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Saudi Consumer

Impact of COVID 19, additional VAT and Removal of COL

We revisit our fiscal estimates post the recent reforms announced by KSA, voluntary oil production cuts post the OPEC cut agreement (link here), and also the recent oil prices. Our oil revenue now is at SAR324bn lower than our previous estimate of SAR342bn. Despite a 10% jump in VAT, we factor only a SAR28bn increase in VAT revenue because of possible pre-buying by consumers and that VAT comes into effect from July 1. If the VAT stays at 15% for 2021, we expect additional revenue from it to be SAR88bn. In terms of fiscal expenditure, while there were cuts announced including the cost of living allowance which amounts to SAR40bn as per our estimates, the finance minister points to expenditure remaining the same as committed before because of expenses not factored in due to the pandemic. However, we forecast SAR60bn lower expenditure at SAR970 leading to a fiscal deficit of SAR333bn (which is around 12% of 2019 nominal GDP)

Key themes

Consumer spending is expected to reduce

Significantly impacted by weak demand due to COVID-19

Reduction in purchasing power due to increase in VAT to 15% from 5% and removal of cost of living allowance

Implications

We expect consumer companies to undergo structural changes and emerge with a new strategy where e-commerce will be a prominent channel to penetrate the market.

Overall, we expect the industry consolidation to strengthen; and large companies with a strong balance sheet to become larger.

Top Three Picks

Stock	Rating	Price Target
Extra	Overweight	SAR 51
SADAFCO	Neutral	SAR169.
AlOthaim	Neutral	SAR116

Figure 1 Expectation of budget for OPEC+ production cut deal

(SARbn)	2019	2020E	
		ARC estimate	Budgeted
Rev. est.	917	627	833
Oil revs (est.)	597	324	487
Non-oil revs (est.)	320	304	346
Exp. est.	1,048	960	1,020
y-o-y	-3%	-8%	-3%
Deficit est.	(131)	(333)	(187)

Source: Company data, Al Rajhi Capital

a) Overall Consumer spending to decline in 2020:

Saudi consumer spending is expected to take a nosedive in 2020e mainly due to weaker demand due to shut down during COVID 19, reduced purchasing power due to an increase of VAT from 5% to 15% effective from July 2020 and removal of cost of living allowance of SAR1,000/month from June 2020. As per our analysis, the overall Saudi consumer spending is expected to decline significantly in 2020e and moderately in 2021e before gradually recovering from 2022e. Therefore, for the Saudi consumer sector, we cut the near-term revenue growth but in medium to longer-term we expect large players to become larger due to consolidation arising as the aftermath of COVID 19 as small players scale back. We advise investors to have a longer-term view on the KSA consumer sector and buy at troughs/dips to position for a longer-term.

b)Discretionary retailers to be impacted the most: We expect the discretionary spending to go down in near term therefore companies operating in discretionary sub-segmeent might face some challenges in the near term.

c) Implication for consumer companies: We expect the consumer sector to continue to consolidate which is driving the growth for organized retailers. In our view, COVID 19 will force the smaller players to exit or will have to scale down its operations thus creating significant opportunities for larger plays.

d) Saudi Consumer Sector: Saudi consumer sector is expected to shrink due to reduced purchasing power of the people as a result of the increment of VAT from 5% to 15% and less disposable income due to the removal of COL allowance. Lower oil prices and weak outlook due to global slowdown will dampen the sentiments of Saudi consumers. COVID 19 has changed the industry dynamics as retailers try to strengthen their online presence thereby we might see more Capex being allocated to IT development in the future. In terms of cost, we are expecting a leaner cost structure for organized retailers in 2021e. In our view, the normalized sales and sustainable margins would be generated towards H2 2021e once the companies adapt to current reforms while in the near term the earnings are expected to remain depressed. Overall we are "Neutral" on the overall sector.

Key takeaways for consumer sector in near to medium term:

1) Market share gains will drive the revenue in intermediate to long term after a one-time steep decline in 2020e.

- Since 2018 we saw a market share shift from unorganized to organized players in the electronic segment which benefitted organized retailers such as Extra and Jarir. They both delivered double-digit growth in 2019 when the overall consumer electronics market sized down. This growth was due to market share gains as Saudization requirements led to the closure of small fragmented electronics stores.

- Though it might be argued that consolidation in consumer electronics is over we still feel that there is further room for consolidation especially after the adverse impact of COVID-19 on small players.

- Organized retailers have a strong supply chain management by having direct tie-ups with the manufacturers, this, in turn, will help them in negotiating rebates and passing it on to the consumers which will play a major role in the near term when the consumer becomes more cost-conscious.

- Our main bet is on grocery retailers as this segment didn't consolidate like other consumer sub-segments. Other sub-segments such as construction material companies, gas, and fuel stations and car rentals might also see significant consolidation. Therefore some companies (which are not covered in this report) worth mentioning, which could benefit from consolidation, are Saudi Ceramics , SASCO, Aldrees and Budget.

- From our list of coverage, we expect Extra, Jarir, Alothaim and Panda to capture the market share from the unorganized sector and grow larger in the long run.

2) Change in strategy to expand through e-commerce and with a leaner cost structure

- We believe that this is a good time for consumer companies to revisit their strategy as it might be the bottom of any further reforms to come with VAT at 15%, expat levy ending in 2020 (as per the latest info available), possibilities of rent renegotiation with landlords and restructuring of administrative costs during COVID 19. The margins which we will observe towards H2 2021 will be the longer-term sustainable margins after factoring in the negative impact of reforms from 2018 to 2020e.

- During COIVD 19 we saw some retailers increasing their spending towards developing their existing e-commerce to reduce latency due to huge online traffic. We expect that online sales will contribute significantly to the top-line in the near future. Therefore companies such as Extra (having a partnership with Noon) and Jarir which have developed e-commerce website will have a competitive advantage compared to smaller players

- We also expect an increase in expenditure towards warehouse and logistics as the e-retailing penetrates in the kingdom. The reason being delivery time is one of the important metrics checked by a customer before placing an order, therefore with a wide network of warehouses and in house delivery feet (partially or tie-up with courier companies) companies can deliver the goods at short interval thereby winning customer loyalty. In fact, Extra recently updated us that they have arranged for a process where customers can apply for installment purchases online while the company's representative collects the documents from the customer's house.

- Smaller organized players have to infuse cash in the business to keep rolling and adapt to the new business environment. This is where the strong balance sheet of Jarir and SADAFCO gives them leverage to quickly change the strategy and capture market share from smaller players till they take time to strategize again. Therefore fragmented players, as well as small organized players, will undergo a tough time as cash generation will become extremely difficult.

f) How should investors position?

Though there are significant headwinds in the near term we advise taking a longer-term bet on the KSA consumer sector as we believe that with VAT being increased to 15% and removal of COL allowance most of the negatives are over. In-fact we are in the middle of the industry consolidation which will eventually play out in the next two years in our view.

1) In the near term, we expect the consumers to down-trade as was the case in 2018. Therefore, we expect the promotions and discounts to play a key role to gain market share and drive customers to the stores. This will lead to some margin erosion in the near term and weigh on profitability.

2) Over the medium term i.e. from 2021 mid we expect the full benefits of industry consolidation and leaner cost structure to accrue in terms of revenue growth and

margin expansion which will sustain over the long term as we don't see any headwinds from new reform.

3) Large organized players with strong brand image, larger store network, SKU range, multi-channel distribution capabilities and strong balance sheet strength will be able to ride the current period of transformation with a better comfort compared to the unorganized and smaller organized players.

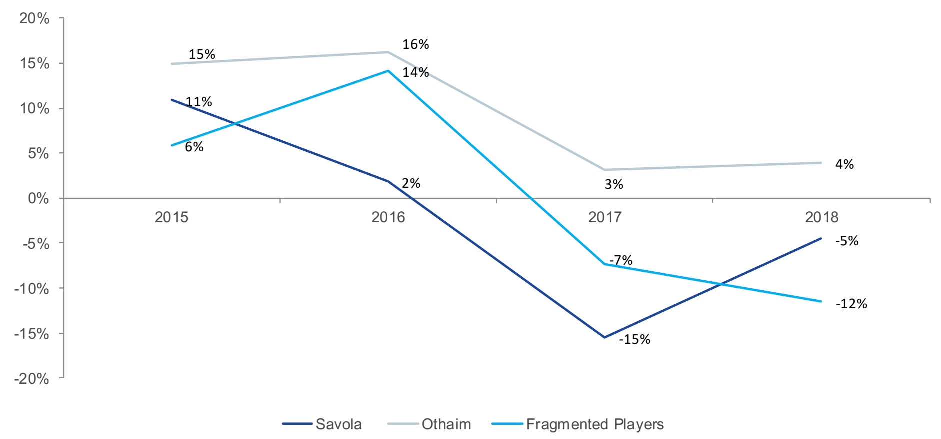
4) Therefore we recommend investors with longer-term horizons to buy at current dips while a wait and watch approach for investors with short to medium term.

g) Understanding of how consolidation played a key role for organized grocery retailers in the past

Market Share gains as in 2018 to continue in 2020 and beyond:
Companies operating in consumer sub-segments with a high share of unorganized players such as grocery retailers (56% market share of unorganized retailers) and electronics retailers with ~50% market share of unorganized retailers will witness a shift in market share gains. For example, AlOthaim's market share increased from 5% in 2015 to ~9% in 2019 while the overall grocery market size had shrunk ~3% during the same period. In-fact Alothaim has been expanding at neighborhood areas in Riyadh aggressively which is helping it to capture the market share from local convenience stores. AlOthaim's revenue grew at a CAGR of 8% from 2015-18 as per our calculations mainly due to market share gains. On a similar note due to reforms implemented in 2018 a lot of unorganized electronic retailers had to shut down. This helped Extra and Jarir to deliver double-digit revenue growth in 2019 as their market share increased significantly especially in consumer electronics and the white goods segment. We believe that in 2020e the reasons for an industry getting organized are stronger due to COVID 19 impact which should benefit the organized players.

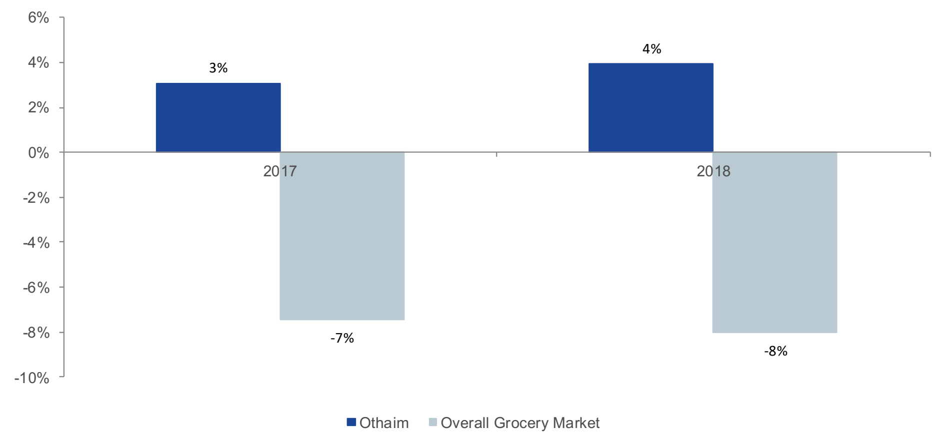
In fig 3 below we can see how AlOthaim's and Savola's top-line growth was superior compared to fragmented players. This was a result of industry consolidation where Othaim gained market share by opening new stores while Savola witnessed a marginal increase in LFL growth in the lower selling space (as the company shut down the stores)

Figure 2 Revenue growth trend for AlOthaim, Savola and other fragmented players



Source: Company data, Al Rajhi Capital

Figure 3 Revenue growth of Alothaim v/s the grocery market growth in 2017 and 2018



Source: Company data, Al Rajhi Capital

g) Key calls in our coverage

- **AlOthaim** (TP: SAR 110/Sh, CMP: SAR107/Sh, Upside:3%) is our top-pick due to I high revenue growth and earnings visibility. AlOthaim is gaining market (as shown above in fig 1) share thus delivering consistent growth mainly due to aggressive expansion plans. It targets low to mid-income segment and its majority of the revenue comes from groceries and fresh food segment. The company plans promotion by negotiating discounts from its suppliers and passing it to customers. AlOthaim is almost debt-free and is using its internally generated free cash flow to generate an ROE of ~25% thereby maximizing shareholder's wealth.
- We like **Extra** (TP: 51/Sh, CMP: 46/Sh, Upside:11%) in the consumer discretionary sector mainly due to its leadership position in the market,

strong tie-ups with suppliers which helps it to roll over annual promotions strategically. The company has gained market share from smaller players since 2018 and we expect this to continue which gives us revenue visibility once things improve gradually in 2021e. Extra's consumer finance business will play a key role in the coming years as disposable income in the hands of people reduce. A credit model will enable the company to attract traffic compared to other players.

- **SADAFCO** (TP:169/Sh, CMP:156, Upside-8%) is another player in the consumer non-discretionary segment which we like over its peers. SADAFCO's recent expansion of the distribution network has improved its penetration in the market. The company has in the past adopted very well when consumer spending was impacted due to VAT by introducing smaller packet items of its products which was the consumer buying behavior at that time. We expect that the dairy and ice-cream segment will continue to do well in the near term and a strong balance sheet gives room for future expansion plans.

Figure 4 Summary of our coverage

Companies	CMP (SAR)	M.Cap (SARmn)	TP (SAR)	Upside (%)	Rating	RoE (%)		P/E (x)		P/B (x)		EV/E (x)	
						2019	2020E	2019	2020E	2019	2020E	2019	2020E
Jarir	134.0	16,080	110	-18%	Underweight	60%	45%	16.3x	21.1x	9.8x	9.5x	13.6x	17.8x
Extra	46.1	2,305	51	11%	Overweight	31%	20%	11.2x	16.2x	3.5x	3.2x	7.5x	8.3x
Al Othaim	111.0	9,990	116	4%	Neutral	23%	25%	28.4x	25.0x	6.6x	6.2x	13.4x	11.8x
Fawaz Al Hokair*	16.8	3,528	13	-23%	Underweight	6%	17%	24.4x	7.2x	1.5x	1.2x	8.2x	4.7x
Almarai	48.5	47,900	51	4%	Neutral	12%	12%	26.4x	24.2x	3.1x	2.9x	14.4x	13.0x
Savola	39.5	21,092	41	3%	Neutral	5%	14%	52.4x	16.8x	2.8x	2.4x	2.6x	2.3x
Herfy	41.2	2,665	39	-6%	Neutral	20%	14%	13.6x	18.4x	2.7x	2.6x	9.2x	11.0x
Sadafco*	156.0	4,992	169	8%	Neutral	18%	18%	18.8x	16.2x	3.4x	2.9x	11.6x	10.2x

Source: Company Data, Al Rajhi Capital; *Year ending 31 March; Note – Leejam Under Review

Figure 5 Jarir

(SARmn)	2019	2020E	2021E
Revenue	8,425	7,264	7,430
Revenue growth	14%	-14%	2%
Gross profit	1,273	969	1,011
Gross margin	15%	13%	14%
EBITDA	1,167	897	945
EBITDA margin	14%	12%	13%
Net profit	985	762	828
Net margin	12%	10%	11%
EPS	8.21	6.35	6.90
DPS	7.76	5.98	6.44
Payout ratio	95%	94%	93%

Source: Company data, Al Rajhi Capital

Figure 6 Extra

(SARmn)	2019	2020E	2021E
Revenue	5,206	4,972	5,220
Revenue growth	18%	-4%	5%
Gross profit	901	862	922
Gross margin	17%	17%	18%
EBITDA	348	290	341
EBITDA margin	7%	6%	7%
Net profit	206	142	184
Net margin	4%	3%	4%
EPS	4.13	2.84	3.68
DPS	2.25	1.56	2.02
Payout ratio	55%	55%	55%

Source: Company data, Al Rajhi Capital

Figure 7 AlOthaim

(SARmn)	2019	2020E	2021E
Revenue	8,166	9,277	9,933
Revenue growth	9%	14%	7%
Gross profit	1,689	1,883	2,016
Gross margin	21%	20%	20%
EBITDA	712	778	887
EBITDA margin	9%	8%	9%
Net profit	352	399	397
Net margin	4%	4%	4%
EPS	3.91	4.43	4.41
DPS	3.00	3.41	3.40
Payout ratio	77%	77%	77%

Source: Company data, Al Rajhi Capital

Figure 8 AlHokair

(SARmn)	2019	2020E	2021E
Revenue	5,426	5,012	4,295
Revenue growth	-11%	-8%	-14%
Gross profit	1,084	1,492	1,034
Gross margin	20%	30%	24%
EBITDA	702	1,188	796
EBITDA margin	13%	24%	19%
Net profit	145	492	247
Net margin	3%	10%	6%
EPS	0.69	2.34	1.18
DPS	0.00	0.00	0.00
Payout ratio	0%	0%	0%

Source: Company data, Al Rajhi Capital

Figure 9 Almarai

(SARmn)	2019	2020E	2021E
Revenue	14,351	15,607	16,700
Revenue growth	-11%	-8%	-14%
Gross profit	5,367	5,775	6,012
Gross margin	37%	37%	36%
EBITDA	4,181	4,520	4,751
EBITDA margin	29%	29%	28%
Net profit	1,802	1,967	1,942
Net margin	13%	13%	12%
EPS	1.83	2.00	1.98
DPS	0.85	0.90	0.89
Payout ratio	46%	45%	45%

Source: Company data, Al Rajhi Capital

Figure 10 Savola

(SARmn)	2019	2020E	2021E
Revenue	22,243	23,146	23,766
Revenue growth	-11%	-8%	-14%
Gross profit	4,504	4,566	4,694
Gross margin	20%	20%	20%
EBITDA	2,510	2,418	2,513
EBITDA margin	11%	10%	11%
Net profit	403	1,254	1,406
Net margin	2%	5%	6%
EPS	0.75	2.35	2.63
DPS	0.00	0.00	0.00
Payout ratio	0%	0%	0%

Source: Company data, Al Rajhi Capital

Figure 11 Herfy

(SARmn)	2019	2020E	2021E
Revenue	1,288	1,222	1,251
Revenue growth	-11%	-8%	-14%
Gross profit	393	336	382
Gross margin	30%	28%	31%
EBITDA	309	249	291
EBITDA margin	24%	20%	23%
Net profit	196	145	193
Net margin	15%	12%	15%
EPS	3.03	2.24	2.98
DPS	2.10	1.57	2.09
Payout ratio	69%	70%	70%

Source: Company data, Al Rajhi Capital

Figure 12 Sadafco

(SARmn)	2019	2020E	2021E
Revenue	2,056	2,191	2,352
Revenue growth	-11%	-8%	-14%
Gross profit	689	747	815
Gross margin	34%	34%	35%
EBITDA	376	407	467
EBITDA margin	18%	19%	20%
Net profit	265	308	359
Net margin	13%	14%	15%
EPS	8.28	9.62	11.21
DPS	0.00	0.00	0.00
Payout ratio	0%	0%	0%

Source: Company data, Al Rajhi Capital

Conclusion: In the near term we expect earnings volatility due to a reduction in consumer spending. We expect the smaller players in each consumer sub-segment to have a difficult time as they might face an intermittent liquidity crisis which would either force them to exit or scale down their operations. This is where we expect the larger companies with a stronger balance sheet to capture the market share lost by the smaller players. We expect the margins to normalize by H2 2020 which should be sustainable in the long term. Therefore, current dips provide an attractive opportunity to position for the long term.

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target 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.

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