Gulf International Services (GISS)

Recommendation	ACCUMULATE	Risk Rating	R-4
Share Price	QR17.00	Current Target Price	QR20.00
Implied Upside	17.6%		

Drilling Operations Improving; Upgrading to Accumulate

We are updating our estimates/price target and upgrading GISS to an Accumulate. *While earnings remain anemic, operating metrics in the drilling segment are improving. We expect strong overall EPS growth next year, primarily driven by drilling, albeit from a modest base. GISS' story consists of a sum of moving parts, not entirely predictable and fairly volatile. We do not expect this to change. However, we do expect the drilling segment to pull itself out of losses suffered during 2016-2018 in light of increasing demand due to the proposed North Field expansion and given our assumption of high utilization of existing rigs, startup of rig utilization contracts for additional rigs (similar to the Seadrill deal announced in July) and modest cost savings. We are also modeling in a resumption of dividends with QR1 in DPS (5.9% yield) expected for 2018. While quarterly results could remain volatile and impact stock price, we do see long-term appreciation potential in the name.* ***We rate GISS an Accumulate with a QR20 target.***

Highlights

- **We are modeling in a recovery in2H2018 with QR69mn in net income vs. QR34mn in 1H2018.** Growth could be primarily driven by drilling with 2H2018 segment loss expected at QR32mn, an improvement from a loss of QR54mn in 1H2018. EBITDA should grow from QR378mn (margin: 28.8%) in 1H2018 to QR414mn (29.1%) in 2H2018.
- **Drilling showing offshoots of recovery and we expect a resumption of profitability next year despite higher interest costs.** We are modeling **all nine offshore rigs** to be deployed from 4Q2018 onward; we expect average rig rates of $79k/day along with 91% utilization in 2019. GISS' fleet of **eight onshore rigs** should continue to be fully utilized as they have been, for the most part, this year. The onshore fleet is expected to generate $33k/d with an average utilization rate of 97%. Further, the Rumailah **lift boat** is expected by fully repaired and available by the end of this year. Moreover, in July, GDI signed a contract with Seadrill for the utilization of Seadrill's offshore drilling rig, West Tucana; GDI will use this jackup in a **rig utilization contract** lasting 440 days (with options for further extensions), in which GDI will manage the rig/crew provided by Seadrill and earn a service fee. We are modeling in an additional rig under a similar arrangement in 2H2019, and increasing this fleet to 3 rigs in 2020, 4 rigs in 2021 and 5 rigs in 2H2022 before gradually reducing the size of this fleet. **Such contracts allow GISS to address demand growth in drilling without undertaking additional debt-driven capex.** On the **costs** front, GIS has undertaken initiatives to streamline operations and we expect a modest $2mn in direct cost savings in 2019/$8mn in 2020. *Net-net, we expect GDI to go from a QR86mn loss in 2018 to a QR35mn net profit (2019) and QR53mn in 2020.*
- **Group earnings should grow from QR103mn (EPS: QR0.55) in 2018 to QR234mn (QR1.26) in 2019.** 92% of this growth is projected to be driven by drilling. Insurance and aviation contribute 8% and 3% to the growth, respectively, while catering is flattish.

Catalysts

- **Stock price improvement depends on a resumption of confidence in company performance.** GISS stock continues to remain in a "show me" mode.

Recommendation, Valuation and Risks

- **Recommendation and valuation:** ***We upgrade GISS to an Accumulate rating with a QR20 price target.*** Our previous rating was Market Perform. GISS trades at 2019 & 2020 EV/EBITDA multiples of 7.1x and 6.6x, respectively.
- **Risks: Geopolitical risks** cannot be modeled. Given the low level of absolute earnings along with paper thin net margins (1H2018: 2.6%), **quarterly earnings could be subject to significant volatility. Debt levels are relatively high** (1H2018: QR5bn/5.6x net-debt-to-EBITDA) but manageable in light of 1.3x interest coverage and expected reduction in leverage going forward, in our view. Further **decline in rig rates/ utilizations** could pressure shares. GISS also faces **concentration risk** given its exposure to QP/affiliates.

Key Financial Data and Estimates

	2017	2018e	2019e	2020e
EPS (QR)	0.46	0.55	1.26	1.49
P/E (x)	37.2	30.7	13.5	11.4
EV/EBITDA (x)	9.5	8.7	7.1	6.6
DPS (QR)	0.00	1.00	1.25	1.50
DY (%)	0.0%	5.9%	7.4%	8.8%

Source: Company data, QNBFS estimates; Note: All data based on current number of shares

Key Data

Bloomberg Ticker	GISS QD
ADR/GDR Ticker	N/A
Reuters Ticker	GISS.QA
ISIN	QA000A0Q6LH4
Sector	Industrials
52wk High/52wk Low (QR)	21.50/13.74
3-m Avg. Volume (000)	93.7
Mkt. Cap. ($ bn/QR bn)	0.9/3.2
EV ($ bn/QR bn)	1.9/7.0
FO Limit* (%)	49.0
Current FO* (%)	8.5
Shares Outstanding (mn)	185.8
1-Year Total Return (%)	(0.3)
Fiscal Year End	December 31

Source: Bloomberg (as of September 17, 2017), *Qatar Exchange (as of as of September 17, 2017); Note: FO is foreign ownership

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Segment Forecasts

Drilling showing offshoots of recovery and we expect a resumption of profitability next year despite higher interest costs.

- **We are modeling all nine offshore rigs to be deployed from 4Q2018 onward**; we expect average rig rates of $79k/day along with 91% utilization in 2019.
- **GISS' fleet of eight onshore rigs should continue to be fully utilized** as they have been, for the most part, this year. The onshore fleet is expected to generate $33k/d with an average utilization rate of 97%.
- Further, the Rumailah **lift boat is expected by fully repaired and available by the end of this year**.
- Moreover, in July, GDI signed a contract with Seadrill for the utilization of Seadrill's offshore drilling rig, West Tucana; **GDI will use this jackup in a rig utilization contract** lasting 440 days (with options for further extensions), in which GDI will manage the rig along with the crew provided by Seadrill and earn a service fee. We are modeling in an additional rig under a similar arrangement in 2H2019, and increasing this fleet to 3 rigs in 2020, 4 rigs in 2021 and 5 rigs in 2H2022 before gradually reducing the size of this fleet. Such contracts allow GISS to address demand growth in drilling without undertaking additional debt-driven capex.
- **On the costs front, GIS has undertaken initiatives to streamline operations** and we expect a modest $2mn in direct cost savings in 2019/$8mn in 2020.
- **In 2020, we expect GDI to sell off/dispose of two older rigs (Al-Doha & Al-Wajbah) leading to a revenue fall YoY but earnings should still expand.** Net income growth in 2020 benefits from lower SG&A and interest expenses.
- ***Net-net, we expect GDI to go from a QR86mn loss in 2018 to a QR35mn net profit (2019) and QR53mn in 2020.***

Forecasts for other segments remain more subdued: For 2019, 92% of the earnings growth is driven by the drilling segment. Insurance and aviation contribute 8% and 3% to the growth, respectively, while catering is flattish.

- **Aviation top-line growth remains tepid with no net fleet expansion expected** beyond the company's existing 48 choppers; **pricing in the industry has also declined** with blanket master agreements encompassing several helicopters coming into prominence as opposed to individual contracts with premium pricing. GHC remains the exclusive provider of MRO (maintenance, repair and overhaul services) and simulated training services for Augusta Westland; however, the services business remains a small part of the aviation segment. The lifting of the moratorium on North Field's development should help longer-term but pricing is not expected to go back up to the levels seen in 2013-2015. GHC is also considering expanding in countries such as Turkey and Tunisia.
- **For the insurance segment, we do not expect significant impact from the recent hurricanes.** The overall level of business (both gross revenue and costs) has increased as Al Koot is underwriting its own medical insurance having exited from its agreement with AXA. The company is also hopeful of regaining QP's medical insurance business next year. Longer-term, we expect decent growth in the energy insurance segment due to the expansion of the North Field.
- **Catering outlook remains tough with the blockade increasing costs.** GISS is optimistic recent management changes in the division could reignite growth going forward.

Key Segment Details

In QR mn		2017	2018e	2019e	2020e	2021e
Revenue		2,486	2,734	2,953	2,944	2,993
Gulf Drilling International (GDI)		*1,175*	*1,274*	*1,420*	*1,371*	*1,378*
Gulf Helicopters Company (GHC)		*532*	*544*	*558*	*572*	*586*
Amwaj Catering Company (AHC)		*453*	*447*	*459*	*472*	*486*
Al Koot Insurance & Reinsurance (AKIR)		*326*	*469*	*516*	*529*	*542*
Net Income		85	103	234	277	332
	Net Margin	***3%***	***4%***	***8%***	***9%***	***11%***
Drilling		*(102)*	*(86)*	*35*	*53*	*83*
	Net Margin	*-9%*	*-7%*	*2%*	*4%*	*6%*
Helicopters		*145*	*121*	*124*	*134*	*145*
	Net Margin	*27%*	*22%*	*22%*	*24%*	*25%*
Catering		*17*	*11*	*11*	*21*	*26*
	Net Margin	*4%*	*2%*	*2%*	*4%*	*5%*
Insurance		*71*	*79*	*90*	*94*	*102*
	Net Margin	*22%*	*17%*	*17%*	*18%*	*19%*
EBITDA		757	794	944	973	1,015
	EBITDA Margin	***30%***	***29%***	***32%***	***33%***	***34%***
Drilling		*426*	*439*	*581*	*585*	*603*
	EBITDA Margin	*36%*	*35%*	*41%*	*43%*	*44%*
Helicopters		*241*	*218*	*221*	*231*	*241*
	EBITDA Margin	*45%*	*40%*	*40%*	*40%*	*41%*
Catering		*33*	*27*	*27*	*37*	*42*
	EBITDA Margin	*7%*	*6%*	*6%*	*8%*	*9%*
Insurance		*73*	*81*	*91*	*96*	*104*
	EBITDA Margin	*22%*	*17%*	*18%*	*18%*	*19%*

Source: Company data, QNBFS estimates

Key Growth Rates/CAGRs

Particulars	2015	2016	2017	2018	2019	2020	2021	2022	2023	CAGR ('18-'23)
Growth Rates										
Revenue	6.6%	(28.2%)	(16.8%)	10.0%	8.0%	(0.3%)	1.7%	1.3%	1.6%	2.4%
Gross Profit	1.2%	(56.2%)	(14.9%)	12.0%	35.4%	0.9%	6.0%	3.7%	4.6%	9.4%
EBITDA	(24.1%)	(44.2%)	(1.7%)	4.9%	18.9%	3.0%	4.3%	2.7%	3.1%	6.3%
EBIT	(39.7%)	(78.2%)	34.0%	22.7%	48.3%	6.1%	8.5%	5.1%	5.7%	13.7%
PAT/EPS	(43.2%)	(91.6%)	26.9%	21.2%	127.4%	18.3%	19.6%	12.3%	12.7%	32.5%
DPS	(81.8%)	0.0%	(100.0%)	N/M	25.0%	20.0%	16.7%	14.3%	12.5%	17.6%
CFPS	25.3%	(35.1%)	(23.0%)	(7.8%)	38.7%	2.8%	3.5%	3.0%	3.0%	9.4%
FCFPS	N/M	(59.3%)	37.0%	4.7%	67.0%	2.2%	3.3%	2.5%	2.3%	13.1%

Source: Bloomberg, QNBFS estimates

Valuation Metrics

Particulars	2015	2016	2017	2018	2019	2020	2021	2022	2023
Valuation									
EV/Sales	1.7	2.4	2.9	2.5	2.3	2.2	2.1	1.9	1.7
EV/EBITDA	5.2	9.3	9.5	8.7	7.1	6.6	6.2	5.5	4.9
EV/EBIT	8.1	37.4	27.8	21.8	14.2	13.0	11.6	10.2	8.7
P/E	3.9	47.2	37.2	30.7	13.5	11.4	9.5	8.5	7.5
P/CF	2.2	3.3	4.3	4.7	3.4	3.3	3.2	3.1	3.0
P/BV	0.8	0.8	0.9	0.8	0.8	0.8	0.8	0.7	0.7
Dividend Yield	5.9%	5.9%	0.0%	5.9%	7.4%	8.8%	10.3%	11.8%	13.2%
FCF Yield	19.9%	8.1%	11.1%	11.6%	19.4%	19.8%	20.5%	21.0%	21.5%

Source: Bloomberg, QNBFS estimates

Detailed Financial Statements

Income Statement

In QR mn	2017	2018e	2019e	2020e	2021e
Revenue	**2,486**	**2,734**	**2,953**	**2,944**	**2,993**
COGS	2,035	2,229	2,269	2,254	2,261
Gross Profit	**451**	**505**	**684**	**690**	**731**
SG&A	244	220	248	226	226
Total Other Income	23	5	5	5	5
Net Finance Income(Expense)	(145)	(187)	(206)	(191)	(178)
Net Income	**85**	**103**	**234**	**277**	**332**
EBITDA	**757**	**794**	**944**	**973**	**1,015**
EPS	**0.46**	**0.55**	**1.26**	**1.49**	**1.78**
DPS	**0.00**	**1.00**	**1.25**	**1.50**	**1.75**

Source: Company data, QNBFS estimates; Note: EPS based on current number of shares

Balance Sheet

In QR mn	2017	2018e	2019e	2020e	2021e
Current Assets					
Cash & Cash Equivalents	931	971	829	751	660
HFT Investments/ST Investments	221	313	313	313	313
Insurance & Accounts Receivables/Prepayments	695	840	913	917	936
Due From Related Parties	463	416	416	416	416
Inventories	202	230	235	232	234
Total Current Assets	**2,513**	**2,770**	**2,704**	**2,628**	**2,558**
Non-Current Assets					
Available for Sale Investments	391	298	298	298	298
Goodwill & Intangibles	305	304	304	304	304
Property, Plant & Equipment	7,220	7,050	6,896	6,755	6,628
Non-Current Assets	**7,915**	**7,651**	**7,498**	**7,357**	**7,229**
Total Assets	**10,428**	**10,422**	**10,202**	**9,985**	**9,787**
Current Liabilities					
Short-Term Debt	898	563	480	480	419
Insurance Payables, Accounts Payable & Accruals	1,493	1,466	1,561	1,580	1,609
Due to Related Parties	8	28	28	28	28
Current Liabilities	**2,400**	**2,057**	**2,069**	**2,088**	**2,057**
Non-Current Liabilities					
Employees End of Service Benefits	103	142	142	142	142
Long-Term Debt	4,248	4,440	4,159	3,879	3,659
Non-Current Liabilities	**4,350**	**4,582**	**4,301**	**4,021**	**3,802**
Total Liabilities	**6,750**	**6,639**	**6,371**	**6,109**	**5,858**
Shareholders' Equity					
Total Shareholder's Equity	**3,679**	**3,783**	**3,831**	**3,876**	**3,929**
Liabilities & Shareholder's Equity	**10,428**	**10,422**	**10,202**	**9,985**	**9,787**

Source: Company data, QNBFS estimates

Ratio Analysis

Key Metrics

Particulars	2015	2016	2017	2018	2019	2020	2021	2022	2023
Growth Rates									
Revenue	6.6%	(28.2%)	(16.8%)	10.0%	8.0%	(0.3%)	1.7%	1.3%	1.6%
Gross Profit	1.2%	(56.2%)	(14.9%)	12.0%	35.4%	0.9%	6.0%	3.7%	4.6%
EBITDA	(24.1%)	(44.2%)	(1.7%)	4.9%	18.9%	3.0%	4.3%	2.7%	3.1%
EBIT	(39.7%)	(78.2%)	34.0%	22.7%	48.3%	6.1%	8.5%	5.1%	5.7%
PAT/EPS	(43.2%)	(91.6%)	26.9%	21.2%	127.4%	18.3%	19.6%	12.3%	12.7%
DPS	(81.8%)	0.0%	(100.0%)	N/M	25.0%	20.0%	16.7%	14.3%	12.5%
CFPS	25.3%	(35.1%)	(23.0%)	(7.8%)	38.7%	2.8%	3.5%	3.0%	3.0%
FCFPS	N/M	(59.3%)	37.0%	4.7%	67.0%	2.2%	3.3%	2.5%	2.3%
Operating Ratios									
Gross Margin	29.1%	17.7%	18.1%	18.5%	23.2%	23.4%	24.4%	25.0%	25.7%
Gross Margin, Excluding Depreciation & Amortization	40.7%	36.7%	37.9%	35.7%	39.0%	39.4%	40.1%	40.4%	41.0%
EBITDA Margin	33.1%	25.8%	30.4%	29.0%	32.0%	33.0%	33.9%	34.4%	34.9%
EBIT Margin	21.1%	6.4%	10.4%	11.5%	15.9%	16.9%	18.0%	18.7%	19.4%
Net Margin	19.2%	2.2%	3.4%	3.8%	7.9%	9.4%	11.1%	12.3%	13.6%
Working Capital Ratios									
Inventory Days	27.4	32.5	36.3	37.7	37.7	37.7	37.7	37.7	37.7
Average Collection Period	73.8	88.2	74.4	76.0	76.0	76.0	76.0	76.0	76.0
Payable Days	70.8	75.1	88.3	74.3	69.3	68.8	68.1	67.5	66.9
Finance Ratios									
Debt-Equity Ratio	1.3	1.5	1.4	1.3	1.2	1.1	1.0	0.9	0.7
Net Debt-Equity Ratio	1.1	1.1	1.1	1.1	1.0	0.9	0.9	0.7	0.5
Net Debt-to-Capital	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.3
Net Debt-to-EBITDA	3.0	5.5	5.6	5.1	4.0	3.7	3.4	2.8	2.2
Interest Coverage	11.2	1.5	1.5	1.5	2.0	2.3	2.6	2.9	3.3
Return Ratios									
ROIC	9.7%	2.1%	2.9%	3.6%	5.5%	6.0%	6.7%	7.0%	7.4%
ROE	20.4%	1.8%	2.3%	2.7%	6.1%	7.2%	8.4%	8.7%	8.9%
ROA	7.1%	0.6%	0.8%	1.0%	2.3%	2.8%	3.4%	3.8%	4.2%
FCF Yield	19.9%	8.1%	11.1%	11.6%	19.4%	19.8%	20.5%	21.0%	21.5%
Liquidity Ratios									
Current Ratio	0.9	1.2	1.0	1.3	1.3	1.3	1.2	0.7	1.1
Quick Ratio	0.9	1.1	1.0	1.2	1.2	1.1	1.1	0.7	1.0
Valuation									
EV/Sales	1.7	2.4	2.9	2.5	2.3	2.2	2.1	1.9	1.7
EV/EBITDA	5.2	9.3	9.5	8.7	7.1	6.6	6.2	5.5	4.9
EV/EBIT	8.1	37.4	27.8	21.8	14.2	13.0	11.6	10.2	8.7
P/E	3.9	47.2	37.2	30.7	13.5	11.4	9.5	8.5	7.5
P/CF	2.2	3.3	4.3	4.7	3.4	3.3	3.2	3.1	3.0
P/BV	0.8	0.8	0.9	0.8	0.8	0.8	0.8	0.7	0.7
Dividend Yield	5.9%	5.9%	0.0%	5.9%	7.4%	8.8%	10.3%	11.8%	13.2%
FCF Yield	19.9%	8.1%	11.1%	11.6%	19.4%	19.8%	20.5%	21.0%	21.5%

Source: Company data, QNBFS estimates

Recommendations *Based on the range for the upside / downside offered by the 12-month target price of a stock versus the current market price*	
OUTPERFORM	Greater than +20%
ACCUMULATE	Between +10% to +20%
MARKET PERFORM	Between -10% to +10%
REDUCE	Between -10% to -20%
UNDERPERFORM	Lower than -20%

Risk Ratings *Reflecting historic and expected price volatility versus the local market average and qualitative risk analysis of fundamentals*	
R-1	Significantly lower than average
R-2	Lower than average
R-3	Medium / In-line with the average
R-4	Above average
R-5	Significantly above average

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