

Arkan Building Materials

Valuations running ahead of fundamentals

INVESTMENT RESEARCH

COMPANY UPDATE | April 30, 2008

UNITED ARAB EMIRATES

Hassan Awan
Tel: +971 (2) 619 2369
hawan@tni.ae

Last Price: AED 4.80
Price Target: AED 3.70
Sector: Cement

Stock Rating
OVERPRICED

BLOOMBERG: ARKAN:UH

REUTERS: ARKN.AD

Share Data

No of shares (m)	1,750
Daily vol (AEDm)	90
Daily vol (US\$m)	25
Free Float	43%
Mkt cap (AEDm)	8,400
Mkt cap (US\$m)	2,286

Source: Zawya, Reuters

**Recommendation
changed to
Overpriced**

Solid top line performance continues

The first quarter results of Arkan Building Materials demonstrated the impact of better cement prices and volumes. Revenue for the quarter grew by 33% YoY to AED 103m, which is the highest ever quarterly sales figure for Arkan. Net profit however dropped to AED 17.2m from AED 38m in the same period last year. This was a consequence of investment losses. Due to both rising cement prices and access to affordable energy, margins were maintained at their previous levels.

Investment losses eat into net profits

Despite solid growth in revenues over the last year, net profits of the company declined by nearly 55% YoY. This was due to investment losses amounting to AED 29.9m. The company's portfolio amounts to AED 78.1m and is very insignificant when compared to the balance sheet size of AED 2.3bn. This is the first time however that the investment income component has impacted net margin so severely. Net margin dropped to 16.7% from a historic quarterly average of above 55%.

Gradually diversifying from a pure cement company

Last month, Arkan announced that it had acquired 40% of Vision Group, a conglomerate involved in furniture and home decorations. Little is known about the deal at this stage but we expect it to impact the bottom-line of the company starting 2008. This investment opens more doors for Arkan to use its strong net cash position for further investments up the value chain.

Very expensive valuation multiples!

Arkan's stock price has appreciated by nearly 25% since our last publication in June. We continue to believe strongly in Arkan's strategic position in the cement industry, strong fundamentals and growth prospects. However with a 2008 P/E multiple of 37x, Arkan looks expensive. We are downgrading our recommendation to Overpriced with a target price of AED 3.70.

Forecasts and Ratios

Yr to Dec	Revenue (AEDm)	EBITDA (AEDm)	Net Profit (AEDm)	P/E	EV/EBITDA
2007	346.4	154.8	202.7	40.6	47.7
2008E	446.5	204.7	224.6	37.4	36.1
2009E	431.4	237.8	225.6	37.2	31.1
2010E	1,307.5	635.7	544.6	15.4	11.6

Source: TNi Investment Research

Stock price performance



Source: Reuters

Valuation

We have adjusted our target price to AED 3.70, which is at a 23% downside from the current price of AED 4.80. Our previous target price was AED 3.45 therefore incorporating the quarterly results has resulted in a 7.2% increase. The changes to our estimates are minimal at this stage varying between 1% and 7% in different years.

Table 1: Arkan Building Materials - DCF valuation

AED(m)	2008E	2009E	2010E	2011E	2012E
EBIT	168.3	167.4	482.5	599.2	661.4
+Depreciation	36.4	70.4	153.2	158.9	165.1
-Capex	-133.9	-151.0	-261.5	-71.3	-76.5
-Working capital Δ	-29.6	-14.2	167.6	33.9	24.4
=Free cash flow	100.4	101.0	206.6	652.9	725.6
xDiscount factor	0.92	0.81	0.71	0.63	0.55
=Discounted FCF	92.1	81.6	147.0	408.8	399.8
Terminal value (TV)	7,868.9				
Sum of discounted FCF	1,129.4				
+Discounted TV	4,336.2				
=Firm value	5,465.5				
+Net cash (debt)	-1,012.7				
=Value of equity	6,478.2				
÷Number of shares	1,750.0				
=Fair value (AED)	3.70				
Current price (AED)	4.80				
Upside/(downside)	-22.92%				

Source: TNI Investment Research

Table 2: Sensitivity analysis of DCF valuation

		Terminal growth rate				
WACC		2.0%	3.0%	4.0%	5.0%	6.0%
	9.59%	4.94	5.53	6.34	7.49	9.29
	11.59%	3.91	4.24	4.67	5.22	5.97
	13.59%	3.23	3.45	3.70	4.02	4.41
	15.59%	2.77	2.91	3.08	3.27	3.51
	17.59%	2.42	2.52	2.64	2.77	2.93

Source: TNI Investment Research

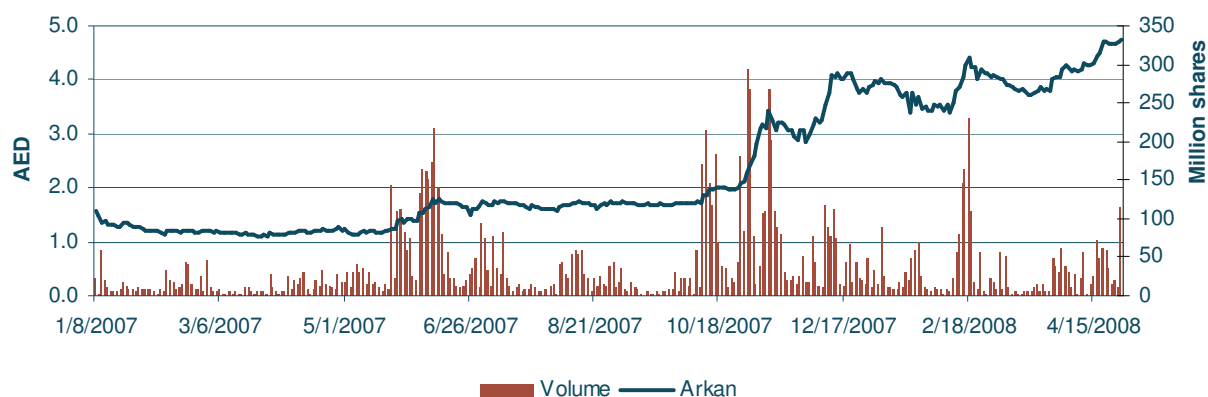
Assuming a terminal growth rate of 4%, the market is clearly pricing Arkan at a WACC of 11.6%. This is still a high discount rate when compared to its peers however Arkan has a higher beta. Arkan is the most liquid cement company with average trading volume of 36m shares. However it is also the youngest, having listed in January, 2007.

Valuation

Stock price continues to fly

Arkan has recently been trading at very high valuation multiples. We believe that opening up to foreign ownership can serve as a catalyst for the stock price going forward. The management issued a statement earlier this year saying they were not aware of any reason for the soaring stock price. Moreover this recent price hike is in sharp contrast to the sector trend, which has been flat and range-bound.

Chart 1: Arkan stock price

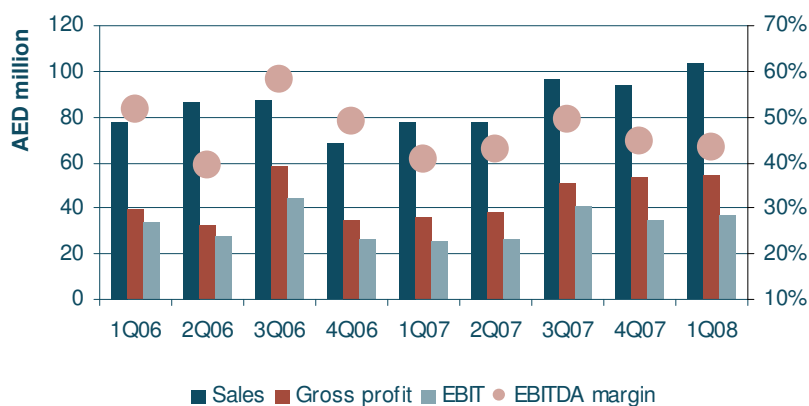


Source: Reuters

Stable profit margins

Profit margins of Arkan have been stable during the last nine quarters. EBITDA margin has stayed above 40% during most of this time. This compares to a sector average of 35% since the first quarter of 2006.

Chart 2: Arkan - Profitability



Source: Arkan Building Materials

Updated financials

Table 3: Arkan Building Materials - Financials and ratios

Data in AED million	2007	2008E	2009E	2010E	2011E	2012E
Income statement						
Revenues	346.4	446.5	431.4	1,307.5	1,425.3	1,529.8
Cost of Sales	(168.1)	(214.3)	(202.8)	(634.1)	(641.4)	(673.1)
Gross Profit	178.2	232.2	228.7	673.3	783.9	856.7
EBITDA	154.8	204.7	237.8	635.7	758.1	826.5
Net Income	202.7	224.6	225.6	544.6	682.1	781.1
Balance sheet						
Cash and cash equivalents	1,012.7	1,046.8	1,083.5	1,229.8	1,843.1	2,565.9
Net PPE	543.1	649.1	738.2	854.9	775.7	695.6
Total assets	2,156.7	2,279.7	2,377.6	2,995.3	3,558.2	4,231.2
Total debt	0.0	0.0	0.0	0.0	0.0	0.0
Shareholders funds	2,080.4	2,182.5	2,285.6	2,707.7	3,267.2	3,925.8
Total liabilities & equity	2,156.7	2,279.7	2,377.6	2,995.3	3,558.2	4,231.2
Cash flow statement						
Operating Cash Flow	130.5	233.8	251.4	466.4	722.4	800.1
CapEx	87.1	133.9	151.0	261.5	71.3	76.5
Investing Cash Flow	(84.2)	(77.1)	(92.2)	(197.7)	13.5	45.1
Proceeds/repayment of debt	6.1	0.0	0.0	0.0	0.0	0.0
Financing Cash Flow	(270.2)	(122.5)	(122.5)	(122.5)	(122.5)	(122.5)
Net Cash Flow	(223.9)	34.1	36.7	146.3	613.4	722.7
Growth ratios						
Revenues	8.3%	28.9%	-3.4%	203.1%	9.0%	7.3%
Gross profit	8.1%	30.3%	-1.5%	194.5%	16.4%	9.3%
EBIT	-3.9%	31.9%	-0.6%	188.2%	24.2%	10.4%
Net profit	15.7%	10.8%	0.5%	141.4%	25.2%	14.5%
Margins						
Gross margin	51.5%	52.0%	53.0%	51.5%	55.0%	56.0%
EBIT margin	36.9%	37.7%	38.8%	36.9%	42.0%	43.2%
Net margin	58.5%	50.3%	52.3%	41.7%	47.9%	51.1%
Valuation & returns						
P/E	41.4	37.4	37.2	15.4	12.3	10.8
EV/Revenue	21.3	16.5	17.1	5.7	5.2	4.8
EV/EBITDA	47.7	36.1	31.1	11.6	9.7	8.9
ROE	9.9%	10.5%	10.1%	21.8%	22.8%	21.7%

Source: Arkan Building Materials, TNI Investment Research

Updated financials

This report is solely intended to be a market update for the recipients of this report on certain information about the company, which we reasonably believe may be price sensitive. However it should be noted that the report does not constitute a recommendation or opinion expressed by TNI Investment Research, nor should be construed as a solicitation or offer, to buy or sell any securities. The content of the report should be read in conjunction with our initiation report on the company and disclaimers included therein.