July 2020

Fawaz Abdulaziz Alhokair Co.

Investment Update

ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Fawaz Abdulaziz AlHokair Co. (Alhokair) posted Q4-FY20 earnings below estimates. Revenue growth is expected to decrease by low double-digits in FY21 due to the dual impact of the COVID-19 pandemic and increase in VAT. Alhokair reported high inventory provisions in Q4-FY20, which resulted in significant net loss in the quarter. We expect consumer demand to be subdued in the near term due to withdrawal of cost-of-living allowance, higher VAT, and COVID-19 impact. Margins are likely to remain under pressure in the medium term owing to a potential decline in demand driven, as a result of the factors mentioned above. We update our rating on Alhokair to "**Neutral**" with a revised TP of **SAR 20.1/share**.

Store additions to drive revenue in long term: Revenue grew 1.2% Y/Y to SAR 1,085mn in Q4-FY20 due to the temporary closing of stores to contain the spread of COVID-19 and implementation of a portfolio optimization strategy, wherein the company shut down non-performing stores and disposed weak brands. On a like-for-like (LFL) basis, net revenue decreased 1.2% Y/Y in Q4-FY20, following the 1.7% and 3.5% LFL growth achieved in Q2-FY20 and Q3-FY20, respectively. The company plans to open 52 new stores in FY21. E-commerce represented only 1% of sales in FY20; this figure should be higher to drive sales. We expect revenue to be adversely impacted by COVID-19 and the increase in VAT, resulting in a low double-digit revenue decline in FY21. A rebound in consumer demand in H2-21 is likely to benefit Alhokair in the long term.

Operations adversely impacted by COVID-19 in H1-CY20; turnaround expected in a few quarters: Alhokair closed most of its stores in the Kingdom on March 16 as per the government directive to contain the spread of the COVID-19 pandemic. The stores reopened on April 26 in all cities, except Makkah, with limited operating hours. From June 21, stores resumed normal operations similar to pre-COVID levels. This temporary closing of stores adversely affected the company's financials in Q4-FY20, and would also impact Q1-FY21 financials. We believe demand would be subdued for the next few quarters, as people would try to restrain from shopping as before COVID to avoid contracting the virus. This could have a direct impact on the company's sales and margins.

Increase in VAT to weigh on company performance in near term: Saudi Arabia announced important austerity measures to contain the fiscal deficit, which include an increase in VAT to 15% from July 1 from 5% earlier, and discontinuation of cost-of-living allowance as of June 2020. These steps were necessary given the current economic scenario. Alhokair witnessed higher-than-normal sales in the last 10 days of Q1-FY21, which can be attributed to pre-buying to avoid the VAT hike. However, after June-2020, the dual impact of the VAT hike and withdrawal of living allowance would diminish people's purchasing power and significantly hurt company's financials in the near term.

Acquisition of Innovative Union facilitates diversification to lucrative F&B sector: Alhokair completed the acquisition of Innovative Union Company from Food and Entertainment Company in Q4-FY20. The acquisition added 10 international brands and over 200 branches in the F&B sector around the Kingdom, and also leverages the company's shared central services and relationship with landlords. Revenues from the F&B segment increased 20.0% Y/Y to SAR 419.8mn in FY20, with an EBITDA of SAR 70.1mn. Alhokair plans to open 35 branches in 2020. It expects the acquisition to be earnings accretive from the first year of acquisition. An increase in consumer spending would drive this segment.

Neutral

Target Price (SAR)	**20.1**
Upside / (Downside)*	**7.1%**

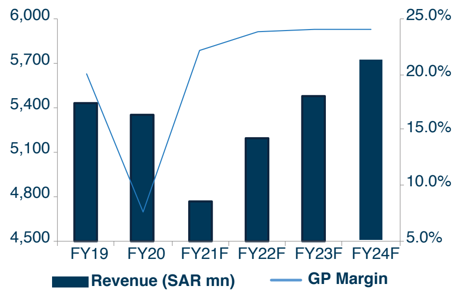
Source: Tadawul *prices as of 19th of July 2020

Key Financials

SARmn (unless specified)	FY20	FY21E	FY22E
Revenue	5,342	4,760	5,199
Gross Profit	408	1,049	1,238
Net Profit	-656	-53	184
EPS	-3.13	-0.25	0.88

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

Key Ratios

	FY20	FY21E	FY22E
Gross Margin	7.6%	22.0%	23.8%
Net Margin	-12.3%	-1.1%	3.5%
P/E	NM	NM	21.4x
P/B	2.6x	2.7x	2.4x
EV/EBITDA (x)	42.0x	9.8x	7.9x

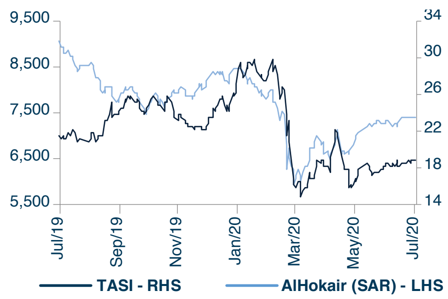
Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (bn)	3.9
YTD %	-26.6%
52 Week (High)/(Low)	30.6/15.0
Shares Outstanding (mn)	210.0

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

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Franchise rights to open Decathlon stores bodes well for future: Alhokair obtained commercial franchise rights to open "Decathlon" stores. Decathlon, a French company, specializes in sports equipment and products, and has presence in 70 countries with over 1,600 stores. Alhokair intends to launch its first store opening in the Arab Mall in Jeddah in H1-CY21, with expansion plans to open 30 stores in the next seven years. This is another important addition to the company's existing portfolio of brands, and benefit company in the long term once the situation normalizes.

GP margin narrows on high inventory provisions in FY-20, expected to return to previous levels: Alhokair recorded SAR 596.7mn in inventory provision in FY20 to lower inventory ageing and in line with the company's optimization and restructuring strategy. While this lowered the inventory level to SAR 1.65bn in Q4-FY20 from SAR 2.0bn in the previous quarter, the GP margin for FY20 plummeted to 7.6% from 20.0% in FY19. With a significant reduction in inventory levels, we expect the GP Margins to return to historical levels from FY21, wherein the inventory provisions could be lower compared to FY20.

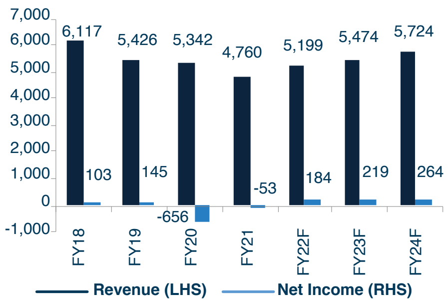
Cost rationalization measures, coupled with government support, to help stem margin contraction in short term: Alhokair has adopted cost rationalization measures that include rent relief agreements with landlords and waivers on contractual base rent for a specific period. The company has also received support from the government under the SANED program, which covered 60% of salaries of 70% of the company's workforce. Moreover, the company has implemented additional salary reduction to cut costs. Alhokair is also planning additional measures in case it continues to face COVID-related challenges. Furthermore, the company refinanced its debt in Q4-FY20, which should help lower its finance costs. It is very important that the company adapts to changes and takes appropriate measures based on the changing situation, so it can have meaningful presence and capitalize on the attractive long-term growth prospects.

Highly leveraged balance sheet, adaptation to e-commerce represent key risks: Alhokair's D/E ratio stands at 4.6x (FY20) after including lease liabilities as part of debt, which is very high for a retail company. E-commerce represented just 1% of sales in FY20. The company needs to increase this percentage and adapt to current trends in the market such as cash on delivery, refunds, and returns.

AJC view and valuation: We believe Alhokair stands to benefit from increased retail demand, which would primarily drive growth in the long term. Market growth is expected to be fueled by higher consumer spending, supported by the government's focus on increasing spending power. However, there remain near-term challenges due to the COVID-19 impact, increase in VAT, and suspension of living allowance. Proactive measures to manage these challenging times would place the company in a favorable position over the long term. The acquisition of Innovative Union enables diversification through exposure to the food businesses. The company's plan to add stores would allow it to capitalize on growth opportunities in the sector, with improvements in margins through cost rationalization measures. However, a decrease in purchasing power in the short term, a high D/E ratio and adaption to e-commerce pose major challenges.

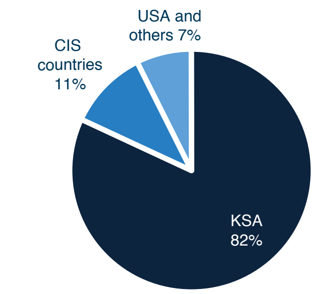
We value Alhokair on 50% weight for DCF (3.0% terminal growth, 6.9% average WACC), and 25% weight each for P/E (20.4x FY21E EPS) and EV/EBITDA (11.8x FY21E EBITDA) based on relative valuation. These yield a TP of SAR 20.1 per share, implying a 7.1% upsi de from current levels. The stock is currently trading at a P/E of 21.4x as per our FY22E EPS estimate. We update our rating on Alhokair to "**Neutral**" with a revised TP of **SAR 20.1/share**.

Revenue and Profit (Mn SAR)



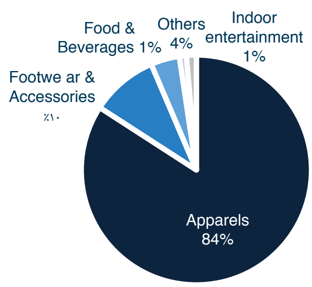
Source: Company reports, Aljazira Capital

Revenue by Geography (FY20)



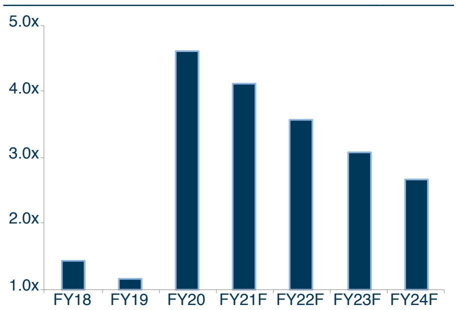
Source: Company reports, Aljazira Capital

Revenue by Segment (FY20)



Source: Company reports, Aljazira Capital

Debt-Equity Ratio



Source: Company reports, Aljazira Capital

Amount in SAR mn, unless otherwise specified	FY18	FY19	FY20	FY21E	FY22E	FY23E
Income statement						
Revenues	6,117	5,426	5,342	4,760	5,199	5,474
Y/Y	**-8.6%**	**-11.3%**	**-1.5%**	**-10.9%**	**9.2%**	**5.3%**
Cost of Sales	**(4,902)**	**(4,341)**	**(4,934)**	**(3,711)**	**(3,961)**	**(4,161)**
Gross profit	**1,215**	**1,084**	**408**	**1,049**	**1,238**	**1,314**
Selling and marketing expenses	(248)	(180)	(138)	(144)	(153)	(161)
General and Administrative exp	(322)	(278)	(218)	(233)	(245)	(258)
Depreciation and amortization	(318)	(290)	(296)	(316)	(321)	(337)
Other income	(13)	79	168	24	26	27
Operating profit	**314**	**412**	**(133)**	**380**	**545**	**585**
Y/Y	**-49.4%**	**31.3%**	**NM**	**NM**	**43.5%**	**7.3%**
Financial charges	**(181)**	**(201)**	**(204)**	**(185)**	**(153)**	**(148)**
Profit before zakat	**133**	**193**	**(634)**	**(2)**	**221**	**263**
Zakat	(43)	(55)	(48)	(51)	(39)	(46)
Net income	103	145	(656)	(53)	184	219
Y/Y	**-76.2%**	**39.9%**	**NM**	**NM**	**NM**	**19.4%**
Balance sheet						
Assets						
Cash & bank balance	331	516	686	82	151	300
Other current assets	2,919	3,038	2,369	2,041	2,187	2,294
Property & Equipment	2,046	1,752	1,514	1,341	1,202	1,084
Other non-current assets	1,416	1,401	5,448	5,401	5,369	5,345
Total assets	**6,711**	**6,707**	**10,018**	**8,865**	**8,909**	**9,023**
Liabilities & owners' equity						
Total current liabilities	2,501	2,112	2,352	1,659	1,706	1,735
Total non-current liabilities	2,025	2,184	6,137	5,729	5,543	5,408
Paid -up capital	2,100	2,100	2,100	2,100	2,100	2,100
Statutory reserves	191	206	206	200	219	241
Other reserve	(525)	(452)	(579)	(579)	(579)	(579)
Retained earnings	482	624	(112)	(160)	5	203
Minority interest	(64)	(67)	(85)	(85)	(85)	(85)
Total owners' equity	2,185	2,411	1,530	1,476	1,660	1,880
Total equity & liabilities	**6,711**	**6,707**	**10,018**	**8,865**	**8,909**	**9,023**
Cashflow statement						
Operating activities	782	804	543	631	594	636
Investing activities	(491)	21	285	(143)	(182)	(219)
Financing activities	(290)	(556)	(691)	(1,094)	(343)	(269)
Change in cash	1	270	137	(605)	69	149
Ending cash balance	**331**	**516**	**686**	**82**	**151**	**300**
Key fundamental ratios						
Liquidity ratios						
Current ratio (x)	1.3	1.7	1.3	1.3	1.4	1.5
Quick ratio (x)	0.6	0.8	0.6	0.5	0.5	0.6
Profitability ratios						
GP Margin	19.9%	20.0%	7.6%	22.0%	23.8%	24.0%
Operating Margins	5.1%	7.6%	-2.5%	8.0%	10.5%	10.7%
EBITDA Margin	10.3%	12.9%	3.1%	14.6%	16.7%	16.8%
Net Margins	1.7%	2.7%	-12.3%	-1.1%	3.5%	4.0%
Return on assets	1.6%	2.2%	-7.8%	-0.6%	2.1%	2.4%
Return on equity	4.7%	6.1%	-32.1%	-3.4%	11.1%	11.8%
Market/valuation ratios						
EV/sales (x)	1.4	1.5	1.3	1.4	1.3	1.2
EV/EBITDA (x)	13.3	11.8	42.0	9.8	7.9	7.4
EPS (SAR)	0.5	0.7	(3.1)	(0.3)	0.9	1.0
BVPS (SAR)	10.4	11.5	7.3	7.0	7.9	9.0
Market price (SAR)*	26.8	24.5	17.5	18.8	18.8	18.8
Market-Cap (SAR mn)	5,619	5,153	3,679	3,679	3,679	3,679
P/E ratio (x)	54.3	35.6	NM	NM	21.4	18.0
P/BV ratio (x)	2.5	2.1	2.4	2.7	2.4	2.1

Source: Company financials, AlJazira research (Y/E is March)

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AlJazira Capital, the investment arm of Bank AlJazira, is a Shariaa Compliant Saudi Closed Joint Stock company and operating under the regulatory supervision of the Capital Market Authority. AlJazira Capital is licensed to conduct securities business in all securities business as authorized by CMA, including dealing, managing, arranging, advisory, and custody. AlJazira Capital is the continuation of a long success story in the Saudi Tadawul market, having occupied the market leadership position for several years. With an objective to maintain its market leadership position, AlJazira Capital is expanding its brokerage capabilities to offer further value-added services, brokerage across MENA and International markets, as well as offering a full suite of securities business.

RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

Disclaimer