

Herfy Food Services Co.

Challenging year for Herfy due to the impact of COVID-19 on QSR

22 March 2021

Herfy Food Services Co. (Herfy) faced a challenging year due to the timely store closures on back of the COVID-19's restrictive measures, resulting in a 16.5% drop in revenues Y-o-Y. Nevertheless, most of the damage during the year was due to the non-recurring provisions that totaled to SAR34.0mn. We believe that the VAT will pressure demand FY2021e, meanwhile Herfy's bottom-line performance will gradually improve until it normalizes.

We update our 52 weeks target price SAR61.8/share while maintaining our Neutral recommendation.

Despite the recovery seen by Herfy in Q3 2020 as commercial centers reopened in the kingdom, the company saw another slowdown in Q4 2020. During the quarter, the company's revenues were SAR298mn, which is a drop of 8.8% Y-o-Y compared to SAR327mn in Q4 2019 (-4.2% Q-o-Q). The drop in revenues could be attributed to the 15% VAT that posed a strain on the average consumer wallet, making them less likely to eat out. Moreover, it is possible that the demand has normalized since Q3 2020, as people were more enthusiastic about the easing in restrictions.

In line with the drop in revenues, the company's COGS also dropped by 3.0% Y-o-Y (-3.3% Q-o-Q), leading to a gross profit of SAR78mn (-21.8 Y-o-Y, -6.8% Q-o-Q). Gross profit for Q4 2020 stood at 26.3%, which is a drop from 30.0% in Q4 2019.

On lighter note, SG&A for Q4 2020 dropped from SAR44mn in Q4 2019, to SAR39mn representing a 9.9% drop Y-o-Y (22.4% Q-o-Q). The drop in SG&A is due to the low traffic on Herfy branches on the back of the pandemic, however, the Q-o-Q drop in SG&A is due to the SAR8.4mn provisions on slow moving inventory endured by the company in Q3 2020.

The company posted operating profit of SAR30mn in Q4 2020, which is a 48.9% drop compared to SAR59mn in Q4 2019 (-40.5% Q-o-Q). The drop in operating income is due to a combination of low gross profit and impairments on property that totaled to SAR8mn during the quarter. Consequently, operating profit margin stood at 10.1% compared to 18.0% in Q4 2019.

Finally the company posted net income of SAR21mn in Q4 2020, representing a significant drop of 58.5% compared to SAR50mn in Q4 2019 (-50.3% Q-o-Q). Net income margin stood at 6.9% in Q4 2020, compared to 15.2% in Q4 2019

During the year, the company announced cash dividends amounting to SAR1 per share for the year FY2020, for a total amount of SAR64.7mn.

Being in the Quick Service Restaurant (QSR) industry, Herfy suffered greatly throughout the year, however the impact of the VAT, coupled with the expat exodus was significantly amplified during the quarter. Moreover, the fear of public dining that was instilled in customers from the COVID-19 pandemic, made it hard for the company to recover lost sales since the COVID-19 outbreak. It seems that despite having an online delivery application didn't change the consumer's reluctance to spend on fast food in light of the VAT.

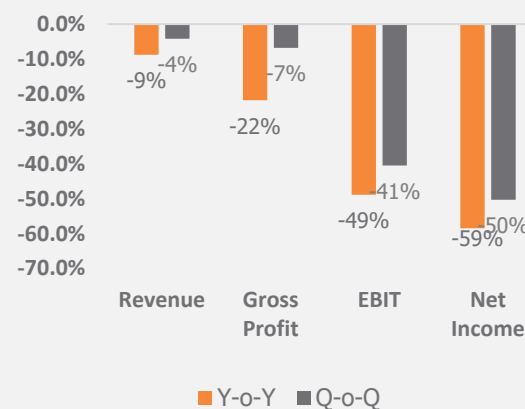
Recommendation **Neutral**

Previous Recommendation	Neutral
Current Price (21-03-2021)	SAR63.80
Target Price (52 Weeks)	SAR61.83
Upside/ (Downside)	-3.08%
Shariah Compliance	Pass

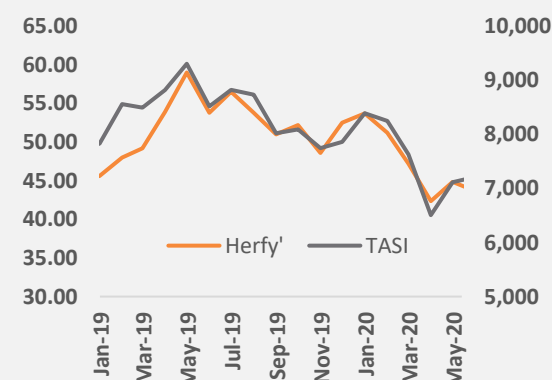
Key Financial Ratios

Ratio	Q4 2020	Q3 2020	Q4 2019
Revenue Growth	-4.2%	82.9%	-3.7%
Gross Margin	26.3%	27.0%	30.6%
EBIT Margin	10.1%	16.2%	18.0%
Net Margin	6.9%	13.3%	15.2%

Key Financial Results (Q4 2020)



Share Price Performance



Financial Overview

2020A Overview & Outlook

FY2020 was a highly challenging year for Herfy, which was significantly reflected in the company performance. Herfy started the year with a slight decline in revenues, as the outbreak of the Corona virus was responded to with rigid quarantine measures by the end of March, 2020. The restrictions intensified by Q2 2020, leading to a complete lockdown that resulted in the shut-down of f Herfy restaurants in commercial centers, which is one of the precautionary means of containing COVID-19 in the kingdom. The closure of restaurants resulted in a 45% drop in revenues Y-o-Y in Q2 2020, during which the company was relying heavily on online orders from the application and aggregators. By Q3 2020, despite the application of the 15%, the kingdom saw slight easing in the precautionary measures as commercial centers opened again with a limited time window, resulting in a significant Q-o-Q recovery from the company as sales increased by 83.0% compared to Q2 2020. However, revenues for the quarter were still 8.0% lower than pre-COVID levels. Finally in Q4 2020, the company was hit with the impact of the lowered demand that was in place due to the high VAT and the expat exodus during the year. FY2020, the company posted revenues of SAR1,076mn, representing a drop of 16.5% compared to SAR1,288mn FY2019. It is worth mentioning that despite the significant drop in the company's top-line number, it seems that Herfy's online presence significantly supported the company during the lockdown, allowing the company to adapt quickly to the circumstances.

Unhealthy margins due to non-recurring provisions during the pandemic. It was evident the Herfy was highly sensitive to the turbulence in the market the occurred due to the COVID-19 outbreak. While the government did its best to support the economy, the company endured high levels of provisions during the year that out-weight the government's support. FY2020, Herfy received a total of SAR5.7mn as a refund of Iqama charges to combat the increasing SG&A levels during the pandemic, in addition to a total of SAR2.2mn as gain on sale of some assets. However, the non-recurring gains couldn't outweigh the provisions made during the year. The company made provisions for trade and other receivable of a total of SAR11.3mn during the year 2020, in addition to provisions for slow moving inventory with a total of SAR14.7mn. Furthermore, during the year the company accounted for provisions for the impairment on property assets that reached SAR8mn. That being said, the company's operating profit margin dropped significantly from 18.5% FY2019, to only 8.5% FY2020. Moreover, the non-recurring provisions endured by the company during FY2020, totaling to SAR34.0mn, weighed down heavily on Herfy's bottom-line. Herfy posted Net income margin of only 4.9% FY2020, compared to 15.2% FY2019.

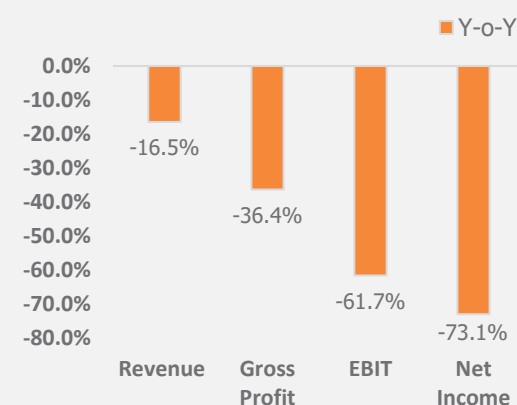
Herfy's expansion plans on hold as the market adjusts to the shift in demand. While previously announcing (in the company's board of director's report FY2019) the plan to open 15 more stores in 2020, the company strategically held back on its expansion plans. Due to the restrictive measures applied by the Kingdom to contain the outbreak of the virus, the company witnessed a significant drop in average revenue per store. Moreover, the limited working hours and hygiene measures taken in-store would have significantly increased the company's expenses during an already challenging year. The quarantine highlighted the importance of home delivery and food aggregators, which we expect to be the future of the demand trend.

Going forward, we expect a demand on fast food to remain slightly low on the short-term as the consumer adjusts to the lower disposable income, therefore we do not expect Herfy to reach pre-COVID top-line numbers FY2021e. However, we believe that the company's margins and bottom-line performance will significantly improve as the non-recurring losses made FY2020 a low base year.

Key Financial Ratios

Ratio	FY2020	FY2019
Revenue Growth	-16.5%	5.0%
Gross Margin	23.2%	30.5%
EBIT Margin	8.5%	18.5%
Net Margin	4.9%	15.2%

Key Financial Results (2020A)



Quarterly Performance



Financial Projection

DCF Valuation

	2020 E	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
EBITDA	251	267	281	290	299	300	301
Operating CF	267	222	262	278	288	293	295
Capex	(82)	(84)	(95)	(93)	(86)	(84)	(83)
FCFF	185	138	168	185	203	209	212
Stub Period (FCF to be discounted)	0	138	168	185	203	209	212
PV (FCFF)	0	129	146	150	153	147	138
WACC	7.19%	<p>We have valued Herfy using DCF approach, considering a WACC is equal to 7.2% (based on a risk-free rate of 2.7%, market risk premium 7.0%, Beta of 0.87) Based on the DCF valuation, the fair price of Herfy share price is SAR61.8, which is lower than the traded value by 3.1%.</p>					
Perpetuity Growth	3.00%						
PV-FCFF	864						
PV-TV	3,242						
Net Debt	(42)						
Less: End of services benefits	(94)						
Less: NCI	29						
Intrinsic Values	3,999						
Shares Outstanding	65						
Equity value per share	61.83						
CMP (21-03-2021)	63.80						
Upside / (Downside%)	-3.08%						

All values are in SARmn

Financial Projection

Financial Ratios	2019 A	2020 E	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
Return on Average Assets (%)	11.3%	2.7%	3.7%	4.7%	5.6%	6.5%	7.0%	7.5%
Return on Average Equity (%)	20.3%	5.4%	7.7%	10.0%	12.0%	14.2%	15.4%	16.5%
Earnings Before Zakat Margin	15.6%	5.4%	6.7%	7.9%	8.8%	9.7%	10.2%	10.7%
Net Income Margin (%)	15.2%	4.9%	6.3%	7.5%	8.5%	9.3%	9.9%	10.5%
Revenue Growth (%)	5.0%	-16.5%	7.8%	7.2%	5.2%	4.9%	2.3%	2.3%
EPS	3.0	0.8	1.1	1.4	1.7	2.0	2.1	2.3

Income Statement	2019 A	2020 E	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
Revenues	1,288	1,076	1,160	1,243	1,308	1,372	1,404	1,436
Cost of Revenues	(746)	(667)	(731)	(790)	(837)	(885)	(912)	(940)
Gross Profit	393	250	277	308	330	353	363	374
SG&A	(156)	(158)	(162)	(173)	(180)	(188)	(191)	(194)
Zakat	(5)	(5)	(5)	(5)	(5)	(5)	(4)	(4)
Net Income	196	53	73	94	111	128	139	150

Balance Sheet	2019 A	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
Current Assets	345	367	488	565	605	667	731	810
Non-Current Assets	1,683	1,582	1,499	1,432	1,369	1,306	1,248	1,196
Total Assets	2,028	1,949	1,987	1,997	1,975	1,973	1,979	2,006
Current Liabilities	402	402	453	460	458	451	434	416
Non-Current Liabilities	627	588	599	604	610	623	643	674
Total Equity	998	959	936	932	907	899	902	917
Total Liabilities and Equity	2,028	1,949	1,987	1,997	1,975	1,973	1,979	2,006

All values are in SARmn

Financial Projection

Guide to Ratings

Buy	An upside potential of more than 20% in 52-week period
Overweight	An upside Potential of more than 10% in 52-week period
Neutral	Will stay in the range of it value (up/down 10%) in a 52-week period
Underweight	A downside potential of more than 10% in 52-week period
Sell	A downside potential of more than 20% in 52-week period

Itqan Capital

Al Zahraa District, Al Zahraa Commercial Center,
PO Box 8021, Jeddah 21482,
Kingdom of Saudi Arabia
Tel: 966 12 263 8787
Fax: 966 12 263 8789
info@itqancapital.com
www.itqancapital.com

Disclaimer

This research document has been prepared by Itqan Capital Company ("Itqan Capital"), Saudi Arabia. It has been prepared for the general use of Itqan 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 Itqan 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 Itqan Capital. The information contained was obtained from various public sources believed to be reliable, but we do not guarantee its accuracy. Itqan Capital makes no representations or warranties (express or implied) regarding the data and information provided and Itqan 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. Itqan 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. Itqan 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. Itqan 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. Itqan 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 Itqan Capital or any of its affiliates to any registration or licensing requirement within such jurisdiction.

Itqan Capital is licensed by the Saudi Arabian Capital Market Authority, License No.07058-37 and CR No.4030167335