Dar Al Arkan:
A safe house

جدوى للإستثمار
Jadwa Investment

16 November 2008

Equity Research

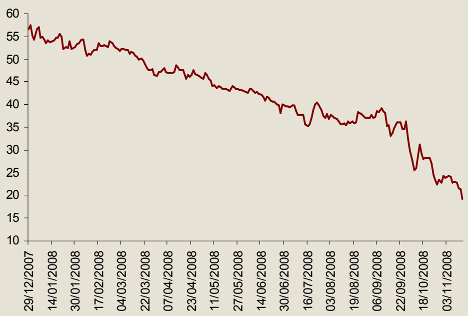
BUY
Target price*: SR40
Current price: SR19.3
Fair value: SR38

*12-month target

Share details

Market cap (SR million)	15,408
Shares outstanding (million)	720
Free float (million)	205
Earnings per share (SR)	3.17
Dividends per share (SR)	3.00
Book value per share (SR)	15.6
52-week high (SR)	60.75
52-week low (SR)	19.3

Share price



Key ratios

Price-earnings ratio (P/E)	6.08
Price-book ratio (P/B)	1.24
Return on equity (%)	18.3
Return on total assets (%)	13.4
Gross margin (%)	49.0
Operating margin (%)	46.0
Quick ratio	5.28
Market risk (beta)	0.9
Company risk (standard deviation)	19
Earnings yield (%)	14.8
Dividend yield (%)	15.5

12-month target price SR40

Current price SR19.3

>SR47	SR47-43	SR43-36	SR36-32	<SR32
Sell	Consider selling	Hold	Consider buying	**Buy**

Investment summary

Dar Al-Arkan Real Estate Development Company is the largest real estate developer by market value in Saudi Arabia. It focuses on providing housing for middle income families through the development of master-planned communities. It has a large land bank and land sales are currently the major source of revenue. We believe that at its current share price Dar Al-Arkan is undervalued.

Investment positives:

- Strong demand for its products stemming from a shortage of affordable housing.
- The imminent implementation of a new mortgage law should increase the pool of potential customers.
- Collaboration with global players has helped to establish a strong brand name.
- Recently launched large-scale projects that are expected to boost the company's revenue over the next five years.
- A revitalized management team with considerable expertise and knowledge of the local and global real estate markets.
- Strong track record of sales and net income growth.
- Attractively valued compared to other companies in the real estate sector.

Investment negatives:

- Dependence on a limited number of large-scale projects.
- Heavily exposed to real estate prices.
- Vulnerable to fluctuations in prices of construction materials.
- The less favorable financing outlook (both domestic and external) is likely to increase the cost and reduce the availability of project financing.

Industry analysis

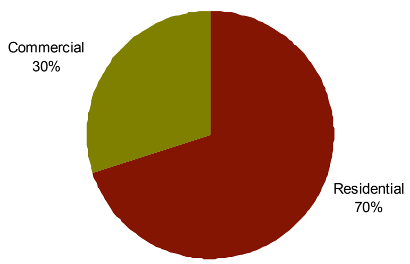
The real estate and construction sector is one of the largest non-oil sectors in Saudi Arabia. We estimate that it contributed more than 10 percent per annum to the GDP over the last decade. There is no official information as to the size of the real estate sector in the Kingdom; we estimate it is around SR1.3 trillion. The sector has grown rapidly since 2004 and according to Mazaya Real Estate, real estate investments more than doubled from SR46.5 billion in 2006 to SR100.4 billion in 2007

Higher government spending, stemming from high oil prices, and greater private sector investment have been the main drivers of growth in the real estate sector. In addition, the government has relaxed some rules such as speeding building permits, allowing multi-story buildings in some areas and foreign ownership. Furthermore, high levels of liquidity and lower interest rates have further stimulated growth in real estate activity. New economic and industrial cities are currently in the pipeline, government offices are being upgraded and the provision of housing is being stepped up.

Soaring raw material costs and labor shortages have slowed the pace of growth during 2008. Prices of key construction material rose by more than 50 percent coupled with increasing wage rates for skilled construction labor have put pressure on profitability of real estate investments. Furthermore, key sectors such as housing and residential market continue to face acute shortage of supply which had prompted both the government and the private sector to mobilize resources to meet the increasing demand for affordable housing.

However, the prices of key construction goods such as steel and cement have fallen sharply as the outlook for the global economy has significantly deteriorated in recent months. Although the financing environment has got more difficult for real estate investors, we feel that the real estate sector will remain strong as it is driven by strong local demand.

Breakdown of property market



The real estate market can be divided into three categories:

- **Raw land:** undeveloped land.
- **Residential:** apartments, villas, traditional homes and housing compounds.
- **Commercial:** office buildings, retail outlets, shopping malls and hotels.

In this analysis, we focus on the housing market, Dar Al-Arkan's core business, and briefly touch on the raw land sector, which is also a source of revenue for Dar Al-Arkan.

Housing sector

Housing accounts for more than 70 percent of real estate activity. It is currently estimated that there are over 4 million units in the Kingdom. According to the eighth National Development Plan (2005-2009), the real estate sector is expected to grow at an annual rate of 6.3 percent and the demand for housing is expected to increase at an average of 200,000 units per year.

Housing in Saudi Arabia takes the following forms:

- **Detached villas:** popular among those on middle income (around SR8,000) and above. Villas of this kind tend to be in different shapes and styles and do not follow a specific standard.
- **Duplexes:** rented floors of either villas or houses, which are highly demanded by middle income families.
- **Apartments:** becoming more popular today due to the surge in house rents. Apartments are generally used by those on middle and lower incomes and expatriates.
- **Housing compounds:** mostly private owned and targeted at expatriates. Currently, virtually all compounds are fully occupied.
- **Traditional housing:** these are becoming less popular due to changes in demographics and life styles. They have generally been funded by collective family savings.

Currently, more than 90 percent of homes are built by individuals, most of whom do not follow any code or standard. The remaining 10 percent includes apartments and housing compounds.

Real estate developers account for less than 10 percent of the housing market, but their share is growing (data on individual developers' market shares is not available). Community developments, such as those provided by Dar Al-Arkan, are becoming increasingly popular. These are developed over a large parcel of land and include social as well as public service utilities, leisure space, sporting facilities and other amenities, they also provide cost and quality advantages for residents, as they are built by experienced developers. The first community developments in the Kingdom were built to house the staff of major government entities (such as National Guard compound and Aramco) and these have been successful.

Real estate developers are expected to play a greater role in the housing market through collaboration with local municipalities to generate well-designed new urban communities. Municipalities would focus on securing basic services and developers on the design and implementation of high-standard community projects. The housing market in Saudi Arabia faces an acute supply shortage, especially of affordable housing for those on middle incomes. According to the eighth national development plan, home ownership fell from 65 percent to 55 percent from 2000-2004. Presently, it is estimated that home ownership has further declined significantly. The main reason for the low home ownership rate is the high cost of land and construction materials. The very limited availability of housing financing schemes has further compounded the difficulty in obtaining affordable houses. The government takes this issue seriously and is pushing forward a mortgage law and has increased the funding of the Real Estate Development Fund. According to the eighth national development plan, the new housing strategy aims at increase the house ownership from currently 40 percent to 80 percent by 2020.

Most Saudi banks already offer Sharia-compliant home financing schemes. Common features of home financing loans provided by local banks including:

- Maximum borrowing of SR3 million.
- Includes houses, apartments and residential buildings.
- Duration of loans of up to 30 years.

- Minimum monthly salary requirements of an average of SR4,000.
- Monthly salary assignment.

A number of specialized installment and finance companies provide real estate financing of a similar nature to the banks.

While banks compete to increase market share in the home financing market, a large portion of Saudis has not participated in these programs due to the high cost of financing and eligibility requirements. It is hoped that a new mortgage law will provide the flexibility needed for financial institutions to safely provide innovative financing schemes that would increase access to home ownership. The new law, which has been in the making for nearly a decade, was approved by the Shoura Council earlier this year. The draft of the new law will be submitted to the council for ministers for final ratification. Once enacted, it should ease some of the restrictions on the amount and tenure of mortgage loans, it may also formalize the foreclosure process. A formal framework for the mortgage market will encourage local and foreign real estate developers in the Kingdom.

The Real Estate Development Fund provides housing finance loans on a concessional basis. Established in 1974, the Fund accounted for more than 60 percent of home financing loans between 2001 and 2006. However, its ceiling for borrowers is SR 300,000 per household, far below what an average house would cost in the current market conditions and the average waiting time to obtain a loan is around 9 years.

Demand for housing comfortably exceeds supply and this imbalance points to a healthy outlook for developers. We think the housing market has a huge potential because of the undersupply. Yet it is important to note that meeting the demand for affordable houses poses a challenge. New mortgage finance and more cost efficient housing will help bridge the widening gap. We believe the high demand for housing will be driven by the following:

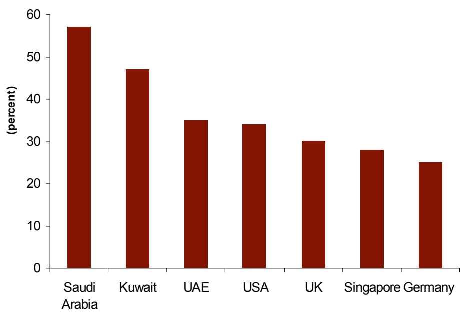
- **New mortgage law:** A mortgage law is to be ratified by the council of ministers. Once implemented it should significantly reduce the financial barriers to home ownership.

- **Population growth:** Saudi Arabia has a rapidly growing young population in addition to influx of expatriates (population growth averaged 2.5% in the last decade and over one million new expatriate work visas were issued last year) will result in healthy domestic demand for new housing units. It is estimated that Saudi Arabia will need 4 million new homes by 2024.

- **Social and demographic factors:** The size of the average household is falling as young married couples are increasingly choosing to move to independent housing units instead of staying in larger residences with their extended family.

- **Improved housing finance schemes**: Saudi banks and financing companies have introduced housing Shariah-compliant loan programs to finance home purchases that extend up to 25 years in advance of the approval of the mortgage law.

Population under 25 years old (2006)



Raw land sector

Acquiring raw land is a key stage of any real estate project. Official information on the raw land market in Saudi Arabia is not available due to the lack of a central registry. We have obtained our data from discussions with real estate experts and third parties.

We estimate that over the past three years the price of raw land went up by 20-30 percent on an annual basis (leading to similar increases in housing prices and commercial rents). This rise was due to an increase in demand for land, an abundance of liquidity and investors searching for a safe haven following the collapse in share prices on the Saudi stock market in 2006. While the rate of increase in price varies throughout the Kingdom, major cities such as Riyadh, Jeddah, Mecca and Al Khobar witnessed the highest growth rates. According to the Mazaya real estate index, 66 percent of the land activity in 2007 was in the residential lands and 27 percent was for the commercial and investment sector

Buying and selling land is a relatively straightforward process and raw land is therefore a reasonably liquid asset. Land is also one of the few investment avenues in Saudi Arabia (along with the stock exchange) and the land market in major cities has a lot of buyers and sellers. Due to its liquidity and high yields, there was a very high turnover of raw land over the last few years (data on the size of the market is not available). We believe that the raw land market in Saudi Arabia, in line with other segments of the real estate market, will experience period of slowdown over the next year.

The company

Dar Al-Arkan Real Estate Development Company, a Saudi joint stock company, is a real estate developer specialized in the residential sector. Established in 1994, it is focused on residential compounds and developing master-planned communities that offer land parcels, villas and apartments. On October 14, 2008, the company increased its capital from SR5.4 billion to SR7.2 billion through the issuance of 180 million new shares. According to the management, the increase in capital is a sign of the commitment of the major shareholders to growing the company. It was financed from retained earnings.

Dar Al-Arkan has progressed from being a small real estate developer to one of the largest in Saudi Arabia. It has developed in three stages:

- **First stage (1994-1999)**: The company started as a small real estate developer focused on the installation of basic infrastructure on raw land parcels mainly in the Riyadh area. It purchased huge land plots and developed the water and sewage infrastructure, electricity and other utilities as well as roads and pavements. The land was divided into pieces that were sold to individuals, investors or other real estate developers. In this first stage, Dar Al-Arkan residential construction was limited to small development contracts and a small number of residential units.

- **Second stage (2000-2004)**: Dar Al-Arkan gradually shifted to residential development through the implementation of several housing projects targeted those on middle incomes. It also expanded into the Western and Eastern regions.

- **Third stage (2005-present)**: The company is currently focused on large-scale housing projects through the development of master-planned communities that contain villas, apartments and attached units. Dar Al-Arkan is also engaged in the development of raw land to be used for residential construction for individuals and other developers.

Dar Al-Arkan aims to become the leading community developer in Saudi Arabia. Its strategy is to increasingly focus on residential projects to meet the demand for quality housing for the middle income segment. It uses a master-planned community development model in which it purchases a large portion of land and pre-plans every aspect of the community including residential and commercial properties, parks and other public amentias. Normally, these master-planned communities are located in the outskirts of major cities. According to the company's management, integrated community developments in good locations with a wide range of amenities are likely to be in great demand over the foreseeable future as they allow more efficient management of city growth.

There are five phases that Dar Al-Arkan goes through in developing communities:

- **Land acquisition:** Dar Al-Arkan buys raw land from primary sources in order to get lower cost than the secondary market where premiums apply. In a primary market, owners of land select a group of potential buyers (real estate developers or other investors) to buy land parcels before the land is put on the open market. In a secondary market, land is open to all and tends to trade for a higher price factoring in commissions and premiums. Dar Al-Arkan regularly receives invitation to purchase huge land parcels for potential community projects.

- **Administrative approvals:** Local municipalities have certain standards for the design and layout of communities. For instance, one-third of the land has to be allocated for schools, mosques, parks and other public amentias. Consultations with local municipalities are ongoing throughout the life cycle of a project.

- **Site development:** Water, electricity and sewage systems are installed and roads and pavements are built.

- **Construction of residential units:** This is sub-contracted to external contractors, though Dar Al-Arkan manages the projects to ensure the work is in accordance with the designs and plans.

- **Finishing and decorating the residential units**

Sales and marketing

Since Dar Al-Arkan has land and residential projects, it uses several strategies to market its products. For land projects, the company sets up sales offices at the sites to serve walk-in customers in addition to its offices across the country. It also sells land projects through real estate agents and through auctions that are held on-site.

Dar-Al-Arkan sells all its units directly. These may be sold before construction (off-plan), pre-finished (when approximately 75 percent of the unit has been completed) or finished. Historically, 70 percent of residential units are sold when finished, 20 percent pre-finished and the remaining 10 percent are sold off-plan. Dar Al-Arkan plans to increase its off-plan and pre-finished sales in future projects, which it believes it can do as its products gain popularity. Greater off-plan sales would help the company manage working capital. The majority of the residential units are sold in offices set up at the project site. Recently, the company has intensified its promotional activities through new brochures and advertisements. Dar-Al-Arkan received support from UK property consultant Cluttons in its marketing efforts and in building its in-house marketing team.

In a normal sale, a buyer pays a deposit to reserve the unit for 30 days and the remainder on delivery of the unit. Some of the transactions are funded through Saudi Home Loans company (see below) in which the buyer pays 10 percent of the value and the remaining 90 percent is paid on installments extending up to 20 years. A breakdown between sales on a cash or financing basis is not available.

Alliances and partnerships

Dar Al-Arkan has established various key strategic alliances and partnerships with local and global players that have helped to develop its business. These are as follows:

- **Kingdom Installment Company (KIC)**: Dar Al-Arkan's founders established KIC in 2001 to provide mortgage financing to Dar Al-Arkan customers. Currently KIC owns around 7.6 percent of Dar Al-Arkan. KIC claims to have been the first company to offer fixed rate housing finance extending up to 20 years in the Kingdom. No information is available on the company's financial performance.

- **Saudi Home Loans (SHL):** Dar Al-Arkan entered into an alliance with International Finance Corporation (IFC) (the private sector development arm of the World Bank), Arab National Bank (ANB) and KIC to establish SHL. It started operations in January 2008. It is the first specialized home financing companies to receive a license from SAMA, the regulator. SHL offers shariah-compliant real estate finance for those on middle incomes. The capital of SHL is SR2 billion with ANB and KIC owning 40 percent each; Dar Al-Arkan has 15 percent and the IFC 5 percent. No information is available on the company's financial performance.

- **Unicorn Capital:** in 2008, the company co-established Unicorn Capital in Saudi Arabia, taking a 33 percent stake. It is currently being established and expected be operational next year. Unicorn Capital is a franchise of the Unicorn Investment Bank (headquartered in Bahrain) with presence in several countries specialized in shariah-compliant products. The chairman of Dar Al-Arkan is also the chairman of the Unicorn investment bank.

- **Turner Construction:** a well-known US company specialized in construction consulting, project management and construction management. Dar Al-Arkan entered into a knowledge-transfer agreement with Turner in 2005 through which Turner provides technical expertise relating to project management needs. The agreement also includes overall management and administration, financial planning and human resource management.

- **Cluttons:** a UK company specialized in property management and consultancy services. In 2005 Dar Al-Arkan signed a contract under which Cluttons provided assistance in the marketing and research functions. Cluttons supported Dar Al-Arkan in the development of marketing strategy, employee training and identification of potential client needs for existing and upcoming projects. As the objectives stated in the contract are now achieved, support from Cluttons is now very limited.

- **CRAI:** a leading consultancy firm based in the US. Dar-Al-Arkan entered into an agreement with CRAI in 2007 to enhance strategic management and assist the company in achieving its targets.

Major projects

Al-Qasr: Al-Qasr, located in the Al-Swaidi suburb of Riyadh, comprises 3,054 residential and commercial units with a total built-up area of 914,017 square meters. The project comprises apartments, villas, commercial units (including a four-level shopping mall with hypermarket) and parks. It is divided into four phases, three of which have been completed; completion of the fourth is expected by the end of this year. According to the company, it has sold most of the units in the completed phases. The project also contains Al-Qasr mall which is a four-storey building and underground car parking.

Shams Ar-Riyadh: Located in Al-Dariyia district north of Riyadh, Shams Al-Riyadh occupies an area of around 5.6 million square meters. It is the biggest residential project developed by the private sector in Saudi Arabia. The project is in the initial stages of implementation and expected to be completed in the first half of 2012. Shams Al-Riyadh comprises around 3,200 residential units built on an area of approximately 1.2 million square meters with a total expected investment value of SR6.4 billion. Sales of residential units will start in early 2009.

Al-Tilal: This project is located in Medina and covers 2.2 million square meters. The first phase of the project comprises 500 villas most of which are under construction. The second and third phase could include an additional 1,500 residential units. Completion of the second and third (and final) phase is expected within the next five years.

Qasr Khozam: Launched in October, this project involves the development of the Qasr Khozam area in the old town of Jeddah, which incorporates the palace of King Abdulaziz. Along with Jeddah municipality, Dar Al-Arkan will restore the place and develop infrastructure, residential and commercial complexes and public facilities. The project is expected to take five to six years to complete and will be done in phases. The development occupies a four million square meters and will include shopping malls, villas, hospitals and schools.

Land sales have been the major contributor to the company's revenues since its inception, accounting for an average of more than 70 percent of total revenues. The company continues to build its land bank for potential residential projects or to be sold to other real estate developers for high yields. While focusing on residential projects, company management thinks that land projects will continue to be a major revenue generator.

Management

The company has an experienced management team which has considerable expertise and knowledge of the local and global real estate market. It also has access to foreign expertise through the alliances with various global players. Earlier this year the company strengthened its human resources by hiring new foreign staff in senior management positions. In-house marketing and sales teams have been built following the knowledge transfer agreements with foreign affiliates and other internal functions have been bolstered. In particular, Dar Al-Arkan has invested in enhancing its in-house research and development activity.

The company currently employs around 450 employees, with Saudis accounting for more than 35 percent of the total workforce. Eleven members sit on the board of directors. The company is managed through four committees: executive, audit, nominations and investment committees. The chairman of the board is company founder Yousef Abdullah Al Shalash. He is also the chairman of Emar Al-Byader, Madarat Co., Kingdom Installment Company; and Unicorn Investment Bank of Bahrain. The managing director is Abdulatif Bin Abdullah Al-Shalash who has also been at the company since its inception.

Disclosure and transparency

The company has been transparent in providing shareholders and potential investors with adequate information. The company listing on Dubai International Financial Exchange DIFX has also contributed to enhancing transparency and disclosure. We were able to meet with the company management as part of our due diligence process. Dar Al-Arkan was recently fined by the CMA for a leak of company results, however during our interaction with the management they firmly adhered to a policy of not disclosing unpublished information.

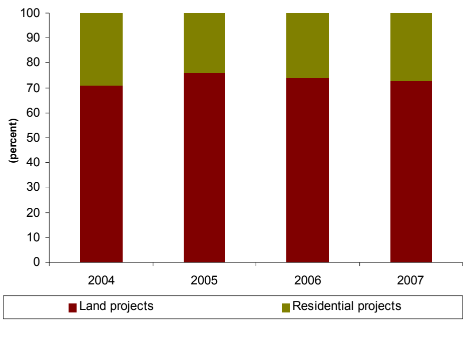
Financial analysis

Sales revenue grew by 13.2 percent in 2007 compared to 3.7 percent growth in 2006. The acceleration in sales growth in 2007 is due to the following:

- Higher demand for residential units and land.
- Enhanced efficiency of the company's planning and construction process enabled the company to increase number of units sold.
- Improved housing financing options have made house purchases more accessible.
- Higher land and residential real estate prices.

The land segment is the main source of the company's revenue, accounting for an average of 73 percent of total revenues over the

Revenue breakdown



last four years. Residential projects contribute the remaining. While land projects will remain a key source of revenue, Dar Al-Arkan plans to significantly increase the contribution to revenues from residential projects. As the phases of an increasing number of projects are being brought to the market over the next few years, we think this goal will be achieved.

Revenue breakdown
(SR million)

	2004	2005	2006	2007
Land projects	**1,759**	**3,191**	**3,202**	**3,605**
Growth (percent)	—	81	0	13
Contribution to revenues (percent)	71	76	74	73
Residential projects	**724**	**1,006**	**1,151**	**1,321**
Growth (percent)	—	39	14	15
Contribution to revenues (percent)	29	24	26	27
Total revenues	**2,484**	**4,197**	**4,353**	**4,926**

Cost of sales has been 51 percent of total revenues over the last two years, in line with its historical average. For the first three quarter of 2008, cost of sales has gone down to 45 percent. Land projects tend to yield higher margins as they cost less to sell than residential projects. For the first half of 2008, land projects' gross margin was 52 percent as opposed to 48 percent for residential projects.

Profitability indicators
(percent)

	2005	2006	2007	Q3 2008
Gross margin	48.4	48.8	48.9	55
Net profit margin	42.3	41.7	40.8	46
Return on assets	21.0	16.1	13.4	13.4[1]
Return on equity	22.4	17.3	18.6	20.4[1]

[1] last twelve months

Profitability, measured by the net profit margin, declined slightly in 2007 due mainly to higher financial charges; the company has issued two sukuk and increased in Murabaha financing in recent years. The first three quarters of 2008 indicate improved performance. The deterioration in the return on assets and return on equity ratios to 2007 was due to the increase in asset and equity bases over the last two years as the company initiated a number of residential projects. These residential projects are capital intensive and highly cash-flow dependent. The company financed its projects through:

- **Sukuk:** Dar Al-Arkan successfully tapped into resources from international markets through two sukuk issues. Following the successful US$600 million three-year issue that was listed on the Dubai International Financial Exchange (DIFX) in March 2007, the company raised US$1 billion in a five-year issue in July of last year that is listed on the Bahrain Stock Exchange, DIFX and Malaysian Labuan International Financial Exchange. It recently announced that it may issue a third sukuk; no details as to the amount, timing or exchanges it will be listed on have been revealed.

- **Credit facilities from local banks:** Since 2006 the company has been using Murabaha facilities from Saudi banks to finance its operations. The Murabaha financing account stood at SR1.13

billion at the end of the third quarter of this year.

Leverage ratios
(percent)

	2005	2006	2007	Q3 2008
Debt to equity ratio	3.9	10.1	67.0	70
Equity to total capital	96.2	90.8	59.9	59

The company's capital structure changed considerably in 2007 owing to the two sukuk issues. This is reflected in the leverage ratios, with debt-to-equity jumping from 10 percent in 2006 to 67 percent in 2007. Prior to the sukuk issues, Dar Al-Arkan used to finance its operations through the co-investor approach in which the company invited selected investors to participate in project development. Upon completion of the project, the company distributes dividend to investors (participants). As the company grew and its capital requirements expanded it chose to tap international and local markets through its sukuk and stock market listing. The ability of the company to diversify sources of funding has helped it generate the cash flow needed in its operating and investing activities.

Dar Al-Arkan listed its shares on the Saudi stock market in December 2007 with the free float currently stands at 30%. In October, Dar Al-Arkan increased its capital by 33 percent to SR7.2 billion. This was financed from retained profits and it should allow the company to expand its operations and take on more debt while maintaining its capital structure.

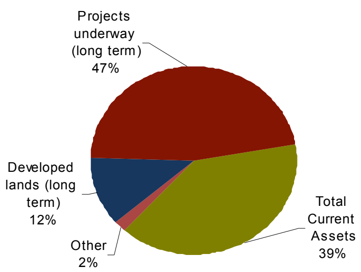
Liquidity ratios

	2005	2006	2007	Q3 2008
Current ratio	26.11	10.71	5.28	3.90
Net working capital (SR million)	10,147	10,359	5,869	5,330

Despite a worsening of liquidity indicators, the liquidity position remains solid due to the diversification of its sources of funding.

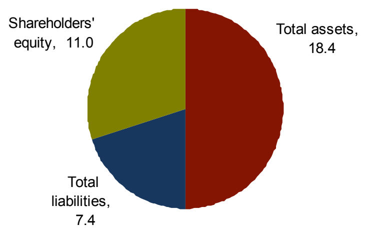
The company classifies its projects under construction into short term or long term projects. Short term projects are residential and land projects that are expected to be sold within the accounting period and are reported under current assets. Long term projects are expected to be completed over a future accounting period and are classed as long-term assets to be converted into fixed assets. Prior to 2007, all of the company's projects were accounted for as short-term projects reported under current assts. For 2007, the ratio of short-term to long-term projects around 1:4 of total projects; in the first half of 2008 this ratio had changed to 1:2, with residential projects accounting for 48 percent of short-term projects and 38 percent of long-term projects. Land projects were subject to a similar change in accounting treatment, with developed land projects split into short and long term assets. Long term developed lands accounted for 80 percent of the company's land bank in 2007.

Asset composition (end-2007)



Total assets grew by 57 percent in 2007 as the company stepped up its residential projects and invested in SHL (taking a 15 percent stake for SR75 million). In 2008, the company co-established Unicorn Capital taking a 33 percent stake of SR 100 million), increasing its long term investments to SR175 million.

Balance sheet (end-2007)
(SR billion)



Total liabilities grew six-fold in 2007 as a result of the SR1.6 billion sukuk issues. While this is a massive leap, leverage is still within acceptable levels as total liabilities account for only 40 percent of the company's total assets.

Results for the first three quarters of 2008

Profit for the first three quarters of 2008 was SR720 million, up 4.3 percent on the same period of 2007. Revenues were 17 percent higher than in the first nine months of last year. This is attributed to enhanced efficiency of the company's operations and an increase in demand for their products. Over the first quarters of the year land projects accounted for 78 percent of the company's revenues.

The last two quarters show improved cost management, as gross margin rose from 48 percent in the first quarter to 55 percent in the third quarter. Net profit margin also rose, from 37 percent in the first quarter of this year to 46 percent for the third quarter; a reflection of the enhanced operational efficiency.

Quarterly performance
(SR'000)

	First three quarters		Third quarter	
	2008	**2007**	**2008**	**2007**
Sales	4,351,566	3,595,893	1,567,043	1,641,139
Gross profit	2,282,051	1,780,140	859,321	767,132
Net profit	1,859,791	1,586,207	719,500	689,796
EPS (SR)	3.44	2.94	1.33	1.28

Valuation

We base our valuation of Dar Al-Arkan on a combination of the discounted cash flow (DCF) and relative valuation approaches. We have assigned 70 percent weight to the DCF and 30 percent to relative valuation.

DCF valuation calculations

- **Risk free rate:** 4.6 percent.
- **Equity risk premium:** 8.90 percent.
- **Beta:** 0.90.
- **Terminal growth rate:** 3 percent.

Projected cash flows: Taking into account the number of projects that are being implemented and the strong local demand for housing, we project healthy growth in sales volume. However, we expect a decline in house and land prices over the next two years and therefore forecast that sales revenue will only rise by 5 percent between 2009 and 2010, picking up to 8 percent between 2011 and 2013.

A sharp rise in demand for housing units is expected in Saudi Arabia driven by population growth. According to official estimates 200,000 housing units are needed to meet the increasing demand. Therefore, Dar Al-Arkan's housing segment is expected to be a major contributor of the company's revenues (revenues from the large-scale projects initiated over the last two years are expected to flow in over the next five years). While growth in real estate prices is forecast to slow, and prices could fall, raw material prices are likely to fall faster, leading to major savings in construction costs. Furthermore, an improved regulatory environment following the introduction of the mortgage law is expected to enable financial institutions to offer a variety of home financing schemes which in turn should increase the demand of Dar Al-Arkan products. With the company's land bank valued at purchase price and much of it acquired several years ago, land sales will remain a healthy source of net income even if land prices fall.

We selected the net cash flow to equity (NCFe) approach as the appropriate measure of economic income to use in this valuation. Net cash flow represents the maximum amount of cash that could be distributed to shareholders without affecting the company's normal operational cash requirements. We calculated net cash flow to equity by adding back depreciation and deducting capital expenditures, debt repayments and increases in working capital from net income. Dar Al-Arkan has borrowed in international capital markets in the past and we think that they company will require further funding. This is likely to take the form of a domestic sukuk and we think that investor appetite should be strong, though pricing would likely be higher than it would have been before the global financial crisis.

We calculated that the present value of the company's NCFe for fiscal years 2008 through 2014 is approximately SR17.5 billion. Dar Al-Arkan will continue to generate cash flows beyond the discrete projection period and we have selected a long-term growth rate of 3 percent as appropriate for the company's net cash flow. Combining the present value of the terminal cash flow with the present value of the discrete cash flow projections results in a total value of Dar Al-Arkan of SR28.5 billion. Based on the above, we estimate that the fair market value of Dar Al-Arkan's common stock on the valuation date is SR38.

Relative valuation calculation

Relative valuation, or comparable company analysis, values a company in reference to other publicly traded companies with similar operating and financial characteristics. Some of the most commonly used financial ratios for this process are the price-to-earnings ratio (PE) and price-to-book value ratio (PB). A lower ratio than its peers and the industry average may suggest that a stock is undervalued and vice versa. The rationale for using the PE is that earnings power is the main driver of investment value. The PB ratio measures how much investors are willing to pay for a unit of the company's net asset value.

Company	EPS (SR)	P/E ratio	Book value	P/B ratio
Real Estate	1.34	15.27	25.62	0.79
Taiba	1.03	15.13	19.41	0.80
Makkah	1.31	20.30	24.78	1.07
Arriyadh Develop-	0.78	13.15	13.86	0.74
Emaar E .C	-0.24	n/a	9.69	1.15
Jabal Omar	-0.05	n/a	9.94	1.69
Dar Al Arkan	**3.17**	**6.08**	**15.61**	**1.23**
Sector	**1.53**	**13.99**	**16.99**	**1.07**
Market	**2.32**	**11.66**	**14.16**	**1.98**

We compare Dar Al-Arkan against a peer group of real estate development companies listed on the stock market.

Dar Al-Arkan stock is currently trading at a trailing PE of 6.08, which is the lowest amongst real estate companies, suggesting its share price is relatively undervalued. From a PB perspective, the stock is 15 percent higher than the average of the industry. Bases on our analysis of the company's future performance, we have assigned Dar Al-Arkan a forward earning per share of 3.3 and a forward book value per share of 23.

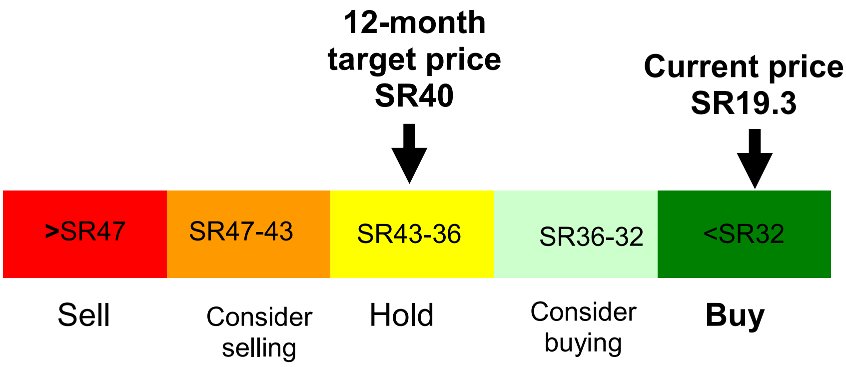
Applying Dar Al-Arkan's forward looking earnings per share to the industry's average one-year trailing PE of 14 gives a price for Dar Al-Arkan shares of SR46. Applying Dar Al-Arkan's forward book value per share to the industry average of 1.07 gives a price for Dar Al-Arkan's shares of SR25. Averaging these results gives a share price for Dar Al-Arkan of SR35.

Recommendation

Based on the two valuation parameters weighted 70:30 in favor of the DCF, we arrive at a fair value of SR38. To get our 12-month target price, we ran a DCF as of 12 months after the valuation date, then discounted the resulting value by the current discount rate; we leave the relative valuation unchanged as it is already forward looking. This generates a 12-month target price for Dar Al-Arkan of SR40. With Dar Al-Arkan currently trading at SR19.3, we recommend that investors "buy".

	Price per share (SR)	**Weights**	**Contribution**
Valuation method			
Free cash flow to equity (DCF)	42	70%	29.6
Relative valuation (PE/PB)	35	30%	10.6
12-month target price (SR)			**40.2**

The Jadwa recommendation bar



The bar on the front page of this report is Jadwa's method of conveying our investment recommendation as clearly and concisely as possible. The bar is based on traffic lights, where green means "go" (buy), yellow is "slow" (hold), and red is "stop" (sell). Our 12-month target for the stock is the middle of the yellow area. This is the price that we expect the shares to trade at in 12 months time. This is different to fair value, which is our estimate of the fair value of the company's share price as of the valuation date.

We use five colors in our recommendation bar, with those on either side of the yellow area signifying that an investor should consider buying or selling the stock. The price range for each of these alternatives is within the colored section. These price ranges have been adjusted to take account of share price volatility (using the stock's variance-mean ratio). The more volatile the share price, the larger the price ranges.

Performance matrix

This table ranks Dar Al Arkan's performance against what we believe are the key success factors for the sector it operates in (real estate). A green rating is positive, yellow neutral and red negative.

Factor	Measures	Dar Al-Arkan status	Rating
Valuation	Fair market value of the company	The stock is undervalued.	
Management	How efficiently and effectively the company is run.	The company is managed by an experienced team with expertise in local and global real estate markets.	
Competitive position	Position of the business relative to others in its industry.	Dar Al-Arkan is a leader in master-planned community projects.	
Product diversification	The degree of diversification between products, product lines, business lines and services.	While the company's engagement in raw land development and housing projects provides a degree of diversification, it is heavily exposure to the real estate prices.	
Marketing effectiveness	How effective is the company's marketing activities.	Dar Al-Arkan uses a diverse range of marketing tools and has built a strong brand name.	
Operational efficiency	The company's ability to enhance its productivity and product quality.	Key strategic alliance have enhanced the company's operational efficiency.	
Disclosure and transparency	Company practice in providing information required by investors.	Financial statements provide adequate level of information. Listing on regional markets has enhanced transparency and disclosure.	
Quality of products	Consumer's impressions about the quality of products	Perception of the company's housing units is good as the resale rate is very low.	
Profitability	The end-result of a company's operations utilizing all resources at its disposal.	Dar Al-Arkan maintained an average of 42 percent net profit margin over the last five years.	
Activity	How efficient management is in using its assets.	There has been a noticeable improvement in the efficiency in the company utilizes its assets, reflected in its activity ratios.	
Performance	Efficiency in generating sales.	Sales continued to grow at healthy rates mainly driven by the land development segment.	
Liquidity	Company's ability to meet short-term and current obligations on time.	Although Dar Al-Arkan's liquidity position is deteriorating due to increased Murabaha financing, liquidity position remains healthy as the company diversified its sources of funding.	
Leverage	Capital adequacy and company's ability to meet long-term obligations and take advantage of opportunities as they arise.	There has been a significant change in the leverage position owing to sukuk issuance during 2007. While leverage ratios have jumped, debt levels are within acceptable levels.	

The discounted cash flow model

The DCF method estimates value on the basis of future cash flows over an investment horizon using empirical market data, macroeconomic and industry evidence and the underlying fundamental trends of the subject company. The DCF method then applies a present value discount rate, known as the required rate of return on investment, to project future cash flows, which results in an estimation of net present value of projected cash flows.

The value of the company is estimated by projecting the cash flows that the company is expected to produce and discounting those cash flows back to the valuation date using a discount rate that reflects the related risk. An in-depth analysis of the company's revenues, fixed and variable expenses and capital structure were conducted.

DCF valuation calculations

Present value discount rate: We estimated the cost of Dar Al-Arkan's equity capital (net of long-term debt) using the capital asset pricing model which incorporates a risk free rate, a long-term risk premium and a company's stock beta.

- **Risk free rate:** The risk free rate is used as to measure the opportunity cost of investing. Since DCF analysis is based upon a long-term investment horizon, the appropriate risk-free rate is that of a long-term government security. We use the 10-year Saudi riyal bond issued by SAMA, which yielded 4.6 percent on the valuation date.

- **Equity risk premium:** We calculate the equity risk premium as the average of the arithmetic and geometric means of TASI historical returns, less the long-term rate of return on the 10-year SAMA bond. The arithmetic mean of the TASI over the period from 1980 to November 15 2008, was 15.9 percent. The geometric mean over the same period was 11.07 percent. The average of the two is 13.48 percent, which is the market return. Accordingly, the equity risk premium is 8.88 percent.

- **Beta:** Beta is a measure of the risk inherent in the company's investment returns. The market (TASI) beta is always one. Because the company was only listed at the very end of last year, we have used the real estate development industry beta, which is 0.9. A stock beta that is lower than one indicates that the stock tends to be less volatile (up or down) than the TASI. Applying beta to the long-term equity risk premium gives a beta-adjusted long-term equity risk premium of 7.99 percent .

The capital asset pricing model resulted in a total estimated cost of equity capital of approximately 12.59 percent. This is arrived at by adding the beta-adjusted equity risk premium and the risk free rate.

DCF valuation

SR' 000	2008	2009	2010	2011	2012	2013	2014
Net income	**2,354,127**	**2,408,811**	**2,467,257**	**2,664,860**	**2,878,288**	**3,108,806**	**3,357,783**
+ Depreciation	20,284	22,312	24,544	26,998	29,698	32,668	35,934
- Capital expenditure	(16,840)	(21,050)	(26,313)	(32,891)	(41,113)	(51,392)	(64,240)
-/+ Increase/decrease in working capital	401,967	(145,145)	(111,278)	(122,406)	(134,646)	(148,111)	(81,461)
+ Increase in long-term debt	-	500,000	-	-			
-Repayment of long term debt	-	-	-	-	(1,600,000)		
= Net cash flow to equity	**2,759,538**	**2,764,928**	**2,354,210**	**2,536,562**	**1,132,226**	**2,941,971**	**3,248,017**
Estimating the discount rate							
k = rf + (rm - rf)B							
Risk-free rate (rf)	4.60%						
Market return (rm)	13.48%						
B (beta)	0.90						
Discount rate (k)	**12.59%**						

	2008	2009	2010	2011	2012	2013	2014
Discounted Value of Equity (DFCFe)	2,724,464	2,424,434	1,833,385	1,754,429	695,513	1,605,064	1,573,817
Total DFCF	11,037,288						

Terminal Cash Flow	
Value in year 5	2,941,971
Assumed growth into perpetuity	3.00%
Present value of terminal cash flow	17,452,255
Total value of business (SR '000)	**28,489,543**
Shares outstanding	720,000,000
Value per share (SR) as @ 15-11-2008	**39.57**
Closing Price @ 15-11-2008	19.30

Financial statements

Balance sheet

ASSETS	2003 SR '000	2004 SR '000	2005 SR '000	2006 SR '000	2007 SR '000
Current Assets:					
Cash	35,934	65,537	525,619	183,645	3,346,865
Short term investments	-	72,596	121,025	77,000	6,648
Accounts receivable, net	3,885	509,284	437,851	480,659	483,561
Receivables from related party				2,525	3,576
Projects underway	1,402,614	3,725,360	7,592,911	7,935,867	2,244,735
Developed lands	-	1,250,360	1,795,668	2,530,783	551,387
Prepaid expenses and other	745	49,400	78,591	215,521	601,418
Total Current Assets	**1,443,178**	**5,672,537**	**10,551,665**	**11,426,000**	**7,238,190**
Long term investments	-	295,258	135,000	87,510	-
Land, property and equipment, net	7,451	85,063	133,525	-	-
intangible assets	-	114	-	165,565	160,596
developed lands long term					2,234,451
projects underway long term					8,552,506
Investment in companies' capital					75,000
Deferred expenses	-	-	3,611	2,512	113,585
Total Fixed Assets	**7,451**	**375,724**	**272,136**	**255,587**	**11,136,138**
TOTAL ASSETS	**1,450,629**	**6,052,670**	**10,823,802**	**11,681,588**	**18,374,326**
LIABILITIES & SHAREHOLDERS EQUITY					
Current Liabilities:					
Investors payable	449,410	429,946	83,826	34,530	3,052
Murabaha				414,024	400,000
Accounts payable	11,044	81,211	94,871	45,179	104,667
Notes payable	3,221	25,146	-	930	-
Accrued expenses and other	25,745	57,038	225,477	572,097	861,882
Total Current Liabilities	**489,420**	**593,341**	**404,174**	**1,066,760**	**1,369,601**
Shareholders accounts	543,513	814	-	-	-
Provision for employees end of service indemnities	696	-	1,902	3,152	4,475
Sukok payable	-	-	-	-	6,000,000
TOTAL LIABILITIES	**1,033,629**	**594,155**	**406,076**	**1,069,912**	**7,374,076**
SHAREHOLDERS' EQUITY					
Share capital	70,000	5,400,000	5,400,000	5,400,000	5,400,000
Statutory reserve	35,000	143,879	3,242,254	3,242,254	3,242,254
Settlement reserves	-	1,041,025	-	-	-
Treasury stock		(2,418,303)			
Retained earnings	312,000	1,291,914	1,775,472	1,969,422	2,357,996
TOTAL SHAREHOLDERS' EQUITY	**417,000**	**5,458,515**	**10,417,726**	**10,611,676**	**11,000,250**
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	**1,450,629**	**6,052,670**	**10,823,802**	**11,681,588**	**18,374,326**

Income statement

	As of December 31,				
	2003	2004	2005	2006	2007
	SR '000	SR '000	SR '000	SR '000	SR '000
Operating Revenue	1,323,452	2,483,561	4,196,817	4,352,587	4,925,933
Cost of operations	(712,160)	(1,272,540)	(2,167,174)	(2,229,876)	(2,517,925)
Gross operating income	**611,292**	**1,211,021**	**2,029,643**	**2,122,711**	**2,408,008**
SG&A expenses	(22,448)	(29,997)	(38,828)	(40,546)	(82,855)
Participation expenses	(32,331)	(60,897)	(121,514)	(13,310)	(12,591)
Depreciation	(1,622)	(1,662)	(13,253)	(17,256)	(18,440)
Operating income, net	**554,891**	**1,118,465**	**1,856,048**	**2,051,599**	**2,294,122**
Investment income	115	-	66,790	33,667	45,149
Financial charges (Murabaha and Sukuk)	-	-	-	-	(278,079)
Other expenses		(819)	(1,099)	(1,099)	(24,027)
Income before Zakat	**555,006**	**1,117,646**	**1,921,739**	**2,084,167**	**2,037,165**
Provision for Zakat	(23,704)	(28,853)	(146,268)	(270,217)	(28,591)
Net Income	**531,302**	**1,088,793**	**1,775,471**	**1,813,950**	**2,008,574**
Shares outstanding (units)	-	-	-	540,000,000	540,000,000
Earnings per share (EPS) SR	-	-	-	3.36	3.72

Cash flow statement

	For the Fiscal Year Ending December 31,				
	2003	2004	2005	2006	2007
	SR '000	SR '000	SR '000	SR '000	SR '000
Cash flows from operating activities	153,708	(2,954,557)	(2,743,725)	821,784	9,649,908
Cash flows from investing activities	(2,858)	(446,975)	45,217	42,218	(10,852,664)
Cash flows from financing activities	(160,499)	3,431,135	3,158,591	(1,205,976)	4,365,976
Cash and cash equivalents at yearend	**(9,649)**	**29,603**	**460,083**	**(341,974)**	**3,163,220**

Ratio analysis

	2003	2004	2005	2006	2007
Liquidity					
Current ratio	2.95	9.56	26.11	10.71	5.28
Quick ratio (Acid-Test)	0.08	1.09	2.68	0.69	2.80
Net working capital (SR million)	954	5,079	10,147	10,359	5,869
Activity					
Turnover:					
Sales to net working capital	1.4	0.5	0.4	0.4	0.8
Inventory	124.7	2.0	1.4	1.03	1.63
Receivables	76.9	9.7	8.9	9.5	10.2
Average collection period (days)	5	38	41	39	36
Days to sell inventory	3	179	257	354	223
Performance (Asset utilization ratios)					
Sales to Total Assets (%)	91.2	41.1	38.8	37.3	26.8
Profitability (per share)					
Gross Margin (%)	46.2	48.8	48.4	48.8	48.9
Operating margin before depreciation (%)	44.5	47.6	47.4	47.8	47.2
Operating margin after depreciation (%)	41.9	45.0	44.2	47.1	46.6
Pretax profit margin (%)	41.9	45.0	45.8	47.9	41.4
Net profit margin (%)	40.1	43.8	42.3	41.7	40.8
Return on:					
Total assets (%)	36.6	29.0	21.0	16.1	13.4
Equity (%)	127.4	19.9	17.0	17.1	18.3
Investment (%)	55.3	33.9	22.4	17.3	18.6
Average assets (%)	36.6	29.0	21.0	16.1	13.4
Average equity (%)	127.4	37.1	22.4	17.3	18.6
Average investment (ROIC, %)	55.3	33.9	22.4	17.3	18.6
Leverage (Balance sheet)					
Debt to equity ratio	247.9	10.9	3.9	10.1	67.0
Equity to total assets (Equity ratio, %)	28.7	90.2	96.2	90.8	59.9
Equity to total capital (%)	43.4	100.0	100.0	100.0	100.0

Summary of quarterly results

Balance Sheet as on	Q4 2007 SR '000	Q1 2008 SR '000	Q2 2008 SR '000	Q3 2008 SR '000
Current Assets	7,238,188	6,261,319	7,139,229	7,153,521
Inventory	0	0	0	0
Investments	10,861,958	12,708,364	10,844,263	11,628,968
Fixed Assets	160,596	156,366	151,365	146,536
Other Assets	113,585	104,611	98,212	140,732
Total Assets	18,374,327	19,230,660	18,233,069	19,069,757
Current Liabilities	1,369,601	1,772,676	1,705,856	1,822,575
Non-Current Liabilities	6,004,476	6,004,976	6,006,672	6,007,141
Other Liabilities	0	0	0	0
Shareholder's Equity	11,000,250	11,453,008	10,520,541	11,240,041
Total Liabilities & Shareholder Equity	18,374,327	19,230,660	18,233,069	19,069,757

Statements of Income for the period ending	Q4 2007 SR '000	Q1 2008 SR '000	Q2 2008 SR '000	Q3 2008 SR '000
Sales	1,330,039	1,234,165	1,550,358	1,567,043
Sales Cost	702,171	647,463	714,331	707,722
Total Income	627,868	586,702	836,027	859,321
Other Revenues	48,628	8,819	2,618	2,455
Total Revenues	676,496	595,521	838,645	861,776
Admin and Marketing Expenses	43,195	22,282	38,646	37,194
Depreciation	6,973	5,848	5,585	5,567
Other Expenses	175,369	114,633	106,881	99,515
Total Expenses	225,537	142,763	151,112	142,276
Net Income Before Zakat	450,959	452,758	687,533	719,500
Zakat	28,591	0	0	0
Net Income	422,368	452,758	687,533	719,500

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