

Herfy Food Services

Agriculture & Food sector

HERFY AB: Saudi Arabia

26 June 2010

الراجحي المالية
Al Rajhi Capital



US\$0.54bn Market cap
51.1% Free float
US\$2.600mn Avg. daily volume

Target price **89.60** 21.9% over current
Consensus price **n/a**
Current price **73.50** as at 23/06/2010

Research Department

Khalid Alruwaigh

Tel 966 1 211 9310, alruwaighka@alrajhi-capital.com

Underweight

Neutral

Overweight

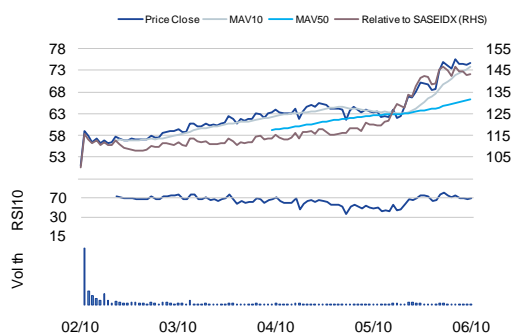
Key themes

We believe that the fast food industry will continue to grow strongly. Herfy has a very strong position in the fast food market. It's currently the second just behind McDonalds. We believe that Herfy's strategy to open 20 to 25 restaurants coupled with increasing 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 (SARmn)	518	584	667	765
Revenue Growth	11.0%	12.9%	14.1%	14.8%
EBITDA (SARmn)	145	166	191	217
EBITDA Growth	16.2%	14.1%	15.2%	13.5%
EPS	6.20	4.83	5.59	6.51
EPS Growth	-32.1%	-22.1%	15.7%	16.4%

Source: Company data, Al Rajhi Capital

Herfy It's getting better

Herfy is the only fast food chain company that is listed in the Saudi food & agriculture sector. The company has grown decently during the last couple of years. The aggressive expansion strategy of opening around 20-25 new restaurants each year coupled with increasing production capacity of bakery and meats divisions should drive the company's growth over the next three years. Therefore, we are initiating coverage of Herfy with an Overweight rating and a target price of SAR89.6. This implies upside potential of 21.9%.

Market. We believe that the young (50% below 20) and rapidly growing population play a vital role in stimulating the fast food market. By our estimate, the Quick Service Restaurants (QSR) market size is currently about SAR6.3bn, in which 32% is Fast Food Hamburger Restaurants (FFHR). Although competitive, the fast food market can potentially grow considering the big cities' rapid horizontal expansion and the transforming in Saudi lifestyle. Nevertheless, high demand for available land and increasing Saudization are imposing pressure on the QSR market and impeding expansion.

Organic growth is the current mode. Herfy has an aggressive plan to improve all divisions sales organically. For the fast food division, it plans to open 20-25 restaurants per year. A new bakery plant is already under construction with a capacity four times greater than currently. Moreover, the company is considering expanding its international business in the GCC and MENA regions through franchises. It has now 15 stores in Kuwait, Bahrain, the UAE and Egypt. Therefore, taking into account this aggressive expansion plan, we expect Herfy to achieve top-line growth of 13% and 14% in 2010 and 2011 respectively.

Same-store sales is questionable, but can improve. Although it was stronger in 2008 and 2009 at around 5%, we estimate that Herfy achieved same store sales (SSS) growth of only around 1% in Q1 2010. Moreover, despite the fact that Herfy has 55 more stores than McDonalds, we estimate that McDonalds has higher market share. This means, by our estimate, that McDonalds has 2.6x the average sales per store of Herfy. Nevertheless, we believe Herfy can improve this figure through home delivery, drive-through, new large stores, and new menu items.

Valuation: Herfy still offers value. Using long-run discounted economic profit valuation, we estimate fair value per share for Herfy at SAR97.0. On a comparative multiples analysis basis, we estimate fair value at SAR72.3. Our target price for Herfy of SAR89.6 is a weighted average of the two estimates with a weight of 70% to the long run DEP method and 30% to the multiples. Our target price implies 21.9% upside from current levels. Herfy is trading on a 2010 EV/EBITDA multiple of 11.9x, a 2010 PE ratio of 15.2x, and offering a dividend yield of 4.4%. While no longer cheap, Herfy's valuation is in line with that of international peers such as McDonalds and Burger King. We also believe that the valuation is justified for a company which 1) is very transparent for a company that was listed only a few months ago, 2) offers a dividend yield of 4.4%, and 3) achieves an impressive economic profit. Herfy's return on invested capital of 29.7% (our estimate for 2010) is more than triple its WACC of 8.9%.



Page

3 **Saudi fast food market: growing but competitive**

Many opportunities, few obstacles

The Saudi population is one of the fastest growing in the world. Saudi Arabia has a very young generation as 50% is below 20 years old (IMF). Furthermore, although fast food markets in big cities are well penetrated, huge horizontal expansion within these cities offers new opportunities for growth. High demand for available land and Saudization are imposing pressure on QSR and impeding expansion.

4 **Herfy: organic growth is the current mode**

Restaurants segment: aggressive and clever expansion strategy

Opening around 20 to 25 stores per year, Herfy plans to continue expanding its restaurant business. This should not only drive the company's growth, but enlarge the overall size of the burger market. In our view, what is interesting about this strategy is not so much the number of stores that Herfy is opening, as its geographical approach. In addition to large cities such as Riyadh and Dammam, Herfy plans to expand in rural areas, suburbs, and smaller cities where no other restaurant chains exist.

Bakery division: await for 2011 expansion

The company is in the process of constructing a new production plant that is four times the capacity of the first one. This plant is expected to start producing late 2011. We believe that Herfy will capitalise on its distribution network and achieve solid sales growth of 20% in this segment in 2012.

Meats division: remarkable growth

The meats segment contributed 2.5% of Herfy's revenues in 2009; however, it grew by 47% year-on-year in Q1 2010 to make up 3% of total revenues. We expect the meats segment to surpass the rusk segment and to account for 4.5% of revenues by 2012.

Rusk division: decent growth

The fourth segment of Herfy is rusk ("shaborah"). This division includes rusk products, biscuits, and dates ("ma'mol"). It contributes just over 3% of Herfy's top line. This segment's sales have been growing at a respectable rate of about 11% annually.

11 **Valuation: Herfy still offers value**

Herfy: very profitable business

Herfy has a net margin of 22.2% compared to 20.0% and 7.9% for McDonalds and Burger King respectively. Also, by our estimates, over the period 2008-2009 Herfy achieved a return on invested capital (ROIC) of 32-33%. Currently, Herfy trades on a dividend yield around 4.4%; this is good compared to other food companies.

Our rating for Herfy is Overweight

We value Herfy using a combination of long-run discounted economic profit and comparative multiples analysis. We rate Herfy Overweight and set a target price of SAR89.6, implying 21.9% upside potential. Handsome dividend, outstanding economic profit, and decent transparency are likely to continue to support the company's share price, and we expect it to find favour with international investors if the Saudi stock market is opened up.

14 **Company summaries and financial data**



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\$)	bn / bn
52-week range	51.00 - 75.50
Daily avg volume (US\$)	2.600mn
Shares outstanding	27.00mn
Free float (est)	51.1%

Performance:	1M	3M	12M
Absolute	20.1%	23.6%	%
Relative to index	19.3%	27.6%	%

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	584	667	765
EBITDA (SARmn)	145	166	191	217
Net Profit (SARmn)	115	130	151	176
EPS (SAR)	6.20	4.83	5.59	6.51
DPS (SAR)	2.97	3.28	3.77	4.34
EPS Growth	-32.1%	-22.1%	15.7%	16.4%
EV/EBITDA (x)	9.5	12.1	10.6	9.5
P/E (x)	12.1	15.5	13.4	11.5
P/B (x)	6.4	5.0	4.4	3.9
Dividend Yield	4.0%	4.4%	5.0%	5.8%

Source: Company data, Al Rajhi Capital

Saudi fast food market Competitive but growing

QSR market size is about SAR6.3bn

With a size of about SAR12.5bn, the Saudi restaurants industry is the biggest in the GCC and has the potential to grow further. It is made up of different sub categories such as casual dining, formal dining, quick service restaurants (QSR), and other restaurants. The QSR market, another name for fast food, comprises all restaurants that offer menus with items that can be quickly prepared; this includes burgers, pizza, sandwiches, beverages and other snacks. We estimate that the QSR market size is about SAR6.3bn. There are many big players within this market: local companies such as Kudu, Herfy, and Albaik, and international brands such as McDonalds, Burger King, Dominos, and Hardees.

FFHR markets in large cities are concentrated

The QSR market can be broken down into Fast Food Hamburger Restaurants (FFHR) and other fast food. This market includes all fast food restaurants whose main items are burgers, and comprises around 32% (SAR2bn) of QSR. By our estimates, McDonalds is leading this market with market share of around 38%; Herfy comes second with market share of 24%. Nevertheless, these markets are overlapping; for example, Herfy, whose leading menu item is burgers, also offers fried chicken. As another instance, Kudu, which specialises in unique chicken and beef sandwiches, also offers burgers.

Since the entrance of international fast food chains, many local chains and independent restaurants have faded away. A few local brands such as Herfy and Kudu have survived and can, in our opinion, compete efficiently against international brands such as McDonalds. However, the Saudi QSR market has recently seen many successful local endeavours. Education plays a role in this as we see increasing attempts by Saudi entrepreneurs to move into the QSR market. Although it is hard for new operations to compete with the large international chains, we think that they are making the market more competitive and so helping to enlarge it overall.

Lots of opportunities, few obstacles

50% of Saudi population is less than 20 years old

Favourable demographics and new lifestyle

The Saudi population is one of the fastest growing in the world. Saudi Arabia has a very young generation as 50% is below 20 years old (source: IMF). This is a vital factor considering that fast food restaurants' main customers are teenagers and young people. Furthermore, the Saudi lifestyle has been changing as people eat from restaurants more often and simulate an American lifestyle. Moreover, women, who used to cook at home, are obtaining more roles in society and gradually joining the workforce. We believe that all these factors will drive the growth of this market in the future.

Large cities are experiencing rapid horizontal extension

Horizontal expansion is enlarging the market

Although fast food markets in big cities are well penetrated, the massive horizontal expansion within these cities offers new opportunities for growth. For example, Riyadh is extending so rapidly that small cities that used to be outside Riyadh have started to fall within the Riyadh city boundaries. Moreover, smaller cities, rural areas, and suburbs offer other opportunities for this market to grow. Currently, many of these areas have small local restaurants. We



Buying land to open stand-alone store is too expensive

Saudi government requires 30% Saudi workers within a company

Fast food restaurants division is the biggest in Herfy

believe, however, that these areas offer growth potential for local brands such as Kudu and Herfy as the residents of these areas tend to be more conservative and might even engage in boycotts against international brands. Generally, we think that there is huge potential for this industry to grow geographically.

Booming real estate is a challenge

Fast food restaurants comprise three types of stores: stand-alone outlets, leased stores within buildings, and stores inside malls. Booming real estate markets are imposing pressure on fast food chains to expand. Stand-alone stores, by our estimate, comprise around 40% of QSR sales. In order to open a stand-alone store, a fast food company can either buy or rent the land. Buying land can be very expensive and so is often not feasible. Renting the land is usually much better; however, not many landowners are tempted to enter into long-run rental contracts when they may get much better sale opportunities considering that the real estate market in Saudi Arabia is so strong. Similarly, renting stores within buildings is getting more expensive as a result of increasing demand for space within cities.

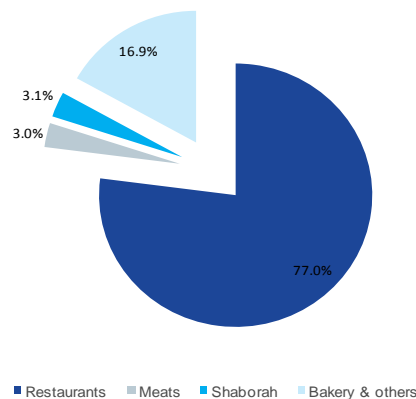
Saudization is imposing pressure

Continuing its attempts to decrease the unemployment rate, the Saudi Ministry of Labour and Workers has set 30% as a minimum required percentage of Saudi workers within fast food companies. Not only that, but also it has made it more difficult to issue visas for foreigners, especially for companies which do not maintain the minimum requirement of 30%. This is imposing financial and operational pressure on the industry. Financially, Saudis are more expensive than many foreigners, Filipinos for example. However, the financial pressure has been relieved by the Human Resource Development Fund. This fund supports the state policy of “Saudization” by paying 50% of Saudi workers’ salaries. Of course the fund imposes tough conditions, but many companies, such as Herfy, have agreements with the fund that help them to hire more Saudis. Operationally, the problem seems to be more difficult; many of the Saudis who work as cashiers, generally inside restaurants, are teenagers and youth who are often uncommitted to work. For example, they may work for a month and leave thereafter. Also, their productivity is low when compared to foreigners, e.g. the Filipinos who have been very successful in restaurants in the Kingdom. We believe that this issue is pressuring fast food chains and impeding their expansion.

Herfy is expanding Organic growth is the current mode

Herfy’s business contains four divisions: fast food chain, bakery, rusk (Shaborah), and meats. In 2010 Q1, these segments contributed 77.0%, 16.9%, 3.1%, and 3.0% of total revenues respectively. All divisions have grown strongly recently; the meats segment has been the biggest winner, recording sales growth of more than 47% in Q1 2010 from the same period the previous year. Restaurants, bakery and rusk sales grew by 11%, 7%, and 8% respectively from the same period in 2009.

Figure 1. Herfy: revenues breakdown in 2010 Q1



Source: Company data, Al Rajhi Capital



We expect top-line growth of 13% and 14% in 2010 and 2011 respectively.

Herfy plans to open 20 to 25 new restaurants a year

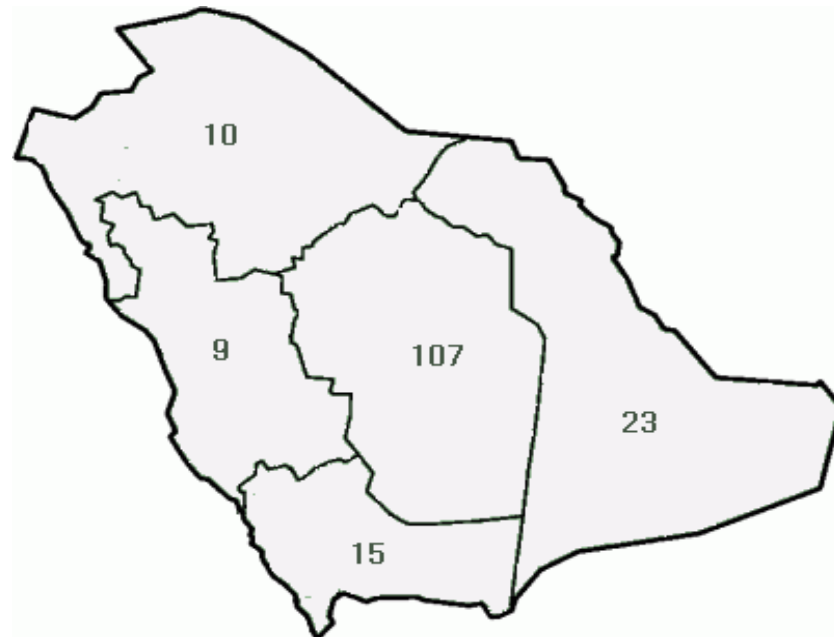
Herfy has an aggressive plan to improve all divisions' sales organically. Regarding the fast food division, it plans to open around 20 to 25 restaurants per year. A new bakery plant is already under construction with a capacity that is approximately four times the current level. Moreover, the company is considering expanding its international business in the GCC and MENA regions through franchises. It now has 15 stores in Kuwait, Bahrain, UAE, and Egypt. Taking this aggressive expansion plan into account, we expect Herfy to achieve top-line growth of 13% and 14% in 2010 and 2011 respectively.

Restaurants segment: aggressive and clever expansion strategy

Opening around 20 to 25 stores per year, Herfy plans to continue expanding its restaurant business. This should not only drive the company's growth, but enlarge the overall size of the burger market. In our view, what is interesting about this strategy is not so much the number of stores that Herfy is opening, as its geographical approach. In addition to large cities such as Riyadh and Dammam, Herfy plans to expand in rural areas, suburbs, and smaller cities where no other restaurant chains exist. It has already opened new stores in Arar and Ahsa. Although the Riyadh fast food market is highly penetrated, we think that it still offers substantial growth potential considering the rapid horizontal expansion, the high population density, and the high income per household.

Currently, Herfy has 107 stores in the Central Province, ten in the Southern Province, 15 in the Northern Province, 23 in the Eastern Province, and nine in the Western Province. We see the weak showing in the Western Province as a natural result of the strong presence of Albeik, a fried chicken chain, which dominates the fast food market in that region.

Figure 2. Herfy: restaurants distribution by province



Source: Company data, Al Rajhi Capital

In addition to large cities, Herfy plans to approach smaller cities.

Pursuing this strategy, Herfy aims to kill two birds with one stone. On one hand, it will expand in areas that are not penetrated while coping with the expansion in big cities, which would allow Herfy to maintain its strong position in these cities. On the other hand, international competitors such as McDonalds and Burger King would think long and hard before they follow Herfy as acceptance of these chains among consumers within these areas, smaller cities, is normally low. The residents of these areas tend to be more conservative and might be willing to support boycotts against American and European brands. Even if they decide to follow, Herfy will have the advantage of being there first. Thus, we believe that the pursuit of this strategy is bright and should pay off in the future.

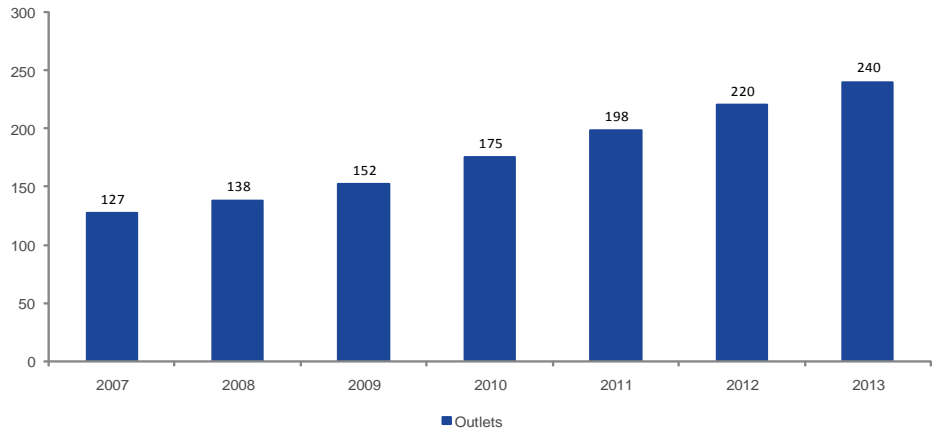
We estimate number of Herfy outlets to reach 240 by 2013

Based on the company's plans, we estimate that the number of Herfy stores will reach 240 by 2013. It has already opened 13 stores in 2010, we expect that it will open ten more stores



during this year. We estimate that this will result in a solid sales growth of 13% in Herfy's restaurants division in 2010.

Figure 3. Herfy: number of outlets



Source: Company data, Al Rajhi Capital

We estimate that SSS growth was around 1% in Q1 2010

Same-store sales is questionable

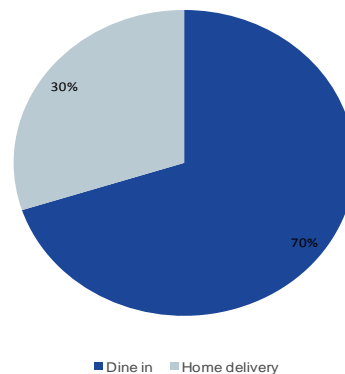
Although Herfy claims that it achieved average same-store sales (SSS) growth of about 5% in 2008 and 2009. The chain benefited in 2008 and 2009 from boycotts against foreign chains such as McDonalds as a result of political incidents; these practices strengthened Herfy's SSS. By our estimate, however, 2010 Q1 SSS growth was low at around 1%. The restaurants division recorded sales growth of 11% in Q1. Considering that five stores were opened during this period, we believe that this figure, 11%, was mainly driven by the new stores sales.

Herfy's home delivery service contributes about 30% of restaurants revenues

Drive-through and home delivery could boost SSS

As Herfy plans to open 20 to 25 new stores per year, we believe that the company's increasing focus on large outlets should improve same-store sales (SSS). Large stand-alone restaurants will provide space for drive-through service as well as increasing dine-in sales. Also, large outlets usually play a marketing role by being eye-catching. On the other hand, home delivery constitutes a large portion of the fast food market in the kingdom. The sedentary Saudi lifestyle, the fact that women don't drive, and the hot climate support the home delivery market. We estimate that about 20 to 25% of fast food sales come from home delivery. For Herfy, 30% of restaurants sales come from home delivery. Considering that Herfy is implementing a new call centre service for home delivery, we believe that Herfy can improve this subcategory's sales, which should eventually improve SSS.

Figure 4. Herfy: sales breakdown



Source: Company data, Al Rajhi Capital

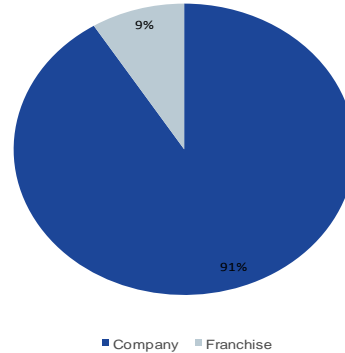


Herfy has 15 Franchise restaurants only

Franchise has potential to grow

Herfy has a few franchises in the GCC and Egypt. It has six restaurants in Kuwait, three restaurants in Bahrain, three restaurants in UAE, and three restaurants in Egypt. This comprises only around 9% of the total number of stores. Obviously, Herfy’s business is not primarily a franchise model as is that of McDonalds; however, we believe that the company has the potential to expand in the GCC and MENA regions through franchises. According to Herfy, it’s currently considering international expansion in Lebanon. Currently, franchise income contributes about 5% of net income.

Figure 5. Herfy: ownership breakdown



Source: Company data, Al Rajhi Capital

Herfy has more chicken items which reflects the Saudi demand

Diverse menu dominated by chicken items

The Herfy chain offers a variety of items that include chicken, beef and fish meals. Chicken items dominate the menu as there are eight chicken meals; the “Super Chicken Combo” is the most well known chicken meal. This high number of chicken items reflects the Saudi fast food market style which is generally dominated by chicken. We estimate that chicken items comprise 65 to 70% of meat sales in this market. The menu has, on the other hand, five beef meals of which the “Super Herfy” meal is the most widely recognised. Moreover, Herfy offers fish meals, children’s meals, and side orders such as salads and desserts.

Chicken tortilla and superstar were launched recently and successful

Herfy has been successful in launching new products such as chicken, beef and fish tortilla. According to the company, it plans to launch two to three new menu items each year. How successful will this plan be? Historically, Herfy has enjoyed recent success in launching the chicken tortilla and superstar burger, and in launching fried chicken long before that. However, although these products appear to enjoy wide acceptance in the market, we have no figures for individual product lines to judge precisely how successful they are. Furthermore, we are not sure about the rate of cannibalisation of existing items that has resulted from the launch of these new items, and hence we cannot measure to what extent they have added new sales and new customers. By looking at the SSS growth of 5% that Herfy claims to have achieved over the past two years, new items do seem to have driven new sales. However, considering our estimation of Q1 2010 SSS growth, we think that Herfy may need to improve its product development in order to lift its same-store sales, and hence to boost its top line beyond the growth that will accrue from new store openings.

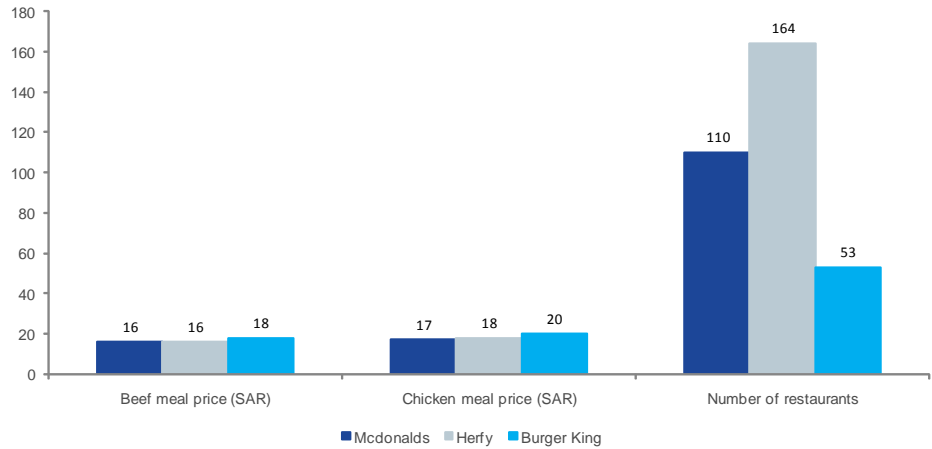
Herfy is leading the Saudi fast food market in terms of number of stores

Herfy versus other fast food restaurants

Herfy is the leader in terms of number of stores in the Kingdom. It now has 165 stores compared to 110 McDonalds stores and 53 Burger King stores. In terms of pricing, we believe that Herfy falls between McDonalds as the cheapest and Burger King as the most expensive. Herfy’s chicken meal (“Super Chicken Combo”) price is SAR18 compared to SAR17 and SAR20 for the comparable meals in McDonalds (“MacChicken”) and Burger King (“Whopper Chicken”) respectively. Similarly, Herfy’s beef meal (“Super Herfy Combo”) price is SAR16 compared to SAR16 and SAR18 for the comparable meals in McDonalds (“Big Mac”) and Burger King (“Whopper” meal) respectively. Now, one could argue that the meals from Burger King and Herfy are bigger in size than those from McDonalds, an argument with which we would tend to agree. However, we believe that Saudi consumers are most sensitive to pricing and compare fast food restaurants primarily on pricing rather than on size.



Figure 6. Saudi Arabia: Herfy vs. Mcdonalds vs. Burger King



Source: Company data, Al Rajhi Capital

McDonalds, by our estimates, has higher market share than Herfy

Despite the fact that the number of Herfy stores is substantially higher than that of McDonalds, we estimate that McDonalds has the top market share of around 38% in the fast food hamburger restaurants (FFHR) market. Herfy comes after with a market share of around 24%. Why is it that McDonalds has higher market share when Herfy has 55 more stores? The answer must be that McDonalds has much higher average sales per restaurant. In order for McDonalds to maintain such a market share, it must have 2.6x times average sales per store of Herfy. This raises the question: how could McDonalds outperform Herfy and achieve much higher average sales than Herfy? We explain this in three points below:

McDonalds is more selective in restaurants locations and has more large stores than Herfy

Store location, size, and design

McDonalds is very selective in choosing locations for new stores. It hunts locations with high visibility and high population density; many are at the corners of plazas. Furthermore, most of its branches are large stand-alone stores accompanied with convenient drive-through service. We estimate that around 70 to 80% of McDonalds stores are stand-alone, whereas the ratio is less than 50% for Herfy. Moreover, McDonalds has recently renovated many stores; by contrast, when we have looked around Herfy stores, we have got the impression that many are old and need to be renovated.

Saudi youth and teenagers

We think that McDonalds seem to appeal more to teenagers and the youth segment. This is an advantage knowing that 50% of Saudi population is below 20 years old. Fast food consumers are concentrated among youth and teenagers.

Marketing activity and promotions

McDonalds is very active in both outdoor and TV advertisements. It is clearly targeting teenagers and youth. In our view, Herfy is active only in outdoor advertisements; it is targeting all segments and family consumers.

We believe that these are the main factors that have allowed McDonalds to outperform Herfy in terms of average sales per restaurant. In order for Herfy to improve its average sales per store, we think that the company needs to focus on stand-alone stores in the future, renovate its old stores, and increase its marketing activity.

Herfy does plan to take steps to improve average sales per store

According to Herfy's management, it plans to open more large stores, which are equipped with convenient drive-through and home delivery services, than smaller ones. Furthermore, the company plans to have TV advertisements in addition to its current outdoor advertisements. We believe that such a strategy ought to improve its average sales per store, and help to start closing the gap with McDonald's.



Increasing production capacity will drive bakery growth in 2012

We expect bakery segment to grow by about 11% in 2010

Meats division grew by 47% in Q1, we expect it to maintain this growth in 2010 and 2011

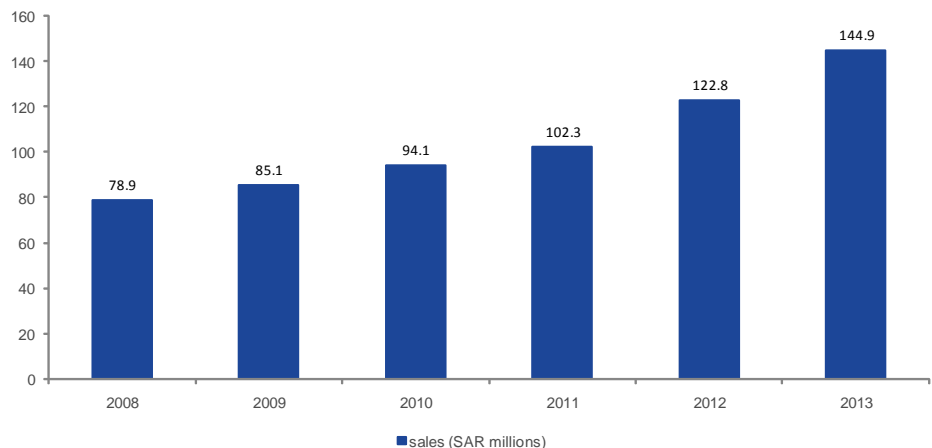
Bakery division: await expansion in 2011

With market size of about SAR1.4bn, we think the bakery market is set to continue growing by about 4 to 5% per annum, driven by favourable demographics. We believe that this market is highly fragmented: small and local stores dominate the market, besides supermarket brands. However, there are a few important players such as Lusine, Alrashed, Americana and Herfy. Currently, Herfy has a market share of about 7%; we believe it can outperform the market growth by increasing market share, mainly from small players.

Herfy's bakery operation is the second biggest segment in the company by revenues. It contributes around 17% of Herfy's total turnovers. This segment's revenues have grown by about 8% annually over the last couple of years. Around 15% of this division's production goes to the restaurants segment. Bakery includes bread, pastry, and cakes. Herfy bakery items are distributed through super and hypermarkets, grocery stores, and Herfy bakery stores. The Herfy bakery stores idea has been implemented recently. Currently, Herfy has 19 stores and all of them are in the central region. According to Herfy, it plans to open three stores a year; this should support the bakery sales and increase Herfy's market share.

The company is in the process of constructing a new production plant that is four times the capacity of the first one. This plant is expected to start producing in late 2011. We believe that Herfy will capitalise on its distribution network and achieve a solid sales growth of 20% in this segment in 2012. Until then, we expect bakery sales growth to remain decent at around 10%. Although this is higher than last two years average sales growth, it's reasonable, in our opinion, considering the company plans to increase sales and marketing activities.

Figure 7. Herfy: bakery division revenues



Source: Company data, Al Rajhi Capital

Meats division: remarkable growth

With a market size of about SAR1.7bn, total meats market in Saudi Arabia is growing significantly, driven by the rapidly expanding restaurant market and changes in consumers' lifestyles. This market comprises fresh meats and frozen meats; meat includes chicken, beef and – in contrast to western markets – fish. Restaurants consumption comprises about 60% of total meat sales, whereas household consumption is around 40%.

The meats division in Herfy includes chicken items (including chicken nuggets, patties, wings and tenders) and beef patties. The restaurants division consumes about 60% of Herfy's meats production, while the remainder is sold externally. The meats segment only represented 2.5% of Herfy's revenues in 2009; however, it grew impressively in Q1 2010, with sales rising by 47% from same period in 2009 to make up 3% of total revenues. We expect the meats segment to surpass the rusk segment and to contribute 4.5% of revenues by 2012.

The current production of meats is taking up around 85% of production capacity. Although we expect Herfy's meat plant to run at full capacity by the end of 2010, the plant is not fully utilized as is run on a single eight-hour shift. This implies that Herfy can increase its capacity by simply adding another shift. According to Herfy, nevertheless, meats segment is currently undergoing an increase in production capacity increase; this expansion ought to increase the

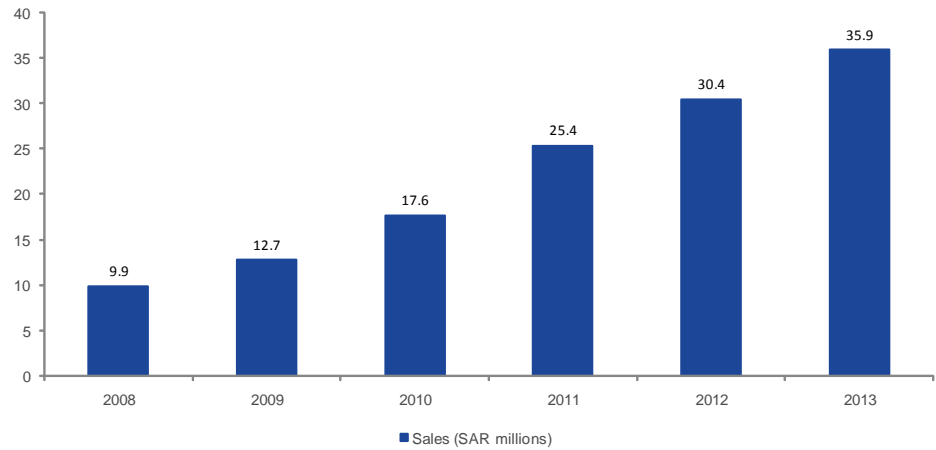


Increasing production capacity plus expanding distribution channels will drive this division growth

capacity by 50%. There will be no new plant; this expansion will be within the existing plant and should be complete early 2011.

Currently, distribution channels for meat are limited to hyper and supermarkets, Herfy bakery stores, and a few grocery stores. The company's increased focus on this division in recent months has been clear, and it can capitalise on its distribution network to extend its meats distribution to more grocery stores. We believe that this trend coupled with the capacity increase and new products should drive growth in the segment in the future. Therefore, we expect Herfy to maintain strong sales growth of above 40% in this division in 2010 and 2011.

Figure 8. Herfy: meats division sales



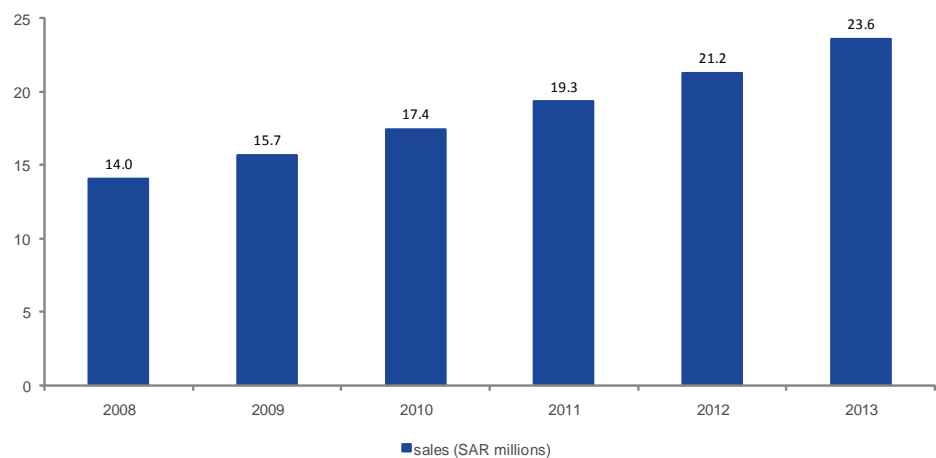
Source: Company data, Al Rajhi Capital

We expect Rusk segment to grow steadily by 10%

Rusk division: decent growth

The fourth segment of Herfy is rusk ("shaborah" in Arabic). This division includes rusk products, biscuits, and ma'mol (made of dates). It contributes around 3% of Herfy's turnover. This segment's sales have shown respectable growth of around 11% annually. Products from this division are distributed, like those of the bakery division, through hyper and supermarkets, Herfy bakery stores, and grocery stores. According to the company, there are no plans to expand this segment, at least for the time being. Thus, we estimate that this segment will show steady growth of 10-11% over the next couple of years.

Figure 9. Herfy: Rusk division sales



Source: Company data, Al Rajhi Capital



Valuation: Herfy still offers value

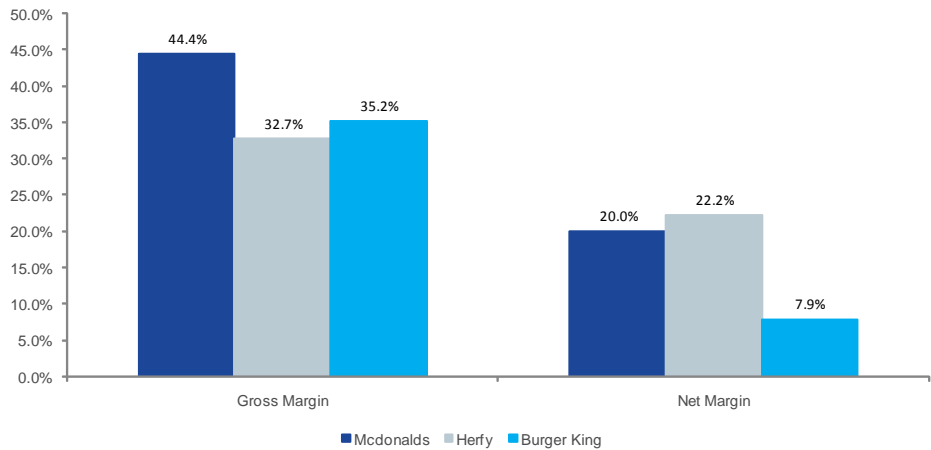
Herfy: very profitable business

Net margin is very competitive

Herfy has the highest net margin of 22.2% among the three companies

McDonalds and Burger King are not publicly listed in Saudi Arabia; therefore, we have decided to compare Herfy's profitability with that of McDonalds Inc and Burger King Inc in the US. Although the two companies' enjoy higher gross margins than Herfy's, McDonalds and Burger King underperform Herfy in terms of the net margin. Herfy has a net margin of 22.2% compared to 20% and 7.9% for McDonalds and Burger King respectively. We believe that this can be attributed to: firstly, the lower tax rate in Saudi Arabia, and secondly, the higher net margin of Herfy's other divisions (meats, rusk, and bakery).

Figure 10. Herfy versus. McDonalds and Burger King (gross & net margins)



Source: Bloomberg, Al Rajhi Capital

Herfy's gross margin looks decent, but is low compared to McDonald's. The main raw materials for Herfy is meats, which it imports mostly from Brazil, and flour. Prices of raw meat, principally beef, have been rapidly rising due to increasing demand. According to Herfy, the beef price is likely to rise by around 4% during 2010. Although we think it will be difficult for Herfy to improve its gross margin during 2010, we believe it will be able to maintain the current gross margin level. In future, unless meat prices surge unexpectedly, expansion in the meats and bakery division ought to improve Herfy's gross margin considering their strong profitability.

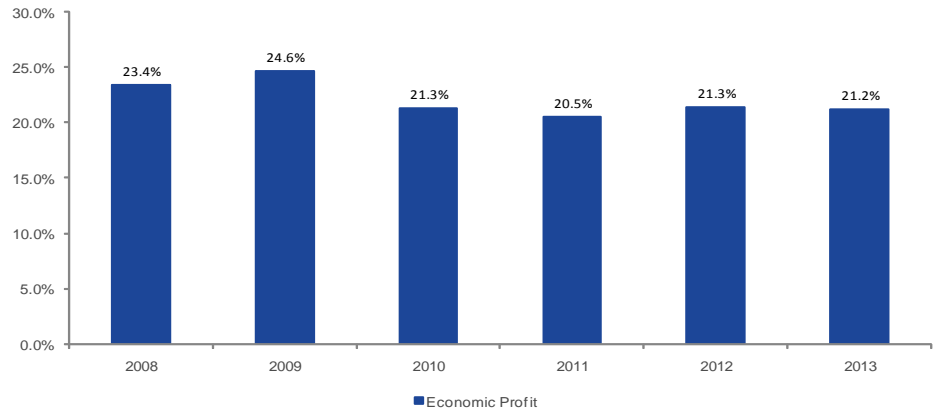
Impressive economic profit; dividend is the dessert

Strong economic profit of 23-24%

By our estimates, over the period 2008-2009 Herfy achieved a return on invested capital (ROIC) of 32-33%. This is more than triple our estimate of the company's weighted average cost of capital (WACC) of 8.9%, implying that the company achieved an economic profit spread (ROIC - WACC) of 23-24%. We expect Herfy's economic profit spread to decline slightly from this year onwards, but nevertheless believe that the company can maintain an outstanding 20-22% economic return over the period 2010-2013.



Figure 11. Herfy: economic profit spread (ROIC-WACC)



Source: Company data, Al Rajhi Capital

Herfy's dividend yield is currently around 4.4%

Our key long-run method of forecasting is discounted economic profit (DEP) forecasting

We estimate Herfy's WACC at 8.9%

Herfy trades on a dividend yield of around 4.4%; this is good compared to other food companies, e.g. Almarai on 2.2%. Dividends can potentially grow considering the company strong cash flows. By our estimates, we expect dividend yield to reach around 6% by 2013.

Valuation: summary of our approach and conclusions

Our key method of valuation for the Saudi food producers is long-run discounted economic profit (DEP), sometimes also called discounted long-run EVA ("economic value added"). This is a simple variation on discounted cash flow and is mathematically equivalent. In our models, we make explicit forecasts for income statement, balance sheet and cash flow out to 2020. We then assume a steady fading of return on invested capital, i.e. excess return, down to the cost of capital over a period of up to 50 years from end of our period of explicit forecasting. This approach avoids a common problem in long-run modelling: namely, that the analyst stops forecasting at some arbitrary point when the company in question is still generating high returns. In terms of financial theory this is implausible, and excess returns will eventually disappear through competition, regulation or some other means.

Our DEP valuations are sensitive to many factors, including assumed revenue growth, EBITDA margin and capex/sales ratio in 2020, i.e. the last year of explicit forecasting. Another important variable is the assumed duration of the period of competitive advantage, i.e. the period during which the company generates returns above weighted average cost of capital (WACC). Deciding on the length of the period of the competitive advantage is naturally a subjective exercise. We have assumed 25 years for Herfy on the grounds that it is one of the leaders in its market and that it would take several years for rivals to challenge it effectively. Also, Saudi Arabia has tough bureaucratic conditions to license new international businesses intending to enter the Saudi market.

However, as with any DCF-based approach, the factor to which the DEP valuation is most sensitive is WACC; we have assumed a WACC of around 8.9% for Herfy. According to Bloomberg, Herfy has an adjusted Beta of 0.6. Because Herfy was only listed by IPO in February, in our view the company does not have a sufficiently long stock market history for the Beta to be meaningful, and so we have used a Beta of 0.95. based on the average Beta of Almarai and Savola (other food sector companies). Moreover, Herfy has a low interest rate on debt which stems from the fact that a significant portion of its loans comes from the Saudi Development Industrial Fund; these loans carry a very low or zero interest rate.

WACC is in turn highly sensitive to assumed terminal capital structure. Estimating terminal capital structure is again a rather subjective exercise. We have assumed a terminal debt/(debt plus equity) ratio of 25% for Herfy, compared to about 5% at present. While this is a low figure by conventional standards, we regard Herfy's business as highly cash-generative and so expect gearing to stay low over the long run.



We estimate DEP fair value for Herfy at SAR97.0

Figure 12. Herfy: weighted average cost of capital (WACC)

Risk-free Rate	3.2%
Expected Mkt Return - Risk-free Rate	8.0%
Adjusted Beta	1.0
Cost of Equity	10.8%
Pre-tax Cost of Debt	3.5%
Effective Tax rate	3.6%
After-tax Cost of Debt	3.4%
Target D/(D+E)	25.0%
WACC	8.9%

Source: Bloomberg, Al Rajhi Capital

Based on long-run DEP analysis, and using our core assumption of a period of competitive advantage of 25 years, we estimate fair value per share for Herfy at SAR97.0.

We use comparative multiples analysis in addition to DEP

In addition to long-run DEP, we use comparative multiples analysis to value Herfy in relation to other strong multinational players. Under this approach we use comparisons of valuation measures – notably, EV/EBITDA and PE multiples– with other listed multinational fast food companies to estimate fair value. We have taken a weighted average of the two methods as our target price by giving a weight of 70% to the long-run DEP method and 30% to the comparative multiples analysis method. Arguably, we should be using only the long-run DCF or DEP method, not only because it is theoretically more defensible, but also because it is well-suited to a sector like food with reasonably predictable cash flows. However, we see the comparative multiples method as a good indicator of performance and pricing in the real world considering that Herfy was only recently listed.

We have selected two multinational fast food companies as benchmarks for Herfy

Regarding the comparative multiples analysis, we believe that we have been very selective and conservative by choosing strong multinational companies as benchmarks. Those two companies are McDonalds and Burger King. Despite their higher market capitalisation than Herfy, we believe that they provide excellent comparables considering their business nature. The table below shows these companies' major figures and ratios compared to Herfy's.

Figure 13. Herfy: comparative multiples analysis

Company	Market	Sector	MKT Cap	P/E	EV/EBITDA	Bloomberg Code
McDonald's	US - NY	Retail-Restaurants	\$ 71,756	15.4	11.9	MCD US
Burger King	US - NY	Retail-Restaurants	\$ 2,540	16.8	11.5	BKC US
Herfy	KSA - Tadawul	Food & Agriculture	\$ 497	14.6	11.7	Herfy AB

Source: Bloomberg, Al Rajhi Capital

Using the average of the benchmark companies' PE and EV/EBITDA ratios for 2010, we estimate a fair share price for Herfy on this method at SR72.3.

We rate Herfy as Overweight with a target price of SAR89.6

Based on a 70% weighting for the long-run DEP method and 30% for the comparative multiples analysis, we set a target price of SAR89.6 for Herfy. This implies 21.9% upside potential from the current share price and so we rate Herfy as Overweight. We would add that Herfy offers not only potential for capital appreciation, but also a respectable dividend yield of 4.4%. We believe that the dividend yield is strong compared to other food companies and has potential to grow considering that Herfy enjoys strong cash flows.

High transparency likely to continue to support Herfy stock price

While the share price of Herfy has performed strongly already, we believe that it can rise further. One of the key reasons for this is the transparency of the company. We had a very good meeting with Herfy at which nearly all of our questions were answered. Herfy could always do more to strengthen its investor relations; however, we think that the company's investor relations function is already very good considering that the company was only listed a few months ago. The commitment to high transparency not only demonstrates the professional standards of the company, but also shows its high confidence in their businesses. We believe that institutional investors, especially international investors, are more interested in investing in transparent companies than in others.

Once the market is opened, we expect international investors to invest in Herfy

In this context, it is worth stressing that we expect Herfy to attract strong buying interest once international investors are allowed to participate fully in the Saudi stock market. We note that the Saudi Capital Market Authority (CMA) has recently approved the launch of exchange-traded funds (ETFs) in the Saudi market. International investors should be allowed



to invest in ETFs initially, and it is widely expected that they will be allowed to invest directly in Saudi stocks in the future.

Risks associated with our assumptions

It is important to highlight that our valuation relies heavily on future forecasts which are uncertain. We have come up with several assumptions including growth, cost of capital, and market trend to predict future performance. We have tried to arrive at the most accurate assumptions; however, reality may deviate from our forecasts depending on new microeconomic or macroeconomic factors. Competition is another factor that can influence our assumptions. New entrants or/and transformation of current rivals' business models might cause a change in the whole market, and hence in our overall assumptions and forecasts.



We expect revenues to reach SAR584mn this year

Income Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue	466	518	584	667	765
Cost of Goods Sold	(323)	(348)	(391)	(445)	(509)
Gross Profit	144	169	194	222	256
Government Charges					
S.G. & A. Costs	(48)	(56)	(64)	(72)	(82)
Operating EBIT	96	113	130	150	174
Cash Operating Costs	(342)	(372)	(418)	(476)	(548)
EBITDA	125	145	166	191	217
Depreciation and Amortisation	(29)	(32)	(36)	(41)	(42)
Operating Profit	96	113	130	150	174
Net financing income/(costs)	(2)	(1)	(1)	(1)	0
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	(2)	5	5	5	5
Other Expenses					
Net Profit Before Taxes	94	118	134	155	180
Taxes	(3)	(3)	(4)	(4)	(5)
Net Profit	91	115	130	151	176
Dividends	-	(80)	(89)	(102)	(117)
Transfer to Capital Reserve					

	12/08A	12/09A	12/10E	12/11E	12/12E
Adjusted Shares Out (mn)	10.00	27.00	27.00	27.00	27.00
CFPS (SAR)	12.04	7.92	6.15	7.09	8.07
EPS (SAR)	9.13	6.20	4.83	5.59	6.51
DPS (SAR)	0.000	2.972	3.280	3.772	4.337

We expect revenue growth to remain above 13%

Growth	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue Growth	24.4%	11.0%	12.9%	14.1%	14.8%
Gross Profit Growth	32.2%	17.6%	14.3%	14.8%	15.3%
EBITDA Growth	39.4%	16.2%	14.1%	15.2%	13.5%
Operating Profit Growth	46.8%	18.5%	14.6%	15.6%	16.0%
Net Profit Growth	48.2%	25.6%	13.7%	15.7%	16.4%
EPS Growth	-25.9%	-32.1%	-22.1%	15.7%	16.4%

We expect the gross margin to remain decent at around 33%, while the net margin should be impressive at 22-23%

Margins	12/08A	12/09A	12/10E	12/11E	12/12E
Gross profit margin	30.9%	32.7%	33.1%	33.3%	33.5%
EBITDA margin	26.8%	28.1%	28.4%	28.6%	28.3%
Operating Margin	20.5%	21.9%	22.3%	22.5%	22.8%
Pretax profit margin	20.2%	22.8%	22.9%	23.2%	23.5%
Net profit margin	19.6%	22.2%	22.3%	22.6%	23.0%

By our estimates, ROIC is impressive at around 33%

Other Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
ROCE	34.2%	34.8%	31.1%	30.1%	30.9%
ROIC	34.0%	37.8%	37.8%	34.4%	33.5%
ROE	37.0%	39.6%	36.2%	35.0%	35.8%
Effective Tax Rate	3.2%	2.7%	2.6%	2.5%	2.5%
Capex/Sales	7.2%	16.4%	16.7%	16.3%	15.0%
Dividend Payout Ratio	0.0%	70.0%	67.9%	67.5%	66.7%

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

Valuation Measures	12/08A	12/09A	12/10E	12/11E	12/12E
P/E (x)	8.2	12.1	15.5	13.4	11.5
P/CF (x)	6.2	9.4	12.1	10.5	9.3
P/B (x)	2.9	6.4	5.0	4.4	3.9
EV/Sales (x)	1.6	2.7	3.4	3.0	2.7
EV/EBITDA (x)	6.1	9.5	12.1	10.6	9.5
EV/EBIT (x)	7.9	12.2	15.5	13.5	11.7
EV/IC (x)	2.6	6.0	4.7	4.0	3.6
Dividend Yield	0.0%	4.0%	4.4%	5.0%	5.8%

Source: Company data, Al Rajhi Capital



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

Balance Sheet (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Cash and Cash Equivalents	21	20	29	36	20
Current Receivables	14	20	23	25	28
Inventories	54	43	49	54	61
Other current assets	39	51	47	47	47
Total Current Assets	128	134	148	162	157
Fixed Assets	226	277	339	407	480
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	-	-	-	-	-
Total Other Assets	-	-	-	-	-
Total Non-current Assets	226	277	339	407	480
Total Assets	355	411	488	569	637
Short Term Debt	12	9	9	9	9
Trade Payables	-	-	-	-	-
Dividends Payable	-	-	(20)	(20)	(20)
Other Current Liabilities	-	-	-	-	-
Total Current Liabilities	57	62	46	46	49
Long-Term Debt	18	9	15	40	43
Other LT Payables	-	-	-	-	-
Provisions	18	22	24	24	24
Total Non-current Liabilities	36	32	38	64	67
Minority interests	-	-	-	-	-
Paid-up share capital	100	270	270	270	270
Total Reserves	162	47	133	189	251
Total Shareholders' Equity	262	317	403	459	521
Total Equity	262	317	403	459	521
Total Liabilities & Shareholders' Equity	355	411	488	569	637

Debt/equity ratio is currently very low

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Net Debt (SARmn)	9	(2)	(6)	14	32
Net Debt/EBITDA (x)	0.07	(0.01)	(0.04)	0.07	0.15
Net Debt to Equity	3.3%	-0.6%	-1.5%	2.9%	6.1%
EBITDA Interest Cover (x)	75.6	148.6	240.3	201.0	(705.4)
BVPS (SAR)	26.21	11.73	14.93	17.00	19.31

Herfy enjoys strong cash flows

Cashflow Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Net Income before Tax & Minority Interest	-	-	-	-	-
Depreciation & Amortisation	29	32	36	41	42
Decrease in Working Capital	(19)	0	(2)	(7)	(8)
Other Operating Cashflow	97	124	134	151	176
Cashflow from Operations	107	156	167	185	210
Capital Expenditure	(34)	(85)	(98)	(109)	(115)
New Investments	-	-	-	-	-
Others	7	7	0	-	-
Cashflow from investing activities	(27)	(78)	(98)	(109)	(115)
Net Operating Cashflow	81	78	70	76	95
Dividends paid to ordinary shareholders	(60)	(60)	(64)	(95)	(113)
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	-	-	-	-	-
Cashflow from financing activities	(72)	(72)	(59)	(70)	(111)
Total cash generated	9	6	11	6	(16)
Cash at beginning of period	20	21	20	29	36
Implied cash at end of year	29	27	31	36	20

We expect Capex/Sales to remain around 16%

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Capex/Sales	7.2%	16.4%	16.7%	16.3%	15.0%

Source: Company data, Al Rajhi Capital



Disclaimer and additional disclosures for Equity Research

Disclaimer

This research document has been prepared by Al Rajhi Capital Company ("Al Rajhi Capital") of Riyadh, Saudi Arabia. It has been prepared for the general use of Al Rajhi Capital's clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Al Rajhi Capital. Receipt and review of this research document constitute your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this document prior to public disclosure of such information by Al Rajhi Capital. The information contained was obtained from various public sources believed to be reliable but we do not guarantee its accuracy. Al Rajhi Capital makes no representations or warranties (express or implied) regarding the data and information provided and Al Rajhi Capital does not represent that the information content of this document is complete, or free from any error, not misleading, or fit for any particular purpose. This research document provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment products related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this document.

Investors should seek financial, legal or tax advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this document and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that the price or value of such securities and investments may rise or fall. Fluctuations in exchange rates could have adverse effects on the value of or price of, or income derived from, certain investments. Accordingly, investors may receive back less than originally invested. Al Rajhi Capital or its officers or one or more of its affiliates (including research analysts) may have a financial interest in securities of the issuer(s) or related investments, including long or short positions in securities, warrants, futures, options, derivatives, or other financial instruments. Al Rajhi Capital or its affiliates may from time to time perform investment banking or other services for, solicit investment banking or other business from, any company mentioned in this research document. Al Rajhi Capital, together with its affiliates and employees, shall not be liable for any direct, indirect or consequential loss or damages that may arise, directly or indirectly, from any use of the information contained in this research document.

This research document and any recommendations contained are subject to change without prior notice. Al Rajhi Capital assumes no responsibility to update the information in this research document. Neither the whole nor any part of this research document may be altered, duplicated, transmitted or distributed in any form or by any means. This research document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or which would subject Al Rajhi Capital or any of its affiliates to any registration or licensing requirement within such jurisdiction.

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.

Contact us

Dr. Saleh Alsuhaibani
Head of Research
Tel : +966 1 2119434
alsuhaibanis@alrajhi-capital.com

Al Rajhi Capital
Research Department
Head Office, King Fahad Road
P.O. Box 5561
Riyadh 11432
Kingdom of Saudi Arabia
Email: research@alrajhi-capital.com

Al Rajhi Capital, a subsidiary of Al Rajhi Bank, is licensed by the Saudi Arabian Capital Market Authority, License No. 07068/37.