Galfar Engineering and Contracting Co SAOG – Investor Meeting Note

(Closing: RO 0.093, Rating- Accumulate, 12 Month Fair Value: RO 0.106)

Turnaround in Performance seen, Management focus remain on RoE enhancement

Management team (CEO and CFO) of Galfar met the local investors at MSM today to discuss about 2018 results and the strategy going forward

Overall, we came out of the meeting on a positive note amid expectations of improved operating margins, cost optimization and operational efficiency along with efforts taken towards improvement in working capital through receivable management.

About Order Backlog

- Order backlog of the company is at about RO 380 million as compared to 2018 revenue of RO 270 million. The company has been extremely careful in their project selection strategy and looking for projects from good clientele which proper payment schedule.
- **Of the current order backlog, Oil and Gas sector form about 47%, Civil & Marine form about 33%, Utility & Services form 12% and Roads & Bridges form about 8% of total backlog. The company remain agile to adopt to varied market conditions and sectors.**
- Order backlog reduced intentionally to focus on quality clients and projects. The company has participated in tendering activities of various Road projects, Water Projects and others. Management expect these contracts to materialize during this fiscal year.
- **Management remain positive on Kuwait projects and expect about KD 40 to 50 million worth of orders initially and to increase to about KD 100 million over medium term. Key focus areas would be Oil & Gas, Infrastructure and Roads etc., and margins remain healthy in this market.**
- Discussed on BOOT, PPP and other models, which may probably used in the upcoming infrastructure projects in Oman.

Turnaround of operations

- As per the management, the efforts taken by the company has led to turnaround in operations. We believe this would effectively reflect in improved numbers during the coming quarters.
- Cleaning up process of Balance Sheet is complete.
- **Focus on receivables Management-** Receivable delays continue to impact. While the management has taken efforts towards improvement in collections. Monthly collections average around RO 25 to 30 million.

The breakup of receivables includes the below items,

- **Certified- Due- RO 35.14 million**
- Certified- Not due- RO 25.31 million
- Billed & Due for Certification- RO 67.73 million
- Billed (contractual issues)- RO 22.88 million
- Unbilled- RO 72.75 million

- **Regarding Muscat Expressway dues, the management indicated that RO 16 to 17 million has been collected during last two years.** The balance left over in this contract is about RO 22 million (RO 18 million with one party and another 3 million with second party)
- The company has ensured the collections come on time and if there is any delay, the company has chosen to stop work without payments.
- Implementation of new accounting standards (IFRS 9 and IFRS 15) has been taken care. No impact seen on this introduction.
- **Total employees' strength of the company has reduced to 19,600 as compared to about 27,000 before three years**, in line with the contract outlook and cost optimization. Added, Total fleet size is about 5,400.
- The company continued to look at further cost reduction in all key areas.
- **Key ratios (end 2018) - Asset turnover ratio is at 5.1X and Current ratio is at 1.1X – Management has indicated post sale of Indian operations the ratios to improve going forward**

Outlook on Margins

- The company has managed to increase operating margins during 2018, while the increase in financing costs has led to lower profits**. Amid continued efforts taken towards collection, the overall borrowings would be lower going forward.**
- **Over the medium term, the company anticipates net profit margins to increase to about 2.5% to 3% levels, which is positive.**
- Still the company faces additional costs like Increase in diesel costs has led to higher costs of about RO 2.7 million in 2018, the company has got impacted severely and looking at ways to reimburse the same from the clients.
- **Change in insurance law with the introduction of mandatory health insurance to increase overall costs.** The new projects would include this clause, while the existing projects also has a clause related to change in legislations to be compensated. The company has been successful in legislation award in few of the historical contracts.
- IFRS 9 receivable provisioning is taken care off based on the respective models along with Auditors.

Step forward in financial restructuring- Sale of India Operations

- Sale of loss-making Indian operations to remain positive. The sale process is going on and would move forward post the EGM approval on the sale process.
- The earlier proposed financial restructuring is mainly to finance the projects in India and the divestment of this business is part of the restructuring process.
- **As per the management, there is no equity raising option at the table now. No funding requirements seen.**

Overall Outlook

We believe in the management focus and strategy adopted towards turnaround of operations, cost optimization measure taken, and trust given on RoE enhancement. Several key steps have been taken towards the improvement of overall performance which would start reflecting during the coming quarters. Caveat to remain on continued stress in payment dues, receivable management and escalation of costs.

On the other hand, the sale of loss-making Indian operations is the first step towards achieving their key objectives towards financial restructuring. This would in a way lower the funding requirements and the resources could be utilized for other lucrative business opportunities including Oman, Kuwait, Iraq and East Africa.

At the current levels, the stock trades at PE (2019E) of 8X and PBV (2019E) of 0.7X. Galfar is also part of our Top 10 stock recommendations in Oman for 2019 on expectations of turnaround benefits. Our 12-month fair value is at RO 0.106 (subject to revision post Q1 results)

Find below addendum with Key focus points during the meeting.

Strategy 2018-2020- Key focus areas

- Divestment of loss-making Indian Operations
- Restructure the company to suit the market conditions
- Focus on Oil and Gas markets
- Lean on site and new ERP systems (to monito actual day to day operations)
- Expansion into new geographies (Kuwait, Iraq and East Africa)

Management focus and trust remain on RoE and the way forward, incorporating the below points to work towards the improvement.

- Robust order acquisitions (Quality of Order addition remain paramount)
- Net Working Capital Control (proper collection mechanism)
- Value monetization
- Operational excellence (several steps taken towards this initiative)- very critical
- Efficient and Profitable execution
- Better Asset utilization
- Divestments

Business Plan- 2019- Four- pronged approach

- **Cost Reduction**
  - Close out, collect and consolidate
  - ERP based organizational efficiency and cost control
  - Minimize overhead and outsourcing
  - Leadership competence training
  - Multi skilled workforce
  - Single support center in Khazzan
  - Effective Omanization
- **Cheaper and Faster Project delivery**
  - Pre and Post tender risk and opportunity review
  - Rapid mobilization team
  - Alternative execution methods
  - Value engineered scope
  - ERP based activity costing and monitoring
  - Manpower productivity improvement tools
  - E-Procurement
  - Strong Internal control
- **Focus on paying customers with track record of project close out**
  - Focus to remain on Oil & Gas
- **Operations in other countries**
  - Kuwait
  - Iraq
  - East Africa

Stock Rating Methodology:

Buy - Upside more than 20%
Accumulate - Upside between 10% and 20%
Neutral - Upside or downside less than 10%
Reduce - Downside between 10% and 20%
Sell- Downside more than 20%
Not Rated - Stocks not in regular research coverage

LT- Long Term
ST- Short Term

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