جلوبل Global

UAE Construction Contractors

UAE Contractors

- **Sector profits surge 50.0%QoQ in 4Q12; expected to rise 26.7%QoQ in 1Q13**
- **Order backlog touches a new two-year high, standing at AED27.0bn in 4Q12**
- **Stiff competition and rising costs to continue pressurizing margins**
- **Recommendation: HOLD: ARABTEC(AED 2.02/share) & HOLD: DSI(AED 0.77/share)**

Arabtec continues to lead the sector with a healthy order backlog supported by some large project wins recently. The company remains focused on expanding its portfolio and extending its reach to new geographies. Arabtec shuffled its management also and is going all out in raising money though bonds and rights issue. However, tough competition and rising input costs are expected to erode its margins over the medium term. On the other hand, DSI made a robust comeback in 4Q12, riding on the back of the ongoing recovery witnessed in the UAE real estate and construction markets. Nevertheless, DSI continues to struggle too with high competition and rising material costs. As a result the company is expected to witness a decline in margins over the coming few years.

Sector profits surge 50.0%QoQ in 4Q12; expected to rise 26.7%QoQ in 1Q13

Consolidated profit of UAE contractors continued to improve in 4Q12, maintaining the momentum gained since 2Q12. Consolidated profit rose to AED58.4mn in 4Q12, up 50.0%QoQ; however, it was down 70.5%YoY. The top line grew notably to AED2,857mn in 4Q12, up 41.6%QoQ, but a 48.9%QoQ rise in cost-of-sales led to a decline in gross margin from 11.1% in 3Q12 to 6.5% 4Q12. On the other hand, operating expenses came down 37.2%QoQ, which helped the operating margin rise to 2.1% in 4Q12 from 1.2% in 3Q12. As a result, the overall net margin of the sector improved to 2.0% in 4Q12 from 1.9% in 3Q12.

UAE Contractors

(AED mn)	**4Q11**	**3Q12**	**4Q12**	**QoQ**	**YoY**
Sales Revenue	2,340	2,018	2,857	41.6%	22.1%
Cost of Sales	2,014	1,794	2,671	48.9%	32.6%
Gross Profit	326	224	186	-16.9%	-42.9%
Operating Expense	75	200	126	-37.2%	67.7%
Operating Profit	251	24	61	151.5%	-75.9%
Financial Charges	15	13	29	127.5%	91.0%
Net Profit	198	39	58	50.0%	-70.5%
Gross Margin (%)	13.9%	11.1%	6.5%	-	-
Operating Margin (%)	10.7%	1.2%	2.1%	-	-
Net Margin (%)	8.5%	1.9%	2.0%	-	-

Source: Company Report & Global Research

As the construction industry picks up in UAE, revenues of firms are expected go up and translate into higher earnings for the industry from 2013. However, competition and construction costs remain key concerns. Competition is expected to affect margins of companies over the medium term while construction costs are expected to rise after having remained subdued over the past two years. Nevertheless, the uptick in the construction industry is expected to boost overall earnings to AED74mn in 1Q13, up 26.7% on a QoQ basis.

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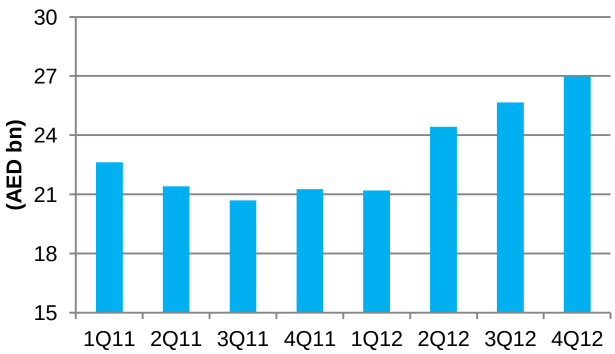
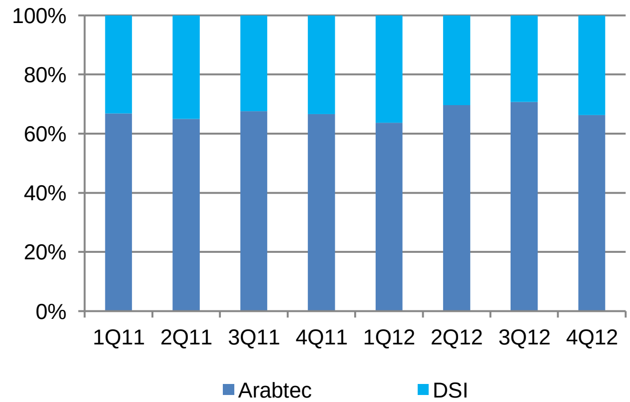
Order backlog touches a fresh two-year high; improving regulatory framework to provide further support

UAE contractors witnessed a robust growth in their order backlog over the last three quarters. Order backlog grew to a fresh two-year high of AED27.0bn in 4Q12, up 5.2%QoQ and 27.0%YoY. Order backlog was boosted by a solid growth in order receipts throughout the year 2012. Arabtec continues to lead the race with a market share of 66.3% of the total order backlog in 4Q12, remaining steady when compared to its market share of 66.6% in 4Q11. DSI accounts for remaining 33.7% of the market share.

UAE Contractors backlog (AED bn)



Backlog composition

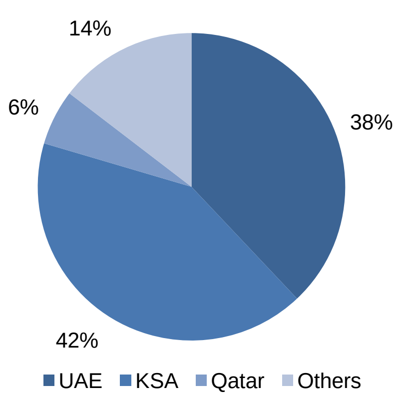


Source: Company Accounts and Global Research

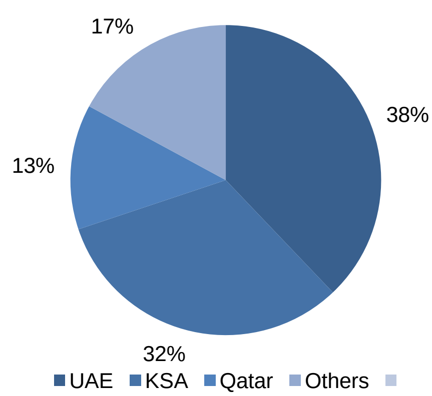
In terms of geography, order backlog from the UAE currently makes up the largest share for UAE contractors, standing at 38% in 4Q12, remaining unchanged from the level witnessed in 4Q11. Backlog from Qatar witnessed its market share going up to 13% in 4Q12 from 6% in 4Q11, driven by solid public sector spending in the country. Meanwhile, Saudi Arabia saw a decline in its market share from 42% in 4Q11 to 32% in 4Q12. Saudi Arabia's share declined as bureaucratic hurdles delayed projects in 2012.

UAE's construction sector is gearing up to grow robustly in the coming years primarily driven by its growing population that is estimated to increase to 6mn by 2015 from 5.4mn in 2010. The construction sector is projected to contribute 11.1% to UAE's GDP by 2015 (the Dubai Chamber of Commerce and Industry), up from 10.3% in 2011. The UAE construction industry continues to focus on projects in the infrastructure and residential/non-residential segments. At the same time, the construction sector has been receiving adequate support from the government in the form of favorable policies, such as permitting freeholds and leaseholds to non-UAE/GCC nationals, and allocation of 20% of the residential gross floor area to the middle income population. Moreover, the government policy of extending visas of real estate investors from six months to three years has facilitated in drawing fresh investments into the sector.

Order backlog by geography – 4Q11



Order backlog by geography – 4Q12

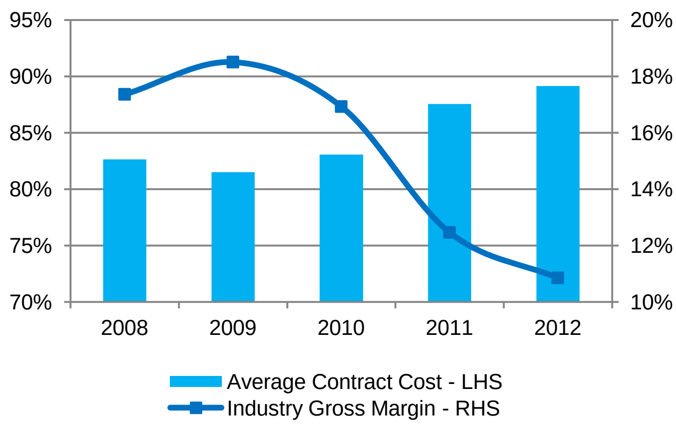


Source: Company Accounts and Global Research

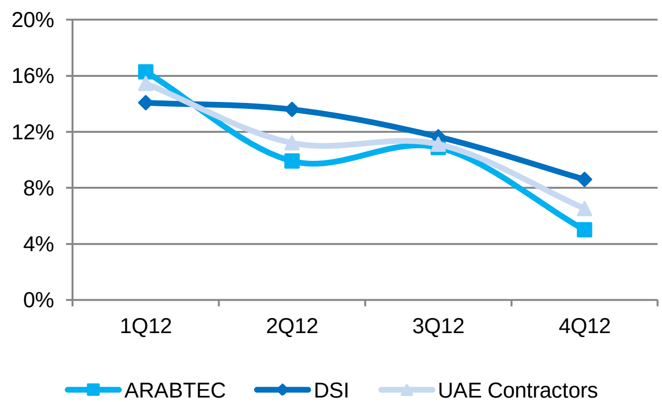
Stiff competition and rising costs to continue pressurizing margins

Delays in project execution, rising construction costs, and stiff competition in the civil segment have affected margins for UAE contractors in the past few years. Average contract costs (as % of revenues) for the industry increased from 81.5% in 2009 to 89.2% in 2012. Consequently, margins declined from 18.5% in 2009 to 10.3% in 2012. Rising competition has been limiting the contractors' bargaining power and thereby exerting pressure on margins. As a result, industry players have been forced to accept projects at lower margins to win new contracts. Furthermore, recent consolidation in the real estate sector (such as the recent merger Aldar Properties and Sorouh Real Estate) has led to fewer projects from larger developers, thereby reducing the bargaining power of contractors further.

Contract costs (% of revenues) & Gross margin (%)



Gross margin (%) - Quarterly



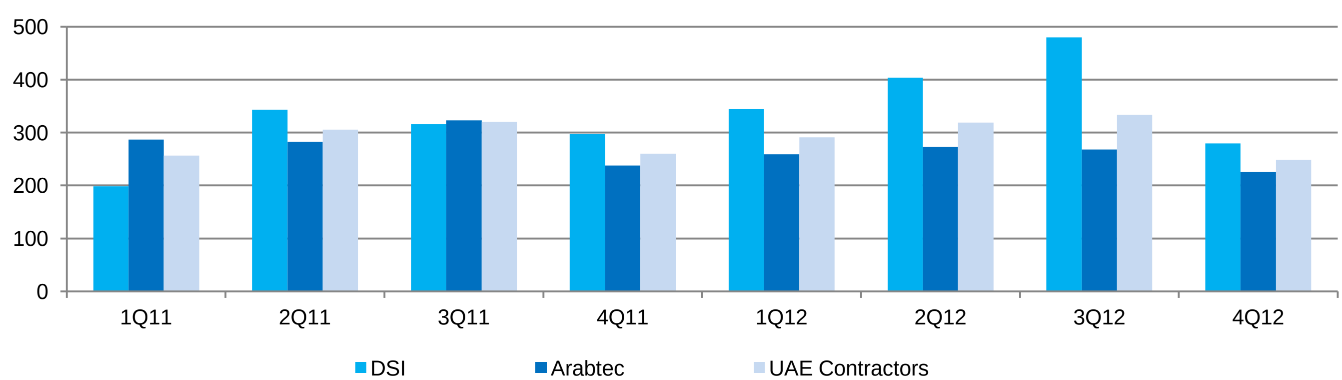
Source: Company Accounts and Global Research

During 4Q2012, Arabtec's gross margin declined to 5.0% (from 10.9% in 3Q2012 and 15.0% in 4Q2011) and net margin declined to 1.9 %(from 2.5% in 3Q2012 and 10.9% in 4Q2011). Decline in gross margin can be ascribed to the company's investment in low margin contracts. However, lower operating expenses and other income amounting to AED80mn aided in offsetting the decline in net margin. DSI also witnessed a decline in margins at gross level, while net margins improved on lower operating costs. The company's gross and net margins stood at 8.6% and 2.2%, respectively, in 4Q2012 vis-à-vis 11.6% and 0.6%, respectively, in 3Q2012. We expect margins to continue to decline over the next five years due to pricing pressure emanating from heightened competition and volatility in input prices.

Receivables position improve for the sector

During the financial crisis, many projects in the UAE were shelved or cancelled due to tight liquidity in the system, higher cost of debt, and fund raising difficulties. However, with an uptick in economic activities, there has been a reversal in trends in the construction industry.

Receivable performance (days)



Source: Company Accounts and Global Research

With new high profile projects and better management of receivables, UAE contractors have seen a decline in receivable days in 4Q12. Total receivable days for UAE contractors declined to 248 days in 4Q12 from 333 days in 3Q12. Arabtec witnessed a decline to 226 days in 4Q12 from 268 days in 3Q12, while DSI saw a significant fall to 280 days in 4Q12 from 480 days in 3Q12. Arabtec has been managing liquidity by contracting debt and delaying payments to its suppliers. We believe Arabtec is well positioned to meet its working capital requirements with low leverage and improving cash position. Currently, Arabtec's debt-to-equity stands at 0.27x, lower than the industry average of 0.69x. On the other hand, DSI's liquidity position is slightly stretched compared to Arabtec; however, it remains healthy with a debt-to-equity ratio of 0.49x. Going forward, stable business environment, smoother cash conversion cycle, and resolution of long dues will further improve the balance sheets of both the contractors.

UAE construction sector to remain on an upward curve

The UAE construction sector recovered notably in 2012 with its order backlog picking up from AED21.2mn in 1Q12 to AED27.0mn in 4Q12. Project activity has also picked up considerably across the spectrum aided by revival of previously stalled projects, fresh investments into new open spaces and improvement in the financing environment. In addition, the government continues to play an important role in pushing the sector up by setting up favorable policies. We expect the industry to receive further support from the rising activity in the tourism sector. Overall, we see the sector bouncing back to near the pre-crisis levels in 2013. However, tough competition continues to plague the sector, resulting in decline in margins across the board. At the same time, we expect rising construction costs to dent the margins further. Thus, we remain cautiously optimistic about the sector in 2013.

Valuation Methodology

For arriving at the fair value, we have used a blend of two valuation methods:

- Cash flow approach represented by the Discounted Cash Flow method.
- Relative valuation using peer group P/E multiple.

Valuation

	Drake & Scull (AED mn)	Arabtec Holding (AED mn)
DCF		
PV of Cash Flows & Terminal Value		
Yr 1	151	126
Yr 2	80	77
Yr 3	98	116
Yr 4	130	132
Terminal	2,939	4,037
Assumptions		
Growth Rate	3%	3%
Risk Free Rate	1.8%	1.8%
Risk Premium	10.3%	9.8%
COE	12.1%	11.6%
Equity Value	1,837	3,454
DCF based Fair Value per Share	**0.80**	**2.20**
Relative Valuation		
Peer Group Multiple	13.0	13.0
Price based on Relative Valuation Method	**0.64**	**1.30**
Fair Value		
Fair Value - DCF (80%)	0.64	1.76
Fair Value - Relative Valuation (20%)	0.13	0.26
Fair Value (AED)	**0.77**	**2.02**
Current Market Price (AED) - As of 11 April 2013	**0.80**	**2.16**
Upside / (Downside)	**-3.1%**	**-6.4%**
Recommendation	**HOLD**	**HOLD**

Source: Global Research

Sensitivity Analysis

Arabtec

	Terminal Growth Rate						COE				
WACC	1.0%	2.0%	3.0%	4.0%	5.0%	COD	9.6%	10.6%	11.6%	12.6%	13.6%
5.4%	2.11	2.62	3.56	5.84	19.72	4.0%	3.56	3.24	2.98	2.75	2.56
6.4%	1.75	2.07	2.56	3.48	5.70	5.0%	2.75	2.56	2.40	2.26	2.13
7.4%	1.51	1.72	2.02	2.51	3.40	6.0%	2.26	2.13	2.02	1.92	1.83
8.4%	1.33	1.48	1.68	1.98	2.45	7.0%	1.92	1.83	1.75	1.68	1.61
9.4%	1.19	1.30	1.45	1.65	1.94	8.0%	1.68	1.61	1.55	1.50	1.45

Drake & Scull

	Terminal Growth Rate						COE				
WACC	1.0%	2.0%	3.0%	4.0%	5.0%	COD	10.1%	11.1%	12.1%	13.1%	14.1%
7.4%	0.81	0.97	1.19	1.55	2.22	1.0%	1.19	1.01	0.87	0.76	0.67
8.4%	0.68	0.79	0.94	1.16	1.51	2.0%	1.11	0.94	0.82	0.72	0.64
9.4%	0.58	0.66	0.77	0.92	1.13	3.0%	1.03	0.88	0.77	0.68	0.61
10.4%	0.51	0.57	0.65	0.75	0.89	4.0%	0.96	0.83	0.73	0.65	0.58
11.4%	0.44	0.49	0.55	0.63	0.73	5.0%	0.90	0.79	0.69	0.62	0.55

Peer Group Comparison

Name of Company	Market Cap USD	Absolute 1M	Absolute 3M	Absolute 12M	PE(x)*	PB(x)*	ROE (%)	ROA (%)	Net Margin (%)
Regional Contractors									
Arabtec Holding	923.2	2.4%	-18.5%	-34.3%	21.54	1.12	4.76	1.57	2.46
Drake and Scull International	495.6	3.6%	4.1%	-17.2%	16.24	0.66	3.44	1.55	2.84
Combined Group Contracting	508.6	-4.2%	-5.6%	-12.0%	14.79	3.59	25.18	6.46	5.79
Al Khodari & Sons	437.7	21.7%	11.2%	-29.1%	11.49	1.90	17.52	5.02	8.89
Galfar Engineering	264.3	5.5%	3.5%	-11.8%	16.65	1.37	9.80	2.00	2.70
Nass Corporation	79.9	-15.4%	-1.4%	0.0%	7.35	0.54	7.38	3.93	3.56
Global Contractors									
Larsen & Toubro Ltd	15,361.7	-9.8%	-11.2%	5.3%	90.60	2.83	17.24	4.39	6.81
China Railway Construction	10,079.4	-2.4%	-19.6%	18.9%	7.23	0.85	12.40	1.89	1.76
ENKA	8,920.8	6.0%	-5.3%	15.7%	15.11	1.86	12.47	7.98	11.63
Hitachi Construction	4,911.0	12.2%	18.1%	24.8%	20.07	1.47	7.42	2.83	3.58
Gamuda Bhd	2,882.2	4.6%	10.4%	13.8%	14.79	2.12	14.39	7.35	17.87
Aveng Ltd	1,336.5	-15.1%	-1.7%	-26.1%	22.60	0.89	4.03	1.99	1.28

*Source: Reuters & Global Research, * Values for Arabtec, DSI and Al Khodari are one year forward multiples and the rest on TTM basis*

As of April 14, 2013

Arabtec Holding (Arabtec)

HOLD
Target Price
AED2.02

Market Data

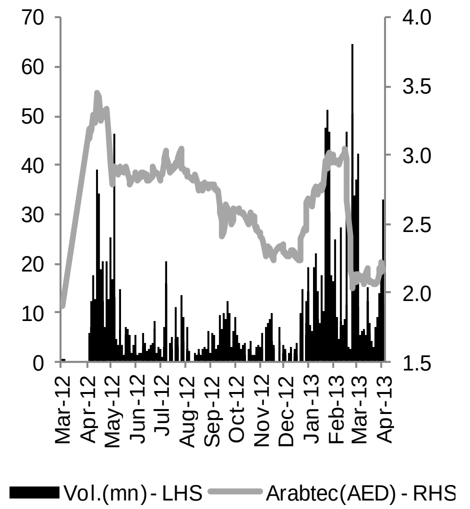
Bloomberg Code:	ARTC UH
Reuters Code:	ARTC.DU
CMP (14th Apr 2013):	2.16
O/S (mn)	1,569.8
Market Cap (AED mn):	3,390.6
Market Cap (USD mn):	923.2
P/E 2013e (x):	21.5
P/BV 2013e (x):	1.1

Price Performance 1-Yr

High (AED):	3.5
Low (AED):	2.0
Average Volume ('000):	8,440

	1m	3m	12m
Absolute (%)	2.4	-18.5	-34.3
Relative (%)	3.1	13.8	17.7

Price Volume Performance



Source: Reuters

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- **Earnings slide 37.1%YoY in 2012**
- **Robust order backlog to propel revenue growth**
- **Aabar Investments continues to drive Arabtec's strategic objectives**
- **Target price revised down with a HOLD rating**

Arabtec continues to remain aggressive, with its initiative to grow in newer business segments as well as new geographies. With expected recovery in the UAE construction market, we see Arabtec increasing its revenues significantly over the coming years. However, rising competition and increasing input prices continue to be the biggest concerns. We expect the EPS for 2013 to come in at AED0.10 and thus revise our recommendation to a HOLD rating on the stock.

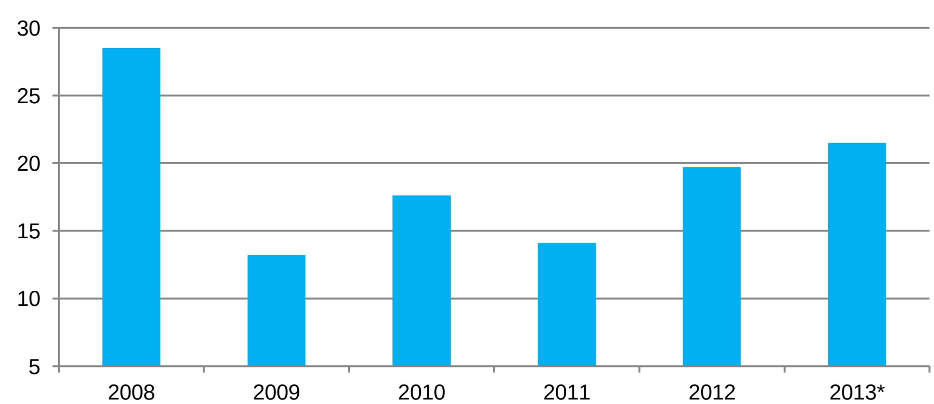
Earnings slide 37.1%YoY in 2012

Arabtec's net profit fell 37.1%YoY to AED139.2mn in 2012 and declined 9.5%YoY to AED31.7mn in 4Q12. The decline was majorly caused by a rise in contract costs and a decline in one-off items that included other operating income, profit from sale of investments, and miscellaneous income. Adjusting for these one-off items (except for other operating income) net income increased 13.9%YoY during 2012.

Robust order backlog to propel revenue growth

Arabtec witnessed a significant improvement in its order backlog over last year, rising 39.7% to AED19.7bn in 2012 from AED14.1bn in 2011. As a result, Arabtec's revenues surged 15.0%YoY to AED6.5bn in 2012. Furthermore, the order backlog has already gained 9.1% to AED21.5bn to date in 2013.

Order backlog (AED bn) – 2008-13

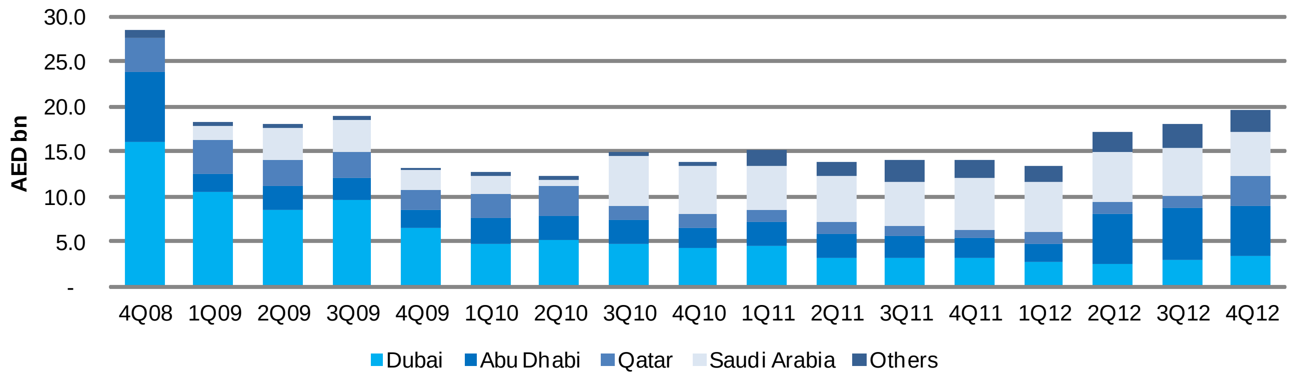


*Source: Company accounts and Global Research, *YTD*

Arabtec won some major projects at the tail end of 2012. These projects include the AED3.6bn contract for Abu Dhabi International Airport and the AED2.3bn contract for Phase 2 of Msheireb Downtown Doha. The company continues to win big projects in 2013, having bagged the contracts for the Fairmont Hotel and the Louvre project, worth AED1.1bn and AED0.8bn respectively.

Currently, Arabtec's backlog/revenues ratio stands at 3.3x, the highest level in the last five years. Project cancellations in the UAE have reduced significantly during the year; project execution pace of Arabtec has not declined either. Thus we expect Arabtec to post strong revenue growth in the coming quarters.

Backlog Break-Up



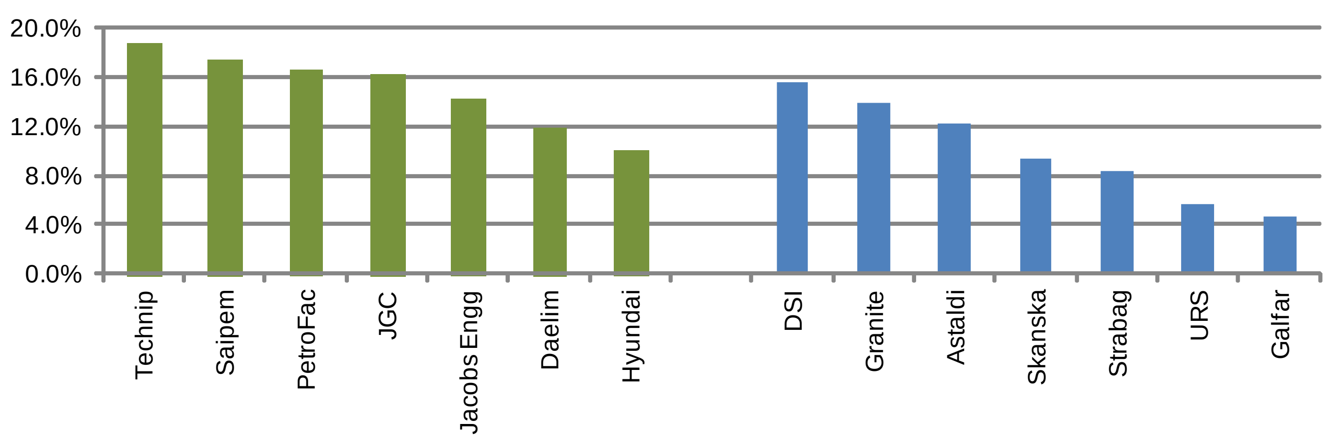
Source: Company data, Global Research

Arabtec is expected to remain aggressive in its expansion strategy over the coming years. The company sees tremendous opportunities in the sectors of Oil & Gas, Power, Infrastructure, and Housing, and plans to expand in these areas. Arabtec intends to capitalize on the ongoing construction boom in UAE, Saudi Arabia, and Qatar. At the end of 2012, UAE remains the biggest contributor to Arabtec's order backlog at 46%, followed by Saudi Arabia at 24%, and Qatar at 17%. In addition, the company also plans to expand operations in the emerging markets, with specific focus on India.

Oil & Gas, Infrastructure, and Housing sectors to help sustain margins

Arabtec has clearly stated its strategy of focusing on the higher margin segments of Oil & Gas and Infrastructure in the next five years. The company plans to augment its capabilities in the Oil & Gas through its subsidiary Target Engineering (Target). Up till 2015, capital expenditure amounting to almost USD300bn is expected in the MENA region. Arabtec plans to form tie-ups with other established international players in the market to tap the huge potential in this segment. As for the Housing industry, Arabtec realizes the need of affordable housing for the rising population across the MENA region. As per recent estimates, there exists a shortage of 3.6mn homes in the MENA region and Arabtec wants to leverage its existing status in this segment.

Oil & Gas EPC (Gross Margin - Avg 2010-12) | **Civil / Infrastructure EPC (Gross Margin - Avg 2010-12)**



Source: Arabtec

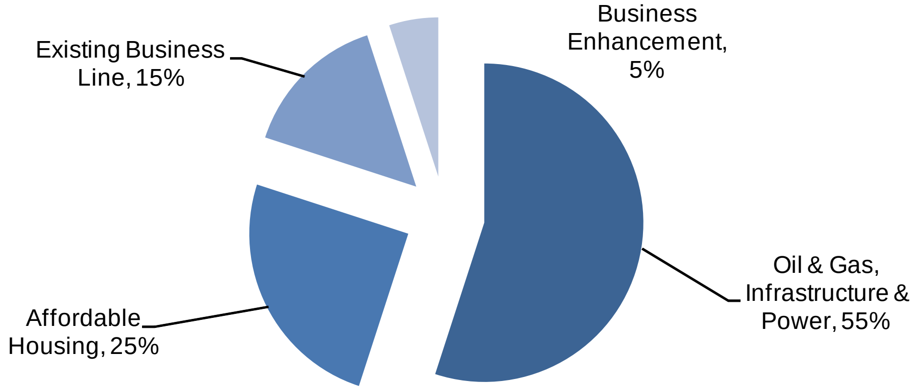
In the current competitive industry scenario, Arabtec's focus on higher margin business of Oil & Gas is expected to restrict its margin fall in the next five years. However, margins would continue to decline owing to increasing input prices and high competition. We expect gross margin to decline to 9.7% in 2016 from 10.2% in 2012. On the other hand, we expect the operating margin to remain fairly steady at 1.9% in 2016 from 1.9% in 2012.

Aabar Investments continues to drive Arabtec's strategic objectives

Aabar Investments (Aabar) continues to influence Arabtec's strategic direction. Aabar upped its stake in Arabtec to 21% in 2012, which was welcomed by the investors as reflected in a single day 4.7% jump in the stock price. Since then, Aabar has brought in a sea of change within Arabtec. On one hand, four executives from Aabar were brought into Arabtec's board including the Chairman; on the other hand, the upper management, including CEO, CFO (Construction Group) and COO, were all replaced. In addition, Arabtec roped in a new executive to head its mergers & acquisitions division. Aabar has also been instrumental in getting new projects to Arabtec in recent times that include the AED10.8bn Abu Dhabi Airports Company contract and the AED222mn residential development project in Reems Island (Abu Dhabi).

Furthermore, in order the fuel the company's strategic objectives, Arabtec announced a rights and convertible bonds issue recently. Arabtec plans to raise USD1.3bn through the rights issue, spread equally over the coming two years. Additionally, the company plans to raise another USD450mn through a non-convertible bonds issue. The rights issue proposal has already been approved by Arabtec's Board and the Securities and Commodities Authority (SCA) for an issuance up to 3.2bn shares with a nominal value of AED1.0 and an issuance premium of AED0.5 per share. Similarly, the convertible bond issue has also been granted approval by the Board.

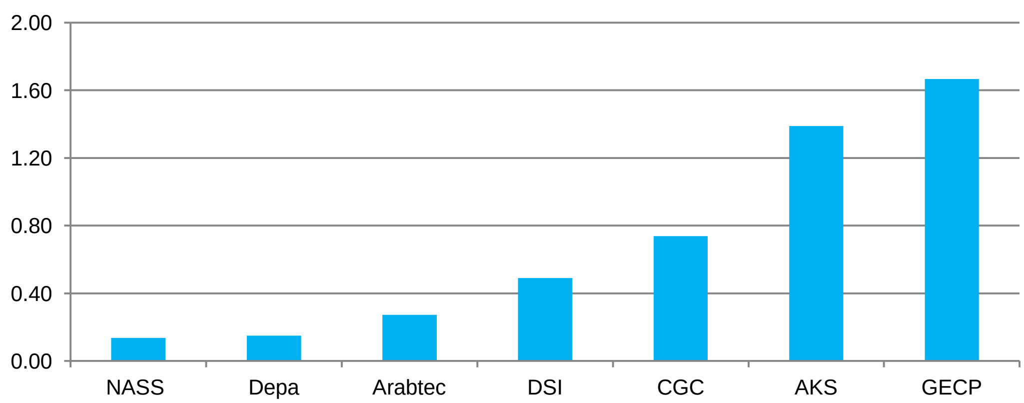
Use of Right Share Proceeds



Source: Arabtec

However, Arabtec's intention to raise money via the rights/bonds issue route has not gone down well with the investors due to concerns of shareholding dilution. As a result, the stock was beaten down to a year-to-date low of AED2.04 on March 6, 2013, from AED2.96 on February, 27, 2013 (the date of announcement). As for the convertible bond issue, the company has maintained that it will engage in the issuance only if it feels a need to do so. However, we feel that Arabtec has adequate debt capacity at the moment to go ahead with the bond issuance, given its low debt-to-equity ratio of 0.27x vis-à-vis 0.69x of the industry. Even if Arabtec goes through the bond issuance, its debt-to-equity ratio would come in around 0.42x, still lower than the industry average.

Debt-to-Equity ratio (x) – Industry peers



Source: Company accounts and Global Research

Arabtec agrees for an out-of-court settlement with Meydan

The four-year long running dispute between the Arabtec – WCT (Malaysia) joint venture and Meydan Group has moved towards a stage of amicable solution recently. Both the parties have decided to put an end to their multimillion dollar dispute by engaging into an out-of-court settlement. Arabtec continues to carry a significant amount of receivables from Meydan (around AED500mn), which has not been provisioned yet and could hit the earnings notably once the settlement takes place. We await more clarity on the settlement process to assess the financial impact of this event.

Focus on emerging markets offer further opportunities

Arabtec realizes the potential offered by emerging economies such as India, Brazil, and China, and thus wants to concentrate on the opportunities offered by these markets. The emerging markets continue to invest in infrastructure development in their respective economies. Furthermore, the emerging economies are expected to see growth rates (in construction sector) higher than that expected in the MENA region. While the construction sector in the MENA market is expected to grow at 6–7%, most of the other emerging markets are expected to see a 7% plus level of growth in their respective construction segments. Out of all these markets, Arabtec intends to focus mainly on India. Indian government plans to invest USD5tr in the infrastructure industry over the next five years. In order to foster growth in the segment, the government has also signed various agreements in the recent past that also includes the MoU with the Department for Business, Innovation and Skills, UK. Thus, the company remains on track to increase its presence across key construction markets.

Target price cut to AED2.02 – revised recommendation to HOLD

Arabtec remains aggressive in its growth plans, especially with its investment in areas of Oil & Gas, Infrastructure, and Housing. At the same time, the company also remains focused on expanding geographically across key markets such as India, China, and Latin America, which instills our confidence in the company's revenue growth prospects over the coming years. However, profitability of the business remains the biggest concern at the moment. High competition and increasing input prices are expected to slash the margins going forward.

We arrived at our final valuation using the weighted average of DCF and relative methodologies, which yielded a target price of AED2.02, which is 6.4% below the current market price. Thus, we revise down our recommendation to **HOLD** on the stock.

Financial Statements

	(AED mn)	2010	2011	2012	2013E	2014E	2015E	2016E
Income Statement	Total Revenues	5,464	4,924	5,660	6,792	7,811	8,787	9,885
	Cost of Production	(4,637)	(4,375)	(5,084)	(6,096)	(7,019)	(7,918)	(8,922)
	Gross Profit	**827**	**548**	**576**	**696**	**792**	**869**	**963**
	General & Administrative Expenses	(225)	(175)	(208)	(251)	(289)	(316)	(356)
	Staff Costs	(173)	(193)	(200)	(238)	(273)	(308)	(346)
	Other Operating Income	47	37	17	20	23	26	30
	Depreciation & Amortisation	(83)	(78)	(77)	(80)	(88)	(97)	(107)
	Provision for bad debts	32	-	-	-	-	-	-
	Total Operating Income	**425**	**139**	**108**	**147**	**164**	**174**	**185**
	EBITDA	507	217	185	227	253	271	291
	Other Income	13	127	82	65	67	69	71
	Profit Before Tax	**438**	**266**	**190**	**212**	**231**	**243**	**256**
	Taxation	(6)	(2)	(2)	(2)	(2)	(2)	(2)
	Net Profit	**432**	**264**	**188**	**210**	**229**	**241**	**253**
	Minority Interest	(124)	(42)	(49)	(52)	(57)	(60)	(63)
	Net Profit Attributable to Parent	**307**	**221**	**139**	**157**	**172**	**180**	**190**
Balance Sheet	Cash & cash equivalents	593	688	812	1,011	1,198	1,438	1,756
	Trade & other receivables	4,202	3,856	4,145	4,681	5,435	6,235	7,015
	Due from related parties	724	1,058	1,061	1,273	1,464	1,647	1,853
	Inventories	369	319	203	243	280	316	356
	Other current assets	306	262	267	256	294	331	372
	Total Current Assets	**6,194**	**6,183**	**6,487**	**7,463**	**8,672**	**9,967**	**11,352**
	Intangible assets and Goodwill	391	343	293	293	293	293	293
	Retentions receivable (Non-current)	775	798	668	802	922	1,037	1,167
	Net fixed assets	1,272	1,181	1,108	1,111	1,101	1,076	1,036
	Other non-current assets	58	218	395	395	395	395	395
	Total Assets	**8,689**	**8,722**	**8,952**	**10,065**	**11,383**	**12,768**	**14,243**
	Bank borrowings (Current)	627	468	647	725	812	901	991
	Trade & other payables	4,183	3,866	3,930	4,810	5,845	6,941	8,066
	Due to related parties	348	817	571	585	615	651	733
	Total Current Liabilities	**5,163**	**5,153**	**5,148**	**6,120**	**7,273**	**8,494**	**9,792**
	Retentions payable (Non-current)	110	56	153	176	197	216	238
	Bank borrowings (Non-current)	114	127	166	174	200	225	253
	Employee Indemnity Provision	204	92	139	145	153	160	168
	Paid-up Capital	1,196	1,495	1,570	1,570	1,570	1,570	1,570
	Retained Earnings	1,216	1,107	1,068	1,140	1,216	1,292	1,373
	Other Reserves	268	294	309	325	342	360	379
	Shareholders' Equity	**2,680**	**2,896**	**2,947**	**3,034**	**3,128**	**3,222**	**3,322**
	Non-controlling interest	418	398	399	415	432	450	469
	Total Equity & Liability	**8,689**	**8,722**	**8,952**	**10,065**	**11,383**	**12,768**	**14,243**
Cash Flow	Cash from Operating Activities	361	503	217	364	347	410	455
	Cash from Investing Activities	(157)	(125)	(250)	(160)	(148)	(151)	(115)
	Cash from Financing Activities	(250)	(199)	(38)	(6)	(11)	(19)	(23)
	Change in Cash	(46)	179	(71)	198	187	240	318
	Net Cash at End	**236**	**688**	**812**	**1,011**	**1,198**	**1,438**	**1,756**
Ratio Analysis	Gross Profit Margin	15.1%	11.1%	10.2%	10.2%	10.1%	9.9%	9.7%
	Operating Margin	7.8%	2.8%	1.9%	2.2%	2.1%	2.0%	1.9%
	EBITDA Margin	9.3%	4.4%	3.3%	3.3%	3.2%	3.1%	2.9%
	Net Profit Margin	5.6%	4.5%	2.5%	2.3%	2.2%	2.1%	1.9%
	Current Ratio (x)	1.2	1.2	1.3	1.2	1.2	1.2	1.2
	Debt/Equity (x)	0.3	0.2	0.3	0.3	0.3	0.3	0.4
	ROAA	3.5%	2.5%	1.6%	1.7%	1.6%	1.5%	1.4%
	ROAE	12.1%	7.9%	4.8%	5.3%	5.6%	5.7%	5.8%
	Adjusted EPS (AED)	0.2	0.1	0.1	0.1	0.1	0.1	0.1
	Adjusted BVPS (AED)	1.7	1.8	1.9	1.9	2.0	2.1	2.1
	Market Price (AED) *	1.58	1.51	2.24	2.16	2.16	2.16	2.16
	Market Capitalization (AED mn)	2,473.9	2,370.3	3,516.2	3,390.6	3,390.6	3,390.6	3,390.6
	EV/EBITDA (x)	4.7	8.5	18.3	13.8	12.0	10.6	9.1
	P/E Ratio (x)	8.1	10.7	25.3	21.5	19.7	18.8	17.8
	P/BV Ratio (x)	0.9	0.8	1.2	1.1	1.1	1.1	1.0

Source: Company Reports & Global Research

** Market price for 2013 and subsequent years as per closing prices on DFM on April 14, 2013*

Drake & Scull International (DSI)

HOLD
Target Price
AED0.77

Market Data

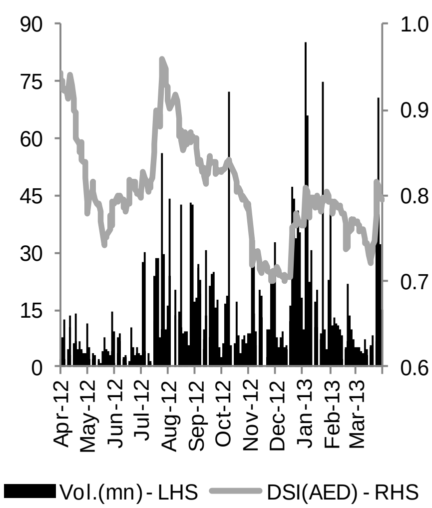
Bloomberg Code:	DSI UH
Reuters Code:	DSI.DU
CMP (14th Apr 2013):	0.80
O/S (mn)	2,252.6
Market Cap (AED mn):	1,820.1
Market Cap (USD mn):	495.6
P/E 2013e (x):	16.2
P/BV 2013e (x):	0.7

Price Performance 1-Yr

High (AED):	1.0
Low (AED):	0.7
Average Volume ('000):	12,637

	1m	3m	12m
Absolute (%)	3.6	4.1	-17.2
Relative (%)	3.1	13.8	17.7

Price Volume Performance



Source: Reuters

- **Earnings grow over five-fold to AED26.7mn in 4Q12**
- **Order backlog on an upswing; revenues expected to surge in 2013**
- **Competition and rising cost of building materials to erode margins**
- **Target price revised to AED0.77; maintain HOLD rating**

DSI made a strong comeback in 4Q12, with over five-fold growth in net income. However, the company's performance remains weak on an annual basis. Revenues are expected to grow in line with the current uptrend in the industry. However, rising competition and construction costs are expected to significantly dent margins. We revise our EPS estimate for 2013 to AED0.05 while maintaining a HOLD rating on the stock.

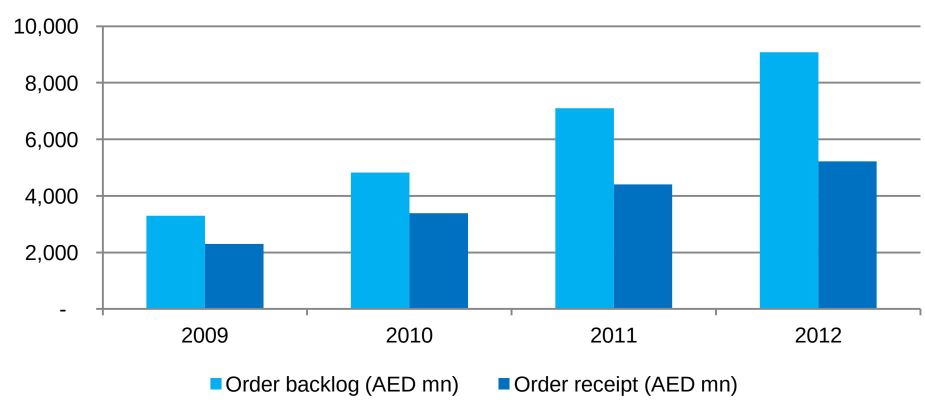
Earnings grow over five-fold to AED26.7mn in 4Q12

DSI picked up momentum in 4Q12, after a dismal performance in the previous four quarters. Net profit surged more than five-fold (QoQ) to AED26.7mn in 4Q12. The rise in earnings is ascribed to a 46.4%QoQ decline in General & Administrative costs to AED43.7mn from AED81.5mn in 3Q12. However, on an annual basis, net profits were down 51.2%, weighed heavily by the weak performance in the previous quarters.

Order backlog on an upswing; revenues expected to surge in 2013

DSI's order backlog remains strong, increasing 27.9%YoY in 2012, despite a high-growth phase during the previous two years (47.1% YoY in 2011 and 46.3%YoY in 2010). New order receipts rose 18.6%YoY to AED5.2bn in 2012, after surging 30.1%YoY in 2011 and 47.0%YoY in 2010.

Order backlog (AED mn) and Order receipt (AED mn) – 2009–12



Source: Company Accounts and Global Research

DSI won some major contracts in 2012, including the Jabal Omar and KAPSARC projects worth AED1.7bn and AED0.4bn, respectively. With an uptick in the UAE construction industry, we expect the trend to continue. Accordingly, we expect DSI's order backlog to grow to almost AED14.1bn by 2016.

At 2.7x, DSI's current backlog/revenues ratio is sound and ahead of most regional peers (barring Arabtec). In addition, a stable rate of project execution is expected to boost revenues to AED3.9bn in 2013 from AED3.3bn in 2012. Furthermore, with the sector building up momentum in the coming years, we expect DSI's revenues to grow at a CAGR of 13.4% to AED5.5bn by 2016.

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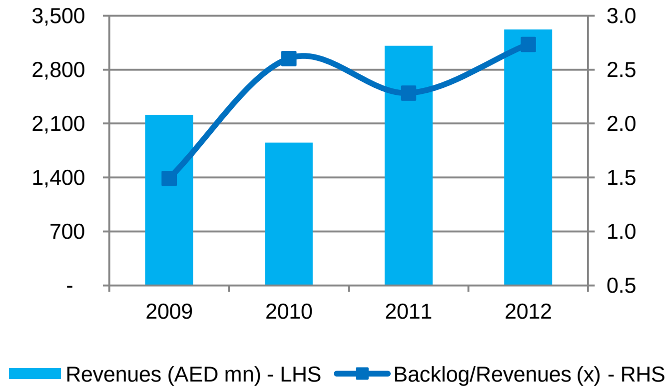
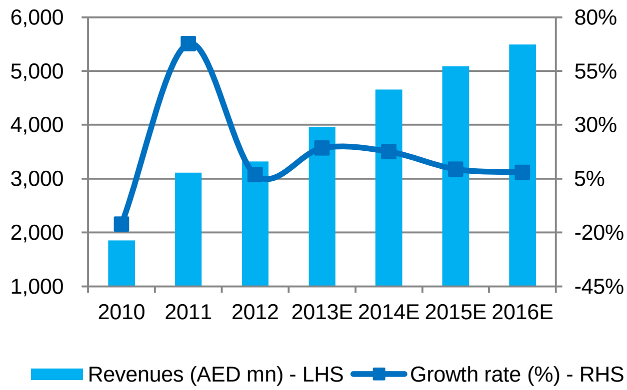
Revenues (AED mn) and Backlog/Revenues (x)



Revenues (AED mn) and Growth Rate (%)



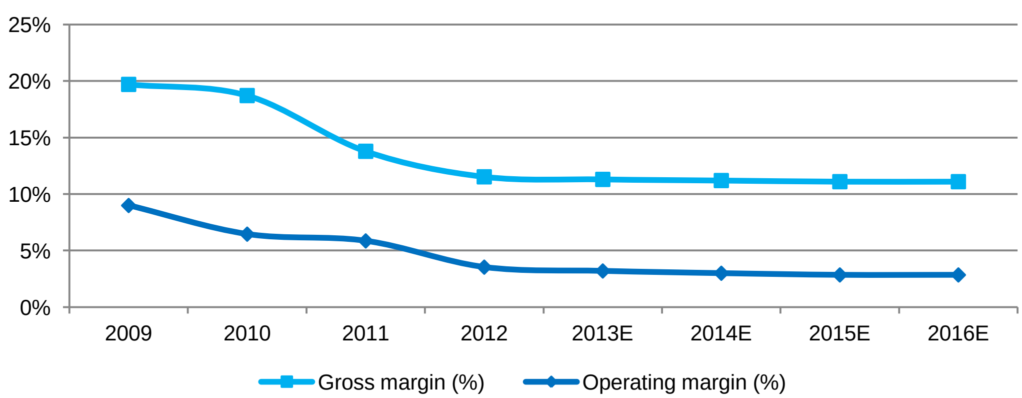
Source: Company Accounts and Global Research

DSI's MEP and Civil divisions continue to drive order backlog. During 4Q12, the Civil division contributed AED1.7bn to the total new contracts and the MEP division AED0.6bn. In addition, DSI continues to expand presence in the key markets of Saudi Arabia and Qatar, which is expected to further boost the order backlog.

Competition and rising cost of construction materials to erode margins

Rising competition in the UAE construction industry continues to pose a challenge for all major players. With consolidation at the upper end of the real estate sector value chain, especially the recent merger of Aldar Properties and Sorouh Real Estate, we expect more number of contractors bidding for the few projects. This is forcing contractors to accept projects at lower margins, which is evident from the continuous decline in DSI's gross margin over the past few quarters. Meanwhile, this has trickled down to hurt the company's operating margins.

Gross margin (%) and Operating margin (%)



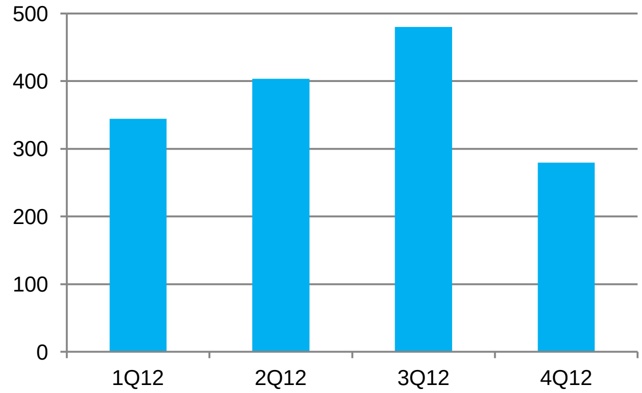
Source: Company Accounts and Global Research

We expect the competitive scenario to continue in the coming years. Furthermore, the cost of construction materials is expected to increase 2013 onwards, after remaining subdued over the past two years. Thus, we expect DSI's gross margin to decline to 11.1% by 2016 from 11.5% in 2012. Similarly, we expect operating margin to fall to 2.8% from 3.5% during the same period.

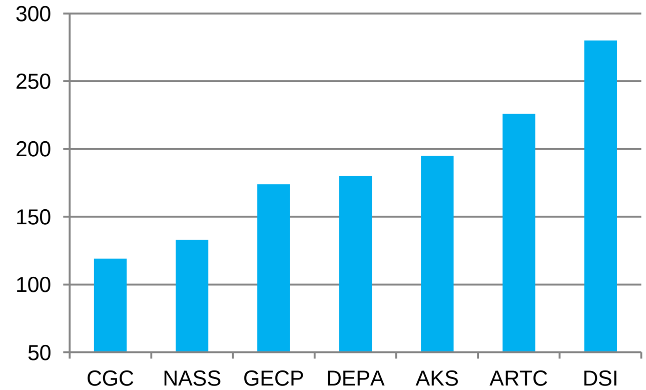
Receivable days decline unexpectedly; cash position improves

DSI's outstanding receivable days declined sharply to 280 in 4Q12 from 480 in 3Q12. This is a marked improvement given that the stall in the UAE construction industry led to an abnormal rise in DSI's receivables in the previous years. The unexpected decline in receivable days has been resulted by a 93.4% growth in revenues in 4Q12. However, DSI's receivable days continue to rise on an annual basis, coming in at 411 days in 2012, up from 341 days in 2011. Furthermore, DSI's receivable days (quarterly basis) continues to be the highest among regional peers.

Receivable days - Quarterly



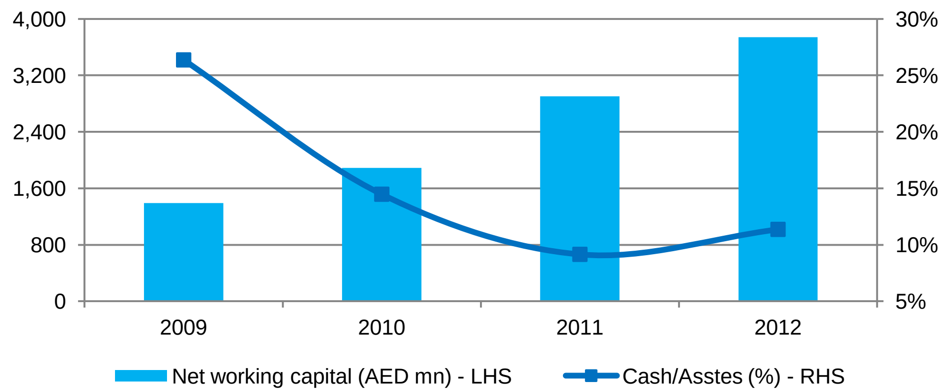
Receivable days – Peer comparison



Source: Company Accounts and Global Research

During 4Q12, DSI reported improvement in its cash position. The cash/assets ratio jumped to 11.4% from 4.3% in 3Q12. Similarly, the cash/debt ratio improved to 55.0% from 28.8% during this period. On an annual basis, the cash/assets ratio increased to 11.4% in 2012 from 9.2% in 2011. An improved cash position is expected to help the company to manage its increased working capital requirements efficiently.

Net working capital (AED mn) and Cash/Assets (%)



Source: Company Accounts and Global Research

Target price increased to AED0.77; maintain our rating at HOLD

DSI's order backlog continues to expand significantly; the company has already won some major projects in 2013. DSI remains focused on key regional construction markets such as Saudi Arabia and Qatar in addition to its strong presence in the UAE. However, this improvement in project activity has been primarily driven by overall expansion in the UAE construction industry. Moreover, the company continues to jostle rising competition and construction costs, resulting in lower margins.

We arrived at our final valuation using the weighted average of the DCF and relative methodologies, yielding a target price of AED0.77, which is 3.1% below the current market price. Thus, we maintain our **HOLD** recommendation on the stock.

Financial Statements

	(AED mn)	2010	2011	2012	2013E	2014E	2015E	2016E
Income Statement	Contract Revenue	1,855	3,110	3,321	3,959	4,654	5,091	5,492
	Contract Costs	(1,507)	(2,681)	(2,938)	(3,512)	(4,133)	(4,526)	(4,883)
	Gross Profit	**347**	**429**	**383**	**447**	**521**	**565**	**610**
	Selling, Gen. & Administrative Expense	(227)	(247)	(265)	(321)	(382)	(420)	(453)
	Operating Profit	**120**	**182**	**118**	**127**	**140**	**145**	**157**
	Other Income	70	61	34	37	41	45	50
	Financial Charges	(33)	(24)	(17)	(20)	(19)	(17)	(16)
	Profit Before Tax	**156**	**219**	**134**	**144**	**162**	**173**	**190**
	Minority Interest & Income Tax	(2)	(26)	(40)	(32)	(36)	(38)	(42)
	Profit After Tax	**155**	**193**	**94**	**112**	**126**	**135**	**148**
Balance Sheet	Cash and Bank Balance	705	525	731	754	721	733	814
	Contract Receivables & Retentions	1,266	1,857	1,912	2,061	2,295	2,371	2,408
	Contract Work in Progress	622	1,044	1,830	2,117	2,435	2,666	2,876
	Inventories	25	26	27	32	34	37	40
	Other Assets	738	293	96	96	96	96	96
	Total Current Assets	3,356	3,746	4,595	5,059	5,580	5,903	6,234
	Goodwill & Other Assets	1,203	1,381	1,311	1,316	1,321	1,327	1,333
	Long Term Investments	13	65	20	20	20	20	20
	Prepayments	15	3	-	-	-	-	-
	Property, Plant & Equipment	250	423	504	583	664	741	816
	Loans & Advances	34	123	-	-	-	-	-
	Total Non-Current Assets	1,514	1,995	1,835	1,919	2,005	2,088	2,168
	Total Assets	**4,871**	**5,741**	**6,430**	**6,978**	**7,585**	**7,991**	**8,402**
	Loans	789	829	1,329	1,220	1,124	1,041	968
	Payables	963	1,399	1,518	1,924	2,321	2,604	2,876
	Others	575	794	792	976	1,207	1,333	1,455
	Share Capital	2,178	2,178	2,285	2,285	2,285	2,285	2,285
	Statutory Reserve	49	98	104	106	108	110	112
	Treasury Shares	(29)	(29)	(29)	(29)	(29)	(29)	(29)
	Minority Interest	72	32	53	64	77	90	105
	Foreign Currency Translation Reserve	(8)	(9)	(8)	(8)	(8)	(8)	(8)
	Retained Earnings	280	447	364	418	479	544	616
	Total Shareholders Equity	2,542	2,718	2,769	2,836	2,911	2,992	3,081
	Total Equity & Liability	**4,871**	**5,741**	**6,430**	**6,978**	**7,585**	**7,991**	**8,402**
Cash Flow	Cash Flow from Operating Activities	(138)	(121)	(450)	162	113	157	225
	Cash Flow from Investing Activities	(219)	25	234	(92)	(98)	(99)	(99)
	Cash Flow from Financing Activities	(266)	276	617	(47)	(48)	(46)	(45)
	Change in Cash	(623)	180	402	23	(33)	13	81
	Net Cash at End	**705**	**525**	**731**	**754**	**721**	**733**	**814**
Ratio Analysis	Current Ratio (x)	1.5	1.3	1.3	1.3	1.3	1.3	1.3
	Quick Ratio (x)	1.5	1.3	1.3	1.3	1.3	1.3	1.3
	Gross Profit Margin	18.7%	13.8%	11.5%	11.3%	11.2%	11.1%	11.1%
	Operating Margin	6.5%	5.9%	3.5%	3.2%	3.0%	2.9%	2.8%
	Net Profit Margin	8.3%	6.2%	2.8%	2.8%	2.7%	2.6%	2.7%
	Return on Average Assets	3.3%	3.6%	1.5%	1.7%	1.7%	1.7%	1.8%
	Return on Average Equity	6.1%	7.3%	3.4%	4.0%	4.4%	4.6%	4.9%
	Debt / Equity (x)	0.31	0.31	0.48	0.43	0.39	0.35	0.31
	EV/Backlog (x)	0.50	0.29	0.25	0.22	0.19	0.17	0.15
	EV/Revenues (x)	1.31	0.66	0.68	0.59	0.49	0.44	0.38
	EV/EBITDA (x)	10.88	7.37	11.64	10.97	9.63	8.65	7.43
	EPS (AED)	0.07	0.09	0.04	0.05	0.06	0.06	0.06
	Book Value Per Share (AED)	1.13	1.18	1.19	1.21	1.24	1.27	1.30
	Market Price (AED) *	1.04	0.79	0.70	0.80	0.80	0.80	0.80
	Market Capitalization (AED mn)	2,264.9	1,720.4	1,608.7	1,820.1	1,820.1	1,820.1	1,820.1
	Dividend Yield	6.6%	0.0%	10.7%	3.1%	3.5%	3.7%	4.1%
	P/E Ratio (x)	14.6	8.9	17.1	16.2	14.4	13.5	12.3
	P/BV Ratio (x)	0.9	0.7	0.6	0.7	0.6	0.6	0.6

Source: Company Reports & Global Research

** Market price for 2013 and subsequent years as per closing prices on DFM on April 14, 2013*

Disclosure

The following is a comprehensive list of disclosures which may or may not apply to all our researches. Only the relevant disclosures which apply to this particular research have been mentioned in the table below under the heading of disclosure.

Disclosure Checklist

Company	Recommendation	Bloomberg Ticker	Reuters Ticker	Price	Disclosure
Arabtec Holding	HOLD	ARTC UH	ARTC.DU	AED2.16	1,10
Drake & Scull International	HOLD	DSI UH	DSI.DU	AED0.80	1,10

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Global Rating	Definition
STRONG BUY	Fair value of the stock is >20% from the current market price
BUY	Fair value of the stock is between +10% and +20% from the current market price
HOLD	Fair value of the stock is between +10% and -10% from the current market price
SELL	Fair value of the stock is < -10% from the current market price

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