Fawaz Abdulaziz Alhokair and Company
ALHOKAIR AB: Saudi Arabia

21 November 2019

الراجحي المالية
Al Rajhi Capital

US$1.306bn	30%	US$3.238mn
Market cap	Free float	Avg. daily volume

Target price	22.00	-8.00% over current
Current price	23.84	as at 20/11/2019

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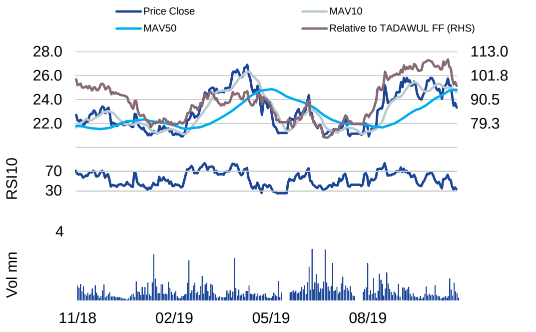
Existing rating

Underweight | **Neutral** | Overweight

Performance



Source: Bloomberg

Earnings

Period End (SAR)	3/19A	3/20E	3/21E	3/22E
Revenue (mn)	5,426	5,213	5,107	5,256
Revenue Growth	-11.3%	-3.9%	-2.0%	2.9%
Gross profit	1084	1616	1583	1629
Gross margin	20.0%	31.0%	31.0%	31.0%
EBITDA (mn)	702	1,299	1,291	1,334
EBITDA margin	12.9%	24.9%	25.3%	25.4%
Net Profit	144.7	-42.8	103.1	158.1
Net Margin	2.67%	NA	2.02%	3.01%
EPS	0.69	NA	0.49	0.75

Source: Company data, Al Rajhi Capital

Fawaz Abdulaziz Alhokair

Missed Estimates; Remain Neutral

Fawaz Alhokair reported a net loss of SAR27mn against our estimates of SAR9mn profit mainly due to IFRS 16 implementation and negative top-line growth in Q2 2020. Revenue, which was impacted by store closures, came in at SAR1234mn slightly higher than our estimates of SAR1210mn (-3% y-o-y). Gross margins improved 8.4% y-o-y mainly due to the implementation of IFRS 16. However, after adjusting for IFRS 16, gross margin was flat to marginally down. As a result, EBIDTA margin pre IFRS 16 level remained almost flat at 10.8%. Due to operating efficiency achieved as a result of company's cost cutting initiatives SG&A expenses reduced by SAR17mn pre IFRS 16 to reach SAR105mn in Q2 2020. Key achievement during the quarter was 1.7% growth LFL and 2% y-o-y increase in units per transaction.

Growth assumptions: Going forward we expect that the store closures will be minimum by the end of FY 2020 and company will open 135 stores till 2023e. We forecast a negative top-line growth for 2020e and 2021e and incorporate a gradual recovery in sales from 2022e onwards as the new stores ramp-up. The company's elevated debt level remains a key concern as it puts a negative constraint on the free cash flow available for reinvestment, therefore as per our analysis future expansion plan is dependent on debt rescheduling which will further increase the overall debt level and reduce the ROIC for the shareholders (Fig 3).

Sector views: We are bullish on the overall retail sector of Saudi Arabia however based on our ground research we have observed a change in the basket of discretionary spending (fig 4). We have seen that there is an increasing spending towards entertainment, restaurants and healthcare. Therefore with marginal increase in overall income level and increasing avenues to spend we feel that people will trade-off spending on shopping with entertainment and other leisure activities. Though our long term view on the growth remains optimistic boosted by pick-up in consumer sentiments following an overall economic recovery and increase in disposable income, however in near term we remain wary about the loss of market share due to store closure and reduced consumer spending towards clothing and apparel. Accordingly we revise our forward looking estimates and remain "neutral" on the stock with a target price of SAR 22 per share thus keeping it unchanged from our previous rating.

Fig 1: Summary of Q2 2020 results (SARmn)

SARmn	2Q19	1Q20	2Q20	% chg y-o-y	% chg q-o-q	ARC est.
Revenue	1274	1732	1235	-3%	-29%	1210
Gross Profit	250	656	346	38%	-47%	372
G. margin	19.6%	37.9%	28.0%	43%	-26%	30.7%
Op. profit	65	65	105	62%	62%	75
Op. margin	5.12%	3.76%	8.54%	67%	127%	6.20%
Net profit	9	9	-27	-400%	-400%	9
Net margin	0.70%	0.51%	-2.16%	NM	NM	2.57%

Source: Company data, Al Rajhi Capital

Top-line to remain muted in near term before gradually recovering: Due to several store closure in the past we believe it will difficult for the company to regain the lost market share in near term. We are expecting the store closure to stop by the end of this year and expect a gradual recovery in sales from 2022e onwards. In 2020e and 2021e we forecast a negative revenue growth of -4% y-o-y and -2% y-o-y respectively thereby factoring in the impact of market share loss. We expect the total number of stores to increase to 1814 by 2023e and based on a LFL growth of 1.8% in both Saudi and international market we forecast overall revenue to reach SAR5.48bn by 2023e.

Negative pressure on net margins due to high debt levels: Total debt outstanding as on H1 2020 is SAR2.685bn with an average maturity of 5.71 years which equates to an annual debt repayment of SAR470mn. Such levels of debt will increase the interest expense and lead to a pressure on the net profit margins as well as free cash flow of the company. In figure 3 we have tried to show the total wealth created by the company for the shareholders. We have assumed that company will open in total of 135 stores till 2023e thus adding a total area of 41,000sqm of space, for capex we have assumed investment per sqm to be SAR5,625 and a maintenance capex @2% on gross fixed assets. Therefore after reinvesting the EBIDTA for the future expansion we see that the company will still be in deficit of SAR 63mn in 2021e and accordingly SAR219mn in 2023e which indicates further need for borrowing. Therefore with additional debt the ROIC will be further lower and the gap between ROIC and WACC will widen thus indicating a negative return for the investors in near term.

Fig 3: Details of the existing debt

Long Term Borrowing	Amount	Maturity	Remaining Maturity	Duration
Facility 1	89	10/16/2019	0.29	0.01
Facility 2	141	12/28/2021	2.49	0.13
Facility 3	31	12/25/2019	0.49	0.01
Facility 4	1104	10/9/2025	6.28	2.58
Facility 5	766	11/30/2026	7.42	2.12
Facility 6	279	11/30/2026	7.42	0.77
Short Term Borrowing				
Short-term Murabaha facilities	233	6/30/2020	1.00	0.09
Long-term Murabaha facilities	21	1/15/2020	0.54	0.00
Short-term financing (Jordan)	22	6/30/2020	1.00	0.01
Total Debt	2,685		**Average Duration**	5.71

Source: Company data, Al Rajhi Capital

Fig 3: Indicative analysis of wealth created by the company

	2021e	2022e	2023e
EBIDTA as per our calculation post IFRS 16	1291	1334	1396
Less: Rental expense	741	775	816
Less:capex requirement	142	162	182
(+/-):working capital requirement	154	18	-24
Less: Interest exp @6% excluding IFRS 16	134	116	98
Less:Repayment of debt	470	470	470
Taxes	21	17	25
cash available/cash required	-63	-188	-219
ROIC	3.68%	3.13%	4.62%
WACC assuming 35% average debt	8.81%	8.81%	8.81%
ROIC-WACC	-5.13%	-5.68%	-4.19%

Source: Company data, Al Rajhi Capital

(NB: For calculating rental expense we have assumed the rent per store to be SAR415,000 in 2019 and increased it by 2% each year, for calculating working capital the receivables due from sale of commercial center company amounting to SAR223.6mn have been excluded as we don't have much clarity on the timeliness when the payment will be received by the company. It is worth mentioning that for arriving at our fair value we have assumed a debt rescheduling and above analysis is just indicative in nature to understand the current scenario and not conclusive.)

Opening of new entertainment avenues changes the basket of discretionary spending: We have observed a structural shift in the spending pattern of Saudi nationals due to significant changes happening in the kingdom. The increasing entertainment avenues are expected to take a considerable share of consumer discretionary spending. Earlier due to limited options shopping was one of the main mode of entertainment activities for the people. However with movie theatres, various cultural events, music shows, sports events taking place very frequently people have more options to spend. Recently the government started Riyadh season which is expected to last for three months and we have observed a heavy footfall in the event where till date more than 5mn visitors and 100,000 tourists visited the season. As per our understanding visiting the season would cost on an average SAR300-400 per person and with various events taking place on a daily basis it has attracted the people of various age groups as well as residents from nearby GCC countries. Further there is a growing awareness towards health benefits and with relatively young demographics the spending towards health services, sports activities, gym, etc. is expected to increase. Therefore we believe that the amount of discretionary spending which was earlier flowing to shopping of clothing, apparels and footwear will remain modest and therefore the primary source of growth for the fashion retailers will come more from store expansion to untapped areas rather than increase in basket value.

Fig 4 Average monthly income and expenditure in Saudi Arabia (SAR)

	2018	2019E	2020e	2021e	2022e
Average monthly household income	14,823	15,078	15,338	15,602	15,871
Average monthly household consumer spending	16,125	16,403	16,685	16,973	17,265
Monthly household expenditure					
Services and Personal goods	3,612	3,609	3,504	3,395	3,280
Housing and utilities	3,612	3,937	4,004	4,073	4,144
Food and Beverages	2,628	2,460	2,419	2,461	2,503
Transportation	2,000	2,034	2,069	2,105	2,141
Home furnishing	1,048	1,066	1,168	1,188	1,209
Telecom	822	837	851	866	881
Restaurants and Hotels	726	820	868	900	950
Fabric apparel and footwear	597	525	467	424	432
Entertainment and culture	468	541	617	696	777
Education	355	361	501	509	518
Health	226	262	300	339	380
Tobacco	48	33	33	34	35

Source: Company data, GASTAT, Al Rajhi Capital

Fig 5 Average monthly income and expenditure in Saudi Arabia (Percentage)

	2018	2019E	2020e	2021e	2022e	2023e	2024e
Average monthly household income	14823	15078	15338	15602	15871	16144	16422
Average monthly household consumer spending	16125	16403	16685	16973	17265	17562	17865
Monthly household expenditure							
Services and Personal goods	22.40%	22.00%	21.00%	20.00%	19.00%	19.00%	19.00%
Housing and utilities	22.40%	24.00%	24.00%	24.00%	24.00%	24.00%	24.00%
Food and Beverages	16.30%	15.00%	14.50%	14.50%	14.50%	14.00%	14.00%
Transportation	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%	12.40%
Home furnishing	6.50%	6.50%	6.50%	7.00%	7.00%	6.50%	6.50%
Telecom	5.10%	5.10%	5.10%	5.10%	5.10%	5.10%	5.10%
Restaurants and Hotels	4.50%	5.00%	5.20%	5.30%	5.50%	6.00%	6.00%
Fabric apparel and footwear	3.70%	3.20%	2.80%	2.50%	2.50%	2.50%	2.50%
Entertainment and culture	2.90%	3.30%	3.70%	4.00%	4.40%	4.80%	4.80%
Education	2.20%	2.20%	3.00%	3.00%	3.00%	3.00%	3.00%
Health	1.40%	1.60%	1.80%	2.00%	2.30%	2.50%	2.50%
Tobacco	0.30%	0.20%	0.20%	0.20%	0.20%	0.20%	0.20%

Source: Company data, GASTAT, Al Rajhi Capital

Valuation: We value Alhokair based on equal weights for DCF and EV/EBIDTA based relative valuation. Our DCF based target price is SAR24 per share, assuming 9% WACC (35% debt in capital structure) and 2.0% terminal growth. The EV/EBIDTA based relative valuation based on 9x FY2020e EBIDTA yields a target of SAR20 per share. The equal weighted target price stands at SAR22 per share implying ~8% downside from current price of SAR23.84. We remain neutral on the stock.

Risks: Downside risks include (a) higher-than-expected rise in employment expenses on the back of Saudization, (b) lower than expected rebates on rent, which can result in higher rental expense and reduce the margins. Key upside risks include (a) higher-than-expected rise in disposable income driven by Saudization (b) faster revamping of new stores than our expectations (c) higher number of store openings compared to our forecast.

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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.

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