Herfy Food Services

Agriculture & Food Sector

HERFY AB: Saudi Arabia

24 July 2011

Al Rajhi Capital

US$0.626bn	51.1%	US$1.039mn
Market cap	Free float	Avg. daily volume

Target price	91. 70	5.4% over current
Consensus price	88.00	1.1% over current
Current price	87.00	as at 23/7/2011

Research Department

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Underweight | **Neutral** | Overweight

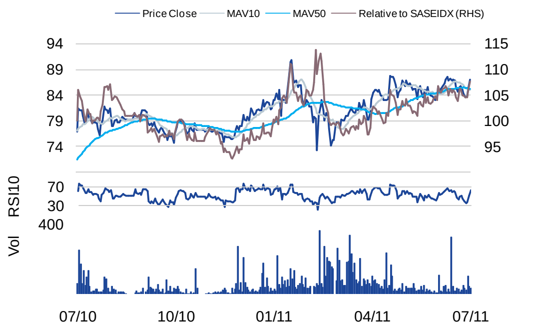
Key themes

We believe 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 think Herfy's strategy of opening 20 to 25 restaurants coupled with increasing production capacity in the bakery and meats divisions 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 with a strong position in the fast food market. However, we believe that Herfy share price is almost priced in and offers limited upside.

Performance



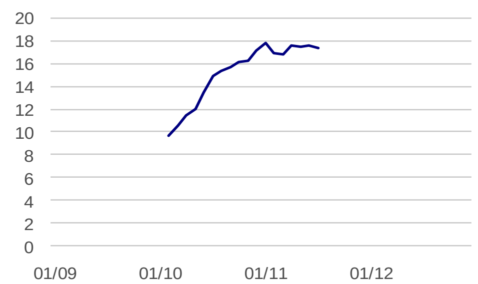
Earnings

Period End (SAR)	12/11E	12/12E	12/13E	12/14E
Revenue (mn)	690	789	875	968
Revenue Growth	19.0%	14.4%	10.9%	10.6%
EBITDA (mn)	185	211	231	258
EBITDA Growth	17.3%	14.4%	9.4%	11.6%
EPS	5.31	5.95	6.64	7.32
EPS Growth	15.3%	12.2%	11.5%	10.2%

Source: Company data, Al Rajhi Capital

Valuation

P/E (x)



Source: Company data, Al Rajhi Capital

Herfy

Outstanding results but priced in

Herfy released Q2 results with robust year-on-year sales growth of 28% and remarkable net profit growth of 21%. Gross margin continued to contract in Q2 as a result of increasing foodstuff prices and packaging costs. In our view, though the overall results were solid and well above our expectation, they were driven by the two salary bonus and thus unsustainable. Moreover, Herfy stock has recently rallied around 11% and offers limited upside potential at current level. Therefore, we downgrade our rating to Neutral and maintain our target price of SAR91.7.

Sales growth across all segments: Herfy reported sales growth of 28% from SAR147mn in Q2 2010 to SAR188mn in Q2 2011; this was above our forecast of 13% sales growth. Sales in two divisions, restaurants and meats, showed outstanding growth of 32% and 33% respectively; with an impressive same store sales growth above 15% in the core restaurants division. The bakery and rusk divisions showed strong growth of 14% and 10% after struggling in the second half of 2010. Bakery is benefiting from the expansion in Bakery stores; Herfy opened two stores in the first half and plans to open four stores in 2011.

Remarkable same store sales growth: Herfy opened four new restaurants in Q2 to reach 177 restaurants. On this basis, we estimate that Herfy's same store sales (SSS) grew by 15% during Q2, much higher than the level of about 7% in Q1. This acceleration in SSS growth can be mainly attributed to two factors: consumer's spending appetite as a result of the declared two salary bonus by the government and many private entities, and Herfy's continuous adding of new items to its menu. However, we don't expect Herfy to replicate this growth in Q3 as it coincides with summer holiday and Ramadan season. We expect Herfy to open 7 new stores during Q3 2011 in which 4 have been already opened in July.

Continuous pressure on gross margin: Gross margin declined from 34% in Q2 2010 to 32.5% in Q2 2011. However, this decline in gross margin was offset by strong sales and lower than expected SG&A costs. At this level, administrative and marketing costs comprise 11.5% of sales, lower than the level of 12.1% for the same period last year. We believe that it will be difficult for Herfy to maintain its 2010 gross margin level of 33.3% due to increasing food commodities prices, but we expect it to remain within reasonable level above 32%.

Herfy Cafe opening in Q3: Herfy is entering a new segment, Cafe shops, through the opening of its first store this September in Riyadh city. The second store will be opened later this year in Qassim. We believe that Herfy is testing the market by opening one store only, and hence, we don't expect to see major impact on Herfy's financials in 2011. It is worth to note that Cafe industry is very competitive in the kingdom and well concentrated.

Valuation and conclusion: Herfy reported strong sales and profit growth for Q2 2011. Herfy also announced that it is increasing its capital to SAR300mn through share dividends. On the back of Q2 results, we have made slight changes to our forecasts reflecting the acceleration in SSS growth and the decline in gross margin. Herfy stock has recently rallied and, in our view, offers limited upside potential. Therefore, we downgrade our rating to Neutral and maintain our target price of SAR91.7. Herfy stock is currently trading on a 2011 PE of 16.4x and an EV/EBITDA ratio of 12.7x.

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$)	2.349bn / 0.626bn
52-week range	73.25 - 90.75
Daily avg volume (US$)	1.039mn
Shares outstanding	27.00mn
Free float (est)	51.1%

Performance:	1M	3M	12M
Absolute	1.8%	4.5%	14.5%
Relative to index	0.7%	5.5%	7.4%

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

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/11E	12/12E	12/13E	12/14E
Revenue (SARmn)	690	789	875	968
EBITDA (SARmn)	185	211	231	258
Net Profit (SARmn)	143	161	179	198
EPS (SAR)	5.31	5.95	6.64	7.32
DPS (SAR)	3.33	3.67	3.65	4.02
EPS Growth	15.3%	12.2%	11.5%	10.2%
EV/EBITDA (x)	12.7	11.1	10.2	9.1
P/E (x)	16.4	14.6	13.1	11.9
P/B (x)	5.4	4.7	4.0	3.5
Dividend Yield	3.8%	4.2%	4.2%	4.6%

Source: Company data, Al Rajhi Capital

Below we summarize sales breakdown and profits for Q2 and Q3 for both years 2011 and 2010 (our estimate versus actual results).

Figure 1. Herfy: 2010Q2A vs. 2011Q2E vs. 2011Q2A & 2010Q3A vs. 2011Q3E

(SAR) mn	2010Q2A	2011Q2E	2011Q2A	YOY % chg.	2010Q3A	2011Q3E	YOY % chg.
Restaurants	115.8	131.1	152.4	31.6%	121.0	139.1	15.0%
Meats	4.4	6.4	5.9	33.6%	4.3	5.8	35.0%
Rusk	3.4	3.5	3.7	10.4%	2.3	2.4	5.0%
Bakery	23.1	24.3	26.3	13.7%	18.3	20.0	9.5%
Total Revenues	**146.7**	**165.3**	**188.4**	**28.4%**	**145.8**	**167.3**	**14.7%**
Gross Profit	49.8	54.9	50.6	1.5%	47.8	54.2	13.4%
Gross margin	34.0%	33.2%	26.9%		32.8%	32.4%	
Operating Profit	**32.0**	**35.7**	**32.9**	**2.8%**	**30.9**	**34.8**	**12.8%**
Net Income	**32.6**	**36.1**	**32.5**	**-0.4%**	**30.4**	**34.2**	**12.5%**

Source: Company data, Al Rajhi Capital

We expect revenues to reach SAR690mn by the end of 2011

We expect revenues growth to remain strong over the next three years

Increasing costs (material and packaging) are likely to depress gross margin

Herfy is trading on a P/E of 16.4x and EV/EBITDA 12.7x

Income Statement (SARmn)	12/10A	12/11E	12/12E	12/13E	12/14E
Revenue	**580**	**690**	**789**	**875**	**968**
Cost of Goods Sold	(387)	(466)	(535)	(593)	(656)
Gross Profit	**193**	**224**	**254**	**282**	**312**
Government Charges					
S.G. & A. Costs	(69)	(80)	(93)	(102)	(113)
Operating EBIT	**124**	**144**	**162**	**179**	**198**
Cash Operating Costs	(423)	(505)	(578)	(644)	(710)
EBITDA	157	185	211	231	258
Depreciation and Amortisation	(34)	(41)	(49)	(52)	(59)
Operating Profit	**124**	**144**	**162**	**179**	**198**
Net financing income/(costs)	(0)	(1)	(1)	1	0
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	4	4	4	4	4
Other Expenses					
Net Profit Before Taxes	**128**	**147**	**165**	**184**	**203**
Taxes	(3)	(4)	(4)	(5)	(5)
Minority Interests	-	-	-	-	-
Net profit available to shareholders	**124**	**143**	**161**	**179**	**198**
Dividends	(81)	(90)	(99)	(99)	(109)
Transfer to Capital Reserve					

	12/10A	12/11E	12/12E	12/13E	12/14E
Adjusted Shares Out (mn)	27.00	27.00	27.00	27.00	27.00
CFPS (SAR)	5.85	6.81	7.78	8.55	9.51
EPS (SAR)	4.60	5.31	5.95	6.64	7.32
DPS (SAR)	2.981	3.333	3.667	3.653	4.025

Growth	12/10A	12/11E	12/12E	12/13E	12/14E
Revenue Growth	12.0%	19.0%	14.4%	10.9%	10.6%
Gross Profit Growth	13.9%	15.9%	13.7%	10.7%	10.6%
EBITDA Growth	8.3%	17.3%	14.4%	9.4%	11.6%
Operating Profit Growth	9.1%	16.3%	12.4%	10.8%	10.6%
Net Profit Growth	8.4%	15.3%	12.2%	11.5%	10.2%
EPS Growth	-25.7%	15.3%	12.2%	11.5%	10.2%

Margins	12/10A	12/11E	12/12E	12/13E	12/14E
Gross profit margin	33.3%	32.4%	32.2%	32.2%	32.2%
EBITDA margin	27.1%	26.7%	26.7%	26.4%	26.6%
Operating Margin	21.3%	20.9%	20.5%	20.5%	20.5%
Pretax profit margin	22.0%	21.3%	20.9%	21.0%	20.9%
Net profit margin	21.4%	20.8%	20.4%	20.5%	20.4%

Other Ratios	12/10A	12/11E	12/12E	12/13E	12/14E
ROCE	30.8%	31.8%	30.6%	29.4%	28.3%
ROIC	38.2%	38.5%	37.4%	34.7%	32.8%
ROE	35.7%	35.1%	34.2%	33.0%	31.4%
Effective Tax Rate	2.7%	2.5%	2.5%	2.5%	2.5%
Capex/Sales	14.3%	15.0%	15.5%	15.0%	15.0%
Dividend Payout Ratio	64.8%	62.8%	61.6%	55.0%	55.0%

Valuation Measures	12/10A	12/11E	12/12E	12/13E	12/14E
P/E (x)	18.9	16.4	14.6	13.1	11.9
P/CF (x)	14.9	12.8	11.2	10.2	9.1
P/B (x)	6.2	5.4	4.7	4.0	3.5
EV/Sales (x)	4.0	3.4	3.0	2.7	2.4
EV/EBITDA (x)	14.8	12.7	11.1	10.2	9.1
EV/EBIT (x)	18.9	16.2	14.5	13.1	11.9
EV/IC (x)	6.4	5.5	4.7	4.0	3.5
Dividend Yield	3.4%	3.8%	4.2%	4.2%	4.6%

Source: Company data, Al Rajhi Capital

Herfy's balance sheet is continuously expanding

Balance Sheet (SARmn)	12/10A	12/11E	12/12E	12/13E	12/14E
Cash and Cash Equivalents	50	41	36	31	30
Current Receivables	24	27	29	31	34
Inventories	48	56	62	70	77
Other current assets	51	48	48	48	48
Total Current Assets	**173**	**171**	**176**	**180**	**189**
Fixed Assets	326	388	461	541	627
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	-	-	-	-	-
Total Other Assets	-	-	-	-	-
Total Non-current Assets	**326**	**388**	**461**	**541**	**627**
Total Assets	**499**	**559**	**637**	**721**	**816**
Short Term Debt	13	11	11	11	11
Accounts Payable	25	29	32	35	39
Accrued Expenses	-	-	-	-	-
Dividends Payable	-	-	-	-	-
Other Current Liabilities	30	36	36	36	36
Total Current Liabilities	**71**	**78**	**79**	**82**	**86**
Long-Term Debt	21	16	26	26	26
Other LT Payables	-	-	-	-	-
Provisions	26	29	29	29	29
Total Non-current Liabilities	**47**	**45**	**56**	**56**	**56**
Minority interests	-	-	-	-	-
Paid-up share capital	270	270	270	270	270
Total Reserves	110	166	233	313	405
Total Shareholders' Equity	**380**	**436**	**503**	**583**	**675**
Total Equity	**380**	**436**	**503**	**583**	**675**
Total Liabilities & Shareholders' Equity	**499**	**559**	**637**	**721**	**816**

Gearing measures are at extremely low level

Ratios	12/10A	12/11E	12/12E	12/13E	12/14E
Net Debt (SARmn)	(16)	(15)	1	7	7
Net Debt/EBITDA (x)	(0.10)	(0.08)	0.00	0.03	0.03
Net Debt to Equity	-4.2%	-3.4%	0.1%	1.1%	1.1%
EBITDA Interest Cover (x)	340.5	282.9	260.7	(327.4)	(621.2)
BVPS (SAR)	14.08	16.16	18.61	21.60	24.98

Cashflow Statement (SARmn)	12/10A	12/11E	12/12E	12/13E	12/14E
Net Income before Tax & Minority Interest	**128**	**147**	**165**	**184**	**203**
Depreciation & Amortisation	34	41	49	52	59
Decrease in Working Capital	(3)	5	(9)	(7)	(6)
Other Operating Cashflow	1	(2)	(4)	(5)	(5)
Cashflow from Operations	**159**	**190**	**202**	**224**	**251**
Capital Expenditure	(83)	(103)	(123)	(131)	(145)
New Investments	-	-	-	-	-
Others	1	1	-	-	-
Cashflow from investing activities	**(82)**	**(103)**	**(123)**	**(131)**	**(145)**
Net Operating Cashflow	**78**	**88**	**79**	**93**	**106**
Dividends paid to ordinary shareholders	(61)	(87)	(95)	(99)	(106)
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	(8)	-	-	-	-
Cashflow from financing activities	**(45)**	**(95)**	**(84)**	**(99)**	**(106)**
Total cash generated	33	(7)	(5)	(6)	(1)
Cash at beginning of period	20	50	41	36	31
Implied cash at end of year	**53**	**43**	**36**	**31**	**30**

We expect Capex to remain high as a result of bakery and restaurants expansion plans

Ratios	12/10A	12/11E	12/12E	12/13E	12/14E
Capex/Sales	14.3%	15.0%	15.5%	15.0%	15.0%

Source: Company data, Al Rajhi Capital

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Additional disclosures

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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