



Growth priced in

- We forecast a 2010–14e backlog CAGR of 23% for Al Khodari, driven by an estimated USD223bn of awards in the KSA over 2011–13e
- Business model geared as it relies on high margins and leverage to deliver exceptional returns (29% ROE, 18% ROIC), but collection risk appears minimal for now as c85% of receivables are government related
- We initiate on Al Khodari with a TP of SAR73.0 and a Neutral rating as we estimate that at current multiples (2012e EV/EBITDA of 11.6x) the market is fully discounting its superior return/growth profile

We forecast a 2010–14e backlog CAGR of 23% for Al Khodari, or SAR14bn of awards over the next 4 years. We see revenue growth mirroring backlog growth with a 3-year lag, reflecting a typical construction cycle. Al Khodari's backlog almost doubled over the past 2 years; however, revenue remained flat. As such, medium-term earnings visibility is high in our view as it is driven largely by the current backlog. **We forecast a 2010–14e EPS CAGR of 20% versus a sector average of 10%.**

Al Khodari's business model delivers exceptional returns (29% 2012e ROE and 18% 2012e ROIC), driven by high margins (2011e GPM of 25%) and leverage (2011e net debt/equity of 100%). While margins in the sector have been driven down by competition, Al Khodari aims to sustain its profitability by targeting a highly specialized segment mix, focusing on quality, and implementing cost cutting measures, if necessary. The company also seeks to continually improve returns through gearing given the prevailing low interest environment and banks' appetite to lend to it due to its clientele.

Working capital requirements, however, are intensive as the company chooses to expedite development in order to free up capacity. The funding gap has thus far been largely financed by debt, but also by Al Khodari's high profitability. **We estimate that in a 2/3 construction/billing cycle, c15% of construction in excess of billing is covered by profits with a peak funding shortfall of 30% of project value.**

We initiate on Al Khodari with a Neutral rating and TP of SAR73.0/share, implying 11% total potential return. Its valuation is most sensitive to margins, with each 100 bps contraction shaving 8% off our TP. **Al Khodari trades at a 2012e EV/EBITDA of 11.6x versus the MENA average of 7.5x and global average of 6.3x, reflecting its superior growth and return profile, which we estimate is being fully discounted at current levels (refer to page 13).**

Key ratios	2011e	2012e	2013e	2014e
P/B	3.7x	3.0x	2.2x	1.7x
P/E	13.0x	10.3x	7.0x	6.1x
EV/EBITDA	14.9x	11.6x	7.8x	5.5x
ROIC	16%	18%	21%	20%
ROE	28%	29%	32%	28%

Source: HC

Neutral

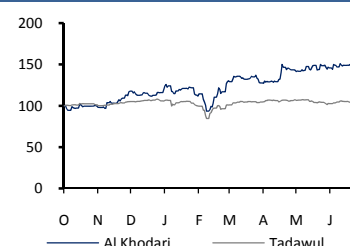
Target price (SAR)	73.0
Current price (SAR)	66
Potential return	11%

Bloomberg	ALKHODAR AB
Reuters	1330.SE

Mcap (SARm)	2794
Mcap (USDm)	745
Free float	30%
Daily volume (USDm)	4.2
Foreign own. limit	N/A
Foreign ownership	N/A

Note: All prices as of 23 July 2011

Price performance



25 July 2011

Majed Azzam

Analyst

+971 4 2935 385

majed.azzam@hc-si.com

Ankur Khetawat

Analyst

+971 4 2935 387

ankur.khetawat@hc-si.com

Nermeen Abdel Gawad

Analyst

+20 2 3535 7362

nermeen.abdelgawad@hc-si.com

Shireen Wissa

Analyst

+20 2 3535 7374

Shireen.wissa@hc-si.com

Please refer to important disclosures and analyst certifications on pages 22–24 of this report.



Al Khodari financial statements and ratios (SARm)

Income statement	2008a	2009a	2010a	2011e	2012e	2013e	2014e	2015e
Revenue	1,159	1,048	1,074	1,208	1,442	2,087	2,371	2,307
Total costs	(824)	(753)	(785)	(913)	(1,076)	(1,557)	(1,769)	(1,721)
Gross profit	335	295	289	295	366	530	602	586
<i>Margin</i>	29%	28%	27%	24%	25%	25%	25%	25%
EBIT	274	236	230	225	281	407	462	450
<i>Margin</i>	24%	23%	21%	19%	19%	19%	19%	19%
Profit before taxes	246	223	229	222	283	417	484	478
Zakat	(7)	(6)	(11)	(7)	(12)	(17)	(27)	(36)
Net profit (loss)	240	217	218	215	271	400	457	441
<i>Margin</i>	23%	21%	20%	18%	19%	19%	19%	19%
EPS (SAR)	6	5	5	5	6	9	11	10
DPS (SAR)	-	3	3	1	2	2	2	2
Balance sheet								
Bank balances and cash	33	33	71	107	200	265	897	1,245
Accounts receivable and prepayments	438	534	687	1,502	1,699	2,310	2,184	2,130
Amounts due from related parties	37	39	9	18	18	18	18	18
Inventories	27	20	37	62	62	62	62	62
Current assets	699	937	1,379	1,722	2,012	2,688	3,194	3,487
Noncurrent assets	641	513	448	517	514	547	585	609
Total assets	1,340	1,450	1,826	2,239	2,526	3,234	3,779	4,096
Current liabilities	569	410	693	1,115	1,216	1,609	1,782	1,743
Noncurrent liabilities	423	534	545	364	364	364	364	364
Total equity	348	506	588	760	946	1,261	1,633	1,989
Total equity and liabilities	1,340	1,450	1,826	2,239	2,526	3,234	3,779	4,096
Cash flow statement								
Net profit	246	223	229	216	271	400	457	441
CF generated from operating activities	73	131	121	354	250	253	836	548
CF generated from investing activities	(74)	8	(44)	(184)	(72)	(104)	(119)	(115)
CF generated from financing activities	(57)	(140)	(39)	(134)	(85)	(85)	(85)	(85)
Net addition (deduction) in cash	(57)	(0)	38	36	93	64	633	348
Cash at beginning of fiscal year	99	33	33	71	107	200	265	897
Cash at end of fiscal year	33	33	71	107	200	265	897	1,245
Key ratios								
Revenue growth		-10%	2%	12%	19%	45%	14%	-3%
Net profit growth		-9%	0%	-2%	26%	47%	14%	-4%
Debt/equity	1.8	1.3	1.3	0.9	0.7	0.5	0.4	0.3
Net debt	604	622	681	553	459	395	(237)	(585)
Net debt/equity	1.7	1.2	1.2	0.7	0.5	0.3	-0.1	-0.3
Current ratio	1.1	1.3	0.6	0.5	0.4	0.3	0.3	0.3
ROE	69%	43%	37%	28%	29%	32%	28%	22%
ROIC	28%	20%	17%	16%	18%	21%	20%	17%
Backlog/sales	1.4x	1.8x	2.9x	3.2x	3.5x	3.1x	3.2x	
P/B	8.0x	5.5x	4.8x	3.7x	3.0x	2.2x	1.7x	1.4x
EV/EBITDA	12.4x	14.5x	15.1x	14.9x	11.6x	7.8x	5.5x	4.9x
P/E	11.0x	12.9x	12.8x	13.0x	10.3x	7.0x	6.1x	6.3x

Source: Company data, HC



MENA real estate & construction valuation multiples

Company	BB code	Curr	CMP ⁽¹⁾	Mcap (USDm)	Rec	TP	Upside	P/B			P/NAV			P/E			ROE		
Real estate								10a	11e	12e	10a	11e	12e	10a	11e	12e	10a	11e	12e
KSA																			
Dar Al Arkan	AL ARKAN AB	SAR	7.4	2,142	OW	13.2	77%	0.6x	0.5x	0.5x	0.3x	0.3x	0.3x	5.5x	9.1x	5.9x	10%	6%	8%
Al Akaria	SRECO AB	SAR	24.1	771	N	25.9	7%	0.9x	0.9x	0.9x	0.4x	0.4x	0.4x	14.9x	24.9x	26.5x	6%	4%	3%
Average								0.7x	0.7x	0.7x	0.4x	0.4x	0.3x	10.2x	17.0x	16.2x	8%	5%	6%
UAE																			
Aldar	ALDAR UH	AED	1.3	1,122	OW	2.69	114%	1.3x	0.7x	0.5x	0.1x	0.1x	0.1x	N/M	2.6x	4.8x	N/M	26%	10%
Emaar	EMAAR UH	AED	3.0	4,975	N	3.2	8%	0.6x	0.6x	0.6x	0.4x	0.3x	0.3x	7.4x	45.4x	11.5x	8%	1%	5%
Sorouh	SOROUH UH	AED	1.2	815	OW	1.8	45%	0.5x	0.5x	0.4x	0.3x	0.3x	0.2x	9.1x	5.4x	3.2x	6%	9%	14%
Average								0.6x	2.1x	0.8x	0.3x	0.2x	0.2x	5.4x	25.4x	5.2x	5%	73%	16%
EGYPT																			
SODIC	OCDI EY	EGP	58.4	349	N	95	63%	0.9x	0.7x	0.6x	0.4x	0.4x	0.4x	N/M	4.2x	3.2x	10%	17%	19%
Heliopolis	HELI EY	EGP	17.9	334	N	21.4	19%	5.7x	5.7x	5.7x	0.2x	0.2x	0.2x	12.6x	7.3x	12.9x	78%	44%	57%
MNHD	MNHD EY	EGP	18.8	315	N	26	38%	6.5x	5.0x	3.3x	0.2x	0.2x	0.2x	22.8x	22.8x	10.0x	28%	22%	33%
ODH	ODHN EY	CHF	28.0	966	N	51	82%	0.7x	0.6x	0.5x	0.2x	0.3x	0.2x	8.0x	6.9x	5.5x	8%	9%	10%
Egyptian Resorts	EGTS EY	EGP	1.1	197	UW	1.49	33%	1.1x	1.1x	1.1x	0.1x	0.1x	0.1x	N/M	N/M	N/M	N/M	N/M	N/M
TMG	TMGH EY	EGP	4.4	1,501	UW	6.2	39%	0.4x	0.3x	0.3x	0.3x	0.3x	0.3x	8.5x	4.5x	3.5x	4%	8%	9%
PHD	PHDC EY	EGP	2.2	383	UW	4.6	111%	0.5x	0.4x	0.3x	0.2x	0.2x	0.2x	4.8x	2.1x	1.4x	11%	20%	23%
Average								0.4x	0.4x	0.3x	0.3x	0.2x	0.2x	6.6x	3.3x	2.5x	8%	14%	16%
KUWAIT																			
Mabaneer	MABANEE KK	KWd	831.1	1,688	N	1015	22%	3.6x	3.1x	2.4x	1.3x	1.2x	0.8x	22.5x	23.4x	9.4x	16%	13%	26%
Average								3.6x	3.1x	2.4x	1.3x	1.2x	0.8x	22.5x	23.4x	9.4x	16%	13%	26%
Sector average								1.4x	1.6x	1.1x	0.5x	0.5x	0.4x	11.2x	17.3x	8.3x	9%	26%	16%
								P/B			EV/EBITDA			P/E			ROE		
Construction								10a	11e	12e	10a	11e	12e	10a	11e	12e	10a	11e	12e
DSI	DSI UH	AED	1.0	569	OW	1.3	35%	0.8x	0.8x	0.7x	10.9x	7.5x	6.5x	13.5x	11.7x	10.0x	6%	7%	7%
DSI (ex goodwill)	DSI UH	AED	1.0	569	OW	1.3	35%	1.6x	1.4x	1.2x	10.9x	7.5x	6.5x	13.5x	11.7x	10.0x	12%	12%	12%
Arabtec	ARTC UH	AED	1.4	556	N	1.4	3%	0.9x	0.9x	0.8x	4.5x	5.7x	5.0x	5.3x	9.4x	8.5x	17%	9%	10%
Depa	DEPA DU	USD	0.5	308	OW	0.95	90%	0.7x	0.6x	0.5x	28.3x	4.6x	3.4x	N/M	12.3x	5.5x	N/M	5%	10%
OCI	OCIC EY	EGP	267.9	9298	N	275	3%	3.0x	2.7x	2.5x	7.4x	6.8x	5.9x	21.8x	16.3x	15.5x	18%	18%	20%
Al Khodari	ALKHODAR AB	SAR	65.8	724	N	73.9	12%	4.8x	3.7x	3.0x	15.1x	14.9x	11.6x	12.8x	13.0x	10.5x	37%	28%	29%
Sector average								1.9x	1.7x	1.5x	12.9x	7.8x	6.5x	13.4x	12.4x	10.0x	18.0%	13.2%	14.7%

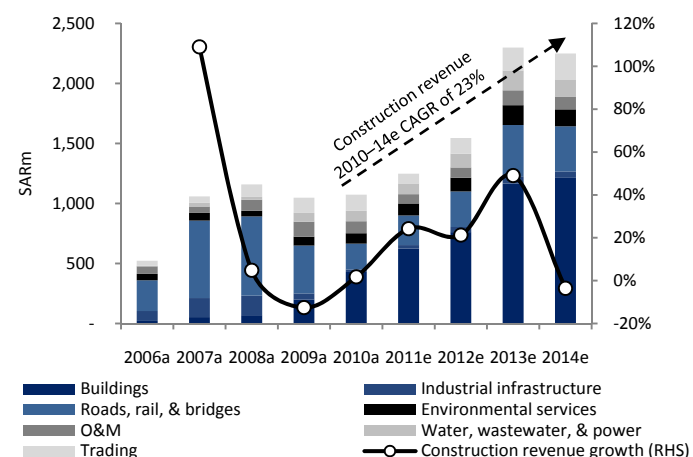
Source: Bloomberg, HC

Note: (1) Prices as of 23 July 2011

Al Khodari: Exceptional returns driven by high margins and leverage

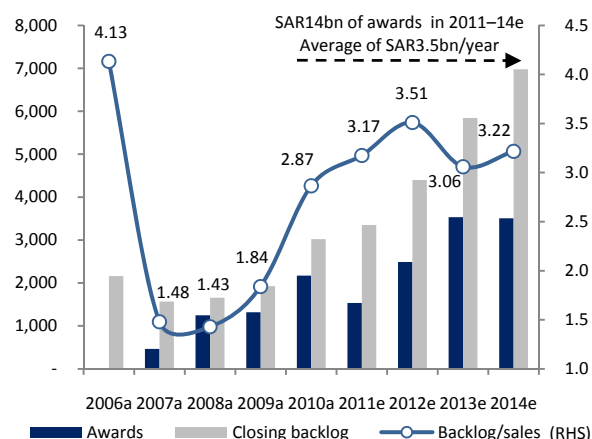
- We forecast a 2010–14e backlog CAGR of 23% for Al Khodari, driven by an estimated USD223bn worth of awards in Saudi Arabia over the next 3 years
- Business model highly geared as it relies on high margins and leverage to deliver exceptional returns (29% 2012e ROE, 18% 2012e ROIC), but collection risk appears minimal for now as c85% of receivables are government related
- As Al Khodari's backlog grows, a slowdown in construction in excess of billing may be driven by banks' reluctance to increase their exposure to the company; as such, working capital could see an improvement at the expense of returns

Backlog breakdown by segment: 23% 2010–14e CAGR driven by the civil segment



Source: Company data, HC

SAR14bn worth of award wins over 2011–14e, averaging SAR3.5bn per year (SARm)



Source: Company data, HC

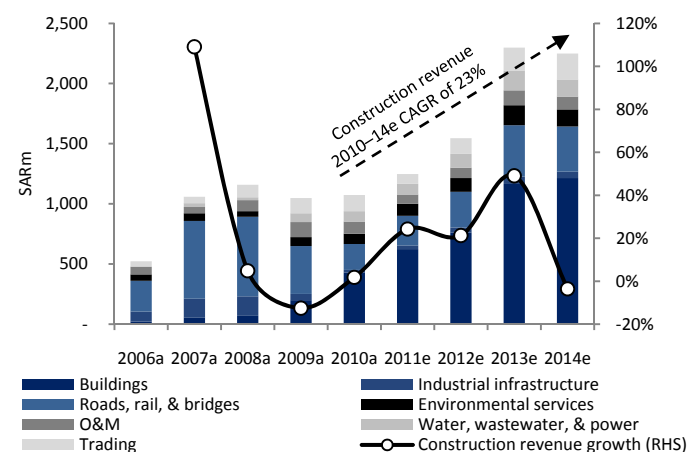
Backlog growth driven by an estimated USD233bn worth of awards in Saudi Arabia over the next 3 years, on our estimates

Over the past 2 years, Al Khodari has seen its backlog mix shift from mostly infrastructure to a higher proportion of civil contract awards. The company expects this trend to continue, driven by the recently announced SAR250bn government initiative to construct 500,000 homes over the next 3 years. While the civil segment is likely to drive growth, infrastructure is also expected to remain strong, showing double-digit growth in line with the government's record budget. MEED data (please refer to industry analysis on page 16) supports these expectations, pointing to a 65% in awards in 2011e, followed by a 16% in 2012e (USD150bn in total project awards). Accordingly, we expect Al Khodari's backlog to more than double by 2014e to cSAR7bn, which implies a CAGR of 23% or SAR14bn worth of award wins over the next 4 years.

While this growth forecast may seem optimistic, it is important to note that Al Khodari is part of a consortium currently bidding for a SAR40bn project being tendered by the Ministry of Higher Education; this alone would take Al Khodari's backlog above the SAR7bn mark, if won. The company is also bidding for the Saudi Land Bridge project, worth SAR37bn. Al Khodari appears well positioned to win, given its track record with the North-South rail project. Additionally, the company recently set up a subsidiary in Abu Dhabi and Qatar to bid for infrastructure projects, including the GCC rail network, which is slated for completion by 2017. Abu Dhabi has already awarded phase 1 (Al Khodari did not bid for this project), while Qatar and Kuwait have completed their designs and are expected to start construction soon. It is also worth noting that while the big contractors (e.g. Saudi Bin Laden Group, Saudi Oger, etc) previously monopolized government projects, it is likely that medium-sized contractors may be able to gain market share going forward, given the qualified capacity shortage.

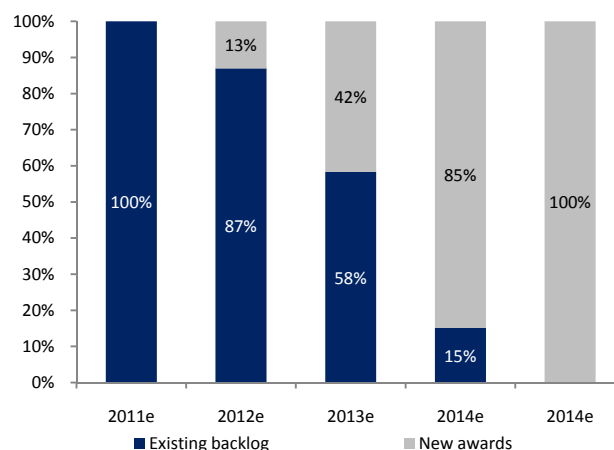
We see revenue growth mirroring backlog growth with a 3-year lag, reflecting the typical construction cycle. We forecast 2010–14e CAGRs of 22% for total revenue and 23% for construction revenue. We believe that trading revenue is unlikely to grow in line with construction revenue as the company takes on more projects at an accelerated rate. Revenue is expected to peak in 2012e and 2013e given the typical end loaded construction cycle, where the average 3-year project yields only c20% of contract value in year 1, with c40% in each of the last 2 years to completion.

Revenue breakdown by segment: 2010–14e construction revenue CAGR of 23%



Source: Company data, HC

Revenue visibility: 2011–12e growth driven largely by existing backlog

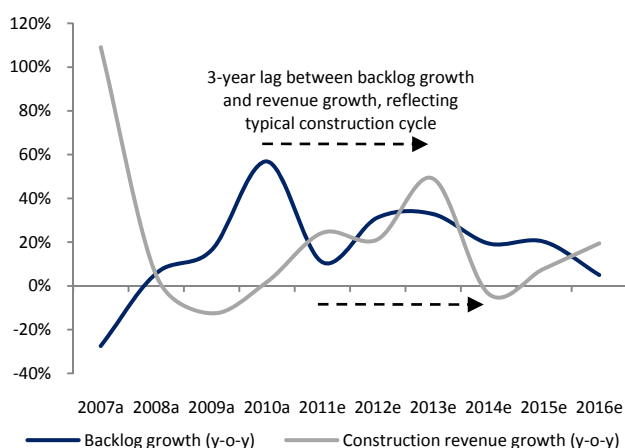


Source: Company data, HC

Al Khodari's backlog almost doubled over the past 2 years (to SAR3.2bn in 1Q11 from SAR1.8bn in 2009); however, revenue remained flat. We estimate that most of this backlog growth should be captured starting this year, peaking in 2012/13e as previously indicated. Revenue visibility for 2011–13e is high, in our view, as it is driven largely by the current backlog, as shown in the right chart above. As such, unlike peers, the company's backlog/sales ratio is set to rise until 2014e as backlog growth is expected to outpace execution.

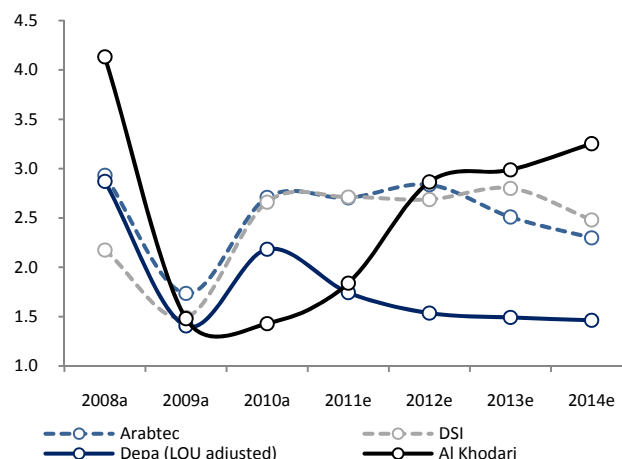
Earnings visibility high as revenue growth is likely to mirror backlog growth with a 3-year lag

Revenue growth to mirror backlog growth with a c3-year lag, reflecting a typical construction cycle



Source: Company data, HC

Al Khodari backlog/sales ratio set to rise until 2014e as backlog growth is expected to outpace execution



Source: Company data, HC

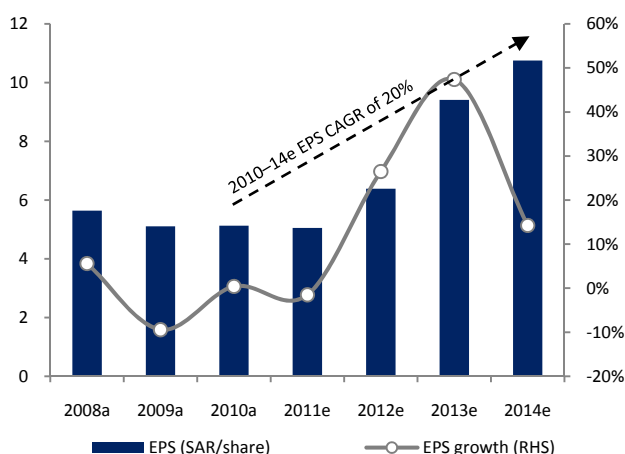
We estimate that EPS growth (2010–14e EPS CAGR of 20%) is likely to lag revenue growth due to margin compression. As mentioned earlier, we do not assume any contraction in the construction business margin, but overall margins should naturally decline going forward given that the higher-margin (c49% GPM in FY10) trading business is unlikely to keep up with the construction business as construction revenue growth is driven largely by existing backlog over the medium term. At current valuation multiples, the market also seems to be giving the company the benefit of the doubt by not factoring in any construction margin compression, on our estimates.

Margins to decline naturally as construction revenue is expected to outpace trading revenue

The company appears confident in its ability to maintain its current, exceptionally high gross margin of 27% – double the regional industry average – by targeting a segment/project mix that it expects to provide similarly high margins. This is despite the fact that civil now is Al Khodari's largest segment (54%) and is expected to be its main growth driver. The company aims to focus on the mid-income housing segment, but, to maintain margins, it is looking to reduce its expenses by gaining economies of scale and implementing production line processes. Its presence throughout Saudi Arabia and its consequent ability to mobilize quickly may give it a competitive advantage, in our view. Regional/foreign contractors (e.g. DSI and Arabtec) recently entering the market en masse is unlikely to be a threat to Al Khodari, in our opinion, as on the face of it there seems to be plenty of work to go around (USD223bn over the next 3 years; please refer to page 18). Also, given the company's small base, it is much easier for it to grow in the current macroeconomic environment. Additionally, it is important to distinguish between certified and uncertified contractors – a large portion of the capacity in Saudi Arabia is uncertified and cannot bid for high-quality projects, according to the company.

There are 2 ways to play the construction market in Saudi Arabia: targeting a volume business or a margin business. Over the past 40 years, Al Khodari has positioned itself as a premium contractor unwilling to compromise on margins. While globally the sector has become very competitive, leading to low profitability, and while the industry has seen significant margin compression since the onset of the crisis, driven by competition and cost cutting, Al Khodari has nonetheless been an exception. The situation in Saudi Arabia appears different as, up until now, contractors have had pricing power due to low capacity in the face of planned government construction initiatives. In the longer term, the company may position itself strategically for any potential downturn by diversifying into higher value-added segments where barriers to entry are high. Another part of Al Khodari's strategy is to expand its environmental services business (waste management, etc), which provides a long-term recurring income stream that could act as a partial buffer against cyclicalities.

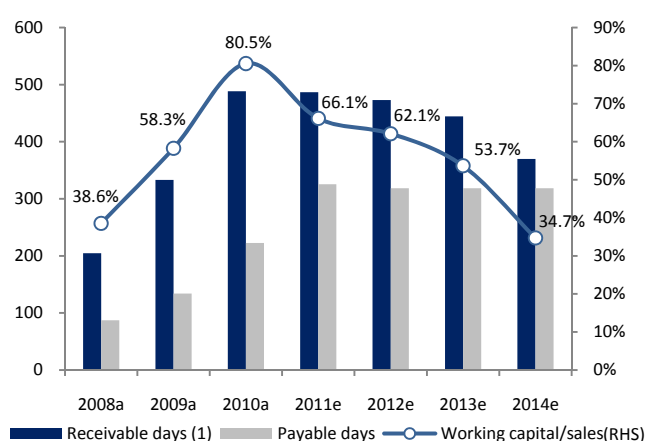
EPS growth to lag revenue growth slightly due to expected margin compression⁽¹⁾



Source: Company data, HC

Note: (1) 2007/08 EPS adjusted for current number of shares

Wide WC gap due to construction in excess of billing; improvement could be driven by funding constraints



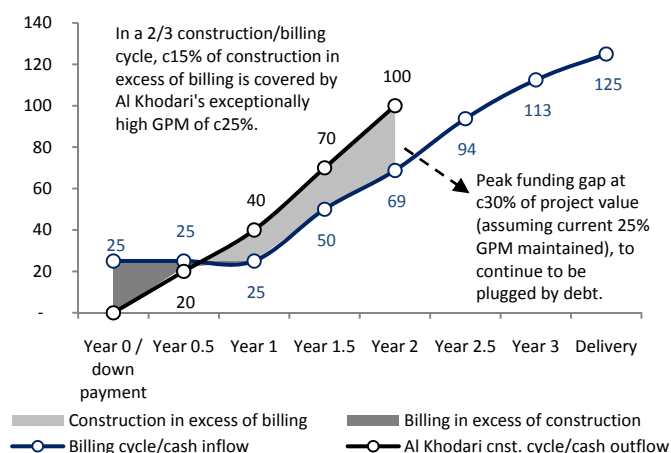
Source: Company data, HC

Note: (1) Includes construction in excess of billing

Intensive WC due to construction in excess of billing: Funding gap largely plugged by debt but financed partly by high profitability as well

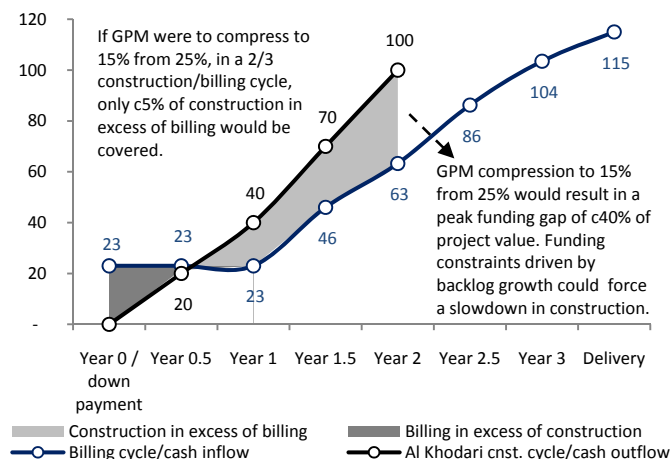
Al Khodari's working capital requirements are intensive due to construction in excess of billing, which takes its receivable days to 455, the highest by far within our coverage universe. The WC gap has historically been funded through debt. We understand that the company always conducts a cost-benefit analysis and, as long as the cost of capital is low, they feel it is best to expedite construction in order to free up capacity. Given the bureaucracy associated with government projects, collection progress can at times be slow.

Construction in excess of billing partly covered by exceptionally high GPM of c25%; in a 2/3 construction/billing cycle, c15% of project value is covered by profits



Source: HC

GPM compression to market levels would lead to a 40% funding gap, potentially forcing a slowdown in construction



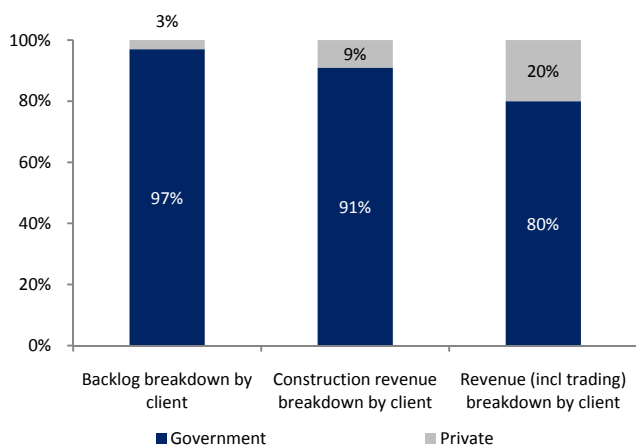
Source: HC

The typical government project billing cycle takes the form of a 15%–20% down payment, which covers construction in the first year, and payments of c35% in years 2 and 3, with the final balance of 10% paid upon completion. Any construction in excess of this billing scheme is financed by the company and is recorded in construction in excess of billing, which is essentially a receivable for unbilled work. As highlighted in the previous charts, in a 2/3 construction/billing cycle, c15% of construction in excess of billing is covered by Al Khodari's exceptionally high GPM of c25%. We estimate the peak funding gap at c30% of project value, assuming the current 25% GPM is maintained. This gap has historically been plugged by debt. Intensive WC requirements make it especially relevant for the company to maintain its high GPM as it proceeds with construction ahead of schedule. Compression of GPM to market levels would increase the funding burden 10 percentage points as, on our estimates, only 5% of construction in excess of billing would be covered by profit. This could potentially force a slowdown in construction.

Collection risk appears minimal as c85% of receivables are government related

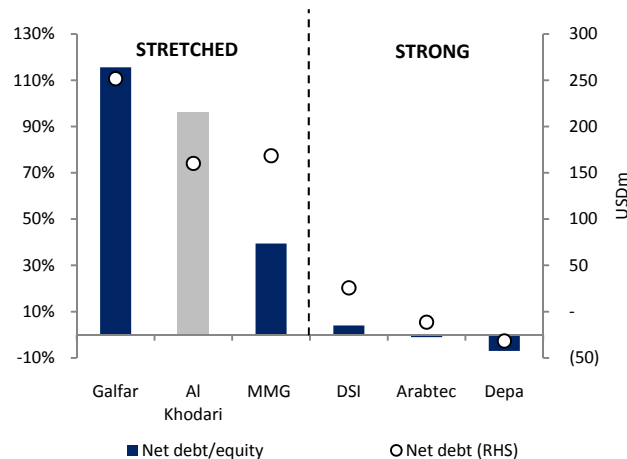
Since 85% of the company's backlog is government related, collection/default risk appears minimal. While the company is aiming to increase the contribution from the private sector, it will only go after high-quality companies (such as Ma'aden, which accounts for 3% of its backlog). Regardless, the government is expected to remain the main growth driver over the medium term. The local banks seem to understand how Al Khodari works and are happy to lend to the company at an average rate of 2.5% despite the company's high gearing, with net debt/equity standing at c100%. Going forward, the company plans to continue using debt to finance its WC needs despite an expected pickup in execution. Anecdotal evidence suggests that many Saudi contractors are lobbying for a streamlining of government processes in order to expedite billing, which could lead to working capital improvement. In our opinion, as the company's backlog grows, banks may become more reluctant to increase their exposure to the company despite their comfort with its receivables. In that scenario, funding constraints could lead to a slowdown in construction in excess of billing. In our model, we assume a 90-day improvement in receivables to 365 days by 2014e.

Given that Al Khodari's backlog is dominated by government contracts, default risk is low, allowing for access to bank credit



Source: Company data

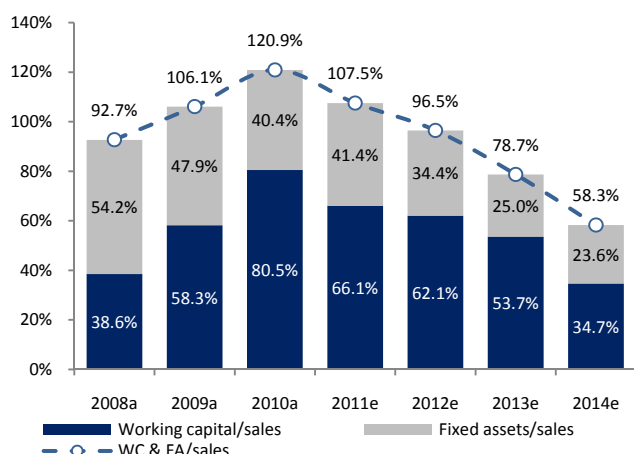
MENA contractors' 1Q11 gearing: Al Khodari's balance sheet is stretched as its working capital gap is funded through leverage



Source: Company data
Note: (1) Depa as of FY10

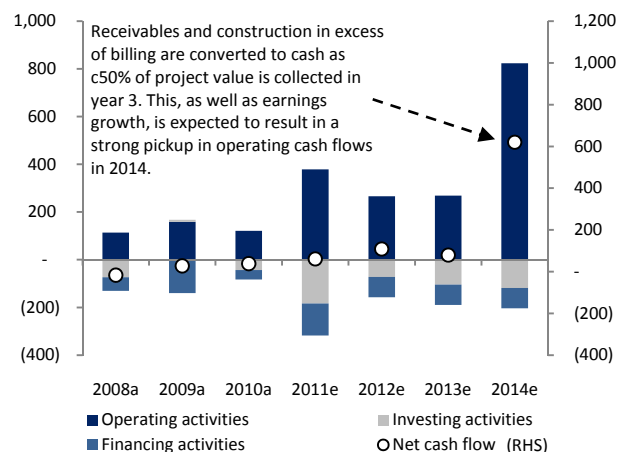
Another way to fund backlog growth would be a capital increase. Typically, it is important for a construction company to have a balanced capital structure in order to absorb any impairment. Al Khodari's case is not as straightforward given its client base. The company's equity base looks relatively small (backlog/equity of 5.1x versus a MENA average of 2.9x) and there may be a need to expand it at some stage to support growth, but we understand that such an increase would not necessarily be in proportion to Al Khodari's growth. Arguably, it may be inefficient to do so, at least over the short term, given that the company has no issues leveraging its balance sheet and given the prevailing low interest environment (Al Khodari's average cost of debt is 2.5%). The company is focused on returns and wishes to continue improving them. Regardless, we feel that the current capital structure is risky as the backlog is concentrated and any default/disagreement (e.g. Galfar) or market downturn could significantly impair the company's equity.

WC & FA/sales ratio: Expected improvement driven by (1) a slowdown in construction in excess of billing, (2) a shift to civil work, and (3) a pickup in sales



Source: Company data, HC

Al Khodari's high GPM improves operating cash flows – a strong pickup is expected in 2014e on monetization of receivables and construction in excess of billing (SARm)



Source: Company data, HC

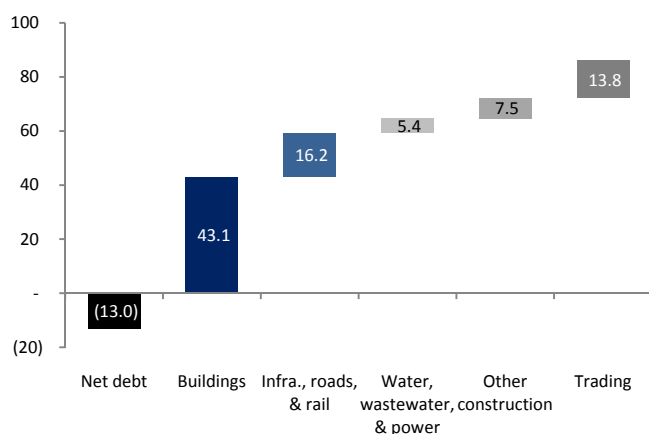
In the absence of construction in excess of billing, the company would enjoy a negative WC model as back-to-back payments as well as high margins provide sufficient funding. Given the bell-shaped billing cycle, operating cash flows are set to peak in 2014e due to earnings growth and as receivables and construction in excess of billing are converted to cash with c50% of project value collected in year 3. In terms of dividend policy, according to management, the company should at least maintain its current dividend payout (in absolute terms) unless the funding model comes under pressure. Going forward, we assume an average dividend payout of SAR2/share, which implies a dividend yield of 3% at current levels. In our model, we do not assume any debt repayment or additional debt. As we noted earlier, we assume WC improvement going forward, which should alleviate the need for increased leverage.

Valuation

- We initiate on Al Khodari with a Neutral rating and a TP of SAR73.0/share, implying a total potential return of 11%
- At current multiples (2012e EV/EBITDA of 11.6x), we estimate that the market is fully discounting the company's superior return and growth profile
- Al Khodari's valuation is highly sensitive to margins, with each 100 bps contraction resulting in an 8% decline in our TP

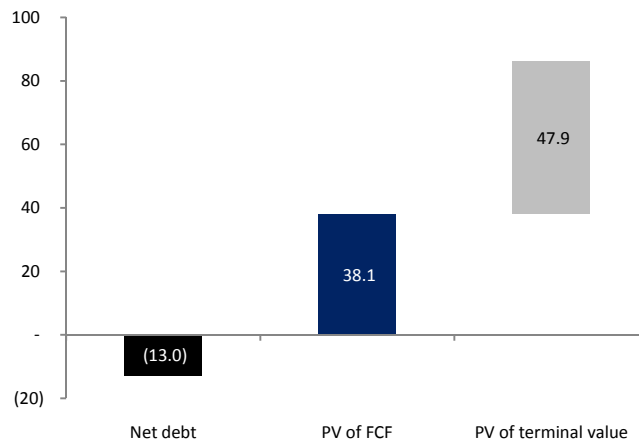
Initiate with a TP of SAR73.0/share and a Neutral rating

Valuation breakdown by segment (SAR/share)



Source: HC

Valuation breakdown (SAR/share)



Source: HC

We initiate on Al Khodari with a Neutral rating and a TP of SAR73.0/share, implying 11% total potential return. To value construction companies, we use an SOTP DCF model. We then add net cash and investments, which we do not liquidate in our model. For Al Khodari, we use a beta of 1.4, a risk-free rate of 4.5%, and a country risk premium of 5.5% to derive a cost of equity of 12.2%. We use a long-term cost of debt of 5%, a target debt/equity ratio of 30/70, and a tax (zakat) rate of 2.5% to arrive at a WACC of 10%. Finally, we assume a perpetual growth rate of 2%, in line with long-term inflation.

Given Al Khodari's high leverage, the PV of the implicit period plus net debt accounts for only 35% of its valuation (38% of market cap), while the remaining is derived from the terminal value. Breaking our valuation down by segment, we estimate that the contribution from the civil sector will continue to rise, making up 54% of our overall valuation, versus 19% for the infrastructure segment (including roads and rail). The trading business, despite contributing only 9% of revenue on average, accounts for 19% of Al Khodari's valuation given its higher margins.

Valuation highly sensitive to margins

Al Khodari valuation sensitivity analysis: Each 100 bps margin compression results in an 8% decline in our valuation, while every 5 pp reduction in backlog growth shaves 15% off our TP

		Construction gross profit margin						
		-300 bps	-200 bps	-100 bps	23%	+100 bps	+200 bps	+300 bps
2010–14e backlog CAGR	-10%	-43%	-37%	-31%	-26%	-20%	-14%	-8%
	-5%	-37%	-31%	-24%	-15%	-11%	-5%	2%
	23%	-24%	-16%	-8%	0%	8%	16%	24%
	+5%	-13%	-4%	5%	14%	23%	32%	41%
	+10%	-1%	9%	20%	30%	40%	50%	61%

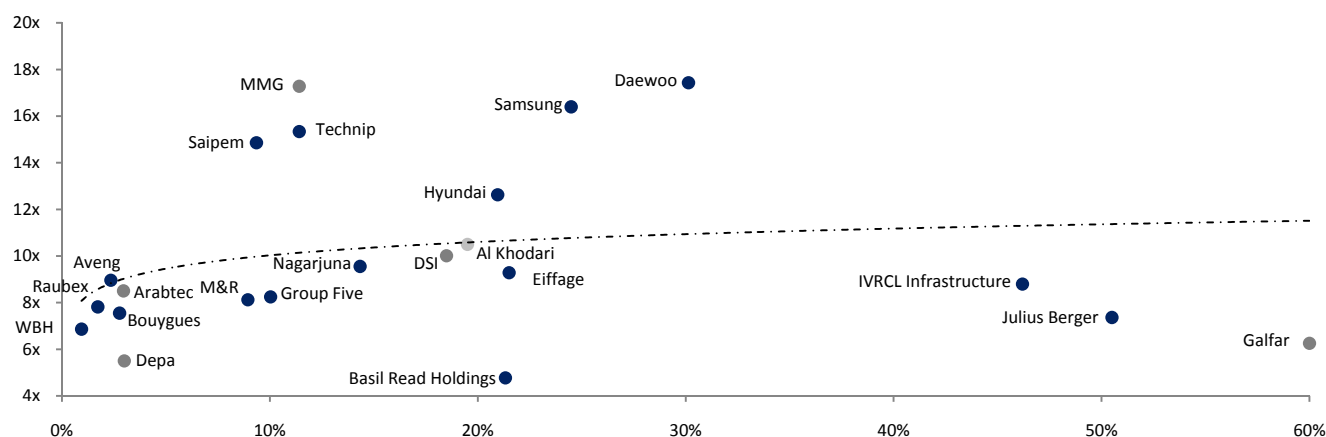
Source: HC

As shown in the table above, Al Khodari's valuation is highly sensitive to margins. We estimate that for each 100 bps compression in construction margins, the company's valuation declines 8%. Al Khodari's valuation is also sensitive to backlog growth, with every 5 pp reduction in growth shaving c15% off our valuation.

Construction margins have been trending downwards since the start of the year, from 23% in 1H10 to 22% in 1Q11 and 21% in 2Q11. This is raising concerns about the company's ability to maintain margins in the face of intensifying competition while still growing its backlog. For now, we do not assume any margin compression in our model as quarterly numbers may vary greatly depending on segment mix and execution speed. It is also important to note that the company appears confident in its ability to maintain its margins going forward as it always targets a mix of segments/projects that it expects to provide similarly high margins. This is despite the fact that civil now is its largest segment (54%) and is expected to be its main growth driver.

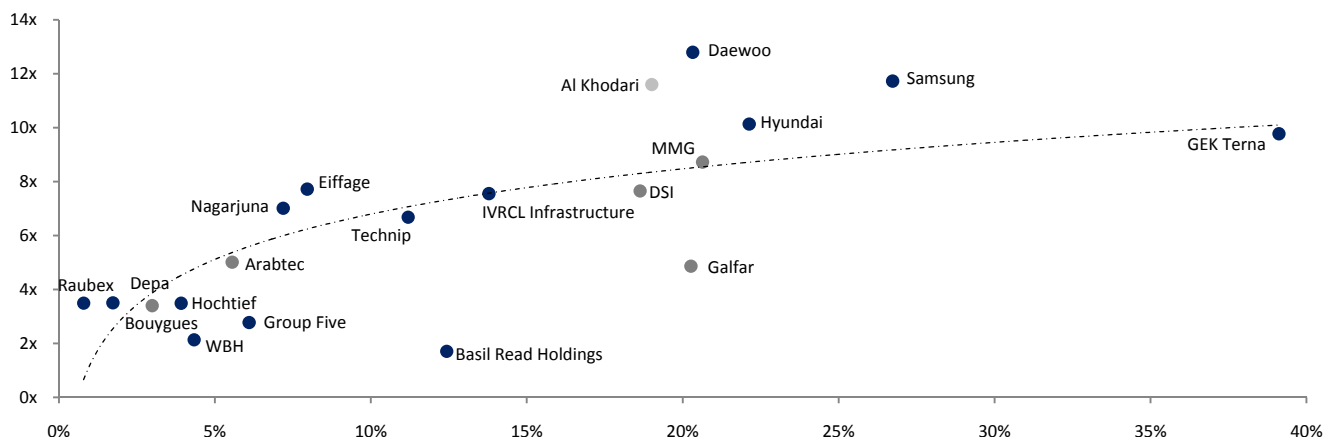
Peer comparison: Superior return and growth profile already discounted by the market

2012e P/E versus 2010–14e EPS CAGR: On P/E, Al Khodari looks fairly valued relative to regional and global peers given its superior growth profile



Source: Bloomberg, HC

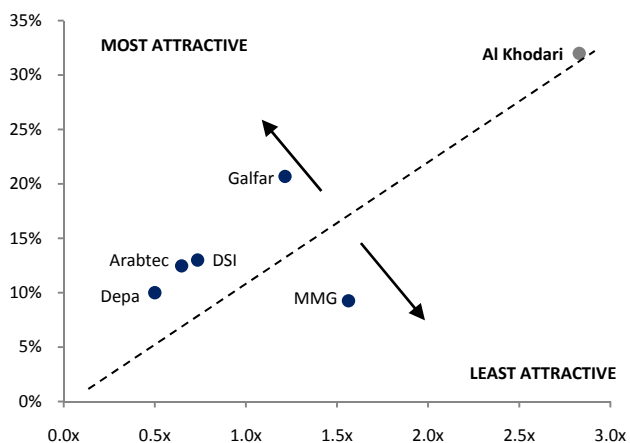
2012e EV/EBITDA versus 2010–14e EBITDA CAGR: On EV/EBITDA, Al Khodari's valuation look rich compared with regional and global peers given the company's relatively high leverage position



Source: Bloomberg, HC

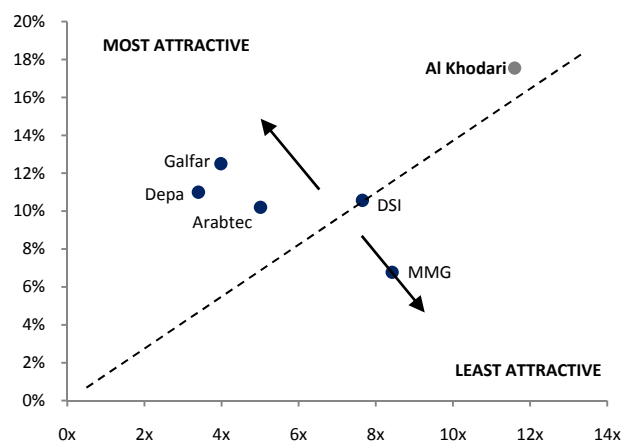
Al Khodari trades at a 2012e P/E of 10.5x and, based on the regression analysis above, appears fairly valued given its superior growth profile, with a 2010–14e EPS CAGR of 20%, on our estimates. On EV/EBITDA, the company's 2012e valuation multiple of 11.6x looks rich versus regional (average 2012e EV/EBITDA of 7.5x) and global peers (average 2012e EV/EBITDA of 6.3x) given its relatively high leverage position, with net debt/equity standing at c100%. That said, given the prevailing low interest environment (average cost of debt is 2.5%) and Al Khodari's low receivable collection risk, management aims to continue to improve returns by taking on more debt. Regardless, the company already has the best return profile among regional peers, with a 2012e ROE of 29% compared with a regional average of 13%, and a 2011e ROIC of 18% versus a regional average of 10%. Nonetheless, as highlighted in the following charts, Al Khodari's superior return profile is already being discounted by the market, with the stock trading at a 2012e P/B of 3.0x and an EV/EBITDA of 11.6x.

2012e ROE versus P/B: Al Khodari's superior return profile already discounted by the market



Source: HC

2012e ROIC versus EV/EBITDA



Source: HC



Downside risks

- **Execution rates and order book replenishment:** Project cancellations, slower rates of execution, or lack of backlog replenishment could impact the order book negatively
- **Economic and political risk:** As Al Khodari's current backlog remains concentrated in Saudi Arabia, an economic slowdown or political instability could adversely impact the company's prospects
- **Working capital management:** Any payment delays or defaults could stress the company's balance sheet and negatively impact its ability to fund construction in excess of billing through debt
- **Cost inflation and backlog mix:** Cost inflation could lead to a greater than expected margin contraction; variability of quarterly earnings due to the work in progress mix by segment could cause our forecasts to diverge greatly from reported numbers

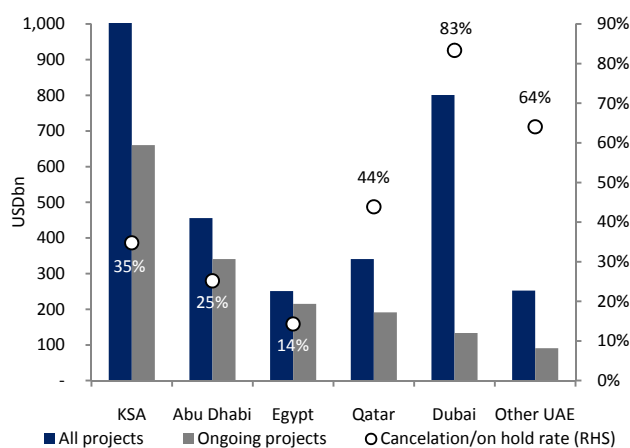
Upside risks

- **Margin enhancement:** In our model, we assume that trading revenue will not keep up with construction revenue and that accordingly we will see a natural decline in margins; the company, however, indicated to us that it expects to maintain the trading revenue contribution ratio, and thus margins may improve
- **Backlog replenishment and execution:** Higher than expected award growth and/or timely execution would result in stronger cash flows and hence a higher valuation
- **Working capital management:** A better than expected improvement in working capital on the back of a reduction of work in excess of billing would ease the company's cash burden

MENA construction sector

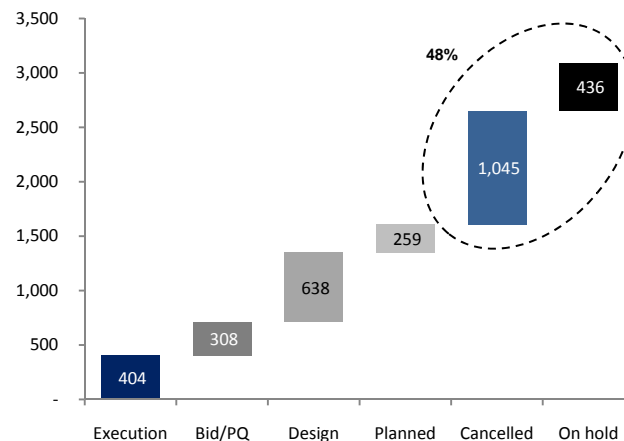
- Project pipeline remains solid, with cUSD1.6bn worth of projects still ongoing despite 48% being cancelled or put on hold
- Saudi Arabia has emerged as by far the largest market, with cUSD660bn worth of projects under development, and has been relatively more resilient, with only 35% of projects cancelled or put on hold
- Recently announced USD70bn housing initiative to construct 500,000 homes over the next 3 years further increases the appeal of the Saudi market and the civil sector; insufficient capacity means reallocation of regional and global resources should continue

2Q11 MENA ongoing projects by geography



Source: MEED Projects, HC

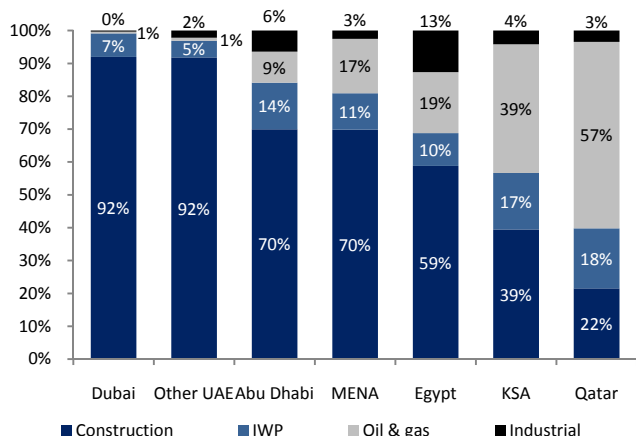
2Q11 MENA project breakdown by status (USDbn)



Source: MEED Projects, HC

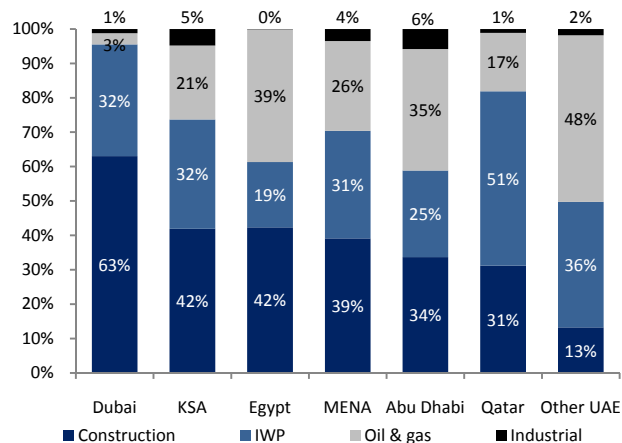
According to MEED data, the project pipeline in the MENA region remains solid, with cUSD1.6bn worth of projects still ongoing. Since the onset of the global financial crisis, the Middle East has seen 48% of planned development cancelled or put on hold. Saudi Arabia has emerged as by far the largest market, with cUSD660bn (40%) of projects under development. However, the sector composition, although still tilted towards civil construction (42%) given the acute housing shortage, has large IWP (32%) and oil and gas (21%) components. The recently announced USD70bn housing initiative to construct 500,000 homes over the next 3 years further increases the attractiveness of the Saudi market and the civil sector. Insufficient capacity in the kingdom means the reallocation of regional and global resources is likely to continue over the medium term. While Saudi Arabia offers attractive opportunities for regional players, we feel it is a market that is very difficult to break into given the dominance of local players. While construction capacity in Saudi Arabia is set to increase, it appears that there is plenty of work to go around for now. Additionally, it is important to distinguish between certified and uncertified contractors – a large portion of the capacity in Saudi Arabia is uncertified and cannot bid for high-quality projects.

2Q11 cancelled projects by segment/geography



Source: MEED Projects, HC

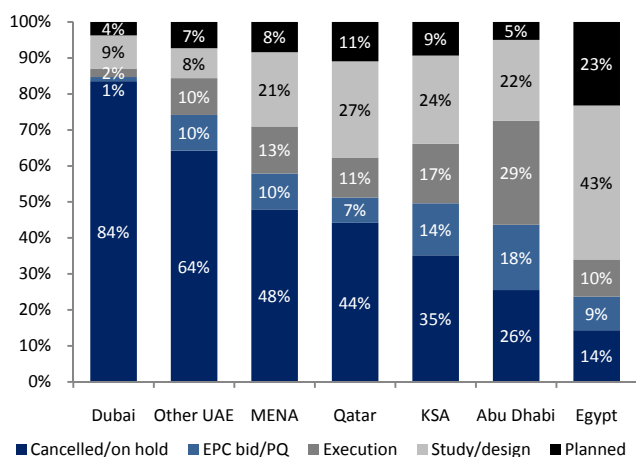
2Q11 ongoing projects by segment/geography



Source: MEED Projects, HC

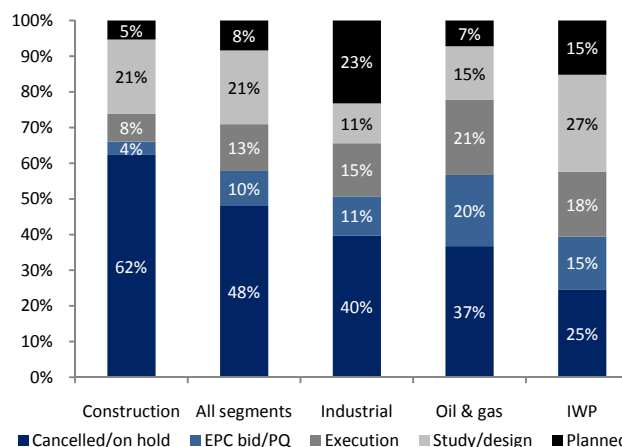
Dubai saw the highest cancellation/on hold rate at more than 80%. In our opinion, this has to do with the segment mix in Dubai being highly skewed towards civil construction (87%), which is driven largely by the private sector, which is very susceptible to economic conditions. Overall, civil construction witnessed the highest cancellation/on hold rate at 62%, while the infrastructure segment saw the lowest at 25%, helped by continued government fiscal spending. Egypt, Abu Dhabi, and Saudi Arabia were the most resilient – only 14% of projects were cancelled or put on hold in Egypt, 25% in Abu Dhabi, and 27% in Saudi Arabia. This, we believe, is a function of their stronger sector fundamentals, supported by real indigenous demand or strong government spending. It is no surprise then that regional contractors are trying to diversify away from Dubai and civil construction and into more defensive markets and segments such as Saudi Arabia and infrastructure. But, as we argued earlier, this is unlikely to bear fruit quickly given the high barriers to entry. Also, as of late a redeployment back to the civil segment seems to be taking place, especially in Saudi Arabia and Kuwait, as both have acute housing shortages.

2Q11 MENA project status by geography



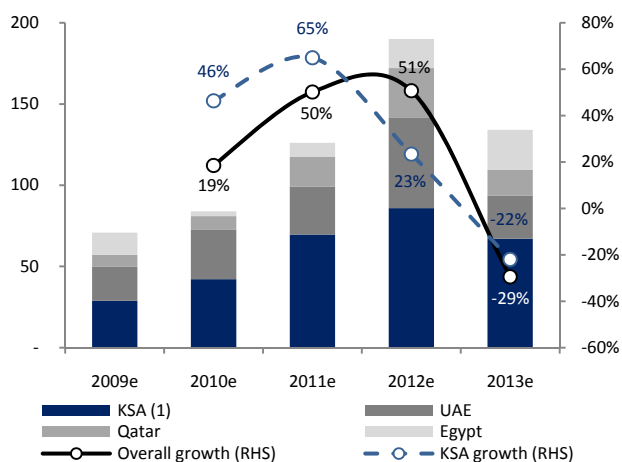
Source: MEED Projects, HC

2Q11 MENA project status by segment



Source: MEED Projects, HC

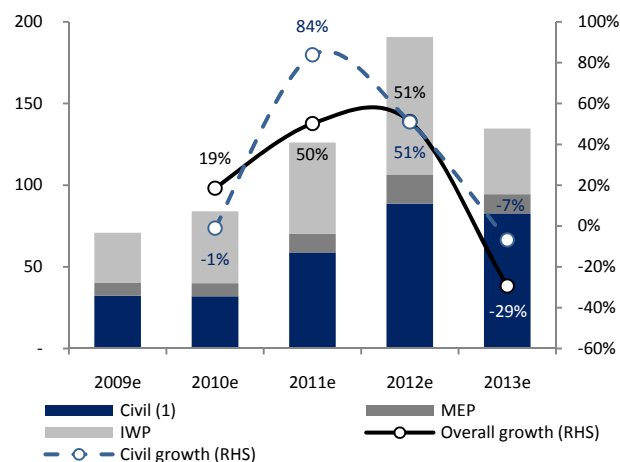
MENA award breakdown by geography (USDbn)



Source: MEED Projects, HC

Note: (1) Includes recently announced USD70bn housing program

MENA award breakdown by segment (USDbn)



Source: MEED Projects, HC

Note: (1) Includes recently announced USD70bn Saudi housing program

Our analysis of MEED data suggests that Saudi Arabia will continue to lead in MENA construction award growth over the medium term. After including the announced USD70bn housing program, we estimate a 65% jump in awards in Saudi Arabia in 2011e to USD70bn, followed by a 16% increase in 2012e. While the infrastructure segment saw the highest awards in 2010, accounting for 52% of projects, this is set to change from 2011e onwards in favor of the civil sector, driven largely by housing developments.

It is important to note here that these estimates maybe too optimistic as projects maybe delayed, put on hold, or cancelled. At any rate, according to MEED data, USD8.5bn worth of projects were awarded in Saudi Arabia as of 1H11, while the UAE saw the highest awards at USD8.6bn. In both Qatar and Kuwait roughly USD4bn of contracts were awarded in the first half of the year. For the most part, the run rate falls short of the above forecasts. For this reason, we feel that taking these figures at face value may be misleading. Thus, for Al Khodari we assume a 2010–14e backlog CAGR of 23%, or SAR14bn worth of awards over the period.



Al Khodari financials and valuation

Al Khodari income statement (SARm)

Year to December	2008a	2009a	2010a	2011e	2012e	2013e	2014e	2015e
Contracting revenue	1,062	914	937	1,126	1,311	1,897	2,155	2,097
Trading revenue	97	135	137	81	131	190	216	210
Revenue	1,159	1,048	1,074	1,208	1,442	2,087	2,371	2,307
Contracting costs	(770)	(680)	(715)	(873)	(1,008)	(1,459)	(1,657)	(1,612)
Trading costs	(54)	(73)	(69)	(58)	(68)	(98)	(112)	(109)
COGS	(824)	(753)	(785)	(913)	(1,076)	(1,557)	(1,769)	(1,721)
Gross profit	335	295	289	295	366	530	602	586
<i>Gross profit margin</i>	<i>29%</i>	<i>28%</i>	<i>27%</i>	<i>24%</i>	<i>25%</i>	<i>25%</i>	<i>25%</i>	<i>25%</i>
SG&A expenses	(61)	(59)	(59)	(70)	(85)	(123)	(140)	(136)
EBITDA	274	236	230	225	281	407	462	450
<i>EBITDA as a % of sales</i>	<i>24%</i>	<i>23%</i>	<i>21%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>
Operating profit – EBIT	274	236	230	225	281	407	462	450
<i>EBIT as a % of sales</i>	<i>24%</i>	<i>23%</i>	<i>21%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>
Financial charges	(34)	(21)	(14)	(18)	(15)	(15)	(7)	1
Other revenue	6	7	12	15	17	25	29	28
Net profit before taxes	246	223	229	222	283	417	484	478
Zakat	(7)	(6)	(11)	(7)	(12)	(17)	(27)	(37)
NPAT	240	217	218	215	271	400	457	441
<i>NPAT as a % of sales</i>	<i>21%</i>	<i>21%</i>	<i>20%</i>	<i>18%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>	<i>19%</i>
Minority interest	-	-	-	-	-	-	-	-
Net income before appropriations	240	217	218	215	271	400	457	441
Dividends	(10)	(109)	(136)	(43)	(85)	(85)	(85)	(85)
Retained earnings	230	109	82	172	186	315	457	441
Net margin	23%	21%	20%	18%	19%	19%	19%	19%
EPS (SAR)	6.0	5.1	5.1	5.0	6.4	9.4	10.8	10.4
Number of shares	40	43	43	43	43	43	43	43
DPS (SAR)	0.3	2.6	3.2	1.0	2.0	2.0	2.0	2.0
Dividend payout	4%	50%	62%	20%	31%	21%	19%	19%

Source: Company data, HC



Al Khodari balance sheet (SARm)

Year to December	2008a	2009a	2010a	2011e	2012e	2013e	2014e	2015e
Bank balances and cash	33	33	71	107	200	265	897	1,245
Accounts receivable and prepayments	438	534	687	1,502	1,699	2,310	2,184	2,130
Value of work executed in excess of billings	157	299	568	-	-	-	-	-
Amounts due from related parties	37	39	9	18	18	18	18	18
Inventories	27	20	37	62	62	62	62	62
Assets held for sale	7	12	7	33	33	33	33	33
Current assets	699	937	1,379	1,722	2,012	2,688	3,194	3,487
Investments in subsidiaries	4	4	4	4	4	4	4	4
Mobilization costs	9	7	10	13	14	20	22	18
Property, plant, and equipment	628	502	434	500	496	523	559	586
Fixed assets	641	513	448	517	514	547	585	609
Total assets	1,340	1,450	1,826	2,239	2,526	3,234	3,779	4,096
Current liabilities								
Accounts payable and accruals	175	248	437	778	879	1,272	1,446	1,406
Billings in excess of the value of work executed	9	1	-	-	-	-	-	-
Due to related parties	26	3	5	1	1	1	1	1
Provisions	19	5	11	4	4	4	4	4
Short-term loans	53	32	11	-	-	-	-	-
Current portion of term loans	188	120	230	332	332	332	332	332
Dividends payable	50	-	0	0	0	0	0	0
Partners' current accounts	49	-	-	-	-	-	-	-
Current liabilities	569	410	693	1,115	1,216	1,609	1,782	1,743
Noncurrent liabilities								
Term loans	396	503	511	328	328	328	328	328
Employee end of service benefits	23	27	30	32	32	32	32	32
Loan from an affiliate	4	4	4	4	4	4	4	4
Advances from customers	-	-	-	-	-	-	-	-
Noncurrent liabilities	423	534	545	364	364	364	364	364
Shareholder equity								
Share capital	300	400	425	425	425	425	425	425
Statutory reserves	-	11	22	43	62	93	131	166
Proposed dividends	-	95	-	-	-	-	-	-
Retained earnings	48	1	141	291	459	743	1,078	1,398
Total equity	348	506	588	760	946	1,261	1,633	1,989
Total equity and liabilities	1,340	1,450	1,826	2,239	2,526	3,234	3,779	4,096

Source: Company data, HC



Al Khodari cash flow statement (SARm)

Year to December	2008a	2009a	2010a	2011e	2012e	2013e	2014e	2015e
Net profit	246	223	229	216	271	400	457	441
Depreciation	138	114	111	91	76	78	83	88
Amortization	-	2	3	2	-	-	-	-
Impairments/provisions	(17)	(8)	2	-	-	-	-	-
Provision for employees end of service benefits	2	4	3	2	-	-	-	-
Add: Finance charges	34	21	14	15	15	15	7	(1)
Others	(2)	-	-	-	-	-	-	-
Changes in working capital	(288)	(197)	(221)	51	(97)	(224)	297	20
Net cash from operating activities	114	159	141	379	266	268	843	547
Interest paid	(34)	(21)	(14)	(15)	(15)	(15)	(7)	1
Zakat	(6)	(7)	(5)	(9)	-	-	-	-
Net cash used in operating activities	73	131	121	354	250	253	836	548
Purchase of property, plant, and equipment	(132)	(59)	(95)	(162)	(72)	(104)	(119)	(115)
Net movement in assets held for sale	55	67	51	(21)	-	-	-	-
Investments	2	-	-	-	-	-	-	-
Others	2	-	-	-	-	-	-	-
Net cash from investing activities	(74)	8	(44)	(184)	(72)	(104)	(119)	(115)
Movement in shareholders' current accounts	(102)	(49)	-	-	-	-	-	-
Dividends paid	(10)	(109)	(136)	(42)	(85)	(85)	(85)	(85)
Movement in short- and long-term loans	55	17	97	(92)	-	-	-	-
Net cash used in financing activities	(57)	(140)	(39)	(134)	(85)	(85)	(85)	(85)
Increase (decrease) in cash and cash equivalents	(57)	(0)	38.4	36	93	64	633	348
Opening cash balance	99	33	33	71	107	200	265	897
Bank balances and cash transferred	(8)	-	-	-	-	-	-	-
Closing cash balance	33	33	71	107	200	265	897	1,245

Source: Company data, HC



Al Khodari FCF forecasts (SARm)

	2009a	2010a	2011e	2012e	2013e	2014e	...	2020e	Terminal
EBITDA	236	230	225	281	407	462		712	
Taxes	(6)	(11)	(7)	(12)	(17)	(27)		(97)	
EBITDA less taxes	231	220	218	270	390	435		615	
Changes in working capital	(164)	(254)	66	(97)	(224)	297		(56)	
Gross cash flow	67	(35)	284	172	166	732		559	
CAPEX	(59)	48	(79)	(72)	(104)	(119)		(183)	
Free cash flow explicit period	8	13	206	100	61	613		377	4,803
FCF yield	-	0%	7%	4%	2%	22%		13%	
Present value	0	13	206	91	51	461		160	2,037

Source: HC

Al Khodari valuation (SARm)

Terminal growth rate	2.0%		
<i>PV of FCF</i>	<i>1,619</i>	Beta	1.4
<i>PV of terminal value</i>	<i>2,037</i>	Risk-free rate	4.5%
FCF to firm	3,655	Country risk premium	5.5%
Minority	-		
Gross debt	(660)	Cost of equity	12.2%
Cash	107	Cost of debt	5.0%
Investments	-	After tax cost of debt	4.9%
Equity value	3,103	Equity market capitalization	2,869
Number of shares	43	Debt	660
Target price (SAR)	73.0	Total	3,529
Market price (SAR)	65.8	Tax rate	2.5%
Potential upside	11%	WACC	10%

Source: HC



Disclaimer

HC Brokerage, which is an affiliate of HC Securities & Investment (referred to herein as “HC”) – a full-fledged investment bank providing investment banking, asset management, securities brokerage, research, and custody services – is exclusively responsible for the content of this report. JonesTrading Institutional Services LLC (“JonesTrading”), a member of SIPC/FINRA, has not had any input informing or determining the content of this report. The information used to produce this document is based on sources that HC believes to be reliable and accurate. This information has not been independently verified and may be condensed or incomplete. HC does not make any guarantee, representation, or warranty and accepts no responsibility or liability for the accuracy and completeness of such information. Expression of opinion contained herein is based on certain assumptions and the use of specific financial techniques that reflect the personal opinion of the authors of the commentary and is subject to change without notice.

The information in these materials reflects HC’s equity rating on a particular stock. HC, its affiliates, and/or their employees may publish or otherwise express other viewpoints or trading strategies that may conflict with the views included in this report. Please be aware that HC and/or its affiliates, and the investment funds and managed accounts they manage, may take positions contrary to the included equity rating.

This material is for informational purposes only and is not an offer to sell or the solicitation of an offer to buy. Ratings and general guidance are not personal recommendations for any particular investor or client and do not take into account the financial, investment, or other objectives or needs of, and may not be suitable for, any particular investor or client. Investors and clients should consider this only a single factor in making their investment decision, while taking into account the current market environment. Foreign currency-denominated securities are subject to fluctuations in exchange rates, which could have an adverse effect on the value or price of, or income derived from, the investment. Investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk. Neither HC nor any officer or employee of HC accepts liability for any direct, indirect, or consequential damages or losses arising from any use of this report or its contents.

Copyright

No part or excerpt of this research report’s content may be redistributed, reproduced, or conveyed in any form, written or oral, to any third party without prior written consent of the firms. The information within this research report must not be disclosed to any other person until HC has made its information publicly available.

Issuer of report:

HC Brokerage

Building F15-B224, Smart Village
KM28 Cairo-Alexandria Desert Road
6 October 12577, Egypt
Telephone: +202 3535 7666
Fax: +202 3535 7665
Website: www.hc-si.com

Pursuant to Rule 15a-6, this report is only available in the United States to Major US Institutional Investors and is being distributed pursuant to an agreement between JonesTrading and HC. The Alembic Global Advisors trade name is licensed by JonesTrading. Brokerage services in the United States are made available through JonesTrading.

JonesTrading Institutional Services LLC

32133 Lindero Canyon Road, Suite 208
Westlake Village, CA 91361
Telephone: +1 800 423 5933
Website: www.jonestrading.com

Alembic Global Advisors

780 Third Avenue, 8th Floor
New York City, NY 10017
Telephone: +1 212 359 8292
Website: www.alembicglobal.com



IMPORTANT DISCLOSURES

Analyst certification:

The analysts preparing and contributing to this report are not associated persons of JonesTrading, are not registered/qualified as research analysts with FINRA, and are not subject to the NASD Rule 2711 and incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

We, Majed Azzam, Ankur Khetawat, Nermeen Abdel Gawad, and Shireen Wissa, certify that the views expressed in this document accurately reflect our personal views about the subject securities and companies. We also certify that we do not hold a beneficial interest in the securities traded.

Analyst disclosures:

The analyst or a member of the analyst's household does not have a financial interest in the securities of the subject company (including, without limitation, any option, right, warrant, future, long or short position).

The analysts or a member of the analysts' household do not serve as an officer, director, or advisory board member of the subject company.

The analysts' compensation is not based upon HC's investment banking revenues and is also not from the subject company in the past 12 months.

HC disclosures:

Company name:	Disclosure:
Abdullah A.M. Alkhodari Sons Company	None
<ol style="list-style-type: none"> 1. HC or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. 2. HC or its affiliates have managed or co-managed a public offering of securities for the subject company in the past 12 months. 3. HC or its affiliates have received compensation for investment banking services from the subject company in the past 12 months. 4. HC or its affiliates expect to receive or intend to seek compensation for investment banking services from the subject company in the next 3 months. 5. HC has received compensation for products or services other than investment banking services from the subject company in the past 12 months. 6. The subject company currently is, or during the 12 month period preceding the date of distribution of this research report was, a client of HC. 7. HC makes a market in the subject company's securities at the time this report was published. 	

The HC Rating System consists of 3 separate ratings: Overweight, Neutral, and Underweight.

The appropriate rating is determined based on the estimated total return of the stock over a forward 12 month period, including both share appreciation and anticipated dividends.

Overweight rated stocks include a published 12 month target price. The target price represents the analysts' best estimate of the market price in a 12 month period. HC cautions that target prices are based on assumptions related to the company, industry, and investor climate. As such, target prices remain highly subjective.

The definition of each rating is as follows:

Overweight (OW): Estimated total potential return greater than or equal to 20%

Neutral (N): Estimated total potential return greater than or equal to 0% and less than 20%

Underweight (UW): Estimated total potential return less than 0%

NR: Not Rated

SP: Suspended

Stocks rated Overweight are required to have a published 12 month target price, while it is not required on stocks rated Neutral and Underweight.

Distribution of HC ratings			
Rating	Count	Percent	Percent provided investment banking services in past 12 months
Overweight (OW)	32	47.06	0.00
Neutral (N)	26	38.24	0.00
Underweight (UW)	10	14.71	0.00



All HC employees and its associate persons, including the analyst(s) responsible for preparing this research report, may be eligible to receive non-product or service specific monetary bonus compensation that is based upon various factors, including total revenues of HC and its affiliates, as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by directors, analysts, or employees and may affect transactions in and have long or short positions in the securities (options or warrants with respect thereto) mentioned herein.

Although the statements of fact in this report have been obtained from and are based upon recognized statistical services, issuer reports or communications, or other sources that HC believes to be reliable, we cannot guarantee their accuracy.

All opinions and estimates included constitute the analysts' judgment as of the date of this report and are subject to change without notice. HC may affect transactions as agent in the securities mentioned herein.

This report is offered for information purposes only, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such would be prohibited.

Additional information available upon request.