

OMAN CABLES CO. SAOG (OCAI.MSM)

A recovery in copper prices to improve its margins while global economic slowdown dampens its sales outlook for 2009

RECOMMENDATION : BUY
 CMP : RO 0.631
 TARGET PRICE : RO 0.826
 VARIANCE : 31%

INVESTMENT OPINION

OCAI reported poor results in Q4 2008 owing to hedging losses on copper futures contracts as a result of a steep fall in copper prices in that quarter which was reflected as higher cost of sales in the income statement and higher level of inventories on the balance sheet.

The sharp economic contraction in Oman as well as in the other GCC states which are the primary markets for the company, has resulted in cancellation of several orders by its customers thereby shrinking its order book for 2009. The company has managed to clock a 69% CAGR in sales during 2003-08 and a 40% YoY growth rate in sales in 2008. We estimate on a conservative basis a meager 10% YoY growth rate in sales for 2009 which is likely to gradually improve to 40% by 2011 once the current slowdown ends.

However, on the positive front, copper prices have recovered smartly by around 43% in Q1 2009 on strong buying from China which alone accounts for 30% of global demand. The outlook for copper prices has turned slightly optimistic in 2009 on expectations that strong buying from China and a likely return of stability in the global economy will keep prices firm. Deutsche Bank has raised its earlier forecast for average price of copper by 17% to \$3,288 per metric ton while its predictions for 2010 and 2011 are \$ 4,189 and \$ 5,071 per metric ton respectively. An uptrend in copper prices will lead to hedging gains for Oman Cables which will result in lower cost of sales. Higher copper prices also enable the company to negotiate future orders with its customers at higher prices. We therefore expect its EBIT margin to improve from 3% in 2008 to 6% in 2009 and finally reach a sustainable level of 9% from 2011 as demand picks up again. We estimate an EPS of RO 0.098 in 2009, an increase of 44% over its 2008 EPS of RO 0.068.

Demand for electricity is on the rise worldwide and more so in the emerging world. Demand for electricity in the GCC is expected to average at 6% p.a. during 2010-20. The GCC states have chalked out ambitious plans to augment their power generation and distribution capabilities. Projects such as the \$ 7 billion GCC unified

FINANCIAL INDICATORS	FY2008
CMP (March 26, 2009)	0.631
MCAP (RO Mn)	56.60
P/E (FY08)	9.26x
P/BV (FY08)	1.80x
DIV YIELD (FY08)	3.2%
ROAE	20.60%
ROAA	6.70%
LT DEBT/EQUITY	0.10
CURRENT RATIO	1.13
OPERATING PROFIT MARGIN	3.10%
NET PROFIT MARGIN	2.00%
NET DEBT (RO Mn)	75.85
INTEREST COVERAGE	3.31
FCFE/SHARE (RO)	0.393
FCFE YIELD	62.3%

Source: FINCORP Investment Research

COMPANY
UPDATE

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power grid expected to become operational from 2010 are expected to significantly benefit power cable manufacturers such as Oman Cables in the medium term.

BUSINESS MODEL

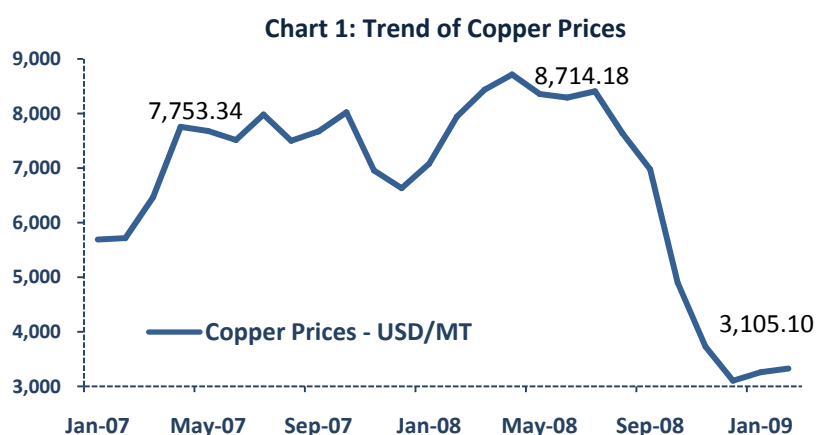
Oman Cables is engaged in the manufacture of a wide range of power cables and overhead line conductors serving markets in Oman, MENA and select international markets. Besides, geographical diversification, its end users are also well diversified in industries such as power generation, electricity distribution, mass transportation, oil & gas and petrochemicals.

In terms of production capacity, the company is capable of meeting the entire demand for cables and conductors in Oman and still has 70% of its capacity left for exports. OCAI copper processing volume has grown from 20,773 tons in 2004 to 71,803 tons in 2008. OCAI currently enjoys an 80% market share in the Sultanate, a 7% share in the GCC and a 4% share internationally. The company therefore enjoys a great deal of pricing power as it has a near monopoly in the local market and at the same time is diversified globally. The company has successfully made a foray into the South East Asian markets in 2008 to capitalize on their high economic growth rates.

OCAI has a 51% stake in Oman Aluminium Processing Industries LLC (OAPIL) engaged in the manufacture of aluminium rods and overhead conductors which are expected to commence operations in Q1 2010. Also the company has a 100% interest in Oman Power Conductors LLC, a company registered in the Sultanate of Oman and yet to commence commercial operations.

MARGINS PLUNGE IN Q4 ON A SHARP FALL IN COPPER PRICES

Total revenue for FY2008 amounted to RO 304 million registering a 40% YoY increase over the previous year. However, Q4 2008 sales revenues declined to RO 59 million from RO 89 million in Q3 2008 as a result of the crimping effects of the current global downturn. A severe slowdown in the construction sector, a major user of the company's products, affected sales during the last quarter of 2008. Consequently, OCAI's Q4 sales revenues plunged from a targeted level of around RO 100 million to RO 59 million.



The sharp drop in copper prices from an average of \$7,878/MT for 9M 2008 to \$3,940/MT in Q4 2008 led to massive derivative hedging losses on expiry which resulted in increase in the cost of sales by RO 12.9 million thereby adversely affecting its margins.

TABLE 1: OCAI SALES (RO Million)

	Q1'08	Q2'08	Q3'08	Q4'08	2008	2007	YoY%
Sales	71.48	84.54	88.92	59.44	304.38	217.45	39.98%
Copper Prices USD/MT (LME)	8,434	8,292	6,975	3,940	3,105	6,631	-53.17%

Cost of sales for the year amounted to RO 288 million of which RO 281 million represented the cost of materials consumed. OCAI has adopted a strategy wherein it uses copper futures to hedge its risk associated with metal price appreciation. The drastic fall in copper prices in Q4 2008 has led to a RO 12.96 million one-time charge which formed part of the cost of sales.

TABLE 2: OCAI GROSS PROFIT (RO Million)

	Q1'08	Q2'08	Q3'08	Q4'08	2008	2007	YoY%
Sales	71.48	84.54	88.92	59.44	304.38	217.45	39.98%
Cost of Sales	64.23	71.27	79.28	72.95	287.74	192.46	49.51%
Gross Profit	7.25	13.27	9.64	(13.51)	16.64	24.99	-33.40%
Gross Profit Margin	10%	16%	11%	NA	5%	11%	-

Gross profit for the full year 2008 amounted to RO 16.64 million while recording a gross loss of RO 13.51 million in Q4. Gross profit margins declined from 10% in Q1 2008 to negative in the last quarter. For the full year gross profit margin was at 5% as against 11% in 2007.

OCAI's **total operating expenses** comprises of selling & distribution expenses and administrative expenses. Employee costs on an average make up for most of the administrative expenses at 52% while marketing and freight expenses make up for 81% of the selling & distribution expenses. Higher freight costs in 9M 2008 due to high oil prices led to a 63% YoY increase in selling and distribution expenses to RO 3.36 million. Employee costs on the other hand fell 10% to RO 1.83 million.

As a result, operating profit for the FY2008 amounted to RO 9.84 million, registering a substantial decline of 51% over FY2007 while operating profit margin for the year stood at 3% as against 9% in 2007.

During 2006 OCAI acquired a 35% in Associated Cables Pvt. Ltd. India (ACPL) in accordance with the terms of the commercial understanding agreement with Draka Holding NV, the associate company's major shareholder. However in 2008 OCAI increased its share to 40% having received an additional 5% stake in the company.

TABLE 3: OCAI NET PROFIT (RO Million)

	Q1'08	Q2'08	Q3'08	Q4'08	2008	2007	YoY%
Net Profit	3.98	7.55	6.26	(11.68)	6.15	15.13	-59.48%
Net Profit Margins	6%	9%	7%	-20%	2%	7%	-
EPS	0.044	0.084	0.070	(0.130)	0.068	0.169	-59.61%

Consolidated net profit for the FY2008 amounted to RO 6.15 million attributable to the ordinary shareholders. Net profit recorded a decline of 60% YoY while net profit margin declined to 2% in 2008 as against 7% recorded in FY2007. OCAI recorded a net loss of RO 11.68 million in Q4 2008 largely on account of the losses made on the futures contract. EPS for FY2008 amounted to RO 0.068 as against RO 0.169 recorded in FY2007.

AN INEFFICIENT INVENTORY MANAGEMENT CONTINUES TO AFFECT FREE CASH FLOWS

OCAI's **cash and cash equivalents** for FY2008 amounted to RO 7.10 million of which RO 4.33 million is held in bank current accounts while RO 2.75 million are held as short term deposits.

Inventories surged sharply to RO 56 million at the end of FY08 as against RO 36 million in FY07 mainly attributable to raw materials which rose 326% YoY from losses realized in copper hedging contracts which are reflected in the effective cost of raw materials. The company needs to improve a lot in its inventory management as each year its working capital increases greater than its NOPAT resulting in negative free cash flows to the firm as shown below:

TABLE 4: FREE CASH FLOW TO FIRM (RO Million)			
	2006	2007	2008
EBIT *(1-t)	10.74	17.28	8.43
Capex	(6.88)	(5.19)	(2.88)
Change in working capital	(21.70)	(19.89)	(25.28)
FCFF	(17.84)	(7.80)	(19.73)

Trade receivables were slightly lower at RO 50 million. Of these, RO 41.88 million were "neither past due nor impaired" and are believed to be collectible based on historical experience. In terms of credit risk, 42% of company's trade receivables are due from eight customers while 66% of the trade receivables are secured against letters of credit, bank guarantees or other credit risk cover. The balance is mainly due from government authorities.

OCAI's **total borrowings** amount to RO 81.36 million of which RO 78.40 represents the current portion. The company's total debt equity ratio increased to 2.63x at the end of FY08 compared to 1.96x at the end of the previous year.

The **current portion of long term debt worth RO 78.40 million** comprises of RO 40.84 million loans against trust receipts (LTRs) that are sanctioned against inventories while RO 36.83 million are short term loans. The company has resorted to heavy short-term borrowing in 2008 as it encountered a big cash outflow from operations (an outflow of RO 11.6 million compared to an inflow of RO 1.5 million in FY07 as a result of hedging losses).

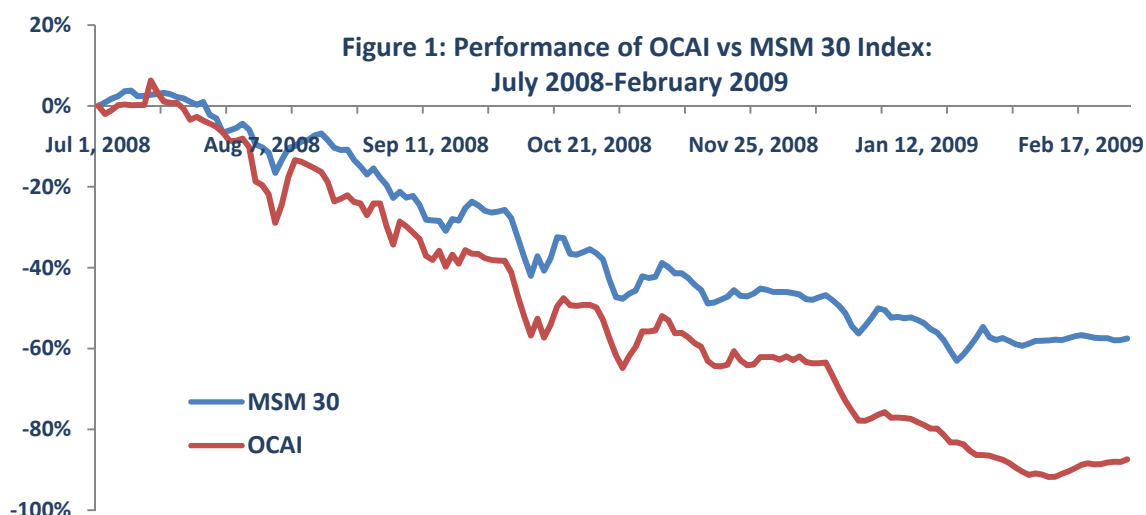
Term loans of **RO 2.96 million representing the noncurrent portion** of the total debt are loans availed from commercial banks. It includes a loan of RO 300,051 denominated in US dollars repayable in a semi annual instalment of RO 300,051 in March 2009 and a second loan denominated in US Dollars of RO 3,498,500 repayable in seven half yearly instalments of RO 499,786 each up to August 2012. The company's long term debt equity ratio is at 0.10x.

Trade payables for FY2008 amounted to RO 19.96 million inclusive of 'other payables' and relates to commodity future contracts. Other payables included an amount of RO 4.18 million which is the cumulative change in fair value relating to the unrealised loss in commodity future contracts. These unrealized losses are mainly on account of differences between the original values of the future commodity contracts entered into by OCAI in the normal course of business and the market value of these contracts as at the balance sheet date. The reported fair value changes on will have an impact on the company's 2009 profitability.

OCAI has announced a **dividend of RO 0.020 per share for FY2008** amounting to a payout ratio of 29.3%. On an average OCAI has maintained a dividend payout ratio of 21% for the period 2005-2008.

STOCK PRICE PERFORMANCE

OCAI currently trades at P/E multiple of 9.3x its FY08 EPS. OCAI has significantly underperformed the MSM Index losing in excess of 87.5% since July 2008 as a result of copper hedging losses and lower sales in Q4. In comparison, the MSM 30 index has declined only 57%. OCAI has a 3 year beta of 1.16.



VALUATION

We arrive at a fair value of RO 0.742 for OCAI using DCF methodology as shown in the tables below:

TABLE 5: FORECAST OF FCFF (RO Million)

	2006	2007	2008	2009E	2010E	2011E	2012E	2013E
Sales	125.718	217.445	304.377	334.814	451.999	632.799	885.918	1,284.582
EBIT	12.207	19.638	9.575	20.089	36.160	56.952	79.733	115.612
EBIT Margins	9.7%	9.0%	3.1%	6%	8%	9%	9%	9%
Tax Rate	12%	12%	12%	12%	12%	12%	12%	12%
Capex	6.880	5.192	2.884	2.127	2.446	2.813	3.235	3.720
Non Current Assets	17,274	21,528	23,120	26,589	30,577	35,163	40,438	46,504
Capex/Non Current assets	39.8%	24.1%	12.5%	8%	8%	8%	8%	8%
Change WC	(21.701)	(19.885)	(25.275)	(26.785)	(31.640)	(44.296)	(62.014)	(89.921)
Change WC/Sales	17.3%	9.1%	8.3%	8%	7%	7%	7%	7%
FCFF	(17.839)	(7.795)	(19.733)	(11.234)	(2.265)	3.009	4.915	8.098

TABLE 6: WACC computation

R _f	4.50%
R _m	10.50%
3 yr Beta	1.16
Cost of Equity	11.46%
Equity	31,516
Short Term Debt	79,951
Long Term Debt	2,956
Interest on LT Debt	8%
Interest on ST Debt	6%
Tax Rate	12%
WACC	7.03%

Source: FINCORP Investment Research

TABLE 7: Fair value computation

Terminal Growth Rate	3%
Terminal Value	207,045
Dis Terminal Value	147,423
Dis FCFF Explicit	(508)
Firm Value	146,915
Net Debt	78,561
Equity Value	68,354
Number of Shares	89,700
Fair Value per Share	0.762
Less: cash dividend (0.020)	0.742

Source: FINCORP Investment Research

TABLE 8: PEER COMPARISON

INDICATORS	Oman Cables	Saudi Cables	Middle East Cables	Mean
P/E (FY08)	9.26x	5.72x	12.85x	9.28x
P/BV (FY08)	1.80x	1.30x	2.24x	1.78x
ROE	20.60%	24.18%	18.79%	
DIV YIELD (FY08)	3.17%	4.00%	4.23%	
DIV PAYOUT (FY08)	29.41%	22.87%	54.30%	

Source: FINCORP Investment Research

In Table 8 above, OCAI is compared against its GCC peers, Saudi Cables and Middle East Cables. OCAI trades near the mean P/E and P/BV multiples of the peer group. At an expected FY09 EPS of RO 0.098 and mean P/E multiple of 9.28, the fair value works out to RO 0.909.

Giving equal weightage to values arrived by DCF and relative valuation, the fair value for Oman Cables works out to RO 0.826, 31% higher than the closing price of RO 0.631 on March 26, 2009.

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