SALHIA REAL ESTATE

Going Steadily

October 09, 2011

KEY DATA

Fair Value per Share (KD)	0.280
Closing Price (KD) *	0.204
52-week High / Low (KD)	0.278 / 0.204
YTD / 12-month return	-26.6% / -10.6%
Trailing P/E	14.0
Shares Outstanding (million)	496
Market Cap (KD million)	101
Free Float	72.22%
Reuters / Bloomberg Code	SREK.KW / SRE KK

**Price close as of October 06, 2011. Sources: Reuters, Zawya, and NBK Capital*

KEY METRICS

	2010A	2011F	2012F	2013F
EPS (KD)	0.026	0.012	0.008	0.008
EPS Growth	39.9%	-53.1%	-31.7%	0.3%
P/E	9.9	16.7	24.4	24.3
PBV	0.91	0.79	0.79	0.78
Dividend Yield	9.8%	4.2%	2.9%	2.9%
EV/EBITDA	7.7	8.1	8.4	8.5
Revenue (KD 000s)	42,996	40,585	39,959	39,664
Revenue Growth	-2.8%	-5.6%	-1.5%	-0.7%
EBITDA (KD 000s)	20,905	19,926	19,159	18,832
EBITDA Growth	-2.6%	-4.7%	-3.9%	-1.7%
EBITDA Margin	48.6%	49.1%	47.9%	47.5%
Net Profit (KD 000s)	10,204	6,082	4,153	4,165
Net Profit Growth	40.8%	-40.4%	-31.7%	0.3%

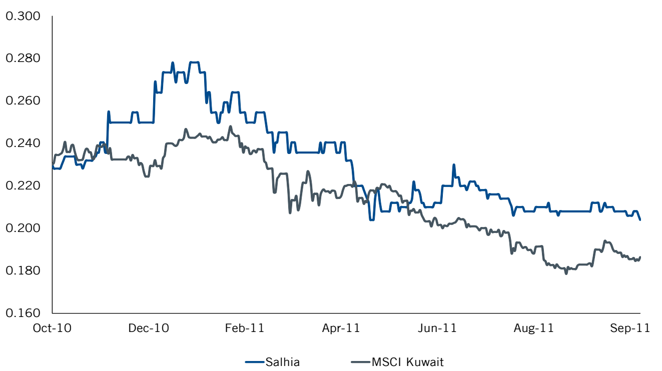
Sources: Company and NBK Capital

QUARTERLY FORECASTS

KD 000s	3Q2010A	2Q2011A	3Q2011E	4Q2011F
Revenue	9,316	11,162	10,958	10,552
EBITDA	2,874	5,430	5,380	5,181

Sources: Company financial statements and NBK Capital

REBASED PERFORMANCE



Sources: Reuters and NBK Capital

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HIGHLIGHTS

12-Month Fair Value: KD 0.280

Recommendation: Buy – Risk Level: 3**

Reason for Report: 2Q2011 Results

- **2Q2011 results were very much in line with our expectations**, with the exception of a slightly stronger-than-expected performance in the hotels segment. This surprising performance was mainly due to the increase in Arraya ballroom activities.
- **Stake in Al Asima Real Estate company increased to 99.7%:** Salhia acquired an additional stake in Al Asima Real Estate Co., increasing the company's ownership to 99.7%. Since the acquisition did not constitute an acquisition of business, the transaction has been accounted for as an acquisition of assets. Accordingly, the difference between the carrying value of the net assets acquired and the purchasing consideration has been allocated to the carrying value of the investment property in Al Asima (thus generating no goodwill).
- **Impact on our assumptions:** We have adjusted our estimates slightly for our forecast period, mainly to reflect the higher interest cost generated by the Al Asima acquisition. We are also slightly less conservative on selected general cost items. However, we believe the acquisition has no material impact on our valuation on Salhia, and we are still comfortable with our earlier assumption for the top line.
- **We reiterate our "Buy" recommendation on Salhia:** Our new fair value for the stock is KD 0.280 per share, only 5.7% higher than our old fair value. Thus, the Al Asima acquisition did not materially impact our valuation. We reiterate our "Buy" recommendation, with the fair value of KD 0.280 per share representing an upside potential of 37% from the last closing price of KD 0.204.

*** Please refer to page 6 for recommendations and risk ratings.*

SALHIA 2Q2011 RESULTS

Salhia's 2Q2011 revenues were up 2% year-on-year (YoY) to KD 11.2 million, which was 5.8% higher than our forecast of KD 10.6 million. This growth was mainly due to an 11% YoY rise in care home operations to KD 4.02 million in 2Q2011, which was 5% ahead of our forecast. However, this increase was offset by the decline in the company's real estate and hotel operations. Revenue from real estate was down 1.7% YoY to KD 3.97 million in 2Q2011 (less than 1% below our forecast). In addition, revenue from hotel operations decreased by 2% to KD 3.2 million in 2Q2011 (9% ahead of our forecast).

The company reported EBITDA of KD 5.43 million in 2Q2011, up 2.6% YoY and 6.4% ahead of our forecast of KD 5.1 million. This growth was driven by the increase in total revenue and a 51% YoY decrease in general and administrative expenses during the period. However, operating margins were consistent with our expectations overall.

Investment income dropped by 80% to KD 0.62 million in 2Q2011, compared to KD 3.2 million in 2Q2010. As a result, Salhia recorded a net profit of KD 1.7 million in 2Q2011, which is 57% lower than 2Q2010.

Overall, Salhia's 2Q2011 results were very much in line with our expectations, with the exception of a slightly stronger-than-expected performance in hotel operations. Salhia management indicated that the latter is mainly due to the Arraya ballroom's increased activity during 2Q2011. Management does not expect this trend to continue over the coming quarters. Accordingly, we are treating this increased activity as a one-off event and maintain our earlier assumptions for this segment.

AL ASIMA ACQUISITION

Salhia has acquired an additional stake in Al Asima Real Estate Co., increasing the company's stake from 50% to 99.7% (refer to our previous analyst comment on Salhia, June 21, 2011). Since the acquisition did not constitute an acquisition of business, the transaction has been accounted for as an acquisition of assets. Accordingly, the difference between the carrying value of the net assets acquired and the purchasing consideration has been allocated to the carrying value of the investment property in Al Asima (thus generating no goodwill).

In 2006, Salhia sold real estate assets with a carrying value of KD 16.5 million to Al Asima, resulting in a gain of KD 98.1 million (of which Salhia recorded KD 49.05 million in its accounts, in line with Salhia's ownership of the company at that time). The assets in question consisted of a prime parcel of land in central Kuwait, which Al Asima was due to develop into a retail and office project. The excess of the gain over the carrying value of the associate was accounted for as a deferred gain in prior periods. Following the acquisition in June 2011, the elimination of the gain on sale of real estate assets of KD 49.05 million was adjusted against the value of the acquired investment property. As a result, investment properties more than doubled to KD 141.1 million as of June 30, 2011, compared to KD 66.1 million in 2010.

With the increased stake, Salhia started consolidating Al Asima Real Estate's financials beginning in 2Q2011. Accordingly, the company's debt-to-equity ratio jumped to 1.08x at the end of June 2011, compared to 0.59x at the end of 2010. Salhia's equity and total debt stood at KD 128.4 million and KD 139.2 million, respectively, as of June 30, 2011.

IMPACT ON OUR ESTIMATES

We believe this acquisition has no material impact on our valuation of Salhia. Essentially, Salhia added an asset (the purchased land), financed 70% through debt and 30% through equity. The company is still engaged in acquiring licenses to develop the land, with a retail project the preferred option. However, there is little visibility at present on when the final decision on the license can be expected (remember Al Asima has been trying to obtain a license since FY2006). Alternative solutions (such as disposing of the land, either wholly or in parts) are being looked at. In the meantime, this asset will not be generating any income. We are therefore including this asset in other long-term assets, not in investment properties. This will change once we have clarity on how this asset is to be used.

Changes to our estimates

We are still comfortable with our earlier assumption for the top line. Thus, we have made only minor changes to our earlier estimates over our forecast period to reflect the following:

- We have significantly increased total debt over our forecast period to KD 125.2 million for FY2011 (compared to our previous assumptions of KD 58.78 million for FY2011). This reflects the impact of the Al Asima acquisition, as well as other debt raised by the company in 2Q2011. Therefore, our forecast debt-to-equity ratio has increased to a five-year average of 0.90x (FY2011-FY2015), compared to our old assumption of 0.42x.
- In addition, we have increased total assets to KD 285.97 million for FY2011 (compared to our earlier assumption of KD 221.4 million for FY2011). This is mainly due to additional land rising from the asset acquisition.
- We have classified the land resulting from the asset acquisition under other long-term assets and not under investment property as the company reported, since we believe that this land will not generate any income in the short-term (see above).
- In addition, we are valuing the acquired land at book value, in line with what the company recorded. We believe it is fair to assume that the market value of the land is higher than its current book value, since Salhia's purchasing price was based on the land's FY2006 value. However, the lack of visibility over what will happen with the land coupled with the strong possibility that the asset will sit on the balance sheet without generating any revenue for the foreseeable future mean we are comfortable with our valuation at book.
- We have raised our interest expense estimates for the company upward to reflect the significant increase in total debt resulting from the acquisition.
- Finally, we have cut our selling, general, and administrative (SG&A) expenses and foreign tax forecasts, as these were too conservative.

Valuation

We increased our fair value for Salhia by 5.7% to KD 0.280 per share, compared to our earlier value of KD 0.265 per share. With Salhia's last closing price of KD 0.204, the share retains an upside potential of 37%. We therefore reiterate our "Buy" recommendation on the stock.

Our new 12-month fair value for Salhia is KD 0.280

Figure 1 Fair Value per Share

Valuation Method	Old		New		Change
	Weight	Value (KD)	Weight	Value (KD)	
Discounted cash flow	70%	0.196	70%	0.219	12%
Net asset value	20%	0.409	20%	0.436	7%
Sum-of-the-parts	10%	0.458	10%	0.439	-4%
Weighted average fair value	**100%**	**0.265**	**100%**	**0.280**	**6%**

Source: NBK Capital

DCF (discount cash flow): Our new valuation captures the additional value arising from the difference in the book value of the land acquired and the additional debt to finance this acquisition. However, this valuation also captures other debt raised by the company during 2Q2011.

Net asset value (NAV) valuation: The 7% increase our valuation results from the increase in equity resulting from the Al Asima acquisition (representing the difference between the book value of the acquired asset and the additional acquisition debt), adjusted for other changes to equity (mainly the payment of the dividend for FY2010).

Sum-of the-parts valuation: The difference between the old and new valuations in Figure 1 is due to the fact that we have updated the multiple for our sample.

We still believe that the current stock price of KD 0.208 is extremely depressed and that the concerns regarding the expected new supply in the Kuwaiti office and hotel segments are already factored into the current stock price.

FINANCIAL STATEMENTS

Income Statement (KD Thousands)	Historical		Forecast				
Fiscal Year Ends December	2009	2010	2011	2012	2013	2014	2015
Total Revenue	44,213	42,996	40,585	39,959	39,664	40,148	40,329
Cost of Revenue	17,249	17,895	17,085	17,456	17,676	18,212	18,428
Gross Profit	**26,964**	**25,101**	**23,499**	**22,503**	**21,988**	**21,935**	**21,901**
Selling/General/Admin. Expenses	5,230	5,359	5,073	5,095	5,156	5,119	5,142
Depreciation/Amortization	5,043	6,239	6,270	6,075	5,887	5,704	5,527
Operating Income	**16,692**	**13,503**	**12,156**	**11,333**	**10,945**	**11,112**	**11,232**
Interest Income (Exp), Net Non-Operating	(6,263)	(4,719)	(5,969)	(7,825)	(7,538)	(7,031)	(6,563)
Net Income before Taxes	**8,475**	**10,820**	**6,996**	**4,837**	**5,099**	**5,931**	**6,715**
Provision for Income Taxes	(1,525)	(1,051)	(904)	(674)	(924)	(791)	(1,009)
Net Income after Taxes	**6,950**	**9,770**	**6,092**	**4,163**	**4,175**	**5,140**	**5,707**
Minority Interest	(299)	(434)	(10)	(10)	(10)	(10)	(10)
Net Income	**7,249**	**10,204**	**6,082**	**4,153**	**4,165**	**5,130**	**5,697**

Balance Sheet (KD Thousands)	Historical		Forecast				
Fiscal Year Ends December	2009	2010	2011	2012	2013	2014	2015
ASSETS							
Cash and Short-Term Investments	7,472	7,385	11,296	16,670	14,024	14,516	13,933
Total Receivables, Net	9,628	6,435	6,899	7,193	7,536	8,030	8,267
Total Current Assets	**17,437**	**14,124**	**18,520**	**24,203**	**21,897**	**22,947**	**22,624**
Property/Plant/Equipment, Total - Net	172,067	161,864	157,030	152,344	147,800	143,394	139,122
Long-Term Investments	63,798	23,405	23,405	23,405	23,405	23,405	23,405
Other Long-Term Assets, Total	9,040	10,291	88,156	88,488	88,868	89,248	89,628
TOTAL ASSETS	**262,342**	**209,684**	**287,111**	**288,440**	**281,970**	**278,994**	**274,780**
LIABILITIES & EQUITY							
Accounts Payable	17,148	17,287	17,249	17,182	17,155	17,464	17,644
Total Current Liabilities	**17,148**	**17,287**	**17,249**	**17,182**	**17,155**	**17,464**	**17,644**
Total Debt	110,937	65,794	125,200	125,200	116,000	109,000	101,000
Other Liabilities	12,926	14,354	15,854	17,354	18,854	20,354	21,854
Total Liabilities	**141,011**	**97,435**	**158,303**	**159,737**	**152,009**	**146,818**	**140,498**
Total Equity	**119,974**	**111,710**	**128,269**	**128,164**	**129,423**	**131,637**	**133,743**
TOTAL LIABILITIES AND EQUITY	**262,342**	**209,684**	**287,111**	**288,440**	**281,970**	**278,994**	**274,780**

Cash Flow (KD Thousands)	Historical		Forecast				
Fiscal Year Ends December	2009	2010	2011	2012	2013	2014	2015
Cash from Operating Activities	17,241	22,756	17,814	17,269	16,729	17,054	17,021
Cash from Investing Activities	7,861	29,903	(78,404)	(585)	(475)	(308)	(96)
Cash from Financing Activities	(12,840)	(33,410)	64,501	(11,310)	(18,901)	(16,254)	(17,507)
Net Change in Cash	12,262	19,249	3,911	5,375	(2,647)	492	(583)

Sources: Company financials and NBK Capital

RISK AND RECOMMENDATION GUIDE

RECOMMENDATION	UPSIDE (DOWNSIDE) POTENTIAL
BUY	MORE THAN 20%
ACCUMULATE	BETWEEN 5% AND 20%
HOLD	BETWEEN -10% AND 5%
REDUCE	BETWEEN -25% AND -10%
SELL	LESS THAN -25%

RISK LEVEL				
LOW RISK				HIGH RISK
1	2	3	4	5

DISCLAIMER

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