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Avalon Pharma

Key player in high growth derma segment

Overweight

Target Price (SAR): 107.0

IPO Price: 82.0
Upside/Downside: 30.0% above offer price

Valuation Multiples	23E	24E	25E
P/E at listing price (x)	24.1	21.5	18.4
P/E at target price (x)	31.5	28.1	24.0

IPO Details

Offered Price	82.0
Offered Shares	600,000 ordinary shares
Use of IPO Proceeds	Net of IPO proceeds to be distributed to selling shareholder
Financial Advisor	Aldukheil Financial Group

Post IPO	% Ownership
Tabbaa National Holding Co.	42.2%
Talal Yousuf Zahid	14.7%
Others	13.1%

Earnings

(SAR mn)	2023E	2024E	2025E
Revenue	334	374	434
YoY %	*10.3%*	*11.9%*	*16.2%*
Gross Profit	204	229	264
GM Margin %	*61.1%*	*61.3%*	*60.9%*
YoY %	*10.7%*	*12.2%*	*15.4%*
EBITDA	96	108	125
EBITDA Margin	*28.7%*	*29.0%*	*28.7%*
Net Income	68	76	89
Net Income Margin %	*20.4%*	*20.4%*	*20.5%*
YoY %	*14.3%*	*12.1%*	*17.0%*
EPS	3.4	3.8	4.5
DPS	1.8	1.9	2.2
ROE	22%	23%	23%

Source: Company data, Al Rajhi Capital

Middle East Pharmaceutical Industries, Avalon Pharma, is a market leader in the fast-growing dermatology market. It has established itself in topical products with a portfolio of strong brands such as Avogain in the hair loss category, Avohex in oral care Salinose in nasal solution and Prila in anesthetics. The company generates over 70% of its revenues from the high margin segments, that are dermatology and respiratory, which is the reason for gross margins of 60%. However, going forward the company plans to diversify its exposure to other therapeutics areas (TAs) such as CMD, ophthalmology, oncology, etc. It has notably increased its capacity (4.4x) in the solids, that are tablets, to grow in these new TAs. The company guides for 18% revenue growth during 2024-2027 with improvement in EBITDA margins (29-31% versus 28.7% in 2023E). However, we estimate the revenues to grow at around 14% as we prefer to be conservative in terms of assuming higher growth in the tablet's category given the lack of key products in the specialized therapeutic areas (other than derma and respiratory) currently as well as growing competition from other players. Moreover, its reliance on overseas markets, such as Egypt, Morocco, to achieve these growth targets, also compel us to be a bit conservative. Nevertheless, the company has a new factory in place (capex completed) and has notable exposure to the government channel, that should help the company in maintaining a healthy topline growth. We initiate our coverage on the stock with an Overweight recommendation and a target price of SAR 107/share, this implies an upside of 30% from the listing price of SAR 82/share.

Leadership position in derma and respiratory TAs: The dermatological category, has been one of the fastest growing therapeutic areas in the recent past, a CAGR of 8.9% between 2018 and 2022, and is expected to grow at a similar growth rate of 7.1% during 2023-2027. The company has a flagship product in hair growth segment, with a brand name of Avogain. Avogain is a topical solution that stimulates hair growth and prevents hair loss. In the derma market, Avalon Pharmaceuticals ranks first with an 8.9% market share (calculated at retail selling price) and generates 50% (as of FY22) of its total revenues from this segment. The company is also one of the top players in the respiratory market, which has grown at a rate of almost 5% between 2018 and 2022. Avalon ranks fourth in Saudi Arabia's respiratory market with a market share of 9.1%. Avalon Pharma's large assortment of nasal decongestants, cough & cold preparations, and anti-asthma and COPD products, available through healthcare and health insurance services with a doctor's prescription or OTC, gives it an advantage in the respiratory market.

Strong relationship with government: Avalon Pharma has established a strong relationship with the government through participating in NUPCO tenders as well as supplying products part of the Wasfaty program. The company has a strong win rate of 56% of the public tenders floated since 2019. Currently, the revenue contribution from the government channel is around 23%, that is expected to remain broadly at this level in the medium term. The advantages of exposure to the government channel is that the company can sell the products in bulk, that helps in higher utilization of the production facilities and over a period of time can reap benefits of operating leverage.

Capacity ready to achieve the goal of diversification: Avalon's revenues are concentrated in just two categories (75% from derma and respiratory as of FY22). Thus, the company plans to diversify its exposure by venturing into specialised therapeutic areas that includes ophthalmology, neurology and cardiometabolic (CMD). The company has recently expanded its capacity notably, especially in the solids category (tablets), after constructing a new factory in 2022 (Avalon 2). The capacity of the solid medicines increased by more than 4x from 8.1 mn strips to >35 mn strips. The notable expansion in the solid's capacity would be targeted to grow in the CMD and oncology categories.

Strong balance sheet and attractive return ratios: Avalon has a pretty solid balance sheet with a 2023E net debt/EBITDA of 0.9x and net debt/equity of just 0.3x (targets 0.25-0.35x). The company generates sufficient cash flows to fund its capex as well as pay dividends. Given that the company is done with building its new factory, Avalon 2, the cash flow position is expected to improve further. Avalon's return ratios indicate that the company is one of the most efficiently run pharma companies with fixed asset turnover ratio of almost 3.0x (versus peers' average of 1.5x), gross margins and EBITDA margins of >60% and ~29%, respectively, and return on equity of over 20%.

Outlook appears ambitious, but double-digit growth possible: On the back of sharp increase in capacity, and its strategy to enter into new markets and therapeutic areas, the company is targeting to grow its topline by 18% CAGR during 2024-2027. The company has three pillars to achieve this growth: 1) Accelerate 2) Catalyze and 3) Expand. The first two pillars focus on accelerating the existing portfolio and launching new products as well as entering into new therapeutic areas. The third Pillar, Expand, relies on growing in overseas markets and entering new markets. Of all the three pillars, we are a bit sceptical about the third pillar as we have noticed growing outside KSA, especially in Egypt, can be challenging. Moreover, the company targets EBITDA margins of 29-31%, which implies expansion of about 100-125 bps (midpoint) from 28.7% in 2023E. In our view, this margin expansion assumption also appears optimistic to us given that the company plans to grow overseas as well as venture into specialised therapeutic areas, which is a competitive space and could require investments related to R&D and manpower hiring.

Valuations: We value the stock based on a blended approach of equal weight to DCF as well as P/E methodology. Given that bulk of the capex for the new plant is behind, and the company will be investing only for adding new production lines and maintenance capex, free cash flows are expected to be solid in the near future and grow at a rate of 11% over the next 9 years (2024-2032E). Based on our WACC assumption of 8.2% (cost of equity of 10.1%, optimal D/E mix of 40.0%) and terminal growth of 4%, our DCF derived fair value for the stock is SAR 104/share. Our P/E based valuation is SAR 110/share, derived through a forward P/E multiple of 29x on 2024E EPS of SAR 3.81/share. The 29x P/E is derived through a 15% discount to Jamjoom's forward P/E multiple of 34x (based on our 2024E EPS of SAR 4.39) given Jamjoom's diversified portfolio and established presence in key specialised TAs. Based on the blended approach, our fair value for the stock is SAR 107/share, which is our target price. This offers 30% upside from the listing price of SAR 82/share, implying Overweight recommendation on the stock.

Key risks: Key risks in our view are concentrated exposure in two products, Avogain and Salinose, lesser core pharma products in the portfolio; minimal exposure in the solids business and key therapeutic areas such as cardiovascular, oncology, life style diseases such as diabetes, blood pressure, etc.

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Industry Overview

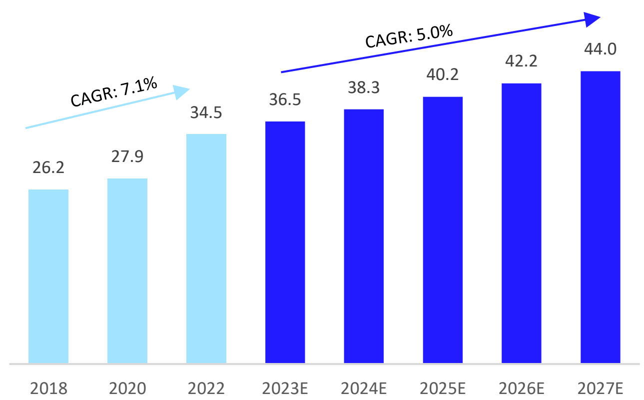
The pharmaceutical sector in Saudi Arabia is an important and rapidly growing industry that plays a vital role in the country's healthcare system. The sector is primarily driven by the government's focus on improving the quality of healthcare services, increasing the accessibility of medications to the population, and reducing the dependency on imported pharmaceutical products. The increasing demand for generic drugs, the rising prevalence of chronic diseases, and government incentives to promote local production of drugs are some of the factors contributing to the sector's growth. Additionally, the Saudi government is taking steps to attract foreign investment into the pharmaceutical sector.

In 2022, the collective worth of the medicine and medical supplements industry reached SAR 34.5bn, demonstrating a CAGR of 7.1% from 2018 to 2022. This encompassed various categories such as Dermatology, Respiratory, Dermacosmetics, Hygiene products (including hand sanitizers), and oral care, which collectively experienced a growth of 7.3% from 2018 to 2022, reaching SAR 7.3bn by the end of 2022. These specific categories constituted 21.2% of the total medicine and medicinal supplements sector valued at SAR 34.5bn in 2022.

The total medicine and medical supplements sector is forecasted to achieve a 5% CAGR, reaching SAR 44bn by 2027. Within this sector, specific categories, including Dermatology, Respiratory, Dermacosmetics, Hygiene products (hand sanitizers), and oral care, are expected to witness a 6.2% CAGR (2023-2027), reaching SAR 9.9bn by 2027. This category is projected to constitute 22.5% of the overall medicine and medicinal supplements sector valued at SAR 44bn in 2027. The anticipated industry growth is fueled by robust macroeconomic conditions, substantial government support and spending, an uptick in mandatory health insurance coverage, and an increasing focus on localization initiatives.

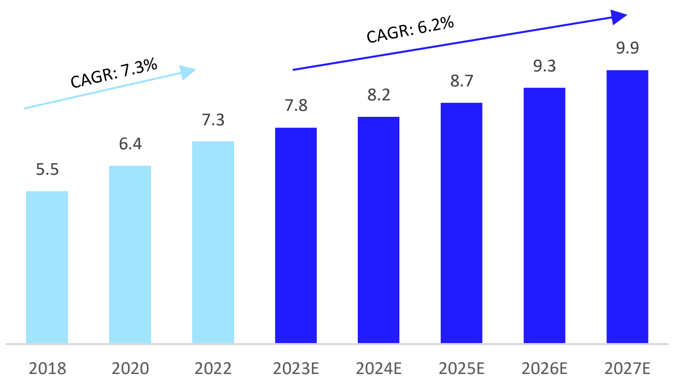
The progression of the overall medicine and medical supplements industry is significantly influenced by factors such as demographic changes (particularly an aging population), the escalation of non-communicable diseases, the expansion of the healthcare sector, advancements in medical procedures and medications, international collaborations, and increased investments from both private and public sectors. These dynamic elements collectively contribute to shaping the developments within the industry. Since 2018, the majority of the medicine and medical supplements industry has been dominated by prescription products, specifically originating from multinational corporations. These prescription drugs, constituting over 60% of the market, are often imported and benefit from patent protections. Local players, on the other hand, focus mainly on producing OTC drugs, while imported medications address more specific health conditions.

Figure 1 **Market Size of Medicine market (SAR bn)**



Source: Euromonitor, Al Rajhi Capital

Figure 2 **Market Size of Dermatology, Respiratory, Derma cosmetics and Hygiene products (hand sanitizers) and oral care**



Source: Euromonitor, Al Rajhi Capital

Key categories

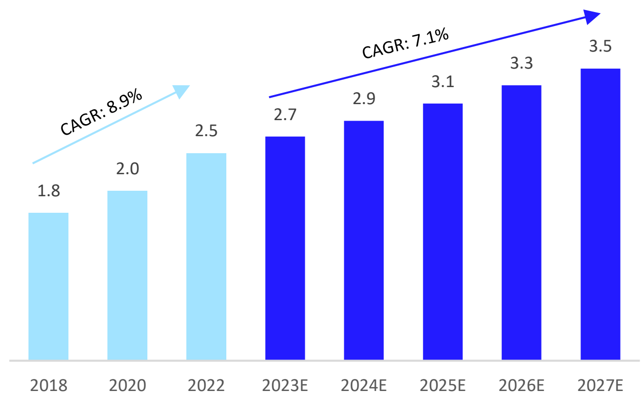
Dermatological

The dermatological category exhibited substantial growth with a notable CAGR of 8.9% from 2018 to 2022, reaching SAR 2.5bn in 2022, as per Euromonitor research. Contributing to this expansion were various subcategories such as topical corticosteroids, anti-acne treatments, hair loss remedies, wound healing agents, and emollients & protectives, collectively making up around 61% of the overall dermatological market. The surge in dermatological issues like irritated skin and hair loss in the Kingdom has driven this growth.

Increased consumer spending on dermatological products was observed, driven by a growing interest in overall skin health, changing weather conditions, and heightened awareness of skin diseases, including the early detection of skin cancer. The demand for dermatological further rose during the pandemic, facilitated by increased sales through both traditional pharmacy outlets and online platforms from 2018 to 2022. This upward trend is expected to persist, propelling the market to SAR 3.5bn at a CAGR of 7.1% from 2023 to 2027, as per Euromonitor research. The need for specialised dermatological products to treat conditions including hair loss, eczema, and skin irritations will be the primary driver of growth in this industry.

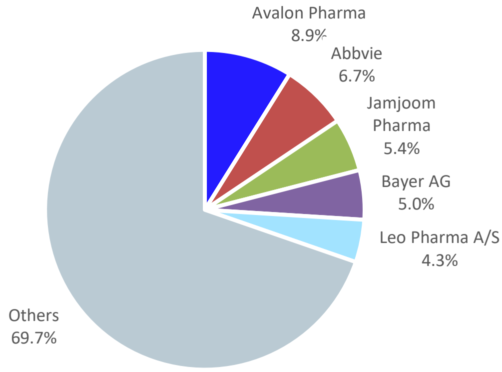
In Saudi Arabia, the dermatological market exhibits a high degree of fragmentation, with the top five competitors collectively representing approximately 30.4% of total value sales in 2022. Importantly, most of the sales in dermatology comes from imported items, evident in the fact that three out of the top five ranked players in 2022 are of foreign origin. Avalon Pharma secured an 8.9% market share, followed by Abbvie Inc (6.7%), local producer Jamjoom Pharmaceuticals (5.4%), Bayer AG (5.0%), and LEO Pharma A/S (4.3%), as per Euromonitor research.

Figure 3 **Market Size of Dermatology market (SAR bn)**



Source: Euromonitor, Al Rajhi Capital

Figure 4 **Market Share of key players**



Source: Euromonitor, Al Rajhi Capital

Dermocosmetics

The Dermocosmetics market experienced a CAGR of 2.2% from 2018 to 2022, achieving a total value of SAR 237mn in 2022, as per Euromonitor research. Facial care stands out as the largest segment within the market. Consumer awareness and demand for Dermocosmetics are significantly shaped by recommendations from dermatologists and retail pharmacists. The rising participation of women in the workforce, driven by goals of empowerment and economic benefits, has led Dermocosmetics companies to make substantial investments in marketing and advertising.

Companies operating in this sector have particularly focused on social media marketing, forming partnerships with local and international beauty companies, and collaborating with social media influencers to enhance brand awareness and reach potential consumers. The emergence of the "K-beauty" trend, featuring South Korean brands known for their strong dermatological focus, has further contributed to the growth of the Dermocosmetics market. The Dermocosmetics category is primarily driven by OTC products and is witnessing a rising trend of utilizing the internet, especially social media, for product information and application methods. The widespread internet penetration, reaching 100% of the total population in Saudi Arabia as of 2022, serves as a significant factor contributing to the growth of this category.

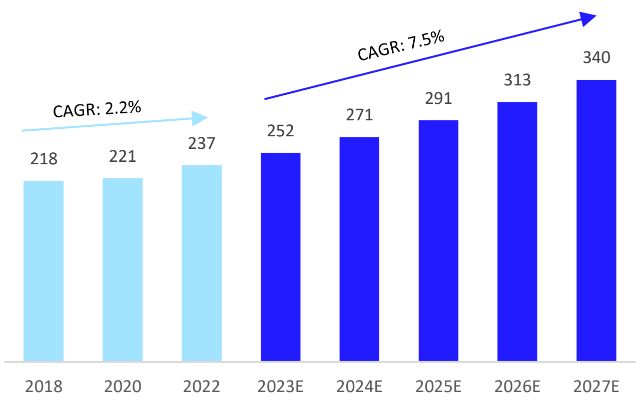
During the forecast period, Dermocosmetics are expected to grow steadily, reaching SAR 340mn by 2027 with a CAGR of 7.5%, as per Euromonitor research. This growth is driven by factors such as rising income levels, an expanding retail landscape, and an increase in skin irritations due to harsh climatic conditions. The influence of social media is also contributing to heightened consumer awareness about maintaining healthy skin, leading to a greater demand for products with functional ingredients known for brightening and repairing the skin barrier.

Hygiene products (hand sanitizers) and Oral Care

The hygiene products (hand sanitizers) and Oral care market are primarily influenced by the widespread adoption of preventive measures against COVID-19 and the Saudi government's educational initiatives to emphasize the importance of maintaining good hygiene practices for a safe and healthy society. This adherence to hygiene is considered a fundamental requirement. Organizations like the World Health Organization (WHO) define hygiene as conditions and practices that help prevent the spread of diseases. From 2018 to 2022, the market for hygiene products (hand sanitizers) and oral care exhibited significant growth, with a CAGR of 11.4%, reaching SAR 1.5bn in 2022, as per Euromonitor research.

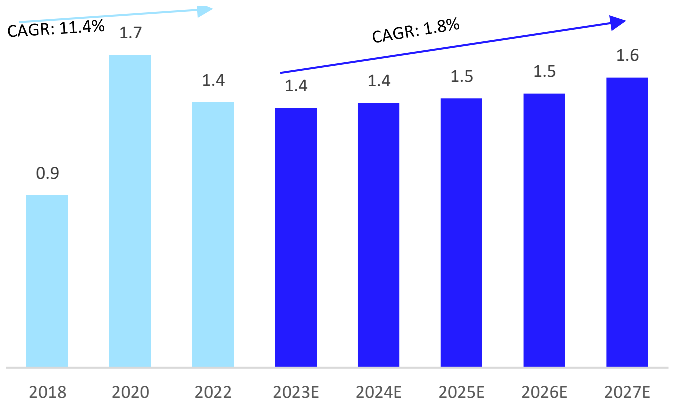
Although the frequency of purchasing hygiene products has reduced from the peak during the pandemic, the market has become more competitive with an expanded range of product options, resulting in more competitive prices. By 2027, as per Euromonitor research, total sales for hygiene products (hand sanitizers) and oral care are projected to reach SAR 1.6bn, indicating a more moderate CAGR of 1.8% between 2022 and 2027 as consumer caution normalizes.

Figure 5 **Market Size of Dermocosmetics market (SAR mn)**



Source: Euromonitor, Al Rajhi Capital

Figure 6 **Market size of Hygiene and Oral care market (SAR bn)**



Source: Euromonitor, Al Rajhi Capital

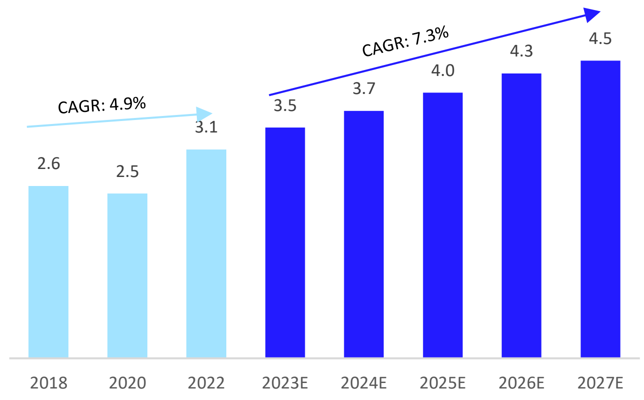
Respiratory

The respiratory category witnessed a CAGR of 4.9% between 2018 and 2022, reaching SAR 3.1bn in 2022, as per Euromonitor research. This growth is attributed to factors like increased air pollution, harsh dusty weather conditions, a persistently high prevalence of smoking among younger age groups, a growing awareness of respiratory diseases such as asthma and Chronic Obstructive Pulmonary Disease (COPD), and an aging population. Anticipated for 2027, total respiratory product sales are projected to reach SAR 4.5bn, with a CAGR of 7.3% between 2022 and 2027, as per Euromonitor research.

The contribution of the respiratory category to the overall market is expected to rise from 9.1% in 2022 to 10.2% by 2027. This growth is fueled by factors like early diagnosis of asthma and COPD patients, improved healthcare systems, and increased access to medicines. The incidence of smoking among the adult population is estimated to increase from 7.1mn in 2022 to 7.4mn in 2026, resulting in an additional 331,000 new smokers. This rise in smoking is anticipated to further contribute to the growth of COPD and asthma.

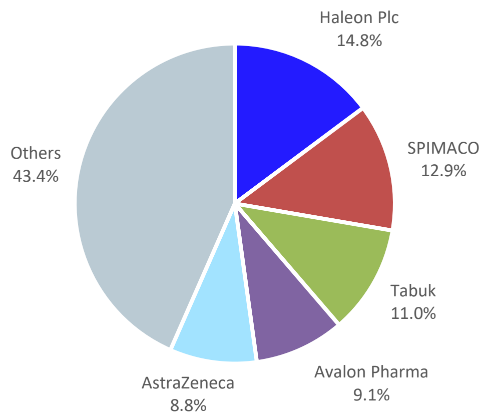
In the Saudi Arabia, the top five players—Haleon plc, SPIMACO, Tabuk Pharmaceutical Mfg Co, Abalon Pharma, and AstraZeneca—comprised 56.6% of total value sales in 2022. Among them, Haleon plc held a 14.8% market share, followed by SPIMACO (12.9%), Tabuk Pharmaceutical Mfg Co (11.0%), Avalon Pharma (9.1%), and AstraZeneca (8.8%). The market was relatively fragmented in 2022, with other players accounting for 43.4% of the market share. These additional contributors include pharmaceutical manufacturers like Jamjoom Pharma (Triopan, Clara), Reckitt Benckiser (Strepsils), Sanofi (Telfast and Mucosolvan), and Bayer (Clarinase and Claritine), as well as generic products.

Figure 7 **Market Size of Respiratory market (SAR bn)**



Source: Euromonitor, Al Rajhi Capital

Figure 8 **Market Share of key players**



Source: Euromonitor, Al Rajhi Capital

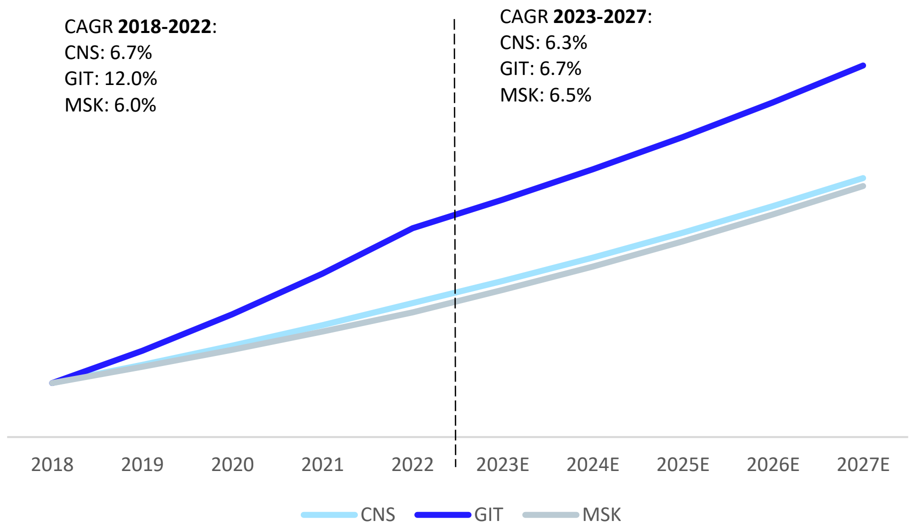
Other Categories

CNS: The central nervous system (topical anaesthetics) market in the Kingdom exhibited a CAGR of 6.7% from 2018 to 2022, reaching SAR 85mn. It is projected to continue its growth with an expected CAGR of 6.3% between 2022 and 2027, as per Euromonitor research. The market's primary driving forces have been and are likely to remain cosmetic and dental procedures, along with minor injuries necessitating stitches. Avalon's Prila stands out as the sole topical anesthetic on the market featuring a unique combination of lidocaine and prilocaine, justifying its 61% share in value terms in 2022.

GIT: The expansion of the gastro-intestinal category is propelled by elevated obesity rates and unhealthy dietary habits, notably the excessive consumption of fast food and a lack of regular exercise. Lifestyle-related ailments, particularly heart conditions, often necessitate consistent, long-term medication, potentially leading to gastro-intestinal issues and the subsequent consumption of regular gastro-intestinal medicines. The overall gastro-intestinal market in Saudi Arabia grew at a remarkable CAGR of 12% from 2018 to 2022, reaching SAR 2.1bn, as per Euromonitor research. In the country, gastro-intestinal diseases such as gastroesophageal reflux disease, inflammatory bowel disease, and irritable bowel syndrome are prevalent and on the rise. The increasing incidence of gastro-intestinal disorders is expected to fuel the category's growth, with a projected CAGR of 6.7% between 2023 and 2027.

Musculoskeletal: From 2018 to 2022, the market for musculoskeletal (MSK) in the Kingdom demonstrated growth at a CAGR of 6%, reaching SAR 2.9bn, as per Euromonitor research. In Saudi Arabia, prevalent MSK issues include back pain, neck pain, osteoarthritis, and various other musculoskeletal disorders. The incidence of MSK disorders is gradually increasing, attributed to shifting demographics, inadequate consumption of nutrient-dense foods, sedentary lifestyles, lack of physical activity or stretching, prolonged sitting, and the aging population, as these disorders are more common among older age groups. The momentum of MSK cases is expected to persist, driven by the aging demographic and a lack of significant innovation in the field. Between 2022 and 2027, the musculoskeletal market in Saudi Arabia is forecasted to expand at a CAGR of 6.5%.

Figure 9 **Market size of other categories (Rebased to 100)**



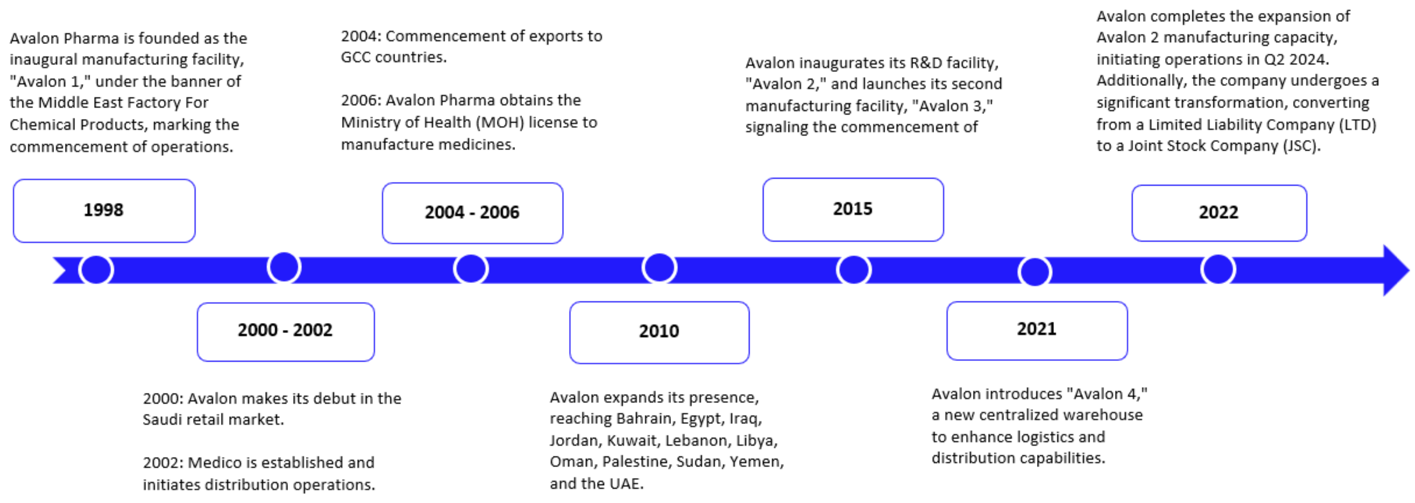
Source: Euromonitor, Al Rajhi Capital, *MSK - Musculoskeletal

Company Overview

Avalon Pharma was founded in 1998 and is based out of Riyadh. The company is engaged in the development, manufacturing, marketing, and distribution of a diverse range of generic medicines and pharmaceutical preparations within the Kingdom of Saudi Arabia and internationally. The company boasts a comprehensive product portfolio spanning various therapeutic categories, including treatments for skin diseases, skin creams, respiratory, nervous system, digestive system, musculoskeletal system, and more. The company manufactures an extensive range of over 250 products across more than 70 brands. Currently, efforts are in progress to register 19 new products with the Food and Drug Authority. These include 4 skin medicines, 4 respiratory medicines, 1 digestive system medicine, 1 musculoskeletal medicine, and 9 assorted medicines within the company's other therapeutic categories. The typical registration period for these products spans between 12 to 18 months. Avalon Pharma has a significant market presence in the Gulf countries, Middle East, and Africa, with operations in Kuwait, UAE, Jordan, Iraq, Yemen, Bahrain, Lebanon, Egypt, Sudan, and Libya.

With three factories situated in Riyadh—Avalon Factory (1), Avalon Factory (2), and Avalon Factory (3)—the company is equipped with advanced production and manufacturing lines for creams, cosmetics, liquid and solid medicines, and disinfectants. Notably, Avalon Pharma completed the construction of Avalon Factory (2) in 2022, and its commercial production is anticipated to commence in the second quarter of 2024. Current manufacturing capacity consists of 124mn units per annum and it has 4 warehouses.

Figure 10 **Company Timeline**



Source: Company Data, Al Rajhi Capital,

Avalon Pharma's products are categorized into various therapeutic areas, with the primary focus on two main categories. The first category includes medicines, dermatological products, and skin care items, accounting for the largest share of total revenues at 55.4% in 1H23. The second category encompasses respiratory medicines, representing the second-largest share of total revenues at 20.0% in 1H23. Additional therapeutic categories encompass medications for the nervous system, digestive system, and musculoskeletal system, along with various other therapeutic areas. During the first half of 2023, these categories contributed to 24.6% of total revenues. The company offers an extensive array of both prescription and non-prescription medicines within its operational therapeutic categories. Revenues generated from prescription medicines constituted 61% of total revenues in 1H23. Notable products include dermatology medicines under the brand names "Avogain" (a topical solution promoting hair growth and preventing hair loss) and "Alpha Plus" (a pigmentation-lightening cream for skin tone uniformity). Additionally, the company offers respiratory medicines branded as "Salinose" (a saline solution for nose moisturization and cleaning) and "Avocom" (a water nasal spray for treating symptoms of seasonal allergic rhinitis and perennial rhinitis). The sterilizer product line, "EZ Clean," experienced a significant surge in sales during 2020 and 2021 due to the impact of the Covid-19 pandemic.

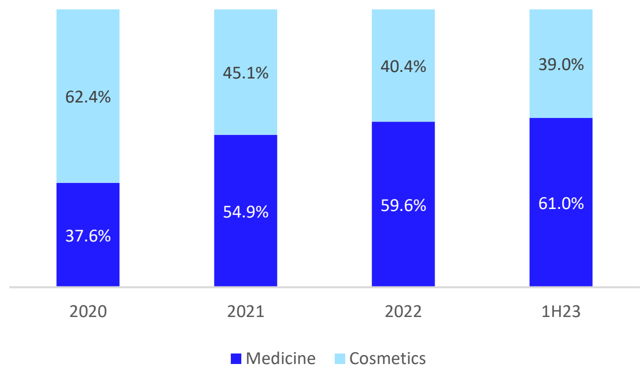
Figure 11 **Company's products according to Therapeutic categories**

Category	Product description	No. of Trademarks	Key products
Dermatologicals and skin care products	Multi-use medicines, products and preparations that help treat skin diseases such as bacterial and fungal infections, dermatitis, alopecia, hair loss, dryness and cracks in the skin, burns and scars, skin care, skin health and hygiene, etc.	23	Avogain Alpha Plus Avocom-M EZ Care Avomeb Extra Avoban Avomeb
Respiratory system medications	Multi-use medications that help treat nasal allergies, asthma, and respiratory diseases.	7	Salinose Avocom NS Rhinaze NS Cortrief NS Broncast Rolenium
Nervous system medications	Versatile products for nerve anesthesia and local anesthesia.	2	Prila Avocaine
Gastrointestinal medications	Multi-use medicines that help treat diseases of the digestive and internal systems, stomach problems, and nutrition.	8	Avohex Avodyl Avalon povidone Iodine MW Rotavex
Musculoskeletal drugs	Multi-use medications that help relieve musculoskeletal pain.	4	AvalonActiv Avotrene Xibax Exxara
Other medications in various therapeutic classes	It includes sexual, diabetes, cardiovascular, antiinfective, anti-parasitic, pain relievers, antiseptics, and women's and men's health medications.	27	Amaglime Lyrgaba Avocin Avialis Candan Amodip Tavflox Virecta Evoka EZ Clean

Source: Company Data, Al Rajhi Capital,

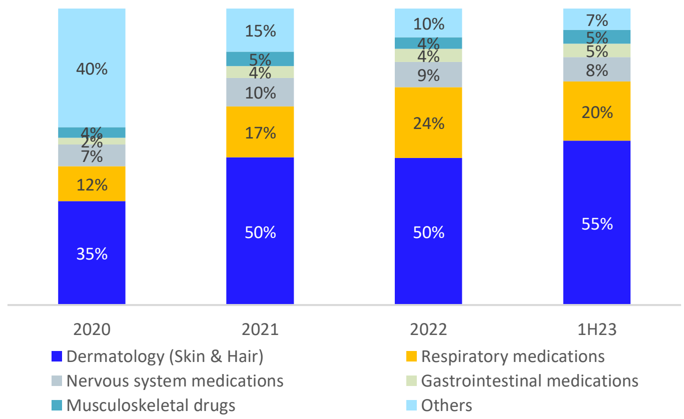
Financial Analysis in Charts

Figure 12 **Revenue split by business (company definition)**



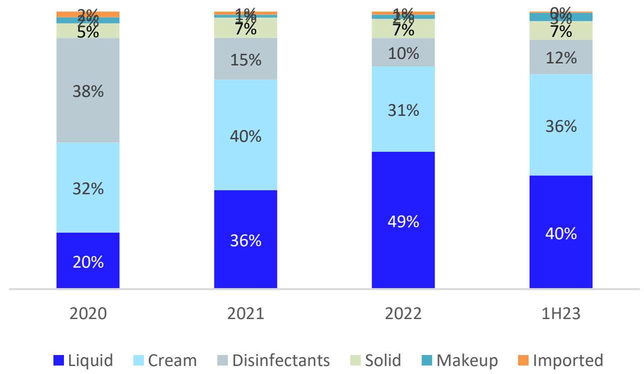
Source: Company Data, Al Rajhi Capital

Figure 13 **Revenue split by Therapeutic areas**



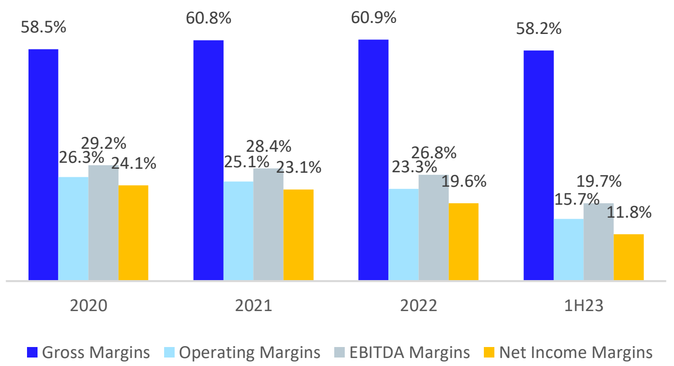
Source: Company Data, Al Rajhi Capital

Figure 14 **Revenue breakup by products**



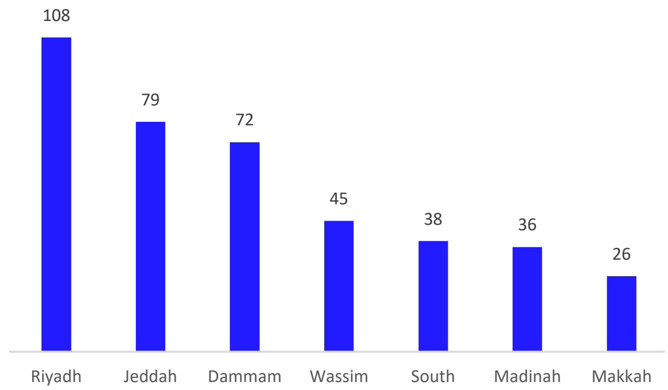
Source: Company Data, Al Rajhi Capital

Figure 15 **Margin over the years**



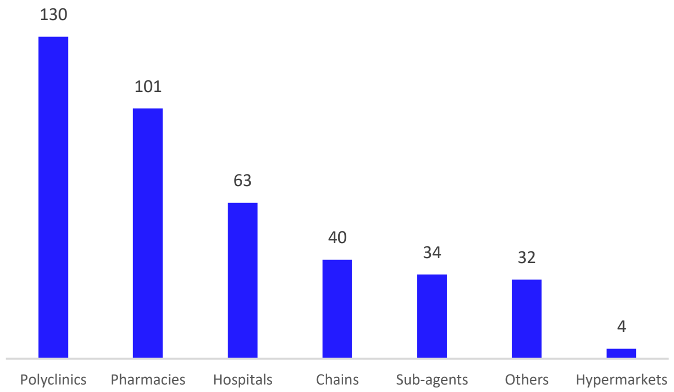
Source: Company Data, Al Rajhi Capital

Figure 16 **No. of clients by region (2022)**



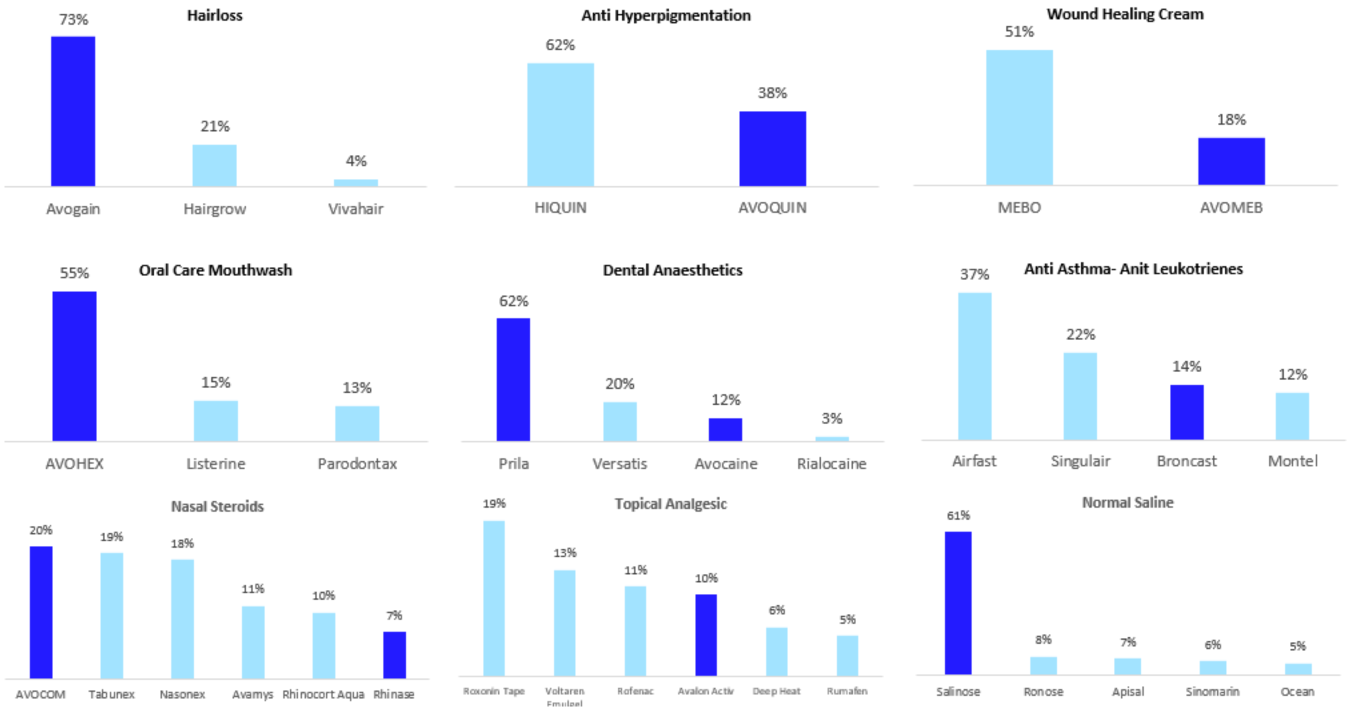
Source: Company Data, Al Rajhi Capital

Figure 17 **No. of clients by distribution channel (2022)**



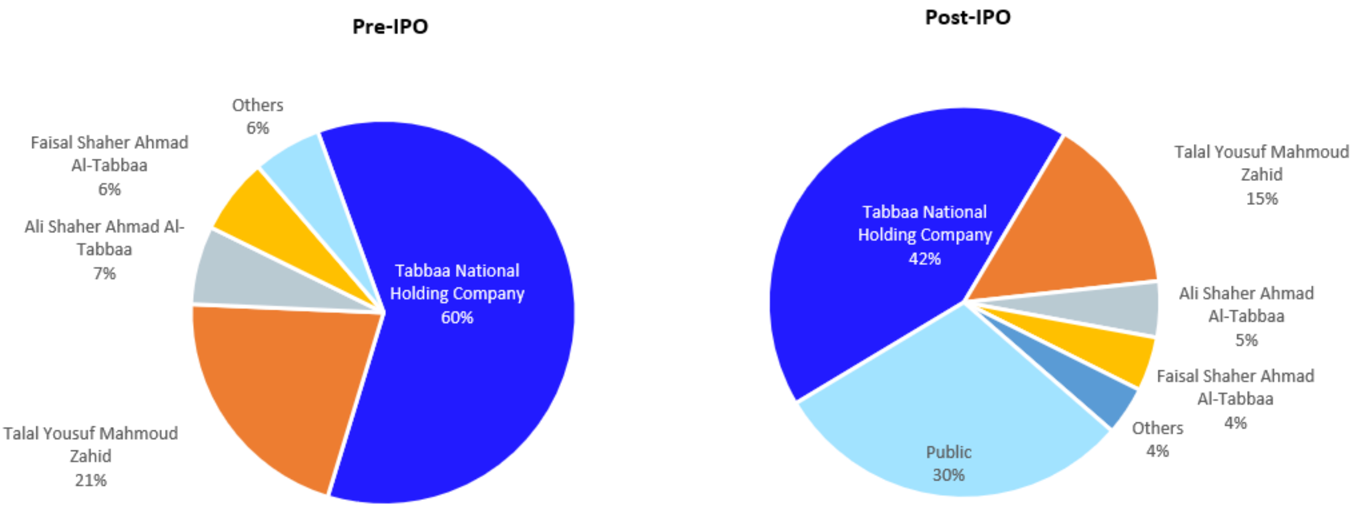
Source: Company Data, Al Rajhi Capital

Figure 18 **Market Share of Avalon's products (Dark Blue represents Avalon product)**



Source: Company Data, Al Rajhi Capital

Figure 19 **Shareholding**



Source: Company Data, Al Rajhi Capital.

Investment Rationale

Leadership position in fast growing derma market and key player in high margin respiratory:

The dermatological category has been one of the fastest growing therapeutic areas in the recent past, a CAGR of 8.9% between 2018 and 2022, reaching SAR 2.5bn (USD 0.67bn) in 2022. Given the weather conditions, sedentary lifestyle, increased awareness of having a good physical appearance, there is growing demand for products that can treat hair loss issues, skin related issues such as acne, pigmentation, etc. Subcategories such as topical corticosteroids, anti-acne, hair loss treatments, wound healing agents and emollients & protectives (collectively contributing ~61% of overall dermatologicals) are contributing to the expansion of dermatologicals as irritated skin and hair loss problems become more widespread in the Kingdom. Going forward, the demand for specialised dermatological products to treat conditions such as hair loss, dermatitis, and skin irritations is expected to drive the market to SAR 3.5bn at a CAGR of 7.1% between 2023-27E. The company has a flagship product in hair growth segment, with a brand name of Avogain. Avogain is a topical solution that stimulates hair growth and prevents hair loss. In the derma market, Avalon Pharmaceuticals ranked first with an 8.9% (calculated at Retail Selling Price) and generates 50% of its total revenues from this segment. The company resonates with consumers and stakeholders as the foremost recalled brand for dermatological products. Avalon Pharmaceuticals has a competitive advantage in the dermatology industry due to its extensive selection of hair loss remedies, anti-hyperpigmentation, wound healing, and skin-whitening products.

Within derma, dermocosmetics, that is beauty products, is also a high growth market. Although, in the past this market has grown at a modest rate of 2.2% CAGR between 2018-2022, going forward the prospects are bright. As per Euromonitor International, the dermocosmetics category is expected to grow by 7.5% during 2023-2027E led by multiple factors such as increase in disposable income, an increase in women's labour force participation, increase in skin health awareness, etc. The category is dominated by OTC products where there is an increased use of the internet, specifically social media to gather information about products and ways to apply them. During the forecast period, Dermocosmetics are anticipated to experience a steady increase in retail value, capitalizing on growing income levels, expanding retail landscape and anticipated increase in skin irritations or sensitivity (arising due to acne, pigmentation, dryness, and others) due to the country's harsh climatic conditions. Within dermocosmetics, the company's flagship brand is Alpha Plus, which is a cream to lighten pigmentation and unify skin tone.

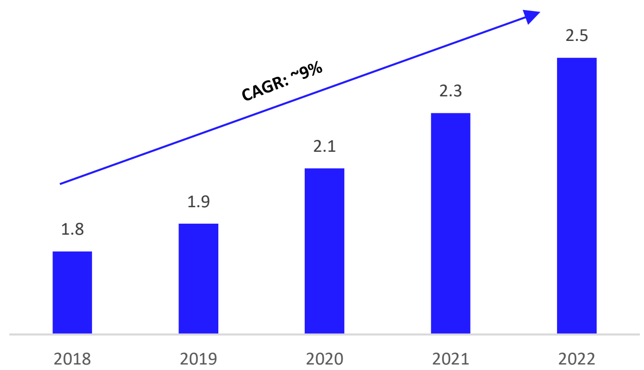
The company is also one of the top players in the respiratory market, which has grown at a rate of almost 5% between 2018 and 2022. Avalon ranks fourth in Saudi Arabia's respiratory market with a market share of 9.1% (calculated at Retail Selling Price). Avalon Pharma's large assortment of nasal decongestants, cough & cold preparations, and anti-asthma and COPD products, available through healthcare and health insurance services with a doctor's prescription or OTC, gives it an advantage in the respiratory market.

Increasing air pollution, dusty weather, the continued high prevalence of smoking among younger age groups, growing awareness of respiratory diseases, and the increase in the elderly/geriatric population are the primary factors driving the growth of the respiratory disease category. Going forward, enhanced healthcare systems, and broader access to medications, are anticipated to drive a high-single digit growth of a 7.3% CAGR between 2022 and 2027. Avalon's key brands in the respiratory space are Salinose (Saline solution to moisturize and clean the nose) and Avocom (a water nasal spray used to treat the symptoms of seasonal allergic rhinitis and perennial rhinitis).

Another key product, that the company has in its portfolio, is Prila, the only topical anesthetic on the market with the combination of lidocaine and prilocaine, which is its unique selling point as there are no alternative in the market. In commands a market share of 61% in value terms in 2022. The demand for central nervous system (topical anaesthetics) medicines is growing in the

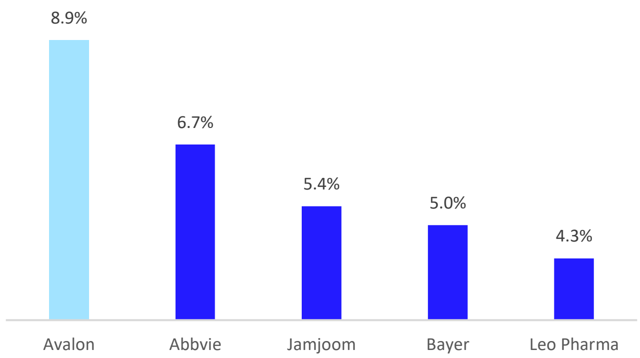
Kingdom, exacerbated partially by the demand for cosmetic procedures and minor injuries. The market size for central nervous system (topical anesthetics) in the Kingdom grew at a CAGR of 6.7% between 2018 and 2022 reaching SAR 85mn (USD 23mn). It is expected to report a CAGR growth of 6.3% over 2022-2027. The market has been and is likely to be driven primarily by cosmetic and dental procedures, and minor injuries requiring stitches.

Figure 20 **Dermatological market in KSA (SAR bn)**



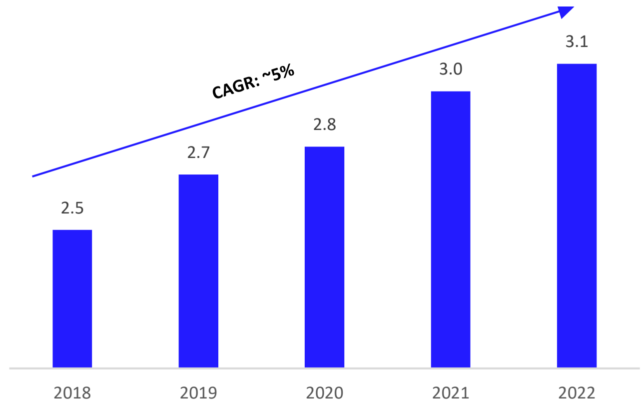
Source: Euromonitor, Al Rajhi Capital

Figure 21 **Key players in Dermatological market**



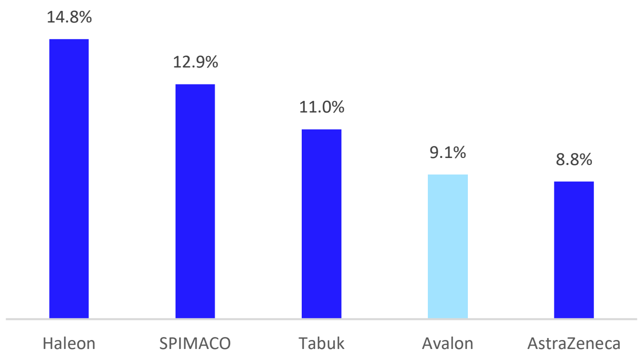
Source: Euromonitor, Al Rajhi Capital

Figure 22 **Respiratory market in KSA (SAR bn)**



Source: Euromonitor, Al Rajhi Capital

Figure 23 **Key players in Respiratory market**



Source: Euromonitor, Al Rajhi Capital

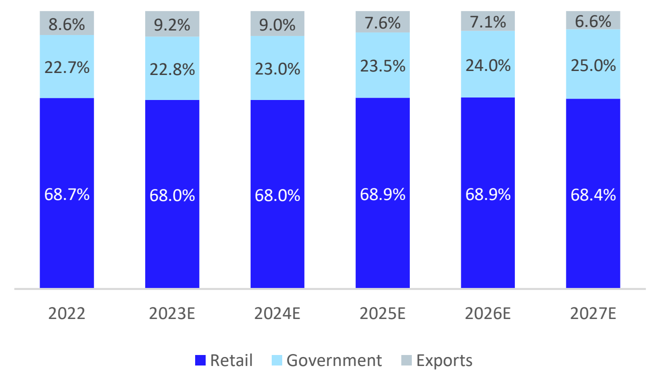
Strong relationship with government:

Avalon Pharma has established a strong relationship with the government through participating in NUPCO tenders as well as supplying products part of the Wasfaty program. The company has a strong win rate of 56% of the public tenders floated since 2019. The value of the tenders won is SAR 125mn. Currently, the revenue contribution from the government channel is around 23%, that is expected to remain at this level or slightly grow in the near future. Given that the company targets to grow its revenues by 18% during 2024-2027E, this implies strong growth is also expected in the government channel.

The advantages of exposure to the government channel is that the company can sell the products in bulk, that helps in higher utilization of the production facilities and over a period of time can show benefits of operating leverage. Moreover, the company can plan its capex based on assurance that the government channel will absorb the incremental capacity. On the negative side, the receivable cycle would become lengthy and the gross margins can take a hit. Typically, the gross margins on government channel are at 30-40% versus 50-60% at the retail channel.

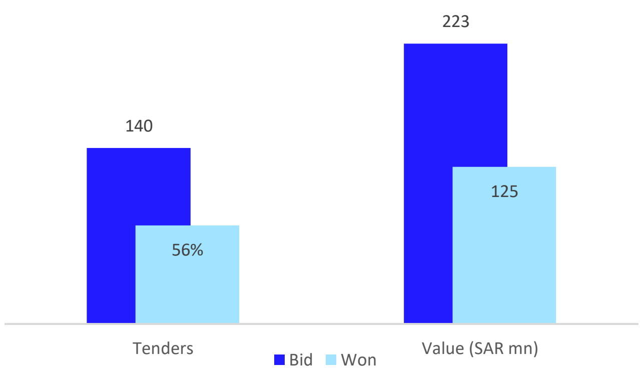
Nevertheless, the government channel is a high growth channel as the country is focussed on giving preferential treatment for local pharma manufacturing companies and targets to increase the contribution of local production to 40% from current 27% (as of 2022).

Figure 24 **Government sales to see boost in future**



Source: Euromonitor, Al Rajhi Capital

Figure 25 **Tenders won since 2019**



Source: Euromonitor, Al Rajhi Capital

Capacity ready to achieve the goal of diversification:

Avalon's revenues are concentrated in just two categories (75% from derma and respiratory). Thus, the company plans to diversify its exposure by venturing into specialised therapeutic areas that includes ophthalmology, neurology and cardiometabolic (CMD). The company has recently expanded its capacity notably, especially in the solids category (tablets), after constructing a new factory in 2022 (Avalon 2). This added a new production lines for creams, liquids and solid medicines. The construction of the Avalon Factory (2) has been completed, and it is expected that commercial production of the factory will begin during the second quarter of 2024. Post the expansion, the company now has a capacity of producing 123 mn units per annum, that includes 14.7 mn units for antiseptics. The capacity of the solid medicines increased by more than 4x from 8.1 mn strips to >35 mn strips.

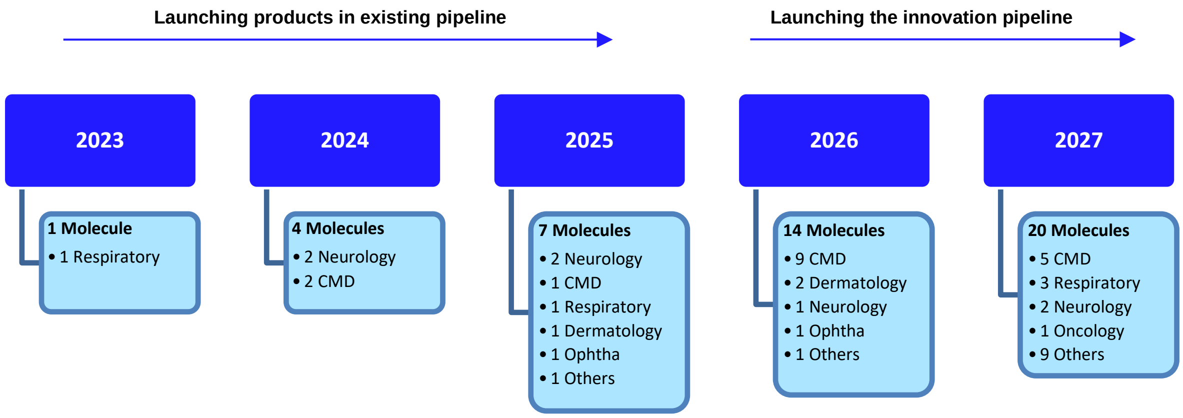
The notable expansion in the solid's capacity would be targeted to grow in the CMD and oncology category. In the CMD, the company has a product pipeline of releasing 17 molecules, starting with 2 molecules in 2024 and 9 in 2026. Post the expansion, the company now has a large manufacturing capacity (123 mn units p.a.) and a network of 4 warehouses throughout Saudi Arabia, with 3 manufacturing facilities with R&D capabilities. By 2026, the company intends to expand its research and development and production capacities in Saudi Arabia to develop general injectables and ophthalmological products. By utilizing its existing manufacturing capabilities, Avalon can manufacture for large pharmacy chains, with the possibility of manufacturing for private label across multiple categories. Avalon is committed to investing in innovative therapeutic areas for the future. With planned investments in manufacturing, enhancing R&D, portfolio expansion in existing categories, and new product launches in dermatology, respiratory, diabetes, gastro-intestinal and musculoskeletal sectors, Avalon Pharmaceuticals is well positioned to become a market leader medicine and medical supplements market in Saudi Arabia.

Figure 26 **Production Capacity**

Class	Creams	Skin & Cosmetics	Liquid	Solid	Disinfectants
Type	Tubes	Tubes	Box	Strips	Box
2003	6.1	-	4.0	-	3.5
2007	-	-	9.2	-	-
2010	12.9	-	-	-	-
2013	-	-	-	8.1	-
2015	-	-	-	-	8.3
2020	-	3.4	-	-	2.9
TOTAL Production capacity Pre-expansion	**19.0**	**3.4**	**13.2**	**8.1**	**14.7**
2022-2023 Expansion	21.8	-	16.3	27.2	-
CURRENT	**40.8**	**3.4**	**29.5**	**35.3**	**14.7**

Source: Company Data, Al Rajhi Capital, Commercial production of the expansion capacity is expected to begin during 2Q24.

Figure 27 **Molecular expansion looks set to aid Avalon**



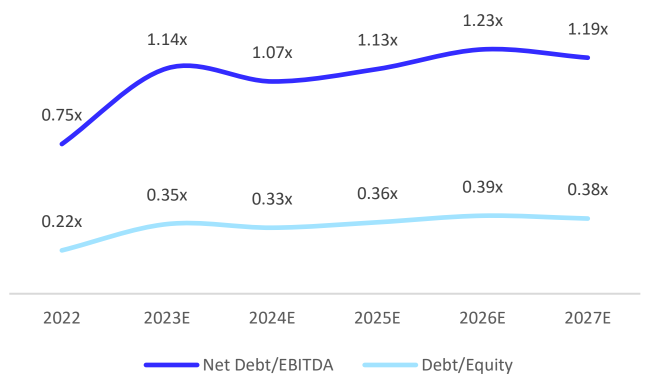
Source: Company Data, Al Rajhi Capital

Strong balance sheet and attractive return ratios:

Avalon has a pretty solid balance sheet with a 2023E net debt/EBITDA of 1.1x and net debt/equity of just 0.35x (targets 0.25-0.35x). The company generates sufficient cash flows to fund its capex as well as pay dividends. Given that the company is done with building its new factory, Avalon 2, the cash flow position is expected to improve further. We are estimating CFO of SAR 79mn in 2023E, that should leave the company with SAR 22mn in free cash flows after funding the capex and dividends for the year. Despite capex remaining elevated until 2027 as the company plans to add production lines for new product launches, we believe the company can fund most of the requirement through internal cash flows. Thus, the strong balance should remain intact going forward.

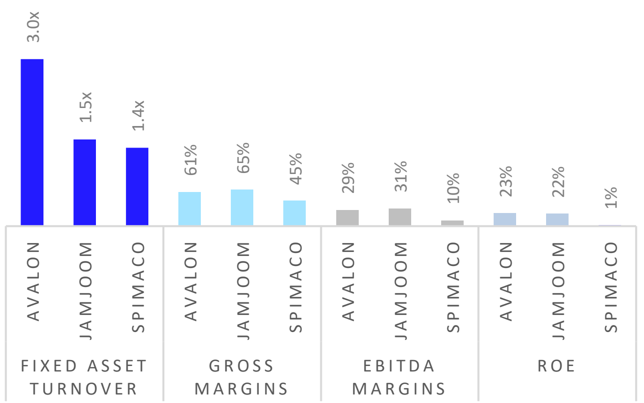
Avalon's return ratios indicate that the company is one of the most efficiently run pharma companies with fixed asset turnover ratio of almost 3.0x (versus peers of 1.5x for Jamjoom and 1.4x for SPIMACO), gross margins of over 60%, EBITDA margins of around 29%, and return on equity of over 20%. Despite the strong topline growth planned in the years ahead, the margins are expected to remain at these levels with some decline broadly due to efficiency, foray into specialised therapeutic areas and focus on selling bulk drugs, especially to the government channel.

Figure 28 **Debt levels to see improvement**



Source: Company Data, Al Rajhi Capital estimates

Figure 29 **Return ratios look attractive**



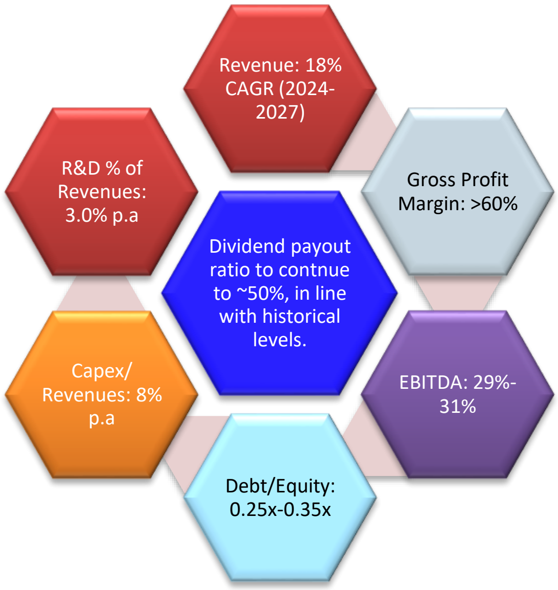
Source: Company Data, Al Rajhi Capital estimates

Outlook appears ambitious, but double-digit growth possible

On the back of sharp increase in capacity, and its strategy to enter into new markets and therapeutic areas, the company is targeting to grow its topline by 18% CAGR during 2024-2027. The company has three pillars to achieve this growth: 1) Accelerate 2) Catalyze and 3) Expand. The first two pillars focus on accelerating the existing portfolio and launching new products as well as entering into new therapeutic areas. The first pillar, Accelerate, would focus on growing its existing flagship brands, improving inventory and supply chain efficiencies and focussing on boosting exposure to retail channel. The second pillar, Catalyse, is key to the growth story as it relies on launching OTC products in fast growing therapeutic areas, focus on launching first generics, venture into chronic and fast-growing primary care products in specialised therapeutic areas such as cardiometabolic, ophthalmology and neurology, that can help in growing the retail channel exposure. Among the targeted product launches, bulk of the launches are in CMD therapeutic areas, about 17 new product launches, of which 14 are lined up in 2026 and 2027. The company targets to maintain a healthy R&D spending, 3% of sales per annum in the near term.

The third Pillar, Expand, relies on growing in overseas markets and entering new markets. The company has identified five core export markets that are Egypt, UAE, Morocco, Malaysia, and Indonesia. It is also open to explore inorganic growth opportunities through full-fledged acquisitions or joint venture. Moreover, to benefit from operating leverage and run the production facility at optimum utilization levels, Avalon also plans to explore new geographies. Of all the three pillars, we are a bit sceptical about the third pillar as we have noticed growing outside KSA, especially in Egypt, can be challenging. Moreover, the company's target of EBITDA margins of 29-31%, which implies expansion of about 100-125 bps (midpoint) from 28.7% expected in 2023E. In our view, growing overseas as well as venturing into solid medicines, with no impact on margins can be challenging.

Figure 30 **Guidance**



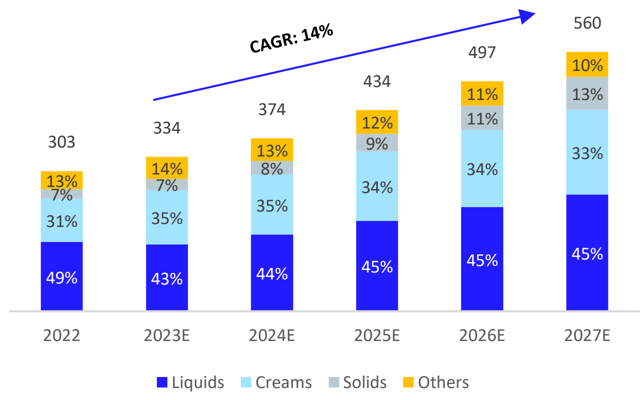
Source: Company Data, Al Rajhi Capital

Financial estimates and valuations

We estimate revenues to grow at a CAGR of almost 14% during 2024-2027 led by growth across the key segments, including liquids and solids. Post the increase in liquids' capacity (3x rise to 29.52 mn units p.a.), and the growing demand in the derma and respiratory segments, the liquids segment is expected to grow by 15% CAGR during the same period. On the other hand, the creams business is estimated to grow at a CAGR of 12% led by demand for skin care products. However, the key growth driver is expected to be the solids segment, which is poised to grow multifold (4x on low base) in the next 4 years supported by the company's strategy to venture into primary care products of specialised therapeutic areas, such as CMD, oncology, etc. The company plans to launch 11 molecules in 2024 and 2025, followed by 34 molecules in 2026 and 2027. On the flip side, we are estimating disinfectants segment to have a modest growth of just over 1% supported by demand for sterilization and sanitisation of medical equipments.

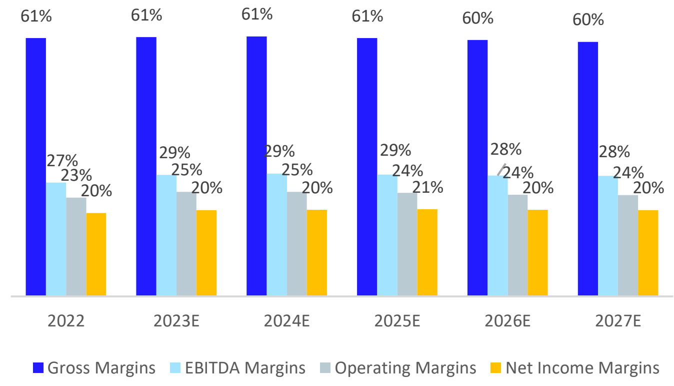
In terms of margins, the company targets 60%+ gross margins and 29%-31% EBITDA margins in the near future. However, we prefer to be conservative and expect gross margins to stabilise around the 60% mark and not exceed as despite the growth of specialised TAs in solids, the change in mix from high margin liquids to solids would weigh on the grow margins. Further, exploring overseas markets such as Egypt, Morocco, Indonesia could also hurt the margins. At the same time, EBITDA margins are expected to hover around 28.5% by 2027E due to requirements of investments in manpower, R&D, higher marketing expenses to venture into new therapeutic areas, launch of products, etc. Similarly, operating margin and net margins are expected to stabilise around 24% and slightly over 20%, respectively in the next 3-4 years from 2023E levels of 24.6% and 20.4%, respectively. On the back of these assumptions, net profit is expected to grow in line with the topline at 14% during 2024-2027.

Figure 31 **Revenues to grow at 14% CAGR (SAR mn)**



Source: Company Data, Al Rajhi Capital estimates

Figure 32 **Return ratios look attractive**



Source: Company Data, Al Rajhi Capital estimates

Valuations:

We value the stock based on a blended approach of equal weight to DCF as well as P/E methodology. Given that bulk of the capex for the new plant is behind, and the company will be investing only for starting new production lines and maintenance capex, free cash flows are expected to be solid in the near future and grow at a rate of 11% over the next 9 years (2024-2032E). Based on our WACC assumption of 8.2% (cost of equity of 10.1%, D/E mix of 40.0%) and terminal growth of 4.0%, our DCF derived fair value for the stock is SAR 104/share. The reason for high terminal growth is pharma being a structural growth story, government's focus to boost local pharma production, and growing capabilities of the local companies.

Our P/E based valuation is SAR 110/share, derived through a forward P/E multiple of 29x on 2024E EPS of SAR 3.81/share. The 29x P/E is derived through a 15% discount to Jamjoom's current forward P/E multiple of 34x (based on our 2024E EPS of SAR 4.39). In our view, among the listed peers, Jamjoom is the closest peer given its high exposure to OTC products and decent market share in derma. However, Jamjoom is much more diversified compared to Avalon and is already a proven name in specialised therapeutic areas such as ophthalmology, CVD, CNS and consumer health. Moreover, its core pharma exposure is also on the higher side unlike Avalon, that has more exposure towards non-pharma products and is heavily reliant on 2-3 products. Nevertheless, the revenue growth prospects are similar, we estimate both Avalon and Jamjoom to grow at a broadly similar rate in the near future and make similar margins.

Based on the blended approach, our fair value for the stock is SAR 107/share, which is our target price. This offers 30% upside from the listing price of SAR 82/share, implying Overweight recommendation on the stock.

Key risks:

Concentrated exposure in two products, Avogain and Salinose, lesser core pharma products in the portfolio; minimal exposure in the solids business and key therapeutic areas such as cardiovascular, oncology, life style diseases such as diabetes, blood pressure, etc.

Figure 33 **Valuations**

DCF	2024E	2025E	2026E	2027E	2028E	2029E	2030E	2031E	2032E
NOPAT	**84.8**	**97.5**	**109.6**	**123.0**	**137.2**	**144.7**	**151.0**	**156.0**	**159.7**
Add: Depreciation	11.1	12.8	15.3	17.3	19.1	20.8	22.5	24.3	26.2
Less: Capex	(29.9)	(34.7)	(49.7)	(39.2)	(37.5)	(33.0)	(34.6)	(36.0)	(37.0)
Less: Change in working capital	(19.8)	(40.7)	(40.6)	(40.8)	(40.7)	(22.3)	(19.5)	(16.3)	(12.8)
FREE CASH FLOW TO FIRM	**46.2**	**34.9**	**34.6**	**60.3**	**78.2**	**110.2**	**119.4**	**128.1**	**136.0**
PV of Free Cash Flows	**43.2**	**30.2**	**27.6**	**44.5**	**53.4**	**69.5**	**69.6**	**69.0**	**67.8**
Sum of present values of FCFs	**474.9**								
Terminal value	3,376.1								
Present value of terminal value	**1,681.9**								
Enterprise Value	**2,156.8**								
Less: Debt	(73.1)								
Less: End of service benefits + Lease	(21.4)								
Add: Cash	9.9								
Equity value	**2,072.1**								
Shares Outstanding	20.0								
Value per share	**104.0**								

Price to earnings method	Multiples/Values	DCF Assumptions	Multiples/Values
Justified P/E	28.9x	WACC	8.2%
Jamjoom P/E	34.0x	Cost of Equity	10.1%
Discount to Jamjoom	-15.0%	Terminal Growth	4.0%
2024E EPS	3.81	Debt/Equity Mix	40.0%
Value per share	**110.0**		

Valuation Method	Fair Value per share	Weightage	Weighted value per share (SAR)	Upside/downside
DCF Valuation	104	50.0%	52	26.8%
Relative Valuation - P/E	110	50.0%	55	34.1%
Target price			**107**	
Listing Price			82.0	
Upside/(Downside)			**30%**	
Dividend yield			2%	
Total returns			**33%**	

Source: Al Rajhi Capital estimates

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Financials

Figure 34 **Income Statement**

SAR mn	2023E	2024E	2025E	2026E	2027E
Revenue	**334**	**374**	**434**	**497**	**560**
y-o-y growth	*10.3%*	*11.9%*	*16.2%*	*14.4%*	*12.8%*
Cost of Sales	(130)	(145)	(170)	(197)	(224)
Gross Profit	**204**	**229**	**264**	**300**	**336**
y-o-y growth	*10.7%*	*12.2%*	*15.4%*	*13.5%*	*12.0%*
margins	*61.1%*	*61.3%*	*60.9%*	*60.4%*	*60.0%*
Selling and marketing expense	(67)	(76)	(88)	(101)	(112)
General & administrative expense	(43)	(49)	(56)	(64)	(72)
R&D expense	(11)	(12)	(14)	(16)	(18)
Impairment loss on trade receivables	0	0	0	0	0
Operating Profit	**82**	**92**	**106**	**119**	**134**
y-o-y growth	*16.7%*	*11.8%*	*15.2%*	*12.4%*	*12.3%*
margins	*24.6%*	*24.6%*	*24.4%*	*24.0%*	*23.9%*
Finance cost	(8)	(9)	(8)	(8)	(9)
Pre-Tax Income	**74**	**83**	**98**	**111**	**125**
Zakat	(6)	(7)	(8)	(10)	(11)
Net Income/Net Profit (Losses)	**68**	**76**	**89**	**101**	**114**
y-o-y growth	*14.3%*	*12.1%*	*17.0%*	*13.6%*	*12.5%*
margins	*20.4%*	*20.4%*	*20.5%*	*20.4%*	*20.3%*
EPS	3.4	3.8	4.5	5.1	5.7

Source: Al Rajhi Capital estimates

Figure 35 **Cash Flow Statement**

SAR mn	2023E	2024E	2025E	2026E	2027E
Cash flow from Operations	**79**	**73**	**68**	**83**	**99**
Capex	*(21)*	*(30)*	*(35)*	*(50)*	*(39)*
Net change in intangibles	*(11)*	*(12)*	*(14)*	*(16)*	*(18)*
Cash flow from Investing	**(32)**	**(42)**	**(49)**	**(66)**	**(57)**
Net change in Loans	*46*	*32*	*16*	*18*	*19*
Dividends	*(36)*	*(38)*	*(45)*	*(51)*	*(57)*
Others	*(7)*	*0*	*0*	*0*	*0*
Cash flow from Financing	**3**	**(6)**	**(29)**	**(33)**	**(38)**
Change in cash	50	25	(10)	(15)	4

Source: Al Rajhi Capital estimates

Figure 36 **Balance Sheet**

SAR mn	2023E	2024E	2025E	2026E	2027E
Cash and equivalents	74	99	90	74	78
Trade receivables	154	174	201	230	260
Inventories	105	111	132	153	173
Prepaid expenses and other	17	19	22	26	29
TOTAL CURRENT ASSETS	**351**	**403**	**445**	**483**	**540**
PP&E, net	118	137	159	193	215
Other Intangible Assets	47	54	62	71	81
Investments	1	1	1	1	1
TOTAL NON-CURRENT ASSETS	**166**	**192**	**222**	**266**	**297**
TOTAL ASSETS	**517**	**595**	**667**	**748**	**838**
Trade payables and other current liabilities	39	43	50	58	67
Accrued liabilities	15	16	19	22	25
Current portion of LT debt	117	146	161	177	194
Income taxes payable	4	6	6	7	9
CURRENT LIABILITIES	**175**	**211**	**236**	**264**	**295**
LT debt	11	14	15	17	18
Employees' end of service benefits	22	22	23	24	25
NON-CURRENT LIABILITIES	**33**	**36**	**38**	**41**	**43**
SHAREHOLDERS EQUITY	**310**	**348**	**392**	**443**	**500**
TOTAL LIABILITIES	**517**	**595**	**667**	**748**	**838**

Source: Al Rajhi Capital estimates

Figure 37 **Key Ratios**

	2023E	2024E	2025E	2026E	2027E
ROA	15.5%	15.0%	15.5%	15.7%	15.7%
ROE	23.0%	23.2%	24.1%	24.2%	24.2%
Current Ratio (x)	2.0x	1.9x	1.9x	1.8x	1.8x
Asset turnover ratio (x)	0.7x	0.7x	0.7x	0.7x	0.7x
Inventory turnover ratio (x)	1.3x	1.3x	1.4x	1.4x	1.4x
Receivables turnover ratio (x)	2.2x	2.3x	2.3x	2.3x	2.3x
Capex to Sales	6.3%	8.0%	8.0%	10.0%	7.0%
FCF Yield (%)	3.6%	3.1%	2.5%	2.5%	4.2%
P/E (x)	24.1x	21.5x	18.4x	16.2x	14.4x
P/BV (x)	5.3x	4.7x	4.2x	3.7x	3.3x
EV/EBITDA (x)	16.6x	14.5x	12.6x	11.2x	10.0x

Source: Al Rajhi Capital estimates

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

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

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

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