18th May 2009

Initial Coverage

Drake & Scull International- Cashing In On Growth Opportunities

Drake and Scull International *(DSI)*

Rating: Outperform

Target Price: AED 0.96

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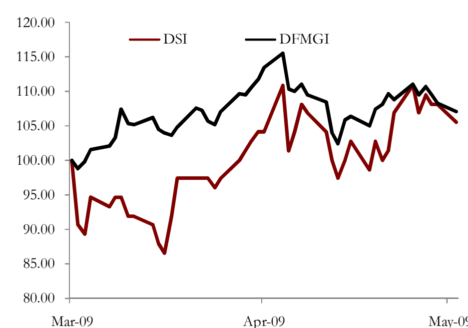
- **We initiate on Drake & Scull International *(DSI)* with an Outperform rating and a target price of AED 0.96 implying 23% upside to the current price.**
- DSI benefits from positive net cash strength, healthy backlog, an aggressive expansion strategy and a balanced client mix. We believe that the rare combination of these factors could mitigate the negative impact of the economic downturn on the company.
- Post 3Q 09, DSI is likely to utilize AED 250-500mn from its IPO proceeds to grow inorganically through acquisitions of MEP and civil contractors in Saudi, Qatar & Kuwait.
- Despite their higher risk, IWP projects could provide some respite from the growth slowdown in the MEP segment. Therefore, DSI is actively pursuing diversification into the IWP segment to tap opportunities in neighboring countries and relieve potential margin stress.
- Although the revenues are likely to contract and margins might weaken in the near term, we believe that organic diversification and inorganic expansion could enhance growth prospects post 2009, leading to a recovery in the top line growth from 2010 onwards. However, we do not expect a significant margin improvement until 2011 as difficult market conditions could limit the potential upside on contracts negotiated in 2009/10 and executed in 2009, 2010 & 2011.
- Margin softening and rising receivables are likely to be the most challenging issues in the near term. A successful track record to sign credible orders and long standing customer relationships should help alleviate working capital challenges.
- Overall, we see the company's performance to be healthy relative to its peer group despite the taxing economic conditions in the region.
- We feel that at a 2009e P/E net of net cash multiple of 3.61, the stock is an attractive buy. Our 12 month DCF derived target price is AED 0.96.

Equity Data	
Price, AED	0.78
Target Price, AED	0.96
Upside %	23%
Hi-Lo, AED	1.00 - 0.64
Performance, Until Date	5.4%
Market Cap (AED, mn)	1,698.67
EV (AED, mn)	694.66
Bloomberg	DSI UH



Financial Data (AED, mn) Except per share data	2007A	2008A	2009E	2010E	2011E
Revenue	820.46	1,720.48	1,674.22	1,706.64	1,777.35
Gross Margin %	18.9%	18.8%	16.5%	14.8%	13.9%
EBITDA	120.70	183.01	138.71	133.15	148.76
EBITDA Margin %	14.7%	10.6%	8.3%	7.8%	8.4%
Net Profit After Min Int	99.98	209.90	192.49	181.94	177.55
Net Margin %	12.2%	12.2%	11.5%	10.7%	10.0%
Minority Interests	5.66	2.03	6.98	6.60	6.44
Shares Outstanding	15.00	2,177.78	2,177.78	2,177.78	2,177.78
EPS	6.67	0.10	0.09	0.08	0.08
Cash EPS	7.68	0.09	0.08	0.08	0.09
P/E	NM	8.09	8.82	9.34	9.57
EV/EBITDA	NM	3.31	3.61	3.82	3.91

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Investment Summary

We initiate on Drake & Scull International ((DSI) with an Outperform rating and 12 month target price of AED 0.96 with 23% upside to the current price. At the current price, we believe there is limited downside to the stock price as the company benefits from a net cash reserve (IPO proceeds) of AED 0.47 per share which should provide a floor to the share price.

Although the construction industry faces a dramatic slowdown in the UAE, we believe **DSI with its positive net cash strength, healthy backlog, aggressive expansion strategy, and a balanced client mix is well positioned to ride out the downturn**. However, we remain cautious about the company's organic growth plan as we believe that there will be limited possibilities for growth in the core MEP business. In fact, for the MEP segment, we feel that DSI is unlikely to repeat the top line growth of 2007-2008 in the near term and the MEP order book, which contributes over 57% of the company's revenue, may shrink. Consequently, we expect top line to contract marginally (2.6%) in 2009.

Post 3Q 09, DSI is likely to utilize AED 250-500mn from its IPO proceeds to grow inorganically through acquisitions of MEP and civil contractors in Saudi, Qatar & Kuwait. The company is also likely to tap into its available cash reserve in 2010 to fund its IWP diversification plans and to exploit opportunities in the MENA region. IWP projects should provide some respite from the slowdown in growth in the MEP segment as- 1) IWP contracts tends to enjoy relatively higher margins, 2) the projects are likely to be state funded and 3) due to complexity and scale, IWP projects assure a recurring revenue stream. **As a result, we believe there could be a recovery in the top line growth from 2010 onwards.**

Margin softening and rising receivables are likely to be the most challenging issues in the near term. A successful track record of signing credible orders and long standing customer relationships should help alleviate working capital challenges but we are skeptical about the possibilities of reviving gross margins in the near term. Despite the support from low commodity prices (steel, cement and copper), the uncertainty surrounding the construction industry is likely to lead to a considerable margin squeeze and limit the possible upside especially in the MEP and civil segments. Therefore, we expect gross margins to decline to 16.5% in 2009 due to risks associated with MEP and civil segments but net margins may benefit from the exceptional interest earned on unused cash (IPO proceeds) for most of 2009 and 1H of 2010. Therefore, net margin might weaken slightly to 11.5% during 2009. **Overall, we see the company's performance to be healthy despite the weakening economic conditions in the region.**

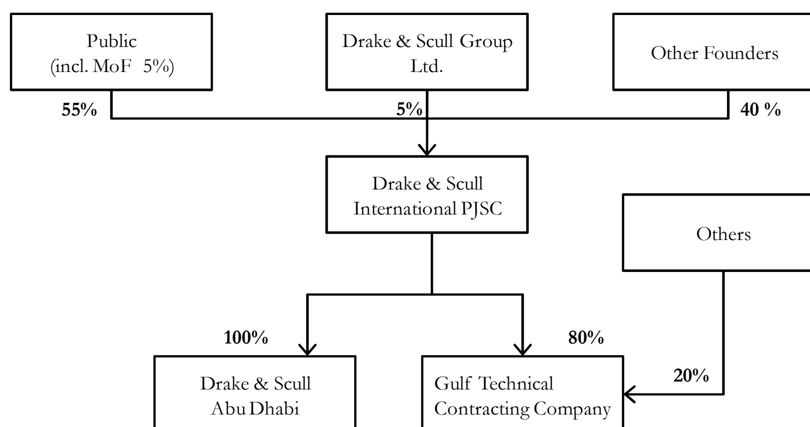
At a 2008 P/E of 8.09, DSI appears to be relatively expensive in comparison to ARTC (current P/E of 3.06) and DEPA (current P/E of 4.82). We feel this is a distorted view as DSI P/E does not reflect its unique cash strength and relatively better working capital condition. **We feel that P/E net of cash would be a better comparable as it adjusts for the cash position of the company. At a 2009e P/E (net of cash) of 2.61 or P/E (net of net cash) of 3.61, DSI is an attractive buy and we have a 12 month DCF derived target price of AED 0.96.**

Company Overview

Drake & Scull International PJSC (DSI) was incorporated in the UAE in 1966 and is a leading local MEP and civil contractor. The company offers Mechanical Electrical and Plumbing (MEP) solutions, Infrastructure, Water and Power (IWP) solutions and Civil Contracting services across the UAE. It acquired 100% of Drake & Scull Abu Dhabi and 80% of GTCC (Gulf Technical Construction Company) in 2007.

In March 2009, DSI listed 55% of its shares on the DFM following a successful IPO in July 2008. Founding members, a group of HNWIs and institutional investors, retain 45% of the holding while the remaining shareholders, individuals as well as local, regional and international institutions hold 55% of the company.

Ownership Structure



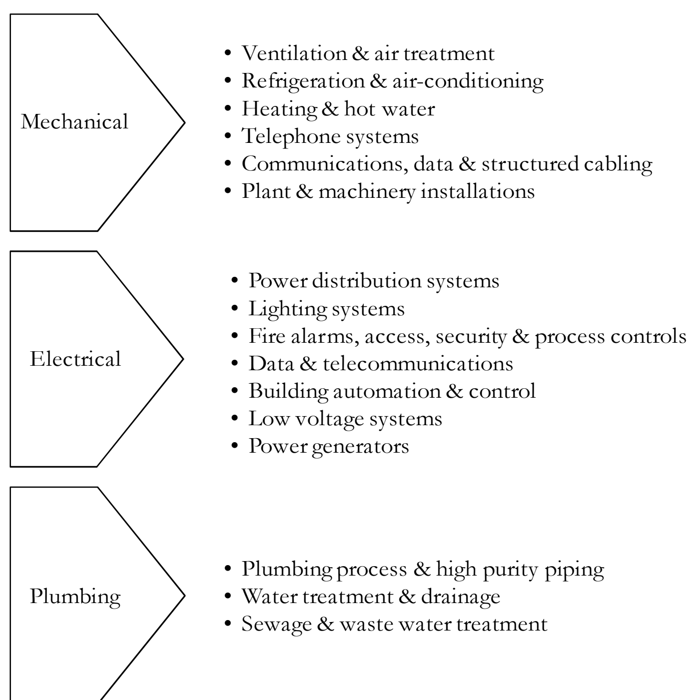
Source: Company, DSI Prospectus

DSI employs 12,000 people across the UAE and management anticipates this number to increase post the planned acquisitions in Saudi Arabia, Kuwait & Qatar.

Range of Services

Mechanical Electrical and Plumbing (MEP)

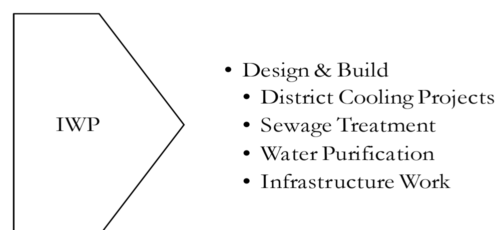
DSI provides quality, high end MEP solutions across the UAE to commercial, industrial and institutional customers. The MEP segment operates in the following areas:



Source: Company, Al Mal Capital Research

Infrastructure, Water & Power (IWP)

The IWP division operates from Dubai and offers various services, including district cooling technology to large-scale developments in the UAE, Saudi Arabia, Oman, Bahrain and Sudan. This division operates on an EPC (Engineering, Procurement & Construction) & EPCM (Engineering, Procurement, and Construction Management) basis.



Source: Company, Al Mal Capital Research

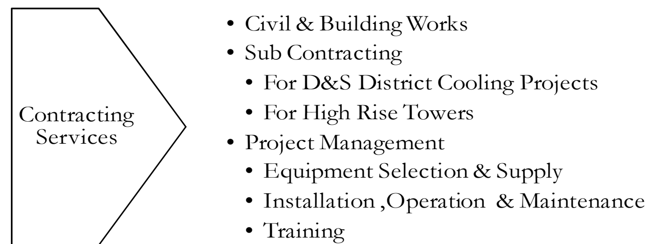
DSI is focusing on building up its IWP strength as the company believes this sector will provide a number of potential business opportunities in the MENA region in

the near future. In the UAE, the increasing emphasis on green buildings is positive for DSI's MEP and IWP divisions. With the rulers of both Dubai and Abu Dhabi issuing directives for all new buildings to comply with green standards, the scope of work for MEP services and district cooling is likely to increase.

Some of DSI's successfully completed MEP and IWP projects in Dubai and Abu Dhabi include Zayed University, JBR district cooling scheme, Dubai Festival City district cooling, NEB office building phase 1 and the Habshan residential complex expansion.

Civil Contracting

GTCC is involved in the design, planning and construction of civil and building work primarily in Dubai. The subsidiary has worked alongside DSI as the civil contractor for district cooling plants as well as general civil contracting for third party clients. DSI is now focusing on expanding the civil business across GCC to exploit the opportunities in the neighboring countries.



Source: Company, Al Mal Capital Research

GTCC targets a niche market which has low barriers to entry and was left untapped by large contractors during the UAE construction boom that lasted until mid 2008. Primarily the GTCC segment aims to secure civil projects which are in the range of AED 100mn – 500mn. Historically, approximately 70% of GTCC revenues have been generated from third party contracts.

DSI-Contract Cost Structure

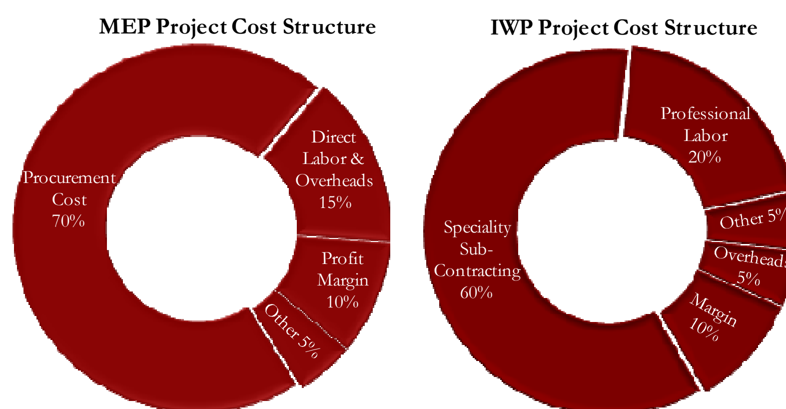
DSI contracts are mostly of the **"lump sum fixed price"** nature and advance /down payments are generally 5% to 10% of total value of the contract. This percentage can change depending on the risk of the geographical area, e.g., projects in Libya or Sudan, which are considered relatively high risk, would call for a higher down payment. However, at present most of DSI's contracts are in the UAE which the company considers as medium risk. These projects in UAE command about 5 to 10% of the contract value as a down payment.

The MEP contract price is generally determined at the beginning of a project. A mark-up is applied to the estimated costs and revenue is then recognized by the percentage of completion method throughout the life of the project (which includes meeting specific milestones).

The cost structure of a MEP contract is heavily dependent on the cost of raw materials, which is considered by industry experts to contribute up to 70% of the total project cost. Direct labor and overheads account for approximately 15 - 25% of project costs in MEP. Large players in the MEP industry tend to hedge against commodity price fluctuations, especially as copper is the most widely used commodity and has seen substantial price volatility. We believe civil contracts would tend to have a similar cost structure to MEP with cement and steel being the most widely used raw materials.

According to DSI guidance, **the IWP projects differ from MEP** with respect to specialty subcontracting involved in case of the former. In IWP, if the assumption is that 85% of the cost is direct, then 70% to 80% of the direct cost is related to specialty subcontract cost and the rest is professional labor.

Overall DSI targets to maintain a minimum net margin of 9-10% on its projects.



Source: Company, Al Mal Capital Research

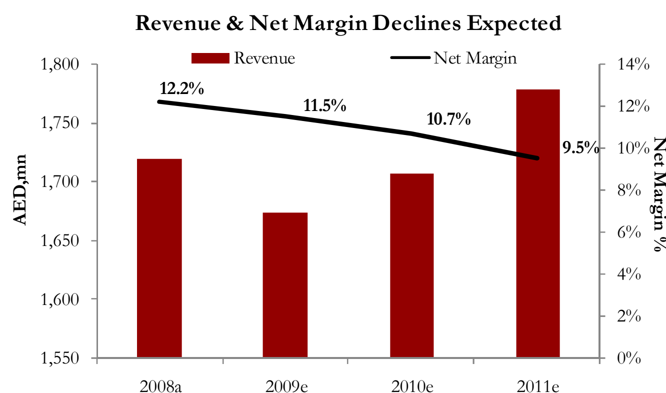
Investment Positives

1Q 09 Results

DSI continued its track record of good performance during the first three months of the year, with revenues increasing by 116% y-o-y while net margins grew by 161% y-o-y. For 1Q 09, DSI registered revenues of AED 488mn and net profit of AED 78mn, while for FY 08, the company reported revenues of AED 1.72bn with net profit of AED 212mn. For the first three months of 2009, DSI's recorded a net margin 15.98% versus our expectation of 11.5%. The first quarter net margin reflects a significant improvement from 12.2% achieved for FY 08.

The net profit for FY 08 and 1Q 09 includes an exceptional item of interest income (AED 42mn and AED 21mn respectively) earned on IPO funds which the company has accrued since 2H 08. Excluding the special item, DSI registered a net margin of 11.8% in 1Q 09 as against 9.9% for FY 08.

We continue to believe that the DSI's approach to selectively bid for orders that have a strategic fit with the company's client mix ensures minimal weakening of margins. In the existing market conditions, we expect 2009 revenues to decline by 2.6% from growth of 110% in 2008. Although margin softening is unavoidable, we are confident that DSI's strategy to diversify and expand geographically will help it survive the economic downturn better than contractors in its peer group and we expect net margin of 11.5% for 2009 & 10.7% for 2010.



Source: Al Mal Capital Research, Company financials

Cash Rich Balance Sheet

Perfect IPO Timing - DSI was the last UAE IPO before the global financial crisis hit the capital markets. At a time when oil prices were as high as $147.27 per barrel and markets were upbeat and awash with liquidity, DSI offered to list 55% of its share capital. The IPO was 101 times oversubscribed, raising AED 124bn in cash versus the required AED 1.19bn. In hindsight, DSI's perfect timing to float the IPO has landed them with a net cash position of AED 1.02bn or AED 0.47 cash per share.

We favor DSI's policy to keep a minimum of AED 300mn as a cash reserve rather than undertaking any risky financial investments. The remainder is expected to fund DSI's aggressive acquisition and expansion strategy. We believe DSI will be

one of the few companies that will be able to weather the current storm and come out stronger with an established footprint across GCC when the markets turnaround.

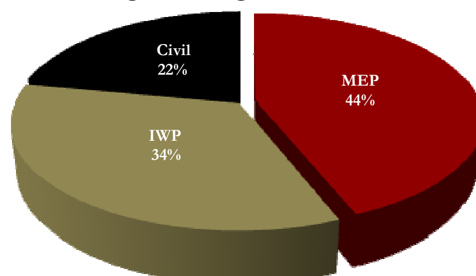
Healthy Backlog Ensured By Deep Client Relationships

DSI has an outstanding backlog of AED 2.9bn, after shedding AED 550mn worth of risky projects. We have further discounted the backlog by another AED141mn for projects that we believe are likely to be suspended or entail collections issues. We are comfortable with a backlog value of AED 2.7bn (44% MEP, 34% IWP and 22% Civil), as it is supported by down-payments from UAE clients ranging between 5-10% of contract value. For overseas contracts, DSI states that the scale of down-payments varies based on the risk associated with a project.

Considering that realty based MEP projects have an average life span of 1-2 years and MEP comes in the latter stage of a real estate project, the backlog assures a solid revenue base for 2009 and 1Q of 2010. We anticipate that in the near future, down-payments could be difficult to guarantee, but the stage of a project's life cycle where MEP comes in, is certainly a crucial factor to ensure project continuity.

We support the company's approach to pursue MEP, IWP, and civil projects for a selected list of clients with whom it shares long standing business relationships. This has indeed ensured that DSI's backlog is less prone to cancellations due to difficult economic conditions.

DSI Backlog -Focusing More On IWP +Civil



Source: Company, Al Mal Capital Research

Organic & Inorganic Growth to Establish Broader Footprint

DSI plans to expand across the MENA region through organic and inorganic growth. Whilst MEP, IWP and Civil are all growing divisions, management see IWP as the area with the most potential.

Expanding Range of Specialized Services - DSI expects the slowdown in UAE construction market to directly impact its MEP division. In the IWP segment, however, there is less competition and the margins are better. IWP division is currently operating in district cooling and sewage treatment, however in the future Drake and Scull plans to move into the more specialized areas of water distribution and power generation.

IPO Money to Fund Acquisitions - Funds from the IPO are expected to fund 2 to 4 acquisitions of MEP and civil contractors in Saudi Arabia, Qatar & Kuwait. We see this as a great opportunity to purchase companies with good cash flow at attractive valuations. DSI has indicated that it has plans for horizontal integration through

acquisitions or joint ventures and has shortlisted 4 companies which are currently undergoing due diligence. DSI Board has not yet finalized any acquisitions and the funds from the IPO are likely to be mobilized only by 3Q 09 at the earliest. In total, the company expects to spend about AED 250–500mn on acquisitions.

Shopping for New Revenues to Beat the Slowdown

Geographic Expansion- In 2007, the dynamics of the UAE construction industry offered plenty of opportunities for contractors, and 100% of DSI revenues came from UAE operations with Dubai contributing 89.5%, with the remainder coming from Abu Dhabi. In 2008, DSI started expanding operations beyond the borders of the UAE and consequently 5.8% of their revenues were from Saudi Arabia. We believe that expanding scope of operations through MEP & IWP projects in the broader MENA region is likely to strengthen the company's growth profile, though it might entail a foreign execution risk.

In March 2009, DSI won its largest IWP project, worth AED596mn, for Durrat Al Bahrain in Bahrain. DSI is pursuing further organic growth by biding for small to medium size projects (AED 100mn - 300mn) in the MENA region particularly in Libya. In 1Q 09, shareholders approved the company's plan to establish offices in Libya and Jordan to increase market presence and to tap potential opportunities in these.

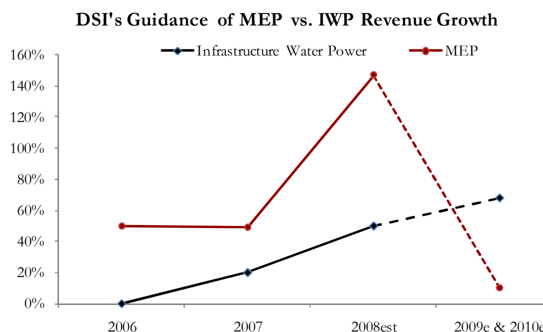
Diversification to IWP Pursued Actively

Energy Demands and Infrastructure Focused Budgets to Pave the Way Ahead - Through our industry analysis we believe that infrastructure, water and power will present sizeable opportunities for contractors in the near future. With a virtual freeze on developments within the private residential property market, GCC countries have indicated their intentions to start expending on infrastructure based budgets to stimulate economic growth. We forecast district cooling to gain increasing popularity, especially where the demand density warrants it, as it uses 50% less power than traditional air conditioning. Though expensive to install, it is operationally cost effective in the longer term.

Diversification Essential – We support the company's long term strategy to diversify as its core MEP business is likely to suffer a setback on the back of a declining construction industry especially in the UAE. According to the guidance issued by the company, the revenue growth in the MEP business, which contributed 57% of the revenues for FY 08 and constitutes 44% of the current backlog, is likely to slow down from approximately 120% in 2008 to 5-10% p.a. during 2009-2010. In the same period, DSI aims for top line growth in IWP to be about 50%. Although we agree that IWP segment has better growth potential than MEP and civil, and diversification is essential to ensure revenue growth, we are unconvinced of the company's ambitious organic top line growth target in the near term.

Potential for Higher Margins & Project Credibility Builds the Case for IWP - We would like to highlight that though IWP projects could offer margins of 15-20% (relatively higher than those on MEP~10% or Civil ~10-15% in current market conditions), the risk of undertaking an IWP project is also higher. Traditionally DSI has been a sub-contractor for the most part on MEP projects, but for the IWP projects DSI is the main contractor which entails higher operational risk for the company. However, as IWP projects are mostly government backed and crucial for the

development of the country, the credit risk is expected to be lower while project continuity factor is higher than that of MEP or civil projects.



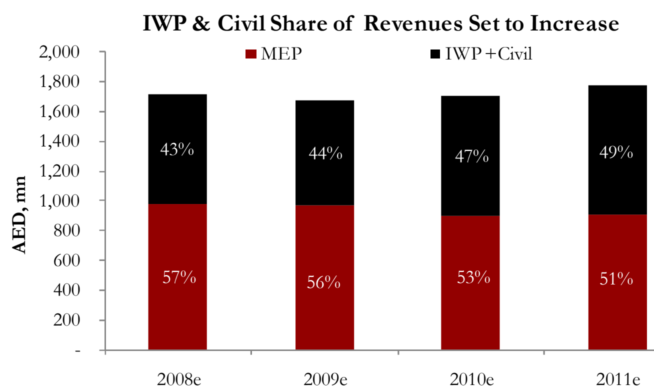
Source: Company Financials & Presentations

Seeking A New Revenue Mix

Revenue Mix to Change in Near Future - Recently, DSI secured an AED 400mn project in Abu Dhabi (AED 300mn Civil and AED 100mn IWP). Post the Durrat Al Bahrain contract worth AED596mn and Mangrove Place contract worth AED 352mn in Abu Dhabi, IWP projects account for 34% and civil projects 22% of the current backlog. We believe that in FY 08 top line growth for the IWP segment could have been over 100%.

IWP projects by nature are more agile and less labor intensive than MEP projects. For our projections, we expect the share of MEP contribution to the top line will shrink post 2009 from 57% in 2008 to 51% in 2011. We forecast an increasingly larger contribution to come from the IWP and civil segments in the next 3 years. Together, these could fetch approximately 49% of the 2011e revenues.

Higher Risk May Result In Relatively Higher Reward - The risk for the IWP and civil projects tends to be higher as DSI is the main contractor on these projects. Also, civil projects tend to have higher renegotiation and cancellation possibilities. However, IWP projects tend to be secure in terms of credibility and offer margins of 15-20% (higher than of MEP and civil). Also, GTCC's (DSI's civil subsidiary) forte is to operate on projects in the range of AED100-500mn which we believe is likely to offer more opportunities in the near term, with 10-15% margins.



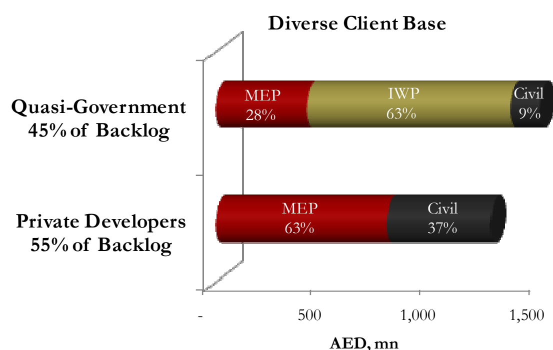
Source: Company, Al Mal Capital Research

Balanced Client Mix

Building The Order Book- Unlike some of the larger local contractors who chose to focus on big government backed projects, DSI chose to diversify its customer base by bidding for sophisticated projects in a niche market. Favorable construction industry dynamics in the last few years, coupled with an established domestic presence, helped DSI build a robust order book. Until 2008, DSI held an 8% share of the UAE MEP market, which it acquired on the back of experience and technical expertise.

Relatively Balanced MEP Client Exposure - We favor the company's approach to maintain a balanced exposure within its client base, to diversify potential risks of project cancellations and to hedge against possible payment defaults. While 55% of its backlog comes from private developers, 45% of its backlog stems from government / quasi-government developers. In the GCC construction market, we consider DSI's client mix to be relatively stable in comparison to that of the contractors in its peer group.

Since infrastructure developments are more likely to be state funded, it is natural for IWP client base to be heavily government / quasi-government oriented. MEP and civil projects, however, have been more skewed towards private developers for two reasons: 1) DSI's MEP services were heavily reliant on the growing UAE hospitality sector until recently and 2) Civil contracts targeted medium size projects for sub-developers, overlooked by the big contractors.



Source: Company, Al Mal Capital Research

Prioritizing Collections

Prudent Strategy - DSI's management has prioritized collections as its primary responsibility in order to avoid potential stress to its balance sheet. In order to ensure minimal damage to its cash conversion cycle, management has partnered with its clients to draft a payment plan compatible to circumstances of both parties. In the recent past, UAE contractors have been going through challenging working capital environment, an outcome of deteriorating economic conditions. We feel that slow payments from GRE's (government related entities) are likely to continue for this year leading to rising receivables and a potential cash strain in the near term. We are hopeful that the management's approach of prioritizing collections may encourage timely and adequate cash flow which we believe is essential in the current market conditions.

Investment Risks

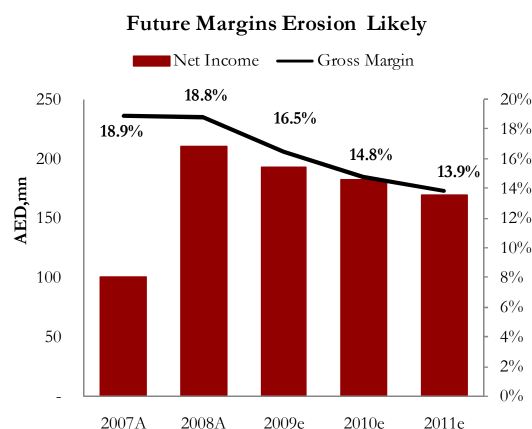
Share Buy-Back May Not Be Sustainable in Future

Returning Value to Shareholders- While we appreciate the company's decision to buy-back 10% of its shares outstanding and return value to its shareholders, we doubt the company can keep buying back shares at the same rate in future. DSI will need the cash to fund its operations and aggressive business strategy. Therefore, the share buy-back decision (pending approval from regulatory authorities) provides for stock momentum in the near term but should be viewed as a one-time event. For the long term, DSI's dividend policy remains undefined.

Robust Margins May Face Erosion

New & Retendered Projects May Entail Lower Margins - Robust revenue growth coupled with favorable UAE industry dynamics until mid 2008, resulted in better than expected top line and bottom line growth for DSI over the past 2 years. Despite the high commodity prices until June 08, gross margins have improved from a low of 11.3% in 2005 to 18.8% in 2008. Considering the nature of DSI's project lifecycle, we believe that the company has already secured most of its contract revenues for 2009 in line with our estimates. If the company continues to lock in more projects during the year, it could lead to further upside, in our view.

Recently developers have resorted to design modifications to avail of cost savings and there is a strong possibility that DSI's gross margins could be pressured in the near term. DSI anticipates provisions or impairment losses of below 1.5% for the year 2009. We believe that the falling commodity prices could offer some support as direct costs account for over 70% of a project's cost structure. For MEP & civil projects secured in 2009 (executed in 2010-2011), we forecast a relatively sizeable drop in gross and net margins due to the tough competition and challenging business conditions in the region.



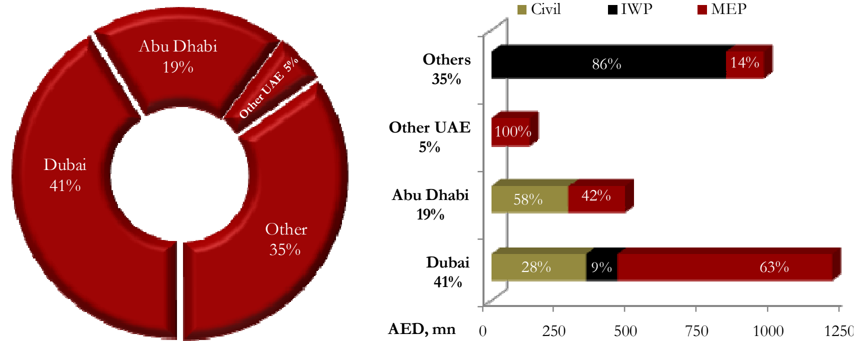
Source: Company, Al Mal Capital Research

Backlog Dubai Focused

Future MEP Order Book is likely to Shrink - The current AED 2.7bn backlog is focused heavily on the UAE, with Abu Dhabi & Dubai together constituting 60% of the total backlog. Furthermore, 53% of the UAE backlog stems from MEP

while 33% comes from civil projects. As market conditions continue to worsen, the demand for specialized MEP works is likely to weaken and we feel that DSI's future MEP order book is likely to shrink. Although we have discounted the backlog for projects we believe could be delayed, suspended or entail payments issues, our analysis is not immune to unanticipated possibilities of cancellations. We will adjust the backlog and forecast revenues accordingly, for any unforeseen events. We have taken into consideration the possible shrinkage in revenues and margin erosion for 2009.

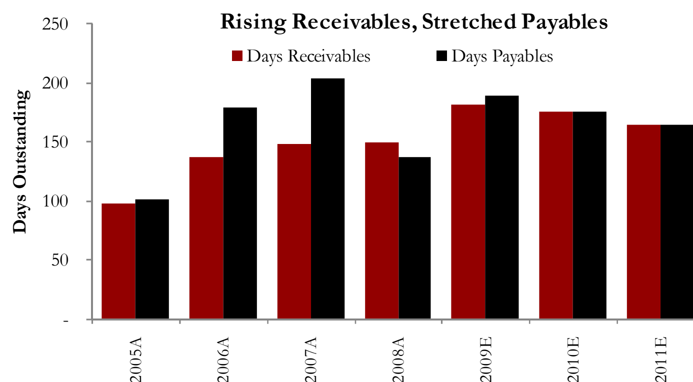
Current Backlog Heavily UAE Focused



Source: Company, Al Mal Capital Research

Rising Receivables & Stretched Payables – A Balancing Act

Working Capital Challenges Are In The Pipeline- Contractors across the board are dealing with delayed or slowing receivables and most resort to stretching out payables to deal with the cash strain. DSI acknowledges that its receivable days have crossed the 120 days mark and our estimate indicates days sales outstanding at the end of 1Q 09 are approximately, 132 while days payables for the same period are 120. We believe that the trend of rising receivables is likely to continue for the next 2 years and DSI is likely to stretch its payables to handle its working capital concerns before it resorts to digging into its cash pool for operating needs. However, the policy of stretching payables may not be sustainable for long considering the company's aggressive expansions plans. Overall, we believe that DSI's cash strength could prove to be instrumental to - 1) push ahead with the aggressive expansion strategy and 2) deal with potential working capital issues.



Source: Company, Al Mal Capital Research

International Expansion Could be Tougher than Expected

Foreign Execution Risks Exist - Expansion outside of the UAE enables Drake and Scull to harness the growth in other countries in the region. Although Saudi and Qatar still have good potential for growth, the logistics of expanding overseas could prove more difficult than expected. Although inorganic expansion through joint ventures is the fastest way to gain an international presence, we remain cautious of DSI's preference of the acquisition route in the GCC. Identifying acquisition opportunities, developing synergies and managing the company or the relationship post acquisition may encounter teething problems and delays.

Financial Projections

- **Revenue**: We expect the top line to contract by 2.6% in 2009 as a result of difficult market conditions which could limit possibilities to secure credible MEP and civil projects during 2009. A recovery of 1.9% in 2010 is possible once the company secures more IWP projects in 2009/10 and completes the acquisitions as planned, during this year.

- **Gross Margin**: For 2009, we forecast gross margins to face some pressure due to project retendering, which could offset the relatively lower cost of materials benefit. We project 2009 margins to come in at 16.5%. As difficult market conditions continue to persist across GCC, gross margins are likely to be stressed, possibly declining to 14.8% and 13.9% in 2010 and 2011 respectively.

- **Net Margin**: DSI ended the year 2008 with 12.2% net margin. It is likely that DSI will continues to benefit from high net interest income in the near future, as it has plans to invest a portion of the cash into non-risky high interest bearing financial instruments. We expect net margins to be around 11.5% for FY 09 and decline thereafter.

- **PP&E**: We expect DSI to spend AED 250-500mn on acquisitions in the next 12-18 months.

- **Cash & Equivalents**: We believe that DSI will undertake acquisitions in a phased manner to ensure smooth transitions. Consequently the payments towards those are likely to be phased as well from 3Q 09 onwards. Post the planned acquisitions, we forecast the company to comfortably settle with cash reserves of approximately AED 900mn in 2009.

- **Receivable & Payable Days**: DSI's outstanding receivables days have risen to over 132 days for 1Q 09, while outstanding days payables for the same period are 120. We believe DSI is likely to continue stretching its payables in order to manage its near term cash conversion cycle. However, in the long term this policy may not be sustainable especially as DSI presses ahead with its aggressive expansion plans. Therefore, we expect the company could dip into its cash reserves post 2009 for operational needs and as a result the outstanding receivable days and payable days may level off.

Valuation

We have used the discounted cash flow to equity holders method to obtain our target price. Although, we have also looked at comparable PE ratios, we believe that in current market conditions, multiples are not sufficient indicators of good cash flow or net cash strength of a company. In current market conditions, debt markets are difficult to tap and equity markets suffer from tight liquidity. With respect to DSI's AED 1bn cash strength, the company is very different from its peer group. Therefore, we rely on our DCF to reach our target price.

DCF Analysis

In our DCF analysis we have utilized a cost of equity of 14.2% based on the Qatar sovereign 30-year rate of 6.59% as our risk-free rate and an equity risk premium of 6.00%, adjusted for beta of 1.27. We use a terminal growth rate of 3.00%.

We initiate coverage on DSI with an *Outperform* rating and a target price of AED 0.96 implying a 23% upside on the current price.

Sensitivity Analysis

We show the sensitivities of our target price and upside potential to cost of equity and terminal growth rate.

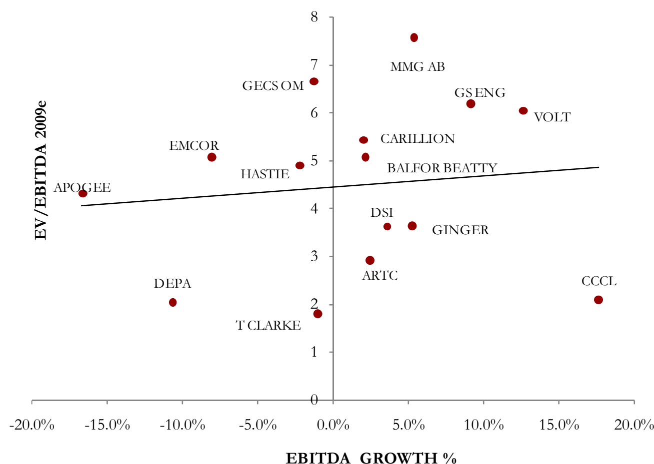
Perpetual Growth \ Cost of Equity	13.50%	13.75%	14.00%	14.25%	14.50%	14.75%	15.00%
2.0%	0.96	0.94	0.91	0.89	0.88	0.86	0.84
2.5%	0.99	0.97	0.95	0.92	0.90	0.88	0.87
3.0%	1.03	1.00	0.98	0.96	0.93	0.91	0.89
3.5%	1.07	1.04	1.02	0.99	0.97	0.94	0.92
4.0%	1.11	1.08	1.06	1.03	1.00	0.98	0.96

Perpetual Growth \ Cost of Equity	13.50%	13.75%	14.00%	14.25%	14.50%	14.75%	15.00%
2.0%	23%	20%	17%	15%	12%	10%	8%
2.5%	27%	24%	21%	18%	16%	13%	11%
3.0%	32%	29%	25%	23%	20%	17%	14%
3.5%	37%	34%	30%	27%	24%	21%	18%
4.0%	43%	39%	35%	32%	29%	25%	22%

Industry Multiples

DSI appears to be expensive with respect to multiples. In our selected peer group (companies depicted in the charts below), DSI's 2009e EV/EBITDA multiple (5.01) is higher than that of the industry average of 4.48 as well as that of ARTC (4.13) and DEPA (1.88). **However, we believe that the company with its aggressive expansion and diversification strategy is likely to experience a better top line and bottom line growth.**

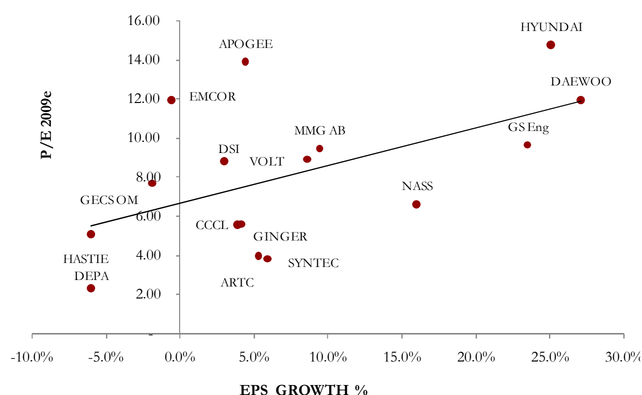
DSI Multiples May Not Reflect the Complete Story



Source: Reuters, Bloomberg, Al Mal Capital Research, Company Financials

With respect to P/E ratios, we feel that the comparables fail to reflect the cash position of the company. In terms of 2009e P/E, DSI appears to be relatively expensive in comparison to ARTC and DEPA but lower than industry average of 7.97. We believe that P/E net of net cash is a better comparable as it is adjusted for the cash per share. DSI's 2009e P/E net of net cash (3.61) is more attractive than that of ARTC in line with our expectations.

2009e P/E Multiples Are Not Indicative of the Cash Position



Companies	Close Price	Market Cap USD, mn	Current P/E	2009e P/E	2008 P/E net of cash	2009e P/E net of cash	Current P/E net of net cash	2009e P/E net of net cash
ARTC	2.45	797.33	3.06	3.99	2.09	2.72	3.66	4.77
DEPA	0.47	294.57	4.82	2.33	5.62	2.72	3.29	1.59
DSI	0.78	462.22	8.09	8.82	2.39	2.61	3.31	3.61

Close Prices are in listing currency

Source: Reuters, Bloomberg, Al Mal Capital Research, Company Financials

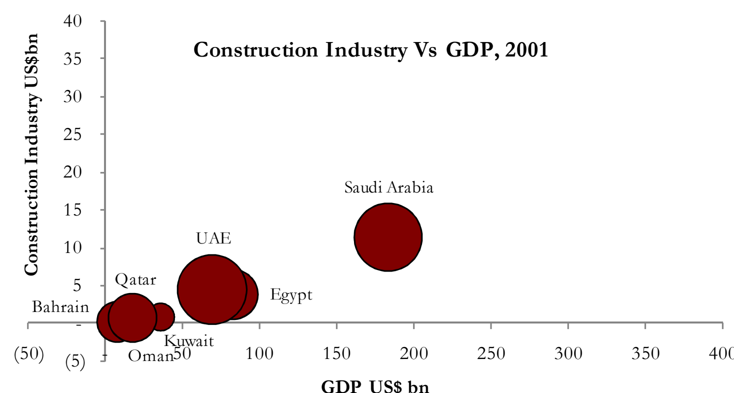
Overview of the Construction Sector

The global financial crisis put an abrupt break to six and half years of growth in the GCC. Bleak fundamental drivers leave many questioning the Middle East's ability to reposition itself in the low growth environment, weakening any possibilities of a dramatic turnaround. The IMF projects that the growth in the MENA region is expected to slow to 2.6% in 2009 from 5.7% in 2008 and possibly recover to 3.6% in 2010. According to the IMF, three economies (Saudi, UAE & Kuwait) in GCC are likely to contract in 2009 on the back of declining oil prices.

As questions linger over the sustainability of real estate demand and the impact of the credit crunch deepens, we expect a slowdown in population growth in the Middle East as well as a reversal of demand for premium hospitality and tourism. Though we expect a near term freeze on the rush to launch / develop iconic structures, we are positive about the growth potential of the MENA infrastructure and utilities sector. Government spending on infrastructure, power and water projects in the next 3-4 years is likely to steer the MENA region towards an upward trend and return a favorable business climate from 2010.

In order to understand the growth story of the MEP sector, it is imperative to analyze the underlying construction industry relative to the GDP in the GCC & selected MENA countries.

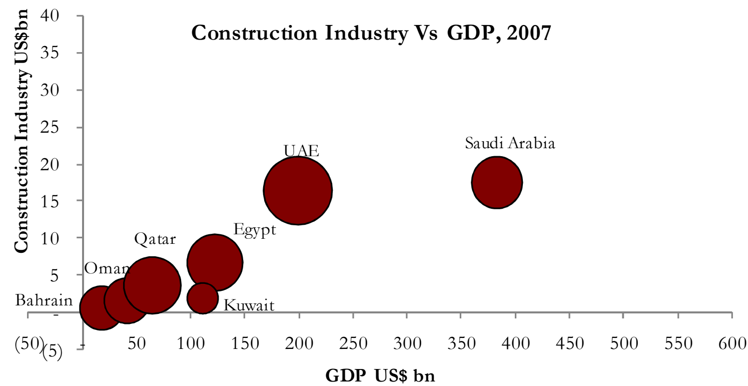
From 2001 to 2007- During 2001-2007, the construction industry in the GCC grew at an annual rate of 18.6%, in tandem with the GDP CAGR of 19.43% in the GCC. In the graphs below, the size of the bubbles represents the country's construction industry relative to the country's GDP. It is evident that in the past 6 years KSA, UAE, Qatar, and Egypt have led the growth story. The size and concentration of the bubbles in the first graph clearly indicates that in 2001, the construction industry of the GCC countries was small relative to its GDP.



Source: BMI, Al Mal Capital Research

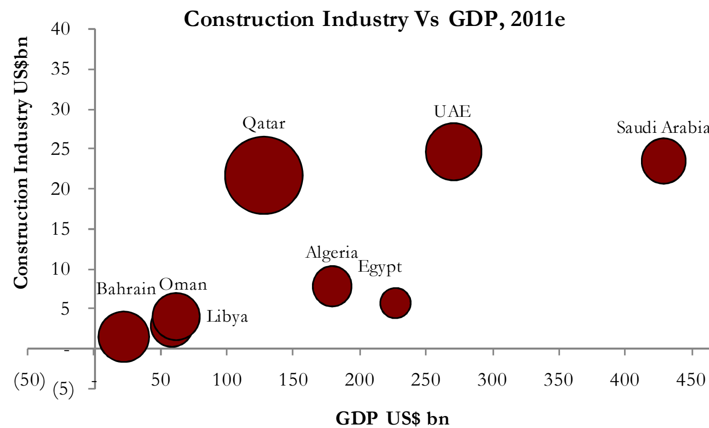
Feeding off the oil price increases from 2001 to 2007, the budgets of regional governments enjoyed robust surpluses which were then invested in infrastructure, tourism and real estate. Public and private investment had been injected into the GCC construction industry with a view to build communities to house a growing population, develop business centers to attract global corporations and construct hotels and airports to facilitate tourist traffic with a target of 10mn tourists per annum by 2012.

By 2007, the bubbles show a growth trend moving upwards in size and scale. The GCC GDP had grown rapidly and the construction industry had grown to be a significant contributor to the countries GDP. UAE and KSA stood out in particular as their construction and real estate industry spearheaded the countries dazzling development record.



Source: BMI, Al Mal Capital Research

We anticipate the construction industry in our selected market (GCC + selected MENA countries) to continue this upward trend stemming from rise in government spending to develop infrastructure and utilities. Qatar, UAE, & Saudi Arabia will still be the key performers while Libya, Algeria, and Bahrain start presenting attractive opportunities for stable cash rich construction companies. Upto 2011, the GDP of our target market is expected to continue to grow at 4.9% per annum while the construction industry will still grow at 9.2% per annum on the back of increased government spending on developing infrastructure.

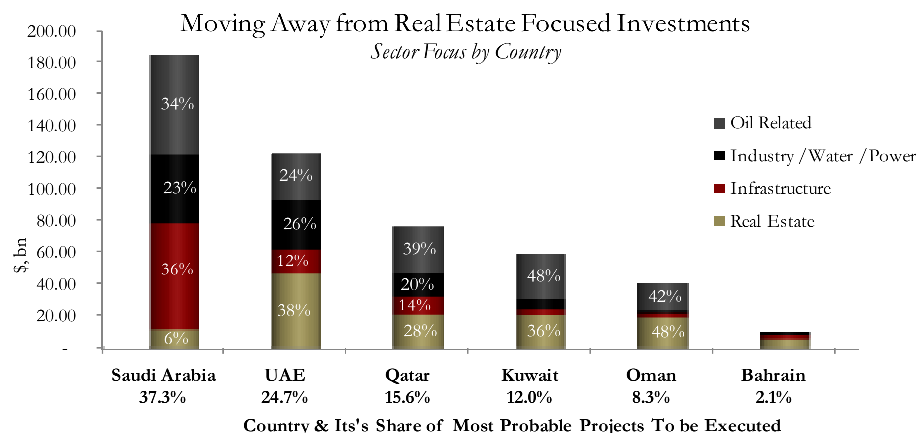


Source: EIU, BMI, IMF, Al Mal Capital Research

GCC Projects Shift Focus from Real Estate To Infrastructure

Considering the fact that the slowdown in economic growth could directly impact the planning and development of projects in the near future, we have also looked at a profile of the top projects most likely to be executed in various phases until 2025. As per a recent study, over AED 2.4trn (US$ 641.76bn) worth of projects are ongoing in the GCC and are scheduled for completion in phases from 2009 to 2025. We conservatively estimate the value of projects most likely to be executed in the same time frame would be approximately AED 1.8trn (US$ 496.9bn). Saudi

Arabia accounts for the biggest chunk of planned projects on track (37.3% or US$ 185.3bn worth), followed by UAE (24.7% or US$ 122.5bn worth). Third in line is Qatar, (15.6% or US$ 77.5bn worth), followed by Kuwait, Oman and Bahrain accounting for the balance 22.5% or US$ 1115.6bn of projects most likely to be executed.



Source: IMF, Zawya, The Wealth Matrix, Al Mal Capital Research

We believe that US$ 200bn worth of projects are likely to be executed during 2009-2012 and Saudi, UAE and Qatar will continue to provide the majority of opportunities for contractors. Although UAE & Qatar present sizeable opportunities in the real estate, there is a visible trend across the GCC to move away from the traditional real estate based investments for the longer term. However, in the near term we do not expect this picture to change much.

The profile of the investments undertaken by governments since 2H 08 attempts to transform the long held view that the construction industry in GCC thrives on real estate. Recent project awards indicate that Saudi followed by the UAE, has planned substantial investments in infrastructure, industrial, water & power. Qatar has plenty of projects planned to harness its abundant natural gas resources.

Regional Sector Focus, US$ bn

Country	Real Estate	Infrastructure	Industry / Water / Power	Oil Related
Saudi Arabia	9%	66%	43%	37%
UAE	37%	15%	32%	18%
Kuwait	17%	11%	15%	18%
Qatar	17%	3%	6%	17%
Oman	16%	2%	1%	10%
Bahrain	5%	3%	2%	0%
Total by Sector, US$ bn	128.0	101.9	100.1	168.3
Total % by Sector	25.7%	20.4%	20.1%	33.8%

Source: IMF, Zawya, The Wealth Matrix, Al Mal Capital Research

DSI is one of the few contractors in the region with net cash strength of over AED 1bn. We believe the market has substantial opportunities to offer in the IWP segment and DSI with its experience, expertise, and aggressive expansion and diversification strategy is well positioned to exploit these opportunities.

DSI Business Segments

MEP

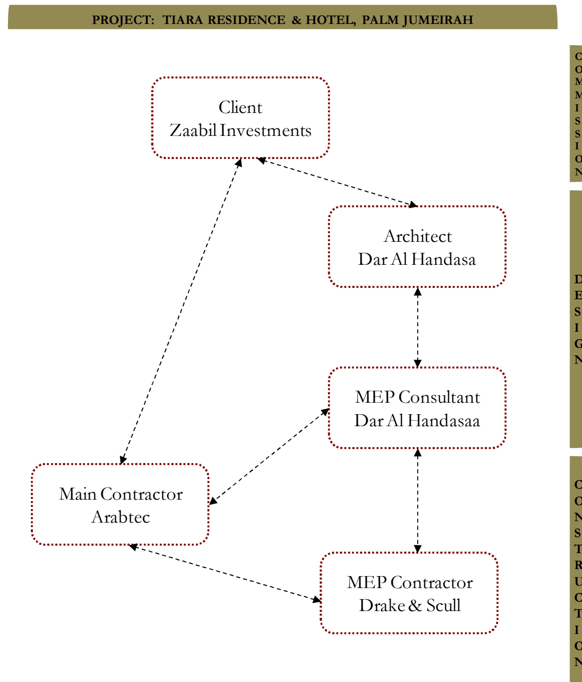
MEP is a highly specialized area of construction and as per industry experts, is the service area most in-demand in the region. There are many different facets of MEP, including heating, ventilation air conditioning ("HVAC"), sanitation, plumbing, fire safety, lighting, power supply, piping and treated water supply systems. MEP consultants are primarily involved with the design scheme whilst a MEP contractor, such as Drake and Scull, is involved with the installation and testing.

The construction industry exerts significant influence on the MEP and civil contracting segment and we anticipate the MEP sector to grow in line with construction.

MEP & Its Fit in the Project Life Cycle

A MEP contractor is typically invited to tender for a project and can be appointed by either the developer or the main contractor depending on the contract. The MEP contractor will estimate the cost based on the design, cost of purchase and installation of the materials and then apply a mark-up before presenting to the client. Traditionally, MEP companies have worked as subcontractors although this process has changed as buildings have become more technically advanced. In situations where the MEP contract costs are higher than civil, the MEP contractor may in fact take the lead role. The MEP contractor receives design schematics from the MEP consultant and works alongside the main contractor to install and test the MEP systems.

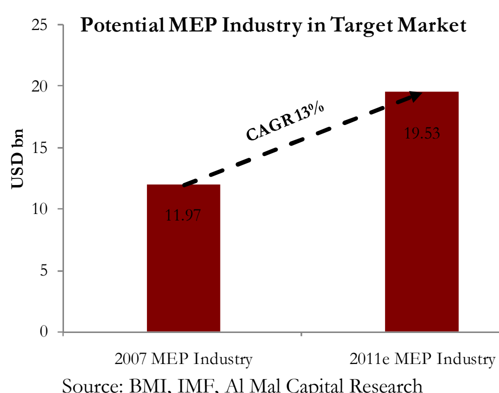
The Role Of The MEP Contractor In A Typical Project.



This diagram is for illustrative purposes only

Source: Industry Sources, MEP magazine, Al Mal Capital Research

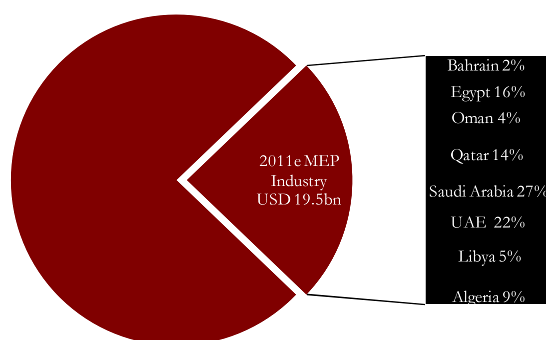
Industry experts reveal that MEP services contribute anywhere between 15% and 60% of total construction costs, depending on the project. For example, construction of a water park would require a higher percentage of MEP services compared to that of a residential complex. Consensus in the UAE market estimates MEP services to average one third of constructions costs. However, a change in the type of projects that are likely to take precedence in the next few years and we believe MEP share of a project's cost is likely to decline. We believe that the MEP industry in DSI's new target market (GCC and select MENA countries) could be anywhere in the range of US$ 13-30bn.



Source: BMI, IMF, Al Mal Capital Research

Based on this assumption we have taken a prudent approach and forecast the potential 2011 MEP market to be at US$ 19.5bn (roughly 22.5% of the GCC and select MENA construction sector). This would imply a CAGR of 13% for the MEP industry and the most notable opportunities are likely to be found in KSA, UAE & Qatar.

MEP Industry MENA- Slow but Steady Growth till 2011



Source: BMI, IMF, Al Mal Capital Research

IWP (Infrastructure, Water & Power)

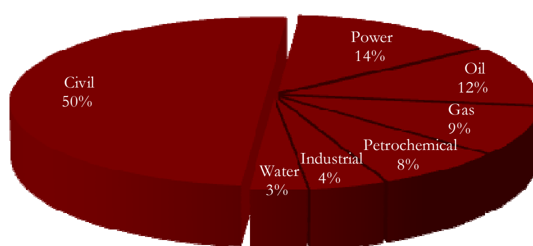
IWP is the future for the stumbling GCC economies. Contractors are increasingly shifting their focus to IWP to tap potential opportunities for stable and recurring revenue streams. IWP by the very nature of the projects (due to the technicalities involved and scale of investment) tend to be of a long tenure. Although, the economic downturn has stalled a lot of the planned real estate developments, a demand for better infrastructure spurred by underdeveloped roads network,

scarcity of public transport, and shortage of water & power is forcing the GCC governments to think about long term development and sustainability.

According to Proleads, US$ 1trn is likely to be spent on MENA industrial, power & water projects in the next 10 years. Our analysis indicates that investments in sectors other than civil are likely to constitute 50% of the GCC projects pie. DSI targets to tap this space as these projects tend to be higher margin bearing and provide stable recurring revenue streams.

It is important to note that although several real estate projects are on hold, delayed or cancelled, and future real estate based investments are likely to slow down, we believe civil projects (backed by infrastructure) are still likely to take the major share of the GCC projects. DSI has indicated plans to tap the civil and infrastructure space in near future for projects that fit within the company's scope of activities.

Sector Investment in MENA, USD bn



Source: Proleads, Al Mal Capital Research

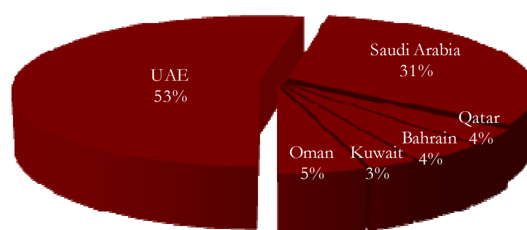
Recently reports support our thesis of growth in the IWP & Civil sector. To put this in perspective, US$ 38bn worth of power projects & US$ 44bn worth of other infrastructure are already in the execution phase in the MENA region.

District Cooling

The air conditioning market in the Middle East grew by 15% in 2008 compared to roughly 5% growth in the rest of the world. With temperatures in the region reaching 50˚C and high humidity levels during the summer months, air conditioning is an absolute must. The construction boom and a move towards sustainable standards are among the factors driving the growth of this sector. Traditional air conditioning accounts for as much as 70% of a building's energy consumption and consequently there has been increased focus on the efficiency and environmental consequences of air conditioning.

District cooling is an alternative method of temperature control and, if designed and installed properly, could lead to 40% energy savings as well as operate more efficiently and effectively. District cooling distributes chilled water from a central plant to individual buildings through a network of underground pipes. The water, which has been chilled to 5˚-8˚C, is circulated through fan coil units. The fans blow air across coils carrying the chilled water and the air is subsequently cooled. Additional environmental benefits include reduced green house emissions and better noise control. They are also easier to maintain and are less prone to breaking down. However, it should be noted that district cooling systems consume vast quantities of water, which of course is in high demand in the Middle East. District cooling tends to be used on large-scale projects such as residential communities or shopping centers'. According to MEP Middle East, more than 60% of new developments will have district cooling installed.

Potential District Cooling Capacity by 2017 in GCC



Source: IDEA Conference 2006 & 2007, Al Mal Capital Research

District cooling reflects the GCC governments' sustainable development policies and though projects are likely to be delayed/cancelled/ renegotiated in the near term, we feel that in the long term the GCC is more likely to continue with its development stride in its non oil sectors. The hot climate along with growing concerns to be energy efficient, increased government spending on power projects to resolve power shortage issues and the proposed green legislative framework should drive the use of this technology. MEED reports that currently 1.8mn TR (tons of refrigeration) of district cooling capacity is in operation in the GCC, most of which has been built in the UAE over the past 10 years. An additional 6.5mn TR will be in operation in the GCC by 2015, with a further 8.4mn TR under construction, in design, or at the planning stage. The cost of the new capacity is likely to be in the region of US$ 20bn. However, tight credit markets and a nascent district cooling project finance market in GCC are likely to pose growth challenges for the sector.

Market MEP & IWP players

Many of the MEP/IWP players are affiliated with, or are owned by construction contractors or developers that have chosen to bring the MEP/district cooling in-house. The MEP contractors do operate for third parties. DSI, for example is currently working on a few MEP projects with Arabtec, despite Arabtec having MEP in-house. This is because the contractors will have different offerings; in this case Drake and Scull is a high-end provider.

Market Players & Their projects

Base	Name	Parent Company / JV	Description	Employees	Regions	Prestigious Projects
Dubai	ETA -M & E	ETA-Ascon	MEP & District Cooling services. In 2006, the company was awarded MEP Contractor of the Year.	20,000	Dubai, Egypt, Qatar, Kuwait, Oman, India	• Burj Dubai; • Dubai Light Rail Project; • Ethihad Airport Terminal, Abu Dhabi • 100,000TR district cooling for DWC
Dubai	Trans Gulf Electro-Mechanical	Al Naboodah Holdings	Supply, installation, testing & commissioning of Electro-Mechanical solutions and District Cooling.	2,650	Dubai, Sharjah	• Burj Dubai development • 305 villas for Al Barari • The Canal Point Hospital • Meydan Racecourse Hotel and Racing Club
Dubai	Hastie Intl.	Al Futtaim Group & Hastie Intl.	MEP servies & air-conditiong systems installation for hotels, residential / commercial & retail.	7,000	Dubai, Abu Dhabi, Qatar, AUS & NZ, UK, and Singapore	• Dalma Mall, Abu Dhabi • Four Seasons Hotel, Dubai Festival City • JAL Hotel and mixed-use tower, Dubai
Dubai	Voltas Limited	TATA Group - India	HVAC, MEP & water treament for selected projects	8,000	India, GCC - Dubai, Abu Dhabi, Bahrain, Qatar, KSA	• Burj Dubai, Dubai • 7 energy transfer stations, DIFC • Ferrari Experience theme park, Abu Dhabi • Oceana Movenpick Hotel, Palm Jumeirah
Abu Dhabi	BK Gulf	Dutco Balfor Beatty	Contracting services- design and procurement, MEP and HVAC installation and facilities management	7,000	Middle East	• Index Tower • Burj Al Arab, Dubai • Infrastructure - IBN Battuta Mall • Marza Plaza, Dubai Festival City • Abu Dhabi Power Transmission
Abu Dhabi	Bilt ME	Al Basti & Muktha Group	Electrical, HVAC, Plumbing and Drainage works for residential and hotel projects	3,500	Dubai	• 1051 villas - Arabian Ranches • Dubai Health Care City Hotel & Apts • Burj Dubai Development -The Old Town

Source: Industry Sources, Al Mal Capital Research

Financials

Income Statement	**2007A**	**2008A**	**2009E**	**2010E**	**2011E**
Revenue	820.46	1,720.48	1,674.22	1,706.64	1,777.35
COGS	(665.33)	(1,396.25)	(1,398.08)	(1,454.03)	(1,530.83)
Gross Profit	155.13	324.24	276.14	252.62	246.52
Gross Margin	*18.9%*	*18.8%*	*16.5%*	*14.8%*	*13.9%*
SG&A	(34.43)	(141.22)	(137.42)	(119.46)	(97.75)
EBITDA	120.70	183.01	138.71	133.15	148.76
EBITDA Margin	*14.7%*	*10.6%*	*8.3%*	*7.8%*	*8.4%*
Deprec. & Ammort.	(15.28)	(27.04)	(27.04)	(27.26)	(30.61)
EBIT	105.42	155.98	111.68	105.89	118.16
EBIT Margin	*12.8%*	*9.1%*	*6.7%*	*6.2%*	*6.6%*
Management Fee	(5.47)	(14.80)	(15.24)	(15.53)	(16.17)
Net Interest Income	(0.83)	2.78	42.62	32.02	18.79
Other Income	6.51	26.01	8.37	34.13	44.43
Income Tax	-	-	-	-	-
Profit for the Year	**105.63**	**211.93**	**199.47**	**188.53**	**183.99**
Net Margin	*12.2%*	*12.2%*	*11.5%*	*10.7%*	*10.0%*
Minority Interests	5.66	2.03	6.98	6.60	6.44
Net Profit After Min Int	99.98	209.90	192.49	181.94	177.55
Shares Outstanding	15.00	2,177.78	2,177.78	2,177.78	2,177.78
EPS	6.67	0.10	0.09	0.08	0.08
Balance Sheet	**2007A**	**1Q 09A**	**2009E**	**2010E**	**2011E**
PP&E	95.66	166.46	389.43	612.17	671.56
Non-current Assets	**252.90**	**1,050.20**	**1,252.21**	**1,475.58**	**1,550.56**
Development Properties	38.20	27.87	33.48	34.13	35.55
Inventories	3.16	2.50	2.43	2.48	8.89
Work in progress	151.47	295.73	251.13	256.00	266.60
Prepayments & Other receivables	40.69	96.68	135.24	137.86	143.57
Accounts & Retentions Receivables	333.59	706.74	837.11	819.19	799.81
Due from related parties	0.35	29.21	28.42	28.97	44.43
Other Current Assets	10.78	6.59	6.41	6.53	6.81
Cash & Equivalents	127.52	1,196.09	946.09	696.09	606.09
Current Assets	**705.76**	**2,361.40**	**2,240.32**	**1,981.25**	**1,911.74**
Total Assets	**958.65**	**3,411.59**	**3,492.53**	**3,456.83**	**3,462.29**
Long term debt	6.38	8.17	-	-	-
Non-current Liabilities	**193.88**	**31.71**	**33.48**	**34.13**	**35.55**
Accounts Payable & Accruals	373.31	526.65	727.00	697.93	688.87
Advances from customers	154.89	288.67	329.92	256.00	266.60
Due to related parties	1.82	12.68	19.91	20.30	21.14
Current portion of LT Debt	4.85	4.59	-	-	-
Due to Banks	54.52	179.33	-	-	-
Other Current Liabilities	22.48	39.95	38.88	39.63	41.27
Current Liabilities	**611.87**	**1,051.86**	**1,115.71**	**1,013.86**	**1,017.89**
Total Liabilities	**805.75**	**1,083.57**	**1,149.19**	**1,047.99**	**1,053.43**
Shareholder Equity	**152.39**	**2,328.03**	**2,343.34**	**2,408.84**	**2,408.86**
Cash Flow	**2007A**	**1Q 09A**	**2009E**	**2010E**	**2011E**
EBIT	105.42	155.98	111.68	105.89	118.16
Depreciation	15.28	27.04	27.04	27.26	30.61
EBITDA	120.70	183.01	138.71	133.15	148.76
Change in Working Capital	(24.59)	(229.63)	(97.78)	65.91	(86.07)
Other Income (Expense)	4.98	23.41	45.17	50.62	47.05
Capex	(55.04)	(96.69)	(250.00)	(250.00)	(90.00)
Net Financial Expense	(0.83)	2.78	42.62	32.02	18.79
Increase (Decrease) in Financing	49.48	193.02	(352.03)	(218.29)	(51.46)
Free Cash Flow	94.70	1,033.76	(230.75)	(250.00)	(90.00)
Change in Cash Position	64.70	1,033.76	(250.00)	(250.00)	(90.00)

Source: Company Statements & Al Mal Capital Research

Al Mal Securities Group

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