Almarai Company

Food-Diversified – Industrial
ALMARAI AB: Saudi Arabia
08 July 2018

الراجحي المالية
Al Rajhi Capital

US$15.39bn	36%	US$7.54mn
Market cap	Free float	Avg. daily volume

Target price	50.00	-13.3% over current
Current price	57.70	as at 5/7/2018

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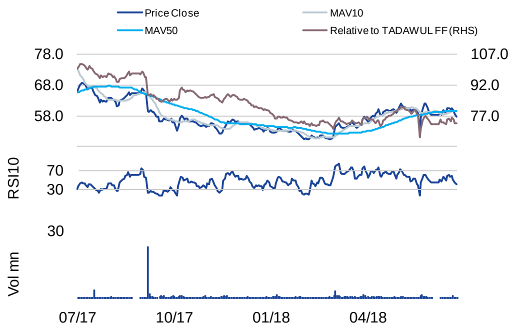
Existing rating

Underweight	Neutral	Overweight

Performance



Source: Bloomberg

Almarai

Q2: Structural headwinds drag bottom-line

Almarai's Q2 2018 earnings of SAR661mn came below our estimate of SAR711mn (consensus: SAR663mn), primarily due to higher-than-expected cost of sales, which was impacted by higher alfalfa and labor costs. Consequently, gross margin contracted to 40.4% (-100bps y-o-y; our estimate: 42.5%). Going forward, we expect Almarai's profitability to remain pressurized, given challenging operating conditions, decrease in overall market size, higher input costs, expat levy and lower export revenue amid slowdown in GCC markets. Moreover, we opine that improvement in EBITDA amid stable top-line would be an uphill task, given the limited scope for further cost improvements. However, improved performance of the Poultry and the Infant nutrition segments should help the company to absorb the adverse impact of the above headwinds. Moreover, we expect the recent price hike in milk products to be accretive to the bottom-line unless volumes decline. Consequently, we maintain our earnings estimates for 2018/2019 despite the Q2 earnings miss. We reiterate our target price of SAR50 per share, implying 13.3% downside from the current market price. Maintain Underweight.

Q2 Results: Revenue for Q2 2018 declined marginally to SAR3,731mn (-0.8% y-o-y; our estimate: SAR3,723mn) on the back of lower exports, change in demographics, reduction in market size and increased promotions. However, higher alfalfa and labor costs dragged gross profit down by 3.2% y-o-y. Further, G&A expenses declined by SAR14mn; partially offset by higher S&D expenses (+SAR10.8mn). Accordingly, EBITDA inched up to SAR1,145mn, up by 2.8% y-o-y. The Poultry segment's profit increased to SAR67mn (vs. loss of SAR7mn in Q2 2017), thereby contributing ~10% to the overall bottom-line, benefitting from higher sales, improved operational performance, growth within food service channel and continued low mortality. However, performance of the Dairy & Juice (-8.1% y-o-y) and Bakery (-44.9% y-o-y) segments was impacted by difficult market dynamics and lower discretionary spending.

Impact of price hike on bottom-line: In our recently published note (Milk Price hike unlikely to impact valuation), we had analyzed the impact of the price hike on the company's 2018 and 2019 bottom-line (Fig 2) under three different scenarios: 1) No change in volumes sold, 2) 5% reduction in volumes sold, and 3) 10% reduction in volumes sold. Under the first scenario, we anticipated the bottom-line to grow by 6.5% and 12.7% for 2018 and 2019, respectively, while the second scenario displayed a mixed result with a decline of 1.5% for 2018 but a rise of 3.4% in 2019. However, scenario 3 is expected to erase net profit by 5.9% (2018) and 4.1% (2019). Moreover, the indifference point for 2018 and 2019 is expected to be at a reduction of volumes by ~3% and ~7%, respectively.

Figure 1 Almarai: Summary of Q2 2018 results

(SAR mn)	Q2 2017	Q1 2018	Q2 2018	% chg y-o-y	% chg q-o-q	ARC est
Revenue	3,760.4	3,232.0	3,731.1	-0.8%	15.4%	3,722.8
Gross profit	1,554.9	1,253.0	1,505.6	-3.2%	20.2%	1,582.2
Gross profit margin	41.3%	38.8%	40.4%			42.5%
Operating profit	788.2	481.0	759.7	-3.6%	57.9%	870.9
Net profit	674.1	344.2	660.6	-2.0%	91.9%	710.9

Source: Company data, Al Rajhi Capital

Figure 2 Impact of price rise on bottom-line

	2018 *				2019			
SAR mn	Current estimate	Volume change			Current estimate	Volume change		
Fresh dairy:		**0%**	**-5%**	**-10.0%**		**0%**	**-5%**	**-10.0%**
Revenue	5,396	5,396	5,396	5,396	5,326	5,326	5,326	5,326
Incremental revenue based on new prices	0	157	13	(130)	0	322	40	(243)
Implied revenue	**5,396**	**5,553**	**5,410**	**5,267**	**5,326**	**5,648**	**5,366**	**5,083**
Impact on revenue	***0.0%***	***2.9%***	***0.3%***	***-2.4%***	***0.0%***	***6.0%***	***0.7%***	***-4.6%***
COGS (excl. depreciation and employee costs)	2,304	2,304	2,353	2,317	2,274	2,274	2,227	2,135
Depreciation and employee costs	880	880	880	880	868	868	868	868
Gross profit	**2,212**	**2,369**	**2,177**	**2,070**	**2,184**	**2,506**	**2,271**	**2,080**
Gross margin	41%	43%	40%	39%	41%	44%	42%	41%
		7.1%	-1.6%	-6.5%		**14.7%**	4.0%	-4.7%
Consolidated:								
Total revenue at old prices	13,839	13,839	13,839	13,839	14,145	14,145	14,145	14,145
Implied total revenue	13,839	13,995	13,852	13,709	14,145	14,467	14,184	13,902
Impact on revenue	0.0%	1.1%	0.1%	-0.9%	0.0%	2.3%	0.3%	-1.7%
Impact on consolidated net profit:								
COGS (excl. depreciation and employee costs)	7,218	7,218	7,267	7,231	6,057	6,057	6,009	5,918
Other expenses	4,209	4,209	4,209	4,209	5,559	5,559	5,559	5,559
Net profit before Zakat	2,411	2,568	2,376	2,268	2,529	2,851	2,616	2,426
Zakat	72	77	71	68	76	86	78	73
Zakat %	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*
Net profit after Zakat	2,339	2,491	2,304	2,200	2,453	2,765	2,538	2,353
Impact on net profit		6.5%	-1.5%	-5.9%		12.7%	3.4%	-4.1%

Source: Company data, Al Rajhi Capital, * for 2018, only half year impact considered

Valuation: We continue to value Almarai on equal weights for DCF (3% terminal growth, 35% debt in capital structure and 7.9% WACC) and relative valuation (20x FY19 EPS), yielding the target price of SAR50 per share. The stock is currently trading at a P/E of 24.7x, based on our 2018 EPS estimate, higher than its 3-year average P/E of 23.2x. We remain Underweight on the stock, given the expensive valuations and structural challenges as mentioned above.

Risks: Downside risks includes (a) Further increase in alfalfa costs starting 2019, (b) increase in commodity prices, (c) significant decline in market size amid expat levy and stagnant population, and (d) lifting ban on Brazil poultry imports or lowering custom duties on frozen poultry imports.

Upside risks includes (a) Gains in market size despite increase in product prices, (b) Increase in export revenues amid economic recovery in GCC countries, and (c) Significant improvement in the consumer sentiments amid various reforms in the Kingdom

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

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