

Salhia Real Estate Company (Salhia)

HOLD

Target Price
KWD0.398

Market Data

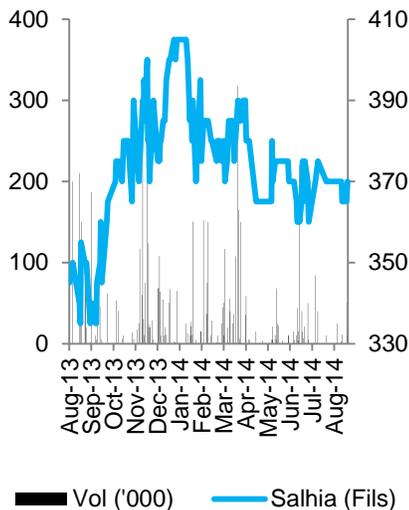
| | |
|-----------------------|---------|
| Bloomberg Code: | SRE KK |
| Reuters Code: | SREK.KW |
| CMP (24 August 2014): | KW0.370 |
| O/S (mn) | 512.7 |
| Market Cap (KWD mn): | 189.7 |
| Market Cap (USD mn): | 667.1 |
| P/E 2014e (x): | 19.3 |
| P/Bv 2014e (x): | 1.3 |

Price Performance 1-Yr

| | |
|------------------------|-------|
| High (KWD): | 0.405 |
| Low (KWD): | 0.335 |
| Average Volume ('000): | 44 |

| | 1m | 3m | 12m |
|--------------|-----|------|------|
| Absolute (%) | 0.0 | -1.3 | 7.2 |
| Relative (%) | 3.7 | 0.6 | -8.8 |

Price Volume Performance



Source: Bloomberg

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- Revenue to increase at 0.9% CAGR during 2013-18
- Margins to stabilize only after 2015
- No major expansion plans restrict growth potential
- HOLD recommendation maintained; Target Price: KWD0.398/share

*Salhia Real Estate Company (Salhia) reported weak revenue figures in both quarters of 2014, mainly due to lower occupancy in the Hotel segment. Therefore, gross and operating profit also declined YoY during the quarters. However, increased non-operational income i.e. higher other income and sharp decline in impairment losses drove net profit 0.4% in 1Q14 and 31.8% in 2Q14. We expect revenue growth to remain subdued (CAGR of 0.9% during 2013–18) due to already very high occupancy rate in Salhia's Real Estate segment; therefore, growth potential is limited in the absence of expansion plans. The rising number of hotels in Kuwait poses a competition risk to the company's Hotel segment. However, Salhia's Care Home operations would witness revenue growth after a decline in 2014, supported by an expected improvement in Eurozone's economy coupled with falling unemployment rate in Germany. Additionally, we expect Salhia's margins in 2014 to be lower than those in 2013, but they would stabilize in the long run. We have raised our target price to KWD0.398/share from KWD0.370/share. Given the current price, we maintain our **HOLD** rating.*

2Q14 net profit rises despite fall in revenue

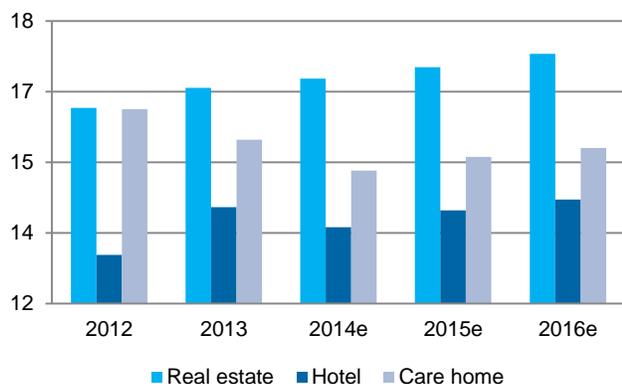
Salhia's net profit rose 31.8%YoY to KWD2.5mn in 2Q14 despite a 2.3%YoY decline in revenues (down 2.8%YoY in 1Q14); we believe this was primarily due to a sharp contraction in impairment losses as well as higher other income. The revenue decline in 1Q14 and 2Q14 was mainly due to lower revenues in the Hotel segment as the increasing number of upcoming hotels in Kuwait is pressurizing the occupancy rate. However, we believe, recovery in Kuwait's real estate sector during 2014 will support revenue growth in the company's real estate segment. As in 1Q14, we believe operating margins will have contracted in 2Q14 due to a rise in operating costs, including SG&A expenses. Despite this, net profit growth was significant in 2Q14 (0.4%YoY growth in 1Q14), driven by robust performance at the non-operating level (as discussed above).

Revenue to increase at 0.9% CAGR during 2013-18

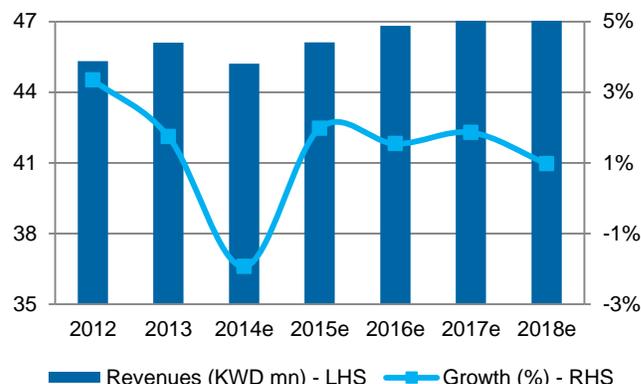
Salhia's revenue increased 1.7%YoY in 2013, supported by a 7.8%YoY and 2.6%YoY rise in its Hotel and Real Estate segments, respectively, despite a 4.0%YoY fall in the Care Home segment. However, the company's revenue declined during 1H14, mainly due to a fall in Hotel revenues. We believe the fall will continue in 2H14 and Salhia would record a 1.9%YoY revenue decline in 2014. Thereafter, we expect improvement across segments, partly driven by the overall recovery in Kuwait's real estate sector. In light of this, we expect Salhia's Real Estate segment to report a 1.7% CAGR in revenue during 2013–18, mainly driven by higher rentals. The Hotel segment's revenue is likely to rise at a CAGR of 0.5% during the same period as we expect occupancy rates to stay at the same level 2015 onward, after declining in 2014 due to increased supply. Furthermore, we believe Salhia would be able to increase its hotel rentals from 2015 due to the location of its properties, services offered, and its brand.

We believe, Salhia's Care Home operations faced marginal pressure on occupancy rates and rentals in 1H14 due to a decline in consumer spending in the Eurozone and lack of skilled workers in Care Home facilities, which would result in slight fall in revenue for full-year 2014.

Segment-wise revenues (KWD mn)



Revenue and growth (%)

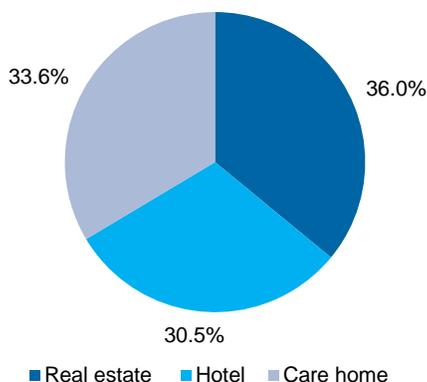


Source: Company Accounts, Global Research

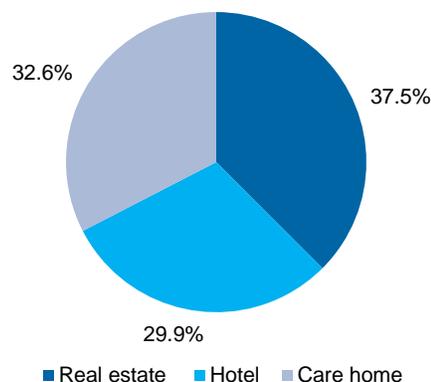
However, overall improvement in Eurozone’s economy (IMF forecasts GDP growth rate of 1.5% in 2015 compared with 1.1% in 2014) combined with expected gradual decline in unemployment in Germany (which would reduce skilled workforce in Care Home operations) would improve consumer spending and occupancy in the segment. Accordingly, we expect the Care Home segment’s revenue to increase from 2015 after a dip in 2014 and register a CAGR of 1.4% during 2014-18.

We expect Salhia’s revenue mix to change gradually in the coming years; Real Estate would remain the largest contributor to revenue, with its share rising from 36.0% in 2013 to 37.5% in 2018. However, the revenue contribution of Care Home and Hotel would decline to 32.6% and 29.9%, respectively, in 2018 from 33.6% and 30.5% in 2013. Overall, Salhia’s revenue outlook appears weak as we expect its existing portfolio to remain stagnant. Concurrently, we expect the company’s revenue to increase at a 0.9% CAGR during 2013-18.

Revenue share in 2013



Revenue share in 2018e



Source: Company Accounts, Global Research

Absence of major expansion plans amid high occupancy concerning

There is no clarity on Salhia’s major expansion plans in the near future, which we believe would be a major concern. The company owns 99.74% of Al-Asima Real Estate Company, which in turn owns a major plot of land in Kuwait. The company had planned to develop the land years ago, but it did not materialize due to pending government approvals. The project’s expected total cost is about KWD240mn. Furthermore, Salhia is operating at a high occupancy rate of around 96% and 60% in its Real Estate and Hotel segment, respectively. We believe this restricts the company from capitalizing on incremental demand, especially in the backdrop of the recovering real estate market in Kuwait, thus limiting revenue growth potential.

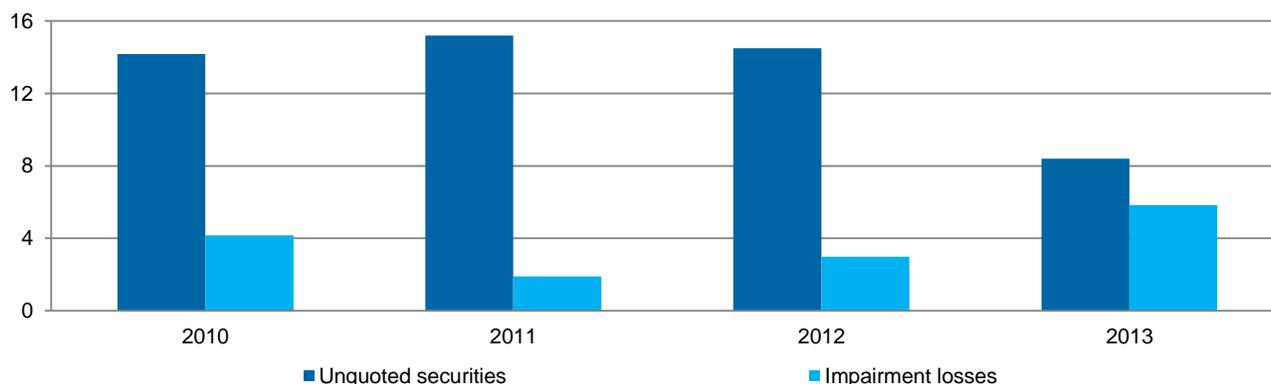
Margins to remain under pressure in 2014, but stabilize in long term

After remaining high in 2013, Salhia’s gross margin came under pressure in 2014 as a result of subdued revenue growth combined with higher SG&A costs. We expect pressure on margins to continue; thus we estimate a lower gross margin of 57.2% in 2014 compared with 57.8% in 2013. Considering slow growth in revenues, we expect gross margin to continue contracting to reach 56.9% in 2016 from 57.0% in 2015, and stabilize thereafter. At the same time, we believe lower depreciation due to no major addition in the existing portfolio would help improve operating margin 2015 onward to 33.1% in 2018.

Impairment losses still a concern

Salhia recognizes impairment losses on the basis of reduction in the fair value of financial assets available for sale. Historically, most impairment losses were recognized from unquoted securities, which were categorized as level 3 (valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable). Owing to the high share of level 3 unquoted securities, the company recorded impairment losses of KWD14.9mn during 2010–13, which is roughly 36% of total net profit during the period. However, level 3 unquoted securities fell drastically from 41% of total unquoted securities during 2010–12 to 6% in 2013, thus limiting the possibility of impairment losses being as high as historical levels. However, total value of unquoted securities still stands at KWD8.3mn as of 1Q14, which may potentially be categorized as level 3, leading to impairment losses in the coming years.

Unquoted securities and Impairment losses (KWD mn)



Source: Company Accounts, Global Research

Valuation update: Fair value up; HOLD rating maintained

We used the SOTP approach to value Salhia, and applied the two-stage DCF methodology to each of its projects. Our SOTP approach yielded a target price of KWD0.398/share (up 7.6% from KWD0.370/share earlier), which is 7.6% above the current market price of KWD0.370/share as of August 24, 2014. We assumed a risk-free rate (US 10-year Treasury yield) of 2.7% and risk premium of 9.1%, including country- and stock-specific risks. Currently, revenues from existing projects are likely to grow marginally, and we do not expect any major projects to come on stream in the near term. Thus, we remain cautious on the stock and maintain our **HOLD** rating.

Financial Statements

| | (KWD mn) | 2012 | 2013 | 2014e | 2015e | 2016e | 2017e | 2018e |
|--|-------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Income Statement | Revenue | 45.3 | 46.1 | 45.2 | 46.1 | 46.8 | 47.7 | 48.2 |
| | Revenue growth | 3.3% | 1.7% | -1.9% | 2.0% | 1.5% | 1.9% | 1.0% |
| | Cost of sales | (19.4) | (19.4) | (19.4) | (19.8) | (20.2) | (20.6) | (20.8) |
| | Gross Profit | 25.9 | 26.7 | 25.9 | 26.3 | 26.6 | 27.1 | 27.4 |
| | SG&A | (5.0) | (5.1) | (5.2) | (5.4) | (5.5) | (5.6) | (5.7) |
| | D&A | (6.3) | (6.3) | (6.2) | (6.1) | (6.0) | (5.9) | (5.8) |
| | Other operating income | - | - | - | - | - | - | - |
| | Operating profit | 14.7 | 15.3 | 14.5 | 14.8 | 15.1 | 15.6 | 15.9 |
| | Net financial charges | (6.9) | (5.4) | (5.5) | (4.7) | (4.5) | (4.2) | (3.9) |
| | Other income | 1.8 | 7.8 | 1.9 | 0.3 | 0.3 | 0.3 | 0.3 |
| | Profit Before Taxation | 9.5 | 17.8 | 10.9 | 10.4 | 11.0 | 11.8 | 12.4 |
| | Income tax | (1.2) | (1.7) | (1.0) | (1.0) | (1.4) | (1.5) | (1.6) |
| | Net Profit | 8.3 | 16.1 | 9.9 | 9.4 | 9.6 | 10.3 | 10.8 |
| | Minority interest | 0.0 | 0.0 | 0.0 | 0.1 | 0.2 | 0.3 | 0.7 |
| Net profit attributable to shareholders | 8.3 | 16.0 | 9.8 | 9.3 | 9.4 | 9.9 | 10.1 | |
| Net profit growth | 15% | 94% | -39% | -5% | 1% | 5% | 2% | |
| Balance Sheet | Cash and marketable securities | 7.4 | 7.3 | 35.7 | 43.3 | 50.8 | 58.9 | 69.5 |
| | Fixed Deposits | 3.5 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| | Receivables and prepayments | 5.0 | 6.9 | 5.0 | 5.1 | 5.2 | 5.3 | 5.3 |
| | Inventories | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| | Net fixed assets | 231.2 | 228.9 | 224.7 | 220.6 | 216.7 | 213.1 | 207.3 |
| | Available for sale investments | 17.0 | 11.3 | 11.3 | 11.3 | 11.3 | 11.3 | 11.3 |
| | Other long term assets | 13.3 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 |
| | Total Assets | 277.8 | 274.3 | 296.6 | 300.2 | 304.0 | 308.5 | 313.4 |
| | Accounts payables | 16.9 | 16.6 | 16.3 | 16.6 | 16.9 | 17.2 | 17.4 |
| | Short-term debt | 14.7 | 11.9 | 31.1 | 31.4 | 31.7 | 32.0 | 32.3 |
| | Long-term debt | 113.3 | 102.5 | 103.6 | 104.6 | 105.6 | 106.7 | 107.8 |
| | Other liabilities | - | - | - | - | - | - | - |
| | Retained earnings | 8.3 | 14.5 | 16.9 | 18.8 | 20.7 | 23.2 | 25.9 |
| Other Adjustments | 124.6 | 128.7 | 128.8 | 128.8 | 129.0 | 129.3 | 130.0 | |
| Total Equity & Liability | 277.8 | 274.3 | 296.6 | 300.2 | 304.0 | 308.5 | 313.4 | |
| Cash Flow | Cash flow from operating activities | 21.7 | 18.9 | 23.5 | 22.0 | 22.1 | 22.8 | 23.2 |
| | Cash flow from investing activities | 3.3 | 8.8 | (2.0) | (2.0) | (2.1) | (2.2) | - |
| | Cash flow from financing activities | (10.2) | (25.6) | 7.0 | (12.4) | (12.5) | (12.5) | (12.6) |
| | Change in cash | 14.8 | 2.2 | 28.4 | 7.6 | 7.5 | 8.1 | 10.6 |
| | Net Cash at End | 7.4 | 7.3 | 35.7 | 43.3 | 50.8 | 58.9 | 69.5 |
| Ratio Analysis | Gross margin | 57.2% | 57.8% | 57.2% | 57.0% | 56.9% | 56.9% | 56.9% |
| | Operating margin | 32.4% | 33.2% | 32.0% | 32.1% | 32.3% | 32.8% | 33.1% |
| | Net margin | 18.2% | 34.7% | 21.7% | 20.2% | 20.1% | 20.8% | 21.0% |
| | Return on assets | 3.0% | 5.9% | 3.3% | 3.1% | 3.2% | 3.3% | 3.4% |
| | Return on equity | 6.2% | 11.2% | 6.8% | 6.4% | 6.4% | 6.7% | 6.9% |
| | Current ratio (x) | 0.52 | 0.60 | 0.92 | 1.07 | 1.21 | 1.36 | 1.57 |
| | Quick ratio (x) | 0.50 | 0.59 | 0.91 | 1.06 | 1.21 | 1.36 | 1.56 |
| | Debt / Equity (x) | 0.67 | 0.60 | 0.71 | 0.72 | 0.72 | 0.73 | 0.74 |
| | Times Interest Earned (x) | 2.07 | 2.70 | 2.48 | 2.34 | 2.37 | 2.42 | 2.44 |
| | EV/Revenues (x) | 6.85 | 6.44 | 6.38 | 6.12 | 2.97 | 2.74 | 2.50 |
| | EV/EBITDA (x) | 14.83 | 13.75 | 13.97 | 13.52 | 6.58 | 6.08 | 5.53 |
| | EPS (KWD Fils) | 16.10 | 31.23 | 19.13 | 18.18 | 18.37 | 19.35 | 19.73 |
| | Book Value Per Share (KWD Fils) | 0.26 | 0.28 | 0.28 | 0.29 | 0.29 | 0.30 | 0.30 |
| | Market Price (KWD Fils) * | 370 | 380 | 370 | 370 | 370 | 370 | 370 |
| | Market Capitalization (KWD mn) | 189.7 | 194.8 | 189.7 | 189.7 | 189.7 | 189.7 | 189.7 |
| Dividend Yield | 4.2% | 4.1% | 4.1% | 4.1% | 4.1% | 4.1% | 4.1% | |
| P/E Ratio (x) | 22.98 | 11.85 | 19.35 | 20.36 | 20.14 | 19.12 | 18.75 | |
| P/BV Ratio (x) | 1.43 | 1.32 | 1.30 | 1.29 | 1.27 | 1.24 | 1.22 | |

Source: Company accounts & Global Research

* Market price for 2014 and subsequent years as per closing prices on August 24, 2014

Disclosure

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

Disclosure Checklist

| Company | Recommendation | Bloomberg Ticker | Reuters Ticker | Price | Disclosure |
|-------------------------------------|----------------|------------------|----------------|----------|------------|
| Salhia Real Estate Company (Salhia) | HOLD | SRE KK | SREK.KW | KWD0.370 | 1,10 |

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|---------------|--|
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| BUY | Fair value of the stock is between +10% and +20% from the current market price |
| HOLD | Fair value of the stock is between +10% and -10% from the current market price |
| SELL | Fair value of the stock is < -10% from the current market price |

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