



Drake & Scull International (DSI.DU - AED 1.06) Neutral

Operating Results

3Q09 results: Treading water over summer

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Investment Conclusion

With a backlog replenished at the same rate it is being monetised and quarterly profits relatively range bound the company is effectively treading water during 2009. The growth will come from acquisitions which have been flagged to the market and news of such should start to eventuate in 4Q09. This is what the market is waiting for. The cost paid for the backlog will determine the accretive value to the company. Arguably the current cash squeeze (for the market) has come at the right time for DSI with backlogs coming cheaper in 2009 than 2008, but too long a delay may see bargaining positions start to weaken. Acquisition news will be the market catalyst.

Summary

- 3Q09 revenues AED 400m (9M09 AED 1.4bn)
- 3Q09 net profit AED 71m (Nomura est AED 73m)
- Revenue guidance, at least AED 1.8bn
- Net profit on track for ~AED 300m for full year
- Liquid with net cash of AED 920m
- Static backlog at AED 3bn
- We retain our NEUTRAL rating and AED 1.09 price target
- Share catalysts: Acquisitions

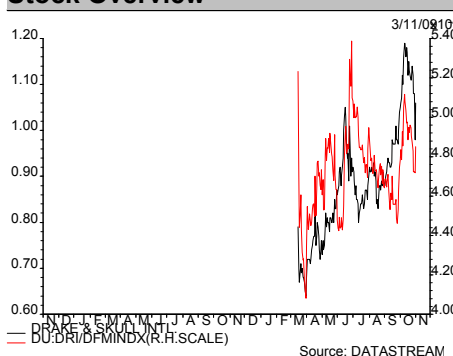
Stock Rating	Target Price
New: Neutral	New: AED 1.09
Old: Neutral	Old: AED 1.09

Sector View: Not Rated

FY Dec	2008A	2009E	2010E	2011E			
Currency AED	Actual	Old	New	Old	New	Old	New
Revenue	1720	1988	1831	2203	2268	1930	1936
EBIT	166	252	248	254	268	210	217
Net Income (m)	210	300	280	308	296	271	259
EPS (adj.)	0.10	0.14	0.13	0.14	0.14	0.13	0.12
DPS	0.00	0.00	0.00	0.05	0.05	0.06	0.06
NAV	1.02	1.16	1.15	1.25	1.24	1.32	1.30
Adj. PER(x)	11.1	N/A	8.2	N/A	7.7	N/A	8.8
Adj. P/NAV prem/(disc)	1.66	1.14	1.39	1.01	1.24	0.94	1.15

Market Data		Financial Summary	
Market Cap (m)	2308	Net Debt (m)	-788.0
Units Outstanding (m)	2177.8	Net Debt / Equity (adj)	-32.0
Float (%)	79	EBITDA/EV	N/A
Net Distribution Yield	0.00	NAV 3yr CAGR (%)	7.00
Convertible	No	EPS 3yr CAGR (%)	2.00
Shares per ADR	N/A		

Stock Overview



Reuters	DSI.DU
Bloomberg	DSI UH
ADR	
Performance	1M 3M 12M
Absolute %	0 18 0
Rel. Market %	0 -1 0
Rel. Sector %	0 0 0
52 Week Range	1.19 - .64

No market surprises in Q3 results: Mid-summer seasonal lag; FY09 year-end guidance in tact

3Q09 was understandably a slow quarter with the seasonal effects of both summer and Ramadan constrained productivity somewhat, but this was well flagged to the market and therefore was no surprise. At AED 400m, revenues (3Q09) lagged our AED 500m estimate but hit the market consensus. For the full year, management have guided to top line revenues of around AED 1.8bn to AED 1.9bn. At 15% net profit margins (company guides at least this amount) on AED 1.8bn then profits should be at a minimum of AED 270m. Given that the year to date run rate is AED 239m, then AED 300+ looks more appropriate. This is one of the few companies in our coverage universe which gives both 'top and bottom' guidance, for the market to digest. This sets the benchmark for the company to either outperform or underperform with the pre-IPO financial statements a baseless indicator (a less developed business model and a completely different capital structure), in our view. Therefore 2010 will be more meaningful, but with ~2bn of potential acquisitions in the pipeline, then the like for like (i.e. organic growth) is again increasing less relevant. Inorganic growth should be the key accretive driver and we think the CFO, Mr Khaled Jarrar was right not to commit to a 2010 forecast (given the unknown status of potential acquisitions), but we think that more clarity will be given at the year end results. At that stage one or two of the acquisitions should be announced, with one completed and awaiting local (the acquired company) regulatory approval and announcement. The acquisition is part of a traded entity outside of GCC, so likely Europe based and probably IWP based (our view) if the strategy is to increase that part of the business.

We highlight the quarterly movements in the table below. At the headline level, gross margins improved slightly from 21.2% (2Q09) to 22.6%. Net margins were flat at 17.7% so margins are being maintained at a comparatively high level. The year to date ROE is 11%, ROA 7% and return on paid up capital of 13% (17% less intangibles). We think this is low relative to the cost of capital (we calculate a

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blended WACC of 12% and cost of equity of 13%) and this is partially a function of the un-deployed cash. Once the cash is deployed we expect a more efficient balance sheet (and with a combination of additional debt financing) which should result in a higher return on equity.

Figure 1: Results summary

AEDm (unless stated)	1Q09	2Q09	3Q09	q-q % ¹	q-q % ²	Comment
Gross revenues	488	512	400	5%	-22%	Represented by MEP 59%, construction 23%, IWP 18%
Cost of sales	-401	-403	-309			
Gross Profits	87	109	91	25%	-17%	Represents seasonal low (Ramadan and Summer)
Gross profit margins(%)	17.9	21.3	22.7			Margin development
SGA	-25	-34	-35	32%	4%	Includes management fees paid to the parent amortised over 5 years
EBIT	59	73	73	23%	1%	
EBIT margins (%)	12.1	14.2	18.3			
Net profit before tax	78	90	71	15%	-21%	Against Nomura 3Q09 estimate AED 73m
Net profit attrib. to equity holders	77	87	69	12%	-20%	
Net profit margins(%)	16.0	17.7	17.7			Quarterly improvements in net margin
EPS (AED)	0.04	0.04	0.03	12%	-19%	Based on weighted average NOSH for the period 2.155m shares (2Q09, 2.177m)
Net debt	-1,004	-1,039	-788	3%	-24%	49% debt short term, AED 1.1bn cash holdings with a further 100m due to banks
Shareholders equity	2,328	2,413	2,466	4%	2%	Improved working capital, receivables outstanding reduced to 163 days (2Q09, 190 days)
Net debt / equity gearing (%)	-43%	-43%	-32%			

¹) Percentage change in 2Q09 over 1Q09 ²) Percentage change in 3Q09 over 2Q09

Source: Company reports, Nomura research

Quarterly backlog movement static at AED 3bn (FY08 ~AED 2.4bn, Nomura estimate)

The backlog has remained relatively static during the year and shows around 18 months. During the period DSI won an AED 130m MEP project in Thailand (Luxury condominium building by Raimon Land) and has announced an AED 400m MEP neighbourhood project contract in Abu Dhabi (Al Dar Muneerah). This takes total announced awards year to date of AED 2bn, which has replenished the current pipeline. If we assume AED 2bn of announced awards and AED 1.4bn year to date revenue then we assume the backlog has increased from AED 2.4bn as at FY08. During the period there was no movement on the AED 600m Durrat Al Bahrain project which remains part of the backlog. According to management the risk of delays or cancellation is increasing (which is contrary to past guidance and acknowledged as such) which does add an element of backlog risk with 20% exposure – but some or all of the project may continue in some form, but there will now be a delay in monetising the contract in our view with work not progressing yet.

Working capital and balance sheet

The cash position of the company is currently AED 1.0bn (after deducting AED 101m of overdraft facilities and time deposits under lien) against borrowings of AED 228m. On this basis DSI is cash positive at ~AED 770m, but the cash balance is currently being squeezed by operations. Year to date operational cash flows have been negative at – AED 190m (1Q09 from incorporation, -AED 170m; 2Q09, +AED 25m; 3Q09, -AED 45m), with cash flows pre-working capital changes still positive at AED 264m and trending in line with revenues (1Q09 from inc., AED 121m, 2Q09, AED 82m; 3Q09, AED 61m). Around 30% of the term loans totalling AED 66m (out of AED 228m) mature over the next 12 months.

Trade receivables currently stand at AED 834m (from AED 706m at 1Q09) against trade payables of AED 519m (AED 527m). Sales outstanding have been managed down to 163 days from 190 days in the current quarter with payables raised from 99 to 118 days payable which has improved the this aspect of the working capital. Our analysis however shows total working capital (ex cash and short term debts etc) is annualising at around 90 days and flat from 2Q09.

In the money

The share back programme has appreciably slowed with just 8m shares bought back during the quarter. As at 15 July the company had bought back 22m shares before the 2Q09 close period and subsequently 8m shares were bought back (announced 16 September) at a total cost of AED 27m (AED 0.89 per share). In May the company sought approval to buy back up to 10% or 217m shares.

Medium-term prospects

We still think the long term prospects of DSI (and other regional construction companies) remain good. The business model is balance sheet light and managing the working capital situation is one of the key challenges. The other is the continual replenishment of the existing backlog to support future earnings where the company is trying to diversify activities into higher margin IWP business. Approximately 60% is MEP with 20% roughly split in construction and IWP. We think construction businesses are less cyclical than the market believes. A fall in general or private contracting is generally cushioned by an increased public infrastructure spend which is fine if you have the expertise to divert operations, which we think DSI does. Ultimately the growth prospects for DSI rest with the deployment of the IPO cash into accretive business acquisitions. If the backlog can be secured at attractive values then we see a catalyst for a positive re-rating. We expect acquisition announcements in the coming quarter, but hopefully not much longer with the risk that the market loses patience.

We have made some minor changes to our top line revenue forecasts on the back of the 3Q09 results, but with strong margins we keep out net profit estimates relatively unchanged.

Figure 2: Summary financial estimates

Income statement							Balance sheet						
Year-end 31 Dec (m AED)	FY07	FY08	FY09E	FY10E	FY11E	FY12E	Year-end 31 Dec (m AED)	FY07	FY08*	FY09E	FY10E	FY11E	FY12E
Gross revenues	820	1,720	1,831	2,268	1,936	1,656	Fixed Assets/PPE	134	193	234	256	272	280
Cost of goods sold	-665	-1,396	-1,428	-1,815	-1,549	-1,325	Intangibles	147	830	830	830	830	830
Gross Profit	155	324	403	454	387	331	Investments	10	13	253	253	253	253
S,G and A	-37	-161	-125	-148	-126	-107	Inventories	3	2	8	9	8	9
Depreciation	-15	-21	-30	-37	-44	-52	Contract work in progress	151	226	276	342	292	250
Other net operating income	2	24	0	0	0	0	Trade & other receivables	375	650	1,003	994	769	680
Core EBIT	105	166	248	268	217	172	Other assets	11	57	12	12	12	12
Net financing income (costs)	-1	3	41	44	65	72	Bank balances and cash	128	1,402	1,102	1,352	1,602	1,902
Mtm/provisions/non cash	2	1	0	0	0	0	Total Assets	959	3,373	3,717	4,049	4,038	4,216
Other non-operating income	0	42	0	0	0	0	Total debt	66	262	323	125	109	310
PBT	106	212	288	313	282	244	Payables	706	830	846	1,071	916	786
Taxes	0	0	0	-8	-14	-18	Other liabilities	35	47	47	155	166	178
Exceptional/unusual items	0	0	0	0	0	0	Total Liabilities	806	1,139	1,217	1,351	1,191	1,274
PAT	106	212	288	305	267	226	Share capital	15	2,178	2,156	2,156	2,156	2,156
Minority interests	-6	-2	-9	-9	-8	-7	Reserves / retained surpluses	129	42	322	510	651	740
Attributable to equity holders	100	210	280	296	259	219	Minority interests	8	14	23	32	40	47
							Total equity	152	2,234	2,500	2,698	2,847	2,942

Cashflow statement							Key data						
Year-end 31 Dec (m AED)	FY07	FY08*	FY09E	FY10E	FY11E	FY12E	Year-end 31 Dec (AED)	FY07	FY08	FY09E	FY10E	FY11E	FY12E
Net income before tax and MI	106	158	288	305	267	226	EPS Adj	n/a	0.10	0.13	0.14	0.12	0.10
Depreciation and amortization	15	21	30	37	44	52	DPS	n/a	0.00	0.00	0.05	0.06	0.06
Change in provisions/non-cash	4	-4	0	0	0	0	BVPS	n/a	1.0	1.2	1.2	1.3	1.3
Working capital	-50	-186	-392	166	122	0	BVPS (adjusted)	n/a	0.6	0.8	0.9	0.9	1.0
Cash flow from operations (a)	75	-11	-73	508	434	277	Gross profit margin (%)	19%	19%	22%	20%	20%	20%
(inc) decrease in PPE	-54	-97	-71	-60	-60	-60	Core EBIT margin (%)	13%	10%	14%	12%	11%	10%
(inc) decrease in investments	20	-4	-240	0	0	0	ROE (%)	88%	18%	12%	11%	9%	8%
Change in other investing activity	4	2	0	0	0	0	ROA (%)	15%	10%	8%	8%	6%	5%
Cash flow from investing (b)	-30	-98	-311	-60	-60	-60	Net debt/Equity (%)	-41%	-51%	-31%	-45%	-52%	-54%
Free cash flow (a+b)	45	-109	-384	448	374	217	Valuation						
Equity raised (repaid)	0	0	-22	0	0	0	Year-end 31 Dec	FY07	FY08	FY09E	FY10E	FY11E	FY12E
Debt raised (repaid)	-26	206	61	-198	-17	202	P/E (x)	0.0	11.0	8.2	7.7	8.8	10.4
Dividends	-30	0	0	0	-108	-118	P/BVPS (x) Adj	0.0	1.7	1.4	1.2	1.2	1.1
Others	0	-45	45	0	0	0	EV/EBITDA (x)	18.5	6.1	5.4	3.5	3.0	3.1
Cash flow from financing (c)	-56	161	84	-198	-124	83	Dividend yield (%)	n/a	0.0%	0.0%	4.7%	5.2%	5.7%
Net change in cash (a+b+c)	-11	52	-300	250	250	300							
Cash and cash equiv.	32	85	-215	35	285	585							

* As on Nov 17 2008

Source: Company data, Nomura research

Analyst Certification:

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Company Description:

DSI recently listed on the DFM (March 2009) with core operations currently focused in the UAE, but with international expansion plans. It is an integrated end-to-end service provider. The company offers mechanical electrical and plumbing (MEP); infrastructure, water and power (IWP) and civil contracting services across MENA. DSI plans to grow via a two pronged strategy of organic growth and strategic acquisitions across the MENA region aimed at expanding its footprint beyond the UAE to Saudi Arabia, Kuwait and Qatar. It is also looking at Algeria, Syria, Jordan & Lebanon as potential growth markets.

Important Disclosures:

Drake & Scull International (DSI.DU)

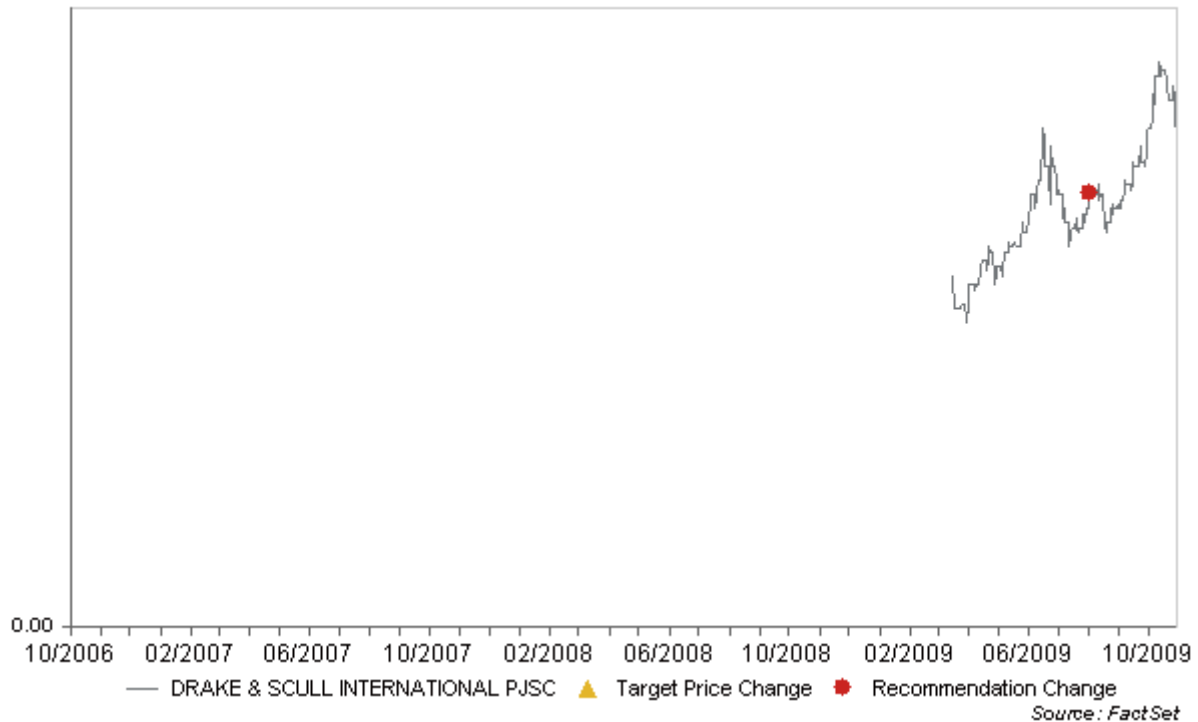
AED 1.06 (02-Nov-2009)

Neutral / Not Rated

Rating and Price Target Chart:

02-Oct-2006 to 29-Oct-2009

PRICE(AED)



Currency=AED

Date	Closing Price	Rating	Price Target
04-Aug-09	0.91	Neutral	

FOR EXPLANATIONS OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE PAGE FOLLOWING THE LAST PRICE CHART.

Valuation Methodology: Our primary valuation approach for Drake & Scull is a two-stage, DCF-based methodology, although as a cross-check, we consider a ROIC-WACC spread (an EVA™ approach). We assume a WACC of 12 % , terminal growth rate of 3% and discount cash flows to 2010E to arrive at our 18-month price target. The stock currently trades at a EV/Backlog ratio of 0.45x.

Our benchmark for this stock is the DFM Index.

Risks Which May Impede the Achievement of the Price Target: With regard to Drake & Scull, the key challenges are securing the current acquisition portfolio and effectively integrating it into the group. Moreover, despite the diversification strategy, the focus on larger awards does introduce additional cluster and concentration risk.

Important Disclosures Continued:

Company Name	Ticker	Price	Price Date	Stock / Sector Rating
Drake & Scull International	DSI.DU	AED 1.06	02-Nov-2009	Neutral / Not Rated

All share prices mentioned are closing prices unless otherwise stated.

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As at 30 September 2009.

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- A rating of "3", or **"Neutral"**, indicates that the analyst expects the stock to either outperform or underperform the Benchmark by less than 5% over the next six months.
- A rating of "4", or **"Reduce"**, indicates that the analyst expects the stock to underperform the Benchmark by 5% or more but less than 15% over the next six months.
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- A rating of "1", or **"Strong buy"** recommendation indicates that upside is more than 20%.
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- A rating of "5", or **"Sell"** recommendation indicates that downside is more than 20%.

Sectors:

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A "**Bearish**" rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

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