Initiation of Coverage Report

Arabian Centers Co. (ACC)

We initiate our coverage for Arabian Centers with an Overweight recommendation, despite its short-term challenging outlook, as the company's long-term prospects remain promising, in our view.

06 April 2021

Recommendation	Overweight
Current Price (05-04-2021)	SAR22.28
Target Price (52 Weeks)	SAR24.8
Upside/ (Downside)	11.3%
Shariah Compliance	Pass

Reuters Code	4321.SE
Bloomberg Code	ALMRAKEZ: AB
52 Weeks High	SAR27.90
52 Weeks Low	SAR18.76
Market Cap	SAR10.6bn
P/E (TTM)	23.2x
EPS (TTM)	SAR1.0
Last Dividend (H1 FY2021)	SAR0.5
AVG Value Traded	SAR572mn

Key Points

We initiate our coverage for Arabian Centers with an Overweight recommendation and 52 weeks target price at SAR24.8; this represents an upside potential of 11.3%.

- Arabian Centers Co. (ACC) is the leading operator of shopping malls in the Kingdom with a market share of 16%. While the company's short-term outlook is challenging, the long-term prospects remain promising, in our view. The company has ambitious expansion plans over the coming 3 years, which are expected to drive earnings growth over the forecast period. The company enjoys a competitive advantage through its strong ties with Alhokair and high adaptability to changing market conditions, which will enable it to outperform its competitors. The company also stands to benefit from supportive socio-economic reforms and long-term potential of the Saudi retail market. We believe that the market's concerns regarding malls sustainability post-COVID are overstated given malls' position as leisure destinations.
- ACC was hit by COVID-19 where its revenues and net income fell by 16.5% and 13.6% Y-o-Y, respectively, during Q3-FY2021 mainly as a result high discount rates offered to tenants and lower lease renewal prices. However, we see a strong recovery potential for ACC's top-line and bottom-line starting FY2022 as the (i) impact of rental discounts subsides, (ii) occupancy in recently opened malls ramp-up, (iii) footfall recovers in existing malls supported by vaccine rollout and lift of restrictions on malls, and (iv) lease renewal rates gradually recover. While COVID-induced discounts will continue to impact ACC's top-line over the coming period, earnings from new malls are expected to compensate for the shortfall in LFL growth thus supporting the company's bottom-line. Key downside risks, however, are represented in lower rental rates and rise in the debt levels.

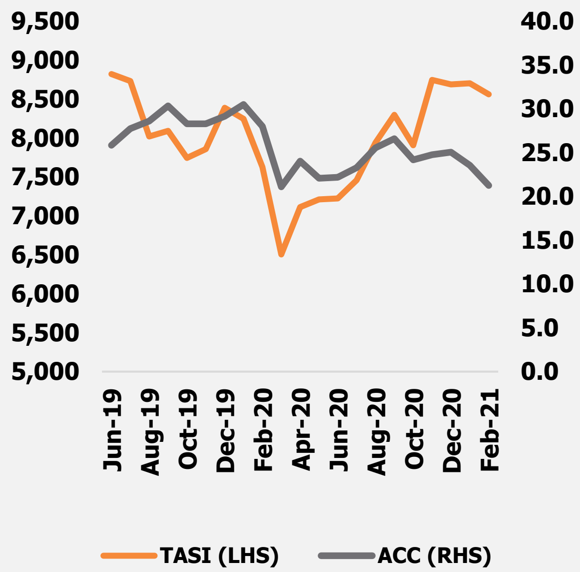
Key Growth Catalysts

- New expansions in the pipeline
- Competitive advantage in attracting tenants and footfall

Key Risk Factors

- Weak market conditions
- Rise in interest burden

ACC Share Price vs TASI



Company Overview

Arabian Centers Establishment

- Arabian Centers Co. ("ACC") is the largest owner, developer, and operator of shopping malls in Saudi Arabia with a portfolio of 21 malls over a total Gross Leasable Area (GLA) of 1.2mn square meters. ACC was established in 2005 and listed on Saudi stock exchange in 2019. ACC's malls hosted around 111mn visitors during 2019. The company consistently maintained above 90% occupancy rates in its portfolio and a pre-letting track record. ACC's portfolio grew from 12 malls in 2014 to 21 in 2020. The company's market share in the Kingdom is reported at around 16%.

ACC's Revenue at Glimpse

- ACC generates revenues from 3 key sources, namely rental revenue, media sales, and utilities & other. Rental revenues account for 90% of the company's total revenues, which consists of the rents received from tenants, net of discounts offered.
- Media sales account for 3% of total revenues and consist of advertisements in the malls in the form of banners, advertisements on escalators, or in cinemas.
- Utilities revenue is a contractual amount charged to tenants for the recovery of water and electricity charges consumed by the tenants. The segment accounts for 7% of revenues.

ACC's Portfolio

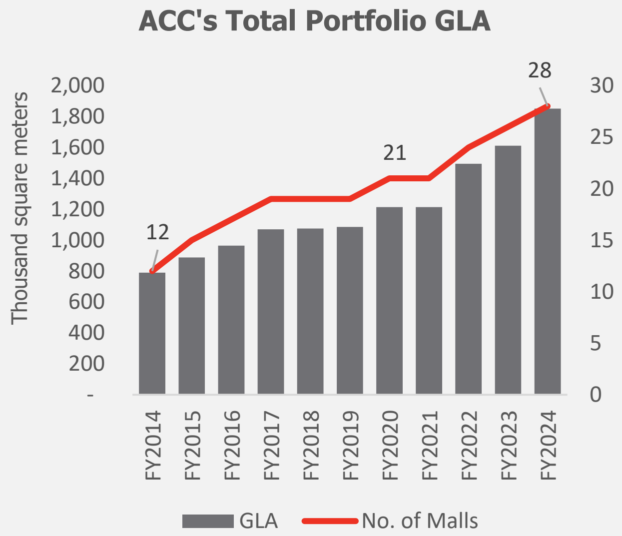
- ACC currently operates 21 malls in 10 cities across the Kingdom with a total GLA of 1.2 million square meters. During 2014-2020, ACC increased its GLA by c.37% adding 326k in GLA. The company completed cinema rollout in 10 out of 21 malls as of December 2020 and is planning to open cinemas in 9 additional locations by December 2021.
- Going forward, the company is planning to increase its GLA by c.600k sqm in the medium term by 2024 through 6 new malls and 2 extensions, which will bring the total number of malls and total GLA to 28 and 1.8mn sqm, respectively. The company recently opened 2 new malls and an extension during 2019 and 2020 with a total GLA of 129k sqm. At least 2 more projects (Khaleej Mall and Jeddah Park) are planned to be open during 2021 with a total GLA of 180k sqm.
- Around 60% of ACC's malls are built on leased lands ("leasehold") with long term lease contracts extending up to 30 years, while the remaining 40% are built on lands fully owned by ACC ("freehold"). The company might consider letting go of the leasehold malls upon expiry of the lease contract if the mall is underperforming.
- The majority of ACC's malls are located in Riyadh (33% of malls), Jeddah (24%), and Dammam (10%). The company holds 28% and 11% market share in Jeddah and Riyadh, respectively. Around 75% of ACC's future projects will be located in the two cities.

Key Shareholders

Name	Ownership (%)
Fawaz Alhokair Real Estate Co.	42.0%
Free float	20.0%
Dr. Abulmajid Abulaziz Alhokair	8.0%
Mr. Fawaz Abulaziz Alhokair	8.0%
Eng. Salman Abdulaziz Alhokair	8.0%

Source: Tadawul

ACC's Portfolio Data



Source: Company disclosures, Itqan Capital research

ACC's Projects Pipeline

New Mall	GLA*	Opening
Khaleej Mall	51.0	2021
Jeddah Park	128.7	2021
Najd Mall	35.3	2022
U Walk Jeddah	60.0	2023
Madinah U-Walk	57.2	2023
Jawharat Jeddah	80.4	2024
Jawharat Riyadh	158.9	2024

Source: Company disclosures, Itqan Capital research
*GLA in thousand square meters

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Company Analysis

Key Growth Catalysts

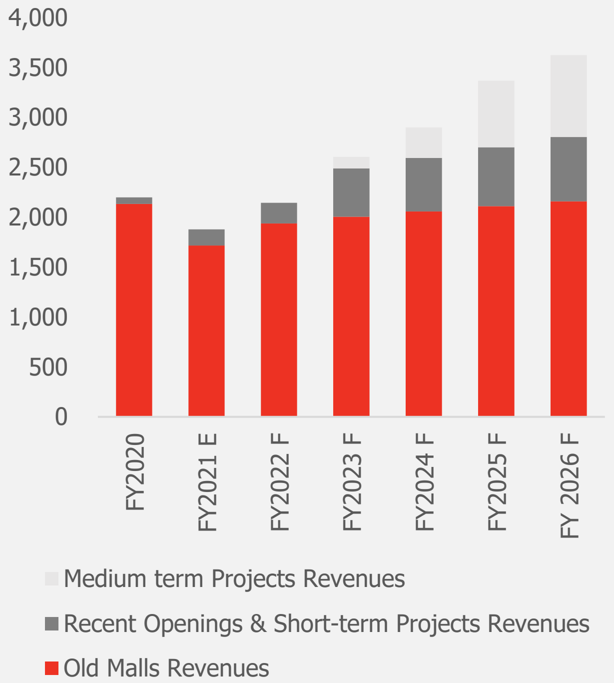
New Expansions in the Pipeline

- ACC has ambitious plans to strengthen its market position in the Kingdom by increasing its GLA by around 53%. The company's near-term pipeline is expected to be completed during 2021, bringing the total number of malls to 23. While rental rates declined during 2020, and will likely remain suppressed in the medium term on the back of weaker demand, new expansions are expected to compensate for the shortfall in existing malls. The company recently opened 2 new projects and an extension which are still in their early stages of growth and are expected to reflect positively on the company's results over the coming quarters. Occupancy rates in the new projects opened during 2019 reached 84%-90%. Typically, occupancy rates in the new projects take around 3 years until they reach their target occupancy of 93-95%. Management expects the new projects to reach 95% occupancy over the coming 12 months. Jeddah Park, which is forecast to open during 2021, would be the second largest addition to ACC's malls with 128k sqm. We forecast the mall to contribute SAR178mn to revenues during its first full year of operations. ACC's current focus on continuation with its expansion strategy is expected to ease the impact of the downfall in LFL growth of its portfolio. Revenues from ACC's 3 latest projects opened during 2019 & 2020 grew by 122% Y-o-Y during 9M FY2021, increasing their contribution to total revenues to 8% vs 3% in 9M FY2020. We expect the contribution of recently opened malls and the upcoming near-term pipeline to increase over the coming quarters, partially offsetting the downfall in LFL revenues.

Competitive Advantage in Attracting and Maintaining Footfall and Tenants

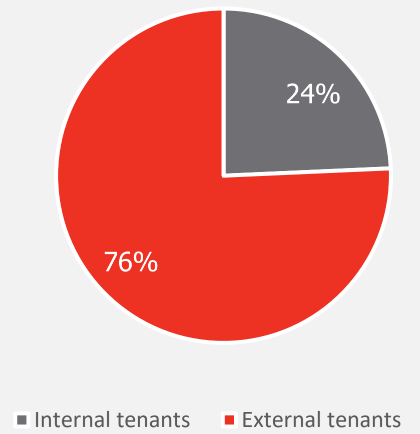
- ACC has a consistent track of record of high pre-leasing rates for its new malls, which provides reassurance of the success of the company's new projects. Being a key related party to ACC, Alhokair Group typically pre-leases 20%-25% of the GLA of each mall through its subsidiaries Alhokair Fashion Retail, Food & Entertainment Company, and FAS Entertainment. ACC's new malls are typically over 60% pre-leased before their opening. Jeddah Park and Khaleej Mall, which are expected to open during 2021, have pre-leasing rates of 65% and 70%, respectively.
- Alhokair Fashion Retail is the largest franchise retailer in the Kingdom with 95+ well-known brands. Existence of such anchor tenants in ACC's malls not only attracts footfall to its malls, but also draws smaller tenants to ACC's malls.

Contribution of New Malls to ACC's Total Revenues



Source: company data, Itqan Capital estimates

Internal and External Tenant Mix

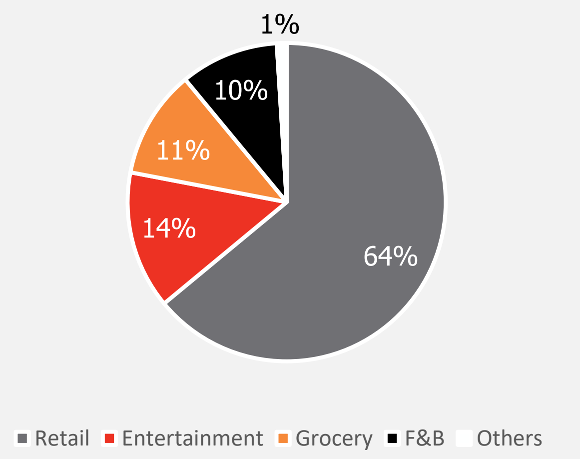


Source: company data, Itqan Capital research

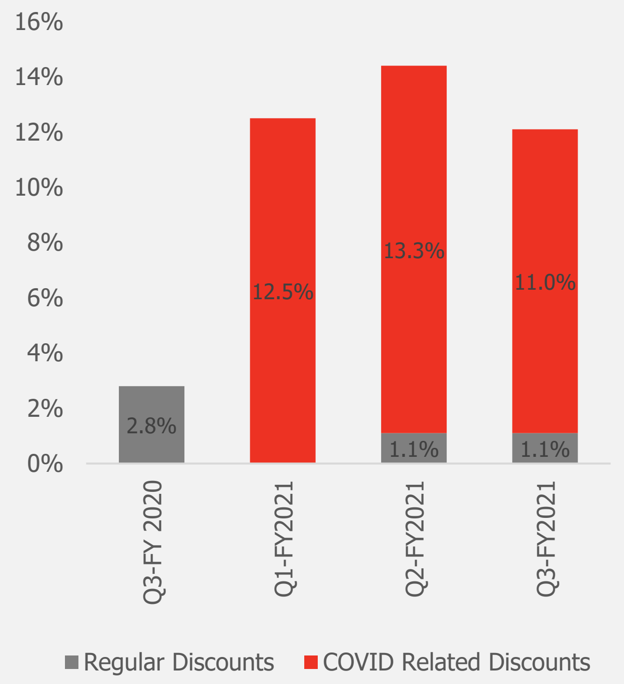
*Internal tenants refer to related party tenants which are mainly Alhokair Group companies

Company Analysis

- ACC embraced the shift in customers' shopping habits and recently announced the acquisition of 25% of VogaCloset, an online fashion platform. Through this partnership, ACC will be able to offer its tenants a holistic proposition by giving their brands online presence- a key need for any retailer. The move is expected to add to ACC's appeal as a tenant as well as a customer destination, while it will not cannibalize physical store sales as the customer will still need to pick up the purchased item from the physical store, thus maintaining the footfall in its malls.
- ACC is committed to continue its cinema rollout throughout 19 out of its 21 malls by the end of 2021. The introduction of cinemas is expected to increase footfall on ACC's malls, thus increasing occupancy and allowing the company to demand higher rents from tenants if market conditions allow on the longer term. The company is aiming to shift its entertainment and F&B contribution to GLA from 14% to 30% as it attempts to meet customers' shifting demand.
- ACC's continuous support for its tenants is bound to make its malls more tenant attractive. Since the commencement of the COVID crisis, ACC provided weighted average discount rate of 12-14% for its tenants in an attempt to maintain occupancy rates. Additionally, the company signed an agreement with Quara Finance Company to grant the SME business tenants in its malls access to easier and cheaper financing. While such measures are bound to hurt ACC's earnings and margins in the short term, it strengthens its position as a market leader and ensures business sustainability and tenants loyalty.
- We do not see a long-term permanent impact on the sustainability of ACC's operations following the rise of e-commerce during COVID-19 given the positioning of malls as a "leisure destination" rather than a shopping destination. We expect shopping malls to retain their position in the Kingdom given the unique experience they offer their customers that online shopping cannot replace. ACC is also effectively addressing the rising demand for e-commerce and diversifying away from retail tenants to entertainment and F&B tenants, which is expected to further support its market position.



Source: Company data, Itqan Capital research



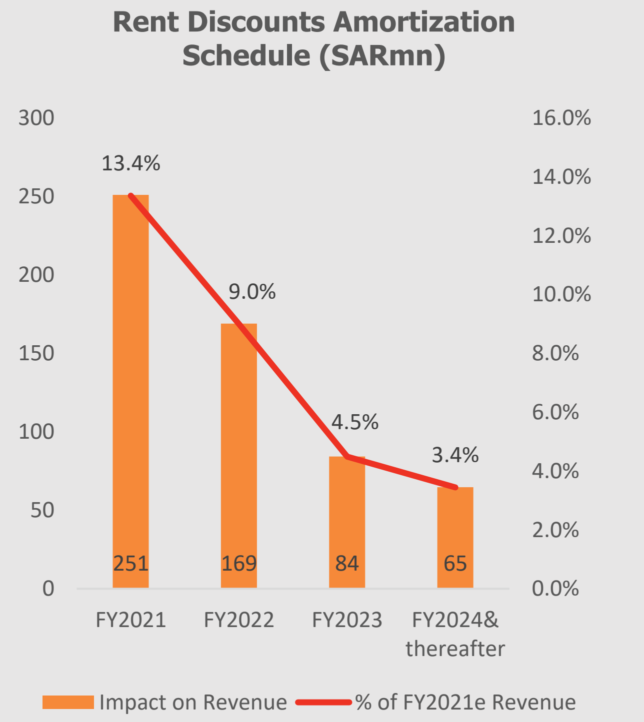
Source: Company data, Itqan Capital research

Company Analysis

Key Risk Factors

Weak Market Conditions

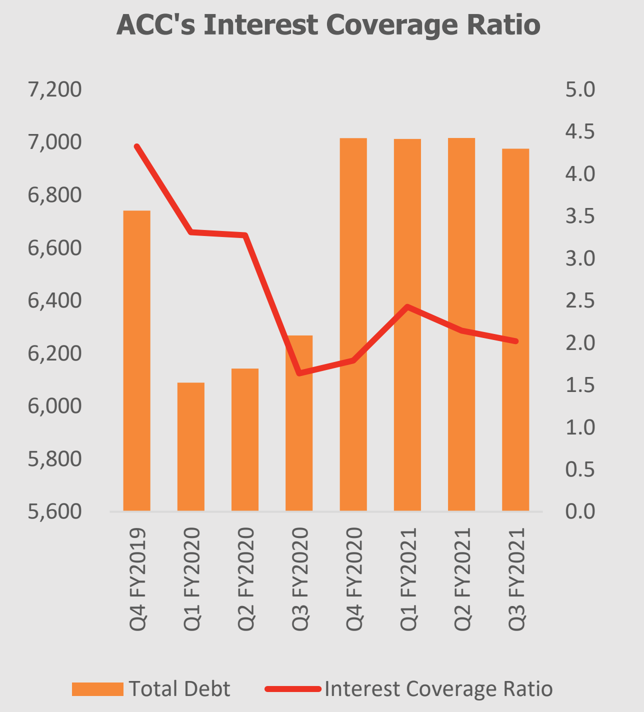
- The real estate sector was among the sectors hit by COVID-19, while the retail real estate sector, in particular, was further pressured by lockdown measures. ACC reported 10-15% drop in lease renewal rates during H2 2020 amid weak market conditions. ACC's rental rates were on their way to recovery pre-COVID where the company reported 2.3% LFL growth as of December 2019 while discounts offered to tenants were below 5%. However, starting June 2020, ACC offered weighted average discounts rate reaching up to 14% in an attempt to maintain high occupancy rates. Such discounts were the key reason behind ACC's revenue downfall by 16.5% Y-o-Y during the 9 months ended December 2020. While the company reported that cash discounts offered to tenants ended as of December 2020, the accounting impact of the discounts will persist over the coming few years as the total amount of the discount is amortized over the tenant's lease term. The company expects a hit of SAR251mn during FY2021 (around 13% of estimated FY2021 revenues), SAR169mn in FY2022, and 84mn in FY2023. Renewal rates are likely to be pressured as well amid weak market conditions. While LFL growth will be pressured, we expect revenues from the near-term pipeline to ease the impact of continued amortization of discounts and low rental rates.



Source: Company data, Itqan Capital research

Rise in Interest Burden

- ACC currently holds around SAR7bn in long term debt, which represents debt to equity ratio of 117%, up from 82% in FY2015. While higher leverage should generally support higher ROE, the company hasn't been successful in efficiently using leverage to boost its earnings. The interest burden is eating away at ACC's earnings and weighing down on its ROE. Interest coverage dropped to a concerning level of 2.1x (trailing 12 months) vs its 3-year average of 2.9x, indicating lower ability of servicing its interest payments. We expect cash from operations, however, to cover interest and debt principal repayments by more than 3.0x. On a positive note, the company should benefit from the current low interest rate environment and its transition to longer debt maturities, thus partially reducing the impact of higher debt burden in the future.



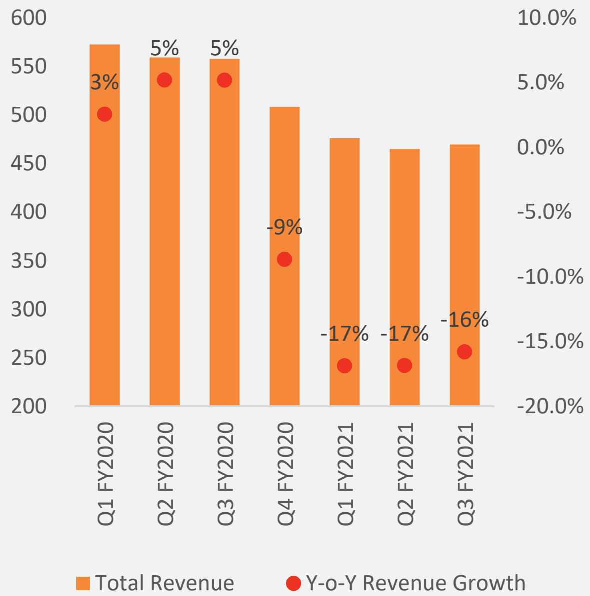
Source: Company data, Itqan Capital research

Company Analysis

Financial Results: Q3 FY2021[1]

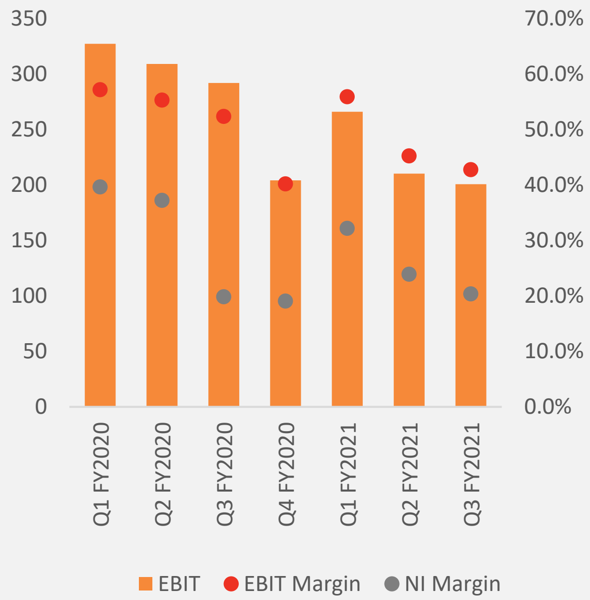
- ACC's revenues fell by 15.8% as COVID-induced discounts offered to tenants pressured the company's net rental income. Weighted average discounts offered to tenants during the quarter reached 12.1% vs 2.8% in Q3 FY2020. On quarterly basis, revenues recovered by 1.0% Q-o-Q as average rent discount rate fell slightly from 14.4% in Q2 FY2021 to 12.1% in Q3 FY2021. LFL rental revenue dropped by 21.7% during 9M FY2021 vs a growth of 2.3% in 9M FY2020. Since Q4-FY2020, ACC recorded SAR214mn in COVID related discounts which is subtracted from gross rental income and reflects in lower revenues. Leases renewed during the quarter were also reported to be renewed at 10-15% lower rates than the previous lease contract price.
- Gross profit dropped by 31.2% Y-o-Y and 2.3% Q-o-Q; almost twice the drop in revenues due to the high fixed cost incurred by the company which are irrelevant to occupancy rates or footfall, in addition to high fixed costs from newly opened malls which haven't reached their target occupancy yet. Gross margin tightened to 53.0% vs 64.9% in Q3 FY2020.
- Impairment loss on accounts receivable surged by 79.2% Y-o-Y, but fell by 1.2% Q-o-Q, due to higher provisions on rent receivables. The company's decision to support SMEs through its agreement with "Quara Finance Company" should help lower provisions over the coming quarters. During the quarter, the company reported non-recurring gain of SAR40mn from the disposal of an associate. SG&A hiked by 23.9% Y-o-Y and 10.4% Q-o-Q on the back of higher employees' salaries and professional fees. EBIT dropped by 31.2% Y-o-Y and 4.5% Q-o-Q, while EBIT margin contracted by 9.6% to 42.8%. Excluding the non-recurring gain on disposal of associate, EBIT slumped by 45.0% Y-o-Y and 23.7% Q-o-Q.
- Finance costs dropped from a high base in Q3-FY2020 by 44.2% Y-o-Y and increased by 1.4% Q-o-Q. Net income decreased by 13.6% Y-o-Y and 14.0% Q-o-Q. Net margin increased by 60bps to 20.4% vs 19.8% a year earlier.
- High operating leverage wasn't in ACC's favor during Q3-FY2021 as it continued to pay the malls' fixed costs, in addition to the new malls which aren't mature yet, while offering high discount rates to its tenants to maintain occupancy. Coupled with continued elevated impairments and higher SG&A during the quarter, ACC reported its lowest net income in 10 quarters. However, we see a strong recovery potential for ACC's top-line and bottom-line starting FY2022 as the impact of rental discounts subsides, occupancy in recently opened malls ramp-up, footfall recovers in existing malls supported by vaccine rollout and lift of restrictions on malls, and lease renewal rates normalize.

ACC's Revenue & Revenue Growth



Source: Company data, Itqan Capital research

ACC's EBIT,EBIT Margin, NI Margin



Source: Company data, Itqan Capital research

[1] ACC's fiscal year end on March 31st, thus Q3 FY2021 represents the three months ended December 2020.

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Valuation Rationale

DCF Valuation

	2021E	2022 F	2023 F	2024 F	2025 F	2026 F	2027 F	2028 F	2029 F	Perp.
EBITDA	997	1,201	1,541	1,738	2,128	2,299	2,374	2,395	2,433	1,894
Operating CF	692	1,393	1,774	1,991	1,990	2,185	2,265	2,282	2,316	1,776
Capex	(822)	(1,613)	(1,110)	(153)	(230)	(230)	(234)	(271)	(271)	(274)
FCFF	(130)	(220)	664	1,838	1,761	1,956	2,031	2,011	2,045	1,502
Stub Period (FCF to be discounted)	(32)	(220)	664	1,838	1,761	1,956	2,031	2,011	2,045	1,502
PV (FCFF)	(31)	(201)	567	1,457	1,292	1,326	1,268	1,148	1,070	-

WACC	7.5%
Perpetuity Growth	1.0%
PV-FCFF	7,895
PV-TV	9,945
Net Debt	(6,182)
Less: End of services benefits	(26)
Less: Minority interest	(4)
Add: Abha Land	62
Add: Investments	84
Intrinsic Value	11,775
Shares Outstanding (mn shares)	475
Equity value per share (SAR)	24.8
CMP (05/04/2021)	22.28
Upside / Downside (%)	11.3%

We have valued Arabian Centers using Discounted Cash Flow (DCF) approach considering a Weighted Average Cost of Capital (WACC) of 7.5% in FY2021 and 8.6% at perpetuity. This was based on a blended cost of equity of 10.0% and a cost of debt of 5.5%. The terminal growth rate is 1.0%.

In estimating perpetuity FCFF, we took into consideration that current lease costs for leasehold properties will be renewed at significantly higher prices than the price in the current lease contract. We estimate lease costs to account for 50% of leasehold revenues upon renewal, while other cash flows will grow at the terminal growth rate of 1.0%.

Based on the DCF valuation, the 52 weeks target price of Arabian Centers is SAR24.8, which is higher than the traded value by 12.9%

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Comparable Peers

Local Peers	Country	Code	Market Price (SR)*	Market Cap (SRBN)	P/E	Sales (SRMN)	Net Income (SRMN)
Arabian Centres Co.	**KSA**	**4321**	22.28	10.6	23.2	1,918	457
Andalus Property Company	KSA	4320	23.00	1.6	Above 50	168	14
Red Sea Housing Service Co	KSA	4230	28.55	1.7	NEG	536	(158)
Saudi Real Estate Co. (SRECO)	KSA	4020	18.70	4.5	NEG	500	(141)
Taiba Holding Co	KSA	4090	30.90	5.0	Above 50	221	91
Makkah Construction & Development (MCDC)	KSA	4100	62.80	10.4	Above 50	123	(63)
Arriyadh Development Company (ARDCO)	KSA	4150	21.86	3.9	17.1	238	228
Emaar EC	KSA	4220	11.08	9.4	NEG	547	(1,248)
Jabal Omar	KSA	4250	29.00	27.0	NEG	177	(1,339)
Dar AL Arkan Development	KSA	4300	9.33	10.1	Above 50	1,945	19
Knowledge Economic City	KSA	4310	17.60	6.0	NEG	113	(26)

Financial Projections

Financial Ratios

	2020 A	2021 E	2022 F	2023F	2024 F	2025 F	2026 F
Return on Average Assets (%)	4.1%	2.5%	3.0%	4.6%	5.3%	6.8%	7.1%
Return on Average Equity (%)	11.5%	7.4%	9.2%	14.1%	16.2%	20.6%	21.1%
Income Before Zakat Margin (%)	30.2%	24.5%	26.8%	34.1%	36.2%	41.3%	41.3%
Net Income Margin (%)	29.2%	23.8%	26.0%	33.1%	35.1%	40.1%	40.0%
Revenue Growth (%)	1.0%	-14.5%	14.2%	21.5%	11.3%	16.1%	7.7%
DPS	0.9	1.0	1.2	1.5	1.7	2.1	2.3
Payout Ratio	67.4%	110.3%	101.0%	85.2%	81.0%	76.2%	76.7%

Income Statement

	2020 A	2021 E	2022 F	2023F	2024 F	2025 F	2026 F
Revenues	2,197	1,878	2,145	2,605	2,900	3,367	3,625
Cost of revenues	(759)	(811)	(882)	(974)	(1,067)	(1,175)	(1,243)
Gross Profit	**1,438**	**1,067**	**1,263**	**1,631**	**1,834**	**2,192**	**2,382**
SG&A	(315)	(332)	(273)	(305)	(337)	(375)	(412)
Other income, net	25	136	9	9	9	9	9
Finance Costs	(486)	(411)	(425)	(447)	(457)	(435)	(482)
Zakat	(20)	(14)	(17)	(27)	(31)	(42)	(45)
Net Income	**643**	**446**	**557**	**862**	**1,018**	**1,349**	**1,452**

Balance Sheet

	2020 A	2021 E	2022 F	2023F	2024 F	2025 F	2026 F
Current Assets	2,079	1,808	1,006	1,415	1,697	1,529	1,720
Non-Current Assets	15,882	16,418	17,418	17,803	17,252	19,069	18,565
Total Assets	**17,961**	**18,226**	**18,423**	**19,218**	**18,949**	**20,598**	**20,285**
Current Liabilities	1,024	1,172	1,275	1,463	3,485	1,937	2,092
Non-Current Liabilities	10,953	11,108	11,202	11,671	9,175	12,038	11,217
Total Equity	**5,984**	**5,945**	**5,947**	**6,084**	**6,289**	**6,623**	**6,977**
Total Liabilities and Equity	**17,961**	**18,226**	**18,423**	**19,218**	**18,949**	**20,598**	**20,285**

Guide to Ratings and Disclaimer

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

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