# Saudi Consumer Sector, *Gaining traction on rising footfall…*

**31 March 2022**

| Company | Rating |
|---|---|
| Arabian Centres Co. (ACC) | Accumulate |
| Alandalus Property Co. (Alandalus) | Accumulate |
| Leejam Sports Co. (Leejam) | Buy |

- **The modern retail and hospitality sector registering healthy recovery amid favorable conditions**
- **Improving economic activities and consumer sentiments to drive footfall as well as revenue per customer, which is favorable for the discretionary consumer and related names**
- **Favorable demographics, high urban population, and rising income levels augur well for the sector**
- **The players continue to invest in organic expansion, indicating optimism about future growth**
- **Rising vaccination coverage to help the government expedite the unlock process**

We expand our coverage of the GCC Consumer Sector by adding three more names – **Arabian Centres Co. (ACC), Alandalus Property Co., and Leejam Sports Co.** Overall, we believe the removal of the remaining COVID-related restrictions on retail and entertainment avenues, revival in religious and general tourism activities, favorable demographics, increase in households' income, and changing lifestyles will lead to an acceleration in the sector's growth. We have used different valuation methodologies (DCF, relative P/E, P/B, and EV/EBITDA), and applied a combination of DCF and appropriate relative valuation multiples as per the business dynamics of each company.

- **Sector experiencing a revival in fortunes as the grievousness of COVID reduces.** The companies under our coverage are registering an improvement in occupancy levels at their properties, accompanied by an increase in footfalls as the severity of the COVID pandemic reduces. With the government taking stimulatory measures for the economy, keeping a focus on short-term growth while achieving Vision 2030 goals, we expect footfalls and occupancies would reach pre-pandemic levels soon and may even surpass it over the medium term.
- **An underpenetrated market makes case for continued investment in organic expansion.** Saudi Arabia has witnessed significant development in terms of the transformation of urban areas over the years, yet, it still has one of the lowest per capita retail spaces in the region. This offers ample scope for the sector's organic growth, both in the existing urban areas as well as in new megacities being planned and likely to come up over the next decade.
- **Favorable demographics, along with growing urbanization and a rebound in tourism augur well for the sector.** The sector is still subject to some COVID-driven restrictions like the type and number of people allowed, their vaccination status, etc. The removal of these constraints, plus an expected jump in international tourists coming for pilgrimage are anticipated to be the primary near-term catalysts for the sector's growth. Over the medium-to-long term, the retail sector is expected to benefit from i) changing lifestyles & habits, ii) a growing urban landscape, iii) and a boost to households' spending ability with growing job opportunities and more women coming to work.
- **Uncertain global geopolitical conditions.** The global geopolitical situation is quite unstable at present owing to the ongoing conflict between Russia and Ukraine, which poses a threat to the global economic recovery and may impact consumer sentiments. In addition, the risk of any new, vaccine resistant COVID variant persists, considering the current situation in China, Hong Kong, and some European nations.

We hold a favorable stance on all three companies mainly anticipating a continued improvement in sector dynamics, backed by further normalization of economic conditions.

| Name | Last Px (SAR) | Target Price (SAR) | Upside / (Downside) (%) | P/E'22e, (x) | P/B'22e, (x) | EV/EBITDA '22e, (x) | ROE'22e, (%) | Cash Div Yield, % |
|---|---|---|---|---|---|---|---|---|
| Arabian Centres | 22.14 | **25.50** | 15.2% | 22.8 | 1.7 | 15.6 | 7.6% | 4.3% |
| Alandalus Property | 18.00 | **20.80** | 15.5% | 21.8 | 1.5 | 10.0 | 7.2% | 2.9% |
| Leejam Sports | 121.40 | **149.00** | 22.7% | 22.0 | 6.7 | 12.7 | 33.0% | 2.3% |
| **Average** | | | | **22.2** | **3.3** | **12.8** | **15.9%** | **3.2%** |

*Source: Bloomberg, U Capital Research; Last price as of 30 March 2022; ACC's year ends in March*

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# Saudi Consumer Sector

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# Valuation

We have used DCF and relative valuation methodologies with different weights assigned to each of them to derive the target price for each company. For DCF, we have used a 5-year explicit forecast period (2022-26) and afterward assumed a 2% terminal growth rate. We have then calculated the present value of future cash flows (Enterprise Value or EV) using the weighted average cost of capital (WACC). After computing EV, we have made the required adjustments such as net debt, minorities, etc. to derive equity value.

For the relative valuation (P/E, P/B, and EV/EBITDA), we have considered the company's average historical and forward multiples as well as the average multiples of relevant peers. Then, these were adjusted by giving a premium or discount, as required, considering the recent and/or expected movement in the multiples to reflect our assessment of each company's future financial performance. The adjusted multiples are then multiplied by the forecasted EPS, BVPS, and EBITDA, respectively. We have used P/B for ACC and Alandalus (more balance sheet driven), and P/E as well as EV/EBITDA for Leejam (EV/EBITDA because the company has a decent capex plan going forward, and the method would take care of an increase in depreciation).

**Valuation**

| | ACC* | Alandalus | Leejam |
|---|---|---|---|
| **DCF (ACC & Alandalus: 75% weight; Leejam: 33% weight)** | | | |
| **PV of Free Cash Flow (SAR mn)** | | | |
| Year 1 | 774 | 146 | 400 |
| Year 2 | 845 | 137 | 370 |
| Year 3 | 888 | 138 | 418 |
| Year 4 | 863 | 130 | 488 |
| Year 5 | 834 | 121 | 525 |
| Terminal | 24,803 | 2,875 | 10,751 |
| Total PV of Excess Returns | 17,884 | 1,969 | 6,910 |
| **Assumptions** | | | |
| Risk Free Rate (%) | 2.9% | 2.9% | 2.9% |
| Adjusted Beta | 0.99 | 0.73 | 0.96 |
| Risk Premium (%) | 10% | 10% | 10% |
| Cost of Equity (COE) (%) | 13.0% | 10.3% | 12.6% |
| WACC (%) | 6.8% | 8.3% | 9.7% |
| Equity value (SAR mn) | 12,287 | 2,006 | 7,943 |
| Outstanding Shares (mn) | 475.0 | 93.3 | 52.4 |
| ***Target Price (SAR)*** | ***25.9*** | ***21.5*** | ***151.6*** |
| **P/E based Relative Valuation (33% weight)** | | | |
| Target P/E multiple for 2022e | *NA* | *NA* | 28.0 |
| EPS 2022e (SAR) | *NA* | *NA* | 5.5 |
| ***Target Price (SAR)*** | ***NA*** | ***NA*** | ***154.6*** |
| **EV/EBITDA based Relative Valuation (34% weight)** | | | |
| Target EV/EBITDA Multiple for 2022e | *NA* | *NA* | 15.0 |
| EBITDA FY22e (SAR mn) | *NA* | *NA* | 570 |
| ***Target Price (SAR)*** | ***NA*** | ***NA*** | ***141.0*** |
| **P/B based Relative Valuation (25% weight)** | | | |
| Target P/B Multiple for 2022e | *1.8* | *1.6* | *NA* |
| BVPS FY22e (SAR) | *13.6* | *11.7* | *NA* |
| ***Target Price (SAR)*** | ***24.4*** | ***18.7*** | ***NA*** |
| **Weighted Average Target Price (SAR)** | **25.5** | **20.8** | **149.0** |
| *Current Market Price (SAR)* | *22.1* | *18.0* | *121.4* |
| Upside/(Downside), % | 15% | 16% | 23% |
| **Recommendation** | **Accumulate** | **Accumulate** | **Buy** |

***Source: Company Filings, Bloomberg, U Capital Research; *ACC's year-end is March, hence BVPS used for ACC is of the year ending March 2023***



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# Risks to Valuation

Key downside risks to our valuations include:

- Delay in the addition of new properties, contrary to the expected movement in the average revenue per unit area or per member.
- Spread of any new mutations of the COVID virus, given that some European and East Asian countries, including China, are grappling with a sudden surge in new COVID cases as well as related deaths

Key upside risks to our valuations include:

- More-than-forecasted growth in per-unit/per member average revenue, above expected occupancy at existing commercial properties, a faster ramp-up of new properties.
- Better-than-expected improvement in operating efficiencies.

# Sensitivity Analysis

Our TP for **ACC** is moderately sensitive to +/- 0.25% changes to terminal growth or in WACC assumptions (changes about +/-6-8%). Our TP is slightly sensitive to +/-0.25x changes in the target P/B multiple, affecting our TP by c.+/-3% with every change.

**ACC**

| WACC \ Terminal growth | 1.5% | 1.8% | 2.0% | 2.3% | 2.5% |
|---|---|---|---|---|---|
| 6.3% | 26.1 | 27.8 | 29.7 | 31.8 | 34.1 |
| 6.5% | 24.3 | 25.8 | 27.5 | 29.3 | 31.4 |
| 6.8% | 22.7 | 24.0 | **25.5** | 27.1 | 29.0 |
| 7.0% | 21.2 | 22.4 | 23.7 | 25.2 | 26.8 |
| 7.3% | 19.8 | 20.9 | 22.1 | 23.4 | 24.9 |

| P/B multiple \ 2023e BVPS (SAR) | 12.6 | 13.1 | 13.6 | 14.1 | 14.6 |
|---|---|---|---|---|---|
| 1.30x | 23.5 | 23.6 | 23.8 | 24.0 | 24.1 |
| 1.55x | 24.3 | 24.5 | 24.6 | 24.8 | 25.0 |
| 1.80x | 25.0 | 25.3 | **25.5** | 25.7 | 25.9 |
| 2.05x | 25.8 | 26.1 | 26.3 | 26.6 | 26.9 |
| 2.30x | 26.6 | 26.9 | 27.2 | 27.5 | 27.8 |

Our TP for **Alandalus** is slightly sensitive to +/- 0.25% changes to terminal growth or in WACC assumptions (changes about +/-3-4%). Our TP is also slightly sensitive to +/-0.25x changes in the target P/B multiple, affecting our TP by c.+/-3.5% with every change.

**Alandalus**

| WACC \ Terminal growth | 1.5% | 1.8% | 2.0% | 2.3% | 2.5% |
|---|---|---|---|---|---|
| 7.8% | 21.1 | 21.8 | 22.6 | 23.5 | 24.4 |
| 8.0% | 20.3 | 21.0 | 21.7 | 22.4 | 23.3 |
| 8.3% | 19.6 | 20.2 | **20.8** | 21.5 | 22.2 |
| 8.5% | 18.9 | 19.4 | 20.0 | 20.6 | 21.3 |
| 8.8% | 18.2 | 18.7 | 19.2 | 19.8 | 20.5 |

| P/B multiple \ 2022e BVPS (SAR) | 10.7 | 11.2 | 11.7 | 12.2 | 12.7 |
|---|---|---|---|---|---|
| 1.10x | 19.1 | 19.2 | 19.3 | 19.5 | 19.6 |
| 1.35x | 19.7 | 19.9 | 20.1 | 20.2 | 20.4 |
| 1.60x | 20.4 | 20.6 | **20.8** | 21.0 | 21.2 |
| 1.85x | 21.1 | 21.3 | 21.5 | 21.8 | 22.0 |
| 2.10x | 21.7 | 22.0 | 22.3 | 22.5 | 22.8 |

Our TP for **Leejam** is not sensitive to +/- 0.25% changes to terminal growth or in WACC assumptions (changes about +/-1%). Our TP is also not sensitive to +/-0.25x changes in the target EV/EBITDA multiple, affecting our TP by less than +/-1% with every change.

**Leejam**

| WACC \ Terminal growth | 1.5% | 1.8% | 2.0% | 2.3% | 2.5% |
|---|---|---|---|---|---|
| 8.7% | 154.2 | 156.1 | 158.1 | 160.2 | 162.5 |
| 9.2% | 149.9 | 151.5 | 153.2 | 155.1 | 157.0 |
| 9.7% | 146.2 | 147.6 | **149.0** | 150.6 | 152.3 |
| 10.2% | 142.8 | 144.0 | 145.3 | 146.7 | 148.1 |
| 10.7% | 139.9 | 140.9 | 142.0 | 143.2 | 144.5 |

| EV/EBITDA multiple \ 2022e EBITDA (SAR mn) | 370,258 | 470,258 | 570,258 | 670,258 | 770,258 |
|---|---|---|---|---|---|
| 14.50x | 128.3 | 137.8 | 147.2 | 156.6 | 166.0 |
| 14.75x | 128.9 | 138.5 | 148.1 | 157.7 | 167.2 |
| 15.00x | 129.5 | 139.3 | **149.0** | 158.8 | 168.5 |
| 15.25x | 130.1 | 140.0 | 149.9 | 159.8 | 169.7 |
| 15.50x | 130.7 | 140.8 | 150.9 | 160.9 | 171.0 |



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# Peer Group Valuation

| Name | Mkt Cap (SAR mn) | Last Px (SAR) | Px Change 1M, % | Px Change 3M, % | Px Change YTD, % | EV/EBITDA' 22e, (x) | P/E'22e, (x) | ROE'22e, (%) | Div Yield' 22e, (%) | FCF Yield'22e (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| ***Retail & Consumer Services*** | | | | | | | | | | |
| ARABIAN CENTRES CO LTD | 10,516.5 | 22.14 | -2 | -2 | -2 | 15.6 | 22.8 | 7.6% | 4.3% | 9.1% |
| ALANDALUS PROPERTY CO | 1,680.0 | 18.00 | 1 | 0 | 0 | 10.0 | 21.8 | 7.2% | 2.9% | 9.2% |
| EMAAR PROPERTIES PJSC | 50,543.7 | 6.05 | 19 | 24 | 24 | 7.4 | 8.5 | 10.0% | 2.9% | 9.0% |
| SEEF PROPERTIES | 823.8 | 0.18 | 2 | 1 | 1 | 11.8 | 0.9 | 5.3% | na | na |
| MABANEE CO KPSC | 13,302.3 | 920.00 | 8 | 16 | 16 | 16.4 | nm | 9.9% | 0.0% | 0.0% |
| LEEJAM SPORTS CO JSC | 6,359.3 | 121.40 | -4 | 11 | 11 | 12.7 | 22.0 | 33.0% | 2.3% | 4.4% |
| **Average** | | | | | | **12.3** | **15.2** | **12.2%** | **2.5%** | **6.3%** |
| **Median** | | | | | | **12.3** | **21.8** | **8.8%** | **2.9%** | **9.0%** |

**Source: Bloomberg, U Capital Research, na – not available, nm – not meaningful; *valued as of 30 March 2022**

**Fig. 1: Retail - Price to Earnings & Dividend Yield**

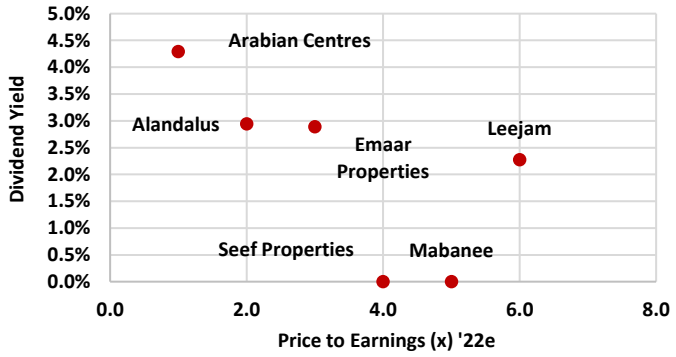
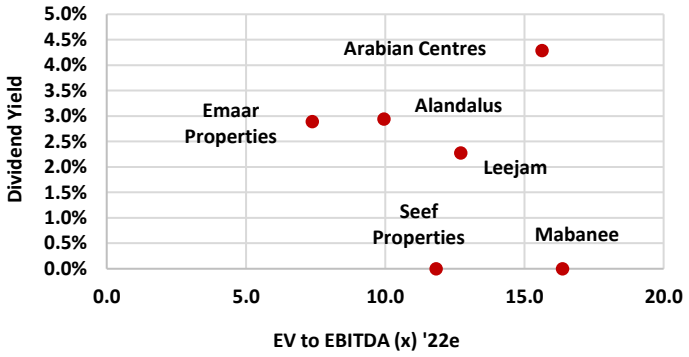



**Fig. 2: Retail - EV to EBITDA & Dividend Yield**




***Source: Bloomberg, U Capital Research; As of 30 March 2022***



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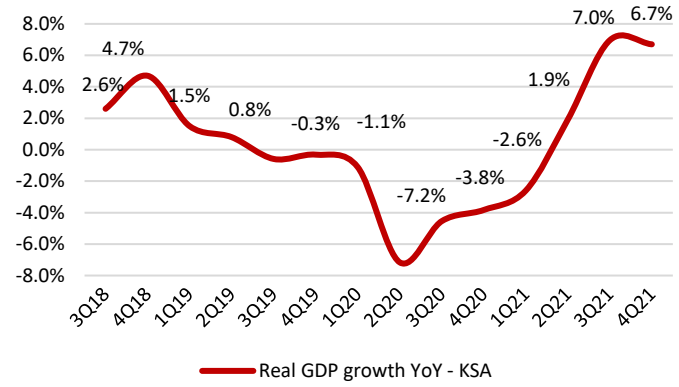
# Macro-economic & Sector Overview

## The economy continues to strengthen

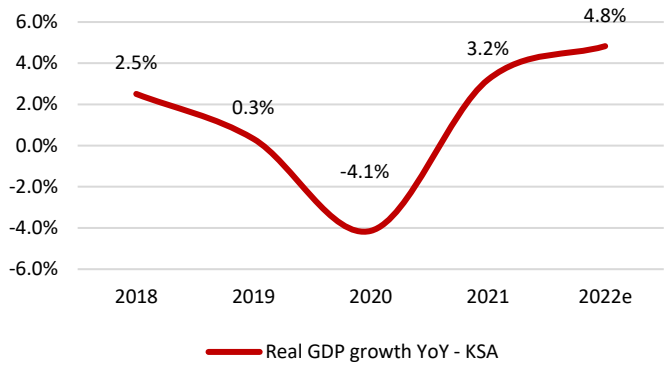
Saudi Arabia's economic growth gained momentum as the real gross domestic product (GDP) rose 6.7% YoY in 4Q 2021 after expanding by 7.0% YoY in 3Q 2021, which was its fastest pace of expansion since 1Q 2012. The oil sector's GDP climbed 10.9% YoY (aided by a rise in crude oil production, elevated levels of crude oil prices), whereas non-oil activities grew 5.1% YoY (rollback of COVID restrictions amid gradually subsiding pandemic situation).

**Fig. 3: GDP remains on a solid growth trajectory**




*Source: GASTAT, U Capital Research*

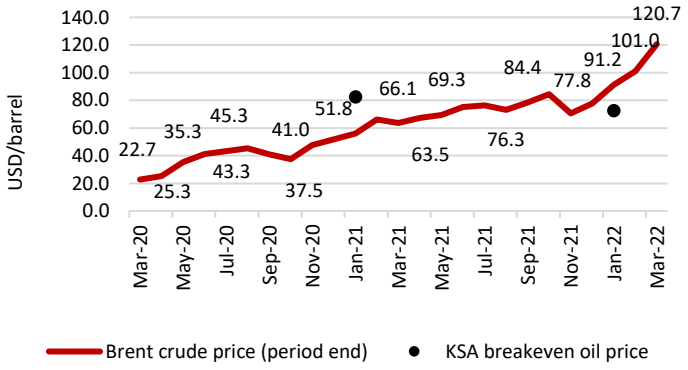
**Fig. 4: Real GDP forecasted to improve further in 2022**




*Source: GASTAT, IMF, U Capital Research*

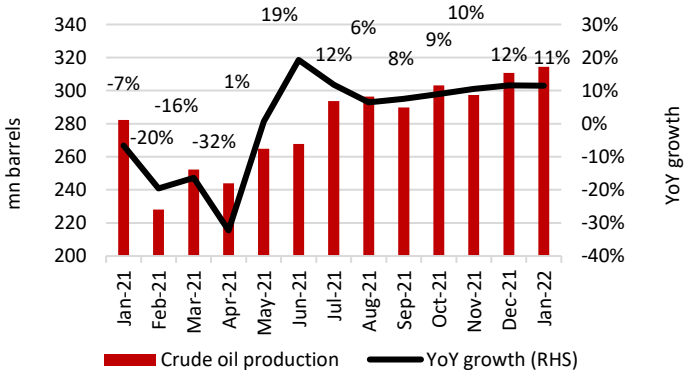
Overall in 2021, the Kingdom's real GDP grew 3.2%, recording the fastest expansion since 2015 and beating the International Monetary Fund's (IMF) estimate of 2.8%. The economy witnessed strong domestic non-government demand as private final consumption expenditure increased 9.7% YoY while gross fixed capital formation jumped 10.1% YoY. For 2022, the IMF forecasts a higher GDP growth rate of 4.8% for Saudi Arabia. This seems quite likely as the government continues to take initiatives to stimulate the economy amid rising vaccination coverage. For instance, to ensure long-term growth and as part of its economic diversification plan, Saudi Arabia's Crown Prince Mohammed bin Salman launched a program named 'Shareek' in March 2021. Shareek aims to bring SAR 5tn worth of private investment into the economy by 2030 and is part of a larger SAR 12tn investment program. The initiative revealed that by the end of this decade, private consumption spending would reach SAR 5tn, in addition to government spending of SAR 10tn. Further, the Crown Prince also announced a new strategy in March 2022 under which the National Development Fund (NDF) is required to invest SAR 570bn in the Kingdom to stimulate its real GDP growth. Also, to expedite the economic diversification process, the NDF has been directed to target tripling non-oil GDP to SAR 605billion by 2030. These initiatives should catalyze domestic demand while creating a more resilient Saudi economy over the medium-to-long term.

**Fig. 5: Multi-year high levels of oil prices a boon for the economy**




*Source: Bloomberg, IMF, U Capital Research*

**Fig. 6: KSA's crude oil production continues to rise on OPEC+ deal**




*Source: JODI, U Capital Research*

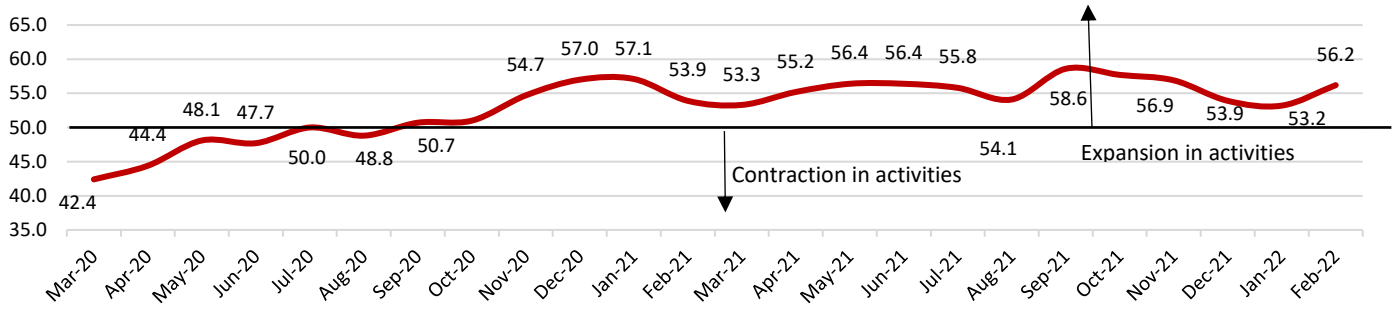
The continued solid increase in the average world crude oil prices, post-global economic recovery, and more recently Russia-Ukraine war, and sustained growth in Saudi Arabia's crude oil production on the back of July 2021 OPEC+ deal to completely phase-out oil

production cuts by September 2022 should also aid in driving GDP growth up by relieving pressure on government finances. The IMF estimates Saudi Arabia's breakeven crude oil price to fall to USD72.4/barrel in 2022 as compared to USD82.4/barrel in 2021 amid the Kingdom's rising average crude oil production YoY, higher level of crude oil prices, spending cuts taken by the government like a reduction/removal of subsidies, etc. Accordingly, the government estimates to record a budget surplus for the first time in around 10 years in 2022 at ~2.5% of GDP.

## Non-oil private sector activity remains vibrant

Non-oil private sector's Purchasing Managers' Index (PMI) for Saudi Arabia remained in an expansionary mode, registering a reading of over 50 for the 18th consecutive month in February 2022. The latest PMI number snapped a falling trend of the last 3-4 months as the spike in new COVID infections of the Omicron variant at the start of 2022 proved to be less harmful than feared previously. Business confidence and customer demand improved during the period, while inflationary pressures eased somewhat for a second month. Overall, the PMI data suggest that the private sector remains optimistic about the near future and gradually getting used to living with the pandemic.

**Fig. 7: Saudi PMI snaps the softening trend**

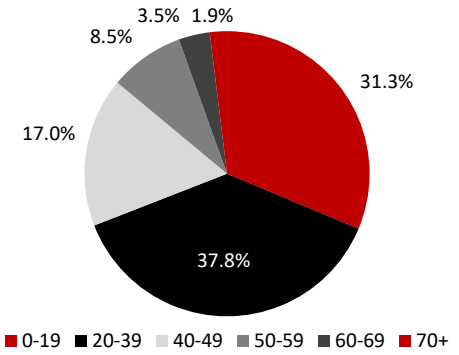



**Source: Trading Economics, FX Empire, markiteconomics.com, U Capital Research**

## Young and growing population to support demand

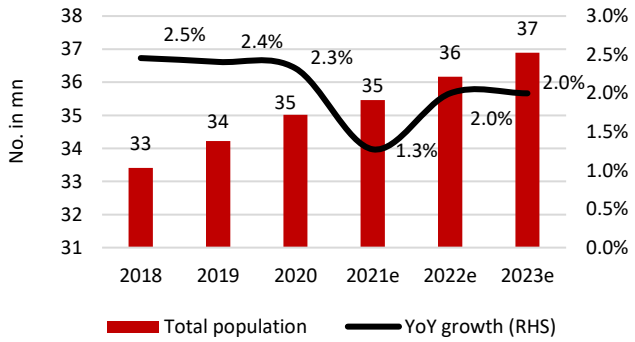
The GCC countries boast of a young population, in contrast with many developed nations that are facing the problem of an aging and declining population. In the 20–39 years age group, Saudi Arabia has 37.8% of its total population, as per the mid-2020 population estimate. The Kingdom's population has grown at a ~2% rate on average during 2017–2020. However, the expatriate population in Saudi, which accounts for a significant portion of the total population, shrank post imposition of expat fees and the COVID-19 pandemic as the employment opportunities reduced and the government intensified its drive to give preferences to locals in the government and private jobs. According to a report from Okaz/Saudi Gazette, a total of 1.05mn expatriates left Saudi Arabia's labor market from the start of 2018 until the end of 3Q 2021. Nevertheless, with an improvement in the job market, the Saudi government allowing free visa renewals for expatriates from 17 countries and automatically extending the validity of residency permits, the decline in the population of non-Saudis is anticipated to stop. Over the medium term, the IMF forecasts the population of Saudi Arabia to grow at an average rate of ~2%. A young and growing population should support the demand for the retail industry as the current generation, having more income at its disposal, has more inclination towards brands and shopping.

**Fig. 8: Saudi has a young population**




***Source: GASTAT, U Capital Research. *as per the mid-2020 census***

**Fig. 9: Saudi population to continue expanding at ~2% average rate**

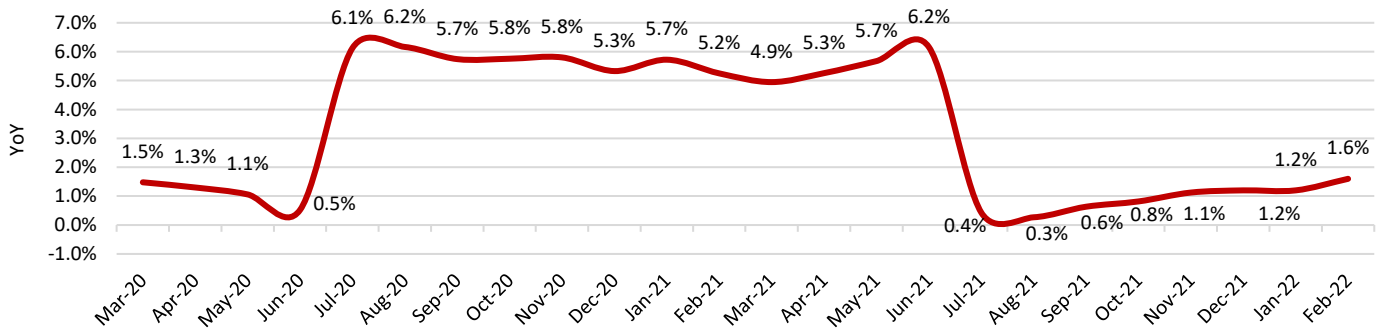



***Source: IMF, U Capital Research***

## Consumer inflation edges up in Saudi

Inflation in Saudi Arabia has been witnessing a slight uptrend possibly led by runaway commodity and fuel prices partly resulting from supply disruptions from the ongoing conflict between Russia and Ukraine. Yet, it still is considerably lower than the high rates registered last year due to a VAT hike (5% to 15%). Now, with the VAT likely remaining at the current level and the effect of an increase in base fading, the Kingdom is likely to experience nominal inflationary pressures in the range of 1–2% going forward, according to the forecasts from economists. The current inflation expectations for KSA are reasonable, and low inflation is always desirable from the consumers' point of view as less purchasing capacity is eroded. However, a prolonged period of battle might cause inflation to breach the expected range and bring hardships for consumers.

**Fig. 10: Inflation trends in Saudi (YoY)**



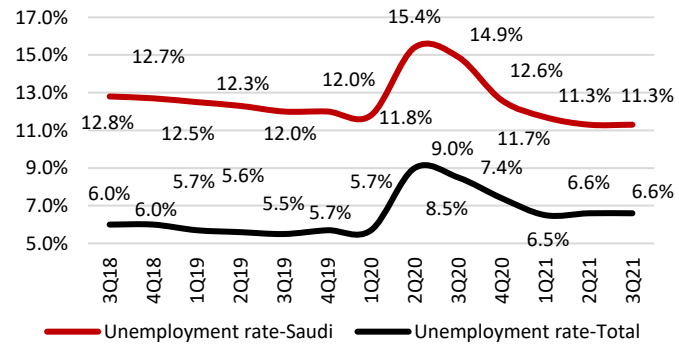

***Source: GASTAT, U Capital Research***

## Stable consumer sentiments amid an improving employment situation

Coinciding a pickup in economic growth, the labor market situation in Saudi Arabia is improving too as the unemployment rate is coming down over the past few quarters. Saudi unemployment rate had reached a high of 15.4% in 2Q 2020 at the peak of the coronavirus crisis. However, it has started easing and fell to 11.3% in 3Q 2021, supported by Saudization, the exodus of expatriates, and rising female participants. Apart from the decreasing jobless rate, female participation in the country's labor force is consistently rising, supported by the reforms undertaken by the government previously like the removal of the ban on women driving. This is a welcome development as it would aid in driving households' income higher and thereby consumption spending.

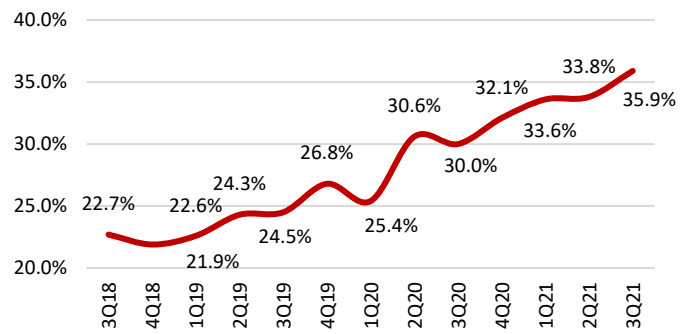
The government is undertaking various steps that are likely to ensure the job market remains vibrant in the near-to-medium term. According to Saudi Arabia's Ministry of Human Resources & Social Development (MHRSD), for the first time, a record 400k men and women joined the country's labor force in 2021. That was double the ministry's target to create 200k jobs in 2021 through 32 localization decisions. In 2022, the ministry intends to issue 30 new localization decisions that could lead to the creation of significant incremental job opportunities for locals. In addition, the implementation of mega projects, investments from the NDF, and initiatives like Shareek would ensure the creation of multiple job opportunities for the country's citizens and residents. These developments would ultimately lead to higher income and consumption of households which is positive for the growth of the country's consumer sector in the long term.

**Fig. 11: Total unemployment rate in Saudi eases**




***Source: GASTAT, U Capital Research***

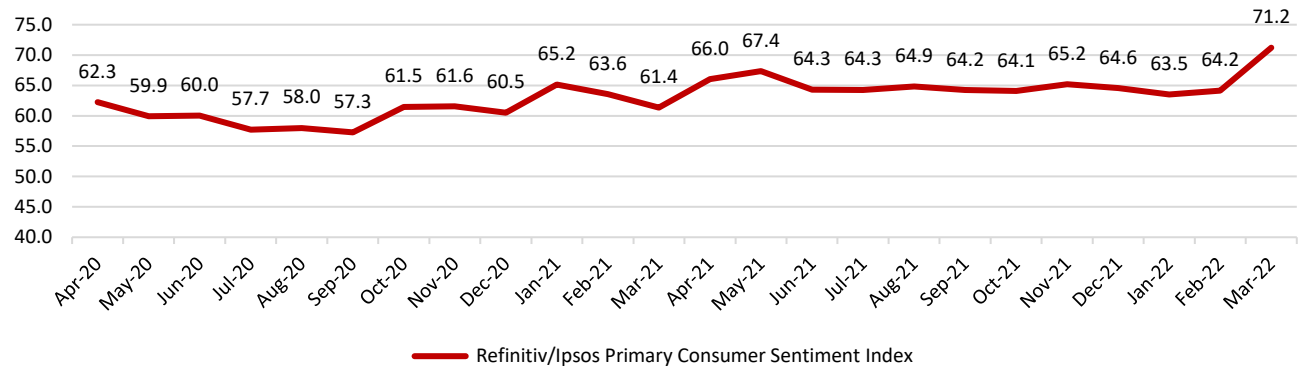
**Fig. 12: Female participation in KSA's labor force in an uptrend**




***Source: GASTAT, U Capital Research***

Saudi Arabia's consumer sentiment index from Refinitiv/Ipsos has hovered in the range of 60–65 since the start of 2021. However, despite the global economic environment becoming more uncertain recently, the Ipsos consumer sentiment index improved significantly in March 2022 to hit its highest level in the last two years, indicating Saudi consumers have a more positive outlook on the economic conditions and their wellbeing in the near future. A sustained expansion in the private sector activity coupled with improving consumer sentiments is positive for the consumer companies in the country.

**Fig. 13: The consumer sentiment index indicates optimism about economic well-being rises**




***Source: Refinitiv, U Capital Research***

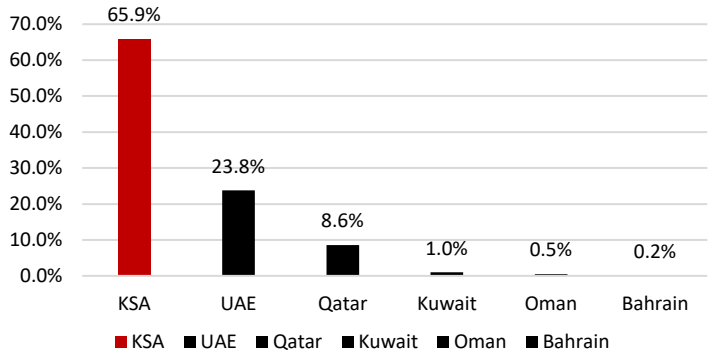
Overall, with an improving job market and rising consumer confidence, we expect the retail and consumer companies under coverage to benefit from these trends going forward.

## Saudi Arabia is the largest retail market in the GCC, but modern retail is still underpenetrated

Saudi Arabia is the GCC's biggest economy and hence it has the highest market share in the region's retail sales. The Kingdom's total retail sales in 2020 are estimated to exceed SAR 200bn. The retail industry has been one of the worst hits during the last two years of the pandemic as the malls, shopping complexes, cinemas, etc. were shut down fully for some time and after reopening, have been operating at below optimum capacity. Nevertheless, as the government has introduced several economic reopening measures, gaining confidence from rising vaccinations and a decline in new COVID infections, the retail sector is showing signs of sustainable recovery.

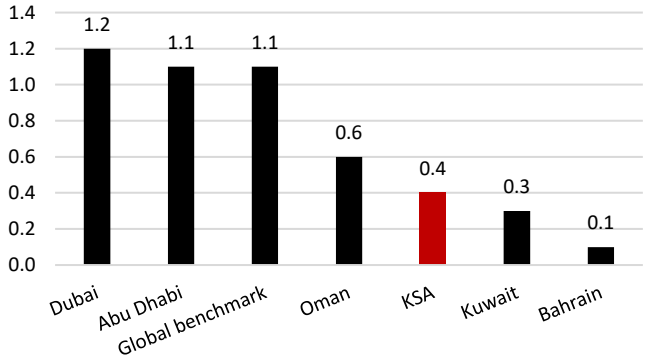
While Saudi Arabia is a large retail market in the region and has been witnessing significant advancements in the organized or modern retail sector, its penetration is still quite low, when compared with some of its neighboring countries. This offers ample growth opportunities for the players in the sector. Development of the retail sector is also a key objective in the government's long-term economic diversification program Vision 2030, which is being implemented through five-yearly National Transformation Programs (NTP). One of the objectives of the first NTP (2016-2020) – to enable the development of the retail sector – is being continued in the second NTP (2021-25). Under this, the retail sector's share in the GDP is targeted to increase to 12% by 2025 from 10% in 2019.

**Fig. 14: KSA has more than twice the market share of the UAE…**




***Source: ACC's Presentation (data for 2017), U Capital Research***

**Fig. 15: …but lags the per capita penetration of retail space (sqm)**




***Source: ACC's Presentation, U Capital Research***

## Malls are not likely to lose charm despite the influx of e-commerce

The COVID-19 pandemic has proven to be a blessing in disguise for e-commerce, as lockdowns, social distancing, more focus on sanitization, and personal hygiene boosted the appeal of e-commerce. As a result, this avenue of the retail market has been registering solid growth and a recent report from the consultancy firm BCG estimates e-commerce in Saudi Arabia to clock ~25% CAGR to reach ~SAR 57bn by 2025 as compared to ~SAR 19bn in 2020.

**Fig. 16: E-commerce's share is growing, but brick & mortar set up still rules**

| Category | Share in total sales | 2016 | 2018 | 2020 |
|---|---|---|---|---|
| Apparel and footwear | E-commerce | 1.3% | 2.4% | 6.2% |
| | Offline | 98.7% | 97.6% | 93.8% |
| Beauty & personal care | E-commerce | 0.9% | 1.2% | 3.4% |
| | Offline | 99.1% | 98.8% | 96.6% |
| Electronics | E-commerce | 4.6% | 9.5% | 18.0% |
| | Offline | 95.4% | 90.5% | 82.0% |
| Consumer health | E-commerce | 0.4% | 0.7% | 7.4% |
| | Offline | 99.6% | 99.3% | 92.6% |
| Appliances | E-commerce | 6.7% | 7.6% | 13.8% |
| | Offline | 93.3% | 92.4% | 86.2% |
| Home care | E-commerce | 0.7% | 1.2% | 4.6% |
| | Offline | 99.3% | 98.8% | 95.4% |

**Source: BCG, U Capital Research**

The table above shows that e-commerce is making inroads into the retail industry. However, this also makes us notice that the brick-and-mortar retail structure still has a dominating market share of the overall retail industry, and the economy reopening would help them to remain so in the foreseeable future.

**Fig. 17: Typical sizes of various categories of retail stores**

| Type of the retailer | Category | Size range |
|---|---|---|
| **Standard** | Grocery & supermarket | 650-850 sqm |
| | Gym & fitness facilities | 450-600 sqm |
| | Casual dining | 400-500 sqm |
| | Healthcare clinics | 350-400 sqm |
| | Fashion retailers | 150-500 sqm |
| | Coffee shops | 120-150 sqm |
| | Quick eat joints & food court | 40-50 sqm |
| **Entertainment-based** | Indoor theme parks | 3,700-5,600 sqm |
| | Cinema theaters | 1,200-2,800 sqm |
| | Sports club | 950-1,800 sqm |
| | Children edutainment centers | 950-1,800 sqm |
| | Family entertainment centers | 950-1,800 sqm |
| | Multi-purpose studios | 280-470 sqm |

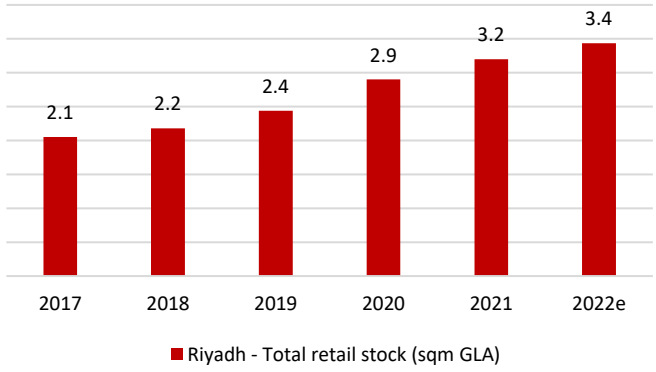
**Source: CBRE, U Capital Research**

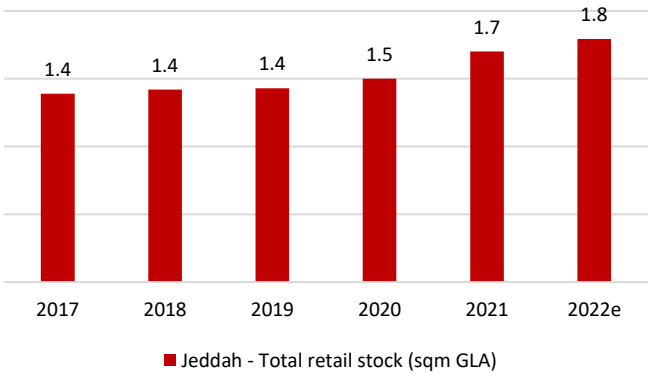
While e-commerce provides the convenience of shopping from anywhere and the availability of numerous choices across product categories at different price points, shopping centers or malls serve as a one-stop solution for an individual or family's outing, shopping, entertainment, and leisure needs. The Gulf region's extreme weather conditions also partly play a role in enhancing the appeal of the malls/shopping complexes as they offer a climate-controlled environment.

## Favorable demand outlook conducive for additional supply of retail space

The retail players in Saudi Arabia managed their businesses quite well during the pandemic and continued to invest in organic expansions. Arabian Centres, one of the major players in organized retail in the Kingdom, is likely to open six new malls over the next 4-5 years, Kuwait-based Mabanee is expected to launch two malls, UAE-based retail and hospitality conglomerate Majid Al-Futtaim is working on to develop a mixed-use project including the Mall of Saudi, one of the largest malls in the world, some hotels and residential units. In Saudi Arabia, Jeddah and Riyadh have more availability of organized retail and are also witnessing higher activity in terms of upcoming projects.

**Fig. 18: Supply of retail space continues to rise in both Riyadh and Jeddah**




***Source: JLL, U Capital Research***

***Source: JLL, U Capital Research***

We believe that the upcoming new supply of retail space in Saudi will be easily accommodated, given that a recovering economy, rising employment levels, women's participation, improving income levels, and changing lifestyles are expected to create a favorable environment for their growth. In addition, the hospitality sector is also witnessing an improvement in operating parameters, despite an increase in the supply of rooms.

**Fig. 19: Hospitality supply grew even during the pandemic**

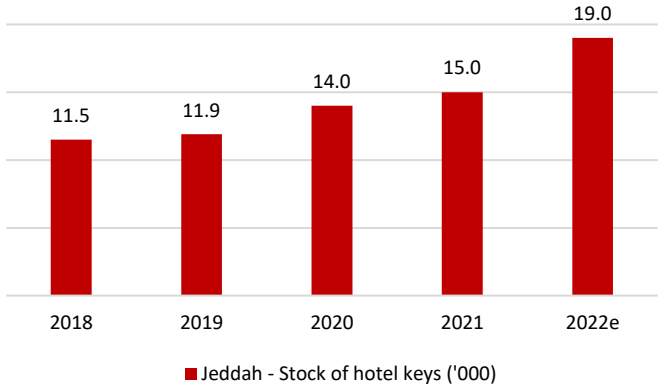
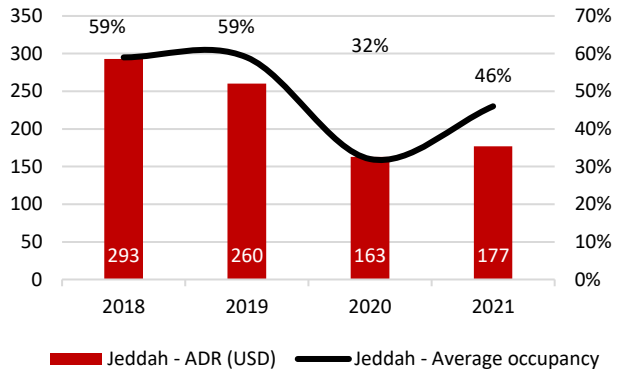



**Fig. 20: Sector dynamics improve**



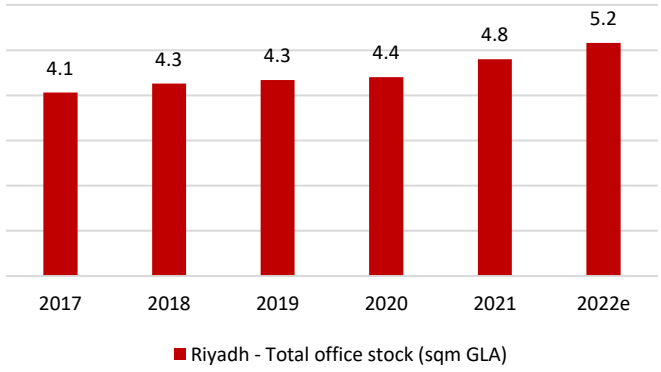

***Source: JLL, U Capital Research***

***Source: JLL, U Capital Research***

This bodes well for Alandalus which manages one premium hotel in Jeddah. Another point worth highlighting here is that Alandalus' hotel registered lower average occupancy as compared to the sector in 2020 (23% vs. 32%, respectively). However, in 2021, the average occupancy of the company's hotel exceeded the sector average (50-55% vs. 46%, respectively). In the coming periods, we expect further improvement in these metrics with an expected rise in Umrah pilgrims in Ramadan and the government allowing Hajj in 2022.

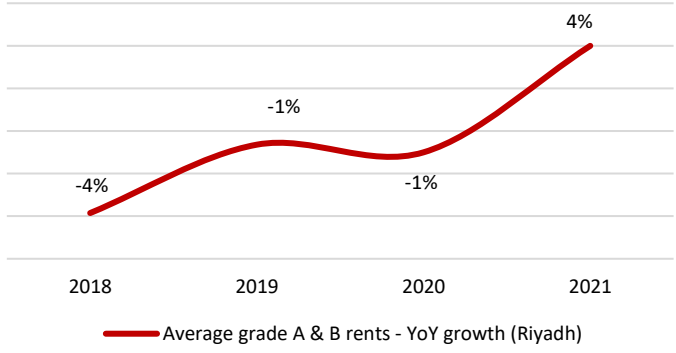
In tandem with the improvement in retail and hospitality, commercial office space is also registering a turnaround on the back of resumption of work from the office and general improvement in overall economic activity. The latest data from real estate consultancy JLL shows average rents of office properties in Riyadh and Jeddah moved up in 2021 after weakening in 2020. According to JLL, the recovery in office rents has also been driven by demand from international firms as a government mandate requires them to set up their regional headquarters in the kingdom by 2024.

**Fig. 21: Riyadh's office stock maintains steady growth**




*Source: JLL, U Capital Research*

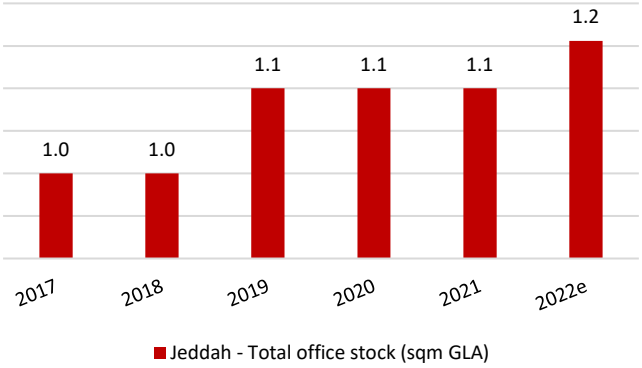
**Fig. 22: Rental rates recover after weakening in the last three years**




*Source: JLL, U Capital Research*

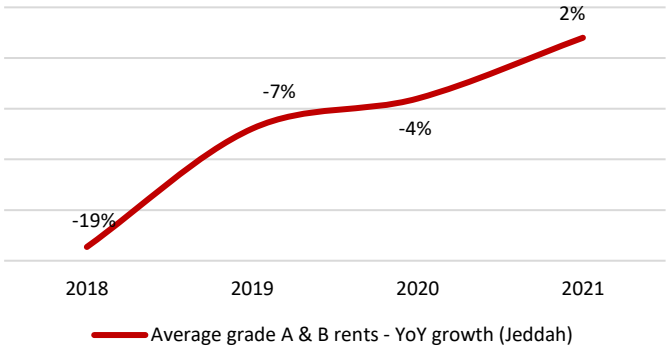
This again is a good development as far as Alandalus is concerned since its portfolio of commercial assets includes two office properties, one each in Riyadh and Jeddah.

**Fig. 23: Jeddah's office space stock flat over the last 3 years**




*Source: JLL, U Capital Research*

**Fig. 24: In tandem with Riyadh's office market rents**

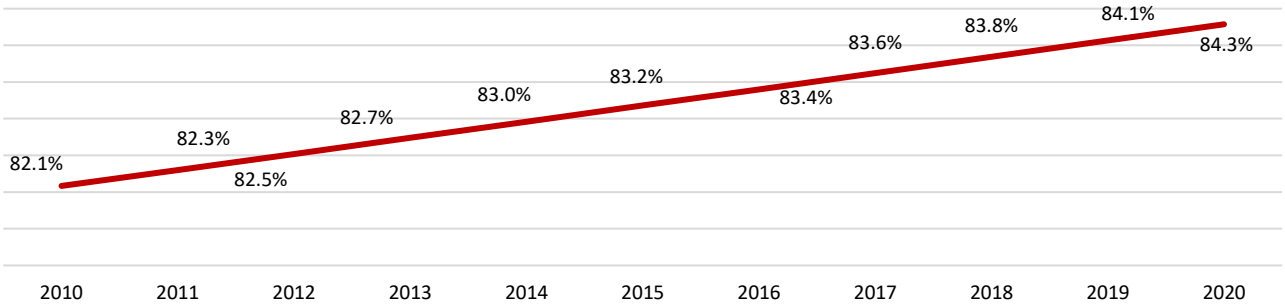



*Source: JLL, U Capital Research*

## An increasing urban map provides the right ingredients for the growth of commercial retail

Saudi Arabia's Ministry of Municipal & Rural Affairs (MMRA) had projected in 2013 that 88% of the total population to live in urban areas by 2025 as compared to ~80% in 2000. As per the latest data from the World Bank, the urbanization rate in Saudi Arabia had reached ~84% in 2020. Furthermore, the Kingdom is working on several new megacities (NEOM, King Abdullah Economic City, Al Faisaliah City, etc.) as well as the transformation/expansion of existing cities (Riyadh). Needless to say, a growing urban population and the upcoming new advanced urban areas provide the right environment for the commercial retail sector growth since their format suits the busy lifestyle of the new generation and their preference for brands.

**Fig. 25: New planned cities to keep the urban rate high**



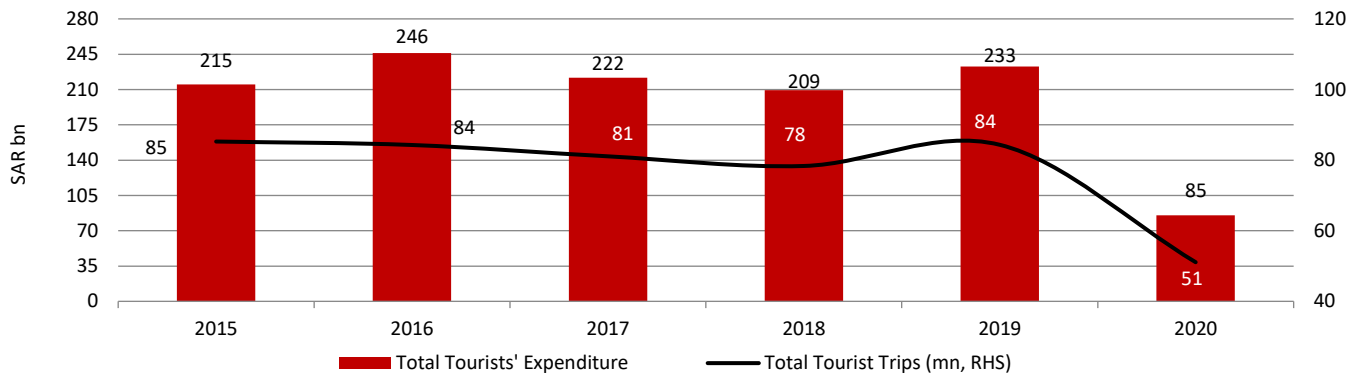

*Source: World Bank, U Capital Research*

## Tourism sector development is beneficial for the modern retailers

The development of the tourism industry is one of the key pillars of Saudi Arabia's economic diversification efforts as the government wants to lower its dependency on oil and gas revenues. Tourism is one of the important sectors in the Vision 2030 plan and the government has been introducing several measures to enhance the attractiveness of the Kingdom as a tourist destination.

According to the Saudi Tourism Authority, the sector is expected to contribute 5.3% to GDP in 2022 and employ 800,000 people as compared to 700,000 in 2021. At the same time, the government also looks forward to attracting 62mn tourists by 2022 end vs. ~54mn tourists in 2021. During the coming decade, Saudi Arabia aims to invest USD 1tn in the tourism sector, said the Minister of Tourism Ahmed Al-Khateeb. By 2030, **the Kingdom targets to bring in 100mn visitors, including 55mn international tourists every year, thus increasing** tourism's contribution to GDP to ~10% and employing ~1.6mn persons. In this regard, the tourism minister expects the sector to create 260,000 employment opportunities during 2022—2024.

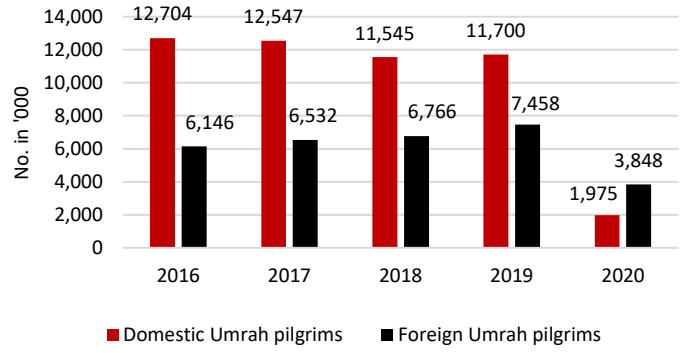
**Fig. 26: COVID-19 pandemic heavily impacted the Saudi tourism sector**



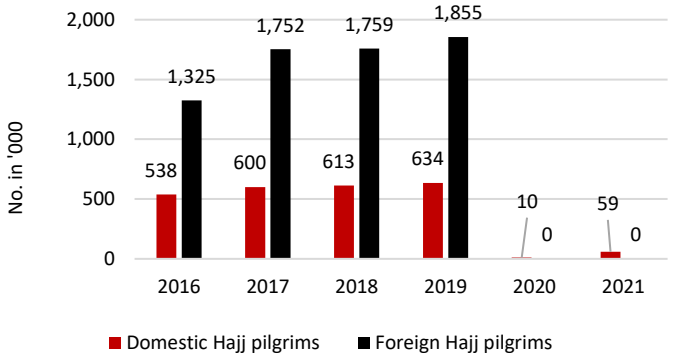

***Source: Saudi Ministry of Tourism, U Capital Research***

Apart from general tourism, the government is also taking steps to revive religious tourism which has been hit hard since last year in the backdrop of the COVID-19 pandemic. Saudi Arabia gets a sizeable number of visitors every year for Umrah and Hajj pilgrimage. But their numbers fell exponentially last year as the Kingdom banned outside visitors from performing Umrah and Hajj.

**Fig. 27: COVID-19 affected Umrah and Hajj pilgrimages badly**




***Source: GASTAT, U Capital Research***



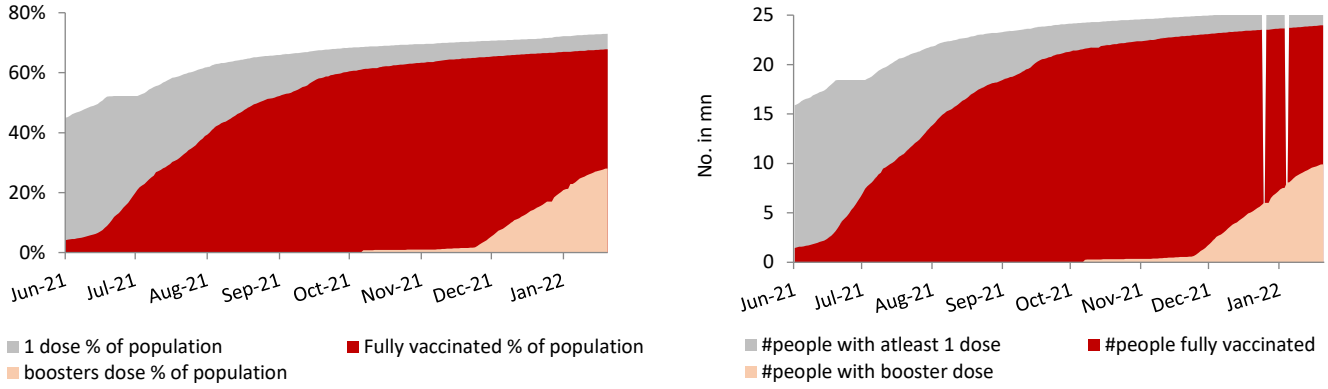

***Source: GASTAT, News reports, U Capital Research***

However, as the government allowed Umrah since October 2020 after putting in place required safety protocols, 10mn pilgrims performed Umrah till September 2021, according to the Saudi Ministry of Hajj and Umrah. Over the last few months, the government has taken several measures so that more pilgrims can perform Umrah, like the abolition of the age limit to enter the Two Holy Mosques, allowing partially vaccinated or unvaccinated persons for Umrah with some restrictions, permitting females aged 18 to 65 to undertake Umrah without a male guardian, provided they are part of a group, etc. The ministry is also targeting to increase the capacity of pilgrims to 3.5mn from the current 100,000 pilgrims a day. The government has also announced that Hajj will be resumed this year and is expected to soon publish a revised quota of pilgrims for the concerned countries. These religious tourists represent a significant target market for the players in commercial retail i.e., developers, operators, and managers of shopping complexes or malls and they generate decent business for many of them.

## Rising vaccination coverage, booster doses to support the sector in reaching its full potential

As per ourworldindata.org, ~73% of the population in the Kingdom has been administered at least one dose of the COVID-19 vaccine by the end of the 2nd week of February 2022. Saudi Arabia has also made it mandatory to have the booster shot of the COVID-19 vaccine after eight months of getting the second dose. The authorities are not leaving any stone unturned for vaccination so that the situation remains under control and things get back to normality fast. An increase in the vaccinated population will help the government in opening up the economy to its full potential. This will also be desirable for the commercial retail sector to boost growth as malls, shopping complexes, cinemas, etc. are still subject to some COVID-related restrictions like compulsory wearing of masks, vaccination checks, limitations on people allowed on the premises, etc.

**Fig. 28: More than 70% of the population in Saudi Arabia has been administered at least 1 dose of the COVID vaccine**




***Source: ourworldindata.org, U Capital Research***

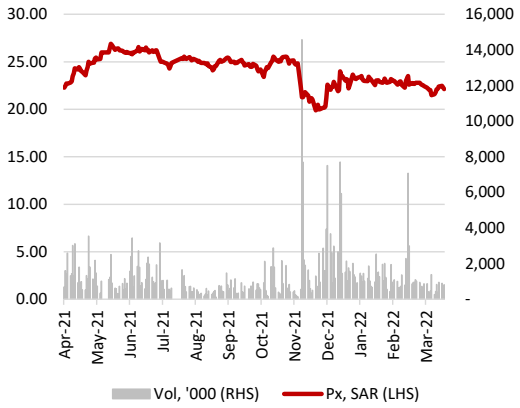
# Arabian Centres

**Target Price: SAR 25.5/share**
**Upside: 15.2%**

| Recommendation | Accumulate |
|---|---|
| Bloomberg Ticker | ALMRAKEZ AB |
| Current Market Price (SAR) | 22.14 |
| 52wk High / Low (SAR) | 27.300/19.800 |
| 12m Average Vol. (000) | 1,274.7 |
| Mkt. Cap. (USD/SAR mn) | 27,343/10,517 |
| Shares Outstanding (mn) | 475.0 |
| Free Float (%) | 34% |
| 3m Avg Daily Turnover (SAR'000) | 27,158.6 |
| 6m Avg Daily Turnover (SAR'000) | 33,751.3 |
| P/E'22e (x) | 22.8 |
| P/B'22e (x) | 1.7 |
| Dividend Yield '22e (%) | 4.3% |
| **Price Performance:** | |
| 1 month (%) | (2.5) |
| 3 month (%) | (1.9) |
| 12 month (%) | (2.6) |

*Source: Bloomberg, valued as of 30 March 2022*

**Price-Volume Performance**




*Source: Bloomberg*

- **One of the major players in commercial retail; has a portfolio of over 20 malls with a market share of 16% in FY21 (ended March)**
- **Work is ongoing on six more malls; expected to begin operations over the next 4-5 years in a staggered manner**
- **The company aims to go asset-light by favoring lease over purchase; other initiatives are also planned to lower capex requirements and operating costs**
- **Sustained dividends with the management committing a minimum 60% payout**

We initiate coverage on Arabian Centres Company (ACC) and assign an **Accumulate** rating with a target price of SAR 25.5 per share, offering an upside of 15.2%. Currently, the stock trades at a P/B of 1.7x, based on our FY23 (ending March) estimates. ACC has started witnessing a turnaround in its business, with the average occupancy at its malls inching towards the pre-COVID level driven by a pick-up in the footfalls on easing restrictions. Two newly launched malls have also gained good traction in a short span, which shows ACC's strong market position, and hence we believe the upcoming additions would also scale up quickly. However, a correction of ~2% in the stock till date from December 2021-end, post ~10% dip in 2021 is overdone, in our opinion, given that Tadawul appreciated ~50% during this period.

## Investment Thesis

**Valuation and risks:** Our target price is based on blended valuation methodologies – (i) Discounted Cash Flow (DCF) and (ii) Relative Valuation (using P/B multiple). Key downside risks to our valuation include i) below-estimated occupancy levels ii) less-than-expected growth in the revenue per sqm of leased area, iii) non-renewal of land leases or renewal with less favorable terms, iv) delay in the addition of new properties, and iv) an adverse impact on footfalls due to deterioration in macro and sector-wide conditions. Key upside risks to our valuation include i) better-than-estimated occupancy levels, ii) higher-than-forecasted increase in revenue per sqm of leased area, and iii) more-than-expected improvement in operating efficiency.

**Improvement expected:** ACC has a vast and diverse portfolio of shopping malls, located at important places across the Kingdom i) Revenue estimated to grow ~9% YoY in FY22e, after falling ~15% in FY21 ii) Footfalls increased, leading to an improvement in average occupancy, iii) Six new properties to be added over the next 5-6 years, iv) Margins in FY22e to remain subdued, but likely to recover next year onwards as operating conditions turn favorable v) debt burden forecasted to come down as ACC focuses on asset-light model vi) comfortable liquidity position to ensure sustained dividend payouts

| Year | FY19 | FY20 | FY21 | FY22e | FY23e | FY24e |
|---|---|---|---|---|---|---|
| Revenues (SAR mn) | 2,176.4 | 2,197.3 | 1,856.4 | 2,024.9 | 2,734.2 | 2,397.3 |
| Net income (SAR mn) | 789.6 | 633.9 | 486.7 | 461.4 | 969.0 | 752.7 |
| Gross margin | 64.0% | 65.5% | 55.1% | 55.6% | 60.7% | 59.4% |
| Net profit margin | 36.3% | 28.9% | 26.2% | 22.8% | 35.4% | 31.4% |
| RoE | 15.8% | 11.5% | 8.1% | 7.6% | 15.5% | 11.5% |
| FCF (SAR/share) | 0.3 | 2.0 | 1.8 | 2.0 | 1.7 | 2.0 |
| DPS (SAR/share) | 1.4 | 0.9 | 1.0 | 1.0 | 1.2 | 1.3 |
| Dividend Yield | NA | 4.3% | 4.5% | 4.3% | 5.6% | 5.7% |
| P/E (x) | 0.0x | 15.7x | 21.8x | 22.8x | 10.9x | 14.0x |
| P/BV (x) | 0.0x | 1.7x | 1.8x | 1.7x | 1.6x | 1.6x |

*Source: Company Reports, U Capital Research* **P/E and P/B from FY22 (ending Mar) onwards calculated on price of 30/03/2022*

## A strong network and long remaining lease period ensure sustainable operations

ACC boasts of a large network of 20+ shopping complexes or malls located across various major cities in the Kingdom. These malls are built on a mix of leasehold and freehold lands. The latest composition of the company's malls portfolio indicates that it favors an optimum asset mix, which is also visible considering ACC's six upcoming projects as three of them have freehold ownership and the remaining three are on leasehold. The distribution between leasehold and freehold properties also helps the company in keeping a relatively asset-light business model, as the cost of land constitutes a major chunk of the total cost of the project.

**Fig. 29: ACC's malls' portfolio is nearly evenly distributed between leasehold and freehold ownerships**

| Mall | City | Category | Year opened | Lease Expiry |
|---|---|---|---|---|
| Mall of Dhahran | Dammam | A | 2005 | Apr-26 |
| Salam Mall | Jeddah | C | 2012 | Jul-32 |
| Mall of Arabia | Jeddah | A | 2008 | Freehold |
| Nakheel Mall | Riyadh | A | 2014 | Jul-34 |
| Aziz Mall | Jeddah | B | 2005 | Nov-46 |
| Noor Mall | Madinah | A | 2008 | Freehold |
| Yasmin Mall | Jeddah | B | 2016 | Nov-34 |
| Hamra Mall | Riyadh | A | 2016 | Freehold |
| Ahsa Mall | Hofuf | C | 2010 | Freehold |
| Salaam Mall | Riyadh | A | 2005 | Freehold |
| Jouri Mall | Taif | B | 2015 | Mar-35 |
| Khurais Mall | Riyadh | C | 2004 | Jan-22 |
| Makkah Mall | Makkah | A | 2011 | Freehold |
| Nakheel Mall Dammam | Dammam | A | 2019 | Freehold |
| U-Walk | Riyadh | A | 2019 | Jul-46 |
| Nakheel Plaza | Qassim | C | 2004 | Dec-29 |
| Haifa Mall | Jeddah | C | 2011 | Apr-32 |
| Tala Mall | Riyadh | C | 2014 | Apr-29 |
| Jubail Mall | Jubail | C | 2015 | Freehold |
| Sahara Plaza | Riyadh | N/A | 2002 | Freehold |
| Jeddah Park | Jeddah | A | 2021 | Operational Agreement |
| The View | Riyadh | A | 2021 | Freehold |

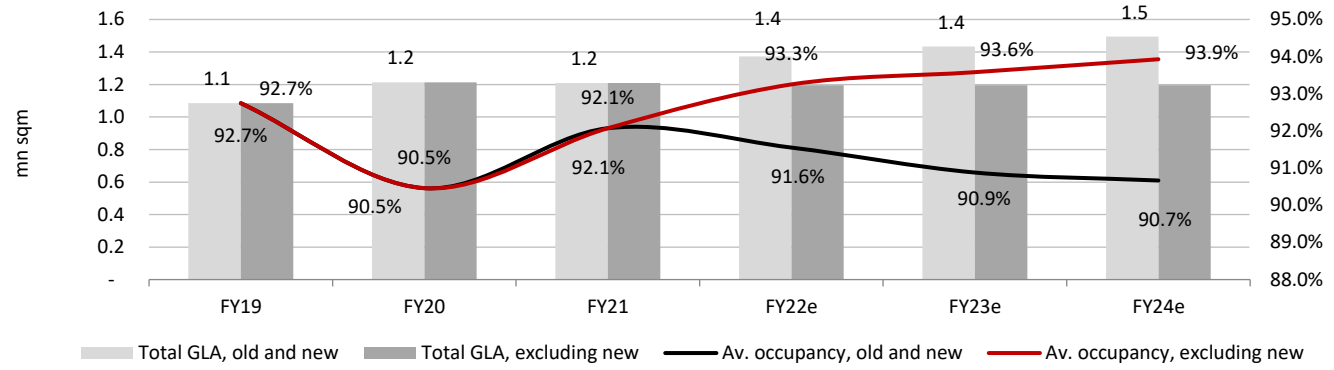
**Source: Company Reports (as of December 2021), U Capital Research**

Most of the ACC's malls have a long lease period remaining, implying it need not bother about the possibility of an unexpected increase in the majority of its lease expenses in the foreseeable future and is also saved from the hassles of lease negotiations. However, two of its malls – Khurais and Salma – had lease expiry in January and March 2022, respectively. Given that ACC has not given any information about Salma Mall's operations in its 3Q FY22 filings, we believe it has chosen not to renew this lease since the Salma Mall was witnessing continued weakness in its occupancy which reached 41.3% by 2Q FY22 vs. 65.0% by 2Q FY21. Khurais Mall, on the other hand, witnessed good occupancy of over 80% during this period. Accordingly, we have assumed that the land lease of the Mall of Dhahran will also be renewed which is due within our forecast period, taking into account the fact that it is one of the strategic assets of the company. This mall is the single largest contributor to ACC's total revenue (14.5% in 9M FY22) and has consistently maintained ~95% occupancy on average since FY17 (ended March 2017).

## Recovery in the commercial activities helps in lifting average occupancy to pre-COVID levels

As the business activities have started normalizing driven by economy unlock initiatives undertaken by the government amid the rising vaccination coverage, the company has witnessed an improvement in its average occupancy. The average occupancy of the company during 3Q FY22 (ended December 2021), excluding two new malls opened in September and November 2021, respectively, reached ~93% as compared to ~89% during 3Q FY21. Interestingly, the average occupancy of ACC's malls was in the range of 92%-93% before the pandemic struck, so the latest statistics can be construed as a sign that the company's operations are inching towards normalization.

**Fig. 30: Average occupancy, excluding new malls, reaches pre-COVID levels**




**Source: Company Reports, U Capital Research**

While the economic environment has improved considerably over the last few quarters, there remains room for it to attain the pre-COVID level. Accordingly, ACC expects the average occupancy of its malls to expand further to ~94% by the end of the next FY in 2023. Previously, new malls launched by ACC have quickly scaled up occupancy levels, and hence, we expect the upcoming malls should also reach average occupancy levels in a short period.

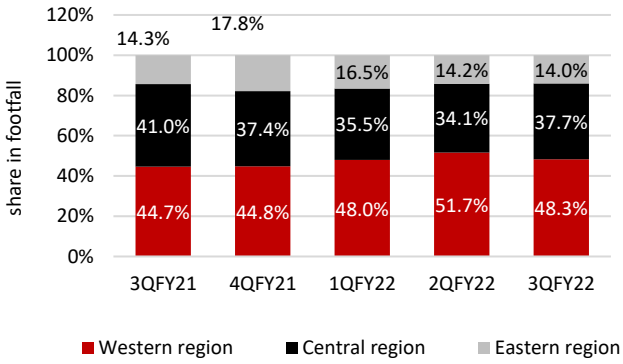
## Strong recovery in footfall; easing restrictions should help it rise further

In our opinion, the increase in occupancy at the company's malls has followed the rise in footfalls. Total visitors' footfall climbed 43.6% YoY during 9M FY22 to 60.8mn, while footfall in 3Q FY22 rose 13.6% YoY to 20.5mn. A point to note here is that in the same period last year, malls and shopping centers operated with some limitations as required by the government's COVID-containment efforts. Thus, if compared with the pre-COVID period of 9M FY20, footfalls are still 25%-30% lower. This is because some COVID-related restrictions are still applicable to the malls, like a mandatory mask, vaccination checks with visitors having administered with two doses, cinemas to operate at ~70% capacity, among others. Nevertheless, the management is hopeful that rising vaccinations will aid in the situation normalizing by the end of next FY. Resumption of Umrah and Hajj pilgrims should also push the footfalls higher, considering that the Western region of the Kingdom has a higher share of the company's footfall (48.3% in 3Q FY22), followed by the Central and Eastern regions (37.7% and 14.0%, respectively).

**Fig. 31: Footfall pick up, but still well below pre-COVID levels**


**Source: Company Reports, U Capital Research**

**Fig. 32: Malls in the western region attract higher footfalls**

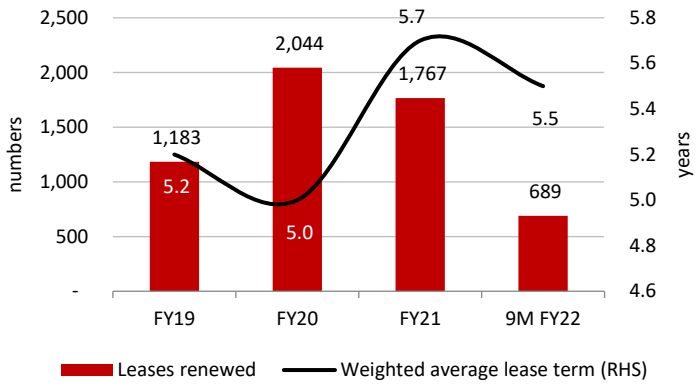



**Source: Company Reports, U Capital Research**

## Improving occupancy and favorable portfolio mix to offset a slight pressure on lease rates

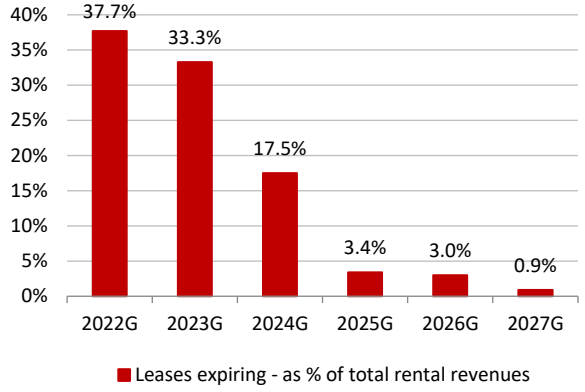
An increase in footfalls and occupancy has facilitated recovery in the revenue per sqm of the leased area and thus the overall revenue. The company earns most of its revenue from tenants at the malls and thus a growing or high occupancy is crucial for it which, in turn, depends on footfalls. Because of the expanse of its malls, ACC has to continuously deal with lease renewals of its tenants. During 9M FY22, it renewed ~90% of nearly 700 lease contracts while the remaining were replaced with other tenants. The management estimates that over the next 12 months, almost one-third of its portfolio will be due for renewal which we believe will be easily handled by the company, considering its record whereby the weighted average lease term has remained stable over the years.

**Fig. 33: ACC has several years of lease renewal experience**




**Source: Company Reports, U Capital Research**

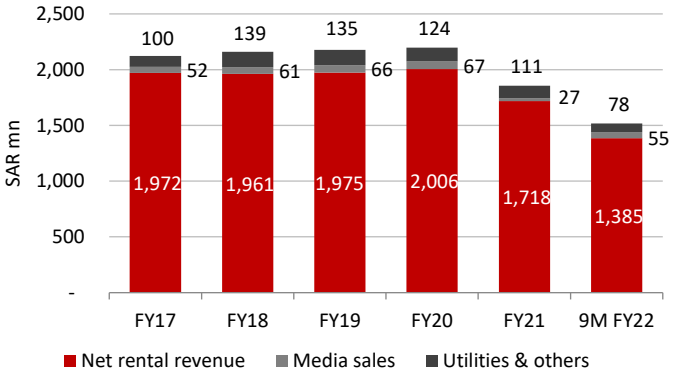
**Fig. 34: Leases with ~38% rental revenue share to be renewed in 2022**




**Source: Company Reports (as of 31 December 2021), U Capital Research**

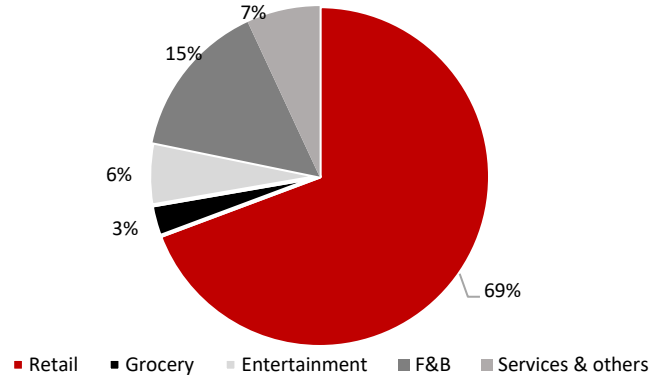
ACC said that the recent lease renewals are with lower rentals owing to slight pressure on rates, particularly at C category malls. However, we do not see this as a major concern since C category malls account for ~10% of the company's total rental revenue, with the A category mall contributing ~70%. Also, an improvement in occupancy should aid the company in partially offsetting this pressure on lease rates, in our view. Furthermore, the company is also working to slightly alter the category mix at its malls, increasing it from ~20% to 30% in favor of lifestyle definitions like fine dining, restaurants, cinemas, gyms, etc. that command higher rates than average retail. This should also aid ACC in getting better rental rates on an average over the near-to-medium term. On the back of an overall improvement in the economy, these developments, and initiatives as well as the addition of new properties and land development projects (Jouri) are expected to boost the revenue growth going forward.

**Fig. 35: Net rental revenue is the largest component of total revenue**



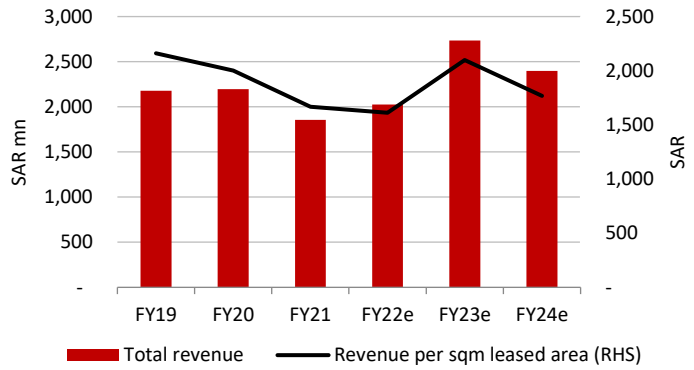

**Source: Company Reports, U Capital Research**

**Fig. 36: Within net rental revenue, retail has the largest share**



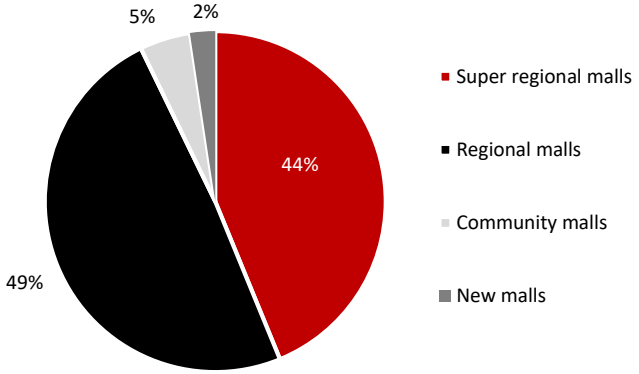

**Source: Company Reports, U Capital Research**

**Fig. 37: Jouri project is expected to boost revenue in short-term**




**Source: Company Reports, U Capital Research**

**Fig. 38: Regional malls generate ~50% revenue for ACC**



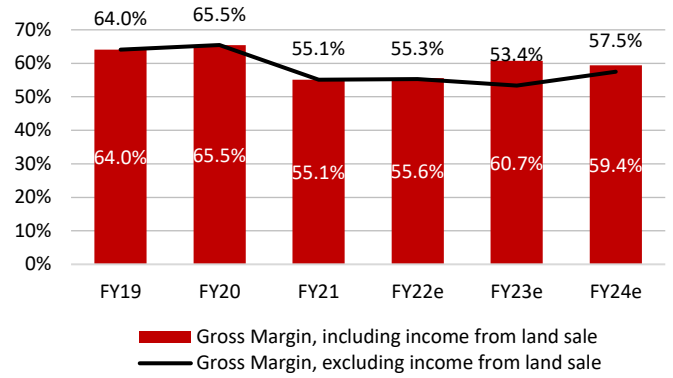

**Source: Company Reports (as of 31 December 2021), U Capital Research**

## Qassim land development project (Jouri) to give a short-term boost to revenue and margins

ACC has secured the Real Estate Developer Qualification Certificate from the Ministry of Municipal Affairs, which allows it to develop land plots, residential and mixed-use projects on its own rather than through a third party. Post that, the company announced on 13 March 2022 that it will develop its 1.6mn sqm land plot at Qassim under the name of "Jouri Project". The mixed-use project, which is located adjacent to the underdevelopment mall of the company "Qassim U Walk" is estimated to rake in around SAR 750mn as net revenue, with a majority of it accruing in FY23 (~21% of total estimated FY23e revenue, assuming between 75%-80% of the project's total expected revenue gets accrued during FY23). Moreover, apart from Qassim, the company has some more land banks, and it intends to announce a plan for them at an appropriate time in the future, which could provide ACC with a short-term revenue inflow or a long-term revenue stream, depending upon the type of development it is subject to.

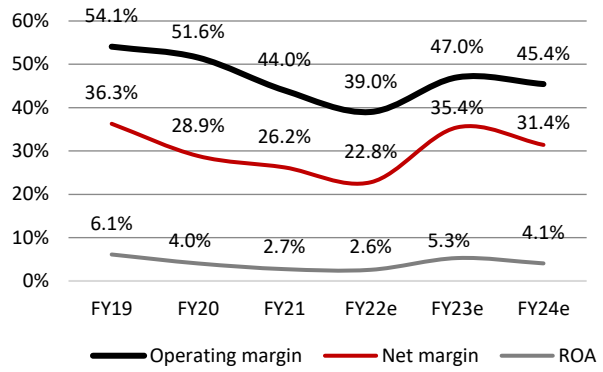
Based on our calculation, we expect the Qassim project to boost gross margin in the short term. However, with a pick-up in business activities, the company is registering an increase in mall maintenance costs, utilities, employee expenses, etc. On the other hand, it has been working to bring down conventional discount rates offered to tenants (6.8% in FY19 to 1.9% in FY21 and 0.9% during 9M FY22) while the COVID-related concessions are also coming down. Thus, over the medium-to-long term, we expect cost savings on discounts offered, and incremental revenue arising from the addition of new properties, higher average occupancy as well as rental rates, driven by a change in category mix, should help alleviate cost increases and support margins expansion.

**Fig. 39: Qassim land project to lift gross margin in FY23e**




**Source: Company Reports, U Capital Research**

**Fig. 40: Margin expansion on the cards**



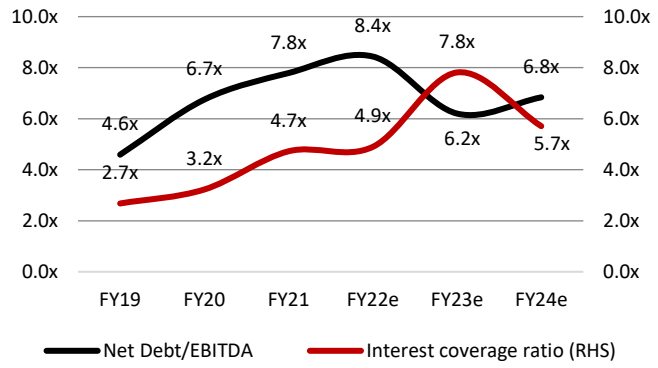

**Source: Company Reports, U Capital Research**

## Focus on the asset-light model, alternate financing options are likely to be margin accretive

Two of the company's malls – City Walk Jeddah and City Walk Qassim – are nearing completion and are likely to commence operations within the next 9-18 months. The company is also in the process of finalizing a financing deal for Jawharat Jeddah and Jawharat Riyadh which are likely to open by 1Q FY24 and 1Q FY25, respectively. This is expected to lower the funding requirements going forward.

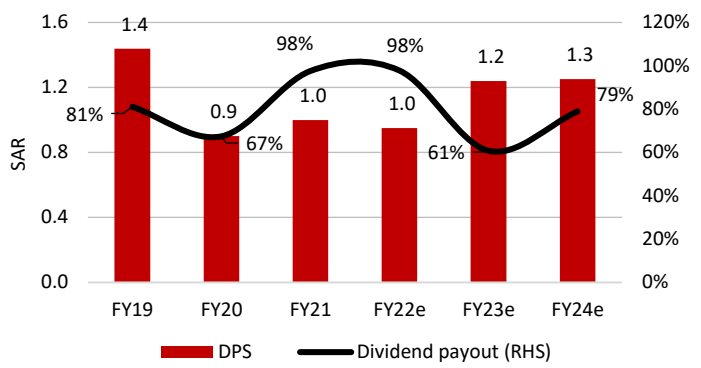
The company's D/E has remained above 1.1x on an average over the last few years, and increased slightly over the past few quarters, although the management is comfortable with the current leverage levels (net debt/EBITDA, including lease liabilities: ~8x as at December 2021-end). Nevertheless, going forward, the company targets to become asset-light by focusing more on leased properties and opting for management agreements for existing malls that bring in benefits like lower operating expenses and capex. Additionally, it is also considering off-balance sheet financing and/or going through REITs to fund the development of new projects in the future. Thus, a decrease in current funding requirements, coupled with the initiatives discussed above might aid the company in lowering its debt levels and the associated debt servicing costs, although it has maintained a good interest coverage so far.

**Fig. 41: Current net debt/EBITDA is within an acceptable range**




**Source: Company Reports, U Capital Research**

**Fig. 42: An expected improvement in earnings should lift dividends**




**Source: Company Reports, U Capital Research**

These changes to the funding mix will also provide the management leeway to continue rewarding the long-term investors with sustained dividend payouts. Incidentally, the company intends to maintain its dividend payout at a minimum of 60% in the foreseeable future. Based on our estimate of a gradual improvement in the company's earnings going forward, we expect the company to raise its dividends over time. On a separate note, the company might also decide to announce a special dividend next year to share the income generated from the "Jouri project".

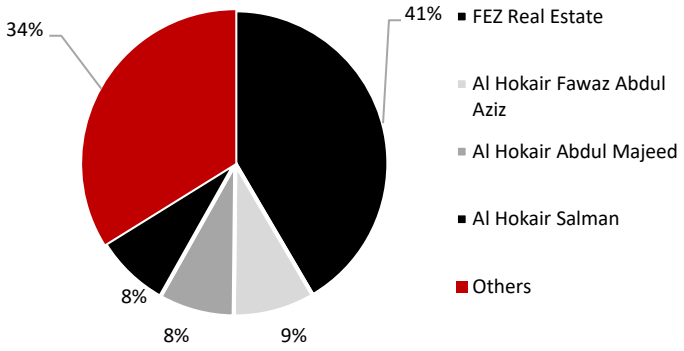
## Assign Accumulate rating on improving prospects

We assign an **ACCUMULATE** rating on the stock with a target price of SAR 25.5, implying an upside of 15.2%. The recent set of results indicates the operating conditions for the company and the sector have started improving and we believe the company, with its vast portfolio and a good market share, stands well placed to benefit as the economy proceeds further towards full unlock. In addition, the continued portfolio expansion along with certain fundamental changes the company is implementing or intends to carry out to become asset-light and leaner should support it in raising its profitability and enhancing returns for its shareholders in the long term.

## About ACC

ACC was established in 2005 and it develops, owns, operates, and manages commercial centers and complexes in the Kingdom of Saudi Arabia. The company had launched an IPO in 2019 and got listed on Tadawul in March of that year. By the close of FY21, the company had an overall 16% market share in the Kingdom. In Riyadh and Jeddah, two of the largest cities of Saudi Arabia where the company has the highest number of shopping centers, it held a market share of 15% and 27%, respectively by the end of FY21. At present, the company has a presence in 10 Saudi cities with a total of 22 shopping malls and a cumulative GLA of nearly 1.4mn sqm. In addition, ACC is also developing six shopping malls that are expected to become operational over the next 4-5 years. During 9M FY22 (ended December 2021), footfalls at the company's stores stood at 60.8mn.

**Fig. 43: ACC's Shareholding Structure**




**Source: Bloomberg, 27 March 2022**

**Key financials**

| In SAR mn, except stated otherwise | FY19 | FY20 | FY21 | FY22e | FY23e | FY24e |
|---|---|---|---|---|---|---|
| **Income Statement** | | | | | | |
| Revenue | 2,176 | 2,197 | 1,856 | 2,025 | 2,734 | 2,397 |
| Cost of revenue | (782) | (759) | (833) | (899) | (1,074) | (973) |
| **Gross profit** | **1,394** | **1,438** | **1,023** | **1,126** | **1,660** | **1,424** |
| General and administrative expenses | (172) | (183) | (191) | (227) | (283) | (251) |
| Advertisement and promotion expenses | (6) | (13) | (20) | (20) | (26) | (23) |
| Other operating income | 11 | 13 | 146 | 11 | 41 | 49 |
| **Operating profit** | **1,177** | **1,133** | **817** | **790** | **1,285** | **1,089** |
| Finance costs on loans and borrowings | (440) | (351) | (173) | (161) | (164) | (191) |
| Finance cost on lease liabilities | - | (135) | (172) | (156) | (139) | (136) |
| **Profit before zakat** | **749** | **663** | **473** | **468** | **982** | **763** |
| Zakat charge | 55 | (20) | 14 | (12) | (24) | (19) |
| **Profit attributable to shareholders of the company** | **790** | **634** | **487** | **461** | **969** | **753** |
| **Balance Sheet** | | | | | | |
| Cash and cash equivalents | 458 | 1,046 | 636 | 528 | 429 | 414 |
| Accounts receivable | 299 | 234 | 248 | 254 | 304 | 245 |
| Investment properties | 10,984 | 11,357 | 11,967 | 12,538 | 13,040 | 13,309 |
| Right of use assets | - | 3,562 | 3,122 | 2,907 | 2,788 | 2,655 |
| Property and equipment | 115 | 91 | 76 | 88 | 112 | 129 |
| **Total assets** | **13,366** | **17,961** | **17,655** | **18,113** | **18,545** | **18,565** |
| Loans and borrowings | 6,741 | 7,016 | 6,981 | 7,609 | 7,724 | 7,832 |
| Lease liabilities | - | 4,237 | 3,861 | 3,728 | 3,575 | 3,405 |
| Accounts payable and other liabilities | 218 | 382 | 405 | 379 | 424 | 364 |
| **Total liabilities** | **8,301** | **11,977** | **11,602** | **12,054** | **12,118** | **11,988** |
| Share capital | 4,450 | 4,750 | 4,750 | 4,750 | 4,750 | 4,750 |
| Retained earnings | 183 | 326 | 320 | 284 | 568 | 651 |
| **Equity Attributable to Shareholders** | **5,065** | **5,983** | **6,051** | **6,062** | **6,442** | **6,601** |
| **Cash Flow Statement** | | | | | | |
| Net cash generated from operating activities | 497 | 1,169 | 1,034 | 1,310 | 1,637 | 1,541 |
| Net cash generated from investing activities | (699) | (463) | (343) | (949) | (945) | (708) |
| Net cash (used in) provided by financing activities | 579 | (118) | (1,101) | (468) | (792) | (847) |
| **Cash and cash equivalents at the end of the period** | **458** | **1,046** | **636** | **528** | **429** | **414** |
| **Key Ratios** | | | | | | |
| Gross margin (%) | 64.0% | 65.5% | 55.1% | 55.6% | 60.7% | 59.4% |
| EBITDA margin (%) | 67.5% | 75.9% | 75.0% | 66.4% | 66.6% | 68.6% |
| Operating margin (%) | 54.1% | 51.6% | 44.0% | 39.0% | 47.0% | 45.4% |
| Net margin (%) | 36.3% | 28.9% | 26.2% | 22.8% | 35.4% | 31.4% |
| ROA | 6.1% | 4.0% | 2.7% | 2.6% | 5.3% | 4.1% |
| ROE | 15.8% | 11.5% | 8.1% | 7.6% | 15.5% | 11.5% |
| Current Ratio (x) | 1.0x | 2.0x | 1.4x | 1.5x | 1.4x | 1.4x |
| Capex/Sales | 21.1% | 5.7% | 12.7% | 15.8% | 34.5% | 29.5% |
| Debt-Equity Ratio | 1.3x | 1.9x | 1.8x | 1.9x | 1.8x | 1.7x |
| EPS | 1.8 | 1.3 | 1.0 | 1.0 | 2.0 | 1.6 |
| BVPS | 11.4 | 12.6 | 12.7 | 12.8 | 13.6 | 13.9 |
| DPS | 1.4 | 0.9 | 1.0 | 1.0 | 1.2 | 1.3 |
| Dividend Payout Ratio | 81.1% | 67.4% | 97.6% | 97.8% | 60.8% | 78.9% |
| Dividend Yield (%) | NA | 4.3% | 4.5% | 4.3% | 5.6% | 5.7% |
| P/E (x) | 0.0x | 15.7x | 21.8x | 22.8x | 10.9x | 14.0x |
| P/BV (x) | 0.0x | 1.7x | 1.8x | 1.7x | 1.6x | 1.6x |
| EV/EBITDA (x) | 4.2x | 12.1x | 14.7x | 15.6x | 11.6x | 12.8x |
| Price as at period end* | - | 21.1 | 22.3 | 22.1 | 22.1 | 22.1 |

*Source: Company Reports, U Capital Research* *Current market price is used for forecast periods

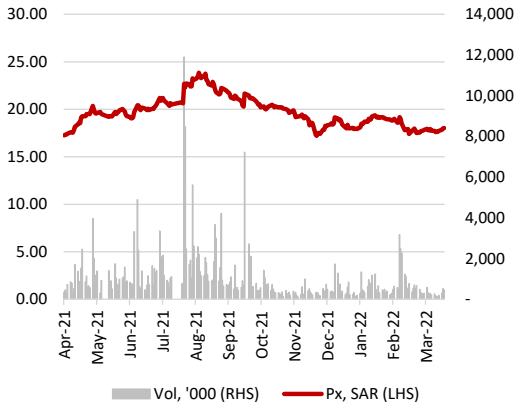
# Alandalus Property

**Target Price: SAR 20.8/share**
**Upside: 15.5%**

| **Recommendation** | **Accumulate** |
|---|---|
| Bloomberg Ticker | ALANDALU AB |
| Current Market Price (SAR) | 18.00 |
| 52wk High / Low (SAR) | 24.000/17.000 |
| 12m Average Vol. (000) | 978.5 |
| Mkt. Cap. (USD/SAR mn) | 4,368/1,680 |
| Shares Outstanding (mn) | 93.3 |
| Free Float (%) | 48% |
| 3m Avg Daily Turnover (SAR'000) | 10,622.7 |
| 6m Avg Daily Turnover (SAR'000) | 9,828.9 |
| P/E'22e (x) | 21.8 |
| P/B'22e (x) | 1.5 |
| Dividend Yield '22e (%) | 2.9% |
| **Price Performance:** | |
| 1 month (%) | 0.7 |
| 3 month (%) | - |
| 12 month (%) | 4.9 |

***Source: Bloomberg, valued as of 30 March 2022***

**Price-Volume Performance**




***Source: Bloomberg***

- **Strong operating performance across all the business verticals despite subdued operating conditions**
- **An improving economic environment in the backdrop of diminishing COVID cases bodes well for the business to carry on the growth momentum going forward**
- **Two new projects through associates are expected to commence operation in FY22 and by FY23-end, providing a boost to the bottom-line**
- **Stable dividend as the company promises a minimum 60% dividend during FY21-23**

We initiate coverage on Alandalus Property (Alandalus) and assign an **Accumulate** rating with a target price of SAR 20.8 per share, offering an upside of 16.4%. Currently, the stock trades at a P/B of 1.5x, based on our FY22 estimates. After witnessing a revival in its business during FY21 across the segments, we estimate the company's revenue and earnings from existing properties to pick pace further in FY22, on the back of continued improvement in the economic activity, and a considerable decline in the new COVID cases amid a rising vaccination coverage. An expected opening of a super-regional mall in Jeddah during 2Q 2022 and West Jeddah Hospital in 4Q 2023 would further boost the company's share of associate income and thereby earnings. These factors form the basis for our favorable view of the stock.

## Investment Thesis

**Valuation and risks:** Our target price is based on blended valuation methodologies – (i) Discounted Cash Flow (DCF) and (ii) Relative Valuation (using P/B multiple). Key downside risks to our valuation include i) occupancy levels coming in less than expected ii) below estimated growth in the revenue per sqm of leased area, iii) non-renewal of land leases or renewal with less favorable terms, iv) delay in the addition of new properties, and iv) an adverse impact on footfalls due to deterioration in macro and sector-wide conditions. Key upside risks to our valuation include i) higher-than-expected occupancy levels, ii) better-than-forecasted increase in revenue per sqm of leased area, and iii) more-than-expected improvement in operating efficiency.

**Resilient performance:** Alandalus operates in the retail sector (malls), which is one of the most affected segments by the pandemic, yet i) revenue decreased only by ~5% in FY 2020 and jumped ~28% in FY21, clocking 10% CAGR during FY16-21. ii) Maintained high occupancy of over 95% on average in its flagship Alandalus Mall during the last five years, which accounts for more than half of the company's revenue, iii) Gross margin in FY21 reached the highest level since FY16 (on a full-year basis); operating margin recovered by ~30pp YoY, iv) stable cash flows with low leverage, v) solid dividend payout, averaging over 100% during FY20-20; management resolves to pay minimum 60% dividend during FY21-23 (68.7% payout in FY21).

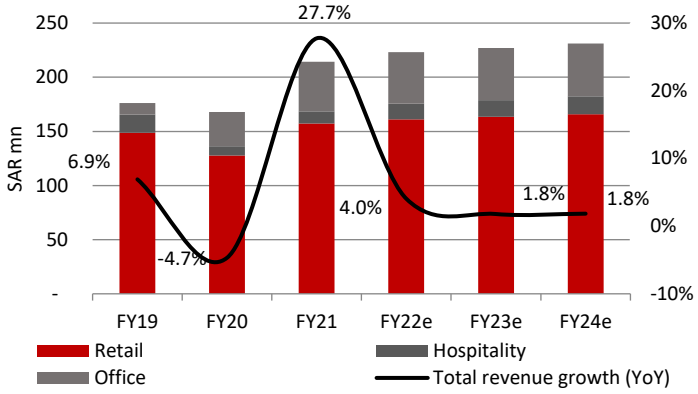
| Year | FY19 | FY20 | FY21 | FY22e | FY23e | FY24e |
|---|---|---|---|---|---|---|
| Revenues (SAR mn) | 176.1 | 167.8 | 214.4 | 223.1 | 227.0 | 231.2 |
| Net income (SAR mn) | 64.8 | 14.3 | 68.0 | 77.2 | 78.8 | 92.1 |
| Gross margin | 58.2% | 57.0% | 67.6% | 68.2% | 68.1% | 68.1% |
| Net profit margin | 36.8% | 8.5% | 31.7% | 34.6% | 34.7% | 39.8% |
| RoE | 5.8% | 1.3% | 6.4% | 7.2% | 7.1% | 8.1% |
| FCF (SAR/share) | (2.0) | (2.1) | 1.6 | 1.7 | 1.7 | 1.8 |
| DPS (SAR/share) | 0.8 | 0.4 | 0.5 | 0.5 | 0.6 | 0.7 |
| Dividend Yield | 6.4% | 2.4% | 2.8% | 2.9% | 3.1% | 4.0% |
| P/E (x) | 16.9x | 103.4x | 24.7x | 21.8x | 21.3x | 18.2x |
| P/BV (x) | 1.0x | 1.4x | 1.6x | 1.5x | 1.5x | 1.5x |

*Source: Company Reports, U Capital Research* **P/E and P/B from 2022 onwards calculated on price of 30/03/2022*

## Strong performance in a semi-normal operating year; likely to continue…

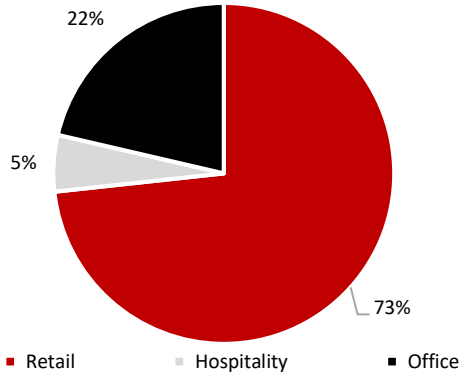
Alandalus witnessed a rebound in its business as it registered strong revenue growth of 27.7% YoY in FY21, with the retail segment being the major revenue contributor. All the three business segments – retail, hospitality, and office – witnessed double-digit revenue growth although the operating environment for these segments stood partially unfavorable during the year when the Kingdom experienced another COVID wave during 1H 2021 and imposed restrictions on leisure and entertainment activities for some time while work-from-home continued.

**Fig. 44: Solid revenue growth despite subdued conditions**




**Source: Company Reports, U Capital Research**

**Fig. 45: Retail segment has the largest revenue share…**




**Source: Company Reports, U Capital Research**

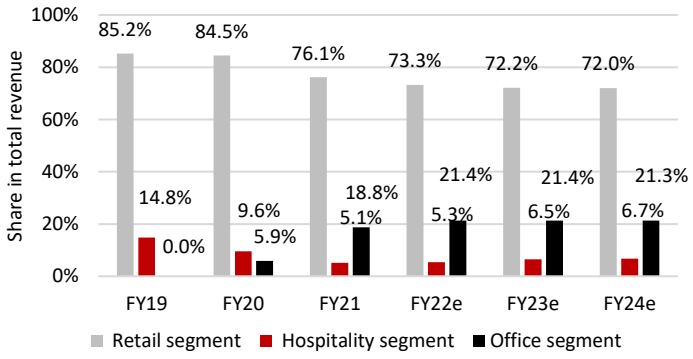
Over the last 6-7 months, operating conditions in the Kingdom have improved considerably as the government eased restrictions on international travel from several countries, allowed physical school openings for almost all categories of students, and took initiatives to revive the Umrah pilgrimage. We opine that a rising vaccination coverage has aided the government in reopening the economy swiftly as recent data suggests around 74% of the Saudi population have been inoculated with at least one dose of the COVID vaccine. As this coverage will grow further, it will allow the government to remove the remaining restrictions, particularly related to the number of people allowed in the malls and cinemas, in the near-to-medium term. Before the pandemic, Alandalus reported total mall footfalls at ~30mn in 2019, which declined by 50% to ~15mn in 2020. The footfalls recovered in 2021 to nearly 16.7mn (+11.3% YoY), yet it is nowhere near the pre-pandemic period and showcases there remains significant scope for growth in footfalls at the company's malls. The higher the footfall, the better it is for the businesses operating at the mall, as well as the operators of the malls since this is expected to boost its average occupancy. A commercial property enjoying high average occupancy is most likely to fetch better rental or lease rates for its owner, thereby driving the overall revenue higher.

## …driven by the retail segment on an expected recovery in footfall amid easing restrictions

The retail segment (malls) has remained the major revenue driver for the company over the years, and we expect it to remain so going forward. The segment comprises Alandalus Mall based in Jeddah and some strip malls in Jeddah and Riyadh. Alandalus Mall is the flagship mall of the company and has likely accounted for ~80% of the retail segment's revenue and nearly 60% of the company's total revenue in FY21. This mall, benefitting from its strategic location, has enjoyed high occupancy levels historically which dipped slightly during the pandemic. However, in the backdrop of an improving economy, and considering the scope for growth in the footfalls as per our discussion above, we forecast Alandalus to continue operating at high occupancy levels while other malls also post improvement in occupancies during our forecast period.

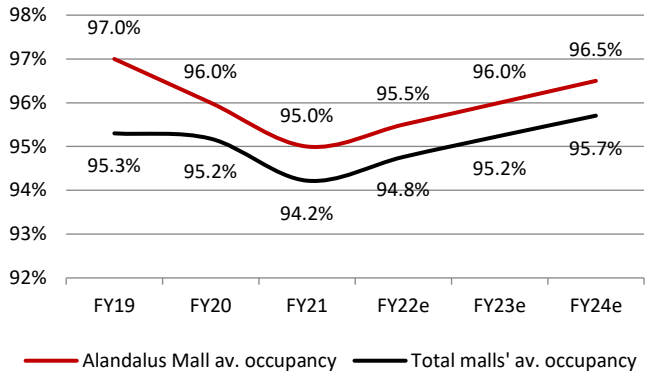
In addition, we expect the malls to benefit from an increase in the pilgrimage traffic, especially Hajj since Jeddah serves as an important connecting center for the international visitors arriving in Saudi Arabia for Hajj. While the government has started taking various steps by the end of 3Q 2021 to revive Umrah, recently Saudi authorities have confirmed to allow international pilgrims for Hajj in 2022 after a gap of two years. In this regard, the government will soon release a list with a revised quota of pilgrims for each participating country. Furthermore, as the Kingdom aims to invest over USD 200bn to transform its capital city Riyadh by 2030, leading to a multifold increase in its population and visitors, we opine the company stands to benefit from these developments in the long-term given that it already has a presence in that region.

**Fig. 46: …and is likely to drive the revenue growth going forward**



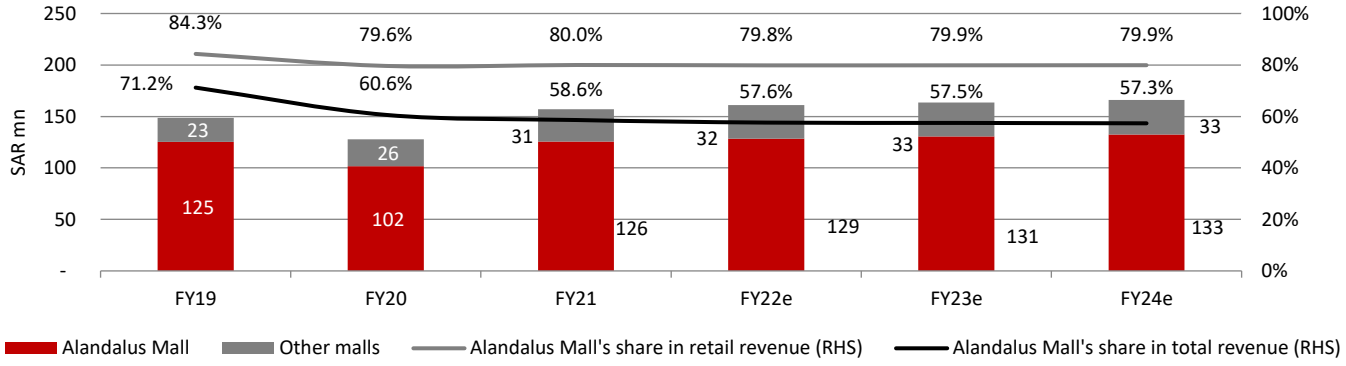

**Source: Company Reports, U Capital Research**

**Fig. 47: Alandalus Mall has maintained high occupancy…**




**Source: Company Reports, U Capital Research**

**Fig. 48: …and continues to account for more than 50% of the company's total revenue**

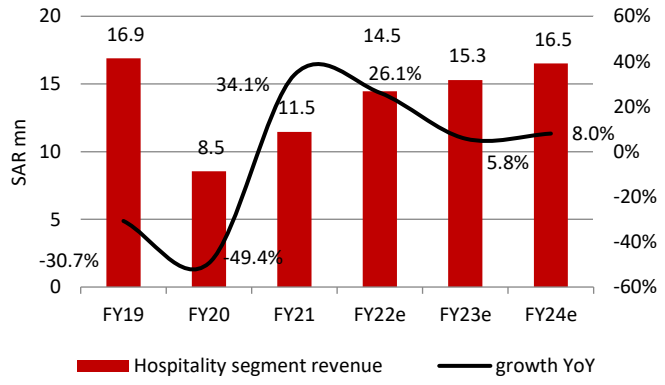



**Source: Company Reports, U Capital Research**

## Hospitality segment to benefit from unlocking activities

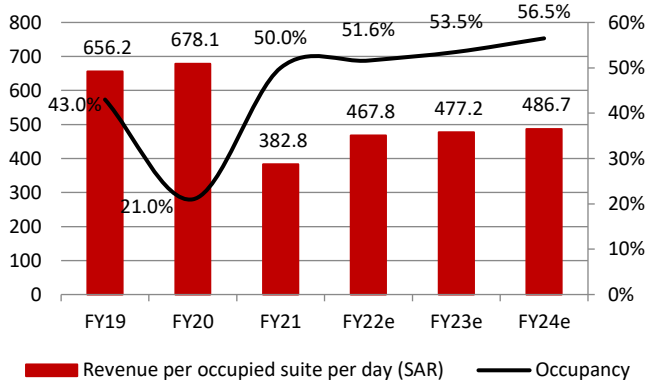
Alandalus has only one property in its hospitality segment (FY21 share in total revenue: 5.1%), which is a 5-star hotel located near the Alandalus Mall. The hotel became operational in 2Q 2017 and consists of 164 suites. As is obvious, operations of this hotel got hit significantly during the pandemic as the occupancy more than halved to 21% in FY 2021 from 43% in FY 2020. This dragged down the hospitality segment's revenue by nearly 50% YoY. However, in tandem with the performance of the retail sector, Alandalus Mall Hotel has recorded its occupancy more than doubling to between 50% and 55% in FY 2021, more than offsetting a ~43% YoY decline in the daily rate, thereby leading to 34% YoY growth in the revenue of the hospitality segment.

**Fig. 49: Rising tourist influx to aid pickup in hospitality revenue**




**Source: Company Reports, U Capital Research**

**Fig. 50: Occupancy levels improve despite subdued conditions**



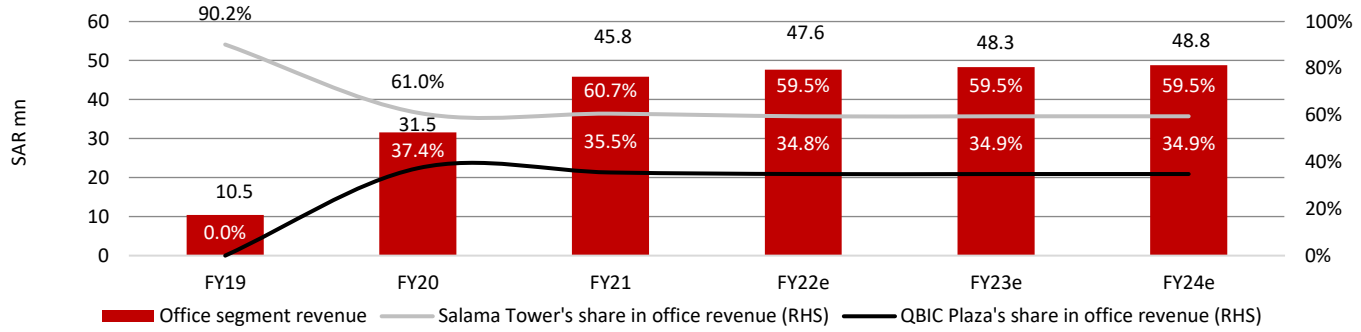

**Source: Company Reports, U Capital Research**

As highlighted previously that while FY21 witnessed relatively better economic conditions as compared to FY20, the period still has had its fair share of problems amid deadly COVID waves. Against this backdrop, we term this performance as commendable and believe the hotel to record its occupancy reaching higher levels in the coming years, supported by further improvement in the general economic conditions and the tourist activity (general + religious) gaining traction. The average tariff rate of the hotel should also improve in our view. Accordingly, we project the hospitality segment to continue registering healthy revenue growth going forward, and hence, the segment's share in total revenue is expected to reach ~8% as compared to ~5% in FY21.

## Good quality tenants lend resilience to the office segment

Alandalus derives revenue under its office segment (FY21 share in total revenue: 5.1%) from three properties – Salama Office Tower in Jeddah, QBIC Plaza in Riyadh, and the Head Office building. The company registered healthy revenue growth in FY20 and FY21 even as offices remain closed or operated at much lesser than full capacity for most of the time during this period amid work-from-home requirements. It is worth mentioning here that Alandalus acquired QBIC Plaza in FY20 which boosted the revenue growth of the segment for the year. Nevertheless, strong revenue growth of ~45% YoY registered in FY21 is a testament to the good quality tenants these office complexes have, in our view. For instance, some of the prominent names present in Salama tower are Samsung Gulf Electronics, Al-Rajhi Cooperative Insurance, Tim Hortons, etc. QBIC Plaza, on the other hand, is leased fully to the Ministry of Housing.

**Fig. 51: The office segment sustains growth under an unfavorable operating environment**



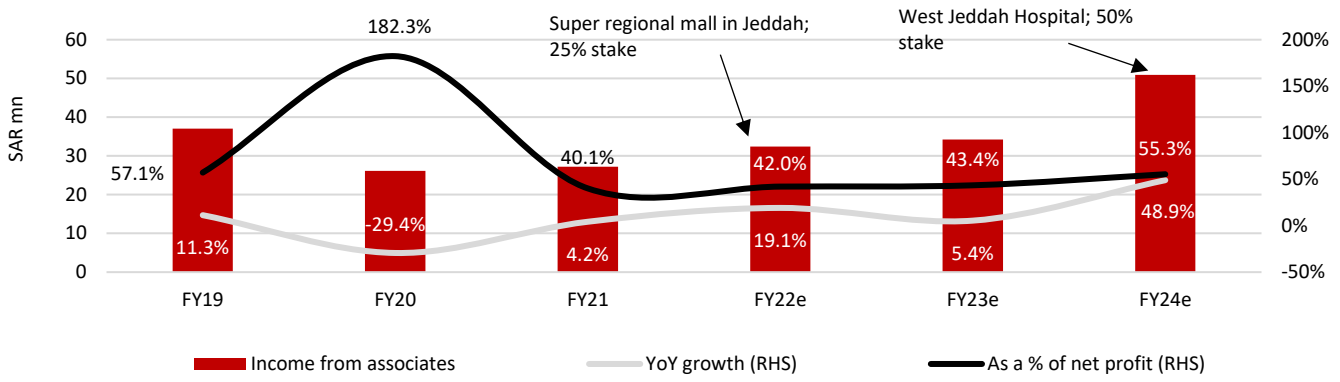

**Source: Company Reports, U Capital Research**

While the good quality of tenants would provide resilience to the office segment under adverse conditions in the future, we believe the company would also benefit from back-to-work from office drives as many employees have resumed going to offices and the numbers would rise as the population having administered the second and booster vaccine doses increase.

## Associate income to get the boost from the new projects

Alandalus generates a decent income from its associates. The company has a 25% stake in Riyadh-based Hayat Mall and a 50% stake in Damman-based Dareen Mall. Attributable to an improvement in the operating conditions, the company's share in associates' income grew slightly by ~4% YoY in FY 2021 after falling ~29% YoY in FY20. Going by our premise for the company-owned malls, we anticipate associate malls to also post relatively better performance this year. In addition, income from associates would get additional thrust in FY22 as a super-regional mall in Jeddah is expected to commence operations from 2Q 2022, in which the company has a 25% stake. Another associate project – 330 beds West Jeddah Hospital – is estimated to come online by 4Q 2023. Alandalus has a 50% stake in the project while the remaining 50% is with Dr. Sulaiman Al Habib Medical Services Group.

**Fig. 52: New projects set to boost the share of income from associates**



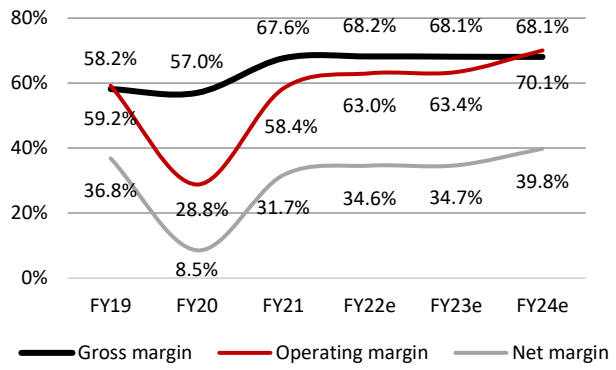

**Source: Company Reports, U Capital Research**

On a conservative basis, we estimate the financial impact of this project to start reflecting from FY24, and as per our calculations, in FY24, this project is likely to add an incremental income exceeding 40% of our estimated FY23 income from associates. In addition to the above, the company also has a 25% stake in two land projects in Jeddah and Makkah, with both of them having an area of over 125k sqm, respectively. These land banks are currently under study for probable development options, hence we have not modeled their financial impact on the company financials, but they certainly create upside risks to our current earnings estimates. Needless to say, these projects will surely aid the company in quickening the expansion of its margins to reach the pre-COVID levels.

## Margins continue to expand on higher top-line, better cost efficiencies, and growing associate income

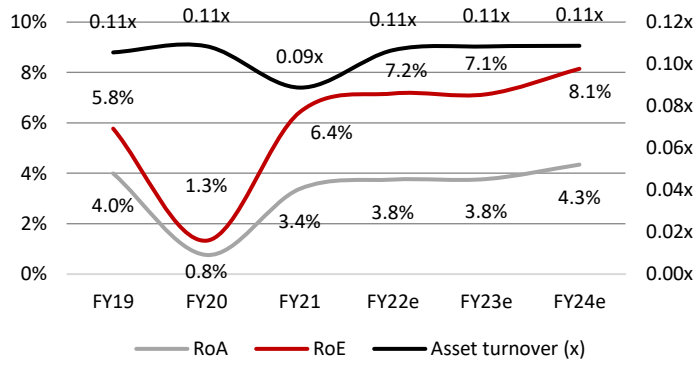
Supported by a rebound in top-line and the cost containment measures undertaken by the company, Alandalus' gross profit improved substantially to reach 67.6% in FY21, the highest since FY16 considering the full-year margins. As a result, operating and net margins also staged notable improvements. We believe efficiency improvements achieved during the pandemic would aid in further expansion of margins going forward, as the top line and income from associates grow.

**Fig. 53: Gross margin in FY21 was the highest since FY16**




**Source: Company Reports, U Capital Research**

**Fig. 54: Profitability improvement lifts return ratios significantly**

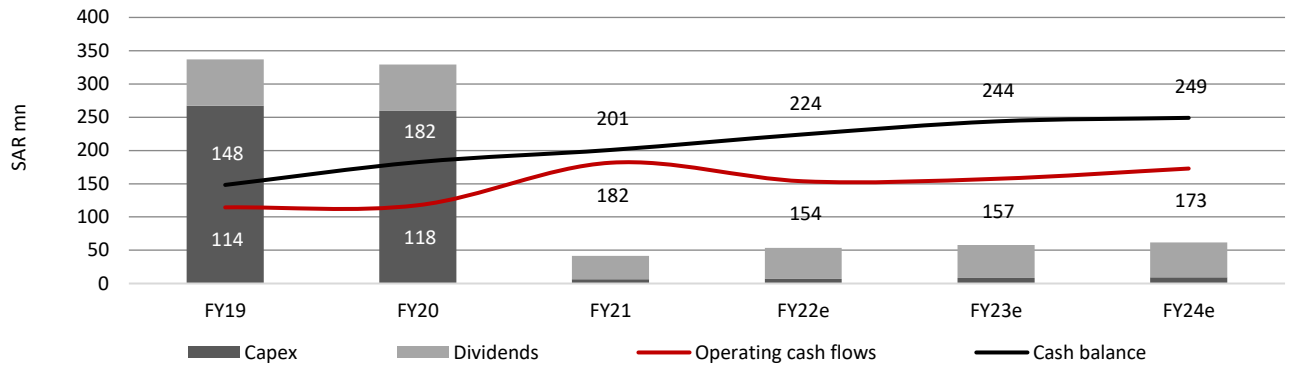



**Source: Company Reports, U Capital Research**

## Healthy balance sheet, limited capex requirements to support stable dividend policy

Alandalus' balance sheet has remained healthy historically, with the company meeting its capex requirements comfortably, as is visible by its good liquidity and low debt levels. Going by the status of the company's current projects under development which are primarily with associates, we estimate the capex requirements of the company to go down materially over the foreseeable future. This, along with healthy cash flows, will provide the company leeway in lowering its debt levels going forward which have increased slightly over the last couple of years as the company forayed into the office segment.

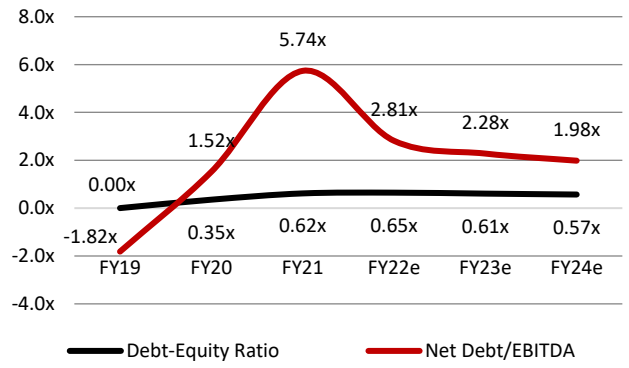
**Fig. 55: Liquidity position to strengthen as capex requirements are estimated to reduce**




**Source: Company Reports, U Capital Research**

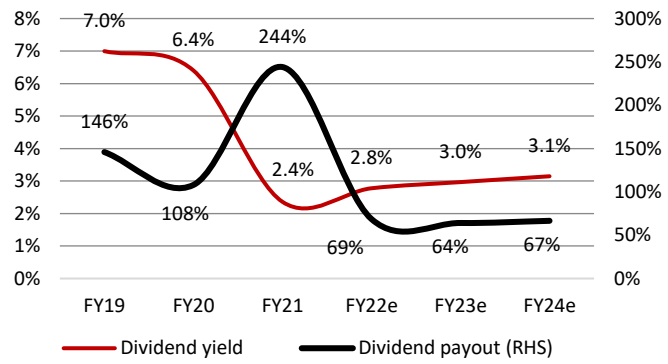
Backed by its healthy cash position, Alandalus has distributed high dividends, with the average dividend payout ratio being more than 100% from FY17 till FY20. The company intends to keep rewarding its shareholders in the future as well and thus it has set out a policy of a minimum 60% dividend payout for three years – FY21 till FY23. In FY21, the dividend declared by the company gives a payout of 68.7%. Over the coming years, a forecasted expansion in margins and cash flows will allow the company to pay a higher than the minimum dividend payout of 60%, in our view.

**Fig. 56: Leverage remains low**




**Source: Company Reports, U Capital Research**

**Fig. 57: Consistent and high dividend payments**




**Source: Company Reports, U Capital Research**

## Assign Accumulate rating as business gains traction

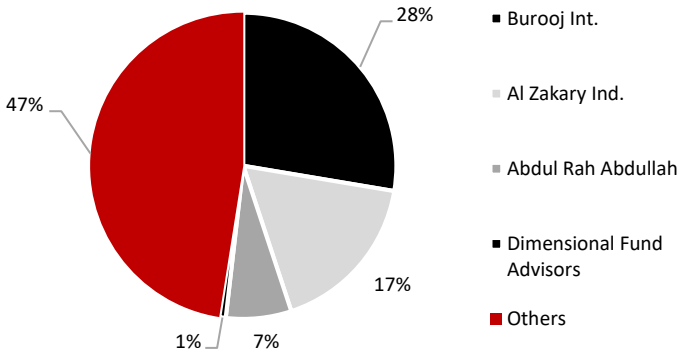
Alandalus has managed its operations well during the pandemic, as evidenced by healthy top-line growth in FY21, amid the continued relaxations in COVID-related curbs and a growing vaccinated population. Going forward, a likely revival in tourist activity and reopening of schools for all grades as well as back-to-work initiatives should increase footfalls at the malls and better occupancy in the hotel, thereby driving revenues. In addition, a likely expansion in margins, partly aided by efficiency gains, along with higher associate income and revenue growth would amplify returns for the shareholders. Despite the company posting a healthy set of financials last year, it has not been translated well into the stock price in our view, which has remained flat YTD till 27 March, in contrast to nearly 15% YTD return generated by TASI during the said period. Accordingly, we believe there is room for the price to appreciate from this level, and accordingly, we allocate an **ACCUMULATE** rating on the stock with a target price of SAR 20.8, implying an upside of 15.5%.

## About Alandalus Property

Alandalus Property Company was established as a Saudi joint-stock company in 2006 with a capital of SAR 238.9mn. The company got approval in December 2015 from the Capital Market Authority and subsequently offered 30% of its 70mn shares outstanding at that time for public subscription through an IPO. The company's current share capital is SAR 933.3mn. Alandalus' business is real estate development and investment, mainly in the commercial segment, and its current portfolio includes malls, strip shopping centers, a hotel, and office buildings, located in Jeddah and Riyadh. However, Jeddah provides the company with a majority of its revenue (87%

in FY20). The company also develops commercial properties in partnerships and some of its existing as well upcoming projects are through the associate/joint venture route.

**Fig. 58: Alandalus' Shareholding Structure**




**Source: Bloomberg, 27 March 2022**

**Key financials**

| In SAR mn, except stated otherwise | FY19 | FY20 | FY21 | FY22e | FY23e | FY24e |
|---|---|---|---|---|---|---|
| **Income Statement** | | | | | | |
| Revenue | 176 | 168 | 214 | 223 | 227 | 231 |
| Cost of revenue | (74) | (72) | (69) | (71) | (72) | (74) |
| **Gross profit** | **102** | **96** | **145** | **152** | **155** | **157** |
| General and administrative expenses | (33) | (39) | (41) | (43) | (43) | (45) |
| Marketing expenses | (2) | (2) | (2) | (2) | (2) | (3) |
| Other income | 6 | 1 | 1 | 1 | 1 | 1 |
| **Operating profit** | **104** | **48** | **125** | **141** | **144** | **162** |
| Interest expenses on lease liabilities | (12) | (13) | (12) | (12) | (12) | (11) |
| Finance costs | (4) | (13) | (14) | (15) | (16) | (16) |
| **Profit before zakat** | **88** | **23** | **99** | **113** | **116** | **135** |
| Zakat expense | (4) | (6) | (7) | (9) | (10) | (11) |
| **Profit attributable to shareholders of the company** | **65** | **14** | **68** | **77** | **79** | **92** |
| **Balance Sheet** | | | | | | |
| Cash and cash equivalents | 148 | 182 | 201 | 224 | 244 | 249 |
| Receivable against operating leases | 39 | 51 | 60 | 64 | 63 | 64 |
| Investment properties, net | 757 | 990 | 977 | 962 | 947 | 933 |
| Right of use assets | 95 | 89 | 83 | 77 | 71 | 65 |
| Property and equipment | 188 | 156 | 150 | 144 | 140 | 136 |
| **Total assets** | **1,799** | **1,980** | **2,040** | **2,075** | **2,102** | **2,136** |
| Accrued and other liabilities | 26 | 28 | 33 | 34 | 34 | 35 |
| Lease liability on right-of-use assets | 139 | 133 | 130 | 120 | 111 | 102 |
| Advances from lessees and deferred revenue | 38 | 36 | 46 | 49 | 49 | 49 |
| **Total liabilities** | **490** | **744** | **800** | **779** | **753** | **730** |
| Share capital | 700 | 700 | 933 | 933 | 933 | 933 |
| Retained earnings | 314 | 256 | 39 | 59 | 78 | 94 |
| **Equity Attributable to Shareholders** | **1,109** | **1,053** | **1,063** | **1,091** | **1,117** | **1,143** |
| **Cash Flow Statement** | | | | | | |
| Net cash generated from operating activities | 114 | 118 | 182 | 154 | 157 | 173 |
| Net cash generated from investing activities | (262) | (223) | (90) | (40) | (43) | (60) |
| Net cash (used in) provided by financing activities | 150 | 140 | (73) | (91) | (95) | (107) |
| **Cash and cash equivalents at the end of the period** | **148** | **182** | **201** | **224** | **244** | **249** |
| **Key Ratios** | | | | | | |
| Gross margin (%) | 58.2% | 57.0% | 67.6% | 68.2% | 68.1% | 68.1% |
| EBITDA margin (%) | 75.6% | 48.4% | 74.2% | 78.3% | 78.2% | 84.4% |
| Operating margin (%) | 59.2% | 28.8% | 58.4% | 63.0% | 63.4% | 70.1% |
| Net margin (%) | 36.8% | 8.5% | 31.7% | 34.6% | 34.7% | 39.8% |
| ROA | 4.0% | 0.8% | 3.4% | 3.8% | 3.8% | 4.3% |
| ROE | 5.8% | 1.3% | 6.4% | 7.2% | 7.1% | 8.1% |
| Current Ratio (x) | 2.7x | 2.6x | 2.6x | 2.8x | 3.0x | 3.1x |
| Capex/Sales | 151.7% | 154.6% | 3.0% | 3.2% | 3.7% | 4.0% |
| Debt-Equity Ratio | 0.4x | 0.6x | 0.6x | 0.6x | 0.6x | 0.5x |
| EPS | 0.7 | 0.2 | 0.7 | 0.8 | 0.8 | 1.0 |
| BVPS | 11.9 | 11.3 | 11.4 | 11.7 | 12.0 | 12.2 |
| DPS | 0.8 | 0.4 | 0.5 | 0.5 | 0.6 | 0.7 |
| Dividend Payout Ratio | 108.0% | 244.0% | 68.7% | 64.1% | 66.6% | 72.2% |
| Dividend Yield (%) | 6.4% | 2.4% | 2.8% | 2.9% | 3.1% | 4.0% |
| P/E (x) | 16.9x | 103.4x | 24.7x | 21.8x | 21.3x | 18.2x |
| P/BV (x) | 1.0x | 1.4x | 1.6x | 1.5x | 1.5x | 1.5x |
| EV/EBITDA (x) | 7.8x | 20.4x | 11.3x | 10.0x | 9.5x | 8.4x |
| Price as at period end* | 11.7 | 15.9 | 18.0 | 18.0 | 18.0 | 18.0 |

*Source: Company Reports, U Capital Research* *Current market price is used for forecast periods

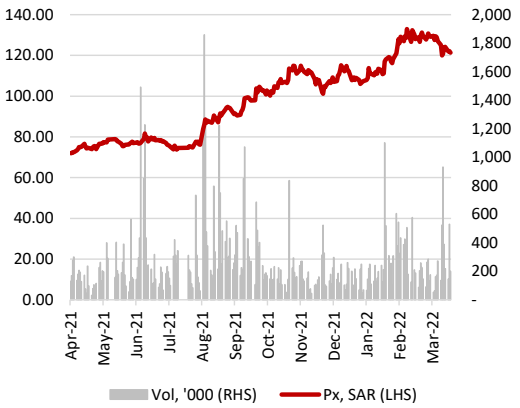
# Leejam Sports Co.

**Target Price: SAR 149.0/share**
**Upside: 22.7%**

| **Recommendation** | **Buy** |
|---|---|
| Bloomberg Ticker | LEEJAM AB |
| Current Market Price (SAR) | 121.40 |
| 52wk High / Low (SAR) | 138.000/71.500 |
| 12m Average Vol. (000) | 268.7 |
| Mkt. Cap. (USD/SAR Mn) | 16,534/6,359 |
| Shares Outstanding (mn) | 52.4 |
| Free Float (%) | 49% |
| 3m Avg Daily Turnover (SAR'000) | 31,897.5 |
| 6m Avg Daily Turnover (SAR'000) | 25,938.8 |
| P/E'22e (x) | 22.0 |
| EV/EBITDA'22e (x) | 12.7 |
| Dividend Yield '22e (%) | 2.3% |
| **Price Performance:** | |
| 1 month (%) | (4.1) |
| 3 month (%) | 11.4 |
| 12 month (%) | 69.6 |

***Source: Bloomberg, valued as of 30 March 2022***

**Price-Volume Performance**




***Source: Bloomberg***

- **Centers expansion to remain a key growth driver in the medium to long run**
- **Revenue is likely to cross the pre-pandemic levels soon given the normalization post Covid-19**
- **Robust margins are likely to sustain, underpinned by increased footfall, better efficiency, and increased realized prices per center**
- **The company's focus on delivering quality services and constant effort to enhance the user experience by integrating the latest technology and equipment is noteworthy**

We initiate coverage on Leejam Sports Co. (Leejam) and assign a **Buy** rating with a target price of SAR 149.0 per share, offering an upside of c.23%. Currently, the stock trades at a P/E of 22.0x and EV/EBITDA of 12.7x, based on our FY22 estimates. Also, the dividend yield stands at c.2.3% based on the current market price and our FY22 DPS estimate. Our TP is broadly underpinned by estimates for healthy center expansion, an expected increase in footfall due to normalization post-Covid-19, improved demand in general for fitness centers, and likely improvement in margins. Moreover, the penetration of organized fitness centers is low in KSA which presents a good growth opportunity for Leejam. The stock has been rallying for quite some time now and has generated a robust 1-year return of ~68% vs. the ~32% increase in TASI. Going forward, we expect the stock to continue outperforming the broader market, given its superior growth visibility.

## Investment Thesis

**Valuation and risks:** Our target price is based on blended valuation methodologies – (i) Discounted Cash Flow (DCF) and (ii) Relative Valuation (using P/E and EV/EBITDA multiples). Key downside risks to our valuation include i) slower-than-expected expansion in centers ii) resurgence of COVID positive cases and iii) unexpected impact from the recent geopolitical issues, especially from inflation and supply chain point of view. Key upside risks to our valuation include i) sooner-than-expected ramp-up of new centers ii) higher than estimated utilization of existing portfolio of centers iii) better-than-expected improvement in operating efficiency due to management initiatives iv) major reduction in debt reducing the interest burden, a positive given the backdrop of rising interest rate environment.

**Strong fundamentals:** Leejam's performance has been consistent in every aspect: i) consistently expanded the network of centers (126 in FY18 to 145 in FY21) and has a healthy expansion plan with the guidance of adding 12 to 19 centers in FY22 itself. ii) it is focused on delivering quality service and has always been ahead in integrating the latest technology and equipment iii) has sustained a healthy margin both at gross and operating levels iv) it has generated robust operating cash flows v) strong balance sheet outlook.

| | FY19 | FY20 | FY21 | FY22e | FY23e | FY24e |
|---|---|---|---|---|---|---|
| Revenues (SAR bn) | 944.9 | 662.6 | 885.3 | 1,088.3 | 1,299.4 | 1,533.5 |
| Net income (SAR bn) | 205.9 | (58.7) | 206.0 | 289.3 | 349.0 | 428.8 |
| Gross margin | 38.1% | 21.1% | 42.1% | 43.1% | 43.7% | 43.9% |
| Net profit margin | 21.8% | -8.9% | 23.3% | 26.6% | 26.9% | 28.0% |
| RoE | 28.7% | -8.5% | 28.0% | 33.0% | 34.3% | 36.8% |
| FCF (SAR/share) | 3.7 | 2.3 | 3.6 | 5.3 | 7.0 | 8.4 |
| DPS (SAR/share) | 1.4 | - | 2.1 | 2.8 | 4.0 | 5.3 |
| P/E (x) | 20.6x | -69.0x | NM | 22.0x | 18.2x | 14.8x |
| EV/EBITDA (x) | 12.0x | 25.8x | 14.7x | 12.7x | 10.5x | 8.7x |

*Source: Company Reports, U Capital Research* **P/E and EV/EBITDA from 2022 onwards calculated on price of 30/03/2022*



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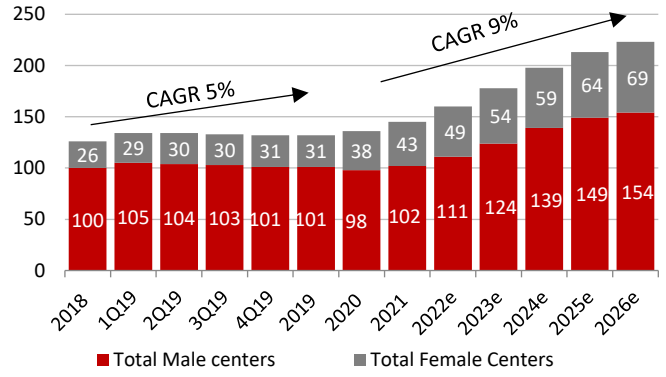
## Continued expansion to remain a key growth driver

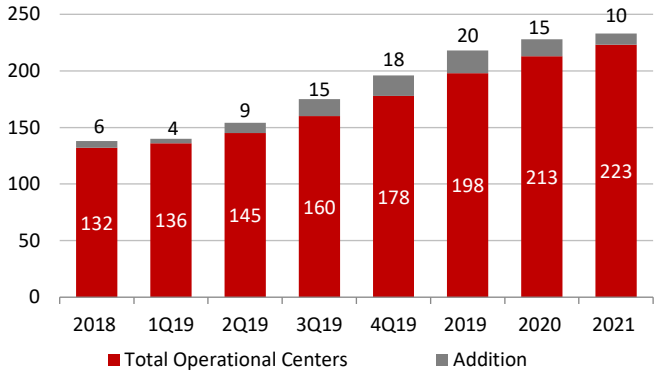
Leejam sees strong demand for fitness centers in the Kingdom, aided by increased footfall, lower penetration levels in KSA, and the fading impact of COVID-19. The company is looking at expanding its network in both the Big Box and Xpress category of centers. Leejam currently has 145 centers in total and aims to further grow to 157-164 by end of FY22. We believe the company should be able to achieve it given the strong fundamentals, its leading position in the industry, improved business outlook, favorable macro-economic backdrop, and demographic advantage in KSA. However, it should be noted that the Big Box facilities take 6 to 18 months to ramp up, while the Xpress facilities may take less time. This adds to the complexity, given the considerable lag in benefiting from the expansion as the related costs run well ahead of the revenue generated from the same. The increased focus on the Xpress format could offset some of this lag given the low ramp-up period. Moreover, given the low penetration rate in KSA, the company stands to gain well from these expansion activities in the medium to long term. Also, the new facilities are likely to stay ~20% of the legacy portfolio of gyms at any given point in time with a moderate utilization rate and thus the ramp-up issue does not pose a major risk to the business. We expect the centers to grow at a CAGR of ~9% over the next 5 years, bringing the total center count to around 220.

**Fig. 59: Strong growth seen in centers**




**Source: Company Reports, U Capital Research**

**Fig. 60: Total operational centers vs. additions**

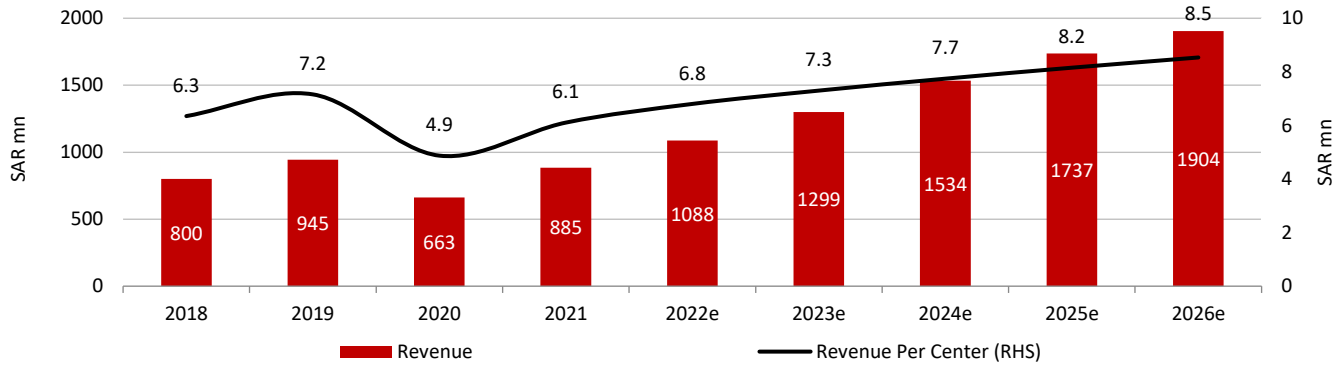



**Source: Company Reports, U Capital Research**

## Per center revenue to improve on higher footfall

The revenue per center seems to be stabilizing and we see strong growth here and expect it to reach ~SAR 9mn by 2026 on an annual basis. Among other factors, this growth can mostly be attributed to the relatively new centers reaching the later stage of ramp-up and, also by the general improvement in demand given the increased focus on fitness. Further, the expected increase in female members counts due to social reforms (increasing participants in the labor force, lifting of driving ban, among others) are expected to drive the revenue per center going forward.

**Fig. 61: Strong growth in revenue seen with an increase in utilization per center**




**Source: Company Reports, U Capital Research**



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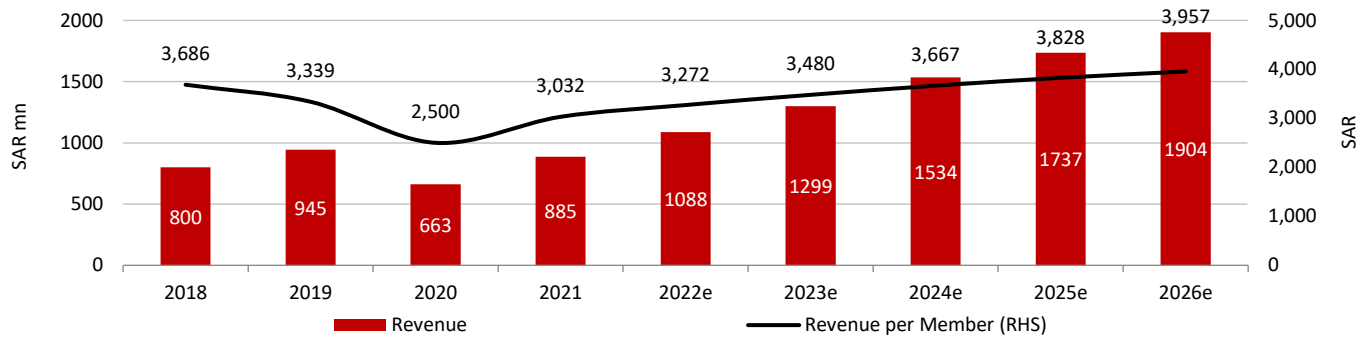
## Revenue close to pre-pandemic level and poised to grow well in future

The top line is close to the pre-pandemic level with 2021 revenue at SAR 885mn vs. SAR 952mn in 2019. However, we note that 2021 revenue is not exactly comparable given the 30-day closure during 1Q 2021 due to Covid-19 related restrictions. Nevertheless, we believe that revenue is poised to grow strongly, supported by the following factors.

- **Expansion plans:** Around 12 to 19 centers are likely to be opened in FY22 as per management guidance. We estimate the overall center count to reach around 220 by FY26.
- **Gradual improvement in realized prices:** We see the blended subscription revenue per member to increase to ~SAR 3,400 by FY26 from the current ~SAR 3,000.
- **Growth in the corporate segment:** Although the no. of corporate members has declined in 2021 to 41k from 50k in 2020, the no. of corporate tie-ups has increased to 215 from 160. With reduced COVID-19 restrictions, corporate footfall should also rise.
- **Improved outlook for personal training:** Given the prevalence of the younger population and the increasing female footfall, the demand for personal training is likely to increase going forward.

We would like to highlight that Leejam's business is seasonal with 1Q typically being the lowest and 4Q generating the highest revenue and it is thus better to look at the growth trend on annual basis. We estimate the revenue to grow at a CAGR of 17% over the next 5 years.

**Fig. 62: Realization on the rise**

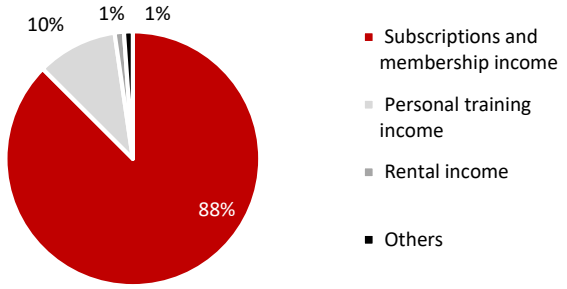



**Source: Company Reports, U Capital Research. * Revenue per member is calculated on total revenues**

## Segment analysis shows personal training to drive higher utilization

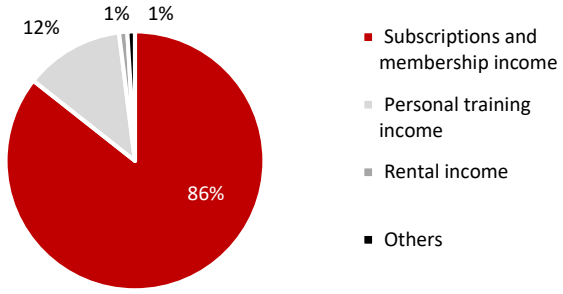
The company derives 88% of its revenue from the subscription business and 10% from personal training. While we see good growth in the subscription business, we estimate the personal training segment is likely to gain even more traction owing to i) changing consumer behavior with the increased focus on fitness ii) the favorable demographic mix of KSA (~25% of the population is in the age bracket 15-29 years) which could be more inclined to seek professional assistance iii) higher disposable income iv) increased female footfall. That said, we expect the mix to change and personal training's contribution to increasing to ~12.5% of the revenue by 2026. This is incremental to the utilization rate as the centers stand to generate higher revenue with no capex requirement. The only caveat here is the availability of professional personal training staff where there could be a supply constraint.

**Fig. 63: Segment break up FY21**




**Source: Company Reports, U Capital Research**

**Fig. 64 Segment break up: FY26e**




**Source: Company Reports, U Capital Research**



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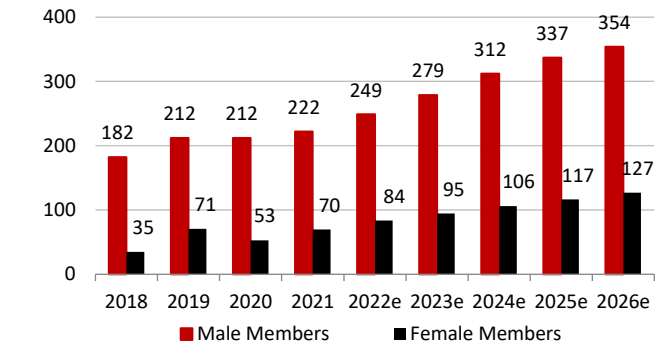
## Margins are likely to benefit from the recovery in footfall…

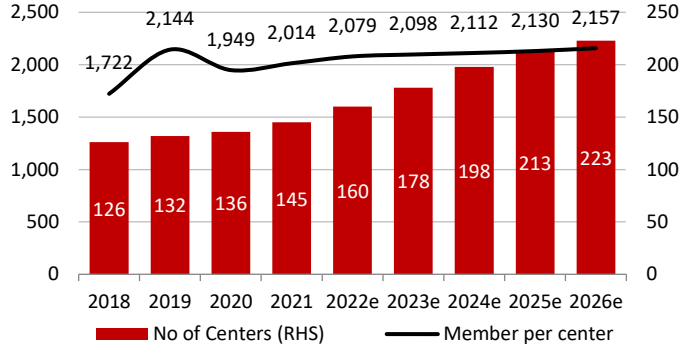
Leejam has witnessed a healthy footfall growth of 10% in FY21 with the number of members now at 292k vs. 265k in FY20 and 283k at FY19 end. An increase in footfall alludes to higher confidence in the members, that the presence of COVID-19 is ebbing meaningfully thus making it safe to socialize. The company's operations are likely to rebound faster and as such we estimate the member count to grow to ~480k by 2026-end, which is slightly on the conservative side compared to guidance of 500k by 2025. Our estimates translate to a 5-year CAGR growth of ~11% in the member count. Among other factors, we see this growth primarily coming from the low penetration rate in the KSA which has led to demand being higher than the increase in new facilities. Consequently, the members per center which stand at ~2,000 at 2021 end is likely to grow to ~2,160 by 2026. The higher utilization levels on top of the center growth will contribute handsomely to the gross margin as the economies of scale and high operating leverage kicks in. We expect Leejam's gross margin to expand by ~200bps to reach ~44% (vs. the current 42% and 38% in 2019, pre-pandemic) in the medium term. Further, the mix between male and female members is likely to gradually shift towards females which bodes well for the company as subscription revenue per female is usually slightly higher than that for males.

**Fig. 65: Membership base to increase**




**Source: Company Reports, U Capital Research**

**Fig. 66: Members per center**



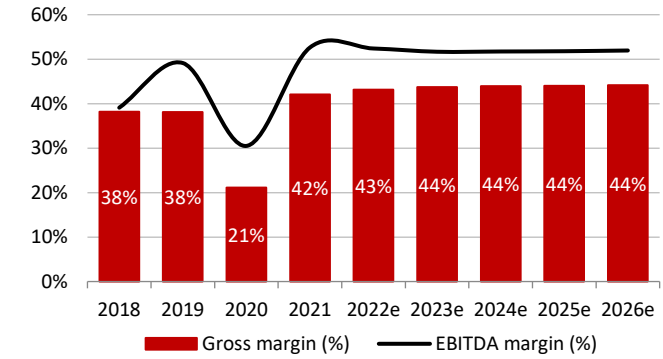

**Source: Company Reports, U Capital Research**

## …and further from cost efficiency initiatives and Xpress format centers

Leejam's management is focused on controlling its costs which is evident in its latest 2021 result. Despite the 30-day closure in 1Q 2021 (owing to COVID-19 restrictions) taking a toll on its annual top line, the company posted a strong gross margin of 42.1% vs. 38.1% in 2019, a 394bps margin expansion. This was largely sustained even at the operating level with the company registering an adjusted operating margin (ex. other income/impairment of financial assets) of 30.6%, a 339bps expansion compared to 2019. The margins will continue to expand further as the business scales up and the company introduces more cost-saving initiatives.

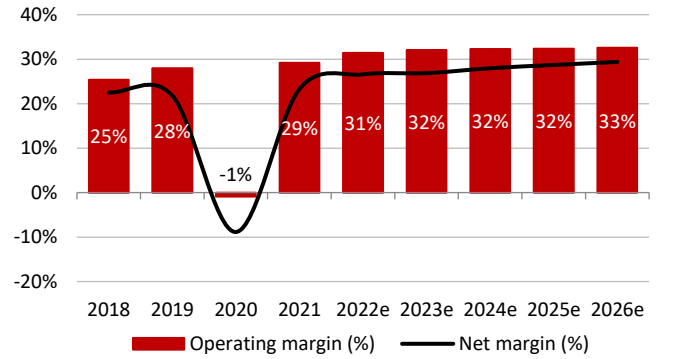
In addition, the management is inclined towards the Xpress format which typically has a lower operating and maintenance cost than the Big Box format, and hence we believe this could be margin accretive for the company. Currently, the company has 16 Xpress format centers which are yet to completely ramp up. The usual ramp-up period is 6 to 18 months; however, Xpress centers' ramp-up period is at the lower side of this range, and that can act as a catalyst to margin expansion, in our opinion. Further, with the improved cash flow, we expect the company will be able to deleverage, and this comes at an opportune time when the rate environment is turning hostile. This should aid in reducing the debt burden and benefit the net margin.

**Fig. 67: Gross and EBITDA margin**




**Source: Company Reports, U Capital Research**

**Fig. 68: Operating and net margin**




**Source: Company Reports, U Capital Research**



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**Fig. 69: Focus on Xpress centers**

| | Male | | Female | |
|---|---|---|---|---|
| | Big Box format | Xpress format | Big Box format | Xpress format |
| 2020 | 94 | 4 | 37 | 1 |
| 2021 | 90 | 12 | 39 | 4 |
| Change | -4 | 8 | 2 | 3 |

**Source: Company Reports, U Capital Research**

## Higher profitability and optimal capex plan to aid healthy free cash flow generation

Considering the margin expansion and the higher scale of business activity, Leejam is likely to generate strong operating cash flows in the coming years. Moreover, we expect the capital expenditure requirements would be relatively lesser going forward due to an optimal mix between Xpress and Big Box facilities. As per the management, the cost for building an Xpress facility ranges between SAR 2.5mn to SAR 5mn, and that for a Big Box is between SAR 15mn to SAR 20mn. We have factored in capex for around 78 new centers (30 Xpress and 48 Big Box) over the next 5 years and we believe the combined capex requirement excluding the maintenance capex to be around SAR 900mn.

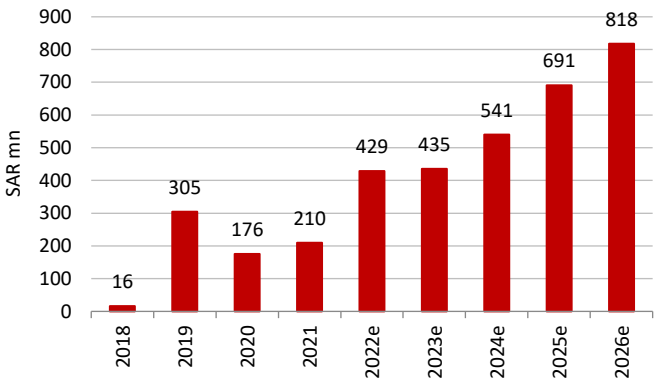
Overall, the strong operational cash flow generations coupled with an optimal capex plan should ensure healthy free cash flow in the coming years.

**Fig. 70: Estimated Capital expenditure**

| | 2022E | 2023E | 2024E | 2025E | 2026E |
|---|---|---|---|---|---|
| **Total new centers** | **15.0** | **18.0** | **20.0** | **15.0** | **10.0** |
| - **Xpress** | 6.0 | 7.2 | 8.0 | 6.0 | 4.0 |
| - **Big Box** | 9.0 | 10.8 | 12.0 | 9.0 | 6.0 |
| **Cost per center (SAR mn)** | | | | | |
| - Xpress | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| - Big Box | 17.5 | 17.5 | 17.5 | 17.5 | 17.5 |
| **Total costs (SAR mn)** | | | | | |
| - Xpress | 22.5 | 27.0 | 30.0 | 22.5 | 15.0 |
| - Big Box | 157.5 | 189.0 | 210.0 | 157.5 | 105.0 |
| **Total center costs** | **180.0** | **216.0** | **240.0** | **180.0** | **120.0** |
| **Maintenance (SAR mn)** | **20.0** | **23.0** | **25.0** | **28.0** | **30.0** |
| **Total capex (SAR mn)** | **200.0** | **239.0** | **265.0** | **208.0** | **150.0** |

**Source: Company Reports, U Capital Research**

**Fig. 71: Robust free cash flow to the firm**




## Balance sheet impacted by pandemic, but likely to improve

Leejam's balance sheet growth has been tepid over the last 3 years and has been impacted adversely due to the pandemic. Given the capital-intensive nature of the business, coupled with disruption in the cash flow, the company's debt to equity (including lease) increased from 0.7x in 2018 to 1.6x in 2021, after reaching a peak of 2.4x in 2Q21. However, we take comfort in the prospects for the fitness industry in KSA and believe that Leejam is well placed to capitalize on this opportunity and strengthen its balance sheet further. We estimate the reliance on debt to reduce gradually over the next 5 years and see the debt to equity multiple at around 0.6x in the long run. Moreover, we estimate that the company's ability to generate healthy free cash flow should be enough to cater to the expansion plans, even after accounting for a handsome dividend outflow (assumed payout ratio of 60% to 70%) and accelerated debt payment.



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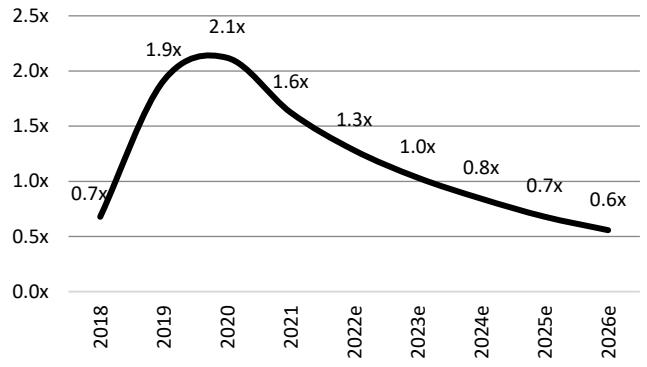
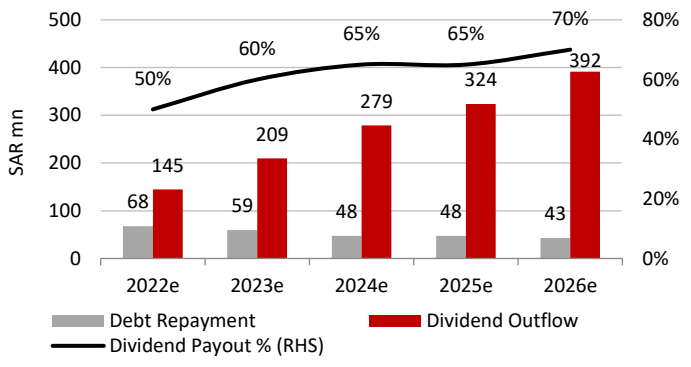
**Fig. 72: Debt to equity ratio**




**Source: Company Reports, U Capital Research**

**Fig. 73: Debt repayment and dividend outflow**




**Source: Company Reports, U Capital Research**

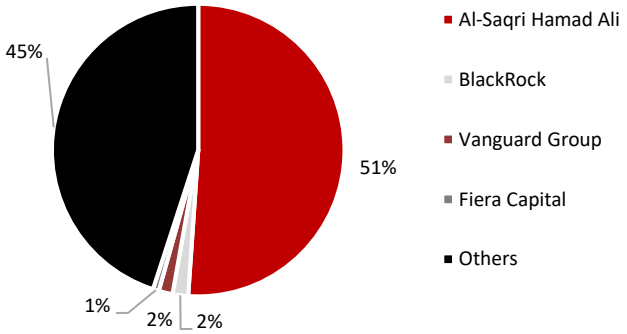
## Assign a Buy rating owing to the aggressive expansion plans and healthy margins

Leejam is poised for growth given the company's aggressive expansion plan which is very much in line with the increasing demand in KSA, given the low penetration of organized fitness centers. Also, the increased footfall is a testimony to the revival in the confidence of members to resume their regular life post unlocking economic activities. We see this confidence as cardinal to the growth of Leejam given the nature of its business. Moreover, the demographic advantage considering the prevalence of the young population and the increased awareness of maintaining a healthy lifestyle are some of the key factors that will aid in achieving this high growth. We believe the Xpress centers will continue to gain acceptance from members and will be margin accretive for the company. Further, the gradual increase in the subscription charges per member due to the supply-demand gap and inflation in general, followed by higher growth of female members due to social reforms and increased contribution from the personal training segment will help in expanding the margin. The higher margin when applied to a robust top-line growth will lead to a meaningful earnings expansion which should reflect in its stock price. Accordingly, we assign a **BUY** rating on the stock with a target price of SAR 149.0, implying an upside of ~23%.

## About Leejam Sports Co.

Leejam is into the fitness industry and its business activities include building, managing, and operating fitness centers under the Fitness Time trademark, including Fitness Time Plus, Fitness Time Pro, and Fitness Time Junior among others. It currently has a network of 145 centers which are broadly classified into two categories namely, Big Box and Xpress. The Company acquired the trademark "Fitness Time", which was owned by Fitness Time Establishment for Trading in 2005. In 2010, the company purchased all assets of Fitness Time Establishment for Trading.

**Fig. 74: Leejam: Shareholding Structure**




**Source: Bloomberg, 27 March 2022**



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**Key financials**

| In SAR mn, except stated otherwise | FY19 | FY20 | FY21 | FY22e | FY23e | FY24e |
|---|---|---|---|---|---|---|
| **Income Statement** | | | | | | |
| Revenues | 945 | 663 | 885 | 1,088 | 1,299 | 1,534 |
| Cost of revenue | (585) | (523) | (513) | (619) | (732) | (860) |
| **Gross profit** | **360** | **140** | **372** | **469** | **568** | **674** |
| General and Administrative Expenses | (74) | (77) | (88) | (109) | (129) | (153) |
| Advertising and Marketing Expenses | (19) | (16) | (14) | (19) | (22) | (26) |
| Other Income, net | 7 | - | - | - | - | - |
| **Operating profit** | **264** | **(6)** | **258** | **342** | **416** | **495** |
| Finance Cost, net | (52) | (53) | (46) | (45) | (59) | (55) |
| **Income before zakat and income tax** | **212** | **(59)** | **212** | **296** | **358** | **439** |
| Zakat | (6) | - | (6) | (7) | (9) | (11) |
| **Net income for the period** | **206** | **-59** | **206** | **289** | **349** | **429** |
| **Balance Sheet** | | | | | | |
| Cash and cash equivalents | 68 | 258 | 180 | 335 | 419 | 554 |
| Trade Receivables | 25 | 21 | 24 | 33 | 32 | 38 |
| Advances to contractors, suppliers and other receivables | 17 | 13 | 34 | 35 | 37 | 43 |
| Right-of-Use Assets | 840 | 771 | 787 | 768 | 742 | 714 |
| Property, plant and equipment | 1,512 | 1,446 | 1,510 | 1,556 | 1,624 | 1,681 |
| **Total assets** | **2,516** | **2,567** | **2,594** | **2,810** | **2,945** | **3,142** |
| Borrowings | 425 | 488 | 365 | 297 | 238 | 190 |
| Lease Liabilities | 956 | 921 | 941 | 919 | 887 | 854 |
| Accounts Payable | 29 | 53 | 81 | 87 | 100 | 118 |
| **Total liabilities** | **1,795** | **1,903** | **1,789** | **1,860** | **1,856** | **1,903** |
| Share Capital | 524 | 524 | 524 | 524 | 524 | 524 |
| Retained Earnings | 142 | 85 | 204 | 320 | 425 | 560 |
| **Equity Attributable to Shareholders** | **722** | **664** | **805** | **949** | **1,089** | **1,239** |
| **Cash Flow Statement** | | | | | | |
| Net cash generated from operating activities | 531 | 330 | 438 | 702 | 749 | 887 |
| Net cash generated from investing activities | (208) | (110) | (228) | (266) | (305) | (338) |
| Net cash (used in) provided by financing activities | (274) | (30) | (289) | (280) | (359) | (415) |
| **Cash and cash equivalents at the end of the period** | **68** | **258** | **180** | **335** | **419** | **554** |
| **Key Ratios** | | | | | | |
| Gross margin (%) | 38.1% | 21.1% | 42.1% | 43.1% | 43.7% | 43.9% |
| EBITDA margin (%) | 49.1% | 30.5% | 52.6% | 52.4% | 51.7% | 51.7% |
| Operating margin (%) | 27.9% | -0.9% | 29.2% | 31.4% | 32.0% | 32.3% |
| Net margin (%) | 21.8% | -8.9% | 23.3% | 26.6% | 26.9% | 28.0% |
| ROA | 10.0% | -2.3% | 8.0% | 10.7% | 12.1% | 14.1% |
| ROE | 28.7% | -8.5% | 28.0% | 33.0% | 34.3% | 36.8% |
| Current Ratio (x) | 0.2x | 0.5x | 0.4x | 0.6x | 0.6x | 0.7x |
| Capex/Sales | 22.0% | 16.6% | 25.7% | 24.4% | 23.5% | 22.1% |
| Debt-Equity Ratio | 1.9x | 2.1x | 1.6x | 1.3x | 1.0x | 0.8x |
| EPS | 3.9 | (1.1) | 3.9 | 5.5 | 6.7 | 8.2 |
| BVPS | 13.8 | 12.7 | 15.4 | 18.1 | 20.8 | 23.7 |
| DPS | 1.4 | - | 2.1 | 2.8 | 4.0 | 5.3 |
| Dividend Payout Ratio | 35.6% | 0.0% | 53.4% | 50.0% | 60.0% | 65.0% |
| Dividend Yield (%) | 1.7% | 0.0% | 1.9% | 2.3% | 3.3% | 4.4% |
| P/E (x) | 20.6 | -69.0 | 27.7 | 22.0 | 18.2 | 14.8 |
| P/BV (x) | 5.9 | 6.1 | 7.1 | 6.7 | 5.8 | 5.1 |
| EV/EBITDA (x) | 12.0 | 25.8 | 14.7 | 12.7 | 10.5 | 8.7 |
| Price as at period end* | 81.1 | 77.3 | 109.0 | 121.4 | 121.4 | 121.4 |

*Source: Company Reports, U Capital Research* *Current market price is used for forecast periods



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## Recommendation

| | |
|---|---|
| BUY | Greater than 20% |
| ACCUMULATE | Between +10% and +20% |
| HOLD | Between +10% and -10% |
| REDUCE | Between -10% and -20% |
| SELL | Lower than -20% |

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