Salhia Real Estate

Investment Portfolio - Worrying

November 11, 2008

Key Data

Current Price*	Avg. Value Traded per Day
KD 0.255	KD 244,552
52-Week High	**Market Cap**
KD 0.620	KD 101.58 million
52-Week Low	**Shares Outstanding**
KD 0.255	398.37 million
Reuters	**Bloomberg**
SREK.KW	SRE KK
Ownership Structure	
Privately Held: 35.3%	Public: 64.7%

** Price as of close on November 10, 2008. Sources: Reuters, Zawya, and NBK Capital*

Rebased Performance

Sources: MSCI, Reuters, and NBK Capital

Key Ratios

	2007 a	2008 f	2009 f	2010 f	2011 f
EBITDA Margin	39%	43%	43%	43%	43%
ROAE	22%		Under Review		
EPS Growth	-45%		Under Review		
P/E	6.2		Under Review		
EV/ EBITDA	12.4	10.8	10.3	10.3	10.3
Dividend Yield	9.2%		Under Review		

1Q2008 EBITDA a	3Q2008 EBITDA f
KD 4.3 million	KD 4 million
2Q2008 EBITDA a	**4Q2008 EBITDA f**
KD 3.6 million	KD 4.8 million

a = actual, f = forecast. Sources: Reuters and NBK Capital

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Highlights

12-Month Fair Value: Under Review

Recommendation: Under Review

Reason for Report: Event Update

- With the bears taking control of the global and regional equity markets, Salhia's investment portfolio (KD 97.7 million as of 1H2008) raises significant concern, considering the likely adverse impact on the company's financials. A 30%–40% hit to the investment portfolio (global and regional markets are down 30%–40% YTD) could actually wipe out around a fifth of the shareholders' equity (KD 143.3 million as of 1H2008). Though we are unable to support our reasoning with specific data (due to the absence of a detailed breakdown of the investment portfolio), we think the impact of the recent market turmoil on the company warrants attention.
- However, in core operations, the company is strongly positioned and has benefitted from higher rental and occupancy rates. Rental income increased 26.5% in 1H2008 compared to the same period a year earlier. The opening of the Arayya II office tower in the beginning of 2Q2009 will act as a rental income booster as well.
- The hotel segment revenue was up 10.8% in 1H2008 compared to 1H2007. However, we expect that the unattractiveness of Kuwait as a tourist destination compounded by the oversupply of new hotel rooms is likely to negatively impact the average room and occupancy rates of hotels in Kuwait going forward.
- Management is quite upbeat about the care home operations, taking into account the demographics in Germany, which are dominated by high life expectancy and falling birth rates. Salhia's management feels that the segment will be, by and large, insulated from the recent global turmoil, and the outlook appears steady.
- Although we remain confident about the company's operations, due to our concerns regarding the investment portfolio and its potential adverse impact on Salhia's equity, we withdraw our previous recommendation for the company and have it under review until we get better clarity on the matter.

Available-for-Sale Investment Portfolio - Our Main Concern

The company's available-for-sale investment portfolio stood at KD 97.7 million as of 1H2008 (33.2% of total assets and 68% of total equity as of 1H2008). The managed portfolio accounted for almost 81.5% (79.7% as of 2007 year end) of the total investment portfolio; whereas unquoted securities accounted for 18.2% (20% as of 2007 year end). Managed funds accounted for the rest. The managed portfolio is composed of local and foreign equity and structured products; whereas the unquoted securities are private equity investments. Foreign investment (as a % of total investment portfolio) gradually increased from 33% in 2004 to 62.6% in 1H2008.

With the ongoing turmoil in the financial markets globally as well as regionally, we are apprehensive about the impact of the investment portfolio on the financials of the company as a whole. Though we are not in a position to support our reasoning with specific data (due to the absence of a detailed breakdown of the investment portfolio), we think that the impact of the recent market turmoil on the company's financials warrants attention. The magnitude of the impact can be seen through a scenario analysis given below.

A 30%-40% hit to the investment portfolio could actually wipe out around a fifth of the shareholders' equity

Figure 1 Scenario Analysis - Impact of Investment Losses

	Impact	
Investment Portfolio	Income Statement	Balance Sheet
10% down	Inv. loss - KD 10 million Marginal net loss*	Marginal impact on total equity
20% down	Inv. loss -KD 20 million Net loss* - approx. KD 10 million	7% decrease in total equity
30% down	Inv. loss - KD 30 million Net loss* - approx. KD 20 million	14% decrease in total equity
40% down	Inv. loss -KD 40 million Net loss* - approx. KD 30 million	21% decrease in total equity
50% down	Inv. loss - KD 50 million Net loss* - approx. KD 40 million	28% decrease in total equity

** We were expecting net profit of KD 8.5 million for 2008. Source: NBK Capital*

However, as discussed in our last report (dated August 20, 2008, pages 5 and 6), the company holds hidden reserves in the form of real estate properties that were recorded at KD 43.7 million on the balance sheet and had been valued by independent valuers at KD 222.9 million as of FY2007. This could come in handy in case the company needs recapitalization.

Debt - Would Salhia be able to meet short-term obligations?

Salhia has maintained an average debt-to-equity ratio of 0.96 over the last 11 years from 1997 to 2007, ranging from a maximum of 1.28 in 2003 to a minimum of 0.64 in 2006. The ratio stands at 0.85 as of 1H2008. Under the worst-case scenario (highlighted in Figure 1) Salhia's debt-equity ratio rises to 1.3, which is acceptable. The company's robust business model has a proven history of continued service of its debt burden and is likely to work in this manner in the foreseeable future. We expect the EBITDA interest cover ratio to be around 2.3x for FY2008.

However, what concerns us is the short-term debt of KD 26.21 million borrowed against an investment portfolio of KD 44.79 million as of 1H2008. However, what appeases our concern is that this debt was raised from the same financial institution managing the portfolio. Under the terms of the facility agreement, repayments will be funded by the proceeds from the sale of investments in the portfolio. Logically, if that portfolio was hit, the debt should have been settled, and no short-term negative impact on Salhia's cash flow would occur.

This leaves us with a short-term overdraft facility of KD 21.5 million as of 1H2008 compared to a cash balance of KD 10 million. We believe the net short-term debt could be covered from cash flow from operations.

Real Estate Operations - Outlook

The company is strongly positioned and has benefitted from higher rental and full occupancy rates. Rental income increased by 26.5% in 1H2008 compared to the same period a year earlier. The management expects the Arayya II office tower to open in the beginning of 2Q2009, which would further boost rental income in the future. Forty-three out of fifty-three leasable floors in the new office tower have been leased, and prospective tenants are interested in the remaining ten as well. Rising concerns about potential oversupply in the office space segment in Kuwait are likely to have a negative impact on the rental and occupancy rates for real estate players as a whole. However, we feel that since Salhia has a portfolio of Class A properties in prime locations in Kuwait, the company's main competition is from the fresh supply of similar kinds of properties. We expect Salhia to bear the brunt of the expected excess supply of office space to an extent, and accordingly, this has been built into our model. However, we are confident that Salhia's longstanding reputation as a quality service provider will be an advantage in difficult times. We expect the decrease in occupancy rates and office rental rates to be lower for Salhia compared to other players in the market. In the retail space business, we feel the company will do well, keeping in mind the upmarket niche malls it manages.

Hotel Operations - Outlook

This segment also posted strong results in 1H2008 compared to 1H2007; revenues were up 10.8%. However, we feel that occupancy rates have peaked, judging by the falling trend over the last three years (67% in 2005, 63% in 2006, and 61% in 2007) and the expected large supply of new hotel rooms in the next 3–4 years.

According to the Kuwait Hotel Owners' Association, an additional 1,400 new hotel rooms (almost 50% of the existing hotel rooms in the 5-star category) are expected to become available in the next 3–4 years. The scenario looks even more serious in the 4-star category, where it is expected that the number of hotel rooms will double in the next 3–4 years. This is likely to negatively impact the average room and occupancy rates in these categories. We feel the prime location and the fact that both of Salhia's hotels are managed by the Marriott group are positives for the company. However, with the large supply of new rooms managed by equally renowned global names, the hotel segment for the company will definitely be put to the test.

Care Home Operations - Outlook

The company management is upbeat about this segment, taking into account the demographics in Germany, which are dominated by higher life expectancy and falling birth rates. With an aging population and higher disposable income, the developed countries of Western Europe are seeing a heightened demand for quality facilities and nursing skills to address the needs of older adults. We expect Germany, with its high per-capita GDP and aging population, will experience increasing demand for care homes for senior citizens. Coupled with the fact that an increasing number of baby boomers will be moving into the old-age bracket, the prospects for the care home business in Germany appear bright.

Salhia's management feels that the target customers for this segment will be, by and large, insulated from the global turmoil, and the future appears steady. People contemplating a move to a senior care home usually plan it well in advance and actually have the resources to do so. A slowdown in the general economy may not have a severe impact on this particular line of business.

Performance in the First Half of 2008

- Salhia's total revenue increased by 11.2% to KD 23.6 million in 1H2008 compared to KD 21.3 million in 1H2007. Revenue from real estate operations accounted for almost 60% of the total incremental revenues. Real estate revenues increased by a healthy 26.5% to KD 6.65 million in 1H2008 compared to KD 5.3 million in 1H2007.

- Revenue from hotel operations accounted for 38% of the total incremental revenues. Hotel revenues went up by 10.8% to KD 9.3 million in the first half of 2008 compared to the same period in the previous year. Revenue from care home operations was almost flat during 1H2008 compared to 1H2007.

- Gross profit grew at a moderate rate of 7% to reach KD 13.4 million in 1H2008 compared to KD 12.5 million in 1H2007. However, the operating profit for 1H2008 decreased by more than 50% to KD 5.08 compared to KD 10.7 million in 1H2008. This was entirely due to the share in the UK joint venture's result, which amounted to a profit of KD 4.2 million in 1H2007 compared to a loss of KD 0.8 million in 1H2008. An increase in general and administrative expenses during the period was also partly instrumental in the dip in operating profit.

- Investment income increased by 54% to KD 6.1 million in 1H2008 compared to KD 3.9 million a year earlier. In spite of the rise in investment income, net profit decreased by 26.3% to KD 8.06 million in 1H2008, compared to KD 10.9 million in 1H2007. The reason for the decrease in net profit was very similar to that of the operating profit.

- Total assets decreased by 9.3%, to KD 294.5 million, in 1H2008 compared to 2007. This was mainly due to recoveries from accounts receivables and other assets. Available-for-sale investments stood at KD 97.7 million in 1H2008 compared to KD 102.7 million in 1H2007. Total equity stood at KD 143.74 million at the end of 1H2008.

Net income was down by 26.3% to KD 8.06 million in 1H2008

Figure 2 First-Half Performance

Key Financial Data	1H 2007	1H 2008	Y-O-Y growth
Income Statement	KD million	KD million	
Real Estate Operations	5.26	6.65	26.5%
Hotel Operations	8.35	9.25	10.8%
Care Home Operations	7.66	7.74	1.1%
Total Revenue	21.26	23.64	11.2%
Gross Profit	12.52	13.39	7.0%
Operating Profit	10.72	5.08	-52.6%
Investment Income	3.94	6.09	54.4%
Finance Costs	3.41	3.62	6.3%
Net Profit	10.94	8.06	-26.3%
Balance Sheet	**2007**	**1H 2008**	**Y-O-Y growth**
Available-for-Sale Investments	102.67	97.74	-4.8%
Investment Properties	43.70	43.14	-1.3%
Property and Equipment	110.20	118.72	7.7%
Total Assets	324.70	294.48	-9.3%
Total Borrowings	143.01	123.01	-14.0%
Total Shareholders' Equity	151.12	143.74	-4.9%

Sources: Salhia and NBK Capital

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Risk and Recommendation Guide

Recommendation	Upside (Downside) Potential
Buy	more than 20%
Accumulate	between 10% and 20%
Hold	between -5% and 10%
Reduce	between -10% and -5%
Sell	less than -10%

Risk Level				
1	2	3	4	5
Low Risk				High Risk