughput per station was ~SAR10mn as per our calculations and we expect it to drop in 2020e due to loss in volume during curfew but a strong rebound in 2021e.

Figure 14 No. of stations



Source: Company data, Al Rajhi Capital

Figure 15 2019 fuel revenue by geography



Source: Company data, Al Rajhi Capital

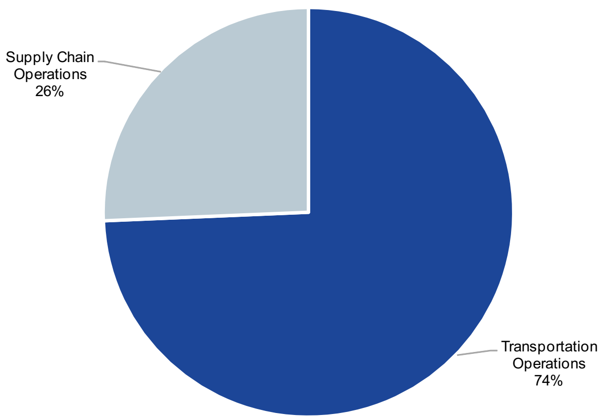
Recent Changes to comply with MOMRA regulations

Aldrees incurred a capex of SAR548mn in fuel segment from 2016-2019 to comply with the MOMRA regulations as well as implement fuelling systems in their stations which attracted the customers and improved the LFL sales of the company. Due to high quality and standards implemented in the stations the company was licensed and qualified by the government to be eligible for the new gross margins of SAR0.15/litres for Octane and SAR0.05/litres for diesel. In 2020e the expected capex to renovate the existing stations and expand new stations will be approx. SAR100mn as per our calculations.

Key highlights of Transportation Segment (5% of the revenue)

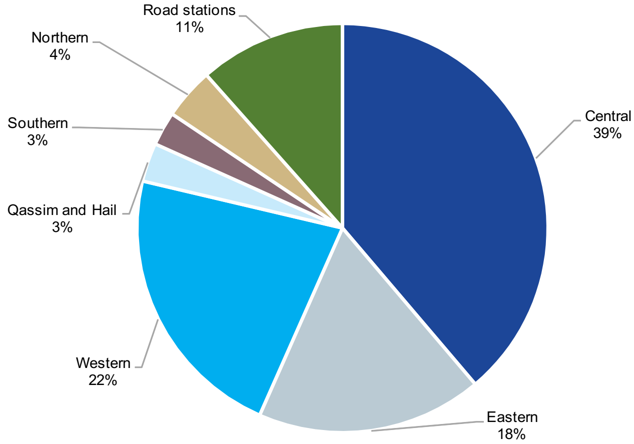
In the transportation segment, the company is involved in the business of transporting fuel, chemicals, sugar, grains, and other related products. It also has a supply chain-operations under transportation segment where they provide warehousing and container services. The total warehouse capacity as per our analysis is 1,760sqm. The company has 1,205 trucks and 2,422 trailers as on Q2 2020, the transport fleet is well-reputed in the kingdom and other Arab countries as their fleets are better in terms of specifications required to transport chemicals. This provides a competitive edge to the company compared to its peers. Approximately 69% of the trucks are of Mercedes and the remaining is of Volvo and Man TGA19-400. Maaden is one of the top clients for Aldress as it generates ~40% of the total revenue of the transport segment. The contract with Maaden is up for renewal in 2021e and the company expects it to get renewed at a revised term.

Figure 16 H1 2020 revenue by segments



Source: Company data, Al Rajhi Capital

Figure 17 2019 total revenue by geography



Source: Company data, Al Rajhi Capital

Figure 18 TRUCKS & TRAILER SUMMARY

Type	Brand	Opening	As of 30 Jun 2020			%
		1-Jan-20	Addition	Deletion	Balance	
Trucks	Mercedes	859	0	(22)	837	69.5%
	Volvo	307	0	(28)	279	23.2%
	Man	82	0	0	82	6.8%
Truck - fuel tanks	Mitsubishi	1	0	0	1	0.1%
	Isuzu	6	0	0	6	0.5%
Total trucks		**1,255**	**0**	**(50)**	**1,205**	**100.0%**
Total Trailers		**2,390**	**32**	**0**	**2,422**	
Grand total fleets		**3,645**	**32**	**(50)**	**3,627**	

Source: Company data, Al Rajhi Capital

Non-Fuel revenue (~3% of the total fuel revenue)

There is a smaller portion (3.2% of the total fuel revenue in 2019) of revenue coming from leasing the space in the petrol station to F&B outlets and small convenience stores which is currently merged with fuel revenue in the company's financials. The average lease rate charged is SAR79,400 annually. The company plans to increase its non-fuel revenue by leasing the space to leading retail companies, this will directly impact the profitability and free cash flow of the company.

Key Growth Drivers

Aggressive expansion plan to add 250 stations over the next five years

Aldrees has announced an aggressive plan to add 250 new stations to its existing network of stations till 2024e. The company, being a market leader, is pushing hard to capture the market share from the unorganized players. We forecast the revenue to grow at a CAGR of 15% from 2020e till 2025e to reach SAR9.2bn. The average capex on the new rented station is SAR500,000 and the average rent per station is SAR650,000 (for calculation we have considered the rent for the new stations to be approximately six months as per the company's guidance). After the new margin rules, the company is generating sufficient cash to incur the capex required and will be requiring very minimal debt financing. (Please note for our forecasting we have assumed the total additions to be 200)

Throughput per station to gradually recover from Q3 2020 with a strong rebound in 2021e

Aldrees revenue in Q2 2020 was significantly impacted due to lockdown measures imposed in the kingdom. In Q2 the fuel segment top-line dropped 47% y-o-y while the transport segment revenue dropped 20% y-o-y mainly due to weaker economic activities. We expect a gradual recovery in H2 2020 as people are back to offices and COVID cases have reduced. In the absence of international flights and international tourism we expect local tourism to increase, we expect people to drive to nearby cities in private vehicles as it's a safe option compared to flights at the moment. This will offset the low volume due to schools being shut till December. Once schools start operating normally, we expect the fuel demand to pick pace towards Jan 2021e.

Transportation segment to grow amid growing logistics demand in the kingdom

We expect the logistics industry in Saudi Arabia to grow as it is an area of the major focus for the government. Recently the demand for transportation, warehouses and delivery fleets has increased as the e-commerce sector is witnessing a structural change after the COVID crisis. We expect Aldrees will benefit from the overall growth of the transportation and logistics sector in the mid to longer-term. In 2020E the company is spending heavily as it plans to incur ~SAR100mn to buy new trucks, construct depot and warehouse to meet the upcoming demand from various industries. We expect the revenue from the transportation segment to grow to SAR320mn by 2023e from SAR187mn in 2020E. Being a high margin segment (gross margin of ~31-32%) and with relatively higher operating leverage this will directly impact the profitability of the company.

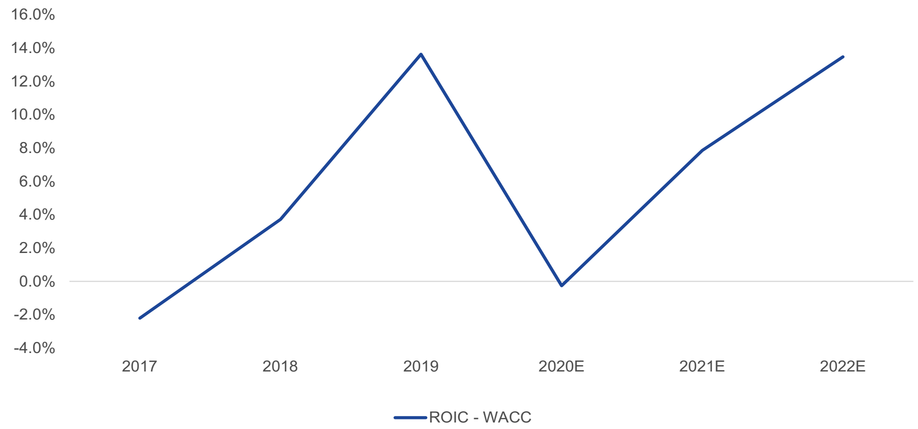
Low cash conversion cycle led by higher inventory turnover minimizes working capital requirements

Aldrees has a solid business model where it sells its inventory on an average in 5 days and receives a credit of ~30 days from Saudi Aramco. The average day's sales outstanding is in between 25-30 days therefore cash conversion cycle is ~0-2 days, this ensures that the company doesn't require any working capital funding and enhances the free cash flow of the company. Due to its strong cash balance the company was able to sustain the COVID 19 related disruptions when the fuel demand nosedived during the lockdown.

Expanding through internally generated cashflows generating industry-leading ROCE

Since the implementation of the new margin of SAR0.15/sh for octane and SAR0.05/litre for diesel the return on capital employed of the business has improved significantly from 10% in 2017 to 38% in 2019e. Due to the fragmented nature of the sector Aldrees have strong potential to grow as the industry is expected to consolidate amid new government regulations which leave smaller players with an option to either shut down or operate through licensed players. Aldrees being a market leader is aiming to capture a large share of the market through its aggressive plans of adding 250 new stations by 2024e. The majority of the capex required for this expansion will be done through internally generated free cash flows thus maximizing share-holders wealth. We expect ROCE to be maintained at 36-38% level during our forecasting period. In fig 16 we can see that company's ROIC-WACC has improved from -2% in 2017 to 12% in 2019 and is expected to remain the same with future investments.

Figure 19 ROIC - WACC trend (Aldrees)



Source: Company data, Al Rajhi Capital

Dividend payout ratio can increase amid solid cash flow generation

We expect Aldrees to increase the payout ratio in the future as the company's business model generates sufficient FCF to fund the capex plans. We expect the payout ratio to be 30% in 2021e, 50% in 2020e and increase to 60% by 2024e. The company provides a solid growth prospect as a well stable dividend for the coming few years and looks extremely attractive at current levels.

Valuation

We value Aldrees with equal weight given to DCF, EV/EBITDA and PE based relative valuation. Our DCF target price based on 1% terminal growth and 8.5% WACC is SAR85, EV/EBITDA based on 13.3x (average EV/EBITDA of regional peers) FY 2022E EBITDA is SAR92 and PE based on relative valuation based on 18x FY 2022E EPS is SAR59 thus equal-weighted target price stands at SAR79/sh which implies 23% upside from CMP of SAR64/sh. The stock looks extremely attractive at current levels considering the future growth and dividend potential. We initiate on Aldrees with a "Buy" recommendation.

Key Risks

Significant downside risks to our valuations include

1)Slower than expected expansion of gas stations will have a negative impact on our top-line forecast and poses a downside risk to our valuations.

2)Since the overall industry has become attractive after the new margin implementation many international players have expressed their interest in entering the KSA fuel sector. If this happens then the competition will intensify and might have a negative impact on through-put per station. This will impact our valuation negatively.

3)Any downward revision in the gross margins will have a negative impact on the company's return metrics, expansion plans and profitability.

4)Any further lockdown measures implemented or delay in the full resumption of economic activities, schools and offices might delay the recovery in volume further than our initial forecast and will have a negative impact on our valuations.

5)In transportation segment Aldrees's main client is Maaden and its contract is up for renewal in 2021e, if the contract is renewed at a significantly lower price, then the gross margins of the transportation segment will come down and will impact our future forecast.

6)Prolonged slowdown in consumer spending will impact the non-fuel revenue of the company and will impact the overall profitability of the company.

7)Any further requirement of CAPEX by the regulator will have a negative impact on the company's free cash flow and poses a downside risk to our valuation.

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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.

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