

Herfy Food Service Co.

Sales weakness and reliance on delivery have led to margins deterioration

27 April 2020

Herfy's net income slumped by 47.7% Y-o-Y, posting a record low net income of SAR25mn compared to SAR48mn in Q1 2019, well behind our estimates. This hit came on the back of lower revenues (-5.3% Y-o-Y) as a result of COVID-19 precautionary measures, coupled with the continued rise in selling and marketing expenses and Herfy's high operating leverage. We expect weaker performance in Q2 2020 and 2020 full year as COVID-19 hits revenues in H1 2020 and restaurants expansion slows down. We adjusted our recommendation for Herfy from Overweight to Underweight by cutting our target price 30% to SAR38.4 per share.

Herfy's revenues dipped by 5.3% Y-o-Y and 9.1% Q-o-Q to record SAR297mn compared to SAR313mn in Q1 2019 on the back of precautionary measures taken to limit the spread of COVID-19, which took place starting Mid-March. Measures included the shutdown of Herfy's restaurants in commercial centers, with operations of the remaining restaurants limited to takeout and delivery-only. It is worth mentioning that restaurants operations account for almost 85% of Herfy's revenues.

Consequent to lower revenues and higher percentage of cost of sales, Herfy's gross profit slipped by 18.1% Y-o-Y and 23.4% Q-o-Q recording SAR77mn in Q1 2020 compared to SAR94mn in Q1 2019. Gross margins reached a record low of 25.8% compared to 29.8% and 30.6% during Q1 2019 and Q4 2019, respectively.

EBIT slumped by 41.2% Y-o-Y and 40.7% Q-o-Q, posting a record low of SAR35mn compared to SAR59 in Q1 2019. The rise in selling and marketing expenses during the quarter further weighed down on operating profit. EBIT margins contracted by more than 700bps to reach 11.7% in Q1 2020 compared to 18.9% and 18.0% in Q1 2019 and Q4 2019, respectively.

Herfy's net income collapsed by 47.7% Y-o-Y and 49.4% Q-o-Q to only SAR25mn from SAR48mn during Q1 2019. Decrease in other income during the quarter further pressured the company's bottom-line, yet this was partly offset by lower financing expenses. Net margin was slashed to 8.5% compared to 16.1% and 15.2% in Q1 2019 and Q4 2019, respectively.

We expect a steeper fall in Herfy's top-line in Q2 2020 on the back of continued partial closure of restaurants during the quarter. Continued operations of delivery and takeout should support the company's sales, yet not likely to offset the negative impact of the suspension of dining-in operations. Restaurants expansion (a key revenue growth driver) is expected to slow down during the year compared to the company's estimate of 12 new restaurants in 2020. We expect store yields to return to FY 2019 levels by FY 2022, but margins to compress. However, the company will continue to face risks from lower expected discretionary spending and continued fears of eating out. Moreover, while the Saudi economy is starting to show signs of re-opening, suspension of dining-in operations is likely to linger, given its contradiction with social distancing, which delays recovery for Herfy.

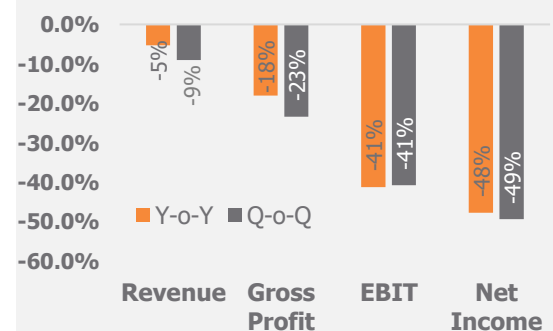
We adjusted our recommendation for Herfy from Overweight to Underweight with a target price of SAR38.4 per share; a downside potential of 11.9%.

Recommendation	Underweight
Previous Recommendation	Overweight
Current Price (26-04-2020)	SAR43.6
Target Price (52 Weeks)	SAR38.4
Upside/ (Downside)	(11.9%)
Shariah Compliance	Pass

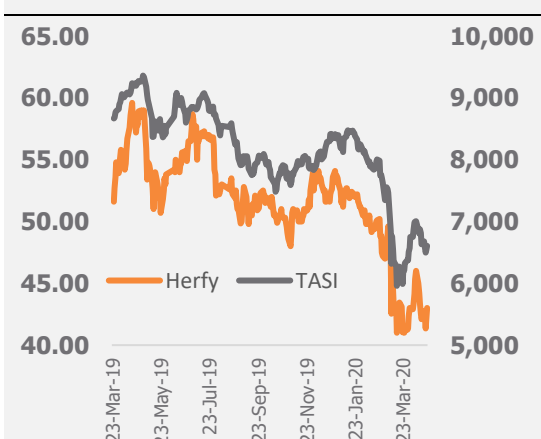
Key Financial Ratios

Ratio	Q1 2020	Q4 2019	Q1 2019
Revenue Growth	-9.1%	-3.7%	-3.6%
Gross Margin	25.8%	30.6%	29.8%
EBIT Margin	11.7%	18.0%	18.9%
Net Margin	8.5%	15.2%	15.3%

Key Financial Results (Q1 2020)



Share Price Performance





Herfy Food Service Co.

DCF Valuation

	2020 E	2021 F	2022 F	2023 F	2024 F
EBITDA	257	284	334	345	355
Operating CF	217	206	241	261	265
Capex	(51)	(57)	(76)	(71)	(66)
FCFF	166	149	165	190	199
Stub Period (FCF to be discounted)	125	149	165	190	199
PV (FCFF)	117	128	130	136	129
WACC	8.85%	We have valued Herfy using DCF approach, considering a WACC is equal to 8.85% (based on a risk-free rate of 4.4%, market risk premium 7.3%, Beta of 0.9)			
Perpetuity Growth	3.00%				
PV-FCFF	640	Based on the DCF valuation, the fair price of Herfy share price is SAR38.4, which is lower than the traded value by 11.9%.			
PV-TV	2,029				
Net Debt	(169)				
Less: End of services benefits	(73)				
Add: JV and associates	56				
Intrinsic Values	2,483				
Shares Outstanding	65				
Equity value per share	38.4				
CMP (26-04-2019)	43.6				
Upside / (Downside%)	-11.9%				

All values are in SARmn

Financial Ratios

	2019 A	2020 F	2021 F	2022 F	2023 F	2024 F
Return on Average Assets (%)	11.3%	3.0%	5.0%	8.0%	8.9%	10.1%
Return on Average Equity (%)	20.3%	6.0%	9.6%	15.3%	16.6%	17.8%
Earnings Before Zakat Margin (%)	18.5%	8.7%	10.5%	12.8%	13.2%	13.5%
Net Income Margin (%)	15.2%	5.6%	7.9%	10.7%	11.3%	11.9%
Revenue Growth (%)	5.0%	-16.9%	9.6%	16.6%	2.6%	2.1%
EPS	3.0	0.9	1.4	2.3	2.4	2.6
DPS	2.1	1.0	2.1	2.1	2.5	2.5

Income Statement

	2019 A	2020 F	2021 F	2022 F	2023 F	2024 F
Revenues	1288	1070	1173	1367	1402	1431
Cost of revenues	-746	-674	-738	-858	-879	-896
Gross Profit	393	247	289	364	377	389
SG&A	-156	-139	-151	-175	-178	-180
Zakat	-5	-2	-2	-4	-4	-4
Net Income	196	60	93	146	158	171

Balance Sheet

	2019 A	2020 F	2021 F	2022 F	2023 F	2024 F
Current Assets	351	339	349	406	408	422
Non-Current Assets	1,683	1,571	1,472	1,401	1,321	1,233
Total Assets	2,033	1,911	1,822	1,807	1,730	1,655
Current Liabilities	408	343	357	391	386	377
Non-Current Liabilities	627	575	516	460	391	316
Total Equity	998	993	948	956	953	962
Total Liabilities and Equity	2,033	1,911	1,822	1,807	1,730	1,655

Guide to Ratings and Disclaimer

Guide to Ratings

Buy	An upside potential of more than 20% in 52-week period
Overweight	An upside Potential of more than 10% in 52-week period
Neutral	Will stay in the range of its value (up/down 10%) in a 52-week period
Underweight	A downside potential of more than 10% in 52-week period
Sell	A downside potential of more than 20% in 52-week period

Itqan Capital

The HQBP Tower, Corniche Road, Al Shatea District,

PO Box 8021, Jeddah 21482,

Kingdom of Saudi Arabia

Tel: 966 12 510 6030

Fax: 966 12 510 6033

info@itqancapital.com

www.itqancapital.com

Disclaimer

This research document has been prepared by Itqan Capital Company ("Itqan Capital"), Saudi Arabia. It has been prepared for the general use of Itqan Capital's clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Itqan Capital. Receipt and review of this research document constitute your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this document prior to public disclosure of such information by Itqan Capital. The information contained was obtained from various public sources believed to be reliable, but we do not guarantee its accuracy. Itqan Capital makes no representations or warranties (express or implied) regarding the data and information provided and Itqan Capital does not represent that the information content of this document is complete, or free from any error, not misleading, or fit for any particular purpose. This research document provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment products related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this document. Investors should seek financial, legal or tax advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this document and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that the price or value of such securities and investments may rise or fall. Fluctuations in exchange rates could have adverse effects on the value of or price of, or income derived from, certain investments. Accordingly, investors may receive back less than originally invested. Itqan Capital or its officers or one or more of its affiliates (including research analysts) may have a financial interest in securities of the issuer(s) or related investments, including long or short positions in securities, warrants, futures, options, derivatives, or other financial instruments. Itqan Capital or its affiliates may from time to time perform investment banking or other services for, solicit investment banking or other business from, any company mentioned in this research document. Itqan Capital, together with its affiliates and employees, shall not be liable for any direct, indirect or consequential loss or damages that may arise, directly or indirectly, from any use of the information contained in this research document. This research document and any recommendations contained are subject to change without prior notice. Itqan Capital assumes no responsibility to update the information in this research document. Neither the whole nor any part of this research document may be altered, duplicated, transmitted or distributed in any form or by any means. This research document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or which would subject Itqan Capital or any of its affiliates to any registration or licensing requirement within such jurisdiction.

Itqan Capital is licensed by the Saudi Arabian Capital Market Authority, License No.07058-37 and CR No.4030167335