**Savola Group Company**

**Food-Diversified – Industrial**

SAVOLA AB: Saudi Arabia

28 August 2019

| US$4.563bn | 60% | US$6.45mn |
|---|---|---|
| Market cap | Free float | Avg. daily volume |

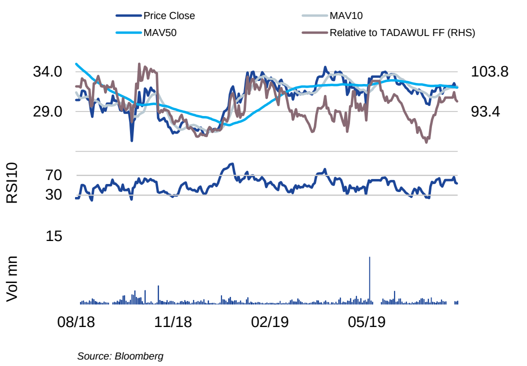
| | | |
|---|---|---|
| Target price | 30.00 | -4.61% over current |
| Current price | 31.45 | as at 28/8/2019 |

Research Department
Pratik khandelwal,
Tel +966 11 211 828 4642, pratikK@alrajhi-capital.com

**Existing rating**

| Underweight | Neutral | Overweight |
|---|---|---|

**Performance**




**Earnings**

| (SARmn) | 2018 | 2019e | 2020e |
|---|---|---|---|
| Revenue | 21,815 | 21,101 | 21,147 |
| Revenue growth | -8.5% | -3.3% | 0.2% |
| Gross profit | 3,898 | 3,806 | 3,765 |
| Gross margin | 17.9% | 18.0% | 17.8% |
| EBITDA | 664 | 1,055 | 1,100 |
| EBITDA margin | 3.0% | 5.0% | 5.2% |
| Net profit | (458) | 634 | 677 |
| Net margin | -2.1% | 3.0% | 3.2% |
| EPS | -1.0 | 1.19 | 1.27 |
| DPS | 0.0 | 0.0 | 0.0 |
| Payout ratio | NA | NA | NA |
| EV/EBITDA | 34.0x | 21.4x | 20.51 |
| P/E | NA | 26.4x | 24.8x |
| RoE | NA | 7.23% | 6.78% |

**Source:** Company data, Al Rajhi Capital

# Savola Group

## Missed Estimates; Slow-down in food business hurts top-line

*Savola' s Q2 2019 net profit deteriorated to SAR110mn compared to a profit of of SAR140mn in Q2 2018 missing our estimates of SAR140mn. The net profit growth was mainly impacted by the overall negative revenue growth and lower share of income from investment in affiliates. The top-line declined 2% y-o-y to SAR6bn mainly due to 13% y-o-y decline in sales of food business which consists of 41% of the total business. The retail business observed a growth of 1% even after store closure mainly due to improvement in customer count and basket size which improved the LFL growth for panda stores. The adjusted EBIDTA for retail business has turned positive to SAR30mn mainly due to store rationalization strategy adopted by the company leading to closure of shut down of loss making stores. The weakness in the volume growth (-4.7% y-o-y for H1 2019) of food business continued as we predicted in our last earnings note mainly due to lower sales of edible oil in central Asia. Since December 2018 the company has shut down 13 stores against an addition of 1 store leading to a reduction of selling space by 11.4% in Q2 2019. The company might close another 3-5 stores in the current financial year which will further shrink the overall revenue of the retail business. Going forward we remain wary about the top-line growth due to loss of market share amidst store closures and weaker volume growth in the food business. Due to diverse nature of its business the company always faces structural headwinds from volatile commodity and currency movements as well as the risk of intermittent impairments and one off provisions which might adversely impact the profitability of the company. Therefore we remain neutral on the stock with a target price of SAR30/share.*

**Q2 2019 Results:** Revenue declined 2% y-o-y to SAR6bn mainly due to weak food business in international market. The gross profit increased 9% y-o-y to SAR1.2bn mainly due to improved gross margins by 190 basis points; this increment in gross margin is mainly due to IFRS 16 adjustment as the lease rental is not recorded as a part of cost of goods sold. The EBIDTA has improved 52% y-o-y to SAR664mn mainly due to positive EBIDTA achieved in the retail business, consequently the EBIDTA margin improved by 390bps. The net profit was down 22% y-o-y even after a higher EBIDTA is mainly due to higher zakat and tax expense, lower share of income from associates and higher interest cost arising due to IFRS16 implementation.

**Retail Business:** The company's store rationalization strategy adopted few years back played well as the retail business EBIDTA turned positive this quarter due to lower SG&A arising due to closure of loss making stores, the top-line for the retail business increased 1% y-o-y to SAR3.2bn likely due to improving LFL growth and increasing basket size, the gross profit improved 3% y-o-y due to increment in gross margins by 500bps. The adjusted EBIDTA improved to SAR30mn against a negative SAR62mn in Q2 2018. Consequently the net loss decreased from SAR210mn in Q2 2018 to SAR65mn in Q2 2019. The selling space reduced 11.4% from 730k sqm in Q2 2018 to 647k sqm in Q2 2019.

Going forward we expect the company to shut 2-3 more stores for the remaining part of the year and the EBIDTA to improve on the back of lower selling and general overheads. However with lower number of stores the market share loss remains a key concern for the top-line growth.

**Food Business:** The top-line for the food business declined 13% y-o-y to SAR2.3bn from SAR2.6bn in Q2 2018 mainly due to lower volume growth in the edible oil business. The contribution of revenue from food segment has reduced from 46% in H1 2018 to 41% in H1 2019 indicating a weak overall demand especially for the edible oil segment in international market. Apart from weaker demand the overseas investment also faces headwinds due to currency devaluation. The gross profit for the food business reduced 1% y-o-y while the gross margins improved 190bps partly due to higher sale of pasta which have a higher margin compared to oil and sugar. The EBIDTA increased 2% y-o-y to SAR215mn while the EBIDTA margin improved by 130bps. The net profit declined 51% y-o-y to SAR65mn due to reduction of net margin by 220bps.

**Other Business:** The share of income from Herfy foods reduced to SAR41mn from SAR46mn (-11% y-o-y) in Q2 2018. The frozen food business is doing good as it contributed SAR20mn to the company's bottom-line while the income from associate investment in Almarai fell 12% y-o-y to SAR201mn in Q2 2019.

**Valuation and Risks:** Post Q2 results, we revise our target price to SAR30 per share (earlier SAR27/share) reflecting the positive EBIDTA achieved in retail segment. We use SoTP to value Savola. The value of Almarai stake is based on our target price of SAR51.0 per share and includes 20% hold-co discount, while other investments are valued at book. The standalone business (including Herfy) is valued at 10x FY20EBITDA. Based on our revised estimates, our target price stands at SAR30 per share, which implies -4.61% downside from the current market price of SAR31.45/share. We remain "neutral" on the stock.

**Figure 1 Savola: Summary of Q2 2019 results**

| (SARmn) | Q2 2018 | Q1 2019 | Q2 2019 | % chg y-o-y | % chg q-o-q | ARC Est |
|---|---|---|---|---|---|---|
| Revenue | 6,148 | 5,388 | 6,024 | -2.0% | 11.8% | 6,306 |
| Gross profit | 1,067 | 1,066 | 1,163 | 9.0% | 9.1% | 1,195 |
| Gross margin | 17.4% | 18.5% | 19.3% | NM | NM | 18.5% |
| Operating profit | 235 | 206 | 364 | 55.2% | 76.7% | 375 |
| Operating profit margin | 3.81% | 3.82% | 6.04% | NM | NM | 5.95% |
| Net profit | 141 | 6 | 110 | -22.0% | NM | 140 |
| Net profit margin | 2.29% | 0.12% | 1.83% | NM | NM | 2.22% |

Source: Company data, Al Rajhi Capital

**Upside Risk:** Better than expected recovery in retail business due to new store openings and higher LFL growth will improve the EBIDTA for the company and pose upward risk to our target price.

**Downside Risk:** Volatility in the global commodity prices and weaker demand in food segment specially oil and sugar might create pressure in the top-line growth. Further, currency devaluation is another risk which might badly impact the overall top-line growth of the company in international market. These structural issues along with any impairment pose a downside risk to our target price.

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## Contact us

**Mazen AlSudairi**
Head of Research
Tel : +966 211 828 5468
Email: alsudairim@alrajhi-capital.com

**Al Rajhi Capital**
Research Department
Head Office, King Fahad Road
P.O. Box 5561, Riyadh 11432
Kingdom of Saudi Arabia
Email: research@alrajhi-capital.com

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