

# Herfy Food Services

Agriculture & Food sector

HERFY AB: Saudi Arabia

24 October 2010

الراجحي المالية  
Al Rajhi Capital



**US\$0.547bn** Market cap  
**51.1%** Free float  
**US\$0.860mn** Avg. daily volume

Target price **90.20** 18.70% over current  
Consensus price **n/a**  
Current price **76.00** as at 18/10/2010

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Underweight

Neutral

Overweight

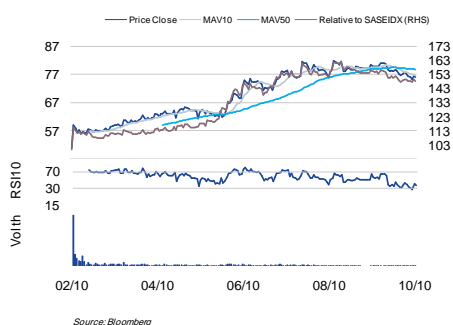
## Key themes

We believe that the fast food industry will continue to grow strongly. Herfy has a very strong position in the fast food market. It is currently the second just behind McDonalds. We believe that Herfy's strategy of opening 20 to 25 restaurants per year coupled with increasing production capacity in the bakery and meats divisions production capacity will allow the company to grow strongly.

## Implications

Herfy is one of our preferred stocks in the agriculture & food sector. It is performing well operationally and offers growth in the near term at a reasonable valuation. We believe Herfy's handsome dividends coupled with decent transparency will continue to support Herfy's share price.

## Performance

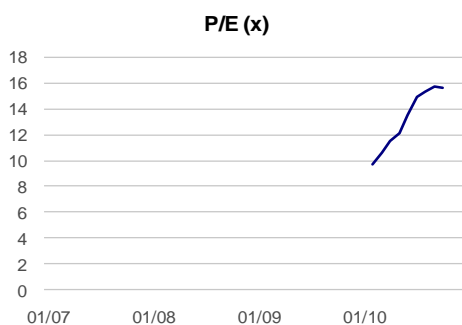


## Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (mn)	518	577	648	727
Revenue Growth	11.0%	11.5%	12.3%	12.3%
EBITDA (mn)	145	160	182	204
EBITDA Growth	16.2%	10.1%	14.1%	12.1%
EPS	6.20	4.58	5.24	6.06
EPS Growth	-32.1%	-26.0%	14.4%	15.5%

Source: Company data, Al Rajhi Capital

## Valuation



Source: Company data, Al Rajhi Capital

# Herfy

## Good sales, unexciting profits

*Herfy's Q3 results were decent. Sales in two divisions, restaurants and meats, showed robust growth of 12% and 42% respectively, with around 3% same store sales growth in the core restaurants division. Herfy was able to improve its gross margin, but unexpectedly high administrative and marketing costs hurt net profit. We expect Q4 2010 to be good with stronger net profit. Although we like the acceleration in same store sales growth, we have lowered our target price to SAR90.2 reflecting the declining net margins.*

**Top line close to our estimates:** Herfy reported sales growth of 9.5% from SAR133mn in Q3 2009 to SAR145mn in Q3 2010; this was below our forecast of 12.3% sales growth. We attribute this discrepancy to the unexpected decline in the bakery segment. The restaurants and meats divisions showed solid growth, while bakery and rusk sales declined unexpectedly. As we had expected, the meats division showed the highest sales growth of 42%. Sales in the core restaurants division grew by 12%, better than our forecast of 11%. Rusk division sales declined by 32%, but this is too small to affect Herfy's growth. Likely, Bakery sales declined by 4%, far below our estimate of 10% growth. We believe that the Ramadan season and increasing competition in the bakery market resulted in this decline. We estimate that Q4 sales will be stronger.

**Decent same store sales growth:** As we had expected, Herfy opened recently four new restaurants to reach 170 restaurants by the end of Q3. On this basis we estimate Herfy's same store sales (SSS) grew by around 3% during this quarter, higher than the level of about 1.5% in Q1 and similar to that of Q2. This acceleration in SSS growth can be mainly attributed to marketing activities despite their adverse impact on margins. We expect Herfy to open three more stores during Q4 2010 to reach 173 stores by the end of the year. The robust overall growth in the restaurants division, and the acceleration in SSS growth in particular, are encouraging; however, the lower than expected sales in the rusk and bakery divisions might hold down Herfy's revenue growth in the near term.

**Administrative and marketing costs hurt net profit:** Although the gross margin improved slightly from 32.7% in Q3 2009 to 32.8% in Q3 2010, it declined considerably from 34.0% in Q2 2010. Despite the higher year-on-year gross margin, Herfy achieved lower net profit of SAR30.8mn than our estimate of SAR33.2mn. This shortfall can be attributed to higher marketing and administrative costs and lower other income (franchising) than we had assumed. At this level, administrative and marketing costs comprise 11.6% of sales, higher than the level of 9.8% for the same period last year. Although we believe it will be difficult for Herfy to bring marketing costs back down to the 2009 level, we think the company will be able to reduce administrative costs as a proportion of sales during the last quarter.

**Valuation and conclusion:** Herfy reported good sales growth for Q3 2010 (though not as strong as we had hoped), and it should achieve better growth over the remaining months of the year. Net profit was depressed by higher marketing and administrative costs, but we expect it to improve over the remaining months. We expect Herfy to maintain its dividend policy; the current dividend yield is about 4.0%. We have made slight changes to our forecasts. Therefore, we have set a new target price of SAR90.2; this implies 18.7% upside and so we remain Overweight.



### Corporate summary

Herfy is a food services company that was founded in 1981 by Ahmed Alsaeed and Hamod Albrahim. The company's business includes four divisions: fast food chain, bakery, rusk (Shaborah), and meats. The fast food chain is the biggest division as it comprises about 77% of total revenues. Herfy has international business in the GCC and MENA regions through franchise and exports. The company was listed in February 2010.

### Share information

Market cap (SAR/US\$) 2.052bn / 0.547bn  
52-week range 51.00 - 81.75  
Daily avg volume (US\$) 0.860mn  
Shares outstanding 27.00mn  
Free float (est) 51.1%

Performance: 1M 3M 12M  
Absolute -4.7% -1% 49%  
Relative to index -3.5% -3.7% 50.7%

Major Shareholder:  
Savola group 47.6%  
Ahmed Hamad Mohammed Alsaeed 20.3%

Source: Bloomberg, Al Rajhi Capital

### Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	518	577	648	727
EBITDA (SARmn)	145	160	182	204
Net Profit (SARmn)	115	124	142	164
EPS (SAR)	6.20	4.58	5.24	6.06
DPS (SAR)	2.97	2.98	3.28	3.61
EPS Growth	-32.1%	-26.0%	14.4%	15.5%
EV/EBITDA (x)	9.7	12.8	11.3	10.1
P/E (x)	12.3	16.6	14.5	12.5
P/B (x)	6.5	5.4	4.7	4.1
Dividend Yield	3.9%	3.9%	4.3%	4.7%

Source: Company data, Al Rajhi Capital

## Looking forward we expect decent full year results

We estimate strong revenues growth in Q4, but decent profits growth

We estimate Q4 2010 revenue growth of 14%, stronger than growth in previous quarters. We expect Q4 net income to reach SAR32.6mn, implying year-on-year growth of 10%. This would also be a stronger outcome than in the previous two quarters.

Based on our estimates for Q4, we expect full-year revenue to grow by 11.5% and reach SAR577mn. We think that Herfy can boost its gross margin over the last quarter and so achieve a gross margin of 33.1% in 2010. We further expect full-year net income to reach SAR124mn, implying 7.9% growth from the level of 2009.

Figure 1. Herfy: 2009Q4A vs. 2010Q4E & FY2009A vs. FY2010E

(SAR) mn	2009Q4A	2010Q4E	YOY % chg.	FY2009A	FY2010E	YOY % chg.
Restaurants	99,249	116,275	17.2%	404,025	457,850	13.3%
Meats	3,707	5,079	37.0%	12,742	17,849	40.1%
Rusk	4,334	3,467	-20.0%	15,683	13,476	-14.1%
Bakery	22,541	23,443	4.0%	85,144	87,847	3.2%
<b>Total Revenues</b>	<b>129,831</b>	<b>148,263</b>	<b>14.2%</b>	<b>517,594</b>	<b>577,021</b>	<b>11.5%</b>
Gross Profit	42,634	49,075	15.1%	169,303	191,105	12.9%
	32.8%	33.1%		32.7%	33.1%	1.3%
<b>EBITDA</b>	<b>36,052</b>	<b>41,843</b>	<b>16.1%</b>	<b>145,203</b>	<b>159,803</b>	<b>10.1%</b>
EBITDA margin (%)	27.8%	28.2%		28.1%	27.7%	
<b>Net Income</b>	<b>29,605</b>	<b>32,560</b>	<b>10.0%</b>	<b>114,641</b>	<b>123,746</b>	<b>7.9%</b>

Source: Company data, Al Rajhi Capital

Following the results, we have lowered our revenue and profit forecasts for the next few years by a few per cent. These changes have pushed down our estimate of long-run DEP-run fair value per share by 3.4%, from SAR102.6 to SAR99.2. As before, we value Herfy using long-run fair value and comparative multiples analysis with a 70%/30% weighting to the two methods. With other assumptions unchanged, our new target price is SAR90.2, down by 3.2% from SAR93.2 previously. This target implies 18.7% upside and so we stay Overweight.



We expect revenues to reach SAR577mn this year

We expect revenue growth to remain above 11%

We expect the gross margin to remain decent at around 33%

By our estimates, ROIC is impressive around 33%

EV/EBITDA and P/E are on the low side when compared to other food companies

Income Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
<b>Revenue</b>	<b>466</b>	<b>518</b>	<b>577</b>	<b>648</b>	<b>727</b>
Cost of Goods Sold	(323)	(348)	(386)	(432)	(484)
<b>Gross Profit</b>	<b>144</b>	<b>169</b>	<b>191</b>	<b>216</b>	<b>244</b>
Government Charges					
S.G. & A. Costs	(48)	(56)	(67)	(73)	(80)
<b>Operating EBIT</b>	<b>96</b>	<b>113</b>	<b>124</b>	<b>143</b>	<b>164</b>
Cash Operating Costs	(342)	(372)	(417)	(465)	(523)
EBITDA	125	145	160	182	204
Depreciation and Amortisation	(29)	(32)	(36)	(40)	(41)
<b>Operating Profit</b>	<b>96</b>	<b>113</b>	<b>124</b>	<b>143</b>	<b>164</b>
Net financing income/(costs)	(2)	(1)	(1)	(1)	0
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	(2)	5	4	4	4
Other Expenses					
<b>Net Profit Before Taxes</b>	<b>94</b>	<b>118</b>	<b>127</b>	<b>145</b>	<b>168</b>
Taxes	(3)	(3)	(3)	(4)	(4)
Minority Interests	-	-	-	-	-
<b>Net profit available to shareholders</b>	<b>91</b>	<b>115</b>	<b>124</b>	<b>142</b>	<b>164</b>
Dividends	-	(80)	(81)	(89)	(97)
Transfer to Capital Reserve					
	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Adjusted Shares Out (mn)	10.00	27.00	27.00	27.00	27.00
CFPS (SAR)	12.04	7.91	5.90	6.71	7.57
EPS (SAR)	9.13	6.20	4.58	5.24	6.06
DPS (SAR)	0.000	2.972	2.981	3.280	3.608
<b>Growth</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Revenue Growth	24.4%	11.0%	11.5%	12.3%	12.3%
Gross Profit Growth	32.2%	17.6%	12.9%	13.0%	12.9%
EBITDA Growth	39.4%	16.2%	10.1%	14.1%	12.1%
Operating Profit Growth	46.8%	18.5%	9.5%	14.9%	14.7%
Net Profit Growth	48.2%	25.6%	7.9%	14.4%	15.5%
EPS Growth	-25.9%	-32.1%	-26.0%	14.4%	15.5%
<b>Margins</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Gross profit margin	30.9%	32.7%	33.1%	33.3%	33.5%
EBITDA margin	26.8%	28.1%	27.7%	28.2%	28.1%
Operating Margin	20.5%	21.9%	21.5%	22.0%	22.5%
Pretax profit margin	20.2%	22.8%	22.0%	22.4%	23.1%
Net profit margin	19.6%	22.1%	21.4%	21.8%	22.5%
<b>Other Ratios</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
ROCE	34.2%	34.8%	30.8%	30.9%	30.9%
ROIC	34.0%	37.8%	36.1%	33.3%	33.5%
ROE	37.0%	39.6%	35.5%	34.7%	34.7%
Effective Tax Rate	3.2%	2.7%	2.7%	2.5%	2.5%
Capex/Sales	7.2%	16.4%	14.6%	16.3%	15.0%
Dividend Payout Ratio	0.0%	70.0%	65.1%	62.6%	59.6%
<b>Valuation Measures</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
P/E (x)	8.3	12.3	16.6	14.5	12.5
P/CF (x)	6.3	9.6	12.9	11.3	10.0
P/B (x)	2.9	6.5	5.4	4.7	4.1
EV/Sales (x)	1.6	2.7	3.5	3.2	2.8
EV/EBITDA (x)	6.2	9.7	12.8	11.3	10.1
EV/EBIT (x)	8.0	12.4	16.5	14.4	12.6
EV/IC (x)	2.6	6.1	4.9	4.3	3.8
Dividend Yield	0.0%	3.9%	3.9%	4.3%	4.7%

Source: Company data, Al Rajhi Capital



Herfy's balance sheet is expanding due to expansion in operations

<b>Balance Sheet (SARmn)</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Cash and Cash Equivalents	21	20	44	31	26
Current Receivables	14	20	23	26	27
Inventories	54	43	49	54	58
Other current assets	39	51	58	58	58
<b>Total Current Assets</b>	<b>128</b>	<b>134</b>	<b>174</b>	<b>169</b>	<b>170</b>
Fixed Assets	226	277	327	393	461
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	-	-	-	-	-
Total Other Assets	-	-	-	-	-
<b>Total Non-current Assets</b>	<b>226</b>	<b>277</b>	<b>327</b>	<b>393</b>	<b>461</b>
<b>Total Assets</b>	<b>355</b>	<b>411</b>	<b>501</b>	<b>562</b>	<b>631</b>
Short Term Debt	12	9	15	15	15
Trade Payables	-	-	-	-	-
Dividends Payable	-	-	-	-	-
Other Current Liabilities	-	-	-	-	-
<b>Total Current Liabilities</b>	<b>57</b>	<b>62</b>	<b>73</b>	<b>75</b>	<b>76</b>
Long-Term Debt	18	9	23	25	25
Other LT Payables	-	-	-	-	-
Provisions	18	22	26	26	26
<b>Total Non-current Liabilities</b>	<b>36</b>	<b>32</b>	<b>49</b>	<b>50</b>	<b>50</b>
Minority interests	-	-	-	-	-
Paid-up share capital	100	270	270	270	270
Total Reserves	162	47	110	167	235
<b>Total Shareholders' Equity</b>	<b>262</b>	<b>317</b>	<b>380</b>	<b>437</b>	<b>505</b>
<b>Total Equity</b>	<b>262</b>	<b>317</b>	<b>380</b>	<b>437</b>	<b>505</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>355</b>	<b>411</b>	<b>501</b>	<b>562</b>	<b>631</b>

<b>Ratios</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Net Debt (SARmn)	9	(2)	(6)	8	13
Net Debt/EBITDA (x)	0.07	(0.01)	(0.04)	0.04	0.06
Net Debt to Equity	3.3%	-0.6%	-1.7%	1.9%	2.6%
EBITDA Interest Cover (x)	75.6	145.6	222.4	148.3	(543.6)
BVPS (SAR)	26.21	11.73	14.06	16.18	18.71

Herfy enjoys strong cash flows

<b>Cashflow Statement (SARmn)</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
<b>Net Income before Tax &amp; Minority Interest</b>	<b>94</b>	<b>118</b>	<b>127</b>	<b>145</b>	<b>168</b>
Depreciation & Amortisation	29	32	36	40	41
Decrease in Working Capital	(19)	0	(11)	(6)	(5)
Other Operating Cashflow	3	6	2	(4)	(4)
<b>Cashflow from Operations</b>	<b>107</b>	<b>156</b>	<b>153</b>	<b>175</b>	<b>200</b>
Capital Expenditure	(34)	(85)	(84)	(106)	(109)
New Investments	-	-	-	-	-
Others	7	7	1	-	-
<b>Cashflow from investing activities</b>	<b>(27)</b>	<b>(78)</b>	<b>(84)</b>	<b>(106)</b>	<b>(109)</b>
<b>Net Operating Cashflow</b>	<b>81</b>	<b>78</b>	<b>70</b>	<b>70</b>	<b>90</b>
Dividends paid to ordinary shareholders	(60)	(60)	(61)	(85)	(95)
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	-	-	-	-	-
<b>Cashflow from financing activities</b>	<b>(72)</b>	<b>(72)</b>	<b>(32)</b>	<b>(83)</b>	<b>(95)</b>
Total cash generated	9	6	38	(13)	(5)
Cash at beginning of period	20	21	20	44	31
<b>Implied cash at end of year</b>	<b>29</b>	<b>27</b>	<b>58</b>	<b>31</b>	<b>26</b>

We expect Capex/Sales to remain around 16%

<b>Ratios</b>	<b>12/08A</b>	<b>12/09A</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Capex/Sales	7.2%	16.4%	14.6%	16.3%	15.0%

Source: Company data, Al Rajhi Capital



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#### 1. Explanation of Al Rajhi Capital's rating system

Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:

**"Overweight"**: Our target price is more than 15% above the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

**"Neutral"**: We expect the share price to settle at a level between 5% below the current share price and 15% above the current share price on a 6-9 month time horizon.

**"Underweight"**: Our target price is more than 5% below the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

#### 2. Definitions

**"Time horizon"**: Our analysts make recommendations on a 6-9 month time horizon. In other words, they expect a given stock to reach their target price within that time.

**"Fair value"**: We estimate fair 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.

**"Target price"**: This may be identical to estimated fair value per share, but is not necessarily the same. There may be very good reasons why a share price is unlikely to reach fair value within our time horizon. In such a case we set a target price which differs from estimated fair value per share, and explain our reasons for doing so.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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