

Herfy Food Services

Food & Agriculture Sector

HERFY AB: Saudi Arabia

12 November 2011

الراجحي المالية
Al Rajhi Capital



US\$0.610bn Market cap
51.1% Free float
US\$0.475mn Avg. daily volume

Target price **84.90** 11.34% over current
Consensus price **88.00** 15.4% over current
Current price **76.25** as at 2/11/2011

Research Department
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Underweight **Neutral** Overweight

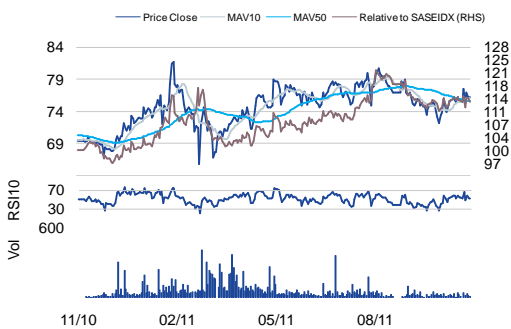
Key themes

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

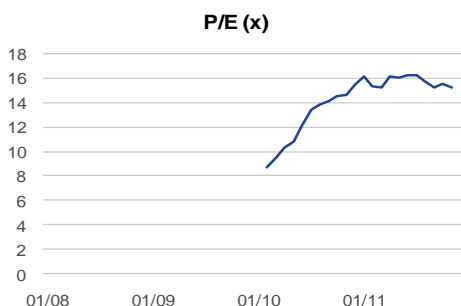


Earnings

Period End (SAR)	12/10A	12/11E	12/12E	12/13E
Revenue (mn)	580	698	795	886
Revenue Growth	12.0%	20.3%	14.0%	11.3%
EBITDA (mn)	157	184	215	235
EBITDA Growth	8.3%	17.2%	16.6%	9.3%
EPS	4.60	5.04	5.50	6.12
EPS Growth	-25.7%	9.6%	9.0%	11.2%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

Herfy

Q3: in line but concerning

Herfy released Q3 results with robust year-on-year growth in both top and bottom line of 18% and 13% respectively, in line with our estimates. Gross margin shrank by 260bps in Q3 as a result of increasing foodstuff prices, packaging, and direct labour costs (Saudization). Herfy continues to grow organically and by opening new stores. In our view, overall Q3 results were encouraging, but the contraction in gross margin is concerning. Thus, we have marginally revised our forecasts on the back of recent results. We maintain our Neutral rating on the company with a revised price target of SAR84.9.

Sales growth across major segments: Herfy reported sales growth of 18% from SAR146mn in Q3 2010 to SAR173mn in Q3 2011. Sales in restaurants and meats divisions showed strong growth of 20% and 25% y-o-y respectively, while bakery segment showed healthy growth of 13%. However, despite that it's relatively a small segment, Rusk sales declined by 17% y-o-y. The company attributed this decline to summer holiday season and fierce competition. We are more convinced with the latter reason.

Diverse menu boosts SSS growth: Herfy opened six new restaurants in Q3 to reach 183 restaurants. On this basis, we estimate that Herfy's SSS grew by 10% during Q3, higher than the level of about 7% in Q1 but lower than that seen in Q2 of 15%. This y-o-y acceleration can be mainly attributed to the continuous adding of new items to its menu. During 2011, Herfy introduced new meals such as jumbo hotdog and jalapeno chicken; this ought to support like-for-like sales growth. We expect Herfy to open four new stores during Q4 2011 to reach 187.

Concerning decline in gross margin: Gross margin declined from 32.8% in Q3 2010 to 30.2% in Q3 2011. This can be attributed to increasing foodstuff prices, packaging costs, and direct labour costs (Nationalization program). It's worth noting that Herfy falls within the green category (rate of Saudization between 23% and 30%). Nevertheless, this decline in gross margin was slightly offset by strong sales and lower than expected SG&A costs. At this level, administrative and marketing costs comprise 10.2% of sales, lower than the level of 11.6% for the same period last year.

Herfy Cafe opening delayed: As mentioned in our previous report, Herfy is entering a new segment, Cafe shops, through the opening of its first store in Riyadh city. The opening, initially planned in September, has been postponed to November. 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 material impact on Herfy's financials in 2011.

Dividends likely to increase: Herfy distributed cash dividends of SAR1.5 per share for H1. We expect a higher dividend of SAR2.0 for H2, resulting in a full year dividend of SAR3.5. This implies a dividend yield of 4.5%.

Valuation and conclusion: Q3 results were mostly in line with our estimates and support our stance on the company. As a result, we have made slight changes to our forecasts reflecting the acceleration in SSS growth and the decline in gross margin. In our view, Herfy share price offers limited upside potential at current levels. Therefore, we retain our Neutral rating with a new target price of SAR84.9 (adjusted for the recent capital increase).



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\$)	2.287bn / 0.610bn		
52-week range	65.93 - 81.68		
Daily avg volume (US\$)	0.475mn		
Shares outstanding	27.00mn		
Free float (est)	51.1%		
Performance:	1M	3M	12M
Absolute	1.3%	-4.7%	10.7%
Relative to index	-0.4%	-1.2%	13.2%
Major Shareholder:			
Savola group	47.6%		
Ahmed Hamad Mohammed Alsaeed	20.3%		

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/10A	12/11E	12/12E	12/13E
Revenue (SARmn)	580	698	795	886
EBITDA (SARmn)	157	184	215	235
Net Profit (SARmn)	124	144	165	183
EPS (SAR)	4.60	5.04	5.50	6.12
DPS (SAR)	2.98	3.50	3.50	3.97
EPS Growth	-25.7%	9.6%	9.0%	11.2%
EV/EBITDA (x)	13.0	11.7	10.7	9.9
P/E (x)	16.6	15.1	13.9	12.5
P/B (x)	5.4	5.2	4.6	4.1
Dividend Yield	3.9%	4.6%	4.6%	5.2%

Source: Company data, Al Rajhi Capital

Q3: in line with our estimates

Below we present Q3 actual figures versus our estimates.

Figure 1. Herfy: 2010Q3A vs. 2011Q3A vs. 2011Q3E (our estimates)

(SAR) mn	2010Q3A	2011Q3A	YOY % chg.	2011Q3E
Restaurants	121.0	144.5	19.5%	139.1
Meats	4.3	5.4	24.7%	5.8
Rusk	2.3	1.9	-17.1%	2.4
Bakery	18.3	20.7	13.3%	20.0
Total Revenues	145.8	172.5	18.3%	167.3
Gross Profit	47.8	52.1	8.9%	54.2
Gross margin	32.8%	30.2%		32.4%
Operating Profit	30.9	34.5	11.7%	34.8
Net Income	30.4	34.5	13.4%	34.2

Source: Company data, Al Rajhi Capital

Q4: another strong round

Below we summarize our estimates for Q4 and 2011 full year.

Figure 2. Herfy: 2010Q4A vs. 2011Q4E & FY2010A vs. FY2011E

(SAR) mn	2010Q4A	2011Q4E	YOY % chg.	FY2010A	FY2011E	YOY % chg.
Restaurants	119.6	142.5	19.2%	461.1	564.1	22.3%
Meats	5.6	6.4	15.1%	18.3	24.0	30.8%
Rusk	3.0	3.2	5.0%	13.0	13.2	1.4%
Bakery	23.0	25.6	11.0%	87.4	96.6	10.5%
Total Revenues	151.2	177.6	17.5%	579.9	697.9	20.3%
Gross Profit	50.9	57.2	12.4%	192.9	221.2	14.6%
	33.7%	32.2%		33.3%	31.7%	
Operating Profit	32.3	36.8	14.0%	123.7	143.8	16.3%
Net Income	33.1	37.4	13.1%	124.3	143.8	15.7%

Source: Company data, Al Rajhi Capital



We expect revenues to reach SAR698mn by the end of 2011

Better DPS of SAR3.5 per share

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

Increasing costs (material and packaging) depressed gross margin

Herfy is trading on a P/E of 15.3x and EV/EBITDA of 11.8x

Income Statement (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Revenue	518	580	698	795	886
Cost of Goods Sold	(348)	(387)	(477)	(542)	(602)
Gross Profit	169	193	221	254	283
Government Charges					
S.G. & A. Costs	(56)	(69)	(77)	(88)	(100)
Operating EBIT	113	124	144	166	183
Cash Operating Costs	(372)	(423)	(513)	(580)	(651)
EBITDA	145	157	184	215	235
Depreciation and Amortisation	(32)	(34)	(41)	(50)	(52)
Operating Profit	113	124	144	166	183
Net financing income/(costs)	(1)	(0)	(0)	(1)	0
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	5	4	4	4	4
Other Expenses					
Net Profit Before Taxes	118	128	147	169	188
Taxes	(3)	(3)	(4)	(4)	(5)
Minority Interests	-	-	-	-	-
Net profit available to shareholders	115	124	144	165	183
Dividends	(80)	(81)	(105)	(105)	(119)
Transfer to Capital Reserve					
	12/09A	12/10A	12/11E	12/12E	12/13E
Adjusted Shares Out (mn)	27.00	27.00	30.00	30.00	30.00
CFPS (SAR)	7.91	5.85	6.47	7.15	7.84
EPS (SAR)	6.20	4.60	5.04	5.50	6.12
DPS (SAR)	2.972	2.981	3.500	3.500	3.975
Growth	12/09A	12/10A	12/11E	12/12E	12/13E
Revenue Growth	11.0%	12.0%	20.3%	14.0%	11.3%
Gross Profit Growth	17.6%	13.9%	14.6%	14.8%	11.6%
EBITDA Growth	16.2%	8.3%	17.2%	16.6%	9.3%
Operating Profit Growth	18.5%	9.1%	16.2%	15.1%	10.8%
Net Profit Growth	25.6%	8.4%	15.7%	14.7%	11.2%
EPS Growth	-32.1%	-25.7%	9.6%	9.0%	11.2%
Margins	12/09A	12/10A	12/11E	12/12E	12/13E
Gross profit margin	32.7%	33.3%	31.7%	31.9%	32.0%
EBITDA margin	28.1%	27.1%	26.4%	27.0%	26.5%
Operating Margin	21.9%	21.3%	20.6%	20.8%	20.7%
Pretax profit margin	22.8%	22.0%	21.1%	21.3%	21.2%
Net profit margin	22.1%	21.4%	20.6%	20.7%	20.7%
Other Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
ROCE	34.8%	30.8%	31.8%	30.8%	30.2%
ROIC	40.8%	38.2%	38.5%	38.1%	35.3%
ROE	39.6%	35.7%	35.2%	35.3%	34.6%
Effective Tax Rate	2.7%	2.7%	2.5%	2.5%	2.5%
Capex/Sales	16.4%	14.3%	15.1%	15.5%	15.0%
Dividend Payout Ratio	70.0%	64.8%	73.0%	63.7%	65.0%
Valuation Measures	12/09A	12/10A	12/11E	12/12E	12/13E
P/E (x)	12.3	16.6	15.1	13.9	12.5
P/CF (x)	9.6	13.0	11.8	10.7	9.7
P/B (x)	6.5	5.4	5.2	4.6	4.1
EV/Sales (x)	2.7	3.5	3.1	2.9	2.6
EV/EBITDA (x)	9.7	13.0	11.7	10.7	9.9
EV/EBIT (x)	12.4	16.5	15.0	13.9	12.6
EV/IC (x)	6.5	5.6	5.4	4.5	3.9
Dividend Yield	3.9%	3.9%	4.6%	4.6%	5.2%

Source: Company data, Al Rajhi Capital



Herfy's balance sheet is continuously expanding

Balance Sheet (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Cash and Cash Equivalents	20	50	37	38	20
Current Receivables	20	24	27	30	32
Inventories	43	48	57	63	71
Other current assets	51	51	50	50	50
Total Current Assets	134	173	171	181	172
Fixed Assets	277	326	389	464	545
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	-	-	-	-	-
Total Other Assets	-	-	-	-	-
Total Non-current Assets	277	326	389	464	545
Total Assets	411	499	560	645	717
Short Term Debt	9	13	8	8	8
Accounts Payable	21	25	30	33	35
Accrued Expenses	-	-	-	-	-
Dividends Payable	-	-	-	-	-
Other Current Liabilities	29	30	36	36	36
Total Current Liabilities	62	71	78	77	80
Long-Term Debt	9	21	15	40	42
Other LT Payables	-	-	-	-	-
Provisions	22	26	31	31	31
Total Non-current Liabilities	32	47	46	71	72
Minority interests	-	-	-	-	-
Paid-up share capital	270	270	300	300	300
Total Reserves	47	110	137	197	264
Total Shareholders' Equity	317	380	437	497	564
Total Equity	317	380	437	497	564
Total Liabilities & Shareholders' Equity	411	499	560	645	717

Gearing measures are at extremely low level

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Net Debt (SARmn)	(2)	(16)	(14)	10	30
Net Debt/EBITDA (x)	(0.01)	(0.10)	(0.07)	0.05	0.13
Net Debt to Equity	-0.6%	-4.2%	-3.1%	2.1%	5.3%
EBITDA Interest Cover (x)	145.6	340.5	395.4	290.1	(518.6)
BVPS (SAR)	11.73	14.08	14.56	16.55	18.81

Cashflow Statement (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Net Income before Tax & Minority Interest	118	128	147	169	188
Depreciation & Amortisation	32	34	41	50	52
Decrease in Working Capital	0	(3)	5	(10)	(6)
Other Operating Cashflow	6	1	(1)	(4)	(5)
Cashflow from Operations	156	159	191	205	229
Capital Expenditure	(85)	(83)	(105)	(124)	(133)
New Investments	-	-	-	-	-
Others	7	1	1	-	-
Cashflow from investing activities	(78)	(82)	(104)	(124)	(133)
Net Operating Cashflow	78	78	87	81	96
Dividends paid to ordinary shareholders	(60)	(61)	(87)	(105)	(116)
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	-	(8)	-	-	-
Cashflow from financing activities	(72)	(45)	(97)	(80)	(114)
Total cash generated	6	33	(10)	1	(18)
Cash at beginning of period	21	20	50	37	38
Implied cash at end of year	27	53	40	38	20

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

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Capex/Sales	16.4%	14.3%	15.1%	15.5%	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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