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Investment Update

Kuwait

Salhia Real Estate Company

Growth through differentiation

Reuters Code:
SREK.KW

Listing:
Kuwait Stock Exchange

CMP:
500fils (May 21,2007)

BUY

Investment Summary

- Salhia Real Estate Company (SREC) results witnessed a remarkable increase in its bottom-line to reach KD48.9mn in FY06 compared to KD17.5mn recorded in the previous year. This significant increase in net profit came on the back of capital gains from the sale of the land of "Al Asima project".

- SREC sold 21,414sqm of land in Al-Sharq area to "Al Asima Real Estate Company"at a price of KD115mn, realizing a profit of KD49mn. The transaction took place upon the completion of a rights issue that increased "Al Asima Real Estate Company"capital to KD80mn. Salhia now owns 50% of "Al Asima Real Estate Company".

- SREC revenues from real estate, hotel and care home operations increased by 8% on a y-o-y basis to reach KD36.5mn in FY06. The highest y-o-y increase in revenues came from real estate and hotels operations which witnessed a y-o-y increase of 10.3%, and 10.1% respectively, while revenues from care home operations grew by 4.4% on a y-o-y basis.

- The company's total assets grew by 11% on y-o-y basis to reach KD242.4mn in FY06, with core operating assets forming 72% of total assets.

- The company's future projects include "Al Asima" and "Arraya II" commercial projects in Kuwait, a commercial project in Bahrain, the Elephant and Castle commercial complex, (which is subject to bid and council approval) and the Farnborough shopping centre in the UK. The company is also considering other opportunities in Germany through its German subsidiary.

- SREC's Arraya II project is expected to be completed by 2008 while the Bahrain project is expected to be completed by 2010. Revenues from real estate, hotel and care home operations are expected to grow at a CAGR of 10% during 2007-10E compared to a CAGR of 12% during 2003-06.

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- Al Asima project is expected to be launched in March 2010, accordingly the company's share in JV results is expected to witness a significant increase in 2010 and thereafter.

- SREC is planning to sell the fixed assets of the German operation which is owned through its subsidiary SAREC on a sale/leaseback basis during 2007. This transaction is expected to free up capital for Salhia thus improving the company's debt-to-equity ratio and reducing depreciation and interest costs going forward.

- We have assigned an 80% weight to the DCF valuation and 20% to the P/BV valuation. Based on the weighted average valuation approach we have reached a fair value for SREC of 569fils, given a current market price of 500fils on May 21 2007, the stock is currently trading at 13.8% below the fair value. Therefore, we upgrade our earlier "HOLD" rating on SREC's stock and recommend a **"BUY"**.

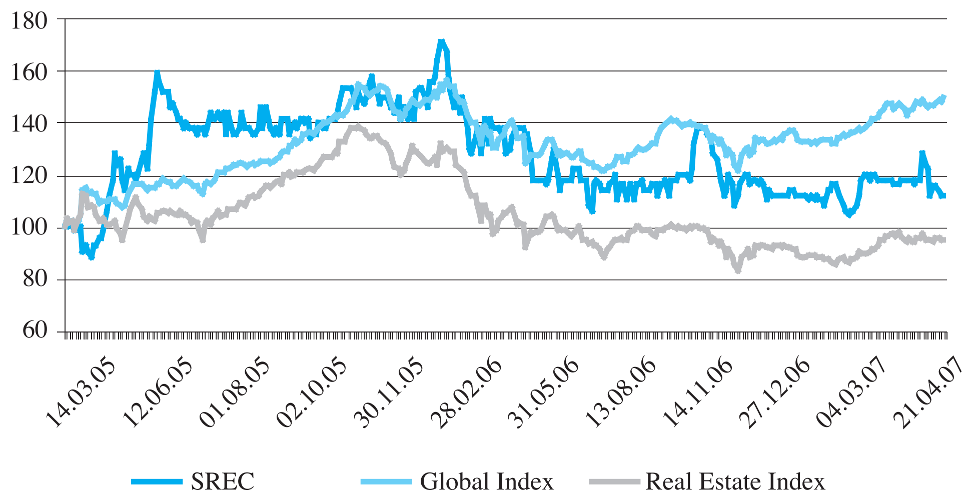
Table 1: SREC at a glance

Price (May 21, 2007) - fils	Shares in issue	Market Cap - KDmn	52 - week price range
500	362,162,255	181.1	609-461 fils

Year	Operating Revenues (KDmn)	Operating Profit (KDmn)	Net Profit (KDmn)	EPS (fils)	BVPS (fils)	ROAE (%)	P/E (x)	P/BVPS (x)
2008F	43.6	15.1	17.4	57.3	477.4	7.7%	8.7	1.0
2007F	38.5	13.3	42.2	139.1	451.4	18.1%	3.5	1.1
2006A	36.5	10.5	49.0	163.0	446.3	21.3%	3.6	1.3
2005A	33.8	9.1	17.5	57.9	338.8	8.0%	13.5	2.3

*Source: **Global** Research and SREC.*
Historical P/E & P/BV multiples pertain to market prices on KSE on May 21, 2007.

Chart 1: Relative Performance of SREC Vs Market Indices.



*Source: Reuters, **Global** Research*

Industry Overview

GCC real estate sector grew at unprecedented levels over the past few years fuelled by high oil revenues and abundant levels of liquidity in the region. Construction projects planned or under development in GCC have crossed the US$1trillion mark. Other factors that have contributed to the trend include high government capital spending, easy availability of credit and the establishment of real estate funds investing in the region.

Key drivers of the real estate sector in Kuwait

- The economic growth and abundant liquidity of Kuwait continues its good run, thanks to high oil prices. We estimate the real GDP growth rate in 2006 to be in the range of 6.5%-7.0%. The real GDP growth rate in 2005 was 8.1%, which followed a growth rate of 6.2% in 2004.

- Rapid population growth. The latest available data for September 2006 revealed a rise in total Kuwait population to 3.117mn, registering a growth of 4.22% over the end of 2005.

- Increase in employment opportunities and inflow of expatriates which accounted for 67% of Kuwait's total population in 2005 and grew by 11% on a year on year basis.

- Favourable demographics with around 29% of total population in the age group of 15-30.

- Higher purchasing power with a per capita GDP of US$28,100 compared to an average per capita GDP of US$17,425 for the entire GCC region.

- Salaries increased by 8% in 2006, while inflation is estimated at 3.5% in 2006.

- Variety of home financing products such as Ijara and increase in housing finance companies.

Industry Structure

Real estate in Kuwait is broadly divided into three main segments; Residential, Investment and Commercial.

Residential – The residential segment has been the most important segment of the real estate sector in Kuwait, and is comprised of the freehold market. In the absence of regulations allowing foreign ownership of real estate in Kuwait, the freehold market is only targeting Kuwaitis while expatriates dominate the rental market.

Investment – This segment represents investments in land and construction of either villas or apartment buildings for the purpose of rent. The construction usually takes the form of high-rise apartment buildings. Although not substantially different from the residential segment, the possible difference that may be cited is the final user not being the investor and is unlikely to become the owner of the property.

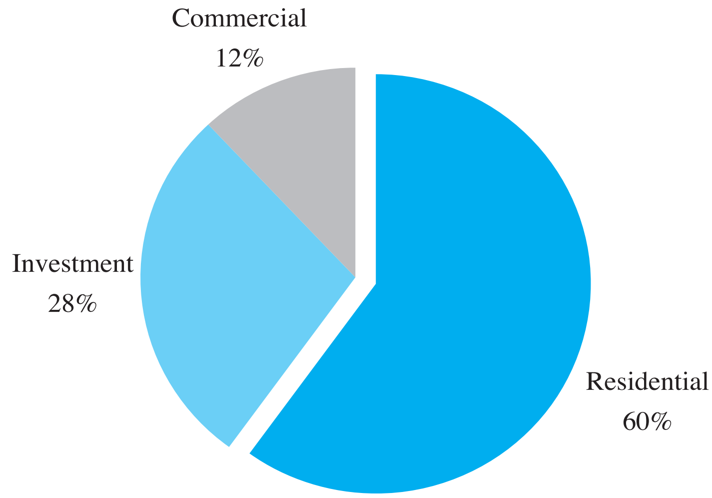
Commercial – This segment represents the construction of commercial complexes and sale or rent of spaces in commercial complexes either for office use or for retail use. The main commercial areas in Kuwait are Kuwait City, Sharq, Farwaniya, Hawally and parts of Salmiya. While commercial space in Kuwait City comprises largely of offices, Salmiya, Hawally and Farwaniya mostly have retail commercial space.

Industry Performance-2006

The number of real estate transactions traded in 2006 among residential, commercial, warehousing and industrial segments amounted to 10,370 transactions for total value of KD2.7bn increasing by 22% on y-o-y basis compared to KD2.2bn in 2005.

The residential segment accounted for 83% of the total number of real estate transactions and accounted for 60% of the total value of transactions. Next was the investment segment, which accounted for 15% of the total number of real estate transactions and accounted for 28% of the total value of transactions. Finally, the commercial segment formed 2% of the total number of transactions and 12% of the total value of transactions.

Chart 02: Value of Real Estate Transactions



Source: Mazaya Quarterly News bulletin

Industry Outlook

Major Upcoming Projects

A number of new projects are currently in the pipeline, which includes Failaka Island Project, Kuwait University Project, the Ring-road Project, the Bubiyan Island Project and Project Kuwait. Mega Projects Agency (MPA), a division of the Ministry of Public Works, is charged with overseeing the development of the state's two most important infrastructure projects, Failaka and Bubiyan. Such projects are bound to affect the real estate market in Kuwait. Moreover, it is stated that the Public Authority for Housing Welfare is executing 27 housing projects at a value of KD153mn. Out of these projects is the establishment of housing plots, residential units and public facilities and services in the Fahad Al-Ahmad housing project, East Sulaibikhat, Jaber Al-Ahmad city, and Saed Al-Abdullah area.

Silk City project – The Silk City Project at the Subiyah peninsula is considered as one of the largest additions to real estate development in Kuwait. It will comprise residential and commercial areas, schools, and hospitals. The city will be built on 250 square kilometres, and is expected to house 500,000 residents. The project will be built on a BOT model, by Tamdeen Real Estate and Ajiyal Real Estate companies. The completion date of the first phase will be within a period of 5-7 years.

Jabr Al-Ahmad Township and Sabbeya projects – Jabr Al-Ahmad project is already under construction and due for completion in two years. It will have 1220 housing units to accommodate 78,000 residents. Sabbeya project located at the north of Kuwait city is to construct 50,000 residential units in the area. The project will also require developing a new 75 km motorway and 36 km causeway from Kuwait city.

Liberation City project – The project is a KD50bn investment to be built gradually within 25 years. It involves the construction one of the highest skyscrapers in the world, Kuwait Tower, with 1.1km height over 250 floors. The tower will be the center of the Silk City. The project will contain commercial, tourist and entertainment establishments in addition to residential units to accommodate 700,000 residents.

Arefijan and the Khairan projects - Two major residential projects are also slated for execution, being offered to the private sector on a BOT basis over a 20-year period, namely; the Arefijan and the Khairan Residential Projects. The Arefijan project costing $1.87bn is to be a comprehensive residential area with associated facilities to house more than 100,000 people. It is a new city with estimated area of 40 square kilometers and comprises more than 11,000 residential units. The Khairan Residential Project is a massive 40 square kilometers project, which would add 26,000 residential units, at a cost of more than US$20bn.

Failaka Island Project - The estimated US$5bn project is to be developed on a 20-50 year BOT basis and calls for the construction of tourism infrastructure on the 43-square-kilometer island, including hotels, chalets, leisure and entertainment facilities. The Ministry of Public Works has received tenders from nine local companies for executing the project. Moreover, the Mega Projects Authority is said to float a BOT investment project for the construction of a water station and a 165-megawatt electricity plant in addition to a water distillation station at an estimated cost of US$25mn.

Bubiyan Island Project – The estimated US$6bn development of Bubiyan involve the construction of a new port, container terminal and residential and commercial infrastructure on the island. The Bubiyan seaport project is a US$6bn investment with the aim of opening (2.5mn ton a year) port by 2008. Nineteen companies were pre-qualified for the first phase tender covering the construction of road and bridge access to island, plus railway option at a cost of US$200-300mn. The second stage will cover the dredging of 40KM long, 260m wide, 14m deep approach channel at a cost of US$500mn.

Kuwait University Project – The project has an estimated KD1bn value, aiming to bring all the current university faculties, currently spread across the capital, under one roof. The new educational facility will be co-educational and accommodate up to 40,000 students. Local consultants are doing the designs for the dormitories, sports facilities and auditoriums as well as all the individual faculties.

The International Hospital and South Surra Hospital Projects– the International Hospital project is a KD8mn investment to construct a private hospital in Salmiya. The hospital is a 52-bed facility with a built-up area of 6000 square meter. The South Surra Hospital is a 1050-bed facility with estimated investment of KD50-60mn; it is expected to be the largest general-purpose hospital in Kuwait.

The First Ring Road project– The US$100mn first ring road project involves the upgrade of 2.5km of carriage way, 10 bridges and a division of existing underground utilities. The project also involves the construction of an 800 meter long stretch of single-lane overpass and a 1.5km section below ground.

Project Kuwait & 4th Refinery Project – Project Kuwait entails US$8.5bn development of the strategically vital Northern Oilfields, to achieve production levels of 5mn b/d by 2020 from about 2.8mn b/d today. The 4th refinery project is expected to be the world's largest Greenfield refinery project. It would raise the country's refining capacity to 1.5mn b/d with estimated overall investment of US$6.3bn.

Table 02: Landmark Projects in Kuwait

Project	Type	Expected Delivery Date	Estimated Cost (US$ bn)	Developer
City of Silk	Mixed use	-	86	Tamdeen Real Estate Co. / Ajial Real Estate Co.
Khairan Residential City	Residential	-	27	Public Authority for Housing Welfare
Project Kuwait	Industrial	2010	8.5	Kuwait Petroleum Corporation (KPC)
Bubiyan Island	Tourism	2016	6.0	Mega Projects Agency (MPA)
Failaka Island	Tourism	2014	5.0	Mega Projects Agency (MPA)

*Source: **Global** Research.*

Outlook

- Looking forward vacancies in apartment buildings are expected to widen because developers are still erecting new complexes at a breakneck pace. Unless there is further economic activation, an oversupply situation will persist.

- The only way to address the oversupply situation is to change the regulations and allow non-Kuwaitis to own property, which is not a possible scenario.

- The story is quite different for the supply of housing of Kuwaiti nationals which is witnessing a clear shortage.

- Demand for commercial real estate space is on the rise and is expected to increase further in the course of the coming years as the steaming economy and booming consumer spending persist in triggering business expansion, contributing to an increase in the net absorption of commercial space, in both retail as well as the office segments. To benefit from this latent demand, several real estate companies launched projects in the commercial segment. However, most of these projects in the segment are of high-end nature. This is a natural consequence of land prices being extremely high.

- It is estimated that the total supply of commercial space coming into the market by 2007-09 would reach 750,000sq.m. Among the main projects coming up in the commercial segment is the US$250mn Kuwait Business Town (KBT) project which will transform downtown Kuwait into a central business district. KBT will consist of nine office towers, shopping malls, and a hotel.

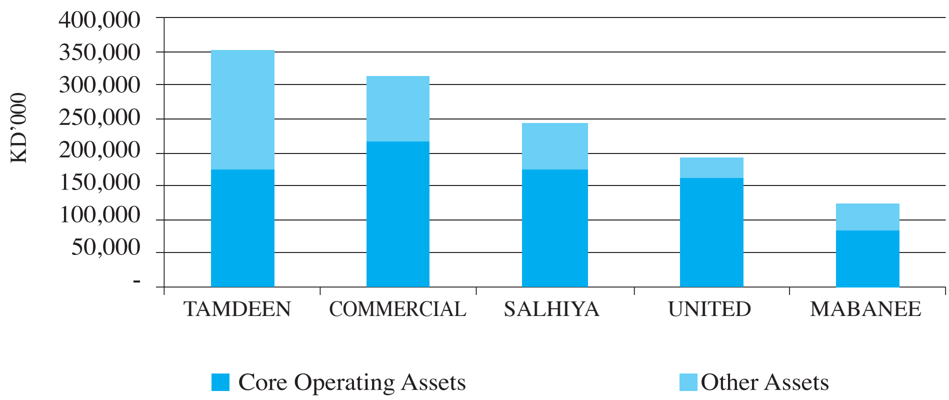
Peer Group Comparison

Our peer group consists of five companies including Salhia (SREC), United Real Estate (UREC), Commercial Real Estate Company (CRC), Tamdeen Real Estate Company, and Mabanee Real Estate Company. The following criteria were used to select the Peer Group: 1) Assets size (valued on a historical cost basis); 2) Revenues from real estate operations; and 3) Market capitalization. In addition, most of our peer group companies operate in the retail and commercial segments.

Asset Structure

During 2005 and before the recent stock market downturn, most of the real estate companies increased their investment portfolios at the expense of their core operating assets. Stock market investments might have been a favorable situation in 2005, however, the situation has now reversed. Therefore, we believe that companies with the highest percentage of core operating assets have more potential for sustainable growth. Although, Tamdeen ranked the first in terms of asset size in 2006, United Real Estate company ranked the first in terms of the contribution of core operating assets with core operating assets forming 84% of total assets, followed by Salhia with core operating assets contributing 72% to total assets in 2006.

Chart 03: Asset Structure in 2006

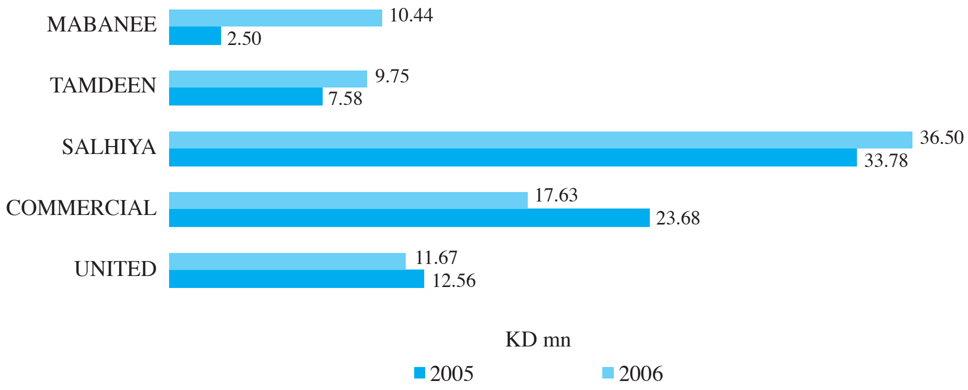


*Source: Annual Reports, **Global** Research.*

Core Revenues

In selecting our peer group, we focused on companies with the highest share of revenues from real estate operations. In absolute numbers, Salhia recorded the highest core revenues in 2006, with core revenues amounting to KD36.5mn. In terms of the growth in core revenues in 2006, Mabanee recorded the highest y-o-y growth in 2006, growing by a remarkable 318%. Following Mabanee were Tamdeen, and Salhia, growing by 29%, and 8% respectively on a y-o-y basis, while Commercial Real Estate and United Real Estate recorded negative growth in 2006.

Chart 04: Core Revenues

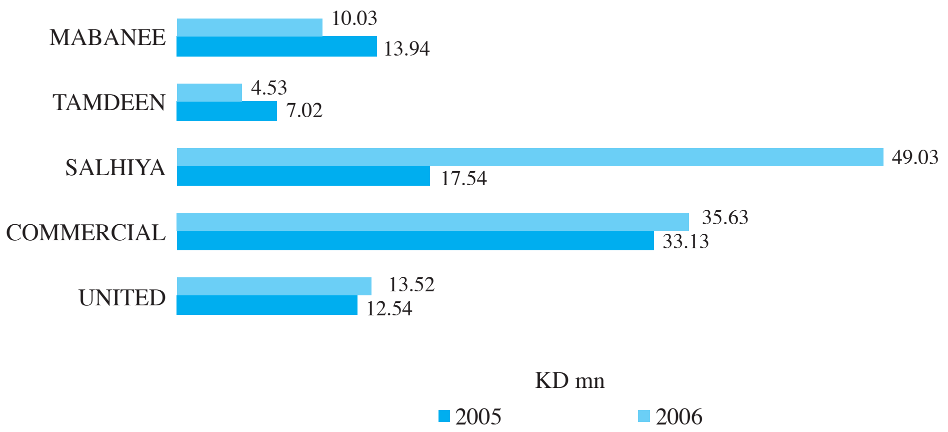


*Source: Annual Reports, **Global** Research.*

Net Profit

Consolidated net profit of listed real estate companies took a plunge in 2006, decreasing by 70% from KD442mn in 2005 to KD132.5mn in 2006. The reason for this significant decline was the huge investment gains recorded by real estate companies in 2005. Owing to the surge in stock prices in 2005, net profit for most of listed real estate companies benefited from the investment portfolio in their assets and not from real estate operations. Consolidated net profit for our peer group on the other hand increased by 34% from KD84.16nm in 2005 to KD112.74mn in 2006, and constituted 85% of the consolidated net profit of listed real estate companies in 2006. Among our peer group, Salhia ranked the first in terms of both the size and the y-o-y growth in net profit. The company recorded a net profit of KD49mn, which is 180% over 2005 net profit of KD17.5mn. Following Salhia were United Real Estate, and Commercial Real Estate, recording a y-o-y growth of 8%, and 7% in net profit respectively, while Tamdeen and Mabanee recorded negative growth in 2006.

Chart 05: Net Profit

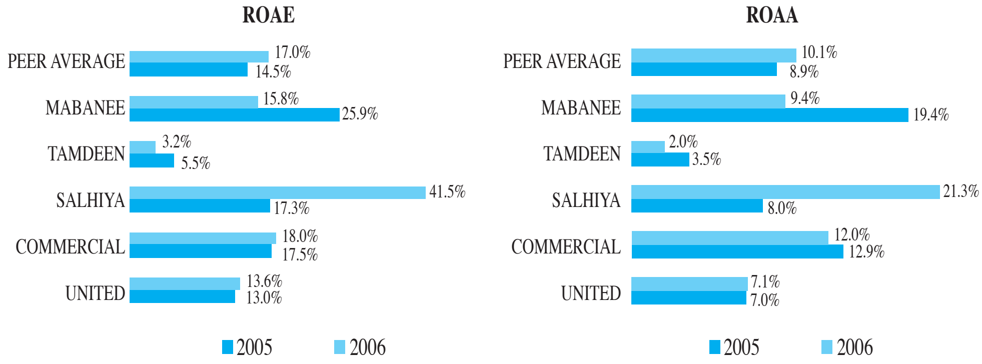


*Source: Annual Reports, **Global** Research.*

Profitability

Salhia ranked the first in terms of both ROAE and ROAA in 2006, recording a ROAE and ROAA of 41.5%, and 21.3% respectively in 2006 outperforming the peer group average ROAE and ROAA of 17.0%, and 10.1% respectively. Most of our peer group companies recorded improvement in their ROAE and ROAA in 2006 except for Tamdeen and Mabanee companies.

Chart 06: Return Ratios



*Source: Annual Reports, **Global** Research.*

Trading Comparables

There are currently 29 listed real companies on Kuwait Stock Exchange (KSE) with a total market cap of KD3.2bn on May 21, 2007, forming 6% of the total market cap of KSE. Our selected peer group formed 36% of the total market cap of listed real estate companies on KSE on of May 21, 2007. Salhia's P/E ratio stood at 3.2x 2006 earnings compared to a peer group average of 9.2x and a sector weighted average of 13.2x, while P/BV stood 1.2x compared to a peer group average of 1.5x and a sector weighted average of 1.6x.

Table 03: Trading Comparables

	Market Cap (KD '000)	Price (Fils)	EPS (Fils)	BVPS (Fils)	P/E	P/BV
UNITED	106,106	178	25.6	188.8	6.9	0.9
COMMERCIAL	412,670	285	27.2	148.2	10.5	1.9
SALHIA	181,081	500	163.2	425.9	3.1	1.2
TAMDEEN	142,464	420	13.4	626.3	31.3	0.7
MABANEE	304,920	840	30.7	207.6	27.3	4.0
Peer Group Average	**1,147,241**	**-**	**-**	**-**	**9.2**	**1.5**
Sector Average	**3,208,566**	**-**	**-**	**-**	**13.2**	**1.6**

*Source: Annual Reports, **Global** Research.*
Market Cap, P/E and P/BV are calculated based on closing market prices on KSE as of May 21, 2007.

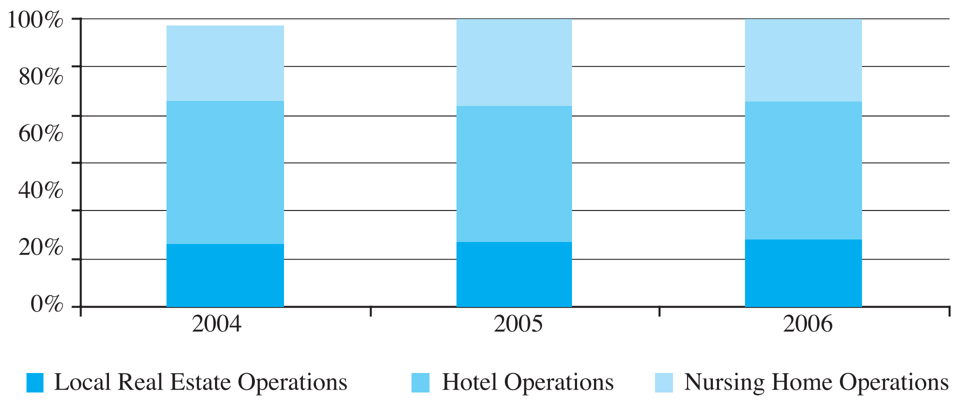
Business Strategy

The company's business strategy is based on two foundations, 1) Superior quality in planning and implementing projects and, 2) focus on commercial property ownership in the Central Business District (CBD). This implies that the company follows a differentiation strategy that aims to focus its geographical operations in the downtown, where most of Kuwait businesses are located since these projects are expected to achieve a good capital appreciation in value regardless of the rental income.

Diversified operations…

The company's rental income consists of revenues from local real estate operations, hotel operations, and nursing home operations in Germany. Revenues from hotel operations accounted for 36.3% of SREC's revenues in 2006, followed care home operations, which contributed 35.7%, and local real estate operations contributing 28% to total revenues.

Chart 07: Revenue Mix

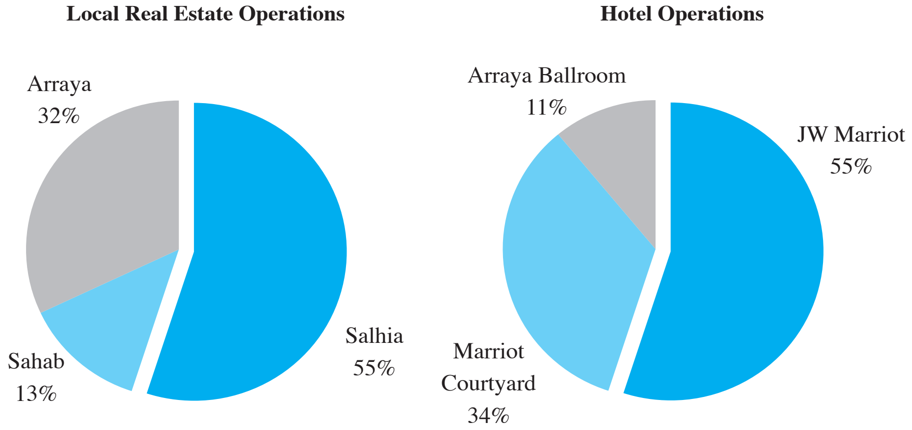


*Source: SREC, **Global** Research.*

Commercial and Hospitality segments are the focus of operations in Kuwait…

Salhia's real estate and hotel operations are mainly concentrated in Kuwait, with a focus on commercial and hospitality segments. The company is the developer and owner of the luxurious Salhia and Arraya commercial complexes. The company also owns the Sahab commercial complex. Hotel operations include the JW Marriott, Courtyard by Marriott, and the Arraya Ballroom, all located in the heart of Kuwait city. According to management, occupancy rates in the Salhia and Arraya complexes have been close to 100%, while average occupancy levels for the company's hotels are 60% for the JW Marriot, and 70% for the Marriot courtyard.

Chart 08: Revenues from local real estate operations and hotel operations (FY06)



*Source: SREC, **Global** Research.*

Care home operations in Germany…

The company also operates care homes business in Germany through its subsidiary, "Haddia Holding Company" in Germany. The primary activities of Haddia Holding Gmbh are the development, ownership and management of nursing homes and senior residence in northern Germany. Salhia also owns 89.7% of SAREC Company, which specializes in leasing properties. SAREC mainly leases nursing homes to Dana Company, another subsidiary of Salhia. Dana Company is the operating company of the care homes operation of Salhia. Salhia began operating in Germany 14 years ago; currently it has around 900 employees in its German subsidiaries, and owns around 1,700 Beds with a weighted average occupancy level of 85%, and an average rental yield of 7%.

Joint ventures in the UK…

The company also has two operating companies in the United Kingdom, which form part of its consolidated financials, which are:

- A 50/50 Joint venture with a UK publicly listed real estate developer by the name of St.Modwen Properties; this joint venture is operating under the name of "Key Property Investments" (KPI). From 2001 until 2005, KPI acquired 3 commercial complexes and 30 properties, which are mainly industrial buildings and warehouses facilities; in addition, KPI purchased 65% of the "Basingstoke Mall" in the UK at KD24.2mn.

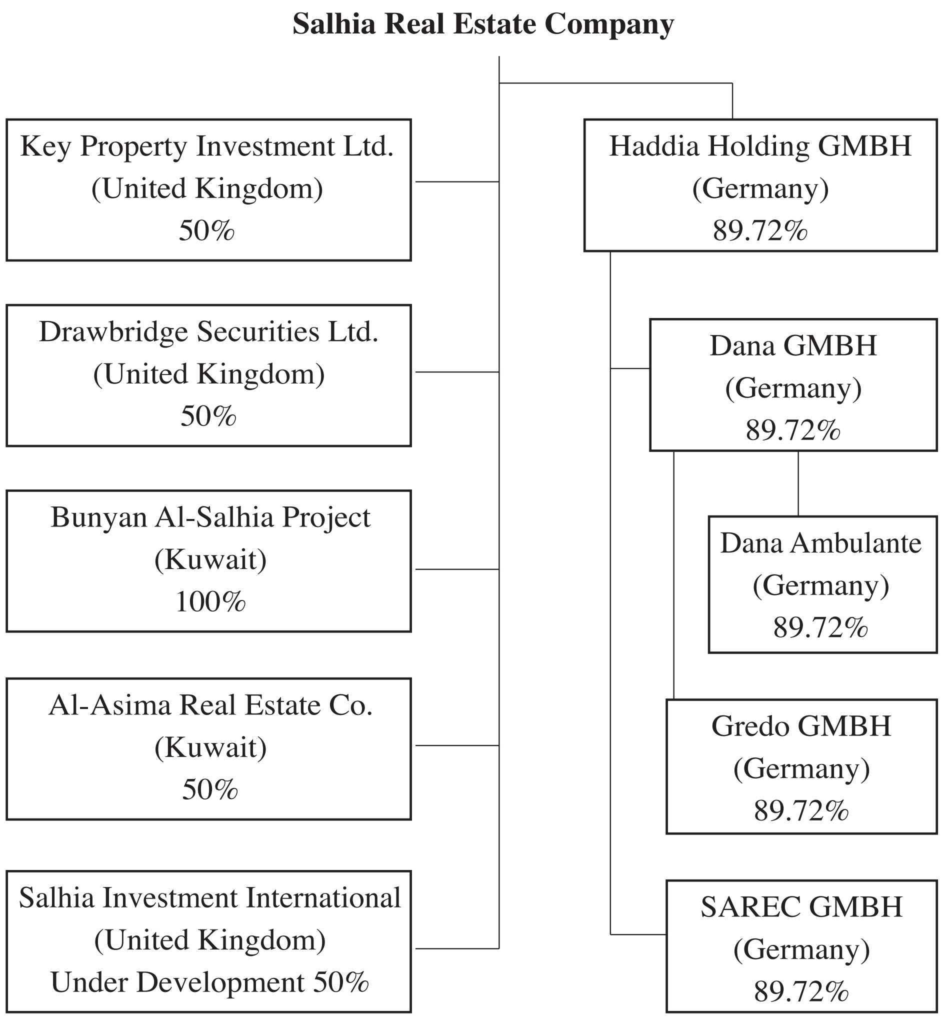
  On April 16 2007, Salhia sold through KPI the headquarters/distribution building it is developing for Adidas Group at Trafford Park, Manchester, U.K. to the National Farmers Union Mutual Insurance Society Ltd for approximately KD19.1mn. Salhia's share from the sale was approximately KD1.06mn, and will be included in the company's fourth-quarter results.

- Salhia also owns 50% of Drawbridge Securities in the UK. The main activity of the company is to purchase exclusive land options. Drawbridge might sell the land options afterward, or enter into joint venture to redevelop the land with the capital gain shared among Drawbridge and the co-partners. Recently, Salhia has sold through Drawbridge Securities; the Ditton Widnes Property (UK) to West Link Company Ltd. for a price of KD12.1mn realizing a KD467,482 profits that was reflected in the consolidated Q1-2007 financial statements.

Other markets in the pipeline…

Besides the German and the UK operations, the company is also contemplating to venture into other GCC countries. The company has initiated studies of commercial projects in Bahrain, which will be developed on an area of 5,100sqm at a total cost of KD23mn. Salhia is also considering entering into commercial projects in Oman.

Chart 09: Salhia Subsidiaries



Source: Company 2006 financial statements, ***Global*** *Research.*

Table 04: Future projects in the pipeline

Project	Description
Al Asima Project-Kuwait	The project is located in Sharq and is spread over an area of 21,414 sqm. It comprises of a mall, a 3-floor car park, a café, cinema theater, restaurants, 4-star hotel with multi-purpose ballrooms and health club, 70 floor office towers of approximately 1,400 sqm, and an outdoor recreational plaza. The project is expected to be completed by March 2010.
Arraya Tower II-Kuwait	This new 57-storey tower will be built on a 1,058-sqm land. Phase I has been already completed, and the project is expected to be fully completed by 2008.
Elephant and Castle Commercial Complex-UK	KPI has passed phase I and II of the bidding process. If chosen, KPI will enter a JV with the local counsel to undergo a major regeneration plan for the area surrounding the Elephant and Castle commercial complex. The plan, subject to bids and council approval, aims to construct 6,600 residential units, 79,400sqm of retail space, 17,000-sqm hospitality space and 8,300 sqm of community space. KPI is now only competing with one other bidder for the regeneration project. The scheme is scheduled to commence in 2010 and complete in 2019. The cost of the scheme is currently projected to be £1.5 billion.
Farnborough Shopping Center-UK	KPI will soon be starting (summer 2007) a major re-development of the Farnborough town centre. The development will create 16,722 sqm of retail and hospitality units, 159 residential apartments, 2,694 sqm 8 screen cinema, 2,323 sqm of restaurants and a multi storey car park. The scheme is scheduled to be completed by the end of 2009. The establishment cost for the project is approx. £53 million.
Boughton Rd./Leicester Rd./Mill Rd., Rugby-UK	Upon receiving planning consent (imminent), KPI will be re-developing this industrial site into a mixed-use scheme. Land uses on master plan include housing on 28 acres, employment on 10 acres, industrial on 6.4 acres, DIY retail on 5 acres, landscape on 7.66 acres, and Infrastructure on 5 acres and Rugby College on 7 acres. The residential site will be marketed for sale by Q2/Q3 of 2007 and construction of the college to commence at that time as well. The scheme is scheduled to be completed in Q1 2010 at a cost of £22.2 million.
10 Dorset Street, Southampton-UK	The development of the 25,000 sq ft office building is due for completion at the end of May 2007. The 50/50 JV, between Drawbridge Securities and Deeley Properties, were successful in letting 3 out of the 4 floors to Grant Thornton at a rent of £21 per sq ft, the highest achieved in Southampton. It is anticipated that the asset will be sold in Q3 of 2007 for a significant profit. The total cost of the scheme will be £6.7 million.

Source: Company

Financial performance FY-06

Upward rate revisions induce revenue growth…

Revenues from real estate, hotel and care home operations have increased by 8% on a y-o-y basis to reach KD36.5mn in FY06. The highest y-o-y increase in revenues came from real estate and hotels operations, which witnessed a y-o-y increase of 10.3%, and 10.1% respectively, while revenues from care home operations grew by 4.4% on a y-o-y basis. The growth in revenues from real estate and hotel operations was mainly attributed to rental rate revisions and a 15% upward revision for hotel rates. Revenues from the UK joint venture- KPI- witnessed a y-o-y increase of 11.3% to reach KD1.7mn.

Table 05: Operating revenue breakdown

In KD	2005	2006	Change
JW Marriot	6,391,465	7,198,676	12.6%
Marriot Courtyard	4,353,409	4,545,650	4.4%
Arraya Ballroom	1,274,070	1,518,086	19.2%
Total Hotel Operations	**12,018,944**	**13,262,412**	**10.3%**
Salhia	5,271,340	5,634,487	6.9%
Sahab	984,395	1,320,471	34.1%
Arraya	3,010,384	3,248,087	7.9%
Total Local Real Estate Operations	**9,266,119**	**10,203,045**	**10.1%**
Nursing Care Operations	12,490,955	13,037,913	4.4%
Other Buildings	1,519	-	-
Total	**33,777,537**	**36,503,370**	**8.1%**

Source: SREC.

Higher operating expenses affect gross profit margin …

Operating expenses as a percentage of operating revenues increased to reach 44.3% in FY06 as opposed to 40.5% in FY-05. The increase in operating expenses in FY06 was attributable to increased start up cost of new nursing homes in Germany coupled with an increase in hotel staff provision expenses. Accordingly, Gross profit margin declined from 59.5% in FY05 to 55.7% in FY06.

Capital gain of KD49mn from Al Asima transaction…

During the year, Salhia increased the share capital of “Al Asima Real Estate Company”, the company responsible for the upcoming Asima project from KD1mn to KD80mn. Later, it offered 50% of its newly formed subsidiary through an IPO. National Bank of Kuwait (NBK) was the lead manager and underwriter of the 50% IPO. Following the IPO, Salhia’s equity interest has been diluted to 50%, and the investment has been classified as an associate.

Later, Salhia sold the 21,414-sqm land of the Asima project to the newly formed company at a value of KD115mn and realized a net gain of KD49mn. This land will be totally owned and developed by “Al Asima Real Estate Company”. Salhia Real Estate now owns 50% (KD40mn) of the capital of “Al Asima Real Estate Company”. The excess gain over the investment (KD9mn after excluding the share of Salhia in Asima Real Estate) has been recorded as a deferred gain liability on the balance sheet and will be offset by future increases in the carrying value of associate.

Profits shooting up on the back of capital gains…

Net profit witnessed a remarkable increase on the back of the Asima transaction to reach KD48.9mn compared to KD17.5mn in FY05. EPS for FY06 stood at 163.2fils as opposed to an EPS of 57.9Fils for FY05. ROAE improved from 17% in FY05 to 41% in FY06, while ROAA jumped from 8% in FY05 to 21% in FY06.

Cash inflow of KD115.2mn…

The Asima real estate company transaction resulted in a total cash inflow of KD115.2mn. Out of which KD40mn were used to subscribe in the capital increase of the associate "Al Asima Real Estate Company", KD20mn were placed as fixed deposits with local banks while the remaining proceeds were used to retire debt. Accordingly, cash and cash equivalents increased from KD2.5mn in FY05 to KD22.4mn in FY06, while total debt including overdrafts dropped by 16% from KD103.3mn to KD86.8mn in FY06.

AGM approves 50% cash dividend and 15% bonus shares distribution…

The company approved the distribution of 50-fils cash dividend per share for FY06, and a 15% bonus shares issue, which will increase the company's capital from KD31.49mn to KD36.21mn.

Key Assumptions

- Revenues from Arraya II project were expected to kick in 2008 while revenues from Bahrain project were expected to kick in 2010.

- Share in JV results is expected to witness a significant increase in 2010 following the launch of Al Asima project in March 2010.

- Operating costs as a percentage of operating income were expected to decline to their normal levels of 40%.

- The company is planning to sell the fixed assets of the German Operation on sale/ leaseback basis in 2007. Salhia will only sell SAREC, the company holding the fixed assets, however, the operating company DANA which handles all of the functional activities will remain in the Haddia group. This transaction was expected to lessen fixed assets by KD43.1mn, and decrease debt by KD35mn.

- The sale/leaseback transaction is expected to free up capital for Salhia improving the company's debt-to-equity ratio and reducing depreciation and interest costs going forward.

- A net gain of KD34.7mn on the above sale of fixed assets was assumed in FY07E.

- Recently, Salhia has sold through Drawbridge Securities; the Ditton Widnes Property (UK) to West Link Company Ltd. for a price of KD12.1mn realizing a KD467,482 gain. In addition, Salhia sold through KPI the headquarters/distribution building it is developing for Adidas Group at Trafford Park, Manchester, U.K. Salhia's share from the sale was approximately KD1.06mn. We have included these gains in our forecast for gain on sale of investment property for FY07E.

- Paid up capital and the number of shares were adjusted according to the approved 15% bonus shares issue for FY06.

Valuation

To maintain the consistency in our recommendation we have used the same valuation techniques applied in the previous reports on SREC, the Discounted Cash Flow (DCF) – discounting the company Free Cash Flow to Firm (FCFF)- beside the relative valuation methods, specifically the Price to Book Value (P/BV).

Discounted Cashflow Model

The DCF model is based on a 4-year (FY2007-FY2010) explicit forecast period for the Free Cash Flow to Firm (FCFF). The terminal value is estimated using the constant growth Gordon Growth Model (GGM). The forecasted cash flow and the terminal value is then discounted at the company Weighted Average Cost of Capital (WACC). In our DCF valuation, we have used the following assumptions:

1. Risk Free Rate (RFR) of 6.25%.
2. Equity risk premium of 6%.
3. Beta of 1.
4. A terminal growth rate of 4%.
5. Cost of debt of 7.5%

Using the above assumptions, we have derived a cost of equity for the company under the Capital Assets Pricing Model of 12.25%, and a WACC of 10.83%. Given the methodology and assumption discussed above, we estimated the fair value of 556fils. This suggests that the stock is undervalued as compared to current market price of 500fils as on May 21 2007.

Sensitivity Analysis

We provide below a sensitivity analysis table, which shows the probable value given different growth rate assumption and WACC. The shaded area represents the most probable outcomes.

Table 06: Sensitivity Analysis

		Terminal Growth rate				
	556.3	**1.75%**	**2.75%**	**4.00%**	**4.75%**	**5.75%**
WACC	**8.83%**	564.2	629.6	749.6	856.8	1,081.3
	9.83%	505.1	553.2	636.5	706.1	839.0
	10.83%	458.9	495.5	**556**	604.9	691.9
	11.83%	421.7	450.4	496.6	532.1	593.1
	12.83%	391.2	414.2	450.2	477.2	522.0

*Source: **Global** Research.*

Relative Valuation Method

We arrived at SREC's share fair value via the relative valuation method using the following assumptions:

1. Forward P/BV of 1.4x for the peer group, and market prices on May 21 2007.
2. SREC's projected BVPS for 2007.

Based on the assumption discussed above, we arrived at a fair value for SREC of 619fils per share.

Weighted Average Valuation

We have assigned an 80% probability to the DCF technique and 20% to the P/BV technique, since the relative valuation approach is very volatile and subject to the market sentiment and other qualitative factors. Based on the weighted average valuation approach provided below we have reached a fair value for SREC of 569fils, given a current market price of 500fils on May 21 2007, the stock is currently trading at 13.8% below the fair value. Therefore, we upgrade our earlier "HOLD" rating on Salhia and recommend a **"BUY"**.

Table 07: Weighted average valuation

	Fair Value per share (fils)	Weight	Weighted Value (fils)
As per FCFF Method	556	80%	445
As per P / BV multiple	619	20%	124
Weighted Price(fils)			**569**

*Source: **Global** Research.*

Balance Sheet

	Salhia Real Estate Company						
Amount in KD'000	**2004A**	**2005A**	**2006A**	**2007F**	**2008F**	**2009F**	**2010F**
Cash & Cash Equivalents	4,259	2,540	22,458	41,929	41,445	40,992	38,454
Account Receivables & prepayments	8,211	7,108	8,370	8,169	9,235	9,664	10,840
Inventories	409	430	462	471	533	557	625
Current Assets	12,879	10,078	31,290	50,569	51,213	51,213	49,919
Investments	23,066	28,099	36,819	38,660	40,593	42,623	44,754
Investment in joint venture	17,188	15,447	18,575	19,565	20,654	21,852	30,462
Gross Fixed Assets (incl. cwip)	120,109	121,271	134,822	98,210	88,710	95,210	75,710
Accumulated Depreciation	(20,880)	(21,990)	(30,866)	(33,910)	(36,351)	(38,754)	(40,986)
Net fixed Assets	99,229	99,281	103,956	64,300	52,358	56,456	34,723
Investment Properties (Gross)	80,707	77,869	64,161	64,161	78,093	75,818	99,316
Acc. Depreciation	(12,000)	(13,711)	(12,349)	(14,025)	(15,883)	(17,894)	(20,182)
Investment Properties (Net)	68,707	64,159	51,812	50,136	62,210	57,924	79,134
TOTAL ASSETS	**221,070**	**217,063**	**242,453**	**223,230**	**227,029**	**230,068**	**238,992**
Due to banks	9,770	19,477	6,925	-	-	-	-
Payables	8,048	7,285	6,539	7,707	8,713	9,117	10,226
Prepaid Revenues	1,207	1,676	2,899	2,774	3,137	3,282	3,681
Provisions	172	104	133	140	147	154	162
Current portion of long-term debt	15,780	-	-	-	-	-	-
Current Liabilities	**34,977**	**28,543**	**16,496**	**10,621**	**11,996**	**12,553**	**14,069**
Long-term loans	83,022	83,911	79,875	35,912	28,662	20,662	12,662
Employee indemnity (terminal benefits)	1,342	1,705	1,989	2,449	2,641	2,849	3,149
Long-term Liabilities	84,364	85,616	81,864	38,360	31,302	23,510	15,811
TOTAL LIABILITIES	**119,341**	**114,158**	**98,360**	**48,981**	**43,298**	**36,063**	**29,880**
Deferred Gain	-	-	9,057	9,057	9,057	9,057	9,057
Minority interest	935	940	926	987	1,049	1,111	1,172
SHAREHOLDERS EQUITY							
Share capital	31,492	31,492	31,492	36,216	36,216	36,216	36,216
Forex translation reserve	4,637	1,898	3,376	3,376	3,376	3,376	3,376
Cumulative Changes in Fair Value of Investments	978	(66)	(2,696)	(2,830)	(2,972)	(3,120)	(3,276)
Share Premium	27,525	27,525	27,525	27,525	27,525	27,525	27,525
Treasury stock	(2,779)	(7,751)	(8,445)	(8,445)	(8,445)	(8,445)	(8,445)
Statutory reserve	8,121	9,943	15,035	18,108	18,108	18,108	18,108
Voluntary reserve	8,121	9,943	15,035	19,632	21,550	23,630	26,638
General reserve	4,250	4,250	4,250	4,250	4,250	4,250	4,250
Retained earnings	18,451	24,733	48,538	66,374	74,017	82,298	94,492
TOTAL SHAREHOLDERS EQUITY	**100,794**	**101,965**	**134,110**	**164,205**	**173,625**	**183,838**	**198,883**
TOTAL LIABILITIES & EQUITY	**221,070**	**217,063**	**242,453**	**223,230**	**227,029**	**230,068**	**238,992**

Income Statement

	Salhia Real Estate Company						
Amount in KD'000	**2004A**	**2005A**	**2006A**	**2007F**	**2008F**	**2009F**	**2010F**
Income from real estate, hotel & care home Ops	34,165	33,778	36,503	38,534	43,563	45,586	51,130
Direct Operating expenses	(13,822)	(13,667)	(16,180)	(15,414)	(17,425)	(18,234)	(20,452)
Gross Profit	**20,343**	**20,110**	**20,324**	**23,121**	**26,138**	**27,352**	**30,678**
Share in JV results	2,094	1,498	1,668	1,834	2,018	2,220	9,734
General & administrative expenses	(4,904)	(5,204)	(5,323)	(5,780)	(6,534)	(7,294)	(8,692)
Depreciation	(4,410)	(5,198)	(5,200)	(4,720)	(4,300)	(4,413)	(4,520)
Sales and marketing expenses	(2,439)	(2,140)	(987)	(1,156)	(2,178)	(2,279)	(3,579)
Operating income from continued operation	**10,684**	**9,066**	**10,481**	**13,299**	**15,143**	**15,585**	**23,621**
Dividends & interest income	784	1,101	870	913	959	1,007	1,057
Finance cost	(5,150)	(7,145)	(8,846)	(4,658)	(2,451)	(1,872)	(1,265)
Recurring income from continued operation	**6,318**	**3,022**	**2,504**	**9,554**	**13,651**	**14,720**	**23,413**
Gain on sale of investment property	-	4,912	49,057	36,276	5,403	5,943	6,538
Gain on sale of investment	5,167	10,435	146	-	-	-	-
Foreign exchange gain /loss	-	286	30	-	-	-	-
Other income	(30)	102	285	299	314	330	347
Provision for impairment	(254)	(123)	(200)	(163)	(185)	(193)	(217)
Income before taxes, BOD and minority interest	**11,202**	**18,634**	**51,823**	**45,967**	**19,184**	**20,800**	**30,081**
Foreign Tax	(604)	(456)	(972)	(943)	(1,032)	(1,130)	(1,238)
KFAS Contribution	(96)	(164)	(458)	(460)	(192)	(208)	(301)
BoD Remuneration	(77)	(110)	(165)	(460)	(192)	(208)	(301)
NLST	(236)	(403)	(1,271)	(919)	(384)	(416)	(602)
Net Income from continued operation	**10,189**	**17,501**	**48,957**	**43,185**	**17,385**	**18,838**	**27,640**
Extraordinary items	-	-	-	-	-	-	-
Net income	**10,189**	**17,501**	**48,957**	**43,185**	**17,385**	**18,838**	**27,640**
Attributable to:							
Equity holder of the parent company	10,252	17,543	49,000	43,247	17,446	18,900	27,701
Minority Interest	**(63)**	**(43)**	**(74)**	**(62)**	**(62)**	**(62)**	**(62)**
	10,189	**17,501**	**48,167**	**43,185**	**17,386**	**18,838**	**27,640**

Cash Flow Statement

	Salhia Real Estate Company						
Amount in KD'000	2004A	2005A	2006A	2007F	2008F	2009F	2010F
Profit before tax, extraordinary items, KFAS payment, NLST and BoD remuneration	**11,202**	**18,178**	**50,851**	**45,024**	**18,152**	**19,670**	**28,843**
Adjustments:							
Investment & interest income	(5,951)	(11,536)	(1,016)				
Share in JV results	(2,094)	(908)	(789)	(1,834)	(2,018)	(2,220)	(9,734)
Forex Translation (Gain) Loss	118	(286)	(30)	-	-	-	-
Financial Charges	5,150	7,145	8,846	4,658	2,451	1,872	1,265
Depreciation	4,410	5,198	5,200	4,720	4,300	4,413	4,520
(Gain) Loss on Disposal of Fixed Assets	-	(4,912)	(49,057)	(37,190)	(6,362)	(6,950)	(7,595)
Provision for employee terminal benefits	246	738	284	-	-	-	-
Provisions for impairment of investments	254	123	200	-	-	-	-
Operating profit before changes in operating assets & liabilities	**13,334**	**13,740**	**14,490**	**15,378**	**16,523**	**16,785**	**17,299**
Decrease / (Increase) in Inventories	(278)	(21)	(32)	(9)	(61)	(25)	(68)
Decrease (Increase) in A/R & Prepayments	(3,328)	(396)	(2,432)	200	(1,066)	(429)	(1,175)
(Decrease) Increase in A/P and Accruals	(1,588)	541	143	1,510	1,567	766	1,817
Cash flow from operations	**8,140**	**13,863**	**12,169**	**17,080**	**16,962**	**17,097**	**17,873**
Payment of Employee Terminal Benefits	(109)	(375)	(190)	-	-	-	-
KFAS payment	(89)	(96)	(403)	(460)	(192)	(208)	(301)
BoD remuneration	(77)	(77)	(110)	(460)	(192)	(208)	(301)
NLST Paid	(161)	(236)	(164)	(919)	(384)	(416)	(602)
Net cash from operating activities	**7,704**	**13,080**	**11,302**	**15,241**	**16,195**	**16,265**	**16,669**
Additions / Purchase of investments properties	(18,440)	(7,651)	(16,139)	-	(13,932)	2,275	(23,498)
Proceeds from sale of investment		28,032	9,254				
Joint Venture Investment	-		-	(990)	(1,089)	(1,198)	(8,610)
Investments & interest income	13,438		-	37,190	6,362	6,950	7,595
Purchase of investments	-	(24,987)	(20,457)	(1,841)	(1,933)	(2,030)	(2,131)
Dividends received	756	1,032	738	-	-	-	-
Purchase of real estate & fixed assets	(20,769)		-	36,612	9,500	(6,500)	19,500
Dividend income from JVs	-	855	-	1,834	2,018	2,220	9,734
Interest income received	28	69	131	-	-	-	-
Proceed from sale of investment prop. & fixed assets	34	7,543	115,257				
Additions to investment in associate			(39,000)				
Net cash from investing activities	**(24,953)**	**4,893**	**49,785**	**72,805**	**926**	**1,717**	**2,590**
Financial charges paid	(5,112)	(7,233)	(8,846)	(4,658)	(2,451)	(1,872)	(1,265)
Inc (dec) in short-term loans	-	-	-	-	-	-	-
Inc (dec) in long-term loans, net	6,088	(9,585)	(4,036)	(43,964)	(7,250)	(8,000)	(8,000)
Inc in share capital & share premium a/c	18,335	-	-	-	-	-	-
Sale (purchase) of treasury shares	(2,779)	(4,972)	(694)	-	-	-	-
Dividend paid	(110)	(7,609)	(15,041)	(12,956)	(7,823)	(8,477)	(12,438)
Change in Minority interest	-	-	-	62	62	62	62
Cumulative Changes in Fair Value of Investments				(135)	(142)	(149)	(156)
Net cash from financing activities	16,421	(29,400)	(28,617)	(61,650)	(17,604)	(18,436)	(21,797)
Inc (dec) in cash & cash equivalents	**(828)**	**(11,427)**	**32,470**	**26,396**	**(483)**	**(454)**	**(2,538)**
Opening cash & cash equivalents	(4,683)	(5,511)	(16,937)	15,533	41,929	41,445	40,992
Closing cash & cash equivalents	(5,511)	(16,937)	15,533	41,929	41,445	40,992	38,454
Due to banks	9,770	19,477	6,925	-	-	-	-
Bank balances & cash	**4,259**	**2,540**	**22,458**	**41,929**	**41,445**	**40,992**	**38,454**

Fact Sheet

	Salhia Real Estate Company							
	Unit	2004A	2005A	2006A	2007F	2008F	2009F	2010F
Liquidity Ratios								
Cash Ratio	X	0.1	0.1	1.4	3.9	3.5	3.3	2.7
Quick Ratio	X	0.4	0.3	1.9	4.7	4.2	4.0	3.5
Current Ratio	X	0.4	0.4	1.9	4.8	4.3	4.1	3.5
Profitability Ratios								
Gross Profit Margin	%	59.5	59.5	55.7	60.0	60.0	60.0	60.0
Direct operating costs / Sales	%	40.5	40.5	44.3	40.0	40.0	40.0	40.0
Operating Profit Margin	%	31.3	26.8	28.7	34.5	34.8	34.2	46.2
Recurring Profit Margin	%	18.5	8.9	6.9	24.8	31.3	32.3	45.8
Net Profit Margin	%	29.8	51.8	134.1	112.1	39.9	41.3	54.1
ROAA	%	11.3%	17.3%	41.5%	29.0%	10.3%	10.5%	14.4%
ROAA	%	4.9%	8.0%	21.3%	18.5%	7.7%	8.2%	11.8%
Efficiency Ratios								
Net Fixed Asset Turnover (average)	X	0.3	0.3	0.4	0.5	0.7	0.8	1.1
Net Fixed Asset Turnover, incl investment prop's (average)	X	0.2	0.2	0.2	0.3	0.4	0.4	0.4
Total Assets Turnover (average)	X	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Equity Turnover (average)	X	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Financial Risk								
Long term Debt to Equity	x	0.82	0.82	0.60	0.22	0.17	0.11	0.06
Total Debt Ratio (TD/CE)	%	61.6	55.6	44.5	24.5	21.4	17.6	14.1
Long term Debt to Assets	%	38.2	39.4	33.8	17.2	13.8	10.2	6.6
Interest Coverage Ratio	X	3.0	3.4	6.5	10.3	8.1	11.1	22.9
Growth Ratios								
Revenue from real estate, hotel operations & care home operation	%	32.2	-1.1	8.1	5.6	13.1	4.6	12.2
Net profit	%	7.0	71.8	179.7	-11.8	-59.7	8.4	46.7
Total assets	%	15.2	-1.8	11.7	-7.9	1.7	1.3	3.9
Valuation Ratios								
EPS	fils	34.4	57.9	163.0	142.4	57.3	62.1	91.2
Book value per share - BVPS (in fils)	fils	325.9	338.8	446.3	453.4	479.4	507.6	549.2
No. of Shares Outstanding	000	314,924	314,924	314,924	362,162	362,162	362,162	362,162
Price Per Share	fils	520.0	780.0	590.0	500.0	500.0	500.0	500.0
Market cap	KD 000	163,760	245,640	185,805	181,081	181,081	181,081	181,081
P/E multiple	X	15.1	13.5	3.6	3.5	8.7	8.0	5.5
P/BV multiple	X	1.6	2.3	1.3	1.1	1.0	1.0	0.9

Historical P / E & P / BV multiples pertain to respecitve year -end prices, while those for future years are based on closing prices on the KSE as of May 21 2007.

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 has been mentioned in the table below under the heading of disclosure.

Disclosure Checklist

Company	Recommendation	Ticker	Price	Disclosure
Salhia Real Estate Co.	BUY	SREK.KW	500fils	1, 10

1. Global Investment House did not receive and will not receive any compensation from the company or anyone else for the preparation of this report.
2. The company being researched holds more than 5% stake in Global Investment House.
3. Global Investment House makes a market in securities issued by this company.
4. Global Investment House acts as a corporate broker or sponsor to this company.
5. The author of or an individual who assisted in the preparation of this report (or a member of his/her household) has a direct ownership position in securities issued by this company.
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9. Global Investment House expects to receive or intends to seek compensation for investment banking services from this company in the next three month.
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Global Research: Equity Ratings Definitions

Global rating	Definition
Buy	Fair value of the stock is >10% from the current market price
Hold	Fair value of the stock is between +10% and -10% from the current market price
Reduce	Fair value of the stock is between -10% and -20% from the current market price
Sell	Fair value of the stock is < -20% from the current market price